



2023  
EDITION



# Financial Accounting

STUDY TEXTBOOK

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# CPA (U)

## PAPER 1

### FINANCIAL ACCOUNTING

This study text has been published in close consultation with lecturers and tutors with vast experience in teaching CPA(U) papers in particular Financial Accounting (Paper 2) and has been updated to capture the new changes in the CPA(U) Syllabus that took effect in June 2016 examination sitting. Therefore, this study text contains all the information that you need to pass your exam.

*The study text therefore,*

- Highlights the most important elements in the CPA(U) Syllabus and the key skills you need
- Emphasizes how each chapter links to the CPA(U) Syllabus and the study guide
- Provide a lot of exam focus points demonstrating what is expected of you in the exam
- Emphasizes key points in regular fast forward summaries
- Examine and Test your knowledge in our activity exercises provided at the end of each chapter

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## **THIS STUDY TEXT INCLUDES THE FULL CPA(U) FINANCIAL ACCOUNTING SYLLABUS**

This book has been specially written and designed to help students preparing for their CPA(U) FINANCIAL ACCOUNTING Paper 1 professional examinations and those undertaking a BUSINESS STUDIES and BSC ACCOUNTING AND FINANCE course at the University. It is also useful for lecturers preparing students for those examinations.

This book covers a variety of contents, exercises, model questions, test papers, mixed exercises and answers to equip and prepare students for their examinations.

*This book contains*

- ✓ Progressive notes targeted to the entire Financial Accounting Syllabus and study Guide.
- ✓ Review exercises and Questions to check your understanding
- ✓ Clear layout and style designed to save your time
- ✓ Plenty of examination Questions from a variety of past papers.

We are grateful to all the examination councils for their permission to reproduce past examination questions.

The suggested solutions to the Illustrative questions have been prepared by the whole entire author Team.

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**PART A**

**Introduction to Financial Accounting**

# 1.0

# INTRODUCTION TO FINANCIAL ACCOUNTING

## UNIT 1 OVERVIEW:

- The Purpose of Financial Accounting.
- Types of Business Entity.
- Branches of Accounting.
- Users' and stakeholder needs.
- The main elements of financial reports.

### 1.1 THE PURPOSE OF FINANCIAL ACCOUNTING

**Financial Accounting** is a way of recording, analyzing and summarizing financial data.

**Financial data** is the name given to the actual transactions carried out by a business e.g. sale of goods, purchase of goods, payment of expenses etc. The transactions are first **recorded** in **source documents**, **analyzed** in the **books of prime entry** and the totals are posted to the **ledger accounts**, finally, the transactions are **summarized** in the financial statements.

### 1.2 TYPES OF BUSINESS ENTITY

#### 1.2.1 *What is a business?*

Businesses of whatever nature exist to make a profit. There are a number of different ways of looking at a business. Some ideas are listed below;

- ↳ A business is a commercial or industrial concern which exists to deal in the manufacture, re-sale or supply of goods and services.
- ↳ A business is an organization which uses economic resources to create goods or services which customers buy.

#### 1.2.2 **Types of Business Entity.**

There are three main types of business entity.

- (a) *Sole Proprietorship*
- (b) *Partnerships*
- (c) *Limited liability companies*

#### 1.2.3 **Sole Proprietorship**

This is the oldest and most straightforward structure for a business. Sole traders are people who work for themselves. Of course, it doesn't necessarily mean that the business has only one worker. The sole trader can employ others to do any or all of the business.

A sole trader owns and runs a business, contributes the capital to start the enterprise, runs it with or without employees, and earns the profits or stands the loss of the venture. Typical sole trading organizations include small local shops, hairdressers, plumbers, IT repair services.

Sole traders tend to operate in industries where the barriers to entry are low and where limited capital is required on start up. In law, a sole trader is not legally separate from the business they operate. The owner is legally responsible for the business.

A sole trader must maintain financial records and produce financial accounts. However, there is no legal requirement to make these accounts publicly available; they are usually only used to calculate the tax due to the tax authorities on the profits of the business. Banks and other financiers may request to see the financial accounts of the business when considering applications for loans and overdraft facilities.

- **Advantages of being a sole proprietorship form of business**

This type of business structure is ideal if the business is not complicated and especially if it does not require a great deal of outside capital. Advantages include:

- (a) Limited paperwork and therefore low cost in establishing this type of structure.
- (b) Owner has complete control over the business.
- (c) Owner is entitled to profits and the ownership of assets.
- (d) Less stringent reporting obligations compared with other business structures – no requirement to make financial accounts publicly available, no audit requirement.
- (e) Can be highly flexible.

- **Disadvantages of being a sole trader**

- (a) Owner is personally liable for all debts (unlimited liability).
- (b) Personal property may be vulnerable for debts and other business liabilities.
- (c) Large sums of capital are less likely to be available to a sole trader, leading to reliance on overdrafts and personal savings.
- (d) May lead to long working hours without the normal employee recreation leave and other benefits.
- (e) May be issues of continuity of business in the event of death or illness of the owner.

## **1.2.4 Partnerships**

Partnerships occur when two or more people decide to run a business together. Examples include an accountancy practice, a medical practice.

Partnerships are generally formed by contract. Partnership agreements are legally binding and are designed to outline the proportionate amount of capital invested, allocation of profits between parties, the responsibilities of each of the parties, allocation of salary and procedures for dissolving the partnership. Some countries have specific legislation for partnerships and thus the provisions of the country's Partnership Act applies where no partnership agreement exists.

Like sole traders, partnerships are not separate legal entities from their owners. To overcome the problematic risk factors associated with unlimited personal liability for the debts of the business a new form of limited liability partnership (LLP) has been created in some countries. As with sole traders, partnerships must maintain financial records and produce financial accounts. However, there is no legal requirement to make these accounts publicly available, unless the partnership has LLP status.



- **Advantages of partnerships**

- (a) Less stringent reporting obligations – no requirement to make financial accounts publicly available, no audit requirement, unless the partnership has LLP status.
- (b) Additional capital can be raised because more people are investing in the business.
- (c) Division of roles and responsibilities and an increased skill set.
- (d) Sharing of risk and losses between more people.
- (e) No company tax on the business (profits are distributed to partners and then subject to personal tax).

- **Disadvantages of partnerships**

- (a) Partners are jointly personally liable for all debts (unlimited liability) unless they have formed a limited liability partnership.
- (b) There are costs associated with setting up partnership agreements.
- (c) There may be issues of continuity of business in the event of death or illness of the partners.
- (d) Slower decision making due to the need for consensus between partners.
- (e) Unless a clause is written into the original agreement, when one partner leaves, the partnership is automatically dissolved and another agreement is required between existing partners.

### Activity 1.1

Mr. Tim Byaruhanga of P.O Box 12464, Kampala and his friends would like to form a partnership business.

**Required**

*Write a letter to Mr. Tim Byarugaba, giving atleast four advantages and four disadvantages of a partnership business. The letter will be signed by Grace Bokello, Assurance Partner, Okello, Rugadya & Co, Certified Public Accountants, P.O Box 55555 Mbale.*  
(10 Marks)

**Source: CPA(U), November 2013, Question 7**

### Activity 1.2

Mrs. Jane Wandera of P.O Box 40222, Tororo is desirous of forming a partnership business with her friends. She has approached you, Hope Mukisa, of P.O Box 12020. Jinja to advise her on accounting issues to be contained in a partnership deed.

**Required**

*Prepare a letter advising Mrs. Jane Wandera of at least eight clauses they should include in the partnership deed.  
(10 Marks)*

**Source: CPA(U), June 2012, Question 6**

## 1.2.5 Limited liability companies

Limited liability companies are incorporated to take advantage of 'limited liability' for their owners (shareholders). This means that, while sole traders and partners are personally responsible for the amounts owed by their businesses, the shareholders of a limited company are only responsible for the amount paid for their shares. They are not responsible for the company's debts unless they have invested in the company if it fails.



Shareholders may be individuals or other companies. Limited liability companies are formed under specific legislation for example in Uganda, the companies Act 2012. A limited liability company is legally a separate entity from its owners, and can confer various rights and duties.

There is a clear distinction between shareholders and directors of limited companies:

- (a) Shareholders are the owners, but have limited rights, as shareholders, over the day-to-day running of the company. They provide capital and receive a return (dividend).
- (b) The Board of Directors are appointed to run the company on behalf of shareholders. In practice, they have a great deal of autonomy. Directors are often shareholders.

The reporting requirements for limited liability companies are much more stringent than for sole traders or partnerships. In Uganda, there is a legal requirement for a company to:

- Be registered with the registrar of companies.
- Complete a Memorandum of Association and Articles of Association to be deposited with the Registrar of Companies.
- Have at least one director (two for a public limited company (PLC) who may also be a shareholder).
- Prepare and have their financial accounts audited (larger companies only).
- Distribute the financial accounts to all shareholders.

➤ **Advantages of trading as a limited liability company**

- (a) Limited liability makes investment less risky than being a sole trader or investing in a partnership. However, lenders to a small company may ask for a shareholder's personal guarantee to secure any loans.
- (b) Limited liability makes raising finance easier (e.g. through the sale of shares) and there is no limit on the number of shareholders.
- (c) A limited liability company has a separate legal identity from its shareholders. So a company continues to exist regardless of the identity of its owners.
- (d) There are tax advantages to being a limited liability company. The company is taxed as a separate entity from its owners and the tax rate on companies may be lower than the tax rate for individuals.
- (e) It is relatively easy to transfer shares from one owner to another. In contrast, it may be difficult to find someone to buy a sole trader's business or to buy a share in a partnership.

➤ **Disadvantages of trading as a limited liability company**

- (a) Limited liability companies have to publish annual financial statements. This means that anyone (including competitors) can see how well (or badly) they are doing. In contrast, sole traders and partnerships do not have to publish their financial statements.
- (b) Limited liability company financial statements have to comply with legal and accounting requirements. In particular, the financial statements have to comply with accounting standards. Sole traders and partnerships may comply with accounting standards e.g. for tax purposes.
- (c) The financial statements of larger limited liability companies have to be audited. This means that the statements are subject to an independent review to ensure that they comply with legal requirements and accounting standards. This can be inconvenient, time consuming and expensive.
- (d) Share issues are regulated by law. For example, it is difficult to reduce share capital. Some traders and partnerships can increase or decrease capital as and when the owners wish.



## 1.3 BRANCHES OF ACCOUNTING

There are 3 major branches of accounting;

- (i) Financial Accounting
- (ii) Management Accounting
- (iii) Cost Accounting

### 1.3.1 Financial Accounting

Financial accounting is mainly a method of reporting the financial performance and financial position of the business. It is not primarily concerned with providing information towards the more efficient running of the business. Although financial accounts are of interest to management, their principal function is to satisfy the information needs of persons not involved in running the business. They provide historical information.

### 1.3.2 Management Accounting.

The information needs of management go far beyond those of account users. Managers have the responsibility of planning and controlling the resources of the business. Therefore they need much more detailed information. They also need to plan for the future (e.g. budgets, which predict future revenue and expenditure).

Management accounting is a management information system which analyses data to provide information as a basis managerial action. The concern of a management accountant is to present accounting information in the form most helpful to management.

### 1.3.3 Cost Accounting

Cost accounting is the process of accounting for costs from the point at which the expenditure is incurred to the establishment of its ultimate relationship with cost centre and cost units.

### 1.3.4 Differences Between Cost and Financial Accounts

- i. Cost accounts are kept by business engaged in manufacturing or rendering services where cost per unit is to be ascertained. Financial accounts are kept by all types of businesses.
- ii. Cost accounts maintain detailed record of all the three elements of costs (materials, labor and expenses). Financial accounts do not keep the details but record expenses and incomes.
- iii. Cost accounts provide information to management for cost ascertainment while financial accounts provide general information to management and outsiders in form of Profit or loss and Financial Position.
- iv. Cost accounting ascertains the cost of each product, job, or order and shows their profit/loss. Financial accounting shows profits/losses as a whole.
- v. Cost accounts provides information to management as and when desired, daily, weekly, or monthly but financial accounting provides operating net results and financial position and the end of a financial year.
- vi. In cost accounts, the costs included therein are based on estimates while in financial accounts, the costs are historical (have already been incurred).
- vii. Cost accounts attaches greater control on materials, stores, labor overheads but financial accounts attaches' greater control on cash and the final position.
- viii. Cost accounts gives data for fixing the prices of the product. Financial accounting does not give data for fixing prices.
- ix. Cost accounting provides information on relative efficiencies of plant, machinery, labor and departments which financial accounts cannot.
- x. In cost accounts, stocks are valued at cost. In financial accounts, stocks are value at cost or market price whichever is lower.



- xi. Cost accounts are voluntary to the organization while financial accounts are obligatory in the company and income tax act for companies.
- xii. There are no specific formats for preparation of cost accounts. There are specific formats for preparations of financial accounts

### 1.3.5 Similarities Between Financial and Cost Accounting

- i. In both systems, accounting is done on the principle of double entry
- ii. Both systems disclose profit and loss of a business
- iii. Both systems account for materials, labor and expenses.
- iv. Cost accounting is supplementary to financial accounting
- v. The results of both accounting systems are reconciled and errors rectified.
- vi. Both systems help in formulating management policies.
- vii. The primary data used in both systems e.g. vouchers, bills, invoices, receipts are the same.

### 1.3.5 Management and Cost Accounting Compared.

Management accounting is the presentation of accounting information in such a way as to assist management in the creation of policy and in the day-to-day operations of an entity. The source of management accounting is cost accounting. This is why most of the cost accounting concepts are used in management accounting. However there are some differences between the two:

- i. Cost accounting is concerned mostly with ascertainment of cost and profitability and with control of cost while management accounting is concerned with such matters in a wide perspective which would go to assist management in formulation of policies.
- ii. Cost accounting is concerned within routine tasks of processing of costs through allocation, apportionment; absorption of overheads whereas management accounting does not.
- iii. Cost accountant reports to management accountant e.g. variances and management accountant uses them to suggest ways of improvement.
- iv. The cost accountant suggests to management the best of the alternatives by use of different cost methods while management accountants will consider other non-cost factors in deciding.

## 1.4 USERS' AND STAKEHOLDERS' NEEDS

**Qn1: Why do businesses need to produce financial statements?**

**Qn2: If a business is being run efficiently, why should it have to go through all the bother of accounting procedures in order to produce financial information?**

The International Accounting Standards Board (IASB) states in its framework for the preparation and presentation of financial statement that:

*"The objective of the financial statement is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions"*

In other words, a business should produce information about its activities because there are various groups of people who want that information. This sounds rather vague: to make it clear, we will study the classes of people who need information about a business. We need also to think what information in particular is of interest to the members of each class.

Larger businesses are of interest to a greater variety of people and so we shall take the case of a large public company, whose shares can be purchased and sold on a stock exchange.

### 1.4.1 Users of financial statement and accounting information

The following people are likely to be interested in financial information about a large company with shares that are listed on stock exchange.

- (a) **Managers of the company** are appointed by the owners to supervise the day-to-day activities of the company. Financial statements reveal the company's financial situation as it is currently and as it is expected to be in future. Information contained in the financial statements shall enable managers to manage the business efficiently and make effective decisions.
- (b) **Shareholders of the company** i.e. the company's owners; want to assess how well its management is performing. They want to know how profitable the company's operations are and how much profit they can afford to withdraw from the business for their own use.
- (c) **Trade contacts** include suppliers who provide goods of the company on credit and customers who purchase goods or services provided by the company. The suppliers want to assess the company's ability to pay its debts; whereas the customers need to know that the company is a secure source of supply and there is no danger of having to close down.
- (d) **Providers of finance** to the company might include a bank which allows the company to operate an overdraft or provide long-term finance by granting a loan. The bank wants to ensure that the company is ready to keep up interest payments and eventually to repay the amounts advanced (the principle).
- (e) **The tax authorities (i.e. URA and KCCA)** want to know the level of business profits in order to assess the tax payable by the company including Value Added Tax (VAT) and any other taxes withheld by the enterprise on behalf of the authority.
- (f) **Employees of the company** should have a right to information about the company's financial situation, because their future careers and the size of their wages and salaries depend on it.
- (g) **Financial analysts and advisers** need information from their client or audience for example stock brokers need information to advise investors whereas credit agencies want information to advise potential suppliers of goods to the company. Journalists on the other hand need information for their reading public.
- (h) **Government and their agencies** are interested in the allocation of national resources and therefore interested in the activities of the entity. They further require information in order to provide a basis for national statistics.
- (i) **The public entities** affect members of the public in a variety of ways .for example they may make a substantial contribution to the local economy by providing employment and using local suppliers. Another is the effect of an entity on the environment, for example as regard pollution.

Accounting information is summarized in financial statements to satisfy the information needs of these different groups though not all will be equally satisfied.

#### Activity 1.3

At the 2013 Financial reporting Awards, the Administrative officer of Lukaya Investments Ltd stated that, "*The purpose of financial statements is to provide information that is useful to a wide range of users in making economic decisions*", You are employed as an administrative Accountant at Lukaya Investments Ltd.

#### Required

*Write a memo to the Administrative Officer, explaining six examples of economic decisions that users may derive from financial statements* (10 marks)

**Source: CPA(U), November 2013, Question 7**



## 1.5 CORPORATE GOVERNANCE

Corporate Governance is the system by which companies and other entities are directed and controlled .good Corporate Governance is important because the owners of the company and the people who manages the company are not always the same which can lead to conflict of interest.

The Board of Directors (BOD) of the company are usually the top management and are those who are charged with governance of that company. The responsibilities and duties of directors are usually laid down in law and are wide ranging.

### 1.5.1 Legal responsibilities of directors

Directors have a duty of care to show reasonable competence and may have to protect the company against loss caused by their negligence. Directors are also said to be in a fiduciary position in relation to the company which means that they must act honestly in what they consider to be the best interest of the company and in good faith.

In Uganda, the companies act 2012 sets out seven statutory duties of directors. The act states that directors should;

- Act with their powers
- Promote the success of the company
- Exercise independent judgment
- Exercise reasonable skill care and diligence
- Avoid conflicts of interest
- Not accept benefits from third parties
- Declare an interest in a proposed transaction or arrangement

An overriding theme of the company's Act 2012 in the principle that the purpose of the legal framework surrounding companies should be to help companies do business. A director's main aim should be to create wealth for the shareholders.

When exercising this duty directors should consider

- The consequences of decisions in the long-term.
- The interests of employees.
- The need to develop good relationship with customers and suppliers.
- The impact of the company on the local community and the environment.
- The desirability of maintaining high standards of business conduct and a good reputation.
- The need to act fairly as between all members of the company.

The Act identifies areas of the particular importance and modern day expectations of responsible business behavior for example the interests of the company's employees and the impact of the company's operation on the community and the environment.

### 1.5.2 Responsibilities for the financial statement

Directors are responsible for the preparation of the financial statements of the company, in particular, the directors are responsible for;

- (a) The preparation of financial statements of the company in accordance with the applicable financial reporting framework (e.g. IFRSs).
- (b) The internal controls necessary to enable the preparation of financial statements that are free from material misstatement whether due to error or fraud.
- (c) The prevention and detection of fraud.
- (d) Ensure that the entity complies with the relevant laws and regulations.



Directors should explain their responsibility for preparing accounts in the financial statements. They should also report that the business is a going concern, with supporting assumptions and qualifications.

Directors should present a balance and understandable assessment of the company's position and prospects in the annual accounts and other reports, such as interim reports and reports to regulators. The directors should also explain the basis on which the company generates or preserves value and the strategy for delivering the company's longer-term objectives.

### 1.5.3 Auditing of financial statement

Companies are often subjected to an annual audit of their financial statements. An audit is an independent examination of the accounts to ensure that they comply with legal requirements and accounting standards. The findings of an audit are reported to the shareholders of the company. An audit gives the shareholders assurance that the accounts, which are responsibility of the directors, present fairly the financial performance and position of the company. An audit therefore goes some way in helping the shareholders asses how well management have carried out their responsibility for stewardship of the company's assets.

## 1.6 THE MAIN ELEMENTS OF FINANCIAL REPORTS

### 1.6.1 STATEMENT OF FINANCIAL POSITION

The statement of financial position is simply a list of assets owned and all the liabilities owed by a business at a particular date. It is a snapshot of the financial position is the business at a particular moment. Monetary amounts are attributed to each of the assets and liabilities.

#### (a) Assets

An asset is something valued which a business owns or can use. The IASB's framework for the preparation and presentation of financial statements defines an asset as follows;

***"An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity."***

Examples of assets include Land, buildings, motor vehicles, plant and machinery, computer equipment, office furniture, cash and inventory.

Some assets are held and used in operations for a long time. An office building for instance is occupied by administrative staff for years; similarly a machine has a productive life many years before it wears out.

Other assets are held for a short time. The owner of news agent shop for example has to sell his newspapers on the same day that he gets them. The more quickly a business can sell the goods it has in store the more profit it is likely to make; provided, of course, that the goods are sold at a higher price than what it cost the business to acquire them.

#### (b) Liabilities

A liability is something which is owed to somebody else. "Liabilities" is an accounting term that refers to the debts of the business. According to the IASB's framework for the preparation and presentation of financial statements, a liability is defined as;

***"A present obligation of the entity arising from past events the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits"***

Examples of liabilities are amounts owned by the supplier for goods bought on credit, amounts owed from the bank, (or other lender), a bank overdraft and amounts owed to tax authorities (e.g in respect of sales tax).

Some liabilities are due to be repaid fairly quickly e.g. suppliers whereas other liabilities may take some years to be repaid (e.g. bank loan)

### (c) Capital or equity

Capital refers to the amount invested in the business by the owner. This is a special kind of liability. In a limited liability company, capital usually takes the form of shares. Share capital is also known as equity.

The IASB framework for the preparation and presentation of financial statement defines equity as follows

***"Equity is the residual interest in the assets of the entity after deducting all its liabilities"***

- **Form of the statement of financial decision**

A statement of financial position used to be called a balance sheet. The former name is appropriate because assets will always be equal to liabilities plus capital (or equity). An example of a very simple statement of financial position is shown below

**HARVEST (U) LTD  
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 2015**

<b>Assets</b>	<b>Shs</b>
Plant and machinery	xx
Inventory	xx
Receivables (from customers)	xx
Bank	<u>xx</u>
<b>Total assets</b>	<u>xx</u>

<b>Capital and Liabilities</b>	
Capital and reserves	xx
Profit for the year	<u>xx</u>
	xx

<b>Liabilities</b>	
Bank loan	xx
Payables (to suppliers)	<u>xx</u>
<b>Total capital plus liabilities</b>	<u>xx</u>

## 1.6.2 STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

The statement of profit or loss and other comprehensive income is a record of income generated and expenditure incurred in a given period. The statement shows whether the business has had more revenue than expenditure (profit) or vice versa (loss).

### Revenue and expenses

- **Revenue** is the income generated by the business for a particular period.
- **Expenses** are the costs of running the business for a particular period of time.



The IASBs framework defines income and expenses as follows;

- **Income is increases** in income benefits during the accounting period in form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participant.
- **Expense is decreases** in economic benefits during the accounting period in the form outflows or depletions of assets or incurrences or liabilities that results in decrease in equity, other than those relating to distributions to equity participants.

#### • Form of the income statement

The period chosen will depend on purpose for which the statement which forms part of the published annual financial statements of a limited liability company will usually be for the period of year commencing from the date of previous year's statement .On the other hand, management might want to keep a closer eye on a company's profitability by making up quarterly or monthly statements.

### **HARVEST (U) LIMITED INCOME STATEMENT FOR THE YEAR ENDED 30 JUNE 2015**

Revenue	XX
Cost of sales	XX
Gross profit	XX
Other expenses	XX

Once again this example is given purely for illustrative purpose

### **1.7 PURPOSE OF FINANCIAL STATEMENTS**

Both the statement of financial position and income statement are summaries of accumulated data for example the income statement shows the figure of revenue earned from selling goods to customers' this is the total amount of revenue earned from all the individual sales earned during the period. One of the jobs of an accountant is to device methods of recording such individual transactions, so as to produce summarized financial statements from them. The statement of financial position and income statement form the basis of financial statements to most business. For limited liability companies, other information by way of statements and notes may be required by national legislation and accounting standards for example a statement of changes in equity and statement of cash flows .

### **SOLUTION TO ACTIVITY 1.1**

OKELLO, RUGADYA & CO.CERTIFIED PUBLIC AACCOUNTANTS.  
P.O.555555, MBALE.

26 November 2013  
Ref.001

To: Mr. Tim Byarugaba,  
P.O. 12464,  
KAMPALA.

Dear Sir,

### **RE: ADVANTAGES AND DISAVANTAGES OF A PARTNERSHIP BUSINESS.**

I have the pleasure to share with you and your friends the advantages and disadvantages of a partnership business so that you can make an informed decision. A partnership is a business run by a minimum of two people and a maximum of 20 with an aim of profiteering. It has the following advantages and disadvantages.



### **Advantages of a Partnership**

- 1) Partnerships are relatively easy to establish.
- 2) The ability to raise funds is increased, either because two or more partners may be able to contribute more funds and/or their borrowing capacity may be greater.
- 3) Benefit from the combination of complementary skills of two or more people. There is a wider pool of knowledge, skills and contacts.
- 4) Partnerships can be cost-effective as each partner specializes in certain aspects of the business.
- 5) Business can be easily expanded since new partners can be admitted and there is a pool of talent to draw from to support business growth.
- 6) Partnerships provide moral support and may allow for more creative brainstorming.
- 7) In case of difficulties, discussions among partners are likely to yield solutions.
- 8) Losses and liabilities are shared, hence reducing the burden placed on an individual.
- 9) Proper accounting and other systems.

### **Disadvantages of a Partnership**

- 1) Partners are jointly and individually liable for the actions of the other partners. If one partner makes a mistake all the other partners will be affected.
- 2) Profits must be shared with others, hence reducing the potential amount receivable by an individual.
- 3) Partners may have difficulties in deciding on how they value each other's time and skills. Partners with better skills and more hardworking may not be appropriately rewarded for their input in the business.
- 4) Since decisions are shared, disagreements can occur hence slowing down the decision making process.
- 5) The partnership may have a limited life; it may end upon the withdrawal, death or bankruptcy of a partner.
- 6) A major disadvantage of a partnership is unlimited liability. General partners are liable without limit for all debts contracted and errors made by the partnership.

In case you need further clarifications, I am available

Yours faithfully  
Grace Bokello  
**Assurance Partner.**

## **SOLUTION TO ACTIVITY 1.2**

### **Clauses for Inclusion in a Partnership Deed:**

- (a) Firm's name, its nature and location of business.
- (b) Commencement and duration of business.
- (c) Amount of capital to be contributed by each partner.
- (d) Rate of interest on each partner's capital or loan.
- (e) Rate of interest on drawings.
- (f) Profit and loss sharing ratios.
- (g) Amount allowable on drawings.
- (h) Salaries payable to partners.
- (i) Variations in the rights and duties of partners.
- (j) Method of computing goodwill on the retirement or death of a partner.
- (k) Procedure for retirement of partners and method of payment of their dues.
- (l) Procedure of resolving disputes among partners.
- (m) Preparation of accounts.

**Allocation of Marks: (8 points of 1 mark each and 2 marks for the letter).**

## SOLUTION TO ACTIVITY 1.3

### LUKAYA INVESTMENTS LTD

To: Administrative Officer,  
From: Assistant Accountant,  
Date: 26 November 2013

#### RE: Economic Decisions.

As requested, I would like to take this opportunity to explain examples of economic decisions derived from financial statements by users. The general purpose of financial statements is to provide information that is useful to a wide range of users in making economic decisions. However, the specific ones include the following

- To decide when to buy, hold or sell an equity investment.
- To assess the stewardship or accountability of management.
- To assess the ability of the entity to pay and provide other benefits to its employees.
- To assess the security for amounts lent to the entity.
- To determine taxation policies.
- To determine distributable profits and dividends.
- To prepare and use national income statistics.
- To regulate the activities of entities.

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### EXERCISE 1

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1.1 State **five** potential users of company published financial statements and briefly explain the likely information needs of each of the users.

1.2 You are the accountant of ABC Ltd, and the Business Manager has sent you the following message:  
*“While you were away, I attended a business forum. Among the topics discussed were the various forms of business. The discussant identified sole proprietorships, partnerships and limited companies among others. He left us with a handout that I will avail to you when you return. In the meantime, could you please clarify on these forms of business.”*

**Required:**

State **ten** differentiating features between a partnership and a limited company.

1.3 Which of the following statements is correct?

- (a) Financial accounting is concerned with the preparation of financial statements for internal use only.
- (b) Management accounting focuses on the preparation of financial statements for both internal and external use.
- (c) Financial accounting focuses mainly on external users of financial statements whereas management accounting focuses on internal users.
- (d) Auditing is basically concerned with the preparation and examination of financial statements of a company.

1.4 You contacted your friend, James, with a view of sharing a business idea with him. James assures you that from his past experience, he can only accumulate his own savings and start trading by himself. What form of business does James intend to start?

- (a) Sole proprietorship.
- (b) Partnership.
- (c) Limited company.
- (d) Non-profit organization.



# **PART B**

## **Reporting Framework of Accounting in Uganda**



Harvest Training and  
Consultancy Uganda Ltd.

# 2.0

# THE REGULATORY FRAMEWORK

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## UNIT 2 OVERVIEW:

- The regulatory system.
  - The International Accounting Standards Board (IASB).
  - International Financial Reporting Standards (IFRSs)
- 

### 2.1 THE REGULATORY SYSTEM

The following factors have shaped financial accounting;

- (a) *National / local legislation*
- (b) *Accounting concepts and individual judgment*
- (c) *Accounting standards*
- (d) *Other international influences*
- (e) *Generally accepted accounting principles (GAAP)*
- (f) *Fair presentation*

#### 2.1.1 National / local legislation

In most countries, limited liability companies are required by law to prepare and publish accounts annually. The form and content of the accounts is regulated primarily by national legislation.

#### 2.1.2 Accounting concepts and individual judgment

Financial statements are prepared on the basis of a number of fundamental accounting assumptions and conventions. Many figures in financial statements are derived from application of judgment in putting these assumptions into practice.

It is clear that different people exercising their judgment on the same facts can arrive at very different conclusions.

#### 2.1.3 Accounting standards

In an attempt to deal with some of the subjectivity, and to achieve comparability between different organizations, accounting standards were developed. These are developed at both a national level in most countries and an international level. The CPA (U) Financial Accounting syllabus is concerned with International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

International Financial Reporting Standards are produced by the International Accounting Standards Board (IASB).

### 2.2 THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

The International Accounting Standards Board (IASB) is an independent, privately-funded body that develops and approves IFRSs.

Prior to 2003, standards were issued as International Accounting Standards (IASs). In 2003 IFRS 1 was issued and all new standards are now designated as IFRSs.



The 15 members of the IASB come from nine countries and have a variety of backgrounds with a mix of auditors, preparers of financial statements, users of financial statements and academics.

The IASB operates under the oversight of the **IFRS Foundation**.

The IASB has two main responsibilities:

- To review, on a timely basis, newly identified financial reporting issues not specifically addressed in IFRSs
- To clarify issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching a consensus on the appropriate treatment.

IFRSs are created in accordance with due process. There are currently 41 IASs and 9 IFRSs in issue.

## 2.2.1 Membership of IASB

Members of IASB are independent experts in Accounting who do not represent any interests of a specific group or country. The board is made up of 14 members. Decisions are taken by at least 8 of the 14 members.

Members of standing interpretation Committee (SIC) are drawn from different cultural and industrial backgrounds.

## 2.3 THE USE AND APPLICATION OF IFRSs

IFRSs have helped to both improve and harmonize financial reporting around the world. The standards are used in the following ways.

- As national requirements
- As the basis for all or some national requirements
- As an international benchmark for those countries which develop their own requirements
- By regulatory authorities for domestic and foreign companies
- By companies themselves

## 2.3.1 Current IFRSs

The current list is as follows. Those examinable in CPA (U) paper 1 “Financial Accounting” are marked with a \*

### INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSs)

<b>IFRS 1</b>	First time adoption of International Financial Reporting Standards
<b>IFRS 2</b>	Share based payment
<b>IFRS 3</b>	Business combinations
<b>IFRS 5</b>	Non-current assets said for sale and discontinued operations
<b>IFRS 6</b>	Exploration for the evaluation of mineral resources
<b>IFRS 7</b>	Financial instruments: disclosures
<b>IFRS 8</b>	Operating segments
<b>IFRS 9</b>	Financial instruments



## INTERNATIONAL ACCOUNTING STANDARDS (IASs)

<b>IAS 1*</b>	Presentation of financial statements
<b>IAS 2*</b>	Inventories
<b>IAS 7*</b>	Statement of cash flows
<b>IAS 8*</b>	Accounting policies, changes in accounting estimates and errors
<b>IAS 10*</b>	Events after the reporting period
<b>IAS 11</b>	Construction contracts
<b>IAS 12</b>	Income taxes
<b>IAS 16*</b>	Property, plant and equipment
<b>IAS 17</b>	Leases
<b>IAS 18*</b>	Revenue
<b>IAS 19</b>	Employee benefits
<b>IAS 20</b>	Accounting for government grants and disclosure of government assistance
<b>IAS 21</b>	The effects of changes in foreign exchange rates
<b>IAS 23</b>	Borrowing costs
<b>IAS 24</b>	Related party disclosures
<b>IAS 27</b>	Consolidated and separate financial statements
<b>IAS 28</b>	Investments in associates
<b>IAS 29</b>	Financial reporting in hyperinflationary economies
<b>IAS 31</b>	Interests in joint ventures
<b>IAS 32</b>	Financial instruments: presentation
<b>IAS 33</b>	Earnings per share
<b>IAS 34</b>	Interim financial reporting
<b>IAS 36</b>	Impairment of assets
<b>IAS 37*</b>	Provisions, contingent liabilities and contingent assets
<b>IAS 38</b>	Intangible assets
<b>IAS 39</b>	Financial instruments: recognition and measurement
<b>IAS 40</b>	Investment property
<b>IAS 41</b>	Agriculture

Various exposure drafts and discussion papers are currently at different stages within the IFRS process, but these are not of concern to you at this stage.

### 2.3.2 Process of setting a new standard

Setting a standard starts with a new topic being proposed by either SAC, IASB or any other interested party. The IASB takes it through the following steps

- i. If it is a major project, then a discussion document is prepared for public comments
- ii. The comments are reviewed and an exposure draft is prepared
- iii. Once the exposure draft is approved by at least 8 of the 14 members of IASB, it is published to invite comments from interested parties
- iv. The comments are reviewed and the IFRS is prepared.
- v. The IFRS must be approved by at least 8 of the 14 members of IASB



## 2.4 SCOPE AND APPLICATION OF IFRSs

### 2.4.1 Scope

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are not intended to be applied to immaterial items, nor are they retrospective. Each individual standard lays out its scope at the beginning of the standard.

### 2.4.2 Application

Within each individual country local regulations govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and / or professional accountancy bodies such as **The Institute of Certified Public Accountants of Uganda (ICPAU)**.

## 2.5 HARMONISATION

Many large businesses operate on a global scale and investors make investment decisions on a worldwide basis. There is therefore need to provide financial information on a consistent basis. i.e. irrespective of where the statements are being prepared from, they should be prepared in the same way hence need for harmonization

### 2.5.1 Advantages of Harmonization include:

- i. International companies would easily access international financial markets using financial information that is presented in a form that is understood internationally
- ii. For business which is operating in several countries, there will be improved management control because all countries report consistently on a uniform basis.
- iii. Consolidation of financial statements becomes easy for multi-national companies
- iv. Investors would make better international investment decisions by analyzing financial reports that are prepared in different countries but on the same basis.
- v. International economic grouping such as the European union, East African Community etc would work better with a harmonized reporting system.

### 2.5.2 Reasons for different reporting.

Some countries have not are still holding out against international standards because:

- i. Legal system: Some countries financial statements are prepared according to the strict code imposed by the local laws for example for the countries taxation system.
- ii. Professional traditions: Countries with a strong and influential accounting profession are often able to harmonize their local standards.
- iii. User groups: In some countries, the tax authorities are the main users of accounts and so a standardized, rule based approach to accounting emerges to suit the user's requirements.
- iv. Nationalism: Many countries believe that their standards are the best.

### Activity 2.1

Accounting, like other professions, has been evolving and rules are required to govern the practice. The evolution can be evidenced by the move from manual bookkeeping to computerized accounting. Nonetheless, the definition and double entry principles remain the same.

#### Required

- (a) *Describe the branches of accounting*
- (b) *Explain the reasons why accounting standards are mandatory in financial accounting / reporting*

(4 Marks)

Source: CPA (U), November 2014, Question 6



## 2.6 THE ROLE OF AN ACCOUNTANT

The major roles of accountants are:

1. To determine the profit/losses of the organization.
2. To assess the value of the assets and the liabilities of the organization and determine the net worth of the business.
3. Assess the taxes payable by the organization
4. To facilitate credit sales. The Accountant establishes the credit policies and assesses its performance.
5. The Accountant plays a control role by putting in place system for recording transactions and reporting.
6. The Accountant is part of the planning team for the organization. He is involved in both tactical and strategic planning for the organization and therefore sets the strategic direction.

### Activity 2.2

'Accountants Run The World' ran a headline in The New Vision of 12<sup>th</sup> February 2014. The Writer made the following statements in his article;

- In the entire private sector in Uganda, accountants hold the most senior positions in business than any other profession.
- The profession trains you in a number of things.
- Accountants ensure protection of sustainable value creation strategy.

The managing Director of Zombo General Machinery Ltd, P.O. Box 11777 Paidha, has written to Zai Zuma, Audit Manager, PLCZ, Certified Public Accountants, P.O Box 12464 Arua, seeking for more information about the role of professional accountants in ensuring organisational success and sustainability.

#### Required

*Prepare a suitable response for your audit manager, explaining to the managing director, the role of professional accountants in employment in ensuring organisational success and sustainability. Include at least two positions they occupy in each role.*  
(10 marks)

**Source: CPA (U), June 2014, Question 7**

## 2.7 THE COMPANY ACT

The company act regulates the preparation and financial reporting of companies in the following ways:

- i. It lists the sets reports that are supposed to be prepared and presented as; the income statement, balance sheet, cash flow statement and statement of change of equity
- ii. It provides the standard formats for the presentation of financial reports
- iii. It gives guidelines on the reporting period
- iv. It also gives guidelines on the reporting currency and the precision to be used
- v. It regulates the kind of notes to accompany the statements.



## 2.8 THE CAPITAL AND FINANCIAL MARKETS AUTHORITY

The Capital Market Authority was established to regulate business at the stock exchange. A capital market authority statute was enacted in 1996 among other things to guide how the financial reporting of companies that need to be listed on the stock exchange should be prepared.

The Capital Market Authority Statute issues rules and regulations governing accounting requirement of companies trading at the stock exchange. In addition, it:

- It has provisions regulating the actives of the stock brokers, dealers, investment advisors etc.
- It also regulates the licensing, and advertising for companies being listed.
- It establishes a framework for the protection of investors.

### 2.8.1 The role of capital markets

- i. It is a source of long-term finance for investment.
- ii. It fosters the growth of other financial services such as banking, insurance etc.
- iii. It encourages higher professional accounting and management standards.
- iv. It promotes corporate governance.
- v. It has provided an avenue for divestiture of state owned enterprises by listing them.
- vi. Provides a platform for issuance of shares and subsequent trading.

## 2.9 THE FINANCIAL INSTITUTION'S ACT

The Financial institution Act provides rules and regulations of financial reporting for financial institutions such as commercial banks and microfinance intuitions.

### Activity 2.3

The companies Act, 2012 provides for annexing non-financial reports to the annual financial reports. Identify two non-financial reports and give at least two items that are likely tom be incorporated in each report. (4 Marks)

**Source: CPA (U), June 2015, Question 3**

### EXAM FOCUS POINT

Candidates are highly encouraged to get a company of the Company's Act and the Financial Institutions Act. The details of these laws are highly examinable.



# 3.0

## QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION

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### UNIT 3 OVERVIEW

- Background.
  - The IASB's *framework*.
  - The qualitative characteristics of financial information
  - The balance between qualitative characteristics.
- 

- Accounting practice has developed gradually over time. Many of its procedures are operating automatically by people who have never questioned whether alternative methods exist which have equal validity. However, the procedures in common use imply the acceptance of certain concepts which are by no means self-evident; nor are they the only possible concepts which could be used to build up an accounting framework.
- Our next step is to look at some of the more important concepts which are taken for granted in preparing accounts. In this chapter we shall single out the important assumptions and concepts for discussion.

### 3.1 THE IASB FRAMEWORK

#### 3.1.1 Introduction to the *Framework*

- The *Framework for the preparation and presentation of financial statements* ('Framework') is a set of principles which underpin the foundations of financial accounting. It is a **conceptual** framework upon which all IFRSs are based and hence which determines how financial statements are prepared and the information they contain. The Framework is not an accounting standard in itself.
- The *Framework* deals with:
  - (a) The objective of financial statements
  - (b) The **qualitative characteristics** that determine **the usefulness** of information in financial statements.
  - (c) The definition, recognition and measurement of the elements from which financial statements are constructed.
  - (d) Concepts of **capital and capital maintenance**

We are only concerned with (b) for the CPA (U), Financial Accounting (Paper 1) syllabus.

### 3.2 UNDERLYING ASSUMPTIONS

- The *Framework* sets out two important underlying assumptions for financial statements, the **going concern** concept and the **accruals basis**.

#### 3.2.1 **Going concern**

- The financial statements are normally prepared on the assumption that an entity is a **going concern** and will continue in operation for the foreseeable future. Hence, it is assumed that the



entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

- This concept assumes that, when preparing a normal set of accounts, the business **will continue to operate** in approximately the same manner for the foreseeable future (at least the next 12 months). In particular, the entity will not go into liquidation or scale down its operations in a material way.
- The main significance of **the going concern concept** is that the assets **should not be values at their 'break-up' value** (the amount they would sell for if they were sold off piecemeal and the business were broken up).

### **3.2.2 Accruals Basis**

- The effects of transactions and other events are recognized when they occur and not as cash or its equivalent is received or paid and they are recorded in the accounting records and reported in the financial statements of the period to which they relate.
- Entities should prepare their financial statements on the basis that transactions are recorded in them, not as cash is paid or received, but as the revenue or expenses are earned or incurred in the accounting period in which they relate.
- According to the accruals assumption, in computing profit, revenue earned must be matched against expenses incurred in earning it. This is also known as the **matching convention**.

## **3.3 THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION**

### **3.3.1 Understandability**

- Users must be able to understand financial statements. They are assumed to have some business, economic and accounting knowledge and to be able to apply themselves to study the information properly. Complex matters should not be left out of financial statements simply due to their difficulty if the information is relevant.

### **3.3.2 Relevance**

- Only relevant information can be useful. Information should be released on a timely basis to be relevant to users.
- Relevant information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.
- The predictive and confirmatory roles of information are interrelated. Information on financial position and performance is often used to predict future position and performance and other things of interest to the user, e.g. likely dividend, wage rises. The manner of showing information will enhance the ability to make predictions, e.g. by highlighting unusual items.
- The relevance of information is affected by its nature and materiality.

### **3.3.3 Materiality**

- Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
- Information may be judged relevant simply because of its nature. In other cases, both the nature and materiality of the information are important.
- An error which is too small to affect anyone's understanding of the accounts is referred to as immaterial. In preparing accounts it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.



- Determining whether or not an item is material is a very subjective exercise. There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example material items are those with a value greater than 5% of net profits). However some items disclosed in the accounts are regarded as particularly sensitive and even a very small misstatement of such an item is taken as a material error. An example, in the accounts of a limited liability company, is the amount of remuneration (salaries and other rewards) paid to directors of the company.
- The assessment of an item as material or immaterial may affect its treatment in the accounts. For example, the income statement of a business shows the expenses incurred grouped under suitable captions (administrative expenses, distribution expenses etc.); but in the case of very small expenses it may be appropriate to lump them together as 'sundry expenses', because a more detailed breakdown is inappropriate for such immaterial amounts.

### Case illustration 3.1

In assessing whether or not an item is material, it is not only the value of the item which needs to be considered. The context is also important. For instance, consider the 2 case illustrations below;

- (a) If a statement of financial position shows non-current assets of She. 20 million and inventories of She. 3 million, an error of Shs. 200,000 in the depreciation calculations might not be regarded as material. However, an error of Shs. 2,500,000 in the inventory valuation would be material. In other words, the total of which the error forms part must be considered.
- (b) If a business has a bank loan of Shs. 50,000,000 and a Shs. 55,000,000 balance on bank deposit account, it will be a material misstatement if these two amounts are displayed on the statement of financial position as 'cash at bank Shs. 5,000,000'. In other words, incorrect presentation may amount to material misstatement even if there is no monetary error.

### Activity 3.1

Describe how you would treat the following items in the accounts of ABC (u) Ltd

- (a) A box file
- (b) A computer
- (c) A plastic display stand

### 3.3.4 Reliability

- Information must also be reliable to be useful. The user must be able to depend on it being a faithful representation.
- Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

#### **Faithful representation**

Information must represent faithfully the transactions it purports to represent in order to be reliable. There is a risk that this may not be the case, not due to bias, but due to inherent difficulties in identifying the transactions or finding an appropriate method of measurement or presentation.

Where measurement of the financial effects of an item is so uncertain, enterprises should not recognize such an item.



### Substance over form

Faithful representation of a transaction is only possible if it is accounted for according to its substance and economic reality, not with its legal form.

Substance over form is the principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

For instance, one party may sell an asset to another party and the sales documentation may record that legal ownership has been transferred. However, if agreements exist whereby the party selling the asset continues to enjoy the future economic benefits arising from the asset, then in substance no sale has taken place.

### Neutrality

Information must be free from bias to be reliable. Neutrality is lost if the financial statements are prepared so as to influence the user to make a judgment or decision in order to achieve a predetermined outcome.

### 3.3.5 Prudence

- Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.
- Prudence must be exercised when preparing financial statements because of the uncertainty surrounding many transactions. It is not permitted, however, to create secret or hidden reserves using prudence as a justification.
- *There are three important issues to bear in mind.*
  - (a) Where alternative procedures or valuations are possible, the one selected should be the one which gives the most cautious result.
  - (b) Where a loss is foreseen, it should be anticipated and taken into account immediately. Even when the exact amount of the loss is not known, an estimate of the loss should be made, based on the best information available. If a business purchases inventory for shs.1,200,000 but, because of a sudden slump in the market, only shs.900,000 is likely to be realized when the inventory is sold, the prudence concept dictates that the inventory is valued at shs.900,000. It is not enough to wait until the inventory is sold, and then recognize the shs. 300,000 loss; the loss must be recognized as soon as it is foreseen.
  - (c) Profits should only be recognized when realized in the form of cash or another asset with a reasonably certain cash value.

#### Activity 3.2

A company begins trading on 1 January 2014 and sells goods worth shs. 100million during the year to 31 December 2014. At 31 December 2014, there are accounts receivable outstanding of shs.15 million of which the company is doubtful whether shs. 6million will ever be paid.

#### Required

*Using your knowledge of prudence, advise the management of the company on the best way to deal with the doubtful accounts receivable as they prepare the accounts of the company for the year ending 31 December 2014*

### 3.3.6 Completeness

Financial information must be complete, within the restrictions of materiality and cost, to be reliable. Omission may cause information to be misleading.



### 3.3.7 Comparability

Users must be able to compare an entity's financial statements:

- ↳ Through time to identify trends
- ↳ With other entity's statements, to evaluate their relative financial position, performance and changes in financial position.
- The consistency of treatment is therefore important across like items over time, within the entity and across all entities.
- The disclosure of accounting policies is particularly important here. Users must distinguish between different accounting policies to be able to make a valid comparison of similar items in the accounts of different entities.
- Comparability is not the same as uniformity. Entities should change accounting policies if they become inappropriate.
- Corresponding information for preceding periods should be shown to enable comparisons over time.

### 3.3.8 Fair presentation

Financial statements are required to give a fair presentation or present fairly in all material respects the financial results of the entity. Compliance with IFRSs will almost always achieve this.

- The following points made by IAS 1 Presentation of financial statements expand on this principle.
  - ↳ *Compliance with IFRSs should be disclosed.*
  - ↳ *All relevant IFRSs must be followed if compliance with IFRSs is disclosed.*
  - ↳ *Use of an inappropriate accounting treatment cannot be rectified either by disclosure of accounting policies or notes / explanatory material.*
- There may be (very rare) circumstances when management decides that compliance with a requirement of an IFRS would be misleading. Departure from the IFRS is therefore required to achieve a fair presentation.
- IAS 1 states what is required for a fair presentation.
  - ↳ *Selection and application of accounting policies.*
  - ↳ *Presentation of information in a manner which provides relevant, reliable, comparable and understandable information.*
  - ↳ *Additional disclosures where required.*

### 3.3.9 Consistency

- To maintain consistency, the presentation and classification of items in the financial statements should stay the same from one period to the next, except as follows:
  - ↳ *There is a significant change in the nature of the operations or a review of the financial statements indicates a more appropriate presentation.*
  - ↳ *A change in presentation is required by an IFRS.*

## 3.4 THE BUSINESS ENTITY CONCEPT

Financial statements always treat the business as a **separate entity**.

- This means that the transactions of the owner should never be mixed with the business' transactions. This applies whether or not the business is recognized in law as a separate entity.



### 3.5 OFFSETTING

Assets and liabilities, and income and expenses, should not be offset unless required or permitted by an IFRS.

#### Activity 3.3

In order to meet their objectives, financial statements are prepared in consideration of several conventions or concepts.

##### **Required**

*Briefly describe the following concepts underlying the preparation of financial statements:*

- (a) Going concern (b) Accruals (c) Offsetting (d) Prudence (e) Consistency **(10 marks)**

**Source: CPA(U), June 2011, Question 7**

### 3.6 THE BALANCE BETWEEN QUALITATIVE CHARACTERISTICS

A **tradeoff between qualitative characteristics** is often necessary, the aim being to achieve an appropriate balance to meet the objective of financial statements.

#### 3.6.1 Relevance Vs Reliability

Information may become irrelevant if there is a delay in reporting it. There should be a balance between timeliness (i.e. relevance) and the provision of reliable information. Information may be reported on a timely basis when not all aspects of the transaction are known, this compromising reliability.

#### 3.6.2 Prudence Vs Accruals

Prudence most obviously conflicts with accruals assumption because it requires that the matching of costs and revenues should not take place if there is any doubt about the future recoverability of different costs. This conflict has been summarised as 'should we report the worst possible situation (prudence) or the most likely position?

#### 3.6.3 Prudence Vs Going concern

Prudence also conflicts with the going concern assumption because it may be prudent to assume that a business is a going concern (although it is realistic).

#### 3.6.4 Prudence Vs Consistency

Prudence makes it difficult to treat items consistently because circumstances in one period may require a different treatment from previous periods in order to be prudent.

#### 3.6.5 Prudence Vs Objectivity

Prudence being too conservative applies subjectively in coming to accounting judgments.



### **3.7 FURTHER CLASSIFICATION OF QUALITATIVE CHARACTERISTICS**

Qualitative characteristics have been classified further by the conceptual framework as follow

- **Fundamental**

The conceptual framework gives 2 fundamental qualitative characteristics; i.e.

- ↳ *Relevance*
- ↳ *Faithful representation*

- **Enhancing**

The conceptual framework lists four enhancing qualitative characteristics; i.e.

- ↳ *Comparability*
- ↳ *Verifiability*
- ↳ *Timeliness*
- ↳ *Understandability*

- **Verifiability** helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.  
Information that can be independently verified is generally more decision-useful than information that cannot.

#### **Activity 3.4**

With relevant examples, explain the enhancing qualitative characteristics of accounting information needed by different users for decision making. (6 marks)

**Source: CPA(U), June 2012, Question 7**

### **3.8 ACCOUNTING PRINCIPLES/CONCEPTS/CONVENTIONS, BASES AND POLICIES.**

#### **3.6.1 Accounting Principles**

Accounting principles also called accounting concepts or accounting conventions are assumptions underlying the preparation and presentation of financial statement.

#### **3.6.2 Accounting Bases**

Accounting bases on the other hand are the different alternative method available for applying the accounting concepts. For example when valuing inventory, the different bases are FIFO, LIFO and Average price. The different bases for handling depreciation are straight line method, reducing balance method or sum of year digit method.

#### **3.6.3 Accounting policies**

Accounting policy are the bases that have been selected to be used by the organization. If the organization chooses to use straight line method to depreciate its fixed assets, then its policy on policy is to depreciate assets on straight line method.

Once a policy has been chosen, the organization should use it consistently for a long period of time.



### SOLUTION TO ACTIVITY 3.1

- (a) Write it off to the income statement as an expense.
- (b) Capitalize the computer and charge depreciation on it.
- (c) Your answer depends on the size of the company and whether writing off the item has a material effect on its profits. A larger organization might well write this item off under the heading of advertising expenses, while a small one might capitalize it and depreciate it over time. This is because the item is material to the small company, but not to the large company.

### SOLUTION TO ACTIVITY 3.2

The company should make an allowance for receivables of shs.6 million. Sales for 2014 are shown in the income statement at their full value of shs.100 million, but the allowance for receivables is a charge of shs.6 million. Since there is some uncertainty that the sales will be realized in the form of cash, prudence dictates that the shs. 6 million should not be included in the profit for the year.

### SOLUTION TO ACTIVITY 3.4

#### Enhanced Qualitative Characteristics:

The qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented are comparability, verifiability, timeliness and understandability. They assist in determining the method to choose, from two alternatives, when depicting a phenomenon in case they are both considered equally relevant and faithfully represented.

- **Comparability**:- It enables users to identify and understand similarities in and differences among items. Users' decisions involve choosing among alternatives, such as purchase or sale of an investment. Hence, information about an entity is more useful if it can be compared with similar information of other entities and with similar information about the same entity for another period/s.
- **Verifiability**:- It helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent persons could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation, e.g. counting cash or inventory. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. E.g. re-computing the tax payable by individual employees using the tax rates to verify their correctness.
- **Timeliness**:- It means availing information to decision-makers in time to help influence their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after a reporting period, for instance, where some users may need to identify and assess trends.
- **Understandability**:- It refers to clearly and concisely classifying, characterising and presenting information. Information should be easy to comprehend.



# LECTURE C

## Principles of Double Entry and Systems of Accounting

# 4.0

## SOURCES, RECORDS AND BOOKS OF PRIME-ENTRY

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### UNIT 4 OVERVIEW OUTLINE:

- The role of source documents.
  - The need of books of prime-entry.
  - Sales and purchases day books.
  - Cash Book.
  - Petty cash.
- 

### 4.1 THE ROLE OF SOURCE DOCUMENTS

#### 4.1.1 Types of source documents.

Whenever a business transaction takes place, involving sales or purchases, receiving or paying money, or owing or being owed money, it is usual for the transaction to be recorded on a document. These documents are the source of all the information recorded by a business.

Documents used to record the business transactions in the ‘books of accounts’ of the business include the following;

- **Quotation.** A document sent to a customer by a company stating the fixed price that would be charged to produce or deliver goods or services. Quotations tend to be used when businesses do not have a standard listing of prices for products, for example when the time, materials and skills required for each job vary according to the customer’s needs. Quotations can’t be changed once they have been accepted by the customer.
- **Purchase order.** A document of the company that details goods or services which the company wishes to purchase from another company. Two copies of a purchase order are often made, one is sent to the company from which the goods or services will be purchased, and the other is kept internally so the company can keep track of its orders. Purchase orders are often sequentially numbered.
- **Sales order.** A document of the company that details an order placed by a customer for goods or services. The customer may have sent a purchase order to the company from which the company will then generate a sales order. Sales orders are usually sequentially numbered so that the company can keep track of orders placed by customers.
- **Goods received note.** A document of a company that lists the goods that the business has received from a supplier. A goods received note is usually prepared by the business’s own warehouse or goods receiving area. This is discussed further below.



- **Goods dispatched note.** A document of a company that lists the goods that a company has sent out to a customer. The company will keep records of goods dispatched notes in case of any queries by the customers about the goods sent. The customer will compare the goods dispatched note to what they receive to make sure all the items listed have been delivered and the right specification.
- **Invoice.** This is discussed further below.
- **Statement.** A document sent out by a supplier to a customer listing the transactions on the customer's account, including all invoices and credit notes issued and all payments received from the customer. The statement is useful as it allows the customer to reconcile the amount that they believe they owe the supplier to the amount the supplier believes they are owed. Any differences can then be queried.
- **Credit note.** A document sent by a supplier to a customer in respect of goods returned or overpayments made by the customer. It is a 'negative' invoice. This is discussed further below.
- **Debit note.** A document sent by a customer to a supplier in respect of goods returned or an overpayment made. It is a formal request for the supplier to issue a credit note.
- **Remittance advice.** A document sent to a supplier with a payment, detailing which invoices are being paid and which credit notes offset. A remittance advice allows the supplier to update the customer's records to show which invoices have been paid and which are still outstanding. It also confirms the amount being paid, so that any discrepancies can be easily identified and investigated.
- **Receipt.** A document confirming confirmation that a payment has been received. This is usually in respect to cash sales, e.g. a till receipt from a cash register. This is discussed further below.

## 4.2 INVOICES.

An invoice relates to a sales order or a purchase order.

- When a business sells goods or services on credit to a customer, it sends out an invoice. The details on the invoice should match the details on the sales order. The invoice is a request for the customer to pay what he owes.
- When a business buys good or services on credit it receives an invoice from the supplier. The details on the invoice should match the details on the purchase order.

The invoice is primarily a demand for payment, but it is used for other purposes as well, as we shall see. Since it has several uses, an invoice is often produced on multi-part stationery, or photocopied, or carbon-copied. The top copy will go to the customer and the other copies will be used by various people within the business.

### 4.2.1 What does an invoice show?

Most invoices are numbered, so that the business can keep track of all the invoices it sends out. Information usually shown on an invoice includes the following.

- (a) Name and address of the seller and the purchaser.
- (b) Date of the sale.
- (c) Description of what is being sold.
- (d) Quantity and unit price of what has been sold (e.g. 20 pairs of shoes at UGX2,500 a pair).
- (e) Details of trade discount, if any (e.g. 10% reduction in cost of buying over 100 pairs of shoes).
- (f) Total amount of the invoice including (usually) details of any sales tax.
- (g) Sometimes, the date by which payment is due, and other terms of sale.



#### 4.2.2 Uses of multi-part invoice

As stated above invoices may be used for different purposes.

- Top copy to customer as request for payment.
- Second copy to accounts department to match eventual payment
- Third copy to warehouse to generate a dispatch of goods, as evidenced by a goods dispatched note.
- Fourth copy stapled to sales order and kept in sales department as a record of sales.

Businesses will design their own invoices and there may be other copies for other departments. Not all businesses will need four part invoices. A very small business may use the customer copy of the invoice as a dispatch note as well. In addition, the sales invoice may be stapled to the sales order and both documents passed to the accounts department.

#### 4.3 THE CREDIT NOTE

China Supplies (U) Ltd sent out an invoice for 20 dinner plates, but the typist accidentally typed in a total of UGX16,210 instead of UGX6,210. The China shop has been **overcharged** by UGX10,000. What is China Supplies to do? Alternatively, when China shop received the plates, it found that they had all been broken in the post and that it was going to send them back. Although the china shop has received an invoice for UGX6,210, it has no intention of paying it because the plates were useless. Again, what is China Supplies to do?

The answer is that China Supplies sends out a **credit note**. A credit note is sometimes printed in red to distinguish it from an invoice. Otherwise, it will be made out in much the same way as an invoice, but with less detail and 'Credit Note Number' instead of 'Invoice Number'.

A credit note is a document relating to returned goods or refunds when a customer has been overcharged. It can be regarded as a **negative invoice**.

#### 4.4 OTHER DOCUMENTS.

The following documents are sometimes used in connection with sales and purchases.

- (a) *Debit notes*.
- (b) *Goods received notes*.

- A **debit note** might be used to **adjust an invoice** already used. This is also commonly achieved by issuing a revised invoice after raising a credit or debit note purely for internal purposes (i.e. to keep the records straight).

More commonly, a debit note is issued to a supplier as a means of formally requesting a credit note.

- **Goods received notes** (GRNs) record a receipt of goods, most commonly in a warehouse. They may be used in addition to suppliers' advice notes. Often the accounts department will want to see the relevant GRN and the matching purchase order before paying a supplier's invoice. Even where GRNs are not routinely used, the details of a consignment from a supplier which arrives without an advice note must always be recorded.

#### 4.5 THE NEED FOR BOOKS OF PRIME ENTRY

In the course of business, source documents are created. The details of these source documents need to be summarized, as otherwise the business might forget to ask for some money, or forget to pay some, or even accidentally pay something twice. It needs to keep records of source documents – of transactions – so that it knows what is going on. Such records are made in **books of prime entry**.



Books of prime entry are books in which we first record transactions.

The main **books of prime entry** are as follows.

- (ii) Sales day book
- (iii) Purchase day book
- (iv) Sales returns day book
- (v) Purchase returns day book
- (vi) Journal (described in the next chapter)
- (vii) Cash book
- (viii) Petty cash book

It is worth bearing in mind that, for convenience, this chapter describes books of prime entry as if they are actual books written by hand. However, books of prime entry are often not books at all, but rather files stored on a computer. However, the principles remain the same whether they are manual or computerized.

#### 4.5.1 The sales day book

The sales day book is the book of prime entry for all credit sales. The sales day book is used to keep a list of all invoices sent out to customers each day. An extract from a sales day book might look like this.

##### SALES DAY BOOK

Date	Invoice	Customer	Total amount invoiced UGX
2014			
Jan 10	247	Jones & Co	105.00
	248	Smith & Co	86.40
	249	Alex & Co	31.80
	250	Enor College	<u>1,264.60</u>
			<u>1,487.80</u>

Most businesses 'analyze' their sales. For example, this business sells boots and shoes. The sale to Smith was entirely boots, the sale to Alex was entirely shoes, and the other two sales were a mixture of both.

Then the sales day book might look like this.

##### SALES DAY BOOK

Date	Invoice	Customer	Total amount invoiced	Boot sales	Shoe sales
			UGX	UGX	UGX
2014					
Jan 10	247	Jones & Co	105.00	60.00	45.00
	248	Smith & Co	86.40	86.40	
	249	Alex & Co	31.80		31.80
	250	Enor College	<u>1,264.60</u>	<u>800.30</u>	<u>464.30</u>
			<u>1,487.80</u>	<u>946.70</u>	<u>541.10</u>

The analysis gives the managers of the business useful information which helps them to decide how to run the business.

#### 4.5.2 The purchase day book

- A business also keeps a record in the purchase day book of all the invoices it receives.
- The purchase day book is the book of prime entry for all credit purchases.
- An extract for a purchase day book might look like this.



### PURCHASE DAY BOOK

Date	Supplier	Total amount invoiced	Purchases	Electricity	etc
		UGX	UGX	UGX	
2014					
Mar 15	Cook & Co	315.00	315.00		
	W Butler	29.40	29.40		
	EEB	116.80		116.80	
	Show Fair Co	100.00	100.00		
		<u>561.20</u>	<u>444.40</u>		<u>116.80</u>

Note that:

- There is no ‘invoice number’ column, because the purchase day book records **other people’s invoices**, which have all sorts of different numbers.
- Like the sales day book, the purchase day book analyses the invoices which have been sent in. In this example, three of the invoices related to goods which the business intends to re-sell (called simply ‘purchases’) and the other invoice was an electricity bill.

#### 4.5.3 The sales returns day book

When customers return goods for some reason, a credit note is raised. All credit notes are recorded in the sales returns day book. An extract from the sales returns day book is as follows.

### SALES RETURNS DAY BOOK

Date	Credit note	Customer and goods	Amount
			UGX
2014			
30 April	CR008	Musoke John 3 pairs ‘Texas’ boots	135,000

The sales returns day book is the book of prime entry for credit notes raised.

Not all sales return day books analyze what goods were returned, but it makes sense to keep as complete a record as possible. Where a business has very few sales returns, it may record a credit note as a negative entry in the sales day book.

#### 4.5.4 The purchase returns day book

Not surprisingly, the purchase returns day book records credit notes received in respect of goods which the business sends back to its suppliers.

An extract from the purchase returns day book is as follows.

### PURCHASE RETURNS DAY BOOK

Date	Supplier and goods	Amount
		UGX
2014		
29 April	Boxes and Co 300 cardboard boxes	46,600

The purchase returns day book is the book of prime entry for credit notes received from suppliers.

Once again, a business with very few purchase returns may record a credit note received as a negative entry in the purchase day book.



## 4.6 CASH BOOK

The cash book is also a day book, used to keep a record of money received and money paid out by the business. The cash book deals with money paid into and out of the business **bank account**. This could be money received on the business premises in notes, coins and cheques, subsequently paid into the bank. There are also receipts and payments made by bank transfer, standing order, direct debit and bank interest and charges, directly by the bank.

Some cash, in notes and coins, is usually kept on the business premises to make occasional payments for odd items of expense. This cash is usually accounted for separately in **petty cash book**.

One side (the left) of the cash book is used to record receipts of cash, and the other side (the right) is used to record payments. The best way to see how the cash book works is to follow through an example. For convenience, we are showing the cash receipts and cash payments separately, but they are part of the same book. The cash book is the book of prime entry for cash receipts and payments.

### Illustrations

-----Left hand side (Receiving side)----- -----Right hand side (Paying side)-----

Date	Part.	Folio	Cash	Bank	Date	part	Folio	Cash	Bank
Jul 09 1 2 4 8 16 26	Capital Jim Sales Cash Sales bank	GL Jim SL C SL C			Jul 09 6 8 23 26 30 31	Rent Bank John Cash Wages Bal			
Aug 1	Bal	B/F							

### Activity 4.1

At the beginning of 1 January 2015, Peter Magazi had UGX900,000 in the bank. During the month of January 2015, Peter had the following receipts and payments.

- (a) Cash sale: receipt of UGX80,000
- (b) Cheque payment from credit customer Hay UGX400,000 less discount allowed UGX20,000
- (c) Cheque payment from credit customer Been UGX720,000
- (d) Cheque payment from credit customer Seed UGX150,000 less discount allowed UGX10,000
- (e) Cheque received from David UGX1,800,000 to provide a short-term loan.
- (f) Second cash sale: receipt of UGX150,000
- (g) Cash received for sale of machine UGX200,000
- (h) Payment to supplier Kew UGX120,000 through the bank
- (i) Cheque payment to supplier Hare UGX310,000
- (j) Payment of telephone bill UGX400,000 by bank transfer
- (k) Payment of gas bill UGX280,000 cash
- (l) UGX100,000 in cash withdrawn from bank for petty cash
- (m) Payment of UGX1,500,000 to Hess for new plant and machinery by cheque

#### Required

**Prepare a cashbook for Peter Magazi to include the above transactions.**



## SOLUTION TO ACTIVITY 4.1

If you look through the transactions given in activity 4.1, you will see that seven of them are receipts and six of them are payments.

The receipts part of the cash book for 1 September would look like this.

### CASH BOOK (RECEIPTS)

Date	Narrative	Amount UGX "000"
2015		
1 Jan	Balance b/d	900
	Cash sale	80
	Accounts receivable: Hay	380
	Accounts receivable: Been	720
	Accounts receivable: Seed	140
	Loan: David	1,800
	Cash sale	150
	Sale of non-current asset	200
		<u>4,370</u>

Note that:

- (a) There is a space on the right hand side of the cash book so that the receipts can be analyzed under various headings – for example, ‘cash from receivables’, ‘cash sales’ and ‘other receipts’.
- (b) The receivables in the day amounted to UGX3,470,000. Added to the UGX900,000 at the start of the day, this comes to 4,370,000. This is not the amount to be carried forward to the next day, because first we have to subtract all the payments made during 1 January.

The payments part of the cash book for 1 January would look like this.

### CASH BOOK (PAYMENTS)

Date	Narrative	Total UGX
2015		
1 Jan	Accounts payable: Kew	120
	Accounts Payable: Hare	310
	Telephone	400
	Gas bill	280
	Petty cash	100
	Machinery purchase	1,500
	Balance c/d (balancing figure)	<u>1,660</u>
		<u>4,370</u>

As you can see, this is very similar to the receipts part of the cash book. The only points to note are as follows.

- (a) The analysis on the right would be under headings like ‘payments and payables’, ‘payments into petty cash’, ‘wages’ and ‘other payments’.
- (b) Payments during 1 January totaled UGX2,710,000. We know that the total of receipts was UGX4,370,000 - UGX2,710,000 = UGX1,660,000 to be ‘carried down’ to the start of the next day. As you can see, this ‘balance carried down’ is noted at the end of the payments column, so that the receipts and payments totals show the same figure of UGX4,370,000 at the end of 1 January.



## 4.7 BANK STATEMENTS

Weekly or monthly, a business will receive a **bank statement**. Bank statements should be used to check that the amount shown as a balance in the cash book agrees with the amount on the bank statement, and that no cash has 'gone missing'. This agreement or 'reconciliation' of the cash book with a bank statement is the subject of a later chapter.

## 4.8 PETTY CASH

Most businesses keep **petty cash** on the premises, which is topped up from the main bank account. Under the **imprest system**, the petty cash is kept at an agreed sum, so that each topping up is equal to the amount paid out in the period.

### 4.8.1 What is petty cash?

Most businesses keep a small amount of cash on the premises to make occasional small payments in cash, e.g. staff refreshments, postage stamps, to pay the office cleaner, taxi fares, etc. this is often called the cash float or **petty cash** account. The cash float can also be the resting place for occasional small receipts, e.g. cash paid by a visitor to make a phone call, etc.

### 4.8.2 The petty cash book

A petty cash book is a cash book for small payments.

Although the amounts involved are small, petty cash transactions still need to be recorded, otherwise the cash float could be abused for personal expenses or even stolen.

There are usually more payments than receipts, and petty cash must be 'topped up' from time to time with cash from the business bank account. A typical layout is as follows.

Receipts UGX	Date 2014	Narrative	Total UGX	Milk UGX	Postage UGX	Travel UGX	Other UGX
250	1 Sept	Bal b/d					
		Milk bill	25	25			
		Postage stamps	5		5		
		Taxi fare	10			10	
		Flowers for sick staff	15				15
		Bal c/d	<u>195</u>	<u>25</u>	<u>5</u>	<u>10</u>	<u>15</u>
<u>250</u>			<u>250</u>				

### 4.8.3 Imprest System

Under what is called the **imprest system**, the amount of money in petty cash is kept at an agreed sum or 'float' (say UGX250). This is called the **imprest amount**. Expense items are recorded on vouchers as they occur, so that at any time:

	UGX
Cash is still held in petty cash	195
Plus voucher payments (25+5+10+15)	55
Must equal the imprest amount	<u>250</u>

The total float is replenished regularly (to UGX250, or to whatever the imprest amount is) by means of a cash payment from the bank account into petty cash. The amount of the 'top-up' into petty cash will be the total of the voucher payments since the previous top-up.



**Activity 4.2**

DEF operates an imprest system for petty cash. During January 2015, the following petty cash transactions took place.

	UGX
02/2/2014	12,000
03/2/2014	25,000
08/2/2014	15,000
17/2/2014	5,000
18/2/2014	8,000
28/2/2014                      Stationery	7,500

The amount remaining in petty cash at the end of the month was UGX9,350. What is the imprest amount?

**Activity 4.3**

State which books of prime entry the following transactions would be entered into;

- (a) Your business pays A Brown (a supplier) UGX450.00.
- (b) You send D Smith (a customer) an invoice for UGX650.
- (c) Your accounts manager asks you for UGX12 urgently in order to buy some envelopes.
- (d) You receive an invoice from A Brown for UGX300.
- (e) You pay D Smith UGX500
- (f) F Jones (a customer) returns goods to the value of UGX250.
- (g) You return goods to J Green to the value of UGX504.
- (h) F Jones pays you UGX500.

**Activity 4.4**

The following were the bank and cash transactions of JB Ltd.

2013 Jan 1 JB banks capital into the bank account of 10,000,000

- 2 Received a cheque from Jim shs 560,000
- 4 Sold goods in cash shs 1,200,000
- 6 Paid rent by cash shs 800,000
- 8 Bank shs 300,000 on the bank account
- 16 Sold goods by cheque shs 600,000
- 23 Paid John by cheque shs 1,000,000
- 26 Withdraw cash from the bank for business use shs 1,500,000
- 30 Paid wages in cash shs 1,000,000.

Draw up the cashbook for JB Ltd. for the month of Jan 2013.

**Activity 4.5 ( With discounts )**

Dec 2012

1 Bal b/f from Nov cash shs 29,000 and bank shs 654,000

Accounts receivable are John shs 120,000, Jimmy shs 280,000 and Jackie shs 40,000

Accounts payable are Alice shs. 60,000, Annet shs 440,000 and Allen shs 100,000

2 John pays by cheque having deducted 2.5% cash discount

8 We pay Allen her account by cheque deducting 5% cash discount

11 We withdrew shs 100,000 cash from the bank for business use

16 Jimmy pays us his account by cheque deducting 2.5% cash discount.

25 We paid office expenses in cash shs 92,000

28 Jackie pays us in cash having deducted 5% cash discount

29 We pay Alice by cheques less 5% cash discount

30 We pay Annet by cheque less 2.5% cash discount.

Prepare a cash book for the month of December 2012.



### Exam Type Question

Enter the following in a three column Cash book for ABC (U) LTD, balance off the cash book at the end of the month and prepare the discount accounts in the general ledger.

May 1      Balances brought forward;

	Shs
Cash	970,000 Dr
Bank	2,186,000 Dr

May 2      The following paid the business by cheque in each case deducting 5% cash discount; R. Janis shs 1 million, Barbara Kisembo shs 280,000, Perpetual shs 180,000. Nankumbi shs 600,000

May 3      Cash sales paid direct into the Bank shs 134,000

May 4      Rent expense paid by cash shs 88,000

May 5      Rent income received by cheque shs 120,000

May 6      Paid the following accounts by cheque in each case deducting 21/2 % cash discounts: M. Charles shs 400,000; H. Sagula shs 640,000; D. Haumba shs 200,000, R. Ndaula shs 350,000

May 9      Withdrew cash from the Bank for business use shs 250,000

May 10     Banked excess cash collections shs 500,000

May 11     Made cash purchases shs 100,000

May 12     Made cash sales shs 206,000

May 13     R. Norman paid the business by cheque shs 890,000 less 10% cash discount

May 15     Paid wages by cash shs 160,000

May 16     The business paid Lukwago by cheque shs 117,000 less cash discount shs 17,000 and also paid Kakumba shs 206,000 less cash discount of shs 6,000.



# 5.0

# LEDGER ACCOUNTS

## UNIT 5 OVERVIEW

- The need for ledger accounts.
- The nominal ledger.
- The accounting equation.

### 5.1 WHY DO WE NEED LEDGER ACCOUNTS?

Ledger accounts **summarize** all the individual transactions listed in the books of prime entry.

A business is continually making transactions, e.g. buying and selling. It does not prepare an income statement and a statement of financial position on completion of every individual transaction. To do so would be a time-consuming and cumbersome administrative task.

However, a business should keep a record of the transactions that it makes, the assets it acquires and liabilities it incurs. When the time comes to prepare an income statement and a statement of financial position, the relevant information can be taken from those records.

*The records of transactions, assets and liabilities should be kept in the following ways;*

- (a) In **chronological order**, and **dated** so that the transactions can be related to a particular period of time.
- (b) Built up in **cumulative totals**.
- (a) Day by day (e.g. total sales on Monday, total sales on Tuesday)
  - (ii) Week by week.
  - (iii) Month by month.
  - (iv) Year by year.

We have already seen the first step in this process, which is to list all the transactions in various books of prime entry. Now we will look at the method used to summarize these records: **ledger accounting** and **double entry**.

This system of summarizing information speeds up the provision of useful information to managers and so helps managers to keep the organizational deadlines (e.g. provision of monthly profit figures for management purposes). This system also provides useful accounting information to other parts of the organization. For example:

- (a) The credit control department monitors the receivable balances. The accounting system will provide valuable information to the credit control department by summarizing all the sales made on credit. This will enable the credit control department to monitor receivables balances and make sure they are paid within the company's allowed credit period. The accounting information produced can also help with cash planning as the credit control department can provide management with predicted timings of cash receipts based on outstanding receivables balances.
- (b) Summarized information relating to sales will be very useful to the sales department. The information provided could be used to work out which products are best sellers and which are not selling very well,

whether products sell better at different times of the year and so on. The sales department could also liaise with the credit control department to make sure that sales are not made to customers who have a history of not paying their bills.

- (c) Summarized information on sales and purchases can also help the company manage their inventory levels. The purchasing department can use the summarized accounting information to spot trends in the use of raw materials to help them predict demand levels and avoid stock outs.

## 5.2 THE NOMINAL LEDGER.

The principle accounts are contained in a ledger called the **general or nominal ledger**

The nominal ledger is an accounting record which summarizes the financial affairs of a business.

The nominal ledger is sometimes called the '**general ledger**'. The information contained in the books of prime entry (e.g. the sales and purchases day books) is **summarized** and **posted** to accounts in the nominal ledger.

It contains details of assets, liabilities, capital, income and expenditure, and so profit and loss. It consists of a large number of different accounts, each account having its own purpose or 'name' and an identity or code.

There may be various subdivisions, whether for convenience, ease of handling, confidentiality, security, or to meet the needs of the computer software design. For example, the ledger may be split alphabetically, with different clerks responsible for sections A-F, G-M, N-R, and S-Z. This can also help to stop fraud, as there would have to be collusion between the different section clerks.

**Examples of accounts in the nominal ledger include the following;**

- (a) Plant and machinery at cost (non-current asset)
- (b) Motor vehicles at cost (non-current asset)
- (c) Plant and machinery, provision for depreciation (liability)
- (d) Motor vehicles, provision for depreciation (liability)
- (e) Proprietor's capital (liability)
- (f) Inventories – raw materials (current asset)
- (g) Inventories – finished goods (current asset)
- (h) Total trade accounts receivable (current asset)
- (i) Total trade accounts payable (current liability)
- (j) Wages and salaries (expense item)
- (k) Rent and local taxes (expense item)
- (l) Advertising expenses (expense item)
- (m) Bank charges (expense item)
- (n) Motor expenses (expense item)
- (o) Telephone expenses (expense item)
- (p) Sales (revenue)
- (q) Total cash or bank overdraft (current asset or liability)

When it comes to drawing up the financial statements, the revenue and expense accounts will help to form the income statement, while the asset and liability accounts go into the statement of financial position.



### 5.3 THE FORMAT OF A LEDGER ACCOUNT.

If a ledger account were to be kept as a manual system in an actual book, rather than as a file in a computerized system, it might look like this:

ADVERTISING EXPENSES							
Date 20X6	Narrative	Ref.	UGX	Date	Narrative	Ref.	UGX
15 April	JFK Agency for quarter to 31 March	PL 348	2,500				

For the rest of this chapter, we will assume that a manual system is being used, in order to illustrate fully the working of the ledger accounts. Remember that a computerized system functions the same way, although the actual ledger accounts will be stored as computer files and so may be hidden away within the system.

There are two sides to a ledger account, and an account heading on top, and so they are often referred to as 'T' accounts.

- (a) On top of the account is its name
- (b) There is a left hand side, or debit side.
- (c) There is a right hand side, or credit side.

NAME OF ACCOUNT			
DEBIT SIDE	UGX	CREDIT SIDE	UGX

We will look at 'debts' and 'credits' in detail in Section 4, but first we shall consider the accounting equation.

### 5.4 THE ACCOUNTING EQUATION.

The accounting equation is ASSETS = CAPITAL + LIABILITIES

This is also known as the **statement of financial position equation**.

#### 5.4.1 Introduction of cash in the business

- The business entity concept requires that regardless of how a business is legally set up, for accounting purposes, a business is always treated separately from its owner(s).
- A business begins by owning cash invested by the proprietor. Because of the business entity concept, in turn, the business entity owes the money to the proprietor as **CAPITAL**.
- In accounting, **capital** is an investment of money (funds) with the intention of earning a return. A business proprietor invests capital with the intention of earning profit. As long as that money is invested, accountants will treat the capital as money owed to the proprietor by the business.

#### Activity 5.1 Introduction of cash in the business

- i. Liza starts a business with UGX2,500,000.

**Required:** Present this transaction on the accounting equation.



- Capital invested is a form of liability, because it is an amount owed by the business to its owner(s). Adapting this to the idea that assets and liabilities are always equal amounts, we can state the accounting equation as follows.

### Activity 5.2

- ii. Liza purchased a market stall from Peter, who is retiring from his fruit and vegetables business. The cost of the stall was UGX1,800,000.
- iii. She also purchased some flowers and potted plants from a trader in the wholesale market, at a cost of UGX650,000.

**Required:** Present the above transactions on the accounting equation.

- The stall and the flowers and plants are physical items, but they must be given a money value. This money value is usually what they cost the business (called **historical cost** in accounting terms).

### 5.4.2 Profit introduced into the accounting equation.

- Profits belong to the owners of a business. However, so long as the business retains the profits and does not pay anything out to its owners, the **retained profits** are accounted for and an addition to the proprietor's capital.

### Activity 5.3

- iv. On 3 July Liza has a very successful day. She sells all her flowers and plants for UGX900,000 cash.

**Required:** Present the above transactions on the accounting equation.

### 5.4.3 Drawings.

- Drawings are amounts of money taken out of a business.
- Since Liza has made a profit of **UGX250,000** from her first day's work, she might want to withdraw some money from the business. After all, business owners, like anyone else, need income for living expenses. Consider example 5.4 below;

### Activity 5.4

- v. On 4 July Liza decided to pay herself UGX180,000 in 'wages'.

**Required:** Analyse the above transaction and present its effect on the accounting equation.

When business transactions are accounted it should be possible to restate the **assets and liabilities** of the business after the transactions have been taken.



### Activity 5.4

- vi. On 10 July Liza purchased more flowers and plants for cash, at a cost of UGX740,000. She was not feeling well, because of a heavy cold, and so she decided to accept help for the day from her cousin Ethel. Ethel was to paid a wage of UGX40,000 at the end of the day.
- vii. Trading on the 10 July was again very sharp, and Liza and Ethel sold all their goods for UGX1,100,000 for cash. Liza paid Ethel her wage and drew out UGX200,000 for herself.

*Required*

- (a) State the accounting equation before trading began on 10 July.
- (b) State the accounting equation at the end of 10 July, after paying Ethel:
  - (i) But before drawings are made
  - (j) After drawings have been made.

## 5.5 PAYABLES AND RECEIVABLES.

**Trade accounts payable** are liabilities. **Trade accounts receivable** are assets.

### 5.5.1 Trade accounts payable and trade accounts receivable.

A payable is a person to whom a business owes money.

A **trade payable** is a person to whom the business owes money for debts incurred during the course of trading operational. In the accounts of a business, debts still outstanding which arise from the purchase of materials, components or goods for resale are called **trade accounts payable**, sometimes abbreviated to 'accounts payable' or 'payables'.

A business does not always pay immediately for goods or services it buys. It is a common business practice to make purchases on credit, with a promise to pay within 30 days, or two months or three months, of the date of the invoice of the goods. For example, A bus goods costing UGX2,000 on credit from B, B sends A an invoice for UGX2,000, dated 1 March, with credit terms that payment must be made within 30 days. If A then delays payment until 31 March, B will be a payable of A between 1 and 31 march for UGX2,000. From A's point of view, the amount owed to B is a **trade account payable**.

A trade account payable is a **liability** of a business.

Just as a business might buy goods on credit, so too might it sell goods to customers on credit. A customer who buys goods without paying cash for them straight away is a receivable.

For example, suppose C sells goods on credit to D for UGX6,000 on terms that the debt must be settled within two months of the invoice date 1 October. If D does not pay the UGX6,000 until 30 November, D will be a receivable of C for UGX6,000 from 1 October until 30 November. In the accounts of the business, amounts owed by receivables are called **trade amounts receivable**, sometimes abbreviated to 'accounts receivable' or 'receivables'.

A trade account receivable is an **asset** of a business. When the debt is finally settled, the trade account receivable 'disappears' as an asset, to be replaced by 'cash at bank and in hand'.



### Activity 5.5

- (b) Liza realizes that she is going to need more money in the business and so she makes the following arrangements.
  - (i) She invests immediately a further UGX250,000 of her own capital.
  - (ii) She persuades her Uncle Henry to lend her UGX500,000 immediately. Uncle Henry tells her that she can repay the loan whenever she likes, but in the meantime, she must pay him interest of UGX5,000 each week at the end of the market day. They agree that it will probably be quite a long time before the loan is eventually repaid.
- (c) She decides to buy a second hand van to pick up flowers and plants from her supplier and bring them to her stall in the market. She finds a car dealer, Gordon, who agrees to sell her a van on credit for UGX700,000. Liza agrees to pay for the van after 30 days' trial use.
- (d) During the week, Liza's Uncle George telephones her to ask whether she would sell him some garden trolls and furniture for his garden. Liza tells him that she will look for a supplier. After some investigations, she buys what Uncle George had asked for, paying UGX300,000 in cash to the supplier. Uncle George accepts delivery of the goods and agrees to pay UGX350,000, but he asks if she can wait until the end of the month of payment. Liza agrees.
- (e) Liza buys flowers and plants costing UGX800,000. Of these purchases UGX750,000 are paid in cash, with the remaining UGX50,000 on seven days' credit. Liza decides to use Ethel's services again as an assistant on market day, at an agreed wage of UGX40,000.
- (f) On 17 July, Liza succeeds in selling all her good earning revenue of UGX1,250,000 (all in cash). She decides to withdraw UGX240,000 for the week's work. She also pays Ethel UGX40,000 in cash. She decides to make the interest payment to her Uncle Henry the next time she sees him.
- (g) We shall ignore any van expenses for the week, for the sake of relative simplicity.

**Required**

**Sate the accounting equation:**

- (i) *After Liza and Uncle Henry have put more money into the business and after the purchase of the van.*
- (ii) *After the sale of goods to Uncle George.*
- (iii) *After the purchase of goods for the weekly market.*
- (iv) *At the end of the day's market trading on 17 July and after withdrawals have been appropriated out of*

### 5.6 Matching.

The **matching convention** requires that revenue earned is matched with the expenses incurred in the earning.

The matching convention comes from the **accruals assumption**. In the example above, we have 'matched' the revenue earned with the expenses incurred in earning it. So in part (iv), we included all the costs of the goods sold of UGX800,000, even though UGX50,000 had not yet been paid in cash. Also the interest of UGX5,000 was deducted from revenue, even though it had not yet been paid. This is an example of the **matching convention**.



### Activity 5.6

How would each of these transactions affect the accounting equation?

- (a) Purchasing UGX800,000 worth of inventory on credit
- (b) Paying the telephone bill UGX25,000
- (c) Selling UGX450,000 worth of inventory for UGX650,000
- (d) Paying UGX800,000 to the supplier.

### Activity 5.7

Present the following transactions on the accounting equation.

- 1) On 1/1/2014, Paul started business by depositing shs 5,000,000 into the business account.
- 2) 1/3/2014, he purchased a machine worth shs 3,000,000 paying by cheque.
- 3) 15/3/2014 he purchased goods worth shs 1,000,000 from John on credit
- 4) 30/3/2014 he sold good worth shs 700,000 and he made part payment of shs 500,000 to John

### Activity 5.8 EXAM TYPE QUESTION

On 1 May 2015 Mukasa's cashbook showed a cash balance of UGX 224,000 and an overdraft of UGX336,000. During the week ended 6 May 2015, the following transactions took place.

- |       |   |
|-------|---|
| May 1 | Sold UGX160,000 of goods to P Dixon on credit.  |
| May 1 | Withdrew UGX50,000 of cash from the bank for business use.  |
| May 2 | Purchased goods from A Clarke on credit for UGX380,000 less 15% trade discount.   |
| May 2 | Repaid a debt of UGX120,000 owing to R Hill, taking advantage of 10% cash discount. The payment was by cheque.          |
| May 3 | Sold UGX45,000 of goods for cash.   |
| May 4 | Sold UGX80,000 of goods to M Maguire on credit, offering a 12½% discount if payment is made within 7 days.              |
| May 4 | Paid a telephone bill of UGX210,000 by cheque.  |
| May 4 | Purchased UGX400,000 of goods on credit from D Daley.   |
| May 5 | Received a cheque from H Larkin for UGX180,000. Larkin has taken advantage of a UGX20,000 cash discount offered to him. |
| May 5 | Sold UGX304,000 of goods to M Donald on credit.   |
| May 5 | Purchased UGX135,000 of goods from Honour Co by cheque.   |
| May 6 | Received a cheque from D Randle for UGX482,000.   |
| May 6 | Purchased UGX100,000 of goods on credit from G Perkins.   |

*Required*

- (i) Write up the sales day book for the period
- (ii) Write up the purchases day book for the period
- (iii) Enter the transactions in a three column cashbook



# 6.0

# DOUBLE ENTRY

## UNIT 6 OVERVIEW

- Double entry book keeping.
- The Journal.
- Day book analysis.
- The receivables and payables ledger.

### 6.1 DOUBLE ENTRY BOOKKEEPING.

- **Double entry bookkeeping** is based on the idea that each transaction has an equal but opposite effect. Every accounting event must be entered in ledger accounts both as a debit and as an equal but opposite credit.

#### 6.1.1 Dual effect (duality concept)

- **Double entry bookkeeping** is the method used to transfer the weekly/monthly totals from the books of prime entry into the nominal ledger.
- It is therefore a method by which a business records financial transactions. An accountant is maintained for every asset, liability, income and expense. Every transaction is recorded twice so that every *debit* is balanced by a *credit*.
- Central to this process is the idea that every transaction has two effects, the **dual effect**. This feature is not something peculiar to businesses. If you were to purchase a car for UGX1,000,000 cash for instance, you would be affected in two ways.
  - (a) You own a car worth UGX1,000,000
  - (b) You have UGX1,000,000 less cash.
- If instead you got a bank loan to make the purchase:
  - (a) You own a car worth UGX1,000,000.
  - (b) You owe the bank UGX1,000,000.
- A month later if you pay a garage UGX50,000 to have the exhaust replaced:
  - (a) You have UGX50,000 less cash.
  - (b) You have incurred a repairs expense of UGX50,000.
- **Ledger accounts**, with their debit and credit sides, are kept in a way which allows the two-sided nature of every transaction to be recorded. This is known as the '**double entry**' system of bookkeeping, because **every transaction is recorded twice** in the accounts.



## **6.2 THE RULES OF DOUBLE ENTRY BOOKKEEPING**

- Increase in an asset, we make a DEBIT entry
  - Decrease in an asset, we make a CREDIT entry
  - Increase in a liability, we make A CREDIT entry
  - Decrease in a liability, we make a DEBIT entry
  - Increase in capital, we make a CREDIT entry
  - Decrease in capital, we make a DEBIT entry
  - Increase in an expenditure, we make a DEBIT entry
  - Decrease in an expense, we make a CREDIT entry

**Therefore,**

- **A debit will:**
    - ⇒ Increase an asset
    - ⇒ Decrease a liability
    - ⇒ Increase an expense
  - **A credit will:**
    - ⇒ Decrease an asset
    - ⇒ Increase a liability
    - ⇒ Increase an income
  - The basic rule, which must always be observed, is that **every financial transaction gives rise to two accounting entries, one a debit and the other a credit**. The total value of debit entries in the nominal ledger is therefore always equal at any one time to the total value of credit entries. Which account receives the credit entry and which receives the debit depends on the nature of the transaction.
  - An **increase in an expense** (e.g. a purchase of stationery) or an **increase in an asset** (e.g. a purchase of office furniture) is a debit.
  - An **increase in revenue** (e.g. a sale) or an **increase in liability** (e.g. buying goods on credit) is a credit.
  - A **decrease in an asset** (e.g. making cash payment) is a credit.
  - A **decrease in a liability** (e.g. paying a creditor) is a debit.

In terms of 'T' accounts:

ASSET		LIABILITY		CAPITAL	
DEBIT	UGX Increase	CREDIT	UGX Decrease	DEBIT	UGX Decrease

For income and expenses, think about profit. Profit retained in the business increases capital. Income increases profit and expenses decrease profit.

INCOME		EXPENSE	
DEBIT	UGX Decrease	CREDIT	UGX Increase
DEBIT	UGX Decrease	CREDIT	UGX Increase

### 6.3 JOURNAL ENTRIES

“Journal entries” is a book of primary entry that records transactions by their date, the name account to be debited, the name account to be credited and the narration of the transaction (description/memo).

Journals are commonly used in some of these instances (Not exhaustive):

- Recording the purchase and sale of fixed assets on credit.
- Writing off bad debts
- The correction of errors in the ledger accounts
- The opening entries
- Any other adjustments of accounts.

THE JOURNAL			
Date	Details	Dr.	Cr.
	Name of account to be debited Name of the account to be credited  Narration		

### Activity 6.1

Identify the debit and credit entries in the following transactions.

- (a) Bought a machine on credit from A, cost UGX8,000.
- (b) Bought goods on credit from B, cost UGX500.
- (c) Sold goods on credit to C, value UGX1,200.
- (d) Paid D (a credit supplier) UGX300.
- (e) Collected UGX180 from E, a credit customer.
- (f) Paid wages UGX4,000.
- (g) Received rent bill of UGX700 from landlord.
- (h) Paid rent of UGX700 to landlord G.
- (i) Paid insurance premium UGX90.
- (j) Received a credit note for UGX450 from supplier, H
- (k) Sent out a credit note for UGX200 to customer, I



### **Activity 6.2**

Record the following transactions in a journal form

1. The owner starts business with Cash, shs 10,000,000 on 1/1/2014
2. A milling machine was bought on credit from John shs 4,500,000 on 15/1/2014
3. A van was bought for cash shs 3,000,000 on 25/1/2014
4. Bought goods for resale shs 2,000,000 cash on 31/1/2014
5. He took goods worth shs 100,000 for personal use on 3/2/2014
6. Sale of goods on credit to Kamau shs 800,000 on 15/2/2014
7. Kamau settled his account by cheque on 28/2/2014
8. He paid for electricity shs 50,000 cash on 1/3/2014
9. He got a loan from Stanbic bank shs 4,000,000 on 15/3/2014 depositing it on his account.

### **Activity 6.3**

Record the following transactions in Journal form

#### **January 2015**

- 1 Started Business with shs 18,000,000 in the bank
- 2 Bought goods on credit from Belinda shs 1,455,000
- 3 Bought goods on credit from Smith shs 472,000
- 4 Sold goods worth shs 210,000 on cash
- 5 He returned goods to Belinda shs 82,000
- 6 Bought goods on credit from Smith shs 370,000
- 10 Sold goods to Patrick shs 483,000
- 12 Sold goods for cash shs 305,000
- 18 Took shs 250,000 out of cash and paid it in the bank
- 21 Bought a printer by cheque 1,000,000
- 22 sold goods on credit to Baker shs 394,000
- 23 Patrick returned goods worth shs 160,000 which had been sold to him
- 25 He returned goods to Smith shs 47,000
- 29 He paid Belinda shs 1,373, 000 by cheque
- 31 Bought a machine from Kikubo boys shs 419,000



# 7.0

# TRIAL BALANCE EXTRACTION

## UNIT 7 OVERVIEW

- Definition.
- Purpose of the Trial balance.
- Proforma Trial balance.
- Limitation of a Trial balance.

## 7.1 DEFINITION

Trial Balance is a list of closing balances of ledger accounts on a certain date and is the first step towards the preparation of financial statements.

- It is usually prepared at the end of an accounting period to assist in the drafting of financial statements. Ledger balances are segregated into debit balances and credit balances.
- Asset and expense accounts appear on the debit side of the trial balance whereas liabilities, capital and income accounts appear on the credit side.
- If all accounting entries are recorded correctly and all the ledger balances are accurately extracted, the total of all debit balances appearing in the trial balance must equal to the sum of all credit balances.

## 7.2 Purpose of a Trial Balance

- Trial Balance acts as the first step in the preparation of financial statements. It is a working paper that accountants use as a basis while preparing financial statements.
- Trial balance ensures that for every debit entry recorded, a corresponding credit entry has been recorded in the books in accordance with the double entry concept of accounting. If the totals of the trial balance do not agree, the differences may be investigated and resolved before financial statements are prepared. Rectifying basic accounting errors can be a much lengthy task after the financial statements have been prepared because of the changes that would be required to correct the financial statements.
- Trial balance ensures that the account balances are accurately extracted from accounting ledgers.
- Trial balance assists in the identification and rectification of errors.

## 7.3 Illustration of a Trial Balance

The table provided below is an example of what a simple Trial Balance looks like.

- Title provided at the top shows the name of the entity and accounting period end for which the trial balance has been prepared.
- Account Title shows the name of the accounting ledgers from which the balances have been extracted.



- Balances relating to assets and expenses are presented in the left column (debit side) whereas those relating to liabilities, income and equity are shown on the right column (credit side).
- The sum of all debit and credit balances are shown at the bottom of their respective columns.

<b>ABC (U) LTD</b> <b>Trial Balance as at 30 June 2015</b>		
<b>Account Title</b>	<b>Debit</b>	<b>Credit</b>
	Shs"000"	Shs"000"
Capital		XX
Furniture & Fixture	XX	
Buildings	XX	
Creditors		XX
Debtors	XX	
Inventory	XX	
Carriage inwards	XX	
Purchases		
Cash / Bank	XX	
Carriage Outwards		XX
Returns inwards (Sales returns)	XX	
Returns outwards (Purchases returns)		XX
Sales		XX
Drawings	XX	
Cost of sales	XX	
General and Administration Expense	XX	
<b>Total</b>	<b><u>XX</u></b>	<b><u>XX</u></b>

#### 7.4 Limitations of a trial balance

- (i) Trial Balance only confirms that the total of all debit balances match the total of all credit balances.
- (ii) Trial balance totals may agree in spite of errors. An example would be an incorrect debit entry being offset by an equal credit entry.
- (iii) A trial balance gives no proof that certain transactions have not been recorded at all because in such case, both debit and credit sides of a transaction would be omitted causing the trial balance totals to still agree.

Types of accounting errors and their effect on trial balance are more fully discussed in the section on Suspense Accounts.



### Exam Type Question

Kabate started business on 1 September 2011 as a sole proprietor. He had the following balances on 1 September 2012:

	Shs'000'
Motor van	9,000
Fixtures and fittings	12,000
Inventory	25,780
Trade payables:	
Bakuru	1,200
Regina	4,000
Trade receivables:	
Lakeri	800
Maido	3,600
Dodo	300
Cash at bank	25,080
Cash in the till box	900

The following transactions transpired during the month of September 2012:

- September 1 Introduced capital in the business of shs. 72,260,000.
- September 1 Paid rent by cheque Shs 1,300,000.
- September 2 Bought goods on credit from Bakuru Shs 1,520,000 and Regina Shs 2,140,000.
- September 3 Sold goods on credit to Lakeri Shs 4,640,000 and Maido Shs 4,120,000.
- September 14 Paid motor expenses in cash Shs 260,000.
- September 15 Cash drawings Shs 340,000.
- September 26 Goods returned by Lakeri Shs 320,000 and Maido Shs 360,000.
- September 27 Settled the accounts of Bakuru and Regina by cheque less 5% cash discount.
- September 28 Paid salaries by cheque Shs 1,120,000.
- September 29 Lakeri settled her account in full by cheque.
- September 29 The debt from Dodo proved irrecoverable and was written off.
- September 30 Bought another motor van paying by cheque Shs 10,000,000.

**Required:**

- (i) Determine Kabate's opening capital balance using the statement of Affairs
- (ii) Post the above transactions in the respective ledger accounts.
- (iii) Extract a trial balance as at 30 September 2012.



## SOLUTION TO EXAM TYPE QUESTION

**(i) Determining Kabate's opening capital balance.**

Here, we shall draft what is known as the Statement of Affairs. If analysed critically, you will notice that we are indeed following the accounting equation.

### KABATE'S OPENING STATEMENT OF AFFAIRS AS AT 1 SEPTEMBER 2012

	Shs '000	Shs '000
<b>Assets</b>		
Motor van		9,000
Fixtures and fittings		12,000
Inventory		25,780
Trade receivables:		
Lakeri	800	
Maido	3,600	
Dodo	<u>300</u>	
		4,700
Cash at bank		25,080
Cash in hand		<u>900</u>
		<u>77,460</u>
<b>Liabilities</b>		
Trade payables		
Bakuru	1,200	
Regina	<u>4,000</u>	
		<u>(5,200)</u>
Capital at 1 September 2012		<u>72,260</u>

- (ii) We shall now post the transactions given in part (b) of the question in their respective ledgers.  
Please note that the opening balances given in part (i) above shall be used as well.**

Dr		Bank Account	Cr
Sep	Details	Shs 000	Shs 000
1	Balance b/f	25,080	1,300
29	Lakeri	5,120	2,584
		-	5,833
		30,200	11,120
	Balance b/f	9,363	10,000
			9,363
			30,400



Dr		Cash Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
1	Balance b/f	900	14	Motor expenses	260
		-	15	Drawings	340
		<u>900</u>	30	Balance c/f	<u>300</u>
		<u>900</u>			<u>900</u>
	Balance b/f	300			
Dr		Motor Van Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
1	Balance b/f	9,000			
30	Bank	<u>10,000</u>	30	Balance c/f	<u>19,000</u>
		<u>19,000</u>			<u>19,000</u>
	Balance b/f	19,000			
Dr		Fixtures & Fittings Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
1	Balance b/f	12,000			
Dr		Inventory Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
1	Balance b/f	25,780			
Dr		Lakeri's Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
1	Balance b/f	800	26	Returns Inwards	320
3	Sales	<u>4,640</u>	29	Bank	<u>5,120</u>
		<u>5,440</u>			<u>5,440</u>
Dr		Maido's Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
1	Balance b/f	3,600	26	Returns Inwards	360
3	Sales	<u>4,120</u>	30	Balance c/f	<u>7,360</u>
		<u>7,720</u>			<u>7,720</u>
	Balance b/f	7,360			
Dr		Dodo's Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
1	Balance b/f	<u>300</u>	29	Bad Debts	<u>300</u>
Dr		Bakuru's Account		Cr	
Sep	Details	Shs 000	Sep	Details	Shs 000
27	Bank	2,584	1	Balance b/f	1,200
	Discount Received	<u>136</u>	2	Purchases	<u>1,520</u>
		<u>2,720</u>			<u>2,720</u>



Dr		Regina's Account		Cr
Sep	Details	Shs 000	Sep	Details
27	Bank	5,833	1	Balance b/f
	Discounts received	<u>307</u>	2	Purchases
		<u>6,140</u>		<u>6,140</u>
Dr		Capital Account		Cr
Sep	Details	Shs 000	Sep	Details
		1		Shs 000
				72,260
Dr		Rent Account		Cr
Sep	Details	Shs 000	Sep	Details
1	Bank	1,300		Shs 000
Dr		Purchases Account		Cr
Sep	Details	Shs 000	Sep	Details
2	Bakuru	1,520		Shs 000
	Regina	<u>2,140</u>	30	Balance c/f
		<u>3,660</u>		<u>3,660</u>
	Balance b/f	<u>3,660</u>		<u>3,660</u>
Dr		Sales Account		Cr
Sep	Details	Shs 000	Sep	Details
		3		Shs 000
30	Balance c/f	<u>8,760</u>	Lakeri	4,640
		<u>8,760</u>	Maido	<u>4,120</u>
			Balance b/f	<u>8,760</u>
				<u>8,760</u>
Dr		Motor Expenses Account		Cr
Sep	Details	Shs 000	Sep	Details
14	Cash	260		Shs 000
Dr		Drawings Account		Cr
Sep	Details	Shs 000	Sep	Details
15	Cash	340		Shs 000
Dr		Returns Inwards Account		Cr
Sep	Details	Shs 000	Sep	Details
26	Lakeri	320		Shs 000
	Maido	<u>360</u>	30	Balance c/f
		<u>680</u>		<u>680</u>
	Balance b/f	<u>680</u>		<u>680</u>
Dr		Discounts Received Account		Cr
Sep	Details	Shs 000	Sep	Details
		27		Shs 000
30	Balance c/f	<u>443</u>	Bakuru	136
		<u>443</u>	Regina	<u>307</u>
				<u>443</u>



Dr		Salaries Account		Cr
Sep	Details	Shs 000	Sep	Details
28	Bank	1,120		Shs 000

Dr		Bad Debts Account		Cr
Sep	Details	Shs 000	Sep	Details
29	Dodo	300		Shs 000

**KABATE'S TRIAL BALANCE  
AS AT 30 SEPTEMBER 2012**

Account Title	DR	CR
	Shs 000	Shs 000
Bank	9,363	
Cash	300	
Motor Van	19,000	
Fixtures & fittings	12,000	
Inventory	25,780	
Maido	7,360	
Capital		72,260
Rent	1,300	
Purchases	3,660	
Sales		8,760
Motor expenses	260	
Drawings	340	
Returns Inwards	680	
Discount received		443
Salaries	1,120	
Bad Debts	300	-
	81,463	81,463



# 8.0

# CORRECTION OF ERRORS

## UNIT 8 OVERVIEW

- Definition of Errors.
- Types of errors.
- Errors not affecting the trial balance.
- Errors affecting the trial balance
- The suspense Account
- The effect of errors on corrected profit
- The suspense account and statement of financial position

## 8.1 DEFINITION

**Errors** are the **incorrect entries** made in the books of accounts as a wrong posting or calculation.

Errors are in most cases committed unknowingly but as a ‘mistake’ such errors have to be discovered by making the necessary correcting entries in the books of accounts.

A **Journal** is used in explaining the correction of errors. It helps in giving full information to the cause and remedy of errors committed. Most errors are discovered at the time of preparing the trial balance.

## 8.2 TYPES OF ERRORS

Errors are divided into two types; i.e.

- (i) Errors not affecting the trial balance
- (ii) Errors affecting the trial balance

## 8.3 ERRORS NOT AFFECTING THE TRIAL BALANCE

These are also known as errors not disclosed or revealed by the trial balance.

A trial balance may not be an absolute proof of double entry i.e. not conclusive evidence of arithmetic accuracy. There are some mistakes that may be made in the process of preparing accounts, i.e. completing double entry but may not be disclosed (exposed) by the trial balance.

The trial balance will appear balanced yet there are some errors not disclosed. In this case therefore, the errors can be corrected by making the following entries;

**DR:** The account wrongly credited

**CR:** The correct account

Or the reverse depending on the balance

The errors not disclosed by the trial balance include the following;



**(a) Errors of Omission**

Errors of omission arise in situations where a transaction is completely omitted from the books of accounts.

**Example 8.1**

The sale of goods of shs. 500,000 on credit to Joseph has been completely omitted from the books.

**Correcting journal Entries**

*DR. Joseph's A/c - UGX500,000*

*CR: Sales A/c – UGX500,000*

*\*\*\*\*\*to introduce the transaction in the books of accounts*

**(b) Errors of commission**

Errors of commission arise in situations where the correct amounts are entered in the books, but in the wrong account.

**Example 8.2**

Goods bought from John Katende on credit for UGX208,000 are credited to the account of Musoke.

**Correcting journal Entries**

*DR. John Musoke A/c - UGX208,000*

*CR: John Katende A/c – UGX208,000*

*\*\*\*\*\*to record the transaction in John Katende's books and cancel the error made in John Musoke's ledger.*

**(c) Errors of principle**

This is where an item is entered in the wrong class of accounts. This may happen especially when the conflicting accounts have the same names or the nature of balances.

**Example 8.3**

Purchase of machinery worth UGX2,000,000 is debited to purchases account instead of being debited to the machinery account.

**Correcting journal Entries**

*DR. Machinery A/c - UGX2,00,000*

*CR: Purchases A/c – UGX2,000,000*

*\*\*\*\*\*to cancel the item out of the purchases account*

**(d) Compensating errors**

This is where errors cancel each other. This happens in situations where an incorrect entry on credit side cancels another incorrect entry on the debit side.

**Example 8.4**

The sales account is overcast by UGX2,000 while the purchases account is overcast by UGX2,000.

**Correcting journal Entries**

*DR. Sales A/c - UGX2,0000*

*CR: Purchases A/c – UGX2,000*

*\*\*\*\*\*to cancel the item out of the purchases and sales account*



### (e) Errors of original entry

This is where original figures entered in the books of accounts are incorrect yet the proper double entry treatment is consistently observed. Such errors cannot be detected by the trial balance since it would still balance.

#### Example 8.5

The purchase of goods on credit from Hassan at UGX9,800 is entered both in the purchase account and on the personal account as UGX8,900.

#### **Correcting journal Entries**

*DR. Purchases A/c - UGX900*

*CR: Hassan's A/c – UGX900*

*\*\*\*\*\*to correct the under cast and overcast in the two accounts*

### (f) Complete reversal of entries

This happens where correct accounts are used and double entry is completed but each item is shown on the wrong side of the account.

#### Example 8.6

A cheque is paid to J. Okello for UGX5,000,000. The double entry is completed by debiting the bank and crediting J. Okello instead of reverse entry.

#### **Correcting journal Entries**

*DR. J. Okello's A/c - UGX10,000,000*

*CR: Hassan's A/c – UGX10,000,000*

*\*\*\*\*\*to correct the reverse of entries*

#### **Key terms**

- (i) **Overcast:** - Means incorrectly adding up a column of figures to give an answer which is greater
- (ii) **Under casting:**-Means incorrectly adding up a column of figures to give a less value.

## **8.4 ERRORS AFFECTING THE TRIAL BALANCE**

Errors affecting the trial balance are those revealed by the disagreement of the trial balance totals. These errors relate to incorrect additions, subtractions, or entries made to the wrong side of the books. The errors are disclosed by the trial balance because the totals of debit and credit side do not agree.

#### **These errors include;**

- (i) Debit balance in the ledger having been entered as credit.
- (ii) Missing a balance when constructing a list of debtors or creditors.
- (iii) Misinterpretation of figures and accounts.
- (iv) Error in computation of balance totals.
- (v) Transposition errors e.g. recording UGX2,400 instead of UGX240.
- (vi) The purchases or sales day book totals not posted to the respective purchases or sales account.
- (vii) The discount totals in the cash book or ledger account omitted from the trial balance or entered in the credit column of the trial balance.
- (viii) Posting a wrong amount to the account.
- (ix) Omission to post an entry.



In big organisations, it may be difficult to locate such errors affecting the trial balance totals, therefore a suspense account is usually created to accommodate the aggregate effect of all errors committed in the period. The errors can later be identified by scrutinizing the suspense account.

## 8.5 THE SUSPENSE ACCOUNT

A suspense account is a ledger account in which items owing to insufficient data are temporarily recorded. For the correction of errors that affect the agreement of trial balance totals, a suspense account is opened, and the difference in the trial balance totals is posted to this account with journal entries. It is worth noting that the difference may either be a debit or credited:-

### Illustration 8.1

**J. Katumwa  
Trial Balance Extract**

	DR UGX	CR UGX
Totals after all accounts have been listed	800,000	600,000
Suspense account	-	200,000
	<u>800,000</u>	<u>800,000</u>

From the above example, the credit total of the trial balance fails to balance to the debit total by shs.200, 000, meaning that the suspense account must be opened to accommodate the above difference and hence we shall say that the suspense account has a credit balance of shs.200,000 and thus the suspense account will look as below.

**J. Katumwa  
Suspense account**

Date	UGX '000'	Date	UGX '000'
2014		2014	
31 Dec		31 Dec	Difference per trial balance

Therefore, the difference is also shown on the credit side of the suspense account as in the trial balance. Errors are then corrected by double entry through the suspense whenever discovered.

However, the suspense account should be opened temporarily and when errors are identified and corrected, the balance on the suspense account should be closed immediately.

## 8.6 THE EFFECT OF ERRORS ON REPORTED PROFIT

When errors are not discovered until later period, it will be found that the gross and the net profit will have been incorrectly stated for the period when the errors were made, but were undetected. If they are corrected in the period when they are found, then the period's profits will be corrected in the period when they are found. The profits will often be overstated or understated.

In this case therefore, a statement of corrected net profit (or an account) showing how the period's profits were affected is prepared

***Usually, the following are considered***

- (i) Income overstated - **Deduct or DR**
- (ii) Income understated - **Add back or CR**
- (iii) Expenses understated - **Deduct or DR**
- (iv) Expenses overstated - **Add back or CR**



### 8.6.1 Format of the statement of Corrected Net Profit

**J. Katumwa**

**Statement of Corrected Net profit for the year ended 31 December 2014**

	UGX “000”	UGX “000”
<b>Profit as per Accounts (reported profit)</b>		<b>XX</b>
<b>Add:</b>		
(i) Income under stated	XX	
(ii) Expenses Over stated	<u>XX</u>	<u>XX</u>
<b>Less:</b>		<b>XX</b>
(i) Income overstated	XX	
(ii) Expenses under stated	<u>XX</u>	<u>(XX)</u>
<b>Corrected profit for the period</b>	<u><u>XX</u></u>	<u><u>XX</u></u>

### 8.7 SUSPENSE ACCOUNT AND THE STATEMENT OF FINANCIAL POSITION

- If the errors are not found before the final accounts are prepared, the suspense account balance will be included in the Statement of financial position for the periods.
- Where the balance is a credit balance, it should be included on the “Equity and Liabilities” side of the statement of financial position and when the balance is a debit, it should be shown on the “Assets” side of the statement of financial position.



## EXAM TYPE QUESTION

### QUESTION 8.1

The bookkeeper of Kikuubo Traders, failed to agree the trial balance for the financial year ending 31 July 2013. She opened a suspense account into which she entered the difference of UGX6,190,000. The reported net profit at the time was UGX60,080,000.

During the month of July 2013, the following errors were discovered;

1. Equipment which had cost UGX18,000,000 by cheque had been omitted from the books. The Kikuubo traders depreciate their equipment over a period of 5 years on cost.
2. Prepaid medical insurance of UGX900,000 was credited to accrued medical insurance account as UGX1,900,000.
3. Returns outwards of UGX4,330,000 were debited to the returns inwards account.
4. Electricity expenses of UGX450,000 was debited to the bank account.
5. A sales invoice of UGX7,500,000 was recorded as UGX7,050,000 in the sales day book.
6. A creditor with a balance of UGX15,000,000 on her account had been posted as UGX16,500,000 to the trial balance.
7. Discounts allowed of UGX1,400,000 were credited to the discount received account.
8. A cheque of UGX10,485,000 received from a debtor was recorded in the debtor's account as UGX1,485,000 but was properly recorded in the cashbook.
9. Bad debts for UGX1,500,000 had not been recorded in the books.
10. Drawings of goods of UGX2,300,000 had been entered through the cash book.

**Required:**

- a. Prepare journal entries to correct the above errors [15marks]  
 b. Prepare a suspense account [5 marks]  
 [Total 20 marks]

Source: CPA(U), November 2013, Question 4

### SOLUTION TO EXAM TYPE QUESTION 8.1

(a) The following Journal entries correct the error presented in the question above

Account title	Debit (Shs)	Credit (Shs)
Equipment	18,000,000	
Bank <i>Narration: Cost of equipment earlier omitted, hereby corrected</i>		18,000,000
Statement of Profit/Loss or Depreciation	3,600,000	
Accumulated Depreciation		3,600,000
<i>Narration: Depreciation of equipment earlier omitted</i>		



Accrued Medical Insurance	1,900,000	
Prepaid Medical Insurance	900,000	
Suspense		2,800,000
<i>Narration: Correction of prepaid medical insurance of Shs 900,000 earlier credited to accrued medical insurance as Shs 1,900,000</i>		
Suspense	8,660,000	
Returns Inwards		4,330,000
Returns Outwards		4,330,000
<i>Narration: Correction of returns outwards earlier debited to returns inwards account</i>		
Suspense	900,000	
Bank		900,000
<i>Narration: Correction of electricity expense earlier debited to in the bank account</i>		
Suspense	450,000	
Sales		450,000
<i>Narration: Correction of an under cast in the sales daybook.</i>		
Trade Payable	1,500,000	
Suspense		1,500,000
<i>Narration: Correction of an overcast on a creditor's balance.</i>		
Discount Allowed	1,450,000	
Discount Received	1,450,000	
Suspense		2,900,000
<i>Narration: Correction of discount allowed earlier credited to discount received account</i>		
Trade Receivable	9,000,000	
Suspense		9,000,000
<i>Narration: Correction of an under cast in the debtors account</i>		
Bad Debts	1,500,000	
Trade Receivable	0	
<i>Narration: Bad debts earlier omitted, hereby corrected</i>		
Bank	2,300,000	
Purchases	0	
<i>Narration: Correction of goods drawn earlier entered in the bank account</i>		



(b) The Suspense account after the identification of errors shall appear as below

Dr	SUSPENSE ACCOUNT	Cr
Balance b/f	6,190,000	1,900,000
Returns Inwards	4,330,000	900,000
Returns Outwards	4,330,000	1,500,000
Bank	900,000	1,450,000
Sales	450,000	1,450,000
	<hr/>	9,000,000
	<b>16,200,000</b>	<b>16,200,000</b>

### EXAM REVISION QUESTION

#### QUESTION 8.2

You have just taken up your job as an accountant of Global Ltd and you find out that your assistant had prepared a trial balance for the company for the month of December 2006 but it failed to balance. The total on the debit side was more than the total on the credit side by shs 66,000. He opened a suspense account for the difference and proceeded to prepare financial statements. He reported a net profit of shs 1,480,000. During the month of January 2007, he discovered the following mistakes which had been made in December 2006.

1. The purchases account had been under cast by shs 4,000
2. Payment of shs 1,110,000 by cheque for insurance was properly recorded in the cash book but was posted to insurance account by mistake as shs 1,030,000.
3. A sales invoice of shs 600,000 was not recorded in the sales day book and therefore not posted to the ledger.
4. The credit side of the sales account was under-added by shs 8,000.
5. Motor vehicle repairs expense of shs 100,000 was debited to motor vehicles account.
6. Payment of shs 1,360,000 cash to John was properly recorded in John's account but was wrongly recorded in the cash book as shs 1,340,000.
7. The book-keeper had made a mistake by debiting ledger fees of shs 30,000 to cash book but well recorded in the ledger fees account.
8. Credit sale of shs 1,200,000 to Tino was recorded by error in Tina's account.
9. The bank column of the cash book credit side was over added by shs 2,000.
10. A credit note issued for shs 1,600,000 was properly recorded in the customer's account but wrongly recorded in the corresponding account as shs 1,640,000.
11. Discount received of shs 12,00 was debited to discount allowed account

**Required:**

**Prepare:**

- a. Journal entries to correct the errors [10marks]
  - b. a suspense account [5 marks ]
  - c. a statement of corrected net profit [5 marks ]
- [Total 20 marks]

**Source: CPA(U), December 2007, Question 3**



# 9.0

# BANK RECONCILIATION

## UNIT 9 OVERVIEW

- Introduction to Reconciliations.
- Types of Reconciliations.
- Bank Reconciliation.
- The Bank Statement
- The Bank reconciliation process
- The Format of Adjusted cashbook
- The Format of Bank reconciliation statement

## 9.1 INTRODUCTION TO RECONCILIATION

**What is Reconciliation?**

This refers to the process of bringing into agreement positions between two or more parties.

## 9.2 TYPES OF RECONCILIATIONS IN ACCOUNTING & FINANCE

In the context of accounting and finance, there exists 3 major reconciliations; i.e.

- (i) Bank reconciliation
- (ii) Accounts receivables reconciliation
- (iii) Accounts payables reconciliation

### 9.2.1 Parties involved in the above reconciliations

RECONCILIATION	PARTIES INVOLVED	
1. Bank Reconciliation	BUSINESS ENTERPRISE “Cash Book”	BANK “Bank Statement”
2. Accounts receivables Reconciliation	BUSINESS ENTERPRISE “Customer Ledger”	CUSTOMER “Trading statement”
3. Accounts payables reconciliation	BUSINESS ENTERPRISE “Vendor Ledger”	VENDOR “Trading statement”

This unit focuses on Bank reconciliations.

## 9.3 BANK RECONCILIATION

A **bank reconciliation** is a comparison of a bank statement (sent monthly, weekly or even daily by the bank) with the cash book. Differences between the balance in the bank statement and the balance in the cash book will be errors or timing differences, and they should be identified and satisfactorily explained.



### 9.3.1 Bank statement and cash book.

In theory, the entries appearing on a business **bank statement** should be exactly the same as those in the business cash book. The balance shown by the bank statement should be the same as the **cash book** balance on the same date.

The cash book of a business is the record **of how much cash the business believes** that it **has in the bank**. In the same way, you might keep a private record of how much you think you have in your own bank account, perhaps by making a note in your cheque book of income received and the cheques you write. If you do keep such a record, you will probably agree that your bank statement balance is rarely exactly the same as your own figure.

### 9.3.2 Discrepancies between Bank statement and cash book.

Why might your own estimate of your bank balance be different from the amount shown on your bank statement? There are three common explanations.

- (a) **Error.** Errors in calculation, or recording income and payments, are more likely to have been made by you than by the bank, but it is conceivable that the bank has made a mistake too.
- (b) **Bank charges or bank interest.** The bank might deduct charges for interest on an overdraft or for its services, which you are not informed about until you receive the bank statement.
- (c) **Timing differences.**
  - (i) There might be some cheques that you have received and paid into the bank, but which have not yet been '**cleared**' and added to your account. So although your own records show that some cash has been added to your account, it has not yet been acknowledged by the bank – although it will be soon once the cheque is cleared.
  - (ii) Similarly, you might have made some payments by cheque, and reduced the balance in your account in the record that you keep, but the person who receives the cheque might not bank it for a while. Even when it is banked, it takes a day or two for the banks to process it and for the money to be deducted from your account.

If you keep a personal record of your cash position at the bank, and if you check your periodic bank statements against what you think you should have in your account, you will be doing a bank reconciliation.

## 9.4 THE BANK STATEMENT.

It is a common practice for a business to issue a monthly statement to each credit customer, itemizing:

- (a) **The balance owed at the beginning** of the month.
- (b) **New debts** incurred during the month.
- (c) **Payments** made during the month.
- (d) **The balance owed at the end** of the month.



In the same way, a bank statement is sent by the bank to its short-term receivables and payables – i.e. customers with bank overdrafts and customers with money in their account – itemizing the balance on the account at the beginning of the period, receipts into the account and payments from the account during the period, and the balance at the end of the period.

It is necessary to remember, however, that if a customer has money in his account, the bank owes him that money, and the customer is therefore a **payable** of the bank (hence the phrase ‘to be in credit’ means to have money in your account). This means that if a business has UGX8,000,000 cash in the bank, it will have a credit balance in its own cash book, but the bank statement, if it reconciles exactly with the cash book, will state that there is a credit balance of UGX8,000,000. (*The bank’s records are a ‘mirror image’ of the customer’s own records, with the credits and debits reversed.*)

## 9.5 BANK RECONCILIATION PROCESS

The cash book and bank statement will rarely agree at a given date. If you are doing bank reconciliation, you may have to follow the four steps below;

### 9.5.1 Steps in the Bank Reconciliation Process

**STEP 1:** Post all the transactions that appear on the bank statement but do not appear in the cashbook. Take note of any errors made in posting transactions to the cashbook and correct these immediately. At the end of this step we shall have an adjusted / corrected cashbook.

***Corrections and adjustments to the cash book will often involve the following;***

- (i) Payments made into the bank account or from the bank account by way of standing order, which have not yet been entered in the cash book.
- (ii) Dividends received (on investments held by the business), paid direct into the bank account but not yet entered in the cash book.
- (iii) Bank interest and bank charges, not yet entered in the cash book.
- (iv) Errors in the cash book that need to be corrected.
- Take note that the **adjusted / corrected cash book** balance is the balance that is shown in the statement of financial position.

**STEP 2:** Identify all those cheques drawn (i.e. paid) by the business and credited in the cash book, which have not yet been presented to the bank, or ‘cleared’, and so do not yet appear on the bank statement. These are known as “UNPRESENTED CHEQUES”

**STEP 3:** Identify all those Cheques received by the business, paid into the bank and debited in the cash book, but which have not been cleared and entered in the account by the bank, and so do not yet appear on the bank statement. These are Known as “UNCREDITED CHEQUES”

**STEP 4:** Write up the bank reconciliation statement. This will mainly include items identified in step 2 and 3 above i.e. Unpresented and uncredited cheques. These together form what is known as “**ITEMS RECONCILING THE CORRECTED CASH BOOK BALANCE AND THE BANK STATEMENT**”



### 9.5.3 Format of the Bank Reconciliation Statement

	Shs "000"	Shs "000"
Balance as per adjusted cashbook		XX
<i>Add: Unpresented Cheques</i>		
Cheque #001	XX	
Cheque #002	XX	
Cheque #003	<u>XX</u>	XX
<i>Less: Uncredited Cheques</i>		
Cheque #004	XX	
Cheque #005	XX	
Cheque #006	<u>XX</u>	(XX) <u>XX</u>
Balance as per Bank statement		

#### Activity 9.1

On 30 June 2015, Mukasa's cash book showed that he had an overdraft of Shs.300,000 on his current account at the bank. A bank statement as at the end of June 2014 showed that Mukasa was in credit with the bank by Shs.65,000. On checking the cash book with the bank statement you find the following.

- (a) Cheques drawn, amounting to UGX500,000, had been entered in the cash book but had not been presented.
- (b) Cheques received, amounting to UGX400,000, had been entered in the cash book, but had not been credited by the bank.
- (c) On instructions from Mukasa the bank had transferred interest received on his deposit account amounting to UGX60,000 to his current account, recording the transfer on 5 July 2016. This amount had, however, been credited in the cash book as on 30 June 2014.
- (d) Bank charges of UGX35,000 shown in the bank statement had not been entered in the cash book.
- (e) The payments side of the cash book had been under-cast by UGX10,000.
- (f) Dividends received amounting to UGX200,000 had been paid direct to the bank and not entered in the cash book.
- (g) A cheque of UGX50,000 drawn on deposit account had been shown in the cash book as drawn on current account.
- (h) A cheque issued to Jones of UGX25,000 was replaced when out of date. It was entered again in the cash book, no other entry being made. Both cheques were included in the total unpresented cheques shown above.

#### Required

- (a) Indicate the appropriate adjustments in the cash book.
- (b) Prepare a statement reconciling the corrected cash book balance with that shown in the bank statement.

#### Activity 9.2

From the information given below relating to PWW Co you are required to:

- (a) Make additional entries in the cash at bank account of PWW as you consider necessary to show the correct balance at 31 October 2014.



- (b) Prepare a statement reconciling the correct balance in the cash at bank account as shown in (a) above with the balance at 31 October 2014 that is shown on the bank statement from ZBK Bank Co.

## CASH AT BANK ACCOUNT IN THE LEDGER OF PWW CO

2014 October	UGX	2014 October	UGX
1 Balance b/f	274		
8 Q Manufacturing	3,443	1 Wages	3,146
8 R Cement	1,146	1 Petty cash	55
11 S Co	638	8 Wages	3,106
11 T & Sons	512	8 Petty cash	39
11 U & Co	4,174	15 Wages	3,029
15 V Co	1,426	15 Petty cash	78
15 W Electrical	887	22 A & Sons	929
22 X and Associates	1,202	22 B Co	134
26 Y Co	2,875	22 C & co	77
26 Z Co	982	22 D & E	263
29 ABC Co	1,003	22 F Co	1,782
29 DEE Corporation	722	22 G Associates	230
29 GHI Co	2,461	22 Wages	3,217
31 Balance c/f	14	25 Petty cash	91
		26 H & Partners	26
		26 J Sons & Co	868
		26 K & Co	107
		26 K, L & N	666
		28 O Co	112
		29 Wages	3,191
		29 Petty cash	52
		29 P & Sons	561
	<u>21,759</u>		<u>21,759</u>

## ZBK BANK CO – STATEMENT OF ACCOUNT WITH PWW CO.

2014 October	Payments UGX	Receipts UGX	Balance UGX
1			1,135
1 cheque	55		
1 cheque	3,146		
1 cheque	421		2,487
2 cheque	73		O/D
2 cheque	155		2,715
6 cheque	212		2,927
8 sundry credit		4,589	
8 cheque	3,106		1,483
8 cheque	39		3,841
11 sundry credit		5,324	
15 sundry credit		2,313	
15 cheque	78		
15 cheque	3,029		3,047
22 sundry credit		1,202	
22 cheque	3,217		
22 cheque	91		941
25 cheque	1,782		
25 cheque	134		975
			O/D



26	cheque	929	
26	sundry credit		3,857
26	cheque	230	
27	cheque	263	
27	cheque	77	1,383
29	sundry credit		4,186
29	cheque	52	
29	cheque	3,191	
29	cheque	26	
29	dividends on Investments		2,728
29	cheque	666	4,362
31	bank charges	936	3,426

### Activity 9.3

Anne Opio has asked you to reconcile the balance on the bank statement to the bank account balance in her nominal ledger. You have checked her bank statement and other records and have noted the following

- i. Cheque No. 200132 from a credit customer is recorded in the Cash book as shs 560,000 but the bank statement shows that the correct figure is shs 650,000
- ii. Anne has paid for a number of items whose total value is shs 390,000 by standing orders that have been omitted from the cash book.
- iii. The bank has charged shs 22,000 for ledger fees and paid interest of shs 17,400 on Anne's account. These amounts have not yet be entered in the cash book.
- iv. One of Anne's customers made a direct deposit of shs 358,000 into the bank that has not been recorded by Anne.
- v. The following cheques have not been debited by the bank but are entered in the cash book.

Cheque No.	Shs
100029	400,000
100683	560,000
100687	120,000
100688	100,000

Cheque No. 100029 was sent to a supplier almost a year ago, but it did not arrive and the supplier was paid in cash

- vi. A lodgment of shs 487,000 has not yet been credited on the bank statement.
- vii. A cheque received from Jane Murungi for sh 500,000 was entered twice as a credit in the cash book.
- viii. The bank account credit column was under cast by shs 120,000
- ix. The bank column of the cash book had a debit balance shs 641,000

#### Required

- a. Prepare an adjusted cash book [10marks]
- b. Prepare the bank reconciliation statement [7marks]
- c. Briefly explain why a bank reconciliation statement should be prepared at the end of each accounting period [3marks]  
[Total 20 marks]

Source: CPA(U), June 2011, Question 4



## EXAM TYPE QUESTIONS

### QUESTION 9.4

The accounts assistant of Mutale Ltd had just completed preparing the draft financial statements for the year ended December 2012, showing a profit of Shs 406,040,000. On the same date the cash book showed a debit balance of Shs 24,450,000. Subsequently the following issues came to light:

- 1 Cheques amounting to Shs 5,000,000 paid to suppliers had been entered in the cash book but had not yet been presented to the bank for payment.
- 2 Cheques from customers totaling to Shs 14,450,000 entered in the cash book on 31 December 2012 were not credited by the bank until 3 January 2013.
- 3 The bank had charged ledger fees amounting to Shs 1,600,000, which amount appeared on the bank statement obtained from the bank on 31 December 2012. However, this amount had not yet been credited in the cash book.
- 4 A cheque for Shs 64,500,000 for new furniture had been mistakenly entered in the cash book and the furniture account as Shs 14,500,000. A full year's depreciation of 10% had been charged in the statement of comprehensive income in respect of this furniture.
- 5 A cheque for Shs 4,900,000 from a credit customer paid into the bank on 28 December 2012 was subsequently dishonored by the bank. It was decided that the debt be written off because the customer had become bankrupt.
- 6 A cheque for Shs 12,000,000 in payment for motor vehicles insurance had mistakenly been entered in the cash book as a debit and posted to the credit of motor vehicles account. Depreciation of 25% per annum is charged on the balance of motor vehicles account at the end of each accounting year on 31 December.
- 7 The total of the payments side of the cash book had been under cast by 5,000.000. It was also discovered that sales for the year were overstated by Shs 5,000,000.
- 8 The bank had credited Shs 800,000 on the company's current account on standing instructions from the company in respect of interest on a fixed deposit account of the company maintained at the same bank. In accounting for this transaction, the bookkeeper had made an entry on the payments side of the cash book for this amount and had posted it to the debit of interest payable account.

**Required:**

Prepare for Mutale Ltd for the year ended 31 December 2012:

- |   |                  |
|---|------------------|
| <p>(a) an adjusted cash book showing the revised balance which should appear in Mutale Ltd's statement of financial position.</p> | <b>(8 marks)</b> |
| <p>(b) a bank reconciliation statement.</p>   | <b>(5 marks)</b> |
| <p>(c) statement of corrected net profit.</p>   | <b>(7 marks)</b> |
| <b>(Total 20 marks)</b>   |                  |

**Source: CPA(U), June 2013, Question 5**



**SOLUTION TO EXAM TYPE QUESTION 9.4**

<b>Adjusted Cashbook</b>		
	Shs '000'	Shs '000'
Balance b/f	24,450	Bank charge
Interest	1,600	Furniture (64,500 - 14,500)
		Dishonoured cheque
		Motor vehicles
		insurance (12,000 x 2)
Balance c/d	<u>59,450</u>	Under casting error
	<u>85,500</u>	<u>5,000</u>
		<u>85,500</u>

5(b)

<b>Bank reconciliation statement</b>		
	Shs '000'	Shs '000'
Overdrawn balance as per adjusted cashbook	(59,450)	
Un-credited cheques	(14,450)	
Dishonoured cheque	<u>(4,900)</u>	(78,800)
Un-presented cheques		<u>5,000</u>
Overdrawn balance as per bank statement		<u>(73,800)</u>

(c)

<b>Statement of corrected net profit</b>		
	Shs '000'	Shs '000'
Profit per draft financial statements	406,040	
<b>Add</b> interest expense overstated	<u>1,600</u>	
Dishonoured cheque	407,640	
<b>Less:</b>		
Depreciation on furniture (64,500 - 14,500) x 10%	5,000	
Bad debts	4,900	
Bank charges	1,600	
Depreciation on motor vehicles (12,000 x 25%)	3,000	
Overstated sales	<u>5,000</u>	(19,500)
Corrected net profit		<u>388,140</u>



# 10.0

# CONTROL ACCOUNTS

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## UNIT 10 OVERVIEW:

- Introduction to Control Accounts.
  - Control Accounts and Personal Accounts.
  - Discounts.
  - Accounting for Discounts
  - The operation of Control Accounts
  - The Purpose of Control Accounts
  - Balancing and agreeing control Accounts
- 

## 10.1 INTRODUCTION TO CONTROL ACCOUNTS

A **control account** is an account in the nominal ledger in which a record is kept of the total value of a number of similar but individual items. Control accounts are used chiefly for trade receivables and payables.

- A **receivables control account** is an account in which records are kept of transactions involving all receivables in total. The balance on the receivables control account at any time will be the total amount due to the business at that time from its receivables.
- A **payables control account** is an account in which records are kept of transactions involving all payables in total. The balance on this account at any time will be the total amount owed by the business at that time to its payables.

Although control accounts are used mainly in accounting for receivables and payables, they can also be kept for other items, such as inventories, salaries, and cash. The first important idea to remember, however, is that a control account is an account which keeps a total record for a collective item (e.g. receivables), which in reality consists of many individual items (e.g. individual trade receivables)

A control account is an (impersonal) ledger account which will appear in the nominal ledger.

## 10.2 CONTROL ACCOUNTS AND PERSONAL ACCOUNTS

The personal accounts of individual customers of the business are kept in the receivables ledger, and the amount owed by each receivable will be a balance on the receivables personal account. The amount owed by the receivables together (i.e. the trade receivables) will be a balance on the receivables control account.

At any time the balance on the receivables control account should be equal to the sum of the individual balances on the personal accounts in the receivables ledger.

For example, a business has three trade accounts receivable. Mukasa owes Shs80,000, Baguma owes Shs310,000 and Mubiru owes Shs200,000. The debit balances on the various accounts would be:



<i>Receivables ledger (personal accounts)</i>	Shs"000"
Mukasa	80
Baguma	310
Mubiru	<u>200</u>
	590
<i>Nominal ledger: receivables control account</i>	<u>590</u>

What has happened here is that the three entries of shs80,000, shs310,000 and shs200,000 were first entered into the sales day book. They were also recorded in the three personal accounts of Mukasa, Baguma and Mubiru in the receivables ledger – but remember that this is not part of the double entry system.

Later, the **total** of shs590,000 is posted from the sales day book by a debit into the receivables (control) account and a credit to sales. If you add up all the debit figures on the personal accounts, they also total shs590,000, as shown above.

## 10.3 DISCOUNTS

### 10.3.1 Definition

A **discount** is a reduction in the price of goods below the amount at which those goods would normally be sold to other customers. There are two types of discount.

### 10.3.2 Types of discount

- (a) *Trade discount.*
- (b) *Cash or settlement discount.*

### 10.3.3 Trade Discount

- A **trade discount** is a reduction in the price of an item, given by a wholesaler or manufacturer to a retailer. It is often given in return for bulk purchase orders.

**Examples of trade discount.**

- (a) A customer is quoted a price of Shs100/= per unit for a particular item, but a lower price of shs95/= per unit if the item is bought in quantities of 100 units or more at a time.
- (b) An important customer or a regular customer is offered a discount on all the goods the customer buys, regardless of the size of each individual order, because the total volume of the customer's purchases is large over time.

### 10.3.4 Cash/settlement Discount

A **cash discount** (or **settlement discount**) is a reduction in the amount payable to the supplier, for a return for immediate payment in cash, rather than purchase on credit, or for payment within an agreed period.

For example, a supplier charges Shs1,000,000 for goods, but offers a discount of 5% if the goods are paid for immediately in cash. Alternatively, a supplier charges shs2,000,000 to a credit customer for goods purchased but offers a discount of 10% for payment within so many days of the invoice date.



### **10.3.5 Accounting for discounts.**

#### **10.3.6 Trade discounts.**

A trade discount is a reduction in the amount of money demanded from a customer.

- (a) If a trade discount is received by a business for goods purchased from a supplier, the amount of money demanded from the business by the supplier will be the net discount (i.e. it will be the normal sales value less the discount).
- (b) Similarly, if a trade discount is given by a business for goods sold to a customer, the amount of money demanded by the business will be after deduction of the discount.

Trade discounts should therefore be accounted for as follows.

- (a) **Trade discounts received** should be deducted from the gross cost of purchases. In other words, the cost of purchases in the trading account will be stated at gross cost minus discount (i.e. it will be stated at the invoiced amount).
- (b) **Trade discounts allowed** should be deducted from the net sales price, so that sales for the period will be reported in the trading account at their invoice value.

#### **10.3.7 Cash discounts received.**

When a business is given the opportunity to take advantage of a cash discount or a settlement discount for prompt payment, the decision whether or not to take the discount is a matter of financing policy, not of trading policy.

##### **Illustration 10.1: Trade Discounts**

For example, Otunnu buys goods from Besigye, on the understanding that Otunnu will be allowed a period of credit before having to pay for the goods. The terms of the transaction are as follows.

- (a) Date of sale: 1 July 2014
- (b) Credit period allowed: 30 days
- (c) Invoice price of the goods: shs2,000,000
- (d) Cash discount offered: 4% discount for prompt payment.

Otunnu has the following choices.

- (a) Holding onto his money for 30 days and then paying the full shs2,000,000.
- (b) Paying shs2,000,000 less 4% - i.e. shs1,920,000 now.

This is a financing decision about whether it is worthwhile for Otunnu to save shs80,000 by paying its debts sooner, or whether it can employ its cash more usefully for 30 days, and pay the debt at the latest acceptable moment. If Otunnu decides to take the cash discount, it will pay shs1,920,000, instead of the invoiced amount of shs2,000,000. The cash discount received (shs80,000) will be accounted for in the books of Otunnu as follows.

- (a) In the purchases account, the cost of purchases will be at the invoiced price (or 'full trade' price) of shs2,000,000. When the invoice for shs2,000,000 is received by A, it will be recorded in A's books of account at that price, and the subsequent financing decision about accepting the cash discount is ignored.
- (b) In the income statement, the cash discount received is shown as income received. There is no expense in the income statement from which the cash discount can be deducted, and so there is no alternative other than to show the discount received as 'other income'.



Note: cash or settlement discounts received are included as other income in the income statement

### Activity 10.1 Trade Discounts

Soft Suppliers Co recently purchased from Hard Imports Co 10 printers originally priced at shs200 each. A 10% trade discount was negotiated together with a 5% cash discount if payment was made within 14 days. Calculate the following.

- (a) The total of the trade discount.
- (b) The total of the cash discount

### 10.3.8 Cash discounts allowed.

The same principle is applied in accounting for cash discounts or settlement discounts allowed to customers. Goods are sold at a trade price, and an offer of discount on that price is a matter of financing policy for the business and not a matter of trading policy.

### Illustration 10.2: Cash Discounts

For example, X sells goods to Y at a price of shs5,000,000. Y is allowed 60 day's credit before payment, but is also offered a discount of 2% for payment within 10 days of the invoice date.

X will issue an invoice to Y for shs5,000,000 when the goods are sold. X has no idea whether or not Y will take advantage of the discount. In trading terms, and in terms of the amount charged in the invoice to Y, Y is a debtor for shs5,000,000.

If Y subsequently decides to take advantage of the discount, Y will pay shs5,000,000 less 2% - i.e. shs4,900,000 – ten days later. The discount allowed (100) will be accounted for by X as follows.

- (a) Sales will be valued at their full invoice price, shs5,000,000.
- (b) The discount allowed will be shown as an expense.

Note: Cash or settlement discounts allowed will be included as expenses in the income statement.

### EXAM FOCUS POINT

Students often get confused between cash and trade discounts. Exam questions could easily contain both types of discount so you must be able to distinguish between them and account for them correctly. Remember that only **cash (or settlement) discounts** are separately recorded in the books, sales and purchases are recorded **net of trade discounts**.



## 10.4 THE OPERATION OF CONTROL ACCOUNTS.

The two most important **control accounts** are those for **receivables** and **payables**. They are part of the double entry system.

## 10.5 ACCOUNTING FOR PAYABLES.

If you are able to follow the example above dealing with the receivables control account, you should have no difficulty in dealing with similar examples relating to purchases/payables. If necessary, refer back to revise the entries made in the purchases day book and purchase ledger personal accounts.

### 10.5.2 Entries in control accounts.

*Typical entries in control accounts are listed below.*

#### RECEIVABLES CONTROL ACCOUNT

	Shs "000"		Shs "000"
Opening debit balance b/d	XX	Opening credit balance (if any) b/d	XX
Sales	XX	Cash received	XX
Dishonoured bills or cheques	XX	Discounts allowed	XX
Cash paid to clear credit balances	XX	Returns inwards from customers	XX
Interest charged in late paid accounts	XX	Irrecoverable debts	XX
Closing credit balances c/d	XX	Closing debits balances c/d	XX
	<u><u>XX</u></u>		<u><u>XX</u></u>
Debit balances b/d	XX	Credit balances b/d	XX

**Note:** opening credit balances are unusual in the receivables control account. They represent customers to whom the business owes money, probably as a result of the over-payment of debts or for advance payment of debts for which no invoices have yet been sent.

#### PAYABLES CONTROL ACCOUNT

	Shs "000"		Shs "000"
Opening debit balance b/d (if any)	XX	Opening credit balance b/d	XX
Cash paid	XX	Purchases	XX
Discount received	XX	Interest paid on overdue accounts	XX
Returns outwards to suppliers	XX	Cash received clearing debit balances	XX
Closing credit balances c/d	XX	Closing debits balances c/d	XX
	<u><u>XX</u></u>		<u><u>XX</u></u>
Debit balances b/d	XX	Credit balances b/d	XX

**Note:** Opening debit balances in the payables control account would represent suppliers who owe the business money, perhaps because the business has overpaid or because a credit note is awaited for returned goods.



### 10.5.3 Contra entries

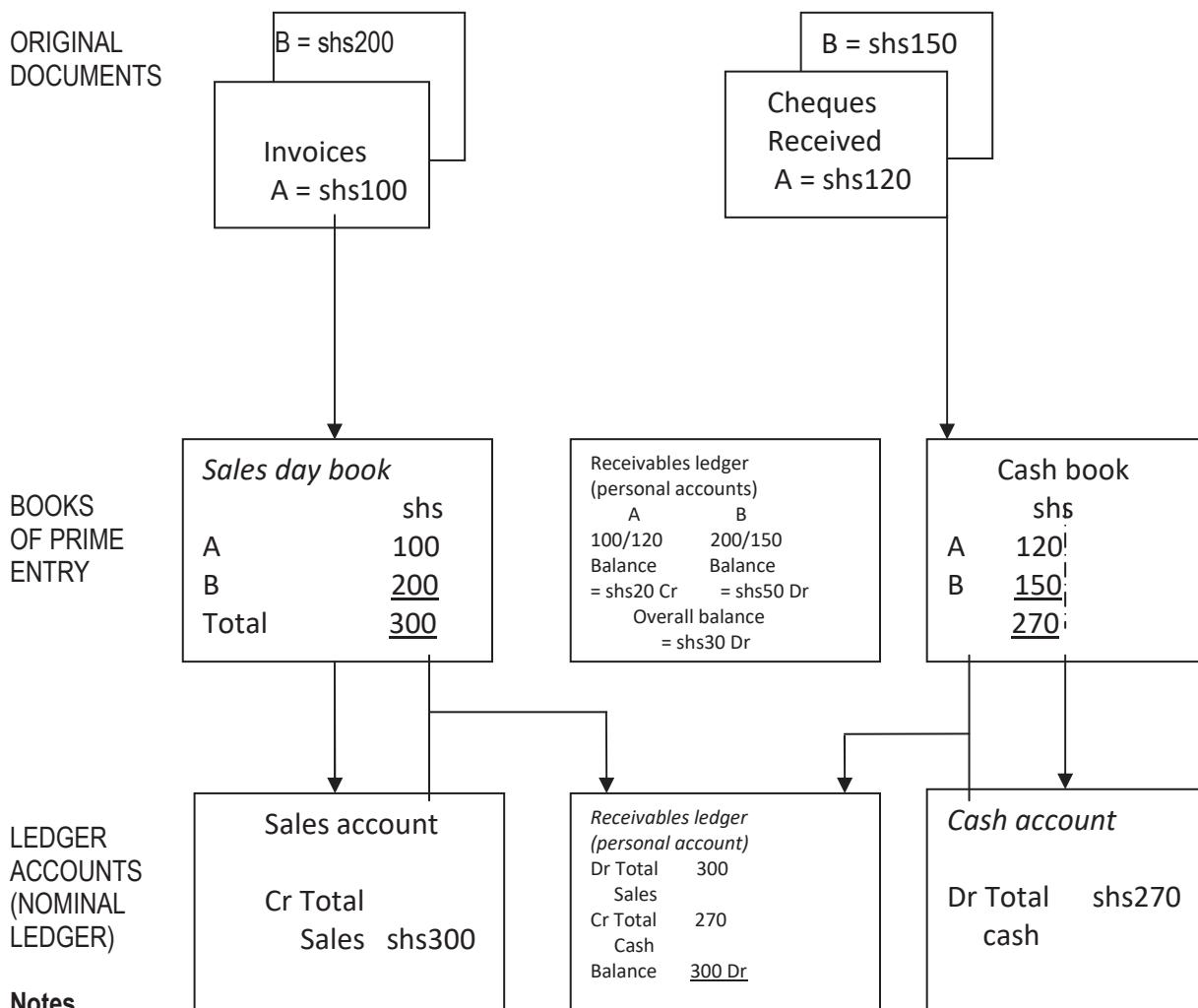
Sometimes the same business may be both a receivable and a payable. For example, Peter buys hardware from you and you buy stationery from Peter. In the receivables ledger, Peter owes you shs130,000. However, you owe Peter shs250,000. You may reach an agreement to offset the balances receivable and payable. This is known as a 'contra'. The double entry is as follows.

DEBIT	Payable control	shs130,000
CREDIT	Receivables control	shs130,000

You will also need to make the appropriate entries in the receivables and payables ledger. After this, Peter will owe you nothing and you will owe Peter shs120,000 (shs250,000 - shs130,000).

### 10.6 SUMMARY OF ENTRIES.

It may help you to see how the receivables ledger and receivables control account are used, by means of a flowchart.



- (a) The receivables ledger is not part of the double entry system (it is not used to post the ledger accounts).
- (b) Nevertheless, the total balance on the receivables ledger (i.e. all the personal account balances added up) should equal the balance on the receivables control account.



### Activity 10.2

On examining the books of Africana Ltd, you ascertain that on 1 October 2013 the receivables ledger balances were shs8,024,000 debit and shs57,000 credit, and the payables ledger balances on the same date shs6,235,000 credit and shs105,000 debit.

For the year ended 30 September 2014 the following particulars are available.

	Shs'000"
Sales	63,728
Purchases	39,974
Cash from trade accounts receivable	55,212
Cash to trade accounts payable	37,307
Discount received	1,475
Discount allowed	2,328
Returns inwards	1,002
Returns outwards	535
Irrecoverable debts written off	326
Cash received in respect of debit balances in payables ledger	105
Amount due from customer as shown by receivables ledger, offset against amount due to the same firm as shown by payables ledger (settlement contra)	434
Allowances to customers on goods damaged in transit	212

On 30 September 2014 there were no credit balances in the receivables ledger except those outstanding on 1 October 2013, and no debit balances in the payables ledger.

#### **Required**

Write up the following accounts recording the above transactions bringing down the balances as on 30 September 2014:

- (a) *Receivables control account*
- (b) *Payables control account.*

## 10.7 THE PURPOSE OF CONTROL ACCOUNTS.

The reasons for having control accounts are as follows.

- (a) They provide a **check on the accuracy** of entries made in the personal accounts in the receivables ledger and payables ledger. It is very easy to make a mistake posting entries, because there might be hundreds of entries to make. Figures can get transposed. Some entries might get omitted altogether, so that an invoice or a payment transaction does not appear in a personal account as it should. By comparing (i) and (ii) below, it is possible to identify the fact that errors have been made.
  - (i) The total balance on the receivables control account with the total individual balances on the personal accounts in the receivables ledger.
  - (ii) The total balances on the payables control account with the total of individual balances on the personal accounts in the payables ledger.



- (b) The control accounts also assist in the **location of errors**, where postings to the control accounts are made daily or weekly, or even monthly. If a clerk fails to record an invoice or a payment in a personal account, or makes a transposition error, it would be a formidable task to locate the error or errors at the end of the year, say, given the number of transactions. By using the control account, a comparison with the individual balances in the receivables or payables ledger can be made for every week or day of the month, and the error found much more quickly than if control accounts did not exist.
- (c) Where there is a separation of clerical (bookkeeping) duties, the control account provides an **internal check**. The person posting entries to the control accounts will act as a check on a different person's whose job it is to post entries to the receivables and payables ledger accounts.
- (d) To provide total receivables and payables balances more quickly for producing a trial balance or statement of financial position. A single balance on a control account is **obviously extracted more simply and quickly** than many individual balances in the receivables or payables ledger. This means also that the number of accounts in the double entry bookkeeping system can be kept down to a manageable size, since the personal accounts are memorandum accounts only.

However, particularly in computerized systems, it may be feasible to use receivables and payables ledgers without the need for operating separate control accounts. In such a system, the receivables or payables ledger print outs produced by the computer constitute the list of individual balances as well as providing a total balance which represents the control account balance.

#### **10.8 Balancing and agreeing control accounts with receivables and payables.**

The control accounts should be **balanced regularly** (at least monthly), and the balance on the account agreed with the sum of the individual debtors' or suppliers balances extracted from the receivables or payables ledgers respectively. It is one of the sad facts of an accountant's life that more often than not that the balance on the control accounts does not agree with the sum of the balances extracted, for one or more of the following reasons.

- (a) An **incorrect amount** may be **posted** to the control account because of a **miscalculation** of the total in the book of original entry (i.e. adding up incorrectly the total balances of the invoices or payments). The nominal ledger debit and credit postings will then balance, but the control account balance will not agree with the sum of the individual balances extracted from the (memorandum) receivables ledger or payables ledger. A **journal entry** must then be made in the nominal ledger to correct the control account and the corresponding sales or expense account.
- (b) A **transposition error** may occur in posting an individual's balance from the book of prime entry to the memorandum ledger, e.g. a sale to Peter of shs250,000 might be posted to the account as shs520,000. This means that the sum of balances extracted from the memorandum ledger must be corrected. **No accounting entry** would be required to do this; except to alter the figure in Peter's account.
- (c) A transaction may be **recorded in the control account and not in the memorandum ledger**, or vice versa. This requires an **entry in the ledger** that has been missed out which means a double posting if the control account has to be corrected, and a single posting if it is the individual's balance in the memorandum ledger that is at fault.
- (d) The sum of balances extracted from the memorandum ledger may be **incorrectly extracted or miscalculated**. This would involve simply **correcting the total of the balances**.



### Activity 10.3

MPK (U) Ltd sells goods on credit to most of its customers. In order to control its receivables collection system, the company maintains a receivables control account. In preparing the accounts for the year to 30 October 2013 the accountant discovers that the total of all personal accounts in the receivables ledger amounts to shs12,802,000, whereas the balance on the receivables control account is shs12,500,000.

Upon investigating the matter, the following errors were discovered.

- (a) Sales for the week ending 27 March 2013 amounting to shs850,000 had been omitted from the control account.
- (b) A customer's account balance of shs300,000 had not been included in the list of balances.
- (c) Cash received of shs750,000 had been entered in a personal account as shs570,000.
- (d) Discount allowed totaling shs100,000 had not been entered in the control account.
- (e) A personal account balance had been under cast by shs200,000.
- (f) A contra item of shs400,000 with the payables ledger had not been entered in the control account.
- (g) An irrecoverable debt of shs500,000 had not been entered in the control account.
- (h) Cash received of shs250,000 had been debited to a personal account.
- (i) Discounts received of shs50,000 had been debited to Bell's receivables ledger account
- (j) Returns inwards valued at shs200,000 had not been included in the control account.
- (k) Cash received of shs80,000 had been credited to a personal account as shs8,000.
- (l) A cheque of shs300,000 received from a customer had been dishonored by the bank, but no adjustment had been made in the control account.

**Required**

- (a) *Prepare a corrected receivables control account, bringing down the amended balance as at 1 November 2013.*
- (b) *Prepare a statement showing the adjustments that are necessary to the list of personal account balances so that it reconciles with the amended receivables control account balance.*



## EXAM TYPE QUESTIONS

### QUESTION 10.4

Mulefu Ltd, a dealer in motor vehicle spare parts, has been in business for the last five years. Most of the company dealings are on credit. Despite the growth and expansion, Mulefu's books of accounts reveal that working capital is not managed efficiently.

The following information was extracted from Mulefu Ltd's day books for the year ended 30 September 2014.

	Shs '000'
Total receipts from customers	3,002,850
Offsets against sales and purchases ledgers	350
Returns outwards	7,400
Discount received from credit suppliers	17,550
Credit purchases	2,483,000
Refund given to credit customers	25,350
Cash purchases	72,200
Credit sales	1,340,935
Cash sales	1,724,450
Total payment to suppliers	2,519,850
Discount allowed to credit customers	27,600
Decrease in allowance for doubtful debts	450
Bad debts written off	3,900
Returns inwards	20,700

On 1 October, 2013 the balances in the company's books were as follows:

Capital	Shs 45 billion
Trade receivables	Shs 132,775,000
Trade payables	Shs 217,250,000
Accrued rent	Shs 6,000,000

**Required:**

- (a) Control accounts are prepared to ascertain end of year balances for accounts receivable and accounts payable. Explain the merits of using control accounts. **(4 marks)**
  
- (b) Prepare the following control accounts to ascertain the end of year balances to be included in the financial statements:
  - (i) Trade receivables. **(8 marks)**
  - (ii) Trade payables. **(8 marks)****(Total 20 marks)**

**Source: CPA(U), November 2014, Question 3**



## EXAM TYPE QUESTIONS

### QUESTION 10.5

The following figures were extracted from the ledger of M/s Amenda & Sons on 30 January 2010:

	Shs '000'
Purchases ledger balance at 1 January 2010	292,280
Sales ledger balance at 1 January 2010	348,500
 Totals for January 2010	
Purchases journal	8,305,300
Sales journal	3,925,920
Returns outwards journal	53,680
Returns inwards journal	86,420
Cheques and cash paid to suppliers	2,833,740
Cheques and cash received from customers	3,937,000
Discounts allowed	107,600
Discounts received	41,580
Bad debts written off	8,240
Customers cheques dishonoured	800
Cash sales	1000
Cash purchases	600

**Required**

- (a) Prepare sales ledger and purchases ledger control accounts, showing clearly the total debtors and total creditors at 31 January 2010. **(16 marks)**
- (b) Briefly explain **four** uses of control accounts. **(4 marks)**

**(Total 20 marks)**

**Source: CPA(U), June 2010, Question 3**



## PART D

# **Adjustments to Financial Statements**

# 11.0

# DEPRECIATION AND DISPOSAL OF NON-CURRENT ASSETS

## UNIT 11 OVERVIEW:

- Non-current assets and current assets
- Capital and revenue expenditures
- Capital Income and Revenue Income
- Depreciation
- Non-current Asset Disposal

## 11.0 NON-CURRENT AND CURRENT ASSETS.

Non-current assets are assets which are bought by the business for **continuing use**. **Tangible non-current assets** are those with **physical form**.

A statement of financial position contains both non-current and current assets. But what is the difference between the two?

- **Non-current assets** are assets which are intended to be used by the business on a continuing basis and include both tangible and intangible assets.
- **Non-current assets** are assets bought by the business for use in the **long term**. Non-current assets include **tangible assets** (so those with physical form that are subject to this chapter) and **intangible assets**.
- **Current assets** are assets that will be realized, consumed or sold in the normal **operating cycle** of the business or are assets held primarily for trading. Current assets include trade receivables and inventories.

## 11.1 CAPITAL AND REVENUE EXPENDITURE.

**Capital expenditure** is expenditure which forms part of a **cost of non-current assets**. **Revenue expenditure** is the expenditure incurred for the **purpose of the trade** or to **Maintain non-current assets**.

- (a) Capital expenditure is not charged as an expense in the income statement, although a depreciation or amortization charge will usually be made to write off the capital expenditure gradually over time. **Depreciation and amortization charges** are expenses in the income statement.
- (b) Capital expenditure on non-current assets results in the recognition of a non-current asset in the statement of financial position of the business.
- **Revenue expenditure** is expenditure which is incurred for either of the following reasons.



- (a) For the purpose of the trade of the business. This includes expenditure classified as selling and distribution expenses, administration expenses and finance charges.
  - (b) To maintain the existing earning capacity of non-current assets.
- **Capital expenditure** is expenditure that can be **capitalized** as part of the cost of a non-current asset.
  - **Revenue expenditure** cannot be capitalized as part of the cost of a non-current asset and must be expensed in the income statement.

#### **Activity 11.1 Capital and Revenue expenditure**

ABC (U) Ltd purchased a building for shs300 million on 1 January 2015. During the month of February 2015, an extension was added to the building at a cost of shs100 million. The building needs to have a few broken windows mended, its floors polished and some missing roof tiles replaced. A quotation for the cleaning and maintenance jobs of shs9,000,00 has been received from the XYZ engineering firm.

#### **Required**

- (i) Identify the capital and revenue expenditure incurred by XYZ in the above scenario.
- (ii) Advise the accountant of XYZ (U) Ltd on the double entry to be made to include the above transactions in the books of accounts

## **11.2 CAPITAL INCOME AND REVENUE INCOME.**

- **Capital income** is the proceeds from the sale of non-trading assets (i.e. proceeds from the sale of non-current assets, including long term investments). The profits (or losses) from the sale of non-current assets are included in the income statement of a business, for the accounting period in which the sale takes place. For instance, the business may sell vehicles or machinery which it no longer needs – the proceeds will be capital income.
- **Revenue income** is income derived from the following sources.
  - (a) The sale of trading assets, such as goods held in inventory.
  - (b) The provision of services.
  - (c) Interest and dividends received from investments held by the business.

### **11.2 Why is the distinction between capital and revenue important?**

Since revenue items and capital items are accounted for in different ways, the correct and consistent calculation of profit for any accounting period depends on the correct and consistent classification of items as revenue or capital.

- **Revenue expenditure** results from the purchase of goods and services for one of the following reasons.
  - (a) To be used fully in the accounting period in which they are purchased, and so be a cost expense in the income statement. OR
  - (b) To result in a current asset as at the end of the accounting period because the goods or services have not yet been consumed or used. The current asset would be shown in the statement of financial position and is not yet a cost or expense in the income statement.



For instance, inventory which is purchased for resale will either be sold during the period as per (a) or still be in inventory as per (b).

- **Capital expenditure** results in the **purchase or improvement of non-current assets**, which are assets that will provide benefits to the business in more than one accounting period, and which are not acquired with a view to being resold in the normal course of trade. The cost of the purchased assets is not charged in full to the income statement of the period in which the purchase occurs. Instead, the non-current asset is gradually depreciated over a number of accounting periods in accordance with the accruals concept.

### Activity 11.2 Capital and Revenue distinction

State whether each of the following items should be classified as 'capital' or 'revenue' expenditure or income for the purpose of preparing the income statement and the statement of financial position of the business.

- The purchase of a property (e.g. an office building).
- The annual depreciation of such a property.
- Lawyer's fees in connection with the purchase of such a property.
- The costs of adding extra storage capacity to a computer used by the business.
- Computer repairs and maintenance costs.
- Profit on the sale of an office building.
- Revenue from sales by credit card.
- The cost of a new plant.
- Customs duty charged on the plant when imported into the country.
- The 'carriage' costs of transporting the new plant from the supplier's factory to the premises of the business purchasing the plant.
- The cost of installing the new plant in the premises of the business.
- The wages of the machine operators.

## 11.3 DEPRECIATION

**Depreciation refers to** the systematic allocation of the depreciable amount of an asset over its estimated useful life.

The need to depreciate non-current assets arises from the **accruals assumption**. If money is expended in purchasing an asset then the amount expended must at some point be charged against profits. If the asset contributes to an entity's revenue over a number of accounting periods, it would be inappropriate to charge any single period (e.g. the period in which the asset was acquired) with the whole of the expenditure. Instead, some method must be found of spreading the cost of the asset over its useful life.

The view of depreciation as a process of allocation of the cost of an asset over several accounting periods is the view adopted by IAS 16. It is worth mentioning here two **common misconceptions** about the purpose and effects of depreciation.

- It is sometimes thought that the carrying amount of an asset is equal to its net realizable value (i.e. the amount the asset could be sold for less the selling costs) and that the reason for changing depreciation is to reflect the fall in value of an asset over its life. This misconception is the basis of a common, but incorrect, argument which says that freehold properties (say) need to be depreciated in times when the property



values are rising. It is true that historical cost often gives misleading impression when a property's carrying amount is much below its market value, but in such a case the business can choose to revalue the property. This is a separate problem from that of allocating the property's cost over successive accounting periods.

- (b) Another misconception is that depreciation is provided so that an asset can be replaced at the end of its useful life. This is not the case.
- (a) If there is no intention of replacing the asset, it could then be argued that there is no need to provide for any depreciation at all.
  - (ii) If prices are rising, the replacement cost of the asset will exceed the amount of depreciation provided.

### 11.3.1 KEY CONCEPTS

#### (a) DEPRECIABLE AMOUNT

The depreciable amount of a depreciable asset is the historical cost or other amount substituted for historical cost in the financial statements, less the estimated residual value.

#### (b) DEPRECIABLE ASSETS

These are assets which:

- (i) Are expected to be used during more than one accounting period.
- (ii) Have a limited useful life; and
- (iii) Are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes.

An amount substituted for historical cost will normally be a **current market value** after a revaluation has taken place.

#### (c) USEFUL LIFE

IAS 16 requires the depreciable amount to be allocated on a **systematic basis** to each accounting period during the useful life of an asset.

**Useful life** is either:

- The period over which a depreciable asset is expected to be used by the enterprise; or
- The number of production or similar units expected to be obtained from the asset by the enterprise.

The following factors should be considered when **estimating the useful life** of a depreciable asset.

- Expected physical wear and tear.
- Obsolescence.
- Legal or other limits on the use of the assets.

Once decided, the useful life should be reviewed at least annually and depreciation rates adjusted for the current and future periods if expectations vary significantly from the original estimates. The effect of the change should be disclosed in the accounting period in which the change takes place.



The assessment of useful life requires judgment based on previous experience with similar assets or classes of asset. When a completely new type of asset is acquired (i.e. through technological advancement or through use in producing a brand new product or service) it is still necessary to estimate useful life, even though the exercise will be much more difficult.

IAS 16 also points out that the physical life of an asset might be longer than its useful life to the enterprise in question. One of the main factors to be taken into consideration is the physical wear and tear the asset is likely to endure. This will depend on various circumstances, including the number of shifts for which the asset is used, the enterprise's repair and maintenance program and so on. Other factors to be considered include obsolescence (due to technological advances/improvements in production/reduction in demand for the product/service produced by the asset) and legal restrictions, e.g. length of a related lease.

#### **(d) RESIDUAL VALUE**

**The residual value** is the net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

In most cases the residual value of an asset is **likely to be immaterial**. If it is likely to be of any significant value, that value must be estimated at the date of purchase or any subsequent revaluation. The amount of residual value should be estimated based on the current situation with other similar assets, used in the same way, which are now at the end of their useful lives. Any expected costs of disposal should be offset against the gross residual value.

**For example:**

- (a) A non-current asset costing shs20,000,000 which has an expected life of five years and an expected residual value of nil should be depreciated by shs20,000,000, in total over the five year period.
- (b) A non-current asset costing shs20,000,000 which has an expected life of five years and an expected residual value of shs3,000,000 should be depreciated by shs17,000,000 in total over the five year period.

#### **11.3.2 DEPRECIATION METHODS.**

- Depreciation is a means of **spreading the cost** of a non-current asset over its useful life, in order to match the cost of the asset with the profits it earns for the business.
- So for each accounting period, depreciation is charged to the income statement and also deducted from the non-current asset balance to give the asset's carrying amount.
- The amount of depreciation deducted from the cost of a non-current asset to arrive at its carrying amount will accumulate over time, as more depreciation is charged in each successive accounting period.
- There are several different methods of depreciation, which include;
  - (i) *Straight line method*
  - (ii) *Reducing balance method*
  - (iii) *Sum of Digits method*

##### **(i) THE STRAIGHT LINE METHOD**

This is the most commonly used method of all. The total depreciable amount is charged in equal installments to each accounting period over the expected useful life of the asset. In this way, the carrying amount of the non-current asset declines at a steady rate, or in a 'straight line' over time.



The annual depreciation charge is calculated as:  $\frac{\text{Cost of asset} - \text{residual value}}{\text{Expected useful life of the asset}}$ .

### Activity 11.3 Straight line method

MPK Ltd purchased an item of non-current asset costing shs20,000,000 with an estimated life of 10 years and no residual value.

**Required**

- (i) Compute the annual depreciation charge of the non-current asset using the straight line method
- (ii) Compute the carrying amount of the asset over its useful life.
- (iii) Express the depreciation charge of the above asset as a percentage on cost

- The straight line method of depreciation is a fair allocation of the total depreciable amount between the different accounting periods, provided that it is reasonable to assume that the business enjoys equal benefits from the use of the asset in every period throughout its life. An example of this shelving (fixtures and fittings) in the accounts department.
- **Assets acquired part-way through an accounting period.**

A business can purchase new non-current assets at any time during the course of an accounting period. It is reasonable to charge an amount for depreciation only from the date that the business has owned the asset, which might be part-way through an accounting period.

### Activity 11.4 Asset acquired part-way through an accounting period

A business which has an accounting year which runs from 1 January to 31 December purchases a new non-current asset on 1 April 2014, at a cost of shs24,000,000. The expected life of the asset is 4 years, and its residual value is nil.

**Required**

Determine the depreciation charge for 2014

#### EXAM FOCUS POINT

If an exam question gives you the purchase date of a non-current asset which is part-way through an accounting period, you should generally assume that depreciation should be calculated in this way as a 'part-year', unless the question states otherwise.

- In practice, many businesses take a simplified approach where an asset has been purchased part-way through an accounting period. Instead of calculating the depreciation from the date the asset is acquired, the business instead charges a full year's depreciation in the year it is purchased and then no depreciation in the year it is disposed of.



## (ii) THE REDUCING BALANCE METHOD.

The **reducing balance method** of depreciation calculates the annual depreciation charge as a fixed percentage of the carrying amount of the asset, as at the end of the previous accounting period.

### Activity 11.5 Reducing balance method

A business purchases a non-current asset at a cost of shs10,000,000. Its estimated residual value is shs2,160,000. The business wishes to use the reducing balance method to depreciate the asset, and calculates that the rate of depreciation should be 40% of the reducing (carrying) amount of the asset.

**Required**

- (i) Compute the annual depreciation charge of the non-current asset using the reducing balance method
- (ii) Compute the carrying amount of the asset over its useful life.

#### EXAM FOCUS POINT

If you are expected to use the reducing balance method in the exam, you will be given the percentage rate to apply; you will not have to calculate it.

You should note that with the reducing balance method, the annual charge for depreciation is higher in the earlier years of the asset's life, and lower in the later years.

The reducing balance might therefore be used when it is considered fair to allocate a greater proportion of the total depreciable amount to the earlier years and a lower proportion to later years, on the assumption that the benefits obtained by the business from using the asset decline over time. An example of this could be machinery in a factory, where productivity falls as the machine gets older.

It is permissible for a business to depreciate different categories of non-current assets in different ways. For example, if a business owns three cars, then each car would normally be depreciated in the same way (e.g. by the straight line method).

### Activity 11.6

A lorry bought for a business cost shs17,000,000. It is expected to last for five years and then be sold for scrap for shs2,000,000.

*Required.*

*Work out the depreciation to be charged each year under:*

- (a) The straight line method.
- (b) The reducing balance method (using a rate of 35%).



## 11.4 CHANGE IN METHOD OF DEPRECIATION.

It is up to the business concerned to decide which method of depreciation to apply to its non-current assets. Once that decision has been made, the chosen method of depreciation should be applied **consistently from year to year**. However, IAS 16 requires that the **depreciation method** should be reviewed periodically. If there has been a change a significant change in the expected pattern of economic benefits from those assets, the method be changed to suit this new pattern. When such a change in depreciation method takes place the remaining carrying amount is depreciated under the new method, i.e. only current and future periods are affected; the change is not retrospective.

### **Activity 11.7 Change in method of depreciation**

Jakob Co purchased an asset for shs100,000 on 1.January 2011. It had an estimated useful life of 5 years and it was depreciated using the reducing balance method at a rate of 40%. On 1.January 2014 it was decided to change the method to straight line.

**Required**

Show the depreciation charge for each year (to 31 December) of the asset's life.

## 11.5 CHANGE IN EXPECTED USEFUL LIFE OR RESIDUAL VALUE OF AN ASSET.

The depreciation charge on a non-current asset depends not only on the cost (or value) of the asset and its estimated residual value, but also on its **estimated useful life**.

A business purchased a non-current asset costing shs12,000,000 with an estimated life of four years and no residual value. If it used the straight line method of depreciation, it would make an annual provision of 25% of shs12,000,000 = shs3,000,000.

Now that would happen if the business decided after two years that the useful life of the asset has been underestimated, and it still had five more years in use to come (making its total life seven years)

For the first two years, the asset would have been depreciated by shs3,000,000 per annum, so that its carrying amount after two years would be shs $(12,000,000 - 6,000,000)$  = shs6,000,000. If the remaining life of the asset is now revised to five more years, the remaining amount to be depreciated (here shs6,000,000) should be spread over the remaining life, giving an annual charge for the final five years of:

$$\frac{\text{Carrying amount at time of life readjustment} - \text{residual value}}{\text{New estimate of remaining useful life}} = \frac{\text{shs6,000,000}}{5 \text{ years}} = \text{shs1,200,000 per year}$$

### FORMULA TO LEARN

$$\text{New depreciation} = \frac{\text{Carrying amount} - \text{residual value}}{\text{Revised useful life}}$$



## **11.6 DEPRECIATION IS NOT A CASH EXPENSE.**

Depreciation spreads the cost of a non-current asset (less its estimated residual value) over the asset's useful life. The cash payment for the non-current asset will be made when, or soon after, the asset is purchased. Annual depreciation of the asset in subsequent years is not a cash expense – rather it allocates costs to those later years for a cash payment that has occurred previously.

For example, a business purchased some shop fittings for shs6,000,000 on 1 January 2015 and paid for them in cash on that date.

Subsequently, depreciation may be charged at shs600,000 every year for ten years. So each year shs600,000 is deducted from profits and the carrying amount of the fittings goes down, but no actual cash is being paid. The cash was all paid on 1 January 2015. So annual depreciation is not a cash expense, but rather an allocation of the original cost to later years.

### **Revision Question 11.1**

- (a) What is the purpose of depreciation?
- (b) In what circumstances is the reducing balance method more appropriate than the straight line method? Give reasons for your answer.

### **ANSWER TO 11.1**

- (a) The purpose of depreciation is to spread the cost of a non-current asset over its useful life in order to match the cost of the asset over the full period over which the asset earns profit for the business. Charging depreciation is an application of the accruals concept.
- (b) The reducing balance method of depreciation is used instead of the straight line method when it is considered fair to allocate a greater proportion of the total depreciable amount to the earlier years and a lower proportion to the later years, on the assumption that the benefits obtained by the business from using the asset decline over time.

In favour of this method it may be argued that the depreciation charge to the costs of maintaining and running the asset. In the early years these costs are low and the depreciation charge is high, while in later years this is reversed.

## **11.7 LEDGER ENTRIES FOR DEPRECIATION.**

The ledger accounting entries for depreciation are as follows.

- (a) There is an accumulated depreciation account for each separate category of non-current assets, for example, plant and machinery, land and buildings. Fixtures and fittings.



(b) The depreciation charge for an accounting period is a charge against profit. It is accounted for as follows.

DEBIT      Depreciation expense (income statement)  
 CREDIT      Accumulated depreciation account (statement of financial position)

*with the depreciation charge for the period.*

- (c) The balance on the statement of financial position, depreciation account is the total accumulated depreciation. This always a credit balance brought forward in the ledger account for depreciation.
- (d) The non-current asset accounts are unaffected by depreciation. Non-current assets recorded in these accounts at cost (or, if they are revalued, at their revaluated amount).
- (e) In the statement of financial position of the business, the total balance on the accumulated depreciation account is set against the value of non-current asset accounts (i.e. non-current assets at cost or revalued amount) to derive the carrying amount of the non-current assets

This is how the non-current asset accounts might appear in a trial balance.

	DR shs	CR shs
Freehold building – cost	2,000,000	
Freehold building – accumulated depreciation		500,000
Motor vehicles – cost	70,000	
Motor vehicles – accumulated depreciation		40,000
Office equipment – cost	25,000	
Office equipment – accumulated depreciation		15,000

And this is how they would be shown in the statement of financial position:

Non-current assets	shs
Freehold building (2,000,000 – 500,000)	1,500,000
Motor vehicles (70,000 – 40,000)	30,000
Office equipment (25,000 – 15,000)	10,000

## 11.9 NON-CURRENT ASSET DISPOSAL

When a non-current asset is sold, there likely to be a **profit or loss on disposal**. This is the difference between the net sale price of the asset and its carrying amount at the time of disposal.

### 11.9.1 The disposal of non-current assets.

Non-current assets are not purchased by a business with the intention of reselling them in the normal course of trade. However, they might be sold off at some stage during their life, either when their useful life is over or before then. A business might decide to sell off a non-current asset long before its useful life has ended.

Whenever a business sells something, it might make a profit or loss. When non-current assets are disposed of, there will be a profit or loss on disposal. As it is a capital item being sold, the profit or loss will be a capital gain or capital loss. These gains or losses are reported in the income and expenses part of the income statement of the



business, after gross profit. They are commonly referred to as ‘**profit on disposal of non-current assets**’ or ‘**loss on disposal**’.

Examination questions on the disposal of non-current assets are likely to ask for ledger accounts to be prepared, showing the entries in the accounts to record the disposal. But before we look at ledger accounting for disposal of assets, we had better look at the principles behind calculating the profit (or loss) on disposal of assets.

### 11.9.2 Principles behind calculating the profit or loss on disposal.

The profit or loss on the disposal of a non-current asset is the difference between (a) and (b) below.

- (a) The carrying amount of the asset at the time of its sale.
- (b) Its net price, which is the price minus any costs of making the sale.

A profit is made when the sale price exceeds the carrying amount, and a loss is made when the sale price is less than the carrying amount.

#### Activity 11.8

A business purchased a non-current asset on 1 January 2011 for shs25 million. It had an estimated life of six years and an estimated residual value of shs7 million. The asset was eventually sold after three years on 1 January 2014 to another trader who paid shs17.5 million for it.

**Required**

**What was the profit or loss on disposal, assuming that the business uses the straight line method of depreciation?**

#### Activity 11.9

A business purchased a machine on 1 July 2011 at a cost of UGX35 million. The machine had an estimated residual value of UGX3 million and a life of 8 years. The machine was sold at UGX18.6 million on 31 December 2014, the last day of the accounting year of the business. To make the sale, the business had to incur dismantling costs and costs of transporting the machine to the buyer’s premises. These amounted to UGX1.2 million.

**Required**

**The business uses the straight line method of depreciation. What was the profit or loss on the machine?**

### 11.9.3 The disposal of non-current assets: ledger accounting entries.

From the above computations, a profit on disposal is an item of ‘other income’ in the income statement, and a loss on disposal is an item of expense in the income statement. It is customary in ledger accounting to record the disposal of non-current assets in a disposal of non-current assets account.

**(a) The profit or loss on disposal is the difference between:**

- (i) The sale price of the asset (if any); and
- (ii) The carrying amount of the asset at the time of sale.



**(b) The following items must appear in the disposal of non-current assets account:**

- (i) The value of the asset (at cost, or revalued amount\*).
- (ii) The accumulated depreciation up to the date of the sale.
- (iii) The sale price of the asset.

\*To simplify the explanation of the rules, we will assume that the non-current assets disposed of are valued at cost.

**(c) The ledger accounting entries are as follows.**

- (i) DEBIT Disposal of non-current asset account  
CREDIT Non-current asset account  
*With the cost of the asset disposed of.*
- (ii) DEBIT Accumulated depreciation account  
CREDIT Disposal of non-current asset account.  
*With the accumulated depreciation on the asset as at date of sale*
- (iii) DEBIT Receivable account or cash book  
CREDIT Disposal of non-current asset account

The balance on the disposal account is the profit or loss on disposal and the corresponding double entry is recorded in the income and expense account.

**Activity 11.10**

A business includes shs110 million worth of machinery at cost in its accounts. Its policy is to make a provision for depreciation at 20% per annum straight line. The total provision now stands at shs70 million. The business sells for shs19 million a machine which purchased exactly two years ago for shs30 million.

**Required**

Show the relevant ledger entries.

**Activity 11.11**

A business purchased two rivet-making machines on 1 January 2012 at a cost of shs15,000,000 each. Each had an estimated life of five years and a nil residual value. The straight line method of disposal is used.

Owing to an unforeseen slump in market demand for rivets, the business decided to reduce its output of rivets, and switch to making other products instead. On 31 March 2014, one rivet-making machine was sold (on credit) to a buyer for shs8,000,000.

Later in the year, however, it was decided to abandon production of rivets altogether, and the second machine was sold on 1 December 2014 for shs2,500,000 cash.

**Required: Prepare the**

- (a) **Machinery account,**
- (b) **Depreciation of machinery account and**
- (c) **Disposal of machinery account for the accounting year to 31 December 2014.**



## **11.10 THE ASSET REGISTER.**

**An asset register** is used to record all non-current assets and is an **internal check** on the accuracy of the nominal ledger.

Nearly all organizations keep an asset register. This is a listing of all non-current assets owned by the organization, broken down perhaps by department, location or asset type.

An asset register is maintained primarily for internal purposes. It shows an organization's investment in capital equipment. The register is also part of the **internal control system**. The asset registers are sometimes called **real accounts**.

### **11.10.1 Data kept in an asset register.**

Details about each non-current asset include the following.

- The internal reference number (for physical identification purposes)
- Manufacturer's serial number (for maintenance purposes)
- Description of asset.
- Location of asset.
- Department which owns asset.
- Purchase date (for calculation of depreciation).
- Cost.
- Depreciation method estimated useful life (for calculation of depreciation).
- Carrying amount.

### **11.10.2 Use of asset register.**

From time to time, the asset register should be checked to the accounting records. Any discrepancies must be investigated and the records corrected. For example, an asset may have been scrapped and the asset register updated, but the asset has not been written off in the accounting records. Periodically, all physical non-current assets should be checked to the current register. This helps to deter theft.



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### Exam Type Questions

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#### **Activity 11.12**

Kabarole Tea Factory Ltd had the following balances at 1 July 2012;

	Shs '000'
Plant and machinery	2,863,000
Accumulated depreciation	1,117,800
Net book value	1,745,200

The company depreciates its plant and machinery at the rate of 40% per annum on book value. A full year's depreciation is made in the year of purchase but none in the year of disposal.

The following transactions took place during the year ended 30 June 2013:

2 August 2012: Purchased 2 machines at Shs 120,000,000 each and paid Shs 2,000,000 for transportation of the machines to the factory.

30 November 2012: A machine which had been bought on 10 September 2010 at Shs 160,000,000 was not matching the factory's latest technology. It was traded in for a new machine costing Shs 200,000,000, the trade in allowance being Shs 40,000,000.

1 March 2013: Purchased plant for Shs 250,000,000, incurring Shs 10,000,000 on installation and assembling the new plant.

30 April 2013: Disposed of plant at Shs 75,000,000, which had cost Shs 180,000,000 on 15 July 2009.

*Note: All the transactions were made through the company's bank account.*

**Required:**

**Prepare the following accounts in the books of Kabarole Tea Factory Ltd, showing all the necessary workings;**

- (a) **Plant and machinery account.**
- (b) **Accumulated depreciation of plant and machinery account.**
- (c) **Disposal of plant and machinery account.**

**Source: CPA(U), November 2013, Question 3**

#### **SOLUTION TO ACTIVITY 11.12 – Kabalore Tea Factory Ltd**

**(a)**

##### **Plant and Machinery A/C**

	Shs '000"		Shs "000"
New Machine:			
Bank	160,000	Disposals A/c	160,000
Disposal	40,000		
Bank - Plant	<u>260,000</u>	Balance c/f	<u>3,225,000</u>
	<u>3,565,000</u>		<u>3,565,000</u>
Balance b/f	3,225,000		



(b)

**Accumulated Depreciation of Plant & Machinery Account**

DR.

CR

	Shs 000		Shs 000
Disposal - Machine	102,400	Balance b/f	1,117,800
Disposal – Plant	141,120	SPL&C - Depreciation	940,280
Balance c/f	<u>1,814,560</u>		-
	<u>2,058,080</u>		<u>2,058,080</u>
		Balance c/f	1,814,560

**WORKINGS:**

**Depreciation Disposed Plant & Machinery:**

Machinery	Shs 000	Plant	Shs 000
<b>Cost</b>	160,000	Cost	180,000
Depreciation for 2010/2011	<u>(64,000)</u>	Depreciation for 2009/2010	<u>(72,000)</u>
NBV at 30.6.2011	96,000	NBV at 30.6.2010	108,000
Depreciation for 2011/2012	<u>(38,400)</u>	Depreciation for 2010/2011	<u>(43,200)</u>
NBV at 30.6.2012	<u>57,600</u>	NBV at 30.6.2011	64,800
		Depreciation for 2011/2012	<u>(25,920)</u>
		NBV at 30.6.2012	<u>38,880</u>

**Accumulated Depreciation of Disposed Plant & Machinery:**

**Machinery:** 64,000,000 + 38,400,000 =Shs 102,400,000

**Plant:** 72,000,000 + 43,200,000 + 25,920,000 =Shs 141,120,000

**Depreciation for the Year Ending 30 June 2013:**

		Shs 000
Cost :	2,863,000-160,000-180,000+242,000+200,000+260,000	3,225,000
Acc Depn b/f:	1,117,800-102,400-141,120	<u>(874,280)</u>
NBV at 1 July 2012		2,350,720
Depreciation for 2012/2013: 40% x 2,350,700		<u>(940,288)</u>
NBV at 30 June 2013		<u>1,410,432</u>

(c)

**Disposal of Plant and Machinery A/C**

	Shs '000"		Shs "000"
Plant and Machinery A/c	160,000	Accum Depn – March	102,400
Plant and Machinery A/c	180,000	Plant and Machinery	40,000
SPL&C - Gain	<u>18,520</u>	Accum Depn - Plant	141,200
	<u>858,520</u>	Bank	<u>75,000</u>
			<u>858,520</u>



## Activity 11.13

Pio Motors Ltd operates a fleet of motor vehicles. The company's financial year ends on 30 September every year. The statement of financial position of the company as at 30 September 2011 showed motor vehicles as follows:

	Shs '000'
Motor vehicles at cost	1,113,300
Accumulated depreciation	<u>(583,668)</u>
	<u>529,632</u>

The company depreciates the motor vehicles using the straight line method over a period of five years. Depreciation is charged pro rata in the year of acquisition, but no charge is made in the year of disposal.

During the year ended 30 September 2012 the following transactions took place:

- (i) Purchase of vehicles (paid by EFT)

Vehicle No.	Date of purchase	Amount Shs '000'
016	1 October 2011	154,800
017	31 October 2011	192,600
018	28 February 2012	72,000

- (ii) Sale of vehicles

Vehicle No.	Date of sale	Amount Shs'000'	Cost Shs'000'	Date of purchase
003	31 October 2011	5,400	50,400	1 July 2008
008	31 December 2011	9,720	43,200	31 December 2009
011	31 March 2012	17,560	34,200	1 April 2010

- (iii) Included in the opening balance is motor vehicle No.001 which cost Shs 40 million and was fully depreciated on 30 September 2011, but is still in use. It is company policy to write off fully depreciated assets in the year following the one in which they are fully depreciated.

**Required:**

**Prepare the following accounts (showing all the necessary workings):**

- (a) Motor vehicles.
- (b) Provision for depreciation on motor vehicles.
- (c) Motor vehicles disposal.

**Source: CPA(U), November 2012, Question 3**



## SOLUTION TO ACTIVITY 11.13 – PIO MOTORS LTD

Dr	Motor Vehicles Account			Cr
	Shs 000			Shs 000
1.10.11	Balance b/f	1,113,300	1.10.11	Disposal – 001
1.10.11	Bank – 016	154,800	31.10.11	Disposal – 003
31.10.11	Bank – 017	192,600	31.10.11	Disposal – 008
28.2.12	Bank – 018	72,000	31.3.12	Disposal – 011
	-	1,532,700	30.9.12	Balance c/f
1.10.12	Balance b/f	1,364,900		<u>1,364,900</u>
				<u>1,532,700</u>

**(b)**

Dr	Prov'n for Depreciation on Motor Vehicles Account			Cr
	Shs 000			Shs 000
1.10.11	Disposal – 001	40,000	1.10.11	Balance b/f
31.10.11	Disposal – 003	32,760	30.9.12	Income Statement
31.12.11	Disposal – 008	23,760		
31.3.12	Disposal - 011	10,260		
30.9.12	Balance c/f	<u>740,698</u>		
		<u>847,478</u>		
			Balance b/f	<u>740,698</u>

**Workings:**

## Depreciation of Disposed Motor Vehicles:

	Shs 000
No. 003:	50,400 x 20% x 3 3/12
	= 32,760
No. 008:	43,200 x 20% x 2 9/12
	= 23,760
No. 011:	34,200 x 20% x 1 1/2
	= <u>10,260</u>
Total	<u>66,780</u>

## Depreciation for the Year:

	Shs 000
Existing Vehicles [1,113,300-(50,400+43,200+34,000+40,000) ] x 20% =	189,140
No. 016: 154,800 x 20%	= 30,960
No. 008: 192,600 x 20% x 11/12	= 35,310
No. 011: 72,000 x 20% x 7/12	= 8,400
Total	<u>263,810</u>

**(c)**

Dr	Disposal of Motor Vehicles Account			Cr
	Shs 000			Shs 000
1.10.11	Motor Vehicles-001	40,000	1.10.11	Prov'n for Depn-001
1.10.11	Motor Vehicles-003	50,400	31.10.11	Prov'n for Depn-003
31.12.11	Motor Vehicles-008	43,200	Bank	5,400
31.3.12	Motor Vehicles-011	34,200	31.12.11	Prov'n for Depn-008
		-	31.3.12	Prov'n for Depn-011
		167,800	30.9.12	Bank
		167,800		10,260
		167,800		Bank
		167,800		17,560
		167,800		Income Statement
		167,800		<u>28,340</u>
		167,800		<u>167,800</u>



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## REVISION QUESTIONS

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### Questions 11.14

Tick Car Hire Ltd operates a large fleet of motor vehicles. The company's financial year ends on 30<sup>th</sup> June every year. The balance sheet of the Company as at 30<sup>th</sup> June 2002 showed motor vehicles as follows.

	Shs '000'
Motor vehicles at cost	556,650
Accumulated depreciation	<u>291,834</u>
	264,816

The Company depreciates the motor vehicles using the straight line method over a five year life. Depreciation is charged proportionately in the year of acquisition, but no charge is made in the year of disposal. The disposal account is written up on the last day of each year.

During the year ended 30<sup>th</sup> June 2003 the following transactions took place.

i. Purchase of vehicles	Date of purchase	shs '000	
Car No.14	30.09.2002	77,400	
Car No. 15	31.10.2002	96,300	
Car No. 16	28.02.2003	36,000	
ii. Sale of vehicles	Date of sale	Amount Received shs.'000	Original cost shs '000
Car No. 7	31.10.2002	2,700	25,200
Car No. 8	31.12.2002	4,860	21,600
Car No. 9	31.3.2003	3,780	17,100
			1.4.2001
iii. Included in the opening balance is a motor vehicle which cost shs 20,000,000 and has been fully depreciated but has not yet been disposed off			

#### **Required**

**Prepare the following accounts.**

- i. Motor Vehicles
- ii. Provision for depreciation of Motor vehicles
- iii. Motor vehicles disposal

### Questions 11.15

Food for All Co Ltd (FFACL) is an agribusiness undertaking processing agricultural products. The company's year ends on 30 June annually. The following non-current assets existed in the company's books at 30 June 2010:

A milling machine purchased on 1 January 2009 at a cost of Shs 25,000,000 and a hulling machine purchased on 1 January 2008 at a cost of Shs 5,000,000. Accumulated depreciation for the hulling machine at 1 July 2010 was Shs 1,250,000 and the company had been depreciating these assets at a rate of 10% per annum on cost.

Starting 1 July 2010, FFACL undertook a phase by phase expansion that resulted into acquisition and disposal of its machinery as indicated below:

- (a) On 1 October 2011 purchased a grading machine from Kenya at a cost of Kshs 100,000. This was being depreciated at 10% per annum on cost.



- (b) On 1 April 2012 purchased a sealing machine at a cost of Shs 1,000,000. It cost Shs 50,000 to transport the machine to FFACL's premises. The machine was to be depreciated at a rate of 25% per annum on cost.
- (c) On 30 March 2013, the hulling machine was disposed of at Shs 4,375,000 and the company incurred Shs 2,000,000 in disposal expenses.
- (d) On 1 June 2014 purchased a generator for Shs 6,500,000. The cost of installation was Shs 50,000 and Shs 120,000 was spent on fuelling the generator in the same month. Depreciation rate for the generator is 15% per annum on cost.
- (e) On 30 June 2014, a new milling machine was acquired through a part exchange of the old one. The old one was valued at Shs 5,000,000. The company made an additional payment of Shs 8,000,000 to acquire the new mill.

Additional information:

- Depreciation expenses are accounted for on pro-rata basis.
- All company transactions are channelled through the bank.
- URA exchange rate for imports for September 2011 was quoted as Kshs 1 = Shs 30.
- The company maintains a non-current assets account for all its assets.

**Required:**

- |   |
|---|
| (a) Distinguish between the terms 'depreciable asset' and 'depreciable amount'. (4 marks) |
| (b) Prepare the following accounts for FFACL:   |
| (i) Non-current assets account. (8 marks)   |
| (ii) Provision for depreciation of non-current assets account. (10 marks)                 |
| (iii) Disposal of non-current assets account. (8 marks)                                   |
| (Total 30 marks)  |

**Source: CPA(U), November 2014, Question 1**

### Questions 11.16

During the current year, James Construction disposed of pieces of property, plant and equipment in the following transactions.

- |          |  |
|----------|--|
| Jan. 6   | Equipment costing shs 38,500,000 was given to a scrap dealer at no charge. At the date of disposal, accumulated depreciation on the office equipment amounted to shs 34,125,000.   |
| Mar. 3   | James sold land and a building for shs 1,312,500,000 for cash. James' records showed the following amounts: Land, shs 87,500,000; buildings, shs 1,225,000,000; Accumulated Depreciation: Building (at the date disposal) shs 525,000,000  |
| July. 10 | James traded in an old truck for a new one. The old truck had cost shs 38,500,000, and its accumulated depreciation amounted to shs 31,500,000. The price of the new truck was shs 70,000,000, but James received shs 17,500,000 trade-in allowance for the old truck and paid shs 52,500,000 in cash. James includes trucks in its vehicles accounts.         |
| Sept. 3  | James traded in its old computer system as part of the purchase price of a new system. The old system cost shs 17,500,000 and its accumulated depreciation amounted to shs 14,000,000. The new computer's list price was shs 10,500,000. James accepted a trade-in allowance of shs 350,000 for the old Computer system, and paid off the balance immediately. |

**Required:**

Prepare journal entries to record each of the disposal and acquisition transactions. (Assume that depreciation expense on each asset has been recorded up to the dated of disposal) and post the affected ledger accounts



# 12.0

# ACCRAULS AND PREPAYMENTS

## UNIT 10 OVERVIEW:

- Introduction
- Accruals
- Prepayments
- Double entry for Accruals and Prepayments
- Effect of Accruals and prepayments of Profit

## 12.1 INTRODUCTION

- Accounting principles require that the gross profit for a period should be calculated by **matching** the sales and the cost of goods. In the same way, the net profit for a period should be calculated by charging the expenses which relate to that period.
- For example, in preparing the income statement for a business for a period of, say, six months, it would be appropriate to charge six months' expenses for rent and local taxes, insurance costs and telephone costs, etc.
- Expenses might not be paid for during the period to which they relate. For example, a business rents a shop for shs2,000,000 per annum and pays the full annual rent on 1 April each year. If we calculate the profit for the business for the first six months for the year 2014, the correct charge for rent in the income statement is shs1,000,000, even though the rent paid is shs2,000,000 in that period.
- Similarly, the rent charge in the income statement for the second six months of the year is shs1,000,000, even though no rent was actually paid in that period.

## 12.2 KEY DEFINITIONS

- **Accrued expenses (accruals)** are expenses which relate to an accounting period but have not been paid for. They are shown in the statement of financial position as a liability. Therefore **accruals** or accrued expenses are expenses which are charged against the profit for a particular period, even though they have not yet been paid for.
- **Prepaid expenses (prepayments)** are expenses which have already been paid but relate to a future accounting period. They are shown in the statement of financial position as an asset. Hence, **prepayments** are payments which have been made in one accounting period, but should not be charged against a profit until a later period, because they relate to that later period.



**Activity 12.1 Accruals**

Spear Motor Spares has an accounting period ending 28 February each year. The company's telephone was installed on 1 April 2014 and receives telephone accounts quarterly at the end of each quarter. On the basis of the following data, you are required to calculate the telephone expense to be charged to the income statement for the year ended 28 February 2015.

	Shs
30.6.2014	23,500
30.9.2014	27,200
31.12.2014	33,400
31.3.2014	36,000

**Activity 12.2 Accruals**

ABC (U) Ltd started business as a paper plate and cup manufacturer on 1 January 2012, making up accounts to 31 December 2012. Electricity bills received were as follows.

	2014	2015	20X4
	shs	shs	shs
21 January	-	6,491.52	6,753.24
30 April	5,279.47	5,400.93	6,192.82
31 July	4,663.80	4,700.94	5,007.62
31 October	4,117.28	4,620.00	5,156.40

**Required**

**What should the electricity charge be for the year ended 31 December 2012?**

**Activity 12.3 Prepayments**

A business opens on 1 January 2014 in a shop which on a 20 year lease. The rent is shs20,000,000 per annum and is payable quarterly in advance. Payments are made on what are known as 'quarter-days' (except the first payment) as follows.

	shs
1 January 2014	5,000,000
25 March 2014	5,000,000
24 June 2014	5,000,000
29 September 2014	5,000,000
25 December 2014	5,000,000

**Required**

**What will be the rental charge for the year ended 31 December 20X4?**



## 12.3 DOUBLE ENTRY FOR ACCRUALS AND PREPAYMENTS.

- **Prepayments** are included in **receivables** in current assets in the statement of financial position. They are **assets** as they represent money that has been paid out in advance of the expense being incurred.
- **Accruals** are included in **payables** in **current liabilities** as they represent liabilities which have been incurred but for which no invoice has yet been received.

Transaction	DR	CR	Description
Accrual	Expense	Liability	Expense incurred in period, not recorded
Prepayment	Asset	(reduction in expense)	Expense incurred in period, not incurred until next period.

## 12.4 EFFECT ON PROFITS AND NET ASSETS

The table below gives a summary of the effects of accruals and prepayments.

	Effect on income/expenses	Effect on profit	Effects on assets/liabilities
Accruals	Increases expenses	Reduces profit	Increases liabilities
Prepayments	Reduces expenses	Increases profits	Increases assets
Prepayments of income	Reduces income	Reduces profits	Increases liabilities



# 13.0

# BAD DEBTS AND PROVISIONS FOR DOUBTFUL DEBTS

## UNIT OVERVIEW:

- Introduction to irrecoverable debts
- Accounting treatment of bad debts
- Bad debts written off and subsequently paid
- Accounting treatment of Doubtful debts
- Allowances / provisions for doubtful debts

## 13.1 BAD / IRRECOVERABLE DEBTS.

### 13.1.1 Introduction.

Very few businesses expect to be paid immediately in cash, unless they are retail businesses on the high street. Most businesses buy and sell to another on credit terms. This has the benefit of allowing the business to keep trading without having to provide cash 'up front'. So a business will allow credit terms to customers and receive credit terms to suppliers. Ideally, a business wants to receive money from its customers as quickly as possible, but delay paying its suppliers for as long as possible. This can lead to problems.

Most businesses aim to control such problems by means of **credit control**. A customer will be given a **credit limit**, which cannot be exceeded (compare on overdraft limit or credit card limit). If an order would take the customer's account beyond its credit limit, it will not be auctioned until a cash payment is received to reduce the customer's outstanding balance.

Another tool in **credit control** is the **aged receivables analysis**. An aged receivables analysis is report of all receivables analyzed by customer and by age of receivable, e.g. balances outstanding for 30 days, 60 days and 90+ days. If a balance has been outstanding for a long period of time, it may indicate that a customer is unable to pay. Most credit controllers will have a system of chasing up payment for long outstanding invoices.

Customers might fail to pay, perhaps out of dishonesty or because they have gone bankrupt and cannot pay. Customers in another country might be prevented from paying by the unexpected introduction of foreign exchange control restrictions by their country's governments during the credit period. Therefore, the costs of offering credit facilities to customers can include:

- *Interest costs of an overdraft.*
- *Costs of trying to obtain payment.*
- *Court costs.*

For one reason or another, a business might decide to give up expecting payment and to write the debt off.



### 13.1.2 Key Definition

An **irrecoverable (or 'bad') debt** is a debt which is definitely not expected to be paid. An irrecoverable debt could occur when, for example, a customer has gone bankrupt.

### 13.2 Writing off Bad / irrecoverable debts.

To begin with, let's recap the ledger entries when a sale on credit is made to a customer:

DEBIT	Trade receivables.
CREDIT	Sales

All being well, a few weeks later, the customer will pay the debt and cash will be received, at which point the double entry is:

DEBIT	Cash account
CREDIT	Trade receivables.

But what happens if, instead, the customer goes bankrupt and then can't pay? Remember that according to the *Framework* an asset is a resource controlled by an entity from which **future economic benefits are expected to flow**. If the customer can't pay, then no economic benefits are expected to flow from the trade receivable. So the trade receivable no longer meets the definition of an asset and it must be removed from the statement of financial position and is charged as an expense in the income statement. The ledger entries to write off an irrecoverable debt are:

DEBIT	Bad debts expense (income statement)
CREDIT	Trade receivables (statement of financial position)

In the receivables ledger, personal accounts of the customers whose debts are irrecoverable are taken off the ledger.

#### Activity 13.1

Toyota Co has a total balance for trade receivables of Shs25 million at the year end. A review of the receivables balances highlights that one of its customers, Magezi has gone bankrupt. Magezi was being demanded shs4 million by Toyota Co for supply of Toyota Premio during the year. This debt is now considered irrecoverable.

##### **Required**

- (a) **What is the balance for trade receivables to be shown in the statement of financial position of Toyota Co at the year end?**
- (b) **What is the Bad debts expense to be shown in the income statement at the year end?**



**Activity 13.2**

At 1 October 2013 a business had total outstanding debts of shs8.6 million. During the year to 30 September 2014 the following took place.

- (a) Credit sales amounted to shs44 million.
- (b) Payments from various customers (accounts receivables) amounted to shs49 million.
- (c) Two debts, for shs180,000 and shs420,000, were irrecoverable and the customers are no longer purchasing goods from the company. These two are to be written off.

**Required**

*Prepare the trade receivables ledger account and the Bad debts expense account for the year.*

**13.3 Bad debts written off and subsequently paid.**

An irrecoverable debt which has been written off might occasionally be unexpectedly paid. Because the debt has already been written off, it no longer exists in the statement of financial position and so the cash received cannot be offset against it in the usual way. Instead, the cash received is offset against the irrecoverable debts expense. Regardless of when the payment is received, the ledger entries are as follows:

DEBIT	Cash account
CREDIT	Bad debts expense

**Activity 13.3**

You have been provided with the trial balance extract of ABC (U) Ltd for the year to 31 December 2014;

	Shs
Inventory, 1 January 2014	6,000
Purchases of goods	122,000
Inventory, 31 December 2014	8,000
Cash sales	100,000
Credit sales	70,000
Bad debts written off	9,000
Debts paid in 2014 which were previously written off as irrecoverable in 2013	2,000
	<b><u>31,800</u></b>

**Required**

*Prepare an Income statement (Extract) for ABC (U) Ltd for the year ended 31<sup>st</sup> December 2014.*

**13.4 PROVISIONS AND ALLOWANCES FOR DOUBTFUL DEBTS.****13.4.1 Doubtful debts.**

Bad debts are specific debts which are **definitely not** expected to be paid. However, there may be some debts which the business thinks might be paid, these are known as **doubtful debts**.



A **doubtful debt** is a debt which is **possibly** recoverable.

Doubtful debts may occur, for example, when an invoice is in dispute, or when a customer is in financial difficulty.

In this situation, the debt is not written off, as it is not certain that the debt is irrecoverable. But because there is doubt whether the debt will be paid, a **provision**, known as **an allowance for receivables / Provision for doubtful debts**, is made against the doubtful debt.

### **13.4.2 Allowance for receivables / Provision for Doubtful debts.**

This is an amount related to receivables that reduces the receivables asset to its **prudent** valuation in the statement of financial position. It is offset against trade receivables, which are shown at the net amount.

An allowance for receivables provides for potential irrecoverable debts, as a **prudent precaution** by the business. The business will thereby be more likely to avoid claiming profits which subsequently fail to materialize because some specific debts turn out to be irrecoverable.

### **13.4.3 Specific and general allowances for receivables.**

There are two kinds of allowances for receivables that can be made:

- (a) A **specific allowance** against a specific doubtful debt. The doubtful debt may be a particular invoice or perhaps the whole balance outstanding from a particular customer.
- (b) A **general allowance** against the remaining trade receivables balance.

**A general allowance for receivables** is an estimate of the percentage of remaining debts (i.e. after deducting bad debts and specific doubtful debts) which are ultimately not expected to be paid for.

A general allowance is an allowance created to provide against the remaining trade receivables balance after writing off any bad debts and after accounting for any specific doubtful debts. A general allowance is calculated based on how many debts usually turn out to be irrecoverable, and tends to be expressed as a percentage, e.g. 'general allowance of @% of trade receivables'.

The **total allowance for receivables** is the sum of any specific allowances plus the general allowance.

### **13.4.4 Accounting treatment in the financial statements.**

The accounting treatment for an allowance for receivables is as follows:

- (a) When an allowance / provision is first made, the amount of this initial allowance is charged as an expense in the income statement, for the period in which the allowance is created.
- (b) When an allowance already exists, but is subsequently increased in size, the amount of the increase in allowance is charged as an expense in the income statement for the period in which the increased allowance is made.
- (c) When an allowance already exists, but is subsequently reduced in size, the amount of the decrease in allowance is credited back to the income statement for the period in which the reduction in allowance is made.



### EXAM FOCUS POINT

In the exam it is highly likely that you will have to calculate the increase or decrease in the allowance for receivables and show the effect of this on the income statement.

The statement of financial position, as well as the income statement of a business, must be adjusted to show the allowance.

**Note:** The value of trade receivables in the statement of financial position must be shown after deducting the allowance for receivables.

This is because the net realizable value of all receivables of the business is estimated to be less than their 'sale value'. After all, this is the reason for making the allowance in the first place. The net realizable value of trade accounts receivable is the total value of receivables minus receivables allowance.

#### Activity 13.4

A company has a trade receivables balance of shs50 million but from past experience, expects 5% of the balance to be eventually irrecoverable. Therefore the allowance for receivables will be 5% of shs50,000,000 = shs2,500,000. This means that although total trade receivables are shs50,000,000 eventual payment of only shs47,500,000 is expected.

- (a) In the income statement, the newly created allowance of shs2,500,000 will be shown as an expense.
- (b) In the statement of financial position, trade receivables will be shown as: Trade receivables (50 million – 2.5 million)

#### 13.4.5 Allowance for receivables: ledger accounting entries.

When an allowance for receivables is first set up, the whole amount is debited to the income statement.

In subsequent years, only the movement on the receivables allowance is debited or credited to irrecoverable debts expense in the income statement.

When a business first sets up an allowance for receivables, the full amount of the allowance should be debited to irrecoverable debts expense as follows:

DEBIT	Bad debts expense (income statement)
CREDIT	Allowance / provision for doubtful debts (statement of financial position)

**In subsequent years, adjustments may be needed to the amount of the allowance.** The procedure to be followed then is as follows.

- (a) Calculate the new allowance required.
- (b) Compare it with the existing balance on the allowance account (i.e. the balance b/f from the previous accounting period)
- (c) Calculate increase or decrease required.



**(i) If a higher allowance is required now:**

DEBIT      Bad debts expense (income statement)  
CREDIT      Allowance / provision for doubtful debts (statement of financial position)  
with the amount of the increase.

**(ii) If a lower allowance is needed now:**

DEBIT      Allowance for receivables (statement of financial position)  
CREDIT      Other Income (income statement)  
with the amount of the decrease.

**Activity 13.5: Accounting entries for allowance for receivables.**

MMM Ltd has total receivables outstanding at 31 December 2013 of shs28 million. Management believes that about 1% of these balances will not be collected and wishes to make an appropriate allowance. Before now, the company has not made any allowance for receivables at all.

On 31 December 2014 the company's trade accounts receivables amounted to shs40 million. From experience during the year management is convinced that an allowance of 5% should be made.

What accounting entries should be made on 31 December 2013 and 31 December 2014, and what figures for trade receivables will appear in the company's statements of financial position as at those dates?

**Activity 13.6: Irrecoverable debts and allowance for receivables combined.**

Fatima's receivables at 31 May 2014 were shs723,800. The balance on the allowance for receivables account at 1 June 2013 was shs15,250. Fatima has decided to change the allowance for receivables to 1.5% of receivables as at 31 May 2014.

On 14 May 2014 Fatima received shs540 in final settlement of an amount written off during the year ended 31 May 2013.

**Required**

**What total amount should be recognized for receivables in the income statement for the year ended 31 May 2014?**

**Activity 13.7**

Gold Traders had a balance of Shs 46,000,000 on its trade receivables account on 1 October 2013 and Shs 55,400,000 at 30 September 2014. A debt of Shs 2,400,000 written off in the previous year was paid in full and bad debts of Shs 1,640,000 were written off during the year. These transactions have not yet been accounted for. Provision for doubtful debts is at the rate of 10% per annum.

- i.      Compute the provision for doubtful debts at the end of 30 September, 2014
- ii.     What was the provision for doubtful debts charge for the year ended 30 September 2014?
- iii.    What was the value of trade receivable that appeared in the balance sheet at 30 September 2014?



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### Exam Type Question

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**Activity 13.8:**

The following balances were extracted from the books of New Polar Retailers on 1 January 2011:

	Shs '000'
Trade receivables	800,000
Bank overdraft	400,000
Provision for bad and doubtful debts	32,000

You ascertain the following information for two years:

For the year ended 31 December 2011:	Shs '000'
Credit sales	8,000,000
Sales returns	80,000
Receipts from customers	7,200,000
Bad debts written off	40,000
Discounts allowed	32,000

For the year ended 31 December 2012:	Shs '000'
Total sales (90% on credit)	8,000,000
Sales returns (90% relating to credit customers)	160,000
Receipts from credit customers	7,600,000
Trade receivables balances settled by contra against trade payables balances	240,000
Bad debts written off	120,000
Discounts allowed	40,000

Notes:

- (i) Provision for bad and doubtful debts is maintained at 5% of the net trade receivables at the end of the year. At the end of 2011 a specific provision for a debt of Shs 16,000,000 from an insolvent customer was required.
- (ii) Bad debts written off during 2012 included 50% of the bad debts due from the insolvent customer, the other 50% having been received in cash from the relative of the insolvent customer during the year.

**Required:**

Prepare for the years 2011 and 2012 the:

- (a) receivables account. (8 marks)
  - (b) provision for bad and doubtful debts account. (8 marks)
  - (c) bad and doubtful debts expense account. (4 marks)
- (Total 20 marks)**

**Source: CPA(U), June 2013, Question 4**



**SOLUTION TO ACTIVITY 13.9 – New Polar Retailers**

<b>NEW POLAR RETAILERS</b> <b>RECEIVABLES A/C</b>		
Bal b/f	Shs '000'	Shs '000'
800,000	Sales returns	80,000
Sales	8,000,000	Bank
		7,200,000
		Bad debts
		40,000
		Discount allowed
		32,000
		Bal c/d
		1,448,000
	<u>8,800,000</u>	<u>8,800,000</u>
Bal b/f	1,448,000	Sales returns
Sales (90% * 8,000)	7,200,000	Bank
		Contra settlements
		240,000
		Discount allowed
		40,000
		Prov BDD-specific
		8,000
		Bad debts (120-8)
		112,000
		Bal c/d
		504,000
	<u>8,648,000</u>	<u>8,648,000</u>

**Answer 4 (b)**

<b>Provision for Bad and Doubtful Debts A/C</b>			
2011	Shs '000'	2011	Shs '000'
Bal b/f 5%( 1,448,000- 16,000)+16,000	<u>87,600</u>	Balance b/f	32,000
		SCI - Specific	16,000
		SCI-General	<u>39,600</u>
	<u>87,600</u>		<u>87,600</u>
2012		2012	
Receivables-Specific	8,000	Balance b/f	87,600
W/O			
SCI - Specific recovered	8,000		
SCI - General (Decrease)	46,400		
Balance c/f - General	<u>25,200</u>		
	<u>87,600</u>		<u>87,600</u>

**Answer 4 (c)**

<b>Bad and Doubtful Debts Expense A/C</b>			
2011	Shs '000'	2011	Shs '000'
	<u>40,000</u>	SCI	<u>40,000</u>
	<u>40,000</u>		<u>40,000</u>
2012		2012	
Receivables	<u>112,000</u>		<u>112,000</u>
	<u>112,000</u>		<u>112,000</u>



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## REVISION QUESTIONS

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**Questions 13.9**

A company maintains a provision for doubtful debts at 5% of total trade receivable and the provision account had a balance of Shs 600,000 as at 1 January 2014. The trade receivable balance before adjustment was Shs 20,000,000 at 31 December 2014. The credit controller recommended that bad debtors amounting to 9% of the total be written off and a provision for discounts allowed of 3% be created.

- ii. *What is the increase in the provision for doubtful debts on 31 December 2014?*
- iii. *How much is the provision for discounts allowed as at 31 December 2014?*
- iv. *What is the correct trade receivables balance to be included under current assets?*
- v. *What is the correct expense figure for bad debts to be included in the income statement?*

**Questions 13.20**

At the beginning of the year a company has a bad debt provision of Ushs 1.8 million. During the year debts of Ushs 1.2 million are written off and Ushs 500,000 is recovered from debts previously written off. An additional provision of U shs 700,000 is created at the end of the year. *What is the bad debt charge in the profit and loss account?*

- a. U shs 1.4 million
- b. Ushs 1.9 million
- c. Ushs 2.4 million
- d. Ush 3.2 million

**Questions 13.21**

At the beginning of the year a company has a bad debt provision of Ushs 1.8 million. During the year debts of Ushs 1.2 million are written off and Ushs 500,000 is recovered from debts previously written off. An additional provision of U shs 700,000 is created at the end of the year. *What is the bad debt charge in the profit and loss account?*

- a. U shs 1.4 million
- b. Ushs 1.9 million
- c. Ushs 2.4 million
- d. Ush 3.2 million

**Questions 13.22**

Isaac does not keep a full set of records, but the following information is available for the month of May 2015.

	Shs.
Trade receivables, 1 May 2015	800,000
Trade receivables 31 May 2015	550,000
Credit sales for May 2015	6,800,000
Cash received from credit customers	6,730,000
Bad debts written off	40,000
General allowance for doubtful debts setup at 31 May 2015	100,000

Assuming no other transactions, how much discount was allowed to customers during the month?

- a. Shs 180,000
- b. Shs 340,000
- c. Shs 280,000
- d. Shs 320,000



## **PART E**

# **Preparation of Financial Statements**

# 14.0

# INTRODUCTION TO PREPARATION OF FINANCIAL STATEMENTS

## UNIT 10 OVERVIEW:

- Objectives of Financial Statements
- The Full Set of Financial Statements
- Accounting Principles in Preparation of Financial Statements
- The Statement of Financial Position
- The Statement of Profit or Loss and Other Comprehensive Income

### 14.1 OBJECTIVES OF FINANCIAL STATEMENTS

- The objective of financial statements is to provide information about the financial position, financial performance, and cash flows of a business enterprise that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements provide information about a business enterprise's
  - assets
  - liabilities
  - capital
  - income and expenses, including gains and losses
  - contributions by and distributions to owners (in their capacity as owners)
  - cash flows.

### 14.2 THE FULL SET OF FINANCIAL STATEMENTS OF A SOLE TRADER.

Given the nature and form of business for a sole trader, a full set of financial statements of a sole trader shall comprise of the following;

- (i) a statement of financial position (balance sheet) at the end of the period
- (ii) a statement of profit or loss and other comprehensive income for the period (presented as a single statement, or by presenting the profit or loss section in a separate statement of profit or loss, immediately followed by a statement presenting comprehensive income beginning with profit or loss)
- (iii) a statement of changes in equity for the period
- (iv) a statement of cash flows for the period
- (v) notes, comprising a summary of significant accounting policies and other explanatory notes

### 14.3 GOING CONCERN.

Financial statements are normally prepared assuming the entity is a going concern and will continue in operation for the foreseeable future.

IAS 1 requires management to make an assessment of an entity's ability to continue as a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties



must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis.

#### **14.4 ACCRUAL BASIS OF ACCOUNTING**

IAS 1 requires that an entity prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

#### **14.5 CONSISTENCY OF PRESENTATION**

The presentation and classification of items in the financial statements shall be retained from one period to the next unless a change is justified either by a change in circumstances or a requirement of a new IFRS.

#### **14.6 MATERIALITY AND AGGREGATION**

Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial.

#### **14.7 OFFSETTING**

Assets and liabilities, and income and expenses, may not be offset unless required or permitted by an IFRS.

#### **14.8 COMPARATIVE INFORMATION**

IAS 1 requires that comparative information to be disclosed in respect of the previous period for all amounts reported in the financial statements, both on the face of the financial statements and in the notes, unless another Standard requires otherwise. Comparative information is provided for narrative and descriptive where it is relevant to understanding the financial statements of the current period.

An entity is required to present at least two of each of the following primary financial statements:

- statement of financial position\*
- statement of profit or loss and other comprehensive income
- separate statements of profit or loss (where presented)
- statement of cash flows
- statement of changes in equity
- related notes for each of the above items.

\* A third statement of financial position is required to be presented if the entity retrospectively applies an accounting policy, restates items, or reclassifies items, and those adjustments had a material effect on the information in the statement of financial position at the beginning of the comparative period.

Where comparative amounts are changed or reclassified, various disclosures are required.

#### **14.9 STRUCTURE AND CONTENT OF FINANCIAL STATEMENTS IN GENERAL**

IAS 1 requires an entity to clearly identify:

- the financial statements, which must be distinguished from other information in a published document
- each financial statement and the notes to the financial statements.



In addition, the following information must be displayed prominently, and repeated as necessary:

- the name of the reporting entity and any change in the name
- whether the financial statements are a group of entities or an individual entity
- information about the reporting period
- the presentation currency
- the level of rounding used (e.g. thousands, millions).

## 14.10 REPORTING PERIOD

There is a presumption that financial statements will be prepared at least annually. If the annual reporting period changes and financial statements are prepared for a different period, the entity must disclose the reason for the change and state that amounts are not entirely comparable.

## 14.11 STATEMENT OF FINANCIAL POSITION (BALANCE SHEET)

### • *Current and non-current classification*

An entity must normally present a classified statement of financial position, separating current and non-current assets and liabilities, unless presentation based on liquidity provides information that is reliable. In either case, if an asset (liability) category combines amounts that will be received (settled) after 12 months with assets (liabilities) that will be received (settled) within 12 months, note disclosure is required that separates the longer-term amounts from the 12-month amounts.

Current assets are assets that are:

- expected to be realised in the entity's normal operating cycle
- held primarily for the purpose of trading
- expected to be realised within 12 months after the reporting period
- cash and cash equivalents (unless restricted).

All other assets are non-current.

Current liabilities are those:

- expected to be settled within the entity's normal operating cycle
- held for purpose of trading
- due to be settled within 12 months
- for which the entity does not have an unconditional right to defer settlement beyond 12 months (settlement by the issue of equity instruments does not impact classification).

Other liabilities are non-current.

When a long-term debt is expected to be refinanced under an existing loan facility, and the entity has the discretion to do so, the debt is classified as non-current, even if the liability would otherwise be due within 12 months.

If a liability has become payable on demand because an entity has breached an undertaking under a long-term loan agreement on or before the reporting date, the liability is current, even if the lender has agreed, after the reporting date and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. However, the liability is classified as non-current if the lender agreed by the reporting date to provide a period of grace ending at least 12 months after the end of the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.



- ***Minimum line items***

The minimum line items to be included on the face of the statement of financial position are:

- (a) property, plant and equipment
- (b) investment property
- (c) intangible assets
- (d) financial assets
- (e) investments accounted for using the equity method
- (f) biological assets
- (g) inventories
- (h) trade and other receivables
- (i) cash and cash equivalents
- (j) assets held for sale
- (k) trade and other payables
- (l) provisions
- (m) financial liabilities
- (n) current tax liabilities and current tax assets
- (o) deferred tax liabilities and deferred tax assets
- (q) non-controlling interests
- (r) issued capital and reserves.

## 14.12 STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

### *Concepts of profit or loss and comprehensive income*

Profit or loss is defined as "the total of income less expenses, excluding the components of other comprehensive income". Other comprehensive income is defined as comprising "items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs". Total comprehensive income is defined as "the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners".

$$\text{Comprehensive income} = \text{Profit or loss} + \text{Other comprehensive income}$$

All items of income and expense recognised in a period must be included in profit or loss.

- ***Choice in presentation and basic requirements***

An entity has a choice of presenting:

- a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections, or



- two statements:
  - a separate statement of profit or loss
  - a statement of comprehensive income, immediately following the statement of profit or loss and beginning with profit or loss.

The statement(s) must present:

- profit or loss
- total other comprehensive income
- comprehensive income for the period
- an allocation of profit or loss and comprehensive income for the period between non-controlling interests and owners of the parent.

### ***Profit or loss section or statement***

The following minimum line items must be presented in the profit or loss section (or separate statement of profit or loss, if presented):

- revenue
- gains and losses from the derecognition of financial assets measured at amortised cost
- finance costs
- share of the profit or loss of associates and joint ventures accounted for using the equity method
- certain gains or losses associated with the reclassification of financial assets
- tax expense
- a single amount for the total of discontinued items

Expenses recognised in profit or loss should be analysed either by nature (raw materials, staffing costs, depreciation, etc.) or by function (cost of sales, selling, administrative, etc.). If an entity categorises by function, then additional information on the nature of expenses – at a minimum depreciation, amortisation and employee benefits expense – must be disclosed.

### ***Other comprehensive income section***

The other comprehensive income section is required to present line items which are classified by their nature, and grouped between those items that will or will not be reclassified to profit and loss in subsequent periods.

### ***Other requirements***

Additional line items may be needed to fairly present the entity's results of operations.

Items cannot be presented as 'extraordinary items' in the financial statements or in the notes.

Certain items must be disclosed separately either in the statement of comprehensive income or in the notes, if material, including:

- write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs
- restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring
- disposals of items of property, plant and equipment
- disposals of investments
- discontinuing operations
- litigation settlements
- other reversals of provisions



# 15.0

# FINAL ACCOUNTS OF A SOLE TRADER

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## UNIT OVERVIEW:

- Statement of Profit or loss
  - The Gross Profit
  - The Cost of Sales
  - The Statement of Financial Position
  - Format of the Statement of Financial Position
- 

- The major financial statements we shall consider here are the Statement of comprehensive income, the Statement of financial position and the cash flows.

## 15.1 STATEMENT OF PROFIT AND LOSS AND OTHER COMPREHENSIVE INCOMES

This is a report that tells the profits/losses of the business for a period of time. It involves grouping of revenues and expenses prior to bringing them together to compute profit/loss. It is at times called the trading, profit and loss account if it is prepared to show the gross profit and the net profit.

### 15.1.1 *Gross Profit*

This is the difference between the sales and the cost of the goods that have been sold. If sales are more than the cost of sales, it results into gross profit. If the cost of sales is more than sales, it results in gross loss. The part of the statement that calculates gross profit is called the trading account.

The cost of goods relates to only the goods that have been sold. Therefore, reconciliation is made for the opening and closing stock of goods.

### 15.1.2 *Cost of goods sold*

This is computed as;

Opening stock of goods + Goods purchases during the period – Closing stock of goods.

### 15.1.3 *The net profit:*

The net profit is computed in the profit and loss account. It is computed as:

Gross profit + other revenues other than from sale of goods – expenses incurred during the period.



### 15.1.3 Other adjustments made in the Income statement

- Return inwards are deducted from sales
- Return outwards are deducted from purchases
- Carriage inwards is always added to cost of goods in the trading account
- Carriage outwards is always treated as an expense and therefore deducted from gross profit
- When Sales and purchases are put on the same line in the trial balance, the figure in the debit column is for purchases and that in the credit column is for sales
- When accounts payable are put on the same line in the trial balance with accounts receivable, the debit is for accounts receivable while the credit is for accounts payable
- Similarly, return inwards is on the debit side and return outwards is on the credit side.
- If cash at bank figure appears on the credit side, it means an overdraft and therefore current liability

### 15.1.4 THE FORMAT

Musoke Enterprises

Statement of comprehensive income for the period that ended .....

	Shs “000”	Shs “000”	Shs “000”
Sales			XXX
Less Returns inwards			(XXX)
Adjusted sales			XXX
<b>Cost of sales</b>			
Opening stock		XXX	
Add purchases	XXX		
Add Carriage inwards	XXX		
Less Returns outwards	(XXX)	XXX	
Less closing stock		(XXX)	(XXX)
<b>Gross profit</b>			XXX
 <b>Add other revenues</b>			
Rent received		XX	
Commissions earned		XX	XXX
 <b>Less operating expenses</b>		XX	
Wages/ salaries		XX	
Rent payable		XX	
Legal fees		XX	
Lighting and heating		XX	
Depreciation of equipment		XX	
Donation		XX	
 <b>Net profit/loss</b>			XXX
			XXX



## 15.2 STATEMENT OF FINANCIAL POSITION

The Statement of financial position contains the details of assets, liabilities and capital. The amounts to be entered in the Statement of financial position are found in the trial balance

### 15.2.1 Assets:

Assets are of two types: **Non current assets** also called fixed assets

- These are assets that were not bought primarily for resale but to be used in business and are expected to be used for along time
- **Current assets** are assets that are likely to change in short term certainly within 12 months of the Statement of financial position.

### 15.2.2 Liabilities:

There are of two types:

- Current liabilities are items that have to be paid within the year of the Statement of financial position.
- Non current liabilities are items that have to be paid more than a year after the Statement of financial position.

### 15.2.3 Format

Musoke Enterprises

Statement of financial position as at .....

	Shs “000”	Shs “000”	Shs “000”
<b>ASSETS</b>			
<b>NON CURRENT ASSETS</b>			
Land		XXX	
Buildings		XXX	
Motor Van		XXX	
Fixtures and fittings		XXX	XXX
<b>CURRENT ASSETS</b>			
Stock	XXX		
Debtors	XXX		
Bank	XXX		
Cash	XXX	XXX	
<b>Total assets</b>			<u>XXX</u>
<b>CAPITAL AND LIBILITIES</b>			
Capital introduced		XXX	
Less drawings		(XXX)	
Add net profit for the year		XXX	XXX
<b>Non-Current Liabilities</b>			
10% Loan			XXX
<b>Current liabilities</b>			
Accounts payable		XXX	
Bank overdraft		XXX	<u>XXX</u>



### Activity 15.1 Accounts of a Sole trader

The following trial balance was extracted from the ledger of Moses Mubeezi, a sole trader, as at 31 May 2015 – the end of his financial year.

#### MUBEEZI MOSES TRIAL BALANCE AS AT 31 MAY 2015

	Dr Shs"000"	Cr Shs"000"
Property, at cost	120,000	
Equipment, at cost	80,000	
Provisions for depreciation (as at 1 June 2014)		
- On property		20,000
- On equipment		38,000
Purchases	250,000	
Sales		402,200
Inventory, as at 1 June 2014	50,000	
Discounts allowed		18,000
Discounts received		4,800
Returns out		15,000
Wages and salaries	58,800	
Irrecoverable debts	4,600	
Loan interest	5,100	
Other operating expenses	17,700	
Trade payables		36,000
Trade receivables	38,000	
Cash in hand	300	
Bank	1,300	
Drawings	24,000	
Allowance for receivables		500
17% long term loan		30,000
Capital, as at 1 June 2014		121,300
	<u>667,800</u>	<u>667,800</u>

The following additional information as at 31 May 2015 is available.

- (a) Inventory as at the close of business has been valued at cost at shs42 million.
- (b) Wages and salaries need to be accrued by shs800,000.
- (c) Other operating expenses are prepaid by shs300,000.
- (d) The allowance for receivables is to be adjusted so that it is 2% of trade receivables.
- (e) Depreciation for the year ended 31 May 2015 has still to be provided for as follows.  
Property: 1.5% per annum using the straight line method.  
Equipment: 25% per annum using the reducing balance method.

#### Required

Prepare Mubeezi Moses's;

- (a) Statement of profit or loss and other comprehensive income for the year ended 31 May 2015.
- (b) Statement of financial position as at that date.



## SOLUTION TO ACTIVITY 15.1 – Mubeezi Moses

- (a) Mubeezi Moses's statement of profit or loss and other comprehensive Income for the year ended 31 May 2015 shall be as below;

<u>MUBEEZI MOSES</u> <u>STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME</u> <u>FOR THE YEAR ENDED 31 MAY 2015</u>		
	Shs"000"	Shs "000"
Sales		402,200
Cost of sales		
Opening inventory	50,000	
Purchases	250,000	
Purchases returns	<u>(15,000)</u>	
		285,000
Closing inventory	<u>42,000</u>	
Gross profit		<u>243,000</u>
Other income – discounts received		159,200
		<u>4,800</u>
		<u>164,000</u>
Expenses		
Operating expenses		
Wages and salaries (Shs58,800 + Shs800)	59,600	
Discounts allowed	18,000	
Irrecoverable debts (W1)	4,860	
Loan interest	5,100	
Depreciation (W2)	12,300	
Other operating expenses (Shs17,700 - Shs300)	<u>17,400</u>	
		117,260
Net profit for the year		<u>46,740</u>

- (b) Mubeezi Moses's statement of financial position as at 31 May 2015 shall be as below;

<u>MUBEEZI MOSES</u> <u>STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 2015</u>			
	Shs"000"	Shs"000"	Shs"000"
<i>Non-current assets</i>			
Property	120,000	21,800	98,200
Equipment	<u>80,000</u>	<u>48,500</u>	<u>31,500</u>
	<u>200,000</u>	<u>70,300</u>	<u>129,700</u>
<i>Current assets</i>			
Inventory		42,000	
Trade receivables net of allowance for receivables (Shs38,000 – 760(W1))		37,240	
Prepayments		300	
Bank		1,300	
Cash in hand		<u>300</u>	
		<u>81,140</u>	
		<u>210,840</u>	



*Capital and Liabilities*

*Capital*

Balance at 1 June 2014	121,300
Net profit for the year	<u>46,740</u>
	168,040
Drawings	<u>24,000</u>
	144,040

*Non-current liabilities*

17% loan	30,000
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*Current liabilities*

Trade payables	36,000
Accruals	<u>800</u>
	<u>36,800</u>
	<u>210,840</u>

*Workings*

	Shs"000"
1. Irrecoverable debts	500
Previous allowance	<u>760</u>
New allowance ( $1.5\% \times 38,000$ )	260
Increase	<u>4,600</u>
Per trial balance	4,860
Income statement	

2. Depreciation

Property	
Opening provision	20,000
Provision for the year ( $1.5\% \times 120,000$ )	<u>1,800</u>
Closing provision	<u>21,800</u>
Equipment	
Opening provision	38,000
Provision for the year ( $25\% \times 42,000$ )	<u>10,500</u>
Closing provision	<u>48,500</u>
Total charge in I/S	<u>12,300</u>



### Activity 15.2 Accounts of a Sole trader

Donald Brown, a sole trader, extracted the following trial balance on 31 December 2014.

#### TRIAL BALANCE AS AT 31 DECEMBER 2014

	Debit Shs'000"	Credit Shs'000"
Capital at 1 January 2014		26,094
Receivables	42,737	
Cash in hand	1,411	
Payables		35,404
Fixtures and fittings at cost	42,200	
Discounts allowed	1,304	
Discounts received		1,175
Inventory at 1 January 2014	18,460	
Sales		491,620
Purchases	387,936	
Motor vehicles at cost	45,730	
Lighting and heating	6,184	
Motor expenses	2,862	
Rent	8,841	
General expenses	7,413	
Bank overdraft		19,861
Provision for depreciation		
Fixtures and fittings	2,200	
Motor vehicles	15,292	
Drawings	<u>26,568</u>	<u>591,646</u>
	<u>591,646</u>	<u>591,646</u>

The following information as at 31 December is also available.

- (a) Shs218,000 is owing for motor expenses.
- (b) Shs680,000 has been prepaid for rent.
- (c) Depreciation is to be provided for the year as follows.

Motor vehicles: 20% on cost.

Fixtures and fittings: 10% reducing balance method.

- (d) Inventory at the close of business was valued at Shs19,926,000.

#### Required

##### Prepare Donald Brown's

- (a) Statement of profit or loss and other comprehensive income for the year ended 31 December 2014
- (b) Statement of financial position at 31 December 2014.
- (c) Given the facts in the Donald Brown question above, what is the net effect on profit of the adjustments in (a) to (c)?



## SOLUTION TO ACTIVITY 15.2 – Donald Brown

- (a) Donald Brown's statement of profit or loss and other comprehensive Income for the year ended 31 December 2014 shall be as below;

*Tutorial note.*

- (a) Discounts allowed are an expense of the business and should be shown as a deduction from gross profit. Similarly, discounts received is a revenue item and should be added to gross profit.
- (b) The figure for depreciation in the trial balance represents accumulated depreciation up to and including 2013. You have to calculate the charge for the year 2014 for the income statement and add this to the trial balance figure to arrive at the accumulated depreciation figure to be included in the statement of financial position.

<u>DONALD BROWN</u>		
<u>INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X0</u>		
	Shs'000"	Shs'000"
Sales		491,620
Cost of sales		
Opening inventory	18,460	
Purchases	<u>387,936</u>	
	406,396	
Closing inventory	<u>19,926</u>	
	386,470	
Gross profit	105,150	
Other income – discounts received	<u>1,175</u>	
	106,325	
Expenses		
Discounts allowed	1,304	
Lighting and heating	6,184	
Motor expenses (2,862 + 218)	3,080	
Rent (8,841 – 680)	8,161	
General expenses	7,413	
Depreciation (W)	<u>13,146</u>	
	39,288	
Net profit for the year	<u>67,037</u>	

*Working*

*Depreciation charge*

Motor vehicles: Shs45,730,000 x 20% = Shs9,146,000

Fixtures and fittings: 10% x Shs(42,200,000 – 2,200,000) = Shs4,000,000

Total: Shs4,000,000 + Shs9,146,000 = Shs13,146,000



- (b) Donald Brown's statement of profit or loss and other comprehensive Income for the year ended 31 December 2014 shall be as below;

**DONALD BROWN**  
**STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2014**

	Cost Shs"000"	Depreciation Shs"000"	Carrying value Shs"000"
<i>Non-current assets</i>			
Fixtures and fittings	42,200	6,200	36,000
Motor vehicles	<u>45,730</u>	<u>24,438</u>	<u>21,292</u>
	<u>87,930</u>	<u>30,638</u>	<u>57,292</u>
<i>Current assets</i>			
Inventory		19,926	
Receivables		42,737	
Prepayments		680	
Cash in hand		<u>1,411</u>	
		<u>64,754</u>	
		<u>122,046</u>	
<i>Capital</i>			
Balance b/f		26,094	
Net profit for the year		<u>67,037</u>	
		93,131	
Less drawings		<u>26,568</u>	
		66,563	
<i>Current liabilities</i>			
Payables	35,404		
Accruals	218		
Bank overdraft	<u>19,861</u>		
		<u>55,483</u>	
		<u>122,046</u>	

- (c) Given the facts in the Donald Brown question above, what is the net effect on profit of the adjustments in (a) to (c)?

**ANSWER**

- (a) Motor expenses accrual - Shs218,000 additional expense, so reduction in profit.
- (b) Rent prepayment - Shs680,000 reduction in expense, so increase in profit.
- (c) Depreciation – total charge shs13,146,000 additional expense, so reduction in profit.

Total effect on net profit = + 680,000 – 218,000 – 13,146,000

= 12,684,000 reduction.



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### Exam Type Question

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#### Activity 15.3

The following trial balance has been extracted from the ledger of Mr. Mubiru Eric, a sole trader.

	Dr. Shs '000	Cr. Shs '000
Sales		138,078
Purchases	82,350	
Carriage	5,114	
Drawings	7,800	
Rent and Insurance	6,622	
Postage and stationery	3,001	
Advertising	1,330	
Salaries and wages	26,420	
Irrecoverable debts	877	
Allowance for receivables		130
Receivables	12,120	
Payables		6,471
Cash on hand	177	
Cash at bank	1,0002	
Inventory as at 1 June 2014	11,927	
Equipment at cost	58,000	
Accumulated depreciation		19,000
Capital		53,091
	<u>216,770</u>	<u>216,770</u>

The following additional information as at 31 May 2015 is available:

- (a) Rent is accrued by Shs 210,000.
- (b) Insurance has been prepaid by Shs 880,000.
- (c) Shs 2,211,000 of carriage inwards represent carriage inwards on purchases.
- (d) Equipment is to be depreciated at 15% per annum using the straight line method.
- (e) The allowance for receivables is to be increased by Shs40,000.
- (f) Inventory at the close of business has been valued at shs13,551,000.

**Required**

- (a) Prepare Eric's statement of profit or loss and other comprehensive income for the year ended 31 May 2015
- (b) Prepare Eric's statement of financial position as at 31 May 2015

#### Activity 15.4

Presented below is a trial balance of Mukasa a sole trader in Kampala extracted after one year of trading on 31 December 2014,

Particulars	DR. SHS "000"	CR SHS "000"
Sales	154,870	265,900
Purchases	4,200	
Rent	530	



Lighting and heating expenses	51,400	
Salaries and wages	2,100	
Insurance	85,000	
Building	1,100	
Fixtures	31,300	
Accounts receivable	412	
Sundry expenses		
Accounts payable	14,590	15,910
Cash at bank	30,000	
Drawings	16,400	
Vans	4,110	
Motor running expenses		114,202
Capital		
	<b>396,012</b>	<b>396,012</b>

*Additional Information*

- Inventory at 31 December 2014 was shs 16,280,000

**Required: Prepare Mukasa's**

(i) Statement of Profit or loss for the year ended 31 December 2014

(ii) Statement of Financial Position as at 31 December 2014

## Activity 15.5

Matovu drew up the following as at 30 June 2014. You are required to draft a statement of profit or loss and other comprehensive income for the year ended 30 June 2014 and statement of financial position as at 30 June 2014

	DR SHS "000"	CR SHS "000"
Capital		49675
Drawings	28,600	
Cash at bank	4420	
Cash at hand	112	
Accounts receivable/accounts payable	38,100	26,300
Inventory (1 July 2013)	72,410	
Van	5,650	
Office equipment	7,470	
Sales/purchases	254,810	391,400
Return inwards/return out wards	2,110	1,240
Carriage in words	760	
Carriage out words	2,850	
Motor expenses	1,490	
Rent	8,200	
Telephone charges	680	
Wages and salaries	39,600	
Insurance	745	
Office expenses	392	
Sundry expenses	216	
	<b>468,615</b>	<b>468,615</b>

*Additional Information*

- Inventory at 30 June 2014 is shs 89,404,000.



## Activity 15.6

You have been provided with the following trial balance as at 31 May 2014 for Sejusa Patrick.

	Dr. Shs '000	Cr. Shs '000
Bank	150,000	
Inventory 1 June 2013	3,600,000	
General expenses	1,800,000	
Electricity	270,000	
Marketing and advertising expenses	744,000	
Salaries	1,470,000	
Buildings at cost	15,000,000	
Motor vehicles at cost	480,000	
Plant and equipment at cost	2,100,000	
Accumulated profits 1 June 2013		840,000
Trade receivables	1,314,000	
Purchases	6,600,000	
Loan interest paid	90,000	
5% Loan		1,800,000
Revenue		17,628,000
Discounts received		450,000
Trade payables		1,500,000
Capital		4,500,000
Accumulated depreciation 1 June 2013		
Building		6,000,000
Motor vehicles		180,000
Plant and equipment		720,000
<b>Total</b>	<b>33,618,000</b>	<b>33,618,000</b>

The following notes are relevant:

1. Inventory at 31 May 2013 was valued at shs 2,400,000,000
2. Marketing and advertising expenses include shs 18,000,000 paid in advance for a marketing campaign scheduled to begin in June 2014.
3. There were salaries outstanding of shs 30,000,000 for the year ended 31 May 2014.
4. Depreciation is to be provided for as follows
  - i. Building at 5% per annum on their original cost.
  - ii. Motor vehicles at 25% per annum of their written down value.
  - iii. Plant and equipment at 20% per annum of their written down value.

### Required

- (a) Prepare Sejusa's Statement of profit or loss and other comprehensive income for the year ended 31 May 2014
- (b) Prepare Sejusa's statement of financial position as at 31 May 2014



# 16.0

# ACCOUNTS OF A MANUFACTURING CONCERN

## UNIT 10 OVERVIEW:

- General introduction
- The Income statement of a manufacturing concern
- Presentation of the Income statement of a manufacturing concern

### 16.1 INTRODUCTION

In firms which are manufacturing a manufacturing account is prepared in addition to the trading and profit and loss account (Statement of comprehensive income). During the preparation of these accounts, it's important for the accountant to categorize the different costs incurred.

### 16.2 CATEGORISATION OF COSTS.

The costs incurred in the financial period are divided into three major parts i.e.

#### 16.2.1 Prime costs

These include -  
-Direct Materials  
-Direct Labour and  
-Direct Expenses

#### 16.2.2 Production costs

- These include -      Prime costs
- Factory overhead expenses

#### 16.2.3 Total Costs

These include    - Prime costs  
                  - Overhead expenses  
                  - Administration expenses,  
                  - Selling and Distribution expenses

### 16.3 DIRECT AND INDIRECT COSTS

#### 16.3.1 Direct costs-

These are costs that can be traced to the item being manufactured.

#### 16.3.2 Indirect costs-

These are costs that cannot be traced to the item being manufactured and hence will be indicated under factory overhead expenses. Such costs include wages of machine operators, carriage inwards, hire of special machinery.



### 16.3.3 Factory Overhead expenses

These are costs which occur in the factory where production is being done but which cannot be traced to the item being manufactured. Such costs include wages of cleaners, rent of the factory etc.

### 16.3.4 Administration expenses.

These include expenses such management's salaries, legal fee, accountancy charges, salaries of secretaries, that cannot be traced to the item being manufactured.

These are costs that are incurred on support / administration activities; where the support / administration activities are necessary to enable the manufacturing department execute its manufacturing functions effectively.

### 16.3.5 Selling and distribution expenses

These include; sales staff salaries and commissions, carriage outwards, depreciation of delivery Vans, advertising and display expenses.

The selling and distribution expenses are incurred on all those activities that aim at delivering the items manufactured to the final consumer or costs that are ensuring that the manufactured item is available for intended users / consumers.

## 16.4 THE INCOME STATEMENT OF A MANUFACTURING CONCERN.

The income statement (i.e. The Statement of Profit or loss and other comprehensive income) of a manufacturing concern is made up of three (3) major parts, i.e.;

- (i) *The Manufacturing Part*
- (ii) *The Trading Part*
- (iii) *The profit or loss part*

### 16.4.1 The manufacturing part

This is debited with the production cost of goods completed during the accounting period. It contains costs of;

- a) *Direct materials*
- b) *Direct labour*
- c) *Direct expense*
- d) *Factory overhead expenses*

When completed this account will show the total production cost. This figure will be transferred down to the trading account.

#### NOTE:

Where the company's policy allows the factory to include a percentage markup or the market profit on the production cost of goods manufactured, then the figure transferred down to the trading account will include the factory markup or market profit.



- **Proforma Manufacturing Account**

**ABC MANUFACTURERS (U) LTD  
MANUFACTURING ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2014**

	Shs "000"
Opening stock of raw materials	XX
Add: Purchases of raw materials	XX
Carriage Inwards of raw materials	<u>XX</u>
	XX
Less: Closing stock of raw materials	(XX)
Cost of Raw Materials Consumed	XX
Direct Wages	XX
Direct expenses	<u>XX</u>
<b>PRIME COST</b>	<b>XX</b>
Factory overheads	<u>XX</u>
<b>FACTORY COST</b>	<b>XX</b>
Add: Opening work in progress	<u>XX</u>
	XX
Less: Closing Work in progress	<u>XX</u>
<b>Production cost of goods completed</b>	<b><u>YY</u></b>

#### 16.4.2 The trading account part

This account consists of;

- *The production cost brought down from the manufacturing account*
- *Closing and opening stocks of finished goods,*
- *Sales*

When completed this account will show the gross profit .This will then be carried down to the profit and loss account Part.

- **Proforma Trading Account**

	Shs
Sales	XX
<b>Less: production cost of goods sold</b>	
Opening stock of finished goods	XX
<b>Add: production cost of goods completed b/d</b>	<u>YY</u>
	XX
Less closing stock of finished goods	(XX)
<b>Gross profit</b>	<b><u>XX</u></b>

#### 16.4.3 The profit and loss account

When completed, this account will show the NET PROFIT. This account includes;

- *The Gross profit brought down from the trading account*
- *All administration expenses*
- *All selling and distribution expenses*



## 16.5 PRESENTATION OF THE INCOME STATEMENT OF A MANUFACTURING CONCERN.

The accounting standards do not prescribe a particular presentation criteria; hence a firm can choose to present the three parts separately or combined the three parts in one statement.

### EXAM FOCUS POINT

In the exam it is highly likely that you will have to present the three parts as a single statement.

### EXAM TYPE QUESTION

#### Activity 16.1:

Wizcom Industries Limited specializes in the manufacture of floor and wall tiles. The company also buys from other manufacturers for special tiles which it cannot manufacture in its factory. The following information was obtained from the books of the company for the year ended 31 December 2012.

	Shs '000'
Purchases:	
raw materials	1,125,000
Special tiles	176,250
Carriage on raw materials	18,750
Factory wages	1,816,875
Factory expenses	478,125
Warehouse expenses	129,375
Salaries	1,826,625
Office expenses	178,500
Carriage outwards	61,500
Advertising	270,000
Discounts received	52,500
Discounts allowed	45,000
Sales	7,366,500
Sales return	16,500
 <i>Inventory on hand:</i>	
	<i>1 January</i>
	<i>Shs '000'</i>
Raw materials	150,000
Finished tiles	356,250
Special tiles	127,500
Work in progress	285,000
	<i>31 December</i>
	<i>Shs '000'</i>
	93,750
	414,375
	88,125
	262,500

The market value of tiles manufactured was ascertained to be Shs. 4,567,500,000 as at 31 December 2014.  
Plant and machinery is to be depreciated by Shs. 412,500,000.

**Required:** (It is company's policy to include a markup on the production cost)

**Prepare for the year ended 31 December 2012, Wizcom's;**

- a. Manufacturing account showing the cost of tiles produced and manufacturing profit (10marks)
- b. Statement of profit or loss and other comprehensive income (10marks)

Source: CPA(U), June 2013, Question 3



**SOLUTION TO ACTIVITY 16.1 – Wizcom Industries Ltd****WIZCOM INDUSTRIES LIMITED****Manufacturing account for the year ended 31 December 2012 Shs '000' Shs '000'**

Opening inventory of raw materials	150,000
Purchases of Raw materials	1,125,000
Carriage on raw Materials	18,750
Closing inventory of raw materials	(93,750)
<b>Cost of raw materials used</b>	<b>1,200,000</b>
Factory wages	1,816,875
<b>Prime Cost</b>	<b>3,016,875</b>
<b>Factory overheads</b>	
Factory expenses	478,125
Warehousing expenses	129,375
<b>Depreciation:</b>	
Plant and machinery	<u>412,500</u>
<b>Factory cost</b>	<b>4,036,875</b>
Opening inventory of work in progress	285,000
Closing inventory of work in progress	(262,500)
<b>Cost of goods manufactured</b>	<b>4,059,375</b>
Manufacturing profit	508,125
<b>Transfer Value of goods manufactured</b>	<b>4,567,500</b>

**WIZCOM INDUSTRIES LIMITED**  
**statement of comprehensive income**  
**for the year ended 31 December 2012**

	Shs '000'	Shs '000'
Sales		7,350,000
<b>Cost of Sales</b>		
Opening inventory		
Finished Tiles	356,250	
Special tiles	127,500	
Purchases of special tiles	176,250	
Goods manufactured at transfer value	4,567,500	
Closing inventory-finished tiles	(414,375)	
Closing inventory -special tiles	<u>(88,125)</u>	4,725,000
<b>GROSS PROFIT</b>		2,625,000
Discount Received		52,500
<b>Total Income</b>		2,677,500
<b>Expenses</b>		
Salaries	1,826,625	
Office expenses	178,500	
Carriage outwards	61,500	
Advertising	270,000	
Discount allowed	<u>45,000</u>	(2,381,625)
Trading Profit		295,875
Manufacturing profit		508,125
<b>NET PROFIT</b>		<b>804,000</b>



**Activity 16.2:**

The following data were obtained from the books of Smarties Ltd, a manufacturer as at 31 December 2011.

	<b>Shs '000'</b>
Raw materials purchases	200,000
Indirect materials	20,000
Carriage on materials	2,000
Direct labour cost	450,000
Raw material returns	4,500
Carriage outwards	30,000
Other overheads	135,00
Lighting	35,000
Power for production machines	145,000
Indirect labour cost	45,000
Office salaries	77,000
Administration expenses	125,000
Sales	4,210,000
Advertising	14,000
Provision for bad debts 1 January 2011	14,500
Bank charges	2,950
Delivery van expenses	8,500
Discounts allowed	4,500
Depreciation:	
Motor vehicle	2,500
Furniture	3,500
Fittings	6,500

The following additional information was provided;

1. Inventory                    1 January 2011(Shs '000')                    31 December 2011 (Shs '000')

Raw materials	50,000	35,000
Work in progress	25,000	10,000
Finished goods	20,000	23,000

2. The production machines had the following balances at 1 January 2011:

	Shs"000"
Cost	800,000
Accumulated depreciation	<u>464,000</u>
Net book value	<u>336,000</u>

A machine which had cost Shs 100 million on February 2009 was disposed of during the year at shs 32 million. This transaction had not yet been accounted for in Smarties Ltd's books. The firm depreciates its production machines at the rate of 40% per annum on the reducing balance basis.

3. Shs 150 million payable for power for the production machines at the production machines had not yet been accounted for.
4. Lighting was apportioned as follows: factory  $\frac{3}{4}$ , Office  $\frac{1}{4}$ .
5. 70 percent of other overheads relate to the office while the balance to the factory.
6. Bad debts provision should be increased to Shs 16 million.
7. Advertising expenses of Shs 1 million were prepaid.
8. Manufactured goods are transferred at factory cost plus mark-up of 20 percentage to cater for factory profit. (Ignore provision for unrealized profits).

**Required: Prepare Smarties Ltd's**

- a) **Manufacturing Cost Statement.**
- b) **Statement of profit or loss and other comprehensive income for the year ended 31 December 2011.**

Source: CPA(U), June 2012, Question 4



**SOLUTION TO ACTIVITY 16.2 – Smarties Ltd****SMARTIES LTD MANUFACTURING COST STATEMENT FOR THE YEAR ENDED  
31 DECEMBER 2011**

	Shs '000	Shs '000
Raw Materials:		
Opening inventory		50,000
Purchases	200,000	
Carriage on materials	<u>2,000</u>	
		202,000
Returns		<u>(4,500)</u>
		197,500
Closing inventory		<u>247,500</u>
Cost of raw materials consumed		<u>(35,000)</u>
Direct factory wages		212,500
Power for production machines	145,000	
Add: Accrued power costs	<u>150,000</u>	
		450,000
Prime Cost		<u>295,000</u>
Factory overheads:		957,500
Indirect materials	20,000	
Other overheads (30% x 135,000)	40,500	
Lighting (3/4 x 35,000)	26,250	
Indirect labour costs	45,000	
Depreciation of production machines	<u>124,800</u>	
		256,550
Gain on sale of production machine		<u>1,268,050</u>
		<u>(8,000)</u>
		1,214,050
Opening WIP		25,000
Closing WIP		<u>(10,000)</u>
Cost of fully manufactured goods		1,229,050
Mark up @ 20%		<u>245,810</u>
<b>Transfer value</b>		<b><u>1,474,860</u></b>

**Workings:**

Accumulated dep of disposed production machine =  
 $(40\% \times 100,000,000) + 40\% \times (100,000,000 - 40,000,000) = 36,000,000$

**Disposal of Production Machine Account**

Production machines	100,000	Accumulated Depn	76,000
Manf A/c - Gain	<u>8,000</u>	Bank	<u>32,000</u>
	<u>36,000</u>		<u>108,000</u>



**Note:** The gain can also be taken under other income if one argued that it does not contribute to the production process.

$$\begin{aligned} \text{Dep of Remaining Production Machines} &= 40\% \times [700m - (464m - 76m)] \\ &= 124,800,000/= \end{aligned}$$

**SMARTIES MANUFACTURING COMPANY**  
**STATEMENT OF PROFIT & OTHER COMPREHENSIVE INCOME**  
**FOR THE YEAR ENDED 31 DECEMBER 2011**

	Shs '000	Shs '000	Shs '000
Sales			4,210,000
Less: Cost of Sales:			
Opening finished inventory	20,000		
Manufactured goods at transfer value	<u>1,474,860</u>		
Value of goods for sale	1,494,860		
Less: Closing finished inventory	<u>23,000</u>		
			<u>1,471,860</u>
Gross Profit			2,738,140
Factory profit			<u>245,810</u>
			2,983,950
Less: Expenses:			
Carriage outwards	30,000		
Other overheads (70% x 135,000)	94,500		
Lighting (1/4 x 35,000)	8,750		
Office salaries	77,000		
Administration expenses	125,000		
Advertising	14,000		
Less: Prepaid	<u>1,000</u>		
			13,000
Increase in provision for bad debts			1,500
Bank charges			2,950
Delivery van expenses			8,500
Discounts allowed			4,500
Depreciation:			
Motor vehicle	2,500		
Furniture	3,500		
Fittings	<u>6,500</u>		
			378,200
Net Profit			<u>2,605,750</u>



**EXAM TYPE QUESTION****Activity 16.3:**

The following trial balance was extracted from the books of ABC Ltd, a manufacturing company, as at 31 October 2012:

	Dr Shs '000'	Cr Shs '000'
Returns inwards and outwards	600	2,700
Carriage inwards	240	
Carriage outwards	113	
Discounts received and allowed	114	480
Plant and machinery at cost	57,300	
Accumulated depreciation on plant and machinery		2,730
Dividends and capital	600	45,000
Sales		54,000
Inventory 1 November 2011:		
Raw materials	1,200	
Work in progress	900	
Finished goods	1,830	
Factory wages	5,550	
Office salaries	5,070	
Salesmen's salaries and expenses	3,120	
General expenses	3,200	
Lighting expense	360	
Rent expense	225	
Insurance	750	
Bad debts written off	195	
Advertising and promotion	420	
Distribution vans at cost	32,600	
Accumulated depreciation on vans		2,520
AM Bank balance	3,733	
PM Bank balance		23,000
Cash in hand	1,000	
Trade receivables and payables	2,310	1,800
Purchases of raw materials	<u>10,800</u>	
	<u>132,230</u>	<u>132,230</u>

Additional information:

1. Inventory at 31 October 2012:  
 Raw materials     Shs 870,000.  
 Finished goods   Shs 2,460,000.  
 There was no closing work in progress.



2. Depreciation for the year is to be charged as follows:  
Plant and Machinery at 15% on cost.  
Distribution vans at 25% on reducing balance method.
3. On 31 October 2012 insurance paid in advance was Shs 45,000 and general expenses unpaid were Shs 225,000.
4. General expenses are to be apportioned 80% factory and 20% office.
5. Lighting and rent are to be apportioned 4/5 factory and 1/5 office.
6. Insurance is to be apportioned  $\frac{3}{4}$  factory and  $\frac{1}{4}$  office.
7. Distribution vans are used for sales promotion activities and delivery of goods.
8. Manufactured goods are transferred at cost plus 15%.

**Required:****Prepare ABC's Ltd's:**

- (a) manufacturing account clearly showing prime cost, factory cost of production and transfer price. (11 marks)
- (b) statement of comprehensive income for the year ended 31 October 2012 for internal use, distinguishing between gross profit on manufacturing and on trading, and administration and distribution costs. (11 marks)
- (c) statement of financial position as at 31 October 2012. (8 marks)  
(Total 30 marks)

**Source: CPA(U), November 2012, Question 2**

### **SOLUTION TO ACTIVITY 16.3 – ABC Ltd**

#### **ABC LTD'S MANUFACTURING ACCOUNT FOR THE YEAR ENDED 31 OCTOBER 2012**

	Shs 000	Shs 000	Shs 000
Opening inventory of raw materials		1,200	
Purchases of raw materials		10,800	
Carriage inwards		240	
		<u>12,240</u>	
Returns outwards		(2,700)	
Closing inventory of raw materials		<u>(870)</u>	
Raw materials consumed		8,670	
Factory wages		5,550	
<b>Prime cost</b>			<b>14,220</b>
Factory overhead expenses			
General expenses paid	3,200		
Add: Accrued	225		
	<u>80% x 3,425</u>	2,740	
Lighting expense ( $360 \times \frac{4}{5}$ )		288	
Rent expense ( $225 \times \frac{4}{5}$ )		180	
Insurance	750		
Less: Prepaid	45		
	<u>75% x 705</u>	528.75	



Dep plant & machinery 15% $\times$ 57,300	<u>8,595</u>	12,331.75
Add: opening work in progress		900
Production cost of completed goods		<u>27,451.75</u>
Add: Transfer profit @ 15%		<u>4,117.763</u>
Transfer price for completed goods		<u>31,569.513</u>

(b):

**ABC LTD'S  
STATEMENT OF COMPREHENSIVE INCOME  
FOR THE YEAR ENDED 31 OCTOBER 2012**

	Shs'000	Shs'000
Sales		54,000
Less: Returns inwards		<u>600</u>
		<u>53,400</u>
<b>Cost of sales:</b>		
Opening inventory finished goods	1,830	
Transfer price of completed goods	<u>31,569.513</u>	
	33,399.513	
Less: Closing inventory finished goods	<u>2,460</u>	
	30,939.513	
Gross Profit on trading	22,460.487	
Add: Gross profit on manufacture	<u>4,117.763</u>	
	26,578.25	
Discount received	<u>480.00</u>	
	27,058.25	
<b>Administrative costs:</b>		
General expenses (3,425 $\times$ 20%)	685	
Lighting (360 $\times$ $\frac{1}{5}$ )	72	
Rent expenses (225 $\times$ $\frac{1}{5}$ )	45	
Insurance (705 $\times$ $\frac{1}{4}$ )	176.25	
Office salaries	5,070	
Provision for unrealized profits *	<u>320.87</u>	
	(6,369.12)	
<b>Distribution costs:</b>		
Carriage outwards	113	
Discount allowed	114	
Salaries & expenses	3,120	
Bad debts written off	195	
Advertising & promotion	420	
Depn of Vans 25%(32,600-2,520)	<u>7,520</u>	
	(11,482)	
<b>Net profit</b>	<b><u>9,207.13</u></b>	
Dividends paid **	<u>(600)</u>	
Retained profits	<u>8,607.13</u>	



* Provision for unrealized profits =	<u>Markup</u>	x Closing Inventory of finished goods
	<u>Markup + 100%</u>	
	$= \frac{15\%}{115\%} \times 2,460,000 = 320,870/=.$	

\*\* Note: Section 12 (1) (h) of Part 1 of the 6<sup>th</sup> Schedule to The Companies Act, Cap 110, provides that, the aggregate amount of dividends paid and proposed should be shown on the face of the profit & loss account.

**ABC LTD'S  
STATEMENT OF FINANCIAL POSITION  
AS AT 31 DECEMBER 2012**

<b>Assets</b>	Cost	Depn	NBV
<b>Non Current assets</b>	Shs '000'	Shs'000	Shs'000
Plant & machinery	57,300	11,325	45,975
Distribution van	<u>32,600</u>	<u>10,040</u>	<u>22,560</u>
	<u>89,900</u>	<u>21,365</u>	<u>68,535</u>
<b>Current assets</b>			
Inventories:			
Raw materials		870	
Finished goods	2,460		
Unrealised profit	<u>(320.87)</u>		
		2,139.13	
Trade receivables		2,310	
Prepaid insurance		45	
Bank – AM		3,733	
Cash	<u>1,000</u>		
		<u>10,097.13</u>	
<b>Total Assets</b>			<b><u>78,632.13</u></b>
<b>Equity &amp; Liabilities</b>			
<b>Equity</b>			
Capital		45,000	
Retained profits		<u>8,607.13</u>	
			53,607.13
<b>Current liabilities</b>			
Bank overdraft – PM Bank	23,000		
Trade payables	1,800		
Accrued General expenses	<u>225</u>		
			<u>25,025</u>
<b>Total Equity &amp; Liabilities</b>			<b><u>78,632.13</u></b>



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## REVISION QUESTIONS

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**Activity 16.4**

The following trial balance was extracted from the books of Sunami Manufacturing Ltd , for the year ended 31 May 2011.

	Shs '000'	Shs '000'
Capital account		5,484,000
Inventory at 1 June 2010:		
Raw materials	252,000	
Work in progress	168,000	
Finished goods	276,000	
Freehold premises	4,920,000	
Plant and machinery	960,000	
Depreciation on plant and machinery 1 June 2010		96,000
Cash at bank	132,000	
Purchase of raw materials	3,096,000	
Fuel and lighting	252,000	
Administration salaries	204,000	
Carriage outwards	48,000	
Factory wages	708,000	
Rent and rates	252,000	
Sales revenue		5,784,000
Sales returns	84,000	
General office expenses	108,000	
Repairs to plant and machinery	108,000	
Trade receivables and payables	240,000	444,000
Bad debts written off	11,000	
Discounts allowed and received	8,000	19,000
	<u>11.827,000</u>	<u>11.827,000</u>

Additional information:

1. Inventories at hand as at 31 May 2011 were as follows:

	Shs '000'
Raw materials	150,000
Work in progress	66,000
Finished goods	126,000

2. Depreciation of 10% per annum on a straight line basis is to be charged on plant and machinery.
3. A further bad debt of Shs 40 million is to be written off.
4. Doubtful debt provision should be at 5% of the remaining trade receivables.
1. 60% of fuel and lighting and 80% of rent and rates are to be charged to manufacturing.
2. Outstanding fuel and lighting bills amount to Shs 24 million.
3. Prepaid rent and rates amount to Shs 52 million.
4. The salesmen's salaries of Shs 49 million, to be treated as selling expenses are outstanding.



**Required:**

For the year ended 31 May 2011 prepare:

- (a) a manufacturing account showing prime cost and factory cost of production. (10 marks)
  - (b) an income statement distinguishing between administration and selling costs. (10 marks)
  - (c) a statement of financial position. (10 marks)
- (Total 30 marks)**

**Source: CPA(U), November 2012, Question 2**

### Activity 16.5

ABC Ltd makes and sells loose tools. The following balances were extracted from the company's books on 31 December 2008.

	Shs '000'
Share capital	30,000
Sales	180,000
Inventory as at 1 January 2008:	
Raw materials	6,800
Work in progress	4,000
Finished goods	12,200
Purchase of raw materials	36,000
Carriage inwards on raw materials	1,600
Factory wages	37,000
Salesman's salary & expenses	20,800
Office salaries	33,800
General expenses:	
Factory	2,400
Office	1,500
Lighting	5,000
Rent	7,500
Insurance	1,900
Bad debts	2,800
Discounts received	3,200
Carriage outwards	750
Advertising	1,300
Plant and machinery (at cost less depreciation)	18,200
Motor car (at cost less depreciation)	8,400
Bank	7,200
Cash in hand	650
Trade payables	12,000
Trade receivables	15,400



**Additional information:**

1. Inventories at 31 December 2008:

	Shs '000'
Raw materials	5,800
Finished goods	10,400
Work in progress	6,000

2. Depreciation for the year is to be charged as follows:

	Shs '000'
Plant and machinery	3,000
Motor car	1,000

3. At 31 December 2008, insurance paid in advance was Shs 300,000 and office general expenses owing were Shs 150,000.  
 4. Lighting and rent are to be apportioned: 4/5 factory, 1/5 office.  
 5. Insurance is to be apportioned:  $\frac{3}{4}$  factory,  $\frac{1}{4}$  office.  
 6. The Salesman's salary and expenses are to be treated as a selling expenses. The salesman has sole use of the motor car.

**Required:**

Prepare a:

- (a) manufacturing account, for the year ended 31 December 2008, showing clearly, the cost of raw materials consumed, prime cost and total cost of production of goods completed. (10 marks)  
 (b) statement of comprehensive income for the year ended 31 December 2008 showing clearly the cost of sales of finished goods, gross profit, administrative cost and selling cost. (10 marks)  
 (c) statement of financial position as at 31 December 2008. (10 marks)  
(Total 30 marks)

**Source: CPA(U), June 2009, Question 2**



# 17.0

## ACCOUNTS OF NON-PROFIT MAKING ORGANISATIONS

### UNIT 17 OVERVIEW

- General Introduction
- Terms Used
- Sources of Income for Non-profit making entities
- Special Funds
- Preparation of final accounts for Non-profit making organisations

### 17.1 GENERAL INTRODUCTION

Non-profit making organisations are also referred to as unincorporated organisations and include entities such as Sports Clubs, Social Clubs and Societies.

The kinds of final accounts prepared by these organisations are either;

- (i) **Receipts and payments Account, or**
- (ii) **Income and Expenditure Account**

The above accounts are a summary of the cash book of the enterprise for the period.

### 17.2 TERMS USED

To differentiate Non-profit making organisations from the profit making organisations, the following terminologies are used;

PROFIT MAKING ORGANISATIONS	NON-PROFIT MAKING ORGANISATIONS
• Trading, profit and loss Account	• Income and Expenditure Account
• Net Profit	• Surplus of Income over expenditure
• Net Loss	• Excess of Expenditure over Income
• Capital / Equity = Assets – Liabilities	• Accumulated Funds = Assets – Liabilities**

\*\*This is the formula / profoma used in determining the Accumulates fund at the beginning of the financial year. This is presented in what we refer to as “THE STATEMENT OF AFFAIRS”



### 17.3 SOURCES OF INCOME FOR NON-PROFIT MAKING ORGANISATIONS

These organisations obtain their income from various sources which include the following;

- (a) Membership subscriptions for annual membership of the club including initial joining subscriptions for first year members.
- (b) Payments for life membership
- (c) Profits from the bar sales.
- (d) Profits from social events such as dinner dances.
- (e) Profits from the sales of food in the club restaurant and cafeteria.
- (f) Interest received on investments.

### 17.4 FUNDS OF NON-PROFIT MAKING ORGANISATIONS

Although the capital of a non-trading organisation is accounted for as the accumulated fund, some separate funds might be setup for particular purposes.

Such funds include;

#### (a) A life Membership Fund

This is the fund for the money subscribed for life membership by various members of the organization. This is commonly invested outside the organization.

#### (b) A building Fund

This fund is setup whereby the organization sets aside money to save for the cost of a new building extension. This money might meanwhile be invested outside the organization to earn interest income.

#### 17.4.1 Accounting for Special Funds

The basic principles of accounting for special funds are as follows;

##### (a) When money is put into the fund;

DEBIT: Cash

CREDIT: Special Fund

##### (b) When cash is invested

DEBIT: Investments (E.g. Building Society Account)

CREDIT: Cash

##### (c) When the Investments earn interest

DEBIT: Cash

CREDIT: Interest received Account (Income and Expenditure Account)

### 17.5 RECEIPTS AND PAYMENTS ACCOUNT

This is a summary of the cashbook of a non-profitmaking organization.

It is used for the preparation of an income and Expenditure Account and the Statement of Financial Position.



## 17.6 PREPARING THE INCOME AND EXPENDITURE ACCOUNT

Examination questions often provide a receipts and payments account, balances of assets and liabilities at the beginning of the period and details of accruals and prepayments at the end of the period. You would typically be required to perform the following tasks;

- Calculate the balance on the accumulated fund at the beginning of the period. Here, you would be required to draft the statement of affairs of the organization.
- Prepare the trading Account for a particular activity for the period.
- Prepare the Income and Expenditure account for the period.
- Prepare a Statement of Financial Position at the end of the period.

However, before preparing the above set of financial statements, the Accountant will normally consider the balances on the following Accounts;

- Membership Subscriptions Account*
- Bar Trading Account*
- Life Membership Account*

Determining the balances on the above three accounts forms an important part in the preparation of the Income and Expenditure Account plus the Statement of Financial position since the balances on these three accounts feed into the Financial Accounts of the Non-profit making organisations.

### 17.6.1 Membership Subscription

Annual membership subscriptions of clubs and societies are usually payable one year in advance.

The club or society therefore receives from members for benefits which the members have yet to enjoy and so **payments in advance by members**, being receipts in advance to the club or society, will be shown in the statement of financial position of the club or society as a **current liability**, to the extent that the year's membership has still to run as at the financial statement date.

When members are in arrears with subscriptions and owe money to the club or society they are "debtors / Receivables" of the organization and so appear as current assets in the statement of financial position as "Subscriptions in arrears". These should be shown as a separate item in the balance sheet and should not be netted off against subscriptions in advance.

**HARVEST SOCIAL CLUB  
SUBSCRIPTIONS ACCOUNT**

DATE	PARTICULARS	Shs'000"	DATE	PARTICULARS	Shs'000"
<b>2014</b>			<b>2014</b>		
Jan 1	Balance b/f (Arrears)	XX	Jan 1	Balance b/f (Advance)	XX
Dec 31	Income & Exp A/c (Bal fig)	XX	Dec 31	Cash A/C	XX
Dec 31	Balance c/f (Advance)	<u>aa</u> <u>XX</u>	Dec 31	Balance C/f (Arrears)	<u>bb</u> <u>XX</u>
<b>2015</b>			<b>2015</b>		
Jan 1	Balance b/f (Arrears)	bb	Jan 1	Balance b/f (Advance)	aa



### 17.6.2 Bar Trading Account

If a club has a bar or cafeteria, a separate trading account will be prepared for the trading activities. A bar trading account will contain the following items;

- (a) Bar takings
- (b) Opening stock of goods, purchases and closing stock of goods, to give the cost of bar sales
- (c) A gross profit items [ Item (a) – Item (b)]
- (d) Other expenses directly related to running of the bar (if any).
- (e) A net profit [item (c) – Item (d)]

The bar net profit is then included under income in the income and expenditure account. A loss on the bar would be included under expenditure.

### 17.6.3 Life Membership

When a member pays for life membership, the following accounting entries are made;

**DEBIT:** Cash

**CREDIT:** Life Membership Fund

The life membership fund is shown in the statement of financial position of the club or society immediately after the accumulated fund.

There are two ways of accounting for the life membership fees;

- (a) We keep the life membership fee in the life membership fund (the organization can invest it to get profits), until when the life member dies. This fee can then be transferred out of the life membership fund and taken directly into the accumulated fund, or;
- (b) To write off subscriptions to the life membership fund by transferring a “fair” amount from the fund into the income and expenditure account.

## 17.7 Accounting for the sale of Investments and Non-current Assets

Occasionally, a club or society might sell off some of its investments or non-current assets and in so doing might make a gain or loss on the sale.

- (a) The gain or loss on sale of investments is not shown in the Income and Expenditure Account; Instead the gain is directly added to (or loss subtracted from) the accumulated fund.
- (b) The gain or loss on the sale non-current assets (such as land) which is not subject to depreciation charges in the income and Expenditure account, is also taken directly to the accumulated fund.
- (c) The gain or loss on the sale of non-current assets which have been subjected to depreciation charges is recorded in the income and expenditure account.

The difference between (c) as compared with (a) and (b) is that since depreciation on the non-current asset has been charged in the income and expenditure account in the past, it's appropriate that a gain or loss on sale should also be reported through the account.



**EXAM TYPE QUESTION****Activity 17.1**

Below are the receipts and payments of the Silver Amateur Football Club (SAFC) for the year ended 30 June 2013.

Dr	Receipts & Payments Account		Cr
	Shs '000'		Shs '000'
Cash & bank balances b/f	115,670	Operating expenses	189,784
Members' subscriptions	300,700	Players & training costs	774,570
Match-day collections	994,500	Repairs & maintenance	382,438
Broadcasting revenue	386,133	Purchase of branded items	148,724
Sale of branded items	233,677	Administration expenses	192,790
Donations	98,000	Salaries & wages - others	355,312
Rental income	275,414	Other expenses	98,598
		Balances cif	261,878
	<u>2,404,094</u>		<u>2,404,094</u>

The following information is also available:

SAFC had the following balances as at 30 June 2013:

	2013 Shs '000'	2012 Shs '000'
Stadium (cost Shs 882,250,000)	705,800	723,445
Property, plant and equipment	312,500	350,000
Subscriptions in arrears	46,820	35,804
Subscriptions in advance	20,380	5,508
Owing to suppliers of branded items	37,456	31,948
Inventory of branded items	25,338	20,932
Outstanding administration expenses	6,426	4,652

At 30 June 2013, salaries & wages advances were Shs 18,324,000, while outstanding broadcasting revenue was Shs 21,665, 000.

**Required:**

- (b) Derive the accumulated fund of SAFC as at 1 July 2012. **(3 marks)**
- (a) Prepare the branded items account and the members' subscriptions account. **(4 marks)**
- (b) Prepare the Club's statement of profit or loss and other comprehensive income for the year ended 30 June 2013. **(8 marks)**



**SOLUTION TO ACTIVITY 17.1 – SAFC****(a) Deriving the accumulated fund of SAFC as at 1 July 2012**

Silver Amateur Football Club's  
Statement of Affairs  
As at 1 July 2012

	Shs 000	Shs 000
Stadium		723,445
Property, Plant & Equipment		350,000
Inventory of Branded Items		20,932
Subscriptions in Arrears		35,804
Cash and Bank		<u>115,670</u>
		<b>1,245,851</b>
<b>Deductions:</b>		
Subscriptions in advance	5,508	
Payables - Branded Items	31,948	
Accrued Administrative Expenses	<u>4,652</u>	<u>42,108</u>
Accumulated Fund as at 1 July 2012		<b>1,203,743</b>

**(b)**

Dr	Members' Subscriptions Account	Cr
	Shs 000	Shs 000
Arrears b/f	35,804	Advance b/f
Income State	296,844	Bank
Advance c/f	<u>20,380</u>	<u>Arrears c/f</u>
	<u>353,028</u>	<u>46,820</u>
Arrears b/f	46,820	Advance b/f
		20,380

Dr	Branded Items Account	Cr
	Shs 000	Shs 000
Inventory b/f	20,932	Payables b/f
Bank - Purchases	148,724	Bank - Sales
Income State-Gain	83,851	
Payables c/f	<u>37,456</u>	<u>Inventory c/f</u>
	<u>290,963</u>	<u>25,338</u>
Inventory b/f	25,338	Payables b/f
		37,456



**Silver Amateur Football Club's,  
Income Statement,  
For the year ending 30 June 2013**

<b>Income</b>	Shs 000	Shs 000	Shs 000
Subscriptions		296,844	
Match-day Collections		994,500	
Broadcasting Revenue	386,133		
Arrears - Broadcasting revenue	<u>21,665</u>	407,798	
Gain on sale of Branded Items		83,851	
Donations		98,000	
Rental Income		<u>275,414</u>	
		2,156,407	
<b>Less Expenditure</b>			
Operating Expenses	189,784		
Players & Training Costs	774,570		
Repairs & Maintenance	382,438		
Admin Expenses(192,790-4,652)	188,138		
Accrued Administration Expenses	<u>6,426</u>	194,564	
Salaries & Wages	355,312		
Prepaid Salaries & Wages	<u>(18,324)</u>	336,988	
Other Expenses		98,598	
Depreciation: Stadium	17,645		
Property, Plant & Equipment	<u>37,500</u>	55,145	
		2,032,087	
<b>Surplus</b>		<u>124,320</u>	



(d)

Silver Amateur Football Club's,  
Statement of Financial Position,  
As at 30 June 2013

ASSETS	Shs 000	Shs 000	Shs 000
Non-Current Assets:			
Stadium			705,800
Property, Plant & Equipment			<u>312,500</u>
			1,018,300
Current Assets:			
Inventory of Branded Items		25,338	
Subscriptions in Arrears		46,820	
Broadcasting Revenue in Arrears		21,665	
Prepaid Salaries & Wages		18,324	
Cash & Bank	<u>261,878</u>		374,025
TOTAL ASSETS			<u>1,392,325</u>
 <b>FUNDS &amp; LIABILITIES</b>			
Funds			
Accumulated Fund b/f			1,203,743
Surplus for the year			<u>124,320</u>
Total Accumulated Fund			1,328,063
Current Liabilities:			
Payables-Branded Items		37,456	
Subscriptions in Advance		20,380	
Accrued Admin Expenses	<u>6,426</u>		64,262
			<u>1,392,325</u>

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**EXAM TYPE QUESTION**

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**QUESTION 17.2**

Workout "QUESTION 4(b), NOVEMBER 2014



## REVISION QUESTIONS

### Activity 17.3

Below is the receipts and payments account of Palabek Community Hospital as at 31 December 2011:

	Shs '000'		Shs '000'
Balance b/f	880,500	Patient care costs	1,460,000
Fees from patients	2,812,000	Employee costs	2,263,000
Grants & donations	3,000,000	Outreach programme expenses	1,888,000
Training fees	730,000	Fuel & transport	236,000
Investment income	230,700	Insurance & rates	234,000
Sale of motor vehicle	15,000	Building & equipment expenses	504,000
Development fund	100,000	Audit & consultancy fees	87,000
		General administration costs	378,800
		New computers & equipment	60,000
		Transfer to fixed deposit account	300,000
	<u>7,768,200</u>	Balance c/f	<u>357,400</u>
Balance b/f	357,400		7,768,200

Palabek Community Hospital had the following balances at 31 December:

	Accumulated Depreciation		
	2011	2010	2010
	Shs '000'	Shs '000'	Shs '000'
Freehold land at cost	800,000	800,000	Nil
Buildings at cost	1,500,000	1,500,000	30,000
Motor vehicles at cost	?	300,000	150,000
Computers & equipment at cost	330,000	270,000	147,500
Furniture & fittings at cost	490,000	490,000	327,500
Investment in treasury bonds	925,000	925,000	
Fixed deposit account	800,000	500,000	
Receivables	198,000	132,000	
Prepaid insurance & rates	66,000	48,000	
Accumulated fund	?	3,396,500	
Development fund	?	1,350,000	
Accrued patient care costs	210,000	266,000	
Training fees received in advance	284,000	178,000	



Additional information;

- (i) Depreciation is charged on a straight line basis at the following annual rates:

Buildings	2%
Motor vehicles	20%
Computers & equipment	25%
Furniture & fittings	10%

- (ii) On 31 March 2011, a motor vehicle which had cost Shs 35,000,000 on 1 February 2008 was disposed of. Its accumulated depreciation at the time of sale was Shs 21,000,000. The transaction was only recorded in the receipts and payments account.
- (iii) All the receivables are in respect of fees from patients. No provision for bad debts has been made because the patients are guaranteed by SACCOs and none of them defaults.
- (iv) The investment in treasury bonds was made on 2 January 2010 for a period of 5 years.

**Required:**

**Prepare the following for Palabek Community Hospital for the year ended 31 December 2011**

- (a) Statement of income and expenditure. (13 marks)  
 (b) Statement of financial position. (7 marks)

#### Activity 17.4

The following is a summary of the receipts and payments of the Kololo members' Club during the year ended 31 October 2014.

**Kololo Members' Club  
Receipts and Payments Account for the year ended 31 October 2014**

	Shs '000	Shs '000	
Cash & bank balances b/d	1,470	Administrative expenses	1,141
Sales of competition tickets	3,059	Rent expenses	7,814
Members' subscription	13,909	Visiting Speakers' costs	8,925
Donations	1,239	Donation to Charities	2,245
Sweepstake winning	3,500	Prizes for competitions	1,890
Balance c/d	91	Stationery & printing	1,253
	<b>23,268</b>		<b>23,268</b>

The following valuations are also available as at 31 October

	2013 Shs '000	2014 shs '000
Equipment (original cost shs 9,940,000)	6,825	5,460
Subscription in arrears	455	495
Subscription in advance	70	259
Owing to suppliers of competition prizes	406	476
Inventory of competition prizes	266	322

**Required**

- Derive the value of the accumulated fund of Kololo members' Club as at 1 November, 2013.
- Prepare the following accounts for the year ended 31 October 2014
  - The subscriptions Account
  - The competition prize Account
- Prepare and income and expenditure Account for Kololo Members' Club for the year ended 31 October 2014 and the statement of financial position as at that date.



# 18.0

# PARTNERSHIP ACCOUNTS

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## **UNIT 18 OVERVIEW:**

- Definition of Partnership
  - The Partnership Agreement
  - Funds employed
  - Appropriation of Profits
  - Adjustments in Partnerships
- 

### **18.1 DEFINITION**

A partnership is a type of business arrangement which involves the combination of two or more individuals (known as partners) with an intention of making a profit. Normally, there can be a minimum of 2 partners and a maximum of 20 partners.

### **18.2 THE PARTNERSHIP AGREEMENT**

The partnership agreement is a written agreement in which the terms of the partnership are set out and in particular the financial arrangements as between partners.

*The terms it should cover includes the following;*

#### **i. Capital**

Each partner puts in a share of the business capital.

#### **ii. Profit sharing ratio**

Partners agree to share profits in a way they choose e.g. more abilities more capital contributed, more capital contributed, more experiencing greater work experience. In absence of a partnership agreement, the partners are deemed by law to share profits and losses equally.

#### **iii. Interest on capital**

Partners might agree to pay themselves interest on capital they put in the business. In absence of a partnership agreement, the interest on capital is not allowed.

#### **iv. Partners' salaries**

Partners may agree to pay themselves salaries. These are an appropriation of profit and not an expense in the profit and loss account. In absence of a partnership agreement, the law disallows partnership salaries.

#### **v. Drawings**

Partners may draw out their share of profits from the business. There could be an interest charged on these drawings. The law prohibits drawings in the case there is no partnership agreement.



## 18.3 LOANS

If a partner makes a loan to the business (as distinct from capital contribution), then interest on loan will be an expense in the profit and loss account, in the same way as interest to any other partner.

## 18.4 FUNDS EMPLOYED

### 18.4.1 Capital account

When a partnership is formed, each partner puts in some capital to their business. These initial capital contributions are recorded in a series of capital account one for each partner.

In addition each partner will have;

- i. Drawings account
- ii. A current account (for profits retained in the business by the partner).

### 18.4.2 A Current Account

A current account is sort of capital account which increases in value when partnership makes profits and falls in value when the partner makes drawings out of the business.

### 18.4.3 Difference between a Capital and a Current account

- The balance on the capital account will always remain static from year to year while the current account will fluctuate up and down (on making profits or drawings).
- Partners receive interests upon their capital account balance but not their current account.
- Drawings are treated as in sole trade only that at the end of the accounting period, each partners' drawings are cleared to his current account.

*The entries in that regard are:*

*Dr: Current Account of Partners*

*Cr: Drawings Account of Partners*

- **Interests on partner's loans** are credited to the partner's current account. Interest on loans from a partner is accounted for as an expense in the profit and loss account and not as an appropriation of profit, even though the interest is added to current account of the partners.

## 18.5 APPROPRIATIONS OF PROFITS

Appropriation of profit means sharing out of profit in accordance with the partnership agreement.

### 18.5.1 The partnership appropriation account

The net profit of a partnership is shared between them according to the terms of their agreement. This sharing out is shown in the profit and loss appropriation Account, which follows on from the profit and loss account itself.



**The accounting entries in this regard are:**

a. **DEBIT:** Profit & Loss A/c with the net profit c/d

**CREDIT:** Profit & Loss A/c with the net profit b/d

b. **DEBIT:** Profit & Loss appropriation A/c with net profit b/d

**CREDIT:** Current A/c's of each partner with an individual share of profits for each partner.

The way in which profit is shared out depends on the partnership agreement. The steps to take are as follows;

**Step 1:** Establish how much net interest is.

**Step 2:** If partners agree to pay interest on their drawings then;

**Debit:** Current account

**Credit:** Appropriation of profit account

**Step 3:** Appropriate interest on capital and salaries first. Both of these items are an appropriation of profit and are not expenses in the Profit & Loss account.

**Step 4:** Residual profit i.e. the difference between net profits (plus any interest on drawings) and appropriations of interest on capital and salaries shared out between partners in their profit sharing ratios.

**Step 5:** Each partner's share of profit is credited to his current account.

**Step 6:** The balance on each partner's drawings account is debited to the current account.

### 18.5.2 PROFORMA I: APPROPRIATION OF PROFITS

	Shs	Shs
Net profit b/f		xx
Add: Interest on drawing		
Partner 1	xx	
Partner 2	xx	
Partner 3	<u>xx</u>	<u>xx</u>
Less: Partners' salaries		
Partner 1	xx	
Partner 2	<u>xx</u>	xx
Less interest on capital;		
Partner 1	xx	
Partner 2	<u>xx</u>	
Residual profits;		
Partner 1 (a%)		<u>xx</u>
Partner 2 (b%)		<u>yy</u>
Partner 3 (c%)		<u>yy</u>

Where a%, b%, and c% are the profit sharing ratios of partners 1, 2 and 3 respectively.



### 18.5.3 PROFOMA 2: PROFIT AND LOSS APPROPRIATION ACCOUNT

	Shs	Shs		Shs	Shs
Partners salaries	xx	xx	Net profit b/f		xx
Interest on capital:			Interest on drawings:		
Partner 1	xx		Current c/c of Partner 1	xx	
Partner 2	xx		Partner 2	xx	
Partner 3	<u>xx</u>	xx	Partner 3	<u>xx</u>	xx
Residual profits:					
Partner 1	xx				
Partner 2	xx				
Partner 3	<u>xx</u>	xx			
			<u>yyy</u>		<u>yyy</u>

### 18.5.4 PROFOMA 3: PARTNER'S CURRENT ACCOUNTS

	P1 Shs	P2 Shs	P3 Shs		P1 Shs	P2 Shs	P3 Shs
Debit balance b/f (if any)				Balance b/f	xx		xx
Interest on drawing	xx	xx	xx	Loan interest	xx		
Drawings	xx	xx	xx	Interest on capital	xx	xx	xx
Balance c/f	<u>xx</u>	<u>xx</u>	<u>xx</u>	Salary	<u>xx</u>	<u>xx</u>	<u>xx</u>
	xx	xx	xx	Residual profits	<u>xx</u>	<u>xx</u>	<u>xx</u>
				Balance b/f	xx	xx	xx

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### EXAM TYPE QUESTION

---

#### Activity 18.1

Vero and Tio are in partnership operating Happy Teens Nursery School, and share profits and losses in the ratio of 3:2, respectively. Below is the school's trial balance as at 31 December 2011:

	Dr	Cr
	Shs 000s	Shs 000s
Capital accounts: Vero		90,000
Tio		60,000
Current accounts: Vero		37,200
Tio		22,800
Furniture and fittings	22,400	
Library books	5,200	
Admission fees		3,500
School fees receipts		235,000
Salaries and wages	68,900	
Meals	82,072	
Payables		12,000



Commission on sale of uniforms	3,680
Accumulated depreciation 1 Jan 2011:	
Furniture and fittings	6,420
Library books	2,100
Donations	40,000
Other income	7,600
Rent and utilities	90,600
Stationery	32,488
Transport costs	15,200
General expenses	27,100
15% investment (1 year)	120,000
Bank balance	37,140
Cash balance	600
Drawings: Vero	10,200
Tio	8,400
	<hr/>
	520,300
	<hr/>
	520,300

**Additional information:**

- (i) The school has 210 pupils, each paying school fees of Shs 1,110,000 per annum (comprising of 3 terms). In November 2011, 20 pupils paid their school fees for the first term of 2012 at the rate of Shs 380,000 each, while some pupils were in arrears at 31 December 2011. All the arrears are receivable in 2012.
- (ii) The investment was made on 1 April 2011 for a period of one year. Interest is receivable on maturity.
- (iii) At 31 December 2011, utilities expenses of Shs 1,180,000 were unpaid, while stationery of Shs 920,000 was unused. These transactions had not yet been accounted for.
- (iv) Donations were of a revenue nature.
- (v) Depreciation is charged on cost at the rate of 10% per annum on furniture and fittings, and 20% per annum on library books.
- (vi) The partners maintain fixed capitals and earn interest on their capital contributions at the rate of 5% per annum.

**Required:****Prepare:**

- (a) **The school fees account for the year 2011.** (2 marks)
  - (b) **Income statement for the year ended 31 December 2011.** (9 marks)
  - (c) **Partners' current accounts, in columnar form.** (2 marks)
  - (d) **Statement of financial position as at 31 December 2011.** (7 marks)
- (Total 20 marks)**

**Source: CPA(U), November 2012, Question 4**



**SOLUTION TO ACTIVITY 18.1 – Vero and Tio****(a)**

Dr	School Fees Account	Cr
	Shs 000	Shs 000
Income Statement	233,100	Balance b/f
Advance c/f (20x380)	<u>7,600</u>	Arrears c/f
	<u>240,700</u>	
Arrears b/f	5,700	Advance b/f
		7,600

**(b)**

**HAPPY TEENS NURSERY SCHOOL'S  
INCOME STATEMENT  
FOR THE YEAR ENDED 31 DECEMBER 2011**

<b>Income:</b>	Shs 000	Shs 000	Shs 000
Admission fees			3,500
School fees			233,100
Commission on sale of uniforms			3,680
Donations			40,000
Other income			7,600
Investment income(15% $\times$ 120,000 $\times$ 9/12)			<u>13,500</u>
			301,380
<b>Expenditure:</b>			
Salaries & wages		68,900	
Meals		82,072	
Rent & utilities	90,600		
Add: Accrued utilities	<u>1,180</u>		
		91,780	
Stationery	32,488		
Less: Unused stationery	<u>920</u>		
		31,568	
Transport costs		15,200	
General expenses		27,100	
Depreciation:			
Furniture & fittings (10% $\times$ 22,400)	2,240		
Library books (20% $\times$ 5,200)	<u>1,040</u>		
		3,280	
Net loss			<u>319,900</u>
Interest on capital: Vero		4,500	
Tio		<u>3,000</u>	
		7,500	
Share of losses: Vero		(15,612)	
Tio		(10,408)	
		(26,020)	
		(18,520)	



(c)

Dr			Current Account (Shs 000s)	Cr	
	Vero	Tio		Vero	Tio
Drawings	10,200	8,400	Balance b/f	37,200	22,800
Share of losses	15,612	10,408	Interest on capital	4,500	3,000
Balance c/f	<u>15,888</u>	<u>6,992</u>		-	-
	<u>41,700</u>	<u>25,800</u>		<u>41,700</u>	<u>25,800</u>
			Balance b/f	15,888	6,992

(d)

**HAPPY TEENS NURSERY SCHOOL'S  
STATEMENT OF FINANCIAL POSITION  
AS AT 31 DECEMBER 2012**

<b>Assets</b>	<b>Cost</b>	<b>Depn</b>	<b>NBV</b>
	Shs '000'	Shs'000	Shs'000
<b>Non Current assets</b>			
Furniture & fittings	22,400	8,660	13,740
	<u>5,200</u>	<u>3,140</u>	<u>2,060</u>
	<u>27,600</u>	<u>11,800</u>	<u>15,800</u>
<b>Current assets</b>			
Unused stationery		920	
School fees in arrears		5,700	
Investment income in arrears		13,500	
15% Investment		120,000	
Bank balance		37,140	
Cash balance		<u>600</u>	
			<u>177,860</u>
<b>Total Assets</b>			<b><u>193,660</u></b>
<b>Capital &amp; Liabilities</b>			
Capital & Current accounts:			
Capital accounts: Vero			90,000
Tio			<u>60,000</u>
			<u>150,000</u>
Current accounts: Vero		15,888	
Tio		<u>6,992</u>	
			<u>22,880</u>
<b>Current liabilities</b>			
Payables		12,000	
Accrued utilities expenses		1,180	
School fees in advance		<u>7,600</u>	
			<u>20,780</u>
<b>Total Equity &amp; Liabilities</b>			<b><u>193,660</u></b>



### Example 18.2 (REVISION QUESTION)

The following lists of balances have been extracted from the books of Brick and Stone trading in partnership as at 30 September 2014. Profits and losses are shared in the ratio of 3:2 respectively.

"000"	Shs "000"	Shs
Printing, stationary and postages	3,500	
Sales and Purchases	322,100	208,200
Stocks in hand as at 1 October 2013	23,000	
Rent and rates	10,300	
Staff salaries	36,000	
Heat and light	8,700	
Telephone charges	2,900	
Motor vehicle running costs	5,620	
Discounts allowed and Discounts received	950	370
Sales returns and Purchases returns	2,100	6,100
Carriage inwards and Carriage outwards	1,700	2,400
Fixtures and fittings at cost	26,000	
Provision for depreciation (fixtures and fittings)	11,300	
Motor vehicle at cost	46,000	
Provision for depreciation (motor vehicle)	25,000	
Provision for doubtful debts	8,000	
Drawings: Brick	24,000	
Stone	11,000	
Current a/c balances 1.10.13		
Brick	3,600	credits
Stone	2,400	credit
Capital a/c balances 1.10.13 ( <i>Attract 5% fixed interest p.a.</i> )		
Brick	33,000	
Stone	17,000	
Debtors and creditors	9,300	8,400
Balance at bank	8,180	

#### Additional information

- Shs. 10 million is to be transferred from Brick's capital A/c to a newly opened Brick loan a/c on 1. July. 2014. Interest at a rate of 10% p.a. on the loan is to be credited to Brick.
- Stone is to be credited with a salary at a rate of Shs. 500,000 per month from 1. April. 2014.
- Stock in hand at 30. September. 2014 have been valued at cost at Shs. 32 million.
- Telephone charges accrued due at 30. September. 2014 amounted to Shs 400,000 and rent of Shs 600,000 prepaid at that rate.
- During the year ended 30. September 2014, stone took goods costing Shs. 1 million for his own use. Interest of 10% is charged on drawings. This transaction has not yet been accounted for.
- Depreciation is to be provided at the following rates on reducing balance;

Fixtures 10%    Motor vehicle 20%

#### Required

**Prepare a statement of Profit or loss and other comprehensive income for the year ended 30 September 2014 and the statement of financial position as at that date.**



## 18.6 ADJUSTMENTS IN PARTNERSHIP

The nature of partnerships may change in the following situations;

- i. On retirement or death of a partner
- ii. Admission of a partner
- iii. Formation of a partnership from two or more sole traders
- iv. The dissolution of a partnership.

## 18.7 RETIREMENT OR DEATH OF A PARTNER

On retirement or death of a partner, various assets and liabilities of a partnership will have to be revalued and the goodwill raised taken into account but on temporary basis.

When assets are revalued, any profits or loss on revaluation are entered in profit sharing ratio, in the partners' capital account.

Since a number of items may be affected, a revaluation a/c is used to arrive at a total balance of profit or loss on revaluation.

The balance is then divided between the partners in their ratios in their capital a/cs.

***Journal entries in this regard will be as follows:***

**DEBIT:** Revaluation A/c with profit on revaluation

**CREDIT:** Partners' capital A/c

*Being net profit on revaluation of assets divided between the partners in their profit sharing ratios.*

**NOTE:** The reserve is true if a loss is made on revaluation.

### 18.7.1 Goodwill

In addition to revaluation of tangible assets, when there is a change in a partnership, goodwill may have to be considered due to the following reasons;

- i) Management skill and know-how
- ii) Reputation for service and quality of goods
- iii) Favourable location of the business
- iv) Good public relations or other positive factors.

Good reputation and profitability of the business is valued as good will. It is an intangible asset (not seen, touchable, transportable etc) and exists along the business as a going concern.

It is not recorded in the books of a business until there is a change in the business. A partner who dies or retires must be credited with a fair share of the partnership assets, including goodwill.



### **Journal entries (Raising of goodwill)**

<b>CREDIT:</b> Partners' Capital A/c	
<i>Partner 1</i>	xx
<i>Partner 2</i>	xx
<i>Partner 3</i>	xx

Goodwill is introduced only if a partner retires or dies or on admission of a new partner so that we can know the value of the business as a whole (less net tangible assets).

Goodwill may be eliminated when remaining or surviving partners proceed with the business.

## 18.7.2 Elimination of goodwill

The surviving partners can treat goodwill using three principles:

- (i) Retain goodwill in the accounts definitely
  - (ii) Write off goodwill over a period of years
  - (iii) Write off goodwill immediately on the grounds of prudence.

### **Journal entries (elimination of goodwill)**

### **DEBIT:** Partners' Capital A/cs

*Partner 1* xx  
*Partner 2* xx  
*Partner 3* xx

#### **18.8 ADMISSION OF A PARTNER**

On admission of a partner into a partnership, the partnership assets (including goodwill) have to be revalued and the new value introduced (and possibly later eliminated) from the partnership books.

If the new partner introduces additional capital into the partnership, the total amount of cash or assets he brings in must be credited to his/her Capital A/c. This A/c may include an amount he brings in for goodwill.

Goodwill must be paid by the new partner in the business because the old partners establish the business and he is going to enjoy future profits.

## 18.9 THE DISSOLUTION OF A PARTNERSHIP

A partnership can be dissolved in the following ways:

- (i) When the purpose for which the partnership has been created has been completed.
  - (ii) When one of the partners dies or become insane, in that the surviving partners can no longer conduct business.
  - (iii) When the partnership gets insolvent in that it can no longer pay its outstanding debts.
  - (iv) When it's discovered that the partnership is conducting illegal business or business construed to harm the citizens or involved in terrorist activities.

- (v) By decree of court.
- (vi) Any other reason that may lead to cancellation of the partnership deed/ relationship.

When a partnership is dissolved, the following steps are followed:

- STEP 1** All assets (except cash) are transferred to a realisation account at their book values.
- STEP 2** Each partner's current account is cleared to his Capital account since the distinction between the two is irrelevant at this stage.
- STEP 3** All the assets are sold and liabilities settled. Double entry is made between the realisation account and the cash account. Any realisation expense is debited to the realisation account. If partners take over assets, this fact is recorded in their accounts.
- STEP 4** When all sales are disposed off and all liabilities met, the balance on the realisation account is transferred to the partners' accounts in their profit-sharing ratios. A credit balance on the realisation account is a profit on dissolution and a debit balance is a loss.
- STEP 5** At this stage, the total amount due to the partners should equal the cash balance. The cash is distributed and the partnership is over.



### EXAM TYPE QUESTION

#### **Activity 18.3:**

Hip, Skip and Jump decide to dissolve their partnership on 1<sup>st</sup> January 2014. The balance sheet of the partnership on 1<sup>st</sup> January 2014 was as follows;

	Shs "000"	Shs "000"		Shs "000"	Shs "000"
<b>Capital A/cs:</b>			<b>Fixed assets at NBV:</b>		
Hip	21,000		Furniture and fittings		20,000
Skip	21,000		Investments		<u>16,000</u>
Jump	<u>10,000</u>	52,000			36,000
<b>Currents A/cs:</b>			<b>Current assets:</b>		
Hip	5,750		Investments	21,000	
Skip	2,450		Debtors	37,000	
Jump	2,500		Balance at bank	<u>3,000</u>	
		10,700			61,000
Loan		15,000			
Creditors		<u>19,300</u>			
		<u>97,000</u>			<u>97,000</u>

#### ***Additional information***

- (i) The loan was repaid, interest already having been paid up to 31<sup>st</sup> December 2014.
- (ii) The furniture and fittings were sold for Shs. 18.2 million
- (iii) Jump took over a motor vehicle (which had a NBV of Shs. 5 million) at an agreed valuation of Shs. 6 million. The other vehicles were sold for Shs. 13.45 million after repairs had first been carried out on a faulty transit van at a cost of Shs. 450,000.
- (iv) Debtors realised only 34.8 million.
- (v) Because of large discounts available, creditors were settled for Shs. 17.6 million.
- (vi) The investments realised Shs. 22.3 million.
- (vii) Dissolution expenses, excluding the transit van repair costs, totaled to Shs. 750,000.
- (viii) Hip, Skip and Jump share profits and losses in the ratio of 2:2:1.

#### ***Required:***

***Show the relevant account and the final distribution between partners.***



# 19.0

# ACCOUNTS OF A LIMITED LIABILITY COMPANY

## UNIT 19 OVERVIEW:

- Limited Liability
- Benefits of trading as a limited liability
- Composition of Share capital
- Description of share capital
- Statement of Changes in equity

### 19.1 LIMITED LIABILITY

Limited liability companies are incorporated to take advantages of “limited liability” of their owners (shareholders). This means that, while sole traders and partners are personally responsible for the amounts owed by their businesses, the shareholders of a limited company are only responsible for the amounts paid for their shares. They are not responsible for the company’s debts unless they have invested in the company if it fails. Shareholders may be individuals or other companies:

Limited liability companies are formed under specific legislation (e.g. in Uganda, the companies Act Cap 340). A limited liability company is legally a separate entity from its owners and can confer various rights and duties.

There is a clear distinction between shareholders and directors of limited companies:

- a) Shareholders are the owners but have limited rights as shareholders, over the day to day running of the company. They provide capital and receive a return (dividend).
- b) The Board of Directors are appointed to run the company on behalf of shareholders. In practice, they have a great deal of autonomy. Directors are often shareholders.

The reporting requirements for limited liability companies are much more stringent than for sole trader or partnerships. In Uganda, there is a legal requirement for a company to:

- 1) Be registered.
- 2) Complete a memorandum of Association and Articles of Association to be deposited with the registrar of companies.
- 3) Have at least one director (two for a public limited companies “PLC” who may also be a shareholder).
- 4) Prepare financial accounts for submission.
- 5) Have financial accounts audited.
- 6) Distribute the financial accounts to all shareholders.



## 19.2 ADVANTAGES OF TRADING AS A LIMITED LIABILITY COMPANY

- a) Limited liability makes investment less risky than being a sole trader or investment in a partnership. However, lenders to small company may ask for shareholder's personal guarantee to secure any loans.
- b) Limited Liability Company has a separate legal identity from its shareholders. So a company continues to exist regardless of the identity its owners.
- c) Limited Liability Company makes raising finance easier (e.g. through the sale of shares)

## 19.3 SHARE CAPITAL

There are mainly two types of shares

1. **Preference shares:** Holders of these shares get an agreed percentage rate of dividends before the ordinary shareholder holders.
  - **Non-Cumulative preference shares:** These can receive dividends up to an agreed percentage each year. If the amount paid is less than the maximum agreed, the shortfall is lost by the shareholders. The shortfall cannot be carried forward and paid in the future years.
  - **Cumulative preference shares:** These also have an agreed maximum percentage dividends. However any shortfall of dividends paid in a year can be carried forward. The arrears of dividends will have to be paid before the ordinary shareholders receive any thing.
  - **Ordinary shares:** Holders of ordinary shares receive the remainder of the total profits available for dividends. There is no upper limit to the amount of dividends they can receive. (They are not preferential when it comes to giving out dividends).

## 19.4 DESCRIPTION OF SHARE CAPITAL

- a. **Authorized Share Capital:** This is sometimes known as registered capital or nominal capital. It is the total of the share capital which the company is allowed to issue to shareholders.
- b. **Issued Share capital:** This is the total of share capital actually issued to shareholders.
- c. **Called up capital:** Where only part of the amount payable on each issued share has been asked for, the total amount asked for is **called up capital**.
- d. **Uncalled up capital:** This is the total amount which is to be received in future relating to issued share capital, but which has not been asked for.
- e. **Calls in arrears:** This is the total amount which has been asked for but not yet paid up.
- f. **Paid up capital:** This is the total of the amount of share capital which has been paid for by the shareholders.

## 19.5 STATEMENT OF INCOMPREHENSIVE INCOME

The trading account section of the statement of comprehensive income of a limited liability company is the same as that of a sole trader. However in the profit/loss account, two additional expenses for the limited liability company are included. These are:

- a. **Directors remuneration:** This expense is only found in company financial accounts since directors exist in companies only.
- b. **Loan interest expense;** This is the interest charged for use of money borrowed



## 19.6 STATEMENT OF CHANGE IN EQUITY

After the profit/loss section of the statement of comprehensive income of a company, the statement of changes in equity is produced. It contains:

- The retained profits (Opening, for the current period & any transfers)
- Distribution of equity e.g. dividends, and share issues
- A reconciliation between the opening and closing carrying amount of each component of equity (share capital and reserves)

### 19.6.1 Proforma Statement of Changes in equity

**HARVEST CO**  
**STATEMENT OF CHANGES IN EQUITY AS AT 31 DECEMBER 2015**

	Share capital	Share premium	Revaluation Reserve	General Reserve	Retained Earnings	TOTAL
	Shs "000"	Shs "000"	Shs "000"	Shs "000"	Shs "000"	Shs "000"
As at 1 January 2014	XX	XX	XX	XX	XX	XX
Retained profit for the year					XX	
Revaluation			XX			
Transfers			(XX)		XX	
As at 31 December 2014	XX	XX	XX	XX	XX	XX

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### EXAM TYPE QUESTION

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#### Activity 19.1

The following trial balance was extracted from the ledger of Tasha Ltd for the financial year ended 31 December 2011:

Particulars	Notes	Dr Shs '000'	Cr Shs '000'
Ordinary share capital			50,000
Land at cost		24,000	
Motor vehicle at cost	1	14,800	
Furniture at cost	1	5,600	
Accounts receivable & payable		32,800	17,000
Bank balance		15,800	
Inventory, 1 January 2011		24,000	
20% bank loan			25,000
Purchases and sales		96,000	131,600
Returns		1,200	5,400
Salaries	5	24,000	
General expenses			7,000
Bad debts	2	1,200	
Provision for bad debts	3		4,200



Commission received		13,600
Discounts	2,400	5,000
Accumulated depreciation:		
Furniture		360
Motor vehicle		440
Retained earnings, 1 January 2011		13,680
Rent	6	10,000
Electricity		7,480
		<u>266,280</u>
		<u>266,280</u>

**Notes:**

1. The company charges depreciation on cost, at the rate of 10% on furniture and 20% on motor vehicle, per annum.
2. Bad debts of Shs 800,000 were written off on 30 December 2011 but have not yet been accounted for.
3. Provide for bad debts at the rate of 10% per annum.
4. Inventory at the 31 December 2011 was valued at Shs 29,400,000.
5. Salaries to the tune of Shs 2,400,000 had not yet been paid and had been omitted from the company's books.
6. 20% of the rent paid was for the following financial year.
7. The bank loan was obtained on 1 July 2010 for a period of 5 years. Interest is payable at the end of each financial year, but has not yet been accounted for.

**Required:**

- (a) Journalize the adjustments. (Ignore narrations) (8 marks)
  - (b) Prepare the company's statement of comprehensive income for the year ended 31 December 2011. (11 marks)
  - (c) Prepare the company's statement of financial position as at 31 December 2011. (8 marks)
  - (d) Briefly explain how the accruals and going concern concepts have affected the preparation of the statements, in (b) and (c) above. (3 marks)
- (Total 30 marks)**

**Source: CPA(U), June 2012, Question 2**

**SOLUTION TO ACTIVITY 19.1 – TASHA LTD**

	<b>Particulars</b>	<b>Debit Shs "000"</b>	<b>Credit Shs "000"</b>
1.	Depreciation of motor vehicle A/c		2,960
	Accumulated depre of motor vehicle A/c		2,960
2.	Depreciation of furniture A/c		560
	Accumulated depreciation of furniture A/c		560
3.	Bad debts A/c	800	
	Accounts Receivable		800
4.	Provision for bad debts A/c		1,000
	Profit or loss A/c		1,000
5.	Inventory A/c		29,400
	Profit or loss A/c		29,400
	Salaries A/c	2,400	



	Accrued salaries A/c		2,400
6.	Prepaid rent A/c	2,000	2,000
7.	Interest on loan (20% x 25,000,000) Loan Interest payable A/c	5,000	5,000

(b)

**TASHA Ltd**  
**Statement of Comprehensive Income**  
**For the Year ended 31 December 2011**

	Shs' 000s	Shs' 000s	Shs' 000s
Sales			131,600
Less: Returns inwards			<u>(1,200)</u>
			130,400
Less: Cost of Sales			
Opening inventory		24,000	
Add purchases	96,000		
Less returns outwards	<u>(5,400)</u>		
		<u>90,600</u>	
		114,600	
Less closing inventory		<u>(29,400)</u>	
			<u>(85,200)</u>
<b>Gross Profit</b>			<b>45,200</b>
Other Incomes:			
Commission received	13,600		
Discount received	5,000		
Increase in Provn for Bad Debts	<u>1,000</u>		
		<u>19,600</u>	
			64,800
Expenses:			
Salaries (24m +2.4m)	26,400		
General expenses	7,000		
Bad debts (1.2m + .8m)	2,000		
Discount allowed	2,400		
Rent (10m – 2m)	8,000		
Electricity & Water	7,480		
Interest on loan	5,000		
Depreciation: Motor vehicles	2,960		
Furniture	<u>560</u>		
			<u>(61,800)</u>
<b>Net Profit</b>			<b>3,000</b>
Retained earnings b/f			<u>13,680</u>
<b>Retained earnings c/f</b>			<b><u>16,680</u></b>



(c)

**TASHA Ltd**  
**Statement of Financial Position**  
**As at 31 December 2011**

Assets	Shs' 000s	Shs' 000s	Shs' 000s
	Cost	Acc Dep	NBV
<b>Non current assets</b>			
Land	24,000	0	24,000
Motor vehicle	14,800	3,400	11,400
Furniture	<u>5,600</u>	<u>920</u>	<u>4,680</u>
	<u>44,400</u>	<u>4,320</u>	40,080
<b>Current assets</b>			
Inventory		29,400	
A/cs receivable (32.8m-0.8m)	32,000		
Prov for bad debts	<u>(3,200)</u>		
		28,800	
Prepaid rent		2,000	
Bank balance		<u>15,800</u>	
			<u>76,000</u>
<b>Total assets</b>			<b><u>116,080</u></b>
<b>Equity &amp; liabilities</b>			
<b>Equity &amp; reserves</b>			
Ordinary share capital			50,000
Retained earnings			<u>16,680</u>
			66,680
<b>Non-current liabilities</b>			
20% Bank Loan			25,000
<b>Current liabilities</b>			
Accounts payable		17,000	
Accrued salaries		2,400	
Accrued interest on loan		<u>5,000</u>	
			<u>24,400</u>
<b>Total equity &amp; liabilities</b>			<b><u>116,080</u></b>

**(d) Application of Accrual & Going Concern Concepts:**

- **Accrual concept:-** The assets, liabilities, income and expenses have been recognized because it is certain that economic benefits will either flow to or from the company.
- **Going concern concept:-** There is no intention of liquidating the company or ceasing to trade, and the current assets can finance the current liabilities by Shs. 51.6 million.



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## REVISION QUESTIONS

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### QUESTION 19.2

You have been provided with the following trial balance as at 31 May 2015 for XYZ Ltd.

	Dr. Shs '000	Cr. shs '000
Bank	150,000	
Inventory 1 June 2014	3,600,000	
General expenses	1,800,000	
Electricity	270,000	
Marketing and advertising expenses	744,000	
Salaries	1,470,000	
Buildings at cost	15,000,000	
Motor vehicles at cost	480,000	
Plant and equipment at cost	2,100,000	
Accumulated profits 1 June 2014		840,000
Trade receivables	1,314,000	
Purchases	6,600,000	
Loan interest paid	90,000	
5% Loan		1,800,000
Revenue		17,628,000
Discounts received		450,000
Trade payables		1,500,000
Shs 1,000 ordinary shares		4,500,000
Accumulated depreciation 1 June 2014		
Building		6,000,000
Motor vehicles		180,000
Plant and equipment		720,000
<b>Total</b>	<b>33,618,000</b>	<b>33,618,000</b>

*The following notes are relevant:*

1. Inventory at 31 May 2015 was valued at shs 2,400,000,000
2. Marketing and advertising expenses include shs 18,000,000 paid in advance for a marketing campaign scheduled to begin in June 2015.
3. There were salaries outstanding of shs 30,000,000 for the year ended 31 May 2015.
4. A customer ceased trading owing the company shs 114,000,000. The debt is not expected to be recovered.
5. An allowance for doubtful debts is to be established at 5% of trade Receivables.
6. Depreciation is to be provided for as follows
  - i. Building at 5% per annum on their original cost.
  - ii. Motor vehicles at 25% per annum of their written down value.
  - iii. Plant and equipment at 20% per annum of their written down value.
7. The audit fee is estimated to be shs 60,000,000

**Required**

- (a) Prepare the income statement for XYZ Ltd for the year ended 31 May 2015
- (b) Prepare the balance sheet for XYZ Ltd as at 31 May 2015



### QUESTION 19.3

Workout “QUESTION 2, JUNE 2014” in your CPA(U) Question Bank.

### QUESTION 19.4

The following is an extract of the trial balance from the books of Kibok Traders Ltd (KTL) as at 30 November 2014.

	Shs “000”	Shs “000”
Land	80,000	
General expenses	13,400	
Buildings	300,000	
Inventory 1 December 2013	46,000	
Purchases	402,600	
Sales		600,000
Ordinary share capital (shs 2,000 per share)		200,000
General reserve		80,000
Revaluation reserve		4,000
Profit or loss 1 December 2013	48,000	
Share premium		6,000
	<hr/>	<hr/>
	890,000	890,000

#### Additional Information

- (i) KTL transferred shs 2 million from the profit for the year to the general reserve account.
- (ii) At 30 November 2014, land and buildings were revalued as follows;
 

Land	shs 100 million,
buildings	shs 295 million.
- (iii) Non current assets are depreciated at 2.5% per annum on reducing balance.
- (iv) Inventory at 30 November 2014 was valued at shs 24 million. KTL expects to realize shs 27.5 million from selling this inventory. KTL values inventory in accordance with IAS 2: Inventories.
- (v) During the year to 30 November 2014, KTL issued an additional 40,000 ordinary shares at shs 2,100 per share.
- (vi) A dividend of shs 210 per share for the year 30 November 2014 was declared.

#### Required

Prepare a statement of changes in equity as at November 2014 for KTL



# 20.0

# INCOMPLETE RECORDS

## **UNIT 20 OVERVIEW:**

- The Accounting and Business Equations
- Opening capital balance Unknown
- Profit Unknown
- Drawings Unknown
- Credit sales and receivables unknown
- Purchase and trade payables unknown
- Determining cost of sales
- Accounting for goods stolen and destroyed

## **20.1 INCOMPLETE RECORD QUESTIONS**

**Incomplete records** questions may test your ability to prepare accounts in the following situations.

- A trader **does not maintain a ledger** and therefore has no continuous double entry record of transactions.
- Accounting records are **destroyed** by accident, such as fire.

Under incomplete records scenario, some essential figure is **unknown** and must be calculated as a balancing figure. This may occur as a result of inventory being damaged or destroyed, or because of misappropriation of assets.

Incomplete records problems occur when a business does not have a full set of accounting records, for one of the following records.

- The proprietor of the business does not keep a full set of accounts.
- Some of the business accounts are accidentally lost or destroyed.

The problem for the accountant is to prepare a set of year-end accounts for the business; i.e. an income statement and a statement of financial position. Since the business does not have a full set of accounts, preparing the final accounts is not a simple matter of closing off accounts and transferring all balances to the trading and income expenses account, or showing outstanding balances in the statement of financial position. The task of preparing the final accounts involves the following.

- (a) Establishing the cost of purchases and other expenses.
- (b) Establishing the total amount of sales.
- (c) Establishing the amount of accounts payable, accruals, accounts receivable and payments at the end of the year.

Examination questions often take incomplete records problems a stage further, by introducing an ‘incident’, such as fire or burglary which leaves the owner of the business uncertain about how much inventory has been destroyed or stolen.



The great merit of incomplete records problems is that they focus attention on the relationship between cash received and paid, sales and accounts receivable, purchases and accounts payable, and inventory, as well as calling for the preparation of final accounts from basic principles.

To understand what incomplete records are about, we need to look at what exactly might be incomplete. The item we shall consider in turn are:

- (a) The accounting and business equations.
- (b) Credit sales and trade receivables.
- (c) Purchases and trade payables.
- (d) Purchases, inventory and cost of sales.
- (e) Stolen goods or goods destroyed.
- (f) The cash book.
- (g) Accruals and prepayments.

#### EXAM FOCUS POINT

Incomplete records questions are a good test of whether you have a really thorough grasp of double entry. The examiner is fond of them because they really test your understanding. With practice, they become easier.

## 20.2 THE ACCOUNTING AND BUSINESS QUESTIONS.

***Two equations are very useful in incomplete records calculations:***

- **The accounting equation**

$$\text{ASSETS} = \text{CAPITAL} + \text{LIABILITIES}$$

- **The business equation**

$$\text{CLOSING NET ASSETS} = \text{OPENING NET ASSETS} + \text{CAPITAL INTRODUCED} + \text{PROFIT} - \text{DRAWINGS}.$$

### 20.2.1 “OPENING CAPITAL BALANCE” IS UNKNOWN

- **The Statement of Affairs**

In practice, there should not be any missing item in the opening statement of financial position of the business, because it should be available from the preparation of the previous year's final accounts. However, an exam question might provide information about the assets and liabilities of the business at the beginning of the period under review, but then leave the balancing figure (i.e. the proprietor's business capital) unspecified. The proprietors capital balance is determined using the statement of affairs that follows the accounting equation “Assets = Capital + Liabilities” .



**Activity 20.1:**

Suppose Joe Han's business has the following assets and liabilities as at 1 January 2014.

	Shs"000"
Fixtures and fittings at cost	7,000
Provision for depreciation, fixtures and fittings	4,000
Motor vehicles at cost	12,000
Provision for depreciation, motor vehicles	6,800
Inventory	4,500
Trade receivables	5,200
Cash at bank and in hand	1,230
Trade payables	3,700
Prepayment	450
Accrued rent	2,000

**Required**

**Prepare a statement of financial position (Statement of affairs) for the business, inserting a balancing figure for proprietor's capital.**

**20.2.2 "PROFIT" IS UNKNOWN**

- **The use of the business equation.**

The business equation is simply an extension of the accounting equation.

**Closing net assets = opening net assets + capital introduced + profit – drawings.**

So if we are able to establish the trader's net assets at the beginning and end of the period, we can compute profits as follows:

**Profit/loss = movement in net assets – capital introduced +drawings.**

We want to eliminate any movement caused by money paid in or taken out for personal use by the trader. So we take out capital introduced and add back in drawings. The most obvious incomplete records situation is that of a sole trader who has kept no trading records. It may not be possible to reconstruct his whole income statement, but it will be possible to compute his profit for the year using the business equation.

**Activity 20.2:**

Joe starts up his camera shop on 1 January 2014, from rented premises with shs5 million inventory and shs3million in the bank. All of his sales are for cash. He keeps no record of his takings.

At the end of the year, he has inventory worth shs6.6 million and shs15 million in the bank. He owes shs3 million to suppliers. He had paid in shs5 million he won on the lottery and drawn out shs 2 million to buy himself a motorbike. The motorbike is not used in the business. He has been taking drawings of shs100,000 per week.

**Required**

**Compute Joe's profit as at 31 December 2014**



### Activity 20.3:

Net assets at the beginning of 2014 were shs101,700. The proprietor injected new capital of shs8,000 during the year and took drawings of shs2,200. Net assets at the end of the 2014 were shs180,000.

What was the profit earned by a business in 2014?

- A. shs72,500
- B. shs88,300
- C. shs84,300
- D. shs(84,100) loss

### 20.3 “DRAWINGS” UNKNOWN

**Drawings** often feature as the missing item in an incomplete records problem. The trader has been drawing money but does not know how much.

Drawings would normally represent no particular problem at all in preparing a set of final accounts from incomplete records, but it is not unusual for exam questions to contain complicated situations.

- (a) The business owner may pay income into his bank account which has nothing whatever to do with the business operations. For example, the owner might pay dividend income, or other income from investment into the bank, from stocks and shares which he owns personally, separate from the business itself. (In other words, there are no investments in the business statement of financial position, and so income from investments cannot possibly be income for the business). These amounts will be credited to his drawings.
- (b) The business owner may pay money out of the business bank account for items which are not business expenses, such as life insurance premiums or payment for his family's holidays etc. These will be treated as drawings.

Remember that the **business entity concept** means that the personal transactions of the trader should be kept separate from the business. Where such **personal items of receipts or payments** are made the following adjustments should be made.

- (a) Receipts should be set off against drawings. For example, if a business owner receives shs600 in dividend income from investments not owned by the business and pays it into his business bank account, then the accounting entry is:

<i>DEBIT</i>	Cash
<i>CREDIT</i>	Drawings

- (b) Payments should be changed to drawings on account; i.e.

<i>DEBIT</i>	Drawings
<i>CREDIT</i>	Cash

Another situation that may arise is that the trader has taken goods from inventory for personal use. When a trader does this, the transaction is treated in the same way as cash drawings. The goods should be taken out of purchases and not included in inventories. The double entry to record the transaction is:

<i>DEBIT</i>	Drawings
<i>CREDIT</i>	Purchases



The value of the goods taken is recorded at cost to the business, not at sale price.

### EXAM FOCUS POINT

Beware of the wording in the exam question.

**You should note that:**

- (a) If a question states that a proprietor's drawings a given year are 'approximately shs40 per week' then you should assume that drawings for the year are  $\text{shs}40 \times 52 \text{ weeks} = \text{shs}2,080$ .
- (b) However, if a question states that drawings in the year are 'between shs35 and shs45 a week', do not assume that drawings average shs40 per week and so amount to shs2,080 for the year. You could not be certain that the actual withdrawals did average shs40, and so you should treat the withdrawals figure as a missing item that needs to be calculated.

The approach to incomplete record questions is to build up the information given so as to complete the necessary **double entry**. This may involve reconstructing control accounts for:

- *Cash and bank*
- *Trade receivables and payables*.

## 20.5 CREDIT SALES AND TRADE RECEIVABLES" UNKNOWN.

If a business does not keep a record of its sales on credit, the value of these sales can be derived from the opening balance of trade receivables, the closing balance of trade receivables, and the payments received from customers during the period.

### FORMULA TO LEARN

	shs
Payments from trade receivables	X
Plus closing balance of trade receivables (since these represent sales in the current period for which cash payment has not yet been received)	X
Less opening balance of trade receivables (these represent credit sales in a previous period)	(X)
credit sales in the period.	X

If there are irrecoverable debts during the period, the value of sales will be increased by the amount of irrecoverable debts written off, no matter whether they relate to opening receivables or credit sales during the current period.



### Activity 20.4:

For example, suppose that Joe Han's business had trade receivables of shs1,750,000 on 1 April 2014 and trade receivables of shs3,140,000 on 31 March 2015. If payments received from receivables during the year to 31 March 2015 were shs28,490,000 and if there are no bad debts, then credit sales for the period would be:

	Shs"000"
Cash from receivables	28,490
Plus closing receivables	3,140
Less opening receivables	(1,750)
Credit sales	29,880

### QUESTION

The calculation above could be made in a T-account, with credit sales being the balancing figure to complete the account. Prepare the T-account.

TRADE RECEIVABLES			
	Shs"000"		shs"000"
Opening balance b/f	1,750	Cash received	28,490
Credit sales (balancing fig.)	29,880	Closing balance c/f	3,140
	31,630		31,630

The same interrelationship between credit sales, cash from receivables, or opening and closing receivables balances can be used to derive a missing figure for cash from receivables, or opening or closing receivables, given te values for the three other items. For example, if we know that opening receivables are shs6,700, closing receivables are shs3,200 and credit sales for the period are shs69,400, then cash from receivables during the period would be as follows.

TRADE RECEIVABLES			
	Shs"000"		shs"000"
Opening balance b/f	6,700	Cash received	72,900
Credit sales (balancing fig.)	69,400	Closing balance c/f	3,200
	76,100		76,100

An alternative way of presenting the same calculation would be:

	shs
Opening balance of receivables	6,700
Credit sales during the period	69,400
Total money owed to the business	76,100
Less closing balance of receivables	(3,200)
Equals cash received during the period	72,900

### 20.6 "PURCHASES AND TRADE PAYABLES" UNKNOWN

A similar relationship exists between purchases of inventory during a period, the opening and closing balances for trade payables, and amounts paid to suppliers during the period.



If we wish to calculate an unknown amount for purchases, the amount would be derived as follows.

FORMULA TO FIND	
Payments to trade payables during the period	shs X
Plus closing balance of trade payables (since these represent purchases in the current period for which payment has not yet been made)	X
Less opening balance of trade payables (these debts, paid in the current period, relate to purchases in a previous period)	(X)
Purchases during the period	X

## 20.7 ESTABLISHING COST OF SALES.

Whereby inventory, sales or purchases is the unknown figure it will be necessary to use information on **gross profit percentages** to construct a working for gross profit in which the unknown figure can be inserted as a balance.

When the value of purchases is not known, a different approach might be required to find out what they were, depending on the nature of the information given to you.

One approach would be to use information about the cost of sales, and opening and closing inventory rather than trade payables to find the cost of purchases.

FORMULA TO FIND	
Since	opening inventory shs X
	plus purchases X
	less closing inventory (X)
	equals the cost of goods sold X
then	the cost of goods sold X
	plus closing inventory X
	less opening inventory (X)
	equals purchases X

- **Mark-up** is the profit as a percentage of **cost**.
- **Gross profit margin** is the profit as a percentage of **sales**.

## 20.8 STOLEN GOODS OR GOODS DESTROYED.

A similar type of calculation might be required to derive the value of goods stolen or destroyed. When an unknown quantity of goods is lost, whether they are stolen, destroyed in a fire, or lost in any other way such that the quantity lost cannot be counted, then the cost of goods lost is the difference between (a) and (b)

(a) The **cost of goods sold**.

(b) **Opening inventory of the goods** (at cost) plus **purchases** less **closing inventory of the goods** (at cost).

In theory (a) and (b) should be the same. However, if (b) is a larger amount than (a), it follows that the difference must be the cost of goods purchased and neither sold nor remaining in inventory, i.e. the cost of goods lost.



### **20.9 Example: Cost of goods destroyed.**

Orlean Flames is a shop which sells fashion clothes. On 1 January 20X5, it had trade inventory which cost shs7,345. During the nine months to 30 September 20X5, the business purchased goods from suppliers costing shs106,420. Sales during the same period were shs154,000. The shop makes a gross profit of 40% on cost for everything it sells. On 30 September 20X5, there was a fire in the shop which destroyed most of the inventory in it. Only a small amount of inventory, known to have cost shs350, was undamaged and still fit for sale.

How much of the inventory was lost in the fire?

### **20.10 Example of goods stolen.**

Beau Gullard runs a jewellery shop in the high street. On 1 January 20X9, his trade inventory, at cost amounted to shs4,700 and his trade payables were shs3,950.

During the six months to 30 June 20X9, sales were shs42,000. Beau Gullard makes a gross profit of 33½% on the sales value of everything he sells.

On 30 June, there was a burglary at the shop, and all the inventory was stolen.

In trying to establish how much inventory had been taken, Beau Gullard was only able to say that:

- (a) He knew from his bank statements that he had paid shs28,400 to trade accounts payables in the 6 month period to 30 June 20X9.
- (b) He currently had payables due of shs5,550.

*Required*

- (a) Calculate the amount of inventory stolen.
- (b) Calculate gross profit for the 6 months to 30 June 20X9.

## **20.8 ACCOUNTING FOR INVENTORY DESTROYED, STOLEN, OR OTHERWISE LOST.**

When inventory is stolen, destroyed or otherwise lost, the loss must be accounted for somehow. The procedure was described briefly in the earlier chapter on inventory accounting. Since the loss is not a trading loss, the cost of the goods lost is not included in the cost of sales, as the previous example showed.

The account that is to be debited is one of two possibilities, depending on whether or not the lost goods were insured against the loss.

- (a) If the lost goods were not insured, the business must bear the loss, and the loss is shown in the net profit part of the income statement, i.e.

DEBIT	Expenses (e.g. administrative expenses)
CREDIT	Cost of sales.

- (b) If the lost goods were insured, the business will not suffer a loss, because the insurance will pay back the cost of the lost goods. This means that there is no charge at all in the income statement and the appropriate double entry is:

DEBIT	Insurance claim account (receivable account)
CREDIT	Cost of sales



With the cost of the loss. The insurance claim will then be a current asset, and shown in the statement of financial position of the business as such. When the claim is paid, the account is then closed by:

DEBIT	Cash
CREDIT	Insurance claim account

### 20.9 The cash book.

The construction of a cash book, largely from bank statements showing receipts and payments of a business during a given period, is often an important feature of incomplete records problems.

We have already seen that information about cash receipts or payments might be needed to establish:

- (a) The amount of purchases during a period.
- (b) The amount of credit sales during a period.

Other items of receipts or payments might be relevant to establishing:

- (a) The amount of cash sales
- (b) The amount of certain expenses in the income statement
- (c) The amount of withdrawals on account of profit by the business proprietor.

It might therefore be helpful, if the business does not keep a cash book day-to-day, to construct a cash book at the end of an accounting period. A business which typically might not keep day-to-day cash book is a shop, because:

- (a) Many sales, if not all sales, are cash sales (i.e. with payment by notes and coins, cheques, or credit cards at the time of sale)
- (b) Some payments are made in notes and coins out of the till rather than payment out of the business bank account by cheque.

Where there appears to be a sizeable volume of receipts and payments in cash (i.e. notes and coins), then it is also helpful to construct a two column cash book.

**A two column cash book** is a cash book with one column for cash receipts and payments, and one column for money paid into and out of the business bank account.

An example will illustrate the technique and the purpose of a two column cash book.

### 20.10 Example: Two column cash book.

Jonathan Slugg owns and runs a shop selling fishing tackle, making a gross profit of 25% on the cost of everything he sells. He does not keep a cash book.

On 1 January 20X7 the statement of financial position of his business was as follows.

	shs	shs
Current assets		
Inventory	10,000	
Cash in the bank	3,000	
Cash in the till	<u>200</u>	
	13,200	
Net long-term assets	<u>20,000</u>	
	<u>33,200</u>	



Trade payables	1,200
Proprietor's capital	32,000
	<u>33,200</u>

In the year to 31 December 20X7:

- (a) There were no sales on credit.
- (b) shs41,750 in receipts were banked.
- (c) The bank statements of the period show the payments.
  - (i) to trade payables
  - (ii) for sundry expenses
  - (iii) to drawings
- (d) Payments were also made in cash out of the till:
  - (i) to trade payables
  - (ii) for sundry expenses
  - (iii) to drawings

At 31 December 20X7, the business had cash in the till of shs450 and trade payables of shs1,400. The cash balance in the bank was not known and the value of closing inventory has not yet been calculated. There were no accruals or prepayments. No further long-term assets were purchased during the year. The depreciation charge for the year is shs900.

**Required**

- (a) *Prepare a two column cash book for the period.*
- (b) *Prepare the income statement for the year to 31 December 20X7 and the statement of financial position as at 31 December 20X7.*

#### 20.11 Theft of cash from the till.

When cash is stolen from the till, the amount stolen will be a credit entry in the cash book, and a debit in either the net profit section (income and expenses account) of the income statement or insurance claim account, depending on whether the business is insured. The missing figure for cash sales, if this has to be calculated, must not ignore cash received but later stolen – see above.

#### 20.12 Using trade receivables to calculate both cash sales and credit sales.

A final point which needs to be considered is how a missing value can be found for cash sales and credit sales, when a business has both, but takings banked by the business are not divided between takings from cash sales and takings from credit sales.

#### 20.13 Example: Using trade receivables.

Suppose, for example, that a business had, on 1 January 20X8, trade receivables of shs2,000, cash in the bank of shs3,000, and cash in hand of shs300.

During the year to 31 December 20X8 the business banked shs95,000 in takings.



It also paid out the following expenses in cash from the till:

Drawings	shs1,200.
Sundry expenses	shs800.

On 29 August 20X8 a thief broke into the shop and stole shs400 from the till.

At 31 December 20X8 trade receivables amounted to shs3,500, cash in the bank shs2,500 and cash in the till shs150.

What was the value of sales during the year?

#### **20.14 ACCRUALS AND PREPAYMENTS.**

Where there's an accrued expense or prepayment, the charge to be made in the income statement for the item concerned should be found from the opening balance b/f, the closing balance c/f, and cash payments for the item during the period. The charge in the income statement is perhaps most easily found as the balancing figure in a T account.

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#### **EXAM TYPE QUESTION**

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#### **QUESTION 20.5**

Workout “QUESTION 5, NOVEMBER 2014” in your CPA(U) Question Bank.



# 21.0

# PREPARATION OF CASHFLOW STATEMENTS

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## **UNIT 21 OVERVIEW:**

- Introduction to Cashflows
  - Presentation of cash flow statements
  - Direct Vs Indirect Method
  - Profoma Cash flow statements
  - Importance of Cash flow statements
- 

## **21.1 INTRODUCTION**

At the end of the Accounting period the Statement of Profit or loss and other comprehensive income and the statement of financial position are prepared.

These two statements however may not tell us clearly the movement of cash and its application during the accounting period. A third financial statement known as CASHFLOW STATEMENT is always prepared in accordance with an international accounting statements Seven (IAS 7).

A Cash flow statement is an additional financial statement that emphasizes the liquidity position of the organisation. It depicts changes in cash position (Cash and cash equivalents) from one period to another.

The cash flow statement explains the reasons for such inflows and outflows of cash as the case might be. Cash flow statement reports cash flows during the period. It provides an explanation for increases and decreases in cash equivalents.

## **21.2 KEY DEFINITIONS**

### **21.2.1 Cash flow**

This refers to the increase or decrease in the amount of cash and cash equivalent resulting from any business dealing.

### **21.2.2 Cash**

Cash refers to cash at hand and deposits repayable on demand with any financial institution, which includes deposits denominated in foreign currency.

### **21.2.3 Cash equivalents**

Cash equivalents, are short term highly liquid investments that are readily convertible into known amount of cash without notice and which are within 3 months of maturity when acquired, less advances from banks repayable within months from the date of advance.

Cash flows help management in making plans for the immediate future. A PROJECTED Cash flow statement or cash budget will help the management in ascertaining how much cash will be available to meet obligations to trade accounts payable, to pay bank loan and to pay dividends to shareholders.



A proper planning of cash resources will enable management to have cash available whenever needed in put in some profitable or productive use in case there is surplus cash available.

The main purpose for the cash flow statement is trying to reconcile the profitability and liquidity stand of any business because the profit and loss account may reflect a high profit figure (level) and in actual sense when it does not correspond with the cash and cash equivalent at hand.

The cash flow statement will help to explain why a firm with increasing profitability will experience liquidity problems and vice versa. In addition, the uses of accounting information may be miss lead by the high profitable level and think there is enough cash at hand for example;

- **Shareholders** might believe that the organisation's profit on those accounts shows high profits then it should be able to pay them dividends returns on capital.
- **Employees** might be convinced that by the high profit revealed they can begin demanding for high pay and they will assume that the company or organisation should pay off their outstanding wages and salaries if any.
- **The government revenue agencies** e.g. URA may not listen to please by the organisation to extend its tax payment period basing on the high profit reflected on the profit and loss account. The URA may not appreciate that the company may not be able to pay because the profitability does not correspond with the liquidity.
- **Investors, public and government** may think that a firm has made profits and that has the ability to pay its debts when they fall due.

Preparation of cash flow statement will help to resolve the above profit misinterpretation.

### 21.3 BENEFITS OF CASHFLOW STATEMENTS/ANALYSIS

Preparation and presentation of cash flow statements is beneficial to the organisation in the following ways.

- **A cash flow statement is useful for short time planning.**

A business needs sufficient cash to meet its various obligations in the near future such as payment to suppliers, procurement of fixed assets, payment of debts maturing in the near future and expenses of the business.

- **Helps in efficient cash management.** Cash flow analysis helps in evaluating financial policies and cash proportion. Cash is the basis for all operations and hence a projected cash flow statement will enable management to plan and coordinate the financial operations properly that not the sources and application of cash.
- **Helps in internal finance management.** Cash analysis provides information about funds, which will be available from operations, this will help management in possibility of repayment of long term debts, dividend policies, planning, replacement of plant and machinery.
- **Disclose the movement of cash.** Cash flow statements disclose the complete story of cash movement. The increase in or decrease of cash and the reason can therefore be known. It discloses the reason for low cash balances in spite of heavy operating profits or for heavy cash balances in spite of low profits.



A comparison of original forecast with the actual results highlights the trend of movement of cash which may otherwise go undetected.

- **Discloses the success or failure of cash planning.**

The extent of success and failure of cash planning can be known by comparing the projected cash flow statement with the actual cash flow statement and necessarily remedial measures can be taken.

## 21.4 LIMITATIONS OF CASH FLOW ANALYSIS

- **Cash flow statements cannot be equated with the income statement.** An income statement takes into account both cash and non-cash items and therefore net cash flow does not necessarily mean net income of the business.
- **The cash balance disclosed by the cash flow statement may not represent the real liquid position of the business** since it can be easily influenced by postponing purchases and other payments.

## 21.5 PRESENTATION OF CASH FLOW STATEMENTS

A CASH FLOW STATEMENT is prepared and presented in accordance with IAS 7. According to IAS 7, Cash flow during the period should be classified and presented under 3 main headings;

- *Cash flow from operating activities*
- *Cash flow from or towards investing activities*
- *Cash flow from or towards financing activities*

### 21.5.1 Operating Activities

This shows whether and to what extent an organisation can generate cash flow from its operations. These are generally cash effects of transaction and other events relating to operating and trading activities. The net cash flow from operating activates represents the net increase or decrease in cash and cash equivalents resulting from the operation.

Generally cash flow from operating activities will be those activities which determine the net profit or loss of any business enterprise for example these include cash receipts from sales, receipts from fees and commission cash payments to suppliers, cash payment for and on behalf of employees.

### 21.5.2 Investing Activities

This relates to changes in non-current assets which will generate future profit and cash flows. Examples include;

- *Sale of property, plant and equipment*
- *Investment in debentures and other loan instruments of other organisations*
- *Purchase of plant, property and equipment*
- *Disposal of equity and debenture interest in another company.*

Please note that in case there is a sale of an asset then you would expect the cost of the asset to reduce as compared to the previous year. But if there is a sale of an asset and the cost of the asset is seen increasing then it would mean that there was double transaction of sale and purchase of an asset during the period. It's hence important to prepare the account of that particular asset and determine the purchase value of the asset procured.



### 21.5.3 Financing Activities

This relates to cash flow from or towards the providers of finance. Examples include;

- (i) **Issue of new shares.** In case shares have been issued and cash is received that is after deducting expenses on issue or discounts on issued shares will be taken as source of cash. This will also include the share premium.
- (ii) **Raising of long term loans and debentures.** Long term loans such as issue of debentures from financial institutions are sources of cash, however the interest paid in these loans is regarded as cash outflows.
- (iii) **Payment of long term loans.** The payment of long term loans such as term loans and debentures result into cash out flows.
- (iv) **Decrease in unsecured deposits.** The decrease in these liabilities denotes that they have been paid off.
- (v) **Payment of dividends.** These are returns on capital invested by the shareholders. This decreases the cash available for business hence its an outflow of cash.
- (vi) **Short-term borrowings.** Cash receipts from banks, short-term borrowing increase cash inflows.

## 21.6 APPROACHES TO PREPARATION AND PRESENTATION OF CASH FLOW STATEMENTS

There are 2 major approaches that can be used in the preparation and presentation of Cash flow statements. These include;

- (i) Indirect Method
- (ii) Direct Method

### 21.6.1 The Indirect method

Here you start with the operating profit (PBIT) as determined in the income statement, adjust it for non-cash items and movements in working capital items as discussed below;

#### ADJUSTMENTS FOR NON-CASHFLOW ITEMS

- **Depreciation on assets**

Depreciation does not result in outflow of cash and yet is charged in the profit and loss account as an expense hence reducing on the net profit. Therefore the depreciation on non-current assets must be added back to the net profit in order to find out the real cash generated from operations.

- **Amortization of intangible assets**

Goodwill, preliminary expenses and other intangible assets written off against profit reduces the net profit without affecting the cash balance. The amount written off should therefore be added back to the operating profit to find out the cash from operations.



- **Loss on sale of assets**

In case of a loss on disposal it does not result in any cash outflow and yet it's charged against the profit and an expense. Such losses on disposal of asset must be added back to the net profit.

- **Gains/profit from sale of non-current assets**

These are taken to be profit earned as a result of the sale/disposal of an asset. The profit is always added on the profit of the year and yet does not result in an extra inflow of cash. Therefore such profit on sale of asset must be subtracted from the operating profit.

- **Provision for bad debts**

These are just mere book keeping entries and does not involve payment out of cash. When preparing the profit and loss account an increase in the provision for bad debts is included in the expense hence reducing on the profit. Such increase must be added back to the profit.

On the other hand, a decrease in the provision for bad debts is taken as an income which is added on the gross profit and hence increasing the net profit of the year yet the cash flow is not affected. Such decrease must be deducted from the operating profit when preparing the cash flow statement.

## **ADJUSTMENTS FOR MOVEMENTS IN WORKING CAPITAL ITEMS**

The term working capital is normally used to indicate the amount of funds which a business has at any time to enable it meet demands requiring immediate settlement. This consists of current assets such as Accounts, Receivables, Inventories, bank, prepayment of expenses, these are sometimes known as circulating capital, they are assets, which are easily converted into cash.

Working capital also includes those liabilities or obligations which the business must satisfy by payment in cash in the very near future; they include trade accounts payable for goods supplied, bank overdraft, bills payable, accrued expenses for services rendered, income tax payable dividends payable, incomes received in advance. Etc.

**The following adjustments are required when preparing a cash flow statement;**

**(i) Accounts receivable**

Increase in accounts receivable means that there is a sale of goods on credit, which has a positive effect on the operating profit. The increase also implies that receipts are being delayed and the business is probably giving a long credit period, which reduces cash inflows yet the profit and loss A/C reflects a high profit figure. This increase should therefore be subtracted from the operating profit.

A decrease will on the other hand imply that there are receipts from credit customers hence inflows. Such a reduction in accounts receivable must be added back to the operating profit.

**(ii) Accounts payable**

An increase means that purchases of goods have been made on credit and the business is delaying payment to suppliers hence retaining suppliers' cash. This is an inflow in return which should be added back to the operating profit from the period.

A decrease means that payments have been made to suppliers. This is an outflow which must be deducted from the PBIT.



**(iii) Outstanding expenses and income received in advance**

These are treated in the same way as accounts payable.

**(iv) Prepaid expenses and outstanding incomes**

These are treated in the same way as accounts receivable.

**(v) Opening and closing inventory.**

The amount of opening inventory is charged on the debit side of the income statement. It thus reduces the PBIT which cuts reducing the cash from operations.

Similarly the closing inventory is credited to the income statement which increases the amount of PBIT without increasing the cash from operations.

An increase in inventory is a cash outflow while an increase is a cash inflow. Generally, any non-cash flow item and changes in working capital item that will have increased the PBIT must be subtracted and vice versa to determine the net cash flow from operations.

## 21.6.2 DIRECT METHOD

If a cash flow statement is presented following the direct method, cash flow are categorized and presented under their major classes. The classes may include;

- Cash received from sales
- Collections from customers/accounts receivable
- Payments to trade suppliers
- Payments to other supplier
- Payments to and on behalf of the employees

Although IAS 7 recommends organisations to use direct method as the most preferred method, the indirect method is more popular. The direct method is preferred because it can be traced to the activities of the organisation unlike indirect method where cash flow from operating activities are determined using the income statement and the balance sheet. However implementation of the method will require management of both accrual and cash accounting system which may be expensive for the organisation.

The indirect method uses information from the income statement and balance sheet prepared following the accrual system hence only one system is required.



### 21.6.3 PROFORMA CASH FLOW STATEMENTS (Indirect method) – IAS 7

	Shs	Shs
<b>Cash flow from operating activities</b>		
Operating profit/ loss before interest and tax	XX	
Depreciation charge for the year	XX	
Amortization of intangible and fictitious assets	XX	
Increase / (decrease) accounts payable	XX/(XX)	
(Increase) / decrease in accounts receivable	(XX)/XX	
(Increase) / decrease in inventory	(XX)/XX	
Loss / (gain) on disposal	XX/(XX)	
Increase / (decrease) in provision for bad debts	<u>XX/(XX)</u>	
<b>Cash generated from operations</b>	<b>XX</b>	
Interest paid	(XX)	
Taxes paid	<u>(XX)</u>	
Net cash flow from operating activities		XX
<b>Cash flow from investing activities</b>		
Acquisition (or purchase) of non-current assets	(XX)	
Disposal of non-current assets	<u>XX</u>	
Net cash flows from investing activities		XX
<b>Cash flow from financing activities</b>		
Issue of shares (including share premium)	XX	
Issue of debentures	XX	
Acquisition of long-term debt	XX	
Dividends paid	(XX)	
Redemption of debentures	(XX)	
Repayment of loan	<u>(XX)</u>	
Net cash flows from financing activities		<b>XX</b>
Increase / (Decrease) in cash and cash equivalents		<u>XX/(XX)</u>
Add: Cash and cash equivalents b/d (Note 1)		<u>XX</u>
<b>Cash and cash equivalents c/d (Note 2)</b>		<b>XX</b>

### NOTES

1. Analysis of cash and cash equivalents
2. When preparing the statement from comparative balance sheets you will usually have to calculate such items as depreciation, loss on sale of asset and profit for the year.
3. Work out the profit if not already given using opening and closing balances of retained earnings, interest expenses, tax charge and dividends.

### Retained Earnings A/c: (vertical Format)

	Shs
Closing balances (P & L a/a) / Retained earnings	XX
Add: Dividends (Proposed and paid)	XX
Provision for taxation	XX
Interest expenses	XX
Less: Opening balance (P & L a/c) / Retained earnings	<u>(XX)</u>
Profit for the year (PBIT)	<b>XX</b>



**Retained Earnings Account**

Balance b/f (Arrears)

	Shs		Shs
Interest Expenses	XX	Balance b/d	XX
Taxation	XX	Operating profit for the year	XX
Dividends	XX	(PBIT) Balancing figure	
Balance c/f	XX		
	<b>XX</b>		<b>XX</b>

**PROFOMA CASH FLOW STATEMENTS (direct method) – IAS 7**

	Shs	Shs
<b>Cash flow from operating activities</b>		
Receipts from sales	XX	
Collections from customers	XX	
Payment to and on behalf of staff	(XX)	
Cash flow from operations	XX	
Taxation	(XX)	
Interest paid	<u>(XX)</u>	
<b>Net cash flow from operating activities</b>	<b>XX</b>	
<b>Cash flow from investing activities</b>		
Acquisition (or purchase) of non-current assets	(XX)	
Proceeds from disposal of non-current assets		XX
Proceeds from sale of investment	<u>XX</u>	
Net cash flows from investing activities		XX
<b>Cash flow from financing activities</b>		
Issue of shares (including share premium)	XX	
Issue of debentures	XX	
Acquisition of long-term debt	XX	
Dividends paid	(XX)	
Redemption of debentures	(XX)	
Repayment of loan	<u>(XX)</u>	
Net cash flows from financing activities		XX
Increase / (Decrease) in cash and cash equivalents		XX/(XX)
Add: Cash and cash equivalents b/d		<u>XX</u>
<b>Cash and cash equivalents c/d</b>	<b>XX</b>	
<b>Uses of cash flow statements</b>		

Besides the statutory requirement;

- (a) Helps the business assess the cash flows it may be able to generate in the future.
- (b) Helps the business assess the extent to which it will be able to meet future commitments, such as taxation due, loan repayments, interest payments, contracts which could possibly lose quite a lot of money.
- (c) Helps the business assess how far future shares may be needed, or additional capital in the case of sole traders or partnerships;
- (d) Facilitates in valuation of the business.



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**EXAM TYPE QUESTION**

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**Activity 20.1**

Rocky Ltd's balance sheet as at 31 December 2013 and 2014, and its income statement for the year ended 31 December 2014 are shown below. Rocky Ltd issued no new ordinary shares during the year. During 2014 Rocky Ltd spent shs 87 million on non-current assets additions. There were no non-current assets disposals during the year ended 31 December 2014.

<b>Statement of Financial Position</b>	<b>2007</b>	<b>2006</b>
	Shs million	Shs million
Non-current assets	<u>811</u>	<u>826</u>
<b>Current assets</b>		
Inventories	45	53
Trade receivables	172	160
Prepayment	17	21
Cash and bank	<u>7</u>	<u>3</u>
	<u>241</u>	<u>237</u>
<b>Total assets</b>	<b>1,052</b>	<b>1,063</b>
<b>Current liabilities</b>		
Overdraft	11	10
Trade payables	39	51
Accruals	24	20
Dividends	78	65
Taxation	<u>47</u>	<u>30</u>
	<u>199</u>	<u>176</u>
<b>Long term liabilities</b>		
Bank loan	<u>195</u>	<u>195</u>
Capital and reserves		
Share capital	260	260
Share premium	52	52
Revaluation reserve	90	90
Retained profits	<u>256</u>	<u>160</u>
	<u>658</u>	<u>562</u>
<b>Total capital &amp; liabilities</b>	<b><u>1,052</u></b>	<b><u>1,063</u></b>



Income statement	Shs million
Turnover	810
Cost of sales	<u>(459)</u>
Gross profit	351
Distribution and administrative costs	<u>(131)</u>
	220
Other operating income	17
Operating profit	237
Interest receivable	<u>18</u>
	255
Interest payable	<u>(34)</u>
Profit before tax	221
Tax on profit from ordinary activities	<u>(47)</u>
Profit from ordinary activities after tax	174
Retained profit 1 January, 2014	<u>160</u>
	334
Proposed dividends	<u>(78)</u>
Retained profit 31 December 2014	256

**Required**

*In accordance with IAS 7: Cash Flow statements, prepare a cash flow statement with supporting schedules for Rocky Ltd for the year ended 31 December 2007 using the indirect method. [20marks]*



# PART F

## Inventories

# 22.0

# INVENTORY

## UNIT 22 OVERVIEW:

- Cost of sales
- Carriage inwards and outwards
- Goods written off and written down
- Counting and valuing inventories
- IAS 2 Inventories

## 22.0 COST OF GOODS SOLD

The **cost of goods sold** is calculated as:  
Opening inventory + purchases – closing inventory

### 22.1 Unsold goods in inventory at the end of an accounting period.

Goods might be unsold at the end of an accounting period and so still be **held inventory**. The purchase cost of these goods should not be included therefore in the cost of sales of the period.

### 22.2 The cost of goods sold

The cost of goods sold is found by applying the following formula.

	Shs
Opening inventory value	XX
Add: Cost of purchases (or, in the case of a manufacturing company, the cost of production)	<u>XX</u>
Less: Closing inventory value	<u>(XX)</u>
Cost of goods sold	<u><u>XX</u></u>

In other words, to match ‘sales’ and the ‘cost of goods sold’, it is necessary to adjust the cost of goods manufactured or purchased to allow for increases or reduction in inventory levels during the period.

The ‘formula’ above is based on a logical idea. You should learn it, because it is a fundamental principle.

### 22.3 Example: Cost of goods sold

Perry P, trading as the Umbrella Shop, end his financial year on 30 September each year. On 1 October 20X4, he had no goods in inventory. During the year to 30 September 20X5, he purchased 30,000 umbrellas costing UGX60,000 from umbrella wholesalers and suppliers. He resold the umbrellas for UGX5 each, and sales for the year amounted to UGX100,000 (20,000 umbrellas). At 30 September there were 10,000 unsold umbrellas left in inventory, valued at UGX2 each.

What was P Perry’s Louis’s gross profit for the year?

**Solution**

Perry P Louis purchased 30,000 umbrellas, but only sold 20,000. Purchase costs of UGX60,000 and sales of UGX100,000 do not represent the same quantity of goods.

The gross profit for the year should be calculated by 'matching' the sales value of the 20,000 umbrellas sold with the cost of those of 20,000 umbrellas. The cost of sales in this example is therefore the cost of purchases minus the cost of goods in inventory at the year end.

	UGX	UGX
Sales		100,000
Purchases (30,000 units)	60,000	
Less closing inventory (10,000 units @ UGX2)	<u>20,000</u>	
Cost of sales (20,000 units)		40,000
Gross profit		<u>60,000</u>

**1.4 Example continued.**

We shall continue the example of the Umbrella Shop into its next accounting year, 1 October 20X5 to 30 September 20X6. During the course of this year, Perry P Louis purchased 40,000 umbrellas at a total cost of UGX95,000. During the course of year, he sold 45,000 umbrellas, leaving 5,000 umbrellas in inventory at the year end. Once again, gross profit should be calculated by matching the value of 45,000 units of sales with the cost of those 45,000 units.

The cost of sales is the value of the 10,000 umbrellas in inventory at the beginning of the year, plus the cost of the 40,000 umbrellas purchased, less the value of the 5,000 umbrellas in the inventory at the year end.

	UGX	UGX
Sales (45,000 units)		230,000
Opening inventory (10,000 units)	20,000	
Add purchases (40,000 units)	<u>95,000</u>	
	115,000	
Less closing inventory (5,000 units)	<u>12,000</u>	
Cost of sales (45,000 units)		103,000
Gross profit		<u>127,000</u>

**QUESTION**

On 1 January 20X6, the Grand Union Food Stores had goods in the inventory valued at UGX6,000. During 20X6 its proprietor purchased supplies costing UGX5,000. Sales for the year to 31 December 20X6 amounted to UGX80,000. The cost of goods in inventory at 31 December 20X6 was UGX12,500.

What is the gross profit for the year?

**ANSWER**

	UGX	UGX
Sales		80,000
Opening inventories	6,000	
Add purchases	<u>50,000</u>	
	56,000	
Less closing inventories	<u>12,500</u>	
Cost of goods sold		43,500
Gross profit		<u>36,500</u>

## 22.3 The cost of carriage inwards and outwards.

**Carriage inwards** is included in the cost of purchases. **Carriage outwards** is a selling expense.

'Carriage' refers to the **cost of transporting purchased goods** from the supplier to the premises of the business which has bought them. Someone has to pay for these delivery costs: sometimes the supplier pays, and sometimes the purchaser pays, the cost to the purchaser is carriage inwards (**into** the business). When the supplier pays, the cost to the supplier is known as carriage outwards (**out of** the business).

**Note:**

The cost of carriage inwards is usually added to the cost of purchases.

The cost of carriage outwards is a selling and distribution expense in the income statement.

### 1.6 Example: Carriage inwards and carriage outwards.

Gwyn Tring, trading as Clickety Clocks, imports and resells clocks. He pays for the costs of delivering the clocks from his supplier in Switzerland to his shop in Wales.

He resells the clocks to other traders throughout the country, paying the costs of carriage for the consignments from his business premises to his customers.

On 1 July 20X5, he had clocks in inventory valued at UGX17,000. During the year to 30 June 20X6 he purchased more clocks at a cost of UGX75,000. Carriage inwards amounted to UGX2,000. Sales for the year were UGX162,000. Other expenses of the business amounted to UGX56,000 excluding the carriage outwards which cost UGX2,500. The value of the goods in inventory for the year ended was UGX15,400.

*Required*

Prepare the income statement of Clickety Clocks for the year ended 30 June 20X6.

**Solution**

CLICKETY CLOCKS  
INCOME STATEMENT FOR THE YEAR ENDED 30 JUNE 20X6

	UGX	UGX
Sales		162,000
Opening inventory	17,000-	
Purchases	75,000	
Carriage inwards	2,000	
	<u>94,000</u>	
Less closing inventory	<u>15,000</u>	
Cost of goods sold		78,600
Gross profit		83,500
Carriage outwards	2,500	
Other expenses	<u>56,000</u>	
		58,500
Net profit		<u>25,000</u>

### 1.7 Goods written off or written down

A trade might be unable to sell all the goods that he purchases, because a number of things might happen to the goods before they can be sold. For example:

- (a) Goods might be lost or stolen
- (b) Goods might be damaged, become worthless and so be thrown away
- (c) Goods might become obsolete or out of fashion. These might be thrown away, or sold off at very low price in a clearance sale.

When goods are **lost, stolen or thrown away** as worthless, the business will make a loss on those goods because their '**sales value**' will be nil.

Similarly, when goods lose value because they have become obsolete or out of fashion, the business will **make a loss** if their clearance sales value is less than their cost. For example, if goods which originally cost UGX500 are now obsolete and could only be sold for UGX150, the business would suffer a loss of UGX350.

If, at the end of an accounting period, a business still has goods in inventory which are either worthless or worth less than their original cost, the value of the inventories should be **written down** to:

- (a) Nothing, if they are worthless.
- (b) Their net realizable value, if this is less than their original cost.

This means that the loss will be reported as soon as the loss is foreseen, even if the goods have not yet been thrown away or sold off at a cheap price. This is an application of the prudence concept.

The costs of inventory written off or written down should not usually cause any problems when calculating the gross profit of a business, because the cost of goods sold will include the cost of inventories written off or written down, as the following example shows

### 1.8 Example: Inventories written off and written down.

Lucas Wagg, trading as Fairlock Fashions, end his financial year on 31 March. At 1 April 20X5 he had goods in inventory valued at UGX8,800. During the year to 31 March 20X6, he purchased goods costing UGX48,000. Fashion and goods which cost UGX12,000 were still held in inventory at 31 March 20X6, and Lucas Wagg believes that these could only now be sold at a sale price at UGX400. The goods still held in inventory at 31 March (including the fashion goods) had an original purchase cost of UGX7,600. Sales for the year were UGX81,400.

#### **Required**

**Calculate the gross profit of Fairlock fashions for the year ended 31 March 20X6.**

#### **Solution**

Initial calculation of closing inventory values:

#### INVENTORY ACCOUNT

	At cost	Realisable value	Amount written down
Fashion goods	UGX 2,100	UGX 400	UGX 1,700
Other goods (balancing figure)	<u>5,500</u> <u>7,600</u>	<u>5,500</u> <u>5,900</u>	<u>1,700</u>

## GROSS PROFIT CALCULATION

	UGX	UGX
Sales		81,400
Value of opening inventory	8,800	
Purchases	<u>48,000</u>	
	56,800	
Less closing inventory	<u>5,900</u>	
Cost of goods sold		50,900
Gross profit		<u>30,500</u>

By using the figure of UGX5,900 for closing inventories, the cost of goods sold automatically includes the inventory written down of UGX1,700.

### 23 Accounting for opening and closing inventories.

**Opening inventories** brought forward in the inventory account are transferred to the income and expense account, and so at the end of the accounting year the balance on the inventory account ceases to be the opening value b/f and becomes instead the closing inventory value c/f.

#### 2.1 Recap

We saw that in order to calculate **gross profit** it is necessary to work out the **cost of goods sold**. In order to calculate the cost of goods sold it is necessary to have values for the **opening inventory** (i.e. inventory in hand at the beginning of the accounting period) and **closing inventory** (i.e. inventory in hand at the end of the accounting period).

You should remember that the trading part of an income statement includes:

Opening inventory  
Plus purchases  
Less closing inventory  
Cost of goods sold

However, there are three basic problems with this formula.

- (a) How do you manage to get a **precise count** of inventory in hand at any one time?
- (b) Even once it has been counted, how do you value the inventory?
- (c) Assuming the inventory is given a value, how does the **double entry bookkeeping** for inventory work?

The purpose of this chapter is to answer all three questions. In order to make the content easier to follow, it is convenient to take the last one first.

#### 1.2 Ledger accounting inventories.

The value of **closing inventories** is accounted for in the **nominal ledger** by debiting an inventory account and crediting the income and expense account at the end of the accounting period. Inventory will therefore have a debit balance at the end of the period, and this balance will be shown in the statement of financial position as a current asset.

It has already been shown that purchases are introduced to income statement by means of the double entry:

DEBIT	Income and expense account	UGXX
CREDIT	Purchases account	UGXX

But what about opening and closing inventories? How are their values accounted for in the double entry bookkeeping system? The answer is that an inventory account must be kept. This inventory account is only ever used at the end of the accounting period, when the business counts up and values the inventory in hand, in an inventory account.

- (a) When an inventory account is made, the business will have a value for its closing inventory, and the double entry is:

DEBIT	Inventory account (closing inventory value)	Shs XX
CREDIT	Income and expense account	Shs XX

However, rather than show the closing inventory as a 'plus' value in the income and expense account (by adding it to sales) it is usual to show it as a 'minus' figure in arriving at cost of sales. This is illustrated above. The debit balance on inventory account represents an asset, which will be shown as part of current assets in the statement of financial position.

- (b) Closing inventory at the end of one period becomes opening inventory at the start of the next period. The inventory account remains unchanged until the end of the next period, when the value of opening inventory is taken to the income and expense account.

DEBIT	Income and expense account	Shs XX
CREDIT	Inventory account (value of opening inventory)	Shs XX

## 22.4 Counting inventories.

The **quantity** of inventories held at the year end is established by means of a **physical count** of inventory in an annual counting exercise, or by a '**continuous**' inventory count.

Business trading is a continuous activity, but accounting systems must be drawn up at a particular date. In preparing a statement of financial position it is necessary to '**freeze**' the activity of a business to determine its assets and liabilities at a given moment. This includes establishing the quantity of inventories on hand, which can create problems.

In simple cases, usually when a business holds easily counted and relatively small amounts of inventory quantities of inventories at hand at the reporting date can be determined by physically counting them in an **inventory count** at that date.

In more complicated cases, where a business holds considerable quantities of varied inventory, an alternative approach to establishing quantities is to maintain **continuous inventory records**. This means that a card is kept for every item of inventory, showing receipts and issues from the stores, and a running total. A few inventory items are counted each day to make sure their record cards are correct – this is called a 'continuous' count because it is spread out over the year rather than completed in one count at a designated time.

One obstacle is overcome once a business has established how much inventory is on hand. But another of the problems noted in the introduction immediately rises its head. What value should the business place on those inventories?

### 22.4.1 Valuing inventories.

The value of inventories is calculated at the lower of **cost** and **net realizable value** for each separate item or group of items. **Cost** can be arrived at by using **FIFO** (first in-first out) or **AVCO** (weighted average costing).

## 22.4.2 The basic rule

There are **several methods** which, in theory, might be used for the valuation of inventory.

- (a) Inventories might be valued at their *expected selling price*.
- (b) Inventories might be valued at their expected selling price, less any costs still to be incurred in getting them ready for sale and selling them. This amount is referred as the *net realizable value* (NRV) of the inventories.
- (c) Inventories might be valued at their *historical cost* (i.e. the cost at which they were originally bought).
- (d) Inventories might be valued at the amount it would cost to replace them. This amount is referred to as the *current replacement cost* of inventories.

The use of selling prices in inventory valuation is ruled out because this would create a profit for the business before the inventory has been sold.

A simple example might help to explain this. A trader buys two items of inventory, each costing UGX100. He can sell them for UGX140 each, but in the accounting period we shall consider, he has only sold one of them. The other is closing inventory in hand.

Since only one item has been sold, you might think it is common sense that profit ought to be UGX40. But if closing inventory is valued at selling price, profit would be UGX80, i.e. profit would be taken on the closing inventory as well.

	UGX	UGX
Sales		140
Opening inventory	-	
Purchases (2 x UGX100)	<u>200</u>	
	200	
Less closing inventory (at selling price)	<u>140</u>	
Cost of sales		60
Profit		<u>80</u>

This would contradict the accounting concept of **prudence**, to claim a profit before the item has actually been sold.

The same objection **usually** applies to the use of NRV in inventory evaluation. The item purchased for UGX100 requires UGX5 of further expenditure in getting ready for sale and selling it (e.g. UGX5 of processing costs and distribution costs). If its expected selling price is UGX140, its NRV is UGX  $(140 - 5) = 135$ . To value it at UGX135 in the statement of financial position would still be to anticipate a UGX35 profit.

We are left with **historical cost** as the nominal basis of inventory valuation. **The only time when historical cost is not used is where the prudence concept requires a lower value to be used.**

Staying with the example above, suppose that the market in this kind of product suddenly slumps and the item's expected selling price is only UGX90. The item's NRV is then UGX $(90 - 5) = UGX85$ . The prudence concept requires that losses should be recognized as soon as they are foreseen. This can be achieved by valuing the inventory item in the statement of financial position at its NRV of UGX85.

The argument developed above suggests that the rule to follow is that the inventories should be valued at cost, or if lower, net realizable value. The accounting treatment of inventory is governed by an accounting standard, IAS 2 *Inventories*. IAS 2 states that **inventory should be valued at the lower cost and net realizable value as we will see below.**

### 1.1 Applying the basic valuation rule.

If a business has inventory items on hand the comparison of cost and NRV should theoretically be carried out for each item separately. It is not sufficient to compare the total cost of all inventory items with their total NRV. An example will show why.

Suppose a company has four items of inventory on hand at the end of its accounting period. Their cost and NRVs are as follows.

<i>Inventory item</i>	<i>Cost</i>	<i>NRV</i>	<i>Lower of cost/NRV</i>
1	27	32	27
2	14	8	8
3	43	55	43
4	<u>29</u>	<u>40</u>	<u>29</u>
	<u>113</u>	<u>135</u>	<u>107</u>

It would be correct to compare total costs (UGX113) and to state inventories at UGX113 in the statement of financial position. The company can foresee a loss of UGX6 on item 2 and this should be recognized. If the four items are taken together in total, the loss on item 2 is masked by the anticipated profits on the other items. By performing the cost/NRV comparison for each item separately the prudent valuation of UGX107 can be derived. This is the value which should appear in the statement of financial position.

However, for a company with large amounts of inventory, this procedure may be anticipatable. In this case it is acceptable to group similar into categories and perform the comparison of cost and NRV category by category, rather than item by item.

### QUESTION

The following figures relate to inventory held at the year end.

	<i>A</i> UGX	<i>B</i> UGX	<i>C</i> UGX	
Cost	20	9	12	
Selling price	30	12	22	
Modification cost to enable sale	-	2	8	
Marketing costs	7	2	2	
Units held	200	150	300	

*Required*

Calculate the value of inventory held.

### ANSWER

<i>Item</i>	<i>Cost</i> UGX	<i>NRV</i> UGX	<i>Valuation</i> UGX	<i>Quantity</i>	<i>Total value</i> <i>Units</i> UGX
A	20	23	20	200	4,000
B	9	8	8	150	1,200
C	12	12	12	300	<u>3,600</u>
					<u>8,800</u>

So have we now solved the problem of how a business should have its inventories? It seems that all the business has to do is chose the lower cost and net realizable value. This is true as far as it goes, but there is one further problem, perhaps not easy to foresee; for a given type of inventory, **what was the cost?**

## 1.2 Determining the purchase cost.

Inventories may be **raw materials** or components bought from suppliers, **finished goods** which have been made by the business but not yet sold, or work in the process of production, but only part-completed (this type of inventory is called **work in progress** or WIP). It will simplify matters, however, if we think about the historical cost of purchased raw materials and components, which ought to be their purchase price.

A business may be continually purchasing consignments of a particular component. As each consignment is received from suppliers the components are stored in the appropriate bin or on the appropriate shelf or pallet, where they will be mingled with the previous consignments. When the storekeeper issues components to production he will simply pull out from the bin the nearest components to hand, which may have arrived in the latest consignment, in an earlier consignment or in several different consignments. Our concern is to devise a technique, which we can use to attribute a cost to each of the components issued from stores.

There are several techniques which are used in practice.

- FIFO (first in, first out). Using this technique, we assume that components are used in the order in which they are received from suppliers. The components issued are deemed to have formed part of the oldest consignment still unused and are costed accordingly.
- AVCO (average cost). As purchase prices change with each new consignment, the average price of components held is constantly changed. Each component held at any moment is assumed to have been purchased at the average price of all components held at that moment.
- LIFO (last in, first out). We assume that components used formed part of the most recent delivery, and inventories are the oldest receipts.

If you are preparing **financial accounts** you would normally expect to use FIFO or AVCO for the valuation of inventory. **IAS 2 inventories does not permit the use of LIFO.** You should note furthermore that terms such as AVCO and FIFO refer to **pricing techniques** only. The actual components can be used in any order.

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### Exam Type Questions

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#### Activity 22.1

ABC (U) Ltd had the following transactions during the month of May 2015

	Quantity Units	Unit cost UGX	Total cost UGX	Market value per unit on date of transactions UGX
Opening balance 1 May	100	2.00	200	
Receipts 3 May	400	2.10	840	2.11
Issues 4 May	200			2.11
Receipts 9 May	300	2.12	636	2.15
Issues 11 May	400			2.20
Receipts 18 May	100	2.40	240	2.35
Issues 20 May	100			2.35
Closing balance 31 May	200			2.38

**Note:** Receipts mean goods are received into store and issues represent the issue of goods from store.

**Required**

**Determine the value of the following (Using FIFO and AVCO)**

- (a) The issues of materials
- (b) The closing inventory

### 1.3 Inventory valuations and profit.

In the previous descriptions of FIFO and AVCO the example used raw materials as an illustration. Each method of valuation produced different costs both of closing inventories and also of material issues. Since raw material costs affect the cost of production, and the cost of production works through eventually into the cost of sales, it follows that different methods of inventory valuation will provide different profit figures. An example may help to illustrate this point.

### 1.4 Example: Inventory valuations and profit.

On 1 November 20X2 a company held 300 units of finished goods item No 9639 in inventory. These were valued at UGX12 each. During November 20X2 three batches of finished goods were received into store from the production department, as follows.

Date	Units received	Production cost per unit
10 November	400	UGX12.50
20 November	400	UGX14
25 November	400	UGX15

Goods sold out of inventory during November were as follows.

Date	Units sold	Sale price per unit
14 November	500	UGX20
21 November	500	UGX20
28 November	100	UGX20

*What was the profit from selling the inventory item 9639 in November 20X2, applying the following principles of inventory valuation?*

- (a) FIFO
- (b) AVCO (using cumulative weighted average costing)

*Ignore administration, sales and distribution costs.*

### Exam Type Questions

#### Activity 22.2

A firm has the following transactions with its product R.

##### Year 1

- Opening inventory: nil
- Buys 10 units at UGX300 per unit
- Buys 12 units at UGX250 per unit
- Sells 8 units at UGX400 per unit
- Buys 6 units at UGX200 per unit
- Sells 12 units at UGX400 per nit

**Year 2**

Buys 10 units at UGX250 per unit  
 Sells 5 units at UGX400 per unit  
 Buys 12 units at UGX150 per unit  
 Sells 25 units at UGX400 per unit

**Required**

*Using FIFO, calculate the following on an item by item basis for both year 1 and year 2*

- (i) The closing inventory
- (ii) The sales
- (iii) The gross profit

## 22.5 IAS 2 INVENTORIES

IAS 2 *Inventories* lays out the required accounting treatment for inventories under International Financial Reporting Standards.

### 22.5.1 Scope

The following items are **excluded** from the scope of the standard.

- Work in progress under **construction standards** (covered by IAS 11 Construction contracts, which you will study in later financial accounting papers)
- **Financial instruments** (i.e. shares, bonds)
- **Livestock**, agricultural and forest products, and mineral ores.

### 22.5.2 Definitions.

The standard gives the following important definitions.

- Inventories and assets:
  - Held for sale in the ordinary course of business.
  - In the process of production for such sale; or
  - In the form materials or supplies to be consumed in the production process or in the rendering of services.
- Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale (IAS 2).

Inventories can **include** any of the following.

- **Goods purchased and held for resale**, e.g. goods held for sale by a retailer, or land and buildings held for resale.
- **Finished goods** produced.
- **Work in progress** being produced.
- Materials and supplies awaiting use in the production process (**raw materials**).

### 22.5.3 Measurement of inventories.

The standard states that '**inventories should be measured at the lower cost and net realizable value'**

### 22.5.4 Cost of inventories

The cost of inventories will consist of all the following costs.

- (a) **Purchase**
- (b) **Costs of convention**
- (c) Other costs incurred in bringing the inventories to their **present location and condition**

### 22.5.5 Costs of purchase

The standard lists the following as comprising the costs of purchase of inventories.

- (a) **Purchase price**
- (b) **Import duties** and other taxes
- (c) Transport, handling and any other cost **directly attributable** to the acquisition of finished goods, services and materials.
- (d) **Less any trade discounts**, rebates and other similar amounts.

### 22.5.6 Costs of conversion

Costs of conversion of inventories consist of two main parts.

- (a) Costs **directly related** to the units of production, e.g. direct materials, direct labor.
- (b) Fixed and variable **production overheads** that are incurred in converting materials into finished goods, allocated on a systematic basis.

You may have come across the terms 'fixed production overheads' or 'variable production overheads' elsewhere in your studies. The standard defines them as follows.

- **Fixed production overheads** are those indirect costs of production that remain relatively constant regardless of the volume of production, e.g. the cost of factory management and administration.
- **Variable production overheads** are those indirect costs of production that vary directly, or nearly directly, with the volume of production, e.g. indirect materials and labor.

The standard emphasizes that fixed production overheads must be allocated to items of inventory on the basis of the **normal capacity of the production facilities**. This is an important point.

- (a) **Normal capacity** is the expected achievable production based on the average over several periods/seasons, under normal circumstances.
- (b) The above figure should take account of the capacity lost through **planned maintenance**.
- (c) If it approximates to the normal level of activity then the **actual level of production** can be used.
- (d) **Low production or idle plant** will *not* result in a higher fixed overhead allocation to each unit.
- (e) **Unallocated overheads** must be recognized as an expense in the period in which they were incurred.
- (f) When production is **abnormally high**, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.
- (g) The allocation of variable production overheads to each unit is based on the **actual use** of production facilities.

### 22.5.7 Other costs

Any other costs should only be recognized if they are incurred in bringing the inventories to their **present location and condition**.

The standard lists types of cost which **would not be incurred** in cost of inventories. Instead, they should be recognized as an **expense** in the period they are incurred.

- **Abnormal accounts** of wasted materials, labor or other production costs.
- **Storage costs** (except costs which are necessary in the production process before a further production stage)
- **Administrative overheads** not incurred to bring inventories to their present location and conditions.
- **Selling costs**.

### 22.5.8 Determining cost

Costs of inventories should be assigned by **specific identification** to their individual costs for items that are not ordinarily interchangeable (i.e. identical or similar) and for goods or services produced and segregated for **specific projects**. Specific identification of cost means that specific costs are attributable to identified items of inventory. However, calculating costs on an individual item basis could be onerous. For convenience, IAS 2 allows the use of cost estimation techniques, such as the **standard cost method** or the **retail method**, provided that the results approximate cost.

- (a) **Standard costs** take into account **normal** levels of materials and supplies, labor, efficiency and capacity utilization. They are regularly reviewed and revised if necessary to ensure they appropriately resemble actual costs.
- (b) The **retail method** is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the percentage gross margin.

### 22.5.9 Interchangeable items.

Where inventories consist of a large number of interchangeable (i.e. identical or very similar) items, it will be virtually impossible to determine costs on an individual item basis. Therefore IAS 2 allows the following cost estimation techniques.

- (a) **FIFO** (first in, first out). Using this technique, we assume that components are used in the order in which they are received from suppliers. The components issued are deemed to have formed part of the oldest consignment still unused and are costed accordingly.
- (b) **Weighted average cost**. As purchase prices change with each new consignment, the average price of components in inventory is constantly changed. Each component in inventory at any moment is assumed to have been purchased at the average price of all components in inventory at that moment. Under the weighted average cost method, a recalculation can be made after each purchase, **or alternatively at the period end**.

The same technique should be used by the entity for all inventories that have a similar nature and use.

Note that the LIFO formula (last in, first out) is **not permitted** by IAS 2.

## QUESTION

You are the accountant at Water Pumps Co, and you have been asked to calculate the valuation of the company's inventory at cost at its year end of 30 April 20X5.

Water Pumps manufactures a range of pumps. The pumps are assembled from components bought by Water Pumps (the company does not manufacture any parts)

The company does not use a standard costing system, and work in progress and finished goods are valued as follows.

- (a) Material costs are determined from product specification, which lists the components required to make a pump.
- (b) The company produces a range of pumps. Employees record the hours spent on assembling each type of pump, this information is input into the payroll system which prints the total hours spent each week assembling each type of pump. All employees assembling pumps are paid at the same rate and there is no overtime.
- (c) Overheads are added to the inventory value in accordance with IAS 2 Inventories. The financial accounting records are used to determine the overhead cost, and this is applied as a percentage based on the direct labor cost.

For direct labor costs, you have agreed that the labor expended for a unit in work in progress is half that of a completed unit.

The draft accounts show the following materials and direct labor costs in inventory.

	<i>Raw materials</i>	<i>Work in progress</i>	<i>Finished goods</i>
Materials (UGX)	74,786	85,692	152,693
Direct labor (UGX)		13,072	46,584

The costs incurred in April, as recorded in the financial accounting records, were as follows.

Direct labor	61,320
Selling costs	43,550
Depreciation and finance costs of production machines	4,490
Distribution costs	6,570
Factory manager's wage	2,560
Other production overheads	24,820
Purchasing and accounting costs relating to production	5,450
Other accounting costs	7,130
Other administration overheads	24,770

For your calculations assume that all work in progress and finished goods were produced in April 20X5 and that the company was operating at a normal level of activity.

*Required*

Calculate the level of overheads which should be added to work in progress and finished goods in accordance with IAS 2 Inventories.

Note: you should include details and a description of your workings and all figures should be calculated to the nearest UGX.

**ANSWER**

*Calculations of overheads for inventory*

Production overheads are as follows.

	UGX
Depreciation/finance costs	4,490
Factory manager's wage	2,560
Other production overheads	24,820
Accounting/purchase costs	5,450
	<u>37,320</u>

Direct labor = UGX61,320

$$\text{Thus production overhead rate} = \frac{37,320}{61,320} = 60.86\%$$

*Inventory valuation*

	Raw materials	WIP	Finished goods	Total	UGX
	UGX	UGX	UGX	UGX	
Materials	74,786	85,692	152,693	313,171	
Direct labor	-	13,072	46,584	59,656	
Production overhead (at 60.86 of labor)	-	<u>7,956</u>	<u>28,351</u>	<u>36,307</u>	
	<u>74,786</u>	<u>106,720</u>	<u>227,628</u>	<u>409,134</u>	

Variable overheads will be included in the cost of inventory.

### 22.5.10 Net realizable value (NRV)

As a general rule assets should not be carried at amounts greater than those expected to be realized from their sale or use. In the case of inventories this amount could fall below cost when items are **damaged or become obsolete**, or where the **costs to completion have increased** in order to make the sale.

The assessment of NRV should take place **at the same time** as estimates are made of selling price, using the most reliable information available. Fluctuations of price or cost should be taken into account if they relate directly to **events after the reporting period**, which confirm conditions existing at the end of the period.

The reasons why inventory is held must also be taken into account. Some inventory, for example, may be held to satisfy a firm contract and its NRV will therefore be the **contract price**. Any additional inventory of the same type held at the period end will, in contrast, be assessed according to general sales prices when NRV is estimated.

Net realizable value must be reassessed at the end of each period and compared again with cost. If the NRV has risen for inventories held over the end of more than one period, then the previous write down must be **reversed** to the extent that the inventory is then valued at the lower of cost and the new NRV. This may be possible when selling prices have fallen in the past and then risen again.

On occasion, a write down to NRV may be of such size, incidence or nature that it must be **disclosed separately**.

### 22.5.11 Recognition as an example

The following treatment is required when **inventories are sold**.

- (a) The **carrying amount** is recognized as an expense in the period in which the related revenue is recognized.
- (b) The amount of any **write-down of inventories** to NRV and all losses of inventories are recognized as an expense in the period the write-down or loss occurs.
- (c) The amount of any **reversal of any write-down of inventories**, arising from an increase in NRV, is recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.



# Harvest Training and Consultancy Uganda Ltd.

*trainers & bookkeepers*



# FINANCIAL ACCOUNTING

*Entrepreneurship*

# ENTREPRENEURSHIP

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## 1.0 INTRODUCTION

**Entrepreneurship** is a term that is used in many business disciplines. It essentially has the money making connotation as commonly understood by many. However, entrepreneurship is much more than that. It entails coming up with an idea that no one else has thought of and capitalizing on it to set up an enterprise. This chapter gives a broad description of the various forms of entrepreneurship and the challenges that an entrepreneur will go through in an attempt to make his dream come true.

Any given economy needs both the government and the private sector to grow. The needs of the country cannot be feasibly catered for by the state on its own. Individuals also need to establish themselves as key components in any healthy economy. The role of the individual is what we are going to look at in this chapter and other subsequent chapters.

## 2.0 DEFINITION OF ENTREPRENEURS AND ENTREPRENEURSHIP

### 23.1.1 Definition of Entrepreneurship

Entrepreneurship is the process of coming up with new ways of achieving some set objectives. Mostly it will involve the production of goods and services. It requires some ingenuity coupled with a lot of time and effort. There are risks involved in this process and they all have to be assumed. With the risks come rewards that are derived by the person who has come up with the new process.

Entrepreneurship can therefore be referred to as the practice of starting new organizations particularly new businesses or revitalizing mature organizations in response to identifying opportunities. It involves scanning the business environment in response to identified business opportunities.

It can further be defined as the capacity and willingness to undertake conception, organization and management of a productive venture with all attendant risks, while seeking profit as a reward.

In economics, entrepreneurship is regarded as a factor of production together with land, labour and capital. Entrepreneurship is often a difficult undertaking because it involves risk taking.

### 23.1.2 Definition of Entrepreneur

The word entrepreneur originates from the French word "etrepren dre" which means to undertake. Hence in business context entrepreneurship means to start a new business.

An entrepreneur is someone who devises a new way of looking at things and comes up with an output out of the new concept. Given an existing technology or some kind of invention, the entrepreneur will come up with a process that will utilize the available tools and technologies to produce a good or a service that will add value to the economy and benefit both him and the society. He is one who will take the risk of the success or failure of the new venture and will also stand to reap the rewards.

An entrepreneur takes the chance that the new idea will work and he directs all his resources towards making the process a success. The fear of failing always looms but driven by ambition and the desire to succeed, the entrepreneur sees his project to completion.



According to Joseph Schumpeter (1950), an entrepreneur is a person who is willing and able to convert new ideas or invention into a successful innovation. Entrepreneurship forces creative distraction across markets and industries by creating new products in the business models.

According to Peter Drucker (1970), entrepreneurship is about taking risks. The behaviour of the entrepreneurs reflects a kind of a person willing to put his or her career and financial security at stake and take risks in the name of an idea, spending much time on a venture that is not certain.

An entrepreneur is a person who has possession of an enterprise or venture and assumes significant accountability for its inherent risk and outcomes. An entrepreneur combines the factors of production that is, land labour and capital to create and market new goods and services. He/she tends to identify a market opportunity and exploit it by organizing the resources effectively to accomplish an outcome that changes an existing interaction within a given sector.

### **23.1.3 Difference between an Entrepreneur and an Intrapreneur**

Entrepreneurs are people who have the ability to identify and evaluate business opportunities, gather the necessary resources to take advantage of the opportunities and initiate appropriate action to ensure success.

An intrapreneur is a person employed to work independently within a company in order to introduce innovation and to revitalize and diversify its business. He is an employee who uses the approach of an entrepreneur within an organizational setting. An intrapreneur must have freedom of action to explore and implement ideas, although the outcome of such work will be owned by the organization and not the intrapreneur.

### **23.1.4 What Makes Someone an Entrepreneur?**

Who can become an entrepreneur? There is no one definitive profile. Successful entrepreneurs come in various ages, income levels, gender, and race. They differ in education and experience. But research indicates that most successful entrepreneurs share certain personal attributes, including:

- (a) creativity,
- (b) dedication,
- (c) determination,
- (d) Flexibility
- (e) leadership
- (f) Passion
- (g) Self-confidence

#### **(a) Creativity**

Creativity is the spark that drives the development of new products or services or ways to do business. It is the push for innovation and improvement. It is continuous learning, questioning, and thinking outside of prescribed formulas.

#### **(b) Dedication**

Dedication is what motivates the entrepreneur to work hard, 12 hours a day or more, even seven days a week, especially in the beginning, to get the endeavor off the ground. Planning and ideas must be joined by hard work to succeed. Dedication makes it happen.

#### **(c) Determination**

Determination is the extremely strong desire to achieve success. It includes persistence and the ability to bounce back after rough times. It persuades the entrepreneur to make the phone call, after nine have yielded nothing. For the true entrepreneur, money is not the motivation. Success is the motivator; money is the reward.



**(d) Flexibility**

Flexibility is the ability to move quickly in response to changing market needs. It is being true to a dream while also being mindful of market realities. A story is told about an entrepreneur who started a fancy shop selling only French pastries. But customers wanted to buy muffins as well. Rather than risking the loss of these customers, the entrepreneur modified her vision to accommodate these needs.

**(e) Leadership**

Leadership is the ability to create rules and to set goals. It is the capacity to follow through to see that rules are followed and goals are accomplished.

**(f) Passion**

Passion is what gets entrepreneurs started and keeps them there. It gives entrepreneurs the ability to convince others to believe in their vision. It can't substitute for planning, but it will help them to stay focused and to get others to look at their plans.

**(g) Self-confidence**

Self-confidence comes from thorough planning, which reduces uncertainty and the level of risk. It also comes from expertise. Self-confidence gives the entrepreneur the ability to listen without being easily swayed or intimidated.

Every entrepreneur has these qualities in different degrees. But what if a person lacks one or more? Many skills can be learned. Or, someone can be hired who has strength that the entrepreneur lacks. The most important strategy is to be aware of strengths and to build on them.

**Qualities of a Successful Entrepreneur**

The knowledge of entrepreneurial competencies or traits has been sharpened over the last five decades. It made the people to believe that entrepreneurs are made not born. According to this view, a person possessing a judicious combination of knowledge, skill and motives can be a successful entrepreneur.

Studies conducted to identify what makes an entrepreneur successful found that possession of a set of entrepreneurial competencies or characteristics is necessary for superior performance. Mere possession of competencies is not enough. One should develop these competencies through training, - experience and guidance.

**The following is a list of major traits of entrepreneur that contributes towards top performance.**

**i. Initiative**

Initiation of any business activity should come from the entrepreneur. It is the entrepreneur who takes action that goes beyond job requirements or the 'demand of the situation. He does things before being asked or forced by the events.

**ii. Looking for opportunities**

A successful entrepreneur is one who is always on the look for new opportunities and takes action on opportunities. He must be always in readiness to exploit it in realizing the interest of the organization.

**iii. Persistence**

An entrepreneur should take repeated actions to overcome the obstacles that get in the way of reaching goals. He should never be disheartened by failures. He should believe in the Japanese proverb, "Fall seven times, stand up eight".



#### **iv. Information seeking**

An entrepreneur is always in search of new ideas and information from various sources to help reach objectives or clarify problems. He can consult experts for business or technical advice. He personally undertakes research, analysis or investigation on his own to get information realizing his goals.

#### **v. Concern for quality products**

Successful entrepreneurs always believe in high quality standards of their products with reasonable prices. They believe in excellence. They act to do things that meet or beat existing standards of excellence.

#### **vi. Commitment to work**

Successful entrepreneurs do every sacrifice to get the task completed. They put highest priority for accomplishing their objective. They are committed to their work. They also express a concern for satisfying their customers.

#### **vii. Efficiency orientation**

Successful entrepreneurs find ways to do things faster with fewer resources at lower costs. They are always interested in devising new methods aimed at promoting efficiency.

#### **viii. Systematic Planning**

Entrepreneurs develop and use logical, step-by-step, realistic and proper plans to accomplish their goals. They believe in systematic planning and its proper execution to reach goals.

#### **ix. Problem solving**

Successful entrepreneurs are challenging by nature. They always try to find out ways and means to overcome the problems that come in their way. They also identify new and potentially unique ideas to achieve their targets.

#### **x. Self-Confidence**

Successful entrepreneurs must have a strong belief in themselves and in their own abilities. They have full faith and confidence on their own knowledge, skill, and competency to complete a task or meet a challenge. They are not at all cowed down by difficult situations.

#### **xi. Assertiveness**

A successful entrepreneur must be assertive in nature so that he can assert his issues with others for promotion of interest of his enterprise. He tells others what they have to do and rebuke or disciplines those failing to perform as expected.

#### **xii. Persuasion**

A successful entrepreneur must be able to persuade others to do the work the way he wants them to do. He is able to convince others through his knowledge and competence. He asserts strong confidence in his own company's product or services. He must possess the ability to convince everybody — sellers, consumers, employees, creditors etc.

#### **xiii. Monitoring**

Successful entrepreneurs ensure regular monitoring of the working to achieve the organization's goal in the best possible manner. They personally supervise all aspects of their project to ensure completion of the work within the schedule time and cost.

#### **xiv. Concern for employee's welfare**

Concern for employees welfare should be at the top of the agenda of successful entrepreneurs. They give priority to improve the welfare of the employees because it is the employees whose dedication and commitment services lead to super performance of the organization;

#### **xv. Effective strategist**

Successful entrepreneur develops and uses varieties of effective strategies to accomplish own objectives. They also evolve relevant strategies which will safeguard and promote the interest of the organization.

### **Types of Entrepreneurs**

There are various types of entrepreneurs as discussed below:

#### **i. Craft entrepreneurs**

These are people with the technical backgrounds who go into business based on their technical expertise. For instance an accountant establishing an accountancy consultancy. They tend to focus on the work which they do themselves and are therefore poor in delegation.

#### **ii. Opportunistic entrepreneurs**

These are entrepreneurs who go into business to pursue opportunities. Their main focus is growth and diversification. They seek new business and delegate technical work to others.

#### **iii. Lifestyle entrepreneurs**

They are people who go into business primarily for life reasons such as personal fulfillment and being their own boss as opposed to a desire for financial wealth. They become business owners so that they can do the kind of work they want, work the hours they want, live where they want, spend time with people they like and admire. Their biggest motivation for most lifestyle entrepreneurs is an overwhelming desire for independence. They dream of working for themselves and running a business i.e. in tune with their lifestyle.

#### **iv. Innovative entrepreneurs**

These are entrepreneurs who are aggressive in experimentation and clever in putting attractive possibilities into practice. They like introducing new products, new services and even improving existing ones. They are also entrepreneurs who launch new products, discover new markets, establish new methods of production and restructure the business.

#### **v. Imitative entrepreneurs**

They are entrepreneurs who adopt victorious innovations launched by the innovative entrepreneurs. They duplicate the technology and techniques innovated by others and are suitable for underdeveloped countries.

#### **vi. Fabian entrepreneurs**

They are entrepreneurs who are exemplified by great caution and are often skeptics in experimenting any change in the organization. They imitate only in situations where it becomes necessary to do so.

#### **vii. Drone entrepreneurs**

They are entrepreneurs who suffer loses as they refuse to make any modifications in the existing production methods. They are against any change in the production methods even at cost of loses.



### **viii. Forced entrepreneurs**

They are people who become entrepreneurs on account of circumstances: For instance someone losses his job and is forced to start a business so as to have a source of income.

### **ix. Administrator/Organizer**

These are entrepreneurs who get involved in organizing events for their clients. A fee is charged per event or based on the attendance of the event. An example is a wedding organizer whose main business is coordinating the various activities that go towards making a successful ceremony.

### **x. Builders/Creators**

Artists, bakers, carpenters, and designers are examples of entrepreneurs driven to create something tangible where it did not exist before.

### **xi. Caretaker:** These are people entrusted to care for someone or a piece of property on behalf of the principal.

### **xii. Communicator/Trainer**

These are people who can transmit information or communicate in different languages. They find demand in sales, marketing, writing, training or a variety of information services.

### **xiii. Entertainer/Host**

These are people who thrive on being with other people. They find entrepreneurial openings in the hospitality industry or service industries such as hairdressing. They may even be entertainers, actors, musicians, or singers. An example is a talk show personality in a T.V program.

### **xiv. Investor/Owner**

If one has money to invest he/she can put the capital to work for him/her by investing in stocks, real estate or businesses.

### **xv. Seller**

This covers salespeople and brokers, from real estate to insurance to art. An example is a music promoter.

### **xvi. Technologist/Engineer:**

These are people who have a talent in technical disciplines such as computers, autos and engines. As an entrepreneur, one may want to explore entrepreneurial opportunities areas such as software development, engineering or technology.

### **Self-employment:**

Self-employment is a concept that has arisen as a result of entrepreneurship. The process of entrepreneurship eventually brings self-employment to the fore. The entrepreneur becomes self-employed when he begins to derive his livelihood from his business venture. Given that the entrepreneur bears all the risks associated with the business, then it comes as given that he has the right to enjoy all the benefits that ensue from his business venture. This success can be trickled down, not just to himself, but also to the business and others who are job seekers. In this way, not only does the entrepreneur become a self-employed person, he also does something positive for the community by employing others.

An entrepreneur can make huge gains if his business is a success. At the same time, should the business experience difficulties, financial or otherwise, then the entrepreneur stands to lose a lot of his investments. This may even lead to bankruptcy.

An entrepreneur may mitigate against the risk of failure in any of the following ways:

- i. Insuring his business against losses. Losses can be in form of burglary and fire
- ii. Co -- owning the business with a partner. This option will dilute the ownership therefore it is a step that should be taken with a lot of caution.
- iii. Investing in extra security in the event that the business deals in valuable products.
- iv. Securing the services of a risk assessment expert. This is a preventive measure and will highlight the areas of risk in the business that the entrepreneur needs to be aware of hence make vital decisions.

The entrepreneur puts himself in a safe position both for his business and himself if he does any one of the above. The list is not exhaustive; the entrepreneur can device other risk mitigating measures that are appropriate for his kind of business.'

On the other hand, the business venture can be a huge success if well managed. The entrepreneur can derive his livelihood from the profits of his venture. This becomes a success story especially in the current economy where many young people are losing out in the job industry even with the relevant qualifications.

Self-employment is so important in an economy that is still struggling to stabilize itself in a world economy that doesn't take into account the plight of many young men with the skills required to work fruitfully in any given economy.

It is important to point out that the entrepreneur needs to be prudent when appropriating the rewards of his investments, for instance some of the profits should be ploughed back into the business. This basically means that the entrepreneur needs to re-invest some of the rewards that come to the business in form of profits.

The business needs to grow and capture many opportunities in its industry. Through proper planning and due diligence, the entrepreneur can device several ways through which he can plough back his interests in an attempt to multiply future rewards. Some of the ways of reinvesting among others are:

1. *Opening up new branches in other locations*
2. *Implementing a new product design*
3. *Hiring professionals to manage various aspects of the venture*
4. *Investing in office automation processes*

### **1. Opening up new branches in other locations**

Depending on the location of the current set up, the entrepreneur can decide to open new outlets for his products in other regions where he has assessed sales will be high. This move also creates jobs for other people and in this way, the entrepreneur also thinks about the society his business serves.

### **2. Implementing new designs**

This should come in when the entrepreneur is sure that his first project is doing well and there is room for more. With the resources generated from the first project, the entrepreneur can then start working on a new brand or improve the current brand. In this way he doesn't sit back and let the business thrive on the success of the first project only.



### 3. Hiring of professionals

With growth of business, the operations also become rather complex in nature. A business that is constantly growing and re-investing its interests needs to ensure that the sensitive aspects of the venture such as finance and customer needs are well managed. The entrepreneur could therefore, think of employing the services of qualified professionals to help him run the business. Here, he could hire accountants, IT specialists, a sales and marketing team et cetera.

### 4. Investing in Office Automation processes.

Addition of more capital is a sure way of expanding hence if the capital will lead to efficient ways of doing business. In the growing world of business, it has become as a necessity that a business arm itself with an ICT strategy that works. The entrepreneur can thus direct some of his expansion efforts in this area so as to keep up with the competitors.

#### **Factors to consider when preparing to be self employed**

Before one gets into employment, the following factors should be considered since the business is challenging. An entrepreneur is required to clearly think and plan the prospective business before implementing the idea. An entrepreneur should therefore consider the following:

- *Opportunity cost*
- *Type of Business*
- *Market*
- *Government Polices*
- *Geographical Location*
- *Resources*

#### **Opportunity cost**

Business requires one to forego many things such as savings and other assets, leisure and rest as well as association and company of friends and relatives. If the advantages of self- employment outweigh the disadvantages then one may go into business.

Ability to bear the opportunity cost would give an entrepreneur self- drive and zeal in the conduct of business.

#### **Type of business**

This means one should look into possible types of business within the various classifications. These businesses should then be assessed or evaluated to determine the one that is most viable and the one that the entrepreneur understands. Business opportunities come in form of need for goods and services.

#### **Market**

A market is a situation where there are sellers who have products and services to sell and buyers who have the capacity and willingness to purchase. Getting to understand the market would enable the enterprise assess the sales potential of the business. It will also indicate the growth potential of the business. Enterprises should select business ideas that have opportunities for growth by observing demand trends.

#### **Government policies**

These are guidelines by the government on how various types of businesses should be conducted. Before setting up a business one should analyze the policies and laws related to the conduct of the specific business. Some policies restrict certain operations while others prohibit location of business



in certain places. Enterprises should know the laws that may affect their businesses and find ways of complying with them. Policies such as taxation policies, pricing policies, interest rates and licensing laws could greatly have a bearing on how business is conducted.

### **Geographical location**

An entrepreneur should look into the population density, infrastructure facilities, and the income level of the community within where the business is to be located. He should also consider the sources of raw material or stock for the business.

Entrepreneurs should consider acceptability of their businesses in the local community. Entrepreneurs should also avoid locating their businesses in areas where there is stiff competition.

### **Resources**

This means an entrepreneur needs to consider the amount and type of resources necessary for the business to start and operate.

The resources may be classified into labor raw materials, finance and equipment.

### **Importance of Self-Employment**

Self-employment has various advantages or benefits or importance as discussed below:

#### **i. Job security**

Many people in salaried employment fear losing their jobs through dismissal, retirement and retrenchment to arrest the fears, the same engage in business activities that will see them earn an income throughout their life.

#### **ii. Independence**

Many people have a need to be self-reliant, be their own bosses and control their destiny. Getting into business will make such people use their time to the maximum and engage in the activities they desire in life.

#### **iii. Need for more income**

A great number of people earn little income from salaries in the face of rising cost of living. Such people may engage in business activities to supplement their little income. While in business, they can make as much money as they desire.

#### **iv. Recognition/ fame**

Business activities can get or enjoy fame in society. Such people are recognized for their achievements in getting the best products or services realizing the highest in profits and participating in community development activities. A person in business can become a pillar in society and act as a role model for others to emulate and consult.

#### **v. One gets power**

Some people desire to exercise control over others. Such people can engage in big activities that create jobs for others and as employers they are able to control their employees. They make decisions on their behalf and decide what they do and earn.

### **Disadvantages/ Challenges of Self- Employment**

Some of the challenges or disadvantages of being self-employed include:



**i. The risk of capital**

By engaging in business, one tends to lose the capital invested because of inability to serve his debts, loses for business and also calamities.

**ii. Unsteady income**

A self-employed person may not be certain of the amount of income business may realize. For this reason, business people are unable to make sound financial plans.

**iii. Lack of adequate capital**

Many self-employed people lack the necessary capital to start and expand their business. Many commercial banks in Uganda do not provide loans/ credit to new business. The interest rates remains high making it difficult for existing businesses to get loans for growth and expansion.

**iv. Fatigue**

Self-employment requires one to work hard and spare little time for friends, relatives and leisure. Many people in business do not rest and some succumb to stress-related ailments.

## SALARIED EMPLOYMENT

This is a situation where a person offers his skills and competence to another for a pay. This is formal employment. In most cases, salaried employment requires one to have attained specified qualifications in order to perform their side tasks.

### Advantages of Salaried Employment

Some of the advantages of salaried employment include;

**i. Responsibilities are specified**

Salaried people engage in tasks they qualify to perform unlike self-employed who may be required to perform all tasks in business. Salaried people therefore have the advantage of performing the duties they are able to do. Their productivity is likely to be higher and their morals boosted.

**ii. Steady income**

This means salaried employees are fairly certain of the income they earn because there is an agreement with the employer at the time of engagement. This is unlike business where the self-employed person may experience fluctuating income because of market dynamics. This makes salaried employees able to make financial plans.

**iii. Fixed working hours**

Salaried employees have specific working hours in a day and can therefore have time to attend to personal matters and to rest. They may use the time they are away from work to engage in other income generating activities. This is impossible in business because customers dictate business hours.

**iv. Minimal risk**

Salaried employees do not risk their capital and other resources. They don't stand to lose if their organizations do not perform well. The employer has the responsibility to meet payment of his employee's salaries irrespective of whether the business makes profits or losses.

Many salaried employees have their risks covered by the employer such as compensation and insurance against accidents at work.



### v. Fringe benefits

Many employers provide their workers with benefits such as housing allowances, transport or car allowance, medical insurance allowance, education and training or entertainment allowance. Income for business on the other hand is ploughed back for growth and expansion. The self-employed person cannot afford the privileges of the salaried employee.

### **Disadvantages of salaried employment**

Some of the disadvantages of salaried employment include;

#### i. Excessive control by the employer

Much of an employee's life is controlled by the employer. The employer is required to follow strict orders from the employer on matters such as what to do, where to do it and how to do it. There is also indirect control of employee's achievement through setting a limit to the income they earn. Salaried employees are therefore not free to make decisions that affect their lives.

#### ii. Limited income

Many employers are investors in business organizations. To control costs and ensure profitability, they limit the salaries they give employers. Salaried employees are therefore likely to earn limited income against increasing cost of life.

Many salaried employees find it difficult to meet their daily needs with the limited income.

#### iii. Inflexibility

Many employers require employees to attend to specific tasks. For this reason, many salaried employees specialize in performance of certain tasks. When the situation demands that they change, they are unable to perform other tasks. Business allows one to engage in a variety of tasks.

### **Little achievement**

Salaried employment does not allow a person to implement different ideas. It also limits the income one may generate in their life. A person in self—employment is free to exploit all their talents and implement their ideas. Such a person may achieve more in life than a salaried employee.

### **Role of an Entrepreneur in Business**

In business, entrepreneurs should take responsibilities that they are able to perform. Since the business is the entrepreneurs idea and initiative. They are expected to take up the following roles.

#### i. To decide on the type of business

This means, the entrepreneurs has the responsibility to accurately determine the needs of customers and design in his mind goods and services to meet those needs. This also means the entrepreneur gives business a purpose/ goal/ vision.

#### ii. To determine capital requirement

An entrepreneur takes the responsibility of providing the capital that business requires to start and grow. This means, an entrepreneur has to identify valuable sources of finance for business. It also means the entrepreneur should ensure the business is not starved of finance at start up and any other time in the life of the business.

#### iii. Staffing the business

It is the responsibility of an enterprise to provide the business with the realistic number of staff and who have suitable skills to undertake the various business activities.



#### **iv. To assume business risks**

It is the responsibility of an entrepreneur to determine the type of risks that could face his business and put in place appropriate measures to safeguard against negative effects of the risk on the business. The types of risks may include losses, accidents as well as unfavorable policies.

#### **v. Meet liabilities of business**

An entrepreneur has responsibility to ensure all business debts are duly paid. Businesses may incur liabilities in form of loans, trade creditors who may have given stock on credit and also operating expenses which may lead to bills payable.

#### **vi. Market the business**

It is the responsibility of an entrepreneur to ensure a positive image of the business is created. Positive image of business may be created through ethical practices in the conduct of business. This may be in form of ensuring fair prices, ensuring efficient customer services, avoiding hoarding and also speaking well of the business.

A positive image goes a long way in drawing customers to their business and keeping off competitors.

#### **vii. Re-investment of profits**

It is the responsibility of an enterprise to ensure that income generated from business activities is ploughed back to ensure greater financial independence of the business.

### **Challenges of Entrepreneurs in Business**

Entrepreneurs in Uganda have had to bear many challenges. These include the following:

#### **i. Unfavorable policies**

The government policies have often created hurdles and made it difficult for entrepreneurs to successfully conduct their business activities. Among these policies include control of prices, tax policies, quality compliance requirements, allowing imported products etc.

#### **ii. Inadequate and poor infrastructure**

Entrepreneurs have had to do with poor infrastructure facilities e.g. transport networks, communication networks, water and sanitation, power supply as well as poorly maintained buildings with which they conduct business. Although government is making efforts to fix infrastructure, a great number of entrepreneurs in different parts of the country cannot access these services.

#### **iii. Limited sources of financial**

The major lending institutions in Uganda are commercial banks. These do not provide startup capital to entrepreneurs.

The same banks also charge high interest rates when they lend existing/ operating businesses. Entrepreneurs therefore find it difficult to raise the finance they need to start and run their businesses.

#### **iv. Competition**

Many entrepreneurs today continue to face increased competition from both local and foreign investors.

The competition is more challenging to small scale enterprises that may not have enough resources to put in place strategies to counteract the competition.



#### v. Poor/ lack of business management skills

Many entrepreneurs in Uganda lack the basic business management skills such as financial management skills, human resource skills, production management skills and marketing skills.

#### vi. Insecurity

Many business organizations in Uganda continue to experience inadequate security arrangement even though the government is making efforts to enhance security of citizens and the nation

### Challenges that entrepreneurs face may further be classified into 5 broad categories

#### a) External Factors

Some events in the economy of a country may well be beyond the control of the entrepreneur. The cycles could adversely affect his business, to the extent of forcing him to close down. The economic cycles of recession, boom, depression and recovery may find the business in any stage of its own cycle.

Other external factors include;

- *Fluctuating interest rates*
- *Interruptions in supplies*
- *Labor market trends*
- *Government regulations e.g. tax laws*
- *Natural catastrophes*

#### b) Personal factors

An entrepreneur goes through a lot of hurdles to get the business going. The going may be tough such that he may even be tempted to close the business. There are a number of risks associated with being an entrepreneur.

#### c) Financial risk

The entrepreneur may places his entire savings into the venture with the firm belief that he will earn something in return. If this does not happen, he risks losing a lot of money.

#### d) Career risk

He may have chosen to give up employment to pursue his business. He may not have a fall back plan if the business collapses, hence loss of career.

#### e) Psychic risk

The entrepreneur may have to give up his social life for a while till the business stabilizes. This may adversely affect family and relations.

The collapse of the business could lead to psychological problems such as depression and/or low self-esteem. The risk here is the probability of failure in the mind of the entrepreneur.

#### f) Lack of skills and experience

A business may start off well as a result of a favorable economic climate and availability of funds. An entrepreneur may well have identified a very good business opportunity and capitalize on it to generate lots of revenue. However, if the entrepreneur does not have sufficient skills to see the business through this success in a consistent manner, he stands to lead the business towards incurring losses and not meeting its obligations on time. It is advisable that the entrepreneur enrolls for courses that will sharpen his skills and help him manage the business better.



### **g) Mismanagement**

The entrepreneur will often employ people to assist him manage the operations of the firm. However, if these people are not trustworthy, he stands to lose a lot of money through embezzlement or pilferage of stocks. The entrepreneur himself could also be the main culprit when he draws a lot of the business resources for personal use.

### **h) Poor Business Ethics**

The lack of proper business grooming could lead to unfair business practices by the entrepreneur. This comes out of practice and peer pressure. The entrepreneur could find himself in conflict with the law and may get sued by his business associates. The risk here is the loss of business reputation and the possible closure of the business under directive from the relevant government authorities,

## **Causes of Business Failure**

The following are the major causes of failure of small scale business enterprises.

1. Poor location of the business enterprise
2. Poor managerial skills in managing the business
3. Inadequate skills in keeping the books of accounts
4. Poor knowledge of business opportunities hence failing to take advantage of available opportunities
5. Inadequate capital
6. High competition from large scale business enterprise
7. Poor infrastructure that can't support business operations
8. Inadequate equipment and facilities
9. Excessive standards of living using the business funds instead of building the business
10. Death or insanity of the owner in case of a sole proprietorship
11. Disasters e.g. fire, strikes, drought and floods
12. Theft from the business by the employees
13. Problems with payment of taxes, duties and licenses
14. Lack of adequate raw materials
15. Lack of time to devote to the business by the owner who are in full time employment
16. Political interference in running of the business.

## **RATIONALE FOR ENTREPRENEURSHIP**

One stereotypical image that sometimes hovers around the concept of the "entrepreneur" is the conniving, step-on-anyone-to-get-ahead, wheeler-dealer — a kind of J.R. Ewing personality who cares for no one but himself and nothing but his own advancement. No doubt there are some individuals like that in the business world. And we do hear the term "entrepreneur" occasionally applied to scam artists who rip off unsuspecting people, to dealers in illegal trades who prey on the weaknesses of others, and to white-collar criminals who try to cheat the system. Applying the term "entrepreneur" to people doing these transactions implies that the term has no basis in values and morals.

But entrepreneurship is not a values-free, amoral process. The very act of starting and building something of significance should require a consideration of values — of combining what is done with how it is done. There's also a very practical reason for a values-based, morally rigorous view of entrepreneurship. That is usually the only viable way for an entrepreneur to do business in the long run.

### **Guiding Values**

What values may be particularly important in guiding the entrepreneur? The following are some needed by an entrepreneur in business development:



**a) Bravery**

In recognizing and pursuing opportunity, an entrepreneur requires bravery. Bravery, which springs from natural creativity and a determined spirit, helps the entrepreneur deal with discouragement and even defeat in the early stages of company formation.

**b) Vision**

Vision guides the entrepreneur through the business planning process, clarifying the opportunity and setting goals for the organization. Vision allows the entrepreneur to see past his or her current position and beyond limited resources to more fully appreciate the potential of the venture.

**c) Respect for self and others**

Respect for one's self and others is essential. It enables the individual to appreciate his or her efforts, relate effectively to family and community, and motivate others. This respect, which stems from pride, hope, and enthusiasm, frees entrepreneurs from the obstacles of low self-esteem, hopelessness, and anger.

**d) Trust**

Trust is an indispensable part of the marketing effort as the company grows. Trust, which results from reliability, compassion, and gentleness, permits the entrepreneur to overcome mistrust, selfishness, and ruthlessness as the company deals with employees, customers, and vendors.

**e) Honesty**

An entrepreneur must be honest in financing the company and managing the assets of the firm. Honesty, which emanates from decisiveness in taking risks and making choices, lets the entrepreneur avoid false security and stay calm amid confusing situations.

**f) Generosity**

In directing the management and operations of a growing business, an entrepreneur should be generous. Generosity, which develops from supporting and leading others, permits an entrepreneur to eliminate racial bias, reduce resistance to change, and heal dysfunctions within the organization.

**g) Fortitude**

An entrepreneur requires fortitude to keep a business strong and eventually bring it to harvest. Fortitude, which stems from persistence, realism, and consistency, strengthens the entrepreneur against scattered thinking and giving up.

### **ENTREPRENEURIAL DECISION PROCESS**

Entrepreneurial decision process is about deciding to become an entrepreneur by leaving present activity i.e. a movement from the present lifestyle to forming a new enterprise. The decision to start a new company occurs when an individual perceives that forming a new enterprise is both desirable and possible.

The decision to become an entrepreneur or to start a new business consists of several decisions including: -

- The decision to leave a present career or lifestyle (pushing and pulling influences active in the decision to leave a present career or lifestyle)
- The decision about desirability of new venture formation i.e. the aspects of a situation that make it desirable to start a new venture and this relates to culture, subculture, family, teachers and peers.

- The decision about the possibility of new venture formation i.e. factors making it possible to create a new venture like government, background, marketing, financial, role models.

### **Decisions and Downfalls**

Entrepreneurship is an attractive career choice. But many decisions have to be made before launching and managing a new business, no matter its size. Among the questions that need to be answered are:

- Does the individual truly want to be responsible for a business?
- What product or service should be the basis of the business?
- What is the market, and where should it be located?
- Is the potential of the business enough to provide a living wage for its employees and the owner?
- How can a person raise the capital to get started?
- Should an individual work full or part time to start a new business? .Should the person start alone or with partners?

Answers to these questions are not empirically right or wrong. Rather, the answers will be based on each entrepreneur's judgment. An entrepreneur gathers as much information and advice as possible before making these and other crucial decisions.

The entrepreneur's challenge is to balance decisiveness with caution—to be a person of action who does not procrastinate before seizing an opportunity—and at the same time, to be ready for an opportunity by having done all the preparatory work possible to reduce the risks of the new endeavor.

Preparatory work includes evaluating the market opportunity, developing the product or service, preparing a good business plan, figuring out how much capital is needed, and making arrangements to obtain that capital.

Through careful analysis of entrepreneurs' successes and failures, economists have identified key factors for up-and-coming business owners to consider closely. Taking them into account can reduce risk. In contrast, paying no attention to them can precipitate the downfall of a new enterprise.

**While starting a new enterprise, the entrepreneur should bear in mind the following factors:**

#### **a. Motivation**

What is the incentive for starting a business? Is it money alone? True, many entrepreneurs achieve great wealth. However, money is almost always tight in the startup and early phases of a new business. Many entrepreneurs do not even take a salary until they can do so and still leave the firm with a positive cash flow. The entrepreneur should be motivated to conduct the business. Motivation should mostly come from within the entrepreneur himself rather than from outside sources.

#### **b. Strategy**

What is the strategy for distinguishing the product or service? Is the plan to compete solely on the basis of selling price? Price is important, but most economists agree that it is extremely risky to compete on price alone. Large firms that produce huge quantities have the advantage in lowering costs.



### c. Realistic Vision

At times it can be difficult to determine the ideal vision for the enterprise. This is due to the fact it may be difficult determine the exact operating cost of the business. The main cause of many failed businesses is inadequate operating. Entrepreneurs often underestimate start-up costs and overestimate sales revenues in their business plans.

### Most Valuable Possession

An entrepreneur's most valuable possession in the business world is not money or products or facilities. It's his or her reputation. If you lie, cheat, or steal, the marketplace usually learns about it, and you lose any credibility that you may have had. On the other hand, those who are guided by a set of values enhance their credibility in the marketplace and draw others who want to do business with them. Sometimes entrepreneurs can get so caught up in the new, new thing — the latest, greatest product, service, or technology — that they fail to see and appreciate what actually sustains them, their employees, and their enterprises over the long term.

## Entrepreneurial Guiding Principles

Defining your beliefs and guiding principles is important to running a successful business. If you don't define your beliefs, others—be it friends, associates or the marketplace—will do it for you. By taking ownership of your own values and defining what's important to you, you are setting up a system that will guide you through the rough waters of entrepreneurship. The following are some of the guiding principles of entrepreneurship:

### a) Be Organized

Organized minds are clear, and clear minds take action towards clear objectives, so get as organized and as clear as possible in your life and business affairs. Start with your desk and work area, then with your plans and actions. Schedule a written plan of your activities and objectives and stick with it the entire day. Do this the night before and you're ahead of 90 percent of the rest of the population—including your competitors.

### b) Be Dedicated

Every day, do at least one thing you've been putting off. As the great Jim Rohn has said: "There are two types of pain you will go through in life—the pain of discipline and the pain or regret." Each moment you can decide which you'd rather experience. Successful people know that the pain of discipline is the price of their success. Start making discipline the price of your success.

### c) Be Confident

Feel as good as possible and achieve a sense of well-being by just being quiet and contemplative for 15 minutes every day. Also, find a way to exercise at least 15 minutes every day. Both will boost positive feelings about yourself, which translates into a confidence that is attractive to others—including new customers and clients.

### d) Be Appreciative

Tell your family, friends and business associates how much you appreciate them. Be generous with praise and compliments—and find more things people in your world are doing right, rather than doing wrong.

### e) Be Optimistic

Leave past failures in the past and focus positively on your future. If you are a glass-half-empty person, start seeing the glass as being half-full. Life-and business-is more enjoyable that way.



**f) Get Educated**

Read something that improves your mind every day. Keep yourself away from unproductive people, activity and news. Become a master and an expert in your industry, and more business will flow to you over time simply on the basis of your credibility and expertise in your field.

**g) Be Thrifty**

Never pay full price. Consume less and never pay more tax than absolutely necessary. Don't be in business simply for tax reasons, but always recognize that the more resources you pay out to the treasury, the less you will have to put back into your business.

**h) Be Sociable**

Be charming and agreeable. Never speak badly of anyone. You never know if your next big client or customer is within earshot of something you have to say. Make it positive, and you'll never have to worry about negative consequences.

**i) Be Alert**

Open yourself to new ideas, experiences and people who can teach you something new-and stay out of ruts and routines. This is one of the best ways to be aware and focused on new opportunities. Remember that some of the greatest product breakthroughs have come from people recognizing the value of interesting and unique innovations.

**j) Dependable**

Meet all of your business, social and moral obligations punctually, honestly and honorably. If you are the "go to" person or the "go to" business, you'll never have to worry about having to generate extra leads or word-of-mouth referrals.

**k) Be Human**

Remember to experience the journey as well as the results, it's absolutely necessary to keep your attention focused on your goals, but don't miss out on all the great experiences going on around you right now. After all, when you get to your destination, you'll realize that some of the greatest lessons learned and values gained were found in the trip there.

**l) Be Tough**

Demand only the highest and best standards of everyone you surround yourself with and that includes setting, demanding and being accountable for high standards for yourself. Remember that as the leader goes, so goes the organization. And if you are truly leading, you have to be firm and consistent in setting, establishing and following your own "rules of the game."

**m) Give and You Shall Receive**

Give the thing you want most and you'll be amazed at what you get in return. See all opportunities as a way to give and share and add value, and you'll see your efforts multiplied in ways you couldn't have imagined, for the greater good of you, your company and your customers.

## **ENTREPRENEURIAL DEVELOPMENT**

A worldwide consensus on the critical role of competitive markets and entrepreneurs in economic development has emerged in the last decade. In developing countries, the primary barrier to economic growth is often not so much a scarcity of capital, labour or land as it is a scarcity of both the dynamic entrepreneurs that can bring these together and the markets and mechanisms that can facilitate them in this task.



## **Concept**

Entrepreneurship can be defined as the process of using private initiative to transform a business concept into a new venture or to grow and diversify an existing venture or enterprise with high growth potential. Entrepreneurs identify an innovation to seize an opportunity, mobilize money and management skills, and take calculated risks to open markets for new products, processes and services.

Entrepreneurship development promotes the creation and/or growth of enterprises by training and counseling to young entrepreneurs to establish their own business and to reduce the failure rate of start-ups thus contributing to the economic growth of the country.

## **The Opportunities or Prospects of Entrepreneurship Development in Uganda**

As a third world country a considerable number of entrepreneurs has not been developed. Nevertheless, there is a great possibility of developing entrepreneurship in Uganda. The following are some of the prospects and opportunity of entrepreneurship development in Uganda.

### **I Availability of human resources**

Uganda has its vast population of about 40 million. So there is a great possibility of developing entrepreneurship and entrepreneurs in Uganda. HR is the fundamental factors of production that is available in vast amount. So production that is available in vast amount. Therefore, abundance of HR is the great opportunity in creating entrepreneurs in Uganda.

### **2. Industrial innovative sensation**

People of Uganda have industrial innovative sensation. They may get involved largely in industrial initiative if they get favorable opportunity. Already they established many small and collage industries with the help of NGOs and other financing institution.

### **3. Mobility of profession**

In Uganda, a considerable number of villagers have now replaced their agriculture-based profession into small businesses. Many of them transferred into city area. Many of them have moved to the city thus creating a mobility of profession. That is another prospect of developing entrepreneurship in Uganda.

### **4. No religious or cultural hindrances on mobility of profession**

In Uganda, there are no religious and cultural hindrances on mobility of profession. Most of the people are changing their work, profession day by day. In past, certain religious people belong to certain profession. But now people get engaged in their desired profession without religious and cultural hindrance. That is another prospect of creating entrepreneurs.

### **5. Large number of educated unemployed**

In our country, there are many educated unemployed people, but there is a limited scope of employment. For this reason, educated unemployed people will take new initiative to do something new themselves. As there is a close connection of education and entrepreneurship, there is a possibility of developing entrepreneurship.

### **6. Tendency toward industries work**

Industrial work bears more salary, status, facilities for living in city area and so on. Thus, industrial sector will be developed in future. Such mentality and tendency is helpful in developing entrepreneurs. Therefore, it is another prospect of developing entrepreneurs.

### **7. Preference in establishing agro-based industry in Government planning**

As our country is agro-based, there is a greater possibility of establishing agro-based industry. Besides, most of the raw materials of industry come from agricultural sector. So our resourceful



agriculture sector is helpful in developing entrepreneurship. Nowadays, government announces preference in agro-based industry that is also greater opportunity to develop entrepreneurs.

#### **8. Liberalization of government industrial policy**

With an aim of rapid industrialization, government has adopted liberalization in industrial policy and encourages entrepreneurs to come ahead in industrial sector with their large capital. For this reason, investors are investing their capital in industrial sector. That is another prospect of developing entrepreneurs in Uganda.

#### **9. Disbursement of micro-credit by different NGO's**

In our country there are large numbers of NGOs providing micro-credit to the village poor people. This is helpful in forming small and cottage industry. NGOs also provide training facilities, advice, investment consultancy, raw materials etc. to its loaner. This is another prospect of developing entrepreneurs in Uganda.

From the above discussion, there is a greater possibility of developing entrepreneurs in Uganda.

### **Problems of Entrepreneurship Development in Uganda**

As a third world country, Uganda does not have abundant facilities or developing entrepreneurship rather there exists a large number of obstacles, which are liable for not developing entrepreneurs in Uganda as described below:

#### **I. Improper publicity of government facilities**

There is improper publicity of government facilities for developing entrepreneurs. Entrepreneurs are not well informed about such facilities. Therefore, these facilities cannot work well. Some urban centered people accept the facilities that are not enough for developing entrepreneurs in the country. So this is one of the fundamental obstacles.

#### **2. Insufficient arrangement of pre-investment advice:**

It is for this reason that most of entrepreneur can't study market feasibility for the product and business demand for the product in market, possibility of gaining profit etc. Due to lack of this study, most of the entrepreneur can't operate their activities successfully. Many of them fail in their initial activities.

#### **3. Lack of required financing**

This is the fundamental problem of developing entrepreneurship in Uganda. Here, entrepreneurs faces problem in collecting required working capital and fixed capital, most of the financing organization demand for supporting papers and apply rigid condition. As a result most of the entrepreneurs cannot get rise capital to operate their activities smoothly. Working capital, fixed capital and capital for expansion of business of business.

#### **4. Scarcity of raw materials and other factors of production**

In our country, there is an immense shortage of basic raw materials to operate industrial activities smoothly such as skilled manpower, technology, capital and so on. For this reason they have to import basic raw materials and supplementary factors of production that increase the cost of production. As a result, entrepreneurs can't take initiatives to establish industrial organization smoothly.

#### **5. Problem in marketing produced product**

Now--a-days marketing of the product has become an important task in business. In open market economy, product of the home and foreign counties compete with each other in same market. Usually quality products capture the market. Because of different problem and lack of factors of production, our entrepreneurs, can't produce or hardly produce quality product as developed country. For this reason, they face marketing problem greatly for every product.



## **6. Lack of training**

Training is essential to work efficiently and effectively in any field. Training is a practical experience regarding job that is necessary to increase efficiency and productivity. In our country, there are few training centers to provide training in developing entrepreneurs. As a result, people cannot come ahead to take initiative there are few an obstacle to develop entrepreneurship.

## **7. Lack of package help**

In a developed country, the government and non-governmental sector provide package help for developing industrial sector. It includes, technical help, raw materials, and working capital and so on. These are helpful in creating entrepreneurship as well as industry. However, in our country there are few abundance package help that are very essential for developing entrepreneurship in our country. So it is another problem of developing entrepreneurs and entrepreneurship in Uganda.

## **8. Lack of knowledge regarding technology and management**

In developed countries most of the business and industries are technology oriented and they follow modern management technique. Those are helpful in developing dynamic entrepreneurs. Nevertheless, in our country there is little scope of technology and modern management. Besides, we also have no proper knowledge regarding those matters.

These are the obstacles or problem in developing entrepreneurs and entrepreneurship in Uganda.

## **Suggestions for Removing the Barriers of Entrepreneurship Development in Uganda**

Some of the ways of removing the barriers of entrepreneurship development in Uganda include:

### **I Making specific policy**

To perform any activities some policies should be maintained. Effective policies should be made to develop entrepreneurship in Uganda. Relating organization and officials should make some specific policies for developing entrepreneurship in Uganda.

### **2. Involving entrepreneurial knowledge in text book**

As our education system is theoretical based so entrepreneurial knowledge should be included in textbook. This enables students achieve entrepreneurial knowledge that will be beneficiary for developing entrepreneurship in future.

### **3. Offering package help**

After providing training, the trainee should be provided with necessary help for developing industrial sector. Necessary help including fixed capital, working capital, technical men, technology, and raw material and so on. This is helpful in creating entrepreneurship.

### **4. Formal arrangement of training**

People who are engaged in entrepreneurial work or people who are willing to take new initiative need training in the respective field that will be helpful for them to take initiative and operates industry smoothly. Government and non-governmental organization can arrange this program.

### **5. Increasing government facilities and its extensive publicity**

Government facilities for developing entrepreneurship are not sufficient. So the government should provide abundant facilities for developing entrepreneurship. The government should also arrange extensive publicity of its given facilities so that rural centered people can get these facilities. That will be very helpful in developing entrepreneurship in Uganda.

### **6. Encouragement in industrialization**

Government and non-governmental organization may encourage people towards industrialization by providing different facilities including tax redemption or tax holiday, EPZ facility, BSCIC industrial state, providing raw material, capital, technical assistance etc. with unqualified condition.



### **7. Establishment of supplementary industry**

Entrepreneurship may be developed by establishing supplementary industry extensively. Some of them produce industrial product that are reproduced by large industry and some of them use by product of large industry. They are also essential to develop large-scale industry.

### **8. Increasing loan facilities**

Most of the people establish small or large-scale industry with loan facility. Financing institution should provide sufficient loan to the entrepreneur with flexible condition and supporting paper. This program will be helpful in establishing and operating new industries and businesses.

### **9. Exhibition of industrial product**

To increase demand for industrial product government and non-government organization may arrange exhibition. Industrial fair in domestic country will be helpful in creating demand for industrial product. Industrial product may introduce in abroad. It is an important recommendation to develop entrepreneurs and entrepreneurship.

### **10. Reduction of tax and duty**

The government may encourage industrialization by lessening duty rate of industrial product. That will also lessen cost of industrial product, which is helpful in capturing market. Thus, way industrialization or entrepreneurship will be developed duty on importing bank raw materials have suggested to reduce.

### **11. Favorable import and export policy**

Most of the basic raw materials used in industry have been imported from foreign countries. Some industrial products have produced to export as a whole. So for developing industrialization and entrepreneurship proper authority should make obvious and flexible export-import policy.

## **LIMITATION IN BUSINESS ENTERPRISE DEVELOPMENT**

There are various limitations that an entrepreneur should be aware of while setting up a business enterprise. This include:-

### **a. Unfavorable legal and regulatory framework**

The absence of policies governing the growth of small enterprises could hamper the growth of small enterprises. This would mean that the small firms are not protected in the harsh markets and the law does not complement their activities. It thus becomes very hard for an entrepreneur to set his toehold in the economy. The high cost of compliance to regulations may discourage potential entrepreneurs from formally setting up their businesses, while driving some existing enterprises out of business and those working for them into unemployment

### **b. Undeveloped infrastructure**

This could be a drawback in the sense that the entrepreneur may not have access to facilities that will enable him pursue the objectives of his business on a larger scale. Most institutions are cautious to lend money to small businesses because of the risks involved. At the same time some of these institutions may require the businesses to pay high interest rates for loans acquired

### **c. Poor business development services**

Lack of training may be a setback in the industry for the small businesses. Most NGOs that come up with the plans lack support from the government and mostly operate on good will from the potential investors. The entrepreneurs lacking in skills need to be imparted with knowledge that will set them at par with the other accomplished businesses, giving them a chance to provide healthy competition.



**d. Poor entrepreneurial Culture**

It has become a trend for most school leavers to look for employment. While it serves as the most convenient route to earn a living, most young people have shied away from engaging in entrepreneurial initiatives because of the high risks involved in setting a business. Most of these young people find it a big struggle that is laden with disappointments.

**e. Lack of Skills and competence**

Most entrepreneurs lack the relevant skills to engage in meaningful business enterprises. Those that manage get the support of strategic investors and managers who mobilize resources on their behalf.

## **SUPPORTING POLICIES**

In the last fifty years, the government of Uganda has made cautious efforts to encourage development of business in the country. These can be through assisting small enterprises sector and also create an enabling environment for large organization to grow even more. Some of these efforts include:

**i. Provision and improvement of infrastructure**

The government realizes that infrastructure facilities such as transport, communication, electricity, water and sanitation, good buildings/ shelter are important in encouraging and attracting investors. There have been deliberate efforts by the government to provide these crucial facilities and improve on the existing ones.

Infrastructure plays a key role in encouraging business to grow enterprises need transport systems to move their products to the market and access raw materials from suppliers. They need power to run their business operators. They also require a healthy environment within which to conduct business.

**ii. Access to technology**

The government has made efforts to sensitize citizens on the need to apply the computer technology in their businesses. There have been efforts to train people on the skills necessary for them to apply the technology. Many public institutions are encouraged to provide computer literacy training and the government has facilitated the same through finance and equipment.

The government has plans to turn Uganda into ICT hub for Africa by establishing a modern ICIT facility in the country.

Enterprises in agriculture industry have had access to new methods of production such as greenhouse technology, drip irrigations, drought and pest resistance crops, high yielding breeds of animals and crops as well as new methods of selling and distribution. This has greatly encouraged enterprises in this sector.

**iii. Provision of credit/ finance for business**

The government realizes the significance of finance in the development of business enterprises. It has provided enterprises with access to those crucial facilities.

The government has also registered and licensed Non- governmental financial institutions to play the same role and ensure greater access of finance to more citizens.

The government has also appealed to commercial banks through the central bank to lower interest rates on borrowed capital.

However, interest rates on borrowed finance remain high and many enterprises cannot afford the loans.



**iv. Creating a favourable legal framework**

The government has made efforts to create laws that encourage establishment of businesses. Such laws include: those related to business protection (ideas and products) from competitors, laws relating to registration, licensing and permit for business operations. The government has done away with laws such as licensing laws in some sectors and only ensured the necessary ones remain.

However procedures of registration remain bureaucratic and still require fine tuning. The new constitution has addressed business development issues at the county levels. This indicates the government concern for business and hence the need to legally address the matter.

**v. Creating markets for products and services.**

The government realized that enterprises need a market for their products and services. To address this concern, the government has facilitated enterprises market their product. The establishment of marketing boards has greatly assisted inventors in agriculture in the collection, distribution and selling of their products.

The government has also partnered with the private sector in undertaking various projects. The private sector may provide raw materials and skill while the government provides the finance. Private companies have also been awarded tenders and contracts to supply certain materials or undertake certain projects.

**vi. Providing Tax breaks and deregulate the economy**

The government has created a free economy in which enterprises have the freedom to start business of their choice without restrictions. The government has also allowed enterprises to set up businesses in any part of the country where they identify opportunities. As a result, enterprises can invest in any sector and start their businesses in any region of the country.

**vii. Training in business management skills**

Business success depends on the skills applied by the enterprise concerned. It is on this understanding that the government has introduced programs to equip citizens with business management skills such as marketing, production managing, human resource management and financial management. There have been attempts to change the attitude of citizens to appreciate business. The introduction of entrepreneurship training programme is aimed at changing this attitude.

**The Government's Role in Enterprise Development**

The government has a huge role to play in creating a conducive environment for the growth and development of enterprises. There are things that the entrepreneur will not be able to accomplish without the support of the government. On this note, it is imperative that supportive institutions and structures are set up for this. We shall look at the government's role through the following salient headings.

**i. Policy Formulation**

The government through an Act of parliament stands in a very strategic position in directing the growth of small businesses. Policies that will enhance the creation and establishment of small businesses need to be set and discussed at length in parliament. This should be done while putting the interest of the small business owners first. Policy documents that address various areas and even geographical locations should be designed with the objective of ensuring equitable chances to all stakeholders.

**ii. Supporting N.G.Os**

In recent years, the country has witnessed the mushrooming of non-governmental organizations that are doing a commendable job in promoting entrepreneurial initiatives. Most of the NOOs are mainly involved in credit delivery, business training, providing general consultancy, and providing short term



loans. However, most of the institutions supporting small businesses are rather weak, fragmented, concentrated in urban areas and uncoordinated. This calls for the need to strengthen the institutions supporting small and medium enterprises. This is where the government comes in with its wealth of influence.

### **iii. Establishing linkages! Networks**

Networks are so important for the entrepreneur who is just starting out. He needs all the support he can get from other entrepreneurs and strategic investors looking for franchises. The business linkages are also critical because networking is crucial in the business world. This is clearly demonstrated by the chain of supply of goods and services between firms in an industry and even between industries. The government can establish organs that will specialize in bringing entrepreneurs with good proposals and strategic investors together in a common forum.

Entrepreneurs also benefit through access to information on financial assistance, materials and suppliers, pricing, training, workshops sub-contracting opportunities and potential joint venture.

### **iv. Political Stability**

Ideally a world where the politics of the government do not interfere with the economic climate would be the best for any kind of business to establish itself. Unfortunately this is not the case and any change doesn't seem forthcoming. There is always bound to be political interference where the business environment is concerned raising questions as to the main issue that needs to be addressed. The government can allay fears of political interference in small enterprise development by setting aside an organ that will strictly concern itself with these matters, while ensuring little or no political interference in small enterprise development.

### **v. Economic Stability**

The government can regulate the economic down turns in the country through the fiscal policies that are enacted and revised from time to time. These can cushion the small businesses against the adverse effects of economic cycles.

#### **Incentive for Aspiring Entrepreneurs**

Entrepreneurs would really do with a bit of encouragement for them to succeed in their businesses. This comes in the form of incentives from the local and the central authorities. The incentives could come in a form that enables them to carry on their businesses with little interference.

Globally, there are some forms of incentives that can help the entrepreneur also keep up with other businesses in other countries. The incentives can come in any of the following ways.

##### **a. Few Entry Barriers**

This will encourage the upcoming entrepreneurs to penetrate a specific industry with ease. Competition may be there but with few barriers that could've been set up by the already existing businesses, it becomes possible for the small firms to compete in a fair environment.

##### **b. Tax Incentives**

Businesses that are operating in certain areas or industries could do with some exemptions in the tax on inputs. This will mean that they will not collect output tax on their products but the incentive in itself will mean less administrative work.

##### **c. Better regulations**

To control the growth of small firms, the government can regulate the issuing of licenses or require stringent requirements for one to get a license. This will act as an incentive for the new business and will create a conducive environment for healthy competition.



**d. Linkages**

The government through the ministry of finance can set up forums where investors can meet with the upcoming entrepreneurs and discuss business prospects where both parties can benefit from each other. This can be organized in form of seminars and trainings or workshops organized by the ministry concerned.

**e. Low interest rates on loans**

The government could set up loan schemes through micro finance institutions where entrepreneurs with good business prospects can get boosts for their growing ventures in the form of low interest loans. The interest subsides will be the government investment for the upcoming business that will eventually contribute to national growth.

### **CONTRIBUTION TO ECONOMIC DEVELOPMENT**

Entrepreneurs play a vital role in today's economy. Most of them get through the tough times and their businesses become success stories. The success or failure of a growing business depends largely on the entrepreneur himself. However, there are factors that may be beyond his control, but if he can get around these, one way or the other, he only has himself to convince that the business can actually develop.

The economy can support the entrepreneur's venture depending on the various cycles, and the stage of growth the business happens to be in any one of these cycles. It would be the entrepreneur's hope that the period of boom finds his business just picking up so that he can be taken by the wave of growth and prosperity that will be represented by most commercial activities during these times.

As the economy grows, the business grows with it. If the economy shrinks, this will have an impact as well on the business. It is suffice to say that the growth of the business depends to a large extent on the state of the economy. In both situations, whether the business is growing or not, the entrepreneur will need to identify ways the business can contribute to the economy which supports him.

This may not be his main objective, since he is in the business to make a profit. Any other requirements that do not lead to this may not be in his priority list. However, the entrepreneur's business will find itself dealing with people and other institutions. Entrepreneurs make various contributions to economic development in the countries as follows:

**i. Employment/ Job creation**

Entrepreneurs contribute to creation of employment opportunities for citizens. They start a business and employ themselves first then expand the same business to absorb more citizens as employees.

**ii. Improved quality of life/ standard**

Entrepreneurs are creative and highly innovative. They are able to design goods and services that fit customer specifications. They continually improve on the same in order to meet changing customer needs. They also provide income to citizens in form of salaries and wages the citizens can therefore afford goods and services.

**iii. Add to National Income**

Entrepreneurs generate a lot of income from their businesses locally and overseas. The amount of money generated can be used for more investment or to provide citizens with goods and services.

**iv. Even distribution of income**

Entrepreneurs spread out to all parts of a nation because it is the business opportunities that guide them where to invest. In the process they open up in accessible areas for development. The presence of entrepreneurs in different parts may mean more income, better infrastructure and higher quality of life for the local community.



**v. Bring new technology in production**

Through their creativity and innovation, entrepreneurs develop different methods of production and provision of services. They are quick to adopt new and efficient operation methods. To survive in a competitive market, they may continuously engage in research on ways to improve production and ensure customer service and profitability.

**vi. Increase investment**

Entrepreneurs are investors and may increase the number of investments in a nation. In so doing, they create more wealth in a nation investment may suggest ability to meet basic needs and save the surplus for investment.

**vii. Increase government revenue**

Entrepreneurs contribute to government revenue through various forms of taxes. The entrepreneur's firm whether registered as a company or not still has a legal requirement to pay its taxes and to furnish the tax authority with the relevant paper work. The entrepreneur running a sole business will need to submit all his income in a given fiscal year and the business income from his firm forms part of this.

An entrepreneur running a public limited company has the responsibility of ensuring corporate taxes are paid each year and in compliance with the Companies Act and any other legislation. Other taxes that the entrepreneur should furnish the tax authorities are taxes on the sales of good to the final consumer, personal taxes on his employees and any other penalties associated with these taxes. The various forms of taxes are sources revenue for the government. The government therefore is able to provide its citizens with basic services.

**viii. Social responsibility**

The entrepreneur should realize that his business will go a long way in getting public approval if it is seen to be doing something positive for the local community. Regular contributions to community projects will put the business in the good books of the community. This should be clearly highlighted in the company's policy. The good will of the business stands to improve and this ensures support not only from regular customers but also the local authorities.

**ix. Formation of cartels**

Cartels are formed by firms with the same business objectives. Theirs is to establish favourable trade terms with suppliers so that when the goods reach the final consumer, sufficient margins have been made. This helps the many small individual firms that perhaps could not have had the same bargaining power as they do when in a cartel. In a way it fortifies the relationships between the various businesses and contributes towards healthy competition. The smaller firms eventually grow and play important roles in the economy as well.

**The Role of Government in Promoting Entrepreneurship**

The government plays an important role in the world of business in general and in entrepreneurship in particular.

The following are some of the roles that the government plays in promoting entrepreneurship:

**1. Training**

The government can train entrepreneurs to expose them to modern development, educate them on efficiency methods of operating businesses and to make the entrepreneurs aware of various available profitable business opportunities.

They can also be trained on how to use available resources so as to minimize costs and maximize profits.



## **2. Licensing**

The government is involved in licensing businesses in order to regulate the number of businesses and to control healthy competition. Licensing also enables the government to ensure that the entrepreneurs engage only in legal businesses.

## **3. Advisory services**

The government can provide entrepreneurs with advisory services especially on better product and management techniques. Entrepreneurs can also be advised on legal procedures involved in starting and operating a business.

## **4. Participation in Business activities**

The government can play a major role in entrepreneurship by participating in business activities directly or indirectly in order to regulate competition and ensure provisions of goods and services. The government can also develop infrastructure as its contribution to entrepreneurship.

## **5. Subsidies**

The government can promote entrepreneurship by providing subsidies for manufactured goods and services. This helps in reducing the cost of product hence reducing the selling price of goods and services. This makes the goods more appealing to the buyer because of fair pricing.

## **DECISION MAKING**

Decision making is all about employing one's mental processes to come up with a final choice after careful consideration of several options or alternatives. The outcome of your decision could significantly affect your work, your business, and even your life. This is why in entrepreneurship, making intelligent decisions is regarded as very important because it could mean the difference between success and failure of your endeavor.

### **Components of Decision-Making**

In order to make intelligent decisions, you need to identify the four components that are instrumental to making the right choices.

#### **1. Context**

This involves the environment where the decision should be made on. You should get all the relevant information, the facts, the data, and everything else you need to help you make a decision.

#### **2. Objectives**

It is important to have a clear understanding of what you hope to achieve after making a decision because this will serve as a guide in the process of deciding. Your objectives should make the whole process logical, easy, and a lot less stressful.

#### **3. Alternatives**

Know all the available alternatives before making a decision. Analyze everything carefully and do not limit your options to a very small number. Gather as many options as possible before making a decision and find out the risks involved.

#### **4. Criteria**

If you have knowledge of your objectives and you have all the information you need, coming up with a criteria should not be difficult. This could be hard or soft criteria; hard includes budget and time allocation whereas soft includes employee satisfaction and organizational disruption. Assess your criteria fully before making a decision.



## **Managerial Versus Entrepreneurial Decision Making**

The difference between the entrepreneurial and the managerial styles can be viewed from five key business dimensions

- a. Strategic orientation
- b. Commitment to opportunity
- c. Commitment of resources
- d. Control of resources
- e. Management structure

### **a. Strategic Orientation**

The entrepreneur's strategic orientation depends on his or her perception of the opportunity.

This orientation is most important when other opportunities have diminishing returns accompanied by rapid changes in technology, consumer economies, social values, or political rules. When the use of planning systems as well as measuring performance to control current resources is the strategic orientation, the administrative (managerial) domain is operant, as is the case with many large multinational organizations.

### **b. Commitment to Opportunity**

In terms of the commitment to opportunity, the second key business dimension, the two domains vary greatly with respect to the length of this commitment. The entrepreneurial domain is pressured by the need for action, short decision windows, a willingness to assume risk, and few decision constituencies and has a short time span in terms of opportunity commitment. This administrative (managerial) domain is not only slow to act on an opportunity, but once action is taken, the commitment is usually for a long time span, too long in some instances. There are often no mechanisms set up in companies to stop and reevaluate an initial resource commitment once it is made—a major problem in the administrative (managerial) domain.

### **c. Commitment of Resources**

An entrepreneur is used to having resources committed at periodic intervals that are often based on certain tasks or objectives being reached. These resources, often acquired from others, are usually difficult to obtain, forcing the entrepreneur to maximize any resources used. This multistage commitment allows the resource providers (such as venture capitalists or private investors) to have as small an exposure as possible at each stage of business development and to constantly monitor the track record being established. Even though the funding may also be implemented in stages in the administrative domain, the commitment of the resources is for the total amount needed. Administratively oriented individuals respond to the source of the rewards offered and receive personal rewards by effectively administering the resources under their control.

### **d. Control of Resources**

Control of the resources follows a similar pattern. Since the administrator (manager) is rewarded by effective resource administration, there is often a drive to own or accumulate as many resources as possible. The pressures of power, status, and financial rewards cause the administrator (manager) to avoid rental or other periodic use of the resource. The opposite is true for the entrepreneur who under the pressure of limited resources, the risk of obsolescence, a need for flexibility, and the risks involved—strives to rent, or otherwise achieve periodic use of, the resources on an as-needed basis.



## **INDIVIDUAL CHARACTERISTICS OF ENTREPRENEURS**

Researchers in entrepreneurship have successfully established that entrepreneurs are associated with certain characteristics which also determine the success for otherwise their business ventures

These characteristics include;

### **1 Moderate/ calculated risk takers**

This means that entrepreneurs do not take a chance and they do not depend on luck.

Moderate risks are those activities whose outcome largely depends on the entrepreneur's skills and actual efforts to minimize dependence on luck. Entrepreneurs ensure they provide the skills and the resources a business needs to succeed. Business success is therefore defendant on their input. Where there is possibility of risk, entrepreneurs control the same by insuring the business and taking other measures to reduce negative effects of the risk on business.

### **ii. Take personal responsibility**

Entrepreneurs take responsibilities for their decisions and actions. The success of their business is attributed to their efforts and skills while failure is blamed on their incompetence. Since entrepreneurs do not desire to account for failure, they commit their efforts, knowledge, skills and other resources to their businesses.

### **iii. Goal- oriented / Achievement oriented**

Many entrepreneurs are achievers and will always work with a goal in mind. They perform their tasks the best they can to ensure they fulfill their goals. Some goals or objectives of business may include profits, quality products and services, market leadership among others. For this reason, entrepreneurs plan and monitor their activities evaluating their achievements along the way to check whether the goals they set are being achieved. Where entrepreneurs find deviations, they put in place measures for improvement so that business goals can be met.

### **iv. Self — confident -**

Many entrepreneurs believe in their own abilities to do things and to succeed. They understand their business well and they know what it takes to get their business achieve the goals. They use all their energy and resources to achieve the goals they set. No amount of distraction can discourage them.

### **v. Highly creative and innovative**

Many entrepreneurs bring around new businesses and also bring around new products and services. They are full of ideas on how to solve their business problems. Today's entrepreneurs are more innovators than creators. They may use the existing resources or modify existing products in order to meet the challenges of modern day competition.

### **vi. Opportunity seekers**

Entrepreneurs are constantly occupied with activities that assist in finding out business opportunities or even ways of developing their existing businesses.

Many entrepreneurs desire to constantly improve the performance of their businesses.

Entrepreneurs may use various methods to acquire information on opportunities. They may read relevant literature, listen to relevant news, observe the environment and identify any opportunities that environmental changes may bring.



vii. **F u t u r e o r i e n t e d**

Many entrepreneurs have great foresight and can sense or 'see' opportunities in the future. They are keen to observe world trends and interpret the implications of the trends to their businesses. They are therefore able to prepare for events in the future.

## RISK MANAGEMENT

Every business faces risks that could present threats to its success. Risk is defined as the probability of an event and its consequences. Risk management is the practice of using processes, methods and tools for managing these risks. Risk management focuses on identifying what could go wrong, evaluating which risks should be dealt with and implementing strategies to deal with those risks. Businesses that have identified the risks will be better prepared and have a more cost-effective way of dealing with them.

To be successful, entrepreneurs cannot just assume the risk of a business venture, they must actively manage risk. However, the business plans of many entrepreneurs indicate they have given relatively little thought to the various operational risks their new enterprises will encounter. As these flaws are readily apparent to prospective investors, the entrepreneur may not get necessary financial backing to move forward. By incorporating risk management into the planning process, the entrepreneur gains a better understanding of the business system and has a tool for analyzing and managing operational risk. Further, the rigor this process adds to a business plan has real value to potential investors.

### The Entrepreneur as a Risk Taker

Entrepreneurs start new business ventures because they have an idea for a new service or product. They have a vision of an unfilled niche in the marketplace that they believe they can capitalize on. Because of this vision, and the creative impulse that drives it, entrepreneurs have a belief in their own uniqueness. The fact that many new business ventures will not get off the ground or will fail within the first year or two is immaterial to entrepreneurs they are different. So while the very nature of an entrepreneur implies taking on risk, their perception of risk is often much different than the actual risk assumed.

### The Risk Management Process

Businesses face many risks; therefore risk management should be a central part of any business' strategic management. Risk management helps you to identify and address the risks facing your business and in doing so increase the likelihood of successfully achieving your businesses objectives.

A risk management process involves:

- methodically identifying the risks surrounding your business activities
- assessing the likelihood of an event occurring
- understanding how to respond to these events
- putting systems in place to deal with the consequences
- monitoring the effectiveness of your risk management approaches and controls

As a result, the process of risk management:

- improves decision-making, planning and prioritization
- helps you allocate capital and resources more efficiently
- allows you to anticipate what may go wrong, minimizing the amount of firefighting you have to do or, in a worst-case scenario, preventing a disaster or serious financial loss
- significantly improves the probability that you will deliver your business plan on time and to budget.

Risk management becomes even more important if your business decides to try something new, for example launch a new product or enter new markets. Competitors following you into these markets, or breakthroughs in technology which make your product redundant, are two risks you may want to consider in cases such as these.



## Types of Risks a Business Faces

The main categories of risk to consider are:

- (a) **strategic**, for example a competitor coming on to the market
- (b) **compliance**, for example the introduction of new health and safety legislation
- (c) **financial**, for example non-payment by a customer or increased interest charges on a business loan
- (d) **operational**, for example the breakdown or theft of key equipment

These categories are not rigid and some parts of your business may fall into more than one category. The risks attached to data protection, for example, could be considered when reviewing your operations or your business' compliance.

Other risks include:

- environmental risks; including natural disasters
- employee risk management, such as maintaining sufficient staff numbers and cover, employee safety and up-to-date skills
- political and economic instability in any foreign markets you export goods to
- health and safety risks

### a. Strategic and Compliance Risks

Strategic risks are those risks associated with operating in a particular industry. They include risks arising from:

- merger and acquisition activity
- changes among customers or in demand
- industry changes
- research and development Where there's a strong possibility of this happening, you should prepare some sort of response.

### b. Compliance risk

Compliance risks are those associated with the need to comply with laws and regulations. They also apply to the need to act in a manner which investors and customers expect, for example, by ensuring proper corporate governance.

You may need to consider whether employment or health and safety legislation could add to your overheads or force changes in your established ways of working.

You may also want to consider legislative risks to your business. You should ask yourself whether the products or services you offer could be made less marketable by legislation or taxation — as has happened with tobacco and asbestos products. For example, concerns about the increase in obesity may prompt tougher food labeling regulations, which may push up costs or reduce the appeal of certain types of food.

### c. Financial Risks

Financial risks are associated with the financial structure of your business, the transactions your business makes and the financial systems you already have in place.

Identifying financial risk involves examining your daily financial operations, especially cash flow. If your business is too dependent on a single customer and they are unable to pay you, this could have serious implications for your business' viability.



You might examine:

- the way you extend credit to new customers
- who owes you money
- the steps you can take to recover it
- insurance that can cover large or doubtful debts

Financial risk should take into account external factors such as interest rates and foreign exchange rates. Rate changes will affect your debt repayments and the competitiveness of your goods and services compared with those produced abroad.

#### **d. Operational Risks**

Operational risks are associated with your business' operational and administrative procedures. These include:

- recruitment
- supply chain
- accounting controls
- IT systems
- Regulations
- board composition

You should examine these operations in turn, prioritise the risks and make provisions for such a risk happening. For example, if you are heavily reliant on one supplier for a key component you should consider what could happen if that supplier went out of business and source other suppliers to help you minimise the risk.

IT risk and data protection are increasingly important to business. If hackers break into your IT systems, they could steal valuable data and even money from your bank account which at best would be embarrassing and at worst could put you out of business. A secure IT system employing encryption will safeguard commercial and customer information.

### **How to Evaluate Risks**

Risk evaluation allows you to determine the significance of risks to the business and decide to accept the specific risk or take action to prevent or minimise it. To evaluate risks, it is worthwhile ranking these risks once you have identified them.

This can be done by considering the consequence and probability of each risk. Many businesses find that assessing consequence and probability as high, medium or low is adequate for their needs.

These can then be compared to your business plan - to determine which risks may affect your objectives - and evaluated in the light of legal requirements, costs and investor concerns. In some cases, the cost of mitigating a potential risk may be so high that doing nothing makes more business sense.

There are some tools you can use to help evaluate risks. You can plot on a risk map the significance and likelihood of the risk occurring. Each risk is rated on a scale of one to ten. If a risk is rated ten this means it is of major importance to the company. One is the least significant. The map allows you to visualise risks in relation to each other, gauge their extent and plan what type of controls should be implemented to mitigate the risks.

Prioritising risks, however you do this, allows you to direct time and money toward the most important risks. You can put systems and controls in place to deal with the consequences of an event. This could involve defining a decision process and escalation procedures that your company would follow if an event occurred.



## Use Preventative Measures for Business Continuity

Risk management involves putting processes, methods and tools in place to deal with the consequences of events you have identified as significant threats for your business. This could be something as simple as setting aside financial reserves to ease cash flow problems if they arise or ensuring effective computer backup and IT support procedures for dealing with a systems failure.

Programs which deal with threats identified during risk assessment are often referred to as business continuity plans. These set out what you should do if a certain event happens, for example, if a fire destroys your office. You can't avoid all risk, but business continuity plans can minimise the disruption to your business.

Risk assessments will change as your business grows or as a result of internal or external changes. This means that the processes you have put in place to manage your business risks should be regularly reviewed. Such reviews will identify improvements to the processes and equally they can indicate when a process is no longer necessary.

### How to Manage Risks

There are four ways of dealing with, or managing, each risk that you have identified. You can:

- *accept it*
- *transfer it*
- *reduce it*
- *eliminate it*

.For example, you may decide to accept a risk because the cost of eliminating it completely is too high. You might decide to transfer the risk, which is typically done with insurance. Or you may be able to reduce the risk by introducing new safety measures or eliminate it completely by changing the way you produce your product. When you have evaluated and agreed on the actions and procedures to reduce the risk, these measures need to be put in place.

Risk management is not a one-off exercise. Continuous monitoring and reviewing are crucial for the success of your risk management approach. Such monitoring ensures that risks have been correctly identified and assessed and appropriate controls put in place. It is also a way to learn from experience and make improvements to your risk management approach.

All of this can be formalised in a risk management policy, setting out your business' approach to and appetite for risk and its approach to risk management. Risk management will be even more effective if you clearly assign responsibility for it to chosen employees. It is also a good idea to get commitment to risk management at the board level.

Good risk management can improve the quality and returns of your business.

### Choose the Right Insurance to Protect Against Losses

Insurance will not reduce your business' risks but you can use it as a financial tool to protect against losses associated with some risks. This means that in the event of a loss you will have some financial compensation. This can be crucial for your business' survival in the event of, say, a fire which destroys a factory.

Some costs are uninsurable, such as the damage to a company's reputation. On the other hand, in some areas insurance is mandatory.



Insurance companies increasingly want evidence that risk is being managed. Before they will provide cover, they want evidence of the effective operation of processes in place to minimise the likelihood of a claim. You can ask your insurance adviser for advice on appropriate processes.

Insurance products.

You can use a business interruption policy, for example, to insure against loss of profit and higher overheads resulting from, say, damaged machinery.

You may also want to consider:

- *products liability insurance*
- *key man insurance*
- *group life assurance*

Liability insurance - public and products liability insurance - is designed to pay any compensation and legal costs that arise from negligence or breach of duty. Key man insurance is designed to cover you for the financial costs of losing key personnel.

Group life assurance is provided by employers as part of a benefits package and pays out a lump sum to an employee's family should the employee die.



# **PART H**

## **Multiple-Choice Questions**



## SET 1

*Each of the following questions or incomplete statements is followed by **FOUR** suggested answers. Select the correct answer in each case.*

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- i. A company purchased a plant on 1<sup>st</sup> January, 2014 for Shs 540,000,000 and has a salvage value of Shs 40,000,000. Depreciation is provided for at the rate of 20% per annum using the reducing balance method.

*Compute the depreciation expense that will be included in the financial statements for the year ended 31 December, 2014*

- a. Shs 80,000,000
- b. Shs 86,400,000
- c. Shs 100,000,000
- d. Shs 108,000,000

- ii. *Which of the following equations are NOT true?*

- i. Assets – Liabilities + Owners' Equity= Zero
  - ii. Assets – Liabilities + Owners' Equity
  - iii. Assets – Liabilities = Owners' Equity
  - iv. Assets – Owners' Equity = Liabilities
  - v. Assets + Liabilities = Owners' Equity
- a. ii and iii
  - b. i and v
  - c. iii and iv
  - d. ii and iv.

- iii. *Which of the following statements is false?*

- a. Receiving rent is cash results into the reduction of an asset
- b. Paying for Insurance by cheque results into the reduction of an asset
- c. Making a drawing results into the reduction of capital of a sole trader.
- d. Making a drawing results into the reduction of an asset of a sole trader.

- iv. *The nature of an asset is best described as*

- a. Something with physical form that is valued at cost in the accounting records.
- b. An economic resource owned by a business and expected to benefit from records.
- c. An economic resource representing cash or the right to receive cash in the near future.
- d. Something owned by a business that has a ready market value.

- v. *A bank reconciliation is performed in order to:*

- a. verify the accuracy of the company's recorded cash balance
- b. Ensure that all bank loans have been properly accounted for.
- c. Verify that all cash disbursements are for a legitimate business purpose.
- d. Verify that only authorized personnel signed the disbursement cheques.



- vi. *The double entry principle states that:*
- For every debit there is an equal credit.
  - Total assets must match total liabilities and owners' equity
  - Expenses should be recognized in the same accounting period in which they generated revenue.
  - Total debits equal total credits
- vii. *Which of the following would not be classified as capital expenditure?*
- Demolition costs to remove an old building before construction can begin.
  - Painting of new building
  - Architect's fees for building plans and for supervising construction of a building.
  - Cost of building an extension to the warehouse.
- viii. Given a purchases invoice showing 5 items of shs 80,000 each, less trade discount of 25% and a possible cash discount of 5% , if paid within 7 days discount, the invoice value would be;
- shs 400,000      shs 380,000    c shs 300,000    shs 285,000
- ix. A company has been unable to collect an account receivable of Shs 1,000,000 and writes it off by debiting the bad debts expense account. *What entry must be made when the debtor eventually pays the entire Shs 1,000,000?*
- Debit bad debts recovered account shs 1,000,000  
Credit accounts receivable account shs 1,000,000
  - Debit accounts receivable account shs 1,000,000  
Credit provision for doubtful debts account shs, 1,000,000
  - Debit cash account shs 1,000,000  
Credit accounts receivable account shs 1,000,000
  - Debit cash account shs 1,000,000  
Credit bad debts expense account shs 1,000,000
- x. *Which of the following errors would be revealed by a trial balance?*
- a credit sale to John has been debited to the ledger account of Johan
  - a remittance from a credit customer has been recorded as a cash sale
  - a credit note received from a supplier has been debited to a trade receivable account
  - discounts received has been posted to the debit side of the discounts allowed account.
- xi. *The matching principle*
- Applies only to situations in which a cash payment occurs before an expense is recognized.
  - Applies only to situations in which a cash receipt occurs before revenue is recognized
  - Is used in accrual accounting to determine the proper period for recognition of expenses and revenues.
  - Is used in double entry to determine the proper period in which to recognize revenue



- xii. Which of the following statements best describes the statement of financial position?
- A statement, which shows how much profit, was made
  - A list of assets and liabilities.
  - A statement showing the solvency position of the organization by disclosing its assets, liabilities and shareholders' / proprietors' funds.
  - A statement showing agreements of the Cash book and bank statement balances.
- xiii. Which of the following is false about cash discounts?
- double entry is completed through the cash book
  - they reduce the amount payable to settle the full obligation
  - they are offered for prompt payment
  - it is still called cash discount even if the account is paid by cheque.
- xiv. Which of the following are books of prime entry?
- Journal proper
  - Sales day book
  - Debtors ledger
  - Private ledger
- i, iii and iv
  - ii
  - i and ii
  - iii and iv
- xv. Given opening capital of Shs 8,250,000 closing capital of Shs 5,675,000 and drawings Shs 1,650,000. then
- profit for the year was shs 925,000
  - loss for the year was shs 925,000
  - loss for the year was shs 2,575,000
  - loss for the year was shs 4,225,000
- xvi. The following is a list of assets and liabilities of a business at the end of an accounting period
- |                    | Shs '000 |
|--------------------|----------|
| Non-current assets | 150,000  |
| Payables           | 75,000   |
| Bank loan          | 40,000   |
| Inventory          | 23,000   |
| Cash               | 8,500    |
- Calculate the Company's Capital at that date (Assume no reserves)
- shs 158,500,000
  - shs 115,000,000
  - shs 138,000,000
  - shs 66,500,000
- xvii. What is the correct treatment for cheques issued during the last two months which have not appeared on the bank statement at the date of reconciliation?
- should be written back in the cash book
  - should be included in the bank reconciliation statement
  - should be cancelled
  - should be included as accruals in the balance sheet



- xviii. ABC Ltd purchased goods worth shs 500,000 from Sam Bemire on credit. The purchases account was duly debited with shs 500,000 but the credit entry was made in the Sam Baize's account, a different supplier. This type of error is
- a. error of complete reversal of entries
  - b. compensating error
  - c. error of principle
  - d. error of commission
- xix. *A complete set of financial statement for Nkozi Ltd, at 30 June 2014, would include each of the following EXCEPT.*
- a. Statement of financial position as at 30 June 2014
  - b. Statement of comprehensive income for the year ended 30 June 2014
  - c. Statement of projected cash flows for year ending 30 June 2014
  - d. Notes containing additional information that is useful in interpreting the financial statements.
- xx. *Which of the following is a correct sequence of the accounting cycle/process?*
- a. From documents to journals , the ledger, trial balance and final account
  - b. From journal to documents, the ledger, trial balance and final accounts
  - c. From the ledger to journals, documents, final accounts and trial balance.
  - d. From documents to the ledger, trial balance, journals and final accounts.

## ANSWERS TO TEST PAPER 1

(i)	(a)	(ix)	(d)	(xvii)	(b)
(ii)	(b)	(x)	(d)	(xviii)	(d)
(iii)	(a)	(xi)	(c)	(xix)	(c)
(iv)	(c)	(xii)	(c)	(xx)	(a)
(v)	(a)	(xiii)	(a)		
(vi)	(a)	(xiv)	(c)		
(vii)	(b)	(xv)	(b)		
(viii)	(c)	(xvi)	(d)		



## SET 2

*Each of the following questions or incomplete statements is followed by **FOUR** suggested answers. Select the correct answer in each case.*

---

- i. *XYZ Ltd, a newly formed company, incurred the following costs related to land and building:*

- Plan approval fees for the building Shs 4 million
- Title search fees Shs 20,000
- Cash paid for land with a building to be demolished Shs 230 million.
- Excavation for construction of basement of new building Shs 36 million.
- Removal of old building Shs 34 million less salvage of Shs 9 million = Shs 25 million.

*At what amount should XYZ Ltd record the land only?*

- a. shs 304,020,000
- b. shs 295,020,000
- c. shs 264,020,000
- d. shs 255,020,000

- ii. A material overstatement in closing inventory was discovered after the financial statements of a company were finalized. *What effect did this error have on the financial statements?*

Current assets	Gross Profit
a. Understated	overstated
b. Overstated	overstated
c. Understated	understated
d. Overstated	understated.

- iii. A company opened a fixed deposit account with its bankers on 1 June 2014. It was agreed that interest payment dates be 1st April and 1 October each year. *Interest income for the year ended 31 December 2014 was for a period of:*

- e. 3 months
- f. 4 months
- g. 6 months
- h. 7 months.

- iv. *Which of the following statements regarding receivables is true?*

- a. A receivable arises when a company buys goods or services from another party on credit
- b. Accounts receivable are more formal than notes receivable.
- c. Accounts receivable are often called trade receivable.
- d. Accounts receivable is a miscellaneous category that may include loans to employees.

- v. XYZ Ltd had the following information for the year ended 30 June 2014

Opening inventory	shs 400,000
Purchases	shs 990,000
Closing inventory	shs 350,000

The gross profit as a percentage of sales is always 20%



*Based on these figures, what is the sales revenue for the year?*

- a. shs 1,248,000
  - b. shs 1,300,000
  - c. shs 1,040,000
  - d. shs 1,740,000
- vi. *Which of the following is a summary of the transactions in partnership dissolution?*
- a. Gains and losses on the sales of assets are divided pro rata to capital balances and the final cash payment to the partners is based on the profit and loss sharing ratios.
  - b. Gains and losses on the sale of assets are divided according to the profit and loss sharing ratios and the final cash payment to the partners is pro rata to the capital balances.
  - c. Gains and losses on the sales of assets and the final cash payment to the partners are divided according to the profit and loss sharing ratios.
  - d. Gains on the sale of assets and final cash payment to the partners are pro rata to the capital balances and losses divided according to the profit and loss sharing ratios
- vii. *Financial statements are prepared*
- a. Only for publicly owned business organizations.
  - b. For companies, but not for sole proprietorship or partnerships.
  - c. Primarily for the benefit of persons outside of the business organization
  - d. In either monetary or non-monetary terms, depending upon the need of the decision maker(s)
- viii. *In preparing a company's cash flow statement, which, if any, of the following items could form part of the calculation of cash flow from financing activities?*
- a. bonus issue of shares
  - b. Dividends received
  - c. Proceeds from sale or premises
  - d. Rights issue of shares.
- ix. *Which of the following is an underlying assumption?*
- a. Consistency concept
  - b. Historical cost concept
  - c. Going concern concept
  - d. Prudence concept
- x. *Which of the following combinations gives the four principal qualitative characteristics of financial statements?*
- a. understandability, reliability, relevance, comparability
  - b. understandability, prudence, relevance, comparability.
  - c. Understandability, reliability, relevance, materiality.
  - d. Completeness, reliability, relevance, comparability.



- xi. *Which of the following do not affect trial balance agreement?*
- i. Purchases of shs 5,000,000 from Kikuubo traders were completely omitted from the books.
  - ii. Sales of shs 1,500,000 to Mr. Masaba were entered in his account as shs 5,100,000.
  - iii. The rent account was over cast by shs 200,000
  - iv. An error of shs 500,000 on one of the purchase invoices from Mr. Jones had been entered in the books as such.
- a. i and iv
  - b. i and ii
  - c. i and iii
  - d. iii and iv
- xii. *Which of the following items is odd?*
- a. Discount allowed
  - b. Carriage outwards
  - c. Bad debts written off
  - d. Discount received.
- xiii. *What journal entry is required to record goods taken from inventory by the owner of a business?*
- a. Debit drawings  
            Credit capital
  - b. Debit sales  
            Credit drawings
  - c. Debit drawings  
            Credit purchases
  - d. Debit purchases  
            Credit drawing
- xiv. *Which of the following statements is true?*
- a. All non current assets must be depreciated
  - b. Bank reconciliation statements must be prepared only once during a given financial reporting period
  - c. A club or an association is not required to prepare financial statements because it is a not for profit organization.
  - d. The capital or a limited company may take the form of shares
- xv. A cheque was received from a credit customer. The book keeper debited the customer's account and credited the cash book. *This type of error is the error of*
- a. principal
  - b. complete reversal of entries
  - c. commission
  - d. compensating error



xvi. Which of the following items increases the equity of a partnership business?

- a. Initial capital of partners
- b. Loan interest
- c. Drawings
- d. Interest on drawings

xvii. The receivables ledger control account below contains several incorrect entries.

Receivables Ledger Control A/c

Shs'000	Shs'000
Opening balance 20,000	Credit sales 13,400
Cash received from credit customers 20,830	Bad debts written off 3,900
Dishonoured cheque from credit customers 2,000	Discount allowed to credit customers 2,760
Contras <u>4,000</u>	Balance carried down <u>26,770</u>
<b>46,830</b>	<b>46,830</b>
Balance b/d 26,770	

What should the closing balance be when all the errors are corrected?

- a. Shs 11.91 million
- b. Shs 15.34 million
- c. Shs 3.91 million
- d. Shs 4.11 million

xviii. Which of the following statement(s) is/are false about the extent to which expenses incurred are included in the cost of inventories?

- i. Carriage inwards, but not carriage outwards, should be included in the cost of purchase of inventories
  - ii. Inventories should be valued on the basis of labour and materials only
  - iii. The cost of inventory shall comprise all costs of purchase and costs of conversion of inventory
  - iv. The costs of purchase of inventories comprise the purchase price import duties and other taxes.
- |             |              |       |                       |
|-------------|--------------|-------|-----------------------|
| a. i and ii | b. i and iii | c. ii | d. i, ii, iii, and iv |
|-------------|--------------|-------|-----------------------|

xix. Karitas does not keep accounting records. She provides you with the following information

Net assets at the beginning of the year shs 1,470,000

Net assets at the year end shs 2,800,000

Drawings during the year shs 336,000

Capital introduced during the year shs 700,000



*Based on this information, what is Karitas' profit for the year?*

- a. shs 966,000
- b. shs 1,694,000
- c. shs 1,330,000
- d. shs 2,366,000

xx. *How should interest charged on partners' drawings appear in partnership financial statements?*

- a. Credited to the partnership appropriation account
- b. Debited to the partnership appropriations account
- c. Credited to the profit and loss account
- d. Debited in the income statement.



## SET 3

*Each of the following questions or incomplete statements is followed by **FOUR** suggested answers. Select the correct answer in each case.*

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- i. *In some Clubs, members are allowed to become life members by making a special payment. What entry is required when life subscription is paid?*

**Debit**

- a. life subscription account
- b. life subscription account
- c. Receipts and payments account
- d. Income and expenditure account

**Credit**

- Income and expenditure account
- Receipts and payments account
- Life subscriptions account
- Life subscriptions account

- iv. *Which of the following accounting concepts requires that; an accountant should not anticipate revenues and profit until realized but provide for all possible losses?*

- a. realization
- b. Prudence
- c. Accrual
- d. Money measurement.

- v. ABC Ltd purchased goods worth shs 500,000 from Sam Bemire on credit. The purchases account was duly debited with shs 500,000 but the credit entry was made in the Sam Baize's account, a different supplier. This type of error is

- a. error of complete reversal of entries
- b. error of principle
- c. compensating error
- d. error of commission

- vi. *Which of the following are books of prime entry?*

- i. Journal proper
  - ii. Sales day book
  - iii. Debtors ledger
  - iv. Private ledger
- 
- a. i, iii and iv
  - b. ii
  - c. i and ii
  - d. iii and iv



- vii. *Ms Betty Nakku used shs 800,000 from her business to pay for her children's medical bills. Which of the following entries are required to record the above transactions*

	Dr. Shs	Cr. Shs
a. Children's account	800,00	
Cash account		800,000
b. Children's account	800,000	
Capital account		800,000
c. Drawings account	800,000	
Cash account		800,000
d. Cash account	800,000	
Drawing account		800,000

- viii. *The following information was taken from the books of Kalongo Golf Club for the year ending 30 June 2014*

	Shs
'000	
Subscriptions due at 30 June 2014	200
Subscriptions received during the year ended 30 June 2014	
1,300	
Subscriptions received for the year commencing 1 July 2014	450
Compute the subscriptions to be taken to income for the year ended 30 June 2014	
a. Shs 650,000	
b. shs 1,550,000	
c. shs 1,050,000	
d. shs 1,950,000	

- ix. *In an accounts receivable ledger control account, which of the following lists is composed only of items which would appear on the credit side of the account?*

- a. Cash received from customers, sales returns, and bad debts written off.
- b. Sales, cash refunds to customers, bad debts written off.
- c. Discounts allowed, interest charged on overdue accounts, bad debts written off.
- d. Sales, Cash refunds to customers, set off against purchases ledger control account.

- x. *After checking a business cash book against the bank statement, which of the following items would require an entry in the Cash book?*

- i. Bank charges.
  - ii. A cheque from a customer which was dishonored
  - iii. A cheque not presented
  - iv. Deposits not credited
  - v. Credit transfer entered in the bank statement
  - vi. Standing order entered in the bank statement.
- a. i, iii, and vi
  - b. ii, iv, and vi



- c. i, ii, v and vi
  - d. i, ii, iii and v
- xi. Dannie is a sole trader and does not maintain a full set of accounting records but wishes to calculate her sales revenue for the year. The following information is available for the year ended 31 December 2014.
- |   |             |
|---|-------------|
| Opening inventory                                 | shs 450,000 |
| Closing inventory                                 | shs 600,000 |
| Purchases for the period                          | shs 900,000 |
| Standard gross profit percentage on sales revenue | 40%         |
- What is the sales revenue figure for the year ended 31 December 2014?*
- a. shs 750,000
  - b. shs 1,200,000
  - c. shs 800,000
  - d. shs 1,250,000
- xii. *Which of the following is a correct sequence of the accounting cycle/process?*
- a. From documents to journals , the ledger, trial balance and final account
  - b. From journal to documents, the ledger, trial balance and final accounts
  - c. From the ledger to journals, documents, final accounts and trial balance.
  - d. From documents to the ledger, trial balance, journals and final accounts.
- xiii. *Accounting bases that have been selected by management to be appropriate for their organization and prevailing circumstances are called accounting.*
- a. Standards
  - b. policies
  - c. concepts / conventions
  - d. rules
- xiv. *A complete set of financial statement for XYZ Ltd, at 30 June 2014, would include each of the following EXCEPT.*
- a. Statement of financial position as at 30 June 2014
  - b. Statement of profit or loss and other comprehensive income for the year ended June 30 2014
  - c. statement of projected cash flows for year ending 30 June 2014
  - d. Notes containing additional information that is useful in interpreting the financial statements.
- xv. *The reason that both expenses and dividends are recorded by debit entries is that*
- a. All dividend and expense transactions involve offsetting credit entries to the cash account.
  - b. Both expenses and dividends are offset against revenue in the income statement
  - c. Both expenses and dividends reduce owner's equity
  - d. The statement is untrue: expenses are recorded by debits, but dividends are recorded by credits to the owner's drawing account.
- xvi. *Inventory is considered a current asset because it*
- a. often reflects the most current trends and styles
  - b. is purchased during the current year.
  - c. Will be converted into cash in the current year.
  - d. Can be returned to the supplier for a cash refund



- xvii. *Ward Company discovered that merchandise purchased on account was defective and returned this merchandise to the supplier. The entry to record this return will reduce Wards'*
- Sales revenue and the cost of goods sold.
  - Inventory and liabilities
  - Inventory and cost of goods sold
  - Sales revenue and liabilities
- xviii. *Which of the following statements about bank reconciliations is correct?*
- adjusted cash book balance + unpresented cheques – uncredited cheques = bank statement balance.
  - Bank statement balance + unpresented cheques – uncredited cheques = cash book balance
  - Cash book blane + uncredited cheques – unpresented cheques + direct debits = bank statement balance.
  - Bank statement balance + uncredited cheques – unpresented cheques – direct credits = cash book balance.
- xix. *Which of the following are prime costs?*
- Direct materials and direct labour
  - Direct materials and overheads.
  - Direct labour and overheads
  - Direct materials, direct labour and over heads.
- xx. *If a journal entry recognizes an expense, the entry might also.*
- increase an asset account
  - decrease the capital account
  - decrease a liability account
  - increase a liability account.
- xxi. At 30th September 2013 the balance on Unilex Ltd's provision for doubtful debts was shs 10,560,000. During the year ended 30 September 2014 bad debts previously provided for shs 412,500 were written off. At 30 September 2014 debtors balances are shs 257.4 million and the Company wishes to have a provision of 5% of this amount in its year end statement of financial position. *The profit and loss account charge for bad and doubtful debts for the year ended 30 September 2014 is?*
- shs 412,500
  - shs 2,310,000
  - shs 2,722,500
  - shs 3,040,000
- xxii. A Company's accounts showed a gross profit for the year of Shs. 44,880,000. An audit found that the opening stock had been overstated by Shs 1,980,000 while closing stock had been understated by Shs. 2,805,000. *What is the amount of the Company's corrected gross profit for the year?*
- shs 40,095,000
  - shs 44,055,000
  - shs 45,705,000
  - shs 49,665,000



## SET 4

*Each of the following questions or incomplete statements is followed by **FOUR** suggested answers. Select the correct answer in each case.*

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- i. *What journal entry is required to record goods introduced into inventory by the owner of a business?*
  - a. Debit purchases and credit capital
  - b. Debit capital and credit drawing
  - c. Debit drawing and credit purchases
  - d. Debit purchases and credit drawings.
- ii. Jane buys goods from Peter. At 31 May 2014, Peter's account in Jane's records shows shs 100,000 owing to Peter. Peter submitted a statement to Jane as at the same date showing a balance due of shs 70,000. *Which of the following could account fully for the differences?*
  - a. Jane has sent a cheque to Peter for shs 30,000 which has not yet been received by Peter.
  - b. Peter has issued a credit note for shs 30,000 to Jane which Jane has not yet received.
  - c. The credit side of Peter's account in Jane's recorded has been under cast by shs 30,000.
  - d. An invoice of shs 15,000 for Peter has been treated in Jane's records as if it had been a credit note.
- iii. *Which of the following correctly describes the imprest system for operating petty cash?*
  - a. A regular equal amount is transferred into cash.
  - b. The exact amount of expenditure out of petty cash is reimbursed at intervals.
  - c. All expenditure out of petty cash must be supported by a properly authorized voucher.
  - d. A budget is fixed for a period which petty cash expenditure must not exceed.
- iv. *Which of the following items will NOT be found in a bank reconciliation statement?*
  - a. Bank errors
  - b. Uncredited cheques
  - c. Standing orders
  - d. Unpresented cheques.
- v. *Which of the following is NOT recorded in the receipts and payments account?*
  - a. Receipt of members' life subscriptions.
  - b. Accumulated fund
  - c. Payment for furniture
  - d. Proceeds from the sale of investments.



- vi. A limited liability company's trial balance did not balance. The totals were debit shs 384,030; credit shs 398,580. This means that the draft financial statements disclosed the difference as
- income shs 14,550
  - capital shs 14,550
  - assets shs 14,550
  - liabilities shs 14,550

- vii. The following information is available for a sole trader who does not keep full accounting records.

Opening inventory	shs 138,600
Closing inventory	shs 149,100
Purchases for the year	shs 716,100

*The sole trader makes a standard gross profit of 30% on sales. Based on these figures, what is the sole trader's cost of sales for the year?*

- shs 705,600
  - shs 865,200
  - shs 726,600
  - shs 854,700
- ix. *Which of the following would reduce the purchase cost of a trading item?*
- import duties and other taxes
  - transport cost
  - trade discounts and rebates
  - Handling and other directly attributable costs
- x. *What is the effect of omitting closing inventory from the income statements?*
- the cost of sales is understated
  - the gross profit from trading is overstated
  - the total payments made to acquire trading items are overstated
  - the net profit from trading is understated
- xi. On admission of a new partner into a partnership business, the buildings are revalued to shs 100 million from shs 120 million. *What is the double entry for this revaluation difference?*
- Debit revaluation account, credit buildings account with shs 20 million
  - Debit revaluation account; credit building account with shs 100 million
  - Debit buildings account; credit revaluation account with shs 20 million
  - Debit buildings account; credit revaluation account with shs 100 million
- xii. *Which of the following may be classified as a non current liability?*
- Members' annual subscriptions in advance
  - Members' annual subscriptions in arrears
  - Members' life subscriptions payable
  - Members' life subscriptions paid

xiii. *Which of the following is the most likely information need of an employee from company published financial statements?*

- a. The risk inherent in and the return provided by the Company's investments.
  - b. The ability of the company to apply loans and the interest attaching to them when due.
  - c. The ability of the company to provide remuneration, retirement benefits and employment opportunities.
  - d. The allocation of resources of the company, the taxation policies and similar statistics.

xiv. *What is the objective of general purpose financial statements?*

- a. to recognize and measure the elements from which these financial statements are constructed
  - b. to determine the qualitative characteristics and usefulness of information in the financial statements.
  - c. To assess the ability of the entity to pay and provide other benefits to its stakeholders.
  - d. To provide information about the financial position, performance and changes in financial position for making economic decisions.

xv. R and S are in partnership sharing profits and losses equally. T joined the partnership half way into the year and it was agreed that the three partners continue to share profits and losses equally. The profit for the year amounted to shs 900,000 accruing evenly over the year after charging a bad debt of shs. 90,000 which, it was agreed, should be borne equally by R and S only. *Derive each partner's share of profits for the year?*

	R Shs	S Shs	T Shs
a.	285,000	285,000	330,000
b.	367,500	367,500	165,000
c.	375,000	375,000	150,000
d.	330,000	330,000	150,000

xvi. What would be the double entry for the sale, on credit, of trading items for shs 295,000 inclusive of transport charges at 18%, which are accounted for separately as transport revenue?

- |    |                                  |             |
|----|----------------------------------|-------------|
| a. | Debit sales account              | shs 250,000 |
|    | Debit Transport Revenue account  | shs 45,000  |
|    | Credit receivables account       | shs 295,000 |
| b. | Debit sales account              | shs 295,000 |
|    | Credit Transport Revenue account | shs 45,000  |
|    | Credit receivables account       | shs 250,000 |
| c. | Debit receivables account        | shs 295,000 |
|    | Credit sales account             | shs 250,000 |
|    | Credit Transport Revenue account | shs 45,000  |



d. Debit receivables account	shs 250,000
Debit transport Revenue account	shs 45,000
Credit sales account	shs 295,000

xvii. *The cost of putting goods into a saleable condition should be charged to;*

- a. statement of reserves
- b. sales
- c. balance sheet
- d. income statement

xviii. *The settlement of a present obligation may occur in the following ways except by*

- a. payment of cash
- b. deferring the date of payment
- c. transfer of other assets
- d. conversion of the obligation to equity

***The following information relates to questions (xix) and (xx)***

A company purchases a machine costing shs 38.4 million. It has an expected life of five years and an expected residual value of shs 8 million. The Company uses the straight line method of depreciation. At the beginning of year 3, shs 12.8 million is spent by the Company on major technical improvement to the machine. This has had the effect of extending its useful life by three years with an expected residual value of shs 3.68 million at the end of the year.

xix. What is the depreciable amount of the asset after the technical improvements have been made?

- a. shs. 30.4 million
- b. shs 31.04 million
- c. shs 35.36 million
- d. shs 32.16 million

xx. What is the amount of the depreciation charge in year 8?

- a. shs 5,893 million
- b. shs 5,9392 million
- c. shs 7,920 million
- d. shs 5,4192 million

