

# THEORETICAL FRAMEWORK OF FINANCIAL ACCOUNTING

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## CONCEPTUAL FRAMEWORK

Financial statements are prepared and presented to external users by many entities around the world. Although such financial statements may appear similar from country to country, there are differences that have probably been caused by a variety of social, economic and legal circumstances and having in mind the needs of different users of financial statements when setting national requirements.

These different circumstances have led to the use of a variety of definitions of the elements of financial statements e.g. assets, liabilities, equity, income and expenses. They have also resulted in the use of different criteria for recognition of items in the financial statements and in a preference for different bases of measurement.

Therefore the **conceptual framework** is like a constitution. It is a statement of generally accepted theoretical principles, which form the frame of reference for financial reporting. These theoretical principles provide a basis for the development of new accounting standards and the evaluation of those already in existence. The financial reporting process is concerned with providing information that is useful in business and economic decision-making process. Therefore a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. Although theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

First, to be useful, standard setting should be built on and relate to an established body of concepts and objectives. A soundly developed conceptual framework should enable the development and issuance of a coherent set of standards and practices built upon the same foundation.

Second, a conceptual framework should increase financial statement users' understanding and confidence in financial reporting.

Third, such a framework should enhance comparability among financial statements of different entities. Similar events should similarly be accounted for and reported on.

## The objective of financial statements

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

Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide nonfinancial information.

## **Financial Position, Performance and Changes in Financial Position**

The economic decisions that are taken by users of financial statements require an evaluation of the ability of the entity to generate cash and cash equivalents and of the timing and certainty of their generation. Users are better able to evaluate this ability if they are provided with information that focuses on the financial position, performance and changes in financial position.

The financial position of an entity is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to the changes in the environment in which it operates.

Information about liquidity and solvency is useful in predicting the ability of the entity to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future after taking account of financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

Information about performance of an entity in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in future.

Information concerning changes in financial position of an entity is useful in order to assess its investing, financing and operating activities during the reporting period.

Information about financial position is primarily provided in the statement of financial position, information about performance is primarily provided in the statement of comprehensive income, and information about changes in financial position is provided in financial statements by means of a similar statement.

## **Qualitative Characteristics of Financial Statements**

Qualitative characteristics are attributes that make the information provided in the financial statements useful to users. Four principal qualitative characteristics are understandability, relevance, reliability and comparability.

### **Understandability**

An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have reasonable knowledge of business, economic activities and accounting together with a willingness to study information with reasonable diligence. However, information about complex matters should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

### **Relevance**

To be useful, information must be relevant to the decision making needs of users. 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 past evaluations. The relevance of information is affected by its nature and materiality. This involves;

- Substance over Form: Consider economic reality and not merely legal form
- Neutrality: Information should be free from bias
- Prudence: There should be a degree of caution in exercising judgment
- Completeness: Within limits of materiality and cost

### **Reliability**

To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be relied upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

### **Comparability**

Users must be able to compare financial statements of an entity through time in order to identify trends in its financial position and performance. Users must be able to compare financial statements of different entities' in order to evaluate their relative financial position, performance and changes in financial position. Hence the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity, and over time for that entity and in a consistent way for different entities.

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in preparation of financial statements, any changes in those policies and the effect of such changes. Users need to be able to identify differences between accounting policies for like transactions and other events used by the same entity from period to period and by different entities. Compliance with International Financial Reporting Standards including the disclosure of accounting policies used by the entity helps to achieve comparability.

### **The Elements of Financial Statements**

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed elements of financial statements. The elements directly related to the measurement of financial position in the statement of financial position are assets, liabilities and equity. The elements directly related to measurement of performance in the statement of comprehensive income are income and expenses.

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. Entities employ assets to produce goods and services capable of satisfying the needs and wants of customers.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of resources from the entity.

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

Income is the increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decrease of liabilities that result in increases in equity other than those relating to contributions from equity participants.

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity other than distributions to equity participants.

### **Recognition of Elements of Financial Statements**

Recognition is the process of incorporating in the statement of financial position or statement of comprehensive income an item that meets the definition of an element. An element should be recognized if;

- a) It is probable that any future economic benefit associated with the item will flow to or from the entity and
- b) The item has a cost or value that can be measured reliably.

### **Measurement of Elements of Financial Statements**

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the statement of financial position and statement of comprehensive income. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed and in varying combinations in financial statements.

**Historical Cost:** Assets are recorded at the amount of cash and cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation or in some circumstances e.g. income taxes at the amounts of cash and cash equivalents expected to be paid to satisfy the liability in the normal course of business.

**Current Cost:** Assets are carried at the amount of cash and cash equivalents that would be have to be paid if the same or equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash and cash equivalents that would be required to settle the obligation currently.

**Realizable (Settlement) value:** Assets are carried at the amount of cash and cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values i.e. the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

**Present Value:** Assets are carried at the present discounted value of future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

## **INTERNATIONAL FINANCIAL REPORTING STANDARDS**

**International Accounting Standards (IAS)** now being replaced by International Financial Reporting Standards (IFRS) is developed by **International Accounting Standards Committee (IASC)**. Financial reporting standards refer to guidelines and rules and procedure formulated to guide reporting and accounting practice. These standards are produced both at national and international level.

In Kenya, **Institute of Certified Public Accountants of Kenya (ICPAK)** had developed Kenya Accounting Standards and IFRS and IAS is developed by an international body.

### **International Accounting Standards Committee (IASC)**

The IASC was founded through the agreement between the professional accounting bodies of various countries. The primary objective of IASC was to achieve uniformity in the accounting principles which are used by business and other organization for financial reporting in the whole world.

#### **Functions of IASC**

- It is responsible for preparing and issuing the IFRS and Exposure Draft including opinion and approval of interpretation by the International Financial Reporting Interpretation Committee (IFRSIC).
- Publication of Exposure Draft (ED) on all projects.
- Publishing of draft statement of principles and other documents for public comments.
- Carrying detailed research and other work and present the finding details to national standard setters and other organization.
- Establishes procedures for reviewing comments made and documents published for comments.
- Forms steering committee and advisory groups to give advice and comments on projects.
- Issues bases for conclusion with IFRS and ED.
- Holds public hearing to discuss proposed standard.

### **International Financial Reporting Standard Interpretation Committee (IFRSIC)**

Formally the committee was known as Standard Interpretation Committee (SIC). Once a new standard has been issued by IASC, there is an application date to which financial statement should be prepared in accordance to that standard. Most of the time, it becomes difficult to use it according to its content. IFRSIC is therefore formed to solve this problem. The major function of IFRSIC is to issue guidelines on how IFRS are to be interpreted.

### **International Federation of Accountants (IFAC)**

The IFAC is a private and non-profit making body established in 1977. It derives its members from professional accounting bodies of countries around the world. Kenya is a member of IFAC through ICPAK. The IASC is also affiliated to IFAC. The mission of IFAC is the development and enhancements of the profession to enable it provide services of consistently high quality in the public interest.

Its main objective is to co-ordinate the accounting profession around the world by issuing and establishing international standards on auditing, management, accounting ethics, education and

training. In addition IFAC is a non-political, non-governmental and international organization which represents accounting profession around the global.

The IASC is connected to the profession by accountancy bodies through joining with the IFAC. IFAC on the other side recognizes IASC as the only body, which has authority to issue accounting standard in its own name. IASC has been conferred authority to cooperate and negotiate with other organizations and to promote IFRS acceptability worldwide.

### **Institute of Certified Public Accountants of Kenya (ICPAK)**

The ICPAK is a private non-profit making body established in 1978 under Accountant Act. It is an accounting regulatory body in Kenya. Its objective is to coordinate the accounting profession in Kenya by issuing guidelines and enforcing IFRS. It is a non-governmental and non-political independent body, which promotes ethics in accounting and a watchdog of all accounting matters. ICPAK is a member of IFAC and ECSAFA.

#### **Purpose of ICPAK**

- Setting and enforcing standards of profession and practice including accounting, auditing and standards.
- Monitoring ethical behavior and adjusting over cases involving indiscipline through the s disciplinary committee.
- Providing for the maintenance of competence, by updating members' knowledge through publications and conducting of Continuing Professional Education (CPE).

### **Eastern, Central and Southern African Federation of Accountants (ECSAFA)**

This is a private body of the member countries of COMESA formed to advance accounting profession in the region. Since this is an inter government body, its major task is to ensure that the norms of the region do not conflict with those of international standards in order to achieve comparability. It also ensures there is harmonization and improvement in financial reporting in the region.

ECSAFA has supported the adoption of IFRS and thus bases its work on the materials of IASC.

#### **Adoption of International Reporting Standards**

ICPAK has directed the adoption of IFRS for the following reasons.

- **International trends.** Many countries in the world which had their own national standards adopted international standards and used it as a common yardstick for international reporting. Due to international flow of investment capital and capital instruments across borders, many entities will be forced to adopt the international standards.
- **Regional considerations.** IFAC and ECSAFA supports the adoption of International Accounting Standards and most of it members have complied.
- **Local pressure.** Central Bank of Kenya and Capital Markets Authority who are the regulators of the economy have adopted the International Standards. CMA developed guidelines required for listing of companies in stock exchange and compliance to International Standards was one of them.

## *PREPARATION AND PRESENTATION OF PUBLISHED FINANCIAL STATEMENTS*

### **Objective of IAS 1 Presentation of financial statements**

The objective of IAS 1 is to prescribe the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. IAS 1 sets out the overall framework and responsibilities for the presentation of financial statements, guidelines for their structure and minimum requirements for the content of the financial statements. Standards for recognizing, measuring, and disclosing specific transactions are addressed in other Standards and Interpretations.

### **Objective of Financial Statements**

The objective of general purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements provide information about an entity's:

- Assets.
- Liabilities.
- Equity.
- Income and expenses, including gains and losses.
- Other changes in equity.
- Cash flows.

That information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

### **Components of Financial Statements**

A complete set of financial statements should include:

a statement of financial position at the end of the period, a statement of comprehensive income for the period, a statement of changes in equity for the period, statement of cash flows for the period, and notes, comprising a summary of accounting policies and other explanatory notes.

When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements, it must also present a statement of financial position as at the beginning of the earliest comparative period.

### **Fair Presentation and Compliance with IFRSs**

The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

IAS 1 requires that an entity whose financial statements comply with IFRSs make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs (including Interpretations).

Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework. In such a case, the entity is required to depart from the IFRS requirement, with detailed disclosure of the nature, reasons, and impact of the departure.

### **Going Concern**

An entity preparing IFRS financial statements is presumed to be 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, in which case IAS 1 requires a series of disclosures.

### **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.

### **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.

### **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.

**Offsetting**> Assets and liabilities, and income and expenses, may not be offset unless required or permitted by a Standard or an Interpretation.

### **Comparative Information**



IAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard requires otherwise.

If comparative amounts are changed or reclassified, various disclosures are required.

### **Structure and Content of Financial Statements in General**

Clearly identify:

- the financial statements ▪ the reporting enterprise
- whether the statements are for the enterprise or for a group
- the date or period covered
- the presentation currency
- the level of precision (thousands, millions, etc.)

### **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 enterprise must disclose the reason for the change and a warning about problems of comparability. [IAS 1.49]

### **Statement of Financial Position**

An entity must normally present a classified statement of financial position, separating current and noncurrent assets and liabilities. Only if a presentation based on liquidity provides information that is reliable and more relevant may the current/noncurrent split be omitted. In either case, if an asset (liability) category commingles 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 cash; cash equivalent; assets held for collection, sale, or consumption within the enterprise's normal operating cycle; or assets held for trading within the next 12 months. All other assets are noncurrent.

Current liabilities are those to be settled within the enterprise's normal operating cycle or due within 12 months, or those held for trading, or those for which the entity does not have an unconditional right to defer payment beyond 12 months. Other liabilities are noncurrent.

Long-term debt expected to be refinanced under an existing loan facility is noncurrent, even if 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 authorization 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 reporting date, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

Minimum items on the face of the statement of financial position

- (a) property, plant and equipment;
- (b) investment property;
- (c) intangible assets;
- (d) financial assets (excluding amounts shown under (e), (h) and (i));
- (e) investments accounted for using the equity method;
- (f) biological assets;
- (g) inventories;
- (h) trade and other receivables;
- (i) cash and cash equivalents;
- (j) trade and other payables;
- (k) provisions;
- (l) financial liabilities (excluding amounts shown under (j) and (k));
- (m) liabilities and assets for current tax, as defined in IAS 12;
- (n) deferred tax liabilities and deferred tax assets, as defined in IAS 12;
- (o) non-controlling interest, presented within equity; and
- (p) Issued capital and reserves attributable to equity holders of the parent.

Additional line items may be needed to fairly present the entity's financial position.

Regarding issued share capital and reserves, the following disclosures are required:

- numbers of shares authorized, issued and fully paid, and issued but not fully paid  par value
- reconciliation of shares outstanding at the beginning and the end of the period
- description of rights, preferences, and restrictions
- treasury shares, including shares held by subsidiaries and associates
- shares reserved for issuance under options and contracts
- a description of the nature and purpose of each reserve within owners' equity

### **Statement of Income**

All items of income and expense recognized in a period must be included in profit or loss unless a Standard or an Interpretation requires otherwise.

Minimum items on the face of the statement of income should include:

- revenue
- finance costs
  
- share of the profit or loss of associates and joint ventures accounted for using the equity method

- a single amount comprising the total of (i) the post-tax profit or loss of discontinued operations and (ii) the post-tax gain or loss recognized on the disposal of the assets or disposal group(s) constituting the discontinued operation
- tax expense
- profit or loss

The following items must also be disclosed on the face of the income statement as allocations of profit or loss for the period:

- profit or loss attributable to non-controlling interest
- profit or loss attributable to equity holders of the parent

Additional line items may be needed to fairly present the enterprise's results of operations.

No items may be presented on the face of the statement of income or in the notes as "extraordinary items".

Certain items must be disclosed either on the face of the statement of income or in the notes, if material, including:

- write-downs of inventories to net realizable 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

Expenses should be analyzed either by nature (raw materials, staffing costs, depreciation, etc.) or by function (cost of sales, selling, administrative, etc.) either on the face of the statement of income or in the notes. If an enterprise categorizes by function, additional information on the nature of expenses – at a minimum depreciation, amortization, and staff costs – must be disclosed.

### **Statement of Cash Flows**

### **Statement of Changes in Equity**

IAS 1 requires an entity to present a statement of changes in equity as a separate component of the financial statements. The statement must show:

- profit or loss for the period
- each item of income and expense for the period that is recognized directly in equity, and the total of those items;

- total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to equity holders of the parent and to minority interest
- for each component of equity, the effects of changes in accounting policies and corrections of errors recognized in accordance with IAS 8

The following amounts may also be presented on the face of the statement of changes in equity, or they may be presented in the notes:

- capital transactions with owners
  - the balance of accumulated profits at the beginning and at the end of the period, and the movements for the period
  - a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and at the end of the period, disclosing each movement
- Notes to the Financial Statements**

The notes must:

- present information about the basis of preparation of the financial statements and the specific accounting policies used;
- disclose any information required by IFRSs that is not presented on the face of the balance sheet, income statement, statement of changes in equity, or cash flow statement; and
- provide additional information that is not presented on the face of the balance sheet, income statement, statement of changes in equity, or cash flow statement that is deemed relevant to an understanding of any of them.

Notes should be cross-referenced from the face of the financial statements to the relevant note.

Suggests that the notes should normally be presented in the following order:

- a statement of compliance with IFRSs
- a summary of significant accounting policies applied, including:
  - the measurement basis (or bases) used in preparing the financial statements
  - the other accounting policies used that are relevant to an understanding of the financial statements
- supporting information for items presented on the face of the balance sheet, income statement, statement of changes in equity, and cash flow statement, in the order in which each statement and each line item is presented
- other disclosures, including:
  - contingent liabilities (see IAS 37) and unrecognized contractual commitments
  - non-financial disclosures, such as the entity's financial risk management objectives and policies (see IAS 32)

Disclosure of judgments. An entity must disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the

process of applying the entity's accounting policies that have the most significant effect on the amounts recognized in the financial statements.

Examples cited in IAS 1.114 include management's judgments in determining:

- whether financial assets are held-to-maturity investments
- when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities
- whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and
- whether the substance of the relationship between the entity and a special purpose entity indicates that the special purpose entity is controlled by the entity

Disclosure of key sources of estimation uncertainty. An entity must disclose, in the notes, information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. These disclosures do not involve disclosing budgets or forecasts.

The following other note disclosures are required by if not disclosed elsewhere in information published with the financial statements:

- domicile of the enterprise
- country of incorporation
- address of registered office or principal place of business
- description of the enterprise's operations and principal activities
- name of its parent and the ultimate parent if it is part of a group

### **Other Disclosures**

#### **Disclosures about Dividends**

The following must be disclosed either on the face of the income statement or the statement of changes in equity or in the notes:

- the amount of dividends recognized as distributions to equity holders during the period, and the related amount per share.
- The following must be disclosed in the notes:
  - the amount of dividends proposed or declared before the financial statements were authorized for issue but not recognized as a distribution to equity holders during the period, and the related amount per share; and
  - the amount of any cumulative preference dividends not recognized.

### **Capital Disclosures**

Additional requirements for capital disclosures include:

- the entity's objectives, policies and processes for managing capital;
- quantitative data about what the entity regards as capital; ▪ whether the entity has complied with any capital requirements; and ▪ if it has not complied, the consequences of such non-compliance.

### September 2007 Revised IAS 1 Is Issued

On 6 September 2007, the IASB issued a revised IAS 1 Presentation of Financial Statements. The main changes from the previous version are to require that an entity must:

- Present all non-owner changes in equity (that is, 'comprehensive income' – see format below) either in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income). Components of comprehensive income may not be presented in the statement of changes in equity.
- Present a statement of financial position (balance sheet) as at the beginning of the earliest comparative period in a complete set of financial statements when the entity applies an accounting policy retrospectively or makes a retrospective restatement.
- Disclose income tax relating to each component of other comprehensive income.
- Disclose reclassification adjustments relating to components of other comprehensive income.

### Comprehensive Income

Comprehensive income for a period includes profit or loss for that period plus other comprehensive income recognized in that period. The components of other comprehensive income include:

- changes in revaluation surplus (IAS 16 and IAS 38).
- actuarial gains and losses on defined benefit plans recognized in accordance with IAS 19.
- gains and losses arising from translating the financial statements of a foreign operation (IAS 21).
- gains and losses on re-measuring available-for-sale financial assets (IAS 39).
- the effective portion of gains and losses on hedging instruments in a cash flow hedge (IAS 39).

## PREPARING THE FINANCIAL STATEMENTS OF COMPANIES LIMITED BY LIABILITY

### XYZ GROUP

#### STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2009

	2009	2008
	Kes '000	Kes '000
Revenue	XXX	XXX
Cost of sales	<u>XXX</u>	<u>XXX</u>
Gross profit	XXX	XXX
Other incomes	XXX	XXX

Distribution costs	XXX	XXX
Administrative expenses	XXX	XXX
Other expenses	XXX	XXX
Finance costs	XXX	XXX
Share of profit after tax of associates	XXX	XXX
Profit before tax	<u>XXX</u>	<u>XXX</u>
Tax	<u>XXX</u>	<u>XXX</u>
Profit for the year from continuing operations	<u>XXX</u>	<u>XXX</u>
Profit for the year from discontinued operations	<u>XXX</u>	<u>XXX</u>
<b>Profit for the year</b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>
<i>Other comprehensive income:</i>		
Exchange differences on translating foreign operations	XXX	XXX
Cash flow hedges	XXX	XXX
Gains on property revaluation	XXX	XXX
Share of other comprehensive income from associate	XXX	XXX
Actuarial gains/ (losses) on defined benefit fund	XXX	XXX
Available for sale financial assets	<u>XXX</u>	<u>XXX</u>
Other comprehensive income for the year	<u>XXX</u>	<u>XXX</u>
<b>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>
<b>Attributable to:</b>		
Owners of the parent	XXX	XXX
Non controlling interest	<u>XXX</u>	<u>XXX</u>
	<u>XXX</u>	<u>XXX</u>
Earnings per share	<u>XXX</u>	<u>XXX</u>

XYZ GROUP

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2009

	2009	2008
	Kes'000	Kes'000
<b>ASSETS</b>		
<i>Non-current assets</i>		
Property, plant and equipment	XXX	XXX
Goodwill	XXX	XXX
Other intangible assets	XXX	XXX
Investments in associates	XXX	XXX
Available-for-sale investments	XXX	XXX
<i>Current assets</i>		
Inventories	XXX	XXX
Trade receivables	XXX	XXX
Other current assets	XXX	XXX
Cash and cash equivalents	<u>XXX</u>	<u>XXX</u>
<b>TOTAL ASSETS</b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>

Equity and Liabilities		
<i>Equity attributable to owners of the parent</i>		
Share capital	XXX	XXX
Retained earnings	XXX	XXX
Other components of equity	XXX	XXX
Non controlling interest	<u>XXX</u>	<u>XXX</u>
<i>Total equity</i>	<u>XXX</u>	<u>XXX</u>
<i>Non-current liabilities</i>		
Long-term borrowings	XXX	XXX
Deferred tax	XXX	XXX
Long-term provisions	<u>XXX</u>	<u>XXX</u>
<i>Total non-current liabilities</i>	<u>XXX</u>	<u>XXX</u>
<i>Current liabilities</i>		
Trade and other payables	XXX	XXX
Short-term borrowings	XXX	XXX
Current portion of long-term borrowings	XXX	XXX
Current tax payable	XXX	XXX
Short-term provisions	<u>XXX</u>	<u>XXX</u>
<i>Total current liabilities</i>	<u>XXX</u>	<u>XXX</u>
<i>Total liabilities</i>	<u>XXX</u>	<u>XXX</u>
<b>TOTAL EQUITY AND LIABILITIES</b>	<b><u>XXX</u></b>	<b><u>XXX</u></b>

## STATEMENT OF RECOGNISED INCOME AND EXPENSE

### XYZ GROUP

## STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X8

### Attributable to equity holders of the parent

	Share capital	Other reserves	Translation reserve	Retained earnings	Total	NCI	Total equity
	'000	'000	'000	'000	'000	'000	'000
Balance at 31 December 2007 brought forward	X	X	(X)	X	X	X	
X Changes in equity for 2008 or transferred from equity	X	X	X	X	X	X	
Net income recognized directly							



in equity	(X)	(X)			(X)	(X)	(X)
Profit for the period				X	X	X	X
Total recognized income and expense for the period		(X)	(X)	X	X	X	X
Dividends				(X)	(X)	(X)	(X)
Issue of share capital,	X			X	X		
Balance at 31 December 2008	X	X	(X)	X	X	X	X

## STATEMENT OF CASH FLOWS

### Objective of IAS 7

The objective of IAS 7 is to require the presentation of information about the historical changes in cash and cash equivalents of an enterprise by means of a statement of cash flows, which classifies cash flows during the period according to operating, investing, and financing activities.

### Fundamental Principle in IAS 7

The statement of cash flows analyses changes in cash and cash equivalents during a period. Cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash and that are subject to an insignificant risk of changes in value. An investment normally meets the definition of a cash equivalent when it has a maturity of three months or less from the date of acquisition. Equity investments are normally excluded, unless they are in substance a cash equivalent (e.g. preferred shares acquired within three months of their specified redemption date). Bank overdrafts which are repayable on demand and which form an integral part of an enterprise's cash management are also included as a component of cash and cash equivalents.

### Presentation of the Statement of Cash Flows

Cash flows must be analyzed between operating, investing and financing activities.

**operating activities** are the main revenue-producing activities of the enterprise that are not investing or financing activities, so operating cash flows include cash received from customers and cash paid to suppliers and employees

**investing activities** are the acquisition and disposal of long-term assets and other investments that are not considered to be cash equivalents.

**financing activities** are activities that alter the equity capital and borrowing structure of the enterprise.

Interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period. Cash flows arising from taxes on income are normally classified as operating, unless they can be specifically identified with financing or investing activities

For operating cash flows, the direct method of presentation is encouraged, but the indirect method is acceptable.

The **direct method** shows each major class of gross cash receipts and gross cash payments. The operating cash flows section of the statement of cash flows under the direct method would appear something like this:

Cash receipts from customers	xx,xxx
Cash paid to suppliers	xx,xxx
Cash paid to employees	xx,xxx
Cash paid for other operating expenses	xx,xxx
Interest paid	xx,xxx
Income taxes paid	xx,xxx
<b>Net cash from operating activities</b>	<b>xx,xxx</b>

The **indirect method** adjusts accrual basis net profit or loss for the effects of non-cash transactions. The operating cash flows section of the statement of cash flows under the indirect method would appear something like this:

Profit before interest and income taxes	xx,xxx
Add back depreciation	xx,xxx
Add back amortization of goodwill	xx,xxx
Increase in receivables	xx,xxx
Decrease in inventories	xx,xxx
Increase in trade payables	xx,xxx
Interest expense	xx,xxx
Less Interest accrued but not yet paid	<u>xx,xxx</u>
Interest paid	xx,xxx
Income taxes paid	xx,xxx
<b>Net cash from operating activities</b>	<b>xx,xxx</b>

The exchange rate used for translation of transactions denominated in a foreign currency and the cash flows of a foreign subsidiary should be the rate in effect at the date of the cash flows. Cash flows of foreign subsidiaries should be translated at the exchange rates prevailing when the cash flows took place.

As regards the cash flows of associates and joint ventures, where the equity method is used, the statement of cash flows should report only cash flows between the investor and the investee; where proportionate consolidation is used, the cash flow statement should include the venturer's share of the cash flows of the investee.

Aggregate cash flows relating to acquisitions and disposals of subsidiaries and other business units should be presented separately and classified as investing activities, with specified additional disclosures. The aggregate cash paid or received as consideration should be reported net of cash and cash equivalents acquired or disposed of.

Cash flows from investing and financing activities should be reported gross by major class of cash receipts and major class of cash payments except for the following cases, which may be reported on a net basis:

- cash receipts and payments on behalf of customers (for example, receipt and repayment of demand deposits by banks, and receipts collected on behalf of and paid over to the owner of a property)
- cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short, generally less than three months (for example, charges and collections from credit card customers, and purchase and sale of investments)
- cash receipts and payments relating to fixed maturity deposits
- cash advances and loans made to customers and repayments thereof

Investing and financing transactions which do not require the use of cash should be excluded from the statement of cash flows, but they should be separately disclosed elsewhere in the financial statements.

- the components of cash and cash equivalents should be disclosed, and a reconciliation presented to amounts reported in the statement of financial position'
- the amount of cash and cash equivalents held by the enterprise that is not available for use by the group should be disclosed, together with a commentary by management.

## **FORMAT FOR PREPARATION OF CASH FLOW STATEMENT**

### **INDIRECT METHOD CASH FLOW STATEMENT**

#### **Cash flows from operating activities**

Profit before taxation	xxx	
<i>Adjustments for:</i>		
Depreciation	xx	
Amortization/Impairment	xx	
(Profit)/ Loss on sale of PPE	xx	
Interest expense		<u>xx</u>

<i>Net cash before working capital changes</i>	xxx
<i>Changes in working capital</i>	
(Increase)/decrease in trade receivables	xx
(Increase)/decrease in inventories	xx
Increase/ (decrease) in creditors	<u>xx</u>
<i>Cash generated from operations</i>	xxx
Interest paid	(xx)
Income taxes paid	(xx)
Dividend paid*	<u>(xx)</u>
<i>Net cash inflow/ (outflow) from operating activities</i>	<u>xxx</u>
<b>Cash flow from investing activities</b>	
Purchase of property, plant and equipment	(xx)
Proceeds from sale of property, plant and equipment	xx
Interest received	xx
Dividend received	<u>xx</u>
<i>Net cash inflow/ (outflow) from investing activities</i>	<u>xxx</u>
<b>Cash flow from financing activities</b>	
Proceeds from issue of share capital	xx
Proceeds from long term borrowings	xx
Payments of finance lease liabilities/long term borrowings	<u>(xx)</u>
<i>Net cash inflow/ (outflow) from financing activities</i>	<u>xxx</u>
<b>Net increase in cash and cash equivalents</b>	xxx
<b>Cash and cash equivalents at the beginning of the period</b>	<u>xx</u>
<b>Cash and cash equivalents at the end of the period</b>	<u>xxx</u>
<b>*This could also be shown as a financing activity</b>	
<b>DIRECT METHOD CASH FLOW STATEMENT</b>	
<b>Cash flows from operating activities</b>	
Cash receipts from customers	xxx

Cash paid to suppliers and employees	(xx)
<i>Cash generated from operations</i>	xxx
Interest paid	(xx)
Income taxes paid	(xx)
Dividend paid*	<u>(xx)</u>
<i>Net cash inflow/ (outflow) from operating activities</i>	<u>xxx</u>
<b>Cash flow from investing activities</b>	
Purchase of property, plant and equipment	(xx)
Proceeds from sale of property, plant and equipment	xx
Interest received	xx
Dividend received	<u>xx</u>
<i>Net cash inflow/ (outflow) from investing activities</i>	<u>xxx</u>
<b>Cash flow from financing activities</b>	
Proceeds from issue of share capital	xx
Proceeds from long term borrowings	xx
Payments of finance lease liabilities/long term borrowings	<u>(xx)</u>
<i>Net cash inflow/ (outflow) from financing activities</i>	<u>xxx</u>
<b>Net increase in cash and cash equivalents</b>	xxx
<b>Cash and cash equivalents at the beginning of the period</b>	<u>xx</u>
<b>Cash and cash equivalents at the end of the period</b>	<u>xxx</u>
<b>*This could also be shown as a financing activity</b>	

#### *IAS 8: ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS*

The objective of this standard is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. It is intended to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Retrospective application is applying a new accounting policy to transactions and other events and conditions as if that policy had always been applied.

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

### **Accounting Policies**

When a standard or interpretation specifically applies to a transaction, other event or a condition, the accounting policy or policies applied to this item shall be determined by applying the standard or interpretation and considering any relevant implementation guidance issued by IASB.

In absence of a standard or an interpretation that specifically applies to a transaction, other events or conditions, management shall use its judgment in developing and applying an accounting policy that results in information that is relevant to the decision making needs of users and is reliable. In making those judgments, management shall refer to and consider the applicability of the following sources:

- a) The requirements and guidance in Standards and Interpretations dealing with similar and related issues; and
- b) The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the framework.

They may also consider the most recent pronouncements of other standard setting bodies that use similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practice to the extent that these do not conflict with the IFRS.

### **Consistency of Accounting Policies**

An entity shall select and apply its accounting policies consistently for similar transactions and other events and conditions unless a Standard or an Interpretation specifically requires or permits categorization of items for which different policies may be appropriate.

### **Changes in Accounting Policies**

An entity shall change an accounting policy only if the change

- a) Is required by a Standard or an Interpretation; or
- b) Results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Users of financial statements need to be able to compare the financial statements of the entity over time to identify the trends in the financial position, performance or cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the above mentioned criteria.

### **Applying Changes in Accounting Policies**

An entity shall a retrospective application, unless it is impracticable to determine the cumulative amount of the charge. Any resulting adjustment should be reported as an adjustment to the opening balance of retained earnings. Comparative information should be restated unless it is impracticable to do so. All comparative information must be restated as if the new policy has always been in force, with amounts relating to earlier periods reflected in an adjustment to opening reserves.

### **Disclosures**

Certain disclosures are required when a change in accounting policy has a material effect on the current period or prior periods presented or when it may have a material effect in subsequent periods.

Reasons for the change

Amount of the adjustment for the current period and for each period presented

Amount of adjustment relating to periods prior to those included in the comparative information

The fact that comparative information has been restated or that it is impracticable to do so.

An entity should disclose the information relevant to assessing the impact of new IFRS on the financial statements where these have not yet come into force.

### **Illustration**

Pigateke Co. was established on 1 January 2005. In the first three years accounts development expenditure was carried forward as an asset in the statement of financial position. During 2008 the managers decided that for the current and future years, all development expenditure should be written off as it is incurred. This decision has not resulted from any change in the expected outcome of development projects on hand, but rather from a desire to favor prudence concept. The following information is available.

Movements on the development account

Year	development expenditure capitalized during the year Kes '000	transfer from capitalized development expenditure a/c to statement of income Kes '000
2005	525	-
2006	780	215
2007	995	360

The 2007 accounts show the following

Kes '000

Retained earnings b/f	2,955
Retained earnings for the year	<u>1,825</u>
Retained earnings c/f	<u>4,780</u>

The retained profit for 2008 after charging the actual development expenditure for the year was Kes 2,030,000.

### Required

Show how the change in accounting policy should be reflected in the reserves in the company's 2008 accounts in accordance with IAS 8.

Ignore taxation

### Changes in Accounting Estimates

Estimates arise in relation to business activities because of the uncertainties inherent within them. Estimation involves judgment based on the latest available, reliable information. E.g., estimates may be required of:

- a) Bad debts provision
- b) Provision for obsolescence of inventory
- c) Fair value of financial assets and liabilities
- d) Useful lives of depreciable assets

The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience.

The effect of a change in an accounting estimate should be included in the determination of profit or loss in one of:

- a) The period of change, if the change affects that period only
- b) The period of change and the future periods if the change affects both.

An example of an accounting estimate which affects only the current period is the bad debt estimate. However a revision in the life over which an asset is depreciated would affect both the current and future periods.

The effect of a change in an accounting estimate should be included in the same statement of income classification as was used previously for the estimate.

### Disclosure



An entity shall disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.

### **Errors**

Errors discovered during a current period which relate to a prior period may arise through

- a) Mathematical mistakes
- b) Mistakes in application of accounting policies
- c) Misinterpretation of facts
- d) Oversights
- e) Fraud

Generally, these errors are corrected through net profit or loss for the current period. Where they are material prior period errors, they shall be corrected retrospectively by either;

Restating the comparative amounts for the prior periods in which the error occurred,

If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest period presented

### ***IAS 10: EVENTS AFTER THE REPORTING PERIOD***

The objective of the standard is to prescribe:

- a) when an entity should adjust its financial statements for events after the end of the reporting period; and
- b) disclosures about the date when the financial statements were authorized for issue, and about events after the end of the reporting period.

### **Events after the end of the reporting period**

These are those events, both favorable and unfavorable, that occur between the end of the reporting period and the date when the financial statements are authorized for issue. Two types of events can be identified;

- a) Adjusting events – the financial statements are adjusted to reflect those events that provide evidence of conditions that existed at the end of the reporting period (such as resolution of a court case after the end of the reporting period).
- b) Non-adjusting events – the financial statements are not adjusted to reflect events that arose after the end of the reporting period (such as a decline in market prices after year end, which does not change the valuation of investments at the end of the reporting period). The nature and impact of such events are disclosed.

## **Recognition and Measurement**

### **Adjusting Events after the End of the Reporting Period Date**

The entity shall adjust the amounts recognized in its financial statements to reflect adjusting events after the end of the reporting period

### **Non-Adjusting Events after the End of the Reporting Period Date**

The entity shall not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the end of the reporting period.

## **Dividends**

Dividends proposed or declared on equity instruments after the end of the reporting period are not recognized as a liability at the end of the reporting period. Such dividends are disclosed in the notes in accordance with IAS 1.

## **Going Concern**

An entity shall prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

## **Disclosure**

Disclosure is required.

- a) Financial statements are not prepared on a going concern basis, if events after the end of the reporting period indicate that the going concern assumption is not appropriate.
- b) An entity discloses the date its financial statements are authorized for issue.

## **IFRS 5**

### **NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS**

The objective of this IFRS is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. In particular, the IFRS requires:

Assets that meet the criteria to be classified as held for sale to be measured at the lower of carrying amount and the fair value less costs to sell, and the depreciation of such assets to cease; and

Assets that meet the criteria to be classified as held for sale to be presented separately on the face of the statement of financial position and the results of the discontinued operation to be presented separately in the statement of income.

### **Classification of Non-Current Assets (or Disposal Groups) Held For Sale**

An entity shall classify a non current asset as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. A number of detailed criteria must be met:

- a) The asset must be available for immediate sale in its present condition
- b) Its sale must be highly probable

For a sale to be highly probable, the following must apply:

- a) management is committed to a plan to sell
- b) the asset is available for immediate sale
- c) an active programme to locate a buyer is initiated
- d) the sale is highly probable, within 12 months of classification as held for sale (subject to limited exceptions)
- e) the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value
- f) actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

An asset or disposal group can still be classified as held for sale, even if the sale has not actually taken place within one year. However, the delay must have been caused by events or circumstances beyond the entity's control and there must be sufficient evidence that the entity is still committed to sell the asset or disposal group. Otherwise the entity must cease to classify the asset as held for sale.

The assets need to be disposed of through sale. Therefore, operations that are expected to be wound down or abandoned would not meet the definition (but may be classified as discontinued once abandoned).

An entity shall account for a non-current asset that has been temporarily taken out of use as if it had been abandoned.

A 'disposal group' is a group of assets, possibly with some associated liabilities, which an entity intends to dispose of in a single transaction. The measurement basis required for non-current assets classified as held for sale is applied to the group as a whole, and any resulting impairment loss reduces the carrying amount of the non-current assets in the disposal group in the order of allocation

### **Measurement of Noncurrent Assets Held for Sale**

The following principles apply:

*At the time of classification as held for sale.* Immediately before the initial classification of the asset as held for sale, the carrying amount of the asset will be measured in accordance with applicable IFRSs. Resulting adjustments are also recognized in accordance with applicable IFRSs.

*After classification as held for sale.* Non-current assets or disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

*Impairment.* Impairment must be considered both at the time of classification as held for sale and subsequently:

- *At the time of classification as held for sale.* Immediately prior to classifying an asset or disposal group as held for sale, measure and recognize impairment in accordance with the applicable IFRSs (generally IAS 16, IAS 36, IAS 38, and IAS 39). Any impairment loss

is recognized in profit or loss unless the asset had been measured at revalued amount under IAS 16 or IAS 38, in which case the impairment is treated as a revaluation decrease.

- *After classification as held for sale.* Calculate any impairment loss based on the difference between the adjusted carrying amounts of the asset/disposal group and fair value less costs to sell. Any impairment loss that arises by using the measurement principles in IFRS 5 must be recognized in profit or loss, even for assets previously carried at revalued amounts.

*Assets carried at fair value prior to initial classification.* For such assets, the requirement to deduct costs to sell from fair value will result in an immediate charge to profit or loss.

*Subsequent increases in fair value.* A gain for any subsequent increase in fair value less costs to sell of an asset can be recognized in the profit or loss to the extent that it is not in excess of the cumulative impairment loss that has been recognized in accordance with IFRS 5 or previously in accordance with IAS 36.

*Non-depreciation.* Non-current assets or disposal groups that are classified as held for sale shall not be depreciated even if they are still being used.

*Statement of Financial Position presentation.* Assets classified as held for sale, and the assets and liabilities included within a disposal group classified as held for sale, must be presented separately on the face of the statement of financial position.

## **Disclosures**

- a) Non-current assets classified as held for sale and the assets of a disposal group classified as held for sale must be disclosed separately from other assets in the Statement of Financial Position.
- b) The liabilities of a disposal group classified as held for sale must also be disclosed separately from other liabilities in the balance sheet.
- c) There are also several other additional disclosures including a description of the nature of assets held and the facts and circumstances surrounding the sale.

## **Subsidiaries Held for Disposal**

IFRS 5 applies to accounting for an investment in a subsidiary for which control is intended to be temporary because the subsidiary was acquired and is held exclusively with a view to its subsequent disposal in the near future. For such a subsidiary, if it is highly probable that the sale will be completed within 12 months then the parent should account for its investment in the subsidiary under IFRS 5 as an asset held for sale, rather than consolidate it under IAS 27.

However, IAS 27 still requires that if a subsidiary that had previously been consolidated is now being held for sale, the parent must continue to consolidate such a subsidiary until it is actually disposed of. It is not excluded from consolidation and reported as an asset held for sale under IFRS 5.

An entity that is committed to a sale involving loss of control of a subsidiary that qualifies for held-for-sale classification under IFRS 5 shall classify all of the assets and liabilities of that subsidiary as held for sale, even if the entity will retain a non-controlling interest in its former subsidiary after the sale.

### **Presenting Discontinued Operations**

A discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale, and:

- a) represents a separate major line of business or geographical area of operations,
- b) is part of a single co-ordinate plan to dispose of a separate major line of business or geographical area of operations, or
- c) is a subsidiary acquired exclusively with a view to resale and the disposal involves loss of control.

### **Statement of Income Presentation**

The sum of the post-tax profit or loss of the discontinued operation and the post-tax gain or loss recognized on the measurement to fair value less cost to sell or fair value adjustments on the disposal of the assets (or disposal group) should be presented as a single amount on the face of the statement of income. Detailed disclosure of revenue, expenses, pre-tax profit or loss, and related income taxes is required either in the notes or on the face of the income statement in a section distinct from continuing operations. Such detailed disclosures must cover both the current and all prior periods presented in the financial statements.

### **Statement of Cash Flows Presentation**

The net cash flows attributable to the operating, investing, and financing activities of a discontinued operation shall be separately presented on the face of the cash flow statement or disclosed in the notes.

### **No retroactive classification**

IFRS 5 prohibits the retroactive classification as a discontinued operation, when the discontinued criteria are met after the balance sheet date.

### **Disclosures**

In addition to the statement of income and of cash flows, presentations noted above, the following disclosures are required:

- a) Adjustments made in the current period to amounts disclosed as a discontinued operation in prior periods must be separately disclosed.
- b) If an entity ceases to classify a component as held for sale, the results of that component previously presented in discontinued operations must be reclassified and included in income from continuing operations for all periods presented.

# PARTNERSHIP DISSOLUTION

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## The need for dissolution

Section 36-39 of the Partnership Act states the various ways in which partnership may be dissolved. This includes:

1. Dissolution by agreement
2. Dissolution by happening of some events:
  - a. If entered into for a fixed term by expiry of that term
  - b. If entered into for a single undertaking, by expiry of that undertaking
3. Dissolution by illegality
4. Dissolution by court e.g. incapacitation of a partner [if insane, bankrupt]

## Settlement of accounts on dissolution

1. The assets are disposed off. The proceeds of the disposal are dealt with in the following manner:
2. First pay debts due to 3<sup>rd</sup> parties
3. Pay the partners advances made by them as distinguished from their contribution
4. Pay the partners proportionately what is due to them on a/c of their capitals
5. If there is any surplus, it shall be divided between the partners in the proportion in which they were entitled to share profits

## Accounting treatment

1. *Close all the balances in current a/c to capital a/c*
  2. *Transfer book values of all assets to realization a/c*
    - Dr. Realization a/c
    - Cr. Asset a/c
3. *Amount received on disposal.*
  - Dr. Cash book
  - Cr. Realization a/c
4. *Assets taken over by partners without payment*
  - Dr. Partner's Capital a/c
  - Cr. Realization a/c [with agreed values]
5. Creditors paid

- Dr. Creditor's a/c  
Cr. cashbook
6. Discount received from creditors if any  
Dr. Creditor's a/c Cr.  
Realization a/c
7. Dissolution expenses  
Dr. Realization a/c  
Cr. Cash a/c
8. The balance on Realization a/c is transferred to the Partner's Capital a/c's in their profit sharing ratio
9. After all this adjustments the balance on the Capital a/c's and Cash Book will be equal and opposite each other.

### Illustration 1

B and W are equal partners and their Statement of Financial Position stands as follows:

Assets	Kes
Machinery	20,000
Stock	15,000
Debtors	20,000
Cash	<u>4,000</u>
<b>Total Assets</b>	<b><u>59,000</u></b>

#### Partner's Capital accounts:

B	29,000
W	12,000
Creditors	<u>18,000</u>
<b>Total Equity and Liabilities</b>	<b><u>59,000</u></b>

They decided to dissolve the partnership and the assets realized the following amounts

	Kes
Debtors	18,800
Stock	12,000
Machinery	18,000

They received Kes 1,000 as discount from creditors, and expenses of winding up amounted to Kes 2,300

#### Required

Dissolve the Partnership.

### Illustration 2

XYZ have been in partnership for several years sharing profits and losses in the ratio of 3:2:1. their last Statement of Financial Position that was prepared before dissolution was as follows:

<b>Assets</b>	<b>Kes</b>
Non-current assets	14,000
Stock	5,000
Debtors	<u>21,000</u>
<b>Total assets</b>	<b><u>40,000</u></b>
Partner's Capital a/c's	
X	4,000
Y	4,000
Z	2,000
Creditors	17,000
Bank overdraft	<u>13,000</u>
<b>Total Equity and Liabilities</b>	<b><u>40,000</u></b>

Despite making good profits during recent years, they had become increasingly dependent on one credit customer S, and in order to retain this customer, they had gradually increased his credit limit until he owed the partnership Kes 18,000. It has now been discovered that S is insolvent and that he is unlikely to pay any money owed by him to the partnership. Reluctantly X, Y and Z have agreed to dissolve the partnership on the following terms:

1. Stock is to be sold at Kes 4,000
2. Non-current assets will realize Kes 8,000 except certain items with a book value of Kes 5,000 which will be taken over by X at an agreed valuation of Kes 7,000
3. All debtors except for S are expected to pay their a/c's in full
4. The costs of dissolution will be Kes 800 and discount received from creditors will be Kes 500

### **Required**

Dissolve the Partnership

### **INSOLVENCY OF A PARTNER**

#### ***Garner vs. Murray Rule***

If a Partner's Capital a/c has a debit balance after transfer of profit or loss from Realization a/c, he will be expected to bring in cash to meet the deficiency. This will apply so long as the partner is solvent. If he has been declared insolvent, the rule *Garner vs. Murray* will apply.

This rule states that the debit balance in the a/c of the insolvent partner must be written off to the other Partner's Capital a/c's in the ratio of their last agreed Capital a/c's balances. The debit balance must be not written off in the profit sharing ratios.



The implication of the rule is that:

- a. Solvent partners to bring cash equal to their share of loss on realization
- b. Deficiency on the a/c of the insolvent partner be shared by the solvent partner in capital a/c ratios

If the partners are maintaining fixed capital a/c's, no adjustments are required. The insolvent partner's deficiency will be borne by the solvent partners in proportion to their respective capitals.

But if capital is maintained on fluctuating basis, the capital a/c should be adjusted for losses or gains carried forward and appearing in the Statement of Financial Position i.e. reserves, profit or loss, etc without adjusting the loss on realization.

The resulting balances in the capital a/c will be the required ratio for sharing the deficiency of insolvent partner.

### **Gradual Realization of Assets and Piecemeal Distribution**

Dissolution of a business may take a long time to complete. This means that assets are never realized on the same date. However the partners who are involved want to obtain the assets to which they are entitled as soon as possible. The gain or loss on realization is not usually known until a later date.

Therefore, when the process of winding up a partnership business and the consequent realization of assets is likely to take a considerable time, the partner's naturally desire that the net proceeds should be distributed to them as and when realized on a/c of their shares in respect of their capitals.

If pending the ascertainment of the total loss on realization, payments are made to the partners; there is a risk of overpayment being made to one or more of the partners. In order to avoid the risk of overpayments being made, the periodical distribution should be made in such a way that the unpaid balances on capitals of each partner are retained in his profit sharing ratio.

#### *Maximum loss method*

Under this method, each realization is treated as the final realization and the book value of all assets not yet realized are assumed to represent maximum loss. A memorandum calculation is then made by debiting the Partners Capital a/c's with the share of maximum loss. The resulting credit balances in each Partner's Capital a/c represent the maximum amount that may be distributed to them

### **Illustration 3**

P, J and K share profits in the ratio of 5:3:2. They dissolved the partnership on 1<sup>st</sup> July 2009. Some of the assets sold realized the following;

	<b>Kes</b>
August 2009	14,000
September 2009	12,000
October 2009	6,000

The Statement of Financial Position after creditors and partners' loans had been discharged is as follows:

Assets	<b>Kes</b> <u>30,000</u>
Financed by: -	
P	10,000
J     8,000	
K <u>12,000</u>	
Total Capital	<u>30,000</u>

**Required: -**

Using maximum loss method, dissolve the partnership

**Illustration 3**

P, R and S were in a partnership sharing profit and losses in the ratio 3:2:1. Their last Statement of Financial Position as at 31<sup>st</sup> Dec 2009 was as follows:-

<b>Assets</b>	<b>Kes</b>
Furniture and fitting	130,000
Stock	220,000
Debtors	180,000
Bills receivable	40,000
Bank	<u>30,000</u>
Total Assets	<u>600,000</u>
Partner's capital a/c's	
	P                   150,000
	R                   150,000
	S                   100,000
S loan a/c	50,000
Creditors	<u>150,000</u>
Total Equity and Liabilities	<u>600,000</u>

The bills receivable were accepted on 1<sup>st</sup> November 2008 payable after 3 months and were duly honored on the due date,

On 1<sup>st</sup> January 2009, the firm was dissolved. The assets realized and expenses paid were as follows:

Date	Stock	Furniture and fittings	Debtors	Bills receivable	Expenses
31 <sup>st</sup> Jan	50,000	50,000	40,000	-	3,000
28 <sup>th</sup> Feb	40,000	-	50,000	40,000	5,000
31 <sup>st</sup> Mar	80,000	60,000	60,000	-	4,000
30 <sup>th</sup> Apr	20,000	10,000	25,000	-	3,000

### Required

- a. Prepare a statement showing the distribution of cash using the maximum loss method
- b. Prepare a Cash Book, Capital's a/c and Realization a/c

### Surplus Capital Method

One must remember that profit or loss on realization of assets will not be known for some time and therefore this profit or loss will not be adjusted for in the capital accounts immediately, yet cash should be distributed in such a way that the amounts left unpaid i.e. the loss to be borne by the partners are in the ratio in which profits and losses are to be shared.

The available cash cannot be distributed according to profit sharing ratios unless the capitals are themselves in profit sharing ratios, because that will leave the balances unpaid out of proportion. The cash available cannot be distributed in capital account ratios, because the partners will be forced to bear the loss in the ratios of capitals, which may be different from profit sharing ratios *Illustration*

Partners	A	B
Partner's capital	70,000	30,000
Profit sharing ratio	3	2
Amounts received in installments:		
1 <sup>st</sup> installment	40,000	
2 <sup>nd</sup> installment	20,000	

If cash is distributed in the profit sharing ratios:

Partners	A	B
----------	---	---

This is also wrong because the final loss is not in profit sharing ratio.

If cash is distributed in capital account ratios:

This is also wrong because the final loss is not in profit sharing ratio.

In this case, it's obvious that A's capital is more than his proportionate share. The profit sharing ratio is 3:2, hence if B's capital is Kes 30,000, A's capital ought to be Kes 45,000. The proper thing to do therefore is to first bring down A's capital a/c balance to Kes 45,000 by paying him cash. After that the cash available will be distributed in profit sharing ratios.

After that the cash available will be distributed in profit sharing ratios.

The rule to follow in a piecemeal distribution is that partners whose capital is more than proportionate to the other partners' capitals, considering profit sharing ratio should be refunded, so much as to bring their capitals to proportionate level. After this, the cash available should be distributed amongst the partners' in profit sharing ratios. **Illustration**

The following is a Statement of Financial Position of A, B and C who share profits and losses in the ratio 2:2:1

<b>Assets</b>	<b>Kes</b>
Fixtures and fittings	10,000
Stock	22,000
Debtors	12,000
Cash	<u>2,000</u>
<b>Total Assets</b>	<b><u>46,000</u></b>
Partner's capital a/c's:	
A     15,000	
B     12,000	
C     4,000	
Creditors	<u>15,000</u>
<b>Total Equity and Liabilities</b>	<b><u>46,000</u></b>

The firm was dissolved gradually and assets realized in 3 installments of Kes 10,000, Kes 15,000 and Kes 9,000. **Required:**

1. Using surplus capital method show how cash was distributed
2. Close the books of accounts

**Illustration**

X, Y, and Z were in a partnership sharing profits in the ratio 3:2:1 respectively. The partnership was dissolved on March 31<sup>st</sup> 2009. The Statement of Financial Position as at that date was as follows:

<b>Assets</b>	<b>Kes</b>
Stock	42,000
Debtors	16,000
Cash	<u>4,000</u>
<b>Total Assets</b>	<b><u>62,000</u></b>
Partner's Capital Accounts:	

X 20,000  
 Y 10,000  
 Z 2,000

Loan Accounts:

X 6,000  
 Y 4,000

Creditors	<u>20,000</u>
<b>Total Equity and Liabilities</b>	<b><u>62,000</u></b>

It was agreed that the net realizations would be distributed in due order at the end of each calendar month. The realizations and expenses were:

	<u>Assets</u> Kes '000	<u>Expenses</u> Kes '000
April	12,000	1,000
May	11,000	500
June	17,000	1,000
July	11,000	400
August	5,000	500

Stock having been completely disposed of, it was agreed that Z should take over the remaining debts at Kes 600,

**Required**

Dissolve the partnership

**Conversion of a Partnership into Limited Companies**

When a partnership is so converted, there are two sets of problems – those concerned with dissolving the partnership and those concerned with constituting the limited company.

*Entries into the Partnership Ledger*

A Realization account is opened in the partnership books to which all assets [excluding bank and cash unless taken over by the company] are debited, the corresponding credit entries appearing in the respective asset accounts thus closing them. Provisions accounts are similarly closed down and transferred to the Realization a/c as credits.

Partnership assets taken over personally by the partners are credited to the Realization a/c and debited to the appropriate capital account.

Dissolution expenses and creditors are discharged from the cash book. If creditors are taken over by the company, debit the creditors account and credit the realization account.

The purchase consideration is debited to an account in the name of the company and credited to realization account. The consideration may be discharged by an issue of shares, or by payment of cash, or by an issue of debentures or loan stock, or by any combination of these methods.

*Entries in the company's ledger*

A Business Purchase account is opened to which the values of the assets are credited and the liabilities taken over are debited. The double entry is completed by making entries in the appropriate asset and liability accounts.

The company is not restricted to assigning the same values to the assets as did the partnership. Any excess of consideration over total values assigned constitutes goodwill and any shortfall constitutes a bargain purchase.

When the purchase consideration passes, the Business Purchase a/c is debited and share capital, bank and debentures are credited respectively with shares, cash and debentures.

**Illustration**

Immediately prior to its conversion into a limited company, the Statement of Financial Position of X and Y, who share profits in the ratio of 3:2 disclosed the following:

	Kes
Premises	15,000
Equipment	7,000
Stocks	8,000
Debtors	5,000
Bank	<u>2,000</u>
<b>Total Assets</b>	<b><u>37,000</u></b>
Partner's Capital a/c's:	
X	20,000
Y	10,000
Creditors	<u>7,000</u>
<b>Total Equity and Liabilities</b>	<b><u>37,000</u></b>

For the purposes of the conversion, all assets [except bank] were taken over at book values but premises were revalued by the company at Kes 30,000. Creditors were taken over by the company YZ Ltd and the agreed consideration was Kes 48,000 to be discharged by the issue of 40,000 ordinary shares of Kes 1 each at a premium of 10% and Kes 4,000 in cash. X and Y each received 20,000 shares.

**Required**

- a. Books of the partnership
- b. Books of the company after the conversion

# BRANCH ACCOUNTS

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Many businesses operate through branches. Branch accounts are generally divided in 3 main classes:

1. Where the branch book keeping is done at the head office with the branch providing the necessary information or making returns
2. Where the branches keep their own records and at the balancing time forwards a copy of the trial balance for incorporation in head office books
3. Foreign branches

## **Operating arrangements**

All branches have a head office that controls to varying degrees the operations of its branches. In the first instance the head office procures the premises and other physical resources which each branch needs before it can become operational.

When the branch has been established and is operating normally, various arrangements may apply. Many head office buy in bulk for all their branches. The goods are then delivered to each branch either direct from the supplier or from the head office central warehouse. This arrangement enables the advantages of centralized buying and storage to be obtained. However to allow the branches some degree of flexibility, a certain amount of local buying is usually permitted

Payment by customers for goods supplied by branches may be made to the branches itself in the case of cash sales and certain credit sales or in the latter instance to the head office direct. Such cash as the branch collects should be banked in the head office bank a/c. Sums of money that the branch requires for everyday running purposes e.g. petty cash should be supplied separately by the head office.

## **Accounting Treatment of Branches where the Head Office Maintains all the Records**

Three different bases are recognized on which the head office may transfer to goods to its branches:

- a. At cost price to the head office
- b. At selling price by the branch
- c. At cost price plus predetermined percentage

*Basis A: Goods transferred to branch at cost price*

The head office will open the following accounts separately for each branch:

1. Branch Stock a/c

Despite its name it serves the purpose of Branch Trading a/c. This account is debited with:  
Balance of stock held at the beginning of the period  
Goods sent to branch

- Returns from branch debtors
- This a/c is credited with
  - Cash and credit sales
  - Goods returned by branch to head office
  - Goods lost at branch
  - Closing balance carried down
- 2. Goods sent to branch a/c
- 3. Branch debtor's a/c
- 4. Branch cashbook
- 5. Branch expense a/c for each expense

**Illustration I**

*Opening balances 1<sup>st</sup> January 2009*

	<b>Kes</b>
Branch stock at cost to head office	63,000
Branch debtor's	27,100
Branch bank	18,200

Transaction at branch during year 2009

▪ Goods transferred from head office to branch	129,000	
▪ Goods returned from branch to head office at cost	2,400	
▪ Cash sales paid into bank	25,200	
▪ Credit sales	162,400	
▪ Goods returned to branch by credit customers	600	▪ Cheque
received from credit customers	170,100	
▪ Discount allowed to credit customers	1,500	
▪ Bad debts	300	
▪ Cash transferred from branch bank a/c to head office bank a/c	173,900	
▪ Rent and rates	2,200	
▪ Wages	800	
▪ General expenses	700	
▪ Branch stock balance carried down at cost to head	48,000	

**Required**

Prepare the necessary a/c in the head office books for the branch

**Illustration 2**

ABC Ltd operates a branch in Nakuru. The following information relates to Nakuru branch for the year ended 31<sup>st</sup> December 2008



<i>Opening balances 1<sup>st</sup> January 2009</i>	<b>Kes</b>
Branch stock at cost	55,000
Branch debtor's	40,000

Transactions for the year

▪ Goods sent by head office to branch at cost	600,000
▪ Goods returned by branch to head office at cost	15,000
▪ Cash sales	250,000
▪ Credit sales	700,000
▪ Goods stolen at branch	5,000
▪ Cash stolen at branch	3,500
▪ Returns from branch debtors	30,000
▪ Cash received from branch debtors	630,000
▪ Discounts allowed to debtors	12,000
▪ Bad debts written off	7,500

*Closing balances 31<sup>st</sup> December 2009*

Branch stock at cost	70,000
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**Required**

Prepare the necessary a/c in the head office books for Nakuru branch for the year 31<sup>st</sup> December 2009

*Basis B: Goods are transferred from head office to branch at selling price*

Under this basis the head office sends goods to branch at selling price. All records relating to the branch are entered at selling price. The branch staff do not know the cost price of the goods.

There are two possible methods of recording the stock transaction:

*Memorandum column method*

The branch stock a/c contains each side of the a/c an extra (memorandum) column that does not form part of the double entry system. The normal double entry column contain figures at cost price for stocks and for transfers to and from the head office and the memorandum column contains figures at the corresponding selling prices.

**Illustration 3**

Using **illustration 1**, assume selling price is at cost plus 33.33%

The other account for goods sent to branch, branch debtors, branch bank, etc will be prepared in the same manner as before.

One advantage of this method of recording is that the branch manager is not able to calculate the amount of profit the branch is making hence the head office is able to preserve the secret of certain key information.

Another advantage of this method is that it highlights stock discrepancies.

#### *Adjustment a/c method*

The Goods to Branch and Branch Stock a/c are maintained at selling price for stock and for transfers to and from the head office and a profit element contained in these figures is taken into Branch Stock Adjustment a/c.

Under this method the gross profit is disclosed by the Branch Stock Adjustment a/c., the closing balance of which represents unrealized profits, is deducted from stock in the Statement of Financial Position.

#### **Illustration 4**

Using **illustration 1** assume selling price is cost price plus 33.33%

#### **Illustration 5**

XY Ltd whose head office is in Nairobi operates a branch in Kisumu. All goods are purchased by head office and are invoiced and sold to the branch at cost plus 25%. Other than a sales ledger kept in Kisumu, all transactions are recorded in the books of the head office in Nairobi. The following particulars are given for the following the transactions at the branch during the year ended 31<sup>st</sup> December 2009:

	<b>Kes</b>
Stock on hand 1 <sup>st</sup> January 2009 at invoice price	44,000
Debtors 1 <sup>st</sup> January 2009	39,460
Goods sent from Nairobi during the year at invoice price	248,000
Credit sales	210,000
Cash sales	24,000
Returns to head office at invoice price	10,000
Invoice value of goods stolen	6,000
Bad debts written off	1,480
Cash from debtors	224,000
Normal loss at invoice price due to wastage	1,000
Cash discount allowed to debtors	4,280
Stock at 31 <sup>st</sup> December 2009 at invoice price	39,480

#### **Required**

Using the Adjustment a/c method, write up the Branch a/c's, including Branch P and L a/c in the ledger of the head office for the year ended 31st December 2009

*Basis C: Goods are transferred from head office at cost plus a pre-determined percentage*

Under this method, goods are charged to branches at cost plus a pre-determined percentage. This method discloses the Gross Profit expected to be achieved by the branch. Either Memorandum Column or the Adjustment a/c method can be used.

**Illustration 6**

Using **illustration 1**, for the purpose of this illustration transfer price is assumed to be cost plus 20%

**Illustration 7**

P.O Ltd deals with electronic goods. The head office is in Nairobi and there are 5 branches in the main towns of Kenya. The head office makes all purchases and goods are charged to branches at cost plus 25%.

The following information relates to Kisumu branch for year ended 31<sup>st</sup> December 2009

<i>Opening balances 1<sup>st</sup> January 2009</i>	<b>Kes</b>
Branch stock at transfer price	30,000
Branch debtors	45,000
<i>Closing balances 31<sup>st</sup> December</i>	
Branch stock at transfer price	25,000
<i>year</i>	<i>Transactions for the</i>
Goods sent to branch at transfer price	250,000
Goods returned to head office at transfer price	20,000
Cash sales	80,000
Credit sales	270,000
Returns from customers	10,000
Discount allowed	3,000
Bad debts written off	2,000
Branch expenses	50,000
Goods stolen at branch	3,000
Cash received from branch debtors	245,000
Cash stolen	1,500

**Required**

Prepare the necessary a/c's in the head office books for Kisumu branch for the year ended 31<sup>st</sup> December 2008.

### **Accounting Treatment of Branches where Branches maintain all the records**

This is common in a firm with few branches, where the branch is large enough to warrant a separate accounting system. A branch cannot operate on its own without resources and it is the head office that provides these in the first instance. The head office will want to know how much money it has invested in each branch and from this arises the concept of branch and head office current accounts.

The relationship between the branch and the head office is seen as that of a debtor/ creditor. The current account shows the branch as a debtor in the head office records while the head office is show as a creditor in branch records.

The current accounts are used for transactions concerned with supplying resources to the branch. For such transactions, full double entry records are needed both in branch records and head office records i.e. each item will be recorded twice in each set of records. Some transactions will however concern the branch only and this will merely need two entries in branch records and none in the head office records

#### **Illustration 8**

1. A company opened a bank a/c at branch by transferring Kes 100,000 from head office bank a/c
2. Bought premises at branch paying by cheque drawn from head office bank Kes 500,000
3. Branch bought a motor vehicle paying cheque on its own bank a/c Kes 60,000
4. Branch bought fixtures on credit from AB equipment for Kes 90,000
5. Head office supplied a machine valued at Kes 25,000 from its own machinery
6. Branch bought goods from supplier paying by cheque from if own its own a/c Kes 27,000
7. Branch cash sales banked immediately to it own bank a/c Kes 300,000
8. Goods invoiced at cost to branch during the period by the head office Kes 280,000
9. A cheque was paid to head office by branch as a general return of funds Kes 180,000
10. Goods returned to head office by branch at costs sh. 10,000

### **Profit and Loss and Current Accounts**

The profit earned by the branch or loss, if any does not belong to the branch. It belongs to the entity and must be shown as such. Profit of the Branch should be credited to Head Office Current a/c, any loss being debited.

The Branch will therefore draw a T, P and L a/c, and after agreement with the Head Office, the Net Profit will then be transferred to the credit of Head Office Current a/c. The Head Office in its own records will then debit the Branch Current a/c and credit its own P and L a/c.

### Illustration 9

Assuming in illustration 8, the profit was Kes 8,000

#### Required

Show the two current accounts

### The Combined Statement of Financial Position

After the T P and L a/c's have been drawn, a statement of financial position is required for the whole firm. The branch will send its trial balance to the head office which will add the assets in its own trial balance to those in the trial balance of the head office to give the total for each type of asset to be shown in the statement of financial position and a similar procedure will be carried out for liabilities

In the trial balance, the head office current a/c will be a credit balance while the branch current a/c will be a debit balance. These therefore cancel out and are not shown in the combined statement of financial position. This is in order as the 2 a/c's do not in fact represent assets and liabilities but are merely a measure of the resources at the branch.

#### Items on transit

When items are on transit at the end of a financial period, each set of records will not contain identical figures e.g. stock sent from head office to branch could take two weeks to arrive the branch. This means that balances on current a/c will not be equal to one another and therefore a simple cancellation stated earlier is not possible. In such cases adjustment are made at head office to reconcile the two sets of a/c's i.e. goods sent by head office are assumed not to have been sent. Remittances or returns made by branches are assumed to have been received

### Illustration 10

This is the 2<sup>nd</sup> period of business shown in the previous illustration:

*Head office records showing current a/c's only*

Goods sent to branch		37,000
Cheque received from branch		29,500
Returns from branch	<i>Branch</i>	4,400
<i>records</i>		
Goods from head office		35,000
Cheque sent to head office		30,300

Returns to head office

5,000

It may be assumed that the net profit as shown by P and L a/c of the branch is sh. 8,000

**Required:**

Prepare the current a/c's

**NOTE:**

- Current a/c's in the head office and branches books must always be equal and opposite to each other
- Goods on transit and cash on transit must always be adjusted in the head office books regardless of the direction in which it is on transit at the end of the year.
- The final entries to close the current a/c's will be the transfer of branch profit to head office

**Preparation of Final Accounts**

For preparation of final accounts from the trial balances of the head office and the branch, the following procedures should be followed:

- i. Use separate columns for head office and each branch with an additional column to record the total for head office and all branches
- ii. The head office column of the trading a/c records transactions from the point of view of the head office. All purchases made by the head office, sales to customers and transfers to the branches at invoice prices are recorded into the head office columns.
- iii. The branch column of the trading a/c records transactions from the point of view of the branch. This column records the goods purchased from the local market at cost, goods received from the head office and sales to branch customers at selling price.
- iv. The combined column for head office and branches records the transactions from the point of view of the business as a whole. Any profits made between the head office and branches are eliminated in this column.
- v. The balances in branch current a/c and head office current a/c will appear in the statement of financial position column of the head office and branch respectively but not in combined column.
- vi. The combined column in the trading profit and loss account and statement of financial position is not a part of the double entry. The individual column for head office and branch should always be prepared first and the combined column prepared from these individual columns.

**Accounting Treatment of Foreign Branches**

The treatment of foreign branches is similar to that of branch maintaining their own books. The only difference is that the Trial Balance of branch will normally be in foreign currency. Therefore in order to amalgamate these figures with those of the head office, the branch figures must be translated into head office currency.

### Methods of Conversion

#### *Fixed rate method*

Under this method all items in foreign branch trial balance are converted at a certain fixed rate. It is rarely used.

#### *Closing rate method*

Under this method all items in the trial balance of the branch are converted at the rate of exchange that prevails at the statement of financial position date. Exception to this are that cash remittance are translated to actual rate on the date it was issued and revenues and expenses resulting in cash flows are translated at the average rate for the period.

#### *Temporal method*

Translation is based on rates ruling at the point of transaction.

Item	Translation rate
Noncurrent assets	Date when the assets was acquired
Depreciation	Same as the non-current to which it relates
Capital	Date of issue
Noncurrent liabilities	Trial Balance date
Current assets and current liabilities	Trial Balance date
Remittances	Actual date of remittances
and expenses	Average for the period
	Revenue

### Exchange Difference

Exchange difference should be reported as part of profits for the year from the ordinary transaction. The following entries will be made:

1. In the branch books no entries are required because a/c's are maintained in foreign currency
2. In the head office books:

*Loss on exchange*  
 Dr. P&L A/C  
     Cr. Branch Current a/c

*Gain on exchange*  
 Dr. Branch Current a/c  
     Cr. P&L A/C

# GROUP ACCOUNTS

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There are many reasons for businesses to operate as groups; for the goodwill associated with the names in the subsidiaries, for tax or legal purposes e.t.c.

## Definition

**Control.** The power to govern the financial and operating policies so as to obtain benefits from its activities.

**Subsidiary.** An entity that is controlled by another entity [known as the parent]

**Parent.** An entity that has one or more subsidiaries

**Group.** A parent and all its subsidiaries

**Associate.** An entity, including an unincorporated entity such as a partnership and which an investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

**Significant Influence.** This is the power to participate in the financial and operating policy decisions of an investee or of an economic activity but is not joint control over those policies.

**Joint Venture.** A contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control

## Investments in subsidiaries

1. The important point here is control. In most cases this will involve the holding company or parent owning a majority of the ordinary shares in the subsidiary to which normal voting rights are attached. Control exists where the parent owns 50% or less in the following circumstances:
2. The parent has power over more than 50% of the voting rights by virtue of agreement with other investors
3. The parent has the power to govern the financial and operating policies of the entity by statute or under agreement
4. The parent has power to appoint or remove a majority of the members of the board of directors [or equivalent governing body]
5. The parent has power to cast a majority of votes at meetings with board of directors



IAS 27 also states that a parent loses control when it loses the power to govern the financial and operating policies of an investee. Loss of control can occur without a change in ownership levels. This may happen if a subsidiary becomes subject to the control of the government, court administrator or regulator [for example in a bankruptcy].

Consolidated financial statements are financial statements of the group. The parent company, the subsidiary and the associate present their accounts as those of a single entity. Section 150 of the Company's Act, requires that if at the end of its financial year, a company has subsidiaries, group accounts consisting of a Consolidated Statement of Comprehensive Income, Consolidated Statement of Financial Position and Consolidated Statement of Cash Flows should be laid before the company in an AGM where the company's own financial statements are laid.

Group accounts will not be required if:

- a. Where the holding company is itself a wholly owned subsidiary of another company incorporated in Kenya, or is partly owned and the parent obtains approval from the owners, including those not otherwise entitled to vote and they do not object to the parent not presenting consolidated financial statements.
- b. The parent's debt and equity instruments are not traded in a public market
- c. The ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use, that comply with IFRS's.

### Group Statement of Financial Position

#### Full Holding Acquired

When one company acquires controlling interest in another, that fact will be reflected in the Statement of Financial Position of the acquiring company. It however does not affect the Statement of Financial Position of the acquiree company.

#### Illustration 1

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	H Ltd Ltd '000	S '000
Noncurrent assets	500	180
Investment in S Ltd [150,000 shares @ Kes 1]	210	
Current assets	<u>90</u>	<u>60</u>
<b>Total assets</b>	<b><u>800</u></b>	<b><u>240</u></b>
Ordinary share capital @ Kes 1 each	600	150
Reserves	130	50
Current liabilities	<u>70</u>	<u>40</u>
<b>Total equity and liabilities</b>	<b><u>800</u></b>	<b><u>240</u></b>

**Required:**

Prepare Statement of Financial Position immediately after consolidation has taken place.

### ***Partial Holding Acquired***

In order to acquire controlling interest in a subsidiary, a parent does not have to acquire full 100% holding. Where a parent company has acquired less than full holding, the subsidiary is described as partly owned. Technically, if a company acquired an 80% holding, the group's financial position would be presented by consolidating the assets and liabilities of the parent company with 80% of assets and liabilities of the subsidiary.

The resultant figure though arithmetically correct will be absurd and would not accord with the true and fair view principle. With relative ease, this difficulty can be overcome by consolidating the assets and liabilities of the subsidiary as though they were wholly owned but at the same time introducing an extra item under equity in the Statement of Financial Position. This item is called **Non-Controlling Interest** and represents the share capital owned by shareholders outside the group.

### **Illustration 2**

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	<b>H Ltd</b>	<b>S Ltd</b>
	<b>'000</b>	<b>'000</b>
Noncurrent assets	500	180
Investment in S Ltd [120,000 shares @ Kes 1]	172	
Current assets	<u>128</u>	<u>60</u>
<b>Total assets</b>	<b><u>800</u></b>	<b><u>240</u></b>
Ordinary share capital @ Kes 1 each	600	150
Reserves	130	50
Current liabilities	<u>70</u>	<u>40</u>
<b>Total equity and liabilities</b>	<b><u>800</u></b>	<b><u>240</u></b>

**Required:**

Prepare the Group Statement of Financial Position immediately after acquisition has taken place

### ***Consolidation Subsequent to Date of Acquisition***

In the group statement of financial position, the reserves comprise of the reserves of the parent company plus post acquisition reserves of the subsidiary and non-controlling interests consist of share capital and reserves attributed to outside shareholders. The goodwill on acquisition will not change.

### **Illustration 3**

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	<b>H Ltd</b>	<b>S Ltd</b>
	<b>'000</b>	<b>'000</b>
Noncurrent assets	794	190
Investment in S Ltd [60,000 shares @ Kes 1]	126	
Current assets	<u>250</u>	<u>30</u>
<b>Total assets</b>	<b><u>1,170</u></b>	<b><u>220</u></b>

Ordinary share capital @ Kes 1 each	800	100
Reserves: P&L A/C	150	60
General Reserve	<u>220</u>	<u>60</u>
<b>Total equity and liabilities</b>	<b><u>1,170</u></b>	<b><u>220</u></b>

**Additional Information:**

When H Ltd acquired its holding on 1<sup>st</sup> January, S Ltd's P&L A/C had a credit balance of Kes 40,000 and General Reserves had a credit balance of Kes 50,000. **Required:**

Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December

***Transactions within the Group [Intra Group Transactions]***

A common feature of groups is that member companies have dealings not only with external parties but also with each other. For example, one member company may supply stock either as trading stock to another group member or to become a non-current asset of the recipient company. The payment of dividends by a subsidiary to the parent is another example of intra group transactions.

*Intra group Indebtedness*

If at the end of the reporting period, one member company is owed a sum of money by another member company, the amount will appear as part of debtors and creditors of the respective parties, but are eliminated on consolidation so that the amounts shown as debtors/creditors are the externally owed by/to amounts. Similarly, the current accounts balances cancel out at group level.

*Intra group Unrealized Profit*

Internal trading transactions within a group may give rise to a transfer profit to the selling company. The transferor correctly takes credit for what it regards as a sale. The transferee records the transfer price as an input cost.

From a group point of view however, transfers from one member of the group to another member of the group, the profit on them i.e. any internal transfer profit plus any further profit added by the transferee undertaking when selling externally can legitimately be regarded as having been realized.

To the extent that such items have not been sold, but are still held by the transferee undertaking, the internal transfer profit has not been realized from a group point of view. Consequently, a provision for unrealized profit must be raised. It should be noted that intra group transfer of stock may be in transit at the end of the reporting period.

*Unrealized Profit on Trading Stock*

The calculation of unrealized profit is based on mark-up and margin

*Unrealized Profit on Non-current Assets*

If a member company transfers non-current assets to another member company, the transaction results in a transfer profit to the transferor. This transaction has a twofold effect at group level:

- The transferor company has made an unrealized profit vis-à-vis the group
- The profits must be reduced by additional depreciation which has been automatically calculated by the transferee company on increased input cost on non-current assets. In this instance, group unrealized profit is the net of the two calculations

#### Illustration 4

H Ltd sold a machine which it manufactured at a cost of Kes 700,000 to S Ltd for Kes 1,000,000. S Ltd depreciates PPE at a rate of 10% p.a.

#### Required

Calculate the amount of unrealized profit to be included in the closing figure for noncurrent assets

#### Illustration 5

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	H Ltd		S Ltd	
	'000		'000	
Noncurrent assets	300		210	
Less: depreciation	<u>100</u>	200	<u>40</u>	170
Investment in S Ltd [200,000 shares @ Kes 1]		340		
Current assets	<u>103</u>		<u>102</u>	
<b>Total assets</b>	<b><u>643</u></b>		<b><u>272</u></b>	
Ordinary share capital @ Kes 1 each		500		200
P & L A/C: as at 31/12/08		77		40
Profit for the year 2009		<u>66</u>		<u>32</u>
<b>Total equity and liabilities</b>		<b><u>643</u></b>		<b><u>272</u></b>

#### Additional information

H Ltd bought the shares on 31/12/2008. During the year, H Ltd sold a machine which had cost it Kes 40,000 for Kes 50,000. S Ltd has written off 20% as depreciation for the year 2009. **Required:**

Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December 2009

#### Illustration 6

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	H Ltd	S Ltd
	'000	'000

Noncurrent assets	168	52
Less: depreciation	<u>28</u> 140	<u>20</u> 32
Investment in S Ltd [20,000 shares @ Kes 1]	46	
Current assets	<u>40</u>	<u>24</u>
<b>Total assets</b>	<b><u>226</u></b>	<b><u>56</u></b>
Ordinary share capital @ Kes 1 each	150	20
P & L A/C: as at 31/12/08	30	12
Profit for the year 2009	46	14
General Reserve as at 31/12/2008		<u>10</u>
<b>Total equity and liabilities</b>	<b><u>226</u></b>	<b><u>56</u></b>

#### Additional information

H Ltd bought the shares on 31/12/2008. During the year, H Ltd sold a van which had cost it Kes 6,000 for Kes 10,000. S Ltd has written off 1,000 as depreciation for the year 2009. **Required:**

Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December 2009

#### Accounting for Unrealized Profit

In the case of unrealized profit on trading stock, the general rule group stocks and un-appropriated profits are reduced. Where non-current assets are the subject of the transaction, the general rule is that group non-current assets are reduced in total for the class of assets concerned:

- At cost stage by gross provision
- At accumulated depreciation stage by the excess depreciation
- At the written value stage by the net provision

No difficulty arises when the items are sold by the parent company to a wholly owned subsidiary. The whole of the unrealized profit is deducted from group asset affected and from group profit.

When however the transaction originates from a partly owned subsidiary company, several different accounting treatments are possible:

- The group provision of unrealized profit is deducted from the appropriate group asset and from group profit
- The whole amount of unrealized profit is deducted from the appropriate group asset and from group profit
- The whole amount of unrealized profit is deducted from the appropriate group asset, but only the group proportion is deducted from group profit and the non-controlling interest portion is deducted from the non-controlling interest.

#### Intra Group Dividends

One result of the parent company's investment in shares of a subsidiary is that the former is likely to receive dividends on its shareholding from the latter. Such dividends may be paid out of pre-acquisition reserves or post acquisition reserves.

*Dividends received out of pre-acquisition profits.* If the parent company acquires its shares in a subsidiary on a cum-div basis, the subsequent receipt of dividends in respect of the pre-acquisition period is usually regarded as a reduction on the capital cost of acquiring the investment. This does not however alter the amount of group goodwill arising on the acquisition of the subsidiary.

### Illustration 7

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	<b>H Ltd</b>	<b>S Ltd</b>
	<b>'000</b>	<b>'000</b>
Noncurrent assets	250	84
Investment in S Ltd [100,000 shares @ Kes 1]	194	
Current assets	<u>59</u>	<u>49</u>
<b>Total assets</b>	<b><u>503</u></b>	<b><u>133</u></b>
Ordinary share capital @ Kes 1 each	400	100
P & L A/C: as at 31/12/08	39	11
Profit for the year 2009	<u>64</u>	<u>22</u>
<b>Total equity and liabilities</b>	<b><u>503</u></b>	<b><u>133</u></b>

#### Additional information

H Ltd bought the shares on 31/12/2008. The profit for the year 2009 for H Ltd includes dividends of Kes 20,000 received from S Ltd for the year 2008 and the balance of Kes 11,000 in P & L A/C of S Ltd is after deducting the proposed dividend for 2010 of Kes 20,000. **Required:**

Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December 2009

#### Dividend Received and Receivable out of Post-acquisition Profits

Dividends received by a parent company from a subsidiary out of profits arising in the post acquisition period are treated as investment income in the books of the parent company. Within the group however, dividends are simply an intra group transaction resulting in an increase in retained earnings in the parent company accompanied by a simultaneous reduction in retained profits of the subsidiary.

Frequently, however a parent company does not take credit for the dividends from a subsidiary company until those dividends have been received. If the dividends are recorded by the subsidiary as proposed, then from a group point of view, such proposed dividends constitute profits retained within the group and as such are included in group reserves.

### Illustration 8

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	<b>H Ltd</b>	<b>S Ltd</b>
	<b>'000</b>	<b>'000</b>
Noncurrent assets	47	36
Investment in S Ltd [30,000 shares @ Kes 1]	44	
Current assets	<u>12</u>	<u>21</u>

<b>Total assets</b>	<b><u>103</u></b>	<b><u>57</u></b>
Ordinary share capital @ Kes 1 each	80	40
P & L A/C: as at 31/12/08	14	04
Profit for the year 2009	09	07
Proposed Dividend for 2009		<u>06</u>
<b>Total equity and liabilities</b>	<b><u>103</u></b>	<b><u>57</u></b>

**Additional information**

H Ltd bought the shares on 31/12/2008. The proposed dividends of S Ltd have not yet been brought into the accounts of H Ltd. **Required:**

Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December 2009

**Illustration 9**

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	<b>H Ltd</b>	<b>S Ltd</b>
	<b>'000</b>	<b>'000</b>
Noncurrent assets	300	203
Investment in S Ltd [120,000 shares @ Kes 1]	230	
Current assets	<u>75</u>	<u>101</u>
<b>Total assets</b>	<b><u>605</u></b>	<b><u>304</u></b>
Ordinary share capital @ Kes 1 each	500	200
P & L A/C: as at 31/12/08	64	51
Profit for the year 2009	41	13
Proposed Dividend for 2009		<u>40</u>
<b>Total equity and liabilities</b>	<b><u>605</u></b>	<b><u>304</u></b>

**Additional information**

H Ltd bought the shares on 31/12/2008. The proposed dividends of S Ltd have not yet been brought into the accounts of H Ltd. **Required:**

Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December 2009

*Revaluation of Assets*

If the assets and liabilities of a subsidiary company are revalued at the time of acquisition, a gain or loss on such revaluation is treated as a capital gain or capital loss and is divided amongst the holding company and non-controlling interest according to the proportion of equity shares held by them.

**Illustration 10**

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	<b>H Ltd</b>	<b>S Ltd</b>
	<b>'000</b>	<b>'000</b>
Noncurrent assets	90	70

Less: depreciation	<u>24</u>	66	<u>7</u>	63
Investment in S Ltd [60,000 shares @ Kes 1]		121		
Current assets		<u>40</u>		<u>28</u>
<b>Total assets</b>		<b><u>227</u></b>		<b><u>91</u></b>
Ordinary share capital @ Kes 1 each		150		60
P & L A/C: as at 31/12/08		44		17
Profit for the year 2009		<u>33</u>		<u>14</u>
<b>Total equity and liabilities</b>		<b><u>227</u></b>		<b><u>91</u></b>

**Additional information**

H Ltd bought the shares on 31/12/2008 when S Ltd valued its noncurrent assets at Kes 95,000 instead of Kes 70,000 shown above. **Required:**

Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December 2009

**Illustration 11**

The Statement of Financial Position of H Ltd and its subsidiary S Ltd is as follows:

	<b>H Ltd</b>		<b>S Ltd</b>	
	<b>'000</b>		<b>'000</b>	
Noncurrent assets	60		40	
Less: depreciation	<u>06</u>	54	<u>04</u>	36
Investment in S Ltd [24,000 shares @ Kes 1]		53		
Current assets		<u>11</u>		<u>11</u>
<b>Total assets</b>		<b><u>118</u></b>		<b><u>47</u></b>
Ordinary share capital @ Kes 1 each		80		30
P & L A/C: as at 31/12/08		27		08
Profit for the year 2009		<u>11</u>		<u>09</u>
<b>Total equity and liabilities</b>		<b><u>118</u></b>		<b><u>47</u></b>

**Additional information**

H Ltd bought the shares on 31/12/2008. S Ltd valued its noncurrent assets at Kes 50,000 instead of Kes 40,000 shown above on 31/12/2009 **Required:**

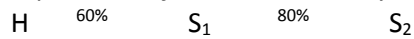
Prepare a Consolidated Statement of Financial Position as at 31<sup>st</sup> December 2009

*Acquisition of Preference Shares in a Subsidiary*

When the parent acquires preference shares in the subsidiary, goodwill/bargain purchase is calculated. The extent to which the parent has not acquired control of preference shares of the subsidiary is combined with non controlling interests.



*Consolidation of financial position of a sub-subsidiary*; this arises for example in the following circumstances.



Effectively H through its direct controlling interest in S<sub>1</sub> is able to control S<sub>2</sub> indirectly. H therefore is required to prepare group accounts consolidating both the subsidiary and sub-subsidiary. The two possible methods used are

Direct method; the figures of the sub-subsidiary are consolidated with those of its parent and then the figures of that group are consolidated with those of the parent (holding).

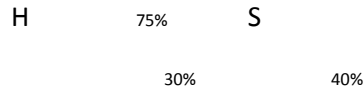
Indirect method; consolidation is done on the basis of the holding company's interest in the subsidiary and sub-subsidiary. E.g. in preparing the above group statement of financial position, H would consolidate 60% of S<sub>1</sub> and 48% of S<sub>2</sub>.

### Illustration 11

From the following Statements of Financial Position, prepare a Consolidated Statement of Financial Position for the group as at 31 December 2009.

	H Ltd	S <sub>1</sub> Ltd	S <sub>2</sub> Ltd
	'000	'000	'000
Noncurrent Assets	200	16	10.50
Investment in S <sub>1</sub> 16,000 shares bought on 31/12/2008	39		
Investment in S <sub>2</sub> 7,000 shares bought on 31/12/2008		13	
Current Assets	<u>40</u>	<u>4</u>	<u>5.50</u>
Total Assets	<u>279</u>	<u>33</u>	<u>16.00</u>
Share Capital	200	20	10
General Reserve [as at 31/12/2008]		3	
P%L A/C: As at 31/12/2008	43	6	1
Profit for the year 2009	<u>36</u>	<u>4</u>	<u>5</u>
<b>Total Equity</b>	<b><u>279</u></b>	<b><u>33</u></b>	<b><u>16</u></b>

*Consolidation of financial position of a mixed group*; the term mixed group is applied in a situation where the parent and one or more of its subsidiaries together hold a controlling interest in another company, although their individual holdings are less than 50%. For example,



S<sub>1</sub>

It is obvious that neither H nor S individually has controlling interest in S<sub>1</sub>, but together they have a majority 70% holding. As H is S's parent it has effective control of S<sub>1</sub> as follows;

H direct interest	30%
H indirect interest [75% x 30%]	<u>30%</u>
	<u>60%</u>

Consolidation techniques for a mixed group are similar to those of a vertical group.

### ***Investment in Associates***

This is neither an investment that is neither a subsidiary nor a simple investment. The essence of the relationship between the holding company and associate is whether the investor is able to exercise **significant influence**. Significant influence can be determined by the holding of voting rights in the entity. IAS 28 states that if an investor holds 20% or more of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, unless it can be clearly shown that this is not the case.

The existence of significant influence is evidenced in one or more of the following ways:

- Representation on the board of directors or a similar governing body of the investee
- Participation in the policy making process
- Material transactions between the investor and investee
- Interchange of management personnel
- Provision of essential technical information

#### *Accounting Treatment in Group Accounts*

The equity method of consolidation is used to consolidate the associate company. Two approaches are preferable:

<b>Pure Approach</b>		<b>Net Asset Approach</b>	
Investment in Associate company	xxx	Group share of Net Assets	xxx
Add: Post Acquisition Profits	<u>xxx</u>	Add: Goodwill	<u>xxx</u>
<b>CSFP</b>	<b><u>XXX</u></b>	<b>CSFP</b>	<b><u>XXX</u></b>

### **Illustration 12**

Below are the summarized Statements of Financial Position of M Ltd, its subsidiary N Ltd and its associate Y Ltd as at 30 November 2008

	<b>M Ltd</b>	<b>N Ltd</b>	<b>Y Ltd</b>
	<b>Kes 000</b>	<b>Kes 000</b>	<b>Kes 000</b>
<b>ASSETS</b>			
Freehold land at cost/valuation	600	200	400
Freehold Buildings (NBV)	1000	400	640
Machinery (NBV)	1200	360	640
Investment in subsidiary	720		
Investment in associate	480		
Inventories	1200	440	880
Accounts receivable	600	200	480
Accounts owed by subsidiary	20		
Bank and cash balance	<u>100</u>	-	<u>160</u>
<b>Total assets</b>	<b><u>5920</u></b>	<b><u>1600</u></b>	<b><u>3200</u></b>
<b>EQUITY AND LIABILITY</b>			
Share capital; 15% cumulative preference			
Shares @ Kes 20	400		
Ordinary Shares @ Kes 20	2400	600	800
Share premium	320	-	200
Revaluation reserve			400
Retained earnings	640	274	420
12% debentures	1200	400	800
Deferred taxation	240	94	160
Corporation tax	160	48	100
Accounts payable	560	136	320
Bank overdraft		40	-
Account due to holding company	-	8	
<b>Total equity and liability</b>	<b><u>5920</u></b>	<b><u>1600</u></b>	<b><u>3200</u></b>

## ADDITIONAL INFORMATION

1. M Ltd acquired 24,000 ordinary shares in N Ltd at the time N Ltd had reserves totaling to Kes 120,000
2. M Ltd purchased 16,000 ordinary shares in Y Ltd at a time when the latter had retained earnings totaling to Kes 80,000. Y Ltd has not issued any shares then but subsequently revalued its noncurrent assets.
3. Cash remitted by N Ltd Kes 12,000 was not received by M Ltd until December 2008 and had not been recorded in M Ltd books prior to year end
4. Kes 100,000 of M Ltd inventory had been purchased from N Ltd. The cost to the latter was Kes 80,000

### Required

- a) Prepare a Consolidated statement of Financial Position as at 30 November 2008
- b) Explain your treatment of the intercompany profit and suggest other methods which could be used.

## Consolidated Statement of Comprehensive Income

The group income must be presented in the form of a statement of comprehensive income in respect of the parent and its subsidiaries and associates. The usual method is to aggregate the subsidiary on an item by item basis and disclose as appropriate amounts relating to non controlling interests and preacquisition profit or loss. *Inter Company Trading*

The consolidated statement of income should deal with reserves of the group as those of a single entity. When one company in the group sells goods to another company in the group, an identical amount is added to the sales revenue of the 1<sup>st</sup> company and to the cost of sales of the 2<sup>nd</sup> company. But as far as dealings with outsiders are concerned, no sale has taken place. The consolidated figures for sales revenue and cost of sales should represent sales and purchases from outsiders. The adjustments involved are either;

- I. Reduce the sales revenue and cost of sales figures by inter-company sales during the year
- II. Calculate URP on unsold inventories at the year end and reduce consolidated gross profit

### *Outside Holdings of Preference Shares*

If part of the share capital of subsidiaries consists of preference shares, some or all of which may be owned by outside interests, it will have a two-fold effect;

1. Preference dividend attributable to outside interests is deducted from profit after tax
2. Non-controlling interest figure is computed on the net figure after 1 above

### *Acquisition of Interest in the Subsidiary during the year*

The group can only take credit in the statement of income for the post acquisition profit or loss in the subsidiary. Two methods may be adopted:

- a. **Whole-year method.** The whole of the subsidiary's sales cost of sales, expenses, and taxation are consolidated and an adjusting entry is made which eliminates the pre-acquisition portion from group profit after tax.
- b. **Part-year method.** The entire statement of income of the subsidiary is split between pre- and post acquisition proportions. Only the post acquisition figures are included in the consolidated statement of income.

*Inter-Company Dividend*

Dividends proposed by the subsidiary company are ignored because:

- 1) Profits out of which they are proposed has been consolidated
- 2) The parents company's share of dividends is merely an internal transfer
- 3) Non-controlling interest share of dividend is included in non-controlling interest

**Illustration 13**

**Statement of income for the year ended 31<sup>st</sup> December 2009**

	H Ltd	S Ltd
	'000	'000
Sales	377	142
Cost of Sales	<u>264</u>	<u>87</u>
Gross Profit	113	55
Expenses	<u>23</u>	<u>15</u>
Net Profit before Tax	90	40
Tax	<u>36</u>	<u>16</u>
<b>Net Profit for Year</b>	<b><u>54</u></b>	<b><u>24</u></b>
Proposed Dividend	<u>35</u>	<u>10</u>
Retained Profit b/d	<u>120</u>	<u>50</u>

Additional Information:

- a. H Ltd owns 70% of ordinary share capital in S Ltd
- b. S Ltd also had 100,000 8% preference shares in issue. H Ltd had acquired 80% of these shares
- c. Acquisition of shares occurred on 1<sup>st</sup> April 2009 **Required:**

Prepare a statement of Income for the year ended 31<sup>st</sup> December 2009

# BANKRUPTCY, RECEIVERSHIP AND LIQUIDATION

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## **Distinction between Bankruptcy and Receivership**

Insolvency is the inability to pay debts as they fall due. Bankruptcy is a legal concept. An insolvent is known as bankrupt when an order of adjudication is passed by a competent court against him. However adjudication is made only after the requirements of the bankruptcy laws are fulfilled.

## **Purpose of Bankruptcy Law**

The main objectives of bankruptcy proceedings are:

- To distribute the proceeds of an insolvent person equitably and fairly among his creditors. In the absence of rules, a general scramble for the property would take place.
- To relieve the debtor of the burden of his liabilities. The debtor will be protected from harassment by creditors after getting a discharge order from court.
- Punishment for fraudulent debtors

## **Acts of Bankruptcy**

The bankruptcy act applies to insolvent persons. A person is declared insolvent when the following conditions are met:

1. That person should be a debtor and must have inadequate assets for repayment of his liabilities
2. That person must have committed an act of bankruptcy. A person commits an act of bankruptcy if:
  - a. He conveys all his property to a trustee/trustees for the benefit of all his creditors in general
  - b. Fraudulently conveys his property with intent to defraud his creditors
  - c. Departs out of Kenya or being out of Kenya, does not come back or does not want to see his creditors with an intention to defeat or delay his creditors
  - d. Execution against him has been caused by seizure of his goods in any civil proceedings in any court and the goods have either been sold or held by auctioneers for 21 days
  - e. The debtor files a declaration of his inability to pay debts or presents a bankruptcy petition against himself
  - f. Fails to comply with the bankruptcy notice

- g. Gives a notice of suspension of or intention to suspend payment of debts

### **Bankruptcy Petition**

The bankruptcy petition may be presented to a bankruptcy court either by the debtor himself or by a creditor. The creditor can present a petition if the following conditions are fulfilled:

- The debt owing to the petitioning creditor is at least Kes 1,000
- The act of bankruptcy has occurred within three months before the presentation of the petition
  - The debtor is domiciled in Kenya

### **Receiving Order**

After the bankruptcy petition is heard by a court, a receiving order is made upon it. The effect of the receiving order is to remove the debtor's property from his own custody and place it in the hands of an officer of the court called the official receiver. The official receiver is empowered to dispose of the assets of the debtor and distribute the sale proceeds among the creditors.

After making of a receiving order, a general meeting of creditors should be held to discuss the issues like the scheme of arrangement, the mode of dealing with the debtor, etc.

When the receiving order is made, the debtor is required to make a statement of affairs in the prescribed form and submit it to the official receiver.

### **Composition or Scheme of Arrangement**

The act allows the debtor to make a proposal for a composition in satisfaction of his debts or a proposal for a scheme of arrangement of his affairs.

The main purpose of a composition arrangement is to enable the debtor and his creditors to make an agreement whereby the creditors will receive less than the originally agreed amounts in full settlement of their claims. This provides for proportionate distribution of the debtors assets in full discharge of their obligations.

### **Adjudication of the debtor**

A debtor can be adjudged bankrupt if the receiving order is made against him and a composition or scheme is not approved by court. If the adjudication order is made by the court, then the property of the bankrupt becomes divisible among his creditors.

### **Trustee**

The creditors can appoint a trustee of the property of the bankrupt after an adjudication order has been made by the court. The official receiver may also be appointed the trustee by the creditors. A trustee is required to maintain the proper books and accounts in respect of the property of the bankrupt. The official receiver can control the activities of the trustee.

A trustee can be released from his duties in the following situations:

- I. He has realized all the property of the bankrupt and distributed the final installment among the creditors

- II. A composition or scheme has been approved by the court
- III. He has resigned or has been removed from office

### **Discharge of the Bankrupt**

After the order of adjudication, the bankrupt can apply to the court for an order of discharge. After hearing the bankrupt debtor and examining the conduct of the debtor as reported by the official receiver, the court may issue an order of discharge which frees the bankrupt from his previous debts except to the government, debt incurred by fraud and liability of maintenance. An order of discharge releases the bankrupt from all debts provable in bankruptcy.

### **Provable and Non-Provable Debts**

Provable debts are those debts and liabilities to which the debtor is subject at the date of the receiving order or to which he may become before his discharge. These debts may be present or future and certain or contingent.

A non-provable debt is that debt which is incapable of being fairly estimated.

### **Committee of Inspection**

This is a small number of creditors appointed by the whole body of creditors to supervise the winding up of debtor's affairs under the trustee or official receiver.

### **Annulment of Adjudication**

The court has power to annul any receiving order that has been made on improper grounds. Where a bankrupt subsequently makes a satisfactory arrangement with creditors or afterwards pays his debts in full, the court may annul the bankruptcy. If this happens, the debtor is restored to his original position before the bankruptcy proceedings.

### **Joint and Separate Estates**

In the case of partners, the joint estate shall be applicable in the first instance, in payment of their joint debts, and the separate estate for each partner shall be applicable in the first instance in payment of his separate debts. If there is a surplus of the separate estates, it shall be dealt with as part of the joint estate and if there is a surplus of the joint estate, it shall be dealt with as part of the respective separate estates in proportion to the rights and interests of each partner in the joint estate.

### **Small Bankruptcies**

Where a petition is presented by or against a debtor and if the court is satisfied or the official receiver reports to the court that the property is small, the court may make an order that the debtor's estate may be administered in a summary manner. The act shall be subject to the following modifications:

- I. If the debtor is adjudged bankrupt, the official receiver shall be the trustee in the bankruptcy
  - II. There shall be no committee of inspection
  - III. Such other modifications may be prescribed by the general rules with the view of saving expense and simplifying procedure
- Bankruptcy Offences**



A bankrupt shall be guilty of an offence if:

- a. He does not fully disclose to the trustee all his property
- b. He does not deliver to the trustee all his property
- c. He does not deliver to the trustee all books, documents, and other papers
- d. He conceals any part of his property to the value of Kes 200 or more
- e. He fraudulently removes any part of his property to the value of Kes 200 or more
- f. Makes any material omission in any statement relating to his affairs
- g. He does not inform the trustee of a false claim by a creditor
- h. He continues to carry on business after being declared insolvent **FINANCIAL**

## **STATEMENTS**

### **Statement of Affairs**

The statement of affairs is a legal requirement in bankruptcy proceedings. Section 16 of the Bankruptcy Act states that the debtor shall make out and submit to the official receiver a statement of and in relation to his affairs in the prescribed form, showing the particulars of his assets, debts and liabilities, securities given, and any other information as may be prescribed or required by the official receiver.

Perceived from an accounting point of view, the statement of affairs is a statement of the financial position from a 'quitting concern' state. The assets are reported at their realizable values. Their classification is no longer the conventional current versus noncurrent categories; instead they are classified according to their legal concerns either as pledged to certain creditor groups or as free and thus available to general creditors. The broad classifications are:

- a. Assets pledged with fully secured creditors
- b. Assets pledged with partially secured creditors
- c. Assets which are free

The claims are similarly given legal classifications. In as far as valuation is concerned; liabilities are reported at their reporting date amounts. The broad legal classifications are:

- Preferential Creditors
- Fully Secured Creditors
- Partly Secured Creditors
- Unsecured Creditors
- Deferred Creditors **Preferential Creditors**

The following claims shall have priority preference and rank next to **liquidation expenses** and are to be discharged forthwith as far as the property of the debtor is sufficient to meet them i.e. they should be paid in full. If the property of the debtor is insufficient to meet them, then these debts shall rank equally between themselves. The claims that have priority are:

All government taxes and local rates due from the bankrupt at the date of the receiving order and having become due and payable within 12 months next before the date of the receiving order and not exceeding in whole one year's assessment.

- a) Rents due to the government not more than 5 years in arrears
- b) The wages or salary, whether or not earned wholly or in part by way of commission of any clerk or servant in respect of the service rendered to the bankrupt during 4 months next before the date of the receiving order and not exceeding Kes 20,000.
- c) Wages of any laborer or workman not exceeding Kes 20,000, whether payable for time or for piece work in respect of service rendered to the bankrupt during four months next before the date of the receiving order.
- d) All amounts in respect of compensation or liability for compensation which are given priority under the provisions of the Workman's Compensation Act.
- e) Amounts due in respect of contributions payable during the period of 12 months immediately preceding the date of the receiving order by the bankrupt as the employer of any person under NSSF.

### **Secured Creditors**

This is one who holds some mortgage or charge on property belonging to the debtor. However a creditor whose debt is secured by guarantee or a charge on property of a third party would be included with unsecured creditors. **Unsecured Creditors**

These are all creditors who do not hold a mortgage or a charge on property belonging to the debtor. Any amounts due to secured creditors in excess of the liabilities in respect of which they are entitled to preferential treatment must be included.

### **Deferred Creditors**

Certain of the creditors are deferred creditors because their claims are not considered unless and until all other creditors have been paid in full. These are:

1. Loans for business purposes from debtors spouse where the debtor is a sole trader. If the husband is a partner in a firm and the wife has lent money to the firm, she can claim as an ordinary creditor.
2. Loans for business purposes at a rate of interest varying with profits
3. Amount due to a seller of goodwill of a business in consideration of a share of profits
4. A creditor, for interest in excess of 5% on an unsecured loan or on a partly secured loan to the extent that the security is insufficient to cover the interest

### **NB**

Rent recoverable by distress: in bankruptcy, the landlord has a right to distrain after commencement of the bankruptcy for not more than six months rent accrued up to date of adjudication. If therefore more than 6 month's rent is due, the balance should be included with unsecured creditors.

In liquidation of a company, the landlord has no right to distrain for rent accrued due prior to winding up order. The full amount thereof must be treated as unsecured liability.

## FORMAT FOR STATEMENT OF AFFAIRS

### **Deficiency Account**

The object of the deficiency account is to show how the deficiency disclosed by the statement of affairs has been caused. The account opens with the excess of assets over liabilities or excess of liabilities over assets one year prior to the date of the receiving order and shows how such surplus has been increased [deficiency reduced] by:

- Net profit
  - Other sums received
  - Profit on realization of assets
- The surplus can also be reduced by:
- Net losses
  - Personal drawings
  - Household expenses
  - Losses on realization of assets
  - Other losses and expenses

## FORMAT FOR DEFICIENCY ACCOUNT

### ***BANKRUPTCY OF THE PARTNERSHIP***

As regards bankruptcy of partnership firms, a distinction is made between assets and liabilities of the firm and private assets and liabilities of partners. The assets of the firm are first used for paying the liabilities of the firm and if any surplus remains, the partner can use his share for the payment of private liabilities. In the same way, private assets are first utilized for the payment of their individual private liabilities and if there is a surplus, it is treated as part of the partnership assets.

The bankruptcy of the partnership entails the bankruptcy of individual partners who make it up. Hence separate statement of affairs must be prepared for the:

- The joint estate
- The individual estate

Only the partnership assets and liabilities will be included in the joint statement and the private assets and liabilities of each individual partner should go to their separate statements.

### **NOTE:**

1. Joint creditors should be paid in full out of the joint assets before surplus assets are available for private creditors.

2. Surplus on the joint estate; any such surplus is divided among the partners private estate according to the balance of their capitals after profits and losses have been adjusted
3. Advances from partners; these are deferred liabilities of the joint estate repayable after all joint creditors have been paid.
4. If there is a deficiency on the joint estate and a surplus on one or more of the private estate, such a surplus must be brought into the joint statement of affairs as an asset available for joint creditors. If however there is a deficiency on the private estate as well as the joint estate, the deficiency on the private estate cannot rank for dividends against the joint estate and vice versa
5. Where a joint creditor holds a security from the separate estate of one of the partners, he can prove against the joint estate and receive dividends from the joint estate, in respect of the full amount of debt without bringing or valuing his security. He may then realize his security to make up any balance due to him, handing over any surplus in his hands to the separate estate to which it belongs.

## ***LIQUIDATION***

The machinery of bankruptcy was set up for individuals and partnerships. These rules also apply to the winding up or liquidation of companies.

The information contained in a statement of affairs and deficiency account of a company in compulsory liquidation is similar to that contained in the corresponding accounts in bankruptcy, but since the coming into force of the Company's Act Cap 486, it is presented in a different format.

### **Receivership**

This involves the appointment of a receiver to take control of assets which are subject to a fixed or floating charge. The primary function of a receiver is to pay out of the proceeds of realization of the assets, the amounts of the debt secured. The receiver is therefore concerned with secured creditors who have appointed him and will carry out the following functions:

- a. Assume possession of the assets subject to the charge and realize all assets
- b. Pay the costs of dissolution, receiver's costs, trustee's costs, etc
- c. If the charge is floating, pay the preferential creditors in priority
- d. Pay secured creditors amount due to them
- e. Pay the surplus back to the company or to the liquidator if the company is being wound up

### ***Liquidation***

This is the means by which a company's existence is legally terminated. In liquidation the three parties concerned are:

- a. The company [which by law is a separate entity]
- b. The creditors
- c. The shareholders who in winding up are referred to as contributories

The most important aspect of liquidation is the distribution of available assets to various persons entitled to them.

A company when found necessary can be liquidated. Bankruptcy proceedings are not applicable to a company and hence liquidation proceedings are applied. However the insolvency of a company is not a necessary condition for its liquidation. A solvent company can also be liquidated.

The Company's Act provides that a company can be liquidated in any of the following ways:

1. Compulsory winding up by court. This is where the courts may order the winding up in the following circumstances:
  - a. The company has by special resolution resolved that it be wound up by court
  - b. The company is unable to pay its debts
  - c. The company does not commence business within a year from its incorporation
2. Voluntary winding up by members or creditors, for example if the period fixed for the duration of the company has come to an end or if the company for whatever reason passes a special resolution to wind up voluntarily
3. Winding up subject to supervision by court. This is where a company has passed a resolution to wind up voluntarily. The courts may order continuation of the voluntary winding up subject to their supervision on any terms and conditions. The liquidator will continue to exercise all powers subject to any restrictions laid down by court

### ***Order of Payment***

The amounts realized from assets not specifically pledged and amounts contributed must be distributed by the liquidator in the following order:

- a. Expenses of winding up including liquidator's remuneration
  - b. Preferential creditors
  - c. Creditors secured by floating charge on assets of the company
  - d. Unsecured creditors
  - e. The surplus, if any, to be shared amongst the contributories i.e. preference shareholders and equity shareholders according to their respective rights and interests
- FORMAT FOR STATEMENT OF AFFAIRS

FORMAT FOR DEFICIENCY ACCOUNT

## ***Liquidator's Final Statement of Account***

The main job of the liquidator is to collect the assets of the company, realize them and distribute them amongst the right claimants. For this purpose, he maintains a cash book for recording receipts and payments and is required to submit an abstract of the cash book to the court in the case of compulsory winding up and to the company in the case of voluntary winding up. The liquidator is also required to prepare an account of winding up known as Liquidator's Final Statement of Account after the affairs of the company are fully wound up. This account takes the form of a cash account and the following receipts are shown on the debit side of this account:

- a. Amount realized on sale of assets [including surplus]
- b. Amount received from directors and other officers of the company
- c. Contributions made by contributories.

**Note:** when a call cannot be recovered, the shares may be forfeited and the defaulting shareholder would not be entitled to participate in distribution of the amount available for return of shareholders.

On the credit side of this account the liquidator will record:

1. Payment to secured creditors
2. Costs of winding up
3. Liquidator's remuneration:
  - a. Commissions on assets realized also include cash and bank balance and surplus on secured assets if from receiver. However if he sells the assets himself then he gets commission from total proceeds
  - b. Commission on payment on unsecured creditors usually include payment to preferential creditors
  - c. If amount available is enough to pay unsecured creditors, - commission = amount due to unsecured creditors x [% commission] /100
  - d. If amount available is not enough to pay unsecured creditors then – commission = amount due to unsecured creditors x [% commission] / [100 + % commission]
4. Payment to preferential creditors
5. Payment to creditors having a floating charge
6. Payment to unsecured creditors
7. Amounts paid to preference shareholders
8. Amounts paid to equity shareholders

# EXECUTORSHIP AND TRUST LAW

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This is the body of statute law and practice concerning the management of the estate of the deceased person i.e. taking charge of the deceased's estate and fulfilling the deceased's desires as expressed in his will. The subject of executorship may be considered under three headings:

- a. Wills and personal representatives. This section deals with making of a will and its subsequent proof after the testator's death and the office of the executor where one is named in a will, and the office of an administrator where an executor is not appointed or there is no will
- b. Distribution of the estate, where consideration is first on creditors then distribution to beneficiaries
- c. Executor's accounts dealing with double entry accounting employed in executors' and trustees account

## ***Wills and Personal Representatives***

A will is a declaration made by a person during his lifetime regarding certain matters which he desires to take effect on or after his death. Such matters primarily relate to the disposition of his property. Property disposed by will is called a legacy and its recipient is called a beneficiary. The person making the will is called a testator \*testatrix+. The person who takes charge of the deceased's estate and fulfils the deceased's desires as expressed in the will is called a personal representative. A personal representative appointed by will is called an executor. Where there is no executor, the personal representative may be appointed by court and he is known as an administrator.

However, the powers of the testator in a will are not absolute but are confined and restricted by law.

*Characteristics of a will:*

***Dispositive Nature:*** a will may, inter alia, dispose of the testator's property. It is therefore said to be dispositive in nature or character

***Declaration of Intention:*** a will operates merely as a declaration of intent in that it may be altered or revoked by the testator at any time before his death

***Formalities:*** a will must generally be in the form prescribed by law. Formalities required include the need for writing and a signature. Where it is desired to alter or explain, alter or add to a will, this may be done through an instrument called a codicil and is taken to form part of the will.

***Revocability:*** a will may always be revoked by the testator

**Posthumous Effect:** a will becomes effective only on death of the testator. So long as he lives, the will is ineffective and he has full discretion in his affairs regardless of the provisions of the will.

### ***Capacity to make a will***

- a. The testator must have testamentary capacity
- b. The testator must have animus testandi
- c. The will must follow certain formal requirements

#### Testamentary Capacity

The following persons do not have the capacity to make a valid will:

- a. Infants or minors
- b. Persons without sound mind. A person is considered to be of sound mind at the time of execution of the will unless he is of such a state of mind that he does not know what he is doing. The burden of proving that the testator was not of sound mind lies with the person who alleges it.

#### Animus Testandi

To make a valid will the testator must have animus testandi i.e. the intention to make a will. Wills obtained by force, fraud fear or undue influence are void. The burden of proof is on the person attempting to upset the will.

#### Formal Requirements of a Will

1. A will may be made either orally or in writing
2. No oral will shall be valid unless:
  - a. It is made before two or more competent witnesses
  - b. The testator dies within a period of three months from date of making of the will
  - c. An oral will made by a member of the armed forces or merchant marine during a period of active service is valid if the testator dies within the same period of active service despite the fact that he died more than three months after the date of making the will
3. No written will is valid unless:
  - a. The testator has signed or affixed his mark to the will or it has been signed by some other person in presence and by direction of the testator
  - b. The will is attested by two or more competent witnesses each of whom must have seen the testator sign or affix his mark to the will
4. If the testator refers to another document in a will or codicil, then it will be considered forming part of the will provided it is clearly identified

### **Probate**



This is the legal recognition of a will. Although the will itself gives authority to the executor to operate, he cannot prove this authority until he has obtained a probate. An application for a grant of representation is made by the executor to the court. A court may give legal recognition to a will where it is proved that a deceased person has left a valid will. In case of the intestate estate, a letter of administration is issued.

### ***Revocation or Alteration of a will***

A will may be revoked or altered by the maker at any time when he is competent to dispose of his free property by way of will.

#### Methods of Revocation

*Express Revocation* is where a later will or codicil contains a clause which expressly revokes the earlier

*Implied Revocation.* Where two wills are in existence at death of the testator and the latter does not expressly revoke the former both will be upheld except where the latter will is inconsistent with the former. To the extent that the latter will, will change the terms of the former will, then the former is revoked

*Destruction.* The following is necessary for an effective revocation by destruction.

Destruction by the testator or by some other person in his presence at his direction

*Subsequent marriage.* A will is always revoked by the subsequent marriage of the testator, unless the will is expressed as being made in contemplation of marriage to a specific individual.

### ***Distribution of the Estate***

The personal representative must distribute the assets of the deceased's estate in the following order of priorities:

1. Secured creditors as far as they can be paid out of the proceeds of their securities
2. Reasonable funeral expenses of the deceased
3. Reasonable administration expenses
4. Unsecured creditors and secured creditors for their balances, in the following order of priority:
  - a. Preferential creditors
  - b. Ordinary creditors
  - c. Deferred creditors
5. Beneficiaries in the following order of priorities:
  - a. Specific Legatees
  - b. General Legatees
  - c. Residuary Legatees

## ***Legacies***

A legacy is a gift by will. Where it relates to movable property, it is called a bequest, and where it relates to immovable property, it is called a devise.

### *Types of Legacy*

#### *Specific Legacy*

This is a testamentary gift of a particular part of the property of the testator, which identifies that part by sufficient description whether in specific terms. It is a gift of some specific part of the estate which is definitely identified and distinguished from all the others. Where the asset has charged or pledged, the legatee takes it subject to the charges unless free from encumbrances.

#### *General Legacy*

This is a gift not distinguishable from all others of the same kind.

*Demonstrative Legacy.* This is a gift which is in its nature general, but which manifests an intention that the gift be satisfied out of a specified fund or a specified part of the property of the testator, but shall upon failure of that fund be met from the general estate.

*Residuary Legacy.* This consists of the surplus or residue of the testator's estate after all the debts and liabilities and other legacies have been paid. A beneficiary who is entitled to the residuary estate is called a residuary legatee.

### **Causes of Failure of Legacies, Devises and Gifts of Residue**

#### *Abatement*

Where there are insufficient assets after the payment of debts to pay the whole of the legacies in full, abatement takes place. The general legacies are abated first being reduced to zero.

#### *Ademption*

Where the testator in his will bequeaths a specific legacy to a named person, but disposes of the article during his lifetime, the legacy is said to be adeemed. It is void and the person to whom it is left gets nothing. *Lapse*

If the legatee dies before the testator, the legacy lapses. It is not payable and falls to residue.

However, where a legacy is left to a child of the testator and the child had predeceased the testator leaving an issue alive at the testator's death, in such a case the legacy is payable as though the child had died immediately after the testator and therefore should be dealt with in accordance with the child's will or the law of intestacy. [PER STIRPES RULE]

#### *Disclaimer*

A beneficiary may disclaim a legacy or devise. The subject matter then falls to residue. If the gift is one of residue, the subject matter devolves as intestacy.

### Uncertainty

This may arise as to:

- i. What is being given
- ii. To whom it is being given

### Illegality

A gift will fail if it has an illegal condition attached to it.

#### **Note:**

Gifts issued subject to a condition which is contrary to public policy will not fail. The beneficiary will take it without the condition.

### ***Provisions for Dependants***

Dependants of a deceased for purposes of the act include:

- a. Wife, wives, and children, whether or not maintained by the deceased immediately prior to his death
- b. The deceased's parents, step parents, grandparents, grand children, and other children whom the deceased had taken into his family as his own, brothers and sisters who were being maintained by the deceased immediately prior to date of death
- c. Where the deceased was a woman, her husband if he was being maintained by her immediately prior to the date of death.

Under this act, the court can make a provision for a dependant from the deceased's property on the application by or on behalf of the dependant. In making provision for the dependant, the court shall have complete discretion to order a specific share of the estate given to the dependant

#### **Adopted Children**

These are treated as though they were children of the adopting parent

#### **Illegitimate Children**

These are children born out of wedlock. They will be legitimized by the subsequent marriage of its parents, otherwise they should not share with legitimate children unless there is every indication that they were meant to be in the will

#### **Law of Commorientes**

When two or more people die in circumstances such that it is impossible to determine the order of death i.e. who survived the other, they will be deemed to have died in the order of seniority. Accordingly, the younger is deemed to survive the elder or to have died last.

## ***Distribution under Intestacy Provisions***

Where a person dies without leaving a will or where he leaves one which is invalid, he is said to die intestate. Statutory rules exist dealing the distribution of the distribution of the intestate estate.

Five situations can be distinguished in applying the intestacy provisions

### **The intestate leaves one surviving spouse and child/children**

The surviving spouse is entitled to:

Personal and household effects of the deceased absolutely

Half share in the whole residue of the net intestate estate. [If the surviving spouse is a widow, then the interest is determined upon her remarriage.

The surviving spouse has a power of appointment of all or any part of the net intestate estate by way of gift, taking immediate effect among the surviving child/children. This power refers to the power to determine disposition of property. Any child aggrieved by the exercise of power may apply to the court.

The surviving child/children may take:

The whole residue of the net intestate estate on the death of, or in the case of a widow, remarriage.

Half share in the residue subject to statutory trusts and appointments made or awards made. [If more than one child, they share equally]

The distribution to the children is made subject to the rules of hotchpot.

### **Hotchpot**

The intestacy rules provide for equal distribution of property between the children. Where advancement has been made to a child during the lifetime of the intestate, this is presumed to be on account of the child's rights on intestacy. Such advancement must therefore be brought into account in dividing the intestate's estate. Advancement is defined as a substantial gift on marriage or with the purpose of establishing a child in life.

### **The intestate leaves one surviving spouse and no child/children**

The surviving spouse is entitled out of the net intestate to:

- i. Personal and household effects of the deceased absolutely
- ii. The 1<sup>st</sup> Kes 10,000 out of the residue of the net intestate estate or 20% thereof whichever is greater
- iii. A life share in the whole of the remainder [subject to determination if in case of a widow she remarries]

The intestate leaves child/ children and no surviving spouse

The net intestate shall subject to the rules of hotchpot develop upon the surviving child if there is only one, or be equally divided among them if many.

The intestate leaves no surviving spouse and no child/children

The net intestate estate shall devolve upon other relatives in the following order of priority:

- a. Father or if dead,
- b. Mother, or if dead,
- c. Brothers and sisters and any child or children of the deceased brothers or sisters in equal shares or if none,
- d. Half brothers or half sisters and any child or children of the half brothers or sisters in equal shares, or if none,
- e. The relatives up to the sixth degree of consanguinity, in equal shares,
- f. Failing the survival of any of the above mentioned, the net estate devolves upon the state and is paid into consolidated fund.

The intestate leaves more than one surviving spouse

Where the intestate married more than one wife under any law permitting polygamy, his personal and household effects and the residue of the net estate shall in the first instance be divided among the houses according to the number of children in each house, but also adding any wife surviving him as an additional unit to the number of children.

The distribution of the personal and household effects and the residue within each house shall then be in accordance with the rules discussed in the above cases.

**NOTE:**

Personal and household effects means clothing and articles of personal use and adornment, furniture, appliances, pictures, ornaments, food, drink, utensils, and all other articles of household use or decoration normally associated with a matrimonial home, but does not include any motor vehicle or any item connected with the business or profession of the deceased.

***TRUST LAW AND ACCOUNTS***

A trust is an obligation binding a person [trustee] to deal with property over which he has control [trust property] for the benefit of the persons called beneficiaries. The creator of a trust is called a settler. A trust is a relationship in which a trustee is compelled to hold property for the benefit of the beneficiary. A trustee is usually considered as the legal owner and the beneficiary as the beneficial or equitable owner.

**Classification of Trusts**

Express Trusts

These are those trusts which are created in express words by the settler. These trusts may be public or private.

*Public Trusts* or charitable trusts are created for a general charitable purpose e.g. advancement of education, relief of poverty, advancement of religion and other purposes beneficial to the community. They are essentially established for the benefit of a large group of people.

*Private Trusts.* These are created by a settler for the benefit of a particular person or group of persons and not for public purpose. They are usually created in writing to ensure certainty of their terms.

#### Trusts created by operation of the law.

*Statutory Trusts.* These are those trusts which are created by law as an automatic consequence to certain circumstances.

*Implied Trust.* This is a non express trust which is based on the presumed intentions of the settler. The court may infer that the settler intended to create a trust.

*Constructive Trust.* This arises by operation of the law either because of the implied intentions of the parties or because it would not be inequitable to impose a trust. In this case the court gives the authority to a person in good faith to perform the duties of a trustee e.g. if the vendor of a piece of land transfers possession to the purchaser before the purchase price is wholly paid, the purchaser holds the land as a constructive trust for the vendor.

*Secret Trusts.* These are a form of constructive trusts because they are imposed by courts. The concept of secret trusts was originally developed to prevent fraudulent use of statutory requirements for the creation of express trusts. It is only applicable to trusts created by will. There are two types of secret trusts i.e. fully secret trusts and half secret trusts. Fully secret trusts are those trusts where the fact of the trust is disclosed but not the true nature of the trust and the identities of the beneficiaries are not disclosed.

#### **Essentials of a Trust**

For the creation of a trust, some conditions must be fulfilled. These are known as the essentials of a trust. They include:

- a. Existence of trust property
- b. Express or implied intention of creating a trust
- c. Identification of settler, trustee and beneficiary
- d. Capacity to create a trust
- e. Lawful purpose for creating a trust

#### **Maintenance**

When trustees hold property for an infant beneficiary, they can make payments out of income of the trust for the maintenance education or benefit of the infant. The trustees may use their discretion to maintain an infant even if other persons are bound by law to support the infant or any other fund is available for that purpose. Any surplus income of trust property can be accumulated but accumulated

income of previous years can be used at any time at the discretion of the trustees for maintenance purposes.

### **Advancement**

Trustees have power to advance capital money to a beneficiary of any age entitled to capital of a trust. The purpose of this advancement is to enable the beneficiary to establish himself on a sound footing e.g. starting a business. The advancement may be made for the benefit of any beneficiary not yet entitled to capital.

### **Trust Investment**

When property is taken over by a trustee in relation to a trust, the trustee can invest in the following types of investments:

1. Those investments which are authorized by will or trust deed
2. Those authorized by statute

The statute authorizes investments in:

1. Securities guaranteed by the Kenya Parliament or any act
2. Local authority securities which the minister has by notice in the Kenya gazette declared to be a trustee security
3. Investments in companies recognized as authorized investments despite the testator not having stated so in the will. These companies offer not only high return but may also be a safe venture. The trustees can only invest in:
  - a. Public companies that are:
  - b. Quoted on a recognized stock exchange
  - c. Must be incorporated in Kenya and registered under the Companies Act
  - d. Must have paid a dividend on all shares eligible for dividend for the previous five years
4. Shares in a building society
5. For the purchase of:
  - a. Immovable property in Kenya which is freehold
  - b. Leasehold for a term of years not less than 40

Statute authorized investments can be divided into:

1. Fixed interest investments
2. Wider range investments

The trustee defines fixed interest security as:

1. A security which under the terms of the issue bears a fixed rate of interest
2. A deposit with a bank or financial institution, building society or Kenya Post Office Savings Bank

What this definition means is that the investment is one which by its terms of issue bears a fixed rate of interest.

A wider range security means a security other than a fixed interest security.

Fixed interest securities have minimal risk and steady returns whereas wider range securities have higher returns and higher but acceptable risks.

The trustee must have regard to diversification in all circumstances of a trust. A trustee is under statutory obligation to obtain advice in writing before investing particularly in wider range investments. He must consider whether the investment is satisfactory and he is under a continuing obligation to keep reviewing the wider range securities. The advice must be given by a person whom the trustee reasonably believes to be qualified by his ability in and practical experience of financial matters.

A trustee may not make or retain any wider range security unless the trust fund has been divided into two parts excluding the special range investments. The parts being subject to the provisions of the act, must be equal in value at the time of the divisions and where such a division has been made, no subsequent division of the trust fund shall be made and no property shall be transferred from one part of the trust fund to the other unless either:

- I. The transfer is authorized or required by the provisions of the act
- II. A compensating transfer is made at the same time

Once the trustee has divided the trust funds, the two parts are kept separate. If the trustee does not divide the fund, then the investment should be in fixed interest securities. After the initial division, the trust funds need not be maintained in equality. Where the trustee invests and holds property under special powers, such property will form a third part of the fund known as the special range. Any part of the property in special range will be excluded from the fund to be divided in two equal parts. Where special range investment is sold the proceeds must either:

- I. Be re-invested in special range securities
- II. Divided equally between Fixed Interest Investment and Wider Range Investment

### **Trust Accounts for Minors**

#### Accumulation of Income

When property is left in trust for minors, the balance will be divided equally or according to the will and credited to the separate accounts of minors. These accounts are called Income Accumulation Accounts.

Any amounts paid by way of maintenance for the children will be debited to their respective accounts and not to the estate income account.

The accumulation must be invested from time to time and the investments so made earmarked as being on accumulation.



# INVESTMENT

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It's fairly common for a business to invest in stocks and/or debenture and /or shares of other companies. There are numerous reasons for this i.e. investments maybe acquired as business income or funds may be set aside and invested to provide finance for a specific future objective e.g. a major expansion programme or redemption of company's debentures. In both this instances, investments would be sold as required to provide cash to enable the objectives to be achieved.

An investing company may acquire a controlling interest in another company by obtaining a major holding i.e. in excess of 50% of the company voting shares. The company thus controlled in termed as subsidiary of the investing company, which is then referred to as the holding company.

In lieu of gaining outright control, the investing company may secure a substantial but not a controlling interest in another company in order to influence that company's policy decision. Where investments comprise 20-50% of the other company's voting shares, the latter maybe termed an associate company.

## Operating Arrangements

There are 2 basic categories of trade investments:

- a) those that carry a fluctuating rate of return on nominal value e.g. ordinary shares
- b) those that carry fixed rate of return on nominal value e.g. preference shares , debentures etc

A distinction can also be made between those investments that are:

- a. listed i.e. quoted on the stock exchange
- b. unlisted i.e. unquoted on the stock exchange

On acquisition of the trade investment, the capital cost includes brokerage and other charges associated with the purchase. On disposal, the capital proceeds are the net amount after deduction of all expenses associated with selling. In each case also further adjustments may need to be made in the light of accrued fixed interest or fixed dividend.

Fixed rate securities are ordinarily bought cum- dividend or cum- interest. The implication of cum- dividend or cum- interest quotation is that the buyer receives the whole of this next payment of dividends or interest without having held the investment for the whole period to which the payment relates. Quotations are always cum- dividend or cum- interest unless specifically stated in the ex-dividend or ex- interest.

The institutions paying the interest or dividend do so to the registered owners. On payment date the interest or dividend is paid to the latest registered holder. About one month before payment date each institution closes its transfer lists and ceases to record change of ownership of its shares. The effects of suspending the recording of transfer until after the payment date means that, where securities have changed hands during this period, payment of dividend will be made to the original and not the current holder.

On suspension of recording the transfers, the quotation change from cum- dividend or cum- interest to ex- dividend or ex-interest. The implication of this is that the next payment of dividend or interest is paid in its entirety to the original holder despite the fact the he is no longer the holder at that time. However in an ex- dividend or ex- interest quotation, that part of dividend or interest with the new holder will not receive from the paying institution reduces the buying price.

Conversely, the cum- dividend or cum- interest quotation means that the accrued dividend or interest applicable to the period from the last payment date to change in ownership date, receivable by the buyer and therefore forgone by the original holder is added in arriving at the buying price.

## **Accounting Treatment**

In the books of the investing company a separate a/c is opened for each security. Each investment a/c has three columns on each side of the a/c:

*Column 1:* A memorandum column in which is recorded the nominal value of each transaction in either value or quantitative terms.

*Column 2:* A double entry income column to record the investment income transactions

*Column 3:* A double entry capital column to record the investment capital transactions

## **Cum Div /Int. Purchases**

When securities are acquired on cum- dividend or cum- interest, the accrued interest or dividend is debited to the income column and the balance being the capital cost is debited to the capital column.

### Illustration 1

A company bought Kes 100,000, 12% M Ltd loan stock on 1<sup>st</sup> September 2008 at 94 cum-interests. Interest payable half yearly on 30<sup>th</sup> June and 31<sup>st</sup> December.

**Required:**

Show entries in the investing company's ledger for the financial year ending 30<sup>th</sup> June 2009

## **Ex- Dividend/Interest Purchase**

### Illustration 2

The facts are the same for illustration one except that acquisition took place on 31<sup>st</sup> December 2008 when the price was 91 ex- interest.

#### **Required:**

Show the entries in the investing company's ledger for its financial year ended 31<sup>st</sup> June 2009

## **Cum Dividend/Interest Sales**

When securities are sold cum- dividend or cum- interest, the dividend or interest element is credited in the income column and the balance being capital proceeds are credited to capital column.

### Illustration 3

The facts are the same as illustration 1

#### **Required:**

Show the entries in the ledger of the seller for the financial year ended 30<sup>th</sup> June 2009. Assume that the balance of the loan stock a/c on 1<sup>st</sup> July 2008 was Kes 100,000 nominal stock at a cost of 90,000/-

## **Ex-Dividend/ Interest Sales**

When securities are sold ex-dividend or ex-interest, the amount of dividend or interest by which the selling price has been reduced is debited to the income column and credited to capital column and the whole of the net sale proceeds are credited to capital column as well.

### Illustration 4

The facts remain the same as in Illustration 2

#### **Required:**

Show the entries in the ledger of the seller for financial year ended 30<sup>th</sup> June 2009. Assume that the balance on loan stock a/c on 1<sup>st</sup> July 2008 was 100,000 nominal at cost of Kes 90,000

## Profit or Loss on Investment

Investments are ordinarily valued at cost of actual acquisition adjusted where necessary for cum-dividend or cum-interest quotation is illustrated above. In investment a/c profits and losses are normally recognized only when actually realized.

## Partial Disposal of Holding

Minor complications arise when there is a sale of only part of the holding. The question arises as to how to value the cost of investment sold for comparison with the sales proceeds, to see whether a profit or loss results. Where the holding was acquired at a single point in time, it is simply a matter of taking that proportion of original cost which the nominal disposal bears to the total original nominal holding.

### Illustration 5

The facts are the same as those of illustration 4 except that on 1<sup>st</sup> December 2008 Kes 25,000 of nominal stock was sold.

#### **Required:**

Show the investment a/c in the seller's ledger for the year ended 30<sup>th</sup> June 2009

Where the holding has been built up by successive acquisitions at different times and prices, a difficulty may be encountered when attempting to arrive at the cost of sales figure for working out profit and loss on sale.

One method is to evaluate the cost of disposal on a weighted average basis. An alternative is to use first in first out [FIFO] basis.

### Illustration 7

An investing company originally acquired Kes 40,000, 9% debentures in Z Ltd at a capital cost of Kes 36,000 and subsequently increase its holding by a further Kes 80,000 nominal at a capital cost at Kes 76,000. Eventually the company sold Kes 60,000 nominal of its holding.

#### **Required:**

Calculate the cost of the investment sold for purposes of arriving at profit or loss on sale using;

1. Weighted average cost method
2. FIFO method

## Rights Issue

A relatively easy and inexpensive way for any well known company whose shares are listed on the stock exchange to raise additional capital is to make rights issue of ordinary shares. The rights enable the holder to subscribe for extra shares in the company at very advantageous rate. The recipients have 3 causes of action open to them either:

- a. Take up the rights and subscribe for the shares
- b. Sell the rights to 3<sup>rd</sup> party
- c. Renounce the rights [in which case the directors can dispose of the shares to 3<sup>rd</sup> parties]

### **Accounting Arrangements of the Investor**

In the books of the investing company, the accounting entries in the investment a/c will vary according to the course of action chosen. The declaration of rights by a company and the issue of rights certificate do not necessitate any entries in the investment a/c. If any of the rights are taken up, the nominal value of the shares acquired is added to the nominal column and cost is debited to capital column.

A sale of rights to 3<sup>rd</sup> parties does not affect the nominal column but the proceeds from the same of rights are credited to the capital column since the proceeds are regarded as capital receipt.

#### Illustration 7

One of the trade investments of a company is a holding of 50,000 Ordinary share of Kes 1 per share in Z Ltd which originally cost Kes 130,000. Z Ltd has now declared a 1 for 5 rights issue at a price of Kes 1.20 per share. The investing company took up 60% of its entitlements and sold the remaining 40% at Kes 0.50 per share on 30<sup>th</sup> April 2009.

#### **Required:**

Record the transactions in the investing company's ledger for the year ending 31<sup>st</sup> December 2009

### **Bonus Issues**

Sometimes the company declares a bonus issue of ordinary shares. This is because the company has considerable reserves that cannot be distributed either by law or as a matter of financial prudence or because they are represented by noncurrent assets, stocks and/or debtors.

### **Accounting Arrangements of the Investor**

On the books of the investing company the accounting entries appear only in nominal column. The capital and income columns are unaffected.

#### Illustration 8

The facts are the same as above except that instead of declaring rights issue, Z Ltd declared a 2 for 5 bonus issues on 30<sup>th</sup> April 2009.

### **Valuation of investment for Statement of Financial Position**

The value placed on the investment is dependent upon the purpose for which the investment was acquired. Short-term investments are usually included in the statement of financial position at cost. Market fluctuation may be reflected in the valuation if significant.

Unlisted securities have to be valued by the directors. These valuations have to be disclosed in the published statements of accounts of the company. For long term investment the usual practice is to value at cost for statement of financial position purposes. Market fluctuations are usually ignored unless there is a substantial permanent form in value in the case a provision should be raised for the loss.

Financial institution such as investment trusts are in a special position. For this company's investment are effectively their operating assets and are valued according to the market valuation. Unrealized revaluation surplus less unrealized losses are held in special reserve.

# HIRE PURCHASE ACCOUNTING

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Hire purchase system is a system under which money is paid for goods by means of periodical instalment with the view of ultimate purchase.

## NOTE

- a) All money paid in the mean time is payment for hire.
- b) Goods become the property of the buyer only when all installments have been paid.
- c) On fulfillment of certain conditions for example the payment of an agreed number of installments, then the customer can become entitled to exercise option to purchase the asset

## Parties of Hire Purchase Agreement

### The buyer

Is the first, the hirer and ownership only passes if and when he exercises to buy the assets

### The seller/ dealer

This is the firm that sells goods to the buyer. Where hire purchase finance is needed, the seller may introduce the buyer to a finance company.

### Finance company

When the buyer requires hire purchase finance, then the goods are sold by the seller/ dealer to the finance company and not to the buyer. The ownership passes from the finance company to hirer when the option to purchase is exercised:

Where the 3 parties are involved in hire purchase agreement, 2 separate contracts can be written:

- 1) Contract of sell between the dealer/ seller and the finance company
- 2) Contract of hire between the finance company and the hirer.

Goods bought on hire purchase are non-current assets because it is illegal to dispose of them during the hiring period. From the buyers' point of view, under the hire purchase contract, the purchase price consists of two elements;

- -Cash cost price
- -Hire purchase price

Which together make the hire purchase price.

In hire purchase transactions, the selling price consists of cost price plus a further sum of hire purchase interest by the way of compensation to the supplier for using the asset before receiving full payment and the attendant risk.

On a strict legal interpretation of facts the supplier should not take credit for any profit and the customer should not debit the cost of the item until the period has ended. However accounting looks at substance of the transaction rather than at its legal form.

Consequently the supplier recognizes profit as arising over the period of the hire instead of at the end of the period. Similarly, the customers/buyer makes the necessary entries in purchase of noncurrent assets at the start of the period and to after the option has been exercised.

In Kenya, the law relating to hire purchase agreements contained in the Hire Purchase Act Cap 507. The act defines the hire purchase agreement as "an agreement for the purchase of goods under which the buyer may buy the goods or under which the property in the goods will pass to the buyer after payment of installments.

Under the provisions of section 6 of the Act before the hire purchase agreement is entered into:

- i. A statement of cash price must be furnished by the owner to the hirer; otherwise the contract and any guarantor or security based on it will not be enforceable.
- ii. The agreement should be registered and signed by the hirer.
- iii. It must contain a notice relating to the hirer rights and a statement of hire purchase cash price, amounts of installments, dates of payment and description of goods sufficient to identify them

Hire purchase price is usually higher than the cash price and the difference between higher purchase price and cash price is known as hire purchase interest

In hire purchase the first instalment is called a deposit or down payments while the monthly payments are known as the monthly instalments.

In a credit sale agreement, title to the goods passes to the buyer immediately on delivery and purchase price is payment in instalment.

When payment is in default, the venture/seller can only sue for unpaid instalments but he cannot repose the goods. In rental agreement the supplier of the goods retains title to himself, the customer paying a higher charge or rental for as long as he possesses the goods

Hire purchase transaction in the buyers' books

The transactions are recorded in the buyers' books in the following accounts:

i) Asset a/c ii) Hire purchase suspense

a/c iii) Hire purchase interest

suspense a/c

N/B

Hire purchase interest is charged under P and L a/c, which represents an expense, the buyer  
Accounting entries

a) When asset is purchased on hire purchase terms

Dr. asset a/c with cash price

Dr. higher purchase interest suspense a/c with the total hire purchase charges

Cr. Hire purchase company a/c with total amount payable under the agreement

b) Deposits and instalments paid to hire purchase

Dr. hire purchase company a/c



Cr. Cash book

c) Hire purchase interest written off at the end of the year

Dr. P and L a/c

Cr. hire purchase interest suspense a/c

d) Balance sheet presentation

The balance on hire purchase a/c less balance on hire purchase interest suspense A/c. it shows as a current liability on the balance sheet

The asset a/c is maintained at cash price and depreciation is charge din the normal way as well as disposal of assets

e) Early repayment to hire company

Where an early repayment is made to hire purchase

Dr. hire purchase company a/c

Cr. Bank a/c with the amount paid early termination

f) The balance remaining on the hire purchase company a/c represents interest paid.

Dr. hire purchase company a/c

Cr. hire purchase interest suspense a/c

g) The balance remaining in the hire purchase interest suspense a/c

Dr. P and L a/c

Cr. Hire purchase interest a/c

Methods of writing off hire purchase interest

There are 3 common methods of writing off hire purchase interest charges with that are as follows

- a) Straight line / equal instalment method
- b) Sum of year digits
- c) Actuarial / reducing balance method

i) Straight line method

Hire purchase is written of on a straight-line basis over the period of the hire purchase agreement

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Hire purchase interest in therefore written off, that is sh. 750 per each instalment

ii) Sum of year digits

This is a un arithmetical method of apportioning interest in approximate proportion to the outstanding at any time. This method follows the number of instalments, giving the highest digit to the first instalment and lowest digit to the last instalment. Then add up the digits finally apportion each to the accounting period, the proportion of hire purchase interest for each instalment paid.

Illustration

N/B

If the number of instalments is 24 then you only need to add the sum of digit starting from 24 to digit 1

iii) Actuarial method

Hire purchase to be written off is computed in the reducing balance basis. For example, assume that an asset was bought on hire purchase on the following terms

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#### ILLUSTRATION

Sony sugar company ltd acquire 2 cars under hire purchase agreement. The details that are as follows

Registration	KAP 482K	KAQ 600B
Date of purchase	30 <sup>th</sup> June 2005	30 <sup>th</sup> June 2005
Cash price	580,000	732,000
Deposit	100,000	132,000
Hire purchase interest	120,000	168,000

Both agreements provides for profits to be made in 24 equal instalments starting the last day of the month following purchase. Interest is assumed to occur evenly over the period of agreement. On 1<sup>st</sup> August 2005, KAP 482K had an accident and become a total wreck. The following information is relevant:

1. Blue shield insurance company paid 440,000/- under the comprehensive policy
2. The hire purchase company accepted 240,000/- for termination of agreement

The firm prepares the accounts annually on 31 December and provides depreciation on straight-line basis at the rate of 20% for motor vehicles with a full year's depreciation in the purchase.

No depreciation is provided in the year of disposal. All instalments were paid in due date

Required

- a) Motor vehicle a/c
- b) Provision for depreciation for motor vehicle a/c
- c) Hire purchase company a/c
- d) Hire purchase interest suspense a/c
- e) Disposal of motor vehicle a/c

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Exercise

XYZ Ltd acquired 2 printing machines on 1<sup>st</sup> January 2008 for sh. 1.291,500. The cash price for these machines was sh. 900,000. The deal was financed by Kenya Traders Ltd. under terms of hire purchase contract required a deposit of sh. 300,000 on delivery, followed by a 3 months instalment of 330,000/-, 330,000/- and 331,500.

The true rate of interest was 30% p.a- actual methods. The depreciation policy of XYZ was to write off 20% on straight-line basis.

Required

- i) Prepare the appropriate a/c of the books of XYZ to record the transactions
- ii) The relevant balance sheet entries at the end of 2009

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Methods of accounting for hire purchase sales

There are 2 methods for hire purchase sales transaction adopted by the vendor/ seller.

- i) The sales system (instalment method)
- ii) Stock system (cost recovery method)

A) Sales system method

Gross profit and interest charged are accounted for separately. Traders are able to take credit for gross profit at the time of delivery of the goods. The interest earned may be spread over a number of accounting periods.

Accounting entries

a) Sales a/c

It is credited with cash selling price. The balance on this account including both cash and hire purchase interest is transferred to the cash a/c

b) Hire purchase interest suspense a/c

It is credited with the total hire purchase interest. At the end of the accounting period a proportion of interest is credited to P and L a/c and the balance carried forward as a deferred income. c) Hire purchase debtors' a/c

Debited with the full hire purchase selling price and credited with cash payments when they are received.

Observe that the above accounts are reverse of the accounts of the buyer

A P and L a/c is credited with the following:

- Gross profit and sales
- Profits on repossession if any.
- Hire purchase interest for the current year

Balance sheet representation

The amount due from hire purchase debtors are indicated as current assets i.e. the figures taken in hire purchase debtors less in earned interest.

Bookkeeping entries

Goods sold on hire purchase

Dr. hire purchase a/c with the hire purchase price

Cr. sales a/c with the cash price and

Cr. hire purchase interest suspense a/c with the hire purchase interest

Total sales at the end of the year

Dr. sales a/c

Cr. Trading a/c

Hire purchase interest earned

Dr. hire purchase interest suspense a/c

Cr. P and L a/c

Un earned gross profit is carried forward to future period. Most firms do not transfer hire purchase interest to the P and L a/c, but they take hire purchase interest and gross profit together into hire purchase trading a/c

A provision for unrealised (un earned) profits is credited and the amount is debited to a trading a/c with provisions of un-realised profits

Provision for unrealised profits – outstanding instalments    X    total gross profit

---

Hire purchase selling price

### Repossession

When a customer does not pay instalments due from them, hire purchase sellers repossess the goods from the customers

Goods repossessed are valued by the directors and stock is carried down at this value till this stock is sold.

i) Outstanding instalments on repossessed goods

Dr. repossession a/c

Cr. Hire purchase debtor's a/c

ii) Un earned interest on repossessed goods

Dr. hire purchase interest suspense a/c

Cr. Repossession a/c

iii) Un realised profits on repossessed goods

Dr. provision for un- realised profits a/c

Cr. Repossession

iv) Loss on repossession Dr. P and L a/c

Cr. Repossession a/c

v) If profit on repossession

Dr. repossession a/c

Cr. P and L a/c

B. Stock system.

No distinction is made between gross profit and hire purchase interest charged. The accounting system used where the trader intends to apportion the whole profit to successive periods in proportion to cash received. Accounts required:

i) Hire purchase trading a/c

It is a separate account showing hire purchase gross profit only

N/B

Cash sales are dealt with in a separate general a/c it is debited with cash received it is debited with

At the end of the accounting period a balance carried forward in form of stock figure representing cost of outstanding instalments.

N/B the trading a/c sales are not credited to the accounts, only cash receive is credited

ii) Memorandum hire purchase debtor's a/c

The account is not part of the double entry, as sales are not recorded in the trading a/c. the account is opened only to find out the amounts due from debtors.

N/B

Valuation of stock out on hire at the end of an accounting period is calculated as follows

Outstanding instalments X cost

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Hire purchase selling price



## Accounting treatment

### i) Cost of goods sold on hire purchase

Dr. hire purchase trading a/c

Cr. General trading a/c

### ii) Deposits and instalments received

Dr. bank a/c

Cr. Hire purchase trading a/c

### iii) Cost element in stock on hire i.e. cost of outstanding instalments

Dr. next year's hire purchase trading a/c

Cr. This year's hire purchase trading a/c

### iv) Gross profit on hire purchase transaction i.e. being the balance on the trading a/c Dr. hire purchase a/c

Cr. P and L a/c

## Repossession

When goods are repossessed, the cost element of outstanding instalments is transferred from hire purchase trading a/c to debit of repossession a/c. directors valuation of repossessed goods is added back to purchases and carried forward as a stock figure till sold.

Any difference in value between the cost element of outstanding stock and director's valuation is written off to P and L a/c as a profit or loss on repossession

## Accounting entries

### i) Cost element of opening stock instalments

Dr. repossession a/c

Cr. Hire purchase trading a/c

ii) Sell proceeds of repossessed goods sold

Dr. bank a/c

Cr. Repossession a/c

iii) Director's valuation of goods repossesses if unsold

Dr. purchases a/c

Cr. Repossession a/c

iv) Loss if any on repossessed goods

Dr. P and L a/c

Cr. Repossession a/c

v) Profits if any on repossessed goods

Dr. repossession a/c

Cr. P and L a/c

### Examples

1. CMC deals with Peugeot vehicles. They sell motor vehicles for cash and on hire purchase basis. They sold 2 motor vehicles on hire purchase to KCA on 1<sup>st</sup> January 2007, for 1,400,000/-

The cash price of the vehicle was 1,160,000/-. The payments were to be made by KCA as follows.

Deposit sh. 200,000

24 monthly instalments of sh. 50,000 each = sh. 1,200,000

The company recognises profit on hire purchase sells in the year of selling but hire purchase interest is apportioned on time basis

Required

Record the above transactions in the books of CMC ltd for the year ended 2007, 2008

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2. ABC ltd sold one canter vehicle to despond Tutu on 1<sup>st</sup> July 2007 and the hire purchase system on the following terms:

Hire purchase price	sh. 4,000,000
Cash price	sh. 3,520,000
Deposit	sh. 800,000
16 monthly instalments of	sh. 3,200,000 (payable on the last day of
Sh. 200,000 each	every month)

Bishop tutu failed to pay instalments due on 31<sup>st</sup> may 2008 and informed ABC ltd that he was un able to proceed with the contract. ABC ltd subsequently obtained a court order and repossessed the canter which was valued at sh. 1,300,000

Required

Accounting entries in the books ABC ltd assuming the finances for the year ended on 31<sup>st</sup> December

CONSIGNMENT ACCOUNTS

it is not always possible or commercially viable for a business to sell goods directly to customers. if for example a business wish to sell goods abroad, establishing a sell, show room or office in each country may not be a viable proposition unless the volume of sales justifies such a course.

One way of overcoming this difficulty is appoint of selling agent in the concerned. This agent is then responsible for organising all aspect of marketing the goods and for collection of cash from customers. for this function he is remunerated on commission basis.

#### Operating arrangements

Goods sent to an agent are usually dispatched in bulk and are termed as consignment. the party sending the goods is the consigner and the agent is the consignee.

Both parties incur expenses in connection with the consignment. periodically the consignee sends account sales to the consigner. This is a document, which shows the sales made by the consignee along with expenses and commission.

A banker draft for the net balance may accompany the accounts sales. Some times the consignee guarantees that all trade debts will be collected and should any proved to be bad, he will bear the loss. he receives the extra commission on all sales of this additional undertaking

#### Accounting arrangements

The act of consigning goods to an agent does not constitute a sale. The consigner merely transfers the location of the goods consigned ownership of such goods remain rested on the consigner although they are in possession of the consignee. A sales arises when the goods are sold by the consignee to the third parties

#### Consigners accounting arrangement

Transfers of goods are recorded by debiting a consignment to (name of the agent) and credit goods on consignment a/c. this procedure is the same as that of branch accounting whereby most of the goods from head office to branch are recorded as transfer and not as a sale.

The closing balance of the goods on is debited at the end of the period and credited to trading a/c to prevent distortion of gross profit figure on non-consigned goods which appears in that a/c

The consigner debits the expenses, which in connection with the consignment to agent a/c and the opposite entry appears in bank, cash, and creditors a/c as appropriate. On receipt of a/c sales, the consignee's expenses and commission are debited to the consignment in agent's a/c and sales are credited

The opposite entries are posted to a personal account opened in the name of the agent. the balance in this account is settled by cash or carried forward to the next accounting period.. at the end of the period, unsold stock in the agent's possession is valued and credited in the consignment agent a/c to be carried down as a debit sale at the start of the next accounting period.

After closing stock has been posted, the difference between the two sides of the consignment to agent a/c constitutes either a profit or a loss. the consignment to agent a/c is effectively a T, P and L a/c for the consignment

Valuation of stock on consignment

In arriving at closing stock valuation , only amounts relating to unsold stock are included. Thus the agents expenses incurred on the incoming consignment are included, but certain items of marketing nature e.g. delivering to customers, are excluded from the calculation on the grounds that they relate to goods which have been sold and not to those remaining unsold.

Closing stock values, thus comprises of the aggregate of the initial cost of goods, plus the attributable costs of both the consigner and consignee, but a further refinement is required when stock loss occurs

Illustration

X consigns 4crates each containing 30 identical items valued at 1,500 to his agent Y, on 1<sup>st</sup> April 2007.insuarance and transport costs paid by X amounted to 150/= and 250/= respectively. Y paid insurance of 200/=, storage charges of 300/= and delivery charges of 50/=. Y sold 90 units for 7,200/= and sent X a cheque for the amount due after deducting the agreed sales commission of 10%

Require

Prepare the appropriate a/c in the books of X

Stock losses

- a) When goods on consignment are lost or stolen or are damaged on transit, other accounting problems will arise i.e. the consignment to the agents account is credited with the cost of the loss and suitable a/c is debited. This is usually insured or uninsured losses a/c is appropriate.
- b) The stocks in the agents hands has to be calculated in two stages, the results of which are added together to give stock values, a calculation has to be made of;

$$\begin{array}{r} \text{Stock quantity} \quad \quad \quad \times \quad \quad \text{consignment attributable cost to point to loss} \\ \hline \text{total} \quad \quad \text{consignment} \\ \text{quantity} \end{array}$$

A further calculation is then made

$$\begin{array}{r} \text{Stock quantity} \quad \quad \quad \times \quad \quad \text{consignment attributable costs} \\ \hline \text{Total consignment quantity - quantity lost} \end{array}$$

The stock is calculated as;

$$\text{Quantity of units} \quad \times \quad \text{consignment attributable cost to point} \quad \text{to loss}$$

If the loss occurs after the receipt by the consignee, suitable modifications must be made to the above calculations

### Illustration

a consigner dispatched 25 identical articles at a total cost including expenses of 1000/= and enroute to the consignee, 5 articles were stolen. The consignee incurred further expenses other than marketing expenses of 400/= at the end of the period.

There are 10 articles unsold

Required

- a) Show the value i) Stock loss ii) Closing stock

Solution

i) Stock loss    5 X 1000

$$\frac{5 \times 1000}{25} = 200$$

ii) Closing stock

Consigner: 10 X 1000 (consigner's expenses up to point of loss)

$$\frac{10 \times 1000}{25} = 400$$

Consignee: 10 X 400

$$\begin{array}{r} \text{---} \\ 20 \\ =200 \end{array}$$

Valuation of closing stock = 400 + 200

$$=600$$

When the consignee signs his acceptance on this bill of exchange originated by the consigner, for the balance due and the consignee subsequently discounts the bills with the bank, the discounting charge may not be regarded as an expense on consignment, but may instead be charged against P and L a/c

Consignees accounting arrangements

The consignee makes a memorandum record of quantity but does not record the value in his ledger. However he open an account in the name of the consigner to which he debits all the expenses he incurs in connection with the consignment together with the commission on sales.

Sales are credited to this account and the double entry to this transaction is made in the consignee's bank, commission etc as is appropriate.

At the end of the period, the consignee does not bring the closing stock balance into a/c, because the value of consignment was not originally recorded in his a/cs. The balance on consigner's a/c at the end of the period represents the net sum due from the consignee for the consigner and maybe settled by payment or carried forward to the next accounting period depending on agreement between the parties.

It should agree in amount with the balance on the agent a/c in consigner's ledger.

Illustration

Using above illustration prepare the appropriate a/cs in Y's ledger



Quiz I

In February 2008 X consigned 40 boxes of toys costing 20/= per box to the selling agent Y. X paid by cheque transport charges of 50/= and sundry expenses of 13. After receipt of boxes Y paid by cheque of 58/=, sundry expenses of 14/= and delivery charges to customers of 8/-

By the end of March Y had sold the whole consignment for 40/= per box on which he was entitled to a commission of 10% of sales

Required

- i) Records of the books of the consigner
- ii) Records of the books of the consignee

Quiz II

The facts are the same as above except that by the end of march Y has sold only 30 boxes and paid delivery charge of 6/=. On arrival at Y's premises the content of 5 boxes were found to be damaged and unsaleable . sundry expenses paid by Y where 12/=

Required

- i) Calculate the cost of stock loss ii) Calculate the cost of stock held by the consignee at the end of the month

## **CO-OPERATIVE ACCOUNTING**

Co-operatives have played a very significant role in this country as a poverty alleviation tool. The members pool their financial resources together and assist each other with affordable loans that cannot be granted by any existing banks. Through membership, many people have been able to develop themselves in all forms and transform their lives to a large extent.

The co-operatives are governed by the Co-operatives Society's Act, which clearly stipulates how a society should be governed. The challenges that are faced by this sector are numerous, one of the major being the management of finances. The cause of such a scenario has been lack of proper personnel to run the administration and largely being a political set up of the management board.

The management board commonly known as the Central Management Committee (CMC) is elected into office at general meetings. Poor management in co-operative societies is caused by a number of reasons:

- Some directors developing corrupt practices and their interests' starts to conflict with those of the society
- Take large loans with long repayment periods in addition to awarding themselves high levels of sitting allowances
- Invest members' funds recklessly in projects not beneficial to the society
- Commit the society into large obligations that cripples the institution with large debts with high interest payments.

With no clear guide and clashing and overlapping accounting principles, the staff will override all the controls and steal monies through collusion with corrupt members.

Co-operative accounting helps to guide on how the co-operative accounting should be carried out. The Co-operative Act states that the financial statements should conform to the International Financial Reporting Standards (IFRS).

### **Categories of Co-operative Societies**

#### **Farmers' Co-operative Societies**

These are formed by small farmers pooling resources together so as to enjoy the benefits of top scale farming. The farmers are able to get farm inputs, chemicals, and other items at cheaper prices, in addition to being able to hire farm machinery.

#### **Consumers' Co-operative Societies**

These are societies formed with an aim of making consumer goods available to members at a reasonable price. They purchase goods directly from manufacturers or producers at wholesale price and sell to members at a lower price than that existing in the market. Thus they eliminate the middleman or retailer by distributing directly to members.

#### **Producers' Co-operative Societies**

These societies are formed by small producers to enable them have the items they need for the production of the goods at reasonable price at the right time.

### **Co-operative Marketing societies**

These are small producers who find it hard to sell or market their products individually and thus they form a society for that purpose. The societies collect the products from the members and take the responsibility of marketing the products in the market.

### **Housing Co-operative Societies**

These societies are formed to provide residential and commercial houses to members. The society purchases land and develops it by constructing houses or flats which are allocated to members. In addition they may provide loans at low interest rate and longer repayment period to members to construct their own houses. On the other hand the land purchased can be subdivided and allotted to members.

### **Saving and Credit Co-operative Societies**

These societies are formed to provide money to members in form of loans. The society accepts deposits and share contribution from members and subsequently uses them to grant members loans at reasonable interest rates and longer repayment periods. These societies also offer mortgages to members to acquire land and building and other real properties.

### **Credit Union**

This is a co-operative financial institution which is owned and controlled by members who use its services. Credit unions are non profit making bodies and exist solely to provide a safe and convenient place for members to save money and get loans and other financial services at reasonable and affordable rates. In addition, credit unions gives services to people who have similar bond e.g. business establishment, work places and social gathering.

Basically, a credit union is formed by Sacco's who come together to form one big union. By doing so, they pool their resources together to give their members better services. Therefore, the excess profit over and above operational costs is shared by members in the form of dividends, low rate of return and new and improved services.

## **REGULATORS OF CO-OPERATIVE SOCIETIES**

The major regulators are

### **Co-operative Act and Co-operative Rules**

These give guidance on how the co-operative will be managed and how the members conduct themselves as the owners of the co-operative. They direct on how responsibility and accountability will be portrayed throughout.

### **Central Bank**

With the emergence of the FOSA which operates like a bank, the Central Bank must regulate it just the same way as other banks. The FOSA must adhere to regulations provided by the Central Bank.

## **Kenya Union of Savings and Credit Co-operatives (KUSCCO)**

This is a co-operative union whose membership is derived from co-operative societies in Kenya. It serves the interests of co-operative societies by being a go between with other regulators. KUSCCO is the umbrella body of the Sacco's playing the role of advocacy and representation.

The main objectives of the KUSCCO are as follows:

- To promote the organization and development of Sacco's
- To circulate information on Sacco's as well as coordinating their operating methods and practice to enhance uniformity
- Provide education and training to members, officials and employees of the Sacco
- To be an international representative of the Sacco by providing standard management systems

### **Kenya Revenue Authority**

They ensure that tax regulations are being followed.

## **Co-operative Bank of Kenya**

The bank offers financial and banking services to the Sacco and other co-operatives. The Coop Bank has enabled Sacco's to be linked using integrated IT systems which create universal and effective cooperative societies. This has also enabled the Sacco's to offer ATM services.

## **World Council of Credit Unions (WOCCU)**

WOCCU is a worldwide representative organization which acts as an advocate and provides a platform for exchange of knowledge and agency of development for credit unions. The objective of WOCCU is to provide quality credit union for everyone.

WOCCU draws its membership from regional and national credit unions, associations, co-operative associations and business service organizations.

**Pearls:** these were developed by WOCCU in partnership with credit unions. WOCCU uses Pearls together with credit unions who are participating in its technical programs all over the world. A pearl is a mnemonic of Protection, effective financial structure, asset quality, rate of return and costs, liquidity and signs of growth.

Pearls are a financial performance monitoring system which was designed to offer management guidance for the credit union and Sacco. The regulators use Pearls as a supervisory tool by showing signs of the problem to managers before such a problem can become destructive. The CMC's use Pearls to monitor the progress of management in order to achieve financial goals. Pearls are also used to compare and rank Sacco's in one country or across countries. They have also been seen as a set of financial ratios or indicators that help to harmonize and standardize co-operative societies across the world. As a result therefore, WOCCU strives to strengthen and modernize credit unions in order to promote growth in savings and deposits of the members. Members in return create confidence that the Sacco is meeting the standards of excellence, by using Pearls and thus their deposits are safe and sound.

## **SACCO**

Sacco membership is derived mainly from urban low income earners and rural small scale farmers who contribute from their earnings. Sacco's play an important role in the development of financial markets in Kenya. Sacco's have grown to be two in one; Back Office Savings Account (BOSA) and Front Office Savings Account (FOSA).

### **Share and Deposit**

Members contribute certain amounts of their earnings every month or any period accepted by the society. These are usually called savings. These have been distinguished into shares and deposits. The shares will not be withdrawn unless a member ceases membership with the society. The deposit account will accumulate as the saving increases. Dividend and interest will be paid on the shares and deposits.

### **Withdrawal of deposit**

The co-operative act provides that deposits may be withdrawn for payment to members according to the terms and conditions under which the accounts are contracted and classified. Where deposits are withdrawn for payment to third parties, it should be provided in the by-laws and policies of the Sacco.

Withdrawal of deposit may be by:

- Death; the next of kin of the deceased lodges the claim by presenting a death certificate of the member. The beneficiary will be given all the accumulated deposits to date. If there was a loan remaining unpaid at the time of death, it is paid by the insurance company that insured the loan.
- Voluntary withdrawal; a member may voluntarily opt to close their account with the Sacco at any time. However, a notice of sixty days must be given prior to the payment of the amount withdrawn. Before the member can withdraw, the following conditions should be fulfilled.
  - If the member had guaranteed another member, he should provide a new guarantor,
  - The outstanding loan balance must not exceed his cumulative savings deposit otherwise the difference after offsetting the loan balance with the savings account must be paid in cash.
  - Monthly loan and savings recoveries should be stopped

### **Loans**

Sacco is allowed to grant loans to members under conditions provided by regulations and established in the by-laws and policy of the CMC. The CMC should establish written policies relating to how the loan will be granted stating clearly the terms and conditions of repayments, the maximum amount that can be borrowed and the acceptable security that can be offered.

For a loan to be granted, an application must be made in writing and shall be evidenced by a loan agreement. The loan granted may be secured by guarantors assigning their shares or salary. The law requires that the maximum amount borrowed must not exceed 5% of the Sacco total assets or as amended from time to time. Where a group, association, partnership or another society is a member of the Sacco, the security in the form of property or acceptable security shall be pledged on an individual capacity.

One common rule regarding the granting of a loan is that a member should not be granted a loan whose monthly deduction exceeds two thirds of the net salary. This means that upon all deductions of

the loan the member should remain with one third of the net salary. This is referred to as the '**a third rule**'.

### **Loan repayment**

This may be paid by the following methods:

- **Check off system**  
This is the method where the employer deducts savings contribution and loan recovery and remits it to the Sacco. There should be such an arrangement between the Sacco and the employer.
- **Cash and cheques**  
Members may pay their outstanding loan balances by cash or by cheques. Members who wish to clear their loans by paying cash before maturity should give the Sacco a grace period of three months before he can be granted a new loan.

### **BOSA – BACK OFFICE SERVICE ACTIVITY**

This is the traditional operation of the Sacco where members' contributions are used to advance loans. Sacco rules are designed to regulate its operations.

### **Members of a Sacco**

**Ordinary members;** these members contribute shares and deposit to the society with an aim of getting a loan.

**Preferential members;** are members who authorize their dividend to be capitalized in order to increase the number of shares in the society, thus getting more dividend in the next period or for them to qualify for a larger loan.

### **BOSA Products**

#### **Ordinary Normal Loan**

This is usually granted at three times of the cumulative shares. It is granted to members who collect their dividends instead of capitalizing them.

#### **Preferential Normal Loan**

Members who choose to capitalize their dividends into shares are allowed to borrow four times of cumulative share deposit, with a longer recovery period. In addition, the members are given further preferential treatment through extension of the repayment period and lower installments if their share contributions are up to a certain level. This encourages savings and increases the liquidity level of the Sacco.

#### **Development Loan**

This is granted to assist members in long term investment like purchase of plots, houses, etc.

#### **Speed Normal Loan**

This is a normal loan which is urgently processed on application to be granted within 48 hours and it is charged a speed commission on the net amount payable.

### **Emergency Loan**

This loan is granted on a daily basis to assist members to solve any emergency matters such as funeral expenses, medical bills, court fines, etc. The emergency loan is granted within 24 hours of application and is recoverable within a period

### **School Fees Loan**

The loan is granted to enable members educate their children by paying school and college fees.

### **Auto Loans**

This is a loan advanced to members to buy motor vehicles. The motor vehicle becomes security of the loan and the Sacco retains the log book until when the loan is paid in full.

### **Mortgage Loan**

This is a loan given to members to acquire real property. The title deed becomes the security of the loan and it is retained by the Sacco

### **Benevolent Fund**

This is a fund created by the Sacco to enable the members of the fund to meet burial expenses. When a member dies, the society helps to meet the expenses either in full or in part depending on the circumstances. The members contribute voluntarily.

### **FOSA – Front Office Service Activity**

FOSA is a 100% subsidiary of BOSA. FOSA is required to operate independently as a separate entity which is able to open branches in other areas as it expands. It operates exactly as a bank, providing services which members are not able to get from ordinary banks. By operating a separate entity, FOSA is able to adhere to the Central Bank regulations in the same way as other banks. Though it is open to members of the Sacco, the members of public can also open accounts and enjoy the benefits offered by FOSA.

The Co-operative Act requires FOSA to maintain 10% of the deposits as a minimum liquidity and should maintain a minimum capital adequacy and reserves at 10% of the total liabilities.

### **FOSA Products**

FOSA is growing at a dramatic speed to compete with the traditional banks in offering quality services to its members. Some of its products include:

#### **Savings Account**

Sacco members are required to open savings account for processing of salaries, payment of loan, dividend refunds, etc. Some Sacco's require a minimum balance to be maintained in the FOSA account.

#### **FOSA One Month Advance**

This product is developed to allow the members to get a salary advance upon application. The amount of the advance is deducted from the salary of the member at the end of the month. One condition for this product is that the member should channel the salaries through a savings account in FOSA.

### **FOSA Credit Facility**

This is a product which allows a member to overdraw his account to certain approved limit. The member can overdraw for a period of six months after which a renewal will be required. The rate of interest is charged on a reducing balance.

### **FOSA Advance**

The loan is granted to a member and the repayment period ranges from six to twelve months depending on the need. The rate of interest is on a reducing balance method. The member should have the salary channeled through the FOSA to be eligible for this loan.

### **FOSA Development Loan**

This loan is granted to a member without due consideration to the third rule, but the ability to pay the loan according to the pay slip is assessed. The member should have the salary channeled through the FOSA to be eligible for this loan.

### **Children Accounts**

This account provides an opportunity to members to save for their children by opening a children savings account. This account attracts better interest rates than other savings accounts. Members are given incentives from time to time. These include bonuses for those who have not made any withdrawal during the year.

### **Fixed Deposit Accounts**

In this account, a member may deposit money for a fixed period of time according to the policies governing this account. The rate of interest is usually very competitive. However, the longer the period the money stays in the account, the more the interest earned on these savings.

## **FINANCIAL STATEMENTS**

The Co-operative Act requires that the societies keep proper books of account which should reflect the true and fair view of the society's affairs. In addition they should be able to explain the transactions in respect of all monies received and paid. The financial statements should conform to International Financial Reporting Standards.

### **Statement of Income**

Statements of income presented by Sacco's and other co-operative societies are in the form of an income and expenditure accounts that are prepared by nonprofit making organizations. The cooperative societies make a surplus which they share with members at the end of the year as dividends and interest. Besides meeting the members' objectives, they also engage in profitable projects that are actually earning a profit.



**Income;** the income items should be present in the statement of income separately for each category or products offered. To make them more transparent, they should never be mixed.

**Sales;** this occurs where the society is in a trading business which involves sales and purchases. There are cases when members deliver their produce to the society for the goods to be sold and the remittance made later. At this time the member is not aware of the price of the item sold. It should be prudent for the society to give the ruling market purchase price and this should be the same price the society should record in the books. If there are changes in the price of the goods and services, the adjustments should be made in the books accordingly.

The member after supply of goods may require the society to pay for school fees, farm inputs or any expense before the payment is due. In such circumstances, the society may charge a commission and pay for the expense or item applied for. The entries will be as follows: Dr Bank a/c, Dr Commission Receivable a/c and Cr Debtor (member) a/c.

**Loans Income; each** category of loan should be recorded separately in distinguishable categories.

**Members Debtors Account;** this is a personal ledger under the debtors control account. A member may have a single loan or a multiple of loans according to the products offered by the Sacco. For each category of the loan, the member should have a separate ledger account. These accounts should be further grouped together in a single group ledger account for this member.

**Loan Disbursal Account;** this is a control account to disburse all loans in each category e.g. normal loan, emergency loan, etc. This account upon loan disbursal should be zero. In case it has a balance, then something is wrong.

**Processing Charges;** when an application is made, the member will be appraised and the loan processing will take place. Some Sacco's charge a processing fee. These charges are income to the society.

**Insurance on Loans;** once a member has taken a loan, he may repay the loan, default on repayment, or die. The loans taken by members should be insured by a registered institution or company which takes the risk to repay the loans advanced to members upon death. If the member defaults on the loan repayment, the guarantors will be asked to repay the loan as per the loan agreement. If the member dies, the guarantor will not pay the loan but the insurance company will settle the amounts due in full.

**Sinking Fund;** sometimes societies do not cover loans through insurance companies but establish a sinking fund through which they pay the claim when the member dies. This fund should be deposited or invested in such a way that it can become available when the need arises.

### Illustration 1

Kamau is a member of KCAU Sacco Ltd and has been saving with them. He applied for a normal loan of Kes 480,000 on 1 January 2008 at 10% interest rate straight line. The loans are insured by Kondoo Insurance Company for Kes 1 for every Kes 100, and the loan will be repaid in one year. KCAU Ltd had opened an account with Kisumu Bank through which all payments are done and had a credit balance of Kes 479,800

### Required

Ledger accounts in the books of KCAU Sacco Ltd

### Equity and Liabilities

**Equity and Deposit; the** shareholding of the society should be distinguished from deposits. The share capital cannot be withdrawn but can be transferred to another member at arms length. The share deposit can be withdrawn after giving the required notice.

**Revenue Reserve;** after the distribution of profit in form of dividend and interest, the retained profit or surplus is transferred to revenue reserve and statutory reserve.

**Statutory Reserve;** the Co-operative Act and rules require a society to maintain 20% of the surplus or retained earnings as reserve fund. The reserve fund can be invested or deposited according to the provisions of the act and should not be distributed to members as dividends or interests. The prime purpose of this fund is that in case the society is dissolved the reserve fund is used to discharge liabilities to the society.

**Management and Supervisory Fund;** the co-operative rule requires a provision audit and supervisory fee to be made annually unless the society is exempted by the commissioner of co-operatives in writing. It is from this fund that audit and inspection fees are paid.

### Illustration 2

KCAU Sacco Ltd had the following members to be paid loans through FOSA

	<b>Kes</b>
Alick Malik	500,000
Ben Benito	95,000
Cent Centuro	<u>56,000</u>
<b>Total</b>	<b><u>651,000</u></b>

The following staff have been paid their net salaries through FOSA

	<b>Kes</b>
Doc Doturi	156,000
Gos Kosori	<u>45,000</u>
<b>Total</b>	<b><u>201,000</u></b>

Salary processing fee is Kes 150

The following have deposited cheques for clearing loans and boosting shares

	<b>Kes</b>
Fen Firasi – emergency loan	435,000
Hos Poturi – increase in shares	100,000
Mit Mosoti – cleared a normal loan from the account	56,000

### Additional information

- a) BOSA co-operative account had a debit balance of Kes 1,000,000
- b) Alick Malik and Cent Centuro FOSA savings account had 20,000 and 50,000 credit balances respectively.

- c) Fen Firasi – emergency loan and Mit Mosoti – normal loan, have balances of Kes 435,000 and 56,000 respectively in BOSA.
- d) Hos Poturi had a balance of Kes 20,000 shares that had accumulated over some time.

### **Required**

The accounts in the books of KCAU Sacco Ltd

## **PUBLIC SECTOR ACCOUNTING**

Public sector accounting is an accounting system used by bodies such as

- Local government authorities
- Publicly-funded bodies
- Education institutions
- Central government departments
- Charitable institutions

Characteristics of the entities in the public sector include the following:

- They are typically established by legislation
- Their objective is to provide goods and services to various recipients or to develop or implement policy on behalf of the government and not to make profit
- They are characterized by the absence of defined ownership interests that can be sold, transferred or redeemed
- They typically have a wide group of stakeholders to consider including the public at large
- Their revenues are generally derived from taxes or similar contributions obtained through the exercise of coercive powers
- Their capital assets are typically acquired and held to deliver services without the intention of earning a return on them

Objectives of public sector accounting

They provide information used to determine and evaluate the performance of the entity in terms of legal, contractual and statutory requirements i.e. the financial statements should be able to indicate whether the transaction of the entity has been carried out legally and with accordance to statutory requirements and contractual terms.

To provide financial information necessary for the preparation of the budget, planning, and to predict the impact of the acquisition and allocation of resources to the entity

To provide information useful for determining and predicting the economic condition and changes therein of the governmental unit

To provide information that is useful for evaluating managerial and entity performance

### **Main users of Public Sector Accounts**

Tax payers/general public; this is to confirm how the tax has been used.

- Investors; usually includes persons giving loans and grants such as donor agencies
- Parliament; they use the information for allocation and control of resources
- Government departments; use this information for performance evaluation

The common user needs are:

Fiscal compliance; this refers to the extent to which the public sector entity has complied with the conditions laid down in its authority to spend. These conditions may be of financial or legal nature.

Management performance; refers to the value for money. It checks whether the resources have been used efficiently, effectively and economically.

Financial viability; refers to the ability of the entity to continue its operations. It checks whether the governmental entity has enough funds or has to continue to rely on continual governmental support.

### **Financial Accounting Techniques**

Different public sector entities adopt different accounting techniques, some which are;

#### **Budgetary Accounting**

This refers to the preparation of the operating accounts in a format of a budget. Under the budgetary accounting, the concept is on forecasted cash flows and operations and this must be limited to the budget estimates. Budgetary accounting aims at:

- Ensuring efficiency of managers
- Communicates the entity goals to employees
- Provides control
- Provides a yardstick or a benchmark for measuring performance of employees

#### **Cash Accounting**

Only cash inflows and outflows are recognized and recorded. It does not recognize any revenue or expenditure that has been received or paid. The resulting final accounts are just summarized cash books.

## **Accrual Accounting**

The accruals concept states that revenues and costs are recognized as they are earned or incurred. Entities in the private sector and some in the public sector follow this system.

## **Commitment Accounting**

This accounting technique recognizes transactions when the entity is committed to them. This means that the transaction is not recognized when cash is received or paid, nor when invoices are received or issued, but at an earlier stage when orders are issued or received. Under this technique, the entity recognizes the issue of an order as a commitment to incur expenditure and the accounts continuously records commitments. The main purpose of commitment accounting is budgetary control rather than financial reporting.

## **Fund Accounting**

A fund is defined as a fiscal and accounting entity with a self balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances and changes therein, which are segregated for the purpose of carrying on specific activities of attaining certain objectives in accordance with special regulations, restrictions or limitations.

In broad terms a single fund accounting entity is somewhat like a business accounting entity. Each business accounting entity has a set of self balancing set of accounts sufficient to capture all the reported attributes for the whole business and all its transactions. Likewise each fund of the government has a self balancing set of accounts sufficient to capture all the reported attributes for the government fund of this type, of the portion of government's activities and resources accounted for in each particular fund. The key difference is that one accounting entity is used to account for all activities and resources of a business, whereas each fund accounting entity is used to account for only a subset of the government's activities and resources.

A general purpose unit of the government has dual nature. Some of its activities are general government in nature, others are business type activities. The general type activities have unique sources of financing such as taxes and grants. The allocation of resources to various purposes and the control of general government activities focus heavily upon the sources and uses of the financial resources. The business type activities function and may be controlled and evaluated much like their business counterparts.

**Government Funds;** these are used to account for the sources, uses and balances of a government's expendable general governmental financial resources and the related current liabilities. In their simplest form, governmental funds are in essence segregations of general government working capital according to the purposes for which it is to be used.

Governmental fund accounting measures the financial position and changes in financial position, sources, uses and balances of net fund financial resources rather than net income.

## **Type of Funds**

### **Governmental Funds**

**The General Fund;** it accounts for all financial resources except those required to be accounted for in another fund.

**Special Revenue Fund;** accounts for the proceeds of specific revenue sources (other than expendable trusts for major capital projects) that are legally restricted to expenditure for specified sources.

**Capital Project Fund;** accounts for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds or trust funds).

**Debt Service Fund/Sinking Fund;** accounts for the accumulation of resources for and the payment of general long- term debt, principal and interest.

**Revolving Fund;** these funds provide financial resources for achieving some specified objectives. The initial appropriation in these funds is made out of the Consolidated Fund. The receipts generated in such funds are automatically used by the respective entities in accordance with the provisions of the act.

### **Proprietary Funds**

**Enterprise Fund;** accounts for:

- a. Operations that are financed and operated in a manner similar to private business entities, where the intent of the governing body is that costs of providing goods and services to the general public on a continuing basis be financed or recovered primarily through user charges or,
- b. Where the governing body has decided that periodic determination of revenues earned, expenses incurred and/or net income is appropriate for capital maintenance, public policy, management control accountability or other purposes.

**Internal Service Funds;** accounts for the financing of goods and services provided by one department or agency to other department or agencies of the governmental unit on a cost reimbursement basis.

### **Fiduciary Funds**

**Trust and Agency Funds;** accounts for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units and/or other funds. These include:

- Expendable trust funds
- Non expendable trust funds
- Pension trust funds
- Agency funds

### **Sources of Government Revenue**

These may be classified as;

- Internal Sources
- External Sources

### **Government Expenditure**

These are the amounts which are spent by the government for different purposes. Government expenditure may be classified as:

- Recurrent Expenditure
- Development Expenditure

**Recurrent Expenditure;** this means revenue expenditure. It is incurred by the government on normal activities. The main expenditure heads of recurrent expenditure are General Public Administration, Defense, Education, Health, Social Welfare, Economic Services, and Other Miscellaneous Services.

**Development Expenditure;** this is expenditure incurred for the establishment of new agricultural and industrial projects, installation of new plant and machinery, construction of various projects, etc. Development expenditure is shown in the capital budget. It is mainly financed from external loans and grants. Internal loans are also another source of financing the development expenditure.

The major steps in Government accounting are as follows:

### **Annual Estimates**

These estimates are prepared by the various ministries and these are submitted to the Treasury. These estimates include revenue and expenditure figures for the next year.

### **Preparation of the Budget**

The budget contains the estimates of government revenue and government expenditure for the current year. The various proposals are debated in Parliament. After approval by Parliament, the budget is implemented.

### **Government Spending**

Specific amounts are appropriated by Parliament to different ministries. The ministries cannot spend amounts in excess of their appropriations without the approval of parliament. In each ministry there is a system of internal controls to ensure that the spending is according to appropriations and for correct purposes.

### **Controller and Auditor General**

The Controller and Auditor General is responsible to audit the accounts of various government departments. The main purpose of this audit is to ensure that all moneys appropriated have been spent for the correct purposes.

### **Public Accounts Committee**

This committee consists of members of parliament. The committee basically deals with the audited report of government accounts presented to it by the Controller and Auditor General.

## **Consolidated Fund**

All revenues or other moneys raised or received by the government are paid in one fund known as the consolidated fund. No money can be withdrawn from the consolidated fund without approval from Parliament. From the consolidated fund, Parliament approves the annual budget of the government. The Appropriation bill is introduced in Parliament after the approval of the budget. The main purpose of this bill is to issue from consolidated fund, the amounts necessary to meet expenses of different ministries.

Therefore the consolidated fund is the main source from which funds are provided to different departments of the government. This fund provides a limit within which the amounts can be spent during a particular year. This fund helps to control the expenditure of the government.

## **Appropriations in Aid**

These are particular classes of revenue which the treasury authorizes the accounting officer to use, in addition to the amounts to be issued from the exchequer, to meet expenditure. The Appropriations in Aid are scheduled in the annual Appropriations Act and any excess over the authorized sum for Appropriations in Aid will be due to the exchequer unless the authorized sum is increased by supplementary appropriation.

## **Paymaster General**

The Paymaster General is the principal paying agent of the government and is considered as a banker of all government departments. The Paymaster General makes the payments on behalf of the government. For this purpose, the Paymaster General arranges with the treasury for the withdrawal of cash from the Exchequer at regular intervals. The amounts withdrawn are transferred from the exchequer account to the Paymaster General account. From these amounts, the payments are made to the respective ministries. The Paymaster General maintains a separate account for each accounting unit or branch so as to show the total receipts and payments in respect of these accounts.

## **Vote Book**

The vote book is used by each fund in the government sector. The vote book is that book in which various accounts are opened. The accounts relate to various expenditure heads and sources of revenue.

In a vote book, the vote number of any particular department or ministry is used. The amounts appropriated to that department for different purposes are recorded into the respective accounts. When expenditure is incurred for any specific purpose, it is recorded into the respective accounts. The total funds allocated for a specific purpose and the amounts spent are compared from time to time. This system helps to ensure that expenditure incurred does not exceed the amounts appropriated for a specific purpose. For various expenses different code numbers are used.

## **Cash Based Accounting**

Traditionally the government has operated on an annual cash basis because appropriations are voted by parliament on proposed expenditures for the forthcoming fiscal year. The Minister for Finance



presents these proposals – the Budget Estimates – to parliament for discussion and approval. The proposed expenditures in the Budget Estimates include both the operating and capital expenditures within that year.

Under cash-based accounting, cash receipts, payments and balances are recorded at the time of the cash transactions, irrespective of when the related goods and services are produced or received. Cash based accounting does not recognize noncurrent assets in the financial statements. All expenditures are written off as expenses during the year they are incurred. Cash based accounting is not without advantages. These include:

1. It is a widely used and traditionally accepted measure of government's short term impact on the economy
2. It is considered tangible, easily prepared and tracked
3. For a number of government transactions, such as grants and salaries, there is not likely to be significant difference between cash and accrual

Cash-based accounting has its shortcomings too, which are cited as major reasons for many governments now moving to full accrual accounting. It has been argued that the cash based accounting provides incomplete or misleading information and perverse incentives:

1. It fails to recognize future costs associated with current government activities
2. It does not properly align costs with the provision of goods and services
3. Cash based accounting systems does not ensure sustainability of government activities as it is:
  - a. More concerned with the current rather than focusing on the future or long term
  - b. The financial statements do not provide details about the assets held by the government and its agencies, the liabilities incurred by it are not clear and it is difficult to gauge the total picture of the government's performance
4. The budgetary process that goes with it is not based on outputs and outcomes. There is no relationship between inputs, outputs and outcomes:
  - a. The budgetary process is mainly focused on inputs which encourages which encourages lavish spending towards the end of the financial year, sometimes merely to avoid surrendering the unspent balance to the treasury
  - b. Departments have no justification whatsoever for their budget allocation except that the amount requested is similar or increased from last year's allocations. Consequently, there is no incentive for managers to justify what they have spent, leading to government inefficiencies

These shortcomings provide a strong case for moving to accrual accounting

Accrual based accounting recognizes transactions in the period when the activity generating the revenue or consuming the resources occurs, regardless of when the associated cash is actually paid or

received. All working capital items (in particular loans, accounts receivable) are carefully adjusted at the end of each reporting period, to match the incurring of liabilities and the consumption of assets.

Another important feature of accrual accounting is its treatment of capital assets. The cost of a capital asset is not added to the operating cost in the year it is acquired. Instead, the capital assets are depreciated over their useful lives such that only the annual amount of depreciation is added to operating costs as the cost allocation for that year.

This treatment of capital assets improves the alignment of costs with consumption of assets and more importantly, assets do not appear to be free goods after initial purchase.

There are compelling advantages for adopting the accrual based accounting, including

- Enhancing accountability
- Encouraging use of performance based measures in the government budgeting
- Ensuring fair distribution of government funds amongst competing interests

### **Enhancing Financial Information and Accountability**

The ultimate benefit of adopting this change of accounting philosophy is to make governments more accountable to the taxpayer/public. The traditional cash based accounting focuses on control over and accountability for cash spending. But the vision of public sector accountability has now changed and there is increased need for robust information including financial information, on which to assess performance and accountability.

Accrual accounting is a tool for decision makers that can help governments make better decisions and improve the allocation of scarce government resources. It provides more complete information on costs for use in analysis and decision making. It reports on all assets – both current and capital – ensuring the entity know which resources are available for future use. It also reports on liabilities to indicate potential demand on future resources to meet an entity's obligations.

### **Use of Performance Based Measures in Government Budgeting**

The most important benefit of accrual accounting is the enhancement of performance based measures through the adoption of Accrual Output Based Budgeting (Accrual OBB). It makes an ideal means of shifting the emphasis of the budgetary process away from cash inputs, towards outputs and outcomes, in the hope that this will result in greater management efficiencies and hence better outcomes for the governments and the citizens.

The budget shift to outcomes will mean focus on outputs, prices, agreements, flexibility in suppliers and performance benchmarking. The key benefits of Accrual OBB include:

1. Funding departments/ministries for outputs (services and products) rather than inputs (resources consumed in their production)
2. Improving the government's management of its funding of services (purchaser interest) and its resource base (ownership interest)

3. Improving the quality of performance information available to the government and departmental managers for strategic planning, resource allocation and operation control
4. Providing a sound basis for internal resource allocation

### **Ensuring Fair Distribution of Government Funds among Competing Interests**

Accrual based budgeting will ensure that government funds are distributed fairly among competing interests. It is a process where all the actors set criteria and engage in discourse as a means of resolving issues of allocating scarce resources.

This is possible with the provision of full information necessary to manage the financial position of the government ministries and other agencies. Information on assets and liabilities, income earned or expenses incurred during the financial year but not resulting in a cash transaction in that year, cash inflows and outflows, and consistent and streamlined reporting arrangements will ensure that there is equitable distribution of resources.

### **Challenges in implementing the accrual based accounting**

The adoption of accrual accounting by any government is a challenging process. It is not just a technical process but a change in philosophy based on a broader view of public expenditure management. Some of the challenges for the government include:

- Collection of information on capital assets, and properly identifying them
- Building capacity within the public service to ensure that those using the system have sound knowledge of accrual accounting principles. This can be achieved through or extensive training.
- Making entity changes to ensure wherever possible that the purchasing, asset management and accounting functions are integrated under the new system

Full accrual accounting should be the way forward for the government to ensure public assets are utilized properly in providing intended services to taxpayers. The adoption of full accrual accounting will:

- Improve access to reliable financial information and internal control systems for decision makers that can help the government to make better decisions and improve the allocation of scarce government resources
- Provide a more comprehensive picture of the government entity's financial condition by reporting on all assets so that governments know which resources are available for future use and liabilities to indicate the potential demand on future resources to meet obligations
- Promote consistent and independently verified reporting practices and increase the likelihood of a cultural change in government spending.

### **Purpose of the International Public Sector Accounting Standards Board**

The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is “to serve the public interest. IFAC will continue to strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession’s expertise is most relevant.” In pursuing this mission, the IFAC Board has established the International Public Sector Accounting Standards Board (IPSASB) to develop high-quality accounting standards for use by public sector entities around the world in the preparation of general purpose financial statements.

In this regard:

- The term public sector refers to national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards, commissions and enterprises); and
- General purpose financial statements refers to financial statements issued for users that are unable to demand financial information to meet their specific information needs.

The IFAC Board has determined that designation of the IPSASB as the responsible body for the development of such standards, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The IPSASB functions as an independent standard-setting body under the auspices of IFAC. It achieves its objectives by:

- Issuing International Public Sector Accounting Standards (IPSASs);
- Promoting their acceptance and the international convergence to these standards; and
- Publishing other documents which provide guidance on issues and experiences in financial reporting in the public sector.

### **Nature, Scope and Authority of Pronouncements**

The IPSASB has been given the authority, on behalf of the Board of IFAC, to issue International Public Sector Accounting Standards (IPSASs) as the standards to be applied by members of the profession in the preparation of general purpose financial statements of public sector entities. The IPSASB adopts a “due process” for the development of IPSASs which provides all interested parties with the opportunity to provide input to the standards development process.

- Studies to provide advice on financial reporting issues in the public sector. They are based on study of the best practices and most effective methods for dealing with the issues being addressed.
- Occasional Papers and Research Reports to provide information that contributes to the body of knowledge about public sector financial reporting issues and developments. They are aimed at providing new information or fresh insights and generally result from research activities such as literature searches, questionnaire surveys, interviews, experiments, case studies and analysis.

In developing its standards, the IPSASB seeks input from its Consultative Group and considers and makes use of pronouncements issued by:

- The International Accounting Standards Board (IASB) to the extent they are applicable to the public sector;
- National standard-setters, regulatory authorities and other authoritative bodies;
- Professional accounting bodies; and
- Other organizations interested in financial reporting in the public sector.

The IPSASB will ensure that its pronouncements are consistent with those of the IASB to the extent those pronouncements are applicable and appropriate to the public sector.

The objective of the IPSASB Consultative Group is to provide a forum in which the IPSASB can consult with representatives of different groups of constituents to obtain input and feedback on its work program, project priorities, major technical issues, due process and activities in general. The Consultative Group does not vote on International Public Sector Accounting Standards or other documents issued by the IPSASB.

The IPSASB cooperates with national standard-setters in preparing and issuing Standards to the extent possible, with a view to sharing resources, minimizing duplication of effort and reaching consensus and convergence in standards at an early stage in their development. It also promotes the endorsement of IPSASs by national standard-setters and other authoritative bodies and encourages debate with users, including elected and appointed representatives; Treasuries, Ministries of Finance and similar authoritative bodies; and practitioners throughout the world to identify user needs for new standards and guidance.

### **Public Sector Financial Reporting**

IFAC's International Public Sector Accounting Standards Board focuses on the development of high quality financial reporting standards for use by public sector entities around the world. It has developed a comprehensive body of IPSASs setting out the requirements for financial reporting by governments and other public sector organizations. The IPSASs represent international best practice in financial reporting by public sector entities. In many jurisdictions, the application of the requirements of IPSASs will enhance the accountability and transparency of the financial reports prepared by governments and their agencies.

### **Objectives of the IPSASB**

The objectives of the IPSASB are to serve the public interest by developing high quality public sector financial reporting standards and by facilitating the convergence of international and national standards,

thereby enhancing the quality and uniformity of financial reporting throughout the world. The IPSASB achieves its objectives by:

- Issuing International Public Sector Accounting Standards (IPSASs);
- Promoting their acceptance and the international convergence to these standards; and
- Publishing other documents which provide guidance on issues and experiences in financial reporting in the public sector.

The IPSASs are the authoritative requirements established by the IPSASB. Apart from developing IPSASs, the IPSASB issues other non-authoritative publications including studies, research reports and occasional papers that deal with particular public sector financial reporting issues.

## **Scope and Authority of International Public Sector Accounting Standards**

### **Scope of the Standards**

The IPSASB develops IPSASs which apply to the accrual basis of accounting and IPSASs which apply to the cash basis of accounting. IPSASs set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events in general purpose financial statements.

The IPSASs are designed to apply to the general purpose financial statements of all public sector entities. Public sector entities include national governments, regional governments (for example, state, provincial, territorial), local governments (for example, city, town) and their component entities (for example, departments, agencies, boards, commissions), unless otherwise stated.

The IPSASB has adopted the policy that all paragraphs in IPSASs shall have equal authority, and that the authority of a particular provision shall be determined by the language used. To avoid any unintended consequences the IPSASB has determined to apply this policy prospectively as it reviews and reissues previously issued IPSASs.

### **General Purpose Financial Statements**

Financial statements issued for users that are unable to demand financial information to meet their specific information needs are general purpose financial statements. Examples of such users are citizens, voters, their representatives and other members of the public. The term “financial statements” used in this preface and in the standards covers all statements and explanatory material which are identified as being part of the general purpose financial statements.

When the accrual basis of accounting underlies the preparation of the financial statements, the financial statements will include the statement of financial position, the statement of financial performance, the cash flow statement and the statement of changes in net assets/equity. When the cash basis of accounting underlies the preparation of the financial statements, the primary financial statement is the statement of cash receipts and payments.

In addition to preparing general purpose financial statements, an entity may prepare financial statements for other parties (such as governing bodies, the legislature and other parties who perform an oversight function) who can demand financial statements tailored to meet their specific information needs. Such statements are referred to as special purpose financial statements. The IPSASB encourages the use of IPSASs in the preparation of special purpose financial statements where appropriate. **IPSASs for the Accrual and Cash Bases** The IPSASB develops accrual IPSASs that:

- Are converged with International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) by adapting them to a public sector context when appropriate. In undertaking that process, the IPSASB attempts, wherever possible, to maintain the accounting treatment and original text of the IFRSs unless there is a significant public sector issue which warrants a departure; and

- Deals with public sector financial reporting issues that are either not comprehensively dealt with in existing IFRSs or for which IFRSs have not been developed by the IASB.

As many accrual based IPSASs are based on IFRSs, the IASB's "Framework for the Preparation and Presentation of Financial Statements" is a relevant reference for users of IPSASs.

The IPSASB has also issued a comprehensive Cash Basis IPSAS that includes mandatory and encouraged disclosures sections.

### **Moving from the Cash Basis to the Accrual Basis**

The Cash Basis IPSAS encourages an entity to voluntarily disclose accrual based information, although its core financial statements will nonetheless be prepared under the cash basis of accounting. An entity in the process of moving from cash accounting to accrual accounting may wish to include particular accrual based disclosures during this process. The status (for example, audited or unaudited) and location of additional information (for example, in the notes to the financial statements or in a separate supplementary section of the financial report) will depend on the characteristics of the information (for example, reliability and completeness) and any legislation or regulations governing financial reporting within a jurisdiction.

The IPSASB also attempts to facilitate compliance with accrual based IPSASs through the use of transitional provisions in certain standards. Where transitional provisions exist, they may allow an entity additional time to meet the full requirements of a specific accrual based IPSAS or provide relief from certain requirements when initially applying an IPSAS. An entity may at any time elect to adopt the accrual basis of accounting in accordance with IPSASs. At this point, the entity shall apply all the accrual based IPSASs and could choose to apply any transitional provisions in an individual accrual based IPSAS.

Having decided to adopt accrual accounting in accordance with IPSASs, the transitional provisions would govern the length of time available to make the transition. On the expiry of the transitional provisions, the entity shall report in full in accordance with all accrual based IPSASs.

International Public Sector Accounting Standard (IPSAS) 1, "Presentation of Financial Statements" includes the following requirement:

An entity whose financial statements comply with International Public Sector Accounting Standards should disclose that fact.

Financial statements should not be described as complying with International Public Sector Accounting Standards unless they comply with all the requirements of each applicable International Public Sector Accounting Standard.

### **Authority of International Public Sector Accounting Standards**

Within each jurisdiction, regulations may govern the issue of general purpose financial statements by public sector entities. These regulations may be in the form of statutory reporting requirements, financial reporting directives and instructions, and/or accounting standards promulgated by governments, regulatory bodies and/or professional accounting bodies in the jurisdiction concerned.

The IPSASB believes that the adoption of IPSASs, together with disclosure of compliance with them will lead to a significant improvement in the quality of general purpose financial reporting by public sector



entities. This, in turn, is likely to lead to better informed assessments of the resource allocation decisions made by governments, thereby increasing transparency and accountability.

The IPSASB acknowledges the right of governments and national standard setters to establish accounting standards and guidelines for financial reporting in their jurisdictions. Some sovereign governments and national standard setters have already developed accounting standards that apply to governments and public sector entities within their jurisdiction. IPSASs may assist such standard-setters in the development of new standards or in the revision of existing standards in order to contribute to greater comparability. IPSASs are likely to be of considerable use to jurisdictions that have not yet developed accounting standards for governments and public sector entities. The IPSASB strongly encourages the adoption of IPSASs and the harmonization of national requirements with IPSASs.

Standing alone, neither the IPSASB nor the accounting profession has the power to require compliance with IPSASs. The success of the IPSASB's efforts is dependent upon the recognition and support for its work from many different interested groups acting within the limits of their own jurisdiction.

### **Introduction to the International Public Sector Accounting Standards**

The International Federation of Accountants' International Public Sector Accounting Standards Board (IPSASB) develops accounting standards for public sector entities referred to as International Public Sector Accounting Standards (IPSASs). The IPSASB recognizes the significant benefits of achieving consistent and comparable financial information across jurisdictions and it believes that the IPSASs will play a key role in enabling these benefits to be realized. The IPSASB strongly encourages governments and national standard-setters to engage in the development of its Standards by commenting on the proposals set out in its Exposure Drafts.

The IPSASB issues IPSASs dealing with financial reporting under the cash basis of accounting and the accrual basis of accounting. The accrual basis IPSASs are based on the International Financial Reporting Standards (IFRSs), issued by the International Accounting Standards Board (IASB) where the requirements of those Standards are applicable to the public sector. They also deal with public sector specific financial reporting issues that are not dealt with in IFRSs.

The adoption of IPSASs by governments will improve both the quality and comparability of financial information reported by public sector entities around the world. The IPSASB recognizes the right of governments and national standard setters to establish accounting standards and guidelines for financial reporting in their jurisdictions. The IPSASB encourages the adoption of IPSASs and the harmonization of national requirements with IPSASs. Financial statements should be described as complying with IPSASs only if they comply with all the requirements of each applicable IPSAS.

### **STATUTORY FINANCIAL REPORTING FOR LOCAL AUTHORITIES**

Every Local Authority (City, Municipal, Town and County Council) should prepare and issue an annual financial report that can easily be read and understood. The basic sources of guidance on the



requirements of the issuance of this annual financial report are the International Public Sector Accounting Standards (IPSAS) and the provisions of the Local Government Act Cap 265.

This template sets out the minimum disclosures that the financial statements of Local Authorities, irrespective of the nature and size, need to comply with. In addition to the template, there are several other documents that the Chief Officers, Treasurers and other staff in the Local Authorities are expected to be familiar with to adequately prepare annual financial reports. These include:

- Financial Management Regulations, 2007
- Kenya National Audit Act, 2003
- Treasurers Manual, 2006
- Budget Guidelines and Procedures

In complying with the provisions of this template, Treasurers will be required to rely on the accounting codes as provided for in the chart of accounts. The accounting codes are standardized in line with the provisions of the Local Government budgeting system. The codes as provided in the budget with cost centers/departments form the basis under which payments incurred are debited against in the financial statements. Therefore, the use of codified accounting systems is to enable Local Authorities to have reliable comparison for performance between actual and budgeted provision by appropriating expenses against the right codes. In this process the Treasurer is to ensure that any major deviation from the budgeted provisions are be disclosed in the accounts and included in the Treasurer’s report with explanations.

The Templates as set out in the following pages provide the framework for financial reporting and should be used by all councils and they are designed to cater for all foreseeable eventualities.

Under these circumstances it is unlikely that any LA will need to use all the items shown in the templates, and will need to replace some of the examples given to fit their particular circumstances.

**Authority**

This template has been issued under the authority of Section 229 (2) of the Local Government Act, Cap 265 which stipulates that the “annual statement of account shall be prepared in such form and shall contain such particulars as the Minister may by rule prescribe.”

**RESPONSIBILITY STATEMENT**  
**NAME OF LOCAL AUTHORITY**  
**ANNUAL FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED**  
**30TH JUNE 20XX**

We are responsible for the preparation of these annual financial statements, which are set out on pages x to x, in accordance with the Local Government Act Cap. 265, the Local Authority Financial Management Regulations 2007 section C3, and the Public Audit Act 2003 sections 21 and 22 which we have signed on behalf of the

..... Council of .....

Name  
**Treasurer**  
Date:.....

Name  
**Clerk**  
Date:.....

**CONTENTS OF THE ANNUAL FINANCIAL REPORT**

1. Treasurers Report
2. The purpose of Annual Financial Statements
3. Controller and Auditors General Report
4. Consolidated Statement of Financial Performance
5. Council Statement of Financial Performance
6. Consolidated Statement of Financial Position
7. Council Statement of Financial Position
8. Consolidated Cash flow Statement
9. Council Cash flow Statement
10. Consolidated Changes in Net Assets/Capital and Reserves
11. Council Changes in Net Assets/Capital and Reserves
12. Summary Fund Statement of Financial Performance
13. Summary Fund Statement of Financial Position
14. Accounting Policies and Notes to Financial Statements

#### TREASURER'S REPORT

The Treasurer's Report contains:

- An overview of general financial performance for the year compared to the previous year and the budget, as well as general factors affecting the financial performance.
- Summary of operating results at corporate and service levels.
- A summary of implementation of capital projects budgeted for the year.

#### Corporate Results

	Actual 20X7 Kes.	Actual 20X8 Kes.	Variance 20X7/8 Kes.	Budget 20X8 Kes.	Variance 20X8 Kes.
Operating Revenue for the year	X	X	X	X	X
Operating Expenses for the year	X	X	X	X	X
Operating Surplus (Deficit) for the year	X	X	X	X	X

Explanatory comments on:

- Decrease in operating revenue if any
- Increase/(Decrease) in operating expenses if material
- Deficit for the year if any
- Controlled entities results

#### Fund or Service operating results summary

A summary of revenue and expenditure, by department, by service delivered and by fund.

#### Capital Expenditure

Capital expenditure on fixed assets during the year should be disclosed showing:

Actual expenditure for the year and explanation for substantial variances

List of major projects undertaken, completed in the year and work in progress carried forward, including levels of physical completion.

**Other possible disclosures should include Major items and issues**

- *External Loans*
- Investments
- Short term investments and cash
- Funds and reserves
- Post balance of financial position events
- Changes in financial reporting format
- General information

**Contingent Liabilities**

*There is a contingent liability of Kes .XXX arising from the following:*

**Expression of appreciation**

“I am grateful to H.W. the Mayor, the Chair and members of the finance committee, councilors, the Clerk, and Departmental Heads for the support they have given to me and to the staff of my department during the year. I would also like to thank the officers from the Ministry of Local Government and the Kenya National Audit Office for their advice and guidance”.

Signed:.....

**TREASURER**

Date:.....

**THE PURPOSE OF THE ANNUAL FINANCIAL STATEMENTS**

**Purpose of the Annual Financial Statements:**

- To inform stakeholders on the financial performance of their Local Authority.
- To ensure consistency amongst all Local Authorities in the presentation of annual financial statements.
- To ensure compliance with the law, Government regulations and other conditionalities set out by other organizations and institutions.
- To provide guidance on the application of Standards of Generally Accepted Accounting Principles (GAAP), International Accounting Standards (IAS) and the International Public Sector Accounting Standards (IPSAS).

**Objective of the Annual Financial Statements:**

- To demonstrate their accountability in the use of resources by issuing financial statements. As elected representatives of the public and through powers provided by the Local Government Act Cap.265, Councils have the authority and responsibility for public financial affairs and resources management. Therefore Local Authorities are authorized to levy rates, taxes and other incomes sufficient to finance the services required by the community. .
- To assist users in assessing the level of services that can be provided by the Local Authority and its ability to meet its obligations.
- To assist users in evaluating the operating results of the Local Authority for the year.
- To show how cash and other liquid resources were obtained and spent
- To provide information useful in assessing whether financial resources were administered in accordance with the limits of budget allocation.

**CONTROLLER AND AUDITOR GENERAL’S REPORT**

**CONSOLIDATED STATEMENT OF FINANCIAL PERFORMANCE**  
**NAME OF THE COUNCIL**  
**CONSOLIDATED STATEMENT OF FINANCIAL PERFORMANCE**  
**FOR THE YEAR ENDED 30TH JUNE, 20X9**

		<b>COUNCIL</b>	<b>ABC CO.</b>	<b>TOTAL</b>	<b>TOTAL</b>
		<b>20X9</b>	<b>20X9</b>	<b>20X9</b>	<b>20X8</b>
		<b>Kes.000</b>	<b>Kes.000</b>	<b>Kes.000</b>	<b>Kes.000</b>
<b>Operating Revenue</b>	<b>NOTE</b>				
<b>Own Source Revenues</b>					
Property Rates		X	O	X	X
Contribution in Lieu of Rates		X	O	X	X
Cess and other levies		X	O	X	X
Single Business Permit		X	O	X	X
Licenses		X	O	X	X
Market Fees		X	O	X	X
House Rent		X	X	X	X
Other Fees and Charges		X	O	X	X
Lease Income		X	O	X	X
Miscellaneous Revenue		X	O	X	X
<b>Total Own Source Revenues</b>		O	X	X	X
<b>Central Government and Other Transfers</b>		O	X	X	X
LATF		X	O	X	X
Road Maintenance Levy Fund		X	X	X	X
Other Government Recurrent Grants		X	X	X	X
<b>Total Central Government and Other Revenues</b>		X	X	X	X
<b>Total Income</b>		<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>
<b>Operating Expenses</b>					
Employee costs		X	X	X	X
Operating costs		X	X	X	X
Repairs & Maintenance costs		X	X	X	X
Depreciation & Amortization		X	X	X	X
Total Operating Expenses		X	X	X	X
<b>Net Surplus/(Deficit) from Operating Activities</b>		<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Bad Debts Provision		X	X	X	X
Interest earned		(X)	(X)	(X)	(X)
Interest paid		X	X	X	X
Gain/ (Loss) on disposal of Fixed Assets		(X)	(X)	(X)	(X)
<b>Total Non-Operating Revenue (Expenses)</b>		<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Net Surplus/ (Deficit) From Ordinary Activities		X	X	X	X
Share of Surplus in Associate		X	O	X	X
Net Surplus/ (Deficit) before Extraordinary					

Items	X	X	X	X
Extraordinary Items	X	X	X	X
Net Surplus/(Deficit) for the Year	X	X	X	X
Provision for Renewals Fund	X	O	X	X
Net Surplus / (Deficit) for the year carried to the				
Consolidated General Rate Reserve Fund	X	X	X	X
<b>Consolidated General Rate Reserve Fund 20X9</b>		<b>20X8</b>		
	<b>Kes.</b>	<b>Kes.</b>		
Consolidated surplus for the year	X	X		
Balance b/f	X	X		
Prior Year and other adjustments	<u>X</u>	<u>X</u>		
<b>Balance c/f</b>	<b><u>X</u></b>			

X

### COUNCIL STATEMENT OF FINANCIAL PERFORMANCE

#### NAME OF THE COUNCIL

#### STATEMENT OF FINANCIAL PERFORMANCE FOR THE YEAR ENDED 30TH JUNE, 20X5

	20X5 Kes.000	20X4 Kes.000
<b>OPERATING REVENUE</b>		
<b>Own Source Revenues</b>		
Property Rates	X	X
Contribution in Lieu of Rates	X	X
Cess and other levies	X	X
Single Business Permit	X	X
Licenses	X	X
Market Fees	X	X
House Rent	X	X
Other Fees and Charges	X	X
Lease Income	X	X
Miscellaneous Revenue	X	X
<b>Total Own Source Revenues</b>	<b><u>X</u></b>	<b><u>X</u></b>
<b>Central Government and Other Transfers</b>		
LATF	X	X
Road Maintenance Levy Fund	X	X
Other Government Recurrent Grants	X	X
<b>Total Central Government and Other Revenues</b>	<b>X</b>	<b>X</b>
<b>Total Operating Revenue</b>	<b><u>X</u></b>	<b>X</b>
<b>OPERATING EXPENSES</b>		
Employee costs	X	X
Operating costs	X	X
Repairs & Maintenance costs	X	X
Depreciation & Amortization	X	X

Total Operating Expenses	X	X
Net Surplus/(Deficit) from Operating Activities	X	X
Bad Debts Provision	X	X
Interest earned	(X)	(X)
Interest paid	X	X
(Gain)/Loss on Disposal of Fixed Assets	(X)	(X)
<b>Total Non-Operating Revenue (Expenses)</b>	X	X
Net Surplus/ (Deficit) before Extraordinary Items	X	X
Extraordinary Items	X	X
Net Surplus/ (Deficit) for the Year	X	X
Provision for Renewals Fund	X	X
Net Surplus/(Deficit) Carried to General Rate Reserve Fund	X	X

<b>General Rate Reserve Fund</b>	20X5	20X4
Kes		X
X		
Balance brought forward	X	X
Prior year and other adjustment	X	X
Surplus/Deficit carried forward	X	X