

COURSE NOTES FOR

FUNDAMENTALS OF ACCOUNTING 2

FOR

MICROFINANCE INSTITUTIONS



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Foreword

These course notes have been prepared in addition to the course notes in fundamentals of accounting one that were developed by Friends' Consult for FSDU.

The objective of these course notes is to link FAP 1 to FAP 2 and give detailed exercises and explanations for FAP 2. In order to understand the concepts of FAP 2, we introduced Chapter one – Overview of FAP one that was aimed at refreshing minds of the participants/ trainees before introducing concepts of FAP 2.

Generally, almost all trainees for FAP 2 must have attended FAP 1. However, we noted from our training experience that in order to understand concepts of preparing financial statements for MFIs we needed to use simpler examples from trading organizations, then at a later stage introduce MFI financial statements

We included all the necessary/basic accounting items necessary for preparation of MFI financial statements. We used simple illustration in all cases in order to bring out the accounting issues easily

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CHAPTER ONE

1.0 OVERVIEW OF FUNDAMENTALS OF ACCOUNTING ONE

1.1 Definition of Accounting

There are many definitions of accounting as was discussed in FAP 1, i.e., according to the American Institute of Certified Public Accountants (AICPA), accounting is the “art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are in part at least, of a financial character, and interpreting the results thereof”.

Another authoritative definition of accounting is given by the American Accounting Association, (AAA), which defines accounting as “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information”.

3 key words in the definition are :(these were explained in detail in FAP 1)

- Measurement
- Communicating information
- Economic information

1.2 Types of Accounting

As discussed in FAP 1, there are various types of accounting, i.e.

Financial Accounting

Financial Accounting deals with historical records such as revenues that have either accrued or have been realized and expenses that have either been incurred or the obligation to incur them have been entered.

Cost Accounting

Cost accounting is a formal mechanism by means of which costs of products and services are ascertained and controlled. It is that branch of accounting dealing with classification, recording, allocation, summarization and reporting of current and prospective costs.

Management Accounting

Management accounting is that branch of accounting that provides information specifically to management for decision-making. The major difference between financial accounting and management accounting is that financial accounting is prepared for the benefit of many other groups apart from management; whereas management accounting is prepared primarily for the benefit of management.

Public Accounting

The Certified Public Accountants offer a variety of services such as auditing work, tax consultancy services, management advisory services like designing and installing accounting systems and budgetary procedures, etc to the public just like other professionals like lawyers, engineers, etc do. They belong to a governing body that regulates standards of performance.

Government Accounting

Government accounting emphasises recording and accountability of expenditures from exchequer account. It also emphasises budget discipline by spending according to amounts voted. The types of accounts to be maintained and reports to be prepared are spelt out in the financial regulations or accounting manuals. In Uganda, central government accountants have to refer to local government financial regulations.

Social responsibility Accounting

This is entirely a new phase in accounting development. It widens the scope of accounting by considering social effects of business activities as well as their economic effects.

1.3 Importance of accounting

- Provide information for decision making
- Helps in planning e.g. Budgets
- Helps in evaluation of the organisation
- Accounts make tax assessments easy
- May be a regulatory requirement
- Eases monitoring of debtors and creditors

Importance of accounting to MFIs

MFI is like any other organisation. Accounting helps MFIs in

- Decision making
- Evaluation of performance
- Tax assessment
- Monitoring debtors and creditors
- Regulatory in tier 4 MFIs and Saccos

1.4 USERS / INTERESTED PARTIES IN ACCOUNTING INFORMATION

Accounting information is very necessary to various parties if decisions are to be made accurately and rationally. These parties are broadly divided into 2 groups namely; (Refer to detailed explanation in FAP1)

1. Internal Users

a) Management

An organization's management team may comprise directors, senior executives, top managers etc, who run the organisation on behalf of the owners (shareholders). Accounting reports also indicate to management whether they are making profits or losses and whether they are in the right business.

b) Employee and trade unions

They need accounting for two major reasons;

- to support their agitation for salary and wage increments using accounting information (The profit and loss account)
- helps them assess and judge their job security

2. External users

a) Share holders (investors)

Existing shareholders or investors are interested in knowing how their business is performing i.e. whether the organization is well managed, expanding and whether they receive dividends.

b) Creditors are individuals and financial institutions that extend credit to their customers or clients.

Trade creditors (suppliers) are interested in getting paid for goods and services that they extend on credit while financial institutions like banks that extend loans to customers are interested in making sure that the loans are serviced and do not become non performing.

c) Government is another user of accounting information.

Though tax authorities, like the Uganda Revenue Authority, government collects tax revenue from companies and individuals for financing public expenditures. Tax authorities are interested in companies filing income tax returns for tax assessments.

d) Competitors

Competitors are interested in accounting information of firms in the industry with that so as to judge whether they are doing badly or fairly in comparison with other players in the same business. Competitors also require accounting information for market intelligence purpose to develop competitive strategies for beating other participants in the market.

e) The General public

The general public includes individuals and organization, which ensure that businesses make their profits in a socially acceptable manner without damage to the environment and consumers health.

1.5. Accounting policies/Concepts

Accounting principle

Accounting principles are basic ground rules, which must be followed when preparing financial accounts

Accounting policy

Accounting policies are defined as “the specific accounting bases selected and consistently followed by a business enterprise as being, in the opinion of management, appropriate to its circumstances and best suited to present fairly its results and financial position.”

Accounting standard

Accounting standards are guideline statements or rules issued by professional accounting bodies governing accounting practice in areas or countries under their jurisdiction relating to how accounts should be prepared and presented.

Accounting standards override accounting policies chosen by management and in case of conflict between the two, accounting standards prevail.

Accounting base

Accounting Bases are accounting treatments. These are methods developed for applying fundamental concepts to financial transactions and items, for the purpose of financial accounts, and in particular;

- For determining the accounting periods in which revenue and costs should be recognized in the profit and loss account and;
- For determining the amounts at which material items should be stated in the balance sheet.

Accounting policies/Concepts

Financial Accounting Concepts represent the broad basic assumptions underlying the preparation of periodic financial accounts of organizations. These assumptions are also known as the Generally Accepted Accounting Principles or Conventions. They include the following:

Accounting principles

Detailed explanations of accounting principles were made in FAP 1 but due to the importance of these principles in accounting, they were recapped. There are two categories of accounting principles

- Fundamental Accounting principles
- Other Accounting principles

Fundamental Accounting principles/concepts

There are two fundamental accounting principles, i.e.

Going Concern concept

The going concern concept is the assumption that the organization or business for which the accounts are kept will exist for the foreseeable future.

Accrual concept

The accruals concept supports the going concern concept by providing that expenses should be deducted from the revenues with which they are associated.

Other Accounting Concepts

Business Entity Concept

Accountants treat business as distinct from those who own it.

Money Measurement Concept

Accounting records only those transactions, which are expressed, in monetary terms, though quantitative records are also kept.

Prudence Concept

Prudence means cautious or careful. The concept provides that if a loss is expected out of transactions that have already been entered into such loss should be provided for even if not yet realized.

Consistency Concept

The consistency concept ensures that results are comparable between periods by requiring the consistent application of methods from one accounting period to another..

Dual Aspect Concept

In financial accounting, each transaction has two aspects. For example if a business has acquired an asset, it must have resulted in one of the following:

- Some other asset has been given up; or
- the obligation to pay for it has arisen;
- there has been, leading to an increase in the amount that the business owes the proprietor, or
- the proprietor has contributed money for the acquisition of the asset. The reverse is also true.

Realization concept.

This concept demands that accountants recognize income as earned only when a sale has been made and the customer has accepted the goods or services have been offered and enjoyed by the customers or where value has been created by a transaction and legal rights and obligations have resulted.

Matching concept.

This concept requires accurate matching of expenses against incomes by writing off only those costs or expenses that were incurred in the generating specific income for the period ended.

Materiality concept

It requires recognition of only material items and excluding immaterial or trivial items or matters. Information is immaterial if it is able to influence the decision.

Substance over form

It states that transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

Relevance concept

Accounting to this concept the overall message that the accounts are trying to relay may be obscured if too much information is presented. Accounting statements should contain only information that complies strictly with the specific requirements of the user. This concept is at times combined with materiality concept.

1.6 Accounting Equation

The whole of financial accounting is based upon a very simple idea. The accounting equation – if a firm is to be set up and start trading, then it needs resources. Assuming that it is the owner of the business who has supplied all of the resources: This can be shown as **Resources in the business = Resources supplied by the owner**. The amount of resources invested and claimed by the owners of the business is called Capital. The actual economic resources that are then used in the business to aid in the income generation process or facilitate operation are called assets. This means that when the owner supplies all the resources the equation above can be shown as: Assets = Capital.

It is usual that people other than the owner supply assets to a business. The amounts owing to these people are known as liabilities. Therefore the equation can be modified as follows:

$$\text{Assets} = \text{Capital} + \text{Liabilities.}$$

Each side of the equation will always have the same totals because it is the same thing.

$$\begin{array}{ccc} \text{Resources: What are they?} & = & \text{Resources: who supplied them?} \\ \text{(Assets)} & & \text{(Capital + Liabilities)} \end{array}$$

Comprehensive illustrations on the accounting equation were demonstrated in FAP 1.

1.7 Double Entry book keeping

Meaning of Double entry

In financial accounting, every transaction is recorded twice. Each transaction is understood to have two sides. Logically, there is a side that receives and another side that gives. For example, if a business has acquired an asset, it must result in one of the following:

- i. Some other asset has been given up; or
- ii. The obligation to pay for the asset has arisen; or
- iii. There has been a profit, leading to an increase in the amount that the business owes the proprietor;
or
- iv. The proprietor has contributed money for the acquisition of the asset. The reserve is also true.

Key Rules of Double Entry

The three basic rules about recording transactions in a double entry system are:

- (i) Debit the receiver and credit the giver;
- (ii) Debit what comes in and credit what goes out
- (iii) Debit all expenses (and losses) and credit all incomes (and gains)

Double entry system is accomplished by the use of ledger accounts. A ledger account has two sides namely debit and credit.

To summarize:

| | | | |
|-----------|-----------------------|-----------|--|
| Debit | Assets | Credit | |
| Increases | | Decreases | |
| | | | |
| Debit | Expenses or Losses | Credit | |
| Increases | | Decreases | |
| | | | |
| Debit | Liabilities & Capital | Credit | |
| Decreases | | Increases | |
| | | | |
| Debit | Incomes or Gains | Credit | |
| Decreases | | Increases | |
| | | | |

The nature of debit and Credit

A debit denotes:

- (a) in the case of a person, that he has received some benefit against which he has already rendered some service or will render service in future. When a person becomes liable to do something in favour of the organization the fact is recorded by debiting that person’s account;
- (b) in the case of goods or properties, that the stock and value of such goods or properties has increased; and
- (c) in the case of expenses, like salary or rent, that the firm has enjoyed some benefit or lost money.

ii. A credit denotes:

- (a) in the case of a person, that some benefit has been received from him; entitling him to claim from the firm a return benefit in the form of cash or goods or service. When a person becomes entitled to money or money’s worth for any reason, the fact is recorded by crediting him;

- (b) in the case of goods or properties, that the stock and value of such goods or properties has diminished; and
- (c) in the case of other accounts, i.e. commission, that the firm has made a gain.

iii. A debit balance shows that;

- (a) money is owing to the firm; or
- (b) the firm owns some property i.e. cash, goods etc.; or
- (c) the firm has lost money or has incurred some expense.

iv. A credit balance shows that;

- (a) money is owing to some person or
- (b) the firm has given up so much property; or
- (c) the firm has earned an income

1.9 ACCOUNTING CYCLE

This is the process, which is followed by accountants and bookkeepers in processing raw financial data into output information in form of financial statements.

The accounting process or cycle is described below;

Stage 1: Occurrence and documentation of business transactions

Business transactions or deals must be concluded first before anything is documented first or recorded.

Stage 2: Entering transactions into journals

Journals are books of original or prime entry. Information entered into journals is generated from the documents described above. There are several types of journals, the major ones include the general journal, sales, purchases journal and the cash book.

Stage 3: Posting of transactions to the ledger

The information, which has been entered into the journals, is posted to the ledger. A ledger is a book, which contains a collection of accounts. For ease of accounting, a ledger is sometimes sub divided into subsidiary ledgers.

Stage 4: Preparation of the Trial Balance

At the end of a period, normally a month, all accounts are closed or balanced off and the trial balance extracted. A trial balance is a list of debit and credit balances extracted from the ledger. Its purpose is to check the accuracy of the double entry.

Stage 5: End of year adjustments and preparation of financial statements

Financial statements are prepared from the trial balance. However, before this happens, the trial balance needs to be adjusted at the end of the year in order to make it up-to-date. (See chapter two below)

Stage 6. Analysis and interpretation of financial statements

This makes the financial statements user friendly. Lay people cannot read the figures in the financial statements and the jargon used by the accountants.

Detailed illustrations on recording of transactions in a typical MFI were demonstrated in FAP 1.

CHAPTER TWO

2.0 End of year adjustments

This is the fifth stage of the accounting cycle.

It is not possible to keep all accounts up to date at all times, therefore, accountants need to prepare adjustments at the end of every year so as the financial statements can represent a true and fair view of the state of affairs of the MFI or SACCO.

Examples of adjustments that are usually made at year-end include:

- Bad & doubtful debts
- Prepaid expenses and incomes
- Accrued expenses and incomes
- Corporation tax payable
- Depreciation and Asset schedule
- Proposed or paid dividends
- Transfers to reserves
- Adjustments for receivables and payables

2.1 Bad & doubtful debts

Some debtors/members who take loans fail to honour their obligations within credit period or fail to pay totally. Un collectable debts/loans should be written off through Profit & Loss.

Example 1 under end of year adjustments:

Kidevo sacco has Loans receivable totalling shs 5,000,000. 5% of these loans are doubtful and are likely not to pay. You are required to pass the end of year adjustment.

Solution:

$$\begin{aligned} \text{Bad \& doubtful loans (B/L)} &= 5\% \times 5,000,000 \\ &= 250,000 \end{aligned}$$

Entries to pass

Dr B/L expense a/c 250,000
 Cr Provision for B/L a/c 250,000

2.2 Writing off bad debts

Bad & doubtful debts become sometimes uncollectible. They must be written-off

Example 2 under end of year adjustments:

Kidevo sacco in example 1 above has 95% certainty that 5% of its loans will not be paid

Required:

Pass the necessary adjustments

Solution:

Entries to pass

Dr Provision for B/L a/c 250,000
 Cr Loans receivable 250,000

2.3 Direct write off of bad debts

There is no need to create provision accounts for small debtors'/loans' amounts. They should be written off directly through P&L

Example 3 under end of year adjustments:

Buhunga sacco runs an employee credit scheme. A loan of shs 8 million was given to Juliet, an employee but sufficient and appropriate evidence existed that she could not pay the loan.

Required:

Pass the appropriate adjustment

Solution:

Entries to pass

Dr P&L (Bad loan write off) 8,000,000
Cr Loans receivable (Juliet) 8,000,000

2.4 Increasing provision for Bad and Doubtful loans

At times, provisions for bad and doubtful loans have to be increased beyond current provisions due to increasing defaulting rate by members.

Example 4 under end of year adjustments:

The following information relates to Kacereere sacco. Current provision for Loan losses - shs 20,000,000. Expected increase is 10% of the current provision for Loan losses

Pass the necessary adjustment

Solution:

Expected increase = $10\% \times 20,000,000$
= shs 2,000,000
Adjusted provision for L/L = shs 22,000,000

Entries:

Dr L/L expense a/c 2,000,000
Cr Provision for L/L a/c 2,000,000

2.5 Decreasing provision for B/D

When debtors start paying, and there's little doubt about amounts due from members being collected, provision for once high bad and doubtful loans can be reduced.

Example 5 under end of year adjustments:

Bukanga sacco had made a provision of shs 15,000,000 against Loan Losses (L/L). Prospects show that provision for L/L has reduced by shs 4,000,000

Required:

Show the adjusting entries to be passed

Solution:

Entries to pass
Dr Provision for L/L 4,000,000
Cr L/L (P&L) 4,000,000

2.6 Bad and Doubtful loans previously written off

Bad and Doubtful loans previously written off as uncollectible can be recovered after several years

Accounting entries to be made are in 3 steps

Step 1 – Reinstatement of the debtor/loan
Step 2 – Recognise receipt of cash or cheque
Step 3- Close the B/D Loan a/c through P&L

Example 6 under end of year adjustments:

Mutara sacco lent Martin, a member shs 40,000,000 .Martin failed to pay & disappeared and Mutara sacco subsequently w/o Martin as a Loan Loss.

After 6 years, Martin surfaced & paid Mutara sacco shs 40 million by cheque in full

Account for the shs 40 million

Solution:

Step 1 – Reinstatement of Martin as a debtor

Dr Loan's a/c (Martin) 40,000,000
Cr L/L recovered a/c 40,000,000

Step 2 – Recognise the cheque received

Dr Bank a/c 40,000,000
Cr Loan's a/c 40,000,000

Step 3 – Close the B/D recovered a/c through P&L

Dr L/L recovered a/c 40,000,000
Cr P&L a/c 40,000,000

2.7 Prepaid expenses

These are expenses paid in advance. They are expenses paid in one financial year but benefit another. Adjustments must be made for such prepaid expenses.

Example 7 under end of year adjustments:

Isingiro sacco paid rent of shs 8,000,000 for 18 months from 1/1/20X4 to 30/6/20X5

Required:

Record the adjusting entries for the entity as at 31/12/20X4

Solution:

Basic accounting assumption – rent paid accrues evenly over the 18 months i.e.

$\frac{\text{Shs } 8,000,000}{18 \text{ months}} = \text{Shs } 444,445$

18 months

Rent for 12 months = 444,445 x 12
= Shs 5,333,340

Prepaid rent = 8,000,000 – 5,333,340
= Shs 2,666,660

Entries to be passed

Dr Prepaid rent 2,666,660
Cr Rent expense a/c 2,666,660

Example 8 under end of year adjustments:

Mayuge sacco paid shs 400,000,000 for insurance covering 2 financial years. By the end of the year 31/12/20X5, insurance for one year had expired.

Record the adjusting entry as at 31/12/20X5

Solution:

Insurance for 1 financial year = $\frac{\text{Shs } 400,000,000}{2 \text{ financial years}}$
= Shs 200,000,000

Adjusting entries:

Dr Insurance expense 200,000,000
Cr Prepaid insurance 200,000,000

2.8 Accrued expenses

These are expenses incurred in one year paid in the next financial year. They are current liabilities to the MFI.

Example 9:

Asonkera sacco paid salaries of shs 15,000,000 for December 2005 in January 2006.

Required:

Account for the transaction at the end of December 2005

Solution:

Dr Salaries expense 15,000,000
Cr Salaries accrued/payable 15,000,000

2.9 Prepaid income

Prepaid income is income received in advance. Income is received before it's earned. It's a current liability in the receiver's balance sheet.

Example 10 under end of year adjustments:

Konye Keni Sacco's tenant paid rent amounting to shs 3,000,000 for 15 months

Required:

Prepare journal entries when rent was paid and journalise the entry at the year end

Solution:

When rent was paid

Dr Cash/Bank 3,000,000
Cr Prepaid income (rent) 3,000,000

At year end

$\frac{\text{Shs } 3,000,000}{15 \text{ months}} = \text{Shs } 200,000 \text{ per month}$

Rent for 12 months = 200,000 x 12 months
= Shs 2,400,000

Adjusting entries:

Dr Prepaid income 2,400,000
Cr Earned income 2,400,000

2.91 Accrued income

This is income earned in one financial year but received in the following accounting period.
It's a current asset in the balance sheet

Example 11 under end of year adjustments:

Kisaka & Co provided consultancy services at shs 5,000,000 to a client on 23rd November, 2005. The client was unable to pay until 15th January, 2006

Account for the transaction as at 31 December 2005

Solution:

Entries

Dr Consultancy fees receivable 5,000,000
Cr Consultancy income 5,000,000

2.92 Depreciation

Fixed Assets/Non Current Assets

These are assets acquired for retention by an MFI for the purpose of providing services to the business. They are not held for sale in the normal course of the business.

Entries passed on acquisition:

Dr Fixed Asset A/C
Cr Cash/Bank

Fixed asset depreciation

Non current Assets such as Machinery, Motor vehicles, fixtures and even buildings do not last for ever. If the amount received (if any) on the disposal of a Non current asset is deducted from the cost of buying it, 15

the value of the non current asset can be said to have ‘depreciated in value’ by that amount over its period of usefulness to the business. For example, if a motor van was bought for Shs 20,000,000 and sold five years later for Shs 5,000,000= than its value has depreciated over the period of its use by Shs 15,000,000.

This is the only time that depreciation can be calculated accurately. That is, you can only estimate what it should be each year while the non current asset continues to be used.

Depreciation refers to reduction in value of assets (except land) due to wear & tear. It’s also referred to as systematic allocation of the cost of the asset over its useful life. Depreciation must be provided for every financial year

Depreciation is an expense

Depreciation is that part of the original cost of a Non current asset that is consumed during its period of use by the business. The annual charge to the Income statement for depreciation is based upon an estimate of how much of the overall economic usefulness of a Non current asset has been used up in that accounting period. It is an expense for services consumed in the same way as expenses are incurred for items such as wages, rent or electricity. Because it is charged as an expense to the income statement, depreciation reduced profits.

Causes of depreciation

These can be divided up between physical deterioration, economic factors, the time factor, and depletion. Let us look at these in more details.

Physical Deterioration

(i) **Wear and Tear**

When a motor vehicle or machinery or fixtures and fittings are used they eventually wear out. Some last many years, others last only a few years. This is also true of buildings, although some may last for a long time.

(ii) **Erosion, rust, rot and decay**

Land may be eroded or wasted away by the action of wind, rain, sun and other elements of nature. Similarly, the metals in motor vehicles or machinery will rust away.

Wood will rot eventually; decay is a process which will also be present due to the elements of nature and the lack of proper attention.

Economic factors

These may be said to be the reasons for an asset being put out of use even though it is in good physical condition. The two main factors are usually **Obsolescence and inadequacy**.

(i) **Obsolescence**

This is the process of becoming out-of-date. For instance, over the years there has been great progress in the development of synthesis and electronic devices used by leading commercial musicians. The old equipment will therefore have become obsolete, and much of it will have been taken out of use by such musicians.

This does not mean that the equipment is worn out. Other people may well buy the old equipment and use it, possibly because they cannot afford to buy new up-to-date equipment.

(ii) **Inadequacy**

This arises when an asset is no longer used because of the growth and changes in the size of the business.

(iii) **The Time factor**

Obviously time is needed for wear and tear, erosion etc and for obsolescence and inadequacy to take place. However, there are Non current assets to which the time factor is connected in a different way. These are assets which have a legal life fixed in terms of years.

For instance, you may agree to rent some buildings for ten years. This is normally called a Lease. When the years have passed, the lease is worth nothing to you, as it has finished. Whatever you paid for the lease is now of no value.

A similar asset is where you buy a patent so that only you are able to produce something. When the patent's time has finished it then has no value. The usual length of life of a patent is sixteen years.

Instead of using the depreciation, the term **amortisation** is often used for these assets.

Depletion

Other assets are of wasting character, perhaps due to the extraction of raw materials from them. These materials are then either used by the business to make something else, or are sold in their raw state to other businesses. Natural resources such as mines, quarries and oil wells come under this heading. To provide for the consumption of an asset of a wasting character is called provision for **depletion**.

Provision for depreciation as an allocation of cost

Depreciation in total over the life of a non current asset can be calculated quite simply as cost less the amount receivable when the non current asset is put out of use by the business. This amount receivable is normally referred to as the **residual value** of an asset. If the item is bought and sold for a lower amount within the same accounting period, then the difference in value is charged as depreciation in arriving at the period's net profit.

Methods of calculating depreciation charges

The two main methods in use are the **straight line method** and the **reducing balance method**. Other methods may be used in certain cases, and some of them are covered later. Most accountants think that the straight line method is the one that is generally most suitable.

Choice of method

The purpose of depreciation is to spread the total cost of a Non current asset over the periods in which it is to be used. The method chosen should be that which allocates cost to each period in accordance with the proportion of the overall economic benefit from using the Non current asset that was expended during that period.

If, therefore, the main value is to be obtained from the asset in its earliest years, it may be appropriate to use the reducing balance method, which charges more in the early years. If, on the other hand, the benefits are to be gained evenly over the years, then the straight line method would be more appropriate.

The repairs and maintenance factor also has to be taken into account. One argument supporting this was mentioned in the last section.

Other methods of calculating depreciation

There are many more methods of calculating depreciation, some of which are used in particular industries, such as the hotel and catering industry.

Sum of the Years' Digits Method

This method provides for higher depreciation to be charged early in the life of an asset with lower depreciation in later years.

Double entry records for depreciation

Introduction

Now that you know what depreciation is and how it may be calculated in the Section below you'll learn how to make the appropriate entries for depreciation in the accounting books. You'll also learn how to make the appropriate period-end entries in the financial statements.

Recording Depreciation

The method now used involves maintaining each non current asset at its cost in the ledger account while operating another ledger account where the depreciation to date is recorded.

This account is known as the 'accumulated provision for depreciation account', often shortened to the accumulated depreciation account (or sometimes, confusingly known as the 'provision for depreciation account').

Let's look at how this method of recording depreciation is applied by first looking at the double entry required and then looking at it being used in the illustration 1. The depreciation is posted directly into the cumulative provision for depreciation account.

The double entry is:

Debit the Income Statement (i.e. deduct from the Gross profit)
Credit the accumulated provision for depreciation account

The disposal of a non current asset

Reasons for accounting entries

Upon the sale of a Non current asset, we will want to remove it from our ledger accounts. This means that the cost of that asset needs to be taken out of the asset account. In addition, the accumulated depreciation on the asset which has been sold will have to be taken out of the accumulated provision. Finally, the profit and loss on sale, if any, will have to be calculated and posted to the income statement.

When we change depreciation on a Non current asset we are having to make an informed guess. We will not often guess correctly. This means that, when we dispose off an asset, the amount received for it is usually different from our estimate.

Accounting entries

On the sale of a non current asset e.g. machinery, the following entries are needed:

- A. Transfer the cost price of the asset sold to an assets disposal account (in this case a Machinery disposals account).

Debit Machinery disposals account
 Credit Machinery account

- B. Transfer the depreciation charged to the assets disposal account.

Debit: Accumulated provision for depreciation machinery
 Credit Machinery disposals account

- C. For the amount received on disposal

Debit Cash book
 Credit Machinery disposal account

D. Transfer the difference (i.e. the amount needed to balance the Machinery disposals account) to the Income statement.

(i) If the machinery disposals account shows a credit balance (i.e. if more has been credited to the account than has been debited to it), there is a profit on the sale.

Debit Machinery disposals account
Credit Income Statement

(ii) If the Machinery disposals account shows a debit balance, there is a loss on sale:

Debit Income Statement
Credit Machinery disposals account

Change of depreciation method

It is possible to make a change in the method of calculating depreciation. This should not be done frequently, and it should only be undertaken after a thorough review. Where a change is made, if material, the effect of doing so upon the figures reported should be shown as a note to the financial statements in the year of change.

Disposal of assets

Disposal of assets can be done through:

1. Sale of Asset or
2. Write off

There are four sets of entries to be passed on disposal of an asset:

- i. Write off of the fixed asset

Dr Fixed Assets Disposal A/C (Cost)
Cr Fixed Asset A/C (Cost)

- ii. Write off of accumulated depreciation

Dr Accumulated Depreciation
Cr Fixed Asset Disposal A/C

- iii. Recording of receipt of cash or cheque (Sales proceeds)

Dr Cash or Bank (Proceeds)
Cr Fixed Asset Disposal A/C

- iv. Closing off the Disposal A/C to the Income Statement for a gain or loss on disposal.

Dr Disposal A/C
Cr Income Statement (Gain on disposal) or

Dr Income Statement (Loss on disposal)
Cr Disposal A/C

Revaluation of fixed assets

Assessing of Current Value of the Asset is done by professional valuers but can also be done by management

Valuer's amount – Carrying amount = Revaluation amount

Entries to pass include:

Dr Fixed Asset (revaluation amount)
Cr Revenue Reserves

Other revaluation issues:

- Requirement of IFRS 16
- Revaluation can be reversed
- Revaluation losses
- Depreciation after revaluation
- Revaluation may increase useful life
- Treatment of revaluation reserves

Fully depreciated asset

A fully depreciated asset is an asset that is not depreciated any further but still exists with MFI. Maintain them at Nominal value, say, Shs 99 or Shs 1000

Fixed asset register

A non-current asset/ fixed asset is a record of details of all Fixed Assets or Non current asset.

Importance of a Fixed Asset register to an MFI

It helps to record:

- Nature of Asset(s)
- Serial Numbers of asset(s)
- Historical Cost of the asset(s)
- Date of acquisition of asset(s)
- Location/ user of the asset(s)
- Useful Life of the asset(s)
- Depreciation Details of the asset(s)

Fixed Asset Controls

- Regularly check them for existence
- Engrave assets with unique identification marks
- Determine the conditions
- Control Assets' movement
- Institute physical controls

Example 12 under end of year adjustments:

The following information relates to Kadungulu sacco:

Equipment at cost – Shs 7,000,000

Its Kadungulu Sacco's policy to depreciate equipment at 25%

Show the adjusting entries

Solution:

Depreciation on equipment
= 25% x 7,000,000
= Shs 1,750,000

Entries:

Dr Depreciation exp a/c (Equipment) 1,750,000
Cr Acc Depreciation (Equipment) 1,750,000

2.93 Corporation tax

When draft accounts suggest a profit, a provision for tax must be made. MFIs are not liable to tax according to the Income Tax Act, CAP 340, Laws of Uganda.

Example 13 under end of year adjustments:

Assuming Kapelebyong sacco accounts suggest PBT of shs 5,000,000. Assume tax provision at 30% and show adjusting entries at year end

Solution:

Corporation tax = 30% x shs 5,000,000
= shs 1,500,000

Entries:

Dr P&L (Provision for corporation tax) 1,500,000
Cr Corp tax payable 1,500,000

2.94 Proposed dividends

Dividends are rewards to shareholders for contributions made. Dividends are proposed when an entity makes profits

Example 14 under end of year adjustments:

Team plc made PBT of shs 50,000,000 during the year and proposed dividends to shareholders at 15% of the profits

Show the adjusting entries at year end

Solution:

Proposed dividends
= 15% x shs 50,000,000
= shs 7,500,000

Entries:

Dr P&L appropriations a/c 7,500,000
Cr Proposed div payable 7,500,000

CHAPTER THREE

3.0 THE WORK SHEET

A Work Sheet is an extension of the Trial Balance

3.1 Components of a Work Sheet

- i. Unadjusted Trial Balance
- ii. Adjustments
- iii. Adjusted Trial Balance
- iv. Income Statement
- v. Balance Sheet

Note:

It's not part of permanent accounting records or a formal Financial Statement

3.2 Objective of a Work Sheet

- Enables accountants make adjustments to figures in it
- Provides assurance of period-end accounting procedures
- Source document for formal Financial Statements
- Shows Debits and Credits in formal Financial Statements

3.3 Preparation of a Work Sheet

In order to understand the concepts of a work sheet, work sheets for trading companies were introduced before attempting an example of a worksheet for MFIs. MFI financial statements are unique and governed by CGAP guidelines or IAS 30. Therefore accountants for MFI who in most cases have little or no accounting knowledge need to understand accounting concepts right from the very basics using trading company examples and later MFI example

We request that physical worksheets specially designed for the workshop should be provided to participants.

3.4 Illustrations

Exercise 1 on preparation of work sheets using a trading company:

Using details in Exercise 1, prepare a Work Sheet for TK Company

(Note that this example is of a trading company intended for providing a simpler illustration on preparation of financial statements, given the nature of MFI accountants)

TK & Company Limited

Trial Balance as at 31 December 2003

| | Dr. (Shs. 000) | Cr. (Shs. 000) |
|---|---------------------------------|---------------------------------|
| Cash at hand | 2,000 | |
| Cash at bank | 4,000 | |
| Land, cost | 100,000 | |
| Motor vehicle, cost | 10,000 | |
| Accumulated depreciation – Motor vehicle | | 2,000 |
| Equipment, cost | 20,000 | |
| Accumulated depreciation – (equipment) | | 4,000 |
| Stock 1 st January (opening stock) | 1,000 | |
| Trade debtors | 5,000 | |
| Provision for bad debts | | 2,000 |
| Trade creditors | | 3,000 |
| Sales | | 200,000 |
| Purchases | 110,000 | |
| Discount allowed | 2,000 | |
| Discount received | | 1,000 |
| Purchases returns (return outwards) | | 5,000 |
| Sales returns (returns inwards) | 10,000 | |
| Carriage inwards | 6,000 | |
| Salaries | 8,000 | |
| Salaries payable (accrued salaries) | | 15,000 |
| Rent | 1,800 | |
| Electricity | 7,000 | |
| Bad debts | 1,200 | |
| Capital | | 26,000 |
| Long term bank loan | | 30,000 |
| | <u>288,000</u> | <u>288,000</u> |

Information for adjustments at the end of the financial year

- a) Closing stock at the end of the financial year was valued at Shs 20,000,000
- b) Salaries of Shs 2,000,000 accrued or remained outstanding at the end of the year and was not recorded in the trial balance
- c) Half of the rent paid if for the forthcoming financial year
- d) Depreciate fixed assets by 20% on the cost at the end of the year
- e) 20% of trade debtors are expected to default, a provision against bad debts should be made.

Required:

As the company's Accountants, prepare TK Company's worksheet

Solution

Reminders:

- T.B is a list of Debit and Credit balances extracted from ledgers
- Debit Balance-Total debits on A/C exceed total credits

- Bal b/f is on debit side while bal c/f is on credit side
- Credit Balance- Total credits on A/C exceed total debits
- Bal b/f is on credit side while bal c/f is on debit side
- All assets except bank overdrafts have debit balances
- All expenses and Drawings have debit balances
- All assets (except bank overdrafts) ,expenses and drawings appear on debit side of TB
- Accounts which should have credit balances include:
 - Revenues/Incomes
 - Capital & Reserves
 - Liabilities
- TB checks accuracy of A/C
- Especially observance of double entry rule and arithmetic accuracy
- If TB fails to balance by an immaterial figure, introduce suspense A/C

Errors not detected by TB

- Errors of original entry
 - Errors of Omission
 - Errors of Commission
 - Compensating errors
 - Errors of Principle
 - Complete reversal of entries
- Final accounts are prepared from adjusted TB
 - A Work sheet is an extended TB
 - Work sheet reflects year-end adjustments
 - It shows whether Final accounts will balance

a) TK & Company Limited
General Journal showing adjusting entries on 31 December 2003

| Account Titles | Dr. | Cr. |
|--|------------|------------|
| 1) Stock 31/12/03 Trading A/C | 20,000,000 | 20,000,000 |
| 2) Bad debts Provision for bad debts | 1,000,000 | 1,000,000 |
| 3) Prepaid rent Rent expense | 900,000 | 900,000 |
| 4) Salaries expense Accrued salaries or salaries payable | 2,000,000 | 2,000,000 |
| 5) Depreciation expense: Vehicle Accumulated depreciation: Vehicle | 2,000,000 | 2,000,000 |
| 6) Depreciation expense: equipment Accumulated depreciation equipment | 4,000,000 | 4,000,000 |

b) TK & Company Limited
Work Sheet for the year ended 31 December 2003

| Accounts | Trial balance | | Adjustments | | Adjusted trial Balance | | Income statements | | Balance sheet | |
|---|---------------|------------|-------------|------------|------------------------|------------|-------------------|------------|---------------|------------|
| | Dr Shs 000 | Cr Shs 000 | Dr Shs 000 | Cr Shs 000 | Dr Shs 000 | Cr Shs 000 | Dr Shs 000 | Cr Shs 000 | Dr Shs 000 | Cr Shs 000 |
| Cash at hand | 2,000 | | | | 2,000 | | | | 2,000 | |
| Cash at bank | 4,000 | | | | 4,000 | | | | 4,000 | |
| Land, cost | 100,000 | | | | 100,000 | | | | 100,000 | |
| Motor vehicle, cost | 10,000 | | | | 10,000 | | | | 10,000 | |
| Accumulated depreciation – motor vehicle | | 2,000 | | 2,000 | | 4,000 | | | | 4,000 |
| Equipment, cost | 20,000 | | | | 20,000 | | | | 20,000 | |
| Accumulated depreciation – equipment | | 4,000 | | 4,000 | | 8,000 | | | | 8,000 |
| Stock 1 st Jan (opening stock) | 1,000 | | | | 1,000 | | 1,000 | | | |
| Trade debtors | 5,000 | | | | 5,000 | | | | 5,000 | |
| Provision for bad debts | | 2,000 | | 1,000 | | 3,000 | | | | |
| Trade creditors | | 3,000 | | | | 3,000 | | | | |
| Sales | | 200,000 | | | | 200,000 | | 200,000 | | |
| Purchases | 110,000 | | | | 110,000 | | 110,000 | | | |
| Discount allowed | 2,000 | | | | 2,000 | | 2,000 | | | |
| Discount received | | 1,000 | | | | 1,000 | | 1,000 | | |
| Purchases returns (returns outwards) | | 5,000 | | | | 5,000 | | 5,000 | | |

[Solution cont'd]

| | | | | | | | | | | |
|--------------------------------------|---------|---------|-------|-------|---------|---------|---------|---------|---------|---------|
| Sales returns (returns inwards) | 10,000 | | | | 10,000 | | 10,000 | | | |
| Carriage inwards | 6,000 | | | | 6,000 | | 6,000 | | | |
| Salaries | 8,000 | | 2,000 | | 10,000 | | 10,000 | | | |
| Salaries payable | | 15,000 | | 2,000 | | 17,000 | | | | 17,000 |
| Rent | 1,800 | | | 900 | 900 | | 900 | | | |
| Electricity | 7,000 | | | | 7,000 | | 7,000 | | | |
| Bad debts | 1,200 | | 1,000 | | 2,200 | | 2,200 | | | |
| Capital | | 26,000 | | | | 26,000 | | | | 26,000 |
| Long term bank loan | - | 30,000 | | | | 30,000 | | | | 30,000 |
| | 288,000 | 288,000 | | | | | | | | |
| Closing stock | | | | | | | | 20,000 | 20,000 | |
| Pre-paid rent | | | 900 | | 900 | | | | 900 | |
| Depreciation expense (motor vehicle) | | | 2,000 | | 2,000 | | 2,000 | | | |
| Depreciation expense (equipment) | | | 4,000 | | 4,000 | | 4,000 | | | |
| NET PROFIT | | | | | | | 70,900 | | | 70,900 |
| TOTALS | | | 9,900 | 9,900 | 297,000 | 297,000 | 226,000 | 226,000 | 161,900 | 161,900 |

c) TK & Company Limited
Income Statement for the year ended 31 December 2003

| | Shs | Shs | Shs |
|------------------------------------|------------------|-------------------|--------------------------|
| Sales | | | 200,000,000 |
| Less: Sales returns | | | <u>10,000,000</u> |
| Net sales | | | 190,000,000 |
| Less: Cost of Goods sold | | | |
| Opening stock | | 1,000,000 | |
| Add: Purchases | 110,000,000 | | |
| Less: Purchases returns | <u>5,000,000</u> | | |
| Net purchases | | 105,000,000 | |
| Add carriage inwards | | <u>6,000,000</u> | |
| Cost of goods available for sale | | 112,000,000 | |
| Less: Closing Stock (31/12/03) | | <u>20,000,000</u> | |
| Cost of goods sold | | | <u>92,000,000</u> |
| Gross profit | | | 98,000,000 |
| Add: Miscellaneous revenues/income | | | |
| Discount received | | | <u>1,000,000</u> |
| | | | 99,000,000 |
| Less: Operating expenses | | | |
| Salaries (see note 1) | | 10,000,000 | |
| Electricity | | 7,000,000 | |
| Rent (see note 2) | | 900,000 | |
| Sales discount (see note 4) | | 2,000,000 | |
| Bad debts (see note 3) | | 2,200,000 | |
| Depreciation – Vehicle (note 5) | | 2,000,000 | |
| - Equipment (note 5) | | <u>4,000,000</u> | |
| | | | <u>28,100,000</u> |
| NET PROFIT | | | <u><u>70,900,000</u></u> |

d) TK & Company Limited

Balance Sheet as at 31 December 2003

| FIXED ASSETS | Cost Shs | Acc depreciation Shs | N.B.V Shs |
|---------------------------------------|-------------|-------------------------|--------------------|
| Land | 100,000,000 | - | 100,000,000 |
| Motor Vehicle | 10,000,000 | 4,000,000 | 6,000,000 |
| Equipment | 20,000,000 | 8,000,000 | 12,000,000 |
| | 130,000,000 | 12,000,000 | 118,000,000 |
| <u>Current assets (see note 7)</u> | | | |
| Cash | | 2,000,000 | |
| Bank | | 4,000,000 | |
| Prepaid rent | | 900,000 | |
| Trade Debtors | 5,000,000 | | |
| Less: Provision for Bad debts | 3,000,000 | 2,000,000 | |
| Closing stock | 20,000,000 | | |
| | | 28,900,000 | |
| Less: Current Liabilities | | | |
| Creditors | 3,000,000 | | |
| Accrued salaries | 17,000,000 | 20,000,000 | |
| Working capital or net current assets | | | 8,900,000 |
| Net assets | | | <u>126,900,000</u> |
| Financed by | | | |
| Capital | | | 26,000,000 |
| Add: net profit (see note 6) | | | 70,900,000 |
| Owner's equity | | | 96,900,000 |
| Long term liabilities | | | |
| Long term bank loan | | | 30,000,000 |
| CAPITAL EMPLOYED | | | <u>126,900,000</u> |

Explanatory notes for TK & Company Limited

Note 1: Wages of 2,000,000= accrued. Whenever an expense accrues it must be added to that expense account figure already in the trial balance or created if it did not exist in the trial balance. In this case.

| | |
|---|------------|
| Wages as per trail balance | 8,000,000 |
| Add: accrued wages | 2,000,000 |
| Total to profit and loss account (income statement) | 10,000,000 |

Accrued wages or wages payable must also be recoded under current liabilities in the balance sheet. In this case 2,000,000= accrued wages or wages payable appears in the balance sheet as a current liability

Note 2: Rent of 900,000= was prepaid. Because much as that rent was paid for the financial year ended 31/12/2003. It is for the following financial year commencing on 1/1/2004. This prepaid rent must be subtracted from rent paid. This is necessary to match expenses accurately against revenues and to apportion or charge expenses to the period they relate. In this case:

| | |
|--|-----------|
| Rent as per trial balance | 1,800,000 |
| Less: prepaid rent | 900,000 |
| Rent to charged in the profit and loss account or income statement | 900,000 |

Any expense which is prepaid (paid in advance) must appear as a current asset in the balance sheet. In this example, a prepaid rent of shs 900,000 appears under current assets in the balance sheet.

Note 3: Additional provision equivalent to 20% of debtors to be made.

| | |
|----------------------|-----------------|
| Additional provision | 5,000,000 x 20% |
| | = 1,000,000= |

This means that there were additional bad debts expense of 1,000,000 which must be added to the existing figure.

| | |
|---|-----------|
| Bad debts as per trial balance | 1,200,000 |
| Add: Addition provision | 1,000,000 |
| Total bad debts figure to be taken to profit and loss account or income statement | 2,200,000 |

Note 4: Sales discount could alternatively be subtracted from sales in arriving at net sales. If it is subtracted from sales, it should not again be charged as an operating expense. Likewise discount received could be subtracted from purchases and not treated as miscellaneous income.

Note 5: Depreciation is an operating expense though it is not a cash flow item. Depreciation of various years are accumulated and subtracted from the cost of the asset in deriving balance sheet book values.

Calculation of depreciation:

| | |
|---------------|------------------|
| Motor Vehicle | 10,000,000 x 20% |
| | = 2,000,000 |
| Equipment | 20,000,000 x 20% |
| | = 4,000,000 |

Note 6: The net profit figure inter-phases between the income statement and balance sheet. Net profit which is not distributed as dividends but ploughed back into the business (retained earnings) becomes a source of equity financing and is added to capital or put under shareholder's reserves in the "financed by" section of the balance sheet.

Note 7: Current assets are normally arranged in the balance sheet in the order of increasing liquidity or decreasing permanency. Stock is the least liquid or more permanent than other current assets and cash is the most liquid or least permanent. Therefore stock appears first (on top) and cash last (bottom) in the arrangement of current assets. However, current assets for MFIs are arranged in the order of decreasing liquidity or increasing permanency because cash is the most important asset to MFIs.

Note 8: Provision for bad debts is offset from the debtors figure in the balance sheet. In this illustration, additional provision was made.

| | |
|--|-----------|
| Provision for bad debts as per trial balance | 2,000,000 |
| Add: addition provision | 1,000,000 |
| Total provision for bad debts | 3,000,000 |

Exercise 2 on preparation of work sheets using a trading company:

The bookkeeper of Seed Company Limited prepared the following trial balance for the financial year ended 31st March 1999.

| | Dr. | Cr. |
|---------------------------------|------------|------------|
| Cash at hand | 800,000 | |
| Cash at bank | 2,500,000 | |
| Debtors | 3,000,000 | |
| Stock | 600,000 | |
| Vehicle, cost | 7,000,000 | |
| Equipment, cost | 5,000,000 | |
| Purchases | 4,000,000 | |
| Wages | 1,000,000 | |
| Electricity | 200,000 | |
| Rent | 700,000 | |
| Bad debts | 30,000 | |
| Sales returns | 50,000 | |
| Sales discount | 60,000 | |
| Drawings | 2,060,000 | |
| Creditors | | 2,000,000 |
| Income taxes payable | | 3,500,000 |
| Purchases returns | | 500,000 |
| Discount received | | 80,000 |
| Sales | | 12,000,000 |
| Provisions for bad debts 1/4/96 | | 60,000 |
| Capital | | 6,860,000 |
| Long term bank loan | | 2,000,000 |
| | 27,000,000 | 27,000,000 |

Information:

- i. Closing stock at the end of the year was valued at 1,500,000=
- ii. Additional provision of 1% of the debtors has to be made against bad debts on 31/3/99
- iii. Of the rent paid 100,000 is for the financial year commencing on April 1st 1999.
- iv. Wages of 300,000 accrued
- v. Motor vehicle is to be depreciated by 20% and equipment by 10% on cost per annum.

Required

- i. Provide journal entries for all adjustments
- ii. Prepare Seed Co's income statement and balance sheet at the end of the financial year

Solution

- a) Seed Co Limited
General Journal showing adjusting entries on 31 March 1999

| Account Titles | Dr. | Cr. |
|--|-----------|-----------|
| 1) Stock 31/3/99 Trading A/C | 1,500,000 | 1,500,000 |
| 2) Bad debts Provision for bad debts | 30,000 | 30,000 |
| 3) Prepaid rent Rent expense | 100,000 | 100,000 |
| 4) Wages expense Accrued wages or wages payable | 300,000 | 300,000 |
| 5) Depreciation expense: Vehicle Accumulated depreciation: Vehicle | 1,400,000 | 1,400,000 |
| 6) Depreciation expense: equipment Accumulated depreciation equipment | 500,000 | 500,000 |

Fundamentals of Accounting Two for Micro Finance Institutions–Course Notes

| | | | | | | | | | | |
|----------------------|-------------------|-------------------|------------------|------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | | 2,000,000 | | | 2,000,000 | | | | 2,000,000 | |
| Rent | 700,000 | | 100,000 | 600,000 | | 600,000 | | | | |
| Electricity | 200,000 | | | 200,000 | | 200,000 | | | | |
| Bad debts | 30,000 | 30,000 | | 60,000 | | 60,000 | | | | |
| Capital | 6,860,000 | | | | 6,860,000 | | | | 6,860,000 | |
| Long term bank loan | 2,000,000 | | | | 2,000,000 | | | | 2,000,000 | |
| Income taxes payable | 3,500,000 | | | | 3,500,000 | | | | 3,500,000 | |
| Accrued wages | | | 300,000 | | 300,000 | | | | 300,000 | |
| Closing stock | | 1,500,000 | | 1,500,000 | | | | 1,500,000 | | |
| Trading account | | | 1,500,000 | | 1,500,000 | | 1,500,000 | | | |
| Prepaid rent | | 100,000 | | 100,000 | | | | 100,000 | | |
| Dep exp-M/V | | 1,400,000 | | 1,400,000 | | 1,400,000 | | | | |
| Dep exp-Equipt | | 500,000 | | 500,000 | | 500,000 | | | | |
| NET PROFIT | | | | | | 5,310,000 | | | | |
| Reserves | | | | | | | | | 5,310,000 | |
| TOTALS | 27,000,000 | 27,000,000 | 3,830,000 | 3,830,000 | 30,730,000 | 30,730,000 | 14,080,000 | 14,080,000 | 21,960,000 | 21,960,000 |

c) Seed Co Limited
Income Statement for the year ended 31/3/1999

| | Shs | Shs | Shs |
|------------------------------------|----------------|------------------|------------------|
| Sales | | | 12,000,000 |
| Less: Sales returns | | | <u>50,000</u> |
| Net sales | | | 11,950,000 |
| Less: Cost of Goods sold | | | |
| Opening stock | | 600,000 | |
| Add: Purchases | 4,000,000 | | |
| Less: Purchases returns | <u>500,000</u> | | |
| Net purchases | | <u>3,500,000</u> | |
| Cost of goods available for sale | | 4,100,000 | |
| Less: Closing Stock (31/3/99) | | <u>1,500,000</u> | |
| Cost of goods sold | | | <u>2,600,000</u> |
| Gross profit | | | 9,350,000 |
| Add: Miscellaneous revenues/income | | | |
| Discount received | | | <u>80,000</u> |
| | | | 9,430,000 |
| Less: Operating expenses | | | |
| Wages (see note 1) | | 1,300,000 | |
| Electricity | | 200,000 | |
| Rent | | 600,000 | |
| Bad debts (see note 3) | | 60,000 | |
| Sales discount (see note 4) | | 60,000 | |
| Depreciation - Vehicle (note 5) | | 1,400,000 | |
| - Equipment (note 5) | | <u>500,000</u> | |
| | | | <u>4,120,000</u> |
| NET PROFIT | | | <u>5,310,000</u> |

d) Seed Co Limited
Balance Sheet as at 31/3/1999

| | Cost Shs | Acc depreciation Shs | N.B.V Shs |
|------------------------------------|-------------|-------------------------|--------------|
| FIXED ASSETS | | | |
| Vehicle | 7,000,000 | 1,400,000 | 5,600,000 |
| Equipment | 5,000,000 | 500,000 | 4,500,000 |
| | 12,000,000 | 1,900,000 | 10,100,000 |
| <u>Current assets (see note 7)</u> | | | |
| Cash | | 800,000 | |
| Bank | | 2,500,000 | |
| Prepaid rent | | 100,000 | |
| Trade Debtors | 3,000,000 | | |
| Less: Provision for Bad debts | 90,000 | 2,910,000 | |

| | | | |
|---------------------------------------|----------------|------------------|-------------------|
| Closing stock | | <u>1,500,000</u> | |
| | | 7,810,000 | |
| Less: Current Liabilities | | | |
| Creditors | 2,000,000 | | |
| Income taxes payable | 3,500,000 | | |
| Accrued wages | <u>300,000</u> | <u>5,800,000</u> | |
| Working capital or net current assets | | | <u>2,010,000</u> |
| Net assets | | | <u>12,110,000</u> |
| Financed by | | | |
| Capital | | | 6,860,000 |
| Add: net profit (see note 6) | | | <u>5,310,000</u> |
| | | | 12,170,000 |
| Less: drawings | | | <u>2,060,000</u> |
| Owner's equity | | | 10,110,000 |
| Long term liabilities | | | |
| Long term bank loan | | | <u>2,000,000</u> |
| CAPITAL EMPLOYED | | | <u>12,110,000</u> |

Explanatory notes for Seed Company Limited

Note 1: Wages of 300,000= accrued. Whenever an expense accrues it must be added to that expense account figure already in the trial balance or created if it did not exist in the trial balance. In this case.

| | |
|---|----------------|
| Wages as per trail balance | 100,000 |
| Add: accrued wages | <u>300,000</u> |
| Total to profit and loss account (income statement) | 1,300,000 |

Accrued wages or wages payable must also be recoded under current liabilities in the balance sheet. In this case 300,000= accrued wages or wages payable appears in the balance sheet as a current liability

Note 2: Rent of 100,000= was prepaid. Because much as that rent was paid for the financial year ended 31/3/1999. it is for the following financial year commencing on 1/4/1999. This prepaid rent must be subtracted from rent paid. This is necessary to match expenses accurately against revenues and to apportion or charge expenses to the period they relate. In this case:

| | |
|--|----------------|
| Rent as per trial balance | 700,000 |
| Less: prepaid rent | <u>100,000</u> |
| Rent to charged in the profit and loss account or income statement | 600,000 |

Any expense which is prepaid (paid in advance) must appear as a current asset in the balance sheet. In this example, prepaid rents of shs 100,000 appears under current assets in the balance sheet.

Note 3: Additional provision equivalent to 1% of debtors to be made.

| | |
|----------------------|-----------------------------|
| Additional provision | 3,000,000 x 1% = 30,000= |
|----------------------|-----------------------------|

This means that there were additional bad debts expense of 30,000 which must be added to the existing figure.

| | |
|---|--------|
| Bad debts as per trial balance | 30,000 |
| Add: Addition provision | 30,000 |
| Total bad debts figure to be taken to profit and loss account or income statement | 60,000 |

Note 4: Sales discount could alternatively be subtracted from sales in arriving at net sales. If it is subtracted from sales, it should not again be charged as an operating expense. Likewise discount received could be subtracted from purchases and not treated as miscellaneous income.

Note 5: Depreciation is an operating expense though it is not a cash flow item. Depreciation of various years are accumulated and subtracted from the cost of the asset in deriving balance sheet book values.

Calculation of depreciation:

| | |
|-----------|--------------------------------|
| Vehicle | 7,000,000 x 20% = 1,400,000 |
| Equipment | 5,000,000 x 10% = 500,000 |

Note 6: The net profit figure inter-phases between the income statement and balance sheet. Net profit which is not distributed as dividends but ploughed back into the business (retained earnings) becomes a source of equity financing and is added to capital or put under shareholder's reserves in the "financed by" section of the balance sheet.

Note 7: Current assets are normally arranged in the balance sheet in the order of increasing liquidity or decreasing permanency. Stock is the least liquid or more permanent than other current assets and cash is the most liquid or least permanent. Therefore stock appears first (on top) and cash last (bottom) in the arrangement of current assets. However, current assets for MFIs are arranged in the order of decreasing liquidity or increasing permanency because cash is the most important asset to MFIs.

Note 8: Provision for bad debts is offset from the debtors figure in the balance sheet. In this illustration, additional provision was made.

| | |
|--|--------|
| Provision for bad debts as per trial balance | 60,000 |
| Add: addition provision | 30,000 |
| Total provision for bad debts | 90,000 |

CHAPTER FOUR

4.0 Financial Statements for MFIs and SACCOS

Financial statements for MFIs are different from those of a trading company. Preparation of Financial Statements for MFIs are governed by CGAP guidelines and IAS 30.

4.1 Illustrations

Exercise 1:

Use the information given below to prepare Financial Statements for Buwenge Sacco as at 31/12/2004

| Account Name | DR | CR |
|--|-------------|-------------|
| LOANS & INVESTMENTS | | |
| Short Term Loans | 25,530,208 | - |
| Allowance for loan losses | - | 840,111 |
| Investment in shares | 100,000 | - |
| Long Term investments and deposits | 537,982,450 | - |
| CASH & BANK BALANCES | - | - |
| Cash | 43,326,600 | - |
| Current DFCU Bank | 2,062,150 | - |
| DEBTORS & PREPAYMENTS | - | - |
| Commissions & Interest receivable | 22,786,950 | - |
| Advance to Employees | 12,263,988 | - |
| Prepaid assets | 10,198,754 | - |
| PROPERTY, PLANT & EQUIPMENT | - | - |
| Equipments | 4,136,850 | - |
| Computer Units and Accessories | 8,377,100 | - |
| Electronic equipment | 1,460,000 | - |
| Office Furniture & Equipment | 10,139,735 | - |
| Accumulated depreciation on Electronic equipment | - | 365,000 |
| Acc depreciation Office Furniture & Equipment | - | 1,675,313 |
| Accumulated depreciation on Computer Sets | - | 2,155,576 |
| Accumulated depreciation on other equipment | - | 1,392,240 |
| SAVINGS & FIXED DEPOSITS | - | - |
| Regular saving | - | 317,085,965 |
| Short term time deposits | - | 19,756,556 |
| Savings and Time deposit | - | 260,026,649 |
| PAYABLES & ACCRUED EXPENSES | - | - |
| Interest payable on regular saving | - | 6,250,502 |
| Pay roll taxes payable (NSSF & PAYE) | - | 1,834,000 |
| Provision for audit fees | - | 17,749,100 |
| Loan Protection Fund | - | 6,669,600 |
| Other payables | - | 425 |
| EQUITY | - | - |
| Members shares | - | 14,849,750 |
| Statutory & Legal reserves | - | 2,903,305 |
| Retained earnings December 2003 | - | 5,267,803 |
| DONATIONS | - | - |

| | DR | CR |
|---|-------------|-------------|
| Donations - SPEED | - | 5,232,400 |
| Donations – STROMME | - | 6,394,740 |
| Deferred STROMME Grant | - | 6,273,450 |
| Other Donations | - | 550,000 |
| INCOME | - | - |
| Commission on loan | - | 4,924,370 |
| Interest Received on Long & Short Term Bank Deposit | - | 52,350,428 |
| Income from Donors - STROMME Grants | - | 2,726,550 |
| | - | 13,101,324 |
| FINANCE COSTS | 22,170,215 | - |
| EMPLOYEE COSTS | 25,091,513 | - |
| Meeting expenses | 1,685,334 | - |
| DEPRECIATION | 2,321,629 | - |
| ADMISTRATIVE EXPENSES | - | - |
| Transportation Expenses | 4,717,600 | - |
| Audit and Supervision Expenses | 651,225 | - |
| Repairs and maintenance | 508,850 | - |
| Telephone/ Fax/ Internet Services Expense | 2,049,400 | - |
| Security, Utility and service exp | 785,450 | - |
| Stationery and Office Supplies Expense | 3,284,950 | - |
| Other admin expenses | 4,797,903 | - |
| Registration Fee | 62,500 | - |
| Provision for loan losses | 1,278,029 | - |
| Other expenses | 2,605,774 | - |
| Retained Earnings 2005 | - | - |
| | 750,375,180 | 750,375,180 |

Buwenge sacco

Balance sheet as at 31 December 2004

| | | 2004 | 2003 |
|---------------------------------------|---|--------------------|--------------------|
| | | Shs 000 | Shs 000 |
| ASSETS | | | |
| Loans and Advances | 1 | 24,690,097 | 25,646,500 |
| Short term investments | 2 | 538,082,450 | 266,750,500 |
| Cash and bank balances | 3 | 45,388,750 | 118,465,000 |
| Receivables (Debtors) | 4 | 45,249,691 | 15,162,500 |
| Property & Equipment | 5 | 18,525,556 | 19,534,485 |
| Other assets | | - | 9,404,518 |
| TOTAL ASSETS | | 671,936,544 | 445,081,303 |
| LIABILITIES | | | |
| Savings and time deposits | 6 | 596,869,169 | 389,381,000 |
| Accounts payable and accruals | 7 | 32,504,051 | 28,726,500 |
| Taxation payable | | - | - |
| Total liabilities | | 629,373,220 | 418,107,500 |
| EQUITY AND RESERVES | | | |
| Members' shares (Capital) | | 14,849,750 | 13,020,000 |
| Statutory & Legal reserves | | 2,903,305 | 2,903,500 |
| Donations (Deferred income) | 8 | 18,450,590 | 5,782,500 |
| Retained earnings December 2005 | 9 | 6,359,679 | 5,267,803 |
| Total equity and reserves | | 42,563,324 | 26,973,803 |
| TOTAL RESERVES AND LIABILITIES | | 671,936,544 | 445,081,303 |

Buwenge Sacco Income Statement for the Period Ended 31 December 2004

| | Note | 2004 Shs 000 | 2003 Shs 000 |
|--|------|----------------------|--------------------|
| INCOME | | | |
| Interest income | 10 | 52,350,428 | 20,578,000 |
| Interest expense | | -22,170,215 | -14,348,500 |
| Net interest income | | 30,180,213 | 6,229,500 |
| Loan loss provision | | 1,278,029 | - |
| Net interest income after provision for loan loss | | 28,902,184 | 6,229,500 |
| Loan commission income | | 4,924,370 | 1,387,500 |
| Other income | | 13,101,324 | 7,067,000 |
| Total income | | 46,927,878 | 14,684,000 |
| EXPENDITURE | | | |
| Administration expenses | 11 | 19,464,077 | 16,888,995 |
| Operating expenses | 12 | 29,098,476 | 10,368,000 |
| Total expenditure | | 48,562,552 | 27,256,995 |
| Loss for the period | | -1,634,675 | -12,572,995 |
| Grant income | | 2,726,550 | 12,362,020 |
| Taxation | | - | - |
| Net Profit for the period | | 1,091,876 | -210,975 |
| Transfer to reserves | | 1,091,876 | -210,975 |
| Note 1 | | | |
| | | 2004 | 2003 |
| LOANS & ADVANCES | | | |
| Short Term Loans | | 25,530,208 | 32,624,000 |
| Allowance for loan losses | | -840,111 | -6,977,500 |
| TOTAL | | 24,690,097 | 25,646,500 |
| Note 2 | | | |
| | | 2004 | 2003 |
| SHORT TERM INVESTMENTS | | | |
| Investment in shares | | 100,000 | 639,500 |
| Long Term investments and deposits | | 537,982,450 | 266,111,000 |
| TOTAL | | 538,082,450 | 266,750,500 |
| GRAND TOTAL | | 1,125,545,093 | 584,794,000 |
| Note 3 | | | |
| | | 2004 | 2003 |
| CASH & BANK BALANCES | | | |
| Cash | | 43,326,600 | 61,948,000 |
| Bank a/c | | 2,062,150 | 56,517,000 |
| TOTAL | | 45,388,750 | 118,465,000 |

| | | |
|-----------------------------------|-------------------|-------------------|
| Note 4 | 2004 | 2003 |
| RECEIVABLES (DEBTORS) | | |
| Commissions & Interest receivable | 22,786,950 | 1,170,500 |
| Advance to Employees | 12,263,988 | 9,093,500 |
| Prepaid assets | 10,198,754 | 4,898,500 |
| TOTAL | 45,249,691 | 15,162,500 |

| | | | | |
|---------------------|--|-------------------------|---------------------------------|-------------------|
| Note 5 | PROPERTY, PLANT & EQUIPMENT | | | |
| | Computer Units and Accessories | Electronic equipment | Office Furniture & Equipment | Total |
| Cost | | | | |
| Bal b/f 1-1-2005 | 8,377,100 | 1,460,000 | 10,139,735 | 19,976,835 |
| Additions | - | - | - | - |
| Bal c/f 31-12-2005 | 8,377,100 | 1,460,000 | 10,139,735 | 19,976,835 |
| Depreciation | | | | |
| Bal b/f 1-1-2005 | 1,182,022 | 195,325 | 496,913 | 1,874,260 |
| Charge for the year | 973,554 | 169,675 | 1,178,400 | 2,321,629 |
| Bal c/f 31-12-2005 | 2,155,576 | 365,000 | 1,675,313 | 4,195,889 |
| NBV | | | | |
| | 1/1/2005 | 7,195,078 | 1,264,675 | 9,642,822 |
| | 31/12/2005 | 6,221,524 | 1,095,000 | 8,464,422 |

| | | |
|-------------------------------------|--------------------|--------------------|
| Note 6 | 2004 | 2003 |
| SAVINGS & FIXED DEPOSITS | | |
| Regular saving | 317,085,965 | 276,764,000 |
| Short term time deposits | 19,756,556 | - |
| Other Savings and Time deposits | 260,026,649 | 112,617,000 |
| TOTAL | 596,869,169 | 389,381,000 |

S.48 Cooperative Societies Act requires that a Sacco shall transfer to reserves; 1% of the Sacco's turnover (Interest income) to Educational Fund

| | | |
|--|-------------------|-------------------|
| Note 7 | 2004 | 2003 |
| PAYABLES & ACCRUED EXPENSES | | |
| Interest payable on regular saving | 6,250,502 | 5,774,500 |
| Pay roll taxes payable (NSSF & PAYE) | 1,834,000 | 918,500 |
| Provision for audit fees Payable | 17,749,100 | 4,191,500 |
| Loan Protection Fund | 6,669,600 | 17,492,000 |
| Other payables | 850 | 350,000 |
| TOTAL | 32,504,051 | 28,726,500 |

| | | |
|------------------------|-------------|-------------|
| Note 8 | 2004 | 2003 |
| DONATIONS | | |
| Donations by SPEED | 5,232,400 | 5,232,500 |
| Donations - STROMME | 6,394,740 | - |
| Deferred STROMME Grant | 6,273,450 | - |
| Other Donations | 550,000 | 550,000 |

| | | |
|---|-------------------|-------------------|
| TOTAL | 18,450,590 | 5,782,500 |
| Note 9 | 2004 | 2003 |
| RETAINED EARNINGS | | |
| Reserves-2003 | 5,267,803 | |
| Profits-2004 | 1,091,876 | |
| TOTAL | 6,359,679 | |
| Note 10 | 2004 | 2003 |
| INCOME | | |
| Commission on loan | 4,924,370 | 2,775,000 |
| Interest Received on Long & Short Term Bank Deposit | 52,350,428 | 41,156,000 |
| Income from Donors – STROMME Grants | 2,726,550 | - |
| Other non fin. Income | 13,101,324 | 14,134,000 |
| TOTAL | 15,827,874 | 14,134,000 |
| Note 11 | 2004 | 2003 |
| ADMISTRATIVE EXPENSES | | |
| Transportation Expenses | 4,717,600 | 4,140,000 |
| Audit and Supervision Expenses | 651,225 | - |
| Repairs and maintenance | 508,850 | 815,000 |
| Telephone/ Fax/ Internet Services Expense | 2,049,400 | 3,591,500 |
| Security, Utility and service exp | 785,450 | 1,631,000 |
| Stationery and Office Supplies Expense | 3,284,950 | 1,598,000 |
| Other admin expenses | 4,797,903 | 3,739,500 |
| Registration Fee | 62,500 | 62,500 |
| Other expenses | 2,606,199 | 18,200,490 |
| TOTAL | 19,464,077 | 33,777,990 |
| Note 12 | 2004 | 2003 |
| OPERATING COSTS | | |
| Employee costs | 25,091,513 | 17,469,500 |
| Meeting expenses | 1,685,334 | - |
| Depreciation | 2,321,629 | 3,266,500 |
| | 29,098,476 | 20,736,000 |

CHAPTER FIVE

5.0 Control Accounts

A Control account is a summary account, also referred to as “total” account. The balance on the Control account should reconcile to individual ledgers

5.1 Examples of Control Accounts:

- Debtors (Sales) Control Account
- Creditors (Purchases) Control Account
- Savings Control Account
- Loans Control Account

Debtors and Creditors control accounts are for trading companies while the savings and Loan control accounts are specifically for Micro Finance Institutions.

5.2 Importance of Control Accounts

- Location of errors
- Detection of fraud
- Enhancing Management Efficiency
- Determination of Credit sales & Credit purchases
- Entries in Control Accounts

Location of Errors

Balance on control account should reconcile to individual subsidiary ledgers.
The two will not reconcile if errors exist.

Detection of Fraud

It's easy to detect manipulation of accounts under control of senior official.
Non reconciliation of the control accounts and individual ledgers is an indicator of fraud

Control accounts strengthen internal control

Enhancing Management Efficiency

Creditors and debtors balances can be obtained at first glance. This saves time

Determination of Credit sales & Credit purchases

These figures always miss in single entry and incomplete records, and Receipts & Payments accounts.

Credit sales and purchases can be obtained from Control Accounts

Entries in Control Accounts

Control accounts exist for other transactions and records

5.3 Illustrations

Example on control accounts:

Use the given information to draw up Debtors' and Creditors' control accounts for Katakwi Sacco

| | | |
|----------------------------|--|------------|
| Debtors' bal 1/1/05 | | 4,000,000 |
| Creditors' bal 1/1/05 | | 2,500,000 |
| Cash paid to suppliers | | 16,000,000 |
| Cash received from debtors | | 25,000,000 |
| Credit purchases | | 17,000,000 |
| Discount received | | 500,000 |
| Bad debts written off | | 100,000 |
| Sales returns | | 200,000 |
| Purchases returns | | 300,000 |
| Debtors cheque dishonoured | | 150,000 |
| Discount allowed | | 700,000 |
| Credit sales | | 30,000,000 |

You are required to draw up debtors and creditors control accounts

Control Accounts-Debtors control

| | | |
|-----------------------|--|-------------------|
| Bal b/f | | 4,000,000 |
| Debtors cheque | | 150,000 |
| (Dishonoured) | | <u>30,000,000</u> |
| Credit sales | | <u>34,150,000</u> |
| Cash | | 25,000,000 |
| Bad debts written off | | 100,000 |
| Sales returns | | 200,000 |
| Discount allowed | | 700,000 |
| Bal c/d | | <u>8,150,000</u> |

Control Accounts-Creditors control

| | | |
|------------------------|--|-------------------|
| Cash paid to suppliers | | 16,000,000 |
| Discount received | | 500,000 |
| Purchase returns | | 300,000 |
| Bal c/d | | <u>2,700,000</u> |
| | | <u>19,500,000</u> |
| Bal b/d | | 2,500,000 |
| Credit purchases | | <u>17,000,000</u> |
| | | <u>19,500,000</u> |

You are required to draw up debtors and creditors control accounts

Illustration of Savings control Account

Procedure:

- i. Divide the Savings ledgers into batches of sub ledgers
- ii. Post daily withdrawals & deposits to pass books & Ledgers
- iii. Summarise transactions that belong to each ledger on a day/transaction sheet

| Individual Ledgers | Summary-Control a/c |
|--------------------|---------------------|
| 10001 Member xxx | |
| 10002 Member xxx | |
| 10003 Member xxx | |

Day/Transaction sheet

Date 12/07/2006

Ledger No.....2.....

| Account | Particulars | Debit | Credit |
|--------------|---------------|------------------|------------------|
| 202 | Turyamureba | 700,000 | |
| 403 | Royal Complex | | 3,000,000 |
| 756 | Otto (U) Ltd | 1,000,000 | |
| 785 | Mukasa | | 500,000 |
| TOTAL | | 1,700,000 | 3,500,000 |

Control A/c Savings Ledger 2

| Date | Details | Debit | Credit | Balance |
|------------|-----------------|-----------|-----------|------------|
| 11/03/2006 | Balance b/f | | | 12,000,000 |
| 12/03/2006 | Day transaction | 1,700,000 | 3,500,000 | 13,800,000 |
| | | | | |
| E.t.c | | | | |

CHAPTER SIX

6.0 Key Performance Measures

6.1 Examples of Key performance measures

- Trend analysis
- Ratio analysis
- Comparative statement analysis
- Inter-Firm analysis

6.2 Trend Analysis:

What is Trend Analysis?

It's the analysis of direction of changes over a period of years, or comparison of financial ratios over a period

Trend analysis is also called “trend-percentage method”

6.3 Ratio Analysis:

What is Ratio Analysis?

Indicated quotient of two mathematical expressions, or relationship between two or more accounting figures, expressed mathematically

In order to understand the concepts of financial ratios, an illustration for trading companies was introduced before attempting an example on financial ratios for MFIs. MFI financial ratios are unique. Therefore accountants for MFI who in most cases have little or no accounting knowledge need to understand accounting concepts right from the very basics using trading company examples and later MFI example

6.31 Types of Ratios for a trading company:

- a) Liquidity ratios
- b) Leverage ratios
- c) Activity ratios
- d) Profitability ratios

a) Liquidity ratios:

Liquidity ratios measure firm's ability to meet current obligations

Examples of liquidity ratios include,

- i. Current ratio
- ii. Quick ratio

Current ratio = $\frac{\text{Current assets}}{\text{Current Liabilities}}$

Quick ratio = $\frac{\text{Current assets} - \text{Inventories}}{\text{Current Liabilities}}$

b) Leverage Ratios:

Leverage ratios show proportions of debt and equity in financing the firm's assets

Examples:

- i. Debt ratio
- ii. Debt – Equity ratio
- iii. Interest cover

$$\text{Debt ratio} = \frac{\text{Total Debt}}{\text{Capital employed}}$$

$$\text{Debt – equity ratio} = \frac{\text{Capital employed}}{\text{Net Worth}}$$

$$\text{Interest cover} = \frac{\text{EBIT}}{\text{Interest}}$$

c) Activity Ratios:

They reflect the firm's efficiency in utilising its assets

Examples:

- i. Inventory turnover
- ii. Debtors' turnover
- iii. Asset turnover

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Average inventory}} \text{ or}$$

$$\frac{\text{Sales}}{\text{Inventory}}$$

$$\text{Days of inventory holdings} = \frac{\text{Inventory}}{\text{Sales}} \times 365$$

d) Profitability ratios:

These measure the overall performance and effectiveness of the firms

Examples:

- i. Gross and Net Profit Margins
- ii. Return on investment (R.O.I)
- iii. Earnings Yield

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}}$$

$$\text{Net Profit Margin} = \frac{\text{Net Profit}}{\text{Sales}}$$

$$\text{Return on investment} = \frac{\text{EBIT}}{\text{Total Assets}}$$

$$\text{Earnings Yield} = \frac{\text{Earnings per share}}{\text{Market value per share}}$$

6.32 illustrations

Example on financial ratios for trading companies:

Using information given, prepare,
Trend Analysis
Key financial ratios for 2004 for HYT Company Ltd

| | 2003 | 2004 |
|--|-------------|-------------|
| Sales | 2,338,900 | 2,825,690 |
| Cost of goods sold | 1,929,040 | 2,322,800 |
| Gross Profit | 409,860 | |
| Selling & admn exp | 239,720 | 262,100 |
| Operating income | 170,140 | 240,790 |
| EBIT | 185,380 | 266,170 |
| Interest | 59,840 | 124,980 |
| Provision for tax | 41,790 | 30,000 |
| Profit after tax | 83,750 | 111,190 |
| Share capital | 225,000 | 225,000 |
| Reserves | 286,130 | 357,950 |
| Net worth | 511,130 | 582,950 |
| Long term debentures | - | 75,750 |
| Others | 199,870 | 285,900 |
| Total Long term debt | 199,870 | 361,650 |
| Short term borrowing | | |
| Total borrowing | 442,920 | 641,390 |
| Capital employed | 642,790 | 1,003,040 |
| Total non current assets | 1,153,920 | 1,585,990 |
| Total current assets (incl. inventories) | 546,700 | 663,620 |
| | 866,080 | 1,404,550 |
| Inventories | 476,280 | 778,890 |
| Debtors | 253,160 | 340,610 |
| Current Liabilities | 258,860 | 482,180 |

Solution:

a) Liquidity Ratios:

$$\text{Current Ratio} = \frac{1,404,550}{482,180}$$

$$= 2.9:1$$

$$\text{Quick Ratio} = \frac{1,404,550 - 778,890}{482,180}$$

$$= 1.3:1$$

b) Leverage Ratios:

$$\text{Debt Ratio} = \frac{1,003,040}{1,585,990} = 0.63$$

$$\text{D/E Ratio} = \frac{1,585,990}{582,950} = 2.7$$

$$\text{Interest cover} = \frac{266,170}{124,980} = 2.13 \text{ times}$$

c) Activity Ratios:

$$\text{Inventory turn over} = \frac{2,322,800}{778,890} = 2.98 \text{ times}$$

$$\text{Debtors turn over} = \frac{2,825,690}{170,305} = 16.6 \text{ times}$$

Note:

$$\text{Average debtors} = \frac{340,610}{2} = 170,305$$

$$\text{Asset turn over} = \frac{2,825,690}{(663,620 + 1,404,550)}$$

$$= \frac{2,825,690}{2,068,170}$$

$$= 1.37 \text{ times}$$

d) Profitability ratios

$$\text{Gross Profit} = \frac{502,890}{2,825,690}$$

$$= 0.178 \text{ or } 17.8\%$$

$$\text{Net Profit margin} = \frac{111,190}{2,825,690}$$

$$= 0.039 \text{ or } 3.9\%$$

$$\text{Return on Investment} = \frac{266,170}{2,068,170}$$

$$= 0.129 \text{ or } 12.9\%$$

Trend Analysis:

| | | |
|-------|------|--|
| | 2003 | 2004 |
| Sales | 100 | $\frac{2,825,690}{2,338,900} \times 100$ |
| | | = 120.8 |

| | | |
|------|------|--------------------------------------|
| | 2003 | 2004 |
| EBIT | 100 | $\frac{266,170}{185,380} \times 100$ |
| | | = 143.6 |

$$\begin{aligned} \text{PAT} \quad 100 &= \frac{111,190}{83,750} \times 100 \\ &= 132.8 \end{aligned}$$

$$\begin{aligned} \text{Current assets} \quad 100 &= \frac{1,404,550}{866,080} \times 100 \\ &= 162.2 \end{aligned}$$

$$\begin{aligned} \text{Current Liabilities} & \quad \begin{matrix} 2003 & 2004 \\ 100 & \frac{482,180}{258,860} \times 100 \end{matrix} \\ &= 186.3 \end{aligned}$$

$$\begin{aligned} \text{Fixed assets} \quad 100 &= \frac{663,620}{546,700} \times 100 \\ &= 121.4 \end{aligned}$$

$$\begin{aligned} \text{Total assets} \quad 100 &= \frac{(663,620 + 1,404,550)}{(546,700 + 866,080)} \\ &= \frac{2,068,170}{1,412,780} \\ &= 146.4 \end{aligned}$$

$$\begin{aligned} \text{Net Worth} \quad 100 &= \frac{582,950}{511,130} \times 100 \\ &= 114.1 \end{aligned}$$

6.4 Financial ratios for MFIs:

Financial ratios for MFIs are different from those of trading companies for instance, MFIs do not have items like inventory and taxation.

Example on financial ratios for MFIs:

Using the financial information of Rubanda Kiizi sacco, let's prepare financial ratios for the sacco

Financial Ratios for Rubanda Kiizi sacco

| | 2005 | 2004 |
|--|-------------|--------------|
| Liquidity ratios | | |
| 1 Current ratio | | |
| Current assets | 90,638,441 | 133,627,500 |
| Current Liabilities | 32,503,201 | 28,726,500 |
| Current assets/Current Liabilities | 3 | 5 |
| 2 Operational self sustaining ratio | | |
| Incomes | 46,927,878 | 14,684,000 |
| Operational expenses | 29,098,476 | 10,368,000 |
| Incomes/Operational expenses | 2 | 1 |
| 3 Interest cover | | |
| Interest income | 52,350,428 | 20,578,000 |
| Interest expense | 22,170,215 | 8,119,000 |
| Interest income/Interest expense | 2 | 3 |
| 4 Loans Vs Member deposits | | |
| Loans | 24,690,097 | 25,646,500 |
| Total deposits | 596,869,169 | 389,381,000 |
| Loans/Total deposits (%) | 4 | 7 |
| 5 Debt/Member capital ratio | | |
| Debt | - | - |
| Member share capital | 14,849,750 | 13,020,000 |
| Debt Vs Member share capital (%) | - | - |
| 6 Provision for loan losses/Short term loans | | |
| Provision for loan losses | 1,278,029 | - |
| Short term loans | 25,530,208 | 32,624,000 |
| Ratio (%) | 5 | - |
| 7 Profitability V s Member deposits | | |
| Profits | - 1,634,250 | - 12,572,995 |
| Member deposits | 596,869,169 | 389,381,000 |
| Profits/Member deposits (%) | - 0 | - 3 |
| 8 Profit vs Assets | | |
| Profit before interest & tax | 1,092,301 | - 210,975 |
| Capital employed | 671,936,544 | 445,081,303 |
| PBIT/Capital employed | 0 | - |
| 8 Cash vs total deposits | | |
| Cash | 45,388,750 | 118,465,000 |
| Total deposits | 596,869,169 | 389,381,000 |
| Cash/total deposits | 0 | 0 |

CHAPTER SEVEN

7.0 Bank Reconciliation

Bank Reconciliation is the process of bringing into agreement the balance as per cash book (bank column) and the balance as per bank statement

7.1 importance of Bank Reconciliation

It strengthens an organisation's internal control system, and
Leads to accuracy in records

7.2 Reasons for discrepancy between cash book and bank statement balances

- Direct debits e.g. bank charges, standing orders
- Direct credits e.g. interest received
- Un presented cheques
- Un credited cheques
- Clerical errors
- Dishonoured cheques
- Unrecorded items (intentional)

7.3 Reasons for dishonouring a cheque by a bank

- Insufficient funds (R/D)
- Amount in words and figures differ
- Signature on cheque different from specimen
- Cheque is stale
- No counter signature on alterations in words and figures
- No account title on cheque
- Payee's identity doubted
- Payment vouchers not attached (if a BoU cheque)

7.4 Methods of Bank Reconciliation

- i. Cash book balance adjusted towards bank balance
- ii. Bank balance adjusted towards cash book balance

7.5 Illustrations

Example 1 on preparation of bank reconciliation statements:

The following is a cashbook and bank statement for Mushanga Sacco for December 2005
You are required to prepare a bank reconciliation statement for Mushanga Sacco for December 2005.

| Date | Details | Amount | Date | Details | Amount |
|--------|---------|--------------------|--------|---------|--------------------|
| 12-Jan | Bal b/f | 80,000,000 | 7/12 | Moses | 32,000,000 |
| 12-Feb | Joel | 60,000,000 | 12-Aug | Patra | 40,000,000 |
| 12-Oct | Maria | 24,000,000 | 12-Nov | Pam | 30,000,000 |
| 14/12 | Henry | 10,000,000 | 17/9 | Otto | 14,000,000 |
| 28/12 | Jack | 4,000,000 | 28/12 | Jim | 6,000,000 |
| 16/12 | Jane | 4,000,000 | 30/12 | Jill | 2,000,000 |
| 28/12 | Pat | 34,000,000 | 30/12 | Stella | 1,000,000 |
| 30/12 | Kim | 13,000,000 | 30/12 | Peter | 4,000,000 |
| 30/12 | Sarah | 2,000,000 | | Bal c/f | <u>94,000,000</u> |
| Total | | <u>227,000,000</u> | | | <u>227,000,000</u> |

Note:

A cheque written to Jim on 28th December 2005, and one received from Jane and banked on 16th December 2005 were dishonoured by the bank.

Solution:

Method 1 – Adjusting cash book towards bank statement balance

Adjusted cash book

| Details | Amount | Details | Amount |
|----------------------|--------------------|-------------|--------------------|
| Bal b/f | 94,000,000 | Jane | 4,000,000 |
| Lillian | 18,000,000 | Brenda | 2,000,000 |
| Grace | 16,000,000 | Bank charge | 200,000 |
| Jim | 6,000,000 | | |
| (Dishonoured cheque) | | Bal c/f | <u>127,800,00</u> |
| Total | <u>134,000,000</u> | Total | <u>134,000,000</u> |

Bank reconciliation for Mushanga Sacco for the month of December 2005

| | | |
|-------------------------------|------------------|-------------|
| | Shs | Shs |
| Bal as per adjusted cash book | | 127,800,000 |
| Add: un presented cheques | | |
| Jack | 4,000,000 | |
| Jill | 2,000,000 | |
| Stella | 1,000,000 | |
| Peter | <u>4,000,000</u> | 11,000,000 |
| | | 138,800,000 |
| Less: un credited cheques | | |
| Pat | 34,000,000 | |
| Kim | 13,000,000 | |
| Sarah | <u>2,000,000</u> | 49,000,000 |
| Bal as per bank statement | | 89,800,000 |

Method 2:

Bank statement balance adjusted towards the cash book balance

| | Shs | Shs |
|---------------------------|-------------------|-------------------|
| Bal as per bank statement | | |
| Add: Direct debits | | |
| Brenda | 2,000,000 | |
| Bank charges | <u>200,000</u> | 2,200,000 |
| Un credited cheques: | | |
| Less: Direct credits | | |
| Lillian | 18,000,000 | |
| Grace | <u>16,000,000</u> | 34,000,000 |
| Unpresented cheques: | | |
| Jack | 4,000,000 | |
| Jill | 2,000,000 | |
| Stella | 1,000,000 | |
| Peter | <u>4,000,000</u> | 11,000,000 |
| Dishonoured cheque | | |
| Jim | <u>6,000,000</u> | <u>51,000,000</u> |
| Bal as per cash book | | 94,000,000 |

Example 2 on preparation of bank reconciliation statements:

From the following information, prepare a bank reconciliation statement for Gulu Sacco

| Cheque Number | Amount (shs) |
|---------------|--------------|
| 15 | 500,000 |
| 20 | 1,200,000 |
| 25 | 700,000 |
| 30 | 400,000 |
| 32 | 3,000,000 |
| 40 | 600,000 |
| 45 | 2,500,000 |
| 50 | 1,500,000 |

List of uncredited cheques as at 31 December 2002

| Cheque Number | Amount (shs) |
|---------------|--------------|
| 101 | 2,400,000 |
| 83 | 100,000 |
| 163 | 900,000 |
| 75 | 1,400,000 |
| 105 | 250,000 |

January 2003 Cash book (Bank column) for Gulu Sacco

| Details | Amount Shs'000 | Details | Amount Shs'000 |
|---------------|-------------------|--------------|-------------------|
| Bal b/f | 4,650 | Cheque No 60 | 2,500 |
| Cheque No 204 | 1,500 | Cheque No 61 | 1,400 |
| Cheque No 310 | 2,800 | Cheque No 62 | 300 |
| Cheque No 802 | 4,000 | Cheque No 64 | 700 |
| Cheque No 740 | 600 | Cheque No 65 | 2,600 |
| Cheque No 150 | 2,000 | Cheque No 66 | 200 |
| Cheque No 610 | 1,500 | Cheque No 68 | 1,000 |
| Cheque No 550 | 3,200 | Cheque No 69 | 7,200 |
| Cheque No 440 | 1,900 | Cheque No 70 | 3,000 |
| Cheque No 320 | 400 | Cheque No 71 | 2,200 |
| Cheque No 280 | 5,000 | Cheque No 72 | 100 |
| Cheque No 900 | 6,000 | Cheque No 73 | 800 |
| Cheque No 260 | 5,500 | Bal c/f | 18,350 |
| Cheque No 850 | 1,300 | | |
| Total | 40,350 | Total | 40,350 |

January 2003 Bank Statement for Gulu Sacco

| Details | Debit Shs'000 | Credit Shs'000 | Balance Shs'000 |
|---------------|------------------|-------------------|--------------------|
| Bal b/f | | | 10,000 |
| Cheque No 25 | 700 | | 9,300 |
| Cheque No 32 | 3,000 | | 6,300 |
| Cheque No 15 | 500 | | 5,800 |
| Cheque No 105 | | 250 | 6,050 |
| Cheque No 163 | | 900 | 6,950 |
| Cheque No 204 | | 1,500 | 8,450 |
| Cheque No 310 | | 2,800 | 11,250 |
| CM | | 1,000 | 12,250 |
| Cheque No 60 | 2,500 | | 9,750 |
| Cheque No 61 | 1,400 | | 8,350 |
| Cheque No 64 | 700 | | 7,650 |
| Cheque No 40 | 600 | | 7,050 |
| Cheque No 802 | | 4,000 | 11,050 |
| Cheque No 740 | | 600 | 11,650 |
| Cheque No 75 | | 1,400 | 13,050 |
| Cheque No 66 | 200 | | 12,850 |
| Cheque No 68 | 1,000 | | 11,850 |
| Cheque No 150 | | 2,000 | 13,850 |
| Cheque No 30 | 400 | | 13,450 |
| Cheque No 610 | | 5,100 | 18,550 |
| CM | | 500 | 19,050 |
| Cheque No 70 | 3,000 | | 16,050 |
| Cheque No 280 | | 5,000 | 21,050 |
| Cheque No 69 | 2,700 | | 18,350 |
| Ledger fee | 50 | | 18,300 |
| Commission | 150 | | 18,150 |
| Interest | | 100 | 18,250 |

Note:

Cheque No 440 and 65 were dishonoured by the bank and returned together with the bank statement

In case of any mistakes in figures, they must have arisen due to mis-recording of the cashbook.

Solution:

Method 1 – Adjusting cash book towards bank statement balance

Adjusted cash book

| Details | Amount Shs 000 | Details | Amount shs 000 |
|--------------------------|-------------------|--------------------|-------------------|
| Bal b/f | 18,350 | Ledger fee | 50 |
| CM | 1,000 | Commission | 150 |
| Mistake on cheque No 610 | 3,600 | Dishonoured cheque | 1,900 |
| CM | 500 | | |
| Interest | 100 | | |
| Dishonoured cheque No 65 | 2,600 | | |
| Mistake on Cheque No 69 | <u>4,500</u> | | |
| | | Bal c/f | <u>28,550</u> |
| Total | 30,650 | Total | 30,650 |

Bank reconciliation for Gulu Sacco for the month of December 2005

| | Shs | Shs |
|-------------------------------|--------------|---------------|
| Bal as per adjusted cash book | | 28,550 |
| Add: un presented cheques | | |
| Cheque No 20 | 1,200 | |
| Cheque No 45 | 2,500 | |
| Cheque No 50 | 1,500 | |
| Cheque No 62 | 300 | |
| Cheque No 71 | 2,200 | |
| Cheque No 72 | 100 | |
| Cheque No 73 | <u>800</u> | <u>8,600</u> |
| | | 37,150 |
| Less: un credited cheques | | |
| Cheque No 101 | 2,400 | |
| Cheque No 83 | 100 | |
| Cheque No 550 | 3,200 | |
| Cheque No 320 | 400 | |
| Cheque No 900 | 6,000 | |
| Cheque No 260 | 5,500 | |
| Cheque No 850 | <u>1,300</u> | <u>18,900</u> |
| Bal as per bank statement | | 18,250 |

Note:

Unpresented cheques with numbers 20,45 and 50 were unpresented in December 2002 and were still unpresented by 31 January 2003. Likewise, uncredited cheques 101 and 83 from December 2002 were still uncredited by 31 January 2003.

Where unrepresented or uncredited cheques are very many, only the total can be quoted in the bank reconciliation statement. A schedule or lists of those cheques are then attached to the reconciliation statement as appendices or annexes.

Method 2:

Bank statement balance adjusted towards the cash book balance

| | Shs | Shs | Shs |
|----------------------------|--------------|---------------|---------------|
| Bal as per bank statement | | | 18,250 |
| Add: Direct debits | | | |
| Ledger fee | 50 | | |
| Commission | <u>150</u> | 200 | |
| Dishonoured cheque No. 440 | | 1,900 | |
| Un credited cheques: | | | |
| Cheque No 101 | 2,400 | | |
| Cheque No 83 | 100 | | |
| Cheque No 550 | 3,200 | | |
| Cheque No 320 | 400 | | |
| Cheque No 900 | 6,000 | | |
| Cheque No 260 | 5,500 | | |
| Cheque No 850 | <u>1,300</u> | <u>18,900</u> | <u>21,000</u> |
| | | | 39,250 |
| Less: Direct credits | | | |
| CM | 1,000 | | |
| CM | 500 | | |
| Interest | <u>100</u> | 1,600 | |
| Cash book mistakes | | | |
| Cheque No 610 | 3,600 | | |
| Cheque No 69 | <u>4,500</u> | 8,100 | |
| Unrepresented cheques: | | | |
| Cheque No 20 | 1,200 | | |
| Cheque No 45 | 2,500 | | |
| Cheque No 50 | 1,500 | | |
| Cheque No 62 | 300 | | |
| Cheque No 71 | 2,200 | | |
| Cheque No 72 | 100 | | |
| Cheque No 73 | <u>800</u> | 8,600 | |
| Dishonoured cheque | | | |
| Cheque No 65 | | <u>2,600</u> | 20,900 |
| Bal as per cash book | | | 18,350 |

CHAPTER EIGHT

This is one of the complicated areas for MFIs, being that participants have low accounting education. None the less, we believe that the following concepts and explanations will help the trainees understand preparation of Cash Flow Statements.

8.0 Cash Flow Statements

A Cash Flow Statement is a logical statement i.e. a summary of how cash flowed in and out of the business (MFI) during the reporting period

8.1 Objective of Cash Flow Statements:

Information about the cash flow of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The objective of this standard is to require the provision of information about the historical changes in cash and cash equivalents of a cash flow statement, which classifies cash flow during operating, investing and financing activities.

8.2 Importance of Cash Flow Information.

A cash flow statement, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amount and timing of cash flows in order to adopt changing circumstances and opportunities.

Cash flow information is useful in the ability of the enterprise (MFI) to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprise.

It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatment for the same transactions and events.

Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessment of future relationship between profitability and net cash flow and the impact of changing prices.

8.3 Definitions:

The following terms are used in this standard with the meanings specified;
Cash comprises cash on hand and demand deposits.

Cash Equivalents are short – term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

8.4 Major components of Cash Flow statements

- Cash Flows from operating activities
- Cash Flows from investing activities
- Cash Flows from financing activities
- Net increase or decrease in cash and cash equivalents
- Cash and cash equivalents at beginning of the period
- Cash and cash equivalents at end of the period

Operating activities are the principle revenue – producing activities of the enterprise and other activities.

Examples of each cash flow from operating activities are;

- a) Cash receipt from the sale of goods and the rendering of services.
- b) Cash receipts from royalties, fees, commissions and other revenue.
- c) Cash payments to suppliers for goods and services.
- d) Cash payments to and on behalf of employees.
- e) Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits.
- f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities and
- g) Cash receipts and payments from contracts held for dealing or trading purposes.

Investing activities are the acquisitions and disposal of long – term assets and other investments not included in cash equivalents.

Examples of cash flows arising from investing activities are;

- a) Cash payments to acquire property, plant and equipment, intangibles and other long term assets. These payments include those relating capitalised development costs and self – constructed property, plant and equipment.
- b) Cash receipts from sales of property, plant and equipment, intangibles and other long term assets.
- c) Cash payments to acquire equity or debt instruments of other enterprises and interests in joint venture (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purpose.
- d) Cash receipts from sales of equity or debt instruments of other enterprises and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes).
- e) Cash advances and loans made to other parties (other than advances and loans made by a financial institution).
- f) Cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution).
- g) Cash payments for futures contracts, forward contracts, option contracts are held for dealing or trading purposes or the payments are classified as financing activities; and
- h) Cash receipts from futures contracts forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities. When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contracts are classified in the same manner as the cash flows of the position being hedged.

Financing activities are activities that result in changes in the size and composition of the equity capital and borrowings of the enterprise.

Examples of cash flows arising from financing activities are;

- a) Cash proceeds from issuing shares or other equity instruments.
- b) Cash payments to owners to acquire or redeem the enterprises' shares.

- c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long term borrowings.
- d) Cash repayments of amounts borrowed and
- e) Cash payments by a lesser for the reduction of the outstanding liability relating to a finance lease.

Cash and cash Equivalents:

Cash equivalents are held for the purpose of meeting short – term cash commitments rather than for investment or other purposes. For an investment to qualify as cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value.

Therefore an investment normally qualifies as a cash equivalent only when it has a short maturity of say, three months or less from the date of requisition.

Equity investments are excluded from cash equivalents unless they are in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

Bank borrowings are generally considered to be financing activities. However in some countries, bank overdrafts that are repayable on demand from an integral part of an enterprises cash management, in these circumstances, are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to over drawn.

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities.

Cash management includes the investments of excess cash in cash equivalents.

8.5 Presentation of Cash flow statement;

The cash flow statement should report cash flows during the period classified by operating, investment and financing activities.

An enterprise presents its cash flows from operating, investing and financing activities in a manner, which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the capital elements is classified as a financing activity.

8.6 Illustrations

In order to understand the concepts of a cash flow statement, it is necessary to introduce the cash flow of a trading company before that of a Micro Finance Institution. Accountants for MFI who in most cases have little or no accounting knowledge need to understand accounting concepts right from the very basics using trading company examples and later MFI example

Exercise on preparation of Cash Flow Statements for trading companies:

Using information provided, prepare a Cash Flow statement for Underwriters Limited

The following are the abridged annual financial statements of underwriters limited

Income statement for the year ended 31 December 2003

| | Shs |
|----------------------------------|---------------|
| Revenue | 850,000 |
| Cost of sales | 637,500 |
| | 110,800 |
| Gross profit | 212,500 |
| Administration expenses | (28,100) |
| Operating expenses | (73,600) |
| | 110,800 |
| Finance cost | (15,800) |
| | 95,000 |
| Income tax | 44,000 |
| | 51,000 |
| Net profit for the period | 51,000 |

Statement of changes in equity for the year ended 31st December 2003.

| | Share capital Shs | Revaluation reserve Shs | Accumulated profit Shs | Total Shs |
|----------------------------|----------------------|-------------------------------|---------------------------|----------------|
| Opening | 120,000 | - | 121,000 | 241,000 |
| Revaluation of buildings | - | 20,000 | - | 20,000 |
| Net profit for the period | - | - | 51,000 | 51,000 |
| Dividends paid | | | (25,000) | (25,000) |
| Repayment of share capital | (20,000) | - | - | (20,000) |
| | 100,000 | 20,000 | 147,000 | 267,000 |
| Closing | 100,000 | 20,000 | 147,000 | 267,000 |

Balance sheet as at 31st December 2003

| | Note | 2003 Shs | 2002 Shs |
|-------------------------------|------|-------------|-------------|
| <u>Assets</u> | | | |
| Property, plant and equipment | 1 | 355,000 | 304,000 |
| <u>Current assets</u> | | | |
| Inventories | | 82,000 | 42,000 |
| Debtors and prepayments | 2 | 84,000 | 59,000 |
| Bank | | - | 6,000 |
| | | 166,000 | 107,000 |
| <u>Current liabilities</u> | | | |
| Creditors | | 72,000 | 35,000 |
| Bank | | 43,000 | - |
| Taxation payable | | 40,000 | 10,000 |
| | | 155,000 | 45,000 |
| Net current assets | | 11,000 | 62,000 |
| Net total assets | | 366,000 | 366,000 |
| <u>Equity and debt</u> | | | |
| Loan | | 99,000 | 125,000 |
| Share Capital | | 100,000 | 120,000 |
| Revaluation reserve | | 20,000 | - |
| Accumulated profits | | 147,000 | 121,000 |
| | | 366,000 | 366,000 |

Notes:

1. Property plant and equipment

| | 2003 | 2002 |
|--------------------|-------------|-------------|
| | Shs | Shs |
| Land and buildings | 250,000 | 220,000 |
| Machinery | 35,000 | 20,000 |
| Motor vehicles | 6,000 | 4,000 |
| Furniture | 64,000 | 60,000 |
| | 355,000 | 304,000 |
| | 355,000 | 304,000 |

2. Debtors and prepayment s

| | 2003 | 2002 |
|------------------|-------------|-------------|
| | Shs | Shs |
| Debtors | 63,000 | 43,000 |
| Prepaid expenses | 21,000 | 16,000 |
| | 84,000 | 59,000 |
| | 84,000 | 59,000 |

3. The following depreciation charges are included in operating expenses

- Machinery Shs. 25,000
- Motor vehicles Shs 2,000

4. A fully depreciated machinery with an original cast of Shs 15,000 was sold for Shs 5,000 during the year.

Profit is included in the operating expenses.

Required:

Prepare a cash flow statement in accordance IAS 7.

Underwriters Limited
Cash Flow Statement
For the year ended 31 December 2003

| | Shs | Shs |
|---|-----------------|-----------------|
| Profit before interest and tax | | 10,800 |
| Adjustments for: | | |
| Depreciation | | 27,000 |
| Elimination of profit on sale of machinery | | <u>(5,000)</u> |
| | | 132,800 |
| Changes in working capital changes: | | |
| Increase in debtors | (20,000) | |
| Increase in prepayments | (5,000) | |
| Increase in inventory | (40,000) | |
| Increase in creditors | <u>37,000</u> | |
| Cash Flows from operating activities | | (28,000) |
| Taxation | (14,000) | |
| Dividends | (25,000) | |
| Interest paid | <u>(15,800)</u> | <u>(54,800)</u> |
| Net Cash flows from operating activities | | 50,000 |
| Cash Flows from investing activities | | |
| Purchase of Land and Buildings | (10,000) | |
| Sale of Motor Vehicle | 5,000 | |
| Purchase of Motor Vehicle | (4,000) | |
| Purchase of Furniture & Fittings | (4,000) | |
| Purchase of Machinery | <u>(40,000)</u> | |
| Net operating cash flows from investing activities | | (53,000) |
| Cash flows from financing activities | | |
| Share redemption | (20,000) | |
| Loan repayment | <u>(26,000)</u> | |
| Net operating cash flows from financing activities | | (46,000) |
| Net decrease in cash and cash equivalents | | (49,000) |
| Cash and cash equivalents b/f | | 6,000 |
| Cash and cash equivalents c/f | | (43,000) |

Exercise on preparation of Cash Flow Statements for MFIs:

Using the financial statements of Isingiro Sacco, prepare the sacco's Cash Flow Statement.

Isingiro sacco

Balance sheet as at 31 December 2004

| | | 2004 | 2003 |
|---------------------------------------|---|--------------------|--------------------|
| | | Shs 000 | Shs 000 |
| ASSETS | | | |
| Loans and Advances | 1 | 24,690,097 | 25,646,500 |
| Short term investments | 2 | 538,082,450 | 266,750,500 |
| Cash and bank balances | 3 | 45,388,750 | 118,465,000 |
| Receivables (Debtors) | 4 | 45,249,691 | 15,162,500 |
| Property & Equipment | 5 | 18,525,556 | 19,534,485 |
| Other assets | | - | 9,404,518 |
| TOTAL ASSETS | | 671,936,544 | 445,081,303 |
| LIABILITIES | | | |
| Savings and time deposits | 6 | 596,869,169 | 389,381,000 |
| Accounts payable and accruals | 7 | 32,504,051 | 28,726,500 |
| Taxation payable | | - | - |
| Total liabilities | | 629,373,220 | 418,107,500 |
| EQUITY AND RESERVES | | | |
| Members' shares (Capital) | | 14,849,750 | 13,020,000 |
| Statutory & Legal reserves | | 2,903,305 | 2,903,500 |
| Donations (Deferred income) | 8 | 18,450,590 | 5,782,500 |
| Retained earnings December 2005 | 9 | 6,359,679 | 5,267,803 |
| Total equity and reserves | | 42,563,324 | 26,973,803 |
| TOTAL RESERVES AND LIABILITIES | | 671,936,544 | 445,081,303 |

Isingiro Sacco Income Statement for the Period Ended 31 December 2004

| | Note | 2004 Shs 000 | 2003 Shs 000 |
|--|------|-------------------|--------------------|
| INCOME | | | |
| Interest income | 10 | 52,350,428 | 20,578,000 |
| Interest expense | | -22,170,215 | -14,348,500 |
| Net interest income | | 30,180,213 | 6,229,500 |
| Loan loss provision | | -1,278,029 | - |
| Net interest income after provision for loan loss | | 28,902,184 | 6,229,500 |
| Loan commission income | | 4,924,370 | 1,387,500 |
| Other income | | 13,101,324 | 7,067,000 |
| Total income | | 46,927,878 | 14,684,000 |
| EXPENDITURE | | | |
| Administration expenses | 11 | 19,464,077 | 16,888,995 |
| Operating expenses | 12 | 29,098,476 | 10,368,000 |
| Total expenditure | | 48,562,553 | 27,256,995 |
| Loss for the period | | -1,634,675 | -12,572,995 |
| Grant income | | 2,726,550 | 12,362,020 |
| Taxation | | - | - |
| Net Profit for the period | | 1,091,875 | -210,975 |
| Transfer to reserves | | 1,091,875 | -210,975 |

Isingiro SACCO

Cash Flow Statement for the Period Ended 31 December 2004

| | 2004 Ushs 000 |
|---|--------------------------------|
| OPERATING ACTIVITIES | |
| Operating surplus for the period | 1,091,875 |
| Adjustments for: | |
| Depreciation | 2,321,629 |
| Impairment of stock & other assets | - |
| Deferred income | - 2,726,550 |
| Loan loss provision | 1,278,029 |
| Operating surplus before working capital changes | 1,964,984 |
| Increase in Receivables | - 30,087,191 |
| Increase in Savings and time deposits | 207,488,169 |
| Increase in Accounts payable and accruals | 3,777,551 |
| Increase in Loans and advances | - 321,626 |
| Taxation payable | - |
| Cash generated from operations | 182,821,887 |
| INVESTING ACTIVITIES | |
| Increase in investments | - 271,331,950 |
| Purchase of property and equipment | - |
| Disposal of other assets | 9,404,518 |
| Net cash outflow from investing activities | - 263,240,132 |
| FINANCING ACTIVITIES | |
| Members shares | 1,829,750 |
| Donations (Deferred income) | 15,394,640 |
| Net cash inflow from financing activities | 17,224,390 |
| Net increase in cash and cash equivalents | - 73,076,250 |
| CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD | 118,465,000 |
| CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD | 45,388,750 |

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