**TRAINING IN FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE ONE: SESSION FIVE PARTICIPANTS’ NOTES**

**FINANCIAL ACCOUNTING FRAMEWORK**

**1.0 Purpose of session:**

The purpose of this session is;

1. To introduce the trainees to the nature of financial transactions, the double entry system, basic financial documents, records and books
2. To explain and appreciate the concept of basic internal controls in business and financial management

**1.1 Nature of financial transactions**

A financial transaction occurs when there is a monetary exchange of goods, service or promises between one party and another. If the exchange is immediate, that is a cash transaction but where there is promise to pay latter it is a transaction on credit.

 A business has an accounting period lasting a year. It could coincide with the calendar year or any period of twelve months the business may choose. If a transaction relates only to the accounting period of one year, the transaction is categorized as current. Current transactions that bring in money into the business are revenue transactions while those that take away money are expenses. Examples of revenue transactions include billed works done and say money earned from sale of scrap. Expense transactions include wages, purchase of materials and hire of equipment.

Where an expense relates to an item whose usefulness goes beyond one accounting period, it is a capital transaction. An example of such a transaction is the purchase of a lorry or a building. The item acquired through a capital transaction is called a fixed asset. A lorry is a fixed asset of the business while fuel is an expense to it.

In every financial transaction whether recurrent or capital there are two parties; one party gives value while another receives value. For example when the business buys materials, the business receives value but the supplier gives away value. When the material is paid for, the supplier receives value but the business gives it away.

**1.2 Double entry**

Financial transactions of a business are recorded in a book called a general ledger. The general ledger for convenience may be segmented into sub-ledgers or subsidiary ledgers and therefore only use control totals in the main ledger.

Every transaction in the ledger is recorded twice in suitable accounts, one a debit and the other a credit, that are self-checking, one to indicates who takes and the other who gives value. An account is just a ledger sheet with a collection of similar transactions. The account that receives value is debited and the one that gives value is credited. For example when we pay wages by cash, the wages account is debited and the cash account is credited. When we buy a motor vehicle, the motor vehicles account is debited and the cash account is credited. Therefore, a ledger is full of debit accounts and credit accounts that are equal and opposite and that classify transactions of a business whether revenue or expenses, assets or liabilities. (In modern times these ledgers are computerized but the principles remain the same.)

Debit balances that classify transactions for goods and services that are consumed by the business are expense accounts, for example wages. Debit balances that classify items of short term value to the business are current assets such as cash and bank, accounts receivables (debtors) or stock of materials. Debit balances that classify items of long term value to the business are fixed assets such as land and buildings.

On the other hand credit balances that record income earned are revenue accounts, those that record short term indebtedness of the business are current liabilities such as accounts payable (creditors); and others record long term indebtedness such as loans and share capital.

**1.3 Bookkeeping process:**

The process of recording business transactions in their respective accounts, summing up the transactions to obtain account balances and listing of the accounts in the ledgers is what is known as bookkeeping. At interval that could be monthly, quarterly or annually, the transactions in an account are summed up to give a total called a balance. The list of all the balances in the ledger is called a trial balance. Because of the double entry rule a list of all balances in the ledger totals zero (all debits equal all credits). Debits balances consist of expenses and assets while credit balances comprise of revenue and liabilities. Books are balanced when the debit balances equal the credit balances.

Finally, the list of balances is analyzed and summarized to make financial statements.

Classification of financial transactions may be summarized as follows:

* Recurrent transactions that constitute a profit and loss statement consist of:
	+ Income (credit)
	+ Expenditure (debit)
* Capital expenditure consist of :
	+ Assets (debit)
	+ Liabilities (credits)

Classification of recurrent transactions (profit or loss)

The recurrent transactions are processed and expenses deducted from the income to arrive at the profit or loss for the period. Examples of recurrent transactions are:

|  |  |
| --- | --- |
| Expenses (debits) | Income/Revenue (Credits) |
| Materials | Certified work |
| Labour | Equipment hired out |
| Maintenance | Sale of fabricated items |
| Plant hire |  |
| Fuel |  |
| Telephone |  |
| Stationery |  |
| Site rent |  |

Classification of the balance sheet transactions:



**1.4 Internal controls**

Internal controls are the whole system of controls, financial or otherwise, established and approved by management of the organisation/business to ensure that operations are done in an orderly manner and to safeguard the resources/assets of the organization. Some controls are formal others are not, similarly the controls could be documented in procedural manuals but sometimes they are just known by tradition or practice. There are no standard controls as such but what is adopted should be what is suitable for the business in the existing circumstances bearing in mind that the primary purpose of internal controls is to safeguard resources and to ensure orderliness.

**1.5 Usefulness of Internal Controls to managers:**

Internal controls are a management tool that assists managers to mobilise the stakeholders and direct them to the sole purpose of attaining the corporate objectives. They help management to organise and to operate in a systematic and orderly manner. Consider the purchase of materials for example, internal controls over it would indicate who is responsible to source for materials and who approves the purchase order as well as who receives and inspects the goods. Internal controls do put in place the documentation to be used such as materials requisition, quotations, purchase orders and goods received notes. It may provide at the time of payment to attach evidence of ordering and receipt and at times may involve internal audit verifications.

Internal controls prevent errors and intentional acts of defalcation to misrepresent financial information and where such errors have occurred to be able to detect them early so that they can be corrected.

 Internal controls safeguard the assets and resources of the business from unauthorised access or usage, from malicious acts and from outright theft.

During the preparation of financial statements, internal controls give assurance over the integrity of financial reports; that they are substantially accurate, free from material omissions or inclusions that would compromise them from being true and fair.

**1.6 Basic Internal Controls:**

1. Physical controls:
	* Limiting access to resources, data, records or information say by keeping them under lock, having pass words or manning entry points.
	* Recording such access.
2. Administrative controls:
	* + Having a mission, objectives and targets
		+ Establishing policies, rules and regulations
		+ Having structures, hierarchy and delegation of authority
		+ Appointments of persons to offices and providing them with job profiles
3. Financial controls that are expounded below.

**1.7 Types of Financial Internal Controls:**

These are key controls mainly financial in nature.

* 1. Segregation of duty to ensure that no transaction is handled from beginning to end by one person. For a good internal control, the persons who executes a transaction, the one who approves it and the one who holds custody of or records should preferably all be different. Although for small organizations this may not be possible, at the worst two of the roles should be segregated e.g. approval and execution or execution and recording.
	2. Documentation of financial transaction immediately, accurately and completely.
	3. Internal checks that one person checks on the works of others.
	4. Testing arithmetical accuracy of all documents, the additions and cross castings.
1. Reporting regularly and noting and investigating exceptional items.
2. Reconciliation of information from different data bases such as bank reconciliations and control accounts.
3. Analysis of financial information to obtain trends and patterns and subjecting the data to reasonableness tests.
4. Verification and audits by independent persons.
5. Audit trailing to keep clear tracks of what has been done so that financial data could be traced in all directions; from source documents to the end and vice versa.

**1.7 List of basic financial documents**

|  |  |
| --- | --- |
| Local Purchase Order | Materials Received Note |
| Materials Delivery Note | Invoice |
| A certificate | A receipt |
| A cash sale | A pro forma invoice/quotation |
| Bill of quantities (BOQ) | Payment voucher |
| A cheque  | Electronic transfer forms (ETF) |

**1.8 List of common accounting books**

|  |  |
| --- | --- |
| Cashbook | Purchases journal |
| Sales journal | Nominal Journal |
| Nominal Ledger | Subsidiary Ledgers: |
| Purchases Ledger | Sales Ledger |
| Stock Ledger |  |

**1.9 Statements generated from accounting records**

1. Statement of trading performance or the profit or loss statement reports how well we have done.
2. Statement of position reports the status of the business at a given time.
3. Statement of transformation (generation and investment of funds) reports how the business changed over a given period from one position to another.

**1.10 Dangers of not maintaining proper accounting records**

1. The legal requirement for directors to keep proper books of accounts that form a basis for financial statements that are true and fair is violated.
2. A legal requirement for directors to put in place adequate internal controls that safeguard the assets of the business is also violated.
3. Inaccurate or incomplete financial statements are produced due to error or defalcation
4. Poor financial or uncompetitive bids are prepared based on incorrect financial information.
5. Problems with tax authorities
6. Fraud or misappropriation of business resources
7. Inability to relate with funding institutions
8. Inability for owners to adequately monitor the performance of the business
9. Misrepresentation of the true position of the business and failing to detect avoidable risks in time e.g. insolvency.

**Discussion topics:**

1. Justify the keeping of proper accounting records and outline with examples (ref. to case study) the major classes of business transactions.
2. List the major accounting documents and records used in road construction. Comment on challenges posed by computers.
3. State the major categories of financial internal controls and identify core internal controls over site purchase (or labour) transactions.
4. Explain to Munaku the dangers of not maintaining proper accounting records
5. Identify internal control weaknesses in Munaku Contractors and list the dangers of maintaining weak internal controls.