BUSINESS STUDIES NOTES
FORM FOUR

- SOURCE DOCUMENTS AND BOOKS OF ORIGINAL ENTRY

These are documents containing the information that makes basis of making entries in the books of accounts. They act as evidence that the transaction actually took place. They includes

- **Cash sale receipt**: - a document that shows that cash as been received or paid out of the business either in form of cash or cheque. It is a source document that is mainly used in making records in the cash journals cash book, cash accounts or bank accounts. If the receipt is received, it means payments has been made and therefore will be credited in the above accounts, or taken to cash disbursement/payment journals, while when issued, it means cash/cheque has been received and therefore will be debited in the above accounts or taken to cash receipt journals

- **Invoice**: - a document issued when the transaction was done on credit to demand for their payment. If the invoice is an incoming invoice/invoice received, then it implies that the purchases were made on credit, and if it is an outgoing/invoice issued then it implies that sales were made on credit.
  The incoming invoice will be used to record the information in the purchases journals/diary, while an outgoing invoice will be used to record information in sales journals/diaries

- **Credit note**: - a document issued when goods are returned to the business by the customer or the business return goods to the supplier and to correct any overcharge that may have taken place. If it is received, then it means part of the purchases has been returned and therefore the information will be used to record information in the purchases return journals, while if issued then it means the part of sales has been returned by the customers and therefore used to record the information in the sales return journals/diaries

- **Debit note**: - a document used to correct an undercharge that may have taken place to inform the debtor to pay more. It therefore acts as an additional invoice

- **Payment voucher**: - a document used where it is not possible to get a receipt for the cash/cheque that has been received or issued. The person being paid must sign on it to make it authentic. It is therefore used to record information just as receipts

Books of original entries/Journals/Diaries/day's books/Subsidiary books

These are books where the transactions are listed when they first occur, with their entries being made on a daily basis before they are posted to their respective ledger accounts. The information in the source documents are used to make entries in these books. The books of original entries include:

- Sales journals
- Sales return journals/Return inwards journals
- Purchases journals/creditors journals/bought journals
- Purchases return journals/return outwards journal
- Cash receipt journals
- Cash payment/cash disbursement journals
- Three column cash book
- The petty cash book
- Analysis cash book

- General journals/journal proper

- **Sales journals**

This is used to record credit sales of goods before they can be recorded in their various ledgers. The information obtained in the outgoing invoice/invoice issued is used to record the information in this journal as the source document

The overall total in the sales journal is therefore posted in the sales account in the general ledger on credit side and debtors account in the sales ledger as a debit entry

Sales journal

Date	Particulars/details	Invoice no	Ledger folio	amount

Example:

The following information relates to Tirop traders for the month of June 2010

June 1: Sold goods to wafula on credit of ksh 200, invoice no 0114

2: Sold to the following debtors on credit; Wanjiru ksh 400, Musyoka ksh 300, Wafula ksh 300

5: sold goods on credit to Wanjiru of ksh 300

10: Sold goods to the following on credit Kanini ksh 100, Wafula ksh 500, Wanjiru ksh 600

12: Sold goods on credit to musyoka of ksh 350

Required:

Prepare the relevant day book for the above transactions; hence post the various amounts to their respective individual accounts

Sales journal

Date	Particulars/details	Invoice no	Ledger folio	amount
June 2010:				
1	Wafula	0114	SL	200
2	Wanjiru		SL	400
2	Musyoka		SL	300
2	Wafula		SL	300
5	Wanjiru		SL	300
10	Wanjiru		SL	600
10	Wafula		SL	500
10	Kanini		SL	100
12	Musyoka		SL	350
15	Totals posted to the sales account (Cr)		GL	3050

(Post the rest to their individual debtors account)

- **Sales Return Journals/Return inwards journals**

This is for recording the goods that the customers/debtors have returned to the business. It uses the information in the credit note issued as a source document to prepare it. The information is therefore recorded to the return inwards account in the general ledger, while the individual's entries are reflected (credited) also in their respective debtors account for double entry to be completed. It takes the following format

Sales return journal

Date	Particulars/details	Credit note no	Ledger folio	amount

For example;

Record the following transaction for the 2007 in their relevant diaries, hence post them to their respective ledger accounts;

May 1: goods that had been sold to M Okondo of shs 2600 on credit was returned to the business

“ 2: G. Otuya returned good worth shs 1320 that was sold to him on credit to the business

“ 8: the following returned goods that had been sent to them on credit to the business H Wati shs 3500, Muya shs 4700 M Okondo shs 2900

“ 12: G Otuya returned goods worth shs 5400 that were sold on credit to the business

“ 30: Goods worth sh 8900 that had been sold on credit to G Otuya were returned to the business

Sales Return journal

Date	Particulars/details	Credit note no	Ledger folio	amount
May 2007:				
1	M Okondo		S.L	2600
2	G Otuya		S.L	1320
8	H Wati		S.L	3500
8	Muya		S.L	4700
8	M Okondo		S.L	2900
12	G Otuya		S.L	5400
30	G Otuya		S.L	8900
	Totals posted to Return Inwards a/c (Dr)		GL	29320

(Post the entries to the individual ledger a/c's (Cr))

- **Purchases Journal**

This is used to record the credit purchase of goods. The totals are then debited in the purchases account in the general ledger, while the individual's creditors accounts are credited. It used the invoices received/incoming invoices as it source document. It takes the following format;

Purchases journal

Date	Particulars/details	Invoice no	Ledger folio	amount

For example

The following information relates to Mikwa Traders for the month of April 2011. Record them in their relevant day's book, hence post the entries to their relevant ledger accounts.

April 2011;

“ 2. Bought goods worth shs 25 000 on credit from Juma, Invoice no 3502

3. Bought goods worth shs 16 500 from kamau on credit, invoice no 2607

6. Bought goods worth shs 12 700 from Juma on credit, invoice no 3509

8. Purchased goods of shs 25 200 from juma, invoice no 3605; shs 17 500 from Kamau, invoice no 3700; shs 45 000 from Wamae wholesalers, invoice no 3750

15. Purchased goods of shs 9 200 from Wamae wholesalers on credit, invoice no 3762

18. Bought goods of shs 17 000 from Kamau on credit, invoice no 3802

24. Purchased goods of shs 36 000 from Juma suppliers on credit, Invoice no 3812

Purchases Day book

Date	Particulars/details	Invoice no	Ledger folio	amount
April 2011:				
2	Juma	3502	PL	25 000
3	Kamau	2607	PL	16 500
6	Juma	3509	PL	12 700
8	Juma	3605	PL	25 200
8	Kamau	3700	PL	17 500
8	Wamae	3750	PL	45 000
15	Wamae	3762	PL	9 200
18	Kamau	3802	PL	17 000
24	Juma	3812	PL	36 000

	Totals posted to the Purchase account (Dr)		GL	204100

(Post the individual entries to their relevant accounts in the ledger (crediting))

- **Purchases Return Journals/Return outwards Journals**

This is used to record goods that have been returned to the creditors by the business, reducing the value of the goods that had been purchased. It uses the credit note received as the source documents, with the totals being in the purchases return account while the individual creditor's accounts are debited in their respective ledger accounts. It takes the following format

Purchases return journal

Date	Particulars/details	Credit note no	Ledger folio	amount

For example;
Record the following transaction in the purchases return day book for Njiru's traders for the month of June 2010, hence post the information into their relevant ledger accounts.
June 2010;

" 3. Returned goods worth shs 400 that had been bought from Nairobi stores, credit note no 56
" 8. Return goods of shs 1 200 to Matayos store, Credit no 148
"19. Had some of their purchases returned to the following; Njoka enterprises shs 700, credit note no 205, Nairobi Stores shs 600, credit note no 58, Matayos store shs 1 000 credit note no 191
"26. Returned goods worth shs 1 800 to Njoka enterprise credit note no 210
"30. Return goods worth shs 1 020 to Matayos store, credit note no 200

- **Cash receipt Diaries**

This is used to record all the cash and cheques that have been received in the business. They may be many that posting directly in the cash book may be tedious and are therefore first recorded here. It totals are posted to the cash and bank accounts in the general ledger (Dr), while the individual accounts are credited in their respective accounts in the ledger. It uses the cash receipt issued and bank slips received as the source documents. It takes the following format;

Cash receipt journal

Date	Particulars/details	Receipt no	Ledger folio	Disc allowed	cash	bank

- **Cash payment Journals**

This is used to record cash and cheques that have been issued to the creditors/out of the business. Its totals are credited (Cr) in the cash and bank account and the individual accounts are debited (Dr) in their respective accounts It uses the cash receipt received and bank slips issued as the source documents. It takes the following format;

Cash Payment journal

Date	Particulars/details	Receipt no	Ledger folio	Disc received	cash	bank

For example:
Record the following transactions into their relevant day books of Onyango traders, hence post the entries to their respective ledger accounts and balance them off;
May 2011:

"1. Cash sales amounting to ksh 3 000, receipt no 0112

“2. Paid the following creditors by cheque after having deducted a cash discount of 10% in each case; H. Mwangi ksh 1 500, J. Mwaniki ksh 1 600, N. Mugo ksh 1 200
“3. Receive the following Chaques from debtors in settlement of their debts after having deducted 5% cash discount in each case; Lucy kshs 22 800 cheque no 0115, Otieno kshs 8 550 cheque no 0011, Martha ksh 1 330 cheque no 0016
“5. Paid for repairs in cash kshs 16 000, receipt no 0251
“10. Paid Juma in cash kshs 9 500, receipt no 0295
“14. Cash sales kshs 17 000, receipt no 02714
“15. Banked kshs 6 000 from the cash till
“15. Received cash from Mary of kshs 13 500, receipt no 0258
“16. Cash sales of kshs 26 400 was directly banked, bank slip no 40152
“20. Cash purchases of kshs 8 920, receipt no 117
“22. Cash purchases of kshs 15 200 was paid for by a cheque, cheque no 512

Cash receipt journal

Date	Particulars/details	Document no	Ledger folio	Disc allowed	cash	bank
May 2011						
1	Sales	0112	GL		3 000	
3	Lucy	0115	SL	1200		22 800
3	Otieno	0011	SL	450		8 550
3	Martha	0016	SL	700		1 330
14	Sales	02714	GL		17 000	
15	Cash		“c”			6 000
15	Mary	0258	SL		13 500	
16	Sales	40152	GL			26 400
	Totals to be posted to the cash and bank a/c (Dr)			2 350	33 500	65 080

(Post the totals and the entries to their respective accounts)

Cash Payment journal

Date	Particulars/details	Document no	Ledger folio	Disc Received	cash	bank
May 2011						
2	H. Mwangi		PL	166.70		1 500
2	J. Mwaniki		PL	177.70		1 600
2	N. Mugo		PL	133.30		1 200
5	Repairs	0251	GL		16 000	
10	Juma	0295	PL		9 500	
15	Bank		“c”		6 000	
20	Purchases	117	GL		8 920	
22	Purchases	512	GL			15 200
	Totals to be posted to the cash and bank a/c (Cr)			477.30	40 420	19 500

(Post the totals and the entries to their respective accounts)

- **The petty Cash book**

This is used to record money that has been set aside to make payments that does not require large amounts, such as cleaning, staff tea, posting letters, etc. it is always kept by the petty cashier, under the supervision of the main cashier. The amount received by the petty cashier is always debited, while the payments made from the same is credited. The credit side also contains the analytical columns for various items of expenditure. The amount credited is also extended to the analysis column for the specific item. At the end of the stated period, the petty cash book is balanced, and the totals are posted to their individual accounts. The individual's accounts are debited with the totals of the analytical columns, while the cash account is credited by the main cashier for the total that was spent in the petty cash book.

Petty cash book can also be operated on an imprest system, where the petty cashier receives a given amount of money at an intervals (imprest) to spend, and report back to the main cashier at the end of the period on how the money has been spent and the balance still remaining for re-stocking (reimbursed), and only the amount spent can be reimbursed so that at the beginning of the period the petty cashier will always have the full amount (cash float).

For example:

A petty cashier of sina chuki traders operate a petty cash book on an imprest of kshs 2 500 on a monthly basis. On 1st February 2010, she had cash in hand of shs 150 and was reimbursed the difference by the main cashier to restore her cash float. The following payments were made during the month of February 2010

Feb; 1. Travelling expenses kshs110
2. Correcting fluid kshs 200
3. Sugar for staff tea ksh 180
4. Stamps kshs 255
10. Telephone kshs 255
15. Entertainment kshs 130
18. Postage stamps kshs 100
20. Bread for staff tea kshs 148
25. Fare kshs 200
26. Duplicating ink kshs 250
27. Entertainment kshs 400
28. Telephone kshs 100
28. Atieno a creditor was paid ksh 150

Required;

Prepare a petty cash book from the above information and post the totals to the relevant ledger accounts.

Sina Chuki Traders
Petty Cash Book
For month of Feb. 2010

Receipt sh	L.F	Date	Details	Vouch no	Total sh	Travel exp	Office exp	Staff tea	postage	Telephone	Ent.	Ledger a/c
		2010										
150		Feb 1	Bal b/d									
2 350	C.	1	Reimburseme									
	B	1	nt		110	110						
		2	Travelling		200		200					
		3	exp		180			180				
		4	Correcting		255				255			
		10	fluid		255					255		
		15	Sugar		130						130	
		18	Stamps		100				100			
		20	Telephone		148			148				
		25	Entertainmen		200	200						
		26	t		250		250					
		27	Stamps		400						400	

		28	Bread		100					100		
		28	Fare		150							150
			Duplicating		2478	310	450	328	355	355	530	150
			ink		22							
2500			Entertainmen		2500							
22			t									
			Telephone									
			Atieno									
			Totals									
			Bal c/d									
			Bal b/d									

The totals in the analytical columns are Debited in the individual accounts, with the petty cash book totals being credited in the cash account.

- **The general Journal/Journal proper**

This one is used to record purchases or sales of fixed assets of the business on credit. These assets do not form part of the stock since the business does not deal in them, however the business may decide to buy or sell them for one reason or the other.

In this journal, the account to be debited begins at the margin, while the account to be credited is indented from the margin, with a narration below them put in brackets. The narration simply explains the nature of the transaction that has taken place. The individual entries are then posted to their respective accounts by either debiting or crediting depending on the transactions. It takes the following format;

General journal

Date	Particulars/details	Ledger folio	Dr shs	Cr shs

For example;

Journalise then following transactions which took place in the business of J Opuche during the month of March 2005

March 5; Purchased office furniture on credit for shs 25 000 from miugiza Furniture Limited

10; Sold old duplicating machine for shs 15 000 to samba academy on credit

15; Bought a new motor vehicle for shs 800 000 from explo motors Ltd, paying shs 300 000 in cash and balance was to be settled at a later date

18; Sold old vehicle to Mara Secondary school for shs 500 000 on credit

25;The owner converted personal electronic calculator valued at shs 9 000 into business asset

27; Sold old computers valued at shs 20 000 for shs 15 000 on credit to Mara secondary school

30; Sold old dining chairs worth shs 10 000 to Maendeleo for shs 15 000 on credit

General journal

Date	Particulars/details	Ledger folio	Dr shs	Cr shs
March 2005				
5	Office Furniture a/c		25 000	
	Miugiza a/c			25 000
	(Being a credit purchase of office furniture from Miugiza)			
10	Samba Accademy a/c		15 000	
	Duplicating Machine a/c			15 000

	(Being credit sales of duplicating machine			
15	to Samba academy)			
	Motor vehicle a/c		800 000	
	Cash a/c			300 000
	Explo Motors a/c			500 000
	(Being purchase of motor vehicle from			
18	explo. motors, paying part in cash and part			
	on credit)		500 000	
	Mara Sec sch a/c			500 000
	Motor vehicle a/c			
25	(being the credit sale of old motor vehicle			
	to mara sec sch)		9 000	
	Calculators a/c			9 000
	Capital a/c			
27	(being conversion of private calculator to			
	business asset)		15 000	
	Mara Sec. Sch. a/c		5 000	
	Loss on disposal a/c			20 000
	Computer a/c			
30	(being credit sale of old computers to Mara			
	school at a loss of 5 000)		15 000	
	Maendeleo a/c			10 000
	Furniture a/c			5 000
	Gain on disposal a/c			
	(being the credit sale of dining chairs to			
	maendeleo at a gain of 5 000)			
			1 384 000	1 384 000

The entries are then transferred to their respective accounts in the ledger, with the ones debited in the journals being debited and the ones credited being credited.
The Journal proper can also be used to show the opening entries and the closing entries. That is;

- ***Opening entries***

The opening entries are the entries of the assets and liabilities at the beginning of the trading periods to facilitate the opening of different accounts for them. They are the balance b/d for the assets and liabilities of the business. The assets to be debited are recorded first, followed by the liabilities and capital to be credited. Incase the capital is not given, it can be calculated using the book keeping equation, that is A = C + L. the narration then follows the entries.
The opening entries are necessary when;

- A business that did not keep complete accounting records would like to start keeping
- Opening up new sets of accounting books, after closing the old ones
- Starting accounting records for a business which has been bought, though was in full operation

  For example;

  The following balances were extracted from Martine's store that did not keep complete records, and would like to start keeping on 1st January 2011. Prepare for them their relevant subsidiary book to show the balances.

	Shs
Motor vehicles	230 000
Machinery	40 000
Creditors	10 000
Debtors	5 000
Cash in hand	20 000
Stock	10 000
Insurance prepaid	5 000

Bank		25 000
Premises		335 000
Capital	660 000	

Martine's Store
General journal
On 1st January 2011

Date	Particulars/details	Ledger folio	Dr shs	Cr shs
2011 January 1	Premises		335 000	
	Motor vehicle		230 000	
	Machinery		40 000	
	Debtors		5 000	
	Cash		20 000	
	Insurance prepaid		5 000	
	Bank		25 000	
	Stock		10 000	
	Capital			660 000
	Creditors			10 000
	(being the records of assets, liability and capital at the beginning of new period)			
			670 000	670 000

- **Closing entries**

At the end of the trading period the business asses how it carried out its trade and the amount of profit it made by preparing the Trading profit and loss account and the balance sheet to show its financial position. These are prepared by the information obtained from the ledgers. That is, all the nominal accounts (sale, purchase, expenses and revenue accounts), both opening and closing stocks are transferred to the trading profit and loss account through the trial balance and general journals, while the rest are taken to the balance sheet.

Uses of general journal;

- To record purchases of fixed assets on credit
- To record sales of fixed assets on credit
- To correct errors by checking the balances
- To record the opening and closing entries
- To write off bad debts
- To record the inter ledger transfers
- To issues shares and debentures in companies
- To make end of the year adjustments for the final accounts

In the table below, indicate the books of original entry that the information obtained from the given source documents are used to prepare

Source Document	**Books of Original entry**
Sales Invoice/invoice issued/Invoice retained/invoice copy	Sales journals
Purchases Invoice/Invoice received/Original invoice	Purchases journals
Credit note issued/Credit note retained/Credit note copy	Return inwards/Sales return journals

Credit note received/credit note original	Return outwards/purchases return journals
Original receipt/Receipt received	Cash payment/Analysis cash book/ Cash book
Receipt copy/Retained receipt	Cash receipt journal/Analysis cash book/cash book
Petty cash voucher	Petty cash book

Uses of Journals

- To relive ledger of many details
- To record more details about the transaction that are not found in the ledger
- To facilitate tracing of errors
- To facilitate the preparation of control accounts
- To curb frauds and promote efficiency, since they are prepared by different people from the ones handling ledgers

Assignment:
(Exercise 1B pages 50 and 51, Nos16 and 18 in Inventor book 4, KLB Students book)

FINANCIAL STATEMENTS

These are prepared at the end of a given trading period to determine the profit and losses of the business, and also to show the financial position of the business at a given time.
They includes; trading account, profit and loss account, trading profit and loss account and the balance sheet.
They are also referred to as the final statements.
The trading period is the duration through which the trading activities are carried out in the business before it decides to determines it performances in terms of profit or loss. It may be one week, month, six months or even a year depending on what the owner wants.
Most of the business use one year as their trading period. It is also referred to as the accounting period.
At the end of the accounting period, the following takes place;

- All the accounts are balanced off

- A trial balance is extracted
- Profit or loss is determined
- The balance sheet is prepared

Determining the profit or loss of a business

When a business sells its stock above the buying price/cost of acquiring the stock, it makes a profit, while if it sells below it makes a loss. The profit realized when the business sell it stock beyond the cost is what is referred to as the gross profit, while if it is a loss then it is referred to as a gross loss.

It is referred to as the gross profit /loss because it has not been used to cater for the expenses that may have been incurred in selling that stock, such as the salary of the salesman, rent for the premises, water bills, etc. it therefore implies that the businessman cannot take the whole gross profit for its personal use but must first deduct the total cost of all other expenses that may have been incurred.

The profit realized after the cost of all the expenses incurred has been deducted is what becomes the real profit for the owner of the business, and is referred to as Net profit. The net profit can be determined through calculation or preparation of profit and loss account.

In calculating the gross profit, the following adjustments are put in place

- Return inwards/Sales return: - these are goods that had been sold to the customers, but they have returned them to the business for one reason or the other. It therefore reduces the value of sales, and is therefore subtracted from sales to obtain the net sales

  Therefore Net sales = Sales – Return inwards
- Return outwards/purchases return: - these are goods that had been bought from the suppliers to the business and have been returned to them for one reason or the other. It reduces the purchases and is therefore subtracted from the purchases to obtain the net purchases.
- Drawings: - this refers to goods that the owner of the business has taken from the business for his own use. It reduces the value of purchases, and is therefore subtracted from purchases when determining the net purchases. It is different from the other drawing in that it is purely goods and not money
- Carriage inwards/Carriage on purchases: - this is the cost incurred by the suppliers in transporting the goods from his premises to the customers business. It is treated as part of the purchases, and therefore increases the value of purchases. It is added to purchases to determine the actual value of purchases/Net purchases.

  Therefore Net Purchases = Purchases + Carriage inwards – Return Outwards - Drawings

- Carriage outwards/Carriage on sales: - this is the cost that the business has incurred in transporting goods from its premises to the customers premises. The cost reduces the business profit that would have been realized as a result of the sale, and is therefore treated as an expense and is subtracted from the gross profit, before determining the net profit.
- Opening stock is the stock of goods at the beginning of the trading period, while the closing stock is the stock of the goods at the end of the trading period

  Gross profit is therefore calculated as follows;

  Gross Profit = Sales – Return inwards – (Opening stock + Purchases + carriage inwards – Return outwards – Closing stock)

  Or

  Gross profit = Net sales – Cost of Goods Sold (COGS)

  COGS = Opening Stock + Net Purchases – Closing stock

  Net Profit = Gross profit – Total expenses

Trading Account

This is prepared by the business to determine the gross profit/loss during that trading period

It takes the following format;

Name of the business
Trading Account
Dr For the period (date) Cr

	Shs	Shs		Shs	Shs
Opening stock		xxxxxx	Sales	xxxxxx	
add Purchases	xxxxx		Less Return inwards	xxx	
add Carriage inwards	xxx		Net sales		xxxxxx
less Return Outwards	xxx				
less Drawings	xx	xxxxx			
Goods available for sale		xxxxxx			
Less Closing Stock		xxx			
Cost Of Goods Sold (COGS)		xxxxxx			
Gross profit c/d		xxxx			
		xxxxxx			xxxxxx
			Gross profit b/d		xxxx

The trading account is completed by the time the gross profit b/d is determined
For example
The following balances were obtained from the books of Ramera Traders for the year ending may 31st 2010

Sales	670 000	
Purchases	380 000	
Return inwards	40 000	
Carriage outwards	18 000	
Return outwards		20 000
Carriage inwards		10 000

Additional information;

- During the year the owner took goods worth sh 5 000 for his family use
- The stock as at 1st June 2009 was shs 60 000, while the stock as at 31st May 2011 was shs 70 000
  Required; Prepare Ramera Traders trading account for the period ending 31st May 2010

Ramera Traders
Trading Account
Dr For the period ending 31/5/2010 cr

	Shs	Shs		Shs	Shs
Opening stock		60 000	Sales	670 000	
add Purchases	380 000		Less Return inwards	40 000	
add Carriage inwards	10 000		Net sales		630 000
less Return Outwards	20 000				
less Drawings	5 000	365 000			
Goods available for sale		425 000			
Less Closing Stock		70 000			
Cost Of Goods Sold (COGS)		355,000			
Gross profit c/d		275,000			
		630,000			630 000
			Gross profit b/d		275 000

NB: Carriage outwards is not an item of Trading account, but profit and loss account as an expense.

Importance of Trading account

- It is used to determine the gross profit/loss for a given trading period for appropriate decision making by the management.
- It is used in determining the cost of goods that was sold during that particular accounting period.
- It is used to reveal the volume of turnover i.e net sales

- May be used to compare the performance of the business in the current accounting period and the previous periods. It can also compare its performance with other similar businesses
- It facilitates the preparation of profit and loss account, since the gross profit is carried forward to the profit and loss account.

Profit and Loss account

In preparation of this account, the gross profit is brought down on the credit sides, with all other revenues/income of the business being credited and the expenses together with the net profit being debited. *Net profit = Total Revenues (including Gross Profit) – Total expenses*

Name of the business
Profit and Loss Account
Dr For the period (date) Cr

	Shs		Shs
Expenses		Gross profit b/d	xxxxxx
Insurance	xxx	Discount received	xxx
Electricity	xxx	Rent income	xxx
Water bills	xxx	Commission received	xxx
Carriage Outwards	xxx	Any other income received	xxx
General expenses	xxx		
Provision for Depreciation	xxxx		
Discount allowed	xxx		
Commission allowed	xxxx		
Rent paid	xxxx		
Any other expense	xxxx		
Net profit c/d	xxxx		
	xxxxxx		xxxxxx
		Net profit b/d	xxxx

The Profit and Loss Account is complete when net profit b/d is obtained. In the trial balance, the revenues/incomes are always credited, while the expenses are debited, and the same treatment is found in the Profit and Loss Account. (Any item that is taken to the Profit and Loss Account with a balance appearing in the Debit (Dr) side of a trial balance is treated as an expense, while those appearing in the Credit (Cr) side are revenue e.g. discount balance appearing in the Dr Side is Discount Allowed, while the one on Cr side is Discount Received)

For example

The following information relates to Akinyi's Traders for the period ending March 28th 2010. Use it to prepare profit and loss account.

Gross profit	100 000	Discount received	12 000
Salaries and wages	20 000	Power and lighting	10 000
Opening stock	150 000	Rent income	10 000
Commission allowed	15 000	Commission received	16 000
Repairs	10 000	Discount allowed	8 000
Provision for depreciation	6 000	Carriage outwards	4 000

Akinyi Traders
Profit and Loss Account
Dr For the period ending 28th March 2010 Cr

	Shs		Shs
Expenses		Gross profit b/d	100 000
Power and lighting	10 000	Discount received	12 000
Carriage Outwards	4 000	Rent income	10 000
Salaries and wages	20 000	Commission received	16 000
Provision for Depreciation	6 000		
Discount allowed	8 000		

Commission allowed	15 000		
Repairs	10 000		
Net profit c/d	65 000		
	138 000		138 000
		Net profit b/d	65 000

Incase the expenses are more than the income, then the business shall have made a net loss, and the loss will be credited.

Net profit/loss can also be found through calculation as follows;

Net profit/loss = Gross profit + Total other revenues – Total expenses

For the above example;
Total other revenues = 12 000 + 10 000 + 16 000
= 38 000
Total expenses = 10 000 + 4 000 + 20 000 + 6 000 + 8 000 + 15 000 + 10 000
= 73 000
Therefore; Net profit = Gross profit + Total other revenues – Total expenses
= 100 000 + 38 000 – 73 000
= 65 000

Importance of Profit and Loss account

- It shows the revenue earned, and all the expenses incurred during the accounting period
- It used to determine the net profit/net loss of a given trading period
- It is a requirement by the government for the purpose of taxation
- May be used by the employees to gauge the strength of the business, in terms of its ability to pay them well
- It is vital for the prospective investor in the business, in terms of determining the viability of the business
- The creditors or loaners may use it to asses the business ability to pay back their debts
- It is used by the management to make a decision on the future of their business.

Trading, Profit and Loss Account

This is the combination of trading account and trading profit and loss account to form a single document. It ends when the net profit/loss brought down has been determined. That is;

Name of the business
Trading, Profit and Loss Account
Dr For the period (date) Cr

	Shs	Shs		Shs	Shs
Opening stock		xxxxxx	Sales	xxxxxx	
add Purchases	xxxxx		Less Return inwards	xxx	
add Carriage inwards	xxx		Net sales		xxxxxx
less Return Outwards	xxx				
less Drawings	xx	xxxxx			
Goods available for sale		xxxxxx			
Less Closing Stock		xxx			
Cost Of Goods Sold (COGS)		xxxxxx			
Gross profit c/d		xxxx			
		Xxxxxx			xxxxxx
			Gross profit b/d		xxxx

Expenses			
Insurance	xxx	Discount received	xxx
Electricity	xxx	Rent income	xxx
Water bills	xxx	Commission received	xxx
Carriage Outwards	xxx	Any other income received	xxx
General expenses	xxx		
Provision for Depreciation	xxxx		
Discount allowed	xxx		
Commission allowed	xxxx		
Rent paid	xxxx		
Any other expense	xxxx		
Net profit c/d	xxxx		
	xxxxxx		xxxxxx
		Net profit b/d	xxxx

End Year Adjustments

The following items may require to be adjusted at the end of the trading period

- Revenues/Income
- Expenses
- Fixed assets

Adjustment on revenues

The revenue may have been paid in advance in part or whole (prepaid revenue) or may be paid later after the trading period (accrued revenue).

Prepaid revenue is subtracted from the revenue/income to be received and the difference is what is treated in the profit and loss account or trading profit and loss account as an income, while the accrued revenue is added to the revenue/income to be received and the sum is what is treated in the above accounts as the actual revenue. Only the prepaid amount and the accrued amounts are what are then taken to the balance sheet.

Adjustment on the expenses

The expenses may have been paid for in advance in part or whole (prepaid expenses) or may be paid for later after the trading period (accrued expenses).

Prepaid expenses is subtracted from the expenses to be paid for and the difference is what is treated in the profit and loss account or trading profit and loss account as an expense, while the accrued expenses is added to the expenses to be paid for and the sum is what is treated in the above accounts as the actual expenses.

NB: Only the prepaid amount and the accrued amounts are what are then taken to the balance sheet.

Adjustment on fixed assets

The fixed assets may decrease in value, due to tear and wear. This makes the value to go down over time, what is referred to as depreciation. The amount of depreciation is always estimated as a percentage of cost.

The amount that shall have depreciated is treated in the profit and loss account or T,P&L as an expense, while the value of the asset is recorded in the balance sheet, less depreciation.

For example;

- 1997 The following Trial balance was prepared from the books of Paka Traders as at 31st December 1995.
  Trial balance December 31st 1995

	Dr. (shs)		Cr. (shs)
Sales		980,000	
Purchases	600,000		
Returns		80,000	20 000
Carriage in		40,000	
Carriage out	3,000		
Stock (Jan 1st 1999)	120,000		

Rent	60,000	45 000
Discount	15,000	25 000
Motor vehicle	150 000	
Machinery	250 000	
Debtors	120,000	
Salaries	18,000	
Commission	7,000	12 000
Capital		178,000
Insurance	15 000	
Creditors		240,000
Cash	122 000	
	1 540 000	1 540 000

Additional information

- Stock as at 31st December was 100,000
- the provision for depreciation was 10% on the cost of Motor vehicle, and 5% on the cost of Machinery

Required: Prepare trading profit and loss account for the period ending 31st December 1999

Adjustments: Provision for depreciation;

Machinery = = 7 500

(New balance of machinery = 250 000 – 7 500 = 242 500. The 242 500 is taken to the balance as Machinery (fixed asset), while 7 500 is taken to the trading profit and loss account as expenses)

Motor vehicle = = 15 000

(New balance of Motor Vehicle = 150 000 – 15 000 = 135 000. The 135 000 is taken to the balance as Motor Vehicle (fixed asset), while 15 000 is taken to the trading profit and loss account as expenses)

Paka Traders

Trading, Profit and Loss Account

Dr For the period 31/12/1995 Cr

	Shs	Shs		Shs	Shs
Opening stock		120 000	Sales	980 000	
add Purchases	600 000		Less Return inwards	80 000	
add Carriage inwards	40 000		Net sales		900 000
less Return Outwards	20 000	620 000			
Goods available for sale		740 00			
Less Closing Stock		100 000			
Cost Of Goods Sold (COGS)		640 000			
Gross profit c/d		260 000			
		900 000			900 000
Expenses			Gross profit b/d		260 000
Insurance		15000	Discount received		25 000
Carriage Outwards		30000	Rent income		45 000
Salaries		18 000	Commission received		12 000
Provision for Depreciation					
Motor vehicle	15 000				
Machinery	7 500	22500			
Discount allowed		15 000			
Commission allowed		7 000			
Rent paid		60 000			

Net profit c/d	174 500		
	342 000		342 000
		Net profit b/d	174 500

The net profit/loss may be taken to the balance sheet.
The items that have been adjusted will be recorded in the balance sheet less the adjustment.

The Balance Sheet

The balance sheet will show the business financial position in relation to assets, capital and liabilities. The adjustment that can be made will be on Fixed assets and capital only. That is;
Fixed assets are recorded less their depreciation value (should there be provision for depreciation) as the actual value.

Actual value of assets = Old value – depreciation.

Capital is adjusted with the following; Net capital, Drawings and additional investment. i.e.

Closing Capital/Net capital (C.C) = Opening/initial capital (O.C) + Additional Investment (I) + Net profit (N.P) or (less Net Loss) – Drawings

$$CC = OC + I + NP - D$$

Where:
Opening Capital: - the capital at the beginning of the trading period
Closing capital: - the capital as at the end of the trading period
Additional Investment: - any amount or asset that the owner adds to the business during the trading period
Net profit: - the profit obtained from the trading activities during the period. Incase of a loss, it is subtracted.

Types of Capital

The capital in the business can be classified as follows

- Capital Owned/Owner's Equity/Capital invested; - this is the capital that the owner of the business has contributed to the business. It is the Net capital/Closing capital of the business (C = A – L)
- Borrowed capital: - the resources brought into the business from the outside sources. They are the long term liabilities of the business.
- Working capital: - these are resources in the business that can be used to meet the immediate obligation of the business. It is the difference between the total current assets and total current liabilities
  Working Capital = Total Current Assets – Total Current Liabilities
- Capital employed: - these are the resources that has been put in the business for a long term. i.e.
  Capital Employed = Total Fixed assets + Working Capital
  Or
  Capital employed = Capital Invested + Long term liabilities

Name of the business
Balance Sheet
As at (date)

	Shs	shs		Shs	shs
Fixed Assets					
Land	xxxxx		Capital	xxxxx	
Buildings	xxxxx		Add Net profit	xxxx	
Motor Vehicle	xxxxx		Add additional investt	xxx	
Any other fixed assets	xxxxx	xxxxxx	Less drawings	xxx	
Current Assets			Net Capital		xxxxx
Stock	xxxx		Long term liabilities		
Debtors	xxxx		Long term loan	xxxx	

Bank	xxxx		Any other	xxxx	xxxx
Cash	xxxx		<u>Current liabilities</u>		
Prepaid Expenses	xxxx		Creditors	xxxx	
Accrued revenues	xxxx		Short term loan	xxxx	
Any other current assets	xxxx	xxxxxx	Accrued expenses	xxxx	
			Prepaid revenues	xxxx	
			Any other	xxxx	xxxxx
		xxxxxx			xxxxxx

Example 00A: The following information were extracted from the trial balance of Mwema traders on 31st December 2010

Sales	750 000	Furniture	288 000
Purchases	540 000	Electricity expenses	16 000
Sales return	24 000	Motor vehicle	720 000
Return outwards	30 000	Rent expenses	2 500
General expenses	72 000	Capital	842 500
Commission received	24 000	Bank Loan	250 000
Cash	156 000	Creditors	216 000
Debtors	244 000		

Additional Information

- Stock as at 31/12/2010 was ksh 72 000
- Electricity prepaid was shs 4 000
- Rent expenses accrued shs 3500
- Depreciation was provided for as follows

-Motor Vehicle 15% p.a. on cost -Furniture 6% p.a. on cost

Required

- Prepare Trading, profit and loss account for the year
- Prepare a balance sheet as at 31st December 2012
- Determine the following:

-Owner's equity -Borrowed capital -Working capital -Capital employed

Adjustments:

Motor Vehicle = = 108 000

Therefore Motor vehicle = 612 000

Furniture = = 17 280

Therefore furniture = 270 720

Mwema Traders

Trading, Profit and Loss Account

Dr For the period 31/12/2010 Cr

	Shs	Shs		Shs	Shs
Purchases	540 000		Sales	750 000	
less Return Outwards	30 000	510 000	Less Return inwards	24 000	
Goods available for sale		510 000	Net sales		726 000
Less Closing Stock		72 000			
Cost Of Goods Sold (COGS)		438 000			
Gross profit c/d		288 000			
		726 000			726 000
<u>Expenses</u>			Gross profit b/d		288 000
General expenses		72 000	Commission received		24 000
Electricity expenses	16 000				
Less Electricity prepaid	4 000	12 000			
Rent expenses	2 500				
Accrued rent exp	3 500	6 000			

Provision for Depreciation					
Motor vehicle	108 000				
Furniture	17 280	125 280			
Net profit c/d		96 720			
		312 000			312 000
			Net profit b/d		96 720

Mwema Traders
Balance Sheet
As at 31/12/2010

	Shs	shs		Shs	shs
Fixed Assets			Capital	842 500	
Motor Vehicle	612 000		Add Net profit	96 720	
Furniture	270 720	882 720	Net Capital		939 220
Current Assets			Long term liabilities		
Stock	72 000		Bank Loan		250 000
Debtors	244 000				
Electricity prepaid	4 000		Current liabilities		
Bank	50 000		Creditors	216 000	
Cash	156 000	526 000	Accrued rent	3 500	219 500
		1 408 720			1 408 720

Basic Financial Ratios
A ratio is an expression of one item in relation to the other. It is used to compare the groups of related items in the business, for the purpose of assessing the performance of the business. They include:

- **Mark-up**

This is the comparison of gross profit as a percentage of cost of goods sold. i.e.

Mark-up =

= 100

For example: in (example OOA) above, determine the mark-up of the business.
Mark-up =
Gross profit = 288 000
COGS = 438 000

Mark-up = 100
= 65.75%
(This implies that the Gross profit of the business is 65.75% of its cost of goods sold)

- **Margin**

This is the expression of the gross profit as a percentage of net sales. That is:
Margin =
= 100
For example: in (example OOA) above, determine the margin of the business
Margin =
Gross profit = 288 000
Net sales = 726 000
= 100
= 39.67%

(This implies that the gross profit of the business is 39.67% of the net sales)

Relationship between margin and mark-up

Since margin and mark-up are all the expression of Gross profit, it is possible to change one to the other.

- Changing mark-up to margin
  Mark-up can be changed to margin as follows:
- Convert the mark-up percentage as a fraction in its simplest form.
- Add the value of the numerator of the fraction to the denominator to come up with the new fraction (margin fraction) that is
  If the mark-up fraction =
  Margin fraction =
- Convert the margin fraction as a percentage to obtain margin

For example: in the above example,

Mark –up = 65.75%

=

=

Margin fraction =

= x 100

= 39.67%

- Changing margin to mark-up
  - Convert the margin percentage as a fraction in its simplest form
  - Subtract the value of the numerator of the fraction from the denominator to come up with the new fraction (mark-up fraction) that is
    If the margin fraction =
    Mark-up fraction =
  - Convert the mark-up fraction as a percentage to obtain mark-up
    For example: in the above example,
    Margin = 39.67%

=

=

Mark-up fraction =

= x 100

= 65.75%

- **Current ratio/working capital ratio**

This is the ratio of the current assets to current liabilities. It can also be expressed as a percentage. That is:

Current ratio =

= current assets: current liabilities

Or

Current ratio = x 100

For examples: in (example **OOA**) above, determine the current ratio;

Current assets = 526 000

Current liabilities = 219 500

Current ratio =

= = 1052: 439

Or

= x 100

239.64%

- **Rate of stock turnover**

This is the rate at which the stock is bought or sold within a given period of time. It is obtained by;

Rate of stock turnover (ROST) =

Average stock =

In (**example OOA**) above, determine the rate of stock turnover;

The cost of goods sold = 438 000

The closing stock = 72 000

The opening stock = 0

Therefore

The average stock =

= = 36 000

Rate of stock turnover (ROST) =

=

= 12.17 Times

- **Return on capital**

This is the expression of net profit as a percentage of the capital invested. That is;

Return on capital = x 100

It can be given as a ratio or a percentage.

For example: in (example OOA) above, determine the return on capital of the business

Net Profit = 96 720

Capital invested/owner's equity = 939 220

Return on capital = x 100

= x 100

= 10.33%

- **Acid test ratio/quick ratio**

This shows how fast the business can convert its current assets excluding stock to settle its current liabilities. That is;

Quick ratio =

It is given in ratio form.

For example: in above (example OOA), determine the quick ratio;

Current assets = 526 000

Stock = 72 000

Current liabilities = 219 500

Quick ratio =

=

= 2.07 (or 207 : 100)

Importance of Financial Ratios

- Mark up and margin helps in the following; setting the selling price, calculating profit or losses and determining the sales for a given period of time
- Working capital and acid test ratio help in showing whether the business is in a position to meet its short term obligations and checking whether the business is utilizing its resources properly. That is high working capital ratio shows that most of the resources are idle
- Return on capital shows the following;
  - The performance of the business in relation to other similar businesses

- Comparison of the performance of the business over different periods
- Whether the business finances have been invested or not
- Help the potential investors on the decision on where to invest

- Rate of stock turnover also help in determining how fast or slow the stock is moving. It also helps in computing the gross profit or loss.

MONEY AND BANKING

Barter trade
This is a form of trade where goods and services are exchanged for other goods and services.

Benefits
- ***Satisfaction of wants:*** And individual is able to get what he or she needs.
- ***Surplus disposal:*** an individual or country is able to dispose off its surpluses.
- ***Social relations:*** it promotes social links since the communities trade together.
- ***Specialization:*** some communities shall specialize in a particular commodity.
- ***Improved living standards:*** this is enhanced by receiving what one is unable to produce.

Limitations of Barter trade
- ***Lack of double coincidence of wants:*** - it is difficult to find two people with the need for each other's product at the same time.
- ***Lack of store of value/ perishability of some commodities:*** - some goods are perishable thus their value cannot be stored for a long time for future purposes e.g. one cannot store vegetables for exchange purposes in future.
- ***Indivisibility of some commodities:*** -it is difficult to divide some products like livestock into smaller units to be exchanged with other commodities.
- ***Lack of standard measure of value:*** - It is not easy to determine how much one commodity can be exchanged for a given quantity of another commodity.
- ***Transportation problem:*** It is difficult to transport bulky goods especially when there is no faster means of transport.
- ***Lack of a standard deferred payment:*** - The exchange of goods cannot be postponed since by the time the payment is made, there could be fluctuation in value, demand for a commodity may not exist and the nature and quality of a good may not be guaranteed. It may be therefore difficult what to decide what to accept for future payment.
- ***Lack of specialization:*** - Everyone strives to produce all the goods he or she needs due to the problem of double coincidence of wants.
- ***Lacks unit of account-*** it is difficult to assess the value of commodities and keep their record.

MONEY SYSTEM

Money is anything that is generally accepted and used as a medium of exchange for goods and services.

Features/ characteristics of Money

For anything to serve as money, it must have the following characteristics:

- ***Acceptability:*** The item must be acceptable to everyone.
- ***Durability***: The material used to make money must be able to last long without getting torn, defaced or losing its shape or texture.
- ***Divisibility:*** Money should be easily divisible into smaller units (denominations) but still maintains it value.
- ***Cognizability:*** The material used to make money should be easily recognized. This helps reduce chances of forgery. It also helps people to differentiate between various denominations.
- ***Homogeneity:*** Money should be made using a similar material so as to appear identical. This eliminates any risk of confusion and forgeries.
- ***Portability: -*** Money should be easy to carry regardless of its value.
- Stability in value: The value of money should remain fairly stable over a given time period.
- ***Liquidity: -*** it should be easily convertible to other forms of wealth (assets).
- ***Scarcity: -*** It should be limited in supply. If it is abundantly available its value will reduce.
- ***Malleability-*** the material used to make money should be easy to cast into various shapes.
- ***Not easy to forge-*** money should not be easy to imitate.

Functions of Money

- ***Medium of exchange:*** It is generally acceptable by everyone in exchange of goods and services. It thus eliminates the need for double coincidence of wants.
- ***Store of value:*** It is used to keep value of assets e.g. surplus goods can be sold and then money kept for future transactions.
- ***Measure of value***: Value of goods and services are expressed in money form. Performance of businesses is measured in terms of money.
- ***Unit of account:*** It is a unit by which the value of goods and services are calculated and records kept.
- ***Standard of deferred payment:*** it is used to settle credit transactions.
- ***Transfer of immovable items (assets):*** Money is used to transfer assets such as land from one person to another.

DEMAND FOR MONEY

This is the tendency or desire by an individual or general public to hold onto money instead of spending it. It also refers to as liquidity preference.

Money is held by people in various forms:

- Notes and coins
- Securities and bonds
- Demand deposits such bank current account balances.
- Time deposits such as fixed account balances

REASONS (MOTIVES) FOR HOLDING MONEY

1. ***Transaction Motive:*** Money is held with a motive of meeting daily expenses for both the firms and individuals. The demand for money for transaction purpose by individuals depends on the following factors:

- Size/level of individual's income: The higher the income of and individual, the more the number of transactions thus high demand for transactions.
- Interval between pay days/ receipt of money: if the interval is long, then high amount of money will be held for transaction reasons.
- Price of commodities: if the prices are high, the value of transactions will also increase thus more money balances required.

- Individuals spending habits-people who spend a lot of money on luxuries will hold more money than those who only spend money on basics.
- Availability of credit-people who have easy access to credit facilities hold little amount of money for daily transactions than those who do not have easy access to credit.

The transaction motive can further be divided to;

- **Income motive i.e.** holding money to spend on personal/ family needs.
- **Business motive i.e.** holding money to meet business recurring needs such as paying wages, postage, raw materials. Etc

2. *Precautionary Motive:* Money is held in order to be used during emergencies such as sicknesses.
The amount of money held for this motive will depend on the factors such as:

- **Level of income-** the higher the income the higher the amount of money held for precautionary motive.
- **Family status-** high class families tend to hold more money for precautionary motive than low class families.
- **Age of the individual-** the aged tend to hold more money for precautionary motive than the young since they have more uncertainties than the young.
- **Number of dependant-** the more the dependants one has, the more the money they are likely to hold for precautionary motive.
- **Individual's temperament-** pessimists tend to hold more money for precautionary motives than the optimists because they normally think things will go wrong.
- **Duration between incomes-** those who earn money after a short time are likely to keep less money than those who earn money after a long time.

3. *Speculative Motive:* Money is held to be used in acquiring those assets whose values are prone to fluctuations such as shares/ money is held anticipating fall in prices of goods and services. This depends on the following:

- The wealth of an individual
- The rate of interest on government debt instruments
- Interest on money balances held in the bank.
- How optimistic or pessimistic a person is.

SUPPLY OF MONEY

This is the amount of money/ monetary items that are in circulation in the economy at a particular period of time. They include the following;

- Total currency i.e. the coins and notes issued by the central bank.
- Total demand deposits: money held in current accounts in banks and are therefore withdrawable on demand.

Factors influencing supply of money

- ***Government policies:*** If there is more money in the economy, the government will put in place measures to reduce the supply such as increasing interest rates.
- ***Policies of commercial banks:*** The more the loans offered by commercial banks, the more the amount of money in circulation.
- ***Increase in national income:*** increase in national income means that more people will be liquid due to increase in economic activities.]
- ***Increase in foreign exchange:*** The foreign exchange reserves will increase thus supply increases.

BANKING

This is the process by which banks accept deposit from the public for safe keeping and lending out the deposits in form of loans.

A bank is a financial institution that accepts money deposits from the public for safe keeping and lending out in terms of loans.

COMMERCIAL BANKS

These are financial institutions that offer banking services with a profit motive. Their activities are regulated by the Central bank.

<u>Functions of commercial banks</u>

- ***Accepting deposits:*** They accept deposit from members of the public inform of current accounts, savings account and fixed deposit accounts. Such accounts help individuals to keep money safely.
- ***Provision of safe means of payments:*** They provide safe and reliable means of payment such as cheques, bank drafts, credit transfers, electronic funds transfers etc.
- ***Provision of loan facilities:*** They provide loans to members in form of short term and long term. These loans are repayable with interests thus income to the banks.
- ***Facilitates foreign exchange payments:*** They provide foreign exchange that is used in international trade. They also make payments on behalf of their customers.
- ***Provision of safe keeping of valuables:*** They provide security for valuables to their customers at a fee
- ***Discounting bills of exchange:*** This is process by which a bank accepts bills of exchange and promissory notes from its customers in exchange of cash less than the face value of the bill or note.
- ***Provision of financial information: -*** They advice their clients on financial matters affecting their businesses such as investment option and wise use of loans.
- ***Money transfer:-*** They provide varied, safe and reliable means of money transfer. Such means include cheques, standing orders, credit transfers, bank drafts, letters of credit, credit cards, travelers cheques etc.
- ***Act as guarantors and referees: -*** They act as guarantors to their customers who want to acquire credit facilities from other financial institutions.
- ***Act as intermediaries: -*** They act as a link between the savers and borrowers.
- ***Credit creation: -*** This is the process of creating money from the customer deposits through lending.
- ***Provision of trusteeship: -*** They can manage a business on behalf of the client especially if the client does not have managerial skills. They can also manage the assets of the deceased client if there was no will.

TYPES OF ACCOUNTS OFFERED BY COMMERCIAL BANKS

- *Current account*

This is an account where money deposited can be withdrawn on demand by the customer by means of a cheque. This means that money can be withdrawn at any time during the official working hours so long as the account has sufficient funds.

This account is also referred to as demand deposits.

Features characteristics of current accounts

- Deposits of any amount can be made at any time.
- Balances in this account do not earn any interest.
- The account holder is not required to maintain a minimum cash balance in this account
- Withdrawals can be at any time without giving and advance notice as long as the customer has sufficient funds.
- Cheque books are issued to the account holder to be used as a means of payment/ cheques are usually used to withdraw money from the account.
- Monthly bank statements are issued to the account holder.
- Overdraft facilities are offered to the account holders' i.e the bank can allow customers to withdraw more money than they have in their accounts.

Advantages of current account

- No minimum balance is maintained hence the account holder can access all his/her money.
- Withdrawals can be made at any time.
- Transactions are made easier by use of cheques for example; one does not have to go to the bank in order to make payment.
- Overdraft facilities are available..
- It is possible to deposit any amount at any time during the office hours.
- Use of cheques as means of payment serves as evidence of payments made.

- Payments can be done even if there are insufficient funds in the account using post dated cheques.
- The account holder can withdraw any amount at any time without notice as long as there are sufficient funds in the account.

Disadvantages of current account

- Lengthy procedures of opening the account.
- The account holder does not earn any income since the balances in the current account does not earn interest.
- Initial deposit when opening the account is usually high hence discourages prospective customers.
- Customers are not encouraged to save since they can access their money at any time.
- Ledger fees are charged on the account making the operations of the account expensive.
    - ***Savings account (deposit account)***

This is an account operated by individuals and firms that have money to save.

Features of Savings account

- There is minimum initial deposit that varies from bank to bank.
- A minimum balance is maintained at all times.
- The withdrawals are up to a certain maximum within a given period. Withdrawal above this maximum will require notice.
- Account holders are issued with a pass book or a debit card (ATM card) for deposits and withdrawals.
- Overdraft facilities are not allowed.
- Ordinarily, withdrawals across the counter can only be done by the account holder.
- The balance on the account above a certain minimum earns some interest.

Advantages of Savings account

- Customers are encouraged to save because of the restricted withdrawals.
- There are relatively low banking charges.
- Initial deposit is usually low as compared to other accounts.
- The balances earn interest to account holder hence an incentive to save.
- ATM facilities have made account operations very convenient to customers.

Disadvantages Savings account

- A minimum balance must be maintained at all times and the customer is denied access to that money.
- For across the counter withdrawals, it is only the account holder who can withdraw cash.
- Withdrawals are restricted and sufficient notice is required before large amounts are withdrawn.
- The account holders do not enjoy services such as cheque books and overdraft facilities like the current account holders.
- Easy access to the money through ATM cards encourages overdrawals.
- Anybody who knows the pin of the card (ATM card) can withdraw money from the account.

Requirements for opening an account

The following are some of the requirements for opening either a current account or a savings account:

- Photocopies of identification documents such as National Identity Card or Passport.
- Passport size photographs (number varies from bank to bank). Some banks are nowadays taking the photographs instead of the customers providing them.
- For current account holders, an introductory letter from an existing customer from the prospective customer's employer.
- Filling in the application form provided by the bank.
- Signing of the specimen signature cards. Usually two.

NB: Once these requirements are fulfilled, the bank allocates the customer an account number, upon payment of an initial deposit.

- ***Fixed deposit account***

This account is also known as **time Deposit account.** It is maintained by those who have money not meant for immediate use.
Once money is deposited, there are no withdrawals until the time expires.

Advantages of Fixed deposit account
- Interest earned is relatively high as compared to savings account.
- There are no bank charges to the account holder.
- Money held in fixed deposit account can be used as security to acquire bank loans.
- Restricted withdrawals encourage savings.
- The account holder has time to plan for the deposited money.

Disadvantages of Fixed deposit account
- Access to money is not allowed until the end of the agreed period.
- Interest is forfeited if there is pre-mature withdrawal.
- The minimum amount of money for this account is high.
- The customer is not allowed to deposit more money in this account.
- A notice is required if the customer wants to terminate the contract before expiry date.
- The customer is denied the use of the deposited funds before the expiry of the period.

REQUIREMENTS TO OPEN AND OPERATE A BANK ACCOUNT
- Identification documents such as National Identification Card, Passport and Driving License.
- Reference letter from employer or and existing customer.
- Filling an application form giving the information about the customer.
- Submission of a specimen signature to be held by the bank.
- An initial deposit is paid and the account becomes operational.

NON- BANK FINANCIAL INSTITUTIONS
These are financial institutions that offer finances for development purposes to individuals and organizations.
These institutions address themselves to the needs of specific sectors in the economy.
They offer the finances inform of either short term or long term loans.
The following are some of the non-bank financial institutions in Kenya
- Development banks
- Building societies
- Finance houses
- Savings and Credit Co-operative Societies
- Micro finance organizations
- Insurance companies
- Pension Funds' Organizations
- Hire Purchase Firms

- **Housing Finance Companies**

They are mainly formed to finance housing activities that is they either put up houses and sell to the individuals or offer mortgage finance to those who wish to put up their own houses. They includes Housing Finance Corporation of Kenya (HFCK), National Housing Corporation (NHC)

- **Development Finance Institutions**

These are development banks which are formed mainly to provide medium term and long term finances, especially to the manufacturing sector. They perform the following functions

- Financing people who wishes to start either commercial of industrial enterprises, as well as the existing enterprises in the above sectors for expansion
- Offering training services through seminars and workshops to equip the entrepreneurs' with the relevant skill in industrial and commercial sectors
- Offer advisory services to those people wanting to start or expand their businesses
- Acting as guarantors to people wishing to take loan from other lending institutions to help them expand their business

They includes the following Kenya Industrial Estates (KIE), Development Finance Company of Kenya (DFCK), Industrial Development Bank (IDB), Industrial and Commercial Development Corporation (ICDC)

- **Savings and Credit Co-operative societies**

These are co-operative societies that are formed to enable members save and obtain loans at most conveniently and favorable conditions. They are formed by those engaged in similar activities. They includes: Mwalimu Savings and Credit Co-operative Societies; Afya Savings and Credit societies; Harambee Savings and Credit Societies

- **Insurance companies**

These are companies that assist in creating confidence and sense of security to their clients as well as offering financial assistance to their clients. Their functions include;

- Enable the policy holders to save through their schemes
- Provide finances to their policy holders in form of loans
- Offer guarantee services to the policy holders wishing to obtain loans from other non-bank financial institutions
- Provide advisory services to the policy holders on security matters
- Provide finances to meet the expenses incases of loans

They includes the following: Stallion Insurance Company; Madison insurance company; Blue shield insurance company

- **Micro Finance Companies**

These are financial companies formed to provide small scale and medium size enterprises with finance. They also carry out the following functions

- Offer advisory services to their clients in matters such as business opportunities available and how to operate them.
- Encourage the clients to carry out business activities by offering loans to them
- They encourage the savings by advancing loans to the individual member of a certain group
- They supervise, monitor and advise those whom they have given loans
  They includes the following: Kenya Women finance Trust (KWFT), Faulu Kenya

- **Agricultural Finance Houses**

These are institutions formed to promote the agricultural sector. They carry out the following

- Giving loans to farmers
- Offering supervisory and training services to the loaned farmer
- Offering technical and professional advice to loaned farmer
- Carry research and come up with better ways and means of agricultural sector
- Coming up with projects that would open up new areas for agriculture

Differences between commercial banks and non-bank financial institutions

Commercial Banks	Non-Bank Financial Institutions
• Offer all types of accounts	• Offer only two types of accounts savings and fixed deposit • Mainly provide medium term and long term finances

• Provide both short term and medium term finances to their customers • Their finance is not restricted to any sector • May offer foreign exchange services • Their finance is mainly for working capital • Participate in clearing house as they offer cheque • Offer facilities for safe keeping of valuable items such as title deeds • Always in direct control of the central bank • May offer overdraft facilities to their customers	• Their finance is restricted to a particular sector • Do not provide foreign exchange services • They provide capital for development • Do not participate in clearing house since they don't offer • Do not offer facilities for safe keeping of valuable items • Not usually in direct control of the central bank • Do not offer overdraft facilities to their customers

THE CENTRAL BANK

This is a bank established by the government through the act of the parliament to manage and control the monetary matters in the country. It was formed to perform the following functions;

- **Issue currency in the country**, which includes both new notes and coins to replace the worn-out ones
- **Banker to the commercial banks**, by ensuring that all the commercial banks in the country operate an account with them
- **Being the government 's bank**, by offering banking services to the government which enables the government to operate an account with them
- **Advisor to the government on financial issues** in the economy
- **Controller of the commercial banks** on how they carry out their functions in the economy to ensure that their customers are served well
- **Provide links with other central banks in other countries**, facilitating financial relationships. It also provide a link between the country and other financial institutions such as IMF
- Maintain stability in the exchange rates between the local currencies and the foreign ones.
- **Act as the lender of the last resort** to the commercial banks to enable them meet their financial obligations when need arise
- **Facilitates the clearing of cheques** between different commercial banks through its clearing house (a department in the central bank)
- **Administering of the public debt** by facilitating the receipt and providing a means through which the government pays back the borrowed money
- **Control of the monetary system in the country in order to regulate the economy.** In doing this they put in place ***various monetary policies*** that can either expand the economic activities in the country or depress them.

Monetary policy refers to the deliberate move by the government through the central bank to manipulate the supply and cost of money in the economy in order to achieve a desirable economic outcome. They do this through the use of various tools of monetary policies which includes the following: Bank rates; Open market Operation (OMO); Cash Liquidity ratio requirement; Compulsory deposit requirement; Selective credit control; Directives; Request.

- **Bank rates**

They may increase or decrease the interest rate at which they lend to the commercial banks to enable them increase or decrease the rate at which they lend money to their customers in the economy to enable the government achieve the desirable economic development in the country

When they increase their lending interest rate, the commercial banks also raise their lending rates to the consumers to reduce the number of people obtaining loans, leading to a reduction of money supplied in the economy.
When they decrease their lending interest rate, the commercial banks also decreases their lending rates to the consumers, increase the amount of money supplied in the economy

- **Open Market Operations (OMO)**

This is where they regulate the supply of money in the economy by either selling or buying the government securities (treasury bills or bonds) in the open market. That is when they want to increase the supply in the economy, they buying the securities from the members of the public who had bought them to increase more supply of money in the economy.
When they want to reduce the amount of money in circulation they will sell the government security to the public in the open market, to mop up/reduce the excess supply in the economy
The payment of the securities takes money from the individuals accounts in the commercial banks, reducing the amount that the individual can use in the economy, while when buying the central bank pays the security holders in their respective accounts in the commercial banks, increasing the amount that they can use in the economy

- **Cash/liquidity ratio requirement**

Here the central bank expect the commercial bank to keep a certain proportion of their total deposits in form of cash to enable them meet their daily needs, while the rest are held in liquid assets. This proportion can be reduced by the central bank to reduces the amount of money held by the commercial banks in order to reduce the amount of money spent by the commercial banks in cash, reducing the amount of money in supply, or they may increase the proportion to be held by the commercial banks to enable them increase the amount of money they spent in cash, increasing the amount of money in supply

Cash ratio =

- **Compulsory deposit requirements**

The commercial banks are required to maintain a certain amount of deposits with the central bank which will be held in a special account where the money stays frozen. This reduces the amount of money that the commercial banks hold and are able to spend in their operation, influencing the supply of money in the economy.
The deposit may be increase to reduce the amount of money in the commercial banks, or reduced to increase the amount of money in the commercial banks

- **Selective credit control**

The central bank may issue a special instruction to the commercial bank and other financial institution only to lend more in a particular sector to control the amount of money reaching the economy. The instruction may be removed, if the bank feels that the supply in the economy has reduced and needs to be increased

- **Directives**

The central bank may issue a directive to the commercial banks on the interest rate they should charge on their lending and to increase or reduce the margin requirement for borrowing to make it harder or easier for the customers to obtain loan.
Margin requirement is the proportion of money expected to be raised by the client to finance the project he/she wants to obtain the loan for, before being given a loan to complete the project with.

- **Request (Moral suasion)**

The central bank may appeal to other financial institutions to exercise restrain in their lending activities to the public to help in controlling the money supply

Trends in Banking

These are the positive changes that have taken place in the banking sector to improve their service deliveries to their customers. They include;

- **The use of Automatic Teller Machines** (ATMs), which has made it possible for the customers to access their money any time of the day. The ATM cards that are used for withdrawals from the ATM machines can also be used as a debit card to make purchases.
- **Networking all their branches**, which has enable the customers to carry out their transactions in any of the branch.
- **E-Banking,** which is the banking through the internet. This has made it possible for the customers to transact their financial businesses on-line.
- **Relaxation of some of the conditions on opening and operating some of the accounts** to make them be more attractive to their customers.
- **Offering varieties of products** which includes easier credit facilities to their customers to attract more customers.
- **Liberalization of foreign exchange dealings by licensing forex bureaus** to offer services to the customers, improving the accessibility to the service.
- **Improving the customers care services**, with some bank setting up a departments known as the customer care department to offer detailed assistance to their customers.
- **Allowing non bank financial institutions to offer banking services** to the members of the public, for example; KWFT, SACCOs, FOSA, Faulu Kenya, etc
- **Mobile Banking services (M-Banking),** which allows the customers to carry out their financial transactions over their mobile phones. It has brought about several benefits/ advantages to their customers which includes;

Advantages of m-banking

- Easy transfer of funds from one account to the other in the same bank (inter account transfer)
- Easy transfer of money from ones account to his mobile phone for other transactions
- Ability to check ones account balance in the bank with ease
- Easy to monitor your financial transactions by checking your transaction details over the phone
- Easy payment of the bills such as electricity bill, Dstv bills, etc and other wages
- Ability to transfer money from one mobile number to other in collaboration with the service providers
- Easy request for new cheque books and bank statements from the banks
- Able to top up air time to your mobile phones in collaboration with the service providers
- Reduced risk of carrying large sums of money in cash or cheques that may be stolen

However this development has also come with its challenges, which includes;

Disadvantages of m-banking

- Registration to enjoy all these services must physically be done in the banking hall, which subject the customers to stress queues of the bank
- Only the registered mobile number can carryout these transactions which limits the customer to only using one number
- Users requires a mobile phone with a screen that can display the transaction which a times some may not a ford
- Mobile phones can easily be lost or stolen from the owner, inconveniencing him from carrying out the transactions
- Bank transaction information may load slowly, which may makes it expensive for the user
- Possibility of transferring the funds to a wrong account, due to error in typing of the account number

- Introduction of agency banking, which has made them to make their services to be more accessible to even areas where they may have not put up a banking hall.

Agency banking is whereby a retail stores, supermarket, or any other commercial businesses are authorized by the financial institutions to carry out financial transactions on their behalf. They may offer the following services

- Receiving customer deposits
- Offering withdrawal services
- Transfer of funds for customers
- Pay bills for the customers
- Balance inquiry services
- Opening new accounts for the customers
- Fill loan application forms for them

Advantages of agency banking

- Reduction of set up and delivery cost to the banks, which in turn passes to the customers in form of reduced cost of accessing services
- Time saving as the agents are located close to the customer and the customer may carry out other transactions as he withdraw the money
- More convenient for the customer to bank with their local retailers other than the traditional banking halls
- Enable the bank to reach far places within the country

REVISION EXERCISES
PAPER 1

- Give four advantages of barter trade.
- Highlight four services offered by the central bank of Kenya to the commercial banks.
- State four methods through which commercial banks can transfer money.
- State any four current developments that have taken place in the banking sector.
- Outline four tools of monetary policy used by the central bank to control money supply.
- Outline four factors that may have led to the downfall of barter trade.
- Highlight two factors that may influence:
  - Transaction motive.
  - Speculative motive.
- Mention four functions of commercial banks in an economy.
- Outline three factors that influence the supply of money.
- Give four characteristics of money.
- The following are some of the accounts available to customers in Kenya banking industry: Current account, Savings account and Fixed deposit account. Give the account that corresponds to each of the description given below.

	Description	Type of account
(a)	Account holders required to deposit a specific initial amount as well as maintaining a minimum balance.	
(b)	Account holders may deposit and withdraw money whenever they want without maintaining a minimum balance.	
(c)	Banks pay interest on deposit at comparatively higher rates.	
(d)	Money may be deposited at any time and interest is earned if a specific balance is maintained.	

- Outline four benefits that accrue to a customer who uses automated teller machine (ATM) banking services.

PAPER 2

- Explain five functions of the central bank of Kenya.
- Describe four measures that the government may put in place to reduce the amount of money in circulation.
- Explain five services offered by commercial banks to their customers.
- Explain five ways in which commercial banks facilitate payment on behalf of their customers.
- Explain four services that the central bank of Kenya may offer as a banker to commercial banks.

- Explain five in which banks contribute to the development of Kenya
- Outline five reasons why banks currently account is popular with traders
- Explain service offered to commercial banks by the central bank of Kenya
- In what ways of the functions of commercial bank differ with those of non- bank Financial institutions
- Explain five ways in which central bank of Kenya may control the supply of money in The country
- Describe methods which may be used by commercial banks to advance money to customers.
- A businessman wishes to obtain a loan from a commercial bank. Highlight the Conditions that he should satisfy before the bank can grant him the loan
- Explain five services that the central bank of Kenya offers to commercial banks
- Explain four disadvantages of using a bank overdraft as a source of finances
- Describe four ways in which a non- bank financial institutions differ from the commercial banks
- Discuss five reasons why business people prefer to operate bank current accounts
- Outline the benefits that bank customer gets from operating a current account
- Explain the 5 services offered by a commercial banks to their customers

PUBLIC FINANCE

Public finance refers to the activities carried out by the government associated with raising of finances and the spending of the finances raised (it is the study of how government collects revenue and how it spends it)

The components of public finance are;

- **Public revenue**
- **Public expenditure**
- **Public debt**
  - ***Public revenue*-refers to the revenues (income) and resources received by the government from different sources.**

- *Public expenditure*-refers to the resources spent by the government.
- *Public debt*-refers to the money and resources borrowed by the government.

<u>Purpose of public finance</u>

- ***Provision of essential goods and services.*** The government has a responsibility of providing its citizens with essential goods and services such as security,health,schools,drought control, law e.t.c such facilities and services may not be adequately covered by the private sector because of the high costs involved and risks.
- ***Encouraging consumption of certain commodities-***The government may encourage consumption of certain commodities e.g. maize by subsidizing on their productions or lowering their taxes.
- ***Controlling consumption of certain commodities-***The government may also encourage consumption of some commodities e.g. cigarettes and alcohol by imposing heavy taxes on them.
- ***Promotion of Balanced regional development-***This may be done by initiating economic projects in areas that are under developed/lagging behind.
- ***Wealth Redistribution-***This is done by heavily taxing the rich and using the money raised to provide goods and services that benefit the poor
- ***To promote economic stability-***Economic instability may be caused by factors such as unemployment. Such problems can be solved through public expenditure in projects that generate employment such as 'kazi kwa vijana'
- ***Creation of a conducive Business Environment-***Through public expenditure, the government may develop infrastructure such as roads, electricity, security e.t.c thereby creating a conducive environment for businesses to thrive in.
- ***To raise government revenue-***Through public finance, the government raises revenue which it uses in provision of essential goods and services to the public.
- ***Improving balance of payment-***This may be done by improving heavy taxes such as customs duty to discourage importation.

<u>Sources of public finance</u>

There are two major sources of public finance i.e.

- **Public revenue**
- **Public debt (government borrowing)**

- **Public revenue-**This is the income that the government gets from its citizens. The main sources of public revenue are;
- ***Tax;*** This is a compulsory payment levied by the government on individuals and firms without any direct benefit to the payer.
- ***Fines and penalties-***These are the charges imposed on individuals, firms and corporations who break the laws of the country.(offenders)

- ***Fees;*** These are the payments charged by the government for the direct services it renders to its people e.g. road licence fee, marriage certificate fee and import licence fee.

- ***Rent and rates;*** Charged on use of government properties e.g. game parks, forests e.t.c

- ***Eschiats;*** Income obtained from properties of persons who die without legal heirs or proper wills. Such people's properties are taken over by the state.

- ***Dividends and profits;*** These are the income received from the government direct investments e.g. income/surplus from public corporations.

- ***Interest from loans-***This is the interest on loans advanced by the government to firms and individuals through its agencies such as ICDc, AFC e.t.c

- **Proceeds from scale of government property.**

- **Public debt (Government borrowing)-**This is the money that the government borrows when public revenue is insufficient to meet all its financial obligations**.**

Government borrowing is also referred to as *national debt*. It includes all outstanding borrowing by the central government, local authorities and government corporations.

These are two majorly two sources of public debts;

- **Internal borrowing**

- **External borrowing**

Internal borrowing

This refers to borrowing by government from firms and individuals within the country. This may be done through;

Open market operation; the government sells its securities such as treasury bonds and treasury bills. This however has a disadvantage of causing 'crowding out effect' where the government leaves the private investors with little to borrow from.

External borrowing

This refers to government borrowing from external sources. It may either be on a *bilateral or multilateral* basis.

Bilateral borrowing is where the government borrows directly from another country.

Multilateral borrowing is where the government borrows from international financial institutions such as international monetary fund (IMF), World Bank, African Development bank e.t.c.such bodies get finances from various sources which they lend to their member countries who are in need of such funds.

Generally, external borrowing has strings attached. The borrowing country is expected to meet some set conditions, sometimes adversely affecting some sectors of the economy. The total internal borrowing (internal debt) added to the total external borrowing (external debt) constitutes the national debt.

<u>**Classes of public (National debt)**</u>

These are two classes of national debt;

- **Reproductive debt**
- **Dead-weight debt.**

(i) Reproductive debt

This is borrowed money used to finance project(s) that can generate revenue. Such projects, once started may become self sustaining and may contribute towards servicing/repaying the debt. E.g. money used to finance irrigation schemes, electricity production e.t.c.

ii. *dead-weight debt*

This is borrowed money that is used to finance activities that do not generate any revenue. Examples are money used to finance recurrent expenditure e.g. payment of salaries or for famine relief e.t.c

Dead-weight debt is a burden to members of the public since they are the ones who are expected to contribute towards its repayment.

Factors to consider before the government decides whether to borrow internally or externally

This refers to how the government spends the finances it has raised on behalf of its citizens.

Categories of government expenditure

- Recurrent expenditure
- Development expenditure
- Transfer payments.

Recurrent expenditure

This refers to government spending that takes place regularly e.g. payments of salaries to civil servants, fuelling of government vehicles e.g.

Every financial year, the government must allocate funds to meet such expenditure.

Recurrent expenditure is also known as *consumption expenditure.*

Development expenditure

This is also referred to as *capital expenditure* .It is government spending on projects that facilitate economic development. Such projects includes construction of *railway lines, roads, airports, rural electrification e.t.c*

Once completed expenditure on such projects ceases and may only require maintenance.

Transfer payments

This is expenditure on things/people who do not directly contribute to a country's national income. Such expenditure include money spent on famine relief, pension, bursaries e.t.c

PRINCIPLES OF PUBLIC/GOVERNMENT EXPENDITURE

These are the considerations that are necessary before any expenditure can be incurred by the government.

They include;

- ***Sanctions;* Every** public expenditure must be approved by the relevant authority like parliament.
- ***Maximum social benefit;*** Any public expenditure must be incurred in such a way that majority of the citizens are able to reap maximum benefit from it e.g. improved living standards and quality of life.
- ***Flexibility /elasticity-***The policy on public expenditure should be flexible enough to meet prevailing economic situations i.e. it should be possible to increase or decrease the expenditure on projects depending on the prevailing circumstances e.g. during drought, it should be possible to spend on famine relief.
- ***Economy-***public expenditure should be planned carefully and prudently to avoid any possible waste.
- ***Proper financial management (Accountability)-***public funds should be well managed. This should be facilitated by maintenance of proper records which should be audited as required.
- ***Productivity-***The biggest proportion of public expenditure should be spent on development projects and less on non-development projects.
- ***Equity-***Government expenditure should be distributed equitably to all sectors of the economy in order to reduce income and wealth inequalities.
- ***Surplus-***Surplus revenue collected should be saved for emergencies or for when collection of revenue is below projections.

TAXATION

Tax; is a compulsory payment by either individuals or organizations to the government without any direct benefit to the payer.

Taxation- refers to the process through which the government raises revenue by collecting taxes.

Purposes/reasons for taxation

- Raising revenue for government expenditure. This is the main reason for taxation.
- Discouraging /controlling consumption of certain commodities e.g. alcohol and cigarattes which are considered to be harmful.
- Discouraging importation of certain commodities in order to protect local industries. This is done by imposing heavy taxes on such commodities.
- Controlling inflation. Taxation reduces money supply by reducing peoples 'disposable' income thereby controlling inflation.
- Reducing inequality in income distribution; this is done by taxing the rich heavily and using the finances raised in provision of goods and services that benefit the poor.
- Influencing locations of businesses. This is done by taxing businesses located in urban areas heavily and those in rural areas lightly hence businesses moving to rural areas.
- Correcting unfavorable balance of payments. High taxes are imposed on imported commodities thereby discouraging their importation leading to an improvement in the balance of payments.

- To protect the key selectors of the economy such as the agricultural sector, by stimulating their growth.

Factors that determine the amount of money raised through taxation

- Distribution of incomes
- Social and political factors
- Honesty and efficiency of tax authorities
- Citizens level of real income
- Economic structure of the country i.e. relative size of the country's commercial and subsistence sectors.

Principles of taxation

These are the characteristics that a good tax system should have. They are also referred to as the *cannons of taxation.*

A good tax system should be;

- ***Equitable/principle of equity***- Every subject of the state should pay tax in proportion to their income. A tax system should therefore have horizontal and vertical equity.

Horizontal equity means that those at the same level of income and circumstances should pay the same amount of tax.

Vertical equity means that those earning higher incomes should pay proportionately higher amounts of tax than those earning less.

- ***Certain/principle of certainty***-The tax that an individual should pay should be clear in terms of the amount, time and manner in which it should be paid. The government should also be fairly certain of the amount of tax expected so that planning can be easier.
- ***Convenient/principle of convenience***-Tax levied ought to be convenient to both the contributor and collector, it should be levied at a time when the payer has money and mode of payment should be convenient to both the payer and the payee.
- ***Economical/principle of economy***-The cost of collecting and administering the tax should be lower than the tax so collected.
- ***Flexible/principle of flexibility***-It should be readily adaptable to changing economic times i.e. when the economic conditions of the people improve it should give raised revenue e.g. VAT
- ***Ability to pay/non-oppressive***-A tax system should be designed in a way that the amount charged is not too high to the extent that the contributors are unable to pay or is discouraged from working hard.
- ***Diversified/principle of diversity***-There should be different types of taxes so that the tax burden is on different groups in the society. This also ensures that the government has money at all times.

- ***Simplicity***-A good tax system should be simple enough to be understood by each tax payer. This will motivate them to pay tax.
- ***Elastic/principle of elasticity***-The tax system should be able to generate more revenue for the government by targeting items of mass consumption.

IMPACT AND INCIDENCE OF TAX

Impact of tax; The burden of tax on the initial person

Incidence of tax; The final resting place of the tax burden.

The person on whom tax is initially imposed may either bear the whole burden or pass part or the whole burden to someone else. E.g. for manufactured goods, the impact of the tax is on the manufacturer and the manufacturer may pass the incidence of the tax to the consumer.

If the manufacturer only passes part of the burden to the consumer, then the incidence of the tax wil be partly on the manufacturer and partly on the consumer.

CLASSIFICATION OF TAXES

Taxes are classified according to;

- Structure of the tax
- Impact of the tax on the tax payer.

According to the structure

In this case, taxes are classified according to the relationship between the amount paid on tax and the income of the tax payer. These are:

Progressive tax

Regressive tax

Proportional tax

- **Progressive tax**

This is a type of tax where the rate/amount paid increases proportionately with increase in income.e.g tax may be as follows

Income	Rate
0-5000	20%
5001-10000	25%
10001-15000	30% e.t.c

-In progressive tax, those with higher income rates remit a higher proportion of their income as tax compared to those in lower income brackets.

This type of tax is based on the belief that one only needs a certain amount in order to have a decent standard of living.

Advantages of progressive tax

- It reduces income inequality as the rich are taxed more
  - It encourages people to work harder/more in order to maintain their standard of living
  - The revenue collected is higher
  - The unit cost of collecting tax reduces as the tax increases.
  - **Disadvantages of progressive tax**
- It is oppressive-some people are taxed more than the others and punishes people for their hard work.
- It may discourage people from working more as any additional income goes tax
- Investors may be discouraged from venturing into risky but more profitable businesses as these would attract more tax
- It assumes that people earning the same amount of money/income have similar needs and ability to pay tax-which in reality may not be true.
- It can lead to tax evasion by taxpayers falsifying their level of income.

Regressive tax

This is a type of tax that takes a higher proportion of low income earners as compared to high income earners. The fax burden falls more heavily on the poor (opposite of progressive)

Example: sales tax where people pay the same amount irrespective of the level of income.

The assumption is based on the understanding that the one who deems it necessary to buy a certain products considers the utility derived from it to be equal to its price, which includes tax.

- **Proportional Tax**

This is a type of tax where the rate of tax remains the same irrespective of the level of income or value of property to be taxed e.g. if the rate is 20% then a person who earns ksh.5000 will pay 20/100 x5000=ksh.1000

Ksh.10, 000 will pay 20/100x10,000=ksh.2000 e.t.c

Example: corporation tax where companies are expected to pay a fixed proportion of their profits as tax.

- **Digressive tax**

This is a type of tax where the tax rate increases up to a given maximum after which a uniform tax rate is levied for any further income.

Classification according to impact on the tax-payee

Based on the impact, the tax has on the tax payer; tax may be classified as either;

- Direct tax
- Indirect tax

- **Direct tax**

These are taxes where the impact and the incidence of the tax are on the same person. It is not possible to shift/pass any part of the tax burden to anybody else.

This type of tax is based on incomes, profits and property of individuals as well as companies.

They include:

- **Personal income tax**

This is a tax that is imposed on incomes of individuals and is usually progressive in nature.

Example pay-As You-Earn (PAYE) for salaries.

In most cases it is paid through check-off system where the employer deducts it from the employee's salary and remits it to the tax authorities.

- **Corporation tax**

This is tax levied on profits of companies. It is usually proportional in nature.

- **Stamps duty**

This is tax paid in areas such as conveyance of land or securities from one person to another.

- **Estate (death) duty**

This type of tax is imposed on property transferred after the owners' death. The tax helps in raising government revenue and also in redistributing income since the inheritor has not worked for it.

- **Wealth tax**

This is tax levied on personal wealth beyond a certain limit.

- **Capital gains tax**

This is tax levied on gains realized when a fixed asset is sold at a price higher than the book value.

- **Capital transfer (gifts) Tax**

This is tax imposed on the value of property transferred from one person to another as a gift. The tax is designed to seal loopholes whereby a wealthy person may try to avoid tax by transferring his/her property to a friend or a relative as a gift.

This type of tax is progressive in nature. It however does not affect transfers between spouses or to charitable organizations.

Merits/advantages of direct taxes

- ***Economical in collection;*** most of direct taxes are collect at source and the cost of collecting them is fairly low.
- ***Tax revenue is certain;*** the tax payer knows what and when to pay and the government knows how much tax revenue to expect at what time (can be collected from the annual tax returns in advance)
- ***Equitable /equity;*** they facilitate fair distribution in tax contribution as people pay according to the size of their income.
- ***Simplicity /simple to understand;*** they are easy and simple to understand by both the tax payer and the collector.
- ***Does not affect the price of goods and services;*** direct tax does not cause inflation as it only affects consumer's disposable incomes and not the prices of goods and services.
- ***Brings redistribution of wealth;*** direct taxes are progressive in nature hence the wealthier members of the society are taxed more than **the poorer members of the society.**
- ***Civic consciousness;*** tax payers feed the pinch of paying tax and thus take a keen interest in government expenditure.
- ***No leakages;*** loss of collected revenue is minimized as the tax is paid directly to the tax authorities and not through middle men.
- ***Desirable;*** the tax is desirable because it only affects people who fall within the jurisdiction of income tax and corporation tax.
- ***Elastic/flexible;*** the tax is flexible in that it can be expanded to cover as many areas as desirable. It can also be raised or reduced according to the needs of the economy.

DEMERITS OF DIRECT TAX

- ***Encourage avoidance and evasion;*** whenever possible people come up with ways of reducing the amount of tax payable by falsifying information or just ignoring payment.
- ***Discriminatory /not imposed on all citizens;*** direct taxes are not paid by all citizens as low income earners who do not fall within the tax brackets are exempted
- ***Discourage investment/deterrent to investment;*** Heavy taxation on profits discourage people from investing in risky but profitable businesses
- ***Discourage work/deterrent to work;*** High rate of direct tax may deter people from working harder as people may opt for leasure instead of working extra time.

- ***Encourage capital flight;*** high taxes such as corporate tax make foreigners to withdraw their investments and transfer them to countries with lower taxes.

- ***Unpopularity;*** the burden of the tax (incidence and impact) of tax is borne by the tax payer directly and at once. This makes direct taxes very unpopular.

- ***May inconvenience the tax payer;*** *the tax payer has to comply with complicated formalities relating to sources of income as well as the expenses incurred while generating it. This may force the tax-payer to engage the services of tax experts who have to be paid.*

- ***Lack of civic awareness;*** on tax payers are not interested in scrutinizing government expenditure as they do not feel the pinch of paying tax.

- ***Indirect tax***

These are taxes in which the impact is on one person and the incidence is partially or wholly on another person. The tax payer may shift either the whole or part of the tax burden to another person.

Such taxes are usually based on the expenditure on goods and services and include the following:

- **Sales tax:** this is based on the sales made and may be assessed either as a percentage of the sales or a fixed amount e.g. sh.2 per every kilograms sold. The tax may be collected at one point or various points of sale. In Kenya, sales tax has been replaced by V.A.T

- **VALUE ADDED TAX (V.A.T):** this is the tax that is levied on the value that a business adds borne by the consumer in the final price.

- **Export duty:** this is a type of tax that is levied on exports. The objective may either to raise revenue or discourage the exploitation of some commodities.

- **Import duty:** This is tax levied on imported products**,** For the following reasons**.**

  - Raising government revenue
  - Reducing incidences of dumping
  - Discouraging consumption of imported goods with a view of boosting local production
  - Protecting local industries

Excise duty: This is a type of tax that is imposed on goods that are manufactured and sold within a country.

Its purpose includes;

Raising revenue for the government

Discouraging the consumption of some commodities such as beer and cigarettes.

MERITS OF INDIRECT TAX

- Can be used selectively; It can be used selectively to achieve a given objective e.g. consumption of some commodities.

- Tax payment is voluntary; indirect tax is only paid by those who consume the tax commodities therefore those who do not want to pay the tax would only need to avoid taxed commodities.
- Difficult to evade; the tax cannot be evaded because it is part of the price of the commodity. All those who buy the commodity taxed must therefore pay the tax.
- Wide coverage/broad based; the tax is levied on a wide range of essential commodities thus a high amount of revenue is collected.
- Stimulate effort; indirect taxes if increased increases the prices of goods and services. People who want to maintain the same living standards will therefore have to work harder to be able to buy/affect the same goods and services.
- Convenient; the tax is paid in bits as one buys the goods and services. The tax is also hidden in the price of the commodity and the payer may not be aware of it.
- Flexible; flexible; the government can raise or reduce the tax rate to suit the prevailing economic situation in a country.

<u>DEMERITS OF INDIRECT TAXES</u>

- May fuel inflation; continued increase in indirect taxes may fuel inflation as it directly increases the prices of goods and services.
- Less equitable/regressive; the same amount is charged on both the high and the low income earners making the tax burden to fall heavily on the low income earners. The low income earners end up paying a larger proportion of their income as tax.
- Can be avoided; indirect taxes can be avoided by people who do not consume the taxed commodity.
- Encourages falsification of records; traders may falsify their rewards in order to pay less tax.
- Lack of civic/contributors awareness; the tax is hidden in the price of the commodities therefore the tax payers are not aware that they are contributing anything to the state.
- Expensive to administer/expensive in collection; the government must employ many tax inspectors making indirect taxes expensive in collection and administration.
- Uncertainty in revenue collection; the government may not predict the amount of revenue yield as it is not easy to forecast sales and people can also not be forced to buy the taxed commodities.
- Might interfere with resource allocation; indirect taxes increases the prices of commodities and can therefore force consumers and producers to shift to the consumption and production of commodities that are not taxed.
- Discourages savings; increased expenditure due to increased prices will lead to low saving and hence low investments.

INFLATION

Introduction

Inflation refers to an economic situation where the demand for goods and services in the economy is continuously increasing without corresponding increase in supply which pushes the general prices up. The opposite of inflation is called **deflation.**

Inflation is measured by considering the Consumer Price Index (C.P.I) which involves comparison of prices of certain goods and services for two different periods.

In constructing the C.P.I;

- A basket of commodities is selected which includes selecting the generally consumed commodities by average consumers.
- Choosing the base period which should be a period when the prices were fairly stable.
- The price of commodities both in the current period (P_1) and base period (P_2)

Consumer Price Index (C.P.I)= × 100

Types and causes of inflation

Inflation is classified in relation to its causes.

Demand pull inflation

This is a type of inflation caused by excessive demand for goods and services without a corresponding increase in production resulting into rise in prices.

Causes of demand pull inflation

- **Increase in population.;**Increased number of people in a family calls for increased demand of goods and services thus fueling demand-pull inflation.
- **Increase in government expenditure;**The government expenditure has the effect of making money available to people thus increasing the aggregate demand for goods and services.
- **A fall in the level of savings;** This increases the consumer expenditure on goods and services which brings pressure on the available goods and services thereby pulling up prices.
- **Effects of credit creation by the commercial banks;** When banks lend more money to the public, their purchasing power increases hence increasing demand which in turn leads to increase in the prices.
- **Consumers' expectation of future price increases;** When consumers expect the prices of goods and services to increase in the future, they will buy more in the present thus increasing the demand thus fueling demand-pull inflation.
- **General shortages of goods and services;** Any shortage in goods caused by factors such as; adverse climatic conditions, hoarding, smuggling, withdrawal of firms from the industry and decline in level of technology calls for scramble for the available goods thus increasing their demand and prices.

\ **Cost push inflation**

This is a type of inflation caused by increase in cost of factors of production which translates to increased prices of goods and services.

Causes of cost push inflation.

- **Increase in wages and salaries**; An increase in the wages and salaries may increase the cost of labour. The increased cost of labour may be reflected in the increased prices of commodities which in turn would cause **wage push inflation.**
- **Increase in cost of raw materials and other inputs;** This increases the cost of production thus increased prices.
- **Increase in indirect taxes;** This increases the cost of production and this causes firms to raise the prices of their product.
- Increase in profit margin; If the business decides to raise its profit, it leads to an increase in the price of the commodities resulting to **profit push inflation.**
- **Reduction in subsidies;** removal of a subsidy implies that the producer would produce at a higher cost that was being met by the subsidy. This increase cost is finally reflected in increased prices.

Imported inflation
This is a type of inflation which is caused by importation of high priced inputs of production such as; technology/machines, skilled human resources
and crude oil.

This in turn increases the prices of locally produced goods which may lead to inflation.

Causes of imported inflation

- Importation of expensive technology especially highly skilled labour.
- Importation of expensive machines and equipment.
- Importation of high priced oil.
- The currency depreciating thus increasing the price of the country's imports.

LEVELS OF INFLATION

- **Mild / Creeping/Moderate Inflation**

This a slow rise in price level of not more than 5 % per annum. It is associated with some beneficial effects on an economy especially to firms and debtors.

- **Galloping /Rapid Inflation**

This is a very rapid accelerating inflation characterized by a situation whereby the general prices levels increase rapidly.

- **Stagflation;**

This is an economic condition in which unemployment is high, the economy is stagnant, but prices are rising.

- **Hyper /Runway Inflation;**

This is when prices are rising at double or triple digit rates of 20%, 100%, 200%.
The price levels are extremely high and under this situation people may lose confidence in the money as a medium of exchange and as a store of value.

EFFECTS OF INFLATION IN AN ECONOMY

positive effects of inflation

- Mild inflation motivates people to work hard as they try to cope with the effects of the inflation in order to maintain their standards of living.
- Mild inflation encourages proper utilization of resources with an attempt of avoiding wastage as much as possible.
- Mild inflation increases investment especially in trading activities since sellers buy goods when prices are low and sell later when prices are higher.
- It promotes creativity in an economy in terms of production in order to survive the effects of inflation.
- It benefits debtors since they obtain goods on credit and pay for them in future at the old low prices.

Negative effects

- It leads to reduction in profits as sales volumes reduce since inflation reduces the purchasing power of consumers resulting to low sales.
- It wastes time as a lot of time is wasted in shopping around for reasonable prices and also firms may waste a lot of time adjusting their price lists to reflect new prices.
- It leads to conflicts between employers and employees as firms are pressurized by employees and trade unions to raise wages and salaries to cope with inflation.
- It leads to loss by creditors as they lend money when the value of money is high but at the time of payment is low since the value of money will have been eroded by inflation.
- It leads to decline in standards of living as consumers' purchasing power decrease and therefore one can not lead the lifestyle he/she used to live before.
- Leads to unemployment.

- Discourages savings and investment since during inflation people tend to spend most of their earnings leaving little or nothing to save.
- Leads to retardation of economic growth.
- Worsens balance of payments position.

CONTROL OF INFLATION

The govt. may adopt the following policies depending on their situation to reduce inflation to manageable levels. They include;

- **Monetary policy**

This is a deliberate move by the govt. through the central bank to regulate and control the money supply in the economy which may lead to demand pull inflation. The policies include;

- Increase rate of interest of lending to the commercial banks. This forces them to increase the rate at which they are lending to their customers, to reduce the number of customers borrowing money, reducing the amount of money being added to the economy
- **Selling of govt. securities in an open market operation (O.M.O).** the selling of securities such as Bonds and Treasury bills mops money from the economy, reducing the amount of money being held by individuals
- **Increasing the commercial banks cash/liquidity ratio**. This reduces their ability to lend and release more money into the economy, reducing their customer's purchasing power
- **Increasing the compulsory deposits by the commercial banks with the central banks**. This reduces their lending power to their customers, which makes their customers to receive only little amount from them, reducing the amount of money in the economy
- **Putting in place the selective credit control measures**. The central bank may instruct the commercial bank to only lend money to a given sector of the economy which needs it most, to reduce the amount of money reaching the economy
- **Directives from the central banks to the commercial banks** to increase their interest on the money being borrowed, to reduce their lending rates
- Request by the central bank to the commercial banks (**the moral persuasion**) to exercise control on their lending rates to help them curb inflation.

FISCAL POLICY

These are the measures taken by the govt. to influence the level of demand in the economy especially through taxation process controlling government expenditure. They include;

- Reducing govt. spending. This reduces the amount of money reaching the consumers, which is likely to increase their purchasing powers, leading to inflation
- Increasing income taxes. This reduces the level of the consumers disposable income and lowering their spending levels, reducing the inflation
- Reducing taxes on production. This reduces the cost of production, lowering the prices of goods reaching the market
- Subsidizing the production. This reduces the cost of production in the economy, which in turn passes over the benefits to the consumers inform of reduced prices.
- Producing commodities that are in short supply. This increases their availability to meet their existing demand in the market, controlling demand pull inflation

- **Statutory measures**

These are laws made by the govt. to help in controlling the inflation. They include;

- Controlling wages and salaries. This reduces the pressure put on the employers to meet high cost of labour for their production which in turn is just likely to lead to cost push inflation. It also minimizes the amount reaching the consumers as their income, to control their purchasing power and the level of demand, controlling the demand pull inflation

- Price controls. This reduces the manufactures ability to fix their prices beyond a given level which may cause inflation due to their desire to receive high profits.

- Restricting imports. This reduces the chances of high prices of imported goods impacting on the prices of the goods in the country (imported inflation) and making the manufactures to look for alternative source of raw materials for their production

- Restricting the terms of hire purchase and credit terms of sales. This reduces the level of demand for those particular commodities in the economy which if not controlled may lead to demand pull inflation

- Controlling exports. This ensures that the goods available in the local market are adequate for their normal demand. Shortage of supply of goods in the market is likely to bring about the demand pull inflation.

Revision Question

Outline measures that the government may employ to control the following types of inflation;

- Demand pull inflation
- Cost push inflation

- **Cost push inflation**

- By controlling the wages and salaries in the economy
- Restricting import on raw materials
- Reducing taxes on production
- Subsidizing the production
- Employing the price control techniques

- **Demand pull inflation**

- Increasing the rate of interest of lending to the commercial banks
- Selling govt. securities on O.M.O
- Increasing the commercial banks cash/liquidity ratio

- Increasing the compulsory deposits from the commercial banks to the central bank
- Putting in place the selective credit control measure
- Directives to the commercial banks
- Request to the commercial banks
- Reducing govt. expenditure
- Increasing income taxes
- Producing commodities that are short in supply
- Restricting terms of hire purchase and credit terms of sale
- Controlling export

INTERNATIONAL TRADE

A trade involving the exchange of goods and services between two or more countries. If the exchange is between two countries only, then it is referred to as bilateral trade, but if it is between more than two countries then it is referred to as multilateral trade.

Advantages of International Trade

- It enable the country to get access to wider range/variety of goods and services from other countries
- It enable the country to get what it does not produce
- It helps in promoting peace among the trading countries
- It enable the country to specialize in it's production activities where they feel they have an advantage

- It earns the country revenue through taxes and licenses fees paid by the importers and exporters in the country
- It enable the country to dispose of its surplus goods and services thereby avoiding wastage
- It creates employment opportunities to the citizens of that country either directly or indirectly
- It may lead to the development of the country through importation of capital goods in to the country
- It encourages easy movement of factors of production across the boarders of the countries involved
- It enable countries to earn foreign exchange which it can use to pay for its imports
- A country may be able to obtain goods and services cheaply than if they have been produced locally
- During hard times or calamities such as wars, the country is able to get assistance from the trading partners
- It brings about competition between the imported and locally produced goods, leading to improvement in their quality
- It gives the country an opportunity to exploit fully its natural resources, due to increased market

Disadvantages of International trade

- It may lead to collapse of the local industries, as people will tend to go for the imported goods. The collapse may also lead to loss of employment
- It may also lead to importation of harmful foods and services such as drugs and pornographic materials
- May lead to over depending on imported commodities especially the essential ones, making the country to be a slave of the other countries, interfering with their sovereignty
- It may make the country to suffered during emergencies if they mainly rely on the imported goods
- May make the country to suffer from import inflation
- May lead to acquisition of bad culture from other countries as a result of their interactions
- May lead to unfavorable balance of payment, if the import is higher than exports

Terms of Trade

This refers to the rate at which the country's export exchanges with those from other country. That is:
Terms of trade =

$$\frac{\text{Price index of export}}{\text{price index of import}}$$

It determine the value of export in relations to import so that a country can know whether it's trade with the other country is favourable or unfavourable
Favourable terms of trade will make the country spent little on import and gain a lot of foreign exchange from other countries

For example;

Then table below shows trade between Kenya and China in the year 2004 and 2005, with the Kenyan government exporting and importing to and from china, and China also importing and Exporting from and to Kenya.

Year	Average prices of export	
	Kenya	China
2004	1000	4000
2005	1200	6500

Calculate the Terms of trade for;

- Kenya
- China
- Solution;

$$\frac{\textit{average prices of exports in the current year}}{\textit{average prices of exports in the base year}}$$

Kenya

- Export price index (E.P.I) = x 100

  = x100

  = 120%

- Import price index (I.P.I) = x 100

  = x 100

  = 162.5%

- Terms of trade (T.O.T) = x 100

  = x 100

  = 73.8%

  This implies that Kenya is importing from China more than it is exporting, leading to unfavourable terms of trade i.e. when the percentage is less than 100%, it implies unfavourable terms of trade.

China **(work out)**

The average prices is the various prices of the individual export or import items divide by their number

Factors that may lead to either favourable or unfavourable terms of trade

The country is experiencing a favourable terms of trade if:

- The prices of imports decline and those of export remains the constant
- The prices of imports declines while those of exports increase
- The price of imports remains constant while those of exports increase
- The prices of import and export increases but the rate of increase in export is higher
- Both prices decrease but the decrease in import prices is higher

The country will experience unfavourable terms of trade if;

- Prices of import increases while those of exports decline
- Prices of import remains constant while those of export declines
- Prices of import increase as the export remains constant
- Both prices increase, but for imports increases at a higher rate than export
- Both prices decrease, but for export decreases at a higher rate than import

Reasons for differences in terms of trade between countries

The terms of trade may differ due to:

- The nature of the commodity being exported. If a country exports raw materials, or unprocessed agricultural products, its terms of trade will be unfavourable, as compared to a country that exports manufactured goods

- Nature of the commodity being imported. A country that imports manufactured goods is likely to have unfavourable terms of trade as compared to that which imports raw materials or agricultural produce
- Change in demand for a country's export. An increase in demand for the country's export at the world market will make it have favourable terms of trade as compared to those with low demand at the world market
- Existing of world economic order favouring the products from more developed countries. This may make the developing countries to have deteriorating terms of trade
- Total quantity supplied. A country exporting what most countries are exporting will have their products trading at a lower price, experiencing unfavourable terms of trade as compared to a country that export what only few countries export
- Trade restrictions by trading partners. A country with no trading restrictions is likely to import more products, leading to unfavourable terms of trade, as compared to if it impose trade restrictions

Balance of trade

This is the difference between value of country's visible exports and visible imports over a period of time. If the value of visible/tangible export is higher than the value of visible/tangible imports, then the country experiences favourable terms. If less than the invisible value, then the country is experiencing unfavourable. The country is at equilibrium if the value of visible export and import is the same

Balance of payments

This is the difference in the sum of visible and invisible export and the visible and invisible imports. If positive then it means the country is having favourable terms, while if negative, then it means unfavourable It goes beyond the balance of trade in that it considers the following

- The countries visible/tangible export and import of goods (visible trade)
- The countries invisible/services exported and imported in the country (invisible trade)
- The inflow and outflow of investment (capital goods)

Balance of Payment account

This is the summary showing all the transactions that have taken place between a particular country and the rest of the world over a period of time. The transaction may arise from

- The export of visible goods
- The import of visible goods
- The export of invisible goods/services
- The import of invisible goods/services
- Flow of capital in and out of the country

Components of balance of payments account

The balance of payment account is made up of the following

- Balance of payment on current account
- Balance of payment on capital account
- Official settlement account/Cash account/foreign exchange transaction account

Balance of payment on current account

This is the account that is used to determine the difference between the value of the country's visible and invisible imports and exports. That is

Balance of payment on current account = (visible export + invisible export) – (visible import + invisible import)
In the account, the payments for the visible and invisible imports are **debited** while the receipts from visible and invisible exports are **credited** that is

Dr **current account** Cr

Payments for imports (Visible and Invisible)	Receipts from exports (Visible and Invisible)

The balance of payment on current account may be;

- In equilibrium i.e. if Dr = Cr
- Unfavourable i.e. if Dr > Cr (-ve)
- Favourable i.e. if Dr < Cr (+ve)

For example;
A given country had the following values of visible and invisible export and import during the year 2004 and 2005

Trade	2004 (shs)	2005 (shs)
Visible export	18926	29954
Visible imports	22780	32641
Invisible exports	6568	19297
Invisible imports	5239	16129

Required
Prepare the country's balance of payments on current account for the years 2004 and 2005 and comment on each of them.

Dr **current account year 2004** Cr

	shs		Shs
Visible imports	22780	Visible export	18926
Invisible imports	5239	Invisible export	6568
Total	28019	Total	25494
		Deficit	**2525**

The country experienced unfavourable balance of payment on current account in the year 2004, since they imported more than they exported

Dr **current account year 2005** Cr

	shs		Shs
Visible imports	32641	Visible export	29954
Invisible imports	16129	Invisible export	19297
Total	28019	Total	49251
Excess 481			

The country experienced favourable balance of payment on current account in the year 2005, since they exported more than they imported

Balance of payments on capital account

This account shows the summary of the difference between the receipt and payments on the investment (capital). Receipts are income from investments in foreign countries while payments are income on local investments by foreigners paid out of the country.
The capital inflow includes investments, loans and grants from foreign donors, while capital outflow includes dividends paid to the foreign investors, loan repayments, donations and grants to other countries.
In the account the payments are debited, while the receipts are credited. That is;

Dr **capital account** Cr

Payments	Receipts

The account may be;

- In equilibrium i.e. if Dr = Cr
- Unfavourable i.e. if Dr > Cr (-ve)
- Favourable i.e. if Dr < Cr (+ve)

The combined difference on the receipts and payments on both the current and capital accounts is known as the overall balance of payments.

The official settlement account

This account records the financial dealings with other countries through the IMF. It is also called the foreign exchange transaction account, and is always expected to balance which a times may not be the case. That is;

- Incase of surplus in the balance of payment, the central bank of that country creates a reserve with the IMF and transfer the surplus to the reserves account.
- Incase of a deficit in the balance of payment, the central banks collect the reserves from the IMF to correct the deficit, and incase it did not have the reserves, the IMF advances it/give loan

Balance of payment disequilibrium

This occurs when there is either deficit or surplus in the balance of payments accounts. If there is surplus, then the country would like to maintain it because it is favourable, while if deficit, the country would like to correct it.

Causes of balance of payment disequilibrium

It may be caused by the following;

- Fall in volume of exports, as this will reduce the earnings from exports leading to a deficit.
- Deteriorating in the countries terms of trade. That is when the countries exports decreases in relation to the volume of imports, then her payments will higher than what it receives.
- Increasing in the volume of import, especially if the export is not increasing at the same rate, then it will import more than it exports, leading to a disequilibrium
- Restriction by trading partners. That is if the trading partners decides to restrict what they can import from the country to a volume lower than what the country import from them, it will lead to disequilibrium
- Less capital inflow as compared to the out flow, as this may lead to a deficit in the capital account, which may in turn leads to disequilibrium.
- Over valuation of the domestic currency. This will make the country's export to very expensive as compared to their import, making it to lose market at the world market
- Devaluation of the currency by the trading partner. This makes the value of their imports to be lower, enticing the country to import more from them than they can export to them.

Correcting the balance of payment disequilibrium

The measures that may be taken to correct this may include;

- **Devaluation of the country's currency** to encourage more exports than imports, discouraging the importers from importing more into the country.
- **Encouraging foreign investment in the country**, so that it may increase the level of economic activities in the country, producing what can be consumed and even exported to control imports
- **Restricting the capital outflow from the country** by decreasing the percentage of the profits that the foreigner can repatriate back to their country to reduce the outflow

- **Decreasing the volume of imports**. This will save the country from making more payments than it receives. It can be done in the following ways;
    - Imposing or increasing the import duty on the imported goods to make them more expensive as compared to locally produced goods and lose demand locally
    - Imposing quotas/total ban on imports to reduce the amount of goods that can be imported in the country
    - Foreign exchange control. This allows the government to restrict the amount of foreign currencies allocated for the imports, to reduce the import rate
    - Administrative bottlenecks. The government can put a very long and cumbersome procedures of importing goods into the country to discourage some people from importing goods and control the amount of imports

- **Increasing the volume of exports**. This enable the country to receive more than it gives to the trading partners, making it to have a favourable balance of payment disequilibrium. This can be done through;
    - Export compensation scheme, which allows the exporter to claim a certain percentage of the value of goods exported from the government. This will make them to charge their export at a lower price, increasing their demand internationally
    - Diversifying foreign markets, to enable not to concentrate only on one market that may not favour them and also increase the size of the market for their exports
    - Offering customs drawbacks. This where the government decides to refund in full or in part, the value of the custom duties that has been charged on raw materials imported into the country to manufacture goods for export
    - Lobbying for the removal of the trade restriction, by negotiating with their trading partners to either reduce or remove the barrier put on their exports

Terms of sales in international trade

Here the cost trading which includes the cost of the product, cost of transporting, loading, shipping, insurance, warehousing and unloading may be expensive. This makes some of the cost to be borne by the exporter, as some being borne by the importer. The price of the goods quoted therefore at the exporters premises should clearly explain the part of the cost that he/she is going to bear and the ones that the importer will bear before receiving his/her goods. This is what is referred to as the terms of sale

Terms of sales therefore refers to the price quotation that state the expenses that are paid for by the exporter and those paid for by the importer.

Some of the common terms include;

- **Loco price/ex-warehouse/ex-works**. This states that the price of the goods quoted are as they are at the manufacturers premises. The rest of the expenses of moving the good up to the importers premises will be met by the importer
- **F.O.R (Free on Rail).** This states that the price quoted includes the expenses of transporting the goods from the seller's premises to the nearest railway station. Other railways charges are met by the importer
- **D.D (Delivered Docks)/Free Docks**. This states that the price quoted covers the expenses for moving the goods from the exporter's premises to the dock. The importer meets all the expenses including the dock charges
- **F.A.S (Free Along Ship).** States that the price quoted includes the expenses from the exporter's premises to the dock, including the loading expenses. Any other expenses are met by the importer
- **F.O.B (Free on Board).** States that the price quoted includes the cost of moving the goods up to the ship, including loading expenses. The buyer meets the rest of the expenses

- **C&F (cost & freight).** The price quoted includes the F.O.B as well as the shipping expenses. The importer meets the insurance charges
- **C.I.F (Cost Insurance & freight).** The price includes the C&F, including the insurance expenses
- **Landed.** The price includes all the expenses up to the port of destination as well as unloading charges
- **In Bond.** The price quoted includes the expenses incurred until the goods reaches the bonded warehouse
- **Franco (Free of Expenses).** The price quoted includes all the expenses up to the importer's premises. The importer does not incur any other expenses other than the quoted price
- **O.N.O (Or Nearest Offer).** This implies that the exporter is willing to accept the quoted price or any other nearest to the quoted one

Documents used in International trade

- **Enquiry/Inquiry**. A letter sent by an importer to the exporter asking about the supply of the goods and the terms of sale.
- **Order of Indent**. This asks the supplier to supply goods. It may specify the goods to be supplied and suggest the preferred mode of transport for them. An indent may be open or closed
    - **Open Indent.** Here the importer does not specify the supplier and the goods to be bought and therefore the exporter or export agent is free to choose the supplier
    - **Closed Indent.** Here the importer specifies the supplier and the goods to be bought
- **Letter of Credit.** A document issued by the importers bank to the exporter's bank to assure the exporter of the payment for the goods ordered. The exporter can then be paid by his bank on the basis of this letter.
- **Import Licence**. A document issued by the country to allow the importer to buy goods from abroad.
- **Bill of Lading**. A document of title to goods being exported issued by the shipping company to the importer who should use it to have goods released at the port of entry.
- **Freight Note.** A document prepared by the shipping company to show the transportation charges for goods.
- **Certificate of insurance**. A document issued by the insurance company or agent, undertaking to cover the risk against the loss or damage to goods being exported.
- **Certificate of Origin.** A document that shows the country from which the goods are being imported have originated from.
- **Commercial Invoice**. A document issued by the exporter to demand for the payment for the sold on credit to the importer.
  It shows the following;
    - The name and address of the exporter
    - The name and the address of the importer
    - The price charged
    - The terms of sale
    - The description of the consignment
    - The name of the ship transporting the consignment
- **Consular Invoice**. A document that shows that the prices of the goods that have been charged is fair as certified by the consul with the embassy of the exporting country.
- **Pro-forma Invoice**. A document sent by the exporter to the importer if he/she is not willing to sell goods on credit. It may be used to serve the following purposes;
    - Serve as a formal quotation
    - Serve as a polite request for payment before the goods are released for the customer
    - To enable the importer to initiated the clearing of the custom duty early enough to avoid delays
    - Used to by the importer to obtain permission from the Central Bank to import goods

- Airway Bill. Issued by the airline company to show the charges for the goods being transported
- **Letter of Hypothecation**. A letter written by the exporter to his/her bank authorizing it to resell the goods being exported. This occurs if the bank fails to get payment on the bill of exchange drawn on the importer that it has discounted for the exporter. Should there be a deficit after the resale, the exporter pays the deficit
- **Weight note.** A documents that shows the weight and other measurements of the goods being delivered at the dock
- Shipping advice note. A document issued by the exporter to his/her shipping agent containing instruction for shipping goods.

INTERNATIONAL FINANCIAL INSTITUTIONS

Some of the institutions that play a role in international monetary system include;

- International Monetary Fund (I.M.F)
- African Development Bank (A.D.B)
- African Development Fund (A.D.F)
- International Bank For Reconstruction and Development (World Bank)

- **International Monetary Fund (I.M.F)**

This bank operates like the central bank of the central banks of the member countries. Its objective includes the following;

- Ensuring that the member country maintains a stable foreign exchange rates for their currencies. This it does by advising the country to raise or increase the supply of their currency to devalue them or increase their value internationally
- Provide financial support to the member country to alleviate poverty and boost their income.
- Relieving heavily indebted countries of debt repayment so that it can use that fund to raise the living standards of its people.
- Providing funds to the member countries to finance the deficits in their balance of payment.
- Provide forum through which the member country can consult and cooperate on matters concerning trade among them
- Maintaining currency reserves of the different countries, enabling member countries to buy foreign exchange to be used to import goods and services.

- **African Development Bank (A.D.B)**

This bank was formed to promote the economic and social progress of its regional member countries in Africa. It main source of finance is the members' contributions and the interest charged on the money they lend members.

Its functions include;

- Providing loans for economic and social development to member countries
- Provide technical advice in planning and implementation of the development plans
- Assist member country to appropriately exploit it resources
- To encourage co-operation among African countries in order to bring economic growth
- To co-operate with various economic institutions in order to bring about development especially in Africa countries

- **African Development Fund (A.D.F)**

This was formed to provide long term financial assistance to the low income countries that cannot obtain loan from other financial institutions at the prevailing terms and condition. Their loans may recover a longer repayment periods with no interest except the commitment fees and service charge which is minimal. They fund activities, which includes;

- Education and research activities
- Offer technical advice to the member countries

- **International Bank For Reconstruction and Development (World Bank)**

The World Bank was formed to carry out the following functions;

- Giving loans to countries at very low interest rates to finance economic development activities.
- Provision of grants to finance the provision of social amenities and basic infrastructural development in developing countries.
- Fighting against corruption and poor governance which may lead to misuse of public funds in different countries.
- Advancing money to countries to finance balance of payment deficit.
- Giving advice on economic challenges that country may face.
- Availing technical assistance and personnel to help countries run their economic programmes

ECONOMIC INTEGRATION

This occurs where two or more countries enter into a mutual agreement to cooperate with each other for their own economic benefit. They may do this by allowing free trade or relaxing their existing trade barriers for the member countries.

Economic integration may occur in the following forms;

- Free Trade Area

  This is a case where the member countries agree to abolish or minimize tariffs and other trade restrictions but the individual countries are free to impose restrictions on non-member countries. They includes; Preferential Trade Area (P.T.A), European Free Trade Area (E.F.T.A), Latin America Free Trade Area (L.A.F.T.A), etc.

- Custom union
  This is where the members of the free trade area may agree not only to abolish or minimize their tariffs, but also establish a common tariff for the exchange of goods and services with the non member countries. They include; Economic Community of West Africa States (E.C.O.W.A.S), East Africa Custom Union (E.A.C.U), Central Africa Custom and Economic Union (C.A.C.E.U)
- Common Market
  This is where the member countries allow for free movement of factors of production across the boarders. People are free to move and establish their business in any member country. They include; East Africa Common Market (E.A.C.M), European Economic Community (E.E.C), Central American Common Market (C.A.C.M), Common Market for Eastern and Southern Africa (COMESA)
- Economic Union
  This is where the members of the common market agree for put in place a common currency and a common central bank for the member countries. They even develop common infrastructures which includes railways, communication networks, common tariffs, etc

Importance of economic integration

Economic integration will ensure the following benefits for the member countries;

- Availability of wider market for the goods and services produced by the member countries. This enables them to produce to their full capacity
- It enables the country to specialize in the goods they produce best, making them to effectively utilize their resources
- It leads to promotion of peace and understanding among the member countries through interaction
- It leads to high quality of goods and services being produced in the country due to the competition they face
- It allow members to get access to wider variety of goods and services which satisfy different consumer needs
- It leads to creation of employment for individuals living within the region, as they can work in any of the member country
- It increase the economic bargaining power in trading activities by the countries forming a trading bloc
- Improvement of the infrastructure in the region due to increased economic activities.
- It brings a bout co-ordination when developing industries, as the members will assign the industries to each other to create balance development and avoid unnecessary duplication

Free Trade Area

This is a situation where there is unrestricted exchange of goods and services between the countries. It has benefits/advantages similar to those of economic integration.

Disadvantages of free trade area

Some of the problems it is likely to bring include;

- It may lead to importation of inferior goods and services to the country, as the member country may not be able to produce high quality as compare to other non-member countries
- It may discourage the growth of the infant industries due to competition from well developed industries in other countries
- It may lead to reduced government revenue because no tariff may be charged on the goods and services
- A country may be tempted to adopt technology not suitable for its level of development.
- If not controlled, it may lead to unfavourable balance of payment, where a country imports more than it export

- It may lead to importation of harmful goods and services, that may affect the members health such as illegal drugs
- It may lead to lack of employment opportunities especially where more qualified people have moved from their country to secure job opportunities in the country
- It may expose the country to negative cultural practices in other countries, interfering with their morals. For example the exposure to the pornographic materials.
- Compromising political ideologies especially where member countries with different ideologies wants to fit in to the bloc
- It may lead to over exploitation of non-renewable economic resources such as minerals

Trade Restrictions

These are deliberate measures by the government to limit the imports and exports of a country. They are also known as protectionism and includes the following;

- Tariffs which include taxes levied on both import and export. It can be used to increase or decrease the level of both import and export
- Quotas which is the restriction on the quantity of goods to be either imported or exported. It can be increased or decreased to increase or decrease the level of import or export respectively.
- Total ban (zero quota) where the government issues a direction illegalizing either the import or export of the products
- Complicated import procedure in order to discourage some importers from importing
- Subsidies on locally produced goods to discourage imports
- Legislation against importation of certain goods
- Setting the standards of products to be imported

Reasons for trade restrictions

- To prevent the inflow of harmful goods into the country, that may be harmful to the lives of the citizens
- To protect the local infant industries that may not be able to compete favourably with well established industry
- To give a country a chance to exploit its natural resources in producing their goods
- To protect strategic industry, since their collapse may make the country to suffer
- To minimize dependency of the country to other countries for their stability
- To create employment opportunity to its people by establishing the industries to produce the goods and services
- To prevent dumping of goods in the country by the developed partners which may create unfair competition
- To correct balance of payment deficit by limiting import
- To protect good cultural and social values which may be influenced by unaccepted values they are likely to acquire from other country through interaction
- To expand market for locally produced goods by restricting the number of foreign goods in the market.
- To enable the country earn foreign exchange through imposing taxes and other tariffs

Advantages of trade restrictions

- It promotes self reliance as industries have an opportunity to engage in the production of goods and services that were previously imported
- It protects the local industries from stiff competition that they may have faced from the well developed countries
- It may help to correct the balance of payment deficit

- It restrict the entry of harmful goods into the country as it controls the inflow of imports in to the country
- It enables the country to conserve their valuable social and cultural values from the external influence
- It help in creating more job opportunities through diversification in the production
- It promotes the growth of local/infant industries in the country.

Disadvantages of trade restriction

- There will be availability of limited variety of goods in the country that will limit the consumer's choices
- May lead to production of low quality goods as there will be no competition for the producing firms
- Other countries may also retaliate, leading to reduction in export from their country
- There is likely to be high prices charged on the locally produced goods, since the small firms which produce them may not be enjoying the economies of scale
- The country is likely to be exposed to small market, should all countries restrict which may lead to reduction in trade.
- As a result of the continued protection, some industries may develop a tendency of remaining young to still enjoy the protection, which limits the level of development
- It may lead to emergence of monopoly as the protected industry may end up remaining alone in the market, bringing about the problems of monopolies

Trends in International Trade

- Liberalization that has led to removal of many trade restriction among the countries, increasing the levels of trade
- Development of E-Banking which has enable the international trader to get access to their bank accounts from wherever they are in
- Development of export processing zones (EPZ) by the government to allow the industries involved just concentrate in the exported goods only. It enable the country enjoy the following benefits (advantages of EPZ)
    - It creates job opportunities to the citizens
    - It creates market for locally produced raw materials that they use in their production
    - It encourage the foreign investors to invest in the countries, i.e. in the processing zones, increasing the level of investment in the country
    - Encourages export in the country as the incentives given to them by the government makes them to produce more and more for export
    - It stimulates industrialization in the country in all sector including the ones producing for local consumptions

    However EPZ's have the following problems/disadvantages
        - Most of them employs foreigners in their management team, denying the locals a chance to get employed
        - They do not generate revenue to the government, especially during tax free periods
        - They are concentrated in few towns, bringing about imbalance regional development
        - Some of them encourages social evils such as prostitution in areas where they are developed
- Development of e-commerce/website trading which has promoted the selling and buying of items through the internet, with payments made online.

    E-commerce has the following benefits/advantages:
    - One is able to access the market world wide, as the countries are connected to the internet
    - There is no discrimination, as both the small and large industries are able to transact through the internet

- It is fast to transact the business through internet, as it saves on travelling time and therefore suitable for urgent transaction
- It is cheap especially on the cost of sending, receiving and storing information
- It is easy for firms to share valuable information about production

ECONOMIC DEVELOPMENT AND PLANNING

Economic Growth
This is the increase in the productivity of a country which can be seen in the continued increase in the national income over a period of years.
It can be measured by taking the average percentage of increase in national income over a period of time (number of years) and be assumed to be the average rate of economic growth in the country

Economic Development
This is the quantitative change or increase in a country's national income over the years, accompanied by favorable changes in the structures within the country that leads to general improvement of the individual well being, as well as the entire nation

A country may experience economic growth without experiencing economic development. This is because the increase in the national income may be as a result of people working for long hours without any time for rest, recreation and other development to occur in their body. This will make them not to have better living, despite the fact that the national income shall have increased.

The expected structural changes to be realized in a case of economic development include;

- Shifting from depending on agricultural sector to manufacturing sector in the economy
- Reducing illiteracy levels
- Increase in skilled manpower in the economy
- Improvement in health facilities within the country
- Increase in technology and improvement of entrepreneurial ability
- Increase and improvement of institution that handles new methods of productive economic activities

Outline the differences that exist between economic growth and economic development

Economic Growth	Economic Development
• An increase in size of the country's National income	• An increase in the size and quality of the country's National income
• Number of people living in absolute poverty can increase despite the increase in national income	ii) Number of people living in absolute poverty does not increase
iii) Increase in national income could be due to increase in income of only few people	• Increase in national income is attributed to general increase of incomes of majority of the people in the country
• No tendency to bridge the gap between the rich and the poor	iv) Tends to bridge the gap between the rich and the poor

Underdevelopment

This refers to a situation whereby the economic growth is in the negative direction (decreasing) accompanied by uneven distribution of wealth and decrease in quality and quantity of the factors of production available

Characteristics of Underdevelopment

- High level of poverty. This is characterized by most of the people in the country depending on mainly subsistence, or lives below the poverty levels. Their per capita income is lower as compared to the developed countries
- High disparity in income distribution. The income in this countries are not evenly distributed with the few rich people earning so much while the poor majority earns so little
- Low levels of savings and investments. They have very little if at all exist to save and invest for their further development, making them to continue being poor. This is well illustrated in the vicious circle of poverty
- High population growth rates. This is due to some of them not being able to afford, ignorant about or simply refusing to use the modern birth control methods since they find consolation on their high number of children
- Dominance of subsistence sector. This is due to their inability to raise capital for indirect production
- Problem of unemployment. The high population growth rate leads to high supply of labour that the country's economy cannot afford to absorb all, leading to unemployment
- Under utilization of natural resources. This may be due to lack of capital in this countries or in appropriate technology they use
- Dependence on the developed countries. This is due to their in ability to sustain themselves financially, which makes them keep on calling upon the developed partners for financial assistance

- Poor infrastructure. Their roads and communication networks are not properly maintained due to the in availability of adequate resources to improve them

Goals of Economic Development

The following are the changes that economic development seeks to put in place, which in Kenya they have been joined together in what is referred to as the millennium development goals. They includes

- Eradicate extreme poverty and hunger
- Achieve universal primary education
- Promote gender equality and empower women
- Reduce child mortality
- Improve maternal health
- Combat HIV/AIDS, malaria and other diseases
- Ensure environmental sustainability
- Develop a global partnership for development
  Some includes
  - Reducing income disparity in distributions
  - Reducing unemployment
  - Provision of important basic needs such as food, shelter, etc

Factor which may hinder development in a country

The rate of a country's economic development may be influenced negatively by the following factors

- Low natural resource endowment. Absence or inadequacy of natural resources such as raw materials, fertile land for agriculture, etc may slow the pace of the country's economic development
- Inadequate capital. This reduces the rate at which they exploit their natural resources, or produce in the economy
- Poor technology used. The traditional methods of production that they use cannot sustain their requirement any more
- Poor human resource endowment. Their inability to train adequate skilled manpower together with their inappropriate system of education leads to their slow development
- Unfavorable domestic environment. Their political, social and economic institutions within their countries are not structured to favour economic development. For example
  - Their political system is characterized by corruption, authoritarian kind of leadership with lengthy procedures and bureaucratic controls that scares the investors
  - Their social environment is still full of outdated or retrogressive cultural values and negative attitude towards work and investment, leading to slow development
  - Their Economic institutions has allowed their markets to be influenced so much that that leads to interference in their smooth operations

Development Planning

This is the process through which the country establishes their objectives to be achieved, identify the resources that will be required and put in place the strategies or methods of acquiring the resources and achieving their pre-determined objectives.

In most cases their objectives or goals are the goals of economic development

The plan will prioritize the objectives to be achieved and even brake it down in to targets that if achieved with the planned strategy and resources, the objective shall have been achieved.

Need for economic planning

It enhances the following

- Appropriate resource allocation, where resources are allocated according to the need of the objective and in a most productive way
- Stimulation of effort of people in the desired direction. The plan outlines including the possible outcomes which persuade people to move to that direction
- Support foreign aid bargain. Since it shows including the objective that the country seeks to achieve, it is capable of convincing the donor to finance it in the country
- Project evaluation, by assisting on checking whether the predetermined targets or objectives are being achieved
- Long term decision making, as it will show what each and every sector of the economy will require in the future to make it stable.
- Avoiding duplication of industries in different parts of the country, for it will show the ones that have been set in those parts and even enhance balancing
- Promote balancing in regional development by ensuring that they are not concentrated in only one region, ignoring other regions

Problems encountered in development planning

Problems at the planning stage

- Lack of accurate or detailed data for planning. This may lead to in appropriate plan being developed, as it entirely depends on the quality and availability of the data
- Existence of large subsistence sector, which make the planning unrealistic
- Lack of qualified personnel to assist in planning. This may make the country to rely on foreign experts who do not fully understand the country
- Problem of the private sector which will always require incentives for them to follow the plan
- Transfer of inappropriate development plan. As some planners may simply borrow a plan that they feel may have worked for a given country, yet the condition in those countries may not be the same

Problems at the implementation stage

- Over reliance on donor funding, which if they don't receive, the plan may not be implemented
- Lack of domestic resources such as skilled personnel, finance and capital may make the implementation a problem
- Failure to involve the local people in planning. This will make them not to be willing to implement it, for they will not be understanding it or rebelling for the fact that they were not included
- Natural calamities such as diseases, floods, drought, etc may make the funds that had been set a side for implementation be diverted to curb them
- Over-ambitious plans which are a times just made to impress the donors to release their funds but may not be easy to implement
- Lack of co-operation among the executing parties which may make the work not to kick off. For example a conflict between the ministry of finance and that of planning of the amount to be released
- Inflation which may make the estimated value of implementation not to be adequate, bringing a problem of finances
- Lack of political will and commitment in implementing the plan. This may frustrate the implementation.