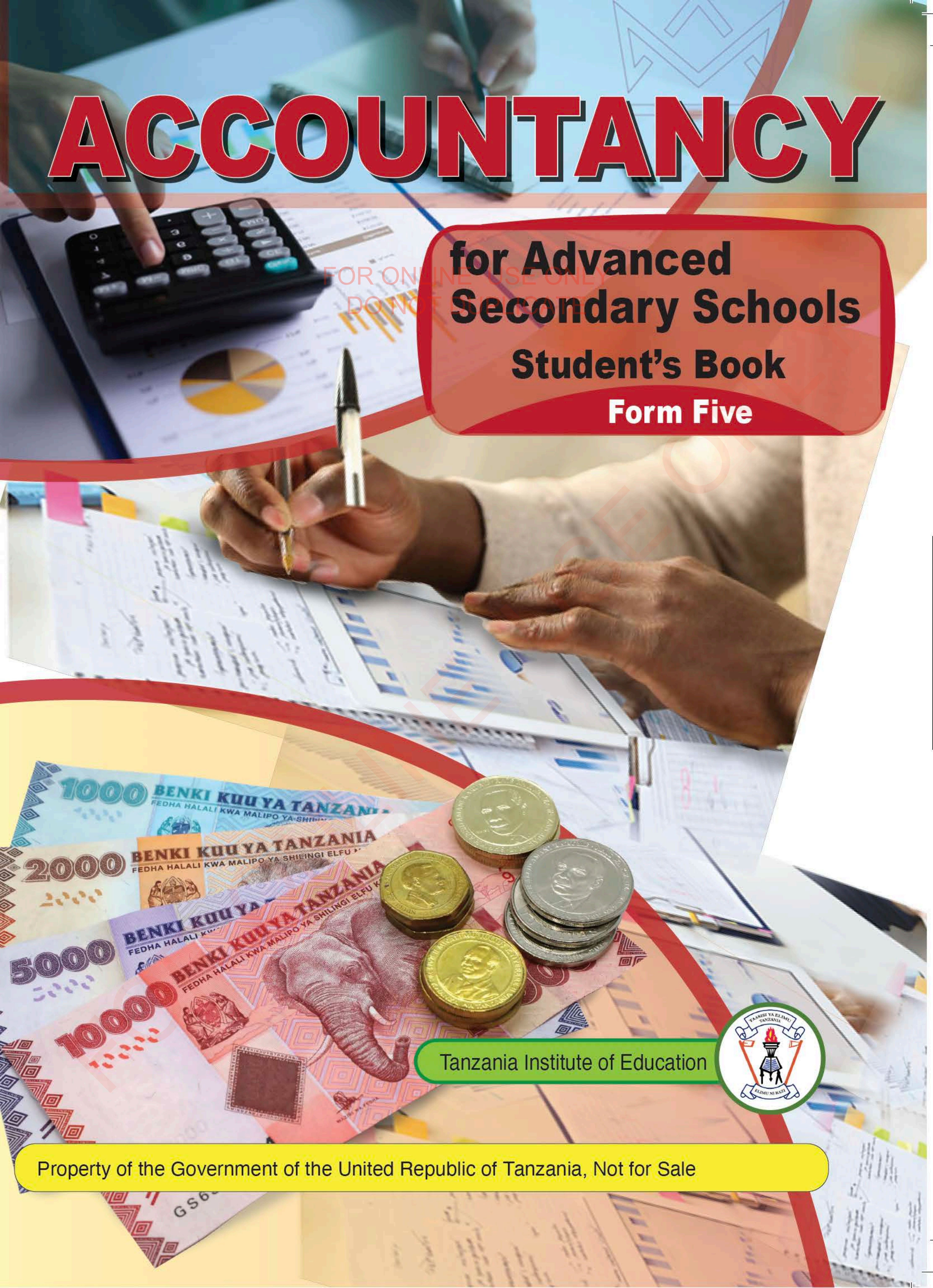
ACCOUNTANCY

for Advanced Secondary Schools

Student's Book

Form Five



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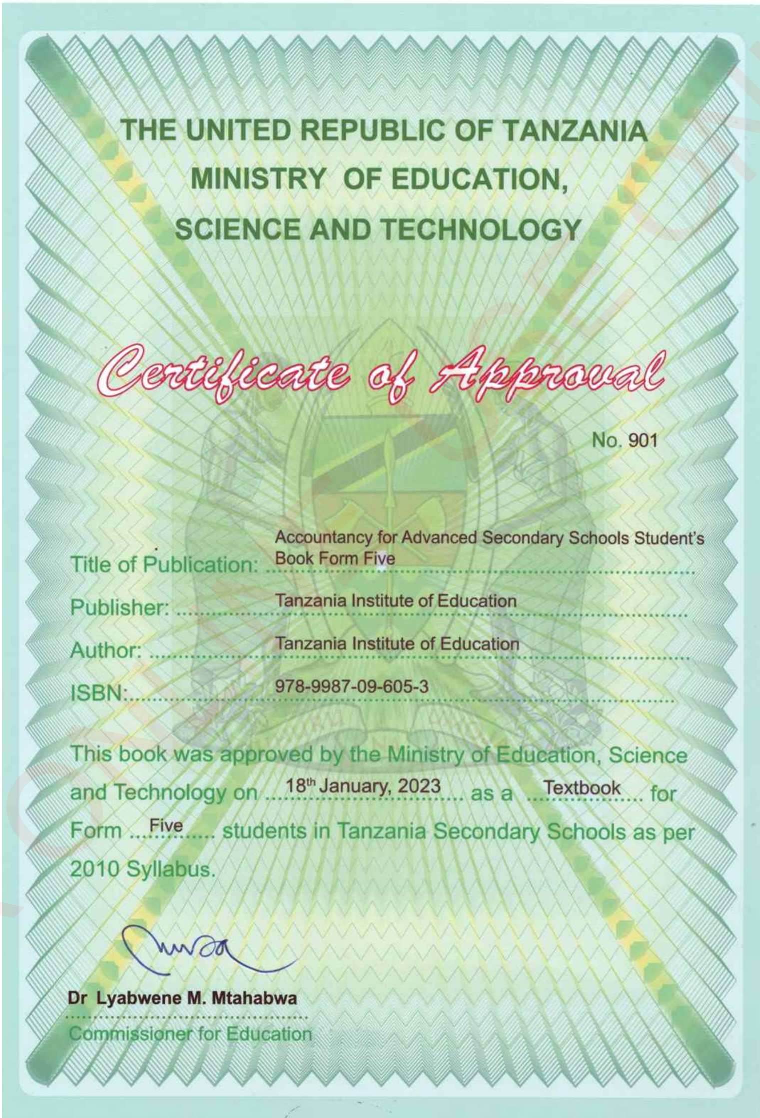

THE UNITED REPUBLIC OF TANZANIA
MINISTRY OF EDUCATION,
SCIENCE AND TECHNOLOGY

Certificate of Approval

No. 901

Title of Publication: Accountancy for Advanced Secondary Schools Student's Book Form Five

Publisher: Tanzania Institute of Education

Author: Tanzania Institute of Education

ISBN: 978-9987-09-605-3

This book was approved by the Ministry of Education, Science and Technology on 18th January, 2023 as a Textbook for Form Five students in Tanzania Secondary Schools as per 2010 Syllabus.

Dr Lyabwene M. Mtahabwa
Commissioner for Education

Tanzania Institute of Education

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Published 2023

ISBN: 978-9987-09-605-3

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Abbreviations and acronyms

A/C	Account
ACF	The Accounting Conceptual Framework
AIS	Accounting Information System
AICPA	The American Institute of Certified Public Accountants
BOD	Board of Directors
BoT	Bank of Tanzania
BRELA	Business Registration and Licensing Agency
CDS	Central Depository System
CMSA	Capital Market and Securities Authority
CPA	Certified Public Accountant
Cr.	Credit
Cum-Div	Cumulative Dividend/With Dividend
DPS	Dividends Per Share
Dr.	Debit
DSE	Dar Es Salaam Sock Exchange
DY	Dividend Yield
EBIT	Earnings Before Interest and Tax
Ex-Div	Excluding Dividend
IAA	Institute of Accountancy Arusha
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICPAK	The Institute of Certified Public Accountants of Kenya
ICPAR	The Institute of Certified Public Accountants of Rwanda
ICPAU	The Institute of Certified Public Accountants of Uganda

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IFAC	The International Federation of Accountants
IFM	Institute of Finance Management
IFRS	International Financial Reporting Standards
MoCU	Moshi Co-operative University
MNCs	Multinational Companies
MUM	Muslim University of Morogoro
NBAA	National Board of Accountants and Auditors
PPE	Property Plant and Equipment
ROA	Return on Assets
ROCE	Return on Capital Employed
ROE	Return on Equity
SOFP	Statement of Financial Position
SOPL	Statement of Profit or Loss
TIE	Tanzania Institute of Education
UDOM	The University of Dodoma
UDSM	University of Dar Es Salaam
USSD	Unstructured Supplementary Service Data
VAT	Value-Added Tax

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Acknowledgments

The Tanzania Institute of Education (TIE) would like to acknowledge the contributions of all the organisations and individuals who participated in designing and developing this textbook.

In particular, TIE wishes to thank the University of Dar es Salaam (UDSM), University of Dodoma (UDOM), Moshi Co-operative University (MoCU), Institute of Finance Management (IFM), Institute of Accountancy Arusha (IAA), Tanzania Institute of Accountancy (TIA), Muslim University of Morogoro (MUM) and Kibasila Secondary School. Besides, the following individuals are acknowledged:

Writers: Dr Helena T. Haule (UDSM), Dr Hamis M. Sinde (IFM), Mr Zakaria N. Swedi (IFM), Mr Amri B. Sanga (UDSM), Ms Mariam S. Said (MUM), Mr Richard B. Swai (IAA) & Mr Amiri H. Mganga (Kibasila Secondary School).

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TIE also appreciates the contributions of the secondary school teachers and students who participated in the trial phase of the manuscript. Likewise, the Institute would like to thank the Ministry of Education, Science and Technology for facilitating the writing and printing of this textbook.

Dr Aneth A. Komba

Director General

Tanzania Institute of Education

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Preface

This textbook, Accountancy for Advanced Secondary Schools, is written specifically for Form Five students in the United Republic of Tanzania. It is written in accordance with the 2010 Accountancy Syllabus for Advanced Secondary Education Form V - VI, issued by the Ministry of Education, Science and Technology.

The book consists of ten chapters, namely, nature and context of accountancy, books of prime entry, corrections of accounting errors, accounting for reserves and provisions, depreciation and disposal of non–current assets, recognition of revenue and expenses, preparation of financial statements, financial statements analysis and interpretations, investment accounts, and accounting for branches. Each chapter contains text, examples and illustrations, activities, exercises and end of chapter revision exercises. You are encouraged to do all the activities and exercises as well as other assignments provided by your teacher. Doing so will enable you to develop the intended competencies.

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Chapter One

The nature and context of accountancy

Introduction

In this chapter, you will learn about the concept of accountancy, its origin, branches and purpose. You will also learn the nature of accounting information, its users, fundamental principles of accounting and accounting system. The competencies developed in this chapter will enable you to describe well accountancy as a field of study, nature of accounting information, the characteristics that makes it useful and its users as well as fundamental principles of accounting used for processing and generating accounting information.

Accountancy as a concept

At one point of time, we are interacting with traders in retail shops, grocery stores, pharmacy and mobile money agents. You might have seen those traders maintaining some financial records of their transactions. Furthermore, you might have seen in some newspapers, financial reports of business entities like commercial banks showing how they have perfomed in a particular accounting period. Have you ever wondered why these practices are taking place? To whom are the published financial reports targeted? How do they make use of reported information and for which purpose or objectives? The answers to these and other related questions define what accountancy is all about. Accountancy is defined by its relevance, that is, what it can offer for those interested to learn about it and what it does in terms of supporting business management and decision making.

As a concept, accountancy is the systematic field of knowledge pertaining to accounting, including the rules and principles that govern actual accounting procedures. Thus, accounting is a subset of accountancy that involves the practical application of accountancy principles to execute the profession's core duties. In other words, accounting tries to explain the nature of the work of the accountants (professionals) and accountancy refers to the profession

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these people adopt. According to American Institute of Certified Public Accountants (AICPA), accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof. Four important activities are captured within this definition including the following:

(i) Recording of transactions and events in books of original entry.

(ii) Classifying transactions through the process of posting from the books of original entry to different accounts in the ledger.

(iii) Summarizing the results periodically in financial reports.

(iv) Interpreting the results of the business operations through the analysis of financial statements.

Differences between accounting and bookkeeping

Better understanding of accounting can also be attained by comparing with bookkeeping learnt at lower-level secondary education. Accounting is much broader; it includes all the basic elements of bookkeeping as well as advanced concepts and practices. Besides the preparation of financial statements, accountants are also involved in financial statements analysis and their interpretation. Individual with relevant accounting skills and knowledge, and can undertake accounting jobs professionally is known as accountant. Besides the recording of business transactions – the usual activity of bookkeeper – they are also engaged in summarizing and further processing of financial data to provide meaningful financial information. Due to their high level of expertise, accountants are also responsible for designing accounting systems of different organizations. In order to carry out these activities in an effective manner, accountants must be highly trained than book keepers.

Historical development of accounting

Accounting is perhaps one of the oldest and structured discipline, which has evolved in response to the changing social and economic development of the society. It is known to have existed in one form or another since at least 3,500 BC. Considerable evidence shows that, accounting was being practised in ancient times in several places e.g., Egypt, China, Greece, and Rome. One of the oldest textbooks relating to accounting is the one written by an Italian Franciscan monk and mathematics Professor, Luca Pacioli in year 1494. His book titled, Summa de Arithmetica, Geometria, Proportione et Proportionalita, translated as, summary of arithmetic, geometry, and algebra is seen by many as providing comprehensive elaborations on the use of double entry bookkeeping in ancient

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times. The book provides a detailed description on the rules of debits and credits in both, journals and ledgers that is still used today as basis of accounting. Due to this, he is referred by many as the father of accounting.

The popularity of accounting increased due to its information usefulness to assist in decision making and control of businesses. People needed accounting to record business transactions, know if they were being financially successful, and know how much they owned and how much they owed. For example, during the period of pre-industrial revolution, accounting was extensively used by feudal societies that had wealthy landlords who owned vast properties and wealth. These properties were scattered at many distant places thus making it difficult to maintain and control activities that were taking place in those properties. In this kind of situation, management were expected to prepare financial reports for the landlords to know what is happening with their businesses as well as how they were performing. By using these reports and physical evidence e.g., increased properties and resources like cash, management could be rewarded, demoted or replaced based on their performance.

During the industrial revolution and the development of Multinational Companies (MNCs), the world has experienced the emergence of large corporations, extending their activities beyond the countries of their incorporation. This requires the use of advanced accounting systems to provide highly sophisticated accounting information reports between individuals located in far distantly places. The role of accounting to act as medium of communication between management and external stakeholders has thus remained the same. Owners and creditors who provide necessary resources for the development of businesses consider accounting as important for understanding the performance and financial position of the businesses. This is important in supporting the achievement of different business decisions and control.

Exercise 1.1

1. What do you understand by the term accounting?
2. In what ways does accounting differ from bookkeeping?

Branches of accounting and their general objectives

There are several branches of accounting, which have emerged due to changes in economic and business development. In other words, the demands of accounting information evolved to suit the needs and objectives of different classes of persons. Conventionally, there are three branches of accounting as presented in figure 1.1.

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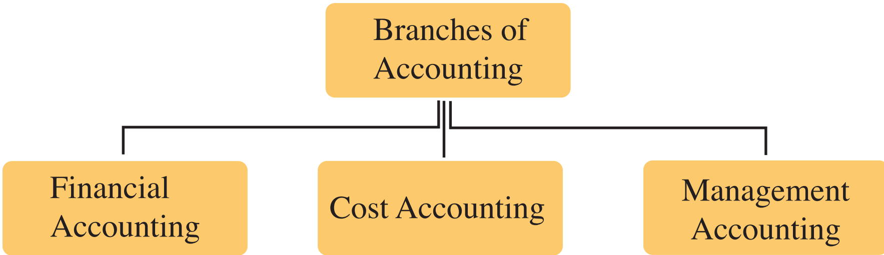

Figure 1. 1*: Conventional classification of accounting*

As observed in Figure 1.1, conventionally, the three branches of accounting include financial accounting, cost accounting and management accounting. Financial accounting is concerned with recording of financial transactions and eventually reporting of financial statements that show the performance (profit or loss) over a span of time/period and financial position of the business (assets, liabilities and capital) as on a particular date. This is usually done at the end of accounting period. One of the distinctive features of financial accounting is that, accounting records and financial reporting are closely guided by well-established accounting standards, known as the International Financial Reporting Standards (IFRS), which were adopted in Tanzania by July, 2004. The information produced under financial accounting, primarily aim at meeting the information needs of external stakeholders of a business.

As for cost accounting, its early development was shaped more by its application in manufacturing firms. Primarily, it was used to record and analyse manufacturing costs with the major objective of determining the cost of products. Nowadays cost accounting is widely used in different organizational settings including, service providing firms. Contrary to financial accounting, cost accounting is not strictly guided by accounting standards (e.g., IFRS) but a variety of cost accounting principles. As for users, it is mainly used by management of the organisation to achieve the objectives of control and reduction of costs in the production of goods and services. In other words, cost accounting information is generally meant for management consumption i.e., internal use of accounting information.

Comparably, Management accounting is closely related to cost accounting as it utilises all the principles and techniques of cost accounting in data processing. However, it is relatively much broader in terms of nature of data to be processed and usage. Besides financial information it also takes into account different types of qualitative factors e.g., issues from areas of marketing and human

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resources. Nevertheless, as observed in cost accounting, management accounting also is not strictly guided by accounting standards. Management accounting reports such as budgets and other types of operational reports, they are normally prepared at the discretion of the management using different methods and formats provided they yield desired quality information. This is different from financial accounting; the contents and format of financial reports are given/specified in different types of accounting standards.

As of recent, other branches/types of accounting have emerged besides the three identified ones. Examples on this include, tax accounting, forensic accounting and social responsibility accounting. For instance, Tax accounting is concerned with tax related matters including, the determination of tax liability and preparation of tax returns for individuals, companies and other entities. Tax accounting is governed by tax laws and regulations applicable in a particular country. For example, in the context of Tanzania, it is the Income Tax Act of 2004 that provide the legal framework for persons to fulfil their tax obligations. Professionals in this area namely, Tax accountants usually provide tax related services to individuals and business community. This includes, the use of legal ways to minimize tax liabilities for their clients. As for forensic accounting, this deals with the application of accounting, auditing and investigative skills in analysing financial information, which can appropriately be used as evidence in the Court of law. Experts in this area, are usually engaged in investigating financial fraud and embezzlement of funds. In contrast, social responsibility accounting is the process of communicating the social and environmental effects of an organization's economic actions to particular interest groups within society and to society at large. In other words, social responsibility accounting focuses on financial reporting on what the business is giving back to the society in return for the benefits it enjoys from it. Arguably, the business economic actions have direct or indirect impact to different stakeholders such as employees, customers, the community and the environment in general. Due to this, the role that business plays besides its ordinary business undertakings must be of great interest to different stakeholders in the society.

Regulatory framework governing financial accounting practices

To regulate something means to exercise control over it by way of directing or governing according to a given set of rules. The regulation of the accountancy profession covers several issues. These include, entry and licensing requirements (including education requirements; monitoring of the behaviour and performance of professional accountants; the accounting standards (including ethical

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standards) that professional accountants must meet, disciplinary systems and procedures for those who fail to meet the requirements. For implementation and enforcement, there are different sources of rules and regulations and professional bodies, which oversee the practice and development of accounting. For example, sources of rules and regulations include the use of company laws and accounting standards. Different countries have their own company laws, which provide different conditions and rules for the establishment and operation of the companies. In the context of Tanzania, Companies Act 2002 requires that, every company registered in Tanzania to prepare a set of financial statements including, the statement of financial position (the balance sheet), statement of income (profit and loss account) and cash flow statement. Therefore, companies and their accountants are expected to comply well with the requirements specified in the regulations; otherwise, they may be penalised or punished. Examples on this include, fees or penalty for the late filing and deregistration for serious and extended defaults.

As for accounting standards, they provide different types of accounting rules to guide the preparation of financial statements. They provide the basis for recognition, measurement, presentation and disclosure of different transactions and events reported in the financial statements. For example, companies are required to report their performance (profit/loss) and financial position by using the same accounting rules (consistency) over time. This is considered as important in minimizing fraudulent manipulations and enhancing uniformity in financial reporting. It also simplifies the evaluation and comparison of performance and financial position of business entities operating in the same industry.

A country can opt to have its own locally established standards or adopt the international accounting standards. For the latter, the global International Accounting Standards Board (IASB) is the one responsible for the development and establishment of accounting standards known as International Financial Reporting Standards (IFRS). Regionally, some of the East African countries have adopted IFRS at different times. Each country has its own professional body to oversee the implementation and enforcement of accounting standards and other regulations. For example, the Institute of Certified Public Accountants of Kenya (ICPAK), the Institute of Certified Public Accountants of Uganda (ICPAU) and the Institute of Certified Public Accountants of Rwanda (ICPAR). In Tanzania, we have the National Board of Accountants and Auditors (NBAA).

At the moment, NBAA is responsible for a number of tasks including providing quality assurance review system,

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investigating accounting malpractices and where necessary imposing disciplinary measures to accountants and accounting professional firms. In simple words, NBAA is responsible for reviewing and checking the quality of works done by accountants making sure that, they meet all the established quality standards. Note that, accountants (including, accounting professional firms), provide different accounting related services like auditing, taxation and preparation of financial statements. Their clients, in many cases, are the businesses of different sizes. NBAA is also responsible for the development of a curriculum and administration of accounting professional examinations. To qualify as professional accountant, one is required to attend several examination sessions. The highest level of qualification is known as Certified Public Accountant (CPA). NBAA is also involved in authorization and approval of professional accountants to include, maintaining and publishing register of authorized and approved professional accountants in the country.

Exercise 1.2

1. Conventionally, what are the basic branches of accounting? Explain.
2. Due to development that has taken place, different branches of accounting have emerged beside the traditional ones.

   Required

   (a) Identify several branches of accounting besides the traditional ones that have emerged recently.

   (b) What are the main objectives of different branches of accounting you have identified under (i) above?
3. By referring to the accounting profession in the context of Tanzania, explain the regulatory framework that governs the conduct of accounting.
4. Is there a need to regulate the accounting practice in Tanzania? Discuss.

Accounting information and its users

Nature of accounting information

Accounting information as presented in different types of financial report provides the means through which different users of accounting information can understand the different activities taking place within the business. It does so in a unique way by reflecting the monetary values of different activities undertaken by the business. When recording in books of account, business activities are commonly referred to as business transactions i.e., business events that have monetary impact on an entity's financial statements and

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recorded as entries in financial records. Examples of business activities or transactions include, paying a supplier for services rendered or goods delivered, buying office equipment by cash, and selling goods on credit.

Types of business activities reflected in accounting information

Categorically, there are three major types of business activities reflected in accounting information. They include, operating activities, financing activities and investing activities. **Operating activities** are the main activities that a business does to bring its products and services to the market on an ongoing basis. They depend on the nature of the business. For example, for manufacturing company these include manufacturing, selling and marketing of the products. Non-operating activities will not occur so frequently – they include one-time events that may affect revenues, expenses or cash flow but fall outside the company's routine and core business activities. In contrast, **Financing activities** affect the long–term liabilities and equity/capital of the owners as a result of the flow of cash (inward and outward between a business and its owners on the one hand, and with creditors on the other hand). Examples on these include, selling of shares, adding loans, payment of dividends and interest. In contrast, **investing activities** include, purchases of long-term assets such as property, plant, and equipment. They also include acquisitions of other businesses and investments in financial securities such as stocks and bonds within a specified period.

Accounting information can also be understood well by considering its key attributes or characteristics that makes it useful in decision making, as described in the following section.

Qualitative characteristics of useful accounting information

Qualitative characteristics of useful accounting information are well described in the conceptual framework of financial reporting, as revised in 2018. This provides important theory with details about the basic reasoning underlying the preparation of financial statements and reporting. Qualitative characteristics can be divided into two levels, the fundamental and enhancing qualitative characteristics. Fundamental qualitative characteristics are the basic or primary characteristics while the enhancing attributes are the additional features that add more value or they enhance more the decision usefulness of financial information.

Further details regarding the major categories and specific types of qualitative characteristics of useful accounting information are given using Table 1.1.

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Table 1. 1: *Qualitative characteristics of useful accounting information*

Fundamental qualitative characteristics			
Relevance		**Faithful representation**	
✓ Information is relevant if it is capable of making a difference to the economic decisions made by users.		✓ Information must faithfully represent the substance of what it purports to represent.	
✓ Financial information is capable of making a difference in economic decisions if it has predictive value or confirmatory value		✓ A faithful representation means information should be to the maximum extent possible, complete, neutral and free from material error.	
		✓ A faithful representation is affected by level of measurement uncertainty.	
Enhancing qualitative characteristics			
Comparability	**Verifiability**	**Timeliness**	**Understandability**
✓ These four qualitative characteristics enhance the usefulness of information			
✓ But they cannot make non–useful information useful			
Cost constraint			
✓ The benefit of providing the information needs to justify the cost of providing and using the information			

As indicated in table1.1, to be **relevant**, accounting information should be able to make impact or difference in decision making. Decision making is all about making selection between or among the given alternatives, which may include investments decisions. For example, one may have to decide whether to invest in project A or project B by considering the potential of each project in generating income. The relevance of accounting information will be evaluated by considering its ability to show the attractiveness of each project under consideration such as the differences in revenues to be generated and cost savings.

As for **faithful representation**, major focus is on three attributes as shown in table 1.1, completeness, neutrality and free from material errors. **Completeness** underlines the basic idea that, accounting

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information should be considered as faithfully represented if all pertinent information has been presented. When this is done as expected, then it will be possible for one to make a complete and accurate assessment of business performance and its financial position. On the other hand, any omissions of relevant information, would lead to a false or misleading depiction of accounting activities and phenomena thus providing incorrect picture of business performance as well as its financial position. As a result, this will render information useless to whomever use/need it to support business management or any kind of decisions. As for **Neutrality**, this underscore the basic idea that, accounting information should be neutral, or free from any bias. To achieve this, it is strongly forbidden to alter or present accounting information in any way that is meant to influence a decision to be made with a predetermined result in mind. The logic and justification for this; it will do good for society and accounting profession when the overall societal goals and accounting guidelines are adhered to, rather than the desires of any one person or group of people, with their own agendas. On the other hand, **free from material error** stresses the need or desire to keep accounting information free from error. This can be achieved by ensuring that, there are no errors and inaccuracies in the description of the phenomenon and no errors are made during the different processes of preparing financial statements. Notably, due to human nature, mistakes do occur – it is something that cannot be completely eradicated. As professional, it is advised to be careful and making sure that, one abides by the rules of conduct as well as checking or examining the data and figures used in process of preparing financial statements. This will ensure that, accounting information is accurately portrayed and reported.

It is also important to understand the key differences among the four enhancing qualitative characteristics. For instance, **comparability** is the quality of accounting information to enable its users to identify similarities and differences between two sets of business phenomena. It is important that, similar situations should be presented in the same manner while different situations should be presented differently. Moreover, there is a need to observe consistency, which includes, the use of the same accounting policies and procedures from one accounting period to another – within the businesses and the industry. This will facilitate the ability of users of accounting information to compare the financial statements of the business over time as well as with other similar businesses within the industry.

Verifiability, underscores the basic idea that, for accounting information to be considered as true or correct, it should be possible for one to prove/confirm whether it is true/correct. For example,

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during the audit assignment, auditor may cross check with the bank to see whether the bank account balance of the business being audited is the same as that shown in its balance sheet (i.e., statement of financial position). To enhance the value of verifiability, confirmation may be sought from different knowledgeable and independent parties to see whether they reach the same consensus. However, it is not necessary to have complete agreement that a particular depiction is a faithful representation. Verifiability helps users of accounting information to be assured that, information presented faithfully reflects the business transactions or events being examined. In contrast, **timeliness** captures the general idea that, the sooner information is available, the more useful it is. Delays in financial reporting more than expected may hinder timely access to information by decision makers, and when available it may no longer be useful to solve their decision problem.

As for **understandability**, this underline the basic idea that, information should be presented in a way that is readily understandable by users who have reasonable knowledge of a business and its economic activities. Understandability of accounting information is more likely to be enhanced when information is classified, characterized and presented clearly and concisely. The use of tabular or graphic formats may improve the understanding of presented accounting information. Moreover, clarifying some issues e.g., the ways in which certain financial figures have been derived and relationships between them may also enhance the clarity and understanding of key issues presented in financial reports. Additionally, it is also important to note that, ability of users to understand accounting information as presented in financial reports depend partly, on their capabilities or competencies to understand basic financial matters and the way they are displayed in financial reports.

Table 1.1 also emphasizes the importance of **cost constraint**, in which one is required to consider the cost and benefit of reporting certain items in the financial statements. The benefits of reporting financial information should justify and be greater than the costs imposed on supplying such information. When it is excessively expensive to report certain information in financial statements, the accounting framework allows a reporting entity (i.e., a business entity in respect of which financial reports are prepared) to avoid reporting such information.

Users of accounting information

Users of accounting information are the various stakeholders (parties or persons interested and/or concerned with the affairs of the business) who need financial information to make informed decisions. It is for this reason that, accounting is commonly referred to as the "language of business" since it acts as medium of communication between

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various parties involved/interested in a particular business. Users of accounting information can be classified into two categories, internal and external stakeholders. Further details on these including, specific types of users and basic objectives for demanding accounting information are presented using table 1.2.

Table 1. 2: *Users and their objectives for demanding accounting information*

Users	Objectives and examples of decisions
1. Internal users	Closely related to the company's published financial statements
(i) Management	Accounting information provide the basis for examining the performance of their business e.g., whether, they have been able to make profit or not. Thus, accounting information helps management to analyse their organization's performance and financial position to be able to take appropriate measures, which will improve the business performance in case of poor performance. In short, accounting information is important to achieve effective planning, control and decision making by management.
(ii) Employees	In a market driven economy, demand for wage rise, bonus and better working conditions depends more on the financial performance of a business. Thus, accounting information serves as a useful tool for employees to assess the company's profitability, which might have some consequence on their future remuneration and job security.
(iii) Owners	These provide funds or capital for the organization thus are curious to know whether the business is being conducted soundly including proper use of capital or economic resources of their business. Accounting information as presented in financial reports provides the basis to analyse the viability and profitability of their investment. Based on this, shareholders may decide whether to sell/hold shares and how to vote important matters related to their investments/business.

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Users	Objectives and examples of decisions
2. **External users**	Distantly related to the company which has published its financial statements
(i) Creditors/lenders	Creditors are the persons who supply goods and services on credit. Lenders on the other hand include banks or lenders of money to the business. The two are interested to know the financial soundness of the business before granting credit/loans. This information is very important to decide whether to extend goods and services or loans to the business. The information also is useful in setting the terms of credits.
(ii) Tax authorities	Tax authorities need to know the earnings made by the businesses for the purpose of taxation or to determine the credibility of the tax returns filed on behalf of the business or to assess taxable income.
(iii) Investors	Prospective investors wish to examine the performance and financial position of the business to evaluate the potential for getting good or reasonable returns and prospects for viable and sustainable business undertaking. This information is important for their investment decisions.
(iv) Customers	Customers are interested in getting goods and services at reduced price. Informed customers may wish to know whether the business has in place a proper accounting control, which in turn will reduce the cost of production and eventually less price to be paid for supplied goods and services. For example, utility companies like TANESCO – when negotiating for new price of electricity they will normally be required to show the prevailing performance to justify their claims.

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Users	Objectives and examples of decisions
(v) Research scholars	Researchers/scholars are interested in doing studies to understand and test the performance and financial position of businesses. Accounting information as presented in financial statements reflect well what is taking place within the business as well as the performance and financial position of the business organizations. These are of great interest to scholars/researchers as they assist in achieving their different research objectives.
(vi) Public in general	The public require to know whether the businesses/companies are concerned with different social problems e.g., maintaining safe environment through treatment of water/chemicals that are released from manufacturing process. Information regarding the extent to which the company has adequately invested in this kind of activities can be availed to the public through its financial reports (i.e., the essence of corporate social responsibility accounting).
(vii) Regulatory authorities	Regulatory authorities are normally interested to observe and determine the extent to which businesses are complying with different accounting standards in the preparation and reporting of financial statements. Stakeholders in this category include NBAA and other institutions overseeing the implementation of Company Act, 2002 i.e., the Business Registrations and Licensing Agency (BRELA) and Capital Market and Securities Authority (CMSA).

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Users	Objectives and examples of decisions
(viii) Government	Like the public, the government may obtain indication that, the companies are indeed concerned and adequately invest in different social and environmental challenges including, those related to the business operations by observing information presented in financial reports. As a result, it will be easy for the government to make different environmental decisions. Examples on this may include, which types of disciplinary measures to be imposed to the companies that violate different environmental regulations, demanding more investment by companies in areas of environment protection and redistribution of wealth between the rich and the poor.

Activity 1.1

You are the owner and Managing Director (MD) of Kumekucha Company – a privately owned company that engage in manufacturing of furniture and other associated products. You have been approached by one of the subordinates (Mr. Samuel) asking whether the company will be able to restore some of the fringe benefits ceased due to financial problems that the company was facing. You are not able to provide the answers outright but you promise that, when the financial statements are issued in the next three months, they will provide the basis for deciding whether it will be possible to restore the fringe benefits, which were once stopped.

"I cannot answer your question with certainty though we have been doing well for some time now, at least for the past four months. Our contracts with several secondary schools including, Bright Future Academy and Gift Secondary Schools have enhanced our performance somehow. However, we still need to get some kind of assurance from our colleagues in the Department of Accounting. Today is 6th April, 2022, probably by the end of July, 2022, they will be able to provide us with the early draft of financial reports. Then we can see how they can help us in this matter…"

However, Mr. Samuel probed for further information; "will it be possible to use those financial reports even before their review by external auditors? You respond to this question, "yes tentatively, they can be used to set the plans while waiting for the

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external auditor to finish their job"

Required

(a) Identify different individuals and entities mentioned in Kumekucha Company case as presented above, then proceed to position them within the different typologies of users of accounting information, as discussed in this chapter. You can use a matrix chart to simplify your task.

(b) Provide relevant explanations for your answer in part (a) above. Consider matching the different individuals with different typologies of users of accounting information.

(c) When the said financial statements are issued, what kind of information do you think will be of much interest for negotiating the restoration of fringe benefits between the management and other employees?

(d) Relate some of the narratives used in the given case (of Kumekucha Company) with the following qualitative characteristics of useful accounting information:

(i) Relevance,

(ii) Timeliness,

(iii) Faithful representation,

(iv) Verifiability.

(e) Supported with different sources of information (e.g. library and internet materials), who are the external auditors? Why Kumekucha Company needs them in the process of financial reporting?

Fundamental principles of accounting

Fundamental principles of accounting are the basic rules/regulations and customs that provide guidelines for the preparation of accounting records and financial statements. Since there are many users of accounting information and their interests are not similar, it is important that, information provided is uniform and contains figures, which all can generally agree on. As these users look at information from different businesses and over different periods of time, they need some assurance that, information provided is relevant and faithfully represented. To achieve this, financial statements need to be prepared using similar approaches across businesses and over time. In short, by observing the same basic principles, preparers of financial statements achieve both uniformity and consistency in the structure and quality of presented financial statements. These are critically important in making comparison on the performance and financial position of the business across time and with other similar businesses in the industry.

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Fundamental principles of accounting can be divided into two classes, accounting concepts and conventions. Accounting concepts are the general rules and assumptions established by accounting bodies to guide the recording of business transactions and preparation of financial statements. They include the following: business entity, accrual basis of accounting, going concern, money measurement, accounting cost, dual aspect of accounting, accounting period, realisation and matching concept. On the other hand, accounting conventions refer to the common practices which are universally followed in recording and presenting accounting information of the business entity. One of the important differences with accounting concepts is that, accounting conventions are followed like customs and traditions in a society. They have been developed over the years, and adopted either by general agreement or common consent among accountants. In other words, accounting conventions have been evolved through regular and consistent practice over the years to achieve wider acceptance and influences the recording of books of accounts.

Four important accounting conventions, which have been used over time are; consistency, full disclosure, materiality and conservatism. The following sections describe further the different types of fundamental principles of accounting and how they affect the preparation of books of accounts.

Business entity

A company is considered as a separate living entity or person from its owners. One can observe this by looking at different aspects of business development. For example, a company has its own name, a birth-date which is the date of incorporation (legal process of forming a company) and place of incorporation. These details are usually maintained by the institution responsible for registering companies, business names and intellectual property rights. In Tanzania, the institution responsible for this is called, the Business Registrations and Licensing Agency (BRELA). Other features of business entity include, clearly defined set of activities, regular reporting of financial affairs to the public, payment of taxes and ability to file lawsuits.

From accounting point of view, whatever the legal position or form, any business, whether a company or sole trade, qualifies to be called business entity. Therefore, the books of accounts of any type of business are expected to reflect this viewpoint i.e., as accountant you should refrain from mixing the affairs of business with those of its owners. When recording business transactions, one should not incorporate personal transactions and activities of the owner. For example, if the owner buys a new pair of khanga, trousers or shoes for personal use, it is incorrect to record this in the business' financial records

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as business expenses. The importance of business entity includes, ability to measure properly the performance and financial position of the business as well as determining taxable income of the business. Without observing the business entity principle, the business transactions and owners personal revenue/expenses may be mixed up thus making it difficult to achieve the stated objectives.

Accrual basis of accounting

Accrual basis of accounting is the most important concept in accounting that governs the timing in recording of revenue and expenses. According to this concept, revenue should be recognised/ recorded in financial records and matched against expenses to determine profit in the financial statements, when earned rather than when cash is collected. Revenue is considered as being earned when the goods or services have been delivered to the clients. Expenses are supposed to be recognised (incurred) when goods and services are consumed in generating income rather than when actual cash is paid to suppliers of goods and services. Matching and realisation concepts are closely related with accrual basis of accounting, as explained in the following sections.

Realisation concept

The term realisation means the creation of legal right to receive money. This concept is derived from the principle of recognizing revenue. According to this principle, revenue from the sale of goods/services can only be recognized when such goods/services are delivered/ rendered to the customer. It is at this point that, revenue can be recorded in the financial records of a business.

Matching concept

According to the matching concept, the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised and expenses incurred, the next step is to allocate and match up the two to the relevant accounting period. This can be done with the help of accrual concept already explained.

Going concern

Financial statements are prepared by assuming that, the business will continue to operate for the foreseeable future unless there is evidence which indicate otherwise. In practice, the reasonable period of time, which is 12 months beyond the date when the financial statements are issued, is used to assess the going concern assumption. For example, suppose the business has difficulty in paying its debts or significant outstanding liabilities or has scaled down significant parts of operations or shut down one of its key branches. This might cast doubt on the ability of the business to continue operating as going concern and would need to be reflected in the financial statements. If there are no issues that indicate the existence of going concern problem, the business will be required to continue valuing all of its fixed assets

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(non–current assets) at original cost. This is because, it is not foreseen or expected that, such assets will be sold in a near future. The valuation of assets at current value as reflected in market can only be done when the business is going to be sold or released to different person. The going concern is very important in business world because it gives investors and creditors an indicator of how long a business will be around. The concept is used to indicate the business future stability.

Money measurement

Money measurement is also known as unit of measure concept. This is concerned with how different transactions are usually captured in financial records and financial statements. Generally, only business transactions and events that are capable of being measured in monetary terms are recognised in the financial statements. Money is therefore used as the unit of measurement in different accounting records and related financial reports. Examples of unit of measurement include, but not limited to, Tanzanian shillings (TZS), Kenyan shillings (KES), Uganda shillings (UGX) and the United States Dollar (USD or $).

Cost concept

Cost concept is also known as historical cost concept. Assets of the business are usually recorded at their original cost and no adjustment is made for the changes in the market value. Cost is usually determined through business transactions in which two or more unrelated and unaffiliated parties agree to do business, acting independently and in their self-interest. Therefore, this is more likely to be objective figure to use as long as the going concern is sustained.

Dual aspect of accounting

Dual aspect of accounting is also known as double entry system. This underscores the nature of business transactions i.e., every business transaction has a dual or two aspects that must be recognized within assets, liabilities or equity. It is important to recognise both, the party giving the benefits and the one that receives the benefits. This is closely related to the basics of double entry principles i.e.; each business transaction must be recorded twice; every debit entry must have its corresponding credit entry.

Accounting period

Financial statements are usually prepared and presented to its users in periodical basis referred as accounting period. However, the normal accounting period which is also expected legally is the twelve months period. In other words, on annual basis, financial statements of a particular business will be prepared to determine its performance and financial position.

Consistency

This concept holds that, when a business selects a particular method to account for specific items, then it should

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continue to use that method even in subsequent accounting periods unless condition warrants a change. If, for some unavoidable reasons the method has to be changed, there should be a distinct note in the financial statements of the business giving relevant explanations so that users are informed of the reasons for such changes. This is important to enhance comparability of accounting figures over time in a meaningful manner.

Materiality

Information is considered to be material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality therefore, relates to the significance of transactions, balances and errors contained in the financial statements. Materiality defines the threshold or cut-off point after which financial information becomes relevant to the decision-making needs of the users. Materiality is a relative concept depending with the size and particular circumstances of individual companies under consideration.

Full disclosure

Convention of full disclosure requires that, all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that, there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, full disclosure suggests that, every financial statement should fully disclose all relevant information for all interested parties like investors, lenders, creditors and shareholders to see. This is important because, shareholders would like to know profitability of the firm while the creditors would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statements disclose all relevant information in full, fair and adequate manner.

Conservatism

Conservatism or prudence convention is based on the principle that, one should anticipate no profit, but provide for all possible losses. When recording transactions in the books of accounts, assets and income are not to be overstated and provision/allowance should be made for all known expenses and losses whether the amount is known for certain or just an estimation. By doing so, all business expenses and liabilities will not be understated in the books of accounts. It is based on the policy of playing safe in regard to showing profit – never overstate profit. Doing so, may lead to distribution of dividend out of capital, which is not a fair policy as it will lead to the reduction in the capital of the business. Based on this convention, profit should not

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be recorded until it is realised and any loss that is anticipated in the near future should be provided for. A good example on this includes, valuation of inventory whereby closing stock is supposed to be valued at cost or net realizable value, whichever is lower. Similarly, it is important to create provision/allowance for doubtful debts, discount on debtors, writing off intangible assets like goodwill and patents. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

Exercise 1.3

1. Explain the meaning and significance of the following accounting principles in preparation of accounting records and financial reporting:
   (a) Business entity,
   (b) Dual aspect of accounting,
   (c) Going concerns,
   (d) Accrual basis of accounting,
   (e) Consistency.
2. Assume that, rent of TZS 12,000,000 was paid on 1st September, 2021 to cover one-year period from that date. If financial statements are prepared only on 31st December of each year, what would be the amount of rent to be recognized as expenses on 31st December, 2021?

Accounting information system

Generally, a system refers to a grouping of things, which are connected or interdependent forming a complex unity. A system usually has inputs, processing capability or activities and the output. Accounting information system (AIS) reflect well this definition as it is composed of different interrelated components and activities. They include, inputs (e.g., the source documents), processing (activities of transforming data from source documents into ledger accounts and preparation of financial statements) and output (generated financial statements). Technically, an AIS can be defined as a system or set of processes for collecting data about business transactions; recording, organizing, and summarizing the data, which culminates into preparation of financial statements and other reports for internal and external users.

Types/categories of accounting system

By considering the way in which information is being captured, processed and generated, AIS can be classified into manual and computerised accounting system. A manual accounting system is dominated by paperwork i.e., the use of physical records, pads of paper and books, onto which the transactions are entered by hand. In contrast, in computerized accounting system, most of the work are done using information technology (IT). In other words, computers and application programs are used to process

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business transactions. Nowadays, most of the businesses make use of computerized accounting system except for small scale businesses. The reasons for this include, availability of advanced technology at relatively affordable cost. In other words, computers and related application programs that help in processing and generating of financial reports are relatively inexpensive.

Components/parts and contents of AIS

Accounting information is composed of at least six basic components or parts. These include people, procedures and instructions, data, software, information technology infrastructure and internal controls. People refers to individuals who use the system, including accountants, managers and business analysts or staff. Procedure and instructions are the ways and methods used to collect, store, retrieve and process data. Data include, all the details extracted from source documents while software consists of computer programs used for processing data. Information technology infrastructure includes all the hardware (e.g., computers) used to operate the AIS while internal controls are the security measures used to protect data (e.g., passwords).

The contents of accounting system usually reflect the nature of business activities being undertaken by the company. For example, purchase of goods and services, sales of goods and services, payments to employees for wages earned, and financing activities (e.g., obtaining debt, selling shares, and paying interest to lenders). Specifically, the contents of AIS include, accounts payable, billings and accounts receivable, fixed assets, inventory and payroll. Depending on the size of the company and volume of transactions, specialized accounting staff may be employed to facilitate information processing and generation of financial statements of a business.

Activity 1.2

Make arrangement to visit any business in your local area with potential of having a section or individual dedicated to offering accounting services to that business. Have a conversation with that person to identify different activities being performed as well as facilities used in supporting bookkeeping / accounting functions. You should be keen to observe different facilities like computer, files etc., that are used to support the key functions of interest to this subject. Take note of each and everything to enable you do the following after completing the visit:

(a) Write good notes to identify the main functions performed by the individual/individuals dedicated to the accounting functions in the visited organization.

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(b) Evaluate the accounting system in use to explain whether it is a manual or computerized accounting system?

Chapter summary

This chapter intended to equip you with important knowledge about the nature and context of accounting. Different issues have been considered including, the meaning of accounting as a concept, brief history of the profession and branches of accounting. In order to understand the context that govern the accounting practices, the chapter has introduced the concept of regulatory framework of accounting. Different components of regulatory framework have been considered including, the International Financial Reporting Standards (IFRS), Accounting professional bodies (e.g., NBAA) and company law (Tanzania Company Act, 2002). The chapter has also introduced the concept of conceptual framework of financial reporting. This has been discussed, as the primary source of qualitative characteristics of accounting information and other financial reporting matters.

Two fundamental qualitative characteristics of useful accounting information have also been identified including, faithful representation and relevance. Besides, there are four enhancing qualitative characteristics namely comparability, verifiability, timeliness and understandability. Other important issues such as users of accounting information from within and outside the reporting entity have been considered. Examples on this include, managers and employees (internal users) and lenders, creditors and scholars (external users). The main reasons for each user groups to demand accounting information include, the decision-making usefulness of accounting information. This chapter has also provided the basic principles of accounting such as business entity, going concern and accrual basis of accounting. Moreover, the chapter provides basis for understanding how different accounting principles (concepts and conventions) guide the preparation of financial records and financial reports. The chapter has also introduced the concept of accounting system, which may be adopted by a business to facilitate the preparation of financial statements. Noted is the fact that, accounting system may either be computerised or manual depending on the level at which information technology is used to facilitate different processes involved in the preparation of financial statements. The chapter provides a number of activities and exercises to enhance student's learning about the nature and context of accountancy.

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Revision exercises

1. What do you understand by the term accountancy?
2. Why is accounting usually referred to as the language of business?
3. Differentiate the following concepts as used in accounting:
   (a) Accountancy versus accounting,
   (b) Business entity versus going concern,
   (c) Accrual basis of accounting versus dual aspect of accounting,
   (d) Consistency versus materiality, and
   (e) Accounting period versus cost concept.
4. Why is it important to apply fundamental accounting principles in the preparation of financial statements?
5. Identify the major categories and types of users of accounting information.
6. Think about different users of accounting information for the secondary school you are affiliated with then answer the following questions:
   (a) Identify the main users of accounting information for the school you are affiliated with.
   (b) For what purposes would the identified user groups you have identified in part (a) above need such information?
7. In what basis accounting can be differentiated from book keeping?
8. Why is understanding of accounting concepts and conventions is so important even for an ordinary business person?
9. Accounting information is important in providing valuable inputs for one to make informed decisions in different business environment.

   Required

   (a) Explain at least ten (10) different types of decisions reflecting the real world of business.
   (b) How accounting information can be useful in supporting each type of decision you have explained in part (a) above?

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Chapter Two

Recording business transactions in books of accounts

Introduction

In this chapter you will learn the concepts of business transactions, accounting records, principles of double entry system and books of prime entry. Also, you will learn how to prepare books of prime entry, ledger accounts and trial balance. The competencies developed in this chapter will enable you to describe books of prime entry, analyse different business transactions and how to record them into books of prime entry. You will also be able to post items contained into books of prime entry into ledger accounts and trial balance.

Business transaction

A business transaction is an economic event, which involves the exchange of goods or services from one person to another with money or money equivalent. The business transactions should have monetary value and tangible economic value to the economy of the entity as well as impact on the financial position of the entity. For example, when you go to the shop and buy clothes, food or other groceries for home use, you pay money and receive an item equivalent to the value of money paid.

Cash transactions *versus* credit transactions

By considering the timing of cash payment in exchange for goods and services, business transactions can be classified into two categories, cash transactions and credit transactions. **Cash transactions** is the exchange of goods and services whereby cash is paid or received immediately. In other words, it is a transaction that involves cash receipt or payment. In contrast, **credit transactions** involve the exchange of goods and services but whose payment have been postponed until future time. Therefore, for a business transaction to be considered as cash or credit transaction, this will depend on the nature of the agreement between the parties involved in the exchange. Different transactions, which may be involved in cash or credit transactions include, the purchases or sales of goods and services; the returns of goods previously bought or sold and

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payments to suppliers of goods and services. Others include, payments of expenses and receipts of cash from sale of goods as well as sale or acquisition of properties.

Accounting process

Accounting process is also known as accounting cycle to reflect a series of steps that are regularly repeated in the same order from identifying and recording of business transactions to the time of preparing financial statements. The six basic steps involved in the accounting cycle are presented using figure 2.1:

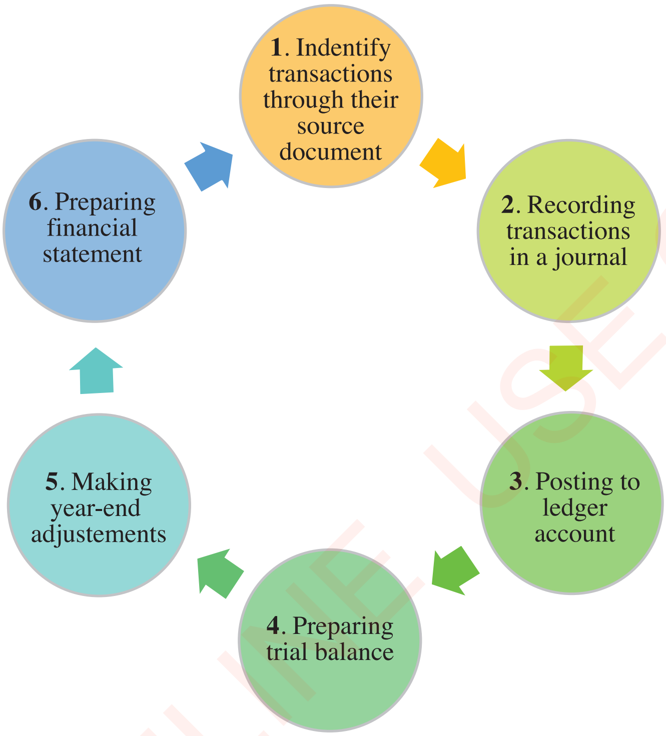

Figure 2. 1: *Accounting process for preparation of financial statements*

As shown in figure 2.1, there are six major accounting steps associated with preparation of financial statements. The arrows in the figure (from one circle to another) indicate the flows of activities from the first step (number 1) to the last step (number 6). An arrow pointing to the first step from the last one i.e., prepare financial statements ⇨ identify business transactions through their source document, indicates that, after completing the cycle, usually at the end of an accounting period, another round or cycle will start again. Therefore, "accounting cycle" involves the cyclic sequence in which business transactions are recorded and processed until they become part of the financial statements at the end of the accounting period. Therefore, the preparation

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of financial statements, will be repeated by using the same procedures in the new accounting period.

In this chapter, the major focus will be on four early processes, which include, identifying business transactions through their source documents, listing source documents in their respective day books, posting to ledger accounts and preparation of trial balance. The other processes are covered in subsequent chapters.

Books of prime/original entry

Books of prime entry or journals are the diaries of business activities where the transactions made by a business are recorded for the first time before posting into separate ledger accounts. The contents of books of prime entry appear in a descriptive and chronological (diary-like) record of day-to-day financial transactions. Other names for books of prime entry that reflect their use include, books of original entry and subsidiary day books or simply day books. Different types of business transactions each evidenced by a specific source document will be recorded in books of prime entry. Due to this, combining them in one book of original entry, especially for large business entities, may be difficult to provide trails or follow-through in the accounting process. However, this might not be the case with a small business, it can be possible to record all its transactions in one book, the general journal, in which every transaction will be differentiated from each other with its specific explanations called narrations.

Therefore, for large businesses, it is a common practice to find specialised day books being used in recording the transactions of similar nature instead of recording all of them in one book (general journal). Used in this context, books of prime entry are also known as specialized journals. Whether general or specialized, books of prime entry serve the same purpose, act as sources of information for the preparation of various ledgers and provide trail of the transactions posted in the ledgers. This is important especially for auditors and accountants to find easily the chain of references that makes it possible to trace information, locate errors, and prevent fraud.

Structurally, books of prime entry are designed to capture the following information:

(i) Date which indicates when the transactions occurred.

(ii) The details column providing explanation related to the transactions, usually reflecting the titles of accounts.

(iii) The folio/reference column for cross-referencing back to the original source document such as the invoice or where the ledger accounts will be posted.

(iv) The amount column, which show the monetary value of the transactions under consideration.

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The number and types of books of accounts to be prepared by the business entity will differ depending on the nature of activities being undertaken. A firm can either be a merchandising firm, a manufacturing firm, a service-providing entity or a non-profit organisation. This chapter will discuss only the books prepared by a merchandising firm. By definition, merchandising firm is a business that is engaged in buying and selling of finished products. The most common books of prime entry prepared in this context are, sales daybook or sales journal, purchases day book or purchases journal, sales returns daybook or returns inward journal, and purchases returns daybook or returns outward journal, cash book, and general journal. The format and recording of business transactions in each book of prime entry are discussed after activity 2.1.

Activity 2.1

In a group of five students, visit any two business entities operating within your locality. The visited business entities should be trading on various scales such as retailers, wholesalers, manufacturing (small or large), and service providers. During your visit, you should collect information to address the following questions:

(a) What kind of transaction are there in each visited entity?

(b) How is recording done and in which books?

(c) What documents are issued to evidence transactions?

The format and recording in special journals

To understand how business transactions are captured within the books of original entries, it is important that, you familiarise well with the format and contents to be entered into each category of special journal.

Sales day book or sales journal

The word sale means, the transacting or the exchange of goods in which a particular business transfer the ownership of goods to another/other persons. The goods under consideration must be those in which that business deals with in its ordinary under takings. The word 'sales' must never be given to the disposal of other items, such as vans or buildings that were purchased to be used and not to be sold. Sales can be made either in cash or on credit.

A sales journal is used to record separately, the sale transactions made on credit, especially for a business that has a lot of transactions. The key source of information (source document) for sales journal recording is sales invoice. All details associated with the transaction are recorded in the journal in different columns. These columns will record the date, customer name and invoice number and folio, which is also known as posting reference column used to

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record the corresponding account numbers where the posting will be done into the sales ledger. Another important column is the one for recording the amount or value of goods sold. Moreover, Value Added Taxes (VAT) column may be included to record the amount of VAT associated with the sold item(s).

Sales journal format

Date	Customer's name	Invoice number	Folio	VAT	Amounts receivable

Example 2.1

The following are credit sales made by Mkali Kwanza Ltd for January 2022. You are required to record them in the sales journal.

January: 1. Credit sales to Jaria TZS 200,000

2. Credit sales to Haji & Co TZS 1,200,000 less 10 percent trade discount.

4. Credit sales to Chetu Ltd. TZS 600,000

8. Credit sales to Jaria TZS 300,000

10. Credit sales to Tulia Enterprises TZS 450,000

14. Credit sales to Haji & Co TZS 300,000

16. Credit sales to Chetu Ltd TZS 1,000,000 less 10 percent trade discount.

20. Credit sales to Jaria TZS 300,000

25. Credit sales to Haji & Co TZS 450,000

28. Credit sales to Tulia Enterprises TZS 450,000

30. Credit sales to Aisha TZS 170,000

31. Cash sales to Haji & Co TZS 2,000,000

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Solution 2.1

Sales day book/sales journal

Date	Customer's name	Invoice No.	Folio	VAT	Amount (TZS)
Jan 1	Jaria		SL01		200,000
Jan2	Haji & Co		SL02		1,080,000
Jan 4	Chetu Ltd		SL03		600,000
Jan 8	Jaria		SL01		300,000
Jan 10	Tulia Enterprises		SL04		450,000
Jan 14	Haji & Co		SL02		300,000
Jan 16	Chetu Ltd		SL03		900,000
Jan 20	Jaria		SL01		300,000
Jan 25	Haji & Co		SL02		450,000
Jan 28	Tulia Enterprises		SL04		450,000
Jan 30	Aisha		SL05		170,000
	Total				**5,200,000**

Sales invoice format

Tax Invoice No. 700/22

Date April 4, 2022

Due Date May 3, 2022

Terms 2/10, n/30

MANDA LTD
BANDARI ST
P O BOX 444
DSM

CUSTOMER: SANGA TRADERS
KIBAMBA ST
BOX 777
DSM

Quantity	Description	Rate	Amount	Total	Remarks

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Purchases day book or purchases journal

The term purchases in accounting is used to mean those goods which the business buys with the prime intention of selling. Sometimes the goods are altered, added to, or used in the manufacture of something else, but it is the element of resale that is important. Purchases can be made either in cash or on credit. A purchases journal is a book of prime entries that is used to record credit purchases of goods. The cash purchases are not recorded in this journal; they are recorded in the cash book. The source of information for recording into purchases journal are invoices and bills received from suppliers. The net amount shown in the bills and invoices is the ones recorded in the journal.

The purchase journal contains the following information: date, details or supplier's name, invoice number, folio and amount payable, as follows.

Purchase journal format

Date	Supplier's Name	Invoice No.	Folio	Amount payable (TZS)

Example 2.2

The following are credit purchases made by Mkali Kwanza Ltd for January 2022. You are required to record them in the purchase journal.

Jan. 5 Bought goods on credit from IPP TZS 800,000

11 Bought goods on credit from Kwanza Ltd. TZS 1,800,000 less 5% trade discount.

17 Bought goods on credit from Zenu TZS 750,000

22 Bought goods on credit from IPP TZS 500,000

27 Bought goods on credit from Zenu TZS 600,000

29 Bought goods on credit from IPP TZS 700,000

30 Bought goods in cash from Kwanza Ltd amounting to TZS 400,000

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Solution 2.2

Purchases journal/sales day book

Date	Supplier's name	Invoice No.	Folio	Amount payable (TZS)
Jan 5	IPP			800,000
Jan 11	Kwanza Ltd			1,710,000
Jan 17	Zenu			750,000
Jan 22	IPP			500,000
Jan 27	Zenu			600,000
Jan 29	IPP			700,000
	Total			**5,060,000**

Note that, purchases made on 30th January is not recorded in purchases journal because it involved cash payment i.e., it is not a credit purchase.

Purchase invoice format

Tax Invoice No. 755/22

Date April 4, 2022

Due Date May 3, 2022

Terms 2/10, n/30

MTENDE LTD
UHURU ST
BOX 222
DSM

CUSTOMER: MANDA LTD
BANDARI ST
BOX 444
DSM

Quantity	Description	Rate	Amount	Total	Remarks

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Sales returns day book or returns inward journal

Sales returns occur when a customer does not accept such goods and returns them to the seller for a full refund or credit. The goods returned are recorded in a journal known as sales return journal or return inwards day book. In response to the returned goods, the firm prepares a credit note for acknowledging the receipt of the goods. The credit note contains all key information associated with the goods returned, including details of the goods (quality, quantity, price), customer name, invoice number of goods being returned, and the date. Depending on the reasons associated with the return, such goods are usually received at the store for appropriate action.

Sales return day book format

Date	Credit memo No.	Customer's name	Folio	VAT	Sales return amount (TZS)

Example 2.3

Using the credit sales in Example 2.1, assume the following customers returned goods to the firm during January.

January 3: Haji & Co returned goods worth TZS 80,000

12. Tulia Enterprises returned goods worth TZS 90,000

21. Jaria returned goods worth TZS 10,000

Solution 2.3

Sales returns day book

Date	Credit note No.	Customer's name	Folio	VAT	Sales return amount (TZS)
Jan 3	001	Haji & Co	SL02		80,000
Jan 12	002	Tulia Enterprises	SL04		90,000
Jan 21	003	Jaria	SL01		10,000
	Total				**180,000**

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Purchases returns day book or returns outwards journal

Purchase returns occur when a firm does not accept such goods and returns them to the supplier for a full refund or credit. The goods returned are recorded in a journal known as purchase return journal or returns outward book. A firm can return purchased items to the supplier either due to a mismatch in the quality of the item versus those required by the firm or for some other genuine reasons. Upon receipt of the returned goods, the supplier may acknowledge through a credit note. Hence, a credit note serves as a source of information for recording the goods returned in a purchases return journal.

Purchase returns day book format

Date	Credit note No.	Supplier's name	Folio	VAT	Purchase return amount

Example 2.4

Using example 2.2 on credit purchase, assume the following are the purchase returns made by the firm for January.

January 15 Returned goods to Kwanza Ltd worth TZS 210,000

January 25 Returned goods to IPP and received a credit note for TZS 50,000

Required:

Record the transactions in a purchase returns day book.

Solution 2.4

Purchases returns day book

Date	Credit note No.	Suppliers name	Folio	VAT	Purchase return amount
Jan 15	001	Kwanza Ltd	PL02		210,000
Jan 25	002	IPP	PL01		50,000
		Total			**260,000**

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Cash book

A cash book is used to record all transactions involving cash payments and cash receipts. The book also serves as a ledger and it usually starts with the opening balance at hand or bank. A cash book of an organisation can have more than one column on both sides; on the receipt side and the payment side. A single-column cash book is used if it does not have a bank account, otherwise two columns or three columns cash book will be used. In two columns cash books, one column is for recording transactions made through cash on hand and the other is for recording transactions made through the bank. In a three columns cash books the third column is used to record discounts allowed to customers and discounts received from suppliers. In a company with a huge number of transactions, a separate petty cash book may be maintained to record smaller payments made by the business entity.

The cashbook has two sides: the debit side which records an increase in cash or cash receipts and the credit side which records a decrease in cash or cash payments. The book will also record the cash withdrawn from the bank by the firm as well as cash deposited in the bank account by either the firm or customers.

Dr. **Three column cashbook** **Cr.**

Date	Description	Fol.	Disc.	Cash	Bank	Date	Description	Fol.	Disc	Cash	Bank

Example 2.5

During the month Mkali Kwanza Ltd made the following transactions:

Jan 1 The firm puts capital into a bank account for the business TZS 2,000,000
2 Received cheque from Haji & Co. TZS 800,000
4 Cash sales to Haji & Co TZS 500,000
6 Paid rent by cash TZS 300,000
7 Banked TZS 1,000,000 of the cash held by the business
15 Cash sales paid directly into the bank TZS 900,000
23 Paid cheque to Kwanza Ltd. TZS 1,000,000
29 Withdrew cash from the bank for business use TZS 200,000
30 Paid wages in cash amounted TZS 300,000 and purchased goods from Kwanza, amounted TZS 400,000

Required:

Prepare the firm's cash book to record transactions and determine the balances at the end.

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Solution 2.5

Dr. **Three columns cash book** **Cr.**

Date	Description	Folio	Disc all	Cash	Bank	Date	Description	Folio	Disc Rec	Cash	Bank
Jan 1	Bal b/d			–	–	Jan 6	Rent	GL01		300,000	
	Capital	GL01			2,000,000	Jan 7	Bank	C		1,000,000	
Jan 2	Haji& Co	SL02			800,000	Jan 23	Kwanza Ltd	PL02			1,000,000
Jan 4	Sales	SL02		500,000		Jan 29	Cash	C			200,000
Jan 7	Cash	C			1,000,000	Jan 30	Wages	GL01		300,000	
Jan 15	Sales				900,000	Jan 30	Purchases	PL02		400,000	
Jan 29	Bank	C		200,000		Jan 31	Balance	c/d		700,000	3,500,000
Jan 31	Sales			2,000,000							
				2,700,000	**4,700,000**					**2,700,000**	**4,700,000**
Feb 1	Balance	b/d		700,000	3,500,000						

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General journal

In a business organisation that keeps a specialised journal, the general journal is used to record transactions that are general and does not qualify to be recorded in any other books of prime entries. Such entries include, but are not limited to recording depreciation, purchase, and disposal of an asset on credit, writing off bad debts, bad debts recovered, interest income, interest expense, correction of errors in the ledger accounts, and other final account adjustments. The preparation of a general journal follows a double-entry system under which two accounts that are affected by the transaction are identified. One account is debited and the other is credited together with a narration that summarizes what happened.

Examination type questions, normally use the term journalizing to describe the process of recording of business transaction into journal. For general journal, this involves the following steps.

(i) Identifying the transaction from the source documents such as, bank slip, salary slip and invoices.

(ii) Identifying the affected accounts by the transaction along with identifying the type of the accounts affected, whether it is an asset, liability or owners' equity account.

(iii) Determining the effect of the transaction on the account i.e., increase or decrease.

(iv) Using the rules of the double entry system, determine whether to debit or credit the account.

(v) Entering the transaction in the journal.

(vi) Prepare the journal entries for the accounts affected and give a short but clear explanation about the nature of the transaction (the narration).

Format of general journal

Date	Account titles and explanations	Folio	Debit	Credit
26/11/2022	Account to be debited		xxx	
	Account to be credited			xxx
	Narration to describe the transaction			

Based on double entry accounting principle, assets and expenses are debited when there is an increase and credited whenever there is a decrease. Liabilities and revenues are credited when there is an increase and debited whenever there is a decrease.

Using example 2.5, the general journal for some of the transactions will be as follows.

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Date	Account titles and explanations	Folio	Debit	Credit
Jan 01	Bank account Capital account *Being capital injection in the business*	GL GL	2,000,000	2,000,000
Jan 02	Bank account Accounts Receivable account *Being cheque received from customers in settlement of debt*	GL GL	800,000	800,000
Jan 04	Cash account Sales account *Being sales made in cash*	GL GL	500,000	500,000
Jan 06	Rent account Cash account *Being rent payment made in cash*	GL GL	300,000	300,000
Jan 07	Bank account Cash account *Being deposit of cash into the bank account*	GL GL	1,000,000	1,000,000
Jan 15	Bank account Sales account *Being cash sales paid directly through the bank*	GL GL	900,000	900,000
Jan 23	Kwanza Ltd account Bank account *Being cheque payment made to a supplier in settlement of debt*	PL GL	1,000,000	1,000,000
Jan 29	Cash account Bank account *Being withdrawal of cash from the bank account for business use*	GL GL	200,000	200,000
Jan 30	Wages account Cash account *Being payment of wages in cash*	GL GL	300,000	300,000

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Exercise 2.1

You are given the following business transactions relating to Kazingumu Enterprises Ltd., for the month of January, 2019.

Motor van	TZS 15,000,000
Plant	TZS 24,000,000
Stock	TZS 4,000,000
Accounts receivables	TZS 2,000,000
Accounts receivables	TZS 3,500,000
Bank loan	TZS 12,000,000

Note

The balancing figure is the amount of capital

Required

As accountant trainee in Kazingumu Enterprises Ltd., prepare general journal for the month of January, 2019 to record the capital in books of accounts.

The principles of double entry and ledger accounts

Double entry principle requires that every business transaction must be recorded twice, a debit entry must have its corresponding credit entry, and vice versa. In other words, every financial transaction undertaken by the firm will have an equal but opposite impact on at least two accounts. This means that, the amounts entered as debits will be equal to the amounts entered as credits. In this respect, double-entry implies that, the accounting equation (Assets=Liabilities + Owner's equity) will always remain in balance. The accounting equation can also be expanded to include drawings made by the owners as well as profits made by the firm in normal business transactions. The equation can be rewritten as follows:

Assets =Liabilities +Capital +Profits-Drawings or

Assets= Liabilities +Capital +Revenues-Expenses-Drawings

Assets +Expenses +Drawings=Liabilities +Capital +Revenues

The assets, expenses, and drawings accounts are debited when there is an increase in balances and credited whenever there is a decrease in balances. The accounts for capital, revenue, and liabilities are credited for any increase in balances and will be debited whenever there is a decrease in balances.

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Account type	*Accounting treatment*	*Impact*
Assets	Debit	To record an increase
	Credit	To record a decrease
Liabilities	Credit	To record an increase
	Debit	To record a decrease
Capital	Credit	To record an increase
	Debit	To record a decrease
Revenues	Credit	To record an increase
	Debit	To record a decrease
Expenses	Debit	To record an increase
	Credit	To record a decrease
Drawings	Debit	To record an increase
	Credit	To record a decrease

Ledger accounts

After recording transactions in the books of original entry and the general journal, individual accounts are prepared and the amount is posted either on the debit side or credit side of the ledger account. An account is a page or a section within the ledger that records a particular transaction of either asset, liability, capital, income or expense. The format of the account indicating key issues to be recorded is presented as follows.

Dr. **Name of account** **Cr.**

Date	Particulars	Folio	Amount	Date	Particular	Folio	Amount

Alternatively, account can be presented in "T format"; hence the name "T Account", which depict the two major sides of the account, i.e., debit and credit side. It is called as such (T Account) to reflect its visual representation as it resembles the shape of the alphabet "T", as presented in the following diagram.

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T Account

Dr.	Account Name (Account No.)	Cr.

T account is widely used by accountants and students for practices and examinations due to its simplicity in recording business transactions as all the additions and subtractions to the account can be tracked and represented easily. For good presentation and maintenance, similar types of accounts will be grouped together depending on the nature or class of the transactions forming what is known as ledger. There are three major categories of ledgers including, sales ledger in which the customers' accounts are kept; purchases ledger, which keeps suppliers' accounts and general ledger which keeps the remaining other accounts.

The general ledger is also known as nominal ledger while purchases and sales ledgers are collectively called personal ledgers. The cash book sometimes is also regarded as ledger as it has the two common accounts for cash and bank transactions. Remember, the accounting process aims at preparing financial statements of the business entity. Therefore, the general ledger accounts are the ones that will be processed throughout the accounting process. The personal or subsidiary ledger accounts will be represented by two "total accounts" called "trade receivables account" and "trade payables account" in the general ledger.

Sales ledger

This ledger book contains all the accounts of individual credit customers, which are the personal accounts. Thus, it is used to records all transactions made between the business and credit customers for goods or services. Periodically the sales day book transactions are posted to the general ledger accounts and to the sales ledger accounts. In addition, transactions listed in the sales returns day book do also affect various customers' accounts in the sales ledger and their totals should be summarised in the general ledger accounts. The double entries postings from sales day book and sales returns day book are as follows:

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In the general ledger:

Dr. Trade receivables account xx

Cr. Sales account xx

(With the periodical total of the sales daybook)

Dr. Returns Inwards account/sales returns account xx

Cr. Trade receivables accounts xx

(With the periodical total sales returns of the sales returns day book)

In the sales ledger:

Dr. Individual customers' accounts xx

(With their respective value of goods sold to individual customers)

Cr. individual customers' accounts xx

(With the respective) value of goods returned by individual customers)

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Example 2.6 – Preparation of sales ledger and general ledger

Example 2.6 utilises the same information that was given earlier to illustrate recording of credit sales and returns inwards in their respective journals (Example 2.1 and 2.3). For quick references, the information is reproduced below to assist in preparation of sales ledger and general ledger:

January: 1. Credit sales to Jaria TZS 200,000
2. Credit sales to Haji & Co TZS 1,200,000 less 10 percent trade discount.
4. Credit sales to Chetu Ltd. TZS 600,000
8. Credit sales to Jaria TZS 300,000
10. Credit sales to Tulia Enterprises TZS 450.000
14. Credit sales to Haji & Co TZS 300,000
16. Credit sales to Chetu Ltd TZS 1,000,000 less 10 percent trade discount.
20. Credit sales to Jaria TZS 300,000
25. Credit sales to Haji & Co TZS 450,000
28. Credit sales to Tulia Enterprises TZS 450,000
30. Credit sales to Aisha TZS 170,000
31. Cash sales to Haji & Co TZS 2,000,000

Additional information include:

January 3: Haji & Co returned goods worth TZS 80,000
12. Tulia Enterprises returned goods worth TZS 90,000
21. Jaria returned goods worth TZS 10,000

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The illustration about sales ledger and general ledger is presented as example 2.6, as follows:

Solution to example 2.6

Sales ledgers

Dr. Aisha A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan.30	Sales	SL05	170,000				

Dr. Chetu A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan.4	Sales	SL03	600,000				
Jan16	Sales	SL03	900,000				

Dr. Haji & Co A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan.4	Sales	SL02	1,080,000	Jan 3	Returns Inward	SRJ1	80,000
Jan 14	Sales	SL02	300,000				
Jan 25	Sales	SL02	450,000				

Dr. Jaria A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan.1	Sales	SL01	200,000	Jan 21	Sales Return	SRJ3	10,000
Jan.8	Sales	SL01	300,000				
Jan.20	Sales	SL01	300,000				

Dr. Tulia enterprises A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan.10	Sales Journal	SL04	450,000	Jan 12	Sales Return	SRJ2	90,000
Jan.28	Sales Journal	SL04	450,000				

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General ledger

Dr. Sales A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Jan.31	Trade receivables	GL01	5,200,000
				Jan 4	Cash		2,000,000
				Jan 15	Cash		500,000
					Bank		900,000

Dr. Returns inward A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan.31	Trade receivables	GL01	180,000				

Dr. Trade receivables A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Sales		5,200,000	Jan.31	Returns inwards	GL01	180,000

Exercise 2.2

Record the following credit sales in the sales journal, post to the sales ledger and show the transfer to the sales account in the general ledger in 2022:

March	2	Credit sales to Nungwi & Co. Ltd TZS 60,000.
	4	Credit sales to Kili Ltd TZS 1,800,000 less 10 percent trade discount.
	9	Credit sales to Siza Ltd TZS 950,000.
	18	Credit sales to Sasi Ltd TZS 800,000 less 10 percent trade discount.
	20	Credit sales to Nungwi & Co. Ltd TZS 300,000
	24	Credit sales to Siza Ltd TZS 180,000
	27	Credit sales to Sasi Ltd TZS 400,000
	29	Credit sales to Siza Ltd TZS 80,000 Nungwi & Co. Ltd TZS 600,000 and Sasi Ltd TZS 240,000.

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Purchases ledger

Purchases ledger book contains all the accounts of individual credit suppliers – the personal accounts used to record credit transactions between business entities and their suppliers of goods and services. The purchases ledger thus provides the detailed transactions of each individual credit suppliers of goods. Periodically, the purchases day book transactions are posted to the general ledger accounts and to the purchase's ledger accounts. Furthermore, transactions listed in the purchases returns day book do also affect various suppliers' accounts in the purchases ledger and their totals should be summarised in the general ledger accounts. The double entry postings from purchases day book and purchases returns day book are as follows:

In the general ledger:

Dr.	Purchases account	xx	
	Cr. Trade payables account		xx
	(With the periodical total of the purchases day book)		
Dr.	Trade payables account	xx	
	Cr. Returns outwards account/purchases returns account		xx
	(With the periodical total purchases returns of the purchases returns day book)		

In the purchases ledger:

Dr.	Individual suppliers' accounts	xx	
	(With their respective value of goods returned to credit suppliers)		
	Cr. Individual Suppliers' accounts		xx
	(With the respective value of goods purchased from them on credit)		

Example 2.7 – Preparation of purchases ledger and general ledger

Example 2.7 uses the same information that was given earlier to illustrate the recording of credit purchases and returns outwards in their respective journals (Example 2.2 and 2.4 about Mkali Kwanza Ltd for January 2022). For quick references, the information is reproduced to facilitate the preparation of purchases ledger and general ledger:

Jan. 5 Bought goods on credit from IPP TZS 800,000
11 Bought goods on credit from Kwanza Ltd. TZS 1,800,000 less 5% trade discount.
17 Bought goods on credit from Zenu TZS 750,000

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22 Bought goods on credit from IPP TZS 500,000
27 Bought goods on credit from Zenu TZS 600,000
29 Bought goods on credit from IPP TZS 700,000
30 Bought goods in cash from Kwanza Ltd amounting to TZS 400,000

Additional information:
Jan.15 Returned goods to Kwanza Ltd worth TZS 210,000
Jan. 25 Returned goods to IPP and received a credit note for TZS 50,000

Solution to example 2.7

Purchases ledger

Dr. IPP A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 25	Returns Outward		50,000	Jan. 5	Purchases	PL01	800,000
				Jan. 22	Purchases	PL01	500,000
				Jan. 29	Purchases	PL01	700,000
						PL02	

Dr. Kwanza A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 15	Returns Outward		210,000	Jan.11	Purchases	PL01	1,710,000

Dr. Zenu A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Jan. 17	Purchases	PL01	750,000
				Jan. 27	Purchases	PL01	600,000

General ledger

Dr. Purchases A/C Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Trade payables Cash	GL01	5,060,000 400,000				

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Dr. **Returns outward A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Jan. 3	Trade payables	GL01	260,000

Dr. **Trade payables A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Returns Outwards		260,000	Jan. 31	Purchases		5,060,000

Exercise 2.3

Record the following credit purchases in the Purchase journal, post to the purchases' ledger, and show the transfer to the purchases account in the general ledger occurred in 2022.

March 1: Credit purchases from Vikoba Ltd, TZS 2,000,000

5: Credit purchases from M&N Ltd TZS 4,800,000 less 10% trade discount

13: Credit purchases from Mandela stores Ltd TZS 500,000

19: Credit purchases from M&N Ltd TZS 900,000

21: Credit purchases from Mandela Stores TZS 780,000

26: Credit purchases from M&N Ltd TZS 600,000; Mandela stores TZS 750,000 and Mwalimu Ltd TZS 1,400,000

General ledger

General ledger is the main ledger book of the business, which contains all the accounts of the business recorded in double entry system. The list of accounts presented in the general ledger include the following; assets, liabilities, capital/equity, revenue and expenses. Therefore, general ledger provides all the accounts used in the preparation of financial statements.

In relation to the books of original entries, the general ledger is the book of accounts into which periodical totals from the books of prime entries are posted to. Information presented earlier as example 2.5 is reproduced here for quick reference to illustrate the preparation of general ledger.

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During the month Mkali Kwanza Ltd made the following transactions:

Jan 1 The firm puts capital into a bank account for the business TZS 2,000,000

2 Received cheque from Haji & Co. TZS 800,000

4 Cash sales to Haji & Co. TZS 500,000

6 Paid rent by cash TZS 300,000

7 Banked TZS 1,000,000 of the cash held by the business

15 Cash sales paid directly into the bank TZS 900,000

23 Paid cheque to Kwanza Ltd. TZS 1,000,000

29 Withdrew cash from the bank for business use TZS 200,000

30 Paid wages in cash amounted TZS 300,000 and purchased goods from Kwanza amounted TZS 400,000

Dr. **Capital A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Jan.1	Bank	GL01	2,000,000

Dr. **Rent A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 06	Cash	GL01	300,000				

Dr. **Wages A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan .30	Cash	GL01	300,000				

Balancing off accounts

In the previous section, you have learned how to prepare accounts using a double-entry system. At the end of each accounting period, figures in the account are examined to summarize the situation they present. This is done to all accounts of customers and suppliers of various services and goods. The purpose is to determine how much customers owe the business for the goods that have been sold to them as well as how much the company is owed by its suppliers as a result of services/goods delivered by them. The remaining balances will either be transferred to the

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next financial year or closed and the total amount transferred to another related account.

The following steps should be followed when balancing off various accounts:

(i) Add up both sides to find out their totals – do not write anything in the account at this stage.

(ii) Deduct the smaller total from the larger total to find the balance (the balancing figure).

(iii) Enter the balance on the side with the smallest total. This now means that the totals in both sides will be equal – this balancing figure that has been inserted is known as balance carried down (balance c/d)

(iv) Enter the total amounts for both the debit and credit side.

(v) Enter the balance amount (labelled earlier as c/d) on the line below the totals on the opposite side to the balance shown above the totals. This is known as balance brought down (balance b/d).

(vi) Against the balance c/d, complete the date column by entering the last day of that period and show the first day of the next period against the balance b/d.

Note that, the balance brought down can appear in any side of the account (debit or credit) depending on the nature of transactions. However, normally all assets, expenses and losses accounts have debit balances while incomes/ revenue; capital and liabilities, credit balances.

During balancing off accounts, one needs to take note of whether the account is nominal, personal or a real account. **Nominal accounts** are temporary accounts that are maintained within one accounting period. In the end, their balances are transferred to income statement. All income statements accounts (losses, gains, expenses, revenues) are nominal accounts. On the other hand, **real accounts** are permanent accounts representing tangibles assets and their balances are carried to the beginning of another accounting period. Hence, they appear in the balance sheet/ statement of financial position. Examples on this include, furniture, motor vans and buildings. As for **personal accounts**, these can either be assets or liabilities. They too have to appear in the balance sheet/statement of financial position.

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Examples of personal accounts are accounts receivables and payables, drawings and capital accounts.

Example 2.8

We may use the accounting information given in examples 2.5 and 2.6 to demonstrate the process of balancing off the different accounts presented in ledger.

In the sales ledger

Dr. **Haji &Co A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 02	Sales	SL02	1,080,000	Jan. 2	Bank		800,000
Jan. 14	Sales		300,000	Jan. 3	Returns Inward	SRJ1	80,000
Jan. 25	Sales		450,000	Jan. 31	Balance c/d		950,000
			1,830,000				**1,830,000**
Feb. 01	Balance b/d		950,000				

Dr. **Kwanza A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 15	Returns Outward		210,000	Jan.11	Purchases	PL01	1,710,000
Jan. 23	Bank		1,000,000				
Jan. 31	/		500,000				
			1,710,000				**1,710,000**
				Feb. 01	Balance b/d		500,000

In the general ledger

Dr. **Sales A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Balance c/d		8,600,000	Jan.31	Account	GL01	5,200,000
				Jan. 4	receivables		2,000,000
				Jan. 15	Cash		500,000
					Cash		900,000
					Bank		
			8,600,000				**8,600,000**
				Feb. 1	Balance b/d		8,600,000

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Dr. **Returns inward A/C** Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Trade Receivables	GL01	180,000	Jan. 31	Balance c/d		180,000
			180,000				**180,000**
Feb. 1	Balance b/d		180,000				

Dr. **Purchases A/C** Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Trade Payables	GL01	5,060,000				
	Cash		400,000	Jan. 31	Balance	c/d	5,460,000
			5,460,000				**5,460,000**
Feb. 1	Balance b/d		5,460,000				

Dr **Trade payables A/C** Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Returns outwards		260,000	Jan. 31	Purchases		5,060,000
Jan. 31	Balance c/d		4,800,000				
			5,060,000				**5,060,000**
				Feb. 1	Balance b/d		4,800,000

Dr. **Trade receivables account** Cr.

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Sales		5,200,000	Jan.31	Returns inwards	GL01	180,000
					Bank		800,000
				Jan.31	Balance c/d		4,220,000
			5,200,000				**5,200,000**
Feb. 1	Balance b/d		4,220,000				

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Dr. **Wages A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 30	Cash	GL01	300,000	Jan. 31	Balance c/d		300,000
			300,000				**300,000**
Feb. 1	Balance b/d		300,000				

Dr. **Returns outward A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Balance c/d		260,000	Jan. 3	Trade payables	GL01	260,000
			260,000				**260,000**
				Feb.1	Balance b/d		260,000

Dr. **Rent A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 06	Cash	GL01	300,000	Jan. 31	Balance c/d		300,000
			300,000				**300,000**
Feb. 1	Balance b/d		300,000				

Dr. **Capital A/C** **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Jan. 31	Balance c/d		2,000,000	Jan.1	Bank	GL01	2,000,000
			2,000,000				**2,000,000**
				Feb. 1	Balance b/d		2,000,000

NB: some of the ledger accounts e.g., Jaria A/C and Tulia A/C, have not been presented since the objective of this example was only to illustrate the balancing off the ledger accounts.

Exercise 2.4

Record the following transactions in the prime books of accounts, post to the ledger and show the transfers to general ledger for January, 2021

Jan. 1 Opening balances: Cash TZS 100,000; Bank 1,500,000; Motor Van TZS 1,000,000; Debtor – DART TZS 90,000; Creditors - Harry TZS 500,000; NBC loan TZS 1,500,000 and Capital TZS 1,690,000.

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3	Credit purchases from SADCO TZS 300,000; LITA & CO TZS 560,000
6	Credit sales to DART TZS 310,000; Jatu Ltd TZS 120,000 and Judi traders TZS 340,000
17	Bought a new motor van on credit from Cooper Motors TZS 8,000,000
24	Credit purchases from SADCO TZS 390,000; LITA & CO TZS 600,000 and SALAMAT Ltd. TZS 250,000
25	Returned goods worth TZS 30,000 to SALAMAT Ltd.
28	Credit sales to DART TZS 180,000; JULY's traders TZS 310,000; Samson & Sons TZS 410,000 and Jatu Ltd TZS 340,000
29.	Issued a credit note to Jatu Ltd, TZS 10,000 and Samson & Sons TZS 15,000 for goods returned

Trial balance and its use in preparation of financial records

A trial balance is a report or a worksheet generated at the end of the accounting period containing the list of all the ledger accounts and their corresponding balances. This worksheet is designed such that it has about three columns. The first column contains the details or particular of the ledger accounts (name of the account) while the second and third columns are usually labelled as debit and credit, respectively. If an account has a debit balance, then this figure will be recorded on the debit side while for the credit balance on the credit side. In other words, trial balance reflects the application of doubled entry system as used in recording ledger accounts. If the summation in the two columns appears to be the same, this is an indication that, the double entry posting was done correctly. However, balancing between the debit totals and credit totals does not mean that, no errors have been committed. Nonetheless, trial balance serves as a useful tool in facilitating the preparation of financial statements. It provides a meaningful summary of important information one would to prepare the financial statements of a business. Moreover, trial balance is also used to check arithmetical accuracy of the ledger accounts, and to detect errors committed in the previous accounting process.

The following are the basic steps that need to be followed when preparing a trial balance:

(i) As already explained, the first step will involve determining the closing balances of all the ledger accounts, i.e., those found in sales ledger, purchases ledger and general ledger.

(ii) Then prepare a three-column worksheet, one column for the account name

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and the corresponding columns for debit and credit balances.

(iii) Fill out the account name and the balance of such account in the appropriate debit or credit column.

(iv) Then find the total for both the debit column and the credit column. Ideally, in a balanced error-free situation, the totals of debit and credit sides should be the same.

(v) Once, it has been established that, the totals for debit and credit sides are same, the trial balance will be closed. If there is a difference between debit and credit sides, it is important to find and rectify errors, as will be discussed in chapter three of this book.

Example 2.9

By using the balanced ledger accounts as given in example 2.8, it is possible to prepare the trial balance of Mkali Kwanza Ltd as of Jan 31. Following is work-sheet for this, presented as solution 2.9.

Solution 2.9

Trial balance of Mkali Kwanza Ltd as at Jan 31

Account Name	Debit	Credit
Sales		8,600,000
Purchases	5,460,000	
Sales Return	180,000	
Purchase Return		260,000
Wages	300,000	
Rents	300,000	
Capital		2,000,000
Cash in hand	700,000	
Bank	3,500,000	
Trade receivables	4,220,000	
Trade payables		3,800,000
Total	14,660,000	14,660,000

At the end of accounting period, a thorough review will be done in the financial records and any accounting error discovered will be corrected and adjustments passed in the

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trial balance. The resulting trial balance is known as adjusted trial balance and is the one that is used to prepare financial statements. Detailed explanation on how to correct accounting errors and prepare adjusted trial balance is given in chapter three.

Chapter summary

In this chapter, you have learned about books of prime entry defined as a diary–like documents used to record day to day business transactions. It is for this reason that they are also termed as book of original entries, day books and journals. Key issue was to elaborate how different types of business transactions are recorded in different types of books of prime entry. It has been shown that, different types of business transactions are recorded in different/specific type of day book – the basis for having terms like specialised journals. For example, credit sales are usually recorded in sales day book while credit purchases, in purchases day book. When dealing with returns; returns inwards (goods returned by customers), will be recorded in sales returns day book while returns outwards (purchases returns or goods returned to suppliers), in purchases returns day book. Other transactions outside the scope of these will be recorded in different types of journals. For example, cash transactions, in cash book and others in general journal.

The chapter has also elaborated the posting of different business transactions from the books of prime entry into ledger accounts. For example, credit customers (debtors), these are usually posted into sales ledger while creditors, in purchases ledger. Other types of entries that do not fall into the scope of the two are usually posted into general ledger. Besides, you have learned how the balancing off the ledger accounts and the preparation of trial balance are done. The importance of trial balance, which contains a list of ledger accounts and their corresponding balances, has also been considered. Trial balance acts as a bridge towards the preparation of financial statements. Rather than referring to a large volumes of ledger accounts, it provides the convenience in terms of having a summarized picture of what has transpired for the whole accounting period. Trial balance is also useful in terms of checking arithmetical accuracy and compliance to the principle of double entry system when preparing financial statements.

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Revision exercises

1. By considering the time period in which payment of cash is affected, explain the different types of business transactions in the modern-day business environment.
2. What does it mean by accounting cycle and why is it called so?
3. Differentiate between trade discounts and cash discounts. Explain how each of them is recorded in the books of account.
4. Identify the main books of primary entry and the information that is recorded in each category of book of prime entry.
5. Differentiate the cash book from other types of journal entries. Why should a company maintain cash book?
6. Lisa & Co is involved in the business of buying and selling of furniture. For the month of January, 2022, the following transactions took place:

Jan.1 Started in business with TZS 20,000,000 in the bank

Jan. 2 CRDB lent us TZS 5,000,000 in cash

Jan. 3 Bought goods on credit from Bakhresa TZS 1,530,000 and Helena TZS 4,162,000

Jan. 4 Sold goods for cash TZS 1,910,000

Jan. 6 Took TZS 200,000 of the cash and paid it into the bank

Jan. 8 Sold goods on credit to Zara Ltd TZS 1,374,000

Jan. 10 Sold goods on credit to Lizi Ltd TZS 341,000

Jan. 11 Bought goods on credit from Bakhresa TZS488,000

Jan. 12 Zara Ltd returned goods to us TZS 65,000

Jan. 14 Sold goods on credit to Patel Ltd TZS 535,000 and Sinotruck Ltd TZS 262,000

Jan. 15 Lisa & Co returned goods to Bakhresa TZS 94,000

Jan. 17 Bought van on credit from Diamond Motors Ltd TZS 4,370,000

Jan. 18 Bought office furniture on credit from JSM Ltd TZS 1,800,000

Jan. 19 Returned goods to JSM Motors TZS 130,000

Jan. 20 Bought goods for cash TZS 390,000

Jan. 24 Goods sold for cash TZS 110,000

Jan. 25 Paid money owing to Bakhresa by cheque TZS 1,924,000

Jan. 26 Goods returned to us by Patel Ltd TZS 34,000

Jan. 27 Returned some of office furniture costing TZS 180,000 to JSM Ltd

Jan. 28 Lisa &Co put a further TZS 2,500,000 into the business in the form of cash

Jan. 29 Paid Diamond Motors Ltd TZS 4,370,000 by cheque

Jan. 31 Bought office furniture for cash TZS 365,000

Required

Prepare books of prime entry for Lisa & Co. for the month of January, 2022

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7. On 1st January 2021, the owner of the Miko Enterprise, Mr Kapesa, decided to start keeping his records using double entry system. His assets and liabilities at that date were as follows:

   Fixtures and equipment TZS 20,000,000

   Stock TZS 15,000,000

   Balance at Amana Bank TZS 17,500,000

   Cash TZS 375,000

   Creditors:

   - Azan TZS 3,175,000
   - IPP TZS 200,000
   - Mwananchi TZS 500,000

Mr. Kapesa's transactions during January were as follows:

Jan. 1 Sold stock to Kazi Ltd., for cash TZS 5,000,000

Jan. 2 Bought stock on credit from KG Ltd., TZS 2,500,000

Jan. 3 Sold Stocks to Muza Ltd., on credit, TZS 1,500,000

Jan. 4 Bought Fixture and Fittings from Kazi Ltd TZS 3,500,000

Jan. 5 Paid the balance owed to Spark on 1st January less 5% cash discount

Jan. 6 Paid KG Ltd., full amount due by cheque

Jan. 7 Received full amount due from Muza Ltd by cheque '

Jan. 8 Paid Kazi Ltd by cheque after deducting a 20% trade discount

Jan. 9 Paid, by banker's order, TZS 10,000,000 for repairs to Enterprise following a disagreement over the amount owing to Kazi Ltd.

Required:

Open Enterprise's ledger accounts on 1 January, record all transactions for the month, balance the ledger accounts, and prepare a trial balance as of 31 January.

8. Stone Town Enterprises (STE) is engaged in buying and selling of soft drinks. For the month of October, 2021, the business had recorded a number of business transactions, as follows:

Oct.1 Sales on credit to Linda TZS 520,000; Teddy TZS 630,000; Musa TZS 240,000

Oct. 2 Purchases on credit from Blue TZS 390,000; Rise TZS 510,000; Lee TZS 280,000

Oct. 8 Sales on credit to Teddy TZS 640,000; Hope TZS 418,000

Oct. 10 Purchases on credit from Rise TZS 92,000; James TZS 870,000

Oct. 12 Returns inwards from Musa TZS 25,000; Teddy TZS 190,000

Oct. 17 STE returned goods to Rise TZS 12,000; James TZS 84,000

Oct. 20 STE paid Blue by cheque TZS 390,000

Oct. 24 Linda paid STE by cheque TZS 400,000

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Oct. 26 STE paid James by cheque TZS 766,000

Oct. 28 Musa paid STE by cash TZS 80,000

Oct. 30 Hope pays STE by cheque TZS 418,000

Required

(a) Prepare the ledger accounts for STE then balance off the accounts at the end of October, 2021.

(b) By referring to the ledger accounts you have prepared under (a) above, differentiate debtors accounts from creditors accounts.

9. Manda Ltd Co. started its business operations on 1st March, 2022 – the following represent its business activities occurred during the month under consideration.

March 1 Started business with cash TZS 8,500,000

March 2 Bought goods on credit from Wakazi TZS 420,000

March 3 Paid rent by cash TZS 210,000

March 4 Paid TZS 6,000,000 of the cash of the business into a bank account

March 5 Sold goods on credit to David TZS 192,000

March 7 Bought stationery TZS 25,000 paying by cheque

March 11 Cash sales TZS 81,000

March 14 Goods returned by Manda Ltd Co. to Wakazi amounted to TZS 54,000

March 17 Sold goods on credit to Jazi TZS 212,000

March 20 Paid for repairs to the building by cash TZS 78,000

March 22 David returned goods to us TZS 22,000

March 27 Paid Wakazi by cheque TZS 366,000

March 28 Cash purchases TZS 470,000

March 29 Bought a van paying by cheque TZS 3,850,000

March 30 Paid motor expenses in cash TZS 62,000

March 31 Bought fixtures TZS 840,000 on credit from B Coal

Required

Prepare Journal entries for Manda Ltd Co. as will appear in its books of accounts

10. The following transactions were taken from books of M & Co Ltd for the month of September, 2022. Fill the table that follow by indicating the effect of transaction on the accounting equation and relevant accounts to be debited or credited.

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Date	Details	Effect	A/C to be debited or credited
Sept. 1	Started business with TZS 16,000,000 in the bank.		
2	Bought van paying by cheque TZS 6,400,000.		
5	Bought office fixtures TZS 900,000 on credit from Bold Ltd.		
8	Bought van on credit from Carton Cars Ltd TZS 7,100,000.		
12	Took TZS180,000 out of the bank and put it into the cash till.		
15	Bought office fixtures paying by cash TZS 120,000.		
19	Paid Carton Cars Ltd a cheque for TZS 7,100,000.		
21	A loan of TZS 500,000 cash is received from Berry.		
25	Paid TZS 400,000 of the cash in hand into the bank account.		
30	Bought more office fixtures paying by cheque TZS 480,000.		

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Chapter Three

Correction of accounting errors

Introduction

In this chapter you will learn about different types of errors and procedures involved in identifying and correcting them in books of accounts. The competencies developed in this chapter will enable you to apply relevant accounting principles in identifying different types of errors and make the necessary corrections in the books of accounts. This is important for preparing financial statements that show a true and fair view on the performance and financial position of the business.

Differentiating errors from frauds

An error is an undeliberate mistake that has occurred or committed accidentally, and no one is intended to benefit. If done intentionally, it becomes fraud. Even though the employees in charge of accounting department are supposed to be very careful and accurate in recording the transactions, the occurrence of mistake or errors is likely.

While recording the transactions in the books of accounts, it is quite likely that some mistakes may be committed. An error may occur while the transaction is initially recorded or while posting from journals to the ledger accounts or in addition/ subtraction of some figures. Whenever an error occurs, it may either affect the arithmetical accuracy of the accounts or may defeat the basic principles of book-keeping. Hence, they need proper rectification by making necessary corrections in the books of accounts. Table 3.1 that follows provides different types of errors that may occur at different stages of the accounting process.

Table 3. 1: *Types of errors in different stages of accounting process*

1	At the recording stage	2.	At the posting stage
(a)	Recording wrong amount	(a)	Posting to wrong account,
(b)	Recording wrong details of the transaction	(b)	Posting on the wrong side of an account

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1	**At the recording stage**	**2.**	**At the posting stage**
(c)	Completely skipping to record a transaction	(c)	Posting of wrong amount
3.	**At the balancing stage**	**4.**	**At the preparation of the trial balance**
(a)	Wrong totalling	(a)	Taking the wrong amount
(b)	Wrong balancing	(b)	Taking the wrong account
		(c)	Taking the account to the wrong side

At the end of the accounting period, a trial balance is prepared to check the arithmetical accuracy of the accounts. If the trial balance does not balance, it implies that, there are arithmetical errors in the accounts which require **detection and correction**. However, even if the trial balance agrees, there may still be some errors - these kinds of errors might be difficult to detect. Their detection may be by chance or during the auditing process.

Errors can also be understood well if one can differentiate them from frauds. Table 3.2 provides some of the important differences between the two by considering the presence or absence of intention or motives and objectives for their commitment.

Table 3. 2: *Differences between errors and frauds*

Error	**Fraud**
(a) This is undeliberate mistake that have occurred during recording or posting process (they are not done intentionally)	(a) This is an act that is intentionally carried out to benefit certain individuals.
(b) Errors are considered as instances -therefore the doer does not plan to hide them – if discovered and corrected even the doer may be happy to see that they have been corrected	(b) Fraud is an act of deception that is carried out with a sense of unfairness. The doer usually conceal it careful so that it cannot be discovered or corrected.
(c) There is no benefit or motives behind its commitment – they occur by chances.	(c) Frauds are purely alternation/ manipulation of accounting records for one's own benefits.

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The need for correcting errors

Once errors are detected it is important that they are corrected accordingly so as to achieve the following objectives:

(i) Generally, to present the correct accounting information.

(ii) To present the correct picture of business performance in terms of profit or loss made during the accounting period.

(iii) To disclose the true and fair view of financial position of the business.

The classification of errors and procedures for their corrections

After detecting the errors, either as wrong entries or wrong amount, the procedure for correcting them involves two steps. The first step is the identification of the correct double entry(ies) and the second is to make appropriate adjustment. In accounting errors may arise due to arithmetical or clerical actions. Thus, we have two types of errors, arithmetical and clerical errors. Within these, there are two main categories of errors, those affecting the agreement of trial balance and others, which do not.

(i) Arithmetical errors

Arithmetical errors arise due to transaction's discrepancies between amounts in words and amount in figures. Also, they can arise due to wrong addition in the content of an invoice.

(ii) Clerical errors

Clerical errors arise from wrong transaction posting due to copying or writing mistakes. Clerical errors are those errors which are generally committed by the clerical staff in recording transactions either in the books of prime entry or in the ledger accounts (books of final entry).

Errors not affecting the agreement of trial balance

When the totals in debit and credit sides of trial balance are equal, this does not provide assurance for correctness and accuracy in the posting of ledger accounts. There may still be some errors, which however, do not create a difference in the debit and credit totals of a trial balance. Despite of this, these errors distort the financial statements. In other words, the financial statements will provide misleading or false information regarding the performance and financial position of a business. Such errors include the following:

(i) **Errors of omission:** under this type of error, a transaction is completely omitted in the financial records. This means, a transaction has been done but was not recorded anywhere in the books of accounts. For example; purchases from MUPSA Co. Ltd worth TZS 200,000 has not been recorded in any books of

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accounts. Since no any records has been made in books of account, then the trial balance would still balance.

(ii) **Errors of commission**: these errors occur when the correct transactions' amount is posted in wrong account but in the same class of accounts. For example, a sale of TZS 11,000,000 to Chacha Godfrey is entered in the account of Kasim Godfrey. Second example, payment of wages, TZS 400,000 posted to rent account. Noted is the fact that, in both cases the correct transaction amounts were posted to the wrong or different accounts of debtors and expenses respectively. Due to this, the trial balance will balance without the errors being noticed because both accounts' balances will appear in the same sides.

(iii) **Errors of principle**: these are errors which occur when the transactions are posted in a wrong class of account, but of the same balance characteristics. For example, a purchase of a non-current asset, such as a van being debited to an expenses account, such as motor expenses account.

(iv) **Errors of original entry:** this type of error occurs where the original transaction is incorrectly recorded in the book of account with the incorrect amount both in the debit and credit entries (double entry system). For example, cash purchases of TZS 23,000,000 being wrongly recorded in the cash book (original entry) as TZS 32,000,000 and the same being posted to the purchases account. The trial balance totals would still balance.

(v) **Compensating errors:** these errors occur when two different mistakes such as posting the amount in the books of accounts are done but they offset or cancel each other. For example, sales account was over added by TZS 70,000 and the purchases account was also over added by the same amount. These two errors would then offset or cancel each other in the trial balance. This is because the totals of both the debit and credit sides of the trial balance will be TZS 70,000 more.

(vi) **Complete reversal of entries:** these errors occur when a transaction is posted in the correct accounts but in the wrong side. For example, cash sales of TZS 800,000 being credited in cash book and debited in sales account. Based on this, the trial balance totals would still agree.

(vii) **Transposition errors:** these errors occur when accounting

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officer accidentally reverses several adjacent digits when recording business transaction. For example, a credit sale of TZS 10,450,000 being entered accidentally in the books of accounts as TZS 10,540,000. For this, the trial balance totals would still balance.

Example 3.1

The following business transactions were recorded in the books of Mtakuja Enterprises in different dates of January, 2022.

Jan. 1 A credit purchase of TZS 500,000 from Mwigazi Ltd was omitted when recording in a day book.

Jan. 3 Sales of TZS 250,000 to Maganga, has been posted to Mganga account.

Jan. 6 Purchases of furniture from Rafiki Enterprises Limited of TZS 1,000,000 have been posted to purchases day book.

Jan. 8 Interest paid TZS 50,000 to CRDB Plc Bank was recorded as TZS 5,000 in the journal entries.

Jan. 12 Sales account was over casted by TZS 100,000 while salary's expenses account was also over casted by TZS 100,000.

Jan. 18 Amount of TZS 350,000 paid to supplier had been debited to cash book and credited to supplier's account.

Jan. 24 TZS 520,000 received from a debtor had been recorded as TZS 250,000 in the general journal.

Required

Show the journal entries needed to correct accounting errors for Mtakuja Enterprises.

Solution 3.1: Mtakuja Enterprises

General journal (to correct some accounting errors)

Dates	Particulars	Dr. (TZS)	Cr. (TZS)
Jan. 1	Purchases account	500,000	
	Mwigazi Ltd		500,000
	Being correction of omitted credit purchase from Mwigazi		

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Dates	Particulars	Dr. (TZS)	Cr. (TZS)
Jan. 3	Maganga account Mganga account Being correction of sales posted to Mganga instead of Maganga	250,000	 250,000
6	Furniture account Purchases account Being correction of the amount charged to the purchases A/C instead furniture A/C	1,000,000	 1,000,000
8	Interest expenses Cash book Being correction of the amount of interest recorded as TZS 5,000 instead of TZS 50,000	45,000	 45,000
12	Sales account Salary expenses account Being sales account overcasted by TZS 100,000 same as salary expenses A/C	100,000	 100,000
18	Creditor's (supplier account) Cash book Being correction of complete reversal of entries in the cash book and suppliers A/C	700,000	 700,000
24	Cash book Debtor's account Being transposition of errors in the respective accounts now adjusted with the difference (i.e. 520,000 - 250,000).	270,000	 270,000

Besides the general journal, corrections of accounting errors as would appear in the ledger accounts is shown in example 3.2 that follows.

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Example 3.2

The following are the different financial records of Maimuna Enterprises in different dates for the month of March, 2022:

March 4 Sales of goods TZS 300,000 to H. Kida had been entered to H. Kidaha account.

March 7 Purchases of TZS 200,000 on credit from Laswai had been entered in Swai's account.

March 10 Commission received TZS 500,000 had been posted to sales account.

March 18 A payment of TZS 160,000 to Upendo was entered on the receipt side of the cash book and credited to Upendo account.

March 25 The sales of goods worth TZS 520,000 to Masunya company has been completely omitted from the books.

Required

Show the necessary corrections to be made in the ledger accounts of Maimuna Enterprises.

Solution 3.2

Maimuna enterprises ledger accounts

(Correction of different errors recorded in different dates of March, 2022)

Dr. H Kida account Cr.

Date	Details	Amount	Date	Details	Amount
March 4	H. Kidaha	300,000			

Dr. H. Kidaha account Cr.

Date	Details	Amount	Date	Details	Amount
March 7	Sales	300,000	March 4	H. Kida	300,000

Dr. Laswai account Cr.

Date	Details	Amount	Date	Details	Amount
			March 7	Swai	200,000

Dr. Swai account Cr.

Date	Details	Amount	Date	Details	Amount
March 7	Laswai	200,000	March 7	Purchases	200,000

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Dr. Commission received account Cr.

Date	Details	Amount	Date	Details	Amount
			March 10	Sales	500,000

Dr. Sales account Cr.

Date	Details	Amount	Date	Details	Amount
March 10	Commission received	500,000	March 10	Cash	500,000

Dr. Cash account Cr.

Date	Details	Amount	Date	Details	Amount
March 18	Upendo	160,000	March 18	Upendo	320,000
	Balance c/f	160,000			
		320,000			**320,000**
				Balance b/f	160,000

Dr. Upendo account Cr.

Date	Details	Amount	Date	Details	Amount
March 18	Cash	320,000	March 18	Cash	160,000
				Balance c/f	160,000
		320,000			**320,000**
	Balance b/f	160,000			

Dr. Sales account Cr.

Date	Details	Amount	Date	Details	Amount
			March 25	Masunya	520,000

Dr. Masunya Company account Cr.

Date	Details	Amount	Date	Details	Amount
March 25	Sales	520,000			

To enhance further your understanding of correction of accounting errors another example will be given.

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Example 3.3

The following are the business transactions of Kayamu Enterprises recorded in different dates for the month of April, 2022: -

April 4 Extra capital of TZS 5,000,000 paid into the bank had been entered in sales account

April 8 Goods taken for own use TZS 50,000 had been debited to sundry expenses account.

April 11 Credit sales of TZS 150,000 was omitted in the books of account.

April 17 Repairs to motor van TZS 1,500,000 have been debited to motor van account.

April 26 Cash received from Mr. Moro TZS 350,000 was credited to Mr. Omoro account.

Required

Give the journal entries to correct the different errors recorded in the books of Kayamu Enterprises (ignore narrations) in different dates of April, 2022.

Solution 3.3

General journal

Dates	Particulars	Dr. (TZS)	Cr. (TZS)
April 4	Sales account Capital account	5,000,000	 5,000,000
8	Drawings account Sundry expenses account	50,000	 50,000
11	Debtor account Sales account	150,000	 150,000
17	Repairs to motor van account Motor van account	1,500,000	 1,500,000
26	Mr. Omoro account Mr. Moro account	350,000	 350,000

Exercise 3.1

You are an Accountant of Mkunazini Enterprises. You are reviewing some financial records prepared by the bookkeeper of organization for the different dates of a September 2022, listed as follows:

Sept. 2 Purchases of stationeries from IBAFSA stationery costing TZS 150,000

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was not recorded in any books of accounts.

Sept. 6 Payment of electricity bill of TZS 20,000 has been posted to Elen's account who was a debtor.

Sept. 9 Rent received amounting to TZS 1,000,000 has been credited to creditors account.

Sept. 13 Cash sales valued at TZS 535,000 was recorded in the books as TZS 355,000.

Sept. 18 Salaries account was over added by TZS 250,000 and the same was done in sales account.

Sept. 22 Rent paid amounting TZS 300,000 was credited in rent account and debited in cash book.

Sept. 25 Credit sales to Mpwapwa Co. Ltd worth TZS 70,250 was credited to sales account with amount of TZS 70,520 and debited to Mpwapwa Co. Ltd account with the same amount of TZS 70,520.

Required

For Mkunazini Enterprises, prepare general journal to rectify the observed accounting errors so as to have more accurate financial records.

Errors which affect the agreement of trial balance

A business entity prepares a trial balance periodically, usually at the end of every reporting period. The general purpose of producing a trial balance is to ensure the entries in a company's financial data are arithmetically correct. When trial balance does not agree, an effort is made to locate errors and rectify them. The following is a description of errors which affect the trial balance agreement.

(i) Single entry

Single entry is a violation of principle of double entry system as a business transaction is recorded only once i.e., no corresponding entry can be found in the books of accounts. This will cause a trial balance not to tally/agree. For example, cash sales of TZS 100,000 being recorded in the cash book only.

(ii) Overcasting and undercasting

Overcasting is used to describe the incorrect recorded amount that is higher than the actual amount of business transaction. In other words, the recorded figure has been overstated. Undercasting, on the other hand, describes the recorded amount that

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is less than the actual amount of business transaction i.e., the recorded figure has been understated. These two types of errors usually occur due to incorrect additions in the books of accounts. When it is stated that, the purchases account has been undercasted/understated by TZS 1,000,000, this means that, the correct summation is less by this amount. Since the purchases account usually has a debit balance, the trial balance will not balance by TZS 1,000,000 with debit side having lesser amount than credit side by the same amount.

(iii) **Wrong amount posted**

The wrong amount is posted to one account related to the transaction. In other words, all of the accounts involved would not balance for the wrong amount. For example, purchase returns valued at TZS 680,000 being credited in the purchase returns account as TZS 860,000 while creditor account debited as TZS 680,000. This means, the purchase returns account had been posted with the wrong or incorrect amount (TZS 180,000) while the correct figure (TZS 680,000) posted accurately in the creditor account.

Correction of errors using suspense account

When the trial balance totals are not equal, we should try our level best to find the errors, which resulted into such a disagreement. When they cannot be found, the trial balance totals can be made to agree with each other by inserting the difference in figure between the two sides (Dr. and Cr.). The recipient side being the one with smaller amount. The inserted figure is usually accompanied with a description "suspense account" to reflect the name of a newly created account. A suspense account can be defined as an account that is used temporarily to carry doubtful entries and discrepancies pending their analysis and permanent classification. It is an imaginary account opened for the purpose of just tallying/resolving the differences in totals found in the trial balance.

In the statement of financial position, the balance of a suspense account will be shown either as liabilities or assets depending on whether it has a credit or debit balance respectively. The journal entries for the correction of accounting errors involving a suspense account can be presented as follows:

(i) Debit the account which should have been debited (but is not debited) and credit the suspense account (which has been debited temporarily),

(ii) Debit suspense account (which has been credited for the time being) and credit the account which should have been credited (but is not credited).

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Example 3.4

The following errors were discovered in the books of Msutta & Family Company, after the trial balance that was extracted on 31st December, 2021 failed to balance by TZS 391,000 on the debit side.

March 1 Carriage inwards TZS 150,000 had been posted to carriage outwards.

June 5 An invoice of TZS 89,000 received from a creditor was entered correctly in purchases day book, but was posted as TZS 98,000 to creditor's account.

Aug. 7 Sales have been overcasted by TZS 150,000

Nov. 5 Cash purchases of TZS 232,000 had been recorded in cash book only.

You are required to prepare:

(a) Journal entries to correct the above errors.

(b) Suspense account dully balanced.

Solution 3.4 (a)

General journal

Date	Details	Dr. (TZS)	Cr. (TZS)
March 1	Carriage Inwards account Carriage outwards account Being the amount of carriage inwards erroneously posted to carriage outwards now corrected	150,000	 150,000
June 5	Creditors account Suspense account Being TZS 89,000 of purchases wrongly posted as TZS 98,000 in creditors account, now corrected	9,000	 9,000
Aug. 7	Sales account Suspense account Being amount of TZS 150,000 which was overcasted in sales account now corrected	150,000	 1,550,000
Nov. 5	Purchases account Suspense account Amount of purchases that was only posted in cash book, now corrected	232,000	 232,000

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Solution 3.4 (b)

Dr. **Suspense account** **Cr.**

Date	Details	Amount (TZS)	Date	Details	Amount TZS
Dec. 31, 2019	Difference in Trial balance	391,000	June 5, 2019	Creditors	9,000
			Aug. 7, 2019	Sales	150,000
			Nov. 5, 2019	Purchases	232,000
		391,000			391,000

Example 3.5

Kilimo Kwanza Ltd extracted a trial balance as at 31st December, 2021 and found that the totals are not equal. They posted the difference to a suspense account. Later on, they found the following errors which accounted for the difference.

7 Jan. 2021	The total of TZS 65,000 for discount allowed for the month, had been posted to discount received.
3 March 2021	Amount received TZS 200,000 from Mtweve had been posted to the debit of Mtweve's account in error.
4 April 2021	A payment of TZS 65,000 to Makuani had been posted to Makuani account as TZS 56,000
5 May 2021	Kilimo Kwanza Ltd bought new furniture for offices costing TZS 2,500,000 but this amount had been posted to the purchases account.
7 July 2021	A payment of TZS 106,000 for water bill had been entered in the cash book but the double entry had not been made.

You are required to prepare:

(a) Journal entries necessary to correct the errors.

(b) Suspense account showing the original difference in the trial balance.

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Solution 3.5 (a)

Kilimo Kwanza Ltd
General journal

Date	Details	DR (TZS)	CR (TZS)
Jan. 7	Discount received account Discount allowed account Suspense account Being amount of discount allowed had been posted to discount received account duly corrected	65,000 65,000	 130,000
March 3	Suspense account Mtweve account Being amount of TZS 200,000 that had been erroneously debited (instead of being credited) in Mtweve account now corrected	400,000	 400,000
April 4	Makuani account Suspense account Being amount of TZS 65,000 paid to Makuani, which had been posted as TZS 56,000 now corrected	9,000	 9,000
May 5	Furniture account Purchases account Being amount of TZS 2,500,000 used to buy furniture, erroneously posted to purchases account now corrected.	2,500,000	 2,500,000
July 7	Water bill expenses account Suspense account Being payment made for a water bill TZS 106,000 that was posted to cash book only	106,000	 106,000

Solution 3.5 (b)

Dr **Suspense account** **Cr**

Date	Details	Amount (TZS)	Date	Details	Amount (TZS)
March 3	Mtweve	400,000	Jan. 7	Discount Received	65,000
				Discount Allowed	65,000
			April 4	Makuani	9,000
			July 7	Water expenses	106,000
				Difference in trial balance	155,000
		400,000			400,000

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Example 3.6

On 31st December 2015, trial balance of XYZ Enterprises disagreed with the difference of TZS 23,100 on debit side. As on 15th January 2016, all errors were detected and the details are as follows:

Jan. 4 Cash of TZS 27,900 received from Kilumbu, was correctly recorded in cash book but not entered in Kilumbu account.

Jan. 6 Stationery expenses account was undercasted by TZS 15,000.

Jan. 12 Cheque worth TZS 45,000 paid by Karanga Supplies had been correctly posted in cash book but not posted in Karanga supplies account.

Jan. 14 Credit sales amounting to TZS 23,000 was correctly posted to sales account but was posted to debtors account as TZ 32,000.

Required

Prepare relevant ledger accounts to rectify the errors.

Solution 3.6

Dr. **Kilumbu account** **Cr.**

Date	Details	Amount	Date	Details	Amount
			Jan. 4	Suspense	27,900

Dr. **Stationery expenses account** **Cr.**

Date	Details	Amount	Date	Details	Amount
Jan. 6	Suspense	15,000			

Dr. **Karanga supplies account** **Cr.**

Date	Details	Amount	Date	Details	Amount
Jan. 12	Suspense	45,000			

Dr. **Debtors account** **Cr.**

Date	Details	Amount	Date	Details	Amount
			Jan. 14	Suspense	9,000

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Dr. **Suspense account** **Cr**

Date	Details	Amount	Date	Details	Amount
	Balance b/d	23,100	Jan. 6	Stationery expenses	15,000
Jan. 4	Kilumbu	27,900	Jan. 12	Karanga Supplies	45,000
Jan. 14	Debtor	9,000			
		60,000			**60,000**

Exercise 3.2

The following errors were discovered in the books of Mjimkongwe General Supplies after the trial balance extracted on 31st July, 2021 failed to balance.

July 2 Cash received TZS 600,000 from Upendo had only been posted on the receipt side of the cash book.

July 5 An item of TZS 250,000 for interest on bank overdraft was credited to interest account.

July 8 Goods sold to Vishandi for TZS 4,000,000 had been posted in purchases ledger as TZS 400,000.

July 16 A bill receivable for TZS 530,000 was posted to bill payable ledger.

July 25 Carriage on machinery, TZS 300,000 had been posted to carriage inwards account.

Required:

Prepare journal entries and suspense account to correct different errors as observed in the books of Mjimkongwe General Supplies.

Revised income statement and statement of financial position

Errors committed with regard to nominal accounts affect the profit or loss of the business. In contrast, errors in personal and real accounts have no effect on profit or loss of the business. Therefore, the profit figure has to be adjusted if there is an error discovered that affects items used in the calculation of profit. This includes all the items that appear in the income statement including but not limited to:

(i) Sales and purchases,

(ii) Sales returns and purchase returns,

(iii) Carriage inwards and outwards,

(iv) Opening and closing stock,

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(v) All revenue items,

(vi) All expenses items, and

(vii) Depreciation.

For an example, there must be adjustment when one of the pages is omitted in the sales day book in calculating the sales total for the month. This means that, the sales and revenue figure for the period were understated. As a result, even the net profit declared for the period would have been understated. Comparably, the statement of financial position is the one that is mostly affected by different types of errors identified in the chapter. This happens when the errors affecting the information contained in financial documents is incorrectly entered into financial database. Likewise, the understatement or overstatement of income statement items such as sales figure will also affect the statement of financial position. This is because, the net profit figure will be included as part of owner's equity.

Correction of accounting errors may also involves dealing with previously issued financial statements. This may include errors in the recognition, measurement, presentation or disclosure in financial statements caused by mathematical mistakes, and mistakes in applying the principle of double entry system. It may also include, the oversight of facts existing when the financial statements were being prepared. In this case, the prior period financial statements should be restated. The restatement requires the accountant to:

(a) Reflect the cumulative effect of the error on periods prior to those presented in the carrying value of assets and liabilities as at the beginning of the first period.

(b) Make an offsetting adjustment to the opening balance of retained earnings for that period.

(c) Adjust the financial statement for each prior period presented, to reflect the error correction.

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Example 3.7

The trial balance of Msasu Company extracted as at 31st July, 2022 failed to agree by TZS 1,000,000 and the difference was entered in the suspense account. Later, the following errors were discovered.

Jan. 1 Sales were overcasted by TZS 700,000

Feb. 2 Rent expenses were undercasted by TZS 800,000

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May 5 Cash received from Chambo were entered in the cash book only TZS 500,000

June 6 A purchases of TZS 950,000 is entered in the creditors account and purchases account as TZS 590,000

You are required to prepare:

(i) General journal to correct the errors,

(ii) Suspense account duly balanced,

(iii) Corrected income statement assuming Msasu Company declared a profit of TZS 3,200,000 up to July 2022,

(iv) Extract of the statement of financial position.

Solution 3.7 (i)

Msasu Company's general journal

Date	Details	Amount TZS	Amount TZS
Jan. 1	Sales account Suspense account Being amount over casted in sales account now corrected	700,000	700,000
Feb. 2	Rent expenses account Suspense account Being amount undercasted in Rent account now correct	800,000	800,000
May 5	Suspense account Chambo account Being amount received from Chambo posted only in the cashbook now corrected	500,000	500,000
June 6	Purchase account Creditors Being amount understated in creditors and purchases account now corrected	360,000	360,000

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Solution 3.7 (ii)

Msasu Company's suspense account

Date	Details	Amount TZS	Date	Details	Amount TZS
2022			2022		
May 5	Chambo	500,000	Jan. 1	Sales	700,000
	Difference on trial balance	1,000,000	Feb. 2	Rent Expenses	800,000
		1,500,000			1,500,000

Solution 3.7 (iii)

Msasu Company

Corrected income statement for the year ending 31st July 2022

Net profit as reported			3,200,000
Less:	Purchases understated	360,000	
	Overcasted sales	700,000	
	Undercasted rent	800,000	1,860,000
Corrected net profit			**1,340,000**

Solution 3.7 (iv)

Msasu Company

Corrected statement of financial position (Extract)

Current asset	
Debtors	xxx
Less: Amount paid but not recorded	500,000
Current Liabilities	
Creditors	xxx
Add: Amount paid but not recorded	360,000
Equity	
Retained earnings – whereby the whole net profit is retained	xxx
Less: Cumulative effect of income statement errors overstated profit	1,860,000

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Example 3.8

1. Below is the statement of financial position of Kapande Enterprises as at 31st Dec 2021

Kapande Enterprises
Statement of financial position as at 31st Dec 2021

Non-current assets:	**TZS**	**TZS**
Furniture	5,000,000	
Less: Accumulated depreciation	1,000,000	4,000,000
Current assets:		
Stock	3,500,000	
Debtors	3,000,000	
Cash	7,275,000	
Bank	1,700,000	
Suspense account	6,850,000	22,325,000
		26,325,000
Equity and liabilities:		
Capital	17,825,000	
Add: Net profit	8,000,000	
	25,825,000	
Less: Drawings	4,500,000	21,325,000
Liabilities (current liabilities):		
Creditors		5,000,000
		26,325,000

After internal audit, the following errors were detected.

(a) Salaries paid were correctly recorded in cash book but wrongly posted in rent account amounted to TZS 3,950,000

(b) On 31st Dec. 2021, cash balance was TZS 7,725,000.

(c) Debtors account was under casted by TZS 2,000,000.

(d) Cash paid to Nuria amounted TZS 1,000,000 was debited to Nurhan as TZS 100,000.

(e) Discount received was posted to discount allowed amounting TZS 2,200,000.

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(f) Cash purchases amounting to TZS 7,900,000 were recorded in cash book only.

You are required to prepare:

(i) Journal entries to rectify the errors.

(ii) Suspense account.

(iii) Statement of corrected net profit.

(iv) The statement of financial position as at 31st Dec, 2021 after rectification of the errors.

Solution 3.8 (i)

Kapande Enterprises
General journal

S/N	Details	Amount TZS	Amount TZS
(a)	Salaries account Rent account Being wrong account postage now corrected	3,950,000	3,950,000
(b)	Cash account Suspense account Being amount undercasted in cash account now corrected	450,000	450,000
(c)	Debtors account Suspense account Being amount undercasted in debtors account now corrected	2,000,000	2,000,000
(d)	Nuria account Nurhan account Suspense account Being error of commission and wrong amount posted now rectified.	1,000,000	100,000 900,000
(e)	Suspense account Discount received account Discount allowed account Being wrong account postage corrected.	4,400,000	2,200,000 2,200,000
(f)	Purchases account Suspense account Being purchases recorded in cash book only corrected.	7,900,000	7,900,000

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Solution 3.8 (ii)

Kapande Enterprises
Suspense account

Date	Details	Amount TZS	Date	Details	Amount Tzs
	Balance b/d	6,850,000	(b)	Cash	450,000
(e)	Discount received	4,400,000	(c)	Debtors	2,000,000
		11,250,000	(d)	Nuria	900,000
			(f)	Purchases	7,900,000
					11,250,000

Solution 3.8 (iii)

Kapande Enterprises

Corrected income statement for the year ending 31st Dec., 2021

Net profit as reported		8,000,000
Add: Discount allowed Discount received	2,200,000 2,200,000	 4,400,000
		12,400,000
Less: Purchases understated		7,900,000
Corrected net profit		4,500,000

Solution 3.8 (iv)

Kapande Enterprises
Corrected statement of financial position as at 31st Dec., 2021

Fixed assets:	TZS	TZS
Furniture	5,000,000	
Less: Accumulated depreciation	1,000,000	4,000,000
Current assets:		
Stock	3,500,000	
Debtors (3,000,000 + 2,000,000)	5,000,000	
Cash (7,725,000 + 450,000)	7,725,000	
Bank	1,700,000	17,925,000
Total Assets		**21,925,000**

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Capital and liabilities:		
Capital	17,825,000	
Add: Net profit	**4,500,000**	
	22,325,000	
Less: Drawings	4,500,000	17,825,000
Liabilities		
Creditors (5,000,000 -900,000)		4,100,000
Total capital and liabilities		**21,925,000**

Chapter summary

In this chapter you have learned about correction of accounting errors. This is one among the important adjustments in accounting, which is supposed to be done even for unintentional mistakes. Errors should never just be accepted. The chapter has introduced the meaning of errors i.e., undeliberate mistakes committed in the process of preparing financial records. This is different from frauds in which mistakes are committed intentionally. Unlike errors, frauds are committed with bad motives of gaining some benefits.

Different classes and types of errors have been identified including, those which do not affect the agreement of trial balance and those, which affect the trial balance. Examples of errors, which do not affect the trial balance include, errors of omission, commission, principles, original entry, compensating errors, complete reversal of entries and error of transposition. Errors which affect the trial balance, on the other hand, include single entry, where the figure in the transaction is overcasted or undercasted and where the wrong amount is posted. The correction of different types of errors have also been considered including the use of suspense account in which doubtful entries and discrepancies will be posted pending their analysis and eventually necessary correction to be done. The importance of general journal in the correction of accounting errors have also been elaborated. The chapter has provided a number of examples, activities and exercises to enable students understand more the concept of corrections of accounting errors.

Revision exercises

1. Mention and explain the seven errors which do not affect trial balance agreement.
2. Show the ledger entries necessary to correct the following errors:

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(a) A sale of goods TZS 750,000 to January had been entered in Jafari account.

(b) Commission revenue TZS 1,500,000 had been posted in error in the sales account.

(c) The purchase of machine TZS 2,000,000 is debited to purchase account.

(d) The payment made to Kilaza TZS 1,600,000 was entered on receipts side of the cash book in error and credited to Kilaza account.

(e) The purchases of office equipment on credit from Moro Electronics TZS 4,500,000 had been completely omitted from our books.

3. Clearly explain the following: -

(a) Any four errors that would result in disagreement of trial balance totals.

(b) 'Suspense account' and reason(s) for opening it in the process of rectifying accounting errors.

4. The trial balance of Pemba Store as at 31st December, 2021 showed a difference of TZS 78,300 and debited to suspense account, which was posted to suspense account. The following were subsequently discovered.

(a) A Sales day book has been over casted by TZS 15,000.

(b) Goods returned by Nungwi Company TZS 22,500 have been entered in returns outward account.

(c) The purchases ledger has been under casted by TZS 30,000.

(d) A sale of TZS 120,000 to Mr. Daruweshi has been passed through the purchases account.

(e) Cash received TZS 11,700 from Shadad though entered in cash book, no transactions was made to Shadad's account.

(f) TZS 22,000 paid for service of motor van has been posted to motor van account.

Required

You are required to prepare necessary ledger accounts to rectify the identified errors.

5. The auditing of books of TARECU for the year ended 30th June 2019 revealed the following errors:

(a) A machine purchased for TZS 2,500,000 had been debited to purchases account.

(b) Goods purchased from Pendo for TZS 250,000 were posted to the account of Upendo.

(c) An invoice from Samboni for TZS 720,000 was omitted from books of accounts.

(d) Goods sold to Shomvi TZS 575,000 were recorded in the sales day book as TZS 557,000.

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(e) Wages account was overstated by TZS 900,0000 and commission received account was understated by TZS 900,000.

You are required to prepare:

(i) Journal entries to correct the above errors

(ii) Suspense account duly balanced

6. The Trial Balance of Mlalakua Farm as at 30th September 2015 failed to agree and the difference was placed in the suspense account. Later the following errors were discovered:

(a) TZS 350,000 paid to Aggreco Ltd had being debited to purchases.

(b) A credit note for goods returned to suppliers amounting to TZS 500,000 had been debited to creditors account and credited to discount allowed account.

(c) A cash sale of TZS 254,900 had been recorded in sales account as TZS 524,900

(d) The credit purchase of an office computer for TZS 600,000 had been journalised through the purchase's day book.

(e) Discount of TZS 160,000 was allowed to Roza for prompt payment and entered in Roza's account was not posted in the cash book.

(f) Commission received TZS 267,000 had been entered in error in the sales account.

You are required to prepare:

(i) Journal entries to correct the errors,

(ii) Suspense account showing the correction of errors.

7. The trial balance of Hapa Kazi Ltd as at 31st May, 2021 failed to agree and the difference was posted in a suspense account. On the income statement, the profit declared was TZS 10,245,000 while the working capital shown in the statement of financial position was TZS 2,832,000.

The company's auditor revealed the following errors:

(a) A credit sale of office furniture for TZS 620,000 had been recorded in the sales day book.

(b) The purchases day book and returns outwards account had both been over casted by TZS 113,000

(c) Discount received of TZS 25,700 had been credited to the interest revenue account as TZS 27,500.

(d) A bad debt recovery of TZS 518,000 had been recorded in the cash book as a receipt from cash sales. The bad debt was written off in 2020.

(e) Carriage inwards of TZS 387,000 had been credited to the returns inwards account as TZS 378,000.

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(f) A payment of TZS 228,000 for electricity charge had been recorded twice in the electricity account, but was omitted from the cash book.

You are required to prepare:

(i) Journal entries to correct the errors.

(ii) Suspense account after the correction of errors.

(iii) Statement showing the adjustment to the net profit after correction of errors.

8. You are required to rectify the following errors which have been discovered after the preparation of the Trial balance as at 31st March 2020: -

(a) Goods taken by the proprietor; TZS 250,000 have not been entered in the books at all.

(b) Rent of TZS 900,000 paid for the proprietor's residence was debited to rent account.

(c) Cash received from Mgaza TZS 750,000 had been entered on the receipts side of the cash book only.

(d) Interest receivable TZS 500,000 was posted to loan account.

(e) TZS 450,000 being purchases returns were posted to the purchases account.

(f) Amount received TZS 540,000 from Makwaia family was posted to the debit of their account.

You are required to prepare

(i) Suspense account duly balanced

(ii) Statement of corrected net profit as the firm shows TZS 2,500,000 as its net profit.

9. The following is the trial balance of Lavida Cosmetics for the year ending 30th June, 2021:

Lavida Cosmetics trial balance as at 30th June, 2021

Names of Account	Dr. TZS. "000"	Cr. TZS. "000"
Capital		60,434
Inventory	25,120	
Receivables	25,760	
Payables and accruals		13,122
Bank	7,508	

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Cash	2,000	
Sales		181,120
Returns inwards	750	
Purchases	145,348	
Carriage inwards	1,948	
Wages	9,368	
Rent and postage expenses	6,400	
Travel and accommodation expenses	764	
Telephone expenses	1,498	
General expenses	1,706	
Drawings	1,506	
	25,000	
	254,676	254,676

Additional information

1. Lavida cosmetics' inventory as at 30th June 2021 was TZS 23,750,000.
2. Lavida cosmetics has discovered the following errors:
   (a) An invoice for carriage inwards was posted to the returns inwards account TZS 528,000.
   (b) A credit invoice for TZS 1,120,000 was posted as TZS 1,300,000.
   (c) A cash purchase of TZS 100,000 was omitted.

You are required to:

(i) Prepare a rectified trial balance after correction of errors.

(ii) Based on the corrected trial balance prepare the income statement for the year ended 30th June, 2021 and statement of financial position as at 30th June, 2021.

10. The following is the drafted statement of financial position of Mtajimwingi Enterprises as at 30th April, 2021.

Assets:	**TZS**	**TZS**
Non-current assets at cost	2,040,000	
Less: Accumulated depreciation	1,530,000	510,000
Current assets:		
Stock	1,036,000	
Debtors	405,000	

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Bank	58,2000	2,023,000
Total assets		2,533,000
Equity and liabilities:		
Capital	1,800,000	
Add net profit	600,000	
	2,400,000	
Less: drawings	400,000	2,000,000
Current liabilities		
Creditors	520,000	
Suspense account	13,000	533,000
Total owner's equity and liabilities		2,533,000

On checking the books, the following errors were found.

(a) Sales day book were undercasted by TZS 20,000

(b) A sum of TZS 30,000 which was part of bad debts amount was recovered.

(c) An interest expense of TZS 30,000 for the bank overdraft was incorrectly omitted.

(d) Purchases ledger was overcasted by TZS 50,000

(e) Commission receivable TZS 90,000 was only posted into cash book.

You are required

(i) Redraft the income statement for the year ending 30th April, 2021 after the correction of the observed errors.

(ii) Prepare the statement of financial position as at 30th April, 2021 after the correction of observed errors.

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Chapter Four

Reserves and provisions/ allowances

Introduction

In this chapter you will learn about the concepts of reserves and provisions/ allowances, classification and proper methods for their estimation and effects on different items as reported in financial statements. The competencies developed will enable you to apply the basic principles of reserves and provisions in determining/ estimating fair value of reserves and provisions to be recorded in the books of accounts.

Nature and classification of reserves

Reserves are part of profits or gains that have been set aside to achieve specific objectives such as paying for bonuses, expected legal settlement, repairs and maintenance or long-term debts. Reserves may also be used by businesses for strengthening their financial position, buying fixed assets (non-current assets) or developing and expanding a business. As a concept, reserves are commonly used in companies' business settings. This is different from sole proprietorship where the decision to retain profit or spend profits on personal use rest with one individual. For a company, the decision on how a company's profit should be spent, is usually made by a governing body of a company that is elected by shareholders in case of a public listed companies. This governing body is known as Board of Directors (BOD), and its main function is to oversee proper management of the company on behalf of the shareholders. The BOD will usually meet regularly to discuss and decide on important matters, which form the basis of the company's policies.

A good example of decision made by BOD in relation to the creation of reserve accounts is on how the company's profit should be utilised. BOD may decide that, a certain portion of the profit should be distributed to shareholders. This portion of a company's profit that is distributed to shareholders is called dividends. The remaining profit is considered as reserve that is called retained earnings. Retained earnings may be designed to achieve different objectives including, paying future dividends in case there is a loss, or profit for the year is not enough. Generally, the company's BOD

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may decide to create different types of "reserves" from the undistributed profit. Notably, all these reserves and retained earnings belong to shareholders. This issue is reflected well in the statement of financial position by listing them as part and parcel of owners/shareholders' equity.

The reserve created from revenue profit is known as revenue reserves. Revenue reserves can either be general reserves or specific reserves. A general reserve is designed to fulfil various business needs. For example, meeting contingencies, offsetting future losses, and enhancing the working capital of a company. On the other side, specific reserves are created for a specific purpose in a business. Specific reserves cannot be used for any other purpose apart from the aim for which they were created. Examples of specific reserves include, investment fluctuation reserves and debenture redemption reserves. Investment fluctuation reserves are aimed at adjusting the difference between the book value and market value of investment while redemption reserves are for paying long-term loans or debentures.

Another category of reserve is named as capital reserves. These are usually created from capital-oriented transactions. A good example would include gains or profit from the sale of non–current assets. These types of reserves are never used for distribution of profits in the form of dividends but to conserve it and improve business financial stability. Besides gains/profits on disposal of non-current assets, capital reserves may be raised from revaluation surpluses of non-current assets and re-issue of shares (share premium) and profits obtained prior to incorporation of a company. A share premium is obtained when the company sells its shares for the price that is higher than the price stated in a share. The price stated in a share certificate or paper value is also known as par value or face value of a company's shares.

Consider that, a company has a total of 1,000,000 shares, and each share is valued at TZS 500 and that company intends to sell its shares to the public to raise the needed capital. If a share is sold at exactly TZS 500, then there is no premium. However, if a share is sold, say at TZS 510, then there is a premium of TZS 10 for a share sold. The company may then open an account called premium account to keep record of collected funds. Assuming that, all the shares are successful sold at premium, then the total premium will be TZS 10,000,000 (TZS 10 X 1,000,000 shares). This premium is a good example of capital reserves, which may be used to pay for different expenses incurred for selling shares to the public. It cannot be distributed as dividends to shareholders.

The treatments of reserves in the financial statements

In the statement of financial performance,

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reserves and dividends are usually deducted after subtracting the tax on the profit levied to the company. The distributions are made through the account called an appropriation account, where transfers are made from the company's profit to various reserves. The following example serves as an illustration to show how the reserve amounts can be raised and presented in books of accounts.

Example 4.1

Kijitonyama Co Ltd has 1,000,000 ordinary shares of par value of TZS 500@ and closes its accounts on 31st December. For the year 2020 they got a net profit of TZS 80,000,000. The balance of undistributed profit for the year 2019 was TZS 19,000,000. Prior to annual general meeting, the board of directors prepared the following proposal:

(a) TZS 10,000,000 be set aside as general reserve, and

(b) TZS 5 to be paid as dividend per share.

Required

Show the appropriation statement, general reserve account, retained earnings account and how they will appear in the statement of financial position of Kijitonyama Co. Assume that tax rate is 30%.

Kijitonyama Co. Ltd

Appropriation statement for the year ended 31st December, 2020

	TZS	TZS
Profit before tax	80,000,000	
Less: Tax	24,000,000	
Profit for the year		56,000,000
Less: Transfers to general reserve	10,000,000	
Dividend payable	5,000,000	15,000,000
Retained earnings for the year		41,000,000
Add: Retained earnings (01.01.2020)		19,000,000
Retained earnings on 31.12.2020		**60,000,000**

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Kijitonyama Co. Ltd

Statement of financial position (extract) as at 31.12.2020

Capital and equity	**TZS**	**TZS**
Ordinary share capital		500,000,000
General reserve		10,000,000
Retained earnings		60,000,000
		570,000,000
Current liabilities		
Tax payable		24,000,000
Dividend payable		5,000,000

Activity 4.1

Visit a library or the website of Dar es Salaam Stock Exchange (DSE) to obtain a set of recent financial statements of two listed companies. Make a thorough review of the financial statements by examining how the selected companies' reserves have been positioned/presented within their financial statements (i.e., statement of financial position and income statement).

Required:

(a) Prepare some notes explaining the meanings of terms used to present reserves in the two financial statements.

(b) Makes some notes about the specific sections, in which the reserves have been presented. In your notes explain why they have been placed in such sections.

(c) Present your findings to your subject teacher or fellow class members to discuss the key issues observed in part (a) and (b) above.

The nature and classification of provisions/allowances

A provision/allowance refers to any funds set aside from a company's profit for the probable future expenses or a reduction in the asset value, although the exact amount is unknown at present. Basically, an entity has to recognise or make a provision, if it is probable that, an outflow of cash or other economic resources will be required to settle the expenses, liability, replenishment of assets or adjusting of loss in the future. If an outflow is not probable, accounting practice is to treat the liability as a contingent. Contingent liabilities' existence is out of the entity's control. An

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example of a contingent liability is when there is a legal proceeding in the court of law against the business, and that the ruling may compel the business to settle a liability.

A provision is a liability of uncertain timing or amount. In order for a provision to be recognised or recorded in books of accounts, the following conditions must be fulfilled: There must be a present obligation as a result of past events. This obligation will probably result into outflow of resources and the obligation can be reliably estimated. For example, if the business wants to make a provision for bad debts, there must be some debts which are likely not to be collected by the business. If these debts are not collected, they will result into loss of money due from debtors. Finally, the expected loss in terms of bad debts must be estimated.

Essentially a provision is an amount charged against revenue as an expense. A provision normally results into a reduction in the value of either an asset or a known liability. Common examples are provisions for audit fees, tax payables, depreciation, bad/doubtful debts and discounts allowed.

Exercise 4.2

1. What do you understand by the term reserve? Explain by identifying the key sources and examples of the reserves.
2. What do you understand by the term provision/allowance? Explain by identifying the key sources and examples of provisions.

Bad debts and provision/allowance for doubtful debts

Doing business with customers on credit is normally associated with default risk – this result into bad debts, which is also known as irrecoverable debts. They are specific debts, which the business has all the reasons to believe that they are not going to be paid. For that matter they have to be written off in books of accounts as a loss. Possible reasons for debtors' complete failure to pay off their debts are death, insolvency, bankruptcy and other business financial difficulties. In some instances, a debt that was previously written off may be recovered. In such circumstances, the recovered bad debts are recognised as an income in the statement of profit or loss. Therefore, accounting entries for bad debt written off is that it has to be debited to the statement of profit or loss and credited to the individual debtors' accounts in the subsidiary ledger. The total bad debts are credited to the trade receivables account in the general ledger. If a bad debt is subsequently recovered, it is debited to cash/bank account and credited to an account called bad debt recovered account. Thereafter, it will be closed by transferring it as income to the statement of income.

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Example 4.2

On 1st January 2022, the following balances appeared in the sales ledger of Masunya Enterprises:

Kingalu	TZS 2,000,000
Gumbo	TZS 1,200,000

During the year, the following events took place:

On March 1st Masunya Enterprises agreed to accept TZS 1,500,000 cash from Kingalu after negotiations and regarded the outstanding balance as irrecoverable.

On May 15th Gumbo was declared bankrupt. A payment of 30% of the debt was received in full settlement.

You are required:

To show how the above given transactions will be treated in Masunya Enterprises' books of accounts. Their financial year ends on 30th June yearly.

Solution 4.2

Masunya Enterprises books of accounts

Dr. Kingalu account Cr.

Date	Details	Amount	Date	Details	Amount
2022			2022		
Jan. 1	Balance b/d	2,000,000	March 1	Cash	1,500,000
			June 30	Bad debts	500,000
		2,000,000			**2,000,000**

Dr. Gumbo account Cr.

Date	Details	Amount	Date	Details	Amount
2022			2022		
Jan 1	Balance b/d	1,200,000	May 15	Bank	360,000
			June 30	Bad debts	840,000
		1,200,000			**1,200,000**

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Dr. Bad debts account Cr.

Date	Details	Amount	Date	Details	Amount
2022			2022		
Jan 1	Kingalu	500,000	June 30th	Profit or loss	1,340,000
	Gumbo	450,000			
		1,340,000			**1,340,000**

Masunya Enterprises

Statement of profit or loss and other comprehensive income (extract)

	TZS
Revenues	xxxxxxx
Less: Bad debts	1,340,000

Provision/allowance for doubtful debts

When preparing financial statements, there are various accounting principles one is required to comply with including, the conservatism/prudence concept. This requires that, the amount of expected losses need to be recognised or recorded in the books of accounts but not the anticipated income. Based on this, all debts which are expected not to be paid (i.e., doubtful debts) will need to be recognised in the statement of profit or loss and then deducted in the trade receivables in the statement of financial position. Thus, to avoid overstating the value of assets that is required to be reported at its net realisable value, an amount of doubtful debts is to be estimated. However, it is practically impossible to determine accurately the actual amount of the trade debtors who will possibly turn out to be bad in the future. Drawing from business experience of dealing with debtors, one may be able to estimate the amount of total debt that will be paid in full or only part or those who will default.

Common sense indicate that, the longer a debtor stays without settling his/her debts, the more likely that, the debt will turn out to be bad. Therefore, in order to obtain the amount of provision for doubtful debts, an analysis can be made on individual debtors against the age of their debts. From the analysis, one can decide on the probability of becoming bad. This procedure seems appropriate for businesses with very few debtors. Another way of estimating the amount for provision for doubtful debts is through experience, where, an estimation is made on the percentage of the total amount of debtors who will ultimately prove to be bad debts. This can be achieved by drawing up an ageing schedule, showing for how long the debts have been outstanding. The guiding principle is that, due to their higher chances of default, the older debtors should be associated with higher percentage estimates of

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bad debts. Based on this, the following table (known as debtors ageing schedule) indicates the estimates for provision of doubtful debts.

Ageing schedule for doubtful debts

Owing period	Amount	Estimated % doubtful	Provision for doubtful debts
Less than 1 month	10,000,000	1	100,000
1 month to 2 months	6,000,000	3	180,000
2 months to 3 months	1,600,000	4	64,000
3 months to 1 year	400,000	5	20,000
More than 1 year	320,000	20	64,000
Total provision for bad debts			**428,000**

Alternatively, the amount for the provision of doubtful debts can be computed as an estimated percentage of the total trade receivables account. This simplified approach is the one that is commonly preferred by many organisations compared to the detailed process associated with debtors ageing schedule. In most cases the rate or percentage is determined using judgement or business experiences or industry standards.

Creation, increasing and decreasing of provisions for bad debts

The provision/allowance for doubtful debts account shows the total allowance for accounts receivable that are expected to be written off. When provision for doubtful debts is to be made for the first time, the whole amount of provision is treated as an expense for that financial year. In case there is a portion of the trade receivable which has been proved to be a bad debt, it has to be deducted first from the trade receivables balance before the amount of the provision for doubtful debts is determined.

The situation will be different when there is already a provision for doubtful debts that was created in the previous financial period. In case the provision for doubtful debts for the current financial period is greater than the existing balance, it is considered that there is an increase in provision for doubtful debts. Therefore, the increased amount (the excess amount) is charged as an expense in the statement of profit or loss for the period in which the increased provision is made. To the contrary, when there is a decrease in provision for doubtful debts, the amount of the decrease in provision is added back as a gain to the statement of profit or loss for the period in which the decrease in provision is made.

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Accounting entries for provision for doubtful debts

Accounting entries are usually made to record creation, an increase or decrease in provision for doubtful debts. For a creation of a provision for doubtful debts, statement of profit or loss account is debited (i.e., it adds the amount of operating expenses) and a provision for doubtful debts account is credited. In subsequent years, the provision for doubtful debts may increase or decrease, depending on the current year's estimations for debts that are considered doubtful. For an increase in provision, the existing provision for doubtful debts is credited and a debit entry is made in the statement of profit or loss with the amount of increase. In case of a decrease in provision for doubtful debts, the accounting entries will be; debit the provision for doubtful debts account and credit the statement of profit or loss with the amount of decrease. In the statement of financial position, the balance in the provision for doubtful debts will be deducted from the total trade receivables account.

Example 4.3

Mahenge Sanga is a trader dealing with consumables. He sells goods on cash and on credit terms. On 31st December, 2019, Sanga had an outstanding balance of trade receivables of TZS 14,000,000. He has estimated that 1% of these balances might not be collected and wishes to make an appropriate provision. Sanga never made any provision for doubtful debts before. On 31 December 2020, his trade accounts receivable amounted to TZS 20,000,000. Upon reviewing the balances, he calculated that a provision for doubtful debts should be made at 5% of the total trade receivables balance.

On 31 December 2021, his trade accounts receivable amounted to TZS 15,000,000 and the estimated provision for bad debts was TZS 700,000.

Required:

(a) Show journal and ledger accounts entries to record the transactions in the books of Mahenge Sanga for the years ending 31st December, 2019, 2020 and 2021.

(b) Show how the transactions will appear in the statement of profit or loss and the statement of financial positions for the years 2019, 2020 and 2021.

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Solution 4.3

Workings

Provision for bad debts required:

On 31st December 2019:

Provision =1% of TZS 14,000,000 = TZS 140,000

On 31st December 2020:

Provision =5% of TZS 20,000,000 =TZS 1,000,000

Amount to the statement of profit or loss (increase in provision)

[TZS (1,000,000-140,000 =860,000)]

On 31st December 2021:

Provision = TZS 700,000

Amount to statement of profit or loss (decrease in provision)

[(TZS (700,000-1,000,000 = -300,000)]

Journal entries in the books of Mahenge Sanga

Date	Particulars	Dr	Cr
Dec. 31, 2019	Statement of profit or loss	140,000	
	Provision for doubtful debts account		140,000
	Being the creation of provision for doubtful debts		
Dec. 31, 2020	Statement of profit or loss	860,000	
	Provision for doubtful debts account		860,000
	Being the increase in provision for doubtful debts		
Dec. 31, 2021	Provision for doubtful debts account	300,000	
	Statement of profit or loss		300,000
	Being the decrease in provision for doubtful debts.		

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Ledger accounts

Dr. Provision for doubtful debts account Cr.

Date	Details	TZS	Date	Details	TZS
Dec. 31, 2019	Balance c/d	140,000	Dec. 31, 2019	Statement of profit or loss	140,000
		140,000			**140,000**
Dec. 31, 2020	Balance c/d	1,000,000	Jan. 1, 2020	Balance b/d	140,000
			Dec. 31, 2020	Statement of profit or loss	860,000
		1,000,000			**1,000,000**
Dec. 31, 2021	Statement of profit or loss	300,000	Jan. 1, 2021	Balance b/d	1.000,000
Dec. 31, 2021	Balance c/d	700,000			
		1,000,000			**1,000,000**
			Jan. 1, 2022	Balance b/d	700,000

Mahenge Sanga
Statements of profit or loss (extracts) for the years ended 31st December

		(Expenses column)	*(Income column)*
2019	Provision for doubtful debts	140,000	
2020	Provision for doubtful debts	860,000	
2021	Provision for doubtful debts		300,000

Mahenge Sanga
Statement of financial position (extracts) as at 31st December

Current Assets	TZS	TZS
2019: Accounts Receivable	14,000,000	
Less: Provision for doubtful debts	140,000	13,860,000
2020: Accounts receivable	20,000,000	
Less: Provision for doubtful debts	1,000,000	19,000,000
2021: Accounts receivable	15,000,000	
Less: Provision for doubtful debts	700,000	14,300,000

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Exercise 4.2

Mrs Krishna Patel is a wholesaler. Patel is worried about an increase in default of her trade receivables in the future. Following a prudent principle, Mrs Patel decides to make a provision for trade receivables equivalent to 2% of outstanding trade receivables at the reporting date from 30th September 2020. On 30th September, 2021, Patel determines that, the previous provision for bad debts has been overestimated and decides to recalculate it to be the equivalent of 1% of outstanding trade receivables. The balances of trade accounts receivables balances at the end of various accounting periods are as follows.

Dates	Sept. 30, 2020	Sept. 30, 2021	Sept. 30, 2022
TZS	30,400,000	34,200,000	42,800,000

Required

Show the following:

(a) Journal entries for three years to record transactions for the provision for doubtful debts.

(b) For each of the three years above, prepare the provision for doubtful debts account, statement of profit or loss account (extracts) and the statement of financial position (extracts) as at the end of each year.

Provision/allowance for discount on debtors

In practice, business enterprises allow cash discounts to their customers as a means of encouraging them to pay their debts on time. The discount period may spill over into the following accounting period for the sales made during the current year. Since it is not certain that the debtor will pay the business on time, it is also prudent to provide for possible loss in terms of discounts allowed to debtors who will pay the business within the prescribed discount period. Accounting treatment for provision for discount on trade receivables/debtors is treated in the same way as provision for doubtful debts. Their difference is on the computation of provision for discounts on debtors which is based on the "good debtors"; that is, after deducting the provision for doubtful debts.

Provision for discount on debtors is created by debiting the statement of profit or loss and crediting the provision for a discount on debtors account. Any increase or decrease in provision is adjusted through the provision for discount on debtors. In the statement of financial position, the balance of the provision for discount on

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debtors account is deducted from the trade receivables figure after deducting the amount for provision for doubtful debts. Finally, the amount for discount allowed can be posted directly to statement of profit or loss as an expense; or can be debited to the provision for discount allowed.

Example 4.4

The provision for discount on debtors' accounts showed a credit balance of TZS 1,000,000 on 1st January 2020. In 2020, the discount allowed to debtors was TZS 850,000. On 31st December 2020 debtors totalled TZS 24,000,000 on which a provision of 5% for doubtful debts and 2% for the discount was considered necessary. During 2021, the discounts allowed were TZS 400,000 and sundry debtors were TZS 30,000,000 on 31st December 2021. The same percentage of provision for doubtful debts and discounts was maintained.

Required

Prepare the provision for the discount allowed account for the two years, 2020 and 2021.

Solution 4.4

Calculations:

(i)	Sundry debtors on 2020	24,000,000
	Less: Provision for doubtful debts (5%)	1,200,000
	Good debtors	22,800,000
	Therefore, Provision for discount =	22,800,000
	(Multiplied by 2%)	x 2
		570,000
(ii)	Sundry debtors on 2021	30,000,000
	Less: Provision for doubtful debts (5%)	1,500,000
	Good debtors	28,500,000
	Therefore, provision for discount =	28,500,000
	(Multiplied by 2)	x 2
		712,500

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Dr. **Provision for discount allowed account** **Cr.**

Date	Details	Amount	Date	Details	Amount
2020			2020		
Dec. 31	Discount allowed	850,000	Jan. 1	Balance b/d	1,000,000
Dec. 31	Balance c/d	570,000	Dec. 31	Profit or loss	420,000
		1,420,000			**1,420,000**
2021			2021		
Dec. 31	Discount allowed	400,000	Jan. 1	Balance b/d	570,000
Dec 31	Balance c/d	712,500	Dec 31	Profit or loss	542,500
		1,112,500			**1,112,500**
			2020		
			Jan 1	Balance b/d	712,500

Exercise 4.3

1. Provide detailed view on reserves and reserves funds, and differentiate the two terms as used in accounting.
2. What are the various objectives of creating reserves?
3. Explain the difference between provisions and reserves as used in accounting.
4. The book of Hassan and Kambanga Partnership shows bad debts of TZS 2,600,000 in 2020. The provision for doubtful debts at the beginning of the year was TZS 3,500,000 and sundry debtors at the end of 2020 stood at TZS 60,000,000. The partnership maintains a provision for doubtful debts at 5% on sundry debtors. During the year 2021, the amount of bad debts was only TZS 800,000, and debtors' amount at the end was TZS 30,000,000.

Required:

From the information given you are required to prepare the following accounts:

(a) Provision/allowance for doubtful debts.

(b) Statement of profit or loss and other comprehensive income statement (extract).

Chapter summary

This chapter main focus was about accounting for reserves and provisions. Reserves has been defined as part of profits or gains set aside to achieve different business objectives such as paying bonuses, repairs and maintenance and settling expected legal issue. Provisions/allowances on the other hand, refers to any funds set

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aside from a company's profit to meet probable future expenses or reduction in the value of assets. Different types of reserves and provisions have been identified. Examples of reserves include, revenue reserves that are created from profits. This is differentiated from capital reserves, which are normally created from capital-oriented business transactions such as share premiums. By considering the purposes for which the reserve has been created, there is general and specific reserves. As the name suggests, the former is designed to meet/fulfil general or various needs of the business while the latter, for specific purpose.

Examples of provisions include, provision for doubtful debts and discount on debtors. The chapter has demonstrated that, accounting for reserves and provisions is one among the important adjustments that need to be dealt with appropriately at the end of accounting period. In line with this, proper accounting treatments in both the ledger accounts and financial statements have been well elaborated through illustrations and examples. Besides, a number of activities and exercises have been provided to enable students practice more to enhance their level of competencies as far as accounting for reserves and provisions is being concerned.

Revision exercises

1. What do you understand by reserves and provisions/allowances? Explain their different classes and give examples for each.
2. Explain the difference between the provision for discount on the debtors and the provision for doubtful debts.
3. What do you understand by the term recovered bad debts? Describe briefly its effect on the net profit of the business.
4. Why an allowance may be created for doubtful debts.
5. On 31st July 2022, total debtors amounted to TZS 24,300,000 but this required to be adjusted as follows:
   (a) Muya, a debtor, owing TZS 600,000 was known to be unable to pay and this amount was to be written off.
   (b) Mboni who owed the business TZS 1,200,000 was declared bankrupt and a settlement of 75% of the total debts was received, while the 25% remaining was treated as a bad debt.
   (c) Mbezi who was declared a bad debtor last year has paid the business TZS 625,000 as total debts.

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Required:

For the business, prepare the following:

(i) Journal entries to show the above transactions.

(ii) Ledger accounts to reflect the reported business transactions.

6. On 31st December 2022 Machibya Company decided to create a provision for bad debts of five percent of its debtors. After writing off bad debts, the debtors' figures at the end of each of three years were as follows:

Year	**TZS**
2019	12,000,000
2020	10,000,000
2021	15,000,000

You are required

To show for each year (ended 31st December):

(a) Provision for bad debts.

(b) The appropriate entries in the statement of profit or loss and other comprehensive income extracts.

(c) The necessary statement of financial position extracts on each of the above dates.

7. In the year 2019, the books of accounts of Nemganga Traders, a soft drink whole seller, showed the bad debts of TZS 800,000. The provision for doubtful debts at the beginning of the year stood at TZS 900,500 and the debtors' amount on 31st December 2019 was TZS 20,000,000.

(a) The firm maintains provisions for doubtful debts at 5%.

(b) During the year 2020, bad debts amounted to TZS 1,000,000 and on 31st December 2020, the debtors' figure was TZS 24,000,000.

(c) In 2021, the bad debts were TZS 400,000 and the debtors at the end of the year was TZS 14,000,000

Required

From the given information, prepare the following accounts:

(i) Provision for doubtful debts.

(ii) Statement of profit or loss and other comprehensive income extracts for those three years.

(iii) Statement of financial position extracts for those three years.

8. Mwigazi Mills debtors amounted to TZS 57,600,000 on 31st December 2021. The company decided to write off R. Nyundo and N. Sengo as bad debts amounting to TZS 720,000 and TZS 960,000 respectively.

The company's policy is to maintain a provision for doubtful debts at 10% of debtors' balance. On 31st

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December 2022, the debtors' balance was TZS 40,000,000.

Required

From the given information, prepare the following adjustments in the books of accounts of Mwigazi Mills.

(i) Provision for doubtful debts account.

(ii) Bad debt account.

9. You are the accounting officer of Sumuya Grocery. On 31st May 2022, which is the end of the firm's financial year, the business had a gross debtors' amount of TZS 4,042,000. At their year-end meeting, the board of directors decided to:

(a) Make a provision for bad debts of 2 after writing off the bad debts.

(b) Write–off Moshi, Jasinta and Janeth accounts, with bad debt amounts of TZS 110,000, TZS 210,000 and TZS 100,000 respectively.

Required

Supported with relevant accounting entries, explain how these transactions will be recorded in the final accounts at the end of the financial year.

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Chapter Five

Depreciation and disposal of non-current assets

Introduction

In this chapter you will learn about the concepts of depreciation and disposal of non -current assets and how the two relate to each other. You will also learn the different principles and methods used to determine depreciation and its recording in the books of accounts. The competencies developed will enable you to apply relevant principles of depreciation and disposal of non-current assets to determine the true and fair view of business performance and its financial position.

Nature and types of non-current assets

A non-current asset is an asset whose useful life is expected to last longer than one accounting period (at least a year). It is a resource an organization acquires with the aim of using in its business operations for a long term period, not available for resale. In summary, the key features of a non-current asset (fixed asset) are as follows:

(a) It is held for use in the production or supply of goods or services or for rental to others or for administrative usage,

(b) It is expected to be used for more than one accounting period/year.

Non–current assets can have either physical or non–physical presence. As a result, we have tangible non-current assets and intangible non-current assets. Tangible assets as the ones that can be vividly seen, touched or felt. In contrast, intangible assets means that, they cannot be seen, touched or felt. Tangible non-current assets including land, building, machinery, vehicles computers and other equipment are commonly known as property plant and equipment (PPE). Examples of intangible assets include, goodwill, patents, trademarks and copyrights.

The third category of non-current assets are termed as natural resources. These include resources that occur naturally, and are derived from the earth. Examples of natural resources include timber, fossil fuels, oil fields and minerals. Natural resources are also known as wasting assets since once removed from the ground or physically consumed they can not be replaced. As a

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matter of illustration, reference is made by focusing on natural gas to show how natural resources can be recorded in the books of accounts. This type of non-current asset must be mined or pumped out of the ground for it to be used as source of energy or fuel. The value of natural gas is usually recorded on the balance sheet at the cost of acquisition plus exploration and development costs, less accumulated depletion. Depletion is a process of allocating the cost of extracting natural resources until their exhaustion similar to depreciation a used in accounting for PPE. As for intangible assets, the allocation/charging of expenses over their useful time is called amortization.

In this book however, we will focus more on the meaning and use of depreciation to account for PPE, how it effect their valuation and relevant entries in the books of accounts until their disposal.

Valuation of non-current assets

For accounting treatment, any expenditure associated with the acquisition of non-current assets is categorized as capital expenditure. Remember, a non-current asset can be acquired either through purchasing of a ready-made asset or through self-construction. Examples of expenditure incurred for acquisition of non-current assets include payments for purchasing land, ready made building, and furniture and equipment. It also includes payment for acquisition of intangible assets like goodwill, patents and trademarks. A good example of the self-constructed asset is construction of an office building or a showroom using own resources. Furthermore, all costs incurred in bringing a non-current asset to a point it is ready for use are capitalised; they are considered to be part of the cost of an asset. Examples of such expenses, in addition to the price paid, include transport/inward cost, fees paid to a lawyer in relation to asset acquisition and asset installation costs.

In the books of accounts, the valuation of non-current asset is done initially at cost and subsequently, using cost or revaluation model. Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction. Where applicable, it is the amount attributed to that asset when initially recognised in accordance with the specific requirements of the standards for the determination of the cost of the asset. The following example provides alternative costing approaches for recognition of an asset in the books of accounts:

(a) Cost as the amount paid to acquire the asset; a firm pays TZS 500,000 to buy a table, or

(b) The value of anything else given in exchange for the asset; a firm gives out a computer with the fair value of TZS 1,500,000 in order to get a table, or

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(c) The valuation method given by other standards for something given in exchange for the asset; a firm gives out a share options worth TZS 900,000 to get a table in return.

Since tangible non-current assets are normally used for more than one year, an entity may incur subsequent cost in the life span of an asset apart from the initial acquisition cost. In this case, the costs of an asset are usually categorised into two types, the initial costs and subsequent costs. Initial costs are those which are incurred during acquisition of an asset for the first time while subsequent costs are those incurred to maintain the asset or to renovate or upgrade it.

Initial costs and accounting for acquisition of non – current assets

These are the costs incurred initially for bringing the asset to the location and in the condition necessary for its intended use. These include acquisition costs, construction costs, and erection costs of the non-current asset. Non-current assets such as property, plant and equipment qualifying for recognition as an asset are initially measured at their acquisition cost. In establishing initial costs of a non-current asset, the following costs are included:

(a) The purchase price.

(b) Costs directly attributable to bringing the asset to its location and in the condition so as to make it available for its intended use,

(c) Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

In contrast, the following costs are NOT included in the definition of cost of non-current asset as defined above:

(a) Administration and general overhead costs; such as office rent.

(b) Costs of launching a new product or service; such as advertising.

(c) Expenses on opening a new business facility or conducting business at a new place e.g., expenses of an inaugural function.

(d) Costs of relocating e.g., costs of shifting a factory following a government order.

(e) Initial losses when the asset operates at a low capacity. For instance, a plant has a capacity of 1,000MW, but initially it operates only at 400MW capacity. If at that operating capacity the generated gross profit is not sufficient to cover fixed costs the loss is not included.

(f) Costs of incidental operations not necessarily related with bringing the asset to its required location and condition. In this case, the asset is capable of operating in the manner intended by management even without such operations.

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As for the accounting entries, the acquisition of non-current assets will be recorded in ledger accounts as follows:

Dr. Non-current asset	xxx	
Cr. Cash / Bank/Payables / other asset		xxx

Example 5.1

Mbasha Holdings Limited is a manufacturer of furniture. The company acquired machinery on 1st January 2022 for TZS 50 million – paying cash for this. On 1st February 2022 the company bought a drilling machine for TZS 6 million – paid by cheque. On 30th June 2022, the company bought on credit a transit van from Tony for TZS 25 million. On 30th September 2022, the company purchased plywood for TZS 3 million in cash.

All transactions of a capital in nature are first recorded in the books of prime entry and then posted to the ledger accounts. The ledger accounts for non – current assets of Mbasha Holding will appear as follows:

Mbasha Holdings Limited

Dr. **Machinery account** **Cr.**

Date	Particulars	TZS "000"	Date	Particulars	TZS "000"
Jan. 1, 2022	Cash	50,000	Dec. 31, 2022	Balance c/d	56,000
Feb. 1, 2022	Bank	6,000			
		56,000			56,000
Jan. 1, 2023	Balance b/d	56,000			

Dr. **Transit van account** **Cr.**

Date	Particulars	TZS "000"	Date	Particulars	TZS "000"
June 30, 2022	Tony account	25,000	Dec. 31, 2022	Balance c/d	25,000
		25,000			25,000
Jan. 1, 2023	Balance b/d	25,000			

Note the following:

(a) The purchase of plywood is not a non-current asset, so it is not shown in the above ledger account. It will be debited to the raw materials purchase account. This is a matter of fact unless otherwise justified.

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(b) The machinery purchased in January and the drilling machine purchased in February are recorded in the same ledger account as they are of the same class, i.e., machinery whereas vehicle is recorded in a separate transit van ledger account.

Measurement of cost after initial recognition of assets

After initial recognition of an asset, an entity can choose to recognise non-current assets using either the cost model or the revaluation model depending on its accounting valuation policy. Whichever valuation model that will be chosen, it shall be applied to an entire class of property, plant and equipment.

(i) Cost model

In this model, after initial recognition of a non-current asset items such as property, plant and equipment, that asset is carried at its initial cost less any accumulated depreciation and any accumulated impairment losses. Accumulated depreciation means that, the amount is charged for the use of an asset in an ordinary operating environment since its acquisition to a point where the valuation takes place. An impairment loss refers to a significant fall in the value of an asset due to reasons other than ordinary usage of such assets. Such reasons may include but not limited to time passage, physical damage of an asset, and technological changes.

(iii) Revaluation model

In this model, after recognition of an asset for the first time, an item of property, plant and equipment whose fair value can be measured reliably is required to be carried at a re-valued amount. Such a re-valued amount is the fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. It is important that revaluation is done regularly to ensure that the carrying amount does not differ materially from the value that would be determined using fair value at the end of the reporting period. The carrying value is measured as the original cost of the asset, minus accumulated depreciation, amortization or impairment costs made against the asset

When an entity uses revaluation model, the intention is to establish the fair value of an asset. The fair value of an asset is found if there is a market-based evidence from registered property valuers. Alternatively, it can also be determined by using income or a depreciated replacement cost approach. The income approach considers the present value of the future economic benefits or cash flows from the use of an asset while depreciated replacement cost refers to the cost required to acquire similar asset at the date of valuation less accumulated depreciation charges.

If it happens that, the carrying value of an asset increases as a result of

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a revaluation, the increment is recognised in the income statement as other comprehensive income and it is accumulated in the equity under the heading of revaluation surplus. The increase shall be recognised in the profit or loss statement to the extent that it reverses a revaluation decrease of the same asset previously recognised in the profit or loss. However, if an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in the profit or loss statement. The decrease is recognised in the part of other comprehensive income to the extent of any credit balance existing in the revaluation surplus associated with that asset. It is meant to reduce the amount accumulated in equity under the heading of revaluation surplus.

Example 5.2

Chiboko Ltd has a machine BX which has a carrying value of TZS 80,000,000. However, after revaluation the machine was re-valued at TZS 88,000,000. In the previous revaluation, which is the last year, its value was decreased by TZS 5,000,000.

Required

Show the accounting adjustments.

Solution 5.2

Increase in the value due to revaluation is TZS 8,000,000 (TZS 88,000,000 – TZS 80,0000,000). The previous reduction of TZS 5,000,000 must have been recognised in the profit or loss part of statement of profit or loss and other comprehensive income. The following journal entry should now be made:

Dr. Machine BX	TZS 8,000,000	
Cr. Revaluation loss (P & L)		TZS 5,000,000
Cr. Revaluation surplus		TZS 3,000,000

Being accounting entries to record the increase in the value of machinery.

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Example 5.3

The carrying value of machine AY is TZS 60 million, but following a revaluation, it is valued at TZS 50 million. On the previous revaluation, which was done last year its value was increased by TZS 7 million (the amount in the revaluation surplus).

Required

What would the accounting entries be?

Solution 5. 3

The revaluation exercise decreased the value of machine AY by TZS 10 million (TZS 60 million – TZS 50 million). The credit balance in revaluation surplus against this asset is TZS 7 million. The following entry will be recorded:

Dr.	Revaluation surplus (in equity)	TZS 7,000,000	
Dr.	Loss on revaluation (P & L part)	TZS 3,000,000	
Cr.	Machinery		TZS 10,000,000

Being revaluation decrease transferred to machinery account.

Exercise 5.1

1. With examples explain the meaning of non-current assets. Your explanation should also discuss whether physical existence is essential in the definition of non-current assets.
2. Classify the assets of Sunflag Limited listed below as natural resources, tangible or intangible non-current assets:
   (a) Patents,
   (b) Machinery,
   (c) Copyrights,
   (d) Building held for sale,
   (e) Computers used at the office,
   (f) Vote-book financial management information system,
   (g) MUSE financial management information system,
   (h) Land and building,
   (i) Trucks,

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(j) Accounting package software,

(k) Cultivated forests (i.e., plantations),

(l) Natural gas.

3. In the initial valuation of non-current assets, there are some costs which can be included in addition to the purchasing price. With examples, explain which cost can be included and which ones cannot.

Nature and objectives of depreciation

Nature of depreciation

Generally, depreciation refers to the actual decrease of the fair value of an asset. For example, value of a machine or equipment may decrease each year as it is used in generating income or due to different reasons such as wear and tear. The concept extends to include the process of allocating a share of the costs of non-current assets in each accounting period to reflect the use of an asset in generating revenue in line with the matching concept. Allocation of an asset's depreciable is usually done very systematically over its useful life. Therefore, the depreciable amount is the cost of an asset or other amount substituted for cost less its residual or scrap value. For example, if the machinery cost is TZS 78,000,000 and its residual/scrap value is TZS 6,000,000, then the depreciable cost is TZS 72,000,000 (i.e., 78,000,000-6,000,000).

Determination of depreciation will start when the assets is made available for use i.e., it is in the location and condition necessary to be used/operated in the manner intended by management. Once the depreciable amount is established, it has to be allocated on a systematic basis over its useful life. Along with this, the residual value and the useful life of an asset shall be reviewed at least at each financial year-end, and if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate. By definition, the useful life of an asset is the period over which an asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity. Based on this, the useful life can be considered either in terms of number of years or in terms of number of units expected to be produced by the asset. On the other hand, the residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, when the asset is at the age and in the condition expected at the end of its useful life.

When charging depreciation on PPE, each part of these items is charged separately

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provided that it has significant cost in relation to the total cost of the items. The allocation of depreciation on an asset will continue as long as an asset is in use. It does not cease even if the asset becomes idle or is retired from active use unless the asset is fully depreciated. Recognition of depreciation continues even when the fair value of the asset exceeds its carrying amount, provided that the residual value does not exceed its carrying value. Similarly, repair and maintenance of an asset do not negate the need to depreciate it. However, depreciation charge can be zero when an organisation charges depreciation based on number of units produced, particularly when there is no production.

If it happens the residual value of an asset increases to an amount equal to or greater than the asset's carrying amount, the asset's depreciation charge is zero till when its residual value subsequently decreases to an amount less than asset's carrying amount. Depreciation charge can cease, but only when an asset is withdrawn from ordinary usage and classified differently (held for sale). It ceases at the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) and the date that the asset is derecognised, i.e., removed from the entity's statement of financial position.

Example 5. 4

Determine whether depreciation will be charged or not in the following scenarios:

1. The carrying value of the machine is TZS 40,000,000 and its residual value is TZS 20,0000,000. Its fair value is TZS 50,000,000.
2. The carrying value of the machine is TZS 20,000,000 and its residual value TZS 21,000,000.

Solution 5.4

1. In this scenario, depreciation will be charged because the carrying value exceeds the residual value i.e., TZS 40,000,000 > TZS 20,000,000, despite the fact that, the fair value of TZS 50,000,0000 exceeds the carrying value, TZS 40,000,000.
2. In this case, the depreciation charge will be zero because the residual value of TZS 21,000,000 > the carrying value TZS 20,000,000.

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Activity 5.1

Mkaka Enterprises Limited has equipment which is in working condition with valuation of TZS 120,000,000. The equipment was classified as held for sale on 2nd April, 2022. The financial statement of the company ends on 31st December, 2022.

Required

Briefly explain if this equipment will be recognized in the financial statements and subsequently depreciated.

Objective of charging depreciation on non-current assets

Businesses hold non-current assets in order to support the generation of revenue. For instance, a manufacturing firm may need to construct or rent a factory building in order to fix manufacturing machines for production. Producers maintain warehouses to store finished goods ready for resale. In the course of production or storage, these assets lose value. Thus, it may be useful to think of depreciation as a charge of the cost of those items which improve the revenue-generating capacity against the profit of the business. Non-current assets are acquired at a cost. However, it would be incorrect to charge the whole cost in the first year of purchase. The asset is going to help generate income for many years. The matching principle in accounting requires that the expenses be recognised in the year in which the revenue is earned (cost is matched with the relevant revenue). If the revenue from an asset is going to be earned over a number of years, then its cost should also be allocated over the same number of years. Hence, it is logical to charge the cost of an asset to revenue over the useful life of the asset. Physical wear and tear and obsolescence also result in the depreciating value of an asset.

As it is for other costs such as material and labour, the depreciation on non-current assets is meant to match the use of an asset with the sales revenue. Thus, the purpose is not to record the decrease in the value of an asset as it would occur from the adjustment of revaluations. Also, the purpose of depreciation is not to set aside some funds to replace the asset at a later stage. Instead, it is a fact that indirectly, the profits are reduced by the depreciation amount.

Causes of depreciation

Depreciation is caused by various factors which give rise to a reduction in the value of a tangible non-current asset. These include physical deterioration, economic factors, time and depletion.

Physical deterioration

The physical deterioration of a tangible non-current asset may be due to wear and tear and erosion, rust or decay. Wear and tear are very common in tangible non-current assets. When assets such as

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motor vehicle, machinery, fixtures and fittings are used, their physical conditions deteriorate, hence they wear out. Metals in motor vehicles or machinery will rust away while wood will eventually rot. Decaying of an asset can be due to elements of nature or the lack of proper attention. Therefore, some of the tangible non-current assets last many years, while others last for only a few years. The same applies to buildings, of which some are lasting for a longer time. For the case of land, it may be eroded or wasted away by the action of wind, rain, sun and other elements of nature.

Deterioration due to economic factors

Depreciation is caused by economic factors when a non-current asset owned by a business being put out of use even though its physical condition is still good. The two main economic factors are usually obsolescence and inadequacy. Obsolescence occurs when an asset is put out of use because it is out of date (outdated). For instance, the development in science and technology caused significant evolution in the electronic devices used in the commercial music industry. The usefulness life of such equipment becomes so short not because of physical deterioration. For instance, the moment a new version of music instrument is released the old equipment becomes obsolete, hence taken out of use by musicians. The other economic factor causing depreciation is inadequacy, which arises due to the asset's low capacity compared to prevailing economic demands. This happens when an asset is no longer used because its capacity cannot cope with the growth and changes in the size of the business. The replacement of the old Wami bridge with a larger and stronger bridge to cope with increasing vehicle traffic is an example of depreciation of the old bridge due to inadequacy. The same example applies with the replacement of the old ferry/boat at Kigamboni due to increasing passengers in the area.

Time passage

Time is a factor that causes depreciation of non-current assets, particularly when its usage access is time bound. Even in the case of wear and tear, erosion, etc., and for obsolescence and inadequacy to take place, time is needed. However, there are non-current assets whose usage is connected with the time in a different way. It includes the right to use assets which have a legal life fixed in terms of years. Once the years elapse, such assets are considered to have been depreciated. The term *amortization* is applied instead of depreciation in those assets whose usage is connected with time.

Exercise 5.2

1. Write short notes on the following terms:
   (a) Residual value,
   (b) Depreciable amount,
   (c) Useful life,
   (d) Carrying amount.

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2. Explain the relationship between depreciation of non-current assets and matching concept.
3. Give example of three types of assets whose legal usage is fixed in terms of specific time period.

Methods for estimation and accounting for depreciation

There are various methods that can be adopted to charge depreciation of an asset. These methods include, but not limited to, the straight-line method, the diminishing balance method and the units of production method. However, the choice of a depreciation method will depend on the pattern in which an asset is used or it is expected to be used to generate future economic benefits over its useful life. Once a certain method is opted it has to be applied consistently from time to time, unless there is a change in the expected pattern of those future economic benefits.

Straight-line Method

Straight-line method of depreciation is the method which results into a constant depreciation charge over the useful life provided that residual value of an asset does not change. It is calculated as a fixed amount or fixed percentage of the depreciable value of the asset. The computation formula is as follows.

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{residual value}}{\text{Estimated life of asset}}$$

Example 5.5

Tanapa Company Ltd bought machinery on 1st January 2022 for TZS 260,000,000. It incurred transportation and installation expenses of TZS 20,000,000 in connection with the machinery. Tanapa Company Ltd expects the useful life of the asset to be 6 years. The estimated realisable value after 6 years is expected to be TZS 10,000,000.

Required

Compute the depreciation and the carrying values for the six years.

Solution 5.5 [all figures in TZS "000,000"]

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{residual value}}{\text{Estimated life of asset}}$$

The carrying values at the end of each year over the six years period will be as follows:

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Years	TZS "000"	Carrying value TZS "000"
1st year	TZS280,000 – TZS45,000	235,000
2nd year	TZS235,000 – TZS45,000	190,000
3rd year	TZS190,000 – TZS45,000	145,000
4th year	TZS145,000 – TZS45,000	100,000
5th year	TZS100,000 – TZS45,000	55,000
6th year	TZS55,000 – TZS45,000	10,000

Notes

1. The carrying value is equal to the disposal or realisable value at the end of its useful life.
2. In case the depreciation rate is applied on a percentage basis, it is applied on original cost instead of the carried down value (net of depreciation). For the case of this example the depreciation rate in percentage would be 16.67% on the depreciable cost based on the straight-line method. Then, the amount of depreciation for each year would be TZS 45,000,000, calculated as 270,000,000 x 16.67%. The rate 16.67% is calculated as:

Solution 5.5 [all figures in TZS "000,000"]

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{residual value}}{\text{Estimated life of asset}}$$

$$\text{Depreciation} = \frac{(\text{TZS } 260 + \text{TZS } 20) - \text{TZS } 10}{6} = \text{TZS } 45$$

The carrying values at the end of each year over the six years period will be as follows:

Years	TZS "000"	Carrying value TZS "000"
1st year	TZS280,000 – TZS45,000	235,000
2nd year	TZS235,000 – TZS45,000	190,000
3rd year	TZS190,000 – TZS45,000	145,000
4th year	TZS145,000 – TZS45,000	100,000
5th year	TZS100,000 – TZS45,000	55,000
6th year	TZS55,000 – TZS45,000	10,000

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1. The carrying value is equal to the disposal or realisable value at the end of the asset's useful life.
2. In case the depreciation rate is applied on a percentage basis, it is applied on original cost instead of the carried down value (net of depreciation). For the case of this example the depreciation rate in percentage would be 16.67% on the depreciable cost based on the straight-line method. Then, the amount of depreciation for each year would be TZS 45,000,000, calculated as 270,000,000 x 16.67%. The rate 16.67% is calculated as:

$$\frac{\text{Depreciation amount per year}}{\text{Total depreciable cost}} \times 100 \quad = \frac{45{,}000{,}000}{270{,}000{,}000} \times 100 = 16.67\%$$

Note: The amount of depreciation remains constant in this method.

Diminishing or reducing balance method

The diminishing balance method is an approach which charges different amount of depreciation in every year. The amount is decreasing from year to year over the useful life of an asset. It is calculated as a percentage of the written down or book value of the asset i.e., cost minus accumulated depreciation. The method is also known as the reducing balance method.

Depreciation = (Cost – Accumulated depreciation) x Depreciation rate

Example 5.6

Sunflower Limited purchased machinery for TZS 100,000,000 on 1st January 2022. Its expected useful life is 4 years and the residual disposal value is TZS 12,960,000. The company charges depreciation at 40% using the reducing balance method.

Required

Calculate the depreciation charge for the four (4) years and show the carrying value at the end of each year over the four (4) years.

Solution 5.6

The calculation of the depreciation and carrying amount for each year is as follows:

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Year	Particulars	Calculation TZS "000"	Depreciation TZS "000"	Carrying value TZS "000"
1st year	Depreciation	100,000 x 40%	40,000	60,000
2nd year	Depreciation	60,000 x 40%	24,000	36,000
3rd year	Depreciation	36,000 x 40%	14,400	21,600
4th year	Depreciation	21,600 x 40%	8,640	12,960

Note: As seen in the solution, the depreciation charge is decreasing from 1st year to 4th year of the asset. In the 1st year, it was TZS 40,000,000, however, it gradually decreased to TZS 8,640,000 in the 4th year.

Under the reducing balance method of depreciation, the carrying value of an asset at the end of its useful life is equal to the disposal or realizable value. Suppose you are given the salvage value (s), number of useful life (n), original cost of asset (A), the rate of depreciation (r) to apply then can be calculated using the following formula:

$$r = 1 - \sqrt[n]{\frac{S}{A}}$$

Note that, the salvage value s must be a significant amount or else the answer will be meaningless as the rate of depreciation will amount to nearly one.

Using the Sunflower example, we can compute the rate of depreciation as follows:

$$r = 1 - \sqrt[4]{\frac{12,960,000}{100,000,000}} = 1 - 0.6 = 0.4 = 40\%$$

The following table provides the comparison between the straight-line method and the reducing balance method:

Table 5.1: *Comparison between straight line and reducing balance methods of depreciation*

Straight line method	Reducing balance method
It calculates a fixed amount of depreciation on the asset each year and charges the amount to the statement of profit or loss.	It calculates a higher amount during the initial years when the machine is new and efficient and a lower amount in later years. The calculated amounts are accordingly charged to the statement of profit or loss each year.

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It is suitable for assets which give the same efficiency year after year e.g., a building is used equally over the years.	It is suitable for assets which give a higher efficiency in earlier years and a lower efficiency in later years e.g., machinery used in various manufacturing processes and motor vehicles
If repairs increase in later years, the charge of depreciation plus repairs increases each year (since the depreciation is constant).	The charge of depreciation plus repairs is expected to be the same over the years. In the initial years when repairs are low, depreciation is high, and in later years when repairs are high, depreciation is low.
It is simple to understand and operate.	It is relatively difficult to understand and operate.

The units of production method

In the units of production method, the depreciation charge depends on the units of output; it charges depreciation based on the expected use of an asset or output. The method is appropriate when the economic benefits derived from the assets are proportional with the units produced and the pattern of production is not uniform from time to time. Therefore, the depreciation charge is reflecting the use of an asset to produce a certain level of output. The cost of the non-current asset is allocated proportionally to the production achieved, as shown in following formula:

$$\text{Depreciation rate} = \frac{\text{Cost of the asset - residual value}}{\text{Total estimated units of output}}$$

Example 5.7

On 1st January, 2017 Chapakazi Ltd bought a new machine for TZS 100,000,000. The machine was estimated to have a working life of 5 years and at the end of its useful life the realisable value was estimated to be TZS 20,000,000. The company is expected to produce 800,000 units of output over its useful life while the actual production was as follows:

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Years	Actual production (units)
2017	150,000
2018	200,000
2019	190,000
2020	150,000
2021	110,000

Required

(i) Calculate the depreciation provision under the units of production method.

(ii) Show the depreciation schedule and the carrying value of the asset at the end of each year.

Solution 5.7

(i) Depreciation rate

$$= \frac{\text{Cost of asset–Estimated residual value}}{\text{Total estimated units of outputs}} = \frac{\text{TZS } 100{,}000{,}000 - \text{TZS } 20{,}000{,}000}{800{,}000}$$

TZS 100 per unit. Thus, the depreciation rate is TZS100 per unit of output.

(ii) The value of TZS 100 per unit is now multiplied by the number of units of output each year as shown in the following table:

Depreciation schedule

Year ended	Production (in units)	Annual depreciation (TZS ”000”)	Carrying value (TZS”000”)
01/01/2017	-	-	100,000
31/12/2017	150,000	15,000	85,000
31/12/2018	200,000	20,000	65,000
31/12/2019	190,000	19,000	46,000
31/12/2020	150,000	15,000	31,000
31/12/2021	110,000	11,000	20,000

Note: the carrying value on 31st December, 2021 is exactly TZS 20 million which is the selling value of the asset is expected to fetch at the end of its useful life.

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Sum of the years' digits

The sum of years' digits method depreciates the non-current assets at a faster rate than the straight-line method, but less than the reducing balance method. It charges higher depreciation expense in the early years of an asset's useful life and declines from year to year. It is most suitable when the value of an asset declines much in the early years of its useful life. The calculation of the depreciation is obtained by dividing the remaining useful life of an asset by the sum of the years of the expected useful life. Thereafter, it is multiplied by the depreciation base to determine the depreciation expense.

Example 5.8

Kibaba Ltd purchased an asset costing TZS 30,000,000 last year, which will be in use for 5 years. The calculations of the depreciation over the five years using sum of the years' digit will be as follows:

Duration	Years
Purchase date to end of asset useful life	5 years
Second year to end of asset useful life	4 years
Third year to end of asset useful life	3 years
Fourth year to end of asset useful life	2 years
Fifth year to end of asset useful life	1 year
Sum of these digits	**15**

The computation of the depreciation for each year is as shown below:

Calculation of depreciation	Amount in TZS "000"
1^{st} year = 5/15 of TZS 30,000,000 is charged =	10,000
2^{nd} year = 4/15 of TZS 30,000,000 is charged =	8,000
3^{rd} year = 3/15 of TZS 30,000,000 is charged =	6,000
4^{th} year = 2/15 of TZS 30,000,000 is charged =	4,000
5^{th} year = 1/15 of TZS 30,000,000 is charged =	2,000

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Revaluation method

Previous methods of calculating depreciation assume fewer and high value non-current assets. With fewer non-current assets, it is not difficult to write up the necessary accounts for depreciation for each item. However, some businesses, because of their nature and the kind of activities they carry out, maintain low-cost non-current assets. Engineering and garage businesses for instance, have a lot of spanners, screw drivers, small tools and other low-cost non-current assets. Similarly, hospitals and medical laboratories have glass items and smaller instruments such as test tubes and glasses. With these non-current assets, depreciation charges can better be determined using the revaluation method. The principle applied is to revalue these items at the beginning and end of the financial year. The difference is the depreciation to be charged in the statement of income.

Example 5.9

Tibakanya Timber Ltd which operate in Kasenyi deals with production of timber and resale. It maintains a number of small tools including chain-saws and screw drivers to facilitate production of timber. The following information relates to these items as at 31st Dec. 2021

January 1, Chain saws and other tools valued at	TZS 4,600,000
During the year, chain saws and tools purchase costed	TZS 12,400,000
Dec 31, Chain saws and other tools were valued at	TZS 5,800,000

Deprecation on non-current assets can be calculated as follows:

Valuation at Jan 1	4,600,000
Add: Items bought during the year	12,400,000
- Total valuation available	17,000,000
Less: Valuation at closing date, Dec. 31	5,800,000
Depreciation for the year (to profit or loss statement)	11,200,000

The information can be summarized in a T account as follows:

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Dr. **Chain saws and tools A/C (in TZS "000")** **Cr.**

2021 Jan. 1:	Inventory b/d	4,600	2021 Dec. 31:	P/L	11,200
Dec. 31:	Cash (bought during the year)	12,400	Dec. 31:	Bal c/d	5,800
		17,000			17,000
2022 Jan. 1:	Balance b/d	5,800			

Exercise 5.3

KB medical laboratory started business on Jan 1, 2019. The following transactions relate to test tubes and other glass instruments:

1. Jan 1, 2019, bought test tubes and glass instruments costing TZS 9,700,000
2. Estimated value of test tubes and other glasses instruments at 31 Dec., 2019 amounted to TZS 7,800,000
3. Tubes and glass instruments bought during the year ended 31 Dec., 2020 costed TZS 18,600,000
4. Estimated value of test tubes and other glasses instruments at 31 Dec., 2020 amounted to TZS 22,800,000
5. Items bought in the year to 31 Dec., 2021 costed TZS 12,300,000
6. Estimated value of items in hand at 31 Dec., 2021 was TZS 29,800,000

Required

Prepare T–account to record the transactions and transfer of depreciation to profit or loss statement for the years ended 2019, 2020 and 2021.

Depreciation provisions and the replacement of assets

There is a widespread misconception that making a provision for depreciation means that, money is invested somewhere to finance the replacement of the asset when it is put out of use. Depreciation is simply a bookkeeping entry, and the end result is that, it lowers the net profits as the provisions have been charged to the income statement. Nevertheless, it is not surprising to find misconception regarding this among many people including, accounting students, teachers and accountants. They often think that, a provision is the same as money kept or invested somewhere with which to replace the asset eventually. Never make that mistake – in fact businesses do not do so in practice. Usually, businesses use the money to finance working capital to generate higher returns than keeping it. Cash can better be used in terms of re-investing in banks or other securities to generate more wealth for the owners.

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Besides, with the availability of long-term financing from banks and other financial markets, it has become practically easier for businesses to borrow funds for buying non-current assets at relatively lower cost and at short notice. This has made the issue of maintaining a sinking fund expensive, outdated and unnecessary. A cautious owner may take out less drawings if the net profit is lower, but that is no justification for arguing that, depreciation results in funds being available to replace the fixed asset later on!

Exercise 5.4

1. Differentiate the sum of the years' digit method from revaluation as method of depreciation.
2. Explain the features of the units of production method of depreciation. Your explanation should include advantages and disadvantages of the method.
3. Explain circumstances under which revaluation method is applied to determine depreciation of non-current assets

Recording of depreciation in books of accounts

When preparing financial statements, especially the statement of profit or loss, the matching principle has to be adhered to. That is, income earned has to be matched with the expenses incurred to generate that income. Depreciation is part of these expenses which represent part of the cost of non-current asset that has been used in generating income.

After computing the depreciation charges for the period, it has to be recorded in books of accounts. Normally, a separate accumulated depreciation account is prepared for each group of non-current asset. This account is credited with the annual depreciation charges and debited to the specific non-current asset depreciation expense account. Depreciation expenses are then transferred to a statement of profit of loss as expenses. The balance of the accumulated depreciation for each non-current asset (which always has a credit balance) is then deducted from the corresponding cost or revalued amount of a non-current asset in the statement of financial position.

The following illustration shows how depreciation is recorded in books of accounts and its effect in the income statement and in the statement of financial position.

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Example 5.10

Mr. Mwakangale is in his farming business. On 1st April 2016 he purchased a Valmet tractor for TZS 80,000,000 and later on he bought a Massey Ferguson tractor for TZS 64,000,000 on 1st January 2017. The estimated useful life of the Valmet tractor is 10 years with a residual value of TZS 20,000,000 while the useful life of Massey Ferguson tractor is estimated to be 12 years with the residual value of TZS 16,000,000. Mr. Mwakangale uses a straight-line method of allocating depreciation per year and prepares his financial statements annually on 31st December.

Required

(a) Prepare the following ledger accounts:

(i) Tractors account,

(ii) Tractors depreciation account, and

(iii) Accumulated depreciations on tractors account.

(b) Show the depreciations charges as would appear in the income statements and the statement of financial positions for 2016, 2017 and 2018? (Allow for the part-year's use of a tractor in computing the annual charge of depreciation.)

Solution 5.10

(a) **Mwakangale Ledger Accounts will appear as follows:**

Dr. **Tractors account** **Cr.**

Date	Details	TZS	Date	Details	TZS
April 1, 2016	Bank	80,000,000	Dec. 31, 2016	Balance c/d	80,000,000
		80,000,000			**80,000,000**
Jan. 1, 2017	Balance b/d	80,000,000	Dec. 31, 2017	Balance c/d	144,000,000
Jan. 1, 2017	Bank	64,000,000			
		144,000,000			**144,000,000**
Jan. 1, 2018	Balance b/d	144,000,000	Dec. 31, 2018	Balance c/d	144,000,000
		144,000,000			**144,000,000**
Jan. 1, 2019	Balance b/d	144,000,000			

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Disposal of non-current assets

Disposal of non-current assets refers to the process involved in derecognising the non-current assets from the books of accounts. When non-current assets are acquired, they are recognised in the books of accounts and when they are disposed, they are derecognised from the books of accounts. The disposal can be due to winding up of the useful life of an asset or asset becoming obsolete or any other genuine reason. The following subsections discuss the nature, procedures and accounting treatment associated with the disposal of tangible non-current assets.

The nature of disposal of non-current assets

A non-current asset can be disposed of at any time from when it is acquired to the end of its useful life, despite the intention to use it to the end. A disposal of non-current asset can be done through discarding, selling or exchanging with another non-current asset. From accounting perspective, the disposal of non-current assets requires eliminating non-current assets from the books of accounts. It involves passing journal entries that results into completely removing the asset together with its corresponding records from the statement of financial position. This process is known as derecognition, which is the opposite of recognition made when the asset was acquired for the first time. Derecognition of a non-current asset is also required when it is stolen or lost because of unforeseeable events like fire or theft. The overall accounting concept behind disposal is to reverse the records associated with the asset, including accumulated depreciation, in the books of accounts.

Derecognition means that items of non-current assets such as property, plant and equipment which were recognised as assets of the business entity are removed from accounting records. The carrying value of a non-current asset is derecognised when the asset is disposed of or when no future economic benefits are expected from the asset. In case a non-current asset is disposed of for a consideration or price, it can result into gain or loss. The gain or loss is simply obtained by taking the difference between the net proceeds from the non-current asset and the carrying value (net book value) of an asset at the time of disposal.

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Exercise 5.5

1. Identify three possible ways of disposing a non-current asset, then provide their advantages and disadvantages.
2. Explain scenarios that may cause a non-current asset to be derecognised from the books of accounts.
3. Explain the reasons for derecognising a disposed non-current asset.

Accounting for disposal of non-current assets (fixed assets)

When a non-current account is disposed of, a disposal account is opened. The account is used to record all entries related to the disposal (or sale) of an asset. The account is also used to determine profit or loss on the disposal. When the current asset is disposed through sale, the accounting treatment will involve two main steps, which are (i) removal of the existing records associated with the asset from books of accounts and (ii) calculating profit or loss from the disposal.

The calculation of profit or loss from the disposal of an asset is very important because it is unlikely that, the asset will be disposed of (through sale) at the value that is equal to its carrying value. The amount of profit or loss from the disposal of an asset is included in the statement of profit or loss and other comprehensive income. Similarly, the firm is required to establish whether there is profit or loss when an asset is disposed through a part exchange deal. Part exchange deal is an agreement that facilitates the seller of a new asset to accept the old asset from the buyer as part of the payment of the new asset. For instance, the seller of the new cars or vans accepts an old asset as part of the considerations on the sale of a new car or van to the customer. In this case, organisation recognises the value of the new asset and derecognises the carrying amount of the old asset given out.

Generally, there are four events an entity must record in its books of accounts in relation to the disposal of non-current assets, which include the following:

(i) To eliminate the non-current asset from the books of accounts by crediting the non-current asset account. Asset disposal reduces the balance of the asset's account.

Dr. Asset disposal account	xxx	
Cr. Non-current asset account		xxx

Being removal of the non-current asset from the statement of financial position

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(ii) To close the accumulated depreciation account associated with the disposed off asset by debiting it.

Dr. Accumulated depreciation xxx

Cr. Non-current asset disposal account xxx

Being removal of accumulated depreciation from the statement of financial position

(iii) To record receipt of any proceeds from disposal of an asset, whether in the form of cash or another asset as part exchange.

Dr. Cash (Asset receivable) account xxx

Cr. Asset disposal account xxx

Recording cash receipt (receivable) on disposal of an asset.

(iv) To determine and to record any gain or loss from disposal.

This is done by balancing the asset disposal account, hence transferring the profit or loss to the income statement.

Disposal of non-current asset at the end of useful life

Usually, non-current assets are disposed at the end of its useful life. At that point, the carrying value of an asset is its salvage value. Therefore, when the proceeds from the disposal are equal to the net book value, then there is neither gain nor loss on disposal. Meanwhile, if proceeds from the sale exceed the net book value, there is a gain on disposal and its vice versa is a loss.

Example 5.11

On 1st January, 2021, the books of Sundra Co Limited had the following net book values in its two non-current asset accounts: plant account TZS 110 million and vehicle account TZS 25 million. The company sold the plant for a cash amount of TZS 30 million on 1st March, 2021 and on 1st December, 2021, the company's vehicle got accident. It was very unfortunate for the company that the motor vehicle was not covered by insurance. Based on company's policy, depreciation is charged on a full year basis using straight line method.

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Required

Prepare asset and asset disposal accounts for recording all these events.

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Solution 5.11

Sundra Company Limited

Dr. **Plant account** **Cr.**

Date	Particulars	TZS "000"	Date	Particulars	TZS "000"
Jan. 1, 2021	Balance b/d	110,000	March 1, 2021	Asset disposal a/c (note 1)	110,000
		110,000			110,000

Dr. **Vehicle account** **Cr.**

Date	Particulars	TZS "000"	Date	Particulars	TZS "000"
Jan. 1, 2021	Balance b/d	25,000	Dec. 1, 2021	Asset disposal a/c	25,000
		25,000			25,000

Dr. **Assets disposal account** **Cr.**

Date	Particulars	TZS "000"	Date	Particulars	TZS "000"
March 1, 2021	Plant	110,000	March 1, 2021	Cash a/c (note 2)	30,000
Dec. 1, 2021	Vehicle	25,000	Dec. 31, 2021	Loss on disposal (note 3&4)	105,000
		135,000			135,000

Notes

1. In the plant A/C, we credit the asset disposal A/C with the original cost of plant, and not the disposal value.

2. When an asset is disposed of, we record the cash received in the asset disposal A/C.

3. For the plant, the cost is TZS 110 million and the cash received on disposal is TZS 30 million. So, the difference is TZS 80 million, which is a loss. The vehicle, however, crushed in an accident and it had no insurance cover. So, the full TZS 25 million is also a loss. Therefore, a total of TZS 105 million (TZS 25 million + TZS 80 million) is a loss on disposal of assets.

4. Profit or loss on disposal of an asset is transferred to the statement of profit or loss.

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5. Depreciation is not considered in determining the profit or loss because both assets were used less than a year while depreciation was charged on a full year basis.

Example 5.12

On 31st Dec., 2021, which was the end of estimated useful life of a motor vehicle, Wananchi Company Limited sold a motor vehicle for TZS 3,000,000. The motor vehicle was bought for TZS 15,000,000 and its accumulated depreciation had a balance of TZS 12,500,000.

Required

Show the relevant journal entries for this transaction and the disposal account.

Solution 5.12

Wananchi Company Limited journal entries

Date	Description	Folio	Debit	Credit
31st Dec., 2021	Disposal of motor vehicle account Motor vehicles account To remove from books the disposal of motor vehicle		15,000,000	15,000,000
31st Dec., 2021	Accumulated depreciation on motor vehicle account Disposal of motor vehicle account Removal of accumulated depreciation from books of the disposed motor vehicle		12,500,000	12,500,000
31st Dec., 2021	Cash account Disposal of motor vehicle account To record receipt of proceeds from the disposed motor vehicle		3,000,000	3,000,000
31st Dec., 2021	Disposal of motor vehicle account Profit or loss To record gain on disposal of motor vehicle.		500,000	500,000

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Dr. **Motor vehicle disposal account** **Cr.**

Date	Details	Amount TZS "000"	Date	Details	Amount TZS "000"
Dec. 31, 2021	Motor vehicles Disposal gain	15,000 500 15,500	Dec. 31, 2021	Accum. depreciation Cash	12,500 3,000 15,500

Disposal of non-current asset before the end of useful life

A non-current asset may be disposed before the end of its useful life. When the non-current asset is sold in this scenario, it is necessary to be certain that depreciation has been provided for up to the time of sale. Usually, before recording the sale, an entry must be made to record depreciation up to the date of disposal. The depreciation figure will depend on the policy of the business, whether to record a partial or a full year's depreciation or none at all.

Example 5.13

On 1st April, 2022; Jitegemee Company Limited sold one of its machines for TZS 5,500,000 cash. The machine was bought on 4th July, 2019, for TZS 15,000,000 cash and expected to have a service life of five years, with no residual value. The business uses straight line method of depreciation.

Required

Show the relevant journal entries, accumulated depreciation account and machinery disposal account.

Solution 5.13

The question is silent on timing of depreciation charge; hence it is pro-rated accordingly. The journal entries will appear as follows:

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Jitegemee company journal entries

Date	Description	Folio	Debit	Credit
July 4, 2019	Machinery account Cash account To record acquisition of machinery for cash		15,000,000	 15,000,000
Dec. 31, 2019	Depreciation expenses Accumulated depreciation To record depreciation for half year		1,500,000	 1,500,000
Dec. 31, 2020	Depreciation expenses Accumulated depreciation To record depreciation for the year		3,000,000	 3,000,000
April 1, 2022	Depreciation expenses Accumulated depreciation To record depreciation for three months.		750,000	 750,000
April 1, 2022	Cash account Accumulated depreciation Disposal of machinery To record receipt of proceeds and closing off accumulated depreciation for the disposed machinery.		5,500,000 8,250,000	 13,750,000
April 1, 2022	Disposal of machinery Loss on disposal of machinery Machinery account To remove from the books the disposed machinery and record the loss on disposal of machinery.		13,750,000 1,250,000	 15,000,000

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Dr. **Accumulated depreciation on machinery account** **Cr.**

Date	Details	Amount TZS "000"	Date	Details	Amount TZS "000"
01st April 2022	Disposal of machinery	8,250	31st Dec 2019	Depreciation expense	1,500
			31st Dec 2020	Depreciation expense	3,000
			31st Dec 2021	Depreciation expense	3,000
			01st April 2022	Depreciation expense	750
		8,250			**8,250**

Dr. **Disposal of Machinery account** **Cr.**

Date	Details	Amount TZS "000"	Date	Details	Amount TZS "000"
01st April 2022	Machinery account	15,000	01st April 2022	Accumulated depreciation	8,250
				Cash	5,500
				Loss on disposal	1,250
		15,000			**15,000**

Activity 5.2

Consider two separate buildings in a school whereby one is used for classrooms and the other as administration block, then respond on the following questions:

(i) If the two buildings were constructed at the same time and have the same quality, will they have the same useful life? Explain with reasons.

(ii) With reasons, explain which of the depreciation methods covered in this chapter is appropriate to use in charging depreciation in each of the two buildings.

(iii) Explain possible way(s) for disposing the building once they reach the end of their useful life.

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Example 5.14

Majiji Secondary school had a pick-up truck that was purchased some years back for TZS 20,000,000. On 1st April, 2022 the school decided to dispose of the pick-up on a part exchange deal in addition to TZS 25,000,000 cash paid to acquire a new truck whose market value was TZS 32,000,000. At the time of disposal, the old pick up was valued at TZS 5,000,000 and its accumulated depreciation was TZS 14,000,000.

Required

Show the journal entries and ledger accounts to record disposal of the old truck and acquisition of a new pick-up truck.

Solution 5.14

The journal entries to record this event would be:

Date	Description	Folio	Debit	Credit
1st April 2022	New pick-up truck		30,000,000	
	Accumulated depreciation		14,000,000	
	Loss on disposal of pick-up truck		1,000,000	
	Cash account			25,000,000
	Pick-up truck (old)			20,000,000
	To remove from books the disposed old pick-up truck, record the loss on disposal of old pick-up truck, record acquisition of new pick-up truck and close accumulated depreciation of the disposed pick up.			

Notes

The new truck is recorded at TZS 30,000,000 (i.e., old–pick valuation of TZS 5,000,000 and cash consideration TZS 25,000,000) which is deemed to be its acquisition cost and not the market value of TZS 32,000,000. The loss on disposal resulted because the book value of the asset disposed was greater than its value at trade in.

The ledger accounts for recording disposal and acquisition of asset will appear as follows:

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Dr. Old pick-up account Cr.

Date	Details	Amount TZS "000"	Date	Details	Amount TZS "000"
1st April 2022	Balance b/d	20,000 20,000	1st April 2022	Disposal	20,000 20,000

Dr. Motor vehicle disposal account Cr.

Date	Details	Amount TZS "000"	Date	Details	Amount TZS "000"
1st April 2022	Old pick-up	20,000 20,000	1st April 2022	Accumulated depreciation New pick-up Income statement	 14,000 5,000 1,000 20,000

Dr. New pick-up account Cr.

Date	Details	Amount TZS "000"	Date	Details	Amount TZS "000"
1st April 2022	Disposal Cash	5,000 25,000 30,000	1st April 2022	Balance c/d	30,000 30,000
	Balance b/d	30,000			

Exercise 5.6

On 1st January, 2019 Kalambo Ltd purchased a second-hand plant for TZS 72,000,000 and immediately spent TZS 48,000,000 in putting the plant into working condition. On 1st July, 2019 additional plant costing TZS 48,000,000 was purchased. On 1st July, 2021 the plant purchased on 1st January, 2019 became obsolete and was sold for TZS 60,000,000. On 1st July, 2021 another new item of plant was purchased at a cost of TZS 144,000,000. The firm provided depreciation on reducing balance method, at 15% per annum, according to the period of use in each year.

Required

Show the machinery account and accumulated depreciation account for the calendar years 2019 to 2021.

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A note on the effect of change of depreciation methods

A company may consider changing the use of particular method of depreciation after using it for some time. The reason for this may include, a significant change in the pattern of future economic benefits from non – current asset under consideration. For example, if an asset loses much of its value early on, the business might decide to switch from using straight line method to accelerated or diminishing balance method. This change is necessary as it improve the quality of information presented in financial statements with regard to depreciation charges. However, in line with the convention of consistency (covered in chapter one), such change in accounting estimation would require full disclosure in the footnotes accompanying the financial statements. What is required is the justification and quantification showing financial effects of such changes. Auditors consider this as matter of importance, and normally pay close attention to any changes to see if they are justifiable. Their concerns are valid since if management are allowed to make changes as per their wishes, it would be difficult to evaluate properly the performance of business from time to time, and to make comparison with other similar businesses in the industry.

Chapter summary

This chapter has focused on depreciation and disposal of non-current asserts. It has introduced the concepts of depreciation and non-current assets. Regarding depreciation, the chapter has considered various methods for charging it and ways of treating it in the statement of financial performance and the resultant accumulated depreciation in the statement of financial position. The depreciation methods discussed in the chapter include, the straight line, reducing balance, sum of the years' digits, units of production and revaluation. Regardless of a method adopted, the aim is to spread the cost associated with the acquisition of an asset over its useful life time in accordance with the matching concept.

As for the question of non-current assets, the chapter has provided the basis for understanding and applying different principles used for valuation of non-current assets and their reporting in the financial statements. Issues like acquisition, types of disposal of non-current assets, and their accounting treatment and the resulting effect in different financial records and financial statements, are well covered. The chapter has shown that, when the asset is acquired for the first time, it is normally recognised (capitalised) in the books of accounts and when disposed off, it is usually derecognised. The derecognition of non-current assets involves passing journal entries that will ultimately result into either profit or loss on the disposal. Eventually, this will be transferred to the income statement and its accumulated depreciation in the statement of financial position.

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Revision exercises

1. Describe the characteristics of an asset to be classified as non-current assets.
2. Differentiate tangible non-current assets from intangible non-current assets.
3. Using the matching concept and accruals as well as prudence concept, examine the rationale for charging depreciation for tangible non-current assets.
4. A photographer owns a property, plant, and equipment worth TZS 10,000,000/= and she estimates to use the equipment for five years with zero residual value.

Required

Compute the depreciation expenses for each of the five years.

5. SAHARA Company Limited purchased a machine for TZS 650,000 on 1st January, 2019. It had an estimated salvage value of TZS 100,000 and an estimated useful life of five years. The company depreciates machinery on a straight-line basis.

   Required

   (a) How much will be the annual depreciation charge?

   (b) If the machine is sold at the end of its third year of use at TZS 280,000, what will be the amount of profit or loss on the sale of this asset?

   (c) Show the ledger accounts for machinery, provision for depreciation and machinery disposal for the years 2019, 2020 and 2021.

6. Lugata Ltd was formed on 1st January, 2018 and the following purchases and sales of machinery were made during the first 3 years of operations.

Date	*Asset*	*Transaction*	*Price*
1st January, 2018	Machines 1 and 2	Purchase	TZS 40,000,000 each
1st October, 2019	Machines 3 and 4	Purchase	TZS 15,200,000 each
30th June, 2020	Machine 3	Sale	TZS 12,640,000
1st July, 2020	Machine 5	Purchase	TZS 20,000,000

Each machine was estimated to last 10 years and to have a residual value of 5% of its cost price. Depreciation was by equal instalments, and it is company's policy to charge depreciation for every month an asset is owned.

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Required

Calculate

(a) The total depreciation on machinery for each of the years 2018, 2019, and 2020,

(b) The profit or loss on the disposal of machine 3 in year 2020.

7. A machine is bought on 1st January, 2019 for TZS 10,000,000 and another one on 1st October, 2020 for TZS 12,000,000. The first machine was sold on 30th June, 2021, for TZS 7,200,000. The business financial year ends on 31st December. The machines are depreciated at 10% using the straight-line method. Machines, which exist at the end of each year are depreciated for a full year. No depreciation is charged on any machinery disposed of during the year.

Required

Prepare the following:

(a) The machinery account,

(b) The machinery accumulated depreciations account,

(c) Machinery disposal account,

(d) Extract of income statement for the years that ended 31st Dec., 2019, 2020 and 2021,

(e) Extract of the statement of financial position as at 31st Dec., 2019, 2020 and 2021.

8. A business buys a non-current asset for TZS 10,000,000. The business estimates that the asset will be used for 5 years. However, after exactly 2.5 years, the asset was suddenly sold for TZS 5,000,000. The business provides a full year's depreciation in the year of purchase and no depreciation in the year of disposal.

Required

(a) Write up the relevant accounts (including disposal account but not income statement for each of years 1, 2 and 3.

(i) Using the straight-line depreciation method (assume 20% per annum),

(ii) Using the reducing balance depreciation method (assume 40% per annum).

(b) What is the purpose of depreciation? In what circumstances would each of the two methods you have used in (a) above be preferable?

(c) What is the meaning of the net figure for the non-current asset in the state-

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ment of financial position at the end of year 2?

(d) If the asset was bought at the beginning of year 1, but was not used at all until year 2 (and it is confidently anticipated to last until year 6), state under each method the appropriate depreciation charge in year 1, and briefly justify your answer.

9. Mr. Machange is a renowned businessman for running a successful restaurant in Kishumba Ward, Tarime district. He believes that, depreciation provides him with a reserve to purchase new assets. One of his hotel cooks has blown up his deep freezer, but Machange knows he has the funds to replace it in the accumulated depreciation account. As an Accountant, you know that, he is completely wrong and have grown tired of listening to him talking about this issue. You are also aware that, he will not listen to what you have to say. However, you know that, he is good at reading memos relating to his business thus you decide to write him a memo about the problem he is facing and the essence of depreciation in assets management.

Required

Write a letter to Mr. Machange, among others, explain what depreciation is all about and the reasons for maintaining depreciation account in business financial records. Proceed to explain, why his views are not correct.

10. Bagonza Limited owned three transport trucks at 1st April, 2021:

Truck J purchased 21st May, 2012, cost TZS 31,200,000,

Truck K purchased 20th June, 2014, cost TZS 19,600,000,

Truck L purchased 1st Jan., 2016, cost TZS 48,800,000.

Depreciation is charged annually at 20% on cost on all vehicles in use at the end of the year. During the year ended 31st March, 2022, the following transactions occurred:

(a) 1st June, 202: truck K was involved in an accident and considered to be a write off by the insurance company which paid TZS 10,500,000 in settlement.

(b) 7th June, 2021: truck M was purchased at the cost of TZS 32,800,000

(c) 21st Aug., 2021: truck J was sold for TZS 7,000,000

(d) 30th Oct., 2021: truck N was purchased at the cost of TZS 39,000,000

(e) 6th March, 2022: truck N was considered not to be suitable for carrying the

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type of goods required and was exchanged for truck P. The value of truck P was deemed to be TZS 37,600,000.

Required

Prepare the ledger accounts to record the above transactions for the year ending 31st March, 2022 and bring down the balances at 1 April, the same year.

11. Makame Transport Ltd owned the following motor vehicles as at 1 April 2021:

Motor Vehicle	Date acquired	Cost TZS	Estimated Residual Value TZS	Estimated Life (years)
T101 AAT	1st Oct., 2018	8,500,000	2,500,000	5
T202 DTH	1st April, 2019	12,000,000	2,000,000	8

Makame Transport Ltd's policy is to provide at the end of each financial year depreciation using the straight-line method applied on a month-by-month basis on all motor vehicles used during the year. During the financial year ended 31 March 2022 the following occurred:

(a) On 30 June 2021 T101 AAT was traded in and replaced by T303 KGC. The trade-in allowance was TZS 5,000. T303 KGC costed TZS 15,000,000 and the balance due (after deducting the trade-in allowance) was paid partly in cash and partly by a loan of TZS 6,000,000 from commercial bank loan. T303 KGC is expected to have a residual value of TZS 4,000,000 after an estimated economic life of 5 years.

(b) The estimated remaining economic life of T202 DTH was reduced from 6 years to 4 years with no change in the estimated residual value.

Required

(i) Show any journal entries necessary to give effect to the above.

(ii) Show the journal entry necessary to record depreciation on motor vehicles for the year ended 31st March, 2022.

(iii) Reconstruct the motor vehicles account and the provision for depreciation account for the year ended 31st March, 2022. Show the necessary calculations clearly.

12. The statement of financial position of Tumaini Company Limited as at 31st December, 2020 contains the following items:

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Details	Amount (TZS)
Motor vehicles:	
Balance on 1st January 2020 at cost	297,000,000
Add: Acquisition during 2020 at cost	107,000,000
Less: Disposals during 2020 at cost	**404,000,000**
Balance on 31st December 2020 at cost	101,000,000
Less: Accumulated depreciation 31st December 2020	**303,000,000**
Net Book Value (NBV)	71,000,000
	232,000,000

Depreciation is charged at 20% per annum over five years. A full year's depreciation is charged in the year of acquisition but none in the year of disposal.

During 2021, the following motor vehicle transactions took place:

Acquisition	Vehicle type	TZS
31st March	Lorry	26,500,000
30th April	Lorry	38,400,000
31st August	Saloon	11,650,000
31st December	Lorry	34,200,000

Disposal	Vehicle type	Purchased	Cost	Proceeds
30th April	Lorry	31/01/2017	35,000,000	5,500,000
30th June	Saloon	30/06/2019	9,500,000	7,500,000
30th September	Lorry	30/12/2016	40,000,000	2,500,000
30th November	Lorry	01/01/2018	30,000,000	11,500,000

Required

(a) Prepare the following for 2021

(i) Motor vehicles account,

(ii) Motor vehicles accumulated depreciation account,

(iii) Motor vehicles disposal account.

(b) Show the relevant entries in the company's profit or loss account (extract) and the statement of financial position (extract) at the end of 2021.

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Chapter Six

Recognition of revenue and expenses

Introduction

In this chapter, you will learn the meanings of revenue and expenses, different criteria and principles used to recognize revenue and expenses as well as how to record them properly in the books of accounts. The competencies developed in this chapter will enable you to prudently recognise the correct amounts of revenue and expenses to be recorded in the books of accounts hence determining the true and fair view of business performance and its financial position.

Concept of revenue

Revenue is the gross inflow of economic benefits (cash receivables and other assets) arising in the ordinary course of business activities of an entity (such as sales of goods or services, interest, royalties and dividends). Those inflows should result in an increase in equity, other than those contributed by equity holders. One should also exclude the collections made on behalf of third parties such as sales taxes, Value Added Tax (VAT) and other types of taxes on goods and services collected on behalf of the government. Why exclude them? For the same reason, they do not account for the economic benefits of the business entity or increase in owners' equity. In the context of principal – agent business relationship, the same logic applies. The agent's gross inflows of economic benefits include the amount collected on behalf of the principal, which do not add value to the agent's equity. Therefore, the amount collected on behalf of the principal should not be considered as revenue by the agent. However, the commission received by a person as a result of fulfilling his/her responsibility as agent, should be recognised as revenue.

The following are implications flowing from this definition:

(i) Revenue should be stated before deduction of costs of sales. For example, if goods are sold for TZS 100,000,000 that costed the seller TZS 60,000,000 to manufacture, the revenue is TZS 100,000,000, not TZS 40,000,000 (i.e. TZS 100,000,000 less TZS 60,000,000).

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(ii) Revenue is recognised when received from sale or provision of goods and services in ordinary course of business activities. If an entity, for example, disposes of its property, plant, and equipment; the proceeds on disposal are not treated as ordinary revenue. Instead, the profit or loss on disposal will be treated as part and parcel of other income.

(iii) Sales taxes that are collected from the customer and remitted to Tanzania Revenue Authority (TRA) are not 'revenue'. For example, if goods are sold for TZS 100,000,000 inclusive of recoverable sales taxes of 10%, then the revenue is TZS 90,000,000 not TZS 100,000,000.

(iv) If the seller is acting as an agent, rather than the principal in a transaction, the revenue the seller should recognise is the amount of commission receivable rather than the gross amount collected from the customer. For example, a travel agent sells a holiday ticket to customers for TZS 100,000,000 plus a commission of TZS 10,000,000. This means, the customer would be paying TZS 110,000,000 and the travel agent remitting TZS 100,000,000 to the entity providing the holiday tickets. Based on this, the travel agent would recognise revenue as TZS 10,000,000.

Criteria for revenue recognition

By definition, recognition is the process of formally incorporating an item in the financial statements of an entity as an asset, liability, revenue or expense. An important question to address in relation to the concept of revenue recognition include, when should a business consider revenue as being earned? Generally, revenue is recognised when it is probable that, future economic benefits will flow to the entity and these benefits can be measured reliably. This chapter identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. In some cases, this may not be probable until the consideration is received or until the uncertainty is removed. For example, it may be uncertain that, a foreign government authority will grant permission to remit the consideration from a sale in a foreign country. When permission is granted, the uncertainty is removed, and revenue is recognised. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of revenue originally recognised.

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The following sales revenue categories have specific recognition criteria that must be met entirely for the revenue to be recognized in the financial statements:

(i) The sale of goods,

(ii) The rendering of services, and

(iii) The use of entity's assets by others yielding interest, royalties and dividends.

Recognition of revenues from sale of goods

Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied as shown in figure 6.1:

Essential criteria/conditions for recognition of revenue from the sale of goods

1. Risks and rewards of ownership heve been transferred from the seller to the buyer
2. The seller loses control over the goods sold
3. The collection of payment from goods or services is reasonably assured
4. The amount of revenue can be reasonably/reliably measured
5. Costs of revenue can be reasonably/reliably measured

Figure 6. 1: *Essential criteria for recognition of revenue from sale of goods*

As can be observed, Figure 6.1 provides the five important criteria for recognition of revenue from the sale of goods. All five conditions must be met, and according to IFRS, conditions (1) and (2) are referred to as performance. Fulfilment of the

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performance obligations occurs when the seller has done what is expected to deserve payment. Condition (3) is referred to as collectability. In this, the seller must have a reasonable expectation that he/she will be paid for the performance. Conditions (4) and (5) are referred to as measurability. This is aligned well with the matching principle; the seller must be able to match the revenues to the expenses. Hence, both revenues and expenses should be able to be reasonably measured.

Understanding of the five criteria presented in figure 6.1 can further be enhanced, as explained in the following parts:

1. *Risks and rewards of ownership have been transferred from the seller to the buyer*: the seller is seen as having transferred to the buyer significant amount of risks and rewards of ownership of the goods when the legal title or the possession of the goods has been transferred to the buyer. Examples on risks of ownership include, obsolescence, damage, and the inability of an asset to operate at its optimum levels. Rewards of ownership include, future economic benefits or revenue from the use of the asset or increases in the value of the asset.

2. *The seller loses control over the goods sold*. This is reflected in the seller ceasing to have managerial involvement to the degree usually associated with ownership, and effective control over the goods sold. Consider a scenario where a company named Infotech Plc, a manufacturer of electronic products enters into a distribution agreement with Msimbazi Stores. The following being the key terms and conditions of the agreement:

   (a) Msimbazi Stores will obtain title to the goods and will sell them to retailers.

   (b) Msimbazi Stores will earn a fixed margin on the products sold to retailers but will have no authority in establishing the sale price of the goods for retailers.

   (c) Msimbazi Stores has the right to return the goods to Infotech if they remain unsold for 2 years.

   Accordingly, Infotech plc sold goods worth TZS 10,000,000 to Msimbazi Store. When should the sale be accounted for? In this case, the sale to Msimbazi Stores cannot be recognised as a sale as Infotech Plc retains continuing managerial involvement with the goods by being able to set the sales price. Also, Msimbazi Stores has the option to return the goods, so the risks and returns are not fully transferred. Therefore, Infotech Plc should continue recognising the inventory on its statement

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of financial position. Infotech should recognise the revenue only when substantially all the risks and rewards of ownership have been transferred, which will be when Msimbazi Stores sells the goods to a third party.

3. *The collection of payment from goods or services is reasonably assured* in the sense that, it is probable that, the economic benefits associated with the transaction will flow to the entity/seller. Consider a situation where a business named Queensland Ltd operating in currency Y, has made sales to Bongoland Ltd, which operates in currency X. Due to political reasons, it is uncertain whether the government in which Bongoland Ltd operates will permit to transact with Queensland Ltd and will remit any consideration from this transaction. In this case, Queensland Ltd cannot recognise the revenue since the economic benefits associated with the transaction may not flow to this company.

   At times this may not be probable until the uncertainty is removed. In this case, revenue will be recognised only after the uncertainty has been removed.

4. *The amount of revenue can be reasonably/reliably measured.* For example, Pleasant Ltd sells 10,000 mobile phones to Smart Co. However, they are still negotiating the value of the mobile phones which have been sold. In this case, Pleasant Ltd cannot recognise any sales revenue until the value of the 10,000 mobile phones is determined.

5. *Costs of revenue can be reasonably measured*. The costs incurred or to be incurred in respect of the transaction should be able to be measured reasonably or reliably. If it is not possible to measure expenses reliably, then any consideration received from the sale of goods should be recognised as a liability. For example, Machine Tools Ltd has sold a plant worth TZS 25,000,000 to Saini Carpentry Ltd., soon after delivering the plant the buyer paid the entire amount as stated in the sales contract. Within this sales contract, it has been stated that, the seller i.e., Machines Tools Ltd is the one to bear the installation expenses. This is expected to be of considerable value. However, as on the statement of financial position date, neither has the plant been installed nor is it possible to reasonably or reliably estimate the expenses involved.

   In this case (Machine Tools Ltd vs. Saini Carpentry Ltd), the amount received (TZS 25,00,000) will not be reflected as revenue but as a current liability. This is similar to advance payment received from Saini Carpentry Ltd.

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Recognition of revenues from rendering services

Recognition of revenue from rendering services depends upon whether the outcome of a transaction can be reliably estimated by considering the following criteria:

(a) If the outcome can be estimated reasonably/reliably, revenue from services will be recognised by considering the stage of completion in rendering the services.

(b) However, if the outcome cannot be estimated reliably, revenue will be recognised only to the extent of the expenses recognised that are recoverable.

Figure 6.2 summarises the criteria for the recognition of revenue from rendering services.

Important conditions for the recognition of revenue from rendering services
[Depending on the outcomes of the following

(1)	(2)	(3)	(4)
Amount of revenue can be measured reliably	It is probable that economic benefit associated with the transaction will flow the entity	Stage of completion of the transaction at the statement of financial position date can be measured reliably	The costs of the transaction and to complete the transaction can be measured reliably

Figure 6. 2: *Criteria for estimating revenue outcome in a reliable manner*

Further explanations to clarify key issues presented in figure 6.2 are given in the following sections.

(a) Criteria number 1: reliable estimates of revenue can be made when both the parties to the contract agree on three important matters including, each party's enforceable rights about the services to be rendered or received, consideration to be exchanged, as well as the manner and the terms of the settlement.

(b) Condition number 2: it is probable that, the economic benefits associated with the transaction will flow to the entity. For example, ABC Company recognised revenue from client XYZ, however, some issues have emerged

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making the probability of receiving payment from that client extremely uncertain. In this case, the company is required to write off the recognised revenue as bad debt.

(c) Criteria number 3: the stage of completion of the transaction at the statement of financial position date, is normally used when the outcome of the transaction can be reasonably/reliably measured. A good example for this includes, a transaction involving a service contract that is completed over an extended period of time. In this case, the seller's performance obligations cannot be immediately completed to deserve the full amount of consideration. Sometimes, it may take several reporting periods. The provision by FRS is that, revenue should be recognised depending on the stage of completion of a contract/service.

(d) Condition number 4: is about the ability to measure reasonably/reliably the costs of the transaction and the cost of completing the transaction. In the early stages of rendering services when the outcome of a transaction is not certain, revenue will be recognised only to the extent of costs incurred. Logically, it is assumed that, at a minimum, these are the costs more likely to be recovered from the client. If it is not probable that the costs will be recovered, no revenue is recognised, and all costs are immediately expensed.

Recognition of revenues from interest, dividends and royalties

When the assets of the entity are released to be used by other persons for certain charge or fee in return, the amount to be received by the entity can be interest, royalties or dividends, depending with the nature of the asset. Interest is received as charges when the entity advances assets in the form of loan or debts while dividends is a reward for holding of investments in shares. On the other hand, royalty is the income received when a business allows other businesses to use its intangible assets e.g., know-how, trademarks, patents and copy rights. If the royalty is payable based on the number of copies, the number of compact discs (CDs) for instance, then it has to be recognised on that basis only. Recognition of these revenues is determined by different conditions i.e., when it is probable that, the economic benefits associated with the transaction will flow to the entity, and the amount of the revenue can be measured reliably. Specifically, the methods and basis for recognising interest, royalties and dividend are summarised in figure 6.3.

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Basis for recognising revenue in the form of interest, royalties and dividends

Interest
Recognised by using effective interest method

Interest
Recognised on acrual basis when shareholders' right to receive payment is established

Interest
Recognised on acrual basis according to the substance of agreement

Figure 6. 3: *Basis of recognising interest, royalties and dividends*

Further clarification on different items presented in figure 6.3 are considered by referring items from left to right. By definition, effective interest method refers to the technique used to calculate the actual interest rate in a period based on the book value of a loan/debt at the beginning of the accounting period. For example, if the book value of the loan/debt decreases, so too will the amount of related interest, and vice versa i.e., if the book value increases, so too will the amount of related interest. This method is used to account for premiums and discounts when transacting. A premium occurs when investors are willing to pay more than the face value of the asset because its stated interest rate is higher than the prevailing market interest rate. On the other hand, discount on asset occurs when investors are only willing to pay less than the face value of a bond, because its stated interest rate is lower than the prevailing market rate.

For example, assume, on 1st January 2020, Mdoki Co., purchased a bond worth TZS 10,000,000. The bond attracts an interest of 5% every year. On 31st December, 2022, it will be redeemed for TZS 11,660,000. The effective interest rate is 10%. In this case, the total revenue is not only interest but also the redemption premium. The total amount receivable as interest and premium on this bond will be determined as follows.

	TZS "000"
On account of interest (TZS 10,000,000 x 5%) x 3 years	1,500
On account of premium on redemption (TZS 11,660,000 – TZS 10,000,000)	1,660
Total amount receivable	**3,160**

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As for methods for recognition of dividend and royalty, as shown in figure 6.3, both are recognised using accrual basis of accounting. However, after observing certain conditions. For dividends, only when it is certain that the board of directors has decided/declared to pay dividends to the shareholders of the company. For royalty, according to the substance of the agreement. For example, assumes that, on 1st July, 2021, Mr. Ongara agreed with the publisher of his book that, the royalty on the sale of his new book will be paid in a particular pattern. For the sales made in month 1, the royalty will be payable on day 1 of month 3. This means that, for the sales made in November, 2021, he will receive a royalty on 1st January, 2022 and for sales made in December, 2021 he will receive a royalty on 1st February, 2022. In this case, the financial statements for the year to 31st December, 2021 will recognise revenue in the form of royalty for all sales made between 1st July, 2021 and 31st December, 2021. This is because the royalty has accrued even on sales made in November, 2021 and December, 2021 even if it has not been paid till the statement of financial position date.

Activity 6.1

1. What do you understand by the term revenue? Explain by identifying the key sources and examples of each.
2. Giving relevant examples, explain well the concept of revenue recognition for each item you have identified under (a) above.
3. ABC Ltd operates in mining industry; it utilizes a certain resource of XYZ Ltd. In return XYZ Ltd received TZS 20,000,000 and 30,000,000 on 31st January 2022 as interest and royalties, respectively, from XYZ Ltd as payment for the use of the resources for the year 2019-2020. State on what basis the interest and royalties would be recognized in the books of XYZ Ltd.
4. On 31st March, 2020, which is the end of the financial year of Ark Ltd, the company recognised TZS 5,000,000 as a dividend income on shares held in the Blues Ltd for the year 2019-2020. Such amount was recognized based on Ark Ltd.'s own estimations, in accordance with the experience of previous years. However, the Blues Ltd proposed dividend on 10th April, 2020 that was later on declared on 30th June, 2020.

Required

In a group session, discuss to assess whether the dividend received from Blues Ltd was recognised accordingly. Among others, give reasons for your answers.

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The nature of accounts for income

Revenue or income is money that has been earned by the business. Therefore, the accounts used to record business transactions relating to income generally will be tracking incoming money both from operational and non-operational business activities. Examples of income accounts include, product sales, rendering of services, rent, and interest received. The increase in accounts used to record business revenue will be reflected by credit entries in relevant accounts. The reason why revenues are credited is that they increase the shareholders' equity of a business. As it is commonly known, shareholders' equity has a natural credit balance. Thus, an increase in equity can only be caused by transactions that are credited. The foundation of this reasoning is the accounting equation, stated as follows:

Assets = Liabilities + Shareholders' equity

The accounting equation appears in the structure of the statement of financial position where assets (with natural debit balances) offset liabilities and shareholders' equity (with natural credit balances). When a sale occurs, the revenue (in the absence of any offsetting expenses) automatically increases profits – in return profits increase shareholders' equity.

The nature and meaning of accruals and prepayments relating to revenues

Accruals are revenues earned that impact a company's net income, although cash has not yet been received. Moreover, accrued revenue commonly represents revenue that has not yet been received. The basic idea behind the use of accrued revenue principles is that revenue should be recognized as earned before actual cash payment is subsequently received. Therefore, accrued revenue is recognized on the date the sale occurs and then included in a firm's gross revenue on the income statement. Accounts receivable must be included on the balance sheet as either a short-term or long-term asset depending on the terms of payment. The recognition of accrued revenue is necessary to properly match revenues with expenses, where the failure to recognize accrued revenue would show lower revenue and profits.

Income received in advance or deferred revenue

Income received in advance also known as deferred revenue represents a prepayment by its customers for goods or services that have yet to be delivered. The basic rule for this unearned revenue under the accrual basis of accounting is that income related to the current year is to be recorded as income for the current year. The excess income received in advance will need to be recorded in the same financial year by

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reducing the income, which is received in advance and shown in the statement of financial position as a liability. These kinds of adjustments are further explained in the following section.

Accounts to effect adjustments for accruals and prepayments

(a) *Adjustments of accrued income (outstanding income)*

Income can also accrue continuously and therefore, there is a need to recognize it in the financial year in which it has accrued regardless of actual receipts of the cash. In other words, the date of actual receipt of the income is not so important. Consider the following example:

Mwenge had business premises that were lying vacant for a relatively long period. However, recently they were able to release them for an agreed rent of TZS 400,000 per month with effect from 1st April 2020. The following rents were received by Mwenge:

Period	Rent received on	Amount (TZS)
1st April, 2020 to 31st Dec., 2020 (9 months)	1st January, 2020	3,600,000
1st Jan., 2021 to 31st March, 2022 (15 months)	1st April, 2021	6,000,000

The reporting period for Mwenge is 31st, March each year.

Necessary adjustments and financial records: the rent for the 9 months from 1st April 2020 to 31st December 2020 must be accounted for as received income. Rent for the 3 months from January 2021 to March 2021 should be considered as accruals even though it had not actually been received by Mwenge. Mwenge needs to record an amount of TZS 1,200,000 (TZS 400,000 x 3) in its accounts as rent receivable for the year ended 31st March 2021.

Journal entries for accrued income and presentation in financial statements:

By referring to Mwenge accrued income as already explained, the following are the relevant journal entries:

Year 2020/2021

(i) **To receive rent in cash/bank and recognize rent income**

Dr. Cash/Bank account	TZS 3,600,000	
Cr. Rent income		TZS 3,600,000

To record cash received rent income for the year ending 31st March, 2021

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(ii) **To recognize accrued rental income**

Dr. Accrued rental income (400,000 x3 months) TZS 1,200,000

Cr. Rental Income TZS 1,200,000

To record accrued rent Jan-March, 2021

Ledger (year 2020/2021)

Dr. Rent (income) account Cr.

Date	Details	TZS	Date	Details	TZS
March 31, 2021	Rent Income (Profit or loss)	4,800,000	Jan. 1, 2020	Cash (receipts)	3,600,000
			March 31, 2021	Accrued rental income (rent income outstanding)	1,200,000
		4,800,000			**4,800,000**
April 1, 2021	Accrued rent b/d	1,200,000			

In the statement of financial position, the rent receivable will be recorded as follows:

Extract of statement of financial position as at 31.03.2021

Current assets	***TZS***
Accrued rental income	1,200,000

Year 2021/2022

Journal entries to received rent in cash/bank and recognize rent income

Dr. Cash/bank TZS 6,000,000

Cr. Accrued rent income TZS 1,200,000

Cr. Rent income for the year (profit or loss) TZS 4,800,000

Ledger (year 2021/2022)

Dr. Rent (income) account Cr.

Date	Details	TZS	Date	Details	TZS
April 1, 2021	Accrued rent income b/d	1,200,000	April 1, 2021	Cash (receipts)	6,000,000
March 31, 2021	Profit or loss (balancing figure)	4,800,000			
		6,000,000			**6,000,000**

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Note that, the accrued rent income of TZS 1,200,000 is shown as a current asset in the statement of financial position. Correspondingly, the same amount of accrued rent (TZS 1,200,000) is added to the figure of rent income appearing in the statement of profit or loss. Therefore, accrued rent has an impact on profit and net assets. Accrued rent income would lead to a creation of current asset in the statement of financial position and increase in income in the profit or loss statement. Hence the following two effects are noticed:

(i) Increase in income = increase in profit for the current period,

(ii) Creation / increase in asset = increase in net assets.

(b) *Adjustment of income received in advance*

A firm of lawyers received TZS 10 million on 24th March 2021 as fees for a case that it was handling and booked the same as revenue for the period. This amount covered 2 court hearings requiring approximately similar time and effort. Up to the end of the reporting period on 31st March 2021, only 1 hearing was complete. The second hearing took place on 30th April 2021.

From the above example, the necessary adjustments and financial records at the reporting date should consider the fact that only half of the work was complete. Therefore, only half of the fees were supposed to be accounted. The fees for both the hearings received in advance must be accounted in the following manner:

(i) Half of the fees i.e., TZS 10 million x 1/2 = TZS 5 million is treated as revenue in 2021.

(ii) The remaining TZS 5,000,000 is treated as income received in advance.

Note that, the fees for both the hearings were received in advance. Thus, journal entries for income received in advance and the treatment in financial statements will be presented as follows:

The journal entries (2020/2021)

Dr. Cash account TZS 10,000,000

Cr. Professional fees account TZS 10,000,000

Being cash received as professional fees

Dr. Professional fees account (SOPL) TZS 5,000,000

Cr. Professional fees received in advance Account (SOFP) TZS 5,000,000

Being adjustment for fees received in advance recorded

NB: SOPL stands for statement of profit or loss while SOFP stands for statement of financial position.

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Dr. Professional fees (income) account Cr.

Details	TZS	Details	TZS
Fees received in advance	5,000,000	Cash (receipts)	10,000,000
Transferred to SOPL (balancing figure) i.e., reduction of income	5,000,000		
	10,000,000		**10,000,000**

Dr. Professional fees received in advance (liability) account Cr.

Details	TZS	Details	TZS
		Professional fees (received in advance recorded here as liability)	5,000,000

The income from professional fees in the statement of profit or loss is reduced by TZS 5,000,000. The fees received in advance are shown as a current liability in the statement of financial position. Income received in advance would lead to a decrease in income. Hence, the following two effects will be noticed:

(i) Increase in expenses = decrease in profit for the current period,

(ii) Creation / increase in liability = decrease in net assets.

You can now continue to record journal entries and ledger for 2021/2022.

Exercise 6.2

1. What do you understand about accruals and prepayments in relation to revenue?
2. Describe the accounting treatment of accruals and prepayments in financial records as well as the statement of profit or loss and other comprehensive income and statement of financial position.
3. Both accruals and prepayments, as far as revenue is concerned, should be considered as liabilities by the business. Do you agree with this statement? Explain by giving relevant examples.

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Activity 6.2

ARC Company specialized in acquisition of assets for leasing and renting. In 2017-2018, the company purchased machinery and plant for TZS 45,000,000 from NM Holdings Ltd, but TZS 5,000,000 remained payable to NM Holdings Ltd. The supplier waived-off the balance amount during the financial year 2020-2021 and the ARC Company decided to treat it as income; hence credited to the statement of profit or loss and other comprehensive income account during 2020-2021.

On 31st January 2022 ARC Ltd received TZS 30,000,000 and 40,000,000 from XYZ Ltd as interest of leased machine and rent of a showroom building, respectively, for two years; 2019-2020 and 2020-2021.

Required

(a) In a group of 5 students discuss and state whether accounting treatment of waived-off balance by the ARC Company is correct or not. Give reasons to support your answer.

(b) In the same group of 5 students, state on what basis and which amount of the interest and rental revenue would be recognized in the books of ARC Ltd in each of the two years i.e. 2019-2020 and 2020-2021.

Concept of expenses and recognition criteria

The definition of expenses encompasses losses as well as those expenses that arise during the ordinary activities of an entity. Examples of expenses arising in the ordinary course of the entity's activities include the cost of sales, wages, and depreciation. They usually take the form of outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant, and equipment. Essentially, expenses are a cost of operations that a company incurs to generate revenue. A proverb, "*it costs money to make money*", holds. It is also important to note that, businesses can write off some tax-deductible expenses in their income tax returns if they meet the Tanzania Revenue Authority's guidelines.

For a businessperson, it is critically important to understand the nature of different expenses incurred by his/her business. Remember, among the main goals of business management is to maximize profits. One way to achieve this is by boosting revenues while keeping expenses in check. Sometimes businesses do slash some costs they consider to be unnecessary to help a business enterprise make even more money from sales. However, if expenses are cut too much, it could have a detrimental effect. For example, the company may decide to pay less in advertising to reduce its marketing costs,

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but this may have a negative effect like lowering the company's visibility and ability to reach out to potential customers. To understand the importance of costs supporting the operation of a business and the ability to record them properly, it is important to understand well the different types and form of costs that are usually being incurred by the business.

Recognition of expenses

Expenses are recognised in the income statement when a decrease in future economic benefit related to a decrease in an asset or an increase of a liability has arisen. In this case, the decrease or increase needs to be the one which can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets. Examples include the accrual of employee entitlements or the depreciation of equipment.

Expenses are recognised in the income statement based on a direct association between the costs incurred and the earning of specific items of income. This process is commonly referred to as the matching of costs with revenues. It involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events. For example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods.

When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit of loss and other comprehensive income based on systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the use of assets such as property, plant, equipment, goodwill, patents, and trademarks. In such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

An expense is recognised immediately in the statement of profit or loss and other comprehensive income when expenditure produces no future economic benefits. In other words, this occurs when, and to the extent that, future economic benefits do not qualify or cease to qualify for recognition in the financial position as an asset. An expense is also recognised in the statement of profit or loss and other comprehensive income in those cases when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises.

In real-world of business, you may find people mentioning expenses as being different from expenditures – what is the

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difference? This question is addressed in the following section.

Major difference between expenses and expenditures

Expenditure is a payment or the incurrence of a liability, whereas an expense represents the consumption of an asset. Thus, a company could make a TZS10,000,000/= expenditure of cash for a non-current asset, but the TZS 10,000,000/= asset would only be charged to expense account over the term of its useful life. Thus, expenditure generally occurs upfront while the recognition of an expense might be spread over an extended period. Table 6.1 is used to distinguish expenses from expenditures.

Table 6. 1: *Differences between expenses and expenditures*

Expenses	Expenditures
(a) An expense recognises the consumption of a cost.	(a) An expenditure represents the disbursement of funds.
(b) Expenses are generally associated with the short-term operations of a business.	(b) Expenditures are associated with the acquisition of assets intended to be used for a long period of time.
(c) They are the costs that are incurred to earn revenues.	(c) They are the costs spent on purchases or growth of fixed assets.

Types of expenses

When preparing income statement and a balance sheet, accountants usually make a clear distinction between operational and non–operational expenses. What do these terms mean? The answer to this question is given in the following parts.

(i) **Operating expenses** – this is an expense directly related to the company's main activities, such as the cost of goods sold, rent, and administration expenses. Operating expenses are associated with the primary operational activities of a business. These activities include the production of goods or provision of services and the ongoing administration of a business.

(ii) **Non-operating expenses** – these expenses that are indirectly related to the business's core operations. Non-operating expenses are not associated with the firm's primary operating activities. Examples of non-operating expenses include, interest expenses and lawsuit losses.

Basic methods for recognizing expenses

There are two basic methods, which are used to recognize expenses namely, cash and accrual basis of accounting.

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(i) **Cash basis** – cash basis of accounting refers to a major accounting method that recognises revenues and expenses at time cash is received or paid out. This method is commonly used by small retail traders due to its simplicity and the small number of business transactions they are dealing with.

(ii) **Accrual basis** – under this method, income is usually recognized at the time the revenue is earned and records expenses when liabilities are incurred regardless of the time of receiving or paying cash. The accrual basis of accounting is commonly used by different business entities, especially large-scale business operations.

Difference between cash basis and accrual basis of accounting

Cash and accrual basis of accounting may be differentiated based on different criteria including, level of simplicity/difficulty in their application. As a result, different types of businesses may find it easy to apply compared to others. The two methods also offer different results, and different levels of accuracy. Differences between the two methods of accounting are summarized in table 6.2.

Table 6. 2: *Differences between cash and accrual basis of accounting*

Cash basis of accounting	Accrual basis of accounting
(a) Immediate recognition of revenue and expenses as cash changes hands.	(a) Recognition is based on anticipated revenue and expenses provided the business has earned or incurred them, respectively.
(b) Easier to apply because it follows the timing of cash flows.	(b) Portrays more accurately the nature and occurrence of business transactions.
(c) Mostly used by sole traders due to its simplicity.	(c) Commonly used by the Government and large-scale business entities e.g. the public companies.

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Exercise 6.3

1. What do you understand by the term expenses? Explain your answer by giving different types of expenses as reported in SOPL and SOFP.
2. Differentiate the accrual basis of accounting for expenses from the cash basis of accounting for the same.
3. By giving relevant examples, explain how expenses are normally recognized under the accrual basis of accounting.

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Accounting for expenses

The posting of expenses is usually done by debiting relevant accounts depending on the nature of the transactions. The normal expense account is characterised by having a debit balance. Following this, an important question to consider would be, why expenses account is debited instead of being credited? Different answers can be provided including, relating it with the effect expenses have on the basic accounting equation. Normally, expenses cause the owner's equity to decrease. Since the owner's equity normal balance is on the credit side of the account, and expense must be recorded as a debit to reduce the amount in that account.

For example, consider a business with only one type of asset, cash TZS 1,000,000 which corresponds with the value of its owner's equity. If this firm pays for advertisement TZS 250,000 the company will be required to reduce its cash by TZS 250,000 by debiting the amount to the advertisement expenses account. Likewise, in the balance sheet, the owner's equity will be reduced to TZS 750,000.

In most cases, the posting of business transactions in the form of expenses largely depends on the mode of payments, as explained in the following relevant journal entries:

(i) If mode of payment is cash or cheque

Dr.	Expenses account	xxxx	
	Cr. Cash/bank account		xxxx

(ii) If incurred expenses not paid immediately

Dr.	Expenses account	xxxx	
	Cr. Account payable account		xxxx

(iii) If other incurred liabilities not yet paid.

Dr.	Expenses account	xxxx	
	Cr. Other liabilities		xxxx

The question of the timing of payments both outstanding and prepaid expenses usually have different treatment in the books of accounts. Key issues related to this are considered in the following sections.

Outstanding expenses – by referring to the current or existing accounting period, these reflect the types of expenses, which have been incurred i.e., the business has used the goods or services but for which payment has not been done**.** They reflect the repayment obligations i.e. the amount of money owed to vendors for expenses incurred but not yet paid. For example, ABC Company has succeeded in marketing

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its products through advertising media namely Universal TV. However, payment for the same has not been done until the time when the company is preparing its financial statements. ABC Company is expected to consider this and other similar expenses as outstanding expenses.

Corresponding to the previous example, when exactly do businesses make payments for goods and services consumed in generating income? The answer to this may differ from one business to another. However, in practice invoices are usually received/paid after the financial year has ended. In certain cases, organisations may prefer to pay a supplier in a lump sum rather than pay them on a weekly/monthly basis. When company acquires goods by orders, sometimes may prefer to make bulk payment for a contract in the middle of the year – covering even a few months of the following year.

Treatment of outstanding expenses in financial statements

Based on the accrual basis of accounting, outstanding expenses will be considered as part and parcel of total expenses to be matched with generated revenues in the statement of profit or loss and other comprehensive income. This is considered fair since outstanding expenses have also been used or incurred in generating the revenue or income that is currently being considered. In the statement of financial position, outstanding expenses will be incorporated as a current liability with other components in this area e.g., creditors. These reflect the credit balance drawn from personal accounts found in ledger accounts. The following is a summary of the treatment of outstanding expenses in two types of financial statements we have already examined.

Table 6. 3: *Treatment of outstanding expenses in financial statements*

Financial statement	Treatment
Statement of profit or loss and other comprehensive income/statement of financial performance	Add to the respective expenses account to obtain the total expenses incurred for the period.
Statement of financial position/balance sheet	Show/list under the “current liabilities” section like creditors.

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Besides the financial statements, it is also important to understand the presentation of outstanding expenses in journal entries. The format for doing this is as follows.

(a) When recording account payable:

Dr.	Expense account	xxxx	
	Cr. Account payable Account		xxxx

(b) On payment: cash/cheque

Dr.	Account payable account	xxxx	
	Cr. Bank/cash account		xxxx

(c) Outstanding expenses recording:

Dr.	Expenses account	xxxx	
	Cr. Outstanding expenses account		xxxx

Example 6.1

On 31st December 2021, Paragoni Investment Company recognises rent due to the tune of TZS 100,000 relating to the same accounting period. What would be the journal entry for this?

Solution 6.1

General journal

Date	Particulars	Dr. TZS	Cr. TZS
31st Dec., 2021	Rent expenses account	100,000	
	Outstanding rent		100,000
	Narration: Outstanding rent recognised as due		

In the income statement, the transaction will be shown as follows:

Paragoni Investment Company

Statement of profit or loss and other comprehensive income (extract)

	TZS	TZS
Revenue		xxxx
Less: expenses:	xxxx	
Rent Expenses	100,000	
Add: Outstanding Rent		

In the statement of financial position, the transaction will be shown as follows:

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Paragoni Investment

Statement of financial position (extract)

	TZS
Current liabilities:	
Outstanding rent	100,000

Example 6.2

Assume that rent is charged at the rate of TZS 600,000 per year. It is payable at the end of each quarter of the year for the three-month tenancy that has just expired. The tenancy commenced on 1st January, 2020 and the rent was paid only for the three quarters up to 30th September, 2020. What will be the amount of the rent expenses to be posted in the SOPL for the year that ended on 31st Dec., 2020? Elaborate your answer using rent expenses account.

Solution 6.2

Dr. **Rent expenses account** **Cr.**

Date	Particulars	Amount TZS	Date	Particulars	Amount TZS
2020			2020	Statement of Profit of Loss and other Comprehensive Income	600,000
March 31st	Bank/Cash	150,000	Dec 31st		
July 31st	Bank/Cash	150,000			
Sept 30th	Bank/Cash	150,000			
Dec 31st	Outstanding c/f	150,000			
		600,000			**600,000**
			2022 Jan 01st	Outstanding b/f	150,000

Prepaid expenses

This is another important issue to consider as far as the timing of payments is concerned. It reflects the kind of expenses that have been paid well in advance before receiving goods or services in the agreement. In other words, the company would have already made the necessary payments but expect to receive the goods in the future. In the context of Tanzania, a good example would include insurance premiums and leased office coverage that provides continual benefits over time. According to International Financial Reporting Standards (IFRS), expenses should

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be recorded in the same accounting period as the benefit generated from the same related asset.

Example 6.3

XYZ Company paid insurance for the upcoming 12 months period on 1st September 2020, TZS 1,440,000 while the yearly accounting period usually ends on 31st December. What would be the insurance expenses and the pre-paid insurance expenses?

Workings:

From 1st September to 31st December, 2020 = TZS 1,440,000 x 4/12 = TZS 480,000. Therefore, in December 2020, TZS 480,000/= will be charged as insurance expenses, while the balance of TZS 960,000 is pre-paid insurance expenses.

Journal Entries:

a) When cash/cheque is paid for insurance premiums:

Dr. Insurance account		TZS 1,440,000	
	Cr. Cash/bank		TZS 1,440,000

Amount paid for one-year insurance premium

b) On 31st December, 2020

Dr. Insurance prepaid		TZS 960,000	
	Cr. Insurance account		TZS 960,000

Being records prepaid of insurance

Ledger entries

Dr. Insurance account Cr.

Date	Particulars	Amount TZS	Date	Particulars	Amount TZS
2020 Sept 01st	Cash/bank	1,440,000 **1,440,000**	2020 Dec 31st	Profit or loss (insurance expenses) Insurance prepaid c/f	480,000 960,000 **1,440,000**
2021 Jan 01st	Insurance prepaid b/f	960,000			

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In the statements of income and financial positions, the transaction will be shown as follows:

XYZ Company

Statement of profit or loss and other comprehensive income (extract)

	TZS
Revenue	**xxxxx**
Less: Expenses	
Insurance expenses	**480,000**

Statement of financial position (extract)

	TZS
Current assets	**xxxxx**
Insurance prepaid	**960,000**

Exercise 6.4

Metro Co. Ltd is the company which operates in construction industry trading on building materials. The goods that are traded include cement, steel, bricks, aluminium, plumbing materials, electrical materials, and other related products. The company signed a one-year lease on a warehouse for TZS 1,000,000 a month at the beginning of the year. The landlord required Metro Co. Ltd to pay the annual amount (TZS 12,000,000) upfront. Just after signing the one-year lease agreement for the warehouse, the company also purchased insurance for the warehouse. The company paid TZS 24,000,000 in cash upfront for a 12-month insurance policy for the warehouse.

Required

(a) Show the journal entries for the transactions as at when they took place.

(b) State the journal entries of rental expense on quarterly basis; from 1st quarter to 4th quarter of the year.

(c) State the treatment of insurance expense on quarterly basis; from 1st quarter to 4th quarter of the year.

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Chapter summary

Revenues and expenses are essential elements of financial statements in determining the performance of any business whether small or large, they assist in determining profits obtained or losses suffered during the accounting year. To properly report the results of business, revenues and expenses need to be well recognised and properly treated. Revenues should be recognised when earned and not when related cash is received, and expenses should be recognised when incurred and not when cash is paid and should be in the same period as revenue to which they relate. Recognition of revenues and expenses are based on how they can be reliably measured as well as being probable to happen.

The chapter also identified accrued revenues and outstanding expenses which are revenues earned, but no cash has been received and expenses incurred but no cash paid for them respectively. The chapter also explain the concept of income received in advance and prepaid expenses. Income received in advance are the payments (cash received) while goods have not yet been supplied, or services not rendered likewise the prepaid expenses are cash paid pending for goods or services to be received. Adjustments for accruals and prepayments should be done in both statements of profit or loss and other comprehensive income and statement of financial position.

The chapter also has enlightened the two methods of accounting for revenues and expenses namely cash basis and accrual basis. When cash basis is used, only the cash received and paid expenses are recognised in determining profit or loss while accrual basis recognises revenues and expenses when they are earned and incurred respectively and not when cash is received or paid out.

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Revision exercises

1. By giving relevant examples differentiate the following terms as used in accounting.
   (a) Revenue *versus* expenses.
   (b) Outstanding expenses *versus* prepaid expenses.
   (c) Accrued *versus* prepaid revenue.
   (d) Cash *versus* accrual basis of accounting.
2. By referring to questions (1) (a) – (c), give relevant explanations for the presentation of the identified items in the statement of profit or loss and other comprehensive income and statement of financial position.
3. By giving relevant examples, explain recognition criteria for both revenue and expenses.
4. Serena International Tours and Travels ordered two luxury buses from Comfort Driving Ltd for TZS 400,000,000 on 17th December, 2021. Comfort Driving Ltd received the full payment but until the date of financial statements was not able to complete the work according to the specifications given by Serena International Tours and Travels. Moreover, the company is not in a position to reliably estimate the expenses for completion of the work as on the statement of financial position date.

   Required

   With reasons, state whether Comfort Driving Ltd can recognise the amount of TZS 400,000,000 as revenue in the financial statements at the end of the month, Dec., 2021.
5. Changanyikeni Ltd prepares its accounts up to 31st March each year. On 30th March, 2022, the company sold a consignment of products for TZS 45,000,000, which was debited to trade receivables and credited to the revenue account. The terms of sale of the products were that Changanyikeni Ltd would provide an after-sales service which involved correcting any defects that became apparent in the products for one-year from the date of sale. The estimated cost of correcting defects was TZS 1,500,000. The gross profit margin for corrective work would be 20%. Revenue as recorded in the trial balance as of 31st March, 2022 was TZS 360,000,000.

   Required

   Determine the revenue to be recognised in the statement of profit or loss and other comprehensive income.
6. What are the major differences between outstanding and prepaid expenses?
7. Explain the treatments of outstanding and prepaid expenses in the income

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statement as well as in the statement of financial position.

8. Mwembechai Co. obtained a loan of TZS 10,000,000 from a bank on 1st January, 2022 at an agreed interest rate of 9%. The dates of interest payment are 30th June and 31st December every year. The financial year ending is on 31st March, 2022. Payment of interest is made every 6 months at the end of June and December.

   Required

   Calculate the accrued adjustments for the interest (if any) for the financial year ending 31st March, 2022.

9. A company buys a financial instrument for TZS 95,000,000 that has a face amount of TZS 100,000,000 and which pays interest of TZS 5,000,000. What is the effective or actual interest it is earning on this type of investment?

10. You are given the following information relating to ABC Enterprises for the year ended 31st December, 2021:

   (a) Rent is payable of TZS 600,000 per annum.

   (b) Rates of TZS 400,000 per annum are payable by instalments.

   (c) At 1st January 2021, rent of TZS 100,000 had been prepaid in 2020.

   (d) On 1st January 2021, rates of TZS 40,000 were owed.

   (e) In 2021, the rent of TZS 450,000 was paid.

   (f) In 2021, rates of TZS 500,000 were paid.

   (g) On 31st December 2021, rent of TZS 50,000 was owing.

   (h) On 31st December 2021, rates of TZS 60,000 had been prepaid.

   Required

   As accountant trainee in ABC Enterprises, prepare a rent account and rates account showing accruals and prepayments respectively (if any) for the year ended 31st December, 2021.

11. Which one between cash accounting and accrual-based accounting is more likely to be used by a sole proprietor? Explain by using relevant examples.

12. PPM General Supplies is dealing with the supply of goods and provision of services in Dodoma. During the month of December, 2021, the company performed the following transactions:

   7th Dec. Paid TZS 75,000 for electricity spent last month,

   12th Dec. Received TZS 1,000,000 from a client for goods supplied and invoiced in the last month.

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24th Dec. Sent out an invoice for TZS 5,000,000 for this month's cleanness services to the referral hospital.

28th Dec. Received a bill of TZS 1,000,000 for services provided during the month.

Required

Determine the revenues and expenses to be recognised in the statement of profit or loss and other comprehensive income based on the following methods.

(a) Cash based accounting,

(b) Accrual based accounting.

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Chapter Seven

Preparation of financial statements

Introduction

In this chapter, you will learn about the concept of financial statements, their objectives and how to prepare complete set of a business financial statements. The competencies developed in this chapter will enable you to identify and describe the different elements of financial statements and prepare them according to established accounting standards.

The meaning of financial statements

Financial statements are written reports prepared by the management of a business or company that capture its financial activities and performance in a summarized format. The IFRS, conceptual framework for financial reporting, defines financial statements as a particular form of financial reports that provide information about the reporting entity's assets, liabilities, equity, income and expenses. Financial statements are usually prepared periodically; quarterly, half a year or on yearly basis. However, many companies are required by the law to prepare and publish their financial statements at the end of accounting period, covering a total of 12 months. Financial statements are also referred to as, the general-purpose financial statements. They are termed as such because they are intended to meet the needs of different users who are not in a position to demand an entity to prepare tailored reports according to their information needs. Primarily, financial statements are prepared to meet the needs of external users including, shareholders, lenders and other creditors.

Note that, the users of financial statements (also known as users of accounting information) are many. Even their interest and objectives for demanding financial statements are so diverse. This makes difficult for management to prepare financial reports that meet the specific needs and objectives of each type of users. To extend their usefulness, financial statements or general-purpose financial statements are prepared to incorporate all important information that reflects the business activities of the company, its financial performance, financial

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position and cash flows. In order to enhance understand-ability and usefulness of financial statements to a wide range of users, accounting principles, concepts and standards are used to guide the preparation of such statements. For instance, IFRS provides useful recommendations, including specific formats to be used as well as the contents to be included in different types of financial statements. However, it is the users themselves that are supposed to identify key information they need and make analysis to inform their different decisions.

The scope and purpose of financial statements

The financial statements of a company usually are composed of five basic components as described in table 7.1. These include the income statement (also known as the statement of financial performance or statement of profit or loss and other comprehensive income), the statement of financial position (also known as balance sheet), statement of cash flows, statement of changes in equity, and notes to the financial statements. As their respective names suggest, they are prepared for the purpose of providing information about the financial performance (also known as the results of business operations), financial position and cash flows of the business. The purposes of different types of financial statements are summarised in table 7.1 as follows.

Table 7. 1: *Types of financial statements and their purposes*

S/N	Name of the financial statement	Purpose
1.	Income statement	To determine the profitability of the business by matching revenue and expenses incurred in the process of generating revenue.
2.	Statement of financial position	Shows the value or financial worthiness of the business at the time of reporting by listing types and value of assets, liabilities/debts and equity/ capital supporting the business operations.
3.	Statement of cash flows	Shows the nature of cash receipts and cash disbursements by categories i.e., operating, financing and investing activities.

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S/N	Name of the financial statement	Purpose
4.	Statement of changes in equity	Reports the changes in owners' capital/equity due to different related transactions e.g., retained profit/earnings, other reserves, issue of new shares and payment of dividends over an accounting period.
5.	Notes to the financial statements	Additional information included with the published financial statements of a company that helps explain how a company arrived at its financial statement figures. These supplemental notes also disclose the detailed assumptions made by accountants when preparing the financial statements. They are essential to fully understand these documents.

The objective of financial statements

The International Accounting Standards state that, the objective of general-purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements provide information about an entity's assets, liabilities, equity, income and expenses. They also show the gains or losses, contributions and distributions to owners (in their capacity as owners), and cash flows. The components of financial statements, along with other information, assist users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

Users of financial statements are not different from those who were described in chapter one; they include persons who have interest in the existence and survival of the business directly or indirectly. These are the persons who read the financial statements of a reporting entity prepared either as a fulfilment of law requirements or just based on entity's own accord. However, in the preparation of general purpose financial statements, major targets are the external stakeholders such as shareholders, lenders and creditors. These persons are critically important for the company since it is from them that the business can raise funds to support operational and strategic activities. In turn, the users would want to have periodical feedback on the financial

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performance and financial position of the business to know how management actually utilizes the resources they have contributed.

The elements of financial statements

The IFRS conceptual framework of financial reporting, identifies the five elements contained in the financial statements namely: assets, liabilities, equity, income and expenses. The basic elements specifically related to financial position (balance sheet) include assets, liabilities and equity. Those specific to the statement of profit or loss (income statement) are income and expenses while the information contained in the cash flow statement reflects both, income statement elements and some elements of the statement of financial position. The meanings of different elements of financial statements are provided in table 7.2 that follows.

Table 7. 2: *Basic elements of financial statements*

S/N	Elements of financial statements	Meanings
	Definitions of the elements relating to financial position	
1.	Assets	Refers to present economic resources controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. Assets can be non-current assets (fixed assets) or current assets. Non-current assets have useful life of more than one accounting period/year, and they can be in a tangible or intangible form. Examples of tangible non-current assets are land, property, machines, fixtures and motor vehicles. Examples of intangible non-current assets are trademarks, goodwill and patents. Meanwhile, current assets are those resources which can be sold or consumed within one period/year. Examples of current assets are cash, stock (inventory), prepayments and debtors (accounts receivable).
2.	Liabilities	A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that the entity has no practical ability to avoid. Liabilities can be non-current liabilities which are the long-term obligations to the business entity or current liabilities which are short term obligations to be settled within a year. Examples of long-term obligations are issued bonds, mortgage loan etc while examples of current liabilities are creditors (accounts payables) and bank overdraft.

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3.	Equity	It is the amount supplied to the business by the owners, either through injecting capital or through retaining any amount of profit derived by the business. Also referred as the residual interest in the assets of the entity after deducting all its liabilities.
	Definitions of the elements relating to financial performance	
4.	Income	Refers to the increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
5.	Expenses	Refers to the decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Activity 7.1

Visit a library or web pages of Dar es salaam Stock Exchange (DSE) to obtain a set of financial statement of any business of your choice, then discuss with your colleague on important issues including the structure and presentation of financial statements. Based on your discussion, make a thorough review and take notes on important issues like the structure and presentation of financial statements. Specifically, observe the name used to introduce the reporting entity or any other kind of identification (e.g., logo). Similarly, examine the elements of financial statements presented in the statements of income and financial position, as provided in this section.

Activity questions

(i) Generally, what are the key issues you have observed with reference to key points highlighted under activity 7.1?

(ii) Does the name used to introduce the reporting entity give an idea regarding the form of business organization i.e., whether a sole trader or a company? Explain!

(iii) What are the new things you have learned regarding the format of financial statements different from what you learned in ordinary level?

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(iv) What new insights have you learned regarding the nature and dimensions of presented elements of financial statements?

(Several groups should make their presentation before the class, and the whole class should be engaged by way of discussion on similarities and differences of key issues of interest to activity 7.1)

While referring to activity 7.1, one of the key issues that should have been observed is that, the names of the reporting entities indicate the form of business organizations i.e., companies. This is relatively different from the sole proprietors' financial statements as observed in the early stages of learning bookkeeping e.g., lower levels of secondary education. The following section considers the differences in preparing the financial statements between sole trader and a company.

The differences between financial statements of a sole trader and a company

As you may recall, business can be organized into different forms including sole trader or sole proprietorship and a company. The sole proprietorship is a kind of business that is owned by a single person with no partners while for the company, several persons may own it through ownership of shares. It is important to understand the major differences between the two, since their differences also affect the ways in which their financial statements are being prepared. Further details on the key differences between sole proprietorship and a company are given in table 7.3, which is followed by details on the differences in their financial statements.

Table 7. 3: *Key differences between sole proprietorship and a company*

S/N.	Distinguishing features	Company	Sole proprietorship
1.	Ownership	Several or many individuals denoted by ownership of shares	Single person with no partners commonly adopted by small retail establishments/shops and individual enterprises/ consulting firms e.g., accountants, lawyers/ attorneys and pharmacists.

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2.	Liability status	Limited liability i.e., owners can suffer on paying the debts of the firms just to the extent of what has been contributed as capital. It also pays corporate tax.	Unlimited liability for the debts, whereby the owner is liable for business debts without limit and pays tax on the profits as personal income tax.
3.	Legal entity status	Complete separation from owners, share ownership can be transferred from one person to another without affecting company existence. Company can buy and sell assets and pay corporate tax based on its own profit. Due to this company are required by law to prepare financial statements.	Though from accounting point of view, each sole proprietorship is a separate entity as discussed in chapter one, no complete legal entity status exists. As a result, on selling the enterprise, sole trader must also sell the (net) assets. No legal condition to prepare financial statements – it the decision by owners to do so.

As noted in table 7.3, in many cases, probably due to their small sizes, most of the sole proprietorships tend to generate smaller amounts of revenue and incur few expenses compared to complex organizations like companies. Also, tax payment and reporting for a sole proprietorship flows through the owner's personal tax return, with a separate form used to itemize the major classes of revenues and expenses incurred by the business. In other words, there is no separate tax return for the business, since there is no separate business entity. As a result, the income statement of a sole proprietorship does not include income taxes expense (since its profits are included in the owner's personal income tax return).

Furthermore, no salaries expense paid to the proprietor is recorded on a proprietorship's income statement, since the proprietor receives all the net income of the business. This is the owner's remuneration. Besides, in the statement of financial position, the owner's equity section will have only one item, the owner's equity account or capital. In contrast, for the company shareholders' fund section, several items will be presented including, share capital plus retained earnings and other income and capital reserves. In order to compare and understand the differences in financial statements between sole proprietorship and a company, the following section first introduces the financial statements of a sole proprietor.

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Financial statements of a sole proprietor

For a sole proprietor of relatively small size, probably only limited set of financial statements would be prepared. In most cases, these would include the income statement and statement of financial position. Example 7.1 that follows provides the illustration of statement of financial position of a sole proprietor, namely Allan Hongo as at 31st December, 2021. It reflects the key idea of the accounting equation i.e., total assets = total capital + total liabilities. It can be observed that, the non-current assets (fixed assets) are shown at their cost less the accumulated depreciation, which equals to the net book value of the assets. Current assets, on the other hand, are shown at their historical costs. Liabilities are also shown as non-current liabilities and current liabilities. For the capital, this starts with opening capital at 1st January, 2021 to which, profit for the year is added and from which the drawing during the period is deducted to arrive at the closing capital at 31st December, 2021.

Example 7.1: The structure and contents of statement of financial position of a sole proprietor

Allan Hongo Statement of financial position as at 31 December 2021			
	Cost	**Accumulated depreciation**	**Net book value**
	TZS "000"	**TZS "000"**	**TZS "000"**
Assets			
- Non-current assets	100,000	10,000	90,000
	100,000	10,000	90,000
Current assets			
- Inventory		9,200	
- Receivables		7,600	
- Prepayments		600	
- Bank		4,000	
			21,400
Total assets			111,400

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Capital and liabilities		**TZS "000"**	**TZS "000"**
Capital			
- Balance at 1st January, 2021			75,000
- Add: Profit for the year			19,700
- Less: Drawings			(900)
- Total capital balance at 31st December, 2021			93,800
Liabilities			
Non-current liabilities			
- Interest free loan from Dad			6,000
Current liabilities			
- Payables		8,800	
- Accruals		2,800	
			11,600
Total capital and liabilities			111,400

As for the statement of income, Allan Hongo's usual accounting period i.e., year ended 31st December, 2021, is applied. At the top, the first section is used to determine gross profit for the period. Conventionally, this is known as the trading account. This is followed by the remaining part of the income statement showing the overheads, and is used to determine the net profit for the period.

Example 7.2: The structure and contents of statement of financial performance of a sole proprietor

Allan Hongo Income statement for the year ended 31st December 2021		
	TZS "000"	**TZS "000"**
Sales/revenue		160,000
Cost of sales:		
- Opening inventory	3,300	
- *Add:* Purchases	109,100	
- *Less:* Closing inventory	(9,200)	

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- Cost of goods sold		(103,200)
Gross profit		56,800
Less: Other expenses:		
- Rent	24,000	
- Electricity	3,800	
- Business rates	3,400	
- Depreciation expense	5,000	
- Irrecoverable receivables expense	900	
Total expenses		(37,100)
Net profit for the year		19,700

The process of preparing financial statements of a sole trader was well covered in Bookkeeping subject taught in lower levels of secondary education. However, for the purpose of refreshing your knowledge and maintaining continuity, the following exercise 7.1 is given for you to attempt.

Exercise 7.1

You are a junior accountant in Mahmud Enterprises, a sole trader with the following trial balance, as at 31st May, 2021. You are required to review the given trial balance thoroughly and then prepare a set of financial statements as directed at the end of the trial balance.

Mahmud Enterprises

Trial balance as at 31st May 2021

Details	**Dr. TZS "000"**	**Cr. TZS "000"**
Sales and purchases	150,000	241,320
Discount allowed	10,800	
Discount received		2,880
Provision for depreciation (as at 1 June 2020)		
On property		12,000
On equipment		22,800

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Inventory as at 1 June 2020	30,000	
Capital as at 1 June 2020		72,780
17% long-term loan		18,000
Irrecoverable debts	2,760	
Returns outward		9,000
Wages and salaries	35,280	
Drawings	14,400	
Loan interest	3,060	
Other operating expenses	10,620	
Accounts payable		21,600
Accounts receivables	22,800	
Cash in hand	180	
Cash in bank	780	
Property at cost	72,000	
Equipment at cost	48,000	
Allowance for receivables		300
	400,680	**400,680**

The following additional information as at 31st May, 2021 is also provided for your review:

(i) Inventory as at 31st May, 2021 has been valued at cost as TZS 25,200,000.

(ii) Accruals required for wages and salaries are TZS 480,000.

(iii) Other operating expenses are pre-paid by TZS 180,000.

(iv) The allowance for receivables is required to be maintained at 2% of accounts receivables.

(v) Depreciation for the year ended 31st May, 2021 has still to be provided for, as follows:

- Property: 1.5% per annum using the straight-line method; and
- Equipment: 25% per annum using the reducing balance method.

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Required

For Mahmud Enterprises, prepare the following

(a) Statements of income for the year ending at 31st May, 2021 and

(b) Statement of financial position as at the same date.

Financial statements of a company

Unlike a small business (a typical of most sole proprietorship), a company would prepare a complete set of financial statements in addition to the two statements already covered so far. For a public company, besides the statements of financial position (balance sheet) and income statement, additional financial reports include, the statement of cash flows and statement of changes in equity. Different types of financial statements, which are usually prepared by the company, can now be considered.

Statement of financial position

As noted earlier, the statement of financial position of a company will be slightly different from that of sole proprietor especially in the equity section. Let us consider the following statement of financial position of a company named Udzungwa Ltd and associated notes, which clarify certain matters presented in the statement.

Example 7.3: The structure and contents of statement of financial position of a company

Udzungwa Ltd
Statement of financial position as at 31st December, 2021

ASSETS	Note	TZS "000"	TZS "000"
Non-current assets at net book value (NBV)			
- Property and equipment	1	18,000	
- Vehicles	1	56,250	74,250
- Non-current investment			18,000
- Total non-current assets at NBV			92,250
Current assets			
- Inventory		70,000	
- Receivables	2	89,110	

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- Prepayments		1,000	
- Bank		62,490	
			222,600
Total assets			314,850
EQUITY AND LIABILITIES			
Equity			
- Share capital: Ordinary shares		80,000	
- Reserves: Retained earnings		107,100	
			187,100
Liabilities			
Non-current liabilities			
- 6% debentures			40,000
Current liabilities			
- Trade payables		63,500	
- Accruals		5,200	
- Corporation tax payable		19,050	
			87,750
Total equity and liabilities			314,850

Notes on accounting policies

1. Depreciation policy: Udzungwa Ltd depreciates non-current assets as follows:
   - Property and equipment – straight-line method over 20 years.
   - Motor vehicles – reducing balance method 25% per annum.
2. Net receivables: receivables are shown net of an allowance for receivables of 5%.

Activity 7.2

Refer to the statement of financial position of Allan Hongo given in example 7.1 and then compare it with that of Udzungwa Ltd in example 7.3. After the review, how do you differentiate the statement of financial position of Udzungwa Ltd from that of Allan Hongo.

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Statement of financial performance

The statement of financial performance is also known as the income statement. For the listed companies, this financial report is identified as 'statement of profit or loss and other comprehensive income' or simply 'comprehensive income statement'. In simple words, comprehensive income is the income of a company that includes both operating profit and income from other sources like return on investments. The two can be presented in the same section or separately as a statement of profit or loss, and a statement of other comprehensive income. Example 7.4 that follows is used as illustration of the income statement of a company.

Example 7.4: The structure and contents of statement of financial performance of a company as reflected in Udzungwa Ltd is as follows

Udzungwa Ltd
Statement of financial performance for the year ended 31st December, 2021

	Note	TZS "000"
Sales revenue		620,000
Less: Cost of sales		(352,500)
Gross profit		267,500
Less: Administrative expenses	3	(120,100)
Less: Distribution expenses	3	(49,750)
Operating profit (profit before interest and tax)		97,650
Less: Finance costs (interest expense)		(2,400)
Profit before tax		95,250
Less: Corporation tax		(19,050)
Net profit for the year		76,200

Notes on accounting policies

3. Administrative expenses and distribution costs: distribution costs include the depreciation of vehicles and vehicle running expense. All other expenses are included in administrative expenses.

Activity 7.3

Refer to example 7.2, the income statement of Allan Hongo and compare it with that of Udzungwa Ltd in example 7.4. Identify the differences between the statement of financial performance of Allan Hongo (sole trader) and that of Udzungwa Ltd (a company)

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Notes to the financial statements

Notes to the financial statements also referred to as disclosure notes or footnotes to the financial statements are presented at the end of financial statements to provide further details clarifying certain information revealed in the financial statements. They are reflected well at the end of the given illustrations of financial statements of Udzungwa Ltd, numbered as 1, 2 and 3. The accounting standards provide that, notes to the financial statements intend to present information about the basis of preparation of the financial statements and the specific accounting policies used. By definition, accounting policies are the specific principles and procedures adopted by the accountants when preparing financial statements. Examples of accounting policies include measurement systems or basis, procedures for presenting disclosures and accounting methods such as depreciation methods.

Example 7.5

The following trial balance has been extracted from the books of Bagonza Plc as at 30th September, 2021:

Details	Dr TZS "000"	Cr TZS "000"
Administrative expenses	400,000	
Ordinary share capital (1,200,000 shares of TZS 1,000 each)		1,200,000
Cash at bank and in hand	60,000	
Corporation tax (overpayment for the year to 30th September 2020)	20,000	
Distribution costs	600,000	
Dividend received (on 31st March 2021)		249,000
Extraordinary items (net of tax)		1,500,000
Freehold property at cost	2,700,000	
Freehold property's accum. depreciation (at 1st Oct., 2020)		260,000
Interim dividend (paid on June 2021)	36,000	
Investments in United Republic of Tanzania companies	2,000,000	
Plant and machinery:		
- At cost	5,200,000	

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- Accumulated depreciation (at 1st October 2020)		3,600,000
Profit and loss (at 1st October 2020)		2,022,000
Purchases	16,000,000	
Research expenditure	75,000	
Stock (at 1st October 2020)	2,300,000	
Tax on extraordinary item		860,000
Trade creditors		2,900,000
Trade debtors	2,700,000	
Turnover		19,500,000
	32,091,000	**32,091,000**

Additional information

1. The stock at 30th September, 2021 was valued at TZS 3,600,000,000
2. Depreciation for the year to 30th September, 2021 is to be charged on the historical cost of the non-current assets as follows: -
   - Freehold property: 5 percent,
   - Plant and machinery: 15 percent.
3. The basic rate of income tax is 30 percent.
4. The directors propose a final dividend of TZS 600 per share.
5. The company was incorporated in 2014.

Required

Prepare Bagonza Plc.'s statement of financial performance for the year to 30th September, 2021 and a statement of financial position as at that date.

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Solution 7.5: Financial statement of Bagonza

Bagonza PLC

Statement of financial performance for the year ending 30th September, 2021

	TZS	TZS
Sales (turnover)		19,500,000,000
Less: Cost of goods sold		
Opening stock	2,300,000,000	
Add: Purchases	16,000,000,000	
Cost of goods available for sale	18,300,000,000	
Less: Closing stock	3,600,000,000	14,700,000,000
Gross profit		4,800,000,000
Less: Expenses		
Administrative expenses	400,000,000	
Distribution costs	600,000,000	
Research expenditure	75,000,000	
Depreciation expenses:		
- Freehold property	135,000,000	
- Plant and machinery	780,000,000	
Total expenses		(1,990,000,000)
Profit before tax		2,810,000,000
Less: Income tax expenses		(843,000,000)
Profit after tax		1,967,000,000
Other comprehensive income:		
Add: Extra-ordinary item (net of tax)	1,500,000,000	
Dividend received	249,000,000	1,749,000,000
		3,716,000,000
Less: Dividends:		
- Interim dividend paid	(36,000,000)	
- Proposed dividend	(720,000,000)	(756,000,000)
Retained profit for the year		2,960,000,000
Add: Profit at 1st October 2020		2,022,000,000
Retained profit at 30th September 2021		4,982,000,000

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Bagonza PLC

Statement of financial position as at 30th September 2021

	TZS	TZS
ASSETS		
Non-current Assets		
Freehold property at costs	2,700,000,000	
Less: Accumulated depreciation	395,000,000	2,305,000,000
Plant and machinery at costs	5,200,000,000	
Less: Accumulated depreciation	4,380,000,000	820,000,000
Investments in URT		2,000,000,000
Total non-current assets		**5,125,000,000**
Current assets		
Stock	3,600,000,000	
Trade debtors	2,700,000,000	
Cash at bank and in hand	60,000,000	
Total current assets		**6,360,000,000**
Total assets		**11,485,000,000**
EQUITY AND LIABILITIES		
Ordinary share capital		1,200,000,000
Add: Retained earnings		4,982,000,000
		6,182,000,000
Current Liabilities		
Proposed dividend	(TZS 600 × 1,200,000)	720,000,000
Tax on extra ordinary items		860,000,000
Corporate tax	(843 mil - 20 mil)	823,000,000
Trade creditors		2,900,000,000
Total current liabilities		**5,303,000,000**
Total equity and liabilities		**11,485,000,000**

Introduction to the statement of cash flows and changes in owners' equity

The meaning of statement of cash flows

To understand the meaning of statement of cash flows, it is important to compare it with income statement. The income statement shows the profit of the company

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based on the accrual basis of accounting where revenues and expenses are matched to show the results of operations in the accounting period to which they relate. Under this, revenue is usually recognised in the accounting period in which it has been earned and expenses when they have actually been incurred in generating the associated income. Thus, the income statement does not provide the amount of net cash that the company has (cash revenue minus cash expenses). Statement of cash flows is designed to determine whether sufficient cash/funds are available as and when needed. Therefore, statement of cash flows is very useful in evaluating cash position and liquidity of the company. It can also be useful in analysing the cash receipts and payments from the various activities of a company. Therefore, one can use it as a tool for short term financial analysis and planning, and decision making on different matters e.g., how much should be distributed to shareholders as dividends.

From the meaning above, the objectives of preparing statement of cash flows can be summarised as follows:

(i) To determine inflow and outflow of cash and the cash equivalents obtained from the different kind of activities.

(ii) To seek out various reasons responsible for change in cash balances during the accounting period.

(iii) It helps in depicting the position of the company in terms of liquidity and solvency.

(iv) It also helps in determining the requirement and the corresponding availability of cash for business in future.

Presentation of the statement of cash flows

Statement of cash flows is usually presented neatly and in a systematic manner to show both the inflows and outflows of cash according to the nature of the business activities namely; operating activities, investing activities, and financing activities. This is reflected in the three main sections used to present statement of cash flows, as discussed in the following sections.

(i) Cash flows from operating activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows its ordinary course of activities. Management and providers of finance are highly interested to know this because generated funds are the ones used in repaying loans, maintain the operating capability of the entity, pay dividends and make new

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investments without recourse to external sources of funds. The principal revenue-producing operating activities that determine the profit or loss include the following:

(a) Cash receipts from the sale of goods and the rendering of services,

(b) Cash receipts from royalties, fees, commissions and other revenue,

(c) Cash payments to suppliers for goods and services;

(d) Cash payments to and on behalf of employees,

(e) Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits,

(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities, and

(g) Cash receipts and payments from contracts held for dealing or trading purposes.

(ii) **Cash flows from investing activities**

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the statement of financial position are eligible for classification as investing activities. Examples of cash flows (both inflows and outflows) arising from investing activities include the following:

(a) Cash payments to acquire property, plant and equipment, intangibles and other long-term assets.

(b) Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets.

(c) Cash advances and loans made to other parties.

(d) Cash receipts from the repayment of advances and loans made by other parties.

(iii) **Cash flows from financing activities**

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity. Examples of cash flows arising from financing activities include the following:

(a) Cash proceeds from issuing shares or other equity instruments,

(b) Cash payments to owners to acquire or redeem the entity's shares,

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(c) Cash proceeds from issuing debentures, mortgages and other short-term or long-term borrowings,

(d) Cash repayments of amounts borrowed,

(e) Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

New terms in financing activities include, debentures and mortgages. Debentures are used as debt instrument in the sense that, a way in which a company may raise capital to meet the expenses of an upcoming project or to pay for a planned expansion from other persons besides the equity holders. The exchanges are legally formalized through the use of certificate, which states how much money the investor provided to the business (principal), the interest rate to be paid and the schedule of payments. Investors usually receive their principal back when the debenture matures (i.e., at the end of its term). During, the loan period, the company will be paying only the interest (a percentage of the face value of the certificate, or loan amount) and then the full principal (the loan amount) will be paid when the certificate matures. However, the company (borrower) can redeem or buy back the debentures at any time depending on the agreement with the debenture holders. Mortgage, on the other hand, is a type of loan used to acquire or maintain a home, land, or other types of real estate. The borrower agrees to pay the lender over time, typically in a series of regular payments that are divided into principal and interest. The property then serves as collateral to secure the loan.

Methods for preparing the statement of cash flows

There are two methods which are used to prepare and present statement of cash flows, as explained below:

(i) The *direct method*, in which major classes of gross cash receipts and gross cash payments are disclosed.

(ii) The *indirect method,* in which profit or loss is adjusted for the effects of transactions of non-cash nature i.e., any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The major difference between the two methods can be observed in the way in which cash flows from operating activities is determined. As already noted, the indirect method will start with the net income or profit that has been determined using the accrual-based accounting and adjusting for different items that indicate the company received or spent cash during its normal business activities. On the other hand, the direct method uses actual cash inflows and outflows from the company's operations,

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instead of modifying the operating sections of financial statements normally prepared by using accrual-based accounting. Through illustrations and examples, you will understand well how the two methods are used to determine cash flows from operating activities in the preparation of the statement of cash flows.

Direct method of cash flow statement

In determining the cash flows from operating activities, the direct method focuses more on the specific cash flows items that define the typical receipts and payments of cash in the business to include the following:

(i) Receipts received from Customers,

(ii) Payments paid to Suppliers,

(iii) Payments paid to Employees

(iv) Interest Payments, and

(v) Income Tax Payments.

Using figures extracted from a certain business operation, the section of cash flows from operating activities using direct method can be presented as follows:

Statement of cash flows for the year ended 31st December, 2021

Cash flows from operating activities	**TZS**
Cash receipts from customers	5,000,000
Cash paid to suppliers and employees	(4,000,000)
Cash generated from operations	**1,000,000**
Interest paid	(200,000)
Income taxes paid	(250,000)
Net cash from operating activities	**550,000**

Example 7.6

From the following details of Rehma Limited, calculate the cash flows from operating activities, using the direct method.

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Particulars	TZS
Cash sales	800,000
Balance of trade receivables on 1 April, 2020	500,000
Credit sales	4,270,000
Balance of trade receivables on 31 March, 2021	570,000
Cash paid to employees	600,000
Cash purchases	200,000
Balance of trade payables on 1 April, 2020	300,000
Credit purchases	3,250,000
Balance of trade payables on 31 March, 2021	350,000
Interest paid	200,000
Income taxes paid	250,000

Solution

Rehma Limited

Cash flows from the operating activities for the year ended 31 March 2021

	TZS
Cash receipts from customers (W1)	5,000,000
Cash paid to suppliers and employees (W2)	(4,000,000)
Cash generated from operations	**1,000,000**
Interest paid	(200,000)
Income taxes paid	(250,000)
Net cash from operating activities	**550,000**

Workings:

W1: Cash received from customers

Dr. **Receivable account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
	Balance b/d	500,000		Cash received (balancing figure)	4,200,000
	Credit sales	4,270,000		Balance c/d	570,000
		4,770,000			**4,770,000**
	Balance b/d	570,000			

Total receipts = cash receipts + collections from credit customers

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TZS 800,000 + TZS 4,200,000 = TZS 5,000,000

W2: Cash paid to suppliers and employees

Dr. **Payables account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
	Cash paid (balancing figure)	3,200,000		Balance b/d	300,000
	Balance c/d	350,000		Credit purchases	3,250,000
		3,550,000			**3,550,000**
				Balance b/d	350,000

Cash paid to suppliers & employees = cash purchases + credit suppliers + cash paid to employees

TZS 200,000 + TZS 3,200,000 + TZS 600,000 = TZS 4,000,000

The indirect method of presenting cash flows statement

Determining the cash flows from operating using the indirect method, as already noted, starts with the identification of the net profit figure from the income statement prepared under accrual-based accounting. Thereafter, it will be adjusted by adding and/or subtracting, the different items that indicate the receiving and/or payments of money by the business. These items are provided by other types of financial statements namely, the income statement and balance sheet. The first category of these items includes the changes (increase or decrease) of current assets as presented in the statement of financial position. Remember, these items i.e., cash, debtors, inventory/stocks, and different types of current liabilities are the ones that closely define the daily operations of the business.

For example, assume that, at the beginning of January, 2022, XYZ Company, reported debtors amounting to TZS 150,000 – however, at the end of the same month, the debtors in the books of books were reported as TZS 90,000. By interpretation, the decrease of debtors, is used to indicate that, some of the debtors have paid their due debts within the month. For the company, this means it has received cash from its debtors, TZS 60,000 (i.e., TZS 150,000 – TZS 90,000).

Furthermore, let assume that, at the beginning of the same month, XYZ Company reported as having creditors valued at TZS 200,000. However, at the end of the month their records showed that, creditors totalled TZS 100,000. Interpretatively, the

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company will be considered as having paid some of its creditors within the month. The change in the amount owed to creditors between two different periods is an indication that, XYZ Company used some of its money to settle its debts obligations. Therefore, changes in the balances of different types of assets and liabilities are seen as affecting cash balances throughout the year. Under the direct method of preparing cash flows statement they are considered either as additions or subtractions from the net income to arrive at the amount of operating cash flow.

The second items to adjust net income include the non-cash items as reported in the income statement in respect of which, no cash movements were involved. For example, depreciation costs, deferred income tax, and gain/loss on disposal of assets. Depreciation though charged in income statement as operating expenses; it does not reflect the actual cash payment by the company in a particular accounting period. Remember, depreciation is just an accounting technique for spreading the costs of assets over its useful lifetime. The same applies to deferred income tax, until such tax is paid, the company cannot claim to have spent cash to settle its tax liability. In other words, no cash was reduced in order to pay tax liability. As for gain/loss on disposal of assets, this is simply a notional figure calculated by deducting depreciation costs from the realized value of asset that has been sold. Thus, it reduces the figure of cash received on disposal of asset. Moreover, the whole of disposal value received in cash is usually shown as income from investing activities.

Thus, using the indirect method of presenting statement of cash flows, the cash flow from operating activities will be presented as follows:

Details	TZS
• Start with net income from the income statement.	xxxx
• Add back non-cash expenses, such as depreciation, amortization, and depletion.	xxxx
• Remove the effect of gains and/or losses from disposal of non-current assets, as cash from their disposal is shown under investing cash flows.	xxxx
• Adjust for changes in current assets and liabilities to remove accruals from operating activities.	xxx

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The use of direct and indirect methods in real world of business

Practically, the direct method of preparing statement of cash flows is used by small businesses with relatively few business transactions. However, most of the businesses of the well-established business have a complex and voluminous business transactions – some of them in the form of cash and others, as credit transactions. Moreover, most of these businesses use accrual-based accounting to capture their financial records. Thus, the use of indirect method is reported to be more dominant due to its convenience and simplicity in obtaining the required information, which is readily available in their counting system. A comprehensive illustration on how to prepare the cash flows statement using indirect method can now be considered, after presenting the basic steps used to prepare the statement of cash flows.

Steps used to prepare the statement of cash flows

From the proceeding discussion, five major items, which act as inputs for preparing the statements of cash flows include; net income, non-cash expenses (e.g., depreciation and amortization), and tax liabilities. Others include, gains/losses on disposal of assets, changes in the value of current assets, and current liabilities, as well as, the value of non–current assets and long-term liabilities. Remember that, all this information can easily be obtained from the company's income statement and balance sheet. Having all the necessary information, the statement of cash flows can be prepared by following five basic steps, that follows:

(i) Determine the cash flows from operating activities,

(ii) Determine the cash flows from financing activities,

(iii) Determine cash flow from investing activities,

(iv) Determine net increase or decrease which is obtained by adding amounts from all the cash flow activities.

(v) Add the opening balance of cash to the amount determined in the previous step.

The following example 7.7 will be used to demonstrate the preparation of statement of cash flows using the basic five (5) steps that have been identified.

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Example 7.7

The following are the summarized financial statements of Bambo Co. Ltd. for 2020 and 2021:

Bambo Co. Ltd

Statement of Financial Position as at 31st December

Details	2021 [TZS "000"]	2020 [TZS "000"]
Assets		
- Cash	17,000	15,000
- Debtors	25,000	31,000
- Stock	60,000	45,000
- Fixed asset at cost	120,000	105,000
	222,000	**196,000**
Liabilities		
- Share capital	32,500	31,500
- 6% Debentures due on 31/12/2023	50,000	70,000
- Retained earnings	57,900	35,500
- Creditors	20,000	12,500
- Income-tax payable	24,600	19,500
- Accumulated depreciation	37,000	27,000
	222,000	**196,000**

Bambo Co. Ltd

Income statement for the year ending 31st December

Particulars	2021 [TZS "000"]	2020 [TZS "000"]
Sales	425,000	450,000
Operating expenses (including depreciation, TZS 10,000,000)	(340,000)	(380,800)
Interest on debentures	(3,000)	(4,200)
Net profit before tax	82,000	65,000
Income tax (30%)	(24,600)	(19,500)
Net income after tax	**57,400**	**45,500**

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Bambo Co. Ltd

Statement of retained earnings

Particulars	2021 [TZS "000"]	2020 [TZS "000"]
Retained earnings at the beginning	35,500	25,000
Add: Net profit for the year	57,400	45,500
	92,900	70,500
Less: Dividends declared and paid	(35,000)	(35,000)
Retained earnings at the end of the period	57,900	35,500

Required

Using the given financial statements, prepare the statement of cash flows using the indirect method for Bambo Co. Ltd.

Solution to example 7.7

The following are the workings to explain how the amounts to be presented in different sections of the statement of cash flows are determined. Thereafter, general view of the statement of cash flows statements of Bambo Co. Ltd for the year ending 31st December, 2021, will be presented.

(1) Cash flows from operating activities

As noted, the operating activities cash flow is based on the company's net income, with adjustments for items that affect cash differently than they affect net income. The profit before tax in the income statement of Bambo Co. Ltd company for 31st December, 2021 is TZS 82,000,000. In the statement of cash flows, this amount is shown in the Cash Flows from Operating Activities section as net income or net profit. From the given solution, cash generated from operating activities is obtained by adjusting the net profit with two items namely changes in current assets and liabilities and noncash items.

Changes in the various current assets and liabilities can be determined from analysis of the company's comparative statement of financial position, which lists the current period and previous period balances for all assets and liabilities, as shown in the following section:

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Details	2021	2020	Change [increase/ (decrease)	Interpretation & effect on cash
Debtors	25,000	31,000	(6,000)	Received cash from debtors thus increases cash
Stock	60,000	45,000	15,000	Paid cash to acquire more stock thus reduces cash
Creditors	20,000	12,500	7,500	Borrowed more thus increases cash

The interpretation column shows how the different items either will increase or decrease cash from operating activities, and is reflected as such in the prepared statement of cash flows for Bambo Co. Ltd. As for noncash items, the sole noncash expense on Bambo Co. Ltd.'s income statement, which must be added back, is the depreciation expense of TZS 10,000,000. As for income tax, it is computed based on generated profit at the end of the accounting period, and according to Tanzania tax laws, it is supposed to be paid within one accounting period. This means, the tax liability amounting to TZS 19,500 established in 2020 was effectively paid in 2021.

The cash flows from operating activities of Bambo Co. Ltd can now be computed by adjusting the net profit before tax by adding the figures of items that increase cash (i.e., decrease in debtors, increase in creditors and depreciation), and subtracting the items that reduces cash (i.e., increase in stock and tax paid). Based on these the cash flows from operating activities will be presented as follows:

(1) Cash flow from operating activities:	**TZS**	**TZS**
Net profit		82,000
Add: Decrease in debtors	6,000	
- Increase in creditors	7,500	
- Depreciation	10,000	
	23,500	
Less: Increase in Stock	(15,000)	8,500
Cash generated from operating activities		**90,500**
Less: Tax paid		(19,500)
		71,000

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(2) Cash flow from investing activities

As noted earlier, cash flows from investing activities always relate to long-term assets (non-current assets) transactions and may involve increases or decreases in cash related to these transactions. Changes in these assets for the period can be identified in the noncurrent assets section of the company's comparative balance sheet, combined with any related gain or loss that is included on the income statement. In our example 7.7, the increase in fixed assets can be determined as TZS 15,000; computed as follows:

Details	TZS
Fixed assets reported in 2021	120,000
Fixed assets reported in 2020	105,000
Increase in fixed assets	15,000

(3) Cash flow from financing activities

As noted, cash flows from financing activities always relate to either long-term debt or equity transactions (including payment of dividends) and may involve increases or decreases in cash related to these transactions. Changes in long-term liabilities and equity for the period can be identified in the noncurrent liabilities section and the shareholders' equity section of the company's comparative balance sheet, and in the retained earnings statement. In the case of Bambo Co. Ltd., two items namely, shares and debentures are identified in the company's balance sheet while dividend payment can be observed in the statement of retained earnings. Changes of identified long term debts (debenture) as well as equity, can be summarized as follows:

Details	2021	2020	Change [increase/ (decrease)	Interpretation & effect on cash
Share capital	32,500	31,500	1,000	Issued more cash thus received cash
6% Debentures due on 31/12/2023	50,000	70,000	(20,000)	Redeemed/bought back part of the debentures thus paid cash

From the statement of retained earnings, dividend paid during the year amount to TZS 35,000. Thus, Bambo Co. Ltd net cash spent on investing activities amounted to TZS 54,000,000, which can be summarised as follows:

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Details	TZS "000"	TZS "000"
Issue of shares	1,000	
Redemption of debentures	(20,000)	
Dividend paid	(35,000)	
Net cash from financing activities (C)		**(54,000)**

Consolidating together the three different sections illustrated so far i.e., cash flows from operating activities plus cash flows from investing activities as well as cash flows from financing activities would provide a general picture of the statement of cash flows, presented as follows:

Bambo Co. Ltd.

Statement of cash flows for the year ended 31st December, 2021

Details	TZS "000"	TZS "000"
(1) Cash flow from operating activities:		
Net profit		82,000
Decrease in debtors	6,000	
Increase in creditors	7,500	
Depreciation	10,000	
	23,500	
Increase in Stock	(15,000)	8,500
Cash generated from operating activities		**90,500**
Less: Tax paid		(19,500)
Net cash from operating activities(A)		**71,000**
(2) Cash flow from investing activities:		
Purchase of fixed assets	(15,000)	
Net cash from investing activities (B)		**(15,000)**
(3) Cash flow from financing activities:		
Issue of shares	1,000	
Redemption of debentures	(20,000)	
Dividend paid	(35,000)	
Net cash from financing activities (C)		**(54,000)**
Net cash flow from all activities (A+B+C)		**2,000**
Add: Opening balance of cash		15,000
Closing balance of bank		**17,000**

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Note that, the opening cash balance is obtained from the statement of financial position of Bambo Co. Ltd., as presented at the end of 31st Dec., 2020.

The statement of changes in equity

The statement of changes in equity summarises all the transactions that the organisation has had with its owners/shareholders. The statement explains the changes in a company's share capital, accumulated reserves and retained earnings over the reporting period. In other words, it shows how the change in the equity section of the statement of financial position of a company has come about. For example, it may show an increase due to profit or a decrease due to loss or dividend payments during the year. It may also show any increase due to new share issues. In summary, the statement of changes in owners' equity will show either of the following:

(i) Whether shareholders have maintained their original investment in the organization.

(ii) If shareholders' capital has been added or reduced over a particular period.

(iii) The levels of profit earned by the organization that has been reinvested into the business and the portion that has been paid out to owners/shareholders in the form of dividends.

The structure of the statement of changes in equity can now be presented as follows:

	Shares	Retained earnings	Total equity
	TZS "000"	TZS "000"	TZS "000"
Balance as at 1 March, 2018	80,000	33,300	113,300
Dividends paid		(2,400)	(2,400)
Total profit for the year		76,200	76,200
Balance as at 28 February, 2019	80,000	107,100	187,100

Example 7.8

Following is the information for Dilunga Company Ltd:

(1) The issued share capital is TZS 50,000,000 as at 1 April, 2020. The company issued 20,000 equity shares on 1 October, 2020 at TZS 1,500 each. The face value of equity shares is TZS 1,000 per share.

(2) The retained earnings as at 1 April, 2020 are TZS 30,000,000. The profit for

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the year ended 31 March, 2021 is TZS 34,810,000. The dividend paid on ordinary shares on 1 June, 2021 is TZS 7,000,000.

(3) Dilunga revalued its property namely ABB to TZS 20,000,000 in June 2021 – the cost of which being TZS 13,200,000 before revaluation.

(4) The opening balance of share premium account at 1 April, 2020 is TZS 40,000,000.

Required

For Dilunga Company Ltd., prepare the statement of changes in equity for the year ending 31st March, 2021.

Solution 7.7

Dilunga Company Ltd

Statement of changes in equity for the year ended 31st March 2021

Particulars	**Share capital TZS '000'**	**Share premium TZS '000'**	**Revaluation Reserve TZS '000'**	**Retained earnings TZS '000'**	**TOTAL TZS '000'**
Balance at 01/04/2020	**50,000**	**40,000**	-	**30,000**	**120,000**
Changes in accounting policy	-	-	-	-	-
Restated balance	**50,000**	**40,000**	**-**	**30,000**	**120,000**
<u>Changes in equity in 2020:</u>					
▪ Shares issues on 01/10/2020	20,000	-	**-**	**-**	20,000
▪ Share premium issued 01/10/2020		10,000	**-**	**-**	10,000
Balance at 31/03/2021	**70,000**	**50,000**	**-**	**30,000**	**150,000**
<u>Changes in equity in 2021:</u>					
▪ Total comprehensive income	-	-	6,800	34,810	41,610
▪ Dividends paid	-	-	-	(7,000)	(7,000)
Balance at 31/03/2021	**70,000**	**50,000**	**6,800**	**57,810**	**184,610**

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Chapter summary

This chapter has provided relevant materials about preparation of financial statements. The chapter has explained the major differences between the financial statements of a sole trader and those of a company. Key features for the differences include, the size of the business, volume and complexities of business transactions, ownership structure and tax legal liability associated with the form of business entity. For example, due to their small size, fewer transactions and less complicated mode of doing business, most of the sole traders will prepare two basic financial statements. These are called statement of financial performance (i.e., income statement) and statement of financial position (i.e., balance sheet). On the other hand, due to voluminous (big) business transactions and complexities, companies usually prepare additional statements namely, statement of cash flows and statement of owners' equity. The chapter has shown that, in the balance sheet, the main difference can be observed in the equity section that reflect the ownership of the business. For sole trader, there is only one item, the owner's capital section while for the company, there is shareholders fund section which contains several items including, share capital, retained earnings as well as other income and capital reserves.

Regarding the income statement, the company's statement will be extended to include income tax liability, which is paid by the company. Note that, legally sole proprietor business entities are not required to pay tax but their owners (the sole traders) are the ones required to pay income tax. The company's income statement also shows the amount of profit that is distributable to its owners and the amount reserved as retained earnings in a particular accounting period. Concerning the additional financial statements, the statement of cash flows is designed to show the amount of cash generated by the business. It is very useful in this regard compared to statement of income since the latter is usually prepared using accrual-based principles rather than cash-based accounting. On the other hand, statement of changes in equity provides important information to understand how the change in the equity section of the balance sheet has come about. The chapter provides a number of class activities and exercises to enhance better understanding of key issues of interest to this topic.

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Revision exercises

1. What are the key features that differentiate sole proprietorship from a company?
2. How do the identified features, in 1 above, affect the structure and contents of a company's financial reports compared to that of a sole trader?
3. Identify all important types of general-purpose financial statements of a company owned by several shareholders.
4. What are the objectives of preparing each type of financial statement identified under (3) above?
5. What are differences between statement of cash flows and statement of changes in owners' equity.
6. Cash flows statements are a waste of time to prepare since all the necessary information provided by this statement are provided in the income statement. Do you agree with this statement? Comment giving relevant examples to support your argument.
7. Differentiate direct method from indirect method of preparing the statement of cash flows.
8. You are the accountant trainee of Kumekucha company, what are the basic inputs and steps you will follow when preparing the statement of cash flows?
9. The following trial balance has been extracted from the books of Bamaga Ltd as at 30th September, 2021

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Particulars	Dr. TZS "000"	Cr. TZS "000"
Administrative expenses	500,000	
Share capital (3,500,000 ordinary shares of TZS 1,000 each)		3,500,000
Cash at bank and in hand	75,000	
Tax (overpayment for the year to 30/09/2019)		25,000
Distribution costs	750,000	
Dividends received (on 31/03/2021)		311,000
Freehold property:		
- At cost	3,375,000	
- Accumulated depreciation (at 01/10/2020)		325,000
Interim dividend (paid on 30/06/2021)	45,000	
Investments	2,500,000	
Plant and machinery:		
- At cost	6,500,000	
- Accumulated depreciation (at 01/10/2020)		4,500,000
Retained earnings at 01/10/2020		3,428,000
Purchases	20,000,000	
Research expenditure	94,000	
Inventory (at 01/10/2020)	2,875,000	
Trade payables		3,625,000
Trade receivables	3,375,000	
Sales revenue		24,375,000
	40,089,000	**40,089,000**

Additional information:

(a) The inventory at 30th September, 2021 was valued at TZS 4,500,000,000

(b) Depreciation for the year to 30th September, 2021 is to be charged on the historic cost of the non-current assets as follows:

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(i) Plant and machinery: 15 per cent

(ii) Freehold property: 5 per cent

(c) On 30th September, 2021, the directors proposed a final dividend of TZS 75 per share.

(d) The company was incorporated in 2014.

(e) Research and expenditure to be included under administrative expenses.

(f) Tax based on the profits for the year at a rate of 30 per cent is estimated to be TZS 1,062,500,000.

Required

As trainee in Bamaga Ltd., prepare the following:

(a) Profit and loss and other comprehensive income for the year ended 30th September, 2021,

(b) Statement of financial position of Bamaga Ltd as at 30th September, 2021, and

(c) Statement of changes in equity as at the same date.

10. The following trial balance was extracted from the books of Hangaya Plc on 31 December 2021.

	TZS "000"	TZS "000"
Sales		120,500
Returns outwards		3,130
Provision for depreciation		
Plant		7,380
Vehicles		3,750
Rent receivable		1,000
Trade payables		7,380
Debentures		2,500
Issued share capital – ordinary TZS 100 shares		31,250
Issued share capital – preference shares (treated as equity)		6,250
Share premium		3,500
Retained earnings		8,750

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Inventory	8,250	
Purchases	62,630	
Returns inwards	3,500	
Carriage inwards	130	
Carriage outwards	1,250	
Salesmen's salaries	8,000	
Administrative wages and salaries	7,380	
Land	1,000	
Plant (includes TZS 362,000 acquired in 2021)	15,620	
Motor vehicles	11,250	
Goodwill	10,620	
Distribution costs	2,900	
Administrative expenses	2,860	
Directors' remuneration	3,750	
Trade receivables	38,750	
Cash at bank and in hand	17,500	
	195,390	**195,390**

Note of information not taken into the trial balance data:

(1) Provide for:

(i) An audit fee of TZS 3,800,000.

(ii) Depreciation of plant at 20% straight-line.

(iii) Depreciation of vehicles at 25% reducing balance.

(iv) The goodwill suffered impairment in the year, TZS 1,770,000.

(v) Income tax of TZS 5,620,000.

(vi) Debenture interest of TZS 250,000.

(2) Closing inventory was valued at TZS 11,250,000 at the lower of cost and net realizable value.

(3) Administrative expenses were prepaid by TZS 120,000.

(4) Land was to be revalued by TZS 500,000.

Required

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(a) Prepare an income statement for Hangaya Plc for the year ended 31 December, 2021.

(b) Prepare a statement of financial position for Hangaya Plc as at that date.

11. The following is the schedule of balance for the year ended 31st March, 2022 extracted from the books of Ugweno Company Ltd, which carries its business activities in Mwanga District:

	DR TZS "000"	CR TZS "000"
Cash in hand	114,000	
Cash at bank	70,000	
Sundry Debtors	860,000	
Stock as on 1/4/2021	620,000	
Furniture & fixtures	214,000	
Office equipment	160,000	
Buildings	600,000	
Motor car	200,000	
Sundry creditors		430,000
Loan from microfinance		300,000
Provision for bad debts		30,000
Purchases	1,400,000	
Purchase returns		26,000
Sales		2,300,000
Sales returns	42,000	
Salaries	110,000	
Rent for warehouse	55,000	
Interest on loan from microfinance	27,000	
Rates and taxes	21,000	
Discount allowed to debtors	24,000	
Discount received from creditors		160,000
Freight on purchases	12,000	

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Carriage outwards	20,000	
Drawings	120,000	
Printing and stationery	18,000	
Electric charges	22,000	
Insurance premix	55,000	
General office expenses	30,000	
Bad debts	20,000	
Bank charges	16,000	
Motor car expenses	36,000	
Capital		1,620,000
TOTAL	**4,866,000**	**4,866,000**

The following additional information was provided:

(a) Depreciate non-current assets as shown hereunder:

(i) Building used for business by TZS 30,000,000,

(ii) Furniture and fixtures by 10%. One steel table purchased during the year for TZS 14,000,000 was sold for the same price but the sale proceed was wrongly credited to sales account.

(iii) Office equipment by 15%. Purchases of a typewriter during the year for TZS 40,000,000 has been wrongly debited to purchases.

(iv) Motor car TZS 40,000,000.

(b) Value of stock at the close of the year was TZS 440,000,000.

(c) One month rent for warehouse is outstanding.

(d) One-month salary is outstanding.

(e) Interest on loan from Microfinance is payable at 12% p.a. This loan was taken on 1/5/2021.

(f) Provision for bad debts is to be maintained at 5% of sundry debtors.

(g) Insurance charges cover the period from 1/4/2021 to 30/6/2022.

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Required

Prepare income statement for the year ended 31st March, 2022 and the statement of financial position as at that date after taking into account all adjustments.

12. You are presented with the following information relating to Tupendane Plc. for the year to 31st March, 2021:

	TZS "000"
Bank overdraft	500,000
Called up share capital (issued and fully paid)	2,100,000
Corporation tax (based on the profit for the year 31/3/2021	900,000
Creditors	300,000
Debtors	200,000
Deferred taxation (credit)	80,000
Fixed assets, at cost	3,800,000
Fixed assets accumulated depreciation (31/3/2021)	1,400,000
Financial assets investments (corporate bonds at cost)	100,000
Profit and loss account (at 1/4/2020, credit)	1,200,000
Proposed dividend	420,000
Retained profit (for the year to 31/3/2021)	585,000
Share premium account	315,000
Closing stock at cost (31/3/2021)	400,000
Trade creditors	2,000,000
Trade debtors	5,300,000

Additional information:

(a) The above information has been obtained after the compilation of the company's statement of profit or loss and other comprehensive income for the year to 31 March, 2021.

(b) Details of non-current assets for the year to 31 March, 2021 are as follows:

		TZS
(i)	At costs	
	At 1 April, 2020	3,400,000,000
	Additions	600,000,000
	Disposals	200,000,000

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(ii) Accumulated depreciation

At 1 April, 2020	1,200,000,000
Additions	500,000,000
Disposals	300,000,000

(c) The market value of the fixed asset investments at 31 March, 2021 was TZS 110,000,000. There were no purchases or sales of financial assets (corporate bonds) during the year.

(d) Closing stocks comprise finished goods. The replacement cost of these goods is similar to the value indicated in the statement of financial position.

(e) Assume that the basic rate of income tax is 25 per cent.

(f) The authorized share capital of the company consists of 2,500,000, ordinary shares of TZS 1,000 each.

Required

Prepare for Tupendane Plc, the statement of financial position as at 31st March, 2021 and a statement of changes in equity as at that date.

13. Toby Plc.'s income statement for the year ended 31 December, 2021 and the statements of financial position as at 31 December 2020 and 2021 are as follows:

Income statement for the year ended 31 December, 2021

	TZS "000"	TZS "000"
Revenue	576,000	
Cost of sales	307,000	
Gross profit	269,000	
Distribution expenses	(65,000)	
Administrative expenses	(26,000)	
	178,000	
Other operating income	21,000	
Operating profit	199,000	
Interest receivable	17,000	
	216,000	
Interest payable	(23,000)	

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Profit before taxation	193,000	
Taxation	(46,000)	
Profit for the year	147,000	

Statements of financial position as at 31 Dec., for 2020 and 2021

	2020	**2021**
	TZS "000"	**TZS "000"**
ASSETS		
Non-current assets		
Property, plant and equipment		
- Land and buildings	241,000	241,000
- Plant and machinery	309,000	325,000
Total non current assets	550,000	566,000
Current assets		
- Inventories	44,000	41,000
- Trade receivables	121,000	139,000
Total current assets	165,000	180,000
Total assets	715,000	746,000
EQUITY AND LIABILITIES		
Equity		
- Ordinary share capital	150,000	200,000
- Share premium account	-	40,000
- Retained earnings	26,000	123,000
Non-current liabilities		
- Bank loans	400,000	250,000
Current liabilities		
- Bank overdraft	68,000	56,000
- Trade payables	55,000	54,000
- Taxation	16,000	23,000
Total current liabilities	139,000	133,000
Total equity and liabilities	715,000	746,000

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During 2021, the business spent TZS 95,000,000 on additional plant and machinery. There were no other non-current-asset acquisitions or disposals. A dividend of TZS 50,000,000 was paid on ordinary shares during the year. The interest receivable revenue and the interest payable expense for the year were equal to the cash inflow and outflow respectively.

Required

As junior accountant of Toby Plc., prepare the following:

(a) The statement of cash flows for the year ending 31st December, 2021, and

(b) The statement of changes in owners' equity as at 31st December, 2021.

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Chapter Eight

Financial statements analysis and interpretation

Introduction

In this chapter you will learn different concepts and principles related to financial statements analysis and interpretation. You will also learn about important tools used in financial statements analysis and how to interpret the results obtained from this process. The competencies developed will enable you to identify and describe important concepts and principles associated with financial statements analysis and interpretation, and apply them appropriate in generating information useful in decision making by different stakeholders interested in the affairs of the businesses.

The concept of financial statements analysis and related objectives

Analysis is the act of studying or examining something in detail, in order to discover or understand more about it. In many cases, analysis is associated with evaluation and interpretation of key issues. This simply means, giving opinion or judgment, which in many cases is supported with logical arguments about the quality and performance of the item being analysed. Interpretation involves sense making or attaching meanings and explanations to the results obtained. Financial statements analysis and interpretation therefore, involves different activities of rearranging data presented in the financial statements to represent a certain kind of logical relationships and do some computations using different types of accounting tools. This process is concluded by doing some evaluation of obtained results, making judgement and drawing conclusions to support decision making by different users of accounting information.

The objectives of financial statements analysis

Let us consider a situation where a lender (bank) has been approached by an individual or company requiring loan to expand its business. Though banks' main business is to advance loans to individuals and businesses, it will not extend loans carelessly without determining the loan applicant's creditworthiness i.e., whether a person or company is suitable enough to receive financial credit (loan). The judgement for this considers the company's ability

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to repay back the borrowed funds with interest in the future. The answer for this can be determined using different ways including analysing the performance and financial position of the business being considered for a loan. Remember, financial statements provide important information about business activities i.e., operating, financing and investing. When this information is subjected to further analysis it can provide useful insights on the creditworthiness of the business.

Another example; let us consider creditors or suppliers of goods or services on credit to the company. When approached to supply goods or services they will also need some assurance that, they will be paid in time or without much delay. How will they be able to determine this? Among others, financial statements analysis can provide some insights on the ability of the company to fulfil its credit repayment obligations as specified within the terms of credit. The difference between a bank and creditor is on the timing of repaying the credit obligations. While many bank loans are of relatively longer time period, suppliers for goods and services on credit expect to be repaid within relatively shorter period say after a month, two or three. Therefore, though their objectives appear to be the same i.e., to be repaid well in due time, the focus of their examination might be relatively different. For creditors, emphasis might be on short term ability while for bankers the long-run financial solvency of the company. Financial solvency is ability of the company to meet its long-term fixed expenses and to accomplish long-term expansion and growth. This might be important for the bank especially when it intends to issue long term loan.

Other examples may also be considered including potential investor. This might be a company or individual interested to acquire shares or part of the business by supplying additional capital. In this case, the potential investor is the prospective owner of the business, and not the lender. This person will be interested to know whether the business he/she intends to invest in has potential for profit generation and long – term sustainability. In other words, this person will need to be assured with the ability of the business to provide sufficient return from the invested funds. As observed for banker and creditor in the preceding discussions, the potential investors can obtain some useful information to assist in their investment decisions by carrying out financial statements analysis.

From the above, one can clearly see that, there are different objectives for doing financial statements analysis, depending on the objective of a person interested in the concerned business. Nonetheless, it is possible to classify the objectives of financial statements analysis to obtain broader categories that cut across the board. In this book, five major objectives of financial statements analysis are identified and discussed accordingly, as follows:

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(i) *Assessment of past and current performance* – assessment of past financial information in the financial statements can be useful in predicting future trends. It may also assist in setting benchmarks in the assessment of current performance.

(ii) *Aid in decision making* – financial statements on their own may not reveal important financial information required for decision making purposes say by investor. However, financial statements analysis using specific ratios designed to answer different questions of interest to investors (investor performance ratios) can provide important information required by that investor. Financial statement analysis may also show whether the business has made sufficient profit by using specific ratios designed to reveal adequacy of profit generated for the period. This might be useful for management and owners (shareholders) to decide whether to declare dividends during the year or not. By definition, dividend is part of company's profit which is set aside for sharing among shareholders

(iii) *Prediction of profitability and growth prospects* – financial statement analysis helps to predict the growth prospects and profitability of a company by comparing performance trends and also through industry comparison. Trend analysis is the analysis that consider the performance of business and its financial position over a span of time to evaluate the developments. The period under consideration may be five, eight, ten or even more years. This analysis provides a clue on what the future may hold.

(iv) *Prediction of bankruptcy and failure* – financial statement analysis helps in assessing and predicting bankruptcy and probability of business failure. In business world, a business becomes bankrupt when it fails to operate as expected including failure to honour its financial obligations or make payment to its creditors or suppliers.

(v) *Assessment of the operational efficiency* – financial statement analysis helps in judging the company's efficiency in terms of its operations and management. They help judge how well the company is able to utilize its assets and profit earning power.

As noted above, especially in objective (i) and (iii), to achieve the most out of financial statements analysis, there is a need of making comparisons using different bases. This is the subject that is being covered in the following section.

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The need of making comparisons in financial statements analysis

Merely calculated ratios will not provide enough explanations about the financial performance and financial position of a business. For example, if financial ratio reveals that, a retail business has generated TZS 100,000 in sales revenue per square metre of floor space, this information would not be sufficient enough to tell whether this particular level of performance is good, bad or average. However, when using ratios to compare with benchmark i.e., standard or point of reference against which our obtained ratio can be compared, it is possible to make meaningful interpretation on key issue of interest to our analysis. There are three important bases of comparison that are considered in this chapter. These include the following; past periods for the same business, comparison with other similar businesses in the same industry and planned performance for the business.

Past periods – assessing the trends in business performance

By comparing the same computed financial ratios between two or more financial periods of the company, it is possible to detect whether there has been an improvement or deterioration in performance over the period. Indeed, it is often useful to track particular ratios over time (say, five or ten years) to see whether it is possible to detect trends. This kind of analysis is usually termed as horizontal or trends analysis. For instance, as it will be discussed in the following section and subsequent ones, it is possible to calculate gross profit ratio in year one, compare it with the same computed ratio in year two and year three. Thereafter, observe the performance trend with respect to this ratio over the three years and then interpret those results to conclude in which year the gross profit is higher and the possible reasons for such results.

Similar businesses – assessing performance within the same industry

In a competitive environment, a business must consider its performance in relation to that of other businesses operating in the same industry. Survival may depend on its ability to achieve comparable levels of performance. A useful basis for comparing a particular ratio, therefore, is the ratio achieved by similar businesses during the same period. Alternatively, especially in developed countries, comparison can be done against the industry performance averages. Industrial averages are standard industry performance ratios which are established by some dedicated service providers doing periodical analysis of performance in the industry.

Planned performance as bases for controlling business

Planned performance in the form of ratios may be used as basis for exercising control of business. This is usually achieved by comparing the targets that management developed before the start of the period

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under review against actual results. This may be a useful way of revealing the level of achievement attained. However, the planned levels of performance must be based on realistic assumptions if they are to be useful for comparison purposes. Planned performance is likely to be the most valuable benchmark against which managers may assess their own business performance. Businesses tend to develop planned ratios for each aspect of their activities. When formulating its plans, a business may usefully take into account of its own past performance and the performance of other businesses.

Activity 8.1

1. Using different sources of information e.g., library or internet services, identify and explain specific objectives for financial statements analysis. Hint: try as much as possible to identify the specific objectives based on the different categories of users of accounting information.
2. Prepare a table of matrix and fit your specific objectives obtained under (a) above into the broader objectives for financial statements analysis as already identified earlier.

Financial ratios as a tool for financial statements analysis

Generally, ratios express a mathematical relationship between one quantity and another. They show the number of times one value contains or is contained within the other. The relationship between the quantities or values is usually expressed in the form of $\frac{a}{b}$; the result can be presented as a percentage/rate/simple proportion/ fraction (e.g., 40%; 1:2; ¼), respectively. Therefore, financial ratios attempt to measure the relationships among selected financial data extracted from a given set of financial statements – reflecting the concept of breaking down data to provide a more refined result.

Usefulness of ratio analysis

When financial ratios are logically interpreted, they can be very informative for different types of decision-making problems. This is because financial ratios simplify task of making comparison of business performance either by looking into the achievement made by the business over time (trend analysis) or by comparing with other similar businesses (cross sectional) or simply by looking at the already established industry performance levels.

Ratios are also useful where businesses under consideration are of different sizes especially in terms of capital employed to support business operations. In the

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absence of ratios, it would be very difficult to make meaningful comparison. In other words, useful insights can be obtained when one extends his/her analysis beyond simple analysis that focus only on the absolute figures as presented in the financial statements. Consider the following two types of businesses of different size namely, Company A and Company B, as showing in the following table.

Details	Company A	Company B
Capital	500,000	300,000
Profit	100,000	75,000

Taking into account the given details about the two businesses, A and B, important question may be asked, which company is doing well as far as profit making is concerned? Different answers may be given. The first one, by simply observing the absolute profit figures i.e. TZS 100,000 and TZS 75,000 for Company A and B, respectively. Conclusively, Company A may be evaluated positively since it has been able to generate higher profit. The second answer involves looking beyond absolute figures as given; to include relationship between the two i.e. the actual amount of capital involved in generating the observed profits. With this in mind, the second analyst may proceed with comparing generated profits relative to capital used, as presented in the following table.

Formula	Ratio for Company A	Ratio for Company B
$\frac{\text{Profit generated}}{\text{Capital employed}} =$	$\frac{100,000}{500,000} \times 100\%$	$\frac{75,000}{300,000} \times 100\%$
Results	20%	25%

Obtained results provide more useful information indicating that if the amount of capital were to be considered then, it is Company B that has higher performance. This is because it has higher profitability ratio of 25%, which can be interpreted as, for every TZS 100 used, the company was able to generate about TZS 25 as profit. For Company A, a ratio of 20% indicates that, for every TZS 100 used in business operations, it was able to generate TZS 20 as profit.

Categories and types of financial ratios

Five major categories of financial ratios commonly used in the analysis and interpretations of financial statements can be identified as follows:

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(i) Liquidity ratios,

(ii) Profitability ratios,

(iii) Financial leverage or solvency ratios,

(iv) Efficiency ratios, and

(v) Market prospects ratios.

Liquidity ratios

Liquidity refers to how easily a particular category of assets can be converted into cash. Generally, current assets including debtors and stocks/inventory are considered as more liquid asset since they can be converted into cash within a relatively shorter period of time. However, non–current assets like property, plant and equipment are not as easily convertible into cash. Best financial management practices involve being aware of the extent to which the current assets owned by your business can easily be turned into cash. This is crucial since the liquidity of your business is very important in judging how quickly the business can be able to settle its short term repayment obligations not only relating to current liabilities but also the long-term liability as they become current i.e., ready to be settled off.

Remember by definition, current liabilities are supposed to be settled within a near future; not exceeding the period of 12 months or a year. It is the cash and other near cash items (highly liquid assets) that can be useful in paying debts under current liabilities. Liquidity ratios have been designed to assess the ability of the firm to fulfil its current or near future repayment obligations without major problems. Notably, liquidity position is not defined by only hard cash – besides cash in hands, it includes bank deposits and other current assets which can easily be converted into cash. They include not only debtors and stocks /inventory but also different types of short – term financial securities also known as marketable securities like treasury bills as well as high-yield savings accounts.

Liquidity ratios are of particular interest to creditors or suppliers of goods and services. Others include employees and lenders/banks. The latter would be interested specially to judge the ability of the business to service loan i.e., paying interest charges and portion of the principal amount in due time. Meanwhile, creditors are interested because they expect the business to pay within relatively shorter period so that they can continue having sufficient amount of working capital to support their business. For employees, they want to know whether their employer will be able to pay for their salaries and other benefits without much delay.

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Types of liquidity ratios

There are two major types of liquidity ratios namely current ratio and quick ratio. **Current ratio** is computed by relating the total current assets to total current liabilities. It is assumed that, current assets will be converted into cash to meet or settle current liabilities when due. Its formula is presented as follows:

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

How is current ratio interpreted? Conventionally, a number greater than 1 is much preferred. This indicates that, the business can settle its current liabilities without any difficulty. Ratio that is less than 1 is closely associated with potential problems in meeting payment obligations in due time.

Example 8.1

An extracted statement of financial position for Mbongo Plc is given below:

Assets	TZS	Liabilities & equity	TZS
Land and building	1,000,000	Share capital (fully paid up)	1,000,000
Plant and machinery	400,000	General reserve	800,000
Inventory	300,000	Profit and loss account	300,000
Accounts receivable	500,000	Accounts payable	400,000
Cash and bank balances	300,000		
Total assets	2,500,000	Total liabilities & Owners equity	2,500,000

Required

(a) Calculate the current ratio of Mbongo Plc, and

(b) Comments the results you have obtained in part (a) above.

Solution

First you need to identify the items defining the current assets and current liabilities to work on, as follows:

Current assets	TZS	Current liabilities	TZS
Inventory	300,000	Accounts payable	400,000
Accounts receivable	500,000		
Cash and bank balances	300,000		
Total current assets	1,100,000	Total current liabilities	400,000

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Answer to part (a):

$$\text{Current ratio} = \frac{\text{Total current assets}}{\text{Total current liabilties}}$$

$$\text{Current ratio} = \frac{1,100,000}{400,000}$$

$$\text{Current ratio} = 2.75:1$$

Answer to part (b)

Note that, when you are asked to provide comments, basically you are expected to give interpretation about the meaning behind the obtained results. The key issue is, what does the ratio tell you? Giving comments also means you should give an evaluation. For example, is the result obtained good enough – if not why? Your answer should resemble the one that follows:

Current ratio is a useful test of the short-term-debt paying ability of the business. Generally, a ratio of 1:1 or higher is considered as satisfactory. In our case, Mbongo Plc has a current ratio of 2.75:1, which means that, its current assets are 2.75 times higher than its current liabilities. Thus, the company can pay off its current liabilities successfully, by 2.75 times, and still remain with satisfactory level of liquidity to support its ongoing business operations.

However, in real world of business, financial analysts usually act cautiously with the derived ratios like the one obtained above. Usually, they will expand their assessment to consider the nature and quality of individual current assets and current liabilities. Sometimes, it may happen that, significant part of current assets consists of slow-moving items. The inventory of this nature usually takes longer time to sale or simply they are obsolete. In this case, the business with high current ratio of that nature may not be able to pay its current liabilities as they become due. To the contrary, business with low current ratio may be able to pay its current obligations promptly as they become due if a large portion of its current assets consists of highly liquid assets such as cash, bank balance, marketable securities and fast-moving inventories.

Quick ratio is also known as acid test ratio; it is designed to measure the ability of business to pay its short-term debts very fast – using its most liquid assets only. The least liquid current asset like inventory or prepayments (prepaid expenses) are excluded. This is because the sales of finished goods depend highly on customer demands. If the need for the good is low, then the inventory stock will increase and not be quickly converted into cash. As for prepaid expenses, these are not expected

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to be translated into cash. Back to our earlier example of Mbongo Plc, the least liquid current thus would be inventory/stock since it will take longer time to convert it into cash compared to debtors. The highly liquid assets for computing quick ratio thus include, accounts receivable and cash only. This ratio measures the quality of current assets rather than quantity.

Computation of quick ratio is based on the following formula:

$$\text{Quick ratio} = \frac{\text{Total current assets} - \text{inventories} - \text{prepayments (e.g. prepaid rent)}}{\text{Total current liabilities}}$$

Example 8.2

Consider the same information as given in example 8.1 where Mbongo Plc had some information extracted from its statement of financial position presented as follows:

Statement of financial position of Mbongo Plc (An extract)

Current assets:	TZS	Current liabilities:	TZS
Stock	300,000	Accounts payable	400,000
Accounts receivable	500,000		
Cash	300,000		
Total current assets	1,100,000	Total current liabilities	400,000

For Mbongo Plc, quick ratio will be determined as follows:

$$\text{Quick ratio} = \frac{\text{Total current assets} - \text{stock}}{\text{Total current liabilities}}$$

$$\text{Quick ratio} = \frac{1{,}100{,}000 - 300{,}000}{400{,}000}$$

Quick ratio = 2:1

In general, the interpretation of quick ratio as obtained under example 8.2 should relate more with the general meaning of quick ratio already discussed. Quick ratio is considered by many as a more reliable test of short-term solvency compared to current ratio because it shows how quickly the business can meet its short-term debts obligations when required to do so. Our result under example 8.2 indicates that, after excluding its least liquid assets (i.e., inventories), Mbongo Plc will be able to cover or pay 2 times more for its current liabilities if creditors demand so within a shorter period of time. Conventionally, Mbongo Plc would be evaluated as doing

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well in this area as it will manage well in repaying all of its current liabilities and still remain with enough funds to support other business activities.

Suppose a quick ratio for Mbongo Plc was less than 1, say 0.5:1. This would indicate that, this business would not be able to repay all current liabilities out of its most liquid assets. As discussed in current ratio, this ratio should also be interpreted carefully. In practice, a quick ratio of 1:1 or higher might not provide a complete assurance that, the business under consideration is having a strong liquidity position. It is very important to examine closely the quality of some current assets, in our case, the debtors to see the potential for business to collect the debts in due time. Debts which have remained overdue for relatively longer period than agreed are more likely to default. A particular business may have a low value debtors hence low quick ratio but if, it has significant number of fast-moving inventories, it may end up being very efficient in paying its debts as they fall due compared to one that has higher quick ratio. As a rational financial analyst, it is therefore very important to exercise high level of professionalism and good judgement to understand and evaluate well the liquidity of a business.

Another important issue to note is that, there is a limit for usefulness of higher quick ratio in judging the financial position of the business. A higher quick ratio, say of 4:1 is not recommendable since it indicates that, the business is holding too much money in its hands. This money could have been used wisely to generate more wealth for the owners. For example, it could be invested in shorter term financial securities such as treasury bills, which can generate returns within relatively shorter period, in 3 to 12 months' period.

Profitability ratios

Profitability ratios measure the ability of a business to generate profit i.e., revenue in excess of expenses. Profitability ratios attempt to measure the overall efficiency in using economic resources or assets employed to support business operations. The ratios attempt to measure the rate of profitability per shilling value of sales or assets. The figures used to compute most of the profitability ratios exclude interest and tax charges thus the term operating profit or Earnings Before Interest and Tax (EBIT). This is done purposely to avoid or isolate the effect of financing decisions and tax policies on operational performance related decisions. In other words, the use of EBIT is done to avoid distortions, which may arise due to having different capital structures and taxation rules, which may differ across companies. Capital structure is nothing but the combinations of equity versus debt in financing business operations.

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Who are interested in profitability ratios? These ratios are of primary interest to both owners and management of the company. Other external users of accounting information like lenders are also interested in these ratios because in the long–run, they indicate the sustainability and going concern of the business. Profitability ratios can be divided into two major categories namely profit margins and return ratios. The profit margins represent the firm's ability to translate sales revenue into profits while returns ratios are used to evaluate its overall ability to generate adequate profits for the owners of the business. In this book, five major categories of profitability ratios mostly used in businesses decisions are considered. They include the following:

(i) Gross profit margin,

(ii) Operating profit margin,

(iii) Net profit margin,

(iv) Return on assets (ROA),

(v) Return on equity (ROE), and

(vi) Return on capital employed (ROCE).

Gross profit margin

Gross profit margin is used to measure business profitability by relating two financial items namely, gross profit and the company's sales revenue. The gross profit is usually determined in the income statement. It reflects the residual of net sales minus cost of goods sold (COGS). Interpretatively, the larger the gross profit margin the better for the business and its owners. This ratio is computed by taking gross profit divide by net sales – usually presented in percentage.

$$\text{Gross profit} = \frac{\text{Gross profit}}{\text{Net sales}} \text{ x } 100\%$$

Operating profit margin

Operating profit refers to the profit before interest and tax, also known as earnings/profit before interest and tax (EBIT). Operating profit is derived by deducting operating expenses from gross profit. Examples of operating expenses incurred in generating income include, rent, wages and salaries, electricity and insurance. Operating profit margin ratio is determined by relating operating profit to sales revenue of a business. Among others, ability of the management to control its operating expenses can be judged using this ratio, which is associated with company's operational efficiency.

$$\text{Operating profit margin} = \frac{\text{Profit before interest and tax}}{\text{Net sales}} \text{ x } 100\%$$

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Net profit margin

Net profit margin ratio is the percentage of firm's net profit relative to its sales revenue. This ratio is different from operating profit ratio because it is determined by incorporating interest expenses and income tax. This ratio therefore shows exactly the proportion of each shilling of sales revenue counted as net income after all the expenses have been paid.

$$\text{Net profit margin} = \frac{\text{Profit after tax}}{\text{Net sales}} \text{ x } 100\%$$

Example 8.3

The following is the income statement of Manda Enterprises Ltd., for the year ending 31st December, 2021.

	TZS "000"	TZS "000"
Sales		400,000
Opening stock	60,000	
Add: Purchase	275,000	
	335,000	
Add: Carriage inwards	25,000	
Cost of goods available for sale	360,000	
Less: Closing stock	75,000	
Cost of goods sold		285,000
Gross profit		115,000
Administrative expenses	45,000	
Selling & distribution expenses	10,000	
Office expenses	5,000	
Non-operating expenses	15,000	
Total operating & non-operating expenses		75,000
Net profit for the year		40,000
Add: Other income		
Interest on investment		10,000
Total comprehensive income		50,000

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Required

(a) Calculate the following:
   (i) Gross profit ratio or margin,
   (ii) Operating profit ratio or margin, and
   (iii) Net profit ratio or margin.

(b) Interpret your results from (i) to (iii) above.

Solution to part (a)

(i) Gross profit margin $= \frac{\text{Gross Profit}}{\text{Net sales}} \times 100\%$

Gross profit margin $= \frac{115,000}{400,000} \times 100\%$

Gross profit ratio = 28.75%

(ii) Operating profit ratio $= \frac{\text{Earnings Before Interest and Tax}}{\text{Net Sales}} \times 100\%$

- Find net operating profit = gross profit – total operating costs (Total operating costs administrative expenses + selling & distribution expenses + office expenses)
- Net operating profit = 115,000 – (45,000 + 10,000 + 5,000)
- Operating profit ratio $= \frac{55,000}{400,000} \times 100\%$
- Operating profit ratio = 13.75%

(iii) Net profit margin $= \frac{\text{Profit after interest and tax}}{\text{Net sales}} \times 100\%$

Net profit margin $= \frac{50,000}{400,000} \times 100\%$

= 12.5%

Answer to part (b)

Generally, obtained financial ratios can be interpreted differently. For example, gross profit ratio of 28.75% means, the business is able to generate TZS 28.75 as gross profit for every TZS 100 it makes as sales. This ratio essentially tells us that Manda Enterprises Ltd is able to generate TZS 28.75 as gross profit out of TZS 100 net sales while the cost of inventory or merchandise sold is TZS 71.25 out of TZS 100 net sales, i.e., net sales = gross profit + cost of goods sold. In other words, the percentage margin is 28.75% on net sales and is available now to cover for operating expenses. The table hereunder depicts the relationship between sales, gross profit and cost of goods sold:

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Relationship between net sales, gross profit and cost of goods sold

Net sales	Gross Profit	Cost of goods sold
TZS 100	28.75	71.25
100%	28.75%	71.25%

As for operating profit ratio of 13.75%, this ratio means for every TZS 100 of sales, Manda Enterprises Ltd is able to make about TZS 13.75 as operating profit before considering interest and tax. Further, a net profit ratio of 12.5% indicates that, after meeting all the expenses including interest charges and tax, Manda Enterprises Ltd remains with TZS 12.5 as profit for every TZS 100 it generates as sales.

Do they indicate good or poor performance? Note that for all three types of profit margins, the higher the ratios, the better, and lower ratios are not preferred. However, to provide more useful answer, more information will be needed including, comparing with what has been achieved in the past. Based on this, the management and other stakeholders will prefer higher ratios that keep on increasing over time. Another benchmark would be the average performance for the industry. If these ratios are well above the average performance in the industry, then we could state confidently that, the company is doing better compared to the industry average performance.

Return on assets

Return on assets (ROA) is calculated by dividing net operating income (also known as earnings before interest and tax (EBIT) by total assets. This ratio is normally expressed in percentage (EBIT/Total Assets x 100%). Interpretatively, ROA attempts to measure how efficiently a business is able to utilize its total assets to generate profit during a particular accounting period. Since most business's assets are maintained for one important objective; to generate revenue and hence profit, this ratio helps both management and investors to see how well the business converts its investments in assets into profits.

$$\text{Return on assets} = \frac{\text{Earnings before interest and tax}}{\text{Total assets}} \times 100\%$$

Return on equity

Return on equity (ROE) is calculated by taking net profit after interest and tax divide by shareholders' equity. This ratio is of great interest to investors or shareholders due to its ability to assess the return on their invested funds. Potential shareholders and investors are also interested in this ratio because it can assist them to forecast the potential capability of business to continue generating income. If what they see is a bright future, then they can rationally decide to invest in a particular business

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of their interest. As it is for other profitability ratios, the higher the ROE the better for both existing and potential shareholders and investors. For management, ROE is equally important since it reflects their performance, whether they have acted in the best interest of shareholders and other types of investors.

$$\text{Return on equity} = \frac{\text{Profit after interest and tax}}{\text{Shareholders equity}} \text{ x } 100\%$$

Return on capital employed

Return on capital employed (ROCE) is a profitability ratio that measures how efficient a business is, in generating profits from employed capital. The computations involve dividing the net operating profit by capital employed. Capital employed can be defined in different ways. One among the most used approach is, adding shareholders' equity and all long-term borrowings (non-current liabilities). Alternatively, you can subtract current liabilities from total assets to obtain the same results. In computing ROCE, the measure of profit that is recommended to use is, the earnings before interest and tax (EBIT). Note that, interest expenses (i.e., the cost of loaned capital) and tax (i.e., corporate tax) are not part and parcel of operating expenses. The two are excluded to avoid mixing them with operating expenses hence limiting our evaluation to the operational efficiency of the business. It is also seen as the best practice because it isolate the effect of different decisions namely, operational versus financing decisions.

$$\text{Return on capital employed} = \frac{\text{Profit before interest and tax}}{\text{Capital employed}}$$

Example 8.4

You are given the following statement reflecting the performance and financial position of Calamari Plc.

Calamari Plc

Extracts of information from income statement and statement of financial position

	TZS "000"
Non-current assets	1,000,000
Current assets	300,000
Share capital	600,000
8% bonds	400,000
Reserves	200,000

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Accounts payable	100,000
Net income before interest and tax	80,000
Interest expenses	4,000
Taxation (30%)	24,000

Required

For Calamari Plc compute the following financial ratios:

(i) Return on Assets,

(ii) Return on Equity and

(iii) Return on Capital Employed.

Solution

(a) Return on assets ratio

$$\text{Return on assets} = \frac{\text{Net profit before interest and tax}}{\text{Total assets}} \text{ x } 100\%$$

$$\text{Return on assets} = \frac{80,000}{1,000,000 + 300,000} \text{ x}100\%$$

ROA = 80,000/1,300,000 = 6.15%

(b) Return on equity ratio

$$\text{Return on equity} = \frac{\text{Net profit after interest and tax}}{\text{Shareholders equity}} \text{ x}100\%.$$

$$\text{Return on equity} = \frac{80,000 - (4,000 + 24,000)}{600,000 + 200,000} \text{ x}100\%$$

ROE = 6.5%

Note that shareholders equity includes share capital and reserves.

(c) Return on capital employed ratio

$$\textit{Return on capital employed} = \frac{\textit{Profit before interest and tax}}{\textit{Capital employed}}$$

$$\text{Return on capital employed} = \frac{80,000}{1,200,000} \text{ x}100\%$$

ROCE = 6.67%

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Note: Total capital employed is determined as follows (all figures in TZS "000"):

= Non-current assets + current assets – current liabilities

= TZS 1,000,000 + TZS 300,000 – TZS 100,000 = TZS 1,200,000

Alternatively, capital employed = share capital + reserves + long term debts

= TZS 600,000 + TZS 200,000 + TZS 400,000 = TZS 1,200,000

Exercise 8.1

The following represent some of the information related to Electrical Supplies Ltd at 31st December, 2021:

	TZS "000"	TZS "000"
Turnover		160,000
Gross profit		40,000
Average stock at cost price		10,000
Expenses		8,000
Non-current assets		108,000
Current assets		
- Stock	10,000	
- Debtors	8,000	
- Bank	2,000	
		20,000
Total assets		128,000
Current liabilities		(10,000)
		118,000
Capital		118,000

Required

(a) Identify the following ratios using the names/terminologies similar to those introduced in this chapter.

(i) Gross profit as percentage of sales

(ii) Net profit as percentage of sales

(iii) Net profit as percentage of total capital employed

(iv) Current ratio

(v) Quick asset/acid test ratio

(b) Compute the ratios in part (i) to (v) above using extracted information from financial statement of Electrical Supplies Ltd., and interpret your results.

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Financial leverage or solvency ratios

Financial leverage or solvency ratios have been designed to assess the ability of a company to pay its long-term liabilities such as debt and the interest on that debt. These ratios attempt to measure financial health of the company in terms of its ability to manage operations into the foreseeable future. Ratios at this level focus more on the capital structure of the business i.e. the combinations or proportions of equity and debt used by the business to finance its assets and overall operations. Therefore, financial leverage is concerned with the need to know the overall debt load of a company compared to its assets and owners' equity. This is useful as it reflects how much of the business assets are actually owned by the shareholders or creditors. If owners' equity is higher than overall debts, shareholders are considered as owning the majority of the company's assets.

Consider the accounting equation where A = C + L (A = Assets; C = Capital and L = Liabilities). Supposed L = 0, it means A = C; the financial leverage of this business equals to zero. On the other hand, the business that is highly leverages means it has more debts than equity. Financial leverage ratios are of major interest to creditors and investors due to their ability to indicate the risks involved when advancing loans or making investment decisions. For example, a bank that is approached by a business for a loan, among others, will use financial leverage ratios to see the extent to which the business is overburdened by other liabilities. Thereafter, it will decide whether to advance loan to a business or not. Financial leverage ratios that are used in this kind of decision include, debt ratio, equity ratio, debt to equity ratio, capital gearing ratio and interest cover/coverage ratio. The latter is also known as times interest earned ratio (TIE).

The basic formula to compute different types of financial leverage ratios are presented in the following section.

i. Debt ratio = $\dfrac{\text{Total debts}}{\text{Total assets}} \times 100\%$

ii. Equity ratio = $\dfrac{\text{Total equity}}{\text{Total assets}} \times 100\%$

iii. Debt to equity ratio = $\dfrac{\text{Total liabilities}}{\text{Total equity}} \times 100\%$

iv. Capital gearing ratio = $\dfrac{\text{Total long term debt}}{\text{Shareholders funds}} \times 100\%$

v. Interest cover or TIE = $\dfrac{\text{Profit before interest and tax}}{\text{Interest expenses}} \times 100\%$

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How do we interpret financial leverage ratios?

Different interpretations are associated with each type of financial leverage ratios. An overview of the meanings of each ratio also shedding some lights on how to interpret the identified ratios is given in table 8.1 that follows.

Table 8. 1: *Financial leverage ratios and their interpretations*

S/N	Type of ratio	Meanings/interpretations
1.	Debt ratio	Indicates the percentage of assets financed by debt as opposed to equity.
2.	Equity ratio	Indicates the percentage of assets financed by owners' equity as opposed to liabilities or debts.
3.	Debt to equity ratio	Indicates the relationship between total liabilities and total equity. It echoes the relationship of capital structure items of the business. A capital structure is a combination of equity and debt that makes up the financing of a company or business
4.	Capital gearing ratio	Expresses the relationship between a company's long – term borrowings and its owners' funds or capital.
5.	Interest cover or TIE	Indicates the number of times, the profit covers the interest charge – the higher the ratio the better. This ratio is very important to the lenders because it help them to know if the client is credit-worthy and will be able to repay the principal and interest.

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Example 8.5

ABC Company has applied for a loan from MCB Bank Ltd. As credit analyst of this bank, you are requested by your supervisor to determine the creditworthiness of ABC Company using three financial leverage ratios namely, ***debt ratio, equity ratios and debt to equity ratio***. Generally, the management of the bank is confident that, these ratios will indicate well the long-term solvency of the client. The statement of financial position of ABC Company for the year ended 31st December, 2021 is provided to assist in your analysis.

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ABC Company

Statement of financial position as at 31st December, 2021

	TZS "000"	**TZS "000"**
ASSETS		
Current Assets		
- Accounts receivables		3,000
- Prepaid building rent		1,500
- Stocks/inventories		2,250
Total current assets		6,750
Non-current assets		
- Equipment	12,000	
- Less Accumulated depreciation_	(3,000)	9,000
Total Assets		15,750
LIABILITIES AND OWNERS' EQUITY		
Current liabilities:		
- Accounts payable		2,900
- Accrued payables		450
- Short-term notes payable		150
Total current liabilities		3,500
Long-term liabilities:		
6% Bonds payable		3,750
Total liabilities		7,250
Stockholders' equity:		
- 6% Preferred stock, TZS 100		1,000
- Common stock, TZS 12 par		3,000
- Additional paid-in capital		500
Total paid in capital		4,500
Retained earnings		4,000
Total stockholders' equity		8,500
Total liabilities and stockholders' equity		15,750

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Solution

$$\frac{\text{Total liabilities}}{\text{Total assets}} \text{x}100\%$$

$$\text{Debt ratio} = \frac{7,250,000}{15,750,000} \text{x}100\%$$

$$=$$

Debt ratio ≈ 46%

$$\text{Equity ratio} = \frac{\text{Total equity}}{\text{Total assets}} \text{x}100\%$$

$$= \frac{8,500,000}{15,750,000} \text{x}100\%$$

Equity ratio = 53.97 ≈ 54%

$$\text{Debt to equity ratio} = \frac{\text{Total liabilities}}{\text{Total equity}} \text{x}100\%$$

$$= \frac{7,250,000}{8,500,000} \text{x}100\%$$

Debt to equity ratio = 85%

Meanings and interpretation from computed financial leverage ratios

As for the debt and equity ratios, the debt ratio of 46% means that, lenders have contributed 46% of the total assets of ABC Company while the remaining 54% has been contributed by owners or shareholders. With respect to debt-to-equity ratio, the ratio stands at 85% (i.e., 0.85 or 0.85: 1), which can be interpreted as, for every TZS 85/= debt in the capital structure of the business, a corresponding TZS 100 is equity or shareholders' contribution. More specifically, it implies that for every TZS 100 in the capital structure of a business, TZS 54.05 or 54.05% (computed as 100/185 x100) come from equity financing and TZS 45.95 or 45.95% (computed as 85/185 x 100) come from debt financing. A lower debt to equity ratio indicates that the business is receiving lower amount of financing from lenders or creditors versus funding through equity via shareholders, and vice versa.

What does the capital structure as provided by the above ratios translate? Generally, a high equity ratio and a low debt ratio indicates a strong financial position of the company and greater security for creditors. In the example given, ABC Company has equity ratio of about 54%, which is more likely to be considered favourably. This is in line with the general understanding that equity ratio of 50% is a reasonable ratio. This means that, less than 50% (to be specific, about 46%) of ABC Company are owned by creditors. Suppose, the equity ratio would have been very low, say 15

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percent. This would indicate that, the company is heavily depending on creditors/ debts to support its business operations, which is very risky.

A large portion of debts in the total capital employed are more likely to reduce creditors' interest to invest more in the company. It will also mean that, the company is incurring significant amount of costs in servicing loans (interest expenses). Failure to meet this obligation would results into going concerns problem. The same can be said with regard to debt to equity ratio. A ratio of 1 or 1:1 means that, creditors and stockholders equally contribute to the assets of the business. Debt to equity ratio of less than 1 indicates that the portion of financing provided by shareholders is greater than the portion of financing provided by lenders or creditors. Alternatively, debt to equity ratio that is greater than 1 indicates that the portion of assets provided by creditors is greater than the portion of assets provided by stockholders.

Generally, creditors would like to see a low debt to equity ratio because a low ratio i.e., less than 1 means greater protection for their money. However, it should be understood that, company should think of the balance or proper mix between debts and equity. Taking reasonable amount of loans/debts may prove to be beneficial when the objective is to increase shareholders' wealth if they can be used efficiently. This may be the case to the extent that, borrowed funds are injected into business operations to generate profit, which is greater than the cost of borrowed funds (i.e., interest expenses).

However, it is important to note that, the importance of debt to equity ratios varies from one industry to another. This is because, different norms have been developed and used for different industries. Ratio that is ideal for one industry may be worrisome for another industry. For example, in the banking industry, the debt to equity ratio is inevitably very high in order to finance the lending business. Banks have to collect more and more deposits and savings (which are liabilities or debts to the banks) in order to build up sufficient loanable funds for on-lending purposes. Shareholders contribute a small proportion of the bank financing just for finance initial start-up activities while most of the funding is raised from the public. Thus, it is not surprising that, the debt to equity ratio in banks are very high, sometimes at the ratio of 9:1 depending on the minimum capital requirement mandated by the banking regulatory authorities. Moreover, in some businesses, the debt to equity ratio of 2.5: 1 is acceptable. Nonetheless, a debt to equity ratio of 1:1 is normally considered as satisfactory for most of the companies to indicate that, they are less risky by lenders.

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Example 8.6

This example focuses on interest coverage ratio. Let us assume you are still working to decide on the creditworthiness of ABC Company. However, your supervisor is now interested to know the interest coverage ratio of the client and the interpretations arising out of it. Additional information to assist you in this regard is also given as follows:

Net operating income	2,570,000
Interest expenses	(320,000)
Net income before tax	2,250,000
Income tax (30%)	675,000
Net income	1,575,000

Solution:

$$\text{Interest coverage/TIE ratio} = \frac{\text{Profit before interest and tax}}{\text{Interest expenses}} \text{x}100\%$$

$$= \frac{2,570,000}{320,000} \text{x}100\%$$

Interest coverage or TIE = 8.03 times

Interpretations

TIE ratio of 8.03 times for ABC Company means that, the interest expenses of the company are 8.03 times covered by its net operating income before interest and tax (EBIT). This ratio is very important for lenders – the MCBL Bank Ltd in our case. A high TIE ratio ensures a periodical interest income for lenders while the company with low TIE ratio indicates that, it may face difficulties in raising funds from their business operations to finance its interest expenses. Fortunately, this appears not to be the case for ABC Company.

As a general rule, a ratio of 2 or higher is considered to be adequate to protect the creditors' interest in the business. A ratio of less than 1 means the company is likely to have problems in paying interest on its borrowings. However, a very high TIE may be the result of the fact that the company is unnecessarily careful about its debts and is not taking full advantage of the credit facilities available to them to support its business operations:

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Class activity 8.2

Using the same data as given in example 8.5 (focus on the statement of financial position of ABC Company) as at 31st December, 2021, answer the following questions:

(a) What is the capital gearing ratio of ABC Company?
(b) What interpretation can you make for your obtained result?

Efficiency/Activity ratios

Activity or efficiency ratios attempt to measure how well the business utilizes its assets to generate sales. Some of the ratios also indicate how a company is able to manage well its liabilities. Turnover ratio is another common name used to identify ratios in this category especially those attempting to indicate the number of times particular assets convert into cash or sales. Typical activity or efficiency ratios include the following:

(i) Inventory ratio or stock turnover (stock velocity),
(ii) Debtors' turnover ratio or receivable turnover (debtor's velocity),
(iii) Debtors' collection period,
(iv) Creditors' turnover ratio or payable turnover ratio (creditor's velocity),
(v) Debt payment period, and
(vi) Total assets turnover.

The different types of activity or efficiency ratios, their formula and interpretation associated with each other are presented in table 8.2 that follows:

Table 8. 2: *Different types of activity/efficiency ratios and their interpretations*

S/N	Type of Ratio	Formula	Basic Meanings
1.	Inventory or stock turnover ratio	$\frac{\text{Cost of goods sold}}{\text{Average inventory}}$	Indicates how many times the inventory is being turned over into sales in a year
2.	Debtors or receivables turnover ratio	$\frac{\text{Net credit sales}}{\text{Average receivables/debtors}}$ Where net credit sales = total sales – cash sales	Reflects the number of times per year that a business collects its average accounts receivable. The higher the ratio the better.

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S/N	Type of Ratio	Formula	Basic Meanings
3.	Debtors' collection period ratio	$\frac{\text{Debtors x 365 days}}{\text{Credit sales}}$ Alternatively: months/days in a year ÷ debtors' turnover	Reflects the number of days it takes for a customer to pay. The lower the ratio the better.
4.	Payables or creditors' turnover ratio	$\frac{\text{Net credit purchases}}{\text{Average accounts payables}}$ Where: net credit purchases = total purchases less cash purchases	Measures how quickly a business makes payments to creditors and suppliers that extend lines of credit.
5.	Creditors payment period ratio	$\frac{\text{Average trade creditors x 365 days}}{\text{Net credit purchases}}$ Alternatively: months/days in a year ÷ creditors turnover	Reflects the number of days it takes for a company to settle its bills.
6.	Total assets turnover ratio	$\frac{\text{Sales}}{\text{Total assets}}$	Measures the extent to which total assets are being utilized by the company to generate sales. The higher the ratio the better – lower ratios indicate underutilization of total assets.

Example 8.7

Following is the income statement and statement of financial position of Pendeza Textile Company– a clothing manufacturing firm for the period ending to 31st December, 2021:

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Pendeza Textile Company

Income statement for the period ending 31st December, 2021

Details	TZS "000"	TZS "000"
Gross sales		200,000
Less: Sales returns		5,000
Less: Cost of goods sold		195,000
- Opening stock	3,000	
- Purchases	120,000	
- Cost of goods available for sale	123,000	
- Closing stock	(5,000)	
- Cost of goods sold		118,000
Gross profit c/d		77,000
Add: other incomes (dividends)		10,000
Adjusted gross profit		87,000
Less: Operating expenses		
- Salaries & wages	7,000	
- Administrative Expenses	15,000	
- Selling & distribution expenses	20,000	
- Loss on sale of non-current assets	5,000	
Total operating expenses		47,000
Net profit (EBIT)		40,000

Pendeza Textile Company

Statement of financial position as at 31st December, 2021

Assets	**TZS "000"**
Non-current assets	
- Land	150,000
- Building	200,000
- Plant & machinery	200,000
Total non-current assets	550,000
Current assets	
- Stock	80,000
- Debtors or receivables	50,000
- Bank balance	20,000
Total current assets	150,000
Total assets	700,000

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Liabilities and owners equity	
Equity share capital (5,000 equity shares of 100 each)	500,000
General reserve	50,000
Net profit	70,000
Owners equity	620,000
Current liabilities	
Sundry creditors or payables	80,000
	700,000

Required

(a) Prepare all important activity or efficiency ratios for Pendeza Textile Company to assist management to improve business performance and increase shareholders' wealth.

(b) Explain the meanings and interpretations to be attached to the ratios you have computed in (a) above. Conclude by recommending important actions to be taken by management in order to improve the company's performance.

Solution

(a) **Important activity and efficiency ratios for Pendeza Textile Company**

There are many activity or efficiency ratios one can compute to assist improving business performance depending on one's objective. However, important activity/efficiency ratios can be computed by focusing on turnover ratios and efforts to convert inventory and debtors into cash. Others include, those ratios attempting to measure efficiency in using company's assets and ability to fulfill its short-term obligations. This is related more with creditors who sustain day to day business operations by supplying Pendeza Textile Company with appropriate goods or services on credit.

Calculations of relevant activity/efficiency ratios follows – all monetary figures are presented in TZS "000".

(i) **Inventory activity ratios**

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

$$\text{Stock turnover ratio} = \frac{118{,}000}{(3{,}000+5{,}000)/2}$$

$$= 29.5 \text{ times}$$

$$\text{Days' sales in inventory} = \frac{\text{Days or months in a year}}{\text{Inventory turnover ratio}}$$

$$= 365 \text{ Days} / 29.5 = 12.4 \text{ days}$$

Alternatively; days' sales in inventory = 12 months /29.5 = 0.4 month

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(ii) Debtors' efficiency ratios

- Debtors' turnover ratio = $\frac{\text{Net credit sales}}{\text{Average receivables}}$

However, opening and closing receivables, which are necessary for finding average receivable, are not provided in the problem. This ratio can thus be calculated as:

- Debtors' turnover ratio = $\frac{\text{Total sales}}{\text{Accounts receivables}}$

$$= \frac{195,000}{50,000}$$

3.9 times

- Debtors' collection period = $\frac{\text{Days or months in a year}}{\text{Debtors turnover}}$

$$= \frac{365 \text{ days}}{3.9} = 93.59 \text{ days}$$

$$\text{Or } \frac{12 \text{ months}}{3.9} = 3.1 \text{ months}$$

(iii) Creditors activity ratios

- Creditors' turnover ratio = $\frac{\text{Total purchases}}{\text{Total accounts payable or total creditors}}$
- Creditors' turnover ratio = $\frac{120,000}{80,000}$

$= 1.5$ times

- Creditors' payment period = $\frac{\text{Days or months in a year}}{\text{Creditors' turnover ratio}}$
- Creditors' payment period = $\frac{365 \text{ days}}{1.5}$

$= 243.3$ days

$$\text{Or} = \frac{12 \text{ months}}{1.5} = 8 \text{ months}$$

(iv) Total assets

Total assets turnover ratio = $\frac{\text{Total sales}}{\text{Total assets}}$

$$= \frac{195,000}{700,000}$$

$= 0.28$ times

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(b) **Meanings and interpretations for answers to part (a) above**

Pendeza Textile Company's activity/efficiency ratios obtained in part (a) can be interpreted as in the following part:

Inventory turnover ratios	29.5 times	Pendeza Textile Company turnover or sale of its average inventory is 29.5 times once after every 12.4 days or 0.4 a month for a year.
Days' sales in inventory	12.4 days or 0.4 a month	
Debtors' turnover ratio	3.9 times	Pendeza Textile Company collects its receivables 3.9 times a year once after every 3.1 months. In other words, the company had to wait for an average of 93.6 days before it collects cash from debtors.
Debtors' collection period	93.58 days or 3.1 months	
Creditors' turnover ratio	1.5 times	On average, Pendeza Textile Company pays its creditors 1.5 times after 8 months in a year or it takes for a company an average of 243.3 days to pay its creditors.
Creditors' payment period	243.3 days or 8 months	
Total assets turnover ratio	0.28 times	Indicates that for every TZS 100 invested in Pendeza Textile Company's assets, this produces an average of TZS 28 of sales.

Further analysis to evaluate the performance of Pendeza Textile Company

A thorough understanding of how Pendeza Textile Company performs would need knowing other important issues surrounding its business operations. Generally speaking, a high inventory turnover ratio indicates fast moving inventories while low ratio indicates slow moving or obsolete inventories in stock. A low ratio may also be the result of maintaining excessive inventories needlessly. Maintaining excessive inventories unnecessarily indicates poor inventory management because it involves tiding up funds that could be used in other business operations. However, this kind of interpretations should also compare with general experiences observed in similar companies operating in the same industry. Average industry performance ratios would indicate whether Pendeza Textile Company is performing well or not. For example, if the industry ratio is 35 times a year, then it will be possible to conclude that, Pendeza Textile Company is underperforming.

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Nonetheless, comparisons among the different ratios indicate that, the company is not performing well. For example, significant differences or gaps can be highlighted by looking into inventory turnover ratios versus debtors' turnover and collection periods. While the company sales more frequently its stock of goods (29.5 after every 12.4 days), the collection efforts lag behind – it takes about 3.9 frequencies a year, i.e., after every 3.1 months. Differences are also observed with regard to debtors' turnover ratios versus creditors' turnover ratios. Poor performance for debtors' turnover ratios, as already shown, exceed the creditors turnover ratios. The analysis shows that creditors are being paid 1.5 in a year – roughly after every 8 months. Generally, it is expected that, the two types of turnover ratios (i.e., debtors' turnover ratios and creditors' turnover ratios) should not differ significantly from each other. Why? Because cash collected from sales proceeds (which include goods sold on credit to debtors) is the ones which will be used in liquidating the company's debts namely, the trade creditors who supplied the goods sold by the company.

For activity and efficiency ratios, appropriate recommendations would need the company to review its credit policies and terms of payment, among others. The objective should be to reduce the credit period for customers such that it does not exceed one-month period if Pendeza Textile Company is working in groceries/ apparel industry. Collection efforts should also be intensified in order to have sufficient funds to pay for creditors. Thus, it is important to reduce the payment period closer to creditors' payment period – at least a month. This would in turn improve the image and creditworthiness of Pendeza Textile Company before its creditors.

With asset turnover ratio, an average of 0.28 sales to total assets ratio – again by considering past performance of the same company and the performance of other similar companies in the same industry, one can better judge whether the ratio of 0.28 is good or not. If in the past, for example, Pendeza Textile Company was able to efficiently produce total assets turnover ratio of 1.2 times, which means, the company was able to generate TZS 120 of sales for every TZS 100 invested in assets – we could say for the current year (2021), Pendeza Textile Company performed poorly. Lastly, it is worth noting that, a more comprehensive evaluation could be achieved if industry standards/benchmarks were available.

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Exercise 8.2

Details	TZS
Cash sales	270,000,000
Credit sales	1,080,000,000
Sales	1,350,000,000
Cost of goods sold	960,000,000
Credit purchases	840,000,000
Average total assets	900,000,000
Average inventory	120,000,000
Average accounts receivable	90,000,000
Average accounts payable	80,000,000

Required

(a) From the above information, calculate the following activity ratios:

(i) Assets turnover ratio,

(ii) Inventory turnover ratio,

(iii) Accounts receivable turnover ratio,

(iv) Accounts payable turnover ratio.

(b) What is your interpretation of the results obtained in part (i) to (iv) above?

Market prospects and investor performance ratios

Investor performance or market prospects ratios have been designed to support different investment decisions. By using these ratios, shareholders and potential investors can evaluate the performance of business in terms of its shares value and expected returns. These ratios incorporate the notion of markets because their computation requires the use of some financial data from stock exchange market i.e., an organized marketplace where the sale and purchase of securities such as shares, stocks, and bonds take place. In Tanzania, this refers to the Dar es Salaam Stock Exchange (DSE), which was incorporated on 19th September 1996. Some of the commonly used investor/market-based ratios include the following:

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(i) Earnings per share ratio,

(ii) Price – earnings ratio,

(iii) Dividend per share ratio,

(iv) Dividend yield ratio, and

(v) Dividend cover ratio.

Further discussion of different types of investor or market prospects ratios is considered in the subsections that follow.

Earnings per share (EPS)

Earnings per share (EPS) ratio indicates the amount which an entity has earned per share for the given period. This ratio attempts to show the value of shares by relating it with the amount of profits made during a particular period. The ratio considers all the profits available to each share whether distributed as dividend or retained for reinvestment in the business. It can be determined using the following formula

$$\text{Earnings per share} = \frac{\text{Net income after interest and taxes}}{\text{Number of ordinary shares}}$$

For example, if a company with total ordinary shares of 20 million has earned net profit after interest and tax of TZS 600 million, what would be its EPS?

$$\text{Earnings Per share} = \frac{\text{TZS } 600{,}000{,}000}{20{,}000{,}000}$$

$$\text{EPS} = \text{TZS } 30 \text{ per share}$$

The obtained result shows that, for every ordinary share the company is able to pay a dividend of TZS 30, if all the profits after interest and tax are distributed as dividends to shareholders. However, in practice, companies usually do not distribute all the profits to its shareholders. Some of the profit after interest and tax is kept or retained in the company to be reinvested for new projects or expansion of business activities. It is shown in the statement of financial position as retained profit/earnings.

Price earnings ratio

Price earnings ratio (P/E ratio) can also be termed as price to earnings ratio. This is a common financial ratio used for valuing a company by measuring its current share price relative to its earnings per share (EPS), which has already been explained. This ratio helps in assessing the relative risk of an investment and is determined by using

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the following formula:

$$\text{P/E ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

For example, consider the current market price of a company's share as TZS 1,500/= while earnings per share is TZS 300 – in this case the P/E ratio would be as follows:

$$\text{P/E ratio} = \frac{1{,}500}{300}$$

$$\text{P/E ratio} = 5$$

P/E ratio of 5 indicates that it would take an investor an average of 5 years to recover the cost of the share. It also implies that; the purchaser of the share is investing TZS 5 per any shilling for annual earning. This interpretation assumes that, all things would remain the same i.e., no changes in future company's performance in comparison to the current year. For a rational investor however, before making any investment decision he/she would need to compare this figure with other companies' P/E ratios. Generally, the higher the P/E ratio, the better the expectations of the company's future profitability.

Dividends per share (DPS)

Dividends per share (DPS) attempts to measure the size of the dividends that the company actually pays to its shareholders, calculated as follows:

$$\text{DPS} = \frac{\text{Total dividend paid}}{\text{Total number of ordinary shares}}$$

For example, a company with after interest and tax profit of TZS 6,000,000,000 decides to issue 25% of this profit as dividends. Let us assume that, this company has issued a total of 40 million ordinary shares. For this company the DPS would be determined as follows:

$$\text{DPS} = \frac{\text{TZS}6{,}000{,}000{,}000 \ \text{x} \ 25\%}{40{,}000{,}000}$$

$$\text{DPS} = \text{TZS } 37.5/=$$

This means that every ordinary share would pay a dividend of TZS 37.5 while the remaining TZS 4.5 billion (TZS 4,500,000,000/=) of the profit after interest and tax would be retained for future investment (retained earnings). Clearly, some of the shareholders would want the dividend per share to be as high as possible to finance their personal expenditures. However, the dividends to be paid is usually determined

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by board of directors. Among others, their responsibility includes, balancing different priorities – funds might be retained to finance expansion of business operations.

Dividend yield ratio

Dividend yield measures the relationship between dividend per share (DPS) and the market price of the share. This ratio attempts to evaluate the return on capital investment as a percentage of market prices, calculated as follows:

$$DY = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100\%$$

For example, reflecting more on our previous example where the company paid a dividend per share of TZS 37.5. Now, assume that you have additional information where the share market price of the same company is TZS 750. From this, the dividend yield would be computed as follows:

$$DY = \frac{37.5}{750} \times 100\%$$

$$DY = 5\%$$

Indeed, the obtained result of 5% is not a very high return considering the risk involved in investing money in shares. However, this figure would need to be compared to other investments (e.g., other companies, banks, etc.) to see if it is providing a competitive return.

Dividend cover ratio

The dividend cover or coverage ratio measures the number of times that a company can pay dividends to its shareholders. The ratio is useful especially for investors in estimating the risk of not receiving dividends. Interpretatively, if a company has a high proportion of net income to its total annual amount of dividend payments, there is a low risk that the business will not be able to continue making dividend payments of the same amount. Conversely, if the ratio is less than one, the business may be borrowing money in order to make dividend payments, which is not sustainable. The formula to calculate dividend cover ratio is given as follows:

$$\text{Dividend cover} = \frac{\text{Net profit after interest and tax}}{\text{Annual dividend}}$$

$$\text{Or} = \frac{\text{Earnings per share}}{\text{Dividend per share}}$$

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For example, if a business is having a profit after interest and tax of TZS 600 million and paid a total dividend of TZS 150 million, what will be the dividend cover ratio? The answer to this is presented as follows:

$$\text{Dividend cover} = \frac{600,000,000}{150,000,000}$$

$$\text{Dividend cover} = 4 \text{ times}$$

Dividend cover ratio of 4 times indicates that, the company did not pay the shareholders a significant proportion of the profit after tax in the form of dividends. The company has actually paid a quarter of their profit after tax as dividends. This means, the company retained much of the profit after tax as retained profit probably for re-investment purposes. The amount paid as dividend usually depends on the company dividend policies and other investment decisions. This may include, deciding whether to use more of the internally generated funds for investments or use externally acquired funds. External providers of funds may include, banks and other types of financial institutions. Dividend decisions are made by the company board of directors, which represent the interest of all shareholders.

Activity 8.3

Conduct desk research in a library or the website of Dar es Salaam Stock Exchange (DSE) to obtain a recently published financial report of any public company. Make a review of the given financial statements and the prices of its shares then address the following questions.

(a) Calculate dividend yield and dividend cover ratios.
(b) What interpretations do you make for the two ratios you have computed in (a) above?

Limitations of financial ratios

Although ratios offer a quick and useful method for analysing the performance and financial position of a business, there are some limitations and problems that one should be aware of. This is important because failure to understand the inherent limitations may not only affect the quality of results but also the interpretation derived from the analysis. Being aware of the limitations will assist one to find or take the necessary measure to minimize their effect and interpret the results cautiously. The common limitations and problems involved are considered below:

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Absence of qualitative data and information

Financial statements do not fully incorporate qualitative characteristics of the business. For example, internally generated goodwill and brands are not included in the statement of financial position because they fail to meet the strict definition of an asset. Factors like these may be important in interpretation of financial statements, absence of which may not give a full picture of why a particular company is doing well compared to the other.

Non–uniformity in reporting periods

When the businesses report their financial results using different time period, comparison of the results may also be limited.

Non–uniformity in accounting estimates and policies

Companies may choose different accounting policies, which can have a significant effect on reported profits and asset values (for example, different methods of calculating depreciation or valuing inventories). This can result into incomparability of results of the company when doing financial statements analysis.

Inflation

Conventional financial statements do not take into account the effect of inflation when reporting financial performance and financial positions of the entity. Inflation is the rising of prices of goods and services due to varying reasons including raising cost of goods and increasing demands of goods and services. Increasing prices may in turn distort the real values reflected in figures on which the ratios are based. Distorted values due to inflation may affect interpretation of the analysed figures.

Chapter summary

This chapter has covered different issues related to the analysis and interpretation of financial statements. In total, five categories of financial ratios have been identified including, liquidity ratios, profitability ratios, financial leverage ratios, activity/efficiency ratios and investor/market-based ratios. These ratios provide logical relationships between items found within the income statements as well as those found within the statement of financial position. For example, liquidity ratios indicate the ability of the business to meet its short-term financial obligations while profitability ratios show the ability of the business to translate sales into profits. Other types of profitability ratios attempt to relate profit for the period to assets or owners' funds. Ratios of this nature aim to show the effectiveness of the business in using its assets in general and particularly, the owners' funds in generating profit. Other important ratios like activity/efficiency ratios are designed to

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evaluate the efficiency with which a business uses its assets to generate cash and sales. Within the chapter it has also been shown that, financial leverage ratios focus on evaluating the capital structure of the business and the extent to which business uses funds from owners' and external financiers (e.g. lenders and credit suppliers) to support business operations. The chapter ends by considering investor performance or market prospects ratios. Market based ratios intend to inform existing shareholders and potential investors in making financing and investment decisions. Besides giving relevant examples, the chapter provides different activities and within the text exercises to enable students understand well the key issues of interest to study.

Revision exercises

1. What do you understand by financial statements analysis?
2. What are the objectives for doing financial statements analysis?
3. Identify and explain five major categories of financial ratios described in this chapter?
4. There are different types of financial ratios used in financial reporting including the following:
   (a) Current ratio,
   (b) Operating profit margin,
   (c) Asset turnover,
   (d) Debt ratio,
   (e) Times interest earned ratio, and
   (f) Dividend cover.

   Required

   What is the purpose in using each of the above identified financial ratios?
5. If you were to assess the solvency ratios of a company, which of the following ratios would be used to achieve your objective? Give reasons.
   (a) Stock turnover,
   (b) Interest cover,
   (c) Return on capital employed,
   (d) Capital gearing ratio,
   (e) Acid test ratio,
   (f) Dividend yield,
   (g) Equity ratio,
   (h) Debt to equity ratio.
6. Financial statement analysis is useful for both internal and external stakeholders of the company. However, each type of stakeholders may have different objectives of doing financial statements analysis thus being interested in different types of financial ratios.

   Required

   Discuss the above given statement by identifying company's stakeholders or users of accounting

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information, their different objectives for doing financial statements analysis and types of financial ratios useful for achieving their objectives.

7. Financial ratios are quite useful in supporting financial statement analysis as they simplify the process involved. However, there are some limitations or problems associated with their use.

Required

(a) In what sense financial ratios support and simplify financial statements analysis.

(b) What are the major limitations associated with financial statements analysis?

8. The following is the statement of financial position of Jambo Enterprises Ltd as at 30th June, 2021:

Jambo Enterprises
Statement of financial position (partial extract)

Assets	TZS "000"	Owners' equity & liabilities	TZS "000"
Land and building	140,000	Share capital	200,000
Plant and machinery	350,000	Profit and loss account	30,000
Stock	200,000	General reserve	40,000
Sundry debtors	100,000	12% debenture	420,000
Bills receivable	10,000	Sundry creditors	100,000
Cash at bank	40,000	Bills payables	50,000
Total	840,000	Total	840,000

Required

(a) For Jambo Enterprises Ltd, compute the following financial ratios:

(i) Current ratio,

(ii) Quick ratio

(iii) Debt to equity ratio

(iv) Proprietary ratio

(v) Capital gearing ratio.

(b) What are the relevant interpretations to be derived from your analysis in part (a) above?

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9. Kiwalo Ltd is a family–owned clothes manufacturer based in the southern part of Tanzania. For a number of years, the chairman and managing director was Diana Kiwalo. During her period of office, sales revenue had grown steadily at a rate of 2 to 3% each year. Diana retired on 30 November 2020 and was succeeded by her son Mr. Mukulu Kiwalo. Soon after taking office, Mukulu decided to expand the business. Within weeks he had successfully negotiated a five-year contract with a large clothing retailer to make a range of sports and leisurewear items. The contract will result in an additional TZS 200 million in sales revenue during each year of the contract. To fulfil the contract, Kiwalo Ltd acquired new equipment and premises. Extracted financial statements concerning the business is given as follows:

Kiwalo Ltd Income statements for the year ended 30th November		
	2020 ***TZS "000"***	**2021** ***TZS "000"***
Revenue	9,482,000	11,365,000
Operating profit	914,000	1,042,000
Interest charges	(22,000)	(81,000)
Profit before taxation	892,000	961,000
Taxation	(358,000)	(386,000)
Profit for the year	534,000	575,000

Statements of financial position as at 30 November		
ASSETS	***TZS "000"***	***TZS "000"***
Non-current assets		
Property, plant and equipment		
Premises at cost	5,240,000	7,360,000
Plant and equipment (net)	2,375,000	4,057,000
Total non-current assets	7,615,000	11,417,000
Current assets		
Inventories	2,386,000	3,420,000
Trade receivables	2,540,000	4,280,000
Total current assets	4,926,000	7,700,000
Total assets	12,541,000	19,117,000

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EQUITY AND LIABILITIES		
Equity		
Share capital	2,000,000	2,000,000
Reserves	7,813,000	8,268,000
	9,813,000	10,268,000
Non-current liabilities		
Borrowing – loans	1,220,000	3,675,000
Current liabilities		
Trade payables	1,157,000	2,245,000
Taxation	179,000	193,000
Short-term borrowings (all bank overdraft)	172,000	2,736,000
Total liabilities	2,728,000	8,849,000
Total equity and liabilities	12,541,000	19,117,000

Dividends of TZS 120,000,000 were paid on ordinary shares in respect of each of the two years.

Required

(a) Calculate, for each year (using year-end figures from the statements above), the following ratios:

(i) Operating profit margin

(ii) Return on capital employed

(iii) Current ratio

(iv) Gearing ratio

(v) Trade receivables settlement period

(vi) Sales revenue to capital employed.

(b) Using the above ratios, and any other ratios or information you consider relevant, comment on the results of the expansion programme.

10. Study the following financial statements for two very similar privately owned supermarkets namely, Abby and Benny located in Dar es Salaam Tanzania, then answer the questions that follow.

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Summary of financial statements

	Abby Ltd. TZS "000"	Abby Ltd. TZS "000"	Benny Ltd. TZS "000"	Benny Ltd. TZS "000"
STATEMENTS OF FINANCIAL POSITION				
ASSETS				
Non-current assets				
- Building at cost	300,000		440,000	
- *Less:* Depreciation to date	(255,000)	45,000	(220,000)	220,000
- Equipment at cost	140,000		180,000	
- *Less:* Depreciation to date	(119,000)	21,000	(90,000)	90,000
Total Non-current assets		66,000		310,000
Current assets				
- Stock	200,000		240,000	
- Debtors	205,000		140,000	
- Bank	4,000	409,000	2,000	382,000
Total assets		475,000		692,000
LIABILITIES AND OWNERS EQUITY				
Less: Current liabilities				
- Creditors		245,000		252,000
Owners equity				
Capital accounts at start of year		240,000		430,000
- *Add:* Net profit		60,000		90,000
		300,000		520,000
- *Less:* Drawings		(70,000)		(80,000)
		230,000		440,000
		475,000		692,000
INCOME STATEMENTS				
Sales		1,800,000		2,700,000
Less: Cost of goods sold				
- Opening stock	300,000		280,000	

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- *Add:* Purchases	1,300,000		2,250,000	
	1,600,000		2,530,000	
- *Less:* Closing stock	(200,000)		(240,000)	
		(1,400,000)		(2,290,000)
Gross profit		400,000		410,000
Less: Depreciation expenses	22,000		40,000	
- Other expenses	318,000		280,000	
		(340,000)		(320,000)
Net profit		60,000		90,000

Required

(a) Calculate the following ratios:

(i) Gross profit as percentage of sales,
(ii) Net profit as percentage of sales,
(iii) Expenses as percentage of sales,
(iv) Stock turnover,
(v) Rate of return of net profit on capital employed (use the average of the capital account for this purpose),
(vi) Current ratio,
(vii) Acid test ratio,
(viii) Debtors to sales ratio, and
(ix) Creditors to purchases ratio.

(b) Drawing upon all your knowledge of accounting, comment upon the differences and similarities of the accounting ratios for A and B. Which business seems to be the most efficient? Justify your opinion.

11. A company has capital of 100 million ordinary shares of TZS 100 each. It pays a dividend of 6% out of its profits after tax of TZS 48,000,000 on sales of TZS 400 million. The market price of the shares is TZS 240.

Required

Determine the following ratios:

(a) Net profit after tax to sales
(b) Dividend yield
(c) Earnings per share
(d) Price earnings ratio?

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Chapter Nine

Investment accounts

Introduction

In this chapter, you will learn about the concepts and principles of investments undertaken by business entities. You will also learn some techniques used to record acquisition and disposal of financial investments of a business. The competencies developed in this chapter will enable you to describe the basic concepts and principles related with financial investments. You will also be able to prepare the basic financial records in the books of accounts.

Meaning of investment and other associated terms

An investment is an asset or item acquired with the goal of generating income or appreciation. Appreciation refers to an increase in the value of an asset over time. When an individual purchases an asset as investment, the intention is not to consume such asset rather using it in the future to create wealth. The amount used to invest can either be a surplus from current spending needs or a fund generated deliberately for investment purposes. Surplus income occurs when the income level exceeds the spending needs. Instead of keeping any surplus income in options that will not attract more income/return in the future (e.g., under a mattress or bury it in the backyard or keep the money with someone trusted), it is better to invest because it will generate more money than the current amount. The extra income to be generated will compensate for the time passage, the inflation level that tends to erode the value of money and the uncertainty in the future payments.

The person who invests is known as an "investor" and can be an individual, a government, an institution (pension funds), or a corporation. Meanwhile, investments can be done in real assets such as plants and equipment, real estate, or in financial assets including shares and bonds. However, as identified in the introductory subsection, the chapter focuses on investments in financial assets, specifically ordinary shares (equity securities) and bonds (which are fixed income securities). The following are some of the key terms associated with investments in financial assets:

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(i) **Capital gain**

Capital gain refers to profit earned from the sale of an asset/security which has increased in value during the holding period. It is the profit obtained in the sale of an asset as result of an increase in the value of an asset.

(ii) **Contractual claim**

Contractual claim is a specified amount that must be paid in accordance with the legal agreement. For the case of financial asset, it is the amount that must be paid to the buyer or owner of a security periodically in accordance with the terms of the financial asset.

(iii) **Dividend**

Dividend refers to the distribution of some of the company's profit to its shareholders as approved by the board of directors of the company.

(iv) **Inflation**

Inflation is simply the general increase in price of goods and services, or a fall in the purchasing power of money.

(v) **Investor**

Investor is a person who puts money into an entity or asset with an aim of getting financial returns.

(vi) **Liquidity**

Liquidity refers to how easier an asset or security can be converted into cash without affecting its market value.

(vii) **Stock exchange**

Stock exchange (is also known as stock market) is a centralised location (market) where the shares of publicly traded companies are bought and sold.

(viii) **Financial assets**

A financial asset is an asset such as cash, bonds and equity whose value comes from a contractual claim i.e., an amount that by legal agreement must be paid periodically to the buyer of a security. Contractual claim may also specify the time at which the principal must be repaid.

(ix) **Shares and stock**

A share is referred to as a unit of ownership which represents an equal proportion of a company's capital while stock is the aggregation of shares ownership in a company.

Major categories of investments

Generally, there are two major categories of investments including, financial assets and real assets. These can also be categorised as trading investments and financial securities investments. Investment in financial assets, which is the focus of this chapter, is further subdivided into two types which are equity-based investments and fixed income-based investments. Following is Figure 9.1 showing the major categories of investments and their examples.

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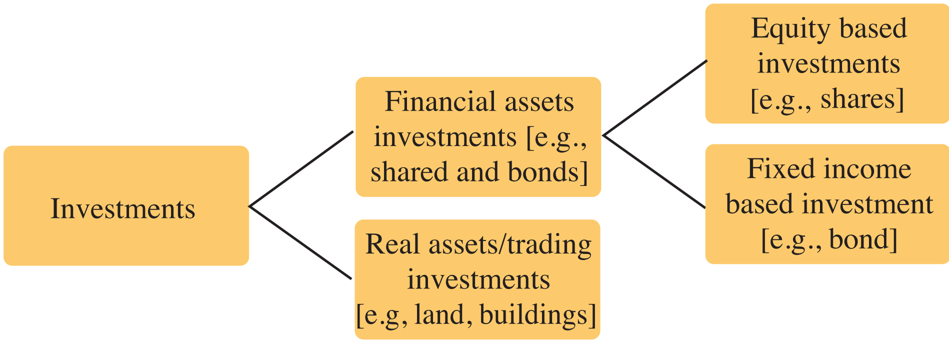

Figure 9. 1: *Major categories of investments*

The advantages and disadvantages of each category of investments

Investments in real and financial assets do share one important similarity, which include providing opportunity or potential for generating cash/revenue. However, there are several differences based on the advantages and disadvantages of each type of investment. For example, real assets are typically less liquid than financial assets since they are usually more cumbersome to exchange and their markets are not as efficient or populated. The value of real assets also is much more dependent on factors such as location, function, and operation and exchange costs. On the other hand, financial assets are typically fungible, thereby making their location independent. The major advantage of real assets includes its ability to offer more protection against inflation – the value of such assets and the income they help generate tend to grow with inflation. Financial assets on the other hand, may or may not be protected against inflation risk. Real assets investment also offers secure and steady income e.g., receiving monthly income from tenants in the form of rent

Activity 9.1

Use different sources of information, including libraries and the internet, to answer the following questions:

1. Identify five possible reasons for an individual to invest in real assets.
2. Identity three real asset investment options that a family can establish to generate income for paying the school fees of two children who are about to start primary school.
3. Identify three real asset investment options that an employee of public institutions (including schoolteachers, police officers, medical doctors, and nurses) can invest in as part of the retirement plan.

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Definition, nature and characteristics of financial assets investment

The following are the different sections providing the definition, nature and characteristics of investment in financial assets:

Definition of investment in financial assets

Investment in financial assets are the investments that arise from contractual agreements on future cash flows or from owning equity instrument of another entity. Financial instrument refers to a contract that generates a financial asset to one of the parties involved in the contractual agreement. Therefore, financial asset is an instrument that is commonly used to facilitate the transfer of funds between those who have surplus funds (known as net savers) and those who have cash deficit (known as net borrowers) in the financial market. Those who provide funds are given certificates, such as share certificates and bond certificates, in return for supplying the funds. These certificates are called financial assets, because they promise future income or returns to the holders (investors). On the other hand, those firms receiving funds (net borrowers or deficit spenders) will issue written certificates (known as shares certificate or bonds certificate) as contractual promise to honour obligations stipulated in the certificates.

Based on the foregoing explanations, we define a financial asset as that asset which derives its value because of a contractual claim. Unlike land or properties, which are tangible physical assets, financial assets do not necessarily have physical worth. It is a claim against the income or wealth of (the other) business firm represented by a certificate, computer record file, receipt or legal document. The claim is created by or related to the transfer of money from the investing firm (net saver) to the cash deficit spender (net borrower). Examples of financial assets are the certificates of deposits in bank, shares bought, bonds, treasury bills, futures contracts and options. These types of financial assets are also termed as securities/financial instruments.

Nature of investment in financial assets

The nature of investment in financial assets is determined by the liquidity of an asset. Some investments are short-term in nature and some investments are long-term in nature. Short term investments are more liquid compared to long term investments. Also, short term investments are less risky than long term investments. Consequently, short term investments promise less return compared to long term investments. In contrast, long term financial investments are those which are not expected to be easily converted into cash in a near period of time. Their acquisition is usually attached to long-term objectives.

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Liquidity preferences can influence investors' decisions. An investor who is expecting to have cash requirement soon (within a year) is more likely to invest in short-term financial assets than in long-term assets. Short-term securities are easily convertible to cash. For example, a person who saves to buy or construct a property is expected to invest in an asset that has different liquidity compared to a person who invests his/her savings to finance school fees of the family. However, some long-term investments (for example publicly traded shares and corporate bonds) can be sold in an open market such as in the stock exchange whenever it is necessary.

Characteristics of financial assets

There are at least three main characteristics that describe financial assets, as explained below:

(i) One of the basic characteristics of financial assets is that they are promises for future returns to the holder. If you buy a share from a certain company, it implies that you own part of that company and you are promised to receive a certain return in form of share of profit and capital growth, respectively known as dividends and capital gain. Similarly, buying a bond issued by the government or by a corporation, you become a creditor to the government or to that corporation. Holding that bond promises you to get returns in form of fixed interest income over a certain period.

(ii) Financial assets serve as store of value (purchasing power). Their value rests on faith that the issuer will honour their contractual promise to pay. Financial assets do not physically depreciate in the same way as physical goods wear out. This is because their physical condition is not relevant in determining their market value (price). The value of financial assets can be affected by demand and supply, company related factors, interest rates, politics, current events, natural calamities, exchange rates, etc. For example, a share certificate not more or less valuable because of the quality of paper used to print it.

(iii) Financial assets are fungible – that is, they can easily be changed into another form and substituted for other assets. Thus, a bond or share can quickly be converted into any other asset the holder desires.

Types and importance of financial assets investment

Financial assets, as identified earlier in the chapter, are subdivided into two main groups, which are equity-based investments and fixed income-based investments. The two categories are discussed in the following subsections, followed by elaboration of importance of financial assets investment.

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Equity-based investment

The most popular equity-based financial asset is the common stock, which is also known as "ordinary share". It is an investment that gives an investor (shareholder) a right to own part of the firm's share capital. Such ownership gives a right to an investor to fully participate in deliberations that affect the success of the investment firm. The following are the benefits accrued to an investor of ordinary shares:

(i) Participating in deliberations of the firm's operations through voting right. The number of shares an investor owns determines the power of the voting right when it comes to deliberations of a firm's operations.

(ii) Investment in ordinary shares attracts a return in the form of either dividends or capital gain or both. Dividend refers to the distribution of the profit generated to shareholders while capital gain refers to an increase in the value of ordinary shares.

(iii) Also, an investor of ordinary shares has a chance to benefit from the bonus shares and rights issue.

Fixed income-based investment

A fixed income-based investment refers to financial assets which attract a fixed amount of return after every period. The return is the interest amount attached to the asset. Fixed income securities include certificate of deposits (CDs), treasury bills, government bonds, corporate bonds, and preference shares. The details of these financial instruments are as follows:

(i) Certificate of deposits is the financial asset that is issued by financial institutions including banks requiring a minimum amount to be deposited for a specified fixed duration. In return, they offer higher interest rates than savings accounts.

(ii) Treasury bills are the short-term financial assets that are issued by the government at a discount and their maturity time is less than a year. The yield of the treasury bill is the difference between the price paid and face value. In Tanzania, for instance, the government through the Bank of Tanzania (BoT) has been issuing treasury bills with maturity days of thirty-five (35), ninety-one (91), one hundred eighty-two (182) and three hundred sixty-four (364).

(iii) Government bonds are the financial assets issued by the government which has maturity duration of more than one year carrying a promise to pay interest periodically. In Tanzania, for instance, the BoT issues treasury bonds on behalf of the government with maturities of two (2) years,

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five (5) years, seven (7) years, ten (10) years, fifteen (15) years, and twenty (20) years. The interest in investment is paid on semi-annual basis.

(iv) Corporate bonds are the long-term financial assets issued by companies. They carry a promise to pay interest periodically. Companies can issue bonds as a way of borrowing funds to finance their operations.

(v) Preference shares are the financial assets issued by companies as means of raising capital. They carry a promise to make an annual payment to an investor, either as a coupon percentage or a specified amount of money, but they do not have a maturity period.

Generally, investment in fixed income financial assets is a loan provided by an investor with an expectation of receiving mandated payment schedules of the interest income and principal amount, except for preference shares. Preference shares do not have a maturity period; consequently, the investor does not expect to get back the principal amount, unless the company is liquidated.

Importance of financial assets investment in business undertaking

Investment in financial assets is very important in the business operations of both an investor and the issuer. Such importance is summarised as follows:

(i) To an investor:

Financial assets provide an opportunity to allocate financial resources wisely. Instead of holding cash, which does not generate a return, it is better to invest.

Investments are the source of regular income.

(ii) To the government and its institutions:

When issuing financial assets, it is the sources of funds/capital to finance their operations and development projects.

Financial assets can be used as a macroeconomic stabilising tool through monetary policy. The government may decide to issue a bond specifically aiming at reducing excessive money supply in the circulation to curb inflation.

(iii) To the issuing firms, financial assets are the source of capital, which contribute to financing their operations, project development and the economic development of a country in general.

The procedures for purchasing and selling financial assets in Tanzania

In Tanzania, financial assets are publicly traded through Dar es salaam Stock Exchange (DSE) except government bonds which are initially traded through auction by the Bank of Tanzania (BoT).

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Thereafter, the government bonds are registered in the DSE for secondary market trading. For an investor to participate in the DSE, he/she is required to have an account with the DSE through the Central Depository System (CDS). The account is used to record the ownership of the stock holdings and transaction history for buying or selling shares. The process involved in opening the CDS accounts slightly differs between individual investors and institutional investors. Individual investors are required to lodge an application form accompanied by an individual's information sheet and a copy of an identity card. DSE has also introduced mobile trading whereby investors enter their registration details, buy shares, sell shares, and check the balance of the shares that they own among other services by using the Unstructured Supplementary Service Data (USSD) code in selected mobile operators or using the mobile application. Meanwhile, corporate investors are required to fill and submit application forms, copies of incorporation certificates, memorandum of association, articles of association, and directors' identity cards. The opening of the account is free of charge to all investors.

Once a CDS account is opened, an investor can buy security by filling purchase order form, an individual's information form, and then depositing money. Corporate investors are required to submit a certificate of incorporation instead of an individual's information sheet. Other procedures remain the same as it is for the individual investor. Similarly, when an individual investor wants to sell the shares, the original certificate of deposit is submitted to the broker together with filling out the sale order form and submitting payment details. For a corporate investor, a signed letter from the company authorising the sale is also required in addition to submitting the original certificate of deposit and filling out the sale order form. The process of buying and selling financial assets can be facilitated through a broker.

Activity 9.3

Mr. Mipango is the father of your best friend. He is expecting to retire from government employment at the end of this year. He is worried that, he will not be able to finance university studies of his son who is expected to join after finishing form six, which is two years from now. Therefore, Mipango is planning to set aside TZS 5,000,000 out of his retirement pension benefit to invest in a financial asset that will generate income to finance his son's university education.

Required

(a) Advice Mr. Mipango, in which financial asset he should invest between UTT Amis investment packages, treasury bills, treasury

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bonds, and ordinary shares of commercial banks to generate income that will be used to finance university education of his son. Give reasons to back up your advice.

(b) Explain procedures that Mr. Mipango will be required to accomplish to invest in a financial asset that you have advised him in (a) above.

Investment in shares and their accounting treatments

Investment in ordinary shares, just like other financial instruments, is considered an asset to an investor. In the books of account, an investor is required to maintain separate investment accounts for each type of investment. For the case of ordinary shares, the amount given out during the acquisition of an asset is the capital and the amount received from the asset is an income received in the form of dividend. By definition, dividend refers to a reward, cash or otherwise, that a company gives to its shareholders. Dividends can be issued in various forms, such as cash payment, stocks or any other form.

As for accounting treatment, the total cost of investment including acquisition expenses is usually debited to the investment account. It is common for an investor to incur additional expenses (for example, brokerage fees) besides the price paid in the acquisition of common stock. Thus, the full cost of an investment is a summation of the price of the stock plus additional expenses.

Investment account has three columns on both sides: the debit side and the credit side. The following are the details, which are recorded in each of the columns:

(i) The first column is for recording the nominal value of an asset, either when an asset is acquired (on the debit side) or when the asset is disposed of (on the credit side). This column is not part of the double-entry bookkeeping system.

(ii) The second column is for recording income: On the debit side, it is used to record any income aspect associated with the asset acquisition (not transferable to statement of profit or loss and other comprehensive income, as investment income) while on the credit side it is used to record income derived from the asset. The column is part of the double-entry bookkeeping.

(iii) The third column is for recording capital; the debit side is used to record the cost of investment during acquisition and the credit side to record the value of an asset during disposal or the balance of the cost of investment brought down. The column is part of the bookkeeping system.

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Dr. Format of an investment account Cr.

Particulars	Nominal	Income	Capital	Particulars	Nominal	Income	Capital
	TZS	TZS	TZS		TZS	TZS	TZS

Buying and selling of shares/bonds

When an investor decides to sell the common stock, it is important to establish whether there is a profit or loss on the sale. This involves calculations, whereas an average price of an asset on the selling date is used. In the capital market, two prices are quoted on a share; the lower is the selling/ask price and the higher is the buying/bid price. Therefore, it is the average of these two prices which is used to calculate profit or loss on disposal. Similarly, the average price is used for reporting in the statement of financial position (balance sheet). The International Financial Reporting Standards (IFRS 9) guide the appropriate treatment of transactions associated with financial instruments.

Bonus issue

A company can decide to issue bonus shares to the existing shareholders as a way of capitalising its reserves. Bonus issue does not require existing investors to pay for them. In this case, the wealth of a shareholder in the common stock account does not change though the number of shares changes. Therefore, in the investment account, only the face value of the bonus shares is recorded in the nominal column on the debit side.

Example 9.1

On 1st April, 2020, Zitendwa Ltd purchased 2,000 ordinary shares of TZS 2,000 each from Mkakati Plc at TZS 4,800,000. On 1st August, 2020, Mkakati Plc issued bonus shares of 1 share for every 5 shares held. Recording of these transactions in the investment account of Zitendwa Ltd will be as follows:

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Dr. **In the books of Zitendwa Ltd** Cr.

Common shares account

Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"	Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"
1st April, 2020 Bank	4,000						
1st Aug., 2022 Bonus issue	800		4,800				

Note:

1. The nominal value of the Bonus issue = $\frac{1}{5}$ x 2,000 shares x TZS 2000 = TZS 800,000
2. The nominal or stated value of shares is only 4,000,000 (i.e., 2000 shares @ TZS 2,000 each). However, those shares were bought at a value of TZS 4,800,000 which is higher than the nominal value i.e., at a premium. This is probably because the buyer had perceived a higher future return.

Rights issue

Rights issue of shares occurs when the company issue new shares, but the privilege is given to the existing shareholders, as their right. This gives existing shareholders an option of either buying them (exercising his/her right) or passing it over to another investor for consideration. In case an investor exercises the right, the nominal value and the amount paid are recorded in the nominal column and capital column, respectively, on the debit side of an investment account.

Example 9.2

On 1st Jan, 2021 Hasa Ltd purchased 2,000 ordinary shares of Sasa Plc of TZS 1,000 each at TZS 2,500,000. On 1st September, 2021, Sasa Plc gave existing shareholders a right to buy 1 new share for every 2 shares held, at TZS 800 each. If Hasa Ltd exercised the right to buy new shares, the following are the records in the investment account:

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Dr.			In the books of Hasa Ltd Common Shares Account				Cr.
Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"	Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"
1st Jan., 2021 Bank	2,000		2,500				
1st Sept., Rights issue	1,000		800				

Workings:

1. The nominal value of the right issue $=\frac{1}{2} \text{x } 2{,}000 \textit{ shares} \text{ x } TZS\ 1000 = TZS\ 1{,}000{,}000$
2. Capital value $=\frac{1}{2} \text{x } 2{,}000 \textit{ shares} \text{ x } TZS\ 800 = TZS\ 800{,}000$

When the rights shares are sold, recording is done only in the capital column on the credit side of the investment account with the amount received. This implies that the total cost of the shareholding is reduced. Similarly, whenever an investor dispose-off common stock, the value of the bonus issue and/or rights issue will reduce the total cost of shareholding to determine whether there is profit or loss on disposal.

Example 9.3

On 1st Jan, 2021 Hasa Ltd purchased 2,000 ordinary shares of Sasa Plc of TZS 1,000 each at TZS 2,500,000. On 1st September, 2021, Sasa Plc gave existing shareholders a right to buy 1 new share for every 2 shares held at TZS 800 each. Hasa Ltd exercised the right to buy new shares. On 15th December it sold 500 shares at a market price of TZS 1,200 each. The following records will be shown in the investment account of Hasa Ltd:

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Dr. **In the books of Hasa Ltd** **Cr.**

Common Shares Account

Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"	Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"
1st Jan- Bank	2,000		2,500	15th Dec; sale -Bank	500	50	550
1st Sept- Rights issue	1,000		800				

Workings:

1. Nominal value of right issue $= \frac{1}{2}$ x 2,000 shares x TZS 1000 = TZS 1,000,000
2. Capital value: Investment cost on rights issue $= \frac{1}{2}$ x 2,000 shares x TZS 800 = TZS 800,000
3. Capital value: Shares sold $= \frac{500}{3,000}$ x (TZS 2,500,000 + TZS 800,000) = TZS 550,000
4. The amount received on sale = 500 shares x TZS 1,200 = TZS 600,000

Exercise 9.1: Recording transactions in investment account

On 1st March, 2021, Msasa Ltd purchased 3,000 ordinary shares of Chata Plc of TZS 1,000 each at TZS 4,500,000. On 1st July, 2021 Chata Plc gave existing shareholders a right to buy 1 new share for every 2 shares held at TZS 900. Msasa Ltd exercised the right to buy new shares. On 31st October, Chata Plc decided to capitalise part of its reserve, hence issued 1 bonus share for every 10 shares held by existing shareholders. On 15th December Msasa sold 1,000 shares at a market price of TZS 1,800 each.

Required

Record the transactions in the investment account of Msasa Ltd.

Acquisition and disposal of ordinary shares under different quotations

An investor can decide to buy ordinary shares at any time provided that he/she has capital. Meanwhile, the value of an ordinary share differs with time, from when the dividend has just been paid to another dividend payment date because its return accrues as time goes on. Therefore, the time at which an investor decides to buy common stock can have an impact on the transaction price.

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When an investor buys ordinary shares, he/she will be entitled to receive the next dividend unless it is agreed at the time of sale as to who should receive the next instalment. Usually, the dividend is paid to the owner, whose name appears on the share certificate of the company when the payment is done regardless of how long he/she has owned the ordinary shares. This highlights the importance of such an agreement between the seller and the purchaser. The agreement can give out two possible transaction prices: The cumulative dividend (Cum-Div.) and excluding dividend (Ex-Div.) prices. The same concept applies to fixed income security's price quotations discussed in earlier whose examples are also relevant to this section.

Cum-div price quotation

The cum-div quotation refers to the price which considers the portion of the dividend accrued to the transaction date. It is higher than the normal price because it incorporates accrued dividends. The purchase price the buyer pays does include the dividend accrued to the time of the transaction. Thus, the capital cost is obtained after deducting interest accrued from the purchase price (see example 9.8). Therefore, an investor who buys a stock at such dividend inclusive price, he/she also pays for the right to receive the accrued dividend. In this case, an investor is required to split the amount paid into the normal price (capital) and dividend (income) aspect in the books of accounts i.e., the investment account. The same consideration is made when an investor disposes-off the common stock at cum-div price.

For illustration purpose, journal entries for recording purchases of ordinary shares at cum – div price are shown as follows:

Dr. Investment Account (normal price in capital column)	xxx	
Dr. Investment Account (accrued dividend in income column	xxx	
Cr. Bank Account (Total amount paid)		xxx

Note that, in practice, dividend/interest is usually paid to a person who holds the share/debenture certificate. However, there is a date at which investors are required to register with the issuer of shares/debenture for the distribution of the dividend/interest. Thus, if the share/debenture is sold prior to the registration date, it will be quoted at cum-div price. On the other hand, if it is sold after registration date, it will be quoted at ex-div price. Thus, once someone has registered for dividend/interest distribution, the dividend/interest will be paid to him/her regardless of whether he/she still holds the share/debenture certificate.

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Ex-div price quotation

The ex-div quotation is the transaction price of ordinary shares which does not include the dividend aspect accrued to the time of sale. The purchase price the buyer pays does not include the dividend accrued to the time of the transaction. Unlike the cum-div quotation transaction for ex-div, the accrued dividends are not deducted from the purchase price to arrive at the capital price. However, when an investor has quoted the investment at the ex-div price, he/she is required to pay the seller the accrued dividend to the transaction date, in addition to the quoted price. In accounting records, the investor will record the quoted price together with the transaction costs (for example brokerage fees and taxes) in the capital column and the accrued aspect of the dividend in the income column.

Following is an illustration of journal entries to record ordinary shares purchases at ex-div price:

Dr. Investment Account (normal price in capital column)	xxx	
Dr. Investment Account (accrued dividend in income column	xxx	
Cr. Bank Account (total amount paid)		xxx

Purchase and sale of fixed interest securities

The purchase and sale of fixed income financial assets are usually done through brokers, as it is for ordinary shares. The price of any financial asset represents the present value of the cash flow expected from an asset. To calculate the present value of an asset it is necessary to establish the cash flows and the discounting rate which is the required return of an asset. The cash flows of a bond, for instance, are the coupon interest payments and the principal amount that will be repaid at maturity. The formula for calculating the price of a bond is as follows:

$$\text{Bond price} = c\left[\frac{1-\left(\frac{1}{(1+i)^n}\right)}{i}\right]+\left[\frac{M}{(1+i)^n}\right]$$

Where: c- is the coupon payment

n – is the number of periods the coupon rate is paid

i – is the periodic interest rate

M – is the maturity value i.e., par value of an asset

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Cash flows of fixed income financial asset

For a fixed income financial asset, the cash flows are determined by the terms stipulated in the asset (coupon rate and par-value at maturity). Meanwhile, the interest rate or discounted rate is normally established by comparing the yield offered by other similar financial assets in the market.

Example 9.4

The cash flows of a 10-year bond with a 12% (6% per 6 months) coupon rate valued at par or maturity value of TZS 20,000,000 are established as follows:

Coupon interest to be received semi-annually = 6% x 20,000,000 = TZS 1,200,000

Maturity value i.e., par value = TZS 20,000,000.

It implies that there will be 20 instalments of TZS 1,200,000 interest payment over the 10 years of the bond period and at the end, the holder of the bond will receive a face value amount of TZS 20,000,000.

Yield of a fixed income financial asset

The return from financial assets including bonds is also known as a yield. The yield of a bond depends on the coupon rate and the price at which it is sold. If an asset is sold at the face value, its yield will be the same as the coupon rate. However, an asset can be sold at a price different from the face value.

In a scenario where an asset is sold at a price lower than the face value, it is said to be sold at discount. It implies that the required rate of return by investors is higher than the stated coupon rate. In contrast, an asset that is sold at a higher price than the stated face value is said to be sold at a premium. In this case, the required return (market interest rate) is lower than the coupon rate.

Example 9.5: bond sold at par

The price of a 10-year government bond with a 12% (6% per 6 months) coupon rate, a par value of TZS 20,000,000 and the required return of 12% (the same as the coupon rate) is established as follows:

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$$\text{Bond price} = c\left[\frac{1-\left(\frac{1}{(1+i)^n}\right)}{i}\right]+\left[\frac{M}{(1+i)^n}\right]$$

$$\textit{Bond Price} = 1{,}200{,}000 \text{ x} \left[\frac{1-\left(\frac{1}{(1+0.06)^{20}}\right)}{0.06}\right]+\frac{20{,}000{,}000}{(1+0.06)^{20}}$$

= 13,763,905.50 + 6,236,094.50

= TZS 20,000,000

Workings:

1. Coupon based payment on semi-annual basis (C) = 6% x 20,000,000 =TZS 1,200,000
2. Number of periods for semi-annual instalment payments (n) = 10 years x 2 instalment = 20
3. The required rate of return - semi-annually; i = $\frac{6}{12}$x12% = 6%
4. The maturity value of the bond (M) = TZS 20,000,000

The price of the bond is TZS 20,000,000 which is the same as the face value. In this case, the bond is sold at par value; it is neither at discount nor a premium because the coupon rate is equal to the required rate of return.

Example 9.6: bond sold at a discount

The price of a 10-year government bond with a 9% (4.5 % per 6 months) coupon rate and a par value/maturity value of TZS 20,000,000 and the required return of 12% is as follows:

$$\text{Thus, bond price} = c\left[\frac{1-\left(\frac{1}{(1+i)^n}\right)}{i}\right]+\left[\frac{M}{(1+i)^n}\right]$$

$$\text{Bond price} = 900{,}000 \text{ x} \left[\frac{1-\left(\frac{1}{(1+0.06)^{20}}\right)}{0.06}\right]+\frac{20{,}000{,}000}{(1+0.06)^{20}}$$

= 10,322,929.10 + 6,236,094.50

= TZS 16,559,023.60

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Workings

1. Coupon based payment on semi-annual basis (C) = TZS 900,000
2. The number of periods for which the semi-annual payment will be done (n) = 20
3. The required rate of return - semi-annually (i) = 6%
4. The maturity value of the bond (M) = TZS 20,000,000

Thus, the bond price will be sold at TZS 16,559,023, which is lower than the par value of the bond. In this case, the bond is said to be sold at discount, i.e. the coupon rate is lower than the required rate of return.

Example 9.7 – bond sold at a premium

Calculate the price of a 10-year government bond with 12% (6% per six months) coupon rate and par value/maturity value of TZS 20,000,000 and required return of 10%

$$\text{Bond price} = c\left[\frac{1-\left(\frac{1}{(1+i)^n}\right)}{i}\right]+\left[\frac{M}{(1+i)^n}\right]$$

$$\text{Bond price} = 1,200,000\left[\frac{1-\left(\frac{1}{(1+0.05)^{20}}\right)}{0.05}\right]+\left[\frac{20,000,000}{(1+0.05)^{20}}\right]$$

= 1,200,000 (12.46221034) + 7,537,789.7
= TZS 22,492,442

The bond will be sold at TZS 22,492,442 which is higher than the par value of the bond, i.e. the bond is sold at premium. The coupon rate is higher than the required rate of return.

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Exercise 9.2: Determining income flow and price of a bond

Mr. Mafanikio has decided to purchase five years 12% Treasury bonds of TZS 10,000,000 with interest payable 30th June and 31st December.

Required

(a) Determine the amount of income that Mr. Mafanikio will be receiving at every interest payment date.

(b) If Mr. Mafanikio expects to have financial needs that will necessitate him to sell the bond through the secondary market, just after receiving the fourth interest instalment, determine the price at which he will sell the bond. Use the coupon rate as the required rate of return in the market.

Recording fixed income security transactions

The cost of acquiring a fixed-income asset is the actual price paid plus other costs such as brokerage fees, stamp duty, and transfer fees associated with the acquisition. An investor of fixed income security expects to receive a fixed amount (interest) after every period. Transactions of the fixed income investments are also recorded in the investment account, in the same way as it is for equity-based investments.

When the purchase or sale of a fixed income asset is done just at the interest payment date, the quoted price is the cost of an investment. Such a price will not include any amount of interest. Therefore, in the books of accounts, an investment account will be debited with the cost of an asset together with the transaction costs in the capital column and its corresponding double entry will be on the bank account. The journal entries on acquisition of fixed income financial asset at cost can be presented as follows:

Dr. Investment account (capital column)	xxx	
Cr. Bank account		xxx

If the transaction is done before the interest payment date, the quoted price can be either inclusive or exclusive of the interest accrued to the transaction date. When the purchase or sale is done at a quoted price inclusive of the interest (cum-interest), the cost of investment should exclude the interest amount accrued. For illustration, relevant journal entries on acquisition of fixed income security quoted at cum-interest price are presented as follows:

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Dr. Investment account (normal price in capital column) xxx

Dr. Investment account (accrued interest in income column) xxx

Cr. Bank account (total amount paid) xxx

Example 9.8

Mjasiria Ltd bought TZS 50,000,000, 11% bonds at 90 cum interest on 1st April, 2021. Interest is payable semi-annually, on 30th June and 31st December. The accounting entries in the investment account of the company are as follows:

In the books of Mjasiria Ltd

Dr. 11%T-bonds account interest payable 30th June & 31st Dec Cr.

Particulars	Nominal	Income	Capital	Particulars	Nominal	Income	Capital
	TZS "000"	TZS "000"	TZS "000"		TZS "000"	TZS "000"	TZS "000"
1st April, 2021 Bank	50,000	1,375	43,625	30th Jun Inter-Bank		2,750	
				31st Dec Inter-Bank		2,750	
31st Dec Invest. income -Profit/Loss		4,125		31st Dec. Bal c/d	50,000		43,625
	50,0000	5,500	43,650		50,000	5,500	43,650

Workings:

1. Purchase price = $\frac{90}{100}$x50,000,000 = 45,000,000
2. Interest accrued (1st Jan – 1st April) = $\frac{3}{12}$ x $\frac{11}{100}$ x50,000,000= 1,375,000
3. Capital cost = 45,000,000 – 1,373,000 = 43,625,000
4. Investment income (six months instalments June-Dec 2021) = $\frac{6}{12}$ x $\frac{11}{100}$ x 50,000,000 = 2,750,000

Note:

Mjasiria Ltd received TZS 2,750,000 on 30th June as 1st interest instalment, but the company had already paid TZS 1,375,000 during acquisition as part of the purchase price. Hence interest income earned from 1st April to 30th June will be TZS 2,750,000 less TZS 1,375,000. Meanwhile, the second instalment received on 31st Dec 2021 is fully recognised as interest income.

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In case the purchase or sale is done at a quoted price exclusive of interest (ex-interest) the cost of an investment is just the quoted price plus the associated acquisition cost. However, an investor who buys a stock at an ex-interest price, he/she will be required to pay the quoted price plus the accrued amount of interest. On the next interest payment date, an investor will receive the full amount of the interest instalment, but in his/her books of accounts, only a portion of the interest for the period from when the asset was purchased to when interest is paid will be recognised. The journal entries for the acquisition of fixed income asset at ex-interest price are illustrated as follows:

Dr. Investment account (normal price in capital column)	xxx	
Dr. Investment account (accrued dividend in income column)	xxx	
Cr. Bank account (total amount paid)		xxx

Example 9.9

On 1st May, 2020, Patapata Ltd sold a 10% corporate bond of TZS 10,000,000 to Borakupata Ltd at 90 ex-interest. Patapata Ltd had purchased these stocks on 31st Dec., 2019 at TZS 8,500,000. On 1st Nov., 2020, Patapata purchased 12% government bond of TZS 20,000,000 with a 10 years maturity period at 95 ex interest. This acquisition is an addition to the 12% government bond of TZS 15,000,000, which Patapata Ltd acquired in 2018 for TZS 13,500,000. All bonds owned by Patapata Ltd pay interest semi-annually every year, i.e., 30th June and 31st December.

Required

Record the transactions of Patapata Ltd in relevant investment accounts as at the end of December, 2020.

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Solution 9.9:

i) **Recording transactions related to 10% corporate bonds**

In the books of Patapata Ltd
10% Corporate bonds account Interest payable 30th June & 31st Dec

Dr **Cr.**

Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"	Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"
1st Jan.2020 Bal b/d	10,000	-	8,500	1st May sales-Bank	10,000	333.33	9,000
31st Dec., 2020 Investment income- P/L	-	333.33	-				
31st Dec., 2020 Profit on sale of inv.	-	-	500				
	10,000	333.3	9,000		10,000	333.3	9,000

Workings:

1. Selling price = 90% x10,000,000 = TZS 9,000,000
2. Interest (1st January -30th April, 2020) = 4/12 x 10% x 10,000,000 = TZS 333,333
3. Purchase cost (capital) TZS 8,500,000

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ii) **Recording transactions related to 12% government bonds**

In the books of Patapata Ltd
12% government bonds account Interest payable 30th June & 31st Dec

Dr. **Cr.**

Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"	Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"
1st Jan.2020 Bal b/d	15,000	-	13,500	30th Jun.,2020 Interest (bank)		900	
1st Dec. Gov. Bond acquisition	20,000	800	19,000	31st Dec., 2020 Interest (bank)		2,100	
31st Dec. Investment income -Profit/Loss	-	2,200	-	31st Dec.,2020 Bal c/d	35,000		32,500
	35,000	3,000	32,500		10,000	3,000	32,500

Workings:

1. Purchasing price (1st Nov. 2020) = 95% x20,000,000 = TZS 19,000,000
2. Accrued interest on purchased bond (1st July -31st Oct. 2020) – paid in addition to purchase price = 4/12 x 12% x 20,000,000 = TZS 800,0000
3. Interest on TZS 15,000,00 bond (30th June & 31st Dec, 2020) = 6/12 x 12% x 15,000,000 = TZS 900,000
4. The amount of interest received in 31st December (TZS 2,000,000) includes semi-annual instalment of TZS 900,000 on bonds acquired in 2018 plus TZS 1,200,000 semi-annual instalment of bonds acquired 1st November 2020 though only two months' interest is recognised as investment income in 2020.

Example 9.10

Majengo Co Ltd. provides the following details relating to his holding in 6% government bonds:

1.1.2021 Opening balance at face value of TZS 60,000,000 and cost TZS 59,000,000.

1.3.2021 Bought TZS 10,000,000, 6% government bonds at 98 ex-interest.

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1.7.2021 Sold a 6% government bond of TZS 20,000,000 at 100 ex-interest out of the original holding.

1.10.2021 Purchased TZS 5,000,000, 6% government bonds at 98 cum-interest.

1.11.2021 Sold a 6% government bond of TZS 20,000,000 at 99 ex-interest out of the original holding.

Interest dates are 30th September and 31st March. Majengo Co. Ltd closes its books every 31st December.

Required

Prepare investment account as it would appear in the books of Majengo Co. Ltd for the year ended 31st December, 2021.

Solution 9.10

In the books of Majengo Co. Ltd
6% government bonds account
Interest payable 30th September and 31st March, 2021

Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"	Particulars	Nominal TZS "000"	Income TZS "000"	Capital TZS "000"
1st Jan. Opening balance	60,000	900	59,000	31st March Bank (interest)	-	2,100	-
1st March Bank (purchases)	10,000	250	9,800	1st July Bank (sales)	20,000	300	20,000
1st July Profit or loss (gain on sale)	-	-	333.33	30th Sept. Bank (interest)	-	1,500	-
1st Oct. Bank (purchases)	5,000	-	4,900	1st Nov. Bank (sales)	20,000	100	19,800
1st Nov. Profit or loss (gain on sale)	-	-	133.33				
31st Dec. To Profit & loss	-	3,375	-	31st Dec. Closing balance	35,000	525	34,366.66
	75,000	**4,525**	**74,166.66**		**75,000**	**4,525**	**74,166.66**

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Note:

When an investor acquires bond at ex-interest, he/she is required to pay accrued interest to the date of purchase in addition to the price paid. That is why calculations in note 2 and note 6 that follow involve finding out the amount of interest to be paid to the seller to the date of sale.

Workings

1. Opening balance accrued interests = TZS 60,000,000 × 6% × $^3/_{12}$ = TZS 900,000
2. Purchases at 1st March (TZS 10,000,0000 @ 98) = TZS 9,800,000 Interest = TZS 10,000,000 × 6% × $^5/_{12}$ = TZS 250,000
3. Semi-annual interest at 31st March = TZS 70,000,000 × 6% × $^6/_{12}$ = TZS 2,100,000
4. Sales on 1st July, interest = TZS 20,000,000 × 6% × $^3/_{12}$ = TZS 300,000

   Gain on sale = TZS 20,000,000 – [$\frac{20,000,000}{60,000,000}$ × 59,000,000] = TZS 333,333.33
5. Semi-annual interest at 30th September = TZS 50,000,000 × 6% × $^6/_{12}$ = TZS 1,500,000
6. Purchases on 1st October (TZS 5,000,000 @ 98) = TZS 4,900,000

   Interest = TZS 5,000,000 × 6% × $^0/_{12}$ = TZS 0.00
7. Sales on 1st November (TZS 20,000,000 @ 99) = TZS 19,800,000

   Interest = TZS 20,000,000 × 6% × $^1/_{12}$ = TZS 100,000

   Gain on sale = TZS 19,800,000 – [$\frac{20,000,000}{60,000,000}$ × 59,000,000] = TZS 133,333.33
8. Closing balance interest = TZS 35,000,000 × 6% × $^3/_{12}$ = TZS 525,000

Exercise 9.3: Purchase and sale of bonds

Sasa Kazi Ltd bought 50, 12% treasury bonds with a par-value of TZS 1,000,000 each on 1st January 2021 at TZS 960,000. On 1st August, 2021, the company decided to sell 10 T-bonds of 12%, each at TZS 970,000. Interest is paid semi-annually; on 30th June and 31st December of every year. The market price of the bond at the time of sale was TZS 980,000.

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Required

(a) Make necessary computations and then record the transactions in the bonds account of Sasa Kazi Ltd.

(b) Make necessary computations and then record the transactions in the bonds account of Sasa Kazi Ltd if the selling price was quoted at ex-interest.

The treatment of year-end entries

At the end of the financial year, when a company closes its books of accounts to establish the outcome of its operations, the company needs to establish whether it has made a profit or loss from investment activities as well as to establish the value of its investment for reporting in the statement of financial position. For investment activities, a company can determine profit or loss every time an individual transaction takes place, or it can wait till the end of an accounting period where all transactions are considered together through balancing the investment account. In balancing the investment account, the difference in a nominal column is just showing the face value of the assets held. Meanwhile, the balance between the principal columns reveals the cost of financial assets to be reported in the statement of financial position and the balance between the interest columns is the income derived from the investment.

While preparing final reports, it is important to remember that transactions associated with investment activities can result in accruals. Acquisition and disposal of financial assets can take place at any time and the payment of interest and dividends may not always match the date at which the books of accounts are closed. Therefore, when an investor is closing the books of accounts, at the end of the accounting period, it is important to establish accrued income (interest/dividend) for their recognition in the financial statements. For instance, a company that purchased a bond just two months before the closing date of its books of accounts will be required to calculate accrued interest for income recognition even if the payment date is not yet.

Exercise 9.4

The following are the transactions of Matata Ltd for investment activities for the financial year ended December 2021:

1. On 1st March, 2021, the company acquired 10,000 preference shares of Wadau Ltd for TZS 19,200,000 as part of its diversification strategy. The face value of each share is TZS 2,000 and the coupon rate 8%, paid annually.
2. On 1st May, 2021, Matata Ltd Sold a 10% corporate bond of TZS. 50,000,000 to Malingumu Ltd at 90 ex-interest. Matata Ltd purchased these stocks on 31st Dec., 2020

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at TZS 42,500,000. Interest is received semi-annually every year i.e., 30th June and 31st December.

3. On 1st August, 2021, the company purchased TZS 20,000,000, 12% treasury bonds at 90 cum interest. Interest is payable semi-annually on 30th June and 31st December.

Required

(a) Determine accrued interest income from investment activities that should appear in the statement of financial position.

(b) Prepare investment account to determine investment income and investment cost for reporting in the financial statements.

Activity 9.4

When teaching the investment topic, your teacher discussed various investment terminologies, some of which are as follows:

1. Financial investment, financial instrument, financial security and financial asset,
2. Nominal value, face value, stated value and coupon rate,
3. Equity-based investment and fixed income investment,
4. Investment income, dividends and interest,
5. Returns, yield and capital gain.

Required

Discuss with your classmates, and then describe the listed terminologies concisely indicating their similarities and differences. You can refer to other sources of information including internet and library.

Chapter summary

In this chapter, we have described the meaning of various terms and concepts along with calculations related to investment in financial assets, particularly ordinary shares, and bonds. Investment in financial assets involves the use of money to buy marketable security with the expectation to generate income in the future. The money used to invest can be either a surplus to the existing expenditure requirement or set aside specifically for investment purposes instead of current spending.

The two main financial assets described in this chapter are ordinary shares which are equity-based financial instruments and bonds which are fixed income-based instruments. The equity-based instruments offer the owner a right to participate in the deliberations of the matter affecting the performance of the company.

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However, these securities have a contingent and varied stream of income because their return is the dividend whose distribution depends on the decisions made from time to time. In contrast, fixed income financial asset guarantees the owner a predictable stream of income based on the agreed interest rates. However, for pricing purposes, both equity-based instruments and fixed income-based instruments are valued based on discounting their expected cash flows using the required rate of return. The required return is also known as the yield of an asset, the discount rate or opportunity cost of capital. For ordinary shares, the expected cash flows are in the form of divided and capital gain which is the increment of ordinary shares prices. Meanwhile, for fixed income security, the cash flows are the interest payments and the repayment of the principal amount.

In the books of accounts, transactions associated with an investment in financial assets are recorded in investment accounts. A separate investment account is opened for every category of asset. All transactions associated with the purchase and sale of financial assets are recorded in such an account throughout the financial year. At the end of an accounting period, the investment accounts are closed to establish income derived from investment activities. The income is established for reporting in the income statement while investment cost is established for reporting in the statement of financial position.

Revision exercises

1. Define the term investment from a financial assets' perspective.
2. With examples explain the meaning of equity-based financial securities.
3. With examples explain the meaning of fixed income financial assets.
4. Differentiate the features of equity-based financial assets from fixed income-based financial securities.
5. Differentiate with examples short term financial assets from long term financial assets.
6. What are the benefits of investing in financial assets?
7. Differentiate rights issue of common stock from bonus issue.
8. What is the difference between cum-div price quotations from ex-div price quotations?
9. Wazazi Ltd bought 4,000 bonds each with a face value of TZS 2,000 at par on 1st January 2019. The coupon rate is 12% bonds with interest payable semi-annually, on 30th June and 31st December.

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Required

Record the transaction in the investment A/C of the company for the year 2019.

10. Kasuku Ltd bought 10,000, 10% treasury bonds with a par-value of TZS 5,000 each on 1st January, 2021 at TZS 45,000,000 through BoT auction. On 1st September, 2021, the company decided to sell half of the bonds each at TZS 4,800 cum interest. Interest is paid semi-annually, on 30th June and 31st December of every year. The market price of a similar bond at the time of sale was TZS 4,600.

Required

(a) Explain whether the bond was purchased at par or discount.

(b) Record the investment transactions in the books of accounts of Kasuku Ltd.

11. Wazawa Ltd bought TZS 30,000,000, 10% corporate bonds of Matata Plc at 90 cum- interest on 1st March, 2022. Interest is payable semi-annually, on 30th June and 31st December.

On 1st November, Wazawa Ltd decided to diversify by buying 10,000 common stocks of XZ Bank Plc at an ex-div price of TZS 1,800 each. The face value of the common shares is TZS 1,500 each. Based on the performance of the company for the first three quarters of the financial year, The XZ Bank Plc expects to distribute TZS 100 per share as a dividend at the end of the year (December), payable one month after the end of the financial year.

Required

(a) Prepare investment accounts of Wazawa Ltd, and then determine investment income from operating activities.

(b) Determine the amount of accrued income for reporting in the statement of financial position.

12. On 1 November, 2022, Sungura Ltd sold an 11% corporate bond of TZS 5,000,000 to Borakupata Ltd at 90 ex-interests. Sungura purchased these stocks on 31st Dec of the previous year at TZS 4,800,000. Interest is received semi-annually every year, on 30th June and 31st December.

Required

Record the investment transaction of Sungura Ltd in the books of accounts, and then determine whether the company got profit or loss from such transactions.

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Chapter Ten

Accounting for branches

Introduction

In this chapter you will learn about different concepts related to branch accounting. You will also learn the basic methods used in recording business transactions between the head office and its branches. The competencies developed in this chapter will enable you to identify and describe all important concepts associated with branch accounting. You will also be able to apply the basic principles and methods to prepare different types of branch accounts.

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Nature and meaning of branch accounts

A branch is a business operating unit that operates away from the head office as a representative and it is meant to break geographical barriers. As a result, the accounting systems of an entity are designed to facilitate operations of the entity at the head office as well as in the branches. Therefore, accounting for branches originates from the expansion of the business operations to the extent of having establishments in different geographical locations. Substantially, these branches undertake the same activities as those undertaken by the head office. For example, when a company starts operations at a small scale, with only a few customers, it may not need to have branches. It may have customers located in different regions, but the company can still manage to serve them from one location. However, the growth of the business may necessitate the establishment of branches to increase business visibility and accessibility of its products to customers.

When a company has branches, obviously there will be transactions undertaken by the head office and there will be others undertaken by the branches. In addition, there will be inter-company transactions i.e., between the head office and branches. Accounting for branches provides methods and techniques that enable capturing transactions of the branches separate from those undertaken by the head office. The importance of capturing business operations of every operating unit separately is to facilitate profit determination, performance evaluation and controlling branch operations. This

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is important for the management to take appropriate actions if the situation requires so. If the branch is making losses, for instance, it will be worthless to keep it, except for strategic reasons. Attention will be required to address the reasons for any branch that is making a loss. Therefore, the basic purpose of branch accounting is to ascertain the branch income, branch expenses, branch assets and branch liabilities.

Branches have three key features. Firstly, branches do not have separate legal statuses. It means their legal existence is depending on the legal existence of the main office and that is why they are considered as an extension of the main office. Secondly, branches do not have independent capital. Their activities are financed through the capital of the head office. Even if they are given the power to generate capital, it will be just on behalf of the head office. Thirdly, the assets and liabilities of the branches are part of the head office. This feature is related to the first and the second, because if branches have neither independent legal status nor independent capital, then they cannot have independent assets. The features of branches are summarised as follows:

(i) Branches are not separate legal entities; they are just extensions of the head office,

(ii) Branches do not have independent capital,

(iii) Assets and liabilities of branches are part of the head office's properties and liabilities.

Classification of branches

From an accounting perspective, branches can be classified based on either location or control. When branches are classified based on location, we get two classes which are inland/local branches and foreign branches. Inland (sometimes known as domestic or home) branches are those which operate in the same country as its head office while foreign branches are those which operate in a different country from the head office with a different currency. On the other hand, when branches are classified based on control, we get two classes, which are dependent (non-autonomous) branches and independent (autonomous) branches. Dependent branches are those which are wholly controlled by the head office and their accounts are kept by the head office. In contrast, independent branches are those which have the autonomy to prepare and maintain their books of accounts.

Advantages and disadvantages of branch accounting

Branch accounting benefits the company in the making, analysing and tracking of business decisions according to a particular branch's requirements over time and in controlling each branch's overall operations. Its disadvantages include, chances of mismanagement

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and decision-making delays may occur due to various reasons. It also increases a company's expense due to separate set-ups at different locations.

Activity 10.1.

Use different sources of information including the library and the internet to respond to the following questions:

(a) From an accounting perspective, discuss the relevance of a branch and branch accounting in general.

(b) What are the advantages and limitations of branch accounting.

(c) Identify at least three companies that operate in Tanzania which have foreign branches.

(d) In the current era of advanced information technology, is there still a need for a company to establish branches while the internet could facilitate e-commerce?

Non-autonomous or integrated branches

As identified above, non-autonomous branches are those which do not have the power to prepare their own books of accounts. They are wholly controlled by the head office. Examples of companies that have non-autonomous branches in Tanzania include those operating in the passenger transportation industry. For example, bus services operators have agencies in different regions/bus stations for ticket booking, and fuel retailing companies which have petrol stations across the country.

The nature of the operations of non-autonomous branches can be in one of the following forms:

(i) A branch is established as an agent of the head office for receiving customers' orders for the products and/or services offered by the company. Then it remits the orders to the head office for execution.

(ii) A branch is established as a retail selling unit for the products from head office.

(iii) A branch is established as a wholesale delivery unit for the products supplied by the head office.

As a result, the head office prepares and maintains the books of accounts of the branch to monitor their operations closely. The accounting records of the branch are

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useful because they enable the head office to observe the changes in assets, liability, and capital. Furthermore, the separate records of each branch help to determine the profitability of each branch and exercise necessary controls to avoid misuse of resources held by the branches.

Activity 10.2

XYZ Ltd., is a big company specialised in processing agricultural food products in Tanzania. The company headquarter is in Dar es salaam where it has two processing plants; one is for cooking oil and the other is for wheat flour. In addition, the company has three branches processing cooking oil in Dodoma, Singida and Kigoma and two branches processing wheat flour in Arusha and Mwanza.

Required

(a) Identify the basic features for the branches of XYZ Ltd. to be classified as non-autonomous branches.

(b) Explain operational arrangements/procedures to be established by XYZ Ltd, that will be used as guidelines for effective operation of its non-autonomous branches.

Transactions and accounts when non-autonomous branches are used

The contents of the accounts for recording branch transactions in relation to the head office depend on the pricing approach the head office adopts (discussed in next section) when sending goods to the branch. Generally, the company can adopt any of the three approaches to transfer goods to a branch. These are: (i) goods are transferred at cost, (ii) goods are transferred at selling price, and (iii) goods are sent at wholesale price. Despite the pricing approach adopted, there are common books of accounts maintained by the company operating with branches. Such accounts include: (i) branch stock account, (ii) branch debtors account, (iii) branch expenses account, (iv) goods sent to branch accounts, and (v) adjustment accounts. The descriptions of these accounts are as follows:

Branch stock account

The branch stock account is used to keep records of stock movement. On the debit side, the account is used to record stock received from the head office at invoice price and on the credit side, the stock sold will be recorded at its cost, and the value of stock on hand. Invoice price is the price in which goods are sent to the branch at relatively higher value than the cost price. Under this system. the head office will invoice goods by adding a certain percentage above the cost prices (e.g.,

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10% or 20%) which account for profit. Therefore, when goods are transferred to a branch at a selling price, the balancing figure between the debit side and credit side is the value of the remaining stock at the invoiced (selling) price. However, if the goods are transferred to the branch at cost, the difference between the debit side (stock received at cost) and the credit side (at selling price and the value of closing stock at cost) is the gross profit generated by the branch.

Branch debtors account

The branch debtors account is used to keep a record of the debtors whenever branches have the permission to sell goods on credit. It is maintained by the branch just for recording credit sales and payments to establish debtors' balances.

Branch expenses account

The branch expenses account is used to record all expenses incurred by the branch, such as sundry expenses and casual labours supporting branch operations. It includes expenses paid by the branch itself as well as expenses incurred by the head office on behalf of the branch. These expenses are included in the ascertainment of the profit made by the branch.

Goods sent to branch account

This account is used to record the movement of goods from the head office to the branch. The head office maintains this account. Once goods are sent to the branch this account is debited. If the branch is permitted to make credit sales, then the account is also used to record (on the credit side) cash paid by branch debtors directly to the head office. In addition, it records any returns of stock from the branch on the credit side.

Adjustment account

The account is used to reconcile the differences between the branch stock account and goods sent to the branch account whenever the head office sends goods at a cost-plus (profit margin) price. Simply, the adjustment account is used to establish unrealised profit and the realised profit on the goods sent to the branch.

For example, the head office of XYZ Company sends 100 units of stock to its branch at a cost-plus price of TZS 10,000. If this price includes a profit margin of TZS 1,500 per unit, then the head office will recognise TZS 150,000 (i.e., 100 units x TZS 1,500 profit margin) as profit from branch sales, but this is correct only when the branch has sold all stock. However, if the branch has sold only 80 units, then the head office will recognise only TZS 120,000 (i.e., 80 x 1,500) as profit earned from branch sales and the remaining TZS 30,000 as unrealised profit on the goods sent to the branch. Thus, all these adjustments related to goods sent to the branch for

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realised and unrealised profit are made through the adjustment account.

Invoicing goods to branch from head office

Goods can be transferred to a branch at either the selling price or at cost or wholesale (cost plus) price. The details of each of these pricing approaches together with their accounting treatments are provided in the following sections and related sub-sections:

Goods sent to branch at selling price

Under this approach, the head office uses the price at which the goods are sold in the market to charge the goods which are sent to the branch. Therefore, when the goods are transferred to the branch, the head office treats them as if they are sold. However, if at the end of the year some remains as branch closing stock, it is not acceptable for the head office to recognise part of the profit associated with the unsold stock as profit because the sale is just within the company. Thus, it is necessary to adjust unrealised profit on unsold stock at the end of the year through the branch adjustment account.

When the company decides to use selling price to charge goods sent to the branch, there are three methods it can adopt. The first is the debtor's method, the second is the stock and debtors method, and the third is the final accounts method.

(a) Debtors method

This is an approach which uses selling price to charge goods sent to the branch. The approach considers branch as a selling outlet or as a debtor to the head office. This method is usually adopted when branch is small and does not make credit sales, and if it does, the debtors are paying in the same branch at which the sale took place. The main accounts for recording branch transactions at the head office are the branch stock account, goods sent to branch account, and stock reserve account. In this case, the head office maintains a separate account for each branch. For instance, a branch that just receives goods and sells them, its account will be debited with the goods sent at the selling price and credited with the value of goods sold by the branch. The difference, which is the balance, will be showing the value of the stock on hand at the selling price.

(i) When goods are sent to branch at the selling price

Dr. Branch stock account	xxx	
Cr. Goods sent to branch account		xxx

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(ii) When goods are sold and cash remitted to the head office

Dr Bank account	xxx	
Cr. Branch stock account		xxx

Example 10.1

Kwetusafi Ltd is a retailing company whose headquarter is in Dar es salaam and a branch in Mtwara. The company policy is to sell its products to customers at a 25% profit margin and the same price is used to transfer goods to the branch.

The following information relates to the branch operations for March, 2022

Particulars	TZS
Opening Stock	8,000,000
Cash sales remitted to Head Office	34,000,000
Goods invoiced to Branch	31,000,000
Closing Stock	5,000,000

Required

Prepare branch stock account and goods sent to branch account by using debtors method.

Solution 10.1

From the information given, the value of the stock at the selling price could be established in the branch stock accounts in the books of the head office as follows:

In the books of accounts of Kwetusafi Ltd

Branch stock account

Dr. **Cr.**

Particulars	TZS	Particulars	TZS
Balance b/d (opening stock)	8,000,000	Cash sales remitted	34,000,000
Goods sent to branch	31,000,000	Balance c/d	5,000,000
	39,000,000		**39,000,000**
Balance b/d	5,000,000		

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In the books of accounts of Kwetusafi Ltd
Goods sent to branch account

Dr. **Cr.**

Particulars	TZS	Particulars	TZS
To Head Office - trading account	31,000,000	Branch stock account	31,000,000
	31,000,000		**31,000,000**

When a company uses the debtors' method to control the operations of the branches, it is important to make physical verification of the amount of stock at regular intervals. In operations of the branch, some stock losses can occur due to wastage (broken, expired) and thefts by customers or employees. Therefore, based on experience, the head office usually provides a certain per cent of the closing stock as an allowance for such deficiencies. Through physical verification of stocks, the head office will be able to establish whether the deficiency in the branch is within the tolerance rate/ provision.

The company can also use columnar format, without adjustment account, to prepare the branch account to establish the amount of profit derived by the branch. With the use of a computerised accounting system, keeping branch accounts in columns would not be a problem. In such a format, one column on the debit side keeps the value of goods sent from head office and opening stock at the selling price (which is the invoice price) and the other column keeps their corresponding values at cost. The column on the debit side which keeps records of the selling price is just for control purposes and it is not part of the double-entry system. Meanwhile, on the credit side, both columns are recorded in the selling price (invoice price).

Example 10.2

Msasa Ltd is a retailing company whose headquarter is in Dar es salaam and a branch in Mwanza. The company policy is to sell its products to customers at a 25% profit margin and to allow a deficiency of 4 % of the sales. The same retailing price is used to transfer goods to the branch.

The following information relates to the branch operations for January 2022

Particulars	TZS
Opening stock	5,000,000
Cash sales remitted to head office	37,000,000
Goods invoiced to branch	40,000,000
Closing stock	6,000,000

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Solution 10.2

The branch stock account in the books of the head office and the amount of deficiency would be worked as follows:

In the books of accounts of Msasa Ltd

Dr. Branch stock account – trading statement Cr.

Particulars	At selling price "TZS"	At cost "TZS"	Particulars	At selling price "TZS"	At cost "TZS"
Balance b/d	5,000,000	3,750,000	Cash sales remitted	37,000,000	37,000,000
Goods invoiced to Branch	40,000,000	30,000,000	Stock loss/ deficiency	2,000,000	2,000,000
			Closing stock (Balance c/d)	6,000,000	4,500,000
Gross profit		9,750,000			
	45,000,000	**43,500,000**		**45,000,000**	**43,500,000**

The following are the basic steps used to establishing whether there is deficiency within the tolerance rate:

1. Determine the allowed deficiency = 4% x 37,000,000 = 1,480,000
2. Identify the amount of the actual deficiency i.e., TZS 2,000,000
3. Compare the two i.e., (1) and (2) above, you will see that, the actual deficiency is higher than the allowable deficiency by TZS 520,000. Thus, the company will initiate an investigation to establish the reasons.

(b) Stock and debtors method

This method is suitable when branches are permitted to make credit sales. There are two ways the company can keep its records under stock and debtors method. The first is the integrated approach and the second is the columnar approach. Under the integrated approach, the head office is required to keep the following six accounts about branch operations:

(i) Branch stock account,
(ii) Branch debtors account,
(iii) Branch expenses account,

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(iv) Branch income statement (statement of profit or loss and other comprehensive income),

(v) Goods sent to branch account and

(vi) Branch adjustment account.

A branch will be required to maintain branch assets account and branch cash account in addition to those kept at the head office, especially when the branch has permission to buy stock and incur expenses. However, when the columnar approach is adopted, there is no need of preparing a branch adjustment account.

Example 10.3

Kasa Ltd is a retailing company whose headquarter is in Dar es salaam and a branch in Morogoro. The company policy is to sell its goods to customers at a 25% profit margin and the same price is used to transfer goods to the branch.

The following information relates to the branch operations for June 2021.

Particulars	TZS
Opening balances:	
- Stock	9,000,000
- Debtors	2,000,000
Cash sales remitted to head office	23,000,000
Cash received from debtors and remitted to head office	14,500,000
Goods invoiced to branch	36,000,000
Closing balances:	
- Stock	8,000,000
- Debtors	1,500,000

Required

Show the necessary ledger accounts in the Kasa Ltd., under the stock and debtor's method.

Solution 10.3

From the information provided, the books of accounts showing the transactions of the branch would be as follows under the stock and debtors (integrated) method:

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In the Books of Kasa Ltd

Dr. **Branch stock account (at selling price)** **Cr.**

Particulars	Amount "TZS"	Particulars	Amount "TZS"
Balance b/d (opening stock)	9,000,000	Cash sales	23,000,000
Goods invoiced to branch	36,000,000	Debtors – credit sales (balancing figure)	14,000,000
		Balance c/d (closing stock)	8,000,000
	45,000,000		**45,000,000**
Balance b/d	8,000,000		

Dr. **Goods sent to branch account (at cost)** **Cr.**

Particulars	Amount in TZS	Particulars	Amount in TZS
Transfer to head office- income statement	27,000,000	Branch Stock	27,000,000
	27,000,000		**27,000,000**

Dr. **Branch debtors account (at selling price)** **Cr.**

Particulars	TZS	Particulars	TZS
Balance b/d	2,000,000	Cash	14,500,000
Branch stock (credit sales)	14,000,000	Balance c/d	1,500,000
	16,000,000		**16,000,000**
Balance b/d	1,500,000		

Dr. **Branch adjustment account (profit aspect)** **Cr.**

Particulars	Amount in "TZS"	Particulars	Amount in "TZS"
Gross profit – income statement	9,250,000	Unrealised profit b/d	2,250,000
Unrealised profit c/d	2,000,000	Branch stock-goods sent	9,000,000
	11,250,000		**11,250,000**

As identified earlier, in this chapter, the company can prepare the branch account in columnar format to reflect the branch's profit or loss account (Statement of profit

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or loss and other comprehensive income). In a columnar format, one column on the debit side keeps the value of goods sent from head office and opening stock at selling price (which is the invoice price) and the other column keeps their corresponding values at cost. The column on the credit side which keeps records of the selling price is just for control purposes and it is not part of the double-entry system. Meanwhile, on the credit side, both columns are recorded in the selling price (invoice price).

On the debit side, the account comprises the opening balances of the stock, debtors, and petty cash. It is also debited with the cost of goods sent to the branch and expenses of the branch including those paid by the head office. On the other side, it is credited with the amount remitted by the branch and the cost of goods returned to the head office. At the end of the year, the value of the closing stock (at cost), outstanding debtors and any petty cash balance are credited to this account to ascertain the profit or loss made by the branch. Referring to the information provided in example 10.3, the columnar branch account would be as follows: -

In the books of Kasa Ltd

Dr. Branch stock account (selling price) Cr.

Particulars	**At selling Price TZS "000"**	**At cost TZS "000"**	**Particulars**	**At selling price TZS "000"**	**At cost TZS "000" (unsold items only)**
Balance b/d:			Cash remittance to head office:		
- Stock	9,000	6,750	- From cash sales	23,000	23,000
- Debtors	2,000	2,000	- From debtors	14,500	14,500
- Goods from head office	36,000	27,000	Balance c/d:		
			- Stock	8,000	6,000
			- Debtors	1,500	1,500
Branch profit		9,250			
	47,000	**45,000**		**47,000**	**45,000**

In some cases, there are expenses incurred for branch operations and the branch manages some assets (including petty cash). When determining branch profit or loss through the branch account, such items should be taken into account. The general format of a columnar branch account would be as follows:

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In the Books of ……………………Ltd

Dr. **Branch account** **Cr.**

Date	Particulars	Amount		Particulars	Amount	
		At selling price (currency)	At cost (currency)		At selling price (currency)	At selling price (except unsold stock) (currency)
	Balance b/d:			Cash remittance to head office:		
	- Stock	xx	xx	- From cash sales	xx	xx
	- Debtors	xx	xx	- From debtors' sales	xx	xx
	- Petty cash	xx	xx	- Goods returned to head office	xx	xx
	- Long term asset	xx	xx			
	- Prepaid expenses	xx	xx			
	Goods from head office	xx	xx	Balance c/d:		
				- Cash	xx	xx
				- Stock	xx	xx
				- Debtors	xx	xx
				- Petty cash	xx	xx
				- Long term asset	xx	xx
				- Prepaid expenses	xx	xx
	Profit (credit side is larger)			Loss (debit side is larger)	xx	xx
		xxx	xxx		xxx	xxx

(c) Income statement (final accounts) method

In this method, separate income statements are prepared for each branch to reflect their trading activities and other operations. In preparation of the branch income statements, the cost of the goods transferred to the branch at selling price is converted into cost price. The income statement does not make part of the double-entry system, it simply shows the financial performance of a branch.

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Goods sent to branch at cost price

Under this approach, the goods sent to the branch are charged at the cost. The approach can be used either under the debtors' method, stock and debtor's method, or income statement (final accounts) method.

(a) Debtors method

Under debtor's method only one account namely branch account is used to record business transactions between the head office and the branch. When goods are transferred at cost, the debit side of the branch account is recorded with the opening balance of the stock, debtors' opening balance, and the petty cash. It is also debited with the cost of goods sent to the branch, expenses of the branch including those paid by the head office. On the other side, it is credited with the amount remitted by the branch and the cost of goods returned to the head office. At the end of the year, the value of the closing stock, outstanding debtors and any petty cash balance are credited to this account to ascertain the profit or loss made by the branch.

Dr. **Branch account** **Cr.**

Date	Particulars	Amount At cost (currency)	Particulars	Amount At selling price (currency)
	Balance b/d: - Cash - Stock - Debtors - Petty cash - Long term asset - Prepaid expenses	 xx xx xx xx xx xx	Cash remittance to head office: - From cash sales - From debtors' sales - Goods returned to head office	 xx xx xx
	Goods from head office	xx	Balance c/d: - Cash - Stock - Debtors - Petty cash - Long term asset - Prepaid expenses	 xx xx xx xx xx xx
	Profit (credit side is larger)		Loss (debit side is larger)	xx
		xxx		xxx

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(b) Stock and debtors method

When the company adopts this method, the head office is required to keep five accounts concerning branch operations. These are branch stock account, branch debtors account, branch expenses account, branch income statement (statement of profit or loss) and other comprehensive income), and goods sent to branch account. Moreover, a branch that has permission to buy stock and incur expenses, will be required to maintain branch assets account and branch cash account in addition to those kept at the head office.

(c) Income statement (final accounts) method

In this method, separate income statements are prepared for each branch to reflect their trading activities and other operations. The statement does not make part of the double-entry system; it simply shows the financial performance of a branch.

Example 10.4

Satellite Ltd is a retailing company whose headquarter is in Dar es salaam and a branch in Tanga. The company policy requires goods to be transferred to the branch at cost. The branch sells goods to customers consistently at cost plus a 30% mark-up. The following information relates to the branch operations for August 2021.

Particulars	**TZS**
Opening balances:	
- Stock	7,200,000
- Debtors	2,000,000
Cash sales remitted to head office	28,284,000
Cash received from debtors and remitted to head office	7,696,000
Goods invoiced to branch	28,800,000
Rent	1,200,000
Salaries	1,800,000
Closing balances:	
- Stock	6,400,000
- Debtors	2,500,000

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Solution 10.4

Based on information in example 10.4 above, the records in the books of accounts at the head office would be as follows under the debtor and stock method:

In the books of satellite Ltd

Dr. Branch stock account Cr.

Particulars	Amount in "TZS"	Particulars	Amount in "TZS"
Balance b/d (opening stock)	7,200,000	Cash sales	30,284,000
Goods sent to branch	28,800,000	Debtors	8,196,000
Branch gross profit	8,880,000	Balance c/d	6,400,000
	44,880,000		**44,880,000**
Balance b/d	6,400,000		

Dr. Goods sent to branch account Cr.

Particulars	Amount in TZS	Particulars	Amount in TZS
Transfer to head office- Income statement (trading account)	28,800,000	Branch Stock	28,800,000
	28,800,000		**28,800,000**

Dr. Branch debtors account Cr.

Particulars	TZS	Particulars	TZS
Balance b/d (opening stock)	2,000,000	Cash	7,696,000
Branch stock (Sales)	8,196,000	Balance c/d	2,500,000
	10,196,000		**10,196,000**
Balance b/d	2,500,000		

Dr. Branch Expenses Account Cr.

Particulars	TZS	Particulars	TZS
Salaries	1,800,000		
Rent	1,200,000	Balance c/d – income statement	3,000,000
	3,000,000		**3,000,000**
Balance b/d	3,000,000		

Goods sent to branch at cost plus

This approach is also known as wholesale pricing, whereby the head office transfers goods to branches at cost plus wholesale profit. As a result, branches are supposed

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to realise profit equal to the difference between retail price and the wholesale price. Meanwhile, the goods sent account will realise the amount of profit on goods sent to branches equal to the profit margin added to arrive at the whole sale price. Meanwhile, the branch stock account or income statement (in the trading aspect) is debited by the value of opening stock and the value of goods sent to the branch. Correspondingly, the account is credited with branch sales at retailing price and closing stock at the wholesale price.

Branch Profit Margin = Sales – cost of goods sold
= Sales – (opening stock + purchases – closing stock)
= Sales – opening stock – purchases + closing stock
= (Sales + closing stock) – (opening stock + purchases at wholesale price)

Note:
Both opening stock and closing stock are at a wholesale price while purchases reflect goods sent from the head office to the branch.

The returns of goods by branches
During business operations, especially under non-autonomous branches, there are two possible pathways for returning goods. The first is when the branch returns some of the goods to the head office and the second is when goods sold to customers are returned either to the branch or straight to the head office. The accounting treatment of the goods returned by the branch to the head office is to debit goods sent account and to credit branch stock account.

Meanwhile, for the return of the goods by customers through a branch, the accounting treatment will involve debiting the branch stock accounts and crediting branch debtors. If customers return goods straight to the head office, its accounting treatment is the same as if the goods are returned by the branch, but through branch debtors. Therefore, the goods sent account is debited and the branch debtors account is credited. However, branches will also need to update their records regarding branch debtors.

Exercise 10.1

Kasa Ltd is a retailing company whose headquarter is in Dar es salaam and a branch in Morogoro. The company policy is to sell its products to customers at a 15% profit margin and the same price is used to transfer goods to the branch. The following information relates to the branch operations for June 2021.

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Particulars	TZS
Opening balances:	
- Stock	5,000,000
- Debtors	2,000,000
Cash sales remitted to head office	30,600,000
Cash received from debtors and remitted to head office	16,200,000
Goods invoiced to branch	43,000,000
Goods returned to head office	6,000,000
Rent	2,000,000
Salaries	4,000,000
Closing balances:	
- Stock	6,000,000
- Debtors	3,500,000

Required

(a) Use debtors method to prepare branch account, then determine the branch profit.

(b) Prepare books of accounts in head office to record branch transactions using an integrated approach under the stock and debtor's method.

Autonomous branches/independent branches

Autonomous branches are those branches that are big and the nature of their operations is complex to the extent of requiring them to manage their operations. Obviously, when branch becomes big it becomes difficult to manage them from the head office. In this case, they should prepare and maintain their books of accounts. However, for branches to prepare their financial reports, they must have sufficient resources to allow them to employ their own accounting staff. An example of a company with independent branches is the Tanzania Breweries Co. Ltd whose head office is in Dar Es Salaam and its branches are in Arusha, Mwanza, and Mbeya.

Recording of business transactions in autonomous branches

The transactions of each branch are recorded in their books of accounts and at the end of the accounting period, each branch prepare its trial balance. The head office maintains only one account known as the current account for recording all transactions associated with the branches. Similarly, each branch maintains a current account for recording transactions associated with the head office. The

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current account of the head office considers the branches as debtors while the current account of the branches considers the head office as a creditor. It means every transaction between the head office and the branch is recorded in both current accounts; in the head office current account and branch current account. However, for transactions that are just concerned with the branches only, they will appear in branch books of accounts and are not recorded in the head office.

Example 10.5

Champions Ltd has a head office in Mwanza and decided to open a branch in Dar es salaam. The following are the transactions that took place in the first month of the branch operations:

(a) The head office opened a bank account for the branch and deposited TZS 30,000,000.

(b) The head office purchased an office building for the branch for TZS 150,000,000.

(c) The branch purchased a motor vehicle at TZS 18,000,000.

(d) The branch purchased goods from supplier of TZS 50,000,000 which was paid through a bank before the end of the financial year.

(e) The branch sold merchandise of TZS 90,000,000 on a cash basis.

(f) The head office sent goods of TZS 84,000,000 at a cost to the branch and there was no payment made till the end of the month.

(g) The branch refunded TZS 40,000,000 to the head office as part of the expenditure incurred during its establishment.

(h) Some of the goods were returned by the head office at a cost price of TZS 3,000,000

Required

Record the above transactions in the books of head office and the branch.

Solution 10.5

Recording of the above transaction in the books of accounts of the head office and those in the branch would be as follows:

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In the books of Champion Ltd (HO)

Dr. **Branch current account** **Cr.**

Particulars	Amount in "TZS"	Particulars	Amount in "TZS"
Bank-initial deposit	30,000,000	Bank-refund	40,000,000
Bank-Office building	150,000,000	Goods returns	3,000,000
Goods sent to branch	84,000,000		

Dr **Bank account** **Cr.**

Particulars	Amount in TZS	Particulars	Amount in TZS
Branch bank- refund	40,000,000	Branch bank– initial deposit	30,000,000
		Branch-office building	150,000,000

Dr. **Goods sent to Branch Account** **Cr.**

Particulars	TZS	Particulars	TZS
Goods returned	3,000,000	Branch – goods sent	84,000,000

In the books of branch – in DSM

Dr. **Head office current account** **Cr.**

Particulars	Amount (TZS)	Particulars	Amount (TZS)
Bank-refund	40,000,000	Bank-initial deposit	30,000,000
Goods returns	3,000,000	Bank-office building	150,000,000
		Goods sent to branch	84,000,000

Dr. **Bank account** **Cr.**

Particulars	Amount (TZS)	Particulars	Amount (TZS)
Head office- initial deposit	30,000,000	Motor vehicle	18,000,000
Cash sales	90,000,000	Purchases	50,000,000
		Head office - refund	40,000,000

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Dr. **Office building account** **Cr.**

Particulars	TZS	Particulars	TZS
Head office Bank – building	150,000,000		

Dr. **Motor vehicle account** **Cr.**

Particulars	TZS	Particulars	TZS
Bank	18,000,000		

End of the year financial reports under autonomous branches

At the end of the financial year, branches do close books of accounts and send their copies to the head office where reconciliation between the branch's current account and the head office's current account is conducted. Thereafter, necessary journal entries are passed to incorporate the trial balance of the branch in the head office books of accounts. Once branches have prepared their income statement, the net profits are transferred to the head office by crediting the head office's current account. Then, the head office will recognise the branch's net profit in their income statement by debiting the branch's current account and corresponding entry to the income statement.

When preparing final accounts, the head office values should be at cost price and the branch final accounts should be at mark-up prices. However, the whole business final accounts should be on cost price basis. After the preparation of the income statement, the head office prepares the combined statement of financial position to establish the total assets and liabilities of the whole company. The head office incorporates in its trial balance the assets and liabilities of the branches as shown in the branches' trial balances. In the preparation of the combined statement of financial position, the balances of the current accounts are ignored because they are like contra-entries; the current account of the head office shows a debit balance of the same figure shown on the credit side of the current account of the branch, resulting to entries cancelling each other.

Referring to example 10.5, the final accounts of the head office and the branch assuming the income statement of the branch for the first month of its operations generated a profit of TZS 6,000,000 would be as follows:

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In the books of Champion Ltd – head office

Dr. Branch current account Cr.

Particulars	Amount (TZS)	Particulars	Amount (TZS)
Bank-initial deposit	30,000,000	Bank-refund	40,000,000
Bank-office building	150,000,000	Goods returns	3,000,000
Goods sent to branch	84,000,000	Balance c/d	227,000,000
Profit from branch – for head office income statement	6,000,000		
	270,000,000		**270,000,000**

Extract of head office income statement

Profit from main office operations	XXXXX
Add: Net profit earned by DSM branch operations	6,000,000
Total income	**XXXXX**

In the books of branch – in DSM

Extract of branch income statement

Gross profit	XXXXX
Less: Branch expenses	XXXXX
Net profit	**6,000,000**

Dr. Head office current account Cr.

Particulars	Amount in "TZS"	Particulars	Amount in "TZS"
Bank-refund	40,000,000	Bank-initial deposit	30,000,000
Goods returns	3,000,000	Bank-office building	150,000,000
Balance c/d	227,000,000	Goods from head office	84,000,000
		Net profit- income statement	6,000,000
	270,000,000		**270,000,000**

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Activity 10.3

XYZ Ltd is a food processing company, which initially specialised in the agricultural sector before expanding its operations into the livestock and fishery sectors. In agricultural food processing, the company has three cooking oil processing plants located in Dar es salaam, Singida and Kigoma and three branches processing wheat flour located in Arusha, Dar es salaam, and Mwanza. In the livestock sector, the company has a big plant in Shinyanga processing meats for local market and export, and in the fishery sector, the company has two branches, one in Mtwara and the other in Mwanza.

Initially, the company had only one accounting clerk in each of the branches just for capturing bookkeeping records which are then submitted to the headquarters for financial report preparations. However, following its expansion the company has been struggling in recent years with record keeping challenges because of the volume of transactions undertaken by branches and the need for the branches to make strategic decisions to suit their sectors and local operating environment.

Required

(a) Identify whether the existing structure of the company reflects non-autonomous or autonomous branches.

(b) Identify and explain the best structure (between autonomous and non-autonomous) by which the company should re-arrange its branches to resolve the problem it experiences in recent years. Your explanations should consider the sectors it operates.

Items in transit

Items in transit reflect those transactions which have been recorded in books of accounts of one part (either at the branch or head office) but not in the other part because the items or transaction is not complete. It also refers to transactions that are supposed to be recorded in the current accounts of both, the branch, and the head office, but due to a mismatch in the time of recording, they are seen in the records of one part only. For example, when the head office sends goods to the branch, it records them straight away in a current account, but the branch will not record them until they are received. Similarly, a branch may return goods to the head office or remit cash to the head office, but their arrival may delay. Hence, they will not be captured in the books of accounts of the head office promptly. Therefore, when these kinds of transactions are made a few days before the closure of the financial year, it is very possible to find some records in the current account of one part missing in the other part.

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In preparing the final accounts, items in transit require adjustments. Otherwise, the books of accounts will not balance because of the differences in the current account's balances. All adjustments are made in the books of accounts of the head office so that the balance of its current account matches that of the branch. Then, the adjusted balance will be used in the preparation of the final accounts as well as in carrying forward to the next accounting period.

The items in transit are normally assets in nature. For instance, the goods in transit to the branch, the goods returned by a branch to the head office, and cash remittance in transit are all assets to the head office. Thus, their adjustment will involve adding (debiting) them to the balances of the head office. Remember, asset balances always increase through debiting.

Example 10.6

Juma is a wholesaler with a head office in Tunduma. Juma has contracted Hanifa as a branch manager of his office in Kyela. The branch is required to prepare its own financial statements. All goods were purchased by head office and goods sent to the branch were invoiced at cost. The following was the trial balance as on 31st December, 2020:

Juma was responsible for all matters relating to the buying department of the business. Juma managed the head office and Hanifa was employed as the branch manager. All goods were purchased by head office and goods sent to the branch were invoiced at cost. The following was the trial balance as on 31st December, 2020.

	Head office (TZS "000")		Branch (TZS "000")	
	Dr.	**Cr.**	**Dr.**	**Cr.**
Drawings	3,700			
Capital		18,000		
Furniture and fittings, at cost	1,500		1,100	
Furniture and fittings, provision for				
Depreciation as at 31 December 2019		500		350
Stock on 31 December 2019	13,000		4,400	
Purchases	37,000			
Goods sent to branches		18,000	17,200	
Sales		39,000		26,000

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Provision for doubtful debts		600		200
Branch and head office current accounts	6,800			3,600
Salaries and wages	4,500		3,200	
Commission			360	
Carriage and travelling expenses	2,200		960	
Administrative expenses	2,400			
Trade and general expenses	3,200		1,800	
Trade receivables	7,000		2,880	
Trade payables		5,800		400
Bank balances	600			1,350
	81,900	**81,900**	**31,900**	**31,900**

You are given the following additional information:

(a) Stocks on 31st December, 2020, amounted to: head office TZS 15,240,000 and branch TZS 6,570,000.

(b) Administrative expenses are to be apportioned between head office and the branch in proportion to sales.

(c) Depreciation is to be provided on furniture and fittings at 10 per cent of cost.

(d) The provision for doubtful debts is to be increased by TZS 50,000 in respect of head office debtors and decreased by TZS 20,000 in the case of those of the branch.

(e) On 31st December 2020, cash amounting to TZS 2,400,000 in transit from the branch to head office, had been recorded in the branch books but not in those of head office; and on that date goods invoiced at TZS 800,000 in transit from head office to the branch, had been recorded in the head office books but not in the branch books.

(f) Any adjustments necessary are to be made in the head office books.

Required

(i) Prepare statement of profit or loss for the year ended 31st December, 2020, showing the net profit of the head office and branch respectively;

(ii) Prepare the balance sheet as on that date, and

(iii) Show the closing entries in the branch current accounts giving the make-up of the closing balance.

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Solution 10.6

M/s Juma
Statement of profit or loss
For the year ended 31 December 2020

	Head office	Branch	Combined
	TZS'000'	TZS'000'	TZS'000'
Sales	39,000	26,000	65,000
Cost of goods sold:			
- Opening stock	13,000	4,400	17,400
- Purchases	37,000	-	37,000
	50,000	4,400	54,400
Goods to branch (less "on transit' 800")	(17,200)	17,200	-
	32,800	21,600	54,400
Less: Closing stock	15,240	6,570	21,810
Cost of goods sold	17,560	15,030	32,410
Gross Profit	21,440	10,970	32,410
Add: decrease in provision for bad debts	-	20	20
Total income	21,440	10,990	32,430
Less: Expenses:			
- Salaries	4,500	3,200	7,700
- Administrative expenses	1,440	960	2,400
- Carriage outwards	2,200	960	3,160
- General expenses	3,200	1,800	5,000
- Increase in provision for bad debts	50		50
- Provision for depreciation-furniture	150	110	260
- Manager's commission		360	360
Total expenses	11,540	7,390	18,930
Net profit	9,900	3,600	13,500

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M/s Juma
Statement of financial position
As at 31 December, 2020

	Head Office	Branch	Combined
	TZS'000'	TZS'000'	TZS'000'
ASSETS			
Non-current Assets			
Furniture	1,500	1,100	2,600
Less: Accumulated depreciation	650	460	1,110
	850	640	1,490
Current assets			
Closing stock	15,240	6,570	21,810
Accounts receivable	7,000	2,880	9,880
Less: Provision for bad debts	650	180	830
Cash in transit	2,400		2,400
Branch current account	8,160		
Bank	600		600
Total assets	**33,600**	**9,910**	**35,350**
CAPITAL AND LIABILITIES			
Capital	18,000		18,000
Add: Net profit (9,900+3,600)	13,500		13,500
	31,500		31,500
Less: Drawings	3,700		3,700
	27,800		27,800
Current liabilities			
Accounts payable	5,800	400	6,200
Bank overdraft		1,350	1,350
Head office current account		8,160	
Total capital and liabilities	**33,600**	**9,910**	**35,350**

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Dr. **Branch current account** **Cr.**

	TZS'000'		TZS'000'
Balance b/d	6,800	Cash in transit	2,400
Branch profit	3,600	Goods in transit	800
Expenses paid by H.O.	960	Balance c/d	8,160
	11,360		**11,360**
Balance b/d	8,160		

Dr. **Head office current account (TZS'000')** **Cr.**

Balance c/d	8,160	Balance b/d	3,600
		Expenses paid by H.O.	960
		Branch profit	3,600
	8,160		**8,160**

Chapter summary

In this chapter, we have discussed various accounting concepts, methods, and techniques associated with the recognition of branch transactions in relations to the head office. A branch is simply a sub-unit of the company operating in different geographical locations as an agency of the head office. Generally, branches can be categorised geographically which gives inland and foreign branches, and according to control which gives out dependent/non-autonomous branches and independent/autonomous branches. The chapter focused on the later categorisation. For non-autonomous branches, the head office wholly controls operations of the branches while autonomous have autonomy in their operations. Consequently, non-autonomous branches do not prepare their books of accounts while autonomous branches have the autonomy to prepare their books of accounts.

In keeping transaction records of the branches with the head office, various accounts are prepared and maintained. These accounts are meant to help the head office to control the operations of the branch and to evaluate their performance. Some of the most common accounts for non-autonomous include branch stock account, branch debtors account, branch expenses account, goods sent to branch account, and an adjustment account. However, we have seen that the nature of information recorded in these accounts depends on the pricing approach used by the head office sending goods to the branch. The head office can opt to transfer

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goods to the branch either at cost or at the selling price or the wholesale price. Meanwhile, for the autonomous branch which has the autonomy to keep full records of accounting, the main account which shows interrelated transactions between the head office and the branch is the current account. When branches are autonomous, their treatment in the current account of the head office is like debtors. In contrast, the head office is considered a creditor in the current account of the branch.

In establishing the performance of the company, the head office incorporates the performance of the branches in the financial statements of the head office. In the case of autonomous branches, which prepare their books of accounts, their trial balances are first incorporated in the trial balance of the head office then the final reports are prepared. However, the head office records should be adjusted to incorporate items in transit because these cause differences in the balance of the current account of a branch and that of the head office. Items in transit include goods in transit to the branch, goods returned by the branch to the head office, and remittances from branches to the head office, but they have not reached the designated destination by the time the books of accounts are prepared.

Revision exercises

1. Explain the objectives of branch accounting
2. With examples, differentiate autonomous branches from non-autonomous branches. Your explanation should include the key books of accounts for recording their transactions in the head office.
3. Differentiate debtors' method of transferring goods to the head office against the stock and debtors method.
4. With examples explain what comprises the "items in transit" as used in branch accounting, and how they are treated in books of accounts.
5. Shambazuri Ltd deals with the purchase and resale of agricultural produce. Its head office is in Mtwara, but it has a branch in Dar es salaam for selling the products. All goods purchased by head office are transferred to the branch for retail selling. The goods are transferred at a cost plus 50% and the same price is used by the branch to sell the products to customers.

   All transactions are recorded in the books of the head office except for the sales ledger which is prepared by the branch. The following are the transactions at the branch during the year that ended on 30 June, 2021.

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	TZS
Stock on hand, 1 July 2020, at invoice price	52,800,000
Debtors on 1 July 2020	47,352,000
Stock on hand, 30 June 2021, at invoice price	47,376,000
Goods sent from Mtwara during the year at invoice price	297,600,000
Credit sales	252,000,000
Cash sales	28,800,000
Returns to head office at invoice price	19,200,000
Bad debts written off	1,776,000
Cash from debtors	268,800,000
Normal loss at invoice price due to wastage	1,200,000
Cash discount allowed to debtors	5,136,000

Required

Prepare the branch stock account and branch total debtors account for the year ended 30 June, 2021, as they would appear in the head office books, showing clearly any abnormal wastage.

6. The following information shows the transaction of the Lake-Zone branch of a company whose headquarter is in Arusha for the 1st quarter of the year 2022.

Particulars	**TZS**
Stock on 1st July, 2022	
- Stock	8,835,000
- Petty cash	108,000
Cash sales during the year	47,370,000
Goods invoiced to branch	49,410,000
Credit sales during the year	21,060,000
Cash sent to branch to cover for:	
- Rent	1,800,000
- Salaries	2,400,000
- Petty cash	1,050,000

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Closing balances:	
- Stock	8,310,000
- Petty cash	109,500
- Goods returned to head office	2,205,000

Required

Prepare relevant accounts in the books of head office to reflect the operations of the branch. Note that, goods are transferred to branch at cost.

7. Maweni traders of Unguja has a branch in Pemba. The head office transfers goods to the branch at cost plus 25%. The branch is required to deposit cash to the head office bank account on daily basis. All expenses are paid by the head office through cheques except for petty cash expenses which are paid by the branch manager.

Particulars	**TZS**
Stock on 1st July, 2022	
- Stock	16,400,000
- Debtors	6,340,000
- Furniture	4,680,000
Cash sales during the year	80,260,000
Goods invoiced to branch	125,600,000
Credit sales during the year	74,420,000
Petty cash paid by the branch	2,090,000
Expenses paid by the head office	26,400,000
Office furniture purchase on 1st Jan 2022 using cash collected from branch sales	500,000
Closing balances:	
- Stock	19,200,000
- Debtors	8,430,000

Depreciation of furniture is charged at 10% using the straight-line method.

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Required

Prepare branch account in the books of the head office taking into account the above information.

8. Show the accounting entries that the Head Office would make to record the following transactions in their books.

   (a) The head office instructed Unguja branch to transfer goods amounting to TZS. 10,000,000 to Dar es Salaam.

   (b) Depreciation charge of branch fixed assets amounting TZS 2,000,000 while such assets' accounts are opened and maintained at the head office books.

   (c) A remittance of TZS 30,000,000 was made by the Dodoma branch to head office on 24th December, 2021 but received by head office on January 4, 2022.

   (d) Goods of TZS 100,000,000 were sent by the head office on 27th December, 2021 but received by the Dodoma branch on 5th January, 2021.

9. Sanga Enterprises has its head office in Dar es salaam and a branch at Mwanza. All purchases are made at head office and invoiced to the branch at cost plus 10%. The following are the trial balances of both, the head office and its branch as at 31st Dec., 2021.

	Head Office		Branch	
	Dr.	**Cr.**	**Dr.**	**Cr.**
	TZS'000'	**TZS'000'**	**TZS'000'**	**TZS'000'**
Capital		450,000		
Furniture and fittings	75,000		15,000	
Accounts receivable	125,000		35,000	
Accounts payable		75,000		
Purchases/sales	1,200,000	1,000,000		550,000
Goods sent to branch (at mark-up price)		375,000		
Goods received from head office (at mark-up price)			320,000	
Cash from branch		300,000		
Cash to head office			325,000	
Branch current account	360,000			

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Head office current account				305,000
Unrealised profit from stock		50,000		
Cash at bank	140,000		5,000	
Opening stock (at mark-up price)	200,000		110,000	
Branch expenses	150,000		45,000	
	2,250,000	**2,250,000**	**855,000**	**855,000**

Other information:

(i) Closing stocks on 31st Dec., 2021 (at mark-up price):

At head office TZS 225,000,000 and at branch TZS 143,000,000.

(ii) Goods sent to branch on 15th Dec., 2021 were in transit, valued at TZS 50,000,000 (at mark-up); and the branch returned goods to head office valued at TZS 5,000,000 on 15th Dec., 2021 were still on transit.

(iii) Cash from branch to head office was still in transit on 31st Dec., 2021.

(iv) Head office paid TZS 15,000,000 on behalf of the branch. This was included in head office expenses.

(v) Depreciation on non-current assets is charged at 20% per annum on cost.

Required

Prepare for the head office, branch and the whole business separately:

(a) Statement of profit or loss for the year ended 31st Dec., 2021,

(b) Statement of financial position as at 31st Dec., 2021, and

(c) Current accounts.

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Glossary

Accountancy is a profession composed of a systematic field of knowledge about accounting, including the rules and principles that govern actual accounting procedures.

Accountant is a person who professionally deals with accounting or accountancy. Their job span beyond those performed by bookkeepers (i.e. recording, classifying, and summarizing financial records) to include, preparation, analysis, and interpretation of financial statements. Is a highly trained personnel and capable of designing accounting systems for different organizations.

Accounting cycle also known as the accounting process reflects a series of steps that are regularly repeated in the same order from identifying and recording business transactions to the time of preparing financial statements

Accounting is a subset of accountancy involving the practical application of accountancy principles to execute the profession's core duties. It explains the nature of the work of the accountants. Accounting is composed of different activities, including identifying and classifying business transactions, recording in books of accounts, preparing financial statements, and analyzing and interpreting the obtained results.

Activity ratios are a group of ratios that attempt to measure how well the business utilizes its assets to generate sales. Some activity ratios are useful in managing liabilities and others show the number of times particular assets convert into cash or sales. These ratios are also known as efficiency ratios. Examples of activity ratios; are stock turnover, debtors turnover, and creditors turnover ratios.

Aging schedule of doubtful debt refers to a periodic report that categorizes business accounts receivable according to the length of time an invoice has been outstanding. It is used as a gauge to determine the financial health and reliability of the business customers. It is used as an indicator of risk regarding the collectibility of debts from customers hence useful in determining the amount of provision for doubtful debts and eventually, bad debts.

Amortization is a term that resembles depreciation as a technique used in spreading out the costs associated with the use of assets but in the category of intangible assets. Examples of intangible assets include goodwill, patents and trademarks, and copyrights, over the expected period.

Arithmetical errors are accounting errors arising due to transaction discrepancies between amounts in

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words and amounts in figures. Also, they can arise due to wrong addition to the content of an invoice.

Auditor is a professional who has been authorized to conduct audit work. This involves reviewing and examining financial statements to determine whether they reflect a true and fair view of the business performance and its financial position (i.e. operational results and financial position).

Autonomous branches are also known as independent branches to reflect their design and functional behaviour. Compared to non–autonomous branches, they are more independent at least within the broad policies framed by the head office. For example, they may be allowed to purchase goods from the local markets and maintain their own set of books. An autonomous branch can either be a home or a foreign branch.

Bad debts refer to debts/loans/ outstanding balances owed that are no longer deemed recoverable and must be written off. Bad debts are treated as part and parcel of operating expenses or losses for the business.

Bookkeeping is part of the accounting process concerned with the classification and systematically recording of business transactions into different books of accounts.

Books of prime entry are used like diaries of business activities where the transactions made by a business are recorded for the first time before posting into separate ledger accounts. Other names for books of prime entry include books of original entries, journals, and day books.

Branch accounting is the system of bookkeeping under which the company maintains separate accounts for each of its branches to increase transparency as well as knowledge of the company's cash flow position and financial position.

Business transaction refers to an economic event, which involves the exchange of goods or services from one person to another with money or money equivalent.

Cash discount refers to an incentive that a seller offers to a buyer in return for paying a bill before the scheduled due date. The seller will usually reduce the amount that the buyer owes by either a small percentage or an agreed monetary figure.

Clerical errors in accounting arise from wrong transaction posting due to copying or writing mistakes. Clerical errors are those errors that are generally committed by the clerical staff in recording transactions either in the books of prime entry or in the ledger accounts (books of final entry).

Cost accounting is the branch of accounting concerned with the recording and analysis of costs as well as the determination of the cost of products.

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Cumulative Dividend (Cum div) is an investment term when a buyer of a security is entitled to receive the next dividend scheduled for distribution. Therefore, the price of the security will be set relatively higher since the value of the pending dividend is included in the sale price of a security.

Debentures a medium to long-term security yielding a fixed rate of interest, issued by a company to raise capital from the public.

Depletion is an accrual accounting technique used to allocate the cost of extracting natural resources such as timber, minerals, and oil from the earth. Like depreciation and amortization, depletion is a non-cash expense that lowers the cost value of an asset incrementally through scheduled charges to income.

Depreciation refers to an accounting method that is used to allocate the cost of a tangible or physical asset (non–current assets) over its useful life. Thus, depreciation expenses will be posted to the income statement similar to other operating expenses while accumulated depreciation will be deducted from the cost of an asset to show its book value in the statement of financial position.

Disposal of assets is the elimination of an asset from a company's records, typically by selling or scrapping it. These are often none – current assets that contributed to generating profits e.g., machinery, technology, or company vehicles.

Dividends are the sum of money paid regularly, typically annually, by a company to its shareholders out of its profits or reserves.

Double-entry bookkeeping is a fundamental principle underlying present-day bookkeeping and accounting, which states that every financial transaction has equal and opposite effects in at least two different accounts. It requires that, for every debit entry, there must be a corresponding credit entry and for every credit entry, there must be a corresponding debit entry. It is the foundation of accounting that satisfies the accounting equation, assets = liabilities + equity.

Doubtful debt is a debt that is unlikely to be paid i.e., a debt, with which there is uncertainty, as to the degree to which the amount will be recovered from the debtor. Thus, provision for doubtful debts is calculated based on debtors' balances after the elimination of bad debts.

Equity is the net amount of funds invested in a business by its owners, plus any retained earnings. It is also calculated as the difference between the total of all recorded assets and liabilities on an entity's balance sheet.

Excluding dividend (Ex div) is an investment term that describes a stock that is trading without the value of the next dividend payment.

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Financial accounting is a specific branch of accounting involving a process of recording financial records, summarizing, and preparation of financial statements i.e., statements of income, statements of financial position, and statement of cash flows over a specified period.

Financial leverage ratios are ratios designed to assess the ability of a company to pay its long-term liabilities i.e., debt and the interest on that debt. The focus is on the capital structure of the business measured by using ratios such as debt ratio, equity ratio, and interest cover ratios.

Financing activities refer to any cash flows that result in changes in the size and composition of the contributed equity capital or borrowings of the entity (i.e., share capital, dividends)

Folio number is a way to reference a bookkeeping entry, most often numbered in chronological or sequential order. For example, entries in the sales day book will have reference numbers to indicate in which account or page number in the sales ledger a record has been posted.

Forensic accounting is a branch of accounting that deals with the application of accounting, auditing, and investigative skills in analysing financial information, which can appropriately be used as evidence in the Court of law.

General journal is the company's journal in which initial record keeping of all the transactions is done which are not recorded in any of the specialty journals maintained by the company like purchase journal, sales journal, and cash journal.

General ledger is the main ledger book of the business, which contains all the accounts of the business recorded using the principle of double-entry. General ledger contains different accounts such as assets, liabilities, capital/equity, revenue, and expenses. In short, the general ledger provides all the accounts used in the preparation of financial statements.

International Accounting Standards (IAS) refer to internationally-agreed principles and procedures guiding the preparation of financial statements by the company. How does this concept relate to international financial reporting standards (IFRS)? Since 2001, those standards have been released under the new name IFRS. In this process, several IAS were replaced with IFRS but some were maintained until to date they are relevantly used in tandem with IFRS.

International financial reporting standards (IFRS) refer to a set of accounting rules governing the preparation and reporting of financial statements of public companies with the objectives of making them

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consistent, transparent, and easily comparable around the world.

Investment is an asset or item acquired to generate income or appreciation. The latter refers to an increase in the value of an asset over time. The asset that has been acquired as an investment will be maintained to use in the future to create wealth rather than use or consume it.

Liquidity ratios are ratios assessing how easily a particular category of assets can be converted into cash. The focus is on current assets e.g., debtors and stocks/inventory – these can be converted into cash within a relatively shorter period – not exceeding one year. Thus seen as appropriate in settling the current liabilities like creditors, which need to be paid within one accounting period. They are computed by dividing current assets by current liabilities.

Management accounting is a branch of accounting designed to assist managers in carrying out their basic functions of planning, control, and decision-making. It utilizes different methods and techniques from cost accounting and other fields of business, economics, and statistics to process information to support management functions.

Market prospects ratios also known as investors ratios are designed to assist shareholders and potential investors to evaluate the performance of the business in terms of the value of its shares and expected returns. The computations of these ratios require the use of some financial data from the stock exchange market.

Operating activities are the principal revenue-generating activities of a business and other activities resulting in a change of current assets and current liabilities provided they do not fall under the categories of financing and investing activities

Profitability ratios are financial ratios designed to measure the ability of a business to generate profit i.e., revenue over expenses. A good example of profitability ratios includes profit margin which relates profit to the amount of revenue.

Provisions refer to any funds set aside from a company's profit for probable future expenses or a reduction in the asset value, although the exact amount is unknown at present e.g., provision for doubtful debts and allowances for discounts.

Purchases day book is a book of prime entries that are used to record credit purchases of goods.

Purchases ledger is a book that contains all the accounts of individual credit suppliers (the personal accounts) used to record credit transactions between business entities and their suppliers of goods and services. The

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purchases ledger thus provides the detailed transactions of each credit supplier of goods.

Reporting entity may also be referred to as an accounting entity, meaning a business entity in respect of which the financial statements are prepared. The IFRS states that reporting entity may have a legal obligation or may choose to prepare external financial reports for the benefit of parties with an interest in its operations. These include suppliers, lenders, and investors.

Reserves are part of profits or gains that have been set aside to achieve specific objectives. These may include paying for bonuses, expected legal settlement, repairs and maintenance or long-term debts, buying non-current assets, or developing and expanding a business.

Retained earnings are the amount of profit remaining after the company has paid all of the costs of goods sold, operating expenses, income taxes, and dividends to shareholders. This represents the portion of the company's equity that can be used, for instance, to invest in new equipment, research and development, and marketing.

Revenue recognition principle asserts that revenue must be recognized as it is earned. This means after a certain critical event has occurred such as the product being delivered to the customer.

Sales day book is a book of prime entries that is used to record sales of goods made on credit.

Sales ledger is a book that is used to record all the accounts of individual credit customers, which are personal accounts. In other words, the sales ledger is used to record all transactions made between credit customers for goods or services and the business entity.

Share capital refers to the amount of money the owners of a company have invested in the business as represented by common and/or preferred shares.

Social responsibility accounting is the process of communicating the social and environmental effects of an organization's economic actions to particular interest groups within the society and the government at large.

Source document is an original document evidencing the occurrence of a transaction e.g., sales invoice or receipt, title deed, purchase order, bank statement, and canceled cheque. The source document contains important details that substantiate the financial transactions that are entered into the internal accounting system of a business.

Statement of cash flows is one of the key financial statements that a business, especially a company, is required to produce to show an overview of all cash flows. These include, operating

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activities, financing activities, and investing activities. Through this, one can be able to know the actual cash position of the business.

Statement of changes in owners' equity is a financial statement that reports changes in equity from net income, owner investment, and withdrawals over a period. For a company, the changes will be observed in the company's share capital, accumulated reserves, and retained earnings over the reporting period.

Suspense account is a general ledger account used for recording business transactions temporarily for different reasons including, correction of bookkeeping errors or simply being unsure of the type of account most appropriate to record those transactions.

Tax accounting is the branch of accounting concerned with tax-related issues such as determining the tax liability of the business, and preparation of tax returns for individuals, companies, and other types of organizations.

Trade discount is the reduction in price a manufacturer/wholesaler gives a wholesaler/retailer when they buy a product or group of products. A trade discount is offered as a certain percentage that the offerer (manufacturer or wholesaler) is willing to reduce from its list price to benefit the wholesalers or retailers.

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