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A3 FINANCIAL ACCOUNTING

FINANCIAL ACCOUNTING

STUDY TEXT

A3

Foundation level

THE NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS TANZANIA (NBAA)

A3

FINANCIAL ACCOUNTING

STUDY TEXT

NBAA

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FOREWORD.

The National Board of Accountants and Auditors is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 (CAP 286 R.E.2002). The Board has been charged with among other things, the responsibility to promote, develop and regulate the accountancy profession in the country.

In fulfilling its statutory obligations, NBAA prepares National Accountancy Examination Scheme for students aspiring to sit for Accounting Technician and Professional Examinations. Further, for effective implementation of the examination scheme and improve examination results, the Board provides Study Guides for all subjects to assist both examination candidates and trainers in the course of learning and teaching.

The Study Guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The Study Guides cover a wide range of topics in the NBAA syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a leaner to pass the respective examination levels.

Furthermore, the Study Guides have been prepared to match with the Competency Based Syllabi to enable the learners to be exposed to practical understanding of issues rather than memorisation of concepts. In this case, the Study Guides are characterized by the following features:-

1. Focus on outcomes – The outcomes shown in every topic provides clear understanding on what to be learnt.

2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge and skills necessary for effectively performance in a work place. This is different from the traditional training where much concern has been expressed in theoretical perspectives.

3. Assessments as judgments of competence – The assessment questions embedded in the Study Guides are adequate measures of understanding of the subject matter.

Study Guides are also useful to trainers specifically those who are teaching in the review classes preparing learners to sit for the professional examinations. They will make use of these Study Guides together with their additional learning materials from other sources in ensuring that the learners are getting sufficient knowledge and skills not only to enable them pass examinations but also make them competent enough to perform effectively in their respectively workplace.

NBAA believes that these standard Study Guides are about assisting candidates to acquire necessary skills and knowledge that will enable them to perform as professionals. The outcomes to be achieved are clearly stated so that learners may know exactly the skills and knowledge they are supposed to acquire in a particular topic.

NBAA wishes all the best to NBAA Examination candidates, trainers in their review classes, lecturers in the higher learning institutions and all other beneficiaries of these learning materials in making good use of the Study Guides towards promoting the accountancy profession in Tanzania.

CPA. Pius A. Maneno
EXECUTIVE DIRECTOR
JUNE, 2019

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A3 – Financial Accounting

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Features of the book

'The book covers the entire syllabus split into various chapters (referred to as Study Guides in the book). Each chapter discusses the various Learning Outcomes as mentioned in the syllabus.

Contents of each Study Guide

'Get Through Intro': explains **why** the particular Study Guide is important through real life examples.

'Learning Outcomes': on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

'Definition': explains the meaning of important terminologies discussed in the learning Outcome.

'Example': makes easy complex concepts.

'Tip': helps to understand how to deal with complicated portions.

'Important': highlights important concepts, formats, Acts, sections, standards, etc.

'Summary': highlights the key points of the Learning Outcomes.

'Diagram': facilitates memory retention.

'Test Yourself': contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

Self Examination Questions': exam standard questions relating to the learning outcomes given at the end of each Study Guide.

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination. 5 conventional questions of 20 marks each need to be solved.

The examination will consist of two sections.

Section A	One conventional question of 20 marks
Section B	Forty multiple choice questions of 2 marks each

1 INTRODUCTION TO ACCOUNTING

Get Through Intro

Financial accounting is the **‘language of business.’** As tomorrow’s managers and business people, you need to be fluent and master this ‘language’ to perfection.

This paper is the foundation of your knowledge: if you can build a solid base, everything you “construct” will be consistent and will last over a long time. By the end of this Study Text, you should be able to understand the underlying principles and concepts of financial accounting and be comfortable with debits and credits. You will have started your career by winning a very important battle - understanding the ‘language of businesses!!

This Study Guide also explains the **accounting principles, concepts and conventions that financial statements should have**. As an accountant, it is assumed that you understand all the accounting principles and their inter-dependence. Without this basic knowledge it is impossible to efficiently complete the entire accounting exercise - which starts with the source document and ends with the financial statements.

As a student of accounting and a future finance and accounting professional, you should be comfortable with the terms **debit** and **credit** and be able to recognise these two elements in each transaction. These two words are so important that the whole process of accounting and financial reporting rests on them.

We will start by explaining what financial accounting is and the purpose and objectives of financial reporting. This will help you to understand the need for financial reporting, so you can carry it out in practice!

Learning Outcomes

a) Define accounting.
b) Identify the users and the financial information they need about an entity.
c) Differentiate financial accounting from management accounting.
d) Identify sources of data and information for compiling financial records.
e) Explain the accounting cycle and accounting equation.
f) Describe Assets, Liabilities, Capital, Income, Expenses and Equity.
g) Identify types of business entity; sole trader, partnership, companies, etc.
h) Explain the concepts, conventions and principles underlying the accounting profession.

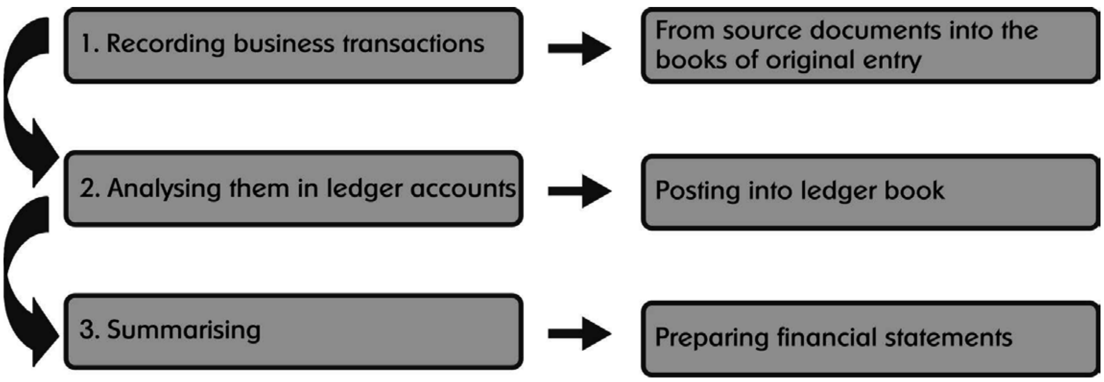
1. Define accounting.

[Learning Outcome a]

From the start of a business, various transactions and events take place. All transactions should have as their base, certain original source documents (such as invoices or receipts - you will study these in detail later on in this Study Text) from which we record information in the business accounts. This information is then summarised in the form of financial statements. .

The accountant will be responsible for accounting of business transactions and reporting them to external users. Financial accounting (or accounting) will therefore consist of the following

Diagram 1: Financial accounting process



Definition

Accounting is the **process of recording and reporting of financial transactions** including the origination of the transaction, its recognition, processing and summarisation in the financial statements**.**

The New York State Society of CPAs

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1. Recording

However good the memory of a businessman may be, he cannot remember each and every transaction that takes place during the course of business. Hence, there is a need to record the day to day transactions e.g. sales, purchases, expenses made, cash paid to someone, cash received from someone and so on.

Recording refers to the actual writing of the transactions that take place in words and figures so that reliable information regarding the position of the business can be made available at any point of time. The books where this information is recorded are known as the **books of original entry.**

The transactions are recorded in the books of accounts on the basis of documents such as invoices, receipts, vouchers, bank statements, etc.

Example

Leroy Madeline has started a business as a sole trader selling tables that he buys from a craftsman's shop called Table Crafters LLC. He started the business in January 20X3 and the following transactions took place during the year

1. He deposited Tshs85 million cash into a bank account exclusively for the business
2. Leroy bought 10 round wooden tables at Tshs3.2 million each from Table crafters LLC.
3. Leroy sold all the tables during the year at Tshs.5 million each for cash.

Required:

What are the documents on the basis of which you could record the above transactions and events?

Answer

1. The business bank statements confirm the receipt and payment of cash into the business account
2. Purchase invoice issued by Table Crafters LLC will be used to record the purchases made
3. Sales invoices issued by Leroy will document the sales made.

---

2. Analysing

From the books of original entry, the transactions are analysed and posted to the ledgers. The ledger book contains separate categories for each typical business transaction such as purchases account, sales accounts, cash account, expenses account etc. Each of these transactions and its related accounts are explained in more detail in Study Guide 2.

Every transaction has two effects. For example, when a trader purchases goods, there are two effects:

the first effect is that the goods are received; and
the other effect is that cash is paid for the goods purchased.

As each transaction will have a double effect, two ledger accounts will be affected when a transaction is posted.

Example

Mary is a book shop owner who conducted the following transactions during the month of May:

1. Purchased books from Best Plc.
2. Gave a cheque to Best Plc.
3. Paid salary in cash to James
4. Sold books to Stephens college
5. Received cash from Stephens college

Required:

Identify the ledger accounts that would be impacted because of the above transactions.

Answer

1. Book purchases account and Best Plc (supplier / vendor) account
2. Best Plc supplier / vendor account and bank account
3. Salary account and cash account
4. Stephens college (customer) account and sales account
5. Cash account and Stephens college account

---

3. Summarising

Thousands of transactions could occur during a year and therefore users of financial accounts may not have the time to go through each one of these transactions. In certain cases, owners of a business also may wish to keep certain transactions confidential. Therefore transactions need to be summarised in a structured manner in order to understand an entity's financial position and performance at the end of a period.

The final products of financial accounting are the business **financial statements.** The two main financial statements that summarise all the transactions and events of a business during a specific period are

(a) Statement of profit or loss
(b) Statement of financial position

These financial statements have been discussed in detail in **Study Guide 5**.

Conclusion

During the accounting process, accountants identify record and analyse the financial dealings of a company. At the end of each period, accountants use the information they have collected to prepare financial statements. Thus financial accounting is the process of **preparing and presenting the financial statements.**

Test Yourself 1

Identify the ledger accounts that would be affected because of the following transactions

1. Commenced business with cash
2. Amount deposited in bank account
3. Goods purchased on credit
4. Furniture purchased in cash
5. Paid to trade payables by cheque

---

2. Identify the users and financial information they need about an entity.
[Learning Outcome b]

As mentioned earlier, there are several stakeholders who study / use an organisation's financial statements. The main groups of stakeholders and their information needs are described below.

1. Owners / shareholders and potential investors

The primary users of an organisation's financial statements are its owners / shareholders. This is because owners / shareholders have provided the **capital** that makes it possible for an organisation to begin its operations. Naturally they want as much information and detail as possible in order to determine if their investment is not only safe but also growing.

As a general rule of thumb, if the owners are satisfied with the contents of an organisation's financial statements, then other groups also feel comfortable.

The information that owners / shareholders are interested in include

- how their capital has been utilised
- the number and type of assets the organisation owns
- the level of debt the organisation has taken on
- how profitable the operations of the organisation are; and
- whether the financial condition and performance of the organisation is improving / deteriorating over time

Potential investors would also be interested in the above information as this information would help them decide if they could become the new owners / shareholders of the business. In addition, they will use the financial statements to assess whether the organisation represents a viable investment option (i.e. is the business likely to grow over the course of time and increase the value of their investment).

Example

Mark is an individual who has recently come into a large inheritance. He would like to use his new found wealth to invest in a suitable business. He identifies the telecom industry as one that is likely to see the most growth in the coming years.

Thereafter he looks at the financials statements of several companies that operate in this industry. He compares the financial condition and performances of these companies before deciding upon which particular organisation to invest his funds in.

---

2. Management

Management will use the financial statements of the organisation as a kind of **"report card**" of their decisions / activities throughout the year. This is because the financial statements reflect how profitable (or unprofitable) these decisions or activities have been for the organisation.

Example

Fly Aircrafts is an organisation that manufactures airplanes. Since its inception the organisation has concentrated on the civilian market due to which sales and correspondingly profits have been stagnant over the past four years.

At the start of its current financial the year, the management of Fly Aircrafts made the strategic decision to move into the military market by making jet-fighters. The organisation's financial statements at the end of the year will help decide whether this decision was worthwhile or not by comparing with the previous year's financial statements.

---

3. Providers of finance e.g. banks or other financial institutions

Payables such as banks and other financial institutions typically provide the funding an organisation needs to carry on its operations and / or expand its business. As a result, they need to ascertain whether the organisation has the ability to repay its debts. As a result, they turn to the organisation's financial statements to determine the general trends followed by the organisation in terms of sales, profits, past scale of operations and cash flows. The specific information they seek from the organisation's financial statements include

- how profitable the organisation has been
- whether the company will continue to operate in the coming years, or is it likely that it will go out of business
- whether the operations of the organisation have generated sufficient cash flow to satisfy their debt repayments, going forward
- the value of the assets the organisation may have pledged as security / collateral

Example

Man-X is an organisation that has recently borrowed Tshs1,650 million from its bank to finance an expansion to its factory. To service this loan it will have to make payments of Tshs240 million to the bank on an annual basis. For this, they have pledged their office premises as security to the bank, which is valued at Tshs3230 million.

Before giving the loan, the bank will complete a detailed analysis of the liquidity position of Man-X. The financial statements of Man-X would be used for this analysis to assess the following

- whether the organisation is generating sufficient cash to make the Tshs240 million payment each year; and
- whether the value of its security (the office premises) still stands at Tshs3,230 million

---

4. Trade relations

Trade relations are the relations between the suppliers and customers of an organisation.

They will use these statements to determine the financial condition and performance of the business in order to find out whether the organisation will be able to pay for the goods / services it orders from them.

Customers are typically less interested in the financial statements of an organisation they deal with. This is because normally their relationship with the organisation ends once the sale of goods / services has been made. However customers who have an on-going relationship with an organisation will be interested in the financial statements to determine if the organisation will continue to operate for the coming years.

Example

Mono Computers manufactures personal computers which it sells to small and medium sized enterprises. It offers a one-year free service guarantee on the purchase of a computer. Customers would therefore be interested to study Mono's financial statements to help them determine whether or not the business would still be operating in 12 months' time (otherwise the one year guarantee becomes worthless).

---

5. Employees

Employees of an organisation are interested in the financial condition and performance of an organisation because that is the source of their salaries. In addition, organisations that are performing poorly or are in a weak financial position are unlikely to offer much scope for promotions, career development etc. Employees can figure out their career prospects from the financial statements.

6. Government and its agencies

Financial statements of organisations serve as a source of data for the government when it is compiling national economic statistics such as the country's GDP (Gross Domestic Product). This helps the government in taking different policy decisions.

7. Financial analysts, stock brokers, financial journalists

This group of users study the financial statements of organisations to determine their financial condition and performance. They also use these statements as a basis from which they make predictions regarding the future financial condition and performance of the organisation. Depending upon their predictions, they then advise their clients (potential investors) on whether to invest in a particular organisation or not.

8. Tax authorities

Tax authorities use the financial statements to determine tax amounts. Income shown by the statement of profit or loss is used as the starting point for calculating taxable income. Revenue and purchase figures are used to determine VAT liability.

Test Yourself 2

How do investors use financial statements to help them make decisions on whether or not to invest in a particular organisation?

---

3. Differentiate financial accounting from management accounting.
[Learning Outcome c]

1. Financial Accounting

Definition

Financial accounting is the **process of recording, analysing and reporting (in the form of statement of profit or loss and statement of financial position).**

Financial accounting is concerned only with the financial state of affairs and financial results of operations. It is mainly concerned with the preparation of financial statements which primarily includes statement of profit or loss and the statement of financial position. These financial statements are used by various stakeholders such as trade payables, investors and financial institutions.

The statement of profit or loss is a statement of the business's financial performance and reflects all the items of income and expenses incurred by a business during a certain period. In a statement of profit or loss, the items of income and expenditure incurred by a business are matched against each other to arrive at the **profit / loss** generated by the business during that period.

The statement of financial position (SOFP) is a statement reflecting everything that the entity **owns** (its assets e.g. property, equipment, cash) and everything it **owes** (its liabilities to the owners and third parties e.g. suppliers / vendors, equity) as at a certain point in time.

2. Cost Accounting

Definition

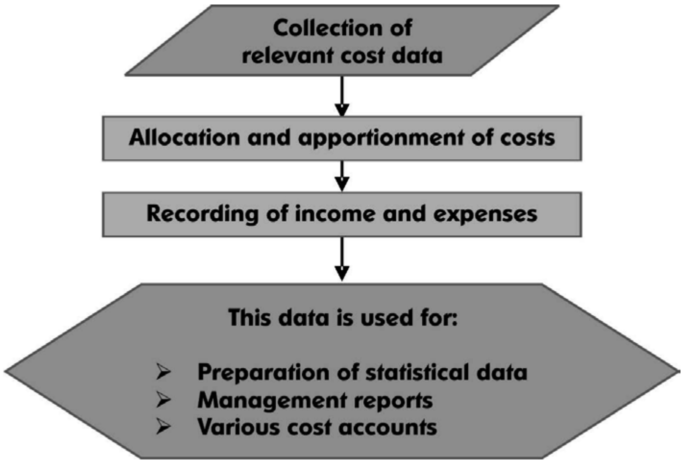
Cost accounting is "the establishment of budgets, standard costs (benchmark for comparison with actual) and actual costs of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds".

CIMA Official Terminology, 2005

Cost Accounting is the process of accounting for costs. It shows classification and analysis of cost on the basis of functions, process, products etc. It also deals with cost computation, cost saving, cost reduction etc. In cost accounting, cost per unit of output produced or services rendered is ascertained. It helps management in the control of cost of output or services rendered.

Cost accounting is the process of accounting or recording all attributable and allocable costs for a product or service, beginning with recording of income and expenditure relating to the product and ending with preparation of statistical data. Costing is essentially an activity of assigning the appropriate costs to a product and creating a data for future references as regards the cost relating to it.

Diagram 2: Cost accounting process



Its main objective is the creation of an underlying data for use in management accounting. This should include recording of

- Cost of goods produced or services rendered
- Cost of combinations of activities grouped as a cost centre
- Accumulation of revenues
- Profitability at any level
- Optimum selling prices, ensuring all costs are covered
- Value of inventory
- Future costs
- Actual cost versus budgeted cost for budgetary control

Cost accounting systems can be found in all types of organisations, but are highly developed and extensively used in the manufacturing sector. This is because the industry is sensitive to costs, and the production costs need to be monitored and controlled effectively for the profit margins to be at the desired level. Cost accounting can be, and is generally, applied to all areas of the organisation. It is not department specific.

3. Management Accounting

Management accounting deals with the processing of data in financial accounting and cost accounting for managerial decision making. It also deals with the application of managerial economic concepts for decision making for the efficient running of the business, thus maximising profits.

In other words, it is accounting for the management. Management accounting is useful to the management to provided necessary information for decision making and creation of suitable policies within the organisation. The aim of management accounting is the efficient running of the business, and thus, maximising profits.

Where financial accounting focuses on external users, management accounting emphasises on the preparation and analysis of accounting information within the organisation.

The concept envisages the application of appropriate techniques and concepts, which would **aid management in the formulation of a strategy** for the achievement of objectives.

Data used for management accounting should serve its intended purpose. An appropriate concept or technique, even if borrowed from other branches of accounting or subjects such as mathematics or economics, can be used for management accounting purposes.

Test Yourself 3

Management accounting, as a concept, makes use of

A Both cost and financial accounting disciplines
B Neither cost nor financial accounting disciplines
C Cost accounting discipline only
D Financial accounting discipline only

4. Identify sources of data and information for compiling financial records. [Learning Outcome d]

4.1 Data sources

A data source is **evidence that proves the occurrence of a transaction or event.** In accounting, all transactions or events are recorded on the basis of a data source.

Example

John purchased a car. The evidence of this transaction is an invoice issued by the car dealer. An invoice contains the seller's name, description of goods, buyer's name, date of transaction and amount of transaction. For the above transaction, the invoice issued by the car dealer is a data source.

The source documents of the various transactions of an entity can be categorised as

Transaction	Source document
Purchases of goods	Supplier's invoice
Sales of goods	Entity's sales invoice
Returns of purchased goods	Debit note raised by the entity and credit note issued by the seller accepting the return
Returns of sold goods	Debit note raised by the customer and Credit note raised by the entity accepting the return
Provision of services	Entity's sales invoice
Purchases of assets	Supplier's invoice
Sales of assets	Entity's sales invoice
Cash receipts	Receipts issued by the entity for cash sales
Cash payments	Remittance advice accompanying the actual cash
Cheque payments	Remittance advice accompanying the actual cheque
Cheque receipts	Receipts issued by the entity
(The above list is not exhaustive)	

For each and every transaction of an entity, there has to be some kind of proof or data source. This is the first step in the accounting process i.e. **identifying transactions**.

The need for data sources in accounting

In accounting, all transactions are recorded on the basis of some data source, which gives evidence of the occurrence of transactions. Source documents are insisted on by auditors while reviewing the accounts. They must be retained by the company and properly filed for future reference.

4.2 Types of data sources

1. **Internal data source:** this is a data source which is **generated internally** by the entity.

Example

Gemini Enterprise sold goods. A sales invoice will be issued by Gemini Enterprise to its customers. This is a data source internally generated by Gemini Enterprise.

---

2. **External data source:** this is a data source which is **generated by another entity.**

Example

Gemini Enterprise purchased furniture from Krone Furniture. Krone Furniture will issue an invoice. This invoice is an external data source for Gemini Enterprise.

---

3. **Oral data source:** this data source is obtained through verbal communication, but it has to be confirmed in writing at a later date.

Example

The board of directors have proposed a dividend of 15% to its shareholders. The proposal at the meeting is an oral data source. However it has to be converted into minutes.

4.3 Different types of business documentation

1. Quotation

A quotation **contains terms and descriptions** about the seller's willingness to sell goods and on what terms. A quotation usually contains the following details

(a) Description of goods
(b) Price including discounts and other benefits
(c) Delivery schedule
(d) Period of validity

Example

James Trading Corp is interested in buying computers from Computech Ltd. It has asked the marketing manager of Computech Ltd for a quotation. The manager has replied with a detailed description including the price of the computers, the payment schedule, the delivery schedule etc.

Proforma quotation

Computech Ltd PO Box 9013, Dar es Salaam, Tanzania Proforma Quotation		
Buyer's Name		**Q. NO.** 1065
James Trading Corp		**Date:** 24 Aug 20X3
Address		
Sr. No	**Details**	**Rate**
1	Computers - 5 Nos	Tshs650,000 each
2		
3		
4		
Terms and Conditions 50% advance on confirmation of the order Final payment on delivery Delivery-First consignment will be sent within 15 days of confirming the order 2nd and final consignment will be sent 20 days after delivery of 1st consignment Freight, transport and insurance to be borne by the buyer Prices will include taxes as applicable **Authorised signatory** For Computech Ltd Marketing manager		

A quotation only gives the potential buyer a fair idea of the cost of purchasing a product / service. It cannot be used as documentation to indicate the sale transaction. The documentation to indicate a sale has been made is the sales invoice (covered later in this Learning Outcome).

2. Purchase order

When a company wants to purchase items, it sends a request to the supplier to supply the goods. The request sent by the buyer to the seller to supply goods to the buyer is known as a 'purchase order'. A purchase order **confirms the order and contains complete information** about it e.g.

(a) Name and address of the buyer
(b) Quantity and description of goods needed
(c) Price offered
(d) Delivery schedule
(e) Place of delivery
Other terms and conditions

Example

James Trading is an electronics retailer. It intends to purchase five laptops from Computech Ltd. The purchase order that would have to be completed by James Trading is given in the below Proforma.

Proforma purchase order

<table>
<tr><td colspan="5">James Trading Corp
Lexington, Kentucky
USA</td></tr>
<tr><td colspan="5">PURCHASE ORDER</td></tr>
<tr><td colspan="2">Seller's Name
Computech Ltd
PO Box 9013, Dar es Salaam, Tanzania</td><td colspan="3">P.O. No. 1125
Date: 23 August 20X3</td></tr>
<tr><th>Sr. No</th><th>Details</th><th>Quantity</th><th>Rate Tshs</th><th>Amount Tshs</th></tr>
<tr><td>1</td><td>Laptop computers</td><td>5</td><td>650,000</td><td>3,250,000</td></tr>
<tr><td>2</td><td></td><td></td><td></td><td></td></tr>
<tr><td></td><td>Total</td><td></td><td></td><td>3,250,000</td></tr>
<tr><td colspan="5">(Two Thousand dollars)</td></tr>
<tr><td colspan="3">TERMS AND CONDITIONS
50% Advance amount before delivery
Final payment on complete delivery
Freight and transport borne by supplier
Sales tax as applicable
Delivery within 20 days from issue of purchase order</td><td colspan="2">Authorised Signatory
For James Trading Corp

Chairman</td></tr>
</table>

3. Sales order book

Sometimes when a buyer finds goods in the seller's premises, he books an order in the sales order book maintained by the seller.

Example

Computech will probably, have a number of customers placing orders on a daily basis. As company policy, Computech allows 15 working days for international orders. Based on the purchase orders received, Computech will enter each order into its Sales order book.

Proforma Sales order

Computech PO Box 9013, Dar es Salaam, Tanzania						
Sales Order book						
Sr. No	**Date**	**Customer's name and address**	**Details**	**Qty**	**Rate Tshs**	**Other details**
1	31/08/20X3	James Trading Corp	Laptop computers	5	0.65 million each	Goods to be delivered by the end of next week
2	01/11/20X3	Mobile World	Office printers	2	0.4 million each	Advance paid
3	03/12/20X3	Coder Decoder	Automated office assistant	1	5.65 million each	Tshs3.2 million paid as advance

4. Goods received note (GRN)

When the purchased goods are received, the receiver of the goods prepares a note for receipt of the goods. This note is called a 'goods received note' and it contains the following information

(a) Information about the supplier
(b) Date of receipt of goods
(c) Quantity and description of goods

The GRN is generally prepared by the goods inwards department.

Example

When James Trading Corp receives computers; it prepares a goods received note. A goods received note will contain certain details e.g. supplier's name, date of receipt of computers, description and quantity of computers, the condition of computers (e.g. damaged) etc.

---

5. Goods despatched note (GDN)

When the sold goods leave the seller's place, the sender prepares a note for the despatch of the goods. This note is called a 'goods despatched note'. It contains the following information

(a) Date of despatch of goods
(b) Buyer's name and address
(c) Quantity and description of goods

The GDN is generally prepared by the goods outwards department.

Example

When Computech Ltd sends computers it prepares a goods despatched note. A goods despatched note contains certain details e.g. customer's name, date of despatch of computers, quantity, description of computers etc.

---

6. Invoice

After supplying the goods, the seller sends an invoice to the buyer. An **invoice is the final proof that the goods have been sold** i.e. it conveys the ownership of the goods from the seller to the buyer.

An invoice contains the following information.

(a) Name of the seller
(b) Address of the seller
(c) Date of transaction
(d) Serial number of the invoice (invoices are pre-numbered documents, to ensure that they do not go missing)
(e) Description of the goods
(f) Name and address of the buyer
(g) Amount involved in the transaction
(h) Date due for payment

Example

Computech Ltd sold computers to James Trading Corp on 3 January 20X3. This was the first sales transaction of Computech Ltd for 20X3. A proforma invoice of the above transaction is given below:

Computech Ltd

PO Box 9013, Dar es Salaam, Tanzania

Invoice

Buyer	
James Trading Corp	**Invoice number:** 01/03
Lexington, Kentucky	**Date:** 31 August 20X3
USA	

An entity can number the invoice in any manner but it should be unique and sequential

S. no	Details	Quantity	Rate	Amount
			Tshs	Tshs
1	Computers	5	650,000	3,250,000
	Total	**5**		3,250,000

Amount in figures: Tshs three million two hundred and fifty thousand only.

For Computech Ltd

Authorised signatory

Invoices are raised (typed) by the seller on the seller's letter-headed stationery. **Within the business they will be termed 'sales invoice', consequently, when the same document is received by the customer / purchaser, it will be referred to as a 'purchase invoice'.**

7. Statement of account

A statement of account consists of the details of all the transactions between two parties that are outstanding on the statement date. In addition, the statement can also show payments received and the sales invoices they were allocated against.

Example

James Trading Corp asked Computech Ltd for a statement of account as at 31 December 20X3.

Computech Ltd will issue a statement in which it will give the following details

Sale of goods with dates and description
Payments made by James Trading Corp
Any other adjustments for discounts, returns and eventual disputes or litigations etc.
The outstanding balance as at 31 December 20X3

A statement acts as a confirmation in accounting of all the transactions outstanding. For example James Trading Corp will compare his records to the statement issued by Computech Ltd, and ensure that it has received and processed all the invoices correctly. Computech Ltd will present the information as clearly and concisely as possible to allow the customer to easily see what is outstanding.

Proforma statement

Computech Ltd					
PO Box 9013, Dar es Salaam, Tanzania					
Proforma Statement as at 31 December 20X3					
Buyers Name			**Account number** X 20016		
James Trading Corp					
Address: Lexington, Kentucky, USA					
For the period from 1/1/20X3 to 31/12/20X3					
Date	**Details**	**Allocated**	**Debit**	**Credit**	**Balance outstanding**
			Tshs'000	**Tshs'000**	**Tshs'000**
31/08/20X3	Sales-Inv-01/03	A1	3,250		
10/09/20X3	Sales-Inv-1023	A-1	1,500		4,750
06/09/20X3	Sales-Inv-1039	A-2	2,500		7,250
07/12/20X3	Receipt -1023	A-1		1,500	5,750
08/12/20X3	Sales-Inv-1098	A-2	1,000		6,750
10/02/20X3	Sales-Inv-1106	A-2	525		7,275
10/12/20X3	Sales returns	A-2		525	6,750
15/12/20X3	Sales-Inv-1122		1,250		8,000
31/12/20X3	Receipt	A-2		3,400	4,600
31/12/20X3	Discount	A-2		100	4,500
Balance outstanding at 31 December 20X3					**4,500**
					For Computech Ltd
					Accounts Manager \ Authorised Signatory

If the supplier prepares a statement in this format he can clearly identify which items have been paid for. This enables the customer to clearly identify which invoices are still outstanding. In this instance, the full outstanding balance of Tshs4,500,000 relates to sales invoice "Sales-Inv-1122" and Sales-Inv-01/03. Below is an alternative statement that Computech Ltd could have sent to its customers.

Proforma statement

Computech Ltd		
PO Box 9013, Dar es Salaam, Tanzania		
Statement as at 31 December 20X3		
Buyers name		
James Trading Corp		Account number X 20016
Address: Lexington, Kentucky, USA		
31/08/20X3	Sales-Inv-01/03	3,250,000
15/12/20X3	Sales-Inv-1122	1,250,000
Balance outstanding		4,500,000
Balance outstanding at 31 December 20X3		**Tshs4,500,000**
Authorised Signatory		
		For Computech Ltd
Accounts Manager		

8. Credit note

A credit note is a document used to adjust or rectify the discrepancies made in a sales invoice, and to account for the goods that are returned. A credit note is **raised by the seller when he has overcharged the customer**. It is generally printed in red to highlight the fact that it is a credit note and not an invoice. A credit note informs the party that its account has been credited due to the given reason.

Sometimes a credit note is referred to as a negative invoice.

Example

Computech Ltd sold 5 computers for Tshs0.8 million each to James Trading Corp. However one computer was damaged and not accepted by James Trading Corp. Now Computech Ltd will have to issue a credit note for the damaged computer.

Proforma credit note

CREDIT NOTE

Credit Note No.:

To Mr / M/s…………………………………………………..

You are hereby informed that we have credited your account with Tshs. ……………………….. only for the goods returned by you to us as under

No. & /date of Invoice	Particulars	Quantity	Amounts Tshs

Amount in words ………………………………………………………………………………

Partner

9. Debit note

A debit note is a document used by the purchaser to adjust or rectify errors made in a sales invoice. A debit note informs the party that its account has been debited due to a certain reason mentioned in the debit note. .

Example

Computech Ltd sold 5 computers to James Trading Corp. However one computer was damaged and not accepted by James Trading Corp. Computech Ltd has not issued a credit note for the damaged computer. While making the payment James Trading Corp will raise a debit note for Tshs0.8 million on Computech Ltd and issue a cheque for Tshs3.2 million.

In reality, businesses rarely raise debit notes. It is more usual to contact the supplier and agree with him that a credit note should be issued. This is good practice, as the same party will raise both the invoice and the correction. This source document will then be processed by the customer, thereby creating the debit note entries in their accounts.

Proforma debit notes

DEBIT NOTE			
Debit Note No.:		Date:	
To Mr / M/s………………………………………………….. You are hereby informed that we have debited your account with Tshs. ……………………….. only for the goods returned by us to you as under			
No. & /date of Invoice	**Particulars**	**Amount Tshs**	**Tshs**
Amount in words …………………………………………………………………………….			
E & O.E.		Partner	

10. Remittance advice

A remittance advice accompanies a payment and contains the following information

a) Amount of payment
b) Cheque number, name of the bank etc. if payment is made by cheque
c) Details of payment
   Invoice for which the payment is being made
   Date and amount of invoice

Example

James Trading Corp made a payment to Computech Ltd for the 5 computers received. It will send the following remittance advice with the cheque to ensure Computech Ltd is aware of which invoices are being paid.

Remittance advice

James Trading Corp	
Advice No.	**Advice Date:**
Paid to: Computech Ltd	**Cheque No.:** 12114
A/c Head: Computer Account	**Date:** 05/01/20X4
Invoice Number: 01/03	**Drawn on:** ABC Bank
	Tshs
Tshs Three thousand two hundred and fifty only	3,250,000
Total	**3,250,000**
Prepared By: Receiver's Signature	Revenue Stamp Approved

11. Receipt

A receipt is a document **issued by the receiver of money to the payer** in acknowledgement of the payment.

A receipt would usually contain the following information

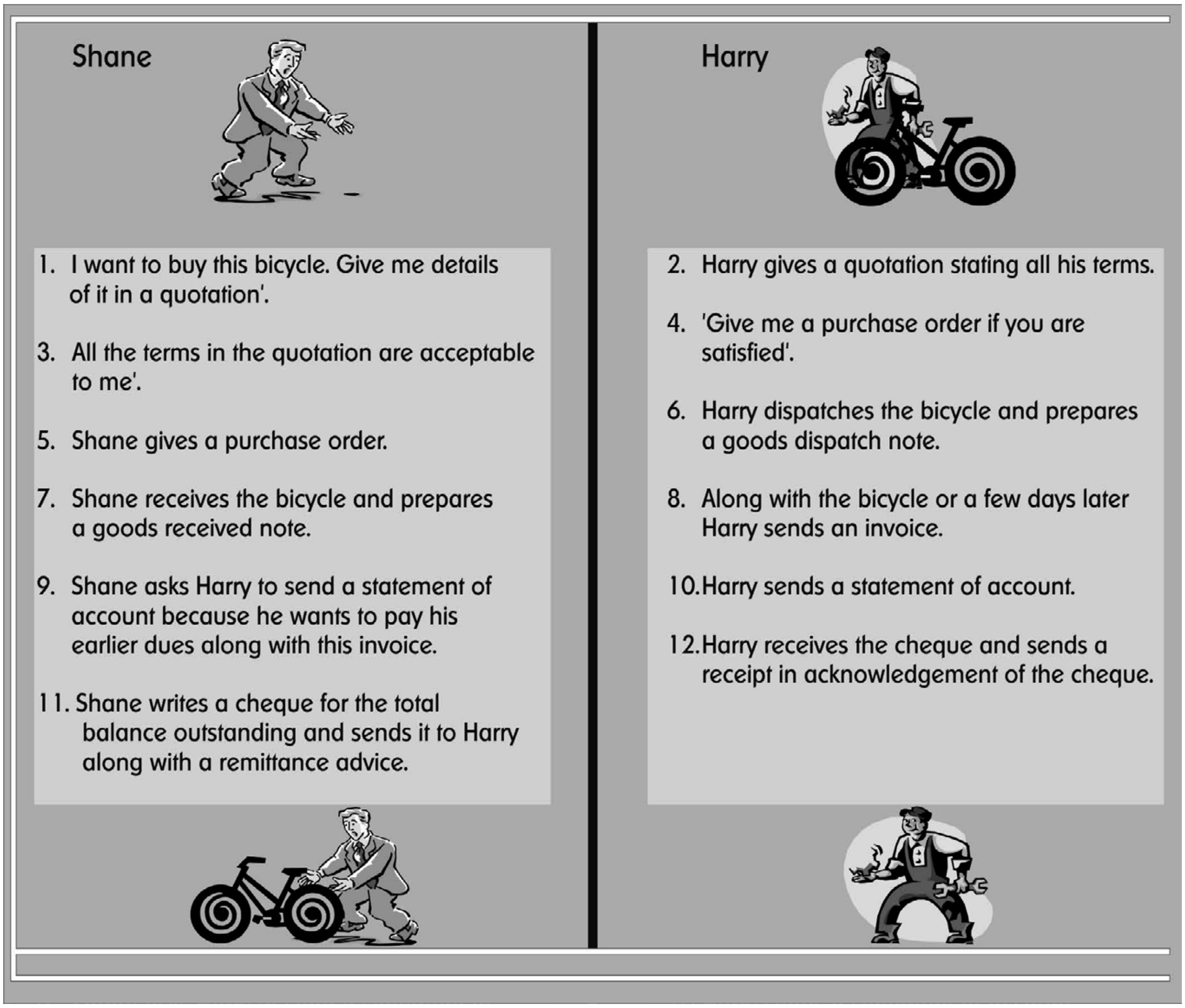
(a) Date
(b) Amount received
(c) Signature of the receiver
(d) Name of the company
(e) Details of payment e.g. cheque number, invoice reference etc.

A receipt must always be obtained if a **cash payment** is made, as this will be your only proof of payment.

Example

Computech Ltd will collect a cheque for Tshs4.05 million from James Trading Corp. The payment will be accompanied by a remittance advice issued by James Trading Corp. On collecting the cheque, Computech Ltd may issue a receipt to James Trading Corp for Tshs4.05 million.

Let us understand all the above documents with the help of the following conversation.



Test Yourself 4

Which of the following pairs do not show the transaction and its related source document on the basis of which the transaction is recorded in the books of accounts?

A Purchase of goods - supplier's invoice
B Goods returned - credit note issued by seller
C Sale of goods - entity's invoice
D Sale of asset - cheque received from the purchaser

Test Yourself 5

Fill in the blanks using the following words

Remittance advice, goods despatched note, sales order, receipts, goods received note, statement, sales invoice, credit note, debit note, quotation, purchase order.

Roger recently opened a shop where he sells shirts. He also stocks shirts in his warehouse. In January Roger obtained the address of a shirt supplier from a business magazine. He found the rates and quality of the supplier reasonable and sent a ____________ to the supplier detailing the items that he wanted to buy, and the price. The supplier sent the goods, and few days later sent ____________ detailing the quantity, description and price of the goods he had delivered.

In February Roger visited Lantapoon's wholesale clothes outlet. He liked some T-shirts. He wrote a ____________ maintained at Lantapoon's outlet detailing what he wanted to buy, with quantities and the price. After 7 days he received a shipment of T-shirts from Lantapoon. The person in charge of Roger's warehouse prepared a ____________ on receipt of the shipment. Roger received the ____________ two days later and found that Lantapoon had over-charged him, so he made a ____________. Roger contacted Lantapoon and told them they had made an error. Lantapoon were very apologetic and immediately raised a ____________.

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5. Explain the accounting cycle and accounting equation.

[Learning Outcome e]

5.1 Accounting cycle

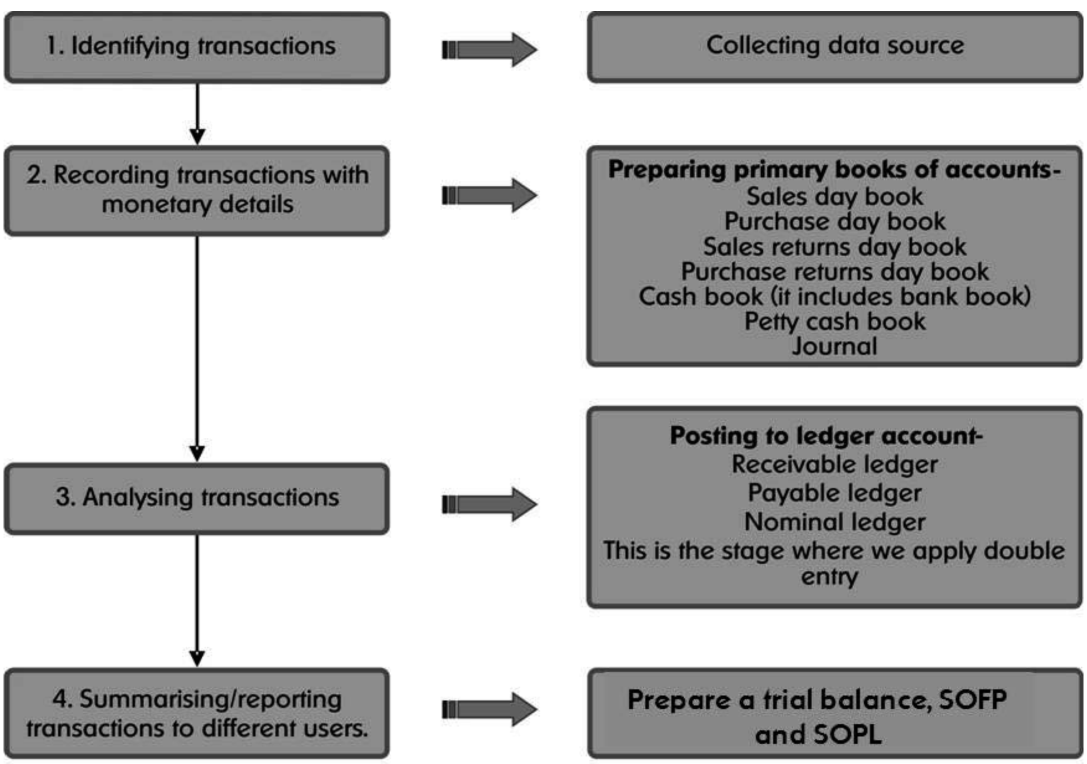
Accounting cycle or financial accounting process mainly consists of the following steps

1. Identifying the transactions from the data source
2. Recording business transactions from source documents into the books of original entry
3. Analysing them in ledger accounts by posting into ledger book
4. Summarising them by preparing trial balance and financial statements

All these steps have already been discussed in Learning Outcome 1 of this Study Guide.

Let's now summarise the accounting cycle using the following flowchart

Diagram 3: Accounting process



5.2 Accounting equation

Under the double-entry book-keeping system, all transactions are recorded by giving two accounting effects - **debit and credit.** Debit is traditionally shown as a positive figure and credit as a negative figure.

Example

John has saved Tshs80 million. He is interested in starting a business selling glass under the name M/s Elite Traders. On 01/01/20X3 he introduced Tshs80 million into the business. On the same day he bought glass worth Tshs24 million and a shop for Tshs48 million. All the glass was sold during the same month for Tshs32 million.

These transactions can be shown at the end of the month as follows:

Table 1

Sr. no.	Transaction	Cash Tshs'000	Capital Tshs'000	Shop Tshs'000	Purchases account Tshs'000	Sales account Tshs'000	Debit	Credit
1	John introduced capital	80,000	(80,000)				Cash (asset)	Capital (liability)
2	John purchased glasses	(24,000)			24,000		Purchases account (expenses)	Cash (asset)
3	John purchased shop	(48,000)		48,000			Shop (asset)	Cash (asset)
4	John sold glasses	32,000				(32,000)	Cash (asset)	Sales (income)
	Balance	**40,000**	**(80,000)**	**48,000**	**24,000**	**(32,000)**		

You can clearly see that

Debits (Tshs)	**=**	**Credits (Tshs)**
(40 million + 48 million + 24 million)	=	(80 million + 32 million) (figures in brackets)
112 million	**=**	**112 million**

The financial statements of M/s Elite Traders will be as follows

Note: the steps related to recording the transactions and preparation of a trial balance, statement of profit or loss and statement of financial position are explained in greater detail later in this book. Here, a simple example is given to explain the accounting equation.

M/s Elite Traders	
Statement of profit or loss	
	Tshs'000
Sales	32,000
Less: Purchases	(24,000)
Profit	**8,000**

M/s Elite Traders	
Statement of financial position as at 1 January 20X3	
	Tshs'000
Assets	
Shop	48,000
Cash in hand	40,000
Total	**88,000**
Capital and liabilities	
Capital of John	80,000
Profit from business	8,000
Total	**88,000**

Capital is the liability of the business towards the owner for the amount contributed at set-up

Profit is a liability of the business to the owners

In accounting, **every transaction is debited in one account and credited in another account**. This means that for every amount that is debited the same amount is credited elsewhere. Therefore the total of all debit amounts and all credit amounts are equal.

Continued on the next page

Debits = Credits

The assets have a debit balance and liabilities have a credit balance. The **total debits** are always **equal** to **total credits** hence; in the **statement of financial position, total assets** are **equal** to **total liabilities (owed to outsiders and to owners).** Therefore, the two sides of the statement of financial position always balance.

The accounting equation is:

Assets = Capital + Liabilities
Dr = Cr

Profit is the net result of all incomes and expenses and is added to capital.
Incomes / expenses are not considered individually in the accounting equation.

Applying this to M/s Elite Traders: Tshs48 million + Tshs40 million = Tshs80 million + Tshs8 million
Tshs88 million = Tshs88 million

The above formula can be presented in a number of ways

Capital = total assets - liabilities
Liabilities = total assets - capital

All are mathematically the same. The most commonly used presentation is

Assets = Capital + Liabilities

Continuing with the same example

John required more funds. He took a cash loan of Tshs21 million from Daniel. This loan will be recorded as follows

Table 2

Transaction	Capital	Shop	Purchase account	Sales account	Cash	Loan from Daniel
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Balance c/f from Table 1	(80,000)	48,000	24,000	(32,000)	40,000	-
Received loan from Daniel					21,000	(21,000)
Balance remaining	**(80,000)**	**48,000**	**24,000**	**(32,000)**	**61,000**	**(21,000)**

The basic equation still holds

Debit (Tshs)	=	Credit (figures in brackets) (Tshs)
48 million + 24 million + 61 million	=	(80 million + 32 million + 21 million)
133 million	**=**	**133 million**

The financial statements of M/s Elite Traders will now be as follows

M/s Elite Traders SOPL	
	Tshs'000
Sales	32,000
Less: Purchases	(24,000)
Profit	**8,000**

Totals assets = Total liabilities

(Because we follow the double-entry book-keeping system)

M/s Elite Traders SOFP as at 1 January 20X3		
	Tshs'000	**Tshs'000**
Assets		
Shop		48,000
Cash in hand		61,000
Total		**109,000**
Capital and liabilities		
Capital of John	80,000	
Profit	8,000	88,000
Loan form Daniel		21,000
Total		**109,000**

Continued on the next page

The accounting equation will be

Capital + Total liabilities (Tshs)	=	Total assets (Tshs)
88 million + 21 million	=	48 million + 61 million
109 million	**=**	**109 million**

We can also reorganise this equation in order to derive the equity of the business as follows

Assets - liabilities (Tshs)	=	Total equity (net assets) (Tshs)
48 million + 61 million - 21 million	=	80 million + 8 million
88 million	**=**	**88 million**

Assets - Liabilities = Net assets = Equity

The accounting equation aims to answer the following question: if we use the assets of the business in order to pay for the business liabilities, how much would be left to give to the shareholders?

Organising the accounting equation in this way recognises that the investors are the main users of the financial statements i.e. the principal group of stakeholders. Net assets represent the book value of the entity to the shareholders.

Receivables and payables

When goods are sold or services rendered on credit, the receivables account is debited (it is an increase in an asset) and the sales account (income account) is credited. Similarly, when credit purchases are made, the purchase account is debited (it is an increase in expense) and payables (liability) are credited (being an increase in liability).

Drawings

Drawings are the amount of money taken out from the business by the owners. The capital or drawings account is debited (being a reduction in capital) and the cash account is credited (being a reduction in an asset).

Business equation

The business equation helps in calculating the amount of profits earned during a period, without preparing a statement of profit or loss! This is helpful, especially when you want to arrive at the profit figure, without going into details of how the profit was earned.

Profit = Increase in net assets + Drawings - Capital introduced.

Note : Net assets means assets after deducting the liabilities.

Let us add the following transactions to the above example

credit purchases	Tshs22 million
credit sales (above quantity sold fully)	Tshs34 million
cash withdrawn from business	Tshs8 million

Transaction	Capital	Shop	Purchase account	Sales account	Cash	Loan from Daniel	Receivables	Payables
	(Tshs'000)							
Balance remaining	(80,000)	48,000	24,000	(32,000)	61,000	(21,000)		
Credit purchases			22,000					(22,000)
Credit sales				(34,000)			34,000	
Cash withdrawn from business	8,000				(8,000)			
Revised balance	**(72,000)**	**48,000**	**46,000**	**(66,000)**	**53,000**	**(21,000)**	**34,000**	**(22,000)**

Now the revised assets are Tshs48 million + Tshs53 million + Tshs34 million = Tshs135 million

Revised liabilities are Tshs21 million + Tshs22 million = Tshs43 million

Revised capital is Tshs72 million + profit Tshs20 million (i.e. Tshs66 million - Tshs46 million) = Tshs92 million
The accounting equation is Assets = Capital + Liabilities

i.e. Tshs135 million = Tshs92 million + Tshs43 million

Here, profit was calculated by deducting the cost of sales from sales. However, it can also be calculated by using the business equation

Profit = Increase in net assets + Drawings - Capital introduced.
= (Tshs135 million - Tshs43 million)* + Tshs8 million - Tshs80 million
= Tshs20 million

*Since it is a new business, the entire net assets amount to an increase in net assets, as the opening net assets were zero.

Test Yourself 6

When M/s Elite Traders received Tshs21 million loans from Daniel the accounting entry will be debit cash and credit which account?

A Income-loan
B Asset-loan
C Expense-loan
D Liability-loan

Test Yourself 7

Fill in the blanks with **debit** and **credit** for the above transactions in the books of M/s Elite Traders.

Julian invested Tshs81 million cash in order to start the business. The accounting entries recorded by John were __________ cash Tshs81 million and __________ capital account Tshs81 million. When Julian purchased goods costing Tshs25 million, the accounting entries were __________ purchases (expense) account Tshs25 million and __________ cash Tshs25 million. On purchasing the shop for Tshs48 million the accounting entries were _____________ shop (asset) account Tshs48 million and ______________ cash Tshs48 million.

Test Yourself 8

Which of the following is correct?

	Assets (Tshs'000)	Liabilities (Tshs'000)	Capital (Tshs'000)
A	9,960	8,660	1,200
B	9,960	8,660	1,100
C	8,660	6,000	2,660
D	8,660	5,000	1,260

Test Yourself 9

A firm has the following assets and liabilities. Calculate the capital of the proprietor.

Premises used by the proprietor for business - Tshs100 million
Residential house of the proprietor - Tshs150 million
Receivables of the firm - Tshs20 million
Cash in the proprietor's house - Tshs50 million (including Tshs20 millions of firm's cash)
Loan given by the bank toward working capital in the business - Tshs80 million
Loan given by the bank to purchase the residential house of the proprietor - Tshs100 million

A Tshs140 million
B Tshs60 million
C Tshs40 million
D Tshs150 million

6. Describe Assets, Liabilities, Capital, Income, Expenses and Equity.

[Learning Outcome f]

6.1 Elements of the statements of financial position

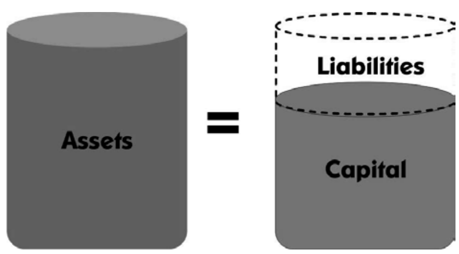
The statement of financial position is comprised of asset, liabilities and capital (equity).

A statement of financial position will include

Company XX **Statement of financial position as at 31 December 20X7**	
	Tshs
Assets	
Non-current assets	X
Current assets	X
Total	**XX**
Capital and Liabilities	
Capital	X
Retained earnings	X
Other reserves	**X**
Non-current liabilities	X
Current liabilities	X
Total	**XX**

It is also important to note that for every statement of financial position, the below formula must hold true

Diagram 4: Composition of a statement of financial position



This is where the word "balance" comes into play. Every asset is financed by either capital or a corresponding liability i.e. the asset is balanced by a liability and / or capital. If an organisation owns assets of Tshs.1,million then it necessarily owes Tshs1 million to the owners and / or to outsiders.

Example

Peter started a manufacturing unit. He needed machinery (an asset) worth Tshs10 million. So he needs funds to purchase the machinery. Where can he get the funds from? He can either use his own money brought into the business by him (capital) or he can obtain a loan from a bank (a liability).

1. **Assets**

Definition

An asset is a **resource controlled** by the entity as a result of **past events** and from which **future economic benefits** are expected to flow to the entity.

Example

On 15 February 20X3 Neil started a business selling toys under the name of M/S Toys Park. Neil put Tshs160 millions of his own money into the business.

During the month, Toys Park bought a small showroom for Tshs130 million. To finance the showroom, it obtained a bank loan of Tshs90 million and used Tshs40 million from the capital brought in by Neil. There were no other transactions before 1 March 20X3.

The statement of financial position of Toys Park at this stage will appear as follows

M/S Toys Park SOFP as at 28 February 20X3

	Tshs'000
Assets	
Showroom	130,000
Cash	120,000
Total	**250,000**
Capital and liabilities	
Capital	160,000
Bank loan	90,000
Total	**250,000**

In practice, the SOPL or SOFP is **not prepared monthly**. It is only for your understanding that it has been prepared monthly in this example.

The entity **owes** Tshs160 million to the owners (i.e. Neil) and Tshs90 million to the bank

Note: Cash = opening balance Tshs160 million + loan taken (cash received) Tshs90 million - showroom purchased (cash paid) Tshs130 million = Tshs120 million

Thus, the entity **owns** assets of Tshs160 million consisting of cash and a showroom and **owes** Tshs160 million to the owner and Tshs90 million to the bank.

Example

Continuing with the above example

During March 20X3, M/s Toys Park entered into the following transactions

1. Bought toys for cash Tshs30 million.
2. Sold **all** the toys for cash Tshs50 million.
3. Paid business expenses: utilities of Tshs1.5 million and interest on the loan for one month (the interest rate is 10% per annum starting 1 March 20X3).

The statement of profit or loss for the period will include the following (ignoring taxation for simplicity)

Statement of profit or loss of M/S Toys Park for March 20X3

	Tshs'000
Income	50,000
Less: expenses	
Purchases	(30,000)
Utilities	(1,500)
Interest (Tshs90 million x 10% / 12 months)	(750)
Profit for the period	**17,750**

Continued on the next page

The statement of financial position at the end of March will therefore consist of the following elements

M/S Toys Park - Statement of financial position as at 31 March 20X3

	Tshs'000
Assets	
Showroom	130,000
Inventories	NIL
Cash (Note	137,750
2) Total	**267,750**
Capital and liabilities	
Capital	160,000
Retained earnings	17,750
Loan	90,000
Total	**267,750**

This is taken from the SOPL above

Notes

1. There is no inventory of toys at the end of the reporting period as all toys have been sold during the month.
2. Closing balance of cash is calculated as follows

	Tshs'000
Opening balance cash	120,000
Add: Income	
Sales	50,000
Less: Payments	
Purchases	(30,000)
Expenses	(1,500)
Interest	(750)
Closing balance cash	**137,750**

3. On 31 March 20X3, the entity **owns** assets of Tshs267.75 million, consisting of cash and a showroom, and **owes** Tshs177.75 million to the owners (made up of the initial capital contributed plus the profits the business has generated) and also Tshs90 million to the bank.

From the above example of M/S Toys Park, the assets of the organisation are

the showroom it acquired,

the cash in hand at the end of the period.

(a) Resource controlled

The assets of a company represent the **resources** it has **under** its **direct control**. This usually means that they provide benefits to the organisation alone. The organisation has the power to restrict others from using these assets and use them at its sole discretion.

With M/S Toys Park, the showroom it had acquired is an asset of the organisation. The organisation controls this asset because it has sole ownership of it. It can prevent any other business from using the showroom. In addition, it can use (or choose not to use) the showroom at any time.

(b) Past events

For an asset to become a controlled resource for an organisation, a transaction or event must have taken place in the past. Resources come under the control of an organisation when they are purchased, produced or donated - these are the past events (from the definition above).

Example

The inventory of goods held by an organisation for trading purposes is its asset as they were purchased in the past.

(c) Economic benefits

To be deemed assets, resources must also

(i) Contribute to the cash inflows OR
(ii) Contribute to reducing the cash outflows (e.g. an organisation buys a photocopier so that it can carry out its copying "in-house" at a rate which is much lower than what it has to pay to outside parties).

Once a resource is deemed to be an asset it is then classified as either a current asset or a non-current asset.

Current assets	Non-current assets
Current assets are those assets that the organisation intends to turn into cash within one year.	Non-current assets are assets that the organisation intends to hold i.e. not liquidate or turn into cash for periods longer than one year.
Examples include an organisation's receivables and inventory - the aim is to convert them into cash quickly.	Examples include an organisation's premises, equipment and machinery.

2. Liabilities

The term liability represents the total amounts payable by the business to others such as bank loans, trade payables, and expenses payable.

Definition

A liability is a **present obligation** of the entity arising from **past events**, which when paid is likely to cause an **outflow of resources from the entity.**

(a) Present obligation

An essential characteristic of a liability is that it must represent a present obligation to the organisation. An obligation involves a duty or responsibility being placed on the organisation to act or perform in a certain way. Present means that this obligation has to exist on the day it is going to be recorded as a liability.

In the previous example of M/S Toys Park, the entity had an obligation to make interest payments on the Tshs.90,million it had borrowed from the bank, hence it is a liability. Remember, it becomes a liability only when the amount is actually received from the bank. M/S Toys Park cannot record this loan as a liability when it has approached the bank for a loan, as no present obligation to repay exists on that day. M/S Toys Park can only record the loan as a liability after it has actually received the loan.

(b) Past events

A liability has to arise out of a transaction or event that has happened in the past. This transaction or event in turn must create an obligation on the part of the organisation. For instance, merely having the intention to purchase an asset does not create an obligation and correspondingly a liability for the organisation.

An obligation normally arises only when the asset is delivered or the entity enters into an **irrevocable agreement** to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the organisation becomes legally bound to carry through the agreement.

Therefore liabilities arise from past transactions or other past events. For example, the acquisition of goods and the use of services give rise to trade payables (unless they are paid for in advance or at delivery) and the receipt of a bank loan results in an obligation to repay the loan.

(c) Outflow of resources from the entity

Furthermore a liability requires an outflow of resources from the organisation to settle the obligation. Instances or types of these outflows are

Payment of cash

Example

On 1 January 20X3, David purchased a machine from Tip Top Plc for Tshs5 million on credit. It was agreed that the payment for the machine would be made after one month. Hence, David has to make a payment of Tshs5 million on 1 February 20X3 for the machine he bought a month ago, which is an outflow of resources.

Transfer of another asset

Example

Peter manufactures wooden furniture. Lara gave him an order to make two tables. The price for the two tables agreed between them was Tshs2.4 million. Lara paid Peter Tshs1.9 million in cash as an advance. Therefore Peter has received cash (an asset) and he has to deliver goods to Lara (an asset).

Other instances of outflow of resources include provision of services, replacement of obligation with another obligation, etc.

Once an item is deemed to be a liability, it is then classified as being either a current liability or non-current liability.

Current liability	Non-current liability
Current liabilities are those that the organisation intends to settle within a period of one year.	Non-current liabilities are liabilities of the organisation that will be settled in periods longer than one year.
An example would be an organisation's payments to its suppliers.	An example would be a mortgage taken by the organisation.

3. Equity / Capital

Definition

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

Tip

The terms capital and equity can be used interchangeably.

Capital = Total assets - Total liabilities

The amount of balance left in a business after all its liabilities have been deducted from its assets represents its equity. This equity or capital is also an obligation for the organisation. It **represents the amount** that is **due to the owners of the business** after all other liabilities have been settled (note an organisation must settle all of its liabilities first before it can return this amount to its owners / shareholders).

Example

Justin is the owner of Cars Park, an organisation that buys and sells second-hand cars. The business has the following assets and liabilities at the end of the year.

	Tshs'000		Tshs'000
Cash	20,000	Bank loan	60,000
Inventory	100,000	Suppliers outstanding	20,000
Furniture	10,000		
Equipment	10,000		
Total	**140,000**	**Total**	**80,000**

Why are the totals different? They are different because the difference is the capital which Justin has invested in the business.

Justin's equity / capital in the business is Total assets - Total liabilities
= Tshs140 million - Tshs80 million
= Tshs60 million

6.2 Elements of the statement of profit or loss

As mentioned in the previous section, income and expenses (including taxes) are the elements of an statement of profit or loss.

A statement of profit or loss will include the following

Company XX Statement of profit or loss for the year to 31 December 20X7	
	Tshs'000
Income	X
Expense (including taxes)	(X)
Profit / (loss)	X / (X)

1. Income

Definition

Income refers to increase in economic benefits during the accounting period in the form of
- Direct inflows OR
- Enhancements of assets OR
- Decreases of liabilities.

Broadly, incomes fall under the following three categories

Revenue: represents earnings through the ordinary activities of the business, for example, sales, fees, interest, dividends, royalties and rent.

Gains: represent other items of income that may not arise in the ordinary course of business, for example, gains on disposal of property.

Income: income (formally defined above) encompasses both revenues and gains.

Example

In the previous example, M/S Toys Park received cash during several transactions. However, cash received from only some of these transactions constitutes income.

Tshs.160,000,000 received from Neil	Treated as capital
Tshs.50,000,000 received from cash sales in March	Treated as income
Tshs.90,000,000 received from the bank as loan financing	Treated as a liability

---

Examples of different types of income

(a) Sales of goods for cash (is an example of a **direct cash inflow**).

(b) Sales of goods on credit (is an example of an enhancement i.e. an **increase of the asset** named receivables)

(c) Discounts received from suppliers for early settlement of outstanding amounts (an example of **decreases in liabilities** to suppliers as you receive goods but you don't need to pay for them).

Example

John purchased 500 pens at Tshs2,000 each from Fluent Traders. The total bill was Tshs1 million. Fluent Traders gave him a discount of Tshs50,000. Here, John has received goods worth Tshs1 million but he has to pay only Tshs0.95 million for them (due to the Tshs50,000 discount). Therefore, in a way, it is his income, as he received 25 pens free of cost.

(d) Interest received

(e) Royalties received etc.

2. Expense

Definition

Expenses are the costs incurred to earn income. Expenses are defined as: decreases in economic benefits during the accounting period in the form of

- direct outflows OR
- depletion of an asset OR
- incurrence of a liability

Examples of expenses are

(a) Purchases of goods for cash (results in a **direct cash outflow**).

(b) Purchases of goods on credit (results in **incurrence of a liability** payable to the supplier of goods).

(c) Discounts allowed to customers for early payment (an example of depletion i.e. a **decrease in an asset** represented by the amount receivable from customers).

Example

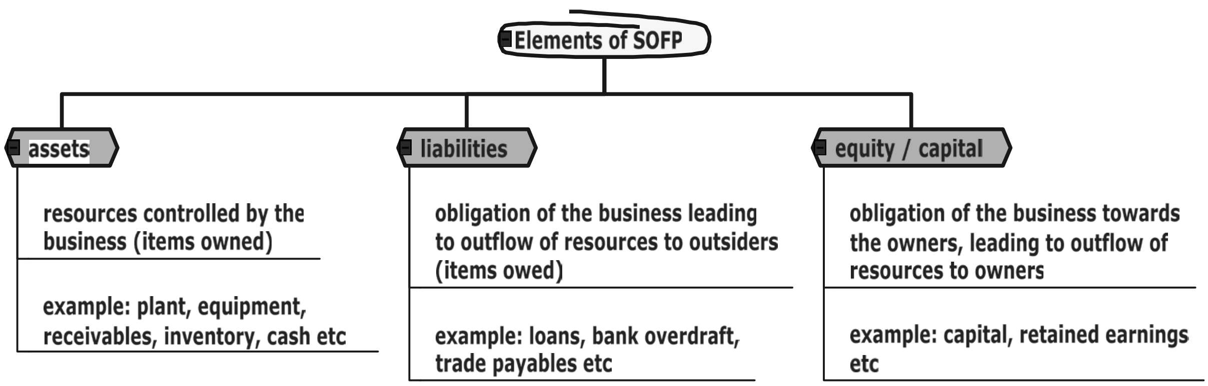
Continuing with the above example where Fluent Traders sold pens to John at Tshs50,000 discount. Here, Fluent Traders has sold goods worth Tshs1 million but they will receive only Tshs0.95 million for them (due to the Tshs50,000 discount). Therefore in a way it is their expense as they have given 25 pens free of cost.

(d) Wages and salaries, office maintenance, utilities (gas, water, electicity consumed).

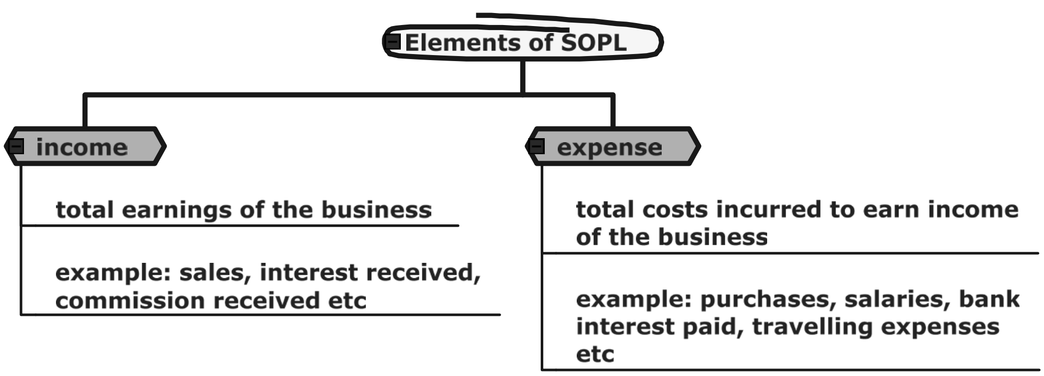
(e) Interest paid

(f) Royalty paid

SUMMARY



SUMMARY

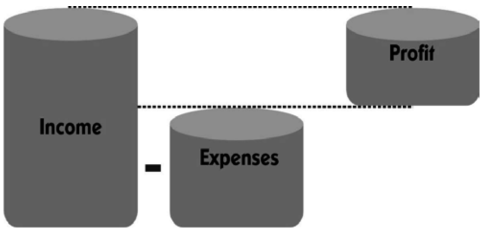


6.3 Determination of profit or loss

Income > Expenses: organisation has made a profit

Profit = Income - Expenses

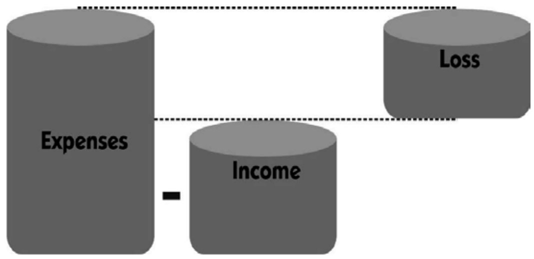
Diagram 5: When profit is earned



Expenses > Income: organisation has incurred a loss

Loss = Expenses - Income

Diagram 6: When a loss is incurred



Test Yourself 10

Classify the following items into current assets, non-current assets, liabilities, non-current liabilities, equity, income or expenses

1. Sale of goods for cash
2. Amounts receivable due to credit sales
3. Rent paid for office premises
4. Amounts payable to credit suppliers
5. Purchase of goods
6. Acquisition of a building
7. Travel expenses
8. Printing charges
9. Corporate tax paid
10. Profit from sale of equipment
11. Interest paid
12. Interest received
13. Purchase of plant and equipment
14. Cash received from owners
15. Bank loans
16. Furniture received from owners
17. Inventories in stock
18. Profit for the period
19. Cash drawings by a sole trader
20. Computers used by employees

Test Yourself 11

Fill in the blanks with the correct elements of the statement of profit or loss and the statement of financial position.

Sale of goods is ___________ but purchases are ___________. When goods are sold and cash is received, the cash which is received is _____________. When goods are sold and the amount is receivable in the future, the receivable amount is ___________. When goods are purchased on credit, the amount payable in the future is _______.

---

7. Identify types of business entity; sole trader, partnership, companies, etc.

[Learning Outcome g]

'Entities' is the generic term used internationally and includes the following

1. **Sole traders:** a 'one-man-band', usually manages and owns the business - for example: a hairdresser, a plumber, an accountant, a lawyer, a trainer.

Advantages of a sole trading form of organisation

No sharing of profits: the business is owned by a proprietor who enjoys the whole profits.

No chances of disputes: all business decisions are taken by the proprietor hence there is no scope for disputes.

Few legal formalities: generally there are only a few legal formalities required to be fulfilled to start a business as a sole proprietor.

Simple accounting procedures: a 'sole trader' form of organisation is not bound by a specific set of accounting rules.

Limitations of a sole trading form of organisation

All business risks are borne by one person.

No scope for sharing of **authority and responsibility**

Low growth rate: the resources employed in a sole trader business are limited and hence the growth rate is low when compared to any other form of business.

Unlimited liability: in the case of bankruptcy, owner's personal assets are used to repay loans or other debts of the business e.g. for making payments to trade payables, the sole trader might have to sell his house, car, personal jewellery etc.

2. **Partnerships:** two or more persons coming together and sharing the profits - for example: professional firms: lawyers, doctors, accountants etc.

A partnership is defined as 'the relationship between persons carrying on a business in common with a view of profit.' This definition is taken from the UK Partnership Act of 1890.

Example

Blake and Henry are both bakers. Blake came up with the idea of starting a business venture with Henry.

By forming a partnership they can pool their resources and share expenses as well as business risks. Forming a partnership will benefit them in the following ways

Instead of paying rent for two different bakery premises they will rent a single bakery premises.
Henry can concentrate on making cakes and Blake can concentrate on making different types of bread so that they can generate more revenue.
They can share staff and machinery needed to make cakes and bread.
Their marketing capability will also increase.

This arrangement between them is called a **partnership,** and Blake and Henry are called **partners**.

Partners are entitled to share all the profits of the partnership in a ratio agreed between them from the beginning. They also jointly bear all the risks i.e. if there are debts due to others which cannot be paid from business funds; they share the amount to be paid to others. In the absence of any agreement to the contrary, the profit sharing ratio is assumed to be equal among the partners.

Another form of partnership is an LLP. In an LLP (limited liability partnership), the partners have limited liability. However, depending on the jurisdiction under which the partnership firm is incorporated, one or more partners must have unlimited liability.

Advantages

Sharing of business risk: unlike a sole trader, who bears all the business risks, in a partnership the business risks are shared between the partners.

Skills and experience: apart from contributing capital to the business, a partnership also provides a better opportunity for a group of individuals to pool their knowledge, skills and experience.

Improvement in business: all the business responsibilities can be distributed amongst the partners who have a larger skill base than a sole trader.

Higher investment: the amount of capital invested in the business is generally higher for a partnership, compared to a sole trader. This gives more scope for expansion.

Fewer legal formalities: a partnership firm is not required to comply with stringent legal formalities as compared to a limited liability company.

Disadvantages

Sharing of profits: the profits earned by the business are distributed among the partners. Determining a fair split-up of profits may be difficult as some partners may work harder than others.

Chances of disputes: while managing the affairs of a business, all the partners need to reach a consensus. However, sometimes this does not happen and disputes occur.

Unlimited liability of the partners: in the case of bankruptcy, the partner's personal assets are taken away to repay loans or other debts of the business.

3. **Companies:** a company is a business entity registered under the Companies Act or any other relevant local law specific to companies. The owners buy shares in the entity and this money is used by the entity to carry out its activities. The owners are known as shareholders. A peculiar feature of an entity incorporated as a company is that unlike partnership or sole trader form of organisations, the liability of the investor is limited to the amount that has been invested in the business.

An entity may be incorporated as

(a) an **LLC (limited liability company** that incorporates both the characteristics of a company and a partnership firm) or

(b) **a Plc (public limited company** - listed on a Stock Exchange - these companies can have thousands of shareholders and they are generally medium to large entities).

Example

Blake and Harry are both bakers. They decide to open a company together to sell bakery products. They create a company legally, called 'Baker-eeze Limited' and each buys shares in the company. Each of them pays Tshs1 million to buy 1,000 shares in the company (each share is Tshs1,000 each). Now the bank account of the company has Tshs2 million. With this money, the company can buy the items it needs to start making and selling the bakery products e.g. rent, equipment, flour and staff.

Advantages

Large amount of capital: as there is no limit on the number of owners, large amounts of capital can be amassed. This will allow the business to expand.

Better management: as ownership and management are different, usually professional managers are appointed to manage the running of the company e.g. finance function may be handled by a professional in finance such as a Certified Accountant.

Limited liability: the liability of each member of the company is always limited to the nominal value of the shares purchased by him. The nominal value is the amount printed on the shares. If the company goes bankrupt, the members are not required to use their personal assets for repaying the debts of the company.

Transfer of shares: shares can be easily transferred from one individual to another. This gives liquidity to the investors.

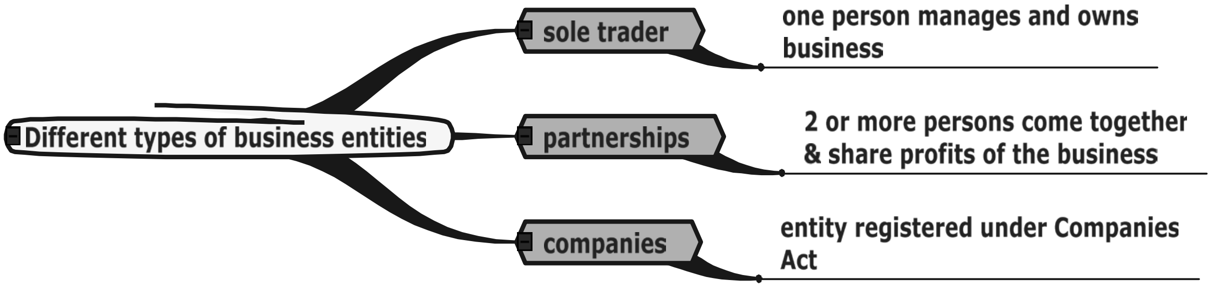
Disadvantages

More legal restrictions: since a company enjoys the benefit of limited liability, many restrictions are imposed by law e.g. a company dealing in computers cannot sell any other item if it is not stated in the memorandum of the company.

Double taxation: profits earned by a company are taxed. However, in some countries, tax is imposed yet again when the above taxed profits are distributed to the shareholders in the form of dividends.

Fraud: the day to day management of affairs does not rest with the owners and hence there is greater scope for committing fraud without the owners' knowledge.

SUMMARY



Test Yourself 12

How many owners does a sole trader business form have?

A Two
B One
C Any number up to a maximum of 20
D Unlimited

Test Yourself 13

Who are the owners of a limited liability company?

A Directors
B Partners
C Shareholders
D Managers

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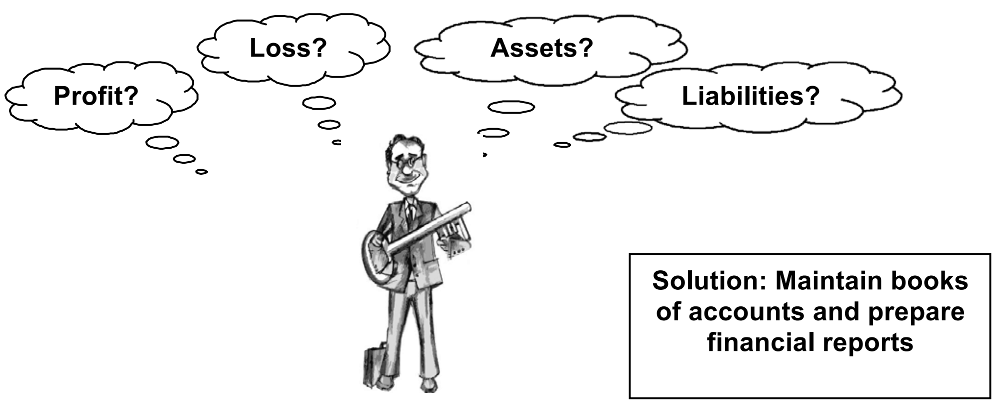
8. Explain the concepts, conventions and principles underlying the accounting profession. [Learning Outcome h]

Financial accounting

Financial accounting is aimed at responding mainly to the needs of external users of financial statements such as shareholders, banks, payables etc. in assisting them to assess

the financial position of the entity as at a certain moment, (what the company owns and owes)
its financial performance during a period (how much profit the company has made) and
the changes in the financial position from one period to the next. (how the company has performed this year compared to the last year)

Diagram 7: Queries resolved by financial accounting



Thus, financial accounting is mainly concerned with dealing with information needs of external users. It is not aimed at providing information to the management of the organisation. This is because management needs detailed information for taking business decisions and running the organisation more efficiently. The information needs of management are fulfilled by **management accounting.**

8.1 Principles of accounting

Generally, a principle is a fundamental truth that is always accepted. However in accounting, principles relate to **an accepted guidance or method**.

As we have seen above, various parties such as shareholders, investors, banks, payables etc. are interested in the financial statements of the organisation. If there is no uniformity in the principles followed by different organisations in preparation of financial statements, nobody will be in a position to interpret the financial statements and draw any conclusions.

To overcome this difficulty, certain standard principles for preparation of financial statements are given. In accounting terminology we use the words "International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Practices (GAAP)" instead of 'Principles'.

8.2 Accounting concepts

Accounting concepts are the **fundamental ideas and assumptions needed in accounting.** These are the fundamental rules that **must be followed** while preparing the financial statements. A clear disclosure must be made in the financial statements if these are not followed.

The following are the most important accounting concepts that an accountant must know and follow while preparing financial statements

1. Going concern

The going concern concept assumes that an entity

(i) will **continue** its operations **for at least the next 12 months**
(ii) does **not have any intention or need to close down its operations**
(iii) does **not have any intention or need to curtail materially, the scale of its operations**

Example

Due to an out-dated production method, the demand for the product is reduced and therefore the company has to reduce its production substantially. This affects going concern assumption.

The difference in accounting for an entity which is a going concern and which is not a going concern

Going concern Financial statements	
	Valuation
Assets	Normal value
Liabilities	Normal value

Normal accounting bases e.g. fair value, historical cost, etc.

The value for an asset which has to be sold forcibly

The value of a liability which has to be settled immediately

Example

Jacques runs a small dress-designing business in Arusha, Tanzania. He operates his business from a small shop. The cost of the shop is Tshs60 million. He also has to repay a bank loan of Tshs10 million. Jacques has an opportunity to move to Paris and work for a top designer. Jacques needs to close down his business in Tanzania. A customer has offered him Tshs35 million for the shop. The bank has agreed to accept Tshs9.5 million in full settlement of the loan.

State, with reasons, how the shop and the loan should be recognised in the financial statements.

Answer

Jacques's business is not a going concern.
Jacques has to sell the shop (no matter how low the realisable value is) and pay off the liability.
When the entity is not a going concern the assets are recognised at disposable value and liabilities at settlement value.
Disposable value: is the realisable value of an asset under a forced sale. Jacques is forced to sell the shop at Tshs35 million hence the disposable value is Tshs35 million.
Settlement value: is the value of a liability for immediate settlement. Jacques can settle the liability immediately by paying Tshs9.5 million hence its settlement value is Tshs9.5 million.

Below is a comparative statement of financial position for Jacques under the two conditions

	Going concern (Tshs'000)
Shop Premises	60,000
Total	**60,000**
Bank loan	10,000
Capital (balancing amount)	50,000
Total	**60,000**

	Not a going concern (Tshs'000)
Shop premises	35,000
Total	**35,000**
Bank loan	9,500
Capital (balancing amount)	25,500
Total	**35,000**

Capital decreased because of a decrease in the asset value. It increased partially by Tshs500,000 because of a decrease in the bank loan.

It is **usually assumed** that the **going concern** concept **is followed** when financial statements are prepared. However, if it is not being followed, then

a disclosure should be made in the financial statements stating that the going concern concept has not been followed
the basis on which the financial statements have been prepared should be given
the reasons and details as to why the entity is not regarded as a going concern should be given

2. Matching concept / Accrual concept

The financial statements should be prepared on the basis of a matching or an accrual system of accounting. In this system, items are recognised as assets, liabilities, incomes and expenses **on the date they satisfy the recognition criteria mentioned in their definitions.** The actual date of payment of cash is immaterial for the purpose of recognition.

The following examples will further explain the accruals concept.

Example

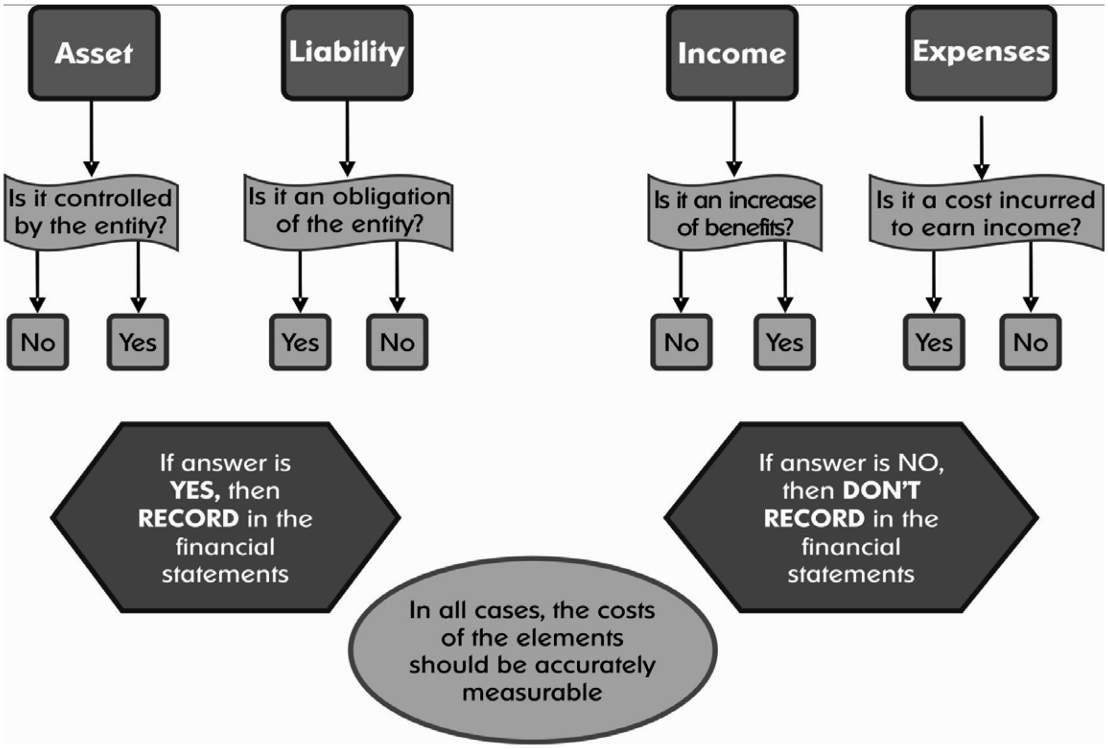
Almond Inc purchased goods on 5 December 20X2 but paid the supplier on 8 February 20X3. Here, Almond Inc became the owner of the goods on 5 December 20X2 even though the payment was made later. Hence the purchase transaction should be recorded on 5 December 20X2.

Example

Almond Inc purchased goods on 5 December 20X2 but paid the supplier on 9 November 20X2. Here, Almond Inc became the owner of the goods on 5 December 20X2 even though the payment was made earlier (in advance). Hence the purchase transaction should be recorded on this date.

Under the accruals system, all the elements of the statement of profit or loss and statement of financial position are recognised as follows

Diagram 8: Recognising elements in the financial statements (Note that the timing of actual payment is immaterial)



3. Consistency

Definition

Consistency means the financial statements should be prepared in the same manner period after period.

IAS 1 Presentation of Financial Statements

According to this concept, the policy once adopted in one accounting period should be consistently followed in the subsequent accounting periods.

Example

Until 20X2, ICC Plc followed the reducing balance method (RBM) for charging depreciation on assets. However, in 20X3, the company calculated depreciation according to the straight line method (SLM). Here, ICC Plc has not followed the principle of consistency.

Depreciation methods such as straight line, reducing balance method, sum-of-digits method have been discussed in Study Guide 6.

A new method of preparing the financial statements **can be used if**

(a) the new method is **more appropriate**

(b) the new method is **prescribed by a standard or interpretation issued by the IASB**

Example

Red Co valued its inventory under the last in first out method (LIFO) until 20X2. But IAS 2: Inventories does not permit the LIFO method of inventory valuation and is applicable to the accounting periods in 20X3. Therefore the company has to follow a different method for valuing inventory from 20X3.

(c) there is a **change in the entity's operations** and a new method is needed

Example

ICC Plc dealt with computer components until 20X0. Therefore it has classified its delivery vans as a non-current asset in the financial statements of 20X1.

In December 20X2, it stopped selling computers and started dealing in used vehicles. All vans are now available for sale. Therefore, all the delivery vans are required to be classified as a current asset in the financial statements of 20X2.

You will notice that during 20X1 delivery vans were classified as a non-current asset but in 20X2 the same vans are classified as current assets because of a change in the type of operations.

4. Prudence / Concept of Conservatism

The concept of prudence or conservatism implies that the **profit should not be over-stated but all anticipated losses should be recognised**. The implication of this is that all anticipated losses should be recognised and recorded immediately. But profits should be recognised and recorded in the books of account only when realised (this need not necessarily be in cash).

Example

Let us imagine that Keira Co makes cakes. Shali bought a cake and ate it. She is now in a hospital suffering from food poisoning and all tests indicate that the cake from Keira Co is to blame.

Shali decides to take legal action against Keira Co and demands payment of her hospital bill from Keira Co. The lawyers have told Keira that it is virtually certain that Keira will lose the case. In this situation, it would make sense for Keira Co to put an additional legal expense in the financial statements, to cover the potential cost of losing the legal case.

Therefore, including the potential expense of the legal case in the financial statements, is the application of the prudence concept.

5. Business entity concept

For accounting purposes, business entity concept treats the business entity as having a separate existence from the owner. Therefore,

(a) The transactions between the owners and the business are also recorded. For example, when a person brings capital into the business or withdraws capital from the business, these are recorded.
(b) Amounts due from the business to the owners are shown as a liability from the business to the owners (i.e. the capital contributed by the owners).
(c) Personal assets and liabilities as well as income and expenses are not recognised in the business financial statements - the statement of financial position will only show business assets and liabilities; similarly, the statement of profit or loss will disclose only the incomes and expenses of the business.
(d) Personal payments or receipts, if routed through a business bank account, are recorded in the capital account of the owners.
(e) It may be noted that in the case of non-corporate entities, business entity concept is a fiction created by accounting practices; the insolvency laws may not treat the business entity as separate from the owners - business assets and personal assets will be combined to pay off business and personal liabilities in case of insolvency.

The business entity concept (i.e. treating the owners and the businesses as one) is applicable to all forms of businesses including sole traders and partnerships.

Example

Tom, a sole trader, purchases two properties at Tshs1,500 million each, using business funds. One of the properties is to be used for business while the other is to be used as Tom's residence. The transaction for the first property will be recorded as a purchase of a business asset. The property is shown in Tom's statement of financial position as an asset. The payment for the second property, which is used for residence, will be recorded as withdrawal of capital by Tom. Tom's capital will be reduced. No asset is recorded in the statement of financial position of Tom's business.

8.3 Accounting conventions

An accounting convention may be defined as a custom or generally accepted practice which is adopted either by general agreement or common consent among accountants. It refers to the **attributes that financial statements should possess.** One has to maintain **balance between** all the **conventions**. These conventions make the financial statements more accurate and acceptable.

The accounting concepts and conventions are given in the framework for the preparation and presentation of financial statements and are issued by the IASB.

When accounting **concepts and conventions** are **adopted,** the information given in the **financial statements becomes** more **useful** and **understandable**.

Let us now discuss the important accounting conventions in detail

1. Fair presentation

(a) Meaning of fair presentation

Fair presentation is

(i) presenting **accurate** financial statements e.g. free from mathematical errors

(ii) adopting in totality, **all** the **accounting standards** (not just a few) prescribed by the IASB for the preparation of financial statements.

(iii) complying with all **legal requirements** e.g. companies in the UK need to present their statement of financial positions according to the format given in the Companies Act, UK. If a company does not follow the prescribed format, this amounts to unfair presentation.

(iv) **not manipulating** the financial statements e.g. reporting more profit than the actual.

Example

Zodiac Enterprise has incurred a loss during 20X2 due to poor management decisions. To hide this loss, the managers falsely issued sales invoices for transfers within departments of the company. This adjustment converted the actual loss into profits. Here, the management has manipulated the financial statements to hide the poor performance. Hence, this is not a fair presentation.

(b) Tools to achieve fair presentation

(i) **Application of IFRSs** is presumed to result in the financial statements being fairly presented.
(ii) Application of all **qualitative characteristics** is also presumed to result in the fair presentation of financial statements.
(iii) An **audit** of financial statements is a very useful tool to ensure fair presentation.

2. Materiality

Materiality means **relative importance**. Material items are **important items that the users of the financial statements must know**. The financial statements should show all the material items separately.

The concept of materiality relates to the time, efforts and the cost of accounting in relation to the usefulness of the data generated. Materiality requires that only those items which have a bearing on the determination of financial position and computation of profit and loss during the accounting period should be recorded and disclosed in the financial statements.

Example

Gemini Plc is a large manufacturing firm. The total of the company's receivables accounts for the year 20X3 is Tshs950 million. One of the company's stationery providers to whom Tshs100,000 was given as advance, closed his business. It was clear that the company would not be able to recover the advance.

Here, considering the company's scale of operations, Tshs100,000 is not a material amount. Hence, Gemini Plc need not adjust the total receivables amount immediately. The financial statements would still be fair.

Let's consider another example.

Example

Gemini Enterprises was penalised by the sales tax authorities for non-compliance with tax rules. The penalty amount was Tshs20 million. However, Gemini Enterprises included this amount of penalty under miscellaneous expenses which amounted to Tshs50 million excluding the penalty. Hence miscellaneous expenses inclusive of penalty is Tshs70 million (Tshs50 million + Tshs20 million)

Here, penalty forms 28.5% of miscellaneous expenses. Hence it is a material item and must be disclosed separately.

Gemini Enterprises
Statement of profit or loss

Materiality followed	
	Tshs (million)
Sales	1,000
Cost of goods sold	(600)
Gross profit	**400**
Expenses	
Miscellaneous expenses	(50)
Penalty	**(20)**
Profit	**330**

Payment of a penalty is a material item hence should be deducted from Miscellaneous expenses and disclosed separately

Materiality not followed	
	Tshs (million)
Sales	1,000
Cost of goods sold	(600)
Gross profit	**400**
Expenses	
Miscellaneous expenses	(70)
Profit	**330**

3. Relevance

Relevance refers to the usefulness of the accounting data generated. The concept of relevance requires that the financial statements should provide all the information that would be relevant to help users determine financial performance.

Example

Easy Telecom Inc has purchased land during 20W8 for Tshs50 million. The current market price of the land in 20X3 is Tshs120 million. If Easy Telecom Inc presents this information in its financial statements then the financial statements become more useful for the users to evaluate the financial position of the company. Hence, the market value of land is relevant information that should be disclosed in the financial statements.

However, if Easy Telecom were to include a list of the past owners of the land in the financial statements, this information would not be of any use to determine financial performance. Hence this information would be irrelevant.

4. Reliability

This concept requires that the financial statements should contain reliable information. Information is reliable when it is **free from material error and bias.**

Relevant but unreliable information should **not be recognised** in the financial statements.

Example

ICC Plc share prices increased 5 times during the current year. This information is relevant for the users of financial statements.

But prices in the share market are volatile, therefore this is unreliable information. Hence, ICC Plc should not include this information in the financial statements.

The difference between reliability and relevance is as follows:

	Relevance	Reliability
Deals with	Relevance deals with the disclosure of information: what to disclose; where to disclose?	Reliability deals with the quality of information: how the information is derived; its accuracy and its correctness.
Disclosure	Relevant but unreliable information should preferably be disclosed outside the financial statements.	Highly reliable information should be presented in the financial statements.

Example

Montek Traders has recently raised funds for a new project. Expenditure incurred on this project from the funds raised is relevant information and should be disclosed separately. If Montek Traders is able to maintain the exact details of the expenditure on the new project, this becomes reliable information.

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5. Faithful representation

The concept of faithful representation requires that the financial statements should **represent the transactions and events that they are expected to represent.**

Example

A statement of financial position lists all assets and liabilities. Therefore a user expects the statement of financial position to show all assets and liabilities. In other words, if a company owns 7 vehicles but reports only 6 vehicles in the statement of financial position then this would not be a faithful representation.

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6. Substance over form

Substance over form would play a significant role while evaluating financial transactions and disclosures. As an accountant, one must critically analyse a transaction and present the reality of the transaction in the financial statements. Transactions and other events should be accounted for and presented in accordance with their substance and economic reality, and not merely their legal form.

Faithful representation of any transaction is only possible if it is accounted for according to its substance and economic reality and not according to its legal form.

Example

BBG Inc provided domestic staff to its directors. BBG Inc pays Tshs1 million directly to the staff. In the legal sense, these domestic staff personnel are employees of BBG Inc but they are actually working for the directors.

Hence, the wages paid to the domestic staff should be treated as payments to the directors and not as company expenses.

BBG Inc

SOPL - 1

Legal form accounted for	
	Tshs'000
Sales	50,000
Cost of goods sold	(30,000)
Gross profit	**20,000**
Expenses (including wages paid to domestic staff)	(11,000)
Directors' fees	(5,000)
Profit	**4,000**

SOPL - 2

Substance accounted	
	Tshs'000
Sales	50,000
Cost of goods sold **Gross profit**	(30,000)
Expenses	**20,000**
Directors' fees	(10,000)
(including wages paid to domestic staff)	(6,000)
Profit	**4,000**

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7. Neutrality

Neutrality is also referred to as objectivity. It refers to the fact that the financial statements must be neutral, unbiased and free from personal opinions and prejudices. Neutrality is an essential aspect of faithful representation because biased financial reporting information cannot faithfully represent such information.

8. Completeness

The concept of completeness requires that **nothing material should be left out** of the financial statements. This is because incomplete financial statements can mislead the users.

Example

ABCL Plc has disclosed a loss due to embezzlement (i.e. stealing from the company) in the statement of profit or loss but failed to give details in the notes to the financial statements.

This is incomplete information. ABCL Plc should give details of the loss in the notes to accounts.

9. Comparability

Comparability implies the ability of users of financial statements to compare the accounts of similar companies (operating within the same industry) and to compare their performance over different periods of time. A company should also be able to compare its own accounts over different periods of time.

The financial statements should be comparable in the following two ways

1. **Horizontal comparison:** this is **comparing** the financial performance of **one company with that of another.**
2. **Vertical comparison:** this is **comparing** the financial performance of one company **with its own past performance.**

To prepare comparable financial statements **one must follow consistency**.

If you do not have any accounting background, you may find it helpful to revisit the next example once you have studied Study Guide 4, which teaches you all about depreciation and non-current assets.

A small background to the next example

A machine is purchased on 1 January 20W8 for Tshs10 million and it can be used to manufacture tea cups over the next 10 years. Although Tshs10 million is paid on 1 January 20W8, the benefit of the machine is actually enjoyed until 1 January 20X8. Depreciation is a concept that will spread the cost of Tshs10 million over the next 10 years.

If the machine can manufacture an equal number of tea cups over the full 10 years, the Tshs10 million could be split equally over the 10 years, so there will be an expense of Tshs10 million/10 = Tshs1 million as depreciation expense, included in each year's expenses. This is called straight line depreciation as it is an equal amount each year.

If the machine gives more tea cups in the first year and progressively less cups in later years, it could make sense to have a higher expense in the first years and lower ones in the later years - this is called reducing balance depreciation.

Example

For calculating depreciation on non-current assets
G & G Co uses the **straight line method.**
Red Co uses the **reducing balance method.**

Now, if both buy non-current assets worth Tshs10 million which are to be depreciated at 10% per annum, then the amount of depreciation expense in the statement of profit or loss will be:

	In G & G Co's books	In Red Co's books
	Tshs	Tshs
In the first year	1 million	1 million
In the second year	1 million	0.9 million

In the books of G & G Co: the **depreciation charge in its statement of profit or loss will remain uniform** over the asset's useful life.

In the books of Red Co: the **depreciation charge in its statement of profit or loss will be higher in the earlier years, and progressively less and less as the years go by,** until the end of the asset's useful life.

The financial statements of G&G Co and Red Co are not comparable because **different accounting policies** are in use for depreciation.

10. Understandability

This concept implies that the financial statements should be expressed in a way which is **clear and easily understandable** to the users. However, the users are expected to possess reasonable knowledge of accounting and business activities. The preparers of financial statements should not ignore any important matters merely because it will be difficult for the users to understand.

8.4 Balance between accounting principles, concepts and conventions

A typical financial statement should include all the accounting principles, concepts and conventions, which have been discussed above. A proper balance should be maintained between all of them. How to make a balance between all these is a matter of professional judgement.

All accounting principles, concepts and conventions should be given equal importance, and no accounting principle, concept or convention should be promoted at the expense of the others.

The following examples discuss the fine line between balancing all of the accounting principles, concepts and conventions:

Example

BBG Inc wanted to ignore material items just because this defeats understandability. In this case, BBG Inc should not comply with understandability at the expense of materiality. It should disclose the material items in the most easily understandable form possible.

Example

Moon Inc has been a manufacturer of motor cars since 20W1. The company has a good reputation in the market and customers are satisfied with the financial position of the company. Moon Inc prepares its financial statements on 31 December each year.

The company purchased a machine on 5 February 20X3 for Tshs800 million and paid installation charges of Tshs120 million. It was to be installed on the first floor of the company building. The wages paid to the workers for taking the machine to the first floor were Tshs15 million.

Twinkle, the accountant of the company, was confused as to how to present the above-mentioned costs incurred on machinery in an accurate manner, understandable to the users. So, she did not disclose them separately. She showed the value of machinery as Tshs935 million.

Here, understandability has been given more importance than materiality because she has not disclosed the costs separately as she found them difficult to present in an understandable form.

So, it is essential to disclose all the costs incurred on machinery in the most easily understandable form possible because they are all material items. It may be shown as follows:

Cost of machinery	Tshs800 million
Incidental cost	
Installation charges	Tshs120 million
Handling charges	Tshs15 million
Total machinery cost	**Tshs935 million**

Moon Inc should not comply with understandability at the expense of materiality. It should disclose the material items in the most easily understandable form possible.

Example

The fair values of assets are said to be more relevant than historical costs for the purpose of taking economic decisions, but unless they are reliable, they should not be used.

The management of a company thinks that the fair value of an asset is Tshs500 million, as opposed to the carrying value of Tshs200 million. However, the fair value cannot be reliably measured. Therefore, even if the fair value is relevant, it should not be recognised, because it is not reliable.

Test Yourself 14

Under which of the following conditions is ICC LLC deemed to be a going concern?

A The company deals in a chemical product. Environmental authorities have issued the company a notice to discontinue production. The company has taken the case to a court of law but the lawyer has recommended withdrawing the case because it is too weak.

B There was an intensive attack by enemies of the country. In this attack the company's plant was heavily damaged. This damage cannot be repaired in the near future.

C The company is facing heavy competition which may result in decline of revenue.

Test Yourself 15

Mack owns a courier service. The business has four delivery vans to make deliveries in the entire city. The total cost of all the delivery vans is Tshs130 million. Mack has recently decided to start a business of delivering newspapers. For this purpose, last month, Mack purchased seven street bikes. The total cost of the bikes amounted to Tshs3.4 million.

Required:

Should Mack disclose the cost of the bikes in the financial statements?

Test Yourself 16

Sun Inc has recorded the value of a property at Tshs100 million until last year. This year the company revalued the property and recorded it at Tshs150 million. Another effect of the increase in value was given by adding Tshs50 million to the reserves account. This adjustment was not disclosed anywhere in the financial statements. Do the statements satisfy the understandability criterion?

Test Yourself 17

On 5 January 20X3, Big Inc filed a lawsuit on Small Inc for damages for breach of contract. The claim was for Tshs500 million. Big Inc prepares its financial statements on 31 December every year. The lawsuit with Small Inc is still pending on 31 December 20X3. Should Big Inc include this claim amount in the financial statements?

Answers to Test Yourself

Answer to TY 1

1. Capital account and cash account
2. Cash account and bank account
3. Goods purchased account and trade payable account
4. Furniture account and cash account
5. Bank account and trade payables account

Answer to TY 2

Investors use financial information included in the financial statements to ascertain

(a) whether the business is profitable or not

(b) whether the cash and other resources entrusted to the entity are being properly utilised e.g. whether the entity is investing in profitable projects, continually searching for profitable expansion opportunities, servicing its debts etc.

(c) the levels of dividends that have been paid in the past. Some investors look for capital growth (share price increase), whilst others favour immediate income (high dividends).

Answer to TY 3

The correct option is **A**.

Management accounting is tailor made for management purposes. As such, it makes use of both cost and financial accounting records to extract appropriate and complete information. It can be anything about which management needs information and therefore information needs to be extracted from all the relevant areas.

Answer to TY 4

The correct option is **D**.

Except for the sale of the asset, all the others are correct pairs of a transaction matched with its source documents. The source document for sale of the asset is an invoice issued by the entity to the purchaser, and not the cheque received from the purchaser.

Answer to TY 5

Purchase order, sales invoice, sales order, goods received note, sales invoice, debit note, credit note.

Answer to TY 6

The correct option is **D**.

M/s Elite Traders have a liability to pay back the Tshs21 million loan in the future.

Answer to TY 7

Debit (an increase in cash-an asset)
Credit (an increase in capital - a liability of business to its owners)
Debit (An increase in purchases - an expense)
Credit (A decrease in cash - an asset)
Debit (An increase in shop - an asset)
Credit (A decrease in cash - an asset)

Answer to TY 8

The correct option is **C.**

The accounting equation is assets = capital + liabilities. Only C holds this equation.

Answer to TY 9

The correct option is **B**.

We need to consider only the business assets and liabilities in the statement of financial position.

	Tshs'000
Assets	
Premises	100,000
Residential house	N.A
Receivables	20,000
Cash- (consider the business cash no matter where it is located)	20,000
Total	**140,000**
Capital and Liabilities	
Capital (balancing figure)	**60,000**
Loan for business	80,000
Loan for personal asset	N.A
Total	**140,000**

Capital = Assets - Liabilities
= Tshs.140 million - Tshs.80 million
= Tshs.60 million

Answer to TY 10

1	Sale of goods for cash	Income	SOPL
2	Amounts receivable due to credit sales	Current assets	SOFP
3	Rent paid for office premises	Expense	SOPL
4	Amounts payable to credit suppliers	Current liabilities	SOFP
5	Purchase of goods	Expenses	SOPL
6	Acquisition of a building	Non-current asset	SOFP
7	Travel expenses	Expense	SOPL
8	Printing charges	Expense	SOPL
9	Corporate tax paid	Expense	SOPL
10	Profit from sale of equipment	Income	SOPL
11	Interest paid	Expense	SOPL
12	Interest received	Income	SOPL
13	Purchase of plant and equipment	Non-current asset	SOFP
14	Cash received from owners	Equity	SOFP
15	Bank loans	Liability	SOFP
16	Furniture received from owners	Equity	SOFP
17	Inventories in stock at year end	Current asset	SOFP
18	Profit for the period	Equity	SOFP
19	Cash drawings by a sole trader	Equity	SOFP
20	Computers used by employees	Non-current assets	SOFP

SOPL - Statement of profit or loss
SOFP - Statement of financial position

Note:

Each transaction is recorded by the double entry accounting system; it will have its second effect in either of the income / expense or asset / liability account.

Answer to TY 11

Income, expenses, an asset, a current asset, a current liability

Answer to TY 12

The correct option is **B**.

A sole trader has a single owner, a partnership has two or more owners and a limited liability company has an unlimited number of owners.

Answer to TY 13

The correct option is **C**.

Directors and managers are employees of the company but not the owners. Shareholders are the owners of the company. Employees / managers may be given shares in the company but this is not covered under Paper A3.

Answer to TY 14

The correct option is **C**.

A **Not a going concern**: because there is a high probability of the company being unable to continue as its only product can no longer be manufactured.
B **Not a going concern:** because there is no scope of rehabilitation.
C **A going concern:** competition and a decline in revenue is a part and parcel of business.

Answer to TY 15

Yes, following the accounting concept of **relevance,** it is essential that Mack discloses the new business venture which will help the users of financial information to assess the risks and opportunities for the company.

Answer to TY 16

No, the financial statements do not satisfy the understandability criterion. The value of the property has increased by a material amount. So, the users of the statements will not have a clear understanding as to what led to the increase in the value of the property.

Answer to TY 17

No, Big Inc should not include this claim in its financial statements because it would not be reliable, as it is unknown at the time of preparation of the financial statements, whether Small Inc will be found to be liable or not. However, disclosure in the notes is desirable though not necessary.

Self Examination Questions

Question 1

Identify the main differences between financial accounting and management accounting.

Question 2

Which of the following is not an advantage of a sole trader form of business?

A Single taxation
B Limited liability
C No sharing of profit
D No need to publish financial statements

Question 3

Which of the following are differences between sole trader entities and limited liability companies?

(i) A sole trader entity is generally not required to publish its financial statements.
(ii) A sole trader has unlimited liability, and a shareholder's liability is limited.
(iii) Only a limited company will have share capital.

A (i) and (ii) only
B (ii) and (iii) only
C (i) and (iii) only
D (i), (ii) and (iii)

Question 4

Which of the following statement(s) is / are correct about a partnership?

(i) Personal assets of partners can be called for in the case of debt repayment.
(ii) Profits are shared equally between the partners.
(iii) Must involve two or more partners.

A (i) and (ii) only
B (ii) and (iii) only
C (i) and (iii) only
D (i), (ii) and (iii)

Question 5

The profits of a company are

A Shared by employees and the shareholders
B Exclusive right of the sole trader
C Shared by the partners
D Distributed to the shareholders in the form of dividends

Question 6

The owners of the business are interested in which of the following?

A Profitability of the business
B Assets of the business
C Total long term liabilities of the business
D All the above

Question 7

Providers of finance are keen to know the following

(i) Profit earnings
(ii) Cash flow information
(iii) Repayment capacity of all debt

A (i) and (ii)
B (iii) only
C All the above
D None of the above

Question 8

Under fair presentation

A It is necessary to fairly disclose the good performance of the entity
B It is necessary to fairly disclose the losses
C It is necessary to fairly disclose the amount paid to the directors
D It is necessary to disclose all the financial information fairly

Question 9

Under the concept of going concern, the entity expects to exist for at least

A The next 50 years
B The next 11 months and 20 days
C Next 5 years
D None of the above

Question 10

An accrual system of accounting prescribes

A Recording the substance of the transaction and ignoring the form
B Recording all expenses when the payment is made
C Recording assets when they are controlled
D Overstating the expenses

Question 11

All material items should be

A Presented in bold type in the financial statements
B Separately presented in the financial statements
C Clubbed together and presented in the financial statements
D Ignored

Question 12

A credit note is issued by the seller to

A Raise invoices.
B Adjust or rectify errors of overcharging made in the sales.
C Adjust or rectify errors of overcharging made in the purchases.
D Acknowledge receipt of cash.

Question 13

Which of the following is the correct accounting equation?

A Capital + Total liabilities - Total assets
B Capital - Total liabilities + Total assets
C Capital = Total assets + Total liabilities
D Capital = Total assets - Total liabilities

Question 14

Which of the following is correct?

A Increase in asset - credit
B Decrease in asset - debit
C Increase in expense - credit
D Decrease in income - debit

Question 15

Which of the following is correct?

A Assets and expenses show debit balance.
B Liabilities and capital show debit balance.
C Assets and incomes show debit balance.
D Liabilities and incomes show debit balance.

Question 16

Which of the following documents will accompany a payment made to a supplier?

A Statement
B Remittance advice
C Credit note
D Purchase invoice

Question 17

Goods are sent to a customer by the goods outward department. What document will be raised?

A Purchase invoice
B Goods despatch note
C Statement
D Remittance advice

Question 18

What does a complete set of financial statements include?

A Statement of financial position and statement of profit or loss
B Statement of financial position, statement of profit or loss, statement of cash flows, statement of changes in equity and notes to the financial statements
C Statement of financial position, statement of profit or loss, statement of cash flows, statement of changes in equity, notes to the financial statements, management performance reports, chairman's declaration and similar items
D Statement of financial position, statement of profit or loss, statement of cash flows, and statement of changes in equity

Question 19

Why are a statement of financial position and statement of profit or loss prepared?

A To help declare the dividend and share price
B To please the owners
C To portray the financial position and performance of the entity over a given time period
D To publish in a newspaper

Question 20

Which of the following items does not appear in the statement of financial position?

A Assets
B Equity
C Liability
D Purchases

Question 21

Frank's business has the following assets and liabilities. What is his equity?

	Tshs'000		**Tshs'000**
Cash	20,000	Bank loan	30,000
Inventory	20,000	Furniture	5,000
Suppliers outstanding	5,000		

Answers to Self Examination Questions

Answer to SEQ 1

Financial accounting is mainly for external users (such as the shareholders) whereas management accounting is geared to respond to the decision making needs of the management.

Financial accounting needs to be done in compliance with specific rules and regulations (such as IFRS or other national GAAP) whereas management information can be tailored according to the specific needs of the business entity or according to the needs of the management.

Answer to SEQ 2

The correct option is **B**.

A sole trader has unlimited liability. Limited liability is enjoyed by the limited liability companies.

Answer to SEQ 3

The correct option is **D**.

A sole trader business does not have to publish its financial statements. The liability of a sole trader is also unlimited. A company has to publish its financial statements and has limited liability. The capital contributed by the shareholders is called 'share capital'.

Answer to SEQ 4

The correct option is **C**.

A partnership has unlimited liability and needs two or more persons to create it. Partners can decide any profit sharing ratio and may not necessarily be equal.

Answer to SEQ 5

The correct option is **D**.

The management of the company declared dividends to the shareholders, which are distributed out of the profits of the company.

Answer to SEQ 6

The correct option is **D**.

Owners are interested in all aspects of the business including its profits, assets and liabilities.

Answer to SEQ 7

The correct option is **C**.

Providers of finance are interested to know the level of cash and profits an organisation is generating and if these are adequate to service its debt requirements, going forward.

Answer to SEQ 8

The correct option is **D**.

Fair presentation relates to presenting the true performance. This includes true presentation of good or bad performance. It also includes disclosing the amounts paid to directors fairly. The option 'D' covers the definition of fair presentation.

Answer to SEQ 9

The correct option is **D**.

An entity should be expected to continue its operations for at least 12 months.

Answer to SEQ 10

The correct option is **C**.

Recording the substance of the transaction comes under the concept ‘substance over form’. According to the accrual system of accounting, expenses should be recorded in the financial statements when there is a decrease in the economic benefits whereas assets should be recorded when economic benefits will flow to the entity.

Answer to SEQ 11

The correct option is **B**.

All material items should be separately presented in the financial statements. There is no need to put all material items in bold type.

Answer to SEQ 12

The correct option is **B**.

When the seller sells goods on a credit basis, the accounting entry is

Dr	XYZ (Receivable) account - SOFP	X	
Cr	Sales account - SOPL		X

However, when the seller wants to make corrections related to overcharging in the invoice (e.g. sales return, overstated price or quantity) then the seller issues a credit note. This entry will be

Dr	Sales account - SOPL	X	
Cr	XYZ (Receivable) account - SOFP		X

Answer to SEQ 13

The correct option is **D**.

As we know, the business has to follow the business entity concept; capital (i.e. the funds brought by the owners of the business) is considered as a business liability. Also the business has to follow the double-entry accounting system; debits are always equal to credits.

The correct accounting equation is
Capital (liability towards owners) + other liabilities = total assets controlled by the business.

Answer to SEQ 14

The correct option is **D**.

You must remember these debit / credit rules

	Debit effect	**Credit effect**
Assets have a **debit balance**	asset	asset
Liabilities have a **credit balance**	liability	liability
Expenses have a **debit balance**	expenses	expenses
Incomes have a **credit balance**	income	income

Answer to SEQ 15

The correct option is **A**.

Refer debit / credit rules mentioned above.

Answer to SEQ 16

The correct option is **B**.

When making payments to a supplier, a remittance advice is sent along with the payment.

Answer to SEQ 17

The correct option is **B**.

All goods going out of an organisation are accompanied by a goods despatch note.

Answer to SEQ 18

The correct option is **B**.

A complete set of financial statements consists of: a statement of financial position, statement of profit or loss, statement of changes in equity, statement of cash flows and notes to the financial statements. Other elements may be included in an annual report but are not part of the financial statements e.g. management reports.

Answer to SEQ 19

The correct option is **C**.

The main purpose of the financial statement is to portray the financial position and performance of the entity and thus to satisfy the information needs of the stakeholders.

Answer to SEQ 20

The correct answer is **D**.

Purchases are expenses that appear in the statement of profit or loss and not in the statement of financial position.

Answer to SEQ 21

The correct answer is **Tshs10 million**

Equity = Total assets - Total liabilities
Equity = (Tshs20 million + Tshs20 million + Tshs5 million) - (Tshs30 million + Tshs5 million)
Equity = Tshs10 million

RECORDING BUSINESS TRANSACTIONS

2

Get Through Intro

This Study Guide will explain to you how to **identify accounting transactions** and how to **record these transactions** in the books of prime entry.

We will also introduce the most important element of accounting: **double-entry book-keeping**. It is very important that you understand this concept before moving on to future Study Guides, as this forms the basic building block of all subsequent Study Guides. If you master debits and credits it means you have understood the core mechanisms that make accounting work!

As a student of accounting and a future finance and accounting professional, you should be comfortable with the terms **debit** and **credit** and be able to recognise these two elements in each transaction. These two words are so important that the whole process of accounting and financial reporting rests on them.

You may have seen a wholesaler of clothes maintaining details of each of his retailers. The details relate to clothes supplied to the retailer and money received for those supplies. In accounting terms we say that the wholesaler maintains ledger accounts for each retailer. These ledger accounts help him identify who owes him how much, who is paying on time and who is not likely to pay up.

In the **previous Study Guide** we **identified** the main **data sources** in an accounting system. In this Study Guide we shall build upon this knowledge and show **how** these **sources of information** such as sales and purchases invoices **are recorded in the books of prime entry**. We will then see **how** this **information** is **recorded** in the **ledger accounts.** Financial statements are prepared on the basis of the balances of these ledger accounts.

Learning Outcomes

a) Describe business transactions.
b) Record the effects of transactions in the accounting equation.
c) Post transactions in the ledgers.

1. Describe business transactions.

[Learning Outcome a]

1.1 Sales

Sale of goods refers to the **income generated by the entity from its main activities**. They may also be referred to as **turnover.** Sales are of two types:

1. Cash sales

The payment for the sale is received immediately. The seller issues a cash invoice. The journal entry to record this transaction is:

Dr	Cash	X	
Cr	Sales		X

Being goods sold and cash received

2. Credit sales

The buyer promises to pay in the future, hence a receivable and payable relationship is created. The seller issues an invoice. The double-entry is:

Dr	Receivables	X	
Cr	Sales		X

Being goods sold on credit

Example

On 1 March 20X3, Sunrise Ltd sold goods worth Tshs2 million for cash to Brian.

The journal entry to record this transaction will be:

Dr	Cash	Tshs2 million	
Cr	Sales		Tshs2 million
	Being goods sold and cash received		

If the same goods are sold on credit, the journal entry will be:

Dr	Brian (Receivables)	Tshs2 million	
Cr	Sales		Tshs2 million
	Being goods sold on credit		

1.2 Purchases

Purchases are one of the most important activities for an entity. These are the opposite of sales - they refer to the main direct **expenses incurred in generating sales income**. Purchases are of two types.

1. **Cash purchases:** The payment for the purchase is made immediately. The double-entry is:

Dr	Purchases	X	
Cr	Cash		X

Being purchases made and cash paid.

2. **Credit purchases:** The buyer does not pay immediately, but promises to pay in the future. The double-entry is:

Dr	Purchases	X	
Cr	Payables		X

Being purchases made on credit.

Example

Jack purchased goods worth Tshs5 million from Alistair in cash. The journal entry for this transaction will be:

Dr	Purchases	Tshs5 million	
Cr	Cash		Tshs5 million

Being purchases made and cash paid.

If the same goods are purchased on credit, the journal entry will be:

Dr	Purchases	Tshs5 million	
Cr	Alistair (Sundry Payables)		Tshs5 million

Being purchases made on credit.

Tip

Sales and purchases are opposite sides of the same transactions. One entity's sales are another entity's purchases.

1.3 Payments

Payments refer to the outflow of cash by the payer. Payments can be either:

1. Payment in cash OR
2. Payment by cheque, credit card, standing order or direct debit.

A payment can be towards:

(a) Cash purchases
(b) Payment to suppliers (payables)
(c) Purchases of non-current assets
(d) Drawings from the business (money taken for **personal** use by the proprietor)
(e) Expenses

(The above list is not exhaustive)

While making a payment you need to **obtain a receipt from the recipient** or obtain his acknowledgement on a payment voucher. This is your primary source of proof that payment has been made. A receipt must be obtained for all cash transactions.

Example

The following payments are made by Carl during the month of March 20X3:

(a) Payment by cheque for rent Tshs800,000
(b) Paid salaries to staff in cash Tshs650,000
(c) Withdrawn for personal use in cash Tshs225,000
(d) Paid for purchase of furniture by cheque Tshs936,000

The journal entries for all these transactions will be:

(a)	Dr	Rent	Tshs800,000	
	Cr	Bank		Tshs800,000

Being rent paid by cheque

(b)	Dr	Salary	Tshs650,000	
	Cr	Cash		Tshs650,000

Being salaries paid by cash

Continued on the next page

(c)	Dr	Drawings	Tshs225,000	
	Cr	Cash		Tshs225,000

Being cash withdrawn for personal use

(d)	Dr	Furniture	Tshs936,000	
	Cr	Bank		Tshs936,000

Being furniture purchased and payment made by cheque

1.4 Receipts

Receipts refer to the inflow of cash to the recipient. Receipts can be either:

1. Receipt in cash OR
2. Receipt by cheque, credit cards, direct credit and standing order

A receipt can be from:

(a) Cash sales
(b) Collection from customers (receivables)
(c) Sale proceeds from disposal of non-current assets
(d) Capital brought into the business by the owners
(e) Loan financing
(f) Other income received in cash

(The above list is not exhaustive)

While receiving money you need to **issue a receipt to the payer** or an acknowledgement of receipt.

Example

Record the following transactions in the books of Bill & Co:

(a) Paid in cheque towards capital Tshs1.5 million
(b) Sold goods to Jimmy for cash Tshs300,000
(c) Received cheque from Adam towards settlement of his account for credit sales Tshs425,000
(d) Cheque received from bank for loan taken of Tshs1,250,000
(e) Sold old furniture for cash Tshs100,000

The journal entries to record these transactions in the books of Bill & Co. will be:

(a)	Dr	Bank	Tshs1.5 million	
	Cr	Capital		Tshs1.5 million

Being amount received against capital

(b)	Dr	Cash	Tshs300,000	
	Cr	Sales		Tshs300,000

Being goods sold and cash received

(c)	Dr	Bank	Tshs300,000	
	Cr	Adams (Receivables)		Tshs300,000

Being cheque received from Adam

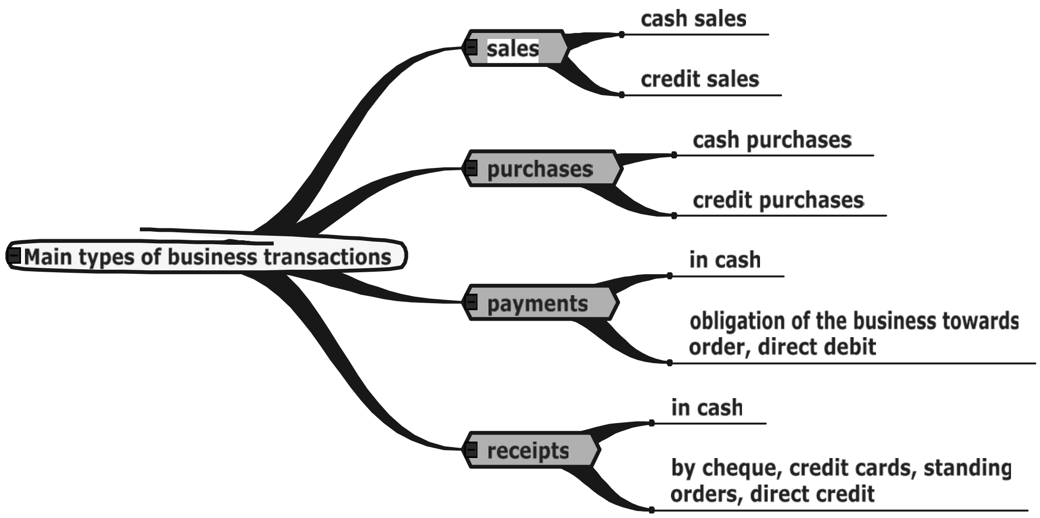
(d)	Dr	Bank	Tshs1,250,000	
	Cr	Loan (liability)		Tshs1,250,000

Being cheque received from bank against loan taken

(e)	Dr	Cash	Tshs100,000	
	Cr	Furniture		Tshs100,000

Being furniture sold for cash

SUMMARY



Test Yourself 1

Refer to the earlier section on debit and credit and fill in the blanks with the words **debit** and **credit**.

While making a payment we _________the cash and when we make a payment by cheque we __________ the cash at bank account because when an asset is decreased we __________ the asset account. When we collect a cheque we ___________ the cash at bank account. When the proprietor withdraws cash from the business we _________ cash and ____________ drawing account. When we make cash expenditure on purchase of goods we ___________ purchases account and ________ cash. But when we make payment to suppliers for goods purchased on credit we ________ payable account and not the purchases account.

---

2. Record the effects of transactions in the accounting equation.
3. Post transactions in the ledgers.
[Learning Outcomes b and c]

2.1 Accounting equation

We have already discussed the accounting equation in detail and studied how the transactions are recorded in the accounting equation in Learning Outcome 5, Study Guide 1. We studied that under the double-entry book-keeping system, all transactions are recorded by giving two accounting effects - **debit and credit.** Debit is traditionally shown as a positive figure and credit as a negative figure. To summarise the accounting equation is as follows:

The accounting equation is:
Assets = Capital + Liabilities
Dr = Cr

2.2 Ledger

Definition

Ledger is a book containing accounts. An account is a record that is used to collect and store information related to an individual element of the financial statements.

In accounting, we classify / record all elements in the following manner:

(a) Classify all items as asset, liability, income or expense (elements of the financial statements).
(b) Each class is then further classified and recorded as a separate ledger account. For example, assets are further classified into plant, machinery, furniture, receivables, cash etc.
(c) Each sub-class is also further classified (if needed) and recorded as a separate ledger account. For example receivables are classified as trade receivables (those created due to sales of merchandise that the entity is dealing in) and other receivables (sale of non-current assets).
(d) This classification continues until we get to the purpose for which or the person with whom the transaction was incurred.

Example

Trade receivables are further classified according to customers - ledger account of customer A, ledger account of customer B etc.

Company Alpha has one building, one machine and one transport vehicle. It will record its assets in different ledger accounts - building account, plant account and vehicle account.

Company Alpha acquires yet another machine. The building account and the vehicle account will remain the same but the plant account will be divided into two - 'Plant-I ledger account' and 'Plant-II ledger account'.

---

1. Types of ledger accounts

There are three types of ledger accounts.

(a) **Receivable ledger / sales ledger / debtors' ledger**: this includes all ledger accounts of customers.
(b) **Payable ledger / purchases ledger / creditors' ledger**: this includes all ledger accounts of suppliers.
(c) **Nominal / general ledger:** this includes all ledger accounts other than the individual receivable and payable accounts. Examples would be plant and machinery, inventory, share capital, sales, expenses and cash.

The above classification of ledgers is done for convenience. The format and basic accounting procedure is the same for all.

2. Books of prime entry

By maintaining a ledger account you have all the transactions with the same person or purpose in one place. This is an easy form that can be used to answer day-to-day queries such as the amount of sales made to a customer in a month or the balance outstanding from any customer etc.

However if transactions are entered directly into the individual ledger accounts there could be many errors. There are no checks to ensure that all the transactions are included or that the values are correct. Hence we have books of prime entry to record transactions as they provide the required checks.

Books of prime entry include:

1. Sales day book also known as sales register
2. Purchase day book also known as purchases register
3. Sales return day book
4. Purchase return day book
5. Cash book
6. Journal

Example

Almond Inc is into sales of computer hardware. There are 5,000 sales transactions every day in Almond Inc. Jim, the accountant of Almond Inc, has to write all these sales into a separate ledger account for each of the customers. There is a high chance that Jim may fail to record a transaction by misreading an entry or turning over two pages in error.

Customer - Alistair	Tshs'000
Sales invoice - 101	5,000

Customer - Brett	Tshs'000
Sales invoice - 102	6,000
Sales invoice - 105	10,000

Customer - Carl	Tshs'000
Sales invoice - 103	8,000
Sales invoice - 104	1,000

Customer - David	Tshs'000
Sales invoice - 107	3,500
Sales invoice - 109	2,500

Customer - Evan	Tshs'000
Sales invoice - 106	2,000
Sales invoice - 108	6,000

A better procedure would be:

To maintain a sales day book
Record all the sales transactions one after the other
From the sales day book, record (post) all transactions into each customer's account.

Continued on the next page

The above procedure ensures that all sales transactions are recorded in the sales book.

Invoice number	Customer's name	(Tshs'000)	Computers (Tshs'000)	Printers (Tshs'000)	Others (Tshs'000)
	Alistair	5,000	5,000	-	-
Sale invoice - 102	-Brett	6,000	-	6,000	-
Sale invoice - 103	-Carl	8,000	8,000	-	-
Sale invoice - 104	-Carl	1,000	-	-	1,000
Sale invoice - 105	-Brett	10,000	10,000	-	-
Sale invoice - 106	Evan	2,000	2,000	-	-
Sale invoice - 107	David	3,500	-	3,500	-
Sale invoice - 108	Evan	6,000	6,000	-	-
Sale invoice - 109	David	2,500	-	-	2,500
	Total	**44,000**	**31,000**	**9,500**	**3,500**

By giving each transaction a sequential number within the sales day book you can clearly see if a transaction has been omitted. This gives you a master record to refer to if you think an error has occurred.

Examples of the books of prime entry follow. These are also called basic / primary / original accounting books.

(a) Sales day book or sales journal

This is a complete record of all **credit sales**.

Proforma of sales day book (with imaginary numbers)

Date	Invoice number	Customer's name	Tshs'000	Computers Tshs'000	Printers Tshs'000	Others Tshs'000
	Sale invoice -101	Alistair	5,000	5,000	-	-
	Sale invoice -102	Brett	6,000	-	6,000	-
	Sale invoice -103	Carl	8,000	8,000	-	-
		Total	**19,000**	**13,000**	**6,000**	

(b) Purchase day book or purchase journal

This is a complete record of all credit purchases. A suggested format is as follows:

Proforma of purchase day book (with imaginary numbers)

Date	Purchase reference number	Supplier's name	Supplier's invoice number	Tshs'000	Coal Tshs'000	Steel Tshs'000	Others Tshs'000
	1	BNG Inc	10042	2,000	2,000	-	-
	2	Christopher	A2001	8,000	-	8,000	-
	3	Alexander	200609	3,000	-	-	3,000
		Total		**13,000**	**2,000**	**8,000**	**3,000**

(c) Sales return day book or journal

This is a complete record of goods returned by customers.

Proforma of sales return day book (with imaginary numbers)

Date	Credit note number	Customer's name	Tshs'000	Computers Tshs'000	Printers Tshs'000	Others Tshs'000
	1850	Alistair	1,000	1,000	-	-
	1851	Brett	500	-	500	-
		Total	**1,500**	**1,000**	**500**	

(d) Purchase returns day book or journal

This is a complete record of goods returned to the supplier.

Proforma of purchase returns day book (with imaginary numbers)

Date	Debit note number	Supplier's name	Tshs'000	Coal Tshs'000	Steel Tshs'000	Others Tshs'000
	1002	Christopher	1,000	-	1,000	-
	1003	Alexander	2,000	-	-	2,000
		Total	**3,000**	**-**	**1,000**	**2,000**

(e) Cash book

A cash book is a complete record of all cash and bank transactions.

Proforma of cash book (with imaginary numbers)

Date	Receipts	Cash sales Tshs'000	Receivables Tshs'000	Total Tshs'000	Date	Payments	Cash purchases Tshs'000	Payables Tshs'000	Others Tshs'000	Total Tshs'000
	Cash sales	2,000		2,000		Cash purchases	2,500			2,500
	Receivables - Tom		2,000	2,000		Salary payments			6,500	6,500
	Dick		3,000	3,000		Balance c/f				1,000
	Harry		3,000	3,000						
	Total	**2,000**	**8,000**	**10,000**		**Total**	**2,500**		**6,500**	**10,000**

Example

On 1 March 20X3, Mark Woods had a bank balance of Tshs1.5 million.

He entered into the following transactions during 1 March 20X3.
1. Cash sale of Tshs90,000
2. Receipt from credit customer John Tshs1.25 million
3. Receipt from credit customer Ted Tshs500,000 less discount allowed Tshs50,000
4. Receipt from credit customer Rob Tshs400,000 less discount allowed Tshs32,000
5. Receipt of cheque from Mary Nelson Tshs2.5 million against loan given
6. Receipt from second cash sale Tshs275,000
7. Receipt of cash for the sale of equipment Tshs650,000
8. Payment made to supplier Ian Tshs240,000
9. Payment made to supplier Peter Tshs405,000
10. Electricity bill paid Tshs800,000
11. Telephone bill paid Tshs400,000
12. Cash withdrawn from bank for petty cash Tshs325,000
13. New plant and machinery purchased for Tshs3.5 million from Nick

Prepare the cash book

Continued on the next page

Answer

Amounts in Tshs'000

Date	Receipts	Cash sales	Receivables	Others	Total	Date	Payments	Payables	Petty cash	Others	Total
01/ March/ 20X3	Balance b/d				1,500		Purchase of machinery			3,500	3,500
	Cash sales	90			90		Payable - Ian	240			240
	Receivable										
	John		1,250		1,250		Peter	405			405
	Ted		450		450		Electricity bill			800	800
	Rob		370		370		Telephone bill			400	400
	Loan - Mary Nelson			2,500	2,500		Petty cash		325		325
	Cash sales	275			275		Balance c/f				1,415
	Sale of non-current asset			650	650						
	Total	**365**	**2070**	**3150**	**7,085**		**Total**	**645**	**325**	**4,700**	**7,085**

(f) Petty cash book

Every business has to make numerous small payments such as stationery, postage, taxi fares etc. If all these small transactions are recorded in the cash book then identifying important transactions from the cash book would be difficult. Therefore, a petty cash book is maintained to record the cash spent for day-to-day expenses.

Date	Details	Amount spent Tshs	Balance Tshs
01/04/20X3	Opening balance		800,000
03/04/20X3	Taxi fare	36,081	763,919
04/04/20X3	Stationery	20,386	743,533
06/04/20X3	Snacks for staff	59,057	684,474
06/04/20X3	Stationery	10,193	674,281
07/04/20X3	Fuel	106,626	567,655
08/04/20X3	Parking charges	5,663	561,992
09/04/20X3	Taxi fare	27,182	534,810
09/04/20X3	Drinks	10,031	524,778
11/04/20X3	Flowers and bouquets	25,080	499,698

Analytical columns are usually added to the petty cash book so as to help in a summary posting into ledger.

(g) Journal

A general principle is that any transaction which cannot be recorded in the following books of original entry has to be recorded in a journal.

(a) Sales day book
(b) Purchases day book
(c) Sales returns day book
(d) Purchases returns day book
(e) Cash book
(f) Petty cash book

Example

Depreciation is a non-cash expense which can be recorded neither in the sales day book nor in the sales returns day book, the purchases day book, the purchases returns day book or the cash / bank book.

Hence it is recorded in the journal.

You will study more about depreciation later in this Paper.

Example

Record the depreciation on machinery at 20% of cost. The cost is Tshs30 million.

Books of ICC Ltd

Journal for the year to 31 December 20X6

31/12/20X3	Dr	Depreciation account	Tshs6 million	
	Cr	Accumulated depreciation account		Tshs6 million
	Being depreciation on the machinery charged at 20% on the cost of Tshs30 million			

Remember that the day books which an entity maintains depend upon the type of the entity.

Example

A service provider need not maintain a sales day book as they are not selling products / inventories, instead they should maintain a service day book.

The following is an illustrative list of transactions that are usually recorded in a journal. This list is neither compulsory nor exhaustive. It all depends on the nature of activities that an organisation performs.

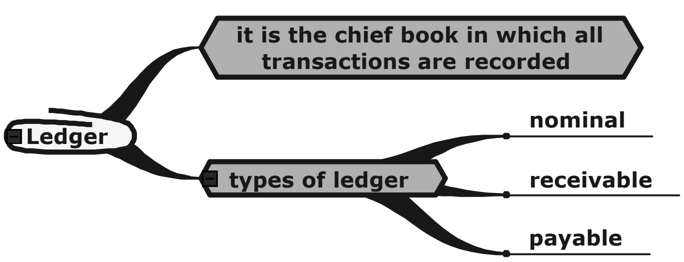
(i) Entries for depreciation of non-current assets
(ii) Accrual entries e.g. to record expenses incurred but not yet paid
(iii) Rectification entries i.e. to correct the errors made in accounting
(iv) Transfer of profit / loss to capital
(v) Purchases and sales of non-current assets on credit
(vi) Opening entries when we prepare a new set of books in the next accounting period
(vii) Entries for closing ledger account
(viii) Exchange entries e.g. exchange of assets

Note: most of these entries are explained in detail in the later Study Guides of this text book.

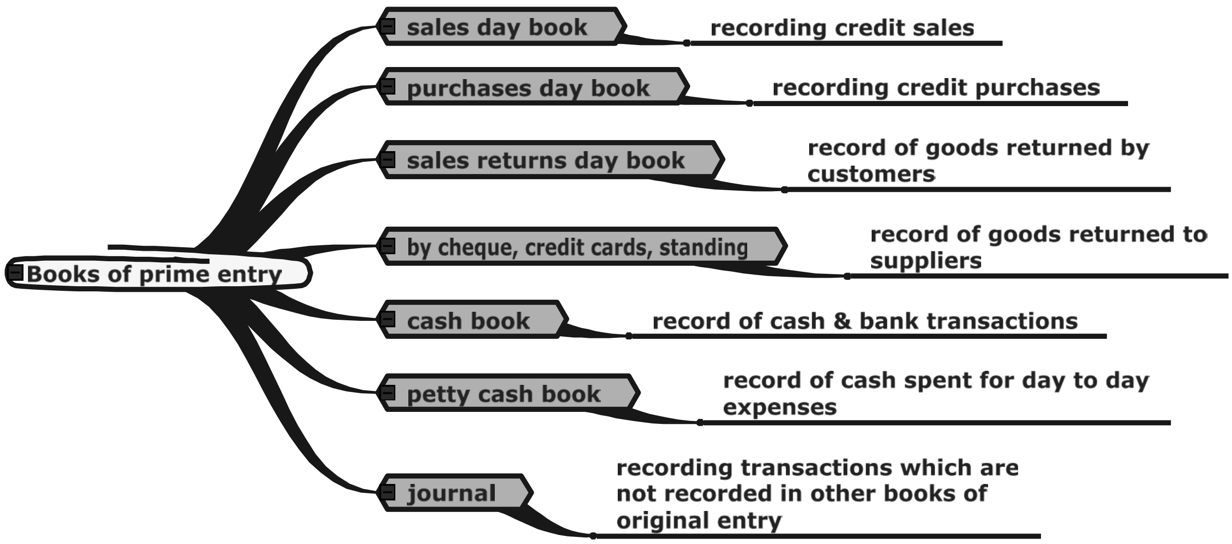
You will remember that in Study Guide 1, we discussed the first step of the accounting cycle or process, i.e. collecting the data source. In this section, we have discussed the second step, i.e. identifying and preparing the books of prime entry.

In the next section, we will look at the third step, i.e. analysis of the data and posting to the ledger accounts.

SUMMARY



SUMMARY



2.3 Journal entries

In simple terms, a journal entry is an interpretation of a financial transaction showing the dual effect of each transaction (account to be debited and credited) along with an explanatory description of the transaction.

Tip

Do not confuse a journal entry and a journal. A journal entry is a way of recording a transaction in a debit / credit form. A journal is a record of some special transactions.

Example

Record the journal entries for the following transactions

1. Bob opened a flower shop on 1 January 20X3 and brought in Tshs3.5 million as capital
2. Bob paid rent by cheque on 31 January 20X3 Tshs0.9 million

Answer

Books of Bob

Journal for the year to 31 December 20X3

Date			Tshs	Tshs
01/01/20X3	Dr	Cash account	3.5 million	
	Cr	Capital account		3.5 million
	Being initial capital introduced in business			
31/12/20X3	Dr	Rent account	0.9 million	
	Cr	Bank account		0.9 million
	Being rent paid			

In this answer - The entries are made in a journal entry format. Such entries are usually routed through the cash book where the debit credit effects are the same but the presentation might be slightly different.

2.4 Uses of posting journal entries to ledger account

The journal and the ledger are the main books of accounts.

In the journal, transactions (journal entries) are recorded daily, as and when they take place. Therefore, one cannot know at a glance the combined effect of all the transactions relating to a particular customer or supplier or item of income or expenditure.

In the absence of a ledger, one would have to go through each page and every entry in the journal to collect all the information and find out the effect of all the transactions with respect to a particular account.

Example

Zeta Traders has completed the following transactions with Vicky for the month of April 20X3:

01 April 20X3 Purchased goods from Vicky Tshs5 million
12 April 20X3 Returned goods to Vicky Tshs0.25 million
12 April 20X3 Paid cash to Vicky Tshs1.2 million
22 April 20X3 Paid cash to Vicky Tshs3 million
24 April 20X3 Purchased goods from Vicky Tshs2.3 million

These transactions would be recorded on different dates and on different pages of the books of prime entry. Hence, it is not possible to find out at a glance what amount Zeta Traders owes Vicky. However if Zeta Traders prepares a ledger account for Vicky then all the transactions will be recorded in that account and the net amount outstanding on a particular day can be easily found out.

2.5 How to prepare a ledger

Let's take up an example to learn this concept.

Example

ICC Ltd carried out the following transactions with a customer, Alan:

02 January 20X3 - Invoice No - 10025 - sold goods worth Tshs1 million
25 February 20X3 - Invoice No - 10092 - sold goods worth Tshs4 million
Received cheque from Alan for Tshs1 million on 02 February 20X3 and issued a receipt to Alan which had a number R1009.

Step 1: Journal entry

As the computers were sold on credit (payment was not received immediately), the journal entry will be:

Dr	Alan's account	Tshs1 million	
Cr	Sales account		Tshs1 million

Being goods sold on credit

Step 2: Preparing ledger accounts

To record the above entry, ICC Ltd has to open two ledger accounts

1. Alan account
2. Sales account

The suggested format of a ledger account is as follows:

Always write the name of the entity in whose books you are writing the accounting entries, at the top.

Write the name of the account here

Books of ICC Ltd
________ **account**

Dr Cr

Date		Tshs	Date		Tshs
	Total			**Total**	

Step 3: Posting

Definition

Recording of transactions from the books of prime entry to the respective ledger account is called posting. Posting is to be made to the debit side of the account which is to be debited and to the credit side of the account which is to be credited.

Let's see how to post our entry in the ledger account:

Dr Alan's account Tshs1 million
Cr Sales account Tshs1 million
Being goods sold on credit

Books of ICC Ltd
Alan's account

Dr Cr

Date		Tshs'000	Date		Tshs'000
02/01/20X3	Sales-10025	1,000			

As Alan's account is debited, the entry will be posted to the debit side of Alan's account. After posting all entries, Alan's account will appear as follows:

Books of ICC Ltd
Alan account

Dr Cr

Date		Tshs'000	Date		Tshs'000
02/01/20X3	Sales - 10025	1,000	02/02/20X3	Receipt - R1009	1,000
25/02/20X3	Sales - 10092	4,000			

Step 4: Balancing of the ledger

Once all entries are posted, the ledger has to be balanced as follows: add up each side and put the higher balance in on both sides. The balancing figure is the carried forward figure.

Books of ICC Ltd
Alan account

Dr Cr

Date		Tshs'000	Date		Tshs'000
02/01/20X3	Sales - 10025	1,000	02/02/20X3	Receipt - R1009	1,000
25/02/20X3	Sales - 10092	4,000		Balance c/f	4,000
	Total	**5,000**		**Total**	**5,000**

Tshs5 million - Tshs1 million

Alan's account shows that ICC Ltd has sold goods worth Tshs5 million and received only Tshs1 million. Therefore, Tshs4 million is receivable from Alan.

2.6 Identifying correct journals from given narrative

This section discusses how journal entries are prepared from the given narratives.

1. Record the following transactions in the books of ICC Ltd

On Ad Labs Corp (customer) account there is a balance of Tshs0.5 million receivable. Ad Labs Corp has declared bankruptcy and there is no chance of the funds being received. ICC Ltd has decided that the ledger balance should be written off as it is not recoverable.

Diagram 1: Analysis of a transaction

Step 1:
Identify the two aspects of the transaction.
Classify the two aspects in asset, liability, income or expense.
1. Decrease in receivable (-asset) from Ad labs corp
2. A loss in the form of bad debts to the business (+ expense)

Step 2:
Apply the accounting rule.

1. Debit ? Expense Tshs0.5 million
2. Credit ? Asset Tshs0.5 million

Step 3:
Record it in the books of accounts

Journal

Dr Bad debts expense account Tshs0.5 million
Cr Ad Labs Corp customer account Tshs0.5 million
Being Tshs0.5 million receivable from Ad Labs Corp written off

Let us see the posting of the above transaction into the respective ledger accounts.

Nominal ledger

Bad debts account (expense account)

Dr Cr

Date			Tshs'000	Date			Tshs'000
	Ad Labs Corp		500				
	Total				**Total**		

Receivables ledger

Ad Labs Corp account (asset account)

Dr Cr

Date			Tshs'000	Date			Tshs'000
					Bad debts		500
		Total				**Total**	

2. Discount allowed to Gemini Enterprises (a customer) of Tshs0.6 million, who owes Tshs2 million.

This means that Gemini does not have to pay the full balance of what it owes - but Tshs0.6 million less

Journal Entry
Dr Discount allowed (SOPL) Tshs0.6 million
Cr Gemini Enterprise customer account (SOFP) Tshs0.6 million
Being a discount of Tshs0.6 million allowed to Gemini Enterprise

(Explanation: (+) discount expenses (-) asset i.e. receivable)

Nominal ledger

Discount allowed account (expense account)

Dr Cr

Date		Tshs'000	Date		Tshs'000
	Gemini Enterprise	600			

Receivable ledger

Gemini Enterprises account (asset)

Dr Cr

Date		Tshs'000	Date		Tshs'000
	Balance b/f	2,000		Discount	600

3. Discount received from Indo Company (a supplier) of Tshs900,000

Journal entry
Dr Indo Company account (SOFP) Tshs0.9 million
Cr Discount received account (SOPL) Tshs0.9 million
Being discount of Tshs0.9 million received from Indo company

(Explanation: (-) liability of payables (+) income of discount)

Nominal ledger

Discount received account

Dr Cr

Date		Tshs'000	Date		Tshs'000
				Indo Company	900

Payable ledger

Indo Company account

Dr Cr

Date		Tshs'000	Date		Tshs'000
	Discount	900			

4. X Traders pays bonus for any year in the following year. The bonus for 20X3 - Tshs50 million is payable in 20X4.

Journal entry in 20X3

Dr Bonus expense account Tshs50 million
Cr Accrued bonus account Tshs50 million
Being accrued bonus for 20X3 recorded

(Explanation: (+) expense of bonus (+) liability of accrued bonus)

Nominal ledger

Bonus expense account

Dr Cr

Date		Tshs'000	Date		Tshs'000
	Bonus for 20X3	50,000			

Accrued bonus account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
				Bonus for 20X3	50,000

2.7 Balancing and closing a ledger account

We have already seen that a ledger account has two sides, a debit side and a credit side. The expression 'to calculate a **balance on the ledger account'** means **to total each side of the ledger account and calculate the difference between the two sides**.

1. Procedure for balancing a ledger account

(a) Total the debit and credit sides
(b) Calculate the difference between the two sides
(c) Find the balancing figure
(d) If the debit side exceeds the credit side then it is a debit balance (This balance is written on the credit side). Now debit total = credit total
(e) If the credit side exceeds the debit side then it is a credit balance (This balance is written on the debit side). Now total of the debit column = total of the credit column

Example

Given below is an unbalanced ledger account:

Books of ICC Ltd
Asset account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
01/01/20X3	Balance b/d	500			
02/08/20X3	New machinery	600			
09/10/20X3	New wheels	330	31/12/20X3	Sale of asset	200
	Total	**1,430**		**Total**	**200**

From the above account we can see that the debit side totals Tshs1.43 million while the credit side totals Tshs0.2 million. Hence there is a difference of Tshs1.43 million - Tshs0.2 million = Tshs1.23 million

In order to balance ICC's ledger account, we take the total of both the sides. Then the difference in the two totals is identified.

As the total of the debit column exceeds the total of the credit column - it is a debit balance.
This debit balance of Tshs1.23 million is written in the credit column

Books of ICC Ltd
Asset account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
01/01/20X3	Balance b/d	500			
02/08/20X3	New machinery	600	31/12/20X3	Sale of asset	200
09/10/20X3	New wheels	330	31/12/20X3	Balance c/f	1,230
	Total	**1,430**		**Total**	**1,430**

Tip

The correct way to write the closing balance is to write it on the last line of the ledger account.
Balance b/d or b/f denotes balance of an account brought forward from the last year
Balance c/d or c/f denotes balance of an account carried forward to the next year.

Continued on the next page

Books of ICC Ltd
Wages payable account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
			01/01/20X3	Balance b/d	850
02/02/20X3	Cash paid	850	30/12/20X3	December overtime	665
31/12/20X3	Balance c/f	1,865	30/12/20X3	December wages	1,200
	Total	**2,715**		**Total**	**2,715**

The credit side is larger hence this account has a credit balance.

Tip

At the end of the financial year:

All income and expense accounts i.e. accounts appearing in the statement of profit or loss **are closed.** This is done by posting the balance in each of these accounts to the statement of profit or loss.

All asset and liability accounts i.e. accounts appearing in the statement of financial position **are carried forward** to the next accounting year.

Now let us see the carry over and closing process.

2. Carry over process

Books of ICC Ltd
Loan account (year - I)

Dr | Cr

Date		Tshs'000	Date		Tshs'000
			01/01/20X3	Balance b/d	850
01/01/20X3	Instalment	500	01/01/20X3	Interest	665
31/12/20X3	Balance c/f	**2,215**	30/09/20X3	Additional loan	1,200
	Total	**2,715**		**Total**	**2,715**

The above account has the following features:

Liability account, as the credit is greater than the debit.
Appears in the statement of financial position (remember, income and expense accounts are closed at the end of the year).
Has a closing credit balance of Tshs2,215,000 (This must be carried over to the next accounting period).

3. Carry over to the next accounting period

Write the opening balance on the first line of the ledger account in the next year.
Opening balance is credit; hence write on the credit side of the ledger account.

Books of ICC Ltd
Loan account (year - II)

Dr | Cr

Date		Tshs'000	Date		Tshs'000
			01/01/20X4	**Balance b/d**	**2,215**
	Total			**Total**	

Let's consider another example

Books of ICC Ltd
Machinery account (year - I)

Dr | Cr

Date		Tshs'000	Date		Tshs'000
01/01/20X3	Balance b/d	7,000			
05/03/20X3	New machinery	25,000	05/02/20X3	Asset disposal	5,000
			01/12/20X3	Asset disposal	1,000
				Balance c/f	**26,000**
	Total	**32,000**		**Total**	**32,000**

The above account has the following features:

It is an asset account and hence appears in the statement of financial position
Has a closing debit balance of Tshs26 million

Hence the balance should be carried over to the next accounting period.

Books of ICC Ltd
Machinery account (year - II)

Dr | Cr

Date		Tshs'000	Date		Tshs'000
1/01/20X4	Balance b/d	**26,000**			
	Total			**Total**	

4. Closing an account

To close the income and expense ledger account simply transfer the balance to the statement of profit or loss as follows:

Sales account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
30/12/20X3	Sales returns	2,260	30/12/20X3	December sales	51,060
31/12/20X3	**Balance transferred to the SOPL**	48,800			
	Total	**51,060**		**Total**	**51,060**

The above account has the following features:

Income account (as it has a credit balance).
Should appear in the statement of profit or loss.
Has a closing credit balance of Tshs48.8 million i.e. credit side is greater than the debit side.

Look at another example:

Purchases - coal account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
01/11/20X3	October purchases	950	01/11/20X3	Purchases returns	143
			31/12/20X3	Balance transferred to the SOPL	807
		950			**950**

The above account has the following features:

Expense account (as it has a debit balance).
Should appear in the statement of profit or loss
Has a closing debit balance of Tshs807,000 i.e. debit side is greater than the credit side.

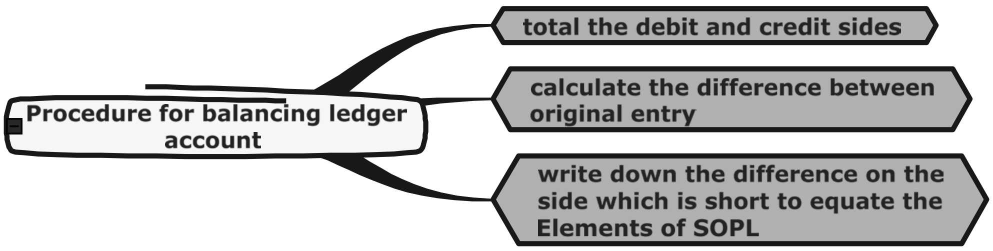
But don't forget that an asset account (which also has a debit balance) and a liability account (which has a credit balance) is not closed. It is carried forward to the next year.

Motor car account

Dr Cr

Date		Tshs'000	Date		Tshs'000
01/01/20X3	Balance b/d	10,000	05/09/20X3	Asset disposal	1,000
			31/12/20X3	Balance c/f	9,000
		10,000			**10,000**

SUMMARY



Test Yourself 2

Which of these would not be recorded in the petty cash book?

A Purchase of a new company car
B Purchase of fuel for the car
C Car wash
D Puncture repairs

Test Yourself 3

Fill in the blanks with sales day book, sales returns day book, purchase day book, purchase returns day book, cash book.

John is an antique dealer with a shop on High Street. He buys some antique furniture. He will record the transaction in the ___________.

However, he notices that some items are damaged. Hence, he returns the furniture. He will record this transaction in his ___________.

John sells some antique pieces to Jenny on credit. He will record this transaction in his ____________.

John has a policy that customers can return the goods purchased by them within 10 days if they change their mind. He will record the goods returned transactions in his ___________.

John sells small items for cash on a daily basis. He will record these transactions in his___________.

Test Yourself 4

State which books of accounts the following transactions would be entered into.

(a) A payment is made to Robin (a supplier) by your business of Tshs500,000.
(b) The administration department urgently requires Tshs50,000 to buy some stationery.
(c) An invoice is sent by your business to Mark (a customer) for Tshs700,000.
(d) An invoice is received from Robin for Tshs200,000.
(e) Mack, a customer, returns goods worth Tshs350,000.
(f) Your business pays Mark Tshs300,000.
(g) Goods worth Tshs612,000 are returned to J Waugh.
(h) Tshs400,000 is paid by Mack to your business.

Test Yourself 5

Fill in the blanks with these words: **income, expense, asset, liability, yes, no, debit, credit**

John has started a metal trading business. He invested Tshs80 million in cash into the business on the first day of trading. The accounting entry will be ___________ cash and _________ capital account. The cash is a / an ___________ and the capital account is a / an ___________. John has paid salaries to his employees in cash. The accounting entry will be __________ cash and __________ the salary account. The salary account is a / an ___________ account.

Test Yourself 6

Terry is a sole trader who manufactures shoes. He makes the following transactions in the month of February 20X3.

01 February Capital introduced Tshs5 million in cash into the business.
Shoe laces purchased for Tshs160,000.
Leather purchased on credit from Letha Manufacturing Tshs900,000
25 February Rent for 3 months paid Tshs810,000

28 February Shoes sold on credit Tshs280,000 to Mary.

Required:

Make the required journal entries and post them to the respective ledger accounts.

Test Yourself 7

Rosy, who owns a beauty and hair clinic, made the following transactions in the month of March 20X3.

On 1 March, Rosy started her business with a capital of Tshs1.5 million. She purchased cosmetics for her clinic on 7 March for Tshs100,000. A credit purchase of Tshs5 million for some equipment required for the clinic was made on 15 March. She provided hair treatment to Tina for Tshs0.5 million on credit on 25 March.

Required:

Write journal entries for the following transactions.

Test Yourself 8

Salary account has the following transactions.

Salary account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/01/20X3	January wages	1,950	31/01/20X3	Rectification of error	143
30/06/20X3	June wages	2,660			
31/07/20X3	July wages	5,996			
31/12/20X3	December wages	2,360			
	Total			**Total**	

Which of the following statement is correct?

A Tshs12,823,000 Debit balance is carried over to next year
B Tshs12,823,000 Debit balance is taken to statement of profit or loss
C Tshs12,823,000 Credit balance is taken to statement of profit or loss
D Tshs12,823,000 Credit balance is carried over to next accounting year

Test Yourself 9

Share capital account has the following transactions.

Share capital account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
			01/01/20X3	Balance b/d	15,880
05/06/20X3	Forfeiture of shares Buy	1,950	05/06/20X3	Additional capital issued	9,886
31/12/20X3	back of shares	2,660	31/12/20X3	Rectification of mistake	143
31/12/20X3	Rectification of mistakes	5,996			
	Total			**Total**	

Which of the following statement is correct?

A Tshs15,303,000 Debit balance is carried over to next accounting year
B Tshs15,303,000 Debit balance is written off to statement of profit or loss
C Tshs15,303,000 Credit balance is written off to statement of profit or loss
D Tshs15,303,000 Credit balance is carried over to next accounting year

Answer to Test Yourself

Answer to TY 1

Credit (A decrease in cash - an asset)
Credit (A decrease in cash at bank - an asset)
Credit (A decrease in asset)
Debit (An increase in cash at bank - an asset)
Credit (A decrease in cash - an asset)
Debit (A decrease in capital - a liability. Drawings account is reported under the equity section in the SOFP)
Debit (An increase in purchases - an expense)
Credit (A decrease in cash - an asset)
Debit (A decrease in payables balance - a liability)

Answer to TY 2

The correct option is **A**.

Purchase of a new company car would not be recorded in the petty cash book.

Answer to TY 3

Purchases day book - purchases returns day book - sales day book - sales returns day book - cash book.

Answer to TY 4

(a) Cash book
(b) Petty cash book
(c) Sales day book
(d) Purchases day book
(e) Sales returns day book
(f) Cash book
(g) Purchases returns day book
(h) Cash book

Answer to TY 5

Debit, credit, asset, liability, credit, debit, expense

Answer to TY 6

The Journal entries for these transactions are as follows:

Date			Tshs'000	Tshs'000
1 February	Dr	Cash account	5,000	
	Cr	Capital account		5,000
		Being capital introduced in the business		
			160	
1 February	Dr	Shoe laces purchase account		160
	Cr	Cash account		
		Being purchase of shoe laces for cash		
1 February	Dr	Leather purchase account	900	
	Cr	Letha Manufacturing (payables) account		900
		Being leather purchased on credit		
25 February	Dr	Rent account	810	
	Cr	Cash account		810
		Being rent paid for 3 months		
28 February	Dr	Mary (receivable) account	280	
	Cr	Sales account		280
		Being credit sale made		

Cash account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/02/20X3	Capital	5,000	01/02/20X3	Shoe lace	160
			25/02/20X3	Rent	810
				Balance c/f	4,030
	Total	**5,000**		**Total**	**5,000**

Capital account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
			01/02/20X3	Cash	5,000
	Balance c/f	5,000			
	Total	**5,000**		**Total**	**5,000**

Shoe Lace purchase account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/02/20X3	Cash	160			
				Balance c/f	160
	Total	**160**		**Total**	**160**

Leather purchase account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/02/20X3	Sundry accounts payable	900			
				Balance c/f	900
	Total	**900**		**Total**	**900**

Rent account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
25/02/20X3	Cash	810			
				Balance c/f	810
	Total	**810**		**Total**	**810**

Sales account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
28/02/20X3				Trade accounts receivable	280
	Balance c/f	280			
	Total	**280**		**Total**	**280**

Sundry accounts payable account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/02/20X3				Leather	900
	Balance c/f	900			
	Total	**900**		**Total**	**900**

Trade account receivable account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
28/02/20X3	Sales	280			
				Balance c/f	280
	Total	**280**		**Total**	**280**

Answer to TY 7

Date			Tshs'000	Tshs'000
01/03/20X3	Dr	Cash account	1,500	
	Cr	Capital account		1,500
	Being capital introduced in the business			
07/03/20X3	Dr	Cosmetics purchase account	100	
	Cr	Cash account		100
	Being cosmetics purchased for cash			
15/03/20X3	Dr	Machinery account	5,000	
	Cr	Sundry accounts payable		5,000
	Being machinery purchased on credit			
25/03/20X3	Dr	Trade accounts receivable	500	
	Cr	Sales account		500
	Being credit sale made			

Answer to TY 8

The correct option is **B.**

Salary account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/01/20X3	January wages	1,950	31/01/20X3	Rectification of error	143
30/06/20X3	June wages	2,660	31/12/20X3	Balance c/d	12,823
31/07/20X3	July wages	5,996			
31/12/20X3	December wages	2,360			
	Total	**12,966**		**Total**	**12,966**

A salary is an expense account and has a debit balance. This balance is transferred to the statement of profit or loss.

Answer to TY 9

The correct option is **D.**

Share capital account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
			01/01/20X3	Balance b/d	15,880
05/06/20X3	Forfeiture of shares Buy	1,950	05/06/20X3	Additional capital issued	9,886
31/12/20X3	back of shares	2,660	31/12/20X3	Rectification of mistake	143
31/12/20X3	Rectification of mistakes	5,996			
31/12/20X3	Balance c/d	15,303			
	Total	**25,909**		**Total**	25,909

A share capital is a liability account and has a credit balance. This balance is taken in the statement of financial position and carried over to the next accounting year.

Self Examination Questions

Question 1

A credit note is issued by the seller to:

A Raise invoices.
B Adjust or rectify errors of overcharging made in the sales.
C Adjust or rectify errors of overcharging made in the purchases.
D Acknowledge receipt of cash.

Question 2

What should the journal entry be if Malcolm purchased goods for cash?

A	Dr		Purchases	X	
		Cr	Sales		X
B	Dr		Purchases	X	
		Cr	Cash		X
C	Dr		Purchases	X	
		Cr	Supplier		X
D	Dr		Cash	X	
		Cr	Purchases		X

Question 3

Which of the following is the correct accounting equation?

A Capital + Total liabilities - Total assets
B Capital - Total liabilities + Total assets
C Capital = Total assets + Total liabilities
D Capital = Total assets - Total liabilities

Question 4

Generally the receivables account has a debit balance. However -

A Closing balance is written on debit side of the receivables ledger
B Closing balance is written on credit side of the receivables ledger
C Opening balance is written on credit side of the receivables ledger
D None of the above

Question 5

The salary account is maintained in:

A Receivable ledger
B Payable ledger
C Nominal ledger
D Cash book

Question 6

Which of the following is not a primary book?

A Sales returns day book
B Purchases returns day book
C Journal
D General ledger

Question 7

Which of the following is true?

	Closed at year end	Carried forward to next year
A	Asset	Expense
B	Expense	Asset
C	Liability	Income
D	Income	Expense

Question 8

Which of the following journal entries is correct for the write off of a customer's debt that is no longer receivable?

	Debit	Credit
A	Bad debt (Expense)	Asset payable
B	Bad debt (Expense)	Asset receivable
C	Accounts payable	Bad debt (Expense)
D	Accounts receivable	Bad debt (Expense)

Question 9

Which of the following is incorrect?

	Closed at year end	Carried forward to next year
A	Cash	Plant & machinery
B	Sales	Plant & machinery
C	Salaries	Loan
D	Purchases	Payable

Question 10
Mr. Akili the owner of **Akili Nyingi Enterprises** started his business on 31st January 2014. During the year ended 31st December 2014 his book-keeper Mr. Kweka recorded the business cash transactions in the cash book as follows:

Date	Details	Lf	Cash (Tshs.)	Bank (Tshs.)	Date	Details	Lf	Cash (Tshs.)	Bank (Tshs.)
Jan 1	Capital		15,000,000	90,000,000	Feb 3	Purchases			12,000,000
Mar 25	Sales			16,000,000	April 4	Bank		6,000,000	
April 4	Cash			6,000,000	May 9	Motor vehicles			15,000,000
Oct 23	Sales		13,000,000		Aug 10	Wages & salaries			13,000,000
					Sept 18	Rent		6,000,000	
					Oct 20	Purchases			7,000,000
					Dec 15	Drawings		500,000	

REQUIRED:

Given the above recorded cash book help Mr. Kweka to:
(a) Post the entries from the cash book to the relevant ledger accounts
(b) Balance off the cash book and other accounts and extract the Trial Balance as at 31st December 2014.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

When the seller sells goods on a credit basis, the accounting entry is:

Dr	XYZ (Receivable) account - SOFP	X	
Cr	Sales account - SOPL		X

However, when the seller wants to make corrections related to overcharging in the invoice (e.g. sales return, overstated price or quantity) then the seller issues a credit note. This entry will be:

Dr	Sales account - SOPL	X	
Cr	XYZ (Receivable) account - SOFP		X

Answer to SEQ 2

The correct option is **B**.

When we purchase goods for cash the two aspects of the transaction are:

an increase in the purchases expense (debit) and
a decrease in cash asset (credit)

Answer to SEQ 3

The correct option is **D**.

As we know, the business has to follow the business entity concept; capital (i.e. the funds brought by the owners of the business) is considered as a business liability. Also the business has to follow the double-entry accounting system; debits are always equal to credits.

The correct accounting equation is:
Capital (liability towards owners) + other liabilities = total assets controlled by the business.

Answer to SEQ 4

The correct option is **B**.

Receivable is an asset and an asset should have a debit balance. While balancing the receivable account if the debit side is greater, then the closing balance is written on the credit side of the account.

Answer to SEQ 5

The correct option is **C**.

In the receivables ledger all customers' accounts are maintained. All the suppliers' accounts are maintained in the payables ledger. All other accounts are maintained in the nominal ledger. Therefore the salaries account is maintained in this ledger. (The cash book is a book of prime entry).

Answer to SEQ 6

The correct option is **D**.

All the mentioned books except the general ledger are the books of prime entry. The general ledger is a secondary book where the records of all accounting transactions are maintained.

Answer to SEQ 7

The correct option is **B**.

All income and expense accounts are closed at the year-end whereas asset and liability accounts are carried forward to the next year.

Answer to SEQ 8

The correct option is **B**.

Bad debt is an expense; therefore we debit the bad debt account. The second effect is that it decreases the receivables balance (an asset), therefore we credit the receivables account.

Answer to SEQ 9

The correct option is **A**.

Cash and plant and machinery account are both asset accounts and carried over to the next year.

Answer to SEQ 10

(a)

Capital a/c

Dec 31 Bal c/d	105,000,000	Jan 1 Bank	90,000,000
		Jan 1 Cash	15,000,000
	=========		========

Sales a/c

Dec 31 Bal c/d	29,000,000	March 25 Bank	16,000,000
		Oct 23 Cash	13,000,000
	29,000,000		
	=========		

Purchases a/c

Feb 3 Bank	12,000,000			
Oct 20 Bank	7,000,000	Dec 31	Bal c/d	19,000,000
	=========			========

Motor vehicle a/c

May 9 Bank	15,000,000	Dec 31	Bal c/d	15,000,000
	=========			========

Wages and salaries a/c

Aug 10 Bank	13,000,000	Dec 31	Bal c/d	13,000,000
	=========			========

Rent a/c

Sept 10 Cash	6,000,000	Dec 31	Bal c/d	6,000,000
	=======			=======

Drawings a/c

Dec 15 Cash	500,000	Dec 31	Bal c/d	500,000
	=======			======

Akili Nyingi Enterprises

The Trial Balance as at 31st December 2014

	DR.	CR
Capital		105,000,000
Sales		29,000,000
Purchase a/c	19,000,000	
Motor vehicle a/c	15,000,000	
Wages and Salaries a/c	13,000,000	
Rent a/c	6,000,000	
Drawings a/c	500,000	
Cash	15,500,000	
Bank	65,000,000	
	134,000,000	**134,000,000**

SECTION E

ACCOUNTING TREATMENT FOR INVENTORIES (IAS 2)

3

ACCOUNTING TREATMENT FOR INVENTORIES (IAS 2)

Get Through Intro

Inventory means the goods-in-hand at the end of an accounting period.

Inventory can be valued in a number of ways. Each method gives a different value for inventory. For example: Playful Cars Ltd has a closing inventory of 30 cars. The value of the cars under the last in first out (FIFO) method is Tshs300 million and under the average cost (AVCO) method is Tshs350 million.

Inventory is included in the cost of sales which means that it directly affects the profitability of the entity. In the above example the profitability of Playful Cars will increase by Tshs50 million (Tshs350 million - Tshs300 million) if it uses the average cost method, to value its closing inventory.

An accountant has to be familiar with all aspects of inventory accounting and valuation. He will be asked to help decide the method of inventory valuation which affects the reported profits of the company. This is a huge responsibility as the amounts tied up in inventory can also be very high!

In this Study Guide, we will be discussing measurement of inventories per IAS 2 and various methods of valuing inventory.

Learning Outcomes

a) Recognise the need for and record adjustments for opening and closing inventory in preparing financial statements.
b) Explain and apply the IASB requirements in IAS 2 for valuing inventories.
c) Recognise which costs should be included in valuing inventories.
d) Explain the use of continuous and period end inventory records.
e) Calculate the value of closing inventory and the cost of goods sold using FIFO (first in, first out) and AVCO (average cost).
f) Identify the impact of inventory valuation methods on profit and on assets.

1. Recognise the need for and record adjustments for opening and closing inventory in preparing financial statements.

[Learning Outcome a]

1.1 What is inventory?

Inventory in simple terms means the stock held by the entity. Inventory is classified as:

- raw materials
- work in progress
- finished goods

Definition

Inventories are assets:

- held for sale in the ordinary course of business;
- used in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

IAS 2 Inventories

Example

Bakewell is engaged in the production of cakes and pastries. To produce a cake, many ingredients are used like butter, flour, eggs and sugar. These are the raw materials used for making the cake mixture.

The cake mixture is the intermediary product. When this mixture is baked, the cake is ready, but in order to sell the cake in the market, it has to be properly packed in packets or boxes. The cake at any point of time before it is ready for sale is termed as work-in-progress.

When packaging is completed, the cake is ready to be sold. The cakes in this form, packed and ready for sale, are called finished goods.

It is important to note here that a **product:**

- **may** be an item of **inventory for one entity** but
- may **not** be an item of inventory **for others.**

Example

Let us consider the same example of Bakewell, as discussed previously.

The butter used as raw material in the process of making the cakes would be the finished product for the butter manufacturing company. Similarly, the processed sugar would be a raw material for Bakewell, but a final product for the sugar manufacturer.

Test Yourself 1

For a computer and related items retailer, which of the following are inventories?

A Desktops and notebook PCs held for sale
B Computer hard disks, chips, pen drives, cords
C Both (a) and (b)
D Desktops' used by staff to process sales orders

Test Yourself 2

Tyres used in the manufacture of cars are work-in-progress. Is this statement true or false?

1.2 Need for recording inventory

Why do you think we **need to maintain a record of inventory?**

Consider the following example:

Example

High-tech Computer is a computer dealer. On 1 January 20X6 High-tech Computers bought 10 computers for Tshs10 million. On 31 December 20X6 they sold 6 computers for Tshs7.5 million. High-tech now has a closing inventory of 4 computers worth Tshs4 million.

If you prepare a statement of profit or loss ignoring the closing inventory, it will reflect a loss of Tshs2.5 million.

High-tech Computers – Statement of profit or loss for the year to 31 December 20X6

	Tshs'000
Sales (6 computers) **Less:**	7,500
Cost of goods sold	
Purchases (10 computers)_	(10,000)
Gross profit / (loss)	**(2,500)**

Impact on current year's profits if inventory is not recorded

According to the matching principle, costs should match revenue. However, in the above statement of profit or loss, the **cost of 10 computers purchased** is being compared to the sale of 6 computers. This is incorrect as according to the matching principle, the cost of 6 computers should be matched with the **sale of 6 computers**.

The remaining 4 computers needs to be shown as inventory and recognised in the statement of financial position. This is because we have not sold the computers yet – we can expect to sell these computers in the next year resulting in an inflow of economic resources.

High-tech Computers – Statement of profit or loss for the year to 31 December 20X6

	Tshs'000	Tshs'000
Sales		7,500
Less: Cost of goods sold (6 computers)		
Purchases	10,000	
Less: Closing inventory (4 computers)	(4,000)	(6,000)
Gross profit		**1,500**

Impact on current year's profits if inventory is properly recorded

You can now see that the **purchase cost of 6** of the purchased computers has been matched with the **sale proceeds of 6** computers. The revised statement of profit or loss hence, reflects a profit of Tshs1,500,000

In the following year, 20X7, High-tech sells the remaining 4 computers (no additional purchases made during the year) for Tshs5,000,000. On this basis, we can now compare the statements of profit or loss:

if no closing inventory was recorded in the previous year:

High-tech Computers - Statement of profit or loss for the year to 31 December 20X7

	Tshs'000
Sales (4 computers)	5,000
Less: Cost of goods sold (4 computers)	
Purchases	-
Gross profit	**5,000**

Continued on the next page

if closing inventory was recorded in the previous year:

High-tech Computers - Statement of profit or loss for the year to 31 December 20X7

	Tshs'000	Tshs'000
Sales (4 computers) **Less:** Cost		5,000
of goods sold Opening inventory		
(4 computers) Purchases	4,000	
Gross profit	-	(4,000)
		1,000

Hence we can see that when inventory is recorded profit for 2006 and 2007 is Tshs1,500 and Tshs1,000 respectively. Alternatively you can refer to the table below to compute the combined profit for the two years\:

	Tshs'000
Total sales (Tshs7,500 + Tshs5,000)	12,500
Total purchases	(10,000)
	2,500

From the above example it is very clear that there is a need to maintain a record of inventory through which we can determine the **income and financial position**. By accounting for opening and closing inventory, we are able to match the purchase cost of the computer to the sale proceeds that a computer generates and **report it in the correct accounting period.** A profit is earned \ a loss is incurred when you sell the computers; the computer represents a current asset owned by the entity.

1.3 Cost of goods sold / Cost of sales

The cost of sales refers to the total cost of purchasing inputs (raw materials) for a product, and the other factors of production that are made use of, in order to produce a given product during a specific accounting period. The cost of goods sold / cost of sales is calculated as follows:

	Tshs
Opening inventory	X
Add: Purchases	X
	X
Less: Closing inventory	(X)
Cost of sales	**X**

Example

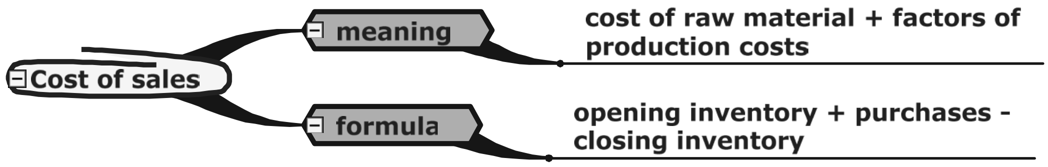
Diana is a sole trader who has bought and sold chocolates for the last 20 years. Her financial year end is 31 December. The inventory on 1 January 20X6 was Tshs50 million. During the year she purchased chocolates worth Tshs75 million. The inventory on 31 December 20X6 was Tshs20 million.

The cost of sales is:

Cost of sales	Tshs'000	Tshs'000
Opening inventory	50,000	
Add: Purchases	75,000	
	125,000	
Less: Closing inventory	(20,000)	
Cost of sales		**105,000**

Thus, the cost of sales is Tshs105 million.

SUMMARY



Test Yourself 3

Mack deals in the purchase and sale of stationery items.
From the details given below, calculate the cost of sales for the year to 31 December 20X6.

	Tshs'000
Inventory on 1 January 20X6	150,000
Purchases	200,000
Inventory on 31 December 20X6	75,000

1.4 Recording opening and closing inventory

Remember, the recording of inventory in the ledger account and maintaining details of inventory is performed in two different sets of books. The **inventory ledger account is a part of the financial accounting records whereas the inventory detail is a part of the stores records.**

In the inventory ledger account we post only the periodic totals, the details of which are available from other records.

1. Opening inventory

Definition

Opening inventory is the inventory present with the entity at the start of the accounting period.

Opening inventory, like closing inventory may **consist of raw material, work-in-progress and finished goods**.

Example

Jack commenced business to purchase and sell garments on 1 May 20X6, and his accounting year ends on 31 December.

His first accounting period is from 1 May 20X6 to 31 December 20X6. Here, as he has just commenced business there will be no opening inventory. If, during the accounting year, he purchases Tshs5 million worth of garments and sells Tshs3 million worth of garments, then his opening inventory for the next year would be Tshs2 million.

Why record opening inventory?

The opening inventory account is considered to be part of the cost of sales. The reason behind this is that the inventory held at the end of the previous year will be sold in the current year, and hence should be a part of the cost of sales for the current year.

Accounting for opening inventory

Opening inventory (which is the previous year's closing inventory – you will soon study about this) is an asset. It therefore carries debit balance, which is transferred to the cost of sales in the statement of profit or loss. After the transfer to the statement of profit or loss, there will be no balance in the opening inventory account. This transaction normally takes place at the end of the year.

Example

To continue with the example of Jack:

		Tshs'000	Tshs'000
Dr	Cost of sales (SOPL)	2,000	
Cr	Inventory (SOFP)		2,000

Being the transfer of opening inventory to the statement of profit or loss

---

2. Closing inventory

Definition

Closing inventory is inventory which is present with the entity at the end of the accounting period.

Closing inventory may **consist of raw material, work-in-progress and finished goods**.

Example

If we were to once again consider Jack's case:

The inventory present with Jack at the end of the accounting period would be worth Tshs2 million. These garments worth Tshs2 million constitute Jack's closing inventory for the accounting period.

Why record closing inventory?

Closing inventory is recorded at the end of the year by excluding it from the cost of goods sold in the statement of profit or loss. This is because these goods have not **been sold in the current year.** The **matching principle** requires only the cost of goods sold in the current year to be included in the statement of profit or loss.

Hence, the closing inventory cannot be included while calculating the cost of sales of the current year.

Accounting for closing inventory

Closing inventory is an asset because it is the result of past events of which there will be an inflow of economic resources (probably in the next financial year).

The closing inventory account is recognised as a **current asset** in the statement of financial position.

Example

Continuing the previous example of Jack,

		Tshs'000	Tshs'000
Dr	Inventory (SOFP)	2,000	
Cr	Cost of goods sales (SOPL)		2,000

Being the closing inventory recorded

Tip

Remember that the closing inventory of Year 1 will be the opening inventory of Year 2.

1.5 Disclosure of inventory in the financial statement

Opening inventory	**Happens only at the end of the year only**
First effect Second effect	Add to the cost of goods sold in the SOPL Removed from current assets in the SOFP
Closing inventory	**Happens only at the end of the year only**
First effect Second effect	Deduct from the cost of goods sold Recognised as current asset in the SOFP

As per IAS 1 Presentation of Financial Statements, inventory is classified as a current asset because:

1. It is expected to be realised, held for consumption or sale during the accounting period
2. It is held for sale
3. It is expected to be sold within a short duration, i.e. usually considered to be not more than 12 months after the end of the reporting period

(The definition and meaning of current asset is explained in detail in Study Guide F1.)

SUMMARY

2. Recognise which costs should be included in valuing inventories.

[Learning Outcome c]

You have learned about the reasons for recording inventory in the financial statements. But now the question is, at what amount should inventory be recorded in the financial statements?

We will discuss **how to value inventory and calculate** cost of inventory, i.e. what items will be included and what items will be excluded from the basic cost.

2.1 Valuation of inventory

Definition

Inventories shall be measured at the lower of cost and net realisable value.

IAS 2

2.2 Net realisable value (NRV)

Definition

Net realisable value is the **estimated selling price** in the ordinary course of business, **less the estimated costs** of completion and the estimated costs necessary to make the sale.

IAS 2

Net realisable value means the **amount which is expected to be realised** in the near future, as a result of a sale. In short, NRV is calculated as follows:

	Tshs
Estimated selling price	X
Less: Estimated cost of completion	(X)
Less: Estimated cost necessary to make the sale	(X)
NRV	**X**

Example

Tea & Cup Traders manufactured 200 antique design cups. All the cups were in the inventory on 31 December 20X6. Tea & Cup Traders can sell these cups for Tshs22 million. However, in order to sell the cups they have to be packed in a special carton. The cost of these cartons is Tshs1 million.

Here, the net realisable value of inventory is calculated as follows:

	Tshs'000
Estimated selling price	22,000
Less: Estimated cost of completion	-
Less: Estimated cost necessary to make the sale	(1,000)
NRV	**21,000**

Why would NRV fall below cost?

Fall in selling price: the sales price is the price at which the goods are sold. When the selling **price falls** it results in a **reduction of the NRV.**

Physical deterioration: the buyer of goods always intends to buy products of high quality. It may happen that during transportation or due to any other reason, the product is damaged. When the product is damaged, the buyer pays less for the product. So, the NRV falls below the cost.

Selling deliberately at a loss: if a seller wants to penetrate the market with a new product, he would deliberately sell at a loss, in order to capture a share of the market. Hence, the NRV of the product falls below the cost.

2.3 Why value inventory at lower of cost and NRV?

The **'principle of prudence'**, states that assets should **neither be overstated nor understated.** Hence the lower of the two costs is considered while valuing inventory.

The **comparison** of cost and net realisable value is to be done **item by item**. However, it may be appropriate to group similar or related items together.

Example

Tea & Cup Traders has the following items in its inventory as at 31 December 20X6:

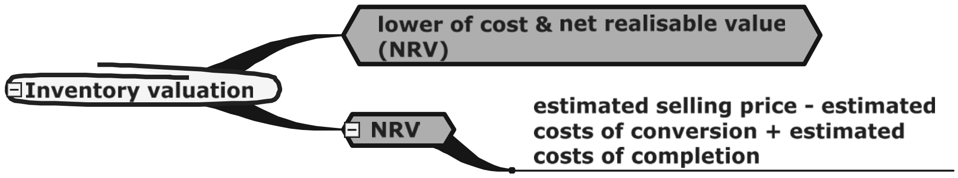
Product	Cost	Selling price	Other details
	Tshs'000	Tshs'000	
A	1,500	1,800	100% completed. Estimated selling expenses are Tshs350,000
B	1,500	1,800	100% completed. Estimated selling expenses are Tshs200,000
C	800	1,200*	80% completed. Additional cost to make 100% completed is Tshs300,000 and selling expenses Tshs200,000
(*for the final product)			

The value of closing inventory is.

Product	Cost	Selling price	NRV	Valuation
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
A	1,500	1,450	NRV = 1800 - 350 = Tshs1,450	1,450
B	1,500	1,600	NRV = 1800 - 200 = Tshs1,600	1,500
C	800	700	NRV = 1200 - 300 - 200 = Tshs700	700
			Total	**3,650**

Inventory is valued at the lower of cost and net realisable value (NRV)
NRV = selling price – selling expenses – additional costs

SUMMARY



Test Yourself 4

What is the value of closing inventory as at 31 December 20X6?

A Cost on 31 December 20X6 - Tshs10,000
B NRV on 31 December 20X6 - Tshs15,000
C Cost on 1 January 20X6 - Tshs5,000
D NRV on 1 January 20X6 - Tshs4,000

Test Yourself 5

Total Dental Care is involved in the manufacture of oral and dental care products. As at 31 December 20X9, the inventory in stock was worth Tshs12.3 million. It will cost Total Tshs2.2 million to pack its entire inventory according to the norms designed by the medical regulatory authorities. The estimated costs of completion are Tshs3.1 million.

Required:

Calculate the net realisable value of Total's inventory.

2.4 Cost of inventory

Definition

The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

IAS 2

We can therefore calculate the cost of inventory as follows:

	Tshs
Cost of purchases	X
Add: Cost of conversion	X
Add: Other costs	X
Cost of inventory	**X**

All these costs are incurred in the development of inventory to the condition it is at the date of valuation

We will examine all elements of the cost of inventory one by one.

1. Cost of purchase, the following are to be included:

(a) purchase price
(b) import duties and other taxes, which are not recoverable
(c) transport and handling costs directly attributable to purchase, (these are also known as carriage inward costs)
(d) other costs directly attributable to the purchase of materials, finished goods and services

Other important points

(i) It is to be noted that, **trade discounts** or **rebates** are **deducted if** not already deducted from the purchase price.
(ii) **Carriage outward costs** should **not be included** in the cost of inventory because these are distribution costs.

Example

The following invoice relates to a purchase made by Tea Traders.

Alpha Co Customer: Tea Traders			
	Units	**Rate**	**Tshs'000**
Product-A	10	20,000	200
Taxes			60
			260
Trade discount			(20)
Amount payable			**240**

Import duty of Tshs75,000 was charged by the custom authorities on the above consignment.

The taxes above comprised Tshs20,000 which can be reclaimed. The balance could not be claimed.

The goods were delivered by the supplier to a warehouse 50 miles away from Tea Traders' factory. The supplier incurred transport costs of Tshs30,000.

The local transportation cost incurred by Tea Traders was Tshs25,000.

Tea Traders sold product A to Mugs company. To transport this product to Mugs, Tea Traders incurred transportation costs of Tshs21,000.

Required:

Calculate the cost per unit.

Answer

The cost of purchase is:

	Units	**Rate**	**Tshs'000**
Purchase price	10	20,000	200
(+) Duties and taxes (which are not recoverable) (W1)			115
(+) Transporting and handling costs (W2)			25
(+) Other costs (directly related to acquisition of goods)			0
(-) Trade discount rebates etc.			(20)
Cost of purchase	**10**		**320**

Therefore, cost per unit

$$= \frac{\text{Total cost of purchase}}{\text{Number of units}}$$

$$= \frac{\text{Tshs}320{,}000}{10}$$

= Tshs32,000 per unit

Workings

W1 Duties and taxes

	Tshs'000	**Tshs'000**
Import duty		75
Taxes Total		
tax	60	
Recoverable	(20)	40
		115

Continued on the next page

W2 Transporting and handling costs

	Tshs'000
Cost borne by the supplier	30
Cost borne by Tea Traders	25

Only the cost borne by Tea Traders is included in the cost of purchase

W3 Carriage outward

The transportation cost of Tshs21,000 incurred to transport goods from Tea Traders to the customer will not be included in the cost of inventory, because it is a distribution cost.

---

2. Cost of conversion

Conversion refers to the **change in the condition of the material, into the finished goods**.

Example

Anna runs a boutique. She purchases different varieties of cloth. She then hires tailors to sew clothes from the cloth. The tailors cut the cloth into proper shapes and sew it with the help of scissors, needles, thread, sewing machines etc. The final product i.e. the clothes are then ready.

Therefore the cloth is a raw material and the clothes are the final product.

Costs of conversion include:

(a) Costs directly related to the production of goods
(b) Allocation of production overheads (fixed and variable)

(a) Costs directly related to the production of goods: these are the costs which are directly related to the number of units produced e.g. direct labour, direct material, direct expenses.

Example

Continuing the previous example of Anna, she will need different varieties of cloth, needles, sewing machines, thread and buttons. She will also need to hire tailors who are good at sewing and ensure that there is a proper system in place to maintain the machines. All these are costs directly related to the production of the clothes.

(b) Allocation of production overheads: overheads are the indirect costs which are not directly attributable to production.

Example

Continuing the previous example of Anna,

She also needs a factory to produce the clothes and will therefore have to incur the additional costs of a watchman to look after the factory. Security costs are not directly attributable to the clothes, but necessary to produce them, and therefore a portion can be included in the cost of production.

There are two types of production overheads:

Fixed production overheads: these overheads remain constant over a period of time regardless of the volume of production e.g. depreciation on plant, rent for factory. Allocation of fixed overheads is based on normal capacity.

Variable production overheads: these overheads vary according to the production e.g. factory management costs, power and fuel etc. Allocation of variable overheads is based on the level of production.

3. **Other costs:** it includes all those costs which are incurred to bring the inventory to its present location and condition. For example, the final production cost of a computer will also include the cost of packing it in a box. However if the customer needs some additional packing the cost is not included in the cost of inventory.

Test Yourself 6

A product is manufactured according to the specifications given by the customer. The material cost is Tshs10 million and wages are Tshs20 million. Professional fees of Tshs20 million are paid for the design of the product.

Required:

Calculate the total cost of production.

2.5 Costs excluded from the valuation of inventories

All costs other than those explained above will be excluded from the cost of inventory. Some examples are:

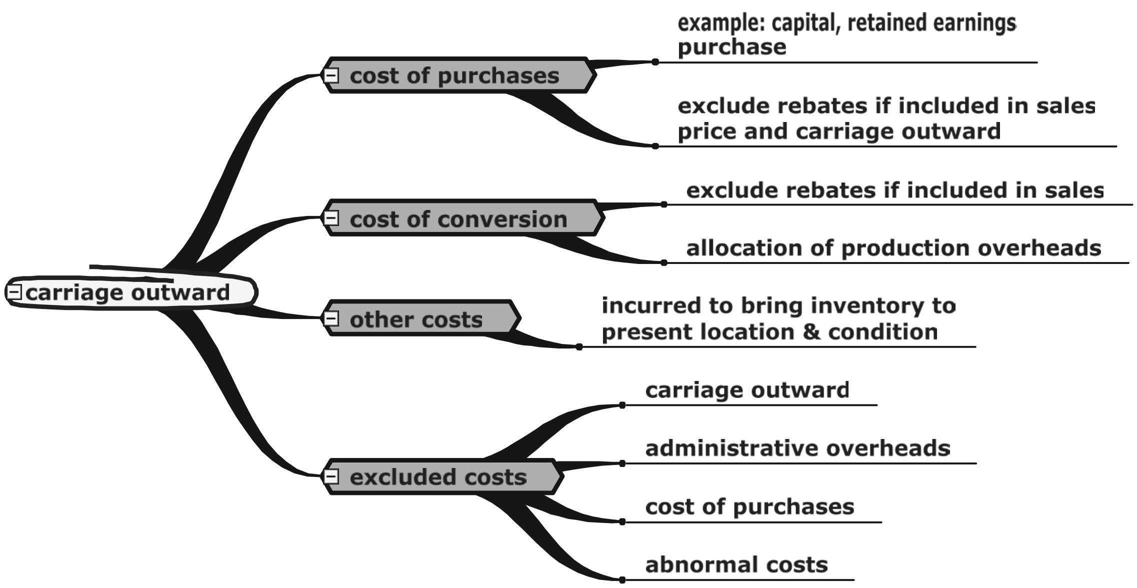
1. **Carriage outward**: are considered as distribution costs and hence will not be included in the cost of inventory.

2. **Administrative overheads**: are costs which are incurred for running the business (e.g. salaries paid to office staff, rent for office, etc.) and hence will not be included in the cost of inventory.

3. **Selling and storage expenses:** selling expenses (e.g. commission paid to salesmen, etc.) are again distribution costs, and so will not be included in the cost of production.

4. **Abnormal costs:** the costs which are not incurred for production, but which are incurred due to an abnormality of some process in production are known as abnormal costs, e.g. loss of material by fire, loss due to theft, etc.

SUMMARY



2.6 Cost formulae

We have seen which elements are included and which are excluded from the cost of inventory. Now, we will see how to calculate the cost of inventory if there are identical units purchased at different costs.

Example

Almond Inc has made the following purchases during 20X6:

Date	Quantity	Rate	Tshs
01/01/20X6	500	350	175,000
06/10/20X6	900	375	337,500
12/12/20X6	1,000	390	390,000
Total	**2,400**		**902,500**

Let us suppose at the end of 20X6, 2000 items of material remained in inventory. Almond Inc does not know which lot these materials relates to i.e. do they relate to purchases on 1 January or 6 October or 12 December? What rate should it use to value the inventory?

The above difficulty can be resolved by applying a cost formula as discussed in **IAS 2 Inventories.**

IAS 2 prescribes assigning specific costs to inventories i.e. each item should be assigned its specific cost.

However, if it is difficult to calculate, then the following methods should be adopted:

First in first out (FIFO)
Weighted average cost (WAC). Also known as average cost method (AVCO).
Last in first out (LIFO) (Not allowed in IAS 2)

An entity can use different methods if it can justify them. FIFO and AVCO are explained in detail in Learning Outcome 6 of this Study Guide.

3. Explain the use of continuous and period end inventory records.

[Learning Outcome d]

Inventory is an important asset of an entity. The financial statements will be misleading if inventory is not recorded accurately. Management also has to have the quantitative details – in order to know when to reorder etc.

There are two methods of maintaining inventory records:

Period end inventory records, and,
Continuous inventory records

3.1 Period end inventory records

Under this system, inventory is physically counted at the end of an accounting period. This procedure is called **inventory counting** or stock taking. A list of all items in inventory is prepared and accordingly the inventory is valued. **This system of maintaining inventory records is useful for small organisations that hold small levels of inventory.**

3.2 Continuous inventory records

A separate department, the 'stores department' is formed. The store keeper is responsible for maintaining the necessary details of inventory items. Usual records include the material inwards, material outwards, scrap, bin card, inventory ledger etc. **This system is useful for medium and large organisations where larger quantities of inventory are stored.**

Under this method of record keeping, the stores manager **physically verifies** the inventory and compares it with the records whenever there is any inflow and outflow of goods in the stores department. In this way, the **inventory counting** is continuously carried out.

3.3 Need for inventory count

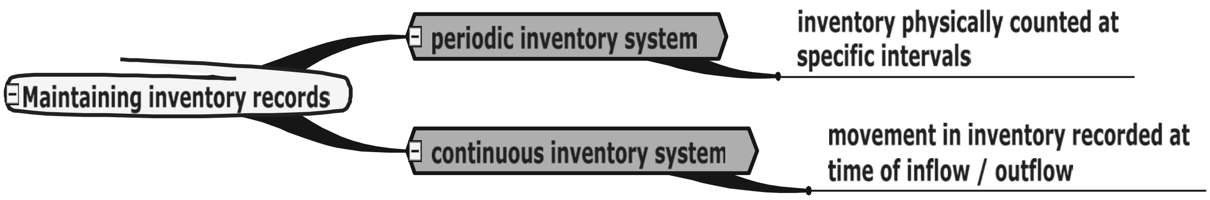
You should keep in mind that physical counting of inventory is undertaken even if continuous inventory records are maintained. A physical inventory count helps to check the accuracy of the quantitative details of the inventory records.

Inventory is valued on the basis of the quantity given by the inventory records. If there is any difference between the physical inventory and the inventory according to the records then this difference has to be adjusted in the books of accounts or further investigated if the difference proves to be suspicious.

Example

Jack and Jill Co when counting its inventory at the end of the reporting period found a difference between the physical inventory and the recorded inventory. The inventory recognised in the statement of financial position will be the value of the revised quantity in the inventory records.

SUMMARY



Test Yourself 7

Which system of maintaining inventory records is suitable for small organisations?

A Period-end inventory
B Continuous inventory
C Both A and B
D Neither A or B

---

4. Explain and apply the IASB requirements in IAS 2 for valuing inventories.

Calculate the value of closing inventory and the cost of goods sold using FIFO (first in, first out) and AVCO (average cost).

[Learning Outcomes b and e]

There are two main **methods used to value closing inventory**. They are:

First in first out (FIFO)
Average cost (AVCO)

4.1 First in first out (FIFO)

In this method, **inventories are valued on the assumption that material which is received first will be consumed first, and material which is received later will be consumed later**.

Consumption of material is in the same order as that of purchase. The valuation of inventory is done on the assumption that the units which are purchased later will remain in the inventory.

Example

Tea & Cup Traders have incurred the following transactions:

1 January 20X6 purchased raw material 500 units for Tshs5,000
2 January 20X6 purchased raw material 200 units for Tshs2,400
3 January 20X6 issued 600 units for production
15 October 20X6 purchased raw material 300 units for Tshs4,500
30 October 20X6 purchased raw material 200 units for Tshs2,500
1 November 20X6 issued raw material 250 units

Calculate the quantity and value of inventory on 31 December 20X6 using the FIFO method.

Tea & Cup Traders										
Raw material ledger card (FIFO method)										
Date		Receipts			Issues			Balance		
		Qty	Rate	Tshs	Qty	Rate	Tshs	Qty	Rate	Tshs
01/01/20X6	Purchases	500	10	5,000	-		-	500	10	5,000
										5,000
02/01/20X6	Purchases	200	12	2,400	-		-	500	10	5,000
								200	12	2,400
										7,400
03/01/20X6	Used in production	-		-	500	10	5,000	100	12	1,200
					100	12	1,200			**1,200**
							(note1)			
15/10/20X6	Purchases	300	15	4,500	-		-	100	12	1,200
								300	15	4,500
										5,700
30/10/20X6	Purchases	200	12.5	2,500	-		-	100	12	1,200
								300	15	4,500
								200	12.5	2,500
										8,200
01/11/20X6	Used in production	-		-	100	12	1,200	150	15	2,250
					150	15	2,250	200	12.5	2,500
				14,400			**9,650**	**350**		**4,750**

The inventory on 31 December 20X6 consists of 350 units with the valuation of 2250 for 150 units and 2,500 for 200 units.

Notes

1. Under the FIFO method it is assumed that the units which are purchased first are consumed first.
2. Issues mean material taken out of the stores. Issues can either be for production or sale out of the entity.

Valuation as per the FIFO method is Tshs**4,750.** This value is **compared** with the **net realisable value** of these units. Closing inventory will be valued at the lower of these two amounts.

It is to be noted here, this is just the valuation of raw materials. Valuation of semi-finished products and finished products will also be done on a similar basis.

FIFO is suitable where perishable goods are concerned and where transactions are limited.

Advantages of FIFO

1. It is easy to operate and understand.
2. In the case of falling prices, this method gives better results.
3. The closing inventory of materials will be very close to the current market price.
4. Material cost charged to production, represents the actual cost with which the cost of production should have been charged.

Disadvantages of FIFO

If prices fluctuate frequently, this method may lead to clerical error.

Test Yourself 8

Energize Inc values its inventories at cost under the FIFO method. Calculate the value of inventory on 31 March 20X7.

20X6			
1 April 1 December	Opening inventory sold	200 batteries 100 batteries	at Tshs100,000 each at Tshs120,000 each
20X7			
1 January	purchased	50 batteries	at Tshs110,000 each

4.2 Average Cost (AVCO)

You have seen that under the FIFO method, the entity has to keep detailed records of issues and receipts of each item of inventory. Unless this is done properly, the valuation of inventory is not possible.

To overcome this difficulty another method of valuation is used which is called Average Cost. Under this method materials are issued at the **average price of purchases.** Inventory is valued on the basis of the average price paid for the goods, weighted to quantity purchased at each price.

Example

Continuing the above example of Tea and Cup Traders

We can solve the above example for Tea and Cup Traders using weighted average cost as follows:

1 January 20X6 purchased raw material 500 units for Tshs5,000
2 January 20X6 purchased raw material 200 units for Tshs2,400
3 January 20X6 issued 600 units for production.
15 October 20X6 purchased raw material 300 units for Tshs4,500
30 October 20X6 purchased raw material 200 units for Tshs2,500
1 November 20X6 issued raw material 250 units.

Answer

Tea and Cup Traders Raw material ledger card (Average Cost)										
Date		**Receipts**			**Issues**			**Balance**		
		Qty		**Tshs**	**Qty**		**Tshs**	**Qty**		**Tshs**
01/01/20X6	Purchases	500	10	5,000	-		-	500	10	5,000
02/01/20X6	Purchases	200	12	2,400	-		-	700	10.57 (note1)	7,400
03/01/20X6	Used in production	-		-	600	10.57 (note2)	6,343 (note3)	100	10.57	1,057
15/10/20X6	Purchases	300	15	4,500	-		-	400	13.89 (note4)	5,557
30/10/20X6	Purchases	200	12.5	2,500	-		-	600	13.43	8,057
01/11/20X6	Used in production	-		-	250	13.43	3,357	350	13.43	4,700

Continued on the next page

Notes

1. Closing inventory is valued at the average price of all purchases
   Total purchases = 5,000 + 2,400 = 7,400
   Total quantity = 500 + 200 = 700
   So, average price = 7,400/700 = Tshs10.57

2. Materials are issued at the rate assigned i.e. the average price to the closing inventory.

3. Materials are issued at the weighted average cost before the issue.

4. Purchases of 15/10/20X6 are valued as follows:

Balance b/d	100 units
Purchase	300 units
Total quantity	**400 units**
Value of balance b/d quantity	Tshs1,057
Value of purchase quantity	Tshs4,500
Total value	**Tshs5,557**
Average price	Tshs5,557/400 units
	Tshs13.89

The inventory on 31 December 20X6 consists of 350 units valued at Tshs4,700.

Valuation as per the AVCO method is Tshs4,700. This value is compared with the net realisable value of these units. Closing inventory is valued at the lower of these two costs.

It is to be noted, this is just the valuation of raw material. The valuation of semi-finished products and finished products will also be done on a similar basis. Spare parts also form part of the inventory.

Advantages of weighted average method

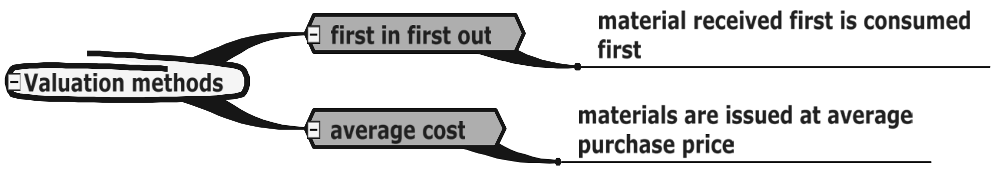
1. The weighted average price combines prior period price with current period price, and so does not cause any fluctuations in the issue price.

2. Issue price, need not be calculated unless a new lot of material is received.

Disadvantages of weighted average method

Material cost price does not reflect actual cost price.

SUMMARY



Test Yourself 9

While valuing inventory which of the following is true?

A FIFO is considered for all types of goods.
B FIFO is applicable only for perishable goods.
C In calculating FIFO the materials received first are issued first.
D None of the above.

4.3 Summary of the requirements as per IAS 2 Inventories

Inventories	Inventories are assets held for sale in the ordinary course of business in the process of production, for sale in the form of material or supplies to be consumed
Net realisable value	the estimated selling price in the ordinary course of business **less** the estimated costs of completion **less** the estimated costs necessary to make the sale
Valuation of inventory	Lower of cost and net realisable value
Cost formula	FIFO, weighted average method, specific identification Not ordinarily interchangeable items - specific identification method2. ordinarily interchange – FIFO / AVCO
Disclosure in the financial statement	accounting policy for measuring the inventory including the cost formula total carrying amount of inventory carrying amount of inventories carried at fair value write downs recognised during the year carrying amount of inventories pledged as security for liabilities

All of these concepts have been discussed throughout this Study Guide.

5. Identify the impact of inventory valuation methods on profit and on assets.

[Learning Outcome f]

Different methods of valuing inventory would result in different values for the closing inventory. The closing inventory of one year becomes the opening inventory of the next year. Hence, the opening inventory is also affected.

Opening inventory is added to cost of sales and closing inventory is reduced from cost of sales. A difference in the value of inventory means that the reported profit (loss) will also change according to the method of valuation adopted.

Inventory is recognised as a current asset in the statement of financial position. Hence the value of assets also changes according to the method of valuation adopted.

We will see the impact on profit and on assets when different methods of valuation of inventory are adopted.

Example

We saw in the above example of Tea & Cup Traders, that under the FIFO method, inventory valuation was Tshs4,750,000 and under the average cost method it was Tshs4,700,000.

The following information is also available:

Particulars	Tshs'000	Particulars	Tshs'000
Opening inventory	2,000	Expenses	10,000
Purchases	35,000	Assets	20,000
Sales	50,000	Capital and other liabilities	17,000

Tea & Cup Traders - Statement of profit or loss for the year to 31 December 20X6

	Inventory valuation method	
	FIFO	AVCO
	Tshs'000	Tshs'000
Sales (a)	**50,000**	**50,000**
Cost of goods sold		
Opening inventory	2,000	2,000
Add: Purchases	35,000	35,000
	37,000	37,000
Less: Closing inventory	(4,750)	(4,700)
Cost of goods sold (b)	**32,250**	**32,300**
Gross profit (a - b)	**17,750**	**17,700**
Expenses	(10,000)	(10,000)
Profit	**7,750**	**7,700**

Tea & Cup Traders - Statement of financial position for the year ended 31 December 20X6

	Inventory valuation method	
	FIFO	Weighted average
	Tshs'000	Tshs'000
Assets		
Other assets	20,000	20,000
Inventory	4,750	4,700
Total	**24,750**	**24,700**
Capital and liability		
Capital and other liabilities	17,000	17,000
Retained earnings (profit)	7,750	7,700
Total	**24,750**	**24,700**

From the above example we can also conclude:,

During period of inflation, the profits and inventory valued under FIFO method will be higher than under AVCO method.

However as the closing inventory of one period is carried over as the opening inventory for the next period, the profits and assets of the next year are proportionately reduced to that extent.

Test Yourself 10

Which of the following inventory valuation methods is likely to lead to the lowest figure for closing inventory at a time when prices are rising?

A Average cost
B First in, first out (FIFO)
C Last in, first out (LIFO)
D Replacement cost

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

Both (a) and (b) because computers which are held for sale, and computer hard disks, chips, pen drives, cords etc. are all inventory.

Answer to TY 2

The correct answer is False.

Tyres used in the manufacture of cars, would form the finished product for the tyre manufacturing company and would be raw material for the car assembly plant.

Answer to TY 3

Cost of sales is calculated as follows:

Cost of sales	**Tshs'000**
Opening inventory	150,000
Add: Purchases	200,000
	350,000
Less: Closing inventory	(75,000)
Cost of sales	**275,000**

Answer to TY 4

The correct option is **A**.

Since the question requires closing inventory to be calculated, the value as on 31 December 20X6 is to be considered.

Inventory is to be valued at lower of cost or NRV.

Here, cost = Tshs10,000
NRV = Tshs15,000

Lower of the two = cost = Tshs10,000, is the value of closing inventory.

Answer to TY 5

The net realisable value of Total's inventory is calculated as follows:

	Tshs'000
Estimated selling price	12,300
Less: Estimated cost of completion	(3,100)
Less: Estimated cost necessary to make the sale	(2,200)
NRV	**7,000**

Answer to TY 6

	Tshs'000
Materials	10,000
Wages	20,000
Other costs	20,000
Total cost of inventory	**50,000**

Being cost incurred for bringing the material to its present condition (finished product).

Here, the fee paid to the professional is other cost, and will be included in the cost of the product.

So, the total cost of the product will be: Tshs50 million.

Answer to TY 7

The correct option is **A.**

Under the period-end inventory system, inventory is physically counted at the end of an accounting period. Small business organisations find it convenient to conduct physical inventory verification once a year rather than on a continuous basis.

Answer to TY 8

Energize Inc										
Batteries ledger card (FIFO method)										
Date		**Receipts**			**Issues**			**Balance**		
		Qty	**Rate**	**Total**	**Qty**	**Rate**	**Total**	**Qty**	**Rate**	**Total**
20X6			**Tshs'000**	**Tshs'000**		**Tshs'000**			**Tshs'000**	**Tshs'000**
01/04	Opening inventory	200	100	20,000	-		-	200	100	20,000
01/12	Sales				100	100 (note1)	10,000	100	100	10,000
01/01	Purchases	50	110	5,500				100	100	10,000
								50	110	5,500
				25,500			**10,000**	**150**		**15,500**

Note 1: We have taken the cost price and not the sale price of batteries when valuing inventory levels. Value of closing inventory = Tshs15.5 million

Answer to TY 9

The correct option is **C**.

In valuing goods in the FIFO method materials received first are issued first.

Answer to TY 10

The correct option is **C.**

When inventories are valued at LIFO, this means that issues are made at latest prices (higher value) and the inventories in hand are therefore valued at historical cost (lower price).

Self Examination Questions

Question 1

Inventory should be valued at

Question 2

According to IAS 2 Inventories, which of the following costs should be included when valuing the inventory of a manufacturing company?

(i) Carriage inwards
(ii) Carriage outwards
(iii) Depreciation of factory plant
(iv) General administrative overheads

A All four items
B 1, 2 and 4
C 2 and 3
D 1 and 3

Question 3

What is the value of closing inventory in the following case?

Category	Cost	NRV
	Tshs'000	Tshs'000
A	200	100
B	100	200
C	250	200

Question 4

The valuation at lower of cost and net realisable value is an application of:

Question 5

BNG Inc valued its closing inventory for 31 December 20X6 at Tshs50 million. The profit disclosed during 20X6 was Tshs80 million. After some time it was found that the correct value of inventory was Tshs45 million. In this case:

A The profit was understated by Tshs5 million
B The profit was overstated by Tshs50 million
C The profit was overstated by Tshs5 million
D None of the above

Question 6

A company's closing inventory was overstated by Tshs20 million.

What is the effect on profit?

A Next year's profits will be overstated and the current year's profits will be overstated
B Next year's profits will be understated and the current year's profits will be understated
C Next year's profits will be understated and the current year's profits will be overstated
D Next year's profits will be overstated and the current year's profits will be understated.

Question 7

High-tech Computers trade in computers. From the following details calculate:

(a) amount of sales
(b) cost of sales
(c) value and quantity of inventory at the end of 20X6.

Calculate your answer using FIFO method.

1. Opening inventory on 1 January 20X6: 100 computers of Tshs350,000 each under FIFO method.
2. Purchases: 1 August 20X6, 250 computers at Tshs390,000 each.
3. Sales:
   15 February 20X6, 75 computers for Tshs400,000 each
   13 September 20X6, 20 computers for Tshs420,000 each.

Question 8

BRG Inc bought 50 hard disks for Tshs125,000 each. On the next occasion it purchased 75 hard disks for Tshs150,000 each. 100 computers were sold for 150 each.

What will be the value of closing inventory according to the FIFO method?

A Tshs3,500,000
B Tshs3,750,000
C Tshs3,125,000
D Tshs3,225,000

Question 9

For the above data, what will be the value of closing inventory according to the Average Cost method?

Question 10

On its statement of financial position, a bakery shows the following costs:

butter Tshs2,500 (NRV Tshs2,000),
eggs -Tshs500 (NRV 550),
cake mixture - 6,000 (NRV 5,900)
cakes -Tshs7,000 (NRV Tshs9,000)

What will be the value of the total closing inventory?

A Tshs7,000
B Tshs2,500
C Tshs15,400
D None of the above

Question 11

Which accounting concept which prevents the firms from frequently changing the inventory valuation method they use?

A Materiality concept
B Consistency concept
C Prudence concept
D Going concern concept.

Question 12

A fire on 30 September destroyed some of a company's inventory and its inventory records. The following information is available:

	Tshs'000
Inventory 1 September	318,000
Sales for September	612,000
Purchases for September	412,000
Inventory in good condition at 30 September	214,000

Standard gross profit percentage on sales is 25%.

Based on this information, what is the value of the inventory lost?

Answers to Self Examination Questions

Answer to SEQ 1

It is lower of cost and net realisable value.

Answer to SEQ 2

The correct option is **D**.

The cost of inventories includes all:

1. costs of purchase
2. costs of conversion
3. costs are incurred to bring inventories to their present location and condition.

Hence, carriage outwards is not included in the cost of inventory as it is a distribution cost. General administration overheads being costs of running the business are not included in the costs of inventory.

Answer to SEQ 3

The comparison of cost and NRV should be done for each category.

In this case, the valuation will be as follows:

Category	Tshs'000
A	100
B	100
C	200
Total	**400**

Answer to SEQ 4

Prudence. Under the concept of prudence, assets are not overvalued.

Answer to SEQ 5

The correct option is **C**.

The closing inventory is recorded on the credit side of the statement of profit or loss. Hence, recording closing inventory increases the profits. Closing inventory and profits have a direct relationship. If closing inventory is overstated that means profits are also overstated.

	Closing inventory	Gross profit	Impact
	Tshs'000	**Tshs'000**	**Tshs'000**
Closing Inventory initially recorded	50,000	80,000	If closing inventory overstated, profit overstated.
After rectification of error in closing inventory recorded	45,000	80,000 – 5,000 = 75,000	If closing inventory reduced byTshs5,000, profits reduced by Tshs5,000 as well

Answer to SEQ 6

The correct option is **C**.

This is because this year's profit is overstated, as closing inventory is recorded at more value.

This overstated value of closing inventory will be carried to the next year as opening inventory; so, the next year's profit will be understated by Tshs20 million.

Answer to SEQ 7

(a) To calculate sales and purchases we need to complete the sales and purchase day books.

Sales day book				
Date		**Qty**	**Rate**	**Total**
			Tshs'000	**Tshs'000**
15/02/20X6	Sales	75	400	30,000
13/11/20X6	Sales	20	420	8,400
	Total			**38,400**

Purchase day book				
Date		**Qty**	**Rate**	**Total**
			Tshs'000	**Tshs'000**
01/08/20X6	Purchases	250	390	97,500
	Total			**97,500**

(b) The statement of profit or loss from the above details would be:

	Tshs'000	**Tshs'000**
Sales		38,400
Less: Cost of sales		
Opening inventory	35,000	
(+) Purchases	97,500	
	132,500	
(-) Closing inventory	99,250	(33,250)
Gross profit		**5,150**

(c)

High-tech Computers - Inventory valuation										
		Receipts			**Issues**			**Balance FIFO**		
Date		**Qty**	**Rate**	**Total**	**Qty**	**Rate**	**Total**	**Qty**	**Rate**	**Total**
20X6			**Tshs'000**	**Tshs'000**		**Tshs'000**	**Tshs'000**		**Tshs'000**	**Tshs'000**
01/01	Opening inventory							100	350	35,000
										35,000
15/02	Sales				75	350(note1)	26,250	25	350	8,750
										8,750
01/08	Purchases	250	390	97,500				25	350	8,750
								250	390	97,500
										106,250
13/09	Sales				20	350	7,000	5	350	1,750
								250	390	97,500
Total				**97,500**			**33,250**			**99,250**

Note 1: the issue rate is not the selling price of goods, but the cost of those goods.

Answer to SEQ 8

The correct option is **B**.

	Qty	Rate per unit	Total
		Tshs'000	**Tshs'000**
Purchase	50	125	6,250
Purchase	75	150	11,250
	125		**17,500**
Sales	50	125	6,250
	50	150	7,500
Total sales			13,750
Balance	**25**		**3,750**

Answer to SEQ 9

The correct option is **A**.

	Qty	Rate per unit	Tshs
Purchase	50	125	6,250
Purchase	75	150	11,250
	125	140	17,500
Sales	100	140(note1)	14,000
Balance	**25**		**3,500**

Note 1: $\text{Average price} = \frac{\text{Tshs}17{,}500}{125} = 140$

Answer to SEQ 10

The correct option is **C**.

The closing inventory will be valued at cost or net realisable value; whichever is lower. Hence the calculation of closing inventory is as follows:

	Cost	NRV	Valuation
	Tshs	**Tshs**	**Tshs**
Raw material			
Butter	2,500	2,000	2,000
Eggs	500	550	500
Intermediary product			
Cake mixture	6,000	5,900	5,900
Finished product			
Cake	7,000	9,000	7,000
Total			**15,400**

Answer to SEQ 11

The correct option is **B**.

The consistency concept

Answer to SEQ 12

The value of inventory destroyed can be calculated as follows:

	Tshs'000
Inventory 1 September	318,000
Purchases for September	412,000
	730,000
Less: Cost of sales for September (Tshs612,000 x 75%)	(459,000)
	271,000
Less: Inventory in good condition at 30 September	(214,000)
Cost of inventory destroyed in the fire	**57,000**

Several students erroneously perform the calculation of cost of sales as Tshs612,000 /125%. Be careful

SECTION F

ACCOUNTING TREATMENT FOR PROPERTY, PLANT AND EQUIPMENT (IAS 16)

4

TANGIBLE NON-CURRENT ASSETS

Get Through Intro

A 'tangible non-current asset' is an asset acquired by an entity for long-term use and which has physical presence i.e. it can be touched. A machine is a tangible non-current asset. Why do we say so?

A machine is used for a long period of time – for more than one accounting period. A machine produces goods which when sold will lead to an inflow of economic resources. Hence it is a non-current asset. A machine has physical presence – it can be touched. Therefore it is a tangible non-current asset.

An accountant has to be very careful when he classifies assets as either current or non-current. He also has to know which costs can be capitalised and the treatment to be given on revaluations and disposal of the non-current assets. Any mistakes in the interpretation and treatment given to these items can affect the reliability of the financial statements.

For example – Cheerleader Inc has had a bad year. Its profits have fallen from Tshs150 million in the last year to Tshs130 million in the current year. The accountant suggests that they should capitalise repairs to machinery by Tshs40 million in order to show more profits. The revised profits would be Tshs170 million (Tshs130 million + Tshs40 million).

What is capitalisation?
How can a mere change in an accounting entry help an entity to show more profits?
Would the directors accept the accountant's suggestion?
Would the auditors allow it?

These questions come to mind when one reads the example. This Study Guide will help you understand why Cheerleader Inc cannot act upon the accountant's suggestion and how important it is for an accountant to know the principles which help determine the classification of assets.

Learning Outcomes

a) Define and identify non-current assets.
b) Describe the difference between current and non-current assets.
c) Explain the difference between capital and revenue items.
d) Classify expenditure as capital or revenue expenditure.
e) Prepare ledger entries to record the acquisition and disposal of non-current assets.
f) Calculate and record profits or losses on disposal of non-current assets in the statement of income including part exchange transactions.
g) Record the revaluation of a non-current asset in ledger accounts, the statement of income and in the statement of financial position.
h) Calculate the profit or loss on disposal of a revalued asset.
i) Illustrate how non-current asset balances and movements are disclosed in notes to the financial statements.
j) Explain the purpose and operation of an asset register.

1. Define and identify non-current assets.
Describe the difference between current and non-current assets.
[Learning Outcomes a and b]

1.1 Current assets and non-current assets

IAS 1 defines a non-current asset as follows:

Definition

All **assets other than the current assets** shall be **classified as non-current assets**.

IAS 1

A non-current asset is defined in a negative manner as it is an asset which is not a current asset. Hence we first need to understand the meaning of current assets.

Definition

An asset should be classified as a current asset when it satisfies any of the following criteria:

- It is expected to be **realised in**, or is **intended for sale or consumption in**, the entity's **normal operating cycle**;
- It is held primarily for the purpose of **being traded**;
- It is expected to be **realised within twelve months** after the end of the reporting period; or
- It is **cash or a cash equivalent**

IAS 1

We shall now discuss this definition:

- **expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle:** a normal operating cycle refers to the duration within which the item is purchased, processed and cash been paid for it.

Example

Hi-tech Computers runs a business of manufacturing computers. The time period between buying the raw material, paying the suppliers, converting the raw material into computers, selling them to customers and recovering the amount from its sale is the normal operating cycle of Hi-tech Computers.

- **purpose of being traded:** a current asset is an item which is purchased by an entity with the intention of selling it. These items are not retained for long term use.

Example

Michael is a sole trader who sells furniture. In this case furniture is his current asset because it is **purchased** for resale. However, the furniture which Michael purchases in order to use in his own office is not a current asset.

- **realised within twelve months:** if an asset is expected to be sold within **twelve months** after the end of the reporting period, then such an asset is called a current asset. If an asset is expected to be held for more than one year then such an asset is called a non-current asset.

- **cash or cash equivalent:** cash equivalents are highly liquid investments that can be easily converted into cash (usually within three months) and where there is little chance of its value being subject to change. You learn more about cash and cash equivalents in Study Guide I4.

Example

Michael has a bank account with Heavenly Investments bank. The balance in the account is Tshs500,000. He also has cash in hand worth Tshs100,000 and Government securities (worth Tshs50,000) with a maturity period of 3 months.

Here, the bank balance of Tshs500,000, cash in hand of Tshs100,000 and Government securities worth Tshs50,000 are all his current assets.

Government securities are current assets because they are cash equivalent as they can be easily converted to cash within a year.

Test Yourself 1

Classify the following items as current assets and non-current assets in the books of Smart Co – a manufacturer of television sets.

A Plant and Machinery
B Inventory
C Cash and bank balance
D Furniture and fixtures
E Raw material

Comparison of current and non-current assets

Current assets	Non-current assets
Expected to be realised within the normal operating cycle of the entity.	Expected to be used for many accounting periods.
Intended for sale or consumption.	Intended to be used over a longer period of time in the process of manufacturing or trading
Used for trading purposes.	Used for investment and to aid the manufacturing or trading process.
Realised within twelve months.	Held for more than twelve months.
Profitability is directly affected.	The effect on profitability is indirect.

Classification of an asset as current or non-current depends upon how the asset is being used. An asset which is a current asset for one entity can be a non-current asset for another entity.

Example

John is a dealer of computers. He purchased five computers for Tshs20,000 each. The following month he sold them for Tshs40,000 each. As he is a dealer of computers and purchases computers for further sale, the computers are his current assets.

Jill runs a clothing business and purchases computers from John for her office. The computers Jill purchases are not for further sale but are retained in the business. For Jill, the computers are classified as non-current assets.

1.2 Tangible and Intangible non-current assets

The word 'tangible' means something that can be seen, touched or felt. On the contrary, the word 'intangible' means something that cannot be seen, touched or felt.

Hence**, a tangible non-current asset** is a non-current asset which physically exists. i.e. we can see, touch and feel this asset.

Example

Tangible non-current assets are plant and machinery, equipment, furniture and fixtures etc.

An intangible non-current asset is a non-current asset which does not exist physically i.e. we cannot see, touch and feel this asset.

Example

Intangible assets are goodwill, patents, copyrights etc.

Test Yourself 2

Classify the assets of Sun Inc. and Home Decorators into current and non-current:

Sun Inc is a manufacturer of steel

(a) Plant and Machinery
(b) Cash and bank balance
(c) Inventory of finished steel
(d) Computers
(e) Iron ore (a raw material in the manufacture of steel)
(f) Furniture and fixtures
(g) Vehicles

Home Decorators is a trader of furniture

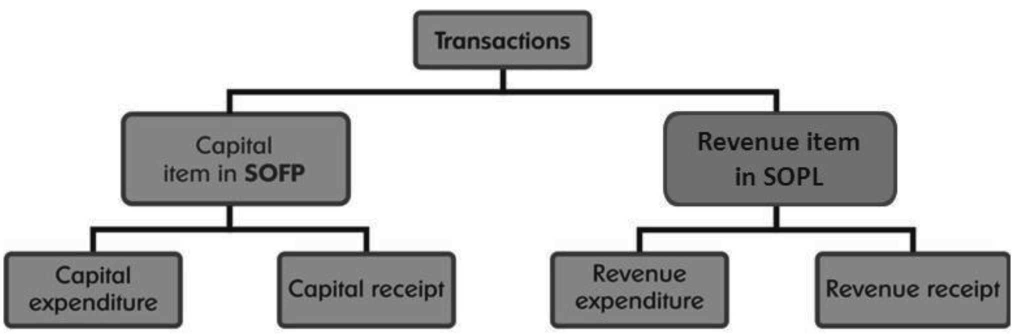
(a) Vehicles
(b) Bank balance
(c) Computers
(d) Furniture and fixtures for resale

---

2. Explain the difference between capital and revenue items. Classify expenditure as capital or revenue expenditure.

[Learning Outcomes c and d]

Diagram 1: Classification of items / transactions



2.1 Capital items: are those items which affect the statement of financial position.

Capital items are of two types: capital **expenditure** and capital **receipt.**

1. Capital expenditure

Capital expenditure is the expenditure which improves the **earning capacity** of an asset so that the asset works more efficiently or lasts longer. This benefit can be expected to last for more than one accounting period.

	Nature of expense	Example
1.	Purchase of non-current assets	Computers, vehicles, building, land, plant and machinery
2.	Cost of bringing the non-current asset into the entity	carriage inward
3.	Legal and professional cost spent on purchasing non-current assets	Stamp duty, registration fees, solicitor's fees, architect's fees.
4.	Cost needed to make these non-current assets ready for use	Installation charges
5.	Improvement to existing non-current assets	Fitting of air conditioner in vehicles

Capital expenditure increases the value of a non-current asset. This means that the working capacity and the life of the asset are increased. This results in long lasting benefits to the entity.

Capitalisation of expenditure: When expenses are recorded in the books of accounts as an increase in the cost of a non-current asset, it is known as capitalisation of expenditure.

Example

On 2 January 20X6, Diana purchased land worth Tshs900 million from Jack. She paid Tshs50 million stamp duty on the purchase price. This amount of Tshs50 million is included in the cost of the land bringing the total cost of the land purchased to Tshs950 million. In Diana's accounts, the cost of the land will be recorded as Tshs950 million.

(You will learn later on in this Study Guide why stamp duty of Tshs50 million is included in the purchase price.)

---

2. Capital receipt

Capital receipt is income which is earned because not of the ordinary activities / regular operations of an entity i.e. not realised by the sale of the merchandise of the entity.

When an item of capital expenditure is sold, the receipt thus generated is called a capital receipt.

A capital receipt decreases the value of a non-current asset.

Example

	Capital receipt
1.	Sale of non-current asset
2.	Receipt of share capital or capital
3.	Receipt of loans and debentures
4.	Premium received on issue of shares

Example

Michael had a building worth Tshs700 million, which he purchased in 19W0 at a cost of Tshs50 million. On 15 November 20X6, he sold the building for Tshs950 million.

Here, Michael has received Tshs950 million as he sold the building, an asset. Hence, Tshs950 million is a capital receipt.

2.2 Revenue items: are those items which affect the statement of profit or loss.

Revenue items consist of two types: revenue **expenditure** and revenue receipt.

1. Revenue expenditure

Revenue expenditure is that expenditure which is incurred to **maintain the existing capacity** of an asset so that it can do its daily work. It is a regular expenditure incurred from time to time in the ordinary course of the business**.**

'Maintaining' the existing capacity of the asset means keeping the asset in a proper working condition so that the productivity of the asset is not reduced. Revenue expenditure provides benefit of a current nature i.e. the benefit arising out of revenue expenses expires in the same accounting period.

Example

Mack purchased computers for Tshs1,500,000 and computer stationery for Tshs50,000. These two expenditures will benefit Mack for different periods. The computers will give benefit of an enduring nature i.e. benefit for a longer duration whereas the expenditure on computer stationery will give benefit of a comparatively short duration. Hence:

purchase of computers Tshs1,500,000 will be treated as **capital** expenditure; and
purchase of computer stationery Tshs50,000 will be treated as **revenue** expenditure.

2. Revenue receipt

A revenue receipt is a **regular** receipt i.e. these transactions are regularly entered into in an entity in the ordinary course of the entity's activities

Revenue receipts are a result of sale of the merchandise of the entity and other revenue items like rent received or commission received.

Example

Michael gave his building on rent to Sam. The monthly rent received is Tshs5,000,000. Therefore, the amount received by Michael is Tshs5,000,000 is his revenue receipt.

Example

The chart given below shows why Better Plc. classified the expenses it incurred as capital or revenue expenses.

Nature of expense	Classification	Reason
Cost of machinery	Capital expenditure	Machinery will be used in business for long term.
Cost of installing the machinery	Capital expenditure	**Costs can be directly attributed** to bringing the asset to its intended location and condition. This allows the asset to be used as intended.
Consumables (spare parts) for machinery	Revenue expenditure	It is expenditure of a regular nature – it helps the machine do its daily work.
Repairs to machinery	Revenue expenditure	Expenditure incurred to maintain its existing capacity.
Electricity cost for machinery	Revenue expenditure	It is expenditure of a regular nature.

Disclosure of capital and revenue expenditure in the financial statements

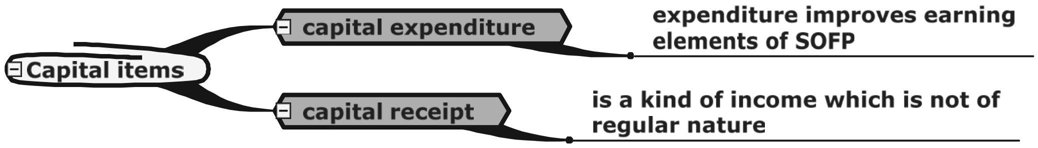
SOPL		
	Tshs	**Tshs**
Income	X	
Less: Expenses	(X)	

Revenue expenses will come here

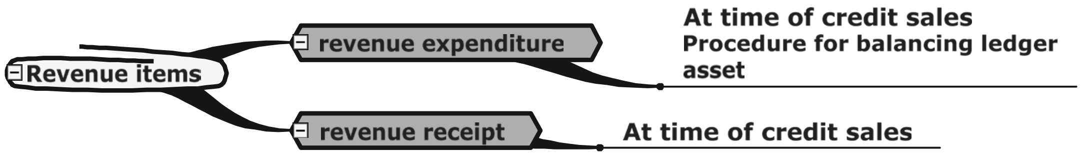
Capital expenses will come here

SOFP		
		Tshs
Non-current assets		X
	Total	
Capital and liability		
	Total	

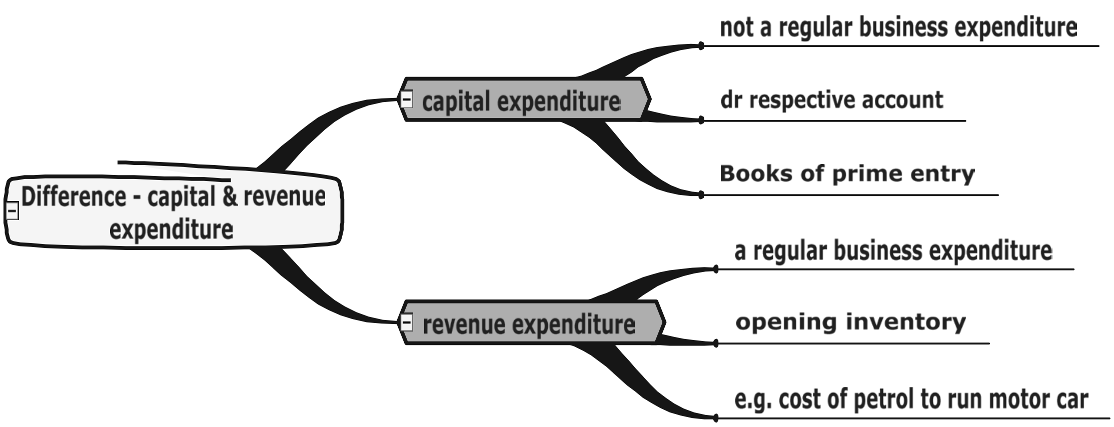
SUMMARY



SUMMARY



SUMMARY



Test Yourself 3

Fill in the blanks.

(a) Comp Plc is a manufacturer of computers. During 20X6, the company purchased machinery for Tshs100,000. This purchase price is a _______ expenditure.

Comp Plc. sold computers for Tshs200,000. This sale price received is a ____________ receipt because it is part of the regular income. The company sold one of its vehicles for Tshs50,000; this is a ____________ receipt because it is a sale of a non-current asset.

(b) Suzy is a sole trader dealing in furniture. A dressing table is sold for Tshs20,000; the amount received for this sale is a ___________ receipt. She also sold a computer used in her showroom for Tshs5,000. This is a __________ receipt because it is a sale of a non-current asset.

Test Yourself 4

Jack is a steel manufacturer. Classify the following expenses as revenue or capital expenditure.

(a) Purchase of computer
(b) Payment of electricity bill of the company
(c) Salaries to staff
(d) Installation cost of a computer server
(e) Extension of office building
(f) Interest on bank loan
(g) Rent on computers
(h) Purchase of vehicle
(i) Fees paid to directors
(j) Construction cost of new building

---

3. Prepare ledger entries to record the acquisition and disposal of non-current assets.

[Learning Outcome e]

3.1 Acquisition of non-current assets

The accounting entry for acquisition of non-current assets is as follows:

Dr	Non-current asset	X	
Cr	Cash / Payables / other asset		X

Being non-current asset acquired

Example

Sweet Home Inc is a manufacturer of furniture. It purchased machinery on 1 January 20X6 for Tshs50 million. The amount was paid in cash. On 1 February it purchased a drilling machine for Tshs60 million by cheque. It purchased a transit van on 30 June 20X6 for Tshs25 million on credit from Tony. On 30 September 20X6 it purchased plywood for Tshs10 million in cash.

All transactions of a capital nature are recorded in the ledger accounts in the following manner:

They are first recorded in the books of prime entry and then posted to ledger accounts.

The ledger accounts are shown below:

BBG Inc

Dr — Machinery account — Cr

Date		Tshs'000	Date	Details	Tshs'000
01/01/20X6	Cash	50,000			
01/02/20X6	Bank account	60,000	31/12/20X6	Balance c/f	110,000
	Total	**110,000**		**Total**	**110,000**

Acquisition of non-current asset is debited to that asset account.

Dr — Vehicle account — Cr

Date		Tshs'000	Date	Details	Tshs'000
30/06/20X6	Tony's account – Transit van purchased	25,000	31/12/20X6	Balance c/f	25,000
	Total	**25,000**		**Total**	**25,000**

Notes

1. 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 purchase account.

2. 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 ledger account.

3.2 Cost of asset

The cost of an asset is not just made up of its purchase price, but also contains other elements. These elements are as follows:

Purchase price
Costs **directly attributable** to bringing the asset to its current location and condition, in order to make it available for its intended use.
Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located

These elements mentioned above should be capitalised as non-current assets. Let us discuss each of these elements in detail:

1. **Purchase price:** The purchase price is the price after deducting trade discounts and rebates, and adding duties and non-refundable taxes.

Example

Tom purchased machinery and paid Tshs120 million, the basic price being Tshs100 million plus value added tax (VAT) of Tshs20 million. While calculating the tax payable on the finished goods sold, he gets credit of VAT paid on machinery.

Therefore, Tshs20 million paid in tax will be treated as refundable, and hence will not be included in the cost of the machinery. Therefore, the machine will be capitalised for Tshs100 million.

(**Note:** VAT has been discussed in Study Guide D1).

---

2. **Costs directly attributable** to bringing the asset to its intended location and condition. These costs include:

(a) Initial delivery and handling costs

Example

Jack purchased a machine on 5 January 20X6 for Tshs50 million. The supplier charged Tshs10 million as transportation costs. According to IAS 16, these delivery charges of Tshs10 million will be included in the purchase price of the machinery. The machine will be recognised in the statement of financial position as:

	Tshs'000
Cost of machine	50,000
Add: Transportation charges	10,000
To statement of financial position	**60,000**

(b) Installation costs

Example

Continuing the previous example of Jack,

The machinery purchased by Jack had to be installed in his factory. He paid Tshs5 million to the workers who installed the machinery. These installation charges will be included in the purchase price of the machinery. The machine will be recognised in the statement of financial position as:

	Tshs'000
Cost of machine	50,000
Add: Transport charges	10,000
Add: Installation charges	5,000
To statement of financial position	**65,000**

(c) Professional fees

Example

Mack decided to construct an office building. He appointed John, an architect to design the plan of the building and paid professional fees Tshs10 million to the architect.

Tshs10 million will be capitalised and added to the cost of the building.

---

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

These costs are applicable when the entity has an obligation to return the assets to its original condition.

Test Yourself 5

Compute the amount to be capitalised in the Plant account in the books of ICC Inc from the following invoice.

Champion Equipments Inc

Customers name: ICC Inc — Date: 01/01/20X6

Address: Manchester, England — Invoice no-699

	Qty	Rate	Tshs'000
Machinery	2	15,000	30,000
Add: Additional handling charges			2,000
Add: Transportation charges			8,320
			40,320
Less: Trade discount @1%			(320)
			40,000
Add: Import duty (set off not available)			6,000
Add: Sales tax (Set off available)			9,200
Add: Service charges for maintenance for next 2 years			3,000
			58,200
Less: Cash discount 5%			(2,910)
			55,290

A Tshs55,290,000
B Tshs58,200,000
C Tshs46,000,000
D Tshs55,200,000

3.3 Disposal of non-current assets

Disposal of a non-current asset can arise due to sale, exchange, loss, redundancy etc.

When a non-current asset is disposed of, the balance on that asset's account has to be reduced. For the purpose of disposal, an asset disposal account is created, to which the full cost of the disposed asset is transferred. The accounting entry to dispose of the asset is as follows:

Dr	Asset disposal account	X	
Cr	Asset account		X

Being the removal of the asset from the SOFP

Test Yourself 6

On 1 January 20X6, BBG Inc bought a plant for Tshs50 million. On 1 March 20X7 they disposed of the plant. What are the accounting entries for the disposal of the plant?

On **disposal of an asset, if money is received** (or receivable) then it is recorded in the asset disposal account.

The "Receivable" here refers to the amount receivable on the asset and is **not a part of the trade receivables** incurred in the normal course of business.

Dr	Cash (Asset Receivable) account	X	
Cr	Asset disposal account		X

Being cash received (asset disposed and amount receivable from asset debtor) on disposal of asset

Test Yourself 7

With reference to the information in Test Yourself 6, BBG received Tshs30 million in cash on selling the plant. What is the accounting entry for the receipt of cash on the sale of the asset?

Example

The books of Superb Co have the following balances on 1 January 20X7 - Plant A/c Tshs110 million and Vehicle A/c Tshs25 million. Superb Co sold the plant for a cash amount of Tshs30 million on 1 March 20X7. On 1 December 20X7 the vehicle met with an accident. It was not covered by insurance.

Prepare an asset and asset disposal account for all these events.

Superb Co
Plant Account

Dr | **Cr**

Date		Tshs'000	Date		Tshs'000
1/01/20X7	Balance b/d	110,000	01/03/20X7	Asset disposal account (Note1)	110,000
	Total	**110,000**		**Total**	**110,000**

Vehicle account

Dr | **Cr**

Date		Tshs'000	Date		Tshs'000
1/01/20X7	Balance b/d	25,000	01/12/20X7	Asset disposal account	25,000
	Total	**25,000**		**Total**	**25,000**

Asset disposal account

Dr | **Cr**

Date		Tshs'000	Date		Tshs'000
1/03/20X7	Plant	110,000	01/03/20X7	Cash (Note2)	30,000
01/12/20X7	Vehicle	25,000	31/12/20X7	Loss on disposal of asset (Note3)	105,000
	Total	**135,000**		**Total**	**135,000**

Notes:

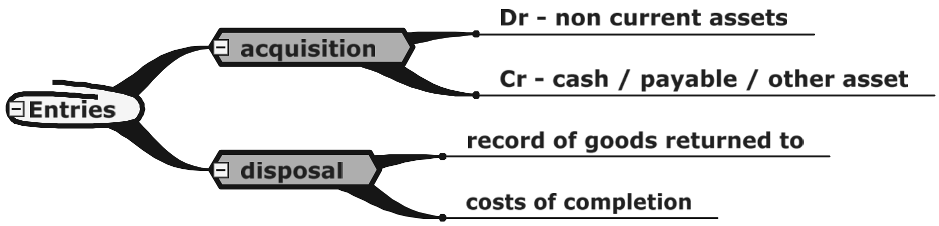
1. In the plant A/c, we credit the asset disposal a/c with the cost of plant, and not the disposal value.

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 Tshs110 million and the cash received on disposal is Tshs30 million. So, the difference is Tshs80 million, which is a loss. The vehicle, however, met with an accident and there was no insurance cover so, the full Tshs25 million is a loss. Therefore, a total of Tshs105 million (Tshs25 million + Tshs80 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.

SUMMARY



Test Yourself 8

Zenith Inc purchased a press machine for Tshs20 million on 1 January 20X6. After six months, the company decided to make changes in its products, so modification to the machinery was required. On 1 July 20X6 the company made some modifications which amounted to Tshs5 million. Unfortunately on 27 November 20X6 a major earthquake occurred and destroyed the machinery.

What will be the amount of loss recognised in the statement of profit or loss?

A 20,000
B 25,000
C Nil
D None of the above

Test Yourself 9

Continuing the question of Zenith Inc, what will be the amount of loss if Zenith Inc receives Tshs18 million from the insurance company?

A Tshs20 million
B Tshs25 million
C Nil
D Tshs7 million

---

4. Calculate and record profits or losses on disposal of non-current assets in the statement of profit or loss including part exchange transactions.

[Learning Outcome f]

The profit or loss on disposal of non-current assets is disclosed in the statement of profit or loss as follows:

	Tshs
Revenue	X
Cost of goods sold	(X)
Gross profit	**X**
Add (less): Profit (loss) on disposal of asset	**X**
Net profit	**X**

If there is a profit on disposal, it is shown as "other income". Similarly, a loss is shown as "other expense".

Important

Profit or loss on disposal of non-current assets is discussed in detail in Study Guide F2.

Example

Best Inc purchased machinery for Tshs50 million on 1 March 20X6 and a plant for Tshs75 million on 2 March 20X6. The company sold the machinery on 15 November 20X6 for Tshs70 million and the plant for Tshs60 million. The amount of profit or loss on the two non-current assets is determined in the following manner:

Best Inc
Plant and Machinery account

Dr Cr

Date		Tshs'000	Date		Tshs'000
01/03/20X6	Machinery	50,000	15/11/20X6	Asset disposal account (machinery)	50,000
02/03/20X6	Plant	75,000	15/11/20X6	Asset disposal account (plant)	75,000
Total		**125,000**	**Total**		**125,000**

Asset disposal account

Dr Cr

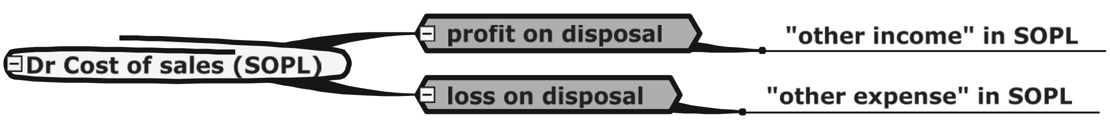
Date		Tshs'000	Date		Tshs'000
15/11/20X6	Plant and Machinery	50,000	31/12/20X6	Cash received (for machinery)	70,000
15/11/20X6	Plant and Machinery	75,000	31/12/20X6	Cash received (for plant)	60,000
31/12/20X6	**Profit on disposal of machinery (reflected in SOPL)**	**20,000**	31/12/20X6	**Loss on disposal of plant (reflected in SOPL)**	**15,000**
	Total	**145,000**		**Total**	**145,000**

Notes:

1. In the plant and machinery account, we **credit the asset disposal a/c with the cost of machinery and not the disposal value.**
2. It is important to note that when two non-current assets are disposed of, one resulting in profit and the other resulting in loss, these two transactions have to be recorded **separately** in the financial statements.

In this section, we have explained the basic principles of calculating profit or loss on disposal of a non-current asset. The effect of depreciation has been ignored as depreciation is explained in detail in the Study Guide F2.

SUMMARY



Purchase price in exchange transactions

Sometimes an asset may not be acquired in exchange for money but in exchange for other monetary or non-monetary assets. If the asset given up is a monetary asset, then measurement is easier, since its amount can be determined easily. However, if the asset given up is a non-monetary asset, then it may be necessary to measure the value of the asset given up.

(a) Fair value: Very simply, the fair value of an asset refers to the market value of the asset. It is the amount at which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction. An arm's length transaction is a transaction between two related parties that is conducted as if they were unrelated so that there is no conflict of interest. The cost of the assets involved in the exchange is determined at fair value (of the asset received or the asset given up), unless:

the transaction lacks commercial substance; or
the fair value of the two assets cannot be reliably measured

Example

Machinery is acquired in exchange for plant. The fair value of the machinery is agreed at Tshs200 million and the fair value of the plant is Tshs250 million (its book value is Tshs225 million). The difference of Tshs50 million is settled by cash. The machinery acquired will be recorded at Tshs200million.

The accounting entry will be:

			Tshs'000	Tshs'000
Dr		Machinery	200,000	
Dr		Cash	50,000	
	Cr	Plant		225,000
	Cr	Profit on sale of Plant		25,000

Being sale of plant, partially in exchange for machinery, and partially for cash.
The resultant profit is accounted for

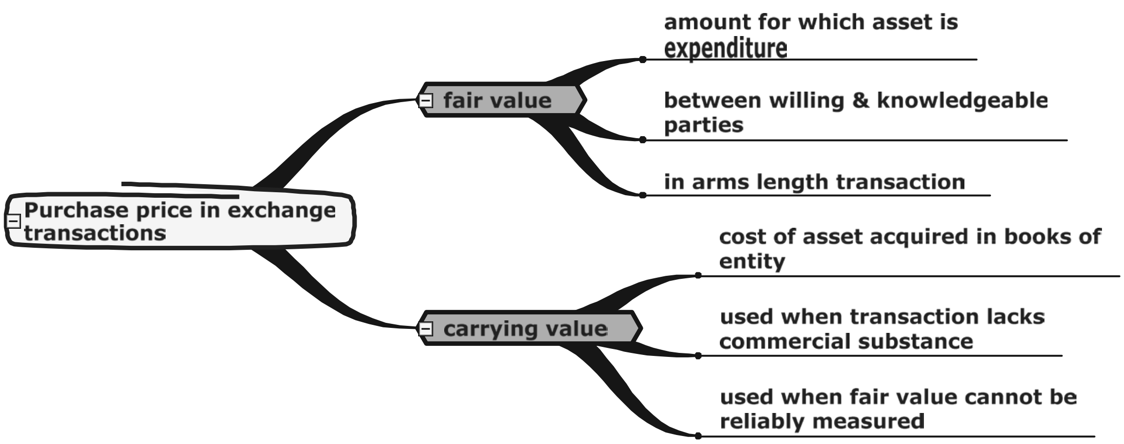
Carrying amount: if any of the above exceptions apply i.e. the transaction lacks commercial substance, or the fair value of both the assets cannot be reliably measured (and therefore the assets cannot be valued at fair value) then the cost of the asset acquired is measured at the carrying amount of the asset given up.

Example

Continuing the previous example

If there is only an exchange of the two assets (with no cash component), and the fair value of the two assets is not reliably measurable, then the book value of the plant, being the asset given up, i.e. Tshs225 million, should be recorded as the cost of the asset acquired i.e. the machinery.

SUMMARY



Test Yourself 10

Mark bought a machine for use in his business on 1 November 2008. He gave the supplier a cheque for Tshs23,140 and traded in an old machine. The supplier allowed him Tshs8,860 in part exchange for the old machine. Mark depreciates machinery on the reducing balance basis at a rate of 20% per annum. The old machine had cost Tshs24,000 and had been depreciated by Tshs11,712.

Calculate the profit or loss on the trade in of the old machine.

A a profit of Tshs2,852
B a profit of Tshs3,428
C a loss of Tshs2,852
D a loss of Tshs3,428

5. Record the revaluation of a non-current asset in ledger accounts, the statement of income and in the statement of financial position.
[Learning Outcome g]

5.1 Revaluation of assets

When assets are purchased, they are recorded at cost. As time passes, these assets can have a different value to what is recorded in the books.

Why do you think this is so?

The value of the asset e.g. a computer could decrease if the technology becomes out-dated.
The value of the asset could increase if there is a relative scarcity of such assets in the market, for example in the case of property.

'Revaluation' as the name suggests means to value the asset at its fair value. As seen earlier in the text, the fair value refers to the amount at which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction.

Test Yourself 11

Zodiac Enterprises purchased an office building in 20X0 for Tshs120 million. Will the value of that building be the same in 20X6? Give adequate reasons for your answer.

Accounting for revaluations

5.2 Upward revaluation

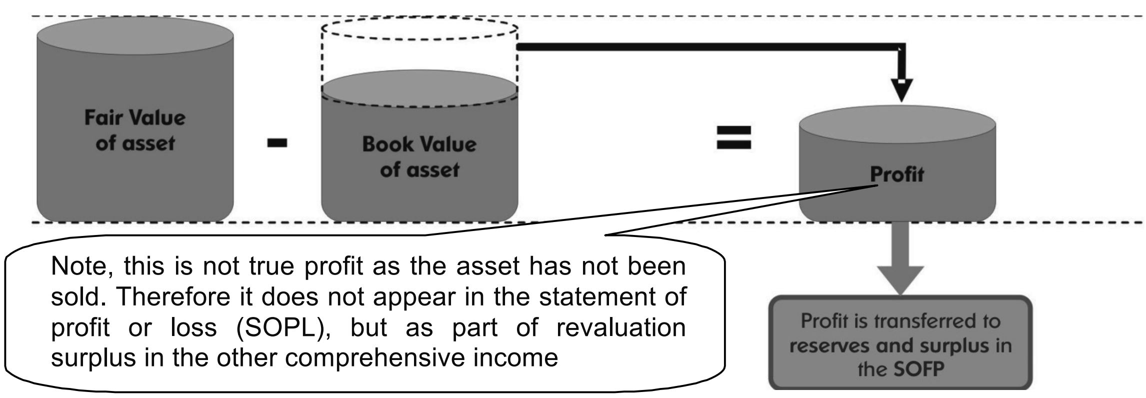
If the book value (known as the carrying cost) of an asset is **less than** the fair value:

the difference between the two is termed as **profit on revaluation**
this profit is transferred to the revaluation surplus account

Tip

The **revaluation surplus account** is recorded under reserves in the **statement of financial position**. However it is routed through the statement of other comprehensive income.

Diagram 2: Upward revaluation



The **entry** for recording revaluation of assets is as follows:

Dr	Asset account	X	
Cr	Revaluation surplus account		X

Being profit on revaluation of asset transferred to revaluation surplus account

Example

Zodiac Inc owns a plant, whose carrying amount (i.e. book value) is Tshs50 million on 31 December 20X6. Its fair value on 31 December 20X6 is Tshs60 million.

Here, Zodiac Inc has recorded the plant's book value as Tshs50 million.
The fair value of the asset is Tshs60 million.
When the book value of an asset is **less than** the fair value, it is known as **upward revaluation**

The **entry** for recording revaluation of an asset is as follows:

		Tshs'000	Tshs'000
Dr	Plant account	10,000	
Cr	Revaluation surplus account		10,000
Being plant brought up to face value			

Ledger accounts are as follows:

Zodiac Enterprises
Plant account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Balance b/d	50,000			
31/12/20X6	**Revaluation surplus**	**10,000**			
			31/12/20X6	Balance c/f	60,000
	Total	**60,000**		**Total**	**60,000**

Revaluation surplus account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
			31/12/20X6	Balance b/d	0
			31/12/20X6	**Plant account**	10,000
31/12/20X6	Balance c/f	10,000			
	Total	**10,000**		**Total**	**10,000**

Notes:

1. We must increase the value of the plant by Tshs10 million to make it equal to the fair value. Hence we debit the plant account.

2. Revaluation surplus will be disclosed in the statement of financial position under the head "Reserves".

3. We cannot record the revaluation surplus in the statement of profit or loss because we apply the concept of prudence, which implies that we cannot recognise the profit in the statement of profit or loss until it is certain or realised. Here the asset has not been sold, so no profit has actually been made.

Extract of disclosure in the financial statements

Zodiac Enterprises – Statement of financial position (extract) for the year ended 31 December 20X6

	Tshs'000	Tshs'000
Assets		
Plant - Cost on 01/01/20X6	50,000	
Add: Revaluation	10,000	60,000
Net value on 31/12/20X6		
Total		**X**
Capital and liabilities		
Share capital		
Reserves		
Revaluation surplus	10,000	
Total		**X**

Continued on the next page

Zodiac Enterprises - Statement of profit or loss and other comprehensive income (extracts) for the year to 31 December 20X6

	Tshs'000
Revenue	X
Cost of sales	(X)
Gross Profit	X
Other Income	X
Expenses	(X)
Profit for the year	**X**
Other comprehensive income	
Gains on property revaluation	10,000
Total comprehensive income for the year	**X**

Notes

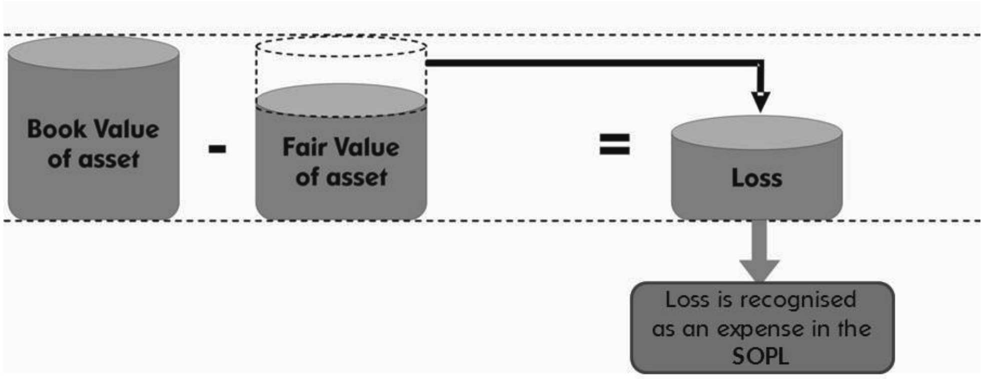
1. After revaluation, the plant is recorded at its fair value, which is Tshs60 million.
2. Revaluation surplus is Tshs10 million, recorded under reserves and routed through the other comprehensive income part of the statement of profit or loss and other comprehensive income.
3. Net value of non-current assets is calculated without giving the effect of depreciation, as depreciation is explained in the next Study Guide.

5.3 Downward revaluation

If the book value of an asset is **more than** its fair value:

the difference between the two is termed as **loss on revaluation**
this loss is charged to the statement of profit or loss

Diagram 3: Downward revaluation



Example

Zodiac Inc owns a plant whose carrying amount (book value) is Tshs50 million on 31 December 20X6. The company decided to revalue the plant at Tshs45 million on 31 December 20X6.

Answer

Here, the company recorded the plant at its book value of Tshs50 million.
It decided to revalue the plant at Tshs45 million. This is its fair value.
As the book value of the asset is **more than** its fair value, this is known as **downward revaluation** which results in **loss.**

The **entry** for recording revaluation of an asset is as follows:

		Tshs'000	Tshs'000
Dr	Loss on revaluation of asset	5,000	
Cr	Plant account		5,000
Being revaluation of plant			

Continued on the next page

Ledger accounts are as follows:
Plant account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Balance b/d	50,000			
			31/12/20X6	Loss on revaluation	5,000
			31/12/20X6	Balance c/f	45,000
	Total	**50,000**		**Total**	**50,000**

Loss on revaluation account Shown as an expense in the SOPL

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Plant account	5,000	31/12/20X6	SOPL	5,000
	Total	**5,000**		**Total**	**5,000**

Notes:

1 We must decrease the value of the plant by Tshs5 million to make it equal to the fair value. Hence we credited the plant account.

2 Loss on revaluation will be charged to the statement of profit or loss.

3 We record the loss on revaluation in the statement of profit or loss because we apply the concept of prudence, which implies that we have to recognise loss in the statement of profit or loss as soon as it is known, even if it is not yet realised.

Extract of disclosure in financial statements

Zodiac Enterprises - Statement of profit or loss and other comprehensive income (extract) for the year to 31 December 20X6

	Tshs'000
Revenue	-
Cost of goods sold	-
	-
Gross profit	**X**
Expenses:	-
	(5,000)
Loss on revaluation	-
Net profit	**(5,000)**

Zodiac Enterprises - Statement of financial position (extract) for the year ended 31 December 20X6

	Tshs'000	Tshs'000
Assets		
Plant - Cost on 01/01/20X6	50,000	
Add: Addition during the year	-	
Less: Loss on revaluation	(5,000)	
	45,000	
Net value on 31/12/20X6		45,000
Total		**X**
Capital and liabilities		
Share capital		
Reserves and surplus		(5,000)
Total		**X**

Continued on the next page

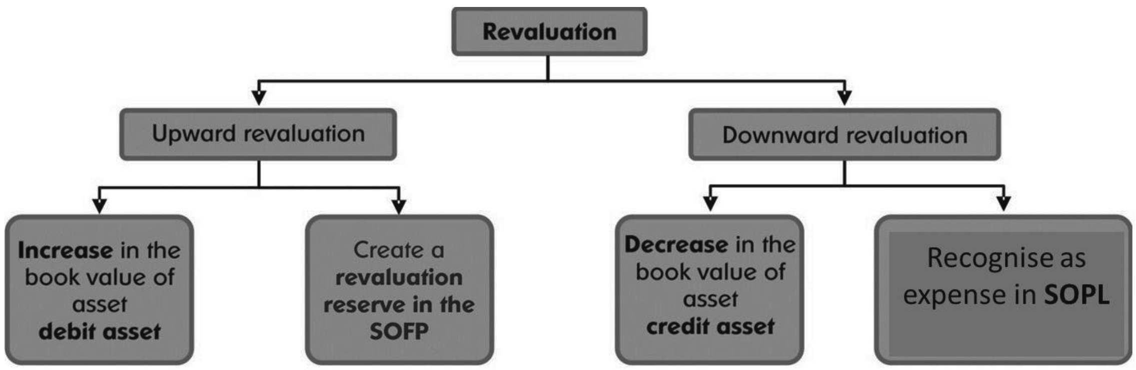
Notes:

1. After revaluation, the plant is recorded at its fair value, which is Tshs45 million.

2. Loss on revaluation is charged to the statement of profit or loss and not to the statement of financial position.

3. Net value of the non-current asset is calculated without giving the effect of depreciation, as depreciation is explained in the next Study Guide.

Diagram 4: Revaluation



All assets belonging to the same class have to be revalued at the same time.

Example

Superb Inc wants to revalue its machinery. The company has 5 types of machinery in its possession. The company will have to revalue all five types of machinery.

Test Yourself 12

Superb Inc owns machinery, the carrying amount (book value) of which as on 31 December 20X6 was Tshs60 million. The company decided to revalue the plant at Tshs50 million on 31 December 20X6. What entry is to be made for recording the revaluation of machinery?

---

6. Calculate the profit or loss on disposal of a revalued asset.

[Learning Outcome h]

6.1 Nature of revaluation surplus account

The revaluation surplus account is created to record an increase in the value of a non-current asset due to a revaluation. As discussed in the previous Learning Outcome, this is an unrealised gain because the increase in the value of the non-current asset does not bring cash into the entity. Hence there cannot be a distribution of profits out of the revaluation surplus.

You should understand that in the above case the revaluation surplus has not brought any realised gains or cash inflows. It is just an accounting adjustment. **If an entity declares dividend out of revaluation surplus, it will result in a declaration of dividend out of future potential profits which is not allowed. The revaluation surplus is therefore a non-distributable reserve.**

6.2 Realisation of revaluation surplus account

Revaluation surplus falls under the category of unrealised gains. But this **unrealised gain becomes realised gain on disposal of the asset.**

Example

Zodiac Enterprises purchased a building on 1 January 20X6 for Tshs150 million.
On 31 December 20X7 it revalued the building at Tshs200 million.
On 31 December 20X8 it sold the building for Tshs280 million in cash.

What is the final gain on disposal of the asset? Draft the ledger accounts to support this.

Answer

Zodiac Enterprises
Building account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X6	Bank account	150,000	31/12/20X6	Balance c/f	150,000
	Total	**150,000**		**Total**	**150,000**
01/01/20X7	Balance b/d	150,000			
31/12/20X7	Revaluation surplus (Note1)	50,000	31/12/20X7	Balance c/f	200,000
	Total	**200,000**		**Total**	**200,000**
01/01/20X8	Balance b/d	200,000	31/12/20X8	Asset disposal account (Note2)	200,000
	Total	**200,000**		**Total**	**200,000**

Revaluation surplus account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
			31/12/20X7	Building	50,000
31/12/20X7	Balance c/d	50,000			
	Total	**50,000**		**Total**	**50,000**
			01/01/20X8	Balance b/d	50,000
31/12/20X8	General reserve (note 5)	50,000			
	Total	**50,000**		**Total**	**50,000**

Asset disposal account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X8	Building	200,000	31/12/20X8	Cash (Note 3)	280,000
31/12/20X8	Profit on disposal of asset (Note4)	80,000			
	Total	**280,000**		**Total**	**280,000**

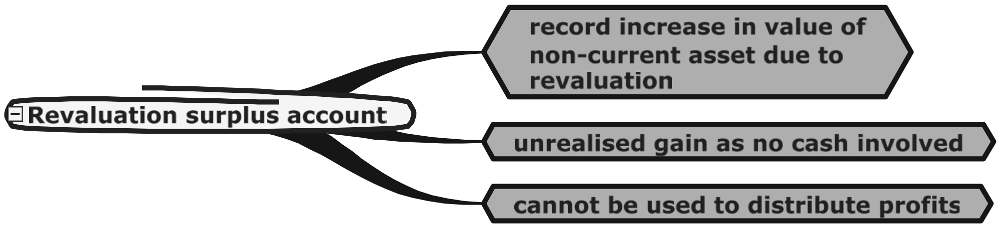
As you can see the final gain of Tshs80 million is realised in the year of disposal.

Notes

1. Building has to be **revalued upwards**, so, we debit the asset account and credit the revaluation surplus account.
2. On disposal of asset, the entire **book value** of the asset is transferred to the asset disposal account.
3. On disposal of asset, any **amount received** is transferred to the asset disposal account.
4. The **profit or loss on disposal** of the asset is recognised in the statement of profit or loss. Here, it is profit.
5. On disposal of asset, the **revaluation surplus** of that asset becomes a realised gain, and hence it is transferred to retained earnings. The following journal entry is passed:

		Tshs'000	**Tshs'000**
Dr	Revaluation surplus	50,000	
Cr	Retained earnings		50,000
Being revaluation surplus recorded			

SUMMARY



Test Yourself 13

Half Moon Inc purchased a plant on 5 January 20X6 for Tshs200 million.

On 31 December 20X7 it revalued the plant at Tshs260 million.
On 31 December 20X8 it sold the plant for Tshs320 million in cash.

Prepare the ledger accounts to calculate the profit or loss on disposal of plant.

---

7. Illustrate how non-current asset balances and movements are disclosed in notes to the financial statements.

[Learning Outcome i]

Non-current asset balances and movements are disclosed in the financial statements in the following format:

Details of non-current assets as on 31 December 20X6						
		Land	**Building**	**Plant**	**Equipment**	**Total**
A	**Cost**					
	Balance on 1 January 20X6					
	(+) Additions					
	(+/ -) Revaluations					
	(-) Transfer to assets held for sale					
	(-) Disposals					
	Balance on 31 December 20X6					

Example

Sun Inc had a building where the opening balance on 1/01/20X6 was Tshs20 million. It purchased land on 5 January 20X6 for Tshs50 million.

The company decided to revalue its building on 31/12/20X6 at Tshs30 million.
The price of land appreciated very quickly, so, the company decided to dispose of its land for Tshs75 million.

The movements of non-current assets are disclosed on the financial statements as follows:

		Land	**Building**
		Tshs'000	**Tshs'000**
A	**Cost**		
	Balance on 1 January 20X6		20,000
	(+) Additions	50,000	
	(+/ -) Revaluations		10,000
	(-) Transfer to assets held for sale	-	-
	(-) Disposals	(50,000)	-
	Balance on 31 December 20X6	0	30,000

Since this example only refers to land and building, only the land and building columns are shown. One can show as many columns for as many non-current assets that are owned by the entity.

Continued on the next page

Notes

1. The above disclosure is made without giving the effects of depreciation because depreciation is explained in detail in the next Study Guide.

2. Here, we have shown the disposal of land at its book value. The profit or loss on disposal is not shown here.

The **statement of financial position** will **contain** a **single figure showing the total carrying amount** of all the non-current assets. All the requirements and **details discussed earlier are disclosed by way of notes** to accounts.

Classes of asset

Each class of property, plant and equipment is disclosed separately in accordance with IAS 16 Property, Plant and Equipment. Therefore it is important to understand what the meaning of a 'class of assets' is. This is a subjective issue, so there may be a difference of opinion.

Properties, plant or equipment can be classified by an entity according to the following criteria:

Geographical location of asset: When an entity has two assets, each in a different place, then the assets are classified on the basis of their location. E.g. plant in the UK, plant in Australia etc.

Nature of asset: Classification can be done on the basis of the type of asset. E.g.: plant, vehicle, tools, furniture etc.

Use of asset: Classification of an asset also depends on the purpose for which it is used. E.g. computers at lab, computers at office etc.

This classification has to be **consistent every year** in order to ensure that annual financial statements are comparable and easily understood by the user.

Test Yourself 14

Which ONE of the following options is not a criteria for asset classification?

A Geographical location
B Nature of assets
C Use of asset
D Size of assets

---

8. Explain the purpose and operation of an asset register.

[Learning Outcome j]

A company invests a huge amount of capital in non-current assets. Therefore they must maintain proper and systematic records to avoid any loss to the assets. Also for the day to day management of the business it is important to know what assets the company owns and where they are located.

An asset register includes the following details about an asset:

Name of the asset
Description
Date of purchase
Purchase cost
Supplier's details
Additions to assets
Revaluation (if any)
Depreciation
Disposal details
Unique asset code
Location

We will discuss this in the next Study Guide

Proforma Asset register

(Amounts in Tshs)

Asset No.	Date of purchase	Description	Location	Depre-ciation rate	Cost	Accumulated depreciation b/f	Depreciation charge in the year	Accumulated depreciation c/f	Net book value
Land and Building									
10015	15/05/19W9	35 High Street	Sheffed USA	Nil	2,500,000				2,500,000
10015 A	12/10/20X2	35 High Street extension	Sheffed USA	Nil	100,000				100,000
10016	12/06/20X6	15 Long lane	Bernsley USA	Nil	250,000				250,000
					2,850,000	**0**	**0**	**0**	**2,850,000**
Plant and Machinery									
20013	05/10/20X4	Milling Machine	Workshop 1	10%	20,000	4,000	2,000	6,000	14,000
20014	01/01/20X5	Pressing Machine	Workshop 1	10%	32,000	3,200	3,200	6,400	25,600
20015	31/12/20X5	Rolling Machine	Workshop 2	10%	50,000		5,000	5,000	45,000
					102,000	**7,200**	**10,200**	**17,400**	**84,600**
Fixtures and Fittings									
3045	4/02/20X4	Office chairs	Office-1	20%	15,000	6,000	3,000	9,000	6,000
3046	5/05/20X5	Shelving Unit	Office-1	20%	10,000	2,000	2,000	4,000	6,000
3047	2/05/20X6	Tall Storage unit	Office-2	20%	20,000		4,000	4,000	16,000
					45,000	**8,000**	**9,000**	**17,000**	**28,000**
				Total	**2,997,000**	**15,200**	**19,200**	**34,400**	**2,962,600**

Maintaining an asset register is compulsory for limited liability companies.

The carrying amount in the asset register should **be equal to** the amount shown in the statement of financial position.

Non-current assets are also physically verified at the year end.

In a computerised system a more complex report could be printed that shows supplier details, improvements made etc.

Purpose of an asset register:

A well maintained asset register could help in the following:

(i) Insurance: when the correct value or description of assets is not known, the company may face a problem of determining the adequate insurance cover. If the assets are over insured, it would entail excess cost in the form of premium charges, and under insuring would imply that the company may not be able to recover adequate amount of claims from the insurance company in the case of any unfortunate event.

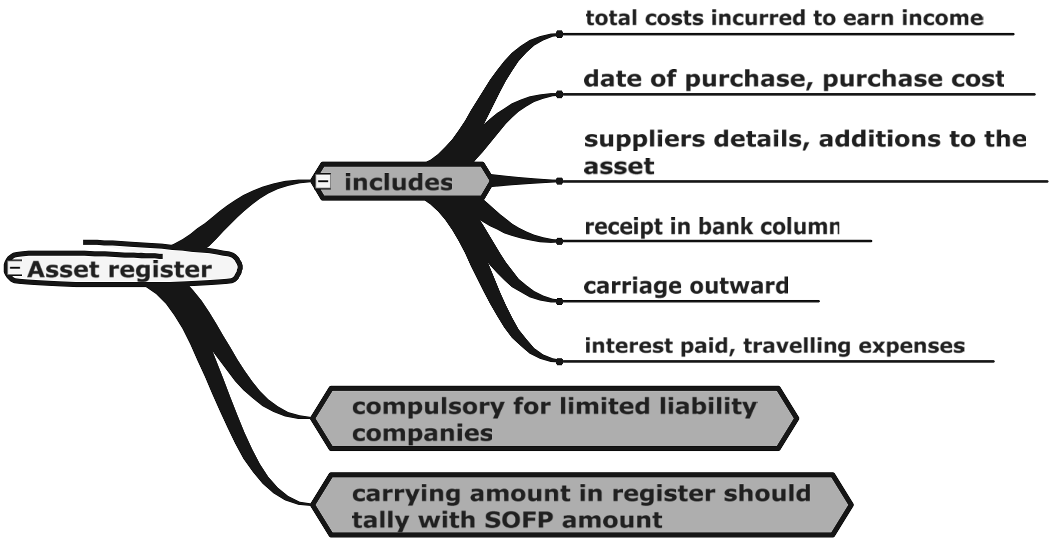
(ii) Impairment of assets: a well-maintained asset register would be the basic requirement for complying with the requirements of revaluation and impairment.

(iii) Costing records: proper maintenance of assets assists the company in deriving information regarding output and efficiency of machines and other assets. This may be useful in the allocation of overheads and cost control.

(iv) Assist statutory investigations: systematic maintenance of asset registers can make the audit proceedings less cumbersome.

(v) Monitoring assets: a well-maintained asset register helps in monitoring and maintenance of assets. This also helps in locating the assets easily.

SUMMARY



Test Yourself 15

Which ONE of the following is not a purpose of maintaining fixed asset register?

A It helps in monitoring the assets.
B It helps in statutory investigations
C It helps in deriving information regarding output and efficiency of machines and other assets for costing purpose
D It is mandatory under IFRS to keep an asset register

Answers to Test Yourself

Answer to TY 1

A **Plant and Machinery:** Non-current asset because it is held for long term use and is used for production of goods.
B **Inventory:** Current asset because it is held with an intention to sell within 12 months in the ordinary course of business.
C **Cash and bank balance:** Current asset because it is specifically included in the definition of current asset according to IAS 1.
D **Furniture and fixtures:** Non-current asset because it is not held with an intention to sell in the ordinary course of business, and expected to be used for more than one year.
E **Raw material:** Current asset because it is consumed for the production of goods in the normal operating cycle.

Answer to TY 2

Sun Inc

Assets	Type of asset	Reasons
Plant and Machinery	Non-current asset	Held for long-term use and used for production of goods.
Cash and bank balance	Current asset	Included in the definition
Inventory of finished steel	Current asset	Held with an intention to sell in the ordinary course of business.
Computers	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Iron ore	Current asset	Consumed for the production of goods in the normal operating cycle.
Furniture and fixture	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Vehicles	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.

Home decorators

Assets	Type of asset	Reasons
Vehicles	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Bank balance	Current asset	Specifically included in definition.
Computers	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Furniture and fixtures for resale	Current asset	Held with an intention to sell in the ordinary course of business.

Answer to TY 3

(a) capital, revenue, capital

(b) revenue, capital

Answer to TY 4

Classification of expenditure:

A	Purchase of computer	Capital expenditure	Computer will be used in the business for a long term.
B	Payment of the company's electricity bill	Revenue expenditure	It is expenditure of a regular nature.
C	Salaries to staff	Revenue expenditure	It is expenditure of regular nature.
D	Installation cost of a computer server	Capital expenditure.	Without incurring these expenses the computer cannot be used.
E	Extension of office building	Capital expenditure	It increases the value of non-current assets and provides benefits of an enduring nature i.e. for more than one accounting period.
F	Interest on bank loan	Revenue expenditure	It is expenditure of a regular nature.
G	Rent on computers	Revenue expenditure	It is expenditure of a regular nature.
H	Purchase of vehicle	Capital expenditure	Purchase of non-current assets is a capital expenditure.
I	Fees paid to directors	Revenue expenditure	It is expenditure of a regular nature.
J	Construction cost of new building	Capital expenditure	It increases the value of non-current assets and includes expenditures that provide benefits of an enduring nature i.e. for more than one accounting period.

Answer to TY 5

The correct option is **C**.

The amount to be capitalised is Tshs46 million because cost of a non-current asset includes transportation charges and import duty but it excludes trade discount, refundable taxes i.e. tax on which set off is available, service charges for maintenance and cash discount. Therefore, the amount to be capitalised is calculated as follows:

	Tshs'000
Machinery	30,000
Add: Additional handling charges	2,000
Less: Trade Discount	(320)
Add: Transportation charges	8,320
Add: Import duty	6,000
	46,000

Notes

1. Tshs9.2 million is sales tax amount, on which set-off is available which will not be included in the cost of purchase.
2. Tshs3 million is service charges paid for maintenance for the next two years which will not be included in the cost of purchase.
3. Tshs2.91 million is cash discount available, which will not be deducted from cost of machinery.

Hence, the amount to be capitalised is Tshs46 million.

Answer to TY 6

The journal entry is as follows:

		Tshs'000	**Tshs'000**
Dr	Plant disposal account	50,000	
Cr	Plant account		50,000
Being plant disposed of			

Answer to TY 7

The journal entry is as follows:

		Tshs'000	**Tshs'000**
Dr	Cash account	30,000	
Cr	Plant disposal account		30,000
Being cash received on disposal of plant			

Answer to TY 8

The correct option is **B**.

Calculation of loss to be recognised in the statement of profit or loss:

Zenith Inc

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

Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X6	Press machine	20,000			
01/07/20X6	Press modifications	5,000			
			27/11/20X6	Asset disposal account	25,000
	Total	**25,000**		**Total**	**25,000**

Dr **Asset disposal account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
27/11/20X6	Plant	25,000			
			31/12/20X6	**Loss on disposal of asset**	**25,000**
	Total	**25,000**		**Total**	**25,000**

Answer to TY 9

The correct option is **D**.

If Zenith receives cash from the insurance company, we have to record the entry for this amount in the asset disposal account. Therefore, the asset disposal account will change.

Calculation of revised loss to be recognised in the statement of profit or loss:

Dr **Asset disposal account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
27/11/20X6	Plant	25,000			
			31/12/20X6	Cash received	18,000
			31/12/20X6	**Loss on disposal of asset**	**7,000**
	Total	**25,000**		**Total**	**25,000**

Answer to TY 10

The correct option is **D.**

NBV of old machine = Tshs12,288 (Cost Tshs24,000 less accumulated depreciation Tshs11,712)

Proceeds Tshs8,860

Loss as proceeds less than NBV = Tshs3,428

Answer to TY 11

The value of the office building in 20X6 will not be same. It can either be more or less than Tshs120 million. The value will depend on local property prices and the condition of the building, i.e. the value of the office building will depend upon its market value on that date.

Answer to TY 12

Here, the company recorded the machinery at its book value of Tshs60 million.

It decided to revalue the machinery at Tshs50 million. This is its fair value.

As the book value of the asset is **more than** its fair value, this is known as **downward revaluation** which results in **loss**

The **entry** for recording revaluation of an asset is as follows:

		Tshs'000	
Dr	Loss on revaluation of asset	10,000	
Cr	Machinery account		10,000

Being decrease in value of machinery due to revaluation

Answer to TY 13

Moon Inc

Dr **Plant account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
05/01/20X6	Purchase	200,000			
			31/12/20X6	Balance c/d	200,000
	Total Balance b/d	**200,000**		**Total**	**200,000**
01/01/20X7 31/12/20X7	Revaluation surplus (note1)	200,000 60,000			
	Total		31/12/20X7	Balance c/d	260,000
	Balance b/d	**260,000**		**Total**	**260,000**
01/01/20X8		260,000	31/12/20X8	Asset disposal account (Note 2)	260,000
	Total	**260,000**		**Total**	**260,000**

Dr **Revaluation surplus account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
			31/12/20X7	Plant	60,000
31/12/20X7	Balance c/f	60,000			
	Total	**60,000**		**Total**	**60,000**
			01/01/20X8	Balance b/d	60,000
31/12/20X8	General reserve (Note5)	60,000			
	Total	**60,000**		**Total**	**60,000**

Dr **Asset disposal account** **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X8	Plant	260,000	31/12/20X8	Cash (Note3)	320,000
31/12/20X8	Profit on disposal of asset (Note4)	60,000			
	Total	**320,000**		**Total**	**320,000**

The final gain of Tshs60 million is realised in the year of disposal.

Notes

1. As we have to increase the value of plant, it has to be **revalued upwards**, so, we debit the asset account and credit the revaluation surplus account.

2. On disposal of asset, the entire **book value** of the asset is transferred to the asset disposal account.

3. On disposal of asset, any **amount received** is transferred to the asset disposal account.

4. The **profit or loss on disposal** of the asset is recognised in the statement of profit or loss. Here, it is profit.

5. On disposal of asset, the **revaluation surplus** of that asset becomes a realised gain, and hence it is transferred to retained earnings.

Answer to TY 14

The correct option is **D.**

Except size of the asset, all other options are criteria to classify an asset.

Answer to TY 15

The correct option is **D.**

IFRS does not mandate entities to maintain asset register. The local laws may require entities to maintain asset register.

Self Examination Questions

Question 1

The accountant of Simplex Cosmetics LLC informs the board that profits of the company for 20X6 are much lower than expected due to heavy repairs and maintenance expenses. An analysis of the repairs and maintenance account shows that it included:

(a) Upgrade of machinery, increasing its production capacity by 10% to Tshs175 million.

(b) Tshs62.5 million for the replacement of major worn-out components in an old piece of machinery. (You receive additional information that the carrying value of the old parts was Tshs7 million. It was sold as scrap and the proceeds of Tshs4 million were credited to the sales account.)

(c) Servicing costs: Sundry materials of Tshs8 million and wages of Tshs1 million.

Required:

Pass Journal entries to record the above transactions

A big machine which costs Tshs1 million is always a non-current asset. **State whether true or false?**

Question 2

Capital expenditure can be used to:

A Improve the quality of a non-current asset
B Increase the quantity of a non-current asset
C Both of the above
D None of the above

Question 3

A non-current asset is_______________

A Always recorded at cost
B Always recorded at fair value
C Initially recorded at cost but must be revalued later
D Initially recorded at cost but can be revalued later

Question 4

A revenue receipt is recorded in [ ]

Revenue expenditure is recorded in [ ]

Question 5

In times of rising prices, **what effect does the use of the historical cost concept have on a company's asset values and profit?**

A Asset values and profit both understated
B Asset values and profit both overstated
C Asset values understated and profit overstated
D Asset values overstated and profit understated.

Question 6

Gareth, a sales tax registered trader purchased a computer for use in his business. The invoice for the computer showed the following costs related to the purchase:

	Tshs'000
Computer	890
Additional memory	95
Delivery	10
Installation	20
Maintenance (1 year)	25
	1,040
Sales tax (17.5%)	182
Total	**1,222**

How much should Gareth capitalise as a non-current asset in relation to the purchase?

A Tshs1,222,000
B Tshs1,040,000
C Tshs890,000
D Tshs1,015,000

Question 7

On disposal of an asset, the following is credited to the asset disposal account:

A Amount received on disposal
B Cost of the asset
C Fair value of the asset
D None of the above

Question 8

When an asset is revalued upward:

A The deficit is charged to the statement of profit or loss and reduced from the value of the asset.
B The deficit is treated as income and added to the value of the asset.
C The surplus is disclosed in reserves and added to the value of the asset.
D The surplus is treated as income and added to the value of the asset.

Question 9

How frequently should an asset be revalued?

A Yearly
B Monthly
C Once in five years
D None of the above

Answers to Self Examination Questions

Answer to SEQ 1

(a) The cost of upgrading machines is capital expenditure as it improves their earning capacity. It should be debited to the machinery account. Assuming that there is no replacement of any parts, no derecognition is required. The entry for correction is:

Dr	Machinery account	Tshs175 million	
	Cr Repairs and maintenance		Tshs175 million

Being the cost of upgrading the machines

Depreciation will be charged on Tshs175 million.

(b) The cost of the new part for Tshs62,500 will be capitalised, and depreciation charged thereon, along with the other assets.

The entry for correction is

Dr	Machinery account	Tshs62.5 million	
	Cr Repairs and maintenance		Tshs62.5 million

Being the cost of new plant wrongly debited to repairs and maintenance, now transferred to machinery account

The old part should be derecognised from machinery and transferred to a disposal account, as:

Dr	Disposal of machinery account	Tshs7 million	
	Cr Machinery account		Tshs7 million

Being machinery disposed and machinery account nullified

Sale proceeds have been wrongly credited to sales. The following rectification entry is needed:

Dr	Sales account (Since wrongly credited)	Tshs4 million	
Dr	Loss on disposal of machinery parts	Tshs3 million	
	Cr Disposal of machinery account		Tshs7 million

Being amount wrongly credited to sales now corrected and the loss on sale of machinery accounted for

(c) Servicing costs are correctly debited to repairs and maintenance account. No correction is required.

The correct answer is false.

Classification of assets into non-current assets and current asset depends on the nature of the asset and not the amount. If the machinery purchased is used for a long period of time, then it is a non-current asset.
If the machinery is purchased with the intention to sell it in the near future, then it is a current asset.

Answer to SEQ 2

The correct option is **C**.

Capital expenditure incurred can be either for addition of a new asset or for improvement / modification to an existing non-current asset.

Answer to SEQ 3

The correct option is **D**.

A non-current asset is initially recorded at cost. However, an entity can revalue it at a later date, as revaluation is not compulsory.

Answer to SEQ 4

All revenue receipts are recorded as income in the statement of profit or loss.

All revenue expenditures are recorded as expenses in the statement of profit or loss.

Answer to SEQ 5

The correct option is **C**.

In times of rising prices, the value of assets would remain the same as their cost. However, the fair value of the assets would be at a price higher than the historical cost of the asset. As a result, the assets would be understated, which would result in the profits being overstated.

Answer to SEQ 6

The correct option is **D**.

(Tshs890 million + Tshs95 million + Tshs10 million + Tshs20 million) = Tshs1,015 million. Maintenance will not be included in the cost of the asset, as it does not fall into the category of those costs which are necessary to bring the asset into its present location and condition.

Answer to SEQ 7

The correct option is **A**.

The asset disposal account is credited with the amount received on disposal.

The account is as follows:

Asset disposal account

Dr **Cr**

	Tshs		**Tshs**
Cost or value in the asset account	X	Cash	X
Profit on disposal	X	Loss on disposal	X
Total	**X**	**Total**	**X**

Answer to SEQ 8

The correct option is **C**.

When an asset is upwardly revalued, the surplus is disclosed in reserves, is added to the value of the asset.

Answer to SEQ 9

The correct option is **D**.

An accounting standard does not prescribe any time limit for revaluation. It is for the correct disclosure of the financial statements of an entity that revaluation should be made regularly.

SECTION F

ACCOUNTING TREATMENT FOR PROPERTY, PLANT AND EQUIPMENT (IAS 16)

4

DEPRECIATION

Get Through Intro

A substantial part of the assets owned by an entity is in the form of non-current assets. Most of these have a finite useful life and need to be depreciated over their useful life. Why is this so?

An entity can expect non-current assets to generate income over their estimated useful life. Hence it follows that the entity should charge the cost of the non-current assets over the period of estimated returns – i.e. costs should match revenue.

For example if a machine costs Tshs30,000 and is expected to produce goods for three years – then this means that the entity can expect the machine to generate revenue for 3 years. Hence the cost of the machine should be spread over 3 years – so that costs match revenue.

A systematic allocation of the cost of a non-current asset over its estimated useful life is called depreciation. An error in the calculation of depreciation leads to an unfair depreciation charge in the statement of profit or loss and as a result the carrying value of non-current asset in the statement of financial position is incorrect.

Misrepresentation of these figures misleads the users of financial statements and may harm the interests of the entity itself. For example banks rely on the financial statements of an entity when approving loans. Misleading figures means that banks may authorise incorrect loans or refuse to authorise loans when they should.

Revaluations of non-current assets also have repercussions on depreciation – the answers are in this Study Guide. This whole Study Guide is very important as the accountant is responsible for deciding and implementing the depreciation policy of an entity.

Learning Outcomes

a) State and explain the meaning of depreciation.
b) Calculate depreciation using straight-line and reducing balance methods.
c) Identify the circumstances where different methods of depreciation would be appropriate.
d) Illustrate how depreciation expense and accumulated depreciation are recorded in ledger accounts.
e) Calculate depreciation on a revalued non-current asset including the transfer of excess depreciation between the revaluation surplus and retained earnings.
f) Calculate the adjustments to depreciation necessary if changes are made in the estimated useful life and/or residual value of a non-current asset.
g) Record depreciation in the statement of profit or loss and statement of financial position.

1. State and explain the meaning of depreciation.

[Learning Outcome a]

1.1 What is depreciation?

Definition

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

IAS 16 Property, plant and equipment

1.2 Why charge depreciation on non-current assets?

Non-current assets are acquired at a cost. However, it would be incorrect to charge the entire cost in the first year itself. The asset is going to help generate income for many years.

The matching principle requires that the expenses be recognised in the year in which the revenue is recognised (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.

Example

Sales revenue in a year was Tshs100 million. Cost of material for the goods produced and sold was Tshs60 million (For simplicity, assume that there was no opening or closing inventory.)

Cost of machine used in the manufacture of these goods is Tshs80 million. The machinery has 10 years' working life.

Since the life of the machine is 10 years, 1/10 of the life and cost of the machine are consumed in producing these goods. Therefore, 1/10 of the cost i.e. Tshs80 million x 1/10 = Tshs8 million is charged as a depreciation. (This calculation is according to the straight line method of depreciation – you will study about this in more detail later in this Study Guide.)

Like material costs, the depreciation on non-current assets is matched with the sales revenue.

The purpose of charging depreciation is not to record the decrease in the **value of an asset**. If and when this adjustment is made to the value, it is called a revaluation adjustment.

Unlike what many accounting students feel, the purpose of depreciation is not setting aside some funds to replace the asset at a later stage. However, it is a fact that indirectly, the profits are reduced by the depreciation amount. If this depreciation amount is invested in outside securities, it can actually provide an amount for replacement of the asset.

1.3 Other important terms used in depreciation

1. **Residual value** is the value which the entity expects to realise from disposal of the asset at the end of its useful life. Residual value is likely to be immaterial and is therefore ignored. However, for exam purposes, if it is given in the question, it must be considered.

2. **Useful life** is the **period** over which the asset is expected to be available for an entity's use.

While useful life is denoted in number of years, it may also be denoted in terms of **number of units** expected to be produced by the asset.

Example

Equipment that is purchased today is expected to last for another 5 years. The useful life of the equipment is 5 years. Alternatively, it can also be said that the useful life of the equipment is 1,000,000 units of the equipment it is expected to produce / last for the production of 1,000,000 units.

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3. An **asset held for sale** is an asset available for immediate sale in its present condition.

Tip

Asset held for sale is not examined in Paper T05.

4. **Derecognising** an asset is to stop recognising the asset in the books.

'**Derecognition**' is the opposite of recognition. By '**recognition**' of an asset, we mean recognising the item as an asset in the accounting records and statement of financial position. Derecognition means **removing it from property, plant and equipment in the statement of financial position**. It may be converted into either other assets (e.g. from non-current asset to cash) or a loss / gain on derecognition, or both.

Example

Equipment which is in working condition and is held for sale on 2 March 20X9 is known as, equipment **held for sale,** and is not recognised in the books. This is known as derecognising the asset.

1.4 Depreciable amount

Definition

Depreciable amount is the **cost** of an asset, or any other amount substituted for cost, **less its residual value.**

According to IAS 16 Property, Plant and Equipment, the depreciable amount of an asset should be allocated on a systematic basis over its **useful life**

The depreciable amount is determined after deducting the residual value from the cost.

Example

The cost of a machine is Tshs600 million and its residual value is Tshs20 million. Its depreciable amount will be Tshs580 million (Tshs600 million - Tshs20 million)

Depreciation is charged even if the fair value (F.V.) of the asset exceeds its carrying amount (C.A.). What is required is for the carrying amount to exceed the residual value (R.V).

Tip

Even if F.V. > C.A. depreciation is charged; as long as C.A. > R.V.

Example

The carrying value of the machine is Tshs40 million and its residual value is Tshs20 million. Its fair value is Tshs50 million. Depreciation is charged even if the fair value Tshs50 million exceeds the carrying value Tshs40 million; as long as carrying value exceeds the residual value i.e. Tshs40 million > Tshs20 million.

Depreciation is charged until the residual value of an asset becomes equal to or greater than the asset's carrying amount. Depreciation is not charged once the asset reaches its realisable amount. This is because the entity knows that it will be able to recover the entire residual amount from the sale of the asset. Hence, there is no need to charge depreciation.

Example

The carrying value of the machine is Tshs20 million and its residual value Tshs21 million.

The depreciation charge in this case will be zero because the residual value Tshs21 million > the carrying value Tshs20 million.

1.5 When does the charge of depreciation begin and when does it end?

The depreciation charge **begins** when an asset is available for use at the location, and in a condition intended by the management.

Depreciation **does not end** when the asset becomes idle or is retired from active use unless the asset is fully depreciated. The depreciation charge of an asset **ends** at the **earlier** of the two following events:

the date the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and/ or
the date that the asset is derecognised (sold)

When depreciation is charged at a given percentage per annum, it is said that it is charged on a time basis. However, **under usage-linked methods of depreciation** if there is no production, the depreciation charge can be zero.

Example

Optimistic Ltd has two factories. At factory 1, depreciation is charged on a time basis and in factory 2 it is charged on a usage basis. There are two items of machinery that each cost Tshs50 million at both the factories. During 20X5 / 20X6, both the items remained idle. For factory 1, depreciation will be charged, whereas for factory 2, it will not be charged. This is because, in factory 1, whether the machine is used or not, its life is decreasing and therefore depreciation should be charged. However, in factory 2, only when the machine starts to produce goods will depreciation be charged on the basis of units produced

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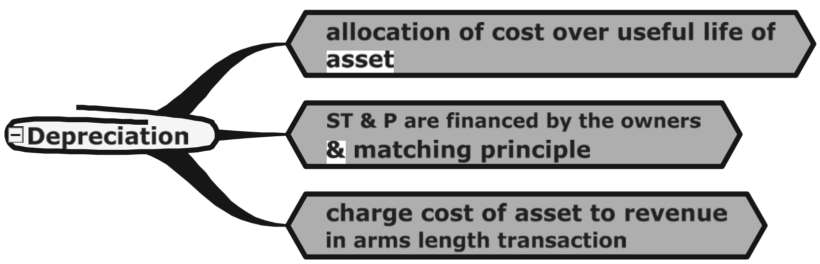
SUMMARY



Test Yourself 1

Which of the following is the most appropriate purpose for charging depreciation?

A To record the decrease in the value of an asset.
B To provide an amount for the replacement of an asset.
C To comply with accrual and the matching principle.
D None of the above.

Test Yourself 2

Depreciation ends:

(i) On the date when the asset is classified as held for sale.
(ii) On the date when the asset is derecognised.
(iii) When the asset becomes idle or is retired from active use no matter whether it is fully depreciated or not.

A (i)
B (i) and (ii)
C (ii) and (iii)
D (i) and (iii)

---

2. Calculate depreciation using straight-line and reducing balance methods.
Identify the circumstances where different methods of depreciation would be appropriate.
[Learning Outcomes b and c]

2.1 Depreciation methods

Definition

"The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity"

IAS 16

The method of charging depreciation selected is to be **applied consistently** from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

The method decided is to be **reviewed at the end of each financial year**. If there is a change in the consumption pattern, the method may be changed. The impact of such a change shall be accounted for as a change in accounting estimates in accordance with IAS 8.

An entity selects the method that **most closely reflects the expected pattern of consumption** of the future economic benefits embodied in the asset.

There are a **variety of depreciation methods** including the **following most widely used methods of depreciation:**

1. Straight-line Method

This method results in a constant charge over the useful life of the asset. The asset's residual value does not change and depreciation is calculated as a fixed amount every year or a fixed percentage of the original cost.

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

Example

Tapra Ltd bought machinery on 01 January 20X4 for Tshs260 million. It incurred transportation and installation expenses of Tshs20 million in connection with the machinery. Tapra Ltd expects the useful life of the asset to be 6 years. The estimated realisable value after 6 years is expected to be Tshs10 million.

Calculate the depreciation for six years.

Answer

(Amounts in Tshs'000)

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

$$= \frac{(\text{Tshs}260{,}000 + \text{Tshs}20{,}000) - \text{Tshs}10{,}000}{6} = \text{Tshs}45{,}000$$

The carrying values at the end of each year will be as follows:

	Tshs'000	Tshs'000
1st year	280,000 - 45,000	235,000
2nd year	235,000 - 45,000	190,000
3rd year	190,000 - 45,000	145,000
4th year	145,000 - 45,000	100,000
5th year	100,000 - 45,000	55,000
6th year	55,000 - 45,000	10,000

The carrying value at the end of the asset's useful life is equal to the **disposal or realisable value**.

If the depreciation rate is applied as a percentage, it will be **applied to the original cost,** and not to the carried down value net of depreciation.

E.g. it may be stated that depreciation is to be charged at 16.07% of the original cost, on a straight line basis.

The amount of depreciation each year would be calculated as 280,000 x 16.07% = 45,000

The amount of depreciation remains constant in this method.

2. Diminishing or reducing balance method

Under this method, depreciation is charged as a percentage of the written down or book value of the asset i.e. cost minus accumulated depreciation. This is also known as the **reducing balance method.** This method results in a decreasing charge over the useful life of the asset.

Depreciation = (Cost – Accumulated depreciation) x Depreciation rate

Example

KPL Inc purchased machinery for Tshs10,000 on 1 January 20X4. Its expected life is 4 years and the residual disposal value is Tshs1,296. KPL charges depreciation at 40% using the reducing balance method. Calculate the depreciation amount for 4 years.

Answer

Calculation of the depreciation amount:

Year	Particulars	Calculation	Depreciation	Carrying value
1st year	Depreciation	= 10,000 x 40%	= Tshs4,000	
	Carrying value	= 10,000 - 4,000		= Tshs6,000
2nd year	Depreciation	= 6,000 x 40%	= Tshs2,400	
	Carrying value	= 6,000 - 2,400		= Tshs3,600
3rd year	Depreciation	= 3,600 x 40%	= Tshs1,440	
	Carrying value	= 3,600 - 1,440		= Tshs2,160
4th year	Depreciation	= 2,160 x 40%	= Tshs864	
	Carrying value	= 2,160 – 864		= Tshs1,296

The depreciation charged in this method keeps reducing every year. In this case it was Tshs4,000 in the first year, which gradually reduced to Tshs864.

Under the diminishing balance method of depreciation, the carrying value at the end of the useful life is equal to the disposal or realisable value.

Comparison between straight-line method and reducing balance method

Straight-line method	Reducing balance method
It charges a **fixed amount each year** to the statement of profit or loss	It charges a **higher amount during the initial years** when the machine is new and efficient and a lower amount in later years
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
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.

3. The units of production method

This method would be appropriate where the economic benefits derived from the assets are in proportion to the units produced and in cases where the pattern of production is not uniform. This method results in a charge based on the expected use or output of the asset. Under this method of depreciation, the cost of the non-current asset is allocated in proportion to the production achieved.

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

Example

On 1 January 20X2 LPN Ltd bought a new asset for Tshs100 million that was estimated to have a working life of 5 years. Its realisable value after that was estimated at Tshs20 million. It is expected to produce 800,000 units of output during its useful life. The actual production for the five years was as follows:
20X2: 150,000; 20X3: 200,000; 20X4: 190,000; 20X5: 150,000; 20X6: 110,000

(a) Calculate the depreciation provision under the units of production method.
(b) Show the depreciation schedule.

Answer

(a)

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

$$= \frac{\text{Tshs100 million - Tshs20 million}}{\text{800,000 units}}$$

$= \text{Tshs100 per unit}$

We now multiply the value of Tshs100 per unit by the number of units of output per year.

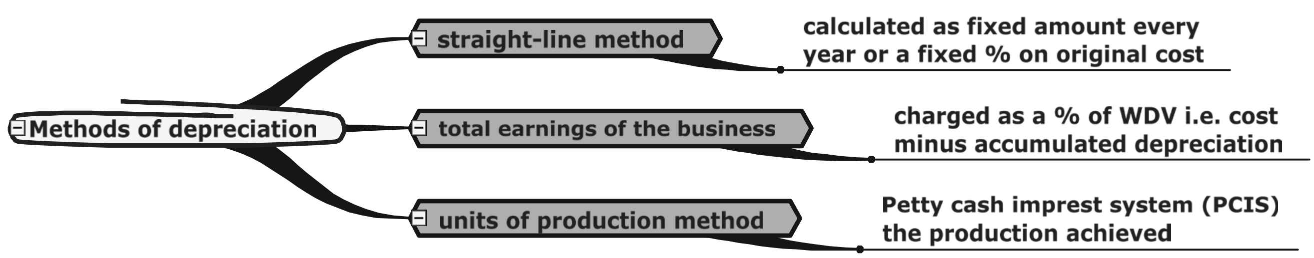
(b) Depreciation Schedule

Year ended	Production (units)	Annual Depreciation	Carrying Value
		Tshs'000	Tshs'000
01/01/20X2		-	100,000
31/12/20X2	150,000	15,000	85,000
31/12/20X3	200,000	20,000	65,000
31/12/20X4	190,000	19,000	46,000
31/12/20X5	150,000	15,000	31,000
31/12/20X6	110,000	11,000	20,000

Note

The carrying value on 31 December 20X6 is exactly Tshs20 million which is the selling value it is expected to achieve.

SUMMARY



2.2 Depreciation on assets acquired or disposed of in the middle of an accounting year

Depreciation is charged pro-rata over the period of use i.e. depreciation is charged for that part of the accounting period during which the asset is used. However, there are two other methods of calculating the depreciation provisions for assets acquired and disposed of during the accounting year which are sometimes followed for the purpose of approximation.

1. **In the year of acquisition,** calculate the depreciation for the whole year irrespective of the date of acquisition. **In the year of sale,** ignore depreciation for the full year irrespective of the date of sale of an asset.

2. Provide for depreciation on the asset on the basis of the number of months the asset is used in the year of sale or purchase.

Tip

In years other than the years of sale and purchase (i.e. the years when the entity owns and uses the asset), depreciation is provided for the whole year irrespective of the number of months the asset is used.

Example

Smart Enterprises runs a computer software business. The proprietor purchases a car for himself, and later for his chief assistant, Peter. The relevant data is as follows:

	Date of purchase	Cost	Estimated life	Estimated residual value
Proprietor's car	1 June 20X6	Tshs20 million	3 years	Tshs2 million
Peter's car	1 January 20X7	Tshs8 million	3 years	Tshs2 million

The straight-line method of depreciation is to be used.

Prepare the motor vehicles account and the accumulated depreciation of the motor vehicles account for the years to 31 December 20X7. (You should allow for the proportionate monthly use of the car while computing the annual charge of depreciation.)

Calculate the net book value of the motor vehicles as at 31 December 20X7.

Answer

Motor vehicles account

Dr | | | | | Cr

Date		Tshs'000	Date		Tshs'000
01/06/20X6	Asset payables (or cash)	20,000	31/12/20X6	Balance c/f	20,000
		20,000			**20,000**
01/01/20X7	Balance b/f	20,000			
01/01/20X7	Asset payables (or cash)	8,000	31/12/20X7	Balance c/f	28,000
		28,000			**28,000**
01/01/20X8	Balance b/f	**28,000**	01/01/20X8		28,000

Continued on the next page

Accumulated depreciation of motor vehicles

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Balance c/f	3,500	31/12/20X6	Statement of profit or loss	3,500
		3,500			**3,500**
			01/01/20X7	Balance b/f	**3,500**
			31/12/20X7	Statement of profit or loss (Tshs6,000 + Tshs2,000)	8,000
31/12/20X7	Balance c/f	11,500			
		11,500			**11,500**
			01/01/20X8	Balance b/f	11,500

Statement of financial position (extracts) for the year ended 31 December 20X7

	Proprietor's car	Peter's car	Total
	Tshs'000	Tshs'000	Tshs'000
Asset at cost	20,000	8,000	28,000
Less: Accumulated depreciation:			
Year to: 31/12/20X7	9,500	2,000	11,500
	10,500	**6,000**	**16,500**

Workings

1. **Proprietor's car**

$$\text{Annual depreciation} = \frac{(\text{Tshs20 million - Tshs2million})}{3 \text{ years}} = \text{Tshs6million p.a.}$$

		Tshs'000
	Monthly depreciation Tshs0.5 million	
Depreciation	1 June 20X6- 31 December 20X6 (7 months)	3,500
	1 January 20X7- 31 December 20X7	6,000
		9,500

2. **Peter's car**

$$\text{Annual depreciation} = \frac{(\text{Tshs8 million - Tshs2 million})}{3 \text{ years}} = \text{Tshs2million p.a.}$$

Depreciation	1 January 20X7-31 December 20X7	Tshs2 million

2.3 Change in the depreciation method

The depreciation method is expected to be followed consistently. However, if the pattern of expected consumption of economic benefits has changed, then the method of depreciation may be changed.

If the method of charging depreciation has been changed, then the change is prospective and not retrospective.

This means:

The net book value on the date of change is depreciated over the remaining period according to the new method.

Only the depreciation for the current period and the future periods will change.

The calculations for the past periods are not restated.

Example

Jack and Rose Co purchased machinery for Tshs60 million on 1 April 20X2. The transportation and installation charges incurred are Tshs5 million. The machinery was estimated to have a useful life of 6 years. It was decided to depreciate the machinery using the reducing value method. The rate of depreciation was 25%.

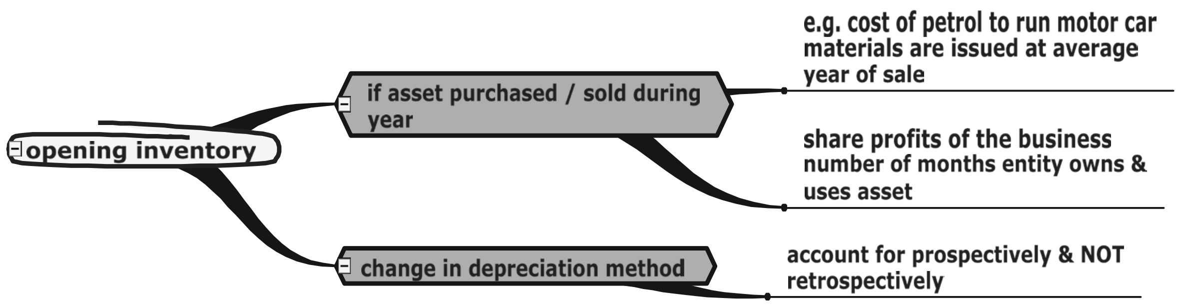
On 01 April 20X5 it is found that the reducing value method is no more appropriate and therefore the method is changed to the straight-line method. The depreciation on the machine over its life will be as follows:

Tshs60 million + Tshs5 million = Tshs65 million

Year	Carrying value at the beginning of the period	Rate of depreciation	Depreciation charge	Written down value at the end of the period	Aggregate depreciation
	Tshs'000		**Tshs'000**	**Tshs'000**	**Tshs'000**
20X2	65,000	25%	16,250	48,750	16,250
20X3	48,750	25%	12,187	36,563	28,437
20X4	36,563	25%	9,141	27,422	37,578
20X5	**27,422		9,141	18,281	46,719
20X6	18,281		9,141	9,140	55,860
20X7	9,140		9,140	0	65,000

** In 20X5, when the written down value was Tshs27,422,000, it was decided to change the method to the straight-line method. Therefore, the depreciation will be = depreciable amount / number of years of remaining useful life i.e. Tshs27,422,000 / 3 years = Tshs9,141,000.

SUMMARY



Example

Jon Bros. acquired a machine on 1 July 20X6 at a cost of Tshs14 million and spent Tshs1 million on its installation. The firm writes off depreciation at 10%. The books are closed on 31 December every year. Show the machinery account and depreciation account for 20X6-20X7 using the straight-line method and reducing balance method.

Machinery account (straight-line method)

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/07/20X6	Asset payables (or cash)	14,000	31/12/20X6	Depreciation (6 months)	750
	Bank (installation)	1,000			
				Balance c/d	14,250
		15,000			**15,000**
01/01/20X7	Balance b/f	14,250	31/12/20X7	Depreciation (Tshs15,000 / 10 years)	1,500
			31/12/20X7	Balance c/f	12,750
		14,250			**14,250**

Continued on the next page

Depreciation account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Machinery account	750	31/12/20X6	Statement of profit or loss	750
		750			**750**
31/12/20X7	Machinery account	1,500	31/12/20X7	Statement of profit or loss	1,500
		1,500			**1,500**

Machinery account (reducing balance method)

Dr | Cr

Date		Tshs'000	Date		Tshs'000
01/07/20X6	Payables (or cash)	14,000	31/12/20X6	Depreciation (6 months)	750
	Bank (installation)	1,000		Balance c/d	14,250
		15,000			**15,000**
01/01/20X7	Balance b/d	14,250	31/12/20X7	Depreciation	1,425
			31/12/20X7	Balance c/d	12,825
		14,250			**14,250**

Depreciation account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Machinery account	750	31/12/20X6	Statement of profit or loss	750
		750			**750**
31/12/20X7	Machinery account	1,425	31/12/20X7	Statement of profit or loss	1,425
		1,425			**1,425**

Test Yourself 3

Which of the following is not a method of charging depreciation?

A The straight-line method
B The reducing value method
C The units of production method
D The residual value method

3. Illustrate how depreciation expense and accumulated depreciation are recorded in ledger accounts.
Record depreciation in the statement of profit or loss and statement of financial position.
[Learning Outcomes d and g]

Accumulated depreciation refers to the cumulation of depreciation expenses of each year. It reflects the loss of the value of the asset, due to wear and tear, usage of asset, obsolesce, etc. It is reflected in the statement of financial position as a reduction from the gross value of the asset.

The accounting entries for recording depreciation expenses are as follows:

1. When the asset is purchased

Dr	Asset account	X	
Cr	Cash / Bank account for the amount paid		X
Cr	Liability account for the amount unpaid		X

Being asset purchased

2. When depreciation is charged

Dr	Depreciation account	X	
Cr	Accumulated depreciation account		X

Being depreciation charged

3. To transfer depreciation to statement of profit or loss

Dr	Statement of profit or loss	X	
Cr	Depreciation account		X

Being depreciation transferred to the statement of profit or loss

Accumulated depreciation has been explained through the following comprehensive example:

Example

On 1 January 20X4 Kalbros Ltd purchased a second-hand plant for Tshs72 million and immediately spent Tshs48 million on getting the plant into working condition. On 1 July 20X4, an additional plant that cost Tshs48 million was purchased. On 1 July 20X6 the plant purchased on 1 January 20X4 became obsolete and was sold for Tshs60 million. On 1 July 20X6 another new plant was purchased at a cost of Tshs144 million. The firm calculated depreciation under the reducing balance method at 15% per annum. Show the machinery account and the accumulated depreciation account for the calendar years 20X4 to 20X6.

Answer

To identify the plants, let us give them nos. I, II and III

The plant-wise break up is given in the account itself. This can also be given in a separate working.

Machinery account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/01/20X4	Bank account (purchased plant I)	72,000			
01/01/20X4	Bank (or cash) account (expenses to get the plant into working condition)	48,000			
01/07/20X4	Bank account (purchased plant II)	48,000	31/12/20X4	Balance c/f	
				Plant I	120,000
				Plant II	48,000
		168,000			**168,000**
Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X5	Balance b/f				
	Plant I	120,000			
	Plant II	48,000			
			31/12/20X5	Balance c/f	
				Plant I	120,000
				Plant II	48,000
		168,000			**168,000**
Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X6	Balance b/f		01/01/20X6	Accumulated depreciation	39,803
	Plant I	120,000			
	Plant II	48,000			
01/07/20X6	Bank (bought plant III)	144,000	01/07/20X6	Bank (sale proceeds: plant I)	60,000
				Statement of profit or loss (Loss on sale Tshs120,000 – Tshs39,803 - Tshs60,000)	20,197
			31/12/20X6	Balance c/f	
				Plant II	48,000
				Plant III	144,000
		312,000			**312,000**

Continued on the next page

Accumulated depreciation account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X4	Balance c/f		31/12/20X4	Depreciation	
	Plant I	18,000		**On plant I** (for full year)	18,000
	Plant II	3,600		(Tshs72,000 + Tshs48,000) x 15%	
				On plant II	3,600
				(for 6 months)	
				Tshs48,000 x 15% x 6/12	
		21,600			**21,600**
Date		**Tshs'000**	**Date**		**Tshs'000**
			01/01/20X5	Balance b/f	18,000
				Plant I	3,600
				Plant II	
31/12/20X5	Balance c/f		31/12/20X5	**Depreciation provision**	
	Plant I	33,300		**On plant I** (for full year)	15,300
	Plant II	10,260		Tshs102,000 x 15%	
				On plant II (for full year)	6,660
				Tshs44,400 x 15%	
		43,560			**43,560**
Date		**Tshs'000**	**Date**		**Tshs'000**
			01/01/20X6	Balance b/f	
				Plant I	33,300
				Plant II	10,260
31/07/20X6	Machinery account	39,803	01/07/20X6	**Depreciation provision**	
	(Accumulated depreciation on plant I transferred)			(**Plant I** - 6 months) Tshs86,700 x 15% x 6/12)	6,503
			31/12/20X6	**Depreciation provision:**	
				On plant II (for full year	5,661
				Tshs37,740 x 15%)	
				On plant III	10,800
				(for 6 months Tshs144,000 x 15 % x 6/12)	
31/12/20X6	Balance c/f				
	Plant II	15,921			
	Plant III	10,800			
		66,524			**66,524**

Continued on the next page

Depreciation Account

Dr					Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X4	Accumulated depreciation On plant I (for full year) (Tshs72,000 + Tshs48,000) x 15%	18,000			
	On plant II (for 6 m) Tshs48,000 x 15% x 6/12	3,600	31/12/20X4	Statement of profit or loss - transfer	21,600
		21,600			**21,600**
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X5	Accumulated depreciation on plant I (for full yr) Tshs102,000 x 15%	15,300			
	On plant I (for full yr) Tshs44,400 x 15%	6,660	31/12/20X5	Statement of profit or loss - transfer	21,960
		21,960			**21,960**
Date		**Tshs'000**	**Date**		**Tshs'000**
31/07/20X6	Accumulated depreciation (Plant I - 6 months) Tshs86,700 x 15% x 6/12)	6,503	31/07/20X6		
31/12/20X6	Depreciation provision: On plant II (for full year Tshs37,740 x 15%)	5,661			
	On plant III (for 6 months Tshs144,000 x 15% x 6/12)	10,800			
			31/12/20X6	Statement of profit or loss - transfer	22,964
		22,964			**22,964**

Presentation in the statement of profit or loss and statement of financial position

1. **If the statement of profit or loss is presented using the 'nature of expenses' method,** then depreciation and amortisation expenses are disclosed on the face of the statement of profit or loss as an expense.

In the above example the presentation of non-current assets and depreciation in the financial statements is as follows:

Example

Extract from statement of profit or loss for the year ended 31 December 20X6
(Nature of expenses method)

Revenue	X
Other income	X
Changes in inventories of finished goods and work in progress	X
Raw materials and consumables used	X
Employee benefits expense	X
Depreciation and amortisation expense	22,964
Other expenses	X
Total expenses	X
Profit	**X**

Tip

Remember statement of profit or loss includes only the depreciation for the current year.

2. **Under the 'function of expenses' method of presentation of the statement of profit or loss**, depreciation does not appear on the face of the statement of profit or loss. The information is given in the notes.

Function of expense method presents expenses according to their function e.g. distribution expenses, administration expenses and finance expenses.

Example

Presentation in the statement of financial position

In the statement of financial position, property, plant and equipment is shown at the carrying value in the following manner:

Assets	
Non-current assets	**Tshs'000**
Property plant and equipment	192,000 (48,000 + 144,000)
Less: Accumulated depreciation	(26,721) (15,921 + 10,800)
	165,279

(**Note:** this calculation may be given on the face of the statement of financial position or in a schedule. The net amount of Tshs165,279,000 must always appear on the face of the statement of financial position).

Example

Diana & Co purchased a non-current asset on 1 January 20X1 for Tshs20 million. It had an estimated life of six years and an estimated residual value of Tshs8 million. The asset was sold after three years on 1 January 20X4 to another trader who purchased it for Tshs17.5 million.

What was the profit or loss on disposal, assuming that the business uses the straight-line method for depreciation?

Answer

$$\text{Annual depreciation} = \frac{(\text{Ths20 million - Tshs8 million})}{\text{6 years}} = \text{Tshs2 million p.a.}$$

	Tshs'000
Cost of asset	20,000
Less: Accumulated depreciation (for 3 years)	(6,000)
Net book value at date of disposal	14,000
Sale price	17,500
Profit on disposal of asset	**3,500**

Example

On 1 July 20X1 Bill Inc purchased a machine for Tshs35 million. The machine had an estimated residual value of Tshs3 million and a life of eight years. The machine was sold for Tshs18.6 million on 31 December 20X4, the last day of the accounting year of the business. To sell the machine, the business had to incur dismantling costs and the costs of transporting the machine to the buyer's premises. These costs amounted to Tshs1.2 million.

Required:

Assuming that the business uses the straight-line method of depreciation, what was the profit or loss on disposal of the machine?

`Continued on the next page

Answer

$$\text{Annual depreciation} = \frac{(\text{Tshs35 million - Tshs3 million})}{8 \text{ years}} = \text{Tshs4 million p.a.}$$

	Tshs'000	Tshs'000
Non-current asset at cost		35,000
Less: Accumulated depreciation		
Depreciation in 20X1 (6 months)	2,000	
20X2, 20X3 and 20X4 (3 years)	12,000	14,000
Net book value at date of disposal		21,000
Sale price	18,600	
Less: Costs incurred in making the sale	(1,200)	
Net sale price		17,400
Loss on disposal		**(3,600)**

Tip

Disposal gains and losses (like most calculations) can also be calculated by preparing a required ledger accounts. However, in order to answer multiple choice questions quickly, it is easier to solve questions using the tabular format.

Test Yourself 4

In the statement of profit or loss the amount of depreciation recorded is for the:

A Remaining life of the asset
B Number of years the asset is used i.e. accumulated depreciation since the purchase of the asset
C Current period
D None of the above

4. Calculate depreciation on a revalued non-current asset including the transfer of excess depreciation between the revaluation surplus and retained earnings.
[Learning Outcome e]

Depreciation on revalued non-current asset

When non-current assets are revalued, the depreciation is calculated on the revalued amount of the asset, not on the book value or cost.

Example

The cost of a machine on 1 January 20X6 is Tshs5 million. At the end of three years, its book value is Tshs3.5 million. On 1 January 20X9, the machine is revalued at Tshs4 million.

Here, depreciation will be calculated on its revalued amount Tshs4 million.

4.1 Depreciation calculation and accounting treatment after revaluation

After revaluation, the depreciation calculations will be based on the revalued amount. The full depreciation amount is charged as an expense to the statement of profit or loss. An amount equal to the difference between the depreciation on the revalued amount and that on the original cost may be transferred from revaluation surplus to retained earnings.

Example

JM Products Plc purchased machinery for Tshs24 million on 1 January 20X4. Its expected life was 6 years. JM Products depreciated it under SLM for 20X4 to 20X6. On 01 January 20X7 the asset was revalued at Tshs21 million.

Show the accounting entries for 20X7.

Answer

	Tshs'000
Cost on 01/01/20X7	24,000
Less: Accumulated depreciation on 01/01/20X7	12,000
Carrying value on 01/01/20X7	12,000
Revalued at	21,000
Difference between the two is a gain	**9,000**

As **carrying value < revalued amount**

The accounting entry will be:

			Tshs'000	**Tshs'000**
Dr		Machinery account	9,000	
	Cr	Revaluation Surplus Account		9,000

Being increased amount of machine on revaluation is recorded

Recognised in OCI part of the SOPL and OCI and accumulated in equity under the heading of revaluation surplus.

Depreciation for the remaining life (3 years) of the asset will be Tshs21 million/3 years= Tshs7 million

Depreciation on the original cost was Tshs24 million / 6 years = Tshs4 million

Each year (from 20X7 to 20X9), depreciation will be charged at Tshs7 million on the revalued amount of the machinery and the difference (between depreciation on revalued amount and original cost) of Tshs3 million (Tshs7 million – Tshs4 million) will be transferred to retained earnings. This is because the additional amount of depreciation is treated as revaluation surplus which is realised.

The entry will be:

			Tshs'000	**Tshs'000**
Dr		Depreciation on machinery	7,000	
	Cr	Accumulated depreciation		7,000

Being depreciation on the revalued asset

Dr		Revaluation Surplus Account	3,000	
	Cr	Retained Earnings		3,000

Being additional depreciation on the revalued asset is transferred to the retained earnings

Continued on the next page

Machinery account

Dr **Cr**

		Tshs'000			Tshs'000
01/01/20X4	Cash	24,000			
			31/12/20X4	Balance c/d	24,000
		24,000			**24,000**
01/01/20X5	Balance b/d	24,000			
			31/12/20X5	Balance c/d	24,000
		24,000			**24,000**
01/01/20X6	Balance b/d	24,000			
			31/12/20X6	Balance c/d	24,000
		24,000			**24,000**
01/01/20X7	Balance b/d	24,000			
01/01/20X7	Revaluation surplus	9,000	31/12/20X7	Balance c/d	33,000
		33,000			**33,000**
01/01/20X8	Balance b/d	33,000			
			31/12/20X8	Balance c/d	33,000
		33,000			**33,000**
01/01/20X9	Balance b/d	33,000			
			31/12/20X9	Balance c/d	33,000
		33,000			**33,000**

Depreciation on machinery account

Dr **Cr**

		Tshs'000			Tshs'000
31/12/20X4	Balance c/d	4,000	31/12/20X4	SOPL	4,000
		4,000			**4,000**
			01/01/20X5	Balance b/d	4,000
31/12/20X5	Balance c/d	8,000	31/12/20X5	SOPL	4,000
		8,000			**8,000**
			01/01/20X6	Balance b/d	8,000
31/12/20X6	Balance c/d	12,000	31/12/20X6	SOPL	4,000
		12,000			**12,000**
			01/01/20X7	Balance b/d	12,000
31/12/20X7	Balance c/d	19,000	31/12/20X7	SOPL	7,000
		19,000			**19,000**
			01/01/20X7	Balance b/d	19,000
31/12/20X8	Balance c/d	19,000	31/12/20X7	SOPL	7,000
		26,000			**26,000**
			01/01/20X7	Balance b/d	26,000
31/12/20X9	Balance c/d	33,000	31/12/20X7	SOPL	7,000
		33,000			**33,000**

Revaluation surplus account

Dr **Cr**

		Tshs'000			Tshs'000
31/12/20X7	Retained earnings	3,000	01/01/20X7	Machinery	9,000
31/12/20X7	Balance c/d	6,000			
		9,000			**9,000**
31/12/20X8	Retained earnings	3,000	01/01/20X8	Balance b/d	6,000
31/12/20X8	Balance c/d	3,000			
		6,000			**6,000**
31/12/20X9	Retained earnings	3,000		Balance b/d	3,000
31/12/20X9	Balance c/d				
		3,000			**3,000**

4.2 Treatment of accumulated depreciation after revaluation

When an item is revalued we arrive at its present fair value that is **comparable to** its carrying value, i.e. **gross value less depreciation**. This raises the issue of how the accumulated depreciation should be treated.
IAS 16 gives two options:

1. The accumulated depreciation may be either **restated proportionately** so that the carrying amount of the asset after revaluation equals its revalued amount. This method is normally used when an asset is revalued by applying an index to its depreciated replacement cost.

Example

An entity adopts a revaluation model. Its building has a carrying value of Tshs500 million (arrived at after deducting accumulated depreciation of Tshs100 million from the gross value of Tshs600 million). The fair value of the building is Tshs700 million.

Tshs700 million - Tshs500 million

There is a 40% increase in the net value (Tshs200 million/Tshs500 million x 100) of the building.

The gross value as well as the accumulated depreciation shall be increased by 40%, to Tshs840 million (Tshs600 million + 40% of Tshs600 million) and Tshs140 million (Tshs100 million + 40% of Tshs100 million) respectively.

This will give a carrying amount of Tshs700 million (i.e. Tshs840 million - Tshs140 million), which is equal to the revalued amount.

Building account

Dr **Cr**

	Tshs'000		**Tshs'000**
Balance b/d	600,000		
Revaluation surplus (gain) (40% of Tshs600,000)	240,000	Balance c/d	840,000
	840,000		**840,000**

Accumulated depreciation account

Dr **Cr**

	Tshs'000		**Tshs'000**
		Balance b/d	100,000
Balance c/d	140,000	SOPL (40% of Tshs100,000)	40,000
	140,000		**140,000**

Revaluation surplus account

Dr **Cr**

	Tshs'000		**Tshs'000**
Retained earnings	40,000	Balance b/d	-
Balance c/d	200,000	Building account	240,000
	240,000		**240,000**

2. Or the accumulated depreciation may be **deducted from** the original gross carrying amount of the asset in order to determine the original net carrying amount of the asset. This net amount is then increased or decreased to make it equal to the revalued amount of the asset. **This is the more common method.**

Example

(i) At present there are two ledger accounts: a building account with a debit balance of Tshs600 million and an accumulated depreciation account with a credit balance of Tshs100 million.

(ii) The balance in the accumulated depreciation account will be transferred to the building account. Therefore the balance of the building account will be reduced from Tshs600 million to Tshs500 million (its net carrying amount). This net amount is then increased by Tshs200 million to make it equal to the revalued amount of Tshs700 million. Tshs100 million accumulated depreciation is transferred to the revaluation surplus account.

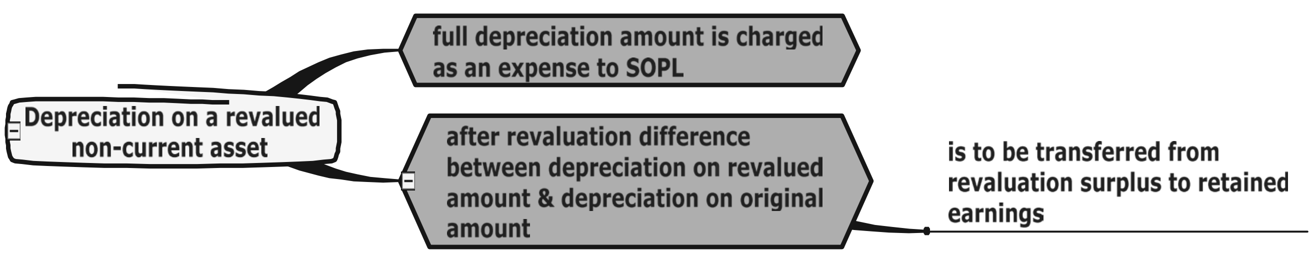
Building account

		Tshs			Tshs
	Balance b/d	600,000		Accumulated depreciation (transfer)	100,000
	Revaluation surplus (gain)	200,000		Balance c/d	700,000
		800,000			**800,000**

Accumulated depreciation account

		Tshs			Tshs
	Building account (transfer)	100,000		Balance b/d	100,000

SUMMARY



Test Yourself 5

Plasto Plc purchased machinery for Tshs120 million on 1 January 20X2. Its expected life was 10 years. Plasto Plc depreciated it by SLM from 20X2 to 20X6. On 1 January 20X7 the asset was revalued at Tshs90 million.

Calculate the amount to be transferred from the revaluation surplus to the retained earnings.

A Tshs3,000,000
B Tshs6,000,000
C Tshs12,000,000
D Tshs9,000,000

5. Calculate the adjustments to depreciation necessary if changes are made in the estimated useful life and / or residual value of a non-current asset.

[Learning Outcome f]

We learnt earlier that;

> The depreciable amount is the cost of an asset, or other amount substituted for cost (i.e. revalued amount), less its residual value, and
> The depreciable amount of an asset shall be allocated on a systematic basis over its **useful life**.

It is obvious that if the residual value changes, the depreciable amount will change and therefore depreciation will change. Similarly, if the estimated useful life changes, then the depreciation charged over the useful life of asset is bound to change. If any of these changes happen, depreciation has to be recalculated.

IAS 16 requires that the residual value and the useful life of an asset are **reviewed** at least at each financial year-end. If expectations differ from previous estimates, the change(s) should be accounted for as follows:

Step 1 Calculate the depreciation until the date of change
Step 2 Calculate the book value until the date of change (Cost – accumulated depreciation)
Step 3 Calculate the new depreciable amount (Book value – residual value)
Step 4 Calculate the remaining useful life
Step 5 Calculate the new amount of depreciation. For a straight line method calculation, it is = new depreciable amount / remaining useful life.

Example

A company purchased a non-current asset for Tshs17 million. It was expected to have a residual value of Tshs1 million, and its useful life was estimated at 8 years. The company charges depreciation under the straight-line method. After two years, it was discovered that the original estimate of useful life was wrong and that the actual total useful life would be only 6 years. Calculate the revised depreciation.

Answer

The initial depreciation under the straight-line method is calculated as:

$$\text{Depreciation (p.a.)} = \frac{\text{Depreciable amount}}{\text{Estimated useful life of the asset}}$$

$$= \frac{\text{Tshs17 million - Tshs1 million}}{\text{8 years}}$$

$$= \text{Tshs2 million p.a.}$$

Depreciation charged for two years	= Tshs2 million x 2 years = Tshs4 million
Book value after two years	= Tshs17 million - Tshs4 million = Tshs13 million
Residual value: remains at	= Tshs1 million
New depreciable amount	= Tshs13 million - Tshs1 million = Tshs12 million
Revised remaining useful life	= 6 years - 2 years
	= 4 years
Revised depreciation	= Tshs12 million / 4 years
	= Tshs3 million

The same procedure is followed if the residual value of the asset changes.

Test Yourself 6

A company purchased a machine for Tshs70 million. It was expected to have a residual value of Tshs2.4 million and its useful life was estimated at 8 years. The company charges depreciation under the straight-line method. After three years, it was discovered that the original estimate of residual value was wrong and that the actual residual value would be only Tshs1.5 million.

The revised depreciation will be:

A Tshs8,562,500
B Tshs5,393,750
C Tshs7,450,750
D Tshs8,630,000

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

The most appropriate purpose for charging depreciation is to comply with accrual and the matching principle.

Answer to TY 2

The correct option is **B**.

Charging depreciation ceases when an asset is classified as held for sale or when it is derecognised. Depreciation does not end when the asset becomes idle or is retired from active use.

Answer to TY 3

The correct option is **D**.

The residual value is the value which the entity expects to realise from disposal of the asset at the end of its useful life. It is not a method of depreciation. All the others are methods of depreciation.

Answer to TY 4

The correct option is **C**.

The statement of profit or loss includes only the depreciation for the current year. Accumulated depreciation is considered in the statement of financial position in order to calculate the carrying amount.

Answer to TY 5

The correct option is **B**.

Depreciation for the remaining life (5 years) will be Tshs90 million / 5 years = Tshs18 million

Depreciation on the original cost Tshs120 million/ 10 years = Tshs12 million

Difference Tshs6 million

Amount to be transferred to the retained earnings = Tshs6 million

Answer to TY 6

The correct option is **D**.

Initial depreciation under the straight-line method is:

$$\text{Depreciation (p.a.)} = \frac{\text{Depreciable amount}}{\text{Estimated useful life of the asset}}$$

$$= \frac{\text{Tshs70 million - Tshs2.4 million}}{\text{8 years}}$$

$$= \text{Tshs8.45 million p.a.}$$

Depreciation charged for three years	= Tshs8.45 million x 3 years = Tshs25.35 million
Carrying value after three years	= Tshs70 million – Tshs25.35 million = Tshs44.65 million
New depreciable amount	= Tshs44.65 million – Tshs1.5 million= Tshs43.15 million
Remaining useful life	= 8 years- 3 years
	= 5 years
Revised depreciation	= Tshs43.150 million / 5 years
	= Tshs8.63 million

Self Examination Questions

Question 1

State any five important points one should keep in mind when charging depreciation.

Question 2

Which of the following statements is incorrect?

A The depreciation method should be followed consistently.
B Under the straight-line method, a fixed amount is charged each year.
C The depreciation charge begins when an asset is available for use at the location and in the condition intended by the management.
D When the fair value of an asset exceeds its carrying amount, the depreciation of the asset ends.

Question 3

An entity adopts the revaluation model. Its building has a carrying value of Tshs900 million i.e. gross value Tshs1,050 million – accumulated depreciation Tshs150 million. The building is revalued at Tshs1,260 million.

Required:

Calculate the revised accumulated depreciation.

Question 4

Which of the following statements is correct?

A Under the straight-line method, depreciation plus repairs remains constant each year.
B Under the reducing value method depreciation remains constant each year.
C Under the reducing value method depreciation plus repairs remains relatively stable over the useful life of the asset.
D The depreciation charge should not be zero under any method for any year, unless the asset is derecognised or classified as held-for–sale.

Question 5

KKAC Inc purchased machinery for Tshs25 million on 1 January 20X4. Installation charges are Tshs2 million. Its expected life is 4 years and the residual disposal value is Tshs3.5 million.

Required:

Calculate the amount of depreciation under the reducing balance method for the first and second year. Rate of depreciation is given as 40% p.a.

Question 6

On 1 October 20X7 James Inc acquired a machine for Tshs29 million. The company spent Tshs1 million for installation, which was paid by cheque. The rate of depreciation is 10%. The end of the reporting period is 31 December 20X8.

Required:

Show the machinery and depreciation account using the straight line method and also the diminishing balance method.

Question 7

At 31 December 20X4 Q, a limited liability company, owned a building which was purchased on 1 January 1995 for Tshs800 million. It was being depreciated at two per cent per year.

On 1 January 20X5 a revaluation to Tshs1,000 million was recognised. At this date the building had a remaining useful life of 40 years.

What is the depreciation charge for the year ended 31 December 20X5 and the revaluation surplus balance as at 1 January 20X5?

	Depreciation charge for year ended 31 December 20X5	Revaluation surplus as at 1 January 20X5
A	25,000	200,000
B	25,000	360,000
C	25,000	200,000
D	25,000	360,000

Question 8

On 1 April 20X3 Pluto Ltd had a motor vehicles account had a balance of Tshs126 million and accumulated depreciation of Tshs55.5 million on 1 April 20X3. One of the vehicles which was purchased on 1 May 20X2 at a cost of Tshs54 million was sold on 1 January 20X5 for Tshs28.5 million. Full year's depreciation is provided in the year of purchase but no depreciation in the year of sale. Depreciation is to be made at 20% on book value for financial years ending 31 March each year.

Required:

Prepare the following ledger accounts, in the books of Pluto Ltd.

(a) Motor vehicles account for the years ended March 20X4 and March 20X5.

(b) Accumulated depreciation on motor vehicles for the years ended March 20X4 and March 20X5.

(c) Motor vehicle disposal account

Answers to Self Examination Questions

Answer to SEQ 1

Important points for charging depreciation

(a) The method of depreciation should be reviewed at the end of each financial year
(b) The method of depreciation should be one that most closely reflects the expected pattern of consumption.
(c) For any change in the method of depreciation, the impact of the change should be accounted for as a change in accounting estimates (i.e. prospectively).
(d) Under usage methods of depreciation if there is no production, the depreciation charge can be zero.
(e) Depreciation is charged pro-rata to the period of use.

Answer to SEQ 2

The correct option is **D**.

The depreciation charge should not cease unless the asset has been classified as held-for-sale or has been disposed of.

Answer to SEQ 3

Calculate percentage of increase in the net value.

Percentage increase in net value = Increase in net value/carrying value x 100
= Tshs360 million/ Tshs900 million x 100
= 40%

Therefore, accumulated depreciation should be increased by 40%

Revised accumulated depreciation = Tshs150 million + 40% of Tshs150 million
= Tshs210 million

Answer to SEQ 4

The correct option is **C**.

The amount of depreciation plus repairs remains relatively stable throughout the life of the asset under the reducing balance method. This is because in the initial years when the depreciation charge is high, the amount of repairs is low. In the later years of the asset's useful life, the amount of repairs rises while the depreciation charge reduces.

Under the straight line method, while the depreciation charge remains constant each year, the amount spent on the repairs each year would increase as the asset approaches the end of its useful life.

Under the reducing balance method, the depreciation charge is a percentage of the written down value of the asset. Hence the amount of depreciation changes each year.

Under usage linked methods of charging depreciation, the depreciation charge can be zero in accounting periods where there is no production.

Answer to SEQ 5

Cost of the assets = Tshs25 million + Tshs2 million = Tshs27 million

Calculation of the depreciation amount

Depreciation = (Cost – Accumulated depreciation) x Depreciation rate
= Carrying value x Depreciation rate

1st year: Depreciation = Tshs27 million x 40% = Tshs10.8 million
Carrying value = Tshs27 million - Tshs10.8 million = Tshs16.2 million

2nd year: Depreciation = Tshs16.2 million x 40% = Tshs6.48 million

Answer to SEQ 6

Machinery account (straight-line method)

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
01/10/20X7	Bank	29,000	31/12/20X7	Depreciation (3 months)	750
	Bank (installation)	1,000		Balance c/d	29,250
		30,000			**30,000**
01/01/20X8	Balance b/f	29,250	31/12/20X8	Depreciation	3,000
			31/12/20X8	Balance c/f	26,250
		29,250			**29,250**

Depreciation account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X7	Machinery account	750	31/12/20X7	SOPL	750
		750			**750**
31/12/20X8	Machinery account	3,000	31/12/20X8	SOPL	3,000
		3,000			**3,000**

Machinery account (reducing balance method)

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
01/10/20X7	Bank	29,000	31/12/20X7	Depreciation (3 months)	750
	Bank (installation)	1,000		Balance c/d	29,250
		30,000			**30,000**
01/01/20X8	Balance b/f	29,250	31/12/20X8	Depreciation	2,925
			31/12/20X8	Balance c/f	26,325
		29,250			**29,250**

Depreciation account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X7	Machinery account	750	31/12/20X7	SOPL	750
		750			**750**
31/12/20X8	Machinery account	2,925	31/12/20X8	SOPL	2,925
		2,925			**2,925**

Answer to SEQ 7

The correct option is **B.**

Depreciable amount = Revalued asset / Useful life = Tshs1,000 million / 40 years = Tshs25 million

Depreciation adjustment = Tshs1,000 million – (Tshs800 million – (Tshs800 million x 2% x 10 years)) = Tshs360 million.

Answer to SEQ 8

(a)

Motor Vehicle A/C

Date	Particulars	Tshs	Date	Particulars	Tshs
01/04/20X3	Balance b/d	126,000,000	31/03/20X4	Balance c/d	126,000,000
		126,000,000			**126,000,000**
01/04/20X4	Balance b/d	126,000,000	01/01/20X5	Disposal A/c	54,000,000
				Balance c/d	72,000,000
		126,000,000			**126,000,000**

(b)

Accumulated Depreciation on Motor Vehicles A/C

Date	Particulars	Tshs	Date	Particulars	Tshs
31/03/20X4	Balance c/d	69,600,000	01/04/20X3	Balance b/d	55,500,000
			31/03/20X4	P & L A/c	14,100,000
		69,600,000			**69,600,000**
01/04/20X5	Disposal A/C (Note ii)	26,352,000	01/04/20X4	Balance b/d	69,600,000
31/03/20X5	Balance c/d	48,998,400	31/03/20X5	SOPL(Note i)	*5,750,400
		75,350,400			**75,350,400**

(i) Depreciation for the year:

*(Tshs72,000,000 – (Tshs69,600,000 – Tshs26,352,000) x 20% = Tshs5,750,400

(ii) Accumulated depreciation on disposed vehicle:

	Tshs
Cost of disposed vehicle	54,000,000
Less: Depreciation	(10,800,000)
	43,200,000
Less: Depreciation	(8,640,000)
	34,560,000
Less: Depreciation	(6,912,000)
	27,648,000

Accumulated depreciation = Tshs10,800,000 + Tshs8,640,000 + Tshs6,912,000 = Tshs26,352,000

(c)

Disposal A/c (Motor Vehicles)

Date	Particulars	Tshs	Date	Particulars	Tshs
01/01/20X5	Motor Vehicle A/c	54,000,000	01/01/20X5	Bank	28,500,000
	Profit on disposal	852,000		Accumulated depreciation	26,352,000
		54,852,000			**54,852,000**

TRIAL BALANCE

5

Get Through Intro

‘Every debit entry has a corresponding credit entry.’ - is the main principle of the double-entry system of accounting. Hence if there are no errors, then the total debit balances and total credit balances of all the ledger accounts of a company should be equal.

Before preparing its financial statements, a company should check the arithmetical accuracy of its accounting records. A list of all the ledger accounts and their respective balances as at a specified point is called a trial balance.

A **trial balance** ensures the arithmetical accuracy of the accounting records. If the trial balance does not balance (i.e. debit totals are not equal to credit totals) then it means that there is definitely an error in the accounts. These errors need to be determined and rectified before the company can prepare its financial statements.

However if the totals of both sides of the trial balance equal each other, it does not automatically mean that there are no errors. This is because there could be compensating errors - you will learn more about this in the Study Guide.

Preparation of financial statements is the main object of the entire accounting exercise. The importance of the trial balance stems from the fact that financial statements cannot be prepared without a trial balance. In this Study Guide you will learn about the **trial balance**, its **preparation and uses**.

Learning Outcomes

a) Describe a trial balance.
b) State the purposes and uses of compiling the trial balance.
c) Prepare the list of balances from ledgers at the end of an accounting period.
d) Prepare a trial balance.

1. Describe a trial balance.
State the purposes and uses of compiling the trial balance.
[Learning Outcomes a and b]

1.1 Trial balance

Definition

A trial balance is the **summary of all the ledger account balances** at a particular point in time.

Under the double entry system of accounting, every debit has a corresponding credit and vice-versa. This means that the **total of the debit** balances of all accounts in the ledger **must equal** the **total of all credit** balances.

The trial balance is simply a list of all the ledger accounts and their respective balances as at a specified point of time e.g. as at 31 December 20X3.

Pro forma of trial balance

Trial balance as at __________

	Debit Tshs	**Credit Tshs**
Cash	X	
Inventory	X	
Payables		X
Share capital		X
Retained earnings		X
Other accounts etc.		X
Total	**X**	**X**

Though it has debit and credit columns, the trial balance is a statement, not a ledger account. It is prepared periodically, usually at the end of every reporting period. Note that, the trial balance is not a part of the financial statements.

1.2 Purpose of a trial balance

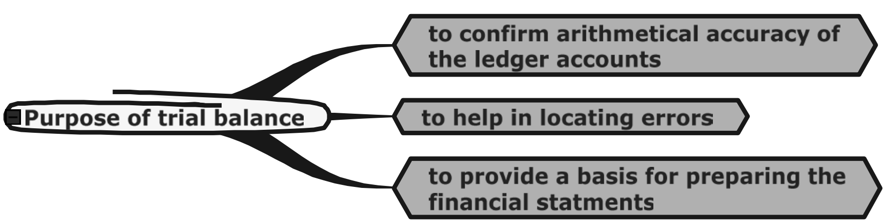
After preparing all required ledgers, a **trial balance** is **prepared,** to **list out at one place,** the **balances** of all the ledger accounts. This helps the accountant to **check** the **arithmetic accuracy of accounting.**

When preparing a trial balance, the debit and credit balances for each ledger account are totalled. If the totals of the debit column and the credit column of the trial balance do not balance, we know at once that there is some error in the ledger balance.

The fact that the trial balance agrees is a preliminary assurance that there are no mathematical / arithmetic errors in the preparation of the accounts.

Checking for mathematical / arithmetical accuracy is the primary purpose of the trial balance. However, because a trial balance presents the ledger account balances in a readily available format it is often used to prepare the financial statements.

SUMMARY



Tip

A trial balance is prepared in order to:

(a) confirm the arithmetical accuracy of the ledger accounts
(b) help in locating errors
(c) provide a basis for preparing the financial statements

1.3 Relationship of the trial balance with the accounting cycle

The entire accounting exercise is summarised below:

(a) Transactions are identified and recorded in day books (journal, sales book, purchase book, cash book, etc.).

(b) Transactions are recorded from day books to ledger accounts.

(c) A trial balance is prepared from the ledger accounts. It is a list of the balances of all ledger accounts where total debits = total credits.

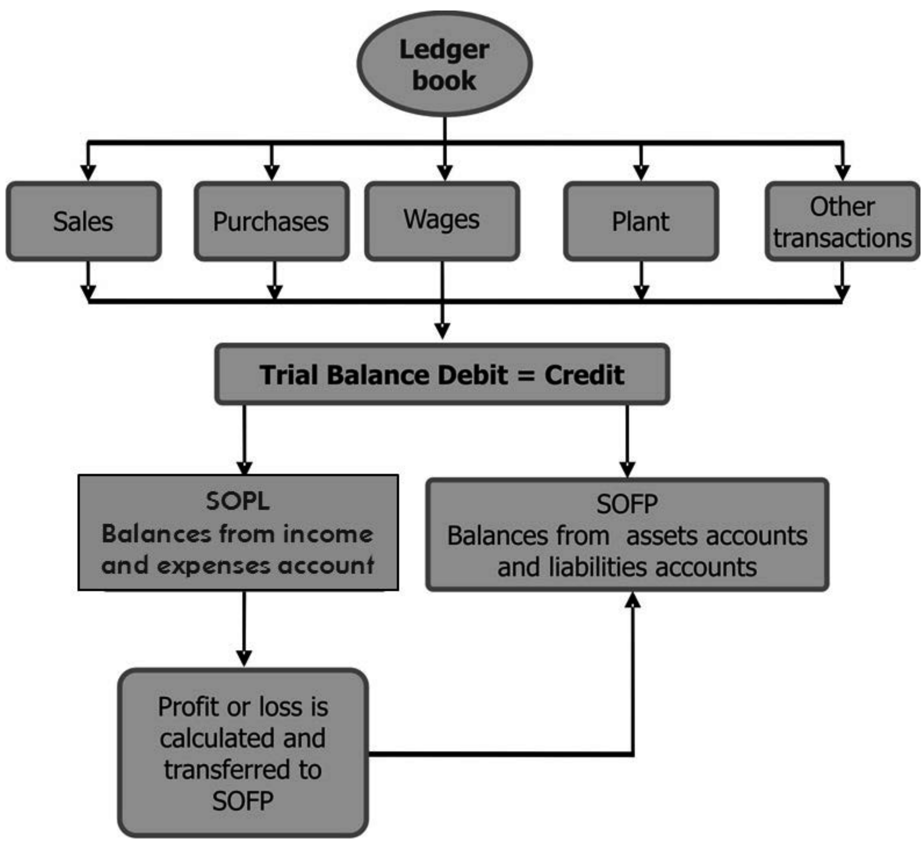
(d) A trial balance contains:
ledger balances that affect the statement of profit or loss: balance of expense accounts and income accounts
ledger balances that affect the statement of financial position: balance of asset accounts and liability accounts

(e) Balances that affect the statement of profit or loss are recorded in it and profit earned or loss incurred during the period is determined.

(f) Balances that affect the statement of financial position along with the profit or loss determined by the statement of profit or loss are recorded in it.

(g) The asset and liability side of the statement of financial position is totalled. The total of the assets side should be equal to the total of the liabilities side.

Diagram 1: Relationship of trial balance and financial statements



This accounting exercise will be discussed in detail as we progress through Study Guides 5 and 6.

Test Yourself 1

Fill in the blanks.

(a) The trial balance only ensures _____________ accuracy.
(b) The total of all debit balances must be _____________ to the total of all credit balances.
(c) A trial balance is _______________, not a _______________.

2. Prepare the list of balances from ledgers at the end of an accounting period. [Learning Outcome c]

2.1 Steps involved in the preparation of a trial balance

1. Balance all the ledger accounts in the general ledger.
2. Calculate the totals of the balances in the accounts payable and accounts receivable ledger accounts. (A single consolidated figure will be taken for total receivables/payables in the trial balance - not all individual ledger accounts).
3. Prepare a trial balance.
   Write the names of all accounts one after the other.
   All credit balances are written in the credit column of the trial balance - against the name of the respective accounts.
   All debit balances are written in the debit column of the trial balance - against the name of the respective accounts.
   Total both the columns.
   The **two totals** should be **equal.**

Example

Given below are the ledger accounts of ICC Ltd as at 31 December 20X3. Capital Tshs23 million

Books of ICC Limited - Nominal ledger

Dr — Wages payable account — Cr

Date		Tshs'000	Date		Tshs'000
			01/01/20X3	Balance b/d	850
30/11/20X3	Cash payment	500	30/11/20X3	Wages-November	665
			31/12/20X3	Wages-December	1,200
31/12/20X3	Balance c/d	**2,215**			
	Total	**2,715**		**Total**	**2,715**

Dr — Machinery account — Cr

Date		Tshs'000	Date		Tshs'000
01/01/20X3	Balance b/d	5,000			
12/05/20X3	Cash - new machinery	23,308	12/05/20X3	Cash-sale of machinery	15,000
			05/09/20X3	Cash-sale of machinery	12,100
			31/12/20X3	Balance c/d	**1,208**
	Total	**28,308**		**Total**	**28,308**

Continued on the next page

Sales account

Dr Date		Tshs'000	Date		Cr Tshs'000
			02/05/20X3	AAL account	10,000
			02/05/20X3	SAIL account	16,000
31/12/20X3	Balance c/d	**31,200**	25/05/20X3	Cash	5,200
	Total	**31,200**		**Total**	**31,200**

Purchases- Coal account

Dr Date		Tshs'000	Date		Cr Tshs'000
31/01/20X3	Accounts payable	20,950			
23/04/20X3	Cash	5,050	31/12/20X3	Balance c/d	**26,000**
	Total	**26,000**		**Total**	**26,000**

Motor car account

Dr Date		Tshs'000	Date		Cr Tshs'000
01/01/20X3	Balance b/d	10,000			
			10/06/20X3	Cash- sale of asset	1,000
			31/12/20X3	Balance c/d	**9,000**
	Total	**10,000**		**Total**	**10,000**

Receivables Ledger

AAL Inc account

Dr Date		Tshs'000	Date		Cr Tshs'000
02/05/20X3	Credit sales	10,000			
			05/10/20X3	Cash received	5,000
			31/12/20X3	Balance c/d	**5,000**
	Total	**10,000**		**Total**	**10,000**

SAIL Ltd account

Dr Date		Tshs'000	Date		Cr Tshs'000
02/05/20X3	Credit sales	16,000			
			05/10/20X3	Cash received	1,000
			31/12/20X3	Balance c/d	**15,000**
	Total	**16,000**		**Total**	**16,000**

Wages account

Dr Date		Tshs'000	Date		Cr Tshs'000
30/11/20X3	Wages payable	665	31/12/20X3	Balance c/d	**1,865**
31/12/20X3	Wages payable	1,200			
	Total	**1,865**		**Total**	**1,865**

Payables Ledger

RAIM Plc account

Dr Date		Tshs'000	Date		Cr Tshs'000
			31/01/20X3	Credit purchases	20,950
31/12/20X3	Balance c/d	**20,950**			
	Total	**20,950**		**Total**	**20,950**

Continued on the next page

Dr **Cash account** **Cr**

Date		Tshs'000	Date		Tshs'000
01/01/20X3	Balance b/d	8,850	30/11/20X3	Wages account	500
10/06/20X3	Motorcar account	1,000	12/05/20X3	Machinery account	23,308
12/05/20X3	Machinery account	15,000	23/04/20X3	Purchase account	5,050
05/09/20X3	Machinery account	12,100			
25/05/20X3	Sales account	5,200			
05/10/20X3	AAL Inc account	5,000			
05/10/20X3	SAIL Ltd account	1,000			
			31/12/20X3	Balance c/d	19,292
	Total	**48,150**		**Total**	**48,150**

Total of receivables ledger: Tshs5 million + Tshs15 million = Tshs20 million
We will now see how to prepare a trial balance from these ledger accounts.

ICC Ltd
Trial balance as at 31 December 20X3

All debit balances written in this column

All credit balances written in this column

	Debit	Credit
	Tshs'000	**Tshs'000**
Wages payable		2,215
Machinery	1,208	
Sales-credit		31,200
Purchases-coal	26,000	
Motor car	9,000	
Wages payable	1,865	
Cash	19,292	
Accounts payable		20,950
Capital		23,000
Accounts receivable	20,000	
Totals	**77,365**	**77,365**

The example we used above had only a few accounts that needed to be closed. In the real world, a trial balance will be far more extensive.

Test Yourself 2

The ledger balances of BBG Inc as on 31 December 20X3 are as follows. Prepare a trial balance.

Ledger Accounts	Tshs'000	Ledger Accounts	Tshs'000
Sales	1,000,000	Plant & machinery	600,000
Purchases	700,000	Intangible assets	200,000
Salaries	25,000	Inventory (opening)	100,000
Power and fuel	40,000	Cash	18,000
Auditor's fees	10,000	Share capital	500,000
Bad debts	2,000	Retained earnings	200,000
Depreciation	35,000		
Miscellaneous income	20,000		
Rent received	60,000		
Dividends	50,000		

Test Yourself 3

Prepare a trial balance for Banana Computers from the following information as at 31 December 20X3.

Books of prime entry

Dr **Cash book** **Cr**

	Tshs'000		Tshs'000
Share capital	12,000	Salaries	2,000
Matthew-receivables	4,000	ABCL Plc.-payables	3,000

Banana Computers - Nominal ledger

Dr **Share capital account** **Cr**

Date		Tshs'000	Date		Tshs'000
				Cash	12,000

Dr **Sales account** **Cr**

Date		Tshs'000	Date		Tshs'000
				John	6,000
				Matthew	4,000

Dr **Purchases account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Montessori Ltd	3,000			
	ABCL Plc.	3,000			

Dr **Salaries and wages account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Cash	2,000			

Banana Computers
Receivables ledger

Dr **John account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Sales	6,000			

Dr **Matthew account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Sales	4,000		Cash	4,000

3. Prepare a trial balance.

[Learning Outcome d]

3.1 Preparing extracts of an opening trial balance

There are two types of accounts:

1. **Accounts that are transferred to the statement of profit or loss** and closed at the year end. These are the incomes and expenses accounts.

2. **Accounts that are taken to the statement of financial position** and carried over to the next accounting year. These are the assets and liabilities accounts.

Example

Consider the trial balance of Banana Computers given above.
(Accounts are classified according to the nature)
Trial balance as at 31 December 20X2

	Debit Tshs'000	Credit Tshs'000	Nature of item	Disclosed in
Sales		10,000	Income	SOPL
Purchases	6,000		Expense	SOPL
Salaries and wages	2,000		Expense	SOPL
Cash	11,000		Asset	SOFP
Receivables	6,000		Asset	SOFP
Payables		3,000	Liability	SOFP
Share capital		12,000	Liability	SOFP
Total	**25,000**	**25,000**		

Example

Prepare an opening trial balance as at 1 January 20X3 from the above trial balance.

Answer

Step - 1: Close all accounts and identify if they should be transferred to the statement of profit or loss or carried over to next year. (We have already done it above).

Step - 2: Transfer all expenses and income to the statement of profit or loss.

Statement of profit or loss

	Tshs'000
Sales	10,000
Purchases	(6,000)
Salaries and wages	(2,000)
Profit	**2,000**

Note: The above **profit** of Tshs2 million is **payable to the owners** and **hence is a liability** on the opening statement of financial position.

Step - 3: Carry over all assets and liabilities to the next year. **Don't forget to include profit or loss** incurred during the previous year.

Continued on the next page

Trial balance as at 1 January 20X3

	Debit Tshs'000	Credit Tshs'000
Cash	11,000	
Receivables	6,000	
Payables		3,000
Share capital		12,000
Profit		2,000
retained	**17,000**	**17,000**

This is profit brought forward from the last year

Total debit = Total credit

Tip

To prepare an opening trial balance, the closing statement of financial position of the previous period is taken as a base. E.g. the balances in a statement of financial position as at 31/12/20X2 constitute the opening trial balance for 01/01/20X3.

3.2 Accounting entries after preparation of a trial balance

You are now aware that a trial balance is a list of all ledger account balances. However, there are some accounting entries which are made directly in the financial statements, and so do not appear in a trial balance.

The following are examples of such entries:
1. Closing inventory
2. Provisions etc.

Tip

The entries which appear in the trial balance have only one effect in the preparation of financial statements while the entries which do not appear in the trial balance have two effects in the financial statements, i.e. debit and credit.

In the following example we will explain how to record these items.

Example

Given below is the trial balance of Enterprise Co.

Enterprise Co - Trial balance as at 31 December 20X3

	Debit	Credit
	Tshs'000	**Tshs'000**
Sales		12,500
Purchases	5,000	
Salaries	2,000	
Plant & machinery	6,000	
Inventory (opening)	1,500	
Cash	5,000	
Equity capital		5,000
Accumulated depreciation		2,000
Totals	**19,500**	**19,500**

Closing inventory on 31 December 20X3 was Tshs2 million.

Continued on the next page

From the given trial balance the statement of profit or loss and statement of financial position will be prepared as follows:

Enterprise Co - Statement of profit or loss for the year to 31 December 20X3

Closing inventory is reduced to find cost of sales in the statement of profit or loss

	Debit	**Credit**
	Tshs'000	**Tshs'000**
Sales		12,500
Opening inventory	1,500	
Add: Purchases	5,000	
Less: Closing inventory	**(2,000)**	(4,500)
Gross profit		**8,000**
Salaries expenses		(2,000)
Profit		**6,000**

Enterprise Co - Statement of financial position as at 31 December 20X3

	Tshs'000	**Tshs'000**
Assets		
Plant and machinery	6,000	
Accumulated depreciation	(2,000)	4,000
Cash		5,000
Closing inventory		**2,000**
Total		**11,000**
Capital and liability		
Equity shares	5,000	
Retained earnings	6,000	11,000
Total		**11,000**

Closing inventory is recorded as a current asset in the SOFP

Entries which don't appear in the trial balance always have two effects in the financial statements, debit and credit

3.3 Limitations of a trial balance

The fact that the trial balance balances is a preliminary assurance that the accounts are free from any mathematical / arithmetic errors. However it is not conclusive proof of the absence of errors. It only shows arithmetical accuracy i.e. every debit has been provided a corresponding credit.

Therefore, even if the totals of the debit column and the credit column agree, certain errors may remain unnoticed. Such errors are:

1. **Errors of omission**: these are errors caused by failure to record a transaction.

2. **Errors of commission:** these are errors caused due to incorrect recording of a transaction in the day book, from day books to ledger, inaccurate totalling/ balancing etc.

3. **Errors of principle**: these include the types of errors which result from the violation of fundamental principles of accountancy e.g. capital expenditure treated as revenue expenditure and vice-versa.

4. **Compensating errors:** when two or more errors are committed in such a way that the net effect of these errors on the debit and credit of accounts is nil.

Tip

Note: All these errors are discussed at length in the Study Guide 4, Learning Outcome 1.

Similarly, if items were incorrectly analysed in the ledger account or posted to the incorrect account, the trial balance will not identify this. Therefore, even when a trial balance agrees, there is always a chance for hidden errors which can be revealed only after a thorough scrutiny of the accounts.

Tip

A trial balance is not a financial statement. It does not reflect the financial position of a company.

A trial balance does not explain the financial position and performance of the entity. To enable us to understand and interpret the financial data, other financial statements e.g. the statement of profit or loss and the statement of financial position are prepared using the trial balance as their source of information.

Conclusion: A trial balance is an important document and it is important that it is fully understood by the student. A comprehensive example of how a trial balance is prepared is given below.

Example

Preparation of financial statements from source documents

The school holidays have started. It occurred to John that, during the holidays, children need toys to play with. He set up a business in the name of Creative Traders and started selling toys. The following transactions took place in January 20X3:

1. **On 1 January 20X3** he invested cash of Tshs50 million in the business.

2. John opened a bank account and deposited Tshs5 million on **02/01/20X3**. The bank allotted him the account number C/A-6630

3. He approached two suppliers from whom he bought the following toys on credit:
(a) Toys Company- Invoice number 88 dated **02/01/20X3** for Tshs15 million.
(b) Fun Inc.- Invoice number 66 dated **05/01/20X3** for Tshs25 million. Fun Inc. gave a trade discount of Tshs1 million.
(c) Toys Company- Invoice number 145 dated **31/01/20X3** for Tshs16 million.

4. **On 03/01/20X3** he found some defects in the material which was purchased on 02/01/20X3 from Toys Company and returned the defected goods. The value of these goods was Tshs5 million.

5. He also made cash purchases from Fun Inc. on **05/01/20X3** worth Tshs20 million. He incurred transportation charges of Tshs2.5 million in cash.

6. He appointed a worker, to manage his business, whom he pays Tshs2 million in cash at the **end of every month**.

7. The worker takes care of the inventory and marketing. He has found two buyers for his products. The two buyers are Enjoy Ltd and Getway Traders. The sales to these customers were:
(a) Enjoy Ltd- Invoice No-1 dated **06/01/20X3** Tshs15 million.
(b) Getway Traders- Invoice No-2 dated **15/01/20X3** Tshs30 million.
(c) Enjoy Ltd- Invoice No-3 dated **31/01/20X3** Tshs16 million.

8. **On 15/01/20X3** John issued a cheque for Tshs22 million to Fun Inc. The amount payable was Tshs24 million but he took a cash discount on this payment.

9. **On 23/01/20X3** Getway Traders returned some goods worth Tshs8 million.

10. John made cash sales worth Tshs30 million on **10/01/20X3**. However he incurred expenditure on transportation of Tshs8 million. He paid by cheque.

11. John received cheques from the customers as follows:
(a) Enjoy Ltd Tshs15 million on **06/01/20X3**.
(b) Getway Traders Tshs22 million on **20/01/20X3**.

12. John paid Tshs10 million in cash to Toys Company on **05/01/20X3** for credit purchases made.

13. **On 31/01/20X3** John withdrew Tshs10 million from the business for personal expenses.

Continued on the next page

John has been following the principles of double entry, but is concerned that he may make a mistake. He asks you, as an accountant, how he can ensure mathematical accuracy. You suggest and he prepares a trial balance.

Check the entries that have been made in the books of prime entry, check how they are recorded in the ledger, find the closing balance of each account and prepare a trial balance as at 31 January 20X3.

Tip

To do this you will first need to prepare the books of prime entry. In this case these are the sales day book, sales returns day book, purchases day book, purchases returns day book and cash book. Next, record the entries in the ledgers, find the closing balance of each account and prepare the trial balance.

Answer

Step 1: Preparing books of prime entry

Purchases day book for January 20X3

Date		Tshs'000
02/01/20X3	Toys Company	15,000
05/01/20X3	Fun Inc	24,000
31/01/20X3	Toys Company	16,000
	Total	**55,000**

Trade discounts are not recorded.

Purchases returns day book for January 20X3

Date		Tshs'000
03/01/20X3	Toys Company	5,000
	Total	**5,000**

Sales day book for January 20X3

Date		Tshs'000
06/01/20X3	Enjoy Ltd	15,000
15/01/20X3	Getway Traders	30,000
31/01/20X3	Enjoy Ltd	16,000
	Total	**61,000**

Sales returns day book for January 20X3

Date		Tshs'000
23/01/20X3	Getway Traders	8,000
	Total	**8,000**

Continued on the next page

Cash book for January 20X3

Date	Receipts	Cash Tshs'000	Bank C/A Tshs'000	Date	Payment	Cash Tshs'000	Bank C/A Tshs'000
01/0120X3	Capital	50,000		02/01/20X3	Bank - contra	5,000	
02/01/20X3	Cash- contra		5,000	05/01/20X3	Purchases	20,000	
06/01/20X3	Enjoy Ltd		15,000	05/01/20X3	Toys Company	10,000	
10/01/20X3	Sales- cash	30,000		05/01/20X3	Carriage inward	2,500	
20/01/20X3	Getway traders		22,000	10/01/20X3	Carriage outward		8,000
				5/01/20X3	Fun Inc		22,000
				31/01/20X3	Salary	2,000	
				31/01/20X3	Drawings	10,000	
				31/12/20X3	Balance c/d	30,500	12,000
		80,000	**42,000**			**80,000**	**42,000**

Step 2: Preparing receivables, payables and nominal ledger

Receivables ledger

Dr Enjoy Ltd account Cr

Date		Tshs'000	Date		Tshs'000
06/01/20X3	Sales	15,000	06/01/20X3	Bank	15,000
31/01/20X3	Sales	16,000			
			31/01/20X3	Balance c/d	16,000
	Total	**31,000**		**Total**	**31,000**

Dr Getway traders account Cr

Date		Tshs'000	Date		Tshs'000
15/01/20X3	Sales	30,000	23/01/20X3	Sales returns	8,000
			20/01/20X3	Bank	22,000
			31/01/20X3	Balance c/d	
	Total	**30,000**		**Total**	**30,000**

Payables ledger

Dr Toys Company account Cr

Date		Tshs'000	Date		Tshs'000
3/01/20X3	Purchases returns	5,000	02/01/20X3	Purchases	15,000
5/01/20X3	Cash	10,000			
			31/01/20X3	Purchases	16,000
1/01/20X3	Balance c/d	16,000			
	Total	**31,000**		**Total**	**31,000**

Dr Fun Inc account Cr

Date		Tshs'000	Date		Tshs'000
15/01/20X3	Bank	22,000	05/01/20X3	Purchases	24,000
	Discount received	2,000			
	Total	**24,000**		**Total**	**24,000**

Continued on the next page

Capital - John account

Dr Date		Tshs'000	Date		Cr Tshs'000
			01/01/20X3	Cash	50,000
31/01/20X3	Balance c/d	50,000			
	Total	**50,000**		**Total**	**50,000**

Sales account

Dr Date		Tshs'000	Date		Cr Tshs'000
			10/01/20X3	Cash	30,000
			31/01/20X3	Credit	61,000
31/01/20X3	Balance c/d	91,000			
	Total	**91,000**		**Total**	**91,000**

Purchases account

Dr Date		Tshs'000	Date		Cr Tshs'000
05/01/20X3	Cash	20,000			
31/01/20X3	Credit	55,000			
			31/01/20X3	Balance c/d	75,000
	Total	**75,000**		**Total**	**75,000**

Carriage inward account

Dr Date		Tshs'000	Date		Cr Tshs'000
05/01/20X3	Cash	2,500			
			31/01/20X3	Balance c/d	2,500
	Total	**2,500**		**Total**	**2,500**

Carriage outward account

Dr Date		Tshs'000	Date		Cr Tshs'000
10/01/20X3	Bank	8,000			
			31/01/20X3	Balance c/d	8,000
	Total	**8,000**		**Total**	**8,000**

Discount received account

Dr Date		Tshs'000	Date		Cr Tshs'000
			15/01/20X3	Fun Inc	2,000
31/01/20X3	Balance c/d	2,000			
	Total	**2,000**		**Total**	**2,000**

Salary account

Dr Date		Tshs'000	Date		Cr Tshs'000
31/01/20X3	Cash	2,000			
			31/01/20X3	Balance c/d	2,000
	Total	**2,000**		**Total**	**2,000**

Drawings account

Dr Date		Tshs'000	Date		Cr Tshs'000
31/01/20X3	Cash	10,000			
			31/01/20X3	Balance c/d	10,000
	Total	**10,000**		**Total**	**10,000**

Sales returns account

Dr Date		Tshs'000	Date		Cr Tshs'000
31/01/20X3	Credit	8,000			
			31/01/20X3	Balance c/d	8,000
	Total	**8,000**		**Total**	**8,000**

Continued on the next page

Dr **Purchases returns account** **Cr**

Date		Tshs'000	Date		Tshs'000
			01/01/20X3	Credit	5,000
31/01/20X3	Balance c/d	5,000			
	Total	**5,000**		**Total**	**5,000**

Step 3: Extracting trial balance from all ledger account balances

Trial balance as at 31 January 20X3

	Debit Tshs'000	Credit Tshs'000	From trial balance c/d to
Purchases	75,000		SOPL
Carriage inward	2,500		SOPL
Carriage outward	8,000		SOPL
Salary	2,000		SOPL
Drawings	10,000		SOFP
Sales returns	8,000		SOPL
Receivables	16,000		SOFP
Cash in hand	30,500		SOFP
Bank balance	12,000		SOFP
Capital		50,000	SOFP
Sales		91,000	SOPL
Discount received		2,000	SOPL
Purchases returns		5,000	SOPL
Payables		16,000	SOFP
Total	**164,000**	**164,000**	

Step 4: Preparing statement of financial position and statement of profit or loss

This final step will be studied in detail in Study Guides 6 and 7. We have included the answer at this stage so you can see the full process from start to finish.

Creative Traders - Statement of profit or loss for January 20X3

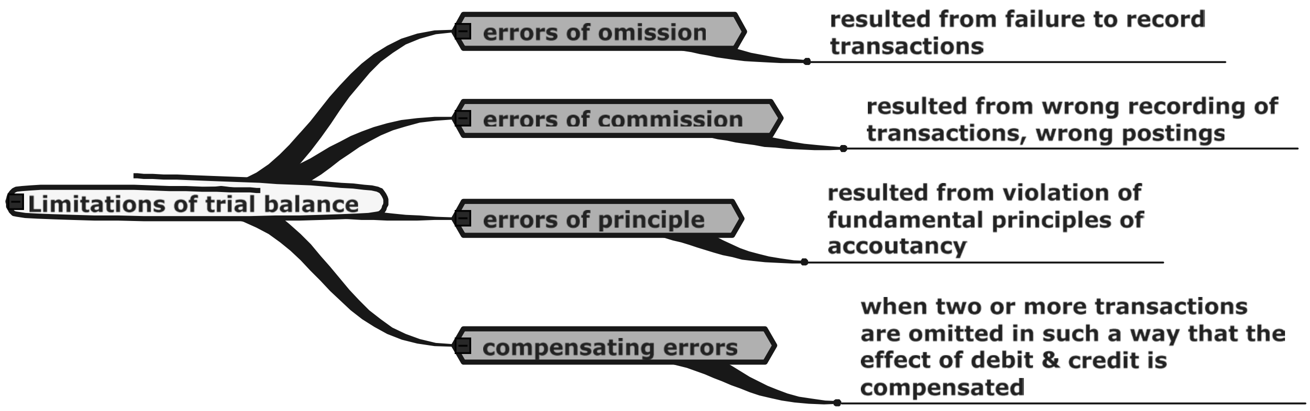
	Tshs'000	Tshs'000
Sales	91,000	
Less: Returns	(8,000)	83,000
Cost of goods sold		
Purchases	75,000	
Less: Returns	(5,000)	
	70,000	
Carriage inward	2,500	(72,500)
Gross profit		**10,500**
Add: Discount received		2,000
		12,500
Indirect expenses		
Carriage outward	8,000	
Salary	2,000	(10,000)
Profit		**2,500**

Continued on the next page

Creative Traders - Statement of financial position as at 31 January 20X3

	Tshs'000	Tshs'000
Assets		
Cash in hand	30,500	
Bank balance	12,000	42,500
Receivable		16,000
Total		**58,500**
Capital and liabilities		
Capital	50,000	
Add: profit	2,500	
	52,500	
Less: drawings	(10,000)	42,500
Payables		16,000
Total		**58,500**

SUMMARY



Test Yourself 4

A credit sale transaction of Tshs3 million was wrongly recorded as Tshs13 million. This is an:

A Error of omission
B Error of commission
C Error of principle
D Compensating error

Test Yourself 5

"Treating a revenue expense as capital expenditure" is an example of:

A A compensating error
B An error of principle
C An error of omission
D An error of commission

Answers to Test Yourself

Answer to TY 1

(a) Arithmetical
(b) Equal
(c) Statement, ledger account

Answer to TY 2

Trial balance as at 31 December 20X3

	Debit Tshs'000	Credit Tshs'000
Sales		1,000,000
Purchases	700,000	
Salaries	25,000	
Power and fuel	40,000	
Auditor's fees	10,000	
Bad debts	2,000	
Depreciation	35,000	
Miscellaneous income		20,000
Rent received		60,000
Dividends	50,000	
Plant & machinery	600,000	
Intangible assets	200,000	
Inventory (opening)	100,000	
Cash	18,000	
Share capital		500,000
Retained earnings		200,000
Totals	**1,780,000**	**1,780,000**

Answer to TY 3

After balancing, the ledger accounts of Banana Computers will appear as follows:

Banana Computers

Books of prime entry

Cash book

Dr **Cr**

	Tshs'000		Tshs'000
Share capital	12,000	Salaries	2,000
Matthew-receivables	4,000	ABCL Plc-payables	3,000
		Balance c/d	**11,000**
	16,000		**16,000**

Nominal ledger

Dr **Share capital account** **Cr**

Date		Tshs'000	Date		Tshs'000
				Cash	12,000
	Balance c/d	**12,000**			
	Total	**12,000**		**Total**	**12,000**

Dr **Sales account** **Cr**

Date		Tshs'000	Date		Tshs'000
				John	6,000
				Matthew	4,000
	Balance c/d	**10,000**			
	Total	**10,000**		**Total**	**10,000**

Dr **Purchases account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Montessori Ltd	3,000			
	ABCL Plc	3,000		Balance c/d	**6,000**
	Total	**6,000**		**Total**	**6,000**

Dr **Salaries and wages account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Cash	2,000			
				Balance c/d	**2,000**
	Total	**2,000**		**Total**	**2,000**

Banana Computers
Receivables ledger

Dr **John account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Sales	6,000			
				Balance c/d	**6,000**
	Total	**6,000**		**Total**	**6,000**

Dr **Mathew account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Sales	4,000		Cash	4,000
	Total	**4,000**		**Total**	**4,000**

Payables Ledger

Montessori Ltd account

Dr					Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
				Purchases	3,000
	Balance c/d	**3,000**			
	Total	**3,000**		**Total**	**3,000**

ABCL Plc account

Dr					Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
	Cash	3,000		Purchases	3,000
	Total	**3,000**		**Total**	**3,000**

Tip

Remember: start preparing the trial balance only when all entries are recorded in the ledger and all ledger accounts have been closed.

Trial balance as at 31 December 20X3

	Debit Tshs'000	Credit Tshs'000
Sales		10,000
Purchases	6,000	
Salaries and wages	2,000	
Cash	11,000	
Receivables	6,000	
Payables		3,000
Share capital		12,000
Total	**25,000**	**25,000**

Answer to TY 4

The correct option is **B**.

Commission: as the numerical error has been committed by the accountant. It has neither been omitted nor is it an error of accounting principle.

Answer to TY 5

The correct option is **B**.

Errors of principle: because this error is a violation of the generally accepted principles of accountancy.

Self Examination Questions

Question 1

A company's machinery account for the year to December 20X3 was as follows:

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

Date		Tshs'000	Date		Tshs'000
	Balance b/d	50,000			
	Additions	20,000		Disposals	10,000
				Balance c/d	60,000
	Total	**70,000**		**Total**	**70,000**

What amount will be included in the trial balance as at 31 December 20X3?

A Tshs50 million Dr
B Tshs50 million Cr
C Tshs60 million Cr
D Tshs60 million Dr

Question 2

(Based on previous SEQ) What amount will be included in the opening trial balance of 20X4?

A Tshs50 million
B Tshs70 million
C Tshs40 million
D Tshs60 million

Question 3

Which of the following is not transferred to the opening trial balance?

A Cash
B Share capital
C Maintenance
D Receivables

Question 4

Which of the following is transferred to the opening trial balance?

A Accumulated depreciation
B Salary costs
C Depreciation in the year
D Rent received

Question 5

Accessories Ltd has the following trial balance as at 31 December 20X3

Trial balance as at 31 December 20X3

	Debit Tshs'000	Credit Tshs'000
Sales		5,000
Purchases	3,000	
Salaries and wages	500	
Cash	3,000	
Receivables	3,500	
Payables		1,000
Share capital		4,000
Total	**10,000**	**10,000**

Prepare the opening trial balance as at 1 January 20X4.

Question 6

Receivables outstanding at the beginning of the year were Tshs10 million. During the year the following transactions occurred:

Credit sales Tshs700 million
Cash sales Tshs100 million
Prompt payment discounts given Tshs3 million
Payment Tshs600 million

What is the closing balance of receivables in the closing trial balance?

A Tshs107 million
B Tshs207 million
C Tshs210 million
D Tshs710 million

Question 7

The trial balance of Enterprise Co is as follows:

Enterprise Co

Trial balance as at 31 December 20X3

	Debit Tshs'000	**Credit Tshs'000**
Sales		50,000
Purchases	30,000	
Power and fuel	2,000	
Auditor's fees	500	
Miscellaneous income		6,000
Plant & machinery	50,000	
Cash	15,000	
Equity capital		35,000
Revaluation surplus		9,000
Retained earnings		3,000
Depreciation	3,500	
Accumulated depreciation		7,000
Prepaid expenses	6,000	
Accrued income	3,000	
Sales tax		1,000
Discount allowed	1900	
Profit on sale of asset		900
Totals	**111,900**	**111,900**

Make a Tshs2.2 million provision for claims.

Required:

Calculate the profit or loss earned by Enterprise Co.
Prepare an opening trial balance as at 01/01/20X4.

Question 8

Prepare a trial balance from the following details:

	Tshs'000		Tshs'000
Sales	50,000	Accrued expenses	6,300
Purchases	30,000	Expenses Discount	12,000
Bad debts	2,000	received Inventory:	600
Depreciation	3,500	01/01/20X3	6,000
Accumulated depreciation	10,500	Loss on sale of asset	500
Rent received	3,500	Amortisation of intangible asset	300
Petty cash	500	Intangible assets	3,000
Cash at bank	35,000	Share premium account	6,000
Share capital	12,900	Provision for bad debts 01/01/20X3	3,000
Inventory:31/12/20X3	7,000	Provision for bad debts 31/12/20X3	4,000

Question 9

As at 31st March 2015, a business of S. Manyisi, has the following nominal ledger balances:

	TZS.'000'
Bank loan	12,000
Cash at bank	11,700
Capital	13,000
Rent	1,880
Trade payables	11,200
Purchases	12,400
Sales	34,600
Other payables	1,620
Trade receivables	12,000
Bank loan interest	1,400
Other expenses	11,020
Non-current assets	22,020

During the year ended 31st March 2016, the business made the following transactions:

1. Bought materials for TZS.1,000,000 half for cash and half on credit.
2. Made sales of TZS.1,040,000 which TZS.800,000 was on credit.
3. Paid wages to shop assistants of TZS.260,000 in cash.

REQUIRED:

(i) Draw up a trial balance showing the balances as at the end of 31st March 2015.
(ii) Draw up a trial balance showing the balances as at the end of 31st March 2016.

Question 10

The trial balance of KAMUSI Used Auto Company, on March 31, 2015 is as follows:

.	Debit TZS "000"	Credit TZS "000"
Cash	10,000	
Accounts receivable	20,000	
Automobile inventory	100,000	
Accounts payable		3,000
Notes payable		70,000
Kamusi, owner's equity		57,000
Total	130,000	130,000

This business is a sole proprietorship, thus the equity account used here is KAMUSI, Owner's Equity. In practise, it is often called Capital account.

KAMUSI rented operating space and equipment on a month-to-month basis. During April, the business had the following summarized transactions:

(i) Invested additional TZS.20,000,000 cash in the business.
(ii) Collected TZS.10,000,000 on accounts receivable.
(iii) Paid TZS.2,000,000 on accounts payable.
(iv) Sold autos for TZS.120,000,000 cash.
(v) Cost of autos sold was TZS.70,000,000.
(vi) Replenished inventory for TZS.60,000,000 cash.
(vii) Paid rent expense in cash, TZS.14,000,000.
(viii) Paid utilities in cash, TZS.1,000,000.
(ix) Paid selling expense in cash, TZS.30,000,000.
(x) Paid interest expense in cash, TZS.1,000,000.

REQUIRED:

(a) Journalize transactions (i) to (x) above with narratives.
(b) Open ledger accounts (T-accounts) for the accounts in the trial balance and from the following: Sales, cost of goods sold, rent expense, utilities expense, selling expense, and interest expense. Enter the March 31 balance, April's transactions in the appropriate accounts and provide closing entries.
(c) Prepare a Statement of Profit or Loss for April. Ignore income taxes.
(d) Prepare the Trial Balance as of April 30, 2015.

Question11

John's Trial balance as at 31st December, 2015 was as follows:

PARTICULARS	**DEBIT 'TZS**	**CREDIT 'TZS**
Capital		17,239,690
Creditors		2,500,000
Sales		28,500,000
Commission received		2,400,000
Returns outwards		4,350,500
Bank		1,300,000
10% Bank loan		4,500,000
Motor van	12,500,000	
Fixtures and fittings	3,700,000	
Stock at 1st January 2015	1,550,000	
Debtors	2,450,000	
Cash	580,000	
Drawings	250,000	
Purchases	18,000,000	
Salaries	5,400,000	
Commission paid	3,500,000	
Rent	2,400,000	
Office expenses	2,140,000	
Carriage inwards	3,213,500	
Carriage outwards	2,345,890	
Returns inwards	2,760,800	
Total	**60,790,190**	**60,790,190**

Stock as at 31st December 2015 was valued at TZS.2,400,000

REQUIRED:

(a) Prepare John's income statement for the year ended 31st December 2015.
(b) Prepare John's statement of financial position as at 31st December 2015.

Question 12

Jovina Mwalukasa, who is a sole proprietor, operates three (3) retail shop in Mbeya City. The following is the trial balance for her business as at 31st December 2016:

	Debit TZS.	Credit TZS.
Sales		54,500,000
Purchases	25,400,500	
Return inwards	560,000	
Return outwards		450,000
Carriage inwards	1,250,000	
Carriage outwards	1,550,500	
Electricity	1,650,000	
Insurance premium	170,000	
Salaries	5,400,000	
Cleaning	250,000	
Salesman commission	2,450,000	
Security expenses	600,000	
Furniture repairs	150,000	
Motor van repairs	560,000	
Office rent	7,200,000	
Stationeries	220,000	
Discount allowed	4,500,000	
Discount received		1,200,000
Interest on loans	4,500,000	
Communication expenses	450,000	
Motor van	25,000,000	
Furniture	5,500,000	
Fixtures and fittings	3,500,000	
Debtors	3,750,000	
Creditors		6,500,000
Bank overdraft		5,400,000
Long term bank loan		12,000,000
Cash	560,000	
Capital		20,721,000
Drawings	1,200,000	
Stock at 1st December 2016	4,400,000	
Total	100,771,000	100,771,000

Additional information

Stock valued at TZS.5,550,000 remained unsold at the end of the financial year 2016.

REQUIRED:

(a) Prepare the Statement of Profit or Loss and other comprehensive income for the year ended, 31st December 2016.

(b) Prepare the Statement of Financial Position as at 31st December 2016.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **D**.

A trial balance consists of the closing balances in the ledger accounts. The closing balance in the machinery account is Tshs60 million Dr.

Answer to SEQ 2

The correct option is **D**.

Some figures from a closing trial balance of a year are taken to the opening trial balance of the next year. Therefore, the closing balance in the machinery account of Tshs60 million debit in 20X3 will be the opening balance of 20X4.

Answer to SEQ 3

The correct option is **C**.

The income and expenditure balances of a year are not transferred to the opening trial balance of the next year. Maintenance is an expense and is included in the statement of profit or loss.

Answer to SEQ 4

The correct option is **A**.

The asset and liability balances of a year are transferred to the opening trial balance of the next year. Accumulated depreciation is a type of reserve (liability) and is therefore transferred to the opening trial balance. Salary costs and depreciation provided for the year are expenditures, while rent received is an income.

Answer to SEQ 5

Accessories Ltd

Statement of profit or loss

	Tshs'000
Sales	5,000
Less: Purchases	(3,000)
Gross Profit	**2,000**
Less: Salaries and wages	(500)
Profit	**1,500**

Trial balance as at 1 January 20X4

	Tshs'000	**Tshs'000**
Cash	3,000	
Receivables	3,500	
Payables		1,000
Share capital		4,000
Profits retained		1,500
Total	**6,500**	**6,500**

Answer to SEQ 6

The correct option is **A**.

Receivables account			
	Tshs'000		**Tshs'000**
Balance b/d	10,000		
Credit sales	700,000	Discounts	3,000
		Payment received	600,000
		Balance c/d	107,000
	710,000		**710,000**

Answer to SEQ 7

Enterprise Co - Statement of profit or loss for the period to 31 December 20X3

	Tshs'000	Tshs'000
Sales		50,000
Purchases		(30,000)
Gross profit		**20,000**
Profit on sale of asset		900
Miscellaneous income		6,000
		26,900
Expenses Power		
and fuel Auditors	2,000	
fees Depreciation	500	
Discount allowed	3,500	
Provision for claims	1,900	
Profit	2,200	(10,100)
		16,800

Enterprise Co - Statement of financial position as at 31 December 20X3

	Tshs'000	Tshs'000
Assets		
Non-current assets Plant		
& machinery Accumulated	50,000	
depreciation **Current**	(7,000)	43,000
assets		
Cash	15,000	
Prepaid expenses	6,000	
Accrued income	3,000	24,000
Total Assets		**67,000**
Capital and liabilities		
Share capital		35,000
Revaluation surplus		9,000
Retained earnings	3,000	
Add: profit for the year	16,800	19,800
Total equity		**63,800**
Liabilities		
Provision for claims		2,200
Sales tax		1,000
Total liabilities		**3,200**
Total equity and liabilities		**67,000**

Enterprise Co - Trial balance as at 01 January 20X4

	Debit	Credit
	Tshs'000	**Tshs'000**
Plant & machinery	50,000	
Accumulated depreciation		7,000
Cash	15000	
Prepaid expenses	6000	
Accrued income	3000	
Equity capital		35,000
Revaluation surplus		9,000
Retained earnings		19,800
Provision for claims		2,200
Sales tax		1,000
Total	**74,000**	**74,000**

Answer to SEQ 8

Trial balance as at 31st December 20X3

	Debit Tshs'000	**Credit Tshs'000**
Sales		50,000
Purchases	30,000	
Bad debts	2,000	
Depreciation	3,500	
Accumulated depreciation		10,500
Rent received		3,500
Petty cash	500	
Cash at bank	35,000	
Share capital		12,900
Share premium account		6,000
Provision for bad debts 01/01/20X3		3,000
Accrued expenses		6,300
Expenses Discount	12,000	
received Inventory:		600
01/01/20X3	6,000	
Loss on sale of asset	500	
Amortisation of intangible asset	300	
Intangible assets	3,000	
Total	**92,800**	**92,800**

Closing inventory is not a part of the trial balance. It is directly taken to the statement of profit or loss and statement of financial position.

Provision for bad debts at the year-end is also not a part of the trial balance.

Answer to SEQ 9

(i) **TRIAL BALANCE AS AT 31.03.2015**

	DR TZS."000"	**CR TZS."000"**
Bank Loan		12,000
Cash at bank	11,700	
Capital		13,000
Rent	1,880	
Trade Payables		11,200
Purchases	12,400	
Sales		34,600
Other Payables		1,620
Trade Receivables	12,000	
Bank Loan Interest	1,400	
Other expenses	11,020	
Non-Current assets	22,020	
	72,420	**72,420**

(ii) **TRIAL BALANCE AS AT 31.03.2016**

	DR TZS."000"	CR TZS."000"
Bank Loan		12,000
Cash at bank	11,180	
Capital		13,000
Rent	1,880	
Trade Payables		11,700
Purchases	13,400	
Sales		35,640
Other Payables		1,620
Trade Receivables	12,800	
Bank Loan Interest	1,400	
Other expenses	11,280	
Non-Current assets	22,020	
	73,960	73,960

Answer to SEQ 10

(a) **Journal Entries**

		Tshs.	Tshs.
i.	Dr. Cash Account	20,000	
	Cr. Kamusi's Equity Account (capital)		20,000
	Being additional capital invested in the business		
ii.	Dr. Cash Account	10,000	
	Cr. Account Receivables		10,000
	Being cash collected on account receivables		
iii.	Dr. Account Payable	2,000	
	Cr. Cash Account		2,000
	Being cash paid on account payables		
iv.	Dr. Cash Account	120,000	
	Cr. Sales Account		120,000
	Being cash sales of autos		
v.	Dr. Cost of goods sold	70,000	
	Cr. Auto Inventory account		70,000
	Being cost of autos sold		
vi.	Dr. Auto Inventory account	60,000	
	Cr. Cash Account		60,000
	Being cash paid for replenishing inventory		
vii.	Dr. Rent Expense Account	14,000	
	Cr. Cash Account		14,000
	Being cash paid for rent expense		
viii.	Dr. Utilities Account	1,000	
	Cr. Cash Account		1,000
	Being cash paid for utilities expense		
ix.	Dr. Selling expense Account	30,000	
	Cr. Cash Account		30,000
	Being cash paid for selling expenses		
x.	Dr. Interest Expense Account	1,000	
	Cr. Cash Account		1,000
	Being interest expense paid in cash		

(b) Ledger Accounts

Cash A\C TSHS "000"

Balance b/d	10,000	Account payable	2,000
Kamusi's Equity (capital a/c)	20,000	Inventory	60,000
Account receivables	10,000	Rent	14,000
Sales a/c	120,000	Utilities	1,000
		Selling expenses	30,000
		Interest expense	1,000
		Balance c/d	**52,000**
	160,000		**160,000**

Account Receivables

Balance b/d	20,000	Cash a/c	10,000
		Balance c/d	**10,000**
	20,000		**20,000**

Inventory Account

Balance b/d	100,000	Cost of goods	70,000
Cash	60,000	**Balance c/d**	**90,000**
	160,000		**160,000**

Accounts Payable

Cash	2,000	Balance b/d	3,000
Balance c/d	1,000		
	3,000		**3,000**

Note Payable

		Balance b/d	70,000
Balance c/d	70,000		
	70,000		**70,000**

KAMUSI's Owners Equity (Capital Account)

		Balance b/d	57,000
Balance c/d	77,000	Cash a/c	20,000
	77,000		**77,000**

Sales Account

		Cash	120,000
Statement of P/L	120,000		
	120,000		**120,000**

Cost of goods Sold Account

Inventory a/c	70,000	Statement of P/L	70,000
	70,000		**70,000**

Rent Expenses Account

Cash a/c	14,000	Statement of P/L	14,000
	14,000		**14,000**

Utilities Account

Cash a/c	1,000	Statement of P/L	1,000
	1,000		**1,000**

Selling Expenses Account

Cash a/c	30,000	Statement of P/L	30,000
	30,000		**30,000**

Interest Expense Account

Cash a/c	1,000	Statement of P/L	1,000
	1,000		**1,000**

(c) **KAMUSI Used Auto Company**

Statement of Profit or Loss for the period to 30 April 2015

	Tshs.	Tshs.
Sales		120,000
Cost of goods sold		(70,000)
Gross Profit		**50,000**
Expenses		
Rent	14,000	
Utilities	1,000	
Selling expense	30,000	
Interest expense	1,000	(46,000)
Profit		**4,000**

(d) **KAMUSI USED Auto Company**

Trial Balance as at 30th April 2015

	Debit Tshs.	**Credit Tshs.**
Cash	52,000	
Account Receivables	10,000	
Inventory	90,000	
Accounts Payable		1,000
Notes payable		70,000
Kiki owners'equity (capital account)		77,000
Profit		4,000
	152,000	**152,000**

Answer to SEQ 11
(a) **John's**

Income Statement for the year ended 31st December 2015

	Tshs.	**Tshs.**	**Tshs.**
Sales			28,500,000
Return Inwards			(2,760,800)
Net Sales			25,739,200
Opening stock	1,550,000		
Purchases	18,000,000		
Carriage Inwards	3,213,500		
Cost of goods available for sale		22,763,500	
Return Outwards	(4,350,500)		
Closing stock	(2,400,000)	(6,750,500)	
Cost of goods sold			(16,013,000)
Gross profit			**9,726,000**
Other Income:			
Commission received			2,400,000
Total			**12,126,000**
Operating Expenses:			
Salaries			5,400,000
Commission paid			3,500,000
Rent			2,400,000
Office expenses			2,140,000
Carriage Outwards			2,345,890
Net Loss			**(3,659,690)**

(b)

John's

Statement of Financial Position as at 31st December 2015

Non-Current Assets	**TSHS.**	**TSHS.**
Motor van		12,500,000
Fixtures and fittings		3,700,000
Total		**16,200,000**
Current Assets		
Stock		2,400,000
Debtors		2,450,000
Cash		580,000
Total		**5,430,000**
Total Assets		**21,630,000**
Capital and Liabilities		
Capital as at 1st January 2012	17,239,690	
Net Loss for the year	(3,659,690)	
Drawings	(250,000)	
Total		**13,330,000**
Long Term Liabilities		
10% Bank loan		4,500,000
Current Liabilities		
Creditors		2,500,000
Bank overdraft		1,300,000
Total		3,800,000
Total Capital and Liabilities		**21,630,000**

Answer to SEQ 12

a) JANETH MWALUKASA

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31ST DECEMBER 2012

	TZS.	TZS.
Net sales (w1)		53,940,000
Cost of sales (w2)		(25,050,500)
Gross profit		28,889,500
Other Incomes		
Discount received		1,200,000
		30,089,500
Operating expenses		
Carriage outwards	1,550,500	
Electricity	1,650,000	
Insurance premium	170,000	
Salaries	5,400,000	
Cleaning	250,000	
Salesman commission	2,450,000	
Security expenses	600,000	
Furniture repairs	150,000	
Motor van repairs	560,000	
Office rent	7,200,000	
Stationeries	220,000	
Discount allowed	4,500,000	
Interest on loans	4,500,000	
Communication expenses	450,000	
Total expenses		29,650,500
Net profit		439,000

Working 1
Net sales = sales – return inwards
Net sales = 54,500,000 – 560,000 = 53,940,000

Working 2
Cost of sales

Opening stock	4,400,000	

Add: Purchases	25,400,500
Carriage inwards	1,250,000
Less: Returns outwards	450,000
Cost of goods available for sale	30,600,500
Less: Closing stock	(5,550,000)
Cost of sales	25,050,000

(b)

JANETH MWALUKASA

STATEMENT OF FINANCIAL POSITION AS AT 31ST DECEMBER 2016

	TZS.	TZS.
Non-Current Assets		
Motor van	25,000,000	
Furniture	5,500,000	
Fixture and fittings	3,500,000	
Total		34,000,000
Current Assets		
Stock	5,550,000	
Debtors	3,750,000	
Cash	560,000	
Total		9,860,000
Total Assets		43,860,000
Capital and Liabilities		
Capital (W3)		19,960,000
Long Term Liabilities		
Bank loan		12,000,000
Current Liabilities		
Creditors	6,500,000	
Bank overdraft	5,400,000	
Total		11,900,000
Total capital and liabilities		43,860,000

Working 3	
Capital at the beginning	20,721,000
Add: Net profit	439,000
Less: Drawings	(1,200,000)
Capital at the end	19,960,000

CORRECTING ACCOUNTING ERRORS

6

Get Through Intro

It is rightly said that "to err is human". As a result, there is plenty of scope for errors to creep into any accounting exercise.

In **this Study Guide** you will learn about **two types of errors**:

Errors that can be highlighted by the extraction of the trial balance - the debit and credit column of the trial balance are not equal when these errors exist

Errors that cannot be highlighted by the extraction of the trial balance - the debit and credit column of the trial balance will balance inspite of these errors

You will also learn the accounting entries to correct the detected errors. Questions are regularly asked on this topic in the exams. Also, as an accountant, you will always make errors. If you are not able to rectify your errors then you will have a problem as you will not be able to prepare financial statements. So ensure that you understand this Study Guide!

In **this Study Guide,** we will also learn the procedure of maintaining **control accounts**. In large companies where customers and suppliers are large in number it is not sensible to include all the customer accounts in the nominal ledger. The nominal ledger will become too big! The way out is to have just one account called the receivable control account for all the receivables, and one account called the payables control account for all the payables. The individual receivable ledger accounts and the individual payable ledger accounts for individual customers and suppliers are maintained separately. Only the total of the debits and credits of these individual accounts are posted in the control accounts.

This serves a dual purpose. The nominal ledger does not become too bulky and one can have an effective control on the individual receivables and payables account as well.

How is this control obtained? To get the answer to this question you must go through this Study Guide.

Similarly, the suspense account is a very useful tool in the hands of an accountant. With the help of a suspense account, he can balance the trial balance. This Study Guide discusses why a suspense account is created, how it helps in identifying errors and how these errors should be rectified. You will no doubt come across some errors during your life as an accountant - a suspense account can help to solve them!

Learning Outcomes

a) Identify errors and discrepancies that require correction.
b) State the procedures for correcting errors.
c) Correct accounting errors using suspense accounts.
d) Correct accounting errors using control accounts.
e) State the effects of errors in financial statements.

1. Identify errors and discrepancies that require correction.

[Learning Outcome a]

1.1 Errors

An error is a mistake which is committed accidentally. If done intentionally, it becomes fraud.

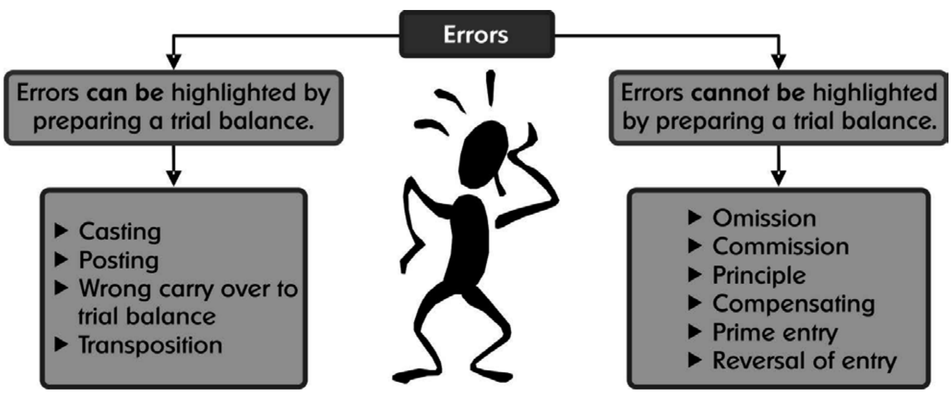
While recording the transactions in the books of accounts, it is quite likely that some mistake may be committed. Errors may happen at any of the following stages.

1. **At the recording stage** (a) Errors of principle (b) Errors of omission (c) Errors of commission	2. **At the posting stage** (a) Errors of omission (b) Error of commission Posting to wrong account Posting on the wrong side Posting of wrong amount
3. **At the balancing stage** (a) Wrong totalling (b) Wrong balancing	4. **At the preparation of the trial balance** (a) Errors of omission (b) Errors of commission Taking the wrong amount Taking the wrong account Taking the account to the wrong side

The 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**. Even if the trial balance agrees, there may still be errors.

From the point of view of correction, errors are classified into two types:

Diagram 1: Types of errors



1.2 Errors which would be highlighted by the extraction of a trial balance

(Also known as **errors that affect the agreement of a trial balance**).

Under the double entry book keeping system, we record the two effects of all transactions as debits and credits. Hence the trial balance totals of debits and credits are equal. Whenever the total of all debits and credits do not match, it means that there is an error in accounting. Common errors of this kind are:

1. Casting error
   - Overcasting
   - Undercasting
2. Posting error
   - Posting to the wrong amount
   - Omission to post either credit or debit entry
   - Posting to wrong side of correct ledger
3. Wrong carry over to trial balance
4. Transposition errors

Each of these will be looked at in turn.

1. Casting error

The term casting means adding up. This error affects the agreement of a trial balance. This error can be an error of overcasting or an error of undercasting.

Overcasting means summing (i.e. arithmetically adding) the totals to more than what they are and undercasting means summing (i.e. arithmetically adding) the total to less than what they are.

Example

Under casting: Margaret sold goods to 3 different customers of Tshs10 million, Tshs25 million and Tshs15 million respectively in July 20X3. She entered the 3 amounts correctly in the sales day book. However, when she totalled the month's sales, she came to Tshs40 million instead of Tshs50 million. Margaret undercast the sales day book by Tshs10 million.

Example

Overcasting: continuing the previous example of Margaret, the following month, exactly the same value of goods was bought by customers. Although she correctly entered the figures individually in the sales day book, when she totalled the month's sales, she came to Tshs60 million instead of Tshs50 million. Margaret overcast the sales day book by Tshs10 million.

There can also be casting errors in the trial balance itself that can lead to Debit Credit.

Example

On 31 December 20X3, Suzy prepared the trial balance of Sun Inc. While totalling the debit side, she arrived at the total Tshs510 million, but the correct grand total was Tshs520 million. So, the trial balance debit side is undercast by Tshs10 million.

---

2. Posting error

This error occurs while posting a transaction from the books of prime entry to the ledgers. This can be:

(a) Posting with wrong amount
(b) Omission to post either credit or debit entry
(c) Posting to wrong side of correct ledger

Example

Posting with wrong amount:

Let us see how the following journal is incorrectly posted:

ICC Ltd Journal entry **Opening balance of AAL account is Tshs5 million**				
31/12/20X3	Dr	Bad debts account	Tshs5 million	
	Cr	AAL account		Tshs5 million
		Being bad debts written off		

Here, the posting of the journal entry should have been Tshs5 million, but was incorrectly posted as Tshs0.2 million.

Continued on the next page

ICC Ltd

Dr		Bad debts account			Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X3	AAL account	**200**	31/12/20X3	Statement of profit or loss	**200**
	Total	**200**		Total	**200**

Receivables ledger

Dr		AAL account			Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
1/12/20X3	Balance b/f	5,000	31/12/20X3	Bad debts	500
			31/12/20X3	Balance c/f	4,500
	Total	**5,000**		Total	**5,000**

Tip

The most common form for posting the wrong amount is a transposition error.

Example

Omission to post either credit or debit entry

Let us see how the posting of the following journal is wrongly omitted.

ICC Ltd Journal entry			
31/12/20X3	Dr Bad debts account	Tshs0.5 million	
	Cr AAL account		Tshs0.5 million
	Being bad debts written off		

The ledger should have been posted with Tshs0.5 million. An error was made, and this amount was omitted and posted with zero.

Dr		Bad debts account			Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X3	**AAL account**	**0**	31/12/20X3	Statement of profit or loss	**0**
	Total	**0**		**Total**	**0**

Dr		AAL account			Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
1/12/20X3	Balance b/f	5,000	31/12/20X3	Bad debts	500
			31/12/20X3	Balance c/f	4,500
	Total	**5,000**		**Total**	**5,000**

Example

Posting on the wrong side of the correct account:

Let us see how the posting of the following journal is made to the wrong side of the correct account.

ICC Ltd Journal entry				
31/12/20X3	Dr	Bad debts account	Tshs500,000	
	Cr	AAL account		Tshs500,000
		Being bad debts written off		

The AAL account should have been on the debit side, and not on the credit side.

Dr **Bad debts account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X3	Statement of profit or loss	500	31/12/20X3	AAL account	500
	Total	**500**		**Total**	**500**

Dr **AAL account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
1/12/20X3	Balance b/f	5,000	31/12/20X3	Bad debts	500
			31/12/20X3	Balance c/f	4,500
	Total	**5,000**		**Total**	**5,000**

3. Figures incorrectly carried over to the trial balance

If the balance of a ledger account is incorrectly recorded in the trial balance, this will also result in the trial balance not balancing.

Example

Continuing the previous example of the AAL account

The bad debt account is correctly posted from the journal with Tshs0.5 million. While taking the balance of the bad debt accounts to the trial balance, it is incorrectly carried over from Tshs0.5 million to Tshs0.9 million.

Dr **Bad debts account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X3	AAL account	500	31/12/20X3	Statement of profit or loss	500
	Total	**500**		**Total**	**500**

Trial balance as at 31 December 20X3		
	Debit Tshs'000	**Credit Tshs'000**
Bad debts (Note1)	900	-

Note 1: it should have been Tshs0.5 million and not Tshs0.9 million. The trial balance will not balance and there will be a difference of Tshs0.4 million.

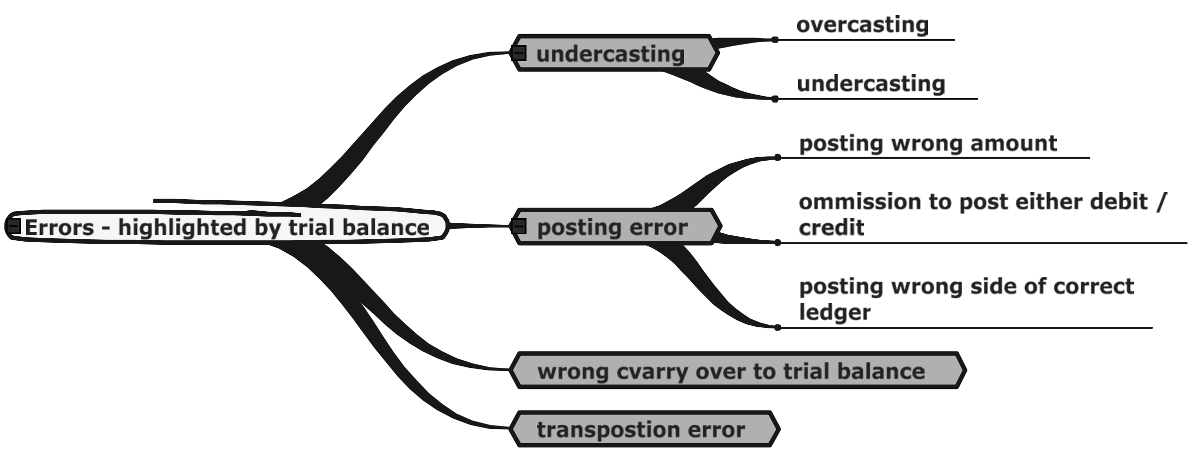
4. Transposition error

Under this type of error, a transaction is recorded in the books of prime / original entry with the figures in the wrong sequence.

Example

A sale to Alan for Tshs5.1 million is recorded as Tshs1.5 million in the Alan-receivable account, and as Tshs5.1 million in the sales account. The error is the transposition of the numbers 1 and 5. As a result, the totals of the debit and credit balances in trial balance will not agree.

SUMMARY



1.3 Errors that cannot be highlighted by preparing a trial balance

(Also known as errors that do not affect the agreement of a trial balance).

The main purpose of the trial balance is to ensure that double entry book keeping has been followed correctly and that debits = credits. If using a manual system, it is possible to post just one side of the entry or even to write in an incorrect amount. The trial balance will highlight this if it occurs, as debits credits.

While it is simple to identify that an error has been made, there is often a long and difficult task of cross checking balances to find out where the error is! We will discuss this in more detail in the next Learning Outcome.

When the totals of debits and credits are equal in a trial balance, this does not assure the correctness of accounting. There may still be errors, which do not create a difference in the debit and credit totals of a trial balance. These errors distort the financial statements, but the trial balance total of debits and credits is equal. These errors are difficult to detect compared to those errors that affect the agreement of the trial balance.

These are given in detail below.

1. Error of omission to record

Under this type of error, a transaction is completely omitted in the financial records.

Example

ICC Ltd sold goods to Alan for Tshs1.2 million but omitted to record the transaction in both the sales day book and the receivables ledger. Since both the accounting effects (i.e. the credit in the sales account and the debit in the receivables ledger) of the transaction are not recorded there cannot be a difference in the trial balance.

---

2. Error of commission

These are basically the clerical errors committed at the time of recording and / or posting the transactions. This includes errors such as the recording of a transaction to the wrong account or recording a transaction with the wrong amount.

Example

ICC Ltd sold goods to Alan for Tshs1.2 million and recorded this in the sales day book. However instead of debiting the amount to Alan's account, it was debited to Peter's account. This error will not affect the agreement of the trial balance because whether Alan's account is debited or Peter's account is debited - the posting has gone to the debit side of the account. The credit effect has been correctly taken and so the trial balance will agree.

---

3. Error of principle

Errors of principle are errors resulting from the violation of generally accepted accounting principles.

Example

Tick-tick Ltd is a pharmaceutical company. It purchased a car for Tshs18 million. The payment was made by cheque. The transaction was recorded as follows:

Dr	Purchases account (IS)	Tshs18 million	
Cr	Bank account (SOFP)		Tshs18 million

Being car purchased

Therefore, the purchases account is debited as opposed to the asset account
As a result, the company's profits and assets will be reported with a Tshs18 million deficit. .

The trial balance will still balance as one account has been debited with the right amount (it does not matter that the account head is wrong) and one account has been credited with the right amount. Hence this error cannot be detected by preparing a trial balance.

---

4. Compensating error

Under this type of error, two errors are committed, in such a way that the total debits remain equal to the total credits in the trial balance.

Example

Goods sold to Jay for Tshs1 million were recorded in the sales day book correctly but were not recorded in Jay-receivables account. At the same time goods purchased from Bob for Tshs1 million were recorded in the purchase day book but not recorded in Bob's payables account.

The two accounting entries were as follows:

Dr	________________	-	
Cr	Sales account		Tshs1 million
Dr	Purchases account	Tshs1 million	
Cr	________________		-

The ultimate effect of the above error is that the debit in the first entry falls short by Tshs1 million and the credit in the second entry falls short by Tshs1 million. Therefore, the two errors will compensate each other and the trial balance will agree in the terms of debit and credit totals.

---

5. Errors of prime entry

Under this type of error, the error is committed while recording the transaction from the source document to the books of prime entry.

Example

A sales invoice of Tshs1.4 million was recorded as Tshs1.6 million in the sales day book and posted to the receivables ledger account as Tshs1.6 million. This error will not result in any disagreement in the trial balance totals.

---

6. Complete reversal of entry

Under this type of error, a transaction is recorded in exactly the reverse manner.

Example

Red Ltd sold goods to John for Tshs1.6 million.

The correct accounting entry should have been:

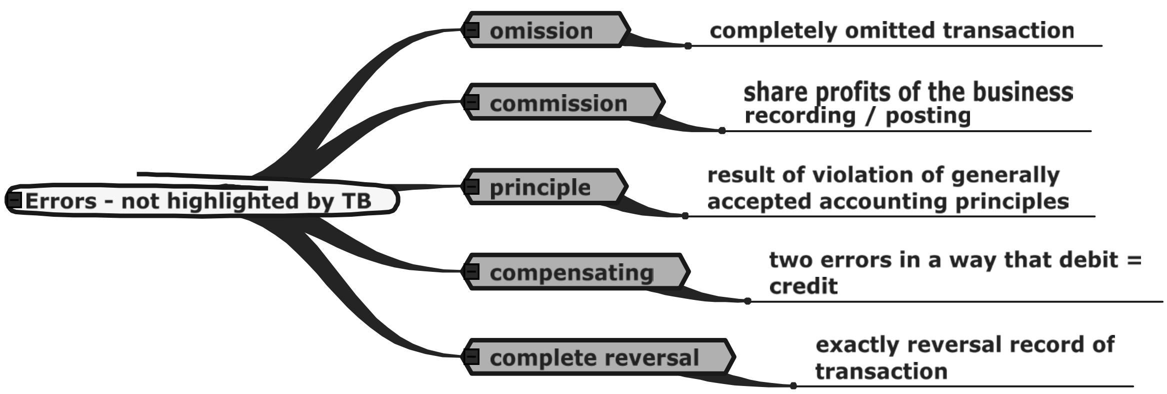
Dr	John account	Tshs1.6 million	
Cr	Sales account		Tshs1.6 million

The wrong accounting entry recorded:

Dr	Sales account	Tshs1.6 million	
Cr	John account		Tshs1.6 million

The trial balance will still balance so this error cannot be detected by preparing a trial balance.

SUMMARY



Test Yourself 1

Jack purchased raw materials from Sam for Tshs20 million. Jack debited the purchase account with Tshs20 million and credited Sam's account with Tshs15 million.

Is there any error? If yes, which type of error it is?

Test Yourself 2

The purchases account has a balance of Tshs50 million. The debit side of the account was overcast by Tshs1 million.

What is the correct balance?

A Tshs49 million debit
B Tshs49 million credit
C Tshs51 million debit
D Tshs51 million credit

Test Yourself 3

The cash book has a balance of Tshs30 million. The credit side of the cash book was overcast by Tshs2 million.

What is the correct balance?

A Tshs32 million debit
B Tshs32 million credit
C Tshs28 million debit
D Tshs28 million credit

Test Yourself 4

The cash book has a balance of Tshs30 million. The credit side of the cash book was undercast by Tshs2 million. What is the correct balance?

A Tshs32 million debit
B Tshs32 million credit
C Tshs28 million debit
D Tshs28 million credit

Test Yourself 5

The audit fees account has a balance of Tshs5 million. The debit side of the account was undercast by Tshs0.5 million. What is the correct balance?

A Tshs4.5 million debit
B Tshs4.5 million credit
C Tshs5.5 million debit
D Tshs5.5 million credit

Test Yourself 6

Samuel purchased raw materials from Sam for Tshs5.2 million. He debited the purchase account with Tshs2.5 million and credited Sam's account with Tshs5.2 million.

Has any error been committed by Samuel? If yes, what is the error?

Test Yourself 7

Name the type of error:

(a) Cash book debit side undercast by Tshs0.1 million and purchases account credit side undercast by Tshs0.1 million.
(b) Interest charged by the bank not recorded.
(c) Payment of Tshs0.9 million recorded as Tshs0.7 million in the cash book.
(d) Payment to Sam recorded in Suzy's account.
(e) Receipt of Tshs1 million recorded as Tshs1.2 million in the cash book.
(f) Payment to supplier not recorded.
(g) Cash book debit side undercast by Tshs0.1 million and purchases account debit side overcast by Tshs0.1 million.
(h) Wages paid of Tshs0.2 million recorded on the receipt side of the cash book and posted to the credit side of the wages account.
(i) Purchase of non-current asset recorded as expense.
(j) Purchases from Mack recorded in Jack's account.
(k) Receipt from Michael recorded in Jackson's account.
(l) Receipt of loan accounted as receipt of income.
(m) Depreciation on machinery debited to accumulated depreciation account, and credited to machinery account.
(n) Revenue expenditure recorded as capital expenditure.
(o) Purchase return to supplier recorded in the sales return day book.

(p) Sale of Tshs0.2 million to Mack not recorded and the payment collected from him of Tshs0.2 million also not recorded.
(q) Sale of Tshs0.5 million recorded as sale of Tshs0.4 million in the sales day book.
(r) Purchases of goods not recorded.

---

2. State the procedures for correcting errors.

[Learning Outcome b]

Errors can be rectified by passing correct journal entries and recording them in the ledgers.

2.1 Correcting the errors that can be highlighted by extraction of a trial balance

Due to the errors mentioned above, the debit total   credit total in a trial balance. You must check through your accounting entries to ensure that all debits and credits have been correctly recorded and posted. In addition you must check for any casting and transposition errors. Debits   credits indicate that there is a mathematical error. A **suspense account is used to rectify these errors.** This is explained later in detail in Learning Outcome 3.

2.2 Correcting the errors that cannot be highlighted by extraction of a trial balance

These errors do not affect the balancing of the trial balance. In other words, in spite of these errors, the trial balance will show debit totals = credit totals. Hence, we need to make journal entries to correct these errors. Such journal entries can be called correction entries.

1. Error of omission to record

Example

ICC Ltd sold goods to Alan for Tshs1.2 million but omitted to record the transaction in both the sales day book and the receivables ledger.

Error of omission to record

The following transaction was not recorded:
Dr Alan account Tshs1.2 million
Cr Sales account Tshs1.2 million

Correction
Record in the sales day books

Correction entry
Dr Alan's account Tshs1.2 million
Cr Sales account Tshs1.2 million
Being goods sold to Alan, omitted from the books of accounts now recorded

Reasons and explanations

The sale transaction of Tshs1.2 million has not been recorded in the books of accounts. Therefore, we need to record the transaction by writing a journal entry.

---

2. Error of commission

Example

ICC Ltd sold goods to Alan for Tshs1.2 million and recorded this in the sales day book. However it debited the amount to Peter's account instead of Alan's account.

Error of commission

Correct entry
Dr Alan account Tshs1.2 million
Cr Sales account Tshs1.2 million

Wrong entry
Dr Peter account Tshs1.2 million
Cr Sales account Tshs1.2 million

Correction
Move to the correct ledger

Correction entry
Dr Alan's account Tshs1.2 million
Cr Peter's account Tshs1.2 million

Being sale of goods to Alan, wrongly debited to Peter's account now recorded in Alan's account

Thus, after correction, Peter's account will have 0 balances (being his account once debited (wrong entry) and once credited (correction entry). Similarly, Alan's account will have a balance of Tshs1.2 million.

---

3. Error of principle

Example

Tick-tick Ltd purchased a car for Tshs18 million. The transaction was recorded as purchases in the Statement of profit or loss instead of purchases of assets.

Error of Principle

Correct entry

Dr Car asset account Tshs18 million
Cr Bank Tshs18 million

Wrong entry

Dr Purchases account Tshs18 million
Cr Bank Tshs18 million

Correction
Move to the correct ledger

Accounting entry
Dr Car (Asset) account Tshs18 million
Cr Purchases account Tshs18 million
Being purchase of car (a non-current asset), wrongly debited to purchases (expenses) now rectified.

4. Compensating error

Example

Goods sold to Jay for Tshs1 million recorded in the sales day book correctly but not recorded in the Jay-receivables account. At the same time, goods purchased from Bob for Tshs1 million recorded in the purchases day book but not recorded in the Bob-payables account.

Compensating Error

Dr ____________ -
Cr Sales account Tshs1 million

Dr Purchase account Tshs1 million
Cr ______________ -

Correction
Make entry for accounts which are omitted

Accounting entry
Dr Jay-Receivables account Tshs1 million
Cr Bob-Payables account Tshs1 million
Being goods sold to Jay, recorded in the sales day book but not recorded in Jay's ledger, now recorded. Similarly purchases from Bob, recorded in the purchase day book but not in Bob's ledger account, now credited

Reasons and explanation

The error is that a sale to Jay is recorded in the sales day book but not in the Jay- receivables account. Now we need to debit the Jay- receivables account. On the other hand, purchases from Bob are also not recorded in the Bob- payables account, so we need to credit Bob- payables account.

5. Errors of prime entry

Example

A sale invoice of Tshs1.4 million was recorded as Tshs1.6 million in the sales day book and posted to the receivables ledger account as Tshs1.6 million.

Error in the original entry
Correct entry
Dr Receivables Tshs1.4 million
Cr Sales account Tshs1.4 million

Wrong entry
Dr Receivables account Tshs1.6 million
Cr Sales account Tshs1.6 million

Correction
Make correction in the sales day book

Accounting entry
Dr Sales account Tshs0.2 million
Cr Receivables ledger Tshs0.2 million
Being sale of Tshs1.4 million recorded as Tshs1.6 million now rectified.

Reasons and explanation

The sales amount was shown higher. Instead of recording Tshs1.4 million as a sale, we have recorded Tshs1.6 million. That means the sales are overstated by Tshs0.2 million. To adjust the over booking of sales we should reverse Tshs0.2 million. To reverse the excess sale we have to post an entry to debit the sales account and credit the receivables account.

---

6. Complete reversal of entry

Example

Sold goods to Alan for Tshs1.6 million, but recorded as:

Dr	Sales account	Tshs1.6 million	
Cr	Alan account		Tshs1.6 million

Error of complete reversal of entry
Correct entry
Dr Alan account Tshs1.6 million
Cr Sales account Tshs1.6 million

Wrong entry
Dr Sales account Tshs1.6 million
Cr Alan account Tshs1.6 million

Correction
Make a correction entry for the **double amount** previously recorded.

Accounting entry
Dr Alan account Tshs3.2 million
Cr Sales account Tshs3.2 million
Being goods sold to Alan for Tshs1.6 million, recorded in reverse. Now the error has been rectified by passing an entry for an amount double the previously recorded amount.

Continued on the next page

Reasons and explanation

Remember, here the entry was made in reverse. There are two requirements needed to correct this error.

The first is to rectify the mistake and
Then record the correct transaction.

The sales account should have been credited when making a sale, but we have debited the sales account by Tshs1.6 million. So, first we have to credit the sales account by Tshs1.6 million to rectify this mistake, we then need to show the sale. So altogether, we credit the sales account with Tshs1.6 million + Tshs1.6 million = Tshs3.2 million, the corresponding debit being made to Alan's account.

---

7. Transposition error

Example

Goods sold to Alan for Tshs5.1 million but recorded as Tshs1.5 million.

Transposition error
Correct entry
Dr Alan account Tshs5.1 million
Cr Sales account Tshs5.1 million

Wrong entry
Dr Alan account Tshs1.5 million
Cr Sales account Tshs1.5 million

Correction
Make a correction entry for the difference

Accounting entry
Dr Alan account Tshs3.6 million
Cr Sales account Tshs3.6 million
Being sale to Alan Tshs5.1 million which was recorded at Tshs1.5 million now rectified

Reasons and explanation

In this error, the original entry was transposed - Tshs5.1 million was recorded as Tshs1.5 million i.e. the sales account is Tshs3.6 million short. To rectify this amount, we debit Alan's account and credit the sales account.

Test Yourself 8

Gemini Ltd issued 10,000 equity shares of Tshs1,000 each at Tshs1,500 per share. However the accountant recorded the whole amount in the share capital account. What is the accounting entry to rectify the error?

Test Yourself 9

Gemini Enterprise paid Tshs5 million for stationery which was recorded in the office expense account. However, the auditor treated the expense as material, needing a separate disclosure. What is the correction entry?

Test Yourself 10

A customer of JJ Collections became bankrupt. He owed Tshs150,000 to JJ, which was not recoverable, and hence, the accountant debited the bad debt account and credited the customer's account. Is the accounting entry made by the accountant correct?

Test Yourself 11

State which of the following is an error of principle?

A While calculating depreciation, the wrong percentage was used
B An item was entered in the wrong class of account
C When stock was issued, the invoice was not issued
D A sales invoice of Tshs0.5 million was entered in the sales journal as Tshs0.4 million

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3. Correct accounting errors using suspense accounts.

[Learning Outcome c]

3.1 Suspense account

Before preparing the financial statements, we prepare a trial balance. If the debit and credit totals of a trial balance do not balance, it indicates that some error has crept into the accounts. Any error in the accounts is unacceptable. These errors have to be identified and rectified before financial statements can be prepared.

Whenever a trial balance does not balance, all possible efforts are made to locate the error and rectify it. However, if the error cannot be found, the difference in the trial balance is temporarily transferred to a **suspense account.** In this way the debit and credit totals of the trial balance become equal.

Definition

A **suspense account** is a temporary account used to carry the difference between the debit and credit total of the trial balance.

3.2 Purpose of a suspense account

The purpose of the suspense account is to put the sum of all the errors in one visible place - in one account. The accountant can then concentrate on locating and rectifying these errors. It is important to ensure that the balance of the suspense account is reduced to zero i.e. all errors are identified and corrected before the financial statements are prepared.

Therefore, a **suspense account** is **temporarily included in** a **trial balance** to balance the debit and credit totals. Any of the two methods explained below can be used to create a suspense account.

1. If the credit total of a trial balance is more than the debit total then the suspense account has a debit balance.

Example

Trial balance before including suspense account

	Debit Tshs'000	Credit Tshs'000
X account	50,000	
Y account		60,000
Total	**50,000**	**60,000**

Trial balance after including suspense account

	Debit Tshs'000	Credit Tshs'000
X account	50,000	
Y account		60,000
Suspense account	**10,000**	
Total	**60,000**	**60,000**

This means that in this example, the suspense account has a debit balance of Tshs10 million.

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

	Tshs'000		Tshs'000
Difference in trial balance	10,000		

---

2. If the debit total of a trial balance is more than the credit total then the suspense account has a credit balance.

Example

Trial Balance before including suspense account

	Debit Tshs'000	Credit Tshs'000
X account	45,000	
Y account		40,000
Total	**45,000**	**40,000**

Trial Balance after including suspense account

	Debit Tshs'000	Credit Tshs'000
X account Y	45,000	
account Suspense		40,000
account		5,000
Total	**45,000**	**45,000**

This means that in this example, the suspense account has a credit balance of Tshs5 million.

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

	Tshs'000		Tshs'000
		Difference in trial balance	5,000

After opening a suspense account, all those errors that affect the agreement of a trial balance are rectified by either debiting or crediting the suspense account. **It is imperative that you investigate and eliminate the balance of the suspense account before proceeding to produce the financial statements.**

In some instances, it is also possible that an accountant might knowingly post entries to the suspense account, thereby creating an error.

Example

An amount of Tshs0.5 million paid directly into the bank account of Nelson Co by a customer. The reference shows that it is a payment for invoice but the accountant is not sure which customer has paid the money. The accountant has two choices:

He can make no entries in his books until the matter is resolved and have Tshs0.5 million as a reconciling item on his bank reconciliation or

The following journal entry can also be made:

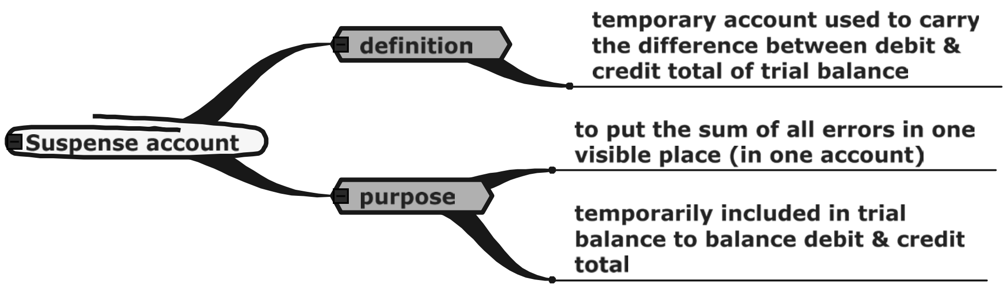
Dr	Cash account	Tshs0.5 million	
Cr	Suspense account		Tshs0.5 million

Being difference in trial balance hence suspense account created

Once a suspense account is opened - it is essential to locate and rectify errors so that the account can be reduced to zero.

Both methods are valid; provided that the suspense account and the reconciling items in the bank statement are investigated on a timely basis. Company procedure will usually dictate which approach is to be adopted.

SUMMARY



3.3 Errors leading to the creation of a suspense account

The errors that can occur while preparing a trial balance have already been discussed in Learning Outcome 1. They can be summarised as follows:

1. Casting error (i.e. errors of adding up)
   (a) Undercasting of the credit side
   (b) Undercasting of the debit side
   (c) Overcasting of the credit side
   (d) Overcasting of the debit side

2. Posting error
   (a) Posting the wrong amount and transposition error
   (b) Omitting to post the debit or credit side of the transaction
   (c) Posting a transaction to the wrong side of the correct ledger account

3. Figures incorrectly carried over to the trial balance

Refer back to Learning Outcome 1 to refresh your memory.

3.4 Record entries in a suspense account

Let's look at some errors that give rise to an unbalanced trial balance which results in the creation of a suspense account. Remember that:

- the creation of a suspense account is temporary
- it may contain more than one entry if a number of errors have been made and
- its balance has to be reduced to zero

Example

The nominal balance of Fancy Paints Ltd has the following balances as on 31/12/20X3:

	Tshs'000		Tshs'000
Cash	11,000	Plant & Machinery	13,000
Capital	15,000	Trade payables	9,000
Purchases	13,000	Sales	18,000
Trade receivables	3,000	Other expenses	2,000

Ted, the accountant, prepares the trial balance and by mistake he reports other expenses as a credit. In order to ensure Debit = Credit he must create a suspense account:

Trial balance

	Debit Tshs'000	Credit Tshs'000
Cash	11,000	
Plant and Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	13,000	
Sales		18,000
Trade receivables	3,000	
Other expenses		2,000
Suspense	4,000	
Total	**44,000**	**44,000**

Should be a debit balance as it is an expense

We will see the accounting entry to correct this later.

Because of an error in recording the amount of other expenses, the trial balance does not agree. Hence the accountant has created a suspense account to balance the trial balance.

Let's take another example of error, which leads to the creation of a suspense account in the trial balance.

Example

Continuing the previous example of Fancy Paints Ltd

Consider Fancy Paints Ltd's ledger balances once again. Let us assume that a totalling error had been made when closing the purchases account. Instead of posting the correct balance Tshs13 million, Ted (the accountant) recorded the amount as Tshs13.5 million.

The trial balance will now look as follows:

	Debit Tshs'000	Credit Tshs'000
Cash	11,000	
Plant & Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	13,500	
Sales		18,000
Trade receivables	3,000	
Other expense		2,000
Suspense	3,500	
Total	**44,000**	**44,000**

Overstated by Tshs0.5 million

Should be a debit balance as it is an expense

You can see that the balance on the suspense account is now Tshs3.5 million which is built up of:

	Tshs'000
Expense entered as credit rather than debit	4,000
Totalling mistake of purchase account	(500)
	3,500

Example

Continuing the previous example of Fancy Paints Ltd

Consider Fancy Paints Ltd once again, Ted was having a really bad day. When posting entries from the sales day book he correctly made the entries in the sales account, but entered Tshs1 million in the trade receivables account rather than Tshs0.1 million.

The trial balance will now look as follows:

	Debit Tshs'000	Credit Tshs'000
Cash	11,000	
Plant & Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	13,500	
Sales		18,100
Trade receivables	4,000	
Other expense		2,000
Suspense	2,600	
Total	**44,100**	**44,100**

Amount of Tshs0.1 million entered correctly in the sales account

Error of posting to the trade receivables account; it is overstated by Tshs0.9 million

Continued on the next page

You can see that the balance on the suspense account is now Tshs2.6 million which is built up of:

	Tshs'000
Expense entered as credit rather than debit	4,000
Totalling mistake of purchase account	(500)
Error in posting trade receivables	(900)
	2,600

The example of Fancy Paint's Ltd above shows that errors can creep into the accounts at any stage. If there is an error in totalling or taking the double entry or in posting these entries in the ledger accounts, then the trial balance will not balance. We will then need to open a suspense account.

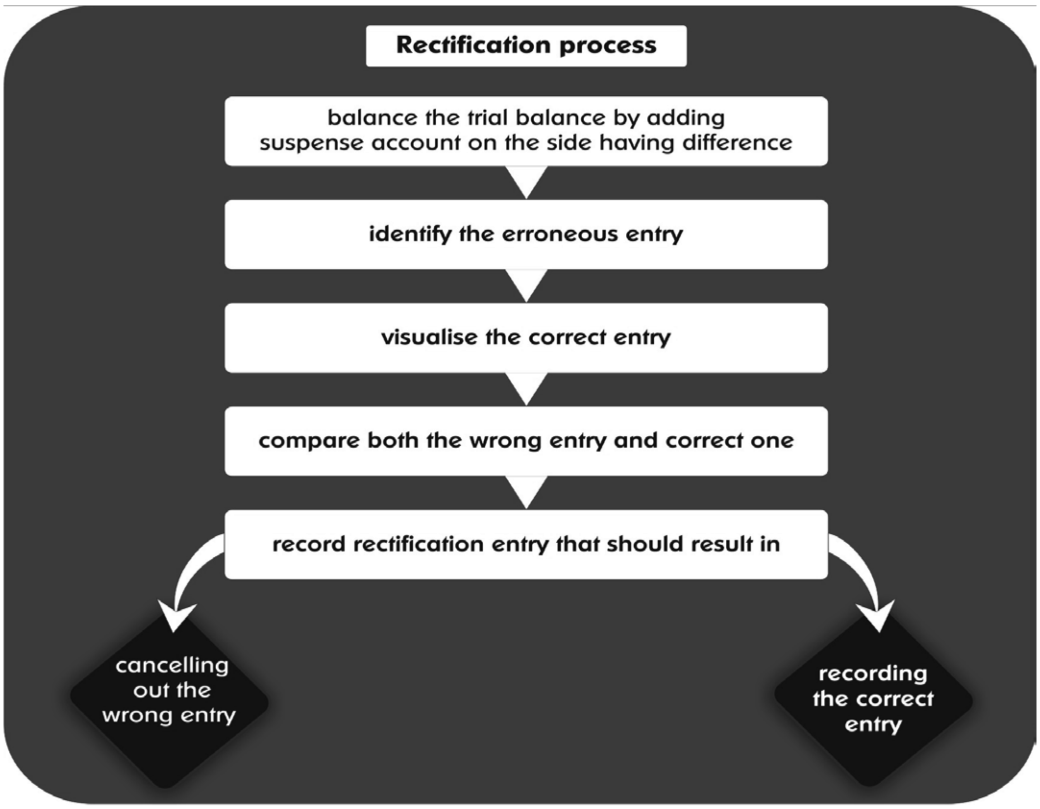
Tip

From all the above examples you can see that a suspense account is needed when total debits total credits.

3.5 Journal entries to clear a suspense account

Before we learn journal entries let us visualise the process.

Diagram 2: Rectification process



Throughout this Learning Outcome, we have indicated that suspense accounts are temporary, and the balance must be reduced to zero. We will now consider some of the most common errors made and how they are corrected through the suspense account.

Tip

A suspense account arises only when the debit is not equal to credit.

Example

Goods are sold to Rajan for Tshs15 million. The amount recorded in the sales book is Tshs51 million; however the correct amount is posted in the account receivables control account.

Wrong e**ntry**
The following transaction was recorded as:
Dr Rajan account Tshs15 million
Cr Sales account Tshs51 million

Debit is not equal to credit.

Correction
Dr Rajan account Tshs15 million
Cr Sales account Tshs15 million

Correction entry
Dr Sales account Tshs36 million
Cr Suspense account Tshs36 million
(Being goods sold to Rajan recorded as Tshs51 million in the sales book instead of Tshs15

Example

A salary amount of Tshs3.5 million is paid to Sam. The accountant erroneously records the entry in the debit side of the salary account and in the receipt side of the cash book.

Wrong entry
The following transaction was recorded as:
Dr Salary account Tshs3.5 million
Dr Cash account Tshs3.5 million
Cr ------------------- NIL

Debit is not equal to credit.

Correction
Dr Salary account Tshs3.5 million
Cr Cash account Tshs3.5 million

Correction entry
Dr Suspense account Tshs7 million
Cr Cash account Tshs7 million
Being cash paid for salary not recorded in cash book however salary account debited appropriately.

Example

Salary paid to Sam of Tshs3.5 million was debited to Sam's account and posted on the payment side of the cash book.

Wrong entry
The following transaction was recorded as: Dr
Sam account Tshs3.5 million
Cr Cash account Tshs3.5 million

Debit is equal to credit. Hence no suspense account.

Correction
Dr Salary account Tshs3.5 million
Cr Cash account Tshs3.5 million

Correction entry
Dr Salary account Tshs3.5 million
Cr Sam account Tshs3.5 million
Being cash paid for salary recorded in Sam's personal account.

Tip

In the exam, the questions are usually based on the correction of errors, using the suspense account rather than recording entries in the suspense account. When correcting an error it is important that you identify the wrong entries made while committing the error. Then it is a simple task to reverse the error and post the correct amount to the correct account.

Let's take some more examples to show the methods of clearing the suspense account and showing the relevant journal entries to be made.

Example

Party Shirts Ltd has drafted its trial balance. It has to correct the imbalance by opening a suspense account having a debit balance of Tshs425,000.

	Debit Tshs'000	Credit Tshs'000
Cash	13,700	
Plant & Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	6,000	
Sales		10,000
Trade receivables	3,000	
Other expenses		2,000
Discount received		125
Suspense	**425**	
Total	**36,125**	**36,125**

Investigation has shown that the following errors have been made:

1. Sales were recorded as Tshs10 million instead of Tshs11 million in trial balance.

2. A purchase invoice of Tshs1.5 million was omitted from the purchases account. However, the correct entry was made in the supplier's account.

3. A cash discount of Tshs75,000 is recorded in the receivables ledger, but not in the discounts received account.

4. Collection of Tshs900,000 from Alistair (a customer) is credited to Bob (a supplier).

The journal entries required to clear the suspense account are as follows:

1.

Dr	Suspense account	Tshs1,000,000	
Cr	Sales account		Tshs1,000,000

Being sales account of Tshs11 million incorrectly recorded as Tshs10 million in the trial balance, now corrected

Reasons and explanations

The credit balance of the sales account was short on the trial balance. Therefore we need to credit the sales account and debit the suspense account.

2.

Dr	Purchases account	Tshs1,500,000	
Cr	Suspense account		Tshs1,500,000

Being purchase invoice of Tshs1.5 million omitted from the purchases account, now recorded

Reasons and explanations

Omission of the purchase invoice results in a short debit balance on the purchases account in the trial balance. Hence we need to increase the debit in the purchases account and credit the suspense account.

3.

Dr Suspense account Tshs75,000
Cr Discount received account Tshs75,000
Being discount received not recorded in the discount received account, now corrected

Reasons and explanations

Due to a one sided posting of the cash discount; the discount received account has a short credit of Tshs75,000. Therefore we need to credit the discount received and debit the suspense account.

4.

Dr Bob-payable account Tshs900,000
Cr Alistair-receivable account Tshs900,000
Being cash received from Alistair wrongly credited to Bob's account, now corrected

Reasons and explanations

This is an error of commission that doesn't affect the suspense account. The amount received from Alistair is not recorded in his account, hence we need to credit Alistair's account and debit Bob's account

After correcting the above errors, the trial balance will be as follows:

	Debit (Tshs'000)	**Credit (Tshs'000)**
Cash	13,700	
Plant & Machinery	13,000	
Capital		15,000
Trade payables (Tshs9,000 - Tshs900)		8,100
Purchases (Tshs6,000 + Tshs1,500)	7,500	
Sales (Tshs10,000 + Tshs1,000)		11,000
Trade receivables (Tshs3,000 - Tshs900)	2,100	
Other expenses		2,000
Discount received (Tshs125 + Tshs75)		200
Suspense	Nil	
Total	**36,300**	**36,300**

Dr Suspense account Cr

	Tshs'000		**Tshs'000**
Balance b/d	425	Purchases	1,500
Sales	1,000		
Discount received	75	Balance c/f	Nil
Total	1,500	Total	1,500

Example

The accountant of Gemini Enterprises asks for your help to correct his trial balance. The trial balance totals were:

Debit - Tshs138,660,000
Credit- Tshs158,000,000

The suspense account was created by Tshs19,340,000 Dr to balance the trial balance.

The following errors, that need rectification, were identified:

1. Omission from the trial balance of the audit fees expense account, Tshs8 million.
2. A discount allowed was debited to the discount received account, Tshs600,000.
3. A cash sale of Tshs900,000 was not recorded in the cash book.
4. Accrued expenses of Tshs330,000 were entered on the debit side of the trial balance.

Continued on the next page

5. Accumulated depreciation of Tshs900,000 was taken to the credit side of the trial balance.
6. Loss on the sale of plant for Tshs6 million was credited as a profit on the sale of plant.
7. Goods taken by proprietor valued at Tshs3.2 million were credited to the drawings account and debited to the purchases account.

Write the correction entry and calculate the closing totals of the trial balance.

Answer

Explanations for each of the above items are given sequentially below:

No	Wrong Entry	Tshs'000	Tshs'000		Correction Entry	Tshs'000	Tshs'000
1	Dr Suspense A/c Cr --------------	8,000	-		Dr Audit fees Cr Suspense A/c	8,000	8,000
2	Dr Discount received Cr Customer's A/c	600	600		Dr Discount allowed Cr Discount received	600	600
3	Dr -------------- Cr --------------				Dr Cash Cr Sales	900	900
4	Dr Accrued expense Cr Suspense A/c	660	660		Dr Suspense A/c Cr Accrued expense	660	660
5	Not an error				------------------		
6	Dr Asset disposal Cr Profit on sale of plant	6,000	6,000		Dr Profit on sale of plant Dr Loss on sale of plant Cr Asset disposal	6,000 6,000	12,000
7	Dr Purchases A/c Cr Drawings	3,200	3,200		Dr Drawings Cr Purchases A/c	6,400	6,400

Explanation

1. The audit fees account has a debit balance. Due to the omission of this account there arises a debit balance in the suspense account of Tshs8 million. Therefore we must debit the audit fees account and credit the suspense account.

2. There was an error in posting to the wrong account. We have not debited the discount allowed account, hence we will debit the discount allowed account and credit the discount received account.

Tip

This error does not cause **the trial balance not to balance; hence there will be no effect on the suspense account.**

3. This is an error of omission. We need to record the entry.

4. Accrued expense has a credit balance of Tshs330,000. Since it was taken to the wrong side of the trial balance, it created a credit balance in the suspense account of Tshs660,000. We need to debit the suspense account and credit the accrued expense account.

5. Not an error.

Continued on the next page

6. Instead of debiting the loss, an incorrect credit was given to the profit on sale of plant account. Therefore, the profit on sale of plant account should be reversed by Tshs6 million to rectify the error. We also need to debit the loss on sale of the plant for the same amount and credit the asset disposal account by Tshs12 million.

7. This is a complete reversal of entry so it does not imbalance the trial balance. Instead of debiting the drawings account by Tshs3.2 million the accountant has credited it by Tshs3.2 million. While correcting the error we need to first reverse the wrong credit and include the correct debit. This requires debiting the drawings account by Tshs6.4 million and crediting the purchases account by Tshs6.4 million.

Dr Suspense account Cr

	Tshs'000		Tshs'000
Balance b/d	19,340	Audit fees	8,000
Accrued expenses	660	Profit on sale of asset	12,000
		Balance c/f	0
Total	**20,000**	**Total**	**20,000**

Trial balance totals after rectification

	Debit (Tshs'000)	Credit (Tshs'000)
Balance earlier	138,660	158,000
Suspense account cleared	19,340	
	158,000	**158,000**
Other adjustments		
Discount	600	600
Cash sales	900	900
Drawings	6,400	6,400
Revised totals	**165,900**	**165,900**

Example

The debit side of a company's trial balance was Tshs0.5 million more than the credit side. Which of the following errors is the sole cause of the difference?

1. Discount received of Tshs0.5 million was recorded on the debit side of the account.
2. Share premium of Tshs0.5 million was credited to the share capital account.
3. Receipt from the customer of Tshs0.5 million was omitted from the records.
4. Discount received of Tshs0.25 million was recorded on the debit side of the account.

Post the rectification entry for each of the above errors.

Continued on the next page

Answer

In order to correct the error it is necessary to first identify it. It is then a simple task to correct the error and make the correct entries. Further explanation is provided below each of the errors.

	Accounting entry with error			Effect on suspense account	Correction entry		
		Tshs'000	Tshs'000			Tshs'000	Tshs'000
1	Dr Discount received Dr Supplier's account	500 500	- -	Suspense account will have a credit balance of Tshs1 million	Dr Suspense account Cr Discount received	1,000	 1,000
2	Dr Cash Cr Share capital	500 -	- 500	No effect on suspense account.	Dr Share capital Cr Share premium	500	 500
3	Dr -------------------- Cr --------------------			No effect on suspense account.	Dr Cash Cr Customer	500 -	- 500
4	Dr Discount received Cr Suppliers account	250	- 250	Suspense account will have a credit balance of Tshs0.5 million	Dr Suspense account Cr Discount received	500	 500

Explanation

1. There is an **error in posting**. Instead of recording the discount on the credit side we have recorded it on the debit side. This will create a difference in the trial balance for twice the amount of error i.e. twice of Tshs0.5 million = Tshs1 million.

2. This error does not affect the agreement of the trial balance. We have not credited the share premium account. While rectifying the error we need to credit the share premium account and debit the share capital account.

3. Complete **omission** does not affect the agreement of the trial balance. We need to record the entries for the first time.

4. There is an **error in posting**. Instead of recording the discount received on the credit side we have recorded it on the debit side. This will create a difference in the trial balance for twice the amount of error i.e. twice Tshs0.25 million = Tshs0.5 million.

Tip

Errors that can be highlighted by extraction of a trial balance will require a suspense account.
Errors that cannot be highlighted by extraction of a trial balance will not require a suspense account.

Example

Rectify the following errors:

1. Other income received of Tshs880,000 was correctly recorded in the cash book, but was debited to the other income account.

2. Cash paid for wages of Tshs9.6 million was posted to the wages account as Tshs6.9 million.

3. The purchases day book was overcast by Tshs2 million.

4. The sales day book was undercast by Tshs6 million.

5. The cash book credit side was undercast by Tshs1.3 million.

6. The prepaid expense account debit side was undercast by Tshs0.6 million.

7. A sale of Tshs1.5 million was fully credited to the sales account. However, sales tax of Tshs0.5 million was included in it.

8. A building purchased for Tshs60 million was entered in the building account as Tshs50 million. The company charges 2% depreciation.

9. Repairs to machinery of Tshs5 million were capitalised and a depreciation of 5% was charged on it.

Also classify these errors into:

Errors requiring suspense account
Errors not requiring suspense account

Error	**Wrong entry**			**Whether Suspense A/c required**	**Correction entry**		
		Tshs’000	**Tshs’000**			**Tshs’000**	**Tshs’000**
1	Dr Cash Dr Other income	880 880	- -	Yes	Dr Suspense A/c Cr Other income	1,760	 1,760
2	Dr Wages Cr Cash	6,900	 9,600	Yes	Dr Wages Cr Suspense A/c	2,700	 2,700
3	Dr Purchases Cr ------------	12,000	 10,000*	Yes	Dr Suspense A/c Cr Purchases account	2,000	 2,000
4	Dr -------------- Cr Sales	16,000*	 10,000	Yes	Dr Suspense A/c Cr Sales A/c	6,000	 6,000
5				Yes	Dr Suspense A/c Cr Cash	1,300	 1,300
6	Dr Prepaid expense Dr--------	1,000	 1,600*	Yes	Dr Prepaid expense Cr Suspense A/c	600	 600
7	Dr Cash Cr Sales account	1,500	 1,500	No	Dr Sales account Cr Sales tax A/c	500	 500

Continued on the next page

8	Dr Building	50,000		Yes	Dr Building	10,000	
	Cr Cash		60,000		Cr Suspense account		10,000
					Dr Depreciation	200	
					Cr Accumulated depreciation (2% on Tshs10 million) (Refer Explanation 8)		200
9	Dr Machinery A/c	5,000		No	Dr Repairs to machinery	5,000	
	Cr Cash		5,000		Cr Machinery A/c		5,000
					Dr Accumulated depreciation	250	
					Cr Depreciation		250
					(5% on Tshs5 million) (Refer Explanation 9)		

***-** figures are assumed for explanation

Explanation

1. There is an error in posting. Instead of recording the other income on the credit side we have recorded it on the debit side. This will create a difference in the trial balance for twice the amount of error i.e. twice Tshs880,000 = Tshs1,760,000. We will credit the other income account by Tshs1,760,000 and debit the suspense account by Tshs1,760,000.

2. There is an error in posting. Instead of posting Tshs9.6 million to the debit side of the wages account we have posted Tshs6.9 million. This means there was a short debit posting of Tshs2.7 million. Therefore to rectify the error we will debit the wages account by Tshs2.7 million and credit the suspense account by Tshs2.7 million.

3. The purchases account has a debit balance. Overcasting of the purchases day book means the purchases account has a higher debit balance than it should have in the trial balance. Hence to rectify this we need to reduce the excess balance by crediting the purchases account and debiting the suspense account.

4. The sales account has a credit balance. Undercasting of the sales day book means that the sales account has a lower credit balance than it should have in the trial balance. Hence to rectify this we need to credit the sales account and debit the suspense account by Tshs6 million.

5. The cash book payment side has a credit balance. Undercasting of the payment side of the cash book means the credit in the cash balance is too low. Therefore to rectify this we need to credit the cash and debit the suspense account by Tshs1.3 million.

6. The prepaid expense account debit side has been undercast. Therefore we need to debit the prepaid expense account and credit the suspense account by Tshs0.6 million.

7. Sales tax included in the sales was not credited to the sales tax account. Therefore to correct the error we need to credit the sales tax account and debit the sales account by Tshs0.5 million.

8. There is an error in posting. Instead of posting Tshs60 million to the debit side of the building account we have posted Tshs50 million. This means the debit side was short by Tshs10 million. Therefore to rectify the error we will debit the building account by Tshs10 million and credit the suspense account by Tshs10 million.

   However, this error also has an impact on depreciation. Due to this error, a lower depreciation was calculated on the building than should have been. We need to increase the depreciation. This entry will not affect the suspense account.

Continued on the next page

9. This is an error of principle. Revenue expenditure was incorrectly capitalised. To rectify the error we need to debit the repairs to machinery account and credit the machinery account by Tshs5 million.

   Due to this error, extra depreciation was recorded. Therefore we also need to reduce the depreciation. This reduction in depreciation will be a correcting journal that does not affect the suspense account.

Test Yourself 12

A sales invoice for Tshs7.5 million has been recorded in the receivables ledger but omitted from the sales account.

What would you expect to see in the suspense account?

A Tshs7.5 million credit
B Tshs7.5 million debit
C Tshs15 million credit
D Tshs15 million debit

Test Yourself 13

A purchase of raw material for Tshs5.8 million was recorded as Tshs8.5 million in the purchases account. What would you expect to see in the suspense account?

A Tshs5.8 million credit
B Tshs8.5 million credit
C Tshs2.7 million credit
D Tshs8.5 million debit

Test Yourself 14

A discount allowed of Tshs1.6 million was incorrectly debited by Tshs6.1 million and a discount received of Tshs5.4 million was incorrectly credited by Tshs4.5 million to the discount received account. What would you expect to see in the suspense account if the correct amounts were posted to the control account?

A Tshs3.6 million debit
B Tshs3.6 million credit
C Tshs5.4 million debit
D Tshs5.4 million credit

Test Yourself 15

Which of the following errors require opening a suspense account?

A A cash sale of Tshs5 million was neither recorded in the cash book nor in the sales account.
B A purchase of trading goods for Tshs1.8 million was recorded as a purchase of an asset.
C A purchase for Tshs9 million was recorded on the receipt side of the cash book and posted to the credit side of the purchases account.
D The cash book debit side was overcast by Tshs0.5 million.

Test Yourself 16

How much will appear in the suspense account due to the following errors?

(i) Cash sales of Tshs1.5 million were recorded as Tshs5.1 million in both the cash book and the nominal ledger.
(ii) Cash purchases of Tshs9.1 million were posted to the purchases account as Tshs1.9 million.
(iii) Plant account was undercast by Tshs0.5 million and the accrued expense account was undercast by Tshs0.5 million.
(iv) Vehicle account was overcast by Tshs1 million and the goodwill account was overcast by Tshs1 million.

A Tshs7.2 million debit
B Tshs5.2 million credit
C Tshs5.2 million debit
D Tshs7.2 million credit

Test Yourself 17

Find the balance in the suspense account for the following errors?

(i) Carriage inward of Tshs6 million has been omitted from the trial balance.
(ii) Other income of Tshs9 million has been omitted from the trial balance.
(iii) Discount received of Tshs5.5 million was posted to the credit of the supplier's account.
(iv) Receipt of Tshs7 million from a customer, Alistair, was posted to Bill's account.

A Tshs8 million debit
B Tshs8 million credit
C Tshs2 million debit
D Tshs2 million credit

Test Yourself 18

You will credit the cash in the rectification entry for:

A the credit side of the cash book was undercast.
B the credit side of the cash book was overcast.
C the debit side of the cash book was undercast.
D None of the above

Test Yourself 19

You will debit the cash in the rectification entry for:

A the credit side of the cash book was undercast.
B the credit side of the cash book was overcast.
C the debit side of the cash book was overcast.
D undercast the debit side of the cash book.

Test Yourself 20

Which of the following errors do not require creation of a suspense account?

(i) Depreciation of machinery Tshs5 million is recorded as maintenance of machinery Tshs5.5 million.
(ii) Credit sales of Tshs10 million are recorded on the debit side of the sales account, and the same was posted correctly into customers' account.
(iii) Office expenses of Tshs5 million are omitted, and not recorded in the books of accounts.

A (i) and (iii)
B (iii)
C All of the above
D None of the above

4. Correct accounting errors using control accounts.

[Learning Outcome d]

4.1 Control accounts

Definition

A **Control Account** is an account maintained in the general ledger that records only the total value of different subsidiary ledgers.

Let us begin with an example.

Example

Suppose there are three customers of Plaza Corp and each one owes Tshs1 million at the end of 20X2, what will be the total amount of receivables from all customers?

Answer: Tshs3 million

Example

Continuing with the above example, suppose during 20X3 Plaza made sales of Tshs0.5 million to Customer-I, Tshs1 million to Customer-II and then Tshs2 million to Customer-III. What will be the total receivables at the end of 20X3?

Answer: Tshs6.5 million

	Tshs'000	Tshs'000
Customer-I	1,500	(1,000 + 500)
Customer-II	2,000	(1,000 + 1,000)
Customer-III	3,000	(1,000 + 2,000)
Total	**6,500**	

Example

Continuing with the above example, suppose during 20X3 Customer-I paid Tshs1 million and Customer-II paid Tshs1.5 million. What will be the total receivables at the end of 20X3?

Answer: Tshs4 million

	Tshs'000	Tshs'000
Customer-I	500	(1,500 - 1,000)
Customer-II	500	(2,000 - 1,500)
Customer-III	3,000	
Total	**4,000**	

If a total receivables account is being maintained for the year to record only the gross summary of transactions with customers, it will be much easier to control the movement in the receivables account.

Using the figures above, the control account can be prepared as follows:

These accounts will be maintained as memorandum accounts

These amounts will be reflected in receivables control account

	Customer-I Tshs'000	Customer-II Tshs'000	Customer-III Tshs'000	Total Tshs'000
Balance b/d	1,000	1,000	1,000	3,000
Credit sales	500	1,000	2,000	3,500
	1,500	2,000	3,000	6,500
Payment received	(1,000)	(1,500)	-	(2,500)
Balance c/d	**500**	**500**	**3,000**	**4,000**

The balance in the total column reflects the total of the columns - Customer - I, Customer - II and Customer - III.

The above examples were very simple. There were only three accounts and relatively few transactions. However, in a normal business there may be hundreds of individual accounts, and innumerable transactions. Under such circumstance it would be very difficult not to make an error! Even the most careful accountant would make an error - for example a mathematical error, error of transposition, omission etc.

To make it easier for the accountant a **control account** is prepared. A control account keeps a record of the total sales and the total receipts from customers. It keeps the general ledger free of details, yet has the correct balance for the financial statements.

For example, for the accounts in the receivable ledger, we can have a receivable control account. This account is updated with the following information for a period

total collections
total credit sales
total returns and
total discounts etc

The period for which the information is recorded is decided keeping in mind the number of transactions and the requirements of the entity. The period can range from a day to a year.

The details about each customer and each transaction will not be recorded in the receivable control account. These details will be recorded in the receivable subsidiary ledger.

How control exists:

After all the postings to the receivable control account are completed; the total of the individual customer balances = the balance in the receivable control account (in the receivable subsidiary ledger).

If the total of the individual customer balances the balance in the receivable control account (in the receivable subsidiary ledger) then it means that there is some **error in the customers' accounts** in the receivable ledger.

Example

Continuing with the above example of Plaza Corp

The receivable control account and individual customer accounts will appear as follows-

Dr — Receivables control account — Cr

Date		Tshs'000	Date		Tshs'000
	Balance b/d	3,000			
	Credit sales	3,500		Cash (collected from customers)	2,500
				Balance c/d	**4,000**
	Total	**6,500**		**Total**	**6,500**

Dr — Customer - I account — Cr

Date		Tshs'000	Date		Tshs'000
	Balance b/d	1,000		Cash (collected from customers)	1,000
	Invoice -	500		Balance c/d	**500**
	Total	**1,500**		**Total**	**1,500**

Dr — Customer - II account — Cr

Date		Tshs'000	Date		Tshs'000
	Balance b/d	1,000		Cash received	1,500
	Invoice -	1,000		Balance c/d	**500**
	Total	**2,000**		**Total**	**2,000**

Dr — Customer - III account — Cr

Date		Tshs'000	Date		Tshs'000
	Balance b/d	1,000			
	Invoice -	2,000		Balance c/d	**3,000**
	Total	**3,000**		**Total**	**3,000**

The **benefits** of preparing **control accounts** are:

1. They provide a **mathematical check** on the accuracy of the individual ledger accounts. If the total of the individual accounts within the ledger account do not agree with the balance of the respective control account, this denotes the existence of an error which needs to be identified and corrected.

2. Control accounts can be **prepared quickly to provide** the **total outstanding balance** in customers' and suppliers' accounts, without having to add up all the individual accounts. As a result, the control account is often used as the account for double entry, and the individual ledger accounts are maintained as memorandum accounts. This is explained in detail later in this learning outcome.

3. If control account reconciliations are prepared on a regular basis they can be used to **locate** the **errors**. Regular reconciliations will reduce the amount of data you need to check in order to identify the discrepancies.

4. In a large company, one person may not post all the transactions. E.g. purchase invoices are posted by the purchases ledger clerk and cash payments are posted by the cashier. The control account provides an **internal check** to ensure that all entries are being correctly posted.

Receivables control account is also known as total receivables account or **sales ledger control account.**
Payables control account is also known as total payables account or **purchases ledger control account.**

4.2 How control accounts relate to the double entry system

A transaction is first recorded in the books of prime entry and then posted to respective ledger accounts.

Example

Consider the sales day book given below:

Sales day book (Book of prime entry)

Date	Customer name	Invoice number	Tshs'000
05/06/20X3	AAL Inc.	1	2,600
15/06/20X3	XY Corp	2	12,500
25/06/20X3	AAL Inc.	3	21,500
		Total	**36,600**

Normally the entries from the sales day book are posted to the ledger account as follows:

Nominal ledger

Dr — AAL Inc. account — Cr

Date		Tshs'000	Date		Tshs'000
05/06/20X3	Invoice-1	2,600			
25/06/20X3	Invoice-3	21,500		Balance c/f	24,100
		24,100			**24,100**

Dr — XY Corp account — Cr

Date		Tshs'000	Date		Tshs'000
15/06/20X3	Invoice -2	12,500		Balance c/f	12,500
		12,500			**12,500**

Dr — Sales account — Cr

Date		Tshs'000	Date		Tshs'000
				Total sales	36,600
	Balance c/f	36,600			
		36,600			**36,600**

(Note: There will be also be similar entries for the purchase day book, cash book, sales returns book and purchase returns day book)

If the control account method is used, instead of posting to the individual customer's account in the receivable ledger, the posting will be made to the sales ledger control account. The double entry is:

Dr	Receivables control account	X	
Cr	Sales account		X

Being sales posted to control account

Receivables ledger

Dr — AAL Inc. account — Cr

Date		Tshs'000	Date		Tshs'000
0/5/06/20X3	Invoice-1	2,600			
25/06/20X3	Invoice-3	21,500		Balance c/f	24,100
		24,100			**24,100**

Dr — XY Corp account — Cr

Date		Tshs'000	Date		Tshs'000
15/06/20X3	Invoice -2	12,500		Balance c/f	12,500
		12,500			**12,500**

Continued on the next page

Nominal ledger

Dr **Sales account** **Cr**

Date		Tshs'000	Date		Tshs'000
				Total sales	36,600
	Balance c/d	36,600			
	Total	**36,600**		**Total**	**36,600**

Dr **Receivables control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Sales Jun 20X3	36,600			
				Balance c/d	36,600
	Total	**36,600**		**Total**	**36,600**

Tip

The details of individual customer's ledger accounts are maintained separately as memorandum accounts.

We can see that while maintaining control accounts, the following stages are necessary.

	Stage-I Record in books of Prime Entry	**Stage-II** Record in Memorandum a/c	**Stage-III** Double Entry	**Stage-IV** Double Entry
Sales day book	Record sales in the sales day book	Record in the individual customer's ledger account	Post periodic totals to sales and other accounts in the nominal ledger **Cr Sales account**	Post periodic totals to the receivables control account in the nominal ledger **Dr Receivables control account**
Purchase day book	Record purchases in the purchase day book	Record in the individual supplier's ledger account	Post periodic totals to purchases and other accounts in the nominal ledger **Dr Purchases account**	Post periodic totals to the payables control account in the nominal ledger **Cr Payables control account**

The control accounts are prepared from the books of prime entry as summaries of a group of accounts.

The totals posted in a control account should agree with the total of all the individual accounts in that group. One must perform reconciliations on a regular basis to ensure this relationship holds true. Any errors or discrepancies must be investigated and resolved.

The control account procedure can be followed for various accounts and not just for payables and receivables. Common examples are:

- inventory control accounts,
- wages and salaries control accounts,
- cash control accounts,
- interest control accounts (normally used in banks) etc.

We will learn about how the control account operates with the help of an exercise.

4.3 Preparation of books of prime entry and posting to the nominal ledger

Example

The following information was supplied by ICC Ltd for January 20X3. Prepare the books of prime entry and post to the nominal ledger using control accounts. Write up the ledger accounts as memorandum books of accounts and ensure that the total reconciles to the payables control account.

1. **Purchases**

   02/01/20X3: Steel Company Tshs5 million (invoice-8)
   05/01/20X3: Coal Company Tshs4 million
   31/01/20X3: Steel Company Tshs6 million (invoice-15)

2. **Cash book**

   05/01/20X3: Payment to Steel Company Tshs4.5 million against invoice-8 (discount received)
   06/01/20X3: Payment to Coal Company Tshs2 million

3. **Journal**

   05/01/20X3: cash discount recorded for Tshs0.5 million from Steel Company

Answer

(a) Books of original entry of ICC Ltd

Purchases day book for January 20X3

Date		Invoice	Tshs'000
02/01/20X3	Steel Company	8	5,000
05/01/20X3	Coal Company	-	4,000
31/01/20X3	Steel Company	15	6,000
		Total	**15,000**

Cash book for the month of January 20X39

Date	Receipts	Tshs'000	Date	Payments	Tshs'000
			05/01/20X3	Steel Co	4,500
			06/01/20X3	Coal Co	2,000
	Total			**Total**	**6,500**

ICC Ltd

Journal for January 20X3

05/01/20X3	Dr	Payables control account	Tshs500,000	
	Cr	Discount received		Tshs500,000
	Being discount received			

(b) Nominal ledger accounts of ICC Ltd

Post all entries from the books of prime entry into the nominal ledger.

Nominal Ledger

Dr **Purchases account** **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X3	Purchases-January 20X3	15,000	31/12/20X3	Balance c/f	15,000
	Total	**15,000**		**Total**	**15,000**

Dr **Discount received account** **Cr**

Date		Tshs'000	Date		Tshs'000
			05/01/20X3	Steel company	500
31/12/20X3	Balance c/d	500			
	Total	**500**		**Total**	**500**

Dr **Payables control account** **Cr**

Date		Tshs'000	Date		Tshs'000
05/01/20X3	Discount / Steel Co	500	31/01/20X3	Purchases-Jan	15,000
31/01/20X3	Cash book -Jan	6,500			
	Balance c/d	8,000			
	Total	**15,000**		**Total**	**15,000**

4.4 Memorandum books of accounts

As discussed, if the control accounts are maintained, these accounts are used for double entry purposes. The **individual payables ledgers become memorandum books of accounts** i.e. additional books of accounts which do not form part of a double entry book keeping system.

In the trial balance only one figure of total payables will be taken, that of the ledger control account.

Example

Continuing the previous example of ICC Ltd Memorandum

Payables ledger

Dr **Steel company account** **Cr**

Date		Tshs'000	Date		Tshs'000
05/01/20X3	Cash	4,500	02/01/20X3	Purchases	5,000
05/01/20X3	Discount	500	31/01/20X3	Purchases	6,000
	Balance c/d	6,000			
		11,000			**11,000**

Dr **Coal company account** **Cr**

Date		Tshs'000	Date		Tshs'000
06/01/20X3	Cash	2,000	05 01/20X3	Purchases	4,000
	Balance c/d	2,000			
		4,000			**4,000**

4.5 Reconciliation of control account to memorandum accounts

The closing total of all individual accounts in the memorandum payables account should be equal to the balance in payables control account.

Example

Continuing the previous example of ICC Ltd Memorandum

	(Tshs'000)
Steel company	6,000
Coal company	2,000
Total	**8,000**
Balance in payables control account	8,000

Tip

In a trial balance, the closing total of the payables or receivables control account will be taken. The customer's or supplier's closing balances will not be taken to the trial balance. These individual accounts do not form part of the double entry book keeping system, but are memorandum accounts.

Below are **examples** of entries you would expect to see in a control account:

Example

Summary of receivables control account

Gemini Ltd

Dr **Receivables control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	50,000		Cash collected from customers	180,000
	Credit sales	250,000		Sales returns	25,000
	Interest charged on overdue balance	3,500		Discount allowed	5,000
	Cash refunds to credit customers	1,000		Bad debts	6,000
				Contra against payables	16,000
				Balance c/d	72,500
	Total	**304,500**		**Total**	**304,500**

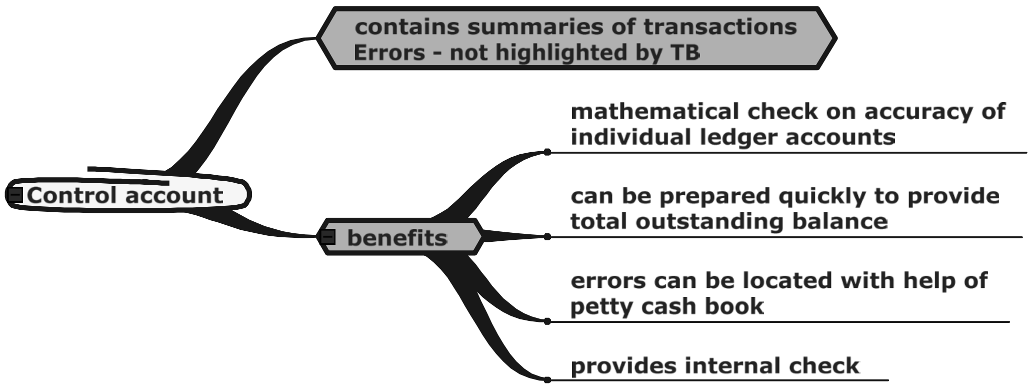
Summary of payables control account

Gemini Ltd

Dr **Payables ledger control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Cash paid to suppliers	160,000		Balance b/d	80,000
	Purchases returns	9,000		Credit purchases	180,000
	Discount received	5,000		Interest charged on overdue balance	6,000
	Contra against receivables	16,000			
	Balance c/d	76,000			
	Total	**266,000**		**Total**	**266,000**

SUMMARY



Test Yourself 21

From the following date, calculate the closing balances on the receivables and payables control accounts for Gamma Ltd.

	Customer Tshs'000	Supplier Tshs'000
Balance b/d		
Alpha Ltd	5,000	
Beta Ltd	10,000	
Chris Trades		6,000
BBG Inc.		4,000
Sales during the year		
Alpha Ltd	15,000	
Beta Ltd	12,000	
Alpha Ltd	6,000	
Purchases during the year		
Chris Trades		5,000
BBG Inc.		12,000
BBG Inc.		1,200
Cash discount		
BBG Inc.		600
Alpha Ltd	1,000	
Payments & receipts		
Chris Trades		6,000
BBG Inc		12,000
Alpha Ltd	15,000	

4.6 Prepare a reconciliation between the list of balances and the corrected ledger balance

How to reconcile?

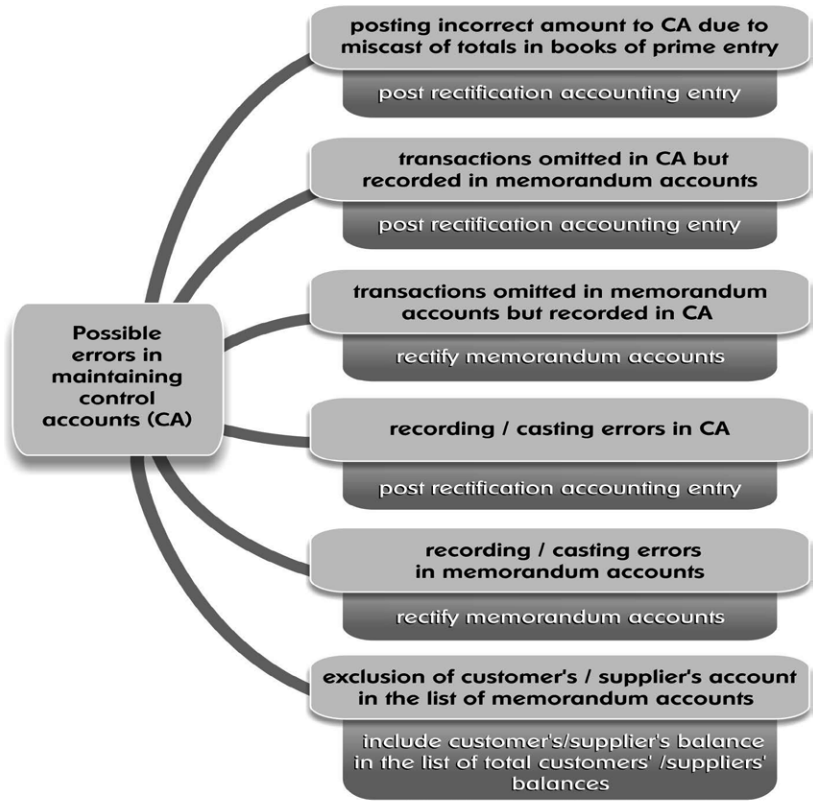
Stage 1: The first stage is to locate any errors / omissions in the preparation of the receivables / payables ledger account and control accounts.

The total of the list of balances on the receivables / payables ledger account should match with the balance on the receivables / payables control account. However, if the total of the list of balances on the receivables / payables ledger account the balance on the receivables / payables control account, it means that there is some error in the customers' / suppliers' personal accounts (receivables / payables ledger account).

We have already studied that different types of errors can be committed when recording or posting transactions in the books of accounts. Refer back Study Guide C1 to refresh your memory.

The following errors can be identified by performing a reconciliation between receivables / payables ledger accounts and control accounts:

Diagram 3: Types of errors made



It is impossible to give a full and complete list of every error that a person can make when posting entries to the control account and recording items in the receivables / payables ledger. Put simply, a person can record the wrong amount, fail to record a transaction, incorrectly enter a debit as a credit or simply just take wrong totals.

However, it is important to remember that if an item is incorrectly entered in the wrong receivables / payables ledger account (i.e. an error of commission), but the value is correct; no error will be identified in the general ledger account reconciliation. Remember, a reconciled general ledger account does not guarantee that there are no errors, but it does reduce the number and type of errors that may be embedded within the financial statements.

Stage 2: the next stage is to rectify the errors / omissions located in stage 1

When the error is made, it is required to be rectified. The error can be rectified making correct journal entries. The following example will help to understand how the error can be rectified.

Example

Fred & Ginger Dance Shoes Inc have a select clientele and only sell to professional dance companies. In January 20X8 they made the following sales on credit:

Sales day book

	Customer name	Invoice number	Tshs'000
	Twinkle Toes	21	5,000
	Tap & Rap	22	10,000
	Boogey Days	23	7,500
	Twinkle Toes	24	2,500
		Total	**25,000**

At the beginning of the month they had no amounts receivable. During the month, Twinkle Toes paid Tshs5,000,000 and Tap & Rap paid Tshs2,000,000.

The accountant who wrote the receivables ledger recorded Tshs5,000,000 received from Twinkle Toes as Tshs2,500,000. However the accountant who wrote the cash book recorded it correctly.

Continued on the next page

Fred & Ginger Dance Shoes Inc

Dr **Receivables control account** **Cr**

Date		Tshs'000	Date		Tshs'00
	Balance b/d	Nil		Cash (collected from customers)	7,000
	Credit sales (Jan)	25,000		Balance c/f	18,000
	Total	**25,000**		**Total**	**25,000**

Dr **Twinkle Toes account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Invoice-21	5,000		Cash received	2,500
	Invoice-24	2,500			
				Balance c/f	5,000
	Total	**7,500**		**Total**	**7,500**

Dr **Tap & Rap account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Invoice-22	10,000		Cash received	2,000
				Balance c/f	8,000
	Total	**10,000**		**Total**	**10,000**

Dr **Boogey Days account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Invoice-23	7,500			
				Balance c/f	7,500
	Total	**7,500**		**Total**	**7,500**

Balance according to receivables control account		Dr Tshs18,000,000	
Balance according to receivables ledgers:			
Twinkle Toes	Tshs5,000,000		
Tap & Rap	Tshs8,000,000		not-reconciled
Boogey Days	Tshs7,500,000	Dr Tshs20,500,000	

Rectification of the error

When an error is made, it must be rectified. The method required, will depend on the type of error made. Not all errors will require a journal entry. In the above error, **Twinkle Toes' receivables ledger account has to be corrected.**

Normally, we make the following journal entry to rectify such type of errors:

Dr Cash account Tshs2,500,000
Cr Twinkle Toes account Tshs2,500,000

However, the cash amount of Tshs5,000,000 received by Twinkle Toes was correctly recorded in the cash book and wrongly recorded in Twinkle Toes' receivables ledger account. This means that it does not form part of the double entry of the accounts. Therefore, no journal entry is required. **Twinkle Toes account** will appear as follows:

Dr **Twinkle Toes account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Invoice-21	5,000		Cash received	5,000
	Invoice-24	2,500			
				Balance c/f	2,500
	Total	**7,500**		**Total**	**7,500**

Reconciliation

Balance according to receivables control account		Dr Tshs18,000,000	
Balance according to receivables ledger:			**reconciled**
Twinkle Toes	Tshs2,500,000		
Tap & Rap	Tshs8,000,000		
Boogey Days	Tshs7,500,000	Dr Tshs18,000,000	

Test Yourself 22

The following control account is prepared by a trainee accountant:

Dr **Payables control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	25,000			
	Cash-purchases	21,500		Cash paid	60,000
	Credit-purchases	50,000			
				Balance c/f	36,500
	Total	**96,500**		**Total**	**96,500**

(i) Prepare the correct payables control account.
(ii) What should be the correct closing balance in the account?

A Tshs16,500,000
B Tshs35,000,000
C Tshs15,000,000
D Tshs25,000,000

Test Yourself 23

The following control account was prepared by the sales ledger clerk:

Dr **Receivables control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	25,000			
	Cash-sales	18,500		Cash received	60,000
	Credit-sales	50,000		Cash-discount	900
				Bad debts	600
				Balance c/f	32,000
	Total	**93,500**		**Total**	**93,500**

(i) Prepare the correct receivables control account.
(ii) What should be the correct closing balance in the account?

A Tshs13,500,000
B Tshs12,000,000
C Tshs33,500,000
D Tshs32,900,000

Stage 3: if all the errors / omissions in the receivables / payables ledger accounts and control accounts are rectified correctly then the total of the list of balances on the receivables / payables ledger accounts **must agree** with the control account balance.

Example

Continuing the previous example of Fred & Ginger Dance Shoes Inc

Prepare a reconciliation of the total of the list of balances on the receivables ledger accounts to the receivables control account balance.

Reconciliation

	Tshs'000
Total of list of balances on the receivables ledger	20,500
Less: Amount of payment recorded in the Twinkle Toes account	2,500
Balance of receivables control account	**18,000**

Once errors are rectified then the total of list of balances on the receivables ledger accounts and balance on the control account agree.

5. State the effects of errors in financial statements.

[Learning Outcome e]

The impact of the errors can either be on the statement of profit or loss or the statement of financial position or on both.

Let's look at an illustration to see how a few of the most common errors can affect the statement of profit or loss and the statement of financial position.

Example

Given below is the draft trial balance of ICC Ltd.

	Debit Tshs'000	Credit Tshs'000
Purchases Directors'	600,000	
fees Distribution	40,000	
expense Car	50,000	
Stationery	50,000	
Plant and machinery	20,000	
Receivables	300,000	
John		
Jerry	10,000	
Kerry	5,000	
Angle	6,000	
Others	7,000	
Cash	80,000	
Sales	35,000	
Share capital		1,000,000
Payables		175,000
Xiang		
Others		8,000
Total		20,000
	1,203,000	**1,203,000**

The following errors were discovered:

1. Error of omission to record: sales to John for Tshs1.2 million were omitted from the sales day book.
2. Error of commission: sales to Jerry for Tshs1.2 million were recorded in the sales day book but debited to Kerry's account and not Jerry's account.
3. Error of principle: purchase of a car for Tshs10 million was recorded as a distribution expense.
4. Compensating error: goods sold to Angle for Tshs1 million were recorded in the sales day book correctly but not recorded in Angle's-receivables account. At the same time goods purchased from Xiang for Tshs1 million were recorded in the purchase day book but not recorded in Xiang's-payables account.
5. Errors of original entry: a sales invoice (cash) of Tshs1.4 million was recorded as Tshs1.6 million and carried to the ledger accounts with the same amount of Tshs1.6 million.
6. Complete reversal of entry: directors' fees paid were credited to directors' fees account and debited to cash Tshs5 million.
7. Transposition error: a stationery bill for Tshs5.1 million is recorded as Tshs1.5 million in the cash book.

Show the journal entries for correction of errors, and also show statement of profit or loss and statement of financial position after correction of errors.

Continued on the next page

Answer

Correction entries

1. Dr John-receivables A/c Tshs1.2 million
   Cr Sales A/c Tshs1.2 million
   Being goods sold to John which were not recorded in the books of accounts, now recorded

2. Dr Jerry-receivables A/c Tshs1.2 million
   Cr Kerry-receivables A/c Tshs1.2 million
   Being sale of goods to Jerry, wrongly debited to Kerry's account now rectified.

3. Dr Car account Tshs10 million
   Cr Distribution expenses account Tshs10 million
   Being purchase of car (a non-current asset), wrongly debited to distribution expense, now rectified.

4. Dr Angle's receivables account Tshs1 million
   Cr Xiang-payables account Tshs1 million
   Being goods sold to Angle, recorded in sales day book but not recorded in Angle's ledger, now recorded. Similarly purchases from Xiang, recorded in purchase day book but not in Xiang's ledger account, now credited

5. Dr Sales A/c Tshs0.2 million
   Cr Cash A/c Tshs0.2 million
   Being sale of Tshs1.4 million, recorded as Tshs1.6 million now rectified

6. Dr Directors fees A/c Tshs10 million
   Cr Cash A/c Tshs10 million
   Being directors' fees paid, recorded in reverse. Now rectified the error by passing an entry for an amount double the previously recorded amount

7. Dr Stationery expenses A/c Tshs3.6 million
   Cr Cash A/c Tshs3.6 million
   Being expense of stationery Tshs5.1 million which was recorded at Tshs1.5 million now rectified

Correction of incomes and expenses ledger accounts						
Errors	**Sales Tshs'000**	**Purchases Tshs'000**	**Distribution expenses Tshs'000**	**Directors fees Tshs'000**	**Stationery Tshs'000**	**Increase \ (decrease) in profit**
Balances before errors	1,000,000	600,000	50,000	40,000	20,000	290,000
Error of omission (Note1)	1,200					1,200
Error of commission (Note2)						0
Error of principle (Note3)			(10,000)			10,000
Compensating error (Note4)						0
Error in original entry (Note 5)	(200)					(200)
Complete reversal of entry (Note6)				10,000		(10,000)
Transposition error (Note7)					3,600	(3,600)
Balances after errors adjusted for	**1,001,000**	**600,000**	**40,000**	**50,000**	**23,600**	**287,400**

Notes (1), (2) etc. are the references for the correction entries.

You can see that some errors affect the statement of profit or loss while others affect the statement of financial position.

Correction of assets and liabilities ledger accounts

Errors	John-receivables Tshs'000	Jerry –receivables Tshs'000	Kerry-receivables Tshs'000	Angle-receivables Tshs'000	Car Tshs'000	Cash in hand Tshs'000	Xiang-payables Tshs'000
Balances for errors	10,000	5,000	6,000	7,000	50,000	35,000	8,000
Error of omission (Note1)	1,200						
Error of commission (Note2)		1,200	(1,200)				
Error of principle (Note3)					10,000		
Compensating error (Note4)				1,000			1,000
Error in original entry (Note5)						(200)	
Complete reversal of entry (Note5)						(10,000)	
Transposition error (Note6)						(3,600)	
Balances after errors adjusted for	**11,200**	**6,200**	**4,800**	**8,000**	**60,000**	**21,200**	**9,000**

ICC Ltd
Statement of profit or loss for the year ended 31 December 20X3

Before correction	
	Tshs'000
Sales	1,000,000
Purchases	(600,000)
Gross profit	400,000
Less: Expenses	
Distribution expenses	(50,000)
Directors' fees paid	(40,000)
Stationery expenses	(20,000)
Profit	**290,000**

After correction	
	Tshs'000
Sales	1,001,000
Purchases	(600,000)
Gross profit	401,000
Less: Expenses	
Distribution expenses	(40,000)
Directors' fees paid	(50,000)
Stationery expenses	(23,600)
Profit	**287,400**

You can see the impact of errors on the profitability. The effect of errors on profits can be summarised as follows:

Continued on the next page

	Tshs'000
Incorrect profit	290,000
Add: adjustments which lead to an increase in the profit	
Error of omission: goods sold to John	1,200
Complete reversal of entry: director's fees	10,000
	301,200
Less: adjustments which lead to a decrease in the profit	
Error of principle**:** purchase of car wrongly debited to distribution expense	(10,000)
Error in original entry: Sales of Tshs1,400 recorded as Tshs1,600	(200)
Transposition error: stationary	(3,600)
Correct profit	**287,400**

On similar lines the statement of financial position will also be affected by errors.

Statement of financial position as at 31 December 20X3

Before correction			After correction		
Assets	**Tshs'000**	**Tshs'000**	**Assets**	**Tshs'000**	**Tshs'000**
Car		50,000	Car		60,000
Plant and machinery		300,000	Plant and machinery		300,000
Receivables			Receivables		
John	10,000		John	11,200	
Jerry	5,000		Jerry	6,200	
Kerry	6,000		Kerry	4,800	
Angle	7,000		Angle	8,000	
Others	80,000	108,000	Others	80,000	110,200
Cash in hand		35,000	Cash in hand		21,200
Total		**493,000**	**Total**		**491,400**
Capital and liability			**Capital and liability**		
Share capital	175,000		Share capital	175,000	
Net profit	290,000	465,000	Net profit	287,400	462,400
Payables			Payables		
Xiang	8,000		Xiang	9,000	
others	20,000	28,000	others	20,000	29,000
Total		**493,000**	**Total**		**491,400**

5.1 Error affecting statement of profit or loss and statement of financial position

There are some errors that affect both the statement of profit or loss and the statement of financial position at the same time.

Example

Enterprise Co purchased equipment for Tshs100 million. However the accountant recorded the amount in the equipment expenses account. Enterprise Co charges 5% depreciation every year.

The above error affects both the statement of profit or loss and the statement of financial position. The financial statements before rectifying the error of Enterprise Co will be as follows:

Equipment Co

Statement of profit or loss	
	Tshs'000
Sales	1,000,000
Purchases	(600,000)
Gross profit	400,000
Equipment expenses	(100,000)
Profit	**300,000**

Statement of financial position	
	Tshs'000
Equipment	-
Other assets	500,000
Total	**500,000**
Capital	200,000
Net profit	300,000
Total	**500,000**

Correction of the above error is made as follows:

1. We need to rectify the error by crediting the equipment expenses account and debiting the equipment account.

Dr	Equipment account	Tshs100 million	
Cr	Equipment expenses account		Tshs100 million

Being purchase of equipment incorrectly recorded as equipment expense, now rectified.

2. Equipment is a non-current asset and should be depreciated as follows:

Dr	Depreciation account	Tshs5 million	
Cr	Equipment account		Tshs5 million

Being depreciation provided on equipment

After rectifying the above errors, the financial statements would be as follows:

Equipment Co

Statement of profit or loss	
	Tshs'000
Sales	1,000,000
Purchases	(600,000)
Gross profit	400,000
Equipment expenses	-
Depreciation	**(5,000)**
Profit	395,000

Statement of financial position		
	Tshs'000	**Tshs'000**
Equipment	**100,000**	
Less: depreciation	(5,000)	95,000
Other assets		500,000
Total		**595,000**
Capital		200,000
Net profit		395,000
Total		**595,000**

5.2 Decrease in errors due to computerisation

It is common practice today to use computers to perform much of the work that was once carried out manually by accounts staff. The introduction of computers in accounting has cut down a lot of the duplication of work, reduced casting errors and posting errors (as one-sided entries cannot be processed). However, many of the other types of errors (e.g. errors of principle) are still possible as wrong information can be input into the computer. It should be ensured that safeguards against these errors must be adopted.

Test Yourself 24

Jack sold goods to Sam for Tshs100 million. Sam's account was correctly posted but the sales account was wrongly credited with Tshs90 million. **This error will have an impact on:**

A Statement of financial position
B Statement of profit or loss
C Sales account
D None of the above

Test Yourself 25

Jack sold goods to Sam for Tshs100 million. The sales account was correctly posted, but Sam's account was incorrectly debited with Tshs90 million. **This error will have an impact on:**

A Statement of financial position
B Statement of profit or loss
C Sam's account
D None of the above

Answer to Test Yourself

Answer to TY 1

Yes, there is a casting error. Sam's account has been undercast (added less) by Tshs5 million.

Answer to TY 2

The correct option is **A**.

The purchase account has a debit balance. If the debit total is overcast by Tshs1 million, it means that the balance (which is a debit balance) will also show an excess amount of Tshs1 million. Hence the correct balance of the purchase account is Tshs49 million (Tshs50 million - Tshs1 million) debit.

Wrong total

Purchases account (before correction)

Dr | | | Cr

	Tshs'000		Tshs'000
		Balance c/f	50,000
Total	**X**	**Total**	**X**

Tshs50 million - Tshs1 million

Purchases account (after correction)

Dr | | | Cr

	Tshs'000		Tshs'000
		Balance c/f	49,000
Total	**X - 1,000**	**Total**	**X - 1,000**

The correct option is **A**.

The cash account has a debit balance. When credit of Tshs2 million is wrongly recorded, it means the cash account balance is wrongly reduced by Tsh2 million. In order to rectify this error, we have to increase the cash balance by Tshs2 million. Hence, the correct balance of the cash account is Tshs32 million.

Credit overcast by Tshs2 million

Cash book (before correction)

Dr	Tshs'000		Tshs'000 Cr
		Balance c/f	X 30,000
Total	**X**	**Total**	**X**

Credit reduced by Tshs2 million. Therefore, balance is Tshs30 million + Tshs2 million

Cash book (after correction)

Dr	Tshs'000		Tshs'000 Cr
		Balance c/f	32,000
Total	**X**	**Total**	**X**

Answer to TY 4

The correct option is **C**.

The cash book has a debit balance. When credit is recorded as Tshs2 million less than the actual amount, it means the cash book balance is wrongly increased by Tshs2 million. So, the correct balance is Tshs28 million debit.

Credit less by Tshs2 million

Cash book (before correction)

Dr	Tshs'000		Tshs'000 Cr
		Balance c/f	X 30,000
Total	**X**	**Total**	**X**

As credit increased by Tshs2 million, balance is Tshs30 million - Tshs2 million

Cash book (after correction)

Dr	Tshs'000		Tshs'000 Cr
		Balance c/f	28,000
Total	**X**	**Total**	**X**

Answer to TY 5

The correct option is **C**.

(The audit fees (an expense) account has a debit balance. It has been undercast by Tshs0.5 million. So, to arrive at the correct balance, we have to add Tshs0.5 million to Tshs5 million).

Debit less by 0.5 million

Audit fees account (extract) (before correction)

Dr	Tshs'000		Tshs'000 Cr
		Balance c/f	5,000
Total	**X**	**Total**	**X**

As the debit increased by Tshs0.5 million, the correct balance is Tshs5 million + Tshs0.5 million

Audit fees account (extract) (after correction)

Dr	Tshs'000		Tshs'000 Cr
		Balance c/f	5,500
Total		**Total**	

Answer to TY 6

Yes, there is an error of transposition because while posting the figures to the purchase account, they were reversed, i.e. Tshs5.2 million was wrongly posted as Tshs2.5 million.

Answer to TY 7

Error of omission

Interest charged by the bank not recorded.
Payment to supplier not recorded.
Purchases of goods not recorded.

Error of commission

Payment to Sam recorded in Suzy's account.
Purchases from Mack recorded in Jack's account.
Receipt from Michael recorded in Jackson's account.

Error of principle

Purchase of non-current asset recorded as expense.
Receipt of loan accounted as receipt of income.
Revenue expenditure recorded as capital expenditure.

Compensating error

Cash book debit side undercast by Tshs0.1 million and purchases account credit side undercast by Tshs0.1 million.
Cash book debit side undercast by Tshs0.1 million and purchases account debit side overcast by Tshs0.1 million.
Sale of Tshs0.2 million to Mack not recorded, and the payment collected from him of Tshs0.2 million also not recorded.

Error of original entry

Payment of Tshs0.9 million recorded as Tshs0.7 million in the cash book.
Receipt of Tshs1 million recorded as Tshs1.2 million in the cash book.
Sale of Tshs0.5 million recorded as sale of Tshs0.4 million in the sales day book

Complete reversal of entry

Wages paid of Tshs0.2 million recorded on the receipt side of the cash book and posted to the credit side of the wages account.
Depreciation on machinery debited to accumulated depreciation account, and credited to machinery account.
Purchase return to supplier recorded in the sales return day book.

Answer to TY 8

Wrong entry recorded by accountant	**Correct entry that should have been recorded**	**Correction entry to correct the error**
Dr Cash Tshs15 million Cr Share capital Tshs15 million Being equity shares issued.	Dr Cash Tshs15 million Cr Share capital Tshs10 million Cr Share premium Tshs5 million Being equity shares issued with premium	Dr Share capital Tshs5 million Cr Share premium Tshs5 million Being no effect given to share premium account, now corrected.

Answer to TY 9

Wrong entry recorded by accountant	Correct entry that should have been recorded	Correction entry to correct the error
Dr Office Expense Tshs5 million Cr Cash Tshs5 million Being office expenses paid.	Dr Stationery Expense Tshs5 million Cr Cash Tshs5 million Being stationary expenses paid.	Dr Stationery Expense Tshs5 million Cr Office Expense Tshs5 million Being stationary expenses wrongly debited to office expenses, now rectified.

Answer to TY 10

The accounting entry posted by the accountant is correct; the bad debt account is to be debited and the customer's account is to be credited.

Answer to TY 11

The correct option is **B**.

The accounting treatment will be different when an item is posted in a different class of account. So, it is an error of principle.

Answer to TY 12

The correct option is **A**.

The accounting entry should have been:

Dr	Receivables account	Tshs7.5 million	
Cr	Sales account		Tshs7.5 million

Only the debit posting has been made. The credit entry has been omitted. Hence, when preparing the trial balance, a credit balance will have to be created in the suspense account to ensure debit = credit. Suspense account = Tshs7.5 million Credit.

Answer to TY 13

The correct option is **C**.

Purchases are a debit balance within the trial balance (Expense). Hence the debit side of the trial balance is overstated by (Tshs8.5 million - Tshs5.8 million) = Tshs2.7 million. Suspense account = Tshs2.7 million Credit.

Answer to TY 14

The correct option is **A**.

The accounting entry for discount allowed should have been:

Dr	Discount allowed	Tshs1.6 million	
Cr	Customers control account		Tshs1.6 million

However the debit posting was made for Tshs6.1 million, which creates Tshs4.5 million more on the debit side. The suspense account will have **Tshs4.5 million C**redit.

The accounting entry for discount received should have been:

Dr	Suppliers control account	Tshs5.4 million	
Cr	Discount received		Tshs5.4 million

However, the credit posting was made for Tshs4.5 million; this creates Tshs0.9 million less on the credit side. The suspense account will have **Tshs0.9 million D**ebit.

Dr Suspense account Cr

	Tshs'000		**Tshs'000**
Discount received	900	Discount allowed	4,500
Balance c/f (credit balance)	**3,600**		
Total	**4,500**	**Total**	**4,500**

Answer to TY 15

The correct option is **D**.

A This is an **error of omission** and needs to be recorded for the first time. This does not create a difference on the trial balance.
B This is an **error of principle**. This does not create a difference in the trial balance.
C The accounting **entry is reversed**. However debit = credit in the entry. This does not create a difference in the trial balance.
D This error makes the debit > credit hence a suspense account is required.

Answer to TY 16

The correct option is **B**.

	Accounting entry	**Effect on suspense account**		
		Debit Tshs	**Credit Tshs**	**Balance Tshs**
i. Mistake in the original entry (**Transposition error**)	Dr Cash Tshs5.1 million Cr Sales Tshs5.1 million			-
ii. Error in posting to purchases account	Dr Purchases Tshs1.9 million Cr Cash Tshs9.1 million	7.2 million		7.2 million Dr
iii. Undercasting of plant account Undercasting of accrued expense **(Compensating errors)**	(-) asset (debit) by Tshs0.5 million (-) liability (credit) by Tshs0.5 million			-
iv. Overcasting of vehicle Overcasting of goodwill	(+) asset (debit) by Tshs1 million (+) asset (debit) by Tshs1 million		2 million	5.2 million Cr

Dr Suspense account Cr

	Tshs'000		**Tshs'000**
Purchases account	7,200	Overcasting of vehicle account	1,000
		Overcasting of goodwill account	1,000
		Balance c/f	5,200
Total	**7,200**	**Total**	**7,200**

Answer to TY 17

The correct option is **A**.

	Accounting entry	Effect on suspense account		
		Debit Tshs'000	**Credit Tshs'000**	**Balance Tshs'000**
1. Omission of carriage inward from trial balance		6,000		6,000 Dr
2. Omission of other income from trial balance			9,000	3,000 Cr
3. Wrong posting to supplier's account	Cr Discount received - Tshs5.5 million Cr Suppliers account - Tshs5.5 million	11,000		8,000 Dr
4. Error of commission	Dr Cash Tshs7 million - Cr Bill's - Tshs7 million			8,000 Dr

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

Date		Tshs'000	Date		Tshs'000
	Omission of carriage inward account from trial balance	6,000		Omission of other income from trial balance	9,000
	Posting to the wrong side in suppliers account	11,000			
				Balance c/d	**8,000**
	Total	**17,000**		**Total**	**17,000**

Answer to TY 18

The correct option is **A**.

Cash has a debit balance. When the credit side is undercast, it makes the closing balance of cash more than the actual. Therefore we need to credit the cash in the rectification entry.

Answer to TY 19

The correct option is **B**.

Cash has a debit balance. When the credit side is overcast, it makes the closing balance of cash less than the actual. Therefore we need to increase the cash balance by debiting cash.

Answer to TY 20

The correct option is **B**.

The first error is an error of principle and transposition, which requires a suspense account.
The second is an error of posting, which requires a suspense account.
The third is an error of omission, which does not require a suspense account.

Answer to TY 21

Dr **Receivables control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d (5 million + 10 million)	15,000			
	Sales (15 million+12 million +6million)	33,000		Discount	1,000
				Cash	15,000
				Balance c/d	32,000
	Total	**48,000**		**Total**	**48,000**

Dr **Payables control account** Cr

Date		Tshs'000	Date		Tshs'000
				Balance b/d (6 million+4 million)	10,000
	Discount	600		Purchases (5 million+12 million+1.2 million)	18,200
	Cash (12 million+6 million)	18,000			
	Balance c/d	9,600			
	Total	**28,200**		**Total**	**28,200**

Answer to TY 22

(i)

Dr **Payables control account** Cr

Date		Tshs'000	Date		Tshs'000
				Balance b/d	25,000
				Credit-purchases	50,000
	Cash paid	60,000			
	Balance c/f	15,000			
	Total	**75,000**		**Total**	**75,000**

Remember cash purchases will not be recorded in payables account.

(ii) The correct option is **C**.

The corrected closing balance of payables control account is Tshs15,000,000.

Answer to TY 23

(i)

Dr **Receivables control account** Cr

Date		Tshs'000	Date		Tshs'000
	Balance b/d	25,000			
	Credit-sales	50,000		Cash received	60,000
				Cash-discount	900
				Bad debts	600
				Balance c/f	13,500
	Total	**75,000**		**Total**	**75,000**

(ii) The correct option is **A**.

The corrected closing balance of receivables control account is Tshs13,500,000.

Answer to TY 24

The correct option is **B**.

The sales account is recorded in the statement of profit or loss and retained earnings from the statement of profit or loss are carried over to the statement of financial position.

Answer to TY 25

The correct option is **A.**

As Sam- the receivable account is recorded in the statement of financial position.

Self Examination Questions

Question 1

Prepare the correct ledger accounts for BBG Inc, after rectifying the following errors:

BBG Inc omitted to record a cash collection from Tony of Tshs5 million.
BBG Inc purchased machinery but recorded it as machinery expenses of Tshs6 million.
BBG Inc sold goods for Tshs0.2 million to customer A, but omitted to record it. It also collected the cash for this sale but omitted to record it.
BBG Inc paid wages of Tshs0.9 million but recorded Tshs0.7 million in the cash book. Tshs0.7 million was posted to the wages account.
BBG Inc received Tshs1 million from a customer but recorded it as Tshs1.5 million in the cash book.

Question 2

A company's profit was Tshs60 million. However it was found that Tshs16 million paid for a motor van was debited to the motor expenses account. The useful life of the motor van was 3 years with Tshs1 million as the residual value.

What will be the correct profit after rectifying the error?

A Tshs60 million
B Tshs11 million
C Tshs55 million
D Tshs71 million

Question 3

A company posted Tshs20 million capital expenditure as revenue expenditure and Tshs5 million revenue expenditure as capital expenditure. **Hence the profits were:**

A Overstated by Tshs5 million
B Understated by Tshs20 million
C Overstated by Tshs15 million
D Understated by Tshs15 million

Question 4

Calculate the correct closing balance in the following control account:

Dr **Receivables ledger control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	25,000			
	Credit-sales	50,000		Cash received	55,000
				Sales returns	5,000
				Interest on overdue balance	6,000
				Bad debts	1,000
				Allowance for bad debts	800
				Balance c/d	7,200
	Total	**75,000**		**Total**	**75,000**

A Tshs8.0 million
B Tshs13.2 million
C Tshs15.0 million
D Tshs20.0 million

Question 5

Calculate the correct closing balance of the following account:

Dr **Receivables ledger control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	25,000			
	Credit-sales	50,000		Cash received	60,000
	Interest on overdue balance	6,000		Allowance for bad debts	800
	Contras against payables	6,000			
				Balance c/d	26,200
	Total	**87,000**		**Total**	**87,000**

A Tshs15.0 million
B Tshs27.0 million
C Tshs20.2 million
D Tshs14.2 million

Question 6

Calculate the correct closing balance of the following account:

Dr **Payables ledger control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Opening balance	25,000			
	Credit-purchases	50,000		Cash paid	60,000
	Interest on overdue balance	6,000		Discount	800
	Contras against receivables	6,000			
	Cash purchases	6,000			
	Purchases returns	6,000			
				Balance c/d	38,200
	Total	**99,000**		**Total**	**99,000**

A Tshs38.2 million
B Tshs28.2 million
C Tshs8.2 million
D Tshs14.2 million

Question 7

An inexperienced bookkeeper has drawn up the following receivables ledger control account:

Dr **Receivables ledger Control Account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Opening balance	180,000		Credit sales	190,000
	Cash from credit customers	228,000		Bad debts written off	1,500
	Sales returns	8,000		Contras against payables	2,400
	Cash refunds to credit customers	3,300		Closing balance (balancing figure)	229,600
	Discount allowed	4,200			
	Total	**423,500**		**Total**	**423,500**

What is the closing balance after rectification of errors?

A Tshs130.6 million
B Tshs129.2 million
C Tshs142.4 million
D Tshs214.6 million

Question 8

Michael's payables control ledger account does not match with the total of the payables ledger. The following errors were located.

(i) The payables column of the cash received day book has been overcast by Tshs0.6 million.
(ii) A contra of Tshs0.4 million against the sales ledger has only been entered in the control account.
(iii) A purchase invoice has been entered twice into the purchase day book.

Which of the above errors would cause a difference between the payables control account and the total of the payables ledger?

A (i) and (iii)
B Only (ii)
C All of the above.
D None of the above.

Question 9

Tshs8 million paid for building maintenance has been correctly entered in the cash book but debited to the building asset account.

What is the correct entry to rectify this error?

A	Dr		Depreciation account	Tshs8 million	
		Cr	Building asset account		Tshs8 million
B	Dr		Building maintenance	Tshs8 million	
		Cr	Building asset account		Tshs8 million
C	Dr		Building maintenance	Tshs16 million	
		Cr	Building asset account		Tshs16 million
D	Dr		Building asset account	Tshs8 million	
		Cr	Building maintenance		Tshs8 million

Question 10

Discount allowed Tshs9 million has been debited to the discount allowed account, but credited to the customer's account.

What is the correct entry to rectify this error?

A	Dr		Discount allowed A/c	Tshs9 million	
		Cr	Suspense A/c		Tshs9 million
B	Dr		Customers A/c	Tshs9 million	
		Cr	Discount allowed A/c		Tshs9 million
C	Dr		Suspense A/c	Tshs18 million	
		Cr	Discount allowed A/c		Tshs18 million
D	No entry required				

Question 11

Discount allowed Tshs7 million has been debited to the discount received account.

What is the correct entry to rectify this error?

A	Dr		Discount allowed A/c	Tshs14 million	
		Cr	Discount received A/c		Tshs14 million
B	Dr		Suspense account A/c	Tshs7 million	
		Cr	Discount allowed A/c		Tshs7 million
C	Dr		Discount allowed A/c	Tshs7 million	
		Cr	Discount received A/c		Tshs7 million
D	No entry required				

Question 12
The cash balance of Tshs1.7 million has been omitted from the trial balance.

The correct entry to rectify this error is:

A	Dr		Cash A/c	Tshs1.7 million	
		Cr	Suspense A/c		Tshs1.7 million
B	Dr		Suspense A/c	Tshs1.7 million	
		Cr	Cash A/c		Tshs1.7 million
C	Dr		Cash A/c	Tshs3.4 million	
		Cr	Discount received A/c		Tshs3.4 million
D	No entry required				

Question 13

Interest received of Tshs34 million was posted to the interest received account as Tshs43 million. There was no error in the cash posting. **What is the correct entry to rectify this error?**

A	Dr		Cash A/c	Tshs9 million	
		Cr	Interest received A/c		Tshs9 million
B	Dr		Suspense A/c	Tshs9 million	
		Cr	Interest received A/c		Tshs9 million
C	Dr		Interest received A/c	Tshs9 million	
		Cr	Suspense A/c		Tshs9 million
D	No entry required				

Question 14

(a) Differentiate between 'error of omission' and 'error of commission.'

(b) The trial balance of Hakika Enterprises failed to agree by TZS.750,000 as the credit side exceeded the debit side. The statement of profit or loss prepared thereafter showed a profit of TZS.5,160,000. On critical examination of the causes of the difference, the following errors were detected:

1. Sales to J. Bani of TZS.2,000,000 was omitted from the sales day book.

2. Sale to B. Kamua of TZS.1,200,000 was recorded in the sales journal but was debited to C. Kam account.

3. Rent paid of TZS.520,000 was recorded in the cash book but was not posted to rent account in the general ledger.

4. Discount received of TZS.120,000 was debited in discount allowed account.

5. Motor vehicles expenses of TZS.250,000 were debited in motor vehicles account.

6. Fees paid to directors of TZS.3,000,000 were credited in both the directors' fees account and cash account.

REQUIRED:

(i) Show the journal entries to correct the above errors.
(ii) Prepare a statement to show correction of the profit figure.

Question 15

Mr. Bonge extracted a Trial Balance at 31st December 2015 and found that it did not balance. He posted the difference to a Suspense Account. Later he found the following errors which accounted for the difference:

(1) The total of TZS.365,000 for Discount Allowed for the month of July 2015 had been posted to the credit side of Discount Received Account.

(2) A payment of TZS.210,000 to Mr. Bonge from a debtor Mr. Tweve had been posted to the credit of Mr. Tete in error.

(3) Mr. Bonge had paid TZS.2,640,000 wages and supplied materials costing TZS.960,000 to his own employees in building a store at the rear of his residence house. No adjustment had been made.

(4) A payment of TZS.56,000 for postage had been posted to that account as TZS.65,000.

(5) Mr. Bonge bought new fittings for his factory costing TZS.1,800,000 but this transaction had been posted to the Purchases Account.

(6) A payment of TZS.96,000 for an electricity bill had been entered in the Cash Book but the double entry had not been made.

REQUIRED:

i. Prepare the journal entries necessary to correct the errors.

ii. Prepare the Suspense Account showing the original difference in the Trial Balance.

Question 16

Mr. Amani has been working as a retail trader and his wife was the one who keeps the books of account. Of recent, they decided to hire an accountant. The Financial Statement for the period ended 31st December 2016 and the books of account were handed over to this new accountant. The profit or loss account showed a net profit of TZS.15,667,000.

On reviewing the books and the Statement of Profit or Loss, the accountant discovered the following:

(i) Drawings of TZS.2,200,000 were included as miscellaneous expenses

(ii) Rent expenses included rate for the half year ending 31st May 2017 of TZS.750,000

(iii) Motor van expenses do not include a repair carried out in December 2016 but not yet invoiced. It is expected to cost TZS.258,000

(iv) Stationery purchases of TZS.780,000 were expensed but did not take into consideration stationery stocks at 31st December 2015 of TZS.105,000 and at 31st December 2016 of TZS.143,000

(v) Debtors amounted to TZS.3,450,000 but 10% of them seems to be uncollectible.
No provision was made in the books.

(vi) Discounts allowed and received amounted to TZS.350,000 and TZS.650,000 respectively. No entry was made in the books.

REQUIRED:

(a) Prepare journal entries necessary to correct the above errors.

(b) Prepare a statement that adjust the net profit figure to reflect the correct amount.

Question 17

George's trial balance as at 30th September 2014 is as shown below:

	Dr.	Cr.
	Tshs '000'	Tshs '000'
Capital at 1st October 2013		60,434
Inventory at 1st October 2013	25,120	
Receivables	25,760	
Payables and accruals		13,122
Bank	7,508	
Cash	2,000	
Sales		181,120
Returns inward	750	
Purchases	145,348	
Carriage inwards	1,948	
Wages	9,368	
Rent	6,400	
Postage expenses	764	
Travel and accommodation	1,498	
Telephone	1,706	
General expenses	1,506	
Drawings	25,000	
	254,676	254,676

Additional information:

- The value of George's inventory as at 30th September 2014 was Tshs.23,750,000.
- George has discovered the following errors in the postings:
  - (i) An invoice for carriage inwards was posted to the returns inwards account. The invoice was for Tshs.528,000.
  - (ii) A credit invoice for Tshs.1,120,000 was posted as Tshs.1,300,000.
  - (iii) A cash purchase of Tshs.100,000 was not recorded.

REQUIRED:

(a) Pass rectification journal entries to correct the errors

(b) Prepare a rectified trial balance after correcting the errors.

(c) Based on the corrected trial balance, calculate:

- (i) The gross profit and the net profit for the year ended 30th September 2014.
- (ii) The capital balance as at 30th September 2014.

Question 18

On 31st March 2015, while balancing the books of account of Anusha they did not agree. The difference in Trial Balance amounting to TZS.783,000 was debited to Suspense Account. Later, the following errors were noticed:

- (i) Total of Purchases Day Book for March, 2015 has been undercast by TZS.300,000 .
- (ii) TZS.220,000 paid for repairing the machinery has been debited to Machinery Account.
- (iii) The Sales Day Book has been overcast by TZS.150,000.
- (iv) A sale of TZS.1,200,000 to Mr. Kapur has been passed through the Purchases Day Book.
- (v) Cash TZS.117,000 received from Sharad though entered in the Cash Book has not been posted to Sharad Account.
- (vi) Goods returned by Mr. Akash, TZS.225,000 have been entered in the Returns Outward Book. However, Mr. Akash Account is correctly posted.

REQUIRED:

Prepare the journal entries for rectification of errors and prepare the suspense Account.

Answers to Self Examination Questions

Answer to SEQ 1

Correction entry

Dr Cash Tshs5 million
Cr Tony's account Tshs5 million
Being cash received which was omitted earlier now recorded.

Tony's account (before correction)

Dr Cr

	Tshs'000		Tshs'000
Sales	5,000		
		Balance c/f	5,000
Total	**5,000**	**Total**	**5,000**

Tony's account (after correction)

Dr Cr

	Tshs'000		Tshs'000
Sales	5,000	Cash	5,000
Total	**5,000**	**Total**	**5,000**

Correction entry

Dr Machinery account Tshs6 million
Cr Machinery expense a/c Tshs6 million
BBG Inc has incorrectly debited the machinery expense account; hence to rectify this mistake it must credit the machinery expense account.

Machinery expense account (before correction)

Dr Cr

	Tshs'000		Tshs'000
Cash	6,000		
		Balance c/f	6,000
Total	**6,000**	**Total**	**6,000**

Machinery expense account (after correction)

Dr Cr

	Tshs'000		Tshs'000
Cash	6,000	Machinery a/c	6,000
		Balance c/f	0
Total	**6,000**	**Total**	**6,000**

Machinery account (before correction)

Dr Cr

	Tshs'000		Tshs'000
	0	Balance c/f	
Total	**0**	**Total**	**0**

Machinery account (after correction)

Dr Cr

	Tshs'000		Tshs'000
Machinery expense a/c	6,000		
		Balance c/f	6,000
Total	**6,000**	**Total**	**6,000**

As entries have been omitted, we have to rectify the mistake by recording the entries.

Correction entry

Dr Customer-A account Tshs0.2 million
Cr Sales account Tshs0.2 million
Being sales to customer A recorded

Dr Cash Tshs0.2 million
Cr Customer-A account Tshs0.2 million
Being cash collected from customer-A

Customer-A account (before correction)

Dr | Cr

	Tshs'000		Tshs'000
	0	Balance c/f	0
Total	**0**	**Total**	**0**

Customer-A account (after correction)

Dr | Cr

	Tshs'000		Tshs'000
Sales	200	Cash	200
		Balance c/f	0
Total	**200**	**Total**	**200**

Correction entry

Dr Wages account Tshs0.2 million
Cr Cash Tshs0.2 million
Being shortfall of Tshs0.2 million (0.9 million - 0.7 million) rectified in wages account
.

Wages account (before correction)

Dr | Cr

	Tshs'000		Tshs'000
Cash	700		
		Balance c/f	700
Total	**700**	**Total**	**700**

Wages account (after correction)

Dr | Cr

	Tshs'000		Tshs'000
Cash	700		
Cash	200	Balance c/f	900
Total	**900**	**Total**	**900**

Correction entry

Dr Customer account Tshs0.5 million
Cr Cash Tshs0.5 million
Being excess Tshs0.5 million recorded in the cash journal, now rectified

Customer account (before correction)

Dr | Cr

	Tshs'000		Tshs'000
Sales	5,000	Cash	1,500
		Balance c/f	3,500
Total	**5,000**	**Total**	**5,000**

Customer account (after correction)

Dr | Cr

	Tshs'000		Tshs'000
Sales	5,000	Cash	1,500
Cash	500	Balance c/f	4,000
Total	**5,500**	**Total**	**5,500**

Answer to SEQ 2

The correct option is **D**

Profit before correction of errors = Tshs60 million

Profit after rectification of error

	Tshs'000
Profit shown	60,000
Add: Expense overstated	16,000
Less: Depreciation on car (Tshs16,000 - Tshs1,000) / 3 years	(5,000)
Revised profit	**71,000**

Therefore the revised profits are Tshs71 million. Profits were understated by Tshs11 million due to this error.

Answer to SEQ 3

The correct option is **D**.

Capital Expenditure affects the statement of financial position and revenue expenditure affects the statement of profit or loss.

Capital expenditure shown as revenue expenditure - as a result, profit under cast by Tshs20 million
Revenue expenditure shown as capital expenditure - as a result, profit over cast by Tshs5 million

Hence, Tshs20 million - Tshs5 million = Tshs15 million understatement of profits.

Answer to SEQ 4

The correct option is **D**.

Dr **Receivables ledger control Account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
	Opening balance	25,000			
	Credit-sales	50,000		Cash received	55,000
	Interest on overdue balance	6,000		Sales returns	5,000
				Bad debts	1,000
				Balance c/d	20,000
	Total	**81,000**		**Total**	**81,000**

Allowance for bad debts is not credited to the receivables account.

Answer to SEQ 5

The correct option is **A**.

Dr **Receivables ledger control account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
	Balance b/d	25,000			
	Credit-sales	50,000		Cash received	60,000
	Interest on overdue balance	6,000			-
				Contras against payables	6,000
				Balance c/d	15,000
	Total	**81,000**		**Total**	**81,000**

Answer to SEQ 6

The correct option is **C**.

Dr **Payables ledger control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Cash paid	60,000		Balance b/d	25,000
	Discount	800		Credit-purchases	50,000
	Contras against receivables	6,000			
	Purchases returns	6,000		Interest on overdue balance	6,000
	Balance c/d	8,200			
	Total	**81,000**		**Total**	**81,000**

Answer to SEQ 7

The correct option is **B**.

Dr **Receivables ledger control account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	180,000		Cash from credit customers	228,000
	Credit sales	190,000		Sales returns	8,000
	Cash refunds to credit customers	3,300			
				Discount allowed Bad	4,200
				debts written off Contras	1,500
				against payables	2,400
				Balance c/d (balancing figure)	1,29,200
	Total	**373,300**		**Total**	**373,300**

Answer to SEQ 8

The correct option is **A**.

An error in recording the sales ledger does not affect the reconciliation of the payables control account and payables ledger.

Answer to SEQ 9

The correct option is **B**.

Dr	Building maintenance A/c	Tshs8 million	
Cr	Building asset A/c		Tshs8 million

Explanation

The building asset account was incorrectly debited by Tshs8 million. We need to credit this account by Tshs8 million, i.e. reverse the wrong entry and debit the building maintenance account by the correct amount.

Nature

An error of principle does not affect the trial balance; therefore no entry to the suspense account is needed.

Answer to SEQ 10

The correct option is **D**.

It is not an error therefore needs no entry.

Dr Discount allowed A/c Tshs7 million

Cr Discount received A/c Tshs7 million

Explanation

There was an incorrect debit to the discount received account. Hence we will credit the discount received account to reverse the entry, and debit the correct account i.e. the discount allowed account.

Nature

Error of principle- does not affect the trial balance therefore no entry to the suspense account is needed.

Answer to SEQ 12

The correct option is **A**.

Dr Cash A/c Tshs1.7 million

Cr Suspense A/c Tshs1.7 million

Explanation

Omission of cash balance in the trial balance will require opening a suspense account. As debit credit on the trial balance, the cash has a debit balance in the trial balance and so the suspense account will be credited.

Nature

Wrong carry over to the trial balance - affects the trial balance. Therefore an entry to the suspense account is needed.

Answer to SEQ 13

The correct option is **C**.

Dr Interest received A/c Tshs9 million

Cr Suspense A/c Tshs9 million

Explanation

This error will create a balance in the suspense account as debit credit in the original entry.

Dr Cash account Tshs34 million

Cr Interest received account Tshs43 million

Hence, to reduce the above excess we need to debit the interest received by Tshs9 million to reverse the error and credit the suspense account to reduce the imbalance.

Nature

Error of transposition in posting - affects the agreement of the trial balance. Therefore an entry to the suspense account is needed.

Answer to SEQ 14

(a) Error of omission occurs when a transactions is left from been recorded in the books of accounts. For example cash sales of TZS.100,000 is not recorded in the cash book. Error of comission occurs when wrong personal accounts are used. For example credit sales to D Mbata of TZS.200,000 are debited to B Mbala account.

(b) (i) **Journal entries:**

1.	Dr J. Born	2,000,000	
	Cr Sales		2,000,000
2.	Dr B. Kamua	1,200,000	
	Cr C. Kam		1,200,000
3.	Dr Rent	520,000	
	Cr Suspense		520,000
4.	Dr Suspense	240,000	
	Cr Discount allowed		120,000
	Cr Discount received		120,000
5.	Dr Motor vehicle expenses	250,000	
	Cr Motor vehicles		250,000
6.	Dr Directors fees	6,000,000	
	Cr Suspense		6,000,000

(ii) **The statement of corrected net profit**

Uncorrected net profit	5,160,000	
Add: unrecorded sales	2,000,000	
Wrong recorded discount allowed	120,000	
Wrong recorded discount received	120,000	7,400,000
Less: Unposted rent	520,000	
Motor expenses recorded as motor vehicle	250,000	
Wrong recorded director's fees	6,000,000	6,770,000
Corrected net profit		630,000

Answer to SEQ 15

(a) Mr. Bonge

(i) Mr. Bonge's Journal Entries

Item No.	Date	Particulars	Dr '000'Tshs	Cr '000'Tshs
1	Dec. 31	Discount Received A/c	365	
		Discount Allowed A/c	365	
		Suspense A/c		730
		Being correction of Discount Allowed Tshs.365,000 wrongly credited to Discount Received Account		
2	Dec. 31	Mr. Tete Account	210	
		Mr. Tweve Account		210
		Being correction of payments Tshs 2,100,000 by Mr. Tweve wrongly credited to Mr. Tete account		
3	Dec. 31	Drawings Account	3,600	
		Wages Account		2,640
		Purchases Accounts		960
		Being correction of error on Wages paid Tshs.2,640,000 and material used Tshs.960,000 for own store		
4	Dec. 31	Suspense Account	9	
		Postage Account		9

		Being correction of Postage overstated Tshs.9 in postage account		
5	Dec. 31	Fittings Account	1,800	
		Purchases Account		1,800
		Being correction of new fittings purchased wrongly debited to Purchases account		
6	Dec. 31	Electricity Account	96	
		Suspense Account		96
		Being correction of electricity paid Tshs.96 not posted to that account		

(ii) Suspense Account

2015		'000' Tshs	2015		'000'Tshs
Dec. 31	Difference as per Trial Balance	817	Dec. 31	Discount allowed	365
	Postage	9		Discount received	365
				Electricity	96
		826			826

Answer to SEQ 16
Mr. Amani
(a) Correcting entries

(i)	Dr.	Drawings	2,200,000	
		Cr. Miscellaneous expenses		2,200,000
(ii)	Dr.	Prepaid rent	625,000	
		Cr. Rent expenses		625,000
(iii)	Dr.	Motor van expenses	258,000	
		Cr. Accrued motor van expenses		258,000
(iv)	Dr.	Suspense	38,000	
		Cr. Stationery expenses/Accounts Receivable		38,000
(v)	Dr.	Doubtful debts expenses	345,000	
		Cr. Provision for doubtful debts		345,000
(vi)	Dr.	Discount allowed	350,000	
		Cr. Debtors		350,000
Vii	Dr	Creditors/Accounts Payable	650,000	
		Cr discount received		650,000

(b) Statement of Adjusted Net Profit

Net Profit		15,667,000
Add: Drawings	2,200,000	
Prepaid rent	625,000	
Stationery	38,000	
Discount received	650,000	3,513,000
		19,180,000
Less: Motor Repair expenses	258,000	
Doubtful debts	345,000	
Discount allowed	350,000	953,000
Adjusted Net Profit		18,277,000

Answer to SEQ 17

(a) The following corrections must be made, with the resulting balances as shown:

		Tshs.	Tshs.
(i)	Dr carriage inwards a/c	528,000	
	CR Returns inwards a/c		528,000

Being invoice for carriage inwards posted to the returns inwards now rectified.

(ii)	Dr Sales a/c	180,000	
	CR Receivables A/c		180,000
(iii)	Dr Purchases A/c	100,000	
	CR Cash A/c	100,000	

Being cash purchase omitted earlier now recorded.

(b) Rectified Trial Balance

	Tshs. '000' Dr	Tshs. '000' Cr
Capital at 1st October 2013		60,434
Inventory at 1st October 2013	25,120	
Receivables	25,580	
Payables and Accruals		13,122
Bank	7,508	
Cash	1,900	
Sales		180,940
Returns Inwards	222	
Purchases	145,448	
Carriage Inwards	2,476	
Wages	9,368	
Rent	6,400	
Postage expenses	764	
Travel and accommodation	1,498	
Telephone	1,706	
General expenses	1,506	
Drawings	25,000	
	254,496	254,496

(c) (i) Calculation of Gross profit and Net profit for the year ended 30th September 2014

	Tshs. '000'	**Tshs. '000'**
Sales	180,940	
Less: Return Inwards	(222)	180,718
Opening Inventory	25,120	
Purchases	145,448	
Carriage Inwards	2,476	
	173,044	
Less: closing Inventory	(23,750)	
Cost of Sales		149,294
Gross profit		**31,424** ======
Telephones	1,706	
Wages	9,368	
Rent	6,400	
Postage expenses	764	
Travel and Accommodation	1,498	
General expenses	1,506	
Total expenses		21,242
Net Profit		10,182

(ii) Calculation of Capital Balance as at 30th September 2014

	Tshs. '000'
Opening capital	60,434
Profit	10,182
Less: Drawings	(25,000)
Closing Balance	45,616

Answer to SEQ 18

(a)

Journal **Dr** **Cr**

Date	Particulars	Tshs.	Tshs.
2015 March 31 (i)	Purchase a/c To Suspense a/c (Being the Purchases Day Book was undercast by TZS 300,000 now rectified)	300,000	 300,000
(ii)	Repairs a/c To Machinery a/c (Being repairing to machinery wrong debited to Machinery Account now rectified)	220,000	 220,000
(iii)	Sales a/c To Suspense a/c (Being Sales Day Book was overcast by TZS 150,000, now rectified)	150,000	 150,000
(iv)	Mr Kapur a/c To Sales a/c To Purchase a/c (Being a sales of TZS 1,200,000 to Mr Kapur wrongly passed through Purchases Day Book, now rectified)	2,400,000	 1,200,000 1,200,000
(v)	Suspense a/c To Sharad a/c (Being cash received from Sharad not posted to his account now rectified)	117,000	 117,000
(vi)	Return Inward a/c Return Outward a/c To Suspense a/c (Being good returned by Mr Akash wrongly passed through the Return Outward Book, now rectified)	225,000 225,000	 450,000

Suspense Account

Dr. **Cr**

Date	**Particulars**	**Tshs.**	**Date**	**Particulars**	**Tshs.**
2015 March 31	Balance Sharad a/c	783,000 117,000 ------------ <u>900,000</u>	2015 March 31	Purchases a/c By Sales a/c By Returns Inward a/c By Returns Outwards a/c	300,000 150,000 225,000 225,000 ----------- <u>900,000</u>

7

BANK RECONCILIATION

Get Through Intro

Every person has a bank account. The entries of deposits and withdrawals are the key components of bank transactions. All the transactions relating to the bank have to be monitored properly because this helps in identifying any differences between the cash book and bank statement. It also helps make sure that nobody has been stealing money directly from your bank account!

Generally, there should be no difference between the balances shown on the bank statement and in the cash book, because all the entries should appear in both. It may happen that on a particular date some entries are recorded in the cash book but are not shown on the bank statement. Entities usually have a policy of entering cheques received from any party immediately in the cash book. In Tanzania, it may take 7 - 21 days for local and country cheques to be cleared respectively if they are issued from a different bank. Therefore these cheques will be reflected in the bank statement only when they are cleared. The time lag between deposit of cheques and clearance of cheques is the most common reason for the differences between the cash book and the bank statement.

It is therefore necessary to prepare a bank reconciliation statement to discover the differences between the bank statement and the cashbook. This will help to keep a check on the accounts maintained by the entities and the transactions recorded by the bank.

Most organisations prepare monthly bank reconciliations to maintain proper records. So, when you become a consultant and have to prepare a bank reconciliation statement, you should be in a position to prepare it accurately.

Learning Outcomes

a) Explain the purpose of bank reconciliation.
b) Identify the main reasons for differences between the cash book and the bank statement.
c) Correct cash book errors and / or omissions.
d) Prepare bank reconciliation statements.
e) Identify the bank balance to be reported in the final accounts.

1. Explain the purpose of bank reconciliation.

[Learning outcome a]

Definition

A bank reconciliation statement is a statement that **compares the cash book and the bank statement.** It provides the differences between the two.

1.1 Purpose of bank reconciliation

Bank reconciliation is essential for any entity. It is prepared for the following reasons:

1. **To check the accuracy of accounts:** a bank reconciliation is prepared to assess whether the transactions entered by the entity in the cash book have actually happened and are reflected in the bank account.

Example

The cash book of Sam showed a balance of Tshs20 million, whereas the balance per the bank statement was Tshs15 million. Sam wondered why there was a difference in the cash book and bank statement.

When he prepared the bank reconciliation statement, he found that he had recorded a receipt of Tshs5 million from one of his customers but this transaction was not reflected in the bank account.

So, by preparing the reconciliation statement, he located the missing link and was also ensured about the accuracy of accounts.

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2. **To find mistakes:** a bank reconciliation helps in discovering any errors in entry, i.e. whether the amounts or the nature of the entry is correct. The amount means the exact figure of the entry, and, by nature of the transaction, we mean whether the transaction has been recorded correctly as a receipt or issue.

Example

The bank statement of Jack showed a cheque received from Suzy of Tshs10 million. The cash book had recorded this cheque for Tshs1 million. This is a mistake made while recording the transaction in the cash book. This mistake was discovered when Jack prepared a bank reconciliation statement.

---

3. **To find out timing differences, if any:** the entry is recorded in the cash book by the entity's personnel, whereas, in the bank statement, the entry is made by the bank's personnel. So, there is a possibility that there may be a difference in timing between these two. A bank reconciliation discloses this timing difference, if any.

Example

On 1 January 20X3, Michael received a cheque from Mack for Tshs20 million. This cheque was entered by the bank on his bank statement after three days. So, there is a difference in cash book balance and bank statement, as the cheque was recorded in the cash book as soon as it was received from Mack. However, it was not reflected in the bank statement as it had to be cleared by the bank. This timing difference is recognised on the bank reconciliation statement.

---

4. **To maintain up-to-date records for management and for the audit:** management need to be sure that all transactions have been recorded and recorded correctly. This helps them make decisions on how to run the business. Also, when an audit is conducted, the audit staff looks through the cash book and bank statements. There may be differences between the two. So, if the entity prepares bank reconciliation, it provides the reasons for these differences at a glance. As a result, it helps in obtaining quick records for audit.

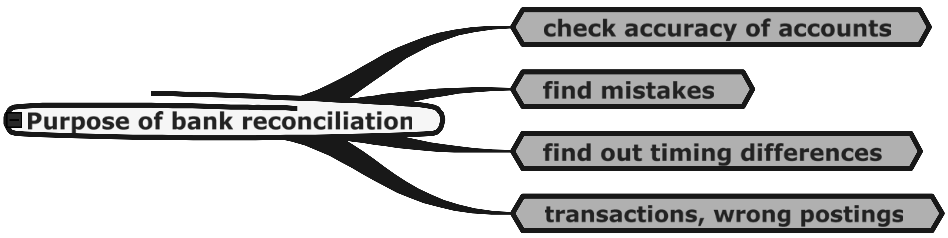
Example

Sun Inc closes its books on 31 December every year. Sam is the auditor of the company. He asked for the cash book and bank statement of the company for verification. Sam found different balances in the two records.

He wanted to be sure that the correct bank balance was being disclosed in the final accounts. So, he asked for a bank reconciliation statement. The bank reconciliation statement stated the reasons for the difference between the two and hence he was able to confirm the correct balance.

Therefore, from the above discussion, it is clear that the preparation of a bank reconciliation statement is essential for any entity.

SUMMARY



Test Yourself 1

A bank reconciliation statement is

(i) prepared by the bank and sent to its account holders
(ii) a statement sent by a bank to those customers who do not maintain a minimum balance
(iii) not a part of the double entry system
(iv) prepared by the entity to find discrepancies

A Only (i)
B (ii) and (iii)
C (iii) and (iv)
D (ii) and (iv)

---

2. Identify the main reasons for differences between the cash book and the bank statement. [Learning outcome b]

An entity has to maintain its records properly so that the business can run efficiently and that management can look at the accounts, to see how the business is performing. We prepare a bank reconciliation statement to determine the differences between the cash book and the bank statement.

First, however, we should understand what a cash book and a bank statement are.

Cash book: The transactions relating to money going in or out of the bank account are entered by the entity's personnel in the cash book. So these records are maintained within the entity.

A **proforma cash book** is given below:

Receipts	Cash Tshs	Bank Tshs	Payments	Cash Tshs	Bank Tshs
Balance b/f					
Bank		X	Accounts payable - Lawson		X
Cash	X		Petty cash	X	
			Employee Remuneration	X	
Accounts receivable - Jesson		X			
Accounts receivable - Masson		X			
Cash withdrawn - contra	X		Cash withdrawn - contra		X
			Balance c/f		
			Bank		X
			Cash	X	
	X	**X**		**X**	**X**

However, for this Study Guide we will show only the bank column in the cash book. This is because a cash book actually reflects what is happening in the bank account. Petty cash book shows actual cash transactions.

Cash Book
(showing only bank transactions)

Date	Receipts	Tshs	Date	Payments	Tshs
	Balance b/d	X		Bank charges	X
	Cheques received	X		Standing orders	X
	Bank interest			Direct debits	X
				Dishonoured cheque	X
				Cheques issued	X
	Total	**X**		**Total**	X

Notes:

1. Cheques received also include **outstanding lodgements** which are cheques received from the customers but not yet shown by the bank.
2. Cheques issued also include **unpresented cheques** which are cheques issued to creditors for payment but not yet cashed by them.

Bank statement: here, the transactions are entered by the bank's personnel. So, these records are maintained outside the entity.

A proforma bank **statement is as follows:**

Bank Statement

Date	Particulars	Withdrawals	Deposits	Balance
01/12/20X3	Balance b/d			X
05/12/20X3	Cheque issued	X		
07/12/20X3	Bank charges	X		
10/12/20X3	Bank interest		X	
15/12/20X3	Cheque deposited		X	
31/12/20X3	Balance c/d			X

Now, let us see why there is a difference between the cash book and the bank statement.

The main reasons for differences between the cash book and the bank statement:

1. **Cheques received but not deposited in the bank:** when a cheque is received by the entity, it immediately enters this receipt in the cash book, whereas the bank makes the entry for this receipt only when the cheque has been processed by the bank and the funds transferred from the customer's account to the entity's account. This is also known as an outstanding lodgement. So, this is a **timing difference** which appears in the bank reconciliation.

2. **Cheques issued:** when a cheque is issued by the entity for payment, the entry for this payment is immediately made by the entity in the cash book, but, the bank will make the entry only when the cheque has been processed by the bank and the funds transferred from the entity's account to the supplier's account. So, there will be a **difference in these two until the time the payment is transferred by the bank**.

3. **Bank charges:** banks charge a certain amount of money simply for keeping a customer's account or providing any other services, e.g. loans or overdrafts. These charges are recorded by the bank. Normally they appear directly on the bank statement.

   Generally, an entity becomes aware of the bank charges only when they appear on the bank statement. Consequently, they are not recorded in the cash book until after the bank statement is received.

Example

Suzy had issued a cheque of Tshs20 million on Sam. The cheque was dishonoured due to insufficient balance in her account. For dishonour of cheque, the bank charged Tshs0.2 million.

Suzy had no information about these bank charges until she got the bank statement. So there was no entry in the cash book. This resulted in a difference of Tshs0.2 million between the balance in the bank statement and in the cash book.

---

4. **Bank interest:** when an entity has an account with a bank, the bank pays a certain percentage of interest on any positive balance in the account. Interest is shown directly on the bank statement, and the entity does not have information about this interest until it receives the bank statement. As a result, the entry for bank interest received is not made in the cash book until after the bank statement is received.

Example

Sam had an account with Excel bank. Every quarter the bank paid some interest on his positive balance. In December 20X3, the bank credited his account with an amount of Tshs1 million as interest. Sam had no information about this interest until he received the bank statement. So, no entry was made in cash book for interest paid by the bank. This will result in a difference of Tshs1 million between the cash book and bank statement.

---

5. **Cheques dishonoured:** cheques are dishonoured by the bank when the party which has issued the cheque has insufficient funds in its bank account. An entity often does not know whether a cheque it has deposited has been dishonoured by the bank until it receives the bank statement. So there will be no entry for the same, in the cash book until the entity receives the bank statement.

Example

Michael deposited a cheque received from one of his customers of Tshs50 million. The cheque was dishonoured by the bank because there was insufficient balance in the customer's account. This fact was not known to Michael.

This resulted in a difference between the cash book and bank statement. Michael had shown this deposit but there was no corresponding entry in the bank book.

---

6. **Errors:** there may be differences between the cash book and bank statement because of errors committed either by the entity's personnel or the bank's personnel. Errors may be of calculation, or may be made while recording a transaction.

Example

Diana received a cheque from Suzan of Tshs20 million. She recorded the cheque received from Suzan with an amount of Tshs2 million. She has made a mistake while recording the transaction into her cash book.

When she received a bank statement from the bank, she found that entry in bank statement was for Tshs20 million. She realised her mistake, which had resulted in the difference between the cash book and bank statement.

Example

A cheque of Tshs10 million has been deposited into Arby Co's bank account. However, the accountant erroneously made an entry of Tshs1 million. This is an error made in the cash book and as a result, the cash and bank balances will not reconcile.

---

7. **Standing order:** the account holder of the bank instructs the bank to pay money regularly from his account for example to pay the electricity bills or phone bills etc. The bank makes the entry for this payment immediately but it will be recorded in the books of the entity only after the bank statement is received.

Example

Jack instructs his bank to pay the rent of the office building of Tshs10 million on the fifth of every month.

8. **Direct debit:** the account holder gives permission to the creditor to claim money directly from his account. Here, the **amounts may vary** each month.

Example

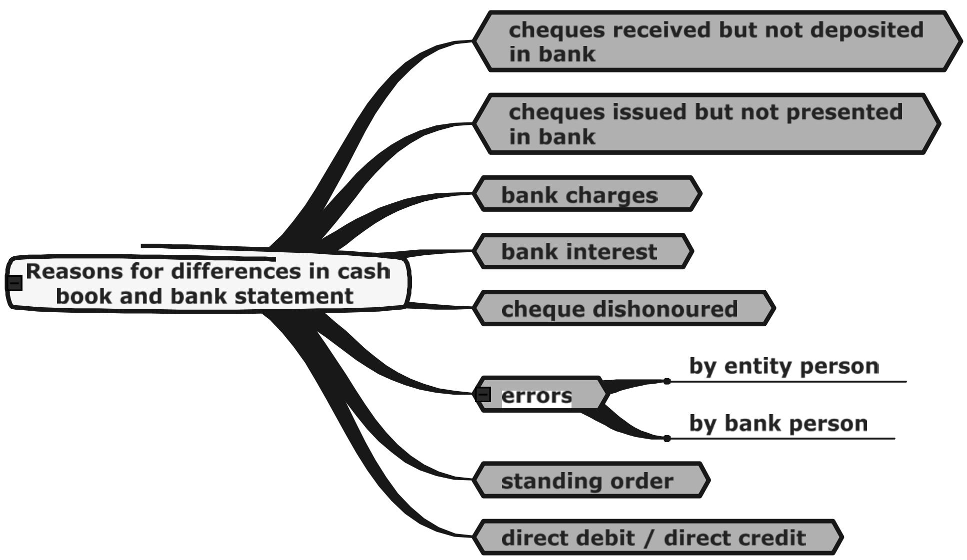
Jack tells the electricity department to collect the bill amount directly from the bank, every month. Here, the bank will pay Jack's electricity bill directly to the department. So, this is a direct debit made by bank in Jack's account.

9. **Direct credit:** the customers may make payments directly into the account holder's bank. The information regarding the credited amount will be known only on receipt of the bank statement.

Example

Jenny, a customer of Jack, paid his dues directly into his bank account. The bank will credit Jack's account with the amount paid by Jenny. Jack will get information regarding this transaction through a bank statement provided after a certain period of time.

SUMMARY



Test Yourself 2

A cheque was issued by Matrix Ltd to Jack (creditor), but it has not yet appeared on the bank statement. This cheque is known as ________.

A A dishonoured cheque
B A standing order
C An outstanding cheque
D A credit transfer

Test Yourself 3

Which of the following does not cause a difference between the cash book and the bank statement?

A Interest on bank overdraft debited in the bank account
B Cheques issued and presented for payment
C Cheques received and entered in the cash book, but not yet paid into the bank for collection
D A certain amount directly deposited by a customer into the bank

3. Correct cash book errors and / or omissions.

[Learning outcome c]

One of the many reasons due to which the bank statements and the cash book show different balances on the same day is that there could be errors or omissions in the recording of transactions in the cash book.
Error means a **mistake committed** while recording a transaction.

Example

Diana received a cheque from Juliet of Tshs25 million on 2 January 20X3. While recording this transaction in the cash book, she wrote the amount as Tshs52 million.

This error (called a **transposition error** as the numbers have been transposed from 25 to 52) leads to a difference of Tshs27 million (Tshs52 million - Tshs25 million) between the two balances.

On the other hand, omission means **not recording** a transaction which has to be recorded.

Example

Continuing the previous example of Diana,

If Diana forgets to record the cheque received from Juliet of Tshs25 million in the cash book then she has made an error of omission.

In this case the difference between the two balances is Tshs25 million (Tshs25 million - Tshs0)

All errors and omissions in the cash book are first rectified to determine the correct balance per the cash book. We then prepare a bank reconciliation statement.

Let us understand how we can determine the correct cash book balance with the following example:

Example

On 30 June 20X3, Superb Inc discovered a difference between the cash book and the bank statement. The accountant of the company was unable to explain the difference. The details of the balances are as follows:

On 30 June 20X3, the balance in the cash book was Tshs900,000 (debit) and in the bank statement was Tshs1,000,000 (credit).

After verification, it was found that the difference was because of the following transactions:

(a) The cash book was understated by Tshs50,000.
(b) Cheques deposited but not credited by the bank amounted to Tshs300,000.
(c) Cheques issued but not presented amounted to Tshs450,000.
(d) Cheques issued of Tshs50,000 wrongly recorded on receipt side of cash book.
(e) The cash book did not include Tshs125,000 towards interest earned by Superb, although it appeared in the bank statement.
(f) The cash book did not include Tshs12,000 towards bank charges incurred by Superb, although it appeared in the bank statement.

a) and d) are errors in the cash book. Furthermore, items mentioned under e) and f) are omissions in the cash book. We will first correct the errors and incorporate the omissions.

Cash Book

Date	Receipts	Tshs'000	Date	Payments	Tshs'000
	Balance b/d	900		Cheque wrongly recorded on receipt side (Tshs50,000 x 2)* - d	100
	Bank interest - e	125		Bank charges – f	12
	Under casting - a	50		Balance c/d	963
	Total	**1075**		**Total**	**1075**

Continued on the next page

The revised balance of the cash book is Tshs963,000.
Items b) and c) are not errors. They are items which will appear in the bank reconciliation statement.

*The amount has been deducted twice: first for the reversal of the previous wrong entry on the receipt side, and later for the correct recording of the entry for cheque issued.

The only error in the cash book is that it **is understated by Tshs50,000** and **issued cheque is debited instead of credited**. Hence, we will first correct this error.

It is explained in the next Learning Outcome.

Test Yourself 4

On 30 July 20X3, Reliable Inc discovered a difference between the cash book and the bank statement. The balance in the cash book was Tshs1,800,000 (debit) and in the bank statement it was Tshs1,900,000 (credit).

After verification, it was found that the difference was because of the following transactions:
(a) The cash book was overstated by Tshs200,000.
(b) Cheques issued, but not presented, amounted to Tshs900,000.
(c) Cheques to the value of Tshs600,000 were deposited, but were not credited by the bank.

Find out the correct cash book balance.

Test Yourself 5

The cash balance of Kelia Plc was Tshs700,000 (debit). The bank statement showed a credit balance of Tshs1,600,000 on 31 March 20X3. The difference was caused due to the following transactions:

(i) Cheques of Tshs500,000 were issued, but not presented to the bank for payment.
(ii) A cheque was received amounting to Tshs200,000, but was recorded as Tshs20,000.
(iii) Payment of Tshs250,000 from a customer was directly received by the bank.
(iv) The cash book was overstated by Tshs30,000.

What will be the revised balance in the cash book after taking the above transactions into consideration?

A Tshs750,000
B Tshs850,000
C Tshs550,000
D Tshs690,000

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4. Prepare bank reconciliation statements.

[Learning outcome d]

We have seen the reasons for the difference between balances in the cash book and the bank statement. We have also seen the purpose and importance of bank reconciliations. Let us now understand how to prepare a bank reconciliation statement.

4.1 Procedure for preparing a bank reconciliation statement

Before learning how to prepare a bank reconciliation statement, let us recap some terms explained in earlier learning outcomes:

Bank statement / pass book: this is the statement a banker gives to the account holder. The banker maintains records of all the transactions of the account holder. These transactions are recorded in the bank statement.

Cash book: this is the record of bank transactions maintained by the entity in its books of accounts.

Direct debit: the account holder gives permission to the creditor to claim money directly from his account. Here, the **amounts may vary** at different occasions.

Direct credit: the customers may deposit their dues directly into the account holder's bank. The information regarding the credited amount will be known to the customer only on receipt of the bank statement.

Diagram 1: Steps in bank reconciliation

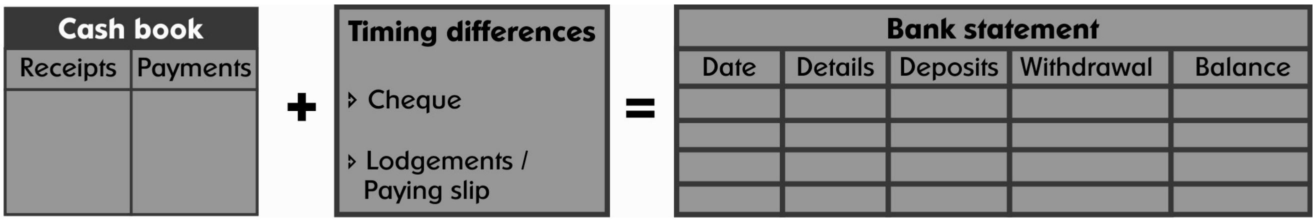
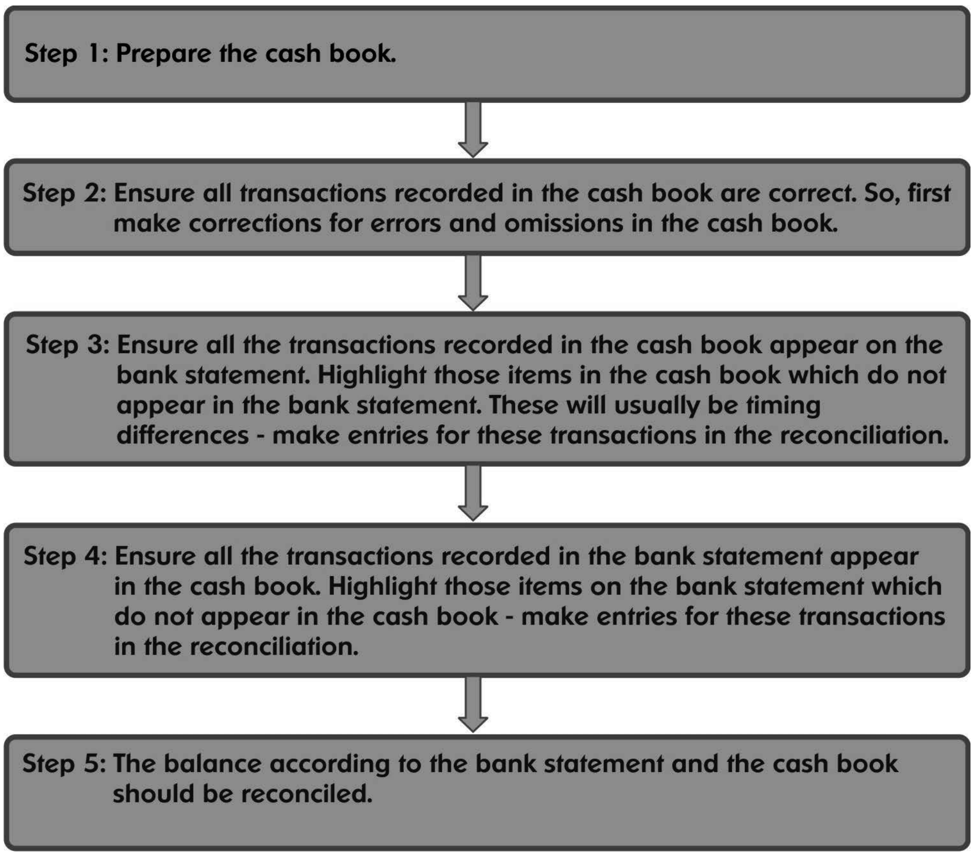


Diagram 2: Steps in bank reconciliation



Note: bank balances can be either favourable or unfavourable in the cash book and the bank statement

The **cash book** shows a debit balance when the receipt (debit) side of the cash book exceeds the payment (credit) side of cash book. This balance is also known as a **favourable balance.**

Similarly, when the payment side of cash book exceeds the receipt side of cash book, the balance is known as an **unfavourable balance**. This balance is also called an **overdraft balance** in the cash book.

The **bank statement** has a credit balance or a **favourable balance** when the credit side of the bank statement is higher than the debit side.

In the same manner when the debit side of bank statement is greater than the credit side of the bank statement, it shows a debit balance or an **unfavourable balance.** This balance is also known as an **overdraft balance.**

Before preparing the bank reconciliation statement, let us see the proforma of the same in two different ways.

1. When we move from the cash book balance to the bank statement balance.
2. When we move from the bank statement balance to the cash book balance.

Proforma of the bank reconciliation statement when we move from the cash book balance to the bank statement balance

Bank Reconciliation Statement

	Tshs
Balance per cash book	**X**
Add:	
Cheque issued but not presented	X
Bank interest	X
Direct credit by customers	X
	X
Less:	
Standing order / direct debit	(X)
Cheques deposited in bank but not credited	(X)
Bank charges	(X)
Cheque dishonoured	(X)
Balance per bank statement	**X**

Tip

If the pass book balance is taken as the starting point, the process needs to be reversed. Add those items which are deducted from cash book balance and deduct those which are added to the cash book.

Proforma of bank reconciliation statement when we move from the bank statement balance to the cash book balance

Bank Reconciliation Statement

	Tshs
Balance per bank statement	**X**
Add:	
Cheques deposited in bank but not credited	X
Bank charges	X
Standing order / direct debit	X
Cheque dishonoured	X
	X
Less:	
Cheque issued but not presented	(X)
Bank interest	(X)
Direct credit	(X)
Balance per cash book	**X**

Let us understand the preparation of a bank reconciliation statement with the help of an example.

Example

Superb Ltd maintains a cash book. The balance in the cash book on 31/03/20X3 was Tshs20 million, but the bank statement of the company showed a balance of Tshs25.98 million. On close scrutiny of the cash book and bank statement, it was found that the difference was due to the following transactions:

a) A cheque issued on 28/03/20X3 of Tshs12 million was debited by bank on 04/04/20X3.
b) Cheques deposited in bank but not credited by bank until 31/03/20X3.
   i. Cheque received from High tech Ltd of Tshs2 million.
   ii. Cheque received from Smart Ltd of Tshs11 million.
c) The bank has collected a payment directly from Talented Ltd of Tshs8 million, but the entry was not recorded in the cash book for it.
d) Bank charges of Tshs0.5 million on 28/03/20X3 were not recorded in the cash book.
e) Standing order of Tshs1 million was given to the bank for payment of Telephone bill. This was not recorded in the cash book.
f) Cheque issued to Phalna Ltd of Tshs0.5 million was dishonoured. Bank has charged noting charges of Tshs20,000 for the same.

Here, we prepare the bank reconciliation statement by starting with the balance according to the cash book.

Continued on the next page

Bank Reconciliation Statement – Cash book to Bank statement

	Tshs'000	Tshs'000
Balance according to cash book		**20,000**
Less: Bank charges	(500)	
Less: Noting charges charged by bank	(20)	(520)
Add: Cheque issued to Phalna dishonoured		500
Corrected cash balance		**19,980**
Add: Cheque issued but not debited by bank	12,000	
Add: Direct credit by Talented Ltd	8,000	20,000
		39,980
Less: Cheques deposited in bank but not credited		
- received from High Tech ltd	(2,000)	
- received from Smart Ltd	(11,000)	
Less: Standing order for telephone bill	(1,000)	(14,000)
Balance according to bank statement		**25,980**

Now using the same data, we will prepare a bank reconciliation statement taking the balance according to the bank statement and reconciling it with the balance according to the cash book.

Bank Reconciliation Statement – Bank statement to Cash book

We need to first correct the cash book (as we have done it above) and then prepare the bank reconciliation as follows:

	Tshs'000	Tshs'000
Balance according to bank statement		25,980
Add: Cheques deposited in bank but not credited by bank		
received from High Tech Ltd	2,000	
received from Smart Ltd	11,000	
Add: Standing order for telephone bill	1,000	14,000
		39,980
Less: Cheque issued but not debited by bank	(12,000)	
Less: Standing order: Talented Ltd	(8,000)	(20,000)
Balance according to cash book		**19,980**

4.2 Dealing with overdraft balances

Sometimes, the trader or the company may have overdraft balance with the bank. This situation occurs when the debit side of a bank statement is higher than the credit side of the bank statement, i.e. when a business withdraws amount more than the available balance from their bank account. This amount is referred to as an **overdraft balance** in the bank pass book. In the cash book, it is shown as a credit balance.

To summarise

In the cash book – credit balance
In the bank statement (pass book) – debit balance

These are also referred to as unfavourable balances.

While dealing with overdraft balances, we need to reverse the procedure discussed above for favourable balances. The following table will help you understand the preparation of bank reconciliation with unfavourable balance.

S.No	Items	If you start with	
		Cash Book Credit Balance	Pass Book debit Balance
1.	Cheques issued but not presented to bank	Subtract	Add
2.	Cheques deposited in bank not entered in cash book	Subtract	Add
3.	Wrong credit in cash book	Subtract	Add
4.	Wrong credit in pass book	Subtract	Add
5.	Standing order	Add	Subtract
6.	Cheques deposited but not credited	Add	Subtract
7.	Wrong debit in cash book	Add	Subtract
8.	Wrong debit in pass book	Add	Subtract

Let us understand how to carry out bank reconciliations through an example with an overdraft balance.

Example

On 31 December 20X3, Big Inc has an overdraft balance in its bank statement of Tshs8.5 million but the cash book showed an overdraft balance of Tshs7 million.

The difference between the two was because of the following reasons:

(a) Interest on overdraft for 6 months ending was Tshs0.2 million, not entered in the cash book.
(b) Bank charges of Tshs0.3 million debited in the bank statement, but no effect given in the cash book.
(c) Cheque deposited but not cleared until 31/12/20X3 was Tshs3 million.
(d) Cheque issued but not presented of Tshs2 million.

Here, the important point to be noted is that both the balances are overdraft balances. So, the transactions which increase the balance in the bank will have to be deducted from the overdraft balance. This is because the cheque deposited into the bank account will reduce the overdraft. Also, transactions which reduce the bank balance will be added to the overdraft balance.

A bank reconciliation statement is prepared as follows:

	Tshs'000
Overdraft balance per cash book	**7,000**
Add:	
Interest on overdraft	200
Bank charges	300
Cheque deposited but not cleared	3,000
	10,500
Less:	
Cheque issued but not presented	(2,000)
Balance per bank statement (overdraft)	**8,500**

Alternatively, bank reconciliation statement can be prepared using the debit and credit columns.

	Tshs'000	Tshs'000
	Debit	Credit
Overdraft balance per cash book		**7,000**
Interest on overdraft		200
Bank charges		300
Cheque deposited but not cleared		3,000
Cheque issued but not presented	2,000	
Total	**2,000**	**10,500**
Balance per bank statement (overdraft)	**8,500**	

Since the final balance in the bank statements lies on the debit column, we can infer that the bank statement shows an overdraft of Tshs8,500,000

Test Yourself 6

Ricky's cash book shows a credit balance of Tshs8.7 million for the month of January. The balance of the bank statement does not match with that of the cash book, due to the following reasons.

(i) Interest on an overdraft of Tshs0.5 million had been debited by the bank but not recorded in the cash book.
(ii) Cheques of Tshs5 million issued during the month, but were not presented in the bank until 31 January 20X3. Cheques of Tshs3.5 million were deposited but not cleared.
(iii) Interest on investments of Tshs1 million was directly collected by the bank.
(iv) The bank had wrongly debited Tshs0.8 million.

The balance per the bank statement is

A Tshs7.5 million (debit)
B Tshs9,5 million (debit)
C Tshs5.9 million (credit)
D Tshs7.5 million (credit)

---

5. Identify the bank balance to be reported in the final accounts.

[Learning outcome e]

Final accounts record all the assets and liabilities of an entity. The bank balance is one of the entity's current assets. The amount to be disclosed in the statement of financial position should be accurate because the financial statements are used by customers and other stakeholders for financial decision-making.

In Learning Outcome 4, we have seen that the balance per the cash book, after making all necessary adjustments, will be reported in the statement of financial position.

The balance in the cash book before all the adjustments have been made, cannot be reported in the final accounts because there is a possibility that some transactions e.g. bank charges or bank interest have not been recorded or errors have been made while recording other entries. So, in order to report an accurate bank balance, the cash book balance should only be reported after all adjustments have been made.

Example

High tech Inc has a bank account with Excel bank. Michael is the M.D. of the company. He found differences between the cash book and the bank statement. He has provided us with the bank reconciliation statement of the company.

Explain which balance will form part of the final accounts.

High tech Inc - Bank Reconciliation Statement

	Tshs'000
Balance per bank statement	60,000
Add: cheque from customer Jay Co deposited but not credited	50,000
	110,000
Less: cheque issued to supplier Zara Co but not presented	(35,000)
Balance per cash book	**75,000**

The balance in the cash book arrived at after all adjustments have been made is recorded in the statement of financial position.

Here, the balance per the cash book after all necessary adjustments is Tshs75 million. So, the bank balance to be reported in the final accounts is Tshs75 million. This is because the adjusted cash balance will reflect all the transactions up until the year end. If the bank balance was reported as Tshs60 million in the financial statements, then the receivables would be overstated. Similarly, if the payment of Tshs35 million to Zara Co is not taken into account, the payables would be overstated.

Report the bank balance in the final accounts

If the corrected bank balance has a debit balance then, it will be reported in the statement of financial position as a current asset. If it has a credit balance, then it should be reported as a current liability.

SOFP		
		Tshs
Assets		
Non-Current assets		X
Current assets		
Bank	**X**	X
Total		**X**
Capital and liability		
Bank	**X**	X
Total		**X**

Debit bank balance will appear here

Credit bank balance will appear here

Test Yourself 7

The following is the bank reconciliation statement of Superb Inc. What bank balance will be reported in the final accounts?

Bank Reconciliation Statement

	Tshs'000
Overdraft per cash book	(3,000)
Add: Cheque issued but not presented	35,000
	32,000
Less: Cheque deposited but not credited	(25,000)
Balance per bank statement	**7,000**

A Tshs7 million
B (Tshs3 million)
C Tshs32 million
D None of the above

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

The bank reconciliation statement is prepared by an entity to find discrepancies in the cash book and the bank statement. It is a statement and not an account and hence is not a part of the double entry system.

Answer to TY 2

The correct option is **C**.

It is a cheque issued to Jack for payment but not yet cashed by him.

Answer to TY 3

The correct option is **B**.

Cheques issued but not presented for payment will cause the difference between the balances of the cash book and the bank statement.

Answer to TY 4

The only error in the cash book is that it is overstated by Tshs200,000.
The correction in the cash book has been made below:

Cash Book

Date	Receipts	Tshs'000	Date	Payments	Tshs'000
	Balance b/d	1,800		Overstated figure (a)	200
				Balance c/f	1,600
	Total	**1,800**		**Total**	**1,800**

The revised balance of the cash book is Tshs1,600,000.
Items b) and c) are not errors. They are items which will appear in the bank reconciliation statement.

Answer to TY 5

The correct option is **B**.

(ii) and (iv) are the errors in the cash book.

The correction in the cash book is made as follows:

Dr **Cash Book** **Cr**

Date	Receipts	Tshs'000	Date	Payments	Tshs'000
	Balance b/d	700		Overstated	30
	Cheque entered with a wrong amount (Tshs200,000 - Tshs20,000)	180		Balance c/d	850
	Total	**880**		**Total**	**880**

The revised balance of the cash book is Tshs850,000. Items (i) and (iii) are not errors. They are items which will appear in the bank reconciliation statement.

Answer to TY 6

The correct option is **A**.

	Tshs'000	Tshs'000
	Dr	**Cr**
Overdraft balance per cash book		**8,700**
Interest on overdraft not entered in the cash book		500
Cheques deposited but not cleared		3,500
Wrong debit by bank		800
Cheque issued but not presented	5,000	
Interest on investment directly collected by bank	1,000	
Total	**6,000**	**13,500**
Overdraft balance per bank statement (debit balance)	**7,500**	

Answer to TY 7

The correct option is **B**.

Tshs3 million **credit** will be reported in the current liabilities.

Self Examination Questions

Question 1

A bank reconciliation statement means:

A A statement sent by a bank to those customers who do not maintain a minimum balance
B A statement sent by an entity to its customers
C A statement giving the difference between the bank balance according to the bank statement and the cash book
D None of the above

Question 2

A bank reconciliation statement is:

A Prepared by an entity and sent to its customers
B A part of a double entry system
C Not a part of a double entry system
D Prepared by a bank and sent to its account holders

Question 3

Which of the following will not result in the difference between the balance per cash book and the balance per bank statement?

A Cheque deposited not yet cleared
B Cheque issued but not presented
C Bank charges
D None of the above

Question 4

Which of the following is a timing difference that reduces the balance according to the cash book in the case of bank reconciliation?

A Cheques deposited but not cleared
B Cheques issued but not presented
C Bank charges
D Bank interest

Question 5

The following is a bank reconciliation statement prepared by Sun Inc:

	Tshs'000
Overdraft per bank statement	40,000
Add: deposits not credited	45,000
	85,000
Less: outstanding cheques	(6,000)
Overdraft per cash book	**79,000**

Assuming the bank statement balance of Tshs40 million to be correct, what should the correct cash book balance be?

A Tshs79 million overdrawn, as stated
B Tshs6 million overdrawn
C Tshs1 million overdrawn
D Tshs60 million cash at bank

Question 6

The bank reconciliation of Star Inc is given as follows:

	Tshs'000
Overdraft per bank statement	60,000
Add: deposits not credited	90,000
	150,000
Less: Cheques issued but not presented	(40,000)
Overdraft per cash book	**10,000**

What would be the correct cash book balance, assuming Tshs60 million to be the correct bank statement balance?

A Tshs40 million overdrawn
B Tshs10 million overdrawn
C Tshs90 million overdrawn
D Tshs10 million cash at bank

Question 7

Mack prepares the cash book for his business. The balance per cash book is Tshs10 million. From the following details, find out what is the balance per bank statement.

	Tshs'000
Standing order	1,000
cheques deposited in bank not yet credited	2,000
Bank charges	500
cheque issued not yet presented	3,000

A Tshs11.5 million
B Tshs9.5 million
C Tshs7.5 million
D Tshs7.5 million overdrawn

Question 8

From the bank reconciliation statement given below, what is the cash book balance?

	Tshs'000
Overdraft per bank statement	90,000
Add: Deposits not credited	95,000
	185,000
Less: Outstanding cheques	(2,000)
Overdraft per cash book	**183,000**

A Tshs185,000,000
B Tshs183,000,000 overdrawn
C Tshs3,000,000 cash at bank
D Tshs3,000,000 overdrawn

Question 9

a) An entity has to maintain its records properly so that the business can run efficiently and that management can look at the accounts to see how the business is performing. Bank reconciliation statements are prepared to determine the differences between the cash book and the bank statement.
REQUIRED:

Explain four main purposes of preparing a bank reconciliation statement.

b) You are working as accounting trainee employed by Masumbuko Ltd. One of your duties is to prepare bank reconciliation, the bank statement sent to you on monthly basis by the local branch of the CBD bank plc. On 30th June 2015 the cash book balance showed an overdraft of TZS.60,000,000 whilst the bank statement showed that on the same date Masumbuko Ltd has TZS.620,000,000 in credit with the bank.
Checking through both the cash book and the bank statement you discover the following:

(i) A cheque for TZS.126,000,000 payable to Malingumu has been entered twice into the cash book.
(ii) Bank charge TZS.50,000,000 debited to the bank statement do not appear in the cash book.
(iii) A dividend for TZS.240,000,000 received by the bank on 28th June 2015 has not entered in the cash book.
(iv) Cheques issued totaling TZS.620,000,000 and entered into cash book have not been presented to the bank for payment
(v) A direct debt for TZS.42,000,000 paid correctly by the bank on 26th June 2015 does not appear in the cash book.
(vi) Receipts from various customers amounting to TZS.187,000,000 have been entered into cash book but do not appear on the bank statement.
(vii) A cheque for TZS.87,000,000 issued to Makusaro shown incorrectly on the bank statement as TZS.78,000,000.
(viii) A customer cheque has been returned unpaid by his bank and the amount of TZS.36,000,000/= shows as adjustment on the bank statement. No entry has been made for this item in cash book.
REQUIRED:

(i) Bring the cash balance up to date as at 30th June 2015.

(ii) Draw a bank reconciliation statement as at June 2015.

Question 10

(a) Briefly explain four (4) reasons for a cheque to be dishonoured by a bank.

(b) Juma Makambo's Cash Book at 30th November 2015 showed an overdrawn position of TZS.3,630,000 although his bank statement showed only TZS.2,118,000 overdrawn.

Detailed examination of the two records revealed the following:

1. The debit side of the cash book had been undercasted by TZS.300,000.
2. A cheque for TZS.1,560,000 in favour of Zamtu Ltd., had been omitted by the bank from its statement, the cheque have been debited to another customer's account.
3. A cheque for TZS.182,000 drawn in payment of the telephone account had been entered in the cash book as TZS.128,000 but was shown correctly on the bank statement.
4. A cheque for TZS.210,000 from A. Moses having been paid into the bank was dishonoured and shown as such on the bank statement although no entry relating to the dishonour had been made in the cash book.
5. The bank had debited a cheque for TZS.126,000 to Juma's account in error; it should have been debited to Rashid Hussein account.
6. A dividend of TZS.90,000 on Juma's holding of ordinary shares has been paid direct to his bank account and no entry made in the cash book.
7. Cheques totaling TZS.1,260,000 drawn on 30th November had not been presented for payment.
8. A lodgement of TZS.1,080,000 on 30th November had not been credited by the bank.
9. Interest amounting to TZS.228,000 had been debited by the bank but not entered in the cash book.

REQUIRED:

(i) Make any necessary entries in the cash book.
(ii) Prepare a statement reconciling Juma Makambo's corrected cash book with his bank statement at 30th November 2015.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **C**.

A bank reconciliation statement is a statement giving the difference between the bank balance according to the bank statement and the cash book.

Answer to SEQ 2

The correct option is **C**.

A bank reconciliation statement is not a part of a double entry system.

Answer to SEQ 3

The correct option is **D**.

It is because all the three result in a difference between the two records.

Answer to SEQ 4

The correct option is **A**.

Cheques deposited but not cleared.

Answer to SEQ 5

The correct option is **C.**

The bank reconciliation statement is prepared as follows:

	Tshs'000	**Tshs'000**
	Dr	**Cr**
Overdraft per bank statement	40,000	
Deposits not credited		45,000
Add: Cheques issued but not presented	6,000	
Total	**46,000**	**45,000**
Cash book (favourable balance)		**1,000**

Answer to SEQ 6

The correct option is **D.**

The cash book balance is calculated as follows:

	Tshs'000	**Tshs'000**
	Dr	**Cr**
Overdraft per bank statement	60,000	
Deposits not credited		90,000
Outstanding cheques	40,000	
Total	**100,000**	**90,000**
Cash book (favourable balance)		**10,000**

Answer to SEQ 7

The correct option is **B.**

	Tshs'000
Balance per cash book	**10,000**
Add: cheque issued but not presented	3,000
	13,000
Less:	
Cheques deposited in bank but not credited	(2,000)
Bank charges	(500)
Standing order	(1,000)
Balance per bank statement (favourable balance)	**9,500**

Alternatively using the debit credit columns

	Tshs'000	Tshs'000
	Dr	Cr
Balance per cash book	**10,000**	
Cheque issued but not presented	3,000	
Cheques deposited in bank but not credited		2,000
Bank charges		500
Standing order		1,000
Totals	**13,000**	**3,500**
Balance per bank statement (favourable balance_		**9,500**

Answer to SEQ 8

The correct option is **C**.

	Tshs'000
Overdraft per bank statement	(90,000)
Add: Deposits not credited	95,000
	5,000
Less: Outstanding cheques	(2,000)
Cash book balance	**3,000**

Answer to SEQ 9

(a) (i) **To check the accuracy of accounts:** bank reconciliation is prepared to assess whether the transactions entered by the entity in the cash book have actually happened and are reflected in the bank account.

(ii) **To find mistakes:** bank reconciliation helps in discovering any errors in entry, i.e. whether the amounts or the nature of the entry is correct. The amount means the exact figure of the entry, and by nature of the transaction, we mean whether the transaction has been recorded correctly as a receipt or issue.

(iii) **To find out timing differences, if any:** the entry is recorded in the cash book by the entity's personnel, whereas, in the bank statement, the entry is made by the bank's personnel. So, there is a possibility that there may be a difference in timing between these two. Bank reconciliation discloses this timing difference, if any.

(iv) **To maintain up-to-date records for management and for the audit:** management need to be sure that all transactions have been recorded and recorded correctly. This helps them make decisions on how to run the business. Also, when an audit is conducted, the audit staff looks through the cash book and bank statements. There may be differences between the two. So, if the entity prepares bank reconciliation, it provides the reasons for these differences at a glance. As a result, it helps in obtaining quick records for audit.

(b)(i) **ADJUSTED CASH BOOK**

		TZS			TZS
30 June 2015	Malingumu	126,000,000.00	30 June 2015	Balance b/d	60,000,000.00
	Devidend	240,000,000.00		Bank charges	50,000,000.00
				Direct debit	42,000,000.00
				Unpaid cheque	36,000,000.00
				Balance c/d	178,000,000.00
		366,000,000.00 ===========			**366,000,000.00** ===========

(ii) **MASUMBUKO LIMITED**
BANK RECONCILIATION STATEMENT AS AT 30 JUNE 2015

Balance per cash book (from part (a)		178,000,000.00	
Add: Un-presented cheque	620,000,000.00		
Bank error (Makusaro)	9,000,000.00		629,000,000.00
		807,000,000.00	
Less: Un-cleared lodgements		187,000,000.00	
Balance per bank statement		620,000,000.00	

Answer to SEQ 10

(a)

(i) The amount in figures is different from amount in words e.g. in words it is written one hundred thousand shillings but in figures it is written shs. 150,000.

(ii) The business deposits the cheque with the bank after the expiration period of the cheque. Cheques usually have a certain period of time by which they must be deposited e.g. 6 months, after this period, these cheques are considered as "stale" cheques if they are not yet deposited. So, the bank may dishonor these cheques.

(iii) The customer's bank account has insufficient funds to pay for the cheque. For instance the customer has a balance of shs. 2 million on his bank account and he wrote a cheque of shs. 4 million to the business while she has not been allowed an overdraft to pay for that cheque. This cheque will be dishonored by the bank.

(i) The signature in the cheque differs from that officially recognized by the bank.
(ii) Postdated cheque.
(iii) Owner instructed the bank not to honour any cheque.

(b)

Dr.	Cash Book		Cr
2015	Shs.000	2015	Shs. 000
Suspense-undercast	300	Balance b/d	3630
Dividend received	90	Telephone-undercast	54
Balance c/d	3732	Moses-dishonoured cheque	210
		Interest	228
	4122		**4122**

Bank Reconciliation Statement as at 30th November 2015

	Shs.000	Shs. 000
Balance as per bank statement		(2,118)
Add: Error by the bank	126	
Uncredited deposit	1,080	1,206
		(912)
Less: Cheque omitted – Zito Limited	1,560	
Unpresented Cheque	1,260	2,820
Balance per adjusted/corrected cash book		**(3,732)**

OR

	Shs.000	Shs. 000
Balance as per adjusted cash book		(3,732)
Add: Cheque omitted – Zito Limited	1,560	
Unpresented Cheque	1,260	2,820
		(912)
Less: Error by the bank	126	
Uncredited deposit	1,080	1,206
Balance per bank statement		**(2,118)**

8 PREPARATION OF YEAR-END ADJUSTMENTS AND TRIAL BALANCE USING WORKSHEET

Get Through Intro

By now you would know what a trial balance is. It is used to prepare the financial statements (statement of profit or loss and statement of financial position). However, the initial trial balance so drawn cannot be used as it is. It needs to be modified to take care of some adjustments.

For example, there would be prepaid expenses, incomes accrued but not received, depreciation on non-current assets, closing inventories, provisions, allowances for doubtful receivables and so on, which need to be considered in order to have a complete, true and fair set of financial statements. These adjustment entries are therefore made and a revised trial balance is drawn, called the extended trial balance. The statement of profit or loss and statement of financial position are then prepared from the extended trial balance. T

his Study Guide prepares you for this task. Remember, it is easy to understand as you already have a thorough knowledge of trial balance preparation.

Learning Outcomes

a) Adjust account balances for accruals and prepayments.
b) Adjust for an allowance for bad and doubtful debts.
c) Adjust for depreciation of non-current assets.
d) Explain the importance of adjusting trial balance at the year end.
e) Prepare trial balance incorporating necessary year end adjustment.

1. Adjust account balances for accruals and prepayments.

[Learning Outcome a]

1.1 Accruals and prepayments

Expenses and incomes which do not pertain to a particular year, need adjustments for accruals and pre-payments in order to comply with the requirements of the matching principle. Remember, when an invoice is received, it is automatically routed to the statement of profit or loss as an expense for the year. Hence, adjustments need to take place if not all the expenses incurred during the year do not belong to the same year.

1. Accrued expenses (Outstanding expenses)

In the practical business world, invoices are received / payment is made after the financial year has ended. In certain cases, organisations may prefer to pay a supplier in a lump sum, rather than pay them for weekly / monthly orders. In other cases, certain customers may prefer making bulk payment for a contract in the middle of the year that even covers a few months of the following year. At times expenses accrue but are not due for payment at the end of the reporting period. However, since the relevant expenses are accrued, (i.e. incurred for earning the revenue recognised in a financial year) we need to record them in the same financial year.

Example

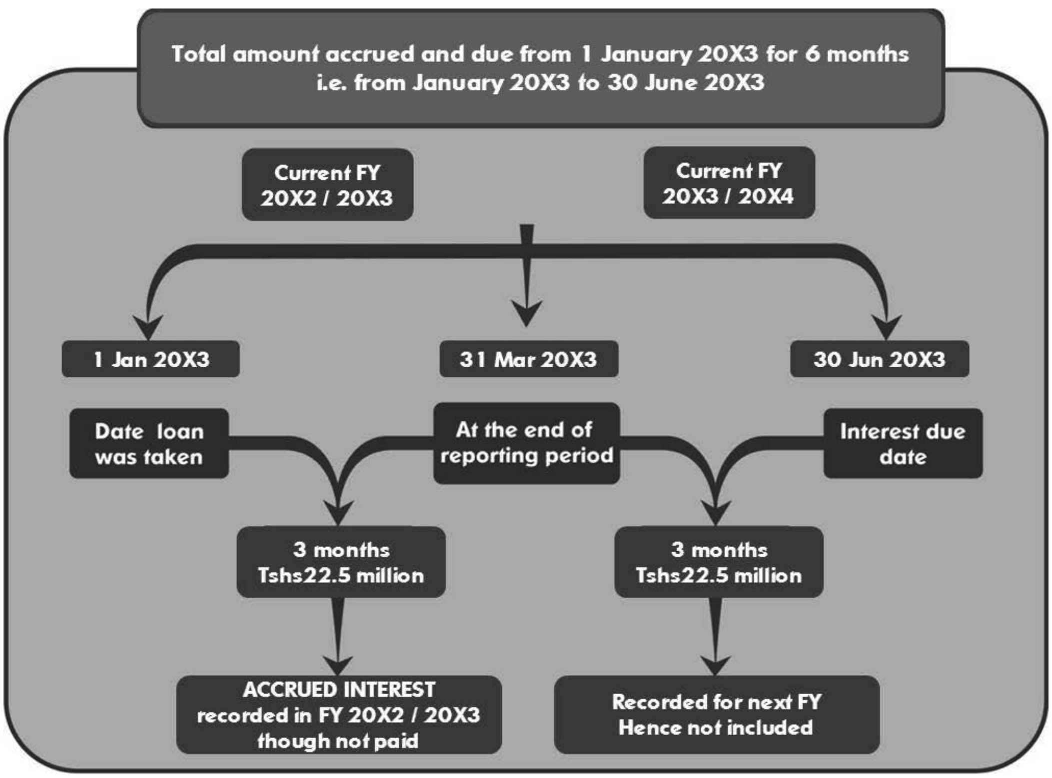
Pallore Co obtained a loan of Tshs1 million from a bank on 1 January 20X3 at an agreed interest rate of 9%. The dates of interest payment are 30 June and 31 December every year. The financial year ending is on 31 March 20X3. Payment of interest is made every 6 months at the end of June and December.

Calculate the accrual adjustments.

Whether the interest is due or not, the accrual continues every day.

Interest for the period 1 January 20X3 to 30 June 20X3 is due on 30 June 20X3. The reporting date for Pallore Co is 31 March 20X3 and it falls in between the interest repayment period.

Interest for the period 1 January 20X3 to 31 March 20X3 is not due for payment on reporting date, but still it has accrued. Therefore the amount of interest outstanding which needs to be recognised is Tshs1 million x 9% x 3/12 = Tshs22.5 million.



Continued on the next page

The journal entry made is

Dr Interest on loan (Expense) Tshs22.5 million
Cr Interest accrued on term loan (Liability) Tshs22.5 million
Being recording of interest accrued on loan

Interest expense account
(Year 20X2-X3)

Dr			Cr
	Tshs'000		**Tshs'000**
Interest accrued on term loan	22,500	Transferred to SOPL	22,500
	22,500		**22,500**

Outstanding expense is added to expenses here

Note: the interest accrued during 20X2-X3 is transferred to the statement of profit or loss even if there is no payment of interest. This is achieved by the accrual adjustment.

Interest accrued on term loan (liability) account (extract)
(Year 20X2-X3)

Dr			Cr
	Tshs'000		**Tshs'000**
		Interest expense	22,500

Outstanding expense recorded as a liability

(a) Presentation in the financial statements

The interest expense will be added to the interest cost under finance costs in the statement of profit or loss.

The interest accrued on the loan is shown in the statement of financial position under current liabilities.

Statement of profit or loss (extract)
For the year ended 31 March 20X3

	Tshs'000	**Tshs'000**
Income		X
Less: Expenses		
Interest accrued	22,500	
Other expenses	X	
Net profit		**X**

Statement of financial position (extract)
as at 31 March 20X3

		Tshs'000
Assets		
Non-current assets		X
Current assets		X
Total		XX
Capital		X
Non-current liabilities		X
Current liabilities		
Interest accrued on term loan		22,500
Total		**X**

(b) Reversal of accrual

At the beginning of the next year, the journal entry is reversed. This is known as reversal of accrual. In the example considered above, the entry to be made in the next year is:

Dr Interest accrued on term loan (Liability) Tshs22.5 million
Cr Cash (payments) Tshs22.5 million
Being the reversal of entry taken for accrued interest in the last year

---

2. Prepaid expenses

Certain suppliers may require payment upfront. In other cases, certain organisations may make payments at a certain date, which may not coincide with their accounting year. Hence, these expenses would be paid in advance. As an accountant you, have to ensure of the total expenses, only the part which relates to the current financial year is presented as an expense. The part which relates to the next financial year is carried forward as an asset under the heading 'Prepaid expenses'.

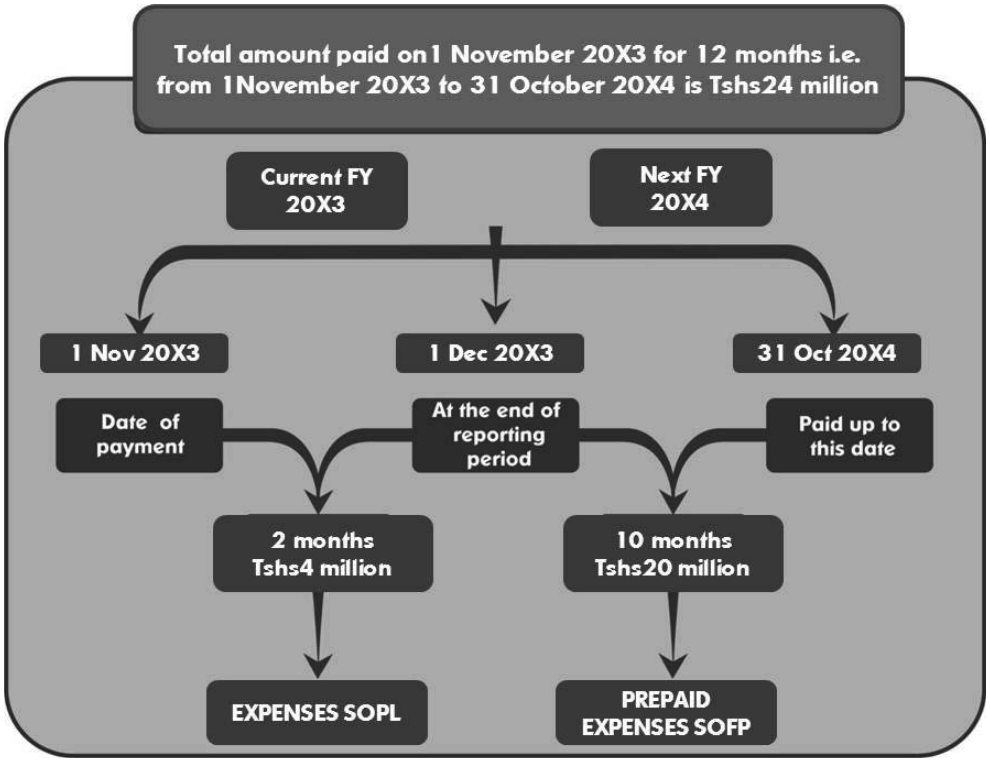
Example

An insurance policy for fire and similar risks is obtained for the year from 1 November 20X3 by paying a premium of Tshs24 million for the full year in advance. The reporting period is 31 December 20X3.

Of the total premium paid of Tshs24 million, the premium accrued up to the end of the reporting period is:
Tshs24 million x (2/12) months = Tshs4 million.

The part which relates to the current financial year is added to the insurance expense account (in this case, two months: November and December 20X3) and the part which relates to the next financial year is carried forward as an asset - 'prepaid expenses'. (in this case 10 months from January to October 20X4).

The premium for the remaining 10 months, i.e., Tshs24 million/12 x 10 = Tshs20 million accrues in the next financial year i.e. it is paid in order to cover the fire and other risks for the period 1 January 20X4 to 31 October 20X4.



(a) The journal entry made is:

When the payment was made, the accountant would have recorded the following entry:

Dr Insurance expense (expense) Tshs24 million
Cr Cash (asset) Tshs24 million
Being payment of insurance premium recorded

Now, at the end of the year, having determined that Tshs20 million is a pre-payment, the following entry is made:

Dr Prepaid insurance (asset) Tshs20 million
Cr Insurance expense (expense) Tsh20 million
Being prepaid insurance recorded

Insurance expense account
(Year 20X3)

Prepaid expense is shown here as a reduction from expense

Dr **Cr**

	Tshs'000		**Tshs'000**	
	X	Transferred to SOPL (balancing figure)	4,000	
Cash (payments)	24,000	Prepaid insurance	20,000	
	24,000		**24,000**	

Continued on the next page

The adjustment for prepaid insurance leads to an amount of Tshs4 million i.e. the amount of expense accrued. This amount is transferred to the statement of profit or loss.

Prepaid expense is recorded here as an asset

Pre-paid insurance (asset) account
(Year 20X3)

Dr **Cr**

	Tshs'000		**Tshs'000**
Insurance expense	20,000		

(b) Presentation in the financial statements

The insurance expense in the statement of profit or loss will be reduced by Tshs20 million.
The prepaid insurance of Tshs20 million is recognised as a current asset in the statement of financial position.

Statement of profit or loss for the year ended 31 December 20X3

	Tshs'000	**Tshs'000**
Income		X
Less: Expenses		
Insurance expenses	24,000	
Less: Pre-paid	(20,000)	4000
Net profit		X
		X

Statement of financial position as at 31 December 20X3

	Tshs'000
Assets	
Non-current assets	X
Current assets	X
Pre-paid expenses	20,000
Total	**X**
Capital and liabilities	X
Total	**X**

(c) At the beginning of the next year, the journal entry is reversed.

In the example considered above, the entry would be:

Dr	Insurance expense	Tshs20 million	
Cr	Prepaid insurance (asset)		Tshs20 million

Being the entry to transfer prepaid insurance to insurance expense, i.e. the reversal of last year's entry

---

3. Accrued income (outstanding income)

Income can also accrue continuously. It needs **to be recognised in the financial year** in which it has accrued, whether the actual cash is received or not (i.e. the date of actual receipt of the income is not important).

Example

Mozart had business premises that were lying vacant. He rented it out for an agreed rent of Tshs4 million per month with effect from 1 April 20X2.

The following rents were received by Mozart

Period	**Rent received on**	**Amount**
1 April 20X2 to 31 December 20X2 (9 months)	1 January 20X3	Tshs36 million
1 January 20X3 to March 20X4 (15 months)	1 April 20X4	Tshs60 million

The reporting period of Mozart is 31 March each year.

The rent for the 9 month's period from 1 April 20X2 to 31 December 20X2 must be accounted as an expense.

Rent for the 3 months from 1 January 20X3 to 31 March 20X3 had accrued even though it had not actually been received by Mozart. Mozart needs to record an amount of Tshs12 million (Tshs4 million x 3) in his accounts as rent receivable for the year 20X2-20X3.

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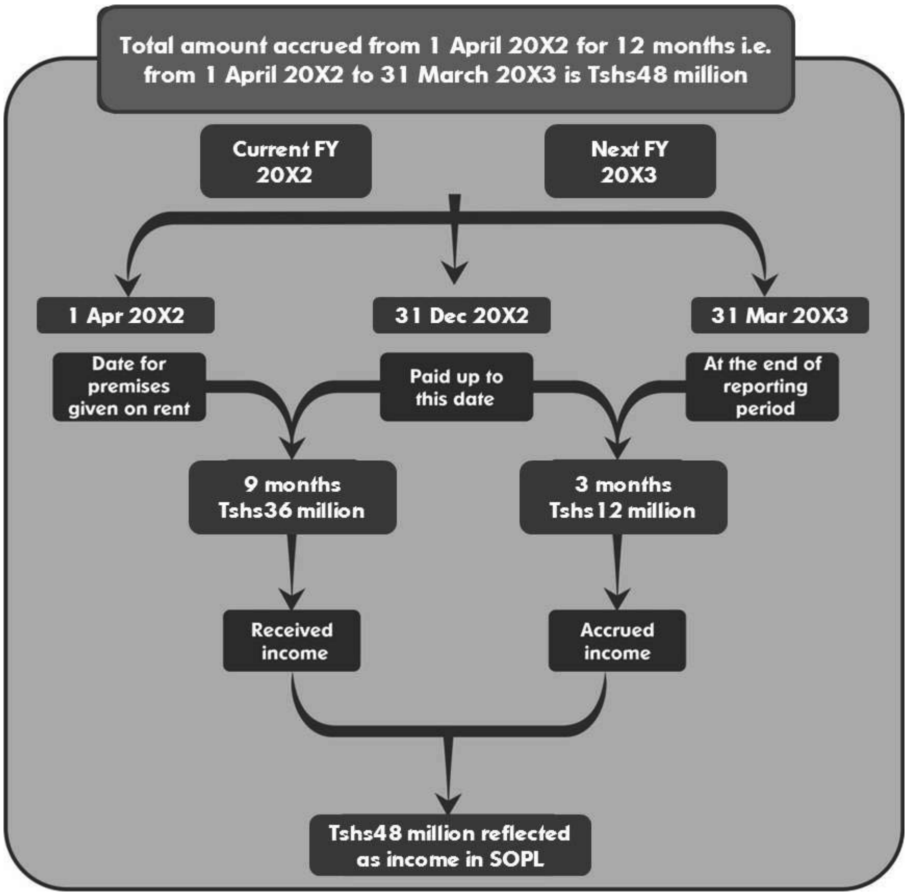


(a) The journal entry

		Tshs'000	Tshs'000
Dr	Cash	36,000	
Cr	Rent income		36,000
Being rent received			
Dr	Rent receivable (SOFP)	12,000	
Cr	Rent income (SOPL)		12,000
Being rent receivable recorded			

A proforma expense account

Accrued income is added to income

Rent (income) account
(Year 20X2-X3)

Dr **Cr**

	Tshs'000		**Tshs'000**
Transferred to SOPL (balancing figure)	48,000	Cash (receipts)	36,000
		Income accrued (outstanding)	12,000
	48,000		**48,000**

Accrued income is recorded as an asset

Rent receivable (asset) account
(Year 20X2-X3)

Dr **Cr**

	Tshs'000		**Tshs'000**
Rent income	12,000		

(b) Presentation in the financial statements

The rent receivable is shown as a current asset in the statement of financial position.
The rent income of Tshs12 million is added to the figure of rent income appearing in the statement of profit or loss.

Continued on the next page

(c) At the beginning of next year, the journal entry is reversed.

Dr	Rent income (SOPL)	Tshs12 million	
Cr	Rent receivable (SOFP)		Tshs12 million

Being the entry to transfer rent receivable account to rent income account, i.e. the reversal of last year's entry no.___.

---

4. Income received in advance

Income is occasionally received before it accrues - it is sometimes given in advance. The income related to the current year is to be recorded as income for the current year. The excess income received needs to be recorded in the same financial year by reducing the income which is received in advance, and shown in the statement of financial position as a liability.

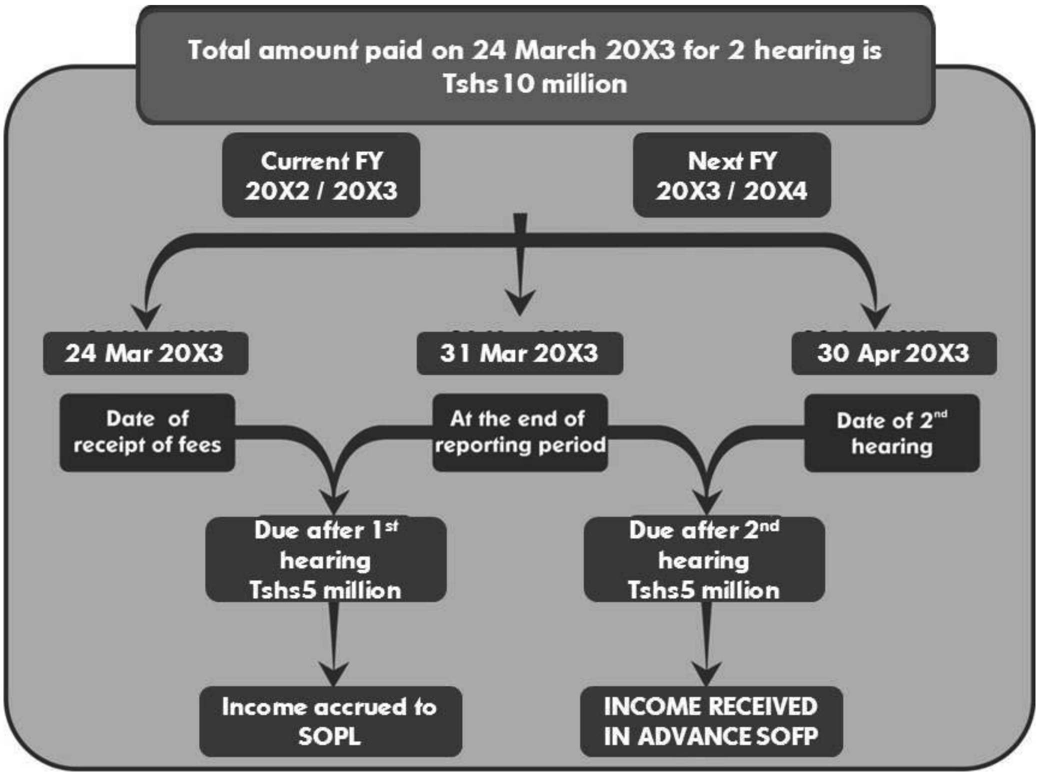
Example

A firm of lawyers received Tshs10 million on 24 March 20X3 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 31 March 20X3, only 1 hearing was complete. The second hearing took place on 30 April 20X3.

At the reporting date only half of the work was complete and therefore only half of the fees must to be accounted.

Since, the fees for both the hearings was received in advance, it must be accounted in the following manner:

half of the fees i.e. Tshs10 million/2 = Tshs5 million is treated as a revenue in 20X3 and
the remaining amount is treated as income received in advance



(a) The journal entry

Dr	Cash	Tshs10 million	
Cr	Professional fees		Tshs10 million

Being cash received

Dr	Professional fees (SOPL)	Tshs5 million	
Cr	Professional fees received in advance (SOFP)		Tshs5 million

Being adjustment for fees received in advance recorded

Continued on the next page

Professional fees (income) account
(Year 20X2-X3)

Dr	Tshs'000		Cr Tshs'000
Transferred to SOPL (balancing figure)	5,000		
Fees received in advance	5,000	Cash (receipts)	10,000
	10,000		**10,000**

Fees received in advance shown here as a reduction from income

Professional fees received in advance (liability) account
(Year 20X2-X3)

Fees received in advance recorded here as a liability

Dr	Tshs'000		Cr Tshs'000
		Professional fees	5,000
	X		

(b) Presentation in the financial statements

The income from professional fees in the statement of profit or loss is reduced by Tshs5 million.
The fees received in advance are shown as a current liability in the statement of financial position.

(c) At the beginning of next year, the journal entry is reversed.

In the example considered above, the entry would be:

Dr Professional fees received in advance (SOFP) Tshs5 million
Cr Professional fees (SOPL) Tshs5 million
Being reversal of fees received in current year, in order to record income in the current year

---

Here is a summary of what we studied in this Learning Outcome:

Sr. No	Description	Adjustment entry	Treatment in the SOPL	Treatment in the SOFP
1	**Accrued expenses**			
	These are expenses which are due for the period but not paid. For example, outstanding rent, wages, etc.	Dr Expense A/c (SOPL) Cr Outstanding expense A/c Being outstanding expenses charged to the SOPL	Appears on the debit side of SOPL	Appears on the liabilities side of SOFP
2	**Accrued income**			
	It refers to the income earned during the year but not yet received. For example, accrued rent, commission, etc.	Dr Accrued income A/c Cr Income A/c (SOPL) Being accrued income credited to the SOPL.	Appears on the credit side of SOPL	Appears on the asset side of SOFP

Continued on the next page

3	**Prepaid expenses**			
	It refers to expenses that are not due, but are paid in advance. For example, prepaid rent, insurance premium, etc.	Dr Prepaid expense A/c Cr Expense A/c (SOPL) Being prepaid expenses recorded	Appears on the debit side of SOPL as a deduction from the respective expense.	Appears on the asset side of SOFP
4	**Income received in advance**			
	It refers to income received in advance i.e. before the due date of its receipt. For example, advance rent received.	Dr Income A/c (SOPL) Cr Income received in advance A/c Being income received in advance recorded	Appears on the credit side of SOPL as a deduction from the respective income account	Appears on the liability side of SOFP

Test Yourself 1

Selection Ltd has taken a loan from Chartered Bank on 1 October 20X3. Interest is due on a six monthly timeline i.e. on 31 March, and 30 September. Each interest instalment is Tshs6 million. According to the local laws, Selection prepares its financial statements to the year ended 30 June. What is the amount of accrued interest that Selection would show in its financial statement for the year ended 30 June 20X4?

A Tshs4 million
B Tshs12 million
C Tshs6 million
D Tshs3 million

Test Yourself 2

Brilliant Brains Ltd, made a deposit of Tshs500 million on 1 April 20X3. Interest on the fixed deposit is accrued quarterly (31 March, 30 June, 30 September and 31 December) but only paid at maturity. The end of the reporting period is 31 August 20X3. Monthly interest is Tshs3 million. The amount to be shown in the statement of financial position is____________.

Test Yourself 3

Saligo Traders earns sales commission on the orders he obtains for Shoe Makers Inc. On 30 December 20X3 Shoe Makers Inc paid commission of Tshs55 million for the year 20X3. Saligo records the commission income only when the related sales orders are executed by Shoe Makers. Later, it was found out that an order, on which a commission of Tshs8 million was due, was executed only on 7 January 20X4. Therefore, this commission amount was due in 20X4, but was erroneously included in the amount of Tshs55 million paid for 20X3. Give accounting entries for 20X3 and 20X4 and the relevant extracts from the financial statements for 20X3.

2. Adjust for an allowance for bad and doubtful debts.

[Learning Outcome b]

2.1 Bad debt

Sometimes, despite effort taken to establish the creditworthiness of customers, there are still amounts that are not recoverable. These amounts are called bad debts or irrecoverable debts in business parlance.

Bad debts could arise as a result of various reasons including:

insolvency of a customer
death of a customer
dishonesty

2.2 Allowance for bad and doubtful debts

The management of most companies can reliably estimate the percentage of debts which become bad. They rely heavily on the past accounting data and other general information to arrive at this percentage.

Prudence dictates that the company must recognise the estimated bad debts as a cost in the statement of profit or loss. This cost recognised as an allowance for receivables ensures that the profits and the assets of an entity are not overstated. However, at this stage, management would not know precisely which accounts have actually become bad. Therefore, it is not possible or desirable to write off any specific accounts. An allowance for receivables also known as an allowance for bad debts allows the entity to recognise the cost, without touching individual receivable accounts. This overall allowance for a certain percentage is known as a general allowance for receivables.

The accounting entries are as follows:

1. In the year in which the allowance is created:

Dr	Bad and doubtful debts expense	X	
Cr	Allowance for receivables		X

Being an allowance made against doubtful debts

The doubtful debts expense is an expense account in the statement of profit or loss. It usually forms a part of the bad debt expense account.

The allowance for receivables is a separate account which is reduced from trade receivables in the statement of financial position.

2. In subsequent years, the following steps are taken:

(a) The allowance required at the end of the financial year will change as the sales figure will have changed. A new allowance is calculated (e.g. on percentage of sales in the subsequent year-end).

(b) It is compared with the existing (opening) balance of the allowance.

If the new allowance required is greater than the existing opening balance then allowance has to be increased.

The following journal entry is made:

Dr	Bad and doubtful debts expense	X	
Cr	Allowance for receivables		X

Being an increase in allowance for receivables accounted for

If the new allowance required is less than the existing opening balance then allowance has to be decreased.

The following journal entry is made:

Dr	Allowance for receivables	X	
Cr	Bad and doubtful debts expense		X

Being a decrease in allowance for receivables accounted for

Example

Headsar Ltd has total receivables outstanding on 31 March 20X3 of Tshs32 million. It is estimated that 1.5% of the receivables will not be collected, so therefore it was decided to make an allowance for this. Being the first year there is no opening balance of allowance for receivables. On 31 March 20X4, the receivables outstanding are Tshs52 million. The allowance is made at the rate of 7%. You are asked to make the accounting entries.

1. Journal entry as on 31 March 20X3

Dr	Bad and doubtful debt expense	Tshs480,000	
Cr	Allowance for receivable		Tshs480,000

Being an allowance made for doubtful debts

Allowance required = Tshs32 million x 1.5% = Tshs480,000

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2. In the subsequent year i.e. on 31 March 20X4

Dr	Bad and doubtful debt expense	Tshs3,160,000	
Cr	Allowance for receivables		Tshs3,160,000

Being the increase in allowance made against doubtful debts

Note

Allowance required for the current year	=	Tshs52 million x 7% =	Tshs3,640,000
Less: Existing balance in the allowance account			Tshs 480,000
			Tshs3,160,000

2.3 Presentation in the financial statements

1. Presentation in statement of profit or loss

(a) Bad debts are transferred to the statement of profit or loss as an expense.
(b) The increase in the allowance for receivables during the year is transferred to the statement of profit or loss as an expense.
(c) The decrease in the allowance for receivables during the year is transferred to the statement of profit or loss as a credit in the total bad and doubtful debt expense.
(d) If the decrease in the allowance for receivables during the year is greater than the bad debt expense then the excess is disclosed as an increase in the expenses.

Diagram 1: Credit in statement of profit or loss

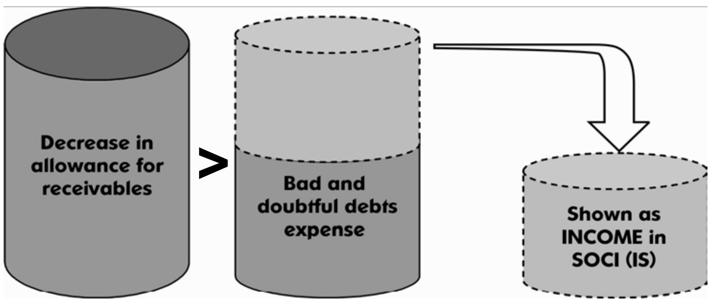
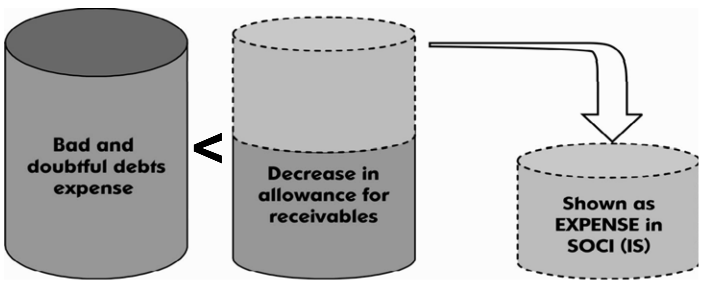


Diagram 2: Debit in statement of profit or loss



Example

The following is date pertaining to Excello Co and Demello Co during 20X3 regarding bad debts written off and change in allowance for receivables:

	Excello	Demello
	Tshs'000	**Tshs'000**
Bad debts written off	70,000	80,000
Change in the allowance for receivables	(50,000)	(90,000)
Net amount	**20,000**	**(10,000)**

The difference between bad debts written off and allowance for receivables is recognised in the following manner:

Excello Tshs20 million: reflect as an expense in the statement of profit or loss.
Demello (Tshs10 million): reflect as other income in the statement of profit or loss or as a reduction in bad debt expense.

2. Presentation in statement of financial position

The closing balance of the allowance for receivables is always reduced from the trade receivables in the statement of financial position. This reduces the trade receivables to their net realisable value. In real life, the net figure of receivables may be shown directly in the statement of financial position.

In the examination present it in the following manner:

	Tshs'000
Trade Receivables	350,000
Less: Allowance for receivables	(20,000)
Net Trade receivables	**330,000**

This shows the examiner that you know the correct procedure.

Example

Information provided by Clover Ltd for the last three years is as follows:

	31/12/20X1	31/12/20X2	31/12/20X3
	Tshs'000	Tshs'000	Tshs'000
Gross profit	32,000	48,000	64,000
Irrecoverable debts written off	2,000	1,000	3,000
Receivables as at 31 December	45,000	58,000	42,000
Salary	2,000	5,000	4,450
Conveyance	1,000	1,100	1,300
Other expenses	1,000	1,500	2,000
Vehicle expenses	2,000	2,330	2,830

Allowance for receivables at 2% on opening balance of receivables
Being the first year of operation, there were no opening balances for 20X1.
Prepare the statement of profit or loss and show how the receivables will appear in the statement of financial position.

Answer

Statement of profit or loss for the year

	20X1		20X2		20X3	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Gross profit		32,000		48,000		64,000
Expenses						
Irrecoverable debts written off	2,000		1,000		3,000	
Increase / decrease in allowances for receivables (W1)	900		260		(320)	
Salary	2,000		5,000		4,450	
Conveyance	1,000		1,100		1,300	
Other expenses	1,000		1,500		2,000	
Vehicle expenses	2,000	(8,900)	2,330	(11,190)	2,830	(13,260)
Net profit / loss		**23,100**		**36,810**		**50,740**

Extracts from the statement of financial position as at:

	31/12/20X1	31/12/20X2	31/12/20X3
	Tshs'000	Tshs'000	Tshs'000
Current assets			
Receivables	45,000	58,000	42,000
Less: Allowance for receivables (W1)	(900)	(1,160)	(840)
Net receivables	**44,100**	**56,840**	**41,160**

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Workings

W1 Allowance for receivables

31 December 20X1

Allowance required = 2% of x Tshs45 million= Tshs900,000
No opening balance of allowances, therefore an allowance should be made for Tshs900,000.

31 December 20X2

	Tshs'000
Allowance required = 2% x Tshs58 million	1,160
Less: Balance in allowance account	(900)
Increase in allowance	**260**

31 December 20X3

	Tshs'000
Allowance required = 2% x Tshs42 million	840
Less: Balance in allowance account	(1,160)
Decrease in allowance	**(320)**

Test Yourself 4

Somergate Co's books showed the following balances on 31 December 20X3.

	Debit	**Credit**
Trade Receivables	Tshs300 million	
Allowance for receivables		Tshs5 million

A debt of Tshs10 million receivable from Tomergate was confirmed to be irrecoverable during 20X3. No accounting entry was made to record this. It was decided that the allowance for receivables would be maintained at 2% of the receivables.

Required:

Show the accounting entries for the above transactions and the presentation in the financial statements.

Test Yourself 5

Allowance for receivables is made:

(i) when, on the basis of past experience, it is estimated that a certain percentage of the receivables are not recoverable on an average
(ii) in accordance with the accounting principle of prudence
(iii) when management is not sure exactly which receivables accounts will definitely become irrecoverable
(iv) on the total amount of receivables without touching individual receivable accounts

Which of the above is correct?

A (i)
B (i) and (ii)
C (i), (ii) and (iii)
D All of the above

3. Adjust for depreciation of non-current assets.

[Learning Outcome c]

3.1 Depreciation

Definition

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

IAS 16 Property, plant and equipment

Non-current assets are acquired at a cost. However, it would be incorrect to charge the entire cost in the first year itself. The asset is going to help generate income for many years.

The matching principle requires that the expenses be recognised in the year in which the revenue is recognised (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.

Example

Sales revenue in a year was Tshs100 million. Cost of material for the goods produced and sold was Tshs60 million (For simplicity, assume that there was no opening or closing inventory.)

Cost of machine used in the manufacture of these goods is Tshs80 million. The machinery has 10 years working life.

Since the life of the machine is 10 years, 1/10 of the life and cost of the machine are consumed in producing these goods. Therefore, 1/10 of the cost i.e. Tshs80 million x 1/10 = Tshs8 million is charged as a depreciation. (This calculation is according to the straight line method of depreciation - you will study about this in more detail later in this Learning Outcome.)

---

1. Methods of depreciation

There are a **variety of depreciation methods** including the **following two most widely used methods of depreciation:**

(a) Straight-line method

This method results in a constant charge over the useful life of the asset. The asset's residual value does not change and depreciation is calculated as a fixed amount every year or a fixed percentage of the original cost.

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

Example

Tapra Ltd bought machinery on 01 January 20X3 for Tshs260 million. It incurred transportation and installation expenses of Tshs20 million in connection with the machinery. Tapra Ltd expects the useful life of the asset to be 6 years. The estimated realisable value after 6 years is expected to be Tshs10 million.

Calculate the depreciation for six years.

Answer

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

$$= \frac{(\text{Tshs260 million} + \text{Tshs20 million}) - \text{Tshs10 million}}{6} = \text{Tshs45 million}$$

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The carrying values at the end of each year will be as follows:

1^{st} year	Tshs280 million - Tshs45 million	Tshs235 million
2^{nd} year	Tshs235 million - Tshs45 million	Tshs190 million
3^{rd} year	Tshs190 million - Tshs45 million	Tshs145 million
4^{th} year	Tshs145 million - Tshs45 million	Tshs100 million
5^{th} year	Tshs100 million - Tshs45 million	Tshs55 million
6^{th} year	Tshs55 million - Tshs45 million	Tshs10 million

(b) Diminishing or reducing balance method

Under this method, depreciation is charged as a percentage of the written down or book value of the asset i.e. cost minus accumulated depreciation. This is also known as the **reducing balance method.** This method results in a decreasing charge over the useful life of the asset.

Depreciation = (Cost - Accumulated depreciation) x Depreciation rate

Example

KPL Inc purchased machinery for Tshs10 million on 1 January 20X3. Its expected life is 4 years and the residual disposal value is Tshs1,296,000. KPL charges depreciation at 40% using the reducing balance method. Calculate the depreciation amount for 4 years.

Answer

Calculation of the depreciation amount:

Year	Particulars	Calculation	Depreciation	Carrying value
1^{st} year	Depreciation	= Tshs10,000,000 x 40%	= Tshs4,000,000	
	Carrying value	= Tshs10,000,000 - Tshs4,000,000		= Tshs6,000,000
2^{nd} year	Depreciation	= Tshs6,000,000 x 40%	= Tshs2,400,000	
	Carrying value	= Tshs6,000,000 - Tshs2,400,000		= Tshs3,600,000
3^{rd} year	Depreciation	= Tshs3,600,000 million x 40%	= Tshs1,440,000	
	Carrying value	= Tshs3,600,000 - Tshs1,440,000		= Tshs2,160,000
4^{th} year	Depreciation	= Tshs2,160,000 x 40%	= Tshs864,000	
	Carrying value	= Tshs2,160,000 - Tshs864,000		= Tshs1,296,000

The depreciation charged in this method keeps reducing every year. In this case it was Tshs4,000,000 in the first year, which gradually reduced to Tshs864,000.

2. Adjustment for depreciation while preparing financial statements

Accumulated depreciation refers to the accumulation of depreciation expenses of each year. It reflects the loss of value of the asset due to wear and tear, usage of asset, obsolescence, etc., and is reflected in the statement of financial position as a reduction from the gross value of the asset.

The accounting entries for recording depreciation expenses are as follows:

(a) When the asset is purchased

Dr	Asset account	X	
Cr	Cash / Bank account for the amount paid		X
Cr	Liability account for the amount unpaid		X

Being asset purchased

(b) When depreciation is charged

Dr	Depreciation account	X	
Cr	Accumulated depreciation account		X

Being depreciation charged

(c) To transfer depreciation to statement of profit or loss

Dr	SOPL	X	
Cr	Depreciation account		X

Being depreciation transferred to the statement of profit or loss

3. Treatment of Depreciation in the financial statements

SOPL: Depreciation expense appears on the debit side of statement of profit or loss
SOFP: Depreciation is presented on the asset side ofstatement of financial position as a deduction from the respective asset account

Accumulated depreciation has been explained through the following comprehensive example:

Example

On 1 January 20X1 Kalbros Ltd purchased a second-hand plant for Tshs72 million and immediately spent Tshs48 million on getting the plant into working condition. On 1 July 20X1, an additional plant that cost Tshs48 million was purchased. On 1 July 20X3 the plant purchased on 1 January 20X1 became obsolete and was sold for Tshs60 million. On 1 July 20X3 another new plant was purchased at a cost of Tshs144 million. The firm calculated depreciation under the reducing balance method at 15% per annum. Show the machinery account and the accumulated depreciation account for the calendar years 20X1 to 20X3.

Answer

To identify the plants, let us give them nos. I, II and III
The plant-wise break up is given in the account itself. This can also be given in a separate working.

Machinery account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X1	Bank account (purchased plant I)	72,000			
01/01/20X1	Bank (or cash) account (expenses to get the plant I into working condition)	48,000			
01/07/20X1	Bank account (purchased plant II)	48,000	31/12/20X1	Balance c/f	
				Plant I	120,000
				Plant II	48,000
		168,000			**168,000**
Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X2	Balance b/f				
	Plant I	120,000			
	Plant II	48,000			
			31/12/20X2	Balance c/f	
				Plant I	120,000
				Plant II	48,000
		168,000			**168,000**
Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X3	Balance b/f		01/01/20X3	Accumulated depreciation	39,803
	Plant I	120,000			
	Plant II	48,000			
01/07/20X3	Bank (bought plant III)	144,000	01/07/20X3	Bank (sale proceeds: plant I)	60,000
				SOPL (Loss on sale Tshs120,000,000 - Tshs39,803,000 - Tshs60,000,000)	20,197
			31/12/20X3	Balance c/f	
				Plant II	48,000
				Plant III	144,000
		312,000			**312,000**

Continued on the next page

Accumulated depreciation account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X1	Balance c/f		31/12/20X1	Depreciation	
	Plant I	18,000		**On plant I** (for full year)	18,000
	Plant II	3,600		(Tshs72 million + Tshs48 million) x 15%	
				On plant II	3,600
				(for 6 months)	
				Tshs48 million x 15% x 6/12	
		21,600			**21,600**
Date		**Tshs'000**	**Date**		**Tshs'000**
			01/01/20X2	Balance b/f	18,000
				Plant I	3,600
				Plant II	
31/12/20X2	Balance c/f		31/12/20X2	**Depreciation provision**	
	Plant I	33,300		**On plant I** (for full year)	15,300
	Plant II	10,260		Tshs102 million x 15%	
				On plant II (for full year)	6,660
				Tshs44.4 million x 15%	
		43,560			**43,560**
Date		**Tshs'000**	**Date**		**Tshs'000**
			01/01/20X3	Balance b/f	
				Plant I	33,300
				Plant II	10,260
31/07/20X3	Machinery account	39,803	01/07/20X3	**Depreciation provision**	
	(Accumulated depreciation on plant I transferred)			(**Plant I** - 6 months) Tshs86.7 million x 15% x 6/12)	6,503
			31/12/20X3	**Depreciation provision:**	
				On plant II (for full year	5,661
				Tshs37.74 million x 15%)	
				On plant III	10,800
				(for 6 months Tshs144 million x 15 % x 6/12)	
31/12/20X3	Balance c/f				
	Plant II	15,921			
	Plant III	10,800			
		66,524			**66,524**

Continued on the next page

Depreciation Account

Dr **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X1	Accumulated depreciation On plant I (for full year) (Tshs72 million + Tshs48 million) x 15%	18,000			
	On plant II (for 6 m) Tshs48 million x 15% x 6/12	3,600	31/12/20X1	SOPL - transfer	21,600
		21,600			**21,600**
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X2	Accumulated depreciation on plant I (for full yr) Tshs102 million x 15%	15,300			
	On plant I (for full yr) Tshs44.4 million x 15%	6,660	31/12/20X2	SOPL - transfer	21,960
		21,960			**21,960**
Date		**Tshs'000**	**Date**		**Tshs'000**
31/07/20X3	Accumulated depreciation (Plant I - 6 months) Tshs86.7 million x 15% x 6/12)	6,503	31/07/20X3		
31/12/20X3	Depreciation provision: On plant II (for full year Tshs37.74 million x 15%)	5,661			
	On plant III (for 6 months)(Tshs144 million x 15% x 6/12)	10,800	31/12/20X3	SOPL - transfer	22,964
		22,964			**22,964**

Test Yourself 6

Which of the following is the most important purpose for charging depreciation?

A To record the decrease in the value of an asset
B To provide an amount for the replacement of an asset
C To comply with accrual and the matching principle
D None of the above

Test Yourself 7

Depreciation ceases to be charged:

(i) On the date when the asset is classified as held for sale.
(ii) On the date when the asset is derecognised.
(iii) When the asset becomes idle or is retired from active use, irrespective of whether it is fully depreciated or not.

A (i)
B (i) and (ii)
C (ii) and (iii)
D (i) and (iii)

Test Yourself 8

In the statement of profit or loss, the amount of depreciation recorded is for the:

A Remaining life of the asset
B Number of years the asset is used i.e. accumulated depreciation since the purchase of the asset
C Current period
D None of the above

---

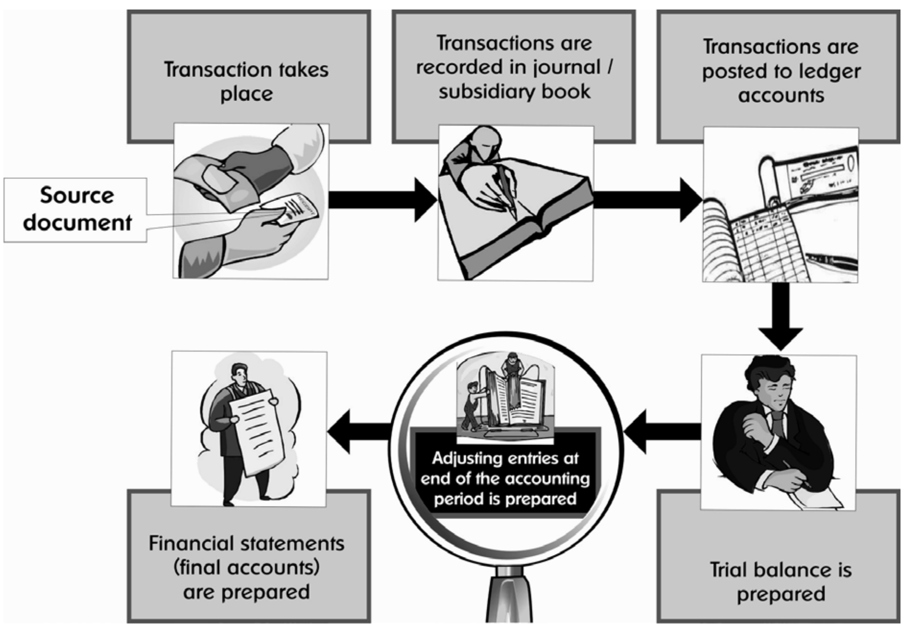
4. Explain the importance of adjusting trial balance at the year end.
Prepare trial balance incorporating the necessary year end adjustments.
[Learning Outcomes d and e]

4.1 Adjusted trial balance

An adjusted trial balance is a trial balance which is prepared after taking into account all the adjustments and estimates like accrued income and expenses, depreciation, allowance for receivables, etc. It is also known as an extended trial balance. We have already discussed all these adjustments in this Study Text.

The importance of a trial balance in financial statements ensures that the accounting cycle is followed correctly and that every transaction in the business is recorded accurately. The purpose of preparing adjusted or extended trial balance is to make adjustments that had not been made when a normal trial balance was extracted. In other words, adjusted trial balance is prepared to make adjustments that were omitted in order to prepare an accurate final accounts and the statement of financial position.

Diagram 3: The accounting cycle



4.2 The following steps will help you to solve questions on this topic:

1. Carefully read the additional information given and link it to the items in the trial balance that need adjustment. Be careful, some items in the trial balance may need more than one adjustment.
2. Prepare a proforma of the relevant statement, writing in the main headings. The proforma can also include subheadings given in the trial balance.
3. Pick up items from the additional information one by one and:

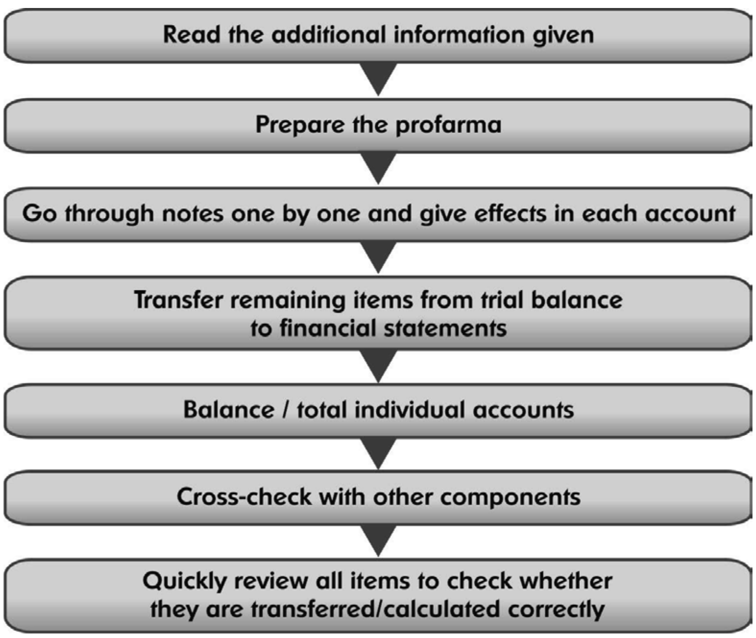
    review it jointly with the relevant trial balance item
    apply the correct IFRS provisions
    prepare workings if required and cross-reference them clearly in the proforma
    transfer the result of the workings to the financial statements
    mark the items in the trial balance that have been dealt with up to this point.

4. Take the remaining items from the trial balance and write them at the appropriate places in the financial statements.
5. Balance or total the individual components of the financial statements.
6. Cross-check with the other components where a link is expected e.g. statement of profit or loss to statement of financial position, etc.
7. If the SOFP does not balance, quickly recheck whether all the items have been taken and / or calculated correctly.

Tip

In the exam, 9 times out of 10 your SOFP will not balance, probably because of a small mistake made somewhere. It is NOT WORTH spending time working out where this mistake is, as it will not get you a lot of extra marks. It is better to go on to the next question, where you have a better chance of obtaining more marks! If you have time at the end of the paper, then go back and look for the mistake.

Diagram 4: Steps to solve questions



The following example explains the method of preparing an extended trial balance.

Example

On 31 December 20X3, the ledger balances of PVR Ltd are as follows.

	Tshs'000
Sales	450,000
Purchases	280,000
Salaries	8,000
Electricity charges	27,000
Auditor's fees Bad	11,000
debts Miscellaneous	800
income Accounts	16,000
payable Rent	38,800
Insurance premium	15,000
Land & building	12,000
Intangible assets	240,000
Inventory (1 January 20X3)	80,000
Cash	40,000
Share capital	8,000
Retained earnings	150,000
Motor vehicle	60,000
Bank loan	50,000
Taxes (paid upto 30 June 20X3)	110,000
Provision for bad debts	9000
Accumulated depreciation on building	2,800
Accumulated depreciation on motor vehicle	18,000
Accounts receivable	11,000
Advertising	70,000
Allowance for receivables	5,850
	2,400

The following are the adjustments:

1. Depreciation of motor vehicle is 20% on cost and building is @ 5%.
2. Irrecoverable debts to be written off are Tshs5 million.
3. Allowance for receivables to be increased to 2% of net accounts receivables.
4. Closing inventory for the year is Tshs30 million.
5. Advertising expenses were paid only for 9 months.
6. Rent includes amount paid upto 31 March 20X3.
7. Purchases of Tshs2.35 million were not recorded in the purchases account.

Required:

Prepare an extended trial balance from the details mentioned above.

Continued on next page

Answer

First prepare the initial trial balance.

PVR Ltd
Trial balance as at 31 December 20X3

	Debit	Credit
	Tshs'000	**Tshs'000**
Sales		450,000
Purchases	280,000	
Salaries	8,000	
Electricity charges	27,000	
Auditor's fees Bad	11,000	
debts Miscellaneous	800	
income Accounts		16,000
payable Rent		38,800
Insurance premium	15,000	
Land & building	12,000	
Intangible assets	240,000	
Inventory (1 January 20X9)	80,000	
Cash	40,000	
Share capital	8,000	
Retained earnings		150,000
Motor vehicles		60,000
Bank loan	50,000	
Taxes (paid upto 30 June 20X9)		110,000
Provision for bad debts	9,000	
Accumulated depreciation on building		2,800
Accumulated depreciation on motor vehicle		18,000
Accounts receivable		11,000
Advertising	70,000	
Allowance for receivables	5,850	
Suspense		2,400
	2,350	
	859,000	**859,000**

Now we can see that the debit and credit of the trial balance does not tally. This difference is entered in the suspense account because there are errors in the accounts. According to the additional information given, purchases of Tshs2,350,000 are not recorded in the purchases account. So, this will appear in the suspense account. This can be understood with the help of W1.

Now we will prepare an extended trial balance. An extended trial balance can be prepared with the help of the trial balance above. A debit and a credit column are added for all the adjustments. Adjustments also include accruals and prepayments, closing inventory, etc.

Continued on next page

PVR Ltd
Extended trial balance as at 31 December 20X3

			Adjustments		SOPL		SOFP	
	Debit	Credit	Debit	Credit	Debit	Credit		
	Tshs'000							
Sales		450,000				450,000		
Purchases (W1)	280,000		2,350		282,350			
Salaries	8,000				8,000			
Electricity charges	27,000				27,000			
Auditor's fees Bad	11,000				11,000			
debts Miscellaneous	800				800			
income Accounts		16,000				16,000		
payable		38,800						38,800
Rent (W6)	15,000			3,000	12,000			
Insurance premium	12,000				12,000			
Land & building	240,000						240,000	
Intangible assets	80,000						80,000	
Inventory (opening)	40,000				40,000			
Cash	8,000						8,000	
Share capital		150,000						150,000
Retained earnings		60,000						60,000
Motor vehicles	50,000						50,000	
Bank loan		110,000						110,000
Taxes (W7)	9000			3,000	6,000			
Provision for bad debts		2,800				2,800		
Accumulated depreciation on building (W3)		18,000		12,000				30,000
Accumulated depreciation on motor		11,000		10,000				21,000
Accounts receivable	70,000			5,000			65,000	
Advertising (W5)	5,850		1,950		7,800			
Allowance for receivables (W4)		2,400		1,300		3,700		
Suspense (W1)	2,350			2,350				
Depreciation expenses (SOPL)(W2) (W3)			22,000		22,000			
Irrecoverable debts			6,300		6,300			
Inventory (SOFP) (W8)			30,000				30,000	
Inventory (SOPL) (W8)				30,000		30,000		
Accruals (advertising) (W5)				1,950				1,950
Prepayments (rent and taxes) (W6) (W7)			6,000				6,000	
Profit for the year					67,250			67,250
Total	**859,000**	**859,000**	**68,600**	**68,600**	**502,500**	**502,500**	**479,000**	**479,000**

After making all the adjustments, the suspense account should be cleared and the adjustments column's debits and credits should be equal.

To calculate the profit we have to make a column of the statement of profit or loss with the debit and credit. All the revenue and expense accounts are extended to the statement of profit or loss columns. The statement of profit or loss debits and credits are added and the balancing figure is either profit or loss. The debit in the statement of profit or loss is a profit and the credit in the statement of profit or loss is a loss.

Continued on next page

The extended trial balance has SOFP columns with debit and credit. All the assets, liabilities and capital are extended to the SOFP columns. The 'difference' figures in statement of profit or loss column and SOFP column should be the same. This difference reflects the net profit or net loss for the period. Net profit increases the capital and will go on the credit side of the SOFP column. Net loss decreases the capital and will go on the debit side of the SOFP column.

Working notes

W1

To clear the suspense account, the journal entry is passed and it is entered in extended trial balance.

Journal entry

Dr Purchases Tshs2.35 million
Cr Suspense Tshs2.35 million
Being purchases recorded through suspense account

Dr Suspense account Cr

	Tshs'000		Tshs'000
Balance b/f	2,350	Purchases	2,350
Total	**2,350**	**Total**	**2,350**

W2

Depreciation on motor vehicle = 20% x Tshs50 million
= Tshs10 million

Dr Depreciation expenses Tshs10 million
Cr Accumulated depreciation on motor vehicle Tshs10 million
Being depreciation provided on motor vehicle

W3

Depreciation on building = 5% x Tshs240 million
= Tshs12 million

Dr Depreciation expenses Tshs12 million
Cr Accumulated depreciation on building Tshs12 million
Being depreciation provided on building

W4

Allowance for receivables is to be increased to 2% on net accounts receivables
Net accounts receivables = Tshs70 million - Tshs5 million (irrecoverable debts)
= Tshs65 million

Allowance for receivables = 2% x Tshs65 million
= Tshs1.3 million

Dr Irrecoverable debts Tshs6.3 million
Cr Allowance for receivables Tshs1.3 million
Cr Receivables Tshs5 million
Being allowances for receivables provided

W5

Advertising expenses are paid upto 30 September 20X3. So, expenses for 3 months are outstanding.
Advertising expenses = Tshs5.85 million x 3/9
= Tshs1.95 million

W6

Rent was paid upto 31 March 20X3
Rent prepaid = Tshs15 million x 3/15
= Tshs3 million

Continued on the next page

W7

Taxes are paid from 1 January 20X3 to 30 June 20X3. So it is prepaid for 6 months.
Provision for taxes = Tshs9 million x 6/18
= Tshs3 million

W8

Journal entry for closing inventory

Dr Closing inventory (SOFP) Tshs30 million
Cr Closing inventory (SOPL) Tshs30 million
Being entry for closing inventory

Test Yourself 9

The ledger balances of Scorpio Ltd on 31 December 20X3 are as follows.

	Debit	Credit
	Tshs'000	**Tshs'000**
Sales		550,000
Purchases	370,000	
Salaries	14,000	
Repairing	25,000	
Commission	4,000	
Bad debts	1,200	
Office expenses	20,000	
Miscellaneous income		15,400
Rent received		25,000
Dividend	16,000	
Furniture	60,000	
Building	200,000	
Intangible assets	90,000	
Inventory (opening)	30,000	
Cash	5,800	
Share capital Retained		160,000
earnings Provision for		25,000
bad debts Bank loan		600
Total		60,000
	836,000	**836,000**

Additional information:

1. Scorpio gave one of its premises on rent from 1 May 20X3 for a monthly rate of Tshs2.5 million.
2. Depreciation on furniture is to be provided at 10% annually on reducing balance method.
3. Scorpio is required to create a provision for warranty claims for Tshs4 million.

Required:

Prepare an extended trial balance using the details above.

Answer to Test Yourself

Answer to TY 1

The correct option is **D**.

Two instalments of Tshs6 million in a year amounts to the yearly interest expense of Tshs12 million. Hence, the monthly interest charge would be Tshs1 million.

The last instalment of Tshs6 million made on 31 March 20X4 would include the period from 1 October 20X3 to 31 March 20X4. The next instalment of Tshs6 million to be made on 30 September 20X4 would include the period from 1 April 20X4 to 30 September 20X4. This instalment would be made in the next accounting period. Hence, the amount of interest accrued would be equal to 3 months interest charge (from 1 April 20X4 to 30 June 20X4) Tshs3 million. This is the amount of interest that has accrued, but has not been paid.

Answer to TY 2

Interest for 5 months will accrue i.e. from 1 April 20X3 to 31 August 20X3. Therefore the amount to be shown in the statement of financial position is Tshs15 million.

Answer to TY 3

When the amount of commission is received, the following entry would be made:

Dr	Cash account	Tshs55 million	
Cr	Commission (income)		Tshs55 million

Being receipt of commission from Shoe Makers Inc recorded

Unless an adjustment is made, this entire amount will be reflected as an income in the statement of profit or loss for the year ended 31 December 20X3. This is wrong. We need to remove the part related to 20X4 and show it in the statement of financial position as income received in advance. The commission of Tshs8 million was accrued only on 7 January 20X4, and hence relates to 20X4.

The following entry is made at the end of the financial year:

Dr	Commission (Income)	Tshs8 million	
Cr	Commission received in advance (Liability)		Tshs8 million

Being commission received in advance transferred to commission received in advance account

Extracts from financial statements:

Statement of profit or loss

Other income
Commission (Tshs55 million - Tshs8 million) Tshs47 million

Statement of financial position

Current liabilities

Commission received in advance Tshs8 million

Year 20X4

The entry given above is reversed at the beginning of 20X4

Dr	Commission received in advance (Liability)	Tshs8 million	
Cr	Commission (Income)		Tshs8 million

Being reversal of commission received in the current year, in order to record income in the current year

Answer to TY 4

Accounting entries

1.
Dr Bad debts account (expense) Tshs10 million
Cr Trade receivables Tshs10 million
Being amount receivable from Tomergate written off

2.
Dr Doubtful debts expense Tshs0.8 million
Cr Allowance for receivables Tshs0.8 million
Being the increase in allowance made against doubtful debts

Presentation in the financial statements (extracts)

Statement of profit or loss	**Tshs'000**
Expenses	
Bad debts	10,000
Allowance for bad debts (W1)	800

Statement of financial position	**Tshs'000**
Current assets	
Trade Receivables	290,000
Less: Allowance for receivables (W1)	(5,800)
	284,200

Workings

W1 Calculation of the allowance required

	Tshs'000
Amount of receivables	300,000
Less: Bad debts	10,000
Amount subject to allowance	**290,000**
Allowance @2% of Tshs290 million	5,800
Existing allowance	5,000
Additional allowance required	**800**

Answer to TY 5

The correct option is **D**.

All of the given statements relate to allowances for receivables.

Answer to TY 6

The correct option is **C**.

The most appropriate purpose for charging depreciation is to comply with accrual and the matching principle.

Answer to TY 7

The correct option is **B**.

Charging depreciation ceases when an asset is classified as held for sale or when it is derecognised. Depreciation does not end when the asset becomes idle or is retired from active use.

Answer to TY 8

The correct option is **C**.

The statement of profit or loss includes only the depreciation for the current year. Accumulated depreciation is considered in the statement of financial position in order to calculate the carrying amount.

Answer to TY 9

Scorpio Ltd
Trial balance as at 31 December 20X3

	Debit	Credit	Adjustments Debit	Adjustments Credit	SOPL Debit	SOPL Credit	SOFP Debit	SOFP Credit
	Tshs'000							
Sales		550,000				550,000		
Purchases	370,000				370,000			
Salaries	14,000				14,000			
Repairing	25,000				25,000			
Commission	4,000				4,000			
Bad debts	1,200				1,200			
Office expenses	20,000				20,000			
Miscellaneous income		15,400				15,400		
Rent received (W1)		25,000	5,000			20,000		
Dividend	16,000				16,000			
Furniture (W2)	60,000			6,000			54,000	
Building	200,000						200,000	
Intangible assets	90,000						90,000	
Inventory (opening)	30,000				30,000			
Cash	5,800						5,800	
Share capital Retained		160,000						160,000
earnings Provision for		25,000						25,000
bad debts Bank loan		600				600		
Rent received in advance (W1)		60,000						60,000
Depreciation on furniture (W2)				5,000				5,000
Warranty claims (W3)			6,000		6,000			
Provision for warranty			4,000		4,000			
Profit for the year				4,000				4,000
Total					95,800			95,800
	836,000	**836,000**	**15,000**	**15,000**	**586,000**	**586,000**	**349,800**	**349,800**

Working notes

W1 Rent

The premises is rented out from 1 May 20X3 and therefore the rent received for the period 1 May 20X3 to 31 December 20X3 relates to the current year 20X3, i.e. for 8 months.
Rent for 8 months = Tshs2.5 million x 8 = Tshs20 million
The actual rent received (according to the trial balance) is Tshs25 million
Therefore the remaining amount is treated as rent received in advance for the year 20X3.
Rent received in advance = Tshs25 million - Tshs20 million = Tshs5 million

The journal entry for rent received in advance is:
Dr Rent received (SOPL) Tshs5 million
Cr Rent received in advance (SOFP) Tshs5 million
Being rent received in advance recorded

Rent received account
Dr **(Year 20X3)** **Cr**

	Tshs'000		Tshs'000
Income and expense account (balancing figure)	20,000		
Rent received in advance	5,000	Cash (receipts)	25,000
	25,000		**25,000**

Rent received in advance shown here as a reduction from income

Rent received in advance (liability) account
(Year 20X3)

Dr			Cr
	Tshs'000		**Tshs'000**
		Rent received	5,000

Rent received in advance recorded here as a liability

W2 Depreciation

Depreciation for the year 20X3 is = Tshs60 million x 10% = Tshs6 million

The journal entry for charging the depreciation is:

Dr Depreciation account Tshs6 million
Cr Furniture account Tshs6 million
Being depreciation charged on furniture

Furniture account

Dr			Cr
	Tshs'000		**Tshs'000**
Balance b/f	60,000	Depreciation (12 months) Balance c/f	6,000 54,000
	60,000		**60,000**

Depreciation account

Dr			Cr
	Tshs'000		**Tshs'000**
Furniture	6,000	Income & Expense account	6.000
	6,000		**6,000**

W3 Warranty Claims

Journal entry for creating a provision for warranty claims

Dr Warranty claims (expense in the SOPL) Tshs4 million
Cr Provision for warranty claims (liability in the SOFP) Tshs4 million
Being provision made for warranty claims

Self Examination Questions

Question 1

Solotel Inc rented new premises for its office on 1 October 20X3 and paid four months' rent, amounting to Tshs20 million on the same date. Show the accounting entries and the extracts from the financial statements for the year ended 31 December 20X3.

Question 2

Mallone Inc invested Tshs100 million in 8% debentures on 1 November 20X3. The next due date for receiving the interest is 31 March 20X4. Show the accounting adjustments related to accrued interest for 20X3 and the extracts from the financial statements for 31 December 20X3.

Question 3

Shamelon Ltd has total receivables outstanding on 31 March 20X2 of Tshs29 million. It estimated that 2% of the receivables will not be collected and therefore decided to make an allowance for the same. Being the first year, there is no opening balance of allowance for receivables. On 31 March 20X3, the receivables outstanding are Tshs58 million. From the previous year's experience, it is decided that the allowance should be made for 5%.

State the amount of allowance which will be charged to Shamlon's statement of profit or loss in 20X3.

A Tshs2,900,000
B Tshs580,000
C Tshs2,320,000
D Tshs1,160,000

Question 4

Refer to the above question, and determine the amount of receivables that will appear in the statement of financial position on 31 March 20X3.

A Tshs55,100,000
B Tshs55,680,000
C Tshs56,840,000
D Tshs57,420,000

Question 5

KKAC Inc purchased machinery for Tshs25 million on 1 January 20X3. Installation charges are Tshs2 million. Its expected life is 4 years and the residual disposal value is Tshs3.5 million. Calculate the amount of depreciation under the reducing balance method for the first and second year. Rate of depreciation is given as 40% p.a.

Question 6

The ledger balances of Supreme Co on 31 December 20X3 are as follows.

	Tshs'000
Share capital	315,000
Inventory (1 January 20X3)	75,450
Sales	945,000
Purchases	572,000
Accounts receivable	147,000
Accounts payable	81,480
Salaries	16,800
Telephone charges	27,000
Auditor's fees Bad	23,100
debts Miscellaneous	2,680
income General	33,680
expenses Electricity	9,800
and rent	71,500
Property, plant and equipment	504,000
Accumulated depreciation on plant	37,880
Intangible assets	168,000
Cash in hand	12,670
Cash at bank	18,000
Provisions	126,000
Furniture and fittings	105,000
Accumulated depreciation on furniture	23,160
Local taxes	18,900
Long term loan	231,000

Additional information:

1. Furniture purchased during the year is for Tshs9 million, but is credited to the furniture and fittings account.
2. Electricity charges Tshs3.3 million posted to cash but not recorded in the ledger account.
3. The closing inventory for the year was Tshs62 million.
4. Provide depreciation for Plant at 5% of cost and furniture for 10% on cost.

Required:

Prepare extended trial balance using the details above.

Answers to Self Examination Questions

Answer to SEQ 1

When rent was paid, the entry would have been:

Dr	Rent (Expense)	Tshs20 million	
Cr	Cash		Tshs20 million

Being the payment of rent for four months from 1 October 20X3

At the year end, we need to adjust prepaid expenses.

The total amount paid is Tshs20 million for the period from 1 October 20X3 to 31 January 20X4.

The period from 1 October 20X3 to 31 December 20X3 relates to 20X3, and the rent expense for this period has accrued.

Rent for January 20X4 needs to be carried forward as prepaid rent, since it relates to the next financial year.

The amount of rent for January 20X4 is Tshs20 million/4 = Tshs5 million

The accounting entry is;

Dr	Prepaid rent (reflected as an asset in the SOFP	Tshs5 million	
Cr	Rent (reflected as an expense in the SOPL)		Tshs5 million

Being prepaid rent for January 20X4 adjusted

Extracts from financial statements:	**Tshs'000**	**Tshs'000**
Statement of profit or loss		
Administration expenses:		
Rent (Tshs20 million - Tshs5 million)	15,000	
SOFP		
Current assets		5,000
Prepaid rent		

It can be seen that the adjustment of prepaid rent of Tshs5 million ensures that only the rent for 20X3 is shown as an expense in the statement of profit or loss, and that the prepaid amount is shown as an asset. If this adjustment was not made, the full amount of Tshs20 million would have been shown as an expense.

Answer to SEQ 2

Interest from 1 November 20X3 to 31 December 20X3 has accrued until the end of the financial year 20X3. The amount is: Tshs100 million x 8/100 x 2/12 = Tshs1,333,000

The accounting entry is:

Dr	Interest accrued on 8% debentures (asset)	Tshs1,333,000	
Cr	Interest on debentures (income)		Tshs1,333,000

Being interest accrued until 31 December 20X3 on 8% debentures recorded

Extracts from financial statements:

Statement of profit or loss
Other Income:
Interest on 8% debentures Tshs1,333,000

Statement of financial position
Current Assets
Interest accrued on 8% debentures Tshs1,333,000

Answer to SEQ 3

The correct option is **C**.

	Tshs'000
Allowance made in the first year = Tshs29 million x 2%	580
Allowance required in the subsequent year = Tshs58 million x 5% =	2,900
Increase in allowance charged to statement of profit or loss	**2,320**

Answer to SEQ 4

The correct option is **A**.

Balance of receivables on 31/03/20X3	Tshs58,000,000
Less: Allowance for receivables	Tshs(2,900,000)
	Tshs55,100,000

While calculating the amount of receivables that will appear in the SOFP, the total allowance should be considered.

Balance of receivables that appears in the statement of financial position is Tshs55,100,000

Answer to SEQ 5

Cost of the assets = Tshs25 million + Tshs2 million = Tshs27 million

Calculation of the depreciation amount

Depreciation = (Cost - Accumulated depreciation) x Depreciation rate
= Carrying value x Depreciation rate

1st year: Depreciation = Tshs27 million x 40% = Tshs10.8 million
Carrying value = Tshs27 million - Tshs10.8 million = Tshs16.2 million

2nd year: Depreciation = Tshs16.2 million x 40% = Tshs6.48 million

Answer to SEQ 6

Supreme Co
Extended trial balance as on 31 December 20X3

			Adjustments		SOPL		SOFP	
	Debit	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**	**Debit**	**Credit**
	Tshs'000							
Share capital		315,000						315,000
Inventory (1 January 20X3)	75,450				75,450			
Sales		945,000				945,000		
Purchases	572,000				572,000			
Accounts receivable	147,000						147,000	
Accounts payable		81,480						81,480
Salaries	16,800				16,800			
Telephone charges	27,000				27,000			
Auditor's fees Bad	23,100				23,100			
debts Miscellaneous	2,680				2,680			
income General		33,680				33,680		
expenses	9,800				9,800			
Electricity and rent (W1)	71,500		3,300		74,800			
Property, plant and equipment	504,000						504,000	
Accumulated depreciation on plant (W2)		37,880		25,200				63,080
Intangible assets	168,000						168,000	
Cash in hand	12,670						12,670	
Cash at bank	18,000						18,000	
Provisions		126,000						126,000
Furniture and fittings (W1)	105,000		18,000				123,000	
Accumulated depreciation on furniture (W3)		23,160		12,300				35460
Local taxes	18,900				18900			
Long term loan		231,000						231,000
Suspense account (W1) Depreciation expenses (W2) (W3)	21,300			21,300				
Inventory (SOFP)			37,500		37,500			
Inventory (SOPL))			62,000				62,000	
Profit for the year				62,000		62,000		
					182,650			182,650
Total	**1,793,200**	**1,793,200**	**120,800**	**120,800**	**1,040,680**	**1,040,680**	**1,034,670**	**1,034,670**

Working notes

W1

To clear the suspense account, the following journal entry is passed, and it is entered in the extended trial balance.

Dr Furniture (Tshs9 million x 2) Tshs18 million
Dr Electricity and rent Tshs3.3 million
Cr Suspense Tshs21.3 million
Being errors recorded through the suspense account

Dr Suspense account Cr

	Tshs'000		**Tshs'000**
Balance b/f	21,300	Furniture Electricity	18,000 3,300
Total	**21,300**	**Total**	**21,300**

W2

Depreciation on plant = 5% x Tshs504 million
= Tshs25.2 million

Dr	Depreciation expenses	Tshs25.2 million	
Cr	Accumulated depreciation on plant		Tshs25.2 million

Being depreciation provided on plant

W3

The initial balance of furniture is Tshs105 million and after adjustments (W1) it is Tshs105 million + Tshs18 million = Tshs123 million

Depreciation on furniture = 10% x Tshs123 million
= Tshs12.3 million

Dr	Depreciation expenses	Tshs12.3 million	
Cr	Accumulated depreciation on furniture		Tshs12.3 million

Being depreciation provided on furniture

INTRODUCTION TO BASIC FINANCIAL STATEMENTS

9

Get Through Intro

Cooking food well is only half the job: The food will not be relished unless it is served in a proper manner! Similarly, doing day-to-day accounting well is only half the job. It will not serve its purpose unless the results are presented in a proper format, with the required content.

The process of accounting ends with the preparation of the financial statements. In this Study Guide, we will learn these concepts and also the method of preparing the statement of financial position. The importance of this Study Guide stems from the fact that the entire accounting exercise is undertaken in order to prepare financial statements.

The financial statements of an entity consist of a number of reports / statements - one such statement is the statement of financial position. The statement of financial position is a statement which reflects the financial position of an entity as at a particular date. The statement of financial position (along with its companions) - the statement of profit or loss and the statement of changes in equity, function like a thermometer - they depict whether the company is ailing or flourishing.

The three primary statements are not sufficient to report the financial performance and position of an entity. Financial statements have to contain some essential further information if they are to be helpful to investors and other users in taking decisions. For example, notes to accounts contain additional information about non-current assets, contingent assets and contingent liabilities.

This Study guide will help you understand the last and the most crucial step in the accounting process i.e. preparation of financial statements.

Learning Outcomes

a) State the objective and qualities of financial statements.
b) Show how information on the main financial statements may be useful to different categories of users.
c) State and explain the purpose, nature and relationships between the main financial statement components.
d) Demonstrate understanding of IAS 1
e) State and explain the basis and purpose of the accruals, cash and break-up bases of accounting.
f) Identify the elements of financial statements.
g) Demonstrate understanding of the framework for financial statements as per IFRSs.
h) Prepare financial statements for sole proprietor, company and partnership, namely.
    i. Statement of profit or loss
    ii. Statement of financial position
    iii. Statement of cash flows.

1. State the objective and qualities of financial statements.
Show how information on the main financial statements may be useful to different categories of users.
[Learning Outcomes a and b]

Financial statements are the accounting reports which are compiled in conformity with the provisions of GAAP (Generally Accepted Accounting Principles) to meet the common needs of wide range of users.

They provide information about the financial strength, performance and changes in financial position of an enterprise.

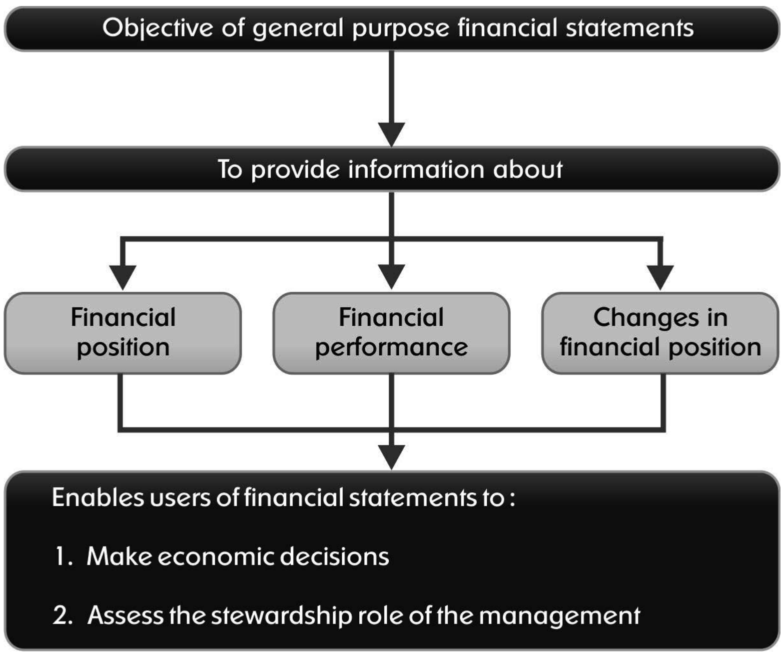
1.1 Objectives of financial statements

Financial reporting is aimed at responding mainly to the needs of external users of financial statements such as shareholders, banks, payables etc. in assisting them to assess:

- the financial position of the entity as at a certain moment, (what the company owns and owes)
- its financial performance during a period (how much profit the company has made) and
- the changes in the financial position from one period to the next. (how the company has performed this year compared to the last year)

The following diagram explains the objectives of financial statements.

Diagram 1: Objectives of financial statements



1.2 The need for the financial statements

Financial statements are important as they enable shareholders, banks, trade payables, etc. who are the external users of financial statements to assess the financial status of the company.

Tip

Financial statements only deal with past events and generally do not contain non-financial data.

1.3 Use of information on the main financial statements by different categories of users

There are several stakeholders who study / use an organisation's financial statements. We have already discussed in detail about the main groups of stakeholders and their information needs in Study Guide 1. The summary of different categories of users and their interest are summarised below.

Users	Use of information on the financial statements
1. Owners / Shareholders i.e. the providers of capital for running the operations of the entity	(a) To assess whether the entity has utilised the capital efficiently. (b) To ascertain the financial position of the entity i.e. information about the assets and liabilities of the company. (c) To determine whether the financial condition and performance is improving / deteriorating over time. (d) To determine the managements' efficiency in running the operations of the entity. (e) To know the extent to which the available profits can be distributed to the shareholders. (f) To assess the safety and growth of their investment. (g) To assess the stewardship function of the management.
2. Potential Investors i.e. the potential owners of the organisation	(a) To assess the organisation as a profitable investment destination. (b) To compare the financial statements of a number of companies from the same industry to make investment decision.
3. Management of the company who are appointed by the owners to supervise the day-to-day activities of the company	(a) Information relating to current and future financial position of the entity. (b) Financial statements act as a report card which reflect: the efficiency of the management in taking timely decisions throughout the year whether the business is profitable the effectiveness of managements control and planning
4. Providers of finance to the company, which include: trade payables funding the operations of the company bank providing overdraft facility long term finance, etc.	(a) To know about the future profitability of the entity. (b) To assess the entity's ability to generate sufficient cash flows to satisfy their debt repayments going forward. (c) To determine the value of the assets that the company has pledged as security / collateral.
5. Trade relations i.e. Suppliers and Vendors Customers	(a) Suppliers want to know the financial stability of the entity, i.e. the ability of the company to pay for the goods and services supplied. (b) Customers want to be assured about the continuity of operations and regular supply of goods and services.
6. Employees	(a) Employees are interested in the company's financial position as their salaries are dependent on it. (b) Employees use the financial statements to determine their future prospects for promotions, career development, etc.
7. Government and their agencies	(a) To know the allocation of resources taking different policy decisions. (b) To collate the information of all entities and compile national economic statistics. e.g. GDP
8. Financial analysts and advisers i.e. Stock Brokers Credit Agencies Journalists	(a) To make predictions on the future financial conditions of the entity on the basis of the current financial statements. (b) To advise their clients (potential investors) on whether to invest in a particular organisation or not.
9. Tax Authorities	(a) To know the business profits. (b) To determine the amount of tax payable by the company, e.g. income tax or VAT liability from revenue and purchase figures.

Test Yourself 1

Sun Inc has recorded the value of a property at Tshs10 million until last year. This year the company revalued the property and recorded it at Tshs15 million. Another effect of the increase in value was given by adding Tshs5 million to the reserves account. This adjustment was not disclosed anywhere in the financial statements.

Required:

Do the statements satisfy the understandability criterion?

Test Yourself 2

Mack owns a courier service. The business has four delivery vans to make deliveries in the entire city. The total cost of all the delivery vans is Tshs80 million. Mack has recently decided to start a business of delivering newspapers. For this purpose, last month, Mack purchased seven street bikes. The total cost of the bikes amounted to Tshs2.1 million.

Required:

Should Mack disclose the cost of the bikes in the financial statements?

Test Yourself 3

Does the general public use the financial statements of an entity? If so, state their interest?

2. State and explain the purpose, nature and relationships between the main financial statement components.
Demonstrate understanding of IAS 1 and IAS 7.

[Learning Outcomes c and d]

Financial statements have the following components:

1. Statement of profit and loss and other comprehensive income
2. Statement of financial position
3. Statement of changes in equity
4. Statement of cash flows
5. Notes to the financial statements

In Tanzania, business entities are required to prepare the financial statements in accordance with the Companies Act 2002. We will discuss all these financial components and the preparation of financial statements of companies in accordance with prescribed formats and relevant accounting standards. The formats of financial statements are provided in **IAS 1 "Preparation and presentation of financial accounts"**.

In most jurisdictions the structure and content of financial statements are determined by the local law. However companies adopting IFRS have to prepare financial statements in accordance with the requirements of IAS1. **IAS 1 gives the following guidance and format for preparation of financial statements.**

2.1 Statement of profit or loss and other comprehensive income (income statement)

This is a statement for a period, typically one year. Revenue, expenses and profits for the period for which it is prepared are to be included in the statement of profit or loss and other comprehensive income (also referred to as an income statement). It is like a video recording of all the transactions that occur in the period!

Example

A statement of profit or loss and other comprehensive income for the year to 31 December 20X3 covers the period between 1 January 20X3 and 31 December 20X3. Incomes and expenses occurring during this period are included in the statement of profit or loss and other comprehensive income.

1. Information to be presented on the face of the statement of profit or loss

The information in the financial statements may be provided for on the face of the statement or in the notes to the financial statements. Certain information, being important for the users of the statements, is required to be presented on the face of the financial statements.

IAS 1, Presentation of Financial Statements, requires particular information to be presented on the face of the statement of profit or loss and other comprehensive income.

As a minimum, the face of the statement of profit or loss and other comprehensive income shall include line items that present the following amounts for the period:

(a) revenue;
(b) finance costs;
(c) tax expense;
(d) profit or loss.

Additional line items, headings and subtotals shall be presented in the statement of profit or loss and other comprehensive income and the separate statement of profit or loss (if presented), when such presentation is relevant to an understanding of the entity's financial performance.

There are other disclosure requirements according to IAS 1 regarding share of the profit or loss of associates and joint ventures and profit or loss of discontinued operations. However, these do not form a part of your syllabus.

Unlike the statement of financial position, IAS 1 does not specify many line items to be disclosed on the face of the statement of profit or loss and other comprehensive income. The probable reason is that reporting entities deal in a wide variety of businesses, and one set of line items may not be applicable to all.

2. Purpose of the Statement of profit or loss and other comprehensive income

- To show whether an entity has made a **profit** or **loss** in an accounting period.
- To describe how the profit or loss arose e.g. it differentiates costs between **operating costs and cost of sales.**
- statement of profit or loss and other comprehensive income analysis gives much more information than a company's earnings.
- It provides important information about management's efficiency in controlling expenses, amount of income, and taxes paid.
- Investors can use it to calculate financial ratios that will ultimately give the rate of return.
- To compare a company's profits with that of its competitors by examining various profit margins e.g. the operating profit margin, gross profit margin and net profit margin.

3. Content

(a) The IASB has introduced the concept of comprehensive income (which replaces the earlier statement of profit or loss). All non-owner changes in equity are to be presented in a separate Statement of profit or loss and other comprehensive income.

(b) The Statement of profit or loss is divided into two parts:

Statement of profit or loss

It includes total income earned during the year less expenses and excludes the components of other comprehensive income.

Other comprehensive income

It includes the total of income less expenses such as gains on revaluation of property that are not recognised in the statement of profit or loss. Other IFRS / IAS do not permit such items to be presented in the statement of profit or loss. All owner changes in equity are included in other comprehensive income.

Therefore total comprehensive income =

Profit for the year (after tax) + Other comprehensive income relating to the year

(c) IAS 1 gives **a choice regarding presentation of expenses** in the statement of profit or loss based on:

- **The nature of expenses,** for example, it contains details of expenses incurred for staff, raw materials, etc.
- **The function of expenses,** for example, cost of sales, administrative cost, etc.

4. Proforma of statement of profit or loss and other comprehensive income

The proforma given below is prepared based on the function of expense method. This is the most commonly used method of presentation of income and expenses.

XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X3

	20X3 Tshs'000	20X2 Tshs'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Profit before tax	**X**	**X**
Income tax expense	(X)	(X)
Profit for the year	**X**	**X**
Other comprehensive income:		
Gains on property revaluation	X	X
Other comprehensive income for the year, net of tax	**(X)**	**X**
Total comprehensive income for the year	**X**	**X**

Important

In the examination, whenever 'Statement of profit or loss and other comprehensive income' is referred to, it always relates to the single statement format which is presented above.

2.2 Statement of financial position (SOFP)

A **statement of financial position** is a statement of assets, liabilities and capital of a business at a given moment.

It discloses the state of affairs of the entity at that moment. Usually a statement of financial position is prepared at the end of the accounting year. The elements of a statement of financial position are:

Assets include what the entity **owns** or what it **has to receive** in the future.

Liabilities indicate the **amounts due** from the entity to outsiders.

Capital represents the **amount that was invested** by the owners into the business and the amount of

Profit retained in the business (i.e. to the extent it is not withdrawn by the owners).
Any transaction or event has an effect on these three categories.
A statement of financial position is based on the accounting equation. This equation can be presented in a manner where the total of capital and liabilities is equal to the total of assets or where

Capital = Assets - Liabilities

The only difference between the statement of financial position and the accounting equation is that a statement of financial position is in a detailed format. It contains the assets and liabilities of the entity, grouped in a suitable manner.

The Companies Acts or similar legislations of different countries lay down the format of statement of financial position and the companies have to adhere to that format. Other entities do not have a format fixed by law.

1. Content

(a) IAS1 prescribes certain minimum disclosure requirements in the statement of financial position. These disclosures are discussed in the proforma of statement of financial position below.

(b) If required by other standards, further classification of the main headings is permitted in the statement of financial position or in the notes to accounts, in order to comply with the requirements of other IAS/IFRS.

For example, IAS 16 Property, plant and equipment requires that the heading "Non-current assets" should be further sub classified into sub-headings such as freehold buildings, plant and machinery, office equipment, etc.

(c) **Distinction between current and non-current**

An entity has to differentiate between current and non-current assets and liabilities while making disclosures in the Statement of financial position.

IAS 1 sets out following four criteria to identify a current asset or liability:

whether the entity expects to use or sell the asset in its normal operating cycle e.g. inventory,

whether the entity holds the asset primarily for trading rather than long-term usage within the business e.g. gold ornaments for a jeweller,

whether the entity expects to realise the asset within twelve months after the reporting period or,

whether the entity has access to the cash or cash equivalent within twelve months after the reporting period e.g. debtors who are offered a credit period of 30 days.

If either of the above four criteria are not satisfied the asset or liability is termed as non-current.

Example

Asterix Ltd supplies bamboo to a furniture manufacturer. The operating cycle of producing bamboo is clearly defined and bamboo is obtained within five to six years after planting the crop.

The cost of the bamboo inventories should be classified as a current asset if they are realised within the normal operating cycle. If Asterix Ltd is not able to liquidate its inventories (after the completion of the operating cycle) in cash or cash equivalent within 12 months after the end of the reporting period it should be classified as a non-current asset in order to assist users of financial statements to assess its liquidity and solvency.

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2. Purpose of statement of financial position

(a) The worth of the business can be ascertained.

(b) The lenders use statement of financial positionto make a decision regarding provision of finance.

(c) It helps as information to take major decisions such as expansion.

(d) The risk bearing capacity of the entity can be known.

(e) The comparison of statement of financial position helps to know where the business was and where it is now.

(f) Liquidity position of the entity can be calculated by analysing the ratios.

3. Proforma of Statement of financial position

XYZ Group - Statement of financial position at 31 December 20X3		
	20X3	**20X2**
	Tshs'000	**Tshs'000**
Assets		
Non-current assets		
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
	X	X
Current assets		
Inventories	X	X
Trade receivables	X	X
Other current assets	X	X
Cash and cash equivalents	X	X
	X	X
Total assets	**X**	**X**
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	X	X
Retained earnings	X	X
Other components of equity	X	X
Total equity	X	X
Non-current liabilities		
Long-term borrowings	X	X
Long-term provisions	X	X
Total non-current liabilities	X	X
Current liabilities		
Trade and other payables	X	X
Short-term borrowings	X	X
Current tax payable	X	X
Total current liabilities	X	X
Total equity and liabilities	**X**	**X**

2.3 Statement of changes in equity

It summarises all the transactions the organisation has had with its owners / shareholders. It is designed to show whether the owners / shareholders have:

maintained their original investment in the organisation and / or

if this capital has been added to or reduced over a particular period

In addition it shows the level of profit earned by the organisation that has been:

reinvested into the business and

paid out to the owners / shareholders in the form of dividends.

The Statement of changes in equity presents all changes regarding all the components of equity such as share capital, share premium, etc. A Statement of changes in equity includes the following:

(a) the effect of change in accounting policy or of corrections in errors regarding each component of equity.

(b) reconciliation between the carrying amount at the beginning and at the end of the period for each component of equity. This reconciliation should take into account the following:

- profit or loss earned during the period
- other comprehensive income during the period
- transactions with owners in the capacity of owners. For example, issue of shares or distribution of dividends

IAS 1 requires an entity to present dividends recognised as distributions to owners during the period and related amounts per share in the Statement of changes in equity or in the notes.

2. Proforma of Statement of changes in equity

XYZ Group - Statement of changes in equity for the year ended 31 December 20X3

	Share capital	Share Premium	Retained earnings	Revaluation surplus	Total
Balance at 01/01/20X2	X	X	X	X	X
Changes in accounting policy	X		X		X
Restated balance	**X**	**X**	**X**	**X**	**X**
Changes in equity for the year 20X2					
Dividends					
Total Comprehensive income for the year					
Balance at 31/12/20X2	**X**	**X**	**X**	**X**	**X**
Changes in equity for the year 20X3					
Issue of share capital	X	X			X
Dividends			(X)		(X)
Total Comprehensive income for the year			X	X	X
Transfer to retained earnings					
Balance at 31/12/20X3	**X**	**X**	**X**	**X**	**X**

Example

Following is the information for Delta Co:

The issued share capital is Tshs50 million as at 1 April 20X1. The company issued 20,000 equity shares on 1 October 20X1 at Tshs1,500 each. The face value of equity shares is Tshs1,000 per share.

The retained earnings as at 1 April 20X1 are Tshs30 million. The profit for the year ended 31 March 20X3 is Tshs34.81 million. The dividend paid on ordinary shares on 1 June 20X2 is Tshs7 million.

Delta revalued its property A to Tshs20 million in June 20X2 the cost of which is Tshs13.2 million. The opening balance of share premium account at 1 April 20X1 is Tshs40 million.

Continued on the next page

	Share capital	Share premium	Revaluation reserve	Retained earnings	Total
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Balance at 01/04/20X1	50,000	40,000	-	30,000	120,000
Changes in accounting policy	-	-	-	-	
Restated balance	**50,000**	**40,000**	**-**	**30,000**	**120,000**
Changes in equity for 20X1					
Shares issued on 01/10/20X1	20,000				20,000
Share premium		10,000			10,000
Balance at 31/03/20X2	**70,000**	**50,000**	**-**	**30,000**	**150,000**
Total comprehensive income			6,800	34,810	41,610
Dividends paid				(7,000)	(7,000)
Balance at 31/03/20X3	**70,000**	**50,000**	**6,800**	**57,810**	**184,610**

2.4 Notes to financial statements

1. Notes **are the supplementary schedule and other information** provided along with the financial statements in order to help the users of financial statements to **understand the financial statements**. Notes form an integral part of financial statements.

2. The purpose of having **notes to the financial statements** is to allow the organisation to disclose any relevant additional information to the reader, not covered in any of the other statements. For instance, an explanation of the type of accounting policies the organisation has used is usually found in this statement.

3. Notes to financial statements may include the following information:

   significant accounting policies and explanatory notes

   risk and uncertainties affecting the organisation,

   resources and obligations not recognised in the financial statements (such as mineral reserves),

   information about geographical and business segments,

   information regarding certain events which occur after the end of reporting period,

   information on the key assumptions made by the management concerning the company’s future, etc.

4. Notes can be in the form of a narrative, disclosures, disaggregation of information presented elsewhere in the financial statements or any additional information which has not been presented elsewhere in the financial statements.

5. No format for disclosure through notes has been prescribed under IFRS. However, notes must be presented systematically (for example, in order of items presented in the financial statements) along with proper cross reference to items in the financial statements.

The following example illustrates the disclosures which are made in the notes to accounts.

Example

Zentel Ltd - Extract of notes to financial statements for the year ended 31 December 2011.

1. Property, Plant and Equipment:

Property plant and equipment are initially recorded at cost Direct costs are capitalized until the assets are ready for use. The assets are carried at cost, less accumulated depreciation and impairments, if any.
Property, plant and equipment are depreciated on a straight line basis over their estimated useful lives.

The Management estimates the useful lives for the assets as follows:

Buildings	20 years
Plant and machinery	10 years
Furniture and fixtures	13 years
Vehicles	5 years

Depreciation methods, useful lives and residual values are reviewed at each reporting date.

The carrying amounts and the movements in the balances are as follows:

Schedule of property , plant and equipment

Tshs million

Cost or valuation	Buildings	Plant and machinery	Furniture and fixtures	Vehicles	Total
Balance at 1 January 2011	**1,500**	**1,700**	**150**	**300**	**3,650**
Additions		500			500
Disposals				(50)	(50)
Balance at 31 December 2011 (a)	**1,500**	**2,200**	**150**	**250**	**4,100**
Depreciation					-
Balance at 1 January 2011	150	510	23	60	743
Depreciation for the year	75	220	11	50	356
Removals				(10)	(10)
Balance at 31 December 2011 (b)	**225**	**730**	**34**	**100**	**1,089**
Net carrying value (a) -(b)	**1,275**	**1,470**	**116**	**150**	**3,011**

2. Provisions and contingencies

A provision is recognized in the Statement of Financial Position when the Company has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. If the effect is material, provisions are recognized at present value by discounting the expected future cash flows.

3. Inventory

Inventory is valued at the lower of acquisition or production cost and net realizable value. The cost is generally determined on the basis of a first-in, first-out method. Production costs comprise direct material and labour and applicable manufacturing overheads, including depreciation charges. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses

At the reporting date, inventories costing Tshs1 million had a net realizable value of Tshs0.8 million. These inventories are written down to the net realizable value and the difference of Tshs0.2 million is charged to the cost of sales for the year 2011.

2.5 Purpose of Disclosure Notes

(a) Provide clarification

The information contained within the disclosure notes not only supplements financial statement information, but also clarifies line-items that are a part of the financial statements. Disclosure notes provide information about how the amounts reported in the financial statements were determined.

Example

Harbour Ltd has impaired a major non-current asset. Notes to financial statements could serve to corroborate the reason for the impairment by providing specific information relative to how the asset became impaired.

(b) Accounting policy followed

Disclosure notes are also used to explain the accounting policies used and valuation model used to prepare the financial statements.

Example

Non-current assets - whether the cost model or the revaluation model
Method of valuing inventory - whether FIFO or Weighted Average Cost

---

(c) Qualitative and descriptive information

Unlike the purely numerical financial statements, information in disclosure notes can be provided in descriptive and qualitative terms. For example the disclosure notes may include details of transactions with directors, related party transactions, details of the ultimate controlling party, detail of any contingent liabilities, details of any going concern issues and events after the reporting date.

2.6 Other requirements of IAS1

1. Identification

(a) The financial statements should be identified **clearly and distinguished** from other information in the same published document.
(b) Each component of the financial statement **should be identified**.

Example

The title (e.g. 'Statement of profit or loss and other comprehensive income', 'Statement of financial position' should be clearly given at the top of the page).

---

2. Comparative information

Unless the standard permits or requires otherwise, comparative information with respect to the previous period should be disclosed for all numerical information in the financial statements. Furthermore, comparative information should be included in the narrative and descriptive information when it is relevant for understanding the financial statements of the current period.

3. Timeliness

If there is undue delay in the reporting of information it may lose its relevance. Therefore management should ensure that timely and reliable information is made available.

A proper balance between reliability and timeliness needs to be maintained. This is because if reporting is delayed, even though the information may be highly reliable it may be of little or no use to the users.

Certain regulatory authorities may require that the reporting of financial statements be done within 6 months from the end of the reporting period. This is to ensure that the users of financial statements are provided with timely information.

4. The following information is to be displayed prominently and repeated when necessary

(a) **Name** of the reporting entity or any other means of identification (e.g. logo), and any changes therein from the end of the preceding period
(b) Whether the statements cover an **individual entity or a group of entities**
(c) The **end date of the reporting period** or period covered by financial statements
(d) **Presentation currency** (e.g. Tshs, Euro, US$)
(e) **Level of rounding off used in presenting amounts (e.g. to the nearest thousand)**

Example

When the report is in a physical, printed form, the above information can be included as titles on each page.

---

5. The period to be covered

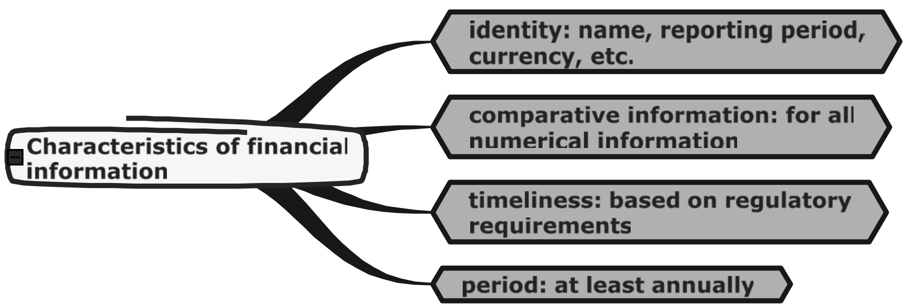
The financial statements are to be presented **at least annually**. If the reporting date is changed, and the financial statements are presented for a period longer or shorter than one year, they should disclose:

a) **the period covered**
b) the **reasons for using a longer or shorter period**
c) the fact that **the prior-period amounts** for the Statement of profit or loss, Statement of changes in equity and cash flow statements are **not entirely comparable** as they relate to periods with varying durations.

Example

Allen Co normally presents its financial statements as on 31 December each year. The last set of statements was prepared for the year ended 31 December 20X2. Local laws were amended in 20X3 to require all entities to follow a uniform accounting year ending on 31 March. Allen will prepare its next financial statements for the period from 1 January 20X3 to 31 March 20X4, and will disclose in the financial statements the fact that the reporting period is of 15 months.

SUMMARY



2.7 Relationship between the main financial statement components

The relationship between the statement of financial position and the statement of profit or loss and other comprehensive income is very significant.

Profit for the year as shown by the statement of profit or loss and other comprehensive income is added to the capital of the owner in the case of a sole trading firm or a partnership firm. In the case of a company, the amount of profit is added (loss deducted from) to the statement of financial position as '**Retained Earnings'**. The components of other comprehensive income are taken to the suitable account under the 'Equity' group. The equity group of accounts consists of the accounts representing capital and other reserves belonging to the owners (shareholders).

Example

According to the statement of profit or loss, profit for the year is Tshs1,400,000, other comprehensive income is Tshs120,000 (net revaluation gain) and therefore, the total comprehensive income is Tshs1,520,000.

Tshs1,400,000 representing profits will be added to the retained earnings. The revaluation gain is added to the revaluation surplus in the statement of financial position.

The accounting equation is:

Assets = Liabilities + Owners' capital
i.e. Owners' capital = Assets - Liabilties

Example

The existing Capital of Troy Co is Tshs60 million, represented by assets worth Tshs100 million less liabilities worth Tshs40 million.

To put it in an equation form,
Capital = Assets - Liabilities
i.e. Tshs60 million = Tshs100 million - Tshs40 million
i.e. Tshs60 million = Tshs60 million

Profits earned by Troy Co for the year to 31 December 20X3 are Tshs25 million.

This profit is added to capital in the statement of financial position. Revised capital is Tshs85 million (Tshs60 million + Tshs25 million). The statement of financial position shows that trade receivables have increased by Tshs35 million and loans have increased by Tshs10 million.

The revised equation is:

Capital = Assets - Liabilities
i.e. Tshs60 million + Tshs25 million = (Tshs100 million + Tshs35 million) - (Tshs40 million + Tshs10 million)
i.e. Tshs85 million = Tshs135 million - Tshs50 million
i.e. Tshs85 million = Tshs85 million

The loss made during a period determined by the statement of profit or loss is deducted from the owners' capital.

When the owners' capital decreases, the net assets of the business are decreased by an amount equal to the loss. This is how the accounting equation is maintained.

Example

To continue the example of Troy, if there was a loss of Tshs20 million during the year, there would then be a reduction in the capital by this amount. The net assets will also decrease by an amount equal to the loss. Assuming there is an increase in the liabilities, the new equation would be:

Capital = Assets - Liabilities
i.e. Tshs60 million - Tshs20 million = Tshs100 million - (Tshs40 million + Tshs20 million)
i.e. Tshs40 million = Tshs40 million

---

1. Business expenses are disclosed in the statement of profit or loss whereas personal expenses paid are treated as drawings, and reduced from the capital in the statement of financial position. For example rent of Tshs20 million paid for the business premises, is charged as a business expense. However, rent worth Tshs6 million paid for the residence of the owner is a drawing and reduced from the capital.

2. Accrued expenses that are not paid at the end of the reporting date are added to the relevant expenses in the statement of profit or loss and recorded as a liability in the statement of financial position. For example if there is a rent of Tshs500,000 accrued but not paid, it is added to rent expense and shown as a current liability.

3. Accrued income that is not received by the reporting date is added to the relevant income in the statement of profit or loss, and as an asset in the statement of financial position. For example if there is an interest of Tshs200,000 accrued but not received, it is added to the other income in the statement of profit or loss and shown as a current asset in the statement of financial position.

4. An expense paid but not yet recognised in the statement of profit or loss (because it has not accrued) is reduced from the concerned expense in the statement of profit or loss and recognised as an asset in the statement of financial position.

Example

Insurance of Tshs1 million is paid for the year commencing 1 April 20X3. The reporting date is 31 December 20X3. At this date, 9 months have passed since the insurance was paid. The correct insurance expense to recognise is Tshs750,000 (Tshs1,000,000 x 9/12). The insurance for 3 months is paid but not yet used. It is reduced from the insurance expense in the statement of profit or loss and shown as an asset in the statement of financial position as a pre-paid expense.

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5. Income received but not yet recognised in the statement of profit or loss (because it was received in advance) is deducted from the income in the statement of profit or loss and recognised as a liability in the statement of financial position. (deferred income). For example if the commission received includes an amount of Tshs600,000 received in advance. It is deducted from commission income and shown as a liability in the statement of financial position.

Test Yourself 4

Barney Ltd has the following items in its trial balance for the year ended 30 September 20X3.

- Gain on valuation of available for sale financial assets
- Interest expense
- Exchange differences on translating foreign operations
- Administrative expenses
- Gains on property revaluation
- Revenue
- Actuarial losses on defined benefit pension plans
- Cost of sales
- Distribution costs
- Share of profit of associates
- Income tax expense

Required:

Where should each of these items be shown in the other comprehensive income according to Revised IAS 1?

Test Yourself 5

Greenwood Ltd had taken an 8% loan from a bank which was to be repaid within a period of 8 months from the date of obtaining the loan. Greenwood was facing a credit crunch and therefore did not repay its debt on the due date. The bank provided Greenwood with an option to repay the loan after 2 years, provided the company paid an interest of 10% p.a.

Under which heading of the Statement of financial position the loan should be presented according to IAS 1?

A Current liabilities
B Current assets
C Non-current liabilities
D Non-current assets

Test Yourself 6

Reliable Ltd gives the following information relating to balances on 1 January 20X3.

	Tshs'000
Balances as at 01/01/20X3	
Share capital	3,000
Revaluation reserve	400
Property revaluation account	700
Accumulated profits	5,400
During the period 01/01/20X3 and 31/12/20X3	
Surplus on revaluation of property, plant and equipment	1,500
Profit earned	7,000
Dividends distributed	4,400
Issue of ordinary shares for cash	2,000

All investments were sold and the revaluation surplus was transferred to accumulated profits.

Required:

Prepare an extract of Statement of changes in equity for the year to 31 December 20X3.

Test Yourself 7

How will you treat an expense paid but not yet recognised in the statement of profit or loss?

A Recognise it as an asset
B Recognise it as a liability
C It's not related to the business, hence no adjustment is required.
D It's not related to the current year, therefore no adjustment is required.

---

3. State and explain the basis and purpose of the accruals, cash and break-up bases of accounting.
Identify the elements of financial statements.
[Learning Outcomes e and f]

3.1 Bases of accounting

1. Cash basis of accounting

Under the cash basis of accounting, revenues are recorded in the statement of profit or loss during the period when the cash is actually received from the customers. Similarly, expenses are recorded in the statement of profit or loss only when the cash is actually paid. The cash basis of accounting is mostly used by small businesses run by an individual. The following are the purposes and benefits of using cash basis:

(a) It is easy to learn and follow.
(b) It requires attention to maintain this method of accounting, but no special accounting skills are required.
(c) It helps in budgetary control as strict control can be exercised by comparing the amount actually spent with the amount authorised.
(d) This method is easy to understand and verify by its users.
(e) In some countries, this method is a statutory requirement.

2. Accrual basis of accounting

Under the accrual basis of accounting, revenues are recorded in the statement of profit or loss when they are earned irrespective of whether they are actually received or not. Similarly, expenses are recorded in the statement of profit or loss in the period when they are incurred which is often in a period different from when the actual payment is made.
Accrual basis of accounting complies with the generally accepted accounting principles by following the matching principle and revenue recognition principle. It is the most common method used by the business as it provides a better picture of a company's profits during an accounting period.

Example

If a company sells machinery worth Tshs5 million, then under the cash basis of accounting, this amount will not be recorded until the amount is actually received either in cash or cheque. However under the accrual basis of accounting, this amount will be recorded as revenue immediately after the sale is made, even if the amount will be received at a later date.

Similarly, in the case of expenses, if a company has received a telephone bill, then under the cash method, the amount will be recorded in the books only when the bill will be actually paid. But in case of accrual method, the amount will be recorded in the books as soon as the bill is received even if it is paid at a later date.

---

3. Break-up basis of accounting

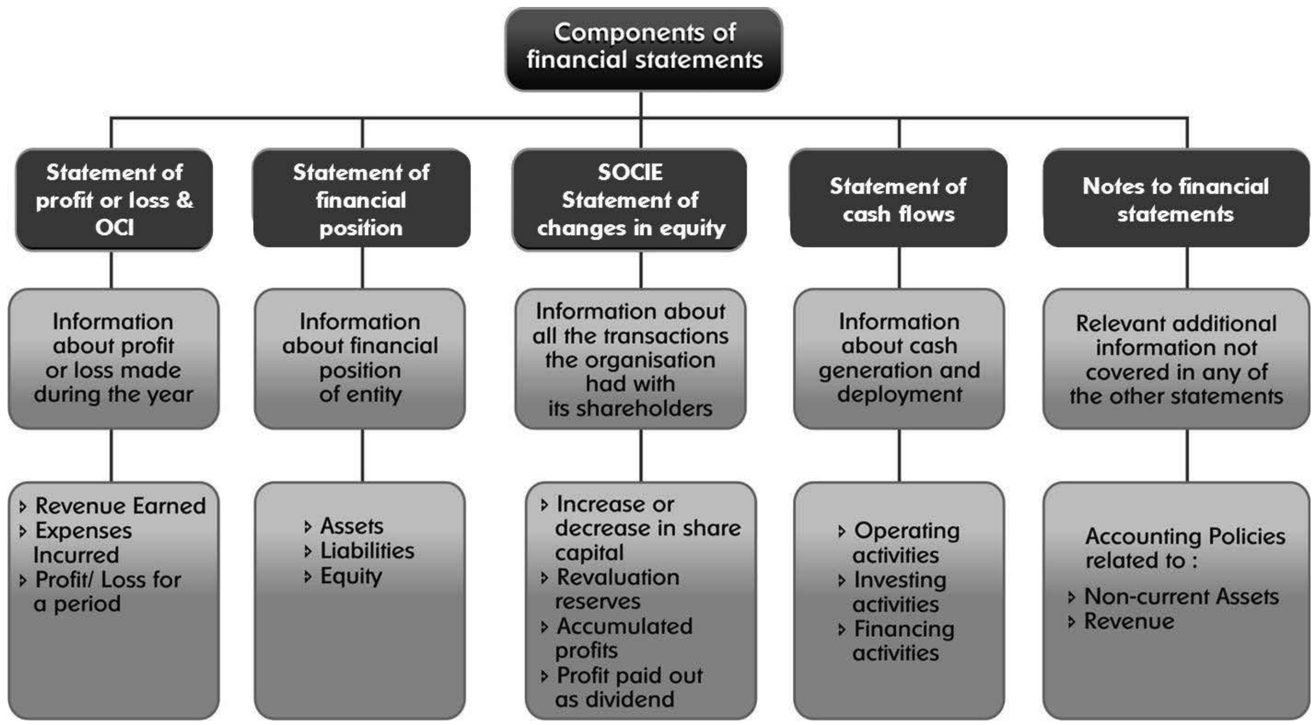
This method is used by a company in a situation where use of going concern principle is inappropriate. For example, if a company is undergoing liquidation, then it will have to prepare its accounts on break-up basis. Going concern principle is based on cost / fair value but break-up basis of accounting is based on net realisable value. All the assets are classified as current assets and are recorded at the net realisable value. Similarly, non- current liabilities are reclassified as current liabilities.

3.2 Elements of financial statements

Financial statements are the end result of the financial accounting process. Financial accounting process consists of recording the transactions through journal entries, posting the entries in appropriate ledger accounts, casting of accounts and preparing the trial balance.

An organisation's financial statements consist of four summary reports accompanied by notes to these statements as set out in **IAS 1 Presentation of financial statements**. Each statement provides separate but complementary information about the financial condition and performance of the organisation. Hence, to get a complete financial picture of the organisation, all five statements need to be prepared.
The following diagram briefly describes these statements

Diagram 3: Purpose and elements of financial statements



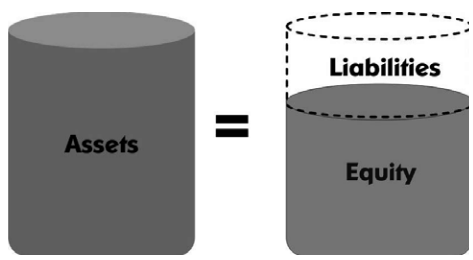
1. Elements of the statement of financial position (SOFP)

The following are the elements of a statement of financial position.

(a) Assets
(b) Liabilities
(c) Equity

It is also important to note that for every statement of financial position, the formula mentioned below holds good:

Diagram 4: Composition of a statement of financial position



(a) Assets

Definition

An asset is a **resource controlled** by the entity as a result of **past events** and from which future **economic benefits** are expected to flow to the entity.

Framework para 49

Therefore, the term asset means the total possessions of a business, such as machinery, buildings, furniture, vehicles, cash, amount receivable from others etc.

(b) Liabilities

Definition

A liability is a **present obligation** of the entity arising from **past events**, which when paid is likely to cause an **outflow** from the entity of resources.

Framework para 49

Therefore, the term liability represents the total amounts payable by the business to others such as bank loans, trade payables, and expenses payable.

(c) Equity

Definition

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

Framework para 49

Tip

The terms capital and equity can be used interchangeably.

Capital = Total assets - Total liabilities

Equity includes reserves and contribution from owners. Reserves are the accumulated profits of the company.

(i) Contribution from owners

Contribution from owners denotes capital. Capital is the amount invested by the owners, into the business. In the case of sole proprietorship, the entire amount of capital is brought into the business, by the sole proprietor alone. In the case of partnership firms, the partners contribute towards the capital. In the case of limited liability companies, the shareholders contribute towards the capital of the entity. These entities issue shares to the shareholders.

(ii) Distribution to owners

Amounts distributed to owners are generally in the form of dividend paid by companies. Dividend may be defined as distribution of profits of company among the owners (shareholders in the case of companies) of the company. It is calculated as a percentage of profits on the nominal value of the shares held by the shareholders.

In the case of partnership firms, the profit is distributed among the partners in the ratio which is pre-determined in the partnership deed.

2. Elements of the Statement of profit or loss and other comprehensive income

The elements of a statement of profit or loss and other comprehensive income include income and expenses.

(a) Income

Definition

Income is increases in economic benefits during the accounting period in the form of:

direct inflows,

or

enhancements of assets,

or

decrease of liabilities

that results in increase in equity, other than those relating to contributions from equity participants.

Framework para 70

Forms of Income

Revenue: represents earnings through the ordinary activities of the business, for example, sales, fees, interest, dividends, royalties and rent.

Gains: represent other items of income that may not arise in the ordinary course of business, for example, gains on disposal of property.

(b) Expense

Definition

Expenses are cost incurred to earn income. Expenses are defined as decrease in economic benefits during the accounting period in the form of:

direct outflow

,or

depletion of an asset,

or

incurrence of a liability

that result in decreases in equity, other than those relating to distributions to equity participants.

Framework para 70

Examples of expenses are purchases of goods, discounts allowed to customers for early payment, wages and salaries, office maintenance, utilities (gas, water, electicity consumed), interest paid, royalty paid.

(c) Profit / loss

Income > Expenses; organisation has made a profit

Profit = Income - Expenses

Expenses > Income; organisation has incurred a loss

Loss = Expenses - Income

Diagram 5: When profit is earned

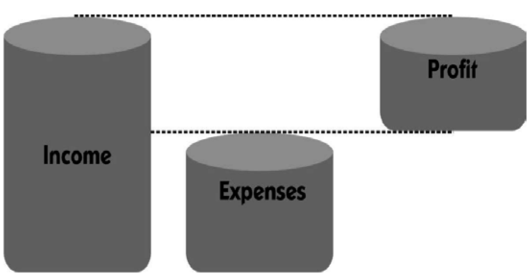
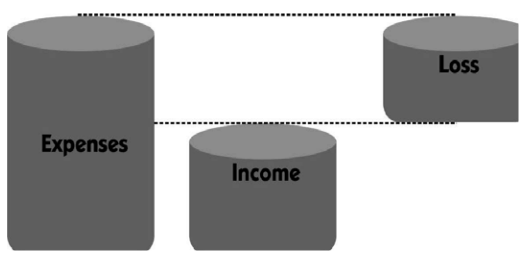


Diagram 6: When a loss is incurred



The elements of statement of changes in equity (SOCIE), statement of cash flows and notes to financial statements have already been discussed in Learning Outcome 2 of this Study Guide.

Test Yourself 8

Which of the following scenarios would generate a profit in the Statement of profit or loss and other comprehensive income?

A Liabilities > Expenses
B Liabilities < Assets
C Income > Expense
D Assets > Expenses

Test Yourself 9

Which of the following items is not an asset?

A Plant and equipment
B Bank loan
C Computer software and hardware
D Land and buildings

---

4. Demonstrate understanding of the framework for financial statements as per IFRSs.
[Learning Outcome g]

4.1 Regulatory framework for financial statements

The main role of a regulatory system for financial statements is to help ensure that accountants produce comparable, consistent, accurate and easily understandable financial statements and reports.

Other reasons why a regulatory system is needed include:

1. The separation of ownership and control that exists for many organisations

Having a regulatory system in place helps ensure that the financial statements / reports that owners receive from management with regards to the financial condition and performance of the organisation are true and fair. This better equips the owners to make economic decisions regarding their investments in the business.

2. To remove / reduce the element of subjectivity from accounting

Users of financial statements such as owners and investors need clear and comparable information to assess the financial condition and performance of different organisations. Therefore all preparers of these financial statements should be following the same set of rules or standards.

Example

Alpha Ltd and Beta Ltd have paid Tshs100 million for salaries to employees. This includes Tshs40 million of salaries paid to directors. However there is no regulation stating that the salaries paid to directors have to be shown as a separate item. The accountants of both the companies prepare their respective statement of profit or loss as follows:

Statement of profit or loss

	Alpha Ltd	Beta Ltd
	Tshs'000	**Tshs'000**
Income	1,000,000	1,000,000
Expenses:		
Salaries	(100,000)	(60,000)
Salaries to directors	-	(40,000)
Other expenses	(700,000)	(700,000)
Profit	**200,000**	**200,000**

Beta Ltd's accountant has decided to segregate the salaries paid into two categories (directors and employees) whilst Alpha Ltd's accountant has decided to group them together. Therefore it appears from Alpha Ltd.'s statement of profit or loss that its directors did not receive any salaries for that particular period which is inaccurate.

However if a specific regulation existed that directors' salaries were to be shown as a separate item the two statement of profit or loss would look as follows:

Statement of profit or loss

	Alpha Ltd	Beta Ltd
	Tshs'000	**Tshs'000**
Income	1,000,000	1,000,000
Expenses:		
Salaries	(60,000)	(60,000)
Salaries to directors	(40,000)	(40,000)
Other expenses	(700,000)	(700,000)
Profit	**200,000**	**200,000**

Therefore every country has a regulatory body that produces local accounting standards or generally acceptable accounting practices that all its accountants must follow.

3. The need for a set of uniform universal accounting standards or International Financial Reporting Standards (IFRS)

This would facilitate comparing and contrasting the financial condition and performance of organisations that operate in different countries.

For instance, in certain countries (e.g. in Central and Eastern Europe, France etc.) the accounting system was one based on strict rules and was closely interlinked to taxation. In others, such as the UK, the local GAAP aims at faithful representation for the shareholders and are conceptually based and driven by professional judgement.

Given how different these two types of systems are in terms of substance, they will naturally produce financial statements that are not comparable or contrastable. However the adoption of IFRS would greatly facilitate comparison between entities in different countries.

4. Statutory and other regulatory requirements

Company law usually lays down the reporting requirements for companies. It not only lays down the format but also gives guidelines regarding the preparation and presentation of the financial statements e.g. Companies Act 2002 in Tanzania, UK company law.

The leading stock exchanges, e.g. the New York Stock Exchange, require companies to comply with certain reporting norms as a part of the listing requirements, i.e. in return for allowing the companies' shares to be listed and traded on the stock exchange. For example companies listed on the Tanzanian Stock exchange have to follow the regulations framed by the Capital Markets and Securities Authority (CMSA)

Security regulators such as the Securities and Exchange Commission monitor the reporting practices of the companies.

5. Requirements of other countries

Whenever an entity operates in more than one country, it has to comply with the accounting requirements of each of these countries. This often results in organisations having to produce multiple financial statements and reports. However with the adoption of IFRS, an organisation can produce one set of statements that would satisfy the statutory requirements of all concerned countries.

To achieve the objective of uniform international standards, the following bodies have been formed

(a) The International Accounting Standards Committee Foundation (IASCF);

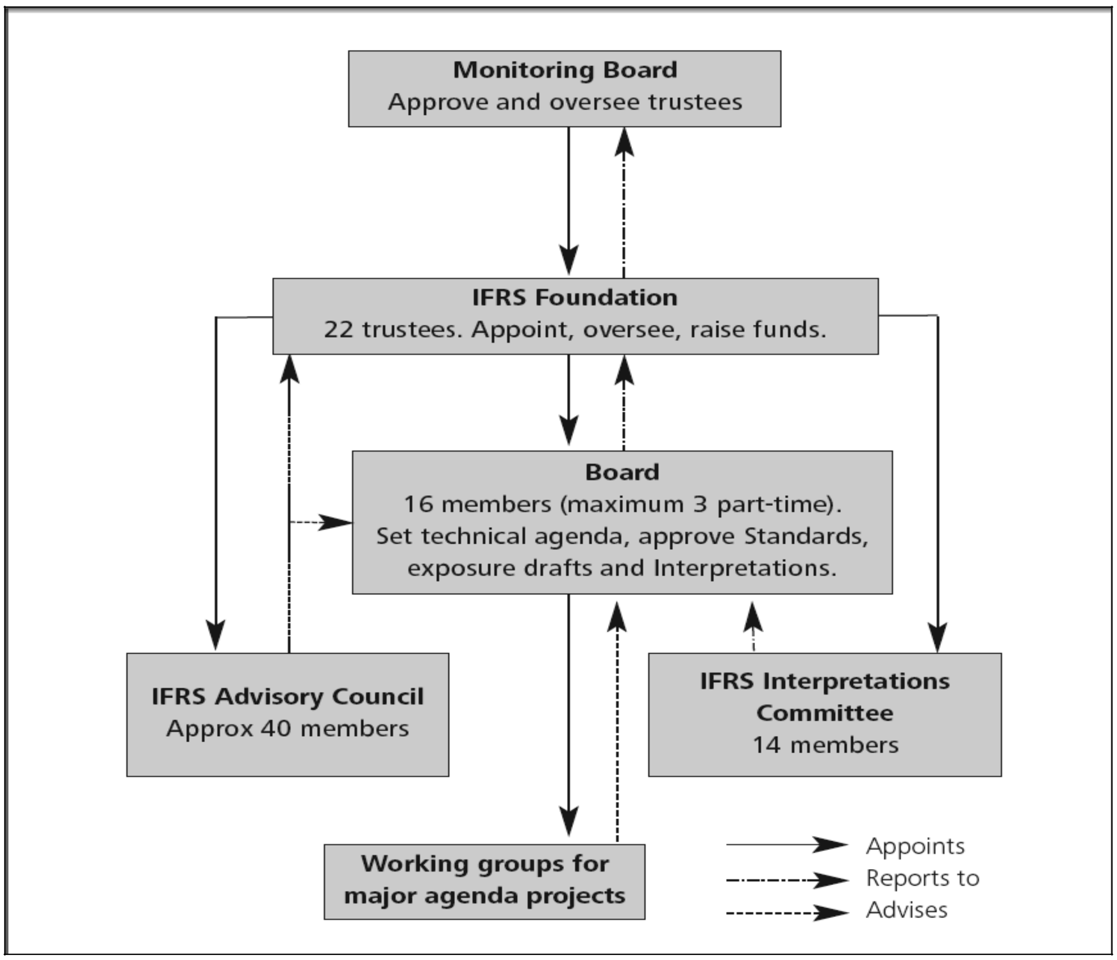
(b) The International Accounting Standards Board (IASB);

(c) The Monitoring Board

(d) The IFRS Council (IFRS AC); and

(e) The IFRS Interpretations Committee (IFRS IC).

Diagram 7: Structure of IFRS Foundation (IFRSF)



The International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs) currently in force are listed below:

International Accounting Standards	
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Consolidated and Separate Financial Statements
IAS 28	Investments in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Interests in Joint Ventures
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

International Financial Reporting Standards	
IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of interest in other entities
IFRS 13	Fair value measurements

Tip

Don't panic! You do not have to know and study all of these for your A3 exam! The most important and basic standards are covered in Paper A3. The remaining ones will be covered in the higher financial reporting papers.

4.2 Role of International Financial Reporting Standards (IFRS)

1. The term International Financial Reporting Standard (IFRS) covers:

(a) International Financial Reporting Standards **(IFRSs)** issued by the International Accounting Standard Board (IASB).

(b) International Accounting Standard **(IAS**) issued by the former International Accounting Standard Committee (IASC).

(c) **Interpretations** issued by the IFRS Interpretations Committee (IFRS IC) and Standards Interpretation Committee (SIC)

2. The main role of IFRS

(a) IFRS, by promoting uniformity, have removed much of the subjectivity in accounting. This was achieved by a timely revision of existing accounting standards and introduction of new standards.

Example

Earlier inventories could be presented either using the last in first out (LIFO) method or the first in first out (FIFO) method. However the IAS-2 Inventories standard prohibited use of the last in first out (LIFO) method. This has subsequently been adopted by many local accounting bodies.

(b) By adopting IFRS most of the countries have started maintaining their accounting systems based on a single set of globally enforceable standards. This has significantly reduced the cost of capital and the ease of using consistent reporting standards from subsidiaries in many different countries. For instance, the European Community has made it mandatory for all listed companies (i.e. companies whose shares are listed on a stock exchange to be publicly traded) in the European Union to adopt IFRS by 2005 for group financial statements.

Test Yourself 10

Who governs the IFRS Foundation?

A Members of IASB
B Members of IFRS Interpretations Committee
C IFRS advisory Council
D None of the above

5. Prepare financial statements for sole proprietor, company and partnership, namely.
i. Statement of profit or loss
ii. Statement of financial position

[Learning Outcome h]

5.1 Financial statements for a sole proprietor

We have already discussed the proforma of all the financial statements in the Learning Outcome 2 of this Study Guide. Now, we will discuss the preparation of basic financial statements of a sole proprietor with the help of an example.

Example

Accounts preparation from a trial balance

Malcolm Chisholm, a sole trader provides you with the following trial balance, as at 31 May 20X3 - the end of his financial year.

Malcolm Chisholm
Trial balance as at 31 May 20X3

	Debit Tshs'000	Credit Tshs'000
Sales Purchase		241,320
Discounts allowed	150,000	
Discounts received	10,800	
Provisions for depreciation (as at 1 June 20X2)		2,880
on property		
on equipment		12,000
Inventory, as at 1 June 20X2		22,800
Capital, as at 1 June 20X2	30,000	
17% long-term loan		72,780
Irrecoverable debts		18,000
Returns outwards	2,760	
Wages and salaries		9,000
Drawings	35,280	
Loan interest	14,400	
Other operating expenses	3,060	
Accounts payables	10,620	
Accounts receivables		21,600
Cash in hand	22,800	
Bank	180	
Property, at cost	780	
Equipment, at cost	72,000	
Allowance for receivables	48,000	
		300
	400,680	**400,680**

Malcolm provides you with the following additional information as at 31 May 20X3:

(a) Inventory as at 31 May 20X3 has been valued at cost at Tshs25,200,000 million.
(b) Accruals required for wages and salaries are Tshs480,000.
(c) Other operating expenses are pre-paid by Tshs180,000.
(d) The allowance for receivables is required to be maintained at 2% of accounts receivables.
(e) Depreciation for the year ended 31 May 20X3 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.

Required:

Prepare Malcolm Chisholm's Statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 May 20X3 as at that date.

Continued on the next page

Answer

Malcolm Chisholm
Statement of profit or loss and other comprehensive income for the year ended 31 May 20X3

	Tshs'000	Tshs'000
Sales		241,320
Less: Cost of sales		
Opening inventory	30,000	
Purchase	150,000	
Purchase returns	(9,000)	
	171,000	
Closing inventory	(25,200)	
		(145,800)
Gross profit		**95,520**
Add: Other income - discounts received		2,880
		98,400
Less: Expenses		
Operating expenses		
Wages and salaries (Tshs35.28 million + Tshs0.48 million) (W4)	35,760	
Discounts allowed	10,800	
Irrecoverable debts (W1)	2,916	
Loan interest	3,060	
Depreciation (W2) (W3)	7,380	
Other operating expenses (Tshs10.62 million - Tshs0.18 million) (W5)	10,440	(70,356)
Profit for the year		**28,044**

Malcolm Chisholm - Statement of financial position as at 31 May 20X3

	Tshs'000	Tshs'000
Non-current assets		
Property (cost)	72,000	
Less: Accumulated depreciation	(13,080)	58,920
Equipment (cost)	48,000	
Less: Accumulated depreciation	(29,100)	18,900
		77,820
Current assets		
Inventory	25,200	
Trade receivables net of allowance for receivables (Tshs22.8 million - Tshs0.456 million) (W1)	22,344	
Prepayments	180	
Bank	780	
Cash in hand	180	48,684
		126,504
Capital		
Balance at 1 June 20X2		72,780
Profit for the year 20X2-X3	28,044	
Less: Drawings	(14,400)	13,644
Current liabilities		
Trade payables	21,600	
Accruals	480	22,080
Long-term liabilities		
17% loan		18,000
		126,504

For sole traders and partnerships, there will be only a capital account in this group.

Continued on the next page

Workings

W1 Irrecoverable debts

	Tshs'000
Previous allowance	300
New allowance required (2% x Tshs22.8 million)	456
Increase in allowance	156
Irrecoverable debts as per trial balance	2,760
Transferred to statement of profit or loss and other comprehensive income	**2,916**

W2 Depreciation on property

	Tshs'000
Opening provision	12,000
Provision for the year on SLM (1.5% x Tshs72 million)	1,080*
Closing provision	**13,080**

W3 Depreciation on equipment

	Tshs'000
Opening provision	22,800
Provision for the year on RBM (25% x Tshs25.2 million (Tshs48 million - Tshs22.8 million))	6,300*
Closing provision	**29,100**
Total depreciation charged to Statement of profit or loss and other comprehensive income i.e. (1,080 + 6,300)*	**7,380**

W4

Accrued wages and salaries are expenses incurred for the current period so they will be included in the Statement of profit or loss and other comprehensive income.

W5

Prepaid operating expenses are expenses for the next year so they will be deducted from the Statement of profit or loss and other comprehensive income.

5.2 Financial statements of a partnership firm

A partnership is defined as 'the relationship between persons carrying on a business in common with a view of profit.' This definition is taken from the UK Partnership Act of 1890.

1. Partnership agreement

The partnership agreement is a written agreement between the partners, spelling out the agreed terms and conditions. It may contain many non-financial clauses such as name and address, business activity, duration etc.

The financial clauses in a partnership agreement are relevant for accountants. Such clauses are:

(a) Capital

Usually each partner puts in a share of capital. If specific amounts have been agreed, it should be stated. If a minimum fixed amount is agreed that will be mentioned.

Example

Initial capital of the firm shall be Tshs150 million, contributed equally by Tony, Boney and Soni.

(b) Profit sharing ratio

The purpose of a business is to earn and share profits.

Partnership agreements usually contain the profit sharing ratio. The profit sharing ratio depends upon:

the experience of the partners
the capital contribution of the partners or
the efforts put in by the partners

In the absence of any specific agreement it is assumed that the partners share profits or losses equally.

Example

The partners shall share profits and losses in the following ratio:

Andy	50%
Sandy	30%
Wandy	20%

(c) Salaries to partners

Salaries to partners are not similar to salaries paid to employees.

Salaries to partners: are an appropriation (distribution) of profits - they are presented after the calculation of profits

Salaries to employees: are expenses - they are presented before the calculation of profits.

Example

Tit and Tat, being the working partners, shall receive a salary of Tshs4 million per month and Tshs3 million per month respectively.

The firm pays salaries of Tshs60 million to the employees.

These will be presented in the Statement of profit or loss as:

	Tshs'000	**Tshs'000**
Gross profit		**X**
Salaries to employees		(60,000)
Other expenses		(X)
Net profit		**X**
Less: Appropriations of profit		
Salary to partners		
Tit (Tshs4,000 x 12)	48,000	
Tat (Tshs3,000 x 12)	36,000	
		84,000
Residual Profit transferred to Current accounts		
Tit		X
Tat		X
		X

Residual profits (profits earned - salaries to partners) will be shared among all the partners in the profit sharing ratio.

(d) Interest on capital

Interest on capital is not similar to interest paid to third parties.

Interest on capital is an appropriation of profits: it is presented after the calculation of profits

Interest paid to third parties (e.g. on a loan from bank) are expenses: it is presented before the calculation of profits.

Residual profits (profits earned - salaries to partners - interest on capital): will be shared among all the partners in the profit sharing ratio.

Example

The partners shall be entitled to an interest on capital at 6% per annum (0.5% per month), calculated on the opening balance of each month.

(e) Withdrawals / Drawings

Usually the partners need to draw some money for their household expenses and other personal needs. Partners may agree on the maximum amounts per month or the maximum frequency of withdrawals.

Example

The partners shall draw in cash reasonable amounts per month for meeting their monthly household expenses.

(f) Interest on drawings

In order to discourage partners from frequent drawings the agreement provides for an interest on drawings.

Example

The partners shall be charged an interest on drawings at 6% per annum (0.5% per month), calculated on the opening balance of each month.

(g) Procedures to be followed at the time of reconstitution of the firm e.g. admission or retirement of partners.

Example

Any reconstitution of the firm shall be done only with the written consent of all the partners.

---

2. Appropriation of profits

Appropriation of profit is also known as division of profit. Net profits in a partnership are divided between the partners in a profit sharing ratio according to the partnership agreement. Before its division it is transferred from the Statement of profit or loss to an account known as the 'Appropriation account'. This account shows how the net profit is divided between the partners. The entire profit is not divided, salaries and interest on capital, if payable according to the agreement, are deducted from it. Once this has been done the interest on the drawings are added to the net profit. The remaining profit is known as residual profit which is shared among the partners using the profit sharing ratio.

Example

An extract of a typical Statement of profit or loss incorporating these is as follows:

Statement of profit or loss (with imaginary names and figures)

	Tshs'000
Revenue	100,000
Cost of sales	(70,000)
Gross profit	30,000
Other income	5,000
Distribution costs	(8,000)
Administrative expenses	(7,000)
Finance expenses (interest on - Sam's Loan)	(2,000)
Other expenses	(3,000)
Profit	15,000
Tax	(3,000)
Profit after tax	**12,000**

Appropriations of profit:

	Tshs'000	Tshs'000
Profit after tax		12,000
Less: Interest on Capital		
Sam	3,000	
Rocky	2,000	(5,000)
Profit transferred to capital accounts		**7,000**
Sam		3,500
Rocky		3,500

In both cases however, the current account of partners is credited.

The current account of Sam would appear as follows:

Sam's Current Account

Dr **Cr**

	Tshs'000		Tshs'000
		Interest on capital	3,000
		Interest on loan	2,000
		Share of profit	3,500
Balance c/d	8,500		
	8,500		**8,500**

Presentation in the accounts

For all the appropriations that are due from the firm to the partners, an appropriation account is debited and the partners' current accounts are credited.

Example

Salary to partners and interest on capital will go through an appropriation account.

A proforma of appropriation account of a firm Statham which has three partners Romy, Maddy and Amy who share profits and losses equally (with imaginary figures)

Statham

Dr **Appropriation account for the year ended 31/12/20X3** **Cr**

	Section reference		Tshs'000		Section reference		Tshs'000
Salaries	6			Net profit b/d (from SOPL)			40,000
Romy			7,000	Interest on drawings	4		
Interest on capital	5			Romy		1,500	
Romy		3,000		Maddy		1,100	
Maddy		2,000		Amy		900	3,500
Amy		1,500	6,500				
Residual profits (Balancing figure)							
Romy		10,000					
Maddy		10,000					
Amy		10,000	30,000				
			43,500				**43,500**

Note: the second effect of all these transactions will be entered in the opposite side of the respective current account e.g. salary to Romy - Tshs7 million is credited to the current account of Romy - Tshs7 million.

If there had been no interest or salaries, then the profit of Tshs40 million would have been shared equally i.e. Romy, Maddy and Amy would have received Tshs13.333 million each (Tshs40 million/3). However, in the above proforma, Romy gets a higher amount. Why is this so?

She could have contributed higher capital or taken greater efforts than the others. These clauses will be agreed by the partners while signing the partnership agreement.

Tip

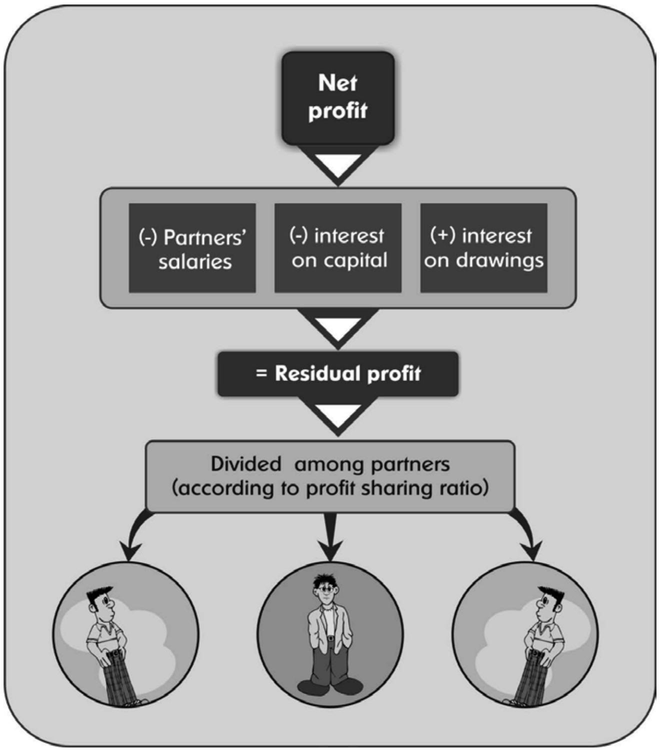
In the exam you will be given information about profit sharing arrangements and interest on capital etc. If you are not, assume an equal profit sharing arrangement between partners.

The residual profits are determined in the following manner:
Residual profit = Net profit + interest on drawings - salaries to partners - interest on capital.
= Tshs40 million + Tshs3.5 million - Tshs7 million - Tshs6.5 million = Tshs30 million

This appropriation account can also be prepared in a vertical form. In that case, net profits are taken as a starting figure and the adjustments are added or subtracted.

	Tshs'000	Tshs'000
Net profit b/d (from Statement of profit or loss)		40,000
Add: Interest on drawings		
Romy	1,500	
Maddy	1,100	
Amy	900	3,500
		43,500
Less: Salaries		
Romy		(7,000)
Less: Interest on capital		
Romy	3,000	
Maddy	2,000	
Amy	1,500	(6,500)
Residual profits		**30,000**
(Balancing figure)		
Romy	10,000	
Maddy	10,000	
Amy	10,000	

Diagram 7: Appropriation of profit



3. Capital accounts

For starting and running a business, partners have to invest funds. A record of how much is contributed by different partners and how much is due to them is kept in capital accounts. The amount contributed by each partner depends upon the mutual agreement between the partners. It need not be the same for all the partners. For example, 1 partner may contribute lots of cash, but not work in the partnership at all, whereas another may contribute little cash, but be working full-time.

Capital accounts, being the amount payable by the firm to the partners, always show a credit balance i.e. the balance brought forward will be a credit entry.

When capital is introduced, the entry is

Dr	Cash or other assets	X	
	Cr Capital		X

Being capital introduced in the partnership firm

4. Current accounts

A current account, as the name indicates, is used to record the current transactions such as profit, salary or interest earned and the drawings made by the partners. It usually shows the profits retained in the business by a partner.

When current accounts are maintained, the relationship between capital and current accounts will be as follows:

- the capital accounts remain static during the year. They change only if fresh capital is introduced or **capital** (not profits) is withdrawn.
- since interest on capital, salary to partners, share of residual profits, drawings, and interest on drawings are **all reflected in the current accounts**, they will keep fluctuating continuously.

Usually current accounts are maintained separately from the capital accounts.

This has the benefit that if a partner draws more than his current dues (salary, interest and profit), his current account shows a debit balance and serves as a warning. As seen above, in these cases the capital accounts remain fixed. Therefore, the presence of current accounts also indicates the presence of fixed capital accounts.

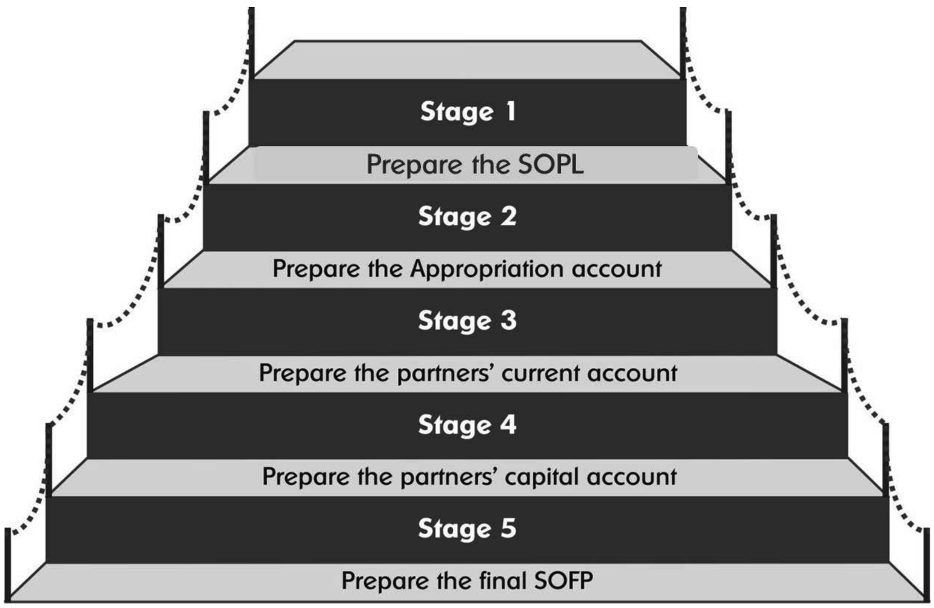
However, at times separate current accounts may not be maintained. Here, the capital accounts themselves will contain all the entries that would otherwise go to the current accounts. As a result, the capital accounts will keep fluctuating. Therefore, they are called fluctuating capital accounts.

5. Preparations of the final accounts

Now we will discuss how to prepare an Statement of profit or loss and other comprehensive income and statement of financial position of a partnership firm. It is also interesting to see how the capital and current accounts appear after incorporating these transactions.

The following steps will help you to prepare the final accounts of partnership from the given information.

Diagram 8: Steps to prepare final accounts of partnership



Example

Neil, Nicky and Jocky are in partnership, NNJ, sharing profits equally. They have agreed the following terms:

(a) Jocky and Neil will receive a salary of Tshs6 million and Tshs5.5 million per annum.
(b) Interest will be charged on drawings at the rate of 6%
(c) The interest rate on the loan by Neil is 5%
(d) All the partners will receive interest at 11% on capital.

The extract of the statement of financial position of the partnership as at 31 December 20X3 is given below:

Capital accounts	**Tshs'000**	**Tshs'000**
Neil	22,000	
Nicky	9,200	
Jocky	7,400	38,600
Current accounts		
Neil	4,100	
Nicky	920	
Jocky	(2,100)	2,920
Capital		41,520
Loan account (Neil)		7,200
Net assets		**48,720**

Drawings made during the year 20X3 were as follows:	**Tshs'000**
Neil	6,200
Nicky	4,400
Jocky	3,400

Sales for the year are Tshs405 million
Opening inventory is Tshs27 million and closing inventory is Tshs29.5 million

Expenditures are as follows:

	Tshs'000
Purchases	285,600
Salary	33,500
Traveling and Conveyance	6,870
Printing, stationery and postage	4,200
Bank interest	986
Sundry expenses	1,130
Vehicle expenses	13,680
Advertisement	12,650
Depreciation	3,584

Other information

Accounts payables	11,530
Accounts receivables	8,164
Cash	1,230
Non-current assets	56,240

Required:

Prepare the partners' current accounts, statement of profit or loss, and appropriation account, and the statement of financial position for the year ended 31 December 20X3

Answer

Stage 1

NNJ - Statement of profit or loss and for the year ended 31 December 20X3

	Tshs'000	Tshs'000
Sales		405,000
Less: expenses		
Cost of sales (W4)	283,100	
Salary	33,500	
Travelling and conveyance	6,870	
Printing and stationery	4,200	
Bank interest	986	
Sundry expenses	1,130	
Vehicle expenses	13,680	
Advertisement	12,650	
Depreciation	3,584	
Loan interest (Partner- Neil) W1	360	(362,560)
Profit for the year		**44,940**

Stage 2

NNJ
Appropriation Account
for the year ended 31 December 20X3

Dr **Cr**

	Tshs'000	Tshs'000		Tshs'000	Tshs'000
Current accounts			Net profit b/d		44,940
(Partners' salaries)		11,500	Current accounts		
(Interest on capital) W3			(Interest on drawings) W2		
Neil	2,420		Neil	372	
Nicky	1,012		Nicky	264	
Jocky	814	4,246	Jocky	204	840
(Residual profits)					
Neil	10,011				
Nicky	10,011				
Jocky	10,012				
		30,034			
		45,780			**45,780**

Stage 3

Partners' Current Accounts
Dr **for the year ended 31 December 20X3** **Cr**

	Neil Tshs'000	Nicky Tshs'000	Jocky Tshs'000		Neil Tshs'000	Nicky Tshs'000	Jocky Tshs'000
Balance b/d			2,100	Balance b/d	4,100	920	
Interest on drawings (W2)	372	264	204	Loan interest (W1)	360		
Drawings	6,200	4,400	3,400	Interest on capital (W3)	2,420	1,012	814
				Salary	5,500		6,000
Balance c/d	15,819	7,279	11,122	Residual profits	10,011	10,011	10,012
	22,391	11,943	16,826		22,391	11,943	16,826
				Balance b/d	**15,819**	**7,279**	**11,122**

Continued on the next

Stage 4

Partner's Capital Account
for the year ended 31 December 20X3

Dr	Neil Tshs'000	Nicky Tshs'000	Jocky Tshs'000		Neil Tshs'000	Nicky Tshs'000	Jocky Tshs'000 Cr
				Balance b/d	22,000	9,200	7,400
Balance c/d	22,000	9,200	7,400				
	22,000	9,200	7,400		22,000	9,200	7,400
				Balance b/d	**22,000**	**9,200**	**7,400**

Stage 5

NNJ - Statement of financial position as on 31 December 20X3

	Tshs'000	Tshs'000
Capital and liabilities		
Capital accounts		
Neil	22,000	
Nicky	9,200	
Jocky	7,400	38,600
Current accounts		
Neil	15,819	
Nicky	7,279	
Jocky	11,122	34,220
Neil Loan account		7,200
Accounts payables		11,530
		91,550
Assets		
Non-current assets	56,240	
Less: Depreciation	3,584	52,656
Current assets		
Inventory		29,500
Cash		1,230
Accounts receivable		8,164
		91,550

Workings

W1 Interest on loan from Neil = Tshs7.2 million x 5% = Tshs0.36 million

W2 *Interest on drawings

		Tshs'000
Neil	6% of Tshs6.2 million	372
Nicky	6% of Tshs4.4 million	264
Jockey	6% of Tshs3.4 million	204
		840

* Charged on the end of year drawings balances

W3 Interest on capital

	Tshs'000
Neil (11% of Tshs22 million)	2,420
Nicky (11% of Tshs9.2 million)	1,012
Jockey (11% of Tshs7.4 million)	814
Interest on capital	**4,246**

W4 Cost of sales

	Tshs'000
Opening inventory	27,000
Add: Purchases	285,600
Less: Closing inventory	29,500
Cost of sales	**283,100**

5.3 Financial statements of a company

Before discussing the preparation of financial statements of a company, we will discuss about few specific items which are part of financial statements of a company.

a) Limited Company

- A limited company is a legal entity which has a separate identity from its shareholders, whose liability for the company's debts is limited.
- A customer will be able to sue the owner of a sole trader as a person, that is accounting concept will not protect the owner of sole trader from any legal action against the business. In case of a limited company, the concept of separate legal entity applies and the customer must sue the company and not the owners (shareholders) of the company

b) Shareholders

Are the owners of a limited company, they buy shares which represent part ownership of a company.

c) Limited Liability

- If the company failed to settle the debts owing to creditors, the shareholders could not be forced to sell their private (personal) assets to settle the company's debts.
- The shareholders could only lose their original investment in the shares i.e. their liability is limited to that original investment
- Unlike a sole trader or the partnership business, a limited company has a separate identity from its owners (shareholders), so any legal actions can be taken against the company rather than members (shareholders) of the company.

d) Characteristics of limited companies

i) Creditors risk not being paid if a company has insufficient funds, that is, the company is insolvent

ii) Shareholders are not entitled to help manage a company because they rely on directors to manage the company for them

iii) The ownership in a company is represented by shares which can easily be transferred from one shareholder to another without need for consent from other owners. This is especially true for public companies where trading of shares is done in a stock exchange.

iv) A company may continue in existence indefinitely when business is operating successfully. It is not affected by the changes in ownership or shareholders and therefore it has a more stable life.

e) Types of limited company

1. Public limited company

- Allowed to offer its shares to the public
- The shares may be bought and sold on the stock exchange

2. Private limited company

- Is usually a small company and is not allowed to offer its shares to the public
- The shares cannot therefore be bought and sold on the stock exchange

f) Articles and memorandum of association

Each company is governed by two documents, known as the **Memorandum of Association** and the **Articles of Association**, generally referred to as the *memorandum* and the *articles*.

Memorandum of Association

- a 'memorandum of association' - a legal statement signed by all initial shareholders agreeing to form the company
- The memorandum is said to be the document which discloses the conditions which govern the company's relationship with the outside world.

The memorandum consists of five clauses for private companies, and six for public companies containing the following details:

1. The name of the company.
2. The part where the registered office will be situated.
3. The objects of the company.
4. A statement (if a limited liability company) that the liability of its members is limited.
5. Details of the share capital which the company is authorised to issue.
6. A public limited company will also have a clause stating that the company is a public limited company.

Articles of Association

- 'articles of association' - written rules about running the company agreed by the shareholders, directors and the company secretary

- The articles of association set out how the company is run, governed and owned. The articles can put restrictions on the company's powers – which may be useful if shareholders want comfort that the directors will not pursue certain courses of action, at least without shareholder approval.

The articles should cover the following:

- Liability of members;
- Directors' powers and responsibilities;
- Directors' meetings, voting, delegation to others and conflicts of interest;
- Retaining records of directors' decisions;
- Appointment and removal of directors;
- Shares, unless a limited by guarantee company;
  - issuing shares;
  - different share classes;
  - share certificates;
  - share transfers;
- Dividends and other distributions to members;
- Members' decision making and attendance at general meetings;
- Means of communication;

g) Share

Is indivisible unit of capital in a company
Each share of a company has equal face value.
Capital of members differ in accordance to the number of shares each hold.

Types of shares

Preference shares	Ordinary shares
They receive a fixed rate of dividend (based on the face value of the shares). The dividend is the same every year	The dividend is not a fixed amount, but can vary according to the profits of the company. i.e. if the trading results are poor the ordinary shareholders may receive no dividend but if the trading results are good they may be awarded high dividend than preference shareholders
The dividend is payable before any dividend is payable to the ordinary shareholders	The dividend on ordinary shares is only payable after that on the preference shares has been accounted for.
If the company is wound up (closed down) any amount left after paying liabilities is used to pay back the preference shareholders before anything is returned to the ordinary shareholders	If the company is wound up (closed down) any amount left after paying liabilities is used to pay back the preference shareholders before anything is returned to the ordinary shareholders
Preference shareholders are not usually entitled to vote at shareholders' meetings.	Ordinary shareholders are usually entitled to vote at shareholders' meetings on the basis of one vote per share.

h) Share capital

Capital of a limited company is divided into shares of a fixed amount. The amount stated in the Memorandum is known as the Authorized Share Capital

- Authorized share capital
  It is the maximum amount of share capital the company is allowed to issue to the public

- Issued share capital

The amount of share capital already issued to the public. There might be part of or all the authorized share capital.

The amount of share capital actually required by the company will be issued to the public (shareholders) i.e. issued share capital

- Called up capital
  The total amount a company has requested from the shareholders out of all shares issued

- Uncalled capital
  This is the total amount of issued share capital to be received in future, but which has not yet been asked for

- Paid up capital
  Refers to that part of the called up capital for which the company has actually received cash from its shareholders.

- Calls in arrear
  This is the total amount of issued share capital for which the payment has been asked, but has not yet been paid by shareholders.

- Calls in advance
  This is the amount of issued share capital which has not yet been called up but is already paid

Example

On 1st January 20X9 Silinde Enterprises plc was formed with legal right to be able to issue 200,000 shares of TZS2,000 each. The company has actually issued 170,000 shares. None of the shares has yet been fully paid up. Shareholders were asked to pay TZS1,500 of the sum due immediately and the remaining balance on 30 June 20X9. So far one shareholder with 3,000 shares have paid the full amount of TZS2,000, and on the same date other shareholders had paid the amount asked by the company except for 5,000 shares owing from one shareholder.

Required

a. Authorized or nominal share capital
b. Issued share capital
c. Called-up capital
d. Call in advance
e. Paid-up capital
f. Call in arrear

Answer

a) Authorised share capital = 200,000shares x TZS2,000 = TZS 400,000,000
b) Issued share capital = 170,000sheres x TZS2,000 = TZS 340,000,000
c) Called up capital = 170,000shares x TZS1,500 = TZS 255,000,000
d) Call in advance = 3,000shares x TZS500 =TZS1,500,000
e) Paid-up capital = (165,000shares x TZS1,500) = TZS247,500,000 + TZS1,500,000 Call in advance = TZS249,000,000
f) Call in arrear = 5,000shares Xtzs1,500 = TZS 7,500,000

Test Yourself 11

Mbalali Limited was formed on 1st January 2009 when it stated that its total capital was to be 500,000 shares of TZS200 each. A total of 300,000 shares were issued immediately and shareholders were asked to pay 60% of the sum due immediately and the other 40% on 1st January 2010.

By 1st May 2009 holders of 290,000 shares had paid the amount due.

State

a) State the authorized capital of Mansi Shah Limited on 1st May 2009
b) State the issued capital of Mansi Shah Limited on 1st May 2009
c) State the called up capital of Mansi Shah Limited on 1st May 2009
d) State the paid up capital of Mansi Shah Limited on 1st May 2009
e) State the call in arrear of Mansi Shah Limited on 1st May 2009
f) State the uncalled up capital of Mansi Shah Limited on 1st May 2009

i) Issue of shares

Company's prospectus
- Is a disclosure document that describes a financial security (shares or debentures) for potential buyers
- Is an offer document that invites the public to subscribe and purchase shares of a company.

The steps followed when a company issues shares are:

1. Invitation
The company invites the public to apply for its shares through a Prospectus

2. Application
The public applies for shares in the company, usually bringing in a portion of the issue price. This is known as application money.

3. Allotment
Taking account of the number of applicants and applications together with the number of shares available for issue, the company decides on how applicants will be awarded company shares.

Oversubscribed occur when applicants apply for more than the shares issued by the company.

Example a company issued 1,000 shares but the public apply for 1,700 shares.

Decision to reduce excess shares back to shares issued

i. Reject some of applicants and return their money back.
ii. Accept all applicants on pro-rata basis. i.e. give them less than what they have applied for, so as to make sure that every applicants become member of a company
iii. Or both, i.e. some are rejected and others are accepted on pro-rata basis.

Once a decision to allot is made applicants are informed and allotment money has to be paid. Only at the stage of allotment is a company stated to have issued share capital.

4. Calls
When companies issue shares they may not require immediately the full issue price. It is normal for companies to demand payment of issue price from shareholders by instalments depending on company needs for funds. For example, payments for a fresh issue of shares of shs. 100 each par value may be made as follows:

Shs. 40	(20%) on application
Shs. 60	(30%) on allotment
Shs. 60	(30%) on first call
Shs. 40	(20%) on final call

The last two installments are calls.

j) Different prices on issue of shares
- At Par value
  A share is issued at a price equal to its face value/nominal value/par value
  Example a share with face value of shs 100/= issued at a price of shs 100

- At premium
  A share is issued at a price greater than its face value
  Example a share with face value of shs 100/= issued at a price of shs 130

- At discount
  A share is issued at a price less than its face value
  Example a share with face value of shs 100/= issued at a price of shs 90
  Issuing shares at a discount is subject to many regulations and restrictions. That it is rarely done in practice.

k) Terms of payment
1. Fully payment on application
- The whole price of share is payable on application
- Example if price is shs 100/=, the shareholder is required to pay all shs 100/= for each share he or she bought.

2. **Instalment Payments.**
   The price of share is payable on installment basis i.e. a certain part of price received on application, the other part received on allotment, and the remaining balance received on calls.

   Example if price is TZS100/=, the shareholder is required to pay may be TZS30/= on application, TZS40/= on allotment, TZS20/= on the first call, and TZS10/= on the final call for each share he or she bought

Example

Ubungo Company Limited has an authorized share capital of TZS16 million divided into 80,000 ordinary shares with a nominal value of TZS200 per share.

Transactions related to the issue of shares were as follows:

(a) Cash was received for 10,000 shares issued at TZS200 per share.
(b) Cash was received for 20,000 shares issued at TZS240 per share.
(c) Applications were invited for the issue of 30,000 shares at TZS260 per share payable by installments:

	shs.
On application	40
On allotment [including the premium]	100
On first call	70
On final call	50

Applications are received for 55,000 shares; and it was decided to reject 5,000 shares, of which 20,000 shares were allotted in full and 30,000 shares were granted $^1/_3$. The excess money received on application was to be applied to the amount due on allotment. There were 1,000 shares not able to pay the amount due for the final call.

The entries to record these transactions would be:

[a] and [b] full payment on application

[a]	*Date*	*Description*	*Folio*	*Debit*	*Credit*
	Jan 1	Cash		2,000,000	
		Share Capital			2,000,000
		To record issue of ordinary shares at par value.			

[b]	*Date*	*Description*	*Folio*	*Debit*	*Credit*
	Jan 1	Cash		4,800,000	
		Share Capital			4,000,000
		Share Premium			800,000
		To record issue ordinary shares at premium			

[c] Installment Payments
50,000 shares have been applied for while there are only 30,000 shares available. There is an oversubscription of 20,000 shares. Allotment is to be made as follows:

Applications		Allotment
20,000	1	20,000
30,000	$^1/_3$	10,000
50,000		30,000

Workings
APPLICATION

Required on application – capital (30,000 x 40)		1,200,000
Cash received on application= 55,000 x 40 = 2,200,000		
Cash refunded (5,000x40)	= 200,000	2,000,000
Excess cash on application		800,000

ALLOTMENT

Required on allotment – capital (30,000 x 40)	1,200,000
- premium (30,000x60)	1,800,000
Total amount required on allotment	3,000,000
Excess cash received on application	800,000
Cash received on allotment	2,200,000

Journal entries to record all remaining events in this issue are as follows:

Date	Description	Folio	Debit	Credit
	Cash		2,200,000	
	Applications and Allotment			2,200,000
	To record receipt of application money for 50,000 ordinary shares each TZS40.			
	Application and allotment Cash Being money for 5,000shares refunded to unsuccessful applicants		200,000	200,000

Date	Description	Folio	Debit	Credit
	Applications and Allotment		4,200,000	
	Ordinary Share Capital			2,400,000
	Share Premium			1,800,000
	To record allotment of 30,000 shares issued at a premium.			

Date	Description	Folio	Debit	Credit
	Cash		2,200,000	
	Applications and Allotment			2,200,000
	To record receipt of allotment money for 30,000 ordinary shares.			

Date	Description	Folio	Debit	Credit
	First Call		2,100,000	
	Ordinary Share Capital			2,100,000
	To record the first call for 30,000 ordinary shares each TZS70.			

Date	Description	Folio	Debit	Credit
	Cash		2,100,000	
	First Call			2,100,000
	To record receipt of money on first call.			

Date	Description	Folio	Debit	Credit
	Final Call		1,500,000	
	Ordinary Share Capital			1,500,000
	To record the first call for 30,000 ordinary shares each TZS50.			

Date	Description	Folio	Debit	Credit
	Cash Calls in arrear		1,450,000 50,000	
	Final Call			1,500,000
	To record receipt of money on final call.			

Note that the 1,000 shares which were not able to pay the final call will have calls in arrear amounting to TZS50,000 (1,000shares*TZS50).

The relevant general ledger accounts after these entries were made are shown below:

Application and Allotment							
Date	Details	Folio	Debit	Date	Details	Folio	Credit
	Bank Share Capital Share Premium		200,000 2,400,000 1,800,000		cash cash		2,200,000 2,200,000
			4,400,000				4,400,000

First Call							
Date	Details	Folio	Debit	Date	Details	Folio	Credit
	Share Capital		2,100,000		Cash		2,100,000
			2,100,000				2,100,000

Final Call							
Date	Details	Folio	Debit	Date	Details	Folio	Credit
	Share Capital		1,500,000		Cash		1,450,000
					Calls in arrear		50,000
			1,500,000				1,500,000

Calls in Arrear

Date	Details	Folio	Debit	Date	Details	Folio	Credit
	Final call		50,000		Balance c/d		50,000
			50,000				50,000
	Balance b/d		50,000				

Cash							
Date	Details	Folio	Debit	Date	Details	Folio	Credit
	Share capital Share capital Share premium Applic and allotment Applic and allotment 1st call Final Call		2,000,000 4,000,000 800,000 2,200,000 2,200,000 2,100,000 1,450,000		Cash Balance c/d		200,000 14,550,000
			14,750,000				14,750,000
	Balance b/d		14,550,000				

Share Capital							
Date	Details	Folio	Debit	Date	Details	Folio	Credit
					Cash		2,000,000
					Cash		4,000,000
					Application & Allotment		2,400,000
					First Call		2,100,000
	Balance c/d		12,000,000		Final Call		1,500,000
			12,000,000				12,000,000
					Balance b/d		12,000,000

Share Premium							
Date	Details	Folio	Debit	Date	Details	Folio	Credit
					Cash		800,000
	Balance c/d		2,600,000		Application & Allotment		1,800,000
			2,600,000				2,600,000
					Balance b/d		2,600,000

The shareholders equity section of Taifa Company Limited's Statement of Financial Position will look as follows:

Authorised shares capital	*shs.*
80,000 ordinary shares of shs. 200 each	16,000,000
Issued share capital	
60,000 ordinary shares of shs. 200 each	12,000,000
less: Calls in arrears, 5,000 shares	50,000
Paid up capital	11,950,000
Share premium	2,600,000
Total equity	14,550,000
Assets Cash	14,550,000

Forfeited shares

If a call remains unpaid after it has become due and payable, the directors may give to the person from whom it is due, notice requiring payment of the amount unpaid, together with any interest which may have accrued. The notice shall name the place where payment is to be made and shall state that if the notice is not complied with, the shares in respect of which the call was made will be liable to be forfeited.

Any amounts of money paid for the shares by the subscriber from whom the shares are forfeited would be retained by the company. These shares will be shown separately in the Statement of Financial Position under Reserves as Forfeited Shares.

Example

Assuming the 1,000 shares with calls on arrear were forfeited by Ubungo Company. The entries to record this would be as follows:

Date	Description	Folio	Debit	Credit
	Ordinary Share Capital		200,000	
	Forfeited Shares			200,000
	To record nominal value of 1,000 ordinary shares forfeited.			

Date	Description	Folio	Debit	Credit
	Forfeited Shares		50,000	
	Calls in Arrears			50,000
	To transfer the unpaid final call on 1,000 ordinary shares forfeited.			

Share Capital							
Date	Details	Folio	Debit	Date	Details	Folio	Credit
					Cash		2,000,000
					Cash		4,000,000
					Application & Allotment		2,400,000
					First Call		2,100,000
	Balance c/d		12,000,000		Final Call		1,500,000
			12,000,000				12,000,000
	Forfeited Shares Balance c/d		200,000 11,800,000		Balance b/d		12,000,000
			12,000,000		Balance c/d		12,000,000
					Balance b/d		11,800,000

Calls in Arrear

Date	Details	Folio	Debit	Date	Details	Folio	Credit
	Final call		50,000		Balance c/d		50,000
			50,000				50,000
	Balance b/d		50,000		Forfeited Shares		50,000

Forfeited Shares

Date	Details	Folio	Debit	Date	Details	Folio	Credit
	Calls in arrear		50,000		Share Capital		200,000
	Balance c/d		150,000				
			200,000				200,000

The shareholders' equity section of the Statement of Financial Position will now look as follows:

Authorised shares capital	shs.
80,000 ordinary shares of TZS200 each	16,000,000
Issued share capital	
59,000 ordinary shares of TZS200 each	11,800,000
Share premium	2,600,000
Forfeited shares	150,000
Total equity	**14,550,000**
Assets Cash	 14,550,000

Test Yourself 12

The authorized number of shares of Kinondoni plc. is 160,000 ordinary shares of shs 1,000 per value.

a. Issued 70,000 shares for cash at shs 1,000 per share.
b. Issued 50,000 shares for cash at shs 1,200 per share.
c. The company issued 12,000 shares for a new machine with market value of shs 13,000,000.

REQUIRED

i. Journal entries
ii. Ledger accounts
iii. Statement of financial position

Test Yourself 13

Boko plc company has a nominal share capital of TZS200,000,000 comprising 200,000 ordinary shares of TZS1,000 each. The whole of the capital was issued at premium on the following terms:

	Per share TZS
Payable on application (Including premium)	350
Payable on allotment	200
First call	300
Second call	350

Applications were received for 260,000 shares, applications for 10,000 shares received no allotment and the cash paid in respect of such shares was returned. and it was decided to allot the remaining shares on the basis of four for every five for which applications had been made. The balance of application monies was applied to the allotment, no cash being refunded. The balance of allotment monies was paid by the members.

The calls were made and paid in full by the members, with the exception of one who failed to pay the first and second calls on the 1,000 shares allotted to him. A resolution was passed by the directors to forfeit the shares. The forfeited shares were later issued to Mbweni at TZS1,100 each.

Show the ledger accounts recording all the above transactions, and the relevant extracts from a statement of financial position after all the transactions had been completed.

Test Yourself 14

The authorised and issued share capital of Bunju plc was TZS 75,000,000 divided into 75,000 ordinary shares of TZS1,000 each, fully paid. On 2 January 20X7, the authorised capital was increased by a further 85,000 ordinary shares of TZS1,000 each to TZS160,000,000. On the same date 40,000 ordinary shares of TZS1,000 each were offered to the public at TZS1,250 per share payable as to TZS600 on application (including the premium), TZS350 on allotment and TZS300 on 6 April 20X7.

The lists were closed on 10 January 20X7, and by that date applications for 65,000 shares had been received. Applications for 5,000 shares received no allotment and the cash paid in respect of such shares was returned. All shares were then allocated to the remaining applicants pro rata to their original applications, the balance of the monies received on applications being applied to the amounts due on allotment.

The balances due on allotment were received on 31 January 20X7, with the exception of one allottee of 500 shares and these were declared forfeited on 4 April 20X7. These shares were reissued as fully paid on 2 May 20X7, at TZS1,100 per share. The call due on 6 April 20X7 was duly paid by the other shareholders.

You are required:

(a) To record the above-mentioned transactions in the appropriate ledger accounts; and
(b) To show how the balances on such accounts should appear in the company's statement of financial position as on 31 May 20X7.

k) Retained earnings

Retained earnings are the profits earned by a company that are retained in the business and not distributed as dividends. As seen earlier, when profits are earned, retained earnings on the liabilities side of a statement of financial position are increased and, simultaneously, the net assets of a company are increased, since the assets generated by way of the profit earned are retained in the business. Conversely, when profits are distributed by way of dividends, retained earnings are reduced and on the opposite side, net assets are also reduced, as dividends would mean an outflow of assets.
The part of distributable profit which is distributed is called dividend

- **Proposed final dividend** – is that dividend which is declared by the board of directors to be paid after the end of financial year. I.e. it's a current liabilities
- **Interim dividend** – is a dividend which is paid to the shareholders during a company's financial year provided the directors are satisfied that profits for the purpose have been earned and the cash resources of the company are sufficient to pay the dividend

Example

Mlimani plc provides the following information.

Authorized capital	200,000 6% TZS300 preference shares TZS 60,000,000
	500,000 TZS400 ordinary shares TZS200,000,000
Issued capital	100,000 6% TZS300 preference shares TZS30,000,000
	300,000 TZS400 ordinary shares TZS120,000,000

During the year ended 31st December 20X6 an interim dividend of 3% was paid on the preference shares and interim dividend of 5% was paid on the ordinary shares.

On 31st December 20X6, the directors agree to:

1. Pay the final dividend on the preference shares
2. Pay a final dividend of 4% on the ordinary shares.

CALCULATE THE FOLLOWING

a) Total dividend on preference shares for the year

b) Total dividend on ordinary shares for the year

Answer

a) Preference dividend - Paid	TZS30,000,000 x 3% =	TZS900,000
- Proposed	TZS30,000,000 x 3% =	TZS900,000
Total preference dividend		TZS1,800,000

b) Ordinary dividend - Paid	TZS120,000,000 x 5% =	TZS6,000,000
- Proposed	TZS120,000,000 x 4% =	TZS4,800,000
Total Ordinary dividend		TZS10,800,000

Example

Mwenge plc's summarized extract statement of financial position as at 31st December 2005 showed the following:

	TZS.
Issued Share Capital:	
Ordinary Shares of TZS500 each	75,000,000
8 percent Preference Shares of TZS1,000	60,000,000

The following additional information is available:

i.] An interim dividend of TZS20 has been paid on the ordinary shares, and one half of the dividend on the preference shares;

ii.] It is proposed to pay the remaining dividend on the preference shares and a final dividend of TZS50 on the ordinary shares;

CALCULATE THE FOLLOWING

a) Total dividend on preference shares for the year

b) Total dividend on ordinary shares for the year

Answer

a) Preference dividend - Paid	TZS60,000,000 x 4% =	TZS2,400,000
- Proposed	TZS60,000,000 x 4% =	TZS2,400,000
Total preference dividend		TZS4,800,000

b) Number of ordinary shares = $\frac{\text{ordinary share capital}}{\text{Face value per share}} = \frac{\text{TZS75,000,000}}{\text{TZS500}} =$ 150,000 ordinary shares

Ordinary dividend - Paid	150,000shares x TZS20 =	TZS3,000,000
- Proposed	150,000shares x TZS50 =	TZS7,500,000
Total Ordinary dividend		TZS10,500,000

Test Yourself 15

Tandale plc has the following capital structure.
Authorized share capital
40,000 ordinary shares of TZS300 each
40,000 8% preference shares of TZS200 each
Issued share capital
30,000 ordinary shares of TZS300 each
20,000 preference shares of TZS200 each

During the year ended 31st December 20X6 an interim dividend of 5% was paid on the preference shares and interim dividend of 6% was paid on the ordinary shares.

On 31st December 20X6, the directors agree to:

1. Pay the final dividend on the preference shares
2. Pay a final dividend of 7% on the ordinary shares.

CALCULATE THE FOLLOWING

a) Total dividend on preference shares for the year

b) Total dividend proposed on ordinary shares for the year

Test Yourself 16

Mwenge plc's summarized extract statement of Trial balance as at 31st December 20X8 showed the following:
Trial Balance, 31st December 20X8

ACCOUNT NAMES	DR 'TZS	CR 'TZS
Ordinary shares of TZS800	-	800,000,000
12% Preference shares of TZS100	-	130,000,000
Interim ordinary dividend	12,000,000	
Interim Preference dividend	8,000,000	

Additional information

a. Provide for the remaining preference dividend
b. A dividend of TZS20 per ordinary share was proposed on 31st December 20X8.

CALCULATE THE FOLLOWING

a) Total dividend proposed on ordinary shares for the year

b) Total dividend on preference shares for the year

Why the heading, 'retained earnings', appears only in a company statement of financial position (and not in sole proprietorship / partnership statement of financial position)

For a sole trader or a partnership, the statement of profit or loss is closed by transferring the profit to the credit of the proprietor's capital account. In the statement of financial position, the profits for the year are usually not disclosed separately but included in the capital account in the following manner.

	Tshs
Opening capital	X
Add: Profits during the period	X
Less: Drawings during the period	(X)
Closing capital	**X**

For a partnership firm, the same principle is followed, except that the balance of profit after appropriations is transferred to partners' current accounts (for fixed capital) or capital accounts (for fluctuating capital accounts). Here too, the profit for the year is usually fully appropriated; no balance carried forward.

For a company, the nominal value of the share capital is disclosed in the share capital account. This total nominal value usually remains fixed and an accountant cannot change it with the amount of profits. As a result, the accountant is compelled to carry forward the balance of profit or loss for the year, in a separate account which is known as the **retained earnings** account. This balance in the retained earnings account is reduced to the extent that it is used for the distribution of dividends.

Example

Lambert started a business with a capital of Tshs200 million on 01 January 20X1.
He earned profits of Tshs90 million from 20X1 to 20X3.
He withdrew Tshs50 million out of these profits.
What will be the balance of capital on 31 December 20X3?

Required:

What difference would there be if the business was run by Lambert Co Ltd and if it distributed dividends worth Tshs50 million?

Answer
If the business was run as a sole trader
Capital account

	Tshs'000
Capital introduced	200,000
Add: Profits earned	90,000
Less: Drawings	(50,000)
Balance of capital on 31 December 20X3	**240,000**

If the business was run as a limited company

	Tshs'000
Share capital issued	200,000
Retained earnings	
Add: Profits earned	90,000
Less: Dividends distributed	(50,000)
Retained earnings on 31 December 20X3	**40,000**

Total capital = Tshs200 million + Tshs40 million = Tshs240 million

I) Reserves in the statement of financial position

RESERVES
Companies therefore, have profits that are available for distribution but they also may have profits that are not available for distribution. All types of profits included in companies are known as reserves. However, those that are available for distribution are known as revenue reserves while those that are not available for distribution are known as capital reserves.

CLASSES OF RESERVES
There are two classes of reserves: revenue reserves and capital reserves

1. Revenue reserves

Is a fund transferred from profit of a business for either identified or unidentified purpose. This reduce the amount of profit available for distribution of cash dividend. Such a reserve remains a revenue reserve which may revert to becoming distributable earnings if the purpose for which it was intended is no longer needed.

- Accounting treatment for creation of revenue reserve
  Dr. Profit and loss account
  Cr. Reserve Account

Types of revenue reserve

i) Specific reserve

   Is a revenue reserve which is created out of profit for a identified/specific purposes (example replacement of non-current assets, or planned expansion of the business)

ii) General reserve

   Is a revenue reserve which is created out of profit for unidentified purpose. This kind of reserve can be used for any task.

Capital reserves

Profits that are not available for distribution as dividends are capital reserved. *Normally these are profits and gains outside normal operations of the business*. Common examples of these are: non-current assets revaluation reserve, share premium and capital redemption reserve. It is prohibited to use capital reserves for payment of cash dividends. These reserves are shown separately in the shareholders' equity section of the Statement of Financial Position.

Types Of Capital Reserve

(a) **Revaluation reserve**: as explained above, this is a reserve created because of an increase in the value of net assets after revaluation of assets and liabilities.

(b) **Share premium**: the Companies Act or similar legislations of some countries requires share premium to be disclosed under the group reserves and surplus. Share premium is the excess of the issue price of shares over their nominal or par value.

Example

A company issued ordinary shares of Tshs100 million for cash at Tshs125 million. The entry is

		Tshs'million	Tshs'million
Dr	Cash	125	
Cr	Ordinary shares		100
Cr	Share premium account		25

Being issue of ordinary shares at a premium

Tip

Share premium is not available for distribution of dividends.

m) BONUS SHARES AND RIGHT ISSUES

i) Bonus Shares

- The Companies Act gives companies the power to use their reserves to issue shares to the ordinary shareholders as fully paid-up shares. These shares are known as bonus shares.
- The shareholders do not have to pay for them; they own the reserves, anyway, and are not being given anything they do not already own
- The main reason why companies issue bonus shares is because the issued share capital does not adequately represent the long-term capital of the company.

Example

Consider the following summarized statement of financial position

	TZS'000
Non-current assets	1,400
Net current assets	350
	1,750
Share capital and reserves	
Ordinary shares of TZS1	800
Share premium	200
Revaluation reserve	50
General reserve	100
Retained profit	600
	1,750

The directors have decided to make a bonus of three new shares for every four already held. They wish to leave the reserves in most flexible form.

Required

Show the ledger accounts recording all the above transactions, and the relevant extracts from a statement of financial position after all the transactions had been completed.

Answer

Workings

Number of ordinary shares before issue of bonus shares = $\frac{\text{ordinary share capital}}{\text{Face value per share}} = \frac{\text{TZS800,000}}{\text{TZS1}}$ = 800,000Shares

Bonus shares

4shares held = 3 bonus shares
800,000shares = ?

Bonus shares = 600,000shares

Dr ordinary share capital Cr

Balance c/d	1,400,000	Balance b/d	800,000
		Share premium	200,000
		Revaluation reserve	50,000
		General reserve	100,000
		Retained earning	250,000
	1,400,000		1,400,000

Dr share premium Cr

Share capital	200,000	Balance b/d	200,000
	200,000		200,000

Dr revaluation reserve Cr

Share capital	50,000	Balance b/d	50,000
	50,000		50,000

Dr General reserve Cr

Share capital	100,000	Balance b/d	100,000
	100,000		100,000

Dr retained earning Cr

Share capital	250,000	Balance b/d	600,000
Balance c/d	350,000		
	600,000		600,000

Statement of financial position

	TZS'000
Non-current assets	1,400
Net current assets	350
	1,750
Share capital and reserves	
Ordinary shares of TZS1	1,400
Retained profit	350
	1,750

Test Yourself 17

Consider the following summarized statement of financial position as at 30 June 2004

	TZS'000
Assets	
Non-current assets	1,800
Inventory	100
Trade receivable	30
Bank	70
	2,000
Share capital and reserves	
Ordinary shares of $1	1,000
Share premium	500
Revaluation reserve	350
General reserve	70
Retained profit	80
	2,000

On 1st July 2004, before any other transaction had taken place, the company made bonus issue of shares on the basis of four new for every five already held. The directors wished to leave the reserves in the most flexible form.

Required

Show the ledger accounts recording all the above transactions, and the relevant extracts from a statement of financial position after all the transactions had been completed.

ii) Right Issues

- Under Right issues, the right to apply for shares is restricted to existing shareholders.
- A right issue entitles existing shareholders to apply for a specified number of shares, depending on how many they already hold.
- The offer price will be below the price at which shares are currently changing hands on the stock exchange
- Shareholders who do not wish to exercise their rights may sell the rights to some other person who might be willing to buy them, if the cost of the rights plus the share offer price is less the price at which the shares are already being traded

Right issue	Bonus issue
Subscribers pay for shares	Shareholders do not pay for shares
The company's net assets are increased by the cash received	The net assets of the company are unchanged
Shareholders do not have to exercise their right to subscribe for the new shares	All the ordinary shareholders will receive their bonus shares
Shareholders may sell their rights if they do not wish to exercise them	Shareholders may sell their bonus shares if they do not wish to keep them

Example

Consider the following summarized balance sheet as at 30 June 2004

	TZS'000
Assets	
Non-current assets	1,800
Inventory	100
Trade receivable	830
Bank	70
	2,800
Share capital and reserves	
Ordinary shares of $1	1,800
Share premium	500
Revaluation reserve	350
General reserve	70
Retained profit	80
	2,800

The company made a rights issue of one new share for every three shares already held. The shares were offered at $1.25 per share and the shares were taken up.

Required

Show the ledger accounts recording all the above transactions, and the relevant extracts from a statement of financial position after all the transactions had been completed.

Answer

Workings

ordinary shares before right issues = $\frac{\text{ordinary share capital}}{\text{Face value per share}} = \frac{\text{TZS1,800,000}}{\text{TZS1}}$=1,800,000Shares

Right issue

3shares held = 1 right issue
1,800,000shares = ?

Right issue = 600,000shares

600,000 shares x TZS1.25
- Share capital = TZS1 x 600,000shares = TZS600,000
- Share premium= TZS0.25 x 600,000shares = TZS150,000

Cash received TZS750,000

Dr ordinary share capital Cr

Balance c/d	2,400,000	Balance b/d	1,800,000
		Bank	600,000
	2,400,000		2,400,000

Dr share premium Cr

Balance c/d	650,000	Balance b/d	500,000
		Bank	150,000
	650,000		650,000

Dr Bank Cr

Balance b/d	70,000	Balance c/d	820,000
Share capital	600,000		
Share premium	150,000		
	820,000		820,000

Statement of financial position

	TZS'000
Assets	
Non-current assets	1,800
Inventory	100
Trade receivable	830
Bank	820
	3,550
Share capital and reserves	
Ordinary shares of $1	2,400
Share premium	650
Revaluation reserve	350
General reserve	70
Retained profit	80
	3,550

Refer the example below to understand the preparation of financial statements of a company.

Example

The following trial balance has been extracted from the books of Baywatch Ltd as at 30 September 20X8

	Tshs million	**Tshs million**
Administrative expenses	500	-
Share capital (3,500,000 ordinary shares of Tshs1,000 each)		
Cash at bank and in hand	-	3,500
Tax (overpayment for the year to 30/09/20X6)	75	-
Distribution costs	-	25
Dividends received (on 31/03/20X8)	750	-
Freehold property:	-	311
- at cost		
- accumulated depreciation (at 01/10/20X7) Interim	3,375	-
dividend (paid on 30/06/20X8) Investments	-	325
Plant and machinery:	45	-
- at cost	2,500	-
- accumulated depreciation (at 01/10/20X7)		
Retained earnings at 01/10/20X7	6,500	-
Purchases	-	4,500
Research expenditure Inventory		3,428
(at 01/10/20X7) Trade payables	20,000	-
Trade receivables	94	-
Sales revenue	2,875	
Total	-	3,625
	3,375	-
	-	24,375
	40,089	**40,089**

Additional information:

(i) The inventory at 30 September 20X8 was valued at Tshs4,500 million

(ii) Depreciation for the year to 30 September 20X8 is to be charged on the historic cost of the non-current assets as follows:

Plant and machinery: 15 per cent
Freehold property: 5 per cent

(iii) On 30 September 20X8, the directors proposed a final dividend of 75p per share

(iv) The company was incorporated in 20X1

(v) Research expenditure to be included under administrative expenses

(vi) Tax based on the profits for the year at a rate of 35 per cent is estimated to be Tshs1,062.5 million

Required:

Prepare the statement of profit or loss, statement of changes in equity and statement of financial position of Baywatch for the year ended 30 September 20X8 in accordance with IAS 1 “Presentation of Financial Statements”.

Answer

Baywatch Ltd - Statement of profit or loss for the year ended 30 September 20X8

	Tshs million	Tshs million
Sales revenue		24,375
Less: Cost of sales (W1)		(18,375)
Gross profit		**6,000**
Distribution costs	750	
Administrative expenses (W2)	1,738	(2,488)
		3,512
Other operating income (W3)		311
Profit before taxation		**3,823**
Income tax expense (W4)		(1,038)
Profit for the year		**2,785**

Baywatch Ltd - Statement of changes in equity for the year ended 30 September 20X8

	Share capital	Retained earnings	Total
	Tshs million	Tshs million	Tshs million
Balance (01/10/20X7)	3,500	3,428	6,928
Profit for the year		2,785	2,785
Dividend (W5)		(2,670)	(2,670)
	3,500	**3,543**	**7,043**

Baywatch Ltd - Statement of financial position as on 30 September 20X8

	Tshs million	Tshs million
Non-current assets Land		
and buildings(W7) Plant	2,881	
and machinery (W8)	1,025	
Investments	2,500	6,406
Current assets		
Inventory	4,500	
Trade receivables	3,375	
Cash at bank	75	7,950
Total assets		**14,356**
Capital and reserves		
Share capital	3,500	
Retained earnings	3,543	7,043
Current liabilities		
Trade payables	3,625	
Tax	1,063	
Proposed dividend	2,625	7,313
Total liabilities		**14,356**

Workings

W1 Cost of sales

	Tshs million
Opening inventory	2,875
Add: Purchases	20,000
	22,875
Less: Closing inventory	(4,500)
	18,375

W2 Administrative expenses

	Tshs million	Tshs million
Per trial balance		500
Add: Research		94
		594
Add: Depreciation		
Property (5% x 3375)	169	
Plant (15% x 6,500)	975	1144
		1738

W3 Dividends received

Dividends received - Tshs311 million

W4 Tax

	Tshs million
Tax	1,063
Less: Overpayment last year	(25)
	1,038

W5 Dividend paid

	Tshs million
Interim	45
Final	2,625
	2,670

W6 Freehold property

	Tshs million
Cost	3,375
Less: Accumulated depreciation	(325)
Less: Depreciation for the year (W2)	(169)
	2,881

W7 Plant and machinery

	Tshs million
Cost	6,500
Less: Accumulated depreciation	(4,500)
Less: Depreciation for the year (W2)	(975)
	1,025

Test Yourself 18

The following is the information provided by the Pearl Beauty Salon. You are required to prepare a statement of financial position as at 31 March 20X3:

	Tshs'000
Equipment	8,800
Accumulated depreciation on equipment	1,400
Furniture and fixtures	8,400
Accumulated depreciation on furniture and fixtures	2,800
Computers	11,100
Accumulated depreciation on computers	4,600
Long-term loan from bank	30,000
Capital as at 1 April 20X2	44,260
Drawings during the year	6,000
Inventory	8,300
Accounts receivable	800
Bank overdraft	1,500
Cash in hand	2,110
Bills payable	6,000
Profit for the year	9,200
Tax payable	2,350
Accounts payable	1,150
Shop rent outstanding	680
Prepaid insurance	430
Investment in Peer Ltd	58,000

Test Yourself 19

Which of the following sentences is incorrect?

A The amount due from an entity to an outsider is known as liability.
B The statement of financial position reflects the state of affairs of an entity on a given date.
C The accounting equation is: Liabilities + capital = assets
D The statement of financial position is always balanced.

Test Yourself 20

Which of the following statements is incorrect?

A Capital accounts always show a credit balance
B Current accounts may show a debit balance.
C Interest on capital is an appropriation of profit
D The residual profits are divided in profit sharing ratios

Answer to Test Yourself

Answer to TY 1

No, the financial statements do not satisfy the understandability criterion. The value of the property has increased by a material amount. So, the users of the statements will not have a clear understanding as to what led to the increase in the value of the property.

Answer to TY 2

Yes, following the accounting concept of **relevance,** it is essential that Mack discloses the new business venture which will help the users of financial information to assess the risks and opportunities for the company.

Answer to TY 3

Yes. The general public use the financial statements of an entity. The public is usually interested in knowing:

(a) the contribution made by the company for the benefit of the local economy in the form of providing employment, the business opportunities made available to the local suppliers.

(b) the impact that the company is making on the environment i.e. pollution, etc. That is why companies should minimise the water pollution, noise pollution as well as air pollution.

Answer to TY 4

The following items should be included in other comprehensive income:

Exchange differences on translating foreign operations
Gains on valuation of available for sale financial assets
Gains on property revaluation
Actuarial losses on defined benefit pension plans

Tip

The share of associates' needs to be in the comprehensive income part of the statement of profit or loss and other comprehensive income.

Answer to TY 5

The correct option is **C.**

This is because Greenwood Ltd decided to roll over the loan beyond the period of 12 months after the end of the reporting period.

Answer to TY 6
Reliable Ltd - Statement of changes in equity - Year to 31 December 20X3

	Share capital	Revaluation reserve	Accumulated profits	Total
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Balance at 01/01/2003	3,000	1,100	5,400	9,500
Issue of shares	2,000			2,000
Surplus on revaluation of property		1,500		1,500
Net profit for the period			7,000	7,000
Ordinary dividends			(4,400)	(4,400)
Balance at 31/12/20X3	**5,000**	**2,600**	**8,000**	**15,600**

Answer to TY 7

The correct option is **A**.

Recognise it as an asset. It is a pre-paid expense and not related to the current year. It is treated as a current asset.

Answer to TY 8

The correct option is **C.**

When income is higher than expenses, it results in a profit. The other three alternatives mention elements from the statement of financial position which do not help determine whether an entity has made a profit or a loss.

Answer to TY 9

The correct option is **B**.

As the name itself suggests, a bank loan is a liability. All other items are assets.

Answer to TY 10

The correct option is **D**.

The IFRS Foundation is the legal entity under which the IASB operates. The Foundation is governed by a board of 22 trustees.

Answer to TY 11

a) Authorised share capital = 500,000shares x TZS200 = TZS100,000,000
b) Issued share capital = 300,000sheres x TZS200 = TZS60,000,000
c) Called up capital = 300,000shares x TZS120 = TZS 36,000,000
d) Paid-up capital = 290,000shares x TZS120 = TZS34,800,000
e) Call in arrear = 10,000shares x TZS120 = TZS 1,200,000
f) Uncalled up capital = 300,000shares x TZS80 = TZS24,000,000

Answer to TY 12

Journal entries

	Narration	Debit	Credit
a)	Bank share capital Being shares issued at par	70,000,000	 70,000,000
b)	Bank Share capital Share premium Being issue of shares at premium	60,000,000	 50,000,000 10,000,000
c)	Machine Share capital Share premium Being issue of share at premium	13,000,000	 12,000,000 1,000,000

Dr bank account Cr

Details	TZS	Details	TZS
a) Share capital	70,000,000	Balance c/d	130,000,000
b) Share capital	50,000,000		
Share premium	10,000,000		
	130,000,000		130,000,000

Dr Machine account Cr

Details	TZS	Details	TZS
c) Share capital	12,000,000	Balance c/d	13,000,000
Share premium	1,000,000		
	13,000,000		13,000,000

Answer to TY 13

Dr share Capital account Cr

Details	TZS	Details	TZS
Balance c/d	132,000,000	a) bank	70,000,000
		b) bank	50,000,000
		c) Machine	12,000,000
	132,000,000		132,000,000

Dr share premium account Cr

Details	TZS	Details	TZS
Balance c/d	11,000,000	b) bank	10,000,000
		c) Machine	1,000,000
	11,000,000		11,000,000

Statement of financial position

Assets	TZS	TZS
Non-current assets		
Machine		13,000,000
Current assets		
Bank		130,000,000
Total assets		143,000,000
Authorised and issued share capital		
Authorised share capital(160,000shares @ TZS1,000)	160,000,000	
Issued share capital (132,000shares @TZS1,000)		132,000,000
Share premium		11,000,000
Total equity		143,000,000

Answer to TY 13

Dr Application and Allotment Cr

Bank	3,500,000	Bank	91,000,000
Share capital	70,000,000	Bank	22,500,000
Share premium	40,000,000		
	113,500,000		113,500,000

Dr 1st Call Cr

Share capital	60,000,000	Bank	59,700,000
		Call in arrear	300,000
	60,000,000		60,000,000

Dr 2nd Call Cr

Share capital	70,000,000	Bank	69,650,000
		Call in arrear	350,000
	70,000,000		70,000,000

Dr Bank Cr

Application and allotment	91,000,000	Application and allotment	3,500,000
Application and allotment	22,500,000	Balance c/d	240,450,000
1st Call	59,700,000		
2nd Call	69,650,000		
Re-issue (Mbweni)	1,100,000		
	243,950,000		243,950,000

Dr Share capital Cr

Forfeited shares & Reissue	1,000,000	Application and allotment	70,000,000
Balance c/d	200,000,000	1st Call	60,000,000
		2nd Call	70,000,000
		Forfeited & Reissue (Mbweni)	1,000,000
	201,000,000		201,000,000

Dr share Premium Cr

Balance c/d	40,450,000	Application and allotment	40,000,000
		Forfeited and re-issue	450,000
	40,450,000		40,450,000

Dr Calls in arrear Cr

1st Call	300,000	Forfeited shares	650,000
2nd Call	350,000		
	650,000		650,000

Dr Forfeited and reissue Cr

Calls in arrear	650,000	Share capital	1,000,000
Share capital (Mbweni)	1,000,000	Bank	1,100,000
Share premium	450,000		
	2,100,000		2,100,000

Statement of financial position

	TZS
ASSETS	
Bank	240,450,000
	240,450,000
EQUITY	
Share capital	200,000,000
Share premium	40,450,000
Total equity	240,450,000

Answer to TY 14

Dr Application and Allotment Cr

Bank	3,000,000	Bank	39,000,000
Share capital	28,000,000	Bank	1,975,000
Share premium	10,000,000	Calls in arrear	25,000
	41,000,000		41,000,000

Dr First & Final Call Cr

Share capital	11,850,000	Bank (39,500shares x TZS300)	11,850,000
	11,850,000		11,850,000

Dr Bank Cr

Application and allotment	39,000,000	Application and allotment	3,000,000
Application and allotment	1,975,000	Balance c/d	50,375,000
1st Call & Final Call	11,850,000		
Forf & Re-issue	550,000		
	53,375,000		53,375,000

Dr Share capital Cr

Dr		Cr	
Forfeited Shares (500xTZS700)	350,000	Application and allotment	28,000,000
Balance c/d	40,000,000	1st Call & Final Call	11,850,000
		Forfeited & Reissue (500x1000)	500,000
	40,350,000		40,350,000

Dr share Premium Cr

Dr		Cr	
Balance c/d	10,375,000	Application and allotment	10,000,000
		Forfeited and re-issue	375,000
	10,375,000		10,375,000

Dr Calls in arrear Cr

Dr		Cr	
Application and allotment	25,000	Forfeited shares	25,000
	25,000		25,000

Dr Forfeited and reissue Cr

Dr		Cr	
Calls in arrear	25,000	Share capital	350,000
Share capital	500,000	Bank	550,000
Share premium	375,000		
	900,000		900,000

Statement of financial position

	TZS
<u>ASSETS</u>	
Bank	50,375,000
	50,375,000
<u>EQUITY</u>	
Share capital	40,000,000
Share premium	10,375,000
Total equity	240,450,000

Answer to TY 15

a) Preference dividend – Paid (20,000issued shares x TZS200)=TZS4,000,000 x 5% = TZS200,000
- Proposed TZS4,000,000 x 3% = TZS120,000

Total preference dividend TZS320,000

b) Ordinary dividend – Paid (30,000issued shares x TZS300)=TZS9,000,000 x 6% = TZS540,000
- Proposed TZS9,000,000 x 7% = TZS630,000

Total ordinary dividend TZS1,170,000

Answer to TY 16

a) Preference dividend - Paid = TZS8,000,000
- Proposed (TZS130,000,000 x 12%)15,600,000-8,000,000 = TZS7,600,000

Total preference dividend TZS15,600,000

b) Number of ordinary shares = $\frac{\text{ordinary share capital}}{\text{Face value per share}} = \frac{\text{TZS800,000,000}}{\text{TZS800}} =$ 1,000,000 ordinary shares

Ordinary dividend - Paid = TZS12,000,000
- Proposed 1,000,000shares x TZS20 = TZS20,000,000

Total Ordinary dividend TZS32,000,000

Answer to TY 17

Workings

ordinary shares before issue of bonus shares = $\frac{\text{ordinary share capital}}{\text{Face value per share}} = \frac{\text{TZS1,000,000}}{\text{TZS1}}$=1,000,000Shares

Bonus shares

5shares held = 4 bonus shares
1,000,000shares = ?

Bonus shares = 800,000shares

Dr ordinary share capital Cr

Balance c/d	1,800,000	Balance b/d	1,000,000
		Share premium	500,000
		Revaluation reserve	300,000
	1,800,000		1,800,000

Dr share premium Cr

Share capital	500,000	Balance b/d	500,000
	500,000		500,000

Dr revaluation reserve Cr

Share capital	300,000	Balance b/d	350,000
Balance c/d	50,000		
	350,000		350,000

Statement of financial position

	TZS'000
Assets	
Non-current assets	1,800
Inventory	100
Trade receivable	30
Bank	70
	2,000
Share capital and reserves	
Ordinary shares of $1	1,800
Revaluation reserve	50
General reserve	70
Retained profit	80
	2,000

Answer to TY 18

Pearl beauty salon - Statement of financial position as at 31 March 20X3

	Tshs'000	**Tshs'000**
Assets		
Non-current assets		
Equipments (Tshs8.8 million -Tshs1.4 million)	7,400	
Furniture and fixtures (Tshs8.4 million -Tshs2.8 million)	5,600	
Computers (Tshs11.1 million - Tshs4.6 million)	6,500	
		19,500
Long-term investment -Peer Ltd		58,000
Current assets		
Inventories	8,300	
Accounts receivable	800	
Prepaid insurance	430	
Cash	2,110	11,640
Total assets		**89,140**
Capital and liabilities		
Capital		
As at 1 April 20X2	44,260	
Add: profit for the year	9,200	
Less: drawings	(6,000)	

As at 31 March 20X3		47,460
Non-current liabilities		
Bank loan		30,000
Current liabilities		
Bank overdraft	1,500	
Accounts payable	1,150	
Bills payable	6,000	
Tax payable	2,350	
Outstanding shop rent	680	
Total capital and liabilities		**89,140**

Answer to TY 19

The correct option is **C.**

The accounting equation is: Liabilities + Capital = Assets

Answer to TY 20

The correct option is **B**.

A current account is maintained to record all current transactions such as interest on capital or loan, salaries to partners, share of residual profits, drawings, and interest on drawings, etc. Therefore it keeps on fluctuating. Occasionally it may have a debit balance.

Self Examination Questions

Question 1

Qualitative characteristics aim to make:

A The statement of financial position show assets = liabilities
B The statement of financial position more presentable
C The statement of financial position more reliable and understandable
D More profits

Question 2

Relevance is:

A Presenting all important items
B Presenting financial information on the day immediately after the end of the accounting period
C Disclosing all losses in bold type
D None of the above

Question 3

Financial Statements help the management of a company to:

A Manage the business profitably and efficiently
B Assess the effectiveness of their activities throughout the year
C Exercise effective control planning
D All of the above

Question 4

Financial Analysts and advisers make use of financial statements to:

(i) Make predictions on the future financial condition
(ii) Advise their clients on potential investments
(iii) Provide information to the general public about the financial position of a company
(iv) Assess repayment capacity of the company

A (i) and (iii)
B (ii) ,(iii) and (iv)
C (i), (ii) and (iii)
D None of the above

Question 5

Additional information provided about a business's financial condition and methods used in preparing the financial statements are called:

A Management summary
B Owners additional information
C Creditors notes
D Notes to financial statements

Question 6

What does a complete set of financial statements include?

A Statement of financial position and Statement of profit or loss
B Statement of financial position, Statement of profit or loss, statement of cash flows, statement of changes in equity and notes to the financial statements
C Statement of financial position, Statement of profit or loss, statement of cash flows, statement of changes in equity, notes to the financial statements, management performance reports, chairman's declaration and similar items
D Statement of financial position, Statement of profit or loss, statement of cash flows, and statement of changes in equity

Question 7

Why are a statement of financial position and statement of profit or loss prepared?

A To help declare the dividend and share price
B To please the owners
C To portray the financial position and performance of the entity over a given time period
D To publish in a newspaper

Question 8

Which of the following are the forms of disclosure notes?
(i) Narrative
(ii) Disaggregation of information presented elsewhere in the financial statements or any additional information which has not been presented elsewhere in the financial statements.
(iii) Cost sheet

A (i) and (ii)
B Only (i)
C (i) and (iii)
D All of the above

Question 9

State whether these statements are true or false

A Disclosures are not a part of financial statements
B Information in disclosure notes can be provided in descriptive and qualitative terms
C Disclosure note may include the information which is not given in the statement of financial position and the statement of profit or loss

Question 10

Which of the following items represents expense?

A Royalty received
B Share capital
C Dividend received
D Purchases of goods

Question 11

An accrual system of accounting prescribes:

A Recording the substance of the transaction and ignoring the form
B Recording all expenses when the payment is made
C Recording assets when they are incurred
D Overstating the expenses

Question 12

Who issues the IFRS?

A IFRS IC
B IFRSF
C IFRS AC
D IASB

Question 13

What does the term IFRS encompass?

A US GAAP, IAS
B IAS, IFRS, interpretations issued by IFRIC
C SAC statements IAS
D Stock exchange guidelines

Question 14

Retained earnings appear in the statement of financial position of the following business entities:

(i) Sole proprietor
(ii) Partnership firm
(iii) Company

A Only (i)
B Only (ii)
C Only (iii)
D (i) and (ii)

Question 15

The owner of Chemidrum Traders gives you the following information:

Inventory	Tshs'000
1 January 20X3	15,700
31 December 20X3	12,300

Transactions during 20X3 are as follows:

	Tshs'000
Purchases at list price	80,000
Trade discount was received at 2.5% of list price	
Early settlement discount earned at 3% on a payment of Tshs50 million	
Sales	104,250
Cash payments	
Salaries	3,000
Electricity	900
Telephone	400
Printing and stationery	500
Refreshments	300
Unpaid expenses related to 20X3	
Telephone	50
Electricity	100
Salary	500

Required:

Prepare a statement of profit or loss for the year to 31/12/20X3.

Question 16

From the following information provided by Pretty Cosmetics, prepare the statement of financial position as at 31 March 20X3.

	Tshs'000
Building	90,000
Accumulated depreciation on building	12,000
Computers	17,250
Accumulated depreciation on computer	7,500
Vehicle	15,000
Depreciation on vehicle	3,900
Furniture and fixtures	14,200
Depreciation on furniture and fixtures	5,800
Inventory	12,450
Trade receivable	3,165
Cash in hand	1,200
Advance given to employees	5,000
Capital as at 1 April 20X2	73,640
Loan from bank Profit for	45,000
the year Drawings during	13,800
the year Trade payable	9,000
Tax payable	1,725
Prepaid insurance	3,525
Electricity expenses payable	645
	1,020

Question 17

Dhone, Boney and Toney are in a partnership, DBT, sharing profits in the ratio of 2:2:1. The following terms were agreed between them:

(i) All three should receive interest at 10% on the capital. The capital of the partners are as follows:

Dhone - Tshs35 million
Boney - Tshs45 million and
Toney - Tshs50 million

(ii) Dhone and Boney will get a salary of Tshs0.5 million per month.

(iii) Interest will be charged on the drawings at a rate of 6%. The drawings are as follows:

Dhone - Tshs0.5 million per month
Boney - Tshs0.75 million per month and
Toney - Tshs0.2 million per month

(assume the drawings are made in the middle of the month).

(iv) The partners' current account balance as on 1 December 20X3 are:

Dhone - Tshs3,871,000
Boney - Tshs4,961,000 and
Toney - Tshs6,568,000

(v) Profit for 20X8 is Tshs34 million

Other information related to DBT is given below:

	Tshs '000
Accounts payable	35,000
Accounts receivable	57,000
Inventory	45,000
Non-current assets	75,000
Cash and bank	33,000
Long-term loan	13,000

You are required to prepare the appropriation of profit, partners' capital and current account and statement of financial position (balance sheet) for the year ended 31 December 20X3.

Question 18

The trial balance of Upendo Enterprises at 31st December 2014 showed the following:

	Dr (Tshs.)	Cr (Tshs.)
Discounts	150,000	160,000
Selling and Distribution expenses	5,400,000	
Cash and Bank	2,350,000	
Cost of sales	30,100,000	
Administration expenses	3,300,000	
Buildings	29,800,000	
Motor vehicles	18,600,000	
Sales		42,900,000
Returns	60,000	
Accumulated Depreciation: Buildings		1,100,000
Accumulated Depreciation: Motor vehicles		3,600,000
Drawings	180,000	
Finance expenses	2,130,000	
Capital		45,860,000
Debtors/Creditors	1,990,000	1,890,000
Stock	1,450,000	
	95,510,000	95,510,000

Additional Information:

(i) Depreciation on building is 2% on book value while depreciation on motor vehicle is 5% on cost. Depreciation is to be charged to administration expenses.

(ii) Prepaid selling and distribution expense are Tshs. 20,000 while accrued finance charges are Tshs. 30,000.

REQUIRED:

Prepare:

(a) The Statement of Income for the year ended 31st December 2014.

(b) The Statement of Financial Position as at 31st December 2014.

Question 19

You have been provided with a trial balance of Brown, a sole trader who started business on 1st July 2012.

Brown

Trial Balance as at 30th June 2016

	DR. TZS.	CR. TZS.
Equipment at cost	204,000,000	
Motor vehicle at cost	88,000,000	
Accumulated depreciation		
Equipment (30th June, 2015)		**45,000,000**
Motor vehicle (30th June 2015)		**18,000,000**
Trade receivables	102,000,000	
Trade payables		84,000,000
Bank		6,600,000
Sundry expenses	17,000,000	
Cash	1,000,000	
Capital as at (1st July 2015)		200,000,000
Accumulated profit (1st July 2015)		43,200,000
Sales		856,000,000
Sales returns	4,000,000	
Purchases	604,000,000	
Purchases returns		2,000,000
Carriage inwards	1,000,000	
Carriage outwards	1,800,000	
Wages and salaries	134,000,000	
Rent	28,000,000	
Heating and lighting	10,000,000	
Inventory (1st July 2015)	30,000,000	
Drawings	44,000,000	
Provision for doubtful debts		8,000,000
Tax liability		6,000,000
	1,268,800,000	**1,268,800,000**

The following additional information as at 30th June 2016 is also provided:

(i) Owing for heating and lighting expenses amounting to TZS.800,000

(ii) Rent prepaid amounting to TZS.1,400,000

(iii) Allowance for doubtful debt was estimated to increase by TZS.9,000,000 and bad debt of TZS.2,400,000 should be written off.

(iv) Depreciation is to be charged for the year as follows:

 ii. Motor vehicle – 20% per annum (straight line method)

 iii. Equipment – 10% per annum (reducing balance method).

(v) Inventory as at 30th June 2016 was valued at TZS.33,000,000.

(vi) Tax provision for the year amount to TZS.2,300,000.

REQUIRED:

Prepare for Brown:

(a) Statement of profit or loss for the year ended 30th June 2016

(b) Statement of Financial Position as at 30th June 2016

Question 20

The Megabox Company Ltd operates its activities in small town near Mtwara. The Company produced the following trial balance as at 31st December 2014

	TZS	TZS
TZS 1000 ordinary Shares fully paid		200,000,000
Retained profit		70,000,000
10% Debenture		50,000,000
Sales		365,000,000
Bank and cash	20,000,000	
Motor lorries – at cost	360,000,000	
- accumulated depreciation		110,000,000
Freehold property	165,000,000	
Repairs and renewals	22,000,000	
Drivers' wages	60,000,000	
Maintenance wages	15,000,000	
Parts and consumables	70,000,000	
Licenses and insurance	20,000,000	
Administration salaries	20,000,000	
Sundry administrative expenses	12,000,000	
Drivers' overnight expenses	6,000,000	
Directors' salaries	25,000,000	
	795,000,000	**795,000,000**

Additional Information:

(a) Drivers' claims for TZS.150,000 relating to overnight expenses had not been taken into account.

(b) The parts and consumables account included parts valued on 1st January 2014 at TZS.15,000,000. A stock take at 31st December revealed that parts valued at TZS.18,000,000 were held at that date.

(c) It was estimated that there was a prepayment of TZS.4,000,000 with regard to licenses and insurance at the end of 2014.

(d) Depreciation of TZS.62,500,000 is to be charged on vehicles for the year to 31st December 2014.

(e) Tax is estimated at TZS.22,400,000.

(f) There is a proposed dividend of TZS.20,000,000.

REQUIRED:

(a) Prepare company's statement of profit or loss for the year ended 31st December 2014.

(b) Prepare statement of financial position as at 31st December 2014.

Question 21

You are given the following trial balance of Mjusi & Co. Limited as at 31st March 2017:

	Dr. TZS '000'	Cr. TZS '000'
Accumulated depreciation at 31.3.2017		
Buildings		43,812
Machinery		214,214
Motor vehicles		36,816
Office fittings		66,444
Administration salaries	265,420	
Accruals		163,400
Bank loan, repayable 2017		35,000
Bank overdraft		578,782
Buildings – cost	808,462	
Current tax liability		93,817
Cost of sales		
Material	1,181,617	
Labour	426,301	
Overheads (excluding depreciation)	526,211	
Depreciation expenses:		
Buildings	25,550	
Machinery	173,600	
Motor vehicles	28,420	
Office fittings	32,210	
Distribution salaries	218,028	
Debenture stock – 2023		100,000
Provision for legal damages		121,639
Inventory of finished goods	406,317	
Inventory of raw materials	964,821	
Interest income		23,550
Interest expense	78,415	
Land – cost	320,000	
Investment	210,000	
Machinery – cost	892,452	
Motor vehicles – cost	68,420	
Other expenses – Administration	130,037	
- Distribution	446,752	
Office fittings – cost	165,752	
Prepaid insurance	31,454	
Trade payables		1,064,299
Petty cash	26,216	
Trade receivables	1,161,307	
Retained earnings, 1.4.2016		764,031
Revaluation reserve		108,500
Sales		3,811,612
Share capital		1,200,000
Share premium		300,000
Tax charge for the year	108,315	
Inventory – work in progress	29,839	
	8,725,916 =======	8,725,916 =======

Notes:

a. The investment is held for the long-term.
b. The legal case for which the provision has been made is expected to be settled late 2017.
c. Depreciation expenses are included in cost of sales.

REQUIRED:

i) Prepare a Statement of Profit or Loss for the year ended 31st March, 2017.
ii) Prepare a Statement of Financial Position as at 31st March 2017.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **C**.

The main purpose of qualitative characteristics is to make the financial statements more reliable and understandable. The statement of financial position is a part of the financial statements.

Answer to SEQ 2

The correct option is **A**.

Financial statements must disclose all the relevant information. There is no compulsion to prepare the financial statements on the day immediately after the year end. There is no need to put the losses in bold type in the financial statements.

Answer to SEQ 3

The correct option is **D**.

Financial Statements help the management of a company to manage the business profitably and efficiently, assess the effectiveness of their activities throughout the year and exercise effective control and planning.

Financial Analysts and advisers make use of financial statements to make predictions on the future financial condition, advise their clients on potential investments and provide information to the general public about the financial position of a company.

Answer to SEQ 5

The correct option is **D.**

Answer to SEQ 6

The correct option is **B.**

A complete set of financial statements consists of: a statement of financial position, a statement of profit or loss and other comprehensive income, a statement on changes in equity, statement of cash flow and notes to the financial statements.

Other reports may be included in an annual report but are not part of the financial statements e.g. management reports.

Answer to SEQ 7

The correct option is **C.**

The main purpose of the financial statement is to portray the financial position and performance of the entity and thus satisfy the information needs of stakeholders.

Answer to SEQ 8

The correct option is **A**.

Answer to SEQ 9

The correct answer is

A False
B True
C True

Answer to SEQ 10

The correct option is **D.**

Royalty and dividend received are income. Share capital is equity. Purchases of goods are expenses of the business. This is because it will amount to a decrease in future economic benefits on account of a decrease in an asset i.e. cash and the amount paid can be measured reliably.

Answer to SEQ 11

The correct option is **C**.

According to the accrual system of accounting, expenses should be recorded in the financial statements when they are incurred.

Answer to SEQ 12

The correct option is **D**.

The IASB is responsible for writing, reviewing and issuing IFRS.

Answer to SEQ 13

The correct option is **B**.

IFRS comprise the IFRSs themselves that had been issued by IASB, the IASs issued by IASC and the interpretations issued by IFRIC.

Answer to SEQ 14

Retained earnings appear only in the books of companies. In the case of sole proprietors, profit is added to the capital, and in the case of partnerships; profit is distributed amongst the partners.

Answer to SEQ 15

Statement of profit or loss for the year to 31/12/20X3

	Tshs'000	**Tshs'000**
Revenue Cost of sales Opening inventory	15,700	104,250
Purchases (W1)	76,500	
	92,200	
Less: Closing inventory	(12,300)	
Cost of goods sold		79,900
Gross profit		**24,350**
Expenses		
Salaries (3,000 + 500)	3,500	
Electricity (900 + 100)	1,000	
Telephone (400 + 50)	450	
Printing and stationery	500	
Refreshments	300	5,750
Profit for the year		**18,600**

W1 Purchases

	Tshs'000	**Tshs'000**
List price of purchases	80,000	
Less: Trade discount at 2.5% X Tshs80 million	(2,000)	78,000
Less: Settlement discount (Tshs50 million x 3%)		(1,500)
Net purchases		**76,500**

Answer to SEQ 16

Pretty Cosmetics - Statement of financial position as at 31 March 20X3

	Tshs'000	Tshs'000
Assets		
Non-current assets		
Building (Tshs90 million - Tshs12 million)	78,000	
Furniture and fixtures (Tshs14.2 million - Tshs5.8 million)	8,400	
Vehicles (Tshs15 million - Tshs3.9 million)	11,100	
Computers (Tshs17.25 million - Tshs7.5 million)	9,750	
		107,250
Current assets		
Inventories	12,450	
Trade receivable	3,165	
Prepaid insurance	645	
Advance to employees	5,000	
Cash in hand	1,200	
		22,460
Total assets		**129,710**
	Tshs'000	**Tshs'000**
Capital And Liabilities		
Capital		
As at 1 April 20X2	73,640	
Add: Profit for the year	13,800	
Less: Drawings	(9,000)	
At 31 March 20X3		78,440
Non-current liabilities		
Bank loan		45,000
Current liabilities		
Trade payable	1,725	
Tax payable	3,525	
Electricity expenses payable	1,020	
		6,270
Total capital and liabilities		**129,710**

Answer to SEQ 17

DBT

Dr APPROPRIATION ACCOUNT Cr

	Tshs'000	Tshs'000		Tshs'000	Tshs'000
			Profit for the year b/d		34,000
Partners' salaries		12,000			
			Interest on drawings (W1)		
Interest on capital (W2)					
Dhone	3,500		Dhone	180	
Boney	4,500		Boney	270	
Toney	5,000	13,000	Toney	72	522
Residual profits					
Dhone	3,809				
Boney	3,809				
Toney	1,904	9,522			
		34,522			**34,522**

Workings

W1 Interest on drawings

		Tshs'000
Dhone	Tshs6 million at 6% for 6 months	180
Boney	Tshs9 million at 6% for 6 months	270
Toney	Tshs2.4 million at 6% for 6 months	72
		522

W2 Interest on capital

		Tshs'000
Dhone	Tshs35 million at 10%	3,500
Boney	Tshs45 million at 10%	4,500
Toney	Tshs50 million at 10%	5,000
		13,000

Capital Accounts

Dr **Cr**

	Dhone Tshs'000	Boney Tshs'000	Toney Tshs'000		Dhone Tshs'000	Boney Tshs'000	Toney Tshs'000
				Balance b/d	35,000	45,000	50,000
Balance c/d	35,000	45,000	50,000				
	35,000	**45,000**	**50,000**		**35,000**	**45,000**	**50,000**

Current Accounts

Dr **Cr**

	Dhone Tshs'000	Boney Tshs'000	Toney Tshs'000		Dhone Tshs'000	Boney Tshs'000	Toney Tshs'000
Drawings	6,000	9,000	2,400	Balance b/d	3,871	4,961	6,568
Interest on drawings	180	270	72	Salary	6,000	6,000	
				Interest on capital (at 6%)	3,500	4,500	5,000
				Residual profit	3,809	3,809	1,904
Balance c/d	11,000	10,000	11,000				
	17,180	**19,270**	**13,472**		**17,180**	**19,270**	**13,472**

Statement of financial position as on 31 December 20X3

	Tshs'000	Tshs'000
Capital accounts		
Dhone	35,000	
Boney	45,000	
Toney	50,000	130,000
Current accounts		
Dhone	11,000	
Boney	10,000	
Toney	11,000	32,000
Long-term loan		13,000
Accounts payables		35,000
		210,000
Non-current assets		75,000
Current assets		
Accounts receivable		57,000
Cash		33,000
Inventory		45,000
		210,000

Answer to SEQ 18

(a)

Upendo Enterprises
The Statement of Income for the year ending 31st December 2014

	Tshs '000'	Tshs '000'
Sales	42,900	
Less: Returns	60	42,840
Cost of sales		30,100
Gross profit		12.740
Discount received		160
		12,900
Less: Operating expenses		
Selling and Distribution expenses (5400 – 20)	5,380	
Administration expenses 3,300 + 574 + 930	4,804	
Finance charges 2,130 + 30 + 150	2,310	12,494
Net Profit		406

(b)

Upendo Enterprises
The Statement of Financial Position at 31st December 2014

ASSETS			**EQUITY & LIABILITIES**		
Non-current Assets			**Equity**		
Buildings 29.800 – 1100 - 574		28,126	Capital beg	45,860	
Motor vehicles 18,600 – 3,600 - 930		14,070	Profits	406	
		42,196	**Less:** Drawings	180	46,086
Current Assets			**Liabilities**		
Stocks	1,450		Creditors	1,890	
Prepaid expenses	20		Accrued exp	30	1,920
Debtors	1,990				
Cash and Bank	2,350	**5,810**			
Total Assets		**48,006**	**Total Equity & Liabilities**		**48,006**

Answer to SEQ 19

(a) **BROWN**

INCOME STATEMENT FOR THE YEAR ENDING 30TH JUNE 2016

	TZS ('000')	TZS ('000')
Sales (856,000 – 4,000)		852,000
Loss: Cost of sales		
Opening stock	30,000	
+ Purchases	604,000	
+ Carriage inwards	1,000	
- Return outwards	(2,000)	
- Closing stock	(33,000)	600,000
Gross Profit		252,000
Sundry expenses	(17,000)	
Carriage outwards	(1,800)	
Wages & salaries	(134,000)	
Rent (28,000 – 1,400)	(26,600)	
Heat + Light (10,000 + 800)	(10,800)	
Increase provision & Doubtful debt	(9,000)	
Bad debt	(2,400)	
Depreciation		
M.V – (20% x 88,000)	(17,600)	

Equipt – (10% x (204,000 – 45,000)	(15,900)	(235,100)
Net profit before tax		16,900
Tax expense		(2,300)
Net Profit After Tax		14,600 =====

(b) **BROWN**

STATEMENT OF FINANCIAL POSITION AS AT 30TH JUNE 2016

	TZS ('000')	TZS ('000')
Non-Current Assets		
Equipment (204,000 – 45,000 – 15,900)		143,100
Motor vehicle (88,000 – 18,000 – 17,600)		52,400
		195,500
Current Assets		
Inventory	33,000	
Debtors (102,000 – 9,000 – 2,400 – 8,000)	82,600	
Cash	1,000	
Prepaid rent	1,400	118,000
		313,500 ======
Financial by equity + liability		
Equity		
Capital	200,000	
+ Profit (43,200 + 14,600)	57,800	
- Drawings	(44,000)	213,800
Current Liabilities		
Trade payables	84,000	
Outstanding Heat exp	800	
Tax liability (6,000 + 2.300)	8,300	
Bank Overdraft	6,600	99,700
		313,500 ======

Answer to SEQ 20

Megabox Ltd.

Statement of Profit or Loss for the year ended 31st December 2014

	TZS	TZS
Sales		365,000,000
Repairs to property	22,000,000	
Wages (60 + 15)	75,000,000	
Salaries (20 + 25)	45,000,000	
Drivers' subsistence	6,150,000	
Depreciation of vehicles	62,500,000	
Parts and consumables (70 – 18)	52,000,000	
Licenses and insurance (20 – 4)	16,000,000	
Administrative expenses	12,000,000	
Debenture interest	5,000,000	295,650,000
Net profit		69,350,000
Corporation tax		22,400,000
Profit after tax		46,950,000

Megabox Ltd
Statement of Financial Position as at 31st December 2014

Assets	Cost	Depr	NBV
Non-current assets	TZS	TZS	TZS
Freeholds property	165,000,000		165,000,000
Motor Vehicles	360,000,000	172,500,000	187,500,000
	525,000,000	172,500,000	352,500,000
Current assets			
Stock of parts, etc.	18,000,000		
Prepaid insurance and licenses	4,000,000		
Bank and cash	20,000,000		42,000,000
Total Assets			394,500,000
Represented by:			
Capital			
TZS 100 ordinary Shares fully paid			200,000,000
Profit and loss account			96,950,000
Shareholders' equity			296,950,000
10% Debentures			50,000,000
			346,950,000
Current Liabilities			
Driver's subsistence owing		150,000	
Taxation		22,400,000	
Proposed dividend		20,000,000	
Accrued interest		5,000,000	
		47,550,000	
Net current liabilities			47,550,000
Total Capital and liabilities			394,500,000

Answer to SEQ 21

(a)

Mjusi & Co Ltd.
Statement of Profit or Loss for the year ended 31 March 2017

Sales		3,811,612
Less: Cost of Sales		(2,393,909)
Gross Profit		1,417,703
Less: Operating Expenses		
Distribution expenses:		
Salaries	218,028	
Others	446,752	
Administration expenses:		
Salaries	265,420	
Others	130,037	(1,060,237)
		357,466
Investment Revenue		23,550
Finance costs		(78,415)
		302,601
Profit before tax		
Tax		(108,315)
Profit for the year		194,286

b)

Mjusi & Co Ltd.
Statement of Financial Position
As at 31 March 2017

Non-Current Assets			
Buildings	808,462	43,812	764,650
Machinery	892,452	214,214	678,238
Motor vehicle	68,420	36,816	31,604
Office Fixtures	165,752	66,444	99,308
Land	320,000	-	320,000
Investment	210,000	-	210,000
			2,103,800

Current Assets		
Raw Materials	964,821	
Work in Progress	29,839	
Finished Goods	406,317	
Petty cash	26,216	
Trade receivables	1,161,307	
Prepayments	31,454	
		2,619,964
		4,723,754
Equity & Liabilities		
Equity		
Share Capital	1,200,000	
Share Premium	300,000	
Revaluation Reserve	108,500	
Retained Earnings	958,317	
		2,566,817
Non-Current Liabilities		
Bank	35,000	
Debenture Loans	100,000	
		135,000
Current Liabilities		
Trade payables	1,064,299	
Accruals	163,400	
Current tax liabilities	93,817	
Bank overdraft	578,782	
Provision	121,639	2,021,937
		4,723,754

STATEMENT OF CASH FLOWS

10

STATEMENT OF CASH FLOWS

Get Through Intro

A few years ago, the phrase "financial statements" indicated mainly the statement of financial position and the statement of profit or loss. However, these two statements do not give adequate information about cash. The statement of cash flows (SOCF) which gives information about the inflow and outflow of cash is necessary to understand the liquidity of the entity.

For example, at 31 March 20X7, Sunfire Inc has assets worth Tshs250 million and has earned a profit of Tshs50 million in the year to 31 March 20X7. This reflects a very comfortable position. However how will its liquidity position be if

it has to repay a loan instalment of Tshs25 million on 5 April 20X7.
the cash balance with Sunfire Inc is Tshs2.5 millionand
it does not expect any customer to pay up before 5 April 20X7 and has no inventory.

So how will Sunfire Inc pay the instalment?
Its liquidity position is shaky!

The example shows that the liquidity position of the entity cannot be determined by the statement of profit or loss and the statement of financial position. This information is obtained from the statement of cash flows.

Cash is the lifeline for any business and it is essential that the owners and other users have sufficient information about its movements. Failure to manage cash properly may snap that lifeline - endangering the survival of the business.

In the future, in your role as an accountant or a consultant / auditor you may be called upon to prepare or give assurance on statements of cash flows. The management or the client will put their faith into your statement of cash flows and take important decisions. This Study Guide helps you to gear up for this challenge.

Learning Outcomes

a) Differentiate between profit and cash flow.
b) Explain the need for management to control cash flow.
c) Recognise the benefits and drawbacks to users of the financial statements of cash flows.
d) Classify the effect of transactions on cash flows.
e) Calculate the figures needed for the statement of cash flows including:
   i. Cash flows from operating activities
   ii. Cash flows from investing activities
   iii. Cash flows from financing activities
f) Calculate the cash flows from operating activities using the indirect and direct method.
g) Prepare statements of cash flows from given information.
h) Identify the treatment of given transactions in a company's statement of cash flows.

1. Differentiate between profit and cash flow.

[Learning Outcome a]

The net profit figure is affected by non-cash items such as:

depreciation expense;
accounting of sales and purchases on an accrual basis and
accrual or prepayment adjustments at the end of the year.

Therefore, profit earned and cash generated from operations are two entirely different amounts.

1.1 The effect of depreciation

Depreciation is a non-cash expense. It does not affect cash flows.

Example

Zombo, a small businessman, has the following statement of financial position as at 1 January 20X7:

	Tshs'
Assets	
Property plant and equipment	180,000
Cash	15,000
	195,000
Capital and liabilities	
Capital (net profit is Tshs105,000)	**195,000**

During 20X7 he has had only cash sales and purchases, and has earned a profit of Tshs105,000 (after charging depreciation of Tshs18,000). He had no transactions in his capital account. Depreciation was charged before arriving at the figure of profit but it does not involve any cash payment.

As the assets are present in the opening statement of financial position, this means that they were not purchased in 20X7. This shows that there was no outflow of cash in 20X7 on account of purchase of assets.

The entry for charging depreciation in 20X7 is:

Dr	Depreciation	Tshs18,000	
Cr	Provision for depreciation		Tshs18,000

Being depreciation on assets accounted for

Depreciation was charged only by way of a book entry so as to allocate the cost of the asset over its useful life. Therefore there was no actual outflow of cash.

Non-cash expenses such as depreciation have to be added back to the book profit in order to find out cash profits or cash from operating activities.

	Tshs
Book profits	105,000
Add: Depreciation	18,000
Cash from operating activities	**123,000**

We can easily see that the profit for the year was Tshs105,000, but the cash flow from operations was Tshs123,000.

1.2 The effect of other accrual factors

Consider the effect of trade receivables on cash flow -

Example

It was stated in Zombo's example that all the sales and purchases were for cash. Suppose that one sale of Tshs9,000 was on credit and the money will not be paid until after 31 December 20X7. This would mean that, out of Tshs123,000 cash generated from operations, Tshs9,000 is tied up in receivables and not yet received in cash. Therefore the cash flow from operating activities will be only Tshs114,000 (i.e. 123,000 - 9,000).

Cash from operations would then be arrived at as:

	Tshs
Book profits	105,000
Add: Depreciation	18,000
	123,000
Less: Increase in receivables	(9,000)
Cash from operating activities	**114,000**

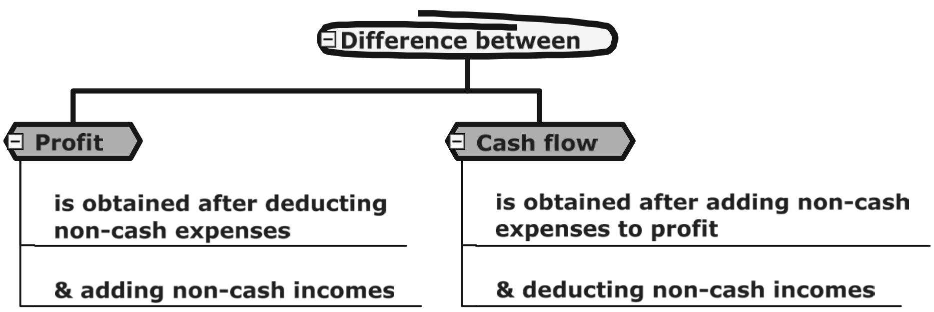
This is confirmed by the statement of financial position as at 31 December 20X7 as given below:

	Opening SOFP	Adjustments	Closing SOFP
	Tshs	Tshs	Tshs
Assets			
Property plant and equipment	180,000	**Less**: 18,000 Depreciation	162,000
Cash	15,000	**Add:** 123,000 Cash from operating activities	138,000
	195,000		**300,000**
Capital and liabilities			
Capital	195,000	**Add:** 105,000 Profit	300,000
	195,000		**300,000**

Tip

Both profit and cash flow are period concepts

SUMMARY



Test Yourself 1

What is the impact of depreciation expense on the company's cash flow?

A Cash inflow
B Cash outflow
C None of the above

2. Explain the need for management to control cash flow.
[Learning Outcome b]

Management need to control cash flow for the following reasons:

1. Cash is the lifeline for any business. Cash is needed regularly for all activities. If adequate cash is not available on time, the **day-to-day operations may be hampered**. Management has to plan the cash flow for the future and initiate steps to raise finance in advance, if required.

2. The **survival of an entity depends upon its ability to generate cash** from operations (not only to show book profits). For example, profit which is tied up in a large amount of inventories may weaken the liquidity position of the company as all its cash is invested in its inventories. Management has to monitor cash flow on a daily basis.

3. For the same reasons, **payables and banks are interested in cash flow figures**. They want to know the repayment capacity of the entity. Management has to remember that their performance will be judged from this angle also, and ensure good cash flow management

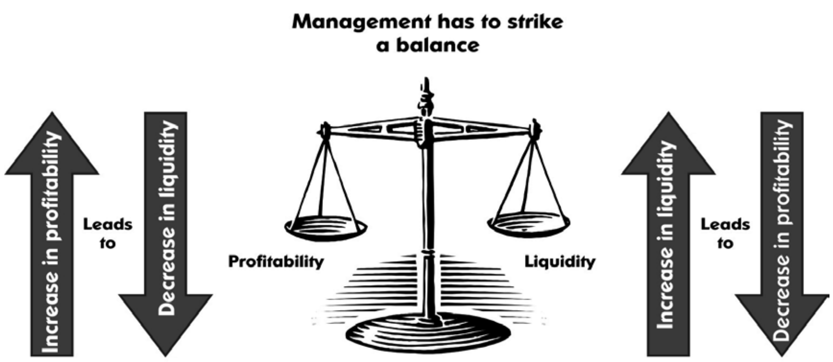
4. Bad cash management can also **adversely affect profitability**. If a large amount of cash is kept idle, it does not earn any income. Similarly if an amount due from receivables is not collected on time, cash is tied up in receivables. The same cash can be employed more profitably in an alternative opportunity.

However, management has to strike a balance between profitability and liquidity. The two have opposite pulls. More liquidity (having more cash) means less profitability. However, having too little cash may endanger the solvency of an entity.

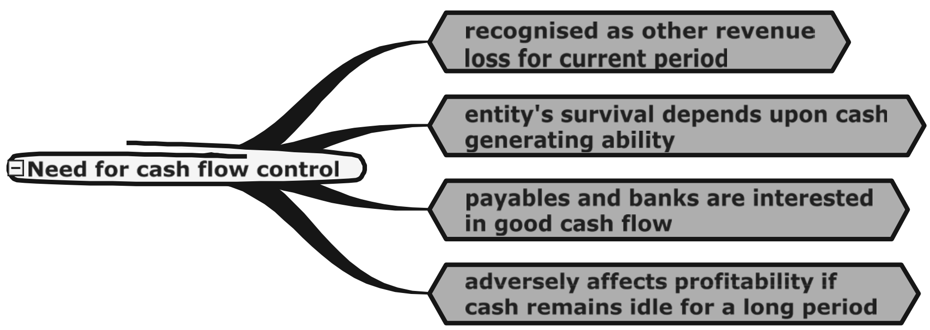
Example

Carlson Ltd generally maintains a higher inventory level in anticipation of greater sales. Due to maintaining high inventory levels, the company would be blocking a lot of liquid cash and thus creating liquidity problems. If the company is unable to achieve its sales target, the liquidity situation will deteriorate further.

Diagram 1: Balance between profitability and liquidity



SUMMARY



Test Yourself 2

State any three reasons why management has to control cash.

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3. Recognise the benefits and drawbacks to users of the financial statements of a statement of cash flows.

[Learning Outcome c]

3.1 Benefits of statement of cash flow (SOCF) in comparison with the statement of profit or loss

1. The statement of cash flows enhances the comparability of the operating performances of two entities or two periods by eliminating the effects of using different accounting treatments for the same transactions and events.

Example

Simple Ltd and Style Ltd are similar entities with similar sales and net assets. Simple Ltd has a profit after depreciation of Tshs50m and Style, Tshs48m. The depreciations charged by them are Tshs5 million and Tshs10 million respectively. Which is more efficient? The profits in the statement of profit or loss may indicate that Simple Ltd is more efficient than Style Ltd. However, this is the wrong conclusion.

The statement of cash flows will tell you that the cash inflow from the operating activities was Tshs55m (50 + 5) in the case of Simple Ltd and Tshs58 million (Tshs48 million + Tshs10 million) in the case of Style Ltd, and therefore Style Ltd is more efficient. This is the correct conclusion in this case.

In this way, an SOCF neutralises the impact of the accrual entries on the other financial statements.

2. The above discussion leads us to the next important use of cash flow. The **survival of an entity depends upon its ability to generate cash** and cash equivalents from operations (not only to show book profits). The statement of cash flows helps in analysing the performance from this angle. For example, profit which is tied up in a large amount of inventories may weaken the liquidity position of the company as all its cash is invested in its inventories.

Example

Lonila Co's financial statements show the following details

	Tshs
Sales	500,000
Closing inventory	250,000
Net profits	300,000
Cash	5,000

Here, in spite of having higher profits, cash balance is very low. This is because most of the cash is tied up in inventories. This indicates that Lonila is not very efficient in generating cash.

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3. For the same reasons, **payables and banks are more interested in cash flow figures**. They want to know the repayment capacity of the entity.

4. The statement of cash flows is much **simpler to understand**, even for businessmen who do not have in-depth accounting expertise.

5. The statement of cash flows gives **better information** than the traditional profitability statements to the management for **decision-making**.

3.2 Other benefits of statements of cash flows

1. The statement of cash flows helps the user evaluate the financial structure and the ability of the entity to adapt to changing circumstances. E.g. if an entity has a reasonable balance of cash and cash equivalents, it may be better placed to cope with impending financial liabilities.

2. Future projections: a statement of cash flows of, for example, 3 to 5 years can be used to project future cash flows. This, along with the other financial statements, will help the entity in planning for the future.

It helps in **planning the future cash movements**, checking the actual movements against those planned and taking corrective actions.

Example

After an analysis of the past 2 - 3 years' cash flows and the financial statements, TRB Ltd projected the cash collections from customers for the year 20X5 - X6 at Tshs800 million.

However, the actual collections turned out to be only Tshs600 million. The finance manager and the sales manager analysed the variance together, and found out that cash inflows from two of the major customers Chris and Joe had slowed down.

At Chris's factory there was a strike which had ended recently so cash flows would be back to normal soon.

Joe was setting up a new plant and had diverted a part of his working capital for investment in the new plant, causing cash shortage. It was decided that the sales manager should fix a meeting with Joe's General Manager to sort out the issues.

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3. When used along with the other financial statements, the statement of cash flows helps the users **evaluate changes in the financial position of an entity**, its financial structure and its ability to affect the amounts and timing of cash flows.

Example

If a loan liability has been reduced, it may or may not be an outflow of cash.

If it is a repayment of a loan, the statement of cash flows will disclose this fact.
If some other asset has been given up to reduce the loan, the notes to accounts will disclose this.

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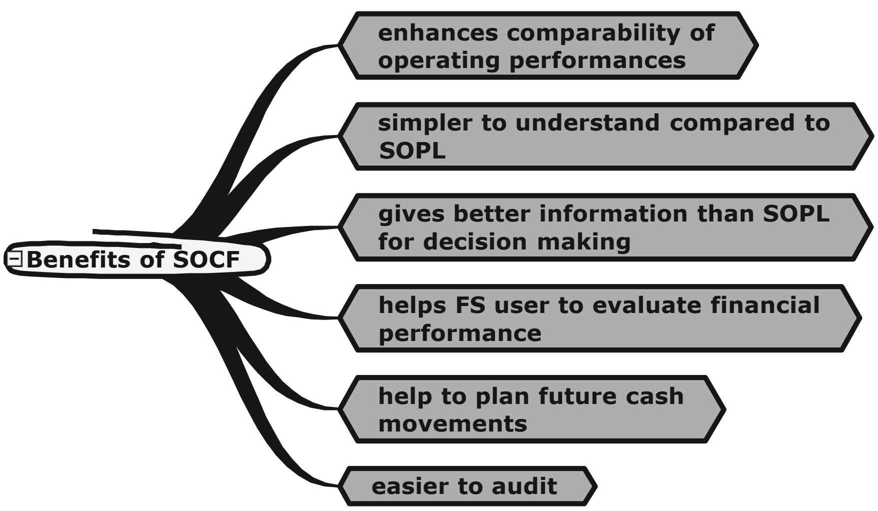
4. The statement of cash flows is **easier to audit.**

SUMMARY



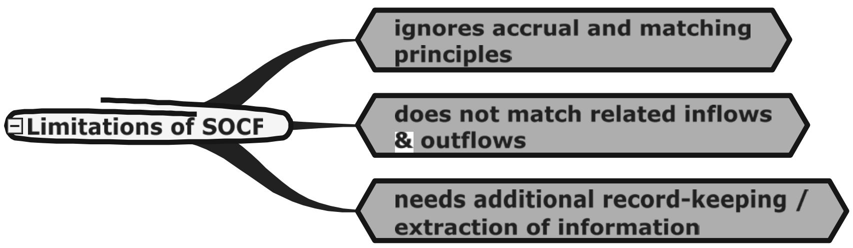
3.3 Drawbacks of statement of cash flows

1. Cash flows statements consider the flows as they occur. They do not match the related inflow and outflows. Therefore, if there is an operating inflow during the current period, the statement of cash flows will paint a good picture. However, there may be a related cash outflow expected in the next period. A cash flow based on historical figures will not reflect this. The statement of profit or loss prepared on accrual and matching principles does not have this drawback.

2. Few businessmen keep the kind of records required to prepare a statement of cash flows. Therefore additional record keeping or extraction of information is needed.

3. Cash flow statements give only some of the information necessary to assess liquidity and solvency hence there are chances that it may be manipulated by management.

SUMMARY



Test Yourself 3

Which of the following are the drawbacks of preparing statement of cash flows?

A A statement of cash flows is prepared on a cash basis. It does not match the related inflows and outflows of expenses on the basis of accrual.
B It is difficult to understand for a person who does not have technical knowledge of accounting.
C It does not facilitate the comparability of the operating performance of two entities or two periods.
D None of the above

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4. Classify the effect of transactions on cash flows.

[Learning Outcome d]

4.1 Cash and cash equivalents

Just as opening and closing balances of cash are shown in the cash book, opening and closing balances of cash and cash equivalents **as a group** are shown in a statement of cash flows.

The movements between any two components of cash and cash equivalents are not treated as cash flows and therefore not reported in a statement of cash flows. They represent only the changes internal to the group of cash and cash equivalents.

Therefore, before we move on to discuss the classification of transactions; it is important that we understand the meaning of cash and cash equivalents.

Definition

Cash comprises cash in hand and demand deposits.

IAS 7 Para 6

Definition

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

IAS 7 Para 6

Cash equivalents enable the entity to meet **short-term cash commitments**.

1. For an investment to be treated as a cash equivalent, the following conditions should be met:
   - It should be readily convertible into cash. It has a short maturity period, e.g. less than three months.
   - There should be no significant risks of changes in the value to be realised.

2. Equity / share instruments are generally excluded from cash equivalents, unless they are, in substance, cash equivalents. For example preference shares acquired within a short period (3 months) of their maturity may be treated as cash equivalents.

3. **Bank borrowings are generally excluded** from cash equivalents, unless they are repayable on demand. For example bank overdrafts repayable on demand are treated as part of cash equivalents.

An entity has to **disclose** the **components of the cash and cash equivalents**. It also has to present a reconciliation of this amount with the cash balance disclosed in the statement of financial position.

Example

Perfect Co's statement of cash flows shows a balance of cash and cash equivalents at the year-end of Tshs40 million. In its statement of financial position, the bank and cash balance is disclosed as Tshs25 million. It must show how the figure of Tshs40 million was arrived at. For example, if an amount of investments of a short maturity period, worth Tshs15 million is treated as a cash equivalent, then Perfect Co will disclose the composition of cash and cash equivalents as:

Cash and bank balance	Tshs25 million
Investments with a maturity of less than 3 months	Tshs15 million
Total	Tshs40 million

4.2 General principles of the classification of cash flows

The effect of any transactions can be classified under any one of the following categories:

- Operating activities
- Investing activities
- Financing activities

The statement of cash flows breaks the overall cash flow into these activities. This makes the presentation more meaningful.

1. Operating activities

Definition

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

IAS 7 Para 6

Generally, cash receipts or payments for all items in the statement of profit or loss will be included in calculating cash flows from operating activities.

Example

Examples of cash flows from operating activities, as given in the IAS 7 are:

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 enterprise for premiums and claims, annuities and other policy benefits;
f) cash payments or refunds of income taxes (unless they can be specifically identified with financing and investing activities);
g) cash receipts and payments from contract held for dealing or trading purposes.

Disclosure of the cash flows from operating activities will enable the users to judge **whether the entity is fulfilling the main purpose for which it exists**, i.e. to earn sufficient money from the principal revenue-producing activities so as to run the company, pay dividends, repay loans, make new investments etc.

Example

Nest Ltd's statement of cash flows shows that it earns cash worth Tshs25 million from operations. It pays dividends of Tshs15 million, repays a loan worth Tshs22 million, takes a new loan of Tshs13 million, and makes new investments for Tshs1 million. Information in its financial statements shows that the repayment of Tshs22 million is towards normal loan instalments due.

The statement of cash flows shows that Nest Ltd is not earning sufficient cash from operations. It has to use the money from a fresh borrowing to repay the earlier loan. (Out of Tshs25 million cash from operations, Tshs15 million is paid as dividends, leaving only Tshs10 million for other purposes, which is not sufficient for loan repayments.)

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2. Investing activities

Definition

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

IAS 7 Para 6

This group of activities indicates the extent to which the entity invests in activities which bring benefits in the future.

Example

If money is invested in new machinery, it will help the entity to produce and sell more goods, which in turn will generate more income in the future.

The cash payments or receipts on account of the following are treated as cash flows from investing activities:

(a) Property, plant and equipment, intangibles and other long-term assets e.g. acquisition or disposal of equipment
(b) Shares or debt of other entities (excluding those forming part of cash equivalents or held for trading) e.g. acquisition / disposal of ordinary shares
(c) Cash advances and loans made to other parties (other than those made by a financial institution) e.g. Star Co, a manufacturing company gives loan of Tshs80,000 to Moon Co.

3. Financing activities

Definition

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

IAS 7 Para 6

This includes the following cash receipts and payments:

(a) Issue or redemption of shares
(b) Borrowing and repayment of debentures, loan notes, bonds, mortgages and other short or long-term borrowings
(c) Cash payments towards the principal portion by the lessee of a financial lease.

The information under this group of activities helps the readers to know how the entity has raised or repaid financial resources. These details help in predicting claims on future cash flows by providers of capital to the entity.

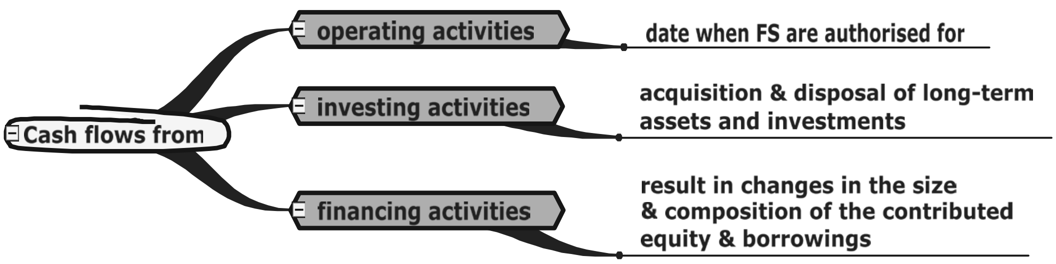
Example

Ingrip Plc raised Tshs500,000 by an issue of shares and Tshs200,000 by way of fixed term loans from banks. It invested Tshs400,000 in a building and Tshs300,000 in plant and equipment.

Raising money by way of an issue of shares or bank loans is a **financing activity** and it is shown as cash inflow under this category.

Similarly, investing money in buildings and plant and equipment is an **investing activity** and is disclosed as cash outflows under this category.

SUMMARY



4.3 Classification of certain specific items

IAS 7 gives guidance on the classification of certain items, as follows:

1. Interest and dividends

(a) Disclosure

(i) Receipts and payments of interest and dividends are disclosed separately.

Example

A receipt of Tshs50,000 of interest on loans given and payment of Tshs75,000 of interest on borrowings should be disclosed separately.

(ii) Whether the interest amount is capitalised (added to the cost of an asset) or shown as an expense, it should be disclosed separately.

Example

A company incurs an interest cost of Tshs0.5 million and, as permitted by IAS 23, capitalises it i.e. adds it to the cost of machinery. The statement of profit or loss will not show the interest cost separately. However, the company will have to show the interest cost separately in the statement of cash flows.

(b) Classification under operating, investing or financing activities

Classification **of interest paid** and **interest and dividends received is as follows**:

(i) Either both the interest paid and the interest and dividends received are classified under **operating activities**.

(ii) Or interest paid is classified under **financing activities** (because it is the cost of obtaining financial resources) and **interest and dividends received** are classified under **investing activities** (being the returns on investments).

Example

Zest Ltd's financial statements show a net profit of Tshs600,000 before the following adjustments:

Interest paid	Tshs55,000
Interest received	Tshs7,000
Dividends received	Tshs18,000
Dividends paid	Tshs49,000

First option

Interest paid Tshs55,000 is classified under operating activities
Interest received Tshs7,000 and dividends received Tshs18,000 are classified under operating activities.

Second option

Interest paid Tshs55,000 is classified under financing activities.
Interest received Tshs7,000 and dividends received Tshs18,000 are classified under investing activities.

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2. Classification of dividends paid: These may be classified

a) **Either** as **financing** activities because they are a cost of obtaining financial resources. (Dividends need to be paid to shareholders. Otherwise shareholders will not continue to hold their shares. It is their return on investment) Or

b) As a component of cash flows from **operating activities**, so that the users can assess whether the entity is able to pay dividends out of operating cash flows.

The IAS allows the entities flexibility to decide how to classify interest and dividends, depending upon circumstances and the judgement of the management.

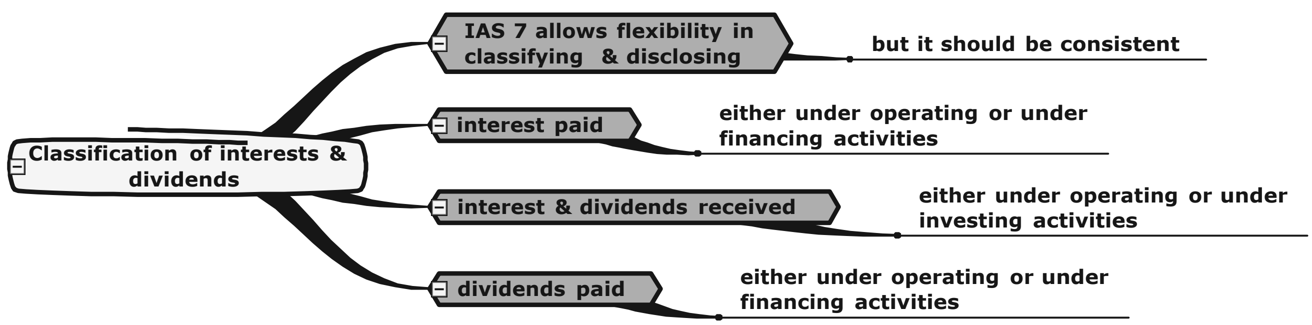
3. Consistency

As seen above, it may be possible to classify interest and dividends under operating, investing or financing activities. There should be **consistency in classifying and disclosing** them under operating, investing or financing activities.

Example

Success Co discloses interest paid under financing activity for the 1st year because it is the cost of obtaining financial resources. During the 2nd year, it cannot classify interest paid under operating activities by stating that the interest should be paid out of the operating activities. There should be consistency in the classification and disclosure of such items.

SUMMARY



4. Taxes on income: classification and disclosure

   Cash flows arising from taxes on income should be separately disclosed and classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Tip

At this level of learning, it is better to show tax adjustments under operating cash flows. This allows greater simplicity of presentation and calculation.

   If it is possible to **identify the tax cash flows** with the related individual **cash flow relating to investing or financing**, then it may be classified under that activity e.g. tax related to dividend received.

Example

Some countries levy a tax on the income distributed as a dividend.

Bracket Ltd distributes dividend of Tshs16 million and immediately pays a 10% dividend distribution tax of Tshs1.6m on these dividends to the government treasury.

If Bracket classifies the dividend of Tshs16 million under financing activity, then it may also classify the tax of Tshs1.6 million under financing activity. This is because the cash outflow on account of tax is clearly identifiable with the cash outflow on account of dividends paid. As dividends paid are classified under financing activities the dividend tax paid is also classified under financing activities.

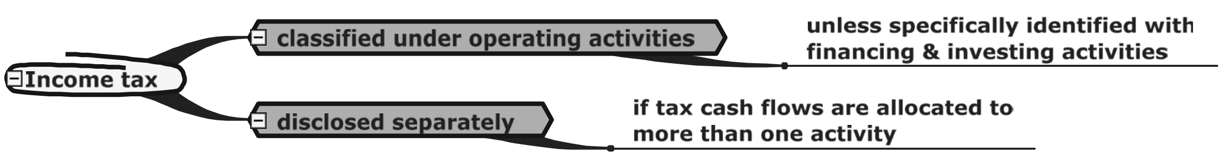
   When the tax cash flows are allocated to more than one activity, the total tax paid should be disclosed separately.

Example

Continuing the previous example of Bracket Ltd,

If in addition to the aforementioned tax of Tshs1.6 million, Image Ltd has paid a separate tax of Tshs10 million which is classified under operating activity, then it needs to separately disclose the total tax paid of Tshs11.6 million, by way of a note.

SUMMARY



5. Other items

Some transactions e.g. sale of non-current assets may be partially reflected in the statement of profit or loss through a profit or loss on sale. However, cash flows resulting from profits or losses on sale should not be classified under operating activities, but should be included in an appropriate activity group, in this case, investing activities.

Example

A building which has a carrying value of Tshs3 million is sold for Tshs5 million. The statement of financial position will show Tshs3million as a reduction from the building value and the statement of profit or loss will show Tshs2 million as profit on sale of the building.

So as far as the statement of cash flow is concerned:

   the entire amount of Tshs5 million is shown as a cash inflow from investing activities.
   the Tshs2 million profit on sale will be shown as an adjustment when calculating cash flows from operating activities.

Test Yourself 4

Identify the classification of the following activities in order to prepare a statement of cash flows.

(a) Issue of share capital for cash
(b) Issue of share capital other than cash, for acquisition of business
(c) Payment to suppliers
(d) Depreciation
(e) Purchase of a plant
(f) Dividend paid
(g) Taxes on income

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5. Calculate the figures needed for the statement of cash flows including:
i. Cash flows from operating activities
ii. Cash flows from investing activities
iii. Cash flows from financing activities

[Learning Outcome e]

5.1 Cash flows from operating activities

This can be prepared by using either an indirect method or a direct method. This is taken up in the next Learning Outcome (i.e. Learning Outcome 6)

5.2 Cash flows from investing activities

Example

Record Plc extracts the following details from its records:

Record Plc acquired a building worth Tshs600,000. It paid Tshs150,000 in advance in the previous year and organised a loan from Richie bank for the balance, to be paid to the supplier.

It sold its long-term investments with a carrying amount of Tshs200,000 at a profit of Tshs80,000. Record Plc also sold a used car which had a carrying value of Tshs90,000 for Tshs60,000. Record Plc put Tshs300,000 as deposit for 1 month, with Fortune Bank.

Record Plc received dividends of Tshs75,000, interest of Tshs53,000 and paid dividends amounting to Tshs150,000.

Calculate the cash flow from investing activities.

Answer

Cash flow from investing activities	Tshs
Purchase of property, plant and equipment (W1)	(450,000)
Proceeds from sale of investments (200,000 + 80,000) (W2)	280,000
Proceeds from sale of car (W3)	60,000
Interest received	53,000
Dividends received	75,000
Net cash used in investing activities	**18,000**

Workings

W1 Acquisition of building: It is an acquisition of a long-term asset and hence is an investing outflow. Raising finance - Tshs450,000 for the building is a financing activity and shall be reported under that heading. Outflow under the investing activities will be Tshs450,000 (Tshs600,000 - Tshs150,000 paid in previous year)

W2 Disposal of long-term investments is an investing activity.

Continued on the next page

W3 Sale of a car is an investing activity.

W4 Bank deposit with a maturity of less than one month is treated as a part of cash equivalent and is not an investing activity.

W5 Dividend paid is not part of investing activities. It may be covered either under financing activities or operating activities.

W6 Interest and dividends received **can be treated as a part of operating activities or investing activities**. If the former option is selected, **net cash outflow** from investing activities would be Tshs110,000 (negative balance)

Tip

Go through the information given and decide what is relevant for "investing activities". Determine the amount of actual cash flow for each of the items. Give workings about the logic applied and give a cross reference of the workings in main statement of cash flows.

5.3 Cash flow from financing activities

Example

The following details are related to Rodiac Inc. Calculate the cash flows from financing activities:

	Tshs
Issued 250,000 ordinary shares for cash	250,000
Obtained an overdraft (repayable on demand)	700,000
Paid instalments of a loan: Principal	400,000
Interest	300,000
Issued debentures at 5% premium, the nominal value is	500,000
Paid dividends	200,000
Paid finance lease liabilities	90,000

Answer

Cash flows from financing activities	Tshs
Proceeds from issue of share capital	250,000
Proceeds from / (repayments of) long-term borrowings	
Term loan repayments	(400,000)
Issue of debentures (Tshs500,000 + 5% premium)	525,000
Payment of finance lease liabilities	(90,000)
Dividends paid	(200,000)
Net cash used in financing activities	85,000

Workings

W1 Overdraft repayable on demand is treated as a cash equivalent, and not as a financing cash flow, for the purpose of the statement of cash flows (it is a movement within the overall cash and cash equivalents of which only the opening and closing balances are included in the statement of cash flows).

W2 Interest paid on the loan can be classified either under operating activities or under financing activities. If the latter option is selected, then an additional outflow of Tshs300,000 will be shown in the above calculations.

Test Yourself 5

For the following information determine the cash flow from investing activities.

Sale of building: carrying value Tshs280,000 at a profit of Tshs38,000.
Sale of long-term investment: carrying amount Tshs340,000 at a loss of Tshs17,000.
Purchase of car: Tshs540,000 out of which Tshs300,000 is outstanding
Interest paid: Tshs45,000

A Tshs401,000
B Tshs356,000
C Tshs701,000
D Tshs641,000

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6. Calculate the cash flow from operating activities using the indirect and direct method. [Learning Outcome f]

The meaning of direct / indirect methods

Definition

An entity shall report cash flows from **operating activities** using either:

(a) the **direct method**, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) the **indirect method**, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, 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

IAS 7 Para 18

6.1 Direct method - Gross receipts & payments

Proforma of direct method statement of cash flows (With imaginary figures)

Cash flows from operating activities	Tshs
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**

Cash flows from investing activities and financing activities will appear same under direct and indirect method.

IAS 7 recommends this method because it provides information that may be useful in estimating future cash flows.

The information under major classes of **gross receipts and payments of cash** may be obtained either:

(a) directly from the accounting records or

(b) by taking the statement of profit or loss as the basis and by adjusting the figures of sales, cost of sales and other items in the statement of cash flows for:
Changes during the period in inventories and operating receivables and payables;
Other non-cash items; and
Other items for which the cash effects are in investing or financing cash flows.

Example

The credit sales figure in the statement of profit or loss is Tshs25 million and the increase in the receivables is Tshs2 million. (Opening balance = Tshs3 million and closing = Tshs5 million). What is the figure for amounts collected from receivables?

Dr **Total Receivables Account** **Cr**

Date		Tshs million	Date		Tshs million
01/01/20X9	Balance b/d	3		Collections (bal. figure)	**23**
	Credit Sales	25	31/12/20X9	Balance c/d	5
		28			**28**

In the above example, the balance of receivables brought forward was Tshs3 million. Additional credit sales were Tshs25 million. This makes the total receivables as Tshs28 million. However, at the year-end, Tshs5 million out of this was in balance. That means that Tshs28 million – Tshs5 million = Tshs23 million were received from the customers.

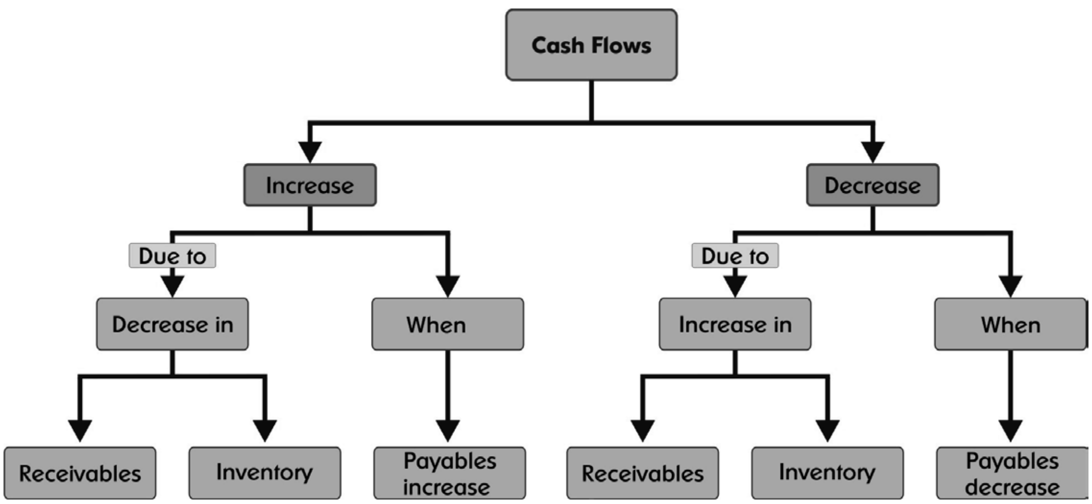
We can make a simplified rule from the above that

Tip

if receivables / inventory increase, more money is tied up in receivables / inventory and less cash is received

if receivables / inventory decrease, less money is tied up in receivables / inventory and more cash is received

Diagram 2: Increase and decrease in cash flow due to increase and decrease in receivables and inventory



Take another example of operating payables

The opening balance on trade payables was Tshs2m. The closing balance was Tshs1m. If purchases during the year were Tshs18m, what was the actual amount paid to suppliers?

Dr **Total Payables Account** **Cr**

	Tshs		Tshs
Payments (balancing figure)	**19**	Balance b/d	2
Balance c/d	1	Purchases	18
	20		**20**

The actual amount paid to suppliers is Tshs19.

A simplified rule can be made that

Tip

If payables are reduced, this indicates an additional outflow as the company's cash has been used to pay suppliers.

If operating payables are increased, this indicates an additional inflow, as the company does not have to pay cash to its suppliers

Example

From the following details of RM Inc, calculate the cash flow from operating activities, using the direct method.

	Tshs
Cash sales	800,000
Balance of trade receivables on 1 April 20X8	500,000
Credit sales	4,270,000
Balance of trade receivables on 31 March 20X9	570,000
Cash paid to employees	600,000
Cash purchases	200,000
Balance of trade payables on 1 April 20X8	300,000
Credit purchases	3,250,000
Balance of trade payables on 31 March 20X9	350,000
Interest paid	200,000
Income taxes paid	250,000

Answer

Cash flows from the operating activities for the year ended 31 March 20X9

	Tshs
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 the customers

Dr **Receivables account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	500		Cash received (balancing figure)	**4,200**
	Credit sales	4,270		Balance c/f	570
		4,770			**4,770**

Total receipts from customers = Cash sales + Collections from credit customers
= 800,000 + 4,200,000
= 5,000,000

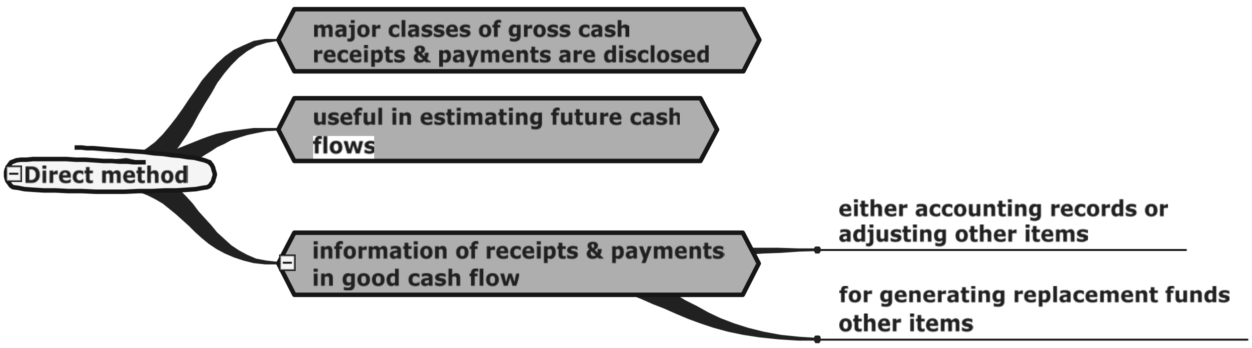
Continued on the next page

W2 Cash paid to the suppliers and employees

Dr			Payables account		Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
	Cash paid (balancing figure)	**3,200**		Balance b/d	300
	Balance c/d	350		Credit purchases	3,250
		3,550			**3,550**

Cash paid to suppliers and employers = Cash purchases + Payments to credit suppliers + Cash paid to employees
= 200,000 + 3,200,000 + 600,000
= Tshs4,000,000

SUMMARY



6.2 Indirect method

This method is **easier, faster and cheaper** and therefore preferred by many companies.

Proforma of indirect method statement of cash flows (with imaginary figures)

Cash flows from operating activities	Tshs
Profit before taxation	640,000
Adjustments for:	
Depreciation	90,000
Loss on sale of non-current assets	30,000
Investment income	(20,000)
Interest expense	200,000
	940,000
Decrease / (Increase) in trade and other receivables	(70,000)
Decrease / (Increase) in inventories	80,000
Increase / (Decrease) in trade payable	50,000
Cash generated from operations	1,000,000
Interest paid	(200,000)
Income taxes paid	(250,000)
Net cash from operating activities	**550,000**

Cash flows from investing activities and financing activities will appear same under direct and indirect method.

Test Yourself 6

Why is a decrease in inventories shown as a positive figure?

Important terms

1. Net profit

The net profit or loss figure according to the statement of profit or loss is taken as a starting figure, and adjustments are made for the effects of the following items:

2. Changes in inventory, receivables, payables

The principles of increases or decreases in assets, e.g. receivables, discussed in the previous Learning Outcome 5 are applicable here also.

Example

The cash profit of an entity was Tshs500,000. Inventory on 1 January 20X9 was Tshs120,000 and on 31 December 20X9, Tshs160,000.

Out of the cash profit of Tshs500,000, an amount of Tshs40,000 (i.e. Tshs160,000 - Tshs120,000) was tied up in the additional inventory. This leaves a net cash flow from operating activities of Tshs500,000 - Tshs40,000 = Tshs460,000.

---

3. Non-cash items

Items such as depreciation, provisions, deferred taxes etc. may appear in the statement of profit or loss but do not represent cash flow. Net profit / loss which is taken as a starting figure includes the effect of all of these items. Hence we need to eliminate it.

Take a case of depreciation. The asset on which depreciation is charged was purchased in the past. When we disclose depreciation as an expense in the statement of profit or loss, we charge an expense for which there is no cash flow.

Example

Gorgeous Ltd's statement of profit or loss shows a net profit of Tshs75 million after charging depreciation worth Tshs8 million and recognising an exchange gain on translation of a foreign operation, Tshs4m.

Analysis of the profit would be as follows:

	Tshs million
Cash operating profit	??
Add: Unrealised operating income	4
Less: Depreciation (non-cash expense)	8
Net profit	**75**

Cash operating profit + Unrealised operating income – Depreciation = Net profit.

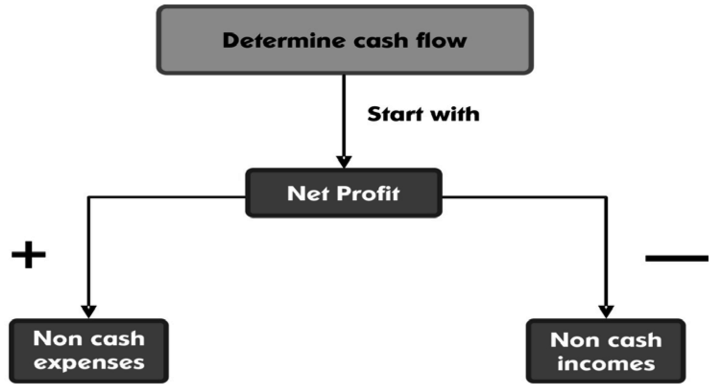
In this case, since the cash operating profit is not given, we keep that to the left hand side and move the others to the right hand side.

We get,

Cash operating profit = Net profit – Unrealised operating income + Depreciation (non-cash expense)
= 75 – 4 + 8
= 79

We can now generalise the rule as: if we start with a figure of net profit, we will add all the non-cash expenses and deduct all non-cash incomes.

Diagram 3: General rule to compute the cash flow by the indirect method



4. Separate the investing and financing components

The net profit figure will include the effects of gains or losses on account of investing and financing activities. Remember: investing activities are shown separately, so these items should be removed from the operating activities. This can be done by adjusting the net profit figure.

Example

The net cash profit of Lorette Company is Tshs7 million after a profit of Tshs0.6 million on the disposal of a machine with a carrying value of Tshs1 million.

Since the cash flow from the disposal of the machine is a cash flow from investing activities, the profit on disposal of the machine needs to be separated from the figure of net profits.

Therefore, the cash from operating activities would be calculated as:

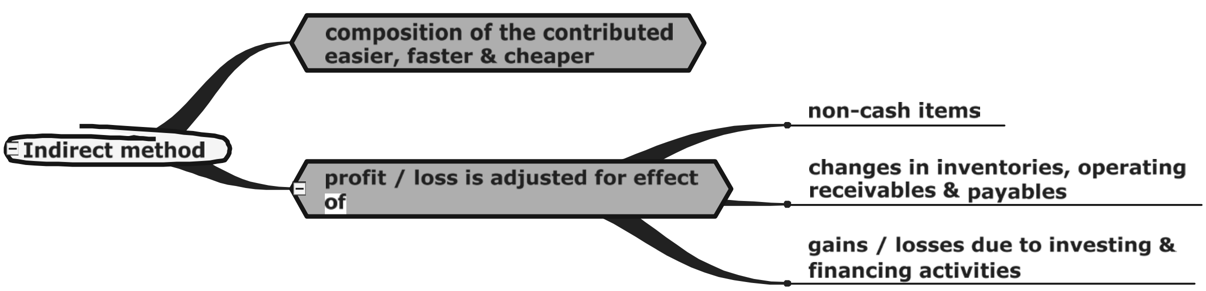
	Tshs million
Net profit	7.0
Less: Profit on disposal of machinery	(0.6)
Cash from operating activities	**6.4**

We shall see in the next Learning Outcome, how the total cash received from the disposal of the machine, i.e. Tshs1.6m (1.0 + 0.6) is shown as a cash flow from investing activities.

Recap: Operating activities

1. Operating cash flows are the cash flows from the principal revenue earning activities and other activities other than investing and financing activities.
2. These cash flows can be reported by using either direct or indirect methods.
3. Non-cash items and the items of investing and financing activities are to be adjusted for.
4. Increases in assets and decreases in liabilities indicate outflows.
5. Decreases in assets and increases in liabilities indicate inflows.

SUMMARY



7. Identify the treatment of given transactions in a company's statement of cash flows. Prepare statements of cash flows from given information.
[Learning Outcomes h and g]

We have learnt the general principles of the statement of cash flows. Let us now put those principles into practice by identifying the treatment to be given to individual transactions and preparing extracts from a statement of cash flows.

7.1 Cash flow from operating activities –direct method

Example

From the following details of Lilly Co, calculate the cash flow from operating activities, using the direct method:

	Tshs
Opening balance of trade receivables	575,000
Credit sales	4,910,500
Closing balance of trade receivables	655,500
Cash paid to employees	690,000
Opening balance of trade payables	345,000
Credit purchases	3,737,500
Closing balance of trade payables	402,500
Interest paid	230,000
Income taxes paid	287,500

Answer

Cash flows from the operating activities for the year ended 31 March 20X9

	Tshs
Cash receipts from customers (W1)	4,830,000
Cash paid to suppliers (W2)	(3,680,000)
Cash paid to employees	(690,000)
Cash generated from operations	**460,000**
Interest paid	(230,000)
Income taxes paid	(287,500)
Net cash from operating activities	**(57,500)**

Workings

W1 Cash received from customers / trade receivables

Trade Receivables account

Dr **Cr**

	Tshs		Tshs
Balance b/d	575,000	Cash received(balancing figure)	**4,830,000**
Credit sales	4,910,500	Balance c/d	655,500
	5,485,500		**5,485,500**

W2 Cash paid to suppliers

Trade payables account

Dr **Cr**

	Tshs		Tshs
Cash paid (4,082,500 – 402,500)	**3,680,000**	Balance brought forward	345,000
Balance carried forward	402,500	Credit purchases	3,737,500
	4,082,500		**4,082,500**

7.2 Cash flow from operating activities –indirect method

Example

Thomson provides the following details

	Tshs
Profit before tax for the year	200,000
Depreciation	40,000
Profit on sale of non-current asset	15,000
Investment income	10,000
Sale of non-current assets	100,000
Decrease in trade and other receivables	30,000
Increase in inventories	55,000
Increase in trade payable	18,000
Interest paid	75,000
Income taxes paid	25,000

Determine the cash flow from operating activities using indirect method

Answer

Cash flows from operating activities	Tshs
Profit before taxation	200,000
Adjustments for:	
Depreciation	40,000
Profit on sale of non-current assets	(15,000)
Investment income	(10,000)
	215,000
Decrease / (Increase) in trade and other receivables	30,000
Decrease / (Increase) in inventories	(55,000)
Increase / (Decrease) in trade payable	18,000
Cash generated from operations	**208,000**
Interest paid	(75,000)
Income taxes paid	(25,000)
Net cash from operating activities	**108,000**

7.3 Cash flow from financing activities

Example

Ideal Inc gives you the following information.

	Tshs	
Issue of 5% debentures at 2% discount	300,000	(nominal value)
Repayment of loan (including interest Tshs80,000)	120,000	
Dividend paid	60,000	
Issue of 15,000 shares for cash of Tshs10 each at 5% premium	150,000	(nominal value)

Continued on the next page

You are required to calculate the cash flow from the financing activities.

Cash flows from financing activities	Tshs
Proceeds from issue of share capital (W1)	157,500
Proceeds from issue of debentures (W2)	294,000
Term loan repayments	(120,000)
Dividends paid	(60,000)
Net cash flows from financing activities	**271,500**

Workings

W1 Issue of share capital	**Tshs**
Nominal value	150,000
5% premium	7,500
	157,500

W2 Issue of Debentures	**Tshs**
Nominal value	300,000
2% Discount	(6,000)
	294,000

7.4 Cash flow from investing activities

Example

Sale of old furniture and fixtures at a loss of Tshs21,000 (carrying value Tshs85,000)

Purchase of new furniture and fixtures	Tshs180,000
Installation charges for the furniture	Tshs15,000

Purchase of a building worth Tshs720,000 for which Tshs100,000 advance was paid last year and remainder is paid by taking a loan from Royton bank.

Amount invested in long-term investments	Tshs175,000
Dividend paid	Tshs35,000
Dividend received	Tshs25,000

Show the cash flow from investing activities.

Cash flow from investing activities	Tshs
Purchase of property and furniture and fixtures (W1)	(815,000)
Proceeds from sale of furniture and fixtures (Tshs85,000-Tshs21,000)	64,000
Long-term investment	(175,000)
Dividend received	25,000
Net cash used in investing activities	**(901,000)**

W1 Purchase of property and furniture and fixtures

	Tshs	Tshs
Worth	720,000	
Less: Advance paid last year	(100,000)	620,000
Furniture and fixtures	180,000	
Add: Installation charges	15,000	195,000
		815,000

Note

Dividend paid and loan from bank is a financing activity

Test Yourself 7

Smith Ltd reported net income of Tshs75,000 for the year ended 31 December 20X8. The following information is provided:

	Tshs
Depreciation expense	24,000
Loss on the sale of land	32,000
Increase in accounts receivable	16,000
Decrease in inventory	8,000
Increase in accounts payable	6,000
Increase in taxes payable	4,000

Required:

Determine the cash flow from the operating activities.

Test Yourself 8

Smith Ltd acquired machinery for cash and the deal was financed in full by issuing 150 shares of Tshs1,000 each for cash at a premium of Tshs2,000 each.

In the statement of cash flows the above transaction would be reflected as:

A Inflow: Tshs450,000; Outflow: Tshs450,000
B Inflow: Tshs450,000; Outflow: Nil
C Inflow: Nil; Outflow: Tshs450,000
D Inflow: Tshs300,000; Outflow: Tshs300,000

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

At the time of charging depreciation only a book entry is passed without affecting the cash flow

Answer to TY 2

a) For smooth running of day-to-day operations
b) For ensuring liquidity
c) For ensuring balance between the liquidity and profitability

Answer to TY 3

The correct option is **A**.

This is a drawback of the statement of cash flows because it ignores the matching principle that is based on accruals.

Options (b) and (c) are not drawbacks of the statement of cash flows.

The statement of cash flows is simple to understand. Even a person who doesn't have an in-depth knowledge of accounting can understand the cash flows. It facilitates the comparability between two entities or two periods

Answer to TY 4

(a) Financing activities

(b) Not a cash flow item, although needs a separate disclosure (section 2e)

(c) Operating activities

(d) It is a non-cash item. Not included in the cash flow. In the indirect method, it is added back since the starting net profit is after depreciation.

(e) Investing activities

(f) Either as a finance activity or as an operating activity. (The IAS allows flexibility to the entities to decide how to classify interest and dividends, depending upon circumstances and the judgement of the management).

(g) Operating activities unless they can be specifically identified with financing and investing activities.

Answer to TY 5

The correct option is **A.**

Cash flow from Investing Activities

	Tshs
Sale of building (280,000 + 38,000)	318,000
Sale of long-term investment (340,000 - 17,000)	323,000
Purchase of car (540,000 - 300,000)	(240,000)
Net cash flow from investing activities	**401,000**

Interest paid will come under the financing activities.

Answer to TY 6

Decrease in inventories is considered positive as it means that less cash is tied up in inventory compared to the previous year (indirectly, there is an inflow).

Answer to TY 7

The correct answer is Tshs**133,000.**

	Tshs
Net income	75,000
Add:	
Depreciation	24,000
Loss on sale of land	32,000
Decrease in inventory	8,000
Increase in accounts payable	6,000
Increase in tax payable	4,000
Less: Increase in accounts receivables	(16,000)
Cash flow from the operating activities	**133,000**

Answer to TY 8

The correct option is **A.**

The outflow is on account of purchase of machinery and the inflow is on account of proceeds received on issuing the share capital.

Self Examination Questions

Question 1

The following is information from Poly Plc. Calculate the cash flow from financing and investing activities of Poly Plc for the year to 31 August 20X7.

	Tshs
Purchase of a plot (out of the purchase price Tshs50,000 is outstanding and advance paid in the last accounting year is Tshs20,000)	150,000
Sale of vehicle (book value of Tshs92,000)	85,000
Depreciation charged during the year on non-current assets	53,000
Dividend received	156,000
Interest on the deposit in bank received	45,000
Dividend paid	50,000
Obtained loan from a bank	200,000
Long-term investment in bank	250,000

Additional information

1. Sale of long-term investments with a carrying amount of Tshs120,000 at a loss of Tshs25,000
2. Repaid the loan Tshs20,000 (out of this, Tshs12,000 is paid for interest)
3. Issued for cash 100,000 ordinary shares of Tshs5 each at premium Tshs1

Question 2

Which of the following statements is incorrect?

A Cash flow from operating activities can be calculated by using the direct as well as the indirect method
B An increase in assets is cash inflow from investing activities
C A decrease in liabilities is cash outflow from investing activities
D Depreciation should be added back to the book profit so as to calculate the cash flow from operating activities under the indirect method

Question 3

Use the following information to calculate the cash flow from operating activities:

	Tshs
Book profit	11,664
Depreciation charges	2,916
Proceeds of sale of non-current assets	486
Increase in inventory	495
Increase in accounts payable	550

A Tshs14,525
B Tshs14,635
C Tshs8,803
D Tshs15,625

Question 4
From the following information calculate the cash flow from operating activities: Profit before depreciation was Tshs100,000

Balances	01/01/20X9 Tshs	31/12/20X9 Tshs
Non-current assets	90,000	65,000
Inventories	63,000	27,000
Receivables	58,000	45,000
Cash in bank	12,000	6,500
Payables	35,000	30,000
Share capital	220,000	120,000

A Tshs42,500
B Tshs(53,500)
C Tshs144,000
D (Tshs44,000)

Question 5
In preparing a company's statement of cash flows complying with IAS 7 Statement of Cash Flows, **which, if any, of the following items could form part of the calculation of cash flow from investing activities?**
(i) Borrowed Tshs200,000 for payment of purchase of new machinery
(ii) Sale of long-term investment
(iii) Redemption of debentures
A Only (i) **B**
Only (ii) **C**
Only (iii)
D (i) and (ii)

Question 6
(a) Non – technical users of accounting information usually find it puzzling that a business can be making profits as shown in the statement of profit or loss and other comprehensive income but still be running short of cash.

REQUIRED:
Explain briefly two basic reasons which make this situation to arise.

(b) The statement of Financial Position of Chema Co. Ltd. as at 30th June 2014 and 30th June 2015 were as follows:

	30th June 2015 TZS. '000'	**30th June 2014 TZS. '000'**
Equity:		
Ordinary shares	600,000	500,000
Retained profits	50,000	40,000
Non-current liabilities:		
10% Debentures	150,000	200,000
Current Liabilities:		
Trade creditors	40,000	25,000
Taxation	15,000	10,000
Proposed Dividends	20,000	10,000
Total Equity & Liabilities	**875,000**	**785,000**
Assets		
Non-current asset	395,000	290,000
Current Assets:		
Stocks	170,000	140,000
Debtors	80,000	60,000
Cash and Bank	230,000	295,000
Total Assets	**875,000**	**785,000**

The Statement of Profit or Loss for the year ended 30th June 2015 was as follows:

	TZS '000'
Sales	372,500
Cost of Sales	(217,500)
Gross Profit	155,000
Other income	5,000
Expenses	(105,000)
Profit before tax	55,000
Less tax	(25,000)
Profit after tax	30,000
Proposed dividends	(20,000)
Retained profits for the year	10,000

Additional Information:

(i) The 10% debentures were redeemed and cancelled on 30th June 2015.

(ii) The expenses include depreciation on non-current assets of TZS. 35,000,000 and debenture interest of TZS.20,000,000.

(iii) Other income relates to gain on disposal of non-current assets which had book value of TZS.25,000,000.

REQUIRED:

Prepare the Statement of Cash Flow for the year ended 30th June 2015 as per IAS 7 using indirect method.

Question 7

An extract from Pangu Pakavu Plc statement of comprehensive income for the year ended 31st December 2014 is as follows:

	TZS '000
Revenue	560,000
Cost of sales	300,000
Gross profit	260,000
Other expenses	160,000
Profit from operations	100,000

Other expenses include TZS.20,000,000 of depreciation. Interest paid was TZS.10,000,000. The tax paid for the year was TZS.25,000,000.

An extract from the statement of financial position is as follows:

	2014	**2013**
	TZS '000	**TZS '000**
Inventories	30,000	25,000
Trade receivables	40,000	42,000
Trade payables	28,000	32,000

REQUIRED:

(i) Prepare a reconciliation of profit from operations to net cash from operating activities using the indirect method.

(ii) Calculate the net cash from operating activities using the direct method.

Question 8

You are recently employed by **SUCCESS Co.** as an Assistant Accountant. The Financial Controller of the company has asked you to prepare the company's statement of cash flows for the year ended on 31st March 2015.

The company's draft Statement of Income for that year and its Statement of Financial Position as at that date are provided below, together with some additional information.

SUCCESS Co.
Statement of Income for the year ended 31st March 2015 (Extracts)

	2015	2014
	TZS	**TZS**
Profit from operations	392,700,000	150,450,000
Finance cost	25,500,000	35,700,000
Profit before tax (PBT)	**367,200,000**	**114,750,000**
Income tax expense	51,000,000	38,250,000
Net Profit for the year	**316,200,000**	**76,500,000**
	=========	========

SUCCESS Co.
Statement of Financial Position as at 31st March 2015 (Extracts)

	2015	2014
	TZS	**TZS**
ASSETS		
Non-current assets		
Property, Plant and Equipment	529,125,000	357,000,000
Current assets		
Inventories	408,000,000	280,500,000
Trade and other receivables	253,725,000	68,850,000
Cash and cash equivalent	-	33,150,000
Total current assets	661,725,000	382,500,000
Total assets	1,190,850,000	739,500,000
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital	76,500,000	76,500,000
Retained earnings	413,100,000	96,900,000
Total Equity	**489,600,000**	**173,400,000**
	=========	=========
Non-current liabilities		
Borrowings	153,000,000	255,000,000
Current Liabilities		
Bank overdrafts	280,500,000	-
Trade and other payables	204,000,000	280,500,000
Interest payables	17,850,000	5,100,000
Tax payables	45,900,000	25,500,000
	548,250,00	311,100,000
	1,190,850,000	**739,500,000**
	==========	=========

Additional information:

(i) An analysis of property, plant and equipment (PPE)

	2015	2014
	TZS	**TZS**
Buildings at cost	561,000,000	306,000,000
Depreciation	102,000,000	25,500,000
	459,000,000	**280,500,000**
Plant and machinery at cost	127,500,000	127,500,000
Depreciation	57,375,000	51,000,000
	70,125,000	**76,500,000**
	529,125,000	**357,000,000**
	=========	=========

(ii) There is no declaration or payment of dividends by the company in recent years.

(iii) At the beginning of the year 2015 the company disposed its machinery with NBV of TZS.6,375,000 and cost of TZS.25,500,000 for TZS.8,925,000.

REQUIRED:

a) Prepare a Statement of cash flows for the year ended 31st March 2015 and the Note reconciling profit before tax with cash generated from operations (using indirect Method)

b) Write a memorandum to a director of SUCCESS Co summarizing the major benefits a user receives from a published statement of cash flows.

Question 9

Mkodomi is a sole trader. He provides the following financial information in respect of his business.

Mkodomi

Profit or Loss statement for the year ending 31 December 20X5

	TZS'000	TZS'000
Gross profit		22,350
Add: rent received	205	
Profit on sale of van	310	515
		22,865
Less: Expenses		
Motor expenses	970	
Wages	8,600	
General expenses	415	
Electricity	260	
Increase in provision for doubtful debt provision	100	
Depreciation: Van	900	11,245
		11,620

Statement of financial position as at 31 December

	20X4		20X5	
	TZS'000	TZS'000	TZS'000	TZS'000
ASSETS				
Non-current assets				
Van at cost		7,700		4,100
Less: Depreciation to date		(2,650)		(1,550)
		5,050		2,550
Current assets				
Inventory	9,300		12,000	
Trade receivable *less provision**	4,100		3,450	
Bank	205		360	
Total assets		13,605		15,810
		18,655		18,360
Equity and Liabilities				
Opening capital	8,605		10,705	
Add: Net profit	10,600		11,620	
	19,205		22,325	
Less: Drawing	(8,500)		(11,315)	
Closing capital		10,705		11,010
Non-current liability				
Loan from Tabata		5,000		3,750
Current assets				
Trade Payable		2,950		3,600
Total equity plus liabilities		18,655		18,360

*Trade receivables 20X4 TZS4,400,000 – Provision TZS300,000

Trade receivables 20X5 TZS3,850,000 – Provision TZS400,000

Note: A van was sold for TZS1,910,000 during 20X5. No new vans were purchased during the year.

Required

Prepare a Statement of cash flows for the year ended 31st December 20X5 (using indirect Method)

Answers to Self Examination Questions

Answer to SEQ 1

Cash flow from financing activities

	Tshs
Issue of shares	600,000
Loan from bank	200,000
Repayment of loan*	(20,000)
Dividend paid	(50,000)
Net cash flow from financing activities	**730,000**

Cash flow from Investing Activities

	Tshs
Sale of vehicle	85,000
Dividend received	156,000
Interest received	45,000
Sale of investment (120,000 - 25000)	95,000
Purchase of plot (150,000 - 20,000 - 50,000)	(80,000)
Long term investment	(250,000)
Net cash flow from investing activities	**51,000**

*interest payment is treated as a financing activity. Alternatively, it may be presented under operating activities.

Answer to SEQ 2
The correct option is **B**.

Increase in assets indicates cash outflow from investing activities. This is because an increase in an asset means purchase of a new asset.

Answer to SEQ 3
The correct option is **B**.

	Tshs
Book profit	11,664
Add: Depreciation charge	2,916
Less: Increase in inventory	(495)
Add: Increase in accounts payable	550
Cash flow from operating activities	**14,635**

Increase in inventory indicates that more cash is locked in inventory and therefore should be deducted. Increase in payables indicates that a longer credit period is given by suppliers and therefore added to the cash flow.

Answer to SEQ 4

The correct option is **C**.

Cash flow from the operating activities

	Tshs
Profit before depreciation	**100,000**
Inventories (63,000 - 27,000)	36,000
Receivables (58,000 - 45,000)	13,000
Payables (35000 - 30000)	(5,000)
Net cash flow from operating activities	144,000

Answer to SEQ 5

The correct option is **B**.

Borrowings for purchase of new machinery and redemption of debentures are financing activities.

Answer to SEQ 6

(c) The basic reasons include:
   (i) The profit or loss shown in the statement of profit or loss statement is determine on accrual basis rather than cash basis
   (ii) Items which affect cash (that is cash receipts and payments) are not only those which affect profits. (Revenue and expenses). Non-revenue or expenses e.g. acquisition and sale of non-current asset for cash also affect cash flow.

Chema C Ltd

The Statement of Cash flow for the year ended 30th June 2015 (Indirect method)

	In 000			
Cash flow from operating activities:				
Profit before taxation	55,000			
Adjustments for Depreciation	35,000			
Gain on disposal	(5,000)			
Interest expense		20,000		
Change working capital (W1)	(35,000)			
Cash generated from operation	70,000			
Interest paid	(20,000)			
Income Tax paid (W2)	(20,000)			
Net cash flow from operating activities			30,000	
Cash flow from investing activities				
Proceeds from sales of non-current asset		30,000		
Purchase of non-current asset (W3)	(165,000)			
Net Cash flows from Investing activities			(135,000)	
Cash flows from financing activities:				
Proceeds from issue of shares	100,000			
Redemption and cancelled 10% Debentures	(50,000)			
Dividend paid (W4)	(10,000)			
Net Cash flow from financing activities			40,000	
Net decrease in cash or cash equivalents				(65,000)

(W1)

Change in working capital:

Increase in stocks	(30,000)	
Increase in debtors	(20,000)	
Increase in creditors	15,000	(35,000)

(W2)

Tax paid:

Beg balance	10,000	
Add charged to Profit and Loss	25,000	
Less end balance	(15,000)	20,000

(W3)

Non-current assets ending	395,000	
Add disposed (bv)	25,000	
Add depreciation	35,000	455,000
Less beginning balance		(290,000)
Purchased for cash		165,000

(W4)

Dividend paid:

Beg balance	10,000	
Add charged to Profit and Loss	20,000	
Less ending balance	(20,000)	10,000

Answer to SEQ 7

(i) **Reconciliation of profit from operation to net cash from operating activities:**

	TZS "000
Profit from operations	100,000
Depreciation	20,000
Increase in inventories (30,000 – 25,000)	-5,000
Decrease in trade receivables (40,000 – 42,000)	2,000
Decrease in trade payables (28,000 – 32,000)	-4,000
Cash generated from operations	113,000
Interest paid	-10,000
Tax paid	-25,000
Net cash for operating activities	**78,000**

(ii) **Net cash from operating activities using the direct method**

	TZS "000"
Cash receipts from customers (w1)	562,000
Cash paid to suppliers and employees (w2)	-449,000
Cash generated from operations	113,000
Interest paid	-10,000
Tax paid	-25,000
Net cash for operating activities	**78,000**

Working 1

Cash receipts from customers	**TZS "000"**
Opening trade receivables	42,000
Revenue	560,000
Closing trade receivables	-40,000
Net cash for operating activities	562,000

Workings 2

Cash paid to suppliers and employees	**TZS "000"**
Opening trade payables	32,000
Total purchases (w3)	445,000
Closing trade payables	-28,000
Net cash for operating activities	**449,000**

Working 3

Total purchases	**TZS "000"**
Cost of sales	300,000
Opening Inventories	-25,000
Closing Inventories	30,000
Other expense	160,000
Depreciation	-20,000
	445,000

Answer to SEQ 8

(a) SUCCESS Co

Statement of cash flows for the year ended 31 March 2015

	TZS	TZS
Cash flows from operating activities		
Cash generated from operations		103,275,000
Interest paid (W5)		(12,750,000)
Tax paid (W4)		(30,600,000)
Net cash from operating activities		59,925,000
Cash flows from investing activities		
Purchases of property, plant and equipment (W1)	(280,500,000)	
Proceeds from sale of property, plant and equipment (W3)	(8,925,000)	
Net cash outflows from investing activities		(271,575,000)
Cash flows from financing activities		
Payment of borrowings	(102,000,000)	
Net cash outflows from financing activities		(102,000,000)
Net change/decrease in cash and cash equivalents		(313,650,000)
Cash and cash equivalents at the beginning		33,150,000
Cash and cash equivalents at the year end		(280,500,000)

NOTE: Reconciliation of Profit before tax to cash generated from operations for the year ended 31 March 2015

	TZS
Profit before tax	367,200,000
Finance cost	25,500,000
Depreciation – PPE (W2)	102,000,000
Gain on disposal – PPE (W3)	(2,550,000)
	492,150,000
Change in working capital items	
Increase in inventories (TZS 408,000,000 – 280,500,000)	(127,500,000)
Increase in trade and other receivable (253,725,000 – 68,850,000)	(184,875,000)
Decrease in trade and other payables (280,500,000 – 204,000,000)	(76,500,000)
	103,275,000

WORKING

(1) Property, Plant and Equipment (PPE) A/c (At cost)

Bal b/d	433,500,000	Disposal	25,500,000
Additions (Bal figure)	**280,500,000**	Bal c/d	688,500,000
	714,000,000		714,000,000

(2) Property, Plant and Equipment (PPE) – Acc Depreciation A/c

Disposal	19,125,000	Bal/b/d	76,500,000
Bal c/d	159,375,000	**Dep charge for the year(Bal fg)**	**102,000,000**
	178,500,000		178,500,000

(3) Property, Plant and Equipment (PPE) – Disposal/c

Cost	25,500,000	Acc Depreciation	19,125,000
Profit	2,550,000	**Proceeds**	**8,925,000**
	28,050,000		28,050,000

Tax Paid A/c (At cost)

Cash paid	**√30,600,000**	Bal b/d	25,500,000
Bal c/d	45,900,000	Income Stat	51,000,000
	76,500,000		76,500,000

Interest Paid A/c (At cost)

Cash paid	**√12,750,000**	Bal b/d	5,100,000
Bal c/d	45,900,000	Income Stat	25,500,000
	30,600,000		30,600,000

Major benefits user receives from a published Statement of cash flows

(i) Statements of cash flows direct attention to the survival of entity which depends on its ability to generate cash
(ii) Statements of cash flows indicate of an entity to repay its debts
(iii) They give information which can be used in the decision making and stewardship process
(iv) They are more easily understood than income statements that depend on accounting conventions and concepts
(v) Statements of cash flows give better means of comparison between different companies.

Answer to SEQ 9

MKODOMI
Statement of cash flow for the year ended 31 December 20X5

	TZS'000	**TZS'000**
OPERATING ACTIVITIES		
Profit before tax		11,620
Depreciation of Van	900	
Increase in provision for doubtful debt	100	
Gain on sale of van	(310)	
Increase in inventory	(2,700)	
Decrease in trade receivable	550	
Increase in trade payable	650	(810)
Net inflow from operating activities		10,810
INVESTING ACTIVITIES		
Disposal of Van	1,910	
Net inflow from investing activities		1,910
FINANCING ACTIVITIES		
Repayment of Loans	(1,250)	
Drawing	(11,315)	
Net inflow from financing activities		(12,565)
Net increase in cash		155
Opening balance of cash		205
Closing balance of cash		360

PREPARATION OF ACCOUNTS FROM INCOMPLETE RECORDS

11

Get Through Intro

When a full set of records is maintained, it is easy to prepare financial statements. A readily available trial balance is used, certain year end procedures are performed and the financial statements are ready.

However, at times a full set of records may not be available and the accountant may still be asked to prepare the financial statements. This may happen when part of the records has been lost or destroyed. Similarly, the proprietor may not maintain full records, but when he approaches a bank for a loan, the bank may insist on a full set of financial statements.

At times, a single missing figure may be needed, rather than the full financial statements. For example a cashier has absconded and we have to determine the amount of missing cash.

Whatever the reason, occasionally a professional accountant does have to become a detective and hunt for missing figures. Each situation may be different and the accountant has to use his judgement to decide ways of finding out the missing information. Sometimes cash and bank summaries may help. At other times, ledger accounts or profit percentages may have to be used.

We try to understand these techniques in this Study Guide.

Learning Outcomes

a) Describe the incomplete records and identify the reasons for incomplete records.
b) Compute profit from comparison of net assets.
c) Describe steps involved in identifying the missing information for:
   i. Sales
   ii. Purchases
   iii. Stocks lost or destroyed.
d) Use control accounts to identify missing information.
e) Compute profits using margins and mark-ups.
f) Complete a double entry from single entry transactions.
g) Prepare financial statements from incomplete records.

1. Describe the incomplete records and identify the reasons for incomplete records. **Compute profit from comparison of net assets.** **[Learning Outcomes a and b]**

1.1 Incomplete records

1. Meaning

Whenever a business does not have a full set of accounting records to prepare financial statements, the records are said to be incomplete records.

2. Reasons for incomplete records

This may happen due to one of the following reasons:

(a) the owner of the business does not keep a complete set of records
(b) the owner of the business may be ignorant of double entry accounting principles
(c) a complete set of records is maintained but part of it has been accidentally lost or destroyed.

3. Limitations of incomplete records

(a) Arithmetical accuracy of accounts cannot be checked

(b) Difficult to:
Carry out audit procedures
Operate internal control system and internal check system
Detect fraud
Ascertain the financial position of the business

(c) If a set of financial statements, i.e. the statement of profit or loss and the statement of financial position, is to be prepared when the records are incomplete, then the accountant does not have the luxury of a ready trial balance from which he can prepare them.

(d) Various methods have to be used to calculate the missing information in order to prepare the financial statements. The methods used vary with the nature of information that is incomplete.

(e) The accountant's approach also depends upon whether both the statement of profit or loss and the statement of financial position are to be prepared or whether only the statement of financial position is to be prepared.

1.2 Computation of profit from comparison of net assets

We have learnt the following accounting equation in Study Guide 1

Capital = Net assets = Assets - Liabilities

The values of variables in the above accounting equation are affected by a business transaction. Any increase or decrease in assets, liabilities and capital can be calculated using this accounting equation.

We also know that:

profits increase capital and
losses decrease capital

Hence if we know the other transactions in the capital account, (for example, capital introduced and drawings) we can calculate the amount of profit earned or loss incurred during the period by using the following equation:

Profit (loss) = Increase / (decrease) in net assets - Capital introduced + Drawings.

Example

Samuel had the following assets and liabilities.

	31/12/20X2 Tshs'000	31/12/20X3 Tshs'000
Assets		
Property plant and equipment	5,000	6,000
Inventories	2,000	2,500
Accounts receivable	3,000	3,500
Total assets	**10,000**	**12,000**
Liabilities		
Bank loan	4,000	3,800
Accounts payable	2,500	3,000
Total liabilities	**6,500**	**6,800**
Net assets / Capital (assets - liabilities)	**3,500**	**5,200**
(10 million - 6.5 million) (12 million - 6.8 million)		

He introduced Tshs1 million as capital during the year and his drawings amounted to Tshs0.6 million.

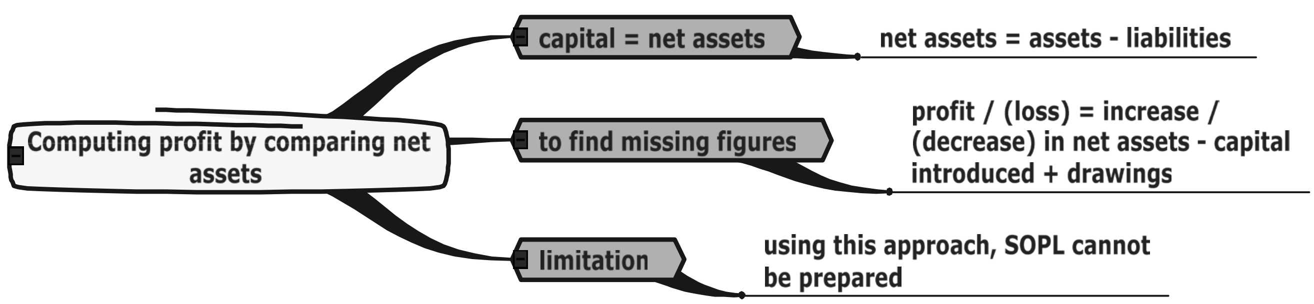
Calculate the profit or loss earned by Samuel

Profit (loss) = Increase / (decrease) in net assets - Capital introduced + Drawings
= (Tshs5.2 million - Tshs3.5 million) - Tshs1 million + Tshs0.6 million
= Tshs1.7 million - Tshs1 million + Tshs0.6 million
= Tshs1.3 million

Limitation of this approach

We cannot prepare a statement of profit or loss using this approach. Therefore even though we can determine **how much profit** has been earned, in the absence of the statement of profit or loss, we cannot determine **how** it has been earned.

SUMMARY



Test Yourself 1

Which of the following is a reason for a decrease in capital when figures from two years are compared?

A Introduction of capital
B Profit earned during the year
C Drawings
D All of the above

---

2. Describe steps involved in identifying the missing information for:
i. Sales
ii. Purchases
iii. Stocks lost or destroyed.
Use control accounts to identify missing information.
[Learning Outcomes c and d]

2.1 Use of ledger accounts and control accounts to calculate missing figures

Accountants know from their experience that certain accounts have a specific pattern. If all known amounts affecting that account have been entered in ledger accounts, then accountants can say that the balancing figures in these accounts are the missing amounts of that account. The following are the examples of such accounts:

1. Accounts receivable
2. Accounts payable
3. Inventory account / trading account
4. Expenses and income accounts incorporating accruals and prepayments
5. Capital and drawing accounts

In practical situations, the missing amounts derived from one account may have to be entered in another account to find out its missing figure and so on. However, initially we will practise simple questions involving one missing figure in one account at a time.

While learning this topic we also learn about the interrelationship of various segments of accounts e.g. sales and accounts receivable, purchases and accounts payable and inventory, cost of sales and gross profits.

Let us now consider these accounts for identifying the missing information;

1. Sales from accounts receivable account

The pattern of a typical accounts receivable account is as follows:

Accounts receivable account

Dr **Cr**

	Tshs		**Tshs**
Balance b/d	X	**Cash / Cheque received**	X
Credit sales	X	Sales returns	X
Dishonoured cheque	X	Discount allowed	X
		Bad debts	X
		Balance c/d	X
Total	**X**	**Total**	**X**

All the items mentioned in this account may not be present all the time. The highlighted items are invariably present in this account. The others may or may not be present. Hence if they are not mentioned in the question, we can assume that they need not be considered.

This process has been followed for all the accounts discussed in this Learning Outcome.

If we know the amounts of all the items except one, then the **balancing figure** can be considered to be the amount of that item.

Example

From the following information of Princeton calculate the missing figure and explain what entry it must be

	Tshs
Opening balance of the trade receivables	25 million
Credit sales	170 million
Closing balance of the trade receivables	17 million

Continued on the next page

Answer

Let us prepare a trade receivables account and fill in the available figures.

Accounts receivable account

Dr **Cr**

	Tshs'000		**Tshs'000**
Balance b/d	25,000	**Cash received (balancing figure)**	*178,000
Credit sales	170,000	Balance c/d	17,000
Total	**195,000**	**Total**	**195,000**

* We now have to decide what this must be. We have already accounted for sales in the year and we also know the final balance of how much we are owed from our receivables. Therefore this figure must represent the cash received during the year.

Cash received = Opening balance + Credit sales - Closing balance
= Tshs25 million + Tshs170 million - Tshs17 million
= Tshs178 million

The cash entry in trade receivables account is on the credit side. The debit effect would be in the cash at bank account.

This method can be used to find out any other missing figure.
E.g. Credit sales = Closing balance + Cash received - Opening balance

2. Purchases from accounts payable account

A typical trade payables account is as follows:

Accounts payable account

Dr **Cr**

	Tshs		**Tshs**
Cash paid	X	**Balance b/d**	X
Purchase returns	X	**Credit purchases**	X
Discount received	X		
Balance c/d	X		
Total	**X**	**Total**	**X**

Example

Dilbert had opening trade payables of Tshs25 million and closing trade payables of Tshs45 million. Cash paid to the suppliers during the period was Tshs235 million. What is the amount of credit purchases?

Answer

Accounts payable account

Dr **Cr**

	Tshs'000		**Tshs'000**
Cash paid	235,000	Balance b/d	25,000
Balance c/d	45,000	Credit purchases (balancing figure) (235 million + 45 million — 25 million)	**255,000**
Total	**280,000**	**Total**	**280,000**

3. Stocks lost or destroyed from inventory account

Typically, small businesses debit the value of goods purchased to the purchases account and not the inventory account. Inventory at the end of the period is recognised as an asset by reducing its value from the total of opening inventory and purchases. However, some companies do prepare an inventory account. Even when this account is not maintained regularly, it may be prepared for the limited purpose of finding out balancing figures.

A typical inventory account is as follows:

Inventory account

Dr **Cr**

	Tshs		Tshs
Opening inventory b/d	X	**Cost of goods sold**	X
Goods purchased	X	Goods stolen Goods	X
		destroyed **Closing**	X
		inventory c/d	X
Total	**X**	**Total**	**X**

Frequently, the amount of cost of goods sold or purchases is calculated using profit percentages. This is discussed in next the Learning Outcome of this Study Guide. Here we will take the figures as given.

Example

Morris gives the following information:

	Tshs
Opening inventory	100 million
Closing inventory	120 million
Goods purchased	600 million
Cost of goods sold	575 million

Some goods were stolen during the period. Calculate the value of the stolen goods.

Answer

Inventory account

Dr **Cr**

	Tshs'000		Tshs'000
Opening inventory b/d	100,000	Cost of goods sold	575,000
Goods purchased	600,000	Goods stolen (balancing figure) (100 million + 600 million - 575 million - 120 million)	**5,000**
		Closing inventory c/d	120,000
Total	**700,000**	**Total**	**700,000**

Accounting for goods stolen or destroyed

If the goods are not covered by insurance

Dr	Loss by theft (SOPL)	X	
Cr	Inventory account (if maintained) or trading account		X

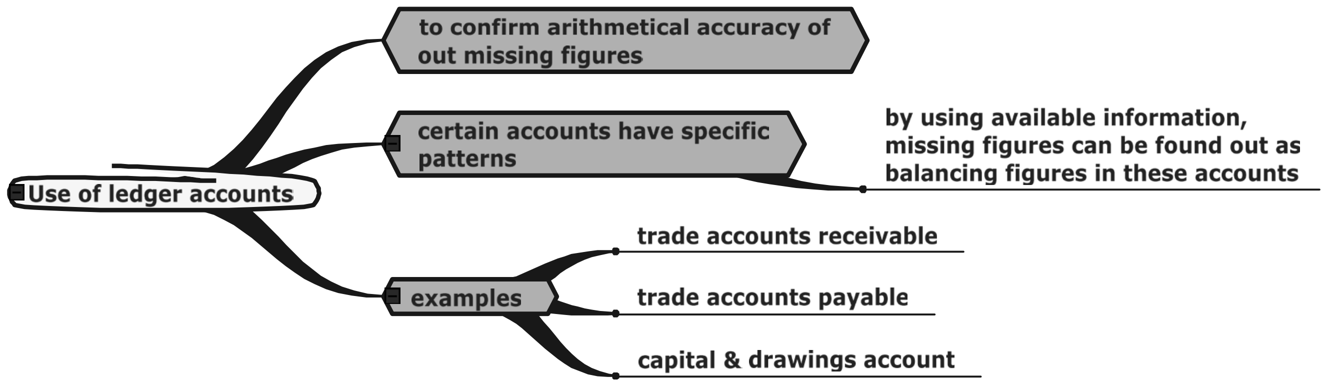
Being loss of goods debited to the statement of profit or loss

If the goods are covered by insurance

Dr	Insurance claim receivable account (to the extent covered by the insurance)	X	
Dr	Loss by theft (SOPL - to the extent not covered)		X
Cr	Inventory account (if maintained) or trading account		

Being the loss of goods due to theft, not fully covered by insurance

SUMMARY



Test Yourself 2

Kinondoni Lady, a ladies' clothes shop, does not keep proper books of accounts. It can give you the following information.

	Tshs
Opening balance of the trade receivables	23 million
Credit sales	172 million
Cash received	175 million
Closing balance of the trade receivables	15 million

You are required to calculate the discount allowed in the year.

A Tshs5 million
B Tshs8 million
C Tshs2 million
D Tshs15 million

Test Yourself 3

Saitoti gives the following information:

	Tshs
Opening trade payables	63 million
Closing trade payables	54 million
Credit purchases during the period	352 million
Discount received	4.2 million
Purchase returns	35 million

What is the amount of cash paid?

A Tshs325 million
B Tshs321.8 million
C Tshs312.8 million
D Tshs318.2 million

3. Compute profits using margins and mark-ups.

[Learning Outcome e]

3.1 Use of profit margins and mark-ups to calculate missing figures

The relationship between sales, cost of sales and gross profit is expected to remain stable over a period. These relationships are expressed as percentages and used for the purpose of finding missing figures. These percentages will be used in combination with the inventory account mentioned earlier for this purpose.

Remember the following terms:

Gross profit percentage is the gross profit as a **percentage of sales**.

Example

The following is the data for XYZ Ltd

Gross profit	= Tshs250 million
Sales	= Tshs1,000 million
Gross profit percentage	= 250/1,000 x 100
	= 25%

Mark up percentage is the gross profit as a **percentage of cost of goods sold.**

Example

Continuing the previous example,

Cost	= Sales - Gross profit
	= Tshs1,000 million - Tshs250 million
	= Tshs750 million
Mark up	= Gross profit/Cost of goods sold x 100
	= Tshs250 million/Tshs750 million x 100
	= 33.33%

Example

Masuma earns a gross profit of 25%. Sales during the year 20X3 were Tshs500 million. The opening inventory was Tshs40 million and the closing inventory, Tshs60 million. What is the value of purchases?

Answer

Step 1

	Tshs'000
Sales	500,000
Less: gross profit at 25%	125,000
Cost of goods sold	375,000

Step 2

Now, the value of purchases can be found out by preparing an inventory account:

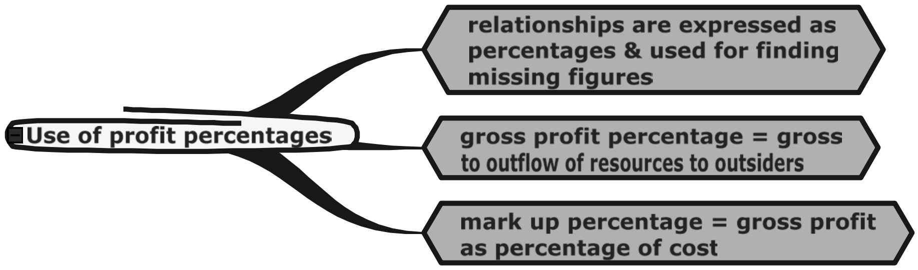
Inventory account

Dr **Cr**

	Tshs'000		**Tshs'000**
Opening inventory b/d	40,000	Cost of goods sold	375,000
Goods purchased **(balancing figure)**	**395,000**	Closing inventory c/d	60,000
Total	**435,000**	**Total**	**435,000**

It may also be the other way round. The cost of sales may be calculated as a missing figure and then sales can be found out based on percentage of mark up.

SUMMARY



Test Yourself 4

Samsoni has a proprietary business which trades in cosmetics. During the year ended 31 December 20X3, he earned gross profit at a rate of 22%.

You are given the following figures and asked to find out the opening inventory.

	Tshs'000
Sales during the year 20X3	250,000
Total purchases during the year	215,000
Closing inventory	60,000

---

4. Complete a double entry from single entry transactions. Prepare financial statements from incomplete records.

[Learning Outcomes f and g]

4.1 Preparation of financial statements from incomplete records

There are two methods to calculate the profit or loss from incomplete records:

1. Statement of affairs method

It is not easy for small businesses to maintain a full set of double entry records due to which trial balance and the complete set of final accounts cannot be prepared. Mostly in such cases, the only records which are available are the assets and liabilities at the beginning of the year and at the end of the year. It is not possible to prepare a proper statement of profit or loss from this information, but a statement of affairs (similar to the statement of financial position) can be prepared. All the assets and liabilities are listed in the Statement of Affairs.

The net assets (total assets less total liabilities) listed in the statement of affairs at the beginning of the year is compared with the net assets at the end of the year. The effect of any additional capital introduced or drawings made during the period is given in this figure to calculate the amount of profit or loss during the period.

The equation for calculating the profit is:

Profit (loss) = Increase / (decrease) in net assets - Capital introduced + Drawings.

We have already discussed this equation in detail in Learning Outcome 1.

2. Conversion of incomplete records into double entry records

In this method, the statement of profit or loss is prepared to calculate the profit or loss during the period. As all the necessary information required for preparing the statement of profit or loss is not available in the records, the missing information is first calculated by converting a single entry system into a double entry system.

The following steps should be taken for converting a single entry system into a double entry system:

(a) Preparation of opening statement of affairs or opening statement of financial position

Usually, all the opening balances should be readily available. However, at times we may have to calculate the opening capital. Opening capital is equal to net assets of the company i.e. the total assets minus the total liabilities.

In order to find the opening capital, an opening statement of financial position will be prepared in which all the assets and liabilities are entered. The balancing figure in this statement of financial position will be the opening capital.

Example

Information provided by the Masamaki Inc for the year ended 31 December 20X3 is as follows:

	Tshs'000
Land and building	15,000
Depreciation on building	2,500
Furniture and fixtures	19,750
Depreciation on furniture and fixtures	10500
Vehicles	34,000
Depreciation on vehicles	16,900
Inventory	12,375
Accounts receivable	4,330
Investment	10,000
Accounts payable	10,175
Cash balances	5,000
Bank overdraft	10,200

You are asked to prepare the statement of financial position for the year ended 31 December 20X3. Assume that there are no accruals and no prepayments.

Statement of financial position as at 31 December 20X3

	Tshs'000	Tshs'000
Non-current assets		
Land and building (Tshs15 million – Tshs2.5 million)	12,500	
Furniture and fixtures (Tshs19.75 million - Tshs10.5 million)	9250	
Vehicles (Tshs34 million - Tshs16.9 million)	17,100	38,850
Investments		10,000
Current Assets		
Inventory	12375	
Accounts receivable	4,330	
Cash in hand	5,000	21,705
Total assets		**70,555**
Capital and liabilities Capital		
(balancing figure)		50,180
(Tshs70,555,000 - Tshs20,375,000)		
Current liabilities		
Account payables	10,175	
Bank overdraft	10,200	20,375
Total capital and liabilities		**70,555**

(b) Preparation of cash book

The principles specified in Learning Outcome 2 in connection with the use of ledger accounts such as accounts receivable account, accounts payable account etc. also apply to the cash and bank summaries. These summaries are, in fact, total cash or bank accounts. The normal items are known, all the available information is filled in and the missing item is the balancing figure. This would complete the double entry of the cash book. When there is no cash book maintained by the business, bank passbook should be carefully examined as it helps to identify the cash transactions relating to business.

A typical cash / bank summary with two columns will appear like this:

Cash book or cash / bank summaries

Dr	Cash	Bank		Cash	Bank **Cr**
Balance b/d (if positive bank balance)	X	X	Balance b/d (if overdraft - possible only for bank column)	------	X
Cash sales	X	------	Cash receipts banked (contra)	X	-----
Cash receipts banked (contra)	------	X	**Cash paid to trade payables**	X	X X
Cash received from trade receivables	X	X	**Sundry expenses**	X	X
Cash withdrawn from bank (contra)	X	------	**Personal drawings**	X	X
Balance c/ f (if overdraft- possible only for bank column)	------	X	Cash withdrawn from bank (contra)	------	X
			Balance c/d (if positive balance)	X	
Total	**X**	**X**	**Total**	**X**	**X**

Most of the information required in order to prepare this summary can be picked up from bank statements. The missing amounts (which you will most likely be asked to find in your examination) that can be found out with the help of the available information are:

(a) Amounts paid to suppliers
(b) Personal drawings
(c) Amounts received from customers
(d) Opening or closing balances of cash or bank.

Example

From the following information, you are asked to prepare the cash book for the year ended 31 December 20X3:

Opening balances	Tshs
Cash in bank	5 million
Cash in hand	0.35 million

Transactions during the year	
Credit sales	36 million
Cash sales	10 million

An extract from the bank account is as follows:

Cash deposited in the bank	35 million
Bank receipts from accounts receivable	54 million
Payments towards accounts payable	57 million
Other expenses paid	4 million
Closing balances	
Cash in bank	5.4 million

Required

Calculate the missing figures in the cash and bank accounts.

Continued on the next page

Cash book or cash/ bank summaries

Dr **Cr**

	Cash Tshs'000	**Bank Tshs'000**		**Cash Tshs'000**	**Bank Tshs'000**
Balance b/d	350	5,000	Cash receipts banked (contra)	35,000	------
Cash receipts banked (contra)	---------	35,000	Cash paid to trade payables	------	57,000
Amounts received from trade receivables	----------	54,000	Sundry expenses	------	4,000
Cash withdrawn from bank (contra)	27,600	-----------	Cash withdrawn from bank (contra) **(balancing figure) (94 million - 57 million -4 million - 5.4 million)**	------	**27,600**
Cash sales	10,000		**Balance c/d (balancing figure) (37,950-35,000)**	**2,950**	5,400
Total	**37,950**	**94,000**	**Total**	**37,950**	**94,000**

Since the opening and closing bank balances are given, we will first calculate the missing figure from the bank column.

Here, the balancing figure is a cash withdrawal; therefore, its second effect will come in the cash column. After this figure has been entered, we can now calculate the closing balance of cash.

(c) Preparation of other ledger accounts

We have already discussed in Learning Outcome 2 how the missing information such as credit sales, credit purchases, cash received from customers, cash paid to suppliers, stock lost or destroyed etc. can be found by preparing accounts receivable account, account payable account and inventory account.

There are a few other ledger accounts that can help in finding out the missing information necessary to prepare the financial statements.

Expenses and income accounts incorporating accruals and prepayments: individual accounts usually have either prepaid or accrued expenses. Depending upon whether it has prepaid or accrued expenses, the presentation of an account will change.

A typical expense account showing accruals is as follows:

This amount relates to current year but not paid for - debited here

Expense incurred last year but not paid for last year so brought forward as a credit

Expense Accrual account

Dr **Cr**

	Tshs		**Tshs**
Cash paid during year	X	**Balance b/d (accruals)**	X
Balance c/d (accruals)	X	________ **Expense a/c** (amount to be shown in SOPL)	X
Total	**X**	**Total**	**X**

A typical expense account showing prepayments is as follows:

Money paid last year - but expense relates to current year, so b/d as a debit

Money paid this year but relates to expenses for following year. - Hence credited here

Expense prepayment account

Dr **Cr**

	Tshs		**Tshs**
Balance b/d (Prepayments)	X	________**Expense a/c**	X
Cash paid	X	**Balance c/d (Prepayments)**	X
Total	**X**	**Total**	**X**

Example

Mbagala Ltd uses electricity in its manufacturing process. Expenses accrued at 1 January 20X3 and 31 December 20X3 were Tshs18 million and Tshs22 million respectively. The amount paid during the year is Tshs210 million. Calculate the electricity expense in the statement of profit or loss.

Answer

Electricity expenses accrual account

Dr **Cr**

	Tshs'000		**Tshs'000**
Cash paid	210,000	Balance b/d (accruals)	18,000
Balance c/d (accruals)	22,000	Electricity expense a/c **(balancing figure)** (amount to be shown in SOPL) (210 million + 22 million - 18 million)	**214,000**
Total	**232,000**	**Total**	**232,000**

Let's look at another example of prepayments.

Example

Saimoni conducts its business in a rented office. It has to pay rent in advance. The rent paid in advance on 1 January 20X3 and 31December 20X3 was Tshs11 million and Tshs12 million respectively. The amount paid during the year is Tshs139 million. Calculate the rent expense in the statement of profit or loss.

Answer

Rent prepayment account

Dr **Cr**

	Tshs'000		**Tshs'000**
Balance b/d (prepayments)	11,000	Rent expense a/c **(balancing figure)** (to be shown in SOPL) (11 million + 139 million - 12 million)	**138,000**
Cash paid	139,000	Balance c/d (prepayments)	12,000
Total	**150,000**	**Total**	**150,000**

Capital and drawing accounts: a typical capital account is as follows

Capital account

Dr **Cr**

	Tshs		Tshs
Drawings (in cash and kind)	X	Balance b/d	X
Loss for the period	X	Additional capital introduced	X
Balance c/d	X	Profit for the period	X
Total	**X**	**Total**	**X**

Personal drawings mean:

the cash drawn;
goods taken for personal use by the proprietor; or
proprietor's personal expenses paid out of business cash.

Tip

If the question states that the drawings were "approximately" __Tshs per month, you should multiply that amount by 12 to get annual drawings. However, if the question states a range of, for example, 100 - 120 per week, then you should not use these figures but calculate the drawings as one of the missing figures.

Capital introduced may be by way of an amount actually brought into the business from personal resources or cheques related to personal income deposited into a business bank account.

Example

Samuel gives the following details:

	Tshs
Opening balance of capital	50 million
Closing balance of capital	260 million
Profit earned during the year	300 million

There was no fresh capital introduced.

Calculate drawings.

Capital account

Dr **Cr**

	Tshs'000		Tshs'000
Drawings (balancing figure) (Tshs50 million + Tshs300 million - Tshs260 million)	**90,000**	Balance b/d	50,000
Balance c/d	260,000	Profit for the period	300,000
Total	**350,000**	**Total**	**350,000**

(d) Preparation of financial statements

The financial statements need to be prepared after completing the double entry of all the transactions and making sure that all the necessary and the missing information required for preparing the final accounts is obtained.

From this information, the statement of profit or loss and statement of financial position can be prepared after taking into consideration the necessary adjustments such as outstanding expenses, accrued income, prepayments, depreciation and provision for bad debts.

Example

Kornelio Co is a small photography studio run by Ngosha. He does not maintain a complete set of records. However, from the analysis of his bank account, the following information has been extracted:

	Tshs'000		Tshs'000
Receipts from customers	8,000	Bank overdraft as on 1 January 20X3	1,200
Additional capital introduced on 1 August 20X3	600	Payments to suppliers	5,400
Loan from Smith on 1 July 20X3 @ 6% interest per annum	3,000	General expenses	1,800
		Salaries	600
		Drawings	800
		Bank balance as on 31 December 20X3	1,800
	11,600		**11,600**

The other information available from his records is as follows:

Opening balances as on 1 January 20X3	**Tshs'000**
Building	5,000
Accounts receivable	10,600
Accounts payable	3,000
Inventory	3,600

Closing balances as on 31 December 20X3	**Tshs'000**
Building	5,000
Accounts receivable	12,000
Accounts payable	3,800
Inventory	5,200

Ashton charges 5% depreciation on building.

Required

(a) Prepare the statement of profit or loss for the year ended 31 December 20X3.
(b) Prepare the statement of financial position as at 31 December 20X3.

Answer

Statement of profit or loss for the year ended 31 December 20X3

	Tshs'000	Tshs'000
Sales (W1)		9,400
Less: Cost of goods sold (W3)		(4,600)
Gross profit		**4,800**
Less: Expenses		
General expenses	1,800	
Salaries	600	
Depreciation on building (5% of Tshs5,000)	250	
Interest on loan taken from Smith @ 6% for 6 months	90	(2,740)
Net profit		**2,060**

Continued on the next page

Statement of financial position as at 31 December 20X3

	Tshs'000	Tshs'000
Non-current assets		
Building (Tshs5 million - Tshs0.25 million)		4,750
Current assets		
Inventory	5,200	
Accounts receivable	12,000	
Cash in bank	1,800	19,000
Total assets		**23,750**
Capital and liabilities		
Capital (W6)	15,000	
Add: Additional capital introduced	600	
Less: Drawings (W7)	(800)	
Add: Net profit for the year	2,060	16,860
Non-current liabilities		
Loan from Smith		3,000
Current liabilities		
Account payables	3,800	
Interest on loan	90	3,890
Total capital and liabilities		**23,750**

Workings

W1 Accounts receivable account

Accounts receivable account

Dr **Cr**

	Tshs'000		Tshs'000
Balance b/d	10,600	Cash received	8,000
Credit sales (Balancing figure) (Tshs20 million - Tshs10.6 million)	**9,400**	**Balance c/d**	12,000
	20,000		**20,000**

W2 Accounts payable account

Accounts payable account

Dr **Cr**

	Tshs'000		Tshs'000
Cash paid	5,400	Balance b/d	3,000
Balance c/d	3,800	**Credit purchases (balancing figure)** (Tshs9.2 million - Tshs3 million)	**6,200**
	9,200		**9,200**

W3 Inventory account

Inventory account

Dr **Cr**

	Tshs'000		Tshs'000
Balance b/d	3,600	**Cost of goods sold (Balancing figure)**	4,600
Goods purchased (W2)	6,200	Balance c/d	5,200
	9,800		**9,800**

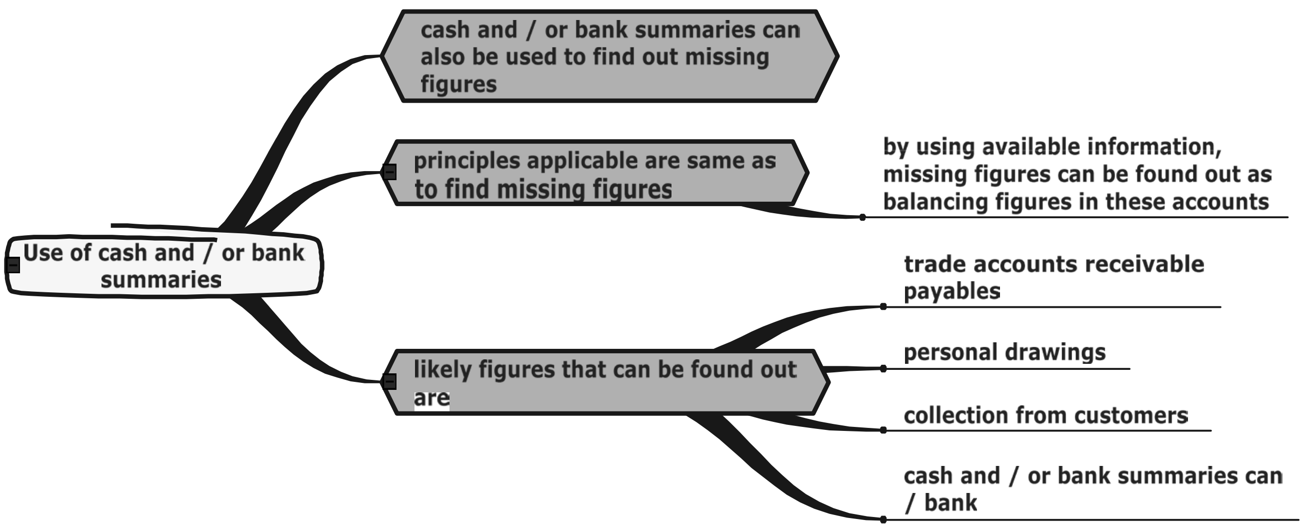
Continued on the next page

W4 Opening capital

Opening Statement of financial position

	Tshs'000
Liabilities	
Accounts payable	3,000
Bank overdraft	1,200
Opening capital **(Balancing figure)**	**15,000**
Total liabilities	**19,200**
Assets	
Accounts receivable	10,600
Inventory	3,600
Building	5,000
Total assets	**19,200**

SUMMARY



SUMMARY

Test Yourself 5

Matana a perfumery provides you with the following information:

Telephone expenses accrued at 1 January 20X3 were Tshs110,000. Electricity expenses outstanding on that date were Tshs294,000. Telephone expenses accrued at 31 December 20X3 were Tshs105,000, and electricity expenses outstanding on that date were Tshs329,000.

During the year, Tshs1,295,000 is recorded as telephone expenses and Tshs2,456,000 as electricity expenses in the statement of profit or loss.

Calculate the amount paid for the telephone and electricity expenses.

	Telephone Expenses	**Electricity Expenses**
A	Tshs1,200,000	Tshs2,421,000
B	Tshs1,300,000	Tshs2,231,000
C	Tshs1,300,000	Tshs2,421,000
D	Tshs1,200,000	Tshs2,231,000

Test Yourself 6

Sara boutique gives you the following information:

	Tshs
Opening balance of capital	120 million
Closing balance of capital	180 million
Capital introduced	20 million
Drawings	50 million

Calculate profit earned in the year.

A Tshs150 million
B Tshs50 million
C Tshs30 million
D Tshs90 million

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

Introduction of capital and profit increases the capital. On the other hand, loss or drawings decreases the capital.

Answer to TY 2

The correct option is **A**.

Accounts receivable account

Dr | Cr

	Tshs'000		Tshs'000
Balance b/d	23,000	Cash received	175,000
Credit sales	172,000	**Discount allowed (balancing figure) (195 million - 175 million - 15 million)**	**5,000**
		Balance c/d	15,000
	195,000		**195,000**

Answer to TY 3

The correct option is **B**.

Accounts payable account

Dr | Cr

	Tshs'000		Tshs'000
Cash paid (balancing figure) (415 million - 35 million - 4.2 million - 54 million)	**321,800**	Balance b/d	63,000
Purchase returns	35,000	Credit purchases	352,000
Discount received	4,200		
Balance c/d	54,000		
	415,000		**415,000**

Answer to TY 4

	Tshs'000
Total sales	250,000
Less: gross profit (W1)	(55,000)
Cost of goods sold	**195,000**

Putting the value of cost of goods sold in the inventory account, we will get the opening inventory.

Inventory account

Dr **Cr**

	Tshs'000		Tshs'000
Opening inventory b/d **(balancing figure)**	**40,000**	Cost of goods sold	195,000
Goods purchased	215,000		
		Closing inventory c/d	60,000
	255,000		**255,000**

Workings

W1 Gross profit = Gross profit ratio x Sales
= 22% x Tshs250 million
= Tshs55 million

Answer to TY 5

The correct option is **C**.

Telephone expenses accrual account

Dr **Cr**

	Tshs'000		Tshs'000
Cash paid (balancing figure)	**1,300**	Balance b/d (accruals)	110
Balance c/d (accruals)	105	Telephone expense a/c	1,295
	1,405		**1,405**

Electricity Expenses accrual account

Dr **Cr**

	Tshs'000		Tshs'000
Cash paid (balancing figure)	**2,421**	Balance b/d (accruals)	294
Balance c/d (accruals)	329	Electricity expense a/c	2,456
	2,750		**2,750**

Answer to TY 6

The correct option is **D**.

Capital account

Dr **Cr**

	Tshs'000		Tshs'000
Drawings	50,000	Balance b/d	120,000
Balance c/d	180,000	Additional capital introduced	20,000
		Profit for the period (Bal. fig.)	**90,000**
	230,000		**230,000**

Self Examination Questions

Question 1

Delila, a shopping mall, had a fire last year. The accountant could not save his books of accounts. From whatever was saved he gave the following information:

	Tshs'000
Opening balance of trade receivables	53,000
Cash received	315,000
Discount allowed	3,000
Bad debts	1,500
Closing balance of trade receivables	51,000

Required:

Calculate credit sales in the year.

Question 2

Continuing the above case of Delila, some of the goods were destroyed in the fire. It has a fire insurance policy. In order to claim the policy amount, Delila Ltd wanted to know the value of the goods destroyed.

	Tshs'000
Opening inventory	21,500
Closing inventory	20,200
Goods purchased	210,000
Cost of goods sold	180,000

Question 3

(a) From the following information prepare the cash book for the year ended 31 December 20X3

Opening balances	Tshs'000
Inventory	10,000
Accounts receivable	15,000
Cash at bank	7,500
Cash in hand	500
Non-current assets	50,000
Accounts payable	3,000
Transactions during the year -	
Credit sales	50,000
Cash deposited in the bank	40,000
Bank receipts from accounts receivable	45,000
Bank payments towards accounts payable	75,000
Sundry expenses made through bank	4,000
Cash withdrawals from bank	9,100
Closing balances -	
Cash balance	600
Accounts payables	3,500

There were no accruals and prepayments.
All payments except petty cash expenses are made by cheque.
All the customers pay by cheque except cash sales.
Depreciation for the year is Tshs2,250,000 (not recorded in the books)
Mark up is 20% on cost.
No other information is available

(b) You are also required to find out the missing figures and prepare the statement of profit or loss and the statement of financial position as at 31 December 20X3.

Question 4

Fresh n Juicy Plc is a proprietary firm belonging to Margaret. She does not keep full accounting records. However, from the records she does maintain, we can extract the following information:

Opening balances	Tshs'000
Accounts payable	8,225
Accounts receivable	12,810
Telephone expenses (accrued)	350
Inventory	8,575
Insurance prepaid	280
Cash and bank account	18,800

Transactions during the year	Tshs'000
Receipts from account receivables	168,000
Payments to suppliers	106,000
Telephone expenses paid	4,550
Salaries	15,100
Office expenses	5,863
Postage and stationery	2,380
Conveyance	1,138
Discount allowed to customers	1,000
Insurance paid	1,400
Purchase of furniture	22,750
Sale of old furniture (carrying value Tshs750,000)	3,675

Closing balances	Tshs'000
Accounts payable	4,530
Accounts receivable	16,625
Telephone expenses (accrued)	455
Inventory	10,325
Insurance prepaid	350
Cash and bank	15,194

It is the policy of Fresh n Juicy to charge depreciation for the full year for purchases before 1 September. Furniture is purchased on 31 August 20X3. The depreciation charge for furniture is 10%.

Required

(a) Prepare the statement of profit or loss for the year ended 31 March 20X3.

(b) Prepare the statement of financial position as at 31 March 20X3.

Question 5

a)Whenever a business does not have a full set of accounting records to prepare financial statements, the records are said to be incomplete. Accounts from incomplete records are prepared at times when full set of records may not be available and there is a requirement to prepare the financial statements for various purposes. This may happen when part of the records has been lost or destroyed. Similarly the proprietor may not maintain full records, but when he approaches a bank for a loan, the bank may insist on a full set of financial statements.

REQUIRED:

Identify limitations of incomplete records information.

b)The Pambakali Wholesale Clothing Company was burgled on the night of 14th December 2012, the raiders stole all that day's cash taking together with the petty cash and a selection of the most expensive clothing. On 30th November 2012, the owner had taken a physical stock count for which the cost was evaluated as Tshs. 32,540,000. The stock of clothing left after the burglary amounted to Tshs. 11,300,000 at cost.

Deliveries from suppliers of further stock items, between 1st and 14th December 2012, were invoiced at Tshs. 5,784,000 after deduction of trade discounts of Tshs. 732.

Sales to retail customers (at selling prices) had been:

	Cash	**Credit**
	Tshs.	**Tshs.**
1st to 6th December	1,429,710	6,250,290
7th to 13th December	1,644,500	8,079,500
14th December	259,320	1,200,680

The cash and bank accounts showed that during the period 1st to 14th December 2012:

1. The cash taking for 1st to 13th December, inclusive, had been banked intact
2. Cheques for Tshs. 168,920 and Tshs. 192,670 had been drawn to pay staff wages.
3. Credit customers had paid cheques amounting to Tshs. 15,867,110 (all of which had been banked) in full settlement of accounts totaling Tshs. 16,102,830.
4. The company had paid credit suppliers a total of Tshs. 17,118,360 by cheque after reducing cash discounts of Tshs. 940,450.
5. The petty cash imprest account had been restored to its established level of Tshs. 25,000 on 1st December by a withdrawal from the bank of Tshs. 9,740. Subsequent disbursements to 14th December had amounted to Tshs. 13,690.

Accounts balances in the firm's books on 30th November 2012 had been:

	Tshs.
Bank	6,625,080 (debit)
Cash	129,600
Petty cash	15,260

Gross profit on sales had been at the rate of 30% throughout 2012 but on 7th December, as part of a sales campaign, this was reduced to 25% for the remainder of the month.

REQUIRED:

Using the above information calculate:

(i) The amount of cash and the value of stock at cost, which had been stolen.
(ii) The balance on the bank account at close of business on 14th December 2012.

Question 6

After completing a training course at a technical college, Mr. John Omari set up a business as a self-employed Electrician on 1st January 2014. He was very competent on his job but has no idea on maintaining proper accounting records. Mr. John Omari is asking for a help in preparing accounts for the year ended 31st December 2014. To do this job he has supplied the following information to you:

(i)

	Opening balances	**Closing balances**
Cash	5,000,000	-
Debtors	4,500,000	5,500,000
Unpaid rent	300,000	-
Electricity paid in advance	200,000	25,000
Buildings	15,000,000	14,500,000

(ii) The bank statement obtained from the bank showed the following:

	Dr	Cr	Balance
Bal b/d		15,000,000	15,000,000
Receipt from Debtors		250,000,000	265,000,000
Wages and salaries	2,500,000		262,500,000
Cash		17,000,000	279,500,000
Purchases	260,000,000		19,500,000
Electricity	800,000		18,700,000

(iii) Cash sales were TZS.16,800,000 of which TZS.500,000 were paid directly as rent. There were no credit purchases.

(iv) Discount allowed were TZS.6,000,000 while returns inwards were TZS.8,000,000

REQUIRED:

Prepare the statement of profit or loss for the year ended 31st December 2014.

Question 7

(a) Mimi does not keep proper accounting records and it is necessary to calculate his sales for the year ended 31st December 2015 from the following information.

Trade receivables: 31st December 2014	140,000,000
31st December 2015	100,000,000
Money banked during the year	95,000,000
Contras with a creditor against debt	23,000,000
Refund paid for wrong payments	4,300,000
Discount allowed	3,200,000
Bad debts written off	7,620,000
Cash sales where the money was not banked	480,000

REQUIRED:

Compute the figure of sales for inclusion in Mimi's financial statements for the year ended 31st December 2015.

(b) Igoma Biscuits (IB) warehouse was destroyed by fire on 31st March 2016. Considerable part of inventory and stock records were destroyed. Igoma Biscuits management need to know the value of stock which was destroyed by fire, so that they can claim compensation from their insurer (Matata Insurance Broker). The trading account of IB for the year ended 31st March 2016 included the following figures:

	TZS.	TZS.
Sales		340,278,000
Opening inventory at cost	160,410,000	
Purchases	210,250,000	
	370,660,000	
Closing inventory at cost	65,460,000	305,200,000
Gross Profit		35,078,000

Igoma Biscuit fixes her prices by adding 50% to the cost of goods purchased.

REQUIRED:

Determine the value of stock which was destroyed by fire.

(c) Mr. Castus, a sole trader does not keep records of his drawings, though his assistant was able to provide the following information on 31st March 2016.

	TZS.
Cash in hand at the beginning of the year	100,000
Bank balance at the beginning of the year	2,300,000
Cash in hand at the end of the year	1,000,000
Bank balance at the end of the year	18,500,000
Receipts	30,000,000
Payments to employees	11,100,000
Payments to suppliers	6,000,000
Payments for other expenses	800,000
Capital balance at the end	24,000,000
Net asset at the end	1,900,000

REQUIRED:
- (i) Calculate Mr. Castus own drawings.
- (ii) Calculate the profit or loss of the business for the period ended 31st March 2016.

Question 8
Mr. Tumaini operates a butcher shop in Kariakoo Market where he sells meat. He employs an assistant who helps him in cutting the meat and maintaining cleanliness of the shop.

During the year to 30th June 2016, the following transactions were paid from the cash collections and the balance deposited in the bank:

- TZS.150,000 per week collected by his wife for home use
- TZS.450,000 as monthly wages to his assistant
- TZS.2,400,000 for packaging materials for meat
- TZS.600,000 sundry expenses

His summarized business bank account for the year revealed the following:

	BANK ACCOUNT DEBIT		CREDIT
	TZS.		TZS.
Balance 1st July 2015	5,100,000	Rent	3,600,000
Shop collections banked	69,850,000	Insurance	250,000
		Electricity	540,000
		Water	360,000
		New Deep freezer	7,200,000
		Purchases of meat	50,000,000
		Balance 30th June 2016	13,000,000
	74,950,000		74,950,000

The following is additional information:

	30th June 2015	30th June 2016
	TZS	TZS
Deep freezers at cost	20,000,000	?
Accumulated depreciation	12,200,000	?
Accrued electricity	150,000	180,000
Prepaid insurance	80,000	120,000
Stock of meat	3,600,000	7,500,000
Debtors	1,560,000	2,480,000
Creditors for meat	2,750,000	4,000,000
Cash balance	660,000	590,000

Depreciation of deep freezers is at 20% on the reducing balance method.

REQUIRED:

- (a) Prepare Mr. Tumaini's Statement of Affairs as at 1st July 2015.
- (b) Prepare a Statement of Profit or Loss for the year ended 30th June 2016.
- (c) Prepare a Statement of Financial Position as at 30th June 2016.

Answers to Self Examination Questions

Answer to SEQ 1

Accounts receivable account

Dr **Cr**

	Tshs'000		Tshs'000
Balance b/d	53,000	Cash received	315,000
Credit sales (Balancing figure) (Tshs370.5 million - Tshs53 million)	**317,500**	Discount allowed	3,000
		Bad debts	1,500
		Balance c/d	51,000
	370,500		**370,500**

Answer to SEQ 2

Inventory account

Dr **Cr**

	Tshs'000		Tshs'000
Opening inventory b/d	21,500	Cost of goods sold	180,000
Goods purchased	210,000	**Goods destroyed (balancing figure)** (Tshs231.5 million - Tshs180 million - Tshs20.2 million)	**31,300**
		Closing inventory c/d	20,200
	231,500		**231,500**

Answer to SEQ 3

(a)

Cash book or cash / bank summaries

Dr **Cr**

	Cash Tshs'000	Bank Tshs'000		Cash Tshs'000	Bank Tshs'000
Balance b/d	500	7,500	Cash receipts banked (contra)	40,000	-
Cash receipts banked (contra)		40,000	Trade account payables	-	75,000
Collection against trade receivables		45,000	Sundry expenses	-	4,000
Cash withdrawn from bank (contra)	9,100	-	Cash withdrawn from bank (contra)	-	9,100
Cash sales (balancing figure) (Tshs40.6 million - Tshs0.5 million - Tshs9.1 million)	**31,000**		**Balance c/d** (Tshs92.5 million - Tshs75 million - Tshs4 million - Tshs9.1 million)	600	**4,400**
	40,600	**92,500**		**40,600**	**92,500**

The balancing figure in the cash column is of cash sales and in the bank column is of closing balance.

	Tshs'000	Tshs'000
Sales (W1)		81,000
Less: Cost of goods sold		
Opening inventory	10,000	
Goods purchased (W2)	75,500	
Less: Closing inventory (W3)	(18,000)	(67,500)
Gross profit		**13,500**
Expenses		
Other expenses	4,000	
Depreciation	2,250	(6,250)
Net profit		**7,250**

Statement of financial position as at 31 December 20X3

	Tshs'000	Tshs'000
Current Assets		
Inventory (W3)		18,000
Accounts receivable (W4)		20,000
Cash in hand	600	
Cash at bank	4,400	5,000
Net non-current assets (Tshs50,000 - Tshs2,250)		47,750
Total assets		**90,750**
Capital and liabilities		
Capital **(balancing figure)**	80,000	
Net profit for the year	7,250	87,250
Current liabilities		
Account payables		3,500
Total capital and liabilities		**90,750**

Workings

W1 Cost of goods sold

	Tshs'000
Credit sales	50,000
Cash sales	31,000
Total sales	**81,000**

From total sales we can calculate the cost of goods sold using the profit formula

	Tshs'000
Cost of goods sold	
Total sales (say 120%)	81,000
Less: profit (20% on cost) (Tshs 81 million X 20/120)	13,500
Cost of goods sold	**67,500**

W2 Accounts payable account

Accounts payable account

Dr	Tshs'000		Tshs'000 Cr
Paid	75,000	Balance b/d	3,000
Purchase returns		**Credit purchases (balancing figure)**	**75,500**
Discount received		(Tshs78.5 million - Tshs3 million)	
Balance c/d	3,500		
	78,500		**78,500**

By putting the value of cost of goods sold in the inventory account and the credit purchases calculated above in the trade payables account, we will get the closing inventory.

W3 Inventory account

Inventory account

Dr **Cr**

	Tshs'000		Tshs'000
Opening inventory b/d	10,000	Cost of goods sold (W1)	67,500
Goods purchased (W2)	75,500		
		Closing inventory c/d (Tshs85.5 million - Tshs67.5 million)	**18,000**
	85,500		**85,500**

W4 Trade receivables account

Trade receivables account

Dr **Cr**

	Tshs'000		Tshs'000
Balance b/d	15,000	Cash received	45,000
Credit sales	50,000		
		Balance c/d (balancing figure) (Tshs65 million - Tshs60 million)	**20,000**
	65,000		**65,000**

Answer to SEQ 4
Statement of profit or loss for the year ended 31 March 20X3

	Tshs'000	Tshs'000
Sales (W1)		172,815
Less: Cost of goods sold		
Opening inventory	8,575	
Goods purchased (W2)	102,305	
Less: Closing inventory	(10,325)	(100,555)
Gross profit		**72,260**
Other incomes		
Profit on sale of furniture (W5)		2,925
		75,185
Expenses		
Telephone expenses (W3)	4,655	
Salaries	15,100	
Office expenses	5,863	
Postage and stationery	2,380	
Conveyance	1,138	
Insurance (W4)	1,330	
Discount allowed	1,000	
Depreciation on furniture 10%	2,275	(33,741)
Net profit		**41,444**

Statement of financial position as at 31 March 20X3

	Tshs'000	Tshs'000
Current Assets		
Inventory	10,325	
Accounts receivable	16,625	
Cash in bank	15,194	
Prepaid insurance	350	42,494
Net non-current assets		
Furniture (Tshs22,750,000 - Tshs2,275,000)		20,475
Total assets		**62,969**
Capital and liabilities		
Capital (W6)	32,640	
Less: Drawings (W7)	(16,100)	
Net profit for the year	41,444	57,984
Current liabilities		
Account payables	4,530	
Accrued telephone expenses	455	4,985
Total capital and liabilities		**62,969**

Workings

W1 Accounts receivable account

Accounts receivable account

Dr **Cr**

	Tshs'000		Tshs'000
Balance b/d	12,810	Cash received	168,000
Credit sales (balancing figure) (Tshs185,625,000 - Tshs12,810,000)	**172,815**	Discount allowed	1,000
		Balance c/d	16,625
	185,625		**185,625**

W2 Accounts payable account

Accounts payable account

Dr **Cr**

	Tshs'000		Tshs'000
Cash account - paid	106,000	Balance b/d	8,225
Balance c/d	4,530	**Credit purchases (balancing figure)** (Tshs110,530,000 - Tshs8,225,000)	**102,305**
	110,530		**110,530**

W3 Telephone expenses accrual account

Telephone expenses accrual account

Dr **Cr**

	Tshs'000		Tshs'000
Paid	4,550	Balance b/d (accruals)	350
Balance c/d (accruals)	455	**Telephone expenses a/c (balancing figure) (to be shown in SOPL) (Tshs5,005,000 - Tshs350,000)**	**4,655**
	5,005		**5,005**

W4 Insurance prepayment account

Insurance prepayment account

Dr **Cr**

	Tshs'000		**Tshs'000**
Balance b/d	280	**Insurance expenses a/c (balancing figure) (to be shown in SOPL) (Tshs1,680,000 - Tshs350,000)**	**1,330**
Cash account - paid	1,400	Balance c/d (accruals)	350
	1,680		**1,680**

W5 Profit on sale of furniture

	Tshs'000
Sale of furniture	3,675
Furniture carrying value	750
Profit on sale of furniture	**2,925**

W6 Opening capital

Opening Statement of financial position

	Tshs'000
Liabilities	
Accounts payable	8,225
Accrued telephone expenses	350
Opening capital (Balancing figure)	**32,640**
Total liabilities	**41,215**
Assets	
Accounts receivable	12,810
Inventory	8,575
Prepaid insurance	280
Cash and bank	18,800
Furniture	750
Total assets	**41,215**

W7 Cash/bank account

Cash/bank account

Dr **Cr**

	Tshs'000		**Tshs'000**
Balance b/d	18,800	Accounts payable	106,000
Accounts receivable	168,000	Telephone expenses	4,550
Sale of furniture	3,675	Salaries	15,100
		Office expenses	5,863
		Postage and stationery	2,380
		Conveyance	1,138
		Insurance	1,400
		Purchase of furniture	22,750
		Drawings (balancing figure)	**16,100**
		Balance c/d	15,194
	190,475		**190,475**

Answer to SEQ 5

(a)

(i) Arithmetical accuracy of accounts cannot be checked

(ii) Difficult to:
- Carry out audit procedures
- Operate internal control system and internal check system
- Detect fraud
- Ascertain the financial position of the business

(iii) If a set of financial statements, i.e. the statement of profit or loss and the statement of financial position, is to be prepared when the records are incomplete, then the account does not have the luxury of a ready trial balance from which he can prepare them.

(iv) Various methods have to be used to calculate the missing information in order to prepare the financial statements. The methods used vary with the nature of information that is incomplete.

(v) The accountant's approach also depends upon whether both the statement of profit or loss and the statement of financial position is to be prepared.

(b) (i) The amount of cash stolen can be derived from a cash summary, or cash account, as follows:

The Pambakali Wholesale Clothing Company

	Tshs.	Tshs.
Balance in hand – 30 November 2012		129,600
Receipts		
Cash sales		1,429,710
1 to 6 December		1,644,500
14 December		259,320
		3,463,130
Payments into bank		
6 December	1,429,710	
13 December	1,644,500	
		3,074,210
Balance 14 December 2012		388,920
		=======

The petty cash balance as 14 December would be Tshs.25,000 – Tshs.13,690 = Tshs.11,310
The total amount of cash stolen would thus be Tshs.388,920 + Tshs.11,310 = Tshs.400,230
The amount of stock stolen can be calculated by estimating the likely stock in hand on 14 December, and comparing it with the amount actually in hand. This can be done as follows:

	1 to 6 December	**7 to 14 December**
Sales	(1,429,710 + 6,250,290) = Tshs.7,680,000	(1,644,500 + 8,079,500 + 259,320 + 1,200,680) = Tshs.11,184,000
Cost of sales	70% of sales = Tshs.5,376,000	75% of sales = Tshs.8,388,000 Total Tshs.13,764,000

Cost of sales is derived from:

	Tshs.
Opening stock	32,540,000
Purchases	5,784,000
	38,324,000
Less: Closing stock	X
= Cost of sales	Tshs.13,764,000

Therefore closing stock (x) should have been Tshs.24,550,000

Since the actual stock in hand amounted to Tshs.11,300,000 the amount of stock stolen can be estimated at Tshs.13,260,000

(ii) The balance on the bank account as at 14 December 2012 may be derived as follows:

	Tshs.	**Tshs.**
Balance at bank at 30/11/2012		6,625,080
Takings banked (1,429,710 + 1,644,500)	3,074,210	

Receipts from credit customers	15,867,110	18,941,320
		25,566,400
Payments to suppliers	17,188,360	
Staff wages (168,920 + 192,670)	361,590	
Petty cash	9,740	17,489,690
Balance at bank 14/12/2012		Tshs.8,076,710
		============

Answer to SEQ 6
John Omari Enterprises
The Statement of Profit or Loss for the year ended 31st December 2014
(In 000)

Sales	Credit	265,000		
	Cash	16,800	281,800	
Less Return inwards			8,000	273,800
Cost of Sales:				
Opening stocks			11,000	
Add: Purchases			260,000	
Available for sale			271,000	
Less: Closing stocks			16,000	255,000
Gross profits				18,800
Operating expenses:				
Rent	(500 – 300)		200	
Electricity	(800 + 200 – 25)		975	
Wages and Salaries			2,500	
Depreciation - Buildings			500	4,175
Net Profits				14,625

Workings:
Cash Book (000)

Date	Details	Cash	Bank	Date	Details	Cash	Bank
1.1.14	Bal. b/d	5,000	15,000		Rent	500	
	Sales	16,800			Bank	17,000	
	Cash		17,000		Purchases		260,000
	Debtors		250,000		Wages & Sal		2,500
					Electricity		800
				31.12.14	Bal. c/f	4,300	18,700
		21,800	282,000			21,800	282,000

Sales:
Debtors Control Account

Bal. b/d	4,500	Bank	250,000
Credit sales	265,000	Discount allowed	6,000
		Return inwards	8,000
		Bal. c/d	5,500
	269,500		269,500

Answer to SEQ 7
(a)

DEBTORS CONTROL A/C

	Tshs		Tshs
Balance b/d	140,000,000	Money banked	95,000,000
Refund	4,300,000	Contras	23,000,000
		Discount allowed	3,200,000
Sales (Balance)	85,000,000	Bad debts W/O	7,620,000
		Money not banked	480,000
		Balance C/d	100,000,000
	229,300,000		229,300,000

(b) Mark – up to margin.

(Mark-up), 50% = $\dfrac{50}{100+50} = \dfrac{50}{150} = \dfrac{1}{3}$ (Margin).

Gross Profit Based on $\frac{1}{3}$ (margin)

$\frac{1}{3}$ x 340,278,000 = 113,426,000

Gross Profit provided in Question

Given. = 35,078,000.

Gross Profit Provided in Question is less than gross profit expected based on the 1/3 margin because of inventory loss

Inventory loss = 113,426,000 – 35,078,000
= 78,348,000

Alternatively
The "EXPECTED" value of stock at 31/3/2016 i.e. 370,660,000 – 226, 852,000 (this is the cost of sale, considering a ⅓ margin)

This figure i.e. 143,808,000 is then compared to the reported (which is actually salvaged) stock of 65,460,000 to arrive at TZS.78,348,000 stock destroyed.

ALT 2: Cost of sales based on 1/3 (margin).

Cost of sales = $\frac{2}{3}$ x 340,278,000 = 226,852,000.

Actual cost of sales

Given	=	305,200,000
Difference	=	Loss of inventory
	=	305,200,000 – 226,822,000
	=	**78,348,000**

(c) Drawings

Cash and Bank memorandum Account.

		Tshs.
Cash in hand and Bank at beg		2,400,000
Receipts during the year		30,000,000
		32,400,000
Payments to employees	11,100,000	
Payments to suppliers	6,000,000	
Payments for other exp.	800,000	
Total payments recorded		(17,900,000)
		14,500,000
Cash in hand and Bank at the end		19,500,000
Difference = missing figure = Deposit		5,000,000
(ii) Profit of the Business		Tshs
Capital balance at the end		24,000,000
+ Profit (Missing)		X
Drawings		15,700,000
Net asset at the end		1,900,000
24m + X + 5m = 1.9m.		
X = 1.9m – (24m + 5m)		
X = 27.1m		

Answer to SEQ 8

(a) Preparation of Mr. Tumaini's Statement of Affairs as at 1st July 2015.

	TZS	TZS	TZS
Non Current Assets			
Deep Frickes at cost		20,000,000	
Less: Depreciation		(12,200,000)	
Net Book Value			7,800,000
Current Assets			
Stock of meat	3,600,000		
Debtors	1,560,000		
Prepaid Insurance	80,000		
Balance at Bank	5,100,000		
Cash in Hand	660,000		
Total Current Assets		**11,000,000**	
Less: Current Liabilities			
Creditors for meat	2,750,000		
Accrued Electricity	150,000	2,900,000	
Working Capital			**8,100,000**
Net worth			15,900,000
Financed by			
Capital			15,900,000

(b) Preparation of Statement of Profit for the year ended 30th June 2016

Mr. Tumaini's – Butcher

Statement of Profit & Loss for the year ending 30th June 2015

	TZS	TZS
Sales		86,900,000
Less: Cost of Goods Sold		
Opening Stock	3,600,000	
Purchases	51,250,000	
Cost of Goods available for Sales	54,850,000	
Less: Closing Stock	7,500,000	
Cost of Goods Sold		47,350,000
Gross Profit		39,550,000
Less: Expenses:		
Assistant's wages	5,400,000	
Water	360,000	
Packaging material	2,400,000	
Sundry expenses	600,000	
Rent	3,600,000	
Insurance	210,000	
Electricity	570,000	
Depreciation (See Workings)	3,000,000	
Total Expenses		16,140,000
Net Profit		23,410,000

(c) Preparation of Statement of Financial Position as at 30th June 2016

Mr. Tumaini's – Butcher

Statement of Financial Position as at 30th June 2016

	TZS	TZS	TZS
	Cost	Accum Depr	Net Book Value
Deep Freezers	20,000,000	13,760,000	6,240,000
New Depfreezer	7,200,000	1,440,000	5,760,000
			12,000,000
Current Assets			
Stock	7,500,000		
Debtors	2,480,000		
Prepaid Insurance	120,000		
Balance at Bank	13,000,000		
Cash in Hand	590,000		
Total Current Assets		23,690,000	

Less: Current Liabilities			
Creditors	4,000,000		
Accrued Electricity	180,000	4,180,000	
Working Capital			19,510,000
Net worth			31,510,000
Financed by:			
Capital		15,900,000	
Less: Drawings		(7,800,000)	8,100,000
Net Profit			23,410,000
			31,510,000

Workings 1: Construction of Cash Account

DR **Cash Account** **CR**

	TZS		TZS
Balance b/f	660,000	Drawings	7,800,000
Debtors	85,980,000	Assistant Wages	5,400,000
		Packaging Material	2,400,000
		Sundry Expenses	600,000
		Bank	69,850,000
		Balance c/d	590,000
	86,640,000		86,640,000

Workings 2: Calculation of Sales figure

DR **Debtors Account** **CR**

	TZS		TZS
Balance b/f	1,560,000	Cash	85,980,000
Sales	86,900,000	Balance c/d	2,480,000
	88,460,000		88,460,000

Workings 3: Calculation of Purchases figure

DR **Creditors Account** **CR**

	TZS		TZS
Bank	50,000,000	Balance b/d	2,750,000
Balance c/d	4,000,000	Purchases	51,250,000
	54,000,000		54,000,000

Workings 4: Calculation of Depreciation

	TZS	TZS	TZS
	Cost	**Accum Depr**	**Annual Depr**
Dee[Freezers	20,000,000	12,200,000	1,560,000
New Deep Freezer	7,200,000		1,440,000
Total	27,200,000	12,200,000	3,000,000

Workings 5: Insurance to be included in P & L

DR **Pre Insurance Account** **CR**

	TZS		TZS
Balance b/f	80,000,000	P & L	210,000
Bank	250,000	Balance c/d	120,000
	330,000		330,000

Workings 6: Electricity to be included in P & L

DR **Accr Electricity Account** **CR**

	TZS		TZS
Bank	540,000	Balance b/d	150,000
Balance c/d	180,000	P & L	570,000
	720,000		720,000

12 FINANCIAL STATEMENTS FOR NOT-FOR-PROFIT ENTITIES

Get Through Intro

Assessing the performance of specialised, not-for-profit and public sector entities is no different from assessing the performance of profit-oriented entities. This is because all types of organisations are required to use the resources available to them efficiently. However, there are still some special needs for these organisations.

This Study Guide discusses the approaches and principles required when assessing the performance of organisations for which making profits is not the primary aim. You should make the required effort to understand these approaches and principles in order to do well in the examination and so as not to get confused when you actually begin such assessments in your professional life.

The International Accounting Standards Board (IASB) and the US Accounting Standards Board (FASB) are currently working to bring out a framework for reporting by not-for-profit entities in the public and private sector. Also, the International Public Sector Accounting Standards Board (IPSAB) has so far issued 31 International Public Sector Accounting Standards (IPSAS), loosely based on IFRS.

Although IFRS have been designed with profit-oriented entities in mind, other kinds of entities may find them appropriate. They can refer to IFRS until such time that they get their own standards.

Learning Outcomes

a) Differentiate not-for-profit entities from other entities.
b) Describe the books of account prepared for not-for-profit entities.
c) Prepare receipt and payment accounts.
d) Prepare financial statements for not-for-profit entities.

1. Differentiate not-for-profit entities from other entities.

[Learning Outcome a]

1.1 Not-for-profit entities

Definition

In direct contrast to commercial organisations, not-for-profit organisations are started and run for the purpose of **providing benefits.** These benefits may be provided on an individual level or to society as a whole.

Ownership and objective

This type of entity is mostly owned and controlled by the government, public sector entities, non-governmental organisations (NGOs), cooperatives etc. Lot of private enterprises also have a separate division that is engaged into not-for-profit activities. For example some pharmaceutical companies run charitable hospitals.

The objective of these organisations is to indulge in social work rather than commercial activity. These organisations work towards a social, cultural, economic or educational cause.

These organisations generally do not earn a profit but aim to provide or deliver a service. Not-for-profit organisations derive their revenue from three sources:

Their own revenue generating activities;
Government funding and
Donations (from both individuals and organisations).

Such companies are prohibited from distributing the profits generated by them through operation.

Not-for-profit organisations vary greatly in terms of both size and type.

Example

Examples include trade unions, public hospitals and universities. All of these organisations have been created and are run for providing a beneficial service. Trade unions exist to bargain for better working conditions for employees, hospitals to treat the sick and universities to provide learning and education.

1.2 For-profit organisations

Definition

It is an entity that has been created **for the purpose of generating profits.**

Ownership and objective

This type of entity is mostly owned and controlled by individuals whose aim is to indulge in commercial activity rather than social work. This is the only criterion that needs to be satisfied for an organisation to be deemed a commercial organisation.

For-profit organisations are commonly referred to as commercial organisations. The primary objective of commercial organisations is to maximise profits.

The type of activity or work that the organisation does is of no relevance. The same rule applies with regard to the size of the organisation.

Example

A small one man consulting firm and a multinational conglomerate like Accenture are both examples of for-profit organisations.

These days, most for-profit organisations do some amount of social work as part of their corporate social responsibility (CSR).

1.3 Difference between not-for-profit and other entities

Other entities can be an individual, partnership or corporation that carries on business for profit.

The differences between not-for-profit and other entities are as follows:

(a) **Motive**: a non-profit entity has a mission that benefits the greater good of the community, society, or the world. On the other hand, other business entities are formed for the financial benefit of its owners and/or shareholders.

(b) **Fund utilisation:** a non-profit entity cannot use its funds for anything other than the mission for which it was formed. Stakeholders of a non- profit organisation are concerned about the appropriate utilisation and allocation of resources based on its mission whereas for the other entities, profit is the main goal.

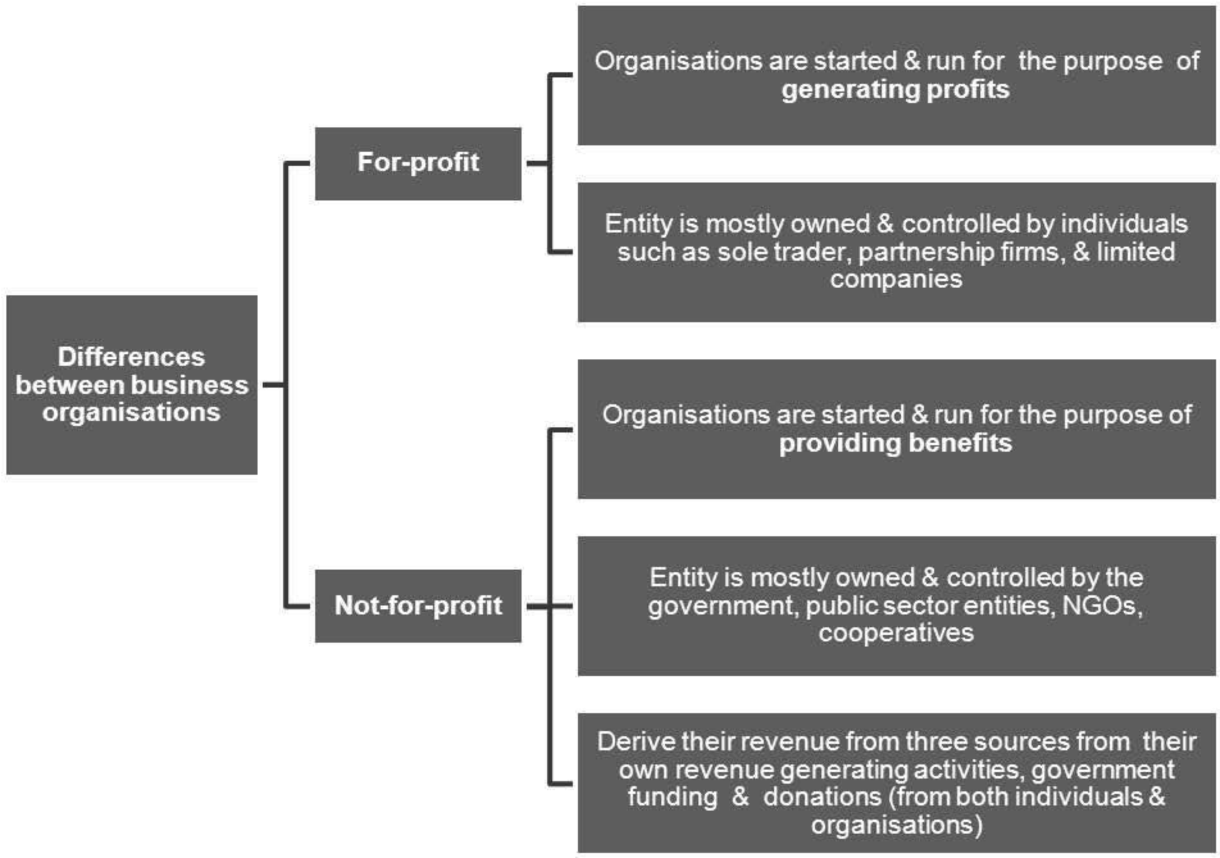
(c) **Taxes:** a non-profit entity does not pay taxes however the other entities pay taxes on their profit.

(d) **Financial statements:** non-profit accounting is focused on tracking the contributions made to an organisation and how these are spent, which is done by preparing Receipts and Payments account, Income and Expenditure account and Statement of financial position. The financial statements prepared in case of for-profit entities are statement of comprehensive income, statement of equity and statement of financial position.

(e) **Users:** the parties that are typically interested in the finances of a for-profit business entity include management, shareholders, investors, lenders, tax authorities, suppliers, and, in the case of public companies, the general public. The non-profit entity stakeholders are board members, government agencies, members, contributors, volunteers, the general public and others.

(f) **Liquidation:** when any for-profit entity goes out of business, its assets can be liquidated and the proceeds are distributed among the owners or the shareholders. But when a non-profit entity goes out of business, its remaining assets must be given to another non-profit entity.

Diagram 1: Differences between business organisations



Test Yourself 1

An entity that is run by the government for providing goods/services to society is called a:

A Not-for profit organisation
B NGO
C Cooperative
D None of the above

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2. Describe the books of account prepared for not-for-profit entities.
Prepare receipt and payment accounts.

[Learning Outcomes b and c]

We have already discussed in the previous Learning Outcome that not-for-profit entities earn their income mainly from admission fees, subscriptions, donations, government grants etc. The financial statements prepared by not-for-profit entities follow the same principles that are followed by for-profit entities.

Not-for-profit entities prepare the following financial statements at the end of the accounting period:

(a) Receipts and Payments Account
(b) Income and Expenditure Account
(c) Statement of financial position

2.1 Receipts and Payments account

This a summary of the cash book for a specific period for a not-for-profit organisation. It reveals everything about what happened financially during the period and records all cash receipts and cash payments irrespective of whether they are capital or revenue in nature.

Characteristics of Receipts and Payments Account

(a) It is a summary of all cash transactions made by the entity during the accounting period.
(b) There is no distinction between capital and revenue receipts and payments while recording the transactions.
(c) It starts with the opening balance of cash and bank and ends with the closing balance of cash and bank.
(d) All receipts are recorded on the debit side and all the payments are recorded on the credit side of the account.
(e) All cash transactions which are incurred during the accounting period are recorded in this account irrespective of whether they relate to the past, current or future period.
(f) Non-cash transactions are not recorded in this account.

Some of the very small not-for-profit organisations which do not have any assets other than cash and no liabilities maintain only Receipts and Payments accounts. For the other not-for-profit organisations, a Receipts and Payments account serves the purpose of a trial balance and becomes the basis for the preparation of Income and Expenditure account and statement of financial position.

2.2 Income and Expenditure account

It is similar to the statement of profit or loss prepared by for-profit entities. If the income is more than the expenditure, the excess amount is known as surplus and if the amount of expenditure exceeds the income, then it is referred to as deficit.

Characteristics of Income and Expenditure Account

(a) All expenses of revenue nature related to a particular period are debited to this account on an accrual basis
(b) Similarly all revenue related to particular period are credited to this account on an accrual basis
(c) Only current years income and expenses are recorded in this account. Amounts outstanding for current period are added and amounts related to other period are deducted.
(d) If the income is more than the expenditure, it is called **Surplus** and is added to the Capital or general fund in the statement of financial position
(e) If the expenditure is more than the income, it is called **Deficit** and is deducted from the Capital or general fund in the statement of financial position

Receipts and Payments Account and Income and Expenditure account seem to be similar to each other, but there are major differences between them which are as follows:

S.No.	Basis	Receipts and Payments Account	Income and Expenditure Account
1	Nature of account	It is a real account.	It is a nominal account.
2	Form	It is a summarised form of cash book.	It is similar to the statement of profit or loss.
3	Basis	Prepared on cash basis of accounting.	Prepared on accrual basis of accounting.
4	Period	Includes receipts & payments of cash made during the year, whether they relate to the past, current or future period.	Includes incomes & expenses of current year only.
5	Revenue and capital items	It records both revenue and capital receipts & payments	It records only revenue items
6	Financial statements	It does not accompany the statement of financial position	It accompanies the statement of financial position
7	Opening and closing balance	It represents opening & closing balance of cash in hand & at bank	It does not show the opening balance. The closing balance represents surplus or deficit.
8	Adjustments	It does not include any adjustments.	Adjustments for outstanding, prepaid & accrued items are accounted for here.

2.3 Statement of financial position

It is similar to the statement of financial position prepared by for-profit entities. It is prepared on the basis of the Receipts and Payments account and Income and Expenditure account, and is based on the same accounting principles which are applicable to a for-profit entity.

2.4 Preparation of Receipts and Payments Account

Like all other ledger accounts, Receipts and Payments account also has two sides, debit side and credit side. All receipts whether cash or cheque are recorded on the debit side of the account, i.e. receipts column whereas all payments are recorded on the credit side of the account, i.e. payments column. There are no separate columns for cash and bank transactions; in fact, both the transactions are merged to avoid contra entries of cash and bank transactions. It starts with the opening balance of cash and bank and ends with the closing balance of cash and bank.

A general format of a Receipts and Payments Account is as follows:

Receipts and Payments Account for the period ending on........................

Receipts	Tshs	Payments	Tshs
Balance b/f		Purchase of assets	
Cash		Printing and stationery	
Bank		Repairs and renewal	
Subscriptions:		Rent and taxes	
Previous year		Postage	
Current year		Investments	
Next year		Conveyance	
Entrance fees		Charity	
Donations for specific fund		Insurance premium	
General donations		Honorarium	
Life membership fees		Upkeep of ground	
Government grants		Telephone charges	
Legacies		Newspapers and magazines	
Dividend		**Balance c/f**	
Interest		Cash	
Rent		Bank	
Sale of old magazines			
Sale of fixed assets			
Sundry receipts			
Balance c/f			
Bank overdraft			

Example

From the following information, prepare Receipts and Payments Account of Mbawala Sports Club for the year ended 31 December 20X3.

	Tshs'000
Cash as on 31 March 20X3	1,200
Subscriptions received	2,500
Upkeep of fields	100
Admission fees	200
Salaries	750
Life membership subscriptions	300
Purchase of newspapers and magazines	180
Donations received	600
Subscriptions received for sports events	2,800
Charity given	270
Sale of old newspapers	40
Sale of old sports material	70
8% Investments	700
Expenses on events	1,300
Sale of old furniture	70
Purchase of sports material	1,250
Interest on 8% investments	36
Printing and stationery	100
Furniture	350
Receipts from charity show	1,600

Answer

Receipts and Payments Account of Mbawala Sports Club for the year ending on 31 December 20X3

Receipts	Tshs'000	Payments	Tshs'000
Cash	1,200	Upkeep of fields	100
Subscriptions received	2,500	Salaries	750
Admission fees	200	Purchase of newspapers and magazines	180
Life membership subscriptions	300	Charity given	270
Donations received	600	8% investments	700
Subscriptions received for sports events	2,800	Expenses on events	1,300
Sale of old newspapers	40	Purchase of sports material	1,250
Sale of old sports material	70	Printing and stationery	100
Sale of old furniture	70	Furniture	350
Interest on 8% investments	36		
Receipts from charity show	1,600	Balance c/f	4,416
	9,416		**9,416**

Test Yourself 2

Which of the following statements is not a feature of a Receipts and Payments account?

A It is a summary of all cash transactions made by the entity during the accounting period.
B It is prepared on an accrual basis of accounting.
C It starts with the opening balance of cash and bank and ends with the closing balance of cash and bank.
D There is no distinction between capital and revenue receipts and payments while recording the transactions.

Test Yourself 3

From the following information available for Mwanza Club, prepare Receipts and Payments account for the year ending 31 December 20X3.

	Tshs'000		Tshs'000
Balance b/f		Stationery	380
Cash Bank	250	Purchase of sports material	2,100
Subscriptions	1,650	Rent	950
Entrance fees	4,680	Purchase of investments	1,350
Admission fees	1,100	Newspaper	600
Donations	1,450	Postage	100
Salaries	1,820	Electricity charges	560
Sale of old newspapers	1,200	Travelling expenses	810
Insurance premium	200	Balance c/f	
Lockers rent	350	Cash	165
Purchase of furniture	640	Bank	1,675
	1,550		

3. Prepare financial statements for not-for-profit entities.

[Learning Outcome d]

3.1 Treatment of specific items in the financial statements of a not-for-profit entity

In the previous Learning Outcome, we saw how to prepare a Receipts and Payments account. Now we will discuss how to prepare Income and Expenditure account and statement of financial position in this section. But before that, we need to discuss the meaning and accounting treatment of some of the specific items of income for not-for-profit entities, which are as follows:

1. Subscription

It is a regular payment received by the not-for-profit organisation from all members each year. It is the main source of income and is of a recurring nature, hence treated as revenue receipts. It is shown on the debit side of the Receipts and Payments account and on the credit side of Income and Expenditure account. However, the figure taken for subscriptions is not the same in both the accounts. The Receipt and Payment Account records the subscription amount on the actual receipt basis whereas the Income and Expenditure account records it on an accrual basis.

The subscription which is outstanding at the end of the year is shown on the assets side of the statement of financial position and the subscription which is received in advance at the end of the year is shown on the liabilities side of the statement of financial position.

The subscription amount to be considered in Income and Expenditure account is calculated as follows:

	Tshs
Subscriptions received during the year (from receipts and payments account)	X
Add: Subscriptions outstanding of the current year	X
Less: Subscriptions received in advance during the current year	(X)
Add: Subscriptions received in advance last year	X
Less: Subscriptions outstanding in the previous year and received this year	(X)
Subscription amount to be shown in Income and Expenditure account	XX

Example

Calculate the amount of subscription to be shown in Income and Expenditure account of Musoma Club for the year ending 31 December 20X3 from the following information:

	Tshs
Subscriptions received during the year	500,000
Subscriptions outstanding as on 31 December 20X2	40,000
Subscriptions outstanding as on 31 December 20X3	50,000
Subscriptions received in advance as on 31 December 20X2	30,000
Subscriptions received in advance as on 31 December 20X3	20,000

Continued on the next page

Answer

	Tshs	Tshs
Subscriptions received during the year		500,000
Add: Subscriptions outstanding as on 31 December 20X3	50,000	
Subscriptions received in advance as on 31 December 20X2	30,000	80,000
		580,000
Less: Subscriptions received in advance as on 31 December 20X3	20,000	
Subscriptions outstanding in 20X2 and received in 20X3	40,000	(60,000)
Subscription amount to be shown in Income and Expenditure account		**520,000**

2. Donation

It is the amount received by a not-for-profit organisation from any other entity by way of a gift. The entity making the donation may be an individual, a firm or a company and the gift may be in cash or kind. Donations can be of two types:

Specific donations: donations received for any specific purpose such as construction of building. These are generally treated as revenue receipts and are credited to the Income and Expenditure account.
General donations: donations which are received without any specific purpose. These are treated as capital receipts and are shown on the liabilities side of the statement of financial position.

3. Legacy

It is an amount received by a not-for-profit organisation in accordance with the will of a deceased person. It is treated as a capital receipt and is shown on the assets side of the statement of financial position.

4. Entrance fees

It is the amount collected from new members of the organisation at the time of admission. It is treated as capital or revenue item according to the specific instructions given in the question.

5. Life membership fees

It is the fee charged by a not-for-profit organisation for granting membership to a person, which is valid for life. It is treated as capital receipts and is therefore shown on the liabilities side of the statement of financial position.

6. Endowment fund

It is a capital receipt that provides for the permanent means of income for a not-for-profit organisation. It is shown on the liabilities side of the statement of financial position.

7. Sale of old newspapers and magazines / sports material

It is a revenue receipt and is shown on the credit side of the Income and Expenditure account.

3.2 Treatment of expenses in a not-for-profit organisation

The guiding principle to decide on the treatment of expenses in a not-for-profit organisation is the same as that followed by a for-profit organisation. The expenses incurred for the current accounting period, whether paid or not, should be considered in the Income and Expenditure account. Similarly, expenses related to the previous or future accounting period, though paid in the current year, should be excluded from the Income and Expenditure account and should be shown in the statement of financial position.

Example

From the information given below, ascertain the amount of salaries to be chargeable to Income and Expenditure account for the year ending on 31 December 20X3

	Tshs
Total salaries paid for the year (according to Receipts and Payments account)	375,200
Salaries paid in advance as on 31 December 20X2	19,500
Salaries paid in advance as on 31 December 20X3	8,700
Outstanding salaries as on 31 December 20X2	11,300
Outstanding salaries as on 31 December 20X3	10,500

Answer

	Tshs	Tshs
Salaries paid during the year		375,200
Add: Salaries outstanding as on 31 December 20X3	10,500	
Salaries paid in advance as on 31 December 20X2	19,500	30,000
		405,200
Less: Salaries paid in advance as on 31 December 20X3	8,700	
Salaries outstanding as on 31 December 20X2	11,300	(20,000)
Salaries to be debited in Income and Expenditure account		**385,200**

3.3 Calculation of cost of supplies and materials consumed

Consumable supplies and materials for not-for-profit organisations include items such as sports material, medicines, stationery, postage and other office supplies. These items are usually purchased in large quantities during the year and are not fully consumed by the end of the accounting period.

The amount to be charged to the Income and Expenditure account for such consumables is calculated as follows:

	Tshs
Opening stock of supplies	
Add: Purchases made during the year	
Less: Closing stock of supplies	
Amount to be charged to Income and Expenditure account	

Example

Calculate the cost of sports material to be charged to Income and Expenditure account of Bukoba Sports Club for the year ended 31 March 20X3 on the basis of the following information:

	Year ended 31 March 20X2 Tshs'000	Year ended 31 March 20X3 Tshs'000
Stock of sports material	7,500	6,400
Creditors for sports material	2,000	2,600

The amount paid to the creditors for sports material during the year was Tshs19 million.

Continued on the next page

Answer

To determine the cost of sports material consumed during the year, we will have to first calculate the purchase of sports material made during the year which can be done by preparing the creditors account.

Creditors account

Dr **Cr**

	Tshs'000		**Tshs'000**
Payments	19,000	Balance b/f	2,000
Balance c/f	2,600	Purchases (Balancing figure)	19,600
	21,600		**21,600**

Calculation of cost of sports material consumed during the year ended 31 March 20X3

	Tshs
Opening stock of supplies	7,500
Add: Purchases made during the year	19,600
	27,100
Less: Closing stock of supplies	(6,400)
Cost of sports material consumed	**20,700**

Example

From the following details of Kilimanjaro Charity Hospital, prepare Income and Expenditure account and the statement of financial position as on 31 March 20X3.

Receipts	Tshs'000	Payments	Tshs'000
Balance b/f		Medicines	30,590
Cash	7,130	Doctor's honorarium	9,000
Subscriptions	47,996	Salaries	27,500
Donations	14,500	Petty expenses	461
Interest on bank fixed deposit	7,000	Equipments	15,000
Charity show proceeds	10,450	Charity show expenses	750
		Balance b/f	
		Cash	3,775
	87,076		**87,076**

Additional information	**As on 31 March 20X2 Tshs'000**	**As on 31 March 20X3 Tshs'000**
Subscription due	240	280
Subscription received in advance	64	100
Stock of medicines	8,810	9,740
Equipment (cost less depreciation)	21,200	31,600
Building (cost less depreciation)	40,000	38,000

Interest on bank deposit was received for the full year at the rate of 7%.

Answer

Tip

Honorarium is an amount paid by a not-for-profit organisation to a person for providing his services in the management of the organisation. These services are provided by such person as a volunteer and not in the capacity of an employee. For example, the cost paid to a coach for providing services to a sports club will be considered an honorarium. These expenses are revenue in nature and are hence debited to Income and Expenditure account.

Continued on the next page

Holy Charity Hospital- Income and Expenditure account for the year ended 31 March 20X3

Dr				Cr
		Tshs'000		Tshs'000
Medicines consumed			Subscriptions (W1)	48,000
Opening stock **Add:**	8,810		Donations	14,500
Purchases **Less:**	30,590		Interest on fixed deposit	7,000
Closing stock	(9,740)	29,660	Charity show proceeds	10,450
Doctor's honorarium		9,000		
Salaries		27,500		
Petty expenses		461		
Charity show expenses		750		
Depreciation on equipment (W3)		4,600		
Depreciation on building (W2)		2,000		
Surplus		5,979		
		79,950		**79,950**

Holy Charity Hospital - Statement of financial position as on 31 March 20X3

	Tshs'000
Non-current assets	
Building	38,000
Equipments	31,600
Investments	
Bank fixed deposit	100,000
Current assets Stock of	
medicines Subscription	9,740
outstanding Cash	280
Total assets	3,775
Current liabilities	**183,395**
Subscriptions received in advance	
Reserves	100
Capital fund	
Surplus	177,316
Total liabilities	5,979
	183,395

Workings

W1 Subscriptions

	Tshs'000
Subscriptions received during the year (from Receipts and Payments account)	47,996
Add: Subscriptions outstanding as on 31 March 20X3	280
Less: Subscriptions received in advance during 20X2-20X3	(100)
Add: Subscriptions received in advance last year (20X1-20X2)	64
Less: Subscriptions outstanding as on 31 March 20X2	(240)
Subscription amount to be shown in Income and Expenditure account	**48,000**

W2 Depreciation on building

	Tshs'000
Cost of building less depreciation as on 31 March 20X3	38,000
Less: Cost of building less depreciation as on 31 March 20X2	(40,000)
Depreciation to be charged to Income and Expenditure account	**(2,000)**

W3 Depreciation on equipment

	Tshs'000
Cost of equipment less depreciation as on 31 March 20X3	31,600
Less: Purchases	(15,000)
Less: Cost of building less depreciation as on 31 March 20X2	(21,200)
Depreciation to be charged to Income and Expenditure account	**(4,600)**

Continued on the next page

W4 Opening capital fund

Statement of financial position as on 31 March 20X2

	Tshs'000
Non-current assets	
Building	40,000
Equipments	21,200
Investments	
Bank fixed deposit (Tshs7million x 100/7)	100,000
Current assets Stock of	
medicines Subscription	8,810
outstanding Cash	240
Total assets	7,130
Current liabilities	**177,380**
Subscriptions received in advance	
Reserves	64
Capital fund (Balancing figure)	
Total liabilities	177,316
	177,380

Test Yourself 4

From the following information, calculate the stationery consumed that is to be shown in the Income and Expenditure account of a Sports Club for the year ended 31 March 20X3:

	Tshs'000
Stock of stationery as on 31 March 20X2	50,000
Stock of stationery as on 31 March 20X3	40,000
Payments during the year	200,000
Creditors for stationery as on 31 March 20X2	20,000
Creditors for stationery as on 31 March 20X3	10,000

Test Yourself 5

The following are the details of receipt and payments of Mamboleo Club for the year ended 31 December 20X3.

Receipts and Payments account for the year ended 31 December 20X3

Receipts		**Tshs'000**	**Payments**	**Tshs'000**
Cash balance b/f		4,500	Salaries (11 months)	1,100
Subscriptions:			Tournament expenses	1,600
20X2	100,000		Investments	1,000
20X3	2,400,000		Furniture	400
20X4	200,000	2,700	Stationery	1,200
Sale of old furniture (Original cost Tshs200,000)		140	Sports expenses	15,000
Tournament receipts		2,000	Newspapers and magazines	200
Sports fund		10,000	Rent paid up to February 20X4	1,400
Donations for sports		3,000	Cash in hand	440
		22,340		**22,340**

Continued on the next page

Other information

(1) The club has 300 members each paying an annual subscription of Tshs10,000. Tshs70,000 is still outstanding for the year 20X2. In 20X2, 10 members had paid their subscription for 20X3 in advance.

(2) Stock of stationery as on 31 December 20X2 was Tshs100,000 and as on 31 December 20X3 was Tshs140,000.

(3) On 1 January 20X3, the club owned Land & Building valued at Tshs20 million and furniture worth Tshs1.3 million. Interest accrued on investment at the rate of 6% per annum for 3 months.

Required:

Prepare Income and Expenditure account and Statement of financial position of Leo Club for the year ended 31 December 20X3

Answer to Test Yourself

Answer to TY 1

The correct option is **D.**

Public sector organisations are organisations that are owned by society. They are set up and run by governments for the purpose of providing goods or services to the people of a society.

Answer to TY 2

The correct option is **B**.

Receipts and Payments account is prepared on the cash basis of accounting and not on accrual basis of accounting.

Answer to TY 3

Receipts and Payments account for the year ending 31 December 20X3

Receipts	Tshs'000	Payments	Tshs'000
Balance b/f		Salaries	1,200
Cash Bank	250	Insurance premium	350
Subscriptions	1,650	Purchase of furniture	1,550
Entrance fees	4,680	Stationery	380
Admission fees	1,100	Purchase of sports material	2,100
Donations	1,450	Rent	950
Sale of old newspapers	1,820	Purchase of investments	1,350
Lockers rent	200	Newspaper	600
	640	Postage	100
		Electricity charges	560
		Travelling expenses	810
		Balance c/f	
		Cash	165
		Bank	1,675
	11,790		**11,790**

Answer to TY 4

Creditors account

Dr **Cr**

	Tshs'000		Tshs'000
Payments	200,000	Balance b/f	20,000
Balance c/f	10,000	Purchases made during the year (Balancing figure)	190,000
	210,000		**210,000**

Calculation of cost of stationery consumed during the year ended 31 March 20X3

	Tshs'000
Opening stock of stationery as on 1 April 20X2	50,000
Add: Purchases	190,000
	240,000
Less: Closing stock of stationery as on 31 March 20X3	(40,000)
Cost of stationery consumed to be charged to Income and Expenditure account	**200,000**

Answer to TY 5

Income and Expenditure account of Mamboleo Club for the year ended 31 December 20X3

	Tshs'000		Tshs'000
Salaries (W3)	1,200	Subscriptions (W1)	3,000
Tournament expenses	1,600	Tournament receipts	2,000
Sports expenses	15,000	Interest on investments (W5)	15
Newspapers and magazines	200	Donation for sports	3,000
Rent (W4)	1,200	Sports fund	10,000
Stationery consumed (W6)	1,160	Deficit	2,405
Loss on sale of furniture (Tshs200,000 - Tshs140,000)	60		
	20,420		**20,420**

Statement of financial position as on 31 December 20X3

	Tshs'000
Non-current assets	
Land and building	20,000
Furniture (W8)	1,500
Investments	1,000
Current assets	
Stock of stationery	140
Subscription outstanding	570
Prepaid rent	200
Accrued interest on investments	15
Cash	440
Total assets	**23,865**
Current liabilities	
Subscriptions received in advance	200
Outstanding salaries	100
Reserves	
Capital fund less deficit (Tshs25,970,000 - Tshs2,405,000) (W7)	23,565
Total liabilities	**23,865**

Workings

W1 Subscriptions amount to be credited to Income and Expenditure account

	Tshs'000	Tshs'000
Subscriptions received during the year		2,700
Add: Subscriptions outstanding as on 31 December 20X3 (W2)	500	
Subscriptions received in advance as on 31 December 20X2 (10 x Tshs10,000)	100	600
		3,300
Less: Subscriptions received in advance as on 31 December 20X3	200	
Subscriptions outstanding in 20X2 and received in 20X3	100	(300)
Subscription amount to be shown in Income and Expenditure account		**3,000**

W2 Subscription outstanding as on 31 December 20X3

	Tshs'000
Total subscription expected during the year 20X3 (300 members xTshs10,000)	3,000
Less: Subscription received in advance for 20X3 during the previous year (10 members x Tshs10,000)	(100)
Total subscription due from the members for the current year 20X3	**2,900**
Less: Subscription received during the year 20X3 (from Receipts and Payments account)	(2,400)
Subscription outstanding as on 31 December 20X3	**500**

W3 Salaries

Salaries paid by the club for 11 months is Tshs1,100,000 according to Receipts and Payments account. The figure in the Income and Expenditure account is considered on the basis of accrual principle. Therefore, the salaries to be debited to Income and Expenditure account for 12 months will be calculated as follows:
Tshs1,100,000 X 12 months/11 months = Tshs1,200,000

The salaries for one month which have not been paid are outstanding liabilities for the club and therefore will be shown on the liabilities side of the statement of financial position of the club.

W4 Rent

Rent is paid by the club up to February 20X4 during the current year 20X3, i.e. for 14 months.

According to the accrual principle, only the rent paid for the current year will be considered in Income and Expenditure account which will be calculated as follows:
Tshs1,400,000 X 12 months/14 months = Tshs1,200,000

The rent paid for January 20X4 and February 20X4 is a prepaid rent and hence the amount of Tshs 200,000 (Tshs1,400,000 - Tshs1,200,000) will be shown on the assets side of the statement of financial position.

W5 Interest on investments

Accrued interest on investments for 3 months at the rate of 6%:
Tshs1,000,000 x 6% x 3/12 = Tshs15,000

It will be credited to Income and Expenditure account and will be shown on the assets side of the balance sheet.

W6 Cost of stationery consumed

	Tshs'000
Opening stock of stationery	100
Add: Purchases	1,200
	1,300
Less: Closing stock of stationery	(140)
Cost of stationery consumed to be charged to Income and Expenditure account	**1,160**

W7 Opening capital fund

	Tshs'000
Non-current assets	
Land and building	20,000
Furniture	1,300
Current assets Stock of	
stationery Subscription	100
outstanding	170
Cash	4,500
Total assets	**26,070**
Current liabilities	
Subscriptions received in advance	100
Reserves	
Capital fund (Balancing figure)	25,970
Total liabilities	**26,070**

W8 Furniture

Furniture account

Dr **Cr**

	Tshs'000		**Tshs'000**
Balance b/f	1,300	Sale of furniture	200
Purchases	400	Balance c/f (Balancing figure)	1,500
	1,700		**1,700**

Self Examination Questions

Question 1

The aim of a not-for-profit organisation is:

A To provide or deliver a service
B To generate losses
C To generate large profits
D To manufacture goods

Question 2

From the following information, calculate the subscription amount to be credited to Income and Expenditure account of Victory Sports Club for the year ended 31 December 20X3:

	31 December 20X2 Tshs'000	**31 December 20X3 Tshs'000**
Outstanding subscription	9,500	10,000
Subscription received in advance	6,200	8,700
Subscription received during the year		250,000

Question 3

The subscription amount which is outstanding at the end of the year is:

A Credited to Income and Expenditure account
B Debited to Income and Expenditure account
C Shown on the assets side of the statement of financial position
D Shown on the liabilities side of the statement of financial position

Question 4

The following information is available in respect of stationery expenses by Star Sports Club for the year ended 31 March 20X3:

	Tshs'000
Stock of stationery as on 31 March 20X2	4,000
Creditors for stationery as on 31 March 20X2	3,000
Amount paid for stationery during the year	11,800
Stock of stationery as on 31 March 20X3	1,500
Creditors for stationery as on 31 March 20X3	2,700

What amount will be charged to Income and Expenditure account of Star Sports Club in respect of stationery expenses for the year ended 31 March 20X3?

A Tshs15.5 million
B Tshs11.5 million
C Tshs14 million
D Tshs11.8 million

Question 5

Prepare Receipts and Payments account of Ruvuma Sports Club for the year ending 31 December 20X3 from the information given below:

	Tshs'000
Cash as on 31 December 20X2	82,600
Fees received including Tshs8 million on account of previous year	38,000
Fees outstanding at the end of the year	1,000
Salaries paid including Tshs3 million on account of previous year	28,000
Salary outstanding at the end of the year	1,000
Entertainment expenses	3,000
Tournament expenses	12,000
Travelling expenses	18,000
Telephone expenses	6,000
Purchase of books and periodicals including Tshs19 million on account of purchase of books	29,000
Rent	10,000
Postage and stamps	3,000
Printing and Stationery	5,000
Donations received	20,000

Question 6

From the following information, prepare the Income and Expenditure account of a club for the year ended 31 December 20X3 and also calculate the capital fund of the club as on 31 December 20X2.

Receipts		Tshs'000	Payments	Tshs'000
Balance b/f		39,100	Electricity charges	2,000
Subscriptions			Salaries	6,000
20X1	2,400,000		Newspapers and magazines	4,100
20X2	53,000,000		Fixed deposit	40,000
20X3	1,000,000	56,400	Books	21,200
Sale of scrap		2,500	Rent	13,600
Government grants		20,000	Furniture	21,000
Sale of old furniture (Original cost Tshs8 million)		11,400	Balance c/f	22,400
Interest on fixed deposit		900		
		130,300		**130,300**

Additional information:

(a) The investment in fixed deposit was made on 1 July 20X3 at the rate of 9% per annum.

(b) Subscription outstanding as on 31 December 20X2 was Tshs4 million and as on 31 December 20X3 was Tshs5 million.

(c) Salary outstanding as on 31 December 20X3: Tshs1.2 million

(d) Rent outstanding as on 31 December 20X3: Tshs2.4 million

(e) The value of assets as on 1 January 20X3 in the books of the club were:

Furniture - Tshs30 million
Books - Tshs14 million

Question 7
The treasurer of Majaliwa singing and dancing group has prepared the following receipts and payment account for the year ended 31st December 2014

Receipts and payments account for the year ended 31st December 2014:

Receipts	TZS	Payments	TZS
Opening Balance	1,760,000	Purchase of amplifier [1st July 2014]	700,000
Subscriptions [see note (i)]:		Musicians' fees	900,000
Singing	2,410,000	Coaching fees	820,000
Dancing	1,690,000	Hall rent for the year to 30 June 2015	1,130,000
Annual dinner and graduation	340,000	Hall decorations	110,000
Sale of tents	670,000	Hall cleaning	160,000
Singing festival admissions	940,000	Annual dancing party	1,320,000
Singing festival sale of clothes	2,100,000	Annual dinner hotel and tickets	410,000
Singing festival sale of refreshments	8,300,000	Singing festival prizes	170,000
		Singing festival judges' fees	90,000
		Singing festival purchase of clothes	1,800,000
		Singing festival purchase of refreshments	7,000,000
		Closing balance	3,600,000
	18,210,000		18,210,000

Additional information:

(i) Subscriptions

	Singing [TZS]	Dancing [TZS]
Received in 2013 for 2014	130,000	60,000
Received in 2014 for 2013	10,000	140,000
Received in 2014 for 2014	2,300,000	1,520,000
Total Received in 2014	2,410,000	1,690,000

It is not the policy of the group to take into account subscriptions in arrears until they are paid.

(ii) The tents and their supporting poles which were sold during 2014 had been valued at TZS.800,000 on 31st December 2013 and were used for the group's activities until sold at 30th June 2014.

(iii) Immediately after the sale of the tents, the group rented a new hall at TZS.1,130,000 per annum.

(iv) The above receipts and payments account is a summary of the group's bank account for the year ended 31st December 2014; the opening and closing balances shown above were the balances shown in the bank statements on 31st December 2013 and 2014 respectively.

(v) All cash is banked immediately and all payments are made by cheques.

(vi) A cheque for TZS.200,000 drawn by the group on 28th December 2014 for stationery used during the year was not paid until 4th January 2015.

(vii) The group's assets and liabilities at 31st December 2013 and 31st December 2014, in addition to those mentioned earlier, were as follows:

	2013	2014
Stock of goods for resale:		
Clothes	1,300,000	1,100,000
Refreshments	310,000	600,000
Sundry creditors:		
Annual dinner – tickets	-	70,000
Purchases – clothes	600,000	400,000
Purchases – refreshments	300,000	500,000

The management has decided to charge depreciation on the amplifier at the rate of 20% per annum on cost, pro-rata to time.

REQUIRED:

(a) Prepare the group's statement income and expenditure for the year ended 31st December 2014.

(b) Prepare the group's statement of financial position as at 31st December 2014.

Question 8
The following particulars relates to Mtemi Ikulu:

Particulars	Amount TZS.	Particulars	Amount TZS.
Opening cash balance	1,000	Sales of old sports materials	1,200
Opening bank balance	7,200	Donation received for pavilion	4,600
		Rent paid	3,000
Subscriptions collected for:		Sports materials purchases	4,800
2013-14 500		Purchase of refreshments	600
2014-15 7,600	9,000	Expenses for maintenance of tennis court	2,000
2015-16 900			
Sales of refreshments	1,000		
		Salary paid	2,500
		Tournament expenses	2,400
Entrance fees received	1,000	Furniture purchased	1,500
		Office expenses	1,200
		Closing cash in hand	400

REQUIRED:
Prepare a Receipt & Payment account for the year ended 31st December 2015.

Question 9
The accounting records of the Nachingwea Sports and Social Club are in good order and you are able to find the following information to help in preparation of the accounts for the year to 30th June 2016:

SUMMARISED STATEMENT OF FINANCIAL POSITION AS AT 30TH JUNE 2015

	TZS.		TZS.
Half share in motorized roller	600,000	Insurance (3 months)	150,000
New sports equipment at valuation	1,000,000	Subscriptions 2016	120,000
Used sports equipment at valuation	700,000	Life subscriptions	1,400,000
Rent (2 months)	200,000		1,670,000
Subscription 2015	60,000		
Café stocks	800,000	Accumulated fund	2,900,000
Cash and Bank	1,210,000		
	4,570,000		4,570,000

Receipts during the year to 30th June 2016	**TZS.**
Subscription - 2014/2015	40,000
- 2015/2016	1,100,000
- 2016/2017	80,000
- Life	200,000
From sales of new sports equipment	900,000
From sales of used sports equipment	14,000
Café takings	4,660,000
	6,994,000

Payments during the year to 30th June 2016	**TZS.**
Rent (for 12 months)	1,200,000
Insurance (for 18 months)	900,000
Suppliers of sports equipment	1,000,000
Café suppliers	1,900,000
Wages of café manager	2,000,000
Total cost of repairing motorized roller	450,000
	7,450,000

Notes:

(i) Ownership and all expenses of the motorized roller are agreed to be shared equally with the Tandahimba Sports and Social Club which occupies a nearby site. The roller cost a total of TZS.2,000,000 on 1st July 2011 and had an estimate life of 10 years.

(ii) Life subscriptions are brought into income equally over 10 years. The scheme began in 2011/2012. Since the scheme began the cost of TZS.200,000 per person has been constant. Prior to 30th June 2015, 10 life subscriptions had been received.

(iii) Four more annual subscription of TZS.20,000 each had been promised relating to 2015/2016, but not yet received. Annual subscriptions promised but unpaid are carried forward for a maximum of 12 months.

(iv) New sports equipment is sold to members at cost plus 50%. Used equipment is sold off to members at book valuation. Half the sports equipment bought in the year (all from a cash and carry supplier) has been used within the club, and half made available for sale, to new members. The 'used equipment at valuation' figure in the 30th June 2016 statement of financial position is to remain at TZS.700,000.

(v) Closing café stocks are TZS.850,000 and TZS.80,000 is owed to suppliers at 30th June 2016.

REQUIRED:

a. Calculate profit on café operations and profit on sale of sports equipment.
b. Prepare statement of subscription income for 2015/2016.
c. Prepare statement of Income and Expenditure for the year to 30th June 2016.
d. Prepare Statement of Financial Position as at 30th June 2016.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **A.**

Not-for-profit organisations are started and run for the purpose of providing benefits on an individual level or to society as a whole.

Answer to SEQ 2

	Tshs	Tshs
Subscriptions received during the year		250,000
Add: Subscriptions outstanding as on 31 December 20X3	10,000	
Subscriptions received in advance as on 31 December 20X2	6,200	16,200
		266,200
Less: Subscriptions received in advance as on 31 December 20X3	8,700	
Subscriptions outstanding as on 31 December 20X2	9,500	(18,200)
Subscription amount to be shown in Income and Expenditure account		**248,000**

Answer to SEQ 3

The correct option is **C.**

Creditors for stationery account

Dr **Cr**

	Tshs'000		Tshs'000
Payments during the year	11,800	Balance b/f	3,000
Balance c/f	2,700	Purchases made during the year (Balancing figure)	11,500
	14,500		**14,500**

	Tshs'000
Opening stock of stationery as on 31 March 20X2	4,000
Add: Purchases made during the year	11,500
	15,500
Less: Closing stock of stationery as on 31 March 20X3	1,500
Stationery consumed during the year to be charged to Income and Expenditure account	**14,000**

Answer to SEQ 4

The correct option is **C**.

The subscription which is outstanding at the end of the year is shown on the assets side of the statement of financial position.

Answer to SEQ 5

Receipts and Payments account of Ruvuma Sports Club for the year ended 31 December 20X3

Receipts		Tshs'000	Payments		Tshs'000
Balance b/f		82,600	Salaries		
Subscriptions			20X2	3,000,000	
20X2	8,000,000		20X3	25,000,000	28,000
20X3	30,000,000	38,000	Entertainment expenses		3,000
Donations received		20,000	Tournament expenses		12,000
			Travelling expenses		18,000
			Telephone expenses		6,000
			Purchase of books		19,000
			Purchase of periodicals		10,000
			Rent		10,000
			Postage and stamps		3,000
			Printing and stationery		5,000
			Balance c/f		26,700
		140,700			**140,700**

Receipts and Payments account is prepared on a cash basis, hence all the receipts and payments made during the period are considered irrespective of their period (past, present or future) and nature (capital or revenue).

Answer to SEQ 6

Income and Expenditure account for the year ended 31 December 20X3

	Tshs'000		Tshs'000
Electricity charges	2,000	Subscriptions (W1)	58,000
Salaries (Tshs6 million + Tshs1.2 million)	7,200	Sale of scrap	2,500
Newspapers and magazines	4,100	Government grants	20,000
Interest on fixed deposit (W2)	1,800	Profit on sale of old furniture (Tshs11.4 million - Tshs8 million)	3,400
Rent (Tshs13.6 million + Tshs2.4 million)	16,000		
Surplus	52,800		
	83,900		**83,900**

Opening capital fund as on 31 December 20X2

	Tshs'000
Non-current assets	
Furniture	30,000
Books	14,000
Current assets	
Subscription outstanding	4,000
Cash	39,100
Total assets	**87,100**
Capital fund (Balancing figure)	87,100
Total liabilities	**87,100**

Workings

W1 Subscription

	Tshs'000	Tshs'000
Subscriptions received during the year		56,400
Add: Subscriptions outstanding as on 31 December 20X3	5,000	
Subscriptions received in advance as on 31 December 20X2	-	5,000
		61,400
Less: Subscriptions received in advance as on 31 December 20X3	1,000	
Subscriptions outstanding in 20X2 and received in 20X3	2,400	(3,400)
Subscription amount to be shown in Income and Expenditure account		**58,000**

W2 Interest on fixed deposit

Interest on fixed deposit for 6 months from 1 July 20X3 to 31 December 20X3

= Tshs40 million x 9% x 6/12

= Tshs1.8 million

Out of the total interest of Tshs1.8 million on fixed deposit, the amount of Tshs0.9 million has been received during the year (according to Receipts and Payments account). Hence, the balance of Tshs0.9 million is accrued interest, which will be shown on the assets side of the statement of financial position.

Answer to SEQ 7

(a) Income and Expenditure

Majaliwa Singing and Dancing Group

Income and Expenditure for the year ended 31st December 2014

Expenditure		Income	
Annual dinner hotel and tickets	480,000	Subscriptions:	
Singing festival prizes	170,000	Singing	2,430,000
Singing festival Judges fees	90,000	Dancing	1,580,000
Musicians' fees	900,000	Annual Dinner and Graduation	340,000
Coaching fees	820,000	Singing festival – admissions	940,000
Hall rent	565,000	Profit from sale of clothes	300,000
Hall decorations	110,000	Profit from sale of refreshments	1,390,000
Hall cleaning	160,000		
Annual dancing party	1,320,000		
Loss from sale of tents	130,000		
Stationeries	200,000		
Depreciation: Amplifier	70,000		
Surplus	1,965,000		
	6,980,000		6,980,000

Statement of financial position

Majaliwa Singing and Dancing Group
Statement of financial position as at 31st December 2014

Assets	
Non-current Assets	
Amplifier: Cost	700,000
Less: Accumulated depreciation	(70,000)
Total Non-Current Asset	**630,000**
Current Assets	
Prepayment – hall rent	565,000
Stock of clothes	1,100,000
Stock of refreshments	600,000
Bank balance	3,400,000
Total Current Assets	5,665,000
Total Assets	**6,295,000**
Accumulated fund and liabilities	
Accumulated fund at 1/1/2014	3,230,000
Surplus	1,965,000
Accumulated fund at 31/12/2014	5,195,000
Current Liabilities	
Creditors: Clothes	400,000
Creditors: Refreshments	500,000
Subscription in advance	130,000
Accrual for tickets	70,000
	1,100,000
Total Accumulated fund and liabilities	**6,295,000**

Workings:
(1) Statement of affairs 1/1/2014

Tents and poles	800,000
Subscription in arrears	150,000
Stock of clothes	1,300,000
Stock of refreshments	310,000
Bank balance	1,760,000
	4,320,000 =======
Liabilities	
Subscription in advance	190,000
Creditors: Clothes	600,000
Creditors: Refreshments	300,000
	1,090,000
Accumulated fund	3,230,000

Subscription

Subscription	**Singing**	**Dancing**
In advance from 2013	130,000	60,000
In arrears for 2013	10,000	140,000
Received in 2014	2,410,000	1,690,000
In advance for 2015: **Singing [Tshs'000**(2,410-10-2,300)]	100,000	
Dancing [Tshs'000(1,690-140-1,520)]		30,000
Income for the year	2,430,000	1,580,000

Alternative
Subscription account (Singing)

Balance b/d	10,000	Balance b/d	130,000
Income & Expenditure:		Receipt & Payment:	2,410,000
(Balancing figure) =	2,430,000		
Balance c/d(2,410-10-2,300)	100,000		
	2,540,000		2,540,000

Subscription account (Dancing TZS)

Balance b/d	140,000	Balance b/d	60,000
Income & Expenditure:		Receipt & Payment:	1,690,000
(Balancing figure) =	1,580,000		
Balance c/d(1,690-140-1,520)	30,000		
	1,750,000		1,750,000

Purchase of clothes

Creditors 31st December	400,000
Payment during the year	1,800,000
Creditors 1st January	(600,000)
Purchase during the year	1,600,000

Purchase of refreshments

Creditors 31st December	500,000
Payment during the year	7,000,000
Creditors 1st January	(300,000)
Purchase during the year	7,200,000

Statement of profit or loss of clothes

Revenue		2,100,000
Cost of sales		
Opening stock	1,300,000	
Purchase	1,600,000	
Closing stock	(1,100,000)	1,800,000
Profit from sale of clothes		300,000

Statement of profit or loss of refreshments

Revenue		8,300,000
Cost of sales		
Opening stock	310,000	
Purchase	7,200,000	
Closing stock	(600,000)	6,910,000
Profit from sale of refreshments		1,390,000

Answer to SEQ 8

Books of Mtemi Ikulu Receipt and Payment Account
for the year ending March 31st, 2015

Dr. Cr.

Receipts	Amount '000' Tshs.	Payments	Amount '000' Tshs.
Balance b/d		Rent	3,000
Cash	1,000	Sports materials purchased	4,800
Bank	7,200	Purchase of refreshments	600
Subscriptions		Maintenance expenses for Tennis court	2,000
2013-14 500			
2014-15 7,600		Salary	2,500
2015-16 900	9,000	Tournament expenses	2,400
Sale of refreshments	1,000	Furniture purchased	1,500
Entrance fees	1,000	Office expenses	1,200
Sale of old sports materials	1,200	Balance c/d	
Donation for pavilion	4,600	Cash	400
		Bank (balancing figure)	6,600
	25,000		25,000

Answer to SEQ 9

(a) Profit Café operation

	TZS	TZS
Sales		4,660,000
Stocks as at 2/7/2015	800,000	
Purchases	1,980,000	
	2,780,000	
Stock at 30/6/2016	(850,000)	
		1,930,000
Gross Profit		2,730,000
wages		2,000,000
Net Profit		730,000 =======

Profit on Sales of Sports Equipment

	TZS	TZS
Sales		900,000
Opening Stocks	1,000,000	
Purchases	500,000	
	1,500,000	
Closing Stock (balancing figure)	(900,000)	
Cost of Sales (900,000 x 100/150)		600,000
Profit		300,000 =======

(b) **Subscription income for 2015/2016**

	TZS
Annual subscriptions (W1)	1,300,000
Life subscriptions (W2)	220,000
	1,520,000
	=======

Workings:

1	**Annual subscription**	**TZS**
	b/f 30/6/2016 (in advance)	120,000
	Received in year	1,100,000
	Owed for 2015/2016 at 30/6/2016 (4 x 20,000)	80,000
		1,300,000

2	**Life subscription**	**TZS**
	Life member subscriptions at 30/6/2015	1,400,000
	New subscriptions in year to 30/6/2016	200,000
		1,600,000
	Less: 11 x TZS.20,000 allocated to current year	220,000
	Life subscriptions c/f at 30/6/2016	1,380,000 =======

(c) **NACHINGWEA SPORTS AND SOCIAL CLUB INCOME AND EXPENDITURE STATEMENT FOR THE YEAR TO 30TH JUNE 2016**

	TZS	TZS
Income		
Subscriptions		1,520,000
Café operations		730,000
Sale of sports equipment		300,000
		2,550,000
Expenses		
Rent	1,200,000	
2014/2015 subscription written off	20,000	
Insurance 900,000 x 12/18	600,000	
Roller repairs (1/2 x 450,000	225,000	
Write down of used sports equipment (W3)	486,000	
Depreciation of roller	100,000	
		2,631,000
Excess of expenditure over income		81,000
Accumulated fund brought forward at 1st July 2015		2,900,000
Accumulated fund carried forward at 30th June 2016		2,819,000 ======

W3 – Write-down calculation

	TZS
Total purchases of sports equipment	1,000,000
Used in club (1/2 x 1,000,000)	(500,000)
Used equipment sold	(14,000)
Additions to be written down	486,000✓ ======

(d)

STATEMENT OF FINANCIAL POSITION AS AT 30TH JUNE 2016		
	TZS	**TZS**
Non-current assets		
Half share in motorized roller	500,000	
New sports equipment unsold	900,000	
Used sports equipment at valuation	700,000	
		2,100,000
Current assets		
Rent pre-paid (2 months)	200,000	
Insurance pre-paid (900,000 – 150,000 – 600,000)	150,000	
Tandahimba's half repairs of roller	225,000	
Subscription in arrears (4 x TZS.20,000_	80,000	
Café stocks	850,000	
Cash (1,210,000 + 6,994,000 – 7,450,000)	754,000	
		2,259,000
Current liabilities		
Subscriptions in advance	80,000	
Life subscriptions (W2)	1,380,000	
Café supplies	80,000	
		(1,540,000)
		2,819,000 **========**
Net assets		
Financed by:		
Accumulated fund brought forward	2,900,000	
Loss for year	(81,000)	
Accumulated fund carried forward		**2,819,000** **=======**

SECTION I

PREPARATION OF MANUFACTURING ACCOUNTS

13

PREPARATION OF MANUFACTURING ACCOUNTS

Get Through Intro

You have already studied the preparation of major financial statements, e.g. statement of profit or loss and statement of financial position, earlier in Section I. However, in the case of a manufacturing entity, a statement referred to as the manufacturing account needs to be prepared in addition. The purpose of a manufacturing account is to present a picture of the contents of the manufacturing activity of the entity.

If you are working with a manufacturing entity in the future and you need to determine the cost of goods sold for this entity, you need to know the difference between production and non-production costs.

This Study Guide helps you to understand the basic concepts relating to manufacturing accounts and how various costs are classified into production and non-production activities.

Learning Outcomes

a) Define, explain and calculate:
   i. Direct cost
   ii. Indirect cost
   iii. Prime cost
   iv. Production cost
   v. Total cost
   vi. Inventory (Finished goods and work in progress).

b) Explain and prepare for a manufacturing entity:
   i. Manufacturing account
   ii. Statement of income and expenditure
   iii. Statement of financial position

1. Define, explain and calculate:
  i. Direct cost
  ii. Indirect cost
  iii. Prime cost
  iv. Production cost
  v. Total cost
  vi. Inventory (Finished goods and work in progress)

[Learning Outcome a]

Important terminologies

Definition

(a) Direct cost: costs which can be traceable to units of production, like direct materials, direct labour and direct expenses.

(b) Indirect costs: cost which cannot be easily or perfectly traceable to each unit of production, like overheads (production, administration and selling and distribution).

(c) Prime cost: also referred to as 'direct costs', these are directly related to the product and vary directly with output.

For example, if an automobile manufacturer doubles the output of cars, more material and wages will be required to generate the output.

(d) Production costs: production cost is the total of prime costs and factory overheads.

(e) Total cost: total costs refers to the total of production costs and non-production costs

(f) Inventories: inventories are assets:

Inventories are explained in detail in Study Guide E1

held for sale in the ordinary course of business (finished products);
in the process of production for such sale (work in progress); or
in the form of materials or supplies to be consumed in the production process or in the rendering of services (raw materials).

There are three broad elements of cost:

Material
Labour
Expenses

These three broad elements can be further classified into:

Production and non-production costs
Direct costs and indirect costs

1.1 Production and non-production costs

The purpose of preparing a manufacturing account is to determine the production costs. A manufacturing account is divided into two sections:

The Prime Cost Section and
The Factory Overheads Section

Production costs form part of the manufacturing accounts, whereas the non-production costs are included in the statement of income.

(a) Production costs

Materials
Labour
Overheads

(b) Non-production costs

Administration costs
Selling and distribution costs
Finance costs

Let us understand the above costs in detail.

1. Production costs

The total of direct costs and indirect costs incurred for manufacturing goods to get them ready for sale is production cost.

Example

Johnson Plc manufactures soft toys. The following is the related cost.

Direct materials	Tshs2,000,000
Indirect materials	Tshs1,200,000
Direct labour	Tshs1,600,000
Indirect labour	Tshs1,000,000
Production overheads	Tshs600,000
Advertisement expenses	Tshs500,000

Production costs will be
Tshs2,000,000 + Tshs1,200,000 + Tshs1,600,000 + Tshs1,000,000 + Tshs600,000 = Tshs6,400,000

Note: advertisement expenses are not directly related to the production of soft toys, hence they will not be considered in the production costs.

Definition

Costs incurred in relation to the operation of a manufacturing process are **production costs**.

The production process generally involves processing raw materials into the final product. All the costs incurred in a factory, directly or indirectly, until the stage when the goods can be marketed as final products are considered production or manufacturing costs.

Example

In the production of glassware (glasses, glass plates etc.), the costs incurred for the glass, wages paid to labour and the cost of fuel used in making the glassware will all qualify as production costs.

Packing costs, where the products require primary packaging in order to sell the goods, are a part of production costs. In these cases, the product is incomplete unless it is packed, e.g. milk packed in bottles / cartons or hair shampoo bottled in plastic containers.

Production costs are sub-classified as:

(a) Direct material
(b) Direct labour
(c) Production overheads

Materials, labour and overheads are discussed in detail below in this Learning Outcome

Production or manufacturing costs incurred in the manufacture of a product are also termed product costs. Manufacturing costs are also known as inventorial costs. This is because until the time the product is actually sold on the market, these costs are recorded in the finished goods inventory account. This account eventually forms a part of current assets in the statement of financial position.

2. Non-production costs

Definition

All the costs incurred from the conceptualisation to the sale of a product other than those attributable to production activity, inclusive of administration costs, selling costs, distribution costs, finance costs and research and development costs, are the **non-production costs**.

Example

Salaries paid to office staff of the finance department are non-production costs. These are not spent on actual production, but are essential for the running of the organisation.

Non-production or non-manufacturing costs are also known as period costs. These are costs incurred in relation to a period and not in relation to a product.

(a) Administration costs

Definition

Any cost incurred for the management or administration of the business that includes planning and controlling its operations, is an **administrative cost**.

Normally, administration costs are fixed in nature. They do not change due to variations in output / input.

Example

- Office rent
- Salary of office staff – cleaners, clerks
- Electricity and telephone costs of the office
- Legal fees, audit fees, insurance expense of office

Administrative costs of an organisation include the costs incurred in formulating policy, directing the organisation and controlling its activities. In a big organisation, administrative costs are split into two types:

- Costs incurred at the factory level to provide the staff with administrative support
- Costs incurred at head office level that are allocated to the factory

(b) Selling and distribution costs

To sell the produced goods, the company has to bear some costs relating to sales. They are termed sales and distribution costs. These are the costs incurred both to get the finished items to the point where customers can buy them and to actually persuade the customers to buy them.

(i) Selling costs

Definition

Costs incurred in relation to the sale of a product or rendering of a service and allied activities are known as **selling costs**.

A product needs to be marketed and advertised so that the customers are aware of it, thereby creating a demand for the product in the market. Selling costs are incurred by all kinds of organisations, whether manufacturing or trading, as both of these have to sell products in the market. Selling costs include all costs that help the sale of the product in the marketplace.

Example

Sales promotion expenses, showroom expenses
Advertising costs such as catalogues, banners, brochures
Salaries of sales and marketing personnel, commission paid to salesmen

(ii) Distribution costs

Definition

Costs incurred for the transport of goods from the factory or depot to the customer and / or the costs incurred for maintaining the channel of distribution are known as **distribution costs**.

This cost also covers the cost of recovering and reconditioning empty containers for reuse.

Once the goods are ready for sale, they need to be transported to the place of sale. The costs incurred in the transportation of the finished goods to the customers' place are known as distribution costs. While maintaining distribution channels, an organisation needs to incur costs in the form of allowing discounts to **stock**ists, distributors and retailers, etc.

Example

The transportation cost of goods between two points, namely the receipt point of goods from production and the delivery point to the customer
The insurance cost of the goods between this period
Depreciation on vehicles used for the distribution of goods
Fuel used by vehicles in the distribution department
Repairs and maintenance cost of the above vehicles
Any cost incurred for the secondary packing

(c) Finance costs

Definition

Costs incurred in relation to the provision of finance to the business, mainly interest costs, are known as **finance costs**.

To incur all the previously discussed costs, the business needs a constant flow of money. This includes initial start-up costs – capital investment, working capital and costs required for the day-to-day running of the business, expansion costs – capital investment required for the expansion of the existing activities.

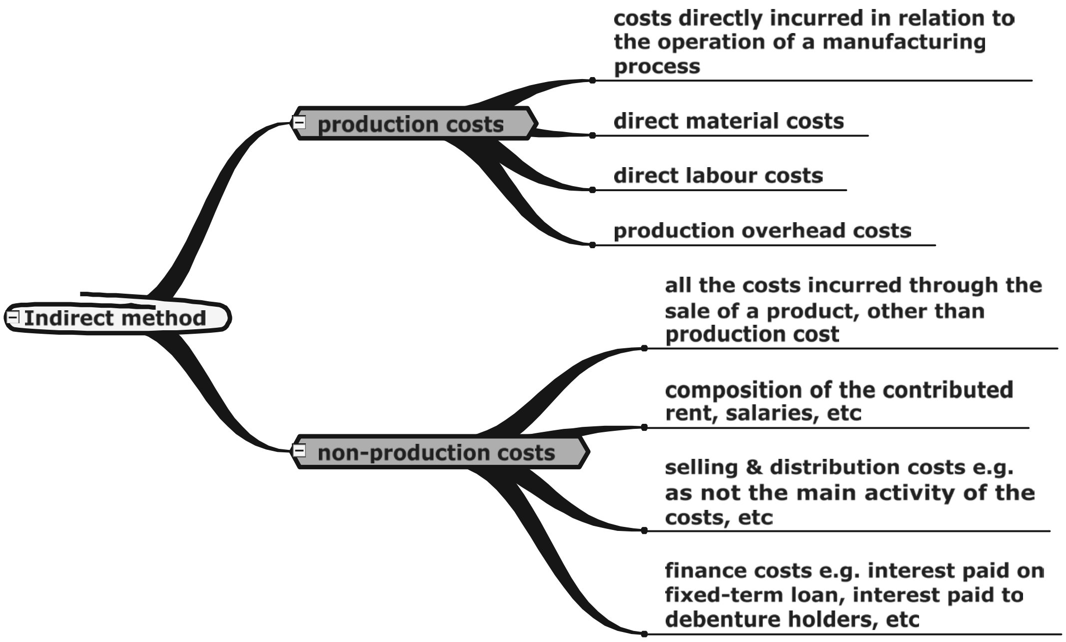
These costs are funded by obtaining a loan from the bank or raising capital from the market by issue of shares and debentures. Finance costs are incurred to meet the working capital as well as long term finance needs of the organisation. This cost cannot be traced to the individual products, but will have to be allocated using a suitable base.

Example

Interest paid on a fixed-term loan taken for the construction of a building
Interest paid on a fixed-term loan taken for the purchase of plant and machinery
Interest paid to debenture holders

The various types of costs make up the total cost of a product.

SUMMARY



1.2 Direct and indirect costs

The distinction of costs into direct and indirect is necessary because they need different treatments for cost computation and control. All direct costs are part of prime costs, whereas indirect costs are split into production and non-production costs.

1. Classification of costs as direct or indirect

The functional classification of costs into production and non-production costs was seen in the earlier discussion of this Learning Outcome. The same category of costs can be differently classified into direct and indirect costs.

This classification is based on the principle of traceability of costs into the final product or service. Let us revise these definitions of direct and indirect costs again.

Definition

Cost that can be specifically identified or traced in full, to the product or service in an economically feasible manner is a **direct cost.**

Definition

A cost that cannot be specifically **identified** with a product or a service is an **indirect cost.**

Example

Potatoes and salt are the direct ingredients in the preparation of potato chips. Costs incurred on these will be direct costs.

Apart from being easily traceable to the products, the traceability of costs should also be economically feasible for the costs to be classified as direct. If the traceability is not cost beneficial, a cost that is direct by nature will be classified as indirect.

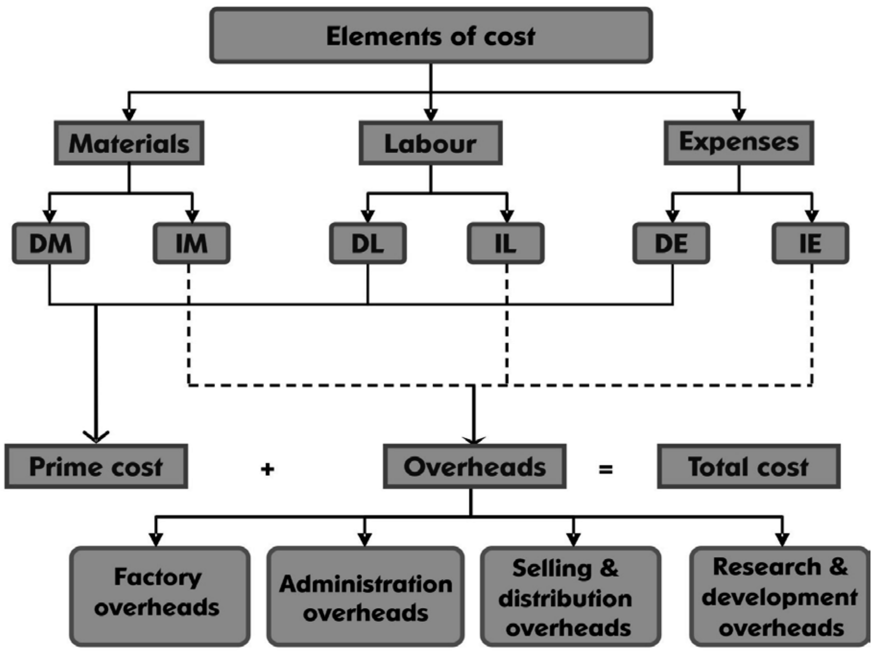
Example

In the above example of potato chips, it is a difficult and a costly affair to trace the amount of oil consumed by each pack of chips and so it will be treated as an indirect cost. Oil is easily traceable to the chips but still is classified as indirect cost.

Direct costs consist of direct materials, direct labour and direct expenses. These form part of the **prime costs**.

Indirect costs comprise indirect materials, indirect labour and indirect expenses. These are collectively also termed overheads. As explained above, **factory overheads** form part of **production costs** and other overheads such as **administrative overheads, selling and distribution overheads and research and development overheads** form part of **non-production costs**.

Diagram 1: Elements of cost



Note:

DM = Direct materials

IM = Indirect materials

DL = Direct labour

IL = Indirect labour

DE = Direct expenses

IE = Indirect expenses

Example

Threads used in manufacturing cloth are direct materials for the end product of rolls of cloth. However, in stitching clothing, thread is an indirect cost as the amount of thread used for each unit of clothing stitched cannot be economically traced to each item of clothing.

2. Direct costs in manufacturing industries

Manufacturing industries use inputs, process them and produce output. Non-manufacturing industries mainly consist of trading and service providing entities.

Example

A manufacturing organisation: an organisation engaged in the manufacture of clothing.

A non-manufacturing organisation: an advertising agency engaged in the marketing and publicity of the clothing brand.

A financial consultancy company engaged in the preparation of various tax related reports and accounting work for its clients.

Direct costs consist of costs incurred on

Direct materials
Direct labour
Direct expenses

(a) Direct Material

Definition

Materials that can be **physically identified** with or **traced to a particular product or service easily** or conveniently in a cost beneficial manner are known as **direct materials.**

Materials are considered to be direct materials when:

A direct relationship can be established between the input and the output.
These are physically identifiable in the product.
The materials can be easily traced to the product without any clerical effort or extra cost or time.

In manufacturing organisations, all materials that are used to produce the product are the direct material costs. The fact that the materials should be traceable to the products in a cost beneficial manner is very important. If materials cannot be traced to the product in a cost beneficial manner then they are not classified as direct materials even if they form a part of the final product.

Example

Sheet steel and spares used in the manufacture of automobiles in an automobile company.

Output of one production process may be used as input materials by yet another process for further processing.

Example

In a shoe manufacturing factory, the shoe sole produced by one department will be a direct material for the department which stitches together the entire shoe.

(b) Direct labour

Definition

Labour that is directly identifiable with and easily traceable to a product or service in an economically feasible manner is **direct labour.**

Labour cost can be considered a part of total direct cost when:

a direct relationship exists between labour cost and the product or process;
labour cost can be measured in the light of this direct relationship;
labour cost is significant enough; and
it is economically feasible to identify it as a direct cost.

In a manufacturing organisation, the wages of workers who are directly involved in the manufacturing activity are direct labour costs.

Example

Wages paid to the labourers engaged in construction work on a building site will constitute direct labour cost.

(c) Direct expenses

Apart from direct material and direct labour costs, some other costs may also be traced directly to a product or a service. These are categorised as direct expenses.

Direct expenses include all expenses other than direct material or direct labour that are specifically incurred for a particular product or process. These expenses can sometimes be hard to trace to the final products and hence are sometimes treated as indirect expenses.

Example

In a manufacturing organisation, direct expenses may include costs such as the cost of hiring a hot mix plant (cement mixer) for the construction of concrete roads. This is a direct cost incurred in relation to concrete roads.

Test Yourself 1

Direct material cost means a material cost that can be:

A Specifically, easily, or conveniently identified with a cost objective
B Attributed to, or allocated to, a cost objective on a rational or logical basis
C Associated with a cost objective as it relates to the production process in general
D All of the above

Test Yourself 2

Which of the following are direct labour costs?

A Cutting, shaping and polishing of a raw material as part of production
B Remuneration of supervisor or shop foreman who oversees the production process
C Wages paid to assistants who help in setting up the production process
D All of the above

Test Yourself 3

Direct expenses are those which:

A Can be included in direct material or direct labour
B Are the same as direct material and direct labour
C Are incurred specifically in connection with a product or service
D All of the above

3. Indirect costs in manufacturing industries

Costs other than direct material and direct labour costs that cannot be specifically identified with a product in an economically feasible manner are indirect costs. These costs need to be assigned to the entire volume of production using a suitable base.

Indirect costs are all the overhead expenses - manufacturing overheads, administration overheads, selling and distribution overheads and research and development overheads. Manufacturing overheads are generally incurred in manufacturing organisations.

(a) Manufacturing overheads

These consist of the costs incurred on:

(i) Indirect materials

Definition

Materials of minor importance in comparison to direct materials are known as **indirect materials**. They are not identifiable easily with the final product.

In a manufacturing organisation, indirect materials are those that cannot be easily and precisely traced to any individual product or service. These are materials that are essential, but used in negligible quantities or are used to bring the product in existence but are not traceable to it.

Example

Glue used in the production of wooden tables. It is used in negligible quantity but is essential for the production of tables. The cost of the glue cannot be traced down to each table as it is used in very small quantities. Glue will therefore be classified as an indirect material and the cost incurred on this will be an indirect material cost.

Gas or fuel used in the preparation of food in hotels is an indirect ingredient in food items sold. It is essential for the preparation of food but is not physically traceable to it.

Test Yourself 4

Indirect materials include which of the following?

A Tools, jigs, dyes used to make the finished product
B Wooden shafts used in construction of buildings
C Oil, grease, lubricants, adhesives, cleaning solutions for material maintenance
D Options B and C

(ii) Indirect labour

Definition

Labour costs that **cannot be traced** to the production of specific goods or provision of services are **indirect labour costs.**

Certain direct labour costs are also sometimes treated as indirect costs as it is more appropriate to classify them in this way e.g. overtime premiums, shift differentials (extra payment for working in odd hours like night shifts) and holiday pay. This is done because these payments are made only during abnormal conditions and hence it is convenient to classify them as indirect costs rather than direct labour costs.

In a manufacturing organisation, indirect labour costs consist of labour costs in service departments such as purchasing or engineering. The labour cost of certain workers in the production departments will be considered indirect labour, such as foremen and supervisors, as their time is split between many items produced and cannot be apportioned easily.

Example

Wages paid to labour working in the storeroom or factory office and maintenance staff in the factory will be the indirect labour costs.

Test Yourself 5

Indirect labour:

A Is synonymous with direct labour; that is, exhibits the characteristic traits of direct labour
B Means cost of labour directly engaged in production or service providing activities
C Consists of labour costs incurred in departments such as purchasing, engineering and stores
D None of the above

(iii) Indirect expenses

Indirect expenses include costs that might be incurred for the overall production or service in order to ensure that operations are carried out smoothly. In a manufacturing organisation, indirect expenses will include rent and rates for factory premises and insurance charges to be paid, if any.

(b) Non-manufacturing overheads

These include administration, research and development, selling and distribution overheads.

Example

Administrative costs such as costs of book keeping, selling costs such as salesmen commission and distribution costs of the products from the factory to the market place are non-manufacturing overheads.

In a non-manufacturing organisation, the proportion of support costs as a percentage of total costs is higher than in manufacturing organisations.

Example

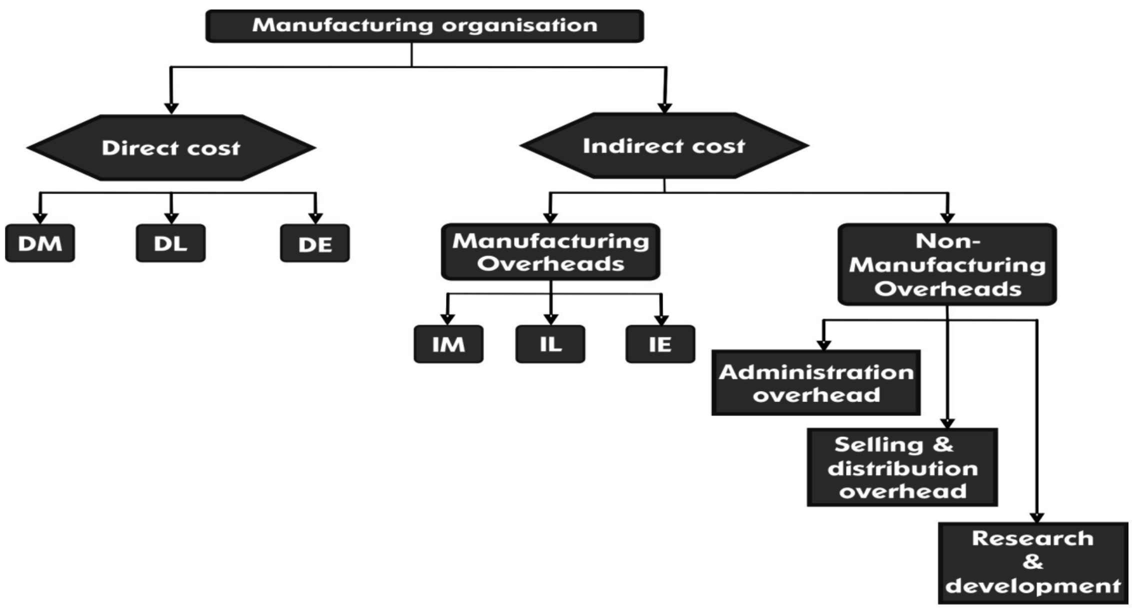
Administrative overhead costs are much higher as office maintenance is vital for non-manufacturing organisations. The office is where all work takes place as there is no factory or production floor.

Selling and distribution costs, which include marketing and promotion costs, are usually higher in service providers.

Example

Business development costs (costs on advertising, meeting clients etc.) incurred by a legal consultancy firm for creating a network base of potential clients are selling overhead costs.

Diagram 2: Direct and indirect cost classification in a manufacturing organisation



Given below is an illustrative list of examples for direct and indirect costs.

Example

Elements of direct costs	Elements of indirect costs
Direct material: cost of dough and sugar used in the preparation of biscuits, the cost of sheet steel used in the body of a car. **Direct labour:** salary of a baker baking biscuits in a bakery, salary of the worker who assembles the body of a car in a car manufacturing company. **Direct expenses:** costs of repairs and maintenance to the oven in which the cake is baked	**Indirect materials:** electricity consumed by the oven, spray paint used to paint the body of the car. **Indirect labour:** salary of the kitchen cleaner in a bakery. **Indirect expenses:** rent of the premises of the bakery. **Administrative overheads:** salary of the general manager of the car manufacturing company. **Selling overheads:** commission paid to the door to door salesmen to market the bakery products. **Distribution overheads:** charges paid to the delivery man for delivering the biscuits to the retail shop.

2. Explain and prepare for a manufacturing entity:
- **i. Manufacturing account**
- **ii. Statement of income and expenditure**
- **iii. Statement of financial position**

[Learning Outcome b]

In the earlier Learning Outcomes, we have studied the different types of costs. In this Learning Outcome, we will prepare the manufacturing account, statement of income and statement of financial position for a manufacturing entity. First let us have a look at the proformas.

Proforma of manufacturing account

	Tshs'000
Raw materials (Opening)	XX
Add: Purchases of raw materials	XX
Less: Raw materials (Closing)	(XX)
Raw material used	**XXX**
Add: Direct labour	XX
Prime cost	**XXX**
Factory overheads	
Factory overheads (direct and indirect)	XX
Depreciation on plant used for production	XX
	XXX
Add: Work-in-progress (Opening)	XX
	XXX
Less: Work-in-progress (Closing)	(XX)
Production costs or cost of goods manufactured	**XXX**

Important

The proforma of a manufacturing account is similar to a cost sheet. Students are advised to refer to Paper T06 and understand how a cost sheet is prepared.

Proforma of statement of income

	Tshs'000	Tshs'000
Sales		XX
Less: Cost of sales		
Finished goods (Opening)	XX	
Add: Production costs (from manufacturing account)	XX	
Less: Finished goods (Closing)	(XX)	(XX)
Gross profit on trading		**XXX**
Less: Administrative expenses:		
- Rent & rates	XX	
- Heat & light	XX	
- Stationery and postage	XX	
- Administrative staff salaries	XX	(XX)
Less: Selling and distribution expenses:		
Advertising expenses	XX	
Delivery van expenses	XX	
Depreciation of delivery van	XX	(XX)
Less: Research and development expense		
Research expenses	XX	
Research and development staff salaries	XX	(XX)
Profit for the year		**XXX**

Proforma of statement of financial position

	Tshs'000	Tshs'000
Non-current assets		
Plant and machinery	XX	
Motor vehicles	XX	XX
Current assets		
Inventory		
- Raw materials	XX	
- Work in progress	XX	
- Finished goods	XX	
Trade receivables	XX	
Bank balance	XX	
Prepaid rent	XX	XX
		XXX
Equity and liabilities		
Equity		
Capital	XX	
Less: Drawings	(XX)	
Add: Profit for the year	XX	XX
Non-current liabilities		
Bank loan	XX	XX
Current liabilities		
Payables	XX	
Accrued expenses	XX	XX
		XXX

Let us understand the preparation of the manufacturing accounts with the help of a comprehensive example.

Example

The following balances as at 31 October 2011 have been extracted from the books of Hasara Co, operating a manufacturing set-up in Arusha.

	Tshs'000
Inventory at November 1 October 2010	
Raw materials	17,500
Work in progress	12,500
Finished goods	17,250
Purchases of raw materials	95,000
Direct labour	70,000
Factory overheads	62,500
Administrative expenses:	
Rent and rates Heat	47,500
and light Stationery	15,000
and postage Staff	5,000
salaries	48,450
Sales	480,000
Plant and machinery at cost	75,000
Motor vehicles at cost (for sales deliveries)	40,000
Provision for depreciation:	
Plant and Machinery	30,000
Motor vehicles	10,000
Trade payables	17,200
Trade receivables	70,000
Drawings	27,750
Bank balance	41,500
Capital at 1 November 2010	120,000
Motor vehicle running expenses	11,250

Additional information:

(a) Inventory as at 31 October 2011 were as follows:

	Tshs
Raw materials	22,500,000
Work in progress	20,000,000
Finished goods	25,875,000

(b) Depreciation is provided annually at the following percentages of the original cost of non-current assets held at the end of each financial year:

Plant and machinery 10%
Motor vehicles 25%

(c) Amounts accrued at 31 October 2011 for direct labour amounted to Tshs9,500,000

(d) Rent and rates prepaid at 31 October 2011 amounted to Tshs4,000,000

Required:

Prepare for the year ended 31 October 2011

Manufacturing account
Statement of income
Statement of financial position

(Adapted from May 2012)

Continued on the next page

Answer

Hasara Co. Ltd - Manufacturing Account for the year to 31 October 2011

	Tshs'000	Tshs'000
Raw materials 1.11.2010		17,500
Add: Purchases of raw materials		95,000
		112,500
Less: Raw materials 31.10.2011		(22,500)
Raw material used		90,000
Add: Direct labour (70,000 + 9,500)		79,500
Prime cost		**169,500**
Factory overheads		
Factory overheads	62,500	
Depreciation on plant	7,500	70,000
		239,500
Add: Work-in-progress 1 Nov 2010		12,500
		252,000
Less: Work-in-progress 31 Nov 2011		(20,000)
Cost of goods manufactured		**232,000**

Hasara Co. Ltd - Statement of Income for the year to 31 October 2011

	Tshs'000	Tshs'000
Sales		480,000
Less: Cost of sales:		
Finished goods 01 Nov 2010	17,250	
Add: Market value of goods completed	232,000	
Less: Finished goods 31 Oct 2011	(25,875)	(223,375)
Gross profit on trading		**256,625**
Less: Administrative expenses:		
- Rent & rates (Tshs47,500 – Tshs4,000)	43,500	
- Heat & light	15,000	
- Stationery and postage	5,000	
- Staff salaries	48,450	(111,950)
Less: Selling and distribution expenses:		
Motor vehicle running expenses	11,250	
Depreciation of motor vehicle (25% of Tshs40,000)	10,000	(22,250)
Profit for the year		**122,425**

Tip

Finished goods are always part of the statement of income, and raw material and work in progress are recorded in the manufacturing account.

Continued on the next page

Hasara Co. Ltd - Statement of financial position for the year ended 31 October 2011

	Tshs'000	Tshs'000
Non-current assets		
Plant and machinery (Tshs75,000 – Tshs30,000 – Tshs10,000)	35,000	
Motor vehicles ((Tshs40,000 – Tshs10,000 – Tshs7,500)	22,500	**57,500**
Current assets		
Inventory		
Raw materials	22,500	
Work in progress	20,000	
Finished goods	25,875	
Trade receivables	70,000	
Bank balance	41,500	
Prepaid rent	4,000	183,875
		241,375
Equity and liabilities		
Equity		
Capital	120,000	
Less: Drawings	(27,750)	
Add: Profit for the year	122,425	214,675
Non-current liabilities		-
Current liabilities		
Trade payables	17,200	
Accrued expenses	9,500	26,700
		241,375

Test Yourself 6

Tipton Co is in the textile industry. It manufactures cotton shirts. The following are the details of their estimated annual expenses for the next financial year. Determine the cost per unit. The annual production of Tipton Co is 10,000 units.

	Tshs'000
Purchase of raw materials	500
Wages paid (80% direct wages)	600
Expenses related to purchases	70
Overheads	
Factory (20% are fixed)	750
Administration	400
Selling and distribution (20% are variable)	50

Required:

Calculate the cost of sales for Tipton Co.

Answers to Test Yourself

Answer to TY 1

The correct option is **A.**

Direct cost is specifically and easily identifiable with the cost object. Direct material cost is not allocable; it is identifiable with a cost objective or cost unit. Direct material cost is not related to the production process in general, but is specifically identifiable in the production process.

Answer to TY 2

The correct option is **A.**

There is a direct measurable relationship between labour cost and the product / process / output. Also, this forms a major part of total direct cost. Remuneration of supervisor or shop foreman who oversees the production process is not directly identifiable with any particular job, product or process. Wages paid to assistants who help in setting up the production process is also not directly identifiable with any particular job, product or process.

Answer to TY 3

The correct option is **C.**

These are called direct expenses because they are directly attributable to production or service provision i.e. incurred in such a way that their benefit can be easily visualised in the product and form a substantial part of total direct cost. Direct expenses are separately charged to the product or process and cannot be included in direct material and direct labour. Direct expenses can be distinguished from direct material and direct labour; they are not the same.

Answer to TY 4

The correct option is **D.**

Temporary wooden shafts, used in construction of buildings, are not a part of the final structure but are required for the construction process. Oil, grease, lubricants, adhesives, and cleaning solutions are all required for material maintenance. Tools, jigs, dyes etc. used to make the finished product are the store items and not indirect material.

Answer to TY 5

The correct option is **C.**

Indirect labour is not directly involved in production or service providing activities and can include labour costs of ancillary departments like purchasing and stores. Therefore, it is distinct from direct labour.

Answer to TY 6

The cost of sales can be calculated as follows:

	Tshs'000	Tshs'000	Per unit cost (Tshs)
Direct materials (purchase of raw materials)	500		
Direct wages (Tshs600 x 80%)	480		
Direct expenses (purchase related)	70		
Prime cost		**1,050**	**105.00**
Production overheads			
Factory overheads			
Variable (Tshs750 x 80%)	600		
Fixed (Tshs750 x 20%)	150		
Indirect wages (Tshs600 x 20%)	120	870	
Production cost		**1,920**	**192.00**
Administration overheads		400	
Administration costs		**2,320**	**232.00**
Selling and distribution costs			
Variable (Tshs50 x 20%)	10		
Fixed (Tshs50 x 80%)	40	50	
Cost of sales / Total costs		**2,370**	**237.00**

Self Examination Questions

Question 1

The following are three types of costs:

(i) CD for the general office computer.
(ii) Maintenance contract for the office photocopying machine.
(iii) The cost of painting advertising slogans on delivery vans.

Which of the following statements is true with regard to the above costs?

A (i) and (ii) are administrative overhead costs.
B (ii) and (iii) are administrative overhead costs.
C (iii) and (i) are selling and distribution costs.
D (i), (ii) and (iii) are selling and distribution costs.

Question 2

Which of the following is an administrative overhead cost?

A Cost of fuel for machinery
B Legal charges
C Salary of a sales manager
D Cost of printing price list

Question 3

Motor vehicle licences for lorries are:

A Production overhead
B Administration overhead
C Finance overhead
D Selling and distribution overhead

Question 4

Which of the following is / are not an example of fixed cost?

A Insurance cost incurred by an organisation
B Monthly machine fuel charges
C Interest on borrowed money for business
D Raw materials cost

Question 5

(i) Costs incurred to improve an existing product are classified as selling costs.

A True
B False

(ii) Salaries of office staff, sales and marketing personnel are classified as administrative and selling **costs.**

A True
B False

Question 6

Jogoo Ltd is a company which mills maize flour. The following balances were extracted from the company's trial balance as at 30 September 2012.

	Tshs'000
Purchases of new materials	2,800,000
Returns of raw materials	10,000
Direct labour	1,250,000
Administration costs	350,000
Sales	7,850,000
General factory expenses	150,000
Plant and machinery at cost	1,400,000
Delivery van at cost	2,100,000
Selling and distribution expenses	200,000
Indirect factory labour	240,000
Stock 01 October 2011: Raw materials	380,000
Work in progress	980,000
Finished goods	180,000
Rent	420,000

The following additional information is available:

(i) Rent was paid for the year up to 31 December 2012 and was to be apportioned between the factory and general administration on the basis of 2:1.

(ii) Indirect factory labour of Tshs60,000,000 were accrued on 30 September 2012.

(iii) Plant and machinery were depreciated at 20% per annum and delivery van at 30% on book value. Usage of the delivery van is apportioned at: 50% factory and 50% administration.

(iv) Stock at 30 September 2012 were:

Raw materials	480,000,000
Work in progress	880,000,000
Finished goods	280,000,000

Required:

Prepare the Manufacturing Account and Statement of Income for the year ended 30 September 2012.

Question 7

Jogoo Ltd is a company which mills maize flour. The following balances were extracted from the company's trial balance as 30th September 2014.

	Tshs
Purchases of raw materials	70,000,000
Returns of raw materials	250,000
Direct labour	31,250,000
Administration costs	8,750,000
Sales	196,250,000
General factory expenses	3,750,000
Plant and machinery at cost	35,000,000
Delivery van at cost	52,500,000
Selling and distribution expenses	5,000,000
Indirect factory labour	6,000,000
Stock 1.10.2013: Raw materials Work in process Finished goods	9,500,000 24,500,000 4,500,000
Rent	10,500,000

The following additional information is available:

(i) Rent was paid for the year up to 31st December 2014 and was to be apportioned between the factory and general administration on the basis of 2:1.

(ii) Indirect factory labour of Tshs.1,500,000 were accrued on 30th September 2014.

(iii) Plant and machinery were depreciated at 20% per annum and delivery van at 30% on book value. Usage of the delivery van is apportioned at: 50% factory and 50% administration.

(iv) Stock at 30th September 2014 were:

Raw materials	Tshs.12,000,000
Work in process	Tshs.22,000,000
Finished goods	Tshs.7,000,000

REQUIRED:

Prepare the Manufacturing Account and Statement of Income for the year ended 30th September 2014.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **A.**

CD for general office use and maintenance contracts for office photocopying machines are administrative expenses incurred for office purposes.

Option B – (ii) is an administrative expense but (iii) is a selling and administrative expense for market promotion.
Option C – (iii) is selling and distribution expense but (i) is administration expense
Option D – (i) and (ii) are administration expenses and (iii) is selling and distribution expense.

Answer to SEQ 2

The correct option is **B.**

Legal charges are an administrative overhead cost.

Option A - Cost of fuel for machinery is a factory overhead cost.
Options C and D - Salary of a sales manager and the cost of printing the price list are selling overhead costs.

Answer to SEQ 3

The correct option is **D.**

Motor vehicle licences for lorries is a selling and distribution overhead as lorries are used to transport goods from one place to another.

Option A – Production overheads must be incurred in relation to the manufacture of a product. Option B – Administration overheads are the overheads incurred in relation to maintaining an office. Option C – Finance costs are the interest costs relating to the capital borrowed for business.

Answer to SEQ 4

The correct options are **A** and **C**.

Insurance cost is a fixed cost. It does not have any relationship with the production activity. Interest on borrowed money for business bears a fixed rate of interest. Both of these costs do not change according to change in the volume of production.

On the other hand, machine fuel charges and raw material requirements change in accordance with changes in production – therefore they are variable costs.

Answer to SEQ 5

(i) The correct option is **B.**

Costs incurred to improve an existing product are classified as research and development costs.

(ii) The correct option is **B**.

Salaries of office staff and sales and marketing personnel are classified as administrative and selling costs. This is because they include the costs of salary of office staff (administrative costs) and the salary of sales and marketing personnel (selling costs).

Answer to SEQ 6

Manufacturing account for the year to 30 September 2012

	Tshs'000	**Tshs'000**	**Tshs'000**
Opening Stock		380,000	
Add: Purchases	2,800,000		
Less: Returns	(10,000)	2,790,000	
Available for use		3,170,000	
Less: Closing stock		(480,000)	2,690,000
Direct labour			1,250,000
Prime cost			3,940,000
Factory overhead:			
General factory		150,000	
Indirect labour		300,000	
Rent		210,000	
Depreciation: Plant		280,000	
Motor Vehicle		315,000	1,255,000
Total Current Production cost			**5,195,000**
Add: Opening WIP			980,000

Total Production cost to date			**6,175,000**
Less: Closing WIP			(880,000)
Production cost			**5,295,000**

Statement of income for the year to 30 September 2012

	Tshs'000	Tshs'000
Sales		7,850,000
Cost of Sales:		
Opening Stock	180,000	
Add: Cost of Goods Manufactured	5,295,000	
Available for sale **Less:**	5,475,000	
Closing Stock **Gross**	(280,000)	(5,195,000)
Profit Administration		**2,655,000**
Expenses Selling &	350,000	
Distribution Rent	200,000	
Depreciation Motor Vehicle	105,000	
Net Profit	315,000	970,000
		1,685,000

Answer to SEQ 7

The Manufacturing Account and Statement of Comprehensive Income for the year ended 30th September 2014

	Tshs.	Tshs.	Tshs.
Material consumed			
Opening stock		9,500,000	
Add: Purchases	70,000,000		
Less: Returns	250,000	69,750,000	
Available for use		79,250,000	
Less: Closing stock		12,000,000	67,250,000
Direct labour			31,250,000
Prime cost			98,500,000
Factory overhead:			
General factory		3,750,000	
Indirect labour (6,000,000 + 1,500,000)		7,500,000	
Rent ($^2/_3$ x 10,500,000 x $\frac{12)}{15}$		5,600,000	
Depreciation; Plant (20% x 35,000,000		7,000,000	
Motor Vehicle (30% 52,500,000 x ½)		7,875,000	31,725,000
Total Current Production cost			130,225,000
Add: beg. WIP			24,500,000
Total Production cost to date			154,725,000
Less: Closing WIP			22,000,000
Production cost			132,725,000
Sales			196,250,000
Cost of Sales:			
Opening Stock		4,500,000	
Add: Cost of Goods Manufactured		132,725,000	
Available for sale		137,225,000	
Less: Closing Stock		7,000,000	130,225,000
Gross Profit			66,025,000
Administration Expenses		8,750,000	
Selling & Distribution		5,000,000	
Rent ($^1/_3$ x 10,500,000 x $\frac{12)}{15}$		2,800,000	
Depreciation Motor Vehicle		7,875,000	24,425,000
Net Profit			41,600,000

SECTION E

INTERPRETATIONS OF FINANCIAL STATEMENTS

14

INTERPRETATIONS OF FINANCIAL STATEMENTS

Get Through Intro

Throughout this book we have seen that International Accounting Standards ensure that **financial statements** reflect a true and fair picture **of a company's financial position.** We are also aware that financial statements are used by **different types of users.**

Two questions which normally come to mind are:

How can financial statements, which are basically just scientifically prepared lists of items computed and presented in a prescribed manner, reflect the financial position of a company?
How can the same list of items be useful to different categories of users?

The answer to these questions lies to a large extent in **accounting ratios and ratio analysis**. Accounting ratios and ratio analysis is **the key to analysing and interpreting financial statements.** They add life to a set of numbers in such a way that numbers reveal those details which even words would find difficult to reveal.

You should devote considerable time to your work on this Study Guide, which takes you through the fascinating world of ratios and ratio analysis.

This will help you **tackle any related question in the examination** with confidence, it will help you in your **professional life** when you might have to give advice on investment decisions, and it will help you **amass wealth in your own life** as well, by ensuring that your personal investment decisions do not turn sour!

Learning Outcomes

a) Explain techniques of analysis and interpretation of financial statements.
   i. Common-size percentage base techniques
   ii. Ratio analysis
   iii. Comparative analysis of financial statement
b) State and explain types of categories of accounting ratios.
c) Explain significance of financial ratios.
d) Identify limitation of financial ratios.
e) Explain and calculate financial ratios for a single company financial statements, such as:
   i. Current ratio
   ii. Quick/Acid test ratio
   iii. Gross margin ratio
   iv. Net margin
   v. Return on Total Assets
   vi. Total Assets Turnover ratio
   vii. Non-current Assets Turnover ratio
   viii. Debtors' collection period
   ix. Creditors payment period
   x. Inventory/stock turnover
   xi. Debt to equity
   xii. Interest cover
   xiii. Earnings per Share (EPS)
   xiv. Price/Earnings
   xv. Dividend yield.

1. Explain significance of financial ratios.

[Learning Outcome c]

Example

The financial statements of Pineapple Inc give the following information:

	20X9		**20X8**	
	Tshs'000		**Tshs'000**	
Sales		40,000		30,000
Cost of sales		(20,000)		(10,000)
Gross profit		20,000		20,000
Selling expenses	7,500		5,000	
Administrative expenses	10,000	(17,500)	8,000	(13,000)
Net profit		**2,500**		**7,000**

The above information reveals the following facts:

- Sales have gone up, gross profit has remained constant and net profit has fallen between the two years.
- Cost of sales, selling expenses and administrative expenses have all gone up.

However, it does not tell us **why** net profit has fallen by Tshs4,500,000 when sales have increased by Tshs10,000,000.

If an analyst were to make decisions on the basis of the information given in the financial statements alone, he might say that the company should reduce its sales to make profits.

The solution however, cannot be as simple as that as well as being counter intuitive. The management of Pineapple Inc has to discover the reasons for the loss of profit in spite of an increase in sales. This is because, if the company has to grow, it definitely needs to increase sales but it cannot afford to have profits fall.

Accounting ratios and ratio analysis help unearth problems and provide solutions.

It is possible to compute an unlimited number of ratios from the financial statements. However, this would be of no use. The user of financial statements has to compute only those ratios which are suited to his needs and which represent meaningful figures. These ratios are explained in detail in Study Guide H2.

These ratios are then compared with similar ratios of:

- a different reporting period of the entity
- another similar entity for the same reporting period
- industry average ratios

The user then needs to analyse them and interpret the results. Analysis of ratios is not an exact science; **there can be no hard and fast rules.** The analysis and interpretation will depend upon the circumstances of each entity.

1.1 Factors on which analysis and interpretation of financial ratios depend include:

- the size of the business
- the state of the economy
- the policies of management
- the company philosophy
- the industry norms
- government rules and regulations

Test Yourself 1

Which of the following factors is not considered while doing analysis and interpretation of financial statements?

A Size of the business
B Government rules and regulations
C State of the economy
D Quality of the services and product sold

1.2 Purpose of interpretation of ratios

The basic purpose of ratio analysis is the interpretation of financial statements. Interpreting the financial statements with the help of various ratios helps us to analyse the business and take appropriate decisions, and also helps to ascertain the following:

1. **To measure the profitability of the business:** Interpretation of financial statements helps in ascertaining whether adequate profits are being earned on the capital invested in the business or not. In this way banks and other financial institutions are assured that their money is safe and they will also earn a satisfactory return on their investments.

2. **To analyse the past trend:** The purpose of interpretation of financial statement is to indicate the past trend in various items of financial statements. For example the gross profits have increased over a period but the net profit has declined. This will help the entity to concentrate on operating expenses and frame suitable budgets to control them.

3. **To evaluate the growth potential of the business:** The purpose of interpretation of financial statement is to provide sufficient information to management regarding the growth potential. This will help management to take decisions regarding expansions or improving capacity.

4. **To do comparative study of firm's position in relation to other firms in the industry:** The purpose of interpretation of financial statement is to help the management in making a comparative study of the profitability of various firms engaged in similar businesses. Such comparison also helps the management to study the position of their firm in respect of sales, expenses, profitability and utilising capital, etc.

5. **To assess overall financial strength of business:** The purpose of interpretation of financial statement is to assess the financial strength of the business for taking important business decisions. For example decision to purchase new machines or whether to issue shares or avail a loan, etc.

6. **To examine solvency of the business:** The purpose of interpretation of financial statement is to assess whether there is adequate liquidity in the entity. This includes short-term and long-term liquidity.

1.3 Users of the financial statements

Analysis of financial statements is performed by various users of financial statements. The various users of financial statements include:

(i) Investors and potential investors: primarily concerned with knowing whether their actual or potential investment is sound and what yield they can expect to get from it. Investors would therefore be interested in analysing ratios such as Earnings Per Share, Price / Earnings ratio, Profit Retention ratio, Dividend Cover, etc.

The performance of the entity is also analysed in order to assess the rate of return on their investments. For this purpose they would be interested in the **Return on Capital Employed and Return on Assets.** Investors would not be much concerned with the profitability ratios as they are not really worried about how the entity earns its profits.

(ii) Lenders and potential lenders: primarily concerned with whether the entity is in a position to repay the loan along with interest**.** For this purpose, they will be interested in the **interest cover ratio.** They will also be interested in assessing the performance of the entity because, if an entity is not performing well, it will not be able to sustain its liquidity.

For this purpose, they will be analysing the **Return on Capital Employed and Return on Assets.** They will also be interested in the **Capital gearing ratio**. If this ratio is too high, it means that already the entity is in debt to a great extent. Lenders would be hesitant to lend money to a highly geared entity.

(iii) Trade payables and other suppliers: primarily concerned with the liquidity position of the entity because they want to know whether the entity is solvent enough to repay its dues on time. For this purpose, they will be interested in the **current ratio, quick ratio, payable days and the working capital cycle.**

(iv) Management: have access to much more detailed financial information than that which appears in the financial statements. However, management would be interested in a comparison with competitors, especially in the ratios which affect their sphere of work.

(v) Employees: primarily concerned with the profitability and liquidity of the entity. If an entity is not able to earn profits, their growth in such organisation may get restricted or if the entity is facing serious liquidity crunch then they may not even get their salaries on time.

Test Yourself 2

Which of the following is not a purpose of interpretation of financial statements?

A To assess the growth potential of the business
B To assume quality control over the products or services of business
C To find out the solvency position of business
D To make a comparative study of own firm with the industry data

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2. Explain techniques of analysis and interpretation of financial statement.
- **i. Common-size percentage base techniques**
- **ii. Ratio analysis**
- **iii. Comparative analysis of financial statement**

State and explain types of categories of accounting ratios.
Explain and calculate financial ratios for a single company financial statements, such as:
- **i. Current ratio**
- **ii. Quick/Acid test ratio**
- **iii. Gross margin ratio**
- **iv. Net margin**
- **v. Return on Total Assets**
- **vi. Total Assets Turnover ratio**
- **vii. Non-current Assets Turnover ratio**
- **viii. Debtors' collection period**
- **ix. Creditors payment period**
- **x. Inventory/stock turnover**
- **xi. Debt to equity**
- **xii. Interest cover**
- **xiii. Earnings per Share (EPS)**
- **xiv. Price/Earnings**
- **xv. Dividend yield**

[Learning Outcomes a, b and e]

In this section, we shall discuss how different financial statements are analysed and interpreted with the help of financial ratios. Further we will discuss the various ratios **from the focus of various stakeholders such as bankers, creditors, investment analysts, etc.**

Definition

The result of dividing one **financial statement** item by another is a **financial ratio**.

Financial statement analysis is as a process of understanding the risk and profitability of a business by analysing the financial information reported in the statement of profit or loss and the statement of financial position.

2.1 Classification of financial ratios

Financial ratios are useful to a variety of users for different purposes. Financial ratios may be classified according to the motive to use the financial ratio i.e.

to analyse whether company is profitable

to analyse the company's liquidity status

to analyse if the company can meet its tax liability

to analyse if the company can repay its debt

to analyse whether the company is performing well and using its resources efficiently

to analyse whether the company meets the expectations of shareholders

In this Study Guide we will discuss various ratios classified under five broad categories. Refer the table below to understand the classification.

A summary of the ratios which are discussed below is provided below for a ready reference.

	Key accounting Ratios	Formula	Interpretation	Favourable situation	
A	**Profitability ratios**			**High**	**Low**
1	Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$	Reflects gross margin made on sales		
3	Net profit margin	$\frac{\text{Net profit (PBT)}}{\text{Sales revenue}} \times 100$	Reflects net margin made on sales		
5	Return on assets	$\frac{\text{Operating profit}}{\text{Total assets}} \times 100$	Reflects relationship between profits earned and total assets		
B	**Liquidity ratios**				
1	Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Measures ability to pay current liabilities from the current assets		
2	Quick ratio	$\frac{\text{Quick assets}}{\text{Current liabilities}}$	Indicates the ability to pay all current liabilities if they become due for payment immediately		
C	**Working capital efficiency ratios**				
1	Total asset turnover	$\frac{\text{Sales revenue}}{\text{Total assets}}$ (times p.a.)	Shows how much revenue generated by a Tshs1,000 worth of assets		
2	Inventory turnover	$\frac{\text{Cost of sales}}{\text{Inventory}}$ (times p.a.)	Indicates how many times the inventory is being turned over in a year		

Continued on the next page

3	Receivable days	$\frac{\text{Recievable}}{\text{Credit sales}} \times 365 \text{ days}$	Reflects the number of days it takes for a customer to pay		
4	Payable days	$\frac{\text{Payables}}{\text{Credit purchases}} \text{ x } 365 \text{ days}$	Reflects the number of days it takes for a company to settle its bills		
D	**Investor performance ratios**				
1	Earnings per share (EPS)	Profits available for distribution to ordinary shareholders/Weighted average number of ordinary shares outstanding	Amount which an entity has earned per share for the given period.		
2	Price / Earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings Per Share}}$	Helps to assess the relative risk of an investment		
3	Dividend yield	$\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$	Measures the return on capital investment as a percentage of market prices		
E	**Financial risk ratios**				
1	Capital gearing ratio or Debt equity ratio	$\frac{\text{Total long - term debt}}{\text{Shareholders funds}} \times 100$	It expresses the relationship between a company's borrowings and its own funds	-	
2	Interest cover	$\frac{\text{Profit before interest and tax}}{\text{Interest expenses}}$	Indicates the number of times, the profit covers the interest charge		

2.2 Computation of financial ratios

The following are the extracts of statement of profit or loss and statement of financial position of Air Ltd. Using the information from these statements, in this section, we shall discuss how the different financial ratios are computed, analysed and interpreted

Extracts of statement of profit or loss of Air Ltd for 20X7 and 20X8

	20X7		20X8	
	Tshs'000	**Tshs'000**	**Tshs'000**	**Tshs'000**
Sales turnover		290,000		350,000
Cost of sales		260,000		320,000
Gross profit		**30,000**		**30,000**
Administrative expenses	(5,000)		(5,000)	
Depreciation	(3,000)		(4,000)	
Selling and distribution expenses	(5,000)		(6,000)	
Finance cost (interest cost)	(3,000)	(16,000)	(3,000)	(18,000)
Net Profit before tax		**14,000**		**12,000**
Tax		2,800		2,400
Profit after tax		**11,200**		**9,600**

Details of dividends paid

	20X7		20X8	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Equity dividend	700		900	
Preference dividend	600	1,300	600	1,500

Extracts of statement of financial position of Air Ltd for 20X7 and 20X8

	20X7		20X8	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Tangible assets		20,000		27,000
Current assets				
Inventory	24,000		21,000	
Trade Receivables	32,500		20,500	
Cash		56,500	600	42,100
Total assets		**76,500**		**69,100**
Equity and liabilities				
Ordinary share capital (Tshs1,000 each)	9,000		9,000	
10% irredeemable preference shares (Tshs1,000 each)	6,000		6,000	
Accumulated profits	9,900	24,900	8,100	23,100
Non-current liabilities				
Loans from banks		11,000		11,000
Current liabilities				
Payables	25,000		35,000	
Bank overdraft	15,600	40,600	-	35,000
Total equity and liabilities		**76,500**		**69,100**

1. Profitability ratios

Profitability ratios help to **analyse the profitability of a company**. The best way to start an analysis of the profitability of a company is by examining the revenue it earns.

(a) Gross Profit Margin

This ratio **reflects the gross margin** that a company makes on its **sales** and is calculated as:

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$

Example

Referring to the financial statements of Air Ltd the gross profit margin is calculated as follows:

	20X7	20X8
	Tshs'000	Tshs'000
Sales	290,000	350,000
Cost of sales	(260,000)	(320,000)
Gross profit	**30,000**	**30,000**
Gross profit margin is	$\frac{30,000}{290,000} \times 100$	$\frac{30,000}{350,000} \times 100$
	10.34%	**8.57%**

Continued on the next page

Sales have increased by 20.69% however the cost of sales has increased by 23.08%. Hence, although the amount of gross profit has remained constant, the profitability of the company has declined because of an increase in the cost of sales. This is the reason for the fall in the gross profit margin.

Some of the variables which affect this ratio are:

- the sales mix, the rise or fall in **selling prices**, the rise or fall in **sales volumes.**
- variations in **direct expenses** like the rise or fall in **purchase costs, labour cost.**

Important

The **higher this ratio**

- the **more efficient is** the **performance of the company.**
- the more efficient it is in **controlling direct costs.**
- the better is its **sales mix and its performance.**

(b) Net profit margin

This ratio reflects the **net margin** (before tax) that a company makes on its **sales** and is calculated as:

$$\text{Net profit margin} = \frac{\text{Net profit (PBT)}}{\text{Sales revenue}} \times 100$$

The variables which affect this ratio are:

- all variables which affect the **net profit**
- variations in **finance costs** and **taxation**

Example

(Amounts in Tshs'000)
Referring to the financial statements of Air Ltd the net profit margin for the year 20X8 is calculated as follows:

	Air Ltd
	Tshs'000
Sales	350,000
Net profit	12,000
Net profit margin	**3.43%**

Now let's say we compare the financials of Air Ltd with another company Water Ltd (a company operating in similar industry).

	Air Ltd	**Water Ltd**
	Tshs'000	**Tshs'000**
Sales	350,000	400,000
Cost of sales	(320,000)	(365,720)
Gross profit	30,000	34,280
Gross profit margin	**8.57%**	**8.57%**
Selling and other costs	(18,000)	(25,000)
Net profit	12,000	9,280
Net profit margin	**3.43%**	**2.32%**

The gross profit margins of both the companies are identical. However, the net profit margin of Air Ltd is more than that of Water Ltd.

This is mainly on account of the lower indirect costs of Air as compared to Water. This means that Air is more efficient than Water Ltd in controlling its selling and administration costs. In fact, this efficiency has helped Air Ltd to operate at a better net profit margin than Water Ltd, in spite of lower sales.

Tip

Sometimes, net profit is considered to be the profit before interest and tax and so **operating profit margin** is the same **as net profit margin**. In the examination, you will have to specify what you mean by **'net profit'.**

Important

The **higher this ratio**

the **more efficient** is the **performance of the company**
the more efficient it is in **controlling its borrowings and borrowing costs**

(c) Return on assets (ROA)

This reflects the relationship between **the profits earned by a company and its total assets.** It is calculated as:

$$\text{Return on assets} = \frac{\text{Operating profit}}{\text{Total assets}} \times 100$$

Operating profit = Profit before interest and tax

Operating profit = Profit before interest and tax

Total assets = Total of the SOFP

Important

The **higher the ratio,** the **more efficiently the assets are managed**. This means the entity is generating optimum profits from the available resources.

Asset turnover is explained in detail under working capital efficiency ratios.

The Return on Assets is a combination of two ratios:

Return on assets = Operating profit margin x Asset turnover

This can be explained by showing the formulae used to calculate the two ratios:

$$\frac{\text{Operating profit}}{\text{Total assets}} = \frac{\text{Operating profit}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Total assets}}$$

Test Yourself 3

The following information is received from the financial statements of Brian Ltd.

Extracts of statement of profit or loss	**Tshs'000**
Revenue	350,000
Cost of sales	(126,500)
Selling and administrative expenses	(98,200)
Profit	**125,300**
Interest	(20,000)
Taxes	(30,000)
Net profit	**75,300**

Continued on the next page

Extracts of statement of financial position	Tshs'000
Ordinary shares	300,000
Preference shares	125,000
Trade payables	34,000
Long-term loans from banks	150,000
Non-current assets	495,000
Current assets	95,000

Other information

	Tshs'000
Operating profit is	125,300
Capital employed is	
Ordinary shares	300,000
Preference shares	125,000
Long-term loans from banks	150,000
	575,000

Note: Brian had a 25% return on assets in the earlier year

Required:

Using the information relating to Brian, calculate and interpret the return on assets ratio.

Liquidity ratios

Liquidity ratios help to **assess the liquidity and cash position of the company**. It is an indicator of whether the business has the capacity to pay its **trade payables, expenses, loans** as well as **current liabilities** at the correct point of time.

(a) Current ratio

This ratio helps decide whether the **current assets** will be able to generate **sufficient cash** to pay off the **current liabilities** as and when they **fall due.**

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

Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the current ratio is calculated as follows:

	20X7 Tshs'000	20X8 Tshs'000
Total current assets	**56,500**	**42,100**
Total current liabilities	**40,600**	**35,000**
The Current Ratio is	(56,500/40,600)	(42,100/35,000)
	= 1.39:1	**= 1.20:1**

This means that Air Ltd has Tshs1,200 of current assets for each Tshs1,000 of current liabilities in the year 20X8. Furthermore there is deterioration in the company's liquidity position during 20X8, when compared to the last year. This implies that the company may face serious problems if liabilities fall due, since the company would not be having adequate assets to convert them into cash, and pay the liabilities.

(b) Quick ratio (Acid test ratio)

This is another ratio used to test the **liquidity position** of a company.

$$\text{Quick ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

Where quick assets is calculated as:

$$\text{Quick assets} = \text{Current assets} - \text{Inventory}$$

The conversion of inventory into cash can take a considerable amount of time. That is why inventory is deducted.

This ratio helps decide whether the **quick assets of a company will be able to generate sufficient cash to pay off the current liabilities as and when they fall due.**

Example

(Amounts in Tshs'000)
Referring to the financial statements of Air Ltd the quick ratio is calculated as follows:

	20X7 Tshs'000	20X8 Tshs'000
Trade receivables	32,500	20,500
Cash	-	600
Total quick assets	**32,500**	**21,100**
Total current liabilities	**40,600**	**35,000**
Quick ratio	32,500/40,600	21,100/35,000
	= 0.80:1	**= 0.60:1**

This means that Air Ltd has Tshs600 of quick assets for each Tshs1,000 of liabilities. Furthermore there is deterioration in the company's liquidity position during 20X8, when compared to the last year. This is not a good position to be in since, when the liabilities fall due, the company will not have adequate liquid assets to convert into cash and thereby pay the liabilities.

Important

The **higher the current ratio** and **the quick ratio**, the better the cash flow of the company. As a conventional rule a current ratio of 2:1 is considered to be satisfactory. The logic is that even in a worse situation if the value of assets becomes half, the entity will still be able to meet its obligation. However an arbitrary ratio of 2:1 should not be blindly followed since it also depends upon the industry in which a firm operates.

Warning: high liquidity could indicate that the company is not able to invest its cash into more profitable investments. Hence absolute ratios have no meaning, unless they are compared with the past performance of the company or the industry average.

2. Working capital efficiency ratios

This set of ratios help us **analyse how efficiently the assets of a company are being used in generating revenue.**

(a) Total asset turnover

It **shows how much revenue is generated by each Tshs worth of assets (or each $ worth of asset)** and is calculated as:

This calculation is not expressed as a percentage but as number of times.

$$\text{Asset turnover} = \frac{\text{Sales revenue}}{\text{Total assets}} \text{ (times p.a.)}$$

This ratio can be further split to calculate:

$$\text{Non-current asset turnover} = \frac{\text{Sales revenue}}{\text{Non-current assets}} \text{ (times p.a.)}$$

$$\text{Current asset turnover} = \frac{\text{Sales revenue}}{\text{Current assets}} \text{ (times p.a.)}$$

Example

(Amounts in Tshs'000)
Referring to the financial statements of Air Ltd the asset turnover ratio is calculated as follows:

	20X7	20X8
	Tshs'000	**Tshs'000**
Sales	**290,000**	**350,000**
Non-current assets	20,000	27,000
Current assets	56,500	42,100
Total assets	**76,500**	**69,100**
Asset Turnover is	290,000/76,500	350,000/69,100
	= 3.79 times	**= 5.06 times**
Non-current Asset Turnover is	290,000/20,000	350,000/27,000
	= 14.50 times	**= 12.96 times**
Current Asset Turnover is	290,000/56,500	350,000/42,100
	= 5.13 times	**= 8.31 times**

The fall in the ratio during 20X8 as compared to 20X7 is mainly on account of the significant fall in the current assets (25%) during 20X8.It indicates that Air is not utilising its assets efficiently

Important

The **higher the ratio, the more efficiently the assets are being used to generate revenues.**

(b) Inventory turnover

It is also referred to as **Stock Turnover Ratio**. The Inventory Turnover ratio is expressed with reference to cost of sales and is calculated as:

This is another turnover ratio, so the calculation is expressed as number of times. Also the numerator is not sales!

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventory}} \text{ (times p.a.)}$$

This indicates how many times the inventory is being turned over in a year.

Example

(Amounts in Tshs'000)
Referring to the financial statements of Air Ltd the inventory turnover ratio is calculated as follows:

	20X7	20X8
	Tshs'000	**Tshs'000**
Cost of sales	260,000	320,000
Inventory	24,000	21,000
In this example:		
Inventory Turnover is	260,000/24,000	320,000/21,000
	10.83 times	**15.24 times**

The increase in the ratio during 20X8 as compared to 20X7 is mainly on account of reduction of inventory although the cost of sales has risen.

Important

The higher the ratio, the more quickly inventory is being sold.

Remember, **this ratio has the word period, which means you need to multiply it with 365.**

The Inventory Turnover ratio can also be reversed to find the number of days of inventory that has been held in the warehouse.

$$\text{Inventory turnover period} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

Example

Continuing with the previous example of inventory turnover (no of times)

(Amounts in Tshs'000)

	20X7	**20X8**
Inventory turnover period is	$\frac{24,000}{260,000} \times 365$	$\frac{21,000}{320,000} \times 365$
	= 34 days	**= 24 days**

Important

The **lower the number of days,** the more quickly inventory is being sold.

Tip

The above ratios have been calculated using the figures at year end. Since the level of inventories fluctuate over the year, average figures of inventory will give a more realistic ratio. To determine the average inventory, the amount of inventory at the beginning and end of the period are considered.

In the above example, inventory turnover of Air Ltd using average inventory figures for 20X8 will be:

$$\text{Average Inventory} = \frac{\text{Tshs}24,000 + \text{Tshs } 21,000}{2} = \text{Tshs}22,500$$

$$\text{Inventory Turnover period} = \frac{\text{Average inventory}}{\text{Cost of sales}} \text{ x } 365 \text{ days}$$

$$= \frac{\text{Tshs}22,500}{\text{Tshs}260,000} \text{ x } 365 \text{ days} = 32 \text{ days}$$

(c) Receivable days

It is also referred to as **Debtor's collection period**. This reflects the **number of days it takes for a customer to pay**. It is calculated as:

$$\text{Receivable days} = \frac{\text{Receivable}}{\text{Credit sales}} \times 365 \text{ days}$$

This ratio can also be calculated using average receivables. It reflects the number of days it takes for an average customer to pay. In other words the receivables collection period provides an indication of the efficiency of the debt collection process.

Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the receivable days is calculated as follows:

Assume that the entire amount of sales during the year is on a credit basis. The following information is available from the financial statements:

	Tshs'000
Trade receivables as of 31 March 20X7	32,500
Trade receivables as of 31 March 20X8	20,500
Credit sales for year ended 31 March 20X8	350,000

The receivables days would be: (Amounts in Tshs'000)

$$\text{Receivables days} = \frac{\text{Average receivables}}{\text{Credit sales}} \times 365$$

$$= \frac{26,500}{350,000} \times 365$$

$$\frac{\text{Tshs}32,500 + \text{Tshs}20,500}{2}$$

= 27.63 days

Important

The **lower the number of days,** the faster is the recovery of receivables.

(d) Payable days

It is also referred to as **Creditor's payment period**. This reflects the **number of days it takes for a company to settle its bills.** It is calculated as:

$$\text{Payable days} = \frac{\text{Payables}}{\text{Credit purchases}} \text{ x } 365 \text{ days}$$

This ratio can also be calculated using average payables. In that case it reflects the number of days it takes on average for a company to settle its bills.

Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the payables days is calculated as follows:

Assume that the entire amount of purchases (cost of sales) during the year is on a credit basis. The following information is available from the financial statements:

	Tshs'000
Trade payables as of 31 March 20X7	25,000
Trade payables as of 31 March 20X8	35,000

Opening inventory + Purchase – Closing inventory = cost of sales

Tshs24,000 + Purchase – Tshs21,000 = 320,000

Therefore Purchases = 317,000 (assumed entirely to be credit purchase)

The payables days would be:

$$\text{Payables days} = \frac{\text{Average payables}}{\text{Credit purchase}} \times 365$$

$$= \frac{30,000}{317,000} \times 365$$

= **35 days**

Important

The greater the number of payable days, the better it is for the company as it provides a source of free finance to the company. An ideal strategy would be to defer the payables for as long as possible. But it should be borne in mind that the company may not get any cash settlements or discounts from suppliers. Also excessive delays in payment may also hamper the trade relations with the suppliers.

3. Investor performance ratios

These ratios help the investors to take decision regarding investing in a company.

(a) Earnings Per Share (EPS)

EPS is the amount which an entity has earned per share for the given period.

Definition

Basic earnings per share shall be calculated by dividing **profit or loss attributable to ordinary equity holders of the parent entity** (the numerator) by **the weighted average number of ordinary shares outstanding** (the denominator) during the period.

IAS 33, Para 10

$$\text{Earnings per share} = \frac{\text{Profits available for distribution to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding}}$$

Remember: Profit available for distribution to ordinary shareholders = Profit after interest and tax – Preference dividend

Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the earnings per share for 20X8 is calculated as follows:

	Tshs'000
Profits after interest and tax	9,600
Preference dividend	(600)
Profits available for distribution to ordinary shareholders	**9,000**
Number of shares of Tshs1,000 each	9,000 shares

$$\text{Earnings per share} = \frac{\text{Profits available for distributi on to ordinary shareholde rs}}{\text{Number of share}}$$

$$= \frac{\text{Tshs9,000, 000}}{\text{9,000 shares}} = \text{Tshs1,000}$$

This means that each share earns a profit of Tshs1,000.

Important

The higher the ratio the better it is for the investor.

(b) Price / Earnings ratio (P/E)

This ratio helps assess the relative risk of an investment. It is calculated as:

$$\text{Price / Earnings ratio} = \frac{\text{Current market price per share}}{\text{Earnings Per Share}}$$

Example

If the current market price of the shares of Air Ltd is Tshs1,750 and the earnings per share is Tshs1,000 then:

P/E ratio = 1,750/1,000 = 1.75

Important

The **higher the ratio** the better it is. This means that the shareholders have **more confidence** in the **company's ability to increase EPS. Hence the shareholders' investments are less risky.**

(c) Dividend yield

Dividend yield ratio measures the return on capital investment as a percentage of market prices. It is calculated as:

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$

Example

Referring to the financial statements of Air Ltd the dividend yield is calculated as follows:

The market price per share is Tshs1,750.

Number of shares 9,000

Dividend Tshs900,000 + Tshs600,000 = Tshs1,500,000

Dividend per share = Tshs167 (Tshs1,500,000/9,000)

$$\text{Dividend retention ratio} = \frac{\text{Tshs167}}{\text{Tshs1,750}} \times 100 = 9.54\%$$

Tip

The dividend yield is the return a shareholder expects currently on his investment. **The lower the ratio, the lower the return he expects.**

Warning:

The parameters used for calculating the numerator and denominator are highly subjective in nature.

It is possible that the **management** may declare a **low dividend** in spite of the company making **a sufficient amount of profit** as it wishes to **retain the profits for expansion purposes.**

Conversely, management could declare a **high dividend** in spite of the company **not making sufficient profit** as it wishes to **maintain the level of dividend** declared in previous years.

The **market price** is influenced by **factors** beyond the **control of the company**.

Example

Continued with the previous example of Air Ltd

If the management paid a dividend of Tshs2,000,000 instead of Tshs1,500,000 then the dividend yield would have been12.7% as follows:

Dividend per share = Tshs222.22 (2,000,000/9,000)

$$\text{Dividend Yield} = \boxed{\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100}$$

$$= \frac{\text{Tshs222.22}}{\text{Tshs1,750}} \text{ x } 100 = 12.7\%$$

This shows that, in spite of the fact that the dividend yield could have been better (12.7%), the **management decision to retain funds** has led to a lower Dividend Yield of 9.71%.

4. Financial risk ratios

These ratios help determine the stability of the company and the ability of the company to repay its long-term debts.

(a) Capital gearing ratio

This ratio is an important measure of the company's risk and stability because it expresses the relationship between a company's borrowings and its own funds. It is calculated as:

Use this formula for calculating the ratio unless otherwise specified.

$$\boxed{\text{Capital gearing ratio} = \frac{\text{Total long-term debt}}{\text{Shareholders' funds}} \times 100}$$

Tip

Total long-term debt includes all items that have to be classified as debts according to the requirements of IAS 32 and IFRS 9. Debts include long-term borrowings, debentures and redeemable preference shares.

Shareholders' funds include all items that have to be classified as equity according to the requirements of IAS 32 and IFRS 9. Shareholders' funds include equity share capital, irredeemable preference shares, and reserves.

Example

Referring to the financial statements of Air Ltd the capital gearing ratio for 20X8 is calculated as follows:

$$\text{Capital gearing ratio} = \frac{\text{Total long-term debt}}{\text{Shareholders funds}} \times 100$$

Long term debt = Tshs6,000,000 + Tshs11,000,000 = Tshs17,000,000

Shareholders funds = Tshs15,000,000

$$= \frac{17,000,000}{15,000,000} \text{ x } 100 = 113.33\%$$

The capital gearing ratio can also be calculated as a relation between the long-term debts and the total long-term funds (equity + long-term debts) of a company. This is calculated as:

$$\text{Capital gearing ratio} = \frac{\text{Total long-term debt}}{\text{Shareholder's funds + Long-term debt}} \times 100$$

In this case, the capital gearing ratio shows how much long-term borrowing the company has for every Tshs100 of shareholders' funds and long-term debt taken together.

Test Yourself 4

The following information is available for Cell Ltd:

	Tshs'000
Ordinary share capital	450,000
8% non-redeemable preference share capital	100,000
Debentures	100,000
Long-term borrowings	400,000
Bank overdraft	50,000
Reserves	125,000

Required:

Calculate the capital gearing ratio showing the relation between long-term debt and total long-term funds (Equity + Long-term debt) of Cell Ltd.

Important

There can be no rule of thumb or limit for this ratio. It has to be analysed keeping in mind the circumstances under which a company operates.

The **higher the ratio, the more geared the company is**. This means that it **relies heavily on debts for conducting its business.** This is fine for a company which is **certain of making consistent profits and has an adequate asset base to offer as security**. The profit available for distribution to shareholders depends upon the level of borrowings as fixed amount have to be paid as interest due to which less profit is available for distribution to shareholders.

A **high capital gearing ratio** is suitable for a company which have a good asset base to backup as security.
For example a hotel or a car manufacturer has tangible assets which they can use as security and thus can prefer a high capital gearing ratio.

A **low capital gearing ratio** is suitable for companies which have **erratic sales / erratic profits and an insufficient asset base**. For example, companies in the consultancy business do not have tangible non-current assets as security. Their main assets are their manpower resources which they own.

Example

Consider the following information pertaining to Hope and Wish Company:

	Company Hope	Company Wish
Gearing ratio	40%	60%
	Tshs'000	**Tshs'000**
Case 1		
PBIT	60,000	60,000
Interest	(20,000)	(35,000)
Profit after interest	40,000	25,000
Tax at 30%	(12,000)	(7,500)
Profit after tax (available for distribution among shareholders)	**28,000**	**17,500**

Continued on the next page

Case 2		
PBIT	50,000	50,000
Interest	(20,000)	(35,000)
Profit after interest	30,000	15,000
Tax at 30%	(9,000)	(4,500)
Profit after tax (available for distribution among shareholders)	**21,000**	**10,500**
Conclusion (Case 1 versus Case 2)		
Fall in PBIT	10,000	10,000
In % terms	**(17)%**	**(17)%**
	(10,000/60,000 x 100)	(10,000/60,000 x 100)
Fall in profit after tax (available for distribution among shareholders)	7,000	7,000
In % terms	**(25)%**	**(40)%**
	(7,000/28,000 x 100)	(7,000/17,500 x 100)

This shows that the **more geared a company is,** the **more volatile will be the profits available for distribution among the shareholders.** This is primarily because interest paid on borrowed funds is tax-deductible expenditure. Furthermore, a company having a high capital gearing may also find that no banks are willing to lend it any more funds, as it has too much debt. The worry is that it will not be able to pay the loan interest or capital.

(b) Interest cover

This indicates how many times the profit covers the interest charge. It is calculated as:

$$\text{Interest cover} = \frac{\text{Profit before interest and tax (operating profit)}}{\text{Interest expenses}}$$

Example

Referring to the financial statements of Air Ltd the interest cover for 20X8 is calculated as follows:

	Tshs'000
Profit before interest and tax	15,000
Interest	3,000
Interest Cover	15,000/3,000
	= 5 times

Important

The **higher the ratio** the better; the **company is in a better position to pay the fixed charge of interest.**

2.3 Analysis and interpretation of financial statements with the help of financial ratios

Analysis of financial statements includes conducting a 'vertical' analysis of them by **expressing relevant figures as a percentage of one key figures.**

If the statement of profit or loss is to be analysed, then usually the **key figure is sales revenue**, and the other figures are expressed as a percentage of this. A vertical analysis of the statement of profit or loss **helps identify the causes of increase or decrease in profits assessed against sales revenue.**

If the statement of financial position is to be analysed, then usually the **key figure is total assets or total debts or total equity**. A vertical analysis of the statement of financial position helps analyse the efficiency of the management in using its total assets, as well as the liquidity and the capital gearing of the company.

Example

The following information is available for Summer Inc:

	Tshs'000	Tshs'000
Sales revenue		400,000
Cost of sales		(250,000)
Gross profit		150,000
Selling expenses		
Transportation	25,000	
Advertisement	45,000	
Bad debts	40,000	(110,000)
Administration expenses		
Salaries	50,000	
Office expenses	76,000	(126,000)
Operating profit / (loss)		(86,000)
Depreciation		(25,500)
Net profit / (loss)		**(111,500)**

(Amounts in Tshs'000)

A vertical analysis of these figures reflects the following:

$$\text{Gross Profit Margin} = \frac{\text{Gross profit}}{\text{Sales revenue}} \text{ x } 100$$

$$= \frac{150{,}000}{400{,}000} \text{ x } 100$$

= 37.5%

$$\text{Operation Profit Margin} = \frac{\text{Operating profit}}{\text{Sales revenue}} \text{ x } 100$$

$$= \frac{(86{,}000)}{400{,}000} \text{ x } 100$$

= (21.5%)

This analysis shows that the **selling and distribution expenses are quite high** and are **affecting profitability.** This analysis could be further continued to express each expense against sales revenue.

Vertical analysis by itself is **insufficient** to serve the purpose of ratio analysis and interpretation. This is because there is no other set of ratios against which these ratios can be compared. Hence it may **not be able to pinpoint 'cause and effect' relationships.**

In the above example, we know that the gross profit ratio of Summer Inc for the current year is 37.5% and that its operating profit ratio is 21.5%.

However, **we have no clue** whether this is more or less than the gross profit ratio and operating profit ratio of

Summer Inc in previous years
the competitors of Summer Inc
the industry average

Hence, **we are unable to decide** whether Summer Inc needs to control its cost of sales or its selling and distribution expenses in order to reduce its losses and eventually make profits.

For ratio analysis to be of any use, it becomes **necessary to compare one set of financial ratios with another set of ratios.**

Such a comparison will have to be done as per the demands of the situation keeping in mind the rules of thumb for analysis purposes and warnings listed above.
The broad guidelines which have to be kept in mind while making such comparisons are listed below:

1. While comparing an entity's performance and financial position with its previous period's financial statements, it is essential to assess the impact of the following events and make necessary adjustments /allowances if necessary.

a) Changes in the economic conditions of society at large
b) Changes / current trends in the industry within which the entity operates
c) Any large scale disposal or purchase of non-current assets, especially towards the end of any year
d) Any new issue of equity / debt, especially towards the end of any year
e) Unusual events such as a fire in the factory leading to unusual losses in the current year.
f) Unusual / seasonal events leading to unusual profits in the current year.

2. When comparing an entity's performance and financial position with another similar entity for the same reporting period, it is still essential to assess the impact of all events listed at (i) to (vi) above.

However, you also need to take into account differences between the entities and make relevant adjustments. Some are mentioned below:

differences in size and scale of operations
equity capital
differences in management thoughts and goals
inherent **advantages / disadvantages**

Example

Coal Inc and Diamond Inc are both involved in the manufacture of electronic goods.

On a sales turnover of Tshs5,000,000, Coal Inc has a gross profit ratio of 40% while Diamond Inc has a gross profit ratio of 25% on a sales turnover of Tshs50,000.

The reasons for Coal Inc's higher ratio could include better bargaining power because of the large scale of operation or lower fixed costs per unit sold.

It would be unfair to expect Diamond Inc to operate at this level of efficiency.

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3. In situations such as in the example above, it would be more beneficial for the management of Diamond Inc to compare its ratios with the industry average ratios.

This is **because industry average ratios are calculated across the cross-section of the industry and would be a better yardstick**. However, it should be remembered that all types of companies – big and small, prosperous and failing – are considered when arriving at an industry average.

Hence the **ratios depend upon the characteristics of those companies which constitute the majority in the industry**.

Example

Glitter Inc is in the candle-making industry. This industry comprises mainly of small-scale businesses, so the industry average will have an influence of norms for industries of that size.

The average gearing ratio of this industry is 30%.

However, Glitter Inc is a large-scale candle-maker exporting more than 75% of its produce. It relies heavily on borrowings and its gearing ratio is 60%.

In this case, even though the gearing ratio of Glitter Inc is way above the average gearing ratio of 30%, it could be correct for the scale of operations at which Glitter Inc performs.

While comparing an entity's performance and financial position with industry average ratios, it is essential to make allowances for any situations which **specifically affect the company** and which other companies in the industry may not have to face / may not benefit from.

4. In practice, a combination of all the types of assessments explained above are undertaken while analysing **an entity's performance and financial position** with the help of financial ratios. However, it should be remembered that the results derived from such an analysis are highly subjective and will differ from situation to situation.

Test Yourself 5

If you are asked to analyse financial data of a company on behalf of a prospective lender of funds, which ratios will you use for your analysis?

2.4 Other techniques of financial statement analysis

We have already discussed ratio analysis in detail in the previous paragraphs. Let us see some popular techniques used in the analysis of financial statements**.**

1. Vertical analysis

Vertical analysis of a financial statement identifies the relationship of each item to its base amount (base amount is assumed to be 100%). Every other item on the financial statement is computed as a percentage of that base. This is also referred to as **common-size percentage based technique.**

Vertical analysis is already discussed previously in this Study Guide.

2. Horizontal analysis

Horizontal analysis spotlights trends and establishes relationships between items that appear on the same row of a comparative statement. Horizontal analysis discloses changes on items in financial statements over time. Each item (such as sales) on a row for one fiscal period is compared with the same item in a different period. Horizontal analysis can be carried out in terms of changes in dollar amounts, in percentages of change, or in a ration format. A sample horizontal analysis is given below for your understanding.

	Tshs'000	**Tshs'000**	**Tshs'000**	**%**
	2012	**2011**	**Amount**	
Shareholders' equity				
Share capital	200,000	200,000	-	-
Retaining earnings	205,200	186,500	18,700	10%
Total stockholders' equity	**405,200**	**386,500**	**18,700**	**5%**

3. Industry comparison

This involves comparison of ratios of a firm with similar firms or with industry averages. The intention behind these comparisons is to determine whether the firm is performing well as compared to its competitors. Industry averages can be obtained from firms involved in similar research, professional articles, membership of trade associations, etc. This is also referred to as **comparative analysis.**

4. Trend analysis

Trend analysis involves comparison of a firm's present ratio with its past and expected future ratios to determine whether the company's financial position is improving or deteriorating over time. Horizontal analysis is an example of trend analysis. This is also a type of comparative analysis.

A horizontal analysis involves comparing financial ratios or line items in a financial statement over a period of time. The time analysed is generally chosen based on the purpose of analysis. This technique is also referred to as comparative analysis.

For example, management takes decision based on whether sales are increasing. But considered alone, this fact may not be very helpful. The information that may be pertinent is

(i) Whether the sales have increased compared to the last year?
(ii) If so, by how much percentage has it increased?

This study of percentage changes in comparative statements is called horizontal analysis.

Example

The following is the information available of Longhorn Ltd for the years 20X6 and 20X7:

	20X6	20X5	Percentage of increase or decrease
	Tshs'000	Tshs'000	
Sales	240,000	200,000	20%
Cost of Goods Sold	147,900	108,000	37%
Selling Expenses	40,100	22,000	82%
Admin Expenses	24,000	28,000	(14)%
Interest Expenses	6,000	12,000	(50)%
Total Expenses	**(218,000)**	**(170,000)**	28%
Income before taxes	22,000	30,000	(27)%
Income taxes expense	(6,000)	(8,000)	(25)%
Net Income	**16,000**	**22,000**	(27)%

By performing a horizontal analysis it becomes relatively very easy to identify areas of wide divergence that require further attention. It can be observed that the sales have increased by 20%, inspite of which the net income has declined by 27% during the year 20X6. This should be a cause of concern to the company. The reason behind this is that the in the year 20X6 the company incurred heavy selling expenses. Also it appears that the there was an increase in the price of goods purchased without any corresponding increase in selling price. Thus a horizontal analysis helps to locate the problem areas.

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3. Identify limitation of financial ratios.

[Learning outcome d]

Limitations of ratios analysis

A lot of problems are encountered while using the tool of ratio analysis for assessing the performance of an entity. Some of these problems are as follows:

1. Ratio analysis is **not a very useful tool to determine the future prospects of an entity**. This is because ratio analysis is generally performed on historical data. Also the future prospects of the company depend on various assumptions made by an entity, relating to sales forecast, investments to be made, etc. Furthermore there is a time lag between the period of the financial statements and the time when the financial statements are published and available for analysis. This would make the ratio analysis outdated.

2. The **ratios can be distorted** due to inflation, use of different bases for valuing assets, or specific price changes. These shortcomings are basically **on account of the limitations of historical cost accounting**.

3. **Changes in the accounting policies** and practices of a company **and differences in accounting policies and practices between two entities** may lead to an incorrect comparison of ratios.

Example

If there is a change in method of depreciation from straight line to reducing balance, the ratios which are calculated using these figures would also be affected. Another example is the difference in the basis of valuation of inventory (LIFO, FIFO or weighted average).

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4. Companies may have **different accounting periods,** due to which ratio analysis in which the performance of these companies are compared may not be realistic.

5. There are **differences of opinion regarding the various variables used** to compute ratios. For example, the capital gearing ratio can be calculated as a relation between the long-term debts and:
   - the total long-term funds (equity + long-term debts) of a company, or
   - the shareholders' funds of a company.

6. Entities sometimes apply **creative accounting** in order to show a good financial performance or position which can be misleading to the users of financial accounting. At such times, ratio analysis may not show the correct position.

7. Ratio analysis in which the performance of an entity is compared with the industry average may not be possible if the information relating **to industry average not available**.

8. Ratio analysis is also subject to inherent limitations of ratios. As discussed earlier, ratios are arrived at by dividing one financial item by another. If there is any extraordinary movement in any financial item, or if the amounts are not spread evenly throughout the period, then the ratios derived from using such an item will not reflect the true position of the entity, and decisions based on these ratios will be incorrect.

Example

Receivable Days are arrived at by using the formula:

Receivable Days = Receivables/Credit sales x 365 days.

This assumes that the sales are spread evenly throughout the year.

If the credit sales for the year ending December 20X7 are Tshs365 million and the receivables at that date are Tshs30 million, then the ratio is (Tshs30 million/Tshs365 million) x 365 = 30 days.

However, if it is a company dealing in greeting cards and of the annual sales of Tshs365 million the credit sales in December are Tshs120 million, then actually the ratio is (Tshs30 million/Tshs120 million) x 30 days) = 7.5 days.

Test Yourself 6

The following ratios have been obtained from the financial statements of Lab Inc:

	20X5	20X6
Net Profit Margin	25.00%	20.00%
Return on Capital Employed	28.50%	22.00%
Capital Gearing ratio	85.00%	92.00%

Required:

(a) Comment on the performance of the company.
(b) Would your answer change if you were informed that a major fire broke out at the premises of Lab Inc in 20X6?
(c) How does this example show the limitations of financial ratios in analysing corporate performance?

Answers to Test Yourself

Answer to TY 1

The correct option is **D**.

Quality of products and services are not considered in financial statements analysis.

Answer to TY 2

The correct option is **B**.

Answer to TY 3

(Amounts in Tshs'000)

Return on assets = $\frac{\text{Operating profit}}{\text{Total assets}} \times 100$

$$= \frac{\text{Tshs}125{,}300}{\text{Tshs}590{,}000} \times 100 = 21.23\%$$

This means that assets worth Tshs100 generate operating profits of Tshs21.23.

Alternatively return of assets can also be calculated as follows:

Return on assets = $\frac{\text{Operating profit}}{\text{Sales revenue}} \times 100$

$$= \frac{\text{Tshs}125{,}300}{\text{Tshs}350{,}000} \times 100 = 35.8\%$$

This means that sales revenue of Tshs100 generates an operating profit of Tshs35.80.

Asset turnover = $\frac{\text{Sales revenue}}{\text{Total assets}}$ (times p.a.)

$$= \frac{350{,}000}{590{,}000} = 0.59$$

This means that assets worth Tshs100 generate sales revenue of Tshs59.

Return on assets = Operating profit margin x Asset turnover
= 35.8% x 0.59 = 21.12%

Interpretation

The ROCE of 21.12% in the current year is lower than the ROCE for the previous year.

This could be on account of additions made to the assets. Some of the assets which have been freshly introduced may take a long time to generate optimal returns. Also another reason could be that the management has not been able to use the assets efficiently.

The **higher the ratio,** the **more efficiently the assets are managed**. This implies that the entity is generating optimum profits from the available resources. Hence the fall in the ratio during 20X8 as compared to 20X7 would be a cause of concern to the company since the investors may withdraw their investment from the company if they get a better return in the market.

Answer to TY 4

The 8% irredeemable preference share capital is to be classified as debt because, although the preference shares are non-redeemable, they carry a fixed interest charge. (The substance of the transaction is given more importance than its form).

In the absence of information, it is assumed that the bank overdraft is a short-term debt and is not to be included in the long-term debts.

	Tshs'000
Long-term debt	
8% non-redeemable preference share capital	100,000
Debentures	100,000
Long-term borrowings	400,000
Total long-term debt	**600,000**
Shareholders' funds	
Ordinary share capital	450,000
Reserves	125,000
Total shareholders' funds	**575,000**
Total long-term funds	
Total shareholders' funds	575,000
Total long-term debt	600,000
Total long-term funds	**1,175,000**

Shareholders' funds + Long-term debt

$$\text{Capital gearing ratio} = \frac{\text{Total long-term debt}}{\text{Shareholders' funds} + \text{Long-term debt}} \times 100$$

$$= \frac{\text{Tshs600,00 0}}{\text{Tshs1,175, 000}} \text{ x } 100$$

$$= 51.06\%$$

Answer to TY 5

A potential lender of funds will be primarily interested in knowing whether the company is in a **position to repay his loan along with interest.** For this purpose, he will be interested in **the Interest Cover.**

He will also be interested in the **Capital Gearing**: if this is **too high,** then it will be **riskier for him to lend money.** In this case, he may **either not lend money or charge a higher rate of interest for the loan advanced.**

He will also be interested in assessing **the company's performance:** if it is not performing well, it will not be able to sustain its liquidity. For this purpose, he will be interested in the **Return on Capital Employed.**

Answer to TY 6

(a) The decline in Net Profit Margin can be attributed to a reduction in sales revenue or an increase in costs. The financial position of the company has suffered a setback, and this could lead to the eventual downfall of the company if this trend is not reversed. The decreased profitability has led to a decrease in the Return on Capital Employed. An increase in the Capital Gearing ratio suggests that there has been an increased dependence on long-term borrowings. An increase in interest costs on the increased borrowings could also be the cause of the decrease in profitability.

(b) Yes, the answer would change. The fire is an extraordinary event which has led to losses that will not be repeated in the next year. The increase in the Capital Gearing ratio suggests that there has been an increase in dependence on long-term borrowings. This could be perhaps in order to rebuild / repurchase assets. Of course, the impact of a major fire can be felt for more than one year but the performance and financial position of the company could revive once again. The true assessment of how the company has fared in 20X6 can be made only if the loss – both actual and opportunity cost – can be quantified and adjustments are made for this.

(c) The differences between answers (a) and (b) show the inherent weaknesses of financial ratios in analysing the performance of a company.

The fire in the premises of the company in 20X6 is not a regular occurrence – hence the loss on account of fire is an extraordinary item. Allowances and adjustments for this extraordinary item are essential for a reliable measurement of the performance of the company.

Ratio analysis on its own is not able to pinpoint the effects of such extraordinary items. Hence a blind trust in financial ratios will lead to incorrect analysis, interpretations and decisions. It is absolutely essential to obtain all possible information and make requisite changes to the ratios which are to be analysed.

Self Examination Questions

Question 1

The capital and reserves of Lamb, a limited liability company, are as follows:

	Tshs million
10% Loan notes	20
Share capital	25
Share premium account	15
Retained earnings	20

What is the company's gearing ratio?

A 20 / 25 x 100 = 80%
B 20 / 45 x 100 = 44·4%
C 60 / 20 x 100 = 300%
D 20 / 80 x 100 = 25%

Question 2

Which of the following factors could cause a company's gross profit percentage to fall below the expected level?

(i) Understatement of closing inventories.
(ii) The incorrect inclusion in purchases of invoices relating to goods supplied in the following period.
(iii) The inclusion in sales of the proceeds of sale of non-current assets.
(iv) Increased cost of carriage charges borne by the company on goods sent to customers.

A (iii) and (iv)
B (ii) and (iv)
C (i) and (ii)
D (i) and (iii)

Question 3

Which **of the following statements about accounting ratios and their interpretation are correct?**

(i) A low-geared company is more able to survive a downturn in profit than a highly-geared company.
(ii) If a company has a high price earnings ratio, this will often indicate that the market expects its profits to rise.
(iii) All companies should try to achieve a current ratio (current assets/current liabilities) of 2:1.

A (ii) and (iii)
B (i) and (iii)
C (i) and (ii)
D All three statements are correct

Question 4

The following is an extract from the statement of profit or loss of a business:

	Tshs'000	Tshs'000
Sales revenue		66,000
Opening inventories	15,000	
Purchases	45,000	
	60,000	
Less: Closing inventories	9,000	51,000
Gross profit		**15,000**

To the nearest day, how many days' sales are held in the closing inventories?

A 9,000 / 66,000 x 365 = 50 days
B 9,000 / 51,000 x 365 = 64 days
C 9,000 / 45,000 x 365 = 73 days
D 9,000 / 60,000 x 365 = 55 days

Question 5

A company's gross profit percentage on sales has decreased by 12% in 2010 compared with 2009.

Which one of the following could have caused the decrease?

A The level of sales in 2010 is higher than that in 2009
B There have been more bad debts in 2010 than in 2009
C Inventory at the end of 2010 is higher than that at the end of 2009
D Theft of inventory by staff and customers has increased.

Question 6

The following is the financial information pertaining to Flute Ltd:

Statement of profit or loss of Shell Inc for the year ended 31 December 20X6

	Tshs'000	**Tshs'000**
Sales turnover		250,000
Cost of sales		(130,000)
Gross profit		**120,000**
Administrative expenses	20,000	
Selling and distribution expenses	25,000	
Net interest payable	8,000	(53,000)
Profit before tax		**67,000**
Tax		(20,100)
Profit after tax		**46,900**

Statement of financial position at 31 December 20X6

	Tshs'000	**Tshs'000**
Non-current assets		
Tangible assets	411,750	411,750
Current assets		
Inventory	45,500	
Receivables	52,500	
Cash	5,250	103,250
Total assets		**515,000**
Equity and liabilities		
Ordinary share capital (200,000 shares of Tshs1000)	200,000	
10% non-redeemable preference shares	100,000	
Accumulated profits	55,000	355,000
Non-current liabilities		
Loans from banks	125,000	125,000
Current liabilities		
Payables	15,000	
Bank overdraft	20,000	35,000
Total equity and liabilities		**515,000**

The following additional information is available:

1. Earnings Per Share is Tshs46,900,000/200,000 shares = Tshs234.5
2. The market price of the shares is Tshs4,000
3. Credit sales equal 75% of total sales
4. Credit purchases equal 60% of total purchases
5. No dividend was declared during the year
6. Opening inventory is Tshs30,000,000

Required:

Calculate the following ratios:

(i) Gross Profit Margin
(ii) Net Profit Margin
(iii) Asset Turnover
(iv) Inventory Turnover
(v) Current ratio
(vi) Quick ratio
(vii) Receivables days
(viii) Payables days
(ix) Return on assets
(x) Capital gearing ratio
(xi) Interest cover

Question 7

Comment upon the working capital management of Penguin Inc on the basis of the ratios given below:

	Apple Inc	Industry average
Inventory Turnover	26 days	35 days
Receivable Days	35 days	30 days
Payable Days	25 days	28 days

Question 8

Star Ltd has an issued and subscribed capital of 600,000 equity shares of Tshs12,000 each, fully paid up. The company's after tax profits for the year amount to Tshs79,800,000. The average present stock exchange price of the company's share is Tshs2,000. The P/E ratios of the four listed companies to be used for calculation, whose businesses are of a similar type to Star Ltd are:

Company	20X7	20X8	20X9
P Ltd	6.8	7.6	8.4
Q Ltd	7.8	7.1	8.1
R Ltd	7.4	6.8	7.0
S Ltd	5.0	5.9	6.1

Required:

Calculate the valuation of the business and the valuation per share based on the average P/E ratio of the industry.

Question 9

a) At December 31, 2014 a company's records show the following information:

	TZS '000
Cash	10,000
Account receivables	30,000
Inventory	80,000
Prepaid insurance	6,000
Non-current assets	200,000
Accounts payables	30,000
Notes payables due in 10 month	25,000
Wages payables	5,000
Long-term liabilities	70,000
Stockholder's (owner's) Equity	196,000

REQUIRED:

Calculate the following: (**Show all your workings).**

(i) Current ratio
(ii) Quick ratio
(iii) Working capital

b) List at least five factors in which analysis and interpretation of financial ratios depend.

Question 10

(a) List and describe five ratios which should be assessed when looking at the short term liquidity of a firm.

(b) You are to study the following financial statements for two furniture stores, Juakali and Bongo for the year ended 31st December 2015.

Statements of income and expenditure:

	Juakali		**Bongo**	
	TZS.	**TZS.**	**TZS.**	**TZS.**
Sales		555,000,000		750,000,000
Less: Cost of goods sold				
Opening stock	100,000,000		80,000,000	
Add: Purchases	200,000,000		320,000,000	
	300,000,000		400,000,000	
Less: Closing stock	(60,000,000	(240,000,000)	(70,000,000	(330,000,000)
Gross Profit		315,000,000		420,000,000
Less: Depreciation	5,000,000		15,000,000	
Wages, salaries and commission	165,000,000		220,000,000	
Other expenses	45,000,000	(215,000,000)	35,000,000	(270,000,000)
Net Profit		100,000,000		150,000,000
		=========		=========

Statement of financial position:

	Juakali TZS.	TZS.	Bongo TZS.	TZS.
Non-current assets				
Equipment at cost	50,000,000		100,000,000	
Less: Depreciation to date	40,000,000	10,000,000	(30,000,000	70,000,000
Current assets				
Stock	60,000,000		70,000,000	
Debtors	125,000,000		100,000,000	
Bank	25,000,000		12,500,000	
Current liabilities				
Creditors	(104,000,000)	106,000,000	(100,500,000)	82,000,000
Net total Assets		116,000,000		152,000,000
Financed by:				
Capitals				
Balance at start of the year		76,000,000		72,000,000
Add: Net Profit		100,000,000		150,000,000
		176,000,000		222,000,000
Less: Drawings		(60,000,000)		(70,000,000)
Total equity		116,000,000		152,000,000

REQUIRED:

Calculate the following ratios for each business:

(i) Gross profit as percentage of sales
(ii) Net profit as percentage of sales
(iii) Expenses as percentage of sales
(iv) Stock turnover
(v) Current ratio
(vi) Acid test ratio
(vii) Debtor/sales ratio

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **D.**

Gearing ratio = (Long term debt) / (shareholder's funds + long term debts) x 100

Answer to SEQ 2

The correct option is **C.**

Points mentioned under (iii) and (iv) do not affect the company's gross profit percentage on sales. However points mentioned under (i) and (ii) affect the company's gross profit percentage on sales.

Statement (iii) is incorrect, since inclusion of sale of non-current assets under sales will in fact increase the gross profit.

Statement (iv) is incorrect since cost of carriage outwards will be part of selling and distribution expenses and will therefore not affect the gross profits.

Answer to SEQ 3

The correct option is **C.**

Statement (iii) is inappropriate as although 2:1 is the generally accepted current ratio. However it depends on the industry norms. Therefore there is no fixed benchmark.

Statement (i) is correct. A highly geared implies that it relies heavily on debts for conducting its business. This means it has to pay a substantial finance costs. Therefore in case of decline in profits, a low-geared company will survive better than a highly-geared company.

Statement (ii) is also correct. When a company has a high price earnings ratio, this will often indicate that the market expects its profits to rise.

Answer to SEQ 4

The correct option is **B.**

Inventory turnover period = Inventory / cost of sales x 365

Answer to SEQ 5

The correct option is **D.**

The change in the level of sales, the level of inventory and the increase in bad debts have no impact on the gross profit margin. However theft of inventory indicates an increase in the cost of sales. Hence it affects the gross profit margin.

Answer to SEQ 6

(Amounts in Tshs'000)

(i) Gross Profit Margin

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

$$= \frac{\text{Tshs}120{,}000}{\text{Tshs}250{,}000} \times 100$$

= **48%**

(ii) Net Profit Margin

$$\text{Net profit margin} = \frac{\text{Net profit}}{\text{Sales revenue}} \times 100$$

Net profit = Tshs75,000 – (Tshs8,000 + Tshs20,100)

= **Tshs46,900**

$$\text{Net profit margin} = \frac{\text{Tshs46,900}}{\text{Tshs250,000}} \times 100$$

= **18.76%**

(iii) Asset Turnover

$$\text{Asset turnover} = \frac{\text{Sales revenue}}{\text{Total assets}} \text{ (times p.a)}$$

$$= \frac{\text{Tshs250,000}}{\text{Tshs515,000}}$$

= **0.49 (times p.a.)**

(iv) Inventory Turnover

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Average inventory}} \text{ (times p.a)}$$

$$\text{Average inventory} = \frac{\text{Tshs30,000} + \text{Tshs45,500}}{2}$$

= Tshs37,750

Inventory turnover

$$= \frac{\text{Tshs130,000}}{\text{Tshs37,750}}$$

= **3.44 (times p.a.)**

(v) Current Ratio

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$= \frac{\text{Tshs103,250}}{\text{Tshs35,000}}$$

= **2.95 i.e. 2.95: 1**

(vi) Quick Ratio

$$\text{Quick Ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

Quick Assets= Current assets – Inventory= Tshs103,250 – Tshs45,500= Tshs57,750

Quick Ratio

$$= \frac{\text{Tshs57,750}}{\text{Tshs35,000}}$$

= **1.65**

(vii)Receivable Days

$$\text{Receivable days} = \frac{\text{Average receivable s}}{\text{Credit sales}} \times 365 \text{ days}$$

Credit sales = 75% of total sales

= 75% x Tshs250,000= **Tshs187,500**

Receivable Days

$$= \frac{\text{Tshs52,500}}{\text{Tshs187,500}} \times 365$$

= **102 days**

(**Note**: In the absence of information, average receivables cannot be calculated.)

(viii) Payable Days

$$\text{Payable days} = \frac{\text{Payables}}{\text{Credit purchases}} \times 365$$

Purchases

Cost of sales = Opening inventory + Purchases – Closing inventory

Tshs130,000 = Tshs30,000 + Purchases – Tshs45,500
Purchases = Tshs130,000 + Tshs45,500 – Tshs30,000
= Tshs130,000 + Tshs15,500
= Tshs145,500

Credit purchases = 60% of total purchases
= 60% x Tshs145,500
= Tshs87,300

Payable Days

$$= \frac{\text{Tshs15,000}}{\text{Tshs87,300}} \times 365$$

= 63 days

(**Note:** in the absence of information, average payables cannot be calculated)

(ix) Return on Assets

$$\text{Return on assets} = \frac{\text{Operating profit}}{\text{Total assets}} \times 100$$

$$= \frac{\text{Tshs75,000}}{\text{Tshs515,000}} \times 100$$

=14.56%

(x) Capital gearing ratio

$$\text{Capital gearing ratio} = \frac{\text{Total long term debt}}{\text{Shareholde r's funds}} \times 100$$

Total long-term debt = Tshs100,000 + Tshs125,000 = **Tshs225,000**

Shareholders' funds = Tshs200,000 + Tshs55,000 =**Tshs255,000**

Capital gearing ratio

$$= \frac{\text{Tshs225,000}}{\text{Tshs255,000}} \times 100$$

= **88.23%**

(xi) Interest cover

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest}}$$

$$= \frac{\text{Tshs75,000}}{\text{Tshs8,000}}$$

= 9.38 times

Answer to SEQ 7

The Working Capital Cycle of Penguin Inc is 26 days + 35 days – 25 days = 36 days

The average Working Capital Cycle of the industry is 35 days + 30 days – 28 days = 37 days

This shows that Penguin Inc has a Working Capital Cycle which is of a slightly smaller duration than the industry average. This signifies that management is doing a good job of managing the working capital on a total basis. The Inventory Turnover and Payable Days are lesser than the industry average. Receivable Days are, however, higher than the industry norms. Management should try to get this down to the industry norms.

They also need to consider whether there have been any forced sales as Inventory Turnover is much lower than the industry average and Receivable Days are higher than the industry average.

Answer to SEQ 8

Calculation of average P/E ratio of four listed companies

Company	20X7	20X8	20X9	Company Average
P Ltd	6.8	7.6	8.4	7.60
Q Ltd	7.8	7.1	8.1	7.67
R Ltd	7.4	6.8	7.0	7.07
S Ltd	5.0	5.9	6.1	5.67
Total				**28.01**

$$\text{Average P/E ratio} = \frac{28.01}{4} = 7$$

$$\text{Earning per share} = \frac{\text{Profit after tax}}{\text{Number of equity shares}} = \frac{79,800,000}{600,000} = \text{Tshs}133$$

$$\text{P/E ratio of Star Ltd} = \frac{\text{Market price per share}}{\text{Earnings per share}} = \frac{2,000}{133} = 15.03$$

Value of share = Earnings per Share x Average P/E ratio = Tshs133 x 7 = Tshs931

Value of business = Total Earnings x Average P/E ratio = Tshs79.8 million x 7 = Tshs558.6 million

Answer to SEQ 9

(a) Workings

Total current assets:

Cash	Shs	10,000
Accounts receivables		30,000
Inventories		80,000
Prepaid insurance		6,000
		126,000

Total current liabilities:

Accounts payables	Shs	30,000
Notes payables in 10 month		25,000
Wages payable		5,000
		60,000

(i) Current ratio = $\frac{\text{Current Assets}}{\text{Current liabilities}}$

$\frac{126,000}{60,000}$ **2.1:1**

(ii) Quick ratio = $\frac{\text{Current Assets – Inventory}}{\text{Current liabilities}}$

$\frac{126,000 – 80,000}{60,000}$ = **0.77:1**

iii) Working capital = Current Assets – current liabilities

126,000 – 60,000 = **shs.66,000**

(b) Factors on which analysis and interpretation of financial rations depend include:
- The size of the business
- The state of the economy is inflations
- The policies of management
- The company philosophy
- The industry norms
- Government rules and regulations
- Seasonality
- Accounting period

Answer to SEQ 10

(a) The following ratios are useful in assessing the short-term liquidity of the firm:

(i) **Current ration** – measures the ability of the firm to meet needs for cash as they arise.

(ii) **Quick ratio** – measures short-term liquidity more rigorously than the current ratio by eliminating inventory, usually the least liquid current asset.

(iii) **Average collection period** – indicates the days required to convert receivables to cash.

(iv) **Accounts receivable turnover** – indicates how many times per year receivables are collected.

(v) **Inventory turnover** – measures the efficiency of the firm in managing and selling inventory.

(b)

	Juakali	**Bongo**
(i) Gross profit as % of sales	$\frac{315{,}000{,}000 \times 100}{555{,}000{,}000} = 56.8\%$	$\frac{420{,}000{,}000 \times 100}{750{,}000{,}000} = 56\%$
(ii) Net profit as % of sales	$\frac{100{,}000{,}000 \times 100}{555{,}000{,}000} = 18\%$	$\frac{150{,}000{,}000 \times 100}{750{,}000{,}000} = 20\%$
(iii) Expense as % of sales	$\frac{215{,}000{,}000 \times 100}{555{,}000{,}000} = 38.7\%$	$\frac{270{,}000{,}000 \times 100}{750{,}000{,}000} = 36\%$
(iv) Stock turnover	$\frac{240{,}000{,}000}{(100{,}000{,}000+60{,}000{,}000) \div 2}$ = 3 times	$\frac{330{,}000{,}000}{(80{,}000{,}000 + 70{,}000{,}000) \div 2}$ = 4.4 times
(v) Current ratio	$\frac{210{,}000{,}000}{104{,}000{,}000} = 2.02$	$\frac{182{,}500{,}000}{100{,}500{,}000} = 1.82$
(vi) Acid test ratio	$\frac{150{,}000{,}000}{104{,}000{,}000} = 1.44$	$\frac{112{,}500{,}000}{100{,}500{,}000} = 1.12$
(vii) Debtors/sales ratio	$\frac{125{,}000{,}000}{555{,}000{,}000} \times 12 = 2.7$ months	$\frac{100{,}000{,}000}{750{,}000{,}000} \times 12 = 1.6$ months