T07 ELEMENTS OF COMMERCIAL KNOWLEDGE AND TAXATION

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STUDY TEXT

T07

Accounting
Technician
Level II

THE NATIONAL BOARD OF
ACCOUNTANTS AND AUDITORS
TANZANIA (NBAA)

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T07

ELEMENTS OF COMMERCIAL KNOWLEDGE AND TAXATION

STUDY TEXT

NBAA

NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS

MSEMA KWELI

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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:-

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

- 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

STUDY TEXT CONTENTS

T07 – Elements of Commercial Knowledge and Taxation

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.

The examination will consist of

Three conventional question of 20 marks	60 marks
Twenty objective questions of 2 marks	40 marks
	100 marks

SECTION A

INTRODUCTION TO COMMERCIAL KNOWLEDGE

A1

STUDY GUIDE A1: INTRODUCTION TO COMMERCE

Get Through Intro

We all want to lead a happy and comfortable life. We need various goods and services to make our life prosperous and comfortable.

Every country desires to attain a high standard of living for its citizens. This is possible when goods and services needed by the people are adequately produced and are available at a cheap cost. This requires smooth flow of goods from the producers to the consumers. Business, commerce and industry play a vital role in making available these goods and services.

This study guide introduces you to the concept of business, commerce and industry. It also deals with the concept of trade and aids to trade.

Understanding these concepts is important for you as these concepts are the foundation for the understanding of the concepts discussed in the subsequent study guides of this book.

Learning Outcomes

a) Differentiate: business, commerce and industry.
b) Identify and state the divisions of commerce.
c) State the role of commerce in production and economy.

1. Differentiate: business, commerce and industry.
State the role of commerce in production and economy.
[Learning Outcomes a and c]

1.1 Business

Business, in simple terms, means an establishment engaged in production and or exchange of goods and services with the objective of earning profit.

The term business includes all activities that are necessary from the stage of production of goods and services to the stage of their distribution to final consumers.

The key characteristics of business are as follows:

1. Business involves production and distribution of goods and services

Every business activity aims at production of goods or provision of services and distribution of goods and services to ultimate consumers. Any activity involved in making the goods and services available to final consumer for a price can be considered a business activity.

2. Business deals in goods and services

Business activity is not possible unless either goods or services are involved. The goods involved in a business transaction may be either:

- Consumer goods: goods which are used by the final consumer for consumption are consumer goods e.g. car, chocolates etc.
- Capital goods: goods used by the manufacturer for further production of consumer goods are capital goods e.g. steel, machines, equipment etc.

Services created for business purpose are intangible services which are exchanged for value e.g. providing transport, warehousing, banking and insurance services, etc.

3. Business involves exchange of goods and services

All business activities involve exchange of goods or services for money or money's worth.

4. Business activities are continuous in nature

In business, the exchange of goods and services is a regular feature. A businessman regularly deals in a number of transactions and not just one or two transactions.

Example

If a person sells his used car then it is not a business as it is a one-off transaction. However, the activity of buying and selling of used cars by a dealer is a used-cars business.

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5. Business aims at profit

The primary aim of every business is earning a profit. The profit is a reward for the services of a businessman.

The amount of profit may change from transaction to transaction but the sale price of every product sold or services provided includes a profit margin for the businessman.

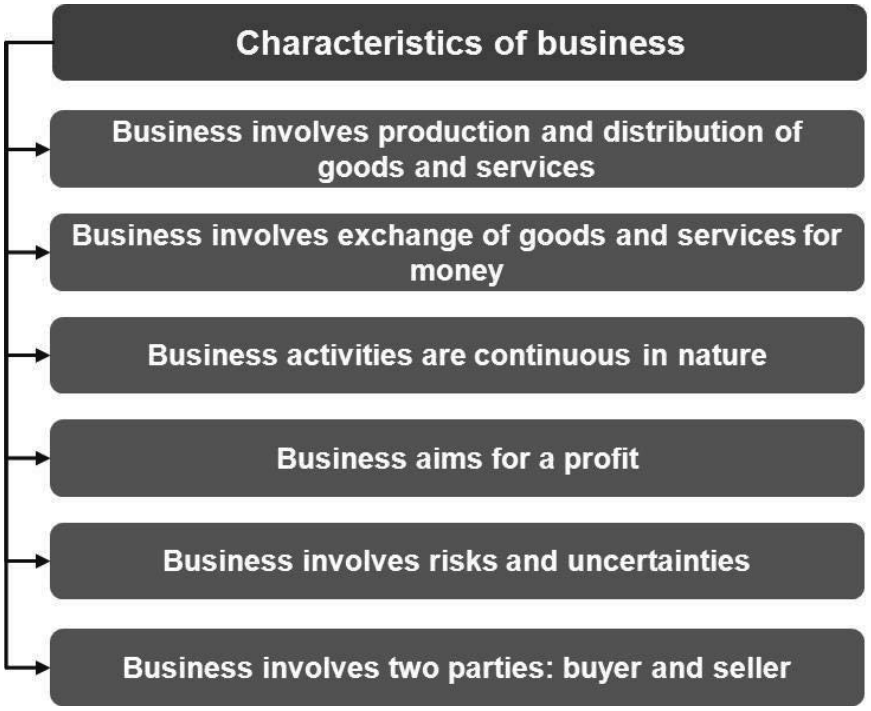
6. Business involves risks and uncertainties

Every business is subject to risks and uncertainties. Some risks, such as risks of loss due to fire and theft can be insured. There are also uncertainties, such as loss due to change in demand or fall in price cannot be insured and must be borne by the businessman. The intensity of the risk may be less or more but the risk cannot be altogether avoided.

7. Business involves two parties as buyer and seller

Business involves an exchange. Therefore, every business transaction needs minimum two parties i.e. a buyer and a seller. Business is an agreement between a buyer and a seller.

Diagram 1: Characteristics of business



1.2 Classification of business

Business includes all activities from the stage of purchase of raw material to making the goods available to final consumers. All these business activities can be further classified into:

1. Industry
2. Commerce

1. Industry

The term industry refers to that part of business which is engaged in manufacturing and production of goods and services.

Industry includes activities of production, conversion, processing, assembling, construction or extraction of products.

The outputs produced by industry are primarily of two categories:

- **Consumer goods:** goods used by final consumers are called consumers goods.

Example

The examples of consumer goods are cloth, cars, cell phones – all the products that are directly used by the final consumer.

- **Capital goods:** goods used in the production of other goods are described as capital goods.

Example

The output produced by a steel plant is steel. This steel is a capital good which is then used in the production of various other goods such as cars, ships, machine tools, surgical equipment, construction etc.

Industries may be classified into three main types:

(a) Primary industry: these are industries which are concerned with nature. The natural resources are processed by these industries to bring them into a usable condition. Primary industry are further grouped into:

(i) Agriculture industry: it involves farming and cultivation of land.

(ii) Genetic Industry: these are industries which are engaged in reproduction and multiplication of plants and animals.

Example

Poultry farming, plant nursery, animal husbandry, sericulture etc.

(iii) Extractive industries: these are industries which are engaged in the supply of commodities extracted from earth e.g. mining.

(b) Secondary industry: these industries use the output of the primary industry as raw material and convert them into usable finished goods. Secondary industries are of two types:

(i) Manufacturing industry: these are industries which are engaged in the conversion of raw materials or semi-finished products into finished products.

Example

Textile mills convert cotton into yarn and yarn into fine cloth.

(ii) Construction industry: these are industries which are engaged in the construction of buildings, dams, bridges etc. It uses the products of the manufacturing industry such as steel, iron, cement etc.

(c) Tertiary industry: these are industries involved in the provision of services such as transportation, banking, insurance, etc.

2. Commerce

The term commerce refers to all activities connected with transferring goods and services from manufacturers to consumers. It refers to the economic system that constitutes an environment for business. It is the process of buying and selling at various scales and is categorised as wholesale, retail, import, export etc.

Commerce also includes all other activities such as storing, grading, packaging, banking, transporting, insuring, communicating, warehousing, etc. which facilitate or assist in buying and selling.

The main functions of commerce are to remove the barriers relating to:

- Persons: through trade distributors
- Place: through transportation and packaging
- Risk: through insurance
- Time: through warehousing and storage
- Knowledge: through salesmanship, advertising
- Finance: through banking, etc. arising in connection with the distribution of goods and services until they reach the consumers

Role of commerce in economy

The goods and services produced by the industry are of no use unless they are made available to the ultimate consumer. All the activities involved in the process of taking the goods produced by the industry and handing it over to the final consumer are commerce. Commerce bridges the gap between the producers and the consumers. Thus, commerce holds an important position in the economy.

It facilitates the buying and selling of goods and services and removes all the barriers in the process of distribution of goods and services.

Case Study

According to "Irish aid", the Irish Government's programme for overseas development:

Trade is central to economic growth of any country. Virtually every country that has achieved sustained economic growth has done so by opening up their economies. However, many low-income countries are still confronted by major obstacles in expanding and diversifying their trade.

Africa's share of global exports still remains low at 3%. Countries that miss out on the benefits of global trade are locked out of opportunities to benefit from international expertise, low-cost production inputs and much-needed technology.

In recognition of the important role of trade, economic growth and generating domestic revenues, Ireland supports a range of initiatives and programmes at national and international level aimed at strengthening the capacity of developing countries to expand and benefit from international trade.

(Source: http://www.dci.gov.ie/what-we-do/how-our-aid-works/supportingtrade/)

Summary of difference between business, commerce and industry

	Business	Industry	Commerce
Meaning	Business means an establishment engaged in production and or exchange of goods and services with the objective of earning profit.	The term industry refers to that part of business which is engaged in manufacturing and production of goods and services.	The term commerce refers to all activities connected with transferring goods and services from manufacturers to consumers.
Scope	Business includes all activities that are necessary from the stage of production of goods and services to the stage of their distribution to final consumers.	Industry includes activities of production, conversion, processing, assembling, construction or extraction of products.	Commerce includes activities such as storing, grading, packaging, banking, transporting, insuring, communicating, warehousing, etc. which facilitate or assist in buying and selling.

Test Yourself 1

Which of the following statements is not a characteristic of business?

A All businesses are involved in the production of goods.
B Businesses deal in goods and services.
C Businesses include frequent exchange of goods and services.
D The profit motive is an important distinguishing feature of business.

2. Identify and state the division of commerce.

[Learning Outcomes a and c]

Commerce refers to activities connected with transferring goods from manufacturers to consumers. Commerce can be divided into two divisions:

1. Trade
2. Aids to trade

These divisions are further explained in detail as follows:

2.1 Trade

Trade simply means buying and selling goods and services. Trade involves exchange of goods and services for money or money's worth. Trade is further divided into:

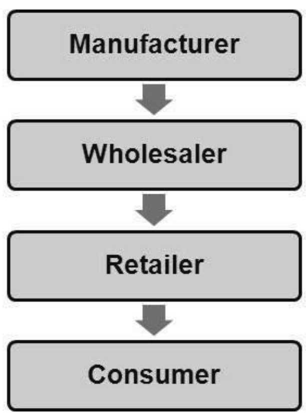
1. **Home trade:** buying and selling goods and services within the country. Home trade is further divided into wholesale trade and retail trade.

2. **International trade:** trade takes place between the buyer and seller of two different countries. International trade is further divided into import and export.

2.2 Aids to trade

It is not possible for the manufacturer to directly contact the consumers which are millions in numbers and are scattered at various places. Therefore, a chain of middlemen like wholesalers, retailers and other agents is needed to help the distribution of goods. The manufacturer manufactures the goods; these goods are then purchased by the wholesaler, the wholesaler then sell the goods to the retailer and the retailer sells the goods to the final consumer.

Diagram 2: Flow of distribution of goods



Thus there is a flow of the goods produced by the manufacturer to the final consumer. To ensure that this process of transfer of goods from the manufacturer to the final consumer is smooth, certain allied activities such as transportation, warehousing, banking, insurance, advertising etc. are required. These allied activities are aids to trade.

The key aids to trade are explained as follows:

1. Transportation

Goods produced by the producer are transported to the final consumer through various modes of transport such as road transport, rail transport, air transport and marine transport. Transportation also involves transport of goods from the place of high availability to a place of low availability or the place of low demand to the place of greater demand.

Example

The oil is transported from the gulf countries to various countries of the world using various modes of transport.

2. Warehousing

All the goods that are produced at one time are not consumed at the same time. There is a time gap between the production and consumption of goods as the production of goods usually takes place in the anticipation of demand and goods are produced during the period of less demand.

This makes it necessary to make adequate arrangements for storage of the goods in a warehouse so that those can be supplied during the period of higher demand.

Example

Agricultural products such as wheat and rice are produced only during a particular season; however, are consumed throughout the year. Therefore it is important that these products are properly stored to protect from adulteration. Certain other goods such as woollen clothes are produced throughout the year but are demanded only during particular seasons in the year. Therefore these goods need to be stored in warehouses till they are demanded.

---

3. Banking

Businesses deal in large amounts of money and it is unsafe to carry the cash from large transactions. Also, due to the time gap between the production and sale of goods, businesses need help to raise funds for investment to produce the goods. Banks fulfil this need by providing short term and long term funds to businesses. Businesses borrow funds from the bank, use these funds to manufacture the goods and then repay the funds to the banks when the products are ultimately sold and money is received.

4. Insurance

Businesses are exposed to risks of losses and failure. These are called business risks and include uncertainties such as losses due to fire, theft, accident etc. Insurance reduces this risk.

5. Advertisement

Advertisement provides information and knowledge about the products to the consumers. If the consumers are not aware of the availability of goods, this may create a barrier in the purchase of goods by the consumers. Advertisement helps remove this barrier of lack of information.

Test Yourself 2

Which of the following is not an aid to trade activity?

A Transportation
B Banking
C Production
D Insurance

Test Yourself 3

What is business risk?

Answers to Test Yourself

Answer to TY 1

The correct option is **A**.

All businesses are not necessarily involved in the production of goods.

Answer to TY 2

The correct option is **C**.

Answer to TY 3

The possibility of failure or loss in business is called business risk. The examples of business risk are loss due to fire or theft and possibility of falling prices in the market.

Self-Examination Questions

Question 1

What is the difference between industry and commerce?

Question 2

The industry that is concerned with converting raw material into finished products is:

A Extraction industry
B Genetic industry
C Manufacturing industry
D None of above

Question 3

The barrier of lack of finance in a business is removed by:

A Insurance
B Banking
C Advertisement
D Warehousing

Question 4

The activity that removes the barrier of risk due to loss or uncertainty in business is:

A Insurance
B Banking
C Advertisement
D Warehousing

Answers to Self-Examination Questions

Answer to SEQ 1

Industry is involved in production of goods and services. Commerce refers to activities connected with transferring goods from manufacturers to consumers.

Industry is divided into primary, secondary and tertiary. Commerce is divided into trade and aids to trade like banking and insurance.

Answer to SEQ 2

The correct option is **C.**

Manufacturing industry is concerned with converting raw material into finished products.

Answer to SEQ 3

The correct option is **B.**

The barrier of finance is removed by banking.

Answer to SEQ 4

The correct option is **A.**

The barrier of risk due to loss or uncertainty in business is removed by insurance.

STUDY GUIDE A2: PRODUCTION

Get Through Intro

As discussed in the previous Study Guide, we have many wants and we need various goods and services to satisfy our wants. But where do these goods and services come from?

We can see that most people around us are occupied with some kind of work, in some kind of activity. There are farmers working in their farms, there are workers working in factories, there are shopkeepers selling goods, there are teachers teaching in schools, and there are doctors serving the patients, and so on.

Thus, through their work, people contribute in producing goods and services needed by everyone.

In this study guide, we will discuss the production function in detail to understand the classification of production, the various types of occupations in production, various factors of production etc.

Learning Outcomes

a) Identify production classification (primary, secondary and tertiary production).
b) State types of occupations in production (Industry, commerce, service oriented production).
c) Explain factors of production (land, labour, capital, and organisation).
d) Illustrate with a diagram and explain the occupational chart.

1. Identify production classification (primary, secondary and tertiary production). [Learning Outcome a]

In simple terms, production means a process of transforming raw material into finished goods with the use of labour, machines, capital.

Thus it includes all the activities undertaken to convert an input to an output.

In the production of biscuits, various factors are needed such as raw material like flour, sugar etc., workers, factory premises, machinery, power for the machinery to operate etc.

Production is classified into the following classes:

1. Primary production
2. Secondary production
3. Tertiary production

1. Primary production

Industries are that involved in primary production produce two types of products. One is finished products that are ready for consumption such as fish, vegetables, fruits etc.

The other type is products like, iron, coal, oil etc. which are products that are used as raw material for the production of other finished goods.

2. Secondary production

The industries that are involved in secondary production are manufacturing and construction industries. These industries manufacture, build and assemble products using the raw material and parts produced by other industries.

Example

Textile mills convert cotton, a product of primary production, into yarn, yarn into fine cloth and cloth into fashionable clothes.

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3. Tertiary production

Tertiary production means the production of services. This means tertiary production does not produce any physical products but produces services that assist in the selling and distribution of manufactured goods to the consumers.

It includes services such as banking, insurance, transportation, warehousing and advertising.

Test Yourself 1

For each of the following item, identify whether it is a product of primary production, secondary production or tertiary production:

A Eggs
B Chocolates
C Milk
D Books
E Furniture
F Insurance
G Cars
H Mobiles
I Warehousing

---

2. State types of occupations in production (Industry, commerce, service-oriented production).
Illustrate with a diagram and explain the occupational chart.
[Learning Outcomes b and d]

The three basic needs of human beings are food, clothing and shelter. In addition to these basic needs, human beings have various other needs which make their life comfortable. These needs make people get engaged in some activities to earn a living for themselves and to satisfy their numerous needs. These activities, in economic terms, are known as occupation.

Definition

An occupation can be defined as a regular activity (often called work or job) for which a person receives income.

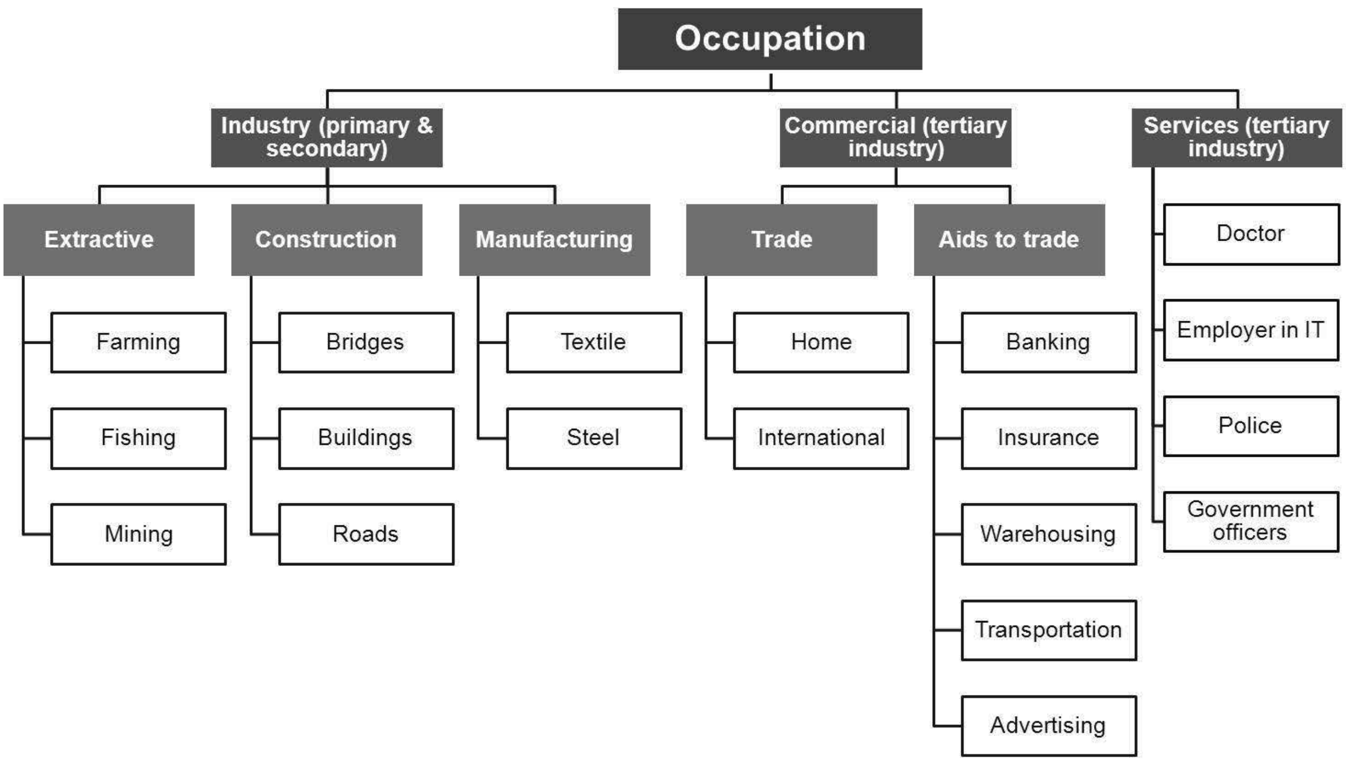
Types of occupations

The industry is divided into three sectors: primary, secondary and tertiary. Taking into consideration the nature of various activities relating to these three sectors, the occupations can be classified into three main categories:

1. Industry-oriented occupation
2. Commercial occupation
3. Service-related occupation

The various types of occupation that a person can engage in are explained in the diagram below.

Diagram 1: Occupation chart



1. Industry oriented occupation

Industry oriented occupations cover occupations relating to activities needed in both primary as well as secondary industry. It involves occupations relating to extracting products from land such as farming, fishing, poultry farming, mining etc. It also involves occupations relating to production of goods, or relating to changing raw material to finished goods; such as textile mills, sugar factories, steel industries etc. It also covers occupations that include activities of assembling and putting the various components together such as automobile industry, electronic products like computers, laptops and mobile phones.

2. Commercial occupation

Commercial occupation covers occupations relating to activities needed in the tertiary industry. It means engagement in activities relating to trade and aids to trade. Thus, all resources that are used for activities relating to distribution and exchanges of goods produced by the primary industry are said to be engaged in commercial occupation. The examples of commercial occupation are banking, transportation, warehousing, insurance, advertising etc.

3. Service-oriented occupations

Service oriented occupation also cover occupations relating to activities needed in the tertiary industry. These are the occupations that provide services to the public. The examples of service oriented occupations are security, teaching, doctors, government officers etc.

Various factors that need to be taken into consideration before deciding the appropriate occupation for each individual includes the following.

(a) Skills: a person who wants to be an artist or painter needs to have the necessary skills.

(b) Education: for being a doctor, one needs to have completed the specific educational qualification.

(c) Selection criteria: there are various selection criteria and policies applicable to various occupations e.g. age limit for government officers.

(d) Environmental suitability: certain occupations need appropriate climatic and natural conditions e.g. farming is possible only in areas where cultivatable land exists; fishing is possible only in areas where water bodies exist.

Test Yourself 2

The economic activity that people engage in to earn a living is called.............

A Specialisation
B Privatisation
C Occupation
D Industrialisation

---

3. Explain factors of production (land, labour, capital, and organisation).
[Learning Outcome c]

The factors of production are basically the inputs that the manufacturers use to attain the objective of producing finished products.

The four factors of production are:

1. Land
2. Labour
3. Capital
4. Organisation

1. Land

Normally, land means the surface of the earth but in the context of factors of production, land means all the natural resources such as land, forests, wind, sunlight, minerals, wind, rain, rocks etc...

Business needs these natural resources to aid the production process. The regions that are rich in natural resources provide various opportunities to businesses to make use of these natural resources.

Example

Companies in the Middle East are highly benefited from the oil available in that region.

Land is one of the most important natural resources that are required for production. It is used for primary production such as food grains, vegetables, fruits, mining products, oil extraction etc.

Land is also an important requirement for secondary production as building the factories needed for undertaking the production is only possible if the suitable land is available in the region.

However, it is also important to note that the natural resources are limited and therefore need to be used carefully to optimise the use.

2. Labour

Labour is the human input into the production process. Labour includes both physical and intellectual work. It is an important factor as other factors of production cannot work without the support of human beings in the form of labour.

Labour is in many ways different from other factors of production due to the human element involved. It is perishable and the productivity and efficiency differs from person to person. Labour has feelings and emotions and therefore good working conditions helps in improving the work efficiency.

Another distinguishing feature of labour is that it is an important resource for production inside the factory, but it is important outside the factory too as the workers may be the consumers of those same goods.

Example

Examples of labour are engineers, designers, paint sprayers, testers, management staff, transport & distribution workers etc.

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3. Capital

Capital means the finance required to operate the business. Various different things are required for production of goods and services such as raw material, plant and machinery, equipment, factories, buildings, technology etc. Funds need to be invested in making available these things in order to be able to produce other goods. Thus, capital means investment in goods that can produce other goods in the future.

Capital can be of two types: fixed capital and working capital.

Fixed capital refers to the investment made in goods that will be used in production for many future years. The examples of fixed capital are investment in machinery, plant and equipment, new technology, factories and buildings.

Working capital is an inventory of finished and semi-finished components that will be either consumed in the process of production (e.g. lubricants, cleaning material, protection equipment etc.) or will be transformed into finished consumer goods.

Example

'Plastic granules' is inventory which is used for making toys, raw iron is used for producing machines, sheet metal is inventory for making cars, rubber is inventory for making tyres etc.

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4. Organisation

The various factors of production i.e. land, labour and capital are scattered at various places, which need to be pulled together. This is done by entrepreneurs through organisation. Thus, organisation is a function to bring together the various factors of production and make them work together.

Definition

An organisation is an arrangement where a collection of people with a set of shared objectives create a formalised group.

There is a lot of risk and uncertainty that the organisation undertakes during this process and the return that the organisation gets in return for this risk is profit.

The functions of organisation include:

- Conceiving the idea of the product to be produced
- Identifying the various factors needed in the production
- Working out the funds required and arranging the funds
- Organising the skilled and unskilled labour
- Managing and supervising the production process
- Bearing the risk
- Innovating ideas to increase the sale

Test Yourself 3

Classify the following items into various classes of factors of production

A Machinery
B Tree
C Engineers
D Bulldozer
E Factory worker
F River

Answers to Test Yourself

Answer to TY 1

A Eggs – primary production
B Chocolates – secondary production
C Milk – primary production
D Books – secondary production
E Furniture – secondary production
F Insurance – tertiary production
G Cars – secondary production
H Mobiles – secondary production
I Warehousing – tertiary production

Answer to TY 2

The correct option is **C**.

The economic activity that people engage themselves in to earn a living is called occupation.

Answer to TY 3

A Machinery - capital
B Tree - land
C Engineers - labour
D Bulldozer - capital
E Factory worker - labour
F River - land

Self-Examination Questions

Question 1

Which factor of production is a tractor?

A Land
B Labour
C Capital
D Organisation

Question 2

Which of the following terms is used to describe the individual or group of individuals that brings together the other economic resources necessary for production?

A Government
B Organisation
C Shareholders
D Society

Question 3

Which of the following is not the correct classification of occupation in production?

A Industry
B Economy
C Commerce
D Service oriented

Question 4

What are the various factors that influence the choice of occupation?

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **C**.

Answer to SEQ 2

The correct option is **B**.

Answer to SEQ 3

The correct option is **B**.

Answer to SEQ 4

The various factors that influence the choice of occupation are skills, education, relevant selection criteria, suitability of environment etc.

STUDY GUIDE A3: TYPES OF TRADE

Get Through Intro

Do you remember when you were first introduced to the concept of trade? Probably when you first tried to exchange your pencil with your friend's chocolate!! From that young age, we are introduced to the concept of trading. Trade is nothing but exchange of something for something else. Thus, trade is crucial for fulfilment of our wants.

Even before money was invented as a medium of exchange, trade existed in the form of exchange of goods in return for some other goods. This system is called barter exchange. With the advent of civilisation, other mediums such as precious metals like gold and silver and then currency notes were used as means of exchanging goods and services.

Trade is an important aspect of our life as it ensures a continuous supply of the goods and services that we want to live a happy and comfortable life. Thus we can say that trade is a very important social activity.

In this study guide, we will understand the meaning of trade and the various types of trade. Understanding this study guide is important as, in the next few study guides, new concepts will be developed based on the concept of trade.

Learning Outcomes

a) Explain the meaning of home trade and international trade.
b) Distinguish between home trade from international trade.

1. Explain the meaning of home trade and international trade.
[Learning Outcome a]

In simple terms, trade means buying and selling of goods and services among people. It involves transfer of goods and services in exchange for money or money's worth.

Trade can be divided into two types:

1. Home trade
2. International trade

1. Home trade

Definition

Home trade means trade conducted within the political and geographical boundaries of a country.

Home trade is also called internal trade or domestic trade.

Domestic trade facilitates exchange of goods and services **within the country**. Trade ensures that different types of goods and services are produced in the country and that they reach the citizens living in various parts of the country. This results in improving the standard of living of the residents of a country.

Domestic trade is further divided into wholesale trade and retail trade.

Tip

The concept of wholesale trade and retail trade is explained in detail in the next study guide.

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2. International trade

Definition

International trade means buying and selling of goods and services between two or more countries.

International trade is also called foreign trade.

Example

Peter purchases raw material from China for the production of goods in his factory in Singapore. This is an example of international trade.

International trade is in the nature of import and export.

Tip

The concept of import and export is explained in detail in the next study guide.

Test Yourself 1

Explain the need for international trade.

---

2. Distinguish between home trade from international trade.
[Learning Outcome b]

The key factors that differentiate home trade from international trade are as follows:

	Home trade	International trade
Meaning	Home trade comprises transactions relating to exchange of goods and services within the political and geographical boundaries of a country.	International trade comprises transactions relating to exchange of goods and services between two or more countries.
Currency	The exchange of goods and services takes place in the national currency of the country.	Different currencies of different countries are used in international trade e.g. Dollar or pound.
Scale of operations	Limited market	Broader market
Transport costs	The transport costs in home trade are low.	The transport costs in international trade are high.
Trade policies	Policies relating to trade, taxation etc. are the same within the country and are relatively simple to follow.	The policies among different countries regarding import, export, exchange controls etc. are different and usually involves very complex documentation.
Movements of factors of production	It is easier to move the factors of production such as raw material and capital to various parts of the country. This usually results in lower cost of production.	It is difficult to move the factors of production across countries due to factors such as differences in languages, customs, occupational skills, unwillingness to leave families behind, high travelling expenses and restrictions. This may lead to higher cost of production

Answer to Test Yourself

Answer to TY 1

Due to unequal distribution of natural resources, some products may not be available in certain countries. For example, all the countries in the world are dependent on the gulf countries for petrol. In some countries, the costs of producing goods are less as compared to other countries due to availability of raw material and labour. Thus, international trade permits the most efficient use of the world's resources, and gains are shared by all the countries that participate in international trade.

Self Examination Questions

Question 1

What are the benefits of international trade?

Question 2

Which of the following is the most appropriate description of international trade?

A International trade means buying and selling of goods and services within a country.
B International trade means buying the goods from another country.
C International trade means buying and selling of goods and services between two or more countries.
D International trade means buying and selling services between two or more countries.

Question 3

State whether true or false:

'Domestic trade is further divided into import and export.'

Answers to Self-Examination Questions

Answer to SEQ 1

The key benefits of international trade are:

- It enables the people across the globe to benefit from the technology developed in other countries.
- It helps increase the sales and profit of the organisations in various countries and enhances the potential for expansion.
- It extends the selling potential of existing products and reduces dependence on existing market.
- It achieves economies of scale as production can be undertaken on a large scale if the international market is available.
- It helps in stabilising market fluctuations due to seasonal differences in various parts of the world.

Answer to SEQ 2

The correct option is **C**.

International trade means buying and selling of goods and services between two or more countries.

Answer to SEQ 3

The statement is false.

Domestic trade is further divided into wholesale trade and retail trade. Import and export are related to international trade.

SECTION A

INTRODUCTION TO COMMERCIAL KNOWLEDGE

A4

STUDY GUIDE A4: HOME TRADE

Get Through Intro

Trade is primarily concerned with the exchange of goods and services. It involves buying and selling of goods and services for a value.

Trade can be categorised into two types as home trade and international trade.

Home trade is buying and selling of goods within the boundaries of a country using the country's national currency. Right from a small shop owner to a big departmental store, all are covered under home trade. Thus, the scale of operation of home trade is very large.

Development of home trade is very important as it facilitates economic development of a country. As the trade increases, the economy of the country also develops.

In this Study Guide, we will discuss the two main types of home trade i.e. wholesale trade and retail trade along with their features, functions and subsequent types.

Learning Outcomes

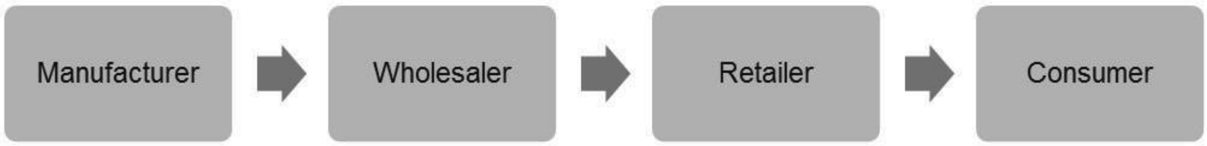
a) Explain the meaning of retail, types, importance and problems facing retail business.
b) Explain the meaning of wholesale trade, importance and functions of wholesalers.
c) Explain methods of solving problems of retail and wholesale business.

1. Explain the meaning of wholesale trade, importance and functions of wholesalers. [Learning Outcome b]

As discussed in the previous Study Guide, home trade is divided into two subdivisions:

1. Wholesale trade
2. Retail trade

Diagram 1: Chain of distribution of goods



1.1 Meaning of wholesale trade

Wholesale trade involves buying of goods in large quantities from producers or manufacturers and selling those goods to other small traders (i.e. retailers) in small quantities. The traders involved in wholesale trade are known as wholesalers.

The key features of wholesalers are as follows:

- They purchase goods in bulk from the producers or manufacturers and sell them in smaller lots.
- They usually need high capital investment as they purchase in large quantities but sell in small quantities.
- Wholesalers sell goods to the retailers and not to the ultimate consumer.
- Wholesalers usually deal in one or few varieties of items or a specialised line of product such as cement, shoes, textile, paper etc.
- They usually undertake other allied activities besides selling, such as packaging, grading, labelling, etc.

1.2 Importance of wholesalers

The wholesalers act as intermediaries between the manufacturers and retailers. They are a very important link in the supply chain, because they buy the goods in bulk from the manufacturer and thus relieve them from the time and efforts of dealing with small traders. This allows them to concentrate on their core business of manufacturing.

They bear the risk related to holding of the goods and their sale. They undertake the activities of contacting and dealing with the retailers to ensure that the products reach the maximum consumers through various small traders. They also maintain the stability of demand and supply by matching the purchase from manufacturers to the demand from the retailers.

The wholesalers provide market information relating to demand, consumer preferences, changing trends and fashion, other products available in the market etc. to the manufacturer to facilitate improvements in the products.

Also, as the goods are purchased in bulk, the various related costs such as transportation, insurance, storage are divided over a number of goods and facilitates economy of scale.

The retailer has to keep a inventory of a large variety of products to meet the demand from the customers. Due the constraints of space and capital, the retailer cannot afford to hold large quantities of each variety of products. The wholesaler saves the retailers from the need to keep a inventory of goods in large quantities and allows them to buy in small quantities as and when the existing inventory with the retailer is nearly sold out.

1.3 Functions of a wholesaler

The wholesaler provides valuable services to the manufacturer and the retailer.

1. Services to manufacturer

(a) Buying goods in large quantities

Wholesalers purchase goods in bulk from manufacturers and relieve them from the task of dealing with various retailers.

(b) Storing the goods

After purchasing the goods from the manufacturer, the wholesaler stores them in their warehouse and release them in proper and required quantities as and when the retailers require them.

As there is a time gap between the production and the consumption of goods, the goods need be stored safely till retailers demand them in order to safeguard the goods from deterioration and to meet the demand when arises.

(c) Price stabilisation

Wholesalers inventory goods during the harvest season when the prices are low and sell them during the period of peak demand. Thus, the wholesalers facilitate the stabilisation of prices.

(d) Transportation of goods

The wholesalers deliver the goods from the place of production to the place where the demand for the goods exists, and thus help in removing the barrier of location.

(e) Providing market information

The wholesaler provides market information to the manufacturers regarding market conditions, consumers' demands, consumers' tastes etc., which helps the manufacturer to regulate his production in accordance with the changing requirements of the market.

(f) Risk bearing

A wholesaler reduces the manufacturer's risk arising out of unexpected fall in prices of goods or by way of damage during storage etc. Also, the wholesalers bears the risk of loss on account of bad debts due to credit sales to retailers.

(g) Marketing functions

The wholesalers carry out various marketing functions such as warehousing, advertising, branding, packaging etc. on behalf of the manufacturer.

2. Services to retailers

(a) Ready inventory of goods

The wholesalers keep large inventory of goods; hence, the retailers are free from the hassles of holding a large inventory. They can buy from wholesalers in the required quantity based on their need.

(b) Regular supply

The wholesalers assure regular supply of goods to the retailers; hence, they are saved from the risk of shortage of goods.

(c) Financial support:

The wholesalers provide credit facility and also provide discounts to their regular retailers, which improves the retailers' working capital efficiency.

(d) Risk bearing

The wholesalers hold large inventory of goods and supply them to the retailers in smaller quantities. Thus, the wholesalers bear the risk of fluctuations in prices, change in demand and change in fashion.

(e) Sales promotion

The wholesalers often undertake advertisement and sales promotion which helps the retailers to sell the goods in larger quantities and improve profits.

(f) Market information

The wholesalers provide information to retailers about the demand for the goods and often advise the retailers on when to buy and how much to buy.

Test Yourself 1

A wholesaler purchases goods from the __________

A Manufacturer
B Retailer
C Consumer
D Government

---

3. Explain the meaning of retail, types, importance and problems facing retail business. Explain methods of solving problems of retail and wholesale business.
[Learning Outcomes a and c]

2.1 Meaning of retail

Definition

Retail trade involves buying of goods from wholesalers and selling them to final consumers in small quantities.

The retailer is the final link in the chain of distribution. He bridges the gap between the wholesalers and the final consumers.

2.2 Key features of retailers are

- Retailers are the connecting link between wholesalers and consumers.
- Retailers usually operate in local markets near residential areas.
- Retailers deal in a wide variety of goods to satisfy different demands of different consumers.
- Retailers have relatively smaller capital investment in business as they buy in smaller quantities.
- Retailers undertake less risk as they do not hold a large inventory of goods.

2.3 Importance of retailers

Retailers provide various important services to wholesalers as well as to consumers as follows:

1. Services to wholesalers

(a) Retailers are the connecting link between wholesalers and consumers and regularly give feedback to the wholesalers about the consumer needs, changes in trends, fashion etc., which the wholesalers can pass on to the manufacturers.

(b) Retailers create demand for products by attracting consumers' attention to new products through attractive display and salesmanship.

(c) Retailers help in fast distribution of goods which is very important, especially in the case of perishable goods such as fruits, vegetables, milk, eggs etc.

2. Services to consumers

(a) Retailers ensure regular supply of goods to consumers as and when they need.

(b) Retailers inventory a wide variety of products from different manufacturers which gives the consumer a wider choice of goods to select from.

(c) Retailers are usually situated near residential areas which makes it very convenient for the consumers.

(d) Retailers collect information from consumers regarding their preferences and changes in the taste and pass on to the manufacturers through the wholesalers. This helps consumers in getting the goods of their preferred size, quality, design etc.

(e) The retailer bears the risk relating to price fluctuations, spoilage and also of damage to goods due to fire, theft, deterioration etc.

(f) Some retailers also provide pre and after sale services to consumers for products like television, refrigerators etc.

(g) The retailers also offer credit facility to regular customers.

2.4 Types of retail trade

The retail trade can be classified into two main types:

1. Small scale retail trade
2. Large scale retail trade

1. Small scale retail trade

This is retail trade where limited variety and quantity of goods is sold within a local area. The investment is low and the turnover of the retailers is also low. Examples are hawkers, general stores and street traders.

Advantages of small scale retailing

- Small amount of capital is sufficient
- Overheads are low
- Personal contact with customers is possible
- Credit facilities can be provided to customers hence more sales
- They have some permanent customers
- They may sell their products at high prices to earn more profit

Disadvantages of small scale retailing

- There is stiff competition as many retailers exist
- Variety of goods offered is limited due to low capital
- Credit customers sometimes disappear without paying
- It is quite inconvenient to move from one place to another with goods
- Sales are affected adversely by changes in weather e.g. rain
- They have no fixed premises
- They cannot get regular customers
- They are usually overworked
- There is uncertainty of business

Small scale retail trade can also be divided into two types:

(a) Itinerant retailers
(b) Fixed shop retailers

(a) Itinerant retailers

Itinerant retailers are mobile retailers who sell a variety of low price items directly to the consumers. They do not have a fixed shop from where they can sell their goods. They include sellers such as street vendors, hawkers and pedlars who sell products like fruits and vegetables.

(b) Fixed shop retailers

The retailers of this type sell goods and services from a fixed place i.e. a shop located at the market place, commercial areas or near residential areas. They have limited capital investment in the business and therefore operate on a small scale and deal with a limited variety of goods.

Some examples of small fixed shop retailers are:

(i) **General stores**: these stores deal in a variety of general use items such as grocery, cosmetics, medicines, toiletry, hosiery, snacks, gift items, stationery, etc. Usually, they provide credit and discount to their regular customers and also offer home delivery.

(ii) **Single line stores:** these stores deal in a particular line of goods. They sell goods of different sizes, brands, designs, styles and qualities of the same product line such as medicines, toys, watches, books etc.

(iii) **Authorised dealer retailers:** these stores deal in goods of a particular manufacturer. They get commission from the manufacturer on sale of the products. Examples are dealers of Nokia, Sony, and Videocon.

2. Large scale retail trade

It is retail trade where retailers conduct their business on a large scale and deal in large variety of goods. Their capital investment in business is more. Large scale retail shops are sometimes opened by big manufacturers to sell their products directly to the customers.

Some examples of large scale retail trade are

(a) Departmental stores

A departmental store is a huge retail shop having different departments under one roof. The departmental stores are usually situated at a central place in the city. Each of its department deals with a separate line of products such as hosiery, grocery, electronic products, cosmetics, shoes etc. Although there are different departments dealing in different line products, all the departments are under central control and management. Famous departmental stores are Woolworths, Marks and Spencer, Walmart etc.

(b) Supermarkets

A supermarket is a large retail organisation which mainly sells a wide variety of food and grocery items. Buyers themselves select the goods, place them in a trolley, bring them over to the payment counter and pay the bill.

(c) Chain stores

Chain stores, as the name suggests, are retail stores owned by a single business organisation. They have a network of a number of branches located in different parts of the country or world. The looks of the shop i.e. the colours used, the furniture, the staff uniforms etc. are the same across all locations. All the shops deal in the same line of products and are owned, managed and controlled by a head office. Examples of chain stores are Pizza hut, Mc Donald's, Starbucks etc.

2.4 Problems of retail and wholesale business along with solutions

The disadvantages of small scale retail business discussed earlier are also some problems faced by retailers

Following are a few problems faced by retailers

- Stiff competition
- Limited capital which affects the variety of goods which are traded
- Risk of bad debts generated by non-payment of credit customers
- Lack of storage facilities which affects quality of goods which are affected by adverse weather conditions
- Non- availability of finance to maintain fixed premises
- Lack of retail space
- Shortage of trained manpower

Solution

- With a view to improve the home trade, public financial institutions must provide cheap finance to retailers
- Groups of retailers should form co-operative bodies which in turn can help its members to procure cheap sources of finance, due to collective bargaining.

- Retailers (with the help of co-operative bodies) must have an inbuilt system of assessing credit worthiness of customers before providing goods on credit.
- Co-operative bodies will be in a position to provide infrastructure (in return for rent to its members) which can be used to preserve goods against adverse conditions.
- Co-operative bodies can provide training to manpower
- Technology is very helpful in reducing the running costs of a business and improving productivity and quality of service. Advancement of technology and making available fast and reliable means of communication and transport would highly benefit the growth and advancement of retail and wholesale business. This would be possible with the intervention of government bodies like Chambers of commerce.
- Lack of enough capital is a major hurdle in the development of retail and wholesale business. Therefore, it is important that steps are taken to ensure that easy and sufficient finance is made available at affordable interest rates. This would ensure growth of retail and wholesale business. Co-operative bodies as well as Chambers of commerce should arrange to provide space to do retail business to its members, at cheap rates.
- Lack of knowledge of opportunities available whereby the retailers and wholesalers can grow and expand their business is also a major problem that the retailers and wholesalers are facing. Hence, government bodies like Chambers of commerce should provide information about the various opportunities to wholesalers and retailers is essential.

Tip

Cooperatives are defined as being autonomous associations of persons united voluntarily to meet a common economic, social and/or cultural objective, through a jointly owned and controlled enterprise.

Source: International Co-operative Alliance statement on the Co-operative identity

In short, it is an organisation that is **owned and managed jointly by those who use its facilities and services.** A cooperative's purpose is to provide services on a non-profit basis to the shareholders or members who control it.

Test Yourself 2

_____________ are mobile traders who deal in low priced articles with no fixed place of business.

A Retailers
B Agents
C Wholesalers
D Itinerant traders

Answers to Test Yourself

Answer to TY 1

The correct option is **A.**

Answer to TY 2

The correct option is **D.**

Self-Examination Questions

Question 1

Wholesalers deal in _____________ quantity of goods.

A small
B large
C medium
D limited

Question 2

Retailers act as a connecting link between............

A Wholesalers and consumers
B Wholesalers and manufactures
C Manufacturers and consumers
D Two different wholesalers

Question 3

Wholesalers act as a connecting link between............

A Retailers and consumers
B Consumers and manufactures
C Manufacturers and retailers
D Two different manufacturers

Question 4

Which trade deals in a variety of goods under one roof and one management?

A Departmental store
B Chain store
C General Store
D None of above

Question 5

McDonald's is an example of........

A Departmental store
B Chain store
C General store
D None of the above

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **B**.

Answer to SEQ 2

The correct option is **A**.

Answer to SEQ 3

The correct option is **C**.

Answer to SEQ 4

The correct option is **A**.

Answer to SEQ 5

The correct option is **B**.

SECTION A

INTRODUCTION TO COMMERCIAL KNOWLEDGE

A5

STUDY GUIDE A5: INTERNATIONAL TRADE

Get Through Intro

Each country has different natural, human and capital resources; therefore, it is not possible to be absolutely self-sufficient. It is not always possible to produce all the goods and services needed by a country's residents with the same efficiency. Hence, countries focus on producing those goods and services for which they have the absolute advantage over other countries.

The other goods which cannot be produced in their country with the same efficiency are purchased from other countries which have a natural advantage in producing those goods. For example, Japan is advanced in technology, so it can focus on producing products like television sets, automobiles and cameras. These products produced in Japan are sold throughout the world.

However, Japan has to buy products like wheat, corn, aircraft, etc. from other countries as the production of these goods cannot be undertaken as effectively in Japan as in some other countries.

Thus, international trade is beneficial to all the countries.

In this Study Guide, we are going to study the various aspects of international trade such as import and export, balance of trade and balance of payment, visible and invisible goods etc.

Learning Outcomes

a) Distinguish between export trade and import trade
b) State the reasons for international trade.
c) Explain the advantages and disadvantages of international trade.
d) State the problems of international trade.
e) Identify and describe types and reasons for import controls.
f) Distinguish between visible and invisible goods.
g) Explain the meaning and differences between balance of trade and balance of payments.
h) Distinguish between favourable and unfavourable balance of trade.
i) Identify, describe and apply documents used in international trade.

1. State the reasons for international trade.
[Learning Outcome b]

International trade means trade among different countries. In other words, international trade is the exchange of goods and services among various countries. It is also sometimes referred to as foreign trade. Foreign trade may be bilateral i.e. between two countries, or multilateral trade, i.e. among many countries.

The fundamental basis of international trade lies in the fact that not all countries can produce all things equally well because of the unequal distribution of natural resources.

Example

All the countries in the world need oil; however, it is a natural resource that is not available everywhere. Oil is available in certain particular areas, i.e. the gulf countries, and therefore oil is traded internationally.

Why international trade is needed?

Countries trade with each other because they do not have all the resources or capacity needed to satisfy all their needs and wants. Their own domestic resources are not sufficient to produce all the goods that they need. Therefore they trade in resources which are abundant in that country and use that revenue to buy the goods which are not available in that country.

There are various reasons for buying goods from other countries such as goods from those countries are less expensive, of better quality, more easily available or simply more appealing than locally produced goods. It is also possible that a suitable local alternative for certain products does not exist and therefore importing those goods is essential.

The reasons for selling the goods to other countries are also many, such as for surplus production of goods, to facilitate expansion of business, to earn foreign currency etc.

International trade also facilitates division of labour; that means countries can choose to produce just a small range of goods or services which all other countries need. Alternatively, it may contribute only a small part to finished products sold in global markets.

Example

A bar of chocolate produced in Switzerland is likely to contain many ingredients from numerous countries such as cocoa from Ghana, coffee from Colombia and nuts from California. Each country can choose to contribute just one ingredient to the final product.

Another important aspect of international trade is specialisation. With international trade, it is possible for each country to concentrate on production of certain specialised products in which they have the most expertise. Thus, specialisation can generate further benefits in terms of efficiency and productivity.

Every country, in the modern world, is dependent upon other countries for supply of various kinds of goods and services. The countries now are not isolated as there is an increased cross border trading and investments. The innovations and development in the field of communication, transportation, technology and infrastructure have brought the various nations closer to each other.

Countries that are geographically located from each other have now started increasingly interacting with each other. This development has resulted into manifold expansion of international trade.

Test Yourself 1

Exchange of goods between two or more countries is called----------------

A Home trade
B International trade
C National trade
D Domestic trade

---

2. Explain the advantages and disadvantages of international trade.
[Learning Outcome c]

Advantages of international trade

- International trade is a vital **source of revenue** for countries which helps the countries **to raise national income** and thereby improve the standard of living.

- Different countries have different types of **natural resources**. Foreign trade helps in distributing the surplus resources of one country to other needy countries. This way, all countries can make the **optimum utilisation of resources available** in their country.

Example

A country may be rich in minerals but may not be technologically advanced and not have necessary equipment and advanced means to extract those minerals from the earth. However, with international trade, it can import modern equipment and machinery from other developed countries and make proper utilisation of those natural resources.

- Various agricultural products can be produced only in certain countries due to the availability of appropriate **weather and climatic conditions**. For example, Argentina produces wheat which is more than its own requirement. Thus, foreign trade enables distribution of excess production to other countries where wheat production is low. Thus, all the countries can enjoy all the variety of agricultural products with the use of foreign trade.

- Foreign trade facilitates **equalisation of prices of products around the world**. Prices rise when supply is less than demand. However, if the domestic supply of goods is less than adequate, those goods can be imported from other countries. Thus, it brings supply up to the level of demand which results in equalising and stabilising the prices.

- Foreign trade enables a country to **share the benefits of low cost of production in other countries**.
- Instead of producing the goods in one's own country, it may be economical to buy goods from other countries where the cost of production is the lowest.

- International trade facilitates **utilisation of a country's comparative advantage** which means that a country can choose to specialise in producing only those goods and services which it can produce more effectively and efficiently and at the lowest opportunity cost.

- International trade increases competition and thus lowers the prices of goods across the world which **enhances the buying power of the consumers**. As options are available to the consumers, the quality of goods and services is likely to improve in the face of completion. It also breaks down monopolies.

- As global market is available for sale, production can be undertaken on a very large scale, which provides further cost benefits in terms of **economies of scale**.

- International trade also facilitates **exchange of know-how, machines, and technological resources** from developed countries to the underdeveloped and developing countries and also creates job opportunities in export oriented industries.

Disadvantages of international trade

- International trade may sometimes lead to **over-specialisation** which may make a country's economical position risky if the demand for the products it produces falls or when goods for domestic consumption can be produced more cheaply abroad.

- As the knowhow and technology is available from other countries, the underdeveloped and developing countries often **avoid making investments** in developing the technologies in-house and slowly this may lead to the **exploitation of these countries by the developed countries**.

- International trade also sometimes **leads to import of unnecessary luxury goods** that are not suitable for the lifestyle of the local people. This may hamper the well-being of the people and may also affect the culture of the country.

Example

Availability of imported goods such as alcohol and cigarettes can lead to encouraging the young population of a country to get addicted to these products, which are harmful for their health.

- In order to earn more money, the essential goods needed by the home country may sometimes be exported to various other countries, which may lead to **shortage of goods** in the home country.
- Excessive exports may result in **exhausting the natural resources** of a country in a shorter period which may lead to economic downfall of the country in the long run.
- International trade also sometimes affects the industrial development of countries as the new domestic industries do not get a chance to grow because they face **competition from more established foreign firms**.
- International trade facilitates purchase of goods from other countries at reduced prices. This may impact the survival of local producers because cheaper imports may destroy their market. Over time, the diversity of output in an economy may diminish as **local producers become unable to sustain the competition** and leave the market.

Test Yourself 2

Which of the following is an advantage of international trade?

A Specialisation
B Optimum utilisation of natural resources
C Economies of scale
D All of the above

---

3. State the problems of international trade.

[Learning Outcome d]

The problems of international trade are explained as follows:

1. International trade relates to exchange of goods and services among various countries. This makes it difficult to establish quick and close trade contact between the importers and exporters.
2. Long distance transportation increases the cost of goods due to high transportation costs. It also takes longer to make goods available at the right place, as repeated loading and unloading of goods is required. Long distances also increase the risk during transportation such as damage and theft.
3. The fact that there is increase of piracy, especially in the ocean, which is a predominant means of transport in the international business, international trade is no longer considered safe.
4. International trade is often subject to various restrictions in terms of customs, tariff, quotas and exchange regulations, which restrict the scope of international trade.
5. Two countries that speak and understand the same language can trade more freely than the others that speak different languages.
6. Different markets have different features as regards to demand, intensity of competition, buyers' preferences, etc. International trade requires extensive study of foreign markets, which again, is a time consuming and expensive procedure. Also, the results produced by this analysis may not always be accurate and this may lead to targeting unsuitable markets.
7. Both import and export of goods involve very costly operations such as transport, insurance, intermediaries and completion of various complicated formalities. This makes the activity very complex and expensive.
8. Each country has its own rules and regulations regarding international trade in order to protect its economic and political interest. These rules change from time to time and traders constantly need to update themselves with the rules and regulations and procedures followed by different countries.

9. The frequent changes in foreign exchange rates, changes in import and export duties etc. make the prices highly volatile.

10. The harsh climatic conditions of some countries scare away traders from other parts of the world which makes international trade difficult.

Test Yourself 3

Which of the following are problems associated with international trade?

A Regulatory and political restrictions by different countries
B Requirement of study of foreign markets which involves high cost
C Frequent changes in trade related rules and regulations
D All of above

---

4. Distinguish between export trade and import trade.
Distinguish between visible and invisible goods.

[Learning Outcomes a and f]

4.1 Export trade and import trade

The meanings of the two concepts enable you to distinguish between them

International trade is divided into two categories as follows:

1. **Export trade**: when a trader from his home country sells his goods to a trader located in another country, it is called export trade for the trader from the home country e.g. it is export when a trader from China sells his goods to a trader located in France.

2. **Import trade**: when a trader in her home country purchase goods from a trader located in another country, it is called import trade for the trader from the home country e.g. it is import when a trader from Tanzania purchases goods from a trader located in China.

Exports earn money for a country, while imports incur expenses.

Example

India has abundant, qualified manpower in the information technology sector. This manpower exports its services to companies doing business in other countries and earns foreign currency for India. On the other hand, India is dependent for oil on gulf countries and needs to import for its fuel requirements. There it has to pay in foreign currency. Thus, it can spend the foreign currency it earns through exports to import goods and services it is deficient in. This is the fundamental concept behind exports and imports.

It is also important to note that often a company is an exporter as well as an importer. That means these companies are involved in international trade, they buy goods from foreign traders and sell in their home country and at the same time also sell the home produced goods to a trader in foreign country. Thus, these companies specialise in the export and import function and can arrange goods for any company from a foreign country on a short notice as it has a well-developed liaising network.

Important

There is also another important term i.e. 'entrepot' trade which means re-export of processed imported goods. When goods are imported from one country, and after doing some processing, are re-exported to another country, it is called entrepot trade. For example, a trader in Tanzania may purchase some raw material or spare parts from a trader from Japan, assembles it, converts into finished goods, and then re-exports to a trader in Australia.

Visible and invisible goods

The meanings of the two concepts enable you to distinguish between them

1. **Visible goods:** visible goods mean tangible goods i.e. goods that can be touched and weighed. When tangible goods are traded between counties i.e. exported, imported or re-exported, it is referred to as visible trade.

2. **Invisible goods**: invisible goods mean services received from other countries or services rendered to other countries e.g. shipping and insurance services, services to foreign tourists, services of foreign technicians, interest on loans etc., are some of the examples of invisible goods.

When services are traded between counties, i.e. exported or imported, it is referred to as invisible trade.

Example

When a student from the UK comes to Singapore to study, it is invisible export for Singapore as it is earning foreign exchange by providing educational services.

If a Singapore citizen travels to the UK for a holiday, it is invisible import for Singapore and invisible export for the UK.

Test Yourself 4

_______________ mean services received from other countries or services rendered to other countries.

A Unsalable goods
B Invisible goods
C Imported goods
D Indirect goods

---

5. Identify and describe types and reasons for import controls.

[Learning Outcome e]

Import control means the various methods employed by the government of a country to control the volume or value of goods imported into the country.

Types of import controls

The import controls are generally of two types:

1. Tariffs
2. Non-tariff/quantitative restrictions

Tariff and non-tariff policies restrict trade between countries. Import restriction is a commercial policy which is adopted by a country to encourage domestic industry. This is done by either subjecting the imports to import duties so as to bring their prices at par with the domestic prices of competing goods or restricting imports by subjecting them to import quotas. Thus tariff and non-tariff barriers can be used as tools for import restriction.

1. Tariffs

Tariffs are the taxes on imported goods that need to be paid upon their entry into a country. The tariffs are usually calculated as a percentage of the value of the products that are being imported. The revenue authority decides the tariffs on various types of goods and services.

The tariffs vary from product to product. Usually the tariffs are high on the import of products for which the government wants to discourage the import. The reason could be to make the imported goods more expensive than domestic goods so that the sale of domestic products is not affected by competition from imported products or to restrict the import of certain products because those products are unhealthy for consumption.

On the other hand, the government does not impose any tariffs on import of certain products which are very beneficial and useful.

Example

The following table shows some sample products and the applicable tariffs

Heading no.	H.S. Code /Tariff No.	Description	Unit of quantity	Rate
21.04	2104.10.00	Soups and broths and preparations therefor	kg	25%
21.05	2105.00.00	Ice cream and other edible ice, whether or not containing cocoa.	kg	25%
21.06		**Food preparations note elsewhere specified or included.**		
	2106.10.00	Protein concentrates and textured protein substances	kg	10%
	2106.90.92	Mineral premix used infortification	kg	0%
27.16	2716.00.00	Electrical energy. (optional heading)	1000KWh	0%
36.03	3603.00.00	Safety fuses; detonating fuses; percussion or detonating caps; igniters; electric detonators	kg	10%

(Source: http://www.tra.go.tz/documents/customs/EACTariff%202012.pdf)

2. Quantitative restrictions

Quantitative restrictions in the form of import quotas limit the total quantity of goods imported or imported from a certain country.

The objective of putting quantitative restrictions on import of products is to limit access to imports by making them scarce. Therefore as established by the laws of supply and demand, since the supply is not equal to demand, such imported goods become more expensive.

Reasons for import control

The reasons for import control are as follows:

(a) To generate revenue

For some governments, especially in the developing countries, tariffs provide a significant source of government revenue.

(b) To address the concern by local manufacturers that imported products subject them to unfair competition.

Every country maintains high tariffs on certain products for which domestic producers are thought to be vulnerable to foreign competition. This tariff protection is usually imposed early in an industry's life or at the times of decline, when the threat from more efficient foreign producers is considered to be particularly severe.

Thus, import protection for some period from established foreign competition allows the infant industry to develop its competitive advantage.

(c) To promote native innovations

Easy availability of goods imported from other countries sometimes restricts the development and manufacturing of certain products within the country. This could make the country dependent on the other countries for those products. Therefore, high tariffs are imposed on import of such goods which make those goods very expensive. This creates demand for the products and motivates the enterprises to undertake innovations to manufacture those goods domestically.

(d) To restrict import of de-merit goods

Goods such as alcohol, tobacco and narcotic drugs have adverse social effects and are termed de-merit goods. Import protection enables safeguarding society from importing such de-merit goods, by imposing high tariff barriers or by banning the import of the goods altogether.

(e) To prevent spread of diseases and pests

Governments use import controls to protect domestic health or safety. A government sometimes bans all imports of a particular good when it has reason to believe it could harm public safety or health.

Example

In March 2001, the United States prohibited all European imports of livestock to protect U.S. livestock herds from foot and mouth disease, which had afflicted large numbers of animals in Europe.

(f) To accomplish certain political motive

Governments also restrict imports and exports for political reasons. If the government of a particular country wants to punish or influence the behaviour of another country for human rights violations or for an act of aggression, then sometimes restrictions are imposed on imports from such a misbehaving country. Also, in times of war, adversaries often prohibit all imports from each other.

Test Yourself 5

Tariffs are taxes that are imposed on-------------------------

A Imported goods upon their entry into a country
B Exported goods upon their departure out of the country

---

6. Explain the meaning and differences between balance of trade and balance of payments. Distinguish between favourable and unfavourable balance of trade.
[Learning Outcomes g and h]

Balance of trade and balance of payments are two very important concepts in the field of international trade. Therefore understanding these concepts is essential.

As discussed earlier, in today's world, all countries import some goods and services from other countries, and also export certain other goods and services which are surplus in their country.

Balance of trade

The meanings of the two concepts enable you to distinguish between them

Balance of trade refers to the total monetary value of a country's exports of commodities and total value of imports of commodities. In other words, balance of trade is the difference between the values of goods and services that are exported and imported.

Tip

Balance of trade = Net earnings on exports – net payment made for imports

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If a country has a balance of trade deficit, it means its imports are more than its exports. However, if a country has a balance of trade surplus, it means its exports are more than its imports.

Balance of trade is only a segment of the balance of payment. **Balance of trade only considers the difference between the value of visible goods exported and visible goods imported.**

The important factors that affect the balance of trade are:

- cost of production
- availability of raw materials
- exchange rate movements

Balance of payment

Balance of payment of a country is the systematic record of all the economic transactions of a country with all other countries of the world during a period of one year.

Balance of payment includes all economic activities and transactions giving rise to payments and receipts between the residents of one country and all other countries of the world. Thus the scope of balance of payment is wider than balance of trade.

It's basically a double entry concept, where payment received from a foreign country is a credit transaction and payment made to a foreign country is a debit transaction.

The balance of payment includes:

- the current account: this mainly measures the flow of goods and services e.g. importing a Japanese car. The balance of trade forms part of the current account.
- the capital account: this consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets e.g. charitable donations.
- the financial account: this records financial asset flows (e.g. shares and debentures) and foreign direct investment flows e.g. purchasing a place of residence abroad.

Favourable and unfavourable balance of trade

The meanings of the two concepts enable you to distinguish between them

Balance of trade of a country may be favourable or unfavourable.

When the total value of commodity exports of a country exceeds the total value of imports, it is said that the country has a favourable balance of trade.

On the other hand, when total value of exports is less than imports then that country is said to have an unfavourable balance of trade.

Tip

A favourable balance of trade means a trade surplus i.e. value of export is more than the value of import.

An unfavourable balance of trade means trade deficit i.e. value of export is less than the value of import.

To sum up, balance of trade is the largest component of a country's balance of payments. Debit items include important, foreign aid, domestic spending abroad and domestic investments abroad. Credit items include exports, foreign spending in the domestic economy and foreign investments in the domestic economy. A country has a trade deficit if it imports more than it exports; the opposite scenario is a trade surplus.

The balance of trade is one of the most misunderstood indicators of the country's economy. For example, many people believe that a trade deficit is a bad thing. However, whether a trade deficit is a bad thing is relative to the business cycle and economy. In a recession, countries like to export more, creating jobs and demand. In a strong expansion, countries like to import more, providing price competition, which limits inflation and, without increasing prices, provides goods beyond the economy's ability to meet supply. Thus, a trade deficit is not a good thing during a recession but may help during an expansion.

Case Study

TANZANIA BALANCE OF TRADE

Tanzania recorded a trade deficit of 414.50 USD Million in November of 2013. Balance of Trade in Tanzania is reported by the Bank of Tanzania. Balance of Trade in Tanzania averaged -303.47 USD Million from 2006 until 2013, reaching an all time high of -101.80 USD Million in January of 2006 and a record low of -763 USD Million in August of 2011. Tanzania major exports are agricultural commodities with tobacco, coffee, cotton, cashewnuts, tea and cloves being the most important. Other exports include gold and manufactured goods. Tanzania main exports partners are India, Japan, China, United Arab Emirates, Netherlands and Germany. Tanzania imports mostly transport equipment, machinery, constructions materials, oil, fertilizers, industrial raw materials and consumer goods. Main imports partners are: China, India, South Africa, Kenya and United Arab Emirates. This page contains - Tanzania Balance of Trade - actual values, historical data, forecast, chart, statistics, economic calendar and news. 2014-01-31

Actual	Previous	Highest	Lowest	Forecast	Dates	Unit	Frequency
-414.50	-312.20	-101.80	-763.00	-426.99 | 2013/12	2006 - 2013	USD MILLION	MONTHLY

Source: http://www.tradingeconomics.com/tanzania/balance-of-trade

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Test Yourself 6

The difference between the values of goods and services exported and imported is called...................

A Balance of trade
B Balance of payment
C Trade balance
D Balancing trade

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7. Identify, describe and apply documents used in international trade.

[Learning Outcome i]

The main documents which are used in international trade are as below:

1. Indent

It is also called **quotation**. An indent or quotation is an order placed for import of goods. Sometimes a buyer asks the seller to give a quotation. A quotation **contains terms and descriptions** about the seller's willingness to sell goods and on what terms. It is sent by the importer to the exporter for supply of goods. This document contains full information regarding the goods to be imported i.e., description of goods, quantity, quality, grade, size, design, period of delivery, price including discounts and other benefits, mode of payment, delivery schedule, period of validity and other instructions regarding shipment and insurance, etc.

Proforma quotation

Computech Ltd **2nd Lane,23/4, Brussels, Belgium** **Quotation**		
Buyer's Name		**Q. NO. 1065**
James Trading Corp		**Date: 24 Aug 20X8**
Address		
Sr. No	**Details**	**Rate $**
1	Computers	400 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		

2. Letter of credit

In international trade, the buyer i.e. the importer has to demonstrate his credit-worthiness to the seller i.e. the exporter. This is done by issuing a letter of credit. A letter of credit is a document issued by a bank in favour of the exporter on the request of the importer. It contains an undertaking by the bank that the seller will receive a specified amount of money within a specified time.

Due to the nature of international dealings including factors such as distance, differing laws in each country and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade. The bank also acts on behalf of the buyer (holder of letter of credit) by ensuring that the supplier will not be paid until the bank receives a confirmation that the goods have been shipped.

3. Bill of lading

It is a document prepared and issued by the ship owner to the exporter as a proof of the receipt of goods. By issuing the bill of lading, the ship owner undertakes to deliver the goods at the port of destination. The exporter then sends this bill of lading to the importer who needs to present it at the port of destination while taking the delivery of the goods.

4. Bill of entry

Bill of entry is a form to be filled by the importer at the time of receiving the goods. It is a document based on which the imported goods are cleared from the port.

Example

The import documents in Tanzania include following:

(a) The quotation

(b) The final invoice

(c) The export contract

(d) The packing list

Continued on the next page

(e) The letter of credit

(f) Certificate of shipment inspection

(g) Transportation documents i.e. Bill of Lading/Airway Bill/Road Consignment

(h) Agent's Authorisation Letter

(i) Import permits i.e. TFDA, TBS, chemical permit etc. (If any)

(j) TIN Certificate (Importer)

The export documents in Tanzania include following:

(a) Invoice

(b) TIN certificate of exporter

(c) Agent Authorisation letter

(d) Export Licence

(e) Government Revenue Receipt (GRR) as evidence of payment of royalty depending on goods to be exported

(f) Export permits from relevant Authorities depending on nature of the goods to be exported; these include:

Certificates from Food and Drugs Authority
Certificates from Ministry of Agriculture for crops
Certificates from Ministry of Energy & Minerals
Certificates from Ministry of Natural Resources
Certificates of origin depending on destination of goods (EAC, SADC, EU and AGOA)

Test Yourself 7

A ---------------------------- is a document issued by an importer's bank in favour of the exporter containing an undertaking by the bank that the seller will receive a specified amount of money within a specified time.

A Indent
B Letter of credit
C Bill of entry
D Bill of lading

Answers to Test Yourself

Answer to TY 1

The correct option is **B**.

Answer to TY 2

The correct option is **D**.

Answer to TY 3

The correct option is **D.**

Answer to TY 4

The correct option is **B**.

Answer to TY 5

The correct option is **A**.

Answer to TY 6

The correct option is **A**.

Answer to TY 7

The correct option is **B**.

Self-Examination Questions

Question 1

Which of the following is a reason for countries to import goods or services?

A Some imported goods are better in quality
B Some imported goods are cheaper as those can be produced in other countries at less cost and more effectively
C Some goods cannot be produced in the home country because the necessary resources are not naturally available.
D All of the above

Question 2

Give any three reasons for countries to export goods or services.

Question 3

When a country imports more than it exports, it is called……….

A Balance of trade
B Recession
C Favourable balance of trade
D Unfavourable balance of trade

Question 4

When a country exports more than it imports, it is called……………

A Favourable balance of trade
B Unfavourable balance of payment
C Trade balance
D Balancing trade

Question 5

The balance of trade is only a segment of the balance of payment. This statement is:

A True
B False

Question 6

Explain the three key problems associated with International Trade.

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **D**.

Answer to SEQ 2

Countries export goods or services for the following reasons.

- Goods and services produced in the country are in excess of the requirements of the country
- Some nations are able to sell goods or services to other nations at higher prices than they can obtain in the home country.
- Export helps earning foreign currency with which the country buys essential imports.

Answer to SEQ 3

The correct option is **D.**

Answer to SEQ 4

The correct option is **A**.

Answer to SEQ 5

The given statement is **true**.

Answer to SEQ 6

The key problems associated with International Trade are as follows:

1. **Problems of distance:** international trade involves two or more countries that are far from one another. This makes it difficult to establish quick and close trade contact between the importers and exporters.

2. **Problem of transport and communication:** this problem arises when transport and communication are not efficient. Long distance transportation increases the cost of gods due to high transportation costs. It also takes longer to make goods available at the right place as frequent loading and unloading of goods is required. This also increases the risk during transportation such as damage and theft.

3. **Different in law and legal interpretation:** international trade law and its interpretation in one country may differ from that of another country. Each country has its own rules and regulations regarding international trade in order to protect its economic and political interest. These rules change from time to time and traders constantly need to update themselves with the rules and regulations and procedures followed by different countries.

SECTION B

AIDS TO TRADE

B1

STUDY GUIDE B1: MONEY AND BANKING

Get Through Intro

People engage themselves in various economic activities. What they get in exchange for these services is money. It is money that we give in exchange for various products like food, clothes, movies, houses, mobiles and all other things.

People also need to meet future needs like buying a bigger house, education, retirement etc., for which they have to save money from their present earning. However, if you keep these savings in your house, there is a risk of loss by theft, robbery and other accidents. Therefore, a bank is the place where you can keep your savings safely and the savings would be available to you when required.

In today's world, banking is considered to be the nerve centre of trade, commerce and business in a country. The banking function plays a key role in providing the finance for the development of trade, industry and commerce.

In this Study Guide, we will discuss the various functions of money and banking.

Learning Outcomes

a) Explain the evolution of money and functions of money.
b) Explain the evolution of banking and functions of central and commercial banks.
c) Identify state and apply various means of payments.
d) Identify and state the legal relationship between a banker and a customer and their respective duties.

1. Explain the evolution of money and functions of money.

[Learning Outcome a]

1.1 Meaning of money

Money is a legally accepted tender that serves as a unit of measuring value and which is used as consideration for financial transactions. For example, in Tanzania, Tanzanian Shillings (Tshs) is the unit of currency.

1.2 Evolution of money

In ancient times, people used to exchange commodities for other commodities. This was called '**barter system'**. So if one person is a fisherman and other owns a poultry farm, they will exchange fish for eggs. Thus, it was exchange of commodities against commodities or exchange of services against services or exchange of commodities against services. However, the problem with exchange is that it can only take place where needs meet. If no one wants fish, no one will give eggs to the fisherman.

Then came the phase of **commodity money** where people used to exchange various goods they needed for various valuable commodities like weapons, sheep and cows. Salt was another popular item exchanged.

Then coins were invented as a medium of exchange of goods. This used to work just like commodity money, but the commodity was the metal that the coin is made of. Precious metals like gold and silver were used to make coins. As the metal content in all the coins can remain the same, it provided uniformity in exchange.

However, using precious metals also involved problems as it was difficult to use the gold and silver coins for small value transactions. Therefore, a medium was needed which acts as a generally accepted medium of exchange and which also can be broken down into smaller denominations.

The money that we use today is '**representative money'.** The actual material of the money i.e. the paper used to make the currency note is not valuable, but it has a market value.

Another type of money that we commonly use in today's world is **credit money**, i.e. the money in your bank account. Although you do not have the money in hand you still own it and you can direct the bank to pay the money to your order.

This is discussed in detail in Study guide: C5

1.3 Functions of money

The key functions of money are:

1. To serve as a medium of exchange

An important function of money is to serve as a medium of exchange. Money is accepted as a medium that facilitates exchange of goods and services.

Manufacturers manufacture goods and sell to the wholesalers in exchange for money who then sell to retailers, and who further sell to the consumers in exchange for money. Similarly, people provide their services in exchange for money and they use that money to buy goods and services which they need.

Money has overcome various problems associated with the barter system such as it is handy and convenient to carry and it is divisible into smaller denominations.

2. To serve as standard of value

Money serves as a unit to measure the value of various goods and services. It has a fixed and determinable value attached to it and the price of various goods and services is determined and expressed in terms of monetary units e.g. Tshs10,000 per kg of wheat. Thus, money expresses the exchange value of goods and services. By working as a unit of value, money has facilitated modern business and trade.

3. To facilitate storing of value

The evolution and acceptance of money as a medium of exchange has made it possible to store the surplus purchasing power and use it when needed. As money has constant value, it facilitates storing the value in the form of saving which was not possible with the barter system. Saving in money is secure and its possibility of being destroyed is very less.

Test Yourself 1

Which of the following is the function of money?

A To serve as a medium of exchange
B To serve as standard of value
C To facilitate storing of value
D All of the above

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2. Explain the evolution of banking and functions of central and commercial banks. [Learning Outcome b]

Although there are many views on the origin of the word 'bank', the widely accepted view is that the word 'Bank' is derived from the word "Bancus" which means a "Bench". It is said that merchants used to transact their business of money exchange on benches. If the business of any businessman failed, people used to destroy his bench – this practice evolved the word "Bankrupt".

Definition

A bank is a financial institution that works as a financial intermediary by receiving the money from one group of people and lending it to other groups of people.

2.1 Evolution of banking

1. Storing wealth underground

In absence of any secured mode of storing wealth, in ancient times**, people used to hide their wealth under land,** i.e. by digging the earth and storing their wealth underground. However, this method was not convenient and there was risk of theft etc. Therefore this method was not satisfactory.

2. Storing wealth in goldsmith's custody

To overcome the difficulty of storing wealth underground, a system was accepted whereby people started giving their money and valuable goods in the custody of a reliable person. For example, in the UK, people started keeping their valuables in the custody of the goldsmiths who were considered trustworthy due to their sound financial position. People started depositing their valuable goods and money with the goldsmiths in return of a charge. Thus, it was the first stage in the evolution of banking, and goldsmiths were the early bankers. In Greece, temples served as banks where priests lent money and charged interest on loans. Jews started banking business in individual capacities.

Eventually, the people who had deposited their wealth with the goldsmiths or priests started using the receipts issued by them as medium of exchange to buy valuable goods from the traders. Traders also started accepting the receipts from goldsmiths against the payments. So the receipts were used just like the bank cheque of the modern age

As the receipts were sufficient to buy the goods they needed, the necessity to actually withdraw the money from the custody of goldsmiths started diminishing so the goldsmiths started using a portion of the people's money in their custody to lend and earn profit.

Thus, the goldsmith started the business of lending. Slowly, in order to attract more deposits from people, they started paying interest to the depositors and that money would be used to lend to other people at higher interest.

Eventually, the number of transactions and amounts involved in these transactions increased manifolds and then the modern banks came into existence which are the financial institutions engaged in the business of accepting deposits from public and using those deposits to lend money.

Tip

Earliest banks that were established are:

Venice in 1157
Spain in 1401
Bank of Genova in 1407
Bank of Amsterdam- (model for many banks in Europe) in 1609

The difference between interest charged on lending and interest paid on borrowing is the income for the bank.

Example

ABC bank pays 8% interest on fixed deposit and gives personal loan at 12% interest. So the difference of 4% between the lending rate of 12% and the deposit rate of 8% is the part of bank's profit. This difference between interest earned and interest paid is also known as **'Spread'**.

2.2 Role of banks in economy

Modern banks play a vital role in the development of the economy of any nation as follows:

(a) Banks **act as a bridge** between people who have surplus money and people who require money and thus make funds available for productive business activities.

(b) Banks **facilitate the development of the national economy** by providing loans and credit available to businesses of various sizes and natures operating in various sectors, and thus help achieve balanced economic development.

(c) Banks **help improve the standard of living of people** by lending funds to fulfil their various wants such as car, house, and holidays. Without the facility of having access to borrowing, which is to be repaid over a period from future earnings, the purchasing of people would have remained at a very low level.

(d) Banks **promote saving habits** amongst people.

2.3 Central and commercial banks

As public money is involved in the functioning of banks, it is extremely important to regulate their operations to keep people's faith in them intact. It is important to ensure that they limit their lending and maintain adequate cash reserves to meet the demands of the depositors.

Therefore the government of every country establishes a central bank. All the commercial banks perform their operations following the instructions and guidelines given by the central bank.

1. The central bank

Every country has its own central bank which is the apex bank and the statutory institution for the monetary transactions of a country. The central bank undertakes the functions of guiding and regulating the banking system of a country. The central bank does not deal with the general public directly by being involved in accepting deposits and lending money. Thus, it is the bankers' bank i.e. it accepts deposits from all other banks and advances money to other banks, when needed.

Tip

The Bank of Tanzania (BOT) is the central bank of Tanzania.

2. Functions of the central bank

The key functions of central bank are as follows:

(a) To advice the government on monetary and credit policies of the country.

Monetary policy involves controlling the supply or level of money in an economy. The key objective of monetary policy is achieving price stability (controlling inflation).

Monetary policy attempts to influence this demand by either raising or lowering interest rates. When governments feel the inflation rate is too high, interest rates are raised. This gives consumers (both individuals and businesses) a greater incentive to not purchase goods and services, thereby reducing the demand for them.

(b) To regulate and supervise the banking system in the country.

The central bank is responsible for making the banking regulations in a country and ensuring the adherence to these regulations by all the banks. The control of the central bank over the country's banking system results in public confidence in the banking system of the country.

(c) To issue currency notes and regulate their circulation in the country.

The central bank of a country has the sole power to issue currency notes and coins. As the central bank enjoys monopoly in the function of issuing currency, it ensures uniformity in the monetary system of note issue and note circulation.

(d) To regulate the interest rates for bank deposits and bank loans in a country.

Central bank controls and monitors the interest rates for deposits and loans to ensure economic growth and stability of a country.

Example

When the economy faces problems like unemployment, it reduces the interest rate on borrowing which makes the loans cheap and enhances investment in businesses, thus giving the required push to the economy.

(e) To act as the banker and fiscal agent of the government.

A central bank performs all the functions for the government that a commercial bank performs for its customers. A central bank accepts deposits from central and state governments, makes short-term advances to the government; collects cheques and drafts deposited in the government account and also provides foreign exchange resources to the government. It also acts as a financial advisor to the government and advises on economic, monetary and financial issues and policies e.g. foreign trade policy.

(f) To act as the banker's bank.

The central bank accepts deposits from all other banks and advances money to other banks, when needed. That is why it is called a banker's bank. In many countries, the banking regulations requires that every commercial bank must keep a certain percentage of its cash balances as deposits with the central bank, and these cash reserves can be utilised by the commercial banks in times of emergency.

(g) To act as the custodian of foreign exchange reserves of the country

The central bank acts as a custodian of foreign exchange reserves of the country. The central bank maintains the international currencies coming into the country. The central bank controls and manages foreign currency inflows and outflows and thereby maintains the value of the domestic currency at an appropriate level.

3. Commercial banks

Commercial banks, in simple terms, are the banks that accept deposits of money from public for the purpose of lending. Thus, the basic function of a bank is to accept deposits from the public who have surplus funds and give loans to people who need it.

Definition

"Bank" means an entity that is engaged in the banking business;

"Banking business" means the business of receiving funds from the general public through the acceptance of deposits payable upon demand or after a fixed period or after notice, or any similar operation through the frequent sale or placement of bonds, certificates, notes or other securities, and to use such funds, in whole or in part, for loans or investments for the account of and at the risk of the person doing such business;

The commercial banks play a key role in the development of trade and commerce in the country.

Although, the commercial banks carry out the traditional banking functions of accepting deposits and giving loans, with the change in the outlook of banks and the evolution of modern banking these banks have started providing a host of different banking services to their customers.

(a) Primary functions of commercial banks

(i) Accepting Deposits

Commercial banks accepts deposits from public in various forms such as saving account deposits, recurring account deposits, fixed deposits, etc. The banks also pay interest on the amounted deposited with it by the clients.

(ii) Granting loans

Commercial banks provide loans and advances in various forms such as short and long terms loans, over draft facility, cash credit, bill discounting, etc. The bank charges interest on the advances made by it.

Tip

Cash credit

The borrower needs to have an account with the bank to avail cash credit facility. The borrower opens a loan account with the bank and can withdraw any amount up to a sanctioned limit.

Overdraft

A borrower can withdraw in excess of his balance to the extent of the loan limit sanctioned. The excess amount withdrawn is treated as loan. Bank charges interest for allowing this facility.

Bill discounting

If a person holding bill of exchange is in need of money before the due date of the bill then he can go to the bank and sell that bill to the bank at a discounted amount. Banks then collect the full money from the drawer of the bill on the due date.

(b) Secondary functions of commercial banks

Over the years, the banking industry is constantly innovating new products. Therefore, apart from the basic borrowing and lending services, banks provide various other functions which can be subdivided into two sub categories as:

(i) Agency functions

- Payment and collection of cheques and promissory notes: The banks collect cheques and promissory notes on behalf of the customers and makes payment against such instruments.

- Execution of standing instructions: Clients give standing instructions to the bank to make payments on his behalf for example, payment of insurance premium, rents, and subscriptions to various magazines. Banks charges small fees for executing such instructions.

- Purchase and sale of securities: Many banks also provides information regarding stocks and shares and also undertakes to purchase or sell shares on behalf of the customers.

(ii) General utility functions

- Providing locker facility, in which the customer can keep precious ornaments, important documents and other things.

- Collecting taxes on behalf of the various government bodies.

- Banks issue letter of credits to their clients which they can use as surety which enable new businessmen to deal with them.

- Banks provides guarantee on behalf of their clients to third parties.

Test Yourself 2

.... occupies a central position in the monetary and banking system of the country and has superior financial authority.

A Central bank
B Commercial bank
C Government bank
D Credit bank

---

3. Identify state and apply various means of payments.
[Learning Outcome c]

The various means of payment are as follows:

1. The cheque

The cheque is a written document through which a person (the drawer) gives order to the bank (the drawee) to remit to him or to his order (the payee), a certain amount.

Tip

- Drawer: the person who draws the cheque, i.e., the depositor of money in the bank.
- Drawee: the drawer's banker on whom the cheque has been drawn.
- Payee: the person who is entitled to receive the payment of the cheque.

The cheque is a most frequently used non-cash payment instrument in various countries, including Tanzania.

2. The demand draft

A demand draft is an order from one branch of a bank to its other branch to pay a specified amount of money to the person in whose favor the demand draft is issued. A demand draft is always payable on demand.

When payments are made through cheques, there is a risk that the cheque may be dishonoured due to non-payment. However, demand draft provides surety of payment. Therefore, this is a more secure means of payment.

3. Banker's cheque or pay order

A pay order is very similar to demand draft but it is issued by and drawn on the same bank. It is an order of one branch of a bank to another branch of that same bank to pay a specified amount to the payee whose name is written on the pay order. Thus, the pay order is as good as cash; the payee can go to any branch of that bank and can withdraw the money.

It is a more convenient mode of payment when the payer and payee have accounts in the different branches of the same bank.

4. The telegraphic transfer (TT)

Transferring funds through telegraphic transfers are relatively reliable and faster. . TT is electronic means of transferring money. Where money is to be sent urgently, a coded message is sent from one bank to another by telephone or telegraph to effect the

This mode is very useful for serving customers in places where the paying bank has no branch.

5. Direct debit

Some banks provide direct debit services to their customers by use of "Standing/Bankers orders". This service is not common and is limited for intra-bank transactions. However, some customers use it for recurring loan repayments, insurance premiums, water and electricity bills payments, house rents and hire purchase installments.

6. Travellers' cheques

Traveller's cheques are very helpful to avoid the risk of carrying money while travelling. A person can deposit money in bank and obtain traveller's cheque in exchange of the money deposited. The person can deposit the travellers' cheque in any branch of that bank and get cash in exchange of it.

7. Payment card

Many banks issue electronic transfer instruments (cards) to facilitate electronic processing of transactions such as transfer of funds, withdrawing and depositing of funds, access to an account etc.

There are two types of cards which are commonly issued:

(i) cards with a sole cash withdrawing function from cash machines (ATM cards) and

(ii) payment cards which, in addition to their withdrawing function, help to pay via electronic payment terminal network (Debit and Credit cards).

(iii) Gift cheques are issued by banks on the request of the clients. The client deposits money into the bank and obtains gift cheque of that amount. The client gifts such cheques to friends and relatives who can then withdraw money from the bank against that gift cheque and buy the gift of their own choice.

Test Yourself 3

State whether the following statement is true or false

'There are only two parties to a cheque: the drawer and the drawee.'

4. Identify and state the legal relationship between a banker and a customer and their respective duties.

[Learning Outcome d]

4.1 Legal relationship

The relationship between a bank and a customer is primarily that of a debtor and a creditor (for deposits and lending transactions). Thus, the money that the customer deposits in the bank is as good as lending by the customer to the bank. The customer becomes the debtor and the bank becomes the creditor.

It is important to note that a bank's position is not the same as that of a custodian in the sense that a bank is entitled to use that money at its discretion. However, the customer has the right to demand his money back from the bank whenever he wants and the bank is under an obligation to repay the debt as and when demanded by the customer.

Another important point to note is that although the customer is in the position of a debtor, he does not have any charge on assets of the creditor (i.e. the bank) so his position is that of an unsecured creditor.

In the case of a loan or overdraft account, the position of the bank changes to debtor and the customer becomes the creditor. This position is continued until the loan is repaid by the customer. Also, as the loans and advances granted by a bank are usually secured by the tangible assets of the borrower, the bank becomes a secured creditor of his customer.

4.2 Duties of banks

(a) It is the duty of a bank to receive the money into the customer's account and accept cheques and other negotiable instruments for clearing into the customers' account.

(b) It is the duty of a bank to honour cheques and other withdrawals properly authorised by the customer when there are sufficient funds in the customer's account.

(c) It is the duty of a bank to inform the customer incidences like forgery of his signature on a cheque or other instrument.

(d) It is the duty of the bank to provide the customer the statements of his account regularly for record and reconciliation purpose.

(e) It is the duty of the bank to pay interest on deposits at agreed rates and any other agreed returns on customer's investments in the account.

(f) It is the duty of a bank to ensure the safety of customer's money.

(g) It is the duty of a bank to keep the customer's information confidential.

4.3 Duties of Customers

(a) It is the duty of a customer to adhere to all the policies of the bank.

Example

When it is the policy of the bank that the customer must sign the register while accessing the safe deposit locker, it is the duty of the client to sign the register every time.

(b) It is the duty of a customer to not conduct any activities with fraudulent purpose or not to participate in any form of malpractices.

Example

It a customer is approaching a bank for a term loan then it his duty to submit all authentic papers related to his application. If the borrower submits a fake letter of employment which mentions the salary in excess of his actual salary then it is clear that the borrower wants to mislead the bank by showing higher income than his real income.

(c) It is the duty of a customer to inform the bank of any information/suspicion of fraud immediately.

(d) It is the duty of a customer to keep updated records of statements of transactions with the bank and inform the bank if any discrepancies are noticed.

(e) It is the duty of the customer to pay the agreed charges for the services of the bank.

Test Yourself 4

Which of the following is not a duty of a bank?

A To pay interest on deposits at agreed rates and any other agreed returns on customer's investments in the account.
B To ensure the safety of customer's money.
C To keep the customer's information confidential.
D To pay the agreed charges for the services of the bank.

Answers to Test Yourself

Answer to TY 1

The correct option is **D**.

Answer to TY 2

The correct option is **A**.

The central bank occupies a central position in the monetary and banking system of the country and has superior financial authority.

Answer to TY 3

The given statement is false.

There are three parties to a cheque: drawer, drawee and payee.

Answer to TY 4

The correct option is D.

To pay the agreed charges for the services of the bank is the duty of the customer, not of the bank.

Self-Examination Questions

Question 1

Only the .... is entitled to issue currency notes.

A Central bank
B Commercial bank
C Government bank
D Credit bank

Question 2

What is a bank?

Question 3

Which of the following is not a function of the central bank?

A To advise the government on monetary and credit policies of the country.
B To regulate and supervise the banking system in the country.
C To issue currency notes and regulate their circulation in the country.
D To accept deposits from the general public.

Question 4

What are the important functions of money?

Question 5

Which of the following assets is the most liquid?

A Currency
B Shares
C Land
D Gold

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **A**.

Only the central bank is entitled to issue currency notes.

Answer to SEQ 2

A bank is a financial institution that works as a financial intermediary by receiving money from one group of people and lending it to other groups of people.

Answer to SEQ 3

The correct option is **D**.

Central bank does not accept deposits from the general public.

Answer to SEQ 4

The important functions of money are:

- To serve as a medium of exchange
- To serve as standard of value
- To facilitate storing of value

Answer to SEQ 5

The correct option is **A**.

Currency is the most liquid asset.

SECTION B

AIDS TO TRADE

B2

STUDY GUIDE B2: INSURANCE

Get Through Intro

Life and business share one thing in common and that is uncertainty. There is a significant risk involved in business as well as in life. Therefore, we always want to protect or indemnify ourselves and our businesses from this risk as much as possible. Insurance is the mechanism whereby this risk is spread among all who are exposed to similar risk and transferring these risks to entities who have the capacity to handle them.

It is believed that over 5000 years ago, insurance was used by Chinese merchants by redistributing the cargo of each vessel across many vessels to limit the loss due to any single vessel's destruction.

After the Great Fire of London destroyed over 13000 houses in 1666, the first fire insurance company. The Insurance Office for Houses, was started in 1680 to insure brick and frame homes from such future events.

In the modern word, insurance has become an indispensable need for people as well as for businesses. In this
Study Guide, we will understand the meaning, importance and various types of insurance.

Learning Outcomes

a) Describe the nature and importance of insurance.
b) Identify and explain principles of insurance.
c) Identify and state types of insurance (life, fire, motor and marine insurances)
d) State property insurance and guarantee insurance policies.
e) State and describe general third party insurance.
f) State and describe the average clause.
g) Explain how to prepare an insurance claim.

1. Describe the nature and importance of insurance.
[Learning Outcome a]

1.1 Nature of insurance

Insurance, in simple terms, means a mechanism by which the risks of loss or damage can be passed on to another party who can bear the risk on the payment of a charge.

- The party which passes the risk is called the insured.
- The party to whom the risk is passed on is called the insurer, which generally is an organisation i.e. insurance company.
- The consideration is called the premium.

Definition

Insurance is a contract between the insurer and insured whereby the insurer undertakes to pay the insured a fixed amount, in exchange for a fixed sum known as premium, on the happening of a certain event (like at a certain age or on death), or compensate the actual loss when it takes place, due to the causes mentioned in the contract.

The insurance industry works on the concept of pooling and co-operation. All the insured, who are subject to similar risks, are brought together, where everyone pays premium and only a few among them who actually suffer the loss or damage are compensated using the money collected from all the insured in the form of premium.

Instead of people forming such groups on their own, the insurance company acts as an intermediary and brings them together, collects premium from all of them and pays compensation to a few of them who actually suffer loss. Thus, the risk is spread across all the insured members.

Tip

Insurance in Tanzania is governed by Tanzania Insurance Regulatory Authority.

1.2 Importance of insurance

Insurance in an important aid to trade as it introduces security and thus increases the efficiency of business. Insurance helps in spreading the effects of personal as well as business risks by way of loss or damage among many and thus facilitates equitable distribution of losses. It provides security to individuals and to businesses.

Businesses invest a large amount of money in properties, factories, raw material, and various other things to facilitate the manufacturing and production of various commodities necessary for consumption. This investment is always subject to various risks such as risk of loss in business, risk of loss due to fire, flood or other natural calamities. Without any means of security, people would be afraid of putting their money in development of business. However, insurance gives them assurance that by contributing a small amount in the form of premium, they will be compensated against a loss that may take place in future.

Economic development of any country depends on growth of businesses, and businesses in turn are dependent on insurance to provide them security. Thus, insurance plays a significant role in the economic development of a country.

Insurance also enables savings of individuals to build up with the insurance companies by way of premium collected against assurance of protection from loss. The insurance companies invest these funds in securities issued by big companies as well as by Government which lead to economic development.

Insurance business also facilitates creation of various employment opportunities for people. The employment opportunities are in the form of direct employment in insurance company offices spread over the country and also in the form of working as agent of the insurance companies.

Test Yourself 1

The party who agrees to compensate the other person against possible losses is called the --------------------.

A Insured
B Insurer
C Assured
D None of above

---

2. Identify and explain principles of insurance.

[Learning Outcome b]

The key principles of insurance are as follows:

1. Principle of good faith

Good faith is a very basic and primary principle of any contract. This principle requires that the insured provides complete, clear and true information of the risk to be covered to the insurer and the insurer also should provide correct and clear information about the terms and conditions of insurance to the insured. If the insurance contract is obtained by way of fraud or misrepresentation, it is void.

2. Principle of insurable interest

The principle of insurable interest states that the person getting insurance must have insurable interest in the subject matter for which he wants to take insurance.

A person is said to have an insurable interest in the insured object of he will suffer some loss by the damage of that insured object.

Example

- A person has insurable interest in his own life or in the life of his spouse, children and parents.
- A person has insurable interest in the assets he owns as he benefits from the use of the assets and is affected if the asset is damaged or destroyed.
- A merchant has insurable interest in his business of trading.
- A creditor has insurable interest in his debtor.
- A bank has insurable interest in the property mortgaged against the loan.

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3. Principle of indemnity

The purpose of insurance is to indemnify i.e. to compensate for the loss suffered.

According to the principle of indemnity, the insurer should compensate the insured only to the extent of the actual loss suffered. The compensation must not be less or more than the actual damage. Insurance is not the means for making profit and its sole purpose is to give compensation in case of any damage or loss.

Example

A trader has taken a fire insurance policy for a machine. If that machine is destroyed by fire, the loss suffered by the trader is indemnified by paying the cost of a similar machine after deducting depreciation charge for usage and wear and tear till the date of fire.

While most general insurance contracts work on the principle of indemnity, life insurance contract is an exception to this principle as the value of human life cannot be measured in terms of money. Therefore, the principle of indemnity does not apply to life insurance contracts.

4. Principle of contribution

Principle of contribution is a corollary of the principle of indemnity and applies to all contracts of indemnity. The principle of contribution requires that where the insured party has taken out more than one policy on the same subject matter then compensation can be claimed only to the extent of actual loss either from all insurers or from any one insurer.

The principle of contribution does not apply to life insurance policies as the loss of human life can never be fully compensated.

5. Principle of subrogation

Principle of subrogation, too, is a corollary of the principle of indemnity and applies to all contracts of indemnity.

According to the principle of subrogation, once the insurer compensates the insured for the losses due to damage to his insured property, the rights of the insured in that insured property get transferred to the insurer.

This principle enables the insurer to make good the damages from the party who caused the loss.

Example

Tom insures his house for Tshs1000,000. The house was subsequently destroyed by the negligence of his neighbour, Jerry. The insurance company shall indemnify Tom for Tshs1000,000. After paying Tom the compensation, the right of Tom to recover damages from Jerry gets transferred to the insurance company who can sue Jerry for making good the loss.

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6. Principle of loss minimisation

The principle of loss minimisation requires that the insured party must always take all possible measures to avoid and minimise the loss to his insured property. The insured must not neglect and behave irresponsibly during events such as fire just because the property is insured.

7. Principle of proximate cause

The principle of proximate cause means when a loss is caused by more than one cause, operating simultaneously or in sequence, the proximate or the nearest cause should be taken into consideration to decide the liability of the insurer.

Example

There was a fire in the warehouse, and all the goods kept in the warehouse were removed and kept in the open area nearby. The goods remained there for many days, unattended, and were destroyed by heavy rainfall after a few days.

In this case, the proximate cause of damage to goods is rain and not the fire in the warehouse.

Test Yourself 2

Which principle suggests that the insured should try to minimise the loss to his property even if it is insured?

A Principle of indemnity
B Principle of loss minimisation
C Principle of proximate cause
D Principle of contribution

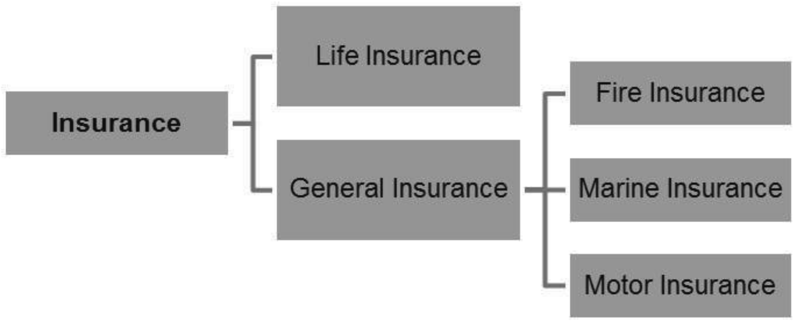
---

3. Identify and state types of insurance (life, fire, motor and marine insurances). [Learning Outcome c]

Insurance may be broadly classified into the following two types.

1. Life Insurance
2. General Insurance

Diagram 1: Types of insurance



1. Life insurance

Life insurance deals with covering lives of human beings against death, accident, disability etc.

Life insurance is a contract whereby the insurer undertakes to pay a certain sum either on the death of the insured or on the expiry of a specific period, in return for a premium.

The principle of indemnity is not applicable for life insurance contracts; therefore, a definite amount to be paid on the event of death or on maturity is decided according to the terms of contract of life insurance.

Life insurance provides financial security to the survivors of the insured in the event of the insured's sudden death.

2. General insurance

General insurance is further divided into the following types:

(a) Fire Insurance
(b) Marine Insurance, and
(c) Motor Insurance

(a) Fire insurance

Fire insurance protects the insurer against the risk of loss to his property because of fire.

In a contract of fire insurance the insurer undertakes to compensate the insured for the loss or damage that he suffers because of the damage to the subject matter caused by fire. In exchange for this undertaking, the insured pays premium to the insurer.

Fire insurance contract is subject to the principle of indemnity which means the insured cannot claim anything more than the value of property lost or damaged by fire or the amount of policy, whichever is lower.

(b) Marine insurance

Marine insurance provides protection to the ship or cargo against all marine related risk.

In a marine insurance contract, the insurance company undertakes to indemnify the owner of a ship or cargo against risks that are incidental to marine adventures such as sinking of the ship, storm, fire or explosion on the ship, hitting an iceberg etc. In exchange for this undertaking, the insured pays premium to the insurer.

Marine insurance contracts are also subject to the principle of indemnity and therefore the amount of compensation is limited to the actual loss or damage or the amount of policy, whichever is lower.

(c) Motor insurance

Motor insurance protects the insured against the damage arising out of or in connection with the use of motor vehicles on land, including third party risks and the carrier's liability.

Test Yourself 3

Which of the following is not covered under the principle of indemnity?

A Fire insurance
B Motor insurance
C Life insurance
D Marine insurance

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4. State property insurance and guarantee insurance policies.
State and describe general third party insurance.
State and describe the average clause.

[Learning Outcomes d, e and f]

4.1 Property insurance

Property insurance is every type of insurance that protects property. Property is subject to various types of natural and unnatural risk. Property insurance covers a broad range of items from goods in transit or in store to building or contents e.g. jewellery, paintings, furniture etc. Property insurance applies to both businesses as well as private householders. It covers damage and losses caused to property on account fire, theft, hail, lightning,etc.

4.2 Third party insurance

Third party insurance policies provide protection against the actions of another party. In third party insurance, the insured takes the insurance cover from an insurer to protect him from any claims made by a third party.

A popular example is third party motor insurance which provides protection to the owner of the vehicle from claims made by a third person who was injured in the accident. Although the contract is between the owner of the motor vehicle and the insurance company, the insurance company under third party insurance contract undertakes to indemnify the third party for losses caused by the insured because of the motor vehicle owned by him. Thus, the insured passes on his liability to compensate the injured person to the insurance company in exchange for a premium.

4.3 Average clause

Average clause is a term associated with property insurance. Average clause describes a formula that an insurance company uses in order to calculate the amount payable for a claim related to the replacement cost of a property covered by an insurance policy.

Where the property is not insured for its full replacement value, then in the event of any loss to the property, the insurance company only pays the insurance amount in proportion to the sum insured.

Example

For example, suppose the replacement value of an office building insured by a company is Tshs90,000,000 and the company took insurance for Tshs45,000,000 i.e. equal to 50% of the total replacement value of the property. In this case, if there is any damage to this insured property worth say Tshs20,000,000 then the insurance company will only accept the claim to the extent of 50% of the damages. In other words, although the total claim of Tshs20,000,000 is less than the insured value of Tshs45,000,0000, still the insured party will be able to recover only 50% of the actual loss from the insurance company.

Thus, where the sum insured is less than the replacement value of the property, in the event of claim for damages to such property, the average clause will apply whereby the claim will be reduced proportionately.

Test Yourself 4

State whether the following statement is true or false.

Property insurance applies only to private householders.

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5. Explain how to prepare an insurance claim.

[Learning Outcome g]

Insurance claim, in simple words, means to demand the amount insured. A claim is a formal request by an insured to an insurance company asking for payment based on the terms of the insurance policy.

Once received, the insurance company reviews the insurance claims for their validity and then approves and pays out the insurance amount.

In life insurance contracts, the insurance claims can either be 'claim by death' or 'claim by maturity'.

1. **Claim by death** arises due to the death of the life assured during the term of the policy. The insurance company scrutinises all documents submitted by the legal heirs of the deceased insured before paying the insurance amount. Once the insurance claim is paid, the insurance contract comes to an end.

The general claim procedure in the case of death claim is as follows:

- The nominee or the relative of the deceased policyhoder needs to inform the insurance company about the death of the insured person. Inforamtion such as name of the insured, the date and place of the death, the cause of death, the policy number etc. needs to be provided.
- The claimant needs to submit the death certificate of the insured issued by an appropriate authority .
- The claimant also needs to provide all the necessary docuemnts to prove that she/he is the genuine nominee entitled to receive the insurance amount.
- The insurance company then verifies all the documents submitted to it and makes the payment of the insurance claim to the claimant.

2. **Claim by maturity** is payable to the insured at the end of the term of the contract of insurance i.e. on the maturity date. The insured person needs to submit the following documents for settling the claims:

- original insurance policy document
- duly stamped and signed discharge form
- any other documents as required in the insurance contract

Answers to Test Yourself

Answer to TY 1

The correct option is **B.**

Answer to TY 2

The correct option is **B.**

Answer to TY 3

The correct option is **C**.

Answer to TY 4

The given statement is false.

Property insurance applies to both businesses as well as private householders.

Self-Examination Questions

Question 1

Existence of insurable interest is necessary for:

A Life insurance contract
B Marine insurance contract
C Fire insurance contract
D All of above

Question 2

Principle of utmost good faith is applicable to:

A Life insurance contract
B Marine insurance contract
C Fire insurance contract
D All types of insurance contract

Question 3

The insurance principle stating that the amount of compensation payable should be exactly equal to the financial loss suffered by the insured is:

A Insurable interest
B Utmost good faith
C Indemnity
D Subrogation

Question 4

Name the principle of insurance which establishes that the actual loss should be shared among all the insurers.

Question 5

Name and explain briefly the principle of insurance which states that:

(a) The person taking the insurance policy must have personal interest in the subject matter.
(b) All the rights and remedies which the insured had are transferred to the insurer.

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **D.**

Existence of insurable interest is necessary for all insurance contracts.

Answer to SEQ 2

The correct option is **D.**

Principle of utmost good faith is applicable to all types of insurance contracts.

Answer to SEQ 3

The correct option is **C.**

Answer to SEQ 4

The principle of insurance which establishes that the actual loss should be shared among all the insurers is the principle of contribution.

Answer to SEQ 5

(a) Principle of insurable interest: according to this principle, the insured must have some pecuniary interest in the subject matter of the insurance contract.

(b) Principle of subrogation: according to this principle, it is the right of the insurer to stand in place of the insured after the settlement of a claim as far as the right of the insured in respect of the recovery from an alternate source is involved.

SECTION B

AIDS TO TRADE

B3

STUDY GUIDE B3: WAREHOUSING

Get Through Intro

In our everyday meal, we have rice, cereals and various other food grains. We use them everyday throughout the year. However, these are seasonal products and are not produced throughout the year. Then how do we still get a continuous and uninterrupted supply of these products throughout the year?

Many people love seafood. After the fish are captured from the sea, they need to be properly stored in cold storages before and during the process of delivering to the final consumers in a fresh and unspoiled condition.

Warehouses play an important role in this process. These products are systematically stored in warehouses so that they can be supplied at the appropriate place and time of demand for these products. Warehouses enable the goods to be stored in huge quantities in a proper and systematic way.

In this study guide, we will learn about the different types of warehouses, their importance as well as their advantages and disadvantages.

Learning Outcomes

a) Define warehousing and identify types of warehouses.
b) State the importance of warehousing.
c) Outline the advantages and disadvantages of warehousing.

1. Define warehousing and identify types of warehouses.
[Learning Outcome a]

1.1 Meaning of warehousing

Warehousing is an important component of the various aids to trade. It removes the barrier of time by bridging the time gap between production and consumption of goods.

Definition

Warehousing refers to the activities involving storage of goods in a systematic and orderly manner and making them available conveniently when needed.

Warehousing enables holding or preserving goods in huge quantities from the time of their purchase or production till their actual use or sale.

Types of warehouses

There are different types of commodities which have different storage needs.

The different types of warehouses are:

1. Private warehouses
2. Public warehouses
3. Government warehouses
4. Bonded warehouses

1. Private Warehouses

Private warehouses are owned and managed by the manufacturers or traders and are used to stock their own goods. For convenience in operations, the private warehouses are usually located near the business set-ups of the owners. The design / structure of the warehouses and the facilities are made available according to the requirements of the owners and the nature of the products to be stored. Big businesses often require bigger storage and therefore need to construct the warehouses in different parts of the country or world.

Example

Amazon product lines include various products such as books, DVDs, music CDs, health and personal-care items, industrial & scientific supplies, kitchen items, jewellery and watches, lawn and garden items, musical instruments, toys, games and many other products.

Amazon owns various warehouses located in various cities across the world to ensure adequate and timely supply of products to its customers.

2. Public Warehouses

Public warehouses are the warehouses which allow businesses to store goods on the payment of rent. Public warehouses are commonly used by manufacturers, wholesalers, exporters, importers, etc. They are generally located near the junctions of railways, highways and waterways. They therefore provide excellent facilities for the easy receipt, despatch, loading and unloading of goods.

Public warehouses may be owned by individuals, firms or companies. To operate a public warehouse, a licence needs to be obtained from the government and the government also regulates the functions and operations of public warehouses.

Public warehouses are very useful to the businesses, especially to small traders and manufacturers, as they can meet their storage needs easily and economically, without heavy investment.

Example

Trends, a renowned fashion store in Dar es Salaam, stores all its garments in the three shops it owns in a nearby suburb. However, during Christmas, it orders a large volume of garments offered at a low promotional price by a supplier.

During this period, to store the stock which is in excess of the capacity of the three owned shops, Trends uses a public warehouse for a period of two to three months.

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3. Government Warehouses

These warehouses are owned, managed and controlled by governments, public corporations or local authorities. Both government and private enterprises may use these warehouses to stock their goods.

Case Study

Tanzania has established the Warehouse Receipts System to foster the efforts of the government to formalise the existing marketing systems aiming at minimising various constraints hampering effective production and marketing of the agricultural produce.

The Warehouse Receipts System denotes a kind of trade by which commodities are stored in a Licensed Warehouse(s), the owner of the commodity receives Warehouse Receipts which certifying the title of deposited commodities as of specific ownership, value, type, quantity and quality (grades). The Warehouse Receipt facilitates storage, future trade and access to credit, without necessarily moving the said commodities from the licensed warehouse.

Source: http://wrs.go.tz/

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4. Bonded Warehouses

Bonded warehouse is a building or other secured area used to store imported goods for which import duty is yet to be paid. In the case of imported goods, the importers are not allowed to take away the goods from the ports till the import duty is paid. In such circumstances, the importer needs some temporary warehousing facility to keep the goods in safe condition until the duty is paid. Therefore, the imported goods are moved to bonded warehouses where the warehouse authorities ensure the safety of the goods stored. The bonded warehouses are licensed by the commissioner.

Bonded warehouses may be managed by the state or by private enterprises. In the latter case, a customs bond must be posted with the government. This system exists in all the developed countries of the world.

As bonded warehouses are generally owned by dock authorities, they usually are located near the ports.

Bonded warehouses are very useful for importers and exporters as they allow time to arrange for funds to pay the import duty. It is also possible to pay the custom duty in instalments and remove proportionate goods from the bonded warehouse.

Upon entry of the goods into the warehouse, the importer and warehouse proprietor incur liability under a bond. This liability is generally cancelled when the goods are:

- Exported; or deemed exported;
- Withdrawn for supplies to a vessel or aircraft in international traffic;
- Destroyed under customs supervision; or
- Withdrawn for consumption domestically after payment of duty

While the goods are in the bonded warehouse, they may, under supervision by the customs authority, be manipulated by cleaning, sorting, repacking, or otherwise changing their condition by processes that do not amount to manufacturing. After manipulation, and within the warehousing period, the goods may be exported without the payment of duty, or they may be withdrawn for consumption upon payment of duty at the rate applicable to the goods in their manipulated condition at the time of withdrawal. In the United States, goods may remain in the bonded warehouse up to five years from the date of importation. Bonded warehouses provide specialised storage services such as deep freeze or bulk liquid storage, commodity processing, and coordination with transportation, and are an integral part of the global supply chain.

Case Study

Specific conditions (for Customs Bonded warehouses and Manufacture Under Bond [MUB])

Application to operate licensed premises from applicants who meet each of the General Conditions specified in (A) must:

1. Be made in the prescribed form (i.e. Form C.18)

2. Be accompanied with a site plan professionally drawn showing the location of the premises and its situation in relation to other premises and thoroughfare;

3. Meet the minimum area coverage i.e. square meters 1,000 and 2,000 for private bonded warehouse and general bonded warehouse respectively;

4. Production formulae approved by relevant Authority (for Manufacturing under Bond).

5. Upon fulfilment of the above, be able to execute bond security by a licensed and approved guarantor as follows

- For a private bonded warehouse – a minimum of shillings 500,000,000
- For a general bonded warehouse – a minimum of shillings1,000,000,000
- For MUB – a minimum of shillings 2,000,000,000

In addition to the above bond securities, successful applicants will be required to execute an appropriate revolving Customs Bond to cover the removal of cargo to and from the respective bonded warehouses/MUB at a minimum of shillings100,000,000.

Source: http://www.tra.go.tz/index.php/customs-licenses-for-2014

Tip

Cold storage warehouses

Cold storage warehouses are used for preservation of perishable items like fruits, vegetables, fisheries, poultries, flowers etc.

Cold Storages are special kind of room in which very low temperature is maintained. Once the fruits & vegetables are kept in cold storage, they do not get rotton even after months & can be made available to consumers very easily.

Test Yourself 1

Goods, for which import duty is not paid, are kept in ___________ warehouses.

A Private warehouse
B Public warehouse
C Bonded warehouse

2. State the importance of warehousing.

[Learning Outcome b]

Importance of warehousing

Warehousing is important because of the following reasons.

1. **Certain products** such as agricultural commodities are **seasonal in nature** but they are consumed throughout the year. Therefore, there is a need for **proper storage** or warehousing for these commodities, from where they can be supplied as and when required.

Example

A sugar factory needs sugarcane as raw material for production of sugar. However sugarcane is a seasonal product that means it is produced only during a particular period of the year. Therefore in order to ensure uninterrupted production of sugar throughout the year, it is important that the sugarcane is supplied continuously.

This requires that sugarcane is properly stored throughout the year in sufficient quantity is required.

Also, after production the final product i.e. the sugar requires some time for sale or distribution during which it need to be properly stored in a warehouse.

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2. Certain products such as woollen garments are **demanded only during particular season** of the year however the production of these goods takes place throughout the year to meet the seasonal demand. Therefore these goods are stored in a warehouse and made available at the time of need.

3. Warehouse **protects goods from loss or damage** due to heat, wind, dust, spoilage, wastage etc. It also facilitates special needs of storage of various products such as cold storage.

4. To obtain the **benefits of economy of scale**, manufacturers always manufacture goods in large quantities to ensure they meet the existing as well as future demand of the products. Such goods produced on a large scale need to be stored properly till they are sold.

5. The industrial and the agricultural goods are produced at some specific places but consumed throughout the country. Warehousing enables storing these goods in **sufficient quantity near the place of consumption**, so that those can be made available to the consumer at the time of their need without any delay.

6. If the demand for the goods not met in time, this may result in increase in prices of these goods. Similarly, if goods are supplied in excess quantity than demand this may also lead to fall in prices of the goods. Warehousing **balances supply of goods** to match the demand which leads to price stabilisation.

Test Yourself 2

Warehouses overcome the barrier of______.

A Personal
B Finance
C Time
D Risk

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3. Outline the advantages and disadvantages of warehousing.
[Learning Outcome c]

Advantages

Warehousing function offers many advantages to the business community as explained below.

1. Warehouses are designed to provide a **safe and sufficient space for storing** the raw material until it is used or finished products until they are in demand. The warehousing allows storing the seasonal raw material such as cotton throughout the year and carry on production of finished goods (cloth) continuously without worrying about the storage of raw materials.

2. Warehousing facility is very helpful, especially for **small traders** who cannot afford to invest in constructing their own warehouses. Warehouses **make available the space to preserve the inventory** of raw materials and finished goods on payment of rent.

3. The warehouses **ensure the safety and protection** of the goods from wastage, spoilage, breakage, theft, fire etc. The warehouses takes appropriate measures such as employment of security, installing the fire-fighting equipment, providing provide cold storage facility for perishable items etc. to ensure security and preservation of the goods. It is also possible to insure the goods stored for compensation in case of loss.

4. Warehouses are usually located at opportune places near road, rail or waterways to **enable easy and fast movement of goods** at low cost.

5. Warehouses provide **modern equipment and appliances to make the handling of heavy and bulky goods** easy. This results in reduced cost of loading and unloading cost and also reduction in wastage due to breakage, spoilage etc.

6. Warehousing business helps **creating employment opportunities** both for skilled and unskilled workers in every part of the country.

7. Many public warehouses provide various other **ancillary services such as picking, grading, packaging, labelling, and shipping etc.** which allows the small companies to focus on their core area instead of worrying about these services.

8. Warehouse Receipt System (WRS) also facilitates getting **loan from financial institutions** against the security of the warehouse-keeper's receipt. This allows the farmers and the small traders to store the goods and wait for prices to go up instead of selling the goods in hurry. They can avail get a loan against the goods to finance their operations during this period. They then sell the goods when prices go up and earn good profit.

Disadvantage

Some disadvantages which need to be consider by the warehousing business are as follows:

- **Heavy initial capital investment** in required, especially for private warehouses for construction.
- There is a **possibility of incurring losses in the initial period** when the warehouse is not used in full capacity until reputation is build up.
- The warehouse need to be located at a convenient location and needs large space. These requirements **limits the flexibility in investment and selection of location** as there is no option to invest less or to select a remote and less costly location.
- The poor administration may lead to **lack of control and other related problems** such as theft, spillage, liability for loss of goods stored etc.

Test Yourself 3

Which of the following are the advantages of warehousing?

A Security of goods
B Saving in transportation cost
C Prevents shortage of goods in times of demand
D All of above

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

Goods, for which import duty is not paid, are kept in bonded warehouses.

Answer to TY 2

The correct option is **C**.

Warehouses overcome the barrier of time.

Answer to TY 3

The correct option is **D**.

All the options given are advantages of warehousing.

Self-Examination Questions

Question 1

Perishable goods should be stored in ______________.

A Bonded warehouse
B Cold storage
C Government warehouse
D Public warehouse

Question 2

Warehouses licensed by the government to accept imported goods before the payment of custom duty are known as ___________.

A Private warehouses
B Bonded warehouses
C Government warehouses
D Public warehouses

Question 3

State whether the following statement is true or false.

Any trader can store the goods in private warehouses.

Question 5

Explain how warehousing helps protecting goods?

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **B**.

Perishable goods should be stored in cold storage.

Answer to SEQ 2

The correct option is **B**.

Warehouses licensed by the government to accept imported goods before the payment of custom duty are known as bonded warehouse.

Answer to SEQ 3

The given statement is **false**.

Private warehouses are the warehouses that are owned and managed by the manufacturers or traders to store, exclusively, their own inventory of goods. The traders can use public warehouses by paying rent for storing their goods.

Answer to SEQ 4

Warehousing makes special arrangements for different types of goods according to their nature to protect them against risk of loss due to heat, cold, wind, dust, moisture etc. Thus, it helps to minimise the losses due to spoilage or wastage during the storage of goods.

SECTION B

AIDS TO TRADE

B4

STUDY GUIDE B4: TRANSPORT

Get Through Intro

Transportation is associated with every step of life. You travel to college every day, your parents travel to work, people travel to different countries for work, goods produced at one place are easily available at distant places – this is possible only because of good modes of transport.

Transportation plays an important role in any nation's economy. A good network of transport systems helps the developing economy of a country. New industries are developed in the regions where transportation facilities are available.

Transport facilitates trade and commerce by carrying goods from the areas of production to that of consumption. Goods from the areas that have surplus are transported to those areas which are underprovided in those items.

Transport also facilitates movement of people from one place to another place in search of job and education.

In this study guide, we will learn about the various means of transport, the various methods with their advantages and disadvantages, and factors to consider while selecting the appropriate mode of transport etc.

Learning Outcomes

a) Define transport and identify various means of transport.
b) State the importance of transport in commerce.
c) Describe methods of transport and their advantages and disadvantages.
d) State factors governing the choice of a method of transport.
e) Select appropriate method of transport to match a product need.

1. Define transport and identify various means of transport.
[Learning Outcome a]

1.1 Meaning

The word 'transport' is derived from the Latin word 'transportare' of which 'trans' means 'across' (or the other side') and 'portare' means 'to carry'.

Thus, transport in simple terms means carrying from one place to another.

Definition

Transport is an activity that facilitates physical movement of people and products from one place to another.

Transportation is an important aid to trade which removes the barrier of place and time by carrying men and material from one place to another. Transport facilitates movement of raw materials to the place of production and movement of finished goods to the various places of consumption.

Goods have no use unless they are made available at a place where and when they are needed. Transport systems help the manufacturer to take the raw material from the place where it is available and labour from their houses to the factories. It also facilitates transportation of finished goods to the distributors and ultimately to the final consumers. Thus, transportation bridges the gap between the producers and the consumers.

Case Study

There has been a sustained effort on the part of Government of Tanzania to create essential transport infrastructure and services to improve access to jobs, education and health facilities and also to facilitate domestic and international trade as well as strengthen regional integration and attract foreign investment. This socio-economic developmental scenario underscores the fact that transportation is pivotal to the overall development of Tanzania. Indeed, it is a key infrastructure sector that acts as a stimulus to socio-economic growth and also accounts for a large pro- portion of public investment.

It is important to emphasise that to be economically and financially sustainable transportation must be cost effective and continuously responsive to changing demands through the creation of a more competitive trans- port sector. Therefore, the availability of proper trans- port infrastructure and efficient transport services are crucial determinants for socio-economic development and industrial development.

In the past five years, the transport sector in Tanzania has helped to integrate market- strengthening competition, increase access to farming techniques, promote trade, tourism, and foreign investment, and has contributed to the government revenue. This was made possible through the implementation of a number of transport development and maintenance programmes and reforms aimed at enhancing the provision of an efficient, cost- effective and safe transport system in the country.

Allocation of funds to the transport sector has increased consistently over the past decade from around 170 billion in 2001/2002 to over 1,100 billion in 2010/2011.

Source: http://www.mot.go.tz/images/uploads/transport.pdf

1.2 Means of transport

Transportation is possible through various modes of transport such as land, water and air. Land transport can be by road or by rail. There are various means of transport e.g. road transport uses trucks and carriers, air transport uses aeroplanes and helicopters and water transport uses ships and steamers to carry goods and people.

The various modes of transport are:

1. Road transport
2. Rail transport
3. Water transport
4. Air transport

1. Road transport

Road transport means transportation of goods and people by road.

From ancient times, roads are used as an important mode of transportation. The means of road transport may be divided into various types such as man driven, animal driven and motor driven. Even today, in small towns, we can see individuals moving goods from one place to another on their head or back or on bicycles. Various animals like horses, donkeys, camels, elephants etc. are also used commonly for transportation of goods.

With civilisation and modernisation, motor driven means of transport have become more important as compared to man driven and animal-driven means of road transport. Various means of motor transportation such as cars, trucks, lorries, buses etc. were invented over the years and extensively used due to their speedy movement and larger carrying capacity.

Case Study

The geography of Tanzania, its size, diversity and dispersion give roads a special position in integration of the national economy. In particular roads serve rural areas (where the majority of the people live) more effectively than any other mode of transport. Road transport is the dominant mode in Tanzania and carries over 80% passengers and over 75% of freight traffic.

The total classified road network is estimated to be 86,472 km of which about 7% is paved. The Ministry of Infrastructure Development through the Tanzania National Roads Agency (TANROADS) is managing the National road network of about 29,847 km comprising 10,601 km of trunk and 19,246 km of regional roads. The remaining network of about 56,625 km of urban, district and feeder roads is under the responsibility of the Prime Minister's Office Regional Administration and Local Government (PMO-RALG).

In the past five years, the conditions of trunk and regional roads have steadily improved, helping to reduce infrastructure problems that people in many parts of the country were facing. The over- all road condition assessment at the end of December 2009 indicated that 73% were good, 23% were fair and 4% were poor compared to 25% good, 40% fair and 35% poor in December 2001.

Between June 2000 and June 2009 a total of 912 km of trunk and regional Roads were upgraded / rehabilitated to bitumen standard.

The road construction budget is increased ever year through the Road Fund.

In 2009/10 financial year, Tanzania Road Fund collected about TZS 284 billion compared to TZS 73 billion in 2005/2006.

Despite the efforts, the road national network remains inadequate, as it is faced with lack of sufficient funds for rehabilitation, upgrading and for routine maintenance, combined with increased traffic.

Source: http://www.mot.go.tz/images/uploads/transport.pdf

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2. Rail transport

Rail transport means transportation of goods and passengers on railway lines by train.

Since its invention, railway has accelerated the commercial and industrial development of various countries, including Tanzania.

Rail transport is considered to be the most dependable mode of transport, especially over long distances. Railway is primarily used for transportation of bulky goods like coal, cement, food grains, fertilizer, petroleum, automobiles etc. from mines to industries and from industries to the areas of consumption.

Case Study

The railways system boasts a total track length of 3,676 km, which are operated by two railway systems: the Tanzania Railway Limited (TRL)-2,706km and Tanzania- Zambia Railway Authority (TAZARA)-970 km.

The two systems inter face at Kidatu and at Dares Salaam port. Together, the railways serve 14 of the 21 regions of Mainland Tanzania. They also serve neighbouring countries of Zambia, DRC, Burundi, Rwanda, Uganda and Malawi.

The Railway system is in very poor condition, particularly the TRL network. It has faced several important infrastructural problems, as well as stiff competition from road transport. This has led to a deterioration of its network assets and its capability to provide a reliable and constant service.

Consequently, tonnage freight volume and passenger number have declined in 2009. Tanzania Railways Limited (TRL) carried a total of 237,000 tonnes of cargo compared to 429,000 tonnes in 2008, representing a decline of 44.8 %. A total of 285,000 passengers were transported compared to 392,000 in 2008. Decrease in the number of passenger and cargo transportation was caused by insufficient number of cabins, poor infrastructure and poor performance caused by workers' occasional strikes. The floods that occurred in Kilosa, Morogoro region in January 2010 destroyed the central railway system, halting train services between Dares Salaam and Dodoma major improvements to services for the passengers who use the country's three major airports.

The same year, TAZARA carried 333,000 tonnes of cargo compared to 525,000 tonnes in 2008, representing a decline of 36.6%. Passengers that used TAZARA in 2009 were 923,000, compared to 1.2 million in 2008, equals to 21.6% decrease due to insufficient funds available to run the company profitably.

Source: http://www.mot.go.tz/images/uploads/transport.pdf

3. Water transport

Water transport means movement of goods and people using waterways. The various means of water transport are boats, steamers, launches, ships etc.

From olden days till now, waterways have been an important means of transportation.

There are two types of water transport:

(a) Inland waterways

Inland waterway means using the river and canal routes for domestic transport of passengers and goods.

The major inland waterway ports in Tanzania are Mwanza, Kemondo Bay, Bukoba and Musoma on Lake Victoria; Itungi on Lake Nyasa; and Kigoma on Lake Tanganyika.

These lake ports are used to transport cargo and passengers inland as well as between neighbouring countries. They are presently 16 operating vessels on the lakes.

(b) Sea / ocean waterways

This includes coastal and overseas shipping. Ocean transport plays a key role in growth of international trade and also in developing economic, social and cultural relations among the countries of the world.

Case Study

Both sea and inland water- ways ports in Tanzania are managed and operated by the Tanzania Ports Authority (TPA).

The TPA's main Indian Ocean ports are Dar es Salaam, Mtwara, and Tanga; minor seaports serving coastal traffic include Lindi, Kilwa Masoko, Mafia Island, Bagamoyo, Pangani and Kwale. The Port of Zanzibar is administered separately by the Zanzibar Port Corporation.

Continued on the next page

The port of Dar es Salaam is one of the key entry points into the East Coast of Africa with an annual throughput of 7 million tons handling about 93% of Tanzania's port traffic. It is also an important outlet for neighbouring land- locked countries. It has a rated capacity of 4.1 million (dwt) dry cargo and 6.0 million (dwt) bulk liquid cargo.

Cargo volumes handled at the port have expanded by 15% per year since 2004, leading to congestion. Despite that, Tanzania has tremendously improved its capacity to efficiently move goods and handle other trade logistics over the last two years. During 2009, port operations in Dar es Salaam improved significantly.

Dwell time has dropped from an average of 20 days in January 2009 to between 11 and 13 days for transit and domestic goods respectively. A ship now waits for only 3.8 days at the outer anchorage com- pared to an average of 12.7 days in January 2009. The turn round time has improved to 6.7 days from 18.9 days in January 2009. The special operation on decongesting the port also saw 37,765 containers being transferred to Inland Container Depots (ICDs) without additional costs between January and December 2009, creating extra space at the port's container terminal. This is in contrast to 10,504 containers that were at the container terminal in 2009. Customs clearance procedures have also eased, due to extended working hours at the custom's department, among other improvements.

Dar es Salaam port's container terminal which was leased to Tanzania International Container Terminal Services (TICTS) for 10 years in 2000, a contract that was later extended for another 15 years in September 2005 has increased the number of containers being handled from 100,000 to over 320,000 at present. TPA recently announced an investment of US $60 million from the private sector investors Hut- chicon Ports Holdings, Wai Chau and TICTS, to facilitate its port operations in easing congestion at its ports. TPA also announced that the Dar es Salaam port would build a second container terminal in an expansion programme valued at USD400-630m in a project due to be completed by 2013/2014.

Source: http://www.mot.go.tz/images/uploads/transport.pdf

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4. Air transport

Since childhood, we have heard about the Wright Brothers who designed the modern day airplane in 1903. Since then the aviation industry all over the world has experienced significant growth.

In today's world, air transport is established as the fastest mode of transport. Air transport is widely used for transportation of passengers as well as goods. It is available for domestic as well as international transport.

Air transport is the most comfortable and convenient mode of transport. However, it is also the most expensive mode of transport and hence is suitable for goods that are less bulky but of high value. The various means of transport used are aeroplanes, aircrafts, helicopters etc.

Air transport also plays an extremely important role in the defence and security of a country.

Case Study

There are 125 airports in Tanzania including airstrips serving domestic and international traffic. 62 out of that total of airports are owned and managed by the government. Tanzania has four international airports located in Dar es Salaam (JNIA), Zanzibar (ZIA), Kilimanjaro (KIA), and Mwanza (MWZ).

Generally, the conditions of basic airport infrastructures, such as runways, aprons and taxiways remain poor for most of the airports in Tanzania. During the last five years, however, the government through the Tanzania Airports Authority (TAA) and Tanzania Civil Aviation Authority (TCAA) has implemented a number of development projects which are designed to further modernise the airports.

Airport infrastructure and services are currently being upgraded to international standards, in particular JNIA, KIA and ZIA. Domestic airports earmarked for infrastructure improvements include Tabora, Bukoba, Dodoma, Kigoma, Mafia and Songwe.

During the year under review aviation industry providers increased to 63, compared to 46 in 2008. The total number of inter- national passengers went down to 988,637 compared to 1,089,346 in 2008. Such a situation was caused by Air Tanzania Corporation Limited (ATCL) decision to halt its services outside the country, and reduce number of domestic flights. Other reasons included world economic crisis and fewer tourists who visited the country.

Source: http://www.mot.go.tz/images/uploads/transport.pdf

Tip

There are also some other modes of transport such as pipeline transport, ropeway transport, cable transport etc. which also contribute in the development of a nation's economy.

The pipeline system consists of 1,750 km which is used to transport crude oil products from Dar es Salaam to Ndola refinery in Zambia, and 232 km which is used to transport natural gas from Songo Songo to Dar es Salaam.

Test Yourself 1

What are the various modes of transport?

2. State the importance of transport in commerce.

[Learning Outcome b]

Transportation plays a vital role in the development of a country. The growth of a nation's domestic and foreign trade is dependent on transport.

From agriculture to manufacturing, all industries require movement of raw materials, fuel, labour and finished products and thus transport plays a key role in the growth of a nation's economy.

The different countries have different natural resources available and therefore each country is dependent on some other country for something.

Example

Most of the countries of Western Europe look to Asia and America for supplies of food grains.

Various countries are dependent on gulf countries for fuel.

As discussed in Study Guide A1, commerce includes trade and aids to trade. Transportation is a vital aid to trade as it is the means by which goods which are produced are distributed to the final consumers.

Importance of transportation

1. Assists trading

Transportation plays a vital role in making the production efficient and purposeful as it bridges the gap between the manufacturers and consumers. It develops and expands the market by helping cover wider areas of market places by making the goods available where there is a demand.

International trade, which is an important aspect of commerce, is not possible without transportation.

Example

Germany manufactures some famous automobile brands such as BMW and Mercedes and these cars are sold all over the world.

2. Removes the barrier of place

Transportation creates utility of place by carrying the goods from the place of its availability to the place of its requirement. If the worldwide network of transport is not available, human beings would be forced to confine consumption to goods produced by them or to goods available locally.

Example

Tea (and even coffee) is produced only in some particular regions but is needed for consumption all over the world. Transportation helps moving it from those particular regions to various other places where there is demand for tea and coffee but it is not grown because of unsuitable weather conditions.

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3. Stabilises prices

If the demand is higher than the supply, it results in increasing the prices and the consumers bear the loss as they need to pay higher prices. Similarly, if the supply is higher than the demand, it results in decreasing the prices and then the manufacturers bear the loss as they earn less. Transport helps to maintain the prices at a stable level by maintaining a balance between demand and supply.

Transport ensures that the goods are supplied at the proper time to satisfy the consumer demand for the goods. If there is a shortage of goods at some place, the goods can be easily supplied from another place by using the appropriate means of transport which ensures the stability of prices.

4. Creates employment

Transportation businesses create direct employment opportunities for travel agents, drivers, pilots, mechanics, helpers etc. It also creates indirect employment opportunities by enabling people to move from one place to another and take advantage of employment opportunities available in those places. This ensures the flow of knowhow from one place to another and helps in achieving overall development of society.

It also contributes to the development of various industries such as the shipping industry, the automobile industry and the aviation industry and thus supports overall development of commerce within a country.

5. Facilitates cost reduction

Efficient means of production help in reducing cost of production and distribution of goods and thus help in making the goods available to consumers at lower prices. It facilitates each region or each country to undertake production of only those products for which it has a comparative advantage over other regions or other countries, which results in achieving economies of scale and reduce cost of production.

The government in Tanzania realizes that an improved transport sector is critical to opening up the development of its economy, strengthening competition, increasing access to farming implements and products, promoting trade, tourism, and foreign investment apart from contributing immensely to the government revenues. With this in mind, efforts are being made to ensure sufficient budget allocations, especially to the roadways sector, which is essential for opening up remote rural areas which are Tanzania's bread baskets.

Test Yourself 2

State whether the following statement is true or false:

'Transportation facilitates creation of employment opportunities.'

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3. Describe methods of transport and their advantages and disadvantages. [Learning Outcome c]

3.1 Road transport

Refer Learning Outcome 1 for detail discussion on road transport

1. Advantages of road transport

- Road transport is a **flexible mode of transport** as it can reach remote villages. It is also possible to easily change routes; and moreover, loading and unloading is possible at any destination.

- It enables **door to door service** and thus reduces cost of intermediate loading and unloading and also avoids handling and the resultant damage. In case of other modes of transport such as railways or aeroplanes, the goods have to be taken to the railway station or airport, unloaded from the carriers and then loaded in the railway wagons or planes. At the destination, they again need to be unloaded and loaded for delivery at the final destination.

- Road transport **takes relatively less time** for short and medium distance travel. Thus, it is ideal for transportation of perishable goods such as milk and vegetables, which need quick delivery.

- It is very much **suitable for small traders** who need to transport goods in small quantity. Road transportation does not usually require much of packing. Furthermore, rates for road transport for short distances are lower in comparison to other modes of transport.

- Developing **road infrastructure is cheaper as compared to laying railway tracks** and the maintenance cost is also less.

- Road transport also **supports other modes of transport** as roads are connected to railway stations, waterways and airways.

2. Disadvantages of road transport

- Road transport is considered to be **irregular and undependable**, as it is affected by vehicle breakdowns, traffic jams, bad quality of roads, accidents etc. This makes road transport suitable only for short and medium distance transport.

- Road transport has **limited carrying capacity**, and therefore, it is not suitable for transport of bulky goods.

- It is affected by adverse weather conditions such as rain, fog, land-slides etc. There are limitations on speed to ensure public safety. This makes this mode of transport unsuitable for long distances.

- As road transport is **usually not controlled by a central authority,** different operators charge different freight -which leads to lack of uniformity in costs, and sometimes exploitation of traders.

- Road transport creates **air pollution.**

3.2 Rail transport

Refer Learning Outcome 1 for detail discussion on road transport

1. Advantages of rail transport

- Railway is a very **convenient and dependable mode** of transport and is even faster than road transport especially over long distances.

- It is the most suitable mode of transport for carrying **heavy and bulky goods**. It also ensures safety and security of goods from sun, rain and dust and therefore is often used even for transportation of costly and delicate goods.

- It is **less affected by adverse weather conditions** such as rains, fog, etc. and also facilitates continuous transportation during both day as well as night.

- In spite of heavy initial investment in developing a network of railway tracks, **in the long term, the running expenses are comparatively lower for railway transport** and therefore the cost of transportation is lower for long distance transportation.

- Rail transport is **subject to Government control and regulation** and hence this prevents exploitation of the public.

2. Disadvantages of rail transport

- Rail transport is **more expensive** for carrying goods over short distances.

- Rail transport **lacks flexibility** as railways run on particular tracks. Hence changing the routes is not possible.

- **Heavy initial investment** is required for constructing and laying the railway track network.

- As the goods need to be loaded and unloaded a number of times, the **risk of loss due to damage to goods**, spoilage and breakage is higher in railway transport.

Example

If 5000 Kg of sugar is to be transported from the factory to a wholesaler via railways then first, from the factory, the gunny bags need to be loaded on a truck or other mode of road transport and unloaded at the railway station. These then need to be again unloaded at the destination railway station and loaded on trucks or other means of road transport for transporting to the wholesaler.

- Usually, railway wagons and coaches are **not used at their full capacity** and that makes the railways run into losses.

3.3 Water transport

Refer Learning Outcome 1 for detail discussion on water transport

1. Advantages of water transport

- Water transport is generally cheaper than other modes of transport and therefore is the most suitable for heavy and bulky goods.
- As the possibility of vibrating, shaking and shuddering during transit is very low, water transport is the ideal mode of transport for the carriage of fragile goods like glassware, earthenware etc. It also protects the goods from sun, rain, wind, dust etc.
- Water transport is very helpful in promoting international trade and spreading culture, education, fashion, modes of living, ideas, etc. among different countries.
- As the routes are naturally available, the cost of constructing waterways and maintenance is very low.

2. Disadvantages of water transport

- It is a **slow moving** mode of transport and therefore is not suitable for transportation of perishable goods.
- It requires **large initial investment** and subsequent maintenance of ships and containers.
- It is **affected by bad weather** conditions and therefore is an unreliable mode of transport.
- There may not be connected bodies of water close to the intended destination, in which case, water transport cannot be used.

3.4 Air transport

1. Advantages of air transport

- It is the most **modern and fastest** mode of transport that provides quick, convenient, safe and efficient transport of goods and passengers.
- It is **suitable even for long distance transportation.**
- Air transport facilitates **access to all the areas** which are not accessible by other means and is also available during periods of natural calamities such as earthquakes, floods, landslide etc.
- It facilitates **quick and safe delivery** of goods, therefore is the most suitable means for perishable items.
- It also **plays a significant role in national defence and security**.

2. Disadvantages of air transport

- Air transport is a **very expensive mode** of transport and therefore not affordable for small traders.
- Air transport is **not suitable for carrying heavy and bulky goods** as the aircrafts' carrying capacity is comparatively very less.
- Air transport is **not dependable** as it is highly affected by unfavourable weather conditions.
- The construction and maintenance of aircrafts and airports **requires huge investment** which makes this mode of transport very costly.

- Air transport is a risky mode of transport as even a slight default may result in serious accident that may lead to substantial loss to goods and passenger life.

Test Yourself 3

The most expensive mode of transportation of goods is:

A Rail transport
B Water transport
C Air transport
D Truck transport

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4. State factors governing the choice of a method of transport.
Select appropriate method of transport to match a product need.
[Learning Outcome d and e]

As discussed in the earlier sections, there are various modes or methods of transportation. Businesses need to select the appropriate mode of transport by taking into consideration the nature of goods to be transported, the cost involved, the distance and many other factors.

The factors governing the choice of method of transport are as follows:

1. **Nature of goods to be transported**: if the goods to be transported are heavy and bulky then water transport or railway transport is more suitable as compared to road transport or air transport.

Example

If heavy plant and machinery is to be transported then air transport is not suitable as the carrying capacity of aircraft is less and it is expensive.

---

2. **Urgency:** the goods that are perishable in nature need to be transported using quick and speedy modes of transport.

3. **Transportation cost:** the traders need to consider the cost involved in transportation of goods. Air transportation, for example, is very expensive and therefore should not be opted as a mode of transport unless the goods need to reach the destination quickly.

4. **Handling:** some forms of transport require frequent loading and unloading, therefore are not suitable for fragile and delicate goods.

5. **Other factors:** Other factors like bad weather conditions, political relationship with other countries, distance to be travelled and geographical specifications of the destination also need to be considered while choosing an appropriate mode of transport.

Test Yourself 4

Match the correct mode of transport

Goods to be transported	Modes of transport
(a) Fruits and meat to be transported at a place located at a distance of 1000km	(i) Rail transport
(b) Chemical tanker	(ii) Rail transport
(c) Bulky gods in huge quantities	(iii) Water transport
(d) Delivering pizza to customer	(iv) Road transport

Answers to Test Yourself

Answer to TY 1

The various modes of transportation are:

1. Road transport
2. Rail transport
3. Water transport
4. Air transport

Answer to TY 2

The given statement is true.

Transportation business creates direct employment opportunities for travel agents, drivers, pilots, mechanics, helpers etc. It also creates indirect employment opportunities by enabling people to move from one place to another and take advantage of employment opportunities available in those places.

Answer to TY 3

The correct option is **C**.

The most expensive mode of transportation of goods is air transport.

Answer to TY 4

(a) Fruits and meat to be transported at a place located at a distance of 1000km.

The most appropriate mode of transport to be used is air transport as the goods are perishable and are to be delivered over a long distance quickly.

(b) Chemical tanker

The most appropriate mode of transport to be used is water transport as there is less vibrating, shaking and shuddering during transit which ensures safety of the chemicals.

(c) Bulky gods in huge quantities

The most appropriate mode of transport to be used is rail transport as the carrying capacity of railway wagons is more.

(d) Delivering pizza to customer

The most appropriate mode of transport to be used is road transport as the distance to be travelled is short and this mode would not be very expensive.

Self-Examination Questions

Question 1

Which is the best mode of transport for transporting heavy goods in large quantities?

A Road transport.
B Railways.
C Air transport.
D None of the above.

Question 2

Which of the following statements is true about water transport?

A It is a less expensive transporting mode for heavy goods.
B It is the fastest mode of transportation
C It is useful only for transportation of lightweight goods.
D All of the above.

Question 3

Which of the following statements is true about rail transport?

A It is the slowest mode of transportation.
B It is best suitable for long distance transportation of bulky commodities.
C It is the most expensive mode of transport.
D None of the above.

Question 4

Differentiate between road transport and water transport.

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **B**.

Railway is the best mode of transport for transporting heavy goods in large quantities.

Answer to SEQ 2

The correct option is **A**.

Water transport is a less expensive transporting mode for heavy goods.

Answer to SEQ 3

The correct option is **B**.

Rail transport is best suitable for long distance transportation of bulky commodities.

Answer to SEQ 4

	Road transport	**Water transport**
Nature	Road transport means transportation on land.	Water transportation means transportation on water.
Suitability	More suitable for transport of lightweight and perishable goods over short distances.	More suitable for transport of bulky goods over long distances.
Carrying capacity	It has limited carrying capacity.	It has large carrying capacity.
Means of transport	Means of road transport are trucks, lorries, buses etc.	Means of water transport are launches, boats, ships etc.

SECTION B

AIDS TO TRADE

B5

STUDY GUIDE B5: ADVERTISEMENT

Get Through Intro

In our everyday life, in newspapers, magazines, roadside hoardings, radio, television etc. we see many advertisements for various products and services like chocolates, mobiles, cars, computers, detergents, transporters, builders etc.

These advertisements make those products familiar to us;, they give information about their features, their benefits, their prices… and so on.

The advertisements are so catchy and attractive that you want to buy the products and that's the purpose of the advertisements – giving you information about the products and encouraging you to buy them.

Advertisements are an important aid available to businesses to reach out to customers. They play a very important role in the growth and success of any business.

In this Study Guide, we will learn the meaning of advertisements, their advantages and disadvantages, factors to consider while choosing advertisement media etc.

Learning Outcomes

a) Define advertisement and identify various types of advertisements.
b) Outline the advantages and disadvantages of advertisement.
c) Identify and state factors determining the choice of advertising media.
d) Select appropriate advertising media to match a product or service need.

1. Define advertisement and identify various types of advertisements.
[Learning Outcome a]

Advertising, in simple words, means activities done by an enterprise to make the product known to the consumers and to influence them to buy the product.

As similar goods are produced by different manufacturers, there is a lot of competition in the market and therefore through advertisement, every manufacturer tries to increase demand for the product made by him.

1.1 Meaning of advertisement

The word 'Advertising' is derived from two Latin words, Ad and vert, ('Ad' - towards and 'Vert' - to turn) which means, "turn towards", i.e., turning the attention of the target audience to a specific thing or product.

Definition

The American Marketing Association has defined advertising as "any paid form of non-personal presentation of ideas, goods and services by an identified sponsor".

Thus, the key features of advertising are:

- It is **a paid form of presentation**, which means the advertiser pays for informing the prospective customers about the product e.g. advertisement in newspapers or magazines.
- The presentation is **non-personal**, which means there is usually no face-to-face direct contact with the customers or it is not directed towards any single customer.
- The objective **of advertisement is to promote the product or services or idea** regarding quality and design of the product.
- Advertisement is **done by an identified sponsor**, which means people know who the advertiser is.
- It **needs some media** through which advertisement can be communicated e.g. print, television, radio etc.

Example

Consider the advertisement of Nestle chocolates on television.

The advertiser, i.e. the Nestle Company, needs to pay the charges to the channel for broadcasting the advertisement on the television.

It is a non-personal presentation i.e. you see it on television but there is no direct contact or communication.

The purpose of the advertisement is to attract the viewer towards the chocolate.

You know who is doing the advertisement i.e. the manufacturer, which is the Nestle Company.

The media used is television.

Advertisement serves as an important tool of sales promotion. It enables the manufacturers to reach the consumers and create demand for their products by giving the prospective customers information about the product.

Thus the very purpose of advertisement is to make the customers aware about the product or service and induce them to purchase it.

1.2 Types of advertisement

The different types of advertisements are:

1. Print advertising
2. Electronic advertising
3. Outdoor advertising

Diagram 1: Types of advertisement

(a) Print advertising

Print media is probably the most common medium of advertising. It includes advertising through newspaper, magazines and journals.

Newspaper advertisements have many advantages such as wide circulation, relatively low cost, flexibility to decide layout and size or to approach only the desired market, region and readers.

However, there are also some limitations of newspaper advertising such as substandard quality, short life, reader's tendency to overlook the advertisement etc.

Advertisements in magazines and journals have advantages such as longer life, better quality and target audience, but they too have some limitations such as higher cost and limited coverage.

(b) Electronic advertising

Electronic media means advertisements through television, radio, internet etc. in exchange for advertisement fees.

In radio or television, advertisements are broadcasted during short breaks while transmission of the various programmes. Many sellers even sponsor the programmes.

This media is a very effective medium of advertisement as it attracts people from all age groups and all backgrounds.

Example

It is not possible to read a newspaper while driving, but it is possible to listen to the radio. Also, newspaper advertisements may not attract children, but a television advertisement is very effective because it uses pictures and sound.

(c) Outdoor advertising

Outdoor advertising includes posters, hoardings, hand bills, sky advertising etc. Advertisements are printed on hoardings and posters and displayed at prominent places in the city.

It is a very effective way to make the brand names popular and build product identity.

Outdoor advertising also includes techniques like sky advertisement using big balloons, window displays etc.

Tip

The above classification of advertisements is the most commonly used classification. However, advertisements can also be classified in other ways, such as:

- Based on geographical spread
- Based on content
- Based on stage of product cycle etc.

Test Yourself 1

What factors about television advertising makes it an effective medium of advertisement?

2. Outline the advantages and disadvantages of advertisement.
[Learning Outcome b]

Advertising always has been an indispensable part of the marketing strategy of any product or service. Companies invest a lot of funds in advertising their products as it has great impact on generating demand for the products and thus increasing the sales.

Disadvantages of advertising

Thus there are various advantages of advertisements, for both, manufacturers as well as consumers, as follows:

- Advertising **helps attract prospective customers** and makes a positive impact about the product.
- Advertising helps to **promote the sales of existing as well as newly launched products**.
- Advertising **gives information about the different products available**, their features, costs and other specifications.
- Advertisements **create a brand name** for the product being promoted. It makes people associate the product with the catchy slogans used in the advertisements. This helps businesses stay ahead in the market.
- Advertisements help the **customers get knowledge and information** about various options available and make the best choice.
- Advertising also **helps in educating people and creating awareness** about social and non-commercial issues such as cancer awareness, literacy etc.

Disadvantages of advertising

- Advertising **enhances competition and rivalry** which often leads to providing false information about the products.
- It is not possible for the **smaller businesses** to spend large amounts on advertising and therefore they find it difficult to compete with the established businesses and create a market for their products.
- Advertising **increases the cost of the product** as the cost is included in the price the customer pay to buy the product.
- Advertisements encourage **people to desire and buy goods**, which they do not need, and in fact, are not within their means. It also make people use articles which are not good for their health e.g. cigarettes.
- Advertising **often results in monopoly** of particular brands. The consumer becomes a slave to a particular brand.

Test Yourself 2

Which of the following statements is not true?

A Advertisement is only beneficial for manufacturers but not for the customers.
B Advertising gives information about the different products available, their features, costs and other specifications.
C Advertising increases the cost of the product as the cost is included in the price the customer pays to buy the product.
D Advertising may result in monopoly of particular brands.

---

3. Identify and state factors determining the choice of advertising media.
Select appropriate advertising media to match a product or service need.
[Learning Outcomes c and d]

Advertisement requires significant investment of funds that could potentially be used for some other business development activity. Therefore, it is important that the business selects the most appropriate medium of advertisement to fulfil the objective of reaching the target audience and increasing the sale of the products.

Factors determining the choice of advertising media

Thus, various factors need to be assessed before selecting the most suitable medium of advertisement such as:

- The nature of the products

Example

For consumer durables, radio can be considered the most appropriate medium whereas capital goods used by the industry can be advertised through business magazines.

- The position of the product in the market
- The target customer

Example

For products such as cold drinks, which are targeted towards the young generation, television advertisements would be considered more appropriate as the use of pictures, sound and catchy taglines can easily attract them.

- The funds available for advertising with the business
- The expected cost of advertising
- The extent of competition from other products in the similar category
- The coverage of the various mediums of advertisement
- The sizes of the message to be advertised

The advertisers need to carefully evaluate all these factors to decide the suitability of each medium of advertising in relation to their product. Broadly, the suitability of various mediums of advertising can be summarised as follows:

1. Newspaper advertisements

This medium of advertisement is suitable for the products that are intended for the public at large. During the initial launch of the product, regular newspaper advertisements in various newspapers can be really helpful in making the product name familiar to the prospective customers. Newspaper advertisements are also very effective for regional target audience such as clearance sale, exchange offers, cleaning services, plumbing services, films running locally etc.

Example

If you are starting home tuitions, then newspaper advertising is a very suitable option as those who are interested in home tuitions usually search for home tutors in the local newspapers. Thus, it will help you reach the target audience in the city. This is an instance of ‘coverage of the various mediums of advertisement’.

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2. Periodical advertisements

This medium of advertisement is suitable for products that are used by the customers of the periodicals.

Example

A newly formed interior decorating business should consider advertising in the home decoration and design magazines as the target audience of such magazines are those who are interested in home furnishings and interior decoration.

Periodicals with wide circulations are also very effective for advertisement of consumer goods like shampoos, soaps, mobile phones etc.

3. Radio advertisements

Radio advertising is suitable for advertising different varieties of local as well as other products and services. That means, while it is suitable for advertising local products such as an annual clearance sale in a garment shop, a new mobile store in the city etc. it is also suitable for other products such as new films released, music CDs, national level banks etc.

Radio advertisements facilitate more detailed description of products as it is verbal. The advertisers carefully need to select the time slot for the advertisements considering the nature of their products.

Example

Office goers usually listen to the radio while commuting to the office in the mornings and evenings. Therefore, the advertisements for consumer goods such as annual clearance sale, restaurants etc. broadcasted during this time are likely to reach more prospective customers. This is an instance of ‘reaching the target customer’.

---

4. Television advertisements

Television is an extremely effective medium of advertisement due to the audio-visual effect. It is suitable for almost all products that are targeted to be sold on the national level. Television advertising is especially suitable for products which require audio-visual demonstration e.g. cosmetics such as nail polishes, lipsticks, hair dyes etc.

The choice of an appropriate channel is important in the case of television advertisements as different channels target different audience e.g. cartoon channels are more suitable for products used by children such as toys and chocolates. The timing of advertisements is also crucial in the case of television advertisements e.g. an evening slot is the most appropriate for consumer goods required by the whole family.

5. Outdoor advertisements

These are suitable for almost all products and services, be it a car or a bank. As outdoor advertisement is highly prominent, the prospective consumer does not need to do anything to access the advertisement. With the use of attractive pictures and catchy tag lines, it is highly effective in engaging the prospective customers.

6. Online/ internet advertisement:

Advertising on the internet is probably the most cost-effective form of advertising available. As it is electronic in nature, there are virtually no costs associated with paper, ink, printing, postage etc. Also, changing the content of the advertisement is easy and fast.

The internet is increasingly being used as an advertisement medium in recent times. Right from placements to jewellery to consumer goods, anything and everything is effectively advertised on the internet.

Test Yourself 3

Which of the following factors need to be considered while selecting the most appropriate media of advertisement?

A Nature of product to be advertised
B Cost of advertisement
C The degree of competition
D All of above.

Answers to Test Yourself

Answer to TY 1

Television is a very effective medium of advertisement because of the following factors:

- It has audio-visual impact, so it has greater appeal and makes a lasting impression.
- The use of catchy slogans, songs, famous personalities makes the advertisements very effective and impressive.
- Clear and apt information can be given as the product is actually shown.
- A lot of choices are available to reach the target customer as various channels are available. For example, kids' channels can be selected for advertisements of biscuits and chocolates.

Answer to TY 2

The correct option is **A**.

It is not true that advertisement is only beneficial to manufacturers. It also helps the customers by providing information about various options available which empower them to make the best suitable choice.

Answer to TY 3

The correct option is **D**.

All the given factors need to be considered while selecting the most appropriate media of advertisement.

Self Examination Questions

Question 1

Banner advertisement is a type of ....

A Outdoor Advertising
B Print Advertising
C Electronic Advertising
D None of these

Question 2

Which of the following are not the features of advertising?

A Paid form of communication
B Sponsor is always identified
C Personal presentation of message
D Communicated through some media.

Question 3

Electronic media of advertising include

A Hoardings
B Newspapers
C Internet
D Posters

Question 4

Match the following:

(i) Advertisement of toys on TV	(a) Print media
(ii) Advertisement of a mobile service provider on a bus	(b) Electronic media
(iii) Advertisement of a bank in the daily newspaper	(c) Outdoor media

Question 5

What are the advantages of newspaper advertisement?

Answers to Self-Examination Questions

Answer to SEQ 1

The correct option is **A**.

Banner advertisement is a type of outdoor advertising.

Answer to SEQ 2

The correct option is **C**.

Advertisement does not involve personal direct presentation of message.

Answer to SEQ 3

The correct option is **C**.

Internet is the electronic media of advertisement.

Answer to SEQ 4

(i) Advertisement of toys on TV	(a) Electronic media
(ii) Advertisement of mobile service provider on a bus	(b) Outdoor media
(iii) Advertisement of a bank in the daily newspaper	(c) Print media

Answer to SEQ 5

The advantages of newspaper advertisements are as follows:

- Newspapers have wide circulation, and therefore reach the public at large.
- The cost of advertisement is comparatively lower than most of the other modes of advertising.
- Newspaper advertisements are very flexible as it is possible to change the shape, size and content of the advertisement according to the convenience and necessity of the advertiser.
- As newspapers are published from different regions, they provide greater choice to advertisers to approach the desired market, region and readers.
- Newspaper advertisement also facilitates creating visually appealing advertisements.

SECTION C

BUSINESS CONTRACTS

C1

STUDY GUIDE C1: LAW OF CONTRACT

Get Through Intro

We frequently enter into contracts in our daily life. Even ordinary transactions such as buying a newspaper or purchasing goods for a certain price from a shop are examples of contracts.

A contract is simply an **exchange of commodities / services between two parties for a price**. Individual owners of commodities meet at a common place, known as a market, and freely enter into negotiations to decide the terms on which they are willing to exchange those commodities.

The **law of contract** is based on an idealised model of how the market operates and has been formulated to **facilitate the smooth functioning of the market**.

This Study Guide deals with the study and analysis of the nature of a contract. In your professional life, knowledge of the law of contracts will always be useful as **contracts are the basis of all commercial transactions.**

Learning Outcomes

a) Explain the nature and essentials of a valid contract.
b) Describe the terms: offer, acceptance, and consideration, intention to create legal relations, capacity and consent.
c) State conditions, warranties and exemption clauses.
d) Describe illegal contacts and contracts in restraint of trade, vitiating factors.

1. Explain the nature and essentials of a valid contract.
[Learning Outcome a]

1.1 Important terms

We need to know the following terms in order to understand the meaning of a contract.

1. **Void:** something that is not legally valid. It is something that has no legal force. A void contract is not legally enforceable and the parties of the contract are not legally obligated to each other.

Example

A contract to kill a person is illegal. Hence, it is a void contract.

---

2. **Voidable:** something that can be legally rescinded i.e. set aside at the option of the innocent party. Voidable contracts are those contracts which may be avoided, that is, set aside, **by one of the parties**. If, however, no steps are taken to avoid the contract, then the contract is considered to be a valid contract.

Example

A contract entered into by a minor is voidable by the minor. Within a reasonable time after attaining majority, he can claim that he was a minor when he entered into the contract. Hence, he was not competent to foresee that the contract was not beneficial for him. After becoming a major, he may cancel the contract or affirm it.

---

3. **Unenforceable contract:** legal remedies are available to the party of an enforceable contract. It can use these remedies to compel the other party of the enforceable contract to perform its part. A contract may become unenforceable if certain statutory requirements regarding the contract have not been met. In the case of an unenforceable contract, if a party of the contract refuses to perform / complete its part, then the other party cannot compel the defaulting party to do so.

Example

An oral contract to buy land is an unenforceable contract because the Statute of Frauds requires such a contract to be in writing. Hence, the property transferred under such a contract is irrecoverable.

The legal remedies against a party refusing to perform / complete its part of the contract are discussed further in this section.

4. **Ultra vires:** something that is beyond the legal capacity of a person, company or other legal entity**.**

Example

Sidney is authorised to sell goods manufactured by Sheldon Ltd. He has no right to lease the goods manufactured by Sheldon Ltd. If Sidney leases Sheldon Ltd's goods to customers, he has committed an ultra vires act.

---

5. **Void ab initio:** something that is invalid from the very beginning. A contract void ab intio is invalid from its inception.

Example

If a person signs a contract under duress, that contract is void ab initio. Duress means force, threat, coercion or compulsion.

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6. **Offer:** when one person expresses his willingness to do or to abstain from doing something, to another person, with a view to obtaining the assent of that other person, he is said to be making an offer. It states the terms on the basis of which a party is willing to form a binding contractual relationship with another party.

   An offer, once accepted by the offeree, becomes a legally enforceable contract.

7. **Offeror:** the person making the offer.

8. **Offeree:** the person to whom the offer has been made.

Example

Merry needs to rent a shop. Cherry, her friend, has a shop which is vacant. Merry offers to rent Cherry's shop for Tshs 100,000 per year. In this case, Merry has made Cherry an offer. Merry is the 'offeror' and Cherry is the 'offeree'.

---

9. **Acceptance:** when the offeree agrees to the offer made by the offeror, it is said that the offer has been accepted.

Example

Continuing the example of Merry and Cherry

If Cherry (the offeree) agrees to give her shop on rent to Merry (the offeror), the offer is said to be accepted.

---

10. **Consideration:** is required for a contract to be enforceable. It is something that is done or promised in return for a contractual promise.

Example

Continuing the example of Merry and Cherry

The availability of the shop is consideration for Merry and Tshs100,000 is consideration for Cherry.

---

11. **Agreement:** when an offer made by the offeror is accepted by the offeree, it becomes an agreement.

Example

Continuing the example of Merry and Cherry,

Merry promises to pay Cherry an annual rent of Tshs10,000 and Cherry promises to give the keys to the office to Merry. This is an agreement.

It is important to note that, although all contracts are agreements, **not all agreements are contracts.** This is because **all agreements (**e.g. to have dinner with someone) **are not legally enforceable.**

Tip

Contract = Enforceable agreement + Consideration

Tip

Agreement = Offer + Acceptance

1.2 Meaning of contract

1. A contract consists of an actionable promise or promises.

2. Every such promise involves two parties, a promisor (the person making the promise) and a promisee (the person to whom the promise has been made).

3. It involves a common intention of acceptance.

4. There must be a consideration as to the act (i.e. agreeing to) or forbearance promised (i.e. not doing something).

Example

Ajay and Ben enter into an agreement. Ajay promises Ben to sell his house for Tshs150,000 and Ben accepts to purchase it for the said amount.

- This is a contract between Ajay and Ben where Ajay is the offeror and Ben is the offeree.
- The promise to pay Tshs150,000 is the consideration by Ben.
- The promise to sell the house is the consideration by Ajay.

Definition

Contract is **“an agreement enforceable by law for a consideration”.**

Tip

Contract = Agreement + Enforceability + Consideration

Tip

Consideration is the element that makes the agreement a contract.

1.3 Essentials of a valid contract i.e. legal requirements for the creation of a contract

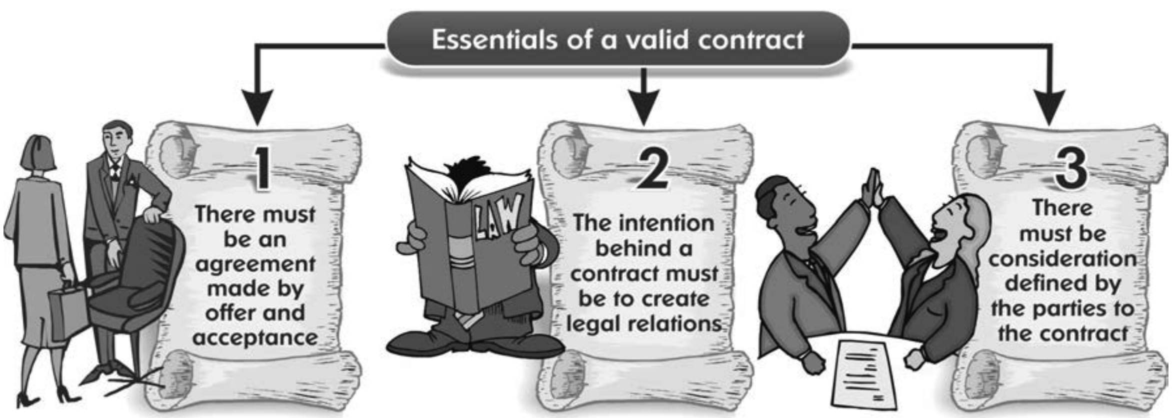
There are **three essential elements,** which would be examined by a court as evidence of any contract. These are

1. Agreement made by offer and acceptance.

2. Intention to create legal relations.

3. Consideration.

Diagram 1: Essentials of a valid contract



1. **The agreement must have an offer and an acceptance:** a contract is a **bilateral agreement** between two or more parties. Every contract has to go through the **stages** of:

(a) an offer being made
(b) negotiations among the parties which lead to a settlement
(c) acceptance of the offer for a consideration

Therefore, the presence of an offer and its acceptance are of utmost importance for any contract to take place.

Example

Lee promises Chee to sell his car for Tshs500,000 and Chee accepts to purchase it for that amount. Lee is said to be the offeror and Chee, the acceptor. An offer becomes a promise when it is accepted.

2. **The intention behind a contract must be to create legal relations:** a contract, which is governed by the law of contract, must be made with a view to creating legal relations.

Example

David is leaving on a business trip. He promises his daughter that he will bring her a camera. This cannot be considered a contract as he does not intend to bind himself legally.

However, if David, while leaving the office, makes a written agreement with James that he will bring goods according to his description for a given price then this can be considered a contract. This is because both parties mutually intend to bind themselves legally.

Case Study

Intention to create a legal relation is essential to create a contract

Balfour v Balfour (1919)

In this case, the defendant, who was working in Ceylon, went on a holiday to England with his wife. At the end of the holiday, his wife fell ill and was advised to remain in England for medical treatment. Before returning to Ceylon, the husband promised to pay £30 a month to his wife for her maintenance. Initially, he sent the amount regularly. However, he stopped paying as certain differences between them led to their separation. By the time of the separation, the allowance had fallen into arrears, so the wife brought an action to recover the arrears.

Court's decision

The wife's action was dismissed. It was held there was no indication that the arrangement was intended to be a contract.

While rejecting the wife's claim, Lord Atkins observed: "there are agreements between parties which do result in contracts within the meaning of that term in our law. The ordinary example is where two parties agree to take a walk together, or where there is an offer and acceptance of hospitality. However, they are not a contract because the parties did not intend that they shall be attended by legal consequences."

3. **There must be consideration defined by the parties to the contract:** consideration is necessary for the formation of every contract. **Consideration is the incentive, price or motive that causes a party to enter into an agreement or contract.**

It is something of value that is given in exchange for receiving something from another person.

An informal promise without consideration is not actionable in law even though the promisor may have acted upon it to his detriment.

Example

John wanted to go for an important meeting. David promised John to drive him to the station at the right time. However, David failed to keep his promise, as a result of which John missed the train and ultimately missed the meeting.

In this situation, John cannot take any action against David for the loss of potential benefits from the meeting as the promise made by David was an informal promise, without consideration.

Tip

Every contract is a bilateral agreement (i.e. an agreement between two or more parties) and hence all the parties to the contract must have some agreed consideration.

Example

Alden enters into a contract with Bayol whereby he agrees to pay Tshs500,000 to Bayol if Bayol's horse wins the race. Bayol's horse wins the race and he claims Tshs500 from Alden.

Bayol is not entitled to get Tshs500,000 from Alden because there is no consideration from his side. The contract contains no condition because of which Bayol will have to pay Alden some consideration. Hence this is not a valid contract.

Besides the three essential conditions explained earlier, there are **some additional elements** which decide the validity of a contract. These are:

(a) capacity to contract
(b) legality of object.
(c) certainty of terms of contract

(a) Capacity to contract: the parties must be competent to contract.

(b) Legality of object: The contracts for illegal activities are not valid.

Tip

The concept of legality of object is explained in more detail later in the Study Guide.

(c) Certainty of terms of contract: the contract terms should not be vague. They must be certain and definite. The intentions of the parties to contract must be clearly indicated by the terms of contract.

Example

Annie makes an offer to Bob to supply her with 100 metres of cloth. Here, the terms of offer are not clear since the type of cloth, colour, and price is not mentioned. Hence this is not a contract.

Test Yourself 1

Is an agreement for service with relatives or friends legally enforceable?

Test Yourself 2

Fenny promises to pay Campbell Tsh 500,000 if he murders her husband. Is the contract valid?

2. Describe the terms: offer, acceptance, consideration, intention to create legal relations, capacity and consent.

[Learning Outcome b]

2.1 Offer

The offer sets out the terms upon which the offeror is willing to enter into contractual relations with the offeree.

Definition

An offer is a definite promise to be bound by particular terms and it must be capable of acceptance.

When one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of the other person to such act or abstinence, he is said to make an offer.

Elements of offer

1. There shall be at least two persons: the offeror and the offeree, who are competent to contract.

2. One person (the offeror) expresses his willingness to another (the offeree) to do, or abstain from doing something.

3. The offeror has the intention of getting the consent of the offeree to do or abstain from doing such an act.

2.2 Acceptance

Definition

When a person to whom an offer is made signifies his assent to the same, the offer is said to be accepted. Acceptance of an offer is a necessary and vital ingredient towards the creation of a contract.

After an offer has been made, the next important step for the formation of a contract is acceptance. An offer creates no legal rights or duties unless it has been accepted. **Acceptance converts an offer into a contract.**

Conditions for valid acceptance

For an acceptance to be binding, it must fulfil the following conditions:

1. The acceptance must correspond with the terms of the offer (Neale v Merrett (1930)).

2. A counter-offer does not signify an acceptance (Hyde v Wrench) i.e. conditional acceptance cannot create a contract (Winn v Bull (1877)).

3. **Acceptance must be communicated:** even if the offeree has made up his mind to accept the offer, the agreement is not yet complete. There must be an external expression of assent. The acceptance of an offer must be communicated to the offeror. The communication of acceptance should be clear and unambiguous.

4. **Mode of communication:** acceptance can be communicated in any of the following three ways:

(a) by express words
(b) by action
(c) inferred from conduct

Case Study

Brogden v Metropolitan Railway Co (1862): mode of communication of acceptance

The claimant had supplied coal to the defendant for several years. The claimant suggested that both the parties must enter into a written contract. The defendant's agent sent a draft to the claimant for consideration. However, the final version of the draft was never signed.

For some time, the claimant and the defendant applied the terms mentioned in the draft to their dealings. The claimant later denied that there was any contract between the two parties.

Court's decision

It had held the behaviour of both the parties showed that they agreed to the terms of the contract. Hence, a contract existed between the defendant and the claimant.

---

5. **The offeror cannot impose upon the offeree an obligation to refuse:** in **Felthouse v Bindley** discussed below, it was also held that the offerer cannot impose upon the offeree the obligation of refusal. In this case, **mere silence from the nephew would not constitute acceptance.**

6. **Communication of acceptance must be by a person who has authority to accept:** communication of acceptance to be valid must be made either by the offeree himself or by his authorised agent. Communication of acceptance by any other person will not be valid.

2.3 Consideration

Consideration is an essential element of a contract. Consideration, in simple terms is a reasonable equivalent or other valuable benefit passed on by the contractor to the contractee. We will discuss the need for consideration, the adequacy and sufficiency of consideration in this section.

1. Need for consideration

Consideration is necessary for the formation of every contract. An agreement can take the form of a contract only when it is made by the free consent of parties competent to contract, for a lawful consideration and with a lawful object. Therefore consideration is one of the essential ingredients of a contract.

Example

Alan promises to give Baron Tshs 100,000. Baron has to give nothing in return. As there is no consideration, this is a gratuitous promise and not legally enforceable.

---

2. Meaning of consideration

Definition

The term 'consideration' has been defined as

From Currie v Misa (1875)

"A valuable consideration in the eye of law may consist either in some right, interest, profit, or benefit accruing, to one party, or some forbearance and detriment, loss or responsibility given, suffered or undertaken by the other".

From Dunlop v Selfridge (1915)

"An act or forbearance of one party, or the promise thereof, is the price for which the promise of the other is bought, and the promise thus given for value is enforceable".

Consideration simply, is the price paid for the promise. **Consideration need not be in the form of money only**. It can be in any form such as rights, interest, profits or benefits. Some examples of consideration are:

(a) giving employment.
(b) permitting goods to remain in the promisor's possession.
(c) assignment of contract.
(d) guarantee of an overdraft.

Consideration may also be forbearance, detriment, loss or responsibility suffered, or undertaken by the promisee.

Consideration can also be defined as 'some benefit to the promisor or detriment to the promisee'. Usually there is a reciprocal exchange of benefit and detriment. However, it is possible for a promisee to provide consideration (for a promise) without the contract directly benefiting the promisor.

Example

Ying promises to pay Yang for an action that helps Wang. Here, Ying receives no direct benefit from the contract but he can still enforce the contract. However, Wang who receives the benefit of the contract cannot directly enforce the contract between Ying and Yang.

2.4 Intention to create legal relations

The intention behind a contract must be to create legal relations. A contract, which is governed by the law of contract, must be made with a view to creating legal relations.

Example

David is leaving on a business trip. He promises his daughter that he will bring her a camera. This cannot be considered a contract as he does not intend to bind himself legally.

However, if David, while leaving the office, makes a written agreement with James that he will bring goods according to his description for a given price then this can be considered a contract. This is because both parties mutually intend to bind themselves legally.

Case Study

Intention to create a legal relation is essential to create a contract

(a) Balfour v Balfour (1919)

In this case, the defendant, who was working in Ceylon, went on a holiday to England with his wife. At the end of the holiday, his wife fell ill and was advised to remain in England for medical treatment. Before returning to Ceylon, the husband promised to pay £30 a month to his wife for her maintenance. Initially, he sent the amount regularly. However, he stopped paying as certain differences between them led to their separation. By the time of the separation, the allowance had fallen into arrears, so the wife brought an action to recover the arrears.

Court's decision

The wife's action was dismissed. It was held there was no indication that the arrangement was intended to be a contract.

While rejecting the wife's claim, Lord Atkins observed: "there are agreements between parties which do result in contracts within the meaning of that term in our law. The ordinary example is where two parties agree to take a walk together, or where there is an offer and acceptance of hospitality. However, they are not a contract because the parties did not intend that they shall be attended by legal consequences."

Continued on the next page

(b) Jones v Padavatton (1969)

In this case, a mother made an offer to her daughter that she would pay for her daughter's expenses if she lived in England and went to a law school there. The daughter returned to England and lived in a house purchased by her mother. The daughter also collected maintenance on behalf of her mother, for the rent collected from the tenants of the house.

The mother tried to break the agreement and repossess the house.

Court's decision

It was held that there is insufficient evidence to rebut the presumption against domestic arrangements. There was no intention of the mother and daughter to create a legal relationship. Hence, there was no binding contract between the mother and the daughter.

2.5 Capacity and consent to contract

The parties must be competent to contract. Capacity refers to a person's ability to enter into a contract. In general, all adults of sound mind have full capacity to contract. However the capacity of certain individuals is limited. Normally, the following persons are considered to be incompetent to contract:

(a) A minor
(b) A person suffering with mental incapacity or intoxication
(c) A person disqualified by law to enter into contracts
(d) A person without free consent

(a) Minor: a minor is a person below the age of 18 years. The contractual capacity of minors is restricted by law to prevent them from entering into disadvantageous agreements.

(b) Mental incapacity and intoxication: a contract entered into by a person who is of unsound mind or under the influence of drugs, or drunk is prima facie invalid. Such a contract can be held void if the person in contract proves that:

- at that time their mind was so affected that they were incapable of understanding the nature of their actions.
- the other party either knew or ought to have known of their disability. In any case, however, the person claiming such incapacity must pay a reasonable price for the goods supplied to them.

Test Yourself 3

Sunny went to a bar. There he met Bobby, who was a painter. Sunny made an offer to Bobby that he paint his farm house for Tshs5000,000. Bobby accepted the offer. Sunny gave him the address of the farm house, the keys and £1000,000 as an advance.

The next day Bobby went to Sunny's farm house and painted the farm house. However Sunny refused to pay the balance amount. He claimed that he was under the influence of alcohol and hence was unable to make a rational decision. In your opinion, is the contract valid?

(c) Disqualifications by law: a person may also be disqualified from entering into a contract by any law to which he is subjected.

Example

An alien is a person who resides in a foreign country. An alien becomes an enemy when the country of which he is a citizen is at war with a country of which the other party to contract is a citizen.

Hence, at the time of war between these two countries, an agreement with an alien enemy is illegal and therefore void.

In Potts v Bell (1918), it was held that all rights and obligations arising out of a contract with an alien enemy are suspended during war and that the contract may be void on the grounds of public policy. This is because it may promote the economic interests of the enemy state (i.e. make money for the enemy country) or it may prejudice the economic interests of the state at war with enemy state.

(d) Free consent: two or more persons are said to consent when they agree upon the same thing in the same sense. Consent is said to be free when it is **not caused** by duress or undue influence.

Tip

Duress and undue influence is explained later in the Study Guide.

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3. State conditions, warranties and exemption clauses.
[Learning Outcome c]

3.1 Conditions and warranties

1. Condition

Definition

Condition is a **stipulation essential to the main purpose of the contract. Condition is a fundamental term** of the agreement and is something which goes to the root of the contract.

The **breach of a condition** to contract gives the right to an innocent party to:

(a) terminate the contract and refuse to perform its part of the contract or
(b) perform its part of the agreement and then sue for damages (**Poussard v Spier & Pound (1876)**).

Example

Jolly has a retail shop dealing in appliances. Jenny, a customer, asks for a clothes washer that can handle 15 pounds of laundry at a time.

Thus, ability of the model to handle 15-pound loads is a condition. If the washer can handle a maximum of 10 pound load at a time, then the condition of ability to handle 15-pound loads is breached. Therefore, Jenny has the right to terminate the contract.

---

2. Warranty

Definition

Warranty is **stipulated collateral to the main purpose of the contract**.

Warranty is a subsidiary obligation. It is comparatively a minor term. If a warranty is broken, the innocent party may claim the damages but does not have the right to terminate the agreement.

The innocent party can sue for damages only after completing its part of the contract.

Example

Continuing the example of Jolly

Sally, a customer, asked for a durable and good quality clothes washer. Jolly recommended a model and Sally purchased it. However, within two months, the clothes washer started making noises.

Thus, good quality was the warranty given by Jolly and as the warranty was broken, Sally may claim **damages.**

---

3. **Distinction between condition and warranties:** whether a stipulation in a contract is a condition or a warranty **depends on the construction of the contract**. A term may be a condition even though it is called a warranty in the contract.

Whether a term is a condition or a warranty depends on a number of factors such as

(a) **Decided by statute**: sometimes, whether a term is a condition or a warranty is made clear by the statute.

Example

The Sale of Goods Act implies a condition into every contract that sale should be of only those goods that the seller has the right to sell.

(b) **Declared by the parties:** the parties to the contract may expressly declare that a particular term in the contract is a condition, the breach of which may result in termination of contract.

Example

When a hotel is booked in order to organise a business event, the term that the hotel should be made available on the date of the event is a condition in the contract.

(c) **Decided on the basis of facts of the case**: whether a particular term is a condition of the contract or a warranty will be decided by the courts on the basis of existing circumstances.

Case Study

Poussard v Spier & Pound (1876): breach of condition

In this case the claimant had entered into a contract with the defendants to sing in an opera that they were producing. As she fell ill, she was unable to sing on the first few nights. When she recovered, the defendants refused her services as they had hired a replacement for the entire run of the opera.

Court's decision

It was held that her failure to appear on the opening night had been a **breach of a condition**, and the defendants were at liberty to treat the contract as discharged.

Case Study

Bettini v Gye (1876): breach of warranty

In this case, the claimant had entered into a contract with the defendants to complete a number of engagements. He had also agreed to be in London for rehearsals six days before his opening performance. As he fell ill, he arrived only three days before the opening night, and the defendants refused his services.

Court's decision

it was held that failure to appear for rehearsals was only a **breach of warranty.** The defendants were entitled to damages, but could not treat the contract as discharged.

4. **Conditions and warranties can be either expressed or implied**

Express conditions and warranties are those which, are expressly provided in the contract. Implied conditions and warranties are those which are implied by laws or customs.

Example

In the case of a contract of sale, there is an implied condition on the part of the seller, that he has a right to sell the goods.

5. **Condition implied by custom or trade usage:** an implied warranty or condition as to quality or fitness for a particular purpose may be decided by the usage of trade.

In certain sale contracts, the purpose for which the goods are purchased may be implied from the conduct of the parties or from the nature or description of the goods. In such cases, the parties enter into the contract with reference to those known usages.

Example

If a person buys a medicine the purpose for which it is purchased is implied from the medicine itself, the buyer need not disclose the purpose to the seller.

It was held in Hutton v Warren (1836) that on quitting his tenancy, the customary usage allowed a farm tenant to claim an allowance for seed and labour.

Conditions imposed by custom or trade usage cannot override the expressed terms mentioned in the contract.

Case Study

Les Affreteurs Reunis SA v Walford (1919)

The charter of a ship expressly provided that commission will be paid to Walford 'on signing of the charter.' According to the trade custom the payment to Walford was to be made at a later stage. The French government requisitioned the ship and hence, no hire was earned. Walford sued the owners of the ship for payment of hire charges.

Court's decision

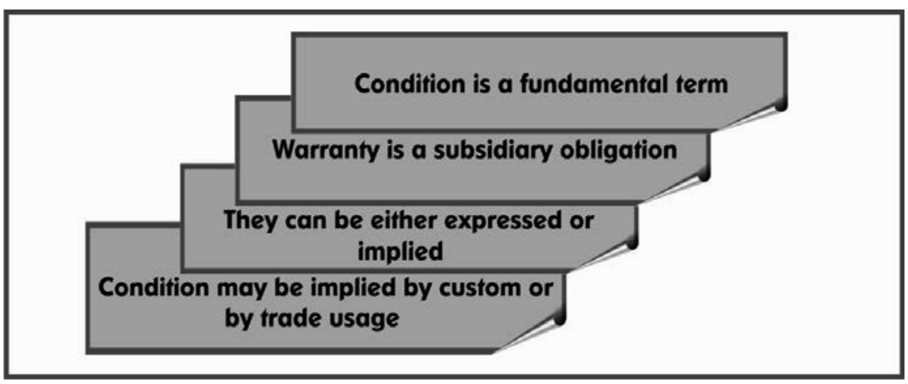
It was held that the commission on hire was payable because a term implied by custom cannot prevail over a term that is expressed in the contract.

If the parties do not reduce the general agreement into specific details then the courts will imply certain terms into such unspecific contracts.

Example

According to the courts, in an employment contract there are several implied terms that impose duties on the employer as well as the employee. These implied terms can be overwritten by including express contractual provisions to the contrary in the employment contract.

Diagram 2: Conditions and warranties



3.2 Exemption clauses

An exemption clause is a clause inserted in a contract which aims to **exempt or limit the party's liability** for breach of contract or negligence.

Exemption clauses generally fall into one of the following categories

1. **True exemption clause:** this clause recognises a potential breach of the contract, and then excuses the liability for the breach. Alternatively, the clause is constructed in such a way that it only includes reasonable care to perform duties on one of the parties.

Example

For many products, the manufacturer inserts an exemption clause which states that no replacement will be given for any breakage or damages due to improper handling of the product. The product will be replaced only for any manufacturing defects.

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2. **Limitation clause:** this clause places a limit on the amount that can be claimed for a breach of contract, regardless of the actual loss.

Example

Alan and Beth entered into a contract according to which Beth was to supply Alan with a painting at a fixed price and in a good condition within one week from signing the contract. The contract also states that in the event Beth does not keep her part of the contract then Beth will be liable to pay Alan Tshs500, 000 as breach of contract. Due to this term, the liability of Beth for breach of contract is limited to Tshs500, 000.

---

3. **Time limitation:** this clause states that an action for a claim must start within a certain period of time or the cause of action becomes extinguished.

Example

When banks send monthly statements to its customers, they include a term that any discrepancies in it should be reported by the customer within a week of receipt of the statement. If no communication is received within the stipulated time, the statement will be considered accurate.

Test Yourself 4

State whether true or false

Implied conditions and warranties are those which, are expressly provided in the contract.

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4. Describe illegal contacts and contracts in restraint of trade, vitiating factors. [Learning Outcome d]

Vitiating factors

The key vitiating factors that undermine a contract are as follows

1. Misrepresentation

A representation is an **untrue** pre-contractual statement of fact which was made to induce another person to enter into a contract.

It is important that the statement is made with the intention of inducing the other party to act or to refrain from acting.

Example

John wanted to buy Elly's laptop. Elly told john that the laptop is practically new when it is in fact 3 years old and heavily used.

A contract entered into as a result of misrepresentation is voidable

2. Duress (Coercion)

This means committing, or threatening to commit any act against a person's will. Duress is some element of force, either physical or economic, which is used to override one party's freedom to choose whether to enter into a particular contract or not. Such contracts are voidable at the insistence of the innocent party.

In order to benefit from the doctrine of duress, claimants must prove that the pressure:

resulted in an absence of choice on their part, was brought on them against their will.

was of a nature considered to be illegal by the court.

Example

Armstrong threatened to kill Barton if he did not sign a contract. This contract will be set aside due to duress to Barton.

---

3. Undue influence

A contract is said to be influenced by 'undue influence' when all the essential elements of undue influence are satisfied. The elements of undue influence are:

the relationship between the parties is such that one of the parties is in a **position to dominate the will of the other.**

influence has been used by one of the parties to obtain an unfair advantage over the other.

unfair advantage is in fact obtained.

Example

Alan advances some money to his son Bobby because Bobby has financial problems in his business. When Bobby's financial problems end, Alan obtains a contract from Bobby for a greater amount than the sum due in respect of the advance**.**

The facts of the case need to be compared with the essential elements of undue influence that:

(i) The relationship between the parties is that of father and son. The father is in a position to dominate the will of his son.

(ii) The father uses his influence to obtain a greater amount than the sum which is due.

(iii) Unfair advantage has been obtained as there is already a contract between Alan and Bobby.

As all the essential elements of undue influence are satisfied, this is a case of undue influence.

---

4. Illegal contract

Legality of object is an essential element of a valid contract. A contract that breaks the law is illegal. The courts have recognised that any contract that tends to prejudice any social or economic interest of the country must be forbidden.

However, contracts that would be contrary to public policy depend on the facts and circumstances of the case under consideration**.**

Some examples of illegal contracts are:

(i) Contracts prohibited by statute.

Example

A contract to employ a child in a factory. Child labour is illegal and therefore this contract is illegal.

(ii) Contracts involving commission of crime.

Example

A contract to smuggle narcotics.

(iii) Contracts leading to corruption in public life.

Example

An amount paid to secure a high-profile job in the government

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Contracts in restraint of trade

Contracts in restraints of trade are contracts between a buyer and a seller of a business, or between an employer and employee, that prevents the seller or employee from engaging in a similar business within a specified geographical area and within a specified period.

The intension of such contracts is to restrict the rights or liberty of a party to carry on a business, trade, or profession in order to limit competition or to protect trade secrets.

Example

Annie is the owner Luvlox beauty salon. All the employees of the Luvlox salon have to sign a contract which specifies that after leaving the job with Luvlox, the employee will not be entitled to start their own beauty salon within 5km of the Luvlox salon premises, for a period of 12 months.

The general principle is that all contractual provisions in restraint of trade are prima facie void, and therefore unenforceable.

However, where the party seeking to enforce the restrictive provision establishes that the restriction is reasonable with reference to the party against whom it is made, and is not contrary to the public policy then it may be enforced

Test Yourself 5

What is misrepresentation?

Answers to Test Yourself

Answer to TY 1

This depends on whether the two parties in question had the intention to enter into a legal relationship when they made their promises. If the promises were made casually on a social occasion, the law would presume that the parties had no such intention. If this presumption can be rebutted and the intention to enter into a legal relationship can be proved, then the agreement would be legally enforceable.

Answer to TY 2

No, because the object of the contract is unlawful. Hence this contract is void.

Answer to TY 3

The contract, prima facie, appears to be a valid contract. However, the contract can be held void if Sunny proves that:

(a) At the time of making the contract, his mind was so affected that he was incapable of understanding the nature of his actions.

(b) The other party i.e. Bobby either knew or ought to have known of his disability.

In any case, however, Sunny must pay a reasonable price for the work done by Bobby.

Answer to TY 4

False, implied conditions are not expressly provided in the contract.

Answer to TY 5

A misrepresentation is an untrue pre-contractual statement of fact which was made to induce another person to enter into a contract.

Self Examination Questions

Question 1

State true or false

(a) All contracts are agreements but all agreements are not contracts.

(b) Every contract must be in writing.

Question 2

Distinguish between an agreement and a contract.

Question 3

Alvin agrees to sell his car to Charley for Tshs500, 000. Is the contract valid?

Question 4

Define consent. When can consent be said to be free?

Question 5

Explain what is an exemption clause.

Answers to Self Examination Questions

Answer to SEQ 1

(a) True, because all agreements are not legally enforceable.

(b) False, a contract can be written or oral or inferred from the conduct of parties.

Answer to SEQ 2

Distinguish between an agreement and a contract is as follows:

Basis of distinction	Agreement	Contract
Meaning	Offer when accepted becomes an agreement	An agreement enforceable by law is a contract
One in another	All agreements are not contracts	All contracts are agreements
Enforceability	An agreement may or may not be enforceable by law	All contracts can be enforced by law

Answer to SEQ 3

Yes, because all the elements for a valid contract are present.

(a) The contract is made because of the offer by Alvin and acceptance by Charley.

(b) The object (the ownership of car) is lawful.

(c) Charley’s promise to pay Tshs500, 000 is the consideration for Alvin’s promise to sell the car and Alvin’s promise to sell the car is the consideration for Charley’s promise to pay Tshs500, 000.

Answer to SEQ 4

Free consent is essential for a valid contract. Two or more persons are said to consent when they agree upon the same thing in the same sense.

Consent is said to be free when it is not caused by

(a) duress
(b) undue influence
(c) fraud
(d) misrepresentation

Answer to SEQ 5

An exemption clause is a term inserted in a contract which aims to exclude or limit on party's liability for breach of contract or negligence.

Exemption clauses generally fall into one of these categories

(a) True exemption clause: it excuses the liability for the breach by recognising potential breach of contract. Alternatively, it can be constructed in such a way that it only includes reasonable care to perform duties in the case of one of the parties to the contract.

(b) Limitation clause: regardless of the actual loss, the limitation clause places a limit on the amount that can be claimed for a breach of contract.

(c) Time limitation: it states that the cause of action will extinguish if the claim for the action is not commenced within a certain period of time.

Traditionally, the courts have sought to limit the operation of exemption clauses. The law explicitly recognises the possibility of exploitation of the consumer by businesses by using exemption clauses.

To protect the consumers from the harsher effect of exemption clauses, the exemption clause must be

(i) properly incorporated into the contract and

(ii) strictly interpreted.

SECTION C

BUSINESS CONTRACTS

C2

STUDY GUIDE C2: LAW OF AGENCY

Get Through Intro

One of the most common legal relationships in business is agency. With the growth of industry, the intervention of a third party in the process of marketing, selling and licensing a company's products is a common feature. The channel of distribution involves distributors, retailers, company and independent sales representatives. The contractual arrangement between these various entities is critical.

The agreement between the parties must be very clear, detailed and unambiguous. This Study Guide deals with an agency relationship, how an agency relationship is created, and the legal authority an agency has under the provisions of law.

Agents play an important role in society and so a sound knowledge of this topic will be needed in your professional life.

Learning Outcomes

a) State the meaning and formation of an agency.
b) Identify various classes of agents.
c) Describe the authority of agents.
d) State the rights and duties of principals and agents.
e) Describe termination of agency.

1. State the meaning and formation of an agency.

[Learning Outcome a]

1.1 Meaning of agency

As a general rule, one person cannot, by contract with another, confer any rights that impose liabilities upon a third party. However, one person may employ another person for the purpose of bringing him into a legal relationship with a third party. Employment for this purpose is called “Agency”.

Definition

An agent is a person employed to do any act for another or to represent another in dealing with a third person, the person for whom such act is done, or who is so represented, is called the principal.

Therefore, in effect, an **agent is the connecting link between the principal and the third person** - a sort of conduit pipe or an intermediary. This intermediary has the power to create a legal relationship between the principal and the third party. He has the competency to make the principal responsible to the third party.

Example

Julie wishes to sell her car. She appoints Jack as her agent to sell the car. Jack meets John and tries to sell him Julie’s car.

Here,

- Jack is the agent.
- Julie is the principal.
- John is the third party.

It is very important to understand here that the contract entered into is between the principal and the third party; the agent has no personal rights or liabilities in relation to the contract and cannot be bound by the contract.

Example

Continuing the previous example of Julie, Jack and John

John purchased Julie’s car. A week after the purchase he discovers that the car needs major repairs. In such a case John cannot sue Jack (the agent). The contract is between Julie (the principal) and John (the third-party).

Hence, John has a right to sue Julie but not Jack.

1.2 Essential elements of agency

1. Principal must be competent to contract

As an agent is acting on behalf of the principal, it is essential that the principal has the full contractual capacity because, ultimately, the party to contract is the principal and not the agent.

Example

Hillary is a minor. She asks Lindsay (a major) to purchase a car on her behalf. We know that a minor does not have full contractual capacity. Hence, no agency can be established among Hillary and Lindsay.

---

2. Any person may become an agent

As the agent is not actually entering into a contractual relationship with a third person, there is no requirement that the agent have contractual capacity. In other words, full contractual capacity is not necessary to enable a person to represent another as an agent.

Example

Continuing the example of Julie, Jack and John

Julie (a major) asks Jack (a minor) to find a buyer for her car. Jack agrees to it. Here an agency relationship is established between Julie and Jack.

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3. No consideration is necessary for the creation of an agency

Normally, however, commission is paid for an agent's services.

Important

This is an exception to the general rule that an agreement without consideration is void.

Example

Continuing the previous example of Julie, Jack and John

Julie asks her friend, Jack to find a buyer for her car. Jack finds John who is interested in buying Julie's car. Jack will receive no remuneration (e.g. commission) for finding a buyer for Julie's car. Still, an agency relationship has been established between Julie and Jack.

The agency relationship is created by mutual consent, although the consent need not be expressly stated.

Case Study

White v Lucas (1887): principle-agent relationship cannot be created without mutual consent.

A firm of estate agents claimed to act on behalf of the owner of a particular property, although that person had denied them permission to act on his behalf. When the owner sold the property to a third party, introduced by the estate agents, they claimed their commission.

Court's decision

It was held that the estate agents were not entitled for commission because the property owner had not agreed to their acting as his agent.

1.3 Formation of agency

An agency can be created by one of the following ways:

1. by consent
2. by ratification
3. by estoppel or 'agency by holding out'
4. by operation of law

Let us look at these in detail.

1.4 Methods to create an agency

1. By consent

The most common way an agency is created is when a principal gives actual authority to contract to his agent. This method does not require a principal to exercise any specific formality to appoint an agent. Under this method the principal appoints the agent to carry out a particular task or to perform a specific function.

(a) Express authority

An authority is said to be express when it is verbally spoken or written. Express authority is given by the principal to his agent to perform certain tasks. It empowers the agent to take necessary steps to perform his duties towards the principal.

Example

An agency may be created when a principal gives power of attorney to a person who will then become the agent.

(b) Implied authority

An authority is said to be implied when it is to be inferred from the circumstances of the case or by their relationship with each other.

Example

Employer and employee, company and company director are implied agency relationship. Although an express agreement is not created, a director, by his position, has the implied authority to act on behalf of his company.

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2. By ratification

Another way of creating an agency is by ratification. Ratification means an act by which the principal confirms the unauthorised acts of the agents.

Example

Bobby appointed Sunny to buy some goods for him. However, Sunny, without authority, bought other goods along with goods specified by Bobby. Bobby later paid the price of all the goods and thereby ratified the contract made by Sunny. In this case, the consent will be assumed to be given in retrospect.

Where the principal elects to ratify the contract, it gives retrospective validity to the action of the self-styled agent.

It may, however, be noted that for a ratification to be valid, it must satisfy certain conditions:

(a) The agent must have acted on behalf of the principal

The agent must admit that he was acting as an agent for the principal. It is not always necessary for the agent to disclose the name of the principal but the principal must be identifiable. If the agent acts in his own name and does not disclose the name of the principal then the principal cannot later ratify his act.

(b) The principal must be in existence at the time of agent's act

The obvious reason for this rule is that the ratification relates to the time when the contract was originally made by the agent on behalf of the principal.

(c) The principal must have the legal capacity to contract

In order to be able to ratify a contract, a principal must be competent to contract both at the time the act was carried out and at the time of the purported ratification.

(d) The contracts must be valid and legal

A principal can ratify only the lawful acts of the agent.

(e) The principal must adopt the whole of the contract

Principals are not at liberty to pick and choose some parts of the contracts for ratification, they must accept all its terms. The contract should be ratified in its entirety.

(f) Ratification must be within a reasonable time

What is a reasonable time depends on the facts and circumstances of each particular case. However, where the third party with whom the agent contracted becomes aware that the agent has acted without authority, a time limit can be set, within which the principal must indicate their adoption / ratification of the contracts for it to be effective.

3. By estoppel or 'agency by holding out'

Estoppel means that a person is not permitted to resist an inference which a reasonable man would draw from his words or conduct. An agency is created by estoppel or holding out when the principal makes other parties believe that he has authorised a person to represent him. In such a case, the person is not an agent of the principal but the third parties are under the impression that there is an agency relationship between the other person and the principal. If the third party acts on this belief, the principal will be held liable for the acts of the agent i.e. the other person.

Example

Francis, a dealer in food items, directed his brother James not to give any guarantee of the freshness of packed food items while selling them. Despite this, James gave a guarantee to Annette that the juices he sold to her were fresh and that he would replace the entire carton if the juices were sour. The entire carton of the juice boxes had turned sour. Annette asked for the replacement.

Here, Francis is liable to replace the goods. His brother had the authority to sell the goods. On the basis of this, he also had ostensible authority to give the guarantee on the basis of which Annette purchased the juices. Francis could escape the liability only if Annette knew that Francis had instructed his brother not to give any guarantee. In the above case, Annette had no knowledge of Francis' instruction to James. Therefore, Annette was not bound by the instructions which Francis gave privately to his brother.

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4. Agency by necessity i.e. operation of law

The most common instance in which agency arises by operation of law is the case of agency by necessity. Usually agency by necessity is created when a person is in possession of another person's goods and is unable to obtain instructions from the other person for safeguarding the goods. According to Halsbury, "Agency of necessity arises whenever a duty is imposed upon a person to act on behalf of another apart from the contract, and in circumstances of emergency, in order to prevent irreversible injury. It may also arise where a person carries out the legal or moral duties of another in the absence of default of that other, or acts in his interest to preserve his property from destruction".

For agency of necessity to arise, some conditions have to be satisfied

(a) There has to be a genuine emergency

A person may become an agent by necessity because of a certain emergency. It is necessary to prove that the course adopted was the only practical one under the circumstances.

(b) There must be no practical way of contacting the principal to obtain further instructions

The circumstances have to be such that the person acting as the agent by necessity did not have enough time or opportunity to communicate with the principal.

(c) The person seeking to establish the agency by necessity must have acted in good faith

This means that he must act in the interests of the principal rather than in his own interests.

Test Yourself 1

No consideration is necessary for the creation of an agency.

A True
B False

---

2. Identify various classes of agents.

[Learning Outcome b]

Different classes of agents

Broadly, there are two types of agents:

1. **General agents:** they act generally for the principal in relation to some particular area of business.

Example

Partners of a firm or directors of a company are authorised to carry out all acts which relate to the firm or the company.

2. **Special agents:** they have the authority to carry out only certain specific acts or transactions.

Example

An auctioneer is appointed to carry out a particular auction.

A few forms of agency are discussed below.

(a) Partners

This is the most important example of agency. Partners are agents to each other. If any contract is signed by one partner in the firm's name, it is binding on all the partners of the firm. The firm as a whole is liable for each partner's actions.

Example

Annie, Benny, Conny are partners of Grasim pharmaceuticals. Benny enters into a contract with Candila medicines for the partnership firm. Therefore this contract is binding on Annie and Conny as Benny has acted as an agent on behalf of the partnership firm.

(b) Directors

A director is the agent of the company. He executes his duty with other directors as part of a board, or on his own when duties are delegated to him by other directors. In the latter he is the agent of the board. A director needs to know whether he has done the right thing. Referencing the duties of an agent and a managing agent can provide directors with clarity on their conduct.

The duties of a director are:

(i) to act in good faith
(ii) to act with care and skill
(iii) to act in obedience to lawful instructions

(c) Brokers

A broker is an agent who is employed by a principal to enter into contracts for sale or purchase on behalf of the principal. He is not given possession of the property. A broker can neither enter into a contract in his own name nor can he receive payment. He cannot even cancel a contract which he has entered into on behalf of his principal.

Therefore a broker is an agent primarily employed to negotiate a contract between two parties in which he is a broker for sale, he has no possession of goods to be sold, and he does not have the authority which a factor enjoys, nor does he have the authority to sue in his own name by virtue of contracts made by him.

Example

Hugh is Sue's broker, who buys or sells shares on behalf of Sue. Sue wants to sell some of her shares, as the market conditions are suitable. She instructs Hugh to get the best price for her shares. Hugh enters into a contract with Lou for the sale of the shares and negotiates the sale price with him. He communicates this sale price to Sue. Sue then shows her approval and she arranges a meeting with Lou where the sale takes place. In this meeting, possession of the shares is passed from Sue to Lou and the sales price is also received directly by Sue.

(d) Auctioneer

An auctioneer is an agent who sells property goods at a public auction. He is primarily an agent for the seller, but upon the property being sold / knocked down he also becomes the agent of the buyer. He has the authority to sell, but not to give warranties as to the property sold, unless expressly authorised by the seller.

Example

Honey has become bankrupt and has to pay off her debts so needs to sell her house. She is not able to do this herself so she appoints Boney as her agent to sell her property at a public auction. Boney sells the property on behalf of Honey.

Test Yourself 2

Which of the following statements relating to agency is correct?

(i) Partners are agents of each other
(ii) Partners are not agents of each other
(iii) A director is an agent of a company
(iv) A director is not an agent of a company

A ii and iii
B i and iii
C ii and iv
D i and iv

3. Describe the authority of agents.

[Learning Outcome c]

An agency relationship allows an agent to represent the principal. The principal gives authority to the agent to enter into a contract on his behalf. However, the principal does not give unlimited power to the agent to create binding obligations on him. The principal places strict limits on the nature of contracts that an agent can enter on the principal's behalf. The authority given by the principal decides the ability of the agent to enter into a contract on behalf of the principal.

The following are the two types of authority:

1. Actual authority
2. Apparent authority

1. Actual authority: it can be either express or implied.

(a) Express authority: it is conferred by the contract of agency and is usually in writing.

Example

As a regular feature of trade, an agent is given power of attorney to act on behalf of the principal

Express authority has been discussed in detail in Learning Outcome 2 of this Study Guide.

Generally, whenever the authority of an agent is defined in writing via a document duly executed, the scope of that authority is determined by construing the document with the help of two simple rules:

(i) The first rule is that the **authority of an agent is limited to the purpose for which it has been given** by the principal. This rule provides instructions to the agent to perform his tasks. It also defines the powers available to the agent to perform the task.

Example

If the document authorises the agent to sell certain jewellery, this does not give him the authority to pledge it.

(ii) The second rule **applies when the words in the document concerning the authority of the agent are ambiguous**. In this case, these words are given a reasonable interpretation and, as long as the agent acts in good faith, he is regarded as acting within his authority, even if what he does is not what the principal intended.

Example

Suppose the document instructs the agent to buy 500 tonnes of sugar at a certain price and adds that he may buy 50 tonnes more or less so long as the price is right. The agent buys only 400 tonnes at that price. The principal is bound to pay for it as the language in the document could be reasonably interpreted to provide that authority to the agent [Ireland v Livingston (1872)].

(b) Implied authority

Assent of the principal may be implied where the circumstances clearly indicate that he has given authority to another to act on his behalf and the assent of the agent may be implied from the fact that he has acted intentionally on another's behalf.

Third parties are entitled to assume that agents holding a particular position have all the powers that are usually provided to such an agent.

Example

Jimmy owns a shop in Manchester. He lives in London and visits the shop occasionally. This shop is managed by Baron and he is in the habit of ordering goods from George in the name of Jimmy for the purposes of the shop, and paying for them out of Jimmy's funds with Jimmy's knowledge. Here, Baron has an implied authority from Jimmy to order goods from George in the name of Jimmy for the purposes of the shop.

2. Apparent authority

This arises when the principal's words or conduct reasonably cause the third parties to believe that the agent has been authorised to act on his behalf. It is an aspect of agency by estoppel. It can arise in the following two ways:

(a) Where a principal, from his conduct, suggests to third parties that a particular person is his agent: In such a case, the principal is bound by the acts of the agent. This also applies where the principal knows that the agent claims to be his agent and does not correct that impression (Freeman & Lockyer v Buckhurst Part Properties (Mangal) Ltd (1964)).

Example

Ira wanted to buy a wooden cupboard. So she entered a furniture store. The owner of the store, who was sitting on the cash counter, welcomed Ira and told her that an attendant would attend to her. A man in a suit introduced himself to Ira and asked if he could help her. On informing him what she wanted, the man showed Ira a piece of furniture. Ira told the man that she liked the furniture and wanted to purchase it, she handed the man a cheque and was told that the furniture would be delivered to her in about a month. After waiting over a month for the furniture to be delivered to her, Ira contacted the furniture store. She learned, to her surprise, that there was no record of her transaction and that there was no man known to have worked there who helped her out.

In this case, the store owner from his conduct suggested to Ira that the person who took the cheque was his agent. Hence he is bound by the act of the so-called agent.

(b) Where a principal has previously represented to a third party that an agent has the authority to act on their behalf.

Example

If a father regularly pays the debts incurred by his daughter at a local shop, then he may be denied the right to prove that she was not acting on his behalf if he should on some subsequent occasion refuse to pay. He has led the supplier to believe, reasonably, that she is acting on his behalf. Hence he will be liable to pay the debts incurred by his daughter, unless he has informed the shop owner that he will not pay any debts incurred by his daughter anymore.

Test Yourself 3

Explain the concept of apparent authority.

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4. State the rights and duties of principals and agents.

[Learning Outcome d]

The principal is usually liable to third parties for contracts formed by agents within his authority. However, the agent owes some duties towards the principal and enjoys certain rights. This Learning Outcome deals with the rights and duties of an agent and an agent's relationships with third parties.

4.1 Rights and duties of an agent

The rights and duties of the principal and agent depend upon the terms of the contract which they enter into. Besides these terms, the mere establishment of the relationship between principal and agent gives rise to certain rights and duties.

1. The following are the duties of an agent

(a) Duty to perform the business according to the direction of the principal

The agent is bound by contractual obligation to carry out the agreed business in accordance with the principal's instructions in so far as these are lawful and reasonable. Even if he believes that non-compliance with the principal's instructions will be in the principal's best interest, he should not disobey the instructions. However, any agent may refuse to perform an illegal act. If there are no instructions from the principal, an agent is bound to conduct the business according to the custom which prevails in carrying out business of the same kind and in the same place where the agent conducts the business. If the agent does not conduct the business according to the directions of the principal or in the absence of such directions, according to the prevalent custom, he will be liable for any loss sustained.

Example

James is a broker. In his business, it is not the custom to sell the goods of Anthony on credit to Bobby, whose credit is very high. Bobby, before payment, becomes insolvent. James must make good the loss to Anthony.

Case Study

Soloman v Barker (1862): if there are no instructions from the principle, an agent is bound to conduct the business according to the prevailing custom.

A broker was entrusted with some goods to sell them at a proper price. Without making an estimate of the value of the goods in accordance with the prevailing custom of that trade, he sold them at an inadequate price.

Court's decision

The agent (broker) was held liable for the loss.

Case Study

Turpin v Biltom (1843): the agent is bound to perform what he has contracted to perform

An insurance agent contracted to arrange for insurance for the principal's ship. He failed to arrange the insurance and ship was lost at the sea.

Court's decision

The agent was held liable to compensate the principal.

(b) Duty to apply reasonable skill and care

Whether the relationship is contractual or gratuitous, an agent is bound to act with reasonable care and skill. The agent must perform his duties with a normal degree of diligence. If the agency is gratuitous, he is expected only to employ as much skill as he would to conduct his own affairs. A somewhat higher standard is required of him if the agency is for reward.

Example

Peter, an insurance broker employed by Lee to arrange insurance on a ship, doesn't notice that the usual clauses are inserted in the policy. The ship was later lost at sea. In consequences of the omission of the clauses nothing can be recovered from the insurance company. As Peter failed to exercise due care, he is bound to compensate Lee for the loss.

In **Keppel v Wheeler (1927),** the defendant estate agents were held liable for failing to secure the maximum price for a property.

(c) Duty to perform personally

An agent owes a duty to perform the task himself. It is the duty of the agent not to delegate his functions to a sub-agent. An agent cannot, except with the express or implied authorisation by the principal, delegate the work. The principal will not be bound by the act or contract of the sub-agent whose appointment is not sanctioned by the principal. However, where it is usual to appoint sub-agent by the ordinary custom of trade, a sub-agent may be employed.

On the other hand, where an agent, having the authority for his principal expressly or by implication, names another person to act for the principal in the business of agency, such a person will not be deemed to be a sub-agent. He will, in fact, be deemed to be an agent of the principal for that part of the business of agency that is entrusted to him.

Example

Alan directs John, his solicitor, to sell his estate by auction, and to employ an auctioneer for the purpose. John names Bob, an auctioneer, to conduct the sale. Here, Bob is not a sub-agent, but is Alan's agent for the conduct of the sale of estate by auction.

(d) Duty to render accounts

An agent who enters into any transaction on behalf of his principal is under an implied duty to render proper accounts to the principal. The agent is required to account for all monetary considerations and other property received on behalf of his principal and should ensure that his personal property / money is kept separately from that of the principal.

(e) Duty to avoid conflict of interests

It is the duty of the agent to ensure that his personal interest does not conflict with the interests of his principal. If there is any possibility of a conflict of interest, the agent must disclose this possibility to the principal. Upon full disclosure by the agent, it is for the principal to decide whether or not to allow a particular transaction. If an agent deals on his own account in the business of the agency, without first obtaining the consent of his principal and acquainting him with all material circumstances which have come to his knowledge on the subject, the principal may repudiate the transaction. If it later comes to the notice of the principal that any fact was dishonestly concealed from him by the agent, the principal may repudiate the transaction

Example

Where an agent is employed to sell some goods, he cannot himself purchase the goods unless full disclosure is made to the principal and the transaction is allowed by the principal.

Case Study

De Bushe v Alt (1984): agent must not allow his personal interest and his duty to conflict with each other

In this case, a ship was consigned by the claimant to a company in China for sale, fixing a minimum price of £90,000 payable in cash. The company, with the consent of the claimant, employed the defendant (an agent in Japan) to sell the ship. The defendant made efforts to sell the ship but failed. The defendant thereupon, purchased the ship himself and paid £90,000 for it. After some time, the defendant resold the ship for £160,000. When this fact came to the knowledge of the principal, he brought an action to recover the profits gained by the defendant.

Court's decision

It was held that the defendant was bound to account for the profits gained by him for resale of the ship. The court observed that it was wrong on the part of agent to buy the property himself, which he received from his principal for sale; he can do so only by disclosing the fact to the principal. If he does not disclose this fact to principal, the principal is entitled to avoid the transaction and may also recover any profit which the agent makes from such a transaction.

Case Study

McPherson v Watt (1877): agent must avoid conflict of interest

In this case, a solicitor was engaged to sell a property. He nominated his brother to purchase the property.

Court's decision

It was held that the sale could be set aside as the solicitor had allowed a conflict of interest to arise. The fact that a fair price was offered for the property, was immaterial.

(f) Duty not to make secret profits

It is also the duty of the agent that he should not make a secret profit or gain from the agency. An agent is bound to disclose and account for all the profits he makes out of the agency.

Case Study

Happisley v Knee Brothers (1905): agent cannot make any secret profit

In this case, the defendants, the auctioneers, were engaged by the claimants for the sale of a certain property. The claimant agreed to pay them a certain commission and certain other expenses. While charging the full amount from the claimant, they did not deduct the discount received from printers and advertisers.

Court's decision

It was held that the defendants were bound to disclose to the claimant the discounts received by them.

If an agent accepts from the other party any commission or reward as an inducement to make the contract with him, this is considered to be a bribe and the contract is fraudulent.

Case Study

Boston Deep Sea Fishing & Ice Co Ltd v Ansell (1957): agent cannot make any secret profit

Ansell was the managing director of Boston Deep Sea Fishing & Ice Co Ltd. Some goods were to be purchased on behalf of the company. Ansell accepted commission from a supplier to order goods from that supplier. On discovering this fact, the company removed him from the directorship.

Court's decision

An agent is in a fiduciary relationship with the principal. Ansell was held to be liable for breach of fiduciary duty. The company could recover the commission paid to him.

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2. The following are the rights of an agent

(a) Right to receive remuneration

It is the right of an agent to receive, from his principal, the agreed remuneration. If remuneration was not agreed, he will be entitled to receive reasonable remuneration with regard to the nature of the work performed by him.

It may however be noted that the agent is entitled to receive his remuneration only after he has carried out his duties. Also, where the remuneration is payable in accordance with an express contract, no implied term can be added to or vary the terms of the express contract.

Case Study

Re Richmond Gate Property Co Ltd (1965): remuneration

In this case, the terms of agreement stated that the remuneration of the agent would be determined by the directors of the company. Actually, the directors had not decided on any payment.

Court's decision

It was held that no remuneration could be claimed by the agent.

(b) Right to claim reimbursement of expenses and indemnity

Agents are entitled to recover the money spent in the course of performing their agreed tasks, from their principal. Similarly the principal is under a duty to indemnify the agent against all liabilities incurred by him in the execution of the work of agency. These rights are limited to the acts of the agent that are carried out properly and are within the limits of his authority.

Example

Bob at the request of Alan sells goods in Alan's possession, but which Alan has no right to dispose of. Bob does not know this, and hands over the proceeds of the sale to Alan. Afterwards Celina, the true owner of the goods, sues Bob and recovers the value of the goods as well as costs. Alan is liable to indemnify Bob for what he has been compelled to pay Celina and for Bob's own expenses.

(c) To exercise lien over principal's property

An agent is entitled to retain the possession of the principal's property which lawfully came into his possession, until the time the debts in respect of the agency commission or the expenses incurred by him for the principal are recovered. It is important to note that **the property on which an agent wants to exercise lien must have come to his possession lawfully.**

Example

An agent has been appointed to purchase a piece of land on behalf of the principal. The agency commission agreed is Tshs500,000. The agent purchases the land and gets it duly transferred in the principal's name. The principal pays the cost of land to the seller but does not pay the agent's commission. In this case, the agent can exercise lien on the property papers in his possession from the seller. However, he cannot forcefully take in his possession the car of the principal and exercise lien on it.

Test Yourself 4

Which of the following is not a duty of an agent?

A Duty to apply reasonable skill and care
B Duty to avoid conflict of interest
C Duty to pay reasonable remuneration to the principal
D Duty not to make secret profits

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5. Describe termination of agency.

[Learning Outcome e]

5.1 Termination of agency

(a) Termination by act of parties

(i) By revocation

An agency is terminated by the principal by revocation of the agent's authority. Revocation may be express or implied by the conduct of the principal or the agent respectively.

Example

Alex empowered Bonny to let out his house. Afterwards, Alex lets out the house himself. This is an implied revocation of Bonny's authority.

(ii) By lapse of time

If the agency is created for a stipulated time then, on the expiry of that time, the agency will come to an end.

Example

Matthew appointed a share broker to sell and purchase securities for him, for one year. At the end of the year, the agency will terminate automatically. If Matthew wants the share broker to continue working for him, he has to renew the agency contract.

(iii) By performance

An agency comes to an end when the business of the agency is completed by due performance.

Example

Nancy appointed an agent to sell her house. The agent sold the house to Lily. The property papers were transferred in Lily's name and the price was paid by Lily to Nancy. As the business of the agency has been completed, the agency relationship comes to an end.

(iv) Irrevocable agreements

In some cases, it is not possible to revoke an agency agreement. Where the agency is coupled with an interest it cannot be terminated unless the interest is also realised.

Example

Axe owes Rose a certain amount and cannot repay it. He makes Rose the agent for selling his estate and whatever amount is realised will be adjusted against the debt. Here, Axe cannot terminate the agency until the debt is repaid.

(b) Termination by operation of law

(i) By frustration

Like any other contract, the contract of agency is also subject to discharge by frustration. When a contract is terminated because it became impossible or illegal to perform the contract, this is called discharge of contract by frustration. In other words, where no impossibility existed at the time of formation of contract but subsequently it becomes impossible to fulfil the contract, then the contract is said to have been discharged by frustration.

Example

John appointed Toby as his solicitor. However, Toby was later found guilty in a case of misconduct according to the Law Society regulations. Hence, he was prohibited from acting as a solicitor for a period of five years. It therefore became illegal for Toby to continue working as a solicitor. Here, the contract of agency is discharged by frustration.

(ii) By death or insanity of the principal or the agent

An agency comes to an end on the death or insanity of either the principal or agent.

(iii) By bankruptcy

The bankruptcy of the principal terminates the agency. The bankruptcy of an agent also terminates the agency, but only when the bankruptcy renders the agent unfit to act as an agent

Test Yourself 5

An agency comes to an end if the agent becomes insane. Which type of termination of agency is this?

A Termination by revocation
B Termination by operation of law
C Termination by agreement
D None of the above

Answers to Test Yourself

Answer to TY 1

The correct option is **A.**

Agency agreement is an exception to the general rule that an agreement without consideration is void.

Answer to TY 2

The correct option is **B.**

Partners are agents of one another. Hence, if any contract is signed by one partner in the firm’s name, it is binding on all partners of the firm.

The relationship between the company and its directors is that of principal and agent. Therefore, when the directors enter into any contract on behalf of the company, it is the company which is bound by the contract and not the directors in their individual capacity.

Answer to TY 3

The apparent authority arises when the principal's words or conduct reasonably cause the third parties to believe that the agent has been authorised to act on his behalf. It is an aspect of agency by estoppel. It can arise in the following two ways:

(a) Where a principal, from his conduct, suggests to third parties that a particular person is his agent: In such a case, the principal is bound by the acts of the agent. This also applies where the principal knows that the agent claims to be his agent and does not correct that impression.

(b) Where a principal has previously represented to a third party that an agent has the authority to act on their behalf.

Answer to TY 4

The correct option is **C.**

To pay reasonable remuneration is the duty of a principal and not an agent.

Answer to TY 5

The correct option is **B**.

Like any other contract, the contract of agency is also subject to discharge by operation of law on the death or insanity of either the principal or the agent.

Self Examination Questions

Question 1

Agency is the result of agreement between…………

A Principal and creditor.
B Principal and agent.
C Principal, agent and the third party.
D Principal and debtor.

Question 2

An agent's authority is implied when……………

A it is inferred on an objective basis
B it is inferred from the circumstances of the case
C it is inferred from the conduct of the parties and the circumstances of the case
D it is inferred from the conduct of the third party and the circumstances of the case,

Question 3

Whether the following statement is true or false?

No consideration is necessary for the creation of an agency.

Question 4

Which of the following is a duty of an agent?

A Duty to apply reasonable skill and care
B Duty to avoid conflict of interest
C Duty not to make secret profits
D All of above

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

Answer to SEQ 2

The correct option is **C**.

Answer to SEQ 3

The given statement is True, although normally commission is paid for rendering services as an agent.

Answer to SEQ 4

The correct option is **D**.

STUDY GUIDE C3: LAW OF SALES OF GOODS

Get Through Intro

Individual owners of commodities meet at a common place, known as a market, and freely enter into contracts to buy and sale commodities.

This process is nothing but a contract between two parties to buy and sell goods. During this process there are number of steps like identifying the buyer and seller, deciding what are the goods that they want to buy and sell, negotiating the terms and agreeing to price, preparing legal documents etc. All these activities form part of contract of sale of goods.

This Study Guide discusses the meaning and various types of goods, the various terms of a sale of goods contract, and remedies for breach of contract.

As the sale contract form the essence of any activity, understanding this Study Guide will be beneficial to you in the examination as well as in your professional life.

Learning Outcomes

a) State and explain the meaning and types of goods.
b) Describe formation of sale of goods contract.
c) Identify and describe terms of the contract of sale.
d) Describe performance, discharge, remedies for breach of contract.

1. State and explain the meaning and types of goods.
[Learning Outcome a]

Goods, in general mean any article, commodity, material or merchandise.

Definition

The Tanzania Sale of Goods Act specifies that goods include all chattels, personal other than things in action and money, emblements, industrial, growing crops, and things attached to or forming part of the land, which are agreed to be severed before sale or under the contract of sale

Example

Goods which are subject to the Sale of Goods Act are cars, shares, copyright, old rare coins, paintings, furniture etc.

Types of goods

The goods which form the subject of a contract of sale may be classified into three categories as:

1. Existing goods

Existing goods are the goods that are owned or possessed by the seller at the time of sell. The existing goods include goods which are specified or ascertained at the time of making contract of sale e.g. a specified painting. The existing goods also includes goods that are part of a lot of unascertained goods e.g. a mobile handset of a specific make.

Important

Property in unascertained goods: Where there is a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer unless and until the goods are ascertained.

Property in specific or ascertained goods passes when intended to pass: Where there is a contract for the sale of specific or ascertained goods, the property in the goods is transferred to the buyer at such time as the parties to the contract intend it to be transferred.

2. Future goods

Future goods are the goods which are to be manufactured or produced or acquired by the seller after the making of the contract of sale.

Example

Alan agrees to sell John all the crop to be grown in his farm during the year 2014 for a sum of Tshs100,00,000. This is an agreement to sell future goods.

3. Contingent goods

There may be a contract for the sale of goods, the acquisition of which by the seller depends upon a contingency which may or may not happen.

Example

John agrees to sell Peter all the crop that Alan sells him during the year 2014 for a sum of Tshs120,00,000. This is an agreement to sell contingent goods as whether John can sell crop to Peter depends upon Alan selling good to John.

Test Yourself 1

State whether the following statement is true or false

Existing goods includes specified goods as well as goods out of a batch of unascertained goods.

2. Describe formation of sale of goods contract.

[Learning Outcome b]

Meaning of contract of sale

Definition

A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a money consideration, called the price, and there may be a contract of sale between one part owner and another.

This definition reveals the following essential characteristics of contract of sale of goods:

1. **Two parties:** There must be two distinct parties to a contract of sale as **a buyer and a seller**. Buyer is a person who, buys or agrees to buy goods. Seller is a person who sells or agrees to sell goods.

2. **Goods:** The contract to sell must be for some goods the **property in which is or is to be transferred**.

3. **Transfer of property:** Property means general property in goods i.e. **the ownership right for the goods**. Thus there must be either a transfer of ownership of goods or an agreement to transfer the ownership of goods.

4. **Price:** There must be a price. Price means the **money consideration** for a sale of goods.

5. **Essential elements of contract:** The contract to sell must fulfill all the specified elements of a valid contract as **specified in the Law of contract**.

Formation of contract

The term contract of sale is a generic term and includes both a sale and an agreement to sell. When the property in the goods is immediately transferred at the time of making the contract, the contract is called a sale. When the transfer of property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, the contract is called an agreement to sell.

Like any other simple contract, a contract of sale is made by an offer to buy or sell goods for a price and the acceptance of such price. No particular form is prescribed by the Sale of Goods Act that is needed to constitute a valid contract of sale. A contract of sale of goods can be made by mere offer and acceptance. The offer may be made either by the seller or the buyer and the same must be accepted by the other. Similarly immediate payment or delivery is not a necessary condition for making the contract of sale.

The contract of sale of goods may be made either orally or in writing or partly orally and partly in writing or may be even implied from the conduct of the parties.

Important

Certain contract of sale to be in writing

A contract for the sale of any goods of the value of two hundred shillings or more shall not be enforceable by action unless the buyer accepts part of the goods so sold, and actually receives, the goods, or gives something in earnest to bind the contract or in part payment, or unless some note or memorandum in writing of the contract is made and signed by the party to be charged or by his agent in that behalf.

Example

Where goods are displayed for sale and a customer picks up one and pays the price and the sales assistant packs the same for him, this is a valid contract of sale of goods by the conduct of the parties.

Test Yourself 2

State whether the following statement is true or false

All contracts of sale of goods must be in writing.

---

3. Identify and describe terms of the contract of sale.

[Learning Outcome c]

During negotiations and before the final contract, many features may be discussed. Some of these features may have induced the other party to enter into the contract. However, such features are mere representations. They may not form a part of the contract.

Parties to the contract will normally be bound by any promise that they have made in the contract. Hence, it is very important to decide which promise to include in the contract.

Terms can be defined as the statements that are considered part of the contract. Other pre-contractual statements, which are not considered terms of the contract, are mere representations.

Example

A salesman approached Mary to sell her a shampoo. He told her that a very well known actress also uses the same shampoo. This statement made by the salesman regarding the product may constitute misrepresentation if were not true.

Representations which become a part of contract of sale are called stipulations. Stipulations are either in the nature of conditions or warranties.

Conditions and warranties

1. Condition

Condition is a **stipulation essential to the main purpose of the contract. Condition is a fundamental term** of the agreement and is something which goes to the root of the contract.

2. Warranty

Warranty is stipulated collateral to the main purpose of the contract.

Tip

Refer to study guide E1 for detailed discussion on condition and warranty.

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3. Distinction between condition and warranties

Whether a stipulation in a contract is a condition or a warranty depends on the construction of the contract. A term may be a condition even though it is called a warranty in the contract.

4. Conditions and warranties can be either expressed or implied

Express conditions and warranties are those which, are expressly provided in the contract.

Test Yourself 1

Free replacement guarantee against all manufacturing defects within 2 years of sale is an expressed warranty.

Implied conditions and warranties are those which are implied by law or customs.

In a contract of sale, unless the circumstances of the contract are such as to show a different intention there is:

an implied condition on the part of the seller that in the case of a sale he has a right to sell the goods, and that in the case of an agreement to sell he will have a right to sell the goods at the time when the property is to pass

an implied warranty that the buyer shall have and enjoy quiet possession of the goods

an implied warranty that the goods shall be free from any charge or encumbrance in favour of any third party, not declared or known to the buyer before or at the time when the contract is made

Conditions implied by description

Where there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description; and if the sale is by sample, as well as by description, it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description

Sale by sample

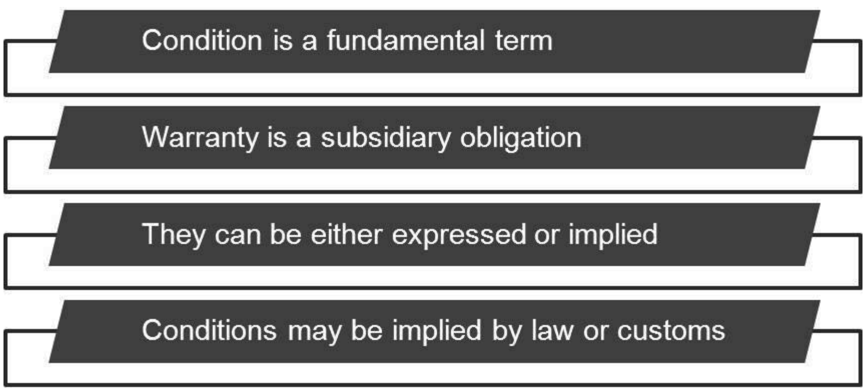
In the case of a contract for sale by sample there is an implied condition that

the bulk shall correspond with the sample in quality

the buyer shall have a reasonable opportunity of comparing the bulk with the sample

the goods shall be free from any defect, rendering them unmerchantable, which would not be apparent on reasonable examination of the sample.

Diagram 1: Conditions and warranties



Test Yourself 3

State whether the following statement is true or false

Implied conditions and warranties are those which, are expressly provided in the contract.

---

4. Describe performance, discharge, remedies for breach of contract.
[Learning Outcome d]

The parties to the contract are freed from their contractual obligations only when the contract is discharged completely and the terms and conditions are fulfilled. A contract is discharged when the rights and liabilities created by the contract come to an end.

A contract may be discharged either:

1. **By agreement:** A discharge of a contract by agreement takes place when both parties of the contract agree to terminate the contract. Some contracts provide for discharge by agreement, for example, by expressly stating that the contract can be discharged by notice.

2. **By performance:** The most common way to discharge a contractual obligation is through performance of the contract by the parties to it.

In the performance of a sales contract, the basic obligation of the:

seller is to transfer and deliver conforming goods
buyer is to accept and pay for conforming goods in accordance with the contract.

Breach of contract

Whenever two or more parties are involved in any transaction, the possibility of disputes can never be eliminated. The law of sale of goods contains provisions which govern the settlement of disputes (if any) between the parties to a contract.

The parties to a contract are not relieved of their obligations until the contract has been discharged in the manner which has been agreed. Failure to discharge a contract in a desired way results in breach of contract, and the most likely consequence of a breach of contract is a claim for damages from the injured party.

Definition

Breach of contract is an **unjustified failure** to fulfil the duties under the contractual terms when the performance is due.

Buyer's remedies for breach of a contract of sale

1. The buyer is entitled to file a legal suit to claim the money lost along with interest because of breach of contract by the seller. E.g. erroneous goods provided.

2. The buyer is entitled to file a law suit against the seller to claim damages for non-delivery of goods.

3. The buyer is entitled to file a law suit to demand specific performance of the contract.

Example

In a contract for the sale of a unique piece of an art-work, the court may order the defendant to actually deliver the artwork instead of awarding money damages.

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4. Where the breach of contract is repudiatory breach then the buyer is entitled to sue for repudiation of contract by the seller before the due date.

Seller's remedies for breach of a contract of sale

1. The seller who has performed his part of contract is entitled to file a legal suit against the buyer to claim for price for contract along with interest.

2. The seller is entitled to file a suit for non-acceptance of the goods where the buyer refuses to accept the delivery.

3. Where the breach of contract is repudiatory breach then the seller is entitled to file a suit for damages for repudiation of contract by the buyer before the due date.

Tip

Specific performance of a contract is a remedy that seeks to award performance specifically as agreed. The party who has been harmed by a breached contract may not be interested in monetary damages, but would prefer to have the contract fulfilled. Specific performance seeks to ensure the benefit of the contract by compelling the breaching party to do what it had agreed to do.

To repudiate means to reject or to disclaim. Where a party to a contract, either by words or by conduct, indicates that he does not intend to honour his contractual liability, this is a repudiatory breach of contract.

The repudiatory breach does not automatically discharge the contract but gives the aggrieved party the choice of:

- either to affirm the contract: if the innocent party opts to affirm the contract, then he may continue with his preparation for performance and recover the agreed price for his services. Any claim for damages will be assessed on the basis of what the claimant has actually lost.

- or to treat the contract as repudiated by the other party: in this case, the breach not only gives rise to a cause for action for damages but also discharges the aggrieved party from any performance still due from him.

Case Study

White & Carter v McGregor (1961): repudiatory breach

McGregor contracted with the claimant to have advertisements placed on litter bins which were supplied to local councils. He then wrote to cancel the contract but the claimants elected to advertise as agreed. They produced and displayed the adverts as required under the contract and then claimed the payment.

Court's decision: it was held that the claimants were not obliged to accept the defendant's repudiation. Repudiation does not, of itself, bring the contract to an end. It gives the innocent party the choice to affirm or reject the contract. The claimants were held entitled to recover the agreed price for their services.

Test Yourself 4

State whether the following statement is true or false

The action for breach is not allowed until the expiry of due date of performance of contract.

Answers to Test Yourself

Answer to TY 1

The given sentence is true.

Answer to TY 2

This statement is false.

Answer to TY 3

This statement is false.
Express conditions and warranties are those which, are expressly provided in the contract.

Answer to TY 4

The given statement is false.

Action can be taken even before the due date where a party to a contract, either by words or by conduct, indicates that he does not intend to honour his contractual liability. This is called a repudiatory breach of contract.

Self Examination Questions

Question 1

Goods which are to be manufactured or produced or acquired by the seller after the making of the contract of sale are called…………

A Existing goods
B Future goods
C Contingent goods
D Ascertained goods

Question 2

Which of the following is not an essential element of a sale of goods contract?

A Existence of two parties
B Transfer of property in goods
C Transfer of goods for price
D Transfer through a sales agent

Question 3

What are the essential characteristics of a sale of goods contract.

Question 4

What are the basic obligations of the parties in the performance of a sales contract?

Question 5

What are the implied conditions in case of a contract for sale by sample?

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

Goods which are to be manufactured or produced or acquired by the seller after the making of the contract of sale are called future goods.

Answer to SEQ 2

The correct option is **D.**

The contract for sale of goods need not be through a sales agent.

Answer to SEQ 3

The essential characteristics of sale of goods contract are:

1. **Two parties:** There must be two distinct parties to a contract of sale as a buyer and a seller. Buyer is a person who, buys or agrees to buy goods. Seller is a person who sells or agrees to sell goods.

2. **Goods:** The contract to sell must be for some goods the property in which is or is to be transferred.

3. **Transfer of property:** Property means general property in goods i.e. the ownership right for the goods. Thus there must be either a transfer of ownership of goods or an agreement to transfer the ownership of goods.

4. **Price:** There must be a price. Price means the money consideration for a sale of goods.

5. **Essential elements of contract:** The contract to sell must fulfill all the specified elements of a valid contract as specified in the Law of contract.

Answer to SEQ 4

The basic obligations of the parties in the performance of a sales contract are as follows,

- Seller's basic obligation is to transfer and deliver conforming goods
- Buyer's basic obligation is to accept and pay for conforming goods in accordance with the contract

Answer to SEQ 5

The implied conditions in case of a contract for sale by sample are as follows:

- the bulk shall correspond with the sample in quality
- the buyer shall have a reasonable opportunity of comparing the bulk with the sample
- the goods shall be free from any defect, rendering them un-saleable, which would not be apparent on reasonable examination of the sample.

STUDY GUIDE C4: LAW OF BUSINESS ASSOCIATIONS

Get Through Intro

An accountant's main function has always been to provide owners / managers with an organisation that has accurate and timely financial information. This information serves as the foundation from which tactical and strategic decisions are often made. However, much more is expected of accountants today. The view of accountants being pure "number crunchers" or gatherers of information is fading.

Today, accountants are becoming increasingly involved in the operational and strategy formulation side of business. They now advise and consult with owners and managers on productivity, profitability and other business issues. In short, an accountant is now expected to become an integral part of the organisation.

To do this, he will need to understand the nature of organisations, their structure and their operations. The contents of this Study Guide will give you an opportunity to appreciate the rationale behind organisations, how business organisations may differ and the different types of business organisations.

Learning Outcomes

a) State and explain the meaning of sole trader, his/her advantages and disadvantages.
b) State and explain the meaning of partnership, partnership act, liability and rewards, number of partners, advantages and disadvantages of partnership.
c) State and explain meaning and forms of registered companies: limited (limited by shares and limited by guarantee) and unlimited companies, public and private companies.
d) Describe the formation of companies, including the Memorandum of Association, Articles of Association, Certificate of Incorporation, Shares, Debentures and Winding up.

1. State and explain the meaning of sole trader, his / her advantages and disadvantages.
[Learning Outcome a]

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.

Test Yourself 1

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

---

2. State and explain the meaning of partnership, partnership act, liability and rewards, number of partners, advantages and disadvantages of partnership.
[Learning Outcome b]

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

Definition

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.

2.2 Firm and firm name

Definition

Persons who have entered into a partnership with one another are collectively called a firm, and the name under which their business is run is called the firm-name.

2.3 Partners

Definition

Persons who have entered into partnership with one another are individually called ‘partners’.

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.

Tip

A partnership is **not a separate legal entity** i.e. it is not a legal person; it is **merely a collection of partners**. The firm does not acquire an identity different from its partners.

Advantages of partnership

- **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 of partnership

- **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.

2.4 Types of partnership

A partnership relationship is divided into three main types:

1. Standard partnership
2. Limited partnership
3. Limited liability partnership

1. Standard partnership

A standard partnership is a **contractual association of two or more persons or entities to operate a common enterprise and to share in the management as well as profits and losses** of the stipulated business. A standard partnership can be formed by either an agreement or by the conduct of the parties, express or implied. Written articles are not necessary to create a standard partnership, although they are advisable as a method of defining the rights and obligations that the partners intend to assume. As with a sole proprietorship, the advantages of a general partnership are the flexibility and simplicity of formation and operation.

Example

Jack and Jill buy 100 bales of cotton, which they agree to sell jointly. They agreed to share the profits and losses from the activity equally and jointly form a firm called cotton organisation. Jack and Jill are therefore partners of the firm cotton organisation.

Liability of partners in a standard partnership

(a) The partners in a general partnership have unlimited liability for the obligations of the partnership, i.e. their liability is not limited to their contributed capital or the assets of the partnership.

(b) Every partner is an agent of the general partnership and can act on behalf of the business and bind the other partners.

(c) Each partner is jointly and severally liable for the debts and obligations of the business, including those arising from the wrongful actions of another partner.

(d) The liability in a standard partnership extends to the personal assets and benefits of the partners to the partnership.

2. Limited partnership

A limited partnership is a partnership formed by two or more persons / entities, **one or more of whom are general partners and one or more of whom are limited partners**. This form is unavailable if no one is willing to assume the risks of a general partner. The **primary purpose** of the limited partnership is to enable one or more persons to **invest in a partnership without incurring the unlimited liability of a general partner.** A limited partnership is more or less similar to a standard partnership except that the liability of one or more partners (but not of all partners) for a partnership debt is limited to their capital contribution in the partnership. The partnership must be registered with the Companies' Registry.

Example

Jacy, Jay and Jill entered into a partnership. All the partners contributed an amount of Tshs200,000 as capital and all are equal partners. However, the agreement provided that Jill's liability towards the partnership debts will be limited to the capital contributed by her i.e. Tshs200,000. This is a limited partnership as the liability of one partner for the partnership debt is limited to her capital contribution to the partnership. Two of the partners have an unlimited liability.

Liability of partners in a limited partnership

(a) In a limited partnership, the liability of limited partners for the obligations of the partnership is limited to their investment.

(b) General partners, however, still have unlimited personal liability.

(c) The limited liability partner is not usually permitted to participate in the management of the business enterprise and cannot usually bind the partnership in any transaction. If he does so, he becomes liable as a general partner for all debts and liabilities incurred during the period of his participation.

(d) In the normal course of business, the limited partners are not allowed to withdraw their capital from the firm.

(e) The firm is not affected in its working by a limited partner's death, bankruptcy or lunacy.

(f) The limited partner can transfer his shares with the consent of the general partners.

(g) The limited partner cannot dissolve the partnership by notice.

(h) The general partners may introduce a new partner without consulting the limited partner. In the event of dissolution, the affairs of the firm are wound up by the general partners.

3. Limited liability partnership (LLP)

It is a form of partnership that differs from standard partnership and limited partnership in that **all partners have a limited liability**. Although the formalities in organising an LLP are sometimes more extensive than those for organising a limited partnership or standard partnership, the LLP has become a popular business structure, particularly for professional firms.

The essence of a limited liability partnership for practical purposes is as a vehicle to contain a partnership of any size where partners may be at risk from the careless or accidental negligence of a colleague.

Example

Partners in international accountancy firms would be protected from personal liability if a claim was successfully pursued by a major client.

Partners in a construction business would be protected if a new building collapsed, causing high level claims against them.

Liability of partners in a limited liability partnership

(a) Unlike partners of a general partnership or the general partner of a limited partnership, all partners of an LLP enjoy limited liability.

(b) Typically, the partners remain liable for contractual debts, but their liability with respect to the tort debts of the business is limited. Contractual debts refer to liability arising out of contract whereas tort debt is a liability due to negligence. Partners of a LLP enjoy limited risk arising from the careless or accidental negligence of a colleague.

(c) All partners may participate in the control of the business and still maintain their limited liability, unlike the limited partners of a limited partnership.

Regardless of which type, all partnerships are considered to be an aggregate of their partners, rather than a separate entity. Unlike corporations, in which stock can be freely traded (assuming a willing buyer), a partner involved in the management of a partnership can only transfer his interest with the consent of the other partners. If the mutual consent to form a partnership breaks down, the partnership breaks down as well.

Test Yourself 2

Soothing and Cooling is a partnership formed by the partners Rosy, Ted and Greg for the same purpose i.e. buying and selling electronic goods. They decided to share the profits arising from the business equally. Among these three partners, Ted is the sleeping partner. He does not take an active part in running the partnership. He also does not visit the place of business very often.

Required:

Ascertain the form of this partnership.

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3. State and explain meaning and forms of registered companies: limited (limited by shares and limited by guarantee) and unlimited companies, public and private companies. [Learning Outcome c]

Types of companies

1. Unlimited company

Every member of an unlimited company is, in the event of its winding up, jointly and severally liable for all the obligations of the company and is therefore in this respect in the same position as a partner in a partnership.

Only a private company can allow the liability of its members to be unlimited. A public limited company cannot register as an unlimited company.

An unlimited company would usually only be appropriate if the company will merely be used to hold land or other investments and will not trade. It may be a useful vehicle where incorporation is necessary or desirable and one or more of the following applies:

The company will operate in a field where limited liability is disapproved e.g., as a service company for a professional firm i.e. in circumstances where limited liability is not vital but perpetual succession is important.

Important privileges enjoyed by an unlimited company

(a) It has separate legal entity and perpetual succession.

(b) It is not required to deliver copies of its annual accounts and reports to the Registrar of Companies (provided it meets certain conditions directed at ensuring that it is not a subsidiary or parent of an undertaking which is limited).

(c) It can buy back its shares from its members without many formalities.

(d) An unlimited company may or may not have a share capital. If a company has no share capital, a member may resign or terminate his membership only if the Memorandum or Articles so provide, and only in the circumstances and in accordance with the conditions set out therein.

2. Limited company

(a) A company limited by guarantee

Such companies cannot be registered with share capital. Hence, a company limited by guarantee has members, rather than shareholders. The liability of the members is limited by an amount guaranteed by each member, which becomes due in the event the company is wound up. However, the members cannot be called upon to contribute beyond that stipulated amount.

The memorandum includes a non-profit distribution clause and these companies are usually formed by professional, trade or research associations. After incorporation the company can be registered with the charity commission.

Example

A company is formed with the following objectives:

(a) To promote awareness and appreciation of classical and associated music from around the world.
(b) To provide entertainment and recreation for residents and visitors, during the time of festivals.

10 members from various fields gathered and registered the company with the 'charity commission' under the name "Find Peace Ltd" and agreed to pay Tshs100,000 each in the event of winding up of the company.

This is a company limited by guarantee.

(b) A company limited by shares

In this type of company, the liability of the shareholder is limited to the extent of the unpaid amount of the shares.

A majority of the companies are those limited by shares. Members or shareholders hold one or more shares issued to them by the company in return for payment. A shareholder's liability to the company's creditors is normally limited to the amount of the shares that have been issued to them and which they have not been fully paid for.

A company limited by shares can be incorporated either as a public company or a private company.

3. Public company

Definition

A public company is a company limited by shares or by guarantee.

A **public limited company** is a company which is registered and complies with the following:

(a) The certificate of incorporation must state that it is a public company.

(b) The name **must end** with the words 'Public Limited Company' or 'PLC'.

(c) The liability of members of the public limited company is limited.

(d) It must have an authorised share capital. There is no maximum limit to any company's authorised share capital.

(e) It must have an issued share capital

4. Private company

A private company is any company that is not a public company. The words 'limited' or 'Ltd' in the name denotes that a company is a private company.

The liability of members of a private company may be limited by shares or by guarantee, or the liability may be unlimited.

Test Yourself 3

Briefly explain the following:

(a) Private company limited by guarantee
(b) Private unlimited company
(c) Public limited company

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4. Describe the formation of companies, including the Memorandum of Association, Articles of Association, Certificate of Incorporation, Shares, Debentures and Winding up.
[Learning Outcome d]

4.1 Formation of a company under the Companies Act

1. Deciding the name of the company

Most names are acceptable to the Registrar of companies when forming a limited company, but there are a few exceptions. These exceptions are:

(a) Proposed name must be different from that of a company already incorporated.

(b) Certain words such as "Group" or "International" must be substantiated by providing evidence of other related companies or companies operating in at least two different countries.

(c) Names containing words likely to cause offence are not allowed.

2. Documents to be submitted

The following must be submitted to register a new Company:

(a) Memorandum of Association

The Memorandum of Association must be delivered to the Registrar together with the following details:

- company's proposed name
- the address of the company's registered office
- whether the liability of the members is to be limited by shares or by guarantee
- whether the company is to be a public or a private company
- the total number of shares taken by the subscribers of the memorandum on the formation of the company
- the total nominal value of the shares of the company
- description of rights attached with each class of shares
- the total nominal value of shares in each class
- the total number of shares in each class
- the total paid-up and unpaid amount on each class of shares
- information as prescribed to identify the subscribers of the memorandum
- the number, nominal value and class of shares taken by each subscriber at the time of formation of the company
- the amount paid and unpaid on each share (including premium)
- details of the first director or directors of the company. A service address must be provided along with the residential address of the director.
- details of the first company secretary. A private company is not required to appoint a company secretary. Hence, if no company secretary is appointed then a private company is not required to submit the details of the company secretary.

The memorandum must be signed by each subscriber in the presence of at least one witness who must attest the signature.

(b) The Articles of Association

The Articles of Association are the rules and regulations or the bye-laws which sets out the internal managements of the company.

The Articles sets out the rules and regulations for the running of the company's internal affairs and form the company's constitution. It is the most important document to be filed with the registrar at the time of incorporation of the company. A company's Articles of Association are its internal rulebook. They typically deal with such matters as decision-making by the company's directors and members and the rights of its members to receive dividends on their shares.

Articles must

- be printed
- be divided into paragraphs numbered consecutively
- be signed by each subscriber of the memorandum in the presence of at least one witness

Model articles

While the articles are always subject to rules of general company law, companies are given considerable freedom to make their own rules in their articles. Alternatively, a company may adopt the whole of Model Article as its articles or any part of it.

Model Article is a specimen set of articles for a company limited by shares. It is used as the basis for most companies' articles.

3. Registrar of company then ensures that:

(a) all the requirements of Companies Act have been complied with
(b) the name of the company is lawful
(c) the Memorandum and Articles of Association do not contravene the provisions of the Companies Act

4. Issue of certificate of incorporation

Once the registrar is satisfied that all the requirements are complied with, he will issue a certificate of incorporation. Such a certificate is conclusive evidence that:

(a) all requirements of the Companies Act in respect of registration and of matters precedent and incidental thereto have been complied with
(b) the company has been properly incorporated
(c) the existence of the company as a legal person is established beyond doubt

The certificate of incorporation is the conclusive proof that the promoters have complied with all the requirements related to the formation of a company under the Companies Act.

The certificate of incorporation contains the following details

- the name of the company
- the registration number of the company
- the date of incorporation
- whether is a limited or an unlimited company (if the company is a limited company then whether it is limited by shares or by guarantee)
- whether it is a public or a private company

5. Meaning of capital

The term capital is used in a variety of meanings. Capital means the amount invested in the company by the promoters for carrying on its business. In a company capital refers to "share capital".

Tip

It means one thing to economists, another to accountants and still another to businessmen and lawyers. In the case of companies, the term capital is used to mean the funds raised by a company.

A company can raise capital in two ways:

1. Share capital (by issue of shares)
2. Loan capital (by issue of debenture)

In simple words, the amount raised by the **issue of shares** is called the share capital.

4.2 Meaning of share

The capital of a company is divided into a number of indivisible units of a fixed amount. These units are known as shares. The face value of a share is also called '**nominal value**'. A company cannot issue shares at a value less than the nominal value of the share.

Example

A company has a capital of Tshs100,000,000 divided into 10,00,000 shares of Tshs100 each. Therefore the nominal value of a share is Tshs100.

A share symbolises a shareholder's interest in a company. This is measured in monetary terms, first for liability and then for interest.

Shares are the units which represent the participation of an owner in the company. By obtaining a share in a company, a person agrees to invest some of his personal money, or assets, or intellectual rights or property into the company. In exchange for this, he acquires the right to participate in the profits of the company, in proportion to his share.

Also, usually shareholders receive the right to participate in the decision-making process of the company by using their voting rights.

Types of shares

1. Ordinary shares

Also known as **equity shares**, ordinary shares are standard shares with no special rights or restrictions. They have the potential to give the highest financial gains, but have the highest risk. Ordinary shareholders are the last to be paid if the company is wound up.

The features of ordinary shares are:

(a) Voting rights: these shares contain the controlling powers of the company. The holders of ordinary shares are entitled to exercise their voting rights in the general meeting of company.

(b) No fixed **dividend:** the equity shareholders are not entitled to fixed dividends. They are paid dividends only from the profits remaining after dividends have been paid to preference shareholders.

(c) No priority **in return for capital:** the equity share capital is repaid only after full payment of liabilities and after the capital has been repaid to preference shareholders.

Advantages of ordinary shares

(a) Since there is no liability for repayments, it is a source of permanent capital.

(b) There is no legal obligation to pay dividends. Therefore, dividend payment can be conveniently skipped until the project starts generating adequate surplus.

(c) Equity capital constitutes the basis for raising debt. In general, the larger the equity base, the higher is the ability to raise debt capital.

However, since dividends are paid out of post-tax profits, there is no tax shield available to the firm on account of this outflow.

2. Preference shares

These shares typically carry a right that gives the holder preferential treatment. The actual rights enjoyed by the preference shareholders are stated in the Articles of Association of the company.

The features of preference shares are:

(a) Preferential right to dividend

When annual dividends are distributed to shareholders, the preference shareholders have a preferential right to receive the dividend. However, the dividend to preference shareholders is paid **according to a fixed rate** or **a fixed amount**, which means that a shareholder would not benefit from an increase in the business' profits.

Tip

Preference shareholders have no entitlement to receive any additional dividend over and above their specified rate.

(b) Preferential right as to repayment of capital

Where a business is wound up, the preference shareholders are likely to be repaid the par or nominal value of their shares **before** repayment of capital of the ordinary shareholders.

Advantages of preference shares

(a) Preference shares are less risky than ordinary shares in that they carry a guaranteed dividend.
(b) The preference shareholders have a right to receive dividends before ordinary shareholders.
(c) The preference shareholders may receive repayment of capital before ordinary shareholders in the event of winding up of the company.

3. Redeemable shares

At the time of issuing these shares, the company enters into an agreement with the purchaser that it will buy the shares back at a future date. This can be at a fixed date or any date as chosen by the business. A company cannot issue only redeemable shares.

Example

If a company issues 1,000 shares and makes an agreement with the purchaser that the company will buy back those 1,000 shares at a certain future date, then these shares are redeemable shares.

4.3 Meaning of debentures

Definition

It is a document in writing, usually under seal, issued as evidence of a debt or the granting of security for a loan of a fixed sum at a rate of interest (or both). The term is often used in relation to loans secured by charges, including floating charges, over companies' assets.

Palmer describes debentures as "an instrument under seal, evidencing a deed, the essence of it being the admission of indebtedness"

According to Gower, "Debenture is a name applied to certain types of documents evidencing an indebtedness which is normally, but not necessarily, secured by a charge over property.

A debenture is defined in company law as including debenture stock, bonds or other securities of a company whether secured or not.

In simple words, a debenture is a written acknowledgement of a debt containing provisions as to payment of interest and terms of repayment of the principal. A debenture is an instrument issued by a company as evidence of a debt or other obligation. It includes debenture stock, bonds and any other securities of a company, whether or not it forms a charge on the assets of the company.

Features of debentures

1. Debentures are instruments for raising long-term debt capital.

2. Debenture holders are creditors of the company.

3. The obligation of the company towards its debenture holders is similar to that of a borrower who promises to pay interest and capital at specified times.

4. The interest payment on debentures is a statutory obligation, unlike dividend payments on equity shares.

5. The interest paid on debentures is a tax-deductible expense.

6. Debentures have to be compulsorily retired in accordance with the terms of the issue, whereas equity share capital need not be redeemed.

7. Debenture holders are not entitled to vote.

8. Debentures are usually secured by a charge on the immovable properties of the company.

9. The interests of the debenture holders are usually represented by a trustee and this trustee is responsible for ensuring that the borrowing company fulfils the contractual obligations embodied in the contract.

4.4 Winding up

Winding up and liquidation are synonyms; they carry the same meaning. Winding up or liquidation is the process of bringing to an end the life of a company. Winding up of a company is the stage**,** whereby the company takes its last breath. It is a process by which the business of the company is wound up, and the company ceases to exist.

1. Meaning of winding up

Winding up is a legal process by which the affairs of a limited company are wound up. At the end of the process, the company ceases to exist. After the company is properly wound up, the name of the company is removed from the register of companies and the company is dissolved, which means it ceases to exist.

2. Types of winding up

Winding up or liquidation can be either voluntary liquidation or compulsory liquidation.

(a) Voluntary liquidation: when the **members** of the company decide to put an end to the life of the company it is called voluntary liquidation. It is again of two types:

(i) Members' voluntary liquidation

This is when the shareholders of a company decide to put the company into liquidation, and there are enough assets to pay all the debts of the company, i.e. the **company is solvent.**

Tip

Solvent company: A company is solvent if it is not ‘insolvent’. A company is insolvent if:

- it is unable to pay its debts
- if its liabilities exceed its assets.

(ii) Creditors' voluntary liquidation

This is when the shareholders of a company decide to put the company into liquidation, but there are not enough assets to pay all the creditors, i.e. the **company is insolvent.**

(b) **Winding up by order of Court (compulsory liquidation):** when the court makes an order for the company to be wound up on the petition of an appropriate person, it is called compulsory liquidation.

A company may be wound up by the court if:

(i) the company has by special resolution resolved that the company be wound up by the court;

(ii) default is made in delivering the statutory report to the Registrar or in holding the statutory meeting;

(iii) the company does not commence its business within a year from its incorporation, or suspends its business for a whole year;

(iv) the number of members is reduced, in the case of a private company below two or, in the case of any other company, below seven;

(v) the company is unable to pay its debts;

(vi) the court is of opinion that it is just and equitable that the company should be wound up.

Test Yourself 4

Define the term "shares". What are the different types of shares which a company can issue?

Answers to Test Yourself

Answer to TY 1

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 2

The partnership of Soothing and Cooling is a **standard partnership** as the liability of none of the partners is limited. All three partners share the profits equally. Ted is the dormant partner as he does take an active part in the operation of the business and also he visits the place of the business very rarely. Nevertheless, shares in the profit of the business.

The partners in a general partnership have unlimited liability for the obligations of the partnership, i.e. their liability is not limited to their contributed capital or the assets of the partnership. Every partner is personally and severally liable for all the debts and liability extends to the personal assets and benefits of the partners to the partnership.

Answer to TY 3

(a) **Sole trader**: a sole trader can withdraw his capital easily, and in the case of a partnership firm also, a partner can withdraw his capital easily. But this is not the case with regards to a company There are strict rules regarding repayment of subscribed capital.

(b) **Partnership:** resources and efforts can be combined in a way similar to a company, yet partners are taxed similar to individuals on their share of income.

(c) **Company:** liability of members of a company for the company's debts is limited to the extent of the capital contributed by them. Also, the company has perpetual succession, which means members may come and go; the company will exist unless it is wound up.

Answer to TY 4

A share is a unit of capital. A shareholder is the owner of the company. The following are the different types of shares that can be issued by the company:

(a) **Ordinary shares** are also known as equity shares. The holders of these shares do not have a preference to receive a dividend. The rate of dividend is not fixed for the equity shareholders. They can get higher rate of dividend but the risk involved is greater. Equity shareholders can vote in the general meeting of the shareholders.

(b) **Preference shares** enjoy the preferential right to receive a dividend. The rate of the dividend is fixed which cannot be changed even if profits increase. As the name suggests, the holders of these shares have preference in the repayment of capital in the event of winding up of the company.

(c) **Redeemable shares** are shares which the company issues through an agreement with the purchaser that the company will buy back these shares at a future date.

Self Examination Questions

Question 1

If a sole trader entity becomes bankrupt, can the personal property of the owner be used for repaying debts?

A No
B Yes
C The liability is limited to the face value of shares
D The liability is limited to profits of the business

Question 2

If a partnership business becomes bankrupt, can the personal property of the owners be used for repaying debts?

A No
B Yes
C The liability is limited to the face value of shares
D The liability is limited to profits of the business

Question 3

Which of the following entities generally have a legal obligation to publish their financial statements?

A Limited liability companies
B Sole traders
C Partnerships
D None of the above

Question 4

If a company becomes bankrupt, can the personal property of the shareholders be used for paying debts?

A No, never
B Yes
C Yes, but to the extent of the amount unpaid on nominal value of shares
D No, the liability is limited to profits of the business

Question 5

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 6

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 7

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 8

Explain the advantages and disadvantages of a company form of business organisation.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

A sole trader does not have limited liability and if the business goes bankrupt, the sole trader's personal assets are utilised to settle business debts if the business' net assets are insufficient to cover these debts.

Answer to SEQ 2

The correct option is **B**.

A partnership does not have limited liability. If the business goes bankrupt, the partners' personal assets are taken away to settle business debts. However, there are some partnerships which can be formed as limited liability depending on the legislation in each country.

Answer to SEQ 3

The correct option is **A**.

A limited liability company has to comply with the legal provisions of the Companies Act, and is required to publish its financial statements.

Answer to SEQ 4

The correct option is **C**.

Shareholders of a company have limited liability. Shareholders are liable to pay the company the amount of face value of shares bought by them. The personal assets are never taken away to settle business debts.

Answer to SEQ 5

The correct option is **B**.

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

Answer to SEQ 6

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 7

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, which may not necessarily be equal.

Answer to SEQ 8

Advantages

- **Large amount of capital**: as there is no limit on the number of owners, large amounts of capital can be raised. 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 employees committing fraud without the owners' knowledge.

STUDY GUIDE C5: LAW OF NEGOTIABLE INSTRUMENTS

Get Through Intro

The simple meaning of the word ‘negotiable, is transferable from one person to another and the word ‘ instrument’ means a written document by which right is created in favour of some person.

Exchange of goods and services is the foundation of every business activity. Goods are bought or sold either for cash or on credit. All these transactions require flow of cash either immediately or after some time.

As the businesses grow, the scale of transactions and the amount of money involved in business transactions also grow. Gradually, the businesses find it difficult to make or receive huge payments in cash. It is also sometimes risky if actual cash transactions of huge amounts are involved.

In order to avoid these problems, modern businesses often make use of certain documents as means of receiving and making payments. Some of these documents are called negotiable instruments.

In this Study Guide, we will discuss the meaning of negotiable instruments and various types of negotiable instruments.

Learning Outcomes

a) Explain the meaning and types of negotiable instruments.
b) Identify and explain parties to a bill of exchange, promissory note and a cheque.
c) State meaning and importance of crossing on cheques.
d) Describe and explain endorsement payment and dishonouring of instruments.

1. Explain the meaning and types of negotiable instruments.

[Learning Outcome a]

1.1 Meaning of negotiable instruments

As the name suggests, negotiable instrument means a written document which creates a right to receive money in favour of some person and which is freely transferable. In other words, it is a method of transferring money owing from one person to another person.

1. Definition

Definition

Justice Willis defines a negotiable instrument as ‘a negotiable instrument is one, the property in which is acquired by anyone who takes it bona fide and for value notwithstanding any defect of title in person from who he took it’.

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2. Characteristics of negotiable instrument

(a) Freely transferable: Negotiable instruments are easily transferable from one person to another person. Right of ownership to property in the instrument is transferred by mere delivery (in case of bearer instruments). The possessor of the negotiable instrument is presumed to be the owner of the property contained therein.

(b) Defect free title: A person accepting an instrument bonafide and for value (known as a holder in due course) gets the instrument free from all defects in the title of the transferor. This means, the holder in due course is not affected by any defect, for example fraud, which might be available against the previous holder of the instrument.

(c) Right to sue: The transferee of the negotiable instrument can sue in his own name, in case of dishonour. A negotiable instrument can be transferred any number of times till it is at maturity. The holder of the instrument need not give notice of transfer to the party liable on the instrument to pay.

(d) Presumptions: Certain presumptions apply to all negotiable instruments. Some of the presumptions are:

- Every negotiable instrument was made, drawn and accepted for consideration.
- Every negotiable instrument bearing a date was made or drawn on that date.
- Every holder of negotiable instrument is presumed to be holder in due course. That means it is assumed that the holder of the negotiable instrument has obtained the right to hold the instrument lawfully without any fraud or malpractice.
- Unless the contrary is proved it is presumed that every transfer of a negotiable instrument was made before its maturity.
- Every bill of exchange is presumed to have been accepted within a reasonable time after its issue and before its maturity
- It is presumed that a lost promissory note, bill of exchange or cheque was duly stamped.

Test Yourself 1

State whether the following statement is true or false:

Generally, every holder of negotiable instrument is presumed to be holder in due course.

1.2 Types of negotiable instruments

The most common negotiable instruments are:

1. Bills of exchange
2. Promissory notes
3. Cheques

1. Bills of exchange

Definition

"A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument".

A bill of exchange, therefore, is a written acknowledgement of the debt, written by the creditor and accepted by the debtor.

Essential characteristics of a bill of exchange

- It must be in writing.
- It must be signed by the drawer.
- There must be three parties as drawer, drawee and payee and all the parties must be certain.
- The sum payable must be certain.
- It should be properly stamped.
- It must contain an unconditional order to pay money.

2. Promissory notes

Definition

"A promissory note is an instrument in writing (note being a bank-note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to or to the order of a certain person, or to the bearer of the instruments."

Essential characteristics of a promissory note

- It must be in writing. A mere verbal promise to pay is not a promissory note.

Example

Peter promises to pay Julie a sum of Tshs100,000 on telephone. This promise is not a promissory note because it is not in writing.

- It must contain an express promise to pay. There must be an express undertaking to pay; a mere acknowledgment is not enough.

Test Yourself 2

State which of the following instruments is promissory notes.

1. Peter, I owe you Tshs100,000.
2. I promise to pay Peter a sum of Tshs100,000

- The promise to pay must be unconditional and must not depend upon the happening of some contingent event.

- It must be signed by the maker as otherwise it is incomplete and of no effect.

- It must clearly show with certainty the parties involved i.e. the maker of the note and the payee of the note.

- The sum payable must be certain.

3. Cheques

Definition

"A cheque is a bill of exchange drawn on a specified banker, and not expressed to be payable otherwise than on demand".

Thus, a cheque is bill of exchange with two more qualifications, as:

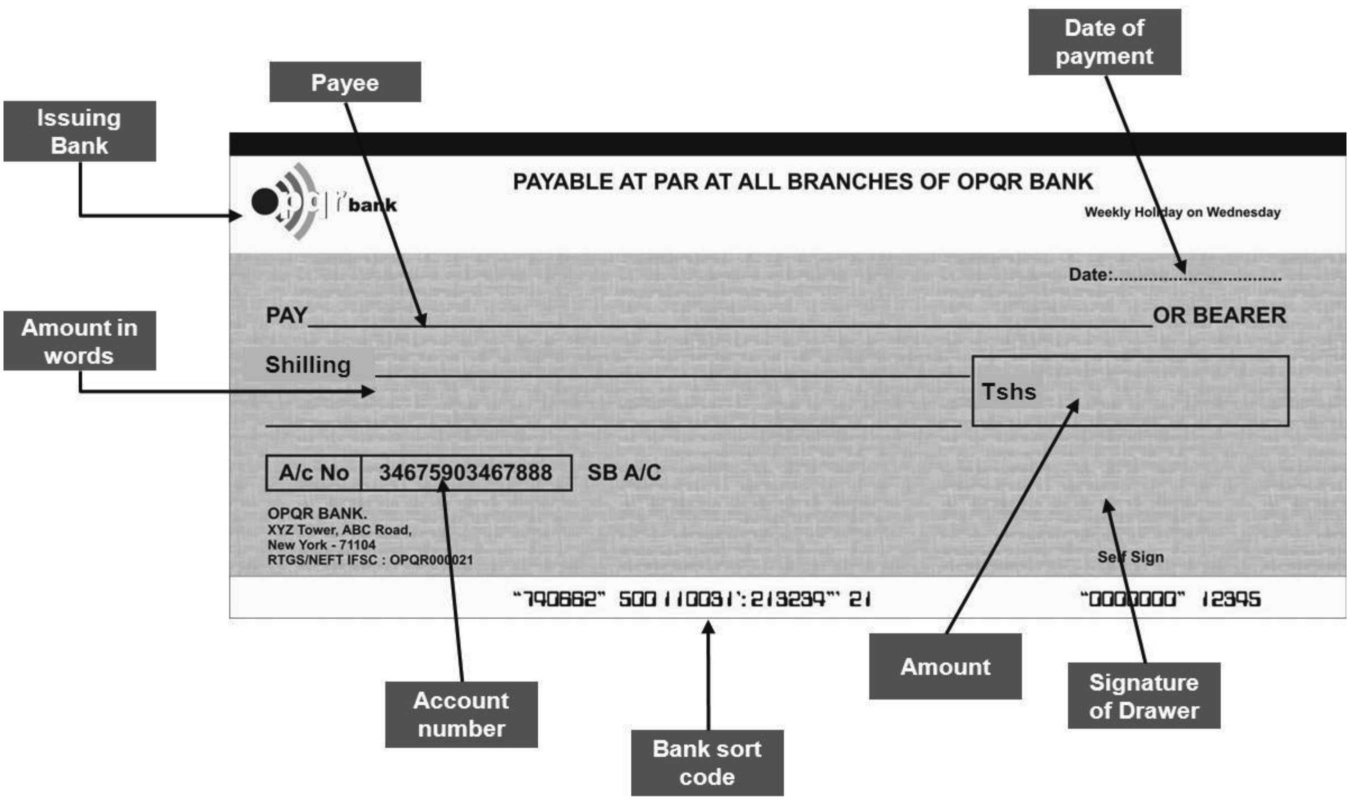
(i) it is always drawn on a specified banker, and
(ii) it is always payable on demand

As a consequence, all cheques are bill of exchange, but all bills are not cheque. Therefore, a cheque must satisfy all the requirements of a bill of exchange; that is, it must be signed by the drawer, and must contain an unconditional order on a specified banker to pay a certain sum of money to or to the order of a certain person or to the bearer of the cheque. However, it does not require acceptance.

Essential characteristics of a cheque

- It must be in writing.
- There must be an express order to pay.
- The order must be to pay a certain sum.
- The order must be to pay money only.
- The order to pay must be unconditional.
- It must be signed by the drawer.
- The three parties i.e. drawer, drawee and payee must be certain.
- The cheque must be drawn on a specified bank.
- It must always be payable on demand.

Diagram 1: Specimen of a cheque



Test Yourself 3

Which of the following statements is correct?

1. All cheques are bills of exchange but all bills are not cheque.
2. All bills of exchange are cheques but all cheques are not bills of exchange.

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2. Identify and explain parties to a bill of exchange, promissory note and a cheque.
[Learning Outcome b]

2.1 Parties to bill of exchange

1. **Drawer:** The maker of a bill of exchange is called the 'drawer'.

2. **Drawee**: The person who is directed to pay the money by the drawer is called the 'drawee'

3. **Payee:** The person named in the instrument, to whom or to whose order the money is directed to be paid by the instrument is called the 'payee'.

In addition to the above three main parties, there can be some other parties involved in a bill of exchange as follows:

1. **Indorser:** When the holder transfers the instrument to anyone else, the holder becomes the 'indorser'.

2. **Indorsee**: The person to whom the bill is indorsed is called an 'indorsee'.

3. **Holder:** A person who is legally entitled to the possession of the negotiable instrument in his own name and to receive the amount thereof, is called a 'holder'. He is either the original payee, or the indorsee. In case the bill is payable to the bearer, the person in possession of the negotiable instrument is called the 'holder'.

4. **Drawee in case of need:** When in the bill or in any endorsement, the name of any person is given, in addition to the drawee, to be resorted to in case of need, such a person is called 'drawee in case of need'.

2.2 Parties to a Promissory Note

1. **Maker:** the person who promises to pay the amount stated in the note. He is the debtor.

2. **Payee:** the person to whom the amount is payable i.e. the creditor.

3. **Holder:** the payee or the person to whom the note might have been indorsed.

4. **Indorser:** When the holder transfers the instrument to anyone else, the holder becomes the 'indorser'.

5. **Indorsee:** The person to whom the bill is indorsed is called an 'indorsee'.

2.3 Parties to a Cheque

1. **Drawer:** He is the person who draws the cheque, i.e., the depositor of money in the bank.

2. **Drawee:** It is the drawer's banker on whom the cheque has been drawn.

3. **Payee**: He is the person who is entitled to receive the payment of the cheque.

Test Yourself 4

State whether true or false.

There are only three parties to a cheque as drawer, drawee and payee.

---

3. State meaning and importance of crossing on cheques.
[Learning Outcome c]

Cheques can be of two types:

1. Open cheques

An open cheque is payable in cash across the counter of the bank. The person who presents the cheque in the bank is called bearer of the cheque. Any person who holds the cheque lawfully can get the payment from the bank.

However, open cheques are risky. If n open cheque is lost, any person who finds that cheque can collect payment from bank.

2. Crossed cheques

Crossing a cheque means drawing two transverse parallel lines across the face of the cheque, with or without the addition of certain words. Crossing is direction to the drawee bank to pay the money only through a banker. The amounted is credited in the bank account of the payee instead of paying in cash across the counter. Unlike open cheques, crossed cheque is not payable in cash across the counter of the bank i.e. crossing the cheque does not permit the bank not to make payment in cash to the person who is presenting the cheque in the bank.

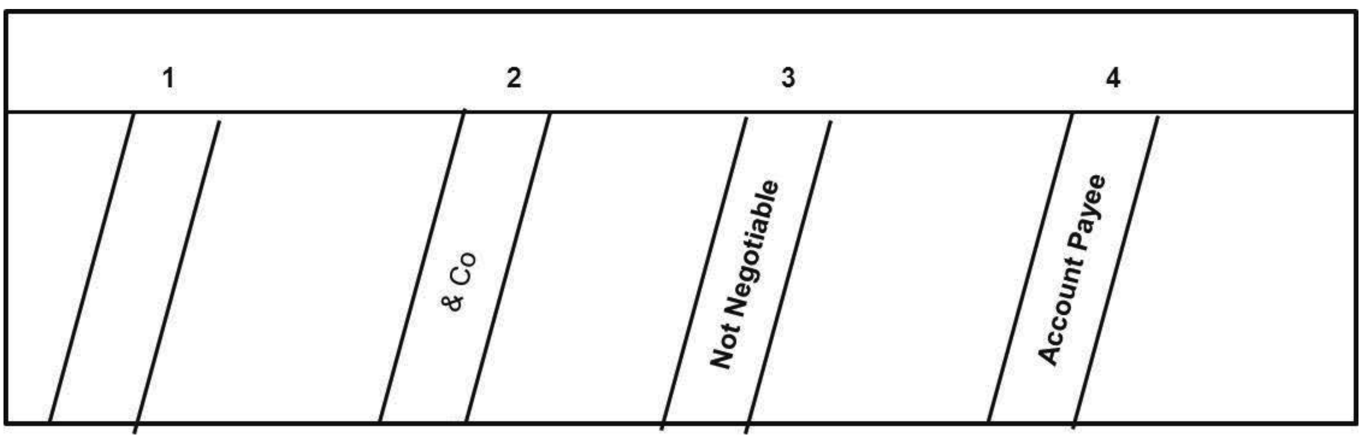
Crossing can be general crossing or special crossing.

(a) General crossing means directing the drawee banker to pay the money only through a banker.

General crossing could be of the following types:

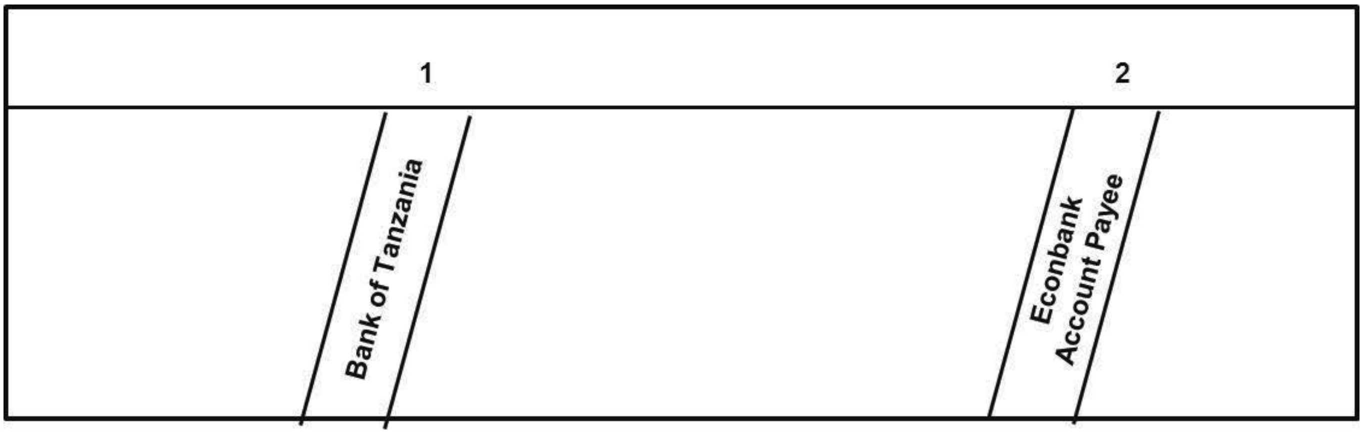
- Drawing two parallel lines on the left hand top corner of the cheque
- Drawing two parallel lines on the left hand top corner of the cheque along with the words '& Co', 'Not negotiable' or 'Account payee'
- By striking out the words 'or bearer' from the cheque and replacing it with 'or order'

Diagram 2: General crossing



(b) Special crossing means name of a specific bank is written between the lines drawn on the cheque. A specially crossed cheque must be presented only through the bank to which it is crossed.

Diagram 3: Special crossing



Importance of crossing the cheque

Crossing on a cheque is a direction to the paying banker that the payment shall not be made across the counter. The payment on a crossed cheque can be collected only through a banker.

The purpose of crossing is to direct the drawee banker to pay the amount of cheque to a banker. Therefore the party who receives the payment can be easily traced. Thus, crossed cheque is the safest way of paying the money. Crossing ensures that the money is paid only to the intended person and not to anybody else.

Test Yourself 5

State whether the following statement is true or false.

A general crossing can be converted into special crossing but a special crossing cannot be converted into general crossing.

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4. Describe and explain endorsement payment and dishonouring of instruments. [Learning Outcome d]

4.1 What is endorsement?

Endorsement means writing of someone’s name on the back of the instrument with the intention of transferring the rights in the instrument. In other words, endorsement is signing a negotiable instrument on the back of it for the purpose of negotiation.

The person who endorses the instrument is called an ‘endorser’, and the person to whom negotiable instrument is transferred by endorsement is called the ‘endorsee’.

Who can endorse?

The payee of an instrument is the rightful person to make the first endorsement. Thereafter the instrument may be endorsed by any person who has become the holder of the instrument.

Essentials of a valid endorsement

The following are the essentials of a valid endorsement:

1. It must be on the instrument, either on the back or face of the instrument.

2. It must be made by the holder of the instrument. A stranger cannot endorse it.

3. It must be signed by the endorser.

4. It must be completed by delivery of the instrument by the endorser himself or by somebody on his behalf with the intention of passing property therein.

5. It must be an endorsement of the entire bill. If the endorsement purports endorse only a part of the amount payable then it does not amount to a valid endorsement.

Types of endorsement

Endorsement can be of two types as:

1. General endorsement

When the endorser merely signs on the instrument without mentioning the name of the person in whose favour the endorsement is made, it is called general endorsement. In general endorsement, the endorsee is not specified by the endorser.

Example

A bill is payable to Mrs. Speranza. Mrs. Speranza endorses the bill by simply signing it. This is general endorsement by Mrs. Speranza. In this case the bill becomes payable to bearer.

2. Special endorsement

When the endorser signs on the instrument and also mentions the name of the person in whose favour the endorsement is made, it is called special endorsement.

4.2 Dishonouring of negotiable instruments

A negotiable instrument can be dishonoured either by non-acceptance or by non-payment.

A cheque and a promissory note can only be dishonoured by non-payment but a bill of exchange can be dishonoured either by non-acceptance or by non-payment.

Dishonour by non-acceptance

A bill of exchange can be dishonoured by non-acceptance in the following ways:

1. If a bill is presented to the drawee for acceptance and he does not accept it within reasonable time from the time it is presented for acceptance.

   When the drawer of a bill of exchange makes a bill, he sends the bill to the drawee for acceptance. The drawee then gives his assent by accepting the bill by signing his name across the face of the bill and delivers the bill back to the drawer. If the drawee does not accept the bill when presented by signing on the face of the bill, the bill is said to be dishonoured by non-acceptance.

2. When the drawee is a fictitious person or if he cannot be traced after reasonable search.

3. When the drawee is incompetent to contract, the bill is treated as dishonoured.

4. When a bill is accepted with a qualified acceptance, the holder may treat the bill of exchange having been dishonoured.

5. When the drawee has either become insolvent or is dead.

Dishonour by non-payment

1. **Bill of exchange:** after being accepted, a bill of exchange is presented for payment on the due date. If the acceptor fails to make payment when it is due, the bill is said to be dishonoured by non-payment.

2. **Promissory note:** if the maker of the promissory note fails to make payment on the due date then the promissory note is said to be dishonoured by non-payment.

3. **Cheque**: a cheque is dishonoured by non-payment when the banker refuses to pay the amount of the cheque.

Test Yourself 6

Identify the negotiable instrument which can be dishonoured through non-acceptance:

A Bearer cheque
B Bill of exchange
C Promissory note
D Crossed cheque

Answers to Test Yourself

Answer to TY 1

The given statement is true.

Unless proven otherwise, holder of negotiable instrument is presumed to be holder in due course.

Answer to TY 2

The first instrument containing a statement ‘Peter, I owe you Tshs100,000’ is not a promissory note as there is no express promise to pay. This is merely acknowledgement of indebtedness.

The second instrument containing a statement ‘I promise to pay Peter a sum of Tshs100,000’ is a promissory note as there is an express promise to pay.

Answer to TY 3

The correct statement is ‘all cheques are bills of exchange but all bills are not cheque’.

This is because a cheque possesses all the characteristics of a bill of exchange but every bill of exchange does not possess the following key characteristics of a cheque:

- A cheque is always drawn on a specified banker, and
- A cheque is always payable on demand

Answer to TY 4

This statement is true.

There are only three parties to a cheque as drawer, drawee and payee.

Answer to TY 5

This statement is false.

A general crossing can be converted in to special crossing by adding bankers name on it. However, if the special crossing is converted into general crossing by striking out the banker’s name, it would amount to material alteration and such cheque will be dishonoured by the drawee bake.

Answer to TY 6

The correct option is **B**.

A cheque (crossed or bearer) and a promissory note can only be dishonoured by non-payment but a bill of exchange can be dishonoured either by non-acceptance or by non-payment.

Self Examination Questions

Question 1

Explain the key presumptions that are presumed to exist with every negotiable instrument.

Question 2

Write key differences between bill of exchange and a cheque

Question 3

State which of the following bills of exchanges accepted by John are valid acceptance?

A John delivers the bill and orally confirms that he has accepted the bill
B John delivers the bill after writing the words ‘accepted’ only.
C John delivers the bill after writing the words ‘accepted’ and signing the bill.

Question 4

State whether the following instruments are promissory notes:

A A promises B over telephone to pay a sum of Tshs500, 000.
B I promise to pay George a sum of Tshs500, 000.
C I promise to pay George a sum of Tshs500, 000 after my marriage with Tin.
D I promise to pay George all sums due to him.

Question 5

State whether the following statement is true or false.

A cheque is always payable on demand.

Answers to Self Examination Questions

Answer to SEQ 1

Until the contrary is proved the following presumptions shall be made in case of all negotiable instruments:

1. **Consideration**: It is presumed that every negotiable instrument was made drawn, accepted or endorsed for consideration.

2. **Date**: Where a negotiable instrument is dated, it is presumed that the instrument has been made or drawn on such date.

3. **Time of acceptance**: Every accepted bill of exchange is presumed to have been accepted within a reasonable time after its issue and before its maturity.

4. **Time of transfer**: It is presumed that every transfer of a negotiable instrument was made before its maturity.

5. **Order of endorsement**: It is presumed that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

6. **Stamp**: It is presumed that a lost promissory note, bill of exchange or cheque was duly stamped.

7. **Holder in due course**: It is presumed that the holder of a negotiable instrument is the holder in due course.

Answer to SEQ 2

The key differences between bills of exchange and cheque are as follows:

1. A bill of exchange is usually drawn on some person or firm, while a cheque is always drawn on a bank.
2. A bill of exchange must be accepted before its payment can be claimed however a cheque does not require acceptance.
3. A bill of exchange may be drawn either payable on demand or on the expiry of a certain period whereas a cheque can only be drawn payable on demand.
4. A cheque may be crossed but a bill of exchange cannot be crossed.

Answer to SEQ 3

The correct option is **C.**

Option A is not a valid acceptance as the acceptance is not in writing.

Option B is not a valid acceptance as the acceptance has not been signed by the drawee.

Answer to SEQ 4

The correct option is **B.**

This is a promissory note as there is an express promise to pay a specific sum of money and is in

writing. Option A is not a promissory note as it is not in writing.
Option C is not a promissory note as the promise to pay is not
unconditional. Option D is not a promissory note as the sum payable is
not certain.

Answer to SEQ 5

The given statement is true.

A cheque is always payable on demand.

STUDY GUIDE C6: LAW OF PUBLIC PROCUREMENT

Get Through Intro

Procurement means to acquire or buy goods, services or works from an external source often through tendering or competitive bidding process. In the context of this Study Guide, it means procuring of goods and services by government.

We all need goods and services and we buy them from shops and service providers. The businesses need goods and services which they buy from other businesses.

In the similar way, government also needs various goods and services.

Let us consider an example. If government decides to construct a government hospital, it will have to hire services of a construction contractor who will build the hospital building. Then the government will have to buy the surgical equipment for the hospital and inventory of medicines and will need to appoint a canteen operator in the hospital for the patients. It will also have to appoint doctors, nurses and other staff and pay them salary and so on.

Thus, for any development work that the government does, it need to buy various goods and services from the outside suppliers. This is called public procurement.

In this Study Guide, we will understand the various types of procurement, the procurement methods and also the tendering process.

Learning Outcomes

a) Identify and state types of procurement.
b) Identify and describe procurement methods.
c) Describe the tendering process.
d) Identify and describe tender documents.

1. Identify and state types of procurement.
[Learning Outcome a]

Public procurement, in simple words, is a process by which the various government departments and agencies make purchases from the private sector through tendering or competitive bidding process.

Definition

Procurement" means buying, purchasing, renting, leasing or otherwise acquiring any goods, works or services by a procuring entity and includes all functions that pertain to the obtaining of any goods, works or services, including description of requirements, selection and invitation of tenderers, preparation and award of contracts;.

Procurement is an important activity to all – individuals, families, organisations etc., and so it is for the government. However, unlike the procurement in the private sector, government procurement is financed from the money collected from the public in the form of taxes and duties. So, the more the government saves on procurement, the greater the funds that will be available for development activities.

Therefore, the efficiency in process, cost saving and quality assurance is much more significant in public procurement as compared to procurement in the private sector.

The procurement process starts with the identification of a requirement by the users, contract award, and contract implementation through to the closure of the contract. The various activities during this process are: defining the description of the goods or work or services to be procured, selecting the procurement method, selecting the criteria for evaluation of various bidders and awarding the contract.

Thus, identifying the requirement is an important step in the whole procurement process.

Types of procurement

The various types of procurement are:

1. Procurement of work: this includes procurement of the services of a contractor for undertaking construction work e.g. procurement for construction of a highway.

2. Procurement of goods: this includes procurement of various goods such as vehicles for use of government officials, equipment for government hospitals, furniture of government offices etc.

3. Procurement of non-consultant services: this includes procurement of services such as maintenance of computers in government offices, cleaning services, courier services etc.

It is important that a detailed description of the requirement is prepared at the beginning of the procurement process. If there is a clear specification of what is to be procured, the prospective suppliers would understand the exact requirement and would be able to supply the appropriate material. If the description of the requirement is incorrect, it would result in purchasing goods and services that fail to accomplish the purpose and thus would lead to wastage of resources.

Test Yourself 1

Which of the following is not a type of procurement?

A Procurement of work
B Procurement of goods
C Procurement of non-consultant services
D Procurement of people

2. Identify and describe procurement methods.
[Learning Outcome b]

Procurement methods are the procedures which the procuring entity uses to acquire goods, services and works. Usually, the government procurement methods are competitive to ensure transparency, economy and efficiency in the procurement process and also limit preferential treatment to one supplier over other.

Important

The public Procurement Act 2011 specifies that the procuring entity engaging in the procurement of goods, works or non - consultancy services shall apply **competitive tendering** depending on the type and value of the procurement and, in any case, the successful tenderer shall be the tenderer evaluated to have the capacity and capability to supply the goods, to provide the services or to undertake the assignment or the highest evaluated offer in case of services for revenue collection or disposal of public assets.

'**Competitive tendering** or tendering' means the method of procurement or disposal of public assets whereby suppliers, service providers, contractors or asset buyers are invited by a procuring entity to compete with each other in submitting priced tenders for the supply of goods or provision of services.

Procurement methods

1. Open procurement

This is a competitive method of public procurement whereby all the qualified and interested bidders are allowed to bid for supplying the required goods, services and infrastructure works. Thus the suppliers compete with each other by trying to bid at a cost lower than the other suppliers as the contract is awarded to the supplier who quotes the least cost for the specified goods and services.

2. Restricted procurement

In this method of procurement, the tenders are only invited from selected suppliers. Thus, the competition is limited only to the suppliers that are shortlisted or invited by the procuring entity. As only limited suppliers submit the tender, the time and cost involved in the selection process is less.

3. Procurement through quotations

This is a simple method of procurement where the procuring entity invites quotation from a minimum of three suppliers and selects one of those suppliers, usually the one who quotes the least cost, for providing the goods or services. This procurement method is appropriate for procuring readily available off-the-shelf goods or standard specification commodities that are small in value.

4. International tendering

In international competitive tendering, otherwise known as international competitive bidding, a procuring entity shall invite suppliers, contractors, service providers or asset buyers regardless of their nationality, by means of a tender notice that shall be advertised nationally and internationally to submit priced tenders for goods, works or services or purchase of public assets.

Tip

The Procurement Act 2011 has set out the procedures and the qualification criteria that need to be followed when open procurement method is applied.

The key factors that need to be considered while selecting the most appropriate procurement method are:

- The nature of the requirement and extent to which the exact requirements can be clearly described - as some requirements may require the suppliers to actively participate in the process of finalising the clear description
- The value of the procurement
- The quantity of the procurement
- The urgency of need

- The availability of the required goods in the market
- The availability of suppliers of the required goods and services
- The after sale support required for the goods and services to be procured.

It is important that the procedures and guidelines prescribed by the Procurement Act 2011 and The Public Procurement (goods, works, non-consultant services and disposal of public assets by tender) Regulations, 2005 are adhered to while selecting a particular procurement method in Tanzania.

Test Yourself 2

Three air-conditioners are to be purchased for the city post office. Which of the below methods of procurement is the most appropriate?

A Open procurement
B International tendering
C Quotations
D Restricted procurement.

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3. Describe the tendering process.

[Learning Outcome c]

The overall tender process primarily involves the following steps:

1. Identifying the goods to be procured

This is based on the requirement submitted by the various departments, offices, projects etc.

2. Determining the most appropriate tendering process for the concerned goods

As there are various methods of tendering available, such as open tendering, restricted rendering and quotations, the concerned officers need to select the most appropriate method for procuring the goods and services in question.

3. Determining the requirements and the procedure that the bidders need to follow

The quality requirements, the features and the nature of the goods and services to be procured need to be properly assessed and described in order to ensure that the correct goods are supplied. The procedure that the bidders need to follow in applying for the tender, the documents and required security also need to be specified.

4. Inviting the tenders

The tenders are then invited from the suppliers; a reasonable time period is allowed in order to enable the suppliers to assess the potential of supply, cost etc.

5. Receiving response from the suppliers on the tenders

The suppliers then submit tenders. Certain facilities need to be provided to ensure the smooth receipt of the tenders and issue acknowledgements.

6. Evaluating various tenders and selecting the most suitable option

All the criteria need to be properly assessed such as the cost quoted by each supplier, the services agreed, the credentials of the suppliers, their financial position and sustainability. The most appropriate supplier is then selected.

7. Notifying the chosen supplier about his selection

The supplier needs to be notified in appropriate format about his selection. The documentation and process set out in the Act needs to be properly followed.

8. Establishing the contract

A contract document is prepared wherein all the terms and conditions are documented, the timeline of supply is decided, and the payment process is agreed upon.

Case Study

Government of the United Republic of Tanzania Procedures for tendering for public sector contracts is briefly explained below:

1. Each tenderer must submit a statement, as part of the tender documents, with the following text.

   “This company places importance on competitive tendering taking place on a basis that is free fair, competitive and not open to abuse. It is pleased to confirm that it will not offer or facilitate, directly or indirectly, any improper inducement or reward to any public officer their relations or business associates, in connection with its tender, or in the subsequent performance of the contract if it is successful.

   This company has an Anti-Bribery Policy/Code of Conduct and a Compliance Program which includes all reasonable steps necessary to assure that the No-bribery commitment given in this statement will be complied with by its managers and employees as well as by all third parties working with this company on the public sector projects, or contract including agents, consultants, consortium partners, sub-contractors and suppliers. Copies of our Anti-Bribery Policy/Code of Conduct and compliance Program are attached"

2. This statement must be signed personally by the Chief Executive Officer or other appropriate senior corporate officer of the tendering company and, where relevant, of its subsidiary in the United Republic of Tanzania. If a tender is submitted by a subsidiary, a statement to this effect will also be required of the parent company, signed by its Chief Executive Officer or other appropriate senior corporate officer.

   Tenderers will also be required to submit similar No-bribery commitments from their subcontractors and consortium partners, the tenderer may cover the subcontractors and consortium partners in its own statement, provided the tenderer assumes full responsibility.

3. Payment to agents and other third parties shall be limited to appropriate compensation for legitimate services.

   Each tenderer will make full disclosure in the tender documentation of the beneficiaries and amounts of all payments made, or intended to be made, to agents or other third parties (including political parties or electoral candidates) relating to the tender and, if successful, the implementation of the contract.

   The successful tenderer will also make full disclosure [quarterly or semi-annually] of' all payments to agents and other third parties during the execution of the contract.

   Within six months of the completion of the performance of the contract, the successful tenderer will formally certify that no bribes or other illicit com- missions have been paid.

4. Tenders which do not conform to these requirements shall not he considered.

5. If the successful tenderer fails to comply with its No-bribery commitment, there will significant implications which may include all or any of the following:

- Cancellation of the contract
- Liability for damages to the public authority and/or the unsuccessful competitors in the tendering possibly in the form of a lump sum representing a pre-set percentage of the contract value (liquidated damages)
- Forfeiture of the tender security
- Banning by the Government of the United Republic of Tanzania from tendering for further public contracts for a period of ten years and as the Government may deem appropriate.

Continued on the next page

6. Tenderers shall make available, as part of their tender, conies of their anti-Bribery Policy/Code of Conduct, if any, and of their - general or project - specific - Compliance Program.

7. The Government of the United Republic of Tanzania has made special arrangements for adequate oversight of the procurement process and the execution of the contract, and has invited civil society and other competent Government Departments to participate in the oversight. Those charged with the oversight responsibility will have full access to all documentation submitted by tenderers for this contract, and to which in turn all tenderers and other parties involved or affected by the project shall have full access (provided, however. that no proprietary information concerning a tenderer may be disclosed to another tenderer or to the public).

Source: http://www.tanzania.go.tz/egov_uploads/documents/reg_works_goods_nonconsult_2_sw.pdf

Test Yourself 3

State whether the following statement is true or false:

Lowest cost is the only criterion for accepting a particular tender.

4. Identify and describe tender documents.

[Learning Outcome d]

Definition

Tender documents or solicitation documents means the documents prepared by a procuring entity, on the basis of which tenders are solicited from tenderers.

The key contents of a tender document are as follows:

- The name, address, and telephone number of the contracting authority
- The name, characteristics, type, description and quantity of the procurement
- The commencement and completion dates for the subject matter of the procurement
- The place of delivery in procurements of goods and the place where the task is to be performed in procurements of services and works
- The rules of participation in the procurement process and the required documents and certificates
- The address where the tenders are to be submitted until the hour specified for opening the tenders e.g. 15th August 2015 by 5 p.m.
- The criteria and procedures relevant to the evaluation of the qualifications of contractors, suppliers, service providers
- The documentary evidence or other information that must be submitted by suppliers, contractors, service providers
- the nature and required technical and quality characteristics of the goods, works or services to be procured, including, but not limited to, technical specifications, plans, drawings and designs as appropriate; the quantity of the goods; any incidental services to be performed; the location where the construction is to be effected or the services are to be provided; and the desired or required time, if any, when the goods are to be delivered, the construction is to be effected or the services are to be provided; the description of the assets, their locations and conditions for sale, responsibilities for the risk and cost for dismantling and removing and asset

Example

For a period of 24 months (which under this component of the Station Services contract may in terms of the contract be extended or curtailed) the Station Services Contractor will perform the function of monitoring live CCTV camera feeds positioned in and on Stations and between Stations.

The primary functions of the monitoring by CCTV camera will be passenger security and fare evasion. Specific cameras will be positioned at card verification devices and access gates so that live feeds may be used to react to immediate situations and recorded footage may be used for evidence.

Source:
http://www.capetown.gov.za/en/irt/Documents/33Proc/Draft_TENDER_Station_Services_Jun10.pdf

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- The criteria to be used by the procuring entity in determining the successful tender, including any margin of preference and any criteria other than price to be used and the relative weight of such criteria
- The terms and conditions of the procurement or disposal contract, to the extent they are already known to the procuring entity, and the contract form, if any, to be signed by the parties
- Where the contractors, suppliers, service providers, or asset buyers are permitted to submit tenders for only a portion of the goods, works, services to be procured, a description of the portion or portions for which enders may be submitted
- The manner in which the tender price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the goods, works or services themselves, such as any applicable transportation and insurance charges, customs duties and taxes
- The currency or currencies in which the tender price is to be formulated and expressed
- The language or languages in conformity in which tenders are to be prepared

Example

The tender shall be written in English. All correspondence and other documents pertaining to the tender that is exchanged by the parties shall also be written in English.

- any requirements of the procuring entity with respect to the issuer and the nature, form, amount and other principal terms and conditions of any tender security to be provided by contractors,

Test Yourself 4

What is a tender document?

Answer to Test Yourself

Answer to TY 1

The correct option is **D**.

Answer to TY 2

The correct option is **C.**

As the value of the requirement is very small, quotation is a best suited method of procurement in the given case.

Answer to TY 3

This statement is false.

Lowest cost is the most important criteria of accepting a particular tender but that is not the only acceptable criteria.

Answer to TY 4

Tender documents or solicitation documents are documents prepared by a procuring entity, on the basis of which tenders are solicited from tenderers.

Self-Examination Questions

Question 1

What are the various types of procurement?

Question 2

What is open procurement?

Question 3

Which of the following are possible implications if the successful tenderer fails to comply with its No-bribery commitment?

- Cancellation of the contract
- Forfeiture of the tender security
- Banning by the Government from tendering for further public contracts
- All of above.

Question 4

Which of the following is not a method of procurement?

A Open procurement
B Close procurement
C Quotations
D Restricted procurement.

Question 5

What are the various types of procurement?

Answers to Self-Examination Questions

Answer to SEQ 1

The various types of procurement are:

1. Procurement of work: this includes procurement of the services of a contractor for undertaking construction work e.g. procurement for construction of a highway.

2. Procurement of goods: this includes procurement of various goods such as vehicles for use of government officials, equipment for government hospitals, furniture for government offices etc.

3. Procurement of services: this includes procurement of services such as maintenance of computers in government offices, cleaning services, courier services etc.

Answer to SEQ 2

Open procurement is a competitive method of public procurement whereby all the qualified and interested bidders are allowed to bid for supplying the required goods, services and infrastructure works. Thus, the suppliers compete with each other by trying to bid at a cost lower than the other suppliers as the contract is awarded to the supplier who quotes the least cost for the specified goods and services.

Answer to SEQ 3

The correct option is **D**.

Answer to SEQ 4

The correct option is **B.**

Answer to SEQ 5

The various types of procurement are:

- Procurement of work
- Procurement of goods
- Procurement of services

SECTION D

OFFICE MANAGEMENT AND MECHANISATION

D1

STUDY GUIDE D1: OFFICE MANAGEMENT

Get Through Intro

Whenever there is a collection of people working towards a common objective, the need for leadership, management and supervision arises. Leadership ensures that the efforts (tasks and activities) of all individuals are coordinated in such a way that a single set direction is being followed. Management and supervision ensure that these tasks and activities are effectively performed.

Over the course of your career as an accountant, you will find yourself on both sides of the fence. You will have your work managed and supervised, and you will have to follow a direction set by someone else (e.g. the CEO of your organisation). However, at some point you will also find yourself managing and supervising the work of others (e.g. junior accountants). In addition, as a member of management you will also be expected to contribute to the process of deciding which direction your organisation should take.

This Study Guide will provide you with an understanding as to what constitutes good and effective management.

Learning Outcomes

a) Define management and explain the principles of management.
b) Define an office, office management, and state the functions of an office.
c) Explain the management functions: planning, organising, directing, motivating, coordinating and controlling.
d) Identify and state the qualifications of a good office manager.
e) Explain the factors to consider in selecting office location.

1. Define management and explain the principles of management.
[Learning Outcome a]

Management, in simple words, means getting things done through people.

The term "management" is used to refer to the collection of individuals in an organisation responsible for a specific function or department of that organisation.

Example

Isla Corporation has four main departments: Finance, Marketing, Human Resources and Production. An individual manager heads each department. Therefore for Isla, the Finance Manager, Marketing Manager, Human Resources Manager and Production Manager represent its management.

Management is the fundamental part of an organisation which is responsible for achieving maximum results through the most effective use of available resources like men, material, machinery and money.

The word management is defined by various authors in various ways. Some of the definitions of management are as follows

Definition

Management has three different meanings, viz.,

Management as a Noun: refers to a Group of Managers.

Management as a Process: refers to the Functions of Management i.e. Planning, Organising, Directing, Controlling, etc.

Management as a Discipline: refers to the Subject of Management.

Theo Heimann

Management is the process of managing people which involves getting things done through and with others.

Zene K. Quible

To manage is to forecast and to plan, to organise, to command, to co-ordinate and to control.

Henry Fayol

Thus, management is the activities pertaining to laying down the plans and policies undertaken by an individual or a group of individuals to effectively run an organisation.

Management is not only about doing work but is more about getting the work done, motivating others to do the work and co-ordinating the work done by each member to achieve the objective of the organisation. However, management can be considered to be effective only if the activities planned are monitored and implemented.

Principles of management

Henri Fayol is widely accepted as the person who revolutionised management with his principles.

Henri Fayol was a French engineer working with a mining company who improved the condition of the company from virtual bankruptcy to high success.

From his practical experience, he developed some guidelines which he believed, could be used in all management situations irrespective of the nature and type of industry and organisational structure.

These guidelines that are established as 14 basic management principles that help in achieving efficient management are as follows:

1. **Division of work:** work should be divided among individuals and groups to ensure that effort and attention are focused on special portions of the task. Specialisation permits the individual to build up experience, and to continuously improve his skills and thereby be more productive.

2. **Authority:** the concepts of authority and responsibility are closely related. The person who assumes authority also assumes responsibility. The right to issue command must be balanced with the accountability.

3. **Discipline:** a successful organisation requires the common effort of people directed towards achieving obedience and discipline. Employees must obey the instructions of managers to ensure smooth functioning, but employees will only obey orders if management play their part by providing good leadership.

4. **Unity of command:** each employee should have only one boss from whom he receives orders. There should be no conflicting lines of command.

5. **Unity of direction:** the activities undertaken by any group in the entire organisation should be moving towards a common objective in a common direction. People engaged in the same kind of activities must have the same objectives to ensure unity and coordination in the organisation.

6. **Subordination of individual interests to the general interests:** the personal interests of one person should not take priority over the interests of the organisation as a whole. Management must see that the goals of the firms are always at the top.

7. **Remuneration of personnel:** remuneration is the important motivator therefore the remuneration policies should be fair and aim at attaining maximum satisfaction to employees and the organisation.

8. **Centralisation (or decentralisation) of authority:** Fayol defined centralisation as lowering the importance of the subordinate role and decentralisation as increasing the importance of the subordinate role. The degree to which centralisation or decentralisation should be adopted depends on the specific conditions of the business and the quality of its personnel.

Example

A purchase manager who is assigned the responsibility of procuring all materials (i.e. raw materials, consumables and spares) needed by a workshop would have a higher authority as compared to a purchase manager who is assigned the responsibility of procuring only the raw materials of the workshop.

9. **Line of authority (scalar chain):** a hierarchy is necessary for unity of direction. The number of levels in the hierarchy from the ultimate authority to the lowest level in the organisation should not be over-stretched and consist of too-many levels.

10. **Material and social order:** to ensure efficiency and coordination, all materials and people related to a specific kind of work should be treated as equally as possible. The material order minimises lost time and useless handling of materials and the social order is achieved through organisation and selection.

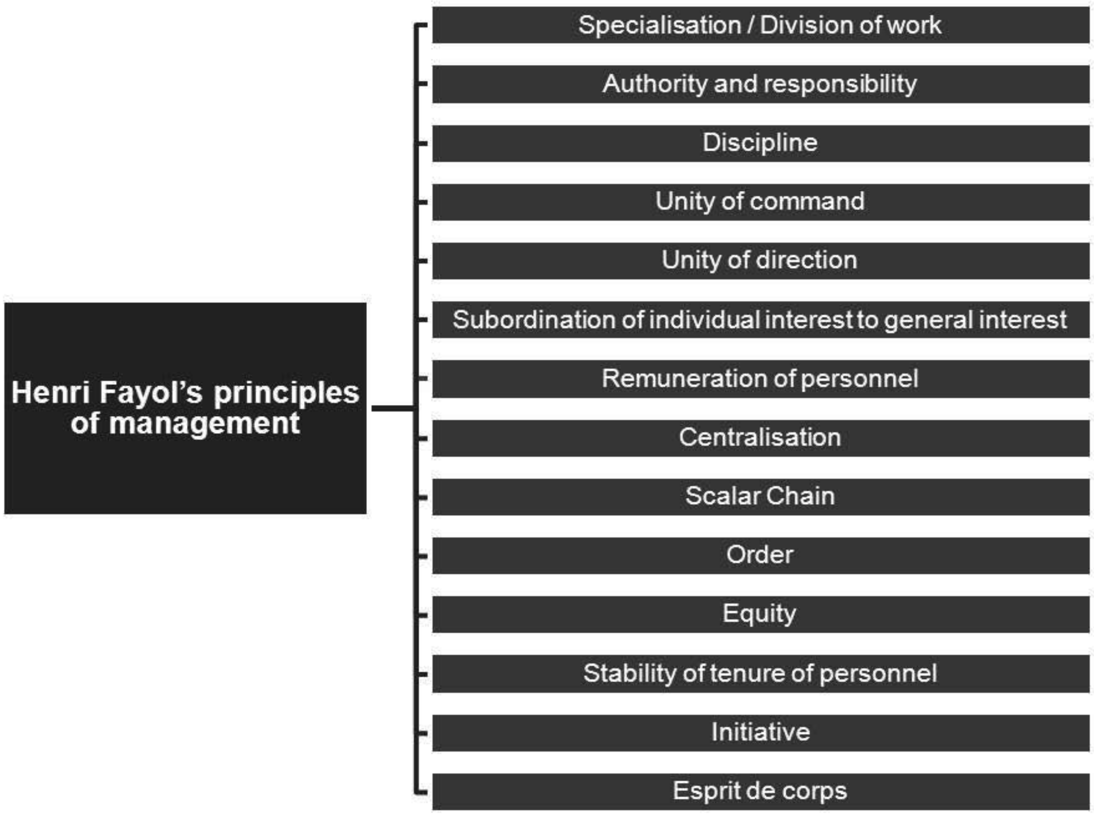
11. **Equity of treatment:** all employees should be treated as equally as possible. In running a business a combination of gentleness and fairness is needed. Treating employees well is important to achieve equity.

12. **Stability of tenure of personnel:** retaining productive employees should always be a high priority of management. Employees work better if job security and career progress are assured to them. An insecure tenure and a high rate of employee turnover will affect the organisation adversely. Recruitment and selection costs, as well as increased product-reject rates are usually associated with hiring new workers.

13. **Initiative:** this includes the thinking out and execution of plans. Management should take steps to encourage workers to show their initiative in some way as this brings the strength for the organisation.

14. **Esprit de Corps:** management should encourage team work, harmony, communication and general good feelings among employees and must maintain the morale of its employees.

Diagram 1: Summary of Henri Fayol's principles of management



Test Yourself 1

Employees should receive orders from one superior only. Which of the following defines this principle?

A Unity of direction
B Equity of treatment
C Unity of command
D Line of authority

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2. Define an office, office management, and state the functions of an office. [Learning Outcome b]

2.1 Office

An office is an effective tool of management that assists in efficient and effective management of the business.

In common parlance, office is a place where clerical and administrative functions are performed to coordinate and control the affairs of the organisation. A usual office performs tasks such as outlining of business policies, processing and communication of information, record keeping, handling mails, execution of orders and managing receipts and payments.

Definition

"An office is the place where the control mechanisms for an enterprise are located, where records are initiated for communication, control and efficient operations of the enterprise."

George R. Terry

"The office is the administrative centre of business. The purpose of an office has been defined as the providing of a service of communication and record"

Mills and Standingford

"Office is a unit where relevant records for the purpose of control, planning and management of the organisation are prepared, handled and preserved. Office provides facilities for internal and external communication and co-ordinates activities of different departments of the organisation."

Littlefield, Rachel and Caruth

2.2 Office management

Office management is a branch of management that is concerned with efficient performance of office work. It includes guiding the personnel of the office to use the appropriate means in order to achieve its specific purpose.

Definition

Office management can be defined as a task of planning, co-coordinating, motivating the efforts of others towards the specific objectives in the office. Office management directs the office personnel and is concerned with the planning, organising, co-ordinating, motivating and controlling of office work.

Terry

Office management may be defined as the art of guiding the personnel of the office in the use of materials, methods, machines and equipments appropriate to their environment in order to achieve its specified purpose.

Mills and Standingoford

The key features of office management are:

- There are certain aims and objectives behind office set up and all the office activities are directed towards the attainment of this objective.

- Various means and tools such as stationeries, supplies, equipment, records, forms etc. are used to perform office activities in the most effective way. Improved means are constantly developed for increasing the efficiency of the organisation.

- The most important constituent of office management are the people who put the means to use. The effectiveness of management largely depends on its people.

2.3 Office Functions

The office functions can be split into two broad categories as:

1. Basic office functions
2. Administrative and management functions

1. Basic Functions

Receiving and processing of information are considered to be the primary functions related to any office. An office is primarily maintained to provide services of receiving, arranging, recording and communicating information. These basic functions of office relating to information are further described as follows:

(a) Receiving the information

There are two sources of receiving information, internal and external. Information received from internal departments, sections, divisions are internal sources of information. Similarly, information received from outside the organisation like the creditors, visitors, customers, competitors and other organisations are external sources of information.

In both cases, information is received in the form of letters, orders, invoices, reports, circulars and telephone calls. This information has to be collected and maintained for records and processes, which is the primary task of an office.

(b) Recording the information

It is important that all information is duly recorded and preserved as it could be required any time in the future for reference and evidence. Normally, every business has to keep financial accounting records, cost accounting records, orders, information on work in progress, rate cards, attendance records, payrolls etc. This is a regulatory requirement, which if not adhered to, is an offence and can result in penalty and imprisonment depending on the significance of the information and evidence. The information which is maintained and kept for future reference is called record.

(c) Analysing, interpreting and arranging information

To make the information readily accessible for reference when needed, it is collected from different sources and arranged in proper sequence or order; for example, preparing invoices, payrolls, reports and statistical statements.

This function hugely increases the value of the information.

(d) Presenting and communicating information

As information is received from internal and external sources, the office also has to give out information to internal and external sources in reply to their communication. The information which has to be given to other departments, divisions, sections, or to the management of the same organisation is called internal source.

This can be routine information (for example, attendance record, holidays, timesheets, daily reports etc.) or it can be of a special nature (for example, a project report). The communication of information can be both in written or verbal form. The management would usually require information like orders for materials, invoices, estimates, statements of account and progress reports.

2. Administrative and management functions

The office performs administrative and management functions in addition to the basic functions. Administrative and management functions are the functions that are performed to achieve operational efficiency or to facilitate the primary functions. Some administrative and management functions are discussed below in detail.

(a) Facilitating the management process

An important aspect of office management is to facilitate the efficient and smooth running of the office through various management functions such as:

- planning
- organising
- staffing
- directing
- controlling
- motivating

Tip

These functions are explained in more detail in the next learning outcome.

(b) Formulating office structure and procedures

To manage the smooth organisation of office, an office system is designed for routine matters which are done in a systematic and planned approach. It is done with a view to achieve a desired objective. Routine tasks include the tasks which are done in an office, regularly, according to the system set up by the office; as a result of which, the organisation's objective is achieved.

Example

Signing the attendance register every day, depositing the cheques every day, weekly staff meetings, recording the minutes of meetings are examples of office routine.

(c) Maintaining good relations

It is important to maintain good professional relations in the office within the various departments and segments of the office as well as with the external parties such as suppliers, creditors, customers, investors, etc. Thus, an office has to ensure that the business maintains and develops public relations and functions which include reception services, liaison services and other similar services.

(d) Safeguarding assets

An organisation usually owns a lot of assets, which need to be kept under safe custody. Therefore, the office has to ensure safeguarding of the assets and maintain them in proper working condition. All the records of the assets need to be kept and relevant reports are to be sent to management regarding any discrepancy and deficiency.

Example

Records of deficiency in stock and account of doubtful debt are reported to management for necessary action.

(e) Other assorted office functions

To have effective control; purchases, sales, issue of stationary and other materials issued to different departments need to be monitored through office records in the form of letters, invoices, reports and other statistical records, which are also used for future reference. Office records help to select and purchase the required office items. Office records of the human resource department assist in processes like recruitment, selection, training, job evaluation and merit rating.

Test Yourself 2

Identify which of the following office functions are basic office functions and which are administrative and management functions.

A Safeguarding assets
B Recording information
C Formulating office structures and procedures
D Receiving information

3. Explain the management functions: planning, organising, directing, motivating, coordinating and controlling.

[Learning Outcome c]

Fayol emphasised five functions, or elements of management: planning, organising, commanding, coordinating, and controlling. He believed these functions to be universal in nature.

3.1 Planning

Fayol defined planning in terms of examining the future and drawing up plans of action. Plans must be flexible and take into consideration unexpected future contingencies. Organisational planning must be coordinated at all levels of the organisation.

Planning, in simple words, means deciding in advance what to do, when to do it and who should do it.

Planning is considered to be the primary, and therefore, the most important function of management. Planning starts with setting of goals and objectives and then involves deciding strategies, policies and procedures to achieve those goals and objectives.

Planning contributes positively in attaining the objectives of the business. Since plans are made from the initial stage of operations, the management is able to handle every problem successfully. A purposeful, sound and effective planning process leads to success.

Thus the planning function basically deals with future course of action. It involves the selection of the best course of action from many alternatives to achieve the desired objective.

Planning is an essential function for the following reasons:

- Planning helps in foreseeing future problems and deciding the appropriate course of action to tackle those problems. Thus planning helps in reducing uncertainties.

- Planning involves costs as it requires time, money and energy for its formulation. However, once formulated and implemented in the right way, it saves a lot of time and cost that would occur without planning.

- Planning guides the business according to predetermined channels. Well guided and directed activities help in achieving the targets well in time without any difficulty.

3.2 Organising

Fayol referred to organising as provision of capital, personnel and raw materials for operation of business and creating an organisational structure to achieve the tasks.

To organise means to arrange in an orderly manner. Organising aims at creating a rational division of work into groups and subgroups of activities and binding them together so as to achieve a well-co-ordinated structure for the attainment of organisational objectives.

Organising is an on-going process of structuring or arranging the parts of an organisation. It is the function of organising work, people and the system.

Thus, in the organising function of management, work is divided between various department and individuals, duties are assigned, authority is delegated and responsibility is fixed.

The organising function of management helps achieve the following benefits:

- It facilitates precise delegation of work
- It helps equitable distribution of work among all departments and all staff
- It ensures closer co-operation and higher employee morale
- It enables smooth management and operation of the enterprise thereby enhancing managerial efficiency
- It ensures steady growth and diversification
- It ensures optimum utilisation of human capital
- It offers ample scope for training and development of staff through job rotation, job enlargement and delegation.

3.3 Directing

Directing involves giving instructions to and leading the subordinates. Managers should properly understand their subordinates and inspire them to put forth unified effort to achieve organisational objectives.

Direction is an important element of management without which managerial processes cannot achieve the desired objective. Directing provides impetus to the whole managerial function. Direction, as a management function, converts the managerial decisions plans and objectives into effective and meaningful actions.

The objectives of the directing function are to ensure that the subordinates do their work and that they do it according to the expectations of management.

Direction is a continuous process. It provides links between different managerial functions like planning, organising, co-ordinating and controlling. Directing involves creating co-operation, harmony and establishing relationships between people in the organisation.

Directing is an important management function for the following reasons:

- Directions put life into the organisation as they give the means to the subordinates to contribute in achieving the organisational objectives.
- Organisation is a group of people having common objectives and goals. To achieve these common objectives, there must be co-ordination and integration, which is provided through the direction function.
- Effective direction through leadership and communication provides stability to the organisation and maintains balance in the different levels of the organisation.

3.4 Motivating

The term motivation is derived from the word 'motive' which means 'purpose'. Motivation means to provide someone with a 'motive'. Motivation is a process of stimulating people to accomplish the desired goals.
Man has the capability to work but no willingness to work and hence motivation is needed. Motivation is an effective instrument for a manager in inspiring and creating confidence in staff.

Motivation includes different aspects of behaviour such as desire, needs, and aspiration. Different techniques may be adapted to motivate the employees at different levels.
Motivation is a continuous process. Human beings have innumerable wants and they work to satisfy these wants. As soon as one want is satisfied, man is not interested in work unless there is another want. It is therefore important for the manager to understand the needs or wants of the individual so that they can be pushed to work by directing them towards achievements of their needs.

Motivating is an important function of management for following reasons

- It makes people willing to do their work and improves their performance. Thus it results into increased productivity of employees.
- Motivation improves efficiency and ensures optimum utilisation of factors of production.
- It helps controlling employee turnover and controls attrition rate. This saves a lot of time and money in recruiting and training new staff.
- Motivation creates good relations between the staff and management and between the staff members. This reduces complaints and grievances and facilitates smooth functioning of the organisation.

3.5 Coordinating

Coordination refers to the harmonisation of the activities of different groups in order to ensure that individuals work towards the achievement of common objectives.

Co-ordination is the orderly arrangement of group efforts to provide unity of action towards a common purpose.
It is a result of conscious action of management on a continuous basis. It requires proper balance in the organisation. Over-emphasis on any one task or department at the cost of others is a constraint to co-ordination. Similarly, excess of one type of resource and shortage of another will hinder co-ordination.

The various departments of the organisation are interdependent and therefore it is important that they support each other. For example, sales department cannot make sales without production department ensuring that goods are produced and available for sale.

Co-ordination is important for the following reasons:

- Effective co-ordination increases efficiency and brings economy in operations.
- Effective co-ordination helps improve profitability and brings prosperity and growth to the enterprise and boosts morale of employees.
- Co-ordination helps in evaluation of work which ultimately results in rewarding the suitable employees.
- Co-ordination facilitates effective implication of other managerial functions such as planning, organising, directing and controlling.

3.6 Controlling

Fayol saw the function of controlling as identifying weaknesses and errors in activities by measuring them against set parameters and correcting deviations.

Controlling means ensuring that everything occurs in conformity with the plan adopted, the instructions issued and the principles established.

Control is a follow up action. It is a continuous process of analysing the validity of established standards, policies and procedures and taking corrective action when needed. Thus it is a preventive and corrective measure that leads to minimum wastage, losses and deviation from standards.

Controlling is an important management function for the following reasons:

- Control facilitates measuring the progress of the planning process.
- A continuous flow of information provides the basis for future action and helps take corrective action.
- Control facilitates decision making regarding what type of follow up action is needed for successful accomplishment of organisational objectives.
- Control facilitates co-ordination by keeping the routine activities and efforts within their fixed boundaries established by predetermined goals, and provide guidance to each member of the organisation to move towards the common goal.
- Control helps to detect managerial weaknesses and important deviations.

So as you can see, all these management functions are very much inter-related and inter-dependent, and support each other.

Example

Sprinkled Co is an IT company that produces specialised business application software. Its strategy and long term objective is to be the market leader in each one of its product market segments. Sprinkled has been particularly successful in the past because the R&D manager and the marketing manager have worked closely together when producing a new software program (the marketing manager has made sure that the R&D manager was aware of what features the customers wanted).

They are currently working together on a specialised web browser product for the manufacturing industry. The marketing manager has informed the R&D manager that several other organisations are also working on a similar product. In addition, given the urgent demand for the software, the first organisation to bring its product to market will gain the majority share.

The R&D manager knows that he and his department must make every effort to ensure that Sprinkled's product is the first to reach the market.

The marketing manager of Sprinkled performs the following four functions so that the organisation can meet its objective of being the first to market its product.

Planning	To ensure that the program is the first to reach the market, the marketing manager creates two teams or shifts of programmers to work on the software twenty four hours a day, seven days a week.
Organising	The marketing manager assigns the best programmers of the department to each of these two teams.
Leading	The marketing manager becomes directly involved with the project, personally monitoring and motivating the two teams.
Controlling	Strict time deadlines are given to each programmer on a daily basis for the amount of work to be completed. If a programmer has not met his target, he is required to stay behind until the work is finished.

Test Yourself 3

The four main functions or responsibilities of a manager are:

A Planning, organising, directing and controlling
B Directing, managing, monitoring and performing
C Planning, performing, controlling and managing
D None of the above

4. Identify and state the qualifications of a good office manager.

[Learning Outcome d]

An office manager is an executive who is responsible for the smooth operation of the office. He undertakes the functions of organising and controlling office activities to ensure smooth running of the business and timely and proper completion of all tasks. He needs to make it possible for other people to function efficiently. He is responsible, and ensures that office work is done and management policies are implemented.

He is responsible for advising and training his subordinates. Depending upon the nature of the business, the office manager is called the controller, the manager of office services, or the system and procedure manager.

The qualifications that a successful manager needs to posses can be categorised in the following broad categories:

1. Personal qualities
2. Formal education and training
3. Experience

1. Personal Qualities

The personal qualities and skills such as leadership, communication, sincerity, initiative, dedication, loyalty, quick thinking, confidence, punctuality, honesty, sound judgement, adaptability are very important for an office manager as these qualities help him in his prime task of getting work done from the employees economically and efficiently.

An office manager has to cater to the needs of each staff member and therefore he must be able to communicate well with everyone in the office. He needs to be able to motivate the staff to perform with utmost efficiency and inspire and guide them throughout their career. He needs to be fair and must maintain harmony and discipline in the office. He should also possess the ability to properly delegate work and responsibilities among the staff. He should have the ability to get the things done tactfully.

2. Educational Qualification

The ideal education requirements that an office manager should have depends to a great extent, on the size of the office or organisation, the level of the management positions, and the assigned responsibilities. An appropriate educational background helps an office manager to perform his duties more efficiently and effectively. There are many courses available which are primarily focused on management. This formal training helps developing the required skills which can be used at the workplace. He should also be well-trained in management policies and decisions.

It is also important for a manager to continually improve his skills through attending trainings, seminars and workshops to keep him updated with the latest happenings in the field. Keeping in constant touch through newspapers, current publications and journals also helps him learn new things to improve his efficiency.

3. Experience

A person who has good experience in a similar organisation can deliver more effectively than an inexperienced person. The office manager should have practical experience of working in a similar organisation as this helps him in understanding and tackling the problems faced in execution of his duties as office manager. To become a successful manager, a person should have wide business experience.

Test Yourself 4

A good office manager should posses which of the following qualities?

A Honesty
B Leadership
C Good communication
D All of above

5. Explain the factors to consider in selecting office location.

[Learning Outcome e]

Selection of appropriate office location is very important for any business as an unsuitable location may result in waste of time, money and efforts and also affects the future growth and success of the business.

What type of location is suitable for a particular business depends upon the nature of the business. Different types of businesses require different types of locations, and therefore there is no rule which can be universally followed regarding the location of an office.

Example

A travel agency office should be situated in close proximity to trade and businesses to make it convenient for the prospective customers. If such office is situated in a residential area, it may not be able to serve as effectively.

However, the common factors that need to be considered before selecting the location for the office are as follows:

- The office should be situated in a place which is convenient to the employees, customers and suppliers.
- The office should be situated in a place which is well connected by convenient modes of transport such as roads and railways as this makes the transportation of goods and people easy, and saves time.
- For certain businesses, it is advisable to have an office near other offices which are engaged in the same line of trade or near the centre of the general business district.

Example

Shares and stock brokers' offices are often situated near the stock exchange.

- The office should be situated at close proximity to service facilities like banks, insurance and post offices.
- The office should be situated near the factory to ensure better control over production and stores.
- The office space should be sufficient considering the number of employees working in the office, the visitors expected etc. and should also be able to meet the future growing needs of the organisation.
- However, sometimes in the initial phase of the business, it may not be possible to invest in a spacious office due to limited funds available and thus the organisation would need to change the office location when the business grows.
- There should be convenient amenities such as washrooms, restrooms, canteen etc. to ensure the comfort of the staff.

Test Yourself 5

Which of the following factors are considered while selecting an office location?

A Availability of convenient modes of transport such as roads and railways.
B Proximity to service facilities like banks, insurance and post offices.
C Sufficient space to accommodate all employees and visitors.
D All of above

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

Answer to TY 2

The basic office functions are recording information and receiving information.

The administrative and management functions are safeguarding assets and formulating office procedures.

Answer to TY 3

The correct option is **A.**

Answer to TY 4

The correct option is **D**.

Answer to TY 5

The correct option is **D**.

All the options are factors that are considered while selecting an appropriate office location.

Self Examination Questions

Question 1

Henry Fayol laid down______________.

A 12 principles
B 13 principles
C 14 principles
D 15 principles

Question 2

The principle that seeks to ensure unity of action is ______________.

A Unity of direction
B Unity of command
C Centralisation
D Scalar chain

Question 3

Explain why planning is considered to be an essential function of management.

Question 4

Summarise Henry Fayol's fourteen principles of management along with his observations for each of the principles.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **C.**

Answer to SEQ 2

The correct option is **A.**

Answer to SEQ 3

Planning is an essential function of management for following reasons:

- Planning helps in foreseeing future problems and deciding the appropriate course of action to tackle those problems. Thus, planning helps in reducing uncertainties.
- Planning involves costs as it requires time, money and energy for its formulation. However, once formulated and implemented in the right way, it saves a lot of time and cost that would occur without planning.
- Planning guides the business according to a predetermined channel. Well guided and directed activities help in achieving the targets well in time without any difficulty.

Answer to SEQ 4

	Principle	Henri Fayol's observation
i.	**Specialisation / Division of work**	Individuals and mangers work on the same part or task, thus leading to improvement in skills and specialisation
ii.	**Authority and responsibility**	Authority: right to give orders, power to exact obedience; goes with responsibility for reward and punishment
iii.	**Discipline**	Employees should obey the instructions given by the management and there should be agreement between the firm and individual.
iv.	**Unity of command**	Employee receives orders from one superior
v.	**Unity of direction**	One head and one plan for activities with the same objective
vi.	**Subordination of individual interest to general interest**	Objectives of the organisation come before objectives of the individual
vii.	**Remuneration of personnel**	Pay should be fair to the organisation and the individual
viii.	**Centralisation**	Optimum degree of centralisation to be decided in each situation: involves proper proportion of discretion held by the manager compared to that allowed to subordinates
ix.	**Scalar Chain**	Line of authority from the top to the bottom
x.	**Order**	A place for everyone and everyone in his or her place
xi.	**Equity**	Combination of kindness and justice, equality of treatment
xii.	**Stability of tenure of personnel**	Work quality increases if job security exists (stability of managerial personnel, time to get used to the work)
xiii.	**Initiative**	Power of thinking out and executing a plan
xiv.	**Esprit de corps**	Harmony and union among personnel is strength

SECTION D

OFFICE MANAGEMENT AND MECHANISATION

D2

STUDY GUIDE D2: OFFICE MECHANISATION

Get Through Intro

Equipment and machines have now become an important part of our life. Right from gym equipment to hair dryers to mixers to refrigerators and vehicles, we use various equipment and machines to make our activities easy and convenient.

In the office also, the various equipment and machines play a key role in the efficient performance of office work. It is very difficult to achieve the required efficiency and productivity in performing office duties without equipment and machines.

Most of the office activities and operations are repetitive and monotonous in nature. The use of various machines and equipment helps to achieve speed, accuracy and quality of these activities every time.

Various equipment and machines such as calculators, computers, phones, fax machines, printers, photocopying machines, scanners, and punch card machines are used in the office for ease in operations. The use of these machines and equipment improves the efficiency of the office employees and also enhances the reputation of the organisation among its visitors.

In this Study Guide, we will study the meaning and various types of machines used in the office and their advantages and disadvantages.

Learning Outcomes

a) State and explain the meaning of office mechanisation.
b) Identify various types of office machines.
c) Outline advantages and disadvantages of office mechanisation.
d) State the factors to consider when selecting office machines.

1. State and explain the meaning of office mechanization.

[Learning Outcome a]

Meaning of mechanisation

Definition

Office mechanisation is a process of introducing various machines and equipment in the office in order to speed up the administrative process.

Although most of the office functions can be performed without using the machines, the speed and accuracy of operations increased manifold with use of machines and equipment.

Example

It is possible to do a total of a debtor book containing fifty pages manually but it will take a very long time. Also, there may be errors in calculations. The use of calculators speeds up the process and eliminates the errors. The use of computers further speed up the process and produces the most accurate results.

It is possible to perform the operations manually when the size and scale of operations to be performed is small. However, as the business grows, the size and scale of operations becomes very large and thus moving form manual operations to using machines becomes very important. It reduces the cost and improves the efficiency.

A systematic and planned effort to introduce suitable machines for doing office work instead of doing manually is mechanisation. In modern offices, machines have become indispensable for performing office work efficiently.

The **primary reasons of mechanisation are savings in labour, time and clerical cost, improved accuracy and a protection against fraud.**

The decision to mechanise the office is based on the cost benefit analysis i.e. a comparison of cost incurred in buying and maintain new machines as against the cost saved on account of staff payment. Certain equipment like computers is costly and also requires regular maintenance after installation. Moreover, skilled people are needed to operate the computers. Hence, the overall cost involved is very high. Therefore, the decision needs to be based on proper analysis of savings in cost through mechanisation.

Test Yourself 1

Which of the following is not the benefit of mechanisation?

A Saving in labour cost
B Saving in time taken to complete a job
C Improved accuracy of job
D All of above

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2. Identify various types of office machines.

[Learning Outcome b]

A wide variety of machines are in use in the modern offices. Some of the common types of office machines which are universally used are as follows:

1. Telephone

Telephone is probably the most commonly used equipment in every office for internal as well as external communication. Now-a-days, mobile phones are also widely used as these are very convenient to use from anywhere.

2. Intercom

Intercom is a system of communications for use within the building or vicinity. It is similar to telephones but does not require a telephone exchange to manage the communication.

3. Typewriter

A typewriter is one of the most commonly used machines in the offices for typing official letters and documents. However, the increased use of computers has reduced the use of typewriters, although some offices still use this machine.

4. Photocopier

A photocopier is a machine that makes copies of documents. Making copies using the photocopier is quick and also cheap. The machine is easy to operate. The copies made can be black-and-white as well as in colour. It can print on both the side of a page.

5. Scanners

A scanner is a machine that captures images from photographic prints, pages, magazines etc. These images can be stored on the computer and used anytime. Thus it is an excellent way of storing the data which is not already in digital form. The machine is very handy and the copies made can be black-and-white as well as in colour.

6. Computer

The computer is the most commonly used machine in offices now-a-days. A computer is an electronic data processing machine that processes raw data into meaningful information. A computer performs various operations such as arithmetical calculations, comparison of data, storage of information, analysis of data and preparation of diagrams and charts etc. It is also very useful in preparing budgets, forecasts and marketing material, sending emails, sharing information with employees, customers and suppliers. The main features of a computer are high speed and accuracy.

7. Printers

A printer is a device which is used with computers. The data stored in the computer can be printed on paper with the use of the printer. The printers are available in various sizes and capacity. The print-outs can be black-and-white as well as in colour.

8. Electronic time keeping machine

The electronic time keeping machines are used in offices to electronically record the arrival and departure time of staff. A card with a magnetic strip is provided to all employees that they need to swipe on arrival and departure. It is highly useful in keeping the record of attendance and number of hours of work.

9. Calculating machines

Various types of calculating machines are available to make the large amount of calculations needed in offices. The most commonly used calculating machine is a calculator. Calculators perform various functions such as addition, subtraction, multiplication, division, percentages, square and cube roots etc. The use of calculating machines increases office efficiency by facilitating speed and accuracy in operations.

10. Cash counting machines

Machines are also available for calculating the currency notes and coins. The use of these machines ensures correct and fast counting of the cash. Big organisations and offices where large amount of cash needs to be handled use these machines to speed up the process.

11. **Close Circuit Television (CCTV): o**rganisations install closed circuit televisions to monitor the movement of employees, outsiders, etc. within the office premises.

12. **Biometric devices:** organisations install eye or finger scanners to detect authorised personnel and grant access to a room or a computer.

13. **Burglar alarms or motion detectors:** burglar alarms or motion detectors are installed to detect any suspicious movement in office premises.

Test Yourself 2

Which of the following devices is used with a computer?

A Typewriter
B Telephone
C Intercom
D Printer

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3. Outline advantages and disadvantages of office mechanisation.
[Learning Outcome c]

Advantages of mechanisation

- Use of machines saves time required for performing the operations as they perform many automatic operations and thus work very fast.
- Use of machines saves labour cost as large volume of work can be handled by less number of employees.
- Use of machines increases the accuracy in operations like calculations, computations and accounting by reducing the chances of human errors and mistakes.
- Use of machines facilitates reduction of monotonous, tiring work.
- Use of machines ensures improved quality of work as work produced with the help of machines is usually neat, clean and uniform in appearance.
- Use of machines facilitates storage of data to be used for future reference.
- Use of machines like computers facilitates interpretation and analysis of data which help in decision making and control.
- Use of machines enables the management to exercise more effective control over activities.

Example

Using a time recorder at the factory gate ensures control over entry and exit time and attendance.

Disadvantages of mechanisation

- Mechanisation involves high cost in purchasing and maintaining the machines and equipment.
- The cost of operating certain types of machines is also high as it requires specialised and skilled labour.
- The continuous training cost is an additional burden, especially for small offices.
- Repairing the machines in the event of breakdown is also expensive and also leads to stopping the work.
- The use of machines creates monotony and restricts initiative and creativeness in processes.
- Sometimes all the machines are not used effectively and lead to losses due to underutilisation.
- Mechanisation of office often leads to less flexibility as it is difficult to change the structure or process to suit the changing circumstances.
- Machines have a high degree of obsolescence risk attached to them. With new technological inventions, the machines become outdated before recovering the full investment in them.
- There are other problems also associated with machines such as noise pollution.

Test Yourself 3

State whether the following statement is true or false:

'Mechanisation is always cost effective.'

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4. State the factors to consider when selecting office machines.

[Learning Outcome d]

After doing the cost benefit analysis, when the decision for mechanisation is finalised, the next important step is to select the right type of machine for the purpose.

Various options are available in each type of machine and equipment. Therefore, it is important to apply care and caution in selecting the best suitable type of machine. Improper selection of machines may result in wastage of money invested in buying the machine.

Therefore, it is advisable to consider the following factors while selecting office machines and equipment:

1. Cost

Both the initial investment as well as the operating cost must be taken into account while selecting a particular machine or equipment. While it is important to not compromise on quality, it is equally important to select a machine which is available at the least cost for the appropriate quality.

2. Quality

It is important to ensure that only good quality machines and equipment are purchased. Only good quality machines and equipment can ensure that the quality of work performed is of the desired standard.

3. Ease of operation

It is important that the machine and equipment which posses the qualities of faster operations, less exhaustion and less errors should only be purchased.

4. Suitability

It is important that the office machines are suitable for the process for which they are bought. Unsuitable machines and equipment would only lead to wastage of money.

5. Durability

Durability is yet another important factor to consider while selecting the appropriate machine or equipment. In the office, the machines and equipment are handled by many people in various ways. Hence, the machine must be sturdy and durable and have a long life.

6. Adaptability and multiple use

It is always beneficial to select the machine that has multiple uses. This ensures the increased efficiency and reduced idle time. It is also important that each machine can be used without disturbing the set up of other machines.

Example

A printer which can perform functions like photocopying and scanning is more suitable over just a printer.

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7. Adequacy

It is important that adequate numbers of machines are purchased to ensure each department in the organisation has the sufficient number of machines. Constant shifting of machines from one department to another would lead to many problems such as wastage of time, clash among employees over use, lack of ownership for wrong use and breakdown.

8. Space

The floor space that the machine would occupy is also an important consideration. Large and heavy machines often occupy more space and thus add to the indirect cost to the organisation.

9. Service and maintenance

It is advisable to purchase machine and equipment for which the maintenance and after sales services are easily available.

10. Reputation of supplier

It is advisable to purchase the machine and equipment from reputed suppliers as that ensures best price, quality and good after-sale service.

Test Yourself 4

Which of the following factors should be considered while selecting a machine to be purchased?

A Cost
B Durability
C Suitability
D All of the above

Answers to Test Yourself

Answer to TY 1

The correct option is **D**.

Answer to TY 2

The correct option is **D**.

Answer to TY 3

The given statement is false. Although mechanisation usually results in cost saving, sometimes it may result in higher costs due to high capital investment and maintenance. For example, computerising the office requires high capital investment and thus can be very costly.

Answer to TY 4

The correct option is **D**.

Self Examination Questions

Question 1

Which of the following is a benefit of using a computer?

A High speed
B Data storage
C Email and internet
D All of above

Question 2

State whether the following statement is true or false.

‘Mechanisation facilitates reduction of errors and fraud.’

Question 3

Which of the following devices facilitates communication?

A Telephone
B Printer
C Photocopier
D Scanner

Question 4

State the common factors to consider when selecting an office machine.

Question 5

What is a printer?

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **D**.

Answer to SEQ 2

The given statement is true.

Answer to SEQ 3

The correct option is **A**.

Answer to SEQ 4

The factors to consider while selecting an office machine are:

- Cost
- Quality
- Ease of operation
- Suitability
- Durability
- Adaptability and multiple use
- Adequacy
- Space
- Service and maintenance
- Reputation of supplier

Answer to SEQ 5

A printer is a device which is used with computers. The data stored in the computer can be printed on paper with the use of the printer. The printers are available in various sizes and capacity. The print-outs can be black-and-white as well as in colour.

STUDY GUIDE D3: OFFICE RECORDS MANAGEMENT

Get Through Intro

Whether it is a person or an organisation, being organised is essential to success. It is extremely important to have good organisational skills, especially when working with documents.

Whether it is a big office or small office, an efficient filing system is essential. Filing system facilitates ready access to information when needed, by storing and maintaining information in easy accessible form.

An efficient filing system results in saving considerable time and money for any office. Without a good filing system, it would be impossible to spot the papers, receipts, invoices, instruction manual, or report when needed from the piles of paper and disorganised drawers.

Nowadays, organisation has become easy through the use of computers and electronic filing systems.

In this Study Guide, we will learn about good filing system and the various methods of filing and storing information. This would help you not only in your professional life but also in your personal life.

Learning Outcomes

a) Identify types of filing systems: manual vs. electronic filing system.
b) State and explain methods of classifying and storing information: alphabetical, numerical, alphanumerical, subject and geographical filing.
c) Explain the characteristics of good filing system.

1. Explain the characteristics of a good filing system.
[Learning Outcome c]

Filing system means systematic and effective maintenance of records right from the creation of a receipt through to the time of its disposal.

The purpose of a filing system is to ensure that records are accurate and reliable, can be retrieved speedily and efficiently, and are preserved for the necessary period. Filing and recoding the documents is critical to all organisations. If the records are not efficiently managed, it is not possible to account for what has happened in the past or to make decisions about the future.

A good filing system facilitates the following:

- It ensures availability of evidence of actions and decisions for future reference.
- It supports prompt compliance with legal and regulatory obligations such as payment of taxes, data protection etc.
- A good filing system provides help in decision making.

A filing system is considered a good filing system when the requirements of the organisation are accomplished.

Therefore, although there is no ideal system of filing that fits the requirement of every record, a good filing system generally is one that possesses the following characteristics:

(a) Compactness

The filing system should be compact as far as practicable. As office space now-a-days is very costly, it is important that the filing system ensures best utilisation of the available space.

(b) Simplicity

The filing system should be simple and easy to understand. Lengthy and elaborate procedures and complicated functions should be avoided to make the filing system easy to operate.

(c) Economy

The filing system should be economical in relation to time, space, money and operation. To ensure economy, it is important that the equipment used for filing uses less space but accommodates maximum number of files, is not very costly and is easy to operate.

(d) Flexibility

The filing system should be flexible to ensure scope for future expansion and contraction. As business grows, the records increase, therefore the filing system should have the capacity to cope with future expansion.

(e) Safety

The filing system should ensure adequate safety of the documents from insects, dust, water, theft and fire. To ensure safety, appropriate measures should be taken such as restricted access to records, installation of fire fighting equipment, employment of security guards etc.

(f) Accessibility

The filing system should ensure easy access of records at the time of need. Locating the required record should be easy and should not involve high cost and delay in finding. It should also allow insertion of new records without disturbing the existing records.

(g) Cross reference

The filing system should facilitate cross reference of letters and correspondence to ensure time saving.

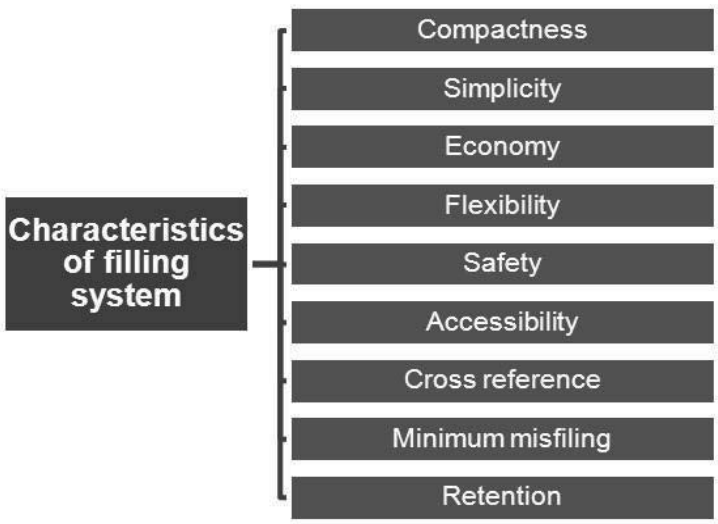
(h) Minimum misfiling

It is said that records not kept at the right place are lost. Misfiling causes delay in locating the required records and documents. The filing system must ensure prevention of misfiling by adopting measures such as clearly set out rules for filing, well designed index of all files, access to files being restricted to authorised people only etc.

(i) Retention

The filing system should ensure retention of records for an appropriate period of time. Sometimes, there are legal requirements relating to period of retention e.g. tax records. It is also important that records that are no more required are regularly destroyed to ensure security of information and best utilisation of space. Thus, a sound retention policy is a key characteristic of a good filing system.

Diagram 1: Characteristic of filling system



Test Yourself 1

Which of the following are the characteristics of a good filing system?

A Compactness
B Simplicity
C Flexibility
D All of above.

---

2. Identify types of filing systems: manual vs. electronic filing system.

[Learning Outcome a]

2.1 Manual filing system

The manual filing system uses the traditional methods for filing the documents.

The common traditional filing methods are:

(a) Cardboard files

These are thick paper or cardboard covers fitted with metal hinges to help fasten the papers together. A separate file is used for each customer, supplier or subject and all the related documents are filed in that folder using a paper punch. All the files are placed horizontally alongside each other in a cupboard or cabinet. An index of files is usually kept to make locating the file easy.

(b) Arch lever files

These are strong cardboard folders containing strong metal arches which are operated by a lever. This makes inserting new papers and removing filed papers easy. It also facilitates filing the papers in a particular order e.g. in order of filing date, in order of subject etc.

(c) Vertical drawer cabinets

This is commonly used as filing equipment. Such cabinets have drawers which roll on ball bearing and are deep to allow keeping folders in standing position. It also facilitates locking to ensure security of files kept in the cabinet. However, such cabinets require more floor space and the physical effort and time required to access the folders is also more than other types of equipment.

(d) Open shelves

Open shelving occupies much less floor space than a vertical cabinet but provides high density access to file folders. Open shelves are readily adaptable to the storage and management of paper records, files, and all other record formats. They are also less in cost as compared to vertical cabinets. They are easy to operate and are widely used in libraries, banks, schools, government offices and other institutions. However, the biggest drawback is that open shelves do not offer security for confidential or vital records.

Advantages of manual filing system

- It does not require special technology
- It is easy to operate
- It is less expensive

Disadvantages of manual filing system

- It increases need for physical space
- There is always risk of deterioration of original records

2.2 Electronics filing system

Modern offices prefer paperless filing as it facilitates saving of space and time.

Various types of technology applications are available that help an office manage its records in electronic format. However, conversion of records to electronic format needs proper planning and is also not cost effective for most offices. To justify the cost, it is important that the company processes and manages the more effectively than merely using it as a storage solution.

The commonly used electronic filing methods are:

(a) Microfilm files

Microfilm is most useful for storing records that need permanent retention. In this system, the record or document is first photographed on a film and then placed in a file cabinet specially built for microfilms. Since the documents have been captured electronically, it is easy to move the images to a CD or other storage device when required.

(b) Computer filing

Computer filing is probably the most convenient method of filing. Records are stored on the computers in alphabetical, alphanumerical or graphical forms. The storage capacity of computers is high. It also facilitates locating the data when needed. Operating computers is easy and cost involved is also not very high. Transfer of data using emails is also possible when records are saved on computers.

Advantages of electronic filing system

- It reduces need for physical space
- It facilitates indexing, searching, and retrieval
- It allows for multiple access points
- It recreates high-quality user copies without image degradation

Disadvantages of electronic filing system

- It requires software or hardware for access
- It requires continuous monitoring
- There is a risk of software and hardware obsolescence
- It requires time-consuming metadata creation
- There is potential threat of modification or corruption

Test Yourself 2

State whether the following statement is true or false.

An efficient filing system is one that stores and maintains information and makes it readily available to those who may need it.

---

3. State and explain methods of classifying and storing information: alphabetical, numerical, alphanumerical, subject and geographical filing.

[Learning Outcome b]

The various methods of classifying and storing information are explained below:

3.1 Alphabetical classification

Under this method, the files are arranged in straight alphabetical order from A to Z based on the name of the subject. A good example to understand this system is a dictionary or telephone directory. This method is simple to operate and very useful for small files where folder titles are easily determined.

Example

Arranging all files of all outgoing correspondence by name of the addressees

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Advantages of alphabetical classification

- It is easy to understand and simple to operate.
- It does not require separate index.
- It is flexible as it is easy to add new files with new headings without disturbing other files.
- Browsing through files is easy.

Disadvantages of alphabetical classification

- There is increased risk of misfiling.
- There may be retrieval problems arising over name changes.
- This system may be inefficient and cumbersome in large organisations.
- It makes it easy for unauthorised persons to check and find records.

3.2 Numerical classification

Under this method, each file or folder is assigned a number and the files are kept in the numerical order. An index is prepared expressing the details of each file to which the numbers are assigned.

Example

Assigning a number say 201 to Mr. Dave and filing all correspondence to and from Mr Dave in that file.

Advantages of numerical classification

- It facilitates faster comprehension of numerical sequences over alphabetical sequences.
- It facilitates expansion as adding new files without disturbing existing arrangement is easy.
- It facilitates easy identification of misfiled or out-of-sequence numbers.
- It facilitates using file number as a reference in future correspondence.

Disadvantages of numerical classification

- It requires preparation of an index which involves cost and time.
- It requires due care as there is a possibility of numbers being transposed when files are created.

3.3 Alphanumeric classification

An alphanumeric filing arrangement uses a combination of numeric digits and alphabets to create a flexible filing system. In this type of system, filing is done in an alphabetical format, but under each of the alphabetical letters there are numbered folders. An index is required to use the system effectively.

Example

In the alphabetical group P, correspondence with Peter is given a number P101, Pamela is given a number P201, and Paul is given a number 301 and so on.

Advantages of alphanumerical classification

- It helps in eliminating the need for long titles through use of codes.
- It facilitates increased file security because users must understand the coding system.
- It facilitates quick reference.
- It is flexible as it can be expanded as much as needed.

Disadvantages of alphanumerical classification

- It needs an index in order to access the files.
- It can become very complex for big organisations.

3.4 Subject classification

Under the subject filing method, all letters and documents relating to a particular subject are brought together in one file although they may have been received from different people. For example, all the papers relating to the bank are filed in one file. This method is useful when subject matter of classification is more important than names of the correspondents.

Advantages of subject classification

- It facilitates convenience of reference if subject is known.
- It is flexible as it can be expanded as much as needed.

Disadvantages of subject classification

- It does not facilitate cross reference.
- It can become very complex for big organisations.
- It requires an index.
- Great care is needed in selecting the appropriate subject.

3.5 Geographical classification

Under this method, the classification is based on the geographical origin of the papers or documents. This filing system is usually used for maintenance of sales records or customers accounts. All cities are arranged in alphabetical form. Within each city, different parties are arranged in alphabetical order.

Advantages of geographical classification

- It facilitates speedy location of files.
- It is flexible as it can be expanded as much as needed.

Disadvantages of geographical classification

- It is difficult to identify the file if geographical location is not known.
- It can become very complex for big organisations.
- It requires an index.

Test Yourself 3

Which of the following is not a method of classifying information?

A Alphabetical classification
B Alpha-numerical classification
C Geographical classification
D Demographical classification

Answers to Test Yourself

Answer to TY 1

The correct option is **D.**

Answer to TY 2

The given statement is true.

Answer to TY 3

The correct option is **D.**

Self Examination Questions

Question 1

What are the benefits of a good filing system?

Question 2

An alphanumeric filing arrangement uses a combination of --------------------------- to create a flexible filing system.

A Numerical digits and alphabets
B Signs and alphabets
C Different colours and numbers
D Numerical digits and codes

Question 3

What are the advantages and disadvantages of electronic filing system?

Question 4

What are the advantages and disadvantages of alphabetical classification of records?

Answers to Self Examination Questions

Answer to SEQ 1

The benefits of a good filing system are as follows:

- It saves time by ensuring that information can be located easily and quickly.
- It saves space by ensuring that records are not preserved longer than necessary.
- It saves money by reducing storage and maintenance costs.
- It improves efficiency by ensuring information is readily accessible when needed.
- It improves usability of information by providing accurate and reliable records.
- It ensures the security of confidential information.

Answer to SEQ 2

The correct option is **A.**

Answer to SEQ 3

Advantages of electronic filing system are as follows:

- It reduces need for physical space
- It facilitates indexing, searching, and retrieval
- It allows for multiple access points
- It recreates high-quality user copies without image degradation

Disadvantages of electronic filing system are as follows:

- It requires software or hardware to access
- It requires continuous monitoring
- There is a risk of software and hardware obsolescence
- It requires time-consuming metadata creation
- There is potential threat of modification or corruption

Answer to SEQ 4

Advantages of alphabetical classification are as follows:

- It is easy to understand and simple to operate
- It does not require separate index
- It is flexible as it is easy to add new files with new headings without disturbing other files
- Browsing through files is easy

Disadvantages of alphabetical classification are as follows:

- There is increased risk of misfiling
- There may be retrieval problems arising over name changes
- This system may be inefficient and cumbersome in large organisations
- It makes it easy for unauthorised persons to check and find records

SECTION E

INTRODUCTION TO TAXATION

E1

STUDY GUIDE E1: TAXATION THEORY

Get Through Intro

Tax is a financial charge imposed by the government. The fundamental purpose of taxation is to finance government expenditure. Any money the government expends mostly comes from taxation.

You will agree that having to pay tax from your earnings is a painful experience. You must also have wondered why the government needs to collect taxes. What is the purpose behind collecting a part of our hard-earned money? Most of the tax payers feel that paying taxes is a waste of their money.

This Study Guide explains the various economic and social purposes of taxation. You are advised to understand the Study Guide thoroughly so that you can encourage your clients to pay taxes regularly and help your country to grow.

Learning Outcomes

a) Identify sources of government revenue.
b) Explain the nature, objectives and rationale of taxation.
c) Explain the canons of taxation.
d) Classify taxes (direct/indirect taxes, proportional, progressive, regressive taxes).

1. Identify sources of government revenue.
[Learning Outcome a]

The key sources of revenue of Government can be classified into categories as:

1. Non - tax revenue
2. Tax revenue

1.1 Non-tax revenue

Non-tax revenue is generated through various sources. They differ in terms of nature and types as follows:

1. Grants or aids

Grants can be defined as the non- repayable voluntary transfer of resources.
.
The grants could be of the following types:

- Grants provided by the central government to state government for specific objectives

- Grants provided by foreign countries to the Central/ State Governments (also called as foreign aid). Foreign aid may be given to support social causes, for contribution during emergencies/ natural calamities, for strengthening ties with the country or for commercial purposes.

2. Debts from other governments or banks/ funds

When public expenditure exceeds public revenue, governments resort to borrowings.

Borrowings may be from:

- foreign countries or
- internal borrowings from the private sector in the form of debentures or bonds etc or
- internal borrowings from central bank of the country

3. Income from investments made by the Government

Governments invest excess funds in bonds, mutual funds of other insitutions. The revenue that is earned by governments from such investments is in the form of interest or dividend.

4. Revenue from public enterprises

Government sets up public sector enterprises, which are owned and controlled by the government. The profit earned by such public sector enterprises is a source of revenue for the government. Furthermore when the public sector enterprise income from sale of its non-current asset, it is revenue for government, although it is a one- time revenue and is not a recurring income.

5. Royalties

Royalty is received by the government when it allows private enterprises to use government/ public assets or intellectual property. Royalty is generally charged as a percentage of revenue derived from the use of the asset or a percentage of the unit price of the product sold. Example: Private sector enterprise has to pay royalty to the government to extract natural resources like petrol/ crude oil from government owned lands.

6. Fees and penalties

Governments charges fees for a number of services it renders to the general public. For example fees for issuing driving license/ passports, fees for generating copies of official documents, fines/ penalties levied for breaking traffic rules etc.

7. User fees

The government charges fees for use of its assets / services provided by the government. For example a toll is charged for the use of roads/ highways.

8. Subsidies received from other countries/ banks

Government receives subsidies from international banks/ monetary funds which are an indirect source of revenue for the government.

9. Rent

Government may earn revenue by way of renting of owned buildings or by renting out parking space etc. A local authority like municipality may rent out some empty space to the central government on requirement.

Tip

The non- tax revenue of Tanzania constituted 8% of total government revenue in the year 2003- 04

1.2 Tax revenue

Revenue from taxation may be in several forms as follows:

Tax	Suffered by
Revenue taxes	
Income tax	➢ Individuals ➢ Partnerships
Corporation tax	Companies
VAT	Final consumer
Capital taxes	
Capital gains tax	➢ Individuals ➢ Partnerships (Companies pay corporation tax on their gains)
Inheritance tax	Individuals

Test Yourself 1

Explain four sources of non-tax government revenue.

2. Explain the nature, objectives and rationale of taxation.

[Learning Outcome b]

2.1 Nature of taxation

1. Revenue Tax

(a) Income tax

It is a tax levied on the income of an individual.

Income can be from any sources such as:

(i) income from earnings (e.g. employment income / trade profit)
(ii) income from pensions
(iii) income from other benefits (e.g. rental income)
(iv) income from savings (e.g. interest income)
(v) income from investments (e.g. dividend income)

Income tax is calculated on earned income (i.e. income from employment) as well as on income from savings etc. Income from various sources is pooled together and tax is charged on the aggregate income after deducting the relevant personal allowance. Taxpayers who are employed pay income tax on their earnings under the statutory Pay As You Earn (PAYE) scheme.

(b) Corporation tax

It is the tax payable by companies on their taxable profits. There are numerous provisions relating to corporation taxes which are dealt with at length in next Study Guide.

(c) VAT

VAT is Value Added Tax. It is the tax which is paid on the value added. This tax is levied at each stage of production. VAT is a consumption tax paid by customers in addition to the price of the product.

2. Capital taxes

(a) Capital Gains Tax

When a person sells an asset that is in his / her possession, the profit arising from such sale is chargeable to tax as capital gains.

Therefore, capital gains tax liability arises when a taxable person makes a chargeable disposal of a chargeable asset.

For example, Adam sells his business asset at a profit of Tshs500, 000. So, the amount of profit i.e. Tshs500,000 is chargeable to capital gains tax.

(b) Inheritance Tax

When a person is in possession of an asset, and on his death the ownership of such an asset is transferred, the value of the transferred asset is chargeable to inheritance tax, subject to certain tax free thresholds.

Therefore, inheritance tax liability arises when the value of chargeable property is transferred by a taxable person.

2.2 Objectives of taxation

The main objective of taxation for the government is to make provision for funds to meet public expenditure for achieving economic and social objectives.

1. Economic objectives

The government imposes taxation policies to:

(a) Encourage

- saving by individuals
- taking risks in investments by entrepreneurs
- entrepreneurs building their own businesses
- donations to charities
- investment in industrial buildings (e.g. factories, warehouses etc.)

(b) Discourage

- motoring e.g. to minimise pollution
- smoking and alcohol
- office buildings

A government does not intend taxes to be neutral, but to be used to encourage or discourage certain activities.

2. Social purpose of taxation

Politicians use taxation policies to encourage social justice; however, there are many different ideas as to what constitutes social justice.

3. Other objectives of taxation include:

- **Encouragement of domestic industry and discouraging imports**: the government may increase custom duties on imports which will increase the price of imported goods and will in turn help government to control import of goods.

- **Income redistribution**: this refers to bridging the gap between the rich and the poor and reducing inequality. This is done by levying higher tax on the richer sections of society. These funds are used for the welfare of the poorer sections to reduce the disparity between different sections of society.

- **Economic stability**: this refers to reducing the effect of inflation/ depression. For example, an increase in direct taxes will reduce the money available with the people to purchase goods and services and will in turn help to reduce inflation, whereas increase in public expenditure during depression helps to increase demand for goods and services, which is otherwise very low during depression.

- **Protection of particular sectors/ industries:** the government may levy lower rates of taxes or give tax concessions to particular sectors/ industries to protect or promote their growth.

2.3 Rationale of taxation

Example

This man is counting money. How happy he looks! If the income of this man is Tshs100,000, some part of this Tshs100,000 will go to the government in the form of tax on his income.

The fundamental purpose of taxation is to finance government expenditure. The tax system can be used for purposes other than raising revenue. In certain situations, imposing a tax may potentially increase efficiency if markets fail to price factors such as pollution or congestion, or the health costs of particular types of behaviour such as cigarette smoking. The government uses the process of taxation to encourage or discourage public activity in specific ways.

So, even if this man has to pay tax, i.e. money goes from his pocket, he should not feel bad because the government uses this tax money for the economic and social benefits of the country as a whole. Therefore, it is the taxpayer himself who ultimately enjoys the benefits of paying taxes.

Source: http://comparativetaxation.treasury.gov.au/content/report/html

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Thus rationale of taxation is:

- To finance government expenditure
- To encourage certain good public activities e.g. saving
- To discourage certain bad public activities e.g. smoking

Test Yourself 2

Corporation tax is payable by

A Individuals
B Families
C Partnerships
D Companies

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3. Explain the canons of taxation.
[Learning Outcome c]

Canons/principles of taxation

Taxation system should adhere to certain basic principles so that it can function effectively.

- the tax system should be fair (that is a person should be taxed according to his ability to pay),
- the provisions of tax should be clearly specified without any ambiguity,
- it should be easy to understand to the common man,
- it should be efficient and cost of compliance should be minimum.

The main principles of a good tax system are:

(a) Equality

This is the most important principle of taxation. It means that the tax system should be framed depending on the ability of the people to pay tax that is the richer sections or the high- income group should be subjected to higher tax while relatively less tax should be imposed on the low income group

(b) Economy

A good tax system will ensure that the cost of collecting and paying tax as well the compliance cost is minimum. For example, if there are many procedures for payment of tax and filing of related documents or if a number of visits are required by the tax payer to the tax office, then the tax system is said to be uneconomical.

In a broader sense, if very high tax is levied on the income of the tax payer, it will discourage savings and the productive capacity of the economy will go down, which will be uneconomical for the country.

Taxes on products like alchohol, cigarettes etc are considered as economical because they fetch revenue to the government as well as increase the price of those products which will discourage their consumption.

(c) Certainty

It means that tax that each tax payer is required to pay should be certain and there should be no ambiguity. The amount to be paid, timing of payment, procedure for payment should all be certain and known to the tax payer. There should be no element of ambiguity in the taxation provisions as this may lead to corruption (if any element of taxation can be controlled by the will of the government authorities).

Certainty is also required from the point of view of the government in terms of the estimated amount to be collected from various taxes and the time frame when the same will be collected.

(d) Efficiency

This means that the revenue collected from the tax payers in the form of tax should be sufficient to meet the government expenditure. However the government has to ensure that in order to raise sufficient revenue to meet expenditure, it does not overburden the tax payers such that the productive capacity is affected.

(e) Understandable

Tax system should be simple and should be such that it can be understood by common man. This will help curb corruption.

(f) Benefit principle

Taxation system should be such that persons who benefit from goods/ services provided by the government and which are primarily funded through taxation, should pay for it.

(g) Convenience

The tax system should be so designed that it causes minimum inconvenience to the tax payers in respect to payment of tax, record- keeping, filing of returns, audits etc.

Generally indirect taxes like VAT are convenient to the consumers because a consumer pays for them when he makes purchases and at a time when he can afford to because he chooses his own time of purchasing.

(h) Fairness / equity

Taxation system should ensure that no special treatment is meted out to specific political or other interest groups.

(i) Demand management

In times of depression in the economy, demand for goods and services is low; government can help increase demand by reducing taxes on goods/ services and consequently, reducing prices.

(j) Elasticity

Government should be able to increase revenues from taxation if required in case of an emergency for eg: a surcharge levied on income- tax can considerably increase government revenue during the period of emergency

(k) Flexibility

This is a necessary criterion for elasticity. Unless the tax system is flexible that is it can be modified to suit new conditions, revenue cannot be increased.

- **Diversity:** There should be a number of taxes both direct and indirect so that all the people who can afford to contribute are subjected to tax.

- **Broad basing:** This principle requires that taxes should be spread as wide as possible over the sections of population/ economy, to minimise individual tax burden.

- **Earmarking:** Tax revenue from a specific source should be used for the purpose for which it is collected when a direct link can be established between the tax collected and the expenditure for eg toll collected for road maintenance.

Taxation system should be such that it **contributes towards the social and economic objectives** of the society.

Tip

Tax policies are formulated with an aim to increase government revenues. They are framed on the basis of clear principles such as:

(a) savings and investments
(b) fairness
(c) equality
(d) enhancing work efficiency

Test Yourself 3

Principle of equality of taxation requires that every person should pay the same amount of tax

A True
B False

---

4. Classify taxes (direct/indirect taxes, proportional, progressive, regressive taxes). [Learning Outcome d]

4.1 Direct and indirect taxes

In order to function effectively, the tax system divides taxes into the following two types:

1. direct taxes
2. indirect taxes.

1. Direct Taxes are either deducted at source or paid directly to the tax authorities**.**

(a) Tax on income or capital.

(b) Tax imposed directly on taxpayers (individual / company).

(c) Direct taxes can be progressive i.e. the more you earn, the higher rate you pay.

(d) Examples
- Income tax
- Corporation tax

2. **Indirect Taxes** are charged **when a taxpayer buys an item, and are paid to the vendor as part of the purchase price. The vendor in turn passes the tax element on to the government, acting as a collector of tax.**

- Tax on what people spend, rather than on what they earn.
- People with low incomes pay a higher proportion of their income on indirect taxes than wealthier people.
- Example: VAT, stamp duty, duties levied on tobacco, alcohol and petrol.

4.2 The progressive and regressive taxes

The basis, on which taxes are levied, can also be bifurcated into following three categories:

1. **Progressive taxation**

a tax such as the income tax demonstrates the progressive principle. As income rises so does the proportion of tax i.e. the rate of tax rises as well as the amount of tax. This can be considered as just and fair, as the higher tax payments are made by those with higher incomes. Taxes which take a higher percentage of the incomes of higher income earners are said to be progressive.

Example

Income tax in Tanzania is an example of progressive taxation. The tax rates rises as the income rises.

Total income (Tshs)	Tax Rate (%)
Up toTshs1,620,000	0%
Tshs1,620,001 - Tshs4,320,000 14%	14%
Tshs4,320,001 - Tshs6,480,000 20%	20%
Tshs6,480,001 - Tshs8,640,000 25%	25%

2. **Regressive taxation**

This is the tax where, as the amount of income increases, percentage of tax is reduced. So in this case, a tax payer in the high income group may be paying more taxes in absolute terms but the percentage of income is falling.

Example

Poll tax existing in the United Kingdom was such that tax payer earning 10,000 pounds and 5,000 pounds had to pay the same amount of tax say 500 pounds. This meant that a person earning 10,000 pounds would be paying 5% tax whereas a person earning 5,000 pounds would be paying 10% tax.

3. **Proportional taxes**:

In this case, as the tax payer's income increases, he pays more tax but the amount that is paid as percentage of the tax payer's income remains unchanged.

Example

All tax payers have to pay say two percent of their income as education cess tax then it is proportional tax. Any increase in income does not increase the percentage of tax; same percentage is charged for all tax payers

Test Yourself 4

Explain the classification of taxes based on how they are levied.

Answers to Test Yourself

Answer to TY 1

Non-tax revenue is generated through various sources. Four main sources of non-tax revenue are as follows:

(a) Grants or aids

Grants can be defined as the non- repayable voluntary transfer of resources.

The grants could be of the following types:

- Grants provided by the central government to state government for specific objectives
- Grants provided by foreign countries to the Central/ State Governments (also called as foreign aid). Foreign aid may be given to support social causes, for contribution during emergencies/ natural calamities, for strengthening ties with the country or for commercial purposes.

(b) Debts from other governments or banks/ funds

When public expenditure exceeds public revenue, governments resort to borrowings.

Borrowings may be from:

- foreign countries or
- internal borrowings from the private sector in the form of debentures or bonds etc or
- internal borrowings from central bank of the country

(c) Income from investments made by the Government

Governments invest excess funds in bonds, mutual funds of other institutions. The revenue that is earned by governments from such investments is in the form of interest or dividend.

(d) Revenue from public enterprises

Government sets up public sector enterprises, which are owned and controlled by the government. The profit earned by such public sector enterprises is a source of revenue for the government. Furthermore when the public sector enterprise income from sale of its non-current asset, it is revenue for government, although it is a one- time revenue and is not a recurring income.

Answer to TY 2

The correct option is **D.**

Answer to TY 3

The correct option is **B**

The principle of equitable taxation does not mean that every person should pay the same amount of tax nor at the same rate. It means that the tax system should be framed depending on the ability of the people to pay tax that is the richer sections or the high- income group should be subjected to higher tax while relatively less tax should be imposed on the low income group.

Answer to TY 4

The basis, on which taxes are levied, can also be classified into following three categories:

1. **Progressive taxation**

A tax such as the income tax demonstrates the progressive principle. As income rises so does the proportion of tax i.e. the rate of tax rises as well as the amount of tax. This can be considered as just and fair, as the higher tax payments are made by those with higher incomes. Taxes which take a higher percentage of the incomes of higher income earners are said to be progressive.

2. **Regressive taxation**

This is the tax where, as the amount of income increases, percentage of tax is reduced. So in this case, a tax payer in the high income group may be paying more taxes in absolute terms but the percentage of income is falling.

3. **Proportional taxes**

In this case, as the tax payer's income increases, he pays more tax but the amount that is paid as percentage of the tax payer's income remains unchanged.

Self Examination Questions

Question 1

_______________taxation is the tax where, as the amount of income increases, percentage of tax is reduced.

A Progressive
B Regressive
C Direct
D Indirect

Question 2

Explain the principle of economy of taxation

Question 3

The principle which relate to taxes which take a higher percentage of the incomes of higher income earners is:

A The ability to pay principle
B Regressive principle
C Progressive principle
D None of the above

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

Answer to SEQ 2

This principle states that the every tax should be framed in such a manner that is takes out of the pockets of the people as little as possible, over and above what it brings into the public treasury. A good tax system will ensure that the cost of collecting and paying tax as well the compliance cost is minimum. For example, if there are many procedures for payment of tax and filing of related documents or if a number of visits are required by the tax payer to the tax office, then the tax system is said to be uneconomical.

In a broader sense, if very high tax is levied on the income of the tax payer, it will discourage savings and the productive capacity of the economy will go down, which will be uneconomical for the State.

Taxes on products like alcohol, cigarettes etc are considered as economical because they fetch revenue to the government as well as increase the price of those products which will discourage their consumption.

Answer to SEQ 3

The correct option is **C.**

A tax such as income tax demonstrates the progressive principle. As income raises so does the proportion of tax i.e. the rate of tax rises as well as the amount of tax. This can be considered as just and fair, as the higher tax payments are made by those with higher incomes.

Option B is incorrect as Regressive principle is where as the income raises, the proportion of tax decreases. Taxes which take a higher proportion of the incomes from lower income earners.

Option A is incorrect as Ability to pay tax is only paid by people who have the income to pay.

SECTION E

INTRODUCTION TO TAXATION

E2

STUDY GUIDE E2: TAX ADMINISTRATION

Get Through Intro

In this Study Guide, we will discuss the meaning and difference between tax avoidance and tax evasion.

It is essential to know the difference between the two because the law makes various provisions relating to the taxability of different types of income. You should be aware of the risk associated with tax evasion and avoidance, because either one of these is likely to have different consequences.

This Study Guide highlights the importance of understanding the difference between the two, because tax avoidance is permitted by law but tax evasion is illegal.

As a tax consultant, you should have thorough knowledge of the difference between them so that your client does not unwittingly commit tax evasion. In addition, you should advise your client on how to effectively and legally reduce the tax liability.

Learning Outcomes

a) Explain the role and functions of TRA.
b) Identify the tax laws administered by the Tanzania Revenue Authority.
c) Describe legal powers of the Tanzania Revenue Authority.
d) Define core tax administration concepts (tax returns, tax assessment, tax audit, tax investigation).
e) Differentiate between tax evasion and tax avoidance.

1. Explain the role and functions of TRA.

[Learning Outcome a]

The Tanzania Revenue Authority (TRA) was established by the Act of Parliament Not. 11 of 1995, and started its operations on 1st July 1996. In carrying out its statutory functions, TRA is regulated by law, and is responsible for administering impartially various taxes of the Central Government.

The role and functions of TRA are as follows:

1. To administer and give effect to the laws or the specified provisions of the laws set out in the First Schedule to The Tanzania Revenue Authority Act, and for this purpose, to assess, collect and account for all revenue to which those laws apply.

2. To monitor, oversee, coordinate activities and ensure the fair, efficient and effective administration of revenue laws by revenue departments in the jurisdiction of the Union Government

3. To monitor and ensure the collection of fees, levies, charges or any other tax collected by any Ministry, Department or Division of the Government as revenue for the Government

4. To advise the Minister and other relevant organs on all matters pertaining to fiscal policy, the implementation of the policy and the constant improvement of policy regarding revenue laws and administration

5. To promote voluntary tax compliance to the highest degree possible

6. To take such measures as may be necessary to improve the standard of service given to taxpayers, with a view to improving the effectiveness of the revenue departments and maximising revenue collection

7. To determine the steps to be taken to counteract fraud and other forms of tax and other fiscal evasions

8. To produce trade statistics and publications on a quarterly basis to perform such other functions as the Minister may determine

Source: The Tanzania Revenue Authority Act, revised edition 2006

In order to carry out its administrative functions, TRA has eleven departments, namely:

1. Domestic Revenue
2. Large Taxpayers
3. Customs and Excise
4. Tax Investigations
5. Internal Audit
6. Finance
7. Human Resources and Administration
8. Research and Policy
9. Taxpayer Services and Education
10. Information and Communication Technology
11. Legal Services

Test Yourself 1

Which of the following are the functions of TRA?

A To ensure the collection of fees, levies and charges for the government
B To ensure the implementation of the fiscal policy and the constant improvement of policy regarding revenue laws and administration
C To promote voluntary tax compliance
D All of the above

2. Identify the tax laws administered by the Tanzania Revenue Authority.
[Learning Outcome b]

There are various tax laws which oversee the taxation process in Tanzania. The core tax laws that are administered by TRA include following.

1. Finance Acts

This section consists of Finance Acts which provide changes in tax laws made during a particular fiscal year.

Finance Act 2007
Finance Act 2008
Finance Act 2009
Finance Act 2010
Finance Act 2011
Finance Act 2012
Finance Act 2013

The Finance Act contains various provisions relating to taxes, duties, exemptions and reliefs applicable and also set out the principal tax rates for each fiscal year.

2. Tax Acts

This section consists of the main tax laws. These are the fundamental laws to be read in conjunction with their respective Regulations and Finance Acts.

- Income Tax Act Revised Edition 2008
- Income Tax Act Revised Edition 2006
- The Value Added Tax Act, 1997
- The Tax Revenue Appeals Act

3. The Hotels Act

This Act regulates all aspects of registration, safety requirements, liability towards guests, lien on property etc.

4. The Tanzania Revenue Authority Act

This Act explains the role, function and constitution of TRA.

5. The Port Service Charges Act, 1973

6. The Motor vehicle (Tax Registration and Transfer) Act, 1972

This Act regulates all aspects of road transport vehicles and provides in detail the legislative provisions regarding licensing of drivers, registration of motor vehicles, traffic regulation, vehicle insurance, liability for offences and penalties, etc.

7. The Airport Service Charges Act, 1992

8. The Road and Fuel Toll Act, 1985

9. The Stamp Duty Act, 1972

10. The East African Community Customs Management Act, 2004

11. The East African Community Customs Management (Amendment) Act, 2011

12. The East African Community Customs Management Act, 2004 (Revised)

- The Excise Management and Tariff Act
- Other tax laws
  - ✓ Protocol on the Establishment of the East African Customs Union
  - ✓ The East African Community Customs Union (Rules of Origin) Rules

Regulations

This part consist of regulations made by the Minister for matters authorised to be made or prescribed and for better carrying into effect of the principles, purposes and provisions of the respective Acts.

(a) GN No 218 of 2012 - Tourism Development Levy

(b) EFD Regulation 2010

(c) EFD Regulation 2012

(d) The Value Added Tax (General) Regulations, 1998

(e) The VAT (Corrections of errors) Regulations, 2000

(f) The VAT (Imported Services) Regulations, 2001

(g) The Value Added Tax (Registration) Regulations, 1998

(h) EAC customs Management (Duty Remission) Regulations, 2008

(i) EAC customs Management Regulations, 2010

(j) EAC customs Management (compliance and enforcement) Regulations, 2012

(k) The excise (Management and Tariff) The Filims and Music Products (Tax Stamps) Regulations 2013

(l) The Income Tax Regulation

Source: http://www.tra.go.tz/index.php/laws

Test Yourself 2

Which of the following Acts contains the legislative provisions regarding registration of motor vehicles in Tanzania?

A The Excise Management and Tariff Act
B The Road and Fuel Toll Act
C The Motor vehicle (Tax Registration and Transfer) Act
D The Excise Management and Tariff Act

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3. Describe legal powers of the Tanzania Revenue Authority.

[Learning Outcome c]

The Tanzania Revenue Authority shall in the discharge of its functions, have the power to:

1. Study revenue laws and identify amendments or alterations which may be made to any law for the purposes of improving the administration of and compliance with revenue laws

2. Study the administrative costs, compliance costs and the operational impact of all intended legislative changes and advise the Government accordingly

3. Collect and process the statistics needed to provide forecasts of revenue receipt and the effect on yield of any proposals for changes in revenue laws and advise the Minister accordingly

4. Negotiate and agree with the Treasury on the revenue collection targets for any given financial year

5. Undertake work measurement exercises in order to determine the manpower needs for the functions of each revenue department in the Authority

6. Set appropriate objectives and work targets in each revenue department and monitor progress in achieving them

7. Take such other measures as it may deem necessary or desirable for the achievement of the purposes and provisions of The Tanzania Revenue Authority Act.

Test Yourself 3

Which of the following is not a function of Tanzania Revenue Authority?

A To regulate registration, safety requirements, liability towards guests, lien on property etc. of hotel property.
B To study revenue laws and identify amendments or alterations which may be made to any law for the purposes of improving the administration of and compliance with revenue laws.
C To study the administrative costs, compliance costs and the operational impact of all intended legislative changes and advise the Government accordingly.
D To collect and process the statistics needed to provide forecasts of revenue receipt and the effect on yield of any proposals for changes in revenue laws and advise the Minister accordingly.

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4. Define core tax administration concepts (tax returns, tax assessment, tax audit, tax investigation).

[Learning Outcome d]

Tax returns

Tax return is a document or a form that is used by a taxpayer to give information of taxable income and tax payable to the revenue authority.

Definition

Tax return is a statement filed to TRA which declares the estimated income and tax payable or the final income and tax payable for each year of income.

For income tax purposes year of income means a calendar year of twelve months period (meaning the period starting from 1st January to 31st December).

Source: http://www.tra.go.tz

The return of income must provide the following details:

- Details of the person's chargeable income for the year of income from each employment, business and investment.
- The source of each income received during the year of income
- The person's total income for the year of income and the income tax payable with respect to that income
- Any income tax paid by the person for the year of income by withholding, instalment or assessment for which a tax credit is available
- Any other information that the Commissioner may prescribe
- In the case of a corporation, the return of income must be prepared or certified by a certified public accountant in public practice
- The return of income must include a declaration that the return is complete and accurate
- The return of income must be signed by the taxpayer and have attached to it any withholding certificates supplied to the person with respect to payments derived by the person during the year of income.

Tip

In Tanzania, the individual taxpayer is required to file a return of income with the Commissioner no later than six months after the end of each year of income.

The Commissioner may extend the due date for filing a return of income upon an application by the person in writing and on such terms and conditions as the Commissioner considers appropriate.

Under the presumptive system an individual is not obliged to file any return of income but instead can pay by instalments if the assessed amount exceeds TSHS 50,000 per year

Source: http://www.tra.go.tz/index.php/income-tax-for-individual/121-when-the-individual-is-required-to-file-the-return-of-income

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Tax assessment

Tax assessment, in simple terms, means calculating the total tax liability by a taxpayer taking into consideration the income from various sources and also the various benefits available to reduce the tax liability, and applying appropriate tax rate to calculate the correct tax liability.

Once the tax return is filed by a taxpayer, the revenue authority verifies whether the tax liability calculated by the tax payer is appropriate.

Tax audit

Tax audit is an independent examination and verification of accounting records and transactions by a certified public auditor undertaken with an objective to assure that the income shown in the tax return by the taxpayer is right, based on his total income and the applicable tax rates.

Tax audit helps in ensuring that the taxpayer has not concealed any income from any source. Since the certified public accountant verifies the taxpayer's financial and accounting records and other supporting documents during the audit, this gives an assurance to the revenue authority that the amount of tax collected from a taxpayer is the correct amount of tax.

Tax investigation

When a taxpayer is suspected of hiding their true income and thereby paying less tax, then the revenue authority undertakes investigation in order to recover the underpaid tax in the previous years of assessment.
The revenue authority also sometimes undertakes the investigation on random sampling basis.

Test Yourself 4

What is a tax return?

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5. Differentiate between tax evasion and tax avoidance.

[Learning Outcome e]

For many years, individuals have found imaginative ways of avoiding liability to tax. Large companies employ highly skilled tax planners in a bid to legally reduce their overall tax liability. There have been many instances of individuals under-declaring their income to reduce their tax liability. The question is one of whether these activities constitute tax avoidance or tax evasion.

Tax evasion is a deliberate act by an individual or company to mislead, misinform or otherwise mis-state their tax position to the revenue authority in order to evade taxes. It involves dishonest conduct or behaviour by the taxpayer.

Tax evasion is illegal and is punishable by hefty fines and imprisonment.

It could consist of:

- providing the revenue authority with false information
- not giving the revenue authority information to which they are entitled
- concealing a source of income

Tax avoidance, on the other hand, is any legal way of reducing the amount of tax payable – involving a sensible arrangement of the taxpayers' affairs so as to minimise the liability to tax. All activities must remain legal at all times. It is the utilisation of "tax loopholes" within the legislation in an ingenious way, thereby affording the tax payer, legally, a favourable tax position.

Tax avoidance is legal. It involves the arrangement of individuals' or companies' tax affairs in a way which reduces the tax liability; for example, using incentivised tax saving schemes. More complex tax avoidance examples would include establishing an offshore company in a tax haven or by forming a limited company to avail of more favourable tax deductions.

Test Yourself 5

Which is legal and permitted, tax avoidance or tax evasion?

Answers to Test Yourself

Answer to TY 1

The correct option is **D**.

Answer to TY 2

The correct option is **C**.

Answer to TY 3

The correct option is **A**.

To regulate registration, safety requirements, liability towards guests, lien on property etc. of hotel property is the function of authority formed under the Hotels Act. This is not a function of TRA.

Answer to TY 4

Tax return is a statement filed to TRA which declares the estimated income and tax payable or the final income and tax payable for each year of income.

Answer to TY 5

Tax avoidance is legal and permitted whereas tax evasion is illegal.

Self Examination Questions

Question 1

Which is illegal and not permitted?

A Tax avoidance
B Tax evasion
C Minimising the liability to tax by using benefits given by tax law
D Utilization of “tax loopholes”

Question 2

Concealing a source of income to reduce the tax liability is ------------------------.

A Tax avoidance
B Tax evasion

Question 3

-------------------------- is any legal way of reducing the amount of tax liability.

A Tax avoidance
B Tax evasion

Question 4

Name any five administrative departments of TRA.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B.**

Tax evasion is the intention to deliberately mislead HMRC and is illegal.

Option A, C and D are incorrect as tax avoidance is any legal way of reducing the amount of tax payable involving a sensible arrangement of the tax payer’s affairs so as to minimise the liability to tax, utilisation of tax loopholes within the legislation in an ingenious way, thereby affording the taxpayer legally, a favorable tax position.

Answer to SEQ 2

The correct option is **B**.

Answer to SEQ 3

The correct option is **A**.

Tax avoidance is any legal way of reducing the amount of tax liability.

Answer to SEQ 4

The five administrative departments of TRA, out of the total eleven, are as follows:

1. Domestic Revenue
2. Customs and Excise
3. Tax Investigations
4. Internal Audit
5. Taxpayer Services and Education

SECTION E

INTRODUCTION TO TAXATION

E3

STUDY GUIDE E3: INTRODUCTION TO INCOME TAX PRINCIPLES

Get Through Intro

Every nation's taxation system is laid down under its tax law. Tax law covers only the legal aspects and does not cover its financial, economic, or any other aspect. The political domain decides to impose various kinds of taxes and their rates. Tax law covers rules of public law which are directly related to the activities of a political community. Tax law is therefore divided into two parts, substantial tax law and procedural tax law. Substantial tax law lays the legal provisions like charging of a tax; and procedural tax law consists of the rules for assessment and enforcement procedure, coercive measures, administrative and judicial appeals and other similar matters.

The government aims to design and implement an equitable taxation policy, which must be:

1. **Adequate**: tax revenue collected should be just enough to cover public services
2. **Broad based**: it should be spread over a large population to minimise the individual tax burden
3. **Compatible**: tax should bring neutrality and should be able to achieve the objectives of good governance.
4. **Convenient**: it should encourage voluntary compliance
5. **Earmarked**: all tax revenue collected for a specific purpose should be dedicated to that expenditure so that a direct cost:benefit link can be established.
6. **Efficient**: the tax collection system should be cost effective in relation to the revenue that is to be collected.
7. **Equal burden**: the tax burden should be equally distributed among all the individuals and entities.
8. **Neutral**: taxes should be levied with no bias.
9. **Simple**: tax assessment and computation should be simple and easy so that the common man can understand.

This Study Guide gives us an idea about the tax system followed in Tanzania and also how income tax is computed. This is a very important study guide from the exam point of view.

Learning Outcomes

a) State the nature and imposition of income tax in Tanzania.
b) Identify the categories of income liable to tax.
c) Describe the concept of total income.
d) Identify types of assessment under the Income Tax Act 2004.
e) Describe tax returns of income tax (their contents, frequency and due date)
f) Identify the forms of payment of income tax (with holding, instalments)
g) Identify taxes subject to withholding.
h) Perform basic income tax computations (identify applicable tax rates and calculate total income, business income, employment income and withholding taxes)

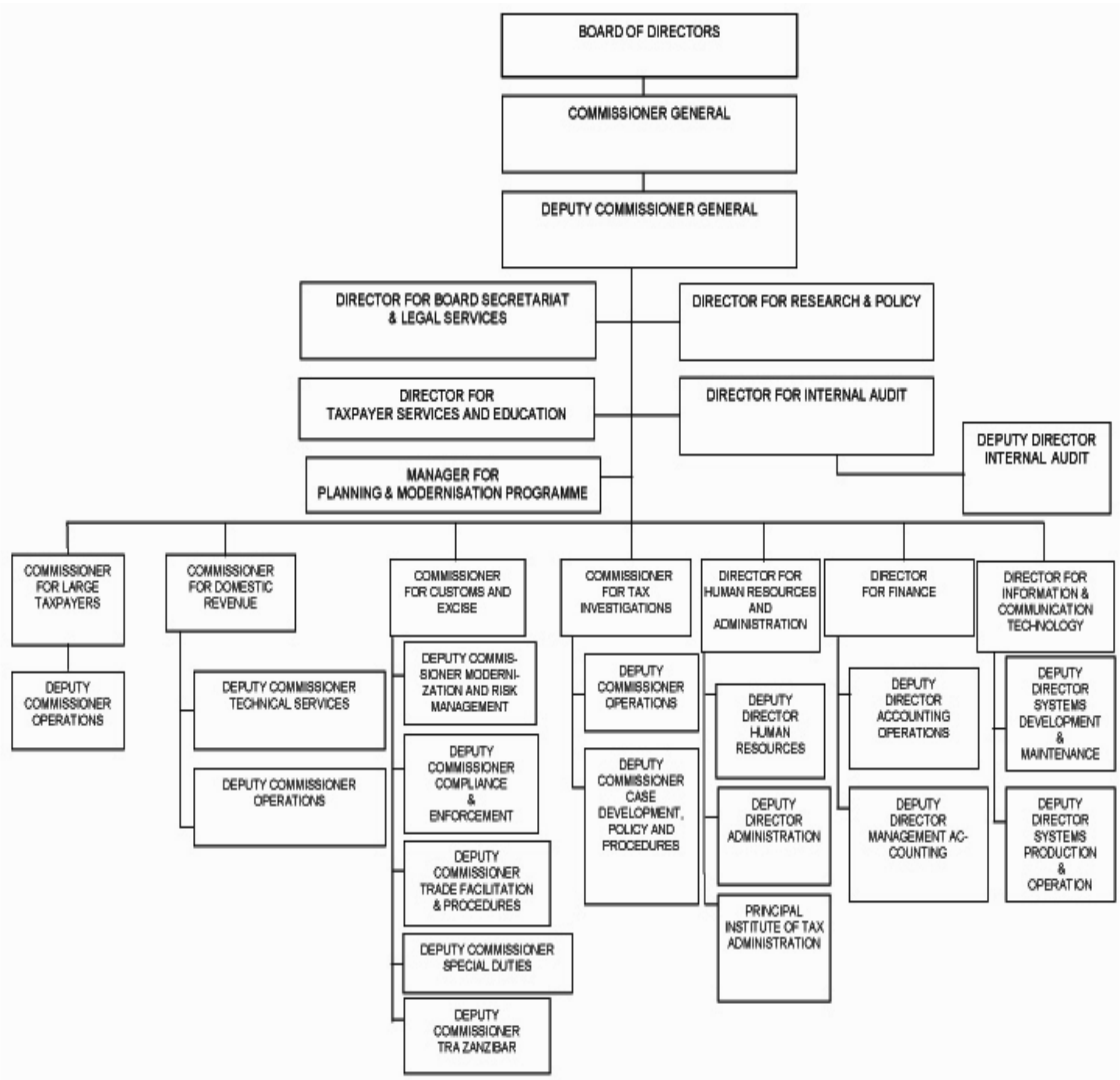
1. State the nature and imposition of income tax in Tanzania.
[Learning Outcome a]

1.1 Nature of Income tax in Tanzania

The Income Tax Act, 2004, which superseded the previous Income Tax Act 1973, came into effect in July 2004 in Tanzania.

The Tanzania Revenue Authority (TRA) was established by the Act of Parliament Not. 11 of 1995, and started its operations on 1st July 1996. In carrying out its statutory functions, TRA is regulated by law, and is responsible for administering impartially various taxes of the Central Government.

Diagram 1: The structure of the Tanzania Revenue Authority



Test Yourself 1

State the four tax commissioners who report to the Deputy Commissioner General.

2. Identify the categories of income liable to tax.

[Learning Outcome b]

The government raises revenue from many different types of taxes for the year of income, irrespective of the source of tax. The main sources of income taxed within Tanzania are as follows:

(a) Income from employment
(b) Income from business
(c) Income from investments

Tax	Suffered by
Revenue taxes	
Income tax	Individuals Partnerships
Corporation tax	Companies
VAT	Final consumer
Capital taxes	
Capital gains tax	Individuals Partnerships (Companies pay corporation tax on their gains)

2.1 Chargeable Income

A taxable person can be both an entity and an individual. The tax year runs from 1st January to 31st December.

An entity can be:

(a) A trust
(b) Unincorporated body of persons or association
(c) Incorporated body of person or association

In case of partnerships, the partnership firm is not taxed; however, the individuals within the partnership who form the partnership (i.e. the partners) are taxed on their share of the income.

Income of a person for a year from income from employment, business or investment shall be:

For residents: the person's income from employment, business or investment for the year of income irrespective of the source of the income. They are taxed on their worldwide employment income.

For non:residents: the person's income from the employment, business or investment for the year of income, but only to the extent that the income has a source in Tanzania.

The income of a person who has been resident in Tanzania for a period of two years or less in total during the whole of the individual’s life will be calculated on the income from Tanzania only.

(a) Employment income includes the following:

(i) Wages, salary, payment in lieu of leave, fees, commissions, bonuses gratuity or any subsistence travelling entertainment or other allowance received in respect of employment or service rendered;

(ii) Payments received for providing any discharge or reimbursement of expenditure incurred by the individual or an associate of the individual;

(iii) Payments received for the individual's agreement to any conditions of the employment;

(iv) Retirement contributions and retirement payments received.

(v) Redundancy or loss or termination of employment compensation received.

(vi) Other payment made in respect of the employment including benefits in kind quantified in accordance with section 27

(b) Employment benefit and profits include the following:

(i) Exempt amounts and final withholding payments;

(ii) On premises, cafeteria services etc. that are available on a non:discriminatory basis;

(iii) Medical services, payment for medical services, and payments for insurance for medical services to the extent that the services or payments are :

- available with respect to medical treatment of the individual, spouse of the individual and up to four of their children; and

- made available by the employer (and any associate of the employer conducting a similar or related business) on a non-discriminatory basis;

(iv) Any subsistence, travelling, entertainment or other allowance that represents solely the reimbursement to the recipient of an amount expended by him wholly and exclusively in the production of his income from his employment or services rendered;

(v) Benefit derived from the use of motor vehicle where the employer does not claim any deduction or relief in relation to the ownership, maintenance, or operation of the vehicle;

(vi) Benefit derived from the use of residential premises by an employee of the Government or any institution whose budget is fully or substantially out of Government budget subvention;

(vii) Payment providing passage of the individual, spouse of the individual and up to four of their children to or from a place of employment which correspond to the actual travelling cost where the individual is domiciled more than 20 miles from the place of employment and is recruited or engaged for employment solely in the service of the employer at the place of employment;

(viii) Retirement contributions and retirement payments exempted under the Public Service Retirement Benefits Act, 1999.

Example

A restaurant waiter receives £2 as a tip from a customer. The employer does not **directly** pay this income. However, he has received this income as a **result** of his employment. This income is, therefore, taxable as employment income for the waiter.

Housing

	Tshs
Lower of: Market value rent of premises paid by employer **Higher of** 15% of employee's total annual income Expenditure claimed as deduction by employer of premises	X
Taxable benefit	**X**

Example

Honey is provided with living accommodation from 1 April 2012, which has a rateable value of Tshs 62,000. The employer pays rent of Tshs 74000 for the property annually. Honey's annual income is Tshs 85000 per annum towards the accommodation. The taxable benefits in 2012-13 are:

		£
Market value of rent of premises paid by employer = Tshs 62000 Higher of 15% of employee's annual income = Tshs 12750 Expenditure claimed as deduction by employer of premises = 74000	**lower**	62,000
Taxable benefit for living accommodation		**62,000**

Car

Taxed according to engine size and vehicle age on following annual values:

Engine size up to 5 years old > 5 years old

	Tshs	Tshs
<= 1,000 cc:	250,000	125,000
1,000 - 2,000 cc:	500,000	250,000
2,000 - 3,000 cc:	1,000,000	500,000
> 3000 cc:	1,500,000	750,000

Note: not chargeable where employer does not claim deduction in respect of the ownership, maintenance, or operation of the vehicle.

Loans

Excess of "statutory rate" over actual interest rate paid

Donations

An employee who makes donation according to Section 12 of the Tanzanian Education Fund Act, such donation is exempt from tax. But such exemption is upon approval by the Commissioner.

Others

The market value will apply in determining other benefits in kind.

Example

Pearl worked for three companies during the tax year 2012-13. In this situation, separate calculations of earnings and deductions are required. Her net earnings from all these companies are to be calculated as follows:

Particulars	**Company A Tshs**	**Company B Tshs**	**Company C Tshs**
Period of work	10 April 2012 to 15 June 2012	7 July 2012 to 5 December 2012	25 December 2012 to 15 March 2013
Total earnings	12,500	16,200	14,800
Less: Deductions			
Donations to charity made under the payroll deduction scheme operated by the employer	(3100)	(1800)	-
Contribution to approved pension scheme	(450)	-	(650)
Net earnings	**8,950**	**14,400**	**14,150**

(c) Business income includes the following:

Service fees
Incomings from trading stock
Gains from the realisation of business assets or liabilities of the business
Amounts required to be included on the realisation of the person's depreciable assets of the business;
Amounts derived as consideration for accepting a restriction on the capacity to conduct the business;
Gifts and other ex gratia payments received by the person in respect of the business.

The following business income is excluded from a person’s gains or profits from conduction of a business:

exempt amounts and final withholding payments
amounts that are included in calculating the person's income from any employment.

In order to ascertain the taxable trading profits for an accounting period, the net profit shown in the income statement must be adjusted as the accounting conventions are different from the rules of taxation.
Adjustments to profits shown in the financial accounts would include:

1. **Add:** adding back depreciation, client entertaining, etc. which **are not allowable for tax purposes.**

AND

2. **Deduct:** deducting capital allowances, (which **are allowable for tax purposes).**

Tip

Capital allowances are a statutory form of depreciation giving relief on capital purchases.

After making these adjustments, we arrive at the trading profit for tax purposes.

Allowable expenses

- Interest incurred under debt obligation
- Trading stock
- Repair and maintenance expenditure
- Agricultural improvement , research and development and environmental expenditure
- Gifts to public and charitable institutions
- Depreciation
- Losses on realisation of business assets and liabilities and
- Losses from a business or investment

Disallowable expenses

- Capital expenditure
- Consumption expenditure (drawings)
- Income tax or tax of a similar nature paid under the income tax act
- Bribes and expenditure incurred in corrupt practice
- Fines and similar penalties for breach of law
- Expenditure incurred in deriving exempt amounts or final withholding payments
- Distributions by an entity
- Pension payments, annuity premiums and contributions to pension and provident schemes and funds
- Interest payments by an exempt, controlled company are disallowed to the extent that they exceed the sum of interest income plus 70% of total income excluding interest

The business income calculation

	Tshs
Net profit per accounts	X
Add: Expenditure not allowable	X
Less: Income not taxable as business income	(X)
Adjusted profits before capital allowances	**X**
Less: Capital allowances on plant and machinery	(X)
Capital allowances on industrial buildings	(X)
Adjusted profits after capital allowances	**X**

Capital Allowances

Initial allowance of 50% for plant and machinery used in manufacturing processes and are fixed in factories, fish farming, hotels or tourist companies.

No.	Qualifying expenditure	Rate of Depreciation	Method
1	Computers and data handling equipment with peripheral devices, automobiles, buses with seating capacity of less than 30 passengers, goods vehicles of less than 7 tonnes loading capacity, construction and earthmoving equipment	37.50%	Reducing balance
2	Buses with more than 30 passenger seating capacity, heavy purpose trucks, trailers, containers etc., plant and machinery and other irrigation installations and equipment	25%	Reducing balance
3	Office furniture, fixtures and equipment	12.50%	Reducing balance
4	Natural resource exploration and production rights and assets of natural resource prospecting exploration and development expenditure	20%	Straight line
5	Buildings structures, dams water reservoirs, fences and other permanent structures for agriculture and live stock	20%	Straight line
6	Buildings structures and similar works of a permanent nature other than the above	5%	Straight line
7	Intangible assets	*	
8	Plant and machinery	100%	Straight line
	* Divided by the useful life of the asset in the pool and rounded down to the nearest half year		

The sale proceeds of disposal are deducted from the relevant pool

The depreciable value for non-commercial vehicles is restricted to Tshs 15,000,000

Annual allowances are computed as follows:

- Residue or written down value brought forward from previous year

- Add: Cost of additions in the current year
- Less: Sale proceeds of disposals of the current year
- Less: Allowance at appropriate percentage

- Written down value carried forward for next year

A balancing charge will arise where the current year's sale proceeds for any pool exceeds the written down value brought forward together with the cost of current additions. A balancing allowance or charge arises on cessation of business and the disposal of all the assets in any pool.

Tax losses

There is no time limit on the carry forward of tax losses. The losses of a company are subject to the going concern and ownership of the business.

Losses are restricted to the following:

- Foreign source losses from investment can be offset only against foreign source investment income.
- Other losses from investment income can be offset against investment income
- Other foreign source losses can be offset from foreign source income
- Losses from an agricultural business can be offset against agricultural income
- If a corporate is making tax losses for three consecutive years, then an alternative minimum tax (AMT) is charged at a rate of 0.3% of gross turnover of the corporate.

Pro forma for calculation of adjusted profit		**Tshs**
	Net trading profits per accounts	X
Add:	**(I) Expenditure shown in the accounts but not deductible for tax purposes**	
	Customer entertaining	X
	Purchases of asset (capital expenditure)	X
	Increases in general provision	X
	(II) Trading income taxable but not included in the accounts	
	Goods taken for own consumption (at market value)	X
Less:	**(I) Expenditure deductible for tax purposes but not shown in the accounts**	
	Business use of private telephone	(X)
	Short term lease premium paid by the trader	(X)
	(II) Income included in the accounts but not taxable as trading income	
	Dividends	(X)
	Property income	(X)
	Adjusted profit before capital allowances	**X**

These are only some of the examples and not an exhaustive list of adjustments.

Tip

Remember, you start with **net trading profits** per accounts, not gross profits.

The general rule is that only **expenditure which is wholly and exclusively for the purposes of trade is allowable.**

Example

Income tax paid by a trader is not allowed as it does not relate to the trade. It is a personal expense of the person carrying on the trade.

Tip

As a general rule, expenditure incurred wholly and exclusively for the purposes of trade is allowable, and expenditure, which does not relate to the trade, is not allowable.

Test Yourself 2

Nick runs a restaurant. His income statement for the year ended 31 March 2013 is as follows:

	Tshs	Tshs
Gross profit		27,430
Expenses		
Salaries	6,300	
Depreciation	2,500	
Bad debts written off	180	
Legal fees relating to the purchase of a new restaurant	350	
Increase in general provision	50	(9,380)
Net profit before taxation		**18,050**

Required:

Compute the trading profit for tax purposes.

(d) Investment income includes the following:

A person's income from an investment for a year of income is the person's gains or profits from conducting the investment for the year of income.

- Any dividend distribution of a trust
- Gains of an insured from life insurance
- Gains from an interest in an unapproved retirement fund
- Interest
- Natural resource payment
- Rent
- Retirement payment paid by an approved retirement fund or royalty
- Net gains from the realisation of investment assets of the investment
- Amounts derived as consideration for accepting a restriction on the capacity to conduct the investment

Dividends from Tanzania shares are deemed to be received **net of a 10% tax credit. Therefore any dividend received needs to be grossed up by 100/90 for inclusion in income tax computation.**

Example

You receive Tshs 180 as dividend from a UK company. Dividends are received net of a 10% tax credit. To find the gross amount of the dividend, multiply the net amount by 100/90.

In this case, the gross dividend is 180 x 100/90 = Tshs 200, which is the amount entered into the income tax computation, with a tax credit of Tshs 20 (Tshs 200 - £180).

The following investment income is excluded from a person's gains from investment

- Exempt amounts and final withholding payments; and
- Amounts that is included in calculating the person's income from any employment or business.

Test Yourself 3

John Smith has the following income and payments for the tax year 2012-13.

- Salary Tshs 32,500 (gross; PAYE deducted of Tshs 2,500)
- Bank interest Tshs 2,400 (net)
- Building society interest Tshs 800 (net)
- Interest paid on loan for qualifying purposes Tshs 2,000 (net)

Required:

Compute his total income for 2012-13.

(e) Pension funds

- Interest received from an unapproved retirement fund is exempt in case the payment is made by a retirement fund.
- Interest received from a non-resident retirement fund is taxable income at source.
- Employee and employer's contributions to approved pension or provident funds are deductible from employment income to the amount of the prescribed limits given in the Income Tax Act as below:
- Actual contributions paid or
- The statutory amount

In order to function effectively, the tax system divides taxes into the following two types:

1. direct taxes
2. indirect taxes

2.2 Direct taxes are either deducted at source or paid directly to the tax authorities**. They are:**

Tax on income or capital.
Tax imposed directly on taxpayers (individual / company).

Direct taxes can be progressive i.e. the more you earn, the higher rate you pay.

Examples

- Income tax
- Corporation tax
- National insurance contributions

(a) Income tax

It is a tax levied on the income of an individual.

Income can be from any sources such as:

(i) income from earnings (e.g. employment income / trade profit)
(ii) income from pensions
(iii) income from other benefits (e.g. rental income)
(iv) income from savings (e.g. interest income)
(v) income from investments (e.g. dividend income)

Income tax is calculated on earned income, i.e. from employment, and unearned income, i.e. income from savings. Income from various sources is pooled together and tax is charged on the aggregate income after deducting the relevant personal allowance. Taxpayers, who are employed, pay income tax on their earnings under the statutory Pay As You Earn (PAYE) scheme.

(b) Corporation tax

It is the tax payable by companies on their 'chargeable profits'. There are numerous provisions relating to corporation taxes.

(c) Capital Gains Tax

When a person sells an asset that is in his / her possession, the profit arising from such sale is chargeable to tax as capital gains.

Therefore, capital gains tax liability arises when a 'chargeable person' makes a chargeable disposal of a chargeable asset.

Example

Adam sells his business asset at a profit of Tshs5,000. So, the amount of profit i.e. Tshs5,000 is chargeable to capital gains tax.

2.3 Indirect taxes are charged **when a taxpayer buys an item, and are paid to the vendor as part of the purchase price. The vendor in turn passes the tax element on to the government, acting as a collector of tax.**

- Tax on what people spend, rather than on what they earn.
- People with low incomes pay a higher proportion of their income on indirect taxes than wealthier people.
- Example: VAT, stamp duty, duties levied on tobacco, alcohol and petrol.

(a) VAT

VAT is Value Added Tax. It is the tax which is paid on the value added. This tax is levied at each stage of production. VAT is a consumption tax paid by customers in addition to the price of the product.

(b) Excise duty

Is the tax levied on some specified goods where the government wants to control its consumption or import, for example cigarettes, wine, petrol etc.

(c) Import duty

One of the main objectives of the economic policy of the government is to maintain the balance of equilibrium. Therefore to control imports, the government levies a tax on imports which is called import duty.

(d) Stamp and Transfer Duty

Stamp duty is levied on a wide range of instruments and documents. The rates of duty vary according to the nature of the instrument or document.

(e) Other Taxes

Skills & Development Levy - 6% of gross cash remuneration, except for farm workers. This is an employer tax.
Excise duty on a range of goods and services such as tobacco, alcohol, petroleum products, motor vehicles, carbonated drinks, mobile phone airtime and satellite television services.

Test Yourself 4

The main taxes payable in Tanzania are from:

A Income from employment
B Income from business
C Income from investments
D All of the above

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3. Describe the concept of total income.

[Learning Outcome c]

3.1 Calculation of the income tax base

Income tax is a tax on the earnings or income of individuals which they receive in different ways from different sources. Not all the income is taxable. Individuals are taxed only on 'taxable income' above a certain level. Income tax assessments of a taxpayer are computed for a tax year, taking into consideration his aggregate income for that year from all sources, and ignoring any income which is exempt from tax. Some basic concepts are as follows:

1. All adults and children are charged to income tax if they receive sufficient income to pay tax.

2. They are liable to income tax on their taxable income in a tax year.

3. Taxable income is made up of:

   - income from all sources i.e. employment income, business income, investment income and gains
   - payments that are tax deductible

3.2 Exemption from tax

The Minister may, by order in the Gazette, provide - that any income or class of incomes accrued in or derived from the United Republic shall be exempt from tax to the extent specified in such order.

3.3 Deductions

(a) All expenditure incurred during the year of income, by the person wholly and exclusively in the production of income from the business or investment.

(b) Interest incurred by a person during a year of income under a debt obligation shall be incurred wholly and exclusively in the production of income from a business or investment.

(c) Allowance on trading stock of the business

(Opening value of the trading stock + (Expenditure included in the cost of trading stock) – (Closing value of trading stock)

(d) Repair or maintenance of depreciable assets

(e) Agricultural improvement, research and development and environmental expenditure

(f) Depreciation of assets

(g) Debt obligation for business

(h) Any unrelieved loss of the year of income of the person from any other business or investment;

(i) Any unrelieved loss of a previous year of income of the person from any business or investment.

(j) Foreign source loss from an investment

No deduction is allowed for expenditure:

- of a capital nature
- for bribes or corrupt practice
- for penalties and fines

3.4 Deductions under Section 16

- Contributions made to charitable organisations or social development projects

- Any donation made under section 12 of the Education Fund Act, 2001.

3.5 Total Income

Total income therefore is the outcome of all the earned income from employment, business and investment after all the allowable deductions

Calculation of income tax payable	**Tshs**
Earned income	X
Investment income	X
Less: Payments that are tax deductible under sec (61) relating to retirement contributions to approved retirement funds.	(X)
Total Income	**X**
Less: Deductions and Exemptions	(X)
Taxable income	**X**
Income tax liability	**X**
Less: Tax suffered	(X)
Income tax payable	**X**

Tip

The income of a person for a year of income from any employment, business or investment shall be:

In the case of a resident person, the individual's income from employment, business or investment for the year of income, irrespective of the source of income

In the case of a non-resident person, the individual's income from the employment, business or investment for the year of income, but only to the extent that the income has a source in Tanzania.

The income tax shall be charged to every individual's total income during the year of income, and also repatriated income related to a PE or any person receiving final withholding payments during the year of income.

Test Yourself 3

Total income of an individual or entity is:

A all the earned income from employment, business and investment after all the allowable deductions
B all the earned income from employment, business and investment less deductions under sec 61
C all the earned income from employment less exemptions
D all the earned income from employment, business and investment after all the allowable deductions and exemptions.

4. Identify types of assessment under the Income Tax Act 2004.

[Learning Outcome d]

4.1 Self-Assessment

1. **Where an entity files a return for a year of income**, the assessment is treated as made on the due date of filing the return of:

- Income tax payable by the entity for the year of income for the amount shown in the return.
- The amount of that tax still to be paid for the year of income shown in the return (the "tax payable on the assessment").

2. **Where an entity fails or is not required to file a return of income for a year of income** then, until such time as a return shall be filed, an assessment shall be treated as made on the due date for filing the return that:

- the income tax payable by the entity for the year of income shall be equal to the sum of any income tax withheld from payments derived by the entity during the year of income and any income tax paid by the person by instalment for the year of income
- there is no tax payable on the assessment.

3. **Where an individual files a return of income after the expiry of the time allowed for the filing of a return of income**, the Commissioner shall assess the tax as expeditiously as possible.

4. **Where an individual has filed a return of income**, the Commissioner may:

- accept such return and make assessment on the basis of the return, or
- if the Commissioner has reasonable cause to believe that such return is not true and correct, determine, according to the best of his judgement, the amount of the income of that individual and assess the tax accordingly.

5. **Where an individual has not filed a return for any year of income**, whether or not he has been required by the Commissioner to do so, and the Commissioner considers that, that individual has income chargeable tax for such year, the Commissioner may determine, according to the best of his judgement, the amount of the income of that individual and assess the tax accordingly

4.2 Jeopardy Assessments

1. **The rules of self-assessment would apply where, prior to the date of filing a return of income for a year of income:**

- a person becomes bankrupt, is wound-up or goes into liquidation
- a person is about to leave the United Republic indefinitely
- a person is otherwise about to cease activity in the United Republic
- the Commissioner otherwise considers it appropriate, the Commissioner may, by notice in writing served on the person, require the person to file, by the date specified in the notice, a return of income for the year of income or part of the year of income

2. **In the cases mentioned in (1) instead of requiring a person to file a return of income, the Commissioner may, according to the Commissioner's best judgement, make an assessment:**

- of the person's chargeable income for the year of income from each employment, business and investment and the source of that income;
- in the case of a domestic permanent establishment of a non-resident person, the permanent establishment's repatriated income for the year of income
- any income tax paid by the person for the year of income by withholding, instalment or assessment for
- which a tax credit is available
- the amount of income tax still to be paid for the year of income calculated as the sum of the tax referred to in subparagraphs (i) and (ii) less the tax already paid referred to in subparagraph (iii);
- the amount of income tax still to be paid for the year of income or part of the year of income (the "tax payable on the assessment")

3. **Where an assessment is made under (the "jeopardy assessment")**

- with respect to a full year of income, the assessed person shall not file a return of income for the year of income self- assessment
- with respect to a part of the year of income the assessed person will be required to file a return of income for the year of income as self-assessment

4. **Any income tax paid on a jeopardy assessment** for a part of the income shall be available as a tax credit against the tax payable on an assessment made for the full year of income

4.3 Adjusted Assessments

1. In Adjusted assessments, the Commissioner may adjust an assessment made under self-assessment, jeopardy assessment or adjusted assessment so as to adjust the assessed person's liability to tax, including any tax payable on the assessment, in such manner as, according to the Commissioner's best judgement and information reasonably available, shall be consistent with the intention of this Act.

2. The Commissioner may adjust an assessment within three years after –

- in the case of self-assessment the due date for filing the return of income to which the assessment relates; or
- in the case of jeopardy assessment, the date on which the notice of assessment is served on the person assessed as under notice of assessment.

3. The Commissioner may adjust an at any time

- in the case of self-assessment where the person assessed fails to file a return of income in accordance with self-assessment with the intent of evading or delaying the payment of tax; or
- in the case of an assessment that is inaccurate by reason of fraud by or on behalf of the assessed person.

4. The Commissioner may not adjust an amended assessment issued in accordance with the Tax Revenue Appeals Act, or an assessment to the extent that the assessment has been adjusted or reduced pursuant to an order of a court of competent jurisdiction unless the assessment or order is vacated.

5. An assessment ceases to have effect to the extent to which it is adjusted in accordance with the Adjusted Assessments.

4.4 Notice of Assessment

Where the Commissioner makes an assessment under jeopardy assessment or adjusted assessment, the Commissioner shall serve a written notice of the assessment on the person stating

- the Commissioner's assessment of the income tax payable by the person employment income and business income for an income year and the tax payable on the assessment for the year of income or period to which the assessment relates;

- the manner in which the assessment referred to the above assessment is calculated;

- the reasons why the Commissioner has made the assessment;

- the date by which the tax payable on the assessment must be paid; and

- the time, place and manner of objecting to the assessment

5. Describe tax returns of income tax (their contents, frequency and due date).

[Learning Outcome e]

5.1 Due date and frequency of filing a tax return of income

Every person shall file a return of income for the year of income after the end of each year with the Commissioner not later than **six months** unless under the income tax act he is not required to file the return of income or there is a provision of time to file the return of income or where jeopardy assessment is required i.e. income for the part of the year.

The taxpayer must file the return in the period between 1st January and 30th June.

The statement of estimated tax payable

The statement of estimated tax payable is a provisional return which a taxpayer is required to complete and file to the Commissioner within three months from the beginning of the year of income (which for individuals shall be calendar year).

The taxpayer is supposed to pay the estimated tax in a maximum of four installments each falling due after three months. The due dates are as follows:

- On or before 31st March
- On or before 30th June
- On or before 30th September
- On or before 31st December

5.2 Content of tax return of income

The return form consists of seven pages and there are other supplementary pages for calculation of the following types of income and gains:

- Gains from realisation of shares and securities in a corporation
- Gains from realisation of assets excluding shares, securities or trading stock
- Repatriated income of an individual's domestic permanent establishment
- Income from general insurance business
- Income from life insurance business
- Income from mining operations

The tax return would generally cover the following:

1. A return of income of a person for a year of income shall be subject to any instructions by the Commissioner to the contrary: be in the manner and form prescribed specifying -

- the person's chargeable income for the year of income from each employment, business and investment and the source of that income

- the person's total income for the year of income and the income tax payable with respect to that income

- in the case of a domestic permanent establishment of a non-resident person, the permanent establishment's repatriated income for the year of income and the income tax payable with respect to that income

- any income tax paid by the person for the year of income by withholding, instalment or assessment for which a tax credit

- the amount of income tax still to be paid for the year of income calculated as the sum of the tax referred above less the tax already paid

2. in the case of a corporation, be prepared or certified by a certified public accountant in public practice

3. include declaration that the return is complete and accurate

4. should be signed by

- the person ; and
- a certified public accountant in public practice as may be required

5. have attached to it

- any withholding certificates supplied to the person with respect to payments derived by the person during the year of income
- any statement provided to the person that is certificate of estimation and returns prepared by a certified public accountant in public practice.

6. In case where a return is not required to be filed or a provision for late payment is made or in case of jeopardy assessment where prior to the date for filing a return of income for a year of income

- a person becomes bankrupt, is wound-up or goes into liquidation
- a person is about to leave the United Republic indefinitely
- a person is otherwise about to cease activity in the United Republic
- the Commissioner otherwise considers it appropriate, the Commissioner may, by notice in writing served on the person, require the person to file, by the date specified in the notice, a return of income for the year of income or part of the year of income

5.3 Return of income not required

Unless requested by the Commissioner by notice in writing served on the person and subject to a right of the person to elect to file a return, no return of income for a year of income shall be required under Sec 91 from:

1. A residential individual who has no income tax payable for the year of income from employment income, business income or investment income.

2. Whose income for the year of income consists exclusively of either or both of the following:

- income from any employment where the employer is required to withhold tax under section 81 from payments made to the individuals that are included in the calculation of the individuals income from the employment
- or capital gains

3. A non- resident person (other than one with a domestic permanent establishment) who has no income tax payable for the year of income or whose income tax payable for the year of income consists of exclusively capital gains

5.4 Provision of time to file return of income

1. A person who is required to file an estimate under section 89 or a return under section 91 makes a written application to the Commissioner by the due date for filing the estimate or return, the Commissioner:

- may, on such terms and conditions as the Commissioner thinks appropriate (including as to payment of security) and where reasonable cause is shown, extend the date by which the estimate or return is to be filed; and

- shall serve the person with written notice of the Commissioner's decision on the application

The commissioner may grant multiple extensions but the extensions in total may not exceed 60 days from the date the estimate or return was originally to be filed.

6. Identify the forms of payment of income tax (with holding, instalments).
[Learning Outcomes f and g]

1.1 Taxes payable by instalments

Normally, business and investor taxpayers are required to pay their taxes in instalments; and employees who are employed by non-resident employers are also required to pay their taxes in instalments because the employers are not required to withhold the taxes (Section 88(1)); unless permitted by the Commissioner of Domestic Revenue to not pay taxes by instalments (Section 89(7)).

The calculation of amount of the instalments starts with estimation of tax payable of a person at the start of the year.

The computation of tax payable requires that the taxpayer estimate his or her future gross income, deductible expenditures etc. and properly uses tax rates to determine it. Then, the taxpayer uses the formula given in the Income Tax Act 2004 to compute how much of the estimated tax payable should be paid in each instalment.

Generally, taxpayers might pay their tax liabilities in 4 instalments i.e. on or before the last day of the 3rd, 6th, 9th and 12th months of the year of income (Section 88(2)). However, when a taxpayer does not have an accounting period of 12 months, the instalments should be made every 3 months and the last one at the last day of the year (Section 88(2)).

Specifically, the amount of each instalment of income tax payable by an instalment payer for a year of income is calculated according to the following formula:

$$\frac{[A - C]}{B}$$

Where:

A is the estimated tax payable by the instalment payer for the year of income at the time of the instalment;
B is the number of instalments remaining for the year of income including the current instalment; and

C is the sum of any income tax paid during the year of income, but prior to the due date for payment of the instalment, by the person by previous instalment, single instalments and non-final withholding taxes (Section 88(3)).

However, taxpayers with estimated tax payable for a year of income of Tshs50,000 or less are not required to pay taxes in instalments (Section 88(4)).

Additionally, resident taxpayers engaged in agricultural business make no payments in the 1st and 2nd instalments but in the 3rd instalment pay 75% of estimated tax payable and the balance payable in the 4th instalment.

Therefore, when the estimated tax payable is accurately estimated, the final tax liabilities after deducting previously paid taxes by way of instalments and withholding may be small.

Example

Carter Ltd whose accounting period ends on 31 December each year estimated that in 2013 it was going to make a total income of Tshs20,000,000. After filing the statement of estimated tax payable on time and paying the first and second instalment, the company changed the estimated taxable income to Tshs30,000,000 and also paid non-final withholding taxes amount to Tshs1,000,000.

Required:

If the tax rate was 30%, estimate the amount that was paid in the 1st, 2nd, 3rd and 4th installment and state the due date of each instalment.

Answer

(i) The due date of the first installment will be on or before 31 March 2013 and tax payable along with filing the statement of estimated taxes would be Tshs, given by:

$$\frac{[A - C]}{B}$$

A is the estimated tax payable by the instalment payer for the year of income at the time of the instalment = Tshs6,000,000

B is the number of instalments remaining for the year of income including the current instalment = 4 instalments and

C is the sum of any income tax paid during the year of income, but prior to the due date for payment of the instalment, by the person by previous instalment, single instalments and non-final withholding taxes (Section 88(3)) = Nil

Therefore the instalment amount would be Tshs6,000,000/4 instalments= Tshs15,000,000.

(ii) In the second instalment

A = Tshs6,000,000,
B = 3 instalments
C = Tshs1,500,000; the amount paid in the first instalment

Therefore the amount of the second instalment would be (Tshs6,000,000 - Tshs1,500,000) / 3 instalments= Tshs1,500,000. The amount was payable on or before 30 June 2013.

(iii) After revision of the estimated amount the value of A = Tshs9,000,000, C = Tshs4,000,000 from (Tshs1,500,000 + Tshs1,500,000 + Tshs1,000,000) i.e. two instalments and taxes paid at the source, and value of B is 2 instalments. Therefore the amount of the third instalment was (Tshs9,000,000 - Tshs4,000,000)/2= Tshs2,500,000. The amount is payable on or before 30 September 2013.

(iv) While in the last instalment the value of A = Tshs9,000,000, value of B = 1 instalment and the value of C = Tshs6,500,000 (Tshs1,500,000 + Tshs1,500,000 + Tshs1,000,000 + 2,500,000). Therefore the amount of the last instalment would be (Tshs9,000,000 –Tshs6,500,000)/1= Tshs2,500,000 payable on or before 31 December 2013.

Test Yourself 6

Robots and Assembler Design Makers Ltd whose accounting period ends on 31 December each year estimated that in 2013 it was going to make a total income of Tshs20,000,000.

If after filing the statement of estimated tax payable on time and paying the first and second instalment, the company changed the estimated taxable income to Tshs10,000,000 and also paid non-final withholding taxes amounting to Tshs1,000,000.

Required:

If the tax rate was 30%, estimate the amount that were paid in the 1st, 2nd, 3rd and 4th instalment and state the due date of each instalment.

1.2 Payment of tax payable on assessment

Tax assessments involve calculating taxable income and application of tax rates on the taxable income to determine tax payable for the year and deduction of tax credit from tax payable for the year to determine tax payable on assessment.

Normally, there are three categories of assessments: self-assessment, jeopardy assessment and adjusted assessment.

Self- assessment occurs when taxpayers estimate their tax payable themselves or with the help of tax consultants and file return on income as required i.e. not later than 6 months after the end of each year of income (Section 91(1)).

However, even when an entity fails or is not required to file a return of income for a year of income then when a return is filed, an assessment is treated as made on the due date for filing the return (Section 94(2)). The tax payable shown in that return on income is known **as tax payable on the assessment** which is payable on the same day (Section 94(1)).

Example

Dinverto Ltd whose accounting period ends on 31 December each year estimated that in 2013 it was going to make a total income of Tshs20,000,000, and paid the estimated tax payable as required. Then, after the year end the actual taxable income turned out to be Tshs30,000,000 and the tax rate was 30%.

Required:

(a) Determine tax payable assessment.
(b) State the due date on payment of tax payable on assessment.

Answer

(a) Total taxes paid by way of instalment were Tshs6,000,000 while the correct amount was Tshs9,000,000. Therefore the tax payable on assessment would be Tshs3,000,000.

(b) Tax payable on assessment is payable at the same time when filing the return on income. The due date for payment of tax payable on assessment is on or before 30 June 2014.

1.3 Tax payable by withholding agents

It should be recalled that withholding taxes are taxes collected and paid to the TRA by payers, and not by recipients of the amount. These payers are collectively known as withholding agents. They are withholding agents because the burden of paying the taxes falls on the recipients of the amount, not them. The withholding agents include resident employers who make a payment that is to be included in calculating the chargeable income of an employee from the employment (Section 81(1)), resident payers of dividend, interest, natural resource payment, rent or royalty if these payments have sources from the United Republic (Section 82(1)).

Furthermore, a resident person who: in conducting a mining business pays a service fee to another person in respect of management or technical services provided wholly and exclusively for the business, pays to a non-resident an insurance premium with a source in the United Republic, pays to a resident or non-resident a service fee with a source in the United Republic; or pays money transfer commission to a money transfer agent, should withhold income taxes (Section 83(1)). Also, resident corporations whose budget is wholly or substantially financed by the Government budget subvention are required to withhold tax when making a payment in respect of goods supplied by a resident person in the course of conducting business (Section 83A). When withholding amounts are not withheld, the withholding agents or the withholdees are supposed to pay the taxes not withheld on due date (Section 84(4)). The withholding agents paying the amount that could have been withheld might recover the same from the withholdees (Section 84(7)).

However, payments made by individuals not doing business, interest paid to a resident financial institution, or payments that are exempt amounts or paid to an approved retirement fund, rent paid to a resident person for the use of an asset other than aircraft, land or buildings, and interest payable to a non-resident bank by a strategic investor except for interest payable on any loan taken by a strategic investor from an associated or related company are not subject to withholding taxes (Section 82(2) and Section 83(2)).

Example

Elite Ltd withheld taxes on employees' salaries, amounting to Tshs10 million on 3 January 2013 for December 2012 salaries, and on dividends amounting to Tshs8 million which were paid to shareholders on 28 February 2013.

Required:

State the due dates the withheld taxes should be paid to TRA

Answer

Income taxes withheld by withholding agents should be paid to TRA within 7 days after the end of each calendar month. Therefore the withholding taxes on salary will be due on 7 February 2013, within 7 days after the end of January 2013 and the due date for taxes on dividends will be on 7 March 2013, within 7 days after the end of February 2013.

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7. Identify taxes subject to withholding.

[Learning Outcomes f and g]

7.1 Withholding by employers

1. A resident employer who makes a payment that is to be included in calculating the chargeable income of an employee from the employment shall withhold income tax from the payment at the rate provided for in paragraph 4(a) of the First Schedule.

2. The obligation of an employer to withhold income tax shall not be reduced or extinguished:

- because the employer has a right or is under an obligation to deduct and withhold any other amount from the payment or
- because of any other law that provides that an employee's income from employment shall not be reduced or subject to attachment

7.2 Withholding from investment returns

1. A resident person who:

- pays a dividend, interest, natural resource payment, rent, royalty or, where the person is an approved retirement fund, a retirement payment to another person;

- the payment has a source in the United Republic and is not subject to withholding under section 81,

The person shall withhold income tax from the payment at the rate provided for in paragraph 4(b) of the First Schedule

2. Withholding shall not apply to

- payments made by individuals unless made in conducting a business;
- interest paid to a resident financial institution;
- payments that are exempt amounts or paid to an approved retirement fund.
- rent paid to a resident person for the use of an asset other than land or buildings

7.3 Withholding from service fees

1. a resident person who

- in conducting a mining business pays a service fee to another resident person in respect of technical services provided wholly and exclusively for the business; or
- pays a service fee or an insurance premium with a source in the United Republic to a non-resident person, shall withhold income tax from the payment at the rate provided for in paragraph 4(c) of the First Schedule

This section shall not apply to

- payments made by individuals unless made in conducting a business; or
- payments that are exempt amounts.

8. Perform basic income tax computations (identify applicable tax rates and calculate total income, business income, employment income and withholding taxes)

[Learning Outcome h]

8.1 Applicable tax rates

1. Individual Income Tax Rates:

Income Range (monthly)	Tax Rate (PAYE) Tshs%
0 – 170,000	Nil
170,000 – 360,000	13% of the amount in excess of Tshs. 170,000
360,000 – 540,000	Tshs 24,700 plus 20% of the amount in excess of Tshs 360,000
540,000 – 720,000	Tshs 60,700 plus 25% of the amount in excess of Tshs 540,000
720,000 and above	Tshs 105,700 plus 30% of the amount in excess of Tshs 720,000

2. Employment Taxes (Payroll Taxes)

	%
PAYE	See above
Social Security (NSSF, PPF) (up to half (10%) can be deducted from employee)	20
Skills and Development Levy (employer)	5

3. Presumptive Income tax for businesses

- For individuals with business turnover not exceeding Tshs 20,000,000=00 (Tanzanian Shillings Twenty Millions) Per Annum specific presumptive income tax rates apply.
- Where turnover exceeds Tshs. 20,000,000=00 (Tanzanian Shillings Twenty Millions) Per Annum the taxpayer is obliged to prepare audited financial statements in respect of his/her business.

Presumptive tax rates

Annual turnover compliance with section 80 of income tax	If financial statements/books of accounts have not compiled	If financial statements/books of accounts have been compiled
Where turnover does not exceed Tshs. 4,000,000	NIl	NIl
Where turnover is between Tshs. 4,000,000=00 and Tshs. 7,500,000=00	Tshs 100,000/=	2% of the turnover in excess of Tshs 4,000,000/=
Where turnover is between Tshs. 7,500,000=00 and Tshs11,500,000=00	Tshs 212,0000/=	Tshs 70,000/= plus 2.5% of the turnover in excess of Tshs7,500,000/=
Where turnover is between Tshs.11,500,000=00 and Tshs.16,000,000=00	Tshs 364,000/=	Tshs 170,000/= plus 3% of the turnover in excess of Tshs11,500,000/=
Where turnover is between Tshs. 16,000,000=00 and Tshs. 20,000,000=00	Tshs 575,000	Tshs 305,000/= plus 3.5% of the turnover in excess of Tshs16,000,000/=

4. Withholding taxes

	Resident %	Non-resident %
Dividend ➢ to company controlling 25% or more 5 n/a ➢ from DSE listed company 5 5 ➢ otherwise	 5 5 10	 n/a 5 10
Interest	10	10
➢ Rent ➢ Land and buildings ➢ Aircraft lease ➢ Other assets	 10 10 0	 15 15 15
Royalties	15	15
Natural resource payment	15	15
Service fees (all services) (taxpayers with/without TIN)	5	15
Technical services to mining companies	5	15
Insurance premium	0	5
Payments to persons by a resident corporation (whose budget is wholly or substantially financed by the government budget subvention) for goods supplied	2	15
Commission on money transfer through mobile phones	10	n/a
Transport (non-resident operator/charterer without permanent establishment)	n/a	5

Note:

1. Payment to non-resident person on rental charges of aircraft lease by a person engaged in air transport business is exempted;
2. Payment of withholding taxes should be within 7 days after the month of deduction; and
3. The submission of withholding tax statement is within 30 days after each 6 month period

8.2 Calculate total income, business income, employment income and withholding taxes

Example

Jane has employment income from 1 January 2013 to 30 June 2013 of Tshs 800,000; she had earned Tshs 100,000 for working overtime and housing allowance of Tshs 55,000. Jane made an NSSF contribution of Tshs76,950 and PAYE of Tshs 150,550. She was self employed from 1 June 2013 to 31 December 2013 and made a profit of Tshs 200,000. She also received dividends of Tshs 35,000.

Tax computation	Tshs	Tshs
Employment income		
Basic salary	800,000	
Overtime	100,000	
Housing allowance	55,000	
Gross Total Income		955,000
Less - Specific Deductions		
NSSF Employee Contribution (10% of gross)		(85,500)
Total Income		869,500
Less - PAYE		150,550
Taxable income from employment		718,950
Business income	200,000	
Investment income	35,000	
Total income		**953,950**

Answers to Test Yourself

Answer to TY 1

- Commissioner for large taxpayers
- Commissioner for domestic revenue
- Commissioner for custom and excise
- Commissioner for tax investigations

Answer to TY 2

	Tshs'000	Tshs'000
Net profits per accounts		18,050
Add: Expenditure shown in the accounts but not deductible for tax purpose		
Depreciation (note 1)	2,500	
Legal expenses relating to the purchase of a capital asset (note 2)	350	
Increase in general provision (note 3)	50	2,900
Adjusted trading profits for tax purposes		**20,950**

Notes

1. Depreciation is never allowable.

2. Legal expenses relate to a capital asset, and are not deductible.

3. Increase in general provision is not deductible.

Answer to TY 3

While calculating John's total income, ensure all his income has been grossed up.

John Smith's total income calculation for 2012-13 is as follows:

	Non savings	**Savings income**	**Total income**
	Tshs	**Tshs**	**Tshs**
Income from employment	32,500		32,500
Building society interest (£800 x 100/80)	-	1,000	1,000
Bank interest (£2,400 x 100/80)	-	3,000	3,000
	32,500	**4,000**	**36,500**
Less: Interest paid	-2,000		-2,000
Total Income	**30,500**	**4,000**	**34,500**

Note: the building society and bank interest received were Tshs800 and Tshs2,400 respectively. They have each been grossed up by multiplying by 100/80 to take account of the 20% tax withheld at source

Answer to TY 4

The correct option is **D**.

Answer to TY 5

The correct option is **B.**

Answer to TY 6

(a) The due date of the first installment will be on or before 31 March 2013 and tax payable along with filing the statement of estimated taxes would be given by:

$$\frac{[A-C]}{B}$$

Where **A** Tshs6,000,000, **B** 4 instalments and **C** Nil.

Therefore the first instalment amount would be 6,000,000/4= Tshs15,000,000

(b) In the second instalment the value A would be Tshs6,000,000, C, Tshs1,500,000 amount paid in the first instalment and value of B is 3 instalments. Therefore the amount of the second instalment would be (Tshs6,000,000 - Tshs1,500,000)/3= Tshs1,500,000. The amount was payable on or before 30 June 2013.

(c) After revision of the estimated amount value of A changed to Tshs3,000,000, C to Tshs4,000,000 from (Tshs1,500,000 + Tshs1,500,000 + Tshs1,000,000) i.e. two instalments and taxes paid at the source, and value of B is 2 instalments. Therefore the amount of third instalment was (Tshs3,000,000 - Tshs4,000,000)/2= (Tshs500,000). Therefore nothing will be payable on or before 30 September 2013.

(d) While in the last instalment the value of A would be Tshs3,000,000, value of B would be 1 instalment and the value of C would be Tshs4,000,000 from Tshs1,500,000 + Tshs1,500,000 + Tshs1,000,000. Therefore the amount of the last instalment would be (Tshs3,000,000 –Tshs4,000,000)/1= (Tshs500,000). Again nothing is payable on or before 31 December 2014.

Self Examination Questions

Question 1

There are two main types of tax.

(a) Give examples of each type of tax.

(10 marks)

(b) Give the advantages of each type of tax

(10 marks)
(Total 20 marks)
(Nov 2011)

Question 2

Based on the tax incentive policy of Tanzania, discuss:

(a) The key features of tax incentives and

(12 marks)

(b) Some policy considerations on investment allowances and tax credits.

(8 marks)
(Total 20 marks)
(Nov 2011)

Question 3

(a) Identify and briefly explain four (4) types of tax assessments.

(6 marks)

(b) Discuss four (4) non-revenue goals of taxation.

(8 marks)

(c) Briefly explain any four (4) deductions or expenditure which is not allowed when computing business income for tax purposes.

(6 marks)
(Total 20 marks)
(Nov 2012)

Answers to Self Examination Questions

Answer to SEQ 1

(a) In order to function effectively, the tax system divides taxes into the following two types:

1. direct taxes
2. indirect taxes

1. Direct Taxes are either deducted at source or paid directly to the tax authorities**.**

- Tax on income or capital.
- Tax imposed directly on taxpayers (individual / company).
- Direct taxes can be progressive i.e. the more you earn, the higher rate you pay.

Examples

- Income tax
- Corporation tax
- National insurance contributions

(i) Income tax

It is a tax levied on the income of an individual.

Income can be from any sources such as:

- income from earnings (e.g. employment income / trade profit)
- income from pensions
- income from other benefits (e.g. rental income)
- income from savings (e.g. interest income)
- income from investments (e.g. dividend income)

(ii) Corporation tax

There are numerous provisions relating to corporation taxes.

- Income from trading income
- Income from capital gains
- Income from investment income

(iii) Capital Gains Tax

When a person sells an asset that is in his / her possession, the profit arising from such sale is chargeable to tax as capital gains.

Therefore, capital gains tax liability arises when a 'chargeable person' makes a chargeable disposal of a chargeable asset.

2. **Indirect Taxes** are charged **when a taxpayer buys an item, and are paid to the vendor as part of the purchase price. The vendor in turn passes the tax element on to the government, acting as a collector of tax.**

- Tax on what people spend, rather than on what they earn.
- People with low incomes pay a higher proportion of their income on indirect taxes than wealthier people.
- Example: VAT, stamp duty, duties levied on tobacco, alcohol and petrol.

(i) VAT

VAT is Value Added Tax. It is the tax which is paid on the value added. This tax is levied at each stage of production. VAT is a consumption tax paid by customers in addition to the price of the product.

(ii) Excise duty

Is the tax levied on some specified goods where the government wants to control its consumption or import, for example cigarettes, wine, petrol etc.

(iii) Import duty

One of the main objectives of the economic policy of the government is to maintain the balance of equilibrium. Therefore to control imports, the government levies a tax on imports which is called import duty.

(iv) Stamp and Transfer Duty

Stamp duty is levied on a wide range of instruments and documents. The rates of duty vary according to the nature of the instrument or document.

(v) Other Taxes

Skills & Development Levy - 6% of gross cash remuneration, except for farm workers. This is an employer tax.
Excise duty on a range of goods and services such as tobacco, alcohol, petroleum products, motor vehicles, carbonated drinks, mobile phone airtime and satellite television services.

(b) Advantages

The Tanzania tax system has developed over the years as each successive government makes changes to the legislation to reflect its political objectives. The Tanzania tax system is managed by Tanzania Revenue Authority (TRA). These are officers appointed by the government to administer and collect taxes. They are charged with the responsibility of implementing and enforcing the legislation of the government.

The imposition of taxation by governments withdraws money from the economy, and their expenditure returns the money to the economy. The overall position of the Tanzania economy is affected by the tax policies and in turn will influence the success or failure of the country's economy.

The level of economic activity in Tanzania is affected by:

- the government's net position regarding taxation and expenditure; and
- public sector borrowing policies.

1. Economic purpose of taxation

The government used to change its taxation policies in response to short-term changes in, for example, levels of employment, imports and exports. This was not always effective, and the current government prefers to plan ahead over a longer term. It publishes a plan for its expenditure over the next three years. This plan shows the proportion of the economy's resources that will be left for the private sector to make decisions on, after the government has fulfilled its spending plans.

The government's spending plans will influence the demand for health and education, the demand for consumer goods is influenced by private spending. Changing levels of demand will affect employment and profitability.

The government imposes taxation policies to:

Encourage

a) saving by individuals
b) taking risks in investments by entrepreneurs
c) entrepreneurs building their own businesses
d) donations to charities
e) investment in industrial buildings (e.g. factories, warehouses)

Discourage

a) Too many vehicles motoring on the road to minimise pollution etc.
b) smoking and alcohol

A government does not intend taxes to be neutral but to encourage or discourage certain activities. The objectives will change over time and successive governments. Increasingly the Tanzania government tax policy is influenced by worldwide economic influences such as international defence policy and overseas aid.

2. Social purpose of taxation

Politicians use taxation policies to encourage social justice; however, there are many different ideas as to what constitutes social justice. The taxation system within the Tanzania would suggest that it operates on an equitable basis. The taxation policies are intended to redistribute income and wealth. In a bid to direct funds away from the rich and towards the poor, the Tanzania government adopts a process of redistributing wealth through its taxation policies. This is the 'Robin Hood Principle'.

There are various principles to consider when debating the social justice of taxation:

(a) The progressive / regressive principle

(i) Progressive: a tax such as the income tax demonstrates the progressive principle. As income rises so does the proportion of tax i.e. the rate of tax rises as well as the amount of tax. This can be considered as just and fair, as the higher tax payments are made by those with higher incomes. Taxes which take a higher percentage of the incomes of higher income earners are said to be progressive.

(ii) Regressive: as income rises, the proportion of tax decreases, e.g. the tax on a packet of cigarettes remains the same, regardless of the income of the consumer. Regressive taxes can be justified as smokers are likely to require additional hospital care, which is the reason why they should contribute towards the cost of it. Taxes which take a higher proportion of the incomes from lower income earners are said to be regressive.

(b) The income / capital / expenditure principle

(i) Income: tax on income is just, because it is only paid by people who have higher income. People who have very low incomes can be taken out of the tax net by the use of personal allowances and effective tax rates.

(ii) Capital: tax on capital is just, as it ensures that people are not avoiding tax by having no income and living off the disposal of capital assets.

(iii) Expenditure: tax on expenditure is just, because it is only incurred by those who spend, not those who save.

(c) The ability to pay / benefit principle

(i) Ability to pay: tax is only paid by people who have the income to pay.

(ii) Benefit: people should only contribute to those types of government expenditure from which they are going to benefit.

3. Environmental concerns

A specific use of taxation in influencing behaviour is in relation to the environment. These are commonly referred to as "Green Taxes". Currently there are environmental concerns about renewable and non-renewable energy and global warming.

It is considered unlikely that individuals will contribute voluntarily to protect the environment as they are unlikely to be affected in their lifetime by the changes taking place. As a result, the government aims to protect the environment through taxation and spending policies.

These policies include:

(a) Taxation on vehicles and fuel provided by companies: taxable benefits are based on the CO_2 emission.
(b) Climate change levy which relates to the proportion of energy consumed by businesses.
(c) Landfill tax charged on operators of landfill sites to encourage recycling.

Tax policies are formulated with an aim to increase government revenues. They are framed on the basis of clear principles such as:

(i) savings and investments
(ii) fairness
(iii) equality
(iv) enhancing work efficiency

Answer to SEQ 2

(a) A deduction, exclusion or exemption from a tax liability offered as an encouragement to engage in a speci ed activity such as investment in capital goods for a certain period is an incentive. Corporate income tax holidays and reductions are tax incentives are the scal form of investment incentives in tax rates.

Government grants, loans and guarantees for specific projects, direct subsidies are non- scal or non-tax incentives

Tax incentives are granted to attract money from foreign investments and/or promote speci c economic policies, such as to encourage investment in certain sectors

Features of tax incentive

1. Tax incentives must be simple to administer and should be free from the influence of ministers
2. They must be economically beneficial in the public interest
3. There should not be many tax incentives to attract and retain FDIs especially to the mining sector which could result in losses
4. Provide tax expenditure analysis to the public yearly to show government expenditure on tax incentives and the beneficiaries of such tax exemptions
5. The tax incentives must be harmonised between TIC and TRA and other government agencies
6. The exemptions must be limited to 5% of the total collected revenues
7. Do not give exemptions to companies that are financially good to pay taxes.

Tax incentives for mining companies

Mining companies enjoy various tax incentives and exemptions These include:

1. **Zero import duty on fuel** (compared to the standard current levy of T.Shs 200 per litre)
2. **Zero import duty on mining-related equipment** till the end of the rst year of production and thereafter 5%
3. **Exemption from capital gains tax** (unlike other companies in Tanzania),
4. **Special VAT relief**, which includes exemption from VAT on imports and local supplies of goods and services to mining companies and their subcontractors
5. **Offset cost of capital equipment against taxable income** (such as machinery or property) incurred in a mining operation.
6. **Reduced rate of stamp duty** at 0.3% as against the statutory rate of 4%
7. **Maximum payment of taxes is only upto $200,000 a year** lower than the 0.3% of turnover as against to the statutory requirement by tax law.
8. **Depreciation allowances** for depreciable assets (which is equal to the amount of total capital expenditure i.e. 100% depreciation allowance) in the year of expenditure. This can be carried forward.
9. **Import and excise duty for mining equipment** at 0% during exploration and mine development for the first year of commercial operation, and thereafter 5% applies

Other incentives are

- **Strategic investors** businesses investing more than $20 million gain ‘Strategic Investor Status’. As they have a great impact to the society or economy can apply for ‘special’ incentives from the Government’ like special concessions to individual companies

- **Newly-listed companies** on the Dar es salaam Stock Exchange (DSE) with 30% of shares issued to the public pay only 25% corporate income tax as against 30% for the first three years. They also are exempted from paying capital gains tax.

- **VAT exempted items** include insurance, education, nancial services and tourist services.

(b) Some policy considerations on investment allowances and tax credits

TRA has identified a long list of disadvantages of giving tax incentives; some are:

- Result in a loss of current and future tax revenue;
- Creates differences in effective tax rates
- Requires large administrative resources;
- Results in rent-seeking and other undesirable activities;
- Income tax holidays are ineffective way of promoting investment companies that are not pro table in the early years of operation;
- Attracts mainly footloose rms.
- Tax holidays strongly favour transitory rather than sustainable investments and create glaring opportunities for aggressive tax avoidance.

Thus, where governance is poor, corporate income tax exemptions ‘may do little to attract investment’ and when they do, ‘this may well be at the expense of domestic investment’.

Tax incentives are also prone to abuse when the incentive is exhausted and the promoters of the business fraudulently wind it down and simultaneously establish another entity to be accorded the same tax incentives.

The government recognises that tax exemptions entail a large revenue loss and is taking some steps to reduce them.

The government must raise taxes on mining companies. It should also call for withholding taxes on interest paid on foreign currency loans; limits on the deductibility of debt nancing for income taxes; and a tightening of provisions for investment allowances for exploration and development

Answer to SEQ 3

(a) The four types of assessment in Tanzania are:

1. Self-Assessments

Where an entity files a return for a year of income, the assessment is treated as made on the due date of filing the return of:

- Income tax payable by the entity for the year of income for the amount shown in the return.
- The amount of that tax still to be paid for the year of income shown in the return (the "tax payable on the assessment").

2. Jeopardy Assessments

Where prior to the date for filing a return of income for a year of income when

- a person becomes bankrupt, is wound-up or goes into liquidation
- a person is about to leave the United Republic indefinitely
- a person is otherwise about to cease activity in the United Republic
- the Commissioner otherwise considers it appropriate, the Commissioner may, by notice in writing served on the person, require the person to file, by the date specified in the notice, a return of income for the year of income or part of the year of income

In such cases the same rules of self- assessment would apply

3. Adjusted Assessments

In Adjusted assessments, the Commissioner may adjust an assessment made under self-assessment, jeopardy assessment or adjusted assessment so as to adjust the assessed person's liability to tax, including any tax payable on the assessment, in such manner as, according to the Commissioner's best judgement and information reasonably available, shall be consistent with the intention of this Act.

4. Notice of Assessment

Where the Commissioner makes an assessment under jeopardy assessment or adjusted assessment, the Commissioner shall serve a written notice of the assessment on the person stating:

- the Commissioner's assessment of the income tax payable by the person employment income and business income for an income year and the tax payable on the assessment for the year of income or period to which the assessment relates;

- the manner in which the assessment referred to the above assessment is calculated;

- the reasons why the Commissioner has made the assessment;

- the date by which the tax payable on the assessment must be paid; and

- the time, place and manner of objecting to the assessment.

(c) Non revenue goal of taxation

Economic Goal

Encourages

a) saving by individuals
b) taking risks in investments by entrepreneurs
c) entrepreneurs building their own businesses
d) donations to charities
e) investment in industrial buildings (e.g. factories, warehouses)

Discourages

a) Too many vehicles motoring on the road to minimise pollution etc.
b) smoking and alcohol

Social Goal

Politicians use taxation policies to encourage social justice; however, there are many different ideas as to what constitutes social justice. The taxation system within Tanzania would suggest that it operates on an equitable basis. The taxation policies are intended to redistribute income and wealth. In a bid to direct funds away from the rich and towards the poor, the Tanzania government adopts a process of redistributing wealth through its taxation policies. This is the Robin Hood Principle.

Environmental Goal

A specific use of taxation in influencing behaviour is in relation to the environment. These are commonly referred to as “Green Taxes”. Currently there are environmental concerns about renewable and non-renewable energy and global warming.

It is considered unlikely that individuals will contribute voluntarily to protect the environment as they are unlikely to be affected in their lifetime by the changes taking place. As a result, the government aims to protect the environment through taxation and spending policies.

These policies include:

a) Taxation on vehicles and fuel provided by companies: taxable benefits are based on the CO_2 emission.
b) Climate change levy which relates to the proportion of energy consumed by businesses.
c) Landfill tax charged on operators of landfill sites to encourage recycling.

Four (4) deductions or expenditure which is not allowed when computing business income for tax purposes:

1. Capital expenditure
2. Consumption expenditure
3. Bribes and expenditure incurred in corrupt practice
4. Fines and similar penalties for breach of law

STUDY GUIDE E4: INTRODUCTION TO INDIRECT TAXES

Get Through Intro

VAT is an indirect tax that you pay when you buy goods and services. Where VAT is payable, it is normally included in the price of the goods or services you buy. However, some goods do not attract VAT.

'Value added tax' (VAT) is an important topic of your syllabus; therefore it is essential that you devote considerable time to this topic.

You will learn about the concept of VAT, all the formalities of VAT registration, calculation of VAT liabilities and payments, filing of VAT returns, assessments and the effect of special accounting schemes.

Proper tax planning requires an in-depth knowledge of all the rules and provisions of income tax as well as the VAT Act.

As the taxation consultant of possibly a big group of companies, you will have to be armed with complete, up-to-date knowledge of the scope, applicability and requirements of VAT.

A thorough learning of this Study Guide will enable you to acquire knowledge which will help you in your exams as well as in your professional life as a tax consultant.

Learning Outcomes

a) Identify the type of indirect taxes administered in Tanzania (local value added tax and Excise Taxes; Import duty and excise duty, and VAT on imports).
b) Explain the nature of value added tax (VAT) (nature of VAT, taxable persons, taxable supplies, the concepts of exemption and zero-rating).
c) Describe tax returns for VAT (their contents, frequency and due date).
d) Explain the nature of excise taxes on domestic goods (type of goods taxed, advalorem vs. specific taxes).
e) Perform basic VAT computations (output VAT, Input VAT and VAT payable).
f) Calculate import duty, excise duty and VAT on imports.

1. Identify the type of indirect taxes administered in Tanzania (local value added tax and excise taxes; import duty and excise duty, and VAT on imports).
Explain the nature of excise taxes on domestic goods (type of goods taxed, advalorem vs. specific taxes).

[Learning Outcome a & d]

The various indirect taxes administered in Tanzania are:

1. Local value added tax (VAT)

VAT is a consumption tax charged on taxable goods and services whenever value is added at each stage of production and at the final stage of sale. The VAT shall be charged on any supply of goods or services in Mainland Tanzania where it is a taxable supply made by a taxable person in the course of any business carried on by him.

2. Excise duty

Excise duty is a duty charged on specific goods and services manufactured locally or imported, at varying rates. It is charged at both specific and ad valorem rates..

Items charged under specific rates include wine, spirits, beer, soft drinks, mineral water, fruit juices, Recorded DVD,VCD,CD and audio tapes, cigarettes, tobacco, petroleum products, natural gas and telecommunication sim cards.

Items charged under ad-valorem rates include money transfer services, electronic communication services, pay to view television services, imported furniture, motor vehicles, plastic bags, specified aircrafts, firearms, specified cases, cosmetics and medicaments.

Ad-valorem rates are: 0%, 0.15%, 5%, 10%, 14.5%, 15%, 20%, 25% and 50%.

3. Import duty

Import duty is a tax levied on goods which are being brought into the country.

4. VAT on imports

Any taxable goods or services that are imported into Tanzania from any place outside Mainland Tanzania shall be charged to VAT. All the importers, whether registered for VAT or not, must pay VAT on goods imported by them in Tanzania. However, the VAT registered importers can claim the VAT paid on the imported goods or services as an input tax.

Test Yourself 1

State whether following statement is true or false.

VAT is a direct tax.

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2. Explain the nature of value added tax (VAT) (nature of VAT, taxable persons, taxable supplies, the concepts of exemption and zero-rating).
Perform basic VAT computations (output VAT, input VAT and VAT payable).

[Learning Outcome b & e]

2.1 Value added tax (VAT)

Value added tax is an indirect tax which means that it is charged on turnover, not profits.

The basic principle of VAT is that tax should be charged at each stage of manufacturing / production as well as at each stage of the whole distribution chain.

The total tax due is ultimately borne by the final consumer of the product i.e. the manufacturer recovers it from the consumer.

The name itself suggests that it is a tax on the value addition put into the process. The final consumer does not "add value" but consumes the final goods or service, therefore the consumer absorbs the charge to tax.

The scope of VAT

- VAT is charged on the **supply of taxable** goods and services by a **taxable person** in the course of a business run by him.
- VAT is an **indirect tax** in that it is charged **on turnover, not profits**.
- VAT is charged on the consumption of goods and services by the **final consumer**.
- **At each stage** of the manufacturing process, a **trader adds VAT to his sales** (output VAT), and acts as a collector of taxes for TRA.
- Each **supplier receives credit for any VAT** he pays **on his purchases** (input VAT).
- The **supplier pays TRA the difference between the VAT charged and the VAT suffered,** so the supplier does **not suffer VAT** himself.
- The **final consumer suffers the total tax**.
- The VAT on a taxable supply of goods or services shall be **payable by a taxable person at the end of a prescribed accounting period** or at any time which the Commissioner may prescribe**.**

Example

Tasty Ltd manufactures chocolates. The selling price of the chocolates is Tshs60,000 per packet plus VAT. The cost of the raw materials required to make 1 packet of chocolates is Tshs20,000 plus VAT of 18%. Mega Ltd is a wholesaler of chocolates. It buys chocolates from Tasty Ltd, wraps them in attractive packaging, and thus adds some value to it.

These chocolates are then sold to various retail outlets for Tshs100,000 per kg plus VAT. The retail outlets sell the chocolates at Tshs120,000 per kg plus VAT. Let's see how VAT is accounted for to TRA at each stage of manufacturing. Ultimately, the final customer will bear the VAT.

	Input		**Output**			
	Cost Tshs	**VAT @18%**	**Net Sales Tshs**	**VAT on sales @18%**	**VAT payable to TRA Tshs**	
Manufacturer	20,000	3,600	60,000	10,800	7,200	(10,800 – 3,600)
Wholesaler	60,000	10,800	100,000	18,000	7,200	(18,000 – 10,800)
Retailer	100,000	18,000	120,000	21,600	3,600	(21,600 – 18,000)

Notice that each of the businesses (manufacturer, wholesaler and retailer) in the chain only account for VAT on the value they are adding. Remember, in accounting for VAT you will have debited the input VAT on purchases to the VAT account while the purchases account has been debited with the purchase value. Similarly, the output VAT on sales is credited to VAT account and the sales account is credited only with the sales value.

The final customers are unable to reclaim the VAT that they have paid (Tshs21, 600). They suffer the VAT.

2.2 Taxable person

A taxable person is a **person making taxable supplies** who **is, or is required** to be, **registered for VAT.**

A person **can be an individual, partnership, limited company, association, charity or club.**

Any person conducting a business **whose taxable turnover exceeds or is likely to exceed TSHS 40 million in a period of 12 consecutive months or TSHS 10 million in a period of 3 consecutive months** is obliged to register as a taxable person.

The application for VAT registration must be made by such person within a period of thirty days of becoming liable to make such application. The taxable person is also required to buy Electronic Fiscal Device (EFD) machine and put into use.

However, where the Commissioner is satisfied that there is good reason to do so, on grounds of national economic interest or for the protection of the revenue, he may register any person, whether or not an application to be registered has been made and regardless of the taxable turnover of the person.

2.3 Taxable supplies

A taxable supply is a supply of goods or services (other than an exempt supply) made in mainland Tanzania. A taxable supply is usually either standard rated or zero rated.

1. Standard-rated e.g. supplies of stationery or

2. Zero-rated e.g. supplies of books

(a) Standard-rated supplies

(i) Standard-rated supplies are **taxable at the rate of 18%**.

(ii) A trader who is registered for VA**T suffers VAT on the purchases (**inputs) which are standard-rat**ed**. The VAT suffered on the purchases is set off against t**h**e output VAT collected on sales at the standard rate. The excess amount collected is paid to TRA. If the amount suffered is greater than the amount collected, then a refund for the VAT suffered is received.

(b) Zero-rated supplies

(i) Zero-rated supplies are **taxable at 0%**

(ii) A trader whose supplies (output) are zero-rated but whose purchases (inputs) are standard rated will **receive a refund for the VAT suffered** on them.

Some examples of zero-rated supplies are:

- supply of goods, including food and beverages, for consumption or duty free sale on aircraft or ships on journeys to destination outside the United Republic of Tanzania
- supply of services which comprise the handling, parking, salvage or towage of any foreign going ship or aircraft while in Tanzania Mainland
- supply of services which comprise the repair, maintenance, insuring, broking or management of any foreign going ship or aircraft
- supply of agricultural produce intended for export by cooperative unions and community based societies registered with the Tanzania Revenue Authority
- supply by a local manufacturer of tractors for agricultural use, planters, harrows, combine harvesters, fertilizer distributors, liquid or powder sprayers for agriculture, spades, shovels, mattocks, picks toes, forks and rakes, axes and other tools of a kind used in agriculture, horticulture or forestry
- supply of medical and paramedical services.

(c) Exempt supplies

(i) Exempt supplies are **not chargeable to VAT.**

(ii) A trader whose supplies (output) are exempt will not have to charge any VAT but will suffer VAT on purchases (inputs). Such a trader will **not** be able to recover the input VAT.

A person making exempt supplies may not:

- **register** for VAT
- **recover VAT** paid on purchases (**inputs**)

Some examples of exempt supplies are:

- pesticides, fertilizers
- health supplies
- educational supplies
- veterinary supplies
- books and newspaper
- transport services
- water
- funeral services
- petroleum products
- agricultural implements
- tourist services

Test Yourself 2

State whether the following statement is true or false:

VAT is charged only on goods.

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3. Describe tax returns for VAT (their contents, frequency and due date).
[Learning Outcome c]

A VAT return is a form used to submit tax payments to TRA. The VAT registered traders need to submit VAT returns to TRA online.

A VAT return is to be completed and submitted to the Commissioner not later than the last working day of the month following the month of business together with payment of tax due if any.

VAT returns are submitted on a **monthly basis**, and are due to be filed on the last working day of the month following that to which the return relates.

Example

VAT return for the month of March 2014 is due to be filed by the last working day of April 2014.

To complete the VAT return, the taxable person must maintain the appropriate VAT records and accounts during the month. The VAT records consist of tax invoices, sales receipts and debit and credit notes.

A tax invoice should contain the following information:

- the name, address, TIN (Taxpayer Identification Number) and VAT registration number of the supplier
- the name and address of the buyer
- the date of invoice
- description of the goods or services supplied
- the quantity or volume of the goods or services supplied
- the rate of tax (VAT) charged, the total amount of tax charged, the consideration for the sale, the consideration including tax
- signature

The VAT returns contain details such as:

- Name of the registered trader
- Address of the registered trader
- Tax period covered: this tells you which period (month) the return relates to.
- Details of standard rate and zero rate sales
- Details of exempted sales.
- Computation of output VAT
- Computation of input VAT
- Total net VAT due

Test Yourself 3

VAT returns are submitted on.............basis.

A Annual
B Half-yearly
C Quarterly
D Monthly

The taxable value of imported goods shall be the value declared and determined in accordance with the provisions of the Customs Laws, taking into account the import duty, the excise duty and any other tax payable on the goods.

4. Calculate import duty, excise duty and VAT on imports.

[Learning Outcome f]

The purpose of determining customs value of imported goods is to charge taxes on the imported goods when they taxable. Customs department charges three main types of taxes on imported goods: customs import duties, excises duties and value added taxes on imported goods. These taxes apply on Cascadian ways i.e. first customs import duties is charged on total values of imported goods as discussed above. Then, the value of customs import duties form part of the costs of the goods which is used to determine the excises taxes. Then the total value (including customs import duties) therefore is used to find the excises taxes, then the value excises taxes also is added to the costs of the goods to find the value added taxes. Consequently, the value on which value added tax is based including not only the customs value of imported goods but also the value of customs import and excise duties.

Definition

Customs import duties are taxes charged on importation of goods not produced in East Africa Community.

Definition

Excises duties are normally, taxes on certain excises goods within the countries, but importing excises goods is also taxable.

The following table presents how customs taxes systems operates

Item	Value (Tshs)
Price/value of the imported goods	A
Add: Freight	B
Insurance	C
Customs value of imported goods(A + B + C)	D
Customs import duties (ID% x D)	E
Total (D + E)	**F**
Excise duties (ED% x F)	G
Total (F + G)	**H**
Value added tax (VAT% x H)	**I**

Where, ID% is import duties tax rate of imported goods; ED% is excise duty tax rate of imported goods; and VAT% is value added tax rate of imported goods.

Test Yourself 4

Red Rose Ltd recently has imported goods from China. The costs related to the goods are the following:

Direct material (per unit)	Tshs6
Direct labour (per unit)	Tshs4
Variable overheads (per unit)	Tshs2
Number of units imported	8,000 units
Selling price to Red Rose Ltd	Tshs15
Freight expenses in China	Tshs500,000
Freight to Dar es salaam	Tshs1,000,000
Insurance to Dar es salaam	Tshs600,000
Clearance agency fees –Dar es salaam port	Tshs100,000

Required:

If the customs import duties rate was 20% excise duty tax rate was 5% and value added tax rate was 18% compute the customs value of imported goods and taxes payable thereof.

Answers to Test Yourself

Answer to TY 1

The given statement is false. VAT is an indirect tax.

Answer to TY 2

False

VAT is also charged on supply of services.

Answer to TY 3

The correct option is **D**.

Answer to TY 4

Items	Tshs
Transaction value of the goods imported is 80000 x15	1,200,000
Add: Total freights	1,500,000
Insurance	600,000
Customs value of imported goods	**3,300,000**
Customs import duties 20% x3,300,000	**660,000**
	3,960,000
Excise duties 5% x3,960,000	198,000
	4,158,000
Value added tax 18% x4,158,000	**748,440**

So the customs value of imported goods is Tshs3,300,000 and total taxes payable on importation is Tshs1,606,440.

Self Examination Questions

Question 1

VAT is suffered by............
(A) All traders
(B) All manufacturers
(C) The government
(D) Final consumer

Question 2

State whether the following statements are true or false:

(a) A 'taxable person' is a person who charges VAT on supplies made by him.
(b) A person who sells exempt goods but whose purchases are liable to VAT actually bears the cost of the VAT.

Question 3

Modern Foods makes zero-rated supplies and its inputs are standard-rated. The VAT exclusive value of sales and purchases for the month ended 30 April 2013 are Tshs360,000 and Tshs280,000 respectively.

Compute the following:

(a) Output VAT
(b) Input VAT
(c) Net profit

Would VAT be payable or refundable? Calculate the amount.

Answers to Self Examination Questions

Answer 1

The correct option is **D**.

Answer 2

(a) **False.** A taxable person means a person who is registered (or is required to be registered) for VAT.

(b) **True.** A person who sells exempt goods, but whose purchase price includes VAT, cannot register for VAT.

Answer 3

(a) Output VAT is nil as Modern Foods makes zero rated sales.
(b) Input VAT is Tshs50,400 (Tshs280,000 @ 18%) as the inputs are standard rated. Therefore the amount of VAT would be computed on the purchases @18%.
(c) The net profit of Modern Foods would be Tshs80,000 (see working below).
(d) VAT would be refundable as the amount of output VAT is nil.

Working

	Tshs	**VAT (Tshs)**
Sales	360,000	
Output hotel @ 0% (zero rates)		Nil
Purchases	(280,000)	
Input VAT @18% (standard rate)		(50,400)
VAT payable/(refundable)		(50,400)
Net profit	**80,000**	