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## EVALUATION OF COST ALLOCATION SYSTEM IN ETHIOPIAN FLOUR SHARE COMPANIES

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### ABSTRACT

All kinds of organizations such as manufacturing firms, service giving companies and non profit making organizations need cost allocation system. Cost allocation is affect by technology, scarcity of raw materials, differences in actual and budget cost, skilled and unskilled manpower etc. These are factors that are common in factories and industries which take inputs from highly uncertain agricultural production. Cost is an important variable that managers use to control the profitability of their organizations, and its proper allocation affects the efficiency of a certain production line or the whole organizational success. Profit making companies like Tigray Flour Share Company can be benefited from cost allocation systems that fit their structure and overall financial targets both in the short run and long run. And studying the type of cost allocation system used and its viability becomes a significant point which this paper tried to deal with. This research work was designed as a case study type with the purpose of analyzing cost allocation system in Tigray Flour Share Company. Both secondary and primary data sources were used. The overall conclusion of this study shows that there is a proper cost allocation method selected on a purpose in mind and using cause and effect criterion. As such, the poor performance observed in the company can be attributed to challenges other than its cost allocation system.

**Keywords:** Cost allocation, Evaluation, Ethiopian Flour Share Company

### INTRODUCTION

Cot is defined as economic sacrifice made to obtain some products and services property transfer and service performed, cot measure and report financial and non financial relating to the cost of acquiring and utilization of resources in an organization and associated with all types of the organization. Cost management describe the approach and activities of managers short, long term and control decision that close value for customers and

lower cot of production an services allocating service cot reflect a cause and effect relationship between pending support services and the service provide. The mot common methods of allocating service cost are direct and step down methods. Direct method: each support department cost directly to operating department. Step down method: it allows partial recognition of service rendered by support department it requires the support department to be ranked.

Standard cost is a budget for the production of one unit of a product or service and

difference between the actual and standard cost is a cost variance.

Cost allocation is assigned to a department to facilitate decision about department efficiency. Also assigned to a product of customer to facilitate a profitability analysis and used to describe the assignment of indirect cost to a particular cost object- material, machinery and labor. This enables the company to be a competitor in a specific product line and to reduce the selling price of a product to break its market.

Though there is no clear information with regard to who was the founder of Tigray Flour Share Company, its document states that the organization's commencement date back to 1990 E.C. There is clear indication why the firm was founded, its initial capital, structure of the management and so on. However, with the coming of privatization concept in Ethiopia, it was recognized in 1992 to be governed by public enterprises authority as per the proclamation number 25/1992 (Negarit Gata proclamation, 1992), and the name of the organization changed from Tigray Flour Factory to Tigray Flour Share Company in March 1992. The supervising authority of the enterprises is a body designated by the government. At this time the company's initial capital was Birr 3,949,000. Tigray Flour Factory uses wheat grain as a raw material to produce the main product (flour) and by product-crusca and cruscallo which is used as animal food, particularly for hens, cows, oxen, donkey etc. There are other weaknesses in the organization:

- Unexpected material price increment
- Decrease in quantity of product
- Market fluctuation
- Inaccessibility of currency

Some of the major purposes of the company:

- To produce and sell various kinds of flour related product and by product
- To renovate and expand the existing facilities and establish new factories may be necessary.

### **STATEMENT OF THE PROBLEM**

All kinds of organizations such as manufacturing firms, service giving companies and non profit making organizations need cost allocation system. Cost allocation is affected by technology, scarcity of raw materials, differences in actual and budget cost, skilled and unskilled man power etc. These are factors that are common in factories and industries in Ethiopia which take inputs from highly uncertain agricultural production.

Determining the right level of capacity is theoretically, one of the most challenging task facing managers of manufacturing companies. Having too much capacity relative to demand leads to incurring costs related to unused capacity, having too little capacity to produce leads to losing customers. Therefore, cost allocation and capacity determination are economically very important tasks that managers should deal with. With this in mind, the researcher seeks to answer questions like: is there a structured way of allocating costs in Tigray Flour Share Company? If so what method does the company use, and is it really viable taking into consideration the prevailing company profile and production line?

And to the best of the researcher's knowledge, there is no previous research study conducted on "Assessment of Cost Allocation System in Tigray Flour Share Company (TFSC).

### **OBJECTIVES OF THE STUDY**

The general objective of the study is to evaluate the cost allocation system in Tigray Flour Share Company by

considering the following specific objectives.

1. To identify the cost structure and composition of costs in Tigray Flour Share Company
2. To study the cost allocation system of the company
3. To evaluate the performance of the company in the light of the particular cost allocation system it uses.

### **Significance of the study**

The researcher believes that this study will help to know the cost allocation system practiced in the company (TFSC). It also enables to know the practical point of view rather than knowing theoretically. In addition, this research highlights the strengths and weaknesses of cost allocation system in the company.

### **METHODOLOGY**

This research work was designed as a case study type with the purpose of analyzing cost allocation system in Tigray Flour Share Company. As such, the subject of discussion is cost allocation system and the organization is specifically TFSC.

Both secondary and primary data sources were used. The secondary sources of the data for this was from Audited Financial Statements of the company, news papers, articles and books. The primary data was collected through interviews with purposely selected employees in a management position of the company.

The analysis method used is almost exclusively descriptive and qualitative. Tables were used to present the data in more condensed and readable format. Some calculations of ratios to find per unit cost were also applied to summarize the nature of costs and other financial matters of the company.

### **Scope of the study**

The main focus of this research is on cost structure and its allocation system of Tigray Flour Share Company. That means, the study covers only cost and cost related variables in the company mentioned.

### **Data analysis and interpretation**

According to the Audited financial statement of TFSC (2009), the company has been consistently applying accounting policies so that the necessary financial information has desired features convenient to users. The accounting policies include valuation of fixed assets and stocks-issues of paramount relevance to the whole discussion of this paper. The specific ways of presenting the document of these provisions are summarized as follows:

The valuation of fixed assets in TFSC is simply cost less depreciation. It is clearly stated as an accounting policy of the company, in which the depreciation is charged on the reduced balance of each pool of fixed assets except building and the straight line method of deprecation is used. Concerning stocks, finished products are valued at an average production cost of that production period; by-products at net selling price, raw material, spare parts and other supplies are valued at moving average cost.

The points in the preceding paragraph coupled with the following list of cost components obtained from TFSC audited financial statements, will make the discussion of cost allocation system in the company.

In a broader view, the components of company cost are overhead cost and support service costs (cost of sales). The former comprises the following items:

- Buildings
- Plant and machinery
- Motor vehicles
- Computers
- Office furniture and equipment

- Specialized equipment, and
- Other tools.

The following are the items that are categorized under the second type of costs which are discussed in the later sections. At this point, it is worth discussing the allocation of costs in terms of their purpose, selection criteria and specific method adopted.

#### **Manufacturing Overhead Costs**

The components of manufacturing overhead costs that TFSC has identified in its accounting policies are the above items listed already. The question is how the company allocates its costs among these items, starting with the purpose and criteria, helps one to identify the method adopted.

#### **Purpose:**

To the extent that TFSC is engaged in the production of a uniform output (flour) by using only wheat as a raw material. The cost allocation system that the company has adopted was selected to serve the purpose of making sound economic decisions in general and measuring income and dividends to be reported to shareholders in particular. Accordingly, the company reports its comprehensive audited financial statements annually, and the management of the company provides the shareholders with profit and loss statement. More importantly cost analysis of the company is also made for the same purpose stated.

#### **Criteria:**

In an interview held with the company general manager, it was found that the company would start with the aforementioned purpose in mind, and on the basis of cause and effect criterion, it would select the 'best' cost allocation method that serve its purpose. To allocate manufacturing overhead costs, the company uses cause and effect criteria, for its structure involves only two department, which is manufacturing and support

(service) which is sales service to be precise.

#### **Method:**

Although the cost allocation follows the purpose and criteria conceived in advance, its application affects the financial status of the company. Tigray Flour Share Company uses process costing system almost exclusively since the output of the company through different processing stages. In other words, given its purpose and based on the cause and effect criteria of method selection, TFSC uses process costing method to determine cost per unit.

The possible rationale of using this method lies in the fact that, the company uses only one raw material (wheat) and produces always homogenous product (flour), which is in effect, marketed using homogenous channels of distribution to a relatively constant customer. As to the evaluation of cost allocation system of the company, one can say that the company has adopted the right cost allocation method that can serve its purpose very well. Referring to the same expression above, the numerator is decomposed into total manufacturing cost components as shown in the table below.

#### **Table-1 about here**

Table-1 shows the share of different components of the manufacturing overhead costs that the company incurred in the years 2008 and 2009. Buildings account for about half of the total cost followed by motor vehicle, plant and machinery. The reason for a higher motor vehicle cost is incurred in transporting raw materials to warehouse and finished product (wheat) to the market.

Since all cost components listed above belong to the same operation system of producing homogenous product, the cost allocation system (process costing) in TFSC merely divides total output level. According to financial statements, per unit cost of manufacturing overheads for TFSC

in the years 2008 and 2009 was about 1.03 Birr each.

The fact that per unit manufacturing overhead cost is constant for both consecutive years is the company did not make additional investment to expand existing buildings, machinery and equipment in 2008 and 2009. This again shows that the revenue of the company per year per unit less than the operation costs that are related to support services given the per unit profit per year.

#### **Costs of Sales**

The second category of costs that Tigray Flour Share Company incurs is the service costs (or costs off sales service). This is also similar for the whole period of the company's operation in terms of the service types given and the cost items associated with them. The presence of homogeneity of products and services in the context of cost allocation is that TFSC uses process costing system as already stated earlier.

In Tigray Flour Share Company what is sold is what has been produced in the manufacturing operation. With a daily capacity of 900 quintals of flour production, the factory operates for 365 days less 43 maintenance days a year. The total output per year under the normal conditions, is determined as:

#### **Total Production per year**

$$\begin{aligned} &= 900 \text{ quintals} \times (365-43) \text{ days} \\ &= \underline{289,800} \text{ quintals per year} \end{aligned}$$

In the support service department, only this much flour can be sold on a uniform selling-strategy basis to a uniform customer base. The question is, as to whether TFSC has a different cost allocation system for the support service department. Theoretically, the answer would be no, because homogenous products are involved. Fortunately, the data obtained from different cost analysis documents of the company show that process costing method is used in the service department as well. The difference with the earlier

discussion is the composition of cost of sales which comprises variable cost items as opposed to the manufacturing overhead cost items.

The cost items which fall under this category are both direct, indirect labor, material costs, and costs associated with the use of facilities, wear and tear of machinery and buildings, to mention a few of them. The whole list is given in the table below with their corresponding values for the year 2008 and 2009.

#### **Table-2 about here**

The information presented in Table-2 above shows the list of cost items in the support service department of the company on the one hand and the cost performance of each item for the year 2008 and 2009 on the other so that the company's distribution of annual cost of sales among cost items is easily depicted and changes in the annual cost of a given item is also presented.

In column two of the above table, both direct and indirect costs items are incorporated and all items included here are the sources of variable costs of the company. Since these components of sales costs are associated with the production and distribution of homogenous product. The cost allocation system adopted by TFSC to allocate cost of sales is also process costing method. In this table, whether each cost is allocated to total output separately and then added or the total sales cost is allocated to total output does not make any difference, as far as per unit cost of sales per annum it concerned.

#### **Illustration:**

The direct material cost for the year 2008 was Birr 4,898,858, and total output was 289,800 quintals. To find the amount of direct material cost allocated for each unit of output, one has to divide direct material cost by total output. That is,

$$\begin{aligned} &\text{Direct material cost per unit (2008)} \\ &= \underline{4,898,858/289,800} \\ &= \underline{16.90} \text{ Birr} \end{aligned}$$

Now suppose one does this for all the remaining items and add the results, it gives the annual cost of sales per unit of output of the company for the year 2008. The only difference is that the values of each cost item under the column labeled 2008 are taken, summed and divided by the corresponding total output of the year 2008.

TFSC has only flour production division which means all the production costs that is, direct material cost as well as manufacturing overhead costs accrue to this department. As a result, the unit overhead cost is calculated as:

**Unit Cost = Total cost added during a year/Total product in the same year**

Records of cost allocation for the year 2008 and 2009 have been taken from secondary data sourced from Tigray Flour Share Company, and the unit costs the company has of the manufacturing overhead costs during these two consecutive years are given below.

**Unit MOH cost (2007) = Total MOH cost (2008)/Total output (2008)**  
 $= 297105/289,800$   
 $= 1.03 \text{ Birr}$

Where total cost (2008) is the sum of manufacturing overhead cost in the year 2008. Similarly, the manufacturing overhead costs per unit of output for 2009 are:

**Unit MOH cost (2009) = Total MOH cost (2009)/Total output (2009)**  
 $= 297105/289,800$   
 $= 1.03 \text{ Birr}$

Here total costs for the year 2009 are the sum of manufacturing overhead cost. Fortunately, there were no additions to overhead costs of the manufacturing department, and the total cost, of the company calculated per unit of output, is the same for both years.

The denominators of the above expressions are obtained from the capacity of the plant, which is 900 quintals of flour per day, for

322 days per year (43 days-maintenance). The annual quantity of flour produced is on average 289,800 quintals for the period under consideration. This being the upper limit of factory capacity, TFSC uses this quantity to determine the unit cost overhead allocated in the manufacturing department here there is only one operation process.

Though the unit costs of each item can be added to find the unit cost of sales allocated on process costing basis, the values for 2008 and 2009 can be computed using the total cost of sales as follows:

**Per unit cost of sales (2008)**  
 $= 122375/289800 = 0.422 \text{ Birr}$ , and  
**Per unit cost of sales (2009)**  
 $= 105935/289800 = 0.365 \text{ Birr}$ .

In a company like TFSC, producing identical products, the unit cost of sales depends on either total cost of sales per annum, total output per annum or both. That means, if the total annual output (denominator) is fixed, then the total cost of sales per annum determines the unit cost allocated to the production department. This is obvious from the data obtained in this research, where total output as observed to have been at full capacity in 2008 and 2009.

If total output is to vary while cost of sales remains the same for both years, per unit cost would be higher for the year with lower productivity performance. The only possible outcome which depends on the relative effects of the numerator and denominator will both vary at the same time.

The empirical outcome from this study shows that total cost decreased from Birr 122,375 to Birr 105,935 in 2008 and 2009 respectively. While total output remained constant. This gives a higher per unit cost allocated in 2008 than in 2009. Evaluating the cost of sales of the company, it can be said that per unit cost decreased from Birr 0.422 in 2008 to Birr 0.365 in 2009. The

interpretation is that each unit of output (a quintal of flour) in 2009 costs on average 33.74 Birr more than it was in 2008 (19.7). In other words, the unit cost of output is increased with constant level of output as a result of inefficiency of production cost management of the TFSC in 2009.

Another important point which perhaps needs further discussion is depreciation cost whose allocation system is similar but it is determined according to predetermined accounting policy of the company.

#### **Depreciation Cost**

Depreciation is charged on the reduced balance of each pool of fixed assets, except buildings, depreciated at the straight-line method. The specific rates used to calculate the amount of depreciation charged on different fixed assets are given in the table below.

#### **Table-3 about here**

The determination of depreciation cost in the computation of cost of sales (considered in the support service cost allocation) depends on the accounting policy the company has set and applied. To find the depreciation cost associated with buildings, a straight-line method is used and it gives 5 percent of the value of the building per annum. To allocate this cost, the process costing method that the company uses assigns the per unit quotient of this part of depreciation cost. The total cost of wear and tear of fixed assets is then determined by adding the values obtained in similar fashion (total depreciation is the sum of individual depreciation).

According to the depreciation percentages presented in Table-3, the absolute depreciation costs the company incurred in 2008 and 2009 are presented below.

#### **Table-4 about here**

The depreciation costs of each fixed asset for the year 2008 and for 2009 that Tigray Flour Share Company (TFSC) incurred as a result of wear and tear of its buildings, machinery, equipment and other fixed plant

assets. This computation is used to obtain the amount deducted from the respective costs of the asset so that the book value of the asset is determined at any point in time. The book values of all fixed plant assets are given below.

#### **Table-5 about here**

The above figures are simple examples that the company uses to compute the book value of a given asset given its balance of cost and percentage of depreciation. The essence of the discussion of depreciation and other costs is that, understanding how they are allocated and how they are determined. The next question is the financial performance of the company when it uses process costing method to directly allocate manufacturing overhead costs and costs of sales to the production and distribution processes of the factory.

#### **Company Performance and cost allocation (Process Costing)**

Theoretically, the company profile and its product line suits the cost allocation system it has adopted. The ultimate goal of the company is to maximize profit in general to have healthy financial status either by maximizing sales (revenue) and/or by minimizing costs. Therefore, the performance of TFSC can be evaluated in terms of its profitability, and to avoid hasty conclusion from a one-shot glance at its financial statement, the following profit and loss statements of the company for 2008 and for 2009 are presented.

These statements were directly taken from the audited financial statements of TFSC. The researcher has tried to associate the insight immediately under the financial statements with the intertwined phenomena of cost allocation system already discussed in detail and that of the cause and effect criterion of selecting a given cost allocation system.

Tigray Flour Share Company adopted process costing method to allocate its cost; does this help the company earn positive

profit? Is process costing of TFSC is efficient?

#### **Table-6 about here**

#### **Table-7 about here**

From the given profit and loss statements of the company, it can be seen that the company incurred loss in 2008 while the situation is aggravated in the following year (2009) since the net loss for the year 2009 is more than 150% of the net loss where incurred in 2008. That is, it uses process costing implying that TFSC can allocate costs directly to the non separable process it has and the profit/loss situations can be evaluated by summarizing everything in a single financial statement. Costs of sales are what have been discussed as support service costs computed using direct and indirect materials as well as labor cost. Depreciation costs are also taken into account.

As to the performance of the company, it is deduced from the whole exposition so far that TFSC has been effective in allocating costs and identifying cost items by using process costing system; nevertheless, TFSC seems to have been inefficient in minimizing its cost or in maximizing its sales revenue.

### **CONCLUSIONS**

Based on the major findings of chapter three, the cost allocation system that Tigray Flour Share Company has adopted can be evaluated theoretically and based on empirical evidence; the following general conclusions are drawn:

Tigray Flour Share Company produces and sells a homogenous product whose input is an identical raw material (wheat). This shows that the use of process costing method by the company to allocate both manufacturing overhead and sales costs is appropriate according to theoretical concepts.

The company has different accounting policies and depreciation cost is determined

based on specific rates charged on different assets of the company. The total cost of depreciation is then allocated using process costing in the non-separable production and sales operation of the company.

Generally speaking, there is a proper cost allocation method selected on a purpose in mind and using cause and effect criterion. As such, the poor performance observed in the company can be attributed to challenges other than its cost allocation system.

### **ACKNOWLEDGEMNT**

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**Table-1: Manufacturing overhead cost components of TFSC**

NO	Component	Cost (in Birr)	
		2008	2009
1	Buildings	1,628,856	1,628,856
2	Plant and machinery	447,083	447,083
3	Motor Vehicles	696,777	696,777
4	Computers	46,592	46,592
5	Office Furniture and Equipment	71,931	71,931
6	Specialized Equipment	51,866	51,866
7	Other tools	4,000	4,000
<b>Total</b>		<b>2,947,105</b>	<b>2,947,105</b>

Source: Audited Financial Statements of TFSC (Various Issues)

**Table-2: TFSC cost of sales for 2008 and 2009**

NO	Cost Item	Amount of cost (in Birr)	
		2008	2009
1	Direct materials	4,898,858	9,089,467
2	Direct labor	207,556	192,875
3	Indirect materials	121,625	220,429
4	Indirect labor	95,878	50,610
5	Employees benefits	77,425	32,256
6	Repair and maintenance	64,809	45,676
7	Travel and per diem	2,403	5,895
8	Power and water	116,289	77,239
9	Tele pone and potage	2,366	1,786
10	Fuel and lubricant	188	242
11	Insurance	887	887
12	Miscellaneous	34	524
13	Depreciation	116,783	99,691
14	Stationery and clearing	670	833
15	Amortization	4,000	4,000
<b>Total</b>		<b>5,709,771</b>	<b>9,776,734</b>

Source: Audited Financial Statements of TFSC (Various Issues)

**Table-3: Rates of Depreciation Charged on Different Assets**

No	Type of Asset	% of depreciation
1	Buildings	5
2	Plant and machinery	16 for the first year and 12 per year then after.
3	Motor vehicle	20
4	Office furniture, equipment and specialized equipment	10
5	Computers	25
6	Other tools	25

Source: Audited Financial Statements of TFSC (Various Issues)

**Table-4: Depreciation cots charged on Different Assets of TFSC in 2008 and 2009**

No	Type f Asset	Amount of depreciation cost	
		2008	2009
1	Buildings	495964	577407
2	Plant and machinery	353156	406806
3	Motor vehicles	357204	443187
4	Computers	34262	40675
5	Office furniture, equipment	35470	42625
6	Specialized equipment	32139	37326
7	Other tools	3990	3990
<b>Total</b>		<b>1312185</b>	<b>1552016</b>

Source: Audited Financial Statements of TFSC (Various Issues)

**Table-5: Book value of an Asset Illustrated of TFSC**

Item	2008			2009		
	Cost (Balance)	Depreciation	Book Value	Cost (Balance)	Depreciation	Book Value
Buildings	1,628,856	495,964	1,132,892	1,628,856	577,407	1,051,449
Plant and Machinery	447,083	353,156	93,927	447,083	406,806	40,277
Motor vehicles	696,777	357,204	339,573	696,777	443,187	253,590
Computers	46,592	34,262	12,330	46,592	40,675	5,917
Office Furniture, Equipment	71,931	35,470	36,461	71,931	42,625	29,306
Specialized Equipment	51,866	32,139	19,727	51,866	37,326	14,540
Other Tools	4,000	3,990	10	4,000	3,990	10
<b>Total</b>	<b>2,947,105</b>	<b>1,312,185</b>	<b>1,634,920</b>	<b>2,947,105</b>	<b>1,552,016</b>	<b>1,395,089</b>

Source: Audited Financial Statements of TFSC (Various Issues)

**Table-6: Profit and Loss Account Statement for the Year Ended June 30, 2008**

<b>Tigray Flour Share Company (in Birr)</b>	
Sales	7750905
Less: cost of sales	(7578794)
Gross profit	<b>172111</b>
Other income	134859
Total Income	<b>306970</b>
<b>Expense</b>	
Distribution	223896
Administration	636881
Board members allowance	18650
Audit fee	19000
Interest	32550
Total Expense	<b>(921977)</b>
Net loss/profit for the year	<b>(615007)</b>

Source: Audited Financial Statements of TFSC (Various Issues)

**Table-7: Profit and Loss Account Statement for the Year Ended June 30, 2009**

<b>Tigray Flour Share Company (in Birr)</b>	
Sales	12173317
Less: cost of sales	(9816654)
Gross profit	<b>2356663</b>
Other income	41070
Total Income	<b>2397733</b>
<b>Expense</b>	
Distribution	230904
Administration	508479
Board members allowance	9500
Audit fee	23400
Total Expense	<b>(772282)</b>
Net loss/profit for the year	<b>(1625450)</b>

Source: Audited Financial Statements of TFSC (Various Issues)