FUNDAMENTAL ACCOUNTING

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7th edition

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PREFACE

There's an adage coined by the ancient Greek philosopher, Heraclitus, which says that the only thing constant in life, is change. This was even more relevant for us as we took on the task of updating this new edition of *Fundamental Accounting*. In planning this update, we attempted to balance what worked in the previous editions with the changes in the accounting environment and with feedback and suggestions from users of the textbook. We are grateful for your comments, as your constructive feedback helped us to ensure that we retain a standard of instruction that is most accessible and suitable for all users.

So for this 7th edition, the objective of accounting – to provide information that is useful for making economic decisions – has once again been top of mind. The structure and teaching sequence of the previous edition has largely been retained, with minor changes to the chapters on cash and credit transactions. Further updates include legislative compliance aligned to the Companies Act 71 of 2008 and International Financial Reporting Standards (IFRS), revised content on the framework of accounting and non-current assets (now with more information relating to VAT transactions), as well as general improvements relating to the treatment of accruals. Changes to accounting terminology have been taken into account, but we acknowledge that even though the new terminology may indeed feature in the latest accounting standards, the old and new terms are generally used interchangeably. This will continue to be a checkpoint for future editions too.

The textbook is divided into eight modules, progressing from recording transactions to the more demanding aspects of reporting in accordance with IFRS, and reviewing the accounting practices of different businesses. The user-friendly presentation of the content allows us to balance solid, explanatory, theory-based content with supporting examples throughout each chapter. The way the content unfolds further supports step-by-step learning, which is fundamental for grasping the basic principles of first-year accounting courses.

Furthermore, our 'two-books-in-one' approach, in which we present the content *plus* more than 500 questions, further aims to support students' success.

The 7th edition introduces new lecturer support elements for prescribing institutions. Solutions to the questions in the textbook are now complemented by PowerPoint® slides and theory-based lecture-readiness questions for each chapter.

As before, we welcome your comments and suggestions on this new edition. We hope that your venture into the world of accounting is a meaningful one, albeit amid constant change, and that *Fundamental Accounting* contributes to your success as a student or academic.

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January 2016

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MODULE

A Introduction

This module is divided into three chapters:

Chapter 1 The exciting world of accounting
Chapter 2 The environment of accounting
Chapter 3 Concepts of accounting

Together these three chapters achieve the following outcomes:

Outcomes

- Differentiating the various types of organisations based on activity and organisational form.
- Describing the historical development of accounting, the current changes within the accounting field, and the road ahead.
- Identifying the different areas of expertise within the field of accounting.
- Defining the nature of accounting and explaining the accounting concepts used in the Conceptual Framework.

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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1 THE EXCITING WORLD OF ACCOUNTING

Chapter objectives

By the end of this chapter, you should be able to:

- Define accounting and explain the nature of accounting.
- Explain why people study accounting.
- Explain the difference between wholesalers, retailers and consumers.
- Explain the difference between service, trading and manufacturing concerns.
- Identify and list the internal and external users of accounting information.
- Explain the difference between the terms 'mutually exclusive' and 'collectively exhaustive'.

Chapter outline

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1 Introduction

There are as many definitions of accounting as there are authors. Below are but a few of these definitions:

- Accounting is an information system that measures, processes and communicates financial information about an identifiable economic entity.
- Accounting is the process of measuring, recording, classifying and summarising financial information that is used in making economic decisions.
- Accounting is an information system that:
  - Selects data.
  - Processes that data.
  - Produces information about an economic entity.
- Accounting is a language of the business community.
- Accounting is a system that communicates a message about the financial effects of all decisions made in an economic entity in the past.

The economic entity mentioned in some of the above definitions refers to a business organisation, an educational institution, a religious institution or a private household.

2 Why study accounting?

It is reasonable to ask oneself why the study of accounting is important. The answer is quite simple. We all deal with money virtually every day of our lives and have grown up in a society in which money plays an essential role.

Almost intuitively one realises that accounting as a subject must have something to do with keeping a record of money. This is indeed so, but as one gains more knowledge about the subject, it will become evident that accounting embraces far more than simply keeping records, as the definitions clearly indicate.

In a word, accounting centres on 'information'. We keep a record of our money as it is received and spent to have information regarding where it came from, how it was spent and how much we have left.

People involved in the activity of accounting in the business world are really engaged in generating financial information about the organisation for which they are working. Those responsible for managing organisations know that they are not able to function unless they have accurate accounting information.

Accounting provides financial information

Compare accounting with any other product or service that is offered. A manufacturer of a product, such as a toothbrush, finds a market for the product because people find it useful. Therefore, they are prepared to pay for it.

In a similar way a person with expertise in accounting produces information that is sold, as it were, to those who find it a useful 'product'. For this reason, management is prepared to employ accountants, as the expertise that they will provide has value to the organisation.

The financial information provided through accounting practice is fundamental to the successful management of the economic entity.

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One may ask why people are prepared to pay for information. The reason is obvious. People who pay for information expect the benefit that they will obtain from the information to be greater than the price they will pay – a fundamental economic principle.

Why study accounting? One answer to this question is clear. The expertise gained through the study of accounting will place you in a position to produce valuable financial information.

Accounting contributes to basic education

Studying accounting also contributes to the development of other qualities. The logical nature of accounting systems and the need to develop orderliness will influence your view of life and the way in which you approach different activities.

Accounting expertise will enable you to listen more intelligently to daily news items and have a better understanding of our environment and society. These life skills will assist you in coping with future challenges that you will inevitably encounter.

Accounting provides career opportunities

It is important for every business to keep financial records. Employment opportunities are thus available at many levels of accounting expertise.

Students who study accounting for one year only will already be equipped for employment in a field that involves accounting procedures. As they familiarise themselves with the financial systems of their business, preferably coupled with further study, they can progress to senior accounting positions.

Students who choose to study further have a choice to do so at a residential institution or through distance education. There are many different qualifications that all require accounting expertise. Some of the more popular qualifications are:

National Diploma in Accounting

This requires a minimum of three years' full time post-matriculation study and equips the student for a position in an accounting department in commerce or industry. Financial accounting features in more than 15 diplomas at tertiary institutions in South Africa. The most popular diplomas are accounting, cost and management accounting, internal auditing, financial information systems and taxation.

Degree programmes

The names of degrees differ from one institution to another. Degrees such a B.Com., B.Acc., B.Bus.Sc. and B.Compt., may be followed at various universities. A minimum of three years' study of financial accounting may be included in the study programme selected by the student.

Chartered Institute of Management Accounting (CIMA)

This qualification is internationally recognised and is administered from London. Students throughout the world study by correspondence or through universities, technikons and colleges and write the required examinations in three stages.

The emphasis is on management accounting and finance, but a thorough knowledge of financial accounting is necessary.

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The Southern African Institute of Chartered Secretaries and Administrators (ICSA)

Formerly known as the CIS, this qualification prepares the student for the position of company secretary, a job requiring a special knowledge of company law, but also a thorough knowledge of accounting. Study for this qualification is usually through correspondence.

Chartered Accountant CA(SA)

This is a specialist qualification in practical accounting. The newest developments allow students to choose a specialisation in either auditing or financial management.

If a student chooses the auditing specialisation, a thorough knowledge of auditing, accounting, financial management, secretarial systems, taxation and estates, and business information systems will be acquired. The student will have to complete an auditing training contract of a minimum of three years and pass the qualifying examination to become a chartered accountant.

The financial management specialisation will require a student to obtain a thorough knowledge of financial management, financial accounting, management accounting, internal auditing, taxation, information systems and management. The student will have to complete a financial management training contract of a minimum of three years and pass the qualifying examination before becoming a chartered accountant.

The qualified chartered accountant with financial management specialisation, will fill positions such as financial manager or financial director, but will not be able to perform the audit function.

Professional Accountant (SA)

As a professional accountant (SA) you are involved in the preparation of financial reports, formulating business plans and financial forecasts for unlisted companies.

To become a professional accountant (SA) students would need to complete a Bachelor's degree from a South African Institute of Professional Accountants (SAIPA) accredited tertiary institution, then complete three years' supervised training at an accredited training centre, as well as complete the SAIPA Professional Evaluation Exam.

You should be able to complete Questions 1.1 to 1.3.

3 Who provides accounting information?

We explained previously that accounting centres on financial information, which is provided by a **business entity**. For the purpose of accounting, an entity refers to any individual or organisation that has an identity of its own. Each business will be involved in one or more business activities.

Business activities are categorised in a number of ways, one of which is the profit motive. For some businesses, it is not important to achieve profits for distribution to individuals. These organisations typically include charitable organisations, government agencies, clubs or any organised group that does not distribute any money in the form of profit resulting from their activities.

The majority of business entities have as one of their main aims profit maximisation. South Africa is a country that supports the system of free enterprise, which means that any person is free to start a business aimed at making a profit.

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If the business is run efficiently, it will make a profit; if not, the individual(s) who started the business may lose the money they invested in the business.

The different types of businesses can be classified by either the nature of their activities, or by the organisational form of the business, which refers to their legal constitution.

Types of business activities

Businesses operating with a profit motive could be classified as any of the business types displayed in Figure 1.1, which include **service**, **manufacturing** and **trading businesses**.

Figure 1.1

TYPE OF BUSINESS BASED ON ACTIVITY

Service business	Manufacturing business	Trading business – Wholesaler	Trading business – Retailer
Electrician	Vehicle assembly	Food wholesaler	Supermarket
Dentist	Brickmaker	Linen wholesaler	Boutique store
Auditor	Canning factory	Toy wholesaler	Hardware store

These types of businesses can be explained by this example:

Example 1.1

Sibu Ntuli, a qualified electrician, has his own business that he runs from home. Sibu installs electrical cables and repairs electrical faults. For him to do so, he needs only his tool-box.

Any cabling or wiring required to do a job must be supplied by the people for whom he is doing the repairs. These people are called his **clients**. Because Sibu merely renders a service to his clients (by fixing electrical faults), we say that he runs a **service business**.

Sibu's clients will buy the necessary cabling from the hardware store. The hardware store is a business that buys and sells hardware products; we, therefore, say that the hardware store is a **trading business**. The people and other business entities served by the hardware store are called **customers**.

Reminder

- A service is provided to a client.
- Goods/products are sold to customers.
- The hardware store is a customer of the manufacturing concern.
- A wholesaler is someone who sells goods mainly to retailers for resale.
- A retailer is someone who sells goods to consumers.

The hardware store has to buy the items that it sells (goods or inventory) to its customers, from the business that manufactures the specific items called a **supplier**. The business entities that manufacture and sell products are called **manufacturing businesses** (also known as manufacturing concerns).

Did you notice that the goods (cabling and wiring) are sold twice? They are sold once by the manufacturing concern, also referred to as manufacturer, to the trading organisation (hardware store) and once by the hardware store to the person who uses it.

A manufacturing concern is a business that sells the goods that it manufactures to either trading organisations or individual customers. We refer to the manufacturer as a **wholesaler**.

The hardware store, which buys from the wholesaler (manufacturer) and sells to the customers, is called a **retailer**. The customer buys goods/products for a specific purpose and is, therefore, called a **consumer**.

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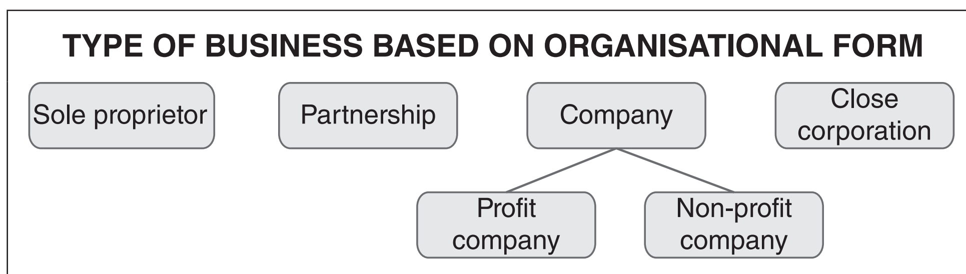
It is important to note that the manufacturer and the wholesaler are not always the same party. Sometimes the distribution chain is longer with the manufacturer selling to a wholesaler, the wholesaler selling to a retailer, and the retailer selling to the consumer.

Organisational forms of ownership

Another way in which a business may be classified is in terms of its organisational form or legal constitution. There are various organisational forms of ownership constituted for the purpose of making a profit.

Figure 1.2 shows the different organisational forms of ownership most frequently used. It is important to note that a business can be classified using both activity and business form.

Figure 1.2



This means that, regardless of its legal form, the businesses may be engaged in any of the activities previously described, that is, service organisation, manufacturer, wholesaler or retailer.

Sole proprietor

A **sole proprietor** is the only owner of the business. The owner of a sole proprietorship is normally responsible for the daily activities of the business, including the management of the business.

Many small service businesses (referring to activity) such as plumbers, hairdressers and lawyers are sole proprietors (referring to organisational form of ownership). Normally, limited investment is required to start such a business and the legal formalities only require a licence to trade. The owner is liable (responsible), in his or her personal capacity, for the debts (money owing to others) of the business.

All profits made by the business will be taxed in the hands of the owner. Why? The owner has to declare the profits of the business as personal income on his or her tax return because the sole proprietorship is not a juristic person (legal 'personality') distinct from its owner.

Not being a juristic person means that the business cannot be summoned to court. It also results in the business discontinuing when the owner of a sole proprietorship dies. If the business activities are taken over by someone else, a new sole proprietorship comes into being.

A sole proprietor is often referred to as a sole trader. This organisational form is used to explain the basic accounting concepts that follow in the first eighteen chapters of this book.

Partnership

As soon as a business with no legal personality has more than one owner, it is no longer a sole proprietor. Medical doctors, stockbrokers, attorneys and accountants often conduct their business as partners in a **partnership**. All the partners are owners of the business. A partnership can have a minimum of two partners and generally a maximum of 20 partners. Normally the partners in a partnership are actively involved in the daily running of the business, similar to the sole proprietor.

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Due to the partnership not being a legal personality, the individual partners are liable in their personal capacities for the debts of the partnership. Partnership profits are taxed in the hands of the individual partners. When a partner withdraws from the partnership, the partnership will be dissolved. If the remaining partners want to continue their business, a new partnership will be formed. This will also be the case if a new partner is admitted into the partnership; the old partnership will be dissolved and a new partnership will be formed.

One of the advantages of a partnership is that it can be set up with relatively little effort and minimal capital investment. In the individual partner's own interest, it is important to draw up a partnership agreement that will contain information such as: the profit sharing ratio, each partner's duties and a general code of conduct.

To ensure that the terms of the partnership agreement are complied with, it is important that financial information is provided by an accounting system. This form of business and its special accounting procedures will be covered later in the book in Chapter 23.

Company

A **company** is a business that may be owned by a few people or by thousands of people known as the shareholders. It is often managed by people who are not the owners.

For the purpose of this book, we will distinguish between two types of companies:

1 Profit company, usually formed with the aim of making a profit.
Think, for example, of Foschini Stores. Anybody can buy their shares on the JSE. We say that Foschini is a **listed company**, and because its shares are sold to the general public, it is also referred to as a public company. The full name of Foschini is Foschini Stores Limited. The word 'Limited' or the abbreviation (Ltd) means that it is a public company limited by share capital.
Top Security is also a company, but its shares are not listed on a stock exchange. This makes Top Security an **unlisted company**, and because the free transfer of its shares is restricted, it is called a private company. Its full name is Top Security (Proprietary) Limited. The word 'Proprietary' (or abbreviation Pty) means that it is a private company.

2 Non-profit company, formed not to make a profit.
The company is a legal entity but it requires more formalities and is more expensive to set up than any of the other business forms. Presentation of the financial statements of a company is prescribed by the Companies Act. 71 of 2008, Schedule 4 to the Companies Act and IFRS or IFRS for SMEs. The accounting and reporting procedures of a company are complex and form the basis of much of the advanced study in accounting. Chapters 17 to 21 of this book deal with these issues.

Close corporation

A **close corporation** may have a minimum of one and a maximum of ten owners (called members). A close corporation is different from the sole proprietor and the partnership in the sense that it has its own legal personality, and it exists independently of its members. Where certain conditions exist, members of the close corporation are personally liable for its debts. The members of the close corporation are usually also actively involved in its daily business activities. The letters CC after the name of a close corporation denote it as such, for example, Industrial Laboratories CC.

Did you know?

CCs are phased out. Currently, no new CCs can be registered, while older CCs are being encouraged to form a private company.

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Presentation of the financial statements of a close corporation is regulated by the Close Corporations Act 69 of 1984 section 58 (2)(b). The special accounting procedures relating to a CC will be covered in Chapter 24 of this book.

You should be able to complete Question 1.4.

4 Users of accounting information

Accounting strives to produce financial information for the purpose of making economic decisions. A fundamental question often asked is – who would typically use this information? A number of research studies addressing this question have been conducted by various groups of people and accounting bodies.

The list of typical users identified in these studies are very similar and include the following categories:

Owners and potential investors

Investors place their money in a business with the expectation of receiving a return on their investment in the form of profit. The investor is continually faced with the problem of whether to leave the money in the business or to withdraw the money and invest it elsewhere.

In the case of an investment in a company, the investor would simply sell the shares either to existing shareholders or to new shareholders.

The decision of an investor to continue holding the investment in a business, or the decision of a potential investor, who is considering investing in a business, depends largely on the expected future performance of the business. To make some estimates about its future prospects, past financial performance of the business will provide important information.

Investors will, therefore, use the financial information generated by the accounting system. They will use this information to decide whether they will continue to keep their money in the business. If they are looking for an investment opportunity, this information will assist them in making a decision. Typical questions asked, include:

- How much does the organisation owe to its creditor?
- How much income does the organisation earn?
- How many dividends are paid, and how often?

Management

The people who are responsible for managing a business are not always the same people as those who have invested money in the business. They are often employees of the business who work for a salary.

The managers' aim is to make the business succeed, as they will be judged on how well they have done their job by the performance of the business.

To monitor the progress of the business on an operational level, they will be interested in the financial condition of the business, the cash available to run the business and the profitability of the business. All this financial information is supplied by the accounting system.

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The managers are thus also users of accounting information. Typical aspects that management will consider include:

- Whether to buy or rent certain premises.
- If bought, whether to pay cash or lease the premises.
- Whether to manufacture or to buy certain products.
- What price to sell these products at.
- Whether to open a new branch or to close an existing branch.
- What systems to install to safeguard the assets of the business and to ensure that it is not defrauded.

Payables/Suppliers

People who lend money to a business and those who may sell on credit are known as creditors/**payables**. They want to know that the money owing to them is likely to be repaid.

This information is only available by knowing the financial condition of the business, its financial resources and the expectations of the profit that is likely to be made. Payables are mostly interested in the liquidity of the business.

Liquidity is the ability of a business to pay its debts in cash when they fall due. All payables take a risk when they lend money to a business or sell goods without receiving the cash payment immediately. The accounting system provides payables with information that assists them in assessing the extent of the risk regarding the repayment of outstanding accounts.

Investment analysts

An investment analyst is a person who studies the financial situation of various businesses and advises clients regarding investments. The requirements of the analysts are, therefore, essentially the same as those of the investors whom they advise.

Analysts spend a great deal of time comparing similar businesses in an attempt to predict which is likely to be the most profitable and what risks are attached to each investment. It is obvious that the accounting system that provides financial information will assist in this task.

Government

Government bodies require financial information for two main reasons:

- To develop statistical material that forms the basis on which economic and industrial policies are based.
- To apply the taxation policies of the South African Revenue Service (SARS). Most taxation of businesses in South Africa is based on the profit that the business has made. Quite clearly the accounting system must be designed to provide this information.

Financial institutions

New businesses seek financial assistance in the form of loans from various financial institutions, such as banks, trust companies and investment dealers.

These financial institutions would require the financial information from the business and would be interested in both the past financial performance and current financial position of the business. Accounting information would be able to provide the necessary evidence needed.

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Employees

There is limited evidence suggesting that **employees** make wide use of accounting information in South Africa. In countries where trade unions have a long tradition, the financial information provided by the accounting system forms the basis for negotiation on wages and salaries.

Generally employees will be interested to know the prospects of their future employment, whether they are being rewarded with a reasonable share of the profits that they helped to produce, and the ability of the business to meet its wage bill.

You should be able to complete Questions 1.5 to 1.7.

5 Classification in accounting

From reading this chapter thus far, it is apparent that efforts have been made to classify items into categories. For example, business entities have been classified by the type of activity in which they engage. They have also been classified by their type of business or organisational form. The users of accounting information have been classified on the basis of their information needs.

Much of what you are going to learn in the rest of this book is based on your ability to correctly classify items, to ensure that the information that is presented is orderly and consistent. For this reason, the two primary qualities of a good classification system are briefly explored. The alphabetical system is an example of a classification system, and it will be used as a basis against which other classification systems will be compared.

Mutually exclusive

This is a term used to describe a situation where an occurrence of an event is not caused or influenced by another.

A good classification system requires every item being classified to be able to fit into only one category. For example, classifying names into categories using the alphabetical system will have the quality of being **mutually exclusive**. A name cannot begin with more than one letter of the alphabet. Therefore, it is classified as either A or B or C and so on.

Classifying a business on the basis of profit or non-profit is also likely to be mutually exclusive, as no business will be both non-profit and profit making. However, to attempt to classify a business in terms of its activity will be more difficult. Some businesses may be both wholesalers and retailers which makes it difficult to decide on the category under which they will fall.

Similar problems will be encountered in the study of accounting. For example, when a large supply of paper is purchased, is it classified as an expense or an asset? If the system attempts to place similar items into categories, will it be classified as stationery or under some other heading?

Most of the classification systems used in accounting do not possess the quality of being mutually exclusive and decisions based on judgement and experience will often have to be made.

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Collectively exhaustive

This is a term used to describe a situation where at least one event must occur. If the one occurs, the other will not.

A classification system may be **collectively exhaustive** if every item could be placed into an existing category. Once again the alphabetical system possesses this quality as every name, for example, must begin with a letter from A to Z. Thus, no name will not find a category.

Classifying a business on the basis of profit or non-profit is likely to be collectively exhaustive as there are only two options – either aimed at making profit or not.

Classifying on the basis of business activity is more complex, and the list provided in Figure 1.1 (page 1–5) is not collectively exhaustive. There may well be businesses engaged in activities that cannot be classified as one of service, manufacturing, wholesaling or retailing. New categories such as mining may well be added to make the classification system more complete.

In accounting, problems of this nature frequently arise where an item cannot comfortably be classified into the existing set of categories. In such instances, the set of categories has to be expanded. Usually this means opening new accounts that result in better quality information.

You should be able to complete Question 1.8.

6 Summary

This chapter has served as an introduction to the discipline of accounting. Accounting is an activity designed to provide financial information. The financial information provided is used by various individuals and groups to make decisions regarding the investment of their resources.

A business may be classified in terms of the type of business activity in which it is engaged, such as service, manufacturing, wholesaling and retailing. A business may also be classified in terms of its type of business, which refers to its form either a sole proprietor, partnership, close corporation or private and public company.

The frequent use of classification systems in accounting requires an understanding of the qualities of a good classification system. Categories in a classification system need to be mutually exclusive and collectively exhaustive. This is often not the case in accounting systems, thus the use of judgement and experience is required.

QUESTIONS

Question 1.1

Provide three to five examples of economic decisions that people are confronted with daily.

Question 1.2

Define the term ‘accounting’.

Question 1.3

Explain the purpose of accounting in the business environment.

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Question 1.4

Describe the characteristics of these forms of ownership: sole proprietor, partnership, close corporation, public company and private company, using the table below:

- Name of the entity.
- Number of owners.
- Rules and regulations to comply with when starting.
- How long can the business continue for?
- What are the financing possibilities?
- Who will manage the business?
- What taxation responsibilities are there?
- To what extent are the owners responsible for the liabilities of the entity?

Complete this table by adding as many lines as necessary to add all the information above.

Characteristics	Sole proprietor	Partnership	Close corporation	Public company	Private company
Name of entity					
Number of owners					
...					

Question 1.5

List three users (both internal and external) who might be interested in accounting information. Explain why they would require such information.

Question 1.6

Potential investors would be interested in the past performance of a business. Provide reasons why.

Question 1.7

List four items of financial information you consider to be important to a manager of a business that has been operating for a year.

Question 1.8

Develop a short list of mutually exclusive categories of business based on their respective activities. Is your list collectively exhaustive?

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2 THE ENVIRONMENT OF ACCOUNTING

Chapter objectives

By the end of this chapter, you should be able to:

- List advantages and disadvantages of a free enterprise system within the South African context.
- Describe the role of accounting within a free enterprise system.
- Discuss briefly the historical development of accounting.
- List and describe the different disciplines that form part of the accounting profession.
- Describe the differences between the disciplines in terms of their fundamental objectives.
- Discuss the role of technology within the field of accounting.

Chapter outline

1 INTRODUCTION 2 – 2
2 THE ECONOMIC SYSTEM 2 – 2
3 THE HISTORICAL DEVELOPMENT OF ACCOUNTING 2 – 2
4 THE ACCOUNTING PROFESSION 2 – 3
The chartered accountant 2 – 3
The professional accountant 2 – 3
The specialist disciplines within accounting 2 – 4
5 THE ROLE OF THE COMPUTER IN ACCOUNTING 2 – 5
6 SUMMARY 2 – 6

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1 Introduction

Financial accounting is an activity that usually takes place in some form of business environment where records of financial transactions are required. For us as South Africans, it also takes place within our economy, with its own particular characteristics. To set the scene, this chapter briefly reviews the type of economy in which business takes place in South Africa.

Thereafter, we briefly trace the history of accounting as an activity and a profession. Modern developments in computer technology have had a considerable impact on the way accounting activities are organised and the way in which transactions are recorded and reported. In this chapter we also briefly review the impact of technology on accounting.

2 The economic system

We speak of the South African economy as a **free enterprise system**. In a pure free enterprise system there is no government participation or intervention of any sort and there exists personal freedom and freedom of enterprise. No country exercises totally free enterprise, as the government is invariably involved in some capacity with a view to ensuring an economy that functions smoothly.

At the other end of the scale is the socialist type of economy which, in its pure form, is characterised by an economy that is government planned and controlled. In such a situation, ownership of fixed property is not permitted and the individual is not free to start a business motivated by the expectation of earning a profit. South Africa tends to be a country where free enterprise is encouraged and small businesses flourish. It is, however, dominated by a few very large companies and semi-state businesses.

An individual who has cash resources may use those resources freely within the country to generate more money. This can be done by making low risk investments in a bank or other financial institution, in return for interest. Another strategy would be to invest money in a new business in the hope that it will prosper and result in profits. A further strategy is to invest the money into an existing business that is expanding. There are in fact numerous alternatives that can be selected.

Such an economic system makes it essential for the owners of capital to have feedback regarding the position of their investments. It also requires a means of measuring the profit or loss that may have resulted from the investment. This information is supplied by the accounting system.

You should be able to complete Questions 2.1 to 2.3.

3 The historical development of accounting

Accountancy stems originally from the need to keep records. In a very primitive sense it has been used ever since humans first needed to add and subtract.

Many examples have been found of early attempts to record business transactions. The Assyrians provided the earliest record as far back as 3500 BC, while clay tablets were found in Babylon dating back to 2300 BC and in Egypt a system of record keeping for the building of the pyramids was unearthed. The absence of recognised numerical and monetary systems in those early times was a major drawback.

In early times the venture system was used predominantly. For example, a quantity of goods was bought, transported and sold. The venture was treated in isolation and the profit was simply the result of income minus expenses.

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During the 6th and 5th centuries BC, a monetary system was developed resulting in improved financial records. The system whereby a servant was given charge of resources entrusted to him, for which he was required to give an account, formed the basis of the accounting system that developed over the centuries. The function of giving an account of the entrusted resources was known as the 'stewardship' function.

The records were in a narrative form for many centuries. Only in the 11th century AD did a number system begin to evolve, initiated by Arab traders. The actual basic system of accounting as it is still used today for record keeping, first received prominence in a publication by a Franciscan monk, Lucia Pacioli in 1494. The emphasis was on the stewardship function, focusing on recording financial data.

As the venture system was still commonly used, accounting did not provide information at periodic intervals as it does today. The profit or loss was calculated at the end of each venture, such as a voyage.

In the 19th century, the rapid development in trade and particularly the evolution of the company as the most important business organisation led to more developments in accounting. While the stewardship function remained important for management to report to shareholders, greater emphasis was placed on the use of accounting figures for decision- making.

The emphasis of accounting is presently focused on reporting financial information to the various classes of users (discussed in Chapter 1), and the use of the financial information on past performance of a business to predict its future performance.

4 The accounting profession

Accounting has developed as a profession over the past century, attaining a status equivalent to that of law and medicine. In South Africa there are two accounting career paths to be considered, that is:

- The chartered accountant – via the South African Institute of Chartered Accountants (SAICA).
- The professional accountant – via the South African Institute of Professional Accountants (SAIPA).

The chartered accountant

The Companies Act 71 of 2008 requires that all listed companies must prepare their annual financial statements in conformity with International Financial Reporting Standards (IFRS). SAICA has therefore devoted considerable resources to developing the profession, from researching and developing standards that are in line with acceptable, international accounting standards to the education of accountants in training. Their focus extends to accountants in practice in terms of their continuous professional development requirements for their members.

Only those accountants who have passed the SAICA qualifying exams, have met certain experience requirements and have joined one of the provincial societies of chartered accountants, may use the designation CA (SA).

The professional accountant

Unlisted companies as deined by the Companies Act 71 of 2008 – small and medium entities with a turnover of less than R100 million per annum – are also required to manage their business activities within an acceptable accounting framework, namely IFRS for SMEs. These

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companies would use the services of a professional accountant to manage the financial information of the business or offer advice that will ensure the sustainability of the business.

The regulatory body that professional accountants in South Africa would typically belong to is SAIPA. The requirements to use the designation Professional Accountant (SA) spans specific academic qualifications, practical training or experience and the professional evaluation exam facilitated by SAIPA.

The specialist disciplines within accounting

Bookkeeping entails the recording of transactions. The activities of the bookkeeper tend to be repetitive. A few months of study may be sufficient to become a good bookkeeper.

Accounting, on the other hand, 'includes not only the maintenance of accounting records, but also the design of efficient accounting systems, the performance of audits, the development of forecasts, income tax work, and the interpretation of accounting information'. It takes several years of study and experience to become a professional accountant.

Accountants qualified as CA (SA) form a relatively small proportion of the total number of people involved in accounting activities. In many businesses, banks and government institutions, it is possible to become the chief accountant for that business or division without a CA (SA) qualification.

Here are the specialist areas where a thorough knowledge of accounting is essential:

Auditing

This is the primary service offered by most public accounting businesses. These businesses act as external examiners of the accounting system and sign the financial statements. Large businesses use people with a thorough knowledge of accounting to ensure that established procedures and policies are being followed.

The internal auditor, who is an employee of the business, is thus not independent but can assist in reducing the time that the external audit would take. The internal auditor will not be required to give the audit opinion and need not be a chartered accountant, but should have a thorough knowledge of accounting and auditing principles.

Tax services

Tax services are offered by accounting businesses, but also by outside consultants and lawyers. Although a thorough knowledge of accounting is important here, knowledge of tax laws and tax case histories is vital.

Accountants specialising in taxation endeavour to reduce their clients' tax liabilities within the parameters of tax legislation. This is known as tax avoidance and is perfectly legal. Tax evasion, on the other hand, whether through deliberate non-disclosure or false disclosure of the true facts, is a serious offence.

Management advisory services

Public accounting businesses are becoming increasingly involved in advising clients on deficiencies in their accounting and other systems.

Again, this task is often performed by persons other than chartered accountants, who have skills in the area requiring attention. However, a thorough knowledge of accounting is usually a fundamental prerequisite for being able to offer this service effectively.

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Financial accounting

This function requires that systems be established to meet four basic requirements:

- The recording of all transactions of the business (bookkeeping).
- The classification and summary of all this information.
- Reporting the results to management and other stakeholders on a regular basis, usually annually, monthly or weekly.
- The analysis of the information to detect areas of financial weakness that require attention.

Every small organisation that deals with money has at least one person involved in this function. Many large organisations have literally hundreds of people whose daily job is some aspect of the financial accounting system of the organisation.

Management accounting

This includes cost accounting that deals with the collection, allocation and control of the cost of producing specific goods or services. It also includes preparation of plans or budgets of future operation costs and income, as well as decision-making.

Once again both these areas require a thorough knowledge of how an accounting system functions and the ability to interpret the information that it provides.

Financial management

The financial manager of a business has two major functions: investigating investment opportunities into projects such as opening new stores or factories, or purchasing additional machinery to increase production. If these projects seem likely to be profitable, then funds must be raised to put them into operation.

These funds are obtained from resources within the business if they are available by obtaining additional capital from owners and investors, or by borrowing. Inevitably the financial manager will need to read and understand the output of accounting systems.

You should be able to complete Question 2.4.

5 The role of the computer in accounting

Computer technology, that is of interest to the accounting function, is often referred to as business data processing or information technology. There is no doubt that the advent of computer technology has had a dramatic effect on the accounting function.

Its main impact has been the removal of much of the drudgery attached to the manual recording of transaction data of a business. It has, therefore, speeded up the activities of recording and processing data.

Accounting packages do have major benefits:

- Transactions are processed more quickly. (Postings to the general ledger and trial balance is done by the computer as well as balancing of individual accounts; in a manual system these are time-consuming tasks.)
- Transactions are processed more accurately. (Double-entries are done by the computer; the only error that can occur is when the computer operator punches in the incorrect information.)

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- More information can be captured on individual transactions than any manual system can accommodate.

From the above it should be evident that the use of computers has changed the role of the accountant. The emphasis in an accountant's job has shifted from recording and processing transactions, to interpretation of results and communication of corrective actions to be taken.

The computer also plays a role in these tasks of the accountant because various reports are available when needed, such as:
- Age analysis.
- Trial balance.
- Financial statements.
- Budgets.

Having said the above, it should also be noted that it is quite possible to access reports and obtain information directly from the business database. Therefore, it can be expected that the output of the accounting process, the traditional financial statements, may eventually disappear.

The rate of development and change in computer technology is phenomenal. This makes it difficult for the layperson to keep pace with the available hardware (the computer) and the available software (the packages).

There is no doubt that it is possible to study accounting in front of a computer. Currently there are courses available that make this possible. However, it is still necessary to understand the processes and relationships for an understanding of accounting.

The fact that accounting is studied by using paper and a pen should not detract in any way from the fact that most accounting, in practice, is performed on a computer. Once you are placed in front of a terminal, with a knowledge of accounting, you will be in a position to use the computer package intelligently.

You should be able to complete Question 2.5.

6 Summary

This chapter has defined the environment in which accounting systems operate. It is possible in South Africa for anyone to start their own business with a view to making a profit. Alternatively, people may invest their money into an existing business and share in the profits if the business is successful.

To select the investment opportunity wisely, accounting information will be of assistance. Accounting systems have developed over centuries from a purely recording device, to those that require managers to give account of their proficiency as stewards of the investments of others. Accounting information about past performance is also used by investors to predict the expected future performance of the business.

The accounting profession plays a role in regulating the standards of accounting and reporting. Although chartered accountants hold the highest accounting qualification, there are many highly skilled and senior positions in a number of areas available to those who are competent in accounting skills.

Accounting students should also take cognisance of the role of the computer in the accounting field.

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QUESTIONS

Question 2.1

List two advantages and two disadvantages of a free enterprise system with particular reference to what you observe in the South African business environment.

Question 2.2

Discuss whether it is possible for a business to survive if it makes no profits.

Question 2.3

'If South Africa moved away from being a relatively free enterprise economy, the need for accounting information would diminish considerably.'

Provide an argument to support or refute the above statement.

Question 2.4

Briefly define each of these disciplines in terms of their most fundamental objective:

- Financial accounting.
- Management accounting.
- Cost accounting.
- Financial management.
- Taxation.
- Auditing.
- Information systems (accounting information applications).

Question 2.5

To what extent is the rapid development in information technology likely to cause financial accounting education to become redundant? Provide examples.

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3 CONCEPTS OF ACCOUNTING

Chapter objectives

By the end of this chapter, you should be able to:

- Discuss the nature of accounting.
- Define and apply the principles and concepts of accounting.
- Explain accounting policies.
- Explain the elements of financial statements.
- List and explain the qualitative characteristics of accounting reports.
- Explain and apply the accounting equation.
- Classify and record transactions using the accounting equation.

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1 Introduction

Studies undertaken by various accounting bodies throughout the world and in South Africa have attempted to define what accounting seeks to achieve and how it should be achieved. Another fundamental reason for undertaking studies of this nature is definitely to attempt to find a framework for accounting.

Such a framework would provide the fundamental principles and theories that underlie the discipline of accounting. By identifying such a framework it will become easier to decide between alternative practices of accounting. Once there is agreement on underlying theory, the practice of accounting becomes easier.

In November 1990, a Conceptual Framework was accepted by the South African Institute of Chartered Accountants. The Conceptual Framework of financial reporting, namely the International Financial Reporting Standards (IFRS), was implemented by the International Accounting Standards Board (IASB).

The rest of this chapter will explore the nature of accounting, International Financial Reporting Standards (IFRS), elements of financial statements and the accounting equation.

This book deals predominantly with the practice of accounting techniques. It is widely accepted that all practices are based on theory. This means that somewhere some idea has given rise to the practice. This chapter explores briefly some of the underlying ideas, concepts and principles on which the practice of accounting is based.

2 The nature of accounting

It has already been said that the primary objective of accounting is to provide information that will be useful for making economic decisions. In Chapter 1, it was explained that accounting is also an information system. Accounting is thus seen as a communication means – sending information from the source, via a channel, to the receiver.

In the above statement **source** will refer to the provider of financial information; **channel** will usually be statements of past performance and present position collectively known as the annual financial statements; and **receiver** will be the user of the financial information.

Other writers, particularly academics and accountants, have identified various images that people have had or may presently have regarding the nature of accounting. The following major images have been identified by various academics and practitioners:

Accounting as a historical record

From the times when management of a company was separated from ownership, the accountant often played the role of caretaker of the owner's assets.

The major function then became a stewardship function that required the accountant to keep accurate records of what had taken place in the business over a period of time and to present a statement of assets and liabilities to the owner.

The emphasis was thus on the owner to ensure that adequate care was taken in the conduct of the business and protection of the business assets.

Accounting as a commodity

This view has some similarity with that of accounting as an information system. The emphasis, however, is on cost and benefit. The information that is provided by the accounting system is seen as a product or commodity that can be sold and should be sold at a price higher than the cost of producing the product.

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This implies that a market for accounting information exists. In the market there will be the sellers (who are the producers of the information) and the buyers (those who are prepared to pay for the commodity).

Clearly the criterion that will be used by buyers is that the commodity must have a value that is greater than the cost.

Accounting as economic reality

There are those who consider that the information provided by accountants should represent real value. Whereas this may be an ideal situation, in practice accountants do not claim to provide information regarding real value. Instead, accountants employ certain basic rules and principles that should be used consistently when producing accounting information.

Users of accounting information are thus required to understand these basic principles and rules to convert accounting information into real values. The burden rests with the user of financial information to interpret accounting numbers correctly, and in the light of current economic situations to arrive at a decision.

You should be able to complete Question 3.1.

3 Accounting principles and concepts

Accounting literature often draws a distinction between postulates, conventions, concepts, principles and techniques. For our purposes we will discuss these under the general heading of accounting principles and concepts, identifying those to which reference is most frequently made.

Clearly, whatever term is used, we are referring to those theoretical or conceptual ideas that underlie the actual techniques used in the practice of accounting.

Money as common unit of account

The financial position of an enterprise consists of tangible and intangible assets and claims for and against third parties. To give a meaningful description of the financial position, it is done in monetary terms.

In South Africa, the monetary unit is the rand and reporting on the financial position is provided in a statement of financial position in rands.

The performance of its operations results in a profit or loss being made. The profit or loss is calculated by deducting expenses from income, and reporting on the results of operations is provided in the statement of profit or loss & other comprehensive income in rands.

The use of money as a unit of account implies that information which cannot be measured in rand terms, such as the quality and experience of the workers in a business, is usually not included in the financial statements.

The cost principle

This concept is probably the most fundamental and controversial concept used in accounting. According to the cost principle, assets are reflected at cost. This means quite simply that accountants do not attempt to reflect assets at real or market values. In times of rising prices, the cost of an asset bears very little resemblance to market value.

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It may thus be said that the information provided by accountants is inaccurate. While it is true that the asset may not be shown at market value, the overriding advantage of the historical cost method is that cost is determined objectively. Given sufficient additional information, the onus is on the user or analyst to establish real value on the basis of cost information provided.

Attempts have been made, particularly during times of high inflation, to introduce systems of accounting that provide value-based information. A compromise has been reached and many businesses provide additional value-based or inflation-adjusted information to assist the user, and to compensate for the distortions caused by inflation.

Example 3.1

Mr Noi started a computer business in 20*x*4 and bought a building for R20 000 on credit. The building is worth R280 000 in the current year, 20*x*9.

By applying the cost principle, the building will still be shown at R20 000 in the financial statements of 20*x*9, that is, at the original cost.

The entity principle

In accounting, it is accepted that an entity or business can be identified. All accounting practices then relate to this particular business. It is for this reason that the personal financial affairs of the owner are never intermingled with those of the business for which the accounting is being performed. The accounting entity is thus the economic unit that engages in activities known as transactions that result in the transfer of wealth.

Using the entity concept the accountant will, for example, record the transactions of a sole proprietor engaged in retailing activities. The only transactions relevant to that business are, therefore, transactions affecting the business of that sole proprietor. Any personal transactions of the owner, other than depositing funds into, or withdrawing funds from the business, are not recorded.

Example 3.2

Mr Morapedi opened a carpet cleaning business on 1 January 20*x*2.

1. Mr Morapedi bought cleaning equipment worth R18 000 and paid per cheque.
2. Mr Morapedi bought detergents and soap that he uses in his business from Sparkling Clean. He received invoice number 386 for R5 670.
3. Mr Morapedi bought a new car for his wife for private use and used his personal savings account for R18 000.

The transactions will have this effect on the reporting entity of the carpet cleaning business:

		Dr.	***Cr.***
1	Cleaning equipment [Increase]	R18 000	
	Bank [Decrease]		R18 000
2	Cleaning materials [Increase]	R5 670	
	Accounts payable [Increase]		R5 670
3	No effect as this is a personal transaction of the owner. [Entity principle applied]		

The principle of duality (double-entry principle)

The principle of duality determines that the financial situation of an enterprise is represented in terms of the basic accounting equation. Every transaction concluded by the enterprise has a twofold influence on the equation, causing it to balance continuously.

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The result of this principle is the technique used in accounting of having a 'credit' entry for each 'debit' entry. An increase in an asset, such as a vehicle, that is not brought about by an equal decrease in assets (such as bank), or increase in liabilities (such as a bank loan), must inevitably increase owner's equity, for example, being a contribution made by the owner.

The basic accounting equation is:

Assets – Liabilities = Owner's Equity

The assets have value to which two groups lay claim, that is, the liabilities and the owner of the business. Should a distinction be made between the two groups, the equation is extended as:

Assets = Owner's Equity + Liabilities

The **basic accounting equation** will be explained in this chapter and also in Chapter 4.

Other principles

The materiality principle, the going concern concept, the accrual concept and the matching concept will be explained in detail in Chapter 8 in the context of the framework for preparation and presentation of financial statements.

You should be able to complete Question 3.2.

4 Disclosure of accounting policies

Despite the fact that International Financial Reporting Standards (IFRS) exist and those who prepare financial statements are aware that their reports should comply with the qualitative characteristics for financial reporting, it is still possible that different businesses will use varying policies.

The use of varying policies inevitably results in accounting numbers that may have been different had an alternative policy been used. For this reason, it is customary for all reporting entities to indicate in their financial statements the accounting policies that they selected and used. The disclosure of accounting policies is discussed in more depth in Chapter 20.

Figure 3.1

Nkomo Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20*x*1

1 *Accounting policies*

These financial statements are prepared on the historical cost basis, modified by the revaluation of certain land and buildings, in accordance with these principal accounting policies. The accounting policies adopted are consistent with those of the previous year.

Property, plant and equipment
Land and buildings are shown at valuation amount. Land and buildings is not depreciated. Vehicles are shown at cost and are depreciated on the straight-line method at 15% per annum.

Inventory
Inventory is valued at the lower of cost net realisable value and on a first-in-first-out basis.

Revenue
Revenue represents sales to customers net of value-added tax (VAT).

Investments
Investments are shown at cost, less allowances and amounts written off, and their results are brought to account only to the extent that dividends are received.

You should be able to complete Questions 3.3 and 3.4.

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5 Qualitative characteristics of financial reports

The information that financial reports provide to users should comply with certain standards of quality to make the information most acceptable. These criteria are often referred to as the qualitative characteristics of financial information. Numerous studies have been undertaken to establish that qualitative characteristics should dominate.

An authoritative study (that of the Financial Accounting Standards Board of the USA), has issued its Statement of Financial Accounting Concepts No 2 that is considered to be the most up to date and comprehensive. The IFRS Conceptual Framework is consistent with this.

Two overriding qualitative characteristics were isolated:

1. Relevance.
2. Faithful representation.

In addition, other important qualitative characteristics were identified. These are briefly discussed.

Relevance

Relevance is defined as the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present and future events or to confirm or correct prior expectations.

This means quite simply that if financial information does not appear to address the decision being made, it does not have relevance and, therefore, does not constitute real information.

Faithful representation

Faithful representation is defined as the quality of information that ensures that information is reasonably free from error and bias and faithfully represents what it purports to represent.

Quite clearly, if information is relevant but not reliable, it will not constitute information as it cannot be acted upon. Similarly, information that is reliable but not relevant is of little use to anyone.

Other qualities

Having established that relevance and faithful representation are the two most fundamental qualitative characteristics, a number of enhancing qualitative characteristics were identified. They include comparability, timeliness, understandability and verifiability.

These qualities together should be present in any set of financial statements. All of these qualitative characteristics will be discussed in detail in Chapter 8.

You should be able to complete Question 3.5.

6 Elements of financial statements

Financial statements are a summary of the financial effects of transactions and other events between the reporting entity and third parties. The transactions and events are grouped together in classes according to their economic characteristics. The IFRS Conceptual Framework defines the three elements of a statement of financial position as:

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1 An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. Examples of assets are property, plant, equipment, patents, copyright, trade receivable, inventories and a positive bank balance. Assets are discussed in more detail in later chapters.
2 A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. Examples of liabilities are trade payables, bank overdraft, debentures and long-term loans.
3 Equity is the residual interest in the assets of the enterprise after deducting all its liabilities and represents the interest of the owners in the business.

Reminder

The statement of financial position consists of three elements – assets, liabilities and equity – while the statement of profit or loss & other comprehensive income summarises the costs of income arising from revenue, gains, expenses and losses.

The elements of the statement of profit or loss & other comprehensive income are defined as:

- Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
  Income includes both revenue and gains.
  - Revenue includes a variety of different items including sales, fees, dividends and rent.
  - Gains are not different from revenue but do not usually arise from normal operating activities. An example of a gain, is a profit on the sale of a vehicle.
- Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.
  - Expenses include losses and expenses that arise in the course of the ordinary activities of the enterprise.
  - Losses as gains may or may not arise from the ordinary activities. An example of a loss, is a loss on the sale of a vehicle.

You should be able to complete Question 3.6.

7 The accounting equation

The accounting equation was mentioned previously under the accounting principle of duality. The accounting equation is a **fact** that states that in any business, at any point in time, assets would be equal to the owner's equity plus liabilities.

To make this true, the principle of duality should be applied to every transaction that takes place. Just to recap, the principle of duality states that for each transaction there should be a double-entry, which means that for each debit entry there should be an equal credit entry. This is an important accounting rule that should always be followed.

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So the rule says that for each debit an equal credit entry is required. Now, how do you decide which account should be debited and which account should be credited? To answer this you need to know a few more accounting rules that relate to the debiting and crediting of different types of accounts:

- If an asset account increases, it should be debited.
- If an asset account decreases, it should be credited.
- If a liability account increases, it should be credited.
- If a liability account decreases, it should be debited.
- If owner's equity increases, it should be credited.
- If owner's equity decreases, it should be debited.

Example 3.3

These transactions took place in the business of Amos Ngcobo during February 20*x*11:

1. The owner, Amos Ngcobo, invested an amount of R80 000 cash in his business, which he called Ngcobo's Traders.
2. The owner donated vehicles to the value of R150 000 as part of his capital contribution.
3. New furniture to the value of R40 000 was bought on credit from Quick Furniture Suppliers.
4. An amount of R30 000 was paid by cheque to Quick Furniture Suppliers.
5. Ngcobo's Traders applied for a loan from AA Bank; the loan of R60 00 was granted and the money was deposited into the bank account of Ngcobo's Traders.
6. Ngcobo's Traders signed a lease agreement with the landlord for the rental of the premises from which they will be operating and paid the current month's rent. A cheque of R6 000 was issued out for this.
7. Amos Ngcobo issued a business cheque to the value of R450 for his home telephone bill.
8. Ngcobo's Traders paid the following items by cheque:
   - Salaries R2 000
   - Electricity R800
   - Rates R1 900
   - Sundry expenses R5 000

You are required to:
Indicate the effect of these transactions on the accounting equation.
(Complete the accounting equation in a table.)

Suggested solution

No.	A	=	OE	+	L
1.	+80 000 (Bank)	=	+80 000 (Capital)	+	0
2.	+150 000 (Assets)	=	+150 000 (Capital)	+	0
3.	+40 000 (Furniture)	=	0	+	+40 000 (Accounts payable)
4.	–30 000 (Bank)	=	0	–	–30 000 (Accounts payable)
5.	+60 000 (Bank)	=	0	+	+60 000 (Loan: AA Bank)
6.	–6 000 (Bank)	=	–6 000 (Rent paid)	+	0
7.	–450 (Bank)	=	–450 (Drawings)	+	0
8.	–2 000 (Bank) –800 (Bank) –1 900 (Bank) –5 000 (Bank)	=	– 2 000 (Salaries) –800 (Electricity) –1 900 (Rates) –5 000 (Sundry expenses)	+	0 0 0 0

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Explanation

The accounting equation is: **assets = owner's equity + liabilities**

- Take notice of the symbols (+ or –) used in front of the amount to indicate an increase or decrease. It is very important that the correct symbol is used because after every transaction you have to test that the accounting equation still balances.
- To decide how the transaction will be entered into the accounting equation, it is important, first, to identify the accounts that will be affected by the transaction. It is then important to classify the account as being asset, liability or owner's equity (the accounts that will be reflected on the statement of financial position of a business).
- But what about income and expense accounts? How do they impact on the accounting equation? Income less expenses = profit. The profit is what the owner is interested in, otherwise he could just as well have invested his money into a fixed deposit. So the profit increases owner's equity.
- Income accounts will, therefore, increase the owner's equity and expense accounts will decrease owner's equity.
- *Transaction 1*: The bank account of the business (an asset) increases with the amount that the owner contributes to the business, the asset will be debited. The owner's equity will increase with the amount that the owner contributed, the capital account will be credited.
- *Transaction 2*: The asset account increases with the amount of the assets that the owner brought into the business, the asset account will be debited. The owner's equity will increase with the amount of the assets that the owner contributed, the capital account will be credited.
- *Transaction 3*: The asset account increases with the amount of the assets that were bought, the asset account will be debited. This time assets are bought and the amount is still payable, which is classified as a liability. In this case, the liability will increase; to do this the payable's account will be credited.
- *Transaction 4*: The payable is paid, therefore, the liability account will decrease; the payable's account will be debited. It is paid from the bank account of the business, so the asset will decrease; the bank account will be credited.
- *Transaction 5*: The money received from the loan will increase the asset account; the bank will be debited. The loan means that the money is owing to a third party; liabilities will increase, which means that the loan account will be credited.
- *Transaction 6*: The rent is seen as an expense, which will decrease owner's equity; the rent paid, an expense account will be debited. Cash to pay this expense comes from the bank account of the business; the asset account will decrease, the bank account will be credited.
- *Transaction 7*: The telephone bill is paid from the bank account of the business, which means that the asset will decrease; the bank account will be credited. The fact that the expense was paid for the owner's personal telephone, decreases the owner's equity; the drawings account will be debited. Drawings is the term used for items that the owner takes for his personal use.
- *Transaction 8*: All these expenses will decrease owner's equity; each expense account will be debited. Cash to pay these expenses comes from the bank account of the business; the asset account will decrease, the bank account will be credited.
- The debiting and crediting of different types of accounts will be elaborated on in Chapter 5.

You should be able to complete Question 3.7.

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8 Summary

Numerous accounting concepts have been identified as the accounting discipline has developed. A search for a conceptual framework consisting of a logical explanation of the theories and principles underlying accounting was completed in the USA in 1990, which led to the Conceptual Framework, AC 000, being accepted in South Africa. In August 2004, AC 000 was renamed the Framework for the preparation and presentation of financial statements.

To regulate financial reporting, a set of standards has been developed in South Africa and throughout the world. This set of standards is governed by the International Financial Reporting Standards (IFRS). The IFRS requires that entities should also disclose the different accounting policies used in the preparation of their final statements.

For information to have value to the user, it should possess certain qualitative characteristics, of which relevance and faithful representation are the most fundamental.

The different elements of a statement of financial position are identified as assets, liabilities and equity, and that of the statement of profit or loss & other comprehensive income as income and expenses.

The principle of duality requires that for each transaction in a business there should be equal debit and credit entries. These could be entered into the accounting equation, which states the fact that assets = owner's equity + liabilities.

QUESTIONS

Question 3.1

Discuss the shortcomings of using historic cost as a measure of financial performance and position.

Question 3.2

Discuss the four accounting principles and concepts explained in this chapter.

Question 3.3

Discuss the use of International Financial Reporting Standards (IFRS) as they relate to disclosure in annual financial statements of South African companies.

Question 3.4

This question relates to the cost principle. If the accounting policy of an enterprise is to depreciate its vehicles at 'a rate that is deemed to be sufficient to reduce the book value of the vehicles over their estimated useful life to their estimated residual value', and the applicable rate is:

Vehicles – 2% per annum on the straight-line method, and in one year, for an unknown reason.

The bookkeeper writes off depreciation on vehicles at 20% per annum on the reducing-balance method:

1. What accounting principle is violated?
2. Why is this a violation?
3. When is this type of practice acceptable?

Question 3.5

List and explain three of the qualitative characteristics to which a set of financial statements should comply, according to the IFRS Conceptual Framework.

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Question 3.6

Compile a list of 'qualities' that you consider important for financial information.

Question 3.7

These transactions took place in Zindile's General Dealers for July 20*x*11:

1. The owner increased her capital contribution by R40 000, by depositing a personal cheque in the current account of the business.
2. Issued a cheque, R150, to Bakkie Services for the delivery services rendered.
3. Rendered services on credit to D. Garner for R300.
4. Received an invoice from PG Garage for repairs done to the delivery vehicle, R450.
5. Purchased stationery on credit from XY Traders amounting to R4 500.
6. Made a loan at Stell Bank of R9 000.
7. The owner took stationery for her personal use, R400.
8. Rendered services for cash, R900.
9. Returned R300 worth of stationery previously purchased from XY Traders.
10. Received a cheque from D. Garner for half the amount outstanding.
11. Received a cheque, R460, from R. Rall as part payment on his account.
12. Purchased equipment for R6 000, made a payment for R1 500 and the balance will be paid off over 6 months.
13. Paid the rates and taxes owing to the municipality by cheque, R1 200.
14. Rendered services on credit for R4 200.
15. Made a payment for salaries, R3 500.

You are required to:

Indicate, with reasons, what effect the given transactions have on the accounting equation.

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MODULE

B Basic recording techniques

This module is divided into five chapters:

Chapter 4 Accounting as a system
Chapter 5 Fundamentals of the recording process
Chapter 6 Expanding the set of accounts
Chapter 7 The general ledger and general journal
Chapter 8 The framework for the preparation and presentation of financial statements

Together these five chapters achieve the following outcomes:

Outcomes

- Collecting and organising financial source documents.
- Using an accounting process to record the information on source documents in a general ledger.
- Applying the output of the accounting system to provide information about the financial position of a business at any given moment.
- Applying the output of the accounting system to provide information about the financial performance of a business over a specified period of time.
- Communicating the financial position and results in the business.
- Critically evaluating and advising on the extent to which productive use has been made of scarce financial resources.

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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4 ACCOUNTING AS A SYSTEM

Chapter objectives

By the end of this chapter, you should be able to:

- Introduce and apply the recording process in accounting as a system with three elements, namely:
  - input
  - process
  - output
- Define the output of an accounting system as a statement of financial position and a statement of profit or loss & other comprehensive income.
- Introduce the examples of the input into an accounting system in the form of these source documents:
  - a receipt
  - a cash slip
  - a cheque and cheque counterfoil
  - an invoice
- Define four basic concepts of value.
- Define the three components of the accounting equation, namely:
  - assets
  - owner's equity
  - liabilities
- Develop the skills of recording financial transactions under the three components of the accounting equation.
- Introduce a statement of financial position.
- Introduce a statement of profit or loss & other comprehensive income.
- Introduce the concept of adjusting entries required prior to reporting financial information.
- Introduce the concept of return on investment.

Chapter outline

1 INTRODUCTION 4 – 2

2 THE SYSTEMS APPROACH TO ACCOUNTING 4 – 2
- Output: Reports on financial position and financial performance 4 – 2
- Input: Source documents 4 – 5
- A brief description of the goods or services provided 4 – 6
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3 RECORDING TRANSACTIONS USING THE ACCOUNTING EQUATION 4 – 10

4 THE INFORMATION GENERATED BY THE PROCESS 4 – 13

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6 SUMMARY 4 – 18

1 Introduction

We now know that the objective of accounting is to provide information about a business that will help users in making decisions.

For the owners and management the information will help in determining whether the business is **performing** as well as was expected and whether its financial **position** is sound. The information may reveal areas that need attention such as certain costs being high or sales revenue being inadequate.

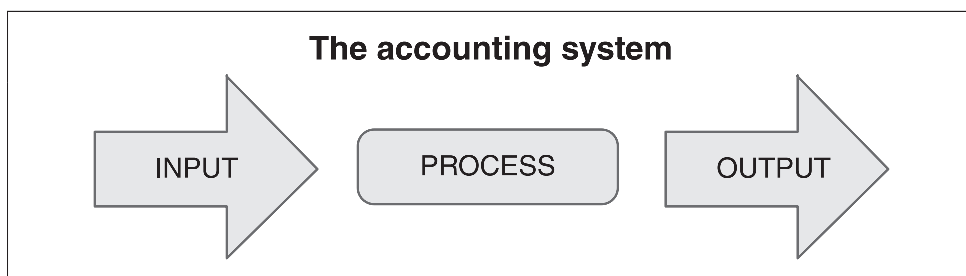
For outsiders, such as payables or persons who may be interested in investing money into the business or even buying the total business from the existing owner, similar information is available. In particular, the percentage return on investment that the business is producing can be compared with other investment alternatives.

This chapter introduces the system that accountants have developed for collecting and recording data. The data is generated from transactions between the business and those with whom it trades.

2 The systems approach to accounting

The accounting process can only be developed once the required output is determined. In this way the accounting system is similar to any system. It has three components and is shown in Figure 4.1.

Figure 4.1



Output: Reports on financial position and financial performance

Any system can only be developed by first determining what that system should achieve. For this reason, we commence the accounting system by defining the **output** that the system aims to achieve.

For accounting, the system attempts to provide information on two fundamental aspects of the business. Each of these aspects will provide information that will help in estimating the value of the business.

- One way of establishing value is by listing all the items owned by a business and attaching a rand value to those items. If amounts are owed by the business, they must be deducted to determine the net value of the business.

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- A second approach in establishing the value of a business is to attempt to predict the future financial benefits that will flow from the business and decide on a price that you will be prepared to pay to receive those benefits. To predict the future benefits, a statement of past profits is required.

Both of these aspects will now be discussed.

Present financial position

The accounting system must provide information that enables the user to determine what the business owns at a given point in time – its **assets**. This could be the most difficult part of accounting as it inevitably introduces subjective judgement.

Reminder

The output is the information required by those who will use the financial reports, usually for the purpose of making decisions that involve money.

To avoid the problem of subjective judgement as to what an item may be worth, accountants have traditionally used **cost** as the basis of determining value. In other words, any asset is recorded at its **cost price** less amounts written off as a result of time and usage, for the purpose of establishing the financial position of a business.

This has considerably simplified the problem of establishing the financial position for the accountant. It has the disadvantage that the financial position, as determined by the traditional accounting approach, does not necessarily reflect the 'true' or economic value of a business.

At first this seems an easy way out for the accountant. However, on reflection, it is a very reasonable approach, because it leaves some scope for users of accounting information to exercise their own judgement in areas where it is difficult to determine precisely the value of an asset. For example, the **value** of a machine may be arrived at by using any one of five methods, each of which will result in a different rand value. Five recognised methods of determining value are:

- **Historic cost** – The rand value is arrived at by deducting a proportion of the cost resulting from age or use.
- **Replacement cost** – The rand value is arrived at by establishing the present cost of replacing the machine with another in a similar condition.
- **Realisable value** – The rand value is arrived at by establishing the net price for which the machine could be sold on the open market.
- **Economic value** – The rand value is arrived at by establishing the present worth of all future profits that are expected from using the machine.
- **Liquidation value** – The rand value is arrived at by establishing the net disposal value of assets and settlement amounts for liabilities, when a business is no longer considered a going concern.

Accountants are aware of the problem of establishing value, and much has been written by both academics and practitioners in an effort to make financial statements more relevant to users. Although this problem is beyond the scope of this book, this will not in any way impair an understanding of the accounting process.

Did you know?

This approach to financial reporting is used all over the western world by both small businesses and large global companies.

However, it is essential to understand clearly from the outset that financial position statements, as one of the two main outputs of our accounting system, are largely based on the **historic cost** of the assets at the time of

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purchase, less amounts known as depreciation, deducted as a result of age or use. The cost concept is thus fundamental to the accounting system being used.

Once the financial position of a business has been established on the basis of the historic cost of the assets, it is then necessary to know who has claims against those assets. In other words, in the event of the business closing down and all the assets being sold, to whom would the money belong?

For convenience, distinction is made between the owners of a business who have a claim, and other people. As a business is usually started at the risk of the owner, the outsiders, known as **liabilities**, have first claim on the assets. Only after they have been repaid what the business owed them, does the owner have a claim.

The owner, therefore, is entitled only to the residue, that is, what is left after liabilities have been repaid. **Owner's equity** is the name given to that part of the value of a business that belongs to the owner after all outside claims against the assets have been settled.

The financial position, in summary, is the output that informs users about the assets held by a business and the persons who have claims against those assets. It distinguishes between outsiders known as **liabilities**, and owners, their claim being known as **owner's equity**. It shows the financial position at a given moment in time. The entity concept is thus apparent, with the performance and position of the business being entirely isolated from those of the owner.

A simple statement of present financial position would contain the information below and may be displayed in a similar form as Figure 4.2.

Figure 4.2

STATEMENT OF FINANCIAL POSITION AS AT 31 JUNE 20x9

Assets		10 000	Owner's equity		7 500
			At beginning of the year	6 000	
			Add: Profit	1 500	
			Liabilities		2 500
		10 000			10 000

Past financial performance or result

The accounting system must also produce information that indicates how well the business has performed during the previous period. The period under review is usually a year, although more frequent information – quarterly, monthly or even weekly – is often preferred by larger business entities.

Information about the past is relevant because it is an indicator of what performance may be expected in the future. Clearly, any investor is interested in how well the investment will perform in the future.

However, the future is unknown and there are no crystal balls that can be used for guidance. Past performance is, therefore, a valuable piece of information for users of accounting information.

Did you know?

In 1946, Sir John Hicks wrote that 'it would seem that we ought to define a man's income as the maximum value that he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning'. (They were obviously less gender sensitive in those days, but the principle of his statement is still applied by researchers in finance and accounting today.)

One way of viewing **performance** is quite simply to take the difference between what the owners were worth at the beginning of a period and compare it with what they are worth at the end of the period.

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Naturally this difference must not include any additional capital that an owner may have invested in the business, or any withdrawals by the owner from the business.

This difference in beginning and ending owner's equity is, therefore, the **profit** or **loss** that the business has earned or incurred for the period under consideration.

Reminder

- The statement of financial position is like a 'snapshot' or photograph of the business at a specific moment in time.
- The statement of profit or loss & other comprehensive income is a report on what happened during a specific period, informing us of the performance of the business.

A statement of profit or loss & other comprehensive income would, in essence, contain the information shown in Figure 4.3. It shows the performance of the business over a specified period, usually one month, six months or one year.

Figure 4.3

STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20*x*9	
Revenue from conducting the business	8 000
Less expenses incurred	6 500
NET PROFIT	1 500

Although the two statements discussed are very short, they do provide us with some valuable information. For example, the following is clear:

- The business made a profit of R1 500 for the year.
- The owner had R6 000 invested in the business at the beginning of the year.
- The business has assets of R10 000.
- The business owes outsiders R2 500.

In addition to information that is apparent from the two statements, we can derive further information. For example:

The percentage return for the owner on the investment of R6 000 for the year is 25% (1 500 ÷ 6 000 × 100). This rate of return can be compared with other investment alternatives available to assess whether it is acceptable.

There is more information that a person who wishes to analyse the business in more detail would need to have. As the recording process is explored, we will learn how to provide this information.

Input: Source documents

Once it is known what output is required, a process must be devised to achieve that output. The process will be dependent on the input. Where does the data ultimately come from to provide the information?

The two statements shown could be the result of many thousands of transactions that took place between the business and other people or entities. Each time such a transaction takes place, it is recorded on a document, or an electronic storage device such as a computer. This is fundamental in accounting. Every transaction must be recorded first on a source document.

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The data captured by the source document usually includes facts such as:

- The type of transaction that has taken place.
- All details of the transaction and the other party involved in the transaction.
- The date of the transaction.
- The amount of money involved.
- Any terms or conditions pertinent to the transaction.

A brief description of the goods or services provided

To simplify the manual handling of source documents, specific documents for a particular transaction are usually used. The most commonly used documents are on the next few pages.

Receipt

Purpose: To record cash received in payment of a debt.

Figure 4.4

Number RTS567
Date: ______________

JABULANI SUPPLIERS
Box 653 Ixopa
Landline: 031-678999
Email: Jabsup@yougogo.co.za

Received from ______________________________

The amount of ______________________________

With thanks

This document is completed in duplicate. The original is given to the person paying the cash. The duplicate remains for further processing.

When payments by cheque are received it is not essential to write out a receipt, as the cheque will eventually be returned to the drawer and serves as proof of payment. The business will use the bank deposit slip as the source document for recording the receipt of a cheque.

Cash sales slip

Purpose: To record cash or cheques received for the sale of goods or for services rendered.

This document is often printed automatically by the cash register. One copy emerges, is torn off and given to the customer. Another is printed simultaneously and remains inside the cash register until removed for further processing.

Figure 4.5

New Dions Discounters
Mitchelle's Plain
Tel: 021-7830384

Day: Mon   Date: 16 Feb 0X
Time: 14h43   Cash Point: PS26

CASH SALE

3 Paint @ 82.99	R248.97
4 Brush @ 9.50	R38.00
2 Garden chairs @ 99.50	R199.00
TOTAL DUE	R485.97
14% VAT incl	R59.68
Amount tendered	R500.00
Change	R14.03

Cheque

Purpose: To pay amounts owing or to pay for goods or services purchased.

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This document instructs the bank, where money has previously been deposited, to pay a named party.

At the time of writing the cheque, a cheque counterfoil may also be completed with details similar to those on the cheque.

Figure 4.6

Daybreak Bank
Registered Bank/Geregistreerde Bank
MAMELODI

00-04-81-66
Date
Datum JYJY-MM-DD

Pay
Betaal

or Bearer
of Toonder

the sum of
die bedrag van

R

A READER

⑆12316⑆ 0004184⑆ 0099645672⑈ 01

Most banks now provide cheque books with carbonised backing paper interleaved between the cheque. All the information written on the cheque is thus captured and retained as the source document after the cheque has been dispatched.

Invoice

Purpose: To record goods or services acquired without immediate payment.

Figure 4.7

TAX INVOICE

PROPEL
CAPE (PTY) LTD.
Reg. No. 72/07746/07

Dreyer Way WATERFRONT
CAPE TOWN 8001
TELEPHONES: 419-1010, 419-1966
P.O. BOX 4695, CAPE TOWN 8000
Email propel@jetline.co.za

Tax Invoice No. 7852

Date: 20

Name: Mr/Ms
Address:

Quantity	Description	R	c

Customer signature

V.R.P. 8603112

When goods or services are acquired, but payment is to be made at a later date, an invoice is completed and signed by the recipient as proof that the goods or services have been provided.

For the entity providing the goods or services, one of the **invoices** (that is, with the supplier's letterhead) is completed in duplicate, the original going to the customer and the **duplicate** being retained for further processing.

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For the entity receiving the goods or services, the **original** is retained as the source document for further processing.

There are many different source documents and it is neither necessary nor possible to list them all. For accounting purposes, it must never be forgotten that every transaction must be recorded on a source document and that these documents will be the input into the accounting process. An accountant must be able to work with any source document that may be used by the business.

Often a business may develop its own specialised source documents. As long as the transaction that has taken place is clear, this should cause no confusion.

The other extreme is of course also possible where, in the absence of any specialised source document, the transaction is recorded initially on a scrap piece of paper. The ground rule is however universal – it must be captured on a document.

Reminder

There are many different source documents used in practice, and designed specially for the needs of the type of business.

Electronic banking

Purpose: To pay amounts owing or to pay for goods and services purchased or to receive payments from customers via an internet-enabled device.

Payments are made via electronic funds transfer (EFT) – this means that money is exchanged between two parties without the physical intervention of the banking institution. The two main forms of electronic payments are:

- **Internet or online banking facility:** A business would need to set up internet banking access via their bank. Suppliers would need to be listed as beneficiaries. Payments could then be made from an internet-enabled computer, tablet or mobile phone. Due to rising internet banking fraud, banks have put rigorous processes in place to make electronic banking safer, for example, a one-time PIN facility when registering a new beneficiary. The one-time PIN is sent to the account holder's mobile phone or email address and then he or she has to verify the new beneficiary with this PIN before money can be transferred. This measure is put in place to ensure that the real account holder is registering the new beneficiary and that subsequent funds paid are therefore authorised by the real account holder. However, it is up to the account holder to ensure that all internet banking information is secured by not divulging passwords and any other information that might compromise his or her electronic banking profile.

  The source document associated with this method of payment is a payment confirmation, which the payer can opt to send to the payee via SMS or email directly from the bank to confirm that payment has been made. The transaction will also be reflected on the payer's bank statement as outgoing funds and on the payee's bank statement as incoming funds.
- **Debit card or credit card facility:** In this instance, a business would pay for goods or services or receive payments from customers with a debit or credit card. The transaction is processed on an internet-enabled point-of-sale device. The card is swiped and the payee approves the payment by entering his or her PIN number. The bank then remotely authorises the transfer of funds if there are funds in the bank account. The account holder can opt to have an SMS or email notification facility activated on his or her account to be alerted when money is deducted from the bank account.

  The source document associated with this method of payment is a receipt generated from the point-of-sale device.

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Due to increasing bank fraud and card cloning, account holders are encouraged to secure their information and cards by not divulging PIN numbers.

Developments in electronic banking now include innovative payment solutions for businesses via a mobile payment application that allows a business to receive payments from customers through the use of a QR code (quick response code – simply put, a type of barcode that contains information about the item to which it is linked) and secure PIN number.

Electronic banking has certainly changed the nature of business transactions and brings with it challenges in terms of recording transactions in non-traditional source documents.

The process: The accounting equation

Having determined that a statement of **position** and **performance** are the required **output**, and the **source documents** are the necessary **input**, a process must now be devised that will transfer the mass of source document data into accounting information.

A logical procedure to achieve this is based on the understanding that has now developed relating to a business and a simple mathematical equation. There are **no rules governing the accounting process**.

The equation has the assets of the entity as its starting point. It holds quite simply that because a business is not a person, and, therefore, cannot really possess wealth, the assets that the business is using must belong in fact to one of the two categories of either owners or liabilities.

From this it can be seen that: **assets** belong to **owner's equity** and **liabilities**, or:

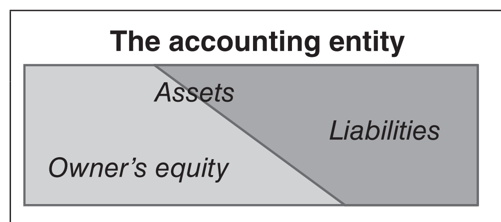
Assets = Owner's equity + Liabilities

This can be shown by the diagrams in Figures 4.8 and 4.9.

Figure 4.8 shows that it is possible to define exactly which assets are under the control of the business. Because the business is not a person, it cannot in the final instance really own the assets. They belong to the people who have placed their resources into the business, that is, the owner and the outsiders. This is shown in Figure 4.9.

Figure 4.8

Figure 4.9



This relationship is expressed in the mathematical equation A = O + L. This equation is the foundation and starting point for the development of the recording process that will be outlined in the remainder of this chapter. The accounting system can now be more clearly shown in Figure 4.10.

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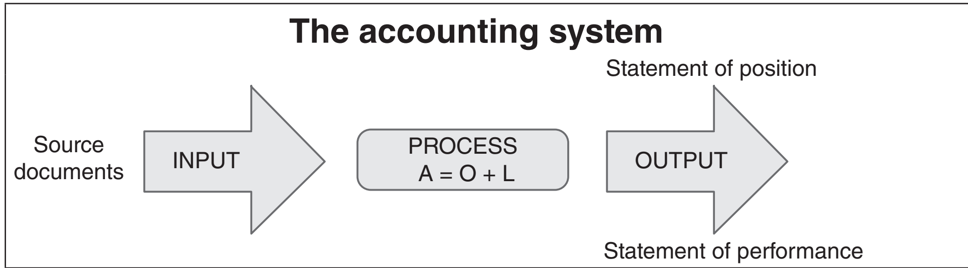
Figure 4.10



From Figure 4.10 it is apparent that the accounting system is designed to produce two financial statements, one reporting on the financial position at a moment in time, and the other reporting on the financial performance over a specified period.

Reminder

Stated very simply, ASSETS are what the business OWNS. But a business is not a person, so the assets belong to people, divided into OWNERS and LIABILITIES. We can say that the business OWES the value of those assets to those people.

The output can only be produced if all transactions are recorded on source documents and processed using the accounting equation as the logical basis.

To understand the system, a simple example of a business will be developed. Each transaction will be considered in the light of its impact on the accounting equation, that is, how the assets under the control of the business have changed, and how these changes affect the claims of the two categories of people against the business.

You should be able to complete Questions 4.1 to 4.4.

We will now discuss the recording process, using an illustrative example, over three stages. Stage one will be dealt with in the remainder of this chapter, stage two in Chapter 5 and the final stage in Chapter 6.

3 Recording transactions using the accounting equation

Recording financial transactions using the accounting equation is shown in Example 4.1. Value-added tax (VAT) is ignored, but will be explained in later chapters.

Example 4.1

Sicelo Kibo decided to resign from his job where he was earning R3 500 per month. He took his life savings of R38 000 and decided to start a dry cleaning business.

Transactions for March (the source document is shown in brackets):

1. Opened a bank account in the name of Kibo Cleaners and deposited R38 000 (original deposit slip).
2. Paid rent for March for the premises by cheque R1 500 (cheque counterfoil).
3. Purchased equipment that was installed. Paid R12 000 (original receipt, or cash sale slip, or cheque counterfoil).
4. Purchased cleaning materials on credit from Cleaning Suppliers R900 (original invoice).
5. Purchased a delivery vehicle on credit from Goods Garage R37 100 (original invoice).
6. Received cash from customers for garments cleaned R5 600 (duplicate cash slips).
7. Cleaned 100 overalls for A–Z Factory that undertook to pay R3 800 in April (duplicate invoice).
8. Paid R5 200 for wages and salaries for the month (cheque counterfoil).

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The eight transactions above are a small portion of the many transactions that a business would enter into during an average month of business. The input confronting the accountant is the source documents.

The output that must be generated are the two statements, one reflecting the present financial position on 31 March 20x7 and the other indicating the past financial performance for the period of one month.

The process will be to record the impact of each of the transactions on the accounting equation.

Transaction 1: Deposited capital.

Assets	=	Owner's equity	+	Liabilities
+ 38 000		+ 38 000		0

The business now has R38 000 of cash under its control. In the event of the entity closing down, the owner Sicelo Kibo would have a claim against it for R38 000, that is, the business owes Sicelo R38 000.

Transaction 2: Paid rent.

	Assets	=	Owner's equity	+	Liabilities
T 1	+ 38 000		+ 38 000		0
T 2	– 1 500		– 1 500		0
	+ 36 500		+ 36 500		0

The business has had to pay an expense. An expense is incurred when payment must be made for items that are not assets. They thus reduce the owner's equity as they are a loss to the business. As a result it now only has R36 500 under its control. In the event of it closing down at this stage, Sicelo would have suffered the loss and only has a claim of R36 500 (38 000 – 1 500) against the business.

Transaction 3: Purchased equipment by cheque.

	Assets	=	Owner's equity	+	Liabilities
T 1	+ 38 000		+ 38 000		0
T 2	– 1 500		– 1 500		0
T 3	– 12 000		0		0
	+ 12 000		0		0
	+ 36 500		+ 36 500		0

The effect on the accounting equation is at first a little difficult to understand. Because an asset has been purchased, all that has happened is that one asset (cash) has been exchanged for another asset (equipment). In the event of the business closing down, it still controls R36 500 worth of assets and the owner still has a claim for R36 500.

Transaction 4: Purchased cleaning materials on credit.

	Assets	=	Owner's equity	+	Liabilities
T 1	+ 38 000		+ 38 000		0
T 2	– 1 500		– 1 500		0
T 3	+ 12 000		0		0
	– 12 000		0		0
T 4	0		– 900		+ 900
	+ 36 500		+ 35 600		+ 900

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The assets of the business remain unchanged. If it is assumed that the materials purchased have no value for resale, but can be used in the service business, the assets are still worth only R36 500. However, the business has incurred an expense and now owes R900 to Cleaning Suppliers (referred to as a payable). As a result the owner now only has a claim of R35 600 against the business.

Transaction 5: Purchased vehicle on credit.

	Assets	=	Owner's equity	+	Liabilities
T 1	+ 38 000		+ 38 000		0
T 2	– 1 500		– 1 500		0
T 3	+ 12 000		0		0
	– 12 000		0		0
T 4	0		– 900		+ 900
T 5	+ 37 100		0		+ 37 100
	+ 73 600		+ 35 600		+ 38 000

The business now has an additional R37 100 under its control. However, Goods Garage now has a claim of R37 100 against the entity. If the business were to close down, then the assets of R73 600 would be sold and R38 000 used to repay liabilities and the remaining R35 600 to repay the owner.

Transaction 6: Received cash from customers.

	Assets	=	Owner's equity	+	Liabilities
T 1	+ 38 000		+ 38 000		0
T 2	– 1 500		– 1 500		0
T 3	+ 12 000		0		0
	– 12 000		0		0
T 4	0		– 900		+ 900
T 5	+ 37 100		0		+ 37 100
T 6	+ 5 600		+ 5 600		0
	+ 79 200		+ 41 200		+ 38 000

Having incurred expenditure, the business now begins to receive income. The assets as a result have increased. The business has not incurred further liabilities and therefore the total liabilities balance remains constant. The owner is the one who benefits and now has a further claim of R5 600 bringing his total claim against the assets to R41 200.

Transaction 7: Customers' cleaning on credit.

	Assets	=	Owner's equity	+	Liabilities
T 1	+ 38 000		+ 38 000		0
T 2	– 1 500		– 1 500		0
T 3	+ 12 000		0		0
	– 12 000		0		0
T 4	0		– 900		+ 900
T 5	+ 37 100		0		+ 37 100
T 6	+ 5 600		+ 5 600		0
T 7	+ 3 800		+ 3 800		0
	+ 83 000		+ 45 000		+ 38 000

This transaction is almost identical to the previous one, except that cash has not been received. However, because there is an amount owing to the business, its assets have increased.

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If the business were to close down at this stage it would receive the money that is owed from customers referred to as receivables. Its total assets of R83 000 would then be used to pay the liabilities of R38 000, the remaining R45 000 belonging to the owner.

Transaction 8: Paid wages and salaries.

	Assets	=	Owner's equity	+	Liabilities
T 1	+ 38 000		+ 38 000		0
T 2	− 1 500		− 1 500		0
T 3	+ 12 000		0		0
	− 12 000		0		0
T 4	0		− 900		+ 900
T 5	+ 37 100		0		+ 37 100
T 6	+ 5 600		+ 5 600		0
T 7	+ 3 800		+ 3 800		0
T 8	− 5 200		− 5 200		0
	+ 77 800		+ 39 800		+ 38 000

The final transaction for the month, the payment of wages and salaries to the staff and to the owner, reduces the assets and the owner's claim.

You should be able to complete Questions 4.5 and 4.6.

4 The information generated by the process

Once transactions have been processed using the accounting equation, it is possible to organise the results in such a way as to constitute meaningful information.

As required by users of accounting information, it should reveal the financial position at a moment in time and the financial performance for the period under review.

Financial position

From the process, the following summary of position can now be drafted:

Kido Cleaners
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

Assets (at cost)	77 800	00	Owner's equity	39 800	00
			Liabilities	38 000	00
	77 800	00		77 800	00

Figure 4.11

Financial performance

To draft a summary statement of profit or loss & other comprehensive income for the month, a little more analysis is necessary. It is important to note that Sicelo started with R38 000 and ended with R39 800, that is, his claims against the assets of the entity have increased by R1 800. To produce a rough statement of profit or loss & other comprehensive income, the increases in owner's equity (all of that are income for the period) and the decrease in owner's equity (all of that are expenses for the period) must be deducted from each other.

The profit is the difference between them. Of course, if the owner had invested additional capital during the period, such an increase would not form part of the profit calculation.

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Similarly, if the owner had withdrawn funds from the business, such withdrawal would not be included in the profit determination, but would be treated as a reduction of capital invested.

Furthermore, it should be noted that no account has been taken of materials that may still be on hand, or of depreciation expenses that should be recorded on equipment and vehicles. The astute student will recognise that the matching principle should be applied.

However, to keep the example uncomplicated by issues that will be dealt with later in the chapter, no entries for these possible adjustments are shown in Figure 4.12. The next section of the text will introduce you to the adjustments that can be made to improve the quality of the information.

Reminder

This statement of profit or loss & other comprehensive income is after only one month of being in business. It seems as if Sicelo Kibo made a good decision to start his own business … but of course it is too early to judge.

Figure 4.12

Kibo Cleaners
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE MONTH ENDED 31 MARCH 20*x*9

Revenue from dry cleaning services (5 600 + 3 800)	9 400	00
Less: Expenses (1 500 + 900 + 5 200)	7 600	00
PROFIT FOR THE MONTH	1 800	00

You should be able to complete Questions 4.7 to 4.10.

Adjusting entries

Transactions 1 to 8 all resulted from interaction between the business and other parties (such as the owner, cash suppliers, payables, receivables, cash customers and so on). Each transaction was supported by a source document that was in turn used to process the transaction under the accounting equation.

If the owner wants more accurate statements of financial position and profit or loss & other comprehensive income at the end of the month, it may be necessary to pass some additional entries that do not originate from source documents, but are necessary to apply the matching concept (shown in Example 4.2).

Example 4.2

Sicelo feels that the statements of financial position and profit or loss & other comprehensive income may be inaccurate as a result of not considering depreciation, and because the cleaning materials have not all been used. The following is established:

1. Cleaning materials with a cost of R600 are still unused.
2. Equipment and vehicles should be depreciated by R500 and R900 respectively each month.

These transactions are processed as follows, using the month-end position as the starting point:

	Assets	=	Owner's equity	+	Liabilities
Amounts before adjustments	+ 77 800		+ 39 800		+ 38 000
Cleaning material on hand	+ 600		+ 600		0
Depreciation: Equipment	– 500		– 500		0
Depreciation: Vehicles	– 900		– 900		0
Adjusted amounts	+ 77 000		+ 39 000		+ 38 000

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Explanation

- As cleaning materials cost R900, the full amount had been written off as an expense. However, at this moment, the end of the first month, the actual expense is only R300 because materials on hand are valued at R600. Because of the going concern concept and the matching concept, the R600 is treated as an asset and R600 is added back to owner's equity. This means that the loss incurred for materials used is only R300 (R900 – R600).
- Because both assets (equipment and vehicles) must be depreciated, the assets are worth less. The owner must treat this as an expense for the period, reducing the equity.

Note: A detailed discussion on depreciation is contained in Chapter 14.

A different set of statements results if adjustments are taken into account. In practice it is essential to consider adjustments at the end of each financial year.

To effect them every month in detail is an onerous task, however, and often only very rough estimates are made on a monthly basis.

Reminder

The statement of financial position shows the situation at a moment in time.

The set of statements after consideration of the adjustments is shown in Figure 4.13:

Figure 4.13

Kibo Cleaners
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

Assets (at cost *less* depreciation)	77 000	00	Owner's equity	39 000	00
			Liabilities	38 000	00
	77 000	00		77 000	00

Kibo Cleaners
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE MONTH ENDED 31 MARCH 20*x*9

Revenue from dry cleaning services (5 600 + 3 800)	9 400	00
Less: Expenses (1 500 + 300 + 5 200 + 1 400)	8 400	00
PROFIT FOR THE MONTH	1 000	00

Further information

To compare the performance of Kibo Cleaners against some yardstick, Sicelo may well calculate the percentage return that his investment has yielded.

If the same kind of performance can be expected in future months, his profit for a whole year would be in the region of R1 000 × 12 = R12 000. To convert this to a measure of performance called return on equity (ROE), this formula may be used – it is actually a 'common sense' formula.

Reminder

The statement of profit or loss & other comprehensive income shows what happened over a specified period.

Did you know?

The return on money invested in a bank seldom exceeds 16% per annum.

$$\text{ROE} = \frac{\text{Profit for the year}}{\text{Investment at the beginning of year}} \times \frac{100}{1}$$

For Kibo Cleaners, for the full year, this is expected to be:

$$\text{ROE} = \frac{12\ 000}{38\ 000} \times \frac{100}{1} = 31.6\%$$

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This is clearly a better return than anyone would expect from a normal investment in a bank or other financial institution. However, a better return is expected by an investor who has taken the added risk of starting a business.

Some other issues that are relevant to evaluating the financial performance and position are:

- Is Kibo Cleaners likely to improve their financial performance as they become better known?
- Was it only the large contract with A–Z Factory, which might not be repeated, that ensured a profit for March?
- Does the amount written off as depreciation realistically reflect the cost of owning those assets for the month?
- Do wages and salaries include a payment to Sicelo for his work in the business?

There are in fact numerous questions that could still be asked. One fact that should be clear, however, at this early stage is that the final output is not totally objective. It contains some estimates and must thus be treated with the necessary caution.

5 Chapter illustrative example

Ayesha Hisham started a business 'Absolut Hair' on 1 March 20*x*4. The business specialises in modern hair styles for young executives. These are her transactions for the first month of business:

1. Ayesha deposited R50 000 in the current bank account as her capital contribution.
2. Issued a cheque to Histar Properties to pay the rent for the first two months, R3 200.
3. Purchased hair-care equipment and paid by cheque, R30 000.
4. Paid R750 to Telkom for telephone expenses.
5. Purchased office equipment on credit from Injani Suppliers, R24 000.
6. Purchased hair-care products for cash and paid R9 000.
7. Received R13 620 in cash and cheques for services to customers.
8. Invoiced Brash Ltd, a local business who opened an account with Absolut Hair, R8 700 for services rendered.
9. Paid Injani Suppliers R4 000 on our account.
10. Paid salaries to the stylists and herself for the month, R12 400.

She considers these adjustments to be relevant prior to reporting on 31 March:

A The rent in Transaction 2 above was paid for two months and, therefore, is not all an expense for the current month.

B The hair-care equipment is likely to last about 2.5 years, after that it will have no value.

C After the inventory count, Ayesha determined that there are hair-care products bought at a cost of R5 200 that were not used during the month, but will be used in later months.

You are required to:

1. For each of the transactions, state the most likely source document that will be generated and used to record the necessary entries.
2. Show how each of the transactions (1 to 10) and each of the adjustments (A to C) will be entered under the accounting equation.
3. Draft a statement of financial position at the end of the month after taking the transactions and adjustments into account.

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4 Draft a statement of profit or loss & other comprehensive income for the month.

5 Presuming that Ayesha can continue this performance, calculate the return on her investment that she may achieve after a year in business.

Suggested solution

1 The most likely source documents for each transaction are:

1 A copy of the deposit slip received from the bank.

2 A cheque counterfoil.

3 A cheque counterfoil.

4 A receipt from Telkom.

5 An invoice received from Injani Suppliers.

6 A cash slip received from the supplier.

7 Copies of the cash slips issued to clients.

8 A copy of the invoice that Absolut Hair completed for Brash Ltd.

9 A receipt received from Injani Suppliers.

10 Either the cheque counterfoils, or a salaries book of records kept by Absolut Hair.

A There is no source document, but a note is made that half the rent was prepaid.

B There is no source document, but the policy of Absolut Hair is to depreciate equipment down to zero over 2.5 years (30 months).

C The records of the inventory count will be used to determine this figure.

2 A record of the transactions and adjustments using the accounting equation:

No.	Assets	=	Owner's equity	+	Liabilities
1.	+ 50 000		+ 50 000		0
2.	– 3 200		– 3 200		0
3.	– 30 000		0		0
	+ 30 000		0		0
4.	– 750		– 750		0
5.	+ 24 000		0		+ 24 000
6.	– 9 000		– 9 000		0
7.	+ 13 620		+ 13 620		0
8.	+ 8 700		+ 8 700		0
9.	– 4 000				– 4 000
10.	– 12 400		– 12 400		0
	66 970		46 970		20 000
A	+ 1 600	Note 1	+ 1 600		0
B	– 1 800	Note 2	– 1 800		0
C	+ 5 200	Note 3	+ 5 200		0
	71 970		51 970		20 000

Note 1: If rent for two months is R3 200, the rent for one month is R1 600.

Note 2: The equipment (office and hair care) cost R54 000 and is estimated to last for 30 months, so the depreciation for one month is R1 800.

Note 3: Only the hair-care products used for the month are an expense. The inventory on hand is an asset at this moment in time.

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3 The statement of financial position is as follows:

Absolut Hair
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20x4

Assets (less accumulated depreciation)	71 970	00	Owner's equity	51 970	00
			Liabilities	20 000	00
	71 970	00		71 970	00

4 The statement of profit or loss & other comprehensive income: (with some additional notes)

Absolut Hair
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE MONTH ENDED 31 MARCH 20x4

Revenue from hair styling services (R13 620 + R8 700)	22 320	00
Less: Expenses (R1 600 + R750 + R12 400 + R1 800 + R3 800)	20 350	00
PROFIT (OR LOSS) FOR THE PERIOD	1 970	00

Details of expenses

Rent for the month (R3 200 ÷ 2)	1 600	00
Telephone for the month (no adjustment)	750	00
Salaries for the month (no adjustment)	12 400	00
Depreciation for the month (R54 000 ÷ 30 months)	1 800	00
Hair-care products used (R9 000 – R5 200)	3 800	00
TOTAL EXPENSES	20 350	00

5. If Absolut Hair achieved a profit of R1 970 for one month, one could (very roughly) estimate that the profit for the whole year of 12 months will be R23 640 (R1 970 × 12). We can now calculate the return on investment for Ayesha as follows:

$$\text{ROI} = \frac{\text{Profit for the year}}{\text{Capital invested}} \times \frac{100}{1}$$

$$= \frac{\text{R23 640}}{\text{R50 000}} \times \frac{100}{1}$$

= 47.3% p.a. (Wow! What an excellent return.)

A very nice return compared with what would have been achieved if the R50 000 had been invested in a bank. However, all business ventures carry risk and Ayesha may not be able to sustain this profitability at all times.

You should be able to complete Questions 4.11 and 4.12.

6 Summary

This chapter has served as an introduction to the accounting system. There are a large number of issues still to be addressed and the process is going to be considerably refined in the next few chapters.

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QUESTIONS

Question 4.1

You are considering conducting a small business enterprise in your neighbourhood to help with financing your studies. You plan to offer your services, washing cars.

If you consider the washing of a car as a system, describe each of the following elements of this activity if you wish your business to be successful:

- Output.
- Input.
- Process.
- Feedback.

Question 4.2

You own a vehicle that was recently purchased for R4 000. A similar vehicle is currently on sale for R4 500.

You are likely to be able to dispose of the vehicle for a net income of R3 800. By using it in a daily lift club, you are likely to receive a net income of R2 000 during the next year, after that it can be sold for R2 800.

What is the value of your vehicle?

Question 4.3

Describe an asset, a liability and owner's equity. Give two examples of items that fall into each category.

Question 4.4

If you wished to determine the value of a business, are you likely to be more interested in its present financial position or its profits earned during the past year? Discuss.

Question 4.5

When these transactions take place, what source documents are likely to be used in recording the transactions in your records? Original or duplicate?

1. Purchased a vehicle on credit.
2. Paid wages.
3. The owner invested money in the business.
4. The owner withdrew goods for private use.
5. Sold goods for cash.
6. Sold goods on credit.
7. Bought goods on credit.
8. Returned unsatisfactory goods to a supplier.
9. Paid electricity by cheque.
10. Invested money on fixed deposit.

Question 4.6

Record these transactions using the accounting equation. Your entries must show the effect on the accounting equation.

1. Amos Ncobo invested R8 700 into a repair business, Ncobo's Fast Fix.

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2 Purchased tools on credit, R3 700.
3 Bought building materials, R2 600 cash.
4 Completed repairs and received R1 550 cash.
5 Paid rent for the month in cash, R1 200.
6 Paid a deposit of R2 000 for a vehicle that cost R8 000.
7 Paid telephone and electricity, R520.
8 Completed repairs and received R400, the balance of R900 to be paid later.
9 Paid wages and salaries, R900.
10 Received R900 due from receivable in Transaction 8 above.

Question 4.7

These source documents were written out during August by the accountant of Deep Di, a business engaged in dying materials and leather.

Date	Number	Receipts issued	
1	RE1	Capital invested by the owner Di Blue	R1 900
4	RE2	Services rendered	R200
9	RE3	Services rendered	R520
14	RE4	Cash received from A Zolly	R650
19	RE5	Services rendered	R630
		Invoices received	
4	IN1	Dye-Merchants for materials	R960
7	IN2	Stop-Go Motors for a vehicle	R8 000
26	IN3	Di-Mech Ltd for machinery	R2 200
		Invoices issued	
8	C1N1	B Zach for services rendered	R970
11	C1N2	A Zolly for services rendered	R1 650
		Cheque counterfoils	
2	X200	Rent expense	R400
7	X201	Stationery expense	R250
14	X203	Salaries expense	R800

You are required to:

1 Process the transactions using the accounting equation. Your entries must show the effect on the accounting equation.
2 Draft a summary statement of financial position.
3 Draft a summary statement of profit or loss & other comprehensive income.

Question 4.8

On 1 January 20*x*1, Dr Jack Lane opened a surgery in Wynberg, Cape Town and engaged in these transactions:

1 Opened a bank account under the business name of Dr Jack Lane and paid in an amount of R50 000.
2 Purchased rooms for the use as surgery and consulting rooms for R40 000, paying R10 000 by cheque and raising a 10-year mortgage loan for the balance.
4 Bought equipment and furniture on credit from Medical Suppliers Limited for R9 500.
13 Dr Lane drew a cheque on his personal bank account for R2 500 in part payment of the Medical Suppliers Limited account.

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16 Paid R820 for surgical supplies.
17 It was discovered that part of the furniture purchased on 4 January was not suitable for his office needs. So, instead Dr Lane sold it on account to a fellow practitioner, Dr Upson, at its cost of R1 000.
31 Received R700 from Dr Upson on account.

You are required to:

1. Show the impact of each transaction on the accounting equation. Your entries must show the effect on the accounting equation.
2. Show the statement of profit or loss & other comprehensive income of Dr Lane for the month ended on 31 January 20*x*1. By how much has his equity increased?
3. Show the statement of financial position of Dr Lane as at 31 January 20*x*1.
4. List other factors that should be accounted for to obtain a more accurate measure of financial performance and position.

Question 4.9

Record the amounts resulting from these transactions on the accounting equation. Your entries must show the effect on the accounting equation. Comment on the financial performance and financial position of Jumpa Taxis after one month of trading.

1. J. Jumper commenced a taxi business by investing R20 000.
2. Purchased a minibus on credit, R26 000.
3. Purchased premises for R80 000 by paying R15 000 in cash and taking out a bond for the remaining R65 000.
4. Paid for inventory of petrol, R2 500.
5. Paid wages and salaries, R1 200.
6. Banked the fares received for the month, R3 920.
7. Paid an amount of R1 000 on the bond of which R800 was towards interest while R200 was towards the bond capital.
8. Bought stationery on credit, R400.
9. Paid R150 for servicing the minibus.
10. J. Jumper withdrew R200 for private use.
11. At the end of the month, the unused petrol totalled R1 000 and the unused stationery totalled R300.
12. The minibus is valued at R25 800 at cost less depreciation.

Question 4.10

Barry Nel started a business Auto Boss, specialising in repairs and services to vehicles. Record these transactions for his first month of trading on the accounting equation. Your entries must show the effect on the accounting equation.

1. Barry deposited R40 000 in the current bank account of the firm as his capital contribution.
2. Sent a cheque to the City Treasurer to pay for the trading licence, R150.
3. Issued a cheque to Hullets Trust for R4 140 to pay the rent for the first two months.
4. Paid R125 to the Postmaster for telephone expenses.
5. Bought hydraulic jacks, spanners, socket sets, etc. from Commodore Ltd to equip his workshop, R8 750 on credit.
6. Purchased the necessary oils and lubricants from Tex Oil Ltd and paid by cheque, R2 909.
7. Received an account from *The Daily Dispatch* for adverts placed, and paid R250 by cheque.
8. Received R3 890 in cash and cheques for cars serviced and repaired.

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9 Bought a typewriter, R800 and desks and shelving, R3 500 from Modquip Ltd, and paid by cheque.
10 Bought typing ribbons on credit from Rank Xerox, R185.
11 Cashed a cheque to pay staff wages, R2 684.
12 Bought a tow-truck from CDA Ltd, R24 800 on credit.
13 Mr Brown's car was repaired. The repairs cost him R5 680. He wrote out a cheque for R680 and agreed to pay the balance over the next five months. Barry entered the R680 on the cash register and completed an invoice for the balance.
14 Purchased a voltmeter for the workshop from Bosch Ltd, R1 500. Barry gave them a cheque for R500 in part settlement of the debt, and received an invoice for R1 000.

Question 4.11

Using the information in Question 4.7, record these adjusting entries at month-end.

Adjusting entries

1 Depreciate machinery by R100.
2 Depreciate vehicles by R200.
3 Stationery unused is worth R120.
4 Materials unused are worth R210.
5 Expenses still owing for electricity and water total R160.

You are required to:

1 Draft the adjusted summary statement of financial position and statement of profit or loss & other comprehensive income.
2 Calculate the expected annual return on investment that Deep Di expects, assuming that monthly profits remain constant.
3 Comment on the output of the accounting process.

Question 4.12

Continuing with the example of Auto Boss from Question 4.10, assume that the balances after all the transactions were:

- Assets R73 677
- Owner's equity R39 127
- Liabilities R34 550

These adjusting entries must still be processed:

1 Rent expense includes R1 140 for the next accounting period.
2 There are still oils and lubricants on hand worth R800.
3 Depreciate tools by R200, and vehicles by R500.

You are required to:

1 Enter the adjustments on the accounting equation.
2 Draft the adjusted summary statements of financial position and financial performance.
3 Calculate the expected annual return on investment that Auto Boss expects, assuming that monthly profits remain constant.
4 Comment on the output of the accounting process.

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5 FUNDAMENTALS OF THE RECORDING PROCESS

Chapter objectives

By the end of this chapter, you should be able to:

- Process the second step in the recording process.
- Explain the concept of a ledger account.
- Explain the concept of a general ledger.
- Name the three primary accounts in the general ledger as:
  - asset accounts
  - owner's equity accounts
  - liability accounts
- Classify and explain how to enter transactions in a general ledger account.
- Explain how to 'balance' a general ledger account.
- Define the terms 'debit' and 'credit'.
- Distinguish between the mathematical concepts '+' and '–' and the accounting concepts 'debit' and 'credit'.
- Motivate the need for controls using the double-entry principle.
- Show how financial accounting is not based on a set of rules, but on a very basic and fundamental mathematical principle.

Chapter outline

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2	THE ACCOUNT	5 – 2
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4	DEBITS AND CREDITS	5 – 7
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1 Introduction

This chapter serves as an introduction to some of the most frequently used terminology in the accounting process. It introduces the general ledger that is the source of summarised accounting information. There are three conceptual steps that must be taken before being able to record accounting data.

- The first step is understanding the elements of the accounting equation and being able to determine the effect that various transactions will have on the equation. This step was covered in the previous chapter. It is important to be thoroughly familiar with the concepts covered in Chapter 4 before proceeding.
- The second step involves the use of general ledger accounts that will be the focus of this chapter and Chapter 6.
- The third step requires the ability to cope with large volumes of data. This is achieved through the use of subsidiary journals to be discussed in later chapters.

2 The account

Up to this point the three basic elements of the accounting equation have been the focus of attention for recording all transactions. For the purpose of this chapter they form the three accounts in the accounting process. In the example of Kibo Cleaners used in the previous chapter, it was seen that these accounts either increased or decreased if a transaction affected them. This process of increasing and decreasing has been modified by accountants.

This has inevitably led to a vocabulary of technical terms not used in everyday conversations. An understanding of the terminology is essential. The assets element of the Kibo Cleaners example will be used to illustrate these further.

You will recall that the assets element of the example, before taking the month-end adjustments into account, was as follows:

Figure 5.1

Transactions recorded under the 'assets' element

1	Deposited capital (Bank increases)	+ 38 000	00
2	Paid rent for March (Bank decreases)	– 1 500	00
3	Purchased equipment and paid (Equipment increases)	+ 12 000	00
	Purchased equipment and paid (Bank decreases)	– 12 000	00
5	Purchased a delivery vehicle on credit (Vehicles increases)	+ 37 100	00
6	Cash received for services to customers (Bank increases)	+ 5 600	00
7	Services to customers on credit (Receivables increase)	+ 3 800	00
8	Paid salaries for the month (Bank decreases)	– 5 200	00
	Balance in the asset accounts at month end	+ 77 800	00

However, this method is not the best way of displaying the information.

Instead, it can be developed by dividing the asset account into two sides and placing increases on the left-hand side and decreases on the right-hand side as shown in Figure 5.2.

Figure 5.2

ASSET ACCOUNT

Increases (+)		**Decreases (–)**	
	38 000		1 500
	12 000		12 000
	37 100		5 200
	5 600		
	3 800		77 800
Total	96 500	Total	96 500

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This is the simple form of a traditional general ledger account. A ledger is simply a book in which the pages have been divided down the middle. This principle can be applied to each of the three elements – assets, liabilities and owner's equity. Assume that each element of the equation is the heading of a page divided into two sides and referred to as an account. It would then look as follows:

Asset account		=	Owner's equity account		+	Liability account	
Increase (+)	Decrease (–)		Decrease (–)	Increase (+)		Decrease (–)	Increase (+)

Figure 5.3

The above is known as the accounting model, and all transactions will now be analysed on the above basis.

One very important aspect of the above accounting model is that assets increase on the left-hand side and decrease on the right-hand side. However, because the remaining two elements of owner's equity and liabilities are on the other side of the equal sign, the signs are swapped and they decrease on the left-hand side and increase on the right-hand side.

You should be able to complete Questions 5.1 to 5.4.

3 Recording transactions using three ledger accounts

Transaction 1: Opened a bank account in the name of Kibo Cleaners and deposited an amount of R38 000.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
Increase (+)	Decrease (–)		Decrease (–)	Increase (+)		Decrease (–)	Increase (+)
38 000				38 000			

Note that one entry has been made on the left-hand side of an account (the assets account) and one entry has been made on the right-hand side of another account (the owner's equity account).

Explanation

The bank account of the business increases, thus the asset account increases. The assets of the new business entity have increased by R38 000 and the owner's claim against the business has increased by R38 000.

Reminder

We are only recording the rand amounts at this stage. More details will follow later.

Transaction 2: Made a payment of R1 500 by cheque for the rent of the premises for March.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
38 000	1 500		1 500	38 000			

Note that one entry has been made on the right-hand side of an account (the assets account) and one entry has been made on the left-hand side of another account (the owner's equity account).

Explanation

The assets of the business have decreased because a payment of R1 500 has been paid out

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of the business. As a result Sicelo, the owner, has R1 500 less that he can claim against the business, that now only has R36 500 (R38 000 – R1 500) worth of assets available.

Transaction 3: Purchased equipment for an amount of R12 000 and paid by cheque.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
38 000	1 500		1 500	38 000			
12 000	12 000						

Note that one entry has been made on the left-hand side of an account (the assets account) and one entry has been made on the right-hand side of an account (also the assets account). It is important to realise that the business has not become any poorer – no loss or expense has been incurred. One type of asset (cash) has merely been replaced by another type of asset (equipment).

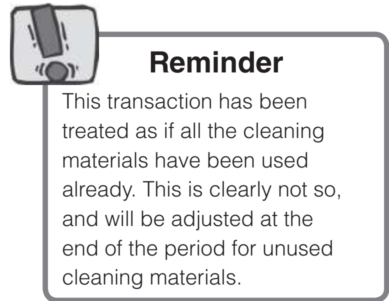
Explanation
The assets of the business increased because new equipment was purchased. However, because the business paid cash, the assets also decreased by the amount of the payment.

Transaction 4: Purchased cleaning materials on credit from Cleaning Suppliers for R900.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
38 000	1 500		1 500	38 000			900
12 000	12 000		900				

Note that one entry has been made on the left-hand side of an account (the owner's equity account) and one entry has been made on the right-hand side of another account (the liabilities account).



Explanation
The assets of the business have neither increased nor decreased as no additional value has come into the business. Unused cleaning material is an asset at the end of the period. However an outsider, Cleaning Suppliers, has now become creditor/payable.

Cleaning Suppliers has a claim of R900 against the business. The owner who must bear all expenses (but will also receive all income) must bear this expense. His claim against the assets of the business has thus decreased by R900.

As this is midway through the eight transactions, it is a useful place to stop briefly and examine the financial position and the performance of the business at this stage. This may be achieved by finding the balance on each of the three accounts, that is, the difference between the two sides.

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
38 000	1 500		1 500	38 000			900
12 000	12 000		900				
36 500				35 600			900

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From these balances, it can be seen that:

- The business has assets of R36 500. The claims against the assets are held by the liabilities of R900 and the owner's equity of R35 600.
- If, in theory, the business closes down at this stage, the assets will realise R36 500 and of this amount R900 will be paid to the payable and R35 600 to the owner. It should be noted that if the assets realised less than R36 500 the payable would still be paid the full R900 but the owner will receive less cash.
- The owner started by investing R38 000 but at this stage only has claim to R35 600, indicating that he has suffered a loss of R2 400. However, the month is not yet over and it is far better to draw conclusions only at the end of each month. The remaining transactions will, therefore, be processed before attempting to analyse the information.

Transaction 5: Purchased a delivery vehicle on credit from Goods Garage for R37 100.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
38 000	1 500		1 500	38 000			900
12 000	12 000		900				37 100
37 100							

Explanation

The assets of the business have increased with the acquisition of a new motor vehicle. However, the money to pay for the vehicle was not provided by the owner. Instead Goods Garage sold the vehicle to the business on credit.

Because the business owes Goods Garage R37 100, the claims of liabilities have increased. This results in an entry on the left-hand side of the assets account and an entry on the right-hand side of the liabilities account.

Reminder

We are recording all the transactions of a business, using three general ledger accounts.

We will develop this further in later chapters and introduce more general ledger accounts with different names.

Transaction 6: Received cash from customers for garments cleaned, R5 600.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
38 000	1 500		1 500	38 000			900
12 000	12 000		900	5 600			37 100
37 100							
5 600							

Note that once again an entry has been made on the left-hand side of an account (the assets account) and one entry has been made on the right-hand side of another account (the owner's equity account).

Explanation

The business has now begun operating and is earning revenue. Note that it was necessary to incur many of the expenses before the revenue could be earned. The assets (*cash*) of the business have increased by the R5 600 that has been received and the owner has a greater claim against the business.

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Transaction 7: Cleaned 100 overalls for A–Z Factory who will pay R3 800 in April.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
38 000	1 500		1 500	38 000			900
12 000	12 000		900	5 600			37 100
37 100				3 800			
5 600							
3 800							

Note once again, that one entry has been made on the left-hand side of an account (the assets account) and one entry has been made on the right-hand side of another account (the owner's equity account).

Explanation
In this transaction it is a little more difficult to explain why the assets of the business increase. The business is worth more because there now exists a debtor/receivable, that is, a customer who owes money to the business. If the business should close down, the receivables would be required to pay what they owe to the business.

For that reason, receivables are assets of the business in much the same way as equipment is an asset. The owner's equity has increased as the new income that is attached to the business belongs to the owner whose claim against the assets has increased by R3 800.

Transaction 8: Paid wages and salaries for the month, R5 200.

Effect on the accounting model:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
38 000	1 500		1 500	38 000			900
12 000	12 000		900	5 600			37 100
37 100	5 200		5 200	3 800			
5 600							
3 800							

Note once again, that one entry is made on the left-hand side of an account (the owner's equity account) and one entry is made on the right-hand side of another account (the assets account).

Explanation
One of the final payments each month is the wages and salaries. The asset account has decreased because of the cash that was paid out. At the same time the claim of the owner against the business has decreased by R5 200 because an expense has been incurred.

Did you know?

- In the same way that we refer to a collection of birds as a 'flock' of birds, so we refer to a collection of accounts as a 'ledger' of accounts.

It is now the end of the transactions for the month. It is a useful stage at which to see what information can be obtained from the processed transactions.

A final look at the accounting model with all the figures and the three accounts balanced will reveal the most relevant information relating to financial performance and financial position of the business.

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Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
38 000	1 500		1 500	38 000			900
12 000	12 000		900	5 600			37 100
37 100	5 200		5 200	3 800			
5 600							
3 800							
77 800		=		39 800	+		38 000

What is the financial position of the business?

It can be seen that the business now controls assets that cost R77 800. In the event of the business deciding to close down, the liabilities of R38 000 would first be repaid and the owner would receive the residue of R39 800.

What is the financial performance of the business?

Sicelo, the owner, started with R38 000 and now has R39 800 due to him.

Sicelo has, therefore, made a profit of R1 800. The two statements that were produced in Chapter 4 Figures 4.11 and 4.12 can now be produced, as the results are identical. If we proceed further and pass the necessary entries to reflect the adjustments at month end, the effect on the accounting model will be:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
77 800	500		500	39 800			38 000
600	900		900	600			
77 000		=		39 000	+		38 000

The two summary statements can now be drafted in exactly the same manner as Figure 4.14.

However, this second phase of learning how to process accounting data was aimed at introducing the general ledger accounts, so we proceed to discuss the terminology used when dealing with general ledger accounts.

You should be able to complete Questions 5.5 to 5.8.

Reminder

Cleaning materials not used (R600) are treated as an asset (which is true, because they have not been used).

4 Debits and credits

Before even embarking on a study of accounting, virtually everyone will have heard of the terms 'debit' and 'credit'. As the workings of the account have now been explained, the terms debit and credit can be introduced.

- Debit – This is simply the name given to the left-hand side of an account.
- Credit – This is equally simple – it is the name given to the right-hand side of an account.

This is the point at which confusion can be caused. Please study the accounting model in Figure 5.4 on the next page very carefully.

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Figure 5.4

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Debit side	Credit side		Debit side	Credit side		Debit side	Credit side

The important point to note is that the words debit and credit are merely names given to the two sides of an account, they have nothing to do with the '+' or '–' used when analysing a transaction.

For example

Transaction 1 was the owner depositing R38 000 into the bank to start the business Kibo Cleaners. When analysing the transaction it was seen that:

Assets increased
Owner's equity increased

However, the entries made were:
Assets: Debit side.
Owner's equity: Credit side.

Did you know?

The oldest surviving record that incorporates double-entry principles is the Giovanni Farolfi branch ledger for their branch in Salon in France, for the years 1299 to 1300.

Farolfi and Company was a business of Florentine merchants.

In fact, in all of the eight transactions we pointed out that for each transaction, one entry was made on the left-hand side (debit side) of an account and another on the right-hand side (credit side). This did not happen by accident.

Reminder

There are no rules in the accounting process – only principles based on a mathematical equation.

The mathematical logic that underlies the accounting equation is such that when any transaction is analysed and the entries are made, there will always be one entry on the debit side of an account and another entry for an equal amount on the credit side of an account.

As a result of this phenomenon in the accounting process, the truth that 'for every debit entry, there must be a credit entry' has evolved. Often it is stated that this is a rule in accounting. That is not correct. It is simply the result of applying the logic developed from the accounting equation, a basic mathematical formula. This is generally referred to as the double-entry system of accounting.

The fact that there will always be a debit entry for every credit entry is nevertheless a very useful principle when processing data. It helps in these ways:

1 If any transaction is analysed in such a way that two debit entries or two credit entries arise, there has definitely been a mistake of logic and deeper analysis is required.

2 At any stage of processing, a spot check can be made to ensure that two entries have been made for each transaction and that one has been made on the debit side and one on the credit side of an account. This can be achieved by adding all the debit entries and all the credit entries to determine that the same total is obtained for both.

3 The accuracy of the numbers entered can be checked. If, for example, the number 16 is entered correctly as a debit entry but is entered as 61 as the credit entry, the totals of debits and credits will not agree, thus the error will be detected.

You should be able to complete Questions 5.9 and 5.10.

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5 Chapter illustrative example

The transactions used in the Chapter 4 illustrative example must now be processed using the accounting equation (posting to the three accounts: assets account, equity account and liabilities account) using the principles of double-entry recording in a general ledger.

The result is shown in Figure 5.5:

Figure 5.5

Asset account				=	**Owner's equity account**				+	**Liability account**			
(1)	50 000	(2)	3 200		(2)	3 200	(1)	50 000		(9)	4 000	(5)	24 000
(3)	30 000	(3)	30 000		(4)	750	(7)	13 620		**c/d**	20 000		
(5)	24 000	(4)	750		(6)	9 000	(8)	8 700					
(7)	13 620	(6)	9 000		(10)	12 400	(A)	1 600					
(8)	8 700	(9)	4 000		(B)	1 800	(C)	5 200					
(A)	1 600	(10)	12 400		**c/d**	51 970							
(C)	5 200	(B)	1 800										
		c/d	71 970										
	133 120		133 120			79 120		79 120			24 000		24 000
b/d	71 970						**b/d**	51 970				**b/d**	20 000

Steps for calculating balances

1 Total both sides, highest recorded.
2 Insert difference in lower side as balance c/d.
3 Transfer the balance c/d to the other side for the next period as balance b/d.

Explanation

Figure 5.5 is actually the start of what will become known as the 'general ledger'. It is a very simplified version because it only has three accounts, the assets account, the equity account and the liabilities account. Each account has a debit side and a credit side.

The three accounts have been 'balanced' by finding the difference in the amounts on the debit and credit side. The assets account has a debit balance of R71 970, while the equity account and the liabilities account both have credit balances of R51 970 and R20 000 respectively. The debit balance equals the sum of the two credit balances.

6 Summary

This chapter examined the accounts used when recording transaction data. It was considered convenient to divide each of the three accounts used, down the middle. The left-hand side of each account is known as the debit side and the right-hand side is known as the credit side.

When analysing transaction data and recording it into the accounts, the accounting model is used. This requires debit entries in the asset account when assets increase, and credit entries when assets decrease. For liabilities and owner's equity the opposite is true. Debit entries are required when those two accounts decrease, and credit entries when they increase. This model is based on the mathematical logic of the accounting equation.

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QUESTIONS

Question 5.1

Define what the terms 'debit' and 'credit' represents and explain their purpose in drafting an account.

Question 5.2

Prepare the accounting model indicating the names of the three primary accounts, the names of the two sides of each account and the sides on which they will increase and decrease.

Question 5.3

Record these amounts in an asset account. Determine the balance of the account.

Increase	Decrease
R800	R200
R600	R100
R900	

Question 5.4

The following are some examples of typical business transactions:

1 Purchased office equipment on credit.
2 The owner contributed capital.
3 Purchased office furniture for cash.
4 Received amounts owing by receivables.
5 Payments to payables.
6 The business returns office equipment previously purchased on credit.

You are required to:
Write down the accounting equation. Write down the number of each transaction on separate lines below the equation.

For each transaction, show how the transaction would affect the elements of the accounting equation, using (+) to show an increase, (–) to show a decrease and (0) to denote no effect.

Question 5.5

A consortium of business people decided to start a taxi business in the centre of Durban.
Note 1: The consortium invested R200 000 as capital.

Transactions for the month:

1 Purchased a taxi on credit for R26 000.
2 Paid R164 000 in total for six additional taxis.
3 Purchased a building for R80 000, paying R15 000 cash and obtaining a bond from the bank for the balance.
4 Paid for inventory of petrol amounting to R20 500.
5 Paid wages and salaries of R14 200.
6 Banked the fares of R39 920 received for the month.

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7 Paid interest of R800 on the bond and made a capital repayment of R200.
8 Bought stationery on credit for R400.
9 Paid R2 150 for servicing the taxis.

Additional information:

- At the end of the month, the unused petrol totalled R10 300 and the unused stationery totalled R300.
- The taxis were valued on the same day as mentioned above at R187 000 that represents cost less depreciation.

You are required to:

1 Record the above transactions and adjustments under the accounting equation. Your entries must show the effect on the accounting equation.
2 Prepare the statement of financial position and comment on the financial performance and financial position of the company after one month of business.

Question 5.6

Record the transactions in Question 4.6 in the three primary accounts of Ncobo's Fast Fix. Balance all three accounts.

Question 5.7

Record the transactions in Question 4.8 in the three primary accounts of Dr Jack Lane. Balance all three accounts.

Question 5.8

Record the transactions in Question 4.9 in the three primary accounts of Jumpa Taxis. Balance all three accounts.

Question 5.9

1 Record the transactions in Question 4.7 and the adjusting entries in Question 4.11 in the three primary accounts of Deep Di.
2 Then balance all three accounts.

Question 5.10

On 1 September 20*x*1, Robert Shaw established an enterprise under the name Shaw Agencies.

Transactions for the month:

1 A business bank account was opened with a deposit of R24 000 from Robert, representing cash received from the investment of capital.
2 Purchased equipment (desk, chairs, filing cabinet, and so on) for R1 800, paid R1 000 in cash, with the balance on account.
3 Purchased supplies (stationery, stamps, pencils, ink) that cost R120 for cash. Treat as an asset at acquisition date.
4 Paid office rent for the month of R2 500.
5 Paid R300 to a payable.

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6 Received R1 400 as sales commissions.

7 Paid car expenses for the month of R160, and miscellaneous expenses of R90.

You are required to:
Record the above transactions as debit/credit entries in the three accounts of the accounting equation.

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6 EXPANDING THE SET OF ACCOUNTS

Chapter objectives

By the end of this chapter, you should be able to:

- Explain the second step in building up a general ledger.
- Show how the three basic elements of the accounting process can be expanded and subdivided into separate general ledger accounts for storing particular information.
- Demonstrate how to draft financial statements.

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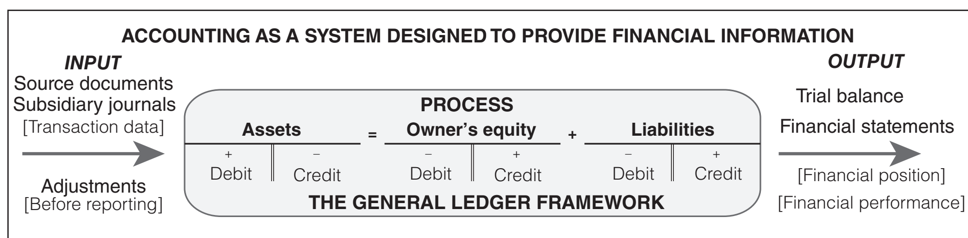
1 Introduction

We have seen that the main aim of processing accounting data is to provide information that will be used in decision-making. The two most important types of information relate to:

- The present financial condition of the business (that is, what it is worth?). This information is shown in a statement of present financial position known as the statement of financial position.
- The profit or loss that the business has made over the most recent period, usually a month or a year. The information about the past financial performance of the business is reported in the statement of profit or loss & other comprehensive income.

Using a systems approach, we can display this as shown in Figure 6.1.

Figure 6.1



2 Modifying the output

The main emphasis in accounting is on information. It is, therefore, a good time to address the question as to whether the accounting system that has been developed provides the quantity and quality of information needed by the users.

Looking again at the output provided by the illustrative example used in the previous chapter, the two financial statements were as follows:

Figure 6.2

Kibo Cleaners
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

Assets (at cost *less* depreciation)	77 000	00	Owner's equity	39 000	00
			Liabilities	38 000	00
	77 000	00		77 000	00

Kibo Cleaners
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE MONTH ENDED 31 MARCH 20*x*9

Income from dry cleaning services (5 600 + 3 800)	9 400	00
Less: Expenses (1 500 + 300 + 5 200 + 1 400)	8 400	00
PROFIT FOR THE MONTH	1 000	00

These two statements, which form the output of information, using the process we have developed, can now be studied to determine what information is provided. However, as we wish to develop the process further in this chapter, it is even more important to establish the information that is not provided in the two statements.

Once we have established this, we will attempt to modify the process to satisfy the information requirements of the users.

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- What information does the process provide?
  - The net depreciated cost (carrying value) of the assets of the business is R77 000.
  - The amount of the claim that the owner has against the business is R39 000.
  - The amount of the claim that payables have against the business is R38 000.
  - The profit for the period is R1 000.
- What information that could be useful, does the process not provide?
  - It does not distinguish between the different types of assets. We know that the business has assets worth R77 000. However, we do not know the types of assets that we have. Does the R77 000 consist of cash, equipment or accounts receivable, or some other combination of assets?
  - It gives no further information about the liabilities. We know that we owe R38 000. But it is not clear whether this is the result of loans that may only need to be repaid in the distant future, or whether they are short-term accounts payable who must be repaid within 12 months. Also, it does not show who the accounts payable are.
  - Although it is clear that a profit of R1 000 was made during the month, there is no indication of the nature of the income. Furthermore, we cannot see from this statement the types of expenses that were incurred. This would be very useful information, as there may be expenses that are being incurred unnecessarily; this would become evident if a breakdown of expenses were given.
- What kind of statements would be most useful?

Before attempting to modify the process of handling transaction data, we must decide what kind of statements we would like to produce. The following examples are suggested:

Figure 6.3

Kibo Cleaners
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

Assets			77 000	00	***Owner's equity***			39 000	00
Equipment	xxx				Capital invested	xxx			
Vehicles	xxx				Profit	xxx			
Accounts receivable	xxx				***Liabilities***			38 000	00
Bank	xxx				Long-term liabilities	xxx			
					Accounts payable	xxx			
			77 000	00				77 000	00

Kibo Cleaners
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE MONTH ENDED 31 MARCH 20*x*9

Revenue from dry cleaning services			9 400	00
Less: Expenses			(8 400	00)
Rent	xxx			
Cleaning materials	xxx			
Wages and salaries	xxx			
Depreciation	xxx			
NET PROFIT			1 000	00

If a process could be designed that captured the data in such a way as to produce the above two statements, considerably more information would be available. Developing such a process is the third and final step in understanding the accounting model and how it processes data.

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3 Modifying the process

To get the necessary information, a process of classification is used. Each of the three accounts will now be expanded into different categories. These questions should be asked when a transaction affects any of the three basic accounts.

- If assets are affected – which asset?
- If owner's equity is affected – why is it affected?
- If liabilities are affected – which liabilities?

At this stage, the modified process may seem confusing. However, for the third time we will work through the same illustrative example used in previous chapters, to describe how the process works.

Transaction 1: Opened a bank account in the name of Kibo Cleaners and deposited R38 000.

Reminder

We are using the same information from the example used in Chapter 4.

Effect on the accounting model:

- Assets increase.
- Owner's equity increases.

Questions to ask:

- Which asset increases? Bank.
- Why does owner's equity increase? Capital was invested.

Entry in the expanded set of accounts:

Asset account = **Owner's equity account** + **Liability account**

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Dr. BANK	Cr.		Dr. CAPITAL	Cr.		NO EFFECT	
38 000				38 000			

Explanation

Instead of simply debiting the asset account, a special category of asset account called bank, has been opened. Because assets have increased, a debit entry is made in the bank account.

To keep a record of why the owner's equity has increased by R38 000, a special category of owner's equity account called capital has been credited.

Transaction 2: Paid rent for March for the premises by cheque, R1 500.

Effect on the accounting model:

- Assets decrease.
- Owner's equity decreases.

Questions to ask:

- Which asset decreases? Bank.
- Why did owner's equity decrease? Rent expense.

Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Dr. BANK	Cr.		Dr. CAPITAL	Cr.		NO EFFECT	
38 000	1 500			38 000			
			RENT EXPENSE				
			1 500				

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Explanation

Because money has been paid, the amount of money deposited in the bank decreases, therefore, a credit entry is made in the bank account. By mentally balancing the bank account it can be seen that there is R36 500 left in the bank.

The owner's equity has decreased because the expenses of the business reduced his claim. It can now easily be seen that the owner invested R38 000 as capital but has had to pay an expense of R1 500 for rent.

Reminder

- The capital account shows the amount of money invested in the business by the owner.
- The rent expense account shows the amount by which his investment has reduced because of expenses.
- Later, income accounts will show how much his investment increases.

Transaction 3: Purchased the necessary equipment that was installed, and paid R12 000.

Effect on the accounting model:

- Assets increase.
- Assets decrease.

Questions to ask:

- Which asset increases? Equipment.
- Which asset decreases? Bank.

Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Dr. **BANK**	*Cr.*		*Dr.* **CAPITAL**	*Cr.*		**NO EFFECT**	
38 000	1 500			38 000			
	12 000						
EQUIPMENT			**RENT EXPENSE**				
12 000			1 500				

Explanation

The assets of the business have increased with the equipment bought. Because equipment is a different type of asset to cash, a special category of assets account dealing only with equipment is opened and a debit entry is made.

However, as the equipment was immediately paid for, the amount of money at the bank is reduced by R12 000. The special category asset account (bank) is therefore credited.

Looking at the above expanded set of accounts it can be seen that the business has R24 500 in the bank and equipment valued at a cost of R12 000.

It can also be seen that the owner originally invested R38 000 as capital and has had to bear an expense of R1 500 for rent. As a result, the business at this stage owns R36 500 (R24 500 + R12 000) and the owner has a claim of R36 500 (R38 000 – R1 500).

Note

In the remaining five transactions we will only reveal the two accounts involved in the entries rather than display all the accounts each time. Once all the transactions have been entered, the full set of accounts will be shown again in Section 5 of this chapter.

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Transaction 4: Purchased cleaning materials on credit from Cleaning Suppliers for R900.

Effect on the accounting model:

- Owner's equity decreases.
- Liabilities increase.

Question to ask:

- Why does owner's equity decrease? A material expense was incurred.
- Which liability increases? Accounts payable.

Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
NO EFFECT			Dr. CLEANING MATERIALS EXPENSE Cr.			Dr. ACCOUNTS PAYABLE Cr.	
			900				900

Explanation

- The assets of the business have neither increased nor decreased. Cleaning materials are an expense that the owner has to bear. Because it is important to keep a record of the different types of expenses incurred, a separate owner's equity account, called cleaning materials, has been opened.
- No payment was made for the cleaning materials. In the event of the business closing down at this stage, the payable (Cleaning Suppliers) would have a claim for R900 against the business that would have to be settled before the owner could receive the residual value.

There is an alternative treatment when cleaning materials are acquired. If purchasing cleaning materials is treated as though an asset was acquired, a cleaning materials inventory account could be opened as a category of assets, rather than as a category of owner's equity.

Either method is acceptable, as the adjusting entry at the end of the year for unused material will always lead to the same end result, regardless of which approach was taken at the time of processing the transaction. (Question 6.14 deals with this.)

Transaction 5: Purchased a delivery vehicle on credit from Goods Garage for R37 100.

Effect on the accounting model:

- Assets increase.
- Liabilities increase.

Questions to ask:

- Which asset increases? Vehicles.
- Which liability increases? Accounts payable.

Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
Dr. VEHICLES Cr.			NO EFFECT			Dr. ACCOUNTS PAYABLE Cr.	
37 100							900
							37 100

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Explanation

- The business has increased its assets by acquiring a vehicle. Therefore a debit entry is made in a special category asset account called 'vehicles'. This provides better information as to the nature of the assets under the control of the business.
- Because no payment was made, the business still owes the full amount to Goods Garage, who has a claim against the business. This is now in addition to the claim of R900 from Transaction 4.

Note that the owner's equity is not affected by this transaction. Why not?

Because no additional money has been invested by the owner, he has not increased his claim against the business as a result of income. Neither has he incurred any expense that would decrease his claim against the business.

Transaction 6: Received cash from customers for garments cleaned, R5 600.

Effect on the accounting model:

- Assets increase.
- Owner's equity increases.

Questions to ask:

- Which asset increases? Bank.
- Why did owner's equity increase? Revenue was received for cleaning.

Entry in the expanded set of accounts:

Asset account			=	**Owner's equity account**			+	**Liability account**	
+	−			−	+			−	+
Dr.	**BANK**	Cr.		Dr.	**CLEANING REVENUE**	Cr.		**NO EFFECT**	
38 000	1 500				5 600				
5 600	12 000								

Explanation

When the R5 600 was received, the assets increased. The type of asset that increased was money, which was deposited into the bank. The information that is available now shows that the bank account has a balance of R30 100. Note that in one asset account (bank), all transactions that affect the flow of money are entered.

The receipt of the money increases the claim that the owner has against the assets of the business. The special owner's equity account is given the name 'cleaning revenue' to show the source of the income. It should be noted that any suitable name may be given to an account, provided it is appropriate to the type of business.

Transaction 7: Cleaned 100 overalls for A–Z Factory who will pay R3 800 in April.

Effect on the accounting model:

- Assets increase.
- Owner's equity increases.

Questions to ask:

- Which asset increases? Accounts receivable.
- Why does owner's equity increase? The business has earned income that is due to the owner.

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Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
Dr. ACCOUNTS RECEIVABLE	Cr.		Dr. CLEANING REVENUE	Cr.		NO EFFECT	
3 800				5 600			
				3 800			

Explanation
As in the previous transaction, revenue has been earned that is due to the owner. His claim against the assets of the business has increased. The assets have also increased, but not yet in actual money.

There cannot be an entry into the bank account yet, because no additional money has been deposited. However, because the factory owes the money to the business, it is an asset of the business. If the business were to close down, the factory would need to pay the money that it owes.

The accounts receivable account serves as a record of money owed to the business. A statement will be sent to the factory at the end of each month until it pays. When that takes place, the necessary entries will be made. The asset (accounts receivable) will then be reduced and the asset bank increased.

Transaction 8: Paid wages and salaries for the month, R5 200.

Effect on the accounting model:
- Assets decrease.
- Owner's equity decreases.

Questions to ask:
- Which asset decreases? Bank.
- Why does owner's equity decrease? Wages and salaries were paid.

Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
Dr. BANK	Cr.		Dr. WAGES AND SALARIES	Cr.		NO EFFECT	
38 000	1 500		5 200				
5 600	12 000						
	5 200						

Explanation
Money has been paid out of the bank, therefore, the special asset account (bank) decreases. The owner must bear this expense, therefore, his claim against the business also decreases.

All the transactions resulting from source documents have now been processed. We now proceed to process the month-end adjusting entries to get accurate and up to date records.

Adjustment 1: Cleaning materials with a cost of R600 are still unused.

Effect on accounting model:
- Assets increase.
- Owner's equity increases.

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Questions to ask:
- Which asset increases? Cleaning material inventory.
- Why does owner's equity increase? Cleaning materials expense is overstated at this moment and must be adjusted to show the accurate expense to date.

Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Dr. CLEANING MATERIALS INVENTORY	Cr.		Dr. CLEANING MATERIALS EXPENSE	Cr.		NO EFFECT	
600			900	600			

Explanation

The cleaning materials account showed a total of R900. At this moment, however, only R300 is an actual expense as R600 remains unused.

To correctly show the position as at 31 March, the expense account is reduced with a credit entry and an asset (showing the cost of cleaning material inventory that has not been used) is created.

It should be noted that in April, as more cleaning material is used, the asset will decline in value. An adjustment will again be made for the material used at the end of April.

Adjustment 2: Equipment and vehicles should be depreciated by R500 and R900 respectively.

Effect on the accounting model:
- Assets decrease.
- Owner's equity decreases.

Questions to ask:
- Which assets decrease? Equipment and vehicles.
- Why does owner's equity decrease? A cost of using assets has been incurred in the form of depreciation expense.

Entry in the expanded set of accounts:

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Dr. EQUIPMENT	Cr.		Dr. DEPRECIATION	Cr.		NO EFFECT	
12 000	500		500				
			900				
VEHICLES							
37 100	900						

Note

From the above you would notice that depreciation is written off directly against the asset (equipment/vehicle). This is done to keep the general ledger process simple. Chapter 14 deals extensively with this and will be further explained as part of property, plant and equipment (PPE) in non-current assets. In Chapter 14 we will deal with accumulated depreciation accounts.

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Explanation
Both assets are worth less as they are used. As a result, the cost of their use must be shown in the decline of asset values. The expense will also reduce profits and as a result there is a decline in the owner's equity.

You should be able to complete Questions 6.1 to 6.3.

Did you know?
Depreciation is an unusual expense because no money is spent when the entry is made. The money was spent when the asset was bought. All we are doing is showing that the asset is worth less now, and as a result the loss must be recorded.

4 The full set of accounts and trial balance

In the last section, we progressed from using a classification system with only three accounts to using a classification system with many more. Remember that the aim of using accounts with more descriptive names is to get better information.

The full set of accounts for Kibo Cleaners, balanced where necessary, is shown in Figure 6.4.

Figure 6.4

Asset account = Owner's equity account + Liability account

Asset account (+ Dr. / − Cr.)

BANK

Dr.	Cr.
38 000	1 500
5 600	12 000
	5 200
24 900	

EQUIPMENT

Dr.	Cr.
12 000	500
11 500	

VEHICLES

Dr.	Cr.
37 100	900
36 200	

MATERIALS INVENTORY

Dr.	Cr.
600	

ACCOUNTS RECEIVABLE

Dr.	Cr.
3 800	

Owner's equity account (− Dr. / + Cr.)

CAPITAL

Dr.	Cr.
	38 000

RENT EXPENSE

Dr.	Cr.
1 500	

CLEANING MATERIALS EXPENSE

Dr.	Cr.
900	600
300	

CLEANING REVENUE

Dr.	Cr.
	5 600
	3 800
	9 400

DEPRECIATION

Dr.	Cr.
500	
900	
1 400	

WAGES & SALARIES

Dr.	Cr.
5 200	

Liability account (− Dr. / + Cr.)

ACCOUNTS PAYABLE

Dr.	Cr.
	900
	37 100
	38 000

To check that no errors have been made, either as a result of not making a credit entry for every debit entry, or as a result of balancing an account incorrectly, a trial balance is drafted.

Note that in a trial balance it is usual to separate the accounts that affect the profit or loss of the owner from the assets, liabilities and the original investment of the owner.

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Those accounts affecting profit or loss (that is, all income and expense accounts) are called **nominal accounts**, while the others are referred to as **real accounts**.

The trial balance shown in Figure 6.5 simply lists the balance of each account. If a debit entry has been made for every credit entry and vice versa, and if the accounts that needed to be balanced are arithmetically correct, the totals of the debit and credit balances must be the same or equal.

Figure 6.5

Kibo Cleaners
TRIAL BALANCE AS AT 31 MARCH 20*x*9

Details	Fol.	Debit		Credit	
Real accounts					
Bank	B2	24 900	00		
Equipment	B3	11 500	00		
Vehicles	B4	36 200	00		
Accounts receivable	B5	3 800	00		
Cleaning material inventory	B7	600	00		
Capital	B1			38 000	00
Accounts payable	B6			38 000	00
Nominal accounts					
Rent expense	N1	1 500	00		
Cleaning materials expense	N2	300	00		
Cleaning revenue	N3			9 400	00
Wages and salaries	N4	5 200	00		
Depreciation	N5	1 400	00		
		85 400	00	85 400	00

It is now possible to see whether this expanded set of accounts can assist in providing better information than what has been possible previously.

Did you know?
Trial is the most frequently misspelt word in accounting. Take care, trial not trail!

Information about past performance

Because the expanded set of accounts under the owner's equity has been classified and entries grouped into the various types of income and expenditure, it is now possible to draft a statement of profit or loss & other comprehensive income as:

Figure 6.6

Kibo Cleaners
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE MONTH ENDED 31 MARCH 20*x*9

Revenue from dry cleaning services			9 400	00
Less: Expenses			(8 400	00)
Rent	1 500	00		
Cleaning materials expense	300	00		
Wages and salaries	5 200	00		
Depreciation	1 400	00		
NET PROFIT			1 000	00

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Note that each type of expense is listed and the total of all the expenses is placed on the line opposite the word expenses. This helps if a very abbreviated version is needed; the user could ignore the detail and only read the second column of figures as follows:

Cleaning revenue	9 400	00
Less: Expenses	8 400	00
NET PROFIT	1 000	00

The figures can now be analysed in many different ways. For example, the following kinds of questions can be answered:

What is the proportion of expenses to income?

$$\frac{\text{Expenses}}{\text{Income}} = \frac{8\ 400}{9\ 400} \times \frac{100}{1} = 89.4\%$$

What is the proportion of net profit to expenses?

$$\frac{\text{Net profit}}{\text{Expenses}} = \frac{1\ 000}{8\ 400} \times \frac{100}{1} = 11.9\%$$

What proportion of the expenses does the rent constitute?

$$\frac{\text{Rent expense}}{\text{Expenses}} = \frac{1\ 500}{8\ 400} \times \frac{100}{1} = 17.9\%$$

These and many other such pieces of information can be used to compare the performance of Kibo Cleaners for March with its performance next month, or to compare it with other similar businesses.

Information about financial position

Once the profit or loss for the year has been established, the financial position can now be displayed in the statement of financial position as follows:

Figure 6.7

Kibo Cleaners
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

Assets			77 000	00	***Owner's equity***			39 000	00
Equipment	11 500	00			Capital invested	38 000	00		
Vehicles	36 200	00			Profit	1 000	00		
Accounts receivable	3 800	00			***Liabilities***			38 000	00
Bank	24 900	00			Long-term liabilities	0	00		
Cleaning materials inventory	600	00			Accounts payable	38 000	00		
			77 000	00				77 000	00

From the statement of financial position it is now possible to get a clearer picture of the assets of the business. For example, it is apparent that the business does not own the buildings in which it operates, but that it does have its own equipment and vehicles.

It can also be seen that there is not sufficient money in the bank to pay the accounts payable if they should demand payment. However, the accounts receivable are likely to pay their debts soon and additional revenue from cleaning services can be expected in April.

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The profit for R1 000 has been added to the capital of R38 000 used to start the business. As a result, Sicelo Kibo, the owner, has R39 000 of his money now invested in the business.

You should be able to complete Questions 6.5 to 6.8.

5 Financial reporting

It is apparent that a number of classification systems have again been used in this chapter. The ledger accounts have been classified into categories that show the type of asset or expense. In the trial balance, ledger accounts have been classified into two categories:

1. **Real accounts** destined for the statement of financial position.
2. **Nominal accounts** destined for the statement of profit or loss & other comprehensive income.

In practice, comprehensive adjustments and detailed reporting to external users of financial information usually take place once each year. A classified statement of profit or loss & other comprehensive income and statement of financial position, often with supporting explanatory notes, is then provided. The format and display of these statements may vary from one entity to another and users must not be confused by cosmetic rearrangements of the information.

The format of the statement of financial position in Figure 6.7 is useful for learning the principles, but is seldom used in practice. Rather, the information is rearranged and further classified. Assets and liabilities are both classified into non-current and current assets and liabilities.

- Non-current assets – assets of a more stable nature used in the production of income.
- Non-current liabilities – are not due for repayment during the next financial year.

If we assume that the debt to Goods Garage is only due to be repaid in two years' time, for example, a more detailed statement of financial position could be prepared as in Figure 6.8 below and Figure 6.9 on the next page.

Figure 6.8

Kibo Cleaners
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

Non-current assets			47 700	00	***Owner's equity***			39 000	00
Equipment at cost	12 000	00			Capital on 1 March	38 000	00		
Less: Accumulated depreciation	500	00			*Add*: Net profit	1 000	00		
	11 500	00			***Non-current liabilities***			37 100	00
Vehicles at cost	37 100	00			Account payable: Goods Garage	37 100	00		
Less: Accumulated depreciation	900	00			***Current liabilities***			900	00
	36 200	00			Accounts payable	900	00		
Current assets			29 300	00					
Accounts receivable	3 800	00							
Bank	24 900	00							
Cleaning materials inventory	600	00							
			77 000	00				77 000	00

Figure 6.8 (the horizontal format) and Figure 6.9 (the vertical format) contain the same basic information, simply arranged differently. Students of accounting and users of accounting

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information must not be confused by cosmetic rearrangements. Figure 6.9 shows the format for the statement of financial position most commonly encountered at present.

Figure 6.9

Kibo Cleaners
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

ASSETS ***Non-current assets***					47 700	00
Equipment at cost	12 000	00				
Less: Accumulated depreciation	500	00	11 500	00		
Vehicles at cost	37 100	00				
Less: Accumulated depreciation	900	00	36 200	00		
Current assets					29 300	00
Accounts receivable			3 800	00		
Materials inventory			600	00		
Bank			24 900	00		
					77 000	00
EQUITY AND LIABILITIES ***Capital and reserves***					39 000	00
Capital: Balance on 1 March			38 000	00		
Add: Profit for the month			1 000	00		
Non-current liabilities					37 100	00
Accounts payable: Goods Garage			37 100	00		
Current liabilities					900	00
Accounts payable			900	00		
					77 000	00

You should be able to complete Questions 6.4 and 6.9 to 6.13.

Did you know?

International Financial Reporting Standards (IFRS) are issued from time to time and are followed by the regulatory bodies in SA to show how financial statements should be formatted. These standards are revised regularly.

6 Recording in subsequent periods

Until now, we have always started the recording process when the business commences for the first time. Most often this is not the case, and recording continues every month. When confronted with an existing set of accounts, one can assume that the ledger accounts will continue to be used.

If we were required to enter transactions into the books of Kibo Cleaners for April, the closing balances at the end of March comprise the opening balances at the beginning of April. Entries for April thus simply continue under the balances in the accounts at the end of March.

It may happen occasionally that adequate records have not been kept, especially in the case of a small business that has grown beyond expectation. In such instances, the first step is to draft a statement of financial position that will show the position as at that moment in time. The amounts that have been allocated to the assets, liabilities and owner's equity will be the balances used in the ledger accounts.

Clearly the debit balance will equal the credit balances. If Kibo Cleaners had not kept records for March, a statement of financial position at the end of March could still be

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constructed provided some records such as accounts receivable and accounts payable had been maintained.

You should be able to complete Question 6.14.

7 Chapter illustrative example

Continuing with the example of Absolut Hair used in Chapters 4 and 5, you are now required to:

1. Process the transactions directly into the full set of ledger accounts and extract a trial balance.
2. Process the adjustments into the general ledger, and extract a trial balance with the new balances.
3. Report in the financial statements.

1 The general ledger showing the transactions without the adjustments and the resulting trial balance:

Dr. BANK Cr.

Dr.		Cr.	
(1)	50 000	(2)	3 200
(7)	13 620	(3)	30 000
		(4)	750
		(6)	9 000
		(9)	4 000
		(10)	12 400
	4 270		

=

Dr. CAPITAL Cr.

Dr.		Cr.	
		(1)	50 000

+

Dr. ACCOUNTS PAYABLE Cr.

Dr.		Cr.	
(9)	4 000	(5)	24 000
			20 000

EQUIPMENT

Dr.		Cr.	
(3)	30 000		
(5)	24 000		
	54 000		

ACCOUNTS RECEIVABLE

Dr.		Cr.	
(8)	8 700		

RENT EXPENSE

Dr.		Cr.	
(2)	3 200		

TELEPHONE

Dr.		Cr.	
(4)	750		

CONSUMABLES EXPENSE

Dr.		Cr.	
(6)	9 000		

FEE REVENUE

Dr.		Cr.	
		(7)	13 620
		(8)	8 700
			22 320

SALARIES

Dr.		Cr.	
(10)	12 400		

Absolut Hair
PRE-ADJUSTMENT TRIAL BALANCE AS AT 31 MARCH 20*x*4

Details	Fol.	Debit		Credit	
Real accounts					
Bank	B1	4 270	00		
Equipment	B2	54 000	00		
Accounts receivable	B3	8 700	00		
Capital	B4			50 000	00
Accounts payable	B5			20 000	00
Nominal accounts					
Rent expense	N1	3 200	00		
Telephone	N2	750	00		
Consumables expense	N3	9 000	00		
Fee revenue	N4			22 320	00
Salaries	N5	12 400	00		
		92 320	00	92 320	00

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2 The general ledger and trial balance after processing the adjusting entries:

Dr. BANK Cr. = **Dr. CAPITAL Cr.** + **Dr. ACCOUNTS PAYABLE Cr.**

BANK

Dr.		Cr.	
(1)	50 000	(2)	3 200
(7)	13 620	(3)	30 000
		(4)	750
		(6)	9 000
		(9)	4 000
		(10)	12 400
	4 270		

EQUIPMENT

Dr.		Cr.	
(3)	30 000	(B)	1 800
(5)	24 000		
	52 200		

ACCOUNTS RECEIVABLE

Dr.		Cr.	
(8)	8 700		

RENT PREPAID

Dr.		Cr.	
(A)	1 600		

CONSUMABLES (ASSET)

Dr.		Cr.	
(C)	5 200		

CAPITAL

Dr.		Cr.	
		(1)	50 000

RENT EXPENSE

Dr.		Cr.	
(2)	3 200	(A)	1 600
	1 600		

TELEPHONE

Dr.		Cr.	
(4)	750		

CONSUMABLES EXPENSE

Dr.		Cr.	
(6)	9 000	(C)	5 200
	3 800		

FEE REVENUE

Dr.		Cr.	
		(7)	13 620
		(8)	8 700
			22 320

SALARIES

Dr.		Cr.	
(10)	12 400		

DEPRECIATION

Dr.		Cr.	
(B)	1 800		

ACCOUNTS PAYABLE

Dr.		Cr.	
(9)	4 000	(5)	24 000
			20 000

Absolut Hair
POST-ADJUSTMENT TRIAL BALANCE AS AT 31 MARCH 20x4

Details	Fol.	Debit		Credit	
Real accounts					
Bank	B1	4 270	00		
Equipment	B2	52 200	00		
Accounts receivable	B3	8 700	00		
Rent prepaid	B4	1 600	00		
Consumables (asset)	B5	5 200	00		
Capital	B6			50 000	00
Accounts payable	B7			20 000	00
Nominal accounts					
Rent expense	N1	1 600	00		
Telephone	N2	750	00		
Consumables expense	N3	3 800	00		
Fee revenue	N4			22 320	00
Salaries	N5	12 400	00		
Depreciation	N6	1 800	00		
		92 320	00	92 320	00

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3 Reporting in the financial statements – both formats of the statement of financial position are shown for the purpose of illustration.

Absolut Hair
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE MONTH ENDED 31 MARCH 20*x*4

Fee revenue			22 320	00
Less: Expenses			20 350	00
Rent	1 600	00		
Telephone	750	00		
Consumables expense	3 800	00		
Salaries	12 400	00		
Depreciation	1 800	00		
NET PROFIT			1 970	00

Absolut Hair
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*4

Assets			71 970	00	***Owner's equity***			51 970	00
Equipment	52 200	00			Capital	50 000	00		
Accounts receivable	8 700	00			Profit	1 970	00		
Rent prepaid	1 600	00			***Liabilities***			20 000	00
Bank	4 270	00			Long-term liabilities	0	00		
Consumables (asset)	5 200	00			Accounts payable	20 000	00		
			71 970	00				71 970	00

Absolut Hair
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*4

ASSETS ***Non-current assets***			52 200	00
Equipment at cost	54 000	00		
Less: Accumulated depreciation	1 800	00		
Current assets			19 770	00
Accounts receivable	8 700	00		
Consumables (asset)	5 200	00		
Rent prepaid	1 600	00		
Bank	4 270	00		
			71 970	00
EQUITY AND LIABILITIES ***Capital and reserves***			51 970	00
Capital: Balance on 1 March	50 000	00		
Add: Profit for the month	1 970	00		
Current liabilities			20 000	00
Accounts payable	20 000	00		
			71 970	00

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8 Summary

This chapter is crucial in understanding the accounting process. We have taken a major conceptual step in moving from the use of only three accounts in the process to the use of many accounts.

It should now be apparent that the set of accounts can expand indefinitely depending on the number of different types of assets that the business uses, on the different types of expenses incurred and income earned and on the financing structure of the business.

For the purpose of explanation, the illustrative example was confined to only eight transactions and three elementary adjustments. However, it is obvious that many transactions take place each month in even the smallest business. It is important not to be confused by a greater quantity of transactions.

The principles learned in this chapter are the most fundamental and pervasive in the recording process. You should now be in a position to process any transaction by asking the necessary questions that will point to the account to be debited and the account to be credited.

There are a number of refinements that must still be brought to bear on the system of accounts that we have developed, as we have only placed rand values in the accounts. However, these refinements will be dealt with in the next chapter.

QUESTIONS

Question 6.1

Describe the output, input and process used in an accounting system.

Question 6.2

Define the purpose of each of these terms:

- Ledger account.
- Statement of profit or loss & other comprehensive income.
- Trial balance.
- Statement of financial position.

Question 6.3

Adjusting entries differ from entries that record transactions from routine source documents.

1. What is the purpose of an adjusting entry?
2. When would an adjusting entry normally be made?
3. Provide an example of an adjusting entry needed for a non-current asset.
4. Provide an example of an adjusting entry needed for a current asset.
5. Provide an example of an adjusting entry needed for an expense incurred.

Question 6.4

Provide a brief explanation of each of these terms and give two examples of each:

- Non-current assets.
- Non-current liabilities.
- Current assets.
- Current liabilities.

Question 6.5

Mr Tswongo decided to start a steam cleaning business. He called his business Executive Steam Cleaners.

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Transactions for January:

1. Mr Joe Tswongo deposited R90 000 in the bank account of the business as his initial capital contribution.
2. The business bought premises for R50 000 and paid by cheque.
3. Joe bought a delivery van from Maluka Motors for R8 340 on credit.
4. Joe bought the necessary steam cleaning equipment and paid R9 840 by cheque.
5. Joe bought desks, typewriter and so on from Office Equipment Ltd, and gave them a cheque for R10 250.

You are required to:

1. Enter the transactions in the correct ledger accounts.
2. Prepare a trial balance for the five-day period.
3. Comment on the performance and position of the business to date.

Question 6.6

In August, Lukus Bird started as a wildlife consultant. He called his business Bird Prolife Consultancy.

Transactions for the month:

2 Started business with R60 000 in the business's bank account.
3 Cashed a cheque for cash float, R150.
4 Purchased delivery van from ZIP Motors and paid by cheque, R26 000.
9 Paid rent by cheque to B. Slade, R450.
10 Cash receipts for consultancy with the local zoo, R465.
12 Purchased equipment for measuring air pollution, R12 500.
14 Paid wages by cheque, R90.
16 Owner cashed cheque for personal use, R43.
18 Paid *The Earth Herald* by cheque for advertising, R210.
22 Cash receipts for bird sanctuary consultancy, R655.
24 Paid Eskom by cheque for electricity, R87.
25 Paid CAN by cheque for stationery bought, R145.
27 Paid for petrol by cheque (consumable stores) bought from Tokai Motors, R55. Treated as an expense at acquisition date.
28 Cash receipts from public lecture, R235.

You are required to:

1. Enter the transactions into appropriate ledger accounts using the format in Figure 6.4.
2. Prepare a classified trial balance as at 31 August.

Question 6.7

Lemmy Sahar owns a business called Nyoni Services that provides a service paving courtyards and driveways.

These balances were from the books at the beginning of a new financial period on 1 January.

Debits	
Bank	R11 500
Vehicles	R24 500
Equipment	R54 000

Credits	
Capital	R90 000

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Transactions for January:

2 Paid Korobrik Ltd for bricks (consumable stores), R490.
5 Cash receipts for services rendered, R680 (cash slip 213).
6 Paid wages by cheque, R85.
7 Cashed a cheque for cash float, R100.
12 Paid Brick Suppliers Ltd for bricks (*consumable stores*), R355.
13 Cash receipts for services rendered, R520.
Received cash for paving job completed, R675.
15 Paid rent by cheque, R300, to S. Minx.
17 Paid wages by cheque, R85.
18 Hilet Ltd paid for courtyard paved, R694.
21 Paid by cheque for new equipment bought form Len Ltd, R2 500.
22 Cash receipts for services rendered, R520.
25 Received a cheque for R120 from J. Ivanhof for services rendered.
27 Paid wages by cheque, R85.
28 Received a cheque from Garage Ltd for paving, R3 200.

You are required to:

1 Enter the transactions into appropriate ledger accounts using the format in Figure 6.4.
2 Prepare a classified trial balance as at 31 January.

Question 6.8

On 1 March, Joan Arendse (an accounting consultant) had these assets and liabilities:

Capital	9 800	00
Office equipment at carrying value	3 000	00
Office supplies	800	00
Accounts receivable	5 000	00
Cash in the bank	4 000	00
Accounts payable	3 000	00

Transactions for March:

1 Paid March rent by cheque R200.
2 Purchased office supplies costing R250 on credit. Treated as an asset at acquisition date.
11 Purchased additional equipment for R1 400, paying R800 by cheque with the balance on account.
13 Received R4 500 from accounts receivable and banked this sum.
17 Joan paid R500, that she had won in a competition, into her business bank account.
19 Paid accounts payable by cheque, R1 600.
24 Joan cashed a cheque for R300 for her personal use.
25 Charged bookkeeping fees to clients, R1 200.
31 Paid wages for the month by cheque R150.
31 Depreciation on office equipment is estimated to be R100.
31 After the inventory count, it was found that the cost of office supplies used was R320.

You are required to:

1 Enter the opening balances and record the above transactions in the ledger accounts.
2 Prepare a trial balance as at 31 March.

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3 Draft the statement of profit or loss & other comprehensive income and statement of financial position.

Question 6.9

Dr James Smith has a successful dental practice. An extract was taken from his records. These balances, excluding the capital invested, were extracted for March:

Bank	4 400	00
Operations equipment at carrying value	10 000	00
Office equipment at carrying value	2 500	00
Accounts receivable: P. Platt	500	00
Accounts receivable: G. Grey	650	00

Transactions for March (source document numbers in brackets):

2 Dr Smith increased his capital by depositing R1 000 in his the bank account (D/S 71).
8 Total of cash received from patients R760 (C/S 110–120).
12 Sold an old typewriter at carrying value and received R300 (R11).
16 P. Platt paid R200 on account (R12).
Banked all cash in till received from patients, R640 (C/S 121–130).
20 Sold old dental equipment at carrying value to Dr P. Bandy and received his cheque for R2 000 (R13).
22 Received a cheque from G. Grey for R650 in full settlement of his account (R14).
24 Mrs L. Brown sent us a cheque for R100 for the rental of the storeroom let to her (R15).
26 Paid by EFT:
Electricity and water (C264) R280
Salaries and wages (C265) R640

You are required to:

1 Enter the transactions into the ledger accounts.
2 Prepare the trial balance.
3 Prepare a statement of profit or loss & other comprehensive income and statement of financial position for Dr Smith as at 31 March.

Question 6.10

Here is an alphabetical list of the assets and liabilities of Tshwete and Sons, as at 28 February 20*x*9:

Accounts payable	23 400	00
Accounts receivable	15 200	00
Capital – Tshwete (1 March 20*x*1)	80 000	00
Cash at bank	6 000	00
Furniture and fixtures	14 300	00
Land and buildings	108 000	00
Mortgage bond (repayable over 20 years)	67 000	00
Stock of materials	32 400	00
Vehicles	3 100	00

You are required to:

Prepare the properly classified statement of financial position of Tshwete and Sons as at 28 February 20*x*9 in both vertical and horizontal format.

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Question 6.11

You have recently been called on to start a set of accounting records for a small business engaged in cartage contracting. The previous set was destroyed by fire.

You established that the business, that trades under the name of Phuthuma Carriers, owns these assets at cost less depreciation to date:

Truck 1	4 000	00
Truck 2	3 000	00
Truck 3	3 700	00
Land and buildings	85 000	00
Tools and equipment	7 000	00
Inventory of petrol, diesel, oil, and so on	3 200	00

- In addition, the business has R8 100 cash in the bank and receivables owe R16 400, while the business owes R70 for petrol recently bought and R1 300 for tools bought last week.
- The land and buildings have a mortgage bond with the Unlimited Building Society that currently has a balance of R41 300. A long-term loan of R20 000 was taken out three years ago and is still outstanding. Interest on the loan is 15% per annum.
- The owner, V. Zuma, tells you that she started the business three years ago by investing R30 000.

You are required to:
Prepare the statement of financial position.

Question 6.12

On 31 July, Misty Steam Cleaners had this trial balance in their books. This is the final trial balance for the financial year:

Misty Steam Cleaners
TRIAL BALANCE AS AT 31 JULY 20*x*6

Details	Fol.	Debit		Credit	
Real accounts					
Bank	B			38 500	00
Capital	B			80 000	00
Drawings	B	2 000	00		
Cash float	B	150	00		
Operations equipment	B	11 450	00		
Vehicles	B	10 600	00		
Loan: First Bank	B			1 000	00
Nominal accounts					
Fees received	N			39 000	00
Consumable stores	N	860	00		
Stationery	N	420	00		
Rent expense	N	12 400	00		
Telephone	N	750	00		
Wages and salaries	N	54 000	00		
Rent received	N			11 130	00
		131 130	00	131 130	00

You are required to:
Prepare the financial statements.

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Question 6.13

Spotless Dry Cleaners had these balances in their ledger accounts on 31 March 20*x*7.

Capital	37 161	00
Vehicles	14 600	00
Operations equipment	27 394	00
Machinery	14 700	00
Electricity and water	1 341	00
Salaries and wages	17 927	00
Fixed deposit: Allied Bank	10 000	00
Advertising	2 349	00
Interest on loan	550	00
Accounts receivable	740	00
Bank (Dr.)	8 397	00
Rent paid	12 370	00
Drawings	1 728	00
Office equipment	8 749	00
Stationery	91	00
Telephone	R609	00
Fees received	78 924	00
Loan: National Bank (liability)	5 000	00
Repairs	1 906	00
Accounts payable	3 740	00
Bad debts expense	98	00
Bank charges	876	00

You are required to:

1. Prepare a trial balance in accordance with Figure 6.5.
2. Prepare the financial statements for the year ended 31 March 20*x*7.
3. Comment on the financial performance and financial position.

Question 6.14

This information relates to the stationery transactions of Wiltons for the year:

1. Stationery bought for cash, R200.
2. Stationery bought on credit, R300.
3. Stationery on hand at the end of the year, R150.

You are required to:

1. Show the entries for the year in accounts under the accounting equation under each of these assumptions:
   - **a** Stationery is treated as an expense at date of purchase.
   - **b** Stationery is treated as an asset at the date of purchase.
2. Discuss the different approaches and decide which one you prefer.
3. Discuss whether the use of alternative methods makes any difference to the information regarding position or performance for the year.

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7 THE GENERAL LEDGER AND GENERAL JOURNAL

Chapter objectives

By the end of this chapter, you should be able to:

- Complete the final step in building a complete general ledger.
- Introduce the general journal as the first recording step for source documents, prior to entries into the general ledger.
- Prepare the format of the general journal.
- Introduce the additional information recorded in accounts in the general ledger.
- Prepare the closing entries into the general journal.
- Prepare the closing entries into the general ledger.
- Describe the distinction between nominal accounts and real accounts.
- Record transactions that the owner of the business may have with the business.

Chapter outline

1	INTRODUCTION	7 – 2
2	THE GENERAL JOURNAL	7 – 2
3	CHAPTER ILLUSTRATIVE EXAMPLE	7 – 2
4	THE GENERAL LEDGER	7 – 4
5	CLOSING ENTRIES IN THE GENERAL LEDGER	7 – 6
6	CHAPTER ILLUSTRATIVE EXAMPLE	7 – 10
7	TRANSACTIONS BETWEEN THE OWNER AND THE BUSINESS	7 – 13
8	SUMMARY	7 – 15

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1 Introduction

In developing the accounting process so far, the focus has been on the output of financial information relating particularly to the past performance of the business and its present position. A process was developed that provided adequate information on both of these aspects.

However, the individual accounts only had figures as the entries on the debit or credit side. As most businesses deal with many transactions each month, further records with such information as the dates on which the transactions took place and the number of the source documents involved is also required. This is essential for reference purposes, in case there are enquiries from the customers or errors that may have been made.

This chapter introduces the concept of a subsidiary book where transactions are recorded before making the entries into the accounts. It aims to demonstrate how the necessary reference information is recorded both in the subsidiary book called the general journal and in the set of accounts in the general ledger.

The word 'general' is used in each case because, as the recording process is developed, special journals and special ledgers will also be used. However, they are topics for later chapters. The illustrative example of Kibo Cleaners will be used again to demonstrate the principles involved in developing these two recording devices.

2 The general journal

The need for a general journal arises because details such as dates and document numbers must be recorded. The general ledger will always be the most important and primary source of transaction information. However, a secondary source with more detail is provided by the general journal.

While this may seem a cumbersome system at first, it will become apparent that journals are a most valuable tool in summarising the masses of transactions that take place in any real business.

It has already been noted that the source of all transaction data is the document that is completed at the time of the transaction. These include, for example, cheques, receipts and invoices. The whole process depends on this recording being done accurately. It must be stressed again, therefore, that every transaction requires a source document.

The procedure is then as follows:

- Obtain the source document.
- Ask the necessary questions about the effect the transaction has on the accounting model.
- Make a journal entry into the general journal.

Did you know?

Another meaning of journal is diary – a place where daily events are recorded.

The entry in the general journal is made by simply stating which account is to be debited and which account is to be credited. These facts are entered into the general journal, together with any further information such as the document number or details that may be important for reference purposes.

The source document can then be filed as evidence that the transaction took place. Needless to say, there are numerous variations of display in a general journal, particularly as many businesses would use a computer package to make the entry rather than do it by hand.

3 Chapter illustrative example

The most commonly used display in the general journal is shown in Figure 7.1 for Kibo Cleaners, using the same transactions as in the previous chapters, repeated below for reference purposes.

1 Opened a bank account for Kibo Cleaners and deposited R38 000 (original deposit slip).

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2 Paid rent for March for the premises by cheque, R1 500 (cheque counterfoil).
3 Purchased the necessary equipment that was installed and paid R12 000 (original receipt, or cash sale slip, or cheque counterfoil).
4 Purchased cleaning materials on credit from Cleaning Suppliers, R900 (original invoice).
5 Purchased a delivery vehicle on credit from Goods Garage, R37 100 (original invoice).
6 Received cash from customers for garments cleaned, R5 600 (duplicate cash slips).
7 Cleaned 100 overalls for A–Z Factory that undertook to pay R3 800 in April (duplicate invoice).
8 Paid R5 200 for wages and salaries for the month (cheque counterfoil).

You are required to:
Prepare the above-mentioned entries in the general journal of Kibo Cleaners.

Figure 7.1

GENERAL JOURNAL OF KIBO CLEANERS FOR MARCH GJ1

Day	Details	Fol.	Debit		Credit	
01/03	Bank	B2	38 000	00		
	Capital	B1			38 000	00
	Bank account number xxx opened at xxx Bank and capital deposited					
02/03	Rent expense	N1	1 500	00		
	Bank	B2			1 500	00
	Paid rent with cheque 001					
03/03	Equipment	B3	12 000	00		
	Bank	B2			12 000	00
	Equipment purchased with cheque 002					
04/03	Cleaning materials expense	N2	900	00		
	Accounts payable	B6			900	00
	Purchased cleaning materials from Cleaning Supplies on credit and received invoice xxx					
05/03	Vehicles	B4	37 100	00		
	Accounts payable	B6			37 100	00
	Purchased a delivery vehicle on credit from Goods Garage and received invoice xxx					
06/03	Bank	B2	5 600	00		
	Cleaning revenue	N3			5 600	00
	Received cash for cleaning. Cash slip 001					
07/03	Accounts receivable	B5	3 800	00		
	Cleaning revenue	N3			3 800	00
	Sent invoice 001 to A–Z Factory for services rendered					
08/03	Wages and salaries	N4	5 200	00		
	Bank	B2			5 200	00
	Paid wages and salaries with cheque 003					

Explanation

- For convenience, the account to be debited is entered first, followed by the account to be credited and then the explanation or narration as it is known.
- There is a column headed 'Fol.' that has not been used. 'Fol.' is an abbreviation for folio number that is the number of the page in the general ledger on which the account will be found. This will be explained further when dealing with the general ledger.

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- The general journal page is numbered GJ1 and subsequent pages will be numbered GJ2, GJ3 and so on.
- The narration will vary in length depending on the detail required. However, a record of the document number is essential for reference purposes should a query arise that requires the original source document to be extracted from the files.
- The adjusting entries are entered in much the same way in the general journal.

You should be able to complete Questions 7.1 to 7.4.

4 The general ledger

Once the journal entries have been completed, entries are then made in the general ledger accounts. This procedure is known as posting from the general journal to the general ledger. It is clear that all the decisions regarding the accounting model and the accounts to be used for each transaction have already been made.

Posting to the general ledger is thus a straightforward procedure requiring, quite simply, that the entries shown in the general journal be made in the general ledger.

To show that the postings have been completed and to enable easy cross-referencing, folio numbers are inserted in the general ledger, cross referencing to the general journal, as shown below.

General Ledger of Kibo Cleaners
Real Accounts Section

Dr. **ACCOUNT NAME** **B1** **Cr.**

Date	Day	Details	Folio	Amount		Date	Day	Details	Folio	Amount	

This is shown for Transaction 1 in Figure 7.2.

Figure 7.2

General Ledger of Kibo Cleaners
Real Accounts Section

Dr. **CAPITAL** **B1** **Cr.**

						Mar.	1	Bank	GJ1	38 000	00

BANK **B2**

Mar.	1	Capital	GJ1	38 000	00						

Explanation

In addition to the amount of money involved, the date, the name of the account in which the corresponding entry is made, and the page number of the general journal from which the entry is made are all recorded.

Another very important difference is now introduced. Instead of using the format that has been used for **explanations**, a general ledger normally has one account per page.

The name 'Capital' for example, makes it apparent that it is an owner's equity account, just as the name 'Bank' makes it apparent it is an asset account.

The general ledger is usually divided into the two sections introduced earlier in the trial balance, namely a section for real accounts and a section for nominal accounts.

The plus and minus signs are also no longer in evidence and reference is simply made to the debit or credit side.

The full set of ledger accounts for Kibo Cleaners, formally balanced, is shown in Figure 7.3.

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Note

The accounts are displayed underneath each other, but each would normally be on a page of its own, as shown by the page (folio) number B1, N2 and so on.

Figure 7.3

General Ledger of Kibo Cleaners
Real Accounts Section

Dr. **CAPITAL** **B1** Cr.

						Mar.	1	Bank	GJ1	38 000	00

BANK **B2**

Mar.	1	Capital	GJ1	38 000	00	Mar.	2	Rent expense	GJ1	1 500	00
	6	Cleaning revenue	GJ1	5 600	00		3	Equipment	GJ1	12 000	00
							8	Wages and salaries	GJ1	5 200	00
							31	Balance	c/d	24 900	00
				43 600	00					43 600	00
Apr.	1	Balance	b/d	24 900	00						

EQUIPMENT **B3**

Mar.	3	Bank	GJ1	12 000	00	Mar.	31	Depreciation	GJ2	500	00
								Balance	c/d	11 500	00
				12 000	00					12 000	00
Apr.	1	Balance	b/d	11 500	00						

VEHICLES **B4**

Mar.	5	Accounts payable	GJ1	37 100	00	Mar.	31	Depreciation	GJ2	900	00
								Balance	c/d	36 200	00
				37 100	00					37 100	00
Apr.	1	Balance	b/d	36 200	00						

ACCOUNTS RECEIVABLE **B5**

Mar.	7	Cleaning revenue	GJ1	3 800	00						

ACCOUNTS PAYABLE **B6**

						Mar.	4	Cleaning materials	GJ1	900	00
							5	Vehicles	GJ1	37 100	00
										38 000	00

CLEANING MATERIALS INVENTORY **B7**

Mar.	31	Cleaning materials expense	GJ2	600	00						

Nominal Accounts Section

RENT EXPENSE **N1**

Mar.	2	Bank	GJ1	1 500	00						

CLEANING MATERIALS EXPENSE **N2**

Mar.	4	Accounts payable	GJ1	900	00	Mar.	31	Cleaning materials inventory	GJ2	600	00
								Total	c/f	300	00
				900	00					900	00
Apr.	1	Total	b/f	300	00						

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Dr.											Cr.
				CLEANING REVENUE					**N3**		
						Mar.	6	Bank	GJ1	5 600	00
							7	Accounts receivable	GJ1	3 800	00
										9 400	00
				WAGES AND SALARIES					**N4**		
Mar.	8	Bank	GJ1	5 200	00						
				DEPRECIATION					**N5**		
Mar.	31	Equipment	GJ2	500	00						
		Vehicles	GJ2	900	00						
				1 400	00						

Note particularly how the accounts in Figure 7.3 are balanced and totalled. In line with the double-entry system, the balance in the bank account, for example, is first entered on the smaller side with a note that it must be carried down (c/d).

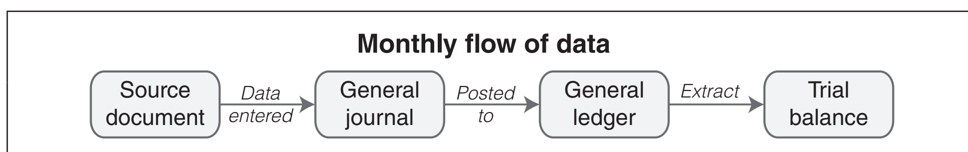
As a result, the totals of both the debit and credit sides will agree. Totals are inserted on the same line. The balance is then brought down on the first day of the next month with a note that it has been brought down (b/d).

Note: The carried down and brought down principle applies to real accounts only. When dealing with nominal accounts, the carried forward and brought forward principle is used.

When there is only one transaction in an account it is not necessary to balance it, as the balance is apparent. Where there are a few entries, all on the same side, they are usually added with the total inserted in pencil. This total is the balance as it constitutes the difference between the two sides of the account.

The procedures used in this chapter are shown in a diagram in Figure 7.4.

Figure 7.4



These procedures are followed continuously. Although it has been called the monthly flow of data because most businesses operate the procedure on a monthly basis, many larger businesses would prefer to post to the general ledger on a weekly basis and extract a weekly trial balance. This has the advantage of keeping management up to date on the progress of the business, as well as detecting errors more frequently through the trial balance if it does not balance.

You should be able to complete Questions 7.5 and 7.6.

5 Closing entries in the general ledger

Although the balances in each account provide some information, the most important information about financial performance and financial position is only obtainable from the statement of profit or loss & other comprehensive income and statement of financial position. Using the accounting principle that for every debit there must be a credit, a special procedure will now be developed to provide this information.

You will recall that the accounts of Kibo Cleaners have been shown using the accounting model spread across the page, as it appears in Figure 7.5 on the next page.

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Figure 7.5

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+

Asset account

Dr. BANK	Cr.
38 000	1 500
5 600	12 000
	5 200
24 900	

EQUIPMENT	
12 000	500
11 500	

VEHICLES	
37 100	900
36 200	

CLEANING MATERIALS INVENTORY	
600	

ACCOUNTS RECEIVABLE	
3 800	

Owner's equity account

Dr. CAPITAL	Cr.
	38 000

RENT EXPENSE	
1 500	

CLEANING MATERIALS EXPENSE	
900	600
300	

CLEANING REVENUE	
	5 600
	3 800
	9 400

DEPRECIATION	
500	
900	
1 400	

WAGES AND SALARIES	
5 200	

Liability account

Dr. ACCOUNTS PAYABLE	Cr.
	900
	37 100
	38 000

In practice, the accounts will not be spread like this, but rather each account will be allocated a page of its own in the ledger. Also, the accounts will not be in any specific order but new accounts will be opened as and when the need arises.

However, for the purpose of understanding how each transaction affects the accounting model, all explanations in this book will refer back to this format.

The accounts enclosed by the dotted line are all nominal accounts. They are the accounts that affect the owner's equity by increasing or decreasing it as a result of business operations.

Note that it is these accounts and only these accounts that affect the financial performance of the business. It is the difference between the balances on these nominal accounts that determines the profit or loss of the business. They are all, therefore, accounts to be displayed in the statement of profit or loss & other comprehensive income.

This section focuses only on the nominal accounts, that is, these accounts within the dotted lines in Figure 7.5, and develops a procedure that achieves two aims:

1. It collects the balances of all the nominal accounts into one account called the profit and loss account. This new account will then display all the information about income and expenses. The balance of the account will be the profit (if the income is more than the expenditure) or the loss (if the expenditure is more than the income) for the period under review.
2. It closes off all the nominal accounts, so that at the beginning of the next period, new nominal accounts can be opened and a fresh start made in determining the performance of the next period.

Reminder

Adjustments are usually only recorded before reporting in the financial statements to reflect more accurate information.

As accounting seeks to provide information, it must do so in a way that enables the users to obtain a clear picture of the business. The individual accounts such

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as cleaning materials expense, for example, were used to collect all the data relating to payments for cleaning material.

Each time some form of cleaning material was purchased, an entry was made into the cleaning materials expense account. The next step is to provide a summary of all the different types of expenses and income in one account.

This account, the profit and loss account then becomes an important source of information that can be communicated to the users as a statement of profit or loss & other comprehensive income. The effect of this after closing all the nominal accounts is shown in Figure 7.6.

Figure 7.6

General Ledger of Kibo Cleaners
Nominal Accounts Section

Dr. **RENT EXPENSE** **N1** Cr.

Mar.	2	Bank	GJ1	1 500	00	Mar.	31	Profit and loss account	GJ2	1 500	00

CLEANING MATERIALS EXPENSE **N2**

Mar.	4	Accounts payable	GJ1	900	00	Mar.	31	Cleaning materials inventory	GJ2	600	00
								Profit and loss account	GJ2	300	00
				900	00					900	00

CLEANING REVENUE **N3**

Mar.	31	Profit and loss account	GJ2	9 400	00	Mar.	6	Bank	GJ1	5 600	00
							7	Accounts receivable	GJ1	3 800	00
				9 400	00					9 400	00

WAGES AND SALARIES **N4**

Mar.	8	Bank	GJ1	5 200	00	Mar.	31	Profit and loss account	GJ2	5 200	00

DEPRECIATION **N5**

Mar.	31	Equipment	GJ2	500	00	Mar.	31	Profit and loss account	GJ2	1 400	00
		Vehicles	GJ2	900	00						
				1 400	00					1 400	00

Final Accounts Section
PROFIT AND LOSS ACCOUNT **F2**

Mar.	31	Rent expense	GJ2	1 500	00	Mar.	31	Cleaning revenue	GJ2	9 400	00
		Cleaning materials expense	GJ2	300	00						
		Wages and salaries	GJ2	5 200	00						
		Depreciation	GJ2	1 400	00						
		Capital (Net profit)	GJ2	1 000	00						
				9 400	00					9 400	00

Explanation

- To collect the balance of all the nominal accounts into one account, each nominal account is closed off using the principle that for every debit entry there must be a credit entry.

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- As a result there are now no balances in any of the nominal accounts. The profit and loss account is the only nominal account that still has a balance. It shows that owner's equity has increased by more than it has decreased and as a result there is a balance of R1 000 that is the net profit for the period, in this case March.

Looking only at the figures, the financial position of Kibo Cleaners is now shown in Figure 7.7.

Figure 7.7

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
BANK B2			**CAPITAL B1**			**ACCOUNTS PAYABLE B6**	
Balance 24 900				Balance 38 000			Balance 38 000
EQUIPMENT B3			**PROFIT AND LOSS ACCOUNT F2**				
Balance 11 500				Balance 1 000			
VEHICLES B4							
Balance 36 200							
ACCOUNTS RECEIVABLE B5							
Balance 3 800							
CLEANING MATERIALS INVENTORY B7							
Balance 600							

Earlier the general ledger was introduced and it was stated that as a matter of procedure, all transactions are entered from a source document into the journal and then posted to the ledger.

Although there is no source document involved in the closing entries, the necessary general journal entries must still be made before posting to the general ledger. They are shown in Figure 7.8.

Figure 7.8

GENERAL JOURNAL OF KIBO CLEANERS FOR MARCH **GJ2**

Day	Details	Fol.	Debit		Credit	
31/03	Profit and loss account	F2	1 500	00		
	Rent expense	N1			1 500	00
	Rent expense closed off					
	Profit and loss account	F2	300	00		
	Cleaning materials expense	N2			300	00
	Cleaning materials closed off					
	Cleaning revenue	N3	9 400	00		
	Profit and loss account	F2			9 400	00
	Cleaning revenue closed off					
	Profit and loss account	F2	5 200	00		
	Wages and salaries	N4			5 200	00
	Wages and salaries closed off					
	Profit and loss account	F2	1 400	00		
	Depreciation	N5			1 400	00
	Depreciation closed off					

It can be seen that because of the number of expense accounts that have to be closed, the profit and loss account has to be debited repeatedly.

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The number of general journal entries may be reduced by grouping the entries in a compound entry as shown in Figure 7.9.

Figure 7.9

GENERAL JOURNAL OF KIBO CLEANERS FOR MARCH **GJ2**

Day	Details	Fol.	Debit		Credit	
31/03	Profit and loss account	F2	8 400	00		
	Rent expense	N1			1 500	00
	Cleaning materials expense	N2			300	00
	Wages and salaries	N4			5 200	00
	Depreciation	N5			1 400	00
	Expense accounts closed off					
	Cleaning revenue	N3	9 400	00		
	Profit and loss account	F2			9 400	00
	Revenue accounts closed off					

This form of general journal entry considerably reduces the repetition that would result if there were many expense and income accounts.

- Using the profit and loss account that summarises the nominal accounts, it is now possible to draft a statement of profit or loss & other comprehensive income in exactly the same way as in the previous chapter, Figure 6.6.
- Using the accounts that remain in the real accounts, it is now possible to draft a statement of financial position in the same way as in Chapter 6, Figures 6.8 and 6.9.

You should be able to complete Questions 7.7 and 7.8.

6 Chapter illustrative example

Use the information from the chapter illustative example in Chapter 4 for this example.

Ayesha Hisham started a business 'Absolut Hair' on 1 March 20*x*4. The business specialises in modern hair styles for young executives. These are her transactions for the first month of business:

1. The owner deposited R50 000 in the current bank account as her capital contribution.
2. Issued a cheque to Histar Properties to pay the rent for the first two months, R3 200.
3. Purchased hair care equipment and paid by cheque, R30 000.
4. Paid R750 to Telkom for telephone expenses.
5. Purchased office equipment on credit from Injani Suppliers, R24 000.
6. Purchased hair care products for cash and paid R9 000.
7. Received R13 620 in cash and cheques for services to customers.
8. Invoiced Brash Ltd, a local business who opened an account with Absolut Hair, R8 700 for services rendered.
9. Paid Injani Suppliers R4 000 in part payment on account.
10. Paid salaries to the stylists and herself for the month, R12 400.

Ayesha considers these adjustments to be relevant prior to reporting on 31 March:

A The rent was paid for two months and, therefore, is not all an expense for the current month.

B The hair care equipment is likely to last about 2.5 years, after that it will have no value.

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C After the inventory count, Ayesha determined that there are hair care products bought at a cost of R5 200 that were not used during the month, but will be used in later months.

You are required to:

For each of the transactions and adjustments:

- Record the entry in the general journal with narrations.
- Show the posting to the general ledger, using the appropriate folio numbers.
- Balance all the accounts in the general ledger.

Suggested solution

The general journal entries will appear as follows. (Note that we have assumed that the entries were recorded on pages GJ1 and GJ2 of this abridged general journal.)

GENERAL JOURNAL OF ABSOLUT HAIR GJ1

Day	Details	Fol.	Debit	Credit
01/03	Bank	B2	50 000	
	Capital	B1		50 000
	Bank account opened with capital contribution			
02/03	Rent expense	N1	3 200	
	Bank	B2		3 200
	Paid rent for 2 months with cheque 001			
03/03	Equipment	B3	30 000	
	Bank	B2		30 000
	Bought equipment with cheque 002			
04/03	Telephone	N2	750	
	Bank	B2		750
	Paid Telkom with cheque 003			
05/03	Equipment	B3	24 000	
	Accounts payable	B5		24 000
	Bought equipment on credit from Injani Suppliers			
06/03	Consumables	N3	9 000	
	Bank	B2		9 000
	Bought consumables with cheque 004			
07/03	Bank	B2	13 620	
	Fee revenue	N4		13 620
	Cash slip 001 issued for services rendered			
08/03	Accounts receivable	B4	8 700	
	Fee revenue	N4		8 700
	Issued invoice 001 for services rendered on credit			
09/03	Accounts payable	B5	4 000	
	Bank	B2		4 000
	Paid Injani Suppliers with cheque 005			
10/03	Salaries	N5	12 400	
	Bank	B2		12 400
	Paid salaries with cheque 006			

GENERAL JOURNAL OF ABSOLUT HAIR GJ2

Day	Details	Fol.	Debit	Credit
31/03	Rent prepaid	B7	1 600	
	Rent expense	N1		1 600
	Adjustment for rent prepaid			
31/03	Depreciation	N6	1 800	
	Equipment	B3		1 800
	Depreciation taken into account based on 30 months useful life span			
31/03	Consumables (asset)	B6	5 200	
	Consumables	N3		5 200
	Consumables on hand at month end			

Explanation

- Each transaction is recorded separately, with a descriptive narration.
- As expected for every debit entry, there is a credit entry.
- We have assumed that two numbered pages have been used in the manual general journal, number GJ1 and GJ2.
- Although the folio numbers are referenced to the general ledger, they are only written in when the general journal entries are posted to the general ledger.

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The general ledger is as follows, after the posting has been completed, and all accounts balanced and/or totalled, as appropriate.

General Ledger of Absolut Hair
Real Accounts Section

Dr. **CAPITAL** **B1** Cr.

						Mar.	1	Bank	GJ1	50 000	00

BANK **B2**

Mar.	1	Capital	GJ1	50 000	00	Mar.	2	Rent expense	GJ1	3 200	00
	7	Fee revenue	GJ1	13 620	00		3	Equipment	GJ1	30 000	00
							4	Telephone	GJ1	750	00
							6	Consumables	GJ1	9 000	00
							9	Accounts payable	GJ1	4 000	00
							10	Salaries	GJ1	12 400	00
							31	Balance	c/d	4 270	00
				63 620	00					63 620	00
Apr.	1	Balance	b/d	4 270	00						

EQUIPMENT **B3**

Mar.	3	Bank	GJ1	30 000	00	Mar.	31	Depreciation	GJ2	1 800	00
	5	Accounts payable	GJ1	24 000	00			Balance	c/d	52 200	00
				54 000	00					54 000	00
Apr.	1	Balance	b/d	52 200	00						

ACCOUNTS RECEIVABLE **B4**

Mar.	7	Fee revenue	GJ1	8 700	00						

ACCOUNTS PAYABLE **B5**

Mar.	9	Bank	GJ1	4 000	00	Mar.	4	Equipment	GJ1	24 000	00
	31	Balance	c/d	20 000	00						
				24 000	00					24 000	00
						Apr.	1	Balance	b/d	20 000	00

CONSUMABLES (ASSET) **B6**

Mar.	31	Consumables	GJ2	5 200	00						

RENT PREPAID **B7**

Mar.	31	Rent expense	GJ2	1 600	00						

Nominal Accounts Section

RENT EXPENSE **N1**

Mar.	2	Bank	GJ1	3 200	00	Mar.	31	Rent prepaid	GJ2	1 600	00
								Total	c/f	1 600	00
				3 200	00					3 200	00
Apr.	1	Total	b/f	1 600	00						

TELEPHONE **N2**

Mar.	4	Bank	GJ1	750	00						

CONSUMABLES **N3**

Mar.	3	Bank	GJ1	9 000	00	Mar.	31	Consumables (asset)	GJ2	5 200	00
								Total	c/f	3 800	00
				9 000	00					9 000	00
Apr.	1	Total	b/f	3 800	00						

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Dr.								FEE REVENUE	N4		Cr.
						Mar.	7	Bank	GJ1	13 620	00
							8	Accounts receivable	GJ1	8 700	00
										22 320	00

		SALARIES							N5		
Mar.	10	Bank	GJ1	12 400	00						

		DEPRECIATION							N6		
Mar.	31	Equipment	GJ2	1 800	00						

Explanation

- For the sake of convenience, the accounts are normally divided between the real accounts and the nominal accounts.
- In manual systems, the numbering of the accounts usually reflects this division – real accounts start at number 1 and nominal accounts start at some higher number.
- The accounts are in a T-format, that is also a characteristic of a manual system – most electronically generated accounts are presented in a 3-column format.
- The transaction number has been used for referencing – in practice, the actual date of the transaction will be used.
- The folio references alongside each entry refer to the page in the general journal where the transaction was recorded. This leaves an 'audit trail', allowing anyone who wants to find the original source document number, to work back to the general journal and find the source document number in the narration.
- In later chapters, we will develop the general journal into a number of specialised journals.

7 Transactions between the owner and the business

Besides the original capital invested in the business by the owner, there may be other transactions between the owner and the business. For example, the owner may wish to withdraw part of the profit that has been made, or, from time to time, withdraw small amounts of cash or other items for personal use. All such transactions must be carefully recorded. A special account called the drawings account is usually used for the purpose of recording such transactions rather than debiting the capital account.

While withdrawals reduce the owner's equity, it is essential to note that they are not treated as a loss for the period, as they only reflect a reduction in the owner's claim against the business and have nothing to do with the performance for the period. Example 7.1 shows the recording process for withdrawals by the owner as well as the closing entries and reporting practice.

Example 7.1

Jos Skosana had these withdrawals from his business Josko TV Maintenance during October 20*x*7.

4 Jos withdrew R300 in cash for personal use.

9 Jos took spare parts home to repair his personal TV set, R120.

17 Paid R60 from the business's bank account to Pete's Service Station to fix to his wife's car.

You are required to:

1. Enter the transactions into the general journal.
2. Show how the owner's equity is reported in the statement of financial position.

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Suggested solution

GENERAL JOURNAL OF JOSKO TV MAINTENANCE GJ8

Day	Details	Fol.	Debit		Credit	
04/10	Drawings	B2	300	00		
	Bank	B4			300	00
	Owner took cash for personal use					
09/10	Drawings	B2	120	00		
	Spare parts	B3			120	00
	Owner took spares for personal use					
17/10	Drawings	B2	60	00		
	Bank	B4			60	00
	Owner took cash for personal use					

Explanation

- In each case, the owner's equity has been reduced, not as a result of a loss or an expense, but because, by withdrawing value from the business, the owner has reduced his claim against the business.
- In each case, the assets have been reduced; the particular account is dependent upon the nature of the withdrawal.
- As always, these general journal entries would be posted to the general ledger.

Reminder

Drawings is simply an account used to show what the owner withdrew from the company – it is not an expense.

At the end of the financial period, when all the nominal accounts have been closed and the net profit established, there will be three owner's accounts each with a balance. Assume these balances in the case of Josko TV Maintenance:

	Debit		Credit	
Capital: Jos Skosana			15 000	00
Drawings	480	00		
Profit and loss account			1 140	00

The above three ledger accounts, in addition to all the asset and liability accounts, will remain after all nominal accounts have been closed.

Both the drawings account and the profit and loss account are usually closed off to the capital account, to have information available in one account regarding the net claim by the owner against the business.

The accounts will appear as shown in Figure 7.10, once the general journal entries to record the transfers have been posted.

Figure 7.10

General Ledger of Josko TV Maintenance
Real Accounts Section

Dr. **CAPITAL** **B1** ***Cr.***

Oct.	31	Drawings	GJ8	480	00	Oct.	1	Balance	b/d	15 000	00
		Balance	c/d	15 660	00		31	Profit and loss account	GJ8	1 140	00
				16 140	00					16 140	00
						Nov.	1	Balance	b/d	15 660	00

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				DRAWINGS						B2		
Oct.	31	Balance	b/d	480	00	Oct.	31	Capital	GJ8	480	00

Final Accounts Section

				PROFIT AND LOSS						F3		
Oct.	31	Capital	GJ8	1 140	00	Oct.	31	Total (Net profit)	GJ8	1 140	00

Both the profit and loss account and the drawings account have now been 'closed off' and no longer have balances. However, the information relating to these two important items is clearly available to the owner in the capital account. As it is information of significance to the owner, the contents of the capital account is usually shown in the statement of financial position as shown in Figure 7.11.

Figure 7.11

Josko TV Maintenance
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

EQUITY AND LIABILITIES ***Capital and reserves***						
Capital: Jos Skosana					15 660	00
Balance on 1 October	15 000	00				
Add: Profit for the month	1 140	00	16 140	00		
Less: Drawings			480	00		

Note that, to ensure that the debit balances equal the credit balances, only the final balance of R15 660 is used. The other information is supplementary and is supplied only because of its importance to the owner.

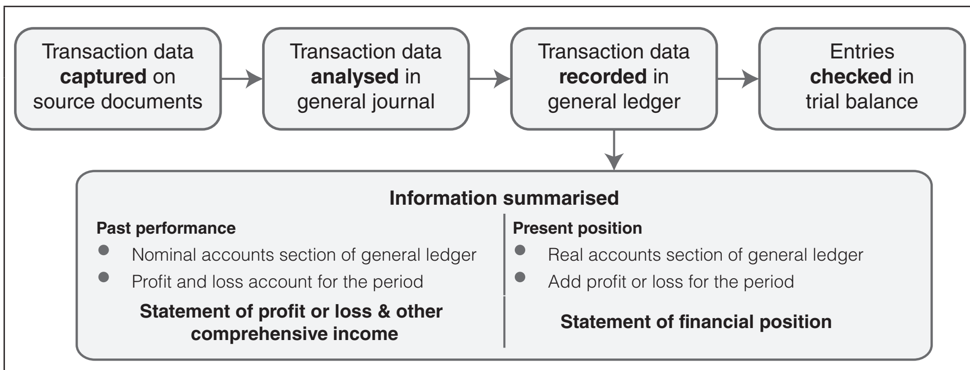
You should be able to complete Questions 7.9 and 7.10.

8 Summary

We have now completed the basic techniques that are used in any system of accounting. Although there is considerably more to learn to define the processes used by different types of business, we have the conceptual knowledge necessary to analyse any transaction, and ultimately to produce the real output of accounting namely information about the past performance and present position of a business.

Figure 7.12 shows the procedures that have been developed.

Figure 7.12



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QUESTIONS

Question 7.1

Explain the need for a general journal.

Question 7.2

Explain why withdrawals by the owner of a sole proprietor business reduce the owner's equity but not the profit for the period.

Question 7.3

Record the transactions of Joan Arendse in Question 6.8 into the general journal.

Question 7.4

Record the transactions of Dr James Smith in Question 6.9 into the general journal.

Question 7.5

On 1 July Sew-Easy had these balances, amongst others:

Capital: Mary Dadla	3 400	00
Supplies inventory	1 800	00
Bank	680	00

These transactions, amongst others, took place during the month:

4 Mary Dadla withdrew R200 in cash for personal use.
7 Mary won a competition and deposited the winnings of R500 into the business.
19 Mary paid a restaurant bill for her son's birthday with a business cheque, R55.
24 Mary took supplies from inventory for use at home R110.

You are required to:

1. Record the transactions in the general journal.
2. Post the transactions to these accounts:
   - **a** Supplies inventory.
   - **b** Drawings.
   - **c** Bank.
   - **d** Capital.
3. Assume that, after all transactions and adjustments, the net profit for the month was R640, and complete the capital account.
4. Show how the owner's equity will be reported in the statement of financial position.

Question 7.6

Norah Pillay had these assets and liabilities as at 1 December in her business, Pillay's Poster Painting:

Bank	800	00
Vehicles	2 700	00
Accounts receivable	700	00
Inventory of materials	1 500	00
Loan from Sam Naidoo	2 000	00
Accounts payable	300	00

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Transactions for December:

1 Received R800 in cash for posters painted.
3 Paid L. Munsamy, a payable, R120 by cheque.
4 Bought materials on credit, R90.
6 Norah withdrew R20 for personal use.
8 Paid for petrol by cheque, R60.
11 Paid general expense, R180.
14 L. Sans, a receivable, paid R300.
17 Paid for petrol by cheque, R50.
19 Purchased materials by cheque, R80.
21 Delivered work and invoice to Baxter Ltd, R2 400.
24 Paid 15% interest on the loan from S. Naidoo for December, January and February.
26 Paid wages and salaries, R2 100.
31 This additional information was established:
Vehicles must be depreciated by R200.
Materials on hand, R1 400.

You are required to:

1. Prepare the statement of financial position of Pillay's Poster Paintings as at 1 December.
2. Record the transactions and adjustments for the month in the general journal.
3. Post from the general journal to the general ledger.
4. Extract a trial balance as at 31 December.
5. Enter the closing transfers of all nominal accounts in the general journal and post to the general ledger.
6. Prepare a statement of profit or loss & other comprehensive income for the month ended 31 December.
7. Prepare a statement of financial position as at 31 December.
8. Comment on the financial performance and position of Pillay's Poster Paintings.

Question 7.7

These balances and totals appeared in the books of Young Beauty Salon on 1 August:

Capital	46 450	90
Drawings	8 465	10
Land and buildings	35 000	00
Equipment	11 679	40
Bank	898	60
Current income	19 506	50
Consumable stores	1 480	70
Salaries	8 433	60

The business's financial year ended on 31 August.

Transactions for August:

1 Issued a cheque to pay the August rent to Kindo Properties, R500.
Received a cheque for R10 000 from the owner as capital. Receipt 06 issued.
4 Bought new equipment for the office from Manzini Shopfitters and paid by cheque, R4 720.80.

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6 Current income according to the cash register roll, R4 010.35.
7 Purchased consumable stores from Tait Ltd for R1 210.24.
10 Drew a cash cheque to put petrol in the personal vehicle of the owner, R66.
12 Fees for services rendered, according to cash register roll, R5 860.44.
14 The owner increased his capital with a cheque for R7 000. Issued receipt 07.
15 Issued a cheque to pay for consumable stores bought from Tait Ltd, R640.89.
18 Cash banked (service fees), R3 215.13.
22 Bought a vehicle form Park Motors and paid by cheque, R18 700.
24 Services rendered, R4 000.
27 Paid the following by cheque:
- Water and electricity R312.90
- Telephone R279.58
- Salaries:
  - J. Long R3 685.85
  - P. Koen R3 715.05

31 Cash received for services rendered, R6 300.23.

You are required to:
1. Open the general ledger on 1 August with the opening balances given.
2. Post the above transactions to the general ledger.
3. Extract a trial balance.
4. Prepare the statement of profit or loss & other comprehensive income and statement of financial position.

Question 7.8

Greenlawns Garden Services (owned by R. Scott) has employed you to write up their books for September. The business specialises in landscaping and garden maintenance.

These balances appeared in the general ledger on 1 September.

Account	R	c
Capital	10 000	00
Vehicles	24 653	00
Bank	9 540	00
Telephone	341	00
Fuel	560	00
Stationery	109	00
Services rendered	19 815	00
Loan: Standard Bank 12%	25 000	00

Account	R	c
Drawings	1 000	00
Machinery	9 809	00
Cash float	50	00
Wages	2 478	00
Repairs	682	00
Consumables expense	3 890	00
Advertising	703	00
Interest on loan	1 000	00

Transactions for September:

1 Paid the telephone account for August, R56 (C81).
Cash takings from services rendered, R1 678 (receipts 100 to 112).
4 Bought a lawn mower from Lawns Unlimited and paid by cheque, R483.
Green Grow delivered the manure and fertilisers ordered. Gave them a cheque for R253.
9 Sold an old second-hand mower at carrying value and received a cheque for R105.
Received an account from the *Constantiaberg Bulletin* for advertisement placed, R20. Sent a cheque to settle the account.

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Greenlawns landscaped a half-acre garden. Received a cheque for R2 500 for the job.

15 The owner sent a bowl of flowers to his wife and paid for them with a business cheque of R30. (Remember this is drawings, that is, not a business expense.)

Sent a cheque to Bobby's Motors to pay for repairs to the business's bakkie, R132 and to his son's car, R75.

17 Paid the wages of the staff, R469.

28 Sent a cheque to the Standard Bank to repay R2 000 of the loan as well as the interest due this month.

Received an account from Bobby's Motors for fuel, R152. Issued a cheque.

Money received from clients for gardening services completed, R2 879.

Bought a printer for R900 and ink cartridges for R75 from Rank Xerox. Paid by cheque.

You are required to:

1 Journalise the transactions for the month, and post them to the general ledger.

2 Extract a trial balance as at 30 September. Provide your workings in the form of the ledger accounts.

3 Indicate what further adjustments may be necessary to achieve good matching and a more accurate indicator of financial performance for the month.

Question 7.9

After he had inherited R50 000, Mike Hill decided to start a steam cleaning business, called Pro-Clean.

Transactions for May:

1 Mike opened a bank account in the name of his business, Pro-Clean. He deposited R35 000 of his cash into the business's bank account as his capital contribution.

Mike signed a lease agreement with Syfrets Trust for offices in Wynberg. He gave them a Pro-Clean cheque for R2 100 for rent for the first three months.

The necessary steam cleaning equipment was purchased from Clean Care (Pty) Ltd for R9 000 and the debt was to be paid over the next nine months in equal instalments. At the same time cleaning materials were bought and paid for by cheque, R480.

3 Mike increased his capital by contributing a Toyota Hi-Ace to the business, worth R12 640. This would transport the equipment to the various jobs.

Received an invoice from Modquip for office furnishings installed by them, R14 640.

Issued a cheque for a trading licence, R850.

Received calling cards and letterheads printed by City Printers and gave them a cheque for R105.

8 Mike received R583 for services rendered. These customers were invoiced for work done during the month:

–	S. Jones	R160
–	P. Wilson	R85
–	Stuttafords	R1 380

14 Cleaning materials arrived today invoiced to the business at R751. The business has an account with Clean Care (Pty) Ltd, the suppliers.

Received an account for advertising done by *The Argus*, R145.

Paid the staff their wages by cash cheque, R245.

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20 A cash cheque for R200 was drawn to create a cash float. Received a statement from Office Stationers for receipt books, etc. delivered at the beginning of the month and gave them a cheque for R78 to settle the account.

25 Received a cheque from S. Jones to settle her account.
Paid the annual insurance premium on the van to Norisk Insurance Company, R192.
Issued a cheque to Clean Care (Pty) Ltd to pay the first instalment and settle the account for the cleaning materials purchased on 14 May.
Received the bank statement and noted these charges: services fees, R46.

31 The following was ascertained to apply the matching concept:
Both rent and insurance were partially prepaid.
Items on hand:
- Cleaning materials R231
- Stationery R63

Assets should be depreciated as follows:
- Steam cleaning equipment R200
- Vehicles R240
- Office equipment R640

You are required to:

1 Enter the transactions in the general journal. Ignore narrations.
2 Post the transactions to the general ledger accounts.
3 Close the nominal accounts to the profit and loss account passing general journal entries and posting to the ledger accounts. What is the expected annual return on equity for the month?
4 Prepare a draft statement of financial position as at 31 May.

Question 7.10

Joe Blogg is the owner of a bakery called Sweet & Sour that has been in operation since 1 May 20*x*2.

Sweet & Sour
TRIAL BALANCE AS AT 31 MARCH 20*x*2

Details	Fol.	Debit		Credit	
Real accounts					
Bank	B	6 000	00		
Capital	B			27 000	00
Drawings	B	2 000	00		
Vehicles	B	20 000	00		
Machinery	B	10 000	00		
Accounts receivable	B	1 400	00		
Accounts payable	B			740	00
Nominal accounts					
Consumable stores	N	250	00		
Advertising	N	140	00		
Rent paid	N	3 000	00		
Telephone	N	310	00		
Stationery	N	300	00		
Fees received	N			15 660	00
		43 400	00	43 400	00

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Note
The trial balance as at 31 March 20*x*2 reflects all the transactions recorded for the period 1 May 20*x*2 to 31 March 20*x*2.

Transactions for April 20*x*2, last month of the financial year:

1 Joe Blogg increased his capital contribution by depositing a further R2 000 into the business's bank account.
2 Received a cheque from P. Platt for R165 in settlement of his account.
3 Bought colourants and other baking material from Sasko and sent a cheque for R210.
4 S. Scott sent us a cheque for R235 in settlement of his account.
5 Joe Blogg purchased stationery from Paperbacks on account, R155. Recorded as an expense at acquisition.
6 Cash takings from services rendered, R578.
7 The owner took a redundant machine, valued at R350 in the books, for his personal use.
8 Baked for school functions on behalf of these receivables on credit:
- P. Platt R65
- S. Scott R47

9 Bought new machinery from Machines R Us on account, R2 300.
10 Paid the telephone account of R120 by cheque.
11 Received a statement of account from Adverts Incorporated for advertising done on our behalf, R355.
12 B. Brett sent us a cheque for R900 in full settlement.
13 Received the bank statement detailing charges, R15.
14 These adjustments must be made at the end of the period to facilitate more accurate reporting:
- Vehicles must be depreciated by 15% of their value in the books.
- Machinery is to be valued at R10 500, the difference being depreciation.
- Stationery on hand, R150.

You are required to:

1 Enter the transactions and adjustments into the general journal.
2 Post to the general ledger accounts.
3 Close the nominal accounts to the profit and loss account by passing general journal entries and then post to the ledger accounts.
4 Prepare a statement of profit or loss & other comprehensive income and statement of financial position.
5 Comment on the financial performance and position of Sweet & Sour.

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8 THE FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

Chapter objectives

By the end of this chapter, you should be able to:

- Introduce the accounting framework that sets out the concepts that underlie the preparation and presentation of financial statements for external users.
- Identify the aim of financial statements.
- Explore the underlying assumptions on which financial statements are prepared.
- List the qualitative characteristics of financial statements.
- Review the constraints related to reporting relevant and reliable information.
- Identify the elements of financial statements.
- Recognise the elements of financial statements.
- Distinguish between the methods of measuring the elements of financial statements.
- Introduce the concepts of capital and capital maintenance.

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3 THE UNDERLYING ASSUMPTIONS ON WHICH FINANCIAL STATEMENTS ARE PREPARED 8 – 3
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1 Introduction

Up to now we have dealt with the environment of accounting and introduced some accounting concepts (Chapter 3). In Chapters 4 to 7, you learnt about the recording process and how to record transactions in the general ledger and general journal. This chapter will introduce you to the accounting framework that sets out the concepts that underlie the preparation and presentation of financial statements for all users.

From the outset it is important to understand that the reporting of financial information in the financial statements must adhere to certain standards, which are set by the International Accounting Standards Board (IASB). As discussed in Chapter 3, a full consultative process is followed before a new statement is issued, which means that the users of accounting standards do have a say in what is included in new statements that they have to use.

Although a sole proprietor does not have to adhere to all the prescriptions of the accounting standards, you will see that the concepts are an integral part of generally accepted accounting practice, which everyone who prepares financial statements has to abide by.

In Chapter 9, the recording of inventory will be explained. In those chapters you will be able to see how certain of the concepts introduced in this chapter are applied. Following that, Chapters 11 to 13 will explain the processing of large volumes of data and once again some of the concepts of this chapter will be applied.

Chapters 14 to 16 will end in preparing a set of financial statements, which must be in line with the requirements of the accounting framework discussed in this chapter. This will be followed by Chapters 17 to 21, which specifically deal with company accounting where the accounting framework will feature very prominently.

The framework for the preparation and presentation of financial statements is issued by IASB. For the remainder of this text this document will be referred to as the framework. The framework sets out the concepts that underlie the preparation and presentation of financial statements for external users.

Reminder

The framework sets out the concepts that underlie the preparation and presentation of financial statements for all users.

The framework identifies typical external users, and also what type of information each external user will want from the set of financial statements. Users of financial statements include investors, employees, lenders, suppliers and other payables, government and its agencies and the public, all of whom were discussed in Chapter 1.

The main aim of this text is to assist students in gaining the necessary knowledge to draft financial statements that meet the required quality standards. The framework assists us in this regard by clearly stating what the objective of financial statements should be.

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2 The aim of financial statements

The aim of financial statements is to provide information about the financial position, performance and cash flow information of an enterprise that is useful to a wide range of users in making economic decisions.

According to the framework, the financial position of an enterprise is affected by the 'economic resources it controls, its financial structure, its liquidity and solvency and its capacity to adapt to changes in the environment in which it operates'. The financial position of a company is showed by its statement of financial position, one of the components of a full set of financial statements.

Financial performance is showed by the statement of profit or loss & other comprehensive income of an entity and it provides information regarding profitability, which is the 'capability of the enterprise to generate cash flows from its existing resource base'.

The cash flow information is shown in the statement of cash flows, which reports on the cash used or generated by investing, financing and operating activities for an accounting period.

You should be able to complete Question 8.1.

3 The underlying assumptions on which financial statements are prepared

The framework states that all financial statements should be based on two underlying assumptions namely the accrual basis and going concern.

The accrual basis

Accrual accounting depicts the effects of transactions, and other events and circumstances, on a reporting entity's economic resources and claims for the period in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Financial statements are prepared on the accrual basis, which means that it matches income earned during the accounting period with expenses incurred during that period. This differs from a cash basis, which would match cash received during the accounting period with cash paid out.

Virtually all businesses are engaged in activities that give rise to income. Income is the proceeds that result from the sale of goods or services. If a business wishes to report on its performance for a given period, the income that has been earned during that period is a crucial accounting number. A problem arises when attempting to determine the income that must be recognised for the period under review. Some of the alternative possibilities are that income could be recognised at the time that the order is placed, or at the time when delivery takes place, or at the time when the cash is received.

In accounting the principle of the 'critical event' is considered to be the criterion for deciding when income should be recognised. The critical event, for example, in a retail organisation would be considered to be the sale of the goods to a receivable. The fact that cash has not yet been received from the receivable during the period does not detract from the fact that the sale has taken place, that ownership of the goods has passed, and that the income can be considered as belonging to the current period.

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The going concern concept

The financial statements are normally prepared on the assumption that the business intends continuing its operations, for the foreseeable future (at least another 12 months after the reporting date). Then, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

If this is not the case, this fact should be clearly stated, and the financial statements should not reflect historical cost values of assets and liabilities, but liquidation values. Historical cost implies that the carrying value of assets is based on their purchase price.

In early times, business was conducted in the form of ventures. Traders purchased goods, transported them and sold them. Profit or loss was a result of the success or failure of that particular venture. With business operations being conducted on a continuous basis it is clear that financial reporting takes place at stages during the life of the business.

Financial statements reflect only the performance over a part of the life of the business and the position at a particular moment in time. The value of an asset to a business that intends continuing operations indefinitely is likely to differ significantly from its value had the intention been to close the business down.

You should be able to complete Question 8.2.

4 The qualitative characteristics of financial statements

The framework argues that there are qualitative characteristics that make the information provided in financial statements useful to the existing and potential investors, lenders and other users for making decisions about the reporting entity on the basis of information in its financial reports.

- **Relevance** – To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events, or confirming or correcting their past evaluations.
- **Faithful representation** – To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent.
- **Applying the fundamental qualitative characteristics** – The most efficient and effective process for applying the fundamental qualitative characteristics would usually be:
  - Identify economic information that has the potential of being useful to the users of the financial statements.
  - Identify the type of information that would be most relevant if it is available and can be faithfully represented.
  - Determine whether that information is available and can be faithfully represented.
  - If so, the process of satisfying the fundamental qualitative characteristics ends. If not, the above process should be followed.
- **Comparability** – Users must be able to compare the financial statements of an enterprise through time to identify trends in its financial position and performance. For financial statements to be comparable, the users must be informed of the accounting policies that were used in preparing the financial statements.

  Comparability should not be confused with uniformity, which means that a business may not continue treating transactions in the same manner if it is not relevant and reliable,

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also accounting policies should be changed if more relevant and reliable alternatives exist.

- **Verifiability** – Verifiability helps assure users that information faithfully represents the economic climate it claims to represent.

  Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation
- **Timeliness** – If there is undue delay in the reporting of information it may lose its relevance. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim.
- **Understandability** – An essential quality of the information provided in financial statements is that it is readily understandable by users. However, complex matters that have relevance to the economic decision-making needs of the users should not be excluded on the grounds that it may be too difficult for certain users to understand.

Applying the enhancing qualitative characteristics

Enhancing qualitative characteristics should be maximised as far as is practically possible. However, it should be noted that the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.

Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic.

For example, a temporary reduction in comparability as a result of applying a new financial reporting standard in a preceding year may be worthwhile to improve relevance or faithful representation in the long term

5 Other factors to consider

Substance over form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Completeness

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

You should be able to complete Question 8.3

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Balance between benefit and cost

The benefits derived from information should exceed the cost of providing it. The process of evaluating benefits and costs is very judgemental. The costs do not necessarily fall onto those users who enjoy the benefits and, on the other hand, the benefits may also be enjoyed by other than those for whom the information is prepared.

Balance between qualitative characteristics

It is often necessary to find a trade-off between the different qualitative characteristics. The aim would be to find a balance to meet the objective of financial statements.

6 The elements of financial statements

The framework states: 'Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements.'

In Chapter 3, we identified and defined the different elements of financial statements as assets, liabilities, equity, income and expenses.

Earlier, we stated that the objective of financial statements is to report on the financial position, the financial performance and change in cash position of an enterprise. The elements of the financial statements will impact on different components of the financial statements.

Assets, liabilities and equity will be summarised on the last day of the financial year to reflect the financial position of an entity and this is done on the statement of financial position. Income and expenses would be closed off to the statement that reflects the financial performance of an entity for a financial year and that is showed by the statement of profit or loss & other comprehensive income.

The process of closing off income and expenses general ledger accounts to the profit or loss general ledger account and presenting the accounts on the face of the profit or loss and statements of other comprehensive income is dealt with in Chapters 17 and 18.

You should be able to complete Question 8.4.

7 Recognition of the elements of financial statements

With recognition we mean the process of incorporating assets, liabilities and equity into the statement of financial position, and income and expenses into the statement of profit or loss & other comprehensive income.
The framework is clear that an item can only be recognised once it meets the definition of an element. If an item meets the definition of a particular element it needs to also comply with these two criteria before it can be recognised:

'If it is probable that any future economic benefit associated with the item will flow to or from the enterprise.'

This criterion has to do with the fact that the future economic benefit that is associated with a specific item is sometimes very uncertain. The uncertainty is assessed based on the evidence that is available when the financial statements are prepared.

'If the item has a cost or value that can be measured with reliability.'

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This criterion deals with the fact that a cost or a value needs to be allocated to an item, and this value needs to be measured with reliability. In many cases it would be necessary to estimate this value but if a reasonable estimation cannot be done, then the item should not be recognised.

In Chapters 4 and 5, the double-entry principle of accounting was explained. The framework links onto this system by explaining that the elements of financial statements are interrelated. This means that 'an item that meets the definition and recognition criteria for a particular element, for example, an asset, it automatically requires the recognition of another element, for example, income or a liability'.

Recognition of assets

'An asset is recognised in the statement of financial position when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost of value that can be measured reliably.'

An asset is defined as:

- A resource, controlled by the entity.
- As a result of past events.
- Which is expected to result in an inflow of economic benefits to the entity.

Recognition of liabilities

'A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.'

A liability is defined as:

- A present obligation of the entity.
- As a result of a past event.
- The settlement of which is expected to result in an outflow of economic benefits from the entity.

Recognition of income

'Income is recognised in the statement of profit or loss & other comprehensive income when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.'

Recognition of expenses

'Expenses are recognised in the statement of profit or loss & other comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.'

You should be able to complete Question 8.5.

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8 Measurement of the elements of financial statements

This refers to the process of determining a monetary value at which the different elements must be carried in the statement of financial position and statement of profit or loss & other comprehensive income.

An entity can employ, to different degrees and in varying combinations, any of these measurement bases:

Historical cost

This basis uses the amount of cash or cash equivalents that have been paid as a fair value for an acquisition at the time of the acquisition.

Current replacement cost

This basis uses the amount of cash or cash equivalents that would have to be paid if the same or equivalent acquisition was acquired currently.

Realisable (settlement) value

An item is carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal or at the values that could be expected to be paid to satisfy the liabilities in the normal course of business.

Present value

Items are carried at the present discounted value of the future net cash inflows or outflows that the item is expected to generate in the normal course of business, or expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost.

You should be able to complete Questions 8.6 and 8.10.

9 Concepts of capital

Most entities adopt a financial concept of capital when preparing their financial statements. Under this concept capital is synonymous with the net assets or equity of an entity. Under a physical concept of capital, capital is regarded as the productive capacity of the enterprise.

The selection of the appropriate concept of capital should be based on the needs of the users of the financial statements of an entity.

10 Summary

The objectives of financial statements are to report on the financial position, performance and changes in financial position of an enterprise. This is done by taking the different qualitative characteristics into account.

Financial statements consist of different elements. These are assets, liabilities, equity, income and expenses. There are certain criteria that have to be met before an item can be recognised in the financial statements of an enterprise. These criteria are different for the different elements – make sure that you know what the criterion for each element is.

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There are different bases on which items in the financial statements could be measured – make sure that you know what these measures are and how they are different. It is also possible to differentiate capital on the bases of two concepts, namely the financial and the physical concept of capital.

QUESTIONS

Question 8.1

Explain why these external users will make use of financial statements:

- Investors.
- Lenders.
- Suppliers.
- Government.
- Management.

Question 8.2

Explain in your own words what is meant by the objective of financial statements.

Further discuss the two underlying assumptions on which financial statements should be based, according to the Conceptual Framework.

Question 8.3

List and explain the qualitative characteristics of financial statements.

Question 8.4

Define each of these elements as described by the accounting framework:

- Asset.
- Liability.
- Expense.
- Equity.

Question 8.5

Discuss whether trade and other receivables meet the definition and recognition criteria of the elements of financial statements.

Question 8.6

Do you consider it possible for a financial reporting system to report real values?

Question 8.7

Briefly discuss what you consider the difference to be between recording and reporting in the practice of accounting.

Question 8.8

A recent graduate, Bob, struggled to find work as an accountant. While at home one day, he noticed large trucks with full-grown trees driving past. They were going to a new housing development in his street, where landscapers were developing the gardens and planting mature trees as instant landscape features.

Because Bob had grown up in a farming area and worked on farms in his vacations, he had some knowledge about growing trees and decided that he would do some research and find a gap in the market for something similar.

He and his friend Neo, who had some inherited money, started a small business selling full-grown palm trees. The palm trees were in high demand from municipalities all over South Africa.

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While visiting his university lecturer, Bob asked her advice as to what would be the best way to register the business so that it would benefit both himself and Neo. (Bob had no start-up capital of his own and the two friends would have to borrow more money to get the business going.) As he left the university area, he noticed a vacant piece of land that had previously been used as a fruit farm. It looked fertile and suitable for growing young palm trees and also storing sourced (purchased) older palm trees.

Once Neo had agreed and become involved in this business idea, the two friends decided to put in an offer to purchase the property on 1 July after the registration of their business. A purchase price of R900 000 was paid on 31 July 20*x*0.

The property was then registered in the deeds office on 15 August 20*x*0 in the name of Breezy Palms Enterprises. The property was now theirs to do with as they pleased.

The purchase price was paid from Neo's capital of R30 000 and a loan (from One Love Bank). This agreement was entered into on 31 July 20*x*0 at an interest rate of 10% payable monthly with the capital portion of the loan being payable in monthly instalments over a period of 10 years.

On 1 September, they brought in another company, Tree Planters CC, who would supply and plant the trees that would generate a revenue over many years. Tree Planters charged them R10 000 for every hectare of trees planted.

Bob and Neo then agreed to an additional maintenance contract with Tree Planters CC, stipulating that they would maintain and prune the young trees to ensure that they grew upright over the next 10 years, for an annual fee of R15 000.

During the current year, Breezy Palms Enterprises incurred R150 000 on the purchase and planting of the trees as well as R15 000 on the pruning and maintenance of the trees. Bob and Neo took care of the sourcing of mature trees themselves, which cost them R3 000 a month in advertising, labour and transport.

Bob and Neo employed an expert to do a profitability study. The report from the expert revealed that they could expect a return on investment of 23% over the period of 10 years.

The accountant showed every cost incurred as an expense in the current year. The financial director feels that a part of the transactions above may be stated as an asset.

You are required to:

Provide a well-reasoned argument with reference to the accounting framework as to whether the treatment of the above transactions was appropriate. Your answer should distinguish between these transactions:

1 The purchase of land.

2 Loan from One Love Bank.

3 Interest on loan.

4 Planting, pruning and maintenance of young trees.

Question 8.9

Ashley Geldenhuys, currently a student at UWC, had a business idea after making an appointment for her learner's licence at one of the traffic departments. She saw a gap in the market for competitively priced photographs for licenses at various traffic departments in her province.

On her way home, she saw a run-down caravan with a for sale sign. After further enquiry and advice from her parents, she decided to purchase the caravan for R22 000. On 5 November 20*x*0, she transferred ownership of the caravan to her name, at the nearby traffic department.

Her parents then suggested that she should approach her Uncle Colin to repair and refurbish the caravan, to fit it for her needs.

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While waiting for her uncle to complete the work on the caravan, Ashley decided to do some research amongst the students in her class. She spoke to some classmates from Elsies River, who told her that the photography service at the traffic department in Halt Road was quite expensive and would be a good place to start.

After receiving the caravan in good working order, Ashley decided to start her license-photo business in the Elsies River area.

She purchased the necessary camera and the film required. The camera cost R8 000 and the film, R5 000.

By 28 February 20*x*1, she had no more inventory of the disposable film she had purchased.

At the end of the first financial year (28 February 20*x*1), her accountant showed all the debits as expenses. An amount of R35 000 was showed as start-up expenses on the statement of profit or loss & other comprehensive income for the year ended 28 February 20*x*1.

Ashley is uncertain as to the correctness of this process and has approached you to find out whether the cash payments described above have been correctly recorded. No discussion is required on the film used in the current year.

You are required to:
Advise Ashley as to whether the above debits were appropriately treated using the accounting framework. If they were incorrect, please provide the correct treatment.

Question 8.10

At the end of 19*x*9, two employees at Zest Manufacturing, Hannie Healthkick and Nomxolisi Loud-Racket decided to quit their jobs. They had 25 years of experience in manufacturing equipment for Xtra - Active Gyms across the country.

They collected a total of R500 000 between the two of them, and planned to open their own gym, based on their expertise. After brainstorming, they decided to register the entity under the name Health and Kickstart Gym (HKG).

On 1 March 20*x*0, after successfully completing the registration, the friends opened their gym. In an attempt to gain entry into the fitness market, HKG decided to run a special offer to entice fitness freaks to move from other gyms to HKG.

The special ran for the first month only and specified these conditions:

All members who joined in the first month and signed a 3-year contract would pay a low fee of R1 800 for the entire 3-year period at no additional cost.

As per the agreement, the payment would have to be made in the first month, that is, March 20*x*0.

At the end of March, HKG noted that 1 250 people had taken advantage of the offer and paid the R1 800 before month end.

At the end of the first financial year (28 February 20*x*1), the accountant showed the entire amount received as revenue for the current year. An amount of R2 250 000 was showed on the statement of profit or loss & other comprehensive income for the year ended 28 February 20*x*1.

Health and Kickstart are uncertain as to the treatment of this and have approached you to find out whether the cash received from all 1 250 gym members has been correctly recorded.

You are required to:
Advise HKG as to whether the cash received was appropriately treated as income using the accounting framework. If it was incorrect, please provide the correct treatment.

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MODULE C

Recording inventory and VAT

This module is divided into two chapters:

Chapter 9 Inventory systems
Chapter 10 Value-added tax (VAT)

Together these two chapters achieve the following outcomes:

Outcomes

- Identifying the fundamental differences between accounting for a service business and a merchandising business.
- Recording the movement of inventory through the purchase, keeping on hand, and sale stages using the two alternative methods of recording inventory movements, namely perpetual and periodic inventory recording systems.
- Separating the accounts which are part of the statement of profit or loss & other comprehensive income from those which appear in the statement of financial position.
- Recognising, identifying and accounting for the alternative methods of assigning costs to the flow of inventory and the valuation of inventory at the end of an accounting period.
- Recording deviations from the normal flow of goods by accounting for events such as inventory in transit and inventory damaged, lost or destroyed.
- Recognising the significance of effective inventory management and the impact of unsold inventory or inventory on hand on the financing of a business.
- Defining value-added tax (VAT).
- Distinguishing between the different types of VAT.
- Calculating VAT amounts.
- Applying VAT principles for the recording of goods bought and sold, as well as services rendered.
- Calculating VAT due from or payable to the South African Revenue Service (SARS).

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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9 INVENTORY SYSTEMS

Chapter objectives

By the end of this chapter, you should be able to:

- Distinguish between a service business and a trading business.
- Introduce the accounting procedures for a trading entity, that is, a business that buys and sells inventory.
- Apply the principles of accounting for inventory bought and sold.
- Use the trading account to calculate the gross profit.
- Identify various methods of establishing the selling price.
- Apply the principles for the recording of inventory on hand at the end of an accounting period.
- Develop the year-end procedures in the general ledger, prior to preparation of the financial statements.
- Introduce the accounting procedures for the recording of purchases and sales under both the periodic and perpetual inventory systems.
- Record transactions involving discounts.
- Examine the different methods of allocating costs to inventory:
  - first-in-first-out (FIFO)
  - weighted average
- Analyse and record the inventory count prior to reporting.
- Complete the year-end procedures for inventory under the periodic inventory system.
- Record the accounting entries for inventory in transit.
- Process the accounting entries for inventory losses.

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2 THE TRADING CYCLE 9 – 3

Gross profit 9 – 3

3 ESTABLISHING THE COST OF INVENTORY 9 – 6

4 ESTABLISHING THE SELLING PRICE 9 – 7

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A percentage mark-up on cost policy 9 – 9

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1 Introduction

In Chapter 1, various types of business were introduced. Businesses involved in buying and selling products either as wholesalers or retailers were collectively referred to as trading businesses.

- All shops, for example, are considered retail traders (retailers).
- While wholesale traders (wholesalers) are businesses that buy from the manufacturers in bulk and sell to the retail traders.

The primary difference for accounting purposes between a trading business and a service business is that the trading business deals with physical inventory and, as a result, usually keeps a supply of the inventory that it trades available on the shelves or in a store room, referred to as 'inventory on hand'.

This section builds on the previous chapters and requires a thorough understanding of the accounting model and the various procedures previously developed. It assumes that you are able to record the transactions relating to:

- Investing of capital by the owner.
- Acquisition of assets.
- Incurring liabilities.
- Incurring expenses.
- Receiving income.

Reminder

The supply of inventory that a trader keeps on hand is known as inventory on hand.

This chapter deals specifically with the transactions relating to the purchase and sale of inventory. Procedures for recording these transactions from source documents to the general ledger via the general journal will be introduced. It is important that you take note of the new accounts used in this procedure.

The final step is always to follow the results of a transaction through to the financial statements to produce useful information to those who use them.

There are two systems used by traders for keeping a record of their inventory. They are:

1 **Perpetual inventory system:** In this system, inventory records are updated each time a sale is made. As a result it is possible, at any moment in time, to have an accurate record of the inventory on hand.
   – This may seem to need a large amount of record keeping. However, computer technology has made this an increasingly popular system. Computers can be programmed to update the inventory records at the moment of sale and, thus, keep an ongoing or perpetual record of the inventory that is still available for sale.

Did you know?

When you buy groceries from a supermarket that uses a barcode scanner, the records of inventory on hand are immediately updated as the scanner reads the barcode.

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   – To understand the information generated by the computer, however, it is necessary to be able to perform the procedure.

2 **Periodic inventory system:** This system requires that an inventory count be undertaken only at the end of the financial period under review. As a result, no ongoing record of the inventory is maintained.
   – Clearly this system requires considerably less recording, as no record of the inventory sold is kept at the point of sale.
   – Inventory on hand is usually determined at the year end by means of an inventory count.

2 The trading cycle

The trading cycle can be broken down into three clearly identifiable activities, that is:

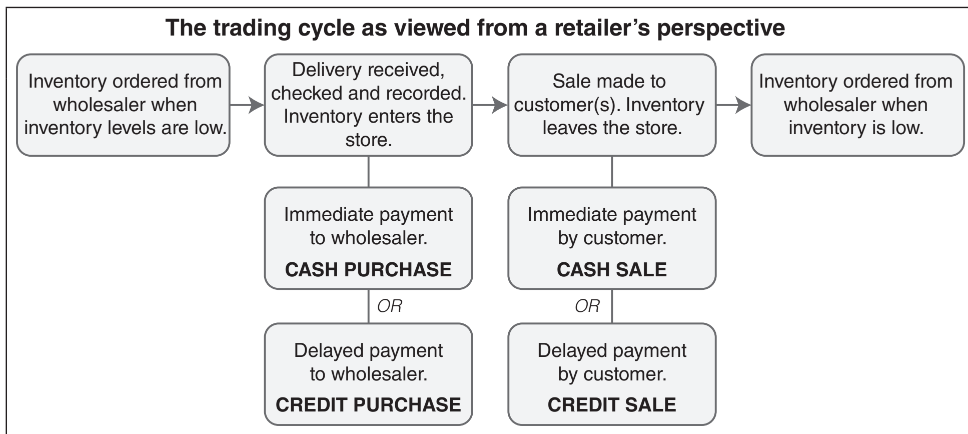
1 The preparation of source documents as evidence of the transaction.
2 The flow of inventory as ownership changes hands.
3 The exchange of money in settlement of the transaction.

If we consider the position of a retailer, for example, the cycle will start with the ordering of inventory from the wholesaler who will make the delivery. Upon delivery, the inventory will be checked and approved. They may be paid for in cash or be subject to credit terms, such as payment within 90 days.

The inventory will be displayed for purchase and will, upon sale for cash or on credit, be taken delivery of by the customer. If the sale was on credit, the receivable should be granted well defined payment terms.

All the transactions should be supported by source documents, which will provide proof that the exchange of inventory and money has taken place. This cycle is outlined in Figure 9.1.

Figure 9.1



Gross profit

Reporting the results of the trading cycle at the end of a period is done in two stages.

1 The gross profit is calculated by finding the difference between the revenue from sales and the cost of sales.
   – This is done by using the **trading account**.
   – The trading account is a final account that precedes the profit and loss account and is used specifically to calculate gross profit.

2 The second stage is identical to that used by a service business when the profit and loss account is used to calculate net profit that is transferred to the capital account of the owner.

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The gross profit is first reported to the managers in a trading statement as shown in Example 9.1 on the next page. Example 9.1 is also used to demonstrate the principle of assigning a cost to inventory in the calculation of gross profit.

Example 9.1

Consider these three cases for Comprint, a retailer who sells computer printers:

1. On 1 April, Comprint bought 30 printers and paid R45 000 in total.
   All the printers were sold for cash for a total of R60 000 during April.
2. On 1 May, Comprint bought 30 printers and paid R45 000.
   Twenty printers were sold during May for a total of R40 000 cash.
3. On 1 June, Comprint bought 15 printers and paid the same price as those bought in May.
   Twelve printers were sold for cash during June for a total of R24 000.

You are required to:

Determine the gross profit for Comprint using both the perpetual and the periodic inventory system.

Note
You may assume that a physical inventory count has taken place when preparing the solution using the periodic inventory system.

Case 1 – April

Perpetual

TRADING STATEMENT – APRIL

Sales	(30 printers)	60 000	00
Less: Cost of sales	(30 printers)	(45 000	00)
GROSS PROFIT		15 000	00

Periodic

TRADING STATEMENT – APRIL

Sales	(30 printers)	60 000	00
Less: Cost of sales	(30 printers)	(45 000	00)
Opening inventory		0	00
Add: Purchases	(30 printers)	45 000	00
Goods available for sale		45 000	00
Less: Closing inventory		(0	00)
GROSS PROFIT		15 000	00

Do you see that the difference between the selling price and the cost of sales is the gross profit?

The purchase of 30 printers shows the number of printers available for sale in the month. All the printers were sold, thus, the cost of sales equals the purchases amount.

Other operating expenses, such as salaries and telephone bill, incurred by Comprint still need to be deducted from gross profit. These expenses will need to be adequately covered by the gross profit, if a net profit is to be earned.

Case 2 – May

Perpetual

TRADING STATEMENT – MAY

Sales	(20 printers)	40 000	00
Less: Cost of sales	(20 printers)	[A] (30 000	00)
GROSS PROFIT		10 000	00

[A] (45 000 ÷ 30) × 20

[B] (45 000 ÷ 30) × 10

Periodic

TRADING STATEMENT – MAY

Sales	(20 printers)	40 000	00
Less: Cost of sales	(20 printers)	(30 000	00)
Opening inventory		0	00
Add: Purchases	(30 printers)	45 000	00
Goods available for sale		45 000	00
Less: Closing inventory (10 printers)		[B] (15 000	00)
GROSS PROFIT		10 000	00

As shown in Case 1, the purchase of 30 printers shows the number of printers available for sale.

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However, in Case 1, all the printers available for sale were sold, while here in Case 2, 10 printers have not been sold. Thus, the closing inventory at the end of the month is R15 000 (10 printers @ R1 500 each).

At this stage, therefore, only R10 000 may be recognised as profit for the period. This agrees with the matching concept that requires expenses incurred to be matched against income for the period.

- The sales for the period is R40 000 (20 printers sold @ R2 000 each).
- The expense for the period is the cost of inventory sold of R30 000 (20 printers @ R1 500 each).
- The inventory on hand at the end of May is a current asset of R15 000 (10 printers @ R1 500 each).

Case 3 – June

Perpetual

TRADING STATEMENT – MAY

Sales	(12 printers)	24 000	00
Less: Cost of sales	(12 printers)	[A] (18 000	00)
GROSS PROFIT		6 000	00

[A] (45 000 ÷ 30) × 10 (old) + (22 500 ÷ 15) × 2 (new)

[B] (45 000 ÷ 30) × 13 (new)

Periodic

TRADING STATEMENT – MAY

Sales	(12 printers)	24 000	00
Less: Cost of sales	(12 printers)	(18 000	00)
Opening inventory	(10 printers)	15 000	00
Add: Purchases	(15 printers)	22 500	00
Goods available for sale		37 500	00
Less: Closing inventory	(13 printers)	[B] (19 500	00)
GROSS PROFIT		6 000	00

Case 3 shows the most commonly encountered situation in a trading business, where:

- The period starts with opening inventory on hand.
- Purchases of inventory is recorded during the period.
- Inventory remains on hand at the end of the period.

Reminder

Gross profit is the difference between the revenue (income) from the inventory sold and the cost of the inventory sold.

Explanation

- 'Goods available for sale' is the sum of the opening inventory plus the cost of all inventory bought during the period.
- 'Cost of sales' is calculated by deducting closing inventory from the inventory available for sale.
- 'Gross profit' is the difference between the selling price of the inventory sold and the cost price of the inventory sold. It is the rand amount by which the inventory has been marked up from the cost price. It may be expressed as a percentage by applying this formula:

$$\text{Percentage mark-up on cost} = \frac{\text{Gross profit}}{\text{Cost of sales}} \times 100$$
$$= \frac{6\ 000}{18\ 000} \times 100$$
$$= 33.33\%$$

- Comprint made a gross profit of R15 000 in April, R10 000 in May and R6 000 in June. At the end of June, the business has a current asset, inventory, of R19 500 (13 printers at a cost of R1 500 each).
- In agreement with the historic cost concept, the closing inventory on hand is shown at its cost price. For example, it could be argued that, because the sets are selling at R2 000 each, the rand amount assigned to closing inventory should be higher than R1 500 per set. However, this would not be consistent with the historic concept. (This issue will be dealt with in more detail later in the chapter.)

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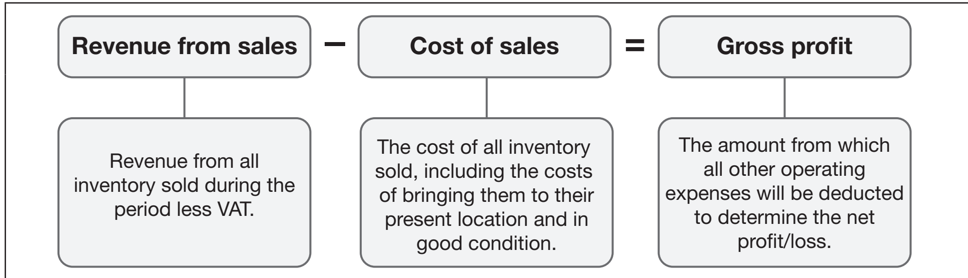
The relationship between the trading cycle and profit is shown in Figure 9.2, and the detail that is suggested by the definitions under each of the three terms is then elaborated upon.

Figure 9.2



You should be able to complete Questions 9.1 to 9.3.

3 Establishing the cost of inventory

When buying inventory for resale, an asset is acquired. The asset 'inventory ' is recorded at its cost, which is defined as the purchase price, including import duties and other purchase taxes, transport and handling costs, less discounts, rebates and subsidies on purchases.

Stated differently, this includes all costs incurred in bringing an item to its present condition and location available for sale. The considerations for determining this are shown in Example 9.2 and 9.4.

Example 9.2

This example is to show how all the costs incurred in bringing inventory to its saleable point is included in the cost.

Mazima Stores of Benoni bought sunglasses from Lekalook Ltd.

- The invoice price of each pair is R20 (*VAT excl.*) and 2 000 pairs were bought.
- The sunglasses are shipped to Cape Town at a cost of R1 300 for the entire shipment. Mazima paid railage cost of R220 from Cape Town to Benoni.
- Mazima paid R2.20 per pair for decorative cases that they decided would enhance the saleability.

You are required to:

Calculate the cost of the sunglasses.

The necessary calculation is:

Invoice price of sunglasses	(2 000 × R20)	40 000	00
Add:			
Shipping costs		1 300	00
Railage/delivery		220	00
Packaging	(2 000 × R2.20)	4 400	00
		45 920	00

The total cost of the sunglasses includes:

The primary cost (the purchase price) of the inventory plus all the costs incurred in bringing them to the necessary location from which the sale will take place, plus the amount of R4 000 spent to place them in the required condition (packaging) for sale.

Therefore, the purchase cost of each pair of sunglasses amounts to R22.96 (45 920 ÷ 2 000).

Another factor affecting the determination of the cost of inventory bought is discount. Discount received on the purchase of inventory is deducted from the final calculated purchase

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price. However, a number of different types of discounts may arise in the course of normal trading operations and it is necessary to distinguish between those that may be deducted from the purchase price and those that may not.

Three popular discounts that must be deducted from the quoted price to establish the cost for recording purposes are trade, bulk and cash discounts. They are usually agreed with the supplier of the inventory when the order is placed.

- **Trade discount** has its origins with wholesalers who provide the retailers with inventory already marked with the selling price that was recorded on the invoice. The trade discount, which was the retailer's profit margin, was then deducted to arrive at the cost to the retailer. This arrangement is not strictly followed in business practice, but trade discounts often appear on the invoice when an outlet supplies inventory to other businesses.
- **Bulk discounts** refer to discounts for purchasing large quantities and are offered because economies of scale on expenses such as handling, delivery and administration may be partially passed on to the purchaser in the form of a discount.
- **Cash discounts** arise as any supplier would prefer to receive cash immediately and may be prepared to offer an incentive to achieve this.

All three discounts may be shown on the purchase invoice. As they are granted before ownership passes and are known with certainty, they do not form part of the cost of inventory bought. They are, thus, not recorded other than possibly on the invoice, and only the net figure after deductions of such discount contributes to the cost of inventory bought.

Early settlement discounts are offered on the invoice from a supplier, who may show a discount that the purchaser may claim if payment is made within a certain period of time.

Deciding whether or not to take such a discount is a financial management issue, and depends on the size of the discount and the uses to which the business's cash could be employed over the discount period.

The ability/transactional history of the buyer needs to be assessed to determine if it is probable that the buyer will take advantage of the early settlement discount. If it is considered probable, the early settlement discount needs to be excluded from calculating the inventory cost. If not, then the early settlement discount needs to remain as part of the cost of the inventory purchased.

4 Establishing the selling price

Once inventory has been bought and the cost of inventory bought has been established, the trader must decide on a pricing policy. The pricing policy requires a mark-up that is the difference between the selling price and the cost price of the inventory. This in turn may be expressed as a percentage of either the cost price or of the selling price.

Three different policies, all of which are commonly practiced, are discussed and shown.

A market-based pricing policy

Under this policy, an effort is made to calculate the price at which buyers are likely to purchase the item. So, for example, if the item is plentiful or if large quantities have been bought, the mark-up is likely to be smaller than if the item is in short supply.

Once priced and sold at the market price, the mark-up percentage may be calculated as shown in Example 9.3 on the next page.

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Trade discounts

Example 9.3

Novelty Toys of Pinetown bought 120 hula-hoops from Zansi Ltd of Worcester. This information appeared on the tax invoice:

120 hula-hoops	@ R37.50 each	4 500	00
Less: 20% trade discount [4 500 × 20%]		(900	00)
		3 600	00

You are required to:

Calculate the gross profit mark-up percentage and the profit margin if Novelty Toys sold hula-hoops at R52.50 each.

Unit selling price (*VAT excl.*)	52	50
Less: Unit cost of hula-hoops (R3 600 ÷ 120)	(30	00)
GROSS PROFIT PER UNIT	22	50

Percentage mark-up on cost $= \frac{\text{Gross profit}}{\text{Cost of sales}} \times 100$

$= \frac{22.50}{30} \times 100$

So, the mark-up % = 75%

It is also common practice to calculate the gross profit as a percentage of the selling price, referred to as the profit margin.

Percentage mark-up on cost $= \frac{\text{Gross profit}}{\text{Sales}} \times 100$

$= \frac{22.50}{52.50} \times 100$

So, the profit margin = 42.86%

Settlement discounts

Example 9.4

Sales Extreme bought inventory on credit from Credit Management for R10 000.

Credit Management offers an early settlement discount of 5% to customers who settle their accounts within 30 days from the purchase date.

There are four different ways of recording this transaction, if we assume that:

1. It is probable that Sales Extreme will take advantage of the discount.
2. It is probable that Sales Extreme will not take advantage of the discount.
3. If Sales Extreme does not take advantage of the discount as it was originally expected to.
4. If Sales Extreme takes advantage of the discount that it did not originally expect to take.

1. *It is probable that Sales Extreme will take advantage of the discount.*

   The price of buying the inventory will be recorded net of the discount. This transaction will appear as follows:

   The entry on the date of purchase would look like this:

GENERAL JOURNAL OF SALES EXTREME **GJ12**

Day	Details	Fol.	Debit		Credit	
10/07	Inventory (10 000 × 95%)	B7	9 500	00		
	Accounts payable	B9			9 500	00

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When Sales Extreme makes the payment:

GENERAL JOURNAL OF SALES EXTREME **GJ12**

Day	Details	Fol.	Debit		Credit	
10/07	Accounts payable	B9	9 500	00		
	Bank	B8			9 500	00

2 *It is probable that Sales Extreme will not take advantage of the discount.*

The entry on the date of purchase would look like this:

GENERAL JOURNAL OF SALES EXTREME **GJ12**

Day	Details	Fol.	Debit		Credit	
10/07	Inventory	B7	10 000	00		
	Accounts payable	B9			10 000	00

When Sales Extreme makes the payment:

GENERAL JOURNAL OF SALES EXTREME **GJ12**

Day	Details	Fol.	Debit		Credit	
10/07	Accounts payable	B9	10 000	00		
	Bank	B8			10 000	00

3 *If Sales Extreme does not take advantage of the discount as it was originally expected to.*

If Sales Extreme does not take the discount, this entry would be completed when they make the payment (*not as expected*):

GENERAL JOURNAL OF SALES EXTREME **GJ12**

Day	Details	Fol.	Debit		Credit	
10/07	Interest expense	N6	500	00		
	Accounts payable	B9	9 500	00		
	Bank	B8			10 000	00

4 *If Sales Extreme takes advantage of the discount that it did not originally expect to take.*

When Sales Extreme makes the payment:

GENERAL JOURNAL OF SALES EXTREME **GJ12**

Day	Details	Fol.	Debit		Credit	
10/07	Accounts payable	B9	10 000	00		
	Bank	B8			9 500	00
	Interest income	N7			500	00

A percentage mark-up on cost policy

Under this policy, a fixed percentage is calculated as the mark-up expressed as a percentage of cost price.

If you are given any two of cost price, percentage mark-up or selling price, the unknown may be calculated. Stated as a percentage, the cost equals 100% and the selling price equals 100% plus the percentage mark-up.

Example 9.5

This example takes into account the percentage mark-up on cost.

Mokete Wholesaler marks all its inventory at cost plus 50%. Goods marked at R600 are sold.

You are required to:
Calculate the cost price of the inventory.

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As the percentage mark-up on cost is known, then on a percentage basis:

	Cost	Mark-up	Selling price
Amount	100%	50%	150%
	R?	R?	R600

To find the cost price of the inventory, the selling price must be reduced in the ratio 100 ÷ 150. This is done like this:

Cost price = Selling price × 100 ÷ 150
= R600 × 100 ÷ 150
= R400

A percentage mark-up on selling price policy

If the selling price is calculated using profit margin, then as a percentage:

- The selling price equals 100% (as it is the basis on which the profit margin is calculated).
- The cost price equals 100% minus the percentage margin.

Example 9.6

This example takes into account the percentage mark-up on selling price.

Mokete Wholesaler marks all its inventory up to earn a profit margin of 50%. Goods marked at R600 are sold.

You are required to:
Calculate the cost price of the inventory.

As the profit margin percentage is based on the selling price, then on a percentage basis:

	Cost	Profit margin	Selling price
Amount	50%	50%	100%
	R?	R?	R600

To find the cost price of the inventory, the selling price must be reduced in the ratio 50 ÷ 100. This is done like this:

Cost price = Selling price × 50 ÷ 100
= R600 × 50 ÷ 100
= R300

Recording the purchase of goods for resale

Example 9.7

1. On 1 May, bought inventory and paid R500 with cheque 1234.
2. On 1 May, paid R30 for delivery charges to the store with cheque 1235.

Effect on the accounting model:

- Assets increase by R530 (more inventory with a cost equal to R500 + R30).
- Assets decrease by R530 (less cash in the bank R550 + R30).

Questions to ask:

- Which asset increased? Inventory.
- Which asset decreased? Bank.

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Perpetual

GENERAL JOURNAL OF XXX GJ1

Day	Details	Fol.	Debit	Credit
01/05	Inventory	B7	500	
	Bank	B8		500
	Inventory	B7	30	
	Bank	B8		30

INVENTORY B7

Debit		Credit	
Bank	500		
Bank	30		

BANK B8

Debit		Credit	
		Inventory	500
		Inventory	30

Periodic

GENERAL JOURNAL OF XXX GJ1

Day	Details	Fol.	Debit	Credit
01/05	Purchases	N2	500	
	Bank	B8		500
	Carriage on purchases	N3	30	
	Bank	B8		30

BANK B8

Debit		Credit	
		Purchases	500
		Carriage on purchases	30

PURCHASES N2

Debit		Credit	
Bank	500		

CARRIAGE ON PURCHASES N3

Debit		Credit	
Bank	30		

Recording the sale of inventory

Example 9.8

Gerries Wholesalers uses the perpetual inventory system and marks all inventory up 50% on cost.

On 1 June, inventory was invoiced to Kallies Retailers for R750 (invoice 321).

You are required to:
Record the transaction in the general journal and general ledger.

The price that will appear on the invoice, consists of two distinct amounts, each of which can be calculated using the formulae in this chapter. The amounts are:

- Cost price R500 (R750 × 100 ÷ 150)
- Gross profit R250 (R750 × 50 ÷ 150)

Effect on the accounting model:

- Assets increase by R750 (accounts receivable owe more money).
- Assets decrease by R500 (cost of inventory sold).
- Equity increased by R250 net (gross profit).

Questions to ask:

- Which asset increased? Accounts receivable.
- Which asset decreased? Inventory.
- Why did owner's equity decrease? Cost of sales.
- Why did owner's equity increase? Revenue from sales.

Perpetual

GENERAL JOURNAL OF GERRIES GJ7

Day	Details	Fol.	Debit	Credit
01/06	Cost of sales	N2	500	
	Inventory	B7		500
	Accounts receivable	B9	750	
	Sales	N1		750

Periodic

GENERAL JOURNAL OF GERRIES GJ7

Day	Details	Fol.	Debit	Credit
01/06	Accounts receivable	B9	750	
	Sales	N1		750

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INVENTORY B7

		Cost of sales	500

ACCOUNTS RECEIVABLE B9

Sales	750		

SALES N1

		Accounts receivable	750

COST OF SALES N2

Inventory	500		

ACCOUNTS RECEIVABLE B9

Sales	750		

SALES N2

		Accounts receivable	750

Explanation

The effect on the ledger is that assets have increased by R250 (R750 – R500). Owner's equity has increased by R250, which is the gross profit on that particular sale. The reason for having four accounts is to produce better quality information.

At the end of the period, users of the information would want to know, for example, what the value is of the inventory on hand. This can only be done using the above entries.

You should be able to complete Questions 9.4 to 9.11.

5 Recording purchases and sales using the two inventory systems

In principle, the periodic inventory system does not change the entry required for the purchase of inventory. However, in place of only the inventory account, two accounts, that is, an inventory account (real account) and a purchases account (nominal account) are used.

As it is desirable to keep intact the rand value of the inventory on hand at the beginning of a period, the inventory account is used only for this purpose. No entries are made into the inventory account when inventory is bought. Instead a separate account, the purchases account, is used. The inventory account is updated only at the end of the financial period, showing the value of inventory on hand at that date.

When using the perpetual inventory system, all additional costs to get the inventory in a desired condition and location for selling, such as railage and packaging, were debited directly to the inventory account.

Using the periodic inventory system this will not be the case. These 'costs' are each debited to a separate general ledger account, which will be closed off to the trading account at the end of an accounting period when the cost of the inventory sold is calculated. The entry required when a sale takes place is considerably simpler under the periodic inventory system, as no entry is made to record the cost price of the inventory sold.

The effect on the accounting equation will be explained after Example 9.9 (which ignores VAT, as it will be dealt with in Chapter 10).

Example 9.9

On 1 June, inventory had a balance of R3 000 in the general ledger of Paul Ndebele.

Paul uses the periodic inventory system.

Transactions for the month:

4 Bought inventory on credit, R2 000.

7 Sold inventory on credit to J. Jones, R450.

15 Sold inventory for cash to B. Baily, R1 150.

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Additional information:
- When using the perpetual inventory system, the business uses a mark-up on cost of 50%.
- When using the periodic inventory system, inventory with a value of R3 900 was on hand on the last day of the financial year after the annual inventory count.
- Assume no other transactions took place.

You are required to:
Record the transactions in the general ledger and calculate the gross profit using both the perpetual and periodic inventory systems.

Perpetual

GENERAL JOURNAL OF PAUL NDEBELE GJ6

Day	Details	Fol.	Debit	Credit
01/05	Inventory	B6	2 000	
	Accounts payable	B9		2 000
	Accounts receivable	B5	450	
	Sales	N1		450
	Cost of sales	N2	300	
	Inventory	B7		300
	Bank	B8	1 150	
	Sales	N1		1 150
	Cost of sales	N2	767	
	Inventory	B7		767

ACCOUNTS RECEIVABLE B5

Debit		Credit	
Sales	450		

INVENTORY B7

Debit		Credit	
Balance b/d	3 000	Cost of sales	300
Accounts payable	2 000	Cost of sales	767
		Balance c/d	3 933
	5 000		5 000
Balance b/d	3 933		

BANK B8

Debit		Credit	
Sales	1 150		

ACCOUNTS PAYABLE B9

Debit		Credit	
		Inventory	2 000

SALES N1

Debit		Credit	
Trading account	1 600	Bank	1 150
		Accounts receivable	450
	1 600		1 600

COST OF SALES N2

Debit		Credit	
Inventory	300	Trading account	1 067
Inventory	767		
	1 067		1 067

Periodic

GENERAL JOURNAL OF PAUL NDEBELE GJ6

Day	Details	Fol.	Debit	Credit
01/05	Purchases	N2	2 000	
	Accounts payable	B9		2 000
	Accounts receivable	B5	450	
	Sales	N1		450
	Bank	B8	1 150	
	Sales	N1		1 150

ACCOUNTS RECEIVABLE B5

Debit		Credit	
Sales	450		

INVENTORY B7

Debit		Credit	
Balance b/d	3 000		

BANK B8

Debit		Credit	
Sales	1 150		

ACCOUNTS PAYABLE B9

Debit		Credit	
		Purchases	2 000

SALES N1

Debit		Credit	
Trading account	1 600	Bank	1 150
		Accounts receivable	450
	1 600		1 600

PURCHASES N2

Debit		Credit	
Accounts payable	2 000		

Explanation
- The balance of inventory, R3 000, is an asset.
- For the periodic inventory system, the transaction for purchasing inventory is entered

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into the purchases account, leaving the inventory account showing the opening balance of inventory on hand at the beginning of the financial period.

- Sale of inventory for cash results in only one double-entry.
  – The asset (bank) increases.
  – The owner's equity (sales) increases.
- Sale of inventory on credit each results in only one double-entry.
  – The asset (accounts receivable) increases.
  – The owner's equity (sales) increases.
- The purchase of inventory may be considered as a temporary reduction of owner's equity. However, at the end of the financial period an adjustment will have to transfer unsold inventory to an asset account to ensure that the owner's equity is reduced by the cost of inventory sold, not by the cost of all inventory bought.
- This is the fundamental difference between the perpetual and the periodic inventory system. The adjustment for the cost of sales is only made at the end of the period, instead of passing an entry each time a sale transaction takes place.

On 30 June, Paul will need to conduct an inventory count.

If the closing inventory had a cost of R3 900, the inventory account will need to be updated and the cost of sales established. This is done in the trading account like this:

Perpetual

TRADING ACCOUNT **F1**

Cost of sales	1 067	Sales	1 600
Profit and loss (GP)	533		
	1 600		1 600

Periodic

TRADING ACCOUNT **F1**

Inventory	3 000	Sales	1 600
Purchases	2 000	Inventory	3 900
Profit and loss (GP)	500		
	5 500		5 500

The trading account could be displayed as follows to form part of the statement of profit or loss & other comprehensive income:

Perpetual

Paul Ndebele
TRADING STATEMENT

Sales	1 600	00
Less: Cost of sales	(1 067	00)
GROSS PROFIT	533	00

Periodic

Paul Ndebele
TRADING STATEMENT

Sales	1 600	00
Less: Cost of sales	(1 100	00)
Opening inventory	3 000	00
Add: Purchases	2 000	00
Goods available for sale	5 000	00
Less: Closing inventory	(3 900	00)
GROSS PROFIT	500	00

Explanation

We can summarise the example as follows:

1. At the end of the financial period, the cost of inventory sold needs to be established. To do this, opening and closing inventory must be taken into account.
   The opening inventory must be added to the purchases using this journal entry:
   – *Dr.* Trading account
   – *Cr.* Inventory (opening)
2. The closing inventory should be subtracted from the purchases using this journal entry:
   – *Dr.* Inventory (closing)
   – *Cr.* Trading account

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3 After the journal entries are passed, an asset with the value of closing inventory will appear in the general ledger, and the gross profit can be calculated using the trading account.

Example 9.10

Indaba Decor is a wholesale business selling furniture.

Transactions for March:

4 Bought inventory with an invoice price of R2 000 after 50% trade discount, on credit from Apex Manufacturers.

Apex offered a 2% settlement discount if the account is settled within 30 days. It is highly likely that the discount will be taken up.

5 Paid railage for delivery of the inventory from Apex Manufacturers of R209.

6 Sold inventory for R440 to A. Ahrendse on credit (based on normal mark-up). Offered A. Ahrendse a settlement discount of 5% for the early settlement on the account, if payment is received within 30 days.

15 Sold inventory for cash to B. Baily and received a cheque for R1 210.

19 Settled the account with Apex Manufacturers by cheque, thus, taking advantage of the settlement discount.

20 A. Ahrendse settled his account taking advantage of the settlement discount.

You are required to:

1 Prepare the general journal, if Indaba Decor uses a periodic inventory system.

2 Prepare the general journal, if Indaba Decor uses a perpetual inventory system. The mark-up on cost is 40%.

Perpetual

GENERAL JOURNAL OF INDABA DECOR GJ3

Day	Details	Fol.	Debit	Credit
04/03	Inventory (2 000 × 98%)	B5	1 960	
	Accounts payable: Apex Limited	B7		1 960
05/03	Inventory	B5	209	
	Bank	B6		209
06/03	Accounts receivable	B8	418	
	Sales (440 × 95%)			418
	Cost of sales	N2	314	
	Inventory (440 × 100 ÷ 140)	B5		314
15/03	Bank	B6	1 210	
	Sales	N1		1 210
	Cost of sales (1 210 × 100 ÷ 140)	N2	864	
	Inventory	B5		864
19/03	Accounts payable: Apex Limited	B7	1 960	
	Bank	B6		1 960
20/03	Bank	B6	418	
	Accounts receivable	B8		418

Periodic

GENERAL JOURNAL OF INDABA DECOR GJ3

Day	Details	Fol.	Debit	Credit
04/03	Purchases (2 000 × 98%)	N2	1 960	
	Accounts payable: Apex Limited	B7		1 960
05/03	Carriage on purchases	N3	209	
	Bank	B6		209
06/03	Accounts receivable	B8	418	
	Sales (440 × 95%)	N1		418
15/03	Bank	B6	1 210	
	Sales	N1		1 210
19/03	Accounts payable	B7	1 960	
	Bank	B6		1 960
20/03	Bank	B6	418	
	Accounts receivable	B8		418

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Explanation

Periodic

- The transaction for the purchase of inventory is entered into the purchases account. No entry is recorded to update the inventory on hand.
- The purchases account may be considered as a temporary reduction of owner's equity. However, at the end of the financial period, an adjustment will have to be made to ensure that the owner's equity is reduced by the cost of inventory sold, not by the cost of inventory bought, thereby eliminating the closing inventory from the purchases.
- The expense for carriage on purchases, necessary to bring the inventory to their present location, is a cost directly attributable to the inventory bought and should therefore be included in the cost of inventory. However, it is temporarily recorded in an appropriately named account, but will be used in the calculation of cost of sales.
- Settlement discounts are considered when the transaction is initially recorded since a probability exists that the business will take up the discount.

Perpetual

- The transaction for the purchase of inventory is entered into the inventory account.
- The expense for carriage on purchases as discussed in the periodic explanation will be directly included in the inventory account when it is incurred.
- Settlement discounts are recorded in the same manner as in the periodic inventory system.

6 Establishing the cost of closing inventory

At inventory count, the inventory amounts are calculated by multiplying the number of units in inventory by the cost price of the unit.

If, for reasons of age or damage, the units could not be expected to be sold for more than the cost price, the price used for establishing the inventory amount would be the net realisable value.

This is an important principle when placing a monetary value on the unsold inventory. In such a case, the accounting principle is to value the inventory at the lower of cost or net realisable value (the estimated selling price in the ordinary course of business less any costs that necessarily have to be incurred to make the sale).

The prudence concept, thus, dictates that inventory should not be valued in excess of the amount that is expected to be realised. The effect of applying it is to recognise and provide for the decline in the value of unsold inventory in the period in which the decline occurs, instead of the subsequent period in which the inventory is sold.

When establishing the cost of the units on hand there is no complication, provided that prices have remained intact.

In establishing the cost of the units being sold, two methods can be used. The methods used are dependent on the business policy as well as the type of goods sold. The methods are:

First-in-first-out (FIFO)

In a FIFO system, the first items/transactions entered in the system are the first ones to be removed from the system. In other words, the items are removed in the same order they are entered. Items which are removed are removed at the same cost price at which they were originally purchased.

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Weighted average

In a weighted average system, inventory is assigned an average cost. When it is sold, the inventory is removed from the records at the average that was calculated on the day that the inventory was purchased, regardless of the actual cost of that inventory. Retailers that sell inventory must keep track of the cost of inventory on hand, as well as the cost of inventory at each purchase date, to calculate the weighted average. In theory this sounds simple, but it can be a lot more complex when dealing with a large number of transactions.

Example 9.11 **First-in-first-out (FIFO) and weighted-average methods**

Here is the record of the purchases and sales of cartons of painkillers by Montey Megrain, a wholesale chemist, for September.

Date					Date				
1	Opening inventory	200	@	10	2	Sales	120	@	20
5	Purchases	300	@	12	10	Sales	200	@	24
16	Purchases	150	@	15	18	Sales	200	@	25

You are required to:

Determine the cost of the closing inventory using the FIFO (perpetual and periodic) and weighted average (perpetual and periodic) inventory calculation.

The solution to this problem will depend on which method is used to allocate costs and on whether the periodic or perpetual inventory system has been used. However, the number of units on hand must still be calculated and this quantity will remain the same whichever system is used.

Date	Details		Units	Value
1 Sep.	Inventory		200	@ R10
2 Sep.	Sales	–	120	
			80	
5 Sep.	Purchases	+	300	@ R12
			380	
10 Sep.	Sales	–	200	
			180	
16 Sep.	Purchases	+	150	@ R15
			330	
18 Sep.	Sales	–	200	
30 Sep.	**UNITS ON HAND IN CLOSING INVENTORY**		130	

The number of units of inventory at the end of the month is 130.

The question to be answered is whether they are to be assigned a rand value as units that cost R10, R12 or R15, or some combination. This will depend upon the cost allocation method used.

Method 1A: First-in-first-out (FIFO: perpetual inventory system)

Costs are assigned on the basis that the first item bought is sold before items bought later.

When using the perpetual inventory system, the units on hand will be gotten from the continuous inventory records.

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Date	Details		Units	Value
1 Sep.	Inventory		200	@ R10
2 Sep.	Sales	–	(120)	@ R10
			80	@ R10
5 Sep.	Purchases	+	300	@ R12
			380	(80 @ R10 + 300 @ R12)
10 Sep.	Sales	–	(200)	(80 @ R10 + 120 @ R12)
			180	(180 @ R12)
16 Sep.	Purchases	+	150	@ R15
			330	(180 @ R12 + 150 @ R15)
18 Sep.	Sales	–	(200)	(180 @ R12 + 20 @ R15)
30 Sep.	**UNITS ON HAND IN CLOSING INVENTORY**		130	(130 @ R15)

The cost of closing inventory established on a FIFO basis is, therefore, R1 950 (130 × R15).

Method 1B: First-in-first-out (FIFO: periodic inventory system)

With the periodic inventory system, the number of units on hand will be established by an inventory count. As they are assigned the most recent cost, the cost will be calculated like this:

130 units × R15	=	1 950	00

It is also useful to show how costs would have been assigned had there been 230 units on hand.

Using the most recent costs, it should be established as follows:

150 units × R15	=	2 250	00
80 units × R12	=	960	00
Therefore, 230 units	=	3 210	00

From the two cases above, it should be clear that the value of closing inventory does not differ as a result of using periodic or perpetual inventory systems.

Method 2A: Weighted-average method (perpetual inventory system)

With the perpetual inventory system, the costs are recalculated on a weighted-average basis after each purchase of units.

When sold, they are entered into the cost of sales account at the new weighted average. (This method is more correctly referred to as the moving-average method.)

The costs assigned are calculated like this:

Date	Details		Units	Value	Cumulative Value
1 Sep.	Inventory		200	@ R10	2 000
2 Sep.	Sales	–	120	@ R10	1 200
			80	@ R10	800
5 Sep.	Purchases	+	300	@ R12	3 600
			380	@ R11.58*	4 400
10 Sep.	Sales	–	200	@ R11.58	2 316
			180	@ R11.58	2 084
16 Sep.	Purchases	+	150	@ R15	2 250
			330	@ R13.13**	4 334
18 Sep.	Sales	–	200	@ R13.13	2 626
30 Sep.	**UNITS ON HAND IN CLOSING INVENTORY**		130	@ R13.13	1 708

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* The weighted average of R11.58 above was calculated like this:

80 items × R10	=	800	00
300 items × R12	=	3 600	00
Therefore, 380 items	=	4 400	00

Unit cost = R4 400 ÷ 380 = R11.58

** The weighted average of R13.13 above was calculated like this:

180 items × R11.58	=	2 084	00
150 items × R15	=	2 250	00
Therefore, 330 items	=	4 334	00

Unit cost = R4 334 ÷ 330 = R13.13

The cost of closing inventory established on a weighted-moving average under the perpetual inventory system is, therefore: R1 706.90 (130 × R13.13).

Method 2B: Weighted-average method (periodic inventory system)

This method assigns cost based on the average cost. Because orders are received in different quantities, they would need to be weighted to establish a real arithmetic average.

Opening inventory	200	@ R10	=	2 000	00
5 Sep. Purchases	300	@ R12	=	3 600	00
16 Sep. Purchases	150	@ R15	=	2 250	00
	650			7 850	00

A total of 650 units are counted at a total cost of R7 850. The average cost is, therefore:
R7 850 ÷ 650 = R12.08.

The closing inventory cost using the weighted-average method is, therefore: R1 570.40 (R12.08 × 130).

This calculation will usually only be made once a year, after completion of the inventory count.

Inventory in transit

Inventory in transit refers to inventory previously bought (and ownership has been passed), but that is still to be delivered at financial year end.

Although this inventory is the property of the business, it will not have been included in the year-end inventory sheets prepared from the physical inventory count (as they were not physically on the premises at the time of the inventory count).

If the inventory bought during a financial period has been correctly recorded, one of three possibilities exist and the additional journal entries resulting from each shows that:

1 The inventory has been sold and recorded as sales during the same period.
   - Dr. Bank/accounts receivable
   - Cr. Sales

2 The inventory is still on hand at the end of the period and should, therefore, be included in the inventory amount at the end of the period. This applies only to the periodic inventory recording system. Under the perpetual inventory recording system, the inventory cost would have been recorded as part of inventory when purchased.
   - Dr. Inventory in transit
   - Cr. Trading account

3 The inventory was not sold but is not on hand, as a result of inventory loss or still being in transit.

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This section deals with inventory unsold at the end of the period, but not yet on the premises of the business. To show the true financial position at the end of a financial period, all assets owned by the business must be shown.

However, we noted above that whereas a purchases transaction may have been legally concluded and ownership of the inventory passed to the buyer, the inventory may not yet have physically arrived at the buyer's warehouse or been recorded as a purchase by the end of the period.

As there are different circumstances under which adjustments for inventory in transit would be necessary, it should first be established whether or not the purchase transaction has been recorded.

Example 9.12

Goods were bought on credit for R500 but the inventory is still in transit.

You are required to:

Show the necessary general journal entries for both the periodic and perpetual inventory systems, given the assumptions below that must be posted.

Assumption 1: The purchases have been correctly recorded in the current accounting period.

Perpetual

GENERAL JOURNAL OF XXX **GJ7**

Day	Details	Fol.	Debit	Credit
01/06	Inventory	B8	500	
	Accounts payable	B10		500

Periodic

GENERAL JOURNAL OF XXX **GJ7**

Day	Details	Fol.	Debit	Credit
01/06	Purchases	N2	500	
	Accounts payable	B10		500

At year end, the inventory is not yet on the premises, so it could not be included in the inventory count.

It is necessary to separate the inventory not physically on hand from other inventory at the end of the financial period, and this adjustment is used:

Perpetual

GENERAL JOURNAL OF XXX **GJ7**

Day	Details	Fol.	Debit	Credit
01/06	Inventory in transit	B14	500	
	Inventory	B8		500

Periodic

GENERAL JOURNAL OF XXX **GJ7**

Day	Details	Fol.	Debit	Credit
01/06	Inventory in transit	B14	500	
	Purchases	N2		500

Explanation

- When the financial statements are drawn up, inventory in transit will appear as a current asset on the statement of financial position and inventory/purchases will be shown at the reduced value on the statement of profit or loss & other comprehensive income.
- Under both inventory systems, that is, periodic and perpetual, the above adjusting entries will be reversed at the beginning of the following accounting period.

Assumption 2: Purchases have not yet been recorded in the current accounting period (invoice received after the trial balance was drafted).

Perpetual

GENERAL JOURNAL OF XXX **GJ7**

Day	Details	Fol.	Debit	Credit
01/06	Inventory in transit	B14	500	
	Accounts payable	B10		500

Periodic

GENERAL JOURNAL OF XXX **GJ7**

Day	Details	Fol.	Debit	Credit
01/06	Inventory in transit	B14	500	
	Accounts payable	B10		500

Explanation

- Reflected on the financial statements will be the current asset, inventory in transit and the equal current liability, accounts payable.

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- Again, both these adjusting entries will be reversed at the beginning of the following accounting period. Once the purchase invoice is received, the entry to record the purchases of inventory will be passed in the general journal or entered into the accounts payable subsidiary journal.

You should be able to complete Questions 9.12 to 9.16.

7 Accounting for inventory losses and insurance claims

Inventory losses occur for a number of reasons. Items may be damaged and destroyed or perish or become obsolete as a result of age. If control is not adequate, loss as a result of theft may also be a possibility. Under certain conditions, inventory losses may be subject to claim from an insurer.

When inventory is insured, usually against disasters such as fire or flood, a value is placed on the inventory to be insured. This value serves as the basis for calculating the premium to be paid and also serves as the maximum amount that the insurance business will pay as a claim in the event of total loss of all inventory covered by the insurance policy.

If a business insures its inventory for more than the actual value of the inventory on hand, and a total loss occurs, the insurance business is obliged only to pay a claim for the actual value of the inventory destroyed.

However, if an insurance policy is for less than the total value of the inventory destroyed, the insurance business is obliged only to pay to the amount of the policy.

An interesting situation arises when a business is under-insured and only a portion of the inventory is destroyed. The insurance company will apply a principle known as the average clause.

Invoking this clause means that if a business is under-insured, the insurance company will only pay some of the claim rather than the full amount for the inventory destroyed.

Example 9.13 shows the calculation of an insurance claim when inventory is under-insured.

Example 9.13

Percy's Bazaar has insured the inventory in their storeroom for R100 000. One night when the value of the inventory in the store was R125 000, a fire destroyed inventory to the value of R30 000.

You are required to:

Determine the amount most likely to be paid out by the insurance business.

Claim submitted = R30 000

Because of under-insurance, payment will be $= \frac{\text{R}100\ 000}{\text{R}125\ 000} \times \text{R}30\ 000$

= R24 000

The necessary entries for inventory losses are once again dependent upon the circumstances and the inventory system used as shown in Example 9.14.

Example 9.14

Assume that inventory to the value of R400 was destroyed by fire.

You are required to:

Show the general journal entries for the periodic inventory system and the perpetual inventory system, if:

1. Inventory was not insured.
2. Inventory was insured for R60 000 and inventory on hand at the time of the fire was R48 000.
3. Inventory was insured for R60 000 and inventory on hand at the time of the fire was R80 000.

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1 *Inventory was not insured.*

Perpetual

GENERAL JOURNAL OF XXX **GJ7**

Day	Details	Fol.	Debit	Credit
01/06	Cost of sales	N16	400	
	Inventory	B10		400
	Adjusting inventory for loss			
	Profit and loss	F2	400	
	Cost of sales	N16		400
	Closing transfer			

Note

- No journal entries are required when using the periodic method.
- When the year-end inventory count is conducted, the closing inventory balance will be obtained, resulting in a larger movement of the cost of sales balance.

2 *Inventory fully insured (over-insured).*

Perpetual

	Details	Debit	Credit
i)	Bank/Insurance asset	400	
	Insurance income		400
ii)	Cost of sales	400	
	Inventory		400
iii)	Profit/Loss	400	
	Cost of sales		400
iv)	Insurance income	400	
	Profit/Loss		400

Periodic

	Details	Debit	Credit
	Bank/Insurance asset	400	
	Insurance income		400
	Insurance income	400	
	Profit/Loss		400

Note

No adjustment is made to inventory. See explanation in 1 above.

3 *Inventory under-insured (average clause applied).*

Perpetual

	Details	Debit	Credit
i)	Bank/Insurance asset	300	
	Insurance income		300
ii)	Cost of sales	400	
	Inventory		400
iii)	Profit/Loss	400	
	Cost of sales		400
iv)	Insurance income	300	
	Profit/Loss		300

Periodic

	Details	Debit	Credit
	Bank/Insurance asset	300	
	Insurance income		300
	Insurance income	300	
	Profit/Loss		300

Note

No adjustment is made to inventory. See explanation in 1 above.

Explanation

- The application of the average clause meant that only 75% of the loss was recovered from the insurance company (R60 000 ÷ R80 000). This principle is applied so that the insurance industry can discourage under-insurance.
- If, for example, R60 000 worth of inventory had been destroyed by fire, leaving R20 000 on hand, it would not be reasonable to expect the insurance business to pay the full insured value of R60 000 on which they received their premium income.

You should be able to complete Questions 9.17 to 9.19.

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8 Year-end procedures for the periodic system

The fundamental difference between the periodic inventory system and the perpetual inventory system is that the adjustment for the cost of the sale is made only at the end of the period, prior to financial reporting, instead of passing an entry each time a sale takes place.

Cost of sales, when using the perpetual system, is calculated in the cost of sales account, whereas, when using the periodic system, it is calculated in the trading account.

Example 9.15 shows the general journal entries, ledger accounts and financial statements using the periodic inventory system.

Example 9.15

Indaba Decor (refer to Example 9.10) had this post-adjustment trial balance as at 31 March, the end of their financial year. Closing inventory must still be recorded using the periodic inventory system.

Indaba Decor
POST-ADJUSTMENT TRIAL BALANCE AS AT 31 MARCH 20x9

Details	Fol.	Debit		Credit	
Capital	B1			237 500	00
Vehicles	B2	168 300	00		
Accounts receivable	B3	10 920	00		
Accounts payable	B4			29 388	00
SARS: VAT	B5			1 692	00
Bank	B6	22 792	00		
Inventory (1 April – previous year)	B7	69 350	00		
Purchases	N1	356 980	00		
Carriage on purchases	N2	5 480	00		
Sales	N3			686 430	00
Salaries	N4	220 810	00		
Wages	N5	10 628	00		
General expenses	N6	89 750	00		
		955 010	00	955 010	00

It was calculated that the inventory on hand on 31 March had a cost of R79 860.

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The necessary entries in the general journal to record the adjustment for closing inventory and the closing transfers are:

GENERAL JOURNAL OF INDABA DECOR **GJ12**

Day	Details	Fol.	Debit		Credit	
31/03	Cost of sales	F1	431 810	00		
	Inventory (opening)	B7			69 350	00
	Purchases	N1			356 980	00
	Carriage on purchases	N2			5 480	00
	Closing transfer of opening inventory, cost of purchases and all location and condition costs					
	Sales	N3	686 430	00		
	Trading account	F1			686 430	00
	Closing transfer of sales of trading account					
	Inventory		79 860	00		
	Cost of sales				79 860	00
	Transfer of closing inventory to cost of sales					
	Trading account		351 950	00		
	Cost of sales				351 950	00
	Transfer of cost of sales to trading account					
	Trading account	F1	334 480	00		
	Profit and loss account	F2			334 480	00
	Transfer of gross profit to the profit and loss account					
	Profit and loss account	F2	321 188	00		
	Salaries	N4			220 810	00
	Wages	N5			10 628	00
	General expenses	N6			89 750	00
	Closing transfers of expenses					
	Profit and loss account	F2	13 292	00		
	Capital (net profit)	B1			13 292	00
	Transfer of net profit					

Posting to the general ledger results in these accounts:

General Ledger of Indaba Decor
Real Accounts Section

Dr. **CAPITAL** **B1** Cr.

Mar.	31	Balance	c/d	250 792	00	Mar.	31	Balance	b/d	237 500	00
								Profit and loss account	GJ12	13 292	00
				250 792	00					250 792	00
						Apr.	1	Balance	b/d	250 792	00

VEHICLES **B2**

Mar.	31	Balance	b/d	168 300	00						

ACCOUNTS RECEIVABLE **B3**

Mar.	31	Balance	b/d	10 920	00						

Dr. **ACCOUNTS PAYABLE** **B4** Cr.

						Mar.	31	Balance	b/d	29 388	00

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SARS: VAT **B5**

						Mar.	31	Balance	b/d	1 692	00

BANK **B6**

Mar.	31	Balance	b/d	18 460	00						

INVENTORY **B7**

Mar.	31	Balance	c/d	69 350	00	Mar.	31	Cost of sales	GJ12	69 350	00
		Cost of sales	GJ12	79 860	00			Balance	c/d	79 860	00
				149 210	00					149 210	00
Apr.	1	Balance	b/d	79 860	00						

Nominal Accounts Section

PURCHASES **N1**

Mar.	31	Total	b/f	356 980	00	Mar.	31	Cost of sales	GJ12	356 980	00

CARRIAGE ON PURCHASES **N2**

Mar.	31	Total	b/f	5 480	00	Mar.	31	Cost of sales	GJ12	5 480	00

SALES **N3**

Mar.	31	Trading account	GJ12	686 430	00	Mar.	31	Total	b/f	686 430	00

SALARIES **N4**

Mar.	31	Total	b/f	220 810	00	Mar.	31	Profit and loss account	GJ12	220 810	00

WAGES **N5**

Mar.	31	Total	b/f	10 628	00	Mar.	31	Profit and loss account	GJ12	10 628	00

GENERAL EXPENSES **N6**

Mar.	31	Total	b/f	89 750	00	Mar.	31	Profit and loss account	GJ12	89 750	00

COST OF SALES **N7**

Mar.	31	Inventory (OB)		69 350	00	Mar.	31	Inventory (CB)	GJ12	79 860	00
		Purchases		356 980	00			Trading account		351 950	00
		Carriage on purchases		5 480	00						
				431 810	00					431 810	00

Final Accounts Section

TRADING ACCOUNT **F1**

Mar.	31	Cost of sales	GJ12	351 950	00	Mar.	31	Sales	GJ12	686 430	00
		Profit and loss account (Gross profit)	GJ12	334 480	00						
				686 430	00					686 430	00

PROFIT AND LOSS ACCOUNT **F2**

Mar.	31	Salaries	GJ12	220 810	00	Mar.	31	Trading account	GJ12	334 480	00
		Wages	GJ12	10 628	00						
		General expenses	GJ12	89 750	00						
		Capital (NP)	GJ12	13 292	00						
				334 480	00					334 480	00

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The statement of profit or loss & other comprehensive income for internal use may be drafted as follows:

Indaba Decor
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MARCH 20*x*9

	Notes	20*x*9	
Sales (net)		686 430	00
Cost of sales		(351 950	00)
Opening inventory		69 350	00
Purchases		356 980	00
Carriage on purchases		5 480	00
Goods available for sale		431 810	00
Less: Closing inventory		(79 860	00)
Gross profit		334 480	00
Operating expenses		(321 188	00)
Salaries		220 810	00
Wages		10 628	00
General expenses		89 750	00
NET PROFIT FOR THE PERIOD		13 292	00

The statement of financial position is drafted from the real accounts that remain in the general ledger after the closing transfers have been done. It may be drafted as follows:

Indaba Decor
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

	Notes	20*x*9	
ASSETS			
Non-current assets		168 300	00
Vehicles		168 300	00
Current assets		113 572	00
Inventories		79 860	00
Trade and other receivables		10 920	00
Cash and cash equivalents		22 792	00
TOTAL ASSETS		281 872	00
EQUITY AND LIABILITIES			
Capital and reserves		250 792	00
Capital		237 500	00
Add: Net profit for the year		13 292	00
Less: Drawings		0	00
Current liabilities		31 080	00
Trade and other payables (29 388 + 1 692)		31 080	00
TOTAL EQUITY AND LIABILITIES		281 872	00

Explanation

From the financial statements it should be noted that:

- The cost of sales includes all expenses in bringing the inventory to its present location and condition necessary for sale.
- The cost of sales cannot be calculated until the inventory count has taken place and costs have been assigned to the closing inventory.

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- Probably the most important aspect of the performance of Indaba Decor for the year, is the return on equity (ROE) based on the capital at the beginning of the year, and is calculated like this:

$$\text{ROE \%} = \frac{\text{Net profit attributable to owner}}{\text{Capital and reserves}} \times 100$$

$$= \frac{13\ 292}{237\ 500} \times 100$$

$$= 5.6\%$$

  The performance for the year is not satisfactory by any standard, because the capital invested in the business could have been invested in a low-risk investment.

  – The return on such an investment would definitely have been higher than the 5.6% made.
  – The reasons for this poor performance must be investigated and addressed.

9 Year-end procedures for the perpetual system

The fundamental difference between the periodic inventory system and the perpetual inventory system is that the adjustment for the cost of the sale is made only at the end of the period, prior to financial reporting, instead of passing an entry each time a sale takes place.

Cost of sales, when using the perpetual system, is calculated in the cost of sales account, whereas, when using the periodic system, it is calculated in the trading account.

Example 9.16

Indaba Decor (refer to Example 9.10) had this post-adjustment trial balance as at 31 March, the end of their financial year. Closing inventory must still be recorded using the perpetual inventory system.

Indaba Decor
POST-ADJUSTMENT TRIAL BALANCE AS AT 31 MARCH 20*x*9

Details	Fol.	Debit		Credit	
Capital	B1			237 500	00
Vehicles	B2	168 300	00		
Accounts receivable	B3	10 920	00		
Accounts payable	B4			29 388	00
SARS: VAT	B5			1 692	00
Bank	B6	22 792	00		
Inventory (1 April – previous year)	B7	69 350	00		
Purchases	N1	356 980	00		
Carriage on purchases	N2	5 480	00		
Sales	N3			686 430	00
Salaries	N4	220 810	00		
Wages	N5	10 628	00		
General expenses	N6	89 750	00		
		955 010	00	955 010	00

It was calculated that the inventory on hand on 31 March had a cost of R79 860.

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The necessary entries in the general journal to record the adjustment for closing inventory and the closing transfers are:

GENERAL JOURNAL OF INDABA DECOR **GJ12**

Day	Details	Fol.	Debit		Credit	
31/03	Inventory	B7	362 460	00		
	Purchases	N1			356 980	00
	Carriage on purchases	N2			5 480	00
	Closing transfer of purchases and related costs					
	Cost of sales	N7	351 950	00		
	Inventory	B7			351 950	00
	Transfer of cost of sales from inventory					
	Trading account	F1	351 950	00		
	Cost of sales	N7			351 950	00
	Closing transfer of cost of sales					
	Sales	N3	686 430	00		
	Trading account	F1			686 430	00
	Closing transfer of sales					
	Trading account	F1	334 480	00		
	Profit and loss account	F2			334 480	00
	Transfer of gross profit to the profit and loss account					
	Profit and loss account	F2	321 188	00		
	Salaries	N4			220 810	00
	Wages	N5			10 628	00
	General expenses	N5			89 750	00
	Closing transfers of expenses					
	Profit and loss account	F2	13 292	00		
	Capital (net profit)	B1			13 292	00
	Transfer of net profit					

Posting to the general ledger results in these accounts:

General Ledger of Indaba Decor
Real Accounts Section

Dr. **CAPITAL** **B1** Cr.

Mar.	31	Balance	c/d	250 792	00	Mar.	31	Balance	b/d	237 500	00
								Profit and loss account	GJ12	13 292	00
				250 792	00					250 792	00
						Apr.	1	Balance	b/d	250 792	00

VEHICLES **B2**

Mar.	31	Balance	b/d	168 300	00						

ACCOUNTS RECEIVABLE **B3**

Mar.	31	Balance	b/d	13 560	00						

ACCOUNTS PAYABLE **B4**

						Mar.	31	Balance	b/d	29 388	00

SARS: VAT

						Mar.	31	Balance	b/d	1 692	00

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BANK **B5**

Dr.											Cr.
Mar.	31	Balance	b/d	22 792	00						

INVENTORY **B6**

Mar.	31	Balance	c/d	69 350	00	Mar.	31	Cost of sales	GJ12	351 950	00
		Purchases	GJ12	356 980	00			Balance	c/d	79 860	00
		Carriage on purchases	GJ12	5 480	00						
				431 810	00					431 810	00
Apr.	1	Balance	b/d	79 860	00						

Nominal Accounts Section

PURCHASES **N1**

Mar.	31	Total	b/f	356 980	00	Mar.	31	Inventory	GJ12	356 980	00

CARRIAGE ON PURCHASES **N2**

Mar.	31	Total	b/f	5 480	00	Mar.	31	Inventory	GJ12	5 480	00

SALES **N3**

Mar.	31	Trading account	GJ12	686 430	00	Mar.	31	Total	b/f	686 430	00

SALARIES **N4**

Mar.	31	Total	b/f	220 810	00	Mar.	31	Profit and loss account	GJ12	220 810	00

WAGES **N5**

Mar.	31	Total	b/f	10 628	00	Mar.	31	Profit and loss account	GJ12	10 628	00

GENERAL EXPENSES **N6**

Mar.	31	Total	b/f	89 750	00	Mar.	31	Profit and loss account	GJ12	89 750	00

COST OF SALES **N7**

Mar.	31	Inventory	GJ12	351 950	00	Mar.	31	Trading account	GJ12	351 950	00

Final Accounts Section

TRADING ACCOUNT **F1**

Mar.	31	Cost of sales	GJ12	351 950	00	Mar.	31	Sales	GJ12	686 430	00
		Profit and loss account (gross profit)	GJ12	334 480	00						
				686 430	00					686 430	00

PROFIT AND LOSS ACCOUNT **F2**

Mar.	31	Salaries	GJ12	220 810	00	Mar.	31	Trading account	GJ12	334 480	00
		Wages	GJ12	10 628	00						
		General expenses	GJ12	89 750	00						
		Capital (NP)	GJ12	13 292	00						
				334 480	00					334 480	00

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The statement of profit or loss & other comprehensive income for internal use may be drafted as follows:

Indaba Decor
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MARCH 20*x*9

	Notes	20*x*9	
Sales (net)		686 430	00
Cost of sales		(351 950	00)
Gross profit		334 480	00
Operating expenses		(321 188	00)
Salaries		220 810	00
Wages		10 628	00
General expenses		89 750	00
NET PROFIT FOR THE PERIOD		13 292	00

The statement of financial position is drafted from the real accounts that remain in the general ledger after the closing transfers have been done. It may be drafted as follows:

Indaba Decor
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*9

	Notes	20*x*9	
ASSETS			
Non-current assets		168 300	00
Vehicles		168 300	00
Current assets		113 572	00
Inventories		79 860	00
Trade and other receivables		10 920	00
Cash and cash equivalents		22 792	00
TOTAL ASSETS		281 872	00
EQUITY AND LIABILITIES			
Capital and reserves		250 792	00
Capital		237 500	00
Add: Net profit for the year		13 292	00
Less: Drawings		0	00
Current liabilities		31 080	00
Trade and other payables (29 388 + 1 692)		31 080	00
TOTAL EQUITY AND LIABILITIES		281 872	00

Explanation

From the financial statements the following should be noted:

- The cost of sales includes all expenses in bringing the inventory to its present location and condition.
- The cost of sales cannot be calculated until the inventory count has taken place and costs have been assigned to the closing inventory.

You should be able to complete Questions 9.20 to 9.25.

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10 Chapter illustrative example – Perpetual inventory system

Here is the trial balance of Purr Pets (a retailer of pet products):

Purr Pets
PRE-ADJUSTMENT TRIAL BALANCE AS AT 30 APRIL 20x9

Details	Fol.	Debit		Credit	
Capital	B1			200 000	00
Equipment (net)	B2	80 000	00		
Accounts receivable	B3	3 500	00		
Accounts payable	B4			9 730	00
Bank	B5	6 980	00		
Inventory	B6	122 500	00		
Sales	N1			358 400	00
Cost of sales	N2	254 000	00		
General expenses	N3	43 790	00		
Salaries	N4	57 360	00		
		568 130	00	568 130	00

These transactions must be processed before year end:

1. Bought inventory for R9 650 before taking a trade discount of 20% on credit from Indigo Ltd.
2. Bought inventory and paid by cheque, the cost of the inventory amounted to R4 070.
3. Paid R187 for transport of inventory received.
4. Sold inventory at a cost of R720 that was marked up by 50% on credit to Mabel Gladly on credit.
5. Sold inventory that was marked up by 40% on cost and received a cheque for R1 120.
6. Mabel Gladly returned inventory that was not the flavour ordered and that had been recorded on the tax invoice at a total charge to her of R300. She was issued with a tax credit note.

You are required to:
Enter the above transactions into the general journal of Purr Pets and then post the entries to the general ledger of Purr Pets.

Before entering the transactions into the general journal, some accounts peculiar to a trading business, which appear in the trial balance require review:

- **Inventory** – This is a current asset and shows the cost price of all inventory still available for sale at the time of drafting the trial balance.
  - Included in the cost of inventory are all costs necessary to bring the inventory to its condition and location necessary for sale.
  - If an inventory count was performed on this date, inventory with a total cost of R122 500 should be on the shelves.
- **Cost of sales** – This is a nominal account that shows the cost price of all the inventory that has been sold during the financial year up to the trial balance date.
- **Sales** – This is a nominal account that shows the selling price of all the inventory that has been sold during the financial year up to trial balance date.
  - The gross profit for the year to date is easily ascertained to be R104 400, by subtracting the cost of sales to date of R254 000 from the revenue from sales to date of R358 400.
  - This shows an average mark-up on cost of 41.1% and a profit margin of 29.1%.
- **Other nominal accounts** – As this is an illustrative example with special emphasis on transactions dealing with inventory, these have been kept to a minimum. General expenses is, therefore, used as a single account in which all operating expenses, except salaries, have been debited.

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GENERAL JOURNAL OF PURR PETS — GJ12

Adj.	Details	Fol.	Debit		Credit	
1	Inventory (9 650 × 80%)	B6	7 720	00		
	Accounts payable: Indigo Ltd	B4			7 720	00
2	Inventory	B6	4 070	00		
	Bank	B5			4 070	00
3	Inventory	B6	187	00		
	Bank	B5			187	00
4	Accounts receivable: M. Gladly	B3	1 080	00		
	Sales (720 × 150 ÷ 100)	N1			1 080	00
	Cost of sales	N2	720	00		
	Inventory	B6			720	00
5	Bank	B5	1 120	00		
	Sales	N1			1 120	00
	Cost of sales (1 120 × 100 ÷ 140)	N2	800	00		
	Inventory	B6			800	00
6	Sales (returns)	N1	300	00		
	Accounts receivable: M. Gladly	B3			300	00
	Inventory (300 × [100 ÷ 150])	B6	200	00		
	Cost of sales	N2			200	00

General Ledger of Purr Pets
Real Accounts Section

Dr. **ACCOUNTS RECEIVABLE** B3 Cr.

Apr.	30	Balance	b/d	3 500	00	Apr.	30	Sales	GJ12	300	00
		Sales	GJ12	1 080	00			Balance	c/d	4 280	00
				4 580	00					4 580	00
May	1	Balance	b/d	4 280	00						

ACCOUNTS PAYABLE B4

Apr.	30	Balance	c/d	17 450	00	Apr.	30	Balance	b/d	9 730	00
								Inventory	GJ12	7 720	00
				17 450	00					17 450	00
						May	1	Balance	b/d	17 450	00

BANK B5

Apr.	30	Balance	b/d	6 980	00	Apr.	30	Inventory	GJ12	4 070	00
								Inventory	GJ12	187	00
		Sales	GJ12	1 120	00			Balance	c/d	3 843	00
				8 100	00					8 100	00
May	1	Balance	b/d	3 843	00						

Dr. **INVENTORY** B6 Cr.

Apr.	30	Balance	b/d	122 500	00	Apr.	30	Cost of sales	GJ12	720	00
		Accounts payable	GJ12	7 720	00			Cost of sales	GJ12	800	00
		Bank	GJ12	4 070	00			Balance	c/d	133 157	00
		Bank	GJ12	187	00						
		Cost of sales	GJ12	200	00						
				134 677	00					134 677	00
May	1	Balance	b/d	133 157	00						

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Nominal Accounts Section

SALES **N1**

Apr.	30	Accounts receivable	GJ12	300	00	Apr.	30	Total	b/f	358 400	00
								Accounts receivable	GJ12	1 080	00
								Bank	GJ12	1 120	00

COST OF SALES **N2**

Apr.	30	Total	b/f	254 000	00	Apr.	30	Inventory	GJ12	200	00
		Inventory	GJ12	720	00						
		Inventory	GJ12	800	00						

Year-end procedures

At financial year end, two tiers of profit are of great interest to the managers in particular, as is the quantity and cost of inventory on hand at the end of the financial period.

The managers want to be sure that the amount by which they have marked up inventory is adequate to meet the operating expenses that was incurred. In a competitive environment, companies are often severely constrained with regard to the mark-up that they can add to inventory before sales decline.

As a result, the gross profit is first calculated in the trading account. Then, the gross profit is transferred to the profit and loss account, where the procedures are identical for both inventory systems.

Purr Pets
POST-ADJUSTMENT TRIAL BALANCE AS AT 30 APRIL 20*x*9

Details	Fol.	Debit		Credit	
Real accounts					
Capital	B1			200 000	00
Equipment (net)	B2	80 000	00		
Accounts receivable	B3	4 280	00		
Accounts payable	B4			17 450	00
Bank	B5	3 843	00		
Inventory	B6	133 157	00		
Nominal accounts					
Sales	N1			360 300	00
Cost of sales	N2	255 320	00		
General expenses	N3	43 790	00		
Salaries	N4	57 360	00		
		577 750	00	577 750	00

With no further adjustments, the closing entries and financial statements will be prepared as shown on the next page.

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GENERAL JOURNAL OF PURR PETS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/04	Trading account	F1	255 320	00		
	Cost of sales	N2			255 320	00
	Sales	N1	360 300	00		
	Trading account	F1			360 300	00
	Trading account (gross profit)	F1	104 980	00		
	Profit and loss account	F2			104 980	00
	Profit and loss account	F2	101 150	00		
	General expenses	N3			43 790	00
	Salaries	N4			57 360	00
	Profit and loss account	F2	3 830	00		
	Capital (net profit)	B1			3 830	00

General Ledger of Purr Pets
Nominal Accounts Section

Dr. **SALES** **N1** **Cr.**

Apr.	30	Accounts receivable	GJ12	300	00	Apr.	30	Total	b/f	358 400	00
		Trading account	GJ12	360 300	00			Accounts receivable	GJ12	1 080	00
								Bank	GJ12	1 120	00
				360 600	00					360 600	00

COST OF SALES **N2**

Apr.	30	Total	b/f	254 000	00	Apr.	30	Inventory	GJ12	200	00
		Inventory	GJ12	720	00			Trading account	GJ12	255 320	00
		Inventory	GJ12	800	00						
				255 520	00					255 520	00

Final Accounts Section

TRADING ACCOUNT **F1**

Apr.	30	Cost of sales	GJ12	255 320	00	Apr.	30	Sales	GJ12	360 300	00
		Profit and loss account (Gross profit)	GJ12	104 980	00						
				360 300	00					360 300	00

PROFIT AND LOSS ACCOUNT **F2**

Apr.	30	Salaries	GJ12	57 360	00	Apr.	30	Trading account	GJ12	104 980	00
		General expenses	GJ12	43 790	00						
		Capital (NP)	GJ12	3 830	00						
				104 980	00					104 980	00

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Purr Pets
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 APRIL 20x9

	Notes	20x9	
Sales (net)		360 300	00
Cost of sales		(255 320	00)
Gross profit		104 980	00
Operating expenses		(101 150	00)
Salaries		57 360	00
General expenses		43 790	00
NET PROFIT FOR THE PERIOD		3 830	00

Purr Pets
STATEMENT OF FINANCIAL POSITION AS AT 30 APRIL 20x9

	Notes	20x9	
ASSETS			
Non-current assets		80 000	00
Equipment		80 000	00
Current assets		141 280	00
Inventories		133 157	00
Trade and other receivables		4 280	00
Cash and cash equivalents		3 843	00
TOTAL ASSETS		221 280	00
EQUITY AND LIABILITIES			
Capital and reserves		203 830	00
Capital		200 000	00
Add: Net profit for the year		3 830	00
Less: Drawings		0	00
Current liabilities		17 450	00
Trade and other payables		17 450	00
TOTAL EQUITY AND LIABILITIES		221 280	00

11 Chapter illustrative example – Periodic inventory system

Stacks Furnishers uses the periodic system for recording inventory movement. Goods are marked up by 25% on their cost price.

Transactions for May 20x1:

1. R100 000 was invested by the owner as capital to start her business.
2. A delivery van was bought from Hick Motors Ltd for R15 000. A cheque for the deposit of R1 500 was sent.
3. Purchased inventory that cost R10 700 and stationery that cost R140 from Credco Ltd.
4. Bought office equipment from Offquip for R2 400.
5. Cash takings from sales to 11 May 20x1 amounted to R2 180.
6. Sold inventory to L. Naidoo for R100.
7. Paid R110 for the installation of a telephone.
8. Sent Paperbacks a cheque for office equipment that cost R100 and stationery that cost R50.

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9 Further cash sales amounted to R1 300.
Received a cheque for R100 from L. Naidoo in settlement of the balance owing.
Sold inventory on credit to J. Jens for R300 and to B. Buuren for R900.
12 Sent a cheque to Hicks Motors Ltd for R2 000.
13 Sent a cheque to Stalfrets Services for R1 000 for the rental of the office.
14 Bought inventory for R500 and paid by cheque.
15 On 31 May, an inventory count revealed inventory to the value of R6 000 was on hand.

You are required to:

1 Enter the transactions into the general journal.
2 Post the entries to the general ledger.
3 Prepare the closing entries in the general journal and post to the general ledger.
4 Prepare the statement of profit or loss & other comprehensive income for the period ending 31 May 20*x*1.

GENERAL JOURNAL OF STACKS FURNISHERS **GJ1**

Day	Details	Fol.	Debit		Credit	
01/05	Bank	B5	100 000	00		
	Capital	B1			100 000	00
02/05	Vehicles	B2	15 000	00		
	Accounts payable: Hick Motors Ltd	B7			15 000	00
	Accounts payable: Hick Motors Ltd	B7	1 500	00		
	Bank	B5			1 500	00
03/05	Purchases	N2	10 700	00		
	Stationery	N3	140	00		
	Accounts payable: Credco Limited	B7			10 840	00
04/05	Equipment	B3	2 400	00		
	Accounts payable: Offquip	B7			2 400	00
05/05	Bank	B5	2 180	00		
	Sales	N1			2 180	00
06/05	Accounts receivable: L. Naidoo	B6	100	00		
	Sales	N1			100	00
07/05	Telephone	N4	110	00		
	Bank	B5			110	00
08/05	Equipment	B3	100	00		
	Stationery	N3	50	00		
	Bank	B5			150	00
09/05	Bank	B5	1 300	00		
	Sales	N1			1 300	00
	Bank	B5	100	00		
	Accounts receivable: L. Naidoo	B6			100	00
	Accounts receivable: J. Jens	B6	300	00		
	Accounts receivable: B. Buuren	B6	900	00		
	Sales	N1			1 200	00
12/05	Accounts payable: Hicks Motors Ltd	B7	2 000	00		
	Bank	B5			2 000	00
13/05	Rent expense	N5	1 000	00		
	Bank	B5			1 000	00
14/05	Purchases	N2	500	00		
	Bank	B5			500	00

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Closing entries:

GENERAL JOURNAL OF STACKS FURNISHERS GJ1

Day	Details	Fol.	Debit		Credit	
31/05	Sales	N1	4 780	00		
	Trading account	F1			4 780	00
	Inventory	B3	6 000	00		
	Trading account	F1			6 000	00
	Inventory loss	N6	1 376	00		
	Purchases	N2			1 376	00
	Trading account	F1	9 824	00		
	Purchases	N2			9 824	00
	Trading account	F1	956	00		
	Profit and loss account	F2			956	00
	Profit and loss	F2	2 676	00		
	Stationery	N3			190	00
	Telephone	N4			110	00
	Rent expense	N5			1 000	00
	Inventory loss	N6			1 376	00

General Ledger of Stacks Furnishers
Real Accounts Section

Dr. **CAPITAL B1** Cr.

						May	1	Bank	GJ1	100 000	00

VEHICLES B2

May	2	Accounts payable	GJ1	15 000	00						

EQUIPMENT B3

May	4	Accounts payable	GJ1	2 400	00	May	31	Balance	c/d	2 500	00
	8	Bank	GJ1	100	00						
				2 500	00					2 500	00
Jun.	1	Balance	b/d	2 500	00						

INVENTORY B4

May	31	Trading account	GJ1	6 000	00						

BANK B5

May	1	Capital	GJ1	6 980	00	May	2	Accounts payable	GJ1	1 500	00
	5	Sales	GJ1	2 180	00		7	Telephone	GJ1	110	00
	9	Sales	GJ1	1 300	00		8	Equipment	GJ1	100	00
								Stationery	GJ1	50	00
							12	Accounts payable	GJ1	2 000	00
							13	Rent expense	GJ1	1 000	00
							14	Purchases	GJ1	500	00
							31	Balance	c/d	99 720	00
				103 480	00					103 480	00
Jun.	1	Balance	b/d	99 720	00						

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ACCOUNTS RECEIVABLE **B6**

May	6	Sales	GJ1	100	00	May	9	Bank	GJ1	100	00
	9	Sales	GJ1	1 200	00			Balance	c/d	1 200	00
				1 300	00					1 300	00
Jun.	1	Balance	b/d	1 200	00						

ACCOUNTS PAYABLE **B7**

May	2	Bank	GJ1	1 500	00	May	2	Vehicles	GJ1	15 000	00
	12	Bank	GJ1	2 000	00		3	Sundry account	GJ1	10 840	00
	31	Balance	c/d	24 740	00		4	Equipment	GJ1	2 400	00
				28 240	00					28 240	00
						Jun.	1	Balance	b/d	24 740	00

Nominal Accounts Section

SALES **N1**

Dr.											Cr.
Apr.	30	Trading account	GJ1	4 780	00	May	5	Bank	GJ1	2 180	00
							6	Accounts receivable	GJ1	100	00
							9	Bank	GJ1	1 300	00
								Accounts receivable	GJ1	1 200	00
				4 780	00					4 780	00

PURCHASES **N2**

May	3	Accounts payable	GJ1	10 700	00	May	31	Inventory loss	GJ1	1 376	00
	14	Bank	GJ1	500	00			Trading account	GJ1	9 824	00
				11 200	00					11 200	00

STATIONERY **N3**

May	3	Accounts payable	GJ1	140	00	May	31	Profit and loss account	GJ1	190	00
	8	Bank	GJ1	50	00						
				190	00					190	00

TELEPHONE **N4**

May	7	Bank	GJ1	110	00	May	31	Profit and loss account	GJ1	110	00

RENT EXPENSE **N5**

May	13	Bank	GJ1	1 000	00	May	31	Profit and loss account	GJ1	1 000	00

INVENTORY LOSS **N6**

May	31	Purchases	GJ1	1 376	00	May	31	Profit and loss account	GJ1	1 376	00

Final Accounts Section

TRADING ACCOUNT **F1**

May	31	Purchases	GJ1	* 9 824	00	May	31	Sales	GJ1	4 780	00
		Profit and loss account (gross profit)	GJ1	** 956	00			Closing inventory	GJ1	6 000	00
				10 780	00					10 780	00

* A mark-up of 25% on cost is applied. Therefore, closing inventory should be:
Sales = 125% = R4 780 and cost = 100% = R3 824.

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Purchases	11 200	00
Less: Closing inventory	(?	00)
COST OF SALES	3 824	00

Closing inventory should have been R7 376.
Therefore, the purchases account should be credited with R1 376 (7 376 – 6 000).

** Gross profit 25%: (4 780 × 25 ÷ 125) = R956. This is confirmed by the trading account (gross profit) of R956.

PROFIT AND LOSS ACCOUNT F2

Mar.	31	Salaries	GJ1	190	00	Mar.	31	Trading account	GJ1	956	00
		Telephone	GJ1	110	00			Capital (NL)	GJ1	1 720	00
		Rent expense	GJ1	1 000	00						
		Inventory loss	GJ1	1 376	00						
				2 676	00					2 676	00

Stacks Furnishers
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MAY 20*x*1

	Notes	20*x*1	
Sales (net)		4 780	00
Cost of sales		(3 824	00)
Opening inventory		0	00
Purchases		9 824	00
Goods available for sale		9 824	00
Less: Closing inventory		(6 000	00)
Gross profit		956	00
Operating expenses		(2 676	00)
Stationery		190	00
Telephone		110	00
Rent expense		1 000	00
Inventory loss		1 376	00
NET LOSS FOR THE PERIOD		(1 720	00)

12 Summary

This chapter introduced the business that trades in inventory that are bought and sold with the aim of making a profit. Two systems of recording the purchase and sale of inventory is commonly used, that is, the perpetual inventory system and the periodic inventory system.

- In the perpetual inventory system, inventory bought and additional costs to get the inventory in a format and on the premises where they are to be sold, are entered into the cost of sales account. When sold, the inventory account is updated in addition to recording the selling price of the inventory in the revenue from sales account, thus keeping a perpetual record in the general ledger of the inventory on hand.
- In the periodic inventory system, it was seen that the entry (at time of sale) does not correctly impact on the accounting equation. However, at the end of each period the necessary correction is made after inventory count by:
  1. Closing off the initial inventory to cost of sales.
  2. Closing off the purchases to trading account.

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3 Creating the asset closing inventory by:
- Dr. Inventory
- Cr. Cost of sales.

The necessary entries for these transactions were shown using the accounting equation as the conceptual basis. An additional account, the trading account, was introduced as the final account used to calculate the gross profit, before entering other income and expense items in the profit and loss account.

The problem of different bases for determining the cost price of closing inventory was then addressed. The two bases most commonly used, that is, FIFO and weighted average, were shown. The financial results are quite clearly different, depending on the method used.

When inventory has been bought and legal ownership exists, but they have not yet arrived on the premises of the business, an adjustment is necessary to show the inventory on hand in the asset account, inventory, and the inventory not physically on hand in the asset account, inventory in transit.

Inventory losses (if found at the time of occurrence) should be claimed against insurance if a policy is in existence. The necessary entries should be recorded at the time of detecting the loss. Where inventory counts at the end of the financial period reveal inventory losses, these should be charged to the cost of sales account.

Under the periodic system of recording sales, there is no book record of what the inventory on hand at the end of the period should be. As a result, it is not possible to detect unusual inventory shortage at the end of the period, unless the business has a constant mark-up.

The information relating to financial performance is reported in the statement of profit or loss & other comprehensive income, while that relating to financial position is displayed in the statement of financial position.

QUESTIONS

Question 9.1

Explain the difference between the perpetual inventory system and the periodic inventory system.

Question 9.2

Explain the difference between a purchases account and a cost of sales account.

Question 9.3

Which accounts are used to calculate the cost of sales under the periodic system of accounting for inventory ?

Question 9.4

Provide reasons for including transport and packaging expenses in the inventory account when using the perpetual inventory system. What concepts or principles of accounting require this?

Question 9.5

Explain the difference between a mark-up on cost and profit margin.

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Question 9.6

Complete this table by filling in the missing amounts:

No.	Cost	Gross profit	Selling price
1	R100	50% mark-up	?
2	?	25% mark-up	R250
3	R300	? mark-up	R450
4	R240	20% profit margin	?
5	?	40% profit margin	R250

Question 9.7

Complete this table by filling in the missing amounts:

No.	Opening inventory	Purchases for the period	Sales for the period	Closing inventory	Gross profit	Mark-up%
1	R1 200	R8 900	R14 700	R1 100	?	?
2	R3 500	R7 300	?	R4 100	R4 200	?
3	R2 100	R10 450	R16 800	R4 700	?	?
4	R3 120	?	?	R2 350	R5 600	20
5	?	R1 370	R15 000	R2 160	R4 300	?
6	R350	R5 240	R8 380	?	R3 700	?

Question 9.8

A business sells inventory for R3 000 (which shows a discount of 10% on normal selling price).

You are required to:

1. Calculate the normal selling price.
2. Calculate the cost of inventory sold, assuming a mark-up of 50% on cost.
3. Calculate the gross profit.
4. Discuss the meaning of gross profit and net profit.

Question 9.9

A vendor bought inventory for R1 430. Expenditure of R270 was incurred to bring the inventory to the required condition for sale. The inventory was sold for R2 380.

You are required to:

1. Calculate the cost price of the inventory that is used as the basis for marking the inventory up to selling price.
2. Calculate the mark-up percentage.

Question 9.10

Wheelies (located in Bellville) bought aluminium wheelbases from Cridel Ltd (located in Johannesburg).

- Wheelies bought 300 aluminium wheelbases.
- The price of each wheelbase is R200.
- The wheelbases were delivered to Bellville by train at a total cost of R870.
- Wheelies paid R10 per wheelbase for packing material, which they decided would enhance the ability to sell the wheelbases.

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You are required to:

1 Calculate the cost price per wheelbase.
2 Calculate the selling price per wheelbase, if the mark-up percentage is 60%.

Question 9.11

Here are some selected transactions for Valley Enterprises:

- Bought inventory on credit, R1 000.
- Bought inventory for cash, R600.
- Sold inventory on credit, R300 (cost R200).
- Sold inventory for cash, R400 (cost R267).
- Assume opening inventory to be R5 000 and closing inventory to be R6 000.

You are required to:

1 Record the transactions in the general journal for both the perpetual inventory system and periodic inventory system.
2 Calculate the:
   a Gross profit for each system.
   b Gross profit as a percentage of sales under each system.
   c What is the mark-up on cost for the perpetual inventory system?

Question 9.12

These transactions are for Sekwele Tractors, a business that sells tractors to farmers in the Eastern Cape, for the period June to August 20*x*9:

1 On 1 June, Sekwele Tractors bought 12 tractors and paid R1 080 000. All the tractors were sold for cash at a total of R1 620 000 during June.
2 On 1 July, Sekwele Tractors bought a further 15 tractors at the same unit cost and sold 10 at the same mark-up as during June.
3 On 1 August, Sekwele Tractors bought a further 20 tractors, paying the same purchase price as in June and July.
4 During August, 14 tractors were sold for cash at a total of R1 764 000.

You are required to:

1 Draft a trading statement for each of the three months.
2 State these statistics for each month:
   a Gross profit.
   b Cost assigned to closing inventory.
   c Unit mark-up in rands.
   d Mark-up as a percentage of cost.
3 Explain how the accounting concepts have been applied in answering Question 1.

Question 9.13

Wonder Wholesalers buys fertiliser in bulk, packages it and supplies major nursery outlets with 10-kg bags of Wonder Lawn and Wonder Flower fertilisers.

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Wonder Wholesalers had these accounts, amongst others, in their general ledger on 15 July (two weeks into the new financial year).

Inventory	18 960	00
Sales	25 000	00
Cost of sales	20 000	00
Accounts receivable	3 600	00
Accounts payable	8 400	00
Bank	1 250	00

Transactions for July:

16 Received delivery of four tons of fertiliser and an invoice for R1 700 from Fedmis. Paid delivery charges of R200.
18 Paid R300 for plastic bags and packaging labour.
21 Sold 150 bags of Wonder Lawn to Biggs Nurseries on credit for R750. The cost was R600.
23 Biggs Nurseries returned 50 bags of Green Lawn as they claimed that the original order was for only 100 bags.
25 Sold 120 bags of Wonder Flower to Valley Nurseries for R8.50 per bag. The cost price was R7.25 per bag.

You are required to:

1. Enter the transactions into the general journal.
2. Post the transactions to the general ledger.
3. Draft the trading account as it would appear at the end of July.

Question 9.14

On 1 May 20*x*7, the assets and liabilities of Snappy Sheets, owned by John Dlomo, were:

Accounts payable	800	00
Accounts receivable	1 750	00
Bank overdraft	400	00
Petty cash	100	00
Equipment	2 000	00
Land and buildings	10 500	00
Inventory	2 100	00

Transactions for May:

3 Purchased sheets for resale and paid R1 700.
6 Sold inventory for cash, R2 300.
13 Purchased inventory for resale on credit, R1200.
16 Sold inventory on credit for R1 600.
24 Sold equipment for R360 and received a cheque for the amount.
26 Purchased furniture on credit for R600.
27 Sold inventory for cash, R1 800.

Additional information:

- Inventory on hand on 31 May, as determined by physical count was R900.
- Snappy Sheets uses the periodic system for recording inventory movements.

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You are required to:

1. Open the general ledger accounts and enter the balances on 31 May 20*x*7.
2. Record the transactions in the general journal and post to the general ledger (ignore VAT).
3. Extract a trial balance.
4. Prepare the trading statement of Snappy Sheets for the month ended 31 May 20*x*7 and the statement of financial position on that date.

Question 9.15

Koo Traders uses the periodic inventory system to account for inventory. Opening inventory at the beginning of June 20*x*6 was R3 600.

Transactions for June:

1. Bought inventory from D. Smith Manufacturers for R3 000.
2. Sold inventory to S. Franklin for R3 000 on credit.
3. Sold inventory to Bermuda Traders for R820 and received a cheque for the full amount.
4. Bought inventory from Pim Traders for R8 000 and paid by cheque.
5. S. Franklin returned inventory worth R20 as they were defective.
6. Sold inventory to J. Brown for R8 000 on credit.
7. Received an invoice for inventory bought from Ajay Manufacturers for R400.

Additional information:

- At the end of June was held and the cost of inventory on hand was R4 000 after an inventory count.
- Expenses for June (all paid by cheque) amounted to R4 200 and consisted of:
  - Stationery R80
  - Rent R2 000
  - Licences R420
  - Consumable stores R800
  - Insurance R300
  - Interest R600

You are required to:

1. Enter the transactions into the general ledger.
2. Prepare all journal entries to the general ledger (including closing entries) and prepare the trading and profit and loss accounts.
3. Prepare the statement of profit or loss & other comprehensive income for the month ended 30 June 20*x*6.

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Question 9.16

Here is the trial balance before of Leisure Gardens (garden furniture retailers):

Leisure Gardens
TRIAL BALANCE AS AT 30 SEPTEMBER 20x8

Details	Fol.	Debit		Credit	
Capital	B1			100 000	00
Equipment	B2	40 000	00		
Accounts receivable	B3	1 750	00		
Accounts payable	B4			2 375	00
Bank	B5	1 000	00		
Inventory	B6	61 250	00		
Sales	N1			179 200	00
Cost of sales	N2	127 000	00		
General expenses	N3	21 895	00		
Salaries	N4	28 680	00		
		281 575	00	281 575	00

Additional information:

1. Bought inventory that cost R4 825, before taking into account a trade discount of 20% on credit from Lumbago Ltd.
2. Bought inventory and paid by cheque, after receiving a tax invoice for R1 850.
3. Paid R170 for transport of inventory received.
4. Sold inventory at a cost of R360 that was marked up by 50% to Gladys Edwards on credit.
5. Sold inventory that was marked up by 40% and received a cheque for R560.
6. Gladys Edwards returned inventory that was the incorrect colour, and which had been recorded on the invoice at a total charge of R140. She was issued with a credit note.

You are required to:
Prepare the above transactions in the general journal of Leisure Gardens for the year ended.

Question 9.17

Ebrahim Patel is a wholesaler who uses the periodic inventory system to account for inventory.

Patel's Wholesalers
STATEMENT OF FINANCIAL POSITION AS AT 31 JANUARY 20x7

Vehicles	3 000	00	Capital	15 400	00
Equipment	2 000	00	8% loan (UBS)	5 000	00
Investment: 6% government bonds	10 000	00	Accounts payable: Rich Traders	1 700	00
Accounts receivable: P. Jones	1 000	00	Accounts payable: H. Barnes	3 200	00
Accounts receivable: D. Pick	1 500	00			
Bank	2 800	00			
Inventory	5 000	00			
	25 300	00		25 300	00

Transactions for February:

1. Bought inventory from Rich Traders for R5 000 on credit.
2. Sold inventory to D. Pick for R1 000 on credit.
   Bought land and buildings for R30 000 paying R2 000 in cash and raising a mortgage bond for the balance.

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Bought inventory from Frank's Retailers, R3 000.
Sold inventory for R8 000 to XYZ Traders and received a cheque for the full amount.
Paid wages, R1 500.

3 Sold inventory to P. Jones for R1 800.
D. Pick returned inventory that was bought on 2 February worth R20.
Purchased inventory for R1 000 cash and paid R40 for railage.

5 P. Jones returned defective inventory worth R10 and Patel's Wholesalers reimbursed him for the amount.
Bought stationery for R80 from The Bookworm Stationers and paid for it by cheque.

9 Paid H. Barnes the amount due to him.

10 Sold inventory to M & Z Traders for R5 210 and received a cheque for the amount.

11 Received a cheque from D. Pick for the full amount outstanding.

15 Bought inventory from Rich Traders R1 800 on credit.

18 Returned defective inventory worth R80 to Rich Traders.

21 Paid electricity and water account, R150.

24 Paid Rich Traders R2 000 on account.

27 Cash sales of inventory, R4 000.

28 Received interest on government inventory for February.
Paid interest on loan from United Building Society for February.
Mr Patel took R30 worth of inventory for his personal use.
Mr Patel had inventory on hand of R7 500 at the end of February.

You are required to:

1. Record the above transactions in the general journal and post to the general ledger.
2. Close off all nominal accounts and prepare the trading and profit and loss account.
3. Draft the statement of profit or loss & other comprehensive income and statement of financial position.

Question 9.18

Here are some of the balances from the books of Link Stores on 1 February 20*x*6.

Capital	B1	160 000	00
Bank	B5	8 360	00
Equipment	B8	11 000	00
Accounts receivable:			
J. Archer	ARL1	64	00
A. Clarkson	ARL2	440	00
D. de Jager	ARL3	320	00

Inventory	B9	4 860	00
Sales	N1	48 567	00
Rent income	N2	1 708	00
Accounts payable:			
ABC Traders	APL1	1 400	00
J. Dreyer & Son	APL2	639	00
Mattel & Co	APL3	168	00

Additional information:

- The pricing policy is to mark inventory up by 40% on cost, which has been done consistently to date.
- The business uses the perpetual inventory system.
- All money received is deposited immediately and all payments are made by cheque.

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Transactions for February 20x6:

1 Received a cheque from A. Poll for a storeroom sublet to him for R854 (receipt 143).
Cash sale of merchandise R964.60 (CS 321–361).
J. Archer sent a cheque in settlement of his account.
Received an account from Mattel & Co for R340 for repairs to the business's computer system (invoice 99).

4 Paid R64.80 to the postmaster for telephone (D345).
Sent a cheque to the City Treasurer for R184.70 to pay the electricity account.
Bought inventory from ABC Traders invoiced to the business at R680.
Received a cheque from A. Clarkson to settle his account on 1 February.

5 Sent a cheque to J. Dreyer & Son for R349
Inventory sold for cash R846.30 (CS 362–400).

7 Sold inventory to Archer that cost the business R150 (invoice 75).
Received an invoice from Kwikprint for letterheads printed R86.
The owner took inventory for his own use R160.30 cost price.
Issued a cheque to ABC Traders for R1 000. This was in part settlement of account.
The balance of the account was settled by ABC Traders, taking over an old delivery van for the amount due.

14 Cash sales, R1 750.14 (CS 201–223).
Issued a cheque to Lyther & Co for stationery, R46 and inventory, R382.
Sold merchandise to D. de Jager, selling price was R350.
Bought inventory from:

–	Colts Enterprises	R3 462
–	Briggs Distributors	R1 694

Donated inventory from the storeroom to the local high school for their annual fee with a cost price of R630.

19 The owner increased his capital contribution by giving his vehicle for use in the business. It was valued at R6 870.
Sold an old office printer to P. Prigg for R150 cash.
Bought merchandise from J. Dreyer & Son and paid by cheque, R300.

24 Bought petrol from Windies' Motors and paid by cheque R78.53.
Settled Mattel & Co's account in full.
Paid the wages of the business by cash cheque, R1 480.
Sent a cheque to J. Dreyer & Son to settle the amount outstanding.

28 Total of inventory sold for cash R1 965.60. Included in this amount was inventory that had been sold for R616. The selling price had been reduced by 20% because they were soiled.
Received the bank statement and noted that the following charges had been made against the business:
Service fees R44.85; and cash handling fees R36.90.

You are required to:

1 Record the above transactions in the general journal.
2 Post from the general journal to the general ledger.

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Question 9.19

Melvyn Jones uses the perpetual inventory system to record purchases and sales of inventory in his retail business, ABC Traders. He marks his inventory at cost plus 20%.

Here is the abridged statement of financial position as at 31 March 20*x*7.

ABC Traders
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*7

Inventory	40 000	00	Capital	15 000	00
Accounts receivable: A. Mays	2 500	00	6% loan (Allied Bank)	30 000	00
J. Black	3 100	00	Accounts payable: H. Smith	2 100	00
Bank	3 000	00	P. Lace	1 500	00
	48 600	00		48 600	00

Additional information:

- The term of the loan agreement is that the loan is to be repaid in five equal instalments, the first instalment starting on 31 March 20*x*7.
- Interest is payable each month, the amount is based on the capital balance outstanding at the beginning of each month.

Transactions for March (*ignore* VAT):

1 The owner increased his capital contribution by investing a further R30 000 cash.
Bought a desk, filing cabinet and printer from J. Mills and Co and paid by cheque, R3 000.
Bought inventory for R1 580 from XYZ (Pty) Ltd.
Bought a motor vehicle for cash, R10 000.
5 Sold inventory to A. Mays that cost R1 500.
Paid electricity account, R50.
Paid wages to staff, R2 000.
Sold inventory that cost R5 000 for cash.
Bought inventory from HW Supplies for R1 000.
7 Paid H. Smith the amount due to him.
8 Bought inventory from P. Lace for R98 on credit.
9 Sold inventory for cash R800.
11 Bought a motor vehicle on credit from HW Auto, R8 000.
12 Paid XYZ (Pty) Ltd the amount due.
13 Received a cheque from A. Mays in full settlement of the amount owing on 1 March 20*x*7.
14 Sold inventory to J. Black R1 500. On the same day, J. Black paid R2 000 on his account.
15 Sold a desk for R300 and received a cheque from A. Dilly for the amount.
16 Paid R3 100 for stationery bought from Faber Castell.
17 Paid rent for March R300.
21 Sold inventory that cost R2 000 to A. Mays.
26 Bought inventory on credit R50 from H. Smith.
Paid HW Suppliers for inventory bought on 5 March.
Sold inventory for cash R3 000. Included in these sales are inventory that was marked down by 10% on selling price, the selling price of these inventory being R900.
27 Paid for car licences, R150.
Paid wages to cleaning staff, R300.

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28 Paid HW Auto half the amount due to them.
Received a cheque from A. Mays for the amount owing.
Mr Jones complied with the terms of the loan agreement and paid the Allied Bank the amount due.

You are required to:

1. Record the transactions for March in the general journal.
2. Enter the opening balances in the general ledger.
3. Post all entries from the general journal to the general ledger.
4. Balance the ledger accounts.
5. Extract a trial balance as at 31 March.
6. Prepare the trading account and profit and loss account. (Show all closing entries in the general journal and post to the ledger accounts.)
7. Prepare the statement of profit or loss & other comprehensive income for the month and statement of financial position as at 31 March.

Question 9.20

Joe Bhengu uses the FIFO method to account for inventory in his retail business.

Opening inventory on 1 January 20*x*1 consists of:

40 printers	@ R300 each	12 000	00
4 photocopiers	@ R800 each	3 200	00
2 computers	@ R6 000 each	12 000	00
		27 200	00

Transactions for January:

1. Sold two printers for R450 each.
2. Bought two photocopiers for R850 each.
3. Sold one computer for R6 800.
4. Bought one photocopier for R860 and six printers for R350 each.
5. Sold four printers for R460 each.
6. Sold three photocopiers for R920 each.
7. Sold eight printers for R460 each.

At the end of the month, the market values were:

Printers	310	00
Photocopiers	820	00
Calculators	5 900	00

You are required to:

1. Calculate the total inventory on hand at the end of January 20*x*1, assuming the perpetual inventory system is used.
2. Calculate the profit and loss in respect of each sale.

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Question 9.21

Here is the post-closing trial balance of Novice Radio (who specialise in two-way radio equipment) as at 31 December 20*x*7:

Novice Radio
POST-CLOSING TRIAL BALANCE AS AT 31 DECEMBER 20*x*7

Details	Fol.	Debit		Credit	
Capital	B1			9 000	00
Inventory – 10 of model HJ2	B2	4 000	00		
Bank	B3	5 000	00		
		9 000	00	9 000	00

Novice Radio trades exclusively in expensive high-quality two-way radios.

Transactions (in chronological order) during the 20x8 financial year:

1 Sold eight of the radios on hand, at the beginning of the period, for R4 800 cash.
2 Bought five of model HJ2 at R320 each and 8 of model XL3 for R400 each.
3 Sold five of model HJ2 at R450 each and one of model XL3 for R600 on credit.
4 Bought four of model HJ2 at R340 each cash and paid an extra R40 for carriage inwards.
5 Two of the model HJ2 radios sold above were returned by dissatisfied customers.
- The owner kept one radio for his own personal use and returned the other, which was defective, to the supplier and the latter gave a cash refund.
- Both radios had been part of the beginning of period inventory on hand.

6 Bought three of model AB4 at R250 each on credit.

Additional information:

1 Novice Radio accounts for inventory using a perpetual recording system and uses the first-in-first-out (FIFO) method of valuation.
2 The demand for model HJ2 dropped towards the end of 20*x*8 because of the introduction of the more sophisticated AB4 model. On 31 December 20*x*8, the price of model HJ2 was R330.
3 A physical inventory count of radios on hand on 31 December 20*x*8 showed:
- Model HJ2 — 6 radios
- Model XL3 — 6 radios

4 The AB4 models were not delivered until mid-January 20*x*9.

You are required to:

1 Entries in the general journal to record:
- **a** Transactions 1 to 6.
- **b** Any end of period adjustments that may be necessary.
- **c** A composite closing entry.

2 Draft the inventory account in the general ledger.
3 Show how inventory should be disclosed in the business's statement of financial position as at 31 December 20*x*8.

Question 9.22

Axel Houston imports and sells replicas of nineteenth century Swiss clocks.

- Although payment for inventory imported is made with the order from NL Clocks Ltd, ownership only passes on delivery.

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- On 1 March 20*x*7, Axel has five clocks in inventory that he has recorded at a total cost of R400.
- Axel uses the perpetual inventory system for recording transactions relating to inventory, and cost of inventory is arrived at on the FIFO method.

Transactions for the year ended 28 *February* 20*x*8:

1. On 1 March 20*x*7, placed an order for 10 clocks of R70 each, for which payment was made with the order.
2. On 10 May, sold one clock on credit, R150.
3. on 1 August, the consignment ordered in March arrived. Axel paid a total of R150 for freight charges and a total of R50 for customs duty on the clocks.
4. On 20 August, sold nine clocks for R150 each on credit.
5. On 1 September, Axel placed a further order for 20 clocks. The price had now risen to R75 per clock. Payment was made with the order.
6. On 15 September, Axel took a clock from inventory that he took home and placed on the wall of his living room.
7. On 1 December, the order placed in September arrived. Axel paid a total of R320 for freight charges and a total of R120 for customs duty on the clocks.
8. On 15 December, sold 19 clocks for R180 each on credit.

   On 28 February 20*x*8, Axel found that the number of clocks on hand was the same as his records.

You are required to:

1. Prepare the journal entries required to record the transactions detailed above. (Narrations are required.)
2. Mr Houston is considering changing his accounting policy to the weighted-average method. Calculate the cost of sales for the year ended at 28 February 20*x*8 under each of the two methods.

Question 9.23

Khumalo Retailers buys and sells two inventory items: Rio and Lima.

- Inventory movements are recorded on a computerised perpetual system on a first-in-first-out (FIFO) method, at the lower of cost and net realisable value.
- On 30 September 20*x*5, part of the inventory of Khumalo Retailers was destroyed by fire. The loss of inventory was insured for R43 280 by a policy that contained the average clause.
- The business's financial year ended on 31 December 20*x*5.

Additional information:

Rio

1. A consistent mark-up of 25% on cost has always been applied when determining selling prices.
2. 30 units of Rio were not destroyed during the fire.
3. Inventory records are updated when invoices are received from suppliers.

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4 An extract from the inventory records:

Purchases	Sales		Balance	
26 September 20x5	20 × R65 = 1 300	00	45 × R45 = 2 025	00
			60 × R60 = 3 600	00
			20 × R65 = 1 300	00
27 September 20x5	25 × R45 = 1 125	00	20 × R45 = 900	00
	60 × R60 = 3 600	00	20 × R65 = 1 300	00
30 September 20x5	25 × R65 = 1 625	00	20 × R45 = 900	00
	20 × R65 = 1 300	00		
	25 × R65 = 1 625	00		

5 On 30 September, inventory of 15 units at a cost of R60 was received. The invoice was received on 3 October 20*x*5.

6 On 1 October, inventory bought on 26 September 20*x*5 was received.

7 On 1 October, the market price for Rio fell to R48. Selling expenses were estimated at R2 per unit.

Lima

1 A consistent mark-up of 25% on cost applied from 1 January 20*x*5 to 30 May 20*x*5, when it was increased to 33.33% on cost.

2 The inventory records of Lima were destroyed shortly before the fire due to a computer malfunction.

3 Sales from the accounts receivable journal, consists of:

– 1 January to 31 May 20*x*5 R80 000
– 1 June to 30 September 20*x*5 R105 000
– 1 October to 31 December 20*x*5 R95 000

4 Included in the sales total was a discount of 15% on normal revenue for these sales amounts:

– April 20*x*5 R4 250
– June 20*x*5 R8 000
– September 20*x*5 R3 900

5 Inventory that cost R3 075 was not destroyed during the fire.

6 Opening inventory at 1 January 20*x*5 was R32 000 and purchases from 1 January 20*x*5 to 30 September 20*x*5 was R160 000.

You are required to:

1 Calculate the amount that can be claimed from the insurance business in respect of the cost of inventory destroyed by the fire.

2 Journalise all the required adjusting journal entries to correct the general ledger. (Narrations are not required.)

Question 9.24

Brenda Folser's accounts, for some years past, show that the percentage of gross profit to turnover is constant.

On 23 February 20*x*6, Brenda's shop was burnt down, and all the inventory was destroyed.

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These figures are extracted from her books:

Inventory on hand at 1 January 20*x*5	96 000	00
Purchases to 31 December 20*x*5	372 000	00
Import duty on 31 December 20*x*5	74 400	00
Railage inwards to 31 December 20*x*5	97 800	00
Sales to 31 December 20*x*5	682 500	00
Purchases to 23 February 20*x*6	123 000	00
Inventory on hand as at 31 December 20*x*5	94 200	00
Import duty to 23 February 20*x*6	18 900	00
Railage inwards to 23 February 20*x*6	24 300	00
Sales to 23 February 20*x*6	195 000	00

At the date of the fire there was inventory at the harbour, imported at a landed cost of R6 600. All other inventory bought had been received.

You are required to:
Draw up a statement to calculate the amount of inventory lost as a result of the fire.

Question 9.25

P&R Traders uses the periodic inventory system to account for inventory. These balances appeared in the trial balance as at 1 January 20*x*7:

Inventory	4 000	00
Accounts receivable	14 000	00
Accounts payable	7 000	00
Capital	22 000	00
Bank	5 200	00
Drawings	800	00
Vehicles	5 000	00

Additional information:

1 On 30 June, a fire destroyed most of the inventory on hand. R3 100 of the inventory was salvaged from the fire.

2 Sales for the year ended 31 December 20*x*7 were R32 000.

3 The business marks up its inventory at 20% on cost.

4 Purchases up to 30 June 20*x*7 were R20 000, and for the next 6 months' purchases were R15 000.

5 Sales for each month was R2 500, except for June when an increase in sales happened because of an excellent advertising campaign.

6 On 31 December, closing inventory was R12 300.

You are required to:

1 Calculate the inventory loss on 30 June 20*x*7.

2 Calculate the gross profit for the year ended 31 December 20*x*7.

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10 VALUE-ADDED TAX (VAT)

Chapter objectives

By the end of this chapter, you should be able to:

- Define value-added tax (VAT).
- Distinguish between the different types of VAT.
- Calculate VAT.
- Apply the VAT principles for the recording of goods bought and sold, as well as services rendered.
- Calculate VAT due from or payable to the South African Revenue Service (SARS).

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1 Introduction

In Chapter 9, you learnt the accounting procedures for a trading business, that is, the buying and selling of goods. This section builds on the experience gained in the previous chapter and requires a thorough understanding of the accounting model and the various procedures previously developed.

This chapter will focus specifically on value-added tax (VAT) and the implications thereof in a South African context. It is necessary to understand the principles underlying this form of indirect taxation and to be able to apply the accounting system that accommodates the collection and payment of VAT.

Value-added tax (VAT) is a form of taxation that is part of the government's fiscal policy. It is a comprehensive tax that is levied on virtually all goods and services with a few exceptions. VAT is an indirect tax that came into effect on 30 September 1991.

When we look at taxation in general, we consider that tax is charged on the income/salary/profit received by either an employee or an employer during a certain period. VAT, however, is considered to be an indirect tax since it is not charged directly by the SARS, but charged as a tax on goods or services (transactions).

Any individual or form of ownership (as discussed in Chapter 1) is required to register as a VAT vendor with the South African Revenue Service (SARS) as soon as the income from sales/services exceeds R1 000 000 for a 12-month period. If income from sales or services is less than R1 000 000, then registration as a VAT vendor is voluntary.

VAT is a tax that is levied whenever a product is sold or service is rendered. VAT is levied on the amount received from the supplier of goods or services by any vendor made in the course of running any business. It is often stated that VAT is charged on a supply of goods or services at a predetermined rate. This predetermined rate has been at 14% for a number of years now and is not expected to change in the next few years.

VAT consists of two components:

1 VAT output.

2 VAT input.

Reminder

The business acts as the agent for the SARS by collecting VAT on all sales. The business also pays VAT on most goods and services. At the end of a specified period, the business then pays the difference between the VAT output and the VAT input to the SARS.

2 VAT output

VAT output is the VAT charged on the supply of goods or services by a registered VAT vendor. Where VAT output is charged, these goods will be referred to as taxable supplies. Taxable supplies can further be divided into standard rated or zero-rated supplies.

- VAT on zero-rated supplies is levied at 0%.
- VAT on standard rated supplies on goods or services are levied at 14%. Thus, if a vendor decides to sell goods (standard rated) for R1 140, the VAT output will be R140. The R140 would be calculated like this:

$$R1\,140 \times 14 \div 114 = R140$$

The registered vendor is responsible for paying VAT to the SARS. Thus, if the above transaction was the only transaction in the VAT period, the vendor will be responsible for paying over an amount of R140 to the SARS as the VAT output for the period.

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3 VAT input

VAT input is the VAT charged on the purchase price of the goods or services supplied to the vendor. On transactions supplied to the vendor, a VAT amount would have been included in the purchase price. This VAT amount can be claimed back from the SARS as the VAT input incurred.

As in the case of VAT output, these goods or services will either be supplied at 14% or 0%. Let's assume that the vendor bought goods for R570, the VAT input would be calculated like this:

$$R570 \times 14 \div 114 = R70$$

The vendor should, therefore, be able to claim VAT of R70 from the SARS. However, if there was any VAT output payable, the VAT input that may be claimed by the vendor is set off against the VAT output. (Consider the examples under output and VAT input above.)

If these two transactions occurred in the same period, the vendor will not claim the R70. The vendor will pay over an amount of R70 to the SARS, this being the difference between the input and the VAT output.

The R140 will, therefore, be set off against the R70, thus ensuring that only the difference is paid to the SARS.

4 VAT returns

In each VAT period, the vendor has to account for either the VAT receivable or the VAT payable. The amount payable (VAT output is more than VAT input) or amount receivable (VAT input is more than VAT output) will be shown on the VAT return.

A VAT return will distinguish between them as follows:

VAT output (in the current VAT period)		
Standard rated supplies of 14%	x xxx	
Zero-rated supplies of 0%	xxx	
	xxx	
Less: VAT input (in the current VAT period)	(xxx)	
VAT PAYABLE OR RECEIVABLE FOR THE PERIOD	xxx	

5 Tax/VAT periods

Many assume that VAT is paid on a monthly basis when it is actually dependent on the VAT period that the vendor falls into. The category that a vendor falls into is based on the amount of income that is generated in a specific period.

Currently there are six different categories starting from Category A and ending with Category F. The period or category will determine when the VAT return is due.

Regardless of the period, the VAT amount due will always be payable on the 25th day of the month following the end of the relevant period.

Where VAT is receivable, the VAT return will firstly have to be supplied to the SARS. The SARS will then pay the amount receivable into the bank account.

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6 Value and consideration for supply

The VAT Act refers to both the value and the consideration received of a supply. The value of the supply excludes the VAT amount, whereas the consideration amount includes the VAT on the supply.

Example 10.1

Purchased a new desk from Notabe Suppliers that cost R1 710.

The consideration would, therefore, be R1 710, while the value of the desk would be R1 500 (1 710 × 100 ÷ 114). You should notice the change in the ratio.

When we calculated VAT, we used the ratio 14 ÷ 114. However, to calculate the value from the consideration figure, we use 100 ÷ 114.

7 VAT input may be prohibited

In certain cases, a vendor may be prohibited from claiming the VAT input on specific items. These items include VAT incurred on some entertainment, as well as on the purchase of certain vehicles.

This also means that if a vendor makes only exempt supplies,they may not be able to claim the VAT input incurred against those supplies.

This is very different when we consider zero-rated supplies. When it comes to zero-rated supplies, VAT is levied at zero percent, thus resulting in the same net effect as a vendor making exempt supplies.

However, zero-rated supplies do not restrict the vendor from claiming the VAT input incurred even though they are not paying VAT output. Zero-rated supplies will include the supply of milk, brown bread and fuel.

However, exempt supplies include certain financial services such as interest income, interest expense and loans payable or receivable. Salaries or wages are also considered an exempt supply.

A comprehensive discussion on zero-rated and exempt supplies is beyond the scope of this book.

Example 10.2

Consideration and value

Mazima Stores of Benoni bought sunglasses from East London. The invoice price of each pair is R22.80 (VAT incl.) and a total of 2 000 pairs of sunglasses were bought.

Consideration
R(22.80 × 2 000) = R45 600

Value
R(22.80 × 2 000) × 100 ÷ 114 = R40 000

The VAT calculation will, therefore, be:
R(22.80 × 2 000) × 14 ÷ 114 = R5 600

8 Recording purchases of goods for resale including VAT

Example 10.3

- On 1 January 20*x*1, Sales Extreme bought goods and paid with cheque 1234, R5 700 (cost R5 000 + R700 VAT).
- The business then paid R1 140 (1 000 + 140 VAT) for delivery charges with cheque 1235.

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Perpetual inventory system

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Inventory (5 700 × 100 ÷ 114)	B6	5 000	00		
	VAT input (5 700 × 14 ÷ 114)	B9	700	00		
	Bank	B7			5 700	00
	Inventory bought and paid for by cheque					
	Inventory (1 140 × 100 ÷ 114)	B6	1 000	00		
	VAT input (1 140 × 100 ÷ 114)	B9	140	00		
	Bank	B7			1 140	00
	Paid delivery costs by cheque					

Periodic inventory system

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
	Purchases (5 700 × 100 ÷ 114)	N2	5 000	00		
	VAT input (5 700 × 14 ÷ 114)	B9	700	00		
	Bank	B7			5 700	00
	Purchased goods and paid by cheque					
	Carriage on purchases (1 140 × 100 ÷ 114)	N3	1 000	00		
	VAT input (1 140 × 100 ÷ 114)	B9	140	00		
	Bank	B7			1 140	00
	Paid carriage on purchases by cheque					

Dealing with discounts

When a supplier offers a settlement discount, we need to consider the implications of this with regard to VAT. From the previous chapter, you would have noted that we have both trade discounts, as well as settlement discounts.

The following examples deal primarily with settlement discounts.

Example 10.4

On 1 January, Sales Extreme bought goods on credit from Credit Management for R11 400. Credit Management offers an early settlement discount of 5% to customers who settle their accounts within 30 days.

There are four different ways of recording this transaction, if we have to assume that:

1. It is probable that we will take advantage of the discount.
2. It is probable that we will not take advantage of the discount.
3. If we do not take advantage of the discount as was originally expected.
4. If we take advantage of the discount that we did not originally expect to take.

1 *It is probable that we will take advantage of the discount*:

The purchase price will be recorded less the discount. The entry on the purchase date will be:

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Inventory (11 400 × 100 ÷ 114 × 95 ÷ 100)	B6	9 500	00		
	VAT input (11 4000 × 14 ÷ 114 × 95 ÷ 100)	B9	1 330	00		
	Accounts payable	B12			10 830	00

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When we make the payment:

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
31/01	Accounts payable	B12	10 830	00		
	Bank	B7			10 830	00

2 *It is probable that we will not take advantage of the discount*:

The entry on the purchase date will be:

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Inventory (11 400 × 100 ÷ 114)	B6	10 000	00		
	VAT input (10 400 × 14 ÷ 114)	B9	1 400	00		
	Accounts payable	B12			11 400	00

When we make the payment:

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
31/01	Accounts payable	B12	11 400	00		
	Bank	B7			11 400	00

3 *If we do not take advantage of the discount as was originally expected*:

Consider the first two methods used above. If we do not take the discount as was expected, this entry would be completed when we pay (not as expected):

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
31/01	Accounts payable	B12	10 830	00		
	Interest expense	N15	500	00		
	VAT input (11 400 – 10 830) × 14 ÷ 114	B9	70	00		
	Bank	B7			11 400	00

4 *If we take advantage of the discount that we did not originally expect to take*:

When we make the payment:

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
31/01	Accounts payable	B12	11 400	00		
	Bank	B7			10 830	00
	Interest income	N16			500	00
	VAT input (11 400 – 10 830) × 14 ÷ 114	B9			70	00

You should be able to complete Questions 10.1 to 10.6.

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9 Recording the sale of goods

Example 10.5 Mazima Stores of Benoni uses the perpetual inventory system and marks all goods up 50% on cost. On 1 June, goods were invoiced to Kallies Retailers (invoice 321) for R8 550.

Perpetual

GENERAL JOURNAL OF MAZIMA STORES OF BENONI GJ6

Day	Details	Fol.	Debit		Credit	
01/06	Accounts receivable	B8	8 550	00		
	Sales (8 550 × 100 ÷ 114)	N1			7 500	00
	VAT output (8 550 × 14 ÷ 114)	B10			1 050	00
	Cost of sales (7 500 × 100 ÷ 150)	N2	5 000	00		
	Inventory	B7			5 000	00
	Goods sold on credit to Kallies Retailers					

Explanation

It should be noted that the VAT calculation is done before adding the mark-up to calculate the cost of sales amount.

At the beginning of the chapter, we said that VAT is charged on the supply of goods or services. The first entry (supply) is the sales transaction. Therefore, VAT has been taken into account in the first entry.

The second entry is the adjustment to system to ensure that the inventory sold is removed from the business records.

Periodic

If the transaction had been completed using the periodic method, this entry would have been made:

GENERAL JOURNAL OF MAZIMA STORES OF BENONI GJ6

Day	Details	Fol.	Debit		Credit	
01/06	Accounts receivable	B8	8 550	00		
	Sales (8 550 × 100 ÷ 114)	N1			7 500	00
	VAT output (8 550 × 14 ÷ 114)	B10			1 050	00
	Goods sold on credit to Kallies Retailers					

Explanation

The first part of the entry would have been the same, while the cost of sales adjustment would only have been made at year end. Refer to Chapter 9 for the difference in recording goods sold under perpetual and periodic.

VAT on services rendered transactions

Example 10.6 On 1 June, invoiced Gibbies Retailers (invoice 321) for R1 710 for painting services rendered.

GENERAL JOURNAL OF MAZIMA STORES OF BENONI GJ1

Day	Details	Fol.	Debit		Credit	
01/06	Accounts receivable: Gibbies Retailers	B8	1 710	00		
	Services rendered (1 710 × 100 ÷ 114)	N1			1 500	00
	VAT output (1 710 × 14 ÷ 114)	B10			210	00
	Rendered services on credit to Gibbies Retailers					

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VAT on bad debts written off

While the writing off of a bad debt is not a supply of goods or services, the SARS will allow the vendor to account for VAT input. This means that the vendor will be able to claim an amount from the SARS that relates to the bad debt.

Consider Example 10.5. If the amount was irrecoverable or written off, the SARS allows the VAT input amount to be claimed back, as the VAT output would have been payable on the previous supply.

Example 10.7

This example takes into account the accounts receivable information in Example 10.6. However, now assume that the balance is either completely or partially irrecoverable.

Case 1 – *If we assume that the entire amount is written off.*

GENERAL JOURNAL OF MAZIMA STORES OF BENONI **GJ7**

Day	Details	Fol.	Debit		Credit	
01/07	Bad debts (1 710 × 100 ÷ 114)	N16	1 500	00		
	VAT input (1 710 × 14 ÷ 114)	B10	210	00		
	Accounts receivable	B8			1 710	00

Case 2 – *If we assume that 50% of the balance is received in cash and the rest is written off.*

GENERAL JOURNAL OF MAZIMA STORES OF BENONI **GJ7**

Day	Details	Fol.	Debit		Credit	
01/07	Bank	B6	855	00		
	Bad debts (855 × 100 ÷ 114)	N16	750	00		
	VAT input (855 × 14 ÷ 114)	B10	105	00		
	Accounts receivable	B8			1 710	00

Explanation

Both Case 1 and 2 relate to bad debts written off. However, it is clear they are each treated differently.

- In Case 1, the entire amount is written off, therefore, the VAT will be claimed on the balance.
- In Case 2, on the other hand, only 50% of the outstanding balance must be written off. Thus, we first account for the receipt of 50%, and then we account for the part that is irrecoverable.

The ratio for VAT remains the same when we calculate the actual value of the bad debt.

VAT on expenses

Example 10.8

Sales Extreme made the following EFT payments related to expenses:

Rent expense	R3 420	00
Insurance expense	R2 850	00
Salaries	R2 280	00
Interest expense	R1 140	00
Fuel expenses	R570	00
Bank charges	R342	00

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You are required to:

Prepare the general journal of Extreme Sales for January.

GENERAL JOURNAL OF SALES EXTREME **GJ1**

Day	Details	Fol.	Debit		Credit	
31/01	Rent expense (3 420 × 100 ÷ 114)	N4	3 000	00		
	VAT input (3 420 × 14 ÷ 114)	B9	420	00		
	Bank	B7			3 420	00
	Insurance (2 850 × 100 ÷ 114)	N11	2 500	00		
	VAT input (2 850 × 14 ÷ 114)	B9	350	00		
	Bank	B7			2 850	00
	Salaries (Note 1)	N12	2 280	00		
	Bank	B7			2 280	00
	Interest expense (Note 2)	N13	1 140	00		
	Bank	B7			1 140	00
	Fuel costs (Note 3)	N14	570	00		
	Bank	B7			570	00
	Bank charges (285 × 100 ÷ 114) (Note 4)	N15	250	00		
	VAT input (285 × 14 ÷ 114)	B9	35	00		
	Bank	B7			285	00

Explanation

1 **Salaries and wages** are considered to be an exempt supply, therefore, no VAT is charged on this transaction.

2 **Interest expense** forms part of financial services. According to the VAT Act, these services are exempt from VAT.

3 Fuel is considered to be a zero-rated supply. According to the VAT Act, VAT is calculated at 0% on this transaction.

4 This transaction tends to confuse people, as the VAT Act states that financial services are VAT exempt. However, bank charges are a service provided by a bank and VAT is charged on the supply of goods or services.

You should be able to complete Questions 10.7 to 10.10.

10 Important issues when preparing the statement of profit or loss & other comprehensive income

When preparing the statement of profit or loss & other comprehensive income it is important to understand the difference between the value of an item or transaction and the consideration. As stated before, the value is the VAT exclusive amount, while the consideration is the VAT inclusive amount.

If we consider the rent transaction in Example 10.8, the value of the rent expense would be R3 000, while the consideration amount would be R3 420.

When preparing the statement of profit or loss & other comprehensive income, we use the value amount of expenses or income and never the consideration received amount.

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Example 10.9 If we were to prepare the statement of profit or loss & other comprehensive income for Example 10.8, it would appear as shown below:

Sales Extreme
ABRIDGED STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 JANUARY 20*x*1

	Notes	20*x*1	
Sales (net)		xxx xxx	
Cost of sales		xx xxx	
Gross profit		xx xxx	
Operating expenses		(9 790	00)
Rent expense		3 000	00
Insurance		2 500	00
Salaries		2 280	00
Interest expense		1 140	00
Fuel costs		570	00
Bank charges		250	00
NET PROFIT FOR THE YEAR		xx xxx	

11 Important issues when preparing the VAT control account

When preparing the VAT control account it is important to note that the amounts that make up the account (whether debit or credit side), will be the difference between the consideration amount and the value.

The VAT control account can either have a debit or credit balance, whether it be the opening or the closing balance. This depends on whether the amount is payable or receivable.

- When an amount is payable, it is considered a liability. This means that the balance will be on the credit side.
- When an amount is receivable, it is considered to be an asset. This will result in the balance being on the debit side since it is considered to be an asset.

You should be able to complete Questions 10.11 to 10.16.

12 Chapter illustrative example

After the recent municipal elections, the City of Cape Town started a new project called CLEAN THE CITY. This project entailed issuing residents across the city with new rubbish bins, as well as cleaning the rubbish bins weekly to rid the city of the flies and other vermin.

The City of Cape Town started a tender process for a rubbish bin supplier, as well as the weekly maintenance of the bins. Barry Lin was successful in winning the tender and immediately registered the business as CA'Bin Suppliers and Cleaners.

The business was successfully registered for VAT. Barry uses the perpetual system to account for inventory purchases along with the first-in-first-out method to account for inventory movement.

Additional information:

1 Bins will be delivered to Cape Town residents on behalf of the City by CA'Bin Suppliers and Cleaners. However, the residents will not have to pay for the bins as Bin Suppliers and Cleaners

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will invoice the City of Cape Town. The same principle will apply to the maintenance/cleaning of the rubbish bins.

Note: The City of Cape Town has two different departments dealing with expenses incurred. The one department deals with expenses relating to the rubbish bins, while the other deals with expenses incurred for the cleaning of the rubbish bins. Any communication with regard to monthly statements to the City should consider the above.

2 All amounts are VAT inclusive, unless otherwise stated and all parties below are registered VAT vendors unless otherwise stated.

Transactions for January (first month of trading):

2 Invested an amount of R92 000 in the business.

Purchased 22 000 rubbish bins from Bin Craze at R57/rubbish bin on credit.

Incurred delivery expenses on rubbish bins from Bin Craze and issued cheque 001, R11 000. The rubbish bins were delivered by DLB who is not registered for VAT.

Purchased cleaning materials from Pick ´n Pay Warehouse and issued cheque 002, R11 400.

Purchased a new truck that cost R171 000. A deposit of R17 100 was paid, with the balance payable over a 5-year period.

3 Paid the rent for the month, R1 710

6 The business delivered 13 500 rubbish bins to residents in the Cape Town Area.

9 Purchased equipment from Pro Offices for R11 400 and issued cheque 003.

Purchased a computer on credit from Incredible PCs, R5 700.

13 Income from cleaning rubbish bins was invoiced to the City of Cape Town, R57 000.

18 Purchased 32 000 new rubbish bins from Bin Craze on credit.

- Received a trade discount of 10% on the original cost of the bins, as more than 25 000 rubbish bins were bought.
- No delivery costs were incurred, as delivery costs are only incurred on purchases of less than 25 000 bins.

20 The business delivered 14 500 rubbish bins to residents in the Cape Town Area.

27 Income from cleaning bins was invoiced to the City of Cape Town, R83 000.

Paid Bin Craze 95% of the outstanding debt.

Received 50% of the income outstanding for selling rubbish bins from the City of Cape Town.

Received 95% of the income for cleaning services from the City of Cape Town.

30 Incurred bank charges of R285.

After an inventory count, it was noted that 500 rubbish bins had been taken from the premises without being recorded. It was later found that a syndicate was stealing rubbish bins and selling them to residents outside the Western Cape area.

The monthly insurance was paid by debit order, R342.

Paid the fuel expense for the month, R570.

You are required to:

1 Prepare the above entries to the general journal for the period ending 31 January 20*x*1.

2 Prepare the VAT control account as at 31 January 20*x*1.

3 Prepare the statement of profit or loss & comprehensive income for the period ending 31 January 20*x*1.

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GENERAL JOURNAL OF CA'BIN SUPPLIERS AND CLEANERS GJ1

Day	Details	Fol.	Debit		Credit	
02/01	Bank	B7	92 000	00		
	Capital	B1			92 000	00
	Inventory (50 × 22 000)	B8	1 100 000	00		
	VAT input	B9	154 000	00		
	Accounts payable	B5			1 254 000	00
	Inventory (non-vendor)	B8	11 000	00		
	Bank	B7			11 000	00
	Cleaning materials	N4	10 000	00		
	VAT input	B9	1 400	00		
	Bank	B7			11 400	00
	Vehicles	B3	150 000	00		
	VAT input	B9	21 000	00		
	Accounts payable	B5			153 900	00
	Bank	B7			17 100	00
03/01	Rent expense	N5	1 500	00		
	VAT input	B9	210	00		
	Bank	B7			1 710	00
06/01	Accounts receivable – sale of bins	B6	1 165 792	50		
	Sales (50.50 × 150 ÷ 100) × 13 500	N1			1 022 625	00
	VAT output	B10			143 167	50
	Cost of a bin (57 × 100 ÷ 114) = R50					
	Includes a 50c delivery charge/bin (11 000 ÷ 22 000 = 0.50)					
	Cost of sales (50.50 × 13 500)	N2	681 750	00		
	Inventory	B8			681 750	00
09/01	Equipment	B4	10 000	00		
	VAT input	B9	1 400	00		
	Bank	B7			11 400	00
	Equipment	B4	5 000	00		
	VAT input	B9	700	00		
	Accounts payable	B5			5 700	00
13/01	Accounts receivable – cleaning of bins	B6	57 000	00		
	Services rendered	N3			50 000	00
	VAT output	B10			7 000	00
18/01	Inventory (45 × 32 000)	B8	1 440 000	00		
	VAT input (1 440 000 × 14%)	B9	201 600	00		
	Accounts payable	B5			1 641 600	00
20/01	Accounts receivable	B6	1 195 717	50		
	Sales [(50.50 × 8 500) + (45 × 6 000)] × 150 ÷ 100	N1			1 048 875	00
	VAT output	B10			146 842	50
	Cost of a new bin (57 × 100 ÷ 114) = R50 × 90% = R45					
	Excludes delivery charges					
	Cost of sales [(50.50 × 8 500) + (45 × 6 000)]	N2	699 250	00		
	Inventory	B8			699 250	00
27/01	Accounts receivable	B6	83 000	00		
	Services rendered	N3			72 807	02
	VAT output	B10			10 192	98

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	Accounts payable	B5	2 750 820	00		
	Bank (1 254 000 + 1 641 600) x 95%	B7			2 750 820	00
	Bank (1 165 792.50 + 1 195 717.5) x 50%	B7	1 180 755	00		
	Accounts receivable	B6			1 180 755	00
	Bank (57 000 + 83 000) x 95%	B7	133 000	00		
	Accounts receivable	B6			133 000	00
30/01	Bank charges	N6	250	00		
	VAT input	B9	35	00		
	Bank	B7			285	00
	Cost of sales (theft) (500 × 45)	N2	22 500	00		
	Inventory	B8			22 500	00
	Insurance	N7	300	00		
	VAT input	B9	42	00		
	Bank	B7			342	00
	Fuel costs	N8	570	00		
	Bank	B7			570	00

General Ledger of CA'Bin Suppliers and Cleaners
Real Accounts Section

Dr. **VAT CONTROL** **B11** **Cr.**

Jan.	31	Inventory	GJ1	154 000	00	Jan.	31	Services rendered	GJ1	10 192	98
		Cleaning materials	GJ1	1 400	00			Services rendered	GJ1	7 000	00
		Vehicles	GJ1	21 000	00			Sales	GJ1	146 842	50
		Rent	GJ1	210	00			Sales	GJ1	143 167	50
		Equipment	GJ1	1 400	00			Balance	c/d	73 184	02
		Equipment	GJ1	700	00						
		Inventory	GJ1	201 600	00						
		Bank charges	GJ1	35	00						
		Insurance	GJ1	42	00						
				380 387	00					380 387	00
Feb.	1	Balance	b/d	73 184	02						

CA'Bin Suppliers and Cleaners
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 JANUARY 20x1

	Notes	20x1	
Sales (net)		2 071 500	00
Cost of sales		(1 403 500	00)
Gross profit		668 000	00
Other income		122 807	02
Services rendered		122 807	02
Gross income		790 807	02
Operating expenses		(12 620	00)
Rent expense		1 500	00
Cleaning materials		10 000	00
Bank charges		250	00
Fuel costs		570	00
Insurance		300	00
NET PROFIT FOR THE YEAR		778 187	02

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13 Summary

This chapter introduced the concept of value-added tax (VAT), as well as the application of VAT in practice.

Under the present system, VAT vendors are required to pay VAT on goods and services received and to levy VAT on goods and services provided.

The difference between VAT input paid and VAT output collected is sent to the South African Revenue Service (SARS).

The current VAT rate in South Africa is 14%.

QUESTIONS

Question 10.1

Goods or services may be subject to VAT. Explain the purpose of VAT.

Question 10.2

Explain the role that a retailer plays in the collection of VAT.

Question 10.3

1. Provide a brief explanation of why VAT is referred to as an indirect tax.
2. Name the two components that make up VAT, and provide a brief explanation of them.
3. Name and explain the two components that make up taxable supplies. Highlight the differences between them.
4. Explain the difference between the value and the consideration amount of goods bought or sold.
5. VAT input may be prohibited in certain instances. Provide examples of these items.

Question 10.4

Fraser Stores Ltd marks its goods up by 20% on cost. If the company received R2 280 for certain goods sold, calculate the:

1. VAT output amount.
2. Cost of the goods sold.

Question 10.5

This table gives the rand amounts for various sales, all of which are subject to VAT at 14%. Complete the table by filling in the missing figures:

Cost price	% mark-up on cost	Selling price	VAT	Marked price
R100	50%	?	?	?
?	40%	?	?	R399
R280	?	R364	?	?
?	25%	?	R28	?

Question 10.6

Footlite Limes marks its goods up by 50%. The business sells an item of inventory for R3 000, which represents a discount of 10% on normal selling price before VAT.

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You are required to:

1. Calculate the VAT payable if inventory is sold at the usual price.
2. Calculate the normal selling price.
3. Calculate the cost of goods sold.
4. Calculate the gross profit.
5. Discuss the meaning of gross profit and net profit.

Question 10.7

A vendor bought goods for R1 630.20 (VAT incl.).

- Expenditure of R307.80 (VAT incl.) was incurred in order to bring the goods to the required condition for sale.
- The goods were sold for R2 713.20 (VAT incl.).

You are required to:

1. Calculate the cost price of the goods that is, used as the basis for marking the system up to selling price.
2. Calculate the mark-up percentage.
3. Calculate the net liability for VAT as a result of the sale of these goods.

Question 10.8

In each case, calculate the answer if VAT is payable on all items at 14%.

1. A cash slip for R171 is issued and the mark-up is 25%. Find the cost price.
2. Goods cost R296.40. Transport of R11.40 and additional packaging of R17.10 were spent on these goods.
   – The goods are sold at a gross profit of 30% on cost.
   – What does the customer pay at the till?
3. A retailer wishes to achieve a gross margin of 25%. If goods cost R1 125 (VAT excl.), what will the customer pay at the till?

Question 10.9

Wheelies of Bellville bought aluminium wheelbases from Cridel Ltd in Johannesburg.

- The price of each wheelbase, of which 300 were bought, is R228.
- The aluminium wheelbases were railed to Bellville at a total cost of R991.80.
- Wheelies paid R11.40 per wheelbase for packing material, which they decided would make the wheelbases sell better.
- VAT at 14% is included in the cost of all of the specified goods and services.

You are required to:

1. Calculate the cost price per wheelbase.
2. Calculate the selling price per wheelbase, if the mark-up percentage is 60%.
3. Calculate the marked price of each wheelbase (VAT incl.).
4. Calculate the net liability to the SARS for VAT if all the wheelbases are sold.

Question 10.10

Laser Stores uses the perpetual inventory system to account for goods.

- They mark their goods up by 25% on cost.

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- VAT is charged at 14%.
- Laser Stores sold goods to the value of R3 078.

You are required to:

1 **a** Calculate the VAT output amount.
   b Calculate the cost of goods sold.

2 Use the information, but assume that the R3 078 represents sales at a 10% discount on selling price.
   a Calculate VAT payable.
   b Calculate the normal marked price.
   c Calculate the cost of goods sold.
   d Calculate the gross profit on these goods.

Question 10.11

Lumber Enterprises had these balances on 1 April 20*x*7:

Capital	30 000	00
Cash at bank	16 000	00
Inventory at cost	3 400	00
Land and buildings, at cost	10 600	00

Transactions for April (VAT *at* 14%):

5 Bought goods on credit from Hardware Suppliers for R6 840.
7 Cash sales, R9 348.
10 Bought goods on credit from Meadow Ridge Timbers for R2 964.
13 Returned unsatisfactory system to Hardware Suppliers, R684 (VAT incl.).
15 Cash sales, R3 990.
17 The owner took goods that had cost R200 (VAT excl.) for his own use.
20 Refunded R45,60 by cheque for goods returned by a dissatisfied customer.
25 Bought goods on credit from Timber Town, R1 026.
A physical system count after the close of business on 30 April established that the cost of unsold system on hand was R2 450.

You are required to:

1 Open ledger accounts and enter the balances and capital as on 1 April 20*x*7.
2 Record the transactions for the month in the ledger accounts.
3 Extract a pre-adjustment trial balance.
4 Prepare the trading account for the month ended 31 April 20*x*7 and a statement of financial position at that date.

Question 10.12

This trial balance and additional information were taken from the books of Ulandi Traders as at 28 February 20*x*1:

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Details	Fol.	Debit		Credit	
Capital	B1			29 300	00
Bank	B2	4 000	00		
Inventory	B3	20 000	00		
Accounts receivable	B4	9 150	00		
Accounts payable	B5			7 700	00
VAT control	B6			1 300	00
General expenses	N5	1 000	00		
Sales	N1			22 000	00
Sales returns	N2	1 000	00		
Purchases	N3	14 450	00		
Purchase returns	N4			500	00
Freight in	N6	1 400	00		
Freight out	N7	800	00		
Rent expense	N8	5 000	00		
Salaries	N9	4 000	00		
		60 800	00	60 800	00

Additional information:

Accounts receivable

A. Bouwer	2 600	00
B. Cilliers	3 000	00
C. Daniels	3 000	00
J. Peterson	550	00
	9 150	00

Accounts payable

Eriksen Ltd	800	00
Foord (Pty) Ltd	4 700	00
Gouws and Son	2 200	00
	7 700	00

Transactions for March (assume VAT *is* 14%):

1 Received and deposited B. Cilliers' cheque of R3 000 in full settlement of the account.
2 Paid rent of R684 for March to Greenside Agencies.
3 Paid Eriksen Ltd R800 in full settlement of the account.
4 Purchased goods on credit from Eriksen Ltd for R2 280.
5 Paid Spoornet R11.40 for railage on goods received from Eriksen Ltd.
8 Sold goods to B. Cilliers on credit for R3 420.
9 Paid Express Deliveries R34.20 for freight on goods delivered to B. Cilliers.
10 Accepted damaged goods returned by B. Cilliers and issued a credit note for R114.
11 Received a cheque for R34.20 from Gouws and Son for discount that had not been deducted when a payment was made to Gouws and Son on 26 February.
16 Deposited R2 000 that was received on account from Daniels.
17 Paid the amount due to Gouws and Son.
19 Paid the SARS the VAT owing for February.
20 Sold goods on credit to C. Daniels for R1 596.
24 Purchased goods on credit from Foord (Pty) Ltd for R912.
31 Paid salaries of R1 000.

You are required to:

1. Record the above transactions in the general journal.
2. Prepare a trial balance as at 31 March.

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3 Prepare the accounts receivable list and the accounts payable list.
4 Prepare the VAT control account in the general ledger.

Question 10.13

On 31 January 20*x*7, Vee Retail Stores had these balances and totals in its trial balance:

Details	Fol.	Debit		Credit	
Stationery	N	540	00		
Cost of sales	N	32 000	00		
12% loan: Unlimited Building Society	B			15 000	00
Drawings	B	2 000	00		
Electricity	N	800	00		
Consumable stores	N	8 000	00		
South African Revenue Service (SARS): VAT	B			3 000	00
Sales	N			38 400	00
Bank	B	48 750	00		
Accounts payable	B			8 340	00
Salaries and wages	N	22 000	00		
Vehicles	B	7 250	00		
10% fixed deposit: Allied Bank	B	10 000	00		
Equipment	B	3 400	00		
Rent income	N			12 000	00
Repairs	N	1 000	00		
Inventory	B	34 260	00		
Interest on loan	N	1 200	00		
Accounts receivable	B	4 000	00		
Capital	B			104 460	00
Rent expense	N	6 000	00		
		181 200	00	181 200	00

Additional information:

- Vee Retail Stores uses the perpetual system to account for inventory movements.
- All goods are marked up at 20% on cost.
- VAT for the period under review is at 14% on all goods and services.
- Accounts payable and accounts receivable consist of:

Accounts receivable

B. Blank	1 000	00
S. Surety	2 900	00
B. Krupt	100	00
	4 000	00

Accounts payable

DW Wholesalers	3 240	00
Trust Wholesalers	3 100	00
P&P Manufacturers	2 000	00
	8 340	00

Transactions for February:

3 Bought goods on credit from P&P Manufacturers, R2 280.
Sold goods to J. de Villiers for cash, R1 368.
8 Bought office equipment from Trust Wholesalers for cash, R18 240.
9 Sold goods to B. Blank on credit, R1 824.
Paid R798 for repairs to equipment.

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14 Bought goods on credit from DW Wholesalers (R912) and from Trust Wholesalers (R684).
Bought goods from B. Bulge for R684 and paid by cheque.

17 The owner took goods that cost R456 for his personal use.
Paid salaries and wages, R800.
Bought stationery from Coastal Printers for R91.20 and paid by cheque.

18 Paid Trust Wholesalers in full settlement of the account outstanding at the beginning of the month.

21 Sold goods to S. Surety for R912 and received a cheque for the amount outstanding at the beginning of the month.
Sold goods for cash, R684.
Sold goods that cost R700 to B. Blank.

26 B. Blank paid his account in full.

You are required to:

1. Record the transactions in the general journal.
2. Post the entries from the general journal to the general ledger.
3. Extract a trial balance as at 28 February.
4. Prepare closing entries and post to the ledger, including the final accounts.
5. Prepare the statement of profit or loss & other comprehensive income for the year ended and a statement of financial position as at 28 February.

Question 10.14

Barry Blender, a renowned chef, stumbled across an eight-in-one blender while on holiday. Upon his return, he decided to quit his current job at the Cape International Hotel to start a trading business called, Blender Craze Enterprises.

Barry bought blenders in bulk and sold it through a chain of retailers in Cape Town. Blender Craze was immediately registered for VAT.

Blender Craze Enterprises uses the perpetual inventory system to account for inventory movements. Cost of sales is calculated using the first-in-first-out (FIFO) system.

Additional information:

- On 28 February 20*x*1, there were 30 units on hand at a cost of R200 per unit (VAT excl.).
- The VAT payable to the SARS on 28 February 20*x*1 was R11 335.

Note

- Blender Craze Enterprises uses a mark-up of 50% on the cost of goods sold.
- All amounts include VAT, unless stated.

Transactions for March:

4 Purchased 100 blenders at a cost of R228 per unit from Blender World on credit. Delivery charges were incurred that amounted to R285. The delivery charges were settled in cash.

5 Sold 60 blenders to Verimail on credit.

12 Sold 60 blenders to Glomark on credit.
Glomark returned 10 blenders as they claimed that the original order was for 50 and not 60 blenders.

13 Settled the VAT liability as shown at the beginning of the period.

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18 Purchased 200 additional blenders from Blender World and issued cheque 383. Blender World gave them a trade discount of 10% on the normal price. (See transaction dated 4 March.)

23 Verimail settled the amount outstanding on their statement of account.

26 Sold 100 blenders to Glomark on credit.

30 Returned 25 defective blenders to Blender World. These blenders were bought on 18 March. Blender World paid out the amount in cash on the same day.

You are required to:
Prepare/record the above transactions in the general journal for the period ending 31 March 20*x*1.

Question 10.15

The transactions below appeared in the books of Fidel Fertiliser Company.

Fidel set up the business to sell the latest grass fertiliser that ensures that grass stays green all year round. Fidel purchases all his Fertiliser on credit on a bi-monthly basis at 1 000 kg at a time.

All fertiliser is sold and bought at a cost/kg.

- The business uses the perpetual system to account for inventory movements.
- Cost of sales is calculated using the first-in-first-out system.
- Fidel uses a mark up of 50% on the cost of goods sold.
- All amounts include VAT unless otherwise stated.

Transactions for May 20x1:

2 Fidel invested R87 000 in the business.
Purchased 2 000 kg at a cost of R16 000 (VAT excl.) on credit from Fertile Ground. Fertile Ground has indicated that a discount of 5% will be received if the account is settled within two weeks.
Incurred delivery charges of R1 140 from Fertile Ground that was settled in cash.
Purchased stationery for an amount of R1 710 and issued cheque 12.

3 Paid the rent for the month that amounted to R5 700 and issued cheque 13.
Purchased office equipment from Off Equ LTD on credit for R9 800.

6 Sold 600 kg of fertiliser to Stoddles Farms on credit.
Sold 1 100 kg of fertiliser to Evergreen Grass on credit.
Sold 100 kg of fertiliser to Miss Biggs and received a cheque.
Paid Fertile Ground the outstanding amount owing.

9 Took 150 kg of fertiliser home for personal use.
Purchased new equipment from Factory Equip that cost R11 400 and issued cheque 14.

13 Stoddles Farms returned 50 kg of fertiliser claiming that the order was for 550 kg and not 600 kg.

16 Purchased an additional 5 000 kg of fertiliser at R7.50 (VAT excl.) a bag from Fertile Ground. Incurred delivery charges of R2 500 (VAT excl.) from Fertile Ground that was settled in cash.

18 Sold 1 100 kg of fertiliser to Stoddles Farms on credit.

20 Sold 1 200 kg of fertiliser to Evergreen Grass on credit.

24 Paid salaries and wages for the month by cheque, R62 500.

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25 Received interest on investment from the Amalgamated Banks of South Africa, R12 300.
Paid interest of R9 800 to Capital Bank.

31 Bank charges for the month, R285.
Electricity for the month was settled by cheque 15, R1 140.
Received R12 000 from Evergreen Grass as part payment on their account.
Stationery available at the end of the month, R700 (VAT excl.).

You are required to:

1. Post the transactions to the general journal for May 20*x*1.
2. Prepare the statement of profit or loss & other comprehensive income on 31 May 20*x*1.
3. Calculate the VAT payable / receivable for the VAT period by distinguishing between output and VAT input using the VAT control account.
4. Show how the VAT balance and the inventory balance should be shown on the statement of financial position for the period ending 31 May 20*x*1.

Question 10.16

You have recently been appointed as the accountant of CHIPPIE – CHIP, a registered VAT vendor that sells potato chips to various entities across the Western Cape.

The business was started 11 months ago by Chip Monk on 1 May 20*x*1. The financial year ends on 30 April. The business purchases potatoes from various farms in the area, after which the potatoes are peeled by internal staff. The potatoes are then placed in a specialised cutting machine that cuts these chips into accurate sizes that are consistent with prior batches.

The business uses the perpetual system to account for inventory movements. Inventory movements are accounted for using the first-in-first-out (FIFO) method.

Here is a summary of the potato chips process:

1. Potatoes are bought in 10 kg bags from surrounding farms.
2. Potatoes are then peeled by staff. A labour cost of 10 cents has been calculated for every kilogram of potatoes peeled.
3. The potatoes are then machine cut to the perfect size. (See details for machine below.)
4. After cutting, the chips are placed (to be sold) into specially manufactured 5-kg bags that allow the chips to stay fresher for longer.
5. Potato chips are then directly sold to businesses in the area at a gross margin of 33.33% on the selling price.

Due to the nature of the goods, the business will always sell the older inventory before it sells the newer/fresher inventory.

Additional information:

- On 1 May 20*x*1, the business bought a new machine at a total cost of R500 000 (VAT excl.).
- The depreciation policy with regard to the machine is based on the total operating hours.
  - According to the manufacturer, the machine is expected to last for a total of 25 000 hours. The business has also determined that 50 kg of chips are cut per hour.
  - **Note:** The machine is exclusively used in the manufacturing process of the potato chips.
- According to the policy of the business, stationery is recognised as an asset on the date it is bought.

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- Inventory includes all costs that are incurred to bring the system to its saleable point.
- On 31 March 20*x*2:
  - The stationery on hand balance was R520.
  - The inventory on hand balance was R4050. This balance is made up of 300 5-kg bags.
  - The VAT liability was R10 400.
- Fish and Chips, a receivable, had a balance of R1 710.

All amounts include VAT unless otherwise stated.

Transactions for April 20x2:

2 The owners invested an additional R50 000 into the business.
Purchased 2 000 bags of potatoes at a cost of R44 000 (VAT excl.) on credit from Potato World, a registered VAT vendor.
Incurred delivery charges of R1 140 to deliver the potatoes to the business premises and issued cheque number 100.
Purchased 20 000 bags from Bagz at a cost of 35 cents per bag to package the 5 kg bags and issued cheque number 101. Bagz is not a registered VAT vendor.
Purchased stationery for an amount of R1 710 and issued cheque 102.

3 Paid the rent for the month and issued cheque 103, R6 840.
Purchased office equipment from Off Equ LTD on credit for R2 850.

6 Sold 1 900 bags of freshly cut chips to Da' Green Family Restaurant on credit.
Sold 1 700 bags of freshly cut chips to Ray-Lene's Bar and Grill on credit.
Paid Potato World 60% of the outstanding debt.

9 Took 150 bags of freshly cut chips home to donate to the fundraiser of a local school where his son attends.

13 Ray-Lene's Bar and Grill returned 100 bags claiming that the order was for 1 600 bags of freshly cut chips instead of 1 700 bags.
Sold 300 bags of freshly cut chips to Luther Martin, a street vendor. Since Luther paid cash, a trade discount of 5% was given. The trade discount is based on the normal selling price per 5 kg bag.

15 According to the bank statement, insurance expense of R285, along with the interest expense of R570, was debited to the bank account.
Paid the outstanding VAT balance as shown at the beginning of the month by Internet bank transfer.

16 Purchased an additional 3 500 bags of potatoes from Potato World and paid the amount due by bank transfer. A 10% trade discount was received. (See transaction dated 2 April for original price.)
Incurred delivery charges of R3 500 (VAT excluded) to transport the potatoes inwards. Delivery charges were settled in cash.

18 Sold an additional 1 200 bags of freshly cut chips to Da' Green Family Restaurant on credit.

20 Sold an additional 1 400 bags of freshly cut chips to Ray-Lene's Bar and Grill on credit.

24 Paid salaries and wages for the month by cheque, R43 200.

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25 Received interest on investment from the Amalgamated Banks of South Africa, R13 600.
Fish and Chips, a receivable, was declared insolvent. His estate paid out 40c in the rand, with the rest being considered irrecoverable. All money receivable was received and banked at this date.

31 Bank charges as per the bank statement, R285.
Electricity for the month amounted to R1 140 and was settled by cheque 105.
Received R15 000 from Da' Green Family Restaurant as part payment on their account.
Received 85% of the outstanding debt from Ray-Lene's Bar and Grill.
Stationery available at the end of the month, R700 (VAT excluded).
A stock take at the end of the month revealed that 4 500 bags of freshly cut potato chips were on hand at month end. On investigation, it was determined that Cameron, a truck driver, was colluding with Ziyaad Mollagee, the stock controller, to remove inventory from the premises and sell it to an unnamed street vendor.
Paid the fuel card for the month, R1 710.

You are required to:

1 Prepare the general journal for the transactions for April 20*x*2.
2 Prepare the statement of profit or loss & other comprehensive income for the month ending 30 April 20*x*2.
3 Calculate the VAT payable/receivable for the VAT period. Use the VAT control account to distinguish between VAT output and VAT input.

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MODULE D

Processing large volumes of data

This module is divided into three chapters:

Chapter 11	Cash transactions
Chapter 12	Credit transactions
Chapter 13	Payroll accounting

Together these three chapters achieve the following outcomes:

Outcomes

- Applying the principle and advantage of summarising cash and credit transactions in subsidiary journals before posting to the general ledger.
- Using subsidiary ledgers for personal accounts.
- Identifying control accounts in the general ledger and reconciling these accounts.
- Posting from subsidiary journals to the general ledger.
- Applying methods for treating credit card sales.
- Recording payroll transactions in the general ledger.
- Calculating weekly, monthly and annual deductions and over payment to the different institutions, for example, Unemployment Insurance Fund (UIF).
- Keeping records and registering with institutions for payroll accounting.

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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11 CASH TRANSACTIONS

Chapter objectives

By the end of this chapter, you should be able to:

- Introduce the principle of summarising cash transactions before posting to the general ledger.
- Establish the need for special journals to record similar types of cash transactions.
- Record cash transactions using multiple columns in the cash journals.
- Explain the drafting of the cash receipts journal (CRJ) and the cash payments journal (CPJ).
- Post from the cash receipts journal and the cash payments journal to the general ledger.
- Prepare a bank reconciliation statement.
- Explain the purpose of the bank reconciliation statement for detecting errors.
- Explain the operation of the petty cash fund according to the imprest system.
- Explain the drafting of the petty cash journal (PCJ).
- Post from the petty cash journal to the general ledger.

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1 Introduction

In Chapter 1, several definitions of accounting were put forward. Throughout this book, accounting has been presented as a system that processes data into information that is used by a number of parties.

This information produced by the accounting system is mainly concerned with the past financial performance and the present financial position of a business. In Chapter 4, we established that **input data** is derived from various source documents. The input data is then processed through the accounting system to produce the required **information output**.

A process was developed using the accounting equation as a basis and applying it consistently to transactions of a service type entity and a trading entity. The following important characteristics of the process have been established:

- The general ledger is the primary accounting record. Data from transactions is entered into accounts in the general ledger. A double-entry results from every transaction entered, that is, one account is debited and another account is credited. (Refer to Chapter 6.)
- The number of different accounts in the general ledger will depend on the size of the business and the amount of detail that is required.
- Transactions are processed through subsidiary accounting records before being posted to the general ledger. The general journal is used for this purpose and it serves to capture both the names of the accounts and secondary information such as document numbers. (Refer to Chapter 7.)
- Transactions may be conveniently classified into two broad categories:
  - **Cash transactions:** These transactions involve the exchange of cash or cheques at the time of the transactions. Cash transactions are recorded in the cash payments and cash receipts journals.
  - **Credit transactions:** These transactions delay payment until later. Credit transactions are recorded in the accounts receivable and accounts payable journals. (Refer to Chapter 12.) A transaction is either a credit transaction or a cash transaction; it cannot be both.

So far we have dealt with business entities that have had only a few transactions in each period. In practice, this is obviously not the case. A business is likely to engage in hundreds, often thousands of transactions each day. Although computer technology is able to cope with large volumes of data, it would still be very cumbersome to enter every transaction as a separate general journal entry and then post it to the general ledger. The general ledger would become so cluttered with data that it would not serve the essential purpose for which it is intended, that is, to record the information about changes in account balances.

Part of the accounting process must, therefore, be devoted to the summarising of transactions. In doing this, care has to be taken to ensure that information required to operate the business effectively is not lost. At the same time, financial information, that is sufficiently brief to enable understanding, must result.

This chapter introduces the concept of subsidiary journals and subsidiary ledgers. The purpose of the subsidiary journals is to:

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- Avoid large numbers of transactions from cluttering the general ledger accounts.
- Keep a record of the details of transactions.

This chapter also deals with cash transactions and develops a procedure for summarising cash transactions to see more clearly the exact position of the entity.

These recordings will be done in the cash receipts journal and the cash payments journal. Thereafter, the appropriate totals are posted to the general ledger.

We will learn that small cash payments are recorded in the petty cash journal. The general journal is used to record the transactions that, by their nature, cannot be recorded in any of the other journals.

Businesses do not keep large sums of cash on their premises. They open bank accounts into which all money received is deposited. If the business has to make a payment, a cheque is issued. We, therefore, assume that all cash received is deposited into the bank at the end of each day and that all payments are made by cheque. The account that is always affected by a cash transaction, is the bank account.

In terms of the accounting equation, bank is an asset, therefore, assets increase (Dr.) when money is received (deposits) and decrease (Cr.) when cheques are written out.

2 Special journals

So far all transactions have been entered in the two-column general journal before being posted to the general ledger. Using only one journal, namely the general journal, for the initial recording of transactions is satisfactory only for the very smallest of business entities. Most businesses use special journals in addition to the general journal.

A special journal is introduced for all types of transactions that occur frequently, such as sales on account and purchases on account. Only if a transaction cannot be recorded in a special journal, should it be recorded in the general journal.

A special journal (usually called a subsidiary journal) is used to summarise multiple transactions resulting in only one general ledger posting of a type.

Did you know?

- The accounts receivable journal is often called the sales journal, and the accounts payable journal is often called the purchases journal. You should not be confused by this difference in terminology.
- Cash does not refer to bank notes and coins only. All legal tender, for example cheques, payment by credit card and electronic funds transfers, are treated as cash.
- Credit sales are also referred to as sales on account.

Examples of subsidiary journals are:

- **Accounts receivable journal** – used for recording all sales on credit.
- **Cash receipts journal** – used for recording all cash received, including cash sales and cash received from accounts receivable.
- **Accounts payable journal** – used for recording all purchases on credit.
- **Cash payments journal** – used for recording all cash payments, including cash purchases and cash paid to accounts payable.

A subsidiary journal consists of multiple columns to allow for the capturing of all the information that is required, for example, document numbers. Only the totals from these four journals are posted to the general ledger accounts.

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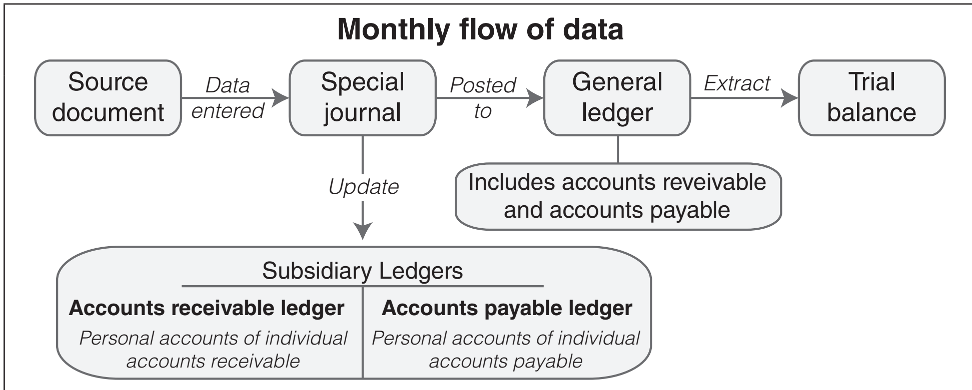
Transactions affecting the receivables and payables are posted individually to the individual receivables and payables accounts in the respective subsidiary ledgers (refer to Chapter 12) and this ensures that each personal account balance is up to date.

This process can be understood by studying Figure 11.1.

Figure 11.1



Example 11.1

Reddy Retailers uses the periodic inventory system and has a balance for accounts payable of R6 000 in its general ledger on 1 May. These are the accounts payable:

Essop Dealers	R1 500
Mafuna Wholesalers	R2 100
Travis Traders	R2 400

These transactions took place between Reddy Retailers and its accounts payable during May:

3 Purchased goods from Mafuna Wholesalers and received invoice M123, R3 000.

4 Purchased goods from Travis Traders and received invoice 8011, R3 500.

7 Paid the following amounts by cheque:

- Essop Dealers R1 500 (cheque 123)
- Mafuna Wholesalers R2 000 (cheque 124)
- Travis Traders R2 200 (cheque 125)

10 Purchase goods from Essop Dealers and received invoice ED39, R4 000. On 1 May, the favourable bank balance of Reddy Retailers was R6 000.

You are required to:

Record the above transactions in the appropriate subsidiary journals and post to the relevant accounts in the general ledger and accounts payable ledger. Ignore VAT.

ACCOUNTS PAYABLE JOURNAL OF REDDY RETAILERS – MAY APJ5

Inv.	Day	Details	Fol.	Accounts payable		Purchases	
M123	3	Mafuna Wholesalers	APL2	3 000	00	3 000	00
8011	4	Travis Traders	APL3	3 500	00	3 500	00
ED39	10	Essop Dealers	APL1	4 000	00	4 000	00
				10 500	00	10 500	00

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CASH PAYMENTS JOURNAL OF REDDY RETAILERS – MAY **CPJ5**

Cheque	Day	Details	Fol.	Bank		Accounts payable	
123	7	Essop Dealers	APL1	1 500	00	1 500	00
124		Mafuna Wholesalers	APL2	2 000	00	2 000	00
125		Travis Traders	APL3	2 200	00	2 200	00
				5 700	00	5 700	00

General Ledger of Reddy Retailers
Real Accounts Section

Dr. **BANK** **B5** **Cr.**

May	1	Balance	b/d	6 000	00	May	31	Accounts payable	CPJ5	5 700	00
								Balance	c/d	300	00
				6 000	00					6 000	00
Jun.	1	Balance	b/d	300	00						

Dr. **ACCOUNTS PAYABLE** **B6** **Cr.**

May	31	Bank	CPJ5	5 700	00	May	1	Balance	b/d	6 000	00
		Balance	c/d	10 800	00		31	Purchases	APJ5	10 500	00
				16 500	00					16 500	00
						Jun.	1	Balance	b/d	10 800	00

Nominal Accounts Section

Dr. **PURCHASES** **N2** **Cr.**

May	31	Accounts payable	APJ5	10 500	00						

Accounts Payable Ledger of Reddy Retailers

ESSOP DEALERS **APL1**

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					1 500	00
	7	Cheque 123	CPJ5	1 500	00			0	00
	10	Invoice ED39	APJ5			4 000	00	4 000	00

MAFUNA WHOLESALERS **APL2**

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					2 100	00
	3	Invoice M123	APJ5			3 000	00	5 100	00
	7	Cheque 124	CPJ5	2 000	00			3 100	00

TRAVIS TRADERS **APL3**

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					2 400	00
	4	Invoice 8011	APJ5			3 500	00	5 900	00
	7	Cheque 125	CPJ5	2 200	00			3 700	00

Explanation

The same principles apply for transactions with accounts receivables as those that apply to accounts payable.

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3 Cash receipts journal (CRJ)

The cash receipts journal is used for the initial recording of all cash received. Cash may be received for any number of reasons, but most frequently for:

- Cash sales.
- Cash from receivables in payment of their accounts.

If only the general journal were used for initial recording of transactions, cash transactions would be recorded as shown in Figure 11.2 (narrations and VAT excluded):

Figure 11.2

GENERAL JOURNAL OF XXX **GJ5**

Day	Details	Fol.	Debit	Credit	Accounts receivable ledger		Accounts payable ledger	
					Debit	Credit	Debit	Credit
01/05	Bank	B4	100 00					
	Sales	N1		100 00				
03/05	Bank	B4	400 00					
	Accounts receivable	B5		400 00				
	B. Brown	ARL1				400 00		
05/05	Bank	B4	600 00					
	Sales	N1		600 00				
08/05	Bank	B4	150 00					
	Sales	N1		150 00				
15/05	Bank	B4	300 00					
	Accounts receivable	B5		300 00				
	G. Green	ARL2				300 00		
						700 00		

Looking at the general journal entries above that reflect only cash transactions, it is clear that they all have one characteristic in common: the bank account is debited in each case.

If all the amounts that the bank account is debited by are added together, a total of R1 550 is obtained. A great deal of time and effort can be spared in posting to the general ledger if only the total of R1 550 could be posted to the bank account, rather than posting each individual amount.

This is done by recording the entries in a special purpose journal, the cash receipts journal. In the cash receipts journal, the entries are arranged in date order, without any loss of necessary information, as shown in Figure 11.3.

Figure 11.3

CASH RECEIPTS JOURNAL OF XXX – MAY **CRJ5**

Rec.	Day	Details	Fol.	Bank
CS146	1	Cash sales		100 00
R281	3	B. Brown	ARL1	400 00
CS147	5	Cash sales		600 00
CS148	8	Cash sales		150 00
R282	15	G. Green	ARL2	300 00
				1 550 00

If the cash receipts journal remained as in Figure 11.3, the posting to the general ledger would be:

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General Ledger of XXX
Real Accounts Section

Dr. **BANK** **B4** **Cr.**

May	1	Balance	b/d	xxx	00						
	31	Total receipts	CRJ5	1 550	00						

Dr. **ACCOUNTS RECEIVABLE** **B5** **Cr.**

May	1	Balance	b/d	xxx	00	May	3	Bank	CRJ5	400	00
							15	Bank	CRJ5	300	00

Nominal Accounts Section

Dr. **SALES** **N1** **Cr.**

						May	1	Total	b/f	xxx	00
								Bank	CRJ5	100	00
							5	Bank	CRJ5	600	00
							8	Bank	CRJ5	150	00

If the cash receipts journal remained as in Figure 11.3, the posting to the accounts receivable ledger would be:

Accounts Receivable Ledger of XXX

B. BROWN **ARL1**

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					400	00
	3	Receipt R281	CRJ5			400	00	0	00

G. GREEN **ARL2**

Date		Details	Fol.	Debit		Credit		Balance	
May.	1	Balance	b/d					300	00
	15	Receipt R281	CRJ5			300	00	0	00

Explanation

- Only one entry is necessary in the bank account rather than five (or however many cash receipt transactions there may have been).
- The debit entry (R1 550) equals the sum of the credit entries (R850 to sales + R700 to accounts receivable).
- The general ledger, therefore, remains in balance. Entries must be made in the personal accounts of Brown and Green in the accounts receivable ledger to update their individual accounts and to ensure that the total of the accounts receivable ledger is the same as the accounts receivable account in the general ledger.

Reminder

Remember that the term 'cash' refers to all legal tender. The transactions recorded in the cash receipts journal would, therefore, consist of the receipt of cash (bank notes, coins, and so on) and cheques, as well as direct transfers into the bank account of the business.

We now ask a question:

Can the information in the general ledger be summarised any further?

It is evident that if there were many hundreds or thousands of transactions, both the sales account and the accounts receivable account in the general ledger could become very lengthy, while the bank account would still require only one posting.

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As a result, the cash receipts journal can be further modified. The principle used here is fundamental to all the remaining techniques for dealing with large volumes of data and should be thoroughly understood. The cash receipts journal is modified by adding columns that collect the data and summarise the effect in the total as shown in Figure 11.4.

Figure 11.4

CASH RECEIPTS JOURNAL OF XXX – JULY **CRJ5**

Rec.	Day	Details	Fol.	Bank		Accounts receivable		Sales	
CS146	1	Cash sales		100	00			100	00
R281	3	B. Brown	ARL1	400	00	400	00		
CS147	5	Cash sales		600	00			600	00
CS148	8	Cash sales		150	00			150	00
R282	15	G. Green	ARL2	300	00	300	00		
				1 550	00	700	00	850	00
				B4 *Dr.*		B5 *Cr.*		N1 *Cr.*	

The postings to the general ledger will now be as follows:

General Ledger of XXX
Real Accounts Section

Dr. **BANK** **B4** **Cr.**

May	1	Balance	b/d	xxx	00						
	31	Total receipts	CRJ5	1 550	00						

Dr. **ACCOUNTS RECEIVABLE** **B5** **Cr.**

May	1	Balance	b/d	xxx	00	May	31	Bank	CRJ5	700	00

Nominal Accounts Section

Dr. **SALES** **N1** **Cr.**

						May	1	Total	b/f	xxx	00
							31	Bank	CRJ5	850	00

Explanation

- By using columns, totals that summarise the numerous transactions are obtained.
- In the general ledger, the debit entry (R1 550) equals the two credit entries (R850 + R700).
- Only one entry is made in the accounts receivable account and also only one entry is made in the sales account. These postings can be done weekly or monthly depending on reporting requirements.
- Irrespective of how many entries there may be in the subsidiary journal, only the total of each column will need to be posted to the general ledger. Transactions with individual receivables are still, however, entered to their accounts in the accounts receivable ledger. This is necessary to keep each individual receivable's account up to date.
- In the cash receipts journal the sum of the total sales column and the accounts receivable column is the same as the total of the bank column. This is referred to as cross-casting.
- A system has been devised for coping with large volumes of transactions without cluttering the general ledger with unnecessary detail.
  - The detail is not lost, however, it is merely relegated to subsidiary journals and subsidiary ledgers. The business is thus able to function efficiently with detailed records of all transactions, which can be traced back to the original source document.

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– The accounting information is also sufficiently summarised to enable the users of the information to see clearly the financial performance and financial position of the business entity.

Example 11.2 On 1 July 20x1, the following balances, among others, appeared in the books of Mpho Moloi:

Sales			28 000	00
Accounts receivable			4 100	00
R. Swart (ARL1)	1 800	00		
M. Israel (ARL2)	1 200	00		
A Maharaj (ARL3)	1 100	00		
Bank (*Dr.*)			8 500	00

Transactions for July 20x1:

2 Banked cash sales, R800.

8 Received from M. Israel in part payment of his account, R600.

15 Banked cash sales, R1 050.

20 Banked cash sales, R780.

24 Received from R. Swart the amount owing by him, R1 800.

25 Received from A. Maharaj in part payment of his account, R700.

31 Banked cash sales, R920.

You are required to:

Record the transactions in the cash receipts journal of Mpho Moloi and post to the general ledger and accounts receivable ledger.

CASH RECEIPTS JOURNAL OF MPHO MOLOI – JULY **CRJ7**

Rec.	Day	Details	Fol.	Bank		Accounts receivable		Sales	
xxx	2	Cash sales		800	00			800	00
xxx	8	M. Israel	ARL2	600	00	600	00		
xxx	15	Cash sales		1 050	00			1 050	00
xxx	20	Cash sales		780	00			780	00
xxx	24	R. Swart	ARL1	1 800	00	1 800	00		
xxx	25	A. Maharaj	ARL3	700	00	700	00		
xxx	31	Cash sales		920	00			920	00
				6 650	00	3 100	00	3 550	00
				B4 *Dr.*		B5 *Cr.*		N1 *Cr.*	

General Ledger of Mpho Moloi
Real Accounts Section

Dr. **BANK** **B4** **Cr.**

Jul	1	Balance	b/d	8 500	00	Jul.	31	Balance	c/d	15 150	00
	31	Total receipts	CRJ7	6 650	00						
				15 150	00					15 150	00
Aug.	1	Balance	b/d	15 150	00						

Dr. **ACCOUNTS RECEIVABLE** **B5** **Cr.**

Jul.	1	Balance	b/d	4 100	00	Jul.	31	Bank	CRJ7	3 100	00
								Balance	c/d	1 000	00
				4 100	00					4 100	00
Aug.	1	Balance	b/d	1 000	00						

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Nominal Accounts Section

SALES

Dr.						Cr. N1					
Jul.	31	Profit and loss account	GJ7	31 550	00	Jul.	1	Total	b/f	28 000	00
							31	Bank	CRJ7	3 550	00
				31 550	00					31 550	00

Accounts Receivable Ledger of Mpho Moloi

R. SWART ARL1

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					1 800	00
	24	Receipt xxx	CRJ7			1 800	00	0	00

M. ISRAEL ARL2

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					1 200	00
	8	Receipt xxx	CRJ7			600	00	600	00

A. MAHARAJ ARL3

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					1 100	00
	25	Receipt xxx	CRJ7			700	00	400	00

Explanation

- Only three amounts are posted to the general ledger.
- All the detail of the transactions is still available in the accounts receivable ledger.
- The total of the receivables outstanding in the accounts receivable ledger (R600 + R400 = R1 000) is the same as the amount outstanding in the accounts receivable account in the general ledger.

Did you know?

When a special purpose journal has more than one column for the analysis of transactions, it is called a columnar journal.

You should be able to complete Question 11.1.

4 Expanding the use of columns

The system of using columns to enable the summary of data has a great many applications when transactions of the same type occur frequently (as in the case of cash received from cash sales or from receivables paying their accounts).

Four problem areas, which arise when using columns in the cash receipts journal have been identified for further discussion. Once they are understood, it should be possible to use the system of columns fairly easily in new and different situations.

Settlement discount allowed

Although settlement discount allowed is clearly not cash received and, therefore, not a cash transaction, it is always associated with cash received.

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Example 11.3

J. Spratt owed R200. On 4 July, she paid R190 in full settlement of her account.

You are required to:

Enter the transaction in the cash receipts journal, general ledger and accounts receivable ledger.

Note: This transaction assumes that the discount was not expected to be taken when the sale was originally recorded.

CASH RECEIPTS JOURNAL OF MPHO MOLOI – JULY **CRJ7**

Rec.	Day	Details	Fol.	Bank		Accounts receivable		Interest expense		Sales	
xxx	4	J. Spratt	ARL1	190	00	190	00	10	00		
				B4 *Dr.*		B5 *Cr.*		B5/N4 *Dr.* Interest expense *Cr.* Accounts receivable			

General Ledger of XXX
Real Accounts Section

Dr. **BANK** **B4** **Cr.**

Jul	1	Balance	b/d	xxx	00						
	31	Total receipts	CRJ7	190	00						

Dr. **ACCOUNTS RECEIVABLE** **B5** **Cr.**

Jul.	1	Balance	b/d	xxx	00	Jul.	31	Bank	CRJ7	190	00
								Interest expense	CRJ7	10	00

Nominal Accounts Section

Dr. **INTEREST EXPENSE** **N4** **Cr.**

Jul.	1	Balance	b/f	xxx	00						
	31	Accounts receivable	CRJ7	10	00						

Accounts Receivable Ledger of XXX

J. SPRATT **ARL1**

Date		Details	Fol.	Debit		Credit		Balance	
Jul	1	Balance	b/d					200	00
	4	Receipt xxx	CRJ 7			190	00	10	00
		Interest expense	CRJ 7			10	00	0	00

Explanation

- Only one transaction has been used for the example. Normally the totals of several transactions would be posted to the general ledger.
- It can be seen that R190 has come into the bank (assets increase), receivables owe R200 less (R190 + R10) (assets decrease) because the account has been paid in full, and an expense of R10 (owner's equity decreases) has been incurred.

You should be able to complete Question 11.2.

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Value-added tax (VAT)

In the case of a retailer who is registered as a vendor for VAT, VAT must be added to the price of all items sold. A VAT column can be introduced that will capture this information.

Example 11.4

On 1 August, sold goods for cash marked at R456 including 14% VAT.

You are required to:

Enter the transaction in the cash receipts journal.

CASH RECEIPTS JOURNAL OF XXX – AUGUST **CRJ8**

Rec.	Day	Details	Fol.	Bank		Accounts receivable		Sales		VAT	
xxx	1	Cash sales		456	00			400	00	56	00
				B4 *Dr.*				N1 *Cr.*		B7 *Cr.*	

Explanation

- The business received R456, although only R400 belongs to them as sales. The R56 VAT is collected on behalf of the South African Revenue Service (SARS) and must be credited to a separate account.
- The VAT amount is calculated as follows: R456 ÷ 114 × 14 = R56.
- The total of the:
  - Bank column is posted to the debit side of the bank account (R456 increase in assets).
  - Sales column to the credit side of sales account (R400 increase in owner's equity).
  - VAT column to the credit side of VAT account (R56 increase in liabilities). (Note that the R56 is a liability because the amount is owing to SARS.)
- VAT is most closely associated with sales and the VAT column will usually be placed next to the sales column.
- The VAT on credit sales is recorded at the same time as the credit sale is recorded. This is explained in Chapter 12.
- It is assumed that the settlement of accounts payable and accounts receivable occurs within 30 days after the initial transaction took place. The VAT included in the discounts will be revised immediately in the input VAT and output VAT respectively.

You should be able to complete Question 11.3.

Sales, using the perpetual inventory system

In Chapter 9, we learned that there are two basic methods that may be applied for recording inventory. These are:

1. The perpetual inventory system.
2. The periodic inventory system.

Under the periodic inventory system, cost of sales is established periodically when an inventory count is performed. The following formula applies:

Cost of sales = opening inventory + purchases – closing inventory

Under the perpetual inventory system, inventory records are updated each time a sale is made. It would, therefore, make sense to record the cost of a sale each time a sale is recorded.

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When goods are sold for cash, therefore, a column in the cash receipts journal is added to collect the data regarding cost price.

Example 11.5 On 1 August, goods sold for cash marked at R456 including 14% VAT. The perpetual inventory system is used and all goods are marked at cost price plus 33,33%.

You are required to:
Enter the transactions into the cash receipts journal.

CASH RECEIPTS JOURNAL OF XXX – AUGUST **CRJ8**

Rec.	Day	Details	Fol.	Bank		Sales		VAT		Cost of sales	
xxx	1	Cash sales		456	00	400	00	56	00	300	00
				B4 *Dr.*		N1 *Cr.*		B7 *Cr.*		B8/N2 *Dr*: Cost of sales *Cr*: Inventory	

Explanation

- The entry is identical to Example 11.4, except that an additional column is necessary.
- The cost of sales amount is calculated as follows: R400 ÷ 133.33 × 100 = R300.
- The total of the cost of sales column will be posted at the end of the month as
  - D*r*. Cost of sales (owner's equity decreases)
  - C*r*. Inventory (assets decrease).
- The cost of sales column is ignored when cross-casting the cash receipts journal.
- Cost of sales is most closely associated with sales, and ideally the cost of sales column should be placed next to the sales column. In this example, it is placed to the extreme right, so that those columns that are ignored when cross-casting, are shown at the end of the page.

The sundries column

So far we have dealt with transactions that occur frequently, that is, those associated with the receipt of cash from sales and from receivables paying their accounts. The inclusion of other columns in the cash receipts journal has made it possible to get totals that are posted to the general ledger reducing the time, effort and space that would otherwise be necessary.

There are, however, numerous different reasons for receiving cash, such as receiving rent for leasing part of the building, or receiving cash when the owner invests more capital into the business. Because these transactions do not occur frequently, they do not warrant a special column but they will still be posted individually to their specific accounts.

Only one column is used for all these types of transactions, but the total is not posted, it is used only to facilitate cross-casting. Each item in this column is posted separately.

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Example 11.6

(Narrations and VAT ignored.)

Transactions for October:

14 The owner invested a further R5 000 cash as capital.

31 Received the monthly rent for a leased office, R800.

You are required to:

Enter the transactions into the cash receipts journal and general ledger.

CASH RECEIPTS JOURNAL OF XXX – OCTOBER CRJ10

Rec.	Day	Details	Fol.	Bank		Sundry accounts		Fol.
xxx	14	Capital		5 000	00	5 000	00	B1
xxx	31	Rent received		800	00	800	00	N6
				5 800	00	5 800	00	
				B4 *Dr.*		*Cr.*		

General Ledger of XXX
Real Accounts Section

Dr. CAPITAL B1 Cr.

							Oct	1	Balance	b/d	xxx	00
								14	Bank	CRJ10	5 000	00

Dr. BANK B4 Cr.

Oct	1	Balance	b/d	xxx	00						
	31	Total receipts	CRJ10	5 800	00						

Nominal Accounts Section

Dr. RENT RECEIVED N6 Cr.

						Oct	1	Balance	b/f	xxx	00
							31	Bank	CRJ10	800	00

Explanation

- Because the total of the other accounts column is not posted, but rather each entry is posted individually, a folio column is necessary to reference the account in the general ledger where the entry will be made.
- It is possible to check the addition in the columns by cross-casting. The total of R5 800 should agree with the sum of the totals of all the additional columns, except for the cost of sales column.
- Cross-casting is a method to make sure that the debits equal the credits when posting to the general ledger.

You should be able to complete Questions 11.4 to 11.5.

5 Cash Payments Journal (CPJ)

The principles used in developing the CRJ are virtually a mirror image of those used in the CPJ and can be compared as follows:

- In place of sales, there are purchases (under the periodic inventory system) or inventory (under the perpetual inventory system), when money is paid for goods purchased.
- In place of receivables, there are payables who have been paid.

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Differences are that:

- There will be no need for a cost of sales column.
- As payments are made for a wide variety of different kinds of expenses, the sundry accounts column will be used far more frequently.
  – Where a particular expense recurs frequently, it will warrant a special column.
  – This will save numerous separate postings to the same general ledger account.
  – This may apply, for example, to wages or stationery.

A typical cash payments journal is shown in Figure 11.5.

Figure 11.5

CASH PAYMENTS JOURNAL OF RAZZLE RETAILERS – DECEMBER **CPJ12**

Chq.	Day	Details	Fol.	Bank		Inventory		VAT input		Accounts payable		Wages		Sundry accounts		Fol.	Interest received	
C100	2	Inventory		798	00	700	00	98	00									
C101	4	Rent expense		1 100	00									1 100	00	N4		
C102	10	E. East	APL1	400	00			(5	60)	440	00						(34	40)
C103	13	Wages		250	00							250	00					
C104	19	Drawings		150	00									150	00	B2		
C105	22	W. West	APL2	570	00			(8	40)	630	00						(51	60)
				3 268	00	700	00	84	00	1 070	00	250	00	1 250	00		(86	00)
				B4 *Cr.*		B8 *Dr.*		B7 *Dr.*		B6 *Dr.*		N7 *Dr.*		*Dr.*			N6 *Cr.*	

Example 11.7

Teresa Broodryk owed these amounts to payables on 1 November 20x2:

S. Bennett R2 000
E. Gashe R2 500
B. Nzovi R2 700

Cash transactions for November:

1 Bought inventory (VAT exclusive), R10 000 (cheque 1207).

5 Paid S. Bennett, R1 500.

7 Paid rent (VAT excluded), R1 800.

Paid weekly wages, R1 000.

10 Paid E. Gashe in full settlement of his account, R2 250.

12 Bought inventory (VAT excluded), R7 800.

14 Paid weekly wages, R1 000.

20 Paid B. Nzovi the amount due to him.

21 Paid weekly wages, R1 000.

28 Paid electricity (VAT excluded), R800.

Paid weekly wages, R1 000.

Teresa uses the perpetual inventory system to account for inventory. The VAT rate is 14%. Use these account numbers:

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Real accounts	
Bank	(B4)
Accounts payable	(B5)
VAT	(B7)
Inventory	(B8)

Nominal accounts	
Rent expense	(N4)
Interest received	(N6)
Wages	(N7)
Water and electricity	(N8)

Personal accounts	
S. Bennett	(APL1)
E. Gashe	(APL2)
B. Nzovi	(APL3)

You are required to:

Prepare the cash payments journal for November and post to the accounts payable ledger.

CASH PAYMENTS JOURNAL OF TERESA BROODRYK – NOVEMBER **CPJ11**

Chq.	Day	Details	Fol.	Bank	Inventory	VAT input	Accounts payable	Wages	Sundry accounts	Fol.	Interest received
1207	1	Inventory		11 400 00	10 000 00	1 400 00					
1208	5	S. Bennett	APL1	1 500 00			1 500 00				
1209	7	Rent expense		2 052 00		252 00			1 800 00	N4	
1210		Wages		1 000 00				1 000 00			
1211	10	E. Gashe	APL2	2 250 00		(30 70)	2 500 00				(219 30)
1212	12	Inventory		8 892 00	7 800 00	1 092 00					
1213	14	Wages		1 000 00				1 000 00			
1214	20	B. Nzovi	APL3	2 700 00			2 700 00				
1215	21	Wages		1 000 00				1 000 00			
1216	28	Water and electricity		912 00		112 00			800 00	N8	
1217		Wages		1 000 00				1 000 00			
				33 706 00	17 800 00	2 825 30	6 700 00	4 000 00	2 600 00		(219 30)
				B4 *Cr.*	B8 *Dr.*	B7 *Dr.*	B6 *Dr.*	N7 *Dr.*	*Dr.*		N6 *Cr.*

Accounts Payable Ledger of Teresa Broodryk

S. BENNETT **APL1**

Date		Details	Fol.	Debit	Credit	Balance
Nov.	1	Balance	b/d			2 000 00
	5	Cheque 1208	CPJ11	1 500 00		500 00

E. GASHE **APL2**

Date		Details	Fol.	Debit	Credit	Balance
Nov.	1	Balance	b/d			2 500 00
	10	Cheque 1211	CPJ11	2 250 00		250 00
		Interest received plus VAT	CPJ11	250 00		0 00

B. NZOVI **APL3**

Date		Details	Fol.	Debit	Credit	Balance
Nov.	1	Balance	b/d			2 700 00
	20	Cheque 1214	CPJ11	2 700 00		0 00

Explanation

- A separate wages column is opened for wages as it is paid regularly.
- The last column included in the cash payments journal is for convenience only, because it arises only when cash is paid. It results in a debit and a credit entry in the general ledger but no entry to the bank account.

You should be able to complete Questions 11.6 to 11.8.

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6 Electronic funds transfers (EFT)

Quite often payments are made directly from one bank account to another without any paper documentation. Such payments are referred to as electronic funds transfers (EFT). Examples of EFT are:

Debit orders and stop orders

Debit and stop orders are typically used for regular payments such as insurance premiums and bond repayments.

The bank automatically debits the account of the customer who accepted the debit or stop order, and pays the amount over to the beneficiary (the insurance company or bond holder).

Direct bank transfers

Very few employers pay their employees with cheques. The employer simply sends magnetic tapes to the appropriate banks for direct deposits into their employees' bank accounts.

Other electronic transfers

New advances in information technology have made it possible for account holders to make payments into another party's account directly using the Internet or electronic data interchange systems. For example, students are now able to pay their university fees using Internet transfers.

Electronic funds transfers are shown on the bank statements. The bank statements are, therefore, used as a source document to record EFT transactions.

Example 11.8

Razzle Retailers marks all goods up by 50% on cost and then adds VAT at 14%. The business uses the perpetual inventory system.

These balances and totals appeared, among others, in the general ledger and accounts receivable ledger on 1 December:

Nominal accounts

Account	Ref	Amount	
Sales	(N1)	90 000	00
Cost of sales	(N2)	60 000	00
Rent received	(N3)	5 500	00
Interest expense	(N5)	1 042	00

Real accounts

Account	Ref	Amount	
Capital	(B1)	25 000	00
Bank	(B4)	2 400	00
Account receivable	(B5)	6 400	00
VAT (*Cr.*)	(B7)	840	00
Inventory	(B8)	17 900	00

Personal accounts

Account	Ref	Amount	
S. South	(ARL1)	2 300	00
N. North	(ARL2)	4 100	00

Cash transactions for December:

3 Sold goods for cash (CS291) and received R615.60.

5 S. South sent a cheque in full settlement of his account, R2 000.

6 The owner invested an additional R4 000.

9 Issued cash slips for sales, R2 565.

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12 N. North paid in part payment of his account, R1 600.

18 Cash sales, R4 104.

21 Received rent for December (VAT not applicable), R500.

You are required to:

1 Prepare the cash receipts journal for December.

2 Post to the subsidiary accounts receivable ledger.

3 Post to the general ledger.

CASH RECEIPTS JOURNAL OF RAZZLE RETAILERS – DECEMBER — CRJ12

Rec.	Day	Details	Fol.	Bank	Sales	VAT output	Accounts receivable	Sundry accounts	Fol.	Interest expense	Cost of sales
CS291	3	Cash sales		615 60	540 00	75 60					360 00
R102	5	S. South	ARL1	2 000 00		(36 84)	2 300 00			(263 16)	
R103	6	Capital		4 000 00				4 000 00	B1		
CS292	9	Cash sales		2 565 00	2 250 00	315 00					1 500 00
R104	12	N. North	ARL2	1 600 00			1 600 00				
CS293	18	Cash sales		4 104 00	3 600 00	504 00					2 400 00
R105	21	Rent received		500 00				500 00	N3		
				15 384 60	6 390 00	857 76	3 900 00	4 500 00		(263 16)	4 260 00
				B4 *Dr.*	N1 *Cr.*	B7 *Cr.*	B5 *Cr.*	*Cr.*		N5 *Dr.* Interest expense	B8/N2 *Dr.* Cost of sales *Cr.* Inventory

General Ledger of Razzle Retailers
Real Accounts Section

Dr. — CAPITAL — B1 — Cr.

					Dec.	1	Balance	b/d	25 000 00
						6	Bank	CRJ12	4 000 00

Dr. — BANK — B4 — Cr.

Dec.	1	Balance	b/d	2 400 00					
	31	Total receipts	CRJ12	15 384 60					

ACCOUNTS RECEIVABLE — B5 — Cr.

Dec.	1	Balance	b/d	6 400 00	Dec.	31	Bank	CRJ12	3 600 00
							Interest expense	CRJ12	263 16
							VAT		36 84

Dr. — SARS: VAT — B7 — Cr.

					Dec.	1	Balance	b/d	840 00
						31	Bank	CRJ12	857 76

Dr. — INVENTORY — B8 — Cr.

Dec.	1	Balance	b/d	17 900 00	Dec.	31	Cost of sales	CRJ12	4 260 00

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Nominal Accounts Section

Dr. **SALES** **N1** **Cr.**

						Dec.	1	Total	b/f	90 000	00
							31	Bank	CRJ12	6 390	00

Dr. **COST OF SALES** **N2** **Cr.**

Dec.	1	Total	b/f	60 000	00						
	31	Inventory	CRJ12	4 260	00						

Dr. **RENT RECEIVED** **N3** **Cr.**

						Dec.	1	Total	b/f	5 500	00
							21	Bank	CRJ12	500	00

Dr. **INTEREST EXPENSE** **N5** **Cr.**

	1	Total	b/f	1 042	00						
	31	Accounts receivable	CRJ12	263	16						

Accounts Receivable Ledger of Razzle Retailers

S. SOUTH **ARL1**

Date	Details	Fol.	Debit	Credit		Balance	
Dec.	1	Balance	b/d			2 300	00
	5	Receipt 102	CRJ12	2 000	00	300	00
		Interest expense plus VAT	CRJ12	300	00	0	00

N. NORTH **ARL2**

Date	Details	Fol.	Debit	Credit		Balance	
Dec.	1	Balance	b/d			4 100	00
	12	Receipt 104	CRJ12	1 600	00	2 500	00

Explanation

- The last two columns included in the cash receipts journal are for convenience only, because both arise only when cash is received. They result in a debit and a credit entry in the general ledger but no entry to the bank account. The cost of sales column is ignored when cross-casting the cash receipts journal.
  - It is recommended that a double line separates these columns from those that have an effect on the bank account.
  - Alternatively, the totals of these columns may be shown one line below the totals used for cross-casting.
- In the cash receipts journal the total of the bank column (to be debited to the bank account) equals the total of the columns to be credited.

You should be able to complete Question 11.5.

7 Accounting controls

When dealing with large volumes of transactions, the probability of errors occurring is considerably increased. A good accounting system will build in controls to ensure that errors are prevented and eliminated as far as possible. This will ensure that the financial

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records are accurate and reliable. Accounting controls will also safeguard the assets of the business.

The bank account of any business is probably the most frequently used account. Money is deposited and withdrawn on a daily basis and it is possible that errors may arise. Often large amounts of money are involved in transactions. This makes it essential that a regular check is made to ensure that all money is accounted for.

Some of the most frequently encountered controls over the cash resources of the business (especially the current banking account) are:

Receipts

- Ensuring that all cash received is supported by a source document.
- Ensuring that all cash received is banked daily.
- Checking that cash and cheques received agree with amounts deposited into the current bank account.

Payments

- Ensuring that all payments are supported by authorised documentation.
- Requiring cheques issued to be signed by at least two authorised people (called signatories).

8 Bank reconciliation

A bank is also a business. Therefore, like any other business entity, a bank also keeps accounting records of all its transactions. As such, the bank will have a personal account for each of its clients. An account into which deposits are made and against which cheques are drawn, is called a current account.

A very useful and essential control over cash that any business applies every month, is to compare the record that the bank keeps of the business's account with its own records. At the end of each month, the bank sends bank statements to its clients.

The bank statement is merely a copy from the bank's records of all the transactions that they have recorded in a client's current account. Clearly, if both the bank and the business have full knowledge of all transactions that have taken place, the balance on the bank statement will be the same as the balance in the business's bank account in the general ledger.

This is, however, seldom the case because of information known by the bank but not the business or vice versa. This is a 'timing' difference. It results only from the fact that the bank or the business becomes aware of the information at different times.

Information known by the bank but not the business

It is possible that certain movements of money have taken place in the current account of the business that are not known until the bank statement is received.

These types of entries are most frequently encountered:

- Amounts deposited directly into the current account of the business by third parties:
  - For example, a receivable may pay his account directly into the current account of the business through EFT.
  - It is common for banks to pay interest on favourable balances on their clients' current accounts. This interest is credited directly to the business's bank account.

  In these two examples, no source document is received by the business until the bank

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statement arrives. As a result, no entry can be made in the records of the business until the bank statement is received. For this reason, the cash receipts journal is usually not closed until the bank statement is received.

Once these items are detected on the bank statement, they are entered into the cash receipts journal using the bank statement as source document to bring the business's records up to date.

- Amounts paid out of the current banking account, not yet known by the business.
- These can be conveniently classified into three types of transactions:
  - Bank charges or interest on overdraft that the bank has deducted from the business current account.
  - Debit orders that do not require a cheque and, therefore, may not have been entered into the cash payments journal.
  - It is possible that cheques received from receivables and deposited are later found to have been returned by the receivable's bank as a result of an irregularity or because the receivable had insufficient funds in his bank account. As the business would already have recorded the deposit as a receipt of cash in the cash receipts journal, it becomes necessary to cancel the entry by recording it in the cash payments journal.

  All three examples result in a decrease of money in the bank and require an entry in the cash payments journal. For this reason, the cash payments journal is usually not closed until the bank statement is received. Once these items are detected on the bank statement, they are entered into the cash payments journal using the bank statement as source document to bring the business's records up to date.

From the above it is apparent that the bank statement is a source of information not available from other source documents. Once the business has entered such information into its records, the records are completely up to date.

When the cash receipts journal and cash payments journal totals are posted to the bank account in the general ledger, the resulting balance in the bank account reflects the actual funds that is the asset (or liability if it is a bank overdraft) of the business.

Information regarding movements in the bank account is contained in the bank statement. To update the records of the business and ensure that they are accurate, any information known by the bank but not the business must be entered in much the same way as any other transaction: into the relevant subsidiary journal and posted to the appropriate ledger accounts.

Explanation
A business often makes arrangements with the bank to spend more money than it actually has in its current account. When this happens, the bank account in the general ledger will reflect a credit balance and the bank statement will reflect a debit balance. This is referred to as a **bank overdraft** (the business has 'overdrawn' on its funds).

Information known by the business but not the bank

As the bank keeps a complete record of all transactions in the current account of the business, and the business also keeps a complete record, it is possible to compare the two records to ensure that neither party has made an error. It has already been shown that the business must first update its records to ensure that all information in the bank statement is recorded.

Once this has been completed, the bank statement entries should agree with the entries in the business cash receipts journal and cash payments journal. We say 'should' because

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this will seldom be the case. More often than not there are entries made by the business of which the bank is not yet aware. Also, the bank or the business may have made a mistake.

The next step is then to identify those entries that the bank has not yet made. It can then be established what the balance on the bank statement would have been had the bank known about the entries. If this adjusted balance as per the bank statement still does not agree with the balance in the bank account, there is an error.

The process of comparing the bank statement with the cash receipts journal and cash payments journal to establish whether there are errors, is known as reconciliation. After the comparison has been done and differences identified, a bank reconciliation statement is prepared. It is a very useful control measure that ensures the reliability of records and is evidence of accuracy.

Two types of entries are most frequently missing from the bank statement. It should be noted that they are absent usually because of a timing difference, that is, the bank will make the entries, but only when it becomes aware of the transactions. These types of entries are:

- *Deposits made by the business that the bank has not credited to the current account.*
  This usually arises if the deposit was made very late on the day prior to the bank statement being printed. It is, therefore, simply a timing difference. Remember that the bank statement is a copy of the current account in the books of the bank.
- *Cheques that the business has issued but that do not yet appear on the bank statement.*
  A cheque, once written out, is usually valid for six months. A payee (the party in whose favour the cheque is issued) who receives a cheque from the business may decide not to deposit it immediately. The business records are up to date as the entry is made at the time of issuing the cheque. The bank, however, is only aware that a cheque was issued when it is presented for payment. Such an unpaid cheque gives rise to a difference between the bank statement and the business records.

Note: The business does not have to update its records. It merely takes note of the timing difference to reconcile the bank statement balance with the bank account balance in the general ledger.

Example 11.9

Jack's Bazaar received its bank statement at the end of May 20*x*5. The items in the bank statement but not in the cash receipts journal and cash payments journal were identified and entered.

After posting to the general ledger, the bank account showed a debit balance of R1 059, while the bank statement showed a credit balance of R892.

On comparing the cash receipts journal and cash payments journal with the bank statement, these items were found to be missing from the bank statement:

Cheques	No. 0246	R86	00
	No. 0312	R98	00
	No. 0314	R127	00
Deposit on 31 May		R478	00

You are required to:

Draft a bank reconciliation statement.

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Jack's Bazaar
BANK RECONCILIATION STATEMENT AS AT 31 MAY 20x5

	Debit		Credit	
Credit balance as per bank statement			892	00
Credit outstanding deposit			478	00
Debit outstanding cheques:				
No. 0246	86	00		
No. 0312	98	00		
No. 0314	127	00		
Debit balance as per bank account	1 059	00		
	1 370	00	1 370	00

Explanation

- Given the information that they have, the bank considered the balance of the business current account to be R892.
- Had the bank known about the deposit of R478, they would have credited the business's bank account. (They will make this entry as soon as the deposit has been processed.)
- Had the three cheques been presented at the bank for payment, they would have debited the business's account. (They will make the debit entries as soon as the cheques are presented for payment.)
- If the bank had entered all of the above, then the bank statement would have shown a credit balance of R1 059 that agrees with the debit balance of the bank account in the general ledger of the business. (In the books of the business, the bank is a 'receivable', while in the books of the bank, the business is a 'payable'. Hence, the bank will record a credit balance, while the business will record a debit balance.)
- It can now be concluded that there are no apparent errors in either the cash receipts journal, cash payments journal or in the records of the bank.
- It must further be noted that when the business receives its bank statement next month, the bank statement will reflect an opening credit balance of R892, while the business's bank account in the ledger will open with a debit balance of R1 059. If the deposit and unpresented cheques are the very first transactions recorded by the bank in June 20x5 (which is unlikely to be the case), the balance at the bank will agree at that moment with the opening balance in the records of the business of R1 059.
- The following steps can be identified when using the bank statement as a means of checking our recorded entries in the cash receipts journal and cash payments journal and ensuring that a control is kept on the movements in our current bank account:
  - On receipt of the bank statement, check all debit entries on the bank statement with entries in the cash payments journal and all credit entries on the bank statement with entries in the cash receipts journal. Tick all the items that agree in pencil.
  - Any items not ticked on the bank statement must be checked against last month's bank reconciliation. If they appear there, they must also be ticked as they have already been entered into the business's records in a previous month.
  - Any items that are unticked on the bank statement represent items that have not been recorded in the business's records. If there are errors on the part of the bank (such as items incorrectly entered), then the bank must be informed and they must correct the error. The error is entered into the bank reconciliation statement in the meantime. If, as is more likely, they are legitimate entries not yet recorded in the business's books, they must be entered. Debit items on the bank statement

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are entered into the cash payments journal and credit items into the cash receipts journal and then ticked against the bank statement. If errors are discovered in the cash payments journal and cash receipts journal, such as an incorrect amount having been recorded for a cheque or deposit, the records must be corrected by the amount of the error. The cash payments journal and cash receipts journal are now complete and must be totalled and posted to the general ledger in the usual way.

- Any items not ticked in the cash receipts journal, cash payments journal and last month's bank reconciliation statement, represent items of which the bank is not yet aware. These items are entered into the bank reconciliation statement, starting with the balance on the bank statement as shown in Example 11.9.
- The resulting balance should agree with the bank account balance that appears in the general ledger. If it does not, then an error has been made that must be identified and corrected.

Example 11.10 Lexicon Supplies reconciled its cash receipts journal, cash payments journal and bank balance on 30 April 20*x*5:

Lexicon Supplies
BANK RECONCILIATION STATEMENT AS AT 31 MARCH 20*x*5

	Debit		Credit	
Credit balance as per bank statement			1 312	00
Credit outstanding deposit			600	00
Debit outstanding cheques:				
No. 794	142	00		
No. 797	275	00		
Debit balance as per bank account	1 495	00		
	1 912	00	1 912	00

This information is given to you on 30 April 20*x*5:

Third National Bank
BANK STATEMENT

Date	Details	Debit	Credit	Balance
April 1	Brought forward			1 312
1	Deposit		600	1 912
2	Cheque 797	275		1 637
3	Cheque 828	218		1 419
	Deposit		312	1 731
5	Cheque 829	302		1 429
9	Cheque 831	737		692
12	Cheque 830	75		617
	Cheque 832	632		–15
14	Deposit		551	536
18	Cheque 834	284		252
21	Deposit		512	764
28	Cheque 835	343		421
	Deposit		472	893
29	R/D: L. Amm	43		850
30	Transfer		1 000	1 850
30	Bank charges	5		1 845

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Here are the relevant portions of the cash receipts journal and cash payments journal for April 20*x*5:

Extract from cash receipts journal	
Date	**Bank**
3	R312
14	R551
21	R512
28	R472
30	R247

Extract from cash payments journal	
Cheque	**Bank**
828	R218
829	R302
830	R75
831	R737
832	R632
833	R136
834	R284
835	R343
836	R53

These steps are necessary:

1 Check all credit entries on the bank statement with entries in the cash receipts journal. We find that two amounts appear on the credit side of the bank statement that do not appear in the cash receipts journal. These are:

- R600 deposited on April 1.
- R1 000 transferred on April 30.

On the bank reconciliation statement for March, note that R600 was credited, indicating that the amount had already been entered into the cash receipts journal. The amount of R600 is now ticked off against last month's bank reconciliation statement.

The only item that remains outstanding after ticking the R600 is the transfer of R1 000. It has been ascertained that this transfer was for rent receivable.

The cash receipts journal is now updated as follows:

Date	Details	Bank	
3	xxx	312	00
14	xxx	551	00
21	xxx	512	00
28	xxx	472	00
30	xxx	247	00
	Rent income	1 000	00
		3 094	00

2 Check all debit entries on the bank statement with entries in the cash payments journal.

These amounts appear on the debit side of the bank statement but do not appear in the cash payments journal:

April 2	Cheque 797	R275
April 29	R/D: L. Amm	R43
April 30	Bank charges	R5

These items are now checked against last month's bank reconciliation statement

- Tick cheque 797 for R275.
- The R/D (refer to drawer) cheque of L. Amm for R43. As the business would already have recorded the deposit as a receipt of cash in the cash receipts journal, it becomes necessary to cancel the entry by recording it in the cash payments journal.
- The bank charges of R5 are now the only items that remain unticked.

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These amounts must be entered into the cash payments journal to bring it up to date as follows:

Cheque	Details	Bank	
828	xxx	218	00
829	xxx	302	00
830	xxx	75	00
831	xxx	737	00
832	xxx	632	00
833	xxx	136	00
834	xxx	284	00
835	xxx	343	00
836	xxx	53	00
B/S	L. Amm (R/D)	43	00
B/S	Bank charges	5	00
		2 828	00

L. Amm (R/D) refers to the fact that a cheque received from L. Amm and deposited at some earlier date has been marked 'Refer to Drawer' and has not been honoured. This means that money that Lexicon Supplies considered to be in their account is in fact not.

As a result, the bank account must be credited and L. Amm must be debited as he still owes R43. A cheque may be returned R/D for a number of reasons, but most frequently because the receivable does not have funds available in his bank to meet the cheque.

There may also be some irregularity on the cheque, such as being post-dated (dated for some future day) or amounts in words and figures not agreeing.

3 Once posting to the general ledger is complete, the bank account will appear as follows:

General Ledger of Lexicon Supplies
Real Accounts Section

Dr. **BANK** **B4** **Cr.**

Apr.	1	Balance	b/d	1 495	00	Apr.	30	Total payments	CRJ4	2 828	00
	30	Total receipts	CRJ4	3 094	00			Balance	c/d	1 761	00
				4 589	00					4 589	00
May	1	Balance	b/d	1 761	00						

4 The bank account of Lexicon Supplies now shows a balance of R1 761, while the bank statement shows a balance of R1 845. This is because the bank is not yet aware of certain transactions that have taken place.

When, in Step 1 above, the credit entries on the bank statement were ticked against the entries in the cash receipts journal, it was noted that two amounts (R600 and R1 000) appeared in the bank statement but not in the cash receipts journal. In addition, an amount of R247, dated 30 April, appeared in the cash receipts journal but not on the credit side of the bank statement.

Similarly, in Step 2 it was seen that these amounts in the cash payments journal were not recorded on the debit side of the bank statement: cheque 833 for R136 and cheque 836 for R53. These amounts, posted to the cash receipts journal and cash payments journal but not to the bank statement, must now be recorded in a bank reconciliation statement to ensure that the bank will arrive at the same balance once they are aware of these transactions.

In writing up the bank reconciliation statement, one must remember also to make sure that all items that appeared in last month's bank reconciliation statement have now been ticked. Items that are still not ticked must again be entered in this month's bank reconciliation statement.

The R600 and the R275 in last month's bank reconciliation statement have now been ticked, but the R142 remains unticked.

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The underlined amounts above (those that appear in the cash receipts journal, the cash payments journal and last month's bank reconciliation statement but not on the bank statement) will be recorded in this month's bank reconciliation statement.

Lexicon Supplies
BANK RECONCILIATION STATEMENT AS AT 30 APRIL 20x5

	Debit		Credit	
Credit balance as per bank statement			1 845	00
Credit outstanding deposit			247	00
Debit outstanding cheques:				
No. 794	142	00		
No. 833	136	00		
No. 836	53	00		
Debit balance as per bank account	1 761	00		
	2 092	00	2 092	00

Explanation

- In the above bank reconciliation statement, the figure of R1 761, arrived at after entering all items not yet known by the bank, agrees with the bank account balance of R1 761 in the general ledger. Therefore, there is confidence that the records kept are accurate.
- If the necessary arrangements have been made with the bank, it is possible for a bank account to go into overdraft, that is, for more money to be paid out of the account than what is available. This amounts to a short-term loan from the bank by arrangement.
  - The existence of an overdraft does not change any of the principles or techniques that have just been shown.
  - A bank overdraft will result in a credit balance on the bank account and a debit balance on the bank statement.
- An alternative approach to updating the records is adopted by some businesses.
  - It may be preferable to close the cash receipts journal and cash payments journal and post to the general ledger before updating them with the information obtained from the bank statement.
  - Any additional entries required to update a business's records are then recorded in the general journal and posted directly to the bank account in the general ledger.
  - The final effect is the same, but this method is not recommended as it requires more entries.
- Cheques are valid for only six months after date of issue. Any cheques appearing on the bank reconciliation statement must be cancelled as soon as they are six months old and have not been presented for payment. Such a cancellation is made by entering the cheques in the cash receipts journal.

You should be able to complete Questions 11.9 to 11.13.

9 Errors exposed by bank reconciliation

Errors made by the business will be rectified in the cash receipts journal and cash payments journal before these are closed off to the bank account.

However, errors made by the bank (of which the business will notify the bank) will only be corrected on the next month's bank statements. Such bank errors will, therefore, be shown in the bank reconciliation statement.

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Example 11.11

The October 20x5 bank statement of Hazy Views showed a credit balance of R4 291 and the records of Hazy Views showed:

Bank account on 1 October 20x5	R1 341
Total of cash payments journal on 31 October 20x5	R6 985
Total of cash receipts journal on 31 October 20x5	R8 277

On receiving the bank statement, these differences were found:

- A deposit for R276 dated 31 October had not been recorded by the bank.
- Five cheques in October and earlier months had not yet been recorded by the bank.
  - Cheque 551 Aug 8 R150
  - Cheque 767 Sept 14 R67
  - Cheque 899 Oct 15 R500
  - Cheque 905 Oct 26 R370
  - Cheque 971 Oct 31 R130
- A deposit for cash sales, dated 6 October, was correctly recorded by the bank as R330, but appears as R300 in the CRJ.
- Returned with the bank statement was a cheque for R128, marked R/D. This cheque from receivable, B. Blank, had been deposited during the month.
- The bank statement showed a debit entry for R25 in respect of service fees.
- On 31 October the bank statement showed a credit entry for R40 for interest earned on the current account balance.
- The bank statement showed a credit entry of R800 on 14 October. This amount did not appear in the cash receipts journal. Closer investigation revealed that the bank had erroneously credited this amount to the current account of Hazy Views.

You are required to:

Draft the bank reconciliation statement at the end of October 20x5. The steps are as follows:

1 Update the cash receipts journal and cash payments journal from the bank statement:

Date	Cash receipts journal: Details	Bank	
31	Total	8 277	00
	Sales (R330 – R300)	30	00
	Interest	40	00
		8 347	00

Date	Cash payments journal: Details	Bank	
31	Total	6 985	00
	Accounts receivable: B. Blank	128	00
	Bank charges	25	00
		7 138	00

2 Post to bank account in general ledger:

General Ledger of Hazy Views
Real Accounts Section

Dr. **BANK** **B4** **Cr.**

Oct.	1	Balance	b/d	1 341	00	Oct.	31	Total payments	CRJ10	7 138	00
	31	Total receipts	CRJ10	8 347	00			Balance	c/d	2 550	00
				9 688	00					9 688	00
Nov.	1	Balance	b/d	2 550	00						

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3 Prepare bank reconciliation statement:

Hazy Views
BANK RECONCILIATION STATEMENT AS AT 31 OCTOBER 20x5

	Debit		Credit	
Credit balance as per bank statement			4 291	00
Credit outstanding deposit			276	00
Debit outstanding cheques:				
No. 551	150	00		
No. 767	67	00		
No. 899	500	00		
No. 905	370	00		
No. 971	130	00		
Debit error on bank statement	800	00		
Debit balance as per bank account	2 550	00		
	4 567	00	4 567	00

You should be able to complete Question 11.14.

10 Chapter illustrative example

These accounts appeared in the records of Tladi Traders on 1 February 20x3:

Account	Fol.	Balance	
Inventory	B2	67 400	00
Accounts receivable	B3	96 800	00
Bank	B5	25 100	00
Cost of sales	N2	250 000	00
Electricity	N5	1 810	00
Insurance	N6	1 840	00
Rent expense	N7	4 600	00
Telephone	N8	2 730	00
Wages	N9	6 700	00
		456 980	00

Account	Fol.	Balance	
Capital	B1	20 080	00
Accounts payable	B4	76 800	00
SARS: VAT	B6	10 100	00
Sales	N1	350 000	00
		456 980	00

Below are the totals of the cash receipts journal and the cash payments journal for February 20x3:

CASH RECEIPTS JOURNAL OF TLADI TRADERS – FEBRUARY **CRJ2**

Rec.	Day	Details	Fol.	Bank		Sales		VAT output		Accounts receivable		Sundry accounts		Fol.	Interest expense		Cost of sales	
xxx	2	Cash sales		13 566	00	11 900	00	1 666	00								8 500	00
xxx	10	M. Smit	ARL	14 400	00			(73	68)	15 000	00				(526	32)		
xxx	12	Cash sales		9 576	00	8 400	00	1 176	00								6 000	00
xxx	18	B. Mokgosi	ARL	22 200	00			(98	25)	23 000	00				(701	75)		
xxx	22	Cash sales		14 364	00	12 600	00	1 764	00								9 000	00
xxx	25	S. Theron	ARL	15 400	00			(49	12)	15 800	00				(350	88)		
xxx	28	Cash sales		10 374	00	9 100	00	1 274	00								6 500	00
xxx		P. Lane	ARL	3 000	00					3 000	00							
				102 880	00	42 000	00	5 658	95	56 800	00	0	00		(1 578	95)	30 000	00
				B5		N1		B6		B3					N3		B2/N2	

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CASH PAYMENTS JOURNAL OF TLADI TRADERS – FEBRUARY **CPJ2**

Chq.	Day	Details	Fol.	Bank		Inventory		VAT input		Accounts payable		Wages		Sundry accounts				Interest received	
														Amount		Fol.	Account		
802	1	Inventory		45 600	00	40 000	00	5 600	00										
803	6	C. Phoko	APL	25 000	00					25 000	00								
804	10	A. Pier	APL	50 000	00			(221	05)	51 800	00							(1 578	95)
805	14	Wages		1 000	00							1 000	00						
806	18	Inventory		59 280	00	52 000	00	7 280	00										
807	21	Eskom		2 000	00			245	61					1 754	39	N5	Electricity		
808	25	Telkom		1 200	00			147	37					1 052	63	N8	Telephone		
809	28	Wages		1 000	00							1 000	00						
				185 080	00	92 000	00	13 051	93	76 800	00	2 000	00	2 807	02			(1 578	95)
				B5		B2		B6		B4		N9						N4	

The bank reconciliation statement as at 31 January 20*x*3 appears below:

Tladi Traders
BANK RECONCILIATION STATEMENT AS AT 31 JANUARY 20*x*3

	Debit		Credit	
Credit balance as per bank statement			16 500	00
Credit outstanding deposit			13 100	00
Debit outstanding cheques:				
No. 209 dated 4 August 20*x*2	480	00		
No. 641 dated 2 December 20*x*2	900	00		
No. 798 dated 21 January 20*x*3	2 120	00		
No. 800 dated 31 January 20*x*3	1 000	00		
Debit balance as per bank account	25 100	00		
	29 600	00	29 600	00

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This bank statement was received from the bank on 1 March 20*x*3:

Gauteng Bank Ltd
BANK STATEMENT

Date		Details	Debit	Credit	Balance
February	1	Brought forward			16 500
		Deposit		13 100	29 600
	3	Deposit		13 566	43 166
	5	Cheque 802	45 600		–2 434
	10	Cheque 803	25 000		–27 434
	11	Deposit		14 400	–13 034
		Cheque 798	2 120		–15 154
	13	Cheque 804	50 000		– 65 154
		Deposit		9 576	–55 578
	14	Transfer L. Tladi		50 000	–5 578
		Cheque 805	1 000		–6 578
	16	J. Herbst (R/D)	1 560		–8 138
	20	Cheque 800	1 000		–9 138
	23	Deposit		14 364	5 226
		Cheque 807	2 000		3 226
	25	Transfer G. Scott reference ARL9	13	2 600	5 813
	26	Deposit		15 600	21 413
	28	Sleep Easy Insurance Company	1 300		20 113
		Interest on overdraft	105		20 008
		Service fees	24		19 984

Additional information:

14 Transfer made by owner, L. Tladi as additional capital contribution, R50 000.

20 The cheque from J. Herbst was in settlement of his account of R1 600.

25 G. Scott is a receivable and made a direct payment into the bank account of Tladi Traders.

26 The deposit of R15 600 refers to the cheque received from receivable, S. Theron. This deposit was entered in the cash receipts journal on 25 February.

Cheque number 209, dated 4 August 20*x*2 was issued to a payable, M. Kelly.

You are required to:

1. Complete the cash receipts journal and cash payments journal for February 20*x*3 and post to the bank account in the general ledger.
2. Prepare the bank reconciliation statement for Tladi Traders at 28 February 20*x*3.

The steps are as follows:

1. *Updating cash receipts journal, cash payments journal and bank account:*

CASH RECEIPTS JOURNAL OF TLADI TRADERS – FEBRUARY **CRJ2**

Rec.	Day	Details	Fol.	Bank	Sales	VAT output	Accounts receivable	Sundry accounts: Amount	Sundry accounts: Fol.	Sundry accounts: Account	Interest expense	Cost of sales
xxx	28	Totals	b/d	102 880 00	42 000 00	5 658 95	56 800 00				(1 578 95)	30 000 00
B/S		L. Tladi		50 000 00				50 000 00	B1	Capital		
B/S		G. Scott	ARL	2 600 00			2 600 00					
B/S		S. Theron	ARL	200 00			200 00					
B/S		M. Kelly	APL	480 00				480 00	B4	Accounts payable		
				156 160 00	42 000 00	5 658 95	59 600 00	50 480 00			(1 578 95)	30 000 00
				B5	N1	B6	B3				N3	B2/N2

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CASH PAYMENTS JOURNAL OF TLADI TRADERS – FEBRUARY **CPJ2**

Chq.	Day	Details	Fol.	Bank		Inventory		VAT input		Accounts payable		Wages		Sundry accounts				Interest received	
														Amount		Fol.	Account		
xxx	28	Totals	b/d	185 080	00	92 000	00	13 051	93	76 800	00	2 000	00	2 807	02			(1 578	95)
B/S		J. Herbst	ARL	1 560	00									1 560	00	B3	Accounts receivable		
		J. Herbst												40	00	B3	Accounts receivable		
		Interest expense						(4	91)					(35	09)	N3	Interest expense		
B/S		Insurance		1 300	00			159	65					1 140	35	N10	Insurance		
B/S		Interest on overdraft		105	00									105	00	N11	Interest on overdraft		
B/S		Bank charges		37	00			4	54					32	46	N12	Bank charges		
				188 082	00	92 000	00	13 211	21	76 800	00	2 000	00	5 649	74			(1 578	95)
				B5		B2		B6		B4		N9						N4	

General Ledger of Tladi Traders
Real Accounts Section

Dr. **BANK** **B5** *Cr.*

Feb.	1	Balance	b/d	25 100	00	Feb.	31	Total payments	CRJ2	188 082	00
	28	Total receipts	CRJ2	156 160	00						
		Balance	c/d	6 822	00						
				188 082	00					188 082	00
						Mar.	1	Balance	b/d	6 822	00

Explanation

- The R/D cheque from J. Herbst was less discount. The discount must also be reversed as J. Herbst is again indebted for the full amount of R1 600.
- The cheque received from S. Theron was for R16 000 – 2.5% = R15 600. It was, therefore, incorrectly entered as R15 400 in the cash receipts journal. An additional amount of R200 is now entered to correct the error.

2 *Bank reconciliation statement as at 28 February 20x3:*

Tladi Traders
BANK RECONCILIATION STATEMENT AS AT 28 FEBRUARY 20*x*3

	Debit		Credit	
Credit balance as per bank statement			19 984	00
Credit outstanding deposit				
18 February			22 200	00
28 February			13 374	00
Debit outstanding cheques:				
No. 641 dated 2 December 20*x*2	900	00		
No. 806	59 280	00		
No. 808	1 200	00		
No. 809	1 000	00		
Credit balance as per bank account			6 822	00
	62 380	00	62 380	00

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Explanation

- Cheque number 209, dated 4 August 20*x*2 is now more than six months old. The cheque is, therefore, stale and can no longer be presented for payment to the bank. It must be cancelled and a new cheque should be issued to M. Kelly.
- Tladi Traders should make enquiries at the bank about the deposit made on 18 February that is still not shown on the bank statement. Deposits should not be outstanding for more than one working day.

You should be able to complete Question 11.15.

11 Petty cash

Despite the fact that in principle all payments should be made by cheque or EFT, there are small or petty items that do not warrant such formality. To make the payment of small amounts in cash possible, a certain amount of cash, called petty cash, is held on the business premises.

The responsibility of handling petty cash is usually given to a capable secretary or office clerk who will act as the petty cashier. An amount of money that is likely to cover the demand for petty cash payments over a given period, usually a month, is decided on. This amount is then drawn from the bank by cheque and kept in the custody of the petty cashier.

Each time a demand for petty cash arises, the cash amount is handed over by the petty cashier. A petty cash voucher, recording the reason for and amount of the payment, is completed and signed by the person receiving the cash. The person who receives the cash will usually provide the petty cashier with a receipt, which is then attached to the petty cash voucher. At the end of the month the petty cashier totals the disbursements (payments) for the month and requests a cheque for that amount. Petty cash on hand at the beginning of each month will, therefore, always be the same amount.

This system is called the imprest system and the amount that is restored at the end of each month is known as the imprest amount.

To maintain accurate records of expenses, a further function of the petty cashier is to keep a petty cash journal or petty cash book as it is sometimes called. The purpose of this journal is to record all payments made and summarise the payments for the month so that they can be entered into the relevant general ledger accounts.

The petty cashier performs these functions:

- Takes the imprest amount in custody at the beginning of the month.
- Pays out petty amounts recorded on signed vouchers.
- Restores the imprest amount at month end.
- Records all petty cash movements in the petty cash journal for posting to the general ledger accounts.

As with all subsidiary journals, the format may differ from one business to another. A short example of the accounting procedures and the format of the petty cash journal are shown in Example 11.12.

Did you know?

Imprest means money advanced for a specific purpose.

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Example 11.12

The petty cashier of Condo Enterprises has a monthly imprest of R150. The full amount was on hand on 1 April, having just had the imprest amount restored following March disbursements.

These vouchers were written and paid out during April:

Voucher	Day	Disbursement	Amount	
371	2	Postage stamps	16	85
372	5	Wages for cleaning	25	00
373	11	Envelope labels	14	78
374	12	Cover for word processor	32	00
375	17	Wages for gardening	25	00
376	23	Postage stamps	9	65
377	28	Note book	3	50
378	29	Paper clips	8	20

At the end of April, the imprest amount was restored.

You are required to:

1 Enter the transactions into a petty cash journal (PCJ) with appropriate analysis columns.

2 Show the amounts that will be posted to the general ledger.

1

PETTY CASH JOURNAL OF CONDO ENTERPRISES – APRIL PCJ4

Doc.	Day	Details	Fol.	Petty cash receipts	Petty cash payments	Wages	Postage	Stationery	Fol.	Sundry accounts	
										Amount	Account
Apr.	1	On hand	b/d	150 00							
371	2	Stamps			16 85		16 85				
372	5	Wages			25 00	25 00					
373	11	Labels			14 78			14 78			
374	12	Consumables			32 00				N4	32 00	Consumbles
375	17	Wages			25 00	25 00					
376	23	Stamps			9 65		9 65				
377	28	Note book			3 50			3 50			
378	29	Paper clips			8 20			8 20			
					134 98	50 00	26 50	26 48		32 00	
						N5	N6	N7			
	30	Receipt	CPJ4	134 98	*Cr.*	*Dr.*	*Dr.*	*Dr.*		*Dr.*	
		Balance	c/d		150 00						
				284 98	284 98						
May	1	On hand	b/d	150 00							

2

General Ledger of Condo Enterprises
Real Accounts Section

Dr. **BANK** **B4** **Cr.**

Apr.	1	Balance	b/d	xxx		Apr.	30	Total payments*	CPJ4	xxx	
	30	Total receipts	CRJ4	xxx							

*The R134,98 paid by cheque to the petty cashier will be included in this total posted from the CPJ.

PETTY CASH **B5**

Apr.	1	Balance	b/d	150	00	Apr.	30	Total payments	PCJ4	134	98
	30	Bank	CPJ4	134	98			Balance	c/d	150	00
				284	98					284	98
May	1	Balance	b/d	150	00						

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Nominal Accounts Section

CONSUMABLES **N4**

Apr.	30	Other entries		xxx							
		Petty cash	PCJ4	32	00						

WAGES **N5**

Apr.	30	Other entries		xxx							
		Petty cash	PCJ4	50	00						

POSTAGE **N6**

Apr.	30	Other entries		xxx							
		Petty cash	PCJ4	26	50						

STATIONERY **N7**

Apr.	30	Other entries		xxx							
		Petty cash	PCJ4	26	48						

Explanation

- The relevant details for each petty cash disbursement are entered in the petty cash journal. If more detail is required, reference will be made to the vouchers that are numbered and filed for this purpose.
- Using analysis columns reduces the burden of numerous postings to the general ledger.

Other analysis columns may be added if transactions of a different nature recur frequently.

- The sundry accounts column is used for items not frequently encountered. Each item in this column must be posted separately.
- VAT has been ignored in this example. Many of the items will be subject to VAT and an extra column may be provided for this purpose.
- Using the accounting equation, the net effect of the petty cash transactions for the month is:
  - Assets have decreased by R134.98 (bank account).
  - Owner's equity has decreased by R134.98 (the various expense accounts).

Petty cash transactions always involve relatively small amounts. However, they still need to be carefully recorded and the full implication for the double-entry system must be clearly understood.

In practice, the presentation of the petty cash journal will vary considerably. However, the cosmetics of presentation must not detract from the accounting principles being applied.

You should be able to complete Questions 11.16 to 11.17.

12 Summary

This chapter has dealt with the problem of dealing with large volumes of transactions, focusing particularly on cash transactions.

It has been shown that subsidiary journals can be adopted so as to obtain totals to be posted to the general ledger in place of posting each entry separately. This has greatly reduced the number of postings required and made the information in the general ledger accounts easier to perceive clearly.

As the bank account is a key account, it requires constant monitoring and control. It is kept up to date by ensuring that items contained in the monthly bank statement but not previously recorded, are immediately entered.

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A bank reconciliation statement is also drafted each month to check the workings of both the bank and the business and to ensure that the important asset of cash at the bank is protected.

When small amounts are paid using cash rather than a cheque, these are most conveniently recorded in a petty cash journal. The use of analysis columns again facilitates easy posting to the general ledger.

QUESTIONS

Question 11.1

Explain the advantages of a cash receipts journal over the use of a general journal for recording cash received.

In what ways does the use of columns in a cash receipts journal help in the recording and processing of information?

Question 11.2

These balances appeared in the books of Bogey Stores as at 1 April 20*x*3:

Bank (favourable) (Dr.)	R24 000
Accounts receivable	R15 000
Sales	R125 000

Ignore VAT.

The amount owing by receivables was made up as follows:

L. Bacall	R6 000
L. Olivier	R5 000
V. Leigh	R4 000

Transactions for April 20x3:

- **1** Cash sales, R1 200.
- **5** Received from V. Leigh, R2 000.
- **9** Cash sales, R1 500.
- **12** Cash sales, R900.
- **16** Received from L. Olivier, R2 500.
- **20** Cash sales, R1 300.
- **23** Received from L. Bacall, R2 000.
- **27** Received from V. Leigh in settlement of her account, R2 000.
- **30** Cash sales, R1 400.

You are required to:

Record the transactions of Bogey Stores in the:

1. Cash receipts journal.
2. Accounts receivable ledger.
3. General ledger for the affected accounts.

Question 11.3

Why is VAT on cash sales recorded separately in the cash receipts journal?

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Question 11.4

What purpose does the sundries column serve in the cash receipts journal and cash payments journal?

Question 11.5

Bafana Sales and Service received these amounts during July 20*x*4:

1 From receivable, A. French, R1 080.
3 From receivable, L. Gandhi, R2 190.
4 Cash for services rendered, R1 881.
7 From receivable, S. Mandala, R970.
10 Cash for goods sold, R2 553.60.
15 From receivable, F. Nightingale, after allowing 5% settlement discount, R2 375. The receivable was recorded net of the discount.
20 Cash for goods sold and services rendered, R5 745.60.
A third of the amount received was for services rendered.
24 From receivable, W. Sisu, R3 120.
31 Cash for goods sold, R798.

Additional information:

- Both sales and services are subject to VAT.
- Where applicable, amounts include VAT at 14%. Goods are sold at cost plus 40%.
- The perpetual inventory system is used.

You are required to:
Record the transactions in the cash receipts journal of Bafana Sales and Service for July 20*x*4.

Question 11.6

Dullah Cash Stores uses the periodic inventory system for inventory and trades for cash only.

Transactions for December 20x6:

1 Bought goods from Lusitania Fish Products for R6 000 and paid by cheque.
2 Sold goods for cash, R2 000.
8 Paid electricity and water, R200.
Paid for stationery, R150.
Paid wages, R4 000.
9 Sold goods to B. Abrahams for cash, R280.
11 The owner took R200 cash for his personal use.
14 Bought goods from B & M Traders and paid by cheque, R1 500.
18 Received R5 000 less 5% cash discount for goods sold to B. Brown for cash.
20 Bought goods from N. Niels and paid by cheque, R15 000.
24 Sold goods to S. South for R2 000 and received a cheque for the amount.

You are required to:
Record the above transactions in the cash receipts journal and cash payments journal for December 20*x*6 (ignore VAT).

Provide for these analysis columns:

- Cash receipts journal → Sales, interest expense.
- Cash payments journal → Purchases, sundry accounts.

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Question 11.7

Oaks Retail Stores uses the perpetual inventory system. Goods are marked up at 20% on cost and the VAT rate is 14%.

These balances appeared in the general ledger on 1 March 20*x*7:

Inventory	5 000	00
Accounts receivable	3 000	00
Accounts payable	6 000	00
Bank (Dr.)	11 000	00
Capital	10 000	00
SARS: VAT (Cr.)	3 000	00

Transactions for March 20x7:

1 Sold goods that cost R2 000 to B Brown Traders for cash.
2 Bought goods from B. Barusso and paid R1 710 by cheque.
3 Received R1 022 from a receivable, J. Jones, in full settlement of his account.
4 Sold goods that cost R800 to S. South Traders for cash.
8 Paid for these expenses by cheque:
- Stationery R57
- Rent R912
- Wages R1 800

11 Sold goods that cost R300 to B. Brown Traders for cash.
14 Bought office equipment for R456 and paid by cheque.
17 Bought goods for R2 337 from B & D Traders and paid by cheque.
20 A cheque for R330 was sent to a payable, A. Caruso, in full settlement of the amount.
21 Sold goods for cash and received, R2 280.
22 Paid VAT to SARS by cheque, R3 000.
27 Received R333 from D. Dowling in full settlement of her account.
31 Bought goods from Princess Wholesalers for R1 596 and paid by cheque.

You are required to:

1 Enter the transactions into the cash receipts journal and cash payments journal. Provide for these analysis columns:
- Cash receipts journal → Sales, VAT, accounts receivable, sundry accounts, interest expense, cost of sales.
- Cash payments journal → Inventory, VAT, accounts payable, sundry accounts, interest received.

2 Post the journals to the general ledger (folio references are not required), and balance the accounts.

Question 11.8

ZAP Traders uses the periodic inventory system to account for inventory.

These balances appeared in the general ledger at the beginning of June 20*x*6:

Inventory	6 000	00
Bank	1 400	00
Accounts receivable	5 000	00
Accounts payable	2 500	00
Capital	9 900	00

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Transactions for June 20x6 (ignore VAT):

1 The owner increased his capital contribution by depositing R20 000 into the business's bank account.
2 Received R800 from J. Golf, a receivable who owed R820, in full settlement of his account.
4 Bought goods from T.J. Hooker and Company for cash R2 000.
7 Paid D. Brown R1 010 in full settlement of our account.
9 Received R4 000 for goods sold to M. Prins for cash.
11 Paid these expenses by cheque:
- Telephone R80
- Electricity R120
- Wages R3 000
- Rent R1 000

14 Received R2 000 for rent of a building to B.J. Mills and Company.
18 Bought goods from ARJ Distributors and paid by cheque R2 000.
24 Received R2 150 from A. Allen in full settlement of his account.
26 Cash sales of goods, R4 000.

You are required to:

1 Record the transactions in the cash payments and cash receipts journals for June 20x6.
2 Post the journals to the general ledger.

Note that these analysis columns are to be used:

- Cash receipts journal:
  - Sales
  - Accounts receivable
  - Sundry accounts
  - Interest expense
- Cash payments journal:
  - Purchases
  - Accounts payable
  - Sundry accounts
  - Interest received

Question 11.9

On comparing the month-end bank account overdraft of R3 460 with the bank statement, the bookkeeper of Clan Enterprises noted that:

1 Cheques totalling R2 876 have not yet been presented to the bank for payment.
2 A deposit of R2 584 entered in the cash receipts journal has not yet been credited by the bank.
3 A credit transfer of R4 500 from a customer had not been entered in the cash receipts journal.
4 A cheque for R169 deposited on the last day of the month was returned by the bank marked 'R/D'. (Clan's records have not yet been adjusted.)
5 These charges shown on the bank statement have not yet been entered in Clan's records:
- Overdraft interest R196
- Service fees R321

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You are required to:

1. Calculate the adjusted month-end bank account balance.
2. Calculate the closing balance as shown on the bank statement.

Question 11.10

After comparing the cash journals for June 20*x*2, and bank reconciliation statement as at 31 May 20*x*2 of Pintorico Traders with their bank statement as at 30 June 20*x*2, these differences were found:

- Pencil totals from the cash journals at 30 June 20*x*2:
  - Cash receipts journal R11 690
  - Cash payments journal R12 325
- Balance (debit) of the bank account in the general ledger as at 31 May 20*x*2, R135.
- Balance (favourable) as per bank statement at 30 June 20*x*2, R450.
- Items that appeared on the bank reconciliation statement as at 31 May 20*x*2 but not on the bank statement for June:
  - Cheque 511 issued to L. Marques on 28 April 20*x*2, R105.
- Items that appeared on the bank statement but not in the cash receipts journal and cash payments journal:
  - Bank charges, R28.
  - Interest on bank overdraft, R32.
  - A stop order for an annual donation to the Bohemia Music School, R100.
  - An R/D cheque that was originally received from receivable, C. Carlos, R140.
  - A deposit that was paid directly into the bank account by a tenant, C. Fidel, R500.
- Items that appeared in the cash receipts journal and cash payments journal but not on the bank statement:
  - Deposit R360
  - Cheque 1008 R1 005

You are required to:

1. Complete the cash receipts journal and cash payments journal for June 20*x*2 by commencing with the given totals. Show only the bank columns.
   All entries in the cash journals must show the correct contra ledger accounts.
2. The bank account in the general ledger in respect of June 20*x*2, properly balanced.
3. The bank reconciliation statement as at 30 June 20*x*2 commencing with the balance as per bank statement.

Question 11.11

Here are some of the balances from Luminary Traders on 1 February 20*x*3.

Debit

Bank (Dr.)	B2	214	70
Inventory	B6	1 080	00
Furniture	B4	10 646	00
Buildings	B3	70 000	00
P. Palm	ARL7	610	00
N. Sangini	ARL9	200	00

Credit

B. Bam	APL1	75	00
A. Aslixi	APL2	25	00
BNC Wholesalers	APL3	400	00
Capital	B1	81 852	00

- All inventory is marked up by 50% on cost.
- The perpetual inventory system is used.

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Transactions for February 20x3:

4 Sold goods on account to N. Sangini, R80.46 (invoice 73).
Sold goods on account to P. Palm, R14.70.

5 Paid R325 for goods bought from BNC Wholesalers and issued cheque 417.
Bought filing cabinet on account from Tafelberg Furnishers, R340 (invoice 101).
Cash sales, R174.75 (K135).

9 Received cheque number R109 from P. Palm to settle his account on 1 February 20x3.
Paid the electricity account by cheque, R63.42.
Bought on account from B. Bam (invoice 999):
– Merchandise R290
– Stationery R83.60
Total of cash sales to date, R369.51.

11 Sent a cheque to B. Bam for R75 to settle our account on 1 February 20x3.
Sold old furniture for cash to N. Boshof, R90. The carrying value of the furniture sold was R90.
Received a cheque from I. Lume, the owner, to increase his capital contribution, R5 000.
Bought goods and paid by cheque, R460.
Received an account from Clive's Garage for repairs to the business's equipment, R146.45.
Drew a cash cheque for R600, R520 was for wages and the rest was taken by the owner.

14 Sold goods on account to N. Sangini, R170. He subsequently sent a cheque to settle his account as at 1 February 20x3.
Bought a new delivery van from Clive's Garage, R8 940. Sent a cheque to pay the 15% deposit.
Issued a cheque to Telkom to settle the telephone account, R41.30.
Merchandise sold for cash, R642.
Bought inventory on account from:
– BNC Wholesalers R206
– A. Aslixi R109.60

18 Paid wages by cheque, R550.
Bought inventory from B. Bam and paid by cheque, R170.
Received a cheque from N. Sangini for R100 in part settlement of his account.
Issued a receipt to A. Tenant for premises sublet to him, R800.

28 Had a special cash sale to get rid of old inventory.
– Takings from the sale amounted to R1 530.
– The selling price was reduced by 33.33% for the sale.
– Paid wages, R710.

You are required to:

1 Enter the above transactions in the cash receipts journal, cash payments journal and the general journal. (Ignore VAT.)

2 Close off the subsidiary journals correctly and post to the ledgers.

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Question 11.12

This bank reconciliation statement was drawn up on 31 March 20*x*3 from the books of Lush Services.

Lush Services
BANK RECONCILIATION STATEMENT AS AT 31 MARCH 20*x*3

	Debit		Credit	
Credit balance as per bank statement			1 650	00
Credit outstanding deposit			960	00
Credit incorrect entry on bank statement			204	60
Debit outstanding cheques:				
No. 558	360	00		
No. 813	102	60		
No. 821	199	20		
Debit balance as per bank account	2 152	80		
	2 814	60	2 814	60

Here is a summary of the cash receipts journal and cash payments journal for April 20*x*3:

Cash receipts journal

Doc.	Day	Details	Bank	
	7	Deposit	932	40
	16	Deposit	1 992	75
	20	L. Luck	420	00
	27	Deposit	2 152	35
	30	Deposit	1 152	78
			6 650	28

Cash payments journal

Doc.	Day	Details	Bank	
822	3	Insurance	360	00
823		Cancelled	0	00
824	6	Purchases	4 350	00
825	11	Insurance	244	80
826	16	Wages	252	00
827	20	F. Ackerman	376	50
S/O	25	Salaries	1 950	00
828	27	Water and electricity	84	90
CU		K. Palmer	142	50
829	30	G. Fraser	685	20
			8 445	90

Abbreviations:
S/O = Stop order
CU = Cheque previously deposited, unpaid (R/D)

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The bank statement received on 30 April was:

Lush Services
BANK STATEMENT – APRIL 20*x*3

Date	Details	Debit	Credit	Balance
April 1	Balance			1 650.00 *Cr.*
	Error corrected		204.60	1 854.60 *Cr.*
	Deposit		960.00	2 814.60 *Cr.*
April 2	Cheque 821	199.20		2 615.40 *Cr.*
April 7	Deposit		932.40	3 547.80 *Cr.*
April 11	Deposit (rent)		240.00	3 787.80 *Cr.*
	Collection charges	2.40		3 785.40 *Cr.*
	Cheque 822	360.00		3 425.40 *Cr.*
April 12	Cheque 824	4 350.00		924.60 *Dr.*
April 16	Deposit		1 992.75	1 068.15 *Cr.*
April 20	Deposit		420.00	1 488.15 *Cr.*
	Bank discount	9.75		1 478.40 *Cr.*
	Service fee	16.80		1 461.60 *Cr.*
	Interest	2.05		1 459.55 *Cr.*
	Cheque 825	244.80		1 214.75 *Cr.*
	Cheque 826	252.00		962.75 *Cr.*
April 25	Stop order	1 950.00		987.25 *Dr.*
April 27	Deposit		2 152.35	1 165.10 *Cr.*
	Unpaid cheque (K. Palmer)	142.50		1 022.60 *Cr.*

Notes

- On 16 October 20*x*2, cheque 558 was drawn in favour of N. Fourie for repairs to the building. The cheque is stale and must be cancelled.
- Cheque 828 was mislaid and the bank was notified to stop payment.

You are required to:

1 Open the bank account in the general ledger. Post the totals of the cash receipts journal and cash payments journal to the bank account after having finalised them. Complete the cash receipts journal and cash payments journal by commencing with the given totals. Show only the bank columns.

2 Prepare a bank reconciliation statement at 30 April 20*x*3.

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Question 11.13

This information appears in the accounting records of Tech Traders:

1 Bank account:

Debit balance on 1 June 20*x*9 is R1 800.

2

CASH RECEIPTS JOURNAL OF TECH TRADERS – JUNE **CRJ6**

Rec.	Day	Details	Fol.	Bank	Sales	VAT output	Accounts receivable	Interest expense	Cost of sales
301	7	F. Fuller	ARL2	120 00		(0 61)	125 00	(4 39)	
CRT		Sales		3 648 00	3 200 00	448 00			2 200 00
302	13	M. Mason	ARL3	154 00		(0 98)	162 00	(7 02)	
CRT		Sales		3 078 00	2 700 00	378 00			1 900 00
303	21	B. Boyce	ARL1	200 00		(1 23)	210 00	(8 77)	
CRT		Sales		2 416 80	2 120 00	296 80			1 620 00
CRT	28	Sales		3 249 00	2 850 00	399 00			2 050 00
CRT	30	Sales		4 115 40	3 610 00	505 40			2 840 00
				16 981 20	14 480 00	2 024 38	497 00	(20 18)	10 610 00

3

CASH PAYMENTS JOURNAL OF TECH TRADERS – JUNE **CPJ6**

Chq.	Day	Details	Fol.	Bank	Inventory	VAT input	Accounts payable	Wages	Sundry accounts	Fol.	Interest received
501	1	Lotz & Son	APL1	2 620 00		(27 02)	2 840 00				(192 98)
502	3	Telphone		67 00		8 23			58 77	N	
503	6	Water and electricity		114 00		14 00			100 00	N	
504	8	Menlyn Ltd		5 278 20	4 630 00	648 20					
505		Cash		330 00				330 00			
506	12	Marx & Co/ Equipment		1 640 00	1 000 00	140 00			500 00	B	
507	15	Nel & Co	APL2	746 00		(2 95)	770 00				(21 05)
508	20	Cash		400 00				400 00			
509	24	AZ Ltd		644 00			644 00				
510	30	Cash		420 00				420 00			
511		RW Insurers/ Insurance		135 00					135 00	N	
				12 394 20	5 630 00	780 46	4 254 00	1 150 00	793 77		(214 03)

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4 Bank statement of Tech Traders:

Number	Cheques, etc.	Deposits	Date	Balance
			01/06/20x9	1 800,00
502	67.00		04/06/20x9	1 733.00
501	2 620.00		04/06/20x9	–887.00
		3 768.00	07/06/20x9	2 881.00
504	5 278.20		08/06/20x9	–2 397.20
CB	4.00		09/06/20x9	–2 401.20
503	114.00		10/06/20x9	–2 515.20
505	330.00		10/06/20x9	–2 845.20
506	1 640.00		12/06/20x9	–4 485.20
		3 232.00	14/06/20x9	–1 253.20
UN	154.00		15/06/20x9	–1 407.20
507	746.00		16/06/20x9	–2 153.20
508	400.00		20/06/20x9	–2 553.20
PT	110.00		21/06/20x9	–2 663.20
		2 616.80	21/06/20x9	- 46.40
SF	14.00		25/06/20x9	- 60.40
SD	2.00		27/06/20x9	- 62.40
		3 249.00	28/06/20x9	3 186.60
		360.00	29/06/20x9	3 546.60
510	420.00		30/06/20x9	3 126.60
IN	18.00		30/06/20x9	3 108.60
TL	1.00		30/06/20x9	3 107.60

Note

- The unpaid cheque (UN) was received from M. Mason on 14 June and dishonoured on account of insufficient funds.
- The deposit of R360 on 29 June was rent paid directly into the current bank account of Tech Traders by Protea Florists.
- The stop order for R110 was the annual insurance premium paid to Unie Insurers.

You are required to:

1 Compare the bank statement with the cash receipts journal and cash payments journal and make supplementary entries in both journals. Show only the bank columns.
2 Close off the journals and post only to the bank account in the general ledger. Then balance the bank account.
3 Prepare a bank reconciliation statement on 30 June 20*x*9 to reconcile the balance of the bank account with that of the bank statement.

Question 11.14

Mr and Mrs Seymour were married on 1 December 20*x*6. The happy couple returned from their honeymoon two weeks later. Their joint bank statement arrived in the post the next day.

Mrs Seymour was enjoying a relaxing cup of tea when she heard a roar of anger from the study. She rushed to the room. Two minutes later they had their first fight.

Mrs Seymour had previously told her husband that they had R197 in their joint bank account but the bank statement showed that an amount of R838 was overdrawn.

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Mr Seymour is extremely unhappy and now wishes that he had never agreed that he and his wife should close their individual bank accounts and operate a joint current account.

This information is for to the Seymours' financial affairs:

Bank Statement #001 (Joint account)

Details	Debit	Credit	Balance
Opening balance			0
Transfer			
– Rondebosch a/c number 10089			
– Mr Seymour		640	640
Paid			
– Muizenberg a/c number 15064			
– Mrs Seymour	110		
Cheque 001	90		
Cheque 002	1 120		680 *Dr.*
Cheque 004	310		990 *Dr.*
Cheque 006	24		1 014 *Dr.*
Cheque 009	740		1 754 *Dr.*
Bank charges	10		1 764 *Dr.*
Interest	14		1 778 *Dr.*
Debit note	48		1 826 *Dr.*
Stop order	92		1 918 *Dr.*
Autobank – Durban	50		1 968 *Dr.*
Autobank – Durban	100		2 068 *Dr.*
Transfer- ex savings a/c – Mrs Seymour		500	1 568 *Dr.*
Deposit		650	918 *Dr.*
Deposit		1 000	82
Cheque 889	200		118 *Dr.*
Cheque 890	282		400 *Dr.*
Cheque 010	38		438 *Dr.*
Cheque 220	400		838 *Dr.*
Carried forward			**838** *Dr.*

Bank Statement #012 (Mrs Seymour)

Details	Debit	Credit	Balance
Opening balance			20
Cheque 219	122		102 *Dr.*
Bank charges	8		110 *Dr.*
Received – Rondebosch		110	0
Carried forward			**0**

Mrs Seymour's calculations were as follows:

Details	Debit	Credit	Balance
Opening balance 01/12/20*x*6			120
Cheque 218	100		20
Cheque 219	122		102 *Dr.*
Cheque 220	400		502 *Dr.*
Salary for December		650	148
Transfer from savings		500	648
Balance to be transferred to joint account			**648**

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Joint account

Details	Debit	Credit	Balance
Opening balance 01/12/20*x*6			0
Transfer – Mr Seymour		640	640
Transfer – Mrs Seymour		648	1 288
Cheque 001	90		1 198
Cheque 002	1 120		78
Cheque 003 – *Cancelled*			78
Cheque 004	310		232 *Dr.*
Cheque 005	198		430 *Dr.*
Cheque 006	24		454 *Dr.*
Cheque 007	201		655 *Dr.*
Cheque 008	20		675 *Dr.*
Cheque 009	740		1 415 *Dr.*
Cheque 010	38		1 453 *Dr.*
Deposit – salary: Mr Seymour		1 000	453 *Dr.*
Deposit – salary: Mrs Seymour		650	197
Balance			**197**

Additional information:

- Cheque 218 appeared on bank statement 11 (Mrs Seymour's account).
- Neither Mr Seymour, nor Mrs Seymour, has ever possessed a cheque book numbered from 850–900.

You are required to:

1 Reconcile the amount R110 paid from the joint account to Mrs Seymour's prior bank account, with her calculation of R648.
2 Reconcile the closing joint account balance with Mrs Seymour's calculations of R197.

Question 11.15

Refer to the information in the chapter illustrative example for Tladi Traders.

You are required to:

Post the adjusted cash journals to the general ledger and prepare a trial balance as at 28 February 20*x*3.

Question 11.16

Here are some of the balances that appeared in the books of Det Stores as at 1 March 20*x*9:

Bank (*Dr.*)	B5	3 572	50
Inventory	B7	4 109	36
G. Rosa	ARL4	360	80
S. Joffe	ARL7	540	00

Equipment	B6	4 370	00
Rous Ltd	APL3	1 260	00
Clarke Wholesalers	APL9	872	20

Transactions for March: (*Ignore* VAT)

1 Paid the local council for the rates and taxes, R956.80 and water, R95.70 (cheque 60).
Merchandise bought from Rous Ltd and paid by cheque, R1 563.32.
4 Goods sold for cash, R1 395.21 (C/S 51).
5 Received rent for premises from C. Rice, R725 (receipt 43).
S. Joffe settled his debt as at 1 March by cheque.
9 Received a cheque for rent, R250.

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12 Sold goods for cash, R226.35.
14 Received a cheque for R360.80 from Rosa in full settlement of account.
17 Cash sales, R1 475.10.
19 Paid by cheque to Clarke Wholesalers on account, R400 and received a discount of R20.
23 Bought goods from Parry Ltd, R325.40 and paid by cheque.
24 Paid by cheque to Rous Ltd, R1 200 and was allowed R60 discount.
28 Drew a cash cheque to restore the petty cash imprest, R197.56.

Additional information:
The business uses the perpetual inventory system to account for inventory and it marks its goods up by 50% on cost price.

You are required to:
1 Record the transactions in the cash receipts journal and cash payments journal for March 20*x*9.
2 Close off these subsidiary journals correctly at the end of the month.

Question 11.17

Tiger Stores has these balances, among others, in its books on 1 July 20*x*7:

Bank	7 928	00
Petty cash	200	00
Stationery expense	2 079	00
Wages expense	14 217	00
Postage expense	197	00

These petty cash disbursements were made during July.
2 String and glue (voucher 263), R3.46.
9 Carriage on purchases, R19.
10 Wages, R32.
13 Notepaper, R13.26.
14 Stamps, R4.50.
16 Staples, R9.25.
19 Wages, R32.
22 Registered letter, R3.75.
25 Fax charges, R6.25.
27 Repairs to motor vehicles, R14.95.
28 Wages, R32.
29 Envelopes, R8.72.
31 The petty cashier restored the imprest amount.

You are required to:
1 Enter the above transactions into the petty cash journal with suitable analysis columns.
2 Post from the petty cash journal to the general ledger.

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12 CREDIT TRANSACTIONS

Chapter objectives

By the end of this chapter, you should be able to:

- Motivate the need for personal accounts.
- Clarify how individual receivables and payables are kept in separate subsidiary ledgers.
- Process transactions using the accounts receivable journal to record credit sales.
- Process transactions using the accounts payable journal to record credit purchases.
- Explain the accounting treatment of sales and purchases returns.
- Distinguish between trade discount and settlement discount.
- Explain the accounting treatment of settlement discounts received from payables.
- Explain the accounting treatment of settlement discounts allowed to receivables.
- Record bad debts.
- Record bad debts recovered previously written off as irrecoverable.
- Use the control accounts in the general ledger to detect errors.
- Record allowance for bad debts adjustments.
- Prepare a statement of reconciliation of accounts payable and accounts receivable.
- Explain the need for a credit policy.
- Explain how the credit policy is controlled.

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1 Introduction

The intention behind any trading activity is to receive the cash for goods and services sold. It is, therefore, apparent that most businesses would prefer to sell their goods and services on a cash basis. However, should a buyer be able to buy on credit elsewhere, it is possible that the business that sells for cash only could lose sales.

Think, for example, how many people operate a clothing account instead of buying clothes for cash. As a result many businesses open accounts for their customers, so that they can buy on credit. A business that allows credit sales incurs additional costs.

Additional administration is required to keep records of amounts outstanding, the postage and stationery in sending out monthly statements will increase costs and interest may be lost on the money owed. Moreover, there always exists the risk that accounts will not be paid, with a resulting loss equivalent to the cost of goods sold.

In this chapter, we will consider all the remaining non-cash, or credit transactions that take place.

To deal with the large volumes of cash transactions, subsidiary journals were created for dealing with cash receipts and cash payments. These subsidiary journals are the cash receipts journal (CRJ) and cash payments journal (CPJ). They allow for a very summarised bank account in the general ledger. In addition, through the use of analysis columns, the posting of totals to other general ledger accounts was made possible.

The same principles for dealing with large volumes of transactions applicable to the cash receipts journal and the cash payments journal apply to credit transactions. The principle of subsidiary journals can be adapted to meet the particular accounting needs of any reporting entry.

In this chapter, we concentrate on the processing of large volumes of credit transactions that are similar in nature with the use of accounts receivable (or sales) journal and the accounts payable (or purchases) journal.

This chapter explores briefly the factors relating to credit management and describes the necessary accounting entries for allowance for bad debts. It considers credit control policies and deals with the creation of allowance for bad debts at the end of the financial year.

2 Personal accounts

So far in this book we have used two personal accounts, namely an accounts receivable account and an accounts payable account. From the view of reporting accounting information, it is sufficient to know how much the business owes its accounts payable and also how much its accounts receivable owe to the business. However, the business cannot function efficiently unless it knows who its accounts receivable are and how much is owed by each.

Similarly, the business needs to know who its accounts payable are and how much is owed to each. Without this information the business would not be able to ensure that it receives the money owing to it. It would also not be able to pay its accounts payable the amounts owing to them. For this reason, in addition to the one account for accounts receivable and the one account for accounts payable in the general ledger, separate accounts also need to be kept for each individual receivable and payable.

Did you know?

Debtors are now called accounts receivable/receivables and creditors are now called accounts payable/payables.

The inventory account is sometimes called the trading stock account in the general ledger.

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These personal accounts are not kept in the general ledger. They are kept in different ledgers called subsidiary ledgers. The personal accounts in the subsidiary ledgers, therefore, do not form part of the double-entry system, as the double-entry results only in general ledger accounts.

- The debit part of a sales transaction is posted to the **subsidiary ledger**, while the total debits are posted as part of the double-entry to the accounts receivable account in the **general ledger**.
- The credit part of a purchasing transaction is posted to the **subsidiary ledger**, while the total credits is posted as part of the double-entry to the accounts payable account in the **general ledger**.

You should be able to complete Question 12.1.

A series of examples will be given throughout the chapter to explain the use of personal accounts and its books of first entry. In all instances VAT has been ignored.

Example 12.1

Letaba Wholesalers uses the periodic inventory system and has a balance for accounts receivable of R9 000 in the general ledger on 1 May. These are their accounts receivable:

A. Lee	R1 500
B. Retailer	R3 700
C. Voosi	R3 800
	R9 000

You are required to:
Show the personal accounts and the accounts receivable general ledger account as they would appear on 1 May.

General Ledger of Letaba Wholesalers
Real Accounts Section

Dr. **ACCOUNTS RECEIVABLE** **B5** **Cr.**

May	1	Balance	b/d	9 000	00						

Accounts Receivable Ledger of Letaba Wholesalers

A. LEE ARL1

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					1 500	00

B. RETAILER ARL2

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					3 700	00

C. VOOSI ARL3

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					3 800	00

Explanation

In this book, we will show the accounts in the general ledger by means of a T-account. (You will notice that the lines in the accounts receivable account form a T).

The format of the accounts in the subsidiary ledgers are shown in a different format: instead of using a T-account, a three-column format is used that requires the account to be balanced after each transaction.

The three-column format is most suitable for computerised accounts, as a balance is electronically calculated after every transaction.

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Example 12.2

Refer to the information in Example 12.1.

These transactions took place between Letaba Wholesalers and its accounts receivable during May:

3 A. Lee settled his account with a cheque for R1 500.

5 Sold goods on credit to:

- B. Retailer R1 300
- C. Voosi R2 400

16 Received a cheque for R3 000 from B. Retailer.

19 Sold goods on credit to C. Voosi for R1 600.

28 Received a cheque for R5 000 from C. Voosi.

You are required to:

Enter the transactions in the general journal of Letaba Wholesalers. Post the entries applicable to the accounts receivable account in the general ledger, as well as the individual accounts in the accounts receivable ledger.

The general journal entries to which you are accustomed would appear as follows:

GENERAL JOURNAL OF LETABA WHOLESALERS

Day	Details	Fol.	Debit		Credit	
03/05	Bank	B4	1 500	00		
	Accounts receivable	B5			1 500	00
	A. Lee settled his account. Issued receipt xxx.					
05/05	Accounts receivable	B5	1 300	00		
	Sales	N1			1 300	00
	B. Retailer purchased goods. Issued invoice xxx.					
05/05	Accounts receivable	B5	2 400	00		
	Sales	N1			2 400	00
	C. Voosi purchased goods. Issued invoice xxx.					
16/05	Bank	B4	3 000	00		
	Accounts receivable	B5			3 000	00
	Received cheque from B. Retailer. Issued receipt xxx.					
19/05	Accounts receivable	B5	1 600	00		
	Sales	N1			1 600	00
	C. Voosi purchased goods. Issued invoice xxx.					
	Bank	B4	5 000	00		
28/05	Accounts receivable	B5			5 000	00
	Received cheque from C. Voosi. Issued receipt xxx.					

General Ledger of Letaba Wholesalers
Real Accounts Section

Dr. **ACCOUNTS RECEIVABLE** **B5** Cr.

May	1	Balance	b/d	9 000	00	May	3	Bank	GJ5	1 500	00
	5	Sales	GJ5	1 300	00		16	Bank	GJ5	3 000	00
		Sales	GJ5	2 400	00		28	Bank	GJ5	5 000	00
	19	Sales	GJ5	1 600	00		31	Balance	c/d	4 800	00
				14 300	00					14 300	00
Jun.	1	Balance	b/d	4 800	00						

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Accounts Receivable Ledger of Letaba Wholesalers

A. LEE **ARL1**

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					1 500	00
	3	Receipt xxx	GJ5			1 500	00	0	00

B. RETAILER **ARL2**

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					3 700	00
	5	Invoice xxx	GJ5	1 300	00			5 000	00
	16	Receipt xxx	GJ5			3 000	00	2 000	00

C. VOOSI **ARL3**

Date		Details	Fol.	Debit		Credit		Balance	
May	1	Balance	b/d					3 800	00
	5	Invoice xxx	GJ5	2 400	00			6 200	00
	19	Invoice xxx	GJ5	1 600	00			7 800	00
	28	Receipt xxx	GJ5			5 000	00	2 800	00

Explanation

- Each entry is posted individually to the accounts receivable account in the general ledger, with reference to the account that will receive the other half of the double-entry. For example, the sales account in the general ledger will be credited with R1 300, R2 400 and R1 600 using the accounts receivable account as reference.
- The individual account of each receivable mentioned in the narration has been updated with each individual entry, indicating the new balance owing. Entries are made with reference to the actual source documents and not the other account involved in the double-entry.
- The general ledger has a complete set of double-entries. A trial balance would thus balance without using any accounts from the accounts receivable ledger.

3 Accounts payable journal

Also known as a purchases journal, this journal is used for entering all purchases on account. Whenever inventory, assets, or consumable stores such as stationery are purchased and payment is not effected on delivery, a credit transaction has taken place.

In all these cases, the accounts payable account is credited, resulting in an increase of liabilities, and another account will be debited. Depending on the nature of the purchase, the debits may, for example, be to:

- **Inventory account** (where the perpetual inventory system is used), resulting in an increase in assets.
- **Purchases account** (where the periodic inventory system is used), resulting in a decrease in owner's equity.
- **Equipment account**, resulting in an increase in assets.
- **Stationery expense account**, resulting in a decrease in owner's equity.

In all credit purchase transactions, the accounts payable account is credited, at the same time crediting the personal account of the payable in the accounts payable ledger.

This similarity in credit purchase transactions makes it possible (and even feasible) to use a special subsidiary journal for entering all credit purchases, rather than posting each individual purchase to a separate general journal entry. The analysis columns to be used

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will depend on the nature of the business and the frequency with which certain types of purchases are made.

As with the cash receipts journal and the cash payments journal, only totals of analysis columns will be posted to the general ledger accounts.

Example 12.3 Rustic Retailers purchases, restores and resells old furniture. Below are some of the transactions of Rustic Retailers for January 20*x*1. Ignore VAT.

3 Purchased a 19th century dining room suite on credit from A. Abdullah for R900.

7 Purchased paint remover and varnish from B. Baijnath for R160 on credit.

8 Received invoice for R3 900 for a vehicle purchased on credit from C. Choane.

11 Bought a Welsh dresser on credit from D. Davel for R700.

16 Received delivery of woodstain from E. Eglin together with an invoice for R420 less 20% trade discount. Account still to be paid.

18 Paid R260 to F. Fullard for tables and chairs purchased.

23 Purchased 12 desks at R220 each from G. Grootboom on credit.

You are required to:

1 Record the above transactions in the accounts payable journal.

2 Post the totals of the accounts payable journal to the general ledger.

1 *Journal*

ACCOUNTS PAYABLE JOURNAL OF RUSTIC RETAILERS – JANUARY APJ1

Inv.	Day	Details	Fol.	Accounts payable		Inventory		Consumables		Sundry accounts			
										Amount		Fol.	Account
1201	3	A. Abdullah	APL1	900	00	900	00						
1282	7	B. Baijnath	APL2	160	00			160	00				
IX14	8	C. Choane	APL3	3 900	00					3 900	00	B3	Vehicles
1073	11	D. Davel	APL4	700	00	700	00						
121	16	E. Eglin	APL5	336	00			336	00				
7917	23	G. Grootboom	APL6	2 640	00	2 640	00						
				8 636	00	4 240	00	496	00	3 900	00		
				B8		B6		N4					

Explanation

- The entries are made in this subsidiary journal instead of the general journal because they are all of the same type. Every entry here results in an increase in payables, and therefore, also an increase in liabilities.
- Columns are opened for the types of transactions that recur frequently, for example, the purchase of inventory and consumables.
- A separate column called sundry accounts is opened to record transactions that occur only once or very occasionally, for example, the purchase of the vehicle on the 8th.
- Trade discount is not recorded in the books of account, but deducted before the entry is made. Refer to the transaction on the 16th.
- The transaction on the 18th is a cash transaction and is, therefore, not entered in the accounts payable journal. It would be recorded in the cash payments journal.
- The sum of the totals of the columns (R4 240 + R496 + R3 900) equals the total of the accounts payable column (R8 636). This means that the subsidiary journal cross-casts.

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2 *Ledger accounts*

General Ledger of Rustic Retailers
Real Accounts Section

Dr. **VEHICLES** **B3** **Cr.**

Jan.	8	Accounts payable	APJ1	3 900	00						

INVENTORY **B6**

Jan.	31	Accounts payable	APJ1	4 240	00						

ACCOUNTS PAYABLE **B8**

						Jan.	1	Total purchases	APJ1	8 636	00

Nominal Accounts Section

Dr. **CONSUMABLES** **N4** **Cr.**

Jan.	31	Accounts payable	APJ1	496	00						

Explanation

- Only totals of columns are posted to the general ledger.
- Note that the debit entries (R4 240 + R496 + R3 900) equal the credit entry of R8 636.
- Here is the effect on the accounting equation:

Assets	=	Owner's equity	+	Liabilities
R8 140 (R4 240 + R3 900)		– R496		R8 636

- VAT has been ignored in this example. If Rustic Retailers is registered for VAT, the purchases in this example would be subject to VAT and a special column for VAT is usually provided for.
- Although not required in this question, the next step would be to update the individual payable accounts in the accounts payable ledger.

4 Accounts receivable journal

The accounts receivable journal (also known as the sales journal) is used to record all credit sales. In addition to selling goods and services, an organisation may also sell other assets that are no longer useful.

Sales on credit are always debited to the accounts receivable account, causing an increase in assets. The corresponding credit entry will either result in an increase in owner's equity (sale of inventory) or a decrease in assets (sale of other assets).

The analysis columns to be used will depend on the nature and frequency of the types of sales. If a perpetual inventory system is used, then the entry for cost of goods sold is made at the same time and consequently a separate cost of sales column is opened.

To develop from the less complex to the more complex, three examples of accounts receivable journals are shown:

1. Periodic inventory system, ignoring VAT.
2. Perpetual inventory system, ignoring VAT.
3. Perpetual inventory system, with output VAT.

The same basic information will be used in all three examples. Although, in practice, there are many more transactions, the principles remain the same.

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Example 12.4

Included in the transactions of Latifa Producers for January 20*x*1 were:

1 Sold goods marked at R200 for cash to H. Hendrickz.

8 Sold goods marked at R400 to I. Isaacs on credit, invoice no 281.

15 Sold goods marked at R900 to J. Jacobs on credit.

21 Sold equipment no longer required, on credit to K. Kruger at its carrying value of R350. Assume that this sale is not subject to VAT.

23 Sent inventory and invoice marked at R320 to L. Lebea on credit.

You are required to:

Prepare the accounts receivable journal assuming:

1. Periodic inventory system is used and VAT is ignored.
2. Perpetual inventory system is used, goods are marked up by 25% on cost price and VAT is ignored.
3. Perpetual inventory system is used and VAT @ 14%, all amounts are VAT exlcusive.

1 *Periodic inventory system, ignoring VAT*

ACCOUNTS RECEIVABLE JOURNAL OF LATIFA PRODUCERS – JANUARY ARJ1

Inv.	Day	Details	Fol.	Accounts receivable		Sales		Sundry accounts			
								Amount		Fol.	Account
281	8	I. Isaacs	ARL1	400	00	400	00				
282	15	J. Jacobs	ARL2	900	00	900	00				
283	21	K. Kruger/Equipment	ARL3	350	00			350	00	B4	Asset disposal
284	23	L. Lebea	ARL4	320	00	320	00				
				1 970	00	1 620	00	350	00		
				B7		N1					

Explanation

- The cash sales on the 1st will be recorded in the cash receipts journal and not in the accounts receivable journal.
- The only postings to the general ledger would be:
  - Dr. Accounts receivable R1 970
  - Cr. Sales R1 620
  - Cr. Asset disposal account R350
  - It is evident that the debits (R1 970) equal the credits (R1 620 + R350).
- Debit entries will be posted to the personal accounts in the accounts receivable ledger.

2 *Perpetual inventory system, 25% mark-up and ignoring VAT*

ACCOUNTS RECEIVABLE JOURNAL OF LATIFA PRODUCERS – JANUARY ARJ1

Inv.	Day	Details	Fol.	Accounts receivable		Sales		Sundry accounts				Cost of sales	
								Amount		Fol.	Account		
281	8	I. Isaacs	ARL1	400	00	400	00					320	00
282	15	J. Jacobs	ARL2	900	00	900	00					720	00
283	21	K. Kruger/Equipment	ARL3	350	00			350	00	B4	Asset disposal		
284	23	L. Lebea	ARL4	320	00	320	00					256	00
				1 970	00	1 620	00	350	00			1 296	00
				B7		N1						B6/N2	

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Explanation

- The only extra information is the cost of the goods sold. The mark-up is 25% on cost price. Therefore, cost is calculated by multiplying the selling price by 100 ÷ 125 or 0.80.
- Equipment is classified as tangible assets, therefore, no cost of sales is calculated on old equipment sold.
- The total of the cost of sales column is posted to the general ledger twice:
  - Dr. Cost of sales R1 296
  - Cr. Inventory R1 296
- In cross-casting, the total of the cost of sales column is ignored as it constitutes a double-entry on its own.
- All the other entries to the general ledger are the same as Solution 1.

3 *Perpetual inventory system, 25% mark-up, 14% VAT*

ACCOUNTS RECEIVABLE JOURNAL OF LATIFA PRODUCERS – JANUARY ARJ1

Inv.	Day	Details	Fol.	Accounts receivable		Sales		VAT output		Sundry accounts				Cost of sales	
										Amount		Fol.	Account		
281	8	I. Isaacs	ARL1	456	00	400	00	56	00					320	00
282	15	J. Jacobs	ARL2	1 026	00	900	00	126	00					720	00
283	21	K. Kruger/ Equipment	ARL3	350	00					350	00	B4	Asset disposal		
284	23	L. Lebea	ARL4	364	80	320	00	44	80					256	00
				2 196	80	1 620	00	226	80	350	00			1 296	00
				B7		N1		B9						B6/N2	

Explanation

- Only one additional column, for VAT output, is required.
- VAT is collected on behalf of SARS. Receivables must pay VAT to the seller who, in turn, will pay it over to SARS.
- Posting to the general ledger will be as follows:
  - Dr. Accounts receivable R2 196.80
  - Cr. Sales R1 620.00
  - Cr. VAT R226.80
  - Cr. Asset disposal account R350.00
  - Dr. Cost of sales R1 296.00
  - Cr. Inventory R1 296.00
  - It is evident that the debits (R2 196.80 + R1 296) equal the credits (R1 620 + R226.80 + R350 + R1 296).
- Only six postings to the general ledger are required, irrespective of the number of credit sale transactions.

You should be able to complete Questions 12.2 and 12.3.

5 Allowances journals

When goods are purchased and sold on credit, it often happens that the recipient of the goods is not satisfied and returns either part or all of the goods. This may happen mainly for these reasons:

- The goods are damaged or faulty. They may either be broken or aged and the seller will usually take responsibility by replacing them or cancelling the sale.

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- The goods are sold on approval ('on appro'). In this case the buyer is uncertain whether the goods will be retained, depending on their suitability, but purchases them on the understanding that they may be returned.
- The buyer has an oversupply. This occurs more frequently with retailers who purchase goods for resale but find that they are not selling well. An understanding often exists with the supplier that such goods may be returned.
- Incorrect type of goods (incorrect size, colour, part number, quantity, and so on).

The accounting procedures for returns were developed in Chapter 9. When goods are returned, the following procedure is most commonly adopted:

- The purchaser returning the goods completes a source document known as a debit note, showing the intention to debit the account of the party to whom the money is owed.
- On receipt of the debit note and the goods, the seller will determine whether the return is valid and then issue a credit note in duplicate indicating the intention to credit the account of the receivable, thus, reducing the amount that is owed by the receivable. One copy is sent to the receivable and the other copy retained for further processing.
- The transaction of returning goods is thus completed only once the credit note has been passed. Both parties will then update their accounting records.

There are two methods of dealing with returns:

- They may be entered into the accounts receivable or accounts payable journal and the amounts bracketed to indicate that it is a return.
- Special journals may be used, applying the identical principles used for accounts receivable and accounts payable journals – but obviously with postings to the opposite sides of the general ledger accounts. These special journals are usually referred to as:
  - The accounts receivable allowances journal (or sales returns journal).
  - The accounts payable allowances journal (or purchases returns journal).

Example 12.5

Zitha Stores was established and started trading on 1 January 20*x*5.

- The VAT rate is 14%. Zitha Stores uses the perpetual inventory system to account for inventory.
- Goods are sold at cost plus 50%.

Transactions for January 20x5:

Cash receipts

Detail	Amount	
Capital contribution by the owner	30 000	00
Received in respect of cash sales	17 100	00
Received from receivable, K. Khumalo (VAT inclusive)	1 710	00

Cash payments

Detail	Amount	
Rent for business premises	3 192	00
Cash purchases of inventory	13 680	00
Payment to payable, S. Stern (VAT inclusive)	1 744	20

Credit sales (VAT inclusive)

Detail	Amount	
K. Khumalo	2 052	00
M. Makeba	1 197	00
C. Coertze	1 470	60

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Credit purchases (VAT inclusive)

Detail	Amount	
S. Stern	2 166	00
S. Selepe	1 254	00
C. Claerhout	1 664	40

Purchases returns (VAT inclusive)

Detail	Amount	
S. Stern	228	00
S. Selepe	125	40

Sales returns (VAT inclusive)

Detail	Amount	
K. Khumalo	342	00

You are required to:

1 Record the entries in the appropriate subsidiary journals.

2 Post to the subsidiary ledgers and general ledger.

3 Compare the accounts receivable and accounts payable lists, extracted from the accounts receivable and accounts payable ledgers, with the accounts receivable account and accounts payable account in the general ledger.

1 *Journals*

CASH RECEIPTS JOURNAL OF ZITHA STORES – JANUARY **CRJ1**

Rec.	Day	Details	Fol.	Bank		Sales		VAT output		Accounts receivable		Sundry accounts				Cost of sales	
												Amount		Fol.	Account		
001	1	Capital		30 000	00							30 000	00	B1	Capital		
CRT	31	Cash sales		17 100	00	15 000	00	2 100	00							10 000	00
002		K. Khumalo	ARL2	1 710	00					1 710	00						
				48 810	00	15 000	00	2 100	00	1 710	00	30 000	00			10 000	00
				B4		N1		B9		B7						B6/N2	

CASH PAYMENTS JOURNAL OF ZITHA STORES – JANUARY **CPJ1**

Chq.	Day	Details	Fol.	Bank		Inventory		VAT input		Accounts payable		Sundry accounts				Interest received	
												Amount		Fol.	Account		
001	31	Rent expense		3 192	00			392	00			2 800	00	B2	Rent expense		
002		Cash purchases		13 680	00	12 000	00	1 680	00								
003		S. Stern	APL3	1 744	20					1 744	20						
				18 616	20	12 000	00	2 072	00	1 744	20	2 800	00				
				B4		B6		B9		B8						B8/N6	

ACCOUNTS RECEIVABLE JOURNAL OF ZITHA STORES – JANUARY **ARJ1**

Inv.	Day	Details	Fol.	Accounts receivable		Sales		VAT output		Cost of sales	
001	31	K. Khumalo	ARL2	2 052	00	1 800	00	252	00	1 200	00
002		M. Makeba	ARL3	1 197	00	1 050	00	147	00	700	00
003		C. Coertze	ARL1	1 470	60	1 290	00	180	60	860	00
				4 719	60	4 140	00	579	60	2 760	00
				B7		N1		B9		B6/N2	

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ACCOUNTS RECEIVABLE ALLOWANCES JOURNAL OF ZITHA STORES – JANUARY **ARAJ1**

C/N	Day	Details	Fol.	Accounts receivable		Sales		VAT output		Cost of sales	
001	31	K. Khumalo	ARL2	342	00	300	00	42	00	200	00
				342	00	300	00	42	00	200	00
				B7		N1		B9		B6/N2	

ACCOUNTS PAYABLE JOURNAL OF ZITHA STORES – JANUARY **APJ1**

Inv.	Day	Details	Fol.	Accounts payable		Inventory		VAT input	
001	31	S. Stern	APL3	2 166	00	1 900	00	266	00
002		S. Selepe	APL2	1 254	00	1 100	00	154	00
003		C. Claerhout	APL1	1 664	40	1 460	00	204	40
				5 084	40	4 460	00	624	40
				B8		B6		B9	

ACCOUNTS PAYABLE ALLOWANCES JOURNAL OF ZITHA STORES – JANUARY **APAJ1**

D/N	Day	Details	Fol.	Accounts payable		Inventory		VAT input	
001	31	S. Stern	APL3	228	00	200	00	28	00
002		S. Selepe	APL2	125	40	110	00	15	40
				353	40	310	00	43	40
				B8		B6		B9	

2 *Ledgers*

General Ledger of Zitha Stores
Real Accounts Section

Dr. **CAPITAL** **B1** **Cr.**

						Jan.	1	Bank	CRJ1	30 000	00

BANK **B4**

Jan.	31	Total receipts	CRJ1	48 810	00	Jan.	31	Total payments	CPJ1	18 616	20
								Balance	c/d	30 193	80
				48 810	00					48 810	00
Feb.	1	Balance	b/d	30 193	80						

INVENTORY **B6**

Jan.	31	Bank	CPJ1	12 000	00	Jan.	31	Cost of sales	ARJ1	2 760	00
		Accounts payable	APJ1	4 460	00			Cost of sales	CRJ1	10 000	00
		Cost of sales	ARAJ1	200	00			Accounts payable	APAJ1	310	00
								Balance	c/d	3 590	00
				16 660	00					16 660	00
Feb.	1	Balance	b/d	3 590	00						

ACCOUNTS RECEIVABLE **B7**

Jan.	31	Sales: VAT	ARJ1	4 719	60	Jan.	31	Bank	CRJ1	1 710	00
								Sales and VAT	ARAJ1	342	00
								Balance	c/d	2 667	60
				4 719	60					4 719	60
Feb.	1	Balance	b/d	2 667	60						

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ACCOUNTS PAYABLE B8

Jan.	31	Bank	CPJ1	1 744	20	Jan.	31	Inventory and VAT	APJ1	5 084	40
		Inventory and VAT	APAJ1	353	40						
		Balance	c/d	2 986	80						
				5 084	40					5 084	40
						Feb.	1	Balance	b/d	2 986	80

SARS: VAT B9

Dr. Cr.

Jan.	31	Bank	CPJ1	2 072	00	Jan.	31	Bank	CRJ1	2 100	00
		Accounts payable	APJ1	624	40			Accounts receivable	ARJ1	579	60
		Accounts receivable	ARAJ1	42	00			Accounts payable	APAJ1	43	40
								Balance	c/d	15	40
				2 738	40					2 738	40
Feb.	1	Balance	b/d	15	40						

Nominal Accounts Section

SALES N1

Jan.	31	Accounts receivable	ARAJ1	300	00	Jan.	31	Accounts receivable	ARJ1	4 140	00
		Total	c/f	18 840	00			Bank	CRJ1	15 000	00
				19 140	00					19 140	00
						Feb.	1	Total	b/f	18 840	00

COST OF SALES N2

Jan.	31	Inventory	CRJ1	10 000	00	Jan.	31	Inventory	ARAJ1	200	00
		Inventory	ARJ1	2 760	00			Total	c/f	12 560	00
				12 760	00					12 760	00
Feb.	1	Total	b/f	12 560	00						

Accounts Receivable Ledger of Zitha Stores

C.COERTZE ARL1

Date		Details	Fol.	Debit		Credit		Balance	
Jan.	31	Invoice 003	ARJ1	1 470	60			1 470	60

K. KHUMALO ARL2

Date		Details	Fol.	Debit		Credit		Balance	
Jan.	31	Invoice 001	ARJ1	2 052	00			2 052	00
		Credit note 001	ARAJ1			342	00	1 710	00
		Receipt 002	CRJ1			1 710	00	0	00

M. MAKEBA ARL3

Date		Details	Fol.	Debit		Credit		Balance	
Jan.	31	Invoice 002	ARJ1	1 197	00			1 197	00

Accounts Payable Ledger of Zitha Stores

C. CLAERHOUT APL1

Date		Details	Fol.	Debit		Credit		Balance	
Jan.	31	Invoice 003	APJ1			1 664	40	1 664	40

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S. SELEPE **APL2**

Date		Details	Fol.	Debit		Credit		Balance	
Jan.	31	Invoice 002	APJ1			1 254	00	1 254	00
		Debit note 002	APAJ1	125	40			1 128	60

S. STERN **APL3**

Date		Details	Fol.	Debit		Credit		Balance	
Jan.	31	Invoice 001	APJ1			2 166	00	2 166	00
		Debit note 001	APAJ1	228	00			1 938	00
		Cheque 003	CPJ1	1 744	20			193	80

3 *Control accounts*

Accounts Receivable List as at 31 January 20*x*5

C. Coertze	ARL1	1 470	60
K. Khumalo	ARL2	0	00
M. Makeba	ARL3	1 197	00
Balance per accounts receivable		2 667	60

Accounts Payable List as at 31 January 20*x*5

C. Claerhout	APL1	1 664	40
S. Selepe	APL2	1 128	60
S. Stern	APL3	193	80
Balance per accounts payable		2 986	80

You should be able to complete Question 12.4.

6 Discount

The concept of discount was introduced in Chapter 9. We will now focus on the accounting treatment of trade, cash and early settlement discounts.

Trade discount

Trade discounts arise when wholesalers sell goods to retailers, or when manufacturers sell goods to wholesalers. The original objective of a trade discount was that it should act as an indicator of the mark-up to be charged on the sale to the next party.

So, for example, if 5 000 slabs of chocolate were sold by Manufacturer X to Wholesaler Y, each marked at R5 per slab (ignoring VAT) the invoice would read as follows:

5 000 slabs of chocolate @ R5	=	R25 000	00
Less: 40% trade discount	=	R10 000	00
		R15 000	00

The wholesaler will then sell the chocolates for R25 000, pay R15 000 and retain a profit of R10 000. As trade discount is used as a guide to set selling prices, there is no entry for trade discount.

The economic reality of the transaction is that Wholesaler Y now owes R15 000 to Manufacturer X. The transaction that took place is that the wholesaler purchased goods for R15 000.

While there are many differing practices and rates used for trade discount, the only record necessary is that which appears on the invoice itself.

The procedure is thus always the same: no entry in the books of account for trade discount; only an entry for the actual price to be paid after the trade discount has been deducted.

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Cash discount

Cash discounts are offered as incentives to customers to buy goods for cash rather than on account. Like trade discounts, it is offered to the purchaser before ownership passes.

A cash discount is therefore not reflected as a discount, but rather as a reduction in the sales amount that would otherwise be recorded. However, it is important to consider cash discounts allowed when calculating cost of sales under the perpetual inventory system.

Early settlement discount

The terms of a credit sale between two parties may not include only the trade discount. Quite often, an invoice will have an additional concession such as 'terms: 30 days less 5%'.

If this is applied to the example of the chocolate bars above, it means that if the buyer settles the account of R15 000 within 30 days and is permitted to deduct a further 5% as a settlement discount.

An explanation has already been provided on the recognition of discounts, if it is expected that the discount will be taken up. The discount will be taken into account at the start of the transaction.

Example 12.6

On 1 June, M. Goolam sold inventory with a marked price of R25 000 subject to 40% trade discount. The terms of the sale were 30 days less 5%. Based on prior experience, it is expected that G. Maans will take advantage of the discount. Maans settled the account on 25 June.

You are required to:
Record the transactions in the relevant journals of both parties.

ACCOUNTS RECEIVABLE JOURNAL OF M. GOOLAM – JUNE **ARJ6**

Inv.	Day	Details	Fol.	Accounts receivable	
xxx	1	G. Maans	ARL2	14 250	00

Debit accounts receivable and credit sales with

CASH RECEIPTS JOURNAL OF M. GOOLAM – JUNE **CRJ6**

Rec.	Day	Details	Fol.	Accounts receivable	
xxx	25	G. Maans	ARL2	14 250	00

Debit bank and credit accounts receivable with

Explanation

- The entry for the sale is in accordance with the normal sales entry using the periodic inventory system.
- In the case of the discount, this is the effect on the accounting equation.

Asset account (+ / −) = **Owner's equity account** (− / +) + **Liability account** (− / +)

BANK

Dr.	Cr.
14 250	

ACCOUNTS RECEIVABLE

Dr.	Cr.
14 250	14 250

SALES

Dr.	Cr.
	14 250

NO EFFECT

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- The effect of the transactions is that bank has increased by R14 250 and owner's equity has increased by R14 250 as a result of the sale.

ACCOUNTS PAYABLE JOURNAL OF G. MAANS – JUNE **APJ6**

Inv.	Day	Details	Fol.	Accounts payable	
xxx	1	M. Goolam	APL2	14 250	00

Debit inventory and credit accounts payable with

CASH PAYMENT JOURNAL OF G. MAANS – JUNE **CPJ6**

Chq.	Day	Details	Fol.	Accounts payable	
xxx	25	M. Goolam	APL2	14 250	00

Debit accounts payable and credit bank with

Explanation

- The entry for the purchase of inventory is in accordance with the normal purchase entry, if G. Maans uses the perpetual inventory system.
- In the case of the discount, this is the effect on the accounting equation.

Asset account = **Owner's equity account** + **Liability account**

Asset account: + | −

Owner's equity account: − | +

Liability account: − | +

Dr.	BANK	Cr.
		14 250

Dr.	ACCOUNTS PAYABLE	Cr.
14 250		14 250

INVENTORY	
14 250	

- The net effect of the transaction is that we have acquired assets valued at R15 000, but at a cash flow cost of only R14 250, the difference of R750 being an increase in the owner's equity.
- Needless to say, the necessary entries would also be made in the personal accounts in the subsidiary ledgers.

You should be able to complete Questions 12.5 and 12.6.

7 Bad debts

Accounting for bad debts (irrecoverable debt)

The sale or purchase of goods on credit is a routine accounting entry supported by an invoice as the source document. One of the risks of selling goods on credit is the possibility of non-payment, regardless of how diligently and carefully credit is extended. While firms would generally take precautions to ensure that accounts receivable are likely to be able to pay their accounts, there are times when even the most stringent debt collection policy fails.

The debts that will not be paid are called bad debts. A bad debt is an amount owing by a receivable (debtor) that is regarded as irrecoverable. The occurrence of a bad debt, however, is not a routine situation.

Bad debts can arise throughout the year. This is usually as a result of a receivable finding themselves in financial difficulties and either moving without leaving a forwarding address or being declared insolvent and going into liquidation. A stage is reached where the cost of pursuing payment becomes greater than the amount outstanding. At this stage, a decision is made to write the amount off as irrecoverable.

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The writing off of bad debts may thus take place periodically during the year or on a monthly or quarterly basis. Alternatively, it may only be done at the end of the financial year, prior to the financial statements being prepared.

Example 12.7

On 1 September, Jaluka Traders had accounts receivable that totalled R9 600. These included:

- B. Barnard R200
- N. Naidoo R500

These transactions for the two accounts receivable took place during the month:

8 B. Barnard could not be traced. Her account is to be written off as a bad debt.

21 N. Naidoo was declared insolvent. Jaluka Traders received 20c in the R1 as final compensation.

You are required to:
Enter the transactions into the books of Jaluka Traders.

GENERAL JOURNAL OF JALUKA TRADERS **GJ9**

Day	Details	Fol.	Debit		Credit	
08/09	Bad debts	N5	200	00		
	Accounts receivable/B. Barnard	B5			200	00
	B. Barnard's account written off as irrecoverable					
21/09	Bad debts	N5	400	00		
	Accounts receivable/N. Naidoo	B5			400	00
	Received 20c in the R1 from N. Naidoo's insolvent estate (R500 × 20 ÷ 100 = R100; R500 – R100 = R400)					

CASH RECEIPTS JOURNAL OF JALUKA TRADERS – SEPTEMBER **CRJ9**

Rec.	Day	Details	Fol.	Bank	
xxx	21	N. Naidoo	ARL2	100	00

General Ledger of Jaluka Traders
Real Accounts Section

Dr. **BANK** **B4** Cr.

Sep.	21	Accounts receivable	CRJ9	100	00						

Dr. **ACCOUNTS RECEIVABLE** **B5** Cr.

Sep.	1	Balance	b/d	9 600	00	Sep.	8	Bad debts	GJ9	200	00
							21	Bank	CRJ9	100	00
								Bad debts	GJ9	400	00
							30	Balance	c/d	8 900	00
				9 600	00					9 600	00
Oct.	1	Balance	b/d	8 900	00						

Nominal Accounts Section

Dr. **BAD DEBTS** **N5** Cr.

Sep.	8	Accounts receivable	GJ9	200	00						
	21	Accounts receivable	GJ9	400	00	Sep.	30	Profit or loss		600	00
				600	00					600	00

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Accounts Receivable Ledger of Jaluka Traders

B. BARNARD **ARL1**

Date		Details	Fol.	Debit		Credit		Balance	
Sep.	1	Balance	b/d					200	00
	8	Bad debts	GJ9			200	00	0	00

N. NAIDOO **ARL2**

Date		Details	Fol.	Debit		Credit		Balance	
Sep.	1	Balance	b/d					500	00
	21	Receipt xxx	CRJ9			100	00	400	00
		Bad debts	GJ9			400	00	0	00

Explanation

- Only two accounts receivable accounts have been selected from all the receivable accounts for illustrative purposes.
- The bad debts account is a nominal account and will be written off as a loss at the end of the financial period. It will reduce the owner's equity while also reducing the carrying value of the accounts receivable, that is, the asset account:

Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
Dr. **ACCOUNTS RECEIVABLE**	*Cr.*		*Dr.* **BAD DEBTS**	*Cr.*		**NO EFFECT**	
	600		600				

- The entry will be made in the general journal, posted to the general ledger, followed by an updating of the accounts receivable ledger.

You should be able to complete Question 12.7.

Debts recovered previously written off

Once a customer with an outstanding debt (receivable) has failed to pay the amount due and a bad debt has resulted, the receivable's name is recorded to ensure that no further sales are made to that receivable.

Such a receivable may recover from financial distress and wish to reopen an account. In such cases, it is necessary first to pay the previous account to establish confidence and credibility.

Such amounts, previously written off as bad debts and later recovered, are usually placed in a separate account known as the bad debts recovered account. The bad debts recovered account will increase owner's equity.

Note that bad debts recovered are not posted to the credit of the bad debts account. A different account is used for two reasons.

- It provides information that would be lost if it was simply netted off against bad debts.
- It often arises as a result of bad debts written off during a previous period and is strictly an income for the current period. Keeping it separate helps to emphasise this fact.

When a receivable whose account was previously written off to bad debts pays his account, two entries are required.

- First the receivable must be reinstated
- Then the receipt of cash must be recorded.

This is necessary to ensure that a record has been made of the fact that the receivable's debt was settled, thus removing the stigma of a bad debt from the receivable's record.

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Example 12.8

Refer back to Example 12.7.

On 20 September 20*x*2, B. Barnard arrived at the office of Jaluka Traders with the news that she has returned from an extended overseas trip. She wishes to resume her account and settles the R200 that had previously been written off.

The following general journal entry will be passed:

GENERAL JOURNAL OF JALUKA TRADERS GJ9

Day	Details	Fol.	Debit	Credit	Accounts receivable		Accounts payable	
					Debit	Credit	Debit	Credit
20/09	Accounts receivable	B5	200 00		200 00			
	Bad debts recovered	N9		200 00				

Explanation

- The cash receipt will be recorded in the cash receipts journal, from where the account of B. Barnard will be credited.
- Posting to the general ledger will be as follows:
  - *Dr.* Accounts receivable R200
  - *Cr.* Bad debts recovered R200
  - *Dr.* Bank R200
  - *Cr.* Accounts receivable R200

8 Control accounts in the general ledger

So far we have established that:

- Every transaction is entered into a journal before being posted to the general ledger.
- Where the same type of transaction frequently occurs, these like transactions are entered into a special journal.
- The purpose of the special journal is, as for the general journal, to record specific details and information that may be required for the daily operations of the business.
- A special journal also serves to prevent cluttering of the general journal and consequently the general ledger.
- Transactions from the sales and purchases journals are posted individually to the personal accounts in the accounts receivable ledger and accounts payable ledger respectively.
- Only total amounts and not individual transactions are posted to the accounts receivable account and accounts payable account in the general ledger.
- The accounts receivable account in the general ledger would represent the individual accounts in the accounts receivable ledger. Similarly, the accounts payable account in the general ledger would represent the individual accounts in the accounts payable ledger.

  The use of subsidiary ledgers have a number of advantages over recording all transactions in the general ledger. These advantages may be summarised as:
  - The subsidiary ledger accounts show all the transactions affecting a single receivable (or payable) in one account. These individual accounts are updated on a daily basis.
  - The general ledger is free of excessive detail, since only one account is kept for receivables (and only one account for payables) in the general ledger. Only totals of entries are posted to these general ledger accounts at the end of each month.

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– Separating the subsidiary ledgers from the general ledger allows for the separation of duties (one person may be responsible for keeping the accounts receivable ledger, another for keeping the accounts payable ledger, and a third to keep the general ledger).
– The accounts receivable and accounts payable accounts in the general ledger serve as control accounts as a means of ensuring that the individual accounts in the subsidiary ledgers are free from error. The total of the individual accounts in the accounts receivable and accounts payable ledgers must be the same as the balance of the accounts receivable and accounts payable accounts in the general ledger.

Example 12.9 Here are the accounts receivable journal and cash receipts journal of Holbein Enterprises for April 20*x*3:

CASH RECEIPTS JOURNAL OF HOLBEIN ENTERPRISES – APRIL CRJ4

Rec.	Day	Details	Fol.	Bank		Sales		VAT output		Accounts receivable		Cost of sales	
529	1	Cash sales		26 231	40	23 010	00	3 221	40			19 175	00
530	2	J. Vermeer	ARL5	440	00					440	00		
531	5	J. Constable	ARL1	240	00					240	00		
532	12	S. Dali	ARL2	440	00					440	00		
533	15	Cash sales		15 160	86	13 299	00	1 861	86			11 082	50
534	19	P. Picasso	ARL3	620	00					620	00		
535	26	V. van Gogh	ARL4	580	00					580	00		
536	30	Cash sales		10 282	80	9 020	00	1 262	80			7 516	67
				53 995	06	45 329	00	6 346	06	2 320	00	37 774	17
				B4		N1		B9		B7		B6/N2	

ACCOUNTS RECEIVABLE JOURNAL OF HOLBEIN ENTERPRISES – APRIL ARJ4

Inv.	Day	Details	Fol.	Accounts receivable		Sales		VAT output		Cost of sales	
3584	6	V. van Gogh	ARL4	3 260	40	2 860	00	400	40	2 383	33
3585	8	J. Vermeer	ARL5	1 698	60	1 490	00	208	60	1 241	67
3586	13	J. Constable	ARL1	1 060	20	930	00	130	20	775	00
3587	15	J. Vermeer	ARL5	649	80	570	00	79	80	475	00
3589	27	S. Dali	ARL2	1 316	70	1 155	00	161	70	962	50
3590	28	P. Picasso	ARL3	2 143	20	1 880	00	263	20	1 566	67
				10 128	90	8 885	00	1 243	90	7 404	17
				B7		N1		B9		B6/N2	

Here are the relevant extracts from the general ledger and accounts receivable ledger:

General Ledger of Holbein Enterprises
Real Accounts Section

Dr. ACCOUNTS RECEIVABLE B7 Cr.

Apr.	1	Balance	b/d	4 970	00	Apr.	30	Bank	CRJ4	2 320	00
	30	Sales & VAT	ARJ4	10 128	90			Balance	c/d	12 778	90
				15 098	90					15 098	90
May	1	Balance	b/d	12 778	90						

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Accounts Receivable Ledger of Holbein Enterprises

J. CONSTABLE **ARL1**

Date		Details	Fol.	Debit		Credit		Balance	
Apr.	1	Balance	b/d					840	00
	5	Receipt 531	CRJ4			240	00	600	00
	13	Invoice 3586	ARJ4	1 060	20			1 660	20

S. DALI **ARL2**

Date		Details	Fol.	Debit		Credit		Balance	
Apr.	1	Balance	b/d					920	00
	12	Receipt 532	CRJ4			440	00	480	00
	27	Invoice 3589	ARJ4	1 316	70			1 796	70

P. PICASSO **ARL3**

Date		Details	Fol.	Debit		Credit		Balance	
Apr.	1	Balance	b/d					1 240	00
	19	Receipt 534	CRJ4			620	00	620	00
	26	Invoice 3588	ARJ4	965	58			1 585	58
	28	Invoice 3590	ARJ4	2 143	20			3 728	78

V. VAN GOGH **ARL4**

Date		Details	Fol.	Debit		Credit		Balance	
Apr.	1	Balance	b/d					580	00
	6	Invoice 3584	ARJ4	3 260	40			3 840	40
	26	Receipt 535	CRJ4			580	00	3 260	40

J. VERMEER **ARL5**

Date		Details	Fol.	Debit		Credit		Balance	
Apr.	1	Balance	b/d					1 390	00
	2	Receipt 530	CRJ4			404	00	986	00
	8	Invoice 3585	ARJ4	1 698	60			2 684	60
	15	Invoice 3587	ARJ4	649	80			3 334	40

You are required to:

Reconcile the accounts receivable list extracted from the accounts receivable ledger to the balance on the accounts receivable account in the general ledger.

Accounts Receivable List as at 30 April 20*x*5

J. Constable	ARL1	1 660	20
S. Dali	ARL2	1 796	70
P. Picasso	ARL3	3 728	78
V. van Gogh	ARL4	3 260	40
J. Vermeer	ARL5	3 334	40
Balance per accounts receivable		13 780	48
Balance of accounts receivable account		12 778	90
DIFFERENCE		1 001	58

Reconciliation of difference:

Balance per accounts receivable list		13 780	48
Error in posting to J. Vermeer account (R440 – R404)		(36	00)
New balance of accounts receivable account		13 744	48

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Balance of accounts receivable account		12 778	90
Invoice 3588 (P. Picasso) omitted from ARJ		965	58
New balance of accounts receivable account		13 744	48

Explanation

A comparison of the accounts receivable ledger with the accounts receivable account will reveal that:

- The payment received from J. Vermeer account was not properly recorded in the accounts receivable ledger. The difference must be updated to correct the error.
- Invoice 3588 recorded in P. Picasso's account was not written in the accounts receivable journal. The journal must be updated and the amount corrected in the accounts receivable account in the general ledger.

You should be able to complete Questions 12.8 to 12.12.

Did you know?

The total of the individual receivable accounts *(*in the accounts receivable ledger*)* needs to agree with the balance of the accounts receivable account in the general ledger.

This must always be the case, as the accounts receivable account is a summary of the individual receivable accounts.

This same principle applies to accounts payable.

9 Accounts receivable year-end accounting

At the end of each financial year, the balance of the sales account is transferred to the trading summary account as a measure of revenue from sales. This amount will include cash sales and credit sales.

It is possible, however, that the recorded revenue may not all be realised as a result of credit sales for which payment will never be received. This will have two effects:

- The profit for the year is overstated.
- Assets in the statement of financial position are overstated.

The accounts receivable amount appears on the statement of financial position as a current asset. However, if this amount includes receivables who are unlikely to be realised, the asset is overstated and requires adjustment.

In both cases, overstated income and overstated assets, the extent of the overstatement is not known. There is no crystal ball with which to predict future bad debts. Because it is impossible to know the amounts that will not be collected, it is necessary to estimate the amount and then update the accounts accordingly. This estimate is known as allowance for bad debt. This ensures that both the matching concept and the prudence concept are complied with.

Estimating allowance for bad debts

The exposure to possible bad debts depends on numerous factors and, in particular, the type of industry, the nature of the business, the credit policy and the economic climate. The risk of bad debts is inherent to the accounts receivable account, since if there were no receivables, the question of bad debts would not arise.

The method of determining expected bad debts from the current accounts receivable involves subjective judgement as there are two unknown factors:

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- Which receivables will be irrecoverable?
- How much will be irrecoverable?

Determining the allowance for bad debts is made easier by consulting past records and the accounts receivable ageing schedule. The percentage of the accounts receivable balance, which has been written off in the past, could be established.

This is usually expressed either as a percentage of the total accounts receivable or as a variable percentage according to the 'ages' of the debts, as shown in Figure 12.1

Figure 12.1

ACCOUNTS RECEIVABLE AGEING SCHEDULE SUMMARY

Days past due	Amount		% considered irrecoverable	Allowance	
Current	30 457	00	1%	305	00
1–30	13 243	00	2%	265	00
31–60	7 950	00	4%	318	00
61–90	4 680	00	8%	374	00
Over 90	2 130	00	50%	1 065	00
	58 460	00		2 327	00

Explanation

- Based on total accounts receivable of R58 460, it is estimated that R2 327 will not be recovered.
  - In general, the longer an account remains outstanding, the less likely it is to be paid. This explains the estimation that 50% of debts longer than 90 days overdue will not be recovered.
- The total of R2 327 will be referred to as an 'allowance for bad debts'.
  - The allowance for bad debt is nearly 4% of the total accounts receivable.
  - If it is found that the proportion of outstanding debts do not vary much over time, it would be easier to adopt a policy of calculating the allowance for bad debts on the basis of 4% of the accounts receivable balance at the end of the year, instead of performing the rather uncertain calculation in Figure 12.1.
- It should be noted that a number of estimates are used when determining the amount of R2 327.
  - It, therefore, serves no purpose to calculate it to the nearest cent. Such pretension only gives a false impression of precision which does not exist.
  - In fact, since the accounting entries for the estimate of bad debts do not affect the individual accounts receivable accounts, the amount of R2 327 may even be rounded up to R2 500.

Accounting entries of allowance for bad debts

The writing off of a bad debt has been seen to take place whenever management is convinced that payment will not be received. By writing the debt off, administrative costs of maintaining and servicing the account by sending monthly demands for payment are thus saved.

The matching concept demands that expenses are matched against the income they helped to produce. The company does not know at the time of the credit sale whether the amount will be paid or not. It may take a couple of months before it becomes evident that a certain amount will not be collected.

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Even if a bad debt is not recognised in the financial year in which the sale took place, it is still seen as an expense for that year.

The aim at the end of the financial year is to determine the profit for the period as accurately as possible and to express the assets fairly in the statement of financial position. It is, therefore, essential to take into account further possible bad debts at the end of the year.

The accounts receivable account in the general ledger is a control account of the amounts owed by individual receivables. The total of all the outstanding balances on the individual accounts in the accounts receivable ledger must be the same as the balance on the accounts receivable account in the general ledger.

In estimating the allowance for bad debts at the end of the financial year, it is impossible to determine exactly which individual receivables' accounts will prove irrecoverable. Estimated bad debt allowances are, therefore, not credited to the accounts receivable account, but rather to the allowance for bad debts account.

Example 12.10

These balances appeared, among others, in the books of Black & Sons on 30 June 20*x*1, the end of their first financial year:

- Sales (80% on credit) R240 000
- Accounts receivable account R43 600
- Bad debts R6 300

If we assume that the sales were made evenly during the year and that the credit terms are 60 days, it is possible to estimate the ideal amount of accounts receivable at year end:

Ideal accounts receivable balance = 80% × R240 000 × 60 ÷ 365
= R31 560

Explanation

It can be seen from the balance of R43 600 that the credit policy has not been strictly applied. It can also be seen that R6 300 has already been written off as bad debts. Note that this amount has already been credited to the accounts receivable account. The balance of R43 600 is thus the balance after writing off bad debts that arose during the year.

As this is the first year of operations, it is difficult to assess how much of the R43 600 is likely to be irrecoverable. An estimate may be made by performing an accounts receivable ageing schedule or by using a reasonable rate such as 5%. Before applying the rate to establish an 'allowance for bad debts', it is customary to identify any accounts which at this stage are most likely to be irrecoverable.

After careful consideration of all the facts, the following was established:

Further bad debts have been identified on the accounts of L. Steyn R240 and J. Laxton R360, therefore, R600 in total. The allowance for bad debts must be 5% of accounts receivable.

The necessary entries in the general ledger posted from general journal entries are:

General Ledger of Black & Sons
Real Accounts Section

Dr. **ACCOUNTS RECEIVABLE** **B6** Cr.

Jun.	1	Balance	b/d	43 600	00	Jun.	30	Bad debts	GJ6	600	00

ALLOWANCE FOR BAD DEBTS **B7**

						Jun.	30	Bad debts	GJ6	2 150	00

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Nominal Accounts Section

BAD DEBTS — N9

Dr.						Cr.					
Jun.	30	Total	b/f	6 300	00	Jun.	30	Profit or loss		9 050	00
		Accounts receivable	GJ6	600	00						
		Allowance for bad debts	GJ6	2 150	00						
				9 050	00					9 050	00

Accounts Receivable Ledger of Black & Sons

J. LAXTON — ARL1

Date		Details	Fol.	Debit		Credit		Balance	
Jun.	1	Balance	b/d					360	00
	30	Bad debts	GJ6			360	00	0	00

L. STEYN — ARL2

Date		Details	Fol.	Debit		Credit		Balance	
Jun.	1	Balance	b/d					240	00
	30	Bad debts	GJ6			240	00	0	00

Explanation

- The allowance for bad debts is calculated on the accounts receivable balance after writing off all known bad debts. In this case, it is 5% of (R43 600 – R600) = R2 150.
- This entry will appear in the financial statements at 30 June 20x1:

Black & Sons
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20*x*1

	Notes	20*x*1	
Gross sales		240 000	00
Operating expenses		(9 050	00)
Bad debts		9 050	00

- This amount consists of R6 300 written off during the year, plus an additional R600 of known bad debts written off at the end of the year, plus R2 150 that results from sales made during the latter part of the year but for which it is estimated that payment will never be received. By including all three aspects of bad debts, the possible overstatement of income as a result of including the full amount of sales has been substantially reduced.

Black & Sons
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*1

	Notes	20*x*1	
ASSETS			
Current assets		40 850	00
Trade and other receivables	5	43 000	00
Less: Allowance for bad debts		(2 150	00)

Remember that the allowance for bad debts had to be estimated so that neither income nor assets (accounts receivable) would be overstated.

Also remember that, since it is not known which individual receivables are affected by this estimate, the accounts receivable could not be reduced, but an allowance for bad debts had to be created.

To disclose its fair value, accounts receivable are shown net of the allowance for bad debts in the statement of financial position as accounts receivable.

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The asset 'accounts receivable', which would have been overstated at R43 000, is thus reduced to a fairer reflection of the likely amount to be recovered from receivables.

Adjusting allowance for bad debts

A main source of confusion in this concept, is the treatment of allowance for bad debts at the end of the second and subsequent years.

Example 12.11

Let us continue the example and assume these balances for Black & Son on 30 June 20*x*2:

Details	Fol.	Debit		Credit	
Accounts receivable account	B6	58 200	00		
Allowance for bad debts	B7			2 150	00
Sales	N1			360 000	00
Bad debts	N9	9 360	00		

- At the end of the 20x2 financial year, it is established that an additional amount of R640 must be written off as bad debts.
- The allowance for bad debts is to remain at 5% of accounts receivable.

Explanation

Note that the allowance for bad debts has remained at R2 150 throughout the year as no further entries have been added during the year. The reason for this is that whenever a bad debt is written off, the individual receivable is known and the accounts receivable account (and thus also the individual receivable's account) is credited and the bad debts account is debited.

Some people are of the opinion that bad debts in subsequent years should be written off to the allowance for bad debts account rather than bad debts account. Of course, had our estimation of bad debts of R2 150 at the end of the previous year for the accounts receivable been perfectly correct, it would have been better to debit the allowance for bad debts account when those debts were proved irrecoverable.

However, the estimate is unlikely to have been precise and the effort and cost incurred in keeping track of which were bad debts resulting from the R43 000 of last year and which resulted from this year's sales are not warranted.

These entries are made. (They will be shown using general journal entries. You should draft rough general ledger accounts and test the effect.)

GENERAL JOURNAL OF BLACK & SON **GJ9**

Day	Details	Fol.	Debit		Credit		Accounts receivable				Accounts payable			
							Debit		Credit		Debit		Credit	
30/06	Bad debts	N9	640	00										
	Accounts receivable	B6			640	00			640	00				
	Additional bad debts written off													
	Allowance for bad debts	B7	2 150	00										
	Bad debts	N9			2 150	00								
	Reversing opening balance of allowance for bad debts													

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Day	Details	Fol.	Debit	Credit	Accounts receivable Debit	Accounts receivable Credit	Accounts payable Debit	Accounts payable Credit
	Bad debts	N9	2 878 00					
	Allowance for bad debts	B7		2 878 00				
	Creating allowance of 5% on accounts receivable outstanding on 30 June 20*x*2: 5% of R(58 200 – 640)							
					0 00	640 00	0 00	0 00

Explanation

- As a result of the above, an amount of R10 728 will be written off against income for the year. Note how it is computed:

Bad debts written off during the year	9 360	00
Add: Additional known bad debts written off at the end of the year	640	00
Add: Further bad debts likely to result from sales during the current year	2 878	00
	12 878	00
Less: Debts considered as bad in respect of sales made last year and for which allowance was made, written back this year	2 150	00
	10 728	00

- Many people see a short cut possibility there which is quite permissible provided the concept of what is being done is clear. The short-cut journal entry is:

GENERAL JOURNAL OF BLACK & SON **GJ9**

Day	Details	Fol.	Debit	Credit	Accounts receivable		Accounts payable	
					Debit	Credit	Debit	Credit
30/06	Bad debts	N9	728 00					
	Allowance for bad debts	B7		728 00				
	Change in allowance for bad debts (R2 878 – R2 150)							

  - The concept is that the opening balance of the allowance for bad debts represents an estimate of sales of the previous year that would not be realised in cash in the current year.
  - The closing balance of the allowance for bad debts represents an estimate of sales of the current that would not be realised in cash in the next year.
  - Debts that are outstanding for longer than one year should not be included in the allowance for bad debts. Such debts must be written off to bad debts and credited to the accounts receivable account (and individual receivables' accounts in the accounts receivable subsidiary ledger).

The above short cut general journal entry will provide the same result as writing the full amount of the old allowance for bad debts back and then crediting the new allowance for bad debts.

While the general journal entry achieves the same end result, it tends to make the concept that is applied indistinct.

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Example 12.12

These balances appeared, among others, in the books of ABC Traders at the financial year end:

Details	Fol.	Debit		Credit	
Accounts receivable account	B6	29 680	00		
Allowance for bad debts	B7			1 050	00
Bad debts	N9	1 920	00		

The allowance for bad debts must equal 5% of outstanding accounts receivable.

Allowance for bad debts = 5% × R29 680 = R1 484

The general journal entries would thus be:

GENERAL JOURNAL OF ABC Traders **GJ6**

Day	Details	Fol.	Debit		Credit		Accounts receivable				Accounts payable			
							Debit		Credit		Debit		Credit	
30/06	Allowance for bad debts	B7	1 050	00										
	Bad debts	N9			1 050	00								
	Last year's allowance written back													
	Bad debts	N9	1 484	00										
	Allowance for bad debts	B7			1 484	00								
	Current year's allowance raised													

Explanation

- The above general journal entries have the effect of cancelling the existing allowances in total and then creating the new allowances. The short-cut journal entries that would achieve the same end result are:

GENERAL JOURNAL OF ABC Traders **GJ6**

Day	Details	Fol.	Debit		Credit		Accounts receivable				Accounts payable			
							Debit		Credit		Debit		Credit	
30/06	Bad debts	N9	434	00										
	Allowance for bad debts	B7			434	00								
	Increase in the bad debt allowance from R1 050 to R1 484													

- If full information regarding accounts receivable is disclosed in the statement of financial position, it would appear as:

ABC Traders
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*2

	Notes	20*x*2	
ASSETS			
Current assets		28 196	00
Trade and other receivables	5	29 680	00
Less: Allowance for bad debts		(1 484	00)

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For reporting purposes it is not essential to indicate the amounts of each allowance. A statement of financial position may simply record accounts receivable as R28 196.

The amount that will appear in the statement of profit or loss & other comprehensive income for bad debts will be R2 354 (R1 920 – R1 050 + R1 484).

You should be able to complete Questions 12.13 and 12.14.

Reminder

The aim of creating this allowance is to ensure that bad debts, as estimated for the current year, are reported according to the matching concept.

Credit balances in the accounts receivable ledger

Sometimes individual receivable accounts in the accounts receivable ledger may have a credit balance. This may happen for various reasons:

- The receivable may have overpaid his account.
- The receivable may have paid a deposit for a purchase, but the goods may not have been delivered yet and, therefore, no invoice would have been raised.
- The receivable may be paying off on a lay-away purchase.

Example 12.13 These balances appeared in the accounts receivable ledger of Dlamini Enterprises as at 30 June 20*x*2, the financial year end:

Name of receivable	Debit balance		Credit balance		Net ( ) = Credit balance	
A. Arends	4 800	00			4 800	00
B. Bayat	10 400	00			10 400	00
C. Chauke			2 000	00	(2 000	00)
D. Davidson	890	00			890	00
E. Erasmus	220	00			220	00
F. Fuchs			414	00	(414	00
G. Gogo	5 618	00			5 618	00
H. Hlatswayo			1 440	00	(1 440	00)
I. Isaacs			379	00	(379	00)
J. Jacobs	597	00			597	00
K. Koen	333	00			333	00
L. Lewis			286	00	(286	00)
M. Mbeki	2 118	00			2 118	00
N. Nkosi	482	00			482	00
O. Omar			88	00	(88	00)
P. Phiri	3 500	00			3 500	00
Q. Qwelane			117	00	(117	00)
R. Rhodes	899	00			899	00
TOTAL	29 857	00	4 724	00	25 133	00

Let us assume, for the sake of simplicity, that we owe our accounts payable R10 000, and that there are no debit balances in any payables' accounts.

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Then amounts will be reported in the statement of financial position as:

Dlamini Enterprises
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x2

	Notes	20x2	
ASSETS ***Current assets***			
Accounts receivable	5	29 857	00
EQUITY AND LIABILITIES ***Current liabilities***			
Accounts payable	8	14 724	00

It is important to note that, where an allowance for bad debts is created as a percentage of outstanding accounts receivable, that this percentage would be calculated on the total of the outstanding **debit** balances only.

Example 12.14

Refer back to Example12.13.

Show the general journal entry, if an allowance for bad debts is to be created at 5% of outstanding accounts receivable.

GENERAL JOURNAL OF DLAMINI ENTERPRISES **GJ6**

Day	Details	Fol.	Debit		Credit		Accounts receivable Debit		Accounts receivable Credit		Accounts payable Debit		Accounts payable Credit	
30/06	Bad debts	N9	1 493	00										
	Allowance for bad debts	B7			1 493	00								
	Creating allowance of 5% of outstanding accounts receivable (5% × R29 857)													

10 Accounts payable year-end adjustment

The main reason for adjusting entries at the end of the financial year is to ensure that expenses and liabilities are not understated.

An allowance must be made for all known liabilities and expenses, whether the amount of the liability and expense is known with certainty or is a best estimate. Accrual for unpaid expenses such as telephone and salaries has already been discussed earlier in the text.

To ensure that the matching and accrual concept is complied with, it is also necessary to anticipate expenses that may not be incurred. This process at the end of the year is often referred to as "cut-off" procedures.

The expenses for a month or two after year end are reviewed to identify any expenses that relate to the current financial year. These expenses may only be incurred or paid in the following financial year.

To match income and expenses correctly in a financial year, these expenses will have to be accrued and included in accounts payable. This procedure is explained further in the year-end adjustments chapter.

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11 Reconciliation of accounts

In much the same way as the bank statement reflects the bank's version of the business's account, a monthly statement of account sent by a payable to a receivable reflects the payable's version of the account.

At times, the balance reflected on the statement of account may differ from the payable's balance reflected in the ledger of the receivable. This occurs for a number of reasons of that the following are the most likely:

- A timing difference resulting from a cheque not yet received by the payable. The payable's statement of account is thus not fully up to date, as the latest payment has not been recorded.
- A timing difference resulting from goods not yet received by the receivable. The accounts receivable ledger account is thus not yet fully up to date with all goods received.
- Errors or omissions.
- Returns or discounts not allowed or not yet recorded by the payable. The purpose of reconciling the ledger account of the payable with their statement of account is to introduce a control measure that is designed to isolate errors and ensure that the correct payment is made to the payable.

Where the amount of the payment differs from the balance on the statement of account, a remittance advice is sent, identifying the difference. A remittance advice is a statement that reconciles the balance on the payable's statement with the amount of the payment made to the payable. An example is used to illustrate the principles involved.

Example 12.15

Maxi's has received a statement dated 28 May 20*x*5 from a payable, AJ Suppliers. Maxi's receives 20% trade discount on all invoices from AJ Suppliers, as well as an additional 5% settlement discount, if payment is made within 30 days of statement date. All discounts for early settlement are accepted.

The statement from AJ Suppliers reflects a debit balance of R3 486 but on comparing this with AJ Suppliers' account in the accounts payable ledger, these discrepancies are found:

- Invoice 189 had been correctly recorded in the accounts payable ledger as R1 400, but had been entered on the statement at its gross amount (that is, R1 750) before the deduction of the trade discount.
- Credit note 73 for R40 had been correctly recorded in the accounts payable ledger, but had been entered as an invoice on the statement.
- AJ Suppliers' account in the accounts payable ledger had been under cast by R900.
- Invoice 194 for R784, had never been entered in the Maxi's accounts payable journal as the goods had not been received.
- Invoice 208 included eight items that had been incorrectly priced at R20 each, instead of R16 each.

You have been requested to settle the amount outstanding on 16 June 20*x*5.

You are required to:
Prepare a remittance advice that reconciles the amount reflected on the statement of AJ Suppliers 28 May 20*x*5, with the amount being paid.

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AJ Suppliers
REMITTANCE ADVICE

Balance per statement dated 28 May 20x5			3 486	00
Less: Trade discount on invoice 189	350	00		
Credit note 73 shown as in invoice (2 × R40)	80	00		
Invoice 194 – goods not received	784	00		
Invoice 208 – incorrect price	32	00	1 246	00
Amount due			2 240	00
AMOUNT OF CHEQUE			2 240	00

Explanation

- The amount due by Maxi's is R2 240. A cheque for this amount will accompany the remittance advice. All items except the under casting by R900 are corrections that AJ Suppliers must make. Maxi's need only recast the account of AJ Suppliers to correct the error of R900.
- As credit note number 73 had been entered on the wrong side of the payable's statement, it must first be cancelled by deducting R40. The credit note must now be entered onto the statement, thus, resulting in a total of R80 being deducted to correct the statement.

You should be able to complete Question 12.15.

12 Credit policy

Any business that sells on credit naturally wants its receivables to pay their accounts as soon as possible. A business will, therefore, develop a credit policy that will incorporate control procedures to increase the odds of selling only to receivables who will pay their accounts on time.

A business's credit policy shows its general approach to the granting of credit, requiring decisions relating in particular to the length of the credit period and the offering of cash discounts. It is important that the policy is clearly stated and explained to employees whose duties must be performed in terms of the policy.

The length of the credit period refers to the amount of time that the business allows its receivable accounts (also called debts) from the time of the sale to the date that the account must be paid. This length of time, granted by the seller to the buyers, differs from business to business and industry to industry.

Within a business, different credit periods may be allowed to different receivables, depending on their creditworthiness and other factors such as trade discounts allowed. In general, however, credit terms are between 30 days and 90 days.

Credit in excess of 90 days is seldom permitted except in cases where receivables are required to pay an interest charge. Some retail stores allow credit of up to six months before interest is charged.

Think, for example, of a clothing account at a retail store. Transactions involving the sale of more expensive items on credit in excess of 90 days fall in the category of an instalment sale, which presents fairly complex accounting problems. Examples of items bought and sold on instalment sale are vehicles, washing machines and stereo sound systems.

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13 Controlling the credit policy

As a general rule, customers owing money will tend to delay payment as long as possible, despite the stated credit terms pressure is usually required to recover receivables in the form of 'overdue' stickers being placed on their statements of account, reminders being sent or telephone requests for settlement.

To implement a system of control, an ageing schedule is prepared, usually just prior to the monthly statements being sent out.

An ageing schedule (also called an age analysis) shows each individual customer who owes money and the status of their account regarding the time since the date of purchases, in other words, how 'old' the debts are, as shown in Figure 12.2.

Figure 12.2

ACCOUNTS RECEIVABLE AGEING SCHEDULE AS AT 31 MARCH 20x1

Accounts receivable/ Customer name	Total balance		Number of days past due									
			Current		1–30		31–60		61–90		Over 90	
A. Arends	2 416	00	1 416	00	1 000	00						
L. Ashew	392	00	392	00								
M. Bodibe	1 529	00	248	00	856	00	208	00	217	00		
G. Boston	844	00									844	00
–												
–												
–												
–												
TOTAL*	58 460	00	30 457	00	13 243	00	7 950	00	4 680	00	2 130	00

**These are fictitious amounts used to represent the column totals.*

Explanation

- If it is the credit policy of the company that outstanding amounts (debts) should be settled within 45 days, all outstanding amounts for purchases within the last 45 days appear in the 'current' column. In terms of the company's credit policy, these debts are not due yet.
- A. Arends owes R1 000 for goods that he purchased more than 45 days ago.
  - The amount is between one and 30 days overdue. This means that the debts are between 46 and 75 days old.
  - He will need a reminder that R1 000 of his account is overdue, that is, older than 45 days.
- L. Ashew is a prompt payer and his account causes no concern at this stage.
- M. Bodibe seems to be a very reluctant payer. If this is the case, he should receive a final request for payment.
  - It can be seen that he is still being supplied with goods despite his late settlement record. Consideration will have to be given to discontinuing further sales to him until his account is settled.
  - It could also be that he is disputing certain amounts shown as outstanding for longer than 45 days. If this is the case, this account should be investigated.
- G. Boston still owes R844 for goods purchased more than four and a half months ago.
  - He has not purchased any goods lately and it is possible that he has changed his address and may not be traced.
  - His account will be handed over to a lawyer or agency for collection.

You should be able to complete Question 12.16.

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14 Chapter illustrative example

Here is the trial balance of Arkansas Traders as at 1 July 20x4:

TRIAL BALANCE OF ARKANSAS TRADERS AS AT 1 JULY 20x4

Detail	Fol	Debit		Credit	
Real Accounts Section					
Capital	B1			308 000	00
Plant, property and equipment	B3	76 000	00		
Inventory	B6	180 350	00		
Accounts receivable	B7	225 000	00		
Bank	B4	9 200	00		
Accounts payable	B8			178 500	00
SARS: VAT	B9			4 050	00
		490 550	00	490 550	00

Accounts receivable

Account	Fol	Amount	
Georgia	ARL1	38 000	00
Florida	ARL2	43 000	00
Texas	ARL3	51 000	00
Virginia	ARL4	36 000	00
Iowa	ARL5	29 000	00
Colorado	ARL6	28 000	00
		225 000	00

Accounts payable

Account	Fol	Amount	
Minnesota	APL1	18 200	00
Idaho	APL2	42 000	00
Louisiana	APL3	37 300	00
Alaska	APL4	23 000	00
Nebraska	APL5	26 000	00
California	APL6	32 000	00
		178 500	00

Additional information:

- Arkansas Traders accounts for inventory according to the perpetual inventory system.
- Inventory is sold at cost plus 40%.
- VAT is charged at 14%.

Transactions for July 20x4:

Invoices issued:

Date	Invoice	Issued to	Amount
3	306	Florida	R21 705.60
7	307	Iowa	R14 842.80
9	308	Virginia	R26 174.40
14	309	Georgia	R17 556.00
17	310	Colorado	R13 087.20
22	311	Iowa	R7 660.80
28	312	Texas	R16 758.00
31	313	Colorado	R19 311.60

Invoices received:

Date	Invoice	Received from	Amount
1	429	Alaska	R2 280
8	851	Minnesota	R4 104
15	237	California	R5 928
22	968	Louisiana	R11 115
29	614	Nebraska	R5 016

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Credit notes received:

Date	D/N	Received from	Amount	Details
17	17	Minnesota	R2 052	Goods returned against invoice 851.
28	89	Louisiana	R2 223	20% trade discount omitted from invoice 968.

Credit notes issued:

Date	C/N	Issued to	Amount	Details
8	22	Florida	R1 755.60	Goods returned against invoice 306.
16	23	Virginia	R638.40	Goods returned against invoice 308.
31	24	Georgia	R877.80	5% special discount against invoice 309 for shop-soiled goods.

Receipts issued:

Date	Receipt	Issued to	Amount	Details
3	219	Florida	R22 000	Part payment of account.
10	C20	Cash sales	R20 520	Cash sales.
10	220	Georgia	R28 000	Part payment of account.
17	221	Iowa	R11 000	Part payment of account.
17	C21	Cash sales	R27 360	Cash sales.
24	222	Virginia	R24 000	Part payment of account.
31	223	Texas	R7 700	Part payment of account.

Cheques issued:

Date	Cheque	Issued to	Amount	Details
1	415	Agents Ltd	R5 700	Rent of premises.
8	416	Idaho	R22 000	Part payment of account.
8	417	Louisiana	R33 000	Part payment of account.
15	418	Minnesota	R18 200	Part payment of account.
15	419	Alaska	R13 000	Part payment of account.
15	420	Nebraska	R13 000	Part payment of account.
15	421	California	R15 000	Part payment of account.
22	422	Telkom	R1 368	Telephone account.
31	423	City of X	R1 083	Water and electricity account.

Items debited on bank statement but not yet recorded in the cash journals:

July 31	DO: Sure-all *	R360	Insurance
	R/D cheque: Hawaii	R11 400	Cheque in full settlement of invoice. Hawaii has disappeared and the chances of recovering this amount are small. The amount must be written off as a bad debt.
	Service fee *	R160	
	* No VAT applicable		

You are required to:

1 Record the transactions for July in these journals of Arkansas Traders:

- 1 Accounts receivable journal
- 2 Accounts receivable allowances journal
- 3 Accounts payable journal
- 4 Accounts payable allowances journal
- 5 Cash receipts journal
- 6 Cash payments journal
- 7 General journal

2 Post the transactions to the relevant subsidiary ledgers.

3 Prepare the accounts payable and receivable control accounts in the general ledger.

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4 Prepare the accounts payable and receivable lists to prove that it balances in the accounts payable and receivables in the general ledger.

1

ACCOUNTS RECEIVABLE JOURNAL OF ARKANSAS TRADERS – JULY **ARJ7**

Inv.	Day	Details	Fol.	Accounts receivable		Sales		VAT output		Cost of sales	
306	3	Florida	ARL2	21 705	60	19 040	00	2 665	60	13 600	00
307	7	Iowa	ARL5	14 842	80	13 020	00	1 822	80	9 300	00
308	9	Virginia	ARL4	26 174	40	22 960	00	3 214	40	16 400	00
309	14	Georgia	ARL1	17 556	00	15 400	00	2 156	00	11 000	00
310	17	Colorado	ARL6	13 087	20	11 480	00	1 607	20	8 200	00
311	22	Iowa	ARL5	7 660	80	6 720	00	940	80	4 800	00
312	28	Texas	ARL3	16 758	00	14 700	00	2 058	00	10 500	00
313	31	Colorado	ARL6	19 311	60	16 940	00	2 371	60	12 100	00
				137 096	40	120 260	00	16 836	40	85 900	00
				B7		N1		B9		B6/N2	

2

ACCOUNTS RECEIVABLE ALLOWANCES JOURNAL OF ARKANSAS TRADERS – JULY **ARAJ7**

C/N	Day	Details	Fol.	Accounts receivable		Sales		VAT output		Cost of sales	
22	8	Florida	ARL2	1 755	60	1 540	00	215	60	1 100	00
23	16	Virginia	ARL4	638	40	560	00	78	40	400	00
24	31	Georgia	ARL1	877	80	770	00	107	80	0	00
				3 271	80	2 870	00	401	80	1 500	00
				B7		N1		B9		B6/N2	

Explanation

Credit note 24 was issued in respect of a special discount due to the delivery of damaged goods. The cost of sales is, therefore, not affected, as no inventory is returned.

3

ACCOUNTS PAYABLE JOURNAL OF ARKANSAS TRADERS – JULY **APJ7**

Inv.	Day	Details	Fol.	Accounts payable		Inventory		VAT input	
429	1	Alaska	APL4	2 280	00	2 000	00	280	00
851	8	Minnesota	APL1	4 104	00	3 600	00	504	00
237	15	California	APL6	5 928	00	5 200	00	728	00
968	22	Louisiana	APL3	11 115	00	9 750	00	1 365	00
614	29	Nebraska	APL5	5 016	00	4 400	00	616	00
				28 443	00	24 950	00	3 493	00
				B8		B6		B9	

4

ACCOUNTS PAYABLE ALLOWANCES JOURNAL OF ARKANSAS TRADERS – JULY **APAJ7**

D/N	Day	Details	Fol.	Accounts payable		Inventory		VAT input	
17	17	Minnesota	APL1	2 052	00	1 800	00	252	00
89	28	Louisiana	APL3	2 223	00	1 950	00	273	00
				4 275	00	3 750	00	525	00
				B8		B6		B9	

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5

CASH RECEIPTS JOURNAL OF ARKANSAS TRADERS – JULY **CRJ7**

Rec.	Day	Details	Fol.	Bank		Sales		VAT output		Accounts receivable		Cost of sales	
219	3	Florida	ARL2	22 000	00					22 000	00		
C20	10	Cash sales		20 520	00	18 000	00	2 520	00			12 857	14
220		Georgia	ARL1	28 000	00					28 000	00		
221	17	Iowa	ARL5	11 000	00					11 000	00		
C21		Cash sales		27 360	00	24 000	00	3 360	00			17 142	86
222	24	Virginia	ARL4	24 000	00					24 000	00		
223	31	Texas	ARL3	7 700	00					7 700	00		
				140 580	00	42 000	00	5 880	00	92 700	00	30 000	00
				B4		N1		B9		B7		B6/N2	

6

CASH PAYMENTS JOURNAL OF ARKANSAS TRADERS – JULY **CPJ7**

Chq.	Day	Details	Fol.	Bank		Accounts receivable		VAT input		Accounts payable		Sundry accounts			
												Amount		Fol.	Account
415	1	Rent		5 700	00			700	00			5 000	00	N12	Rent expense
416	8	Idaho	APL2	22 000	00					22 000	00				
417		Louisiana	APL3	33 000	00					33 000	00				
418	15	Minnesota	APL1	18 200	00					18 200	00				
419		Alaska	APL4	13 000	00					13 000	00				
420		Nebraska	APL5	13 000	00					13 000	00				
421		California	APL6	15 000	00					15 000	00				
422	22	Telkom		1 368	00			168	00			1 200	00	N7	Telephone
423	31	City of X		1 083	00			133	00			950	00	N8	Electricity
D/O		Insurance		360	00							360	00	N9	Insurance
R/D		Hawaii	ARL7	11 400	00	11 400	00								
B/S		Bank fees		160	00							160	00	N10	Bank
				134 271	00	11 400	00	1 001		114 200	00	7 670	00		
				B4		B6		B9		B8					

7

GENERAL JOURNAL OF ARKANSAS TRADERS **GJ7**

Day	Details	Fol.	Debit		Credit	
31/07	Bad debts	N11	10 000	00		
	SARS: VAT	B9	1 400	00		
	Accounts receivable	B6			11 400	00
	Hawaii	ARL6			11 400	00
	Bad debt written off				11 400	00

Explanation

- The initial invoice to Hawaii showed:

Sales	10 000	00
VAT	1 400	00
	11 400	00

– The full amount previously recognised as sales, R10 000 must be written off as a bad debt.

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– Hawaii's account must be written off to R0.
– Cost of sales and inventory are not adjusted as the receivable has disappeared with the inventory sold to him.

2 **Accounts Receivable Ledger of Arkansas Traders**

GEORGIA **ARL1**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					38 000	00
	10	Receipt 220	CRJ7			28 000	00	10 000	00
	14	Invoice 309	ARJ7	17 556	00			27 566	00
	31	Credit note 24	ARAJ			877	80	26 678	20

FLORIDA **ARL2**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					43 000	00
	3	Invoice 306	ARJ7	21 705	60			64 705	60
		Receipt 219	CRJ7			22 000	00	42 705	60
	8	Credit note 22	ARAJ			1 755	60	40 950	00

TEXAS **ARL3**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					51 000	00
	28	Invoice 312	ARJ7	16 758	00			67 758	00
	31	Receipt 223	CRJ7			7 700	00	60 058	00

VIRGINIA **ARL4**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					36 000	00
	9	Invoice 308	ARJ7	26 174	40			62 174	40
	16	Credit note 23	ARAJ			638	40	61 536	00
	24	Receipt 222	CRJ7			24 000	00	37 536	00

IOWA **ARL5**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					29 000	00
	7	Invoice 307	ARJ7	14 842	80			43 842	80
	17	Receipt 221	CRJ7			11 000	00	32 842	80
	22	Invoice 311	ARJ7	7 660	80			40 503	60

COLORADO **ARL6**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					28 000	00
	17	Invoice 310	ARJ7	13 087	20			41 087	20
	31	Invoice 313	ARJ7	19 311	60			60 398	80

HAWAII **ARL7**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					0	00
	31	R/D cheque	CPJ7	11 400	00			11 400	00
		Bad debts	GJ7			11400	00	0	00

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Accounts Payable Ledger of Arkansas Traders

MINNESOTA **APL1**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					18 200	00
	8	Invoice 851	APJ7			4 104	00	22 304	00
	15	Cheque 418	CPJ7	18 200	00			4 1047	00
	17	Debit note 17	APAJ	2 052	00			2 052	00

IDAHO **APL2**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					42 000	00
	8	Cheque 416	CPJ7	22 000	00			20 000	00

LOUISIANA **APL3**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					37 300	00
	8	Cheque 417	CPJ7	33 000	00			4 300	00
	22	Invoice 968	APJ7			11 115	00	15 415	00
	28	Debit note 89	APAJ	2 223				13 192	00

ALASKA **APL4**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					23 000	00
	1	Invoice 429	APJ7			2 280	00	25 280	00
	15	Cheque 419	CPJ7	13 000	00			12 280	00

NEBRASKA **APL5**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					26 000	00
	15	Cheque 420	CPJ7	13 000	00			13 000	00
	29	Invoice 614	APJ7			5 016	00	18 016	00

CALIFORNIA **APL6**

Date		Details	Fol.	Debit		Credit		Balance	
Jul.	1	Balance	b/d					32 000	00
	15	Cheque 421	CPJ7	15 000	00			17 000	00
	15	Invoice 237	APJ7			5 928	00	22 928	00

3 Accounts Receivable List as at 31 July 20x4

Georgia	ARL1	26 678	20
Florida	ARL2	40 950	00
Texas	ARL3	60 058	00
Virginia	ARL4	37 536	00
Iowa	ARL5	40 503	60
Colorado	ARL6	60 398	80
Hawaii	ARL7	0	00
Balance per accounts receivable		266 124	60

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Accounts Payable List as at 31 July 20x4

Minnesota	APL1	2 052	00
Idaho	APL2	20 000	00
Louisiana	APL3	13 192	00
Alaska	APL4	12 280	00
Nebraska	APL5	18 016	00
California	APL6	22 928	00
Balance per accounts payable		88 468	00

4

General Ledger of Arkansas Traders
Real Account Section

ACCOUNTS RECEIVABLE **B7**

Jul.	1	Balance	b/d	225 000	00	Jul.	31	Sales	ARAJ	2 870	00
	31	Sales	ARJ7	120 260	00			VAT output	ARAJ	401	80
		VAT output	ARJ7	16 836	40			Bank	CRJ7	92 700	00
		Bank	CPJ7	11 400	00			Bad debts	GJ7	10 000	00
								VAT output	GJ7	1 400	00
								Balance	c/d	266 124	60
				373 496	40					373 496	40
Aug.	1	Balance	b/d	266 124	60						

ACCOUNTS PAYABLE **B8**

Jul.	31	Inventory	APAJ	3 750	00	Jul.	1	Balance	b/d	178 500	00
		VAT input	APAJ	525	00		31	Inventory	APJ7	24 950	00
		Bank	CPJ7	114 200	00			VAT input	APJ7	3 493	00
		Balance	c/d	88 468	00						
				206 943	00					206 943	00
						Aug.	1	Balance	b/d	88 468	00

15 Summary

This chapter has dealt only with credit transactions and credit card transactions, that is, transactions that do not involve the receipt or payment of cash. To avoid making separate general journal entries for each transaction, accounts receivable and accounts payable journals were devised.

These not only saved a great deal of time and space when recording in a subsidiary journal, but also resulted in summary totals that were posted to the general ledger. This resulted in the general ledger having a minimum of transaction entries, thus, fulfilling its role as a summary of transactions. A system was also developed for recording from the accounts receivable and accounts payable journals into the individual receivables and payables accounts in the subsidiary ledgers.

The principle of subsidiary journals has thus been established. Their purpose is to cope with large volumes of transactions in such a way as to keep detailed records, but to have only summarised information in the general ledger. The control accounts in the general ledger also serve to ensure the accuracy of the detailed accounts in the subsidiary ledger accounts.

Returns and allowances between receivables and payables can be recorded in the accounts receivable or accounts payable journal as deductions. Alternatively, special returns and allowances subsidiary journals may be used. The choice depends on the frequency of such transactions as well as the quality of information required by the business.

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At the end of each month, before settling the accounts of payables, the ledger account should be reconciled with the statement of account received from the payable. This ensures that any discrepancies are detected and serves as another measure of control over the accounting system.

It must be noted that the general journal does not fall away entirely. There are still transactions that are not appropriate for either the cash payments journal, cash receipts journal, accounts receivable journal or accounts payable journal. These include transactions such as the writing off of bad debts. The general journal is thus still used for any transactions that cannot be entered into special subsidiary journals.

To function efficiently, a business that sells on credit must have a credit policy to which it can adhere. Selling on credit incurs additional costs and risks.

- The main risk is the possibility of the debt being irrecoverable.
- The cost is the investment of money in accounts receivable that could otherwise be used to earn interest, and requires additional administrative costs to recover debts. To encourage receivables to pay promptly, a cash discount is often offered.

The focus was also on non-routine accounting procedures relating in particular to bad debts and the allowance for bad debts.

Individual receivables' accounts are written off to the bad debts account when it is virtually certain that they will not be paid.

To comply with the requirements of the matching and prudence concepts, bad debts are always assessed at the end of the financial year. In addition, potential bad debts, based on an estimate of past performance of receivables, are provided for in an allowance for bad debts account. The accounting procedures for updating the allowance for bad debts account at the end of each financial year were outlined.

It is necessary to consider at the end of the financial year whether all costs incurred in the production of the income recognised during the financial year have been recognised.

Allowance for future expenses against income already recognised should be made, for example costs to be incurred on warranty repairs, payroll-related expenses, and so on.

QUESTIONS

Question 12.1

1 Why is it necessary for a business to keep personal accounts of accounts receivable and accounts payable in subsidiary ledgers?

2 Why do entries in personal accounts not form part of the double-entry?

Question 12.2

What advantages do accounts payable journals and accounts receivable journals have over a general journal?

Question 12.3

Narend Singh is a wholesaler trading as Singh's Wholesalers. The business uses the periodic inventory system to account for its inventory. All transactions were on credit.

Transactions for February:

1 Bought goods from Marcus Traders for R5 000, received invoice A11.

5 Sold goods to D. Harnekar for R1 000, issued invoice 201.
Bought goods from Marang Retailers for R3 000, received invoice X13.

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13 Sold goods to P. Smith for R1 800, issued invoice 202.
15 Sold goods to Y. Fuchs for R1 200, issued invoice 203.
18 Sold goods to P. Smith for R 1 300, issued invoice 204.
22 Bought goods from Marcus Traders for R1 200, received invoice A124.
25 Sold goods to D. Harnekar for R2 500, issued invoice 205.
28 Bought goods from Marcus Traders R1 800, received invoice A140.

You are required to:

1. Record the transactions in the accounts receivable and accounts payable journals (ignore VAT).
2. Post the transactions to the general ledger.

Question 12.4

At the end of September 20*x*1, the closing balance on the account of P. Mason, a receivable, exceeded the opening balance by R1 986. During the month he returned goods that cost him R2 815 and paid R55 000 in cash.

The payments in cash were subject to a settlement discount of 5% with the exception of certain goods sold and paid for amounting to R7 500 (you may assume that settlement discounts granted have always been taken up). He was given a further special allowance of R1 000 on defective goods. The invoice relating to these goods had not been paid for by 30 September 20*x*1.

You are required to:
Prepare the general ledger account of P. Mason to calculate the value of goods invoiced to him during September 20*x*1. Ignore VAT.

Question 12.5

1. What are the three types of discounts encountered in the accounting process?
2. Explain the difference between these discounts.
3. How would you record each type of discount in the accounting records?

Question 12.6

These balances appeared, among others, in the records of Nazira Fashions on 1 July 20x3:

Accounts receivable			
M. Tsoai	(ARL1)	810	00
C. Clarke	(ARL2)	1 620	00
		2 430	00

Accounts payable			
I. Deale	(APL1)	600	00
L. Moonsamy	(APL2)	1 100	00
		1 700	00

Transactions for July 20x3:

2 M. Tsoai paid R810 and C. Clarke paid R1 620 in full settlement of their accounts.
7 Nazira Fashions issued cheques to I. Deale and L. Moonsamy in full settlement of each account.

You are required to:
Show the general journal entries to record discount allowed and discount received.

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Question 12.7

On 1 January 20x7, Yebong Traders had accounts receivable that totalled R8 000 in the general ledger.

- The accounts receivable account was made up as follows:

J. Naidoo	400	00
P. Msinga	300	00
D. Omar	150	00
J. Radebe	300	00
Others	6 850	00
TOTAL	8 000	00

- The amounts owing by P. Msinga and D. Omar were written off as being bad debts.
- J. Naidoo and J. Radebe were declared insolvent. Yebong Traders received 50c in the R1 and 40c in the R1 from J. Naidoo and J. Radebe respectively.

You are required to:

1. Enter the transactions in the general journal.
2. Update the four receivable accounts in the subsidiary ledger.
3. Post to the general ledger.

Question 12.8

What is the effect of the introduction of individual personal accounts on the general ledger of a business?

Question 12.9

These balances appeared, among others, in the accounting records of Fuchs Stores on 1 December 20x1: (Ignore VAT)

Purchases				75 000	00
Sales				110 000	00
Accounts receivable:				10 000	00
Caplan	(ARL1)	3 000	00		
Hemus	(ARL2)	2 500	00		
Khati	(ARL3)	2 800	00		
Makola	(ARL4)	1 700	00		
Accounts payable:				7 000	00
Bakkers	(APL1)	2 400	00		
Mokoena	(APL2)	2 600	00		
Ying	(APL3)	2 000	00		
Bank (*Cr.*)				12 000	00

Transactions for December 20x1:

1 Purchased merchandise on account from Bakkers and received invoice F216, R1 700.

3 Purchased merchandise on account from Mokoena and received invoice 524, R2 000.

7 Sold goods on account to:
- Hemus (invoice 2049) for R800.
- Khati (invoice 2050) for R1 100.
- Makola (invoice 2051) for R2 300.

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10 Paid Bakkers, R1 900 (cheque 1423).
Paid Mokoena, R2 000 (cheque 1424). Paid Ying, R1 500 (cheque 1425).

20 Received the following amounts:
- Caplan (receipt R1707) for R600.
- Hemus (receipt R1708) for R1 700.
- Khati (receipt R1709) for R1 500.
- Makola (receipt R1710) for R1 700.

You are required to:

1. Record the transactions for December 20x1 in the appropriate subsidiary journals.
2. Post the journals to the subsidiary ledgers and the general ledger. Then balance the accounts.
3. Prepare a list of accounts receivable outstanding from the accounts receivable ledger. Does your list agree with the accounts receivable account in the general ledger?
4. Prepare a list of accounts payable outstanding from the accounts payable ledger. Does your list agree with the accounts payable account in the general ledger?

Question 12.10

These balances appeared in the books of Swart Traders on 31 July 20*x*7:

Bank	3 200	00	Vehicles	6 000	00
Accounts receivable	2 580	00	Capital	10 000	00
Accounts payable	4 080	00	Equipment	2 700	00
Inventory	5 000	00	15% loan: Sedbank	5 400	00

The lists of balances in the subsidiary ledgers, extracted on 31 July 20*x*7 were:

Accounts receivable		
P. Hull	1 000	00
J. Jones	1 580	00
	2 580	00

Accounts payable		
D. Dowling	1 480	00
X (Pty) Ltd Suppliers	1 200	00
X&Y Manufacturers	1 400	00
	4 080	00

Transactions for August (ignore VAT):

1 Bought goods costing R3 000 from X&Y Manufacturers on credit and receiving a 2% trade discount.
Sold equipment for R1 000 to P. Hull and received a cheque for the full amount. Sold goods to J. Jones for R4 200 on credit.

2 Received R1 580 from J. Jones in full settlement of his account that was outstanding on 1 August.

4 Sold goods to P. Hull, R500 and to D. Davies, R300 on credit.
Bought goods from X (Pty) Ltd Suppliers for R600 on credit and received a trade discount of 2%. Bought stationery for R50 and paid for it by cheque.

10 Sold goods to J. Jones for R80 on credit.
Received R800 from P. Hull.
Paid D. Dowling R1 480 in full settlement of our account. Paid X (Pty) Ltd Suppliers R1 000 on account.

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15 Paid these expenses by cheque:
- Insurance R400
- Wages R1 500
- Electricity R120
- Telephone R95

20 Bought goods from D. Dowling on credit, R200.
23 Paid vehicle licences, R80.
Received a cheque from P. Hull for the full amount outstanding.
26 Sold goods to J. Brown for cash, R3 000.
31 Swart Traders depreciates its vehicles by 10% per annum.
The entry in respect of depreciation for August has not yet been recorded. Paid interest on loan for August 20*x*7.
Paid X&Y Manufacturers R4 000 on account. Closing inventory, R4 000.

Note
Swart Traders uses the periodic inventory system of accounting for inventory.

You are required to:

1 Enter the opening balances in the general ledger and subsidiary ledgers.
2 Record the transactions in these journals where applicable:
- **a** Accounts payable journal.
- **b** Accounts receivable journal.
- **c** Cash receipts journal.
- **d** Cash payments journal.
- **e** General journal.

3 Post the totals of the journals to the appropriate ledger accounts.
4 Extract the list of balances at 31 August 20*x*6 in the subsidiary ledgers and reconcile them to the control accounts in the general ledger.

Question 12.11

Rabie Traders uses the perpetual inventory system to account for its inventory.
- The pricing policy of the business is to mark goods up by 50% on cost.
- All money received is deposited daily.
- All payments are made by cheque. VAT @ 14% must be accounted for on appropriate transactions.

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Rabie Traders
TRIAL BALANCE AS AT 30 MAY 20x9

Details	Fol.	Debit		Credit	
Real Accounts Section					
Bank	B1	10 200	00		
Capital	B2			146 995	00
Drawings	B3	2 000	00		
Premises	B4	50 000	00		
Shares in De Beers	B5	50 000	00		
Vehicles	B6	15 000	00		
Office equipment	B7	12 400	00		
Inventory	B8	25 000	00		
Accounts receivable	B9	1 015	00		
Accounts payable	B10			1 250	00
20% Loan from ABank	B11			10 000	00
SARS: VAT	B12			4 000	00
Nominal Accounts Section					
Sales	N1			40 000	00
Cost of sales	N2	28 600	00		
Wages and salaries	N5	7 000	00		
Telephone	N6	310	00		
Printing and stationery	N7	160	00		
Bank charges	N8	60	00		
Electricity and water	N9	500	00		
		202 245	00	202 245	00

Accounts Receivable List		
A. Altman	215	00
B. Botha	800	00
	1 015	00

Accounts Payable List		
D. Delmas	250	00
E. Els	1 000	00
	1 250	00

Transactions for June 20x9:

1 Sent a cheque Z25 to SARS for the VAT amount outstanding from May.

3 Bought goods from D. Delmas on credit for R1 596 (invoice 41).
Sold goods for cash, totalling R6 000 VAT exclusive (CS 70–80).

4 Paid R2 000 on the loan from ABank.

5 Sold goods with these cost prices on credit to:
- A. Altman R220 (invoice 20)
- B. Botha R180
- L. Zikane R60

7 Bought goods for R820.80 and stationery for R262.20 from E. Els on credit.

8 Bought stationery from Krige Stationers. Paid the R273.60 by cheque.
Sent a cheque for R1 000 to E. Els to settle our account with them as at 1 June. Sold goods that cost R400 on credit to L. Zikane.

10 The owner took a typewriter no longer in use by the business, R1 000 (no VAT).
Sold goods to B. Botha on credit for R720, selling price, VAT exclusive.

15 Purchased stationery on credit from Krige Stationers, R171.
Received a cheque for R215 from A. Altman in full settlement of his account as at 1 June, (receipt R721 issued).

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16 Returned goods to E. Els and received his credit note, R136.80.
17 Donated goods to Tygerhof Primary School for their event, R500 cost price (no VAT).
18 Sold goods to B. Botha on credit. The invoice VAT inclusive totalled R444.60.
Bought goods from G. Nkosi and paid the R706.80 by cheque.
19 Sold an old filing cabinet to A. Altman on credit for R700 (no VAT).
Charged B. Botha R15 interest on his account that was overdue.
20 Received R4 788 for goods sold to customers for cash (CS 81–90).
21 B. Botha sent us a cheque for R1 500 in part payment of his account.
23 Purchased a new delivery vehicle from Parys Motors for R35 500 on credit.
24 Sold an old vehicle to R. Venter for R15 000, and received his cheque (no VAT).
25 Sent cheques to pay for:
Electricity and water R171.00
Telephone R193.80
26 Goods were returned by L. Zikane (cost price R100) and B. Botha (cost price R120).
27 Paid R250 to D. Delmas in settlement of the amount owing on 31 May.
28 Received a cheque for rent of premises sublet to L. Lategan, R319.20.
29 Received a cheque for R22 from L. Zikane. Drew a cash cheque for wages, R2 400.
E. Els sent notification that he had charged R10 interest on overdue account.
30 Received a credit note from Krige Stationers for R57 for stationery returned.

You are required to:

1 Enter the transactions for June 20*x*9 in these journals:
- **a** Cash receipts journal.
- **b** Cash payments journal.
- **c** Accounts receivable journal.
- **d** Accounts payable journal.
- **e** Accounts payable allowances journal.
- **e** Accounts receivable allowances journal.
- **g** General journal.

2 Open all the general ledger accounts and post from the subsidiary journals.
3 Open the accounts receivable and accounts payable ledgers and post from the subsidiary journals.
- **a** Balance all accounts in the general ledger and the subsidiary ledgers and draft a accounts receivable and accounts payable list.
- **b** Compare the list totals with the balances of the accounts receivable and accounts payable accounts.

4 Draft a trial balance at 30 June 20*x*9.

Question 12.12

The abridged special purpose journals for September 20*x*0, the first month of trading of Hotspot Traders Ltd, are given below:

Accounts receivable journal

Details	Sales	VAT	Total
A. Smith	400	56	456
B. Carlisle	500	70	570
Cosmo (Pty) Ltd	300	42	342
	1 200	168	1 368

Accounts payable journal

Details	Purc.	VAT	Total
Xavier Ltd	700	98	798
Y. Cara	800	112	912
	1 500	210	1 710

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Cash receipts journal

Details	Sundry accounts	Accounts receivable	VAT output	Bank
Cosmo (Pty) Ltd		342		342
Rent income	4 000		560	4 560
B. Carlisle		456		456
Share capital	5 000			5 000
	9 000	798	560	10 358

Cash payments journal

Details	Sundry accounts	Accounts payable	VAT input	Bank
Xavier Ltd		798		798
Equipment	1 000		140	1 140
Y. Cara		456		456
Salaries	5 000			5 000
	6 000	1 254	140	7 394

You are required to:

1 Open the necessary accounts and post the above journals to the general, accounts receivable and accounts payable ledgers.

2 Prepare accounts receivable and accounts payable lists and compare them with the balances of the control accounts.

Question 12.13

L. Baadjies had these receivables on her books on 1 December 20*x*8: (Ignore VAT.)

J. Crause	R500
A. Herbst	R700
N. Radebe	R260
Other receivables	R14 800

The allowance for bad debts account on 1 January 20*x*8 = R900.

Transactions for December:

3 J. Crause could not be traced. His account must be written off as bad.

7 A. Herbst was declared insolvent. A payment of 20c in the R1 from his liquidated estate has been received.

11 N. Radebe has communicated that he cannot meet his obligations. His account must be written off as a bad debt.

14 V. Chetty, a receivable previously written off, was traced and settled his account of R360.

31 Accounts receivable accounts settled during the month, R7 300.
Credit sales for the month R8 600.

You are required to:

1 General journal entries for the transactions.

2 Adjust the allowance for bad debts to 5% of outstanding accounts receivables. Show all the closing entries in the general journal.

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Question 12.14

Zeta Ltd is a business that conducts the majority of its sales on a credit basis. The business's policy with regard to the accounting treatment of irrecoverable accounts is:

1 Write off all bad debts authorised by the credit manager to the allowance for bad debts account.

2 Maintain an allowance for bad debts account at the end of each financial year, equal to 5% of outstanding accounts receivable balances.

3 Reinstate accounts receivable balances previously written off and credit the proceeds of any 'bad debts recovered' to the accounts reinstated.

4 Transfer any material debit or credit balances on the allowance for bad debts account resulting from incorrect estimates made in the previous year, to the profit and loss account as a separate item.

On 1 January 20*x*8, the credit balance brought forward on the allowance for bad debts account was R4 120.

Transactions, adjusting entries and closing entries affecting bad and possible bad debts for the year ended 31 December 20x8 were:

16/01 Wrote off R500 owed by J. Kelly who is completely insolvent.

22/03 Received R80 from J. Last whose account had been written off as bad during 20*x*7.

18/06 Received a first and final dividend of 10c in the R1 from L. Masha, who owed R600, and wrote off the balance of his account.

15/12 Wrote off these accounts as bad debts:

- E. Holland R290
- V. Aphane R810

31/12 Recorded the adjusting entry for the year-end allowance for bad debts based on the outstanding accounts receivable total of R30 400.

31/12 Recorded the closing entry for bad debts recovered.

You are required to:

Record the transactions in the general journal. (Ignore VAT.)

Question 12.15

You are the accounts payable clerk of Must Balance Ltd and you receive the following statement from All Right (Pty) Ltd.

Date	Details	Debit		Credit	
March 1	Balance (account rendered)	2 200	00		
March 5	Invoice 11	1 224	00		
March 9	Invoice 21	1 942	00		
March 12	Credit note 7			107	00
March 14	Cash			2 045	00
	Credit note 8			55	00
March 20	Invoice 31	111	00		
March 24	Credit note 9			125	00
March 27	Invoice 41	1 260	00		
March 31	Balance			4 405	00
		6 737	00	6 737	00

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The account of All Right (Pty) Ltd in your books is shown as:

Accounts Payable Ledger of Must Balance Ltd

ALL RIGHT (PTY) LTD **APL1**

Date		Details	Fol.	Debit		Credit		Balance	
Mar.	1	Balance	b/d					2 200	00
	5	Invoice 11	APJ			2 412	00	4 612	00
	9	Invoice 21	APJ			1 942	00	6 554	00
	12	Invoice 07	APJ			107	00	6 661	00
		Cheque	CPJ	2 155	00			4 506	00
		Debit note 08	APAJ	45	00			4 461	00
	20	Debit note 11	APAJ	111	00			4 350	00
	24	Debit note 09	APAJ	125	00			4 225	0
	27	Invoice 41	APJ			1 260	00	5 485	00

You are able to establish that the account statement by All Right (Pty) Ltd is correct in all aspects.

You are required to:
Prepare a reconciliation of your account.

Question 12.16

Explain why:

1. A business would sell on credit.
2. A credit policy is necessary and what such a policy entails.
3. An allowance for bad debts must be created.

Question 12.17

On 30 September 20x5, at the end of its financial year, these balances, among others, appeared in the books of Zabeth Ltd:

Accounts receivable and accounts payable	Debit		Credit	
S. Songelwa	5 900	00		
T. Tshidi			6 300	00
U. Ungerer	5 100	00		
V. Valentyn	4 200	00		
W. Ward			3 400	00
Y. Yogapragasen	3 600	00		
Z.Zwane	5 500	00		
S. Singh	2 600	00		
R. Ramos			3 700	00
P. Proctor	3 100	00		
O. Oosthuizen	4 000	00		
N. Nxumalo	1 900	00		
ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE	35 900	00	13 400	00

Other receivables				
American Express	7 700	00		

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Accruals				
Electricity expense payable			1 800	00
Telephone expense payable			2 900	00

Allowances				
Bad debts			1 200	00

Additional information:

- The allowances for bad debts are adjusted at the end of each financial year.
- On 5 October, paid a cheque to W. Ward.
- On 16 October, received notice that S. Singh has disappeared, and that there is no possibility to recover the amount owing by him. His account should be written off as irrecoverable.

Accounts receivable:

Received from receivables:

- On 5 October, S. Songelwa paid R5 400 in full settlement of his account.
- On 18 October, received R920 from L. Lino. This amount was previously written off as bad.

Goods returned by receivables and taken back into inventory:

- 3 Oct. U. Ungerer R2 100
- 9 Oct. V. Valentyn R200
- 18 Oct. Y. Yogapragasen R300

Other:

- Received notice on 28 October that Y. Yogapragasen is insolvent. His estate will pay 30c in the R1 of the amount owing by him.
- On 15 December 20x5, sent a cheque to T. Tshidi for the amount owing to her on 22 October.

You are required to:
Show General Journal entries for October 20x5 for the above. (Ignore VAT.)

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13 PAYROLL ACCOUNTING

Chapter objectives

By the end of this chapter, you should be able to:

- List the institutions at which an employer should register.
- Define gross remuneration.
- Calculate net remuneration per employee.
- Know how to calculate payments made to other institutions on a monthly or annual basis.
- Prepare the accounting entries for recording remuneration, expenses and payments related to remuneration.

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1 Introduction

A business is classified as an employer if the business employs people and pays them for their services. Such people are the employees of the business. Salaries are paid to employees who earn remuneration on a monthly basis, for example, administrative personnel. The payment is usually made by cheque or by direct bank transfer. Wages are paid to employees who earn hourly wages, such as factory personnel who are usually paid in cash.

Salaries and wages may be recorded in a number of ways. Regardless of the method used, records must be maintained, either manually using a wage/salary register, or more commonly, using a computerised system.

Some basic principles apply to all salary and wage systems, irrespective of which system is used. These basic principles will be discussed in this chapter.

Note: All examples in this chapter are based on legislation and may require amendment if there are any changes in the applicable legislation. The taxation calculations are based on the tax legislation at the time of going to press.

2 Registrations

Any business that employs employees should register with at least the following institutions:

The South African Revenue Service (SARS)

Income tax

All businesses that employ people and remunerate them for their services (salary, wage or commission) must register with SARS as an employer. A reference number is issued and the income tax (pay as you earn /PAYE) deducted from the employees' remuneration is paid over to the SARS each month.

This payment must be made before the 7th day of each month and is accompanied by form EMP201 (monthly employee declaration), under the reference number allocated.

Skills development levy

Employers who are registered with SARS for PAYE and whose annual payroll is in excess of R500 000, must pay the skills development levy.

Registration for the levy is done at the local SARS office. Levy payments are made to SARS monthly before the 7th day of each month, accompanied by a return of contributions, on form EMP201.

The Department of Labour

Unemployment Insurance Fund (UIF)

All employers that employ any person and in return provide them with remuneration in either cash or in kind must register with the Fund as soon as they commence activities as an employer.

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The Unemployment Insurance Contributions Act of 2001 came into effect on 1 April 2002. All employees, as well as their employers, are responsible for contributions to the Unemployment Insurance Fund. However, the Act excludes:

- Employees working less than 24 hours a month for an employer.
- Learners.
- Public servants.
- Foreigners working on contract.
- Employees who earn commission only.
- Employees that get a monthly State pension.

All employees must contribute to the Fund up to and including the ceiling amount of currently R14 872 per month (R178 464 annually). This means that if there are employees earning more than R14 872 per month, their contributions must be deducted up until this ceiling amount.

The payment of contributions is made in one of the following ways:

- SARS will collect all UIF contributions from those employers that are registered with SARS for PAYE. Equal contributions are made by the company and by the contributor on behalf of each contributor. Payments must be made within seven days after the end of the month during which the amount was deducted, accompanied by a return of contributions, on form EMP201.
- Those employers who are not required to register with SARS for PAYE must continue to pay their contributions directly to the Unemployment Insurance Fund. Equal contributions are made by the company and by the contributor on behalf of each contributor. Payments must be made within seven days after the end of the month during which the amount was deducted, accompanied by a return of contributions, on form UF3.

If the last day for payment falls on a public holiday or weekend, the payment must be made on the last business day before the public holiday or weekend.

Compensation for Occupational Injuries and Diseases Act

The Occupational Injuries and Diseases Act 130 of 1993 replaces the Workers' Compensation Act 30 of 1941. This Act establishes a fund that provides compensation to workers for injury, or death, resulting from accidents and industrial diseases contracted during the course of employment.

The following categories of employees are excluded from the definition of a worker:

- Persons undergoing military service or training.
- Members of the SAPS (South African Police Service).
- Persons whose annual income exceeds R149 136 (R12 428 per month; this amount may be amended by the Minister).
- Casual employees.
- Out-workers, that is, persons who are given material or articles to work on at premises not under the control of the employer.
- Contractors who engage other persons to do their contract work, unless they are included in the statement of annual wages and regarded by the Minister as 'workers'.
- Domestic workers employed in private households or in an institution where not more than five domestic workers are usually employed.
- Persons employed as seamen or airmen.

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- Persons employed outside the Republic of South Africa.

The Commissioner determines the rate of assessment according to an estimated risk and cost of accidents. This, in conjunction with the annual wages paid by the employer to workers (the employer must submit wage statements), determines the contribution to be made to the Fund by each employer.

3 Necessary information

It is necessary to keep at least this information for each worker irrespective of the system used:

- First name.
- Last name.
- Address, both physical and postal.
- ID number.
- Contact numbers.
- Employment contracts.
- Tax number.

The Workers' Compensation Commissioner also requires this additional information:

- Date of employment.
- Hourly rate of basic salary, date of increase and details of leave.

SARS also requires the employer to keep a record of the remuneration paid to each employee, as well as employees' tax deducted or withheld from such remuneration. These records must be kept for a period of five years from the date of the last entry.

Employment contract

The contract of employment is a vital document – it regulates the terms and conditions of employment between the employer and the employee. It stipulates what the employer will provide in terms of benefits, and in terms of labour legislation, and it specifies what the employee is entitled to receive in terms of company policy, company benefits, and labour legislation. It also regulates the behaviour of the employee in the workplace, because company policies, procedures, as well as disciplinary codes, form a part of the employment contract.

You should be able to complete Questions 13.1 to 13.4.

4 Calculation of net remuneration

The calculation of net remuneration of an employee can best be explained by means of this table:

Gross remuneration	x xxx	00
Normal time	(xx	00)
Overtime	xx	00
Retirement fund benefit	xx	00
Medical aid fringe benefit	xx	00

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Taxable income	x xxx	00
Less: Deductions	(xxx	00)
PAYE	xx	00
Unemployment Insurance Fund	xx	00
Union membership	xx	00
Medical aid fund contributions	xx	00
Retirement fund contributions	xx	00
NET REMUNERATION	x xxx	00

There may be other deductions, but the above are those most frequently found. Examples of other deductions are loan repayments and payment for parking.

Gross remuneration

Did you know?

The Basic Conditions of Employment Act 75 of 1997 (as amended) states that overtime worked by an employee may not exceed ten hours per week, or three hours per day.

Gross remuneration is the total remuneration that an employee receives, whether in cash or by way of a fringe benefit.

Fringe benefits, as part of the remunerative package, fall outside the scope of this book. Medical aid contributions and retirement fund contributions will however be discussed as this is normally included in employment contracts.

Remuneration can basically be in these three forms:

1 A basic salary/wage that consists of a fixed monthly/weekly salary/wage.
2 Remuneration for the number of hours worked based on a standard rate; thereafter the employee receives overtime.

   Normal time

   The Basic Conditions of Employment Act regulates the number of normal time. No employee may work more than 45 hours per week normal time. The following criteria is given:
   – Employees working 1–5 days per week may work a maximum of 9 normal hours per day.
   – Employees working more than 5 days per week may work a maximum of 8 normal hours per day.

   This applies irrespective of the industry the employer is in, because the Act does not differentiate between different types of industries or the employment environment.

   Overtime

   Overtime is paid for any amount of time over and above the normal time. Overtime payment is usually calculated at one-and-a-half times the normal hourly rate, except on Sundays and public holidays, when it is calculated at twice the normal rate.

   It is, however, management's duty to determine the overtime rate that will be used.
3 Remuneration on a commission basis, for example, a percentage of turnover (sales).

A **bonus** can be added to any of the above forms. It could be a holiday, Christmas, good work or any other bonus as decided by management. In most cases a business will use a combination of the above.

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To calculate gross remuneration, time records can be used. The most common form of attendance record is the clock card on which the employees punch their time in and out as they enter and leave the workplace.

Each week, a new card is issued and old cards are used by the payroll department to calculate the wages for the week.

Example 13.1

Mr Jabulala is the owner of a petrol station and conducts business as a sole proprietor. He employs these people:

- Ms Peme, the full-time bookkeeper, who works for a fixed salary of R16 280 per month regardless of actual hours worked.
- Mr Moloi, the supervisor, for R19 200 per month.

There are also four pump attendants who work a five-day shift and a basic work-week of 45 hours:

- Mr Pule
- Mr Jacobs
- Mr Sekeleko
- Ms Mogogodlana

Any hours after these are treated as overtime. The hourly rate is R24 per hour.

Overtime is paid at one-and-a-half times the hourly rate and Sunday time at twice the normal rate. This information is available for the week ending 9 December 20*x*8.

Mr Sekeleko	45 hours normal time
	5 hours normal overtime
	4 hours Sunday time
Mr Pule	45 hours normal time
	6 hours Sunday time
Ms Mogogodlana	45 hours normal time
	3 hours normal overtime
Mr Jacobs	42 hours normal time

You are required to:

Calculate the gross remuneration for each of the four pump attendants for the week ending 9 December 20*x*8.

The gross remuneration for the four pump attendants can be calculated as follows:

	Normal time	Overtime	Sunday time	TOTAL	
Mr Sekeleko	45 × R24 = R1 080	5 × R24 × 1.5 = R180	4 × R24 × 2 = R192	R1 452	00
Mr Pule	45 × R24 = R1 080		6 × R24 × 2 = R288	R1 368	00
Ms Mogogodlana	45 × R24 = R1 080	3 × R24 × 1.5 = R108		R1 188	00
Mr Jacobs	42 × R24 = R1 008			R1 008	00

Retirement fund contributions

From 1 March 2015, all employer-paid contributions to pension, provident and retirement annuity funds is a deductible employment expense for the employer and a **taxable fringe benefit** in the hands of the employee.

These taxable employer-paid contributions will, however, be deemed to have been made

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by the employee for personal income tax deduction purposes, who shall in turn be eligible for a tax deduction for such contributions to approved funds, in addition to any contributions made by themselves to any of the three fund types.

The tax deduction is limited to a certain amount but, for the purpose of this text, it is important to know that the contributions made by the employer is treated as a fringe benefit and forms part of gross remuneration.

Example 13.2

The owner contributes 15% of the salaries of Ms Peme and Mr Moloi to a pension fund of which their portion is 50%. The pump attendants belong to a union and do not make contributions to the pension fund.

Calculate the amount to be included in gross remuneration as a retirement benefit.

- Contribution for Ms Peme will be R16 280 × 15% x 50% = R1 221.00 per month.
- Contribution for Mr Moloi will be R19 200 × 15% x 50% = R1 440.00 per month.

It is not the intention to discuss medical costs and the tax consequences in detail. For the purpose of this text you need to know that medical costs paid by the taxpayer's employer for the benefit of the taxpayer are regarded as a **taxable benefit** and are therefore subject to tax.

However, medical costs paid by the taxpayer's employer are deemed to have been paid by the taxpayer. These amounts, therefore, form part of the taxpayer's medical scheme contributions and expenses for tax purposes. As such, the total contributions and expenses (which will include those paid for the taxpayer's benefit by the employer) will be taken into account when determining the medical scheme fees tax credit and allowance.

Although the amounts paid by the employer are regarded as a taxable benefit, there are amounts that attract no value and are therefore not subject to tax.

No value will be placed on **contributions** paid by the employer to a medical scheme registered under the Medical Scheme Act when the benefit is derived by:

- The taxpayer who, by reason of superannuation, ill-health or other infirmity retired from the employ of the employer.
- The dependants of a deceased employee after his or her death, if he or she was in the employ of the employer on the date of death.
- The dependants of the taxpayer after his or her death, if he or she retired from the employ of the employer by reason of superannuation, ill-health or other infirmity.

No value is placed on **medical services and expenses** paid by an employer if:

- The employee is over the age of 65.
- The employee retired from the employ of an employer due to superannuation, ill-health or other infirmity.
- The person was in the employ of that employer on the date of his or her death, and the benefits were received by the dependants of that person after death.
- The recipient of the benefit was a dependant of a deceased ex-employee who had retired due to superannuation, ill-health or other infirmity.
- The medical services are rendered by the employer to its employees in general at their place of work for the better performance of their duties.
- The services are rendered or medicine supplied to comply with any law of South Africa.
- The medical treatment provided by the employer consists of one of the prescribed minimum benefits determined by the Minister of Health under the provisions of the Medical Schemes Act.

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The taxpayer may only claim a medical tax credit and an allowance on amounts paid by an employer that has been included in that taxpayer's income as a taxable benefit.

Example 13.3

Mr Jabulala decided to contribute 100% of the medical aid contributions for his employees. Medical aid contributions are as follows:

- Adult members R650 per month
- Children under 18 years R500 per month

The following information is available for the employees:

- Ms Peme and her husband are looking after her mother and as such her mother is a dependant on her medical aid. The contribution for her mother is R650. She is responsible for this and the amount is deducted from her salary and paid over to the medical fund by Mr Jabulala.
- Mr Moloi is married and has one child.
- Mr Sekelelo and Mr Pule are unmarried with no dependants.
- Ms Mogogodlana is a widow with two children under 18 years as dependants.
- Mr Jacobs is 68 years old and unmarried with no dependants.

You are required to:

Calculate the amounts that Mr Jabulala will take into consideration when calculating the gross remuneration of his employees. Medical aid for the pump attendants is deducted equally over four weeks.

Ms Peme	R1 300 per month
Mr Moloi	R1 800 per month
Mr Sekeleko	R650 per month = R162.50 per week
Mr Pule	R650 per month = R162.50 per week
Ms Mogogodlana	R1 650 per month = R412.50 per week
Mr Jacobs	Over 65 no taxable benefit.

You should be able to complete Questions 13.5 and 13.6.

Taxable amount

Gross earnings, that is normal pay, overtime pay, bonuses, retirement fund and medical aid contributions, services and expenses paid by the employer is the amount on which income tax is calculated.

The taxable income of Mr Jabulala's employees can now be summarised as:

	Ms Peme		Mr Moloi		Mr Sekeleko		Mr Pule		Ms Mogogo-dlana		Mr Jacobs	
Normal hours	16 280	00	19 200	00	1 080	00	1 080	00	1 080	00	1 008	00
Overtime hours					372	00	288	00	108	00	0	00
Retirement fund fringe benefit	1 221	00	1 440	00	0	00	0	00	0	00	0	00
Medical aid fringe benefit	1 300	00	1 800	00	162	50	162	50	412	50		
Taxable income	18 801	00	22 440	20	1 614	50	1 530	50	1 600	50	1 008	00
	For December				For the week ending 9 December 20*x*8							

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Medical aid tax credit (MTC)

The manner in which medical expenses may be claimed with effect from 1 March 2012 has changed. An MTC (in the form of a tax rebate) was introduced to replace the tax deduction for contributions paid by a person who has not yet attained 65 years of age by the end of the year of assessment.

The MTC is not applicable to the taxpayer who is 65 years of age or older, since these taxpayers are already entitled to a full medical allowance on contributions and qualifying medical expenses paid.

The credit itself is set at a fixed amount per month. Since the MTC is a 'rebate' and not a 'deduction', it is not refundable and cannot exceed the amount of normal tax to be deducted.

The employer is obliged to take into account the MTC when calculating the employees' tax to be deducted or withheld when the employer pays the contributions. This is usually carried out by using the various payroll systems.

The current medical aid tax credit is as follows:

- R242 for benefits to the taxpayer.
- R484 for benefits to the taxpayer and one dependant.
- R484 for benefits to the taxpayer and one dependant, plus R162 for every additional dependant, for each month in that year of assessment for which contributions are paid.

Example 13.4 Taking the above information into account, calculate the MTC which Mr Jabulala should deduct for each of his employees.

Employee	Number of dependants	Calculation	Amount to use
Ms Peme	1 + 1 + 1	R242 + R242 + R162	R646
Mr Moloi	1 + 1 + 1	R242 + R242 + R162	R646
Mr Sekeleko	1	R242	R242
Mr Pule	1	R242	R242
Ms Mogogodlana	1 + 1 + 1	R242 + 242 + R162	R646
Mr Jacobs	Over 65		nil

PAYE (Pay as you earn)

Employees' tax (PAYE) is the tax that employers must deduct from the employment income of employees – such as salaries, wages and bonuses.

PAYE deductions ensure that an employee's income tax liability is settled in a continuing fashion, at the same time that the income is earned. The advantage of this is that the tax liability for the year is settled over the course of the whole year of assessment.

PAYE is deducted and paid to SARS on a monthly basis. It is calculated by using the tax tables supplied by SARS. These tables are divided according to employees receiving remuneration on a daily, weekly or monthly basis.

The information is also available on a disc from SARS. In computerised systems, care should be taken that the calculations made by the program are correct.

In the petrol station example, Ms Peme and Mr Moloi receive monthly salaries, therefore, their income tax deductions are read from the monthly tables. The pump attendants are paid weekly, so their tax is read from the weekly tables.

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Each table is also divided into the following sections:

- Tax under 65 years of age.
- Tax between 65 and 74 years.
- Tax over 75 years of age.

Example 13.5

Mr Franklin of Frankenstein Ltd, the accountant of Mr Jabulala, supplied you with these extracts from the tax tables:

Weekly deduction tables

Remuneration	Annual equivalent	Tax		
		Under 65	65 – 74	Over 75
R0 – R1 149	R59 748	R0	R0	R0
R1 472 – R1 475	R76 622	R10	R0	R0
R1 532 – R1 535	R79 742	R21	R0	R0
R1 612 – R1 615	R83 902	R35	R0	R0

Monthly deduction tables

Remuneration	Annual equivalent	Tax		
		Under 65	65 – 74	Over 75
R18 790 – R18 815	R225 630	R2 571	R1 954	R1 748
R22 431 – R22 461	R269 352	R3 519	R2 901	R2 696

You are required to:

Use the extracts from the tax tables above to determine the amount of PAYE payable by each of Mr Jabulala's employees based on the information already supplied. Mr Jacobs is the only employee over 65, he is 68 years:

Did you know?

The Tax Act is revised every year. This means that tax rates, deduction amounts and so on, change frequently.

Name	Tax payable						
Ms Peme	R2 571	00	R646	00	R1 925	00	For December
Mr Moloi	R3 519	00	R646	00	R2 873	00	
Mr Sekeleko	R35	00	R35	00	R0	00	For the week ending 9 December 20*x*8
Mr Pule	R21	00	R21	00	R0	00	
Ms Mogogodlana	R10	00	R10	00	R0	00	
Mr Jacobs	R0	00	R0	00	R0	00	

Unemployment Insurance Fund (UIF)

All workers who work for more than 24 hours per month, except those earning commission only, must contribute to the Fund up to and including the ceiling amount of currently R14 872 per month.

This means that if there are employees earning more than R14 872 per month, their contributions must be deducted up until this ceiling amount. Unemployment Insurance Fund (UIF) contributions are payable by employees at a rate of 1% or 0.01 of their remuneration. The employer's contribution is exactly the same as that of the employee.

All definitions of earnings have been standardised in terms of the Fourth Schedule of the Income Tax Act 1962.

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These items (applicable to our discussion) are excluded for the purposes of calculating UIF contributions:

- Commission.
- Pension.
- Retirement allowance.
- Annuity.
- Lump sum payments.

Example 13.6

You are required to:
Calculate the UIF payable by each of the employees in Example 13.3.

Suggested solution

- Ms Peme R16 280 × 1% = R162.80 but limited to a ceiling amount of R148.72
- Mr Moloi R19 200 × 1% = R192.00 but limited to a ceiling amount of R148.72.

Pump assistants:
UIF for the week ending 9 December 20*x*8:

- Mr Sekeleko R1 452 × 1% = R14.52
- Mr Pule R1 368 × 1% = R13.68
- Ms Mogogodlana R1 188 × 1% = R11.88
- Mr Jacobs R1 008 × 1% = R10.08

Union fees

Trade unions are recognised in the Constitution, which provides for the right to join trade unions, and for unions to collectively bargain and strike. The Labour Relations Act has given workers and their unions redress through mediation, conciliation and arbitration.

All workers and active job seekers have the right to join and be active in trade unions. They are also legally protected against discrimination by employers for being union members.

There are three prominent trade union federations with affiliates operating in the different sectors of the economy. These are the Congress of South African Trade Unions (Cosatu), the Federation of Unions of South Africa (Fedusa), and the National Council of Trade Unions (Nactu).

The amount payable to the relevant union is determined by the union.

Medical aid fund

The medical aid fund determines the amount of the contribution and it is usually based on the marital status and number of dependants of the employee.

Other deductions

Any other deductions will depend on the employer and employee's specific agreement regarding the deduction, for example, repayment for a loan taken from the company or payment for company parking.

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Example 13.7

The previous examples can now be summarised as:

Union fees are R15 per week.

	Ms Peme		Mr Moloi		Mr Sekeleko		Mr Pule		Ms Mogogo-dlana		Mr Jacobs	
Normal hours	16 280	00	19 200	00	1 080	00	1 080	00	1 080	00	1 008	00
Overtime hours					372	00	288	00	108	00	0	00
Retirement fund fringe benefit	1 221	00	1 440	00	0	00	0	00	0	00	0	00
Medical aid fringe benefit	1 300	00	1 800	00	162	50	162	50	412	50	0	00
Gross remuneration	18 801	00	22 440	00	1 614	50	1 530	50	1 600	50	1 008	00
Less: Deductions												
PAYE	1 925	00	2 873	00	0	00	0	00	0	00	0	00
UIF	148	72	148	72	14	52	13	68	11	88	10	08
Union fees	0	00	0	00	15	00	15	00	15	00	15	00
Medical aid	650	00	0	00	0	00	0	00	0	00	0	00
Retirement fund	1 221	00	1 440	00	0	00	0	00	0	00	0	00
NET REMUNERATION	14 856	28	17 978	28	1 584	98	1 501	82	1 573	62	982	92

For December (Ms Peme, Mr Moloi) — For the week ending 9 December 20*x*8 (Mr Sekeleko, Mr Pule, Ms Mogogodlana, Mr Jacobs)

Payslips

Weekly wages are usually paid in cash to the employee. For this purpose a pay packet is usually used. An example of a manual pay packet for Mr Pule will look as follows:

Name: Mr Pule		**Nr:** 84256			
Occupation: Pump attendant		**Week ending:** 9 Dec. 20*x*3			
Employer: Jabulala Petrol Station					
	Hours	**Rate**			
Ordinary time	45	24	00	1 080	00
Overtime					
Overtime – Sunday	6	48	00	288	00
Medical aid FB				162	50
Gross remuneration				**1 530**	**50**
Deductions:				**28**	**68**
PAYE & SITE		0	0		
UIF		13	68		
Union fees		15	00		
AMOUNT PAYABLE				**1 501**	**82**

You should be able to complete Question 13.7.

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Here is an example of a payslip that was processed on a computerised system:

PAYSLIP								
JABULALA PETROL STATION				**Period ending:**		9 December 20*x*3		
Name:	Sekeleko, Silas					**Code:**	FLORA3	
Date of birth:	12/3/1970	**Date started:**	3/6/20*x*0	**Run:**	1	**Days:**	7	
Sex:	Male	**Marital status:**	Single	**Children:**	0	**Tax status:**	Single	

Earnings			Deductions		
45 h @ R24	R1 080	00	PAYE	0	00
Overtime – 5.00 h	R180	00	Union fees	15	00
Sunday overtime – 4.00 h	R192	00	Pension	0	00
Medical aid fringe benefit	162	50	UIF	14	52
Gross pay	R1 614	50	***Total deductions***	29	52
Cash – Driveway			***Net salary***	1 584	98
Year to date					
Gross earnings	30 346	80	PAYE	0	00
			Union fees	600	00
			UIF	303	46
Leave days due: 10					

5 Contributions by the employer

Retirement fund

The rules of the applicable retirement fund will determine the amount contributed by the employer. Generally it will be the same of that of the employee but it could also be higher.

Example 13.8

As per Example 13.2 Mr Jabulala contributes 15% towards the retirement fund for his employee of which their portion is 50%.

You are required to:

Calculate Mr Jabulala's contribution to the retirement fund.

Mr Jabulala only contributes towards Ms Peme and Mr Moloi who earn salaries and who contribute to the retirement fund themselves.

Ms Peme	R16 280 × 15% × 50%	1 221	00
Mr Moloi	R19 200 × 15% × 50%	1 440	00
TOTAL FOR DECEMBER		2 661	00

Unemployment Insurance Fund (UIF)

The employer's contribution to UIF is exactly the same as that of the employee's, that is, 1% of normal earnings.

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Example 13.9

Mr Jabulala's contribution to UIF will, therefore, be the same as that of his employees. Refer to Example 13.5.

Name	UIF payable		
Ms Peme	148	72	For December
Mr Moloi	148	72	
Mr Sekeleko	14	52	For the week ending 9 December 20*x*8
Mr Pule	13	68	
Ms Mogogodlana	11	88	
Mr Jacobs	10	08	

Skills development levy (SDL)

The skills development levy (SDL) payable is 1% of the total remuneration paid to employees.

Example 13.10

Assume that the four pump attendants work the rest of December on the same basis as the first week. The total remuneration paid to the employees will then be:

Name	Total	
Ms Peme	18 801	00
Mr Moloi	22 440	00
Mr Sekeleko	6 458	00
Mr Pule	6 122	00
Ms Mogogodlana	6 402	00
Mr Jacobs	4 032	00
Total	64 255	00

Total skills levy payable for December = R64 255 × 1% = R642.55.

6 Recording procedures

Whether employees are paid weekly or monthly, the following general journal entries will be made:

GENERAL JOURNAL OF XXX **GJx**

Day	Details	Fol.	Debit		Credit	
09/12	Gross remuneration		xxx			
	Retirement fund				xx	
	Medical aid fund				xx	
	Union fees				xx	
	SARS				xx	
	Unemployment Insurance Fund (UIF)				xx	
	Salaries and wages				xx	
	Recording weekly/monthly wages of employees					
	Gross remuneration		xxx			
	Retirement fund				xx	
	Medical aid fund				xx	
	Recording the employer's contribution					
	Salaries and wages		xxx			
	Bank				xxx	
	Paying wages/salaries to the employee					

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Explanation

1 The gross remuneration represents the total amount that the employer agrees to pay to the employee. The amounts credited represent the amounts due to the different parties, for example, medical fund, the union, and finally the amount payable (salaries and wages account) to the employee.
2 This is the journal entry to record the amounts payable by the employer to the different parties on behalf of the employee.
3 This is the actual payment of the net wages by cash or cheque to the employee.

The payment of the deductions to the relevant institutions takes place once a month and is explained in Section 7 of this chapter.

Example 13.11 Assume that the four pump attendants work the rest of December on the same basis as the first week. The recording of the previous examples for that week will be:

Wages

GENERAL JOURNAL OF JABULALA PETROL STATION **GJ12**

Day	Details	Fol.	Debit		Credit	
09/12	Gross remuneration	1	5 753	50		
	Union fees	2			60	00
	SARS	3			0	00
	Unemployment Insurance Fund (UIF)	4			50	16
	Salaries and wages	5			5 643	34
	Recording weekly wages of employees					
	Salaries and wages		5 643	34		
	Bank				5 643	34
	Paying wages to the employees					

Each week

Calculations

1 R1 614.50 + 1 530.50 + 1 600.50 + 1 008 (Example 13.1)
2 R15 + 15 + 15 + 15
3 R0 (Example 13.5)
4 R14.52 + 13.68 + 11.88 + 10.08 (Example 13.6)
5 R1 584.98 + 1 501.82 +1 573.62 + 982.92 (Net pay per Example 13.7)

Salaries

GENERAL JOURNAL OF JABULALA PETROL STATION **GJ12**

Day	Details	Fol.	Debit		Credit	
31/12	Gross remuneration	1	35 480	00		
	Retirement fund	2			2 661	00
	SARS	3			4 798	00
	Unemployment Insurance Fund (UIF)	4			297	44
	Medical aid fund contribution	5			650	00
	Salaries and wages control				27 073	56
	Recording monthly salaries of employees					
	Salaries and wages		27 073	56		
	Bank				27 073	56
	Paying salaries to the employees					

Each month

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Calculations

1 R16 280 + 19 200 = R35 480

2 R1 221 + 1 440

3 R1 925 + 2 873 = R4 798

4 R148.72 + R148.72

5 R650

Employer's contribution

GENERAL JOURNAL OF JABULALA PETROL STATION **GJ12**

Day	Details	Fol.	Debit		Credit	
31/12	Gross remuneration		7 370	56		
	Retirement fund	1			2 661	00
	Medical aid fund	2			6 050	00
	Unemployment Insurance Fund (UIF)	3			498	08
	Recording the employer's contribution					

Calculations

1 R1 221 + 1 440

2 R1 300 +1 800 + [4 × (162.50 + 162.50 + 412.50)]

3 R148.72 + R148.72 + [4 × (14.52 + 13.68 +11.88 + 10.08)]

7 Monthly payments

It is expected that the employer pays the deductions made to the relevant institutions monthly. The institutions provide the relevant forms to accompany the payment.

The following entry should be made:

GENERAL JOURNAL OF XXX **GJx**

Day	Details	Fol.	Debit		Credit	
	Retirement fund		xx			
	Medical aid fund		xx			
	Union fees		xx			
	SARS		xx			
	Unemployment Insurance Fund (UIF)		xx			
	Bank				xxx	
	Payment of monthly deductions					

Explanation

- This journal entry is made to show the actual payment made to the institutions. The payments will usually be made by cheque and the debit will go directly to the control account.
- After the payment had been made, the control account for December should be nil.
- The payments include the employer's and employees' contributions.

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Example 13.12 From Example 13.10, the payments will be as follows for the month of December 20*x*3:

GENERAL JOURNAL OF JABULALA PETROL STATION GJ12

Day	Details	Fol.	Debit		Credit	
31/12	Pension fund	1	5 322	00		
	Medical aid fund	2	6 700	00		
	Union fees	3	240	00		
	SARS	4	4 798	00		
	Unemployment Insurance Fund (UIF)	5	996	16		
	Bank				18 056	16
	Payment of monthly deductions					

Calculations

1 R2 661 + 2 661

2 R6050 + 650

3 R60 × 4

4 R297.44 + (50.16 × 4) + 498.08

This payment should also be made to SARS for the skills development levy (see Example 13.10 for the amounts):

GENERAL JOURNAL OF JABULALA PETROL STATION GJ12

Day	Details	Fol.	Debit		Credit	
31/12	Skills development levy		642	55		
	Skills development levy control				642	55
	Provision for SD levies payable					
	Skills development levy control		642	55		
	Bank				642	55
	Recording of skills levy paid					

You should be able to complete Question 13.8.

8 Annual returns

IRP5 reconciliation

It is expected that an employer submits an interim IRP5 reconciliation to SARS within 60 days of the end of August and a final reconciliation by the end of May. The tax year for individuals ends on the last day of February of each year.

The reconciliation reconciles the monthly payments made to the SARS with the total of the tax deducted as shown on each of the employee's IRP5 certificates.

Any variance must be explained.

Payment to Workers' Compensation Commissioner

The payment to the Commissioner is based on the total gross wage/salary, overtime included, and is done annually. The Commissioner determines the rate of assessment according to an estimated risk and cost of accidents. The payment is usually made after February each year.

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Example 13.13 Total salaries and wages for the year came to R235 690. The Commissioner advised Mr Jabulala that his rate is 0.46%.

You are required to:
Calculate the payment to the Workers' Compensation Commissioner and journalise the entry.

Payment = R235 690 × 0.46% = R1 084.17.

GENERAL JOURNAL OF JABULALA PETROL STATION **GJ12**

Day	Details	Fol.	Debit		Credit	
31/12	Workers' Compensation Commissioner		1 084	17		
	Bank				1 084	17
	Paying the Workers' Compensation Commissioner					

9 Summary

In this chapter, we discussed the payroll procedures. This starts by recording the time worked by employees, transferring it to a summary and calculating the gross remuneration.

We also looked at all the applicable deductions that are made from an employee's remuneration before the net remuneration can be paid out.

We then discussed the contributions made by the employer on behalf of the employee. In conclusion we looked at the journal entries recording remuneration and obligations to make monthly or annual payments to different institutions.

QUESTIONS

Question 13.1

Define the terms employer and employee.

Question 13.2

Discuss the difference between salaries and wages and give an example of each.

Question 13.3

With which institutions should an employer register?

Question 13.4

What employee information should an employer keep?

Question 13.5

You receive this information from a client for employees who work at an hourly rate:

	Normal hours	Overtime/ Saturday	Sunday	Normal rate
Mr Brown	45		5	R25
Ms Tsahabala	42		8	R18.50
Mr Goosen	43	4		R17.65
Mr Tembu	45	6		R22.90

Overtime is paid at one-and-a-half times the hourly rate, and on Sundays overtime is twice the normal rate. Saturday rates are the same as overtime rates.

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You are required to:
Calculate the gross remuneration of each employee for the week.

Question 13.6

Mr Hill opened a coffee shop and employs:

- A supervisor for a monthly salary of R16 795.
- A baker at R11 700 per month.
- Two waiters at R1 490 per week.
- Retirement fund contributions equal 7.5% per salary earner.
- Retirement fund contributions by the employer are 10%.

You are required to:

1 Calculate the taxable income of each employee.
2 Calculate the contribution of the employer.

Question 13.7

A. Butcher opened a butchery and employs five people on these terms:

	Salary	Pension fund
Mr Tando	R8 500 per month	7.5 % both employee & employer
Ms Cele	R3 000 per month	7.5 % both employee & employer
Ms Nkosi	R6 250 per month	7.5 % both employee & employer
Mr McGregor	R1 475 per week	None
Mr Noi	R1 475 per week	None

- UIF contributions are calculated at 1% per employer and employee.
- Union fees are R50 per month for all employees.
- Only Mr Tando belongs to the medical aid fund. Mr Tando is unmarried. His contribution is R550 per month. A. Butcher contributes the same amount.
- Tax payable before MTC:
  - Weekly wages R10
  - Mr Tando R424
  - Ms Nkosi R21

You are required to:
Calculate the net remuneration of all the employees.

Question 13.8

Use the information in Question 13.7 and record the:

1 Weekly wages for work done for four weeks, on same basis.
2 Monthly wages.
3 Employer's contribution.
4 Monthly payments.

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MODULE E Accounting policies for financial reporting

This module is divided into three chapters:

Chapter 14 Non-current assets
Chapter 15 Year-end adjustments
Chapter 16 Financial statements

Together these three chapters achieve the following outcomes:

Outcomes

- Determining the cost price of non-current assets and applying different depreciation methods.
- Calculating the profit/loss on the sale of non-current assets.
- Recording the transactions relating to non-current assets.
- Compiling a pre- and post-adjustment trial balance.
- Recording year-end adjustments.
- Drafting a statement of profit or loss & other comprehensive income and statement of financial position.
- Making use of a worksheet to prepare financial statements.

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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14 NON-CURRENT ASSETS

Chapter objectives

By the end this chapter, you should be able to:

- Introduce non-current assets and depreciation.
- Define the different types of assets.
- Explain the determination of the historical cost of assets.
- Identify factors that may have an effect on the useful life of assets.
- Apply different methods of depreciation calculations.
- Calculate the profit or loss on disposal of assets.
- Prepare the journal entries and general ledger entries for:
  - purchase of assets
  - depreciation of assets
  - disposal of assets
- Disclose a non-current asset in the financial statements.

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3 DETERMINING THE COST OF A NON-CURRENT TANGIBLE ASSET 14 – 4

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1 Introduction

According to the International Accounting Standards (IAS 16) property, plant and equipment (PPE) are considered to be assets. An asset is defined as a resource that is controlled by the business, as a result of a past event, from which future economic benefits will flow into the business.

Assets can be divided into non-current and current assets. The general difference between the two groups is that the current assets will be realised over a short-term period (less than 12 months), while non-current assets are normally realised after a period of more than 12 months.

For assets to be considered a current asset, at least one the following has to be present:

- It is expected to be realised in the normal course of the business's operating cycle.
- It is held for sale or consumption in the normal course of the business's operating cycle.
- It is held primarily for trading purposes or for the short-term, and is expected to be realised within 12 months of the year-end date.
- It is cash or a cash equivalent asset that is not restricted in its use.

Current assets include items such as inventory and accounts receivable. A non-current asset on the other hand is bought with an express purpose of holding it for a period longer than 12 months, so that it may be used to produce income.

Non-current assets will include machinery that is bought with the intention of producing a product to sell. The machine will remain in the business for an extended period, but will be used in a process of manufacture to produce items for sale. The sale of these items will result in income flowing into the business.

The difference between non-current and current assets can be explained in Example 14.1 by using vehicles.

Example 14.1

Business 1 This business bought a fleet of vehicles to be used to transport passengers from Cape Town International Airport to a destination within 50 km. The passengers will be required to pay a cost per kilometre for the journey that is calculated at R10.

Business 2 This business bought a fleet of vehicles. These vehicles were bought with the intention of resale at a mark-up on cost of 30%.

Explanation

- Business 1 will record the fleet of vehicles as non-current assets, as the vehicles will be used to generate income in the form of a service income. After providing the service, the business will continue to generate income in the future, as the vehicle will still be owned by the business.
- Business 2 on the other hand will record the vehicles as current assets. More specifically, the vehicles will be recorded as inventory, as these vehicles were bought with intention of being sold.

2 Assets

Consider the definition of an asset in Example 14.1 (Business 1):

- A resource.
- Controlled by the business.
- As a result of past events.
- From which future economic benefits are expected to flow to the business.

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The **resource controlled** in Example 14.1 (Business 1) will be referred to as vehicles that have been bought to transport passengers. The business has the right to use the asset to generate income.

The **past events** referred to in the definition above could be the purchase of the asset by the business, or the manufacture of the asset by the business.

The **future economic benefits** embodied in an asset refer to the asset's potential to contribute, directly or indirectly, to the flow of cash and cash equivalents. This cash flow will flow inward when passengers are transported and pay the necessary fee.

Note

Whether the asset is considered current or non-current, it will still be considered part of assets. The difference between the fleet of cars for Business 1 and 2 is that:

- Business 1 will classify this under non-current assets.
- Business 2 will classify the fleet as current assets.

This will result in a difference in the manner in which the future economic benefits are generated. The one will be through services rendered (Business 1), while the other will be through sales of inventory, that is, the vehicles (Business 2).

Recognising assets

A purchase will be recognised as an asset only if:

- It is probable that future economic benefits associated with the item will flow to the business.
- The cost of the item can be measured reliably.

Non-current assets

Non-current assets can be split between tangible and intangible assets.

- A **tangible asset** is an asset with physical substance. This includes machinery and vehicles.
- An **intangible asset** is an identifiable asset without physical substance. This includes goodwill, patents and trade marks.

In both cases, these assets produce income. An extensive explanation on the difference between intangible and tangible assets is beyond the scope of this chapter.

The focus in this chapter will be on tangible assets, assets that are identifiable and physical in nature.

Tangible assets

A tangible asset has physical substance. Tangible, non-current assets are held by the business and used for more than one year for various purposes, such as:

- Production of goods (for example, machinery and tools).
- Supply of goods (for example, delivery vehicles).
- Supply of services (for example, ultra sound scanners used in the medical profession).
- Rental to others (for example, land and buildings).
- Administration of the business (for example, computer equipment).

Land normally does not lose value and is shown at either historical cost or revaluation. No depreciation is written off against land.

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The value of buildings may, however, appreciate in the short-term but as buildings have a limited useful life, they are usually depreciable assets and depreciation needs to be written off over the long-term.

Vehicles, machinery and equipment are assets that have a limited useful life, that is, eventually the asset will no longer be of any economic use to the business. A vehicle, for example, may eventually become too expensive to maintain in a roadworthy condition.

The loss in value of an asset, such as buildings and vehicles, is referred to as **depreciation**. Assets that are subject to depreciation are referred to as **depreciable assets**.

Note
IAS 36 Impairment of assets aims to ensure that the assets of a business are not carried at more than their recoverable amount.

Intangible assets

An intangible asset is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Among non-current intangible assets are:

- **Goodwill** – comprises factors that are intangible, non-specific and unidentifiable in nature, such as a favourable location, a strong sales department and loyal customers. These factors all affect the valuation of purchased goodwill.
- **Research** – the original and planned investigation undertaken with the hope to gain new scientific or technical knowledge and understanding, for example, the formulation of a new or better product.
- **Development** – the translation of research findings or other knowledge into a plan or design for the production of new or substantially improved materials, devices and products prior to the start of commercial production. This includes the evaluation, pre-testing and design of prototypes.

Note
Intangible assets are amortised, while tangible assets are depreciated over their useful lives.

Current assets

Current assets are the assets used to carry out the daily business activities, for example:

- Trading investments.
- Accounts receivable.
- Inventory.
- Bank and cash.

This chapter concentrates on non-current tangible assets. However:

- Chapter 11 explains accounts payable and accounts receivable.
- Chapter 20 addresses the disclosure requirements of non-current and current assets and liabilities in the financial statements.
- Financial assets are defined as cash or the contractual agreement to receive cash, such as investments or fixed deposits.

3 Determining the cost of a non-current tangible asset

You will recall that inventory are bought for the purpose of resale. The cost of inventory includes all costs involved in bringing them to the point of sale. A similar principle is used for other assets bought.

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All costs incurred in making the assets ready for use may be considered as costs of the asset. The purchase of non-current assets is often referred to as the purchase of **capital** items, while the purchase of goods for resale is referred to as the purchase of **trading** items.

As a result, reference is often made to **capitalising** the expenses involved in preparing non-current tangible assets for use: these further costs are added to the cost price of the asset.

Other costs included in the initial cost:

- The initial cost of dismantling and removing an asset.
- If the business has an obligation to restore a site to the state prior to use, those costs will be included in the cost of the asset.

Example 14.2

Fresh Veg Company bought a delivery truck from XYZ Trucks on credit to deliver vegetables to its different branches.

- The truck cost R350 000 and interest for the whole year was R50 000.
- A cooling system that cost R4 000 was installed to keep the vegetables cool, and to ensure speedy delivery, a two-way radio, which cost R10 000 was installed.
- The company's name was written on the sides of the truck at a cost of R2 000 and to fill the truck with petrol cost R400.

You are required to:

Calculate the cost price of the truck.

Cost of truck	350 000	00
Installation of a cooling system	4 000	00
Installation of a two-way radio	10 000	00
Sign writing	2 000	00
COST PRICE OF TRUCK	366 000	00

GENERAL JOURNAL OF FRESH VEG COMPANY **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Vehicles	B5	366 000	00		
	Accounts payable	B10			366 000	00

Explanation

Interest and cost of petrol are recurring running expenses and are not capitalised as a cost of the asset. Interest and cost of petrol are expensed in the period in which they are incurred.

Example 14.3

J. Peterson bought these assets on 1 March 20*x*1:

Vehicle on credit from XYZ	18 000	00
Shelving for warehouse for cash	14 500	00

Additional costs paid by cheque:

Licence for the vehicle	158	00
Rust proofing for the vehicle	1 800	00
Radio for the vehicle	200	00
Installation of shelving	2 050	00
Structure for shelving	1 450	00

You are required to:

Enter the transactions into the individual general ledger accounts, excluding the bank account.

The license expense is an annual expense and is, therefore, not part of the cost of the vehicle. As a result it is not capitalised but treated as a normal business expense.

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Asset account		=	Owner's equity account		+	Liability account	
+	−		−	+		−	+
Dr. VEHICLES	Cr.		Dr. VEHICLE LICENCE	Cr.		Dr. ACCOUNTS PAYABLE	Cr.
Accounts payable 18 000			Bank 158				Vehicles 18 000
Bank 1 800							
Bank 200							
20 000							

FITTINGS AND FIXTURES	
Bank 14 500	
Bank 2 050	
Bank 1 450	
18 000	

Explanation

All the costs of preparing the asset for use (that is, all 'once-off costs') are capitalised.

- The cost of vehicles is R20 000 and that of the fittings and fixtures is R18 000.
- The license expense is treated as a normal expense that reduces owner's equity.
- In this example, the transactions have been entered directly in the general ledger.
- In a large business using subsidiary journals, or where only a general journal is used, an entry is first made in the appropriate journal before posting to the general ledger.

Value-added tax (VAT) applicable on the cost of non-current assets

In cases where a non-current asset is bought from a registered vendor, VAT will affect the cost price.

- If the business purchasing the non-current asset is registered for VAT, the VAT will be removed from the cost price. This is because the business will be able to claim back the difference between the value and the consideration paid for the asset.
- If the business purchasing the asset is not registered for VAT, the cost of the asset will be VAT inclusive. This means that the entire consideration amount will be shown as the cost of the asset, as the business will not be able to claim back the VAT.

Example 14.4 Fresh Veg company bought a new truck from XYZ Trucks (a registered VAT vendor) that cost R171 000 (VAT included). Assume that the truck was bought for cash.

You are required to:

1 Calculate the cost of the vehicle assuming that the business is a registered VAT vendor.

2 Prepare the general journal entry assuming:

a Fresh Veg Company is a registered VAT vendor.

b Fresh Veg Company is not a registered VAT vendor.

1 R171 000 × 100 ÷ 114 = R150 000

2 **a**

GENERAL JOURNAL OF FRESH VEG COMPANY **GJ3**

Day	Details	Fol.	Debit		Credit	
01/01	Vehicles	B5	150 000	00		
	VAT input	B12	21 000	00		
	Bank	B10			171 000	00

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b

GENERAL JOURNAL OF FRESH VEG COMPANY **GJ3**

Day	Details	Fol.	Debit		Credit	
01/01	Vehicles	B5	171 000	00		
	Bank	B10			171 000	00

Example 14.5 Dr Ntuli is a doctor who bought a house on a busy road for R200 000. She paid for these items:

Agent's commission	12 000	00
Transfer duty	15 000	00
Legal costs	5 000	00
Cost to demolish the old house	10 000	00
Scrap materials sold	3 500	00
Architect's fee for new consulting rooms	8 000	00
Construction cost of the rooms	300 000	00
Electrical installation	15 000	00
Plumbing installation	5 000	00

You are required to:

Calculate the cost of land and buildings.

Cost of land	200 000	00
Agent's commission	12000	00
Transfer duty	15 000	00
Legal costs to transfer the property	5 000	00
Demolition cost	10 000	00
Architect's fee	8 000	00
Construction cost	300 000	00
Electrical installation	15 000	00
Plumbing installation	5 000	00
	570 000	00
Less: Scrap materials sold	(3 500	00)
COST OF LAND AND BUILDINGS	566 500	00

Explanation

Dr Ntuli will use the house for business purposes. This means that:

- All expenses for renovating the house should be capitalised. This means the capital expenditure cannot be deducted from income and forms part of the cost of land and buildings.
- The scrap sold was income of a capital nature. The capital income must be deducted from the capital expenditure.

4 Determining the useful life of an asset

The **useful life** is the period over which a depreciable asset is expected to be used by the business. The length of time during which an entity will find an asset useful depends on numerous factors of which the following are most relevant:

- *The perceived status of owning modern assets*. Some businesses, for example, do not keep vehicles for more than three years as they prefer a modern, successful image. This may also stem from a belief that as vehicles become older, they cost more for maintenance, thus making it economically reasonable to replace every three years.

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- *The nature of the asset*. Clearly assets such as vehicles will not outlast assets such as buildings. It should be noted that land is separated from buildings, as land is considered to last 'forever' and is, therefore, not depreciated.
- *Technological change*. Some industries experience rapid technological development. In such industries machinery and equipment may continuously need replacement to cope with the competitive demands for speed or quality of production. This could result in an asset having a shorter useful life than its physical life.

Whatever the reason, it is apparent that each business needs to make some estimation of the length of time for which various classes of assets are likely to last before replacement. This is necessary for two main reasons:

- To plan the finances of the business in such a way that it will be in a position to purchase the replacement asset when necessary.
- To decide on the period over which the expense of controlling and using the asset will be charged against the profits of the business.

To establish the expense of having used the asset however, the selling price of the asset at the end of its useful life to the business must be estimated.

This selling price is obtained by using various concepts such as residual value, scrap value, disposal value, break-up value and resale value. Once this is known, the depreciable amount can be calculated as:

Depreciable amount = capitalised costs – residual value

- The **depreciable amount** is the amount on which depreciation is calculated.
- The **carrying value** of an asset is the cost of the asset less all depreciation written off to date (accumulated depreciation).
- The **residual value** of an asset is the value of an asset after it has been fully depreciated.

Example 14.6

J. Peterson (see Example 14.2) established the following:

	Vehicle	Fixtures
Cost	R20 000	R18 000
Expected useful life	3 years	10 years
Expected residual value after its useful life	R5 000	R1 000

You are required to:
Calculate the depreciable amounts of the vehicle and fixtures.

Vehicle = R20 000 – R5 000 = R15 000
Fixtures = R18 000 – R1 000 = R17 000

Explanation

- The vehicle will reduce in value to R5 000 over three years (20 000 – 5 000 – 5 000 – 5 000). Therefore, the expense of owning vehicles, apart from running expenses and maintenance, is R15 000. It is an expense incurred over the three-year period.
- The fixtures will decrease by R1 700 in value every year. The expense of owning the fixtures/shelving is R17 000 over its useful life (10 years).
- The residual value is R1 000.

Subsequent costs incurred on a non-current asset after purchase

Subsequent costs incurred on a non-current asset should be taken into account in the cost of the asset only when it is probable that future economic benefits associated with the asset

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will flow to the business. All other subsequent expenditure (such as maintenance costs) should be expensed against profits when they occur.

Measurement of a non-current asset after initial recognition

A business may decide on either the cost model or the revaluation model as its accounting policy. The policy selected shall be applied to the entire class of assets.

Cost model

After its initial recognition as an asset at cost, a non-current asset shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses, which is the carrying value of the asset.

Revaluation model

After its initial recognition as an asset, a non-current asset of which carrying value can be measured reliably is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

Revaluations are done with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

Note
The above description on the revaluation model is provided for completeness. However, a further discussion on this model is beyond the scope of this text book.

You should be able to complete Questions 14.1 and 14.2.

5 Methods of writing off a non-current asset over its useful life

Depreciation is a systematic allocation of the depreciable amount of an asset over its useful life. Each part of a non-current asset with a cost that is significant in relation to the cost of the item shall be depreciated separately.

- Depreciation of an asset starts when an asset is available for use (that is, when it is in the location and condition necessary for it to work in the manner intended by management).
- Depreciation of an asset stops at the earliest of the date that the asset is classified as being held for sale, and the date that the asset is de-recognised. However, depreciation does not stop when the asset becomes idle or is retired from active use, unless the asset is fully depreciated.

There are three common methods for allocating depreciation:

1. The **straight-line method** of depreciation results in the same amount of depreciation over the useful life of the asset, if the residual value of the asset does not change.
2. The **diminishing-balance method** results in the amount of depreciation decreasing annually.
3. The **units of production method** results in a variable amount of depreciation based on the number of units produced.

The business is responsible for selecting the most appropriate method of allocating depreciation. Regardless of the method selected by the business, it will have to be applied consistently from year to year, unless there is a change in the expected pattern of use or the carrying amount of the asset.

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The straight-line method

This is the most straightforward method, and simply requires the depreciable amount to be divided by its useful life. Thus:

Annual depreciation = (cost – residual value) ÷ useful life

While the formula shows an exact answer, it must be noted that both the residual value and the useful life are based on subjective estimations. With this method the amount of depreciation normally remains fixed from year to year, unless the useful life or residual value changes.

Example 14.7

Assume that J. Peterson decided that a straight-line depreciation policy is appropriate for fixtures. (See Example 14.5.)

You are required to:

1. Calculate the annual depreciation.
2. Enter the transactions for the years ending 20*x*2 and 20*x*3 in the general ledger.
3. Calculate the carrying value of fixtures in the statement of financial position for the years ending 20*x*2 and 20*x*3.

1 *Annual depreciation*:

Depreciable amount = (cost – residual value) ÷ useful life
= (18 000 – 1 000)
= R17 000

Annual depreciation = depreciable amount ÷ useful life
= R17 000 ÷ 10 years
= R1 700 p.a.

Explanation

- An amount of R1 700 will be expensed as depreciation each year.
  - At the end of 10 years, a total of R17 000 (R1 700 × 10) will have been written off against profits.
  - Together with the residual value of R1 000, a total of R18 000 will thus have been provided for to replace the asset.
- In an economic climate of inflation, it is apparent that R18 000 will not be the cost of replacing the asset. This is an accounting problem that is not easily resolved and forms part of more advanced study in accounting.
- Once 10 years has been established as the useful life, it is possible to express the policy as a percentage, that is, 100% ÷ 10 years = 10% per annum Had the useful life been 4 years, then the percentage would have been 100% ÷ 4 years = 25% per annum.
- The accounting policy for fixtures in the financial statements will read 'fixtures are depreciated on the straight-line method to estimated residual values over a period of 10 years'.
- In this example:
  - The date of purchase and date on which the business started using the asset was the first day of the financial year. Thus, a full year's depreciation is recorded.
  - If an asset comes into use at another time during the year, a proportional adjustment must be made so as to assign the depreciation for the period of service only.

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2

Dr.	Asset account	Cr.	=	Dr.	Owner's equity account	Cr.
+		−		−		+

FIXTURES B8

Date	Details	Amount	Date	Details	Amount
20*x*1 Mar. 1	Balance b/d	18 000			

ACCUMULATED DEPRECIATION: FIXTURES B9

Date	Details	Amount	Date	Details	Amount
			20*x*2 Feb. 28	Depreciation	1 700
			20*x*3 Feb. 28	Depreciation	1 700

DEPRECIATION N6

Date	Details	Amount	Date	Details	Amount
20*x*2 Feb. 28	Accumulated depreciation: Fixtures	1 700	20*x*2 Feb. 28	Profit and loss	1 700
20*x*3 Feb. 28	Accumulated depreciation: Fixtures	1 700	20*x*3 Feb. 28	Profit and loss	1 700

Explanation

- Once the cost price has been entered into the fixtures account, no further entries are made (until the asset is disposed of).
- The accumulated depreciation: fixtures account serves as the credit side of the asset account. Like the fixtures account, the accumulated depreciation: fixtures account is a real account.
- The accumulated depreciation: fixtures account (real account) must not be confused with the depreciation account in the nominal account section of the general ledger. The balance of the real account becomes greater each year as the asset ages.
- The two real accounts (fixtures (at cost) and accumulated depreciation: fixtures) are really part of one account, the asset 'fixtures'.
  – The two accounts should always be kept together for disclosure in the statement of financial position.
  – The difference between the balances on these two accounts is the carrying value of the asset.

3

J. Peterson
STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20*x*3

	Notes	20*x*3		20*x*2	
ASSETS					
Non-current assets		xxx xxx		xxx xxx	
Fixtures	4	14 600	00	16 300	00

Calculations

20*x*2: R(18 000 – 1 700) = R16 300

20*x*3: R(18 000 – 1 700 – 1 700) = R14 600

The diminishing-balance method

The diminishing-balance method applies a percentage to the carrying value of an asset at the end of each year.

The carrying value of an asset, is the difference between the original cost and the accumulated depreciation. This method does not use the depreciable amount (as used in

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the straight-line method) as the basis for the calculation, but is based on the carrying value.

The appropriate rate will be one that it reduces the carrying value to approximately the residual value over the useful life of the asset.

The appropriate rate is not possible to find with an exact easily workable formula, and is, thus, usually established by trial and error by using a rounded rate that is close to the exact rate for convenience.

Example 14.8 Find the appropriate rate for applying the diminishing-balance method to vehicles with a cost of R20 000, an expected residual value of R5 000 and an expected useful life of 3 years.

Carrying value:

Cost	Rate	After I year	After 2 years	After 3 years
R20 000	30%	R20 000 × 0.7 = R14 000	R14 000 × 0.7 = R9 800	R9 800 × 0.7 = R6 860

As this leaves a residual value after three years that is too high (R6 860), try:

R20 000	40%	R20 000 × 0.6 = R12 000	R12 000 × 0.6 = R7 200	R7 200 × 0.6 = R4 320

As this leaves a residual value that is too low (R4 320), try:

R20 000	37%	R20 000 × 0.63 = R12 600	R12 600 × 0.63 = R7 938	R7 983 × 0.63 = R5 000

The appropriate rate is therefore 37% per annum.

Explanation

- The solution used trial and error to arrive at a rate that is closest to the disposal value after three years. In practice, it is relatively easy to perform this calculation using MS Excel®. The necessary entries when applying this method are much the same as for the straight-line method, as is the disclosure in the statement of financial position.
- If the depreciation rate is 30% of cost, then the carrying value is 70% (or 0.7) of cost (l00% – 30%). Similarly, when the depreciation rate is 40%, the carrying value is 60%.

Example 14.9 Using the information from Example 14.7, enter the transactions in the ledger of J. Peterson for all three years. Then show how vehicles will be disclosed in the statement of financial position.

Dr. **Asset account** Cr. = Dr. **Owner's equity account** Cr.

Asset account: + (Dr.) / – (Cr.); Owner's equity account: – (Dr.) / + (Cr.)

VEHICLES B8

20*x*1 Mar. 1	Balance b/d	20 000			

ACC. DEPRECIATION: VEHICLES B9

			20*x*2 Feb. 28	Depreciation	7 400
			20*x*3 Feb. 28	Depreciation	4 662
			20*x*4 Feb. 28	Depreciation	2 938

DEPRECIATION N6

20*x*2 Feb. 28	Accumulated depreciation: Vehicles	7 400	20*x*2 Feb. 28	Profit and loss	7 400
20*x*3 Feb. 28	Accumulated depreciation: Vehicles	4 662	20*x*3 Feb. 28	Profit and loss	4 662
20*x*4 Feb. 28	Accumulated depreciation: Vehicles	2 938	20*x*4 Feb. 28	Profit and loss	2 938

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Calculations for depreciation

Year 1	R20 000 × 37% =	R7 400
Year 2	R(20 000 – 7 400) × 37% =	R4 662
Year 3	R(R20 000 – 7 400 – 4 662) × 37% =	R2 938

J. Peterson
STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20*x*3

	Notes	20*x*4		20*x*3		20*x*2	
ASSETS							
Non-current assets		xxx xxx		xxx xxx		xxx xxx	
Vehicles	4	5 000	00	7 938	00	12 600	00

Calculations

20*x*2: R(20 000 – 7 400) = R12 600 (or R20 000 × (100 – 37)% = R20 000 × 63%)
20*x*3: R(20 000 – 7 400 – 4 662) = R7 938 (or R12 600 × (100 – 37)% = R12 600 × 63%)
20*x*4: R(20 000 – 7 400 – 4 662 – 2 938) = R5 000 (or R7 938 × (100 – 37)% = R7 938 × 63%)

Explanation

- In year three, the depreciation amount of R2 937.06 is rounded up to R2 938 to leave a residual value of R5 000.
- After three years, the vehicle has a carrying value of R5 000 (20 000 – 15 000), which is the estimated residual value.
- At the end of year three, the vehicle is likely to be sold. It is apparent, however, that in certain cases it may be sold earlier or later than the estimated date at the time of purchase.

The units of production or usage method

In some cases, the service potential of an asset may be affected by the extent to which it is used. For example, machinery may be expected to have a useful life measured in production hours rather than the passage of time.

The appropriate depreciation policy for machinery may then be based on production hours.

Example 14.10

Machinery with a cost of R10 000 and a residual value of R2 000 is expected to have a useful life of 25 000 production hours.

If it was in use for 3 600 hours during its first year of service, calculate the depreciation expense for the year.

Depreciable amount = (cost – residual value)
= R(10 000 – 2 000)
= R8 000

Annual depreciation = depreciable amount ÷ useful life
= R8 000 × (3 600 hours ÷ 25 000 hours)
= R1 152 p.a.

You should be able to complete Questions 14.3 to 14.6.

6 Additions to non-current assets

In the previous examples, the calculation and recording of depreciation were shown where the asset is bought on the first day of the financial year.

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We will now explore the accounting entries where assets are bought throughout the financial year.

Example 14.11

Thabo's Trading Store had these purchase transactions for non-current assets during its financial year ending 30 April 20*x*4:

Date	Asset bought	Cost	Estimated residual value
1 May 20*x*3	Delivery van	R80 000	R8 000
1 August 20*x*3	Office furniture	R22 000	R1 000
31 August 20*x*3	Computer equipment	R36 000	R0
1 January 20*x*4	Shrink wrapping machine	R73 000	R3 000

The accounting policy for depreciation of Thabo's Trading Store is:

- Vehicles 20% diminishing-balance
- Furniture and fittings 10% straight-line
- Computer equipment 33.33% straight-line
- Manufacturing equipment Usage method (Total estimated production hours = 35 000)

During the first four months, the machine was productive for a total of 9 000 hours, and during the financial year ended 30 April 20*x*5, it was productive for 13 000 hours.

You are required to:

1. Calculate the depreciation for the two financial years ending 30 April 20*x*4 and 30 April 20*x*5.
2. Show the journal entries for depreciation for the two financial years ending 30 April 20*x*4 and 30 April 20*x*5.

1 *Calculation of depreciable amounts*

Asset	Cost	Residual value	Depreciable amount
Delivery van	R80 000	R8 000	R72 000
Office furniture	R22 000	R1 000	R21 000
Computer equipment	R36 000	R0	R36 000
Shrink wrapping machine	R73 000	R3 000	R70 000

Calculation of depreciation

Delivery van – 20% diminishing-balance

Depreciable amount	Months depreciated	Calculation	Depreciation 20*x*4	Depreciation 20*x*5
R80 000	12	80 000 × 20% × 12 ÷ 12	R16 000	
	12	(80 000 – 16 000) × 20% × 12 ÷ 12		R12 800

Office furniture – 10% straight-line

Depreciable amount	Months depreciated	Calculation	Depreciation 20*x*4	Depreciation 20*x*5
R21 000	9	21 000 × 10% × 9 ÷ 12	R1 575	
	12	21 000 × 10% × 12 ÷ 12		R2 100

Computer equipment – 33,33% straight-line

Depreciable amount	Months depreciated	Calculation	Depreciation 20*x*4	Depreciation 20*x*5
R36 000	8	36 000 × 33.33% × 8 ÷ 12	R8 000	
	12	36 000 × 33.33% × 12 ÷ 12		R12 000

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Shrink wrapping machine – Usage method

Depreciable amount	Hours depreciated	Calculation	Depreciation 20x4	Depreciation 20x5
R70 000	9 000	70 000 × 9 000 ÷ 35 000	R18 000	
	13 000	70 000 × 13 000 ÷ 35 000		R26 000

2 Journal entry: 20x4

GENERAL JOURNAL OF THABO'S TRADING STORE **GJ12**

Day	Details	Fol.	Debit		Credit	
28/02	Depreciation	N12	43 575	00		
	Accumulated depreciation: Vehicles	B6			16 000	00
	Accumulated depreciation: Furniture	B8			1 575	00
	Accumulated depreciation: Computer equipment	B10			8 000	00
	Accumulated depreciation: Manufacturing equipment	B12			18 000	00

Journal entry: 20x5

GENERAL JOURNAL OF THABO'S TRADING STORE **GJ12**

Day	Details	Fol.	Debit		Credit	
28/02	Depreciation	N12	52 900	00		
	Accumulated depreciation: Vehicles	B6			12 800	00
	Accumulated depreciation: Furniture	B8			2 100	00
	Accumulated depreciation: Computer equipment	B10			12 000	00
	Accumulated depreciation: Manufacturing equipment	B12			26 000	00

Explanation

- The delivery van and computer equipment, although bought during the month, are depreciated from the date that it is available for use (we have assumed that the assets are available for use on the date it is bought).
  - The vehicle is depreciated for nine months (from 1 August 20x3 to 30 April 20x4) for the 20x4 year-end.
  - The computer equipment is depreciated for eight months (from 1 September 20x3 to 30 April 20x4).
- In practice, a business would record details of its non-current tangible assets in an asset register.
  - Details would include, among others, a description of the asset including any identifying numbers, the date and cost of purchase, depreciation rate, and the location of the asset.
  - In most businesses, non-current assets are bar-coded for identification purposes.

You should be able to complete Question 14.7.

7 De-recognition of assets

The carrying amount of a non-current asset shall be de-recognised:

1 On disposal.

2 When no future economic benefits are expected from its use or disposal.

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The **gain** or the **loss** at this date will be recognised in profit or loss when a non-current asset is de-recognised.

The gain or loss arising from the de-recognition of a non-current asset shall be determined as the difference between the net disposal proceeds and the carrying amount of the item.

While the useful life of an asset is estimated on purchase, there are numerous reasons for disposing of an asset at any time both before or after its expected useful life. The asset could be sold, traded in against a new asset, or written off as a result of extensive damage.

The necessary accounting entries on disposal are complicated, so Example 14.12 and the explanation should be studied carefully.

A simple way of recording asset disposal can be done using these rules:

Step 1 Open an asset disposal account and transfer the cost of the asset sold to the account.

Step 2 Calculate (and account for) the depreciation of the asset to the date of sale.

Step 3 Transfer the accumulated depreciation of the asset sold, including the depreciation accounted for in Step 2, to the asset disposal account.

Step 4 Account for the consideration received (cash or trade in value).

Step 5 Calculate the profit (*or loss*) using the asset disposal account.

Example 14.12

These balances appeared in the trial balance of Axe-it Construction as at 30 June 20*x*4:

Equipment (at cost)	60 000	00
Accumulated depreciation: Equipment	24 600	00

- It is established that Axe-it Construction applies a straight-line depreciation policy of 20% on equipment.
- No equipment is expected to have a residual value if it is retained for the full 5 years.
- An item of equipment that cost R15 000 was bought on 1 October 20*x*2, and sold for R8 000 cash on 1 January 20*x*5.

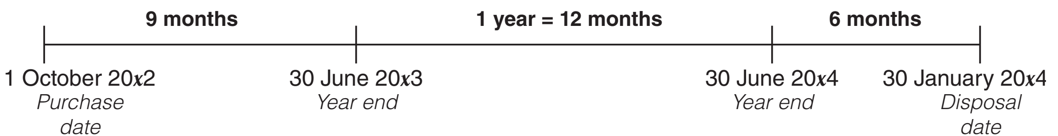
You are required to:

1 Calculate the profit or loss on disposal of the asset.

2 Prepare the ledger accounts as they would appear on 1 January, after the entries for disposal have been completed.

The solution provides the numerical calculations first and then the accounting entries.

This diagram shows the time scale for the equipment disposed of:



As depreciation is entered at the end of each financial year, these amounts have already been written off:

Year end	Calculation	Amount	
30 June 20*x*3	R15 000 × 20% × 9 ÷ 12	2 250	00
30 June 20*x*4	R15 000 × 20% × 12 ÷ 12	3 000	00

The total amount written off by 30 June 20*x*4 is thus R5 250. This amount was credited to the accumulated depreciation: equipment account and is included in the R24 600, which is the accumulated depreciation written off on all pieces of equipment as at 30 June 20*x*4.

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- The equipment has, however, been in use for a further six months for which no entries have been passed. The depreciation for the 6-month period is calculated as:
  R15 000 × 20% × 6 ÷ 12 = R1 500.
- The carrying value on 1 January 20*x*5 is, therefore:
  R15 000 – R(2 250 + 3 000 + 1 500) = R8 250.
- The equipment was sold at a loss of R250 (R(8 000 – 8 250) = proceeds less carrying value).

Dr. Asset account Cr. (+ / –) = **Dr. Owner's equity account Cr.** (– / +)

EQUIPMENT B6

Date	Details	Amount	Date	Details	Amount
20*x*5 Jan. 1	Balance b/d	60 000	20*x*5 Jan. 1	Asset disp.	15 000
				Balance b/d	45 000
		60 000			60 000
Feb. 1	Balance b/d	45 000			

ACCUMULATED DEPRECIATION: EQUIPMENT B7

Date	Details	Amount	Date	Details	Amount
20*x*5 Jan. 1	Asset disposal	6 750	20*x*5 Jan. 1	Balance b/d	24 600
Jan. 31	Balance b/d	19 350	Jan. 1	Depreciation	1 500
		26 100			26 100
			Feb. 1	Balance b/d	19 350

BANK B10

Date	Details	Amount	Date	Details	Amount
20*x*5 Jan. 1	Asset disposal	8 000			

DEPRECIATION N6

Date	Details	Amount	Date	Details	Amount
20*x*5 Jan. 1	Accumulated depreciation: Equipment	1 500	20*x*5 Jan. 31	Profit and loss	1 500

ASSET DISPOSAL N15

Date	Details	Amount	Date	Details	Amount
20*x*5 Jan. 1	Equipment	15 000	20*x*5 Jan. 1	Accumulated depreciation: Equipment	6 750
				Bank	8 000
				Loss on sale of asset	250
		15 000			15 000

LOSS ON SALE OF ASSET N16

Date	Details	Amount	Date	Details	Amount
20*x*5 Jan. 1	Asset disposal	250	20*x*5 Jan. 31	Profit and loss	250

Explanation

- The depreciation account was opened to bring this expense up to date on the date of sale. The double-entry had the effect of updating the accumulated depreciation account to 1 January 20*x*5, the date the asset was sold.
- As the equipment has been sold, the full cost price of R15 000 is taken out of the equipment (at cost) account and the total accumulated depreciation R6 750 (R2 250 + R3 000 + R1 500) is taken out of the accumulated depreciation: equipment account.
  - Both amounts are transferred to an account called asset disposal.
  - At this stage, the asset disposal account will show the carrying value of the equipment sold on the date of sale (R15 000 – R6 750 = R8 250).
- The cash received is then entered. The balance on asset disposal account will constitute either a profit or a loss that will be transferred to a profit (or loss) on asset disposal account.

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- If the accounts were balanced, they would show:

Equipment (at cost) (The cost of the equipment still in use.)	45 000	00
Accumulated depreciation: Equipment (The accumulated depreciation on the equipment still in use.)	19 350	00
Depreciation (The expense for six months' use of the item now sold.)	1 500	00
Loss on sale of asset (The loss on sale of the equipment.)	250	00

You should be able to complete Questions 14.8 to 14.11.

Cases where VAT affects the sale (by a VAT vendor) of a non-current asset

When a business is a VAT vendor and the non-current asset bought included a VAT amount, the business would have removed the VAT from the consideration to obtain the cost (see Example 14.4).

The amount after VAT would be used to calculate the depreciation as the value (amount less VAT) would have been considered the cost. Since the business was allowed to claim the VAT when the non-current asset was bought, the business would have to account for the output VAT when the sale of a non-current asset occurs.

Example 14.13 will provide an idea of how the journal entry would look.

Example 14.13

XYZ Ltd disposed of a machine for a cash amount of R57 000 (VAT included). If we assume this information for the machine:

Machinery (at cost excluding VAT)	100 000	00
Accumulated depreciation: Machinery (to date of sale)	55 000	00

Using the information, the journal entry would appear as:

GENERAL JOURNAL OF XYZ LTD **GJ3**

Day	Details	Fol.	Debit		Credit	
31/03	Accumulated depreciation: Machinery		55 000	00		
	Bank		57 000	00		
	Machinery				100 000	00
	VAT output (57 000 × 14 ÷ 114)				7 000	00
	Profit on sale of asset				5 000	00

Explanation

- As the business selling the machine is a VAT vendor:
  – They would have claimed the VAT input when buying the machine.
  – When they sell the asset, they would have to account for the VAT output.
  – However, the VAT output will be based on the consideration related to the selling price (R57 000).
- Students often get confused with the VAT output figure and base this on the original VAT input figure, when they should base the VAT output figure on the consideration received when the sale occurs.

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8 Disclosure in the financial statements

This is the minimum information to be disclosed in the financial statements:

- The valuation bases (cost or revaluation) used for determining the amounts at which depreciable assets are stated must be included with the disclosure of other accounting policies.
- This information should be disclosed for each major class of depreciable asset:
  - The depreciation methods used.
  - Total depreciation charged in arriving at income for the period.
  - Total depreciation provided for the period.
  - The gross amount of depreciable assets and the related accumulated depreciation.
  - The useful lives or the depreciation rates used.
- A reconciliation of the carrying amount at the beginning and end of the period showing:
  - Additions.
  - Disposals.
  - Depreciation.

The disclosure requirements for non-current tangible assets are shown in Figure 14.1.

Figure 14.1

Name of Company
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20x1

1 *Accounting policies*

These financial statements are prepared on the historical cost basis. The accounting policies adopted are consistent with those of the previous year.

Non-current assets

Land is not depreciated. Buildings are stated at cost. Tangible assets are depreciated at rates appropriate to write them off over their expected useful lives:

- Buildings — 2% straight-line method.
- Vehicles — 20% straight-line method.
- Furniture and fittings — 15% diminishing-balance method.
- Computer equipment — 30% diminishing-balance method.

4 ***Non-current assets***	Equipment		Vehicles		Furniture and fittings		Total	
Carrying value 1 July 20x0	1 747	00	29 200	00	11 990	00	42 937	00
Cost	5 205	00	43 400	00	14 988	00	63 593	00
Accumulated depreciation	(3 458	00)	(14 200	00)	(2 998	00)	(20 656	00)
Movements	2 946	00	(8 700	00)	271	00	(5 483	00)
Additions at cost	4 272	00	0	00	3 566	00	7 838	00
Disposals at carrying value	0	00	0	00	0	00	0	00
Depreciation	(1 326	00)	(8 700	00)	(3 295	00)	(13 321	00)
Carrying value 30 June 20x1	4 693	00	20 500	00	12 261	00	37 454	00
Cost	9 477	00	43 400	00	18 554	00	71 431	00
Accumulated depreciation	(4 784	00)	(22 900	00)	(6 293	00)	(33 977	00)

A register containing the additional information required by the Companies Act is available for inspection at the registered office of the company.

You should be able to complete Questions 14.12 to 14.20.

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9 Chapter illustrative example

Here is an extract from the trial balance of Make-it Ltd as at 31 March 20*x*4:

Details	Fol.	Debit		Credit	
Land and buildings at cost (land at cost R300 000)	B3	1 580 000	00		
Accumulated depreciation (2% straight-line on buildings)	B4			71 680	00
Manufacturing equipment at cost	B5	780 000	00		
Accumulated depreciation (20% diminishing-balance)	B6			348 000	00
Vehicles at cost	B7	519 000	00		
Accumulated depreciation (25% diminishing-balance)	B8			324 000	00
Furniture and fixtures at cost	B9	339 000	00		
Accumulated depreciation (15% straight-line)	B10			201 000	00

1 Ignore VAT.

2 On 1 July 20*x*4, equipment (with an original cost of R84 000 on 1 November 20*x*1) was traded in for R50 000 against new equipment that cost R90 000. The balance due was paid by electronic transfer.

3 On 5 February 20*x*5, a vehicle was involved in an accident.
- The insurance company, Be-Sure, informed Make-it Ltd that the vehicle could not be repaired and that it would pay out an amount of R20 000 in full and final settlement of the claim submitted by the company.
- On 31 March 20*x*5, the amount owing by Be-Sure was still outstanding.
- The original cost of the vehicle on 1 July 20*x*2 was R60 000.

4 On 1 March, a new vehicle (to replace the one that was scrapped on 5 February) was bought for R140 000. The full amount was paid by cheque on that day.

You are required to:

1 Prepare the general journal of Make-it Ltd for the year ended 31 March 20*x*5.

2 Prepare an extract from the profit and loss account for the year ended 31 March 20*x*5

3 Show how the assets will be shown in the statement of financial position as at 31 March 20*x*5. Disclosure notes are required.

1

GENERAL JOURNAL OF MAKE-IT LTD **GJ12**

Day	Details	Fol.	Debit		Credit	
1/07	Equipment	B7	90 000	00		
	Accounts payable	B9			90 000	00
	Purchase of new equipment recorded					
	Accounts payable	B9	90 000	00		
	Asset disposal	N15			50 000	00
	Bank	B10			40 000	00
	Recording of trade-in and settlement					
	Asset disposal	N15	84 000	00		
	Equipment	B7			84 000	00
	Transferring of cost of equipment traded in					

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	Depreciation	N14	2 464	00		
	Accumulated depreciation: Equipment	B8			2 464	00
	Recording deprecation of trade-in for current year until date of trade-in (3 months)					
	Accumulated depreciation: Equipment	B8	37 184	00		
	Asset disposal	N15			37 184	00
	Transferring accumulated depreciation on equipment traded in					
	Asset disposal	N15	3 184	00		
	Profit on sale of asset	N16			3 184	00
	Transfer of profit realised on trading in of equipment					
05/02	Asset disposal	N15	60 000	00		
	Vehicles	B5			60 000	00
	Transferring cost of scrapped vehicle					
	Depreciation	N14	7 167	00		
	Accumulated depreciation: Vehicles	B6			7 167	00
	Recording deprecation of scrapped vehicle for current year until date of scrapping					
	Accumulated depreciation: Vehicles	B6	31 055	00		
	Asset disposal	N15			31 055	00
	Transferring accumulated depreciation on scrapped vehicle					
	Accounts receivable	B10	20 000	00		
	Asset disposal	N15			20 000	00
	Recording amount due from insurance company					
	Loss on sale of asset	N17	8 945	00		
	Asset disposal	N15			8 945	00
	Transfer loss realised on scrapping of vehicle					
01/03	Vehicles	B5	140 000	00		
	Bank	B10			140 000	00
	Recording purchase of new vehicle					
31/03	Depreciation	N14	201 341	00		
	Accumulated depreciation: Buildings	B3			17 920	00
	Accumulated depreciation: Equipment	B8			90 044	00
	Accumulated depreciation: Vehicles	B6			42 527	00
	Accumulated depreciation: Furniture and fixtures	B4			50 850	00
	Recording annual depreciation charge					

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Calculations

A *Profit or loss on trade-in of equipment at 20% depreciation diminishing-balance*

Details		Cost	Depreciation	Acc. dep.	Carrying value
1 Nov. 20x1	Cost	R84 000			
1 Nov. 20x1 – 31 Mar. 20x2	Depreciation		R7 000	R7 000	R77 000
	(84 000 × 20% × 5 ÷ 12)				
1 Apr. 20x2 – 31 Mar. 20x3	Depreciation		R15 400	R22 400	R61 600
	(77 000 × 20%)				
1 Apr. 20x3 – 31 Mar. 20x4	Depreciation		R12 320	R34 720	R49 280
	(61 600 × 20%)				
1 Apr. 20x4 – 1 Jul 20x4	Depreciation		R2 464	R37 184	R46 816
	(49 280 × 20% × 3 ÷ 12)				

Carrying value	46 816	00
Trade-in value	50 000	00
PROFIT REALISED	3 184	00

B *Profit or loss on scrapping of vehicle at 25% depreciation diminishing-balance*

Details		Cost	Depreciation	Acc. dep.	Carrying value
1 Jul. 20x…		R60 000			
1 Jul. 20x2 – 31 Mar. 20x3	Depreciation		R11 250	R11 250	R48 750
	(60 000 × 25% × 9 ÷ 12)				
1 Apr. 20x3 – 31 Mar. 20x4	Depreciation		R12 188	R23 438	R36 562
	(48 750 × 25%)				
1 Apr. 20x4 – 5 Feb. 20x5	Depreciation		R7 617	R31 055	R28 945
	(36 562 × 25% × 10 ÷ 12)				

Carrying value	28 945	00
Scrapping value	20 000	00
LOSS REALISED	(8 945	00)

C *Depreciation charge for the year (excluding assets disposed of during the year)*

Buildings at 2% straight-line (land at R300 000 is not depreciated.)

Purchased and brought into use on 1 April 20x0.

Therefore, accumulated depreciation on 31 March 20x4 (as shown in the trial balance) is for the full four years.

Annual depreciation charge is, therefore, R71 680 ÷ 4 = R17 920.

Equipment at 20% diminishing-balance

	Cost		Acc. dep.		CV	
Balance – 31 Mar. 20x4	780 000	00	(348 000	00)	432 000	00
Adjustment for trade-in (31 Mar. 20x4)	(84 000	00)	34 720	00	(49 280	00)
	696 000	00	(313 280	00)	382 720	00

Depreciation on remaining equipment for the year (R382 720 × 20%) as at 31 Mar. 20x5	76 544	00
Depreciation new equipment (90 000 × 20% × 9 ÷ 12)	13 500	00
	90 044	00

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Vehicles at 25% diminishing-balance

	Cost		Acc. dep.		CV	
Balance – 31 Mar. 20x4	519 000	00	(324 000	00)	195 000	00
Adjustment for scrapping (31 Mar. 20x4)	(60 000	00)	23 438	00	(36 562	00)
	459 000	00	(300 562	00)	158 438	00

Depreciation for the year (R158 438 × 25%) – 31 Mar. 20x5	39 610	00
Depreciation new vehicle (140 000 × 25% × 1 ÷ 12)	2 917	00
	42 527	00

Furniture and fixtures at 15% straight-line

R339 000 × 15% = R50 850

2 *Extract from the profit and loss account in the general ledger*

General Ledger of Make-it Ltd
Final Accounts Section
PROFIT AND LOSS ACCOUNT F2

Dr.											Cr.
Mar.	31	Loss on sale of asset (vehicle)	GJ11	8 945	00	Mar.	31	Profit on sale of asset (equipment)	GJ4	3 184	00
		Depreciation (2 464 + 7 617 + 201 341)	GJ12	211 422	00						

3 *Statement of financial position*

Make-it Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20x5

	Notes	20x5		20x4	
ASSETS					
Non-current assets		xxx xxx		xxx xxx	
Property, plant and equipment	4	2 216 137	00	2 273 320	00

Name of Company
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20x1

1 ***Accounting policies***

These financial statements are prepared on the historical cost basis, modified by the revaluation of certain land and buildings, in accordance with these principal accounting policies. The accounting policies adopted are consistent with those of the previous year.

Property, plant and equipment

Property, plant and equipment, except for land that is not depreciated, are depreciated on the straight-line method to estimated residual values at these rates:

- Buildings — 2% straight-line method
- Equipment — 20% diminishing-balance method
- Vehicles — 25% diminishing-balance method
- Furniture and fittings method — 15% straight-line method

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4 ***Non-current assets***	Land and buildings		Equipment		Vehicles		Furniture and fittings		Total	
Carrying value 1 July 20x0	1 508 320	00	432 000	00	195 000	00	138 000	00	2 273 320	00
Cost	1 580 000	00	780 000	00	519 000	00	339 000	00	3 218 000	00
Accumulated depreciation	(71 680	00)	(348 000	00)	(324 000	00)	(201 000	00)	(944 680	00)
Movements	(17 920	00)	(49 324	00)	60 911	00	(50 850	00)	(57 183	00)
Additions at cost	0	00	90 000	00	140 000	00	0	00	230 000	00
Disposals at carrying value	0	00	(46 816	00)	(28 945	00)	0	00	(75 761	00)
Depreciation	(17 920	00)	(92 508	00)	(50 144	00)	(50 850	00)	(211 422	00)
Carrying value 30 June 20x1	1 490 400	00	382 676	00	255 911	00	87 150	00	2 216 137	00
Cost	1 580 000	00	786 000	00	599 000	00	339 000	00	3 304 000	00
Accumulated depreciation	(89 600	00)	(403 324	00)	(343 089	00)	(251 850	00)	(1 087 863	00)

A register containing the additional information required by the Companies Act is available for inspection at the registered office of the company.

10 Summary

In this chapter, the principles to be used when establishing the cost of a non-current asset were discussed, referring in particular to the capitalisation of the costs involved in acquiring an asset and costs incurred to get it ready for use.

The necessity of assigning the cost of using an asset (depreciation) over a period to an expense account was emphasised, explaining the need for establishing the expected useful life and expected residual value of an asset. This is a book entry that is not based on a source document but on management's estimate in applying the matching concept.

A number of alternative methods of assigning depreciation expense were explored. The entries that are required were shown using ledger accounts, although it must be remembered that entries would first be passed through the relevant journals. Finally, the particular computational and recording issues on disposal of an asset were outlined.

QUESTIONS

Question 14.1

Define these terms in the context of non-current tangible assets and depreciation:

- Capitalised costs.
- Residual value.
- Useful life.
- Depreciable amount.

Question 14.2

JP Spares bought a delivery vehicle on 1 June 20x6 and paid these expenses:

Cost price	116 000	00
Sign writing	1 450	00
Tinting of windscreen and windows	2 430	00
Seat covers	840	00
Licensing fee	160	00
Number plates	120	00

You are required to:
Calculate the cost of the vehicle.

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Question 14.3

Explain fully the difference between the depreciation account and the accumulated depreciation account. Indicate how they arise and when they are written off.

Question 14.4

Define and explain these depreciation methods:

- Straight-line method.
- Diminishing-balance method.
- Units of production or usage method.

Question 14.5

On 1 January 20*x*6, Pigments Manufacturers bought a vehicle for R40 000. The vehicle is expected to have a useful life of four years and a residual value of approximately R8 000.

You are required to:
Calculate the depreciation charge for each of the four years assuming:

1. The straight-line method is used.
2. The diminishing-balance at a rate of 33.33% per annum is used.

Question 14.6

Use the information from Question 14.2 to answer this question.

Assume that management estimates that the useful life of the vehicle is five years and that maintenance cost would increase as the vehicle ages. They are also of the opinion that the vehicle could be sold for R10 000 at the end of its useful life.

You are required to:

1. Determine a suitable basis for depreciation.
2. Determine the depreciable amount.
3. Prepare a schedule for the depreciation of the vehicle over its estimated life.

Question 14.7

On 1 January 20*x*4, Fedoc Distributors had these accounts (among others) in their books:

Land and buildings	390 000	00
Vehicles	120 000	00
Equipment	460 000	00
Accumulated depreciation: Buildings	21 000	00
Accumulated depreciation: Vehicles	47 000	00
Accumulated depreciation: Equipment	143 500	00

Their accounting policies for depreciation are:

- Land is not depreciated (cost R190 000).
- Buildings — 2% straight-line
- Vehicles — 20% per annum straight-line (residual value R40 000)
- Equipment — 10% per annum diminishing-balance

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During the year, these transactions relating to non-current assets took place:

1 Jan. Bought a new vehicle for R30 000 cash. The vehicle had a residual value of R10 000.

1 Jun. Bought equipment on credit from Quip Ltd for R18 000.

You are required to:

1 Prepare the journal entries to record the purchase of the new assets.

2 Prepare the journal entries to record depreciation at the end of the 20*x*4 financial year.

3 Prepare the journal entries to record the closing transfers at the end of the 20*x*4 financial year.

Question 14.8

Rustenburg Ruiters bought a new machine on 1 January 20*x*1 for R22 500. The business estimates the machine to have a useful life of six years, and a residual value at the end of six years of R1 500. (Ignore VAT.)

You are required to:

1 Prepare a depreciation schedule to show:

- **a** The net book value of the machine at the beginning of the year.
- **b** The annual depreciation expense, for each year of the estimated six-year life under these alternative depreciation methods:
  - **i** Straight-line.
  - **ii** Diminishing-balance (at 33.33% per annum).

2 Assuming that the business earned income of R80 000 and incurred expenses (excluding depreciation expense) of R60 000 for each of the six years to 31 December 20*x*6, determine the net profit the company would report in its statement of profit or loss & other comprehensive income for the first (20*x*1) and the sixth (20*x*6) year, under each of the two alternative depreciation methods.

Assume that the machine was sold for R1 500 at the end of the sixth year.

Question 14.9

This information is from the books of AB Transport Company as at 31 December 20*x*7:

Vehicle	Cost price	Date of purchase
A	R50 000	1 July 20*x*6
B	R70 000	1 September 20*x*7

On 1 July 20*x*8, Vehicle A was traded in for R20 000 to buy Vehicle C at a cost of R75 000. The company provides for depreciation at 20% per annum on the diminishing-balance method.

You are required to:

Complete these accounts for the financial year ended 31 December 20*x*8:

1 Vehicles.

2 Accumulated depreciation: vehicles.

3 Asset disposal.

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Question 14.10

AB Transport Services Ltd had this abridged statement of financial position on 30 June 20*x*4:

ASSETS			**EQUITY & LIABILITIES**		
Vehicles	160 000	00	Share capital	200 000	00
Less: Accumulated depreciation	(60 000	00)	Retained earnings	60 000	00
	100 000	00	Other liabilities	40 000	00
Other assets	200 000	00			
	300 000	00		300 000	00

AB Transport Services depreciates vehicles at 25% p.a. on the diminishing-balance method.

These transactions occurred after 30 *June* 20*x*4:

20x4 – 1 July

- Bought a new truck from A1 Motors for R40 000.
- A truck bought for R30 000 on 30 June 20*x*1 was traded in for R13 000 and the balance was paid by cheque.

20x5 – 31 August

- Bought a new truck from A1 Motors for R50 000.
- A truck, bought for R28 000 on 1 April 20*x*2, was traded in for R12 000 and the balance was paid by cheque.

You are required to:
Prepare these accounts for the period from 30 June 20*x*4 to 30 June 20*x*6:

- Vehicles.
- Accumulated depreciation: vehicles.
- Asset disposal.

Question 14.11

1 On 1 July 20*x*5, Manuel da Costa, the owner of Costa Plenti Manufacturers, bought a new machine for R25 000. He estimated that the machine would have a useful life of 10 years, after which it would have a scrap value equal to 20% of cost.
2 On 1 April 20*x*6, he bought a second machine for R36 000 and estimated its useful life at 10 years with no scrap value.
3 On 31 March 20*x*7, he sold the machine bought in 20*x*5 for R22 000 cash. Assume a year end of 30 June and use the straight-line method for calculating depreciation.

You are required to:
Prepare these properly closed off accounts:

1 Machinery at cost.
2 Asset disposal.
3 Accumulated depreciation.
4 Depreciation.

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Question 14.12

Despatch Brick Company (Pty) Ltd owns a fleet of delivery vehicles. For the year ended 30 September 20*x*4, this information relates to the vehicles:

Vehicles at cost on 1 October 20*x*3	164 000	00
Accumulated depreciation on 1 October 20*x*3	64 000	00
Purchase of vehicles	**Purchase price**	
CCN 19764 on 1 December 20*x*3	24 000	00
CCN 10405 on 31 March 20*x*4	18 000	00
Sales of vehicles	**Proceeds**	
CCN 994 on 31 December 20*x*3 (Original cost R18 000, accumulated depreciation to 1 October 20*x*3 R13 000)	4 000	00
CCN 10090 on 31 March 20*x*4	6 000	00

Trade-in on CCN 10405, original cost R17 000, accumulated depreciation to 1 October 20*x*3 was R14 000.

The company depreciates vehicles at 20% per annum on the diminishing-balance method.

You are required to:

- Calculate the depreciation for the year.
- Calculate the profit and loss on sale of each vehicle.
- Show how the non-current assets will be disclosed in the statement of financial position on 30 September 20*x*4.

Question 14.13

Here is an extract from the trial balance of Pro-shade Enterprises as at 1 March 20*x*0:

Vehicles	442 000	00
Machinery	783 000	00
Accumulated depreciation: Vehicles	185 000	00
Accumulated depreciation: Machinery	456 000	00

Additional information:

1 Depreciation on vehicles is calculated on 20% per annum on the straight-line basis.
2 Residual value is based on 25% on the cost of vehicles bought.
3 Depreciation on machinery is calculated at 20% per annum on the diminishing-balance method.
4 No depreciation has been calculated in the current year.

New assets bought:

A New vehicle: 31 May 20*x*0
- A new car was bought from Dart Motors for an amount of R153 000.
- 85% of the purchase price of the car was financed through Nedfin Bank.
- The other 15% was settled in cash.
- The car was available for use on the same day.

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B New vehicle: 30 June 20*x*0
- Purchased a new machine from Machine Manufacturers (Pty) Ltd on credit.
- The machine cost R293 000. The machine was delivered to Machine Modification on the same day.
- A stabiliser was fitted to the machine to ensure that the machine would be suitable for use in the factory. The cost of the stabiliser was R63 000 that was settled in cash.
- The business also paid R12 000 for the labour cost of the conversion.
- The machine was available for use on the same day.

You are required to

1 Record the transactions in the general journal as at 28 February 20*x*1.

2 Show how the above transactions should be shown in the statement of financial position and the statement of profit or loss & other comprehensive income as at 28 February 20*x*1.
Only the non-current assets are required in the statement of financial position.

Question 14.14

You have been appointed as the accountant of A&L Manufacturing for the June 20*x*1 year end. The previous accountant had never accounted for depreciation, thus, resulting in inaccurate financial records.

The financial director, in an attempt to get accurate records for the carrying amounts of the non-current assets, asked that you recalculate the carrying values of these assets.

These assets were owned by A&L Manufacturing:

A Manufacturing machine 1
- This machine was bought on 1 August 19*x*7 at a cost of R173 000.
- A goods lift was added to the machine at a cost of R27 000 (excluding labour and installation cost).
- The labour cost incurred was R9 000 along with installation costs of R11 000.
- A monthly maintenance cost of R400, was incurred.
- The machine was available for use from 1 October 19*x*7.
- The machine has an expected useful life of five years with no resale value.

B Manufacturing machine 2
- This machine was bought on 1 July 20*x*0 after it was decided to expand the business.
- The machine cost R320 000 inclusive of all costs except delivery.
- A delivery cost of R13 000 was incurred and settled in cash.
- The machine was financed with a loan from MANU Bank.
- The machine was available for use from 1 September 20*x*0.
- The machine has an expected useful life of six years and a residual value of R53 000.

C Delivery vehicle
- The business bought a delivery vehicle on 1 October 20*x*0 to facilitate the expansion programme and was brought into use on the same day.
- The delivery vehicle cost R170 000, for which a 25% deposit was payable in cash, with the remainder being payable in monthly instalments of R10 000. The first instalment is payable on 31 January 20*x*1.
- A licensing fee of R1 300 was incurred to register the vehicle and was settled in cash.
- The vehicle was available for use on the same day.
- The vehicle has a useful life of five years with a residual value of 20% on the total cost.

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You are required to:

1 Record the adjustments in the general journal as at 30 June 20*x*1.

2 Prepare these general ledger accounts:

a Machinery.

b Accumulated depreciation: machinery.

3 Show how depreciation should be shown on the statement of profit or loss & other comprehensive income for the year ended 30 June 20*x*1.

4 Show how the non-current assets would be shown in the statement of financial position as at 30 June 20*x*1.

Question 14.15

Machi's Manufacturing
EXTRACT FROM THE TRIAL BALANCE AS AT 30 JUNE 20*x*0

Details	Fol.	Debit		Credit	
Vehicles	B5	420 000	00		
Machinery	B6	355 000	00		
Accumulated depreciation: Vehicles	B7			280 000	00
Accumulated depreciation: Machinery	B8			120 000	00

Additional information:

1 Vehicles are depreciated at 20% per annum on the straight-line basis.

2 The business considers the residual value of the vehicles to be 35% on cost.

3 Depreciation on machinery is calculated at 15% per annum on the diminishing-balance method.

4 No depreciation has been recorded for the current year.

Transactions for the year ended 30 *June* 20*x*1:

A New machine: 1 September 20*x*0

– Purchased a new machine from MA Transformers for R120 000 and paid a 10% deposit.

– Purchased a crane for the machine and issued a cheque for R18 000.

– Entered into a monthly maintenance contract with Maintain My Machine for R2 500 per month.

– Maintenance will begin one month after the machine is brought into use.

– On 1 October 20x0, the machine was available for use and brought into use after incurring a installation cost of R20 000 on the machine. The installation cost was settled by cheque.

B New vehicle: 1 December 20*x*0

– Purchased a new truck that cost R242 000 from Road Truckers and financed 80% of the cost with a loan from ABASA Bank. The balance was paid by cheque.

– On the same day, a hydraulic pump was fitted and settled in cash for R18 000.

– Paid the licensing of R800 to the SA Traffic department.

– The asset was available for use the next day.

– On 1 June 20x1, paid for the service of the truck by cheque, R4 800.

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You are required to:

1 Record the transactions and depreciation in the general journal as at 30 June 20*x*1.

2 Show how the above totals should be shown on the statement of profit or loss & other comprehensive income and the statement of financial position for the year ended 30 June 20*x*1.

Question 14.16

Brenfort Enterprises
EXTRACT FROM THE TRIAL BALANCE AS AT 28 FEBRUARY 20*x*0

Details	Fol.	Debit		Credit	
Land and buildings	B3	880 000	00		
Machinery	B4	400 000	00		
Vehicles	B5	420 000	00		
Equipment	B6	355 000	00		
Accumulated depreciation: Vehicles	B7			140 000	00
Accumulated depreciation: Equipment	B8			120 000	00

Additional information:

1 Vehicles are depreciated at 20% per annum on the straight-line basis.

2 Residual value is based on a 30% of the cost of vehicles.

3 Land and buildings are not depreciated.

4 Depreciation on equipment is calculated at 20% per annum on the diminishing-balance method.

5 Depreciation on machinery is calculated based on the number of units that the machine produces. (See note relating to machine below.)

6 No depreciation has been calculated for machinery in the current year.

Old assets:

- The machine in the trial balance was bought (*and brought into use*) on 15 August 19*x*8 at a total cost of R400 000 with no residual value.
- The machine had a capacity to complete/produce 35 000 units.
- For the years ending 28 February 19*x*9, 20*x*0 and 20*x*1, the number of units produced was 7 000, 14 000 and 10 500 units in the three respective years.

New assets bought:

A New vehicle: 31 May 20*x*0
- A new car was bought from Mart Motors for R153 000.
- 85% of the purchase price of the car was financed through Nedfin Bank. The other 15% was settled in cash.
- The car was available for use on the same day.

B New machine: 30 June 20*x*0
- Purchased a new machine from Machine Manufacturers (Pty) Ltd on credit for R293 000.
- The machine was delivered to Machine Modification on the same day. A stabiliser was fitted to the machine to ensure that the machine would be suitable for use in the factory.
- The cost of the stabiliser was R63 000 and was settled in cash.

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- The business also paid labour for the conversion, R12 000.
- It has been estimated that the machine will be able to produce 50 000 units.
- In the current year, a total of 8 000 units was produced from the day that the machine was brought into use.

You are required to:

1. Record the transactions and depreciation in the general journal as at 28 February 20*x*1.
2. Process the following ledger accounts for the year ended 28 February 20*x*1:
3. Prepare these general ledger accounts:
   - **a** Machinery.
   - **b** Accumulated depreciation: machinery.

   Note: Opening balances are required.
4. Show how the non-current assets would be shown in the statement of financial position as at 28 February 20*x*1.

Question 14.17

Smokey Enterprises
EXTRACT FROM THE TRIAL BALANCE AS AT 30 JUNE 20*x*0

Details	Fol.	Debit		Credit	
Vehicles	B5	484 000	00		
Machinery	B6	783 000	00		
Accumulated depreciation: Vehicles	B7			185 000	00
Accumulated depreciation: Machinery	B8			412 000	00

Additional information:

1. Vehicles are depreciated at 20% per annum on the straight-line basis.
2. The business considers the residual value on the vehicles to be 35% on cost.
3. Depreciation on machinery is calculated at 20% per annum on the diminishing-balance method.
4. No depreciation has been recorded for the current year.
5. All amounts are VAT inclusive, unless otherwise stated.

Transactions for the year ended 30 *June* 20*x*1:

A New vehicle: 1 September 20*x*0
- Purchased a new car from Mart Vehicles for an amount of R159 600. A 10% deposit was paid, with the balance being financed through Sure Bank.
- As per the agreement with the bank, the loan bears interest at 12%, with capital payments towards the loan payable half-yearly starting on 1 March 20*x*1.
- Capital payments due as per the agreement is R20 000 per period.
- A cost of R855 was paid towards the licensing of the car.
- The car was available for use on the same day.

B New vehicle: 1 February 20*x*1
- Purchased a new vehicle from Maximum Cars, a business not registered for VAT. The car cost R114 000, and was settled in cash. The car was available for use on the same day.

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C New machine: 1 April 20*x*1

- Purchased a new machine from Hex Machines for R228 000 and paid a 10% deposit. The balance is to be paid in monthly instalments of R10 000 starting on 30 April 20*x*1.
- The machine was delivered to Modify This (a VAT registered business), where the machine was modified to suit the business at a total cost of R57 000 (settled in cash). Included in this amount was a payment towards labour of R13 680.
- The machine was returned and available for use on 30 April 20*x*1.

You may assume the following:

- All interest has been paid.
- All entities listed above are registered VAT vendors unless otherwise stated.
- Interest has been fully paid at year end.
- Fuel expenses for the year were R5 700 and was fully paid at year end.

You are required to

1 Record the transactions and depreciation in the general journal as at 30 June 20*x*1.

2 Where no VAT has been taken into account, explain briefly the reason for doing so.

Question 14.18

Simthandile Retailers
EXTRACT FROM THE TRIAL BALANCE AS AT 31 AUGUST 20*x*0

Details	Fol.	Debit		Credit	
Vehicles	B3	840 000	00		
Equipment	B4	355 000	00		
Machinery	B5	400 000	00		
Accumulated depreciation: Vehicles	B6			140 000	00
Accumulated depreciation: Equipment	B7			120 000	00

Additional information:

1 Vehicles are depreciated at 20% per annum on the straight-line basis.

2 The business considers the residual value on the vehicles to be 25% on cost.

3 Depreciation on equipment is calculated at 20% per annum on the diminishing-balance method.

4 Depreciation on machinery is calculated based on the units that the machine produces. (See note relating to machine below.)

5 No depreciation has been recorded for the current year.

6 All amounts are VAT inclusive, unless otherwise stated.

7 All suppliers are considered to be registered VAT vendors.

Old assets:

- The machine in the trial balance was bought (and brought into use) on 15 November 19*x*8 at a total cost of R400 000 with no residual value.
- The machine had a capacity to complete/produce 35 000 units.
- For the years ending 31 August 19*x*9, 20*x*0 and 20*x*1 the number of units produced was 7 000, 14 000 and 10 500 units in the three respective years.

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- On 27 August 20*x*1, Simthandile Retailers sold this machine for R53 000 (VAT excluded) to a restoration company.
- The accountant was unfamiliar with the depreciation process and, therefore, has not processed any of the depreciation entries for the machine from the day it was brought into use.
- You may assume that VAT has been accurately accounted for in the respective VAT period.

New assets bought:

A Vehicle: 31 October 20*x*0
- A new car was bought from Flash Motors for an amount of R174 420.
- 90% of the purchase price of the car was financed through Ortel Bank. The other 10% was settled in cash.
- The vehicle was available for use on the same day.

B Machinery: 30 April 20*x*1
- Purchased a new machine from Machines-R-Us on credit for R334 020.
- The machine was delivered to Machine Adaptations on the same day. A stabiliser was fitted to the machine to ensure that the machine would be suitable for use in the factory.
- The cost of the stabiliser was R63 000 (VAT excluding) and was settled in cash.
- The business also paid a labour cost of R13 680 for the conversion to machine .
- It has been estimated that the machine will be able to produce 50 000 units.
- In the current year, a total of 8 000 units was produced from the day that the machine was brought into use.

Assets sold:

C Vehicle: 30 March 20*x*1
- Sold a vehicle for R71 820.
- The vehicle was bought on 1 July 19*x*7 at a total cost of R140 000 (VAT excluding) and was available for use on the same day.

You are required to

1 Record the transactions and depreciation in the general journal as at 31 August 20*x*1.

2 Complete the non-current assets note in the financial statements as at 31 August 20*x*1.

Question 14.19

Titus Enterprises
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20*x*1

	Notes	20*x*1		20*x*0	
ASSETS					
Non-current assets			00	xxx xxx	
Vehicles	4	300 000	00	xxx xxx	
Machinery	5	?		xxx xxx	
Equipment	6	320 000	00	xxx xxx	

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Titus Enterprises
EXTRACT FROM THE TRIAL BALANCE AS AT 28 FEBRUARY 20*x*1

Details	Fol.	Debit		Credit	
Vehicles	B3	450 000	00		
Machinery	B4	500 000	00		
Equipment	B5	600 000	00		
Accumulated depreciation: Vehicles	B6			150 000	00
Accumulated depreciation: Machinery	B7			?	
Accumulated depreciation: Equipment	B8			?	

Additional information:

1. Vehicles are depreciated at 20% per annum on the straight-line basis.
2. The business considers the residual value on the vehicles to be 25% on cost.
3. Depreciation on equipment is calculated at 20% per annum on the diminishing-balance method.
4. Depreciation on machinery is calculated based on the units that the machine produces. (See note relating to machine below.)
5. No depreciation has been recorded for the current year.
6. All amounts are VAT inclusive, unless otherwise stated.
7. All suppliers are considered to be registered VAT vendors.

Old assets:

- The machine in the trial balance was bought (*and brought into use*) on 15 May 19*x*9 at a total cost of R500 000 with no residual value.
- The machine had a capacity to complete/produce 55 000 units.
- For the years ending 28 February 20*x*0, 20*x*1 and 20*x*2 the number of units produced was 11 000, 14 000 and 15 000 units in the three respective years.
- On 28 February 20*x*2, Titus Enterprises sold this machine for R83 000 (VAT *excl.*) to Mac-Peters Burgers.
- The accountant was unfamiliar with the depreciation process and, therefore, has not processed any of the depreciation entries for the machine from the day it was brought into use.

New assets bought:

A Machinery: 30 April 20*x*1
- Titus Enterprise ordered and paid R433 200 for a machine imported from Germany.
- On arrival, the machine was delivered to Fix-My-Machine on the same day. A stabiliser was fitted to the machine to ensure that the machine would be suitable for use in the factory.
- The cost of the stabiliser was R73 000 (VAT excluded) and was settled in cash.
- The business also paid a labour cost of R18 240 for the conversion of the machine.
- It has been estimated that the machine will be able to produce 40 000 units.
- In the current year, a total of 6 000 units was produced from the day that the machine was brought into use.

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B Vehicle: 31 July 20*x*1

- A new car was bought from SI-SI-PHO Motors for an amount of R250 800.
- A 20% deposit was paid on date of purchase and the balance is to financed by a loan from Wentzel Bank.
- The vehicle was available for use on 31 August 20*x*1 after acquiring the necessary finance, but only brought into use on 19 September 20*x*1

Assets sold:

C Vehicle: 30 November 20*x*1

- Sold a vehicle for R125 400.
- The vehicle was bought on 1 May 19*x*9 at a total cost of R160 000 (VAT excluded) and was available for use on the same day.

You are required to

1 Record the transactions and depreciation in the general journal as at 28 February 20*x*2.

2 Complete the non-current assets note in the financial statements as at 28 February 20*x*2.

Question 14.20

Titus Enterprises
EXTRACT FROM THE TRIAL BALANCE AS AT 31 AUGUST 20*x*1

Details	Fol.	Debit		Credit	
Vehicles	B3	840 000	00		
Machinery	B4	400 000	00		
Equipment	B5	355 000	00		
Accumulated depreciation: Vehicles	B6			140 000	00
Accumulated depreciation: Machinery	B7			240 000	00
Accumulated depreciation: Equipment	B8			120 000	00

Additional information:

1 Vehicles are depreciated at 20% p.a. on the straight-line basis.

2 The business considers the residual value on the vehicles to be 25% on cost.

3 Depreciation on equipment is calculated at 20% p.a. on the diminishing-balance method.

4 Depreciation on machinery is calculated based on the units that the machine produces. (See note relating to machine below.)

5 No depreciation has been recorded for the current year.

6 All amounts are VAT inclusive, unless otherwise stated.

7 All suppliers are considered to be registered VAT vendors.

New assets bought:

A Vehicle: 31 October 20*x*1

- A new bakkie was bought from KEET MOTORS for an amount of R174.420.
- 90% of the purchase price of the car was financed by a loan from SMP Bank. The other 10% was settled in cash.
- The vehicle was available for use on the same day.

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B Machinery: 30 April 20*x*2

- Purchased a new machine from Machine Manufacturers (Pty) Ltd on credit for R334 020.
- The machine was delivered to Change That on the same day. A stabiliser was fitted to the machine to ensure that the machine would be suitable for use in the factory.
- The cost of the stabiliser was R63 000 (VAT excluded) that was settled in cash.
- The business also paid a labour cost of R13 680 for the conversion of the machine.
- It has been estimated that the machine will be able to produce 50 000 units.
- In the current year, a total of 8 000 units was produced from the day that the machine was available for use.
- The machine was available for use on 1 May 20*x*2, but only brought into use on 31 May 20*x*2.

Assets sold:

C Vehicle: 31 March 20*x*2

- Sold a vehicle for R71 820.
- The vehicle was bought on 1 July 19*x*8 at a total cost of R140 000 (VAT excluded) and was available for use on the same day.

C Machine: 30 June 20*x*2

- Sold the machine shown in the trial balance as R400 000 for R34 200.
- It had been estimated that the machine would be able to produce 35 000 units.
- In the current year, a total of 10 500 units was produced from the day that the machine was brought into use.

You are required to

Record the transactions and depreciation in the general journal as at 31 August 20*x*2.

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15 YEAR-END ADJUSTMENTS

Chapter objectives

By the end of this chapter, you should be able to:

- Prepare a pre-adjustment trial balance.
- Apply the matching concept underlying financial reporting.
- Prepare the general journal entries for the year-end adjustments.
- Prepare the year-end adjustments to the general ledger accounts (T-accounts).
- Account for closing transfers after adjustments.
- Calculate the gross profit.
- Calculate the net profit.
- Prepare a post-adjustment trial balance.

Chapter outline

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1 Introduction

Throughout this text it has been emphasised that the aim of accounting is to provide financial information, particularly with regard to past financial performance and present financial position. Consequently, there are two areas in which expertise is required:

1 The recording of transactions.

2 The reporting of results.

So far we have concentrated on the recording of transactions. To deal with large volumes of transactions, certain routine procedures were developed. For convenience, they were classified as daily routines, the entry of transactions from source documents into subsidiary journals; and monthly routines, the posting from subsidiary journals to the general ledger and updating of personal accounts in the subsidiary ledgers.

In this chapter, we go a step further, that is, to summarise the accounts of the general ledger in what is called a trial balance.

In Chapter14 we introduced the concept of updating accounts at the end of the financial year. Attention was paid to updating non-current assets accounts by allocating the depreciation expense for the year to the statement of profit or loss & other comprehensive income as a reduction in the owner's equity.

The current asset accounts receivable also required updating at the year end by providing for anticipated bad debts and writing the expense off in the statement of profit or loss & other comprehensive income, resulting in owner's equity being reduced.

In this chapter, we continue with the concept of accounting for items at the year end that have consequences only realised in the next financial year, but which relate to the current year's performance. At the centre of this idea, is a fundamental principle of financial reporting, that is, the matching concept, introduced in Chapter 3.

2 The pre-adjustment trial balance

A trial balance is prepared after all the transactions for the financial period have been posted to the general ledger and the general ledger accounts have been balanced. This is a list of balances of all the accounts in the general ledger of a business on a specific day.

A trial balance is prepared for one reason only and that is to check that a double-entry has been completed for every transaction that took place during the financial period. This is not to say that each double-entry was necessarily a correct entry – it merely confirms that for each debit entry, a credit entry was also completed.

A trial balance will not expose these errors (which often occur):

- Transactions that were omitted.
- Transactions that were recorded in the wrong accounts.
- Transactions that were recorded in error or were erroneously recorded.

A trial balance can be completed at any stage, but normally it is compiled at the end of each month, and also at the end of the financial year of the business.

A trial balance consists of these items:

- A heading that states the specific day on which the trial balance was completed.
- A debit column and credit column.

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- A folio column in which general ledger account number is written.
- A list of all the accounts in the general ledger under these headings:
  - Real accounts.
  - Nominal accounts.

The real accounts include all the assets, liabilities and owner's equity accounts, whereas the nominal accounts are all the income and expense accounts.

For the purpose of explanation, we will use a retail business, Wonder Traders, that has a financial year ending on 30 June each year. Figure 15.1 shows a trial balance before any year-end adjustments have been made.

Figure 15.1

Wonder Traders
PRE-ADJUSTMENT TRIAL BALANCE AS AT 30 JUNE 20*x*2

Details	Fol.	Debit		Credit	
Real Accounts Section					
Capital: S. Wonder	B1			307 000	00
Land and buildings	B2	200 200	00		
Vehicles	B3	90 000	00		
Equipment	B4	41 350	00		
Accounts receivable	B5	20 000	00		
Allowance for bad debts	B6			2 000	00
Accounts payable	B7			22 080	00
Bank	B8	1 532	00		
Investment	B9	1 000	00		
Petty cash	B10	150	00		
Inventory (1 July 20*x*1)	B11	5 440	00		
Long-term loan (15%)	B12			10 000	00
15% fixed deposit	B13	8 000	00		
Nominal Accounts Section					
Sales	N1			56 416	00
Purchases	N2	28 766	00		
Railage (inwards)	N3	2 000	00		
Storage cost	N4	3 000	00		
Vehicle expenses	N5	429	00		
Rent expense	N6	1 200	00		
Salaries	N7	1 100	00		
Rent income	N8			12 000	00
Advertisements	N9	390	00		
Stationery	N10	4 250	00		
Telephone	N11	764	00		
Interest income	N12			600	00
Royalty income	N13			2 400	00
Interest expense	N14	1 125	00		
Insurance	N15	1 800	00		
		412 496	00	412 496	00

This means that the amounts on the trial balance are the balances that appear in the general ledger accounts of Wonder Traders at the end of its last month of trading in the 20*x*2 financial year.

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3 The matching concept

Reminder
Refer back to Chapter 3 for the discussion of the different accounting concepts with specific reference to the matching concept.

The matching concept requires, first, that income for the current financial year be determined. This requires application of the income recognition concept that holds that a sale is considered to have taken place once the 'critical event' has occurred.

In accounting practice, this is generally at the point of making out the invoice. This implies that the money does not have to be received before it is accepted that a real sale has taken place.

Once the sales for the year have been established, all costs for the year that relate to those sales must be accounted for and matched against the income recognised. The matching of relevant expenses against income recognised is the application of the matching concept.

It is often established, at the end of the financial year, that income and expenses for the current year have not been recorded. It may also be established that income and expenses relating to the following year have already been recorded.

As one aim of financial statements is to provide financial information of the financial performance for the past year (in the statement of profit or loss & other comprehensive income) and the financial position at the end of the year (in the statement of financial position), it is necessary to make certain adjustments at the end of the financial year.

The amounts in Figure 15.1 will be used to explain the treatment of these cases.

You should be able to complete Question 15.1.

4 Accrued expenses

In Chapters 11 and 12, it was stated that there are two basic types of transactions, that is, cash transactions and credit transactions. Expenses may, therefore, arise as a result of:

- Cash transactions for expenses initially recorded in the petty cash journal or cash payments journal, such as the payment for postage stamps from petty cash and the payment of telephone and electricity accounts by cheque.
- Credit transactions for expenses initially recorded in the accounts payable journal, when payment is delayed because credit terms are offered, such as invoices received for repairs and stationery.

Cash transactions have this effect on the general ledger:

Figure 15.2

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Dr. BANK/PETTY CASH	Cr.		Dr. EXPENSE ACCOUNT	Cr.		NO EFFECT	
	Expense account xxx		Bank xxx				

Credit transactions have this effect on the general ledger:

Figure 15.3

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
NO EFFECT			Dr. EXPENSE ACCOUNT	Cr.		Dr. ACCOUNTS PAYABLE	Cr.
			Accounts payable xxx				Expense account xxx

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Needless to say, the accounts payable account has to be settled at some stage, in which case an entry is made in the cash payments journal and is posted to the general ledger with this effect:

Figure 15.4

Asset account		=	Owner's equity account		+	Liability account	
+	–		–	+		–	+
Dr. **Bank**	Cr.		**No effect**			Dr. **Accounts payable**	Cr.
	Accounts payable xxx					Bank xxx	

The net effect of the two stages of recording the expense as an amount due to a payable, and later recording the payment, is identical to the effect of paying the expense immediately – that is, the assets decline and the owner's equity declines. Refer to the highlighted sections in Figures 15.2 to 15.4.

At the end of the financial year, the aim is to ensure that all expenses incurred up to and including the last day of the financial year have been recorded.

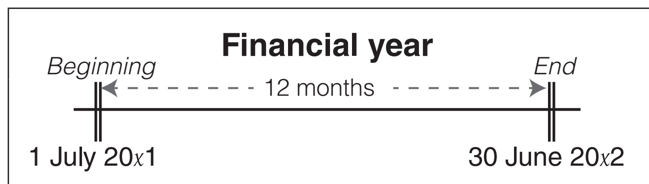


Figure 15.5

A time line is used to show this principle in Figure 15.5.

The word 'incurred' shows that we are not concerned with the actual payments made by 30 June 20*x*2, but rather with the expenses that relate to income earned from the first to the last day of the financial year under review, that is, applying the matching concept.

In many cases, therefore, expenses that relate to the financial year will not yet be recorded in the general ledger because the invoice has not been received by the last day of the financial year.

Example 15.1

Wonder Traders had these amounts in its trial balance as at 30 June 20*x*2 (refer to Figure 15.1):

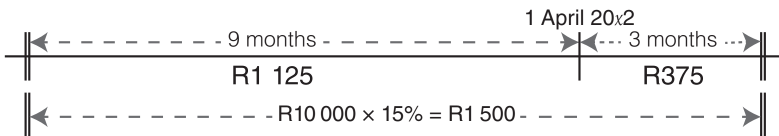
Details	Fol.	Debit		Credit	
Long-term loan (15%)	B13			10 000	00
Telephone	N11	764	00		
Interest expense	N14	1 125	00		

It is established that the interest on the 15% loan that is paid quarterly, is owing for three months and that the telephone account for June has not yet been received.

You are required to:

Establish the amounts involved.

1 For interest, this time line may be used:



The balance of R1 125 in the interest expense account represents interest already paid and the entries arose as the quarterly payments were made.

However, the interest expense account is understated by $\frac{15}{100} \times \frac{10\,000}{1} \times \frac{3}{12}$ = R375 for the year, because the R10 000 has been used throughout the year, thus incurring a total cost of R1 500 (R1 125 + R375) for the year.

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In addition, the bank who granted the loan is owed the outstanding R375 that has not yet been recorded. The R375 is called an accrued expense.

2 For telephone expenses, this time line may be used:

As the telephone account has not yet been received, the exact amount for June cannot be determined. However, an estimate is possible based on R764 that represents 11 months' telephone expense. An amount in the region of R764 divided by 11, say R70, may be used.

The best estimate of telephone expenditure incurred during the year will thus be R834 (R764 + R70). Expenditure accrued at the year end for telephone expense is R70, which is owed to Telkom.

The necessary entry is made in the general journal on 30 June 20*x*2 as follows:

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Interest expense	N14	375	00		
	Telephone	N11	70	00		
	Accrued expenses	B14			445	00
	Expenses owing at year end taken into account					

The entry above can be shown as two separate entries as follows:

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Interest expense	N14	375	00		
	Accrued interest	B14			375	00
	Expenses owing at year end taken into account					
	Telephone	N11	70	00		
	Accrued telephone	B15			70	00
	Expenses owing at year end taken into account					

Explanation

- You will notice that the two journal entries above differ from the original in that the accrual expense account is very specific to the actual expense.
- It should be noted that the first entry is not incorrect. The use of general versus specific naming will differ from business to business, and will be decided by the managers.
- Since this chapter provides an understanding of the accrual principles, we will follow a general approach rather than a specific approach as shown in these two journal entries.

When the postings are complete, the relevant general ledger accounts will appear as follows on 30 June 20*x*2:

Owner's equity account + **Liability account**

TELEPHONE (N11)

+		−	
Total b/f	764		
Accrued expenses	70		
	834		

LONG-TERM LOAN (15%) (B12)

−		+	
		Balance b/d	10 000

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INTEREST EXPENSE		N14
Total b/f	1 125	
Accrued expenses	375	
	1 500	

ACCRUED EXPENSES		B14
	Telephone	70
	Interest expense	375
		445

Explanation

- The owner's equity accounts now more accurately show the expense incurred for the current year. In addition, a liability is created for the amounts owing to the lender of the 15% loan and Telkom on 30 June 20*x*2.
- For convenience, the two amounts are placed in a single liability account. Later it will become evident that the accrued expenses account serves only a temporary function and is cancelled out by reversing the entries in the next financial year.

5 Prepaid expenses

There are many cases where expenses are paid in advance of the benefit actually being received. For example, rates and insurance expenses are usually payable in advance.

Thus, when the financial year ends, it is possible that the amounts shown in these two expense accounts comprise a portion that is an expense for the period as well as a portion that is an expense for the next financial period. An adjustment must, therefore, be made to match only the expense relating to the current period against the income for the period.

Another example relates to stationery and consumable stores. It is necessary for the smooth running of the business always to have supplies on hand in both of these cases. The unused supplies are, however, clearly not part of the current year's expense.

As a result, the amounts shown in the expense accounts comprise a portion that has already been used and is thus an expense, as well as a portion that is on hand and therefore, at year end, is an asset to the business.

Example 15.2

Wonder Traders had these amounts in its trial balance as at 30 June 20*x*2 (refer to Figure 15.1):

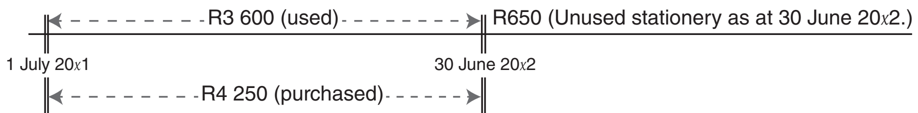
Details	Fol.	Debit		Credit	
Stationery	N10	4 250	00		
Insurance	N15	1 800	00		

- It is established that the insurance expense account relates to an insurance policy entered into on 31 March 20*x*2 granting insurance cover for one year.
- Stationery on hand was assessed to have a cost of R650.

You are required to:

Establish the amounts involved.

1 For stationery, this time line may be used:



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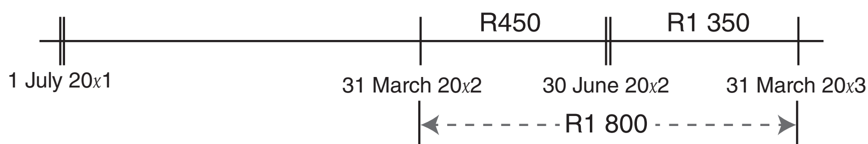
2 For insurance, this time line may be used:



Explanation

From the time lines, it is apparent that in terms of the actual expense to be matched against the year's income, both insurance and stationery are overstated, that is, the amounts shown on expenses are in excess of that actually relating to the current year. For insurance, R1 350 is an expense for the next financial year, and for stationery R650 will be used in the next year.

The necessary entries are made in the general journal on 30 June 20*x*2 as follows:

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Stationery (asset)	B16	650	00		
	Stationery	N10			650	00
	Prepaid expenses at year end taken into account					
	Prepaid insurance	B16	1 350	00		
	Insurance	N15			1 350	00
	Prepaid expenses at year end taken into account					

When the postings are complete, the relevant general ledger accounts will appear as follows on 30 June 20*x*2:

Asset account = **Owner's equity account**

PREPAID INSURANCE B15 (+ / −)

Insurance	1 350	Balance c/d	1 350
	1 350		1 350
Balance b/d	1 350		

STATIONERY N10 (− / +)

Total b/f	4 250	Stationery (asset)	650
		Total c/f	3 600
	4 250		4 250
Total b/f	3 600		

STATIONERY (ASSET)

Stationery	650	Balance c/d	650
	650		650
Balance b/d	650		

INSURANCE N15

Total b/f	1 800	Prepaid insurance	1 350
		Total c/f	450
	1 800		1 800
Total b/f	450		

Explanation

- The total on the insurance account is R450, which shows the actual expense incurred for the current financial year.
- A current asset of R2 000 for prepaid insurance (R1 350) and stationery asset (R650) exists at the year-end date. This is somewhat more difficult to understand.
  - However, one explanation is that if the business was planning to close down on that date (which it is not planning to do) it could be said that the insurance company, which would no longer be required to provide the insurance cover, would repay the R1 350.

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- Another way to explain this, is that an account with a debit balance is either an expense or an asset.
  - * Since the prepaid expenses account is created to correct expense accounts, it follows that the prepaid expenses account cannot be an expense account as well and is, therefore, treated as an asset.
  - * As regards stationery, the physical existence of stationery on hand, like inventory, is regarded as an asset.

- It should be noted that at the time of the stationery purchase, it may be considered the purchase of an asset rather than an expense. This will not alter the results after making the adjustment, although the entries will be slightly different, as follows:
  - On purchase of the stationery:

Asset account

+		−		
BANK				**B**
		Stationery (asset)	x xxx	

Asset account

+		−	
STATIONERY (ASSET)			**B**
Bank	x xxx		

- At the end of the financial year, the effect is identical in that an asset of R650 and an expense of R3 600 have been isolated:

Asset account = **Owner's equity account**

+		−	
STATIONERY (ASSET)			**B16**
Balance b/d	4 250	Stationery	3 600
		Balance b/d	650
	4 250		4 250
Balance b/d	650		

−		+	
STATIONERY			**N10**
Stationery (asset)	3 600	Profit and loss a/c	3 600

6 Accrued income

In much the same way as a business may owe amounts not recorded at the end of the financial year, it is possible that income due has not been captured on source documents and recorded by the end of the financial year.

If an investment was made during the year, for example, an entry would have resulted in the asset 'bank' decreasing and the asset 'investment' being created. If the date for receipt of interest is in the next financial year, however, no record will have been made of the interest earned but not yet received by the year end.

Other examples of income that may have accrued by the financial year end but not yet recorded or received, relate to such items as rent or commissions receivable.

Example 15.3

Wonder Traders had these amounts in its trial balance as at 30 June 20*x*2 (refer to Figure 15.1):

Details	Fol.	Debit		Credit	
15% fixed deposit	B13	8 000	00		
Interest income	N12			600	00

It is established that the fixed deposit was invested on 1 October 20*x*1 and that interest is payable half-yearly in arrears.

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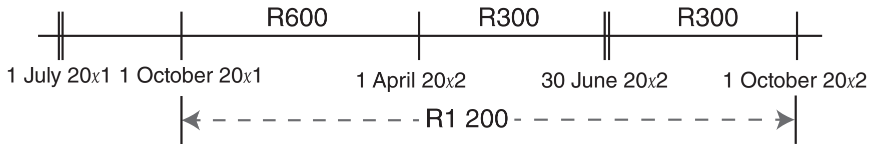
You are required to:
Establish the amounts involved.

For interest income received this time line may be used:



Explanation

- It is apparent that the total of R600 in the interest income account relates to the first six months' interest that would have been received on 1 April 20*x*2.
- The next interest payment will be received only on 1 October 20*x*2.
- However, at the end of the financial year on 30 June 20*x*2, an amount of R300 has been earned but neither received nor recorded.

The necessary entry is made in the general journal on 30 June 20*x*2 as follows:

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Accrued income	B17	300	00		
	Interest income	N10			300	00
	Accrued income at year end taken into account					

The entry above can also be shown as follows:

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Accrued interest	B17	300	00		
	Interest income	N10			300	00
	Accrued income at year end taken into account					

When the postings are complete, the relevant general ledger accounts will appear as follows on 30 June 20*x*2:

Asset account = **Owner's equity account**

Asset account: + | −

15% FIXED DEPOSIT **B13**

Balance b/d	8 000		

ACCRUED INCOME **B17**

Interest income	300		

Owner's equity account: − | +

INTEREST INCOME **N10**

		Bank	600
		Accrued income	300
			600

Explanation

- The net effect of this adjusting entry is to correctly state the income from the investment for the financial year, thereby increasing the owner's equity.
- The account accrued income is an asset, very similar to accounts receivable. It is created on the last day of the financial year to show the amount of interest owed to the business (R300).

Reminder
Refer back to Chapter 7 for the recording process in the general ledger and the use of the general ledger.

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7 Income received in advance

Adjustments falling into this category are less frequent than those in the previous three. However, it is possible to receive income before it has actually been earned. Rent, interest or commissions received in advance are all examples of this.

Once again, as we want to establish the financial performance only for the exact period under review and the financial position at a moment in time, adjustments will be necessary.

Example 15.4

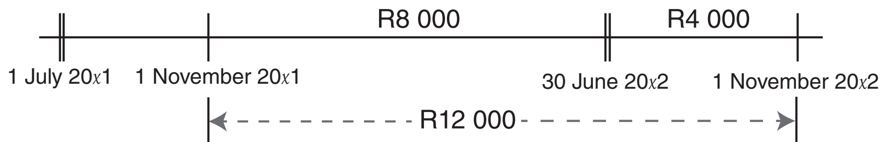
Wonder Traders had these amounts in its trial balance as at 30 June 20*x*2 (refer to Figure 15.1):

Details	Fol.	Debit		Credit	
Rent income	N8			12 000	00

On 1 November 20*x*1, Wonder Traders let a portion of its building to a tenant. The business received a full year's rent of R12 000 in advance.

You are required to:
Establish the amounts involved.

For rent income received this time line may be used:



The necessary entry is made in the general journal on 30 June 20*x*2 as follows:

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Rent income	N8	4 000	00		
	Income received in advance	B18			4 000	00
	Income received in advance at year end taken into account					

The entry above can also be shown as follows:

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Rent income	N8	4 000	00		
	Rent received in advance	B18			4 000	00
	Income received in advance at year end taken into account					

When the postings are complete, the relevant general ledger accounts will appear as follows on 30 June 20*x*2:

Owner's equity account + **Liability account**

RENT INCOME (+ / −) **N8**

Income received in advance	4 000	Bank	12 000
Profit and loss	8 000		
	12 000		12 000

INCOME RECEIVED IN ADVANCE (− / +) **B18**

		Rent income	4 000

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Explanation

- The net effect of the entry is that rent income, which was overstated, will now show a total of R8 000, the actual income for the period under review.
- At the financial year end there also exists a current liability of R4 000. This means that if Wonder Traders withdrew the right to rent the property on 30 June 20*x*2, they would have to repay R4 000.
- As it does not intend to withdraw from the rental agreement, the amount will finally cease to be a liability at the end of the lease term, on 31 October 20*x*2.

You should be able to complete Questions 15.2 to 15.5.

8 Errors and omissions

The end of the financial year is also a convenient time to correct errors and omissions that may have occurred during the year.

As this is the time when the records are audited, it may transpire that a transaction has been incorrectly classified, such as the purchase of an asset being recorded in error as an expense.

Numerical errors such as the transposition of numbers may also be detected. For example, a sale of R2 070 may have been entered in the sales journal as R2 007 only. Because both the sales account and the accounts receivable account would have used the same figure, the error would not be detected by the trial balance.

The sale of non-current assets during the year is another area where omissions may occur. For example, by merely recording the receipt of the cash, the trial balance will still balance. However, the necessary entries to write back the accumulated depreciation and calculate the profit or loss on the sale may still be required.

The treatment of errors and omissions requires a clear understanding of the principles underlying the double-entry system. There are so many variations that each has to be treated differently. They are usually resolved by passing an entry through the general journal.

9 The post-adjustment trial balance

The trial balance has been used thus far as a check at the end of each month that the double-entry system is arithmetically correct. It also provides a list of accounts with their balances that have some information value.

As such, the trial balance has been part of the monthly routine of accounting procedures. The trial balance for the last month of the financial year is used as the basis for effecting the adjustments necessary to measure the financial performance and financial position under the accrual system, using the matching concept.

It is apparent from the preceding examples that the balances on many accounts change as a result of adjusting entries. Moreover, new accounts are created, specifically the accrued expenses, prepaid expenses, accrued income and income received in advance accounts.

As the next step is to close all nominal accounts (those that cause increases or decreases in the owner's equity), it is common practice to first draft a post-adjustment trial balance.

The year-end adjustments are often numerous and it is advisable to ensure that double-entry and balancing have been accurately completed before progressing to the closing of the nominal accounts.

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Example 15.5 A post-adjustment trial balance of Wonder Traders can now be prepared after all the adjustments have been made to amounts in Figure 15.1 (refer to Examples 15.1 to 15.4).

Wonder Traders
POST-ADJUSTMENT TRIAL BALANCE AS AT 30 JUNE 20*x*2

Details	Fol.	Debit		Credit	
Real Accounts Section					
Capital: S. Wonder	B1			307 000	00
Land and buildings	B2	200 200	00		
Vehicles	B3	90 000	00		
Equipment	B4	41 350	00		
Accounts receivable	B5	20 000	00		
Allowance for bad debts	B6			2 000	00
Accounts payable	B7			22 080	00
Bank	B8	1 532	00		
Investment	B9	1 000	00		
Petty cash	B10	150	00		
Inventory (1 July 20*x*1)	B11	5 440	00		
Long-term loan (15%)	B12			10 000	00
15% fixed deposit	B13	8 000	00		
Accrued expenses	B14			445	00
Prepaid insurance	B15	1 350	00		
Stationery (asset)	B16	650	00		
Accrued income	B17	300	00		
Income received in advance	B18			4 000	00
Nominal Accounts Section					
Sales	N1			56 416	00
Purchases	N2	28 766	00		
Railage (in)	N3	2 000	00		
Storage cost	N4	3 000	00		
Vehicle expenses	N5	429	00		
Rent expense	N6	1 200	00		
Salaries	N7	1 100	00		
Rent income (12 000 – 4 000)	N8			8 000	00
Advertisements	N9	390	00		
Stationery (4 250 – 650)	N10	3 600	00		
Telephone (764 + 70)	N11	834	00		
Interest income (600 + 300)	N12			900	00
Royalty income	N13			2 400	00
Interest expense (1 125 + 375)	N14	1 500	00		
Insurance (1 800 – 1 350)	N15	450	00		
		413 241	00	413 241	00

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Explanation

- A rough picture is already emerging from the trial balance displayed in this way.
  - All the nominal accounts are those that affect the statement of profit or loss & other comprehensive income.
    - By simply finding the difference between the nominal accounts only, a figure of R24 447 is obtained. This approximates the profit for the year. Wonder Traders uses the periodic method to account for inventory.
    - So, the only further factor to consider is the closing inventory amount. If it is higher than the opening inventory amount of R5 440, the profit will be greater and vice versa.
  - All the real accounts are those that affect the statement of financial position. However, the information will be more understandable when displayed in an improved format.
- The necessary step required in the accounting procedures before drafting the statement of profit or loss & other comprehensive income and statement of financial position, however, is to effect the closing entries. They require a distinction between transfers to the trading account and transfers to the profit and loss account, once the final inventory amount is known.
- If the final inventory count on 30 June 20*x*2 reveals that inventory on hand is R3 900, the resulting closing entries will be as shown in Example 15.6 (last two entries).

10 General journal – closing entries

The first step in completing financial statements is to close off all the accounts in the nominal accounts section (all the income and expense accounts) of the general ledger to either the trading account or the profit and loss account. These closing entries are done in the general journal.

The reason for these closing entries is simple: income and expense transactions take place for a certain financial period. As soon as the net profit for that period has been calculated, those income and expense accounts must be closed and will open with R0 balances in the next financial period.

Reminder

The fundamental principle for recording is still valid, for every debit entry there is a credit entry.

Example 15.6

Refer to the trial balance in Example 15.5.

All the accounts in the nominal accounts section will be closed off to a R0 total, by completing the closing entries in the general journal as shown on the next page.

GENERAL JOURNAL OF WONDER TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Sales	N1	56 416	00		
	Trading account	F1			56 416	00
	Close off sales account to the trading account					
	Trading account	F1	33 766	00		
	Purchases	N2			28 766	00
	Railage (inwards)	N3			2 000	00

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	Storage cost	N4			3 000	00
	Close off purchases, railage (inwards) and storage cost accounts to the trading account					
	Trading account	F1	5 440	00		
	Inventory	B11			5 440	00
	Closing off of opening inventory balance					
	Inventory	B11	3 900	00		
	Trading account	F1			3 900	00
	Recording of closing inventory					
	Profit and loss account	F2	9 503	00		
	Vehicle expenses	N5			429	00
	Rent expense	N6			1 200	00
	Salaries	N7			1 100	00
	Advertisements	N9			390	00
	Stationery	N10			3 600	00
	Telephone	N11			834	00
	Interest expense	N14			1 500	00
	Insurance	N15			450	00
	Close off all expense accounts to the profit and loss account					
	Rent income	N8	8 000	00		
	Interest income	N12	900	00		
	Royalty income	N13	2 400	00		
	Profit and loss account	F2			11 300	00
	Close off all income accounts to the profit and loss account					

Note
Refer tothe section on inventory in Chapter 9 for the cost of sales journals and adjustments.

After all these closing entries have been completed, no more income or expense accounts appear in the general ledger of the business.

These closing entries are very easy, but they do pose the problem of which accounts are closed off against the trading account and which accounts are closed off against the profit and loss account.

This will be discussed in the following two sections.

11 Trading account and gross profit

The trading account is used to calculate a gross profit. This is the profit that the business has made from its main operations before any other income or expenses are taken into account.

The main operations of Wonder Traders is buying and selling of goods. All the costs that have to do with getting the goods into the business in such a way that they can be sold, have to be allocated to the trading account at the end of the financial year. All these extra costs will affect the cost price of the inventory.

Let us now look at the completed trading account, if the closing inventory is R3 900.

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General Ledger of Wonder Traders
Final Accounts Section

Dr. **TRADING ACCOUNT** F1 Cr.

Jun.	30	Purchases	GJ12	28 766	00	Jun.	30	Sales	GJ12	56 416	00
		Opening inventory	GJ12	5 440	00			Closing inventory	GJ12	3 900	00
		Railage (inwards)	GJ12	2 000	00						
		Storage cost	GJ12	3 000	00						
		Profit and loss account (gross profit)	GJ12	21 110	00						
				60 316	00					60 316	00

Opening inventory of R5 440 and the closing inventory of R3 900 was discussed in Chapter 10.

The R21 110 gross profit will be transferred to the profit and loss account so that the net profit for the year can be calculated.

Here is an example of a general ledger account that has been closed off to the trading account:

Reminder

For a retail business, the cost price of goods is the price paid to the supplier, plus all costs necessary to make them available for sale.

Nominal Accounts Section

Dr. **SALES** N1 Cr.

Jun.	30	Trading account	GJ12	56 416	00	Jun.	30	Bank	CRJ12	30 000	00
								Accounts receivable	ARJ12	26 416	00
				56 416	00					56 416	00

12 Profit and loss account and net profit

The net profit of the business is calculated in the profit and loss account. The net profit is the profit made for the financial period after all the income and expenses for the period have been taken into account.

The profit and loss account will start off with the gross profit (as calculated in the trading account); add all the income (this means that the profit will be greater); and subtract all the expenses.

Let us now have a look at the completed profit and loss account.

Final Accounts Section

Dr. **PROFIT AND LOSS ACCOUNT** F2 Cr.

Jun.	30	Vehicle exp.	GJ12	429	00	Jun.	30	Trading account	GJ12	21 110	00
		Rent expense	GJ12	1 200	00			Interest income	GJ12	900	00
		Salaries	GJ12	1 100	00			Rent income	GJ12	8 000	00
		Advertisements	GJ12	390	00			Royalty income	GJ12	2 400	00
		Interest expense	GJ12	3 600	00						
		Telephone	GJ12	834	00						
		Insurance	GJ12	1 500	00						
		Stationery	GJ12	450	00						
		Capital (net profit)	GJ12	22 907	00						
				32 410	00					32 410	00

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Here is an example of a general ledger account that has been closed off to the profit and loss account:

Nominal Accounts Section

Dr. **VEHICLE EXPENSES** **N5** **Cr.**

Jun.	30	Bank	CPJ12	100	00	Jun.	30	Profit and loss account	GJ12	429	00
		Accounts payable	APJ12	329	00						
				429	00					429	00

The profit of a business belongs to the owner(s). In the case of a sole proprietor the net profit will be credited (to complete the double-entry) to the capital account.

The capital account is opened with the amount with which the owner originally started the business. The business still owes that money to the owner. This amount will increase each year with the profit and decrease with the loss, if any.

The capital account will be further decreased if the owner withdraws funds (drawings), or will be further increased if the owner invests additional capital.

13 The post-closing trial balance

After all the income and expense accounts have been closed off to either the trading account or the profit and loss account, the post-closing trial balance will be:

Figure 15.6

Wonder Traders
POST-CLOSING TRIAL BALANCE AS AT 30 JUNE 20*x*2

Details	Fol.	Debit		Credit	
Real Accounts Section					
Capital: S. Wonder (307 000 + 22 907)	B1			329 907	00
Land and buildings	B2	200 200	00		
Vehicles	B3	90 000	00		
Equipment	B4	41 350	00		
Accounts receivable	B5	20 000	00		
Allowance for bad debts	B6			2 000	00
Accounts payable	B7			22 080	00
Bank	B8	1 532	00		
Investment	B9	1 000	00		
Petty cash	B10	150	00		
Inventory (30 June 20*x*2)	B11	3 900	00		
Long-term loan (15%)	B12			10 000	00
15% fixed deposit	B13	8 000	00		
Accrued expenses	B14			445	00
Prepaid insurance	B15	1 350	00		
Stationery (asset)	B16	650	00		
Accrued income	B17	300	00		
Income received in advance	B18			4 000	00
		368 432	00	368 432	00

Note that only real accounts appear in the post-closing trial balance.

You should be able to complete Questions 15.6 to 15.8.

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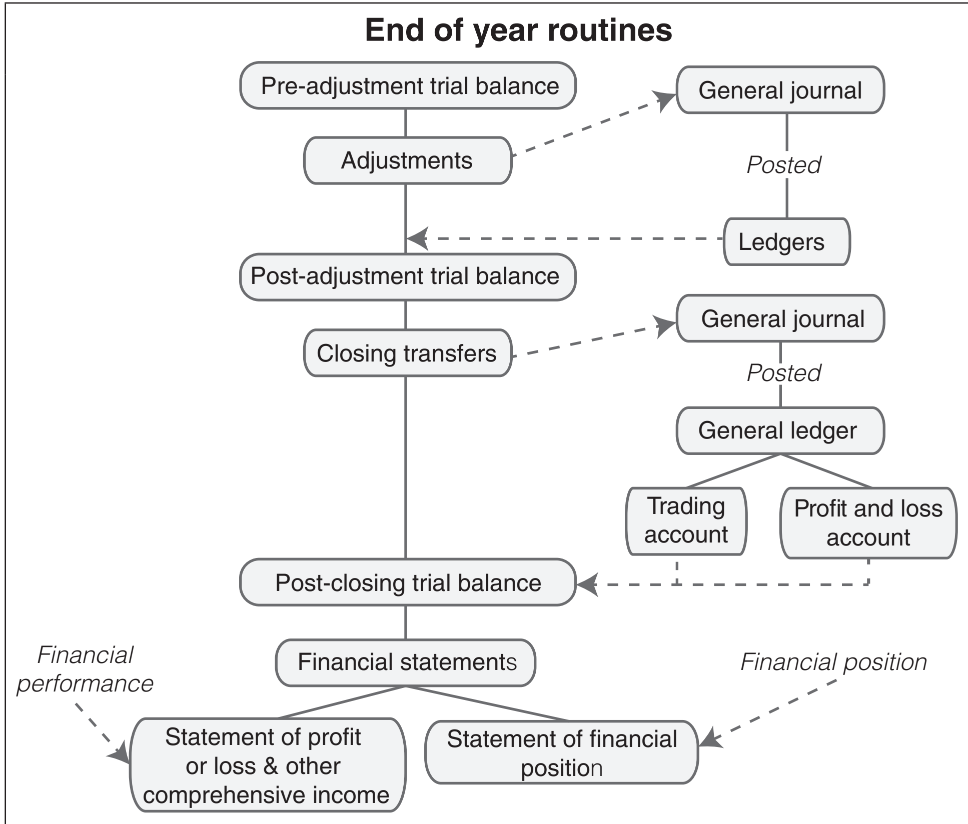
Year-end routines

The end-of-year routines are shown in Figure 15.7.

Figure 15.7



14 Chapter illustrative example

Reminder

Nearly all adjusting entries require a calculation or an estimation, followed by a double-entry in the general journal, which is then posted to the general ledger.

Cheetah Stores is a retail business that uses the periodic inventory system for recording their inventory transactions.

- The financial year is from 1 April to 31 March each year.
- Transactions for the 20*x*4 financial year have been recorded and the pre-adjustment trial balance as at 31 March 20*x*4 appears below:

PRE-ADJUSTMENT TRIAL BALANCE AS AT 31 MARCH 20*x*4

Details	Fol.	Debit		Credit	
Real Accounts Section					
Capital	B1			1 000 000	00
Land and buildings	B2	800 000	00		
Accumulated depreciation: Land and buildings (31 March 20*x*3)	B3			14 940	00
Plant and equipment	B4	350 000	00		
Accumulated depreciation: Plant and equipment (31 March 20*x*3)	B5			59 938	00
Vehicles	B6	460 000	00		
Accumulated depreciation: Vehicles (31 March 20*x*3)	B7			115 000	00

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32-day notice deposit	B8	124 800	00		
Inventory (31 March 20*x*3)	B9	165 000	00		
Accounts receivable	B10	93 750	00		
Bank	B11	227 178	00		
Accrued income (interest) (31 March 20*x*3)	B12	1 500	00		
Prepaid expenses (insurance) (31 March 20*x*3)	B13	3 500	00		
Mortgage bond over land and buildings	B14			739 000	00
Accounts payable	B15			213 400	00
Income received in advance (rent) (31 March 20*x*3)	B16			2 000	00
Accrued expenses (31 March 20*x*3)	B17			2 430	00
Nominal Accounts Section					
Sales	N1			767 000	00
Purchases	N2	466 800	00		
Railage (inwards)	N3	4 200	00		
Interest income	N4			7 800	00
Rent income	N5			20 000	00
Salaries	N6	192 000	00		
Telephone	N7	10 810	00		
Electricity	N8	6 120	00		
Vehicle expenses	N9	5 270	00		
Insurance	N10	7 700	00		
Rates and taxes	N11	6 000	00		
General expenses	N12	11 900	00		
Bad debts	N13	4 980	00		
		2 941 508	00	2 941 508	00

Additional information:

1. Land and buildings were acquired on 1 January 20*x*2. Depreciation on buildings is provided for at 2% per annum on the diminishing-balance method.
2. Depreciation on plant and equipment is calculated at 15% per annum on the diminishing-balance method.
3. Vehicles are depreciated at 20% per annum on the straight-line basis.
   - A vehicle that was purchased on 1 January 20*x*2 for R60 000 was written off in an accident on 30 November 20*x*3.
   - The insurance company must still settle the claim for R40 000.
   - No entries have been made to record the scrapping of the vehicle.
   - All the vehicles were bought at the same time.
4. The 32-day notice deposit account was opened on 1 September 20*x*3 with R120 000. Interest at 12% per annum on the principal amount is capitalised.
5. Accrued income (interest) as at 31 March 20*x*3 was for the fixed deposit that matured on 30 June 20*x*3.
6. An amount of R4 200 written off as bad debts in January 20*x*2 was paid during February 20*x*4 and credited to accounts receivable.
7. The insurance premium is payable in advance annually on 30 September and escalates with 10% each year.
8. Interest on the bond, amounting to R21 000, was debited to the bond account.
9. Part of the building has been sub-let at R2 000 per month since February 20*x*2.

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10 Accrued expenses as at 31 March 20*x*3 consisted of:
- Telephone R1 100
- Electricity R880
- Rates R450

11 On 2 April 20*x*4, the managers signed an agreement with the staff union approving a general salary increase of 7% with effect from 1 January 20*x*4.
- The last increase was 1 January 20*x*3.
- No staff have left or joined Cheetah Stores since then.

12 The telephone and electricity accounts for March 20*x*4 have not yet been received.

13 Rates were paid six-monthly in advance on 30 April and 31 October, in equal instalments.

14 The management of Cheetah Stores have decided to create an allowance for bad debts at 6% of outstanding accounts receivable.

15 The value of inventory on 31 March 20*x*4 was R190 000.

You are required to:

1 Prepare general journal entries for the year-end adjustments. (Do all calculations to the nearest rand.)

2 Prepare a post-adjustment trial balance.

3 Prepare a trading account and a profit and loss account for the year ended 31 March 20*x*4.

1 (The calculations that must be made where necessary are fully explained at the end of the journal entries.)

GENERAL JOURNAL OF CHEETAH STORES **GJ12**

Adj.	Details	Fol.	Debit		Credit	
1	Depreciation	N14	11 701	00		
	Accumulated depreciation: Land and buildings	B3			11 701	00
	Depreciation @ 2% on diminishing-balance (Calc. A)					
2	Depreciation	N14	43 509	00		
	Accumulated depreciation: Plant and equipment	B5			43 509	00
	Depreciation @ 15% on diminishing-balance (Calc. B)					
3	Depreciation	N14	88 000	00		
	Accumulated depreciation: Vehicles	B7			88 000	00
	Depreciation @ 20% on straight-line balance (Calc. C)					
	Accounts receivable: Insurance company	B10	40 000	00		
	Accumulated depreciation: Vehicles	B7	23 000	00		
	Vehicles	B6			60 000	00
	Profit on disposal of assets	N15			3 000	00
	Recording disposal of vehicle (Calc. D)					
4	Accrued income	B12	3 600	00		
	Interest income	N4			3 600	00
	Interest for January to March 20*x*4 (Calc. E)					
5	Interest income	N4	1 500	00		
	Accrued income	B12			1 500	00
	Reversing accrued income as at 1 April 20*x*3					
6	Accounts receivable	B10	4 200	00		
	Bad debts recovered	N16			4 200	00
	Correcting entry for bad debts recovered					

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7	Insurance	N10	3 500	00		
	Prepaid expenses	B13			3 500	00
	Reversing prepaid expenses as at 1 April 20x3					
	Prepaid expenses	B13	3 850	00		
	Insurance	N10			3 850	00
	Insurance paid in advance (Calc. F)					
8	Interest expense	N17	21 000	00		
	Mortgage bond	B14			21 000	00
	Correcting posting for interest					
9	Income received in advance	B16	2 000	00		
	Rent income	N5			2 000	00
	Reversing income received in advance at 1 April 20x3					
	Accrued income	B12	2 000	00		
	Rent income	N5			2 000	00
	One month's rent in arrears (Calc. G)					
10	Accrued expenses	B17	2 430	00		
	Telephone	N7			1 100	00
	Electricity	N8			880	00
	Rates and taxes	N11			450	00
	Reversing accrued expenses at 1 April 20x3					
11	Salaries	N6	3 360	00		
	Accrued expenses	B17			3 360	00
	Salary increase January to March accrued (Calc. H)					
12	Telephone	N7	883	00		
	Electricity	N8	476	00		
	Accrued expenses	B17			1 359	00
	Accrued expenses for March accounts (Calc. I)					
13	Prepaid expenses	B13	500	00		
	Rates and taxes	N11			500	00
	One month's rates and taxes paid in advance (Calc. J)					
	Bad debts	N13	5 877	00		
	Allowance for bad debts	B18			5 877	00
	Allowance for bad debts raised to 6% of receivables (Calc. K)					

Calculations

A Depreciation is calculated on the cost of buildings only. It is, therefore, necessary to isolate the cost of the building from the cost of the land.

Let the cost of the buildings = z

Depreciation

1 Jan. 20x2 to 31 Mar. 20x2 = $z \times 2\% \times 3$ months $= 0.02z \times 0.25$

1 Apr. 20x2 to 31 Mar. 20x3 = $2\% \times [z - (0.02z \times 0.25)] = 0.02[z - (0.02z \times 0.25)]$

Total accumulated depreciation as at 31 March 20x3 is:

$$(0.02z \times 0.25) + \{0.02[z - (0.02z \times 0.25)]\} = R14\,940$$
$$0.005z + \{0.02[z - 0.005z]\} = R14\,940$$
$$0.005z + \{0.02z - 0.0001z\} = R14\,940$$
$$0.0249z = R14\,940$$
$$z = R14\,940 \div 0.0249$$
$$= R600\,000$$

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Therefore, the cost of buildings = R600 000 and the depreciation expense for the year = 2% × (600 000 – 14 940) = R11 701.

B 15% × (350 000 – 59 938) = R43 509

C

(460 000 – 60 000) × 20%	=	80 000
60 000 × 20% × 8 months	=	8 000
		88 000

D

Carrying value at time of accident:		
Cost		60 000
Accumulated depreciation to 31 Mar. 20*x*3: 115 000 × (60 000 ÷ 460 000)	15 000	
Depreciation current year (See Calc. C)	8 000	(23 000)
Carrying value at date of accident		37 000
Amount due from insurance company		(40 000)
Profit on disposal		3 000

E

32-day account per trial balance	=	124 800
Principal amount	=	120 000
Interest at 12% capitalised	=	4 800
Monthly interest (120 000 × 12% ÷ 12 months)	=	1 200
Therefore, interest for 4 months (1 Sep. 20*x*3 to 31 Dec. 20*x*3) already capitalised:		
Interest 1 Jan. 20*x*4 to 31 Mar. 20*x*4 (3 × R1 200 accrued)	=	3 600

F

Insurance prepaid for 6 months on 31 Mar. 20*x*3	=	3 500
Premium for 12 months, therefore (3 500 × 2)	=	7 000
At escalation of 10% (R 7 000 × 1.10) as per trial balance	=	7 700
Prepaid for 6 months (7 700 × 6 months)	=	3 850

G

Rent at R2 000 per month ×12	=	24 000
Rent per trial balance	=	(20 000)
Difference	=	4 000
Paid in advance last year, now reversed	=	(2 000)
In arrears for current year	=	2 000

H

Total salaries 1 Apr. 20*x*3 to 31 Mar. 20*x*4	=	192 000
Salaries per month = 192 000 ÷ 12	=	16 000
Increase at 7%	=	1 120
Increase in arrears for 3 months = 3 × 1 120	=	3 360

I

Estimate of March 20x4 accounts		
Telephone: (10 810 – 1 100) ÷ 11	=	883
Electricity: (6 120 – 880) ÷ 11	=	476

J

Rates and taxes paid 30 Apr. 20*x*3 for May to Oct. 20*x*3	=	3 000
Rates and taxes paid 31 Oct. 20*x*3 for Nov. 20*x*3 to Apr. 20*x*4	=	3 000
	=	6 000
Therefore, one month in advance = 6 000 ÷ 12	=	500

K

Accounts receivable per trial balance	=	93 750
Adjustment for bad debts recovered	=	4 200
	=	97 950
Allowance for bad debts at 6%	=	5 877

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2 *Post-adjustment trial balance*

PRE-ADJUSTMENT TRIAL BALANCE AS AT 31 MARCH 20x4

Details	Fol.	Debit		Credit	
Real Accounts Section					
Capital	B1			1 000 000	00
Land and buildings	B2	800 000	00		
Accumulated depreciation: Land and buildings (14 940 + 11 701)	B3			26 641	00
Plant and equipment	B4	350 000	00		
Accumulated depreciation: Plant and equipment (59 938 + 43 509)	B5			103 447	00
Vehicles (460 000 – 60 000)	B6	400 000	00		
Accumulated depreciation: Vehicles (115 000 + 88 000 – 23 000)	B7			180 000	00
32-day notice deposit	B8	124 800	00		
Inventory (31 March 20x3)	B9	165 000	00		
Accounts receivable (93 750 + 40 000 + 4 200)	B10	137 950	00		
Bank	B11	227 178	00		
Accrued income (1 500 + 3 600 – 1 500 + 2 000)	B12	5 600	00		
Prepaid expenses (3 500 – 3 500 + 3 850 + 500)	B13	4 350	00		
Mortgage bond over land and buildings (739 000 + 21 000)	B14			760 000	00
Accounts payable	B15			213 400	00
Income received in advance (2 000 – 2 000)	B16			0	00
Accrued expenses (2 430 – 2 430 + 3 360 + 1 359)	B17			4 719	00
Allowance for bad debts	B18			5 877	00
Nominal Accounts Section					
Sales	N1			767 000	00
Purchases	N2	466 800	00		
Railage (inwards)	N3	4 200	00		
Interest income (7 800 + 3 600 – 1 500)	N4			9 900	00
Rent income (20 000 + 2 000 + 2 000	N5			24 000	00
Salaries (192 000 + 3 360)	N6	195 360	00		
Telephone (10 810 – 1 100 + 883)	N7	10 593	00		
Electricity (6 120 – 880 + 476)	N8	5 716	00		
Vehicle expenses	N9	5 270	00		
Insurance (7 700 + 3 500 – 3 850)	N10	7 350	00		
Rates and taxes (6 000 – 450 – 500)	N11	5 050	00		
General expenses	N12	11 900	00		
Bad debts (4 980 + 5 877)	N13	10 857	00		
Interest expense	N14	21 000	00		
Depreciation (11 701 + 43 509 + 88 000)	N15	143 210	00		
Profit on disposal of assets	N16			3 000	00
Bad debts recovered	N17			4 200	00
		3 102 184	00	3 102 184	00

3

General Ledger of Cheetah Stores
Final Accounts Section

Dr. **TRADING ACCOUNT** **F1** **Cr.**

Jun.	30	Purchases	GJ12	466 800	00	Jun.	30	Sales	GJ12	767 000	00
		Opening inventory	GJ12	165 000	00			Closing inventory	GJ12	190 000	00
		Railage (inwards)	GJ12	4 200	00						
		Profit and loss account (GP)	GJ12	321 000	00						
				957 000	00					957 000	00

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Final Accounts Section

Dr.		PROFIT AND LOSS ACCOUNT						F2			Cr.
Jun.	30	Salaries	GJ12	195 360	00	Jun.	30	Trading account	GJ12	321 000	00
		Telephone	GJ12	10 593	00			Interest income	GJ12	9 900	00
		Electricity	GJ12	5 716	00			Rent income	GJ12	24 000	00
		Vehicle expenses	GJ12	5 270	00			Profit on disposal of assets	GJ12	3 000	00
		Interest expense	GJ12	21 000	00			Bad debts recovered	GJ12	4 200	00
		Insurance	GJ12	7 350	00			Capital (NL)	GJ12	54 206	00
		Rates and taxes	GJ12	5 050	00						
		General expense	GJ12	11 900	00						
		Bad debts	GJ12	10 857	00						
		Depreciation	GJ12	143 210	00						
				416 306	00					416 306	00

Explanation

- Calculations are shown in the post-adjustment trial balance for explanatory purposes only.
- Income received in advance is shown for explanatory purposes only. Accounts with a R0 balance would, in practice, not be shown in the trial balance.
- Interest income is not limited to the fixed deposit and 32-day notice investments.

15 Summary

At the end of the financial year, the aim is to report as accurately as possible, within the accounting model, the financial performance and financial position of the business.

Because some events took place that affect the performance and position of the business but that were not captured on source documents at a particular moment in time, it is necessary to make adjustments to the records before finalising the statement of profit or loss & other comprehensive income and statement of financial position.

This approach is called the accrual system of accounting that applies the principle of matching expenses incurred (but not necessarily paid) against the income earned (but not necessarily received in cash) in a given period.

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QUESTIONS

Question 15.1

Explain the purpose of year-end adjustments.

Question 15.2

Explain the matching concept as it applies to year-end adjustments.

Question 15.3

This trial balance is for High Flats (owned by Mr Cook) as at 31 December 20*x*5.

TRIAL BALANCE AS AT 31 DECEMBER 20*x*5

Details	Fol.	Debit		Credit	
Capital account – 1 January 20*x*5	B1			194 245	00
Maintenance and repairs	N1	6 295	00		
Rates and taxes	N2	9 190	00		
Drawings	B2	31 920	00		
Wages	N3	9 960	00		
Bad debts	N4	485	00		
Rent income	N5			123 474	00
Interest paid on bond	N6	18 225	00		
Land and buildings at cost	B3	298 000	00		
Office furniture and equipment at cost	B4	14 900	00		
Accounts receivable	B5	19 870	00		
Prepaid expenses (rates)	B6	3 750	00		
Allowance for bad debts	B7			3 000	00
Accounts payable	B8			1 890	00
Electricity and water	N7	5 828	00		
Insurance	N8	5 250	00		
Telephone and postage	N9	1 326	00		
18% mortgage bond over land and buildings	B9			135 000	00
Accumulated depreciation: Office furniture and equipment	B10			3 500	00
Bank	B11	36 110	00		
		461 109	00	461 109	00

Additional information:

1. Office furniture and equipment must be depreciated at 15% per annum on the diminishing-balance method. (No furniture or equipment was bought or sold during the year.)
2. The mortgage is for a fixed term of 20 years. No capital repayment is required until 20*x*5.
3. Insurance includes an amount of R250 for Mr Cook's private house.
4. The payment in advance (rates and taxes) shown in the trial balance is for the previous financial year. The prepayment of R4 500 for the current year is included in the rates and taxes figure of R9 190.
5. It is considered that an allowance for bad debts of R2 000 would be adequate.
6. An annual salary of R650 paid to the bookkeeper was debited to drawings in error.
7. A receivable, whose outstanding balance of R480 is considered to be irrecoverable, is to have the debt written off.

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You are required to:

1 Prepare the necessary adjusting journal entries for the adjustments.
2 Calculate the net profit or loss.

Question 15.4

After the financial statements of P&Q Enterprises had been prepared for the 20x1 financial year and the ledger accounts closed, these errors were discovered:

1 The year-end allowance for bad debts of R3 000 had been transferred to sales in the closing entries.
2 Prepaid insurance of R1 200 had been treated as an expense.
3 Accrued interest payable of R1 000 had been entirely omitted from the books.
4 When counting inventory at the financial year end, goods that cost R4 000 were counted and included twice.
5 Accumulated depreciation: office equipment was understated by R250 as a machine that cost R1 000 was incorrectly debited to repairs expense.
6 Accrued rental income of R500 was omitted from the books.
7 Inventory taken by the owner (and that cost R700) was not recorded.

You are required to:

Prepare journal entries to correct the above errors. If a correcting entry is not required, state this fact and give your reasons why not.

Question 15.5

Lerato Molefe has completed her first year in business as a general dealer and her bookkeeper produced these abridged annual financial statements:

Abridged SOPOL & OCI

Sales	24 000	00
Less: Purchases	(21 600	00)
Gross profit	2 400	00
Add: ***Other income***	4 000	00
Loan	2 400	00
Commission income	400	00
Rent income	1 200	00
Gross income	6 400	00
Less: Expenses	(7 200	00)
Fixture and fittings	4 000	00
Wages paid	1 600	00
Rates and taxes	1 600	00
NET LOSS FOR THE YEAR	800	00

Abridged Statement of Financial Position

Capital 1 June 20x5	40 000	00
Less: Net loss	800	00
	39 200	00
Less: Drawings	4 800	00
	34 400	00
Presented by:		
Land and buildings	24 000	00
Cash at bank	10 400	00
	34 400	00

Lerato Molefe was surprised to discover that she had made a loss and asked her accountant friend to look into the situation for her. The accountant discovered that:

1 The bookkeeper had only recorded double-entries for cash received and cash paid out during the year. However, whenever there had been purchases or sales on credit he had kept a record of these in 'unpaid invoices' files that he transferred to 'invoices settled' files when the debts were subsequently paid. At 31 May, unpaid accounts receivable totalled R2 000 and unpaid accounts payable R1 200.

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2 The inventory count showed that the cost of inventory on hand at 31 May 20*x*6 was R5 200.
3 During the year, Lerato had taken inventory that cost R400 for her personal use and this had not been recorded.
4 On the last day of the financial year, Lerato had borrowed R2 400 for the business for a 5-year period at 6% per annum, in terms of a mortgage over the land and buildings.
5 Commissions earned, but not received at 31 May 20*x*6, totalled R160 and on the same date R240 of the rent received was paid in advance.
6 Fixtures and fittings were bought on 1 June 20*x*5 and should be depreciated by 10% per annum.
7 Wages owing at 31 May totalled R200, and R440 of the rates paid relate to 20*x*7.

You are required to:
Prepare adjusting entries in general journal form to record adjustments 1 to 7. If an adjusting entry is not required, note your opinion and give reasons for it.

Question 15.6

Here are the balances from the statement of financial position of Stix Stores, a retail merchant, as at 31 March 20*x*0 and 20*x*1:

	20*x*0		20*x*1	
Fixtures and fittings	11 000	00	14 000	00
Inventory	6 000	00	7 000	00
Accounts receivable	4 000	00	15 000	00
Cash at bank	5 000	00	0	00
Accounts payable	14 000	00	9 000	00
Bank overdraft	0	00	1 000	00
Capital: L. Tshabalala	12 000	00	26 000	00

Drawings for the years ended 31 March 20*x*0 and 20*x*1 were R4 000 and R6 000 respectively.

You are required to:
1 From the information calculate the net profit or loss for the year ended 31 March 20*x*1.
2 Adjust the profit or loss calculated in Question 1 by taking the following into account:
   a The omission of accrued expenses of R2 000 on 31 March 20*x*1.
   b The omission of accrued rental income of R500 on 31 March 20*x*0.
   c The omission of R1 000 prepaid expenses on 31 March 20*x*1.
   d The misallocation to purchases of fittings purchased on 30 September 20*x*0 of R800 as an expense (fixtures and fittings are depreciated at the rate of 10% per annum on cost).
   e The omission of R600 prepaid expenses on 31 March 20*x*0.

If an adjusting entry is not required, note your opinion and give reasons for it.

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Question 15.7

This list of balances and totals is from the books of Thando Traders as at 30 September 20*x*5:

Capital (1 October 20*x*4)	43 150	00
Drawings	13 100	00
Land and buildings at cost	21 050	00
Furniture and equipment at cost	3 000	00
Provision for depreciation: Furniture and equipment (1 October 20*x*4)	1 000	00
Bank overdraft	2 300	00
Loan from Southern Bank (long-term)	3 000	00
Accounts receivable	30 800	00
Accounts payable	24 000	00
Allowance for bad debts	1 400	00
Inventory (30 September 20*x*5)	22 700	00
Cost of sales	51 100	00
Sales	79 200	00
Sales returns	600	00
Bad debts	250	00
Railage on sales	650	00
Salaries	3 790	00
General expenses	6 810	00
Interest on bank overdraft	200	00

Adjustments and other information:

1. On 30 September 20*x*5, a receivable paid his account of R1 200. Although the money had been deposited at the bank, no entries were made for this transaction.
2. The salaries amount is for an employee who joined Thando Traders six months ago. His salary for September has still not been paid on 30 September 20*x*5.
3. Depreciation on furniture and equipment is to be written off at 10% per annum on the diminishing-balance method. Furniture that cost R1 000 was bought on 1 July 20*x*5.
4. An amount of R600 must be written off as bad debts.
5. Adjust the allowance for bad debts to 5% of trade receivables.
6. The loan of R3 000 at Southern Bank was made on 1 February 20*x*5 and interest of R175 had not yet been paid.

You are required to:

1. Journalise adjustments 2 to 6.
2. Draft the trading account.
3. Draft the profit and loss account.

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Question 15.8

These balances and totals appeared in the books of Peters Parlour as at 28 February 20*x*6:

Bank	?	
Accounts receivable	44 300	00
Sales	145 000	00
Accounts payable	39 100	00
Inventory	32 800	00
Purchases	87 200	00
Salaries	15 300	00
General expenses	5 100	00
Interest paid: Mortgage	12 600	00
Interest paid: Other	2 300	00
Discount allowed	3 400	00
Repairs and maintenance	14 300	00
Capital	110 000	00
Mortgage loan (18%)	133 700	00
Land and buildings	?	
Vehicles	24 000	00
Accumulated depreciation: Vehicles	6 700	00

Additional information:

1 The bookkeeper had made these errors:
- Omitted a debit of R500 in determining the balance for general expenses.
- Overstated payables by R4 500 due to incorrect casting.
- Posted the payment of R1 700 for December salaries as a credit to Bank and a credit to salaries.
- Recorded cash sales of R500 as a debit to cash and a debit to the repairs and maintenance account.
- Posted interest paid on the mortgage loan of R6 300 as a debit to the capital portion of the mortgage loan and a credit to Bank.

2 Land and buildings were acquired on 1 July 20*x*3 and were financed by a 25% cash payment and a mortgage bond for the balance.
- The mortgage bond is repayable annually in arrears on 28 February over 12 years.
- The final partial payment is due on 30 June 20*x*6.
- The instalment due on 1 March 20*x*6 has been included with accounts payable in the trial balance.
- Interest at 18% per annum is repayable quarterly in arrears on 1 March, 1 June, 1 September and 1 December.
- No further land and buildings were acquired. Land and buildings are not depreciated.

3 Repairs and maintenance include these expenses:
- Erection of new wall R8 000
- Painting of building R3 200

4 Depreciation on vehicles is calculated at 10% per annum on the diminishing-balance method. A vehicle that cost R9 600 was acquired on 30 November 20*x*5 and no vehicles were sold during the year.

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5 Goods received amounting to R8 900 have not been raised. The merchandise was included in the inventory count on 28 February 20*x*6 that resulted in a physical closing inventory value of R23 700.

6 Two receivables have been liquidated:
   – XYZ Enterprises R6 300
   – Dicey Company R3 400

   A liquidation dividend of 15c in the R1, from Dicey Company, was received and banked on 28 February 20*x*6.

   Further receivables of R4 600 are considered doubtful.

You are required to:

1 As far as the information provided allows, prepare the general journal entries for adjustments 1 to 6 above.
2 Calculate the cost of land and buildings.
3 Prepare a post-adjustment trial balance at 28 February 20*x*6 (before adjusting for closing inventory).
4 Prepare the trading account for Peters Parlours.
5 Prepare the profit and loss account for Peters Parlours.

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16 FINANCIAL STATEMENTS

Chapter objectives

By the end of this chapter, you should be able to:

- Calculate and post the reversing adjustments in the new financial year.
- Prepare the financial statements of a sole proprietor on the accrual basis.
- Use a worksheet as a tool to draft the financial statements.
- Show the general ledger accounts after reversing the adjustments made in the previous financial year.

Chapter outline

1	INTRODUCTION	16 – 2
2	FINANCIAL STATEMENTS	16 – 2
3	WORKSHEETS	16 – 7
	Procedures for completing a worksheet	16 – 7
4	CHAPTER ILLUSTRATIVE EXAMPLE	16 – 7
5	REVERSING ADJUSTMENTS IN THE NEW FINANCIAL YEAR	16 – 15
6	SUMMARY	16 – 17

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1 Introduction

In Chapter 15, we started with the pre-adjustment trial balance. We explained the entries for accrued expenses, prepaid expenses, accrued income and income received in advance and showed the post-adjustment trial balance. We also introduced the trading account used to calculate the gross profit, and the profit and loss account used to calculate the net profit.

In this chapter, we go a step further by drawing up the financial statements. We will only concentrate on the financial statements of a sole proprietor. Financial statements of other business forms will be discussed in later chapters.

2 Financial statements

The financial statements of a sole proprietor consist of a statement of profit or loss & other comprehensive income and a statement of financial position, together with explanatory notes and a statement of cash flow.

The statement of profit or loss & other comprehensive income

The statement of profit or loss & other comprehensive income is a report setting out the results of the operations of a business. The heading is therefore 'statement of profit or loss & other comprehensive income for the year/month/period ended ...'.

Normally, the statement of profit or loss & other comprehensive income is prepared for a year, and will report on all the income received and accrued and expenses incurred for that year. If the sole proprietor started the business during the current year or decided to change the year end of the business, the statement of profit or loss & other comprehensive income may be drafted for a period of less than a year.

The statement of profit or loss & other comprehensive income of a sole proprietor is prepared from the post-adjustment trial balance. Only the nominal accounts are used to draw up the statement of profit or loss & other comprehensive income.

The nominal accounts section of the post-adjustment trial balance as prepared in Chapter 15 (Example 15.5) is used in Figure 16.1 to explain the drafting of the statement of profit or loss & other comprehensive income of a sole proprietor. (Note that the figures are merely transferred to the statement of profit or loss & other comprehensive income.)

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Figure 16.1

Wonder Traders
POST-ADJUSTMENT TRIAL BALANCE AS AT 30 JUNE 20*x*2

Details	Fol.	Debit		Credit	
Nominal Accounts Section					
Sales	N1			56 416	00
Purchases	N2	28 766	00		
Railage (in)	N3	2 000	00		
Storage cost	N4	3 000	00		
Vehicle expenses	N5	429	00		
Rent expense	N6	1 200	00		
Salaries	N7	1 100	00		
Rent income (12 000 – 4 000)	N8			8 000	00
Advertisements	N9	390	00		
Stationery (4 250 – 650)	N10	3 600	00		
Telephone (764 + 70)	N11	834	00		
Interest income (600 + 300)	N12			900	00
Royalty income	N13			2 400	00
Interest expense (1 125 + 375)	N14	1 500	00		
Insurance (1 800 – 1 350)	N15	450	00		

Opening inventory was R5 440 and closing inventory R3 900. The statement of profit or loss & other comprehensive income is set out in Figure 16.2.

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Figure 16.2

Wonder Traders
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20x2

	Notes	20x2			
Sales (net)				56 416	00
Cost of sales				(35 306	00)
Opening inventory		5 440	00		
Purchases		28 766	00		
Railage (inwards)		2 000	00		
Storage cost		3 000	00		
Goods available for sale		39 206	00		
Less: Closing inventory		(3 900	00)		
Gross profit				21 110	00
Other operating income				10 400	00
Rent income		8 000	00		
Royalty income		2 400	00		
Gross operating income				31 510	00
Operating expenses				(8 003	00)
Vehicle expenses		429	00		
Rent expense		1 200	00		
Salaries		1 100	00		
Advertisements		390	00		
Telephone		834	00		
Insurance		450	00		
Stationery		3 600	00		
Operating profit before interest income and expense				23 507	00
Interest income				900	00
Operating profit before interest expense				24 407	00
Interest expense				(1 500	00)
NET PROFIT FOR THE PERIOD				22 907	00

Explanation

- The statement of profit or loss & other comprehensive income of a sole proprietor commences with the calculation of the cost of sales. The first part is the trading section and the last part the profit and loss section.
- All income and expenses are also shown in the statement of profit or loss & other comprehensive income, as a sole proprietor's statement of profit or loss & other comprehensive income is used mainly by the owner and is not publicly available like that of a company.
- No tax is shown in the statement of profit or loss & other comprehensive income of a sole proprietor, as the total income of the business is taxed in the hands of the owner (sole proprietor).

The statement of financial position

The statement of financial position reflects the financial position of the business on a specific date. The heading is therefore 'statement of financial position as *at* …'.

The statement of financial position of a sole proprietor is drawn up from the post-closing trial balance. The post-closing trial balance as prepared in Chapter 15 (Figure 15.5) and shown in Figure 16.3 on the next page is used to explain the drafting of the statement of financial position of a sole proprietor shown in Figure 16.4 on the next page.

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Figure 16.3

Wonder Traders
POST-CLOSING TRIAL BALANCE AS AT 30 JUNE 20x2

Details	Fol.	Debit		Credit	
Real Accounts Section					
Capital: S. Wonder (307 000 + 22 907)	B1			329 907	00
Land and buildings	B2	200 200	00		
Vehicles	B3	90 000	00		
Equipment	B4	41 350	00		
Accounts receivable	B5	20 000	00		
Allowance for bad debts	B6			2 000	00
Accounts payable	B7			22 080	00
Bank	B8	1 532	00		
Investment	B9	1 000	00		
Petty cash	B10	150	00		
Inventory (30 June 20x2)	B11	3 900	00		
Long-term loan (15%)	B12			10 000	00
15% fixed deposit	B13	8 000	00		
Accrued expenses	B14			445	00
Prepaid insurance	B15	1 350	00		
Stationery (asset)	B16	650	00		
Accrued income	B17	300	00		
Income received in advance	B18			4 000	00
		368 432	00	368 432	00

Figure 16.4

Wonder Traders
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x2

	Notes	20x2			
ASSETS					
Non-current assets				340 550	00
Tangible/Fixed assets					
Land and buildings		200 200	00		
Vehicles		90 000	00		
Equipment		41 350	00		
Investments/Financial assets					
15% fixed deposit		8 000	00		
Share investments		1 000	00		
Current assets				25 882	00
Inventories (3 900 + 650)		4 550	00		
Trade and other receivables (20 000 + 1 350 + 300 – 2 000)		19 650	00		
Cash and cash equivalents (1 532 + 150)		1 682	00		
TOTAL ASSETS				366 432	00
EQUITY AND LIABILITIES					
Capital and reserves				329 907	00
Capital (1 July 20x1)		307 000	00		
Add: Net profit for the year		22 907	00		
Less: Drawings		0	00		
Non-current liabilities				10 000	00
Long-term loan (15%)		10 000	00		
Current liabilities				26 525	00
Trade and other payables (22 080 + 445 + 4 000)		26 525	00		
TOTAL EQUITY AND LIABILITIES				366 432	00

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Explanation

- Accounts receivable shows the total of all receivables, prepaid insurance and accrued income less the allowance for bad debts. Note that bad debts are deducted from accounts receivable and are not shown separately.
- Accounts payable shows the total of all payables, accrued expenses and income received in advance.
- The movement in equity can also be shown in a statement of changes in equity.

A statement of cash flow may also be useful to a sole proprietor and can be added to the set of financial statements. Statements of cash flow are explained in Chapter 21.

Service businesses, for example professionals such as doctors, accountants, engineers and hairdressers, render services and do not trade in products. The net profit is, therefore, calculated by subtracting the expenses from the income:

Net profit = sales – expenses

The statement of profit or loss & other comprehensive income of a sole proprietor operating as a service business is shown in Example 16.1.

Example 16.1

Mr James Ndlovu, an estate agent, provides you with this list of income and expenses for the period 1 March 20*x*8 to 28 February 20*x*9, and asks you to prepare a statement of profit or loss & other comprehensive income for the year.

Commission received	87 500	00
Rent income	3 750	00
Wages	32 900	00
Advertisements	1 625	00
Vehicle expenses	2 500	00
Water and electricity	5 225	00
Advertising	9 257	00
Legal costs	2 369	00

Mr J. Ndlovu
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 28 FEBRUARY 20*x*9

	Notes	20*x*9	
Sales		91 250	00
Commission received		3 750	00
Rent income		87 500	00
Operating expenses		(53 876	00)
Wages		32 900	00
Advertisements		1 625	00
Vehicle expenses		2 500	00
Water and electricity		5 225	00
Advertising		9 257	00
Legal costs		2 369	00
NET PROFIT FOR THE PERIOD		37 374	00

Explanation

No cost of sales is calculated, as an estate agent does not have products; instead they render a service.

You should be able to complete Questions 16.2 to 16.5.

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3 Worksheets

Worksheets are used by accountants to pass the final year-end adjustments and draft the statement of profit or loss & other comprehensive income and statement of financial position.

A worksheet can be used in drafting any set of financial statements, but is especially effective when many late year-end adjustments are required. As the debits and credits of all such adjusting journal entries are regularly balanced when using the worksheet, this ensures that the financial statements remain in balance.

A typical worksheet usually consists of a column for general ledger account descriptions and five main columns that are all subdivided into debit and credit columns. These debit and credit columns for each main column should balance at the completion of each of the worksheets. Figure 16.5 shows the format of a worksheet.

Figure 16.5

FORMAT OF A WORKSHEET

General ledger		COLUMN 1		COLUMN 2		COLUMN 3		COLUMN 4		COLUMN 5	
		Pre-adjustment trial balance		Adjustments		Post-adjustment trial balance		Statement of profit or loss & other comprehensive income		Statement of financial position	
Fol.	Account	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit

Procedures for completing a worksheet

If a worksheet is used to draft the financial statements of a business, these steps should be followed:

1. Extract the pre-adjustment trial balance from the general ledger, write the account descriptions and balances in the worksheet (Column 1) and check if the total of the debit column equals the total of the credit column.
2. Journalise the final adjustments in the general journal.
3. Post the journal entries to the adjustments column (Column 2) of the worksheet. Check if the debit and credit totals in Column 2 are in balance.
4. Complete the post-adjustment trial balance (Column 3) by adding the pre-adjustment trial balance column (Column 1) and the adjustment column (Column 2), and by checking if the post-adjustment trial balance in Column 3 is in balance in the debits and credits columns.
5. Extend the post-adjustment trial balance totals to either the statement of profit or loss & other comprehensive income (nominal accounts in Column 4) or statement of financial position (real accounts in Column 5).
6. Total the debit and credit columns of the statement of profit or loss & other comprehensive income. The balancing figure should be the profit and loss for the year.
7. Post the profit or loss figure from the statement of profit or loss & other comprehensive income to the statement of financial position (a debit to the statement of profit or loss & other comprehensive income will result in a credit to the statement of financial position and vice versa).
8. Check if the statement of financial position debit and credit columns are now in balance.

4 Chapter illustrative example

The pre-adjustment trial balance of Browne and Spies Traders as at 31 December 20*x*5 is given on the next page.

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BROWNE AND SPIES TRADERS WORKSHEET

General ledger		COLUMN 1		COLUMN 2		COLUMN 3		COLUMN 4		COLUMN 5	
		Pre-adjustment trial balance		Adjustments		Post-adjustment trial balance		Statement of profit or loss & other comprehensive income		Statement of financial position	
Fol.	Account	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
B1	Capital		130 000 00								
B2	Drawings	11 000 00									
B3	8% mortgage bond		50 000 00								
B4	Accounts payable		90 000 00								
B5	Land and buildings	81 000 00									
B6	Furniture and fittings	14 000 00									
B7	Inventory (open)	100 000 00									
B8	Fixed deposit	37 200 00									
B9	Accounts receivable	82 000 00									
B10	Bank	14 000 00									
N1	Sales		500 000 00								
N2	Purchases	283 000 00									
N3	Railage (inwards)	5 000 00									
N4	Rent income		2 400 00								
N5	Interest income		800 00								
N6	Advertisements	9 800 00									
N7	Insurance	5 000 00									
N8	Bad debts	2 600 00									
N9	Admin expenses	30 000 00									
N10	Rates and taxes	9 600 00									
N11	Interest expense	3 000 00									
N12	Electricity and telephone	10 000 00									
N13	Salaries and wages	76 000 00									
		773 200 00	773 200 00								

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Additional information (year-end adjustments):

A On 1 August 20*x*5, Browne and Spies let part of their premises to Olympia Traders for 12 months. A cheque for R2 400 was received on that date for the entire year's rent.

B The interest on the fixed deposit that has not yet been received, R1 060.

C An amount of R3 500 of the insurance expense was prepaid.

D Advertising expenses included a payment of R2 400 made to the *Illustrated News Magazine* for advertising to be published from March 20*x*6.

E Salaries and wages earned by employees but not yet paid at 31 December 20*x*5, R800.

F Interest on the mortgage bond is payable quarterly in arrears on the first day of January, April, July and October. The bond was raised on 1 January 20*x*5. No repayment of capital was made during the year.

G Furniture and fittings should be depreciated by R1 400.

H Closing inventory on 31 December 20*x*5 was R72 000.

You are required to:

1 Prepare the necessary adjusting entries to record the above transactions.

2 Enter the adjusting entries on the worksheet and complete the worksheet.

3 Prepare the closing entries for Browne and Spies for the year ended 31 December 20*x*5.

4 Draft the annual financial statements in a suitable form.

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Adj.	Details	Fol.	Debit		Credit	
A	Rent income	N4	1 400	00		
	Income received in advance	B11			1 400	00
	Rent income in advance (7 ÷ 12 × 2 400)					
B	Accrued income	B12	1 060	00		
	Interest income	N5			1 060	00
	Interest on fixed deposit not yet received					
C	Prepaid expenses	B13	3 500	00		
	Insurance	N7			3 500	00
	Insurance paid in advance					
D	Prepaid expenses	B13	2 400	00		
	Advertisements	N6			2 400	00
	Advertising paid in advance					
E	Salaries and wages	N13	800	00		
	Accrued expenses	B14			800	00
	Salaries and wages not yet paid					
F	Interest expense	N11	1 000	00		
	Accrued expenses	B14			1 000	00
	Interest owed not yet paid (8% × 50 000 × 3 ÷ 12)					
G	Depreciation	N14	1 400	00		
	Accumulated depreciation: Furniture and fittings	B15			1 400	00
	Depreciation for the year					
H	Inventory (closing inventory)	B7	72 000	00		
	Trading account	F1			72 000	00
	Closing inventory raised					

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BROWNE AND SPIES TRADERS WORKSHEET

General ledger		COLUMN 1 Pre-adjustment trial balance		COLUMN 2 Adjustments		COLUMN 3 Post-adjustment trial balance		COLUMN 4 Statement of profit or loss & other comprehensive income		COLUMN 5 Statement of financial position	
Fol.	Account	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
B1	Capital		130 000 00				130 000 00				
B2	Drawings	11 000 00				11 000 00					
B3	8% mortgage bond		50 000 00				50 000 00				
B4	Accounts payable		90 000 00				90 000 00				
B5	Land and buildings	81 000 00				81 000 00					
B6	Furniture and fittings	14 000 00				14 000 00					
B7	Inventory (open)	100 000 00			H 72 000 00	100 000 00	72 000 00				
B8	Fixed deposit	37 200 00				37 200 00					
B9	Accounts receivable	82 000 00				82 000 00					
B10	Bank	14 000 00				14 000 00					
N1	Sales		500 000 00				500 000 00				
N2	Purchases	283 000 00				283 000 00					
N3	Railage (inwards)	5 000 00				5 000 00					
N4	Rent income		2 400 00	A 1 400 00			1 000 00				
N5	Interest income		800 00		B 1 060 00		1 860 00				
N6	Advertisements	9 800 00			D 2 400 00	7 400 00					
N7	Insurance	5 000 00			C 3 500 00	1 500 00					
N8	Bad debts	2 600 00				2 600 00					
N9	Admin expenses	30 000 00				30 000 00					
N10	Rates and taxes	9 600 00				9 600 00					
N11	Interest expense	3 000 00		F 1 000 00		4 000 00					
N12	Electricity and telephone	10 000 00				10 000 00					
N13	Salaries and wages	76 000 00		E 800 00		76 800 00					
		773 200 00	773 200 00								
B11	Income received in advance				A 1 400 00		1 400 00				
B12	Accrued income			B 1 060 00		1 060 00					
B13	Prepaid expenses			C 3 500 00		5 900 00					
				D 2 400 00							
B14	Accrued expenses				E 800 00		1 800 00				
					F 1 000 00						
B15	Accumulated depreciation: Furniture and fittings				G 1 400 00		1 400 00				
B7	Inventory (close)			H 72 000 00		72 000 00					
N14	Depreciation			G 1 400 00		1 400 00					
				83 560 00	83 560 00	849 460 00	849 460 00				

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Drafting the worksheet

- Transfer the adjustments to the worksheet and check if the total of the debit entries equals the total of the credit entries.
- Complete the post-adjustment trial balance by adding the pre-adjustment trial balance and the adjustments. Then check the balancing of the debit and credit columns.

Explanation

- New accounts are opened at the bottom of the worksheet as needed.
- The adjustments are shown by letters of the alphabet in Column 2.
- The journal entry for closing inventory should be credited to the trading account as per adjustment H. As the opening inventory will also be allocated to the trading account, these two entries are shown together in the inventory account, instead of opening a separate account for it.
- Note that Columns 1, 2 and 3 balance.

The worksheet can now be completed by following these steps:

1 Extend the post-adjustment trial balance amounts (Column 3) to the statement of profit or loss & other comprehensive income or statement of financial position columns (Columns 4 and 5 respectively).

2 Calculate the balancing figure on the statement of profit or loss & other comprehensive income, being either the profit or the loss for the year.

3 Balance the statement of profit or loss & other comprehensive income debit and credit columns with the profit or loss figure.

4 Post the other leg of the profit and loss entry to the statement of financial position and balance the debit and credit columns of the statement of financial position.

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BROWNE AND SPIES TRADERS WORKSHEET

General ledger		COLUMN 1		COLUMN 2		COLUMN 3		COLUMN 4		COLUMN 5	
		Pre-adjustment trial balance		Adjustments		Post-adjustment trial balance		Statement of profit or loss & other comprehensive income		Statement of financial position	
Fol.	Account	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
B1	Capital		130 000 00				130 000 00				130 000 00
B2	Drawings	11 000 00				11 000 00				11 000 00	
B3	8% mortgage bond		50 000 00				50 000 00				50 000 00
B4	Accounts payable		90 000 00				90 000 00				90 000 00
B5	Land and buildings	81 000 00				81 000 00				81 000 00	
B6	Furniture and fittings	14 000 00				14 000 00				14 000 00	
B7	Inventory (open)	100 000 00			H 72 000 00	100 000 00	72 000 00	100 000 00	72 000 00		
B8	Fixed deposit	37 200 00				37 200 00				37 200 00	
B9	Accounts receivable	82 000 00				82 000 00				82 000 00	
B10	Bank	14 000 00				14 000 00				14 000 00	
N1	Sales		500 000 00				500 000 00		500 000 00		
N2	Purchases	283 000 00				283 000 00		283 000 00			
N3	Railage (inwards)	5 000 00				5 000 00		5 000 00			
N4	Rent income		2 400 00	A 1 400 00			1 000 00		1 000 00		
N5	Interest income		800 00		B 1 060 00		1 860 00		1 860 00		
N6	Advertisements	9 800 00			D 2 400 00	7 400 00		7 400 00			
N7	Insurance	5 000 00			C 3 500 00	1 500 00		1 500 00			
N8	Bad debts	2 600 00				2 600 00		2 600 00			
N9	Admin expenses	30 000 00				30 000 00		30 000 00			
N10	Rates and taxes	9 600 00				9 600 00		9 600 00			
N11	Interest expense	3 000 00		F 1 000 00		4 000 00		4 000 00			
N12	Electricity and telephone	10 000 00				10 000 00		10 000 00			
N13	Salaries and wages	76 000 00		E 800 00		76 800 00		76 800 00			
		773 200 00	773 200 00								
B11	Income received in advance				A 1 400 00		1 400 00				1 400 00
B12	Accrued income			B 1 060 00		1 060 00				1 060 00	
B13	Prepaid expenses			C 3 500 00		5 900 00				5 900 00	
				D 2 400 00							
B14	Accrued expenses				E 800 00		1 800 00				1 800 00
					F 1 000 00						
B15	Accumulated depreciation: Furniture and fittings				G 1 400 00		1 400 00				1 400 00
B7	Inventory (close)			H 72 000 00		72 000 00				72 000 00	
N14	Depreciation			G 1 400 00		1 400 00		1 400 00			
	Net profit for the year							43 560 00			43 560 00
				83 560 00	83 560 00	848 060 00	848 060 00	574 860 00	574 860 00	318 160 00	318 160 00

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Explanation

- The post-adjustment trial balance in Column 3 is split into statement of profit or loss & other comprehensive income accounts and statement of financial position accounts, which are allocated to the statement of profit or loss & other comprehensive income (Column 4) and to the statement of financial position (Column 5).
- To balance the statement of profit or loss & other comprehensive income, a debit amount of R43 560 should be included. Therefore, a credit amount of R43 560 will be included in the statement of financial position. As owner's equity increases by R43 560, you can see that the company has made a profit of R43 560. (The reverse is true for a loss.)

Once the worksheet is complete, the statement of profit or loss & other comprehensive income and statement of financial position can be drafted by transferring the amounts in the last two columns into the standard format for a statement of profit or loss & other comprehensive income and a statement of financial position.

Browne and Spies Traders
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20x5

	Notes	20x5	
Sales (net)		500 000	00
Cost of sales		(316 000	00)
Gross profit		184 000	00
Other operating income		1 000	00
Rent income		1 000	00
Gross operating income		185 000	00
Operating expenses		(139 300	00)
Advertisements		7 400	00
Insurance		1 500	00
Bad debts		2 600	00
Admin expenses		30 000	00
Rates and taxes		9 600	00
Electricity and telephone		10 000	00
Salaries and wages		76 800	00
Depreciation		1 400	00
Operating profit before interest income and expense		45 700	00
Interest income		1 860	00
Operating profit before interest expense		47 560	00
Interest expense		(4 000	00)
NET PROFIT FOR THE PERIOD		43 560	00

Browne and Spies Traders
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x5

	Notes	20x5	
ASSETS			
Non-current assets		130 800	00
Tangible/Fixed assets			
Land and buildings		81 000	00
Furniture and fittings		12 600	00
Investments/Financial assets			
Fixed deposit		37 200	00
Current assets		174 960	00

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Inventories		72 000	00
Trade and other receivables (82 000 + 1 060 + 5 900)		88 960	00
Cash and cash equivalents		14 000	00
TOTAL ASSETS		305 760	00

EQUITY AND LIABILITIES			
Capital and reserves		162 560	00
Capital (1 July 20*x*1)		130 000	00
Add: Net profit for the year		43 560	00
Less: Drawings		(11 000	00)
Non-current liabilities		50 000	00
8% mortgage bond		50 000	00
Current liabilities		93 200	00
Trade and other payables (90 000 + 1 400 + 1 800)		93 200	00
TOTAL EQUITY AND LIABILITIES		305 760	00

Explanation

Cost of sales is calculated like this:

Opening inventory	100 000	00
Purchases	283 000	00
Railage (inwards)	5 000	00
	388 000	00
Less: Closing inventory	72 000	00)
COST OF SALES	316 000	00

Get the closing journal entries from the worksheet by analysing the statement of profit or loss & other comprehensive income column. The closing entries for this example are:

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Day	Details	Fol.	Debit		Credit	
30/12	Sales	N1	500 000	00		
	Closing inventory	B7	72 000	00		
	Purchases	N3			283 000	00
	Opening inventory	B7			100 000	00
	Railage (inwards)	N3			5 000	00
	Trading account	F1			184 000	00
	Closing off nominal accounts to the trading account					
	Trading account	F1	184 000	00		
	Profit and loss account	B11			184 000	00
	Transfer of gross profit					
	Rent income	N4	1 000	00		
	Interest income	N5	1 860	00		
	Profit and loss account	F2	140 440	00		
	Advertisements	N6			7 400	00
	Insurance	N7			1 500	00
	Bad debts	N8			2 600	00
	Admin expenses	N9			30 000	00
	Rates and taxes	N10			9 600	00
	Interest expense	N11			4 000	00
	Electricity and telephone	N12			10 000	00
	Salaries and wages	N13			76 800	00

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	Depreciation	N14			1 400	00
	Closing entries					
	Profit and loss account	F2	43 560	00		
	Capital	B1			43 560	00
	Transfer of net profit to the capital account					

It should be clear by now that the main advantages of using a worksheet are:

- Regular checking of the debit and credit totals ensures that the financial statements remain in balance. Errors affecting the balancing of the financial statements can then be easily identified and corrected.
- Most of the information needed to drafting the statement of financial position and statement of profit or loss & other comprehensive income can be derived from Columns 4 and 5 of the worksheet.
- Adjusting entries are highlighted and may be traced back to the original entries in the general journal.
- When late entries are passed, the statement of financial position and statement of profit or loss & other comprehensive income can be updated fairly easily.
- The closing entries can be found in Column 4 of the worksheet.

Reminder

The post-closing trial balance can be prepared from the information in Column 5.

Refer to Chapter 15 for an explanation of the post-closing trial balance.

You should be able to complete Questions 16.6 to 16.11.

5 Reversing adjustments in the new financial year

Once the annual financial statements have been prepared, the closing entries have been passed and a post-closing trial balance prepared, the accrual and prepaid accounts have achieved their purpose of ensuring correct matching at financial year end.

How these accounts are treated in the following year requires sound insight into the procedures used so far.

As the accrual and prepaid accounts are considered to be temporary, it follows that they must be eliminated early in the new financial year. This is done by reversing the entries.

Once the principle is understood, together with the underlying logic, it can be generalised to apply to all such adjustments.

Example 16.2

Axel Engineering had a balance of R295 in their telephone account at the end of the financial year 30 June 20*x*2. It was estimated that R25 had accrued but was not recorded in June.

1 The first step is to pass the adjusting entry at 30 June 20*x*2 with this effect on the telephone and accrued expenses accounts.

General Ledger of Axel Engineering
Real Accounts Section
ACCRUED EXPENSES B13

Dr.						Cr.					
						Jun.	30	Telephone	GJ12	25	00

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Nominal Accounts Section

TELEPHONE **N11**

Jun.	1	Total	b/d	295	00						
	30	Accrued expenses	GJ12	25	00						
				320	00						

2 The second step occurs when the closing transfers are posted, which would affect the telephone account like this:

Nominal Accounts Section

Dr. **TELEPHONE** **N11** **Cr.**

Jun.	1	Total	b/d	295	00	Jun.	1	Profit and loss	GJ12	320	00
	30	Accrued exp.	GJ12	25	00						
				320	00					320	00

3 In the new financial year the adjustment is reversed like this:

Real Accounts Section

Dr. **ACCRUED EXPENSES** **B13** **Cr.**

Jul.	1	Telephone	GJ1	25	00	Jun.	30	Telephone	GJ12	25	00

Nominal Accounts Section

TELEPHONE **N11**

						Jul.	1	Accrued expenses	GJ1	25	00

4 From the above, it appears unusual that the telephone account has a credit balance. This is unusual but does not last for long. As soon as the actual invoice for the telephone is received and payment made, assume for R27, the account will change like this:

Nominal Accounts Section

Dr. **TELEPHONE** **N11** **Cr.**

Jul.	31	Bank	CPJ1	27	00	Jul.	1	Accrued expenses	GJ1	25	00
							31	Total	c/d	2	00
				27	00					27	00
Aug.	1	Total	b/d	2	00						

Explanation

- If the invoice for the telephone had been exactly R25, the telephone account would have no balance. This would be correct because there has, as yet, been no telephone expense for the current year.
  - Because we are seldom able to forecast accrued expenses exactly, the difference of R2 in this example will have to remain as a current year expense although it really relates to the previous year.
  - This is another example of where estimates have to be made when attempting to report financial information and complying with the matching and accrued concepts.
- This treatment applies to accrued expenses, accrued income, prepaid expenses and income received in advance. These closing entries are reversed at the beginning of the following financial year.

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6 Summary

At the end of the financial year, the aim is to report as accurately as possible within the accounting model the financial performance and financial position of the business.

A worksheet is a convenient method for calculating and displaying the necessary figures to be used in the annual financial statements and to close off the statement of profit or loss & other comprehensive income (or nominal) accounts in the accounting records.

QUESTIONS

Question 16.1

What is the purpose of reversing accruals and prepayments at the beginning of a new year? Give suitable examples in your explanation.

Question 16.2

Use the trial balance of Unisex Hairdressing Salon as at 31 May 20*x*3, to draft the:

1 Statement of profit or loss & other comprehensive income.

2 Statement of financial position.

Unisex Hairdressing Salon
TRIAL BALANCE AS AT 31 MAY 20*x*3

Details	Fol.	Debit		Credit	
Bank	B1			1 350	00
Capital	B2			56 000	00
Drawings	B3	5 000	00		
Premises	B4	80 000	00		
Operations equipment	B5	10 000	00		
Cash	B6			100	00
Loan from Trust Bank	B7			15 000	00
Accounts receivable	B8	150	00		
Accounts payable	B9			2 500	00
Consumable stores	N1	1 400	00		
Wages and salaries	N2	10 000	00		
Office cleaning expense	N3	400	00		
Rent income	N4			12 000	00
Fee income	N5			24 000	00
Stationery	N6	600	00		
Interest on loan	N7	500	00		
		109 500	00	109 500	00

Question 16.3

Mr Slow Dohe died early in March 20*x*6 before having drafted his financial statements for the year ended 28 February 20*x*6.

You are able to establish some information from his books and records:

1 The trial balance as at 28 February 20*x*5 was:

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Slow Dohe
TRIAL BALANCE AS AT 28 FEBRUARY 20x5

Details	Fol.	Debit		Credit	
Capital	B1			5 000	00
Accumulated depreciation: Furniture and equipment	B2			1 750	00
Inventory	B3	4 450	00		
Accounts receivable	B4	3 680	00		
Accounts payable	B5			3 950	00
Bank	B6			290	00
Furniture and equipment (at cost)	B7	2 860	00		
		10 990	00	10 990	00

2 A list of receivables as at 28 February 20x6 showed a total balance of R5 670, but receivables totalling R1 005 should be written off.
3 Drawings for the year, R8 335.
4 Inventory at 28 February 20x6 was valued at R6 900.
5 Accounts payable and accruals at 28 February 20x6, R5 175.
6 These transactions were recorded in the furniture account:
   – Purchases for R650.
   – Sold furniture (cost R500 and accumulated depreciation R490) for R50.
   – Furniture and equipment on hand at year end is to be depreciated by R595.
7 The bank account at 28 February 20x6 showed an overdraft of R1 280. A deposit of R3 400 (directly with the bank) was only credited by the bank account on 1 March 20x6.

You are required to:
1 Calculate the net profit/loss for the year. (Calculations must be clear and neat.)
2 Draft the statement of financial position as at 28 February 20x6.

Question 16.4

These balances were extracted from the pre-adjustment trial balance of Mark Nkosi, a general dealer, on 31 December 20x4:

Details	R	c
Capital	39 000	00
Drawings	7 000	00
Delivery expenses on sales	582	00
Insurance	150	00
Rates	270	00
Salaries and wages	7 300	00
Railage on purchases	540	00
Telephone	250	00
Repairs	400	00
Stationery and printing	208	00
Office cleaning expense	180	00
Rent income	440	00
Inventory (1 January 20x4)	8 370	00
Purchases	26 850	00
Sales	50 682	00
Returns inwards	190	00
Returns outwards	220	00

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Accounts receivable	6 830	00
Mortgage bond on land and buildings	10 000	00
Bank overdraft	1 200	00
Cash on hand	92	00
Accounts payable	6 300	00
Furniture and fittings (at cost)	6 400	00
Land and buildings (at cost)	43 000	00
Accumulated depreciation: Furniture	1 000	00
Allowance for bad debts	150	00

Additional information:

1 Inventory on 31 December 20*x*4:
- Merchandise R9 560
- Stationery R54

2 Nkosi, in his own capacity, donated goods at cost to the local high school, R30.

3 Assessment rates amount to R310 per annum.

4 Salary of R150 per month is still payable to an employee for December 20*x*4.

5 A section of the buildings was rented from 1 January 20*x*4 for R40 per month.

6 On checking the receivables accounts, it is found that debts of R130 must be written off.

7 Adjust the allowance for bad debts to 5% of receivables.

8 Calculate depreciation on furniture and fittings at 10% per annum on the diminishing balance.

9 The mortgage bond started on 1 October 20*x*4. Interest at 18% is payable on 1 September and 1 February each year.

10 Calculate interest on capital at 16% per annum taking into consideration that Nkosi brought R2 000 new capital into the business on 1 July 20*x*4.

You are required to:

1 Prepare the statement of profit or loss & other comprehensive income for the financial year ended 31 December 20*x*4.

2 Draft the statement of financial position as at 31 December 20*x*4.

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Question 16.5

Here is the trial balance of North Traders as at 31 December 20*x*0 (financial year end):

North Traders
TRIAL BALANCE AS AT 31 DECEMBER 20*x*0

Details	Fol.	Debit		Credit	
Capital	B1			30 000	00
Drawings	B2	6 000	00		
Land and buildings	B3	24 000	00		
Fixtures and fittings	B4	4 000	00		
9% mortgage bond	B5	5 000	00		
Accounts receivable	B6	1 425	00		
Bank	B7			2 000	00
Sales	N1			40 000	00
Purchases	N2	20 000	00		
Rent income	N3			3 600	00
Interest income	N4			225	00
Wages and salaries	N5	9 400	00		
Office expenses	N6	6 000	00		
		75 825	00	75 825	00

Additional information:

- The business lets a portion of its premises at a monthly rent of R300. The property was first let on 1 April 20*x*0 and the lessee pays the rent quarterly, in advance.
- On 1 January 20*x*0 the business lent R5 000 to one of its main suppliers for a three-year period. Interest on the loan is payable half-yearly, in arrears, on 1 July and 1 January until the loan is repaid.
- Wages amounting to R600 were earned by the business's employees in December 20*x*0 but were only paid on 3 January 20*x*1.
- The inventory of unused office stationery on hand at 31 December 20*x*0 was R500. The cost of all stationery purchased is included in office expenses.
- Fixtures and fittings were purchased on 1 January 20*x*0, and are to be depreciated at 10% per annum calculated on original cost.
- The cost of unsold goods on hand at 31 December 20*x*0, as determined by an inventory count, was R3 250.
- R2 000 new capital was invested in the business on 1 July 20*x*4.

You are required to:

1. Record the adjusting journal entries.
2. Prepare the statement of profit or loss & other comprehensive income and the statement of financial position as at 31 December 20*x*0.

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Question 16.6

Here is the trial balance for Palace Industries as at 31 December 20*x*6:

Palace Industries
TRIAL BALANCE AS AT 31 DECEMBER 20*x*6

Details	Fol.	Debit		Credit	
Capital	B1			75 000	00
Drawings	B2	5 000	00		
8% mortgage bond	B3	25 000	00		
Accounts payable	B4			45 000	00
Land and buildings	B5	50 000	00		
Fixtures and fittings	B6	7 000	00		
Inventory (1 January 20*x*6)	B7	50 000	00		
Investment: Municipal stock	B8	18 600	00		
Accounts receivable	B9	41 000	00		
Bank	B10	7 000	00		
Sales	N1			270 000	00
Rent income	N2			1 200	00
Interest income	N3			400	00
Purchases	N4	161 500	00		
Carriage inwards	N5	3 000	00		
Advertising	N6	4 900	00		
Insurance	N7	2 500	00		
Admin expenses	N8	17 300	00		
Water and electricity	N9	4 000	00		
Rates and taxes	N10	4 800	00		
Wages	N11	38 500	00		
Interest expense	N12	1 500	00		
		416 600	00	416 600	00

Additional information:

1. Interest earned on the municipal stock but not yet received is R620.
2. Advertising includes a payment of R1 400 made to the *Athlone Tribune* for advertisements to be published from 1 January 20*x*7.
3. R1 250 of the insurance expense is prepaid.
4. Wages earned by employees, but unpaid by 31 December 20*x*6, totalled R700.
5. On 1 August 20*x*6, Palooka Industries let a portion of its premises for 12 months and received a cheque for R1 200 for the entire year's rent.
6. Interest on the mortgage bond is payable quarterly in arrears on the first day of January, April, July and October. The bond was raised on 1 January 20*x*6 and there have been no payments of the capital sum.
7. Fixtures and fittings must be depreciated by R900.
8. Inventory on hand (at cost) on 31 December was R39 200.

You are required to:

1. Prepare the adjusting journal entries for the additional information.
2. Enter your adjusting entries on a worksheet and complete the worksheet.
3. Prepare the statement of profit or loss & other comprehensive income for the year ended 31 December 20*x*6.
4. Prepare the statement of financial position as at 31 December 20*x*6.

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Question 16.7

The trial balance of Leeway Investors as at 31 December 20*x*6 (financial year end), is given below together with additional information:

Leeway Investors
TRIAL BALANCE AS AT 31 DECEMBER 20*x*6

Details	Fol.	Debit		Credit	
Capital	B1			39 700	00
9% mortgage bond	B2			10 000	00
Land and buildings	B3	40 000	00		
Equipment (at cost)	B4	5 000	00		
Investments: Government bonds	B5	8 000	00		
Bank	B6	1 000	00		
Rent income	N1			12 775	00
Interest income	N2			325	00
Advertising	N3	600	00		
Salaries and wages	N4	6 000	00		
Office supplies	N5	1 600	00		
Interest expense	N6	600	00		
		62 800	00	62 800	00

Additional information:

1 Wages earned by employees in December 20*x*6 but only paid in 20*x*7 are R400.
2 Unused office supplies on hand at 31 December 20*x*6 total R250.
3 Interest owing on mortgage bond for 20*x*6 but not yet paid is R225.
4 Equipment, purchased 1 January 20*x*6, must be depreciated at the rate of 10% on cost.
5 Rent income in advance and not earned, R300.
6 Interest earned on government bonds but not yet received, R200.
7 Advertising costs paid that relate to the 20*x*7 financial year are R150.

You are required to:

1 Record adjustments 1 to 7 on a worksheet (add new accounts where necessary) and complete the worksheet.
2 Use the completed worksheet to prepare the annual financial statements.
3 Use the information from the worksheet to open all the ledger accounts you have listed. Then enter the trial balance figures and record adjustments 1 to 7.
4 Compare your adjusted account balances with those on the worksheet and pass the closing entries to the profit and loss account. Then balance the ledger accounts.

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Question 16.8

These balances and totals appeared in the books of Jack Spratt on 28 February 20*x*7:

Bank	11 020	00
Accounts receivable	15 800	00
Accounts payable	18 000	00
Land and buildings	50 000	00
20% mortgage bond	30 000	00
Investment: 18% government bonds	10 000	00
Equipment	8 000	00
Vehicles	6 500	00
Inventory	15 550	00
Purchases	86 200	00
Sales	154 300	00
Returns outwards	5 450	00
Freight inwards	6 230	00
Capital	55 000	00
Drawings	18 200	00
Advertising	2 100	00
Interest expense (mortgage bond)	4 500	00
Interest income	1 350	00
Salaries and wages	27 310	00
General expenses	620	00
Delivery expenses	2 070	00

On presentation to management of the trial balance, it was considered essential to take these items into account:

1 The inventory on hand on 28 February 20*x*7 (at cost), was valued at R24 800.

2 John Davidson, whose account has a debit balance of R1 000, has been declared insolvent. Correspondence from the liquidator of his estate states that a dividend of 30c in the R1 will definitely be received.

3 An amount of R750, written off as irrecoverable in the 20*x*6 financial year, was received during the current year and was posted to accounts payable.

4 The mortgage bond was raised on 1 March 20*x*6, and interest on it is payable quarterly in arrears.

5 The business has held the investment in government bonds for the past several years.

6 Advertising includes a payment of R600 made to *The Daily Bugle* for advertisements for the 20*x*7 calendar year.

7 Equipment must be depreciated at 25% per annum and vehicles by 20% per annum both using the straight-line method.

8 Included in general expenses is an amount of R320 for airfreight on purchases made.

9 During the year, Jack Spratt took inventory that cost R1 850 for his personal use and this was not recorded.

You are required to:

1 Enter the pre-adjustment trial balance of Jack Spratt on a worksheet.

2 Prepare journal entries (where necessary) to record the additional information supplied in adjustments 1 to 9.

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3 Enter your journal entries on the worksheet and complete the worksheet.
4 Draft the trading and statement of profit or loss & other comprehensive income of Jack Spratt for the year ended 28 February 20*x*7.
5 Prepare the statement of financial position as at 28 February 20*x*7.
6 Prepare the closing journal entries of John Spratt as at 28 February 20*x*7.

Question 16.9

These balances and totals are taken from the ledger of SA Moosa on 28 February 20*x*5:

Purchases	364 975	00
Railage on sales	5 642	00
Rates and taxes	4 320	00
Salaries and wages	67 420	00
Rent income	13 200	00
Sales	564 369	00
Telephone	3 622	00
Stationery	2 913	00
Office cleaning expense	4 360	00
Railage on purchases	3 696	00
Returns inwards	5 729	00
Accounts payable	16 733	00
Furniture at cost	24 364	00
Allowance for bad debts	3 600	00
Returns outwards	2 984	00
Accumulated depreciation: Furniture	1 464	00
Accumulated depreciation: Plant	13 000	00
Repairs	995	00
Insurance	1 985	00
Sales expenses	1 800	00
Bad debts	1 365	00
Accounts receivable	99 259	00
Drawings	14 360	00
Plant at cost	73 000	00
Inventory (1 March 20*x*4)	36 982	00

Additional information:

1 Inventory on 28 February 20*x*5, R42 029.
2 Rates and taxes are for the year ended 30 June 20*x*5.
3 Write off a receivable to the value of R965 as irrecoverable.
4 Provide depreciation as follows:
   – Furniture: 10% per annum on the diminishing-balance
   – Plant: 20% per annum on cost
5 Insurance includes a premium of R480 for the six months ended 30 June 20*x*5.
6 Adjust the allowance for bad debts to 5% of receivables.
7 One week's wages for R1 964 is outstanding.
8 Rent income is in arrears for one month.

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You are required to:
Prepare a statement of profit or loss & other comprehensive income, including the trading section, for the year ended 28 February 20*x*5.

Question 16.10

Here is the trial balance of Katrina's Kombuis as at 31 December 20*x*6.

It is Katrina's policy to determine selling prices by marking up all goods by 30% on cost, and to use the perpetual inventory system.

Katrina's Kombuis
TRIAL BALANCE AS AT 31 DECEMBER 20*x*6

Details	Fol.	Debit		Credit	
Accounts payable	B			9 340	00
Accounts receivable	B	12 000	00		
Accrued rent income (1 January 20*x*6)	B	200	00		
Bad debts	N	1 310	00		
Bank	B			2 500	00
Capital	B			73 000	00
Cost of sales	N	80 200	00		
Drawings	B	9 000	00		
Land and buildings (at cost)	B	50 000	00		
Vehicles	B	5 200	00		
Miscellaneous expenses	N	1 000	00		
Office supplies	N	1 350	00		
Allowance for bad debts (1 January 20*x*6)	B			400	00
Rent income	N			2 800	00
Sales	N			104 260	00
Salaries and wages	N	11 500	00		
Inventory	B	15 540	00		
		189 800	00	189 800	00

Additional information:

1 Goods ordered from a supplier on 10 December 20*x*6 were despatched on 20 December.
- The goods were awaiting collection at the Spoornet despatch warehouse on 28 December.
- The goods, with an invoice cost of R800, had not been recorded as a purchase by 31 December and were not collected by the business until 4 January 20*x*7.

2 On 31 December 20*x*6, a dissatisfied receivable had returned goods with a selling price of R260.
- Katrina decided to take the returned items for her own use and informed her bookkeeper.
- The bookkeeper had just journalised and posted an entry debiting drawings and crediting accounts receivable with R260.

3 During October 20*x*6, goods that cost R300 had been stolen from one of the business's delivery vehicles.
- The insurance company agreed to send a cheque for R250 in January 20*x*7, in full settlement of the claim.
- The above entries had not been recorded as at 31 December 20*x*6.

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4 A physical inventory count made after the close of business on 31 December 20*x*6 revealed inventory on hand at cost of R15 240. On the same date, unused office supplies were valued at R450.

5 A portion of the business's premises is leased to an accounting business for R200 per month. The rent of January 20*x*7 was received and banked on 30 December 20*x*6.

6 It is the business's policy to make an allowance for uncollectable receivables accounts at the end of each financial year. Experience has shown that an estimated 2% of the year-end accounts receivable balances will prove to be uncollectable.

7 On 30 September 20*x*6, a vehicle that was valued in the books at R4 000, was sold for R1 600 cash. The only entry recorded for this transaction was to debit the bank account and to credit the vehicles account with R1 600.

You are required to:

1 Record any corrections or adjustments that may be necessary on a worksheet.

2 Use the adjusted trial balance to prepare the statement of profit or loss & other comprehensive income for the 20*x*6 financial year.

3 Prepare a statement of financial position as at 31 December 20*x*6.

Question 16.11

Here is the trial balance of Angela's Antiques, a furniture dealer.

Angela Boshoff determines inventory values on a LIFO basis using the periodic method. Her marketing policy has been to consistently earn a gross profit of 40% of selling prices.

Angela's Antiques
TRIAL BALANCE AS AT 31 DECEMBER 20*x*1

Details	Fol.	Debit		Credit	
Accrued rent receivable (1 January 20*x*1)	B	800	00		
Accounts receivable	B	18 000	00		
Accrued interest received (1 January 20*x*1)	B	750	00		
Bank	B			4 609	00
Capital (1 January 20*x*1)	B			80 000	00
Drawings	B	9 600	00		
Interest income	N			1 500	00
Land and buildings (at cost)	B	40 000	00		
Loan at 10% p.a.	B	10 000	00		
Vehicles (at cost)	B	16 994	00		
Miscellaneous expenses	N	1 185	00		
Accumulated depreciation: Vehicles (1 January 20*x*1)	B			6 960	00
Allowance for bad debts	B	240	00		
Purchases	N	63 500	00		
Rent income	N			6 000	00
Returns of purchases and income	N	1 800	00	1 500	00
Railage (in)	N	3 000	00		
Salaries and wages	N	17 500	00		
Sales	N			101 800	00
Inventory (1 January 20*x*1)	B	19 000	00		
		202 369	00	202 369	00

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Angela's Antiques
TRIAL BALANCE AS AT 31 DECEMBER 20*x*1

Details	Fol.	Debit		Credit	
Accrued rent receivable (1 January 20*x*1)	B	800	00		
Accounts receivable	B	18 000	00		
Accrued interest received (1 January 20*x*1)	B	750	00		
Bank	B			4 609	00
Capital (1 January 20*x*1)	B			80 000	00
Drawings	B	9 600	00		
Interest income	N			1 500	00
Land and buildings (at cost)	B	40 000	00		
Loan at 10% p.a.	B	10 000	00		
Vehicles (at cost)	B	16 994	00		
Miscellaneous expenses	N	1 185	00		
Accumulated depreciation: Vehicles (1 January 20*x*1)	B			6 960	00
Allowance for bad debts	B	240	00		
Purchases	N	63 500	00		
Rent income	N			6 000	00
Returns of purchases and income	N	1 800	00	1 500	00
Railage (in)	N	3 000	00		
Salaries and wages	N	17 500	00		
Sales	N			101 800	00
Inventory (1 January 20*x*1)	B	19 000	00		
		202 369	00	202 369	00

Additional information:

1 Most of Boshoff's inventory on hand was destroyed in a fire that happened after the close of business on 31 December 20*x*1.
- A physical inventory count of the salvaged items was valued at R6 000.
- The inventory was insured for R20 000 by a standard fire policy that contained an 'average' clause.

2 Boshoff leases a portion of her building to a tenant for a monthly rent of R400.

3 On 1 January 20*x*0, the business loaned R15 000 to its main supplier for a five-year period at an interest rate of 10% per annum.
- Interest is payable half-yearly in arrears on 1 January and 1 July.
- On 1 July 20*x*1, the supplier sent a cheque for the half-year's interest.
- On 30 September 20*x*1, he sent another cheque for R5 000 in part repayment of the loan.
- Both transactions were correctly recorded on the dates mentioned.

4 On 1 April 20*x*1, one of the business's delivery vans was traded in as part payment for a new vehicle that cost R6 000.
- The van that was traded in, had been bought two years and three months ago, for R4 000 and its trade-in value was R1 006.
- The balance of the purchase price of the new vehicle was paid by cheque.
- The only entry recorded for the entire transaction has been the debit to vehicles and the credit to bank for R4 994 (the amount of the cheque).

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5 Vehicles are depreciated at 40% per annum using the diminishing-balance method.

6 Miscellaneous expenses includes R324 for property rates for the period 1 January 20*x*2 to 30 June 20*x*2.

7 On 1 January 20*x*1, the allowance for bad debts account had an opening balance of R1 000.

- The account had been debited with a total of R1 240 during the year, with credit entries to receivables.
- It is the business's policy to make an allowance for a proportion of accounts receivable which, at the end of each financial year, is estimated as being uncollectable.
- This estimate is calculated at 5% of year-end accounts receivable balance.

You are required to:

1 Prepare general journal entries for adjustments where appropriate.

2 Prepare the statement of profit or loss & other comprehensive income for the year ended 31 December 20*x*1.

3 Prepare the statement of financial position as at 31 December 20*x*1.

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MODULE F Company accounting

This module is divided into five chapters:

Chapter 17 An introduction to companies
Chapter 18 Share capital
Chapter 19 Assets and liabilities
Chapter 20 Minimum disclosure requirements
Chapter 21 Statement of cash flows

Together these five chapters achieve the following outcomes:

Outcomes

- Acquiring the terminology particular to companies.
- Preparing the following with regard to companies:
  - the statement of profit or loss & other comprehensive income
  - the statement of changes in equity
  - the statement of financial position
  - the statement of cash flows
  - the notes to the financial statements
- Preparing the financial statements of companies to comply with the minimum disclosure requirements of the Companies Act and IAS 1.
- Recording the transactions related to:
  - dividends
  - income taxes
  - issue of shares
  - redemption of preference shares
  - raising and repayment of loans
  - issue and redemption of debentures
  - interest
- Communicating the financial position and results of companies to their stakeholders.

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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17 AN INTRODUCTION TO COMPANIES

Chapter objectives

By the end of this chapter, you should be able to:

- Define a company as a legal entity separate from its owners.
- Identify the categories of companies and their characteristics.
- Introduce the terminology particular to companies.
- Identify the format of company financial statements, in particular:
  - the statement of profit or loss & other comprehensive income
  - the statement of changes in equity
  - the statement of financial position
- Explain the accounting treatment for:
  - income tax
  - dividends

Chapter outline

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1 Introduction

The accounting procedures of sole proprietors were dealt with in earlier chapters. The company, the most popular form of entity for larger businesses, will be discussed in this chapter. The concept of a company was originally introduced to overcome the inherent weaknesses encountered with the sole proprietor and partnership as business entities.

A rapid growth in industrial activity took place during the 19th century, as a result of the industrial revolution. This required businesses to attract large amounts of capital. The sole proprietor and partnership did not provide the necessary access to capital and, as a result, the company as a business form was developed. One of the main advantages of this form of entity is the ability to raise large amounts of capital by issuing shares.

The development of the company introduced new terminology and accounting procedures. This chapter defines a company and explains the important terminology associated with companies. It introduces some of the relevant accounting entries and discusses the financial statements of companies and compares them with the financial statements of a sole proprietor.

Definition of a company

A company is an association of persons with a common goal. A company is recognised by law as being a legal person separate from its owners or shareholders.

The conduct of companies is governed by the Companies Act 71 of 2008, as amended. The Registrar of Companies in Pretoria administers the Companies Act.

Categories of companies

These are the categories of companies:

- Profit companies.
- Non-profit companies.

Profit companies

A profit company is usually formed with the aim of making a profit.

Profit companies may be subdivided into the following four subcategories; public companies, private companies, state-owned companies and personal liability companies as seen in Figure 17.1.

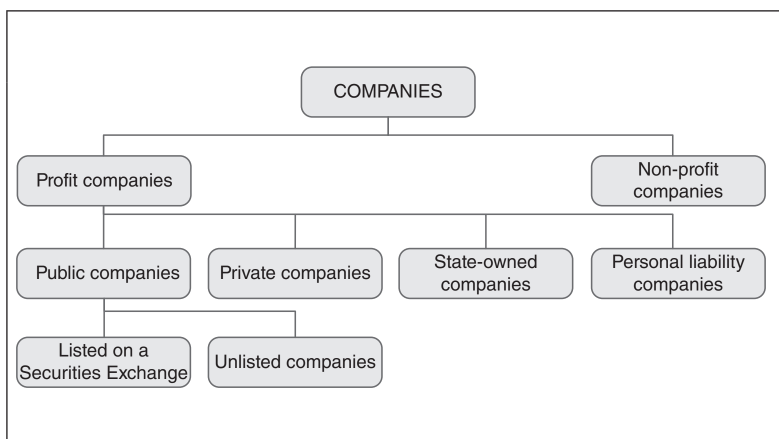

Figure 17.1

Private company

A company is identified as private if the words '(Proprietary) Ltd' (abbreviated to (Pty) Ltd) are added to the name of the company, for example, Beta (Pty) Ltd.

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The Companies Act has certain conditions that should be complied with before a company may register as private:

- Shareholders are restricted from one to a maximum number decided by the company.
- Shares are not freely transferable.
- Shares or debentures may not be offered to the general public.

Public company

The Companies Act requires a public company to have at least one shareholder. The shares of a public company can be offered to the general public. The shares of a public company are also freely transferable. A public company has the word 'Limited' (abbreviated as 'Ltd') added to its name, for example, Alpha Ltd.

A public company may be listed on a stock exchange, such as the JSE Securities Exchange, which improves the marketability of its shares.

State-owned companies

A company is a state-owned company if it is listed as a public entity or is owned by a municipality. The name of a state-owned company ends with the words 'SOC Ltd'.

Personal liability companies

A personal liability company is a private profit company. The Memorandum of Incorporation states that it is a personal liability company. The name of a personal liability company ends with the word 'Incorporated' (abbreviated as 'Inc').

Non-profit companies

Non-profit companies are not formed to make a profit but to promote specific aims. This business form is used mainly by charity organisations, cultural societies and clubs. A non-profit company has the word 'NPC' added to the end of the name.

Characteristics of a company

Companies have very specific characteristics, which distinguish them from partnerships and sole proprietors. These characteristics include:

- A separate legal existence.
- Limited liability of shareholders.
- Transferability of ownership.
- Professional management.
- Formation governed by the Companies Act.
- Reporting governed by the Companies Act and International Financial Reporting Standards (IFRS).

Separate legal existence

The law identifies companies as legal persons. Consequently, assets are registered or bought in the name of companies and liabilities are incurred in their names. Profits and losses belong to companies. Owners have no claim to either the net profit (unless it is declared as dividends) or the net assets (unless the company is liquidated or wound up).

As the company is a separate legal entity, it has a continuous existence, independent of its shareholders, as opposed to sole proprietors or partnerships, where the life of the entity is dependent on the life of the owners.

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Limited liability of shareholders

The liability of the members (called shareholders) of companies is limited to their investments. A shareholder cannot lose more than their investment in the company. Creditors may lodge claims against the assets of the company. If the assets are insufficient to meet the liabilities, the losses incurred are borne by the payables.

In a sole proprietor or partnership, the personal assets of the owner or partner are available to pay the claims of the payables, should the assets of the business prove to be insufficient. The limited liability of shareholders in companies fosters entrepreneurship without the risk of losing personal assets.

Transferability of ownership

The capital of a company is divided into transferable units of ownership, called shares. Each shareholder receives share certificates as proof of ownership in a company. These shares may be sold freely in a public company or, with the approval of the directors, in a private company.

A register of shareholders is maintained by the company. The total number of shares in the shareholder's register should agree with the number of issued shares in the share capital account in the general ledger.

Professional management

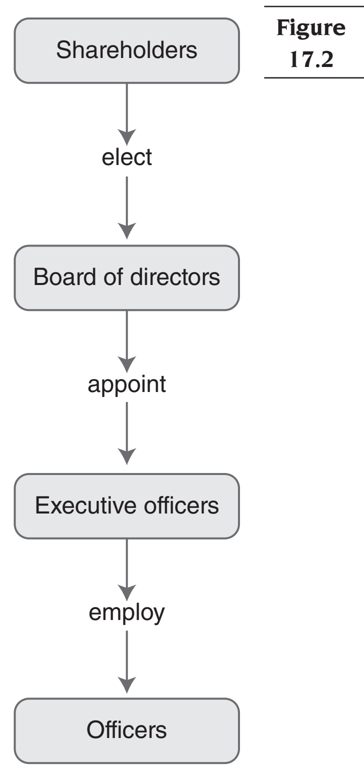
The ownership and management of companies are usually separated as shown in Figure 17.2.

The ownership of the company is put in the hands of the shareholders. The shareholders in a general meeting elect a board of directors who will determine the company policies and strategies. Executive officers are appointed by the directors to manage the daily running of the company.

The directors and executive officers of companies must manage the company in a responsible manner and are accountable to the shareholders.

The King Report III that was recently issued, prescribes the manner in which directors and executive officers should conduct themselves and how the company should be managed; this is called corporate governance.

Figure 17.2



Company formation

The Companies Act gives the procedure for the formation and registration of a company.

An attorney usually draws up the Memorandum of Incorporation (MoI), which is submitted to the Companies and Intellectual Property Commission (CIPC) on the prescribed forms with the necessary registration fee.

The company is formed when the Companies and Intellectual Property Commission certifies the Memorandum of Incorporation to show that the company is incorporated.

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A company may only commence business once a certificate allowing it to do so is issued by the CIPC.

The MoI of a company deals with the internal and external affairs of the company and includes the following information:

- The purpose of the company and its main business activity.
- The company name.
- The details of the registered share capital.
- Meetings.
- Voting rights and procedures.
- Borrowing capacity.
- The powers and duties of the directors.

The procedures for the registration of companies is shown in Figure 17.3.

Figure 17.3

Procedures for the registration of companies

The founding members of the company apply for registration of the company to the Companies and Intellectual Property Commission (CIPC) by:

- Lodging an application for reservation of the proposed name in duplicate on form CM5.
- Lodging the original application along with two notarially-certified copies of the Memorandum of Incorporation (MoI) of the company, signed by each subscribing member.
- Lodging a notice of registered office and postal address of the company in duplicate on form CM22.

Company reporting

The Companies Act requires the annual financial statements of companies to be drafted and audited. It places a number of restrictions on the company, such as limiting financial assistance given to prospective shareholders in acquiring shares in the company and requiring the disclosure of loans made to directors and directors remuneration.

The Companies Act and International Accounting Standard 1 (IAS 1) contain further details of the information that should be disclosed in the annual financial statements.

The rights of shareholders

The shareholders of a company have the right to:

- Change their ownership in a company by selling their shares.
- Vote at shareholders' meetings.
- Elect the board of directors.
- Receive a proportional share of the profits declared as dividends.
- Receive a proportional share of the assets on liquidation of the company after all payables' claims have been paid.

Did you know?

The format and contents of the financial statements of companies (for external use) are mainly prescribed in:

- The Companies Act.
- International Accounting Standards issued by the International Accounting Standards Board (IASB).

These financial statements are drafted for users of the company who do not have direct access to the financial records.

2 Company financial statements

There are numerous parties who are interested in the financial performance and position of a company. The existing shareholders, potential shareholders, the managers, employees, payables and competitors are probably the most significant groups of users of this financial information.

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Figures 17.4 to 17.6 show a typical set of financial statements of a company drafted for the managers. Financial statements drafted for the managers contain detailed information, which they require for decision-making purposes.

Financial statements drafted for other external users have less detail, as these users make different decisions to the managers. The users of financial statements were addressed in more detail in Chapter 1.

Figure 17.4

Nkomo Ltd
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*1

	Notes	20*x*1		20*x*0	
ASSETS					
Non-current assets		416 400	00	375 000	00
Property, plant and equipment	4	280 000	00	310 000	00
Intangible assets	5	10 200	00	15 000	00
Investments/Financial assets	6	126 200	00	50 000	00
Current assets		267 000	00	147 000	00
Inventories	7	120 000	00	57 000	00
Accounts receivable	8	62 000	00	70 000	00
Other current assets	9	20 000	00	0	00
Cash and cash equivalents		65 000	00	20 000	00
TOTAL ASSETS		683 400	00	522 000	00
EQUITY AND LIABILITIES					
Capital and reserves		501 400	00	284 000	00
Share capital	2	252 000	00	192 000	00
Retained earnings		189 400	00	52 000	00
Revaluation reserve		60 000	00	40 000	00
Non-current liabilities		32 000	00	62 000	00
Mortgage debentures	3	24 000	00	32 000	00
Other unsecured interest-bearing borrowings		8 000	00	30 000	00
Current liabilities		150 000	00	176 000	00
Short-term borrowings		8 000	00	0	00
Accounts payable		70 000	00	92 000	00
Provisions	10	30 000	00	35 000	00
SARS: Income tax payable		27 800	00	40 800	00
Shareholders for dividends		14 200	00	8 200	00
TOTAL EQUITY AND LIABILITIES		683 400	00	522 000	00

Nkomo Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20*x*1

2 ***Share capital***	20*x*1		20*x*0	
Authorised				
300 000 ordinary shares				
150 000 redeemable preference shares (fixed annual dividend of 14c/share)				
Issued				
180 000 ordinary shares	192 000	00	192 000	00
120 000 redeemable preference shares (fixed annual dividend of 14c/share)	60 000	00	0	00
	252 000	00	192 000	00

- The 14% redeemable preference shares are redeemable at the option of the company from 1 December 20*x*2 to 30 June 20*x*3 at a premium of 15c/share. (The preference shares are cumulative regarding dividends.)
- The directors have authority to issue the balance of the unissued shares before the next annual general meeting on 15 August 20*x*1.

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Figure 17.5

Nkomo Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20x1

	Notes	20x1		20x0	
Revenue		1 033 000	00	700 000	00
Cost of sales		(528 000	00)	(380 000	00)
Gross profit		505 000	00	320 000	00
Other operating income		47 500	00	16 400	00
Dividends received from investments		6 500	00	6 500	00
Profit on sale of trading investments		9 000	00	9 900	00
Profit on expropriation of land		25 000	00	0	00
Profit on sale of vehicles		2 000	00	0	00
Reduction in provision for guarantee claims		5 000	00	0	00
Gross operating income		552 500	00	336 400	00
Operating expenses		(274 500	00)	(238 600	00)
Administrative expenses		30 000	00	51 000	00
Audit fees		7 000	00	3 000	00
Water and electricity		6 000	00	0	00
Depreciation		12 200	00	7 000	00
Directors' salaries		26 800	00	7 000	00
General expenses		16 500	00	2 600	00
Loss on sale of motor vehicles		4 000	00	0	00
Vehicles expenses		35 000	00	20 000	00
Rent		18 000	00	26 000	00
Sales expenses		30 000	00	28 000	00
Salaries		44 000	00	40 000	00
Wages		15 000	00	12 000	00
Distribution costs		30 000	00	42 000	00
Operating profit before interest and taxation		278 000	00	97 800	00
Interest expense		(13 000	00)	(28 000	00)
Operating profit before taxation	13	265 000	00	69 800	00
Taxation		(74 200	00)	(19 544	00)
PROFIT FOR THE PERIOD		190 800	00	50 256	00
Other comprehensive income Surplus on revaluation of property		20 000	00	20 000	00
Total comprehensive income for the year		210 800	00	70 256	00

Trading section

Profit and loss section

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Figure 17.6

Nkomo Ltd
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20*x*1

	Ordinary share capital		Redeemable preference shares		Revaluation reserve		Retained earnings		Total	
Balance 30 June 20x0	192 000	00	0	00	40 000	00	52 000	00	284 000	00
Total comprehensive income					20 000	00	190 800	00	210 800	00
New shares issued			60 000	00					60 000	00
Ordinary dividends paid							(45 000	00)	(45 000	00)
Preference dividends paid							(8 400	00)	(8 400	00)
Balance 30 June 20x1	192 000	00	60 000	00	60 000	00	189 400	00	501 400	00

The Companies Act identifies the **minimum disclosure** that company financial statements should provide to shareholders. Because this information is made public in the annual report of the company, other users such as payables, competitors and the general public, may also access the information. These minimum information requirements are discussed in a later chapter.

The Companies Act and International Accounting Standard 1 (IAS 1) on the presentation of financial statements stipulate that the financial statements of a company should consist of:

- A statement of financial position.
- A statement of changes in equity.
- A statement of cash flows.
- The auditors' report.
- A statement of profit or loss & other comprehensive income.
- Notes to the financial statements.
- The directors' report.

The format of the statement of financial position, statement of profit or loss & other comprehensive income and statement of changes in equity for internal use is discussed in this chapter. The notes to the financial statements are addressed, to some extent, in the chapter on disclosure requirements.

The statement of cash flows shows the cash flow of the company generated or used over the financial period from operating, investing and financing activities and is dealt with in Chapter 21. (The directors' report and the auditors' report fall outside the scope of this book.)

Statement of financial position

A statement of financial position shows the financial position of the company at a point in time. The equity and liabilities section of the statement of financial position consists of the owner's equity (share capital, share premium and reserves), the non-current liabilities (mortgage debentures, financial liabilities and other long-term loans) and current liabilities (trade payables, short-term borrowings and provisions). The asset section consists of all assets (tangible such as property, intangible such as goodwill, and current such as inventory, receivables and cash).

A scrutiny of the statement of financial position in Figure 17.4 on page 17.6 shows that the equity and liability section of a company differs from that of sole proprietors and partnerships. The capital account of sole proprietors and the capital and current accounts of partnerships are replaced by share capital and reserves. Note that different types of share capital (ordinary and preference share capital) are disclosed separately. Share capital and reserves are addressed in Sections 3 and 4 of this chapter.

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The assets section of the statement of financial position is very similar to those of sole proprietors and partnerships with a few exceptions.

A company, unlike a sole proprietor and a partnership, is a taxpayer and income tax is explained in Section 6 of this chapter. The current liability 'shareholders for dividends' is discussed in Section 5.

Statement of profit or loss & other comprehensive income

A statement of profit or loss & other comprehensive income (SOPOL & OCI) shows the profits or losses (performance) of a company over a period. The display of the statement of profit or loss & other comprehensive income up to operating profit before income tax is similar for companies, partnerships and sole proprietors. However, a company pays income tax, declares dividends and maintains reserves.

The typical statement of profit or loss & other comprehensive income for a trading company is divided into the trading section, where the gross profit is calculated, and the profit and loss section, where expenses and other income are deducted or added respectively to calculate the profit for the period.

Income tax is then deducted from profits.

Statement of changes in equity

The statement of changes in equity is a statement that provides a reconciliation of equity from the beginning to the end of the financial period. Each type of equity (share capital, retained earnings, and so on) is reconciled for the period.

The retained earnings at the beginning of the year is the cumulative undistributed profits brought forward from previous years. The retained earnings at the end of the year is shown in the statement of financial position as distributable reserves. This represents all distributable profits generated over the life of the company that have not been paid out to shareholders in the form of dividends.

The profits are retained in the company in order to finance future growth and expansion. Items that are typically included in the reconciliation of retained earnings are the profit for the period from the statement of profit or loss & other comprehensive income, dividends declared, transfers to and from reserves and prior year adjustments.

You should be able to complete Questions 17.1 to 17.4.

3 Share capital

Shares are transferable units of ownership that are issued as share capital certificates to the shareholders of companies. A company keeps a register of shareholders with shareholder names and contact particulars. Before discussing the types of shares, certain terms specific to the share capital of companies should be explained.

Authorised and issued share capital

Any incorporated company discloses in its Memorandum of Incorporation (MoI) its authorised share capital. The authorised share capital is the **maximum number** of shares that may be issued to shareholders of the company. The issued share capital is the **actual number** of shares already issued to shareholders.

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The difference between the authorised share capital and issued share capital can be called the unissued share capital. It is logical that the issued share capital may never exceed the authorised share capital and that the issued share capital is the share capital balance used in the statement of financial position.

Figure 17.7 shows the authorised, issued and unissued share capital of a company.

Figure 17.7

ALPHA INDUSTRIES LTD	
Authorised share capital	
50 000 shares	
Issued share capital	
30 000 shares (amount that appears in the statement of financial position)	30 000
Therefore:	
Unissued share capital	
20 000 shares	

The shareholders of a company may increase or decrease the authorised share capital. Changes to the authorised share capital require a special resolution at a general meeting of shareholders and approval from the Companies and Intellectual Property Commission (CIPC).

Classes of shares

Shares are classified into different classes of shares according to the rights and privileges inherent in the shares. The classes of shares cater for the preferences of investors for investments with differing levels of risk. However, within a particular class of shares, each share must have equal rights. The main classes of shares are class A and class B shares, commonly referred to as ordinary shares and preference shares.

Ordinary shares

Ordinary shares are held by ordinary shareholders, who are the effective owners of the company. Ordinary shareholders have the right to vote at shareholders' meetings of the company. They appoint the directors and they ultimately control the company. They receive dividends from current or accumulated profits only once the preference dividend, where applicable, has been declared. On the liquidation or winding-up of the company, ordinary shareholders are usually paid once all claims from payables and the preference shareholders have been settled. If a company issues only one class of shares, they will be ordinary shares.

Preference shares

Preference shares are owned by preference shareholders who have preferential rights over ordinary shareholders. The main right is that preference shareholders receive a dividend before the ordinary shareholders, normally at a fixed annual dividend per share.

If the company is liquidated, the preference shareholders will receive the payment of their capital investment before the ordinary shareholders, subject to their terms of issue. Preference shareholders do not normally have voting rights.

Different kinds of preferential rights may be attached to preference shares resulting in several classes of preference shares. A combination of these rights is also possible. The most frequently used preference shares are:

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Cumulative preference shares

Although preference shareholders may receive a fixed dividend every year, they are only **entitled** to the dividend once the dividend has been declared. (A dividend is declared when it is proposed by the board of directors and is approved by the shareholders.)

With cumulative preference shares the shareholder is entitled to receive a dividend every year. If no preference dividend is declared, the shareholders retain the right to receive the backlog dividend in the next year that a preference dividend is declared.

Cumulative preference shareholders must receive all their arrear dividends before an ordinary dividend may be declared. Preference shareholders have voting rights while cumulative dividends are in arrears.

Participating preference shares

As already mentioned, preference shares usually receive a fixed dividend. Participating preference shareholders receive the fixed dividend and participate further with the ordinary shareholders in a share of the profits, according to the terms of issue.

Convertible preference shares

Convertible preference shares may be converted into ordinary shares at a future date, subject to the terms and conditions established when the convertible preference shares were issued.

Redeemable preference shares

Redeemable preference shares indicate that the shares may be redeemable by the company at a specified date, at an agreed amount. The company may redeem the shares from cash or from a new issue of shares.

This class of preference shares has the nature of a long-term loan and should be classified as a non-current liability. Its dividend should then be disclosed with interest paid.

4 Reserves

The equity of a company consists of share capital and reserves. Reserves are divided into distributable reserves (reserves distributable as a dividend) and non-distributable reserves (reserves not distributable as a dividend).

The main distributable reserve is retained earnings (the cumulative balance of undistributed profits). The term 'reserve' is commonly misunderstood as it creates the image of a pile of cash that is stored somewhere. It is not. It is simply a claim that the shareholders have against the assets of the company. In the case of retained earnings, it results from all the profits that have been made by the company, but which have not been distributed to the shareholders.

Non-distributable reserves are created to reflect amounts by which the assets of a company have increased, but which are not distributable as a dividend in terms of legislation or the Memorandum of Incorporation (MoI) of the company. There are a number of reasons for creating a non-distributable reserve. One important reason is to protect the interests of payables.

The MoI of the company may, for example, require that all profits on the sale of non-current tangible assets be transferred to a non-distributable reserve. Transfers to and from reserves are shown in the statement of changes in equity.

You should be able to complete Questions 17.5 to 17.9.

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5 Dividends

Did you know?

The declaration date of dividends may no longer be backdated so that the dividend declared is recognised in the previous financial year. This was a practice followed by many companies in the past.

A dividend is the distribution of profits of the company to shareholders in the ratio in which shares are held.

Ordinary shares have no fixed dividend rate. The ordinary dividend is quoted as cents per share, for example 10 cents per share, and is calculated as the number of ordinary shares issued × dividend per share. Preference shares have a fixed dividend rate that is quoted as a fixed amount of the face value of a share, for example fixed annual dividend of 5 cents per share. It can also be quoted as a fixed annual percentage of the issue price of the preference share capital, for example 10% preference shares. The preference dividend is calculated as the period × annual dividend rate × issued preference share capital.

Dividends are paid from profits that are legally available for distribution. The company should be financially sound and have adequate cash resources to pay the dividend.

The directors of a company normally propose the dividend, which is then approved by a general meeting of shareholders. Companies do not normally distribute all the profits by way of dividends. A proportion of the profits is retained in the company for future growth.

A dividend is only due, and payable, once it has been declared by the company. The liability for the payment of the dividend is raised in the books of the company on the declaration date.

The shareholders to whom dividends are paid are established by identifying a date on which share registers close. All shareholders registered in the Shareholders' Register on the date of the closing of registers will receive a dividend. The dividend is usually paid a few weeks after this date.

Dividends may be paid during the year when the interim results of the company are published (interim dividend) and/or at the end of the financial year (final dividend). When dividends are declared and paid, accounting entries are necessary. Example 17.1 shows the accounting entries for dividends.

Example 17.1

Here is a selection of accounts in the books of Global Ltd on the last day of the financial year.

Issued share capital	
100 000 ordinary shares	R200 000
100 000 preference shares (fixed annual dividend of 10c/share)	R100 000
Retained earnings	R60 000
Cash	R50 000

The directors have declared a dividend of 10c per ordinary share.

Declaration date:	15 December
Closing of registers:	30 December
Payment of dividends:	31 December
Financial year end:	31 December

You are required to:

Prepare the journal entries relating to dividends.

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GENERAL JOURNAL OF GLOBAL LTD **GJ**

Day	Details	Fol.	Debit		Credit	
	Declaration of dividend					
15/12	Preference dividends	N	10 000	00		
	Shareholders for dividends	B			10 000	00
	Dividend declared on preference shares (100 000 × 10c)					
15/12	Ordinary dividends	N	10 000	00		
	Shareholders for dividends	B			10 000	00
	Dividend declared on ordinary shares (10c × 100 000 shares)					
	Payment of dividend					
31/12	Shareholders for dividends	B	20 000	00		
	Cash	B			20 000	00
	Payment of preference and ordinary dividends					
	Closing entries					
31/12	Retained earnings	B	20 000	00		
	Ordinary dividends	N			10 000	00
	Preference dividends	N			10 000	00
	Transfer of dividend expense accounts to the retained earnings account					

Explanation

Reminder

Refer back to the financial statements in Figures 17.4 and 17.6 to see how dividends paid is disclosed in the financial statements of companies.

- The preference dividend must be declared before the ordinary dividend can be declared.
- Note that the dividends on preference shares differ from the dividends on ordinary shares.
  - The preference dividend is quoted as a fixed annual dividend per share.
  - The ordinary dividend is declared as cents per share.
- The nominal accounts (preference dividends and ordinary dividends) are written off to the retained earnings account at the end of the financial year. The charge to this account will be the total declared dividend for the year, paid or unpaid.
- The shareholders for dividends account (also called the dividends recommended account) is a current liability in the statement of financial position until dividends are paid to shareholders. (Separate accounts may be opened for ordinary dividends and preference dividends.) The balance on this account will represent the cumulative amount of all the unpaid dividends.

  In Example 17.1 above, the dividend was paid before year end, and as a result there will be no balance on the shareholders for dividends account.

You should be able to complete Questions 17.10 and 17.11.

6 Company taxation

The South African company is a taxpayer separate from its shareholders. All companies must register with the South African Revenue Service (SARS) for various types of taxes as explained in Figure 17.8. Companies may thus also be registered vendors for VAT purposes. The accounting treatment for VAT is the same for all registered vendors.

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Income tax

Company income tax is paid on **taxable income**, which is the profit, adjusted to comply with the requirements of the Income Tax Act at present, company income tax is in the region of 28c in the R1 of taxable income. The calculation of the taxable income does not fall within the scope of these chapters.

Figure 17.8

REGISTRATION OF COMPANIES WITH SOUTH AFRICAN REVENUE SERVICE

Registration as an employer

All companies that employ people and remunerate them for their services (salary, wage or commission) must register with their local South African Revenue Service as an employer. A reference number is issued and the income tax (PAYE and SITE) deducted from employees' remuneration is paid over to the SARS each month. This payment is accompanied by form IRP4.

Registration for value-added tax (VAT)

All companies that have an annual turnover (sales) of R1 000 000 or more are required to register for VAT (VAT form 101) with the SARS. A reference number is issued and VAT returns (VAT form 201) are submitted monthly or bi-monthly with a payment or for a refund.

Registration for income tax

All companies with a legal identity, such as private or public companies, must register as taxpayers with the SARS and will receive an income tax reference number.

The income tax payable by a company can only be calculated once the profit for the year is known. The journal entry raising the estimated liability for income tax is normally passed at the end of the financial year.

Reminder

Refer back to Chapter 10 to revise the accounting entries for VAT.

Based on the calculations of this entry, an IT14 form, called an **income tax return**, is completed by the company and either filed electronically or sent with the financial statements to the SARS within six months of the end of the financial year.

The tax return and financial statements are checked and analysed by the SARS. An invoice or **income tax assessment** is then sent from the SARS to the company, showing the actual tax payable by the company. This usually takes place after the financial statements have been finalised and published.

The actual income tax liability is only known on the receipt of the income tax assessment, usually after the year end. The company, therefore, raises an estimated income tax entry in the general ledger at the end of the financial year. It follows that if the actual tax payable on the assessment received well after this date differs from the estimated income tax payable in the statement of profit or loss & other comprehensive income and the statement of financial position, it results in either an **over-provision** or **under-provision** for income tax.

The South African company is required to make provisional payments (on form IRP6) to the SARS. Although the actual income tax charge will be known only after year end, the SARS requires companies to make payments for income tax during the year of assessment.

The year of assessment is the same year as the company's financial year. The amounts payable as provisional payments are based on an estimation of the taxable income for the year or on the latest assessment.

Provisional payments are paid as follows:

- First provisional payment: Half of the estimated tax payable is paid six months after the beginning of the current year of assessment.

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- Second provisional payment: The other half of the estimated tax payable is paid at the end of the current year of assessment, in other words, at the financial year end.
- Third provisional payment ('topping up payment'): A third provisional payment may be required within seven months after the last day of assessment, if the tax paid in the first and second provisional payments is less than 100% of the company's actual income tax payable.

Example 17.2 **Income tax, provisional payments, over-provision**

Chaka Ltd is a company with a financial year ending on 31 December 20*x*1.

The following income tax transactions took place during the year:

30/06/20*x*1	Provisional payment	R20 000
31/12/20*x*1	Provisional payment	R20 000
31/12/20*x*1	Provision for income tax	R48 000
30/04/20*x*2	Tax assessment	R45 000
31/05/20*x*2	Payment of outstanding balance on income tax	

You are required to:
Complete the journal entries for the above transactions.

GENERAL JOURNAL OF CHAKA LTD **GJ**

Day	Details	Fol.	Debit		Credit	
20*x*1	*Provisional tax payments*					
30/06	SARS: Income tax	B	20 000	00		
	Bank	B			20 000	00
	First provisional tax payment					
31/12	SARS: Income tax	B	20 000	00		
	Bank	B			20 000	00
	Second provisional tax payment					
	Provision for income tax					
31/12	Income tax expense	N	48 000	00		
	SARS: Income tax	B			48 000	00
	Raising of estimated income tax charge for the current financial year					
	Closing entries					
31/12	Profit and loss account	F	48 000	00		
	Income tax expense	N			48 000	00
	Transfer of income tax expense to the statement of profit or loss & other comprehensive income					
20*x*2	*Receipt of tax assessment*					
30/04	SARS: Income tax	B	3 000	00		
	Income tax expense	N			3 000	00
	Adjustment of 20*x*1 over-provision for income tax: Provided 48 000 Actual 45 000 Over-provision 3 000					
31/05	SARS: Income tax	B	5 000	00		
	Bank	B			5 000	00
	Payment of 20*x*1 income tax still outstanding Actual 45 000 First provisional payment (20 000) Second provisional payment (20 000) 5 000					

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Explanation

- It is assumed that the company based the provisional payments on the latest tax assessment.
- The nominal account 'income tax expense' is written off to the statement of profit or loss & other comprehensive income at year end. The charge to the statement of profit or loss & other comprehensive income will be the total income tax charge for the year, paid or unpaid, as well as the adjustments for over-provision or under-provision of income tax in previous financial years.

Reminder

Refer back to the financial statements in Figures 17.4 to 17.6 to see how income tax is disclosed in the financial statements of companies.

- The real account 'SARS: Income tax ' is either a current liability, or current asset, in the statement of financial position. The balance on this account represents the cumulative amount still payable to, or receivable from, the SARS. All payments to, or from, the SARS are shown in this account.
- The statement of profit or loss & other comprehensive income will highlight this balance for income tax expense:

	20*x*1
Income tax expense	
SA Normal	48 000

- The statement of financial position will highlight this balance for income tax:

	20*x*1
Current liabilities	
SARS: Income tax	8 000

The statement of profit or loss & other comprehensive income for 20*x*2 will show R3 000 as a prior year over-provision under income tax expense.

Example 17.3

Income tax, under-provision

Golf Ltd is a company with a financial year ending on 28 February 20*x*1. On 1 March 20*x*0, the SARS: Income tax account had a credit balance of R24 000.

These income tax transactions took place during the year:

31/08/20*x*0	Provisional payment	R50 000
28/02/20*x*1	Provisional payment	R50 000
28/02/20*x*1	Taxable income	R230 000
25/06/20*x*1	Tax assessment	R72 000

Additional information:

- Income tax is payable at 28c in the R1.

You are required to:

Complete the journal entries for the transactions.

GENERAL JOURNAL OF GOLF LTD **GJ**

Day	Details	Fol.	Debit		Credit	
20*x*0	*Provisional tax payments*					
31/08	SARS: Income tax	B	50 000	00		
	Bank	B			50 000	00
	First provisional tax payment					

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20x1						
28/02	SARS: Income tax	B	50 000	00		
	Bank	B			50 000	00
	Second provisional tax payment					
	Provision for income tax					
28/02	Income tax expense	N	64 400	00		
	SARS: Income tax	B			64 400	00
	Raising of income tax charge for the current financial year (R230 000 × 28c)					
	Closing entries					
28/02	Profit and loss account	F	64 400	00		
	Income tax expense	N			64 400	00
	Transfer of income tax expense to the statement profit or loss and other comprehensive income					
	Receipt of tax assessment					
25/06	Income tax expense	N	7 600	00		
	SARS: Income tax	B			7 600	00
	Adjustment of 20x1 under-provision for income tax: Provided 64 400 Actual 72 000 Under-provision 7 600					

Explanation

- The SARS: Income tax account as at 28 February 20x1:

General Ledger of Golf Ltd
Real Accounts Section

Dr.						**SARS: INCOME TAX**			**B6**		Cr.
Aug.	31	Bank	CPJ8	50 000	00	Mar.	1	Balance	b/d	24 000	00
Feb.	28	Bank	CPJ2	50 000	00	Feb.	28	Income tax expense	GJ2	64 400	00
							28	Balance	c/d	11 600	00
				100 000	00					100 000	00
Mar.	1	Balance	b/d	11 600	00	Jun.	25	Income tax under-provision 20x1	GJ6	7 600	00

- The opening balance on the SARS: Income tax account relates to the previous tax assessment year that has not yet been fully paid.

Dividend tax

Dividend tax was introduced on 1 April 2012 and implies that tax is payable on dividends declared but it is the investor who will bear the tax burden. Dividend tax therefore does not form part of the company's income tax expense.

The company who declares the dividend will be responsible for withholding the 15% tax on dividends declared to the shareholders and paying it to the SARS by the end of the month following the month of the declaration date.

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Example 17.4

Dividend tax

Fox Ltd declared an ordinary dividend of R10 000 on 15 December 20x1. Dividends were paid on 31 December 20x1. Dividend tax on companies amounts to 15%.

You are required to:

Complete the journal entries for the dividend transaction.

GENERAL JOURNAL OF FOX LTD **GJ**

Day	Details	Fol.	Debit		Credit	
20x1	*Declaration of dividend*					
15/12	Ordinary dividends	N	10 000	00		
	Shareholders for dividends	B			10 000	00
	Dividend declared on ordinary shares					
	Dividend tax					
15/12	Shareholders for dividends	B	1 500	00		
	Dividend tax payable	B			1 500	00
	Dividend tax of 15% taken into account					
	Payment of dividend					
31/12	Shareholders for dividends	B	8 500	00		
	Bank	B			8 500	00
	Payment of ordinary dividend					
	Payment of dividend tax					
31/12	Dividend tax payable	B	1 500	00		
	Bank	B				
	Payment of dividend tax				1 500	00

Explanation

- Dividend tax is a tax on the shareholder and does not form part of the income tax expense of the company.
- Dividend tax is payable at the end of the month following the month in which the dividend was declared.

You should be able to complete Questions 17.12 to 17.15.

7 Chapter illustrative example

This information was extracted from the post-closing trial balance of Redlands Ltd as at 28 February 20*x*7.

Share capital	30 000	00
Reserves	17 200	00
Long-term loan	10 000	00
SARS: Income tax	50	00
Accounts payable	5 400	00
Bank	2 425	00
Land and buildings	15 000	00
Plant and equipment (at cost)	44 260	00
Accumulated depreciation: Plant and equipment	11 500	00
Financial asset	2 900	00
Investments	2 100	00

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Accounts receivable	4 500	00
Allowance for bad debts	300	00
Inventory	3 265	00

This information was extracted from the statement of profit or loss & other comprehensive income:

Revenue from sales	54 900	00
Cost of sales	28 000	00
Dividends received	12 850	00
Administration expenses	12 000	00
Depreciation	2 000	00
Selling expenses	3 000	00
Salaries and wages	8 000	00
Insurance	1 500	00

Additional information:

1 The authorised share capital consisted of 25 000 ordinary shares and 25 000 redeemable preference shares (fixed annual dividend of 10c/share).

2 All the redeemable preference shares were issued at the formation of the company at R1.00/share.

3 At the formation of the company on 1 March 20*x*5, 2 500 ordinary shares were issued at 80c/share. On 1 July 20*x*6, a further 2 500 ordinary shares were issued at R1.20/share.

4 Reserves consist of:
- Retained earnings as at 28 February 20*x*7 R16 000
- Revaluation of land (20*x*5) R1 200

These journal entries must still be passed:

1 The interest on the loan is calculated at 18% per annum. The loan is secured by a first mortgage on land and buildings.

2 Provision for income tax for the year amounted to R4 550 and R4 500 was provisionally paid during the year.

3 On 1 February 20*x*7, the preference dividend due was declared, as well as a dividend of 20c per ordinary share.

You are required to:

1 Prepare the journal entries for finance charges, income tax and dividends (ignore dividend tax).

2 Prepare the statement of financial position of Redlands Ltd for the year ended 28 February 20x7. (Notes are not required.)

1 *Journal entries*

Day	Details	Fol.	Debit		Credit	
28/02	Interest expense	N	1 800	00		
	Accounts payable	B			1 800	00
	Accrual of interest on loan					
	Income tax expense	N	4 550	00		
	SARS: Income tax	B			4 550	00
	Provision for taxation					

(The provisional tax was paid during the year and was entered into the cash payments journal on date of payment, therefore, no journal entry is required.)

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28/02	Preference dividends	N	2 500	00		
	Ordinary dividends	N	1 000	00		
	Shareholders for dividends	B			3 500	00

2

Redlands Ltd
STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20x7

	Notes	20x7	
ASSETS			
Non-current assets		52 760	00
Land and buildings } Property, plant and equipment	3	15 000	00
Plant and equipment (44 260 – 11 500)		32 760	00
Intangible assets		2 900	00
Investments/Financial assets		2 100	00
Current assets		9 890	00
Inventories	4	3 265	00
Accounts receivable (4 500 – 300)	5	4 200	00
Cash and cash equivalents	6	2 425	00
TOTAL ASSETS		62 650	00
EQUITY AND LIABILITIES			
Capital and reserves		37 350	00
Share capital	7	30 000	00
Retained earnings (16 000 – 1 800 – 4 550 – 3 500)	8	6 150	00
Other components of equity		1 200	00
Non-current liabilities		10 000	00
Long-term loan		10 000	00
Current liabilities		15 300	00
Accounts payable (50 + 5 400 + 1 800 + 4 550)		11 800	00
Shareholders for dividends (2 500 + 1 000)		3 500	00
TOTAL EQUITY AND LIABILITIES		62 650	00

7	***Share capital***		
	Ordinary share capital	5 000	00
	Preference share capital	25 000	00
		30 000	00

8 Summary

This chapter introduced the company as a business form and discussed its main advantages, such as the ability to raise large amounts of capital by issuing shares, the limited liability protection for shareholders, its unlimited life and the transferability of its shares.

The new terminology, which developed with the advent of the company, was defined. These definitions included terms such as share capital, reserves, dividends and income tax. The types of shares and reserves were discussed and shown with examples.

The chapter also explained the accounting procedures unique to companies for dividends and income tax.

An example of a company's statement of financial position, statement of profit or loss & other comprehensive income and statement of changes in equity drafted for use by the managers, was shown in Figures 17.4 to 17.6 and compared in the discussion to the financial statements of sole proprietors and partnerships.

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QUESTIONS

Question 17.1

Give five advantages and five disadvantages of a public company as a form of business entity.

Question 17.2

Why is a distinction made between company financial statements drafted for the managers' purposes (internal use) and company financial statements for external use?

Question 17.3

What is the purpose of the following statements?

- Statement of financial position.
- Statement of profit or loss & other comprehensive income.
- Statement of changes in equity.
- Statement of cash flows.

Question 17.4

What is the difference between a public company and a private company?

Question 17.5

Define these terms:

- Share capital.
- Retained earnings.
- Redeemable cumulative preference shares.
- Memorandum of Incorporation (MoI).
- Limited liability.
- Authorised share capital.

Question 17.6

What are the main differences between a sole proprietor and a company?

Question 17.7

What should the financial statements of a company consist of in terms of the Companies Act and International Accounting Standard 1 (IAS 1)?

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Question 17.8

This is the trial balance of Tembo Ltd for the year ended 28 February 20*x*0:

TRIAL BALANCE OF TEMBO LTD AS AT 28 FEBRUARY 20*x*0

Details	Fol.	Debit R'000		Credit R'000	
Machinery	B	1 200	00		
Vehicles	B	1 000	00		
Investments	B	360	00		
Accounts receivable	B	450	00		
Bank	B	210	00		
Inventory	B	120	00		
Accounts payable	B			320	00
Ordinary share capital	B			1 050	00
Retained earnings (1 March 19*x*9)	B			1 350	00
Asset replacement reserve (1 March 19*x*9)	B			20	00
Revenue from sales	N			2 500	00
Cost of sales	N	1 450	00		
Administration expenses	N	140	00		
Operating expenses	N	230	00		
Finance expenses	N	30	00		
Selling expenses	N	50	00		
		5 240	00	5 240	00

Additional information:

- The managers transferred an amount of R50 000 to the asset replacement reserve.

You are required to:

Draft the statement of financial position, statement of profit or loss & other comprehensive income and statement of changes in equity for Tembo Ltd for internal use for the year ended 28 February 20*x*0.

- Notes to the financial statements are not required.
- Ignore tax implications and depreciation.

Question 17.9

The statement of financial position of a retail trading company was presented to you by an inexperienced bookkeeper:

Additional information:

1. All the shares have been issued.
2. Accounts receivable of R10 000 were deposited at the bank on 29 June 20*x*1. The transaction was correctly recorded in the accounting records.
3. According to the Memorandum of Incorporation (MoI), the capital profits may not be distributed by way of dividends.

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Naidoo (Pty) Ltd*
STATEMENT OF FINANCIAL POSITION FOR THE YEAR ENDED 30 JUNE 20*x*1

Liabilities		Assets	
Ordinary share capital	150 000	Inventory at cost	110 000
Capital profits – sale of fixed assets	10 000	Cost of plant	100 000
Profit after income tax	25 000	Cost of furniture	10 000
Depreciation plant	25 000	Accounts receivable	82 000
Depreciation furniture	2 000	Bank	20 000
7% secured loan (repayable on 30 June 20*x*9)	40 000	Financial asset	10 000
Accounts payable (including dividends declared of R10 000)	80 000		
	332 000		332 000

*This statement of financial position is drafted in the T-format (or horizontal format) that was used before the new format (vertical format) was prescribed by the accounting standards.

You are required to:
Redraft the above statement of financial position in vertical form for internal use. (Ignore comparative figures.)

Question 17.10

These balances were extracted from the books of XY Ltd as at 30 June 20*x*3:

	Debit		Credit	
Administration expenses	12 050	00		
Authorised and issued share capital			100 000	00
Accounts payable			4 150	00
Accounts receivable	22 550	00		
Accumulated loss (1 July 20*x*2)	1 500	00		
Depreciation	8 000	00		
Directors' fees	800	00		
Dividends received			1 050	00
Gross profit (on net sales for the year of R250 000)			99 800	00
Interim dividend paid	5 000	00		
Investments at cost	9 000	00		
Overdraft – secured by notarial bond over movable property			2 000	00
Plant and machinery (cost R80 000)	56 000	00		
Profit from expropriation of land			8 000	00
Vehicles	6 100	00		
Salaries and wages	29 000	00		
Inventory (at cost 30 June 20*x*3)	65 000	00		
	215 000	00	215 000	00

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Additional information:

The directors have resolved:

- That the entire profit from sale of land be treated as part of the profit available for the current year's dividends paid and proposed.
- That the final proposed dividend on ordinary shares be R5 000.
- That R10 000 be transferred to asset replacement reserve.
- That the annual audit fee of R4 000 be accrued.

You are required to:

Prepare the statement of profit or loss & other comprehensive income of XY Ltd for the year ended 30 June 20*x*3, for internal use.

Question 17.11

Berkshire Ltd provided you (as the accountant) with this information from their accounting records as at 1 July 20*x*0:

250 000 ordinary share capital	550 000	00
100 000 redeemable preference share capital	100 000	00
Revaluation surplus	280 000	00
Asset replacement reserve	200 000	00
Retained earnings	800 000	00

The following information is available for the financial year ended 30 *June* 20*x*1:

1. The company issued 50 000 ordinary shares @ R2.50 each to redeem all the preference shares at R1.00/share.
2. A transfer of R80 000 was made to asset replacement reserve.
3. Machinery was revalued during the year resulting in a R120 000 increase in the revaluation surplus.
4. The profit for the period amounted to R1 400 000 before the payment of the preference dividend of R150 000 and the ordinary dividend of R30 000.

You are required to:

Prepare the statement of changes in equity for Berkshire Ltd for internal use for the year ended 30 June 20x1. (Notes are not required.)

Question 17.12

Define these terms:

- Provisional payment.
- Tax return.
- Declaration date.
- Tax assessment.
- Shareholders Register.
- Interim dividend.
- Dividend tax.
- Taxable income.

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Question 17.13

The trial balance of Daphne (Pty) Ltd as at 30 September 20*x*2 included these accounts:

	Debit		Credit	
SARS: Income tax			45 400	00
Income tax expense (10 000 + 3 400)	13 400	00		
Provisional tax payments (March 20*x*2)	18 000	00		
Dividends declared	10 000	00		

Additional information:

1. The profit before tax figure for the year ended 30 September 20*x*2 is R68 000. The taxable income figure is R150 000. Income tax is payable at 30% and dividend tax at 15%.
2. The provisional payment for September 20*x*2 of R10 000 was incorrectly posted to the income tax expense account.
3. Foreign tax of R3 400 was paid in August 20*x*2.
4. The last income assessment received for 30 September 20*x*0 of R38 000 was fully paid in August 20*x*2. The actual provision for income tax was R42 400. The income tax assessment for 30 September 20*x*1 is still outstanding.
5. Included in the SARS provision for income tax is a liability of R8 000, which has been in dispute since 19x9. The dispute was resolved in the current year when the company agreed to pay R6 800.
6. No dividends were received.

You are required to:

1. Prepare journal entries to record any adjustments that may be necessary to take the above information into account. (Narrations are not required.)
2. What is the minimum amount to be paid in the third provisional payment on 31 March 20*x*3 to avoid incurring penalties.

Question 17.14

Wayout Ltd is a company that makes denim clothes.

This dividend information is available for the year ended 31 December 20x0:

Dividends paid

Interim dividend

20 June	Dividend proposed	R50 000
30 June	Dividend approved in general meeting	
5 July	Closing of the shareholders registers	
31 July	Payment of dividend	

Final dividend

20 December	Dividend proposed	R80 000
31 December	Dividend approved in general meeting	
5 January	Closing of shareholders register	
30 January	Payment of dividend	

Dividend received from investments

30 June	R60 000
31 December	R30 000

Dividend tax is withheld at 15%

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You are required to:

1 Indicate on which dates Wayout Ltd should record their dividends and investors in Wayout Ltd should record their dividends as receivable.

2 Provide the journal entries related to dividends of Wayout Ltd for the year ended 31 December 20*x*0.

Question 17.15

Here is the pre-adjustment trial balance of Tsepo Ltd as at 31 March 20*x*4:

Tsepo Ltd
PRE-ADJUSTMENT TRIAL BALANCE AS AT 31 MARCH 20*x*4

	Debit		Credit	
Ordinary shares capital (200 000 shares)			220 000	00
Redeemable preference shares (20 000 shares) (fixed annual dividend of 7c/share)			20 000	00
Asset replacement reserve			105 000	00
Retained earnings (1 April 20*x*3)			112 750	00
Surplus on revaluation of land			50 000	00
11% secured debentures @ R100 each (issued 1 October 20*x*3)			150 000	00
Land and buildings	385 000	00		
Plant and machinery (1 April 20*x*3):				
at cost	232 570	00		
accumulated depreciation			69 771	00
Vehicles (1 April 20*x*3):				
at cost	83 780	00		
accumulated depreciation			50 268	00
Debenture discount (**Tip:** deduct from debentures in statement of financial position)	27 500	00		
Investments	48 500	00		
Provisional tax payments for 20*x*4	12 500	00		
Inventories (1 April 20*x*3)	122 540	00		
Accounts receivable	112 380	00		
Allowance for bad debts			12 500	00
Accounts payable			44 295	00
Bank overdraft			27 690	00
SARS: income tax	4 115	00		
Revenue from sales			723 295	00
Purchases	410 080	00		
Dividends received			5 335	00
Auditor's remuneration	10 000	00		
Operating and selling expenses	95 979	00		
Interest on debentures	8 250	00		
Directors' emoluments	25 000	00		
Proceeds from sale of motor vehicle			4 250	00
Administration expenses	16 960	00		
	1 595 154	00	1 595 154	00

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This additional information relates to the trial balance:

1 The plant and machinery were bought on 1 April 20*x*0.
- A machine that cost R13 580 has been debited to selling and operating expenses.
- The machine was bought on 1 October 20*x*3.
- Depreciation is written off at 10% per annum on a straight-line basis.

2 The vehicles were bought on 1 April 20*x*0.
- A vehicle that cost R17 780 was disposed of on 1 October 20*x*3.
- No purchases took place during the year.
- Depreciation is written off at 20% per annum on a straight-line basis.

3 Inventories on 31 March 20*x*4 consist of:

Raw material	37 390	00
Work-in-progress	1 594	00
Finished goods	22 331	00
	61 315	00

4 Allowance for bad debts is to be maintained at 10% of accounts receivable.

5 Income tax:
- 20*x*3 provided R55 275
- 20*x*3 actual R59 390

A provision of R39 349 is to be made for the current year.

6 During the year the company had R150 000 on deposit with a bank. Interest received of R6 690 has been credited to sales.

7 A dividend of 5c/share is to be provided for. (Ignore any dividend tax implications.)

You are required to:

1 Journalise the entries to correct the financial statements. (Narrations are not required.)

2 Prepare the statement of profit or loss & other comprehensive income of Tsepo Ltd for the year ended 31 March 20*x*4.

3 Prepare the statement of financial position as at 31 March 20*x*4.

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18 SHARE CAPITAL

Chapter objectives

By the end of this chapter, you should be able to:

- Explain the accounting entries required for:
  - the issue of shares including underwriters' commission
  - the issue of capitalisation shares
  - the redemption of preference shares
  - the acquisition of a company's own shares
- Introduce the minimum disclosure requirements in terms of the Companies Act and International Financial Reporting Standards (IFRS) for share capital and reserves.

Chapter outline

1	INTRODUCTION	18 – 2
2	ISSUING SHARES	18 – 2
	Underwriters	18 – 5
	Capitalisation shares	18 – 8
3	COMPANY FORMATION AND TRANSACTION COSTS	18 – 8
4	REDEMPTION OF PREFERENCE SHARES	18 – 9
	Accounting procedures	18 – 9
5	ACQUISITION OF A COMPANY'S OWN SHARES	18 – 13
6	CHAPTER ILLUSTRATIVE EXAMPLE	18 – 14
7	SUMMARY	18 – 16

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1 Introduction

In Chapter 17, the scrutiny of the statement of financial position of a company showed that the capital structure of a company differed considerably from the statement of financial position of a sole proprietor or a partnership.

For a sole proprietor or a partnership, the original capital investment in the business, as well as the cumulative profits, are accumulated in the capital and current accounts. The capital structure of a company, however, consists of shares and reserves. The classes of shares and reserves were defined and discussed in the previous chapter.

This chapter discusses:

- The issue of shares, including underwriters' commission and capitalisation shares and the relevant accounting entries.
- The share capital account (in accordance with the Companies Act).
- The accounting entries for the redemption of preference shares are introduced.
- The acquisition of a company's own shares.

Wherever examples are used, the statement of financial position is drafted to comply with the **minimum disclosure requirements** for share capital and reserves of companies.

The minimum disclosure requirements for companies is the minimum amount of information that should be disclosed in financial statements to comply with the requirements of the Companies Act and International Financial Reporting Standards (IFRS), specifically International Accounting Standard 1 (IAS 1). Chapter 20 deals with the other minimum disclosure requirements.

2 Issuing shares

The Companies Act outlines the procedures for the issue of shares to shareholders. We will discuss these procedures, as well as the accounting entries for the issue of shares.

The first shares issued are those subscribed to by founding members in terms of the Memorandum of Incorporation (MoI) of the company. Then a public company may offer its shares for subscription to:

- Existing members – called a **rights issue**.
- The general public – a **prospectus** will be issued by the company to explain the terms of the share issue.

Reminder

When a company offers shares to the public it must first issue a prospectus.

A prospectus is a notice or circular that offers shares and explains the terms and the conditions of the share issue to the public.

A rights issue is an offer made to existing shareholders to take up new shares in a company in the same proportion to the shares already held. The rights issue price is usually lower than the market price, to serve as an incentive for shareholders to take up shares. Shareholders forward their applications with the required cash amount to the company.

In terms of the Companies Act 61 of 1973, a company could issue par value shares or no par value shares. Par value shares (PV) can be issued at nominal value (at par), at a price higher than nominal value (at a premium), or at a price lower than nominal value (at a discount).

The Companies Act 71 of 2008 states that a share does not have a nominal or par value and all shares will be no par value shares. Companies with unissued par value shares at the effiective date may continue to issue the unissued shares at par value until the company convert these par value shares into no par value shares.

As par value shares still exists, a brief explanation and example of the conversion of par value shares to no par value shares are included in this chapter.

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In terms of the Companies Act 71 of 2008, only no par value shares can be issued. No par value shares (NPV) have no nominal value, and can, therefore, not be issued at par, at a premium or a discount. They are issued at a price determined appropriate by the directors.

The Companies Act requires that a fresh issue of shares be approved by the shareholders at a general meeting, prior to their issue. Shareholders frequently give the directors a general authority to issue shares until the next general meeting. This authority should be disclosed in the financial statements of the company. The date and terms of a fresh issue of shares are usually approved by the board of directors.

Did you know?

The shares of companies listed on the JSE Securities Exchange no longer have share certificates, as electronic records of the shareholders of companies are kept on the STRATE electronic system of the JSE Securities Exchange.

STRATE is an abbreviation for 'share transactions totally electronic'.

Reminder

Refer to Figure 17.1 to refresh your memory about listed and unlisted shares.

Remember also to look at the glossary at the back of the book as you come across new terms.

The Companies Act requires that a company may not allot or issue any shares unless the full issue price (or other consideration) for such shares is paid to the company. All shares must be fully paid up shares. A company may not issue more shares than the number of shares it is authorised to issue in terms of the Memorandum of Incorporation (MoI) of the company.

If the authorised share capital of a company must be increased, a special resolution must be passed by the shareholders at a general meeting. This special resolution is lodged with the Companies and Intellectual Properties Commission (CIPC) so that the MoI of the company can be updated.

A person wishing to subscribe to new shares in a company is required to complete and send an application form, together with the purchase price of the shares, to the company or its agents.

When these applications are received by the company/agents and they exceed the shares available for issue, the company has an **over-subscription** for the shares. The money of unsuccessful applicants, also called subscribers, is refunded. If fewer applications are received than the shares available for issue, the company has an **under-subscription** of the shares.

Once share applications have been accepted, the shares are allotted or allocated to the new shareholders. On allotment, share certificates are issued and mailed to the new shareholders.

An updated shareholders register is kept by the company, and can be viewed as a subsidiary ledger to the share capital account in the general ledger. An investor can also obtain shares in a company by acquiring the shares of existing shareholders. This type of transaction does not require any entry in the general ledger, but the transfer of shares will be recorded in the shareholders register.

The entries to record the fresh issue of shares are best explained in an example. Example 18.1 will be used to explain the entries required on the issue of no par value shares.

Remember that companies can no longer authorise any shares with a par value but they may still have issued par value shares if they have not been converted to no par value shares.

Example 18.1 **Issuing shares**

Lerato Ltd was formed with an authorised share capital of:

100 000	Ordinary shares
50 000	Preference shares (fixed annual dividend of 8c/share)

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Issuing shares (issue under-subscribed)

The founders of the company subscribe and pay for 20 000 ordinary shares @ R1.50/share. Six months later, the public is offered 50 000 ordinary shares @ R1.75/share and 50 000 preference shares (fixed annual dividend of 8c/share) @ 50c/share.

Subscriptions are received for 30 000 ordinary shares and 50 000 preference shares and all shares are allotted. Ordinary share issue expenses of R5 000 were incurred.

You are required to:

- Record the journal entries for the issue of the shares.
- Draft the statement of financial position of Lerato Ltd to comply with the minimum disclosure requirements of the Companies Act and IFRS.

GENERAL JOURNAL OF LERATO LTD **GJ 1**

Day	Details	Fol.	Debit		Credit	
	Bank (20 000 × R1.50)	B	30 000	00		
	Founders allotment account	N			30 000	00
	Receipt of application money from founders					
	Founders allotment account	N	30 000	00		
	Ordinary share capital	B			30 000	00
	Allotment of ordinary shares to founders					
	Bank (30 000 × R1.75)	B	52 500	00		
	Application and allotment: Ordinary shares	N			52 500	00
	Receipt of application money from the public					
	Application and allotment: Ordinary shares	N	52 500	00		
	Ordinary share capital	B			52 500	00
	Allotment of ordinary shares to the public					
	Bank (50 000 × 50c)	B	25 000	00		
	Application and allotment: Preference shares	N			25 000	00
	Receipt of application money for preference shares					
	Application and allotment: Preference shares	N	25 000	00		
	Preference share capital	B			25 000	00
	Allotment of preference shares to the public					
	Share issue expenses	N	5 000	00		
	Bank	B			5 000	00
	Payment of share issue expenses					
	Ordinary share capital	B	5 000	00		
	Share issue expenses	N			5 000	00
	Write off share issue expenses to the share capital account					

Lerato Ltd
STATEMENT OF FINANCIAL POSITION AS AT …

	Notes	20x …	
ASSETS ***Current assets***			
Cash and cash equivalents (30 000 + 52 500 + 25 000 – 5 000)		102 500	00
EQUITY AND LIABILITIES ***Capital and reserves***		102 500	00
Ordinary share capital (30 000 + 52 500 – 5 000)	2	77 500	00
Preference share capital		25 000	00

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED ...

2	***Share capital***		
	Authorised		
	100 000 ordinary shares		
	50 000 preference shares (fixed annual dividend of 8c/share)		
	Issued		
	50 000 ordinary shares	77 500	00
	50 000 preference shares (fixed annual dividend of 8c/share)	25 000	00
		102 500	00

Lerato Ltd
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED ...

	Ordinary share capital	Preference share capital	Reserves	Total
Opening Balance				
New shares issued				
50 000 ordinary shares	82 500			82 500
50 000 preference shares		25 000		25 000
Share issue expense written off	(5 000)			(5 000)
Closing balance	77 500	25 000	0	102 500

Explanation

- The ordinary share capital and preference share capital form the share capital and reserves.
- The share issue was under-subscribed by 20 000 ordinary shares. Only 50 000 (30 000 + 20 000) ordinary shares were, therefore, issued.
- Share issue expenses must be written off against the share capital account in terms of the Companies Act 71 of 2008.
- If more than one type of share is issued, separate application and allotment and share capital accounts are used.

Underwriters

When a new share issue is announced by a company, there is a risk that the share issue can be under-subscribed. This could result in the company being unable to issue the required number of shares to obtain the necessary capital.

To overcome this risk, companies make use of underwriters. Underwriters provide a guarantee to a company that the share issue will be fully subscribed.

If the share issue is over-subscribed, the guarantee from the underwriters will not need to be exercised but they still receive a commission because they insured the company against the risk. If the share issue is under-subscribed the underwriters take up the shares not subscribed for at the share issue price. In return for this service, they are paid a commission by the company.

Underwriters' commission is calculated using an agreed percentage on the total value of all the shares that they underwrite. This commission is treated as an expense, which must be written off against the equity account and not recognised as an expense in the statement of profit or loss & other comprehensive income. Example 18.2 shows the calculation and recording of underwriter's commission.

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Example 18.2 shows the calculation and recording of underwriters' commission.

Example 18.2

Issue of shares with share issue expenses and underwriters' commission

Beta Ltd has these balances and totals in their records as at 31 December 20x2:

Details	Fol.	Debit		Credit	
Ordinary share	B1			100 000	00
Retained earnings	B2			50 000	00
Preference share capital	B3			30 000	00
Non-current assets	B4	100 000	00		
Current assets	B5	70 000	00		
Share issue expenses (preference shares)	N7	10 000	00		
		180 000	00	180 000	00

Additional information not recorded in the trial balance:

1. On 1 June 20x2, at a meeting of the directors held it was decided:
   - To issue a further 50 000 ordinary shares to the public at R2.50 per share on 31 August 20x2.
     - Share issue expenses amounted to R6 000.
     - The entire issue was underwritten by Able Underwriters Ltd for a commission of 5%.

   Applications were received for 40 000 shares.
2. On 1 June 20x2, at the annual general meeting, the directors were given a general authority to issue the unissued shares of the company until the next annual general meeting.
3. All share issue expenses and underwriters' commission are to be written off on 30 September 20x2.
4. The authorised share capital consists of:

150 000 ordinary shares
50 000 redeemable preference shares (fixed annual dividend of 8c/share)

You are required to:

- Prepare the journal entries to record the transactions.
- Draft the statement of financial position and the notes to the financial statements for the year ended 31 December 20X2.

GENERAL JOURNAL OF BETA LTD **GJ12**

Day	Details	Fol.	Debit		Credit	
31/08	Bank (40 000 × R2.50)	B	100 000	00		
	Application and allotment: ordinary shares	N			100 000	00
	Receipt of application money from the public					
	Application and allotment: ordinary shares	N	100 000	00		
	Ordinary share capital	B			100 000	00
	Allotment of 40 000 ordinary shares to the public					
	Bank (10 000 × R2.50)	B	25 000	00		
	Application and allotment: ordinary shares	N			25 000	00
	Receipt of application money for 10 000 shares underwritten by Able Underwriters Ltd					
	Application and allotment: ordinary shares	N	25 000	00		
	Ordinary share capital	B			25 000	00
	Allotment of ordinary shares to Able Underwriters Ltd					
	Share issue expenses	N	6 000	00		
	Bank	B			6 000	00
	Payment of share issue expenses incurred					

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	Underwriters' commission	N	6 250	00		
	Bank	B			6 250	00
	Payment of underwriters' commission to Able Underwriters Ltd (50 000 shares × R2.50 × 5%)					
30/09	Ordinary share capital	B	12 250	00		
	Share issue expenses	N			6 000	00
	Underwriters' commission	N			6 250	00
	(Share issue expenses written off)					
	Preference share capital	B	10 000	00		
	Preference share issue expenses	N			10 000	00
	(Share issue expenses written off)					

Beta Ltd

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*2

	Notes	20*x*2	
ASSETS ***Non-current assets***		100 000	00
Current assets (70 000 + 100 000 + 25 000 – 6 000 – 6 250)		182 750	00
TOTAL ASSETS		282 750	00
EQUITY AND LIABILITIES ***Capital and reserves***		282 750	00
Ordinary share capital (100 000 + 100 000 + 25 000 – 6 000 – 6 250)	2	212 750	00
Retained earnings		50 000	00
Preference share capital (30 000 – 10 000)		20 000	00
TOTAL EQUITY AND LIABILITIES		282 750	00

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20.2

2 ***Share capital***

Authorised

150 000 ordinary shares

50 000 redeemable preference shares (fixed annual dividend of 8c/share)

Issued

100 000 ordinary shares	212 750	00
30 000 redeemable preference shares (fixed annual dividend of 8c/share)	20 000	00
	232 750	00

- The directors have the authority to issue the unissued shares of the company until the next annual general meeting.
- The redeemable preference shares are redeemable at the option of the company from 1 January 20x4 to 31 December 20x8 at a premium of 15c/share (*information assumed*).

Explanation

- Underwriters' commission is calculated on the total value of the shares that the underwriters guarantee , therefore, on 50 000 shares × R2.50 and not only on the 10 000 shares taken up.
- If directors have been given authority by the shareholders to issue unissued shares, this should be stated as a note to the financial statements.
- For redeemable preference shares that have not yet been redeemed, there should be a note stating:
  - The earliest and latest dates on which the company may redeem them.
  - Whether the redemption is obligatory or at the option of the company or shareholders.
  - The premium payable on redemption.

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Capitalisation shares

Capitalisation shares are also known as bonus shares and are issued to existing shareholders in the same proportion as the shares already held. As no payment is received from shareholders for these shares, only a book entry, which converts reserves into issued share capital, is required. The total equity of the company does not change as reserves (retained earnings) will decrease and issued share capital will increase.

Capitalisation shares are usually issued to reduce the market price of shares and to make the shares cheaper and, therefore, more marketable. The Companies Act of 2008 requires that capitalisation shares be issued for adequate consideration as determined by the board.

Example 18.3 **Issuing capitalisation shares**

The trial balance of Themba (Pty) Ltd included these balances at 31 December 20*x*3:

Details	Fol.	Debit		Credit	
Ordinary share capital 150 000 ordinary shares	B1			195 000	00
Retained earnings	B4			90 000	00
Net other assets	B5	285 000	00		
		285 000	00	285 000	00

At a meeting of directors on 20 December 20*x*3, it was decided to issue on 31 December 20*x*3 capitalisation shares of one ordinary share for every three ordinary shares already held at the current market price of R1.50 each.

You are required to:
Prepare the journal entry in Themba (Pty) Ltd's books to record the above decision.

GENERAL JOURNAL OF THEMBA (PTY) LTD **GJ12**

Day	Details	Fol.	Debit		Credit	
31/12	Retained earnings	B	75 000	00		
	Ordinary share capital	B			75 000	00
	Capitalisation issue of one share for every three held					

3 Company formation and transaction costs

According to IAS, all transaction costs of an equity transaction, such as share issue expenses and underwriters' commission, are accounted for as a deduction from the equity account. If the issue of shares is abandoned, the transaction costs are recognised as an expense in the statement of profit or loss & other comprehensive income.

Preliminary expenses, such as company formation costs, are recognised as an expense in the statement of profit or loss & other comprehensive income.

You should be able to complete Questions 18.1 to 18.7.

Did you know?

An amendment to the Companies Act allows South African companies to buy back their own shares. These shares are called treasury shares.

Section 48 of the Act (which deals with these particular shares) includes specific provisions to protect the interests of payables.

This issue will be dealt with later in this chapter.

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4 Redemption of preference shares

Accounting procedures

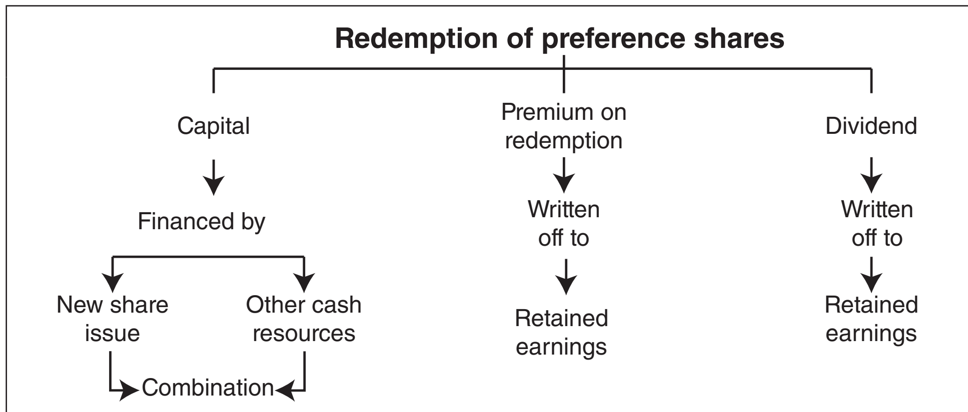
When redeemable preference shares are redeemed, part of the capital investment in the company is paid to the preference shareholders. Before the preference shares are redeemed, the company must satisfy the liquidity and solvency test to protect the other shareholders and creditors of the company.

Preference shareholders may receive:

- Their **capital investment**.
- A **premium on the redemption** of the shares, as agreed at the time of the original issue of the shares.
- Any **preference dividend** up to the date of redemption, still due and payable to them.

Figure 18.1 shows the treatment of the capital, premium on redemption and dividend on the redemption of redeemable preference shares. The redemption of the preference shares may be financed by a new share issue (ordinary or preference shares) by raising a loan, the issue of debentures or from any other cash resources.

Figure 18.1



The Companies Act requires that the premium on redemption be established at a date prior to the allotment date of the preference shares and that the terms of redemption be stipulated in the articles of the Memorandum of Incorporation (MoI) of the company.

Dividends can be provided for out of current or retained earnings available for distribution. Where the redeemable preference shares are cumulative, the full backlog of dividends, if any, should be provided for.

Example 18.4 shows the accounting entries required when preference shares are redeemed. This example will be used in two cases to explain the redemption of preference shares:

Case 1 A new share issue.

Case 2 Without a new share issue.

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Example 18.4

Redeeming redeemable preference shares

The trial balance of Echo Ltd as at 31 March 20x4 is:

Details	Fol.	Debit		Credit	
Ordinary share capital	B1			270 000	00
Retained earnings	B2			130 000	00
Redeemable preference shares (fixed annual dividend of 14c/share)	B3			60 000	00
Bank	B4	160 000	00		
Non-current assets	B5	300 000	00		
		460 000	00	460 000	00

Authorised share capital:		
300 000 ordinary shares		
60 000 redeemable preference shares (fixed annual dividend of 14c/share)		
Issued share capital:		
125 000 ordinary shares	270 000	00
60 000 redeemable preference shares (fixed annual dividend of 14c/share)	60 000	00

Case 1: Redeeming preference shares from a new share issue

On 15 March 20x4, at a meeting of the directors, it was decided to issue 30 000 ordinary shares on 20 March 20x4 at R2.30/share and to redeem the preference shares on 31 March 20x4 at a premium of 25c/share.

You are required to:

1 Prepare the journal entries to implement the directors' decisions in Case 1 and 2.

2 Prepare the statement of financial position for Case 1 and 2.

CALCULATION	Cash needed		Cash available	
Preference shares to be redeemed				
Capital	60 000	00		
Premium payable on redemption (60 000 × 25c)	15 000	00		
Redeemed from new share issue				
Ordinary shares				
(30 000 × R2.30)			69 000	00
Cash in bank			160 000	00
Cash needed/Cash available	75 000	00	229 000	00
Cash surplus			154 000	00

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GENERAL JOURNAL OF ECHO LTD **GJ3**

Day	Details	Fol.	Debit		Credit	
20/03	*New share issue recorded*					
	Bank	B	69 000	00		
	Application and allotment: Ordinary shares	N			69 000	00
	Receipt of application money from the public					
	Application and allotment: Ordinary shares	N	69 000	00		
	Ordinary share capital	B			69 000	00
	Allotment of new share issue					
31/03	*Redemption of preference shares*					
	Preference shares capital	B	60 000	00		
	Premium payable on redemption	N	15 000	00		
	Bank	B			75 000	00
	Redemption of 14% preference shares at a premium of 25c					
	Retained earnings	B	15 000	00		
	Premium payable on redemption	N			15 000	00
	Premium payable on redemption written off against retained earnings					

Echo Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*4

	Notes	20*x*4	
ASSETS			
Non-current assets		300 000	00
Current assets		154 000	00
Bank (160 000 – 75 000 + 69 000)		154 000	00
TOTAL ASSETS		454 000	00
EQUITY AND LIABILITIES			
Capital and reserves		454 000	00
Ordinary share capital (270 000 + 69 000)	2	339 000	00
Distributable reserve			
Retained earnings (130 000 – 15 000)		115 000	00
Preference share capital (60 000 – 60 000)		0	00
TOTAL EQUITY AND LIABILITIES		454 000	00

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 20.4

2 *Share capital*

Authorised		
300 000 ordinary shares		
60 000 redeemable preference shares (fixed annual dividend of 14c/share)		
Issued		
155 000 ordinary shares	339 000	00

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These movements will be disclosed in the statement of changes in equity:

Movement of shares

Shares issued during the current year:		
30 000 ordinary shares	69 000	00
	69 000	00

Explanation

- Although the preference shares have been redeemed, they still remain part of the authorised share capital.
- The premium on the redemption of preference shares must be written off against the retained earnings.

Case 2: Redeeming preference shares without a new shares issue

On 15 March 20*x*4, at a meeting of directors, it was decided to fully redeem the preference shares at a premium of 25c/share on 31 March 20*x*4.

CALCULATION	Cash needed		Cash available	
Preference shares to be redeemed				
Capital	60 000	00		
Premium payable on redemption (60 000 × 25c)	15 000	00		
Cash in bank			160 000	00
Cash needed/Cash available	75 000	00	160 000	00
Cash surplus			85 000	00

GENERAL JOURNAL OF ECHO LTD **GJ3**

Day	Details	Fol.	Debit		Credit	
31/03	*Redemption of preference shares*					
	Preference shares capital	B	60 000	00		
	Premium payable on redemption	N	15 000	00		
	Bank	B			75 000	00
	Redemption of 14% preference shares at a premium of 25c					
	Retained earnings	B	15 000	00		
	Premium payable on redemption	N			15 000	00
	Premium payable on redemption written off against retained earnings					

Echo Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*4

	Notes	20*x*4	
ASSETS ***Non-current assets***		300 000	00
Current assets		85 000	00
Bank (160 000 – 75 000)		85 000	00
TOTAL ASSETS		385 000	00
EQUITY AND LIABILITIES ***Capital and reserves***		385 000	00
Ordinary share capital	2	270 000	00

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Distributable reserve			
Retained earnings (130 000 – 15 000)		115 000	00
Preference share capital (60 000 – 60 000)		0	00
TOTAL EQUITY AND LIABILITIES		385 000	00

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 20*x*4

2 ***Share capital***		
Authorised		
300 000 ordinary shares		
60 000 redeemable preference shares (fixed annual dividend of 14c/share)		
Issued		
125 000 ordinary shares	270 000	00

Explanation

- The premium payable on redemption must be written off against retained earnings.
- The movement in the share capital and reserves is disclosed in the statement of changes in equity.

You should be able to complete Questions 18.8 to 18.12.

5 Acquisition of a company's own shares

Sometimes a company may want to acquire its own shares. The reasons may vary from reducing the number of shareholders to increasing the market value of its shares.

In the past, South African companies were not allowed to buy their own shares, although it was standard practice in many overseas countries to do so.

The latest amendments to the Companies Act 71 of 2008 allow South African companies to buy their own shares (see Section 48).

If a company in South Africa wants to buy its own shares:

- It must pass a special resolution by the board.
- It must be authorised by its Memorandum of Incorporation (MoI) to do so.
- The payment should not affect the ability of the company to pay its debts (liquidity test).
- The payment should not cause the liabilities of the company to exceed its assets (solvency test).

  The company buys its own shares from its shareholders at a market price agreed to by the two parties.

If no par value shares are bought back, the share capital account of these shares is decreased by the average issue price of the no par value shares. The average price is calculated by dividing the rand value of the share capital account by the number of issued shares.

When the company paid more for the shares than the average issue price or book value, the so-called 'premium' must be written off to retained earnings.

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Example 18.5 **Acquisition of a company's own shares**

Tsumi Ltd has this share capital:

Authorised share capital
100 000 ordinary shares
50 000 preference shares (fixed annual dividend of 8c/share)
30 000 redeemable preference shares (fixed annual dividend of 19c/share)

Issued share capital

100 000 ordinary shares	150 000	00
50 000 preference shares (fixed annual dividend of 8c/share)	75 000	00

The directors of Tsumi Ltd decide to acquire its own shares:

Case I: 20 000 ordinary shares @ R2.50 each

Case 2: 10 000 preference shares @ R2.00 each (fixed annual dividend of 8c/share)

You are required to:
Record the journal entries for the issue of shares in each case.

GENERAL JOURNAL OF TSUMI LTD **GJ 1**

Day	Details	Fol.	Debit		Credit	
Case 1	*Acquisition of ordinary shares*					
	Ordinary share capital	B	30 000	00		
	Retained earnings	B	20 000	00		
	Bank	B			50 000	00
	Repurchase and cancellation of 20 000 ordinary shares					
Case 2	*Acquisition of preference shares*					
	Preference share capital	B	15 000	00		
	Retained earnings	B	5 000	00		
	Bank	B			20 000	00
	Repurchase and cancellation of 10 000 preference shares					

Calculation of the average price:

Ordinary shares	
R150 000 ÷ 100 000 own shares	= R1.50
Cancellation: 20 000 x R1.50	= R30 000
Preference shares	
R75 000 ÷ 50 000 own shares	= R1.50
Cancellation: 10 000 × R1.50	= R15 000

6 Chapter illustrative example

On 30 June 20*x*6, Lusiti Ltd had these balances in their records:

120 000 ordinary shares	322 000	00
60 000 redeemable cumulative preference shares (fixed annual dividend of 10c/share)	120 000	00
Retained earnings	100 000	00
Bank overdraft	93 000	00
Preliminary expenses	10 000	00
Underwriters' commission (on ordinary shares)	2 000	00

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On 12 June 20*x*6, at a meeting of the directors of Lusiti Ltd, it was decided:

1. On 1 July 20*x*6, to redeem the redeemable cumulative preference shares (fixed annual dividend of 10c/share).
2. To finance this redemption by:
   - A fresh issue of 60 000 redeemable preference shares (fixed annual dividend of 8c/share) at an issue price of R1.25/share.
   - An 8% secured long-term loan that had been arranged with Gaxa Ltd.
3. To write off all preliminary expenditure and underwriters' commission in the accounting records immediately after the issue of the 8% redeemable preference shares.

Additional information not recorded in the trial balance:

1. The redeemable cumulative preference shares (fixed annual dividend of 10c/share) are redeemable at a premium of 20c/share at any time (at the option of the company).
2. The authorised share capital of the company is:
   - 150 000 ordinary shares.
   - 100 000 redeemable cumulative preference shares (fixed annual dividend of 10c/share).
   - 100 000 redeemable preference shares (fixed annual dividend of 8c/share).
3. The directors have the power to issue unissued shares.
4. No dividends have been paid since 31 December 20*x*3, as the company was in a loss situation up to the commencement of the present financial year.
5. Expenses related to the share issue amount to R7 000.
6. The bank overdraft facility is limited to R100 000.
7. The year end of the company is 31 December.
8. Ignore taxation.

You are required to:
Prepare the general journal entries for Lusiti Ltd to record the above transactions. (Narrations are not required.)

GENERAL JOURNAL OF LUSITI LTD **GJ7**

Day	Details	Fol.	Debit		Credit	
	Bank	B	75 000	00		
	Application and allotment: Preference shares	N			75 000	00
	Application and allotment: Preference shares	N	75 000	00		
	Redeemable preference shares (fixed annual dividend of 8c/share)	B			75 000	00
	Preference share capital	B	120 000	00		
	Premium on redemption	N	12 000	00		
	Dividend	N	30 000	00		
	Bank	B			162 000	00
	Retained earnings	B	12 000	00		
	Premium on redemption	N			12 000	00
	Bank	B	87 000	00		
	Long-term loan (162 000 – 75 000)	B			87 000	00
	Share issue expenses	N	7 000	00		
	Bank	B			7 000	00

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	Preference share capital	B	7 000	00		
	Share issue expenses	N			7 000	00
	Retained earnings	B	10 000	00		
	Preliminary expenses	B			10 000	00
	Ordinary share capital	B	2 000	00		
	Underwriters' commission	N			2 000	00

7 Summary

This chapter dealt with the accounting entries specific to the share capital of companies. Recording the issue of no par value shares was shown with examples. The implications of over-subscription and under-subscription of shares were also explained.

Examples were used to show the accounting entries for underwriters' commission, the issue of capitalisation shares and company formation and transaction costs.

The requirements of the Companies Act and International Financial Reporting Standards (IFRS), the accounting entries for the redemption of preference shares and the acquisition of a company's own shares were discussed and shown with examples.

QUESTIONS

Question 18.1

Briefly define these terms:

- Capitalisation shares.
- Par value shares.
- Share premium.
- Participating preference shares.

Question 18.2

Briefly describe what the purpose of an underwriter is and how they are compensated for their work.

Question 18.3

Explain these terms and highlight the differences between them:

- No par value shares.
- Nominal value and market value.
- Ordinary shares and preference shares.

Question 18.4

Discuss the difference between a rights issue and a capitalisation issue.

Question 18.5

The trial balance of Allumi Limited as at 30 June 20*x*9 included these balances:

Authorised and issued share capital (100 000 ordinary shares)	217 500	00
Retained earnings	273 000	00

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Additional information:
- The directors of Allumi Limited want to issue another 50 000 shares @ R2/share to the public.
- Share issue expenses will be R4 500 and must be written off.

You are required to:
1. Discuss whether the company may issue shares to the public.
2. What legal requirements should be met before the share issue?
3. Prepare the journal entries to record the share issue. (Narrations are not required.)

Question 18.6

The trial balance of Ikaneng Ltd included these balances as at 31 December 20*x*6:

Ordinary share capital (100 000 ordinary shares)	224 000	00
Preference share capital 50 000 redeemable preference shares (fixed annual dividend of 16c/share)	120 000	00
Retained earnings	190 000	00

The directors decided to write all issue expenses off and to issue capitalisation shares.

You are required to:
1. Show against which accounts the expenses and capitalisation issue can be written off:
   - **a** Underwriters' commission (preference shares).
   - **b** Preliminary expenses.
   - **c** Share issue expenses (ordinary shares).
   - **d** Capitalisation shares.
   - **e** Share issue expenses (preference shares).
2. Show the general journal entries to write off these expenses:
   - – Preliminary expenses R14 000
   - – Share issue expenses
     - * Ordinary shares R15 000
     - * Preference shares R8 000
   - – Underwriters' commission
     - * Ordinary shares R12 000

Question 18.7

The trial balance of Alfredo Limited as at 31 December 20*x*6 included these balances:

Ordinary share capital (120 000 ordinary shares)	210 000	00
100 000 preference shares (fixed annual dividend of 15c/share)	50 000	00
Retained earnings	176 000	00
Asset replacement reserve	10 000	00
Reserve for the replacement of machinery	25 000	00
Preliminary expenses	18 000	00

The newly appointed bookkeeper of Alfredo Limited has approached you to assist him with these questions (each question should be treated separately):
1. What is the minimum value at which the company may issue further ordinary shares in terms of the Companies Act?

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2 If the directors decide to issue capitalisation shares in the ratio of one ordinary share for every two ordinary shares already held, which accounts can be used to journalise the capitalisation issue?
3 Which accounts can be used if the preliminary expenses were to be written off?

Question 18.8

Here is the post-closing trial balance of Easy Ltd as at 31 December 20*x*8:

Easy Ltd
POST-CLOSING TRIAL BALANCE AS AT 31 DECEMBER 20*x*8

Details	Fol.	Debit		Credit	
Ordinary share capital (55 000 ordinary share)	B1			110 000	00
50 000 redeemable preference share capital (fixed annual dividend of 7c/share)	B2			50 000	00
Retained earnings	B4			85 000	00
Sundry tangible assets	B5	170 000	00		
Bank	B6	75 000	00		
		245 000	00	245 000	00

Additional information:

- The company has an authorised capital consisting of 400 000 ordinary shares and 50 000 redeemable preference shares (fixed annual dividend of 7c/share).
- The preference shares are redeemable at the option of the company between 1 January 20*x*6 and 31 December 20*x*0 at a premium of 10c/share.
- On 1 January 20*x*9, the directors decided to redeem the preference shares and this was done during January.

You are required to:

1 Show against which account the premium on redemption of preference shares should be written off.
2 Show the journal entries (including cash transactions) to record the redemption of the preference shares assuming the redemption is made out of the proceeds of a fresh issue of 100 000 ordinary shares at 55c/share.

Question 18.9

At a meeting of the board of directors of Nahim Ltd it was decided:

- On 30 September 20*x*1, to redeem the redeemable preference shares of the company.
- To achieve this by a fresh issue of the maximum number of ordinary shares permissible without the necessity to call a meeting of shareholders. The issue price for the proposed issue would be R1.20/share.
- After the redemption and the issue have been made that a proposal is put to the shareholders at a general meeting to increase the authorised share capital by an amount sufficient to allow a capitalisation issue of one ordinary share for every two ordinary shares already held at the current market price of R1.20/share.

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This information is from the records of Nahim Ltd as at 31 August 20*x*1:

80 000 ordinary shares	75 000	00
25 000 redeemable preference shares (fixed annual dividend of 12c/share)	50 000	00
Surplus on revaluation of land	50 000	00
Retained earnings	65 000	00
Bank	80 000	00
Non-current assets	160 000	00

Additional information:

1 The redeemable preference shares are redeemable at a premium of 20c/share at any time, at the option of the company. Dividends for the current year must be paid to the date of redemption.

2 The authorised share capital of the company is:
   - 100 000 ordinary shares.
   - 25 000 redeemable preference shares.

3 The directors have the power to issue unissued shares.

4 The company has sufficient cash, together with the proceeds of the fresh issue, to make any payments that can be required.

5 The company earned a profit after taxation of R5 000 for the month of September 20*x*1.

6 Expenses related to the share issue amount to R1 000.

7 The year end for the company is 31 March.

You are required to:

1 Record the general journal entries for the redemption and the fresh issue of shares on 30 September 20*x*1.

2 Prepare the equity and liabilities section of the statement of financial position, as it would appear immediately after the redemption and fresh share issue. Presentation must comply with the requirements of the Companies Act and IAS 1. Show all workings separately.

3 Show, by means of an abridged journal entry, the effect of the directors' decision on the issue of capitalisation shares, should it be confirmed by the shareholders.

4 Give one good reason for the elaborate provisions made by the Companies Act regulating the procedure for the redemption of redeemable preference shares.

Question 18.10

Here is an extract from Mapule Ltd's statement of financial position as at 31 December 20*x*2:

EQUITY AND LIABILITIES ***Capital and reserves***		xxx xxx	xx
Issued and fully paid up		xxx xxx	xx
10 000 redeemable preference shares (fixed annual dividend of 6c/ share)		20 000	00
Ordinary share capital	2	xx xxx	xx
Distributable reserve	4	10 100	00
Asset replacement reserve		8 000	00
Retained earnings	2	2 100	00

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Additional information:

- The preference shares are redeemable at a premium of 2% on 3 January 20*x*3.
- The directors wish to issue the minimum number of ordinary shares at R1.02 each. Ignore dividends and taxation.

You are required to:

1 Calculate the number of ordinary shares to be issued.

2 Show the balances on distributable reserves (if any).

Question 18.11

On 1 January 20*x*0, the company was incorporated with an authorised share capital of 150 000 ordinary shares and 50 000 preference shares (fixed annual dividend of 10c/share).

The post-closing trial balance of Coral Limited as at 31 December 20*x*2 after the provisional statement of profit or loss & other comprehensive income was drafted is shown.

Coral Limited

POST-CLOSING TRIAL BALANCE AS AT 31 DECEMBER 20*x*2

Details	Fol.	Debit		Credit	
Ordinary share capital (100 000 shares @ R1 each)	B1			100 000	00
Ordinary share premium	B2			5 000	00
Retained earnings	B3			43 000	00
Preference share capital (40 000 preference shares @ R1 each)	B4			40 000	00
Land and buildings	B5	100 000	00		
Plant and machinery	B6	60 000	00		
Underwriting commission – preference shares	B7	4 000	00		
Share issue expenses – preference shares	B8	2 000	00		
Bank	B9	22 000	00		
		188 000	00	188 000	00

Additional information:

The directors decided, with the necessary general meeting approval, to implement these decisions on 1 January 20*x*3 in this order:

1 The authorised share capital must be converted to 150 000 ordinary shares @ no par value.

2 The preference shares are to be redeemed at a premium of 5c/share.

3 The redemption of the preference shares must be financed partly from the issue of 10 000 ordinary shares @ R2/share and partly out of the current bank balance.

4 The ordinary shares were offered to the public.
- The issue was underwritten in full by Down-Under Ltd for an underwriting commission of 6%.
- The public subscribed for 8 000 shares.
- All the shares were allotted on 1 January 20*x*3.
- Share issue expenses amounted to R500.

5 The directors wish to write off all commission and share issue expenses immediately after the redemption of the preference shares.

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6 Subsequent to the above transactions, there must be a capitalisation issue of one ordinary share for every eight already held at the current market price of R2.00/share.

You are required to:

1 Show the general journal entries for the decisions on 1 January 20*x*3. (Ignore dividend tax.)

2 Draw up the equity and liabilities section of the statement of financial position of Coral Ltd on 1 January 20*x*3, in compliance with the Companies Act 71 of 2008 and International Financial Reporting Standards (IFRS) after having made all the above adjustments.

Question 18.12

The bookkeeper of Investor (Pty) Ltd, Ms Inexperienced, prepared a post-closing trial balance as at 31 October 20*x*5. She, however, did not take into account the additional information.

Investor (Pty) Ltd
POST-CLOSING TRIAL BALANCE AS AT 31 OCTOBER 20*x*5

Details	Fol.	Debit		Credit	
Ordinary share capital	B1			300 000	00
50 000 redeemable preference shares @ R1 each (fixed annual dividend of 12c/share)	B2			50 000	00
Non-distributable reserve (profit on sale of investment)	B3			12 750	00
Asset replacement reserve	B4			40 000	00
Retained earnings	B5			228 450	00
16% long-term loan	B6			35 000	00
Preference shareholders	B7	58 000	00		
Investments:					
Listed	B8	215 225	00		
Unlisted	B9	145 875	00		
Fixed deposits	B10	175 000	00		
Bank	B11	91 700	00		
Preliminary expenses	B12	5 600	00		
Share issue expense (ordinary shares)	B13	2 650	00		
Current tax payable	B14			27 850	00
		694 050	00	694 050	00

Additional information:

1 On 1 March 20*x*5, the directors of the company passed these resolutions:
- Preliminary expenses and share issue expenses should no longer appear in the books.
- The preference shares are to be redeemed on 1 May 20*x*5 at a premium of 10%. The dividend for the current year is payable to the date of redemption.

2 The non-distributable reserves can only be distributed to shareholders upon liquidation.

You are required to:

Show the equity and liabilities section of the statement of financial position as at 31 October 20*x*5, after taking the information above into account.

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19 ASSETS AND LIABILITIES

Chapter objectives

By the end of this chapter, you should be able to:

- Address the presentation of liabilities and assets in the statement of financial position of a company.
- Explain the difference between debt (such as debentures) and equity (such as share capital), and the relationship, called leverage, between the two.
- Explain the accounting entries for the issue and redemption of debentures and for debenture discounts and premiums.
- Introduce the disclosure requirements in terms of the Companies Act for loans to directors and key management personnel.

Chapter outline

1	INTRODUCTION	19 – 2
2	NON-CURRENT LIABILITIES	19 – 2
	Financial liabilities	19 – 3
	Debentures	19 – 3
	Leverage	19 – 12
3	CURRENT LIABILITIES	19 – 13
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7	CHAPTER ILLUSTRATIVE EXAMPLE	19 – 14
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1 Introduction

The capital structure of a company consists of capital invested by the owners or shareholders, known as equity capital, and capital loaned to the company by third parties, known as liabilities.

In Chapter 18, the equity of the company (share capital and reserves) was discussed and the accounting entries specific to share capital were shown with examples.

This chapter deals with the assets and liabilities of a company. The assets and liabilities of a company can be divided into two categories in terms of International Accounting Standard 1 (IAS 1): non-current and current.

- A *liability is classified as current if it is repayable within one financial year after the reporting date*.
  - Short-term (or current) liabilities are usually unsecured and often interest free.
  - Long-term (non-current) liabilities are often secured by movable or immovable assets and are usually interest bearing.
- N*on-current assets are those assets that will be held for more than one year with the view of producing income, while current assets are usually realised within one financial year after the reporting date*.

  Non-current assets consist of:
  - Tangible assets such as furniture and vehicles.
  - Intangible assets such as brands and goodwill.
  - Financial assets such as investments.
- C*urrent assets are those assets that will be consumed, or will be receivable, within one financial year*.

  Current assets consist of:
  - Tangible assets such as inventory.
  - Financial assets such as accounts receivable.

Reminder

Refer to Chapter 3 for the definitions of assets and liabilities.

Did you know?

Liquidity refers to the ability of a company to turn an asset into cash.

A further category of assets and liabilities exists, namely contingent assets and liabilities.

These assets or liabilities only arise on the occurrence or non-occurrence of uncertain future events that are beyond the control of management. These items are usually not included in the statement of financial position but are presented in the notes to the financial statements as these items influence the risk profile of the company.

In this chapter, each category of liability and asset is defined and the relevant presentation and disclosure requirements in terms of the Companies Act and IAS 1 are discussed.

As the issue and redemption of debentures require accounting entries, not usually encountered with other types of liabilities, the debenture journal entries are also addressed and shown with examples.

2 Non-current liabilities

Liabilities are separated into non-current and current liabilities on the face of the statement of financial position.

Non-current liabilities are those that are repayable only after one year. Many types of non-current liabilities exist, but for the purposes of this chapter, non-current liabilities are dealt with in two categories:

1 Financial liabilities.

2 Debentures (this is a financial liability).

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Financial liabilities

Financial liabilities may be defined as funds made available to a business, usually at a determined interest rate, and repayable after at least one year. Included under financial liabilities are lease obligations, long-term foreign loans, long-term bank loans and credit instalment obligations.

Financial liabilities may be distinguished from debentures as the financial liabilities are usually aquired from one source, while debentures are offered to the public for subscription and may, thus, be held by different debenture holders.

Financial liabilities may either be secured (a mortgage bond) or unsecured (an unsecured bank loan). The financial statements of a company should distinguish between secured and unsecured loans. When a loan is secured, details of the assets serving as security should be disclosed in the notes.

If a company has several long-term loans, they should be listed in the financial statements in order of liquidity. The loans to be repaid first are listed last in the notes to the statement of financial position. When a loan or portion of a loan is repayable within the next financial year from the reporting date, the amount is transferred from 'non-current liabilities' to 'current liabilities'.

The Companies Act requires that the following minimum information for non-current liabilities (including debentures) be disclosed in the financial statements of a company:

- The amount.
- The interest rate.
- The dates of repayment.
- If repayable in instalments, the instalment amount.
- If secured, details of the assets.

Non-current interest bearing loans should be disclosed on the face of the statement of financial position. If a loan is of a short-term nature the above information is not required in terms of the Companies Act.

Several International Financial Reporting Standards require additional disclosure for assets and liabilities. These requirements are not addressed in this chapter.

Debentures

Definition of debentures

A debenture is a long-term loan from debenture holders to the company (who issues the debentures). Debentures do not form part of the equity of the company, but are classified under non-current liabilities.

The debenture document states the terms of the loan made to the company by the debenture holders, whether the loan is secured or unsecured, the applicable interest rate, as well as the repayment terms. A debenture consists of the nominal value which will be repaid on the redemption of the debenture and the periodic interest payable, calculated on the nominal value of the debenture.

Debentures are an example of a non-current liability. It is important to distinguish debentures from equity.

Figure 19.1 shows the main distinctions between debentures and shares. Note that debenture holders usually receive a fixed interest, irrespective of whether the company makes a profit. Shareholders, however, only receive a dividend when profits are available for distribution and a dividend is declared by the directors and approved by the shareholders.

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Figure 19.1

DEBENTURES	SHARE CAPITAL
• Acknowledgement of debt.	• Unit of ownership.
• Disclosed as a liability.	• Disclosed as equity.
• Issued as secured or unsecured.	• Risk capital, therefore, unsecured.
• May be redeemed by company and reissued or cancelled.	• May be acquired and cancelled.
• Capital may be acquired in instalments.	• Fully paid up when issued.
• Earns fixed interest every year.	• Earns dividends when declared.
• No voting rights.	• Usually has voting rights.
• Secured or unsecured creditor on liquidation.	• Shares in the surplus assets after payment of payables on liquidation of company.
• Issued at par, at a premium, or at a discount.	• Issued at no par value.
• Maturity date.	• No such date.

Different types of debentures may be identified depending on the specific rights attached to them. The interest rate paid is usually influenced by the specific rights attached to the debentures. The categories of debentures may include:

1 Secured debentures – Debentures secured by either movable or immovable assets.
2 Guaranteed debentures – Debentures guaranteed by the controlling or holding company.
3 Unsecured debentures – Debentures not secured by any assets, and debenture holders ranking on par with other payables.
4 Redeemable debentures – Debentures may be redeemed prior to the maturity date on dates specified in the trust deed.
5 Callable debentures – Debentures may be redeemed at any date prior to the maturity date.
6 Convertible debentures – Debenture holders have the option to convert their debentures into specified shares after a given period.
7 Registered debentures – Debentures are registered if the debenture holder's name appears on the debenture certificate and the company maintains an updated register of debenture holders.
8 Bearer of unregistered debentures – Debentures are unregistered if no record is maintained of debenture holders and the present holder of the debenture is deemed the owner.
9 Coupon debentures – Debentures which are not registered, and where interest coupons attached to the debentures are used to claim the interest payments.

Did you know?

Convertible debentures may be converted to shares at some future date. This financial instrument consists of two elements: equity and liability.

In advanced accounting studies you will learn how to recognise these two elements separately and how to disclose them in the financial statements in terms of IAS 32 and 39, as well as IFRS 7 and 9.

The debentures of a company are transferable from one debenture holder to another. A company may purchase its own debentures either for reissue at a later date or for cancellation.

The Memorandum of Incorporation (MoI) of a company normally specify whether a company may reissue debentures which have been redeemed or repaid. A note to the financial statements should identify the debentures held by the company for reissue.

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Issue of debentures

> **Reminder**
> Refer to Chapter 18 for the accounting treatment of underwriters' commission, which also applies here.

Debentures may be issued at par, at a premium or at a discount. The interest rate on similar securities in the market, at the date of the issue of the debentures, will influence the issue price of the debentures.

- If the market rate is higher than the interest rate on the debentures being issued, the debentures are sold at a discount.
- If the market rate is lower than the interest rate on the debentures, the debentures are sold at a premium.

The directors usually determine the interest rates on debentures after considering the market-related interest rates, the timing and the effect of interest payments on the future cash flow of the company.

Debentures are usually offered to the public or financial institutions for subscription. When applications for debentures received by the company exceed the debentures available for subscription, the company has an over-subscription for debentures. If the applications for debentures are fewer than the debentures available for issue, the company has an under-subscription for the debentures. The company may have the issue of debentures underwritten to ensure that all debentures are taken up.

The accounting entries to record the issue of debentures are shown in Example 19.1. The example is used in three cases to show the issue of debentures:

A At par.

B At a premium.

C At a discount.

Transaction costs may be incurred with the issue and redemption of debentures. These costs include fees or commissions to agents, advisors, underwriters, brokers and the duties and levies payable. Transaction costs do not include debt premiums or discounts, financing costs or internal costs.

The statements of financial position in the example are drafted to comply with the disclosure requirements of the Companies Act and IAS 1. The other disclosure requirements for companies are addressed in Chapter 20.

Example 19.1 **Issue of debentures**

At a meeting of the directors of Kilo Ltd on 1 December 20*x*2, it was decided to offer 10 000 12% mortgage debentures @ R100 each to the public on 1 January 20*x*3.

- The mortgage debentures will be redeemed on 31 December 20*x*7.
- The financial year end is 31 December.
- Debentures are secured by a first mortgage bond over land and buildings.

Ignore interest calculations.

You are required to:

1. Prepare the necessary journal entries to give effect to the issue of the debentures.
2. Prepare the equity and liabilities section of the statement of financial position after the issue of the debentures.

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A Debenture issue at par, fully paid on application

In this case, the directors decide to issue the debentures at par. Applications are received for 10 000 debentures and all debentures are subsequently allotted.

GENERAL JOURNAL OF KILO LTD **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Bank (10 000 × R100)	B7	1 000 000	00		
	Debenture application	N9			1 000 000	00
	Cash received with 10 000 debenture applications					
	Debenture application	N9	1 000 000	00		
	12% mortgage debentures	B8			1 000 000	00
	10 000 12% mortgage debentures allotted					

Kilo Ltd
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*3

	Notes	20*x*3	
EQUITY AND LIABILITIES			
Capital and reserves		xxx xxx	xx
Ordinary share capital	7	xxx xxx	xx
Retained earnings	8	xx xxx	xx
Non-current liabilities			
Long-term borrowings		xx xxx	xx
Mortgage debentures	9	1 000 000	00
TOTAL EQUITY AND LIABILITIES		x xxx xxx	xx

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20*x*3

9 *Mortgage debentures*

10 000 mortgage debentures @ R100 each.

- Rate of interest 12%.
- Repayable in full on 31 December 20*x*7.
- Secured by a first mortgage bond over land and buildings.

Explanation

- Debentures are shown in the real account 'mortgage debentures' at nominal value.
- The Companies Act requires that the financial statements contain information about the:
  - Class of debentures issued.
  - Amount of debentures issued.
  - Interest rate.
  - Repayment dates.
  - Details of the security.
- IAS 1 requires that non-current interest-bearing liabilities be shown on the face of the statement of financial position.

B Debenture issue at a premium, over-subscription, fully paid on application

In this case, the directors decide to issue debentures at 105% payable in full on application. Applications for 13 000 debentures are received. Unsuccessful applicants are refunded.

GENERAL JOURNAL OF KILO LTD **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Bank (13 000 × R105)	B7	1 365 000	00		
	Debenture application	N9			1 365 000	00
	Cash received with 13 000 debenture applications					

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	Debenture application	N9	1 050 000	00		
	12% mortgage debentures	B8			1 050 000	00
	10 000 12% mortgage debentures allotted at a premium of 5%					
	Debenture application	N9	315 000	00		
	Bank	B7			315 000	00
	Cash repayment to 3 000 unsuccessful applicants @ R105 per debenture					

Kilo Ltd
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x3

	Notes	20x3	
EQUITY AND LIABILITIES			
Capital and reserves		xxx xxx	xx
Ordinary share capital	7	xxx xxx	xx
Retained earnings	8	xxx xxx	xx
Non-current liabilities			
Long-term borrowings		xx xxx	xx
Mortgage debentures	9	1 050 000	00
TOTAL EQUITY AND LIABILITIES		x xxx xxx	xx

Note 9: As per previous example.

Explanation

Debenture premium will be allocated to the debenture interest expense over the life of the debentures.

C Debenture issue at a discount, under-subscription, fully paid on application

In this case, the directors decide to issue debentures at 97%, payable in full on application. Applications for 8 000 debentures are received.

GENERAL JOURNAL OF KILO LTD **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Bank [8 000 × (97% × 100)]	B7	776 000	00		
	Debenture application	N9			776 000	00
	Cash received with 8 000 debenture applications					
	Debenture application	N9	776 000	00		
	12% mortgage debentures	B8			776 000	00
	8 000 12% mortgage debentures allotted					

Kilo Ltd
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x3

	Notes	20x3	
EQUITY AND LIABILITIES			
Capital and reserves		xxx xxx	xx
Ordinary share capital	7	xxx xxx	xx
Retained earnings	8	xxx xxx	xx
Non-current liabilities			
Long-term borrowings		xx xxx	xx
Mortgage debentures	9	776 000	00
TOTAL EQUITY AND LIABILITIES		x xxx xxx	xx

Note 9: As per previous example, except that 8 000 debentures are issued.

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Explanation
Debenture discount is an expense paid in advance and will be allocated to the debenture interest expense, over the life of the debentures.

Did you know?
Shares and debentures may not be issued to directors unless the allocation is made on the same terms and conditions applying to other shareholders or debenture holders, or if the issue is approved by the shareholders prior to the issue.

Debenture discounts and premiums

Debenture discounts and premiums are identified on the date of the issue of the debentures. Such costs or benefits derived from the issue of the debentures should be allocated over the life of the debentures to which they relate.

The annual allocation of the discount will increase the nominal account 'debenture interest paid' and the allocation of the premium will decrease the account.

By allocating the debenture discounts and premiums to the statement of profit or loss & other comprehensive income over the life of the debentures, instead of writing the amounts off in one amount, matching is gained between the cost of the debentures and the benefits derived from the use of the funds from debentures.

The portion of the debenture discounts, premiums and issue costs which have not yet been apportioned to the statement of profit or loss & other comprehensive income is disclosed in the statement of financial position as a deduction from the nominal value of the debentures and the debenture premium is added to the nominal value of the debentures.

The allocation of the debenture discounts, issue costs and premiums to the statement of profit or loss & other comprehensive income and the disclosure of the unamortised amounts on the statement of financial position are shown in Examples 19.2 and 19.3.

Example 19.2 **Debenture premium on issue**

In this case, the extract from the trial balance of Kilo Ltd on 31 January 20*x*3 contained:

Kilo Ltd
TRIAL BALANCE AS AT 31 JANUARY 20*x*3

Details	Fol.	Debit		Credit	
Real Accounts Section 10 000 12% mortgage debentures @ R100 each (issued @ 105% on 1 January 20*x*3)	B8			1 050 000	00
Other net assets	B…	1 050 000	00		
		1 050 000	00	1 050 000	00

- Interest is payable on 31 December every year.
- Debentures are secured by a first mortgage over land.
- Debentures are redeemable on 31 December 20*x*6 at par.
- No transaction costs were incurred.
- The effective interest rate is 10.41%.

You are required to:

1. Prepare the necessary journal entries to record the debenture transactions for the year ended 31 December 20*x*3.
2. Prepare the equity and liabilities section of the statement of financial position after passing the above journal entries.

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GENERAL JOURNAL OF KILO LTD **GJ12**

Day	Details	Fol.	Debit		Credit	
01/01	Bank (10 000 × R105)	B7	1 050 000	00		
	Debenture application	N9			1 050 000	00
	Cash received with 10 000 debenture applications					
	Debenture application	N9	1 050 000	00		
	12% mortgage debentures	B8			1 050 000	00
	10 000 12% mortgage debentures allotted at a premium of 5%					
31/12	Debenture interest (1 050 000 × 10.41%)	N12	109 305	00		
	12% mortgage debentures (balancing figure)	N13	10 695	00		
	Bank (1 000 000 × 12%)	B7			120 000	00
	Recognised interest paid and amortisation of premium on issue					

Kilo Ltd
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*3

	Notes	20*x*3	
EQUITY AND LIABILITIES			
Capital and reserves		xxx xxx	xx
Ordinary share capital	7	xxx xxx	xx
Retained earnings	8	xxx xxx	xx
Non-current liabilities			
Long-term borrowings		xx xxx	xx
Mortgage debentures (1 050 000 – 10 695)	9	1 039 305	00
TOTAL EQUITY AND LIABILITIES		x xxx xxx	xx

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20*x*3

9 *Mortgage debentures*

10 000 12% mortgage debentures @ R105 each, stated at amortised cost.

- Repayable in full on 31 December 20*x*6 at par.
- Secured by a first mortgage bond over land.

Explanation

- The effective rate of interest is calculated as follows using a financial calculator:

  n = 4
  PV = 1 050 000
  PMT = 120 000 (R1 000 000 × 12%)
  FV = 1 000 000
  Therefore: I = 10.41%

- The interest paid is calculated on the nominal value of the debentures issued.
- At the end of four years, the balance on the 12% mortgage debenture account will be amortised to R1 000 000, which is the settlement value of the debentures.
- The effective interest rate is shown in the profit and loss section of the statement of profit or loss & other comprehensive income and it consists of:
  - The actual interest expense of R120 000.
  - The amortisation of the premium paid on the issue of R10 695.

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Example 19.3

Debenture discount on issue

In this case, the extract from the trial balance of Kilo Ltd on 31 January 20x3 contained:

Kilo Ltd
TRIAL BALANCE AS AT 31 JANUARY 20x3

Details	Fol.	Debit		Credit	
Real Accounts Section					
10 000 12% mortgage debentures @ R100 each (issued @ 97% on 1 January 20x3)	B8			970 000	00
Other net assets	B…	970 000	00		
		970 000	00	970 000	00

- Interest is payable on 31 December every year.
- Debentures are secured by a first mortgage over land.
- Debentures are redeemable on 31 December 20x6 at par.
- No transaction costs were incurred.
- The effective interest rate is 13,01%.

You are required to:

1. Prepare the necessary journal entries to record the debenture transactions for the year ended 31 December 20x3.
2. Prepare the equity and liabilities section of the statement of financial position after passing the above journal entries.

GENERAL JOURNAL OF KILO LTD **GJ12**

Day	Details	Fol.	Debit		Credit	
01/01	Bank (10 000 × R97)	B7	970 000	00		
	Debenture application	N9			970 000	00
	Cash received with 10 000 debenture applications					
	Debenture application	N9	970 000	00		
	12% mortgage debentures	B8			970 000	00
	10 000 12% mortgage debentures allotted at a discount of 3%					
31/12	Debenture interest (970 000 × 13.01%)	N12	126 197	00		
	12% mortgage debentures (balancing figure)	N13			6 197	00
	Bank (1 000 000 × 12%)	B7			120 000	00
	Recognised interest paid and amortisation of discount on issue					

Kilo Ltd
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x3

	Notes	20x3	
EQUITY AND LIABILITIES			
Capital and reserves		xxx xxx	xx
Ordinary share capital	7	xxx xxx	xx
Retained earnings	8	xx xxx	xx
Non-current liabilities			
Long-term borrowings		xx xxx	xx
Mortgage debentures (970 000 + 6 197)	9	976 197	00
TOTAL EQUITY AND LIABILITIES		x xxx xxx	xx

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20x3

9 ***Mortgage debentures***

10 000 12% mortgage debentures @ R97 each, stated at amortised cost.

- Repayable in full on 31 December 20x6 at par.
- Secured by a first mortgage bond over land.

Explanation

- Effective rate of interest is calculated as follows using a financial calculator:

n = 4
PV = 970 000
PMT = 120 000
FV = 1 000 000
Therefore: I = 13.01%

- The interest paid is calculated on the nominal value of the debentures issued.
- At the end of four years, the balance on the 12% mortgage debenture account will be amortised to R1 000 000, which is the settlement value of the debentures.
- The effective interest rate is shown in the profit and loss section of the statement of profit or loss & other comprehensive income and it consists of:
  - The actual interest expense of R120 000.
  - The amortisation of the discount on the issue of R6 197.

You should be able to complete Questions 19.1 to 19.3.

Redemption of debentures

Debentures may be redeemed at par, at a premium or at a discount. The premium or discount on the redemption of the debentures should be provided for over the life of the debentures in terms of the amortisation cost method to achieve matching of income and expenses.

Example 19.4 shows the accounting entries required when debentures are redeemed at a premium. Debentures are seldom redeemed at a discount.

Debentures may also be issued or redeemed in instalments. (The issue or redemption in instalments, however, is a complex area which falls outside the scope of this book.)

Example 19.4

Redemption of debentures at a premium

In this case, the extract from the trial balance of Kilo Ltd on 1 January 20x7 contained:

Kilo Ltd
TRIAL BALANCE AS AT 1 JANUARY 20x7

Details	Fol.	Debit		Credit	
Real Accounts Section 10 000 12% mortgage debentures @ R100 each (issued @ 97% on 1 January 20x3)	B8			1 022 297	00
Other net assets	B…	1 022 297	00		
		1 022 297	00	1 022 297	00

- Interest is payable on 31 December every year.
- Debentures are secured by a first mortgage over land.
- Debentures are redeemable on 31 December 20x7 at 104%.

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- No transaction costs were incurred.
- The effective interest rate is 13.47%.

You are required to:
Prepare the necessary journal entries to record the debenture transactions for the year ended 31 December 20*x*7.

GENERAL JOURNAL OF KILO LTD **GJ12**

Day	Details	Fol.	Debit		Credit	
31/12	Debenture interest (1 022 297 × 13.47%)	N12	137 703	00		
	12% mortgage debentures (balancing figure)	N13			17 703	00
	Bank (1 000 000 × 12%)	B7			120 000	00
	Recognised interest paid and amortisation of premium on issue					
	12% mortgage debentures (1 000 000 × 104%)	B8	1 040 000	00		
	Bank (1 000 000 × 104%)	B7			1 040 000	00
	Redemption of mortgage debentures on settlement date at a premium of 4%					

Leverage

'Leverage' refers to the relationship between equity and debt.

Reminder

Using ratios to calculate the leverage of a company, and, therefore, its risk profile is discussed in Chapter 26.

The definition of equity capital (the issued share capital of a company) in the Companies Act excludes any part of the issued share capital that does not carry any right to participate in any dividends or capital repayment beyond a specified amount.

Equity capital consists, therefore, of ordinary shares, deferred shares and participating preference shares. Fixed dividend redeemable preference shares are classified as debt. Debt may also include debentures, mortgage bonds, interest-bearing loans, bank overdrafts and other interest-bearing debt.

The optimal capital structure, that is, the mix of own and borrowed funds employed, of any company will depend on the required risk profile of that company. Any company has a certain risk factor inherently attached to it. This risk is called business risk.

Consider, for example, a furniture store and a grocery store. The furniture store will feel the effects of a recession more severely than the grocery store, because the consumer with limited disposable income will still spend money on food, but might cut back on spending on furniture. In this example, the business risk attached to the furniture store is, therefore, higher than the risk attached to the grocery store. Many other factors, such as marketing and industrial relations, may have an effect on the business risk.

As long as a company makes use of its own funds only, it is exposed to business risk. As soon as it makes use of borrowed funds, it is also exposed to financial risk. This is so because interest payments and capital repayments of borrowed funds must be made regardless of profits made and available cash flow.

Companies with a low business risk may carry a higher financial risk, and vice versa. The higher the relationship between debt and equity, the higher the leverage but also the higher the financial risk.

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3 Current liabilities

Liabilities are classified as current when:

- It is expected to be settled in the normal operating cycle of the entity.
- It is held primarily for the purpose of trading.
- It is due to be settled within twelve months after the reporting period.
- The company has no unconditional right to defer settlement of the liability for at least twelve months after the reporting period.
- Current liabilities are usually unsecured and often interest free.

All other liabilities are classified as non-current.

The operating cycle of a company is the period that starts with the acquisition of raw materials (for a manufacturing concern) or inventories (for a trading concern) and concludes when the goods are sold and converted into cash.

The operating cycle is usually less than twelve months, although certain businesses, such as construction companies, can have operating cycles of longer than 12 months. It is general practice in South Africa to view liabilities that will be settled within 12 months of the statement of financial position date as current liabilities.

Current liabilities are often non-interest bearing debt. These liabilities include items such as payables, short-term borrowings, bank overdrafts, provisions, the SARS account for taxation payable and shareholders' dividends for the dividends still payable. When classifying current liabilities on the statement of financial position, the items should preferably be disclosed according to their liquidity – from the less liquid to the most liquid.

Liquidity refers to the ability of the company to meet its obligations in the short term. In this instance it means that, as far as practical, current debt that will be settled first should be shown last, under current liabilities on the statement of financial position.

4 Non-current assets

Non-current assets are assets where the intention of management is to hold and or use the asset over a period of longer than twelve months. The types of assets can be divided into:

1. **Tangible assets** such as property, plant and equipment that can be 'seen' and 'touched'.
2. **Intangible assets** such as goodwill, brands and patents that cannot be 'seen' or 'touched'.
3. **Financial assets** such as investments that are contracts where the company has to receive cash or other financial assets.

These three categories are not always mutually exclusive in that certain non-current assets may have elements of more than one category. In these cases the dominant feature is used to classify the asset. (This is an aspect addressed in advanced courses in financial accounting.)

Tangible non-current assets that are used in the company to generate income have a limited useful life, in other words, the value of these assets decline, and depreciation is provided on these assets. Other non-current assets are not used up in the company, and are therefore not depreciated, such as land, but can be tested for impairment.

The classification of non-current assets into three categories is used for disclosure purposes in the statement of financial position.

5 Current assets

An asset is classified as current when:

- It is expected to be realised, sell or consumed in the normal operating cycle of the entity.

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- It is held primarily for the purpose of trading.
- It is expected to be realised within twelve months after the reporting period.
- It is cash or a cash equivalent, unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

Near cash items are also called cash equivalents. All other assets are classified as non-current assets.

Current assets include tangible assets such as inventories and financial assets such as cash. They also include items such as receivables, inventories (inventories of cleaning materials, stationery and printing) short-term and speculative investments and cash.

As with current liabilities, current assets should be classified on the statement of financial position preferably in order of liquidity. Usually inventory, as the least liquid form, will be disclosed first, while cash at bank as the most liquid will be disclosed last.

You should be able to complete Questions 19.4 to 19.9.

6 Loans to directors and key management personnel

The Companies Act regulates the loans that companies make to their directors and managers, to protect the interests of shareholders and payables. In general, a company is not allowed to make a loan to a director or manager or to provide security for them.

There are however exceptions mentioned in Section 45 of the Companies Act where loans may be made, provided the necessary prior approval is gotten from the shareholders in a general meeting.

Loans may also be made to directors or managers to cover expenditure incurred in the performance of their duties and to provide loans or security for housing.

Transactions, including loans, with directors and managers are referred to as transactions and loans with key management personnel of the entity.

IAS24, related party disclosures, describes key management personnel as those persons who have authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, and includes any director (whether executive or otherwise) of the entity.

The following should be disclosed for transactions, including loans, with key management personnel:

- The nature of the relationship with the entity.
- The amount of the transaction.
- The amount of outstanding balances, including commitments.
- Terms and conditions such as interest rates, terms of repayments, security details.
- Details of any guarantees given or received.
- Allowance for bad debts related to the outstanding balance.

7 Chapter illustrative example

The chapter illustrative example combines the knowledge you have acquired on companies and requires you to draft the financial statements of a public company, Themba Ltd.

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Themba Ltd was incorporated on 1 March 20*x*0 with an authorised share capital of:

200 000 ordinary shares
100 000 preference shares (fixed annual dividend of 6c/share)
20 000 cumulative preference shares (fixed annual dividend of 8c/share)

On 28 February 20*x*2, these amounts appeared in the trial balance:

Share capital:		
80 000 ordinary shares	80 000	00
20 000 preference shares (fixed annual dividend of 6c/share)	40 000	00
5 000 cumulative preference shares (fixed annual dividend of 8c/share)	25 000	00
Listed share investment	53 560	00
General administrative costs	11 000	00
Bad debts	5 700	00
Bank	24 780	00
300 5% debentures @ R100 each	30 000	00
Land (at cost)	110 530	00
Furniture and equipment (at cost)	3 040	00
Vehicles (at cost)	5 870	00
Accumulated depreciation (1 March 20*x*1):		
Furniture and equipment	440	00
Vehicles	2 610	00
Accounts payable	34 640	00
Accounts receivable	40 180	00
Retained earnings (1 March 20*x*1)	12 760	00
Debentures interest (up to 1 September 20*x*1)	750	00
Interim/ordinary dividends	4 900	00
Allowance for bad debts	5 823	00
Gross profit	74 787	00
Provisional tax payments	18 000	00
10% loan to director	2 750	00
Inventory (28 February 20*x*2)	27 000	00
Investment income	2 000	00

Additional information:

1. Depreciation should be written off as follows:
   - Furniture and equipment – 10% per annum on carrying value.
   - Vehicles – 20% per annum on cost.
2. Accounts receivable of R180 should be written off as bad debts.
3. The allowance for bad debts remains at 10% of receivables.
4. On 28 February 20*x*2, a final dividend of 4c/share is declared on ordinary shares.
5. Land serves as security for debentures.
6. Included in administrative costs are directors' fees of R2 500 and auditors' fees of R1 000.
7. An amount of R30 000 should be transferred to asset replacement reserves.

Reminder

Once you have completed Chapter 22 on the minimum disclosure requirements for financial statements, you should return to this question and complete the notes to the financial statements (***accounting policy notes are not required.***)

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8 A provision for taxation of R20 000 should be made for the current year.

You are required to:
Draft a statement of financial position, a statement of profit or loss & other comprehensive income and statement of changes in equity of Themba Ltd for the year ended 28 February 20*x*2 for internal use.

Themba Ltd
STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20*x*2

	Notes	20*x*2	
ASSETS			
Non-current assets		171 266	00
Property, plant and equipment	9	114 956	00
Financial assets:		56 310	00
Loan to director	10	2 750	00
Investment	10	53 560	00
Current assets		87 780	00
Inventories	11	27 000	00
Accounts receivable (40 180 – 180 – 4 000)		36 000	00
Cash and cash equivalents		24 780	00
TOTAL ASSETS		259 046	00
EQUITY AND LIABILITIES			
Capital and reserves		184 056	00
Ordinary share capital	12	80 000	00
Reserves		30 000	00
Retained earnings		9 056	00
Ordinary shareholders' interest		119 056	00
Preference shares (fixed annual dividend of 6c/share)	12	40 000	00
Cumulative preference shares (fixed annual dividend of 8c/share)	12	25 000	00
Non-current liabilities		30 000	00
Long-term borrowings	13	30 000	00
Current liabilities		44 990	00
Accounts payable (34 640 + 750)		35 390	00
SARS: income tax (20 000 – 18 000)		2 000	00
Shareholders for dividends (2 400 + 2 000 + 3 200)		7 600	00
TOTAL EQUITY AND LIABILITIES		259 046	00

Alternative presentation of capital and reserves:

EQUITY AND LIABILITIES			
Capital and reserves		184 056	00
Share capital (80 000 + 40 000 + 25 000)	12	145 000	00
Reserves		30 000	00
Retained earnings		9 056	00

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Themba Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 20x2

	Notes	20x2	
Revenue	2	xxx xxx	xx
Cost of sales		xx xxx	xx
Gross profit		74 787	00
Other income	3	3 823	00
Administration and selling expenses		(11 000	00)
Other expenses (5 700 + 1 434 + 180)		(7 314	00)
Finance costs (750 + 750)	4	(1 500	00)
Profit before taxation	5	58 796	00
Income tax expense	6	(20 000	00)
PROFIT FOR THE YEAR		38 796	00

Themba Ltd
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 28 FEBRUARY 20x2

	Ordinary share capital		6% preference shares		8% cumulative preference shares		Asset replace-ment reserve		Retained earnings		Total	
Balance at beginning of year	80 000	00	40 000	00	25 000	00	0	00	12 760	00	157 760	00
Total comprehensive income									38 796	00	38 796	00
Ordinary dividend									(8 100	00)	(8 100	00)
Preference dividend									(4 400	00)	(4 400	00)
Transfer to asset replacement reserve							30 000	00	(30 000	00)	0	00
Balance at end of year	80 000	00	40 000	00	25 000	00	30 000	00	9 056	00	184 056	00

Themba Ltd
NOTES TO THE FINANCIAL STATEMENTS AS AT 28 FEBRUARY 20x2

1 ***Accounting policies***

Not required

Reminder

Return to the Notes section only after you have studied Chapter 20.

2 ***Revenue***

The sale of goods	xxx	xx

3 ***Other income***

Investment income: Dividends	2 000	00
Decrease in bad debt allowance	1 823	00

4 ***Finance costs***

Interest on debentures	1 500	00

5 ***Profit before tax***

Profit before tax is stated after these items have been taken into account:

Depreciation	1 434	00
Furniture and equipment	260	00
Vehicles	1 174	00
Auditors' fees (for audit)	1 000	00

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6 *Income tax expense*

Normal South African corporate tax		
Current tax for the current year	20 000	00
Prior year under-/(over-) provision	0	00
Total income tax expense	20 000	00

7 *Dividends*

Dividends declared and recognised as distributions to owners.	8 100	00
Dividend per share.	10 cent	

8 *Key management personnel compensation*

Short-term employee benefits	2 500	00

9 *Property, plant and equipment*

	Land and buildings		Furniture and equipment		Vehicles		Total	
Net carrying value at beginning of year	110 530	00	2 600	00	3 260	00	116 390	00
Gross carrying amount	110 530	00	3 040	00	5 870	00	119 440	00
Accumulated depreciation	0	00	(440	00)	(2 610	00)	(3 050	00)
Movements	0	00	(260	00)	(1 174	00)	(1 434	00)
Additions at cost	0	00	0	00	0	00	0	00
Disposals at carrying value	0	00	0	00	0	00	0	00
Depreciation	0	00	(260	00)	(1 174	00)	(1 434	00)
Net carrying value at end of year	110 530	00	2 340	00	2 086	00	114 956	00
Gross carrying amount	110 530	00	3 040	00	5 870	00	119 440	00
Accumulated depreciation	0	00	(700	00)	(3 784	00)	(4 484	00)

10 *Financial assets*

Investment

Cost (market value will be stated)	53 560	00

Loans to director

Unsecured loan at 10% interest to Mr A. Khumalo:		
Balance at beginning of year	2 750	00
Movements	0	00
Balance at end of year	2 750	00

11 *Inventories*

Finished goods	27 000	00

12 *Share capital*

Authorised

200 000 ordinary shares

100 000 preference shares (fixed annual dividend of 6c/share)

20 000 cumulative preference shares (fixed annual dividend of 8c/share)

Issued

80 000 ordinary shares	80 000	00
20 000 preference shares (fixed annual dividend of 6c/share)	40 000	00
5 000 cumulative preference shares (fixed annual dividend of 8c/share)	25 000	00

13 *Long-term borrowings*

300 secured debentures @ R100 each	30 000	00

The debentures are secured by land with a carrying value of R110 530 (see Note 9) and bear interest at 5% per annum. Debentures are repayable in full at par.

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Explanation

- The statement of financial position is shown before the statement of changes in equity and the statement of profit or loss & other comprehensive income in the financial statements.

8 Summary

This chapter addressed the classifications and presentation of assets and liabilities in the statement of financial position of companies. This classification is also applicable to other forms of enterprises.

Assets and liabilities are classified into non-current and current assets and liabilities. Current assets and liabilities are those that will be realised or settled in the normal course of the company's operating cycle or within twelve months of the statement of financial position date. All other liabilities and assets are viewed as non-current.

The distinction between equity and debt was explained by contrasting the differences between debentures and share capital.

The leverage or gearing of a company, being the relationship between own capital (share capital) and outside capital (debentures), was explained with a brief reference to the impact of leverage on the risk profile of the company.

The accounting entries to record debentures transactions were shown with examples and the disclosure of loans to key management personnel in terms of the Companies Act and International Financial Reporting Standards were addressed.

QUESTIONS

Question 19.1

Why should the amount of premium or discount arising on the issue of debentures be charged on an equitable basis to revenue?

Question 19.2

A high inflation rate makes the traditional debenture market unattractive to the investor. What changes can be made to debentures in such circumstances to adjust to market needs?

Question 19.3

Explain the difference between debentures and shares.

Question 19.4

Define these terms:

- Current liabilities.
- Debentures.
- Leverage.
- Financial assets.
- Current assets.
- Liquidity.
- Operating cycle.
- Contingent liability.

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Question 19.5

Give the categories into which non-current assets can be divided, with an example of each.

Question 19.6

Flavour (Pty) Ltd issued R200 000 12% secured debentures at 105% on 1 July 20*x*4.

- Interest is payable twice yearly on 31 December and 30 June.
- The debentures are redeemable at par value in ten years' time.
- The effective interest rate is 5.58%.
- The company's financial year end is 30 June.

You are required to:
Prepare the journal entries for the year ended 30 June 20*x*5. (Narrations are not required.)

Question 19.7

Balantine Ltd issued 1 000 10% secured redeemable debentures of R100 each at a discount of 95% on 1 January 20*x*3. Interest is payable twice yearly on 31 December and 30 June. The effective interest rate is 6.06%.

The company's financial year end is 31 December. The debentures are redeemable on 31 December 20*x*7 at a premium of 105%.

You are required to:

1. Prepare the necessary journal entries for the year ended 31 December 20*x*4.
2. Prepare the relevant extracts from the financial statements for the year ended 31 December 20*x*4. (Notes to the financial statements are not required.)

Question 19.8

These balances were included on the statement of financial position of Thebe Ltd as at 30 June 20*x*9:

Share capital		
20 000 ordinary shares	74 300	00
10 000 redeemable preference shares (fixed annual dividend of 12c/share)	10 000	00
Retained earnings	120 000	00
	204 300	00

1. On 31 August 20*x*9, the preference shares were redeemed at a premium of 40c/share. The redemption was financed by the issue of:
   - 3 000 ordinary shares at an issue price of R4/share.
   - 1 000 12% debentures @ R2 each issued at par value.
   - The invitation to subscribe for shares was duly published and on 31 August 20*x*9 6 000 ordinary shares and 1 000 debentures were applied for. On the same day, the shares and debentures were allotted and the unsuccessful applicants were refunded their application money.

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2 The following expenses were incurred:
- R1 000 share issue expenses.
- R400 debenture issue expenses.
- The dividend of R200 payable to preference shareholders to 31 August 20*x*9 was paid. (Ignore dividend tax.)

3 The directors wish to write off all issue expenses.

You are required to:
Record all the transactions (in journal entry form) relating to the redemption of preference shares, and the issue of shares and debentures in terms of the above information. (Narrations are not required.)

Question 19.9

The directors of Vitafix Ltd decided:
- On 30 June 20*x*4, to issue 15 000 15%-convertible debentures of R50 each to the public at 95%.
- All debentures should be fully paid before allocation.
- The debentures are fully convertible into ordinary shares at the option of debenture holders on 30 June 20*x*8 at the ratio of 20 shares for every debenture held. The debentures not converted will be redeemed in full on 30 June 20*x*8.
- The debenture issue will be underwritten by ABC Underwriters at a commission of 7%.
- Applications were received for 18 000 debentures.
- All unsuccessful applicants were refunded.
- Debenture issue expenses of R6 000 were incurred.

You are required to:

1 Prepare the necessary journal entries to record the directors' resolution. (Narrations are not required.)

2 Show the disclosure of debentures in the statement of financial position of Vitafix Ltd as at 30 June 20x4 in accordance with the requirements of the Companies Act and International Financial Reporting Standards (IFRS).

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20 MINIMUM DISCLOSURE REQUIREMENTS

Chapter objectives

By the end of this chapter, you should be able to:

- Explain and show the minimum disclosure requirements for companies in accordance with the Companies Act and IAS 1 for the:
  - statement of profit or loss & other comprehensive income
  - statement of financial position
  - statement of changes in equity
  - notes to the financial statements and accounting policies

Chapter outline

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	Share capital	20 – 10
	Reserves	20 – 12
	Liabilities	20 – 13
	Property, plant and equipment	20 – 14
	Intangible assets	20 – 15
	Investments or financial assets	20 – 16
	Current assets	20 – 17
	Loans to key management personnel	20 – 17
	Contingent liabilities	20 – 17
	Capital commitments	20 – 18
5	STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR PUBLICATION	20 – 18
	Revenue	20 – 19
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6	STATEMENT OF CHANGES IN EQUITY FOR PUBLICATION	20 – 21
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1 Introduction

The aim of accounting is to provide information useful to users for making decisions. In the past, companies have tended to provide as little information as possible.

To ensure that all companies provide adequate financial information, minimum disclosure requirements for company financial statements have been formulated.

The financial statements of companies should be drafted to comply with these minimum disclosure requirements.

Minimum disclosure requirements are defined in:

- The Companies Act 71 of 2008.
- International Financial Reporting Standards (IFRS) approved by the International Accounting Standards Board (IASB) and specifically International Accounting Standard 1 (IAS 1).

International Financial Reporting Standards (IFRS) are the standards and interpretations issued by the International Accounting Standards Board (IASB). Those standards include:

- International Financial Reporting Standards (IFRS).
- International Accounting Standards (IAS).
- Interpretations originated by the Committee on International Financial Reporting Interpretations (IFRIC) or the former Standards Interpretations Committee (SIC).

Further references for good accounting practice may be found in:

- Opinions issued by the South African Institute of Chartered Accountants (SAICA).
- JSE Securities Exchange Regulations.

The directors of a company are responsible for the completion of annual financial statements that comply with minimum disclosure requirements. The directors are also responsible for the presentation of financial statements to the shareholders at the annual general meeting, where the statements are approved.

Section 29 of the Companies Act 71 of 2008, requires that the annual financial statements must:

- Satisfy the IFRS as to form and content.
- Fairly present the company's state of affairs and business.
- Explain the company's transactions and financial position.
- Show the company's assets, liabilities, equity, income and expenses and any other prescribed information.
- Set out the date on which the statements were published.
- Set out the accounting period to which the statements apply.
- Include on the first page a notice indicating whether the statements were audited or not, as well as the name and professional designation, if any, of the individual who prepared or supervised the preparation of the financial statements.

If the directors of a company decide to depart from these accounting standards, full particulars of the departure, the effects and the reasons for it should be given in the financial statements.

In this chapter, emphasis will be placed on the disclosure requirements in the Companies Act 71 of 2008 and IAS 1 with regard to the statement of financial position, the statement of profit or loss & other comprehensive income, the statement of changes in equity, the notes to the financial statements and the accounting policies. The most recent disclosure requirements of IAS 1 should be incorporated into the accounting policy of profit companies.

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There are many other accounting standards, most recently the International Accounting Standards, which also include additional disclosure requirements for financial statements.

These disclosure requirements will be addressed in later years of study when the specific accounting standard (IAS/IFRS) is addressed. The additional disclosure is required by external users of financial statements who do not have access to the financial records of the company.

The directors' report, auditor's report and statement of cash flows are excluded from the examples. The statement of cash flows and its minimum disclosure requirements are addressed in Chapter 21.

The minimum disclosure requirements, with reference to the illustrative example, will be discussed under these headings:

- Accounting policies.
- Statement of financial position and notes to the statement.
- Statement of profit or loss & other comprehensive income and notes to the statement.
- Statement of changes in equity and notes to the statement.

2 Example of annual financial statements

Figures 20.1, 20.2, 20.3 and 20.4 on the next few pages show a full example of the annual financial statements and notes of a company.

Figure 20.1

Nkomo Ltd
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*1

	Notes	20*x*1		20*x*0	
ASSETS					
Non-current assets		373 000	00	375 000	00
Property, plant and equipment	4	280 000	00	310 000	00
Intangible assets	5	10 200	00	15 000	00
Investments/Financial assets	6	82 800	00	50 000	00
Current assets		267 000	00	147 000	00
Inventories	7	120 000	00	57 000	00
Trade receivables	8	62 000	00	70 000	00
Other current assets	9	20 000	00	0	00
Cash and cash equivalents		65 000	00	20 000	00
TOTAL ASSETS		640 000	00	522 000	00

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EQUITY AND LIABILITIES					
Capital and reserves	2	458 000	00	284 000	00
Share capital		252 000	00	192 000	00
Retained earnings		146 000	00	52 000	00
Other components of equity		60 000	00	40 000	00
Non-current liabilities		32 000	00	62 000	00
Mortgage debentures	3	24 000	00	32 000	00
Other unsecured interest-bearing borrowings		8 000	00	30 000	00
Current liabilities		150 000	00	176 000	00
Short-term borrowings	3	8 000	00	8 000	00
Trade payables		70 000	00	84 000	00
Provisions	10	30 000	00	35 000	00
SARS: Income tax payable		27 800	00	40 800	00
Shareholders for dividends		14 200	00	8 200	00
TOTAL EQUITY AND LIABILITIES		640 000	00	522 000	00

Figure 20.2

Nkomo Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20*x*1

	Notes	20*x*1		20*x*0	
Revenue	13	1 033 000	00	700 000	00
Cost of sales		(528 000	00)	(380 000	00)
Gross profit		505 000	00	320 000	00
Other income	14	47 500	00	16 400	00
Administrative expenses		(30 000	00)	(51 000	00)
Distribution costs		(30 000	00)	(42 000	00)
Other expenses		(214 500	00)	(145 600	00)
Finance costs		(13 000	00)	(28 000	00)
Profit before tax	15	265 000	00	69 800	00
Income tax expense	16	(117 600	00)	(39 400	00)
Profit for the year		147 400	00	30 400	00
Other comprehensive income: Surplus on revaluation		20 000	00	20 000	00
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		167 400	00	50 400	00

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Figure 20.3

Nkomo Ltd
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20x1

	Ordinary share capital	Redeemable preference shares	Revaluation reserve	Retained earnings	Total
20x1					
Balance 30 June 20x0	192 000	0	40 000	52 000	284 000
Total comprehensive income			20 000	147 400	167 400
New shares issued		60 000			60 000
Ordinary dividends				(45 000)	(45 000)
Preference dividends				(8 400)	(8 400)
Balance 30 June 20x1	192 000	60 000	60 000	146 000	458 000
20x0					
Balance 30 June 19x9	192 000	0	20 000	66 600	278 600
Total comprehensive income			20 000	30 400	50 400
Ordinary dividends				(45 000)	(45 000)
Balance 30 June 20x0	192 000	0	40 000	52 000	284 000
Dividend per share					20x1 25 cents

Figure 20.4

Nkomo Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20x1

1 ***Accounting policies***

The financial statements are prepared on the historical cost basis, modified by the revaluation of certain land and buildings, in accordance with these principal accounting policies. The accounting policies adopted are consistent with those of the previous year.

Property, plant and equipment
Land and buildings are shown at valuation. Land and buildings is not depreciated. Vehicles are shown at cost and are depreciated on the straight-line method at 15% per annum.

Intangible assets
Purchased patents are recorded at cost and are amortised at 20% per annum on the straight-line method.

Inventory
Inventory is valued at the lower of cost and net realisable value and on a first-in-first-out basis.

Revenue
Revenue represents sales to customers net of value-added tax (VAT).

Investments
Investments are shown at cost, less provisions and amounts written off, and their results are brought to account only to the extent that dividends are receivable.

2 ***Share capital***	20x1		20x0	
Authorised				
300 000 ordinary shares				
150 000 redeemable preference shares (fixed annual dividend of 14c/share)				
Issued and fully paid				
180 000 ordinary shares	192 000	00	192 000	00
120 000 redeemable preference shares (fixed annual dividend of 14c/share)	60 000	00	0	00
	252 000	00	192 000	00

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- The 14% redeemable preference shares are redeemable at the option of the company from 1 December 20*x*2 to 30 June 20*x*3 at a premium of 15c/share. (The preference shares are cumulative regarding dividends.)
- The directors have authority to issue the balance of the unissued shares before the next annual general meeting on 15 August 20*x*1.

3	***Mortgage debentures***	**20*x*1**		**20*x*0**	
	Secured				
	320 14% mortgage debentures at R100 each.	32 000	00	40 000	00
	• Secured by a first mortgage bond on land at a valuation of R60 000				
	• Repayable in five equal instalments from 1 January 20*x*1 to 1 January 20*x*5				
	Less: Instalment repayable within one year, transferred to current liabilities	(8 000	00)	(8 000	00)
		24 000	00	32 000	00
	Unsecured				
	An unsecured loan bearing interest at 18% p.a. and repayable on 30 June 20*x*1 and on 30 June 20*x*8	8 000	00	30 000	00
		32 000	00	62 000	00

4	***Property, plant and equipment***	**Land**		**Buildings**		**Vehicles**		**Total**	
	Net carrying amount at 30 June 20x0	160 000	00	0	00	150 000	00	310 000	00
	Gross carrying amount	160 000	00	0	00	212 800	00	372 800	00
	Accumulated depreciation	0	00	0	00	(62 800	00)	(62 800	00)
	Movements	20 000	00	0	00	(50 000	00)	(30 000	00)
	Additions at cost	0	00	0	00	3 200	00	3 200	00
	Disposals at carrying value	0	00	0	00	(41 000	00)	(41 000	00)
	Depreciation	0	00	0	00	(12 200	00)	(12 200	00)
	Revaluations	20 000	00	0	00	0	00	20 000	00
	Net carrying amount 30 June 20x1	180 000	00	0	00	100 000	00	280 000	00
	Gross carrying amount	180 000	00	0	00	175 000	00	355 000	00
	Accumulated depreciation	0	00	0	00	(75 000	00)	(75 000	00)

5	***Intangible assets***	**Patents**		**Total**	
	Net carrying amount at 30 June 20x0	15 000	00	15 000	00
	Gross carrying amount	24 000	00	24 000	00
	Accumulated amortisation	(9 000	00)	(9 000	00)
	Movements	(4 800	00)	(4 800	00)
	Additions at cost	0	00	0	00
	Disposals at carrying value	0	00	0	00
	Amortisation	(4 800	00)	(4 800	00)
	Revaluations	0	00	0	00
	Net carrying amount at 30 June 20x1	10 200	00	10 200	00
	Gross carrying amount	24 000	00	24 000	00
	Accumulated amortisation	(13 800	00)	(13 800	00)

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6 ***Investments***	% shares held	20x1		20x0	
Listed					
1 000 ordinary shares in Alpha Ltd at cost (market value R38 000)	5%	20 000	00	20 000	00
20 000 ordinary shares in Norway Transport Ltd at cost (market value R30 000)	2%	28 000	00	0	00
8 000 ordinary shares in Metco Ltd at cost (market value R15 000)		0	00	8 000	00
Unlisted					
10 000 ordinary shares in Rolands Ltd at cost (directors' valuation R30 000)	12%	15 000	00	10 000	00
600 ordinary shares in Dino (Pty) Ltd at cost (directors' valuation R15 000)	10%	12 000	00	12 000	00
500 ordinary shares in Franco (Pty) Ltd at cost (directors' valuation R10 000)	5%	7 800	00	0	00
		82 800	00	50 000	00

7 ***Inventories***	20x1		20x0	
Inventories are made up of:				
Consumable stores	10 000	00	7 000	00
Finished goods	110 000	00	50 000	00
	120 000	00	57 000	00

8 ***Trade and other receivables***	20x1		20x0	
Accounts receivable	65 000	00	74 000	00
Allowance for bad debts	(3 000	00)	(4 000	00)
	62 000	00	70 000	00

9 ***Other current assets***	20x1		20x0	
Included in other current assets:				
Short-term interest-free, unsecured loan to officers (other than directors) of the company				
Advances during the year	20 000	00	0	00
Repayments	(6 000	00)	0	00
	14 000	00	0	00

10 ***Provisions***	20x1		20x0	
Provision for guarantee claims Balance at 1 July	35 000	00	35 000	00
Reductions resulting from payments	(5 000)	00	0	00
Balance at 30 June	30 000	00	35 000	00

11 ***Commitments for capital expenditures***	20x1		20x0	
Commitments for the acquisition of property, plant and equipment	220 000	00	100 000	00

12 ***Contingent liabilities***	20x1		20x0	
Pending litigation	75 000	00	0	00
Bills discounted	10 000	00	0	00
	85 000	00	0	00
Income tax	(34 000	00)	0	00
	51 000	00	0	00

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		20x1		20x0	
13	***Revenue***				
	Sale of goods	1 033 000	00	700 000	00

		20x1		20x0	
14	***Other Income***				
	Dividends received from investments	6 500	00	6 500	00
	Profit on sale of trading investments	9 000	00	9 900	00
	Profit on expropriation of land	25 000	00	0	00
	Profit on sale of vehicles	2 000	00	0	00
	Reduction in provision for guarantee claims	5 000	00	0	00
		47 500	00	16 400	00

		20x1		20x0	
15	***Profit before tax***				
	The profit before tax is stated after:				
	Auditors' remuneration	7 000	00	7 000	00
	Auditors' fees	5 500	00	4 000	00
	Employee benefit expense: Salaries	44 000	00	33 000	00
	Depreciation: Vehicles	12 200	00	22 500	00
	Amortisation of patent	4 800	00	4 800	00
	Finance costs	13 000	00	28 000	00

		20x1		20x0	
16	***Income tax expense***				
	Normal South African corporate tax Current tax for the current year	102 800	00	39 400	00
	Prior year under-/(over-) provision	14 800	00	0	00
	Total income tax expense	117 600	00	39 400	00

		20x1		20x0	
17	***Dividends***				
	Dividends declared and recognised as distributions to owners	45 000	00	45 000	00
	Dividend per share	25 cents		25 cents	

		20x1		20x0	
18	***Key management personnel compensation***				
	The remuneration of directors and other members of key management personnel was as follows:				
	Short-term benefits: Salaries	20 000	00	16 000	00
	Post-employment benefits: Pension	6 800	00	0	00
		26 800	00	16 000	00

3 Statement of accounting policies

The accounting policies of a company are important to the users of the financial statements, as the policies help them to interpret the financial performance and position of the company.

IAS 1 requires the disclosure of the significant accounting policies applied in compiling the financial statements, as well as specific matters that would be relevant to gain a basic understanding of the financial statements.

The managers of a company select the accounting policies that are appropriate and apply these policies consistently.

Accounting policies are 'the specific accounting principles, bases, conventions, rules and practices adopted by business enterprises in preparing and presenting financial statements'. Different methods exist to measure items in the financial statements such as historical cost, current cost, net realisable value, fair value and recoverable amount. For example, inventories may be valued on the first-in-first-out basis (FIFO), the weighted-average method

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or the specific-identification basis. The amount for inventories on the statement of financial position may differ depending on the valuation method used.

The accounting policies adopted by a company can have a significant influence on its financial position (statement of financial position) and financial performance (statement of profit or loss & other comprehensive income).

Once the accounting policies of a company have been selected, they should be used consistently. This enables the user of financial statements to compare current financial statements with previous years.

If the directors of a company decide to change an accounting policy, it should be stated in the accounting policies, with a reason for the change in policy. A note to the financial statements should quantify the effect of the change in the accounting policies and the previous year's financial statements should also be redrafted using the new policy.

Details of all areas where a specific method of accounting is adopted should be disclosed in the note on the accounting policies.

An analysis of accounting policies in published financial statements showed that the following policies were frequently included under accounting policies:

- Tangible assets and depreciation.
- Intangible assets and amortisation.
- Inventories.
- Revenue.
- Provisions.
- Investments and financial instruments.
- Taxes (including deferred tax).

The introductory paragraph to the accounting policies usually states that:

- Financial statements are prepared on the historical cost basis (identifying exceptions).
- Accounting policies are applied consistently (identifying exceptions).

The accounting policies or notes to the financial statements should contain a statement that the financial statements have been drafted in accordance with IFRS.

You should be able to complete Questions 20.1, 20.2 and 20.4.

4 Statement of financial position for publication

This section will discuss briefly the disclosure requirements for the statement of financial position.

The statement of financial position and notes to the statement of financial position in Figures 20.1 and 20.4 and IAS 1 should be studied in conjunction with this section.

- The statement of financial position is usually presented in the vertical format with 'equity and liabilities' consisting of the share capital, reserves, non-current liabilities and current liabilities and the 'assets' consisting of the tangible and intangible assets, investments and current assets.
- The horizontal format for the statement of financial position is rarely used.

The heading of the statement of financial position (and other components of the financial statements) should state:

- The name of the company.
- The component being presented (for example, statement of financial position).

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- The date of the financial year end or the reporting date.
- The currency used in the financial statements.
- The level of rounding used in presenting amounts in the financial statements (for example, figures rounded to thousands or millions).

Comparative figures should be given and, where the company was formed or incorporated during the current financial year, and no comparatives exist, this fact should be stated in a note to the financial statements.

The text that follows will elaborate on items requiring additional disclosure, not adequately covered in Figure 20.4.

In terms of IAS 1, this minimum information should be shown on the face of the statement of financial position:

- Property, plant and equipment.
- Investment properties.
- Intangible assets.
- Financial assets.
- Investments recorded using the equity method.
- Biological assets.
- Inventories.
- Trade and other receivables.
- Cash and cash equivalents.
- Assets held for sale.
- Trade and other payables.
- Tax liabilities and assets.
- Provisions.
- Non-current interest-bearing liabilities and financial liabilities.
- Issued share capital and reserves.

Equity and liabilities

Equity

Share capital

General

Disclose either in the statement of financial position, statement of changes in equity or in the notes to the financial statements:

For each class of share capital:

- The number of shares authorised.
- The number of shares issued and fully paid, and issued but not fully paid.
- Par value per share, or that the shares have no par value.
- A reconciliation of the number of shares outstanding at the beginning and at the end of the period.

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- The rights, preferences and restrictions applicable to each class of shares.
- Shares reserved for issue under options and contract, including the terms and amounts.

Where shares were issued during the current year, this additional information should be given:

- Classes of shares.
- Number issued.
- Consideration received.

Redeemable preference shares

If redeemable preference shares are issued, the following should be disclosed:

- The earliest and latest dates of redemption.
- The premium at redemption.
- Whether redeemable at the option of the company or the preference shareholders.
- The dividend rights.

It is important to note that redeemable preference shares with a fixed annual dividend and a fixed date of redemption that was set on the issue date or a redemption at the option of the shareholders, will be classified as a non-current liability and included as such in the statement of financial position.

Convertible preference shares

If convertible preference shares are issued, this information should be disclosed:

- The conditions of the conversion.
- The rights of conversion (or a note where these conditions may be inspected).

Figure 20.5

DISCLOSURE OF CONVERTIBLE PREFERENCE SHARES

The convertible preference shares (fixed annual dividend of 8c/share) are convertible into 10 ordinary shares for every 20 convertible preference shares held, at the option of the company, within a period of five years from the date of issue.

OR

Details of the conditions of conversion of convertible preference shares into ordinary shares are available at the registered office of the company.

Share options

Any options or preferential rights to subscribe to unissued share capital should be disclosed. This information should be stated:

- Number, description and value of the shares.
- Period during which the rights may be exercised.
- Price to be paid.

Figure 20.6

DISCLOSURE OF SHARE OPTIONS

This share option is still outstanding in terms of the company's share option scheme:

- To the directors.

12 000 ordinary shares exercisable until 31 March 20*x*8 @ 75c/share.

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Directors' authority to issue shares

There should be disclosed the:

- Number or amount of shares.
- Terms of authority.
- Period granted that the directors may issue shares.

Cumulative preference shares

If the dividend on cumulative preference shares is in arrears, this information should be disclosed:

- Amount of arrear dividends for each class of cumulative preference shares.
- The period of arrears.

Figure 20.7

DISCLOSURE OF CUMULATIVE DIVIDENDS IN ARREARS

On 30 June 20*x*6, the cumulative dividend in arrears on the redeemable cumulative preference shares (fixed annual dividend of 15c/share) amounted to R15 000.

Dividends were last declared on 30 June 20*x*4.

Reserves

The nature and purpose of each reserve and the opening and closing balances should be disclosed. All movements to (or from) the reserves should also be shown (unless the movements are shown in the statement of changes in equity).

Figure 20.8

DISCLOSURE OF RESERVES

Reserves		
Revaluation reserve	65 000	00
General reserve	108 000	00
Revaluation reserve		
Balance at the beginning of the year	50 000	00
Surplus on revaluation	15 000	00
Balance at the end of the year	65 000	00
The revaluation reserve relates to the revaluation of land and buildings.		
General reserve		
Balance at the beginning of the year	90 000	00
Transfer from retained earnings	18 000	00
Balance at the end of the year	108 000	00
The general reserve is used to transfer profits from retained earnings for appropriation purposes.		

The share capital and reserves represented the total owner's equity or shareholders interest in the company.

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Liabilities

Non-current and financial liabilities

The following information should be stated for all long-term liabilities (loans and usually interest-bearing debts), including debentures:

- A description of the liability.
- The principle amount.
- The carrying amount of each liability.
- A reconciliation of the carrying amount at the beginning and end of the period.
- The interest rate applicable to the liability.
- Settlement conditions and the date of settlement.
- If repayable by instalments, the instalment amounts.
- If the liability is secured, the asset used as security.
- The current portion of the liability payable within the following 12 months.

Liabilities are usually classified in the notes to the financial statements under secured and unsecured liabilities.

Did you know?

When a reserve is classified as non-distributable, it usually indicates that the reserve is not available for distribution as a dividend to shareholders.

Most companies classify the revaluation of property, plant and equipment as a non-distributable reserve.

There is, however, case law (Dimbula Valley case), which permits dividends to be paid from the revaluation of non-current assets, if:

- The increase in value is of a permanent nature.
- The valuation is done by a qualified valuer.
- The capital of the company will remain intact after such a distribution.

Debentures

The disclosure for debentures should also include:

- The class of debentures issued (for example mortgage debentures).
- The redemption date.
- The amount of the debentures issued.
- Particulars of any redeemed debentures that may be re-issued.

Reminder

Refer to Chapter 19 where the minimum disclosure requirements for liabilities and debentures were discussed.

For convertible debentures there should be disclosed:

- The conditions of conversion.
- Where these conditions may be inspected.

The disclosure of convertible debentures is similar to convertible preference shares in Figure 20.5.

If redeemable debentures have been issued, a note to the financial statements should indicate the dates of redemption.

When a portion of a non-current liability is repayable within one year, the amount should be transferred to current liabilities. Details of the transfer should be disclosed in the non-current liabilities note to the financial statements.

Provisions

A provision is a liability of uncertain timing or amount.

Disclose for each class of provision:

- The carrying amount at the beginning and end of the period.

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- Additional provisions made in the period.
- Amounts used during the period.
- Unused amounts reversed during the period.
- The increase during the period in the discounted amount arising from the passage of time and the effect of any changes in the discount rate.

Current liabilities

The aggregate amount of the following items should be disclosed for current liabilities on the face of the statement of financial position:

- Bank overdraft.
- Trade and other payables.
- Provisions.
- Current tax liabilities.
- Non-interest-bearing borrowings.
- Current portion of non-current interest-bearing borrowings.
- Shareholders for dividends declared.

Assets

Non-current tangible assets (property, plant and equipment), current assets and current assets that are tangible (for example, financial assets), should be disclosed separately under the headings of current and non-current assets.

Property, plant and equipment

General

Disclose for each class of property, plant and equipment:

- The gross carrying amount and the accumulated depreciation at the beginning and at the end of the period.
- A reconciliation of the carrying amount at the beginning and end of the period showing:
  - Additions.
  - Disposals.
  - Depreciation.
  - Impairment losses.
  - Increases or decreases resulting from revaluations.
  - Other changes.
- The amounts of property, plant and equipment pledged as security for a liability.

Figure 20.9 provides an example of the disclosure of property, plant and equipment in the financial statements.

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Figure 20.9

4 Property, plant and equipment	**Land**		**Vehicles**		**Equipment**		**Total**	
Net carrying amount at the beginning of the period	120 000	00	150 000	00	181 000	00	451 000	00
Gross carrying amount	120 000	00	200 000	00	252 000	00	572 000	00
Accumulated depreciation	0	00	(50 000	00)	(71 000	00)	(121 000	00)
Movements	30 000	00	65 000	00	(99 000	00)	(4 000	00)
Additions at cost	0	00	80 000	00	0	00	80 000	00
Disposals at carrying value	0	00	0	00	(68 000	00)	(68 000	00)
Depreciation	0	00	(15 000	00)	(31 000	00)	(46 000	00)
Revaluations	30 000	00	0	00	0	00	30 000	00
Net carrying amount at the end of the period	150 000	00	215 000	00	82 000	00	447 000	00
Gross carrying amount	150 000	00	280 000	00	184 000	00	614 000	00
Accumulated depreciation	0	00	(65 000	00)	(102 000	00)	(167 000	00)

Revaluation

For revalued property, plant and equipment disclose:

- The effective date of the revaluation.
- Whether an independent valuer was involved.
- The methods and significant assumptions applied in estimating the fair value of the asset.
- The revaluation surplus.
- For each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model.

The accounting policy note for property, plant and equipment will include the following information for each class of property, plant and equipment:

- The measurement bases used for determining the gross carrying amount (cost model or revaluation model).
- The depreciation methods used.
- The useful lives or the depreciation rates used.

Intangible assets

Disclose the following for each class of intangible assets:

- The gross carrying amount and any accumulated amortisation at the beginning and end of the period.
- A reconciliation of the carrying amount at the beginning and end of the period showing:
  - Additions.
  - Retirements and disposals.
  - Amortisation.
  - Impairment losses.
  - Increases and decreases in the revaluation surplus.
  - Other movements in the carrying amount.

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The accounting policy note for intangible assets will include the following information for each class:

- Policy used for recognising intangible assets (cost model or revaluation model).
- Whether the useful lives are indefinite or finite.
- The useful life of the intangible asset if it is finite.
- The amortisation methods used for intangible assets with finite useful lives.

Investments or financial assets

The investments of a company may be non-current or current assets and is classified as financial assets.

Investments should be disclosed in the financial statements as either listed or unlisted investments, where applicable. A listed investment is listed on a securities exchange.

Listed investments

For each listed investment, this information should be disclosed:

- The name of the company.
- The number of shares held (or the percentage of issued shares held).
- The classes of shares held.
- Carrying amount of the shares.
- Market value.

Unlisted investments

For each unlisted investment, this information should be disclosed:

- The name of the company.
- The number of shares held (or the percentage of issued shares held).
- The classes of shares held.
- Carrying amount of the shares.
- Directors' valuation.

Figure 20.10

DISCLOSURE OF LISTED AND UNLISTED INVESTMENTS

	Cost		Market value or Directors' valuation	
Listed shares	300 000	00	420 000	00
Unlisted shares	120 000	00	150 000	00
	420 000	00	570 000	00

Share portfolio is made up of ordinary shares in:	Number of shares
Listed	
Alpha Ltd	100 000
Bravo Ltd	50 000
Charley Ltd	50 000
Unlisted	
Delta (Pty) Ltd	100 000
Echo (Pty) Ltd	50 000

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An accounting policy note should disclose the method used to arrive at the value of the investments.

Where the carrying amount of unlisted shares is based on valuation:

- The policy regarding the frequency of revaluations.
- The basis of valuation.
- The date of the last revaluation.

Current assets

Inventory

Inventory is a tangible asset to be shown separately on the statement of financial position under current assets.

Disclose the following information for inventory:

- The total carrying amount for each category of inventory.
- The amount of inventories recognised as an expense during the period.
- The amount of any write-down of inventories recognised as an expense.
- The carrying amount of inventories pledged as security for liabilities.

Subheadings and amounts of the categories of inventory should be disclosed under:

- Raw materials.
- Merchandise.
- Work in progress.
- Finished goods.
- Consumable stores.
- Contracts in progress.

The accounting policy note for inventory will usually contain information with regard to:

- The measurement of inventories.
- The cost formula used.

Loans to key management personnel

Disclose the following for loans to key management personnel:

- The nature of the related party relationship.
- The amount of the transaction.
- The amount of outstanding balances, including commitments.
- Terms and conditions such as interest rates, terms of repayments, security details.
- Details of any guarantees given or received.
- Allowance for bad debts related to the outstanding balance.

Reminder

Refer to Chapter 19 where the minimum disclosure requirements for loans to key management personnel were discussed.

Contingent liabilities

Contingent liabilities are liabilities or losses that have not been provided for in the financial statements. The general nature of the contingent liabilities comes from those uncertain factors and events that may affect the future outcome of the liabilities.

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Disclose for each class of contingent liability:

- A description of the nature of the contingent liability.
- An estimate of the financial effect.
- An indication of the uncertainties relating to the amount or timing of any outflows.
- The possibility of any reimbursement.

Examples of contingent liabilities include pending court cases and discounted bills.

Capital commitments

Capital commitments are commitments for future capital expenditure that have not been provided for in the financial statements.

Disclose for each material commitment:

- The nature of the commitment.
- An estimate of the financial effect.

You should be able to complete Questions 20.3 and 20.5.

5 Statement of profit or loss & other comprehensive income for publication

The statement of profit or loss & other comprehensive income disclosure requirements should be studied together with the statement of profit or loss & other comprehensive income and notes to the financial statements given in Figure 20.2 in Section 2 of this chapter and IAS 1.

When comparing the statement of profit or loss & other comprehensive income in the example in this chapter with the statement of profit or loss & other comprehensive income in Chapter 17, it will be noted that details of certain expenses are omitted as not all income and expense items will be disclosed in the statement of profit or loss & other comprehensive income.

The heading for the statement of profit or loss & other comprehensive income should state:

- The name of the company.
- Statement of profit or loss & other comprehensive income for the year (or, if a different period, state the months) ended (the date of the financial year end or the reporting date).

A company may choose to present all income and expense items recognised as either in:

- A single statement that presents profit or loss, other comprehensive income and ending with the total comprehensive income.
- Two separate statements in which one statement presents profit or loss, and the second statement presents other comprehensive income and the total comprehensive income.

The statement of profit or loss & other comprehensive income for publication must present on the face of the statement of profit or loss & other comprehensive income the following three totals:

- Profit or loss for the period.
- Other comprehensive income for the period.
- Total comprehensive income for the period.

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The nature and the amount of all material income and expense items should also be disclosed separately on the face of the statement of profit or loss & other comprehensive income.

Expenses can be categorised according to their nature (such as raw materials, salaries, depreciation and finance costs) or their function in the company (such as administrative, selling, operational and distribution costs).

The following line items of income and expenses are required to be disclosed in the profit or loss section of the statement of profit or loss & other comprehensive income:

- Revenue.
- Gains and losses arising from the derecognition of financial assets measured at amortised cost.
- Finance costs.
- Share of the profit or loss of associates and joint ventures accounted for using the equity method.
- Gains and losses arising from the reclassification of financial assets.
- Income tax expense.
- A single amount for the total of discontinued operations.

Examples of other income and expense accounts to be diclosed are presented in Figure 20.11.

Comparative figures should be given for the statement of profit or loss & other comprehensive income.

Revenue

Disclose the amount of each significant category of revenue recognised during the period including revenue arising from:

- The sale of goods.
- The rendering of services.
- Interest.
- Royalties.
- Dividends.

The accounting policies note will contain information on the policies adopted for the recognition of revenue.

Profit before tax

The profit before tax in the statement of profit or loss & other comprehensive income is shown after the deduction of all expenses and the inclusion of all income through normal business activities.

Specific expenses and income (shown in Figure 20.11) should be disclosed separately, usually as a note to the financial statements.

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Figure 20.11

DISCLOSURE OF CERTAIN INCOME AND EXPENSES

Income and expense items to be disclosed in the notes to the statement of profit or loss & other comprehensive income include:

- Write-down of inventories to net realisable value.
- Profits or losses on share transactions.
- Profits or losses on disposal/scrapping of property, plant and equipment.
- Profits or losses on disposals of investments/financial assets.
- Movement in provisions.
- Discontinued operations.
- Litigation settlements.
- Depreciation and amortisation regarding each class of depreciable assets.
- Impairment of property, plant and equipment.
- Impairment of financial assets.
- Employee benefit expense.
- Key management personnel compensation (directors remuneration).

Employee benefit expense
Disclose the total for the employee benefit expense as well as the total for each of the following categories:

- Short-term employee benefits e.g. salaries.
- Post-employment benefits e.g. pensions.
- Other long-term benefits e.g. long-service benefits.
- Termination benefits e.g. compensations for loss of office.

Key management personnel compensation
Disclose the total of key management personnel compensation (directors' renumeration) as well as the total for each of the following categories:

- Short-term employee benefits e.g. salaries.
- Post-employment benefits e.g. pensions.
- Other long-term benefits e.g. long-service benefits.
- Termination benefits e.g. compensations for loss of office.
- Share-based payments.

Income tax

Income tax is deducted from profit to obtain the profit after income tax.

This information should be disclosed for income tax:

- For the current year:
  - The classes of income tax.
  - The amount of tax for each class of taxation.
  - The origin.
- For previous years:
  - The significant adjustment of prior period provisions.

If no provision for income tax has been made that fact and the reason should be stated.

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Figure 20.12

DISCLOSURE OF INCOME TAX		
Normal South African corporate tax		
Current tax for the current year	15 000	00
Prior year under-/(over-) provision	2 000	00
Total income tax expense	17 000	00

Earnings per share (EPS)

The earnings per share (EPS) for listed companies for each class of equity should be shown, preferably on the face of the statement of profit or loss & other comprehensive income.

6 Statement of changes in equity for publication

The statement of changes in equity reconciles the equity of the company at the beginning and end of a financial period.

The statement of changes in equity should include the following information:

- The total comprehensive income for the period.
- For each component of equity, a reconciliation between the carrying amount at the beginning and end of the period disclosing movements resulting from:
  - The profit or loss.
  - Other comprehensive income.
  - Transactions with owners such as the issue of shares, including related transaction costs, redemption of preference shares and dividends declared.
  - Transfers to or from reserves.

Dividends

Disclose, either in the statement of changes in equity or in the notes to the financial statements:

- The amount of dividends recognised as distributions to owners during the period.
- The amount of the dividend per share.
- The amount of dividends declared or proposed before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the related amount per share.
- The total amount of cumulative preference dividends in arrears that have not been recognised in the financial statements.

Figure 20.13

DISCLOSURE OF DIVIDENDS	
Dividends declared and recognised as distributions to owners	R45 000
Dividend per share	25 cents

You should be able to complete Questions 20.6 to 20.13.

7 Notes to the financial statements

The notes to the financial statements should provide information about the following:

- The basis of preparation of the financial statements.
- The significant accounting policies used, including measurement bases applied and other relevant accounting policies.

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- Supporting information required by International Financial Reporting Standards on items presented in the financial statements.
- Information on items that are not presented in the financial statements, but is relevant to an understanding of any of them.
- Information required by International Financial Reporting Standards that is not presented elsewhere in the financial statements.

The notes must:
- Be presented in a systematic manner.
- Use cross-referencing to any related information in the notes.

8 Chapter illustrative example

Ebrahim Ltd is a chain store that sells clothing, footwear and home textiles and is listed in the stores sector of the JSE Securities.
- During the financial year ended 30 June 20*x*1, the market price of their ordinary shares ranged between a low of 560 c/share and a high of 900c/share.
- No additional shares were issued during the financial year ended 30 June 20*x*1.

These balances and totals appeared in the pre-adjustment trial balance on 30 June 20*x*1:

Ordinary share capital (180 000 shares)	470 000	00
Cumulative participating preference share capital (30 000 shares)	60 000	00
15% secured debentures @ R10 each	30 000	00
Surplus on revaluation of land and buildings	60 000	00
Retained earnings (1 July 20*x*0)	210 000	00
Land	820 000	00
Equipment, at book value	220 000	00
Net current assets	127 000	00
Investment	128 000	00
Income from investments	6 000	00
Revenue	3 250 000	00
Cost of sales	1 893 000	00
Administrative expenses	898 000	00

This information relates to the above trial balance:

1. The authorised share capital is as follows:
   - 220 000 ordinary shares.
   - 50 000 redeemable preference shares (fixed annual dividend of 10c/share).
   - 100 000 cumulative participating preference shares.
   - The participating preference shares are entitled to an annual dividend of 15c/share, plus a participating dividend of a fifth of the amount of ordinary dividends per share declared during the year.
   - In terms of a shareholders' resolution on:

     25 September 20*x*0:
     - The 50 000 redeemable preference shares are to be redeemed on 31 December 20*x*0, with a proportionate dividend, at a premium of 10c/share.
     - The only entry made to give effect to this decision was on 31 December 20*x*0:

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Day	Details	Fol.	Debit		Credit	
31/12	Redeemable preference share capital	B	50 000	00		
	Accounts payable	B	7 500	00		
	Bank	B			57 500	00

— 10 February 20*x*1: 'The directors have authority to issue the remaining shares…'.

2 The debentures are redeemable in ten equal annual instalments of R10 000 on 31 March of each year, the last instalment becoming payable on 31 March 20*x*4. Interest is paid half-yearly on 31 March and 30 September.

3 On 1 September 20*x*10, the land was revalued.

4 Administrative expenses include:

Directors' fees	10 000	00
Ordinary shares interim dividend paid	9 000	00
Debenture interest paid	6 000	00
Property rental	90 000	00
Wages and salaries	591 000	00
Bad debt	6 000	00
Sundry expenses	158 000	00
Lease of vehicles	28 000	00
	898 000	00

5 The net current assets include South African normal taxation of R22 000 over-provided during the previous financial year, provisional tax payments of R132 000 for the current year, and interest accrued on debentures (1 July 20*x*0) of R1 500.

6 During the year an investment was sold at a profit of R4 000. This profit was applied to write down the company's only other investment, as its market price has, for some time, been consistently below the carrying value.

7 Equipment is depreciated at 10% per annum on the carrying value at year end.

Additional information:

1 Auditors will be paid R24 000 to cover their fees and expenses.

2 Director A, the only executive director, has not drawn his annual salary of R24 000. He has, however, received a total of R5 800 for travelling and entertaining expenses, all of which was substantiated by the necessary vouchers. He drives a company car with an estimated personal benefit of R80 per month, and is a member of a pension fund that requires contributions of 9% of gross annual salary. The company deducts 5% of the gross salary of all employees for this purpose, the balance being paid from company funds.

3 Normal South African company taxation for the current financial year has been accurately calculated to be R132 875.

4 The final dividend was authorised and declared on ordinary shares amounting to 20c/share (ignore dividend tax) before year end.

You are required to prepare:

1 The statement of profit or loss & other comprehensive income of Ebrahim Ltd for the year ended 30 June 20*x*1 for the purpose of publication.

2 The equity and non-current liability section of the statement of financial position of Ebrahim Ltd as at 30 June 20*x*1, together with relevant notes as they would appear in the published financial statements.

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Note

- Comparative figures and accounting policies are not required. Disclosure should conform to the minimum requirements of the Companies Act 71 of 2008 as amended and IAS 1.
- Full disclosure of any item that can be inferred from the information given is essential, making any assumption that may be necessary.

1

Ebrahim Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20*x*1

	Notes	20*x*1	
Revenue	5	3 250 000	00
Cost of sales		(1 893 000	00)
Gross profit		1 357 000	00
Other income	6	6 000	00
Administrative expenses		(953 000	00)
Finance costs	7	(5 625	00)
Profit before tax	8	404 375	00
Income tax expense	9	(110 875	00)
PROFIT FOR THE YEAR		293 500	00

Ebrahim Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20*x*1

5 *Revenue*

	20*x*1	
Revenue present sale of goods	3 250 000	00

6 *Other income*

	20*x*1	
Income from investments:		
Dividend	6 000	00

7 *Finance costs*

	20*x*1	
Interest on debentures	5 625	00

8 *Profit before tax*

	20*x*1	
The profit before tax is stated after:		
Auditors' remuneration	24 000	00
Depreciation: Equipment	22 000	00
Leasing charges for vehicles	28 000	00
Profit on sale of investment	4 000	00
Less: Amount used to write down remaining investment	(4 000	00)
Employee benefit expense		
Short-term employee benefits: Salaries	591 000	00

9 *Income tax expense*

	20*x*1	
Normal South African corporate tax		
Current tax for the current year	132 875	00
Prior year under/(over) provision	(22 000	00)
Total income tax expense	(110 875	00)

10 *Dividends*

	20*x*1	
Dividends declared and recognised as distributions to owners	R45 000	00
Dividend per share	25 cents	

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11 *Key management personnel compensation*

	20x1	
The remuneration of directors and other members of key management personnel was as follows:		
Short-term employee benefits: Salaries	24 960	00
Post-employment benefits: Pension	960	00
Total	25 920	00

2

Ebrahim Ltd
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x1

	Notes	20x1	
EQUITY AND LIABILITIES			
Capital and reserves		1 035 000	00
Share capital	2	530 000	00
Non-distributable reserve	3	60 000	00
Retained earnings		445 000	00
Non-current liabilities		20 000	00
Mortgage debentures	4	20 000	00
TOTAL EQUITY AND LIABILITIES		1 055 000	00

Ebrahim Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20x1

2 *Share capital*

	20x1	
Authorised		
220 000 ordinary shares		
50 000 redeemable preference shares (fixed annual dividend of 10c/share)		
100 000 cumulative participating preference shares		
Issued		
180 000 ordinary shares	470 000	00
30 000 cumulative participating preference shares	60 000	00
	530 000	00

- The redeemable preference shares were redeemed on 31 December 20x0.
- The directors have authority to issue 40 000 ordinary shares at a price of XXX. This authority expires at the next annual general meeting.

3 *Non-distributable reserves*

	20x1	
Surplus on revaluation of land *This surplus arose from revaluation during the current year.*	60 000	00

(Show in the statement of changes in equity.)

4 *Non-current liabilities*

	20x1	
Mortgage debentures	30 000	00
Less: Instalment repayable on 31 March 20x2 transferred to current liabilities	(10 000	00)
	20 000	00

- The debentures consist of 3 000 mortgage debentures @ R10 each, secured by a first mortgage bond over land worth R820 000.
- The rate of interest is 15% payable half-yearly.
- The debentures are redeemable in annual instalments of R10 000, payable on 31 March each year.

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Calculations

Ordinary dividends

Interim paid	9 000	00
Final recommended (180 000 × 20c)	36 000	00
	45 000	00
Dividend per share = 45 000 ÷ 180 000 = 25c/share.		

Participating preference share dividend

30 000 × 15 cents	4 500	00
30 000 × (1 ÷ 5 × 25 cents)	1 500	00
	6 000	00

Profit

Revenue			3 250 000	00
Less: Cost of sales			(1 893 000	00)
Gross profit			1 357 000	00
Other income: income from investments			6 000	00
Less: Expenses				
Directors' fees	10 000	00		
Debentures interest: 15% (40 000 × 0.75 + 30 000 × 0.25)	5 625	00		
Property rental	90 000	00		
Wages and salaries	591 000	00		
Bad debt	6 000	00		
Sundry expenses	158 000	00		
Vehicles rental	28 000	00		
Depreciation on equipment	22 000	00		
Auditors' remuneration	24 000	00		
Directors' salary	24 000	00	(958 625	00)
Profit before tax			404 375	00

Key management personnel compensation

Director A's salary	24 000	00
Vehicles (80 × 12)	960	00
Company's pension contribution (4% × 24 000)	960	00
	25 920	00

Calculation of retained earnings in the statement of financial position

Profit for period	293 500	00
Preference dividends	(8 500	00)
Ordinary dividends	(45 000	00)
Premium on redemption	(5 000	00)
Opening balance	210 000	00
	445 000	00

9 Summary

This chapter dealt with the minimum disclosure requirements for company annual financial statements.

The minimum disclosure requirements were discussed under five headings: accounting policies, statement of financial position, statement of profit or loss & other comprehensive

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income, statement of changes in equity and notes to the financial statements, and are illustrated with an example of the annual financial statements of a company.

The directors' report, auditors' report and statement of cash flows were not discussed.

The scope of the chapter was limited to the requirements of the Companies Act and IAS 1.

QUESTIONS

Question 20.1

Why should financial statements of companies be drafted to comply with minimum disclosure requirements and how are these requirements defined?

Question 20.2

What is the purpose of the statement of accounting policies and how may it affect the past performance and present position of a company?

Question 20.3

The Companies Act 71 of 2008 draws a distinction between provisions and reserves, and between distributable and non-distributable reserves.

You are required to:

1. Define the terms 'provision', 'reserve', 'distributable reserve' and 'non-distributable reserve'.
2. Comment briefly on the disclosure, and significance, of the distinction between a provision and a reserve in:
   - **a** Determining profit.
   - **b** Disclosing such items on the statement of financial position.

Question 20.4

The minimum content of a company's annual financial statements is defined in the Companies Act 71 of 2008 and IAS 1.

You are required to:

List the basic contents of a set of company annual financial statements that can be inferred from Section 30 of the Companies Act and IAS 1.

Question 20.5

Explain the meaning of each of these terms and give an example in each case:

- Contingent liability.
- Reserve.
- Provision.
- Capital commitment.

Question 20.6

The statement of profit or loss & other comprehensive income of a company is considered by many to be the most important single statement in the annual financial statements.

Prospective shareholders are a major user group of company annual financial statements.

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You are required to:
Briefly evaluate the disclosure requirements of the Companies Act 71 of 2008 for the statement of profit or loss & other comprehensive income, in the light of the information requirements of prospective shareholders.

Question 20.7

Malapo Ltd operates profitably in the property letting industry. The company owns six blocks of flats, situated on Beach Road, Sea Point.

On 30 June 20*x*3, these items appeared in the annual financial statements:

- Accounting policies
  Tangible assets.
  - No depreciation is provided on land.
  - Buildings are depreciated over 10 years using the straight-line method.
- Tangible assets
  - Land – at cost R3 500 000
  - Buildings – at cost R1 000 000
    – accumulated depreciation R100 000
  - A register of the company's land is available for inspection at the company's registered office.

As a result of the severe rate of inflation experienced over the last 10 years, and to reflect a more realistic return on its investment, the directors decided to reflect the value of the company's tangible assets at the current fair value.

A valuation was undertaken by Mr X, a member of the Property Investors Association, who valued the land and buildings at R8 250 000, being the current fair value at 30 June 20*x*4. (Ignore taxation.)

You are required to:

1 Give the journal entry to record to the above decision.
2 Show how the tangible assets and the reserve should be reflected in the statement of financial position as at 30 June 20*x*4.
3 Briefly discuss whether the revaluation surplus can/should be distributed by way of a dividend.

Question 20.8

Here is a list of balances and totals as at 30 June 20*x*9, from the books of Lapping Ltd.

The registered office of the company is at 12 Robberts Road, Bellville. The detailed trading and profit and loss accounts for the year ended have already been completed.

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Issued share capital			466 000	00
7% debentures			30 000	00
Shareholders for dividends			2 400	00
Long-term loan			30 000	00
Retained earnings			210 500	00
Accounts payable			33 600	00
Accumulated depreciation:				
Furniture and fittings			5 400	00
Vehicles			7 100	00
Plant and machinery			31 200	00
Asset replacement reserve			9 000	00
Allowance for bad debt			5 400	00
Final dividend declared			37 600	00
Land at valuation	190 500	00		
Furniture and fittings (at cost)	14 800	00		
Vehicles (at cost)	22 300	00		
Loose tools and equipment – at directors' valuation	3 900	00		
Financial assets	60 000	00		
Investments – LM (Pty) Ltd	65 000	00		
Machinery (at cost)	245 600	00		
Accounts receivable	120 900	00		
Bank	3 100	00		
Inventories	142 100	00		
	868 200	00	868 200	00

This additional information is available:

- Share capital
  - Authorised:
    - 650 000 ordinary shares.
    - 50 000 redeemable preference shares (fixed annual dividend of 9c/share).
  - Issued:
    - 400 000 ordinary shares.
    - All the redeemable preference shares have been issued @ R1 each.
- Included in accounts payable is an amount of R3 600, due to the SARS for income tax payable for this year. This amount could not be estimated with reasonable certainty.
- A director holds an option to acquire 60 000 ordinary shares. The redeemable preference shares are redeemable at R1 each as from 1 January 20*x*9, at the option of the company.
- The debentures and the loan are secured by a first and second mortgage bond respectively over land.
- Accounts receivable include loans of R12 000 allocated to certain directors during the year. An amount of R3 000 had been paid by one of the directors during the year towards the reduction of his loan.
- The bank balance of R3 100 includes an overdraft of R6 500 with a different bank.
- Replacement of loose tools and small items of equipment is charged directly to maintenance, the total of that is written off against income each year.

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- On 14 September 20*x*9, the company ordered new machinery at an estimated cost of R50 000. No payments had been made on account of this machinery by the end of the financial year and it will be paid from cash derived from normal business operations.
- Land consists of six different plots and were revalued in February 20*x*8.
- The investment in LM (Pty) Ltd consists of 65 000 ordinary shares and the directors valued these shares at R2 each.
  - Upon buying all the shares of LM (Pty) Ltd, the company guaranteed the bank overdraft of LM (Pty) Ltd.
  - This overdraft had not yet been repaid at 30 June 20*x*9.

You are required to:
Prepare the statement of financial position of Lapping Ltd at 30 June 20*x*9 to comply with the requirements of the Companies Act 71 of 2008 and with IFRS. (Comparatives are not required.)

Question 20.9

Epsilon Ltd is engaged in the manufacture and distribution of motor spares and accessories.

These balances and totals appeared in the pre-adjustment trial balance as at 30 June 20*x*2 (financial year end):

Ordinary share capital (180 000 shares)	540 000	00
15% secured debentures @ R10 each	30 000	00
Surplus of revaluation of land and buildings	60 000	00
Retained earnings (1 July 20*x*1)	200 000	00
Land and buildings	820 000	00
Equipment at carrying value	320 000	00
Revenue	2 850 000	00
Cost of sales	1 643 000	00
Directors' fees	10 500	00
Ordinary share interim dividend paid	9 000	00
Debenture interest paid	6 000	00
Property rental	90 000	00
Wages and salaries	591 000	00
Bad debt	6 000	00
Sundry expenses	158 000	00
Rental of vehicles	28 000	00
Income from investments	6 000	00

This information relates to the above balances:

- The debentures are redeemable in ten equal annual instalments of R10 000 on 31 March each year, the last instalment being payable on 31 March 20*x*5. Interest is paid half-yearly on 31 March and 30 September.
- The lands consist of a factory in Cape Town that was revalued on 1 September 20*x*1. Subsequent additions were recorded at cost.
- The net current assets include South African normal taxation of R22 000 over-provided during the last financial year. Also included are provisional tax payments for the current year of R132 000 and interest accrued on debentures (1 July 20*x*1) of R1 500.
- Equipment is depreciated at the rate of 10% per annum on the reducing balance method. There were no acquisitions or disposals of equipment during the current year.

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- South African normal company taxation for the current financial year has been accurately calculated to be R132 875.
- Auditors will be paid a total of R24 000.
- A final dividend of 20c/share has been authorised and declared.

You are required to:

1 Prepare the statement of profit or loss & other comprehensive income and statement of changes in equity of Epsilon Ltd for the year ended 30 June 20*x*2 for the purpose of publication.

2 Prepare the note that would be attached to the item 'land and buildings' in the published statement of financial position of Epsilon Ltd on 30 June 20*x*2. (Comparative figures are not required.)

Question 20.10

Total Onslaught (Pty) Ltd is a small company which (because of its aggressive advertising campaigns) has a significant profile. The company manufactures gas-filled hot air balloons.

On 31 December 20*x*6 (financial year end), this information was extracted from its books:

Bank overdraft			7 266	00
Furniture and office equipment (at cost)	19 725	00		
Listed investments (at cost)	5 120	00		
Loan, secured by notarial bond			125 000	00
Loose tools at valuation	3 260	00		
Accumulated depreciation: Furniture and office equipment			6 225	00
Accumulated depreciation: Vehicles			10 250	00
Provisional tax paid	11 200	00		
Unlisted investment	2 260	00		
Retained earnings			54 002	00
Ordinary share capital			193 621	00
Inventories	280 473	00		
Accounts payable			123 439	00
Accounts receivable	172 145	00		
Vehicles (at cost)	25 620	00		
	519 803	00	519 803	00

After most of the closing entries had been passed, you learn that:

- The listed investments were bought for speculative purposes. Dividends for the year amounted to R400. (Note: Dividends on share investments are exempt from tax.)
- The retained earnings at the beginning of the year amounted to R25 602 and was posted to accounts receivable.
- An interim dividend of R5 000 was declared and paid on 1 October 20*x*6 and a final dividend of R5 000 was declared on 30 December 20*x*6. This dividend was paid on 18 January 20*x*7, but no entries to record it had been made before the trial balance was extracted.
- South African normal tax is to be calculated at the rate of 40c in the R1 on the trading profit which (excluding dividends) is the same as the taxable income.(Ignore dividend tax.)
- The loan of R125 000 is to be repaid in five years' time.

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You are required to:

1 Prepare the statement of financial position and the statement of changes in equity, without giving the amounts unless they are calculable from the information.

2 Prepare any other notes that you would expect from the information above, to be attached to the statement of financial position and statement of changes in equity.

(Comparative figures are not required.)

Question 20.11

Here is a list of balances and totals extracted from the general ledger of Rowells Replacements Ltd at 31 December 20*x*3, other than share capital, reserves and dividends paid:

15% secured debentures @ R10 each	30 000	00
Accounts payable	41 500	00
Accounts receivable	110 500	00
Administrative expenses	104 650	00
Cash at bank	29 900	00
Cost of sales	585 000	00
Dividends received on shares in Y Ltd	1 300	00
Fixtures and fittings at cost	58 500	00
Investments	26 000	00
Land at cost	40 000	00
Buildings at cost	25 000	00
Vehicles at cost	23 400	00
Provisional tax payments	35 100	00
Accumulated depreciation (1 January 20*x*3):		
Fixtures and fittings	13 650	00
Vehicles	11 700	00
Premium on redemption of preference shares	1 950	00
Inventories at cost	136 500	00
Revenue	910 000	00
Selling and distribution expenses	24 310	00

The post-closing trial balance as at 31 December 20x2 included these items:

Ordinary share capital	52 000	00
Redeemable preference share capital (fixed annual dividend of 8c/share)	59 000	00
Retained earnings	71 000	00

Additional information:

- The authorised share capital is:
  - 200 000 ordinary shares.
  - 100 000 redeemable preference shares (fixed annual dividend of 8c/share).
- On 15 March 20*x*3, the company issued a further 26 000 ordinary shares at R2/share. The issue was fully subscribed and the shares allotted.
- On 1 October 20*x*3, 39 000 of the redeemable preference shares were redeemed at a premium of 5c/share, which was written off against retained earnings, and the preference dividends due of R2 340 on these shares to the date of redemption, were paid.
- Tangible assets are depreciated annually at these rates:
  - Fixtures and fittings 10% on cost.
  - Vehicles 25% on cost.

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- The directors have recommended to shareholders that a dividend of 20c/share be paid on the ordinary share capital at 31 December 20*x*3 for the year. (Ignore dividend tax.)
- The income tax expense for the year is estimated to be R53 300.
- The company has guaranteed the overdraft facilities of a company, in which it holds shares, to a limit of R5 000.
- Debenture interest paid and directors' emoluments for the year have been charged to administration expenses.
  - Directors' emoluments are made up of R6 500 directors' fees, R32 500 managing director's salary, and R6 500 compensation to the past chairman for loss of office.
- On 1 November 20*x*3, land and buildings were valued by A. Valuer, a professional property valuer, at R91 000.
  - The directors have resolved to record the property at the above value in the 20*x*3 financial statements.
  - The property is mortgaged as security for the debenture holders.
- Share investments consist of:

	Cost	Market value	Directors' value
15 600 R1 Ordinary shares in Y Ltd (held for dividend income)	R15 600	R1.50/share	–
10 400 R1 Ordinary shares in Z (Pty) Ltd (held for speculative purposes)	R10 400	–	80c/share

- The directors signed a contract for the erection of a new warehouse costing R80 000 during October. Construction of the new building is due to start on 1 June 20*x*4.
  - The directors also authorised the construction of a new office block in Rondebosch at the estimated cost of R150 000.
  - The two projects are to be financed by a further issue of ordinary shares.

You are required to:

1 Prepare the statement of profit or loss & other comprehensive income of Rowells Replacements Ltd for the year ended 31 December 20*x*3.

2 Prepare the statement of financial position of Rowells Replacements Ltd as at 31 December 20*x*3, conforming to the Companies Act 71 of 2008 and International Financial Reporting Standards (IFRS).

Question 20.12

Bonokuhle Ltd is a public company that makes electrical components.

Bonokuhle Ltd
PRE-ADJUSTMENT TRIAL BALANCE AS AT 30 JUNE 20*x*3

Operating profit			350 000	00
Dividends (ordinary)	10 000	00		
Income tax expense	40 000	00		
Shareholders for dividends			3 000	00
SARS: Income tax			20 000	00
100 000 ordinary shares (authorised 200 000 shares)			125 000	00

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8% redeemable preference shares (authorised 50 000 shares)			40 000	00
15% secured debentures @ R10 each			30 000	00
Surplus on revaluation of land and buildings			105 000	00
Retained earnings			82 000	00
Land	120 000	00		
Buildings	100 000	00		
Equipment at cost	190 000	00		
Accumulated depreciation: Equipment			83 000	00
Depreciation (15% straight line)	24 000	00		
Accountants receivable	50 000	00		
Allowance for bad debts			12 000	00
Inventories of finished goods at 30 June 20*x*3	100 000	00		
Bank overdraft			68 000	00
Accounts payable			99 000	00
Listed investments at cost (market value R210 000)	210 000	00		
Dividends received			21 000	00
Preference dividend paid	4 000	00		
Finance charges	4 500	00		
Profit on sale of listed shares			4 800	00
Directors' fees	12 000	00		
Directors' salary	24 000	00		
Bad debts	2 600	00		
Lease of vehicles	12 800	00		
Lease of storeroom (operating lease)	10 200	00		
Profit on sale of equipment			1 500	00
Audit fees – 20*x*3	4 100	00		
Secretarial work done by auditors	2 600	00		
Audit fees – 20*x*2	500	00		
Annual duty	80	00		
Expenses incurred by auditors on Bonokuhle's behalf	260	00		
Sundry expenses	122 660	00		
	1 044 300	00	1 044 300	00

- 10 000 redeemable preference shares were redeemed on 1 June 20*x*3 at a premium of 10%. The only entry made, when this was done, was:

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Day	Details	Fol.	Debit		Credit	
01/06	8% redeemable preference shares	B	10 000	00		
	Retained earnings	B	1 000	00		
	Bank	B			11 000	00

- The directors have the authority to issue the remaining authorised share capital (ordinary and preference) up to the next annual general meeting and can also redeem the preference shares, at their option, at a premium of 10% from 1 January 20*x*3 to 1 January 20*x*6. By that time all preference shares must be redeemed.
- The debentures are redeemable in full on 30 June 20*x*7. Interest is paid annually on the first day of March and accrues from month to month.
- On 15 January 19x6, the land was bought at a cost of R80 000.
  - On 1 August 20*x*2, the property was revalued by Mr Conrad, a sworn valuer, using an existing basis.

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- On 15 May 20*x*3, improvements costing R35 000 were made to the buildings.
- The property consists of a factory situated on Erf 7823, Johannesburg.
- This property was used as security for the debenture holders.

You are required to:
Prepare the statement of financial position, statement of changes in equity and statement of profit or loss & other comprehensive income of Bonokuhle Ltd at 30 June 20*x*3, with the appropriate notes.

Disclosure should conform to the minimum requirements of the Companies Act 71 of 2008, as amended and International Financial Reporting Standards. (Ignore dividend tax and comparative figures are not required.)

Question 20.13

You are the newly appointed auditor of Utopia Ltd and have been presented with this statement of financial position:

Utopia Ltd
STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20*x*6

	Notes	20*x*6	
ASSETS			
Non-current assets		1 305 000	00
Property, plant and equipment	5	950 000	00
Long-term loans to employees		15 000	00
Investments/Financial assets	6	340 000	00
Current assets		685 000	00
Inventories		320 000	00
Accounts receivable		260 000	00
Taxation		55 000	00
Cash and cash equivalents		5 000	00
Sundry expenditure:			
Preliminary expenses		12 000	00
Ordinary share issue expenses		10 000	00
Preference share issue expenses		9 000	00
Underwriters' commission on preference shares		14 000	00
TOTAL ASSETS		1 990 000	00
EQUITY AND LIABILITIES			
Capital and reserves		1 562 000	00
Ordinary share capital and share premium	2	1 030 000	00
Retained earnings		190 000	00
Non-distributable reserve	3	100 000	00
Preference share capital and share premium	2	242 000	00
Non-current liabilities		58 000	00
Mortgage debentures	4	58 000	00
Current liabilities		370 000	00
Bank overdraft		35 000	00
Accounts payable		255 000	00
Shareholders for dividends		80 000	00
TOTAL EQUITY AND LIABILITIES		1 990 000	00

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Utopia Ltd
NOTES TO THE FINANCIAL STATEMENTS OF 30 SEPTEMBER 20x6

1 *Accounting policies*

Property, plant and equipment

- Land and buildings are valued at cost and land is not depreciated. Buildings are depreciated over the useful life on the straight-line method.
- Plant and machinery and vehicles are valued at cost and are depreciated on the reducing-balance method to their residual value over the expected useful lives of the assets.

Inventory

Inventory is valued at the lower of cost and net realisable value on a FIFO basis.

2 *Share capital*

	20x6	
Authorised		
1 000 000 ordinary shares @ R2 each		
80 000 redeemable cumulative preference shares @ R3 each (fixed annual dividend of 12c/share)		
50 000 redeemable preference shares @ R2.50 each (fixed annual dividend of 14c/share)		
Issued		
500 000 ordinary shares @ R2 each	1 000 000	00
80 000 redeemable cumulative preference shares @ R3 each (fixed annual dividend of 12c/share)	240 000	00
	1 240 000	00

- The redeemable cumulative preference shares are redeemable at the option of the company from 1 December 20x6 at a premium of 30c/share.
- The directors have the authority to issue the balance of the un-issued shares until the next annual general meeting.

3 *Non-distributable reserves*

	20x6	
Asset replacement reserve	60 000	00
Revaluation reserve	40 000	00
	100 000	00

4 *Mortgage bond*

	20x6	
15% mortgage bond	58 000	00

Repayable in monthly instalments of R745.00.

5 *Property, plant and equipment*

	Cost or valuation		Accumulated depreciation		Carrying value	
Land	395 000	00	0	00	395 000	00
Buildings	100 000	00	0	00	100 000	00
Plant and machinery	570 000	00	240 000	00	330 000	00
Vehicles	155 000	00	60 000	00	95 000	00
	1 220 000	00	300 000	00	920 000	00
Financial assets	50 000	00	20 000	00	30 000	00
	1 270 000	00	320 000	00	950 000	00

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6 *Investments*	**20x6**	
Listed		
100 000 shares in Metco Ltd (market value R300 000)	180 000	00
Shares in Norway Transport Ltd (market value R60 000)	82 000	00
Unlisted		
10 000 shares in Rolands Ltd	68 000	00
5 000 shares in Dinos (Pty) Ltd	10 000	00
	340 000	00

Additional information

This information was obtained from the minutes of various directors' meetings:

- Utopia Ltd is presently involved in a court case with a potential claim of R250 000 against them. No provision has been made in the accounting records as the directors are of the opinion that they will win the case.
- The company contracted to acquire plant and machinery at a cost of R320 000 from Japan. The directors have authorised a further acquisition of plant of R70 000.
- At a board of directors' meeting of Utopia Ltd, held on 3 October 20*x*6, it was decided:
  – To redeem the 12% redeemable cumulative preference shares of the company on 30 November 20*x*6.
  – To finance this redemption partly by the issue of the maximum number of 14% redeemable preference shares at a premium of 20%. (The company will not be able to issue these shares at a higher premium.)
  – To pay the backlog in the cumulative preference dividends, last provided for on 30 September 20*x*4.
  – To convert the authorised ordinary shares of par value into ordinary shares of no par value on 31 December 20*x*6.
  – To write off all deferred expenditure in the accounting records immediately before the conversion of par value to no par value shares.
- Share issue expenses amounting to R5 000 have been incurred.

You are required to:

1 In point form, list all the items in the above draft statement of financial position that do not comply with the minimum disclosure requirements of the Companies Act and International Financial Reporting Standards (IFRS). (Give full details of minimum disclosure requirements.)

2 Prepare the equity and liability section of the statement of financial position as at 31 December 20*x*6, after the implementation of the decisions taken by the directors on 3 October 20*x*6.

Ignore the results of trading for the three months ended 31 December 20*x*6.

(Show all calculations. Notes to the statement of financial position are not required.)

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21 STATEMENT OF CASH FLOWS

Chapter objectives

By the end of this chapter, you should be able to:

- Introduce the terminology used in a statement of cash flows including:
  - operating activities
  - investing activities
  - financing activities
- Explain the drafting procedures for a statement of cash flows.
- Show the minimum disclosure requirements for a statement of cash flows.

Chapter outline

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1 Introduction

The statement of cash flows is one of the statements required by the Companies Act and IAS 1. The aim of this chapter is to concentrate on the adjustments and calculations required in drafting a statement of cash flows and to address the minimum disclosure requirements.

The statement of cash flows presents the user of financial statements with useful and relevant information. For example, answers to the following questions may be obtained from this statement:

- How much cash was generated from operations, compared to movements of cash from investing or financing activities?
- Was sufficient cash generated from operations to pay the interest charges, dividends and taxation?
- How was expansion funded?
- Is the company a net generator or user of cash?
- Does the company generate sufficient cash from the operations to maintain its present operating capacity?

Did you know?

Cash equivalents are near cash assets or money market instruments that are convertible into cash almost immediately.

An example of cash equivalents is a 32-day call account at a bank.

As a guideline three months is used to determine if an item is a cash equivalent or not.

The chapter describes, first, the types of cash flows. Second, the inflows and outflows of cash in a business are shown in a diagram and the format and minimum disclosure requirements of the statement of cash flows are explained. Finally, the drafting procedure for the statement of cash flows is explained with examples.

2 Types of cash flows

A statement of cash flows identifies the inflows and outflows of cash of a company or business during a specific period. The movements in cash are separated into three categories for reporting purposes:

- Cash flow from operating activities.
- Cash flow from investing activities.
- Cash flow from financing activities.

Ultimately, the statement of cash flows reconciles to the net movement in cash and cash equivalents, in other words, the closing balances less the opening balances of all cash or near cash accounts in the statement of financial position of the business.

A statement of cash flows is drafted on a pure cash basis and includes only transactions that increase or decrease the cash position of the company. This approach ignores the effect of credit transactions that are included in the statement of financial position and statement of profit or loss & other comprehensive income under the accrual concept. Research in the United States of America has indicated that users of financial statements want to assess the amount and timing of the future cash flows in making their decisions.

By including a statement of cash flows in the financial statements, users are supplied with historical information that can be used in their estimates of the future cash flows and the statement may also serve to correct or confirm their previous estimates of the cash flows.

The statement of cash flows discloses the flow of cash in a business for a specific financial period. The flow of cash within a business is shown in the diagram in Figure 21.1.

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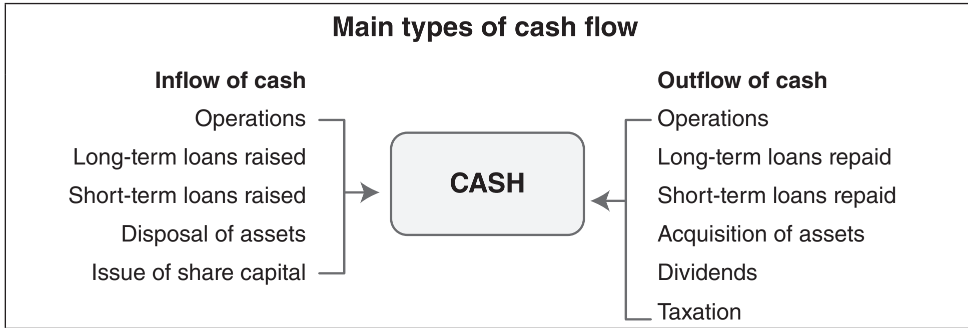
Figure 21.1



You should be able to complete Question 21.1.

3 Minimum disclosure requirements

The accounting standard on the statement of cash flows (IAS 7) identifies the minimum disclosure requirements for the statement of cash flows.

For reporting purposes, the format of the statement of cash flows is flexible and the most meaningful approach should be adopted. These types of activities must be identified separately:

1 Operating activities. **2** Investing activities. **3** Financing activities.

Operating activities

Operating activities are the principal revenue-producing activities of the enterprise and include all activities that are not investing or financing activities.

Examples of cash flows from operating activities are:

- Cash receipts from the sale of goods and the rendering of services.
- Cash receipts from royalties, fees, commissions and other income.
- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of employees.
- Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits.
- Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities.
- Cash receipts and payments from contracts held for dealing or trading purposes.

Investing activities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Examples of cash flows arising from investing activities are:

- Cash payments to buy property, plant and equipment, intangible and other long-term assets.
- Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets.
- Cash payments to buy equity or debt instruments of other enterprises.
- Cash advances and loans made to other parties (other than advances and loans made by a financial institution).

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Financing activities

Financing activities are activities that result in changes in the size and composition of the equity capital and borrowings of the enterprise.

Examples of cash flows arising from financing activities are:

- Cash proceeds from issuing shares or other equity instruments.
- Cash payments to owners to buy or redeem the enterprise's shares.
- Cash proceeds from issuing debentures, loans, bonds and other short- or long-term borrowings.
- Cash repayments of amounts borrowed.

Both cash inflows and cash outflows are recorded under each of the three headings.

The statement of cash flows balances to the net movement in cash and cash equivalents. Cash equivalents are short term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value.

Comparative figures are required for the statement of cash flows. It is a further requirement that, wherever possible, gross amounts rather than net amounts be disclosed. A netting of amounts in the statement may result in the loss of valuable information. For example, a statement of cash flows should disclose the long-term loans raised and the long-term loans repaid separately, instead of merely reporting a net increase or decrease in long-term loans.

Figure 21.2 shows the format for a statement of cash flows. Study the format carefully before starting the next section.

Figure 21.2

Company Name Ltd
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 30 JUNE 20*x*5

	Notes	20*x*5	20*x*4
Cash flow from operating activities		xxx xxx	xxx xxx
Cash receipts from customers		xx xxx	xx xxx
Cash paid to suppliers and employees		xx xxx	xx xxx
Cash generated from operations	1	xxx xxx	xxx xxx
Interest received		x xxx	x xxx
Interest paid	3	(x xxx)	(x xxx)
Dividends received		x xxx	x xxx
Dividends paid	4	(x xxx)	(x xxx)
Normal tax paid	5	(x xxx)	(x xxx)
Cash flow from investing activities		(xx xxx)	(xx xxx)
Acquisition of an investment		(xx xxx)	(xx xxx)
Purchase of non-current assets			
Replacement of non-current assets		(x xxx)	(x xxx)
Additions to non-current asset		(x xxx)	(x xxx)
Proceeds from sale of non-current assets		x xxx	x xxx
Cash flow from financing activities		xx xxx	xx xxx
Proceeds from issue of share capital		xx xxx	xx xxx
Proceeds from long-term borrowings		x xxx	x xxx
Repayment of long-term borrowings		(x xxx)	(x xxx)
Net increase/(decrease) in cash and cash equivalents	2	xx xxx	(x xxx)
Cash and cash equivalents at beginning of period		(xxx)	xxx
CASH AND CASH EQUIVALENTS AT END OF PERIOD	2	x xxx	(xxx)

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A reconciliation between the profit before taxation reported in the statement of profit or loss & other comprehensive income and the cash generated from operations should be given as a note to the financial statements.

Company Name Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20x5

1 ***Reconciliation of profit before taxation with cash generated from operations***	**20x5**	**20x4**
Profit before taxation	xxx xxx	xxx xxx
Adjustment for non-cash flow items and separately disclosable items	x xxx	x xxx
Depreciation	x xxx	x xxx
Investment income	(x xxx)	(x xxx)
Interest expense	xxx	xxx
Operating profit before working capital changes	xx xxx	xx xxx
Changes in working capital:	xx xxx	xx xxx
(Increase)/decrease in accounts receivable	(x xxx)	(x xxx)
(Increase)/decrease in inventories	x xxx	x xxx
Increase/(decrease) in accounts payable	(x xxx)	(x xxx)
Cash generated from operations	xxx xxx	xxx xxx

The direct method presents for cash from operations the gross cash inflows as cash from customers and the gross cash outflows as a result of expenditure (see Figure 21.2).

The indirect method starts with the profit before tax figure in the statement of profit or loss & other comprehensive income and reconciles this to the cash from operations (similar to calculation in Note 1 of Figure 21.2).

The indirect method results in a netting of gross amounts and, therefore, in a loss of useful information.

Did you know?

The earlier version of accounting statement IAS 7 allowed the cash generated from operations to be calculated using either the direct method or the indirect method. However, the current IAS 7 recommends only the direct method.

Cash and cash equivalents

IAS 7 requires an enterprise to disclose the components of cash and cash equivalents and to present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.

Where cash consists of different components, this note should be added to the notes to the statement of cash flows.

Figure 21.3

Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and bank balances, and investments in money market instruments. Cash and cash equivalents included in the statement of cash flows consist of these statement of financial position amounts:

2 ***Cash and cash equivalents***	**20x5**	**20x4**
Cash on hand and bank balances	xx xxx	xx xxx
Short-term investments	x xxx	x xxx
	xx xxx	xx xxx

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4 Advantages and disadvantages

Before starting with the drafting procedures of a statement of cash flows, it is necessary to consider briefly the advantages and disadvantages of this statement.

Advantages

Cash flow information is important in assessing **liquidity** as in the short term, a company generating insufficient cash from its operations may well have trouble meeting its obligations. (Liquidity is the ability of a company to pay its liabilities in the short term.)

In the current economic environment, companies that carefully monitor cash manage to survive better than companies who do not. **Existing cash flow patterns** are identified in a statement of cash flows and this may serve as a guideline to users who wish to predict future cash flows. A statement of cash flows identifies the **main sources** of cash, as well as the **main uses** of cash.

Additional information that may not be readily available from the statement of financial position and statement of profit or loss & other comprehensive income is presented in a statement of cash flows to highlight the company's ability to, amongst others:

- Pay the providers of funds.
- Pay dividends.
- Pay taxation.
- Finance expansion.

Cash flows are not influenced by **subjectivity** and **judgements** as the statement of profit or loss & other comprehensive income is, with its accruals, allocations, provisions and accounting policies. All cash receipts and payments are recognised when they occur and information is provided about the time lag that exists between reported earnings and the actual cash flows.

More **reliable comparisons** between similar companies and previous years are possible, as accounting policies, book entries and arbitrary allocations do not influence cash flows.

Disadvantages

The main disadvantage of the statement of cash flows is that cash flows are volatile and may be influenced with, for example, an upswing or down-swing in the economy.

You should be able to complete Questions 21.2 to 21.6.

5 Accrual approach and the cash approach

A statement of cash flows describes the movement in cash for a specific financial period. In an earlier chapter we explained the matching and accrual concepts of accounting.

The statement of financial position and the statement of profit or loss & other comprehensive income are drafted applying these concepts, therefore, income and expenses are recognised as they are incurred, not when they are received or paid in cash.

- When income accrues but has not yet been received in cash, we raise a receivable in the statement of financial position. Consequently, both the income received in cash and the income still owing are included in the statement of profit or loss & other comprehensive income. The same principle applies to inventory and payables.
- When an expense accrues, but has not yet been paid in cash, we raise a payable in the statement of financial position and the statement of profit or loss & other comprehensive income includes both expenses paid in cash and still owing.

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When a statement of cash flows is drafted, however, we do not adhere to the accrual concept, as only the movements in cash should be disclosed.

The question is, therefore, how to move from the accrual approach in the statement of financial position and the statement of profit or loss & other comprehensive income, to the cash approach in the statement of cash flows.

Example 21.1 will explain the change from an accrual approach to a cash approach.

Example 21.1

Changing from an accrual approach to a cash approach

The accounts receivable account of Opal Ltd as at 31 December 20*x*5 was:

General Ledger of Opal Ltd
Real Accounts Section
Dr. ACCOUNTS RECEIVABLE B7 Cr.

Dec.	1	Balance	b/d	17 000	00	Dec.	31	Bank	CRJ12	42 000	00
	31	Sales	ARJ12	45 000	00		31	Balance	c/d	20 000	00
				62 000	00					62 000	00
Jan.	1	Balance	b/d	20 000	00						

The statement of profit or loss & other comprehensive income includes sales of R45 000, even if the amount is received in cash or not, in accordance with the accrual approach.

- Under the cash approach, we want to show only the cash received from receivables, that is, the R42 000 that they paid to the business.
- To change from sales made of R45 000 to cash received from sales of R42 000, this adjustment is necessary:

Gross income as per statement of profit or loss & other comprehensive income (accrual approach)	45 000	00
Add: Opening balance – accounts receivable	17 000	00
	62 000	00
Less: Closing balance – accounts receivable	(20 000	00)
Cash receipts from customers (cash approach)	42 000	00

Explanation

For accounts receivable, the opening balance is R17 000 and the closing balance is R20 000.

- The company has 'invested' an additional R3 000 in receivables, resulting in a net cash outflow that is deducted from sales.
- It is possible to change sales to the cash received from sales by adding the opening balance and subtracting the closing balance of accounts receivable.

Reminder

Refer to Figure 21.2 to see the disclosure of cash receipts from customers in the statement of cash flows.

Example 21.2

Example 21.1 can now be extended to accounts payable and inventory. Opal Ltd uses the perpetual inventory system.

General Ledger of Opal Ltd
Real Accounts Section
Dr. INVENTORY B7 Cr.

Dec.	1	Balance	b/d	22 000	00	Dec.	31	Cost of sales	CRJ12	27 000	00
	31	Accounts payable	APJ12	* 30 000	00		31	Balance	c/d	25 000	00
				52 000	00					52 000	00
Jan.	1	Balance	b/d	25 000	00						

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Dr.			ACCOUNTS PAYABLE						B8		Cr.
Dec.	31	Bank	CPJ12	51 000	00	Dec.	1	Balance	b/d	15 000	00
	31	Balance	c/d	12 000	00		31	Inventory	APJ12	* 30 000	00
							31	Expenses	APJ12	18 000	00
				63 000	00					63 000	00
						Jan.	1	Balance	b/d	12 000	00

In line with the accrual approach, the statement of profit or loss & other comprehensive income includes charges for cost of sales of R27 000 and expenses of R18 000, whether these amounts are paid or not.

- Under the cash approach, only the cash paid for inventory and expenses should be disclosed, that is, R51 000. (Note that the R30 000 inventory purchase is cancelled by the R30 000 payables liability.)
- To change from R45 000 (R27 000 + R18 000) to cash paid to suppliers of R51 000, this adjustment is necessary:

Cost of sales	27 000	00
Add: Expenses	18 000	00
Accrual approach in the statement of profit or loss & other comprehensive income	45 000	00
Add: Opening balance – accounts payable	15 000	00
Add: Closing balance – inventory	25 000	00
	85 000	00
Less: Opening balance – inventory	(22 000	00)
Less: Closing balance – accounts payable	(12 000	00)
Cash paid to suppliers (cash approach)	51 000	00

Explanation

- For accounts payable, the opening balance is R15 000 and the closing balance is R12 000. Payables have contributed R3 000 less in financing the company, resulting in a cash outflow that is added to the cost of sales and expenses.
- For inventory, the opening balance is R22 000 and the closing balance is R25 000. The company has invested an additional R3 000 in inventory, resulting in a cash outflow that is added to cost of sales and expenses.
- It is possible to change information on the accrual approach in the statement of profit or loss & other comprehensive income to the cash approach by adding or subtracting the opening and closing balances of accounts receivable, inventory and accounts payable.

Reminder

Refer to Figure 21.2 to see the disclosure of cash paid to suppliers in the statement of cash flows.

By expanding the above example to include other expenses, such as salaries and wages, the cash paid to suppliers and employees can be calculated.

It is important to understand this principle before continuing with the drafting procedure.

Reminder

Refer to Figure 21.2 (Note 1 working capital changes), to convert the 'accrual-based approach in the statement of profit or loss & other comprehensive income to the cash-based approach' required in the statement of cash flows.

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6 Drafting procedure

It is apparent that a number of calculations are required in drafting a statement of cash flows.

This section shows these calculations and adjustments, from the essential basic calculations converting the accruals of the statement of profit or loss & other comprehensive income to the cash approach, to the more complex adjustments required frequently such as book entries and entries not resulting in a flow of cash.

In an exam question, this information is usually required to complete the calculations and adjustments necessary in drafting a statement of cash flows:

- The statement of financial position for two consecutive periods.
- The statement of profit or loss & other comprehensive income.
- Details of movements in tangible, intangible and financial assets not given in the statement of financial position and statement of profit or loss & other comprehensive income.
- Additional information not contained in the statement of financial position and statement of profit or loss & other comprehensive income relating to gross movements in cash.

The statement of cash flows discloses the movement in cash from one financial year end to the next. The movements are identified as either inflows or outflows of cash under three headings:

1. Operating activities.
2. Investing activities.
3. Financing activities.

Certain accounts must be analysed when a statement of cash flows is drafted, as they may contain:

- Both cash inflows and outflows in one account.
- Items that do not represent a flow of cash.
- Items that should be disclosed separately in the statement of cash flows to comply with the minimum disclosure requirements.

Typical accounts that need further analysis include non-current assets, dividends and taxation.

Non-cash flow items

It is necessary to discuss the items that do not represent a flow of cash, before the analysis of relevant accounts and the drafting of a statement of cash flows are explained.

Entries that do not represent a flow of cash are often passed in the records of a company. These entries are usually book entries, entries passed by management, or entries that do not represent transactions with third parties. Such entries do not affect the flow of cash in a business and should, therefore, be ignored in drafting the statement of cash flows.

Non-cash flow items include:

- Depreciation.
- Allowance for bad debts.
- Writing off of inventories.
- Profit on sale of non-current assets.
- Transfers to and from reserves.
- Writing off of intangible assets.
- Revaluation/Impairment of assets.
- Loss on sale or scrapping of non-current assets.

Let us explain each of these items with examples.

Depreciation

Depreciation is an operating expense that is deducted from profit. As depreciation is not an actual flow of cash, it should be eliminated when drafting a statement of cash flows, as shown in Example 21.3.

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Example 21.3

Eliminating depreciation

The general journal entry for depreciation is:

GENERAL JOURNAL OF OPAL LTD **GJ12**

Day	Details	Fol.	Debit		Credit	
31/12	Depreciation (nominal account)	N	10 000	00		
	Accumulated depreciation (real account)	B			10 000	00
	Depreciation brought into account					

The effect on the statement of profit or loss & other comprehensive income is:

Profit (for example)	50 000	00
Less: Depreciation	(10 000	00)
Profit after depreciation	40 000	00

To cancel the effect of depreciation, it should be added back to profit:

Profit (for example)	40 000	00
Add: Non-cash flow entries	10 000	00
Profit before depreciation	50 000	00

The profit increases

Explanation

For the purpose of drafting a statement of cash flows, depreciation should be eliminated (by adding it back to profit), as it does not result in a flow of cash.

Profit/loss on sale/scrapping of non-current assets – purchase and sale of non-current assets

The statement of cash flows should show the gross movements on non-current assets. In other words, it should show the cost of purchases (cash outflows) and the proceeds from sales (cash inflows) under the heading 'Investing activities'.

The profit in the statement of profit or loss & other comprehensive income does not show the total cash received when an asset, other than inventory, is sold, but only the profit or loss on the sale. When drafting the statement of cash flows, the profit or loss on sale of non-current assets should be eliminated against the profit before taxation and the total proceeds of the sale should be shown as an inflow of cash.

Reminder

The profit from the statement of profit or loss & other comprehensive income will be adjusted by the reversals of non-cash flow items and other adjustments to obtain the cash from operations used in the statement of cash flows.

Refer to Figure 21.2 (Note 1).

The purchase of non-current assets represents an outflow of cash. Example 21.4 shows this principle.

Example 21.4

Purchase and sale of non-current assets

Lebogeng Ltd had this information about vehicles for the year ended 31 December 20*x*6:

	Cost		Accumulated depreciation	
	20*x*6	**20*x*5**	**20*x*6**	**20*x*5**
Vehicles	R170 000	R160 000	R70 000	R44 000

- On 30 June 20*x*6, the company sold two vehicles at a combined profit of R6 000 and bought a new vehicle that cost R24 000.
- The depreciation for the year was R36 000.

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- Profit (after deducting depreciation and adding the profit on vehicles sold) for the year ended 31 December 20*x*6 was R50 000.

You are required to:
Show the above transactions in the statement of cash flows of Lebogeng Ltd for the year ended 31 December 20*x*6.

- **Tip:** Use this key when you analyse the accounts:
  - *A = Outflow of cash *Disclose*
  - *S = Inflow of cash *Disclose*
  - *N = Not a flow of cash *Reverse*
- Roman numerals identify the general journal entries previously passed.

General Ledger of Lebogeng Ltd
Real Accounts Section

VEHICLES **B4**

Dr.						Cr.					
Jan.	1	Balance	b/d	160 000	00	Jun.	30	Asset disposal	GJ6	(i) 14 000	00
Jun.	30	Bank *A	CPJ6	24 000	00	Dec.	31	Balance	c/d	170 000	00
				184 000	00					184 000	00
Jan.	1	Balance	b/d	170 000	00						

ACCUMULATED DEPRECIATION: VEHICLES **B5**

Jun.	30	Asset disposal	GJ6	(iii) 10 000	00	Jan.	1	Balance	b/d	44 000	00
Dec.	31	Balance	c/d	70 000	00	Dec.	31	Depreciation *N	GJ12	(ii) 36 000	00
				80 000	00					80 000	00
						Jan.	1	Balance	b/d	70 000	00

Nominal Accounts Section

ASSET DISPOSAL **N9**

Jun.	30	Vehicles	GJ6	(i) 14 000	00	Jun.	30	Acc. dep.: Vehicles	GJ6	(iii) 10 000	00
	30	Profit and loss account *N	GJ12	(iv) 6 000	00		30	Bank (balancing figure) *S	CRJ6	10 000	00
				20 000	00					20 000	00

Final Accounts Section

PROFIT AND LOSS ACCOUNT **F2**

Dec.	31	Depreciation	GJ12	(ii) 36 000	00	Dec.	31	Trading account (balancing figure)	b/d	80 000	00
	31	Retained inc. (profit)	GJ12	50 000	00		31	Profit on sale of asset	GJ12	(iv) 6 000	00
				86 000	00					86 000	00

Explanation

- The profit of R50 000 is after deducting depreciation and adding the profit on the sale of vehicles. As both the depreciation and the profit on the sale of vehicles are not cash flows, the entries are reversed as shown in Note 1.
- The depreciation for the year is not a cash flow and is reversed. The reversal is added back to profit as an adjustment for non-cash flow items.
- The profit on sale of non-current assets is also not a flow of cash.
  - To show the actual cash flow (the proceeds of the sale of the vehicle), the profit on the sale of the vehicle is reversed.

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– The reversal is deducted from the profit before taxation as an adjustment for non-cash flow items, and the proceeds of the sale is shown as an inflow of cash under 'Investing activities'.

Lebogeng Ltd
ABRIDGED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20x6

	Notes	20x6		20x5	
Cash flow from investing activities		(xx xxx	xx)	(xx xxx	xx)
Purchase of non-current assets					
Replacement of non-current assets	1	(24 000	00)	(x xxx	xx)
Proceeds from sale of non-current assets	1	10 000	00	x xxx	xx

Lebogeng Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20x6

	20x6		20x5	
1 *Reconciliation of profit before taxation with cash generated from operations*				
Profit before taxation	50 000	00	xxx xxx	xx
Adjustment for non-cash flow items:	30 000	00	x xxx	xx
Depreciation	36 000	00	x xxx	xx
Profit on sale of non-current assets	(6 000	00)	(xxx	xx)
Cash generated from operations	80 000	00	xxx xxx	xx

Writing off intangible assets

Acquired intangible assets such as patents, trademarks and goodwill are usually written off to the statement of profit or loss & other comprehensive income over time. Provided the intangible assets were not bought during the current year, the writing off (or amortisation) is not a flow of cash and will, therefore, be reversed.

The profit before taxation will be increased with the amount of the book entry for writing off the intangible asset.

Note: If the intangible asset is bought in the current year, the purchase transaction related to the asset represents an outflow of cash that is disclosed under investing activities.

Writing off inventory

Any entry writing inventory off as a result of ageing, obsolescence or revaluation, are not flows of cash and should be reversed by increasing the profit figure.

Revaluation/Impairment of assets

If assets are revalued or impaired during the year, the entry will be reversed as a non-cash flow for the purposes of the statement of cash flows, as explained in Example 21.5.

Example 21.5 **Revaluation of assets**

Lebogeng Ltd had this information about land and buildings for the year ended 31 December 20x6:

	20x6	20x5
Land and buildings at valuation	R240 000	R170 000
Surplus on revaluation of land and buildings	R50 000	R0

- Land and buildings are not depreciated.
- A vacant stand that had cost R10 000 was sold for R20 000 on 30 April 20x6.
- Land and buildings were revalued on 30 June 20x6.
- The profit before taxation is R60 000.

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You are required to:

Show the above transactions in the statement of cash flows of Lebogeng Ltd.

- **Tip:** Use this key when you analyse the accounts:
  - *A = Outflow of cash — *Disclose*
  - *N = Not a flow of cash — *Reverse*
  - *S = Inflow of cash — *Disclose*
- Roman numerals identify the general journal entries previously passed.

General Ledger of Lebogeng Ltd

Real Accounts Section

LAND AND BUILDINGS — B3

Dr.						Cr.					
Jan.	1	Balance	b/d	170 000	00	Apr.	30	Sold	GJ4	(i) 10 000	00
Apr.	30	Bank *A (balancing figure)	CPJ4	30 000	00	Dec.	31	Balance	c/d	240 000	00
Jun.	30	Revaluation	GJ6	(ii) 50 000	00						
				250 000	00					250 000	00
Jan.	1	Balance	b/d	240 000	00						

REVALUATION OF LAND AND BUILDINGS — B9

						Jun.	30	Land and buildings	GJ6	(ii) 50 000	00

Nominal Accounts Section

LAND AND BUILDINGS REALISATION ACCOUNT — N9

Apr.	30	Land and buildings	GJ6	(i) 10 000	00	Apr.	30	Bank *S	CRJ6	20 000	00
Dec.	31	Profit and loss account *N (balancing figure)	GJ6	(iii) 10 000	00						
				20 000	00					20 000	00

Final Accounts Section

PROFIT AND LOSS ACCOUNT — F2

						Dec.	31	Profit on sale of asset *N	GJ12	(iii) 10 000	00

Lebogeng Ltd

ABRIDGED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20x6

	Notes	20x6		20x5	
Cash flow from operating activities		xxx xxx	xx	xxx xxx	xx
Cash flow from investing activities		(xx xxx	xx)	(xx xxx	xx)
Purchase of non-current assets					
Additions of non-current assets	1	(30 000	00)	(x xxx	xx)
Proceeds from sale of non-current assets	1	20 000	00	x xxx	xx
Cash flow from financing activities		xx xxx	xx	xx xxx	xx
Net increase/(decrease) in cash and cash equivalents	2	xx xxx	xx	(x xxx	xx)

Lebogeng Ltd

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20x6

1 ***Reconciliation of profit before taxation with cash generated from operations***	20x6		20x5	
Profit before taxation	60 000	00	xxx xxx	xx
Adjustment for non-cash flow items and separately disclosable items	(10 000	00)	(x xxx	xx)
Profit on sale of non-current assets *N	(10 000	00)	(xxx	xx)
Cash generated from operations	50 000	00	xxx xxx	xx

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Explanation

- The profit before taxation is after taking into account the profit on the sale of land and buildings of R10 000. As this profit is not a cash flow, the entry is reversed by decreasing the profit before taxation by R10 000.
- The real flow of funds, the proceeds on the sale of land and buildings of R20 000, may now be shown as an inflow of cash under investing activities.
- The revaluation of land and buildings is not a cash flow and should be reversed.
  Note that the revaluation of land and buildings and the subsequent reversal thereof does not affect the profit before taxation as the amount was taken directly to non-distributable reserves and not through the statement of profit or loss & other comprehensive income.

Allowance for bad debts

The allowance for bad debts is deducted from accounts receivable in the statement of financial position and the net movement of receivables is used to calculate the cash from operations.

Transfers to and from reserves

Transfers to and from reserves are usually shown in the statement of changes in equity. These transfers do not normally constitute a flow of cash and are, therefore, reversed. As the transfers are not included in the profit before taxation, the reversals is not added or subtracted from the profit figure in note 1 to the statement of cash flows.

Dividends, interest and taxation

The profit in the statement of profit or loss & other comprehensive income, used to calculate cash from operations in the note to the statement of cash flows, is before deducting taxation, dividends and sometimes before deducting interest.

IAS 7 requires that the cash flows from these items be shown separately, usually in the cash flow from operating activities section of the statement of cash flows.

Example 21.6 **Cash flow before dividends and taxation**

Gaxa Ltd had these balances as at 1 January 20*x*1:

Shareholders for dividends	20 000	00
SARS: income tax	10 000	00
Bank (favourable = *Dr.*)	75 000	00

- On 1 February 20*x*1, the dividends owed to shareholders of R20 000 was paid.
- On 31 December 20*x*1, dividends of R30 000 were declared, and a provision of R55 000 for taxation was raised.
- The company made two provisional taxation payments of R30 000 each on 30 June 20*x*1 and 31 December 20*x*1.

You are required to:
Show the above transactions in the statement of cash flows of Gaxa Ltd for the year ended 31 December 20*x*1.

Reminder

Refer to Figure 21.2 to see the disclosure of taxation paid, dividends paid and interest paid and received.

Also revise the journal entries for dividends and taxation in Examples 17.1 and 17.2.

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General Ledger of Gaxa Ltd
Real Accounts Section

Dr. BANK B5 Cr.

Jan.	1	Balance	b/d	75 000	00	Feb.	1	Shareholders for dividends	CPJ21	(i) 20 000	00
						Jun.	30	SARS: Income tax	CPJ6	(ii) 30 000	00
						Dec.	31	SARS: Income tax	CPJ12	(iii) 30 000	00

SHAREHOLDERS FOR DIVIDENDS B8

Feb.	1	Bank *A	CPJ2	(i) 20 000	00	Jan.	1	Balance	b/d	20 000	00
Dec.	31	Balance	c/d	30 000	00	Dec.	31	Dividends	GJ12	(v) 30 000	00
				50 000	00					50 000	00
						Jan.	1	Balance	b/d	30 000	00

SARS: INCOME TAX B9

Jun.	30	Bank *A	CPJ6	(ii) 30 000	00	Jan.	1	Balance	b/d	10 000	00
Dec.	31	Bank *A	CPJ12	(iii) 30 000	00	Dec.	31	Taxation expense	GJ12	(iv) 55 000	00
	31	Balance	c/d	5 000	00						
				65 000	00					65 000	00
						Jan.	1	Balance	b/d	5 000	00

Nominal Accounts Section

DIVIDENDS N12

Dec.	31	Shareholders for dividends	GJ12	(v) 30 000	00	Dec.	31	Statement of changes in equity	GJ12	30 000	00

INCOME TAX EXPENSE N13

Dec.	31	SARS: income tax	GJ12	(iv) 55 000	00	Dec.	31	Profit and loss account	GJ12	55 000	00

Explanation

- The dividend paid during the year represents the cash outflow for dividends in the statement of cash flows of R20 000 that can also be calculated as:

1/1	***Opening balance – shareholders for dividends***	20 000	00
31/12	Dividends declared	30 000	00
		50 000	00
31/12	***Closing balance – shareholders for dividends***	(30 000	00)
	DIVIDENDS PAID	20 000	00

- The taxation paid during the year represents the cash outflow for taxation in the statement of cash flows of R60 000 that can also be calculated as:

1/1	***Opening balance – SARS: Income tax***	10 000	00
31/12	Taxation provided	55 000	00
		65 000	00
31/12	***Closing balance – SARS: Income tax***	(5 000	00)
	TAXATION PAID	60 000	00

- IAS 7 requires that dividends paid and taxation paid be disclosed separately on the statement of cash flows in the section operating activities.

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Gaxa Ltd
ABRIDGED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20x1

	Notes	20x1		20x0	
Cash flow from operating activities		xxx xxx	xx	xxx xxx	xx
Cash receipts from customers		xx xxx	xx	xx xxx	xx
Cash paid to suppliers and employees		xx xxx	xx	xx xxx	xx
Cash generated from operations	1	xxx xxx	xx	xxx xxx	xx
Dividends paid	4	(20 000	00)	(x xxx	xx)
Normal tax paid	5	(60 000	00)	(x xxx	xx)

Cash flow from operating activities

The cash generated from operating activities, using the direct method, is calculated like this:

	Notes	20x1		20x0	
Cash flow from operating activities		xxx xxx	xx	xxx xxx	xx
Cash receipts from customers		xx xxx	xx	xx xxx	xx
Cash paid to suppliers and employees		xx xxx	xx	xx xxx	xx
Cash generated from operations	1	xxx xxx	xx	xxx xxx	xx

These items are calculated by eliminating the effect of the accrual approach to show the movement in cash. Thereafter, the items that should be disclosed separately such as interest received and paid, dividends received and paid and taxation, are shown as adjustments.

Reminder
For a discussion of the accrual and cash approach refer to Section 5 of this chapter.

Non-cash flow items should be reversed to calculate the net cash inflow or cash outflow from operating activities. The operating activities in a healthy business normally result in a net cash inflow.

The drafting of the net cash flow from operating activities is best explained in an example.

Example 21.7 **Cash flow from operating activities**

These extracts are from the financial statements of Pentium Ltd for the year ended 31 December 20x9:

Pentium Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20x9

	Notes	20x9	
Revenue		1 033 000	00
Cost of sales		(528 000	00)
Gross profit		505 000	00
Other operating income		8 500	00
Dividends received from investments		6 500	00
Profit on sale of vehicle		2 000	00
Gross operating income		513 500	00
Operating expenses		(57 700	00)
Depreciation		12 200	00
Loss on sale of equipment		4 000	00
Salaries		41 500	00
Operating profit before interest and taxation		455 800	00
Interest expense		(3 500	00)
Operating profit before taxation		452 300	00
Taxation		(158 305	00)
PROFIT FOR THE YEAR		293 995	00

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	20x9	20x8
Accounts receivable	R275 000	R200 000
Inventories	R150 000	R175 000
Accounts payable	R130 000	R95 000

Assume dividends declared and paid were R40 000.

You are required to:

Calculate the cash generated from operations and show the accompanying note to the statement of cash flows for the year ended 31 December 20x9.

Cash received from customers

Revenue	1 033 000	00
Elimination of the effect of accrual basis		
Increase in receivables (275 000 – 200 000) (cash outflow)	(75 000	00)
	958 000	00

Cash paid to suppliers and employees

Revenue	1 033 000	00
Less: Profit before tax	(452 300	00)
Expenses for the year	580 700	00
Removal of items that should appear separately in the statement of cash flow:		
Investment income	6 500	00
Interest paid	(3 500	00)
Elimination of non-cash items:		
Depreciation	(12 200	00)
Loss on disposal of equipment	(4 000	00)
Profit on disposal of vehicles	2 000	00
Elimination of the effect of the accrual concept:		
Decrease in inventories (175 000 – 150 000) (cash inflow)	(25 000	00)
Increase in payables (130 000 – 95 000) (cash inflow)	(35 000	00)
Cash paid to suppliers and employees	509 500	00

Pentium Ltd

ABRIDGED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20x9

	Notes	20x9	
Cash flow from operating activities		411 500	00
Cash receipts from customers		958 000	00
Cash paid to suppliers and employees		(509 500	00)
Cash generated from operations	1	448 500	00
Dividends received		6 500	00
Interest paid	3	(3 500	00
Dividends paid	4	(40 000	00)

Explanation

- You should distinguish between cash from operations of R448 500 and cash inflow from operating activities R411 500.
- Certain items such as investment income and interest should be presented separately on the face of the statement of cash flows. The income and expenses are, therefore, reversed against the profit before tax amount, so that the amounts can be disclosed separately.
- Note that dividends and taxation should also be disclosed separately. These items are not deducted from the profit before tax and need, therefore, not be reversed before being disclosed separately.

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Pentium Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20x9

1	***Reconciliation of profit before taxation with cash generated from operations***	**20x9**	
	Profit before taxation	452 300	00
	Adjustment for non-cash flow items and separately disclosable items	11 200	00
	Depreciation	12 200	00
	Investment income	(6 500	00)
	Loss on disposal of equipment	4 000	00
	Profit on disposal of vehicle	(2 000	00)
	Interest expense	3 500	00
	Operating profit before working capital changes	463 500	00
	Changes in working capital:	(15 000	00)
	(Increase)/decrease in accounts receivable (cash outflow)	(75 000	00)
	(Increase)/decrease in inventories (cash inflow)	25 000	00
	Increase/(decrease) in accounts payable (cash inflow)	35 000	00
	Cash generated from operations	448 500	00

Cash flow from investing activities

The cash flow from investing activities section discloses the cash inflows and cash outflows resulting from the investment in or disposal of property, plant and equipment, intangible assets and financial assets.

If the information is available, it is useful to separate the acquisition of assets between cash flows to maintain operating capacity and cash flows to expand operating capacity.

Reminder

Refer to Example 23.4 for the analysis of accounts required in drafting the investing activities in a statement of cash flows.

It is often necessary to analyse the accounts of assets to separate the purchase of assets from the disposal of assets. Remember that gross amounts should be disclosed in the statement of cash flows, as the net amounts may result in the loss of useful information.

The drafting procedures for the cash flows from investing activities are explained in Example 21.8.

Example 21.8 **Cash flow from investing activities**

These extracts are from the financial statements of Pentium Ltd for the year ended 31 December 20x9:

	20x9	**20x8**
Land and buildings	R250 000	R100 000
Plant and equipment	R150 000	R80 000
Patents	R16 000	R20 000
Investments	R65 000	R50 000

Additional information:

1 Patents bought in 20x5 are amortised on a straight-line basis at R4 000 p.a.

2 The company bought shares for R25 000, and sold shares (that had cost R10 000) for R14 000.

3 Land and buildings:

— During the year, the company bought additional land to the value of R50 000.

— On 31 December 20x9, the land and buildings were revalued by an amount of R100 000 by a sworn appraiser. (**Note:** Land is not depreciated.)

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4 Plant and equipment are depreciated at 20% per annum on cost price.

- During the year, a factory (plant) to the value of R120 000 was bought.
- During the year, equipment was sold for an amount of R40 000.
- Depreciation for plant and equipment for the year was R35 000 (R15 000 was for the equipment sold).

You are required to:

Draft the cash flow from investing activities section of the statement of cash flows for the year ended 31 December 20*x*9.

General Ledger of Pentium Ltd

Real Accounts Section

Dr. **LAND AND BUILDINGS** **B4** **Cr.**

Jan.	1	Balance	b/d	100 000	00	Dec.	31	Balance	c/d	250 000	00
?	?	Bank [*A]	CPJ	50 000	00						
Dec.	31	Revaluation [*N]	GJ12	(i) 100 000	00						
				250 000	00					250 000	00
Jan.	1	Balance	b/d	250 000	00						

PLANT AND EQUIPMENT **B5**

Jan.	1	Balance	b/d	80 000	00	?	?	Sold (balancing figure)	GJ	(ii) 50 000	00
?	?	Bank [*A]	GJ12	120 000	00	Dec.	31	Balance	c/d	150 000	00
				200 000	00					200 000	00
Jan.	1	Balance	b/d	150 000	00						

ACCUMULATED DEPRECIATION: PLANT & EQUIPMENT **B6**

?	?	Sold (balancing figure)	GJ6	(iii) 15 000	00	Jan.	1	Balance	b/d	?	
Dec.	31	Balance	c/d	?		Dec.	31	Depreciation [*N]	GJ12	35 000	00
				?						?	
						Jan.	1	Balance	b/d	?	

PATENTS **B7**

Jan.	1	Balance	b/d	20 000	00	Dec.	31	Amortisation: Patents	GJ12	(iv) 4 000	00
							31	Balance	c/d	16 000	00
				20 000	00					20 000	00
Jan.	1	Balance	b/d	16 000	00						

INVESTMENTS (SHARES) **B8**

Jan.	1	Balance	b/d	50 000	00	?	?	Sold (balancing figure)	GJ	10 000	00
?	?	Bank [*A]	CPJ	25 000	00	Dec.	31	Balance	c/d	65 000	00
				75 000	00					75 000	00
Jan.	1	Balance	b/d	65 000	00						

REVALUATION OF LAND AND BUILDINGS **B9**

						Dec.	31	Land and buildings [*N]	GJ12	(i) 100 000	00

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Nominal Accounts Section

AMORTISATION: PATENTS N8

Dec.	31	Patents *N	GJ12	(iv) 4 000	00	Dec.	31	Profit and loss account	GJ12	4 000	00

Dr. PLANT AND EQUIPMENT REALISATION ACCOUNT N9 Cr.

?	?	Plant and equipment	GJ	(ii) 50 000	00	?	?	Accumulated depreciation: Plant and equipment	GJ	(iii) 15 000	00
Dec.	31	Profit and loss account *N (balancing figure)	GJ	5 000	00	?	?	Bank *S	CRJ	40 000	00
				55 000	00					55 000	00

INVESTMENTS (SHARES) REALISATION ACCOUNT N10

?	?	Investments (shares)	GJ	10 000	00	?	?	Bank *S	CRJ	14 000	00
Dec.	31	Profit and loss account *N (balancing figure)	GJ	4 000	00						
				14 000	00					14 000	00

Pentium Ltd
ABRIDGED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20x9

	Notes	20x9	
Cash flow from investing activities		(141 000	00)
Acquisition of land		(50 000	00)
Acquisition of plant		(120 000	00)
Proceeds on disposal of equipment		40 000	00
Acquisition of shares		(25 000	00)
Proceeds on sale of shares		14 000	00

Explanation

- The revaluation of land and buildings does not result in a flow of cash and is ignored.
- The amortisation of patents does not result in a flow of cash and is ignored.
- The information on plant and equipment is incomplete in the question.
  - Sufficient information is, however, given to calculate that the cost price of the equipment sold was R50 000 (the balancing amount).
  - The opening and closing balances for accumulated depreciation were not given, but as depreciation is a book entry and not a flow of cash, this information is not really required.
- Note that the profit on the sale of equipment and on the sale of shares is not a flow of cash. The actual flow of cash shown in the statement of cash flows is the proceeds.
- If the cash flow from operating activities were also required, these adjustments would be made to the profit before taxation in the note to the statement of cash flows:

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1	***Reconciliation of profit before taxation with cash generated from operations***	**20x9**	
	Profit before taxation	452 300	00
	Adjustment for non-cash flow items and separately disclosable items	30 000	00
	Depreciation of plant and equipment	35 000	00
	Amortisation of patents	4 000	00
	Profit on disposal of equipment	(5 000	00)
	Profit on disposal of shares	(4 000	00)
	Operating profit before working capital changes	482 300	00

Cash flow from financing activities

Reminder

Revise the journal entries for shares in Chapter 18, and loans and debentures in Chapter 19.

The cash flow from financing activities discloses the cash inflows and cash outflows arising from equity and loans from third parties. Again it may be necessary to analyse certain accounts to identify the gross amounts of the loans raised and the loans repaid.

The share capital raised and the share capital redeemed should also be disclosed. Remember that the netting of cash flow amounts in the statement of cash flows should be avoided as it may result in the loss of useful information for the users of financial statements.

The procedures for the cash flow from financing activities are explained in Example 21.9.

Example 21.9 **Cash flow from financing activities**

These extracts are from the financial statements of Pentium Ltd for the year ended 31 December 20x9:

	20x9	**20x8**
Share capital		
Ordinary shares	R230 000	R115 000
8% preference shares	R0	R100 000
10% debentures @ R100 each	R100 000	R50 000
Long-term loans	R150 000	R100 000
Loans to key management personnel	R30 000	R20 000

Additional information:

1. On 1 July 20x9, the company issued 100 000 ordinary shares @ R1.20 to redeem the preference shares. Share issue expenses (R5 000) were paid and written off.
2. The company issued 500 10% debentures at R100 each during the year.
3. The long-term loans consisted of loans raised of R100 000, and loans repaid of R50 000.
4. The loans to key management personnel consisted of new loans to directors of R18 000, and loans repaid by directors of R8 000.

You are required to:

Draft the cash flow from financing activities section of the statement of cash flows for the year ended 31 December 20x9.

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General Ledger of Pentium Ltd
Real Accounts Section

Dr. **ORDINARY SHARE CAPITAL** **B1** **Cr.**

Jul.	1	Share issue expense *A	GJ7	5 000	00	Jan.	1	Balance	b/d	115 000	00
Dec.	31	Balance	c/d	230 000	00	Jul.	1	Application and allotment: ordinary shares *S	GJ7	120 000	00
				235 000	00					235 000	00
						Jan.	1	Balance	b/d	230 000	00

PREFERENCE SHARE CAPITAL **B2**

Jul.	1	Bank *A	CPJ7	100 000	00	Jan.	1	Balance	b/d	100 000	00

Pentium Ltd
ABRIDGED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20x9

	Notes	20x9	
Cash flow from financing activities		115 000	00
Ordinary shares issued (120 000 – 5 000)		115 000	00
Preference shares redeemed		(100 000	00)
Debenture issue		50 000	00
Loans raised		100 000	00
Loans repaid		(50 000	00)

Explanation

- Share issue expenses are an outflow of cash and are allocated to the transaction it relates to.
- If the preference shares were redeemed at a premium, the premium would form part of the total cash outflow on the redemption of preference shares.
- Loans to key mangement personnel should rather be shown under 'Investing activities'.

7 Chapter illustrative example

This chapter illustrative example includes all the aspects you have learned and is designed to comply with the minimum disclosure requirements of IAS 7 and the Companies Act.

These extracts are from the records of United Ltd for the year ended 31 December 20x6.

United Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x6

	Notes	20x6		20x5	
ASSETS					
Non-current assets		328 000	00	286 000	00
Current assets		170 000	00	170 000	00
Inventories	7	90 000	00	110 000	00
Accounts receivable	8	62 000	00	55 000	00
Cash and cash equivalents		18 000	00	5 000	00
TOTAL ASSETS		498 000	00	456 000	00

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		20x6		20x5	
EQUITY AND LIABILITIES					
Capital and reserves		418 000	00	290 000	00
Ordinary share capital (150 000 shares)	2	170 000	00	110 000	00
Preference shares (100 000 14% preference shares)		50 000	00	50 000	00
Non-distributable reserve		8 000	00	0	00
Distributable reserve (retained earnings)		190 000	00	130 000	00
Non-current liabilities		0	00	100 000	00
Long-term borrowings	3	0	00	100 000	00
Current liabilities		80 000	00	66 000	00
Accounts payable		48 000	00	44 000	00
SARS: Income tax payable		20 000	00	12 000	00
Shareholders for dividends		12 000	00	10 000	00
TOTAL EQUITY AND LIABILITIES		498 000	00	456 000	00

United Ltd
ABRIDGED STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20x6

	Notes	20x6	
Revenue		375 000	00
Cost of sales		(217 000	00)
Operating profit before taxation		158 000	00
Income tax expense		(73 000	00)
PROFIT FOR THE YEAR		85 000	00

United Ltd
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20x6

	Ordinary share capital		Preference share capital		Surplus on expropriation of land		Retained earnings		Total	
Balance 1 January 20x6	110 000	00	50 000	00	0	00	130 000	00	290 000	00
Profit for the year							85 000	00	85 000	00
Ordinary dividends declared							(10 000	00)	(10 000	00)
Preference dividends declared							(7 000	00)	(7 000	00)
New shares issued	60 000	00							60 000	00
Profit on sale of land					8 000	00	(8 000	00)	0	00
Balance 31 December 20x6	170 000	00	50 000	00	8 000	00	190 000	00	418 000	00

Additional information:

1 *Non-current assets*

	Cost		Accumulated depreciation		Carrying value	
	20x6	20x5	20x6	20x5	20x6	20x5
Land and buildings	180 000	140 000	–	–	180 000	140 000
Plant and machinery	218 000	190 000	70 000	44 000	148 000	146 000
	398 000	330 000	70 000	44 000	328 000	286 000

2 A small plot that cost R25 000 was sold for a profit of R8 000 on 30 March 20x6.

3 Bought plant and machinery that cost R40 000.

4 Sold plant and machinery with a book value of R8 000 at a loss of R4 000.

5 During the year, 50 000 ordinary shares were issued at R1.20/share.

6 Interest paid was R5 000, and investment income was R2 000.

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7 The profit on the expropriation of land (included in the profit before taxation) should be transferred to a non-distributable reserve.

You are required to:
Prepare the statement of cash flows with notes of United Ltd for the year ended 31 December 20*x*6.

Analysis of accounts

- **Tip:** Use this key when you analyse the accounts:
  - *A = Outflow of cash *Disclose*
  - *N = Not a flow of cash *Reverse*
  - *S = Inflow of cash *Disclose*
- Roman numerals identify the general journal entries previously passed.

A Land and buildings

General Ledger of United Ltd
Real Accounts Section

Dr. **LAND AND BUILDINGS** **B3** Cr.

Jan.	1	Balance	b/d	140 000	00	Mar.	30	Sold	GJ4	(i) 25 000	00
Dec.	31	Bank *A (balancing figure)	CPJ3	65 000	00	Dec.	31	Balance	c/d	180 000	00
				205 000	00					205 000	00
Jan.	1	Balance	b/d	180 000	00						

NON-DISTRIBUTABLE RESERVE **B4**

						Dec.	31	Profit on expropriation of property	GJ12	(iii) 8 000	00

Nominal Accounts Section
LAND AND BUILDINGS REALISATION ACCOUNT **N9**

Mar.	30	Land and buildings	GJ4	(i) 25 000	00	Mar.	30	Bank *S (balancing figure)	CRJ12	33 000	00
	30	Profit on expropriation of property *N	GJ	(ii) 8 000	00						
				33 000	00					33 000	00

PROFIT ON EXPROPRIATION OF PROPERTY **N10**

Dec.	31	Non distributable reserve	GJ12	(iii) 8 000	00	Dec.	31	Profit on sale of asset *N	GJ12	(ii) 8 000	00

Explanation

- The accounts are reconstructed using the information provided in the statement of financial position and the statement of profit or loss & other comprehensive income, as well as the additional information.
- The transfer of the profit on the sale of land and buildings to a non-distributable reserve is not a flow of cash and will, therefore, be reversed.
- The profit on the expropriation of land is not a flow of cash. To show the actual cash flow, the proceeds on the sale of land of R33 000, the profit should be reversed.

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B Plant and machinery

Real Accounts Section

Dr. PLANT AND MACHINERY B5 Cr.

Jan.	1	Balance	b/d	190 000	00	?	?	Sold (balancing figure)	GJ	(i) 12 000	00
?	?	Bank *A	GJ12	40 000	00	Dec.	31	Balance	c/d	218 000	00
				230 000	00					230 000	00
Jan.	1	Balance	b/d	218 000	00						

ACCUMULATED DEPRECIATION: PLANT & MACHINERY B6

?	?	Sold	GJ6	(iii) 4 000	00	Jan.	1	Balance	b/d	44 000	00
Dec.	31	Balance	c/d	70 000	00	Dec.	31	Depreciation *N (balancing figure)	GJ12	(ii) 30 000	00
				74 000	00					74 000	00
						Jan.	1	Balance	b/d	70 000	00

Nominal Accounts Section

Dr. PLANT AND MACHINERY REALISATION ACCOUNT N9 Cr.

?	?	Plant and machinery	GJ	(i) 12 000	00	?	?	Accumulated depreciation: Plant and machinery	GJ6	(iii) 4 000	00
						?	?	Profit and loss account *N	GJ	(iv) 4 000	00
						?	?	Bank *S (balancing figure)	CRJ	4 000	00
				12 000	00					12 000	00

C Share capital

Real Accounts Section

Dr. ORDINARY SHARE CAPITAL B1 Cr.

Dec.	31	Balance	c/d	170 000	00	Jan.	1	Balance	b/d	110 000	00
						?	?	Application and allotment: ordinary shares *S	GJ7	(i) 60 000	00
				170 000	00					170 000	00
						Jan.	1	Balance	b/d	170 000	00

BANK B10

?	?	Ordinary share capital	GJ	(i) 60 000	00						

D Taxation

The actual amount of cash paid to the SARS is calculated by adding the opening balance and subtracting the closing balance on the SARS: Income tax account in the statement of financial position to the taxation charge in the statement of profit or loss & other comprehensive income.

1/1	***Opening balance – SARS: Income tax***	12 000	00
31/12	Taxation provided	73 000	00
		85 000	00
31/12	***Closing balance – SARS: Income tax***	(20 000	00)
	TAXATION PAID	65 000	00

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E Dividends

The actual amount of cash paid to the shareholders for dividends is calculated by adding the opening balance and subtracting the closing balance on the shareholders for dividends account in the statement of financial position to the total dividend charge in the statement of changes in equity.

1/1	***Opening balance – shareholders for dividends***	10 000	00
31/12	Dividends declared (7 000 + 10 000)	17 000	00
		27 000	00
31/12	***Closing balance – shareholders for dividends***	(12 000	00)
	DIVIDENDS PAID	15 000	00

F Other net movements on the statement of financial position

These statement of financial position movements are not analysed and are gotten from analysing the statement of financial position movements, for example, the repayment of the long-term loan of R100 000.

G Calculating the cash generated from operating activities

Cash received from customers

Revenue	375 000	00
Elimination of the effect of accrual basis		
Increase in receivables (62 000 – 55 000) (cash outflow)	(7 000)	00)
	368 000	00

Cash paid to suppliers and employees

Revenue	375 000	00
Less: Profit before tax	(158 000	00)
Expenses for the year	217 000	00
Removal of items that should appear separately in the statement of cash flows:		
Investment income	2 000	00
Interest paid	(5 000	00)
Elimination of non-cash items:		
Depreciation	(30 000	00)
Loss on disposal of plant	(4 000	00)
Profit on expropriation of land	8 000	00
Elimination of the effect of the accrual concept:		
Decrease in inventories (110 000 – 90 000) (cash inflow)	(20 000	00)
Increase in payables (48 000 – 44 000) (cash inflow)	(4 000	00)
Cash paid to suppliers and employees	164 000	00

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Now you are ready to draft the statement of cash flows with relevant notes.

United Ltd
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20x6

Reference to analysis		Notes	20x6	
	Cash flow from operating activities		121 000	00
G	Cash receipts from customers		368 000	00
G	Cash paid to suppliers and employees		(164 000	00)
G	*Cash generated from operations*	1	204 000	00
	Interest received		2 000	00
	Interest paid	3	(5 000	00)
E	Dividends paid	4	(15 000	00)
D	Normal tax paid	5	(65 000	00)
	Cash flow from investing activities		(68 000	00)
A	Proceeds on sale of land and buildings		33 000	00
B	Proceeds on sale of plant and machinery		4 000	00
A	Acquisition of land and buildings		(65 000	00)
B	Acquisition of plant and machinery		(40 000	00)
	Cash flow from financing activities		(40 000	00)
C	Proceeds from issue of share capital		60 000	00
F	Repayment of long-term borrowings		(100 000	00)
	Net increase/(decrease) in cash and cash equivalents	2	13 000	00
	Cash and cash equivalents at beginning of period		5 000	00
	CASH AND CASH EQUIVALENTS AT END OF PERIOD	2	18 000	00

United Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20x6

1 ***Reconciliation of profit before taxation with cash generated from operations***	20x6	
Profit before taxation	158 000	00
Adjustment for non-cash flow items and separately disclosable items	29 000	00
Depreciation	30 000	00
Investment income	(2 000	00)
Loss on disposal of plant	4 000	00
Profit on the expropriation of land	(8 000	00)
Interest expense	5 000	00
Operating profit before working capital changes	187 000	00
Changes in working capital:	17 000	00
(Increase)/decrease in accounts receivable (cash outflow)	(7 000	00)
(Increase)/decrease in inventories (cash inflow)	20 000	00
Increase/(decrease) in accounts payable (cash inflow)	4 000	00
Cash generated from operations	204 000	00

You should be able to complete Questions 21.7 to 21.12.

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8 Summary

The statement of cash flows forms part of the annual financial statements of a company and discloses the inflows and outflows of cash during a financial period.

The cash inflows and cash outflows in the statement of cash flows are disclosed under three headings:

1 Operating activities. **2** Investing activities. **3** Financing activities.

The statement reconciles to the net movement in cash and cash equivalents in the statement of financial position for a specific financial year.

Minimum disclosure requirements for the statement of cash flows are contained in IAS 7 and the Companies Act.

QUESTIONS

Question 21.1

Briefly discuss the two interpretations of the term 'funds' and indicate which interpretations are adopted in drafting the statement of cash flows.

Question 21.2

Why is the statement of cash flows useful to the external analysers of financial statements?

Question 21.3

Define these terms:

- Operating activities.
- Investing activities.
- Financing activities.
- Cash equivalents.
- Statement of cash flows.

Question 21.4

Why does IAS 7 require gross amounts rather than net amounts to be disclosed in a statement of cash flows?

Question 21.5

Discuss briefly the general format of a statement of cash flows and the advantages of this format.

Question 21.6

How and where should the replacement of non-current assets be disclosed in the statement of cash flows?

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Question 21.7

These balances and totals are from Levenstein Ltd for the year ended 30 June 20*x*8:

Real accounts section	**1 July 20*x*7**		**30 June 20*x*8**	
SARS: Income tax	12 000	00	15 000	00
Shareholders for dividends	15 000	00	20 000	00
Nominal accounts section			**30 June 20x8**	
Income tax expense			38 000	00
Under-provision for taxation in the previous year			3 200	00
Dividends				
Interim			18 000	00
Final			20 000	00

You are required to:
Calculate the amount of dividends and taxation paid.

Question 21.8

Frankie and Charlie Ltd has these balances and totals, among others, as at 31 December 20*x*9:

Inventory	96 000	00
Accounts receivable	135 000	00
Accounts payable	131 250	00
Profit before taxation (including interest paid – R15 000)	70 000	00
Revenue	225 000	00

1 Additional information on 1 January 20*x*9:
- Inventory R96 750
- Accounts receivable R118 250
- Accounts payable R116 500

2 These amounts are included in the profit before taxation:
- Depreciation R45 000
- Profit on sale of property R18 000
- Amortisation of goodwill R6 000

You are required to:
Calculate the cash generated from operations.

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Question 21.9

Here are the financial statements of Karriem Manufacturing Company Ltd:

Karriem Manufacturing Company Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*9

	Notes	20*x*9		20*x*8	
ASSETS					
Non-current assets		590 000	00	532 000	00
Land and buildings at valuation (20*x*8 – cost)		280 000	00	240 000	00
Plant and machinery at cost		380 000	00	348 000	00
Accumulated depreciation: plant and machinery		(70 000	00)	(56 000	00)
Current assets		440 000	00	344 000	00
Inventories		153 600	00	154 800	00
Accounts receivable		216 000	00	189 200	00
Cash and cash equivalents		70 400	00	0	00
TOTAL ASSETS		1 030 000	00	876 000	00
EQUITY AND LIABILITIES					
Capital and reserves		760 000	00	500 000	00
Ordinary share capital		460 000	00	300 000	00
Non-distributable reserve		40 000	00	0	00
Distributable reserve: retained earnings		260 000	00	200 000	00
Non-current liabilities		40 000	00	80 000	00
Long-term borrowings		40 000	00	80 000	00
Current liabilities		230 000	00	296 000	00
Accounts payable		210 000	00	186 400	00
Bank overdraft		0	00	109 600	00
Shareholders for dividends		20 000	00	0	00
TOTAL EQUITY AND LIABILITIES		1 030 000	00	876 000	00

Karriem Manufacturing Company Ltd
ABRIDGED STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20*x*9

	Notes	20*x*9	
Revenue		380 000	00
Cost of sales		(268 000	00)
Operating profit before taxation		112 000	00
Income tax expense		(32 000	00)
PROFIT FOR THE YEAR		80 000	00

Additional information:

1 A new machine was purchased to replace an old one during the current financial year.
- The old machine had originally cost R12 000 and was sold for R3 200.
- At the date of the sale accumulated depreciation amounting to R7 600 was provided for.

2 On 1 June 20*x*9, land and buildings were revalued to R280 000.

3 Included in payables are amounts owing to the SARS:
- 20*x*9 R10 000
- 20*x*8 R14 400

4 Interest paid during the year amounted to R28 000.

5 Dividends declared amounted to R20 000.

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You are required to:
Prepare a statement of cash flows for the year ended 31 December 20*x*9.

Question 21.10

Here are the financial statements of Diamond Ltd on 31 December 20*x*7:

Diamond Ltd
ABRIDGED STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20*x*7

	Notes	20*x*7	
Revenue		239 000	00
Cost of sales		(194 000	00)
Operating profit (including profit on sale of land) before taxation		45 000	00
Taxation – normal tax for the current year		(9 500	00)
PROFIT FOR THE YEAR		35 500	00

Diamond Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*7

	Notes	20*x*7		20*x*6	
ASSETS					
Non-current assets	6	316 200	00	281 000	00
Current assets		93 000	00	34 000	00
Inventories	7	61 300	00	28 000	00
Accounts receivable	8	25 800	00	6 000	00
Cash and cash equivalents		5 900	00	0	00
TOTAL ASSETS		409 200	00	315 000	00
EQUITY AND LIABILITIES					
Capital and reserves		381 000	00	192 500	00
Ordinary share capital (400 000 ordinary shares)	2	214 000	00	105 000	00
Non-distributable reserve: Profit on sale of land		6 000	00	0	00
Distributable reserves					
General reserve		50 000	00	30 000	00
Retained earnings		11 000	00	17 500	00
Preference share capital (100 000 6% convertible preference shares)		100 000	00	40 000	00
Non-current liabilities		0	00	100 000	00
8% mortgage debentures	3	0	00	100 000	00
Current liabilities		28 200	00	22 500	00
Accounts payable		24 200	00	17 400	00
Bank overdraft		0	00	2 100	00
Shareholders for dividends		4 000	00	3 000	00
TOTAL EQUITY AND LIABILITIES		409 200	00	315 000	00

Diamond Ltd
NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 20*x*7

6	***Property, plant and equipment***	**Cost**		**Accumulated depreciation**		**Carrying value**	
		20*x*7	**20*x*6**	**20*x*7**	**20*x*6**	**20*x*7**	**20*x*6**
	Land and buildings	268 100	242 100	–	–	268 100	242 100
	Plant and machinery	58 700	34 000	21 600	11 600	37 100	22 400
	Vehicles	18 000	18 000	9 000	4 500	9 000	13 500
	Furniture and fittings	5 000	5 000	3 000	2 000	2 000	3 000
		349 800	299 100	33 600	18 100	316 200	281 000

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Diamond Ltd
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20x7

	Ordinary share capital	Preference share capital	Profit on expropria-tion of land	General reserve	Retained earnings	Total
Balance 1 January 20x7	105 000	40 000	0	30 000	17 500	192 500
Profit for the year					35 500	35 500
Dividends declared					(16 000)	(16 000)
New shares issued	110 000	60 000				170 000
Profit on sale of land			6 000		(6 000)	0
Share issue expenses	(1 000)					(1 000)
Transfer				20 000	(20 000)	0
Balance 31 December 20x7	214 000	100 000	6 000	50 000	11 000	381 000

Additional information:

1 Favourable market conditions enabled the company to place 200 000 ordinary shares privately with institutional investors at 55c/share, and also to issue 60 000 6%-preference shares to the public at R1/share.
- The issue of new shares was to redeem the mortgage debentures.
- The company paid share issue expenses of R1 000 and this amount was written off at 31 December 20x7.

2 The company had sold a small plot in December 20x7. The cost of the land disposed of was R4 000. (No other fixed assets were sold or scrapped during the year.)

3 Included in the profit before taxation is interest paid (R5 400), and interest received (R1 300).

4 Dividends declared consists of:
- Ordinary dividends R10 000
- Preference dividends R6 000

You are required to:
Prepare a statement of cash flows and notes for the year ended 31 December 20x7.

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Question 21.11

Here is the statement of financial position for Ilvico Ltd as at 30 June 20x6:

Ilvico Ltd
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x6

	Notes	20x6		20x5	
ASSETS					
Non-current assets	6	400 000	00	400 000	00
Property, plant and equipment		685 000	00	625 000	00
Accumulated depreciation		(285 000	00)	(225 000	00)
Current assets		685 000	00	550 000	00
Inventories	7	325 000	00	265 000	00
Accounts receivable	8	285 000	00	225 000	00
Cash and cash equivalents		75 000	00	60 000	00
TOTAL ASSETS		1 085 000	00	950 000	00
EQUITY AND LIABILITIES					
Capital and reserves		652 500	00	525 000	00
Ordinary share capital	2	400 000	00	325 000	00
Distributable reserves					
General reserve		135 000	00	100 000	00
Retained earnings		117 500	00	100 000	00
Non-current liabilities		175 000	00	100 000	00
Long-term borrowings	3	175 000	00	100 000	00
Current liabilities		257 500	00	325 000	00
Short-term borrowings		0	00	45 000	00
Accounts payable		222 500	00	250 000	00
Shareholders for dividends		35 000	00	30 000	00
TOTAL EQUITY AND LIABILITIES		1 085 000	00	950 000	00

Additional information:

1 On 30 June 20x6, property, plant and equipment that had cost R25 000 (and on which depreciation of R15 000 was provided) were sold for R5 000.

2 On 30 June 20x6, the company made a capitalisation issue of one ordinary share for every three held by the shareholders. For this purpose an amount of R75 000 was transferred from retained earnings.

3 On 15 December 20x5, an interim dividend of R17 500 was declared and paid.

4 On 30 June 20x6, a final dividend of R35 000 was declared.

5 The income tax expense for the year came to R25 000. Included in payables was the SARS: Income tax account with a closing balance of R3 750 and an opening balance of R2 500.

6 Interest paid during the year amounted to R15 000.

7 Revenue for the year amounted to R750 000.

You are required to:
Prepare the statement of cash flows and notes for the year ended 30 June 20x6.

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Question 21.12

Here are the post-closing trial balances of Pine Oak Ltd as at 30 June 20*x*4 and 30 June 20*x*5:

	20*x*4		20*x*5	
Credits				
Authorised and issued ordinary shares	125 000	00	250 000	00
Authorised and issued 6% preference shares	57 500	00	50 375	00
Surplus on revaluation of land and buildings	0	00	25 000	00
Retained earnings	7 910	00	11 110	00
8% mortgage bond	47 500	00	10 000	00
Accounts payable	45 240	00	12 600	00
Bank overdraft	4 200	00	0	00
Proposed ordinary dividend	2 500	00	5 000	00
Taxation provision	1 050	00	2 100	00
Accumulated depreciation: Plant	30 000	00	39 000	00
Accumulated depreciation: Vehicles	8 000	00	9 980	00
	328 900	00	415 165	00
Debits				
Goodwill	8 000	00	0	00
Land and buildings (at cost/valuation)	100 000	00	120 000	00
Plant (at cost)	76 000	00	97 000	00
Vehicles (at cost)	21 000	00	24 800	00
Inventory	71 400	00	94 000	00
Accounts receivable	52 500	00	51 000	00
Share issue expenses	0	00	5 375	00
Cash at bank	0	00	22 990	00
	328 900	00	415 165	00

Additional information:

1. In March 20*x*5, the company sold a vacant stand that cost R5 000 for R10 000 cash and had the remaining property revalued by a sworn appraiser. The directors decided to show the property in the books at the increased value.
2. Included in the profit before tax is interest paid of R3 000, and interest received of R1 800.
3. Revenue for the year amounted to R168 000.
4. During July 20*x*4, the company purchased additional plant and traded in this asset in part settlement of the purchase price of the plant.

	Cost	Accumulated depreciation	Trade-in value
Plant	R16 000	R9 600	R8 000

The company does not depreciate non-current assets sold during the year.

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5 Profit and loss account for the year ended 30 June 20*x*5:

General Ledger of Pine Oak Ltd
Final Accounts Section
PROFIT AND LOSS ACCOUNT **F2**

Dr.											
Jun.	30	Taxation	GJ6	12 800	00	Jul.	1	Retained earnings	GJ6	7 910	00
	30	Goodwill	GJ6	8 000	00	Jun	30	Profit before tax	GJ6	32 000	00
	30	Preference dividends proposed	GJ6	3 000	00						
	30	Ordinary dividends proposed	GJ6	5 000	00						
	30	Retained earnings	GJ6	11 110	00						
				39 910	00					39 910	00

Cr.

6 During January 20*x*5, the company issued the balance of its shares.
- Issue expenses of R5 375 were incurred.
- In terms of a directors' resolution, the issue expenses must be written off.

You are required to:
Prepare the statement of cash flows and notes for the year ended 30 June 20*x*5.

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MODULE G Other accounting entities

This module is divided into four chapters:

Chapter 22 Non-business organisations and incomplete records
Chapter 23 Partnerships
Chapter 24 Close corporations (CCs)
Chapter 25 Manufacturing concerns

Together these four chapters achieve the following outcomes:

Outcomes

- Acquiring the terminology used for other accounting entities.
- Applying accounting procedures to non-business organisations.
- Exploring a partnership as a form of enterprise.
- Preparing the financial statements of a partnership.
- Using the statement of income and expenditure in accounting for non-business organisations.
- Preparing the financial statements of a close corporation.
- Applying the term manufacturing costs and the three types of costs, namely material, labour and overheads.

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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22 NON-BUSINESS ORGANISATIONS AND INCOMPLETE RECORDS

Chapter objectives

By the end of this chapter, you should be able to:

- Explain and apply the different terminology used by a non-business organisation.
- Introduce the receipt and payments statement used in a non-business organisation.
- Explain the accounting treatment of membership subscription fees, entrance fees, legacies and special funds.
- Introduce the use of coupons and prepare a bar trading account.
- Show the preparation of the statement of income and expenditure and the statement of financial position of a non-business organisation.
- Estimate the profit or loss for an entity from limited (incomplete) information.
- Prepare a statement of profit or loss & other comprehensive income and statement of financial position for an entity from limited (incomplete) information supplied.

Chapter outline

1 INTRODUCTION 22 – 2
2 TERMINOLOGY 22 – 2
3 STATEMENT OF RECEIPTS AND PAYMENTS 22 – 3
4 STATEMENT OF INCOME AND EXPENDITURE 22 – 5
5 SPECIAL ITEMS 22 – 6
Entrance fees 22 – 6
Fundraising activities 22 – 6
Membership subscription fees 22 – 7
Legacies and donations 22 – 10
6 SPECIAL FUNDS 22 – 10
Funds requiring expenditure of the capital sum 22 – 13
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7 COUPONS 22 – 15
8 INCOMPLETE RECORDS 22 – 16
Introduction 22 – 16
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Preparing complete financial statements from incomplete records 22 – 19
9 CHAPTER ILLUSTRATIVE EXAMPLE 22 – 21
10 SUMMARY 22 – 24

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1 Introduction

A non-business organisation such as a school, sports or social club or charitable institution is one that obtains funds from either its members or from donations and uses these to achieve the aims of the organisation.

The main sources of income are membership subscription fees and donations from members, as well as the proceeds of organised functions designed to raise funds. There are two fundamental accounting differences commonly associated with this type of organisation:

- The need for a special terminology that is more appropriate for communicating the financial performance and position to the members of the organisation.
- The fact that many of the administrative and financial tasks are performed by members on a voluntary and unpaid basis means that the organisation's accounting system is very simple, often on a cash basis and sometimes incomplete.

The treasurer of a non-business organisation is entrusted with the task of collecting and paying out cash on its behalf and with keeping a record of these transactions. Below is an example of the typical financial activities and the source documents that arise from them:

	Activity	Source document/record
1	Maintaining a list or register of all members.	Electronic register or file of entry or membership.
2	Sending statements of account to members for fees due.	Duplicate invoices/statements.
3	Receiving monies and issuing receipts.	Carbon copies of receipts.
4	Banking cash received.	Carbon copies of deposit slips.
5	Receiving suppliers' invoices and statements.	Originals of suppliers' invoices/statements.
6	Paying suppliers and expenses.	Cheques.
7	Reconciling the organisation's cash/bank records with the bank statements.	Bank statements and cash book.

The above documents will normally be filed in a systematic manner and the treasurer will invariably prepare a record of cash and bank transactions in the form of a cash book, rather than using separate cash receipts and cash payments journals.

For the purpose of this chapter VAT has been ignored.

2 Terminology

As the aim of non-business organisations cannot include the making of profit, the word profit is never used. However, it is unlikely that the income for a given year will exactly equal the expenditure. The difference is referred to as a **surplus** if income exceeds expenditure, and as a **deficit** if expenditure exceeds income.

Most organisations would strive to ensure a surplus to counteract the consequences of inflation or to finance further growth of the organisation.

In place of the cash receipts and cash payments journals, the treasurer is likely to keep a cash book for all cash transactions. A summary of the cash book is commonly known as a **statement of receipts and payments**.

If the double-entry system of accounting is used, it is possible to post from the cash book to the other accounts involved in the general ledger, balance them and extract a trial balance. Thus, the normal accounting procedures may be applied.

As a form of year-end financial statement, the statement of receipts and payments is most appropriate for organisations operating purely on a cash basis that have little or no

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investment in non-current assets. If the cash book (from which the statement of receipts and payments is prepared) is the only accounting record kept, it is usually not part of a system of double-entry records. Thus, the only record kept is the cash book.

Where a full set of accounts is maintained, the accrual system of accounting is generally used – that is adjustments and depreciation are taken into account. The nominal accounts are closed off to the profit and loss account in the same way as a profit-making organisation. However, the profit and loss account is now called the income and expenditure account.

The word 'capital' used in trading organisations also has implications of requiring a return on capital and, thus, the need to make profit. As a result, this is replaced by the term 'accumulated fund'. In most cases, the accumulated fund is also not distributable to individuals in the event of the closing down of the organisation. The constitution is likely to designate some other club or organisation to which funds would be transferred on liquidation. The word 'capital' is, thus, not appropriate.

In addition to the accumulated fund, special funds designated for a particular purpose, such as a building fund or a scholarship fund, are often used. These are treated separately from accumulated funds and are usually represented by an investment specifically attached to the particular special fund.

To summarise, the main differences in terminology are:

Trading organisation	Non-business organisation
Profit	Surplus
Loss	Deficit
Cash journals	Cash book summarised in the statement of receipts and payments
Profit and loss account	Income and expenditure account
Capital	Accumulated fund

You should be able to complete Questions 22.1 to 22.4.

3 Statement of receipts and payments

When a very small organisation does not require the need for more sophisticated information, they may use a receipts and payments account for keeping records. This is used in an adapted form as a statement of receipts and payments for reporting at the annual general meeting (AGM).

The main disadvantages of this form of financial statement is that it does not adequately disclose the results of the organisation's activities, because it:

- May include receipts or payments relating to the sale or purchase of non-current assets.
- Does not take account of increases or decreases in inventories of items such as consumable stores or refreshments.
- May include receipts of capital amounts.
- Takes no account of accruals, prepayments or on outstanding accounts receivable or accounts payable.

Example 22.1

On 1 January 20*x*7, The Jaded Joggers Club was formally established and was granted the free use of a club house at Bergvliet.

Here are the financial transactions which occurred for the year ended 31 December 20*x*7 as recorded in the treasurer's only financial record, the cash book:

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The Jaded Joggers Club
CASH BOOK **CB1**

Dr.											Cr.
20x7 Jan.	1	Balance	b/d	16 500	00	20x7 Dec.	31	Wages		1 300	00
Dec.	31	Membership subscription fees		800	00			Equipment		4 000	00
		Entrance fees		1 500	00			Wages		1 300	00
		Proceeds from event		2 000	00			Wages		1 200	00
		Membership subscription fees		4 000	00			Balance	c/d	19 300	00
		Donations received		2 300	00						
				27 100	00					27 100	00
20x8 Jan.	1	Balance	b/d	19 300	00						

You are required to:

Prepare a statement of receipts and payments for the year ended 31 December 20x7.

The Jaded Joggers Club
STATEMENT OF RECEIPTS AND PAYMENTS FOR THE YEAR ENDED 31 DECEMBER 20x7

Opening bank balance			16 500	00
Add: **Receipts**			10 600	00
Membership subscription fees	4 800	00		
Entrance fees	1 500	00		
Proceeds from event	2 000	00		
Donations received	2 300	00		
			27 100	00
Less: **Payments**			(7 800	00)
Equipment	4 000	00		
Wages	3 800	00		
CLOSING BANK BALANCE			19 300	00

Explanation

- The statement is prepared on a cash basis and reflects only the receipt and payments of cash.
- No account is taken of the fact that income and expenditure of a capital nature (such as the purchase of equipment) has taken place.
- A distinction has been drawn between entrance fees and subscription fees:
  – Many clubs require an initial payment from a member who joins for the first time. This is called an **entrance fee**. This is regarded as part of accumulated funds of the non-business entity.
  – A subscription or membership subscription fee is paid by all members, usually annually. The membership subscription fees would be classified as an income account.
- No account is taken of items (such as membership subscription fees) that may be in arrears or have been prepaid.

You should be able to complete Questions 22.5 and 22.6.

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4 Statement of income and expenditure

The limitations of the statement of receipts and payments make it necessary for many organisations to present statements that are prepared on the accrual basis and in accordance with the principles of the accrual basis for preparing financial statements.

This usually involves introducing the general journal into the accounting system so as to allow for the additional adjusting and closing procedures that are features of the double-entry recording method.

All recording procedures follow the identical principle to those of profit-making organisations. Because the volume of transactions is not large, all cash transactions may be entered into the receipts and payments journal and all non-cash transactions into the general journal.

At the end of each month or, if there are very few transactions, at the end of the year, postings from these two subsidiary journals are made to the general ledger, general ledger accounts are balanced and a trial balance extracted.

There are likely to be adjustments that once again are treated identical to those of profit-making organisations. Once they have been completed, all nominal accounts are closed off to the income and expenditure account. The remaining real accounts are then available for display in the statement of financial position.

The statement of income and expenditure is the financial report that reflects the summarised results and shows the organisation's surplus of income over expenditure or excess of expenditure over income for the period.

The statement of income and expenditure is prepared together with a statement of financial position.

Often, an organisation may grow to the point where it wishes to change from a single cash book to a more complete and accurate procedure. When converting from a single-entry cash basis to a double-entry accrual basis, these statements, books and documents would be available:

- Statement of financial position as at previous financial year-end date.
- Cash book completed with bank entries for the financial year.
- Bank statement, cheques, deposit slips and receipts.
- Suppliers' invoices and/or statements.
- Membership lists, entrance fees.
- Invoices, charged to members.

The procedure below may then be adopted:

- Prepare a statement of financial position at the beginning of the period; determine the balancing accumulated funds figure and enter all of the balances in suitably titled ledger accounts.
- Complete the double-entry for cash transactions by posting from the cash book/receipts and payments account to ledger accounts.
- Record double entries for outstanding items at year end, that is accounts receivable, accounts payable, accrued and deferred expenses and income.
- Record double entries for the non-routine adjustments such as depreciation.
- Extract a trial balance.
- Prepare the statement of income and expenditure and statement of financial position.
- Close off and balance the ledger accounts.

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5 Special items

A number of items raise particular problems, and alternative treatment in the books of account may be possible. The more frequently recurring items have been singled out for further explanation.

Entrance fees

New members joining a club or society are usually required to pay an initial entrance fee, as well as their annual membership subscription fees. Whereas membership subscription fees are treated as income, the entrance fees are more often treated as being a direct contribution of capital and are usually transferred directly to the accumulated funds account.

The effect that this has on financial reporting is to show the surplus or deficit excluding entrance fees. This is justified because entrance fees are not a normal or recurring form of income. As such, they have little to do with the running expenses and income of the organisation.

Example 22.2

The Jaded Joggers Club
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*7

	Notes	20*x*7		20*x*6	
EQUITY AND LIABILITIES					
Accumulated funds		83 640	00	80 430	00
Balance (1 January 20*x*6)	2	72 180	00	68 320	00
Add: Surplus		6 660	00	8 710	00
Entrance fees capitalised		4 800	00	3 400	00

Fundraising activities

From time to time many clubs take part in activities designed to improve their financial position or provide refreshments to members on a profit-making basis. It is usual to prepare a separate final account, transferring only the net surplus or deficit from the special activity to the income and expenditure account.

For example, if refreshments are provided, a bar trading account would be used for closing all accounts connected to bar activities, and only the net surplus or deficit is transferred to the income and expenditure account. Any final bar inventory on hand will, of course, appear in the statement of financial position as a current asset of the organisation.

Fundraising activities such as an event or carnival are usually handed over to a sub-committee under the chairmanship of a convener. If a treasurer is appointed for that particular activity, a separate record may be kept of all income and expenditure relating to that activity.

Provided the committee is satisfied that financial controls have been adequate, only the net proceeds may be handed over to the organisation, with complete details and documentation relating to the activity. The accounting records may, thus, reflect only the net income or proceeds from the activity.

Example 22.3

The Mpumalanga Tennis Club decided to host a dinner and dance over the Easter weekend to raise some funds for the club. This information was supplied by the convener of the committee:

45 couples attended the dinner and dance at R250 per couple	11 250	00
Cost of food	4 500	00
Decorations and flowers for tables	1 575	00
Hiring of band for the evening	2 500	00
Wages paid to waiters	900	00

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You are required to:

Show how the income and expenses from the dinner and dance will be disclosed by the Mpumalanga Tennis Club.

Mpumalanga Tennis Club
STATEMENT OF INCOME & EXPENDITURE FOR THE YEAR ENDED 31 DECEMBER 20*x*7

	Notes	20*x*7	
Income			
Membership subscription fees			
Dinner and dance income [(45 × R250) – (4 500 + 1 575 + 2 500 + 900)]		1 775	00
Donations received			

Membership subscription fees

Membership subscription fees are monthly/semi-annual or annual payments made for membership of a club. Careful records of members and membership subscription payments are essential for ensuring that there is financial control. To make record keeping easier, it is often presumed that membership subscription fees are for a full year or a part thereof.

When membership subscription fees are due at the end of a period, or have been prepaid for the next period, it is convenient to keep separate accounts recording these accruals and prepayments.

Example 22.4 shows the treatment of the special items discussed so far.

Example 22.4

This information for Mooifontein Golf Club was given to you by the club's treasurer:

On 1 January 20*x*8, the club had these assets:

Bank balance	16 500	00
Furniture (at cost)	8 900	00
Accumulated depreciation: Furniture	890	00

Club members each pay an annual membership subscription fee of R600, and new members pay an entrance fee of R450. The club's financial year end is 31 December.

20*x*8

- The club had 180 members for the year. It received R106 200 from members, which included the membership subscription fees of six members for 20*x*9.

20*x*9

- The register of club members shows:

Membership as at 1 January 20x9	180
Joined during the year	5
Membership as at 31 December 20x9	185

- The arrear memberships for 20*x*8 were received in full as well as the amount due for 20*x*9, while four members paid their membership subscription fees for 20*x*10.

It is the club's practice to treat entrance fees as a contribution towards the accumulated fund.

- Furniture is to be depreciated at a rate of 10% using the straight-line method.
- The convener for the event taking place on 30 April 20*x*9 provided documentation indicating that R6 100 had been raised from the event, but that expenses had totalled R4 190.
- Wages paid amounted to R36 000 in 20*x*8 and R45 900 in 20*x*9.

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You are required to:

1 Prepare the membership subscription fees accounts in the general ledger for the years ended 31 December 20*x*8 and 20*x*9.

2 Prepare a statement of income and expenditure for the year ended 31 December 20*x*9 and a statement of financial position at that date.

Explanation

- The method outlined in Section 4 was followed. The opening accumulated fund (R24 510) = bank balance (R16 500) + equipment carrying value (R8 900 – 890) as these were the only assets on hand on 1 January 20*x*8.
- Postings to the general ledger accounts are then made.
- The adjustments for membership subscription fees (nominal account) and depreciation resulted in these accounts:

General Ledger of Mooifontein Golf Club
Real Accounts Section

FURNITURE B4

Dr.												Cr.
20*x*8 Jan.	1	Balance	b/d	8 900	00							

ACCUMULATED DEPRECIATION: FURNITURE B5

20*x*8 Dec.	31	Balance	c/d	1 780	00	20*x*8 Jan.	1	Balance	b/d	890	00
						Dec.	31	Depreciation	GJ	890	00
				1 780	00					1 780	00
20*x*9 Dec.	31	Balance	c/d	2 670	00	20*x*9 Jan.	1	Balance	b/d	1 780	00
						Dec.	31	Depreciation	GJ	890	00
				2 670	00					2 670	00
						21*x*0 Jan.	1	Balance	b/d	2 670	00

BANK B5

20*x*8 Jan.	1	Balance	b/d	16 500	00	20*x*8 Dec.	31	Wages	CB	36 000	00
Dec.	31	Membership subscription fees	CB	106 200	00			Balance	c/d	86 700	00
				122 700	00					122 700	00
20*x*9 Jan.	1	Balance	b/d	86 700	00	20*x*9 Dec.	31	Wages	CB	45 900	00
Dec.	31	Membership subscription fees	CB	115 200	00			Balance	c/d	160 160	00
		Entrance fees	CB	2 250	00						
		Event	CB	1 910	00						
				206 060	00					206 060	00
21*x*0 Jan.	1	Balance	b/d	160 160	00						

MEMBERSHIP SUBSCRIPTION FEES IN ARREARS B6

20*x*8 Dec.	31	Membership subscription fees	GJ	5 400	00	20*x*9 Jan.	1	Membership subscription fees	GJ	5 400	00

MEMBERSHIP SUBSCRIPTION FEES IN ADVANCE B7

20*x*9 Dec.	31	Membership subscription fees	GJ	3 600	00	20*x*8 Jan.	1	Membership subscription fees	GJ	3 600	00
						20*x*9 Dec.	31	Membership subscription fees	GJ	2 400	00

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Nominal Accounts Section

Dr. **MEMBERSHIP SUBSCRIPTION FEES** **N1** **Cr.**

Date		Details	Fol	Amount		Date		Details	Fol	Amount	
20x8 Jan.	1	Membership subscription fees in advance (6 × R600)	GJ	3 600	00	20x8 Dec.	31	Bank	CB	106 200	00
		Inc. and exp. (180 × R600)	GJ	108 000	00			Membership fees in arrears	GJ	5 400	00
				111 600	00					111 600	00
20x9 Jan.	1	Membership subscription fees in arrears	GJ	5 400	00	20x9 Dec.	31	Membership fees in advance	GJ	3 600	00
		Membership subscription fees in advance	GJ	2 400	00			Bank: 20x8	CB	5 400	00
		Income and expenditure (185 × R600)	GJ	111 000	00			Bank: 20x9 (111 000 – 3 600)	CB	107 400	00
								Bank: 21x0	CB	2 400	00
				118 800	00					118 800	00

DEPRECIATION **N7**

Date		Details	Fol	Amount		Date		Details	Fol	Amount	
20x8 Dec.	31	Accumulated depreciation: Furniture	GJ	890	00						
20x9 Dec.		Accumulated depreciation: Furniture	GJ	890	00						
				1 780	00						

Mooifontein Golf Club
STATEMENT OF INCOME & EXPENDITURE FOR THE YEAR ENDED 31 DECEMBER 20x9

	Notes	20x9		20x8	
Income		112 910	00	108 000	00
Membership subscription fees (185 × R600)		111 000	00	108 000	00
Event		1 910	00	0	00
Expenditure		(46 790	00)	(36 890	00)
Wages		45 900	00	36 000	00
Depreciation (10% × R8 900)		890	00	890	00
SURPLUS OF INCOME OVER EXPENDITURE		66 120	00	71 110	00

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x9

	Notes	20x9		20x8	
ASSETS					
Non-current assets		6 320	00	7 120	00
Furniture at carrying value (8 900 – 2 670)		6 320	00	7 120	00
Current assets		160 160	00	92 100	00
Membership subscription fees in arrears		0	00	5 400	00
Cash and cash equivalents		160 160	00	86 700	00
TOTAL ASSETS		166 390	00	99 220	00
EQUITY AND LIABILITIES					
Accumulated funds		163 990	00	95 620	00
Balance beginning of year		95 620	00	24 510	00
Add: Surplus		66 120	00	71 110	00
Entrance fees capitalised (5 × R450)		2 250	00	0	00
Current liabilities		2 400	00	3 600	00
Membership fees in advance		2 400	00	3 600	00
TOTAL EQUITY AND LIABILITIES		166 390	00	99 220	00

You should be able to complete Questions 22.7 to 22.11.

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Legacies and donations

Reminder

Refer back to Chapter 15 (year-end adjustments and the trial balance) for an explanation of income in arrears/advance and expenditure in arrears/advance.

Legacies are normally treated as a capital item being added to the accumulated fund. Donations may vary in size and the tendency would be to treat smaller donations as income, while capitalising large amounts. Such decisions would be made by the organisation's management committee and adopted as a policy.

When an item is capitalised, it means that it is not treated as income for the period, but is transferred directly to the accumulated fund account. It has the effect of not being included in the surplus in the income and expenditure account.

The reason for adopting this procedure is to avoid a false impression of the surplus (or the deficit) for the year. The primary aim of determining the surplus or deficit for the year is to report on the performance of the organisation.

Users of this information wish to draw conclusions about the future surplus-generating ability of the organisation. Thus items that are not regular or frequent should not be part of the operating statement for the year. However, this principle is also open to abuse and manipulation. Organisations may want to show a very low surplus or even a deficit to strengthen their requests for donations or financial assistance.

To achieve this, the bad practice of bypassing the income and expenditure account may be followed. Users of financial statements must then analyse the accumulated fund account to establish the actual income for the year.

6 Special funds

Clubs and societies frequently wish to set resources aside for a particular purpose. When this decision is made, it is advisable to open a separate investment account in which to place such funds. This has the advantage of ensuring that the cash is not used for the general expenses of the organisation and also makes the amount set aside easily identifiable.

Moreover, as it is removed from the current bank account, it may be placed in an interest-bearing investment, thus, enabling the fund to be further boosted by the interest earned.

Once it is known by members of the organisation or members of the general public that a special fund exists, it frequently occurs that donations to that specific fund are received. Such donations do not form part of ordinary operating income and must be placed with the existing fund investment. Similarly, any expenses relating to the fund are not part of operating expenses and must be paid from the resources of the fund investment.

Because non-business organisations do not have sophisticated accounting systems, the necessary adjustments to reflect the operations and special funds are often only completed at the end of each financial year. At that time, transfers between current accounts and fund investments must also be effected.

Where an organisation is able to keep records accurate and up to date at all times, it is of course preferable.

The fundamental accounting principles for special funds are:

- All dealings with the fund should be kept separate from the income and expenditure account and the accumulated fund.
- The cash representing the fund should appear in a fund investment account, which will be an asset account with a debit balance. The fund account will have a credit balance that should be exactly equal to the fund investment account.

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Example 22.5

Malmesbury Mountain Rescue Club had the following balances on 1 January 20*x*6:

Accumulated fund	16 000	00
Equipment	8 500	00
Bank	7 500	00

During the year, the members decided at the annual general meeting to set aside R5 000 to build a mountain retreat (expected cost = R15 000). These were their receipts and payments for the year:

Membership subscription fees	4 750	00
Donations	8 100	00
Equipment purchased	3 700	00
Investment in 10% special savings	5 000	00
General operations expenses	4 320	00

These facts are established at the year end:

1. Donations of R6 200 (marked specifically for the mountain retreat) were transferred to the special savings account shortly after being received.
2. Interest totalling R550 has accrued on the special savings account.
3. Equipment is depreciated at 10% per annum on the year-end balance.

You are required to:

1. Prepare the general ledger accounts for the year.
2. Prepare the income and expenditure account for the year.
3. Prepare the summarised statement of financial position as at 31 December 20*x*6.

1 & 2

General Ledger of Malmesbury Mountain Rescue Club
Real Accounts Section

Dr. **ACCUMULATED FUND** **B1** Cr.

Dec.	31	Mountain Retreat fund	GJ	5 000	00	Jan.	1	Balance	b/d	16 000	00
		Balance	c/d	12 110	00	Dec.	31	Income and expenditure (surplus)	GJ	1 110	00
				17 110	00					17 110	00
						Jan.	1	Balance	b/d	12 110	00

EQUIPMENT **B5**

Jan.	1	Balance	b/d	8 500	00	Dec.	31	Balance	c/d	12 200	00
Dec.	31	Bank	CPJ	3 700	00						
				12 200	00					12 200	00
Jan.	1	Balance	b/d	120	00						

BANK (RECEIPTS AND PAYMENTS) **B6**

Jan.	1	Balance	b/d	7 500	00	Dec.	31	Equipment	CB	3 700	00
Dec.	31	Membership subscription fees	CB	4 750	00			Special savings	CB	5 000	00
		Donations	CB	8 100	00			General expenses	CB	4 320	00
								Special savings	CB	6 200	00
								Balance	c/d	1 130	00
				20 350	00					20 350	00
Jan.	1	Balance	b/d	1 130	00						

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Dr. **MOUNTAIN RETREAT SS INVESTMENT** **B7** **Cr.**

Dec.	31	Bank	CB	5 000	00	Dec.	31	Balance	c/d	11 750	00
		Bank	CB	6 200	00						
		MRF (interest)	GJ	550	00						
				11 750	00					11 750	00
Jan.	1	Balance	b/d	11 750	00						

MOUNTAIN RETREAT FUND **B8**

Dec.	31	Balance	c/d	11 750	00	Dec.	31	Accumulated fund	GJ	5 000	00
								Donations received	GJ	6 200	00
								MH SS investment	GJ	550	00
				11 750	00					11 750	00
						Jan.	1	Balance	b/d	11 750	00

Nominal Accounts Section

MEMBERSHIP SUBSCRIPTION FEES **N1**

Dec.	31	Inc. and exp.	GJ	4 750	00	Dec.	31	Bank	CB	4 750	00

DONATIONS RECEIVED **N3**

Dec.	31	Mountain retreat fund	GJ	6 200	00	Dec.	31	Bank	CB	8 100	00
		Income and expenditure	GJ	1 900	00						
				8 100	00					8 100	00

GENERAL EXPENSES **N4**

Dec.	31	Bank	CB	4 320	00	Dec.	31	Income and expenditure	GJ	4 320	00

DEPRECIATION **N5**

Dec.	31	Accumulated depreciation on equipment	GJ	1 220	00	Dec.	31	Income and expenditure	GJ	1 220	00

ACCUMULATED DEPRECIATION ON EQUIPMENT

Dec.	31	Balance	c/d	1 220	00	Dec.	31	Depreciation		1 220	00
				1 220	00					1 220	00
						Jan	1	Balance		1 220	00

Final Accounts Section

INCOME AND EXPENDITURE ACCOUNT **F1**

20x6 Dec.	31	Depreciation	GJ	1 220	00	20x6 Dec.	31	Membership subscription fees	GJ	4 750	00
		General expenses	GJ	4 320	00			Donations received	GJ	1 900	00
		Accumulated fund (surplus)	GJ	1 110	00						
				6 650	00					6 650	00

3

Malmesbury Mountain Rescue Club

ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x6

Equipment at carrying level	10 980	00	Accumulated fund	12 110	00
Mountain retreat investment	11 750	00	Mountain Retreat fund	11 750	00
Bank	1 130	00			
	23 860	00		23 860	00

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Explanation

- When the decision is made to set funds aside, two separate double entries are required.
  – The special fund account is credited and the accumulated fund account is debited.
  – Cash is transferred to the fund investment account, in this case, a 10% special savings account. (**Note:** The balance of the fund account = the balance of the fund investment account.)
- Donations for the mountain retreat and interest on the fund investment do not appear in the income and expenditure account, as they are not part of the normal operations of the club.
- Once the adjustments and transfers have been completed, the fund account and the fund investment account appear in the statement of financial position with identical balances.

Special funds may be divided broadly into two categories.

- Those that are established for a specific purpose where the aim is realised by the expenditure of the capital sum, such as the building of the mountain retreat.
- Special funds that will exist in perpetuity, the capital sum remaining intact and only the interest or proceeds of the investment being used to achieve the aim of the fund.

Funds requiring expenditure of the capital sum

Where a fund aimed at acquiring an asset such as a building fund is established, the point will be reached where sufficient cash has been accumulated to acquire the asset.

Once this takes place, the resources in the fund investment account must be applied and will be replaced by the asset acquired. When this happens, the special fund account is closed by transferring it back to the accumulated fund account.

Example 22.6

Refer to Example 22.5. These events occurred during 20*x*7:

1. Donations of R2 600 and interest increase the Mountain Retreat fund to R15 200.
2. The club agrees to build the retreat (total cost = R15 800), using the Mountain Retreat SS investment account, the balance being taken from the bank account.
3. The surplus for the year was R3 120.

You are required to:

Prepare these general ledger accounts:

- Accumulated fund.
- Mountain Retreat SS investment.
- Mountain Retreat fund.
- Mountain Retreat.

General Ledger of Malmesbury Mountain Rescue Club
Real Accounts Section

ACCUMULATED FUND **B1**

Dr.						Cr.					
Dec.	31	Balance	c/d	30 430	00	Jan.	1	Balance	b/d	12 110	00
								MR fund	GJ	15 200	00
						Dec.	31	Income and expediture (surplus)	GJ	3 120	00
				30 430	00					30 430	00
						Jan.	1	Balance	b/d	30 430	00

MOUNTAIN RETREAT SS INVESTMENT **B7**

Jan.	1	Balance	b/d	11 750	00	Dec.	31	Bank	CB	15 200	00
Dec.	31	Donations received	GJ	2 600	00						
		MRF (interest)	GJ	850	00						
				15 200	00					15 200	00

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MOUNTAIN RETREAT FUND **B8**

Dec.	31	Acc. fund	GJ	15 200	00	Jan.	1	Balance	b/d	11 750	00
						Dec.	31	Donations received	GJ	2 600	00
								MH SS investment	GJ	850	00
				15 200	00					15 200	00

MOUNTAIN RETREAT ACCOUNT **B9**

Dec.	31	Bank	CB	15 800	00						

Explanation

- The Mountain Retreat Special Savings investment account is closed by transferring R15 200 to the bank account. The fact that the building costs slightly more, does not affect the fund. A cheque for R15 800 was written out to pay the full cost.
- As a result, the Mountain Retreat special savings fund investment account is closed off.
- The Mountain Retreat fund account is transferred to accumulated funds, as the aim of establishing the fund has been achieved by acquiring the asset.
- The Mountain Retreat account is the asset that has been acquired. It will be subject to depreciation on a basis deemed suitable by the club.

Funds requiring the capital sum to remain intact

Special funds may be established as a result of a decision by the organisation or as a result of a special donation or legacy. Should the decision of the organisation or the terms of the donation or legacy require that only the proceeds of the capital sum be applied to the designated purpose, then the capital sum must remain intact.

In essence, this means that the balance of the fund investment account may never fall below the capital amount set aside for the fund. Only interest or other proceeds received from the fund investment may be used in a given year.

- Should a lesser amount be used in a given year, the balance on the fund and fund investment accounts will be greater than the original capital, and may be used in later years.
- Should the expenditure for the year be greater than the proceeds earned on the capital investment, the additional expenditure will have to be subsidised from ordinary income, requiring an entry to the income and expenditure account for the over-expenditure.

Example 22.7

St Mary's Children's Home recently received an amount of R10 000 from a benefactor.

- The benefactor requested that a fund be established for the purpose of granting bursaries for further study from interest accruing, but that the capital sum must remain intact in perpetuity.
- On 1 January 20*x*8 , the funds were invested at 15% per annum in a fixed deposit account at unlimited bank, interest being available for withdrawal at the end of each year.
- Later in the year, a bursary of R1 200 was paid to a student from the bank account, to be replaced from the fund investment at the year end, the balance remaining invested.

You are required to:

Prepare the general journal entries and the relevant statement of financial position entries as at 31 December 20*x*8.

GENERAL JOURNAL OF ST MARY'S CHILDREN'S HOME **GJ**

Day	Details	Fol.	Debit		Credit	
01/01	Bank	B	10 000	00		
	Bursary fund	B			10 000	00

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Date	Details	Fol	Debit		Credit	
	Cash received from benefactor					
	Bursary fund investment	B	10 000	00		
	Bank	B			10 000	00
	Funds invested at 15% p.a. with unlimited bank					
30/09	Bursary fund expense	N	1 200	00		
	Bank	B			1 200	00
	Bursary granted and paid					
31/12	Bursary fund investment	B	300	00		
	Bank	B	1 200	00		
	Bursary fund	B			1 500	00
	Interest received and cash reimbursed					
	Bursary fund	B	1 200	00		
	Bursary fund expense	N			1 200	00
	Bursary fund expense written off					

St Mary's Children's Home
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x8

- *Under funds (the home's equity)*: After accumulated fund:

Bursary fund	10 000	00
Add: Interest income	1 500	00
	11 500	00
Less: Bursary expense	(1 200	00)
	10 300	00

- *Under fund investments (the home's assets)*: After tangible assets:

Unlimited bank bursary fund investment	10 000	00
Add: Interest	1 500	00
	11 500	00
Less: Withdrawal	(1 200	00)
	10 300	00

Explanation

- Although the bursary expense may be paid out of cash from the bank account, it must be replaced when interest is due from the investment.
- If the bursary had been for more than R1 500 (the available amount), the balance would have had to be paid from other funds, as the balance both on the fund and the fund investment account should not fall below R10 000.
- The Bursary fund expense account will not appear in the income and expenditure account. It is closed off directly to the bursary fund account and is fully disclosed in the statement of financial position.

You should be able to complete Questions 22.12 and 22.14.

7 Coupons

A number of businesses sell goods or services and require payment to be made by means of special coupons. The coupons or tokens are invariably marked distinctively and are sold to customers at some central office or place.

The main reason for using coupons is to minimise the handling of cash by staff, by ensuring that all cash is controlled and collected at a specific point. Common examples of this practice are the sale of books of meal and/or drink coupons in social clubs. As an incentive to customers to use the coupons, books of coupons may be sold at a discount.

It is usual for the organisation issuing the coupons to stipulate a maximum period during

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which coupons may be validly redeemed for goods or services and to make provision for customers to exchange unused coupons and receive cash refunds.

Any system of coupon accounting should provide for:

- Adequate control over the printing, receipt, storage and issue of coupons.
- Control over cash when coupons are sold, and a record of the value of coupons sold.
- A record of the value of coupons surrendered by customers for goods or services received.
- A record of the liability for coupons sold to customers but not yet exchanged by them for goods or services.

As coupons are generally valid for limited periods only, it is preferable to operate separate ledger accounts for each year's issue of coupons. It is important to note that:

- A sale transaction takes place only when the coupons are redeemed (exchanged) for goods or services (not when the coupons are sold to the customers).
- The face value, or exchange value, of any valid but unredeemed coupons held by customers should be disclosed as a current liability on the statement of financial position.

Coupons are popular, especially in clubs or societies that run a bar or restaurant. It follows that they are often associated with a bar trading account or a restaurant trading account.

The principles of these trading accounts are identical to those of all other trading accounts. The organisation may not be aiming to make a profit, the running of a bar or restaurant within the organisation usually does have a small profit motive.

Coupons and bar trading accounts are fully covered in the illustrative example that follows later in the chapter.

8 Incomplete records

Introduction

The administrative and financial tasks of a club are often performed by members on a voluntary and unpaid basis. This causes the organisation to have a very simple accounting system that is often on a cash basis and sometimes incomplete.

Incomplete records are not limited to clubs only; small enterprises also often fail to keep accurate and complete accounting records. Possible causes for incomplete records may be the result of:

- Records that have been inadvertently stolen.
- Records that have been inadvertently destroyed, for example a fire at the premises.
- Records that have been destroyed by employees responsible for fraud.
- Insufficient knowledge by owners of small enterprises.

The result of incomplete records is that financial information is not readily available when the owner needs to prepare financial statements. Such financial statements may be required to obtain additional loan facilities or to submit with the SARS or to evaluate the performance of the business.

The extent to which financial statements can be prepared from incomplete records, depends on the amount of information that can be obtained from the entity.

- If minimum information is available, it is only possible to estimate the profit or loss.
- If more detailed information is available, it is often possible to prepare a complete set of financial statements by using one's knowledge of financial accounting.

We will deal with both situations in this section.

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Estimating profit or loss from basic information

Example 22.8 The Clock Shop buys clocks and sells them at a mark-up of 25%. No accurate records are kept.

- Inventory on hand as at 1 January 20*x*3 was R38 000.
- The Clock Shop has only one supplier.
- After calling the supplier, you get a detailed statement for the year ended 31 December 20*x*3. From this, you are able to determine that the total purchase cost for the year was R245 000.
- The store manager found a copy of the inventory count from 31 December 20*x*3. The inventory at cost amounted to R37 500.

You are required to:

1. Calculate the cost of sales.
2. Calculate the gross profit and total sales for the year.

1

Cost of sales			245 500	00
Opening inventory	38 000	00		
Add: Purchases	245 000	00		
	283 000	00		
Less: Closing inventory	37 500	00		

2 Clocks are sold at a mark-up of 25%.
Therefore, if cost of sales = R245 500, then sales = R245 500 × 125 ÷ 100 = R306 875.
Gross profit = R(306 875 – 245 500)
= R61 375

Example 22.9 Penny Nkosi owns a bookshop called Nice to Read. This statement of financial position as at 30 June 20*x*8 and 20*x*7 was supplied to you:

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*8

	Notes	20*x*8		20*x*7	
ASSETS					
Non-current assets		60 000	00	54 000	00
Furniture at cost		66 000	00	60 000	00
Less: Accumulated depreciation		(6 000	00)	(6 000	00)
Current assets		70 000	00	59 200	00
Inventories		30 500	00	26 700	00
Accounts receivable		31 500	00	22 500	00
Cash and cash equivalents		8 000	00	6 000	00
TOTAL ASSETS		130 000	00	109 200	00
EQUITY AND LIABILITIES					
Owner's equity and reserves		108 000	00	94 200	00
Capital		108 000	00	94 200	00
Current liabilities		22 000	00	15 000	00
Accounts payable		22 000	00	15 000	00
TOTAL EQUITY AND LIABILITIES		130 000	00	109 200	00

Additional information:

- Accounts receivable:
  - Cash collected from customers during the year amounts to R145 000.
  - Accounts receivable is reported net of the provision for bad debts in the statement of financial position.
  - Bad debts of R1 500 had been written off against accounts receivable during the year.
  - A provision for bad debts is kept at 10% of the receivables' balance on 30 June each year.

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- Accounts payable:
  - Cash payment to suppliers for goods for resale R95 000.
  - Goods returned to suppliers to the amount of R3 750.
- Cash withdrawals by the owner, R5 000.
- On 1 January 20*x*8, furniture was bought for cash.
  - Depreciation on furniture for the year has not been taken into account.
  - Furniture is depreciated at 10% using the straight-line method.
- All sales and purchases are on credit.

You are required to:
Calculate the net income for the year ended 20*x*8.

Note: Information that is not provided can be found from the details that are supplied or found in the records. This is best done by opening the account for the specific item and recording the information supplied. The 'balancing figure' would then represent the missing information.

Nice to Read
ABRIDGED SOPOL & OCI FOR THE YEAR ENDED 30 JUNE 20*x*8

	Notes	20*x*8	
Sales (credit)		156 500	00
Cost of sales		(101 950	00)
Opening inventory		26 700	00
Add: Purchases		105 750	00
		132 450	00
Less: Closing inventory		(30 500	00)
Gross profit		54 550	00
Operating expenses		(14 100	00)
Depreciation		6 300	00
Bad debts		7 800	00
NET PROFIT FOR THE YEAR		46 750	00

Calculating depreciation for the year

Depreciation on furniture on hand 1 July 20*x*7 (R60 000 × 10%)	6 000	00
Depreciation on new furniture (R6 000 × 10% × 6 ÷ 12)	300	00
Total for the year ended 30 June 20x8	6 300	00

Calculating credit sales
Accounts receivable is shown after a provision for bad debts of 10%. That means the balance before the provision is as follows:

- 20*x*8 = R31 500 ÷ 90 × 100 = R35 000
- 20*x*7 = R22 500 ÷ 90 × 100 = R25 000

Real Accounts Section
Dr. ACCOUNTS RECEIVABLE B7 Cr.

Jun.	1	Balance	b/d	25 000	00	Jun.	30	Bank	CRJ	145 000	00
	30	Sales (credit) (balancing figure)	ARJ	156 500	00			Bad debts	GJ	1 500	00
								Balance	c/d	35 000	00
				181 500	00					181 500	00
Jul.	1	Balance	b/d	35 000	00						

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Calculating credit purchases

Real Accounts Section

ACCOUNTS PAYABLE **B8**

Dr.												Cr.
Jun.	30	Bank	CPJ	95 000	00	Jun.	1	Balance	b/d	15 000	00
		Purchase returns	APRJ	3 750	00		30	Purchases (balancing figure)	APJ	105 750	00
		Balance	c/d	22 000	00						
				120 750	00					120 750	00
						Jul.	1	Balance	b/d	22 000	00

Preparing complete financial statements from incomplete records

The preparation of a complete set of financial statements can best be explained by a comprehensive example.

Information that is not provided can be found from the details that are supplied or found in the records.

- Sales and purchases can be calculated by using the statement of financial position information that is available.
- Expense and income accounts can also be reconstructed from available information to determine the statement of profit or loss & other comprehensive income amounts.

Example 22.10

The owner of Chris Supplies did not keep proper accounting records. However, this information was established from existing records:

Assets and liabilities:	**31 Dec. 20x8**		**31 Dec. 20x9**	
Non-current assets	20 000	00	20 000	00
Accounts receivable	5 000	00	15 000	00
Accounts payable	15 000	00	9 000	00
Water and electricity (accrued expenses)	0	00	3 000	00
Bank	15 000	00	15 000	00
Cash	2 000	00	1 000	00
Inventory	20 000	00	10 000	00
Long-term borrowings	30 000	00	30 000	00

- *Bank Statement*:
  - Suppliers were paid R12 000 by cheque during the year.
  - Received from receivables and banked R25 000. The owner also informs you that one receivable paid him R5 000 cash.
- *Expenses paid during the year*:

	Amount		**Payment method**
Water and electricity	4 000	00	Cheque
General expenses	9 000	00	Cheque
Water and electricity	1 000	00	Cash
Drawings	5 000	00	Cash

You are required to:

1. Prepare these general ledger accounts:
   - Accounts payable.
   - Water and electricity.
   - Accounts receivable.
   - Bank and cash in columnar form.
2. Prepare a statement of profit or loss & other comprehensive income and a statement of financial position for the year ended 31 December 20*x*9.

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1 *General ledger accounts and cash book*

General Ledger of Chris Supplies
Real Accounts Section

Dr. **ACCOUNTS RECEIVABLE** **B7** Cr.

Dec.	1	Balance	b/d	5 000	00	Dec.	31	Bank (25 000 + 5 000)	CRJ	30 000	00
	31	Sales	ARJ	**40 000**	**00**			Balance	c/d	15 000	00
				45 000	00					45 000	00
Jan.	1	Balance	b/d	15 000	00						

ACCOUNTS PAYABLE **B8**

Dec.	31	Bank	CPJ	12 000	00	Dec.	1	Balance	b/d	15 000	00
		Balance	c/d	9 000	00		31	Purchases	APJ	**6 000**	**00**
				21 000	00					21 000	00
						Jan.	1	Balance	b/d	9 000	00

Nominal Accounts Section

WATER AND ELECTRICITY **N11**

Dec.	31	Bank (4 000 + 1 000)	CPJ	5 000	00	Dec.	31	Profit and loss account	GJ	**8 000**	**00**
		Accrued expenses	GJ	3 000	00						
				8 000	00					8 000	00

Chris Supplies
CASH BOOK

Dr. **CB** Cr.

				Bank		Cash						Bank		Cash	
Jan.	1	Balance	b/d	15 000	00	2 000	00	Dec.	31	Acc. payable		12 000	00		
Dec.	31	Accounts receivable		25 000	00	5 000	00			Water and electricity		4 000	00	1 000	00
										General expenses		9 000	00		
										Drawings				5 000	00
										Balance	c/d	15 000	00	1 000	00
				40 000	00	7 000	00					40 000	00	7 000	00
Jan.	1	Balance	b/d	15 000	00	1 000	00								

2 *Statement of profit or loss & other comprehensive income*

Chris Supplies
ABRIDGED SOPOL & OCI FOR THE YEAR ENDED 31 DECEMBER 20*x*9

	Notes	20*x*9	
Sales (credit)		40 000	00
Cost of sales		(16 000	00)
Opening inventory		20 000	00
Add: Purchases		6 000	00
		26 000	00
Less: Closing inventory		(10 000	00)
Gross profit		24 000	00
Operating expenses		(17 000	00)
Water and electricity		8 000	00
General expenses		9 000	00
NET PROFIT FOR THE YEAR		7 000	00

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2 *Statement of financial position*

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x9

	Notes	20x9	
ASSETS			
Non-current assets		20 000	00
Property, plant and equipment		20 000	00
Current assets		41 000	00
Inventories		10 000	00
Accounts receivable		15 000	00
Cash and cash equivalents (15 000 + 1 000)		16 000	00
TOTAL ASSETS		61 000	00
EQUITY AND LIABILITIES			
Owner's equity and reserves		19 000	00
Capital *		17 000	00
Add: Net profit		7 000	00
Less: Drawings		(5 000	00)
Non-current liabilities		30 000	00
Long-term borrowings		30 000	00
Current liabilities		12 000	00
Accounts payable (9 000 + 3 000)		12 000	00
TOTAL EQUITY AND LIABILITIES		61 000	00

Calculations

Property, plant and equipment	20 000	00
Accounts receivable	5 000	00
Bank	15 000	00
Cash	2 000	00
Inventory	20 000	00
Accounts payable	(15 000	00)
Long-term liability	(30 000	00)
CAPITAL AMOUNT FOR STATEMENT OF FINANCIAL POSITION*	17 000	00

You should be able to complete Questions 22.18 and 22.19.

9 Chapter illustrative example

These draft financial statements for Big Blue Skydiving Club were presented to you by the club secretary. He asks that you review the statements for errors and omissions.

Big Blue Skydiving Club
STATEMENT OF INCOME & EXPENDITURE FOR THE YEAR ENDED 31 MARCH 20x8

	Notes	20x8	
Income		8 400	00
Interest on fixed deposit		1 800	00
Membership subscription fees		5 600	00
Bar profit		1 000	00
Expenditure		(7 000	00)
Administration expenses		4 260	00
Coupon discount		440	00
Parachute maintenance		2 300	00
SURPLUS OF INCOME OVER EXPENDITURE		1 400	00

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Big Blue Skydiving Club
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20x8

	20x7		20x8			20x7		20x8	
Premises	10 000	00	10 000	00	Accumulated fund	40 000	00	43 500	00
Non-current assets	24 000	00	24 000	00	Glen PM fund	15 000	00	15 000	00
Investments	15 000	00	17 000	00	Accounts payable, accruals and prepayments	8 320	00	8 600	00
Bar inventory	6 200	00	8 000	00					
Accounts receivables, accruals and prepayments	3 640	00	2 800	00					
Bank	4 480	00	5 300	00					
	63 320	00	67 100	00		63 320	00	67 100	00

After careful reading of the existing records, you establish that:

1. The calculations made by the secretary are accurate, but incorrect classifications and omissions have resulted in a correct bar profit but an incorrect surplus being reflected.
2. Bar sales are transacted only by means of coupons, which are sold at a discount of 4% and have an unlimited lifespan.
   - The bar operates on a strict profit margin of 10% on turnover.
   - Unredeemed coupons on 31 March 20x7 of R672 were included with accounts payable.
3. Included in 'investments' is an amount of R2 000 received as a legacy on 1 April 20x7 and invested in 5% post office bonds. The policy of the club is to capitalise all legacies and income from legacy investments.
4. The Glen PM fund was established in 19x5 from a donation by the first chairman, Richard Glen.
   - The terms of the donation were that all proceeds must be used exclusively for parachute maintenance, while the capital sum is to remain intact in perpetuity.
   - The funds were invested in 12% fixed deposit and interest paid annually in arrears on 31 March.
5. The club register revealed that there were 204 registered members on 1 April 20x8 (196 members on 31 March 20x7). During the present financial year 16 members resigned membership.

   These are the membership terms and subscription fees:
   - Entrance fee (to be capitalised in terms of the constitution), R50.
   - Membership subscription fees per member (for a year or part thereof), R20.
   - Membership subscription fees prepaid this year amount to R140 (20x7: R120), while those in arrears amounted to R260 (20x7: R200). These amounts are included in accounts payable and accounts receivables respectively.
6. The only omission was depreciation of tangible assets.
   - The club's policy is to depreciate non-current assets at 8% per annum on the reducing balance.
   - Premises are not depreciated.
   - There were no purchases or disposals of tangible assets during the year.

You are required to:

Prepare these accounts correctly with all related prepaid amounts or accruals if applicable:

- Bar trading.
- Subscriptions.
- Coupons.
- Glen PM fund.
- Accumulated fund.
- Income and expenditure.

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General Ledger of Big Blue Skydiving Club
Real Accounts Section

Dr. **ACCUMULATED FUND** **B1** Cr.

Mar.	31	Income and expenditure(deficit)	GJ	1 720	00	Mar.	1	Balance	b/d	40 000	00
		Balance (balancing figure)	c/d	41 580	00		31	Interest accrued (5% × R2 000)	GJ	100	00
								Legacy	GJ	2 000	00
								Entrance fees (24 × R50)	GJ	1 200	00
				43 400	00					43 400	00
						Apr.	1	Balance	b/d	41 580	00

GLEN PM FUND **B4**

Mar.	31	Parachute maintenance	GJ	1 800	00	Mar.	1	Balance	b/d	15 000	00
		Balance (balancing figure)	c/d	15 000	00			Bank (12% × R15 000)	GJ	1 800	00
				16 800	00					16 800	00
						Apr.	1	Balance	b/d	15 000	00

COUPONS **B5**

Mar.	31	Bar sales	GJ	10 000	00	Mar.	1	Balance	b/d	672	00
		Balance	c/d	1 672	00			Coupon discount	GJ	440	00
		(balancing figure)						Bank *	GJ	10 560	00
				11 672	00					11 672	00
						Apr.	1	Balance	b/d	1 672	00

* Bank = R[440 (coupon discount) × (100 ÷ 4) – 440] = R10 560

Nominal Accounts Section

MEMBERSHIP SUBSCRIPTION FEES **N1**

Mar.	1	Balance (arrears)	b/d	200	00	Mar.	1	Balance (prepaid)	b/d	120	00
	31	Income and expenditure (220 × R20)	GJ	4 400	00		31	Bank (balancing figure)	CB	4 360	00
		Balance (prepaid)	c/d	140	00			Balance (arrears)	c/d	260	00
				4 740	00					4 740	00
Apr.	1	Balance (arrears)	b/d	260	00	Apr.	1	Balance (prepaid)	b/d	140	00

BAR TRADING ACCOUNT **N3**

Mar.	31	Bar inventory	GJ	6 200	00	Mar.	31	Bar inventory	GJ	8 000	00
		Bar purchases (balancing figure)	GJ	10 800	00			Bar sales *	GJ	10 000	00
		Income and expenditure (bar profit)	GJ	1 000	00			* (R1 000 ÷ 10 × 100)			
				18 000	00					18 000	00

Final Accounts Section

INCOME AND EXPENDITURE ACCOUNT **F1**

Mar.	31	Administration expenses	GJ	4 260	00	Mar.	31	Membership subscription fees	GJ	4 400	00
		Coupon discount	GJ	440	00			Bar profit	GJ	1 000	00

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		Parachute maintenance	GJ	* 500	00			Accumulated fund (deficit)	GJ	1 720	00
		Depreciation	GJ	** 1 920	00						
				7 120	00					7 120	00

* Parachute maintenance = R(2 300 – 1 800) = R500
** Depreciation = 8% × R24 000 = R1 920

Explanation

- This is a complex example that should be worked through using the concepts outlined.
- **Note:** In the parachute maintenance account an amount of R2 300 was spent, which is in excess of the R1 800 generated by the fund investment. The R500 balance must, therefore, be written off to the income and expenditure account.

You should be able to complete Questions 22.13, and 22.15 to 22.17.

10 Summary

Organisations such as clubs, societies and charities operate on the basis of a contribution that usually does not include the making of profit as an aim. In addition, there are no claims against the organisation by the individual members.

The accumulated wealth of the organisation is usually designated to another organisation in the event of dissolution. As a result, the terminology relating to such organisations is different in some respect to that of profit-making entities. There are also some differences in accounting procedures. A business is sometimes in a position where it only has some of the source documents or accounting records. This may be caused by:

- Records that have been stolen.
- Records that have been destroyed by natural causes, for example a fire at the premises.
- Records that have been destroyed by employees responsible for fraud.
- Insufficient knowledge of owners of small enterprises.

The extent to which financial statements can be prepared from incomplete records depends on the amount of information that can be obtained from the business.

Most of the missing information that is not provided can be found in whatever details are supplied or found in the records. This is best done by opening the account for the specific item and recording the information supplied. The 'balancing figure' would then represent the missing figure.

QUESTIONS

Question 22.1

Define these terms:

1 Non-profit organisation. **2** Accumulated fund. **3** Surplus.
4 Receipts and payments account. **5** Statement of income and expenditure.

Question 22.2

Explain the difference between an income and expenditure account and a receipts and payments account.

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Question 22.3

Under what conditions is it appropriate to capitalise income rather than disclose it in the statement of income and expenditure?

Question 22.4

What is the purpose of special fund accounts?

Question 22.5

This a summary of the transactions of the Keepfit Recreation Club for 20*x*1:

1. The bank statement on 1 January 20*x*1 showed a credit balance of R207.
2. Eighteen new members joined the club during 20*x*1 and paid an entrance fee of R12.
3. The annual subscription was R18. During 20*x*1, 94 members paid their 20*x*1 membership subscription fees, while six members were in arrears with their membership subscription fees for 20*x*1.
   Eight members paid their membership subscription fees for 20*x*2 in advance and five members, who had not paid their membership subscription fees for 20*x*0, paid these during 20*x*1.
4. Maintenance of tennis courts and squash courts paid R362.
5. A cleaner received a monthly payment of R171.
6. Refreshments purchased, R138.40.
7. Sale of refreshments amounted to R196.20
8. Tennis balls bought, R184.
9. Sales of old tennis balls, R16.80.
10. Donations to charity, R40.
11. Proceeds from social functions, R630.
12. Expenses in connection with annual dance, R403.40
13. Honorarium paid to secretary/treasurer, R80.
14. Crockery bought, R36.

Note: All payments were made by cheque.

You are required to:
Prepare the receipts and payments account for the year ended 31 December 20*x*1.

Question 22.6

These balances and totals are from the books of Fit Health Club as at 31 December 20*x*6:

Membership subscription fees received for year 20*x*5	2 200	00
Membership subscription fees received for year 20*x*6	24 000	00
Membership subscription fees received for year 20*x*7	1 200	00
Sales – fruit juices	3 650	00
Sports equipment purchased during year	24 600	00
Sports equipment sold at book value (original cost R2 000 – depreciation R1 500)	500	00
Purchases of fruit juices	1 650	00
Salaries and wages	6 600	00
Assessment rates	900	00
Depreciation of sports equipment for the year 20*x*6	12 800	00
Insurance	490	00

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Accumulated funds as at 1 January 20*x*6	72 180	00
Entrance fees received	4 800	00
Land and buildings at cost	37 300	00
Sports equipment at cost – 1 January 20*x*6	60 420	00
Accumulated depreciation – sports equipment 1 January 20*x*6	30 420	00
Membership subscription fees outstanding – 31 December 20*x*6	1 700	00
Bank balance – 1 January 20*x*6	2 680	00

Additional information:

- Salary bonus of R400 is to be provided.
- R150 of assessment rates is for the 20*x*7 calendar year.
- Entrance fees are credited to the accumulated fund.

You are required to:
Prepare the receipts and payments account for the year ended 31 December 20*x*6.

Question 22.7

This information appeared in the books of Seaview Rugby Club:

Seaview Rugby Club
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*2

Liabilities			***Assets***		
Membership subscription fees prepaid	33	00	Cash in bank	227	00
Accounts payable	173	00	Membership subscription fees in arrears	39	00
Accumulated fund	278	00	Sports equipment	218	00
	484	00		484	00

These transactions took place between 1 July 20x2 and 30 June 20x3:

1. Total membership subscription fees received from existing members up to 30 June 20*x*3 came to R150.
   This amount included R30 that was in arrears on 30 June 20*x*2, as well as the membership subscription fees of eight members who had paid R3 each for the year 1 July 20*x*3 to 30 June 20*x*4.
2. Nine members failed to pay their membership subscription fees of R3 each for the current year.

You are required to:
Prepare the membership subscription fees account, clearly showing the amount to be taken to the income and expenditure account.

Question 22.8

This information is for the NWP Country Club for the year ended 31 December 20*x*3:

1. The club had 36 members during 20*x*2 of whom only 31 members paid their membership subscription fees for 20*x*2, while two members also paid their 20*x*3 fees.
2. Four new members joined on 1 January 20*x*3.
3. The club increased its membership subscription fees by R5 per annum for the previous three years and will continue to do so in the future. Membership subscription fees for 20*x*3 was R40 per annum

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4 R1 555 was received for membership subscription fees during 20*x*3 (and included the balance of the outstanding 20*x*2 fees), as well as for two members who paid for 20*x*4.
5 Two members (whose fees were outstanding on 31 December 20*x*2 (see Note 1 above), disappeared and the membership subscription fees due by them had to be written off.

You are required to:
1 Prepare the membership subscription fees account in the ledger of the club.
2 Show how the R1 555 received was determined.
3 Calculate the number of members who did not pay their 20*x*3 fees.

Question 22.9

A treasurer of a tennis club has prepared this draft statement of receipts and payments.

The club committee, however, wants the financial statements for 20*x*3 (and subsequent years) to be in the form of an income and expenditure account and a statement of financial position. They have asked you to fix the 20*x*3 financial statements.

The Local Tennis Club
STATEMENT OF RECEIPTS AND PAYMENTS FOR THE YEAR ENDED 31 DECEMBER 20*x*3

Opening balances			3 260	00
Cash on hand: 1 January 20*x*3	100	00		
Cash in bank: 1 January 20*x*3				
Current account	1 160	00		
Deposit account	2 000	00		
Add: **Receipts**			9 680	00
Membership subscription fees:				
20*x*2	620	00		
20*x*3	8 220	00		
20*x*4	125	00		
Interest on deposit account	85	00		
Entry fees for club championship	210	00		
Tickets sold for annual dinner/dance	420	00		
Less: **Payments**			(16 890	00)
Groundsman's wages	4 000	00		
Purchase of equipment (on 30 June 20*x*3)	8 000	00		
Rent for year up to 30 September 20*x*3	2 000	00		
Rates for year up to 31 March 20*x*4	1 800	00		
Cost of annual dinner/dance	500	00		
Secretarial expenses	400	00		
Prizes for club championship	90	00		
Miscellaneous expenses	100	00		
Less: Cash on hand: 31 December 20*x*3			(50	00)
CLOSING BANK BALANCE: 31 DECEMBER 20*x*3 (OVERDRAFT)			(4 000	00)

Additional information:
1 On 31 December 20*x*3, R700 was outstanding for membership subscription fees for 20*x*3.
2 During 20*x*2, R230 was received for membership subscription fees for 20*x*3.
3 The cost of equipment purchased in previous years was:
– 30 June 19*x*2 R5 000
– 1 January 19*x*7 R1 000
– 30 September 20*x*1 R1 000

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4 The committee decides that equipment should be depreciated at 10% per annum on cost.
5 Rent has been at the rate of R2 000 per annum for the last two years and is not expected to change in the immediate future.
6 Rates of R750 for the six months to 31 March 20*x*3 were paid on 2 November 20*x*2.
7 Interest of R250 on the bank overdraft had accrued at 31 December 20*x*3.
8 Taxation can be ignored.

You are required to:

1 Prepare the income and expenditure account for the year ended 31 December 20*x*3.
2 Prepare a statement of financial position as at 31 December 20*x*2 and 31 December 20*x*3.

Question 22.10

These balances were taken from the books of the Welkom Squash Club at 28 February 20*x*8:

ASSETS			LIABILITIES		
Cash at bank	84	00	Loan: H. Steyn	1 600	00
Accounts receivable (membership subscription fees due)	90	00	Accounts payable	26	00
Inventory on hand:			Accumulated fund	390	00
Stationery	14	00			
Squash balls	60	00			
Furniture and equipment	248	00			
Fixed property	1 520	00			
	2 016	00		2 016	00

This a summary of the club's cash transactions for the year ended 28 February 20*x*9:

RECEIPTS			PAYMENTS		
Balance b/d	84	00	Accounts payable	13	00
Entrance fees (new members)	14	00	Loan: H. Steyn	200	00
Accounts receivable (membership subscription fees due 28 February 20*x*8)	30	00	Interest on loan	27	00
			Upkeep of fixed property	65	00
			Purchases		
Membership subscription fees	355	00	Furniture and equipment	38	00
Donations received	147	00	Stationery	9	00
Municipal grant	100	00	Squash balls	150	00
Net proceeds of annual function	159	00	Wages	144	00
			Water and electricity	67	00
			Sundry expenses	14	00
			Honorarium to secretary	50	00
			Balance c/d	112	00
	889	00		889	00

Adjustments:

1 Inventory on hand:
  – Stationery R8
  – Squash balls R21
2 R60 of the subscription membership fees due on 28 February 20*x*8 must be written off as irrecoverable.
3 Membership subscription fees still due on 28 February 20*x*9, R35.
4 Membership subscription fees prepaid on 28 February 20*x*9, R15.

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5 Depreciation on furniture and equipment amounted to R250.
6 The fixed property should be depreciated by 2.5%.
7 Interest on loan due amounts to R9.
8 An account of R7 for water and electricity for February 20*x*9 has not been paid.

You are required to:
1 Prepare a statement of income and expenditure for the year ended 28 February 20*x*9.
2 Prepare a statement of financial position as at 28 February 20*x*9.

Question 22.11

Below is the receipts and payments account of the Reygersdal Soccer Club for the period 1 July 20*x*6 to 30 June 20*x*7, and their statement of financial position as at 30 June 20*x*6:

Nominal Accounts Section
RECEIPTS AND PAYMENTS **N**

Dr.											Cr.
20x6 Jul.	1	Total	b/d	200	00	20x6 Jun.	30	Soccer equipment	GJ	230	00
20x7 Jun.	30	Membership subscription fees and entrance fees	GJ	1 200	00			Additions to pavilion	GJ	1 000	00
		Gate collections	GJ	300	00			Grounds equipment	GJ	150	00
		Donations received	GJ	50	00			Stationery	GJ	90	00
								General expenses	GJ	160	00
								Total	c/d	120	00
				1 750	00					1 750	00

Reygersdal Soccer Club
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*6

Soccer equipment	1 000	00	Accumulated fund		
Grounds equipment	1 000	00	Balance as at 1 July 20x5	4 050	00
Pavilion at cost	750	00	*Add*: Entrance fees	150	00
Property	1 500	00	Surplus	200	00
Accounts receivable (membership subscription fees)	50	00		4 400	00
Cash	200	00	Accounts payable	100	00
	4 500	00		4 500	00

Additional information:

1 The accounts payable as at 30 June 20*x*6 were:

20x7 membership subscription fees in advance	20	00
Soccer equipment	40	00
Grounds equipment	30	00
General expenses	10	00
	100	00

2 The accounts payable as at 30 June 20*x*7 were:

Addition to pavilion	300	00
Soccer equipment	50	00
Grounds equipment	10	00

In addition, certain membership subscription fees had been paid in advance.

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3 An examination of the membership list revealed:

Annual membership subscription fee	10	00
Entrance fee	10	00

Paid up members at 30 June 20*x*6	95
New members during year	20
Resignations during year, before paying subscription	15
Members who paid up arrears at 30 June 20*x*6	3
Members written off as bad debts	2
Members with membership subscription fees in arrears at 30 June 20*x*7	6

4 The members wish soccer and ground equipment to remain at a nominal value of R1 000 each on the statement of financial position.

5 Included in the sundry trade receivables as at 30 June 20*x*7 is an amount of R20 owing by a member for old soccer balls he bought from the club.

You are required to:
Prepare a statement of income and expenditure and a statement of financial position for the year ended 30 June 20*x*7.

Question 22.12

On 1 January 20*x*4, these balances appeared in the records of EWR Rugby Club:

LIABILITIES			ASSETS		
			Membership subscription fees in arrears	42	00
Membership subscription fees received in advance (20*x*4)	28	00	Prepaid expenses	28	00
Bar payables	590	00	Buildings	6 300	00
Accrued expenses	80	00	Inventory: Liquor	106	00
Accumulated funds	6 694	00	Glassware	316	00
			Sports equipment	400	00
			Bank	200	00
	7 392	00		7 392	00

Here are the receipts and payments for the year ended 31 December 20*x*4:

RECEIPTS			PAYMENTS		
Gate money received	1 600	00	Barman's wages	800	00
Bar sales	3 756	00	Repairs to buildings	300	00
Entrance fees	86	00	Bar payables	3 266	00
Membership subscription fees:			Salary and wages	1 024	00
20*x*3	22	00	Glassware bought	122	00
20*x*4	1 570	00	Sports equipment	300	00
20*x*5	28	00	Investment: 4% debentures	1 000	00
			Maintenance of grounds	246	00
			Stationery	32	00

Adjustments and other information:

1 On 31 December 20*x*4, the amount owed to bar payables amounted to R326.

2 The accrued expenses on 1 January 20*x*4 was for salaries, while the prepaid expenses on 1 January 20*x*4 was for stationery on hand.

3 On 1 January 20*x*5, the secretary's salary (R80) for December 20*x*4 was paid.

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4 On 31 December 20*x*4:
- The inventory of alcohol was valued at R600 and glassware at R390.
- The value of stationery on hand amounted to R60, and accounts for stationery (R100) and insurance (R20) were still outstanding.

5 Depreciation on sports equipment amounted to R228.

6 Membership subscription fees in arrears at 31 December 20*x*4 amounted to R68. The balance of the membership subscription fees in arrears for 20*x*3 are irrecoverable.

7 The debentures were bought by the club on 1 July 20*x*4.

8 Entrance fees must be capitalised.

You are required to:
Prepare a bar trading account, an income and expenditure account, and a statement of financial position for the year ended 31 December 20*x*4.

Question 22.13

Below are the financial statements of Melkbos Tennis Club:

Melkbos Tennis Club
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*4

	Notes	20*x*4	
ASSETS			
Non-current assets		99 000	00
Property, plant and equipment			
Club buildings (*at cost*)		75 000	00
Furniture (cost 15 000 – accumulated depreciation 5 000)		10 000	00
Tennis equipment (cost 10 000 – accumulated depreciation 6 000)		4 000	00
Investment: Paarl District Bank: Kevin Curren fund (12%)		10 000	00
Current assets		7 745	00
Bar inventory		7 550	00
Accrued income: membership subscription fees		120	00
Prepaid current liabilities		75	00
TOTAL ASSETS		106 745	00
EQUITY AND LIABILITIES			
Owner's Equity and reserves		86 830	00
Capital (1 January 20*x*4)		66 130	00
Add: Surplus		9 800	00
Add: Entrance fees		400	00
Other funds			
Kevin Curren fund: Capital		10 000	00
Income		500	00
Non-current liabilities		15 000	00
Long-term borrowings: Paarl District Bank (20%)		15 000	00
Current liabilities		4 915	00
Bar payables		3 500	00
Income received in advance: membership subscription fees		90	00
Accrued expenses: telephone		25	00
Bank overdraft		1 300	00
TOTAL EQUITY AND LIABILITIES		106 745	00

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Listed below are the receipts and payments for the year ended 31 December 20*x*5:

RECEIPTS			PAYMENTS		
Membership: 20*x*4	80	00	Water and electricity	160	00
20*x*5	2 400	00	Bar payables	6 800	00
20*x*6	60	00	Insurance	150	00
Entrance fees	50	00	Training course	1 500	00
Municipal donations	5 600	00	Telephone	100	00
Bar sales	1 500	00	Tennis equipment	5 000	00
Interest received: Current funds	1 200	00	Long-term loan	2 000	00
			Interest paid	2 000	00
			Wages: Barman	1 100	00
			Supervisor	600	00

Adjustments and other information:

1 On 31 December 20*x*5, bar inventory amounted to R4 800.
2 On 30 April 20*x*5, insurance was paid for the year.
3 The club has 250 members and membership subscription fees are R10 per person per year. Accrued membership subscription fee for 20*x*4 must be treated as irrecoverable.
4 Tennis equipment was bought on 1 July 20*x*5 and depreciation is at 20% per annum on cost.
5 The furniture was bought on 1 January 20*x*4 and is depreciated over the useful life of three years using the straight-line method.
6 On 30 June 20*x*5, a payment of R2 000 was made towards the long-term loan.
7 The income from the current fund was used to finance the training course.
8 The barman earns a salary of R100 per month.
9 Accounts payable as at 31 December 20*x*5:
   – Bar payables R2 200
   – Telephone R15

You are required to:

1 Prepare a bar trading account for the year ended 31 December 20*x*5.
2 Prepare an income and expenditure account for the year ended 31 December 20*x*5.
3 Prepare a statement of financial position as at 31 December 20*x*5.

Question 22.14

On 1 January 20*x*3, these balances appeared in the books of the Stayfit Club:

Inventory: Refreshments	120	00
Stationery	30	00
Bank (*Dr.*)	147	00
Accounts payables	50	00
Equipment (book value)	4 000	00
Membership subscription fees owing	53	00
Loan from B Samson	600	00
Accumulated fund	3 700	00

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Listed below are the receipts and payments for the year ended 31 December 20*x*3:

RECEIPTS			PAYMENTS		
Membership: 20*x*2	41	00	Accounts payables	50	00
20*x*3	1 375	00	Stationery bought	36	00
20*x*4	30	00	Honorarium to secretary	200	00
Sales of refreshments	836	00	Salaries	480	00
Entrance fees	92	00	Purchases: Refreshment	356	00
Donations received	160	00	Crockery	160	00
			Donations	48	00
			Water and electricity	210	00
			Repairs	31	00
			Loan: B. Samson (paid 1 July 20*x*3)	400	00
			Equipment bought (1 October 20*x*3)	120	00

Additional information:

1 Entrance fees are to be posted to accumulated fund accounts.

2 Donations received may be used to cover running expenses.

- Inventory on hand, 31 December 20*x*3:
  - Stationery R14
  - Refreshments R40
- Crockery is valued at R150 on 31 December 20*x*3.
- Equipment is to be depreciated by 20% per annum using the straight-line method.
- Unpaid membership subscription fees for 20*x*2 is to be written off as irrecoverable.
- Membership subscription fees in arrears for 20*x*3 amounted to R45.
- Interest on the loan from B. Samson is payable at 12% per annum.

You are required to:

1 Prepare a refreshments trading account and an income and expenditure account of the Stayfit Club for the year ended 31 December 20*x*3.

2 Prepare a statement of financial position as at 31 December 20*x*3.

Question 22.15

To facilitate payments for drinks and to reduce the risks of misappropriation of cash by waiters, the Wonderboom Walkers Club sells books of coupons to members at a discount of 5% of their face value.

Each book contains coupons of varying denominations with a total face value of R2. Books of coupons are in the custody of, and are sold by, the club secretary who perforates the year of issue on each book sold.

In terms of the club's rules, the coupons are valid only in the financial year of issue and in the financial year immediately following.

These transactions relate to coupons during the years up to 31 *December* 20*x*3:

Coupons issued to members	No. of R2 books	Value	Discount	Cash received
20*x*1	3 300	R6 600	R330	R6 270
20*x*2	5 200	R10 400	R520	R9 880
20*x*3	4 800	R9 600	R480	R9 120

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Value of coupons surrendered by members for drinks:

Coupons marked	20*x*1	20*x*2	20*x*3
20*x*1	R5 165	0	0
20*x*2	R1 230	R9 380	0
20*x*3	0	R750	R8 450

You are required to:

1 Record all entries (including closing entries) relating to coupons in the general journal of the Wonderboom Walkers Club for the years ending 31 December 20*x*1, 20*x*2 and 20*x*3.

2 Post the journal entries to the ledger accounts and balance the real accounts at the end of each year.

Question 22.16

Listed below are the financial statements of Swingles (a social club) for the year ended 30 June 20*x*3:

Swingles
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*3

	20*x*2		20*x*3			20*x*2		20*x*3	
Assets					***Equity & Liabilities***				
Furniture at carrying value	15 200	00	14 400	00	Accumulated funds	15 000	00	24 780	00
Crockery	1 800	00	2 400	00	Opening balance	9 000	00	15 000	00
Bar inventory	3 200	00	5 800	00	Entrance fees	640	00	580	00
Bar receivables	9 200	00	3 700	00	Surplus for the year	5 360	00	9 200	00
Fixed deposit	0	00	10 000	00	12% loan	20 000	00	15 000	00
Membership subscription fees owing	200	00	300	00	Bar payables	1 800	00	2 200	00
Rent prepaid	480	00	0	00	Unredeemed coupons	1 600	00	1 300	00
Bank	8 400	00	7 280	00	Rent accrued	0	00	480	00
					Membership subscription fees prepaid	80	00	120	00
	38 480	00	43 880	00		38 480	00	43 880	00

Swingles
STATEMENT OF INCOME & EXPENDITURE FOR THE YEAR ENDED 30 JUNE 20*x*3

	Notes	20*x*8	
Income		65 600	00
Bar sales		95 000	00
Less: Bar cost of sales		(46 000	00)
Discount from bar payables		2 400	00
Forfeited coupons		200	00
Membership subscription fees		14 000	00
Expenditure		(56 600	00)
Administrative expenses		47 390	00
Rent		5 760	00
Interest		2 100	00
Membership subscription fees written off		150	00
Depreciation on furniture		800	00
Depreciation on crockery		200	00
SURPLUS OF INCOME OVER EXPENDITURE		9 200	00

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Additional information:

1. The bar operates on a coupon and credit basis.
2. Coupons not used within one year of purchase become invalid and may not be returned for refund.
3. Coupons with a face value of R14 000 were surrendered at the bar during the current year, and credit sales totalled R24 000.

You are required to:
Prepare the statement of receipts and payments for the year ended 30 June 20*x*3.

Question 22.17

Fancy Free Social Club was established with the main aim of promoting jogging, cycling and indoor exercise. Their cash flow for the year ended 31 May 20*x*2 is summarised below:

RECEIPTS

Accounts receivable, membership subscription fees, coupon sales	14 000	00
Entrance fees	210	00
Sales of jogging treadmill	2 140	00

PAYMENTS

Bar supplies	3 000	00
Restaurant suppliers	6 500	00
Purchase of gymnastic equipment	3 000	00
Administrative expenses	3 050	00

Their assets and liabilities on 1 June 20*x*1 were:

Indoor equipment (net)	6 000	00
Bar inventory	600	00
Restaurant inventory	1 000	00
Bank	1 200	00
Accounts receivable (restaurant sales)	2 800	00
Accounts payable (restaurant purchases)	2 000	00
Accounts payable (bar purchases)	500	00
Coupons	800	00

On further investigation, the following is established:

1. Payment by cash or cheque is not permitted in either the bar or the restaurant.
   - Bar sales are strictly in exchange for coupons.
   - Restaurant sales are charged to the members' accounts.
2. No cash purchases are made. Discounts of R500 had been deducted from payments made to restaurant suppliers during the year.
3. An uninsured loss on bar inventory stolen during the year amounted to R700.
4. Inventory on hand as counted on 31 May 20*x*2 was as follows:
   - Bar R800
   - Restaurant R2 000
   - Bar inventory that cost R600 was in transit.
5. Coupons are sold in books of R20 each at a discount of 10% and are valid only in the financial year in which they are sold and in the year immediately following.
   - The club maintains a 20% mark-up on selling price on all bar sales.
   - On 31 May 20*x*2, coupons totalling R1 400 (including R1 200 for coupons issued during the current financial year) were in the hands of members.

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6 The jogging treadmill was sold on 31 November 20*x*1 for an amount that was R340 in excess of its book value at 31 May 20*x*1.
   - The gymnastic equipment was purchased on 1 December 20*x*1.
   - All equipment is depreciated at a rate of 20% per annum using the diminishing balance method.

7 The club had 146 members at 1 June 20*x*1.
   - The annual subscription is R10 per member, and each new member pays an additional entrance fee of R15.
   - All membership subscription fees had been received by 31 May 20*x*2 and three members had also paid their membership subscription fees up to 31 May 20*x*3.

8 These balances are known at 31 May 20*x*2:

Accounts receivable (restaurant sales)	2 945
Accounts payable (restaurant purchases)	2 000
Accounts payable (bar purchases, excluding the amount for inventory in transit)	1 400
Accounts payable (restaurant purchase)	800
Wages accrued	50
Insurance prepaid	240

You are required to:

1 Prepare a trading statement for the year ended 31 May 20*x*2.

2 Prepare a statement of income and expenditure for the year ended 31 May 20*x*2.

3 Prepare a post-closing trial balance as at 31 May 20*x*2.

Question 22.18

Arnold Traders, a sole proprietor, did not keep proper accounting records. Mr Arnold furnished you with this information relating to Arnold Traders that he extracted from his note book:

Assets and liabilities	**30/06/20*x*2**		**30/06/20*x*3**	
Delivery vehicle – carrying value	20 000	00	?	
Shop equipment – carrying value	30 000	00	?	
Accounts receivable	10 000	00	10 000	00
Accounts payable	70 000	00	20 000	00
Bank	20 000	00	10 000	00
Cash	15 000	00	30 000	00
Inventory	30 000	00	20 000	00
Accumulated profit	10 000	00	?	

Summary of bank payments and receipts

Delivery vehicle purchased on 1 July 20*x*2	30 000	00
Shop equipment purchased on 1 July 20*x*2	20 000	00
Cash sales deposits for the year	40 000	00
Purchase of inventory	20 000	00
Payment of accounts payable	50 000	00
Receipts for accounts receivable	70 000	00

Summary of cash expenses

Vehicle expenses	5 000	00
Purchase of goods for sale	10 000	00

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Additional information:

1 Mr Arnold paid most major items of expenditure by cheque. Certain other items were paid out of cash takings and the balance of the cash receipts was banked every week.
2 Depreciation must be provided for at 20% per annum on the reducing balance method for the delivery vehicle and shop equipment.
3 On 1 July 20*x*0, the delivery vehicle and shop equipment (shown on 30 June 20*x*2) were bought.

You are required to:

1 Prepare the statement of profit or loss & other comprehensive income of Arnold Traders for the year ended 30 June 20*x*3.
2 Prepare the statement of financial position as at 30 June 20*x*3.

Question 22.19

You are the newly appointed accountant of Inner-City (a sole proprietor) and you have received this letter from your client:

Inner-City
PO Box 5000
Florida
1710

01 February 20x3

Dear Accountant

I was pleased when you agreed to act as my accountant. I would like to indicate that I accept the proposed fee of R15 000 per annum. I regret to inform you that the paper work done during the year is incomplete.

I started my construction business on 1 January last year, and deposited R70 000 into a business bank account on that date. I brought my van, with a value of R30 000, into the firm at that time. I think it will last another three years after the end of the first year of business use.

I was lucky enough, from the start of the business, to have Miss Zwane as my administration clerk. She is paid a salary of R15 000 per annum.

Analysis of the invoices and delivery notes revealed the following:

- *The materials bought cost me R50 000, but there was unused material of R1 000 on 31 December. I have not yet paid for all of the material. I think that I still owed R2 000 to the suppliers on 31 December.*
- *I was perplexed to note that I've made an unintentionally excessive investment on non-working capital. I spent R50 000 on construction equipment that, in my opinion, will last me for four years or so.*
- *Electricity invoices received up to 30 September came to R10 000, but general expenses and motor expenses were R2 000 and R4 000, respectively, for the whole year.*
- *The insurance premium was R15 000 for the year to 31 March.*
- *My administration clerk must have lost invoices for rent as these were not found in the invoice box and were, therefore, not paid. The cost of rent is R500 per month.*

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Miss Zwane sent out invoices to customers for work done, but some of the customers appear to have difficulty in settling their accounts. Although we were able to charge R200 000 to our customers, only R165 000 thereof was collected as at 31 December. I am also of the opinion that 10% of the balance outstanding will not be recovered.

I was able to bank R60 000 of the cash sales with the total value of R100 000, I used R25 000 and R5 000 from this amount for my family holiday trip and for the repair of the building, respectively. The difference was kept in the petty cash box as at 31 December.

I bought the lease of offices, with a remaining period of nine years, for R10 000 with the money that I borrowed from my brother-in-law. An annual rental of R1 000 is payable in advance on the anniversary date of purchase, 31 March. I must pay my brother-in-law interest of 5% per annum on his loan. To the best of my knowledge, I've not yet paid any interest to date. I must pay back the loan at the end of the year.

Yours faithfully

Clement

You are required to:

1 Prepare the statement of profit or loss & other comprehensive Income for Inner-City for the year ended 31 December 20*x*2.

2 Prepare the statement of financial position as at 31 December 20*x*2.

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23 PARTNERSHIPS

Chapter objectives

By the end this chapter, you should be able to:

- Identify the characteristics of the partnership as a business form.
- Identify the issues to be dealt with in the partnership agreement.
- Record the transactions when a partnership is established.
- Record the transactions between the partners and the partnership.
- Calculate and record the profits and losses of the partnership.
- Calculate and record the appropriation of profits and losses of the partnership.
- Prepare the annual financial statements of a partnership.
- Calculate and record changes in the partnership on:
  - withdrawal of a partner
  - admission of a partner
- Calculate changes in profit-sharing ratios.
- Record capital deficiencies on dissolution of a partnership.
- Record a piecemeal dissolution.

Chapter outline

1	INTRODUCTION	23 – 2
2	CHARACTERISTICS OF A PARTNERSHIP	23 – 2
3	ACCOUNTING PROCEDURES	23 – 3
	Establishment of a partnership	23 – 3
	Transactions during the year	23 – 4
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4	CHANGES IN PARTNERSHIP COMPOSITION	23 – 7
	Revalue the assets	23 – 8
	Determine the goodwill	23 – 8
	Record the changes in the general ledger	23 – 8
	Draft the opening statement of financial position of the new partnership	23 – 9
5	SPECIFIC ISSUES IN PARTNERSHIP ACCOUNTING	23 – 18
	Existing partners alter their profit-sharing ratio	23 – 18
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1 Introduction

In the previous chapters, the accounting procedures of sole proprietors and companies have been explained.

By now you should have a thorough grasp of basic accounting recording and reporting principles. This must include an understanding of the double-entry system, the set of accounts and the year-end procedures, which remain common to all business entities.

The main difference between the different types of business entities lies in ownership, that is, the capital contributed and the retention or distribution of profit.

This chapter will explain the accounting recording and reporting on the financial performance and financial position of the partnership as a business entity. The partnership is similar in many respects to the sole proprietor.

This chapter will explore at an introductory level:

- The characteristics of a partnership.
- The accounting procedures for a partnership:
  - When the partnership is established.
  - For transactions during the year.
  - For transactions at the year end.

Transactions to deal with changes in a partnership agreement, such as the occurrence of the admission of a new partner, the retirement of a partner, and the sale or dissolution of the partnership will be explored.

2 Characteristics of a partnership

A partnership is generally defined as:

A legal relationship between two and twenty people where each person contributes something to carry on a lawful business with the aim of making a profit which is to be shared between the partners in a proportion agreed upon by them.

It is advisable that any agreements between the partners be recorded in writing. A written agreement will ensure a common understanding of the terms of the agreement between the partners. The following factors would be considered in such an agreement, which is commonly referred to as a partnership agreement:

- **Contribution of capital.** Just like the sole proprietors, partners in a partnership must also contribute capital to the business. This contribution is usually in the form of money or goods, but can also be skill or expertise.
- **Salaries.** As not all the partners may be employed by the partnership in a full-time capacity, salaries of partners must be agreed to. As a rule, partners' salaries will be part of normal operating expenses and not a distribution of profit.
- **Profit-sharing ratio.** Often profits are shared in proportion to capital contributed. However, this need not be the case but there must be clarity about the sharing of profits and losses.
- **Interest on capital.** Particularly in cases where profits are not shared in proportion to capital contributed, interest on capital may be charged against the partnership to compensate the partners who have the greater capital investment. The interest rate and method of calculation must be stipulated.
- **Interest on drawings.** Like a sole proprietor, partners may from time to time withdraw smaller amounts of money or goods from the partnership. In the interests, of fairness

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there should be a charge attached to the drawings. This will prevent one partner receiving a benefit at the expense of another partner. The rate to be charged on drawings must be specified.

- There are numerous other factors which must be considered and are probably best included in the partnership agreement. They include the rights of partners regarding life policies, pensions, restraints of trade and changes in the partnership structure.

Reminder

Refer to Chapter 1 for a discussion of the differences between a sole proprietor, a partnership, a close corporation and a company.

Refer to Figure 24.1 in Chapter 24 for a summary of the differences between companies, partnerships and close corporations.

It is important to note that, although the partnership creates a legal relationship between the partners, the partnership itself is not a legal entity.

An important characteristic of a partnership is that partners are jointly and severally liable for the debts of the partnership.

- If the assets of the partnership are not enough to pay all its debts, the payables can seek payment from the personal assets of the partners.
- If one partner's personal assets are insufficient to contribute towards his/her share of the partnership's debts, the payables can claim additional assets from the remaining partners.

Since each partner becomes the agent of each of the other partners, each has authority to do all acts incidental to the proper conduct of the business and such acts bind all partners.

A liability incurred by one partner within the partnership binds all the partners as a group as well as individually. Partnerships, thus, require a large measure of trust and confidence between partners to ensure that the business can run smoothly and without acrimony.

You should be able to complete Questions 23.1 and 23.2.

3 Accounting procedures

Most of the routine entries from the monthly transactions of a partnership are identical to that of a sole proprietor. There are, however, a few significant differences. These are discussed under three different headings.

Establishment of a partnership

Each partner (a minimum of two and a maximum of 20) is likely to contribute an amount of capital. A fundamental principle for the accounting treatment is that all aspects of an individual partner's contributions, charges to and charges by the partnership must be accounted for separately.

- In the books of the sole proprietor, two accounts are opened for the owner:
  - Capital account.
  - Drawings account.
- In the books of the partnership, three accounts will be opened for each of the partners:
  - Capital account.
  - Drawings account.
  - Current account.

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Note

To get the maximum benefit from the examples in this chapter, you should post the general journal entries to the general ledger to understand the effect of the transactions.

When working through the examples in the remainder of this chapter, general journal entries will be the main method of explaining the concepts. Although other subsidiary journals may be used when dealing with large volumes of transactions, the general journal will be used for explanatory purposes.

Example 23.1 **Capital contributions by the partners**

On 1 July 20*x*6, Abdullah and Bheki commenced trading as partners under the name Potent Plastics, suppliers and distributors of raw materials to the plastics industry.

Abdullah contributed R30 000. Bheki contributed R15 000, and a vehicle that was agreed to be worth R5 000 as capital. They agreed to share profits in direct proportion to capital contributed.

You are required to:

Record the general journal entries for the establishment of the partnership, Potent Plastics.

GENERAL JOURNAL OF POTENT PLASTICS **GJ1**

Day	Details	Fol.	Debit		Credit	
01/07	Bank	B10	30 000	00		
	Capital: Abdullah	B1			30 000	00
	Capital contribution					
	Bank	B10	15 000	00		
	Vehicles	B7	5 000	00		
	Capital: Bheki	B2			20 000	00
	Capital contribution					

Explanation

- As a result, each partner has a separate capital account. No entries are made in the capital accounts other than the contribution of capital (initial or additional) and the withdrawal of capital.
- All drawings made by the partners are (as in the case of a sole proprietor) debited to a drawings account. Remember that each partner will have an individual drawings account.
- The partners will share profits in the ratio of capital contributed. Abdullah = R30 000 and Bheki = R20 000. Therefore, the ratio will be 30 000 : 20 000.
  - For calculation purposes it is advisable to use the simplest ratio possible, therefore, 3 : 2. (This was derived at after each partner's contribution was divided by 10 000 – the highest common denominator.)
  - Stated differently, Abdullah will receive 60% ($3 \div 5 \times 100$) of the profits and Bheki will receive 40% ($2 \div 5 \times 100$).

Transactions during the year

Once the partnership is established, trading begins. The daily transactions that take place are treated in precisely the same manner as for sole proprietors.

The usual subsidiary journals such as the cash receipts and cash payments journals, accounts receivable and accounts payable journals and general journal will likely be kept. Postings will usually take place at the end of each month to the general ledger and subsidiary accounts receivable and accounts payable ledgers.

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The only new aspect is the transactions which may take place between the individual partners and the partnership. These are recorded in the usual subsidiary journals but posted to a special account which each partner has in the general ledger, called a current account.

Example 23.2

Current accounts and drawings accounts

The partnership agreement of Potent Plastics, which started on 1 July 20*x*6, provided for:

A Abdullah who will manage the partnership will receive a salary allowance of R2 000 per month.

B Interest on drawings is to be charged at 20% per annum.

C Interest on capital will be charged at 15% per annum.

Transactions for the year ended 30 June 20x7:

- On 1 December 20*x*6, Bheki withdrew R3 000 in cash; and goods at a cost of R2 000 on 1 April 20*x*7. This was done on the basis of profits expected at the year end.
- Abdullah drew R1 500 of his salary at the end of each month.

You are required to:
Record the general journal entries for Potent Plastics for the year ended 30 June 20*x*7:

GENERAL JOURNAL OF POTENT PLASTICS **GJ12**

Day	Details	Fol.	Debit		Credit	
01/12	Drawings: Bheki	B4	3 000	00		
	Bank	B10			3 000	00
	Bheki took cash for personal use					
01/04	Drawings: Bheki	B4	2 000	00		
	Inventory	B9			2 000	00
	Bheki took inventory for personal use					
30/06	Salaries	N12	2 000	00		
	Current account: Abdullah	B5			2 000	00
	Abdullah's monthly salary brought into account					
	Current account: Abdullah	B5	1 500	00		
	Bank	B10			1 500	00
	Abdullah drew part of his salary					

Note: The last two entries will be made at the end of every month, from July 20*x*6 to June 20*x*7.

Explanation

- From the above transactions it is evident that the withdrawal of cash by partners can be separated into two classes:
  - In Abdullah's case, he is drawing against money due to him as a result of salary earned. It is, thus, a debit to his current account.
  - In Bheki's case, he is drawing against expected profits. This could be viewed as a small temporary loan, which is entered into a drawings account. In effect he is borrowing money and the charge of interest on drawings, in accordance with the partnership agreement, will be levied against him at the end of the year.
- There is also a third type of withdrawal which was not shown in the example above.
  - This type of withdrawal occurs when a partner intends to reduce their capital contribution. This would need to be specifically stated and the agreement of all other partners would be needed.
  - The entry would then be to debit the capital account of the partner and credit the bank account.

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Example 23.3

Interest on drawings accounts

At the end of the financial year, the 20% per annum interest on drawings for which Bheki is liable is calculated as follows:

R3 000 × 20 ÷ 100 × 7 ÷ 12 = R350 <— From 1 December to 30 June
R2 000 × 20 ÷ 100 × 3 ÷ 12 = R100 <— From 1 April to 30 June
R450

You are required to:
Record the general journal entry in the books of Potent Plastics for the recording of the interest on drawings account.

GENERAL JOURNAL OF POTENT PLASTICS GJ12

Day	Details	Fol.	Debit		Credit	
30/06	Current account: Bheki	B6	450	00		
	Interest on drawings	N14			450	00
	Interest on drawings charged at 20% p.a.					

Transactions at year end

At the end of the year, all the usual year-end procedures are effected in the same manner as for the sole proprietor. There will, however, be additional nominal and real accounts. Another difference relates to the reporting of the profits.

In the case of the sole proprietor, a trading account and a profit and loss account was used. For a partnership, an additional element, the statement of changes in equity, is also required (its aim is to indicate changes in the three personal accounts of partners, and how profits and losses have been appropriated).

Example 23.4

Appropriation of profits

On 30 June 20*x*7 (the end of the financial year) these balances and totals appeared, among others, in the post-adjustment trial balance of Potent Plastics:

Details	Fol.	Debit		Credit	
Capital: Abdullah	B1			30 000	00
Capital: Bheki	B2			20 000	00
Current account: Abdullah	B3			10 500	00
Current account: Bheki	B4	2 450	00		
Interest on capital	N13	7 500	00		
Interest on drawings	N14			450	00
Appropriation account (net profit)	F3			13 800	00

You are required to:

1. Prepare the statement of changes in equity of Potent Plastics for the year ended 30 June 20*x*7.
2. Prepare the owner's equity section of the statement of financial position of Potent Plastics on 30 June 20*x*7.

Note:
The figures above follow from Examples 23.1, 23.2 and 23.3 and can be verified in the statement of financial position on the next page.

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Potent Plastics
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20x7

	Net profit		Current account				Capital account			
			Abdullah		Bheki		Abdullah		Bheki	
Capital accounts										
Balance on 1 July 20x6							30 000	00	20 000	00
Current accounts										
Drawings for the period					(5 000	00)				
Net profit for the period	13 800	00			(400	00)				
Interest on drawings	450	00			(450	00)				
Interest on capital	(7 500	00)	4 500	00	3 000	00				
Distribution of profit	(6 750	00)	4 050	00	2 700	00				
Salary accrued			6 000	00						
Balance on 30 June 20x7	0	00	14 550	00	250	00	30 000	00	20 000	00

Note:
Abdullah's full salary (R2 000 × 12 = R24 000) will be shown in the statement of profit or loss & other comprehensive income. Only the portion not yet taken by him [R24 000 – (R1 500 × 12)], will be shown in the statement of changes in equity.

Potent Plastics
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x7

	Notes	20x7	
EQUITY AND LIABILITIES			
Partners' equity		64 800	00
Capital accounts		50 000	00
Current accounts		14 800	00

Explanation

- Both current accounts now have a credit balance. It is quite possible that they could have a debit balance. If Bheki, for example, had taken another R1 000 during the year, he would have had a debit balance of R750 on his current account.
- The net figure for current accounts on the statement of financial position would then have been R13 800. The resulting total on equity will then be R63 800.

You should be able to complete Questions 23.3 and 23.4.

4 Changes in partnership composition

A partnership is formed when individuals combine their resources for the purpose of making a profit. Any change in the original composition of the partnership essentially ends that partnership and a new partnership comes into existence.

Such changes in composition occur in these situations:

- Amalgamation of two or more sole proprietors.
- Admission of a new partner.
- Retirement or death of an existing partner.
- Conversion to a limited liability company or close corporation.
- Sale of a partnership.
- Dissolution of a partnership.

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Often the existing set of accounting records and reports will be kept. When a change in the composition of the partnership occurs, the existing accounting records need to be adjusted.

Changing the composition of the partnership can result in some complex areas that need to be dealt with. There are a few fundamental procedures which apply to all. The following are the most significant:

Revalue the assets

As the existing partnership ceases to exist whenever a change in partners takes place, it is essential to determine the amounts due to each existing partner on the date of change.

To determine what is due to each partner, it may be necessary to revalue some or all of the assets in the partnership. This is necessary because the market value of the assets may be different from the carrying value thereof. It is useful to open a special revaluation account at this stage, especially if there are a number of revaluations to be made.

The necessary adjustments to bring the assets to their agreed value at that date can then all be made via this revaluation account. The balance on this revaluation account will represent the total profit or loss on revaluation.

Any profit or loss on revaluation is divided among the existing partners in their profit-sharing ratio.

Determine the goodwill

We know that the net asset value of a business = the total assets – the total liabilities.

The reality is that the net asset value is not necessarily the same as the true market value of a business.

Think, for example, of a large manufacturing concern. The business may own expensive factory buildings and plant, that is, lots of assets. If it manufactures goods for which there is very little demand, the business itself will not be worth a lot.

Any change in composition requires a market-related value to be placed on the partnership so as to ensure exchanges of economic value when the change in composition takes place. It is often so that the partnership has a market value greater than its net asset value.

This additional value, which cannot readily be ascribed to any individual asset, is referred to as goodwill. It comprises the difference between the value attached to the tangible net assets and the agreed value of the business as a whole at the time of change in composition.

The goodwill account is classified as an intangible asset. In cases where a partnership is sold, the goodwill is established as the difference between the selling price of the partnership and the net asset value. Because of its tenuous nature, it is often preferable to write goodwill off once the change in partnership has taken place.

Should the opposite situation arise, where the value of the business as a whole is considered to be less than the value attached to the net assets, a credit balance results. This negative goodwill is recorded as a non-distributable reserve.

Record the changes in the general ledger

Once the assets have been revalued and the goodwill (if any) raised, the change can be effected.

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This change may for example be the admission of a new partner, the retirement of an existing partner or the conversion to a company.

The main steps necessary when effecting the change are:

Step 1 Revalue all the assets and liabilities and raise goodwill (if any).
- * This is achieved using a revaluation account if there are numerous revaluations, or by posting directly to the capital accounts of the partners.
- * All profits or losses on revaluation are shared in the profit-sharing ratio of the existing partnership.

Step 2 Record the receipt of cash or other consideration (if it is an admission of a new partner or conversion to another entity type).

Step 3 Record the payment of cash or other assets (if it is the retirement of a partner or dissolution of the partnership).

Step 4 Write off the goodwill, if so decided, in the profit-sharing ratio of the new partnership.

Draft the opening statement of financial position of the new partnership

Once the change in composition is effected, it is useful to draft a statement of financial position reflecting the opening financial position of the new partnership.

For the purpose of the examples, we will use an abridged statement of financial position; that is, a statement of financial position without subheadings and a very simple layout as shown on the next page.

Example 23.5 **Amalgamation of sole proprietors**

Two sole proprietors, Pamela and Quintus, had these balances in their post-closing trial balances as at 30 June 20*x*6:

Details	Pamela				Quintus			
	Debit		Credit		Debit		Credit	
Capital			21 000	00			10 190	00
Vehicles (net)	9 100	00						
Equipment (net)	4 200	00			6 100	00		
Inventories	7 500	00			4 200	00		
Accounts receivable	4 500	00			1 320	00		
Accounts payable			4 300	00			1 430	00
	25 300	00	25 300	00	11 620	00	11 620	00

On 1 July 20*x*6, Pamela and Quintus decide to enter into partnership together.

- The carrying value of all assets is deemed to be fair, except for Quintus' equipment which is valued at R7 700.
- Quintus expects to receive discounts from payables totalling R210. In addition, his goodwill is estimated at R2 000.
- A new set of books will be kept for the partnership.

You are required to:

1 Prepare the general journal entries in the books of Quintus.

2 Prepare the abridged statement of financial position of the new partnership.

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GENERAL JOURNAL OF QUINTUS **GJ7**

Day	Details	Fol.	Debit		Credit	
30/06	Accounts payable	B5	210	00		
	Capital	B1			210	00
	Revaluation of payables					
	Equipment (7 700 – 6 100)	B4	1 600	00		
	Goodwill	B3	2 000	00		
	Capital	B1			3 600	00
	Revaluation of assets					

Pamela and Quintus
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 1 JULY 20x6

Non-current assets			***Owner's equity***		
Vehicles	9 100	00	Capital: Pamela	21 000	00
Equipment (4 200 + 7 700)	11 900	00	Quintus (10 190 + 3 600 + 210)	14 000	00
Goodwill	2 000	00			
Current assets			***Current liabilities***		
Accounts receivable (4 500 + 1 320)	5 820	00	Accounts payable (4 300 + 1 430 – 210)	5 520	00
Inventories (7 500 + 4 200)	11 700	00			
	40 520	00		40 520	00

Explanation

- The statement of financial position of the new partnership reflects the updated asset values at cost to the new partnership.
- If Pamela and Quintus are to share their profits in direct proportion to capital, their profit-sharing ratio will be calculated as follows:
  Pamela (R21 000) : Quintus (14 000) = 3 : 2
- If the partners decide that it would be preferable not to reflect goodwill as an asset, it could be written off in their profit-sharing ratio by passing this entry:

GENERAL JOURNAL OF PAMELA AND QUINTUS **GJ1**

Day	Details	Fol.	Debit		Credit	
30/06	Capital: Pamela (2 000 × 3 ÷ 5)	B1	1 200	00		
	Capital: Quintus (2 000 × 2 ÷ 5)	B2	800	00		
	Goodwill	B9			2 000	00
	Goodwill written off to capital accounts of partners					

- If you were to draw up an abridged statement of financial position after completing the transaction above, the picture would be slightly different:

Pamela and Quintus
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 1 JULY 20x6

Non-current assets			***Owner's equity***		
Vehicles	9 100	00	Capital: Pamela (21 000 – 1 200)	19 800	00
Equipment (4 200 + 7 700)	11 900	00	Quintus (14 000 – 800)	13 200	00
Current assets			***Current liabilities***		
Accounts receivable (4 500 + 1 320)	5 820	00	Accounts payable (4 300 + 1 430 – 210)	5 520	00
Inventories (7 500 + 4 200)	11 700	00			
	38 520	00		38 520	00

Note:
The above entry and statement is only shown as an example of the effect of writing off goodwill.

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Example 23.6 **Change in partnership composition**

One year after starting to trade as a partnership, here is the abridged statement of financial position of Pamela and Quintus:

Pamela and Quintus
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x7

Vehicles	12 300	00	Capital: Pamela	21 000	00
Equipment	15 400	00	Quintus	14 000	00
Goodwill	2 000	00	Current: Pamela	3 400	00
Inventories	14 300	00	Quintus	5 010	00
Accounts receivable	7 900	00	Accounts payable	9 230	00
Bank	740	00			
	52 640	00		52 640	00

Additional information agreed to on 30 June 20x7:

- Equipment is valued at R17 000 and vehicles at R13 700.
- Goodwill is valued at R5 000.
- All other assets and liabilities are fairly valued.

Explanation

- To revalue assets regardless of the type of change of composition which may now take place (that is, an admission, retirement or dissolution), this entry is passed:

GENERAL JOURNAL OF PAMELA AND QUINTUS **GJ12**

Day	Details	Fol.	Debit		Credit	
30/06	Vehicles (13 700 – 12 300)	B7	1 400	00		
	Equipment (17 000 – 15 400)	B8	1 600	00		
	Goodwill (5 000 – 2 000)	B9	3 000	00		
	Capital: Pamela (6 000 × 3 ÷ 5)	B1			3 600	00
	Capital: Quintus (6 000 × 2 ÷ 5)	B2			2 400	00
	Assets revalued upward by R6 000					

- The R6 000 belongs to the partners and is be allocated in the profit-sharing ratio:
  - Pamela R6 000 × 3 ÷ 5 = R3 600
  - Quintus R6 000 × 2 ÷ 5 = R2 400

We will use the admission of a new partner as an example of a change in composition.

Additional information:

On 1 July, it is decided to admit Zanele to the partnership.

- She will contribute capital to get a 20% share in the partnership.
- The remaining partners will keep their existing profit-sharing ratio.

You are required to:

1. Calculate how much capital Zanele must contribute to get a 20% share in the partnership.
2. Show the general journal entries and abridged statement of financial position of Pamela, Quintus and Zanele.
3. Calculate the profit-sharing ratio of the new partnership.

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1 *Calculation*:

Capital: Pamela	=	R24 600	(21 000 + 3 600)
Capital: Quintus	=	R16 400	(14 000 + 2 400)
		R41 000	

Pamela and Quintus are offering Zanele 20% of the new business.

- That means that in future they will have 80% left to be distributed between them.
- Zanele's contribution must be based on the existing partners' capital, thus, her capital contribution will be calculated as: R41 000 × 20 ÷ 80 = R10 250.
  - * The R41 000 is the value of the other two partners' capital contributions.
  - * Zanele gets 20% and the 80% is left after her 20% capital contribution.

2

GENERAL JOURNAL OF PAMELA, QUINTUS AND ZANELE GJ13

Day	Details	Fol.	Debit		Credit	
01/07	Bank	B15	10 250	00		
	Capital: Zanele	B3			10 250	00
	Zanele admitted as a partner in the business					

Pamela, Quintus and Zanele
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 1 JULY 20x7

Vehicles (12 300 + 1 400)	13 700	00	Capital: Pamela (21 000 + 3 600)	24 600	00
Equipment (15 400 +1 600)	17 000	00	Quintus (14 000 + 2 400)	16 400	00
Goodwill (2 000 + 3 000)	5 000	00	Zanele	10 250	00
Inventories	14 300	00	Current: Pamela	3 400	00
Accounts receivable	7 900	00	Quintus	5 010	00
Bank (740 + 10 250)	10 990	00	Accounts payable	9 230	00
	68 890	00		68 890	00

Explanation

The capital accounts of the old partners, Pamela and Quintus, show the profit on revaluation of assets, as well as the goodwill raised on the date of change in composition.

3 *The new profit sharing ratio is*:

Pamela:	60% × 80%	=	48%	OR	$\frac{3}{5} \times \frac{4}{5} = \frac{12}{25}$	<— 12
Quintus:	40% × 80%	=	32%		$\frac{2}{5} \times \frac{4}{5} = \frac{8}{25}$	<— 8
Zanele:		=	20%		$\frac{1}{5} \times \frac{5}{5} = \frac{5}{25}$	<— 5
			100%		$\frac{25}{25}$	

Explanation

- In this new ratio, Pamela and Quintus still share profits between themselves in the ratio 3 : 2. However, because Zanele now receives 20% of the business, the existing partners each have had to give up part of their share in the business, and the new profit-sharing ratio is now 12 : 8 : 5.

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- It is worthwhile to note how much each of the existing partners gave up:

Pamela: 60% – 48% or (15 ÷ 25 – 12 ÷ 25) = 3 ÷ 25 = 12% <— Given up
Quintus: 40% – 32% or (10 ÷ 25 – 8 ÷ 25) = 2 ÷ 25 = 8% <— Given up
20%

- They gave up their share in the ratio 12% : 8%, that is, 3 : 2 (their original ratio).

Example 23.7 **Writing off goodwill**

On 1 July 20*x*7, before starting business in the newly formed partnership Pamela, Quintus and Zanele decide that:

1 Goodwill must be writen off completely.

2 Pamela and Quintus will withdraw cash to bring their current account balances to zero.

You are required to:
Prepare the general journal entries and draw up the abridged statement of financial position of Pamela, Quintus and Zanele after taking the new information into account.

GENERAL JOURNAL OF PAMELA, QUINTUS AND ZANELE GJ13

Day	Details	Fol.	Debit		Credit	
01/07	Capital: Pamela (48%)	B1	2 400	00		
	Capital: Quintus (32%)	B2	1 600	00		
	Capital: Zanele (20%)	B3	1 000	00		
	Goodwill	B12			5 000	00
	Goodwill written off to capital accounts of partners					
	Current account: Pamela	B4	3 400	00		
	Current account: Quintus	B5	5 010	00		
	Bank	B15			8 410	00
	Cash withdrawn to reduce current accounts					

Pamela, Quintus and Zanele
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 1 JULY 20*x*7

Vehicles (12 300 + 1 400)	13 700	00	Capital: Pamela (24 600 – 2 400)	22 200	00
Equipment (15 400 +1 600)	17 000	00	Quintus (16 400 – 1 600)	14 800	00
Inventories	14 300	00	Zanele (10 250 – 1 000)	9 250	00
Accounts receivable	7 900	00	Accounts payable	9 230	00
Bank (10 990 – 8 410)	2 580	00			
	55 480	00		55 480	00

Explanation

- Goodwill no longer appears in the books.
- The capital accounts have been reduced accordingly.
  - It may seem unusual that Zanele, who contributes R10 250, has her capital account immediately reduced by R1 000. It may appear as if she has suffered a loss immediately on joining the partnership.
  - This is not so, because if, for example, the partnership were to admit another partner immediately, or be sold immediately, the goodwill would be raised and her capital account would again be credited with the R1 000.

You should be able to complete Question 23.5.

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Example 23.8

Amalgamation of sole proprietors: statement of changes in equity and current accounts of partners

Barney Bekker and Charlie Cross each operate a business, competing with each other. They agree to form a partnership, BC Traders, with effect from 1 March 20*x*4. The partners agree that:

- Each partner's capital account in the new partnership will be credited with the fair value of the net assets invested by each of them.
- They would share profits in direct proportion to their capital contribution.

Here are the fair values of the assets and liabilities of the two sole proprietors:

Details	Fair value			
	Bekker		Cross	
Bank (cash on hand)	75 000	00	25 000	00
Accounts receivable	31 250	00	0	00
Allowance for bad debts	(6 250	00)	0	00
Inventory	23 750	00	12 500	00
Equipment	63 750	00	25 000	00
Land	0	00	50 000	00
Buildings	0	00	62 500	00
Total assets	187 500	00	175 000	00
Bond over land and buildings	0	00	50 000	00
Accounts payable	7 500	00	5 000	00
Net assets (that is, opening balances of capital accounts)	180 000	00	120 000	00

- During the year ended 28 February 20*x*5, Bekker and Cross had withdrawn R24 000 and R36 000 respectively in anticipation of profits to be made by the partnership.
- The partnership had made a profit of R100 000 for the year.
- Cross takes care of the day-to-day management of the partnership, and the partners agree that he should receive R6 000 as an annual salary.
- They also agreed that interest on capital would be payable at 15% per annum.

You are required to:

1. Record the opening journal entry on 1 March 20*x*4, at the start of the partnership, BC Traders.
2. Show the statement of changes in equity of BC Traders for the year ended 28 February 20*x*5.
3. Show the current accounts of the partners in the general ledger on 28 February 20*x*5.

1

GENERAL JOURNAL OF BC TRADERS **GJ1**

Day	Details	Fol.	Debit		Credit	
01/03	Bank (75 000 + 25 000)	B12	100 000	00		
	Accounts receivable	B11	31 250	00		
	Inventory (23 750 + 12 500)	B10	36 250	00		
	Equipment (63 750 + 25 000)	B9	88 750	00		
	Land	B7	50 000	00		
	Buildings	B8	62 500	00		
	Allowance for bad debts	B15			6 250	00
	Mortgage bond (over land and buildings)	B13			50 000	00
	Accounts payable (7 500 + 5 000)	B14			12 500	00
	Capital account: Bekker	B1			180 000	00
	Capital account: Cross	B2			120 000	00
	Recording capital contributions at start of partnership					

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2

BC Traders
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 28 FEBRUARY 20x5

	Net profit	Current account		Capital account	
		Bekker	Cross	Bekker	Cross
Capital accounts					
Balance on 1 Mar. 20x4				180 000 00	120 000 00
Current accounts					
Drawings for the period		(24 000 00)	(36 000 00)		
Net profit for the period	94 000 00				
Interest on capital	(45 000 00)	27 000 00	18 000 00		
Distribution of profit	(49 000 00)	29 400 00	19 600 00		
Salary accrued			6 000 00		
Balance on 28 Feb. 20x5	0 00	32 400 00	7 600 00	180 000 00	120 000 00

3

General Ledger of BC Traders
Real Accounts Section

Dr. **CURRENT ACCOUNT: BEKKER** **B3** Cr.

Feb.	28	Drawings: Bekker	GJ12	24 000 00	Feb.	28	Interest on capital	GJ12	27 000 00
		Balance	c/d	32 400 00			Appropriation account	GJ12	29 400 00
				56 400 00					56 400 00
					Mar.	1	Balance	b/d	32 400 00

CURRENT ACCOUNT: CROSS **B4**

Feb.	28	Drawings: Bekker	GJ12	36 000 00	Feb.	28	Interest on capital	GJ12	18 000 00
		Balance	c/d	7 600 00			Salary: Cross	GJ12	6 000 00
							Appropriation account	GJ12	19 600 00
				43 600 00					43 600 00
					Mar.	1	Balance	b/d	7 600 00

Explanation

- In the opening journal entry, the combined fair values of the assets and liabilities are recorded in the records of the partnership and each partner's capital account is credited with the value of net assets brought into the partnership by each of them.
- Note that the salary due to Cross is accounted for in the statement of profit or loss & other comprehensive income. The profit for the year as shown in the statement of changes in equity is the profit after the salary of R6 000 has been accounted for (100 000 – 6 000).
- The profit (after subtracting all money due to the partners) must be distributed to the partners in profit-sharing ratio: 180 000 : 120 000 = 3 : 2.
  - Bekker will receive (49 000 × 3 ÷ 5) R29 400 of the profit.
  - Cross will receive (49 000 × 2 ÷ 4) R19 600 of the profit..
- All income and profit due to the partners are credited to their respective current accounts. The drawings accounts of the partners are closed off to their current accounts at the end of the financial year.

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- On the statement of changes in equity the current accounts show a positive figure to indicate money that the partnership owes to the partner/s and a negative figure (in brackets) to show money already taken by the partners.

Example 23.9

Admission of a new partner

This example continues from Example 23.8.

On 1 March 20*x*5, Bekker and Cross agree to allow Delia Dunn into the partnership.

- The new partnership will trade as BCD Traders.
- Dunn is to contribute R150 000 in cash for 25% in the partnership.
- Included in the R150 000, is R37 500 for goodwill. This amount must be credited to the capital accounts of Bekker and Cross in their profit-sharing ratio.
- No goodwill must be shown in the books of the new partnership.
- The partners of BCD Traders will share profits in the same ratio as their capital accounts.

You are required to:

Record the entry in the general journal on admission of Dunn to the partnership.

GENERAL JOURNAL OF BCD TRADERS **GJ1**

Day	Details	Fol.	Debit		Credit	
01/03	Bank (cash on hand)	B15	150 000	00		
	Capital account: Bekker				22 500	00
	Capital account: Cross				15 000	00
	Capital account: Dunn (150 000 – 37 500)				112 500	00
	Recording Dunn's capital contribution					

Explanation

- In this example, goodwill is treated differently than in Example 23.7. The reason is that the amount for goodwill (due to Bekker and Cross) was paid directly from the cash amount that Dunn contributed. Thus, there will be no journal entry for raising goodwill.
- After the admission of the new partner, the balances on the capital accounts and the profit-sharing ratio of the partners are:

Bekker:	(180 000 + 22 500)	=	R202 500	=	45%
Cross:	(120 000 + 15 000)	=	R135 000	=	30%
Dunn:		=	R112 500	=	25%
			R450 000		100%

  Note that the capital for Dunn is shown net of goodwill (she has no claim on goodwill – it belongs to the two old partners).
- In this new ratio, Bekker and Cross still share profits between themselves in the ratio 3 : 2 (45 : 30 = 3 : 2), but each had to relinquish part of their share to Dunn, who will now take 25% of the profits.

Example 23.10

Retirement of a partner

This example continues from Example 23.9.

On 28 February 20*x*6, Bekker, Cross and Dunn agree that Cross is to retire from the partnership. The partnership agreement provides that assets and liabilities be revalued on retirement of a partner.

The statement of financial position of BCD Traders on 28 February 20*x*6, before revaluation, is shown on the next page.

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BCD Traders

ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20x6

Bank (cash on hand)	275 000	00	Mortgage bond	25 000	00
Accounts receivable	85 000	00	Accounts payable	35 000	00
Inventories	125 000	00	Capital: Bekker	202 500	00
Equipment	86 000	00	Cross	135 000	00
Land	50 000	00	Dunn	112 500	00
Buildings	60 000	00	Current account: Bekker	51 000	00
			Cross	70 000	00
			Dunn	50 000	00
	681 000	00		681 000	00

Appraisals indicate that land is understated by R50 000 and the value of the buildings is R100 000. Equipment and inventories are overstated by R6 000 and R8 000 respectively. The amount due to Cross must be paid to him in cash.

After Cross's retirement, the new partnership will trade under the name BD Traders. The remaining partners will share profits and losses in proportion to the balances on their capital accounts.

You are required to:

1 Show the entries in the general journal to record the asset revaluation. A revaluation account must be opened and then closed off to the capital accounts, in the profit-sharing ratio.

2 Show the statement of financial position of the newly formed partnership, BD Traders, immediately after the withdrawal of Cross.

3 Calculate the profit sharing ratio of the partners in the new partnership.

1

GENERAL JOURNAL OF BCD TRADERS **GJ12**

Day	Details	Fol.	Debit		Credit	
28/02	Land	B11	50 000	00		
	Buildings (100 000 – 60 000)	B10	40 000	00		
	Equipment	B12			6 000	00
	Inventories	B13			8 000	00
	Revaluation account	N15			76 000	00
	Recording assets at revalued amounts					
	Revaluation account	N15	76 000	00		
	Capital account: Bekker (45%)	B1			34 200	00
	Capital account: Cross (30%)	B2			22 800	00
	Capital account: Dunn (25%)	B3			19 000	00
	Closing the Revaluation account					

2

BD Traders

ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20x6

Bank (cash on hand)	47 200	00	Mortgage bond	25 000	00
Accounts receivable	85 000	00	Accounts payable	35 000	00
Inventories	117 000	00	Capital: Bekker (202 500 + 34 200)	236 700	00
Equipment	80 000	00	Dunn (112 500 + 19 000)	131 500	00
Land	100 000	00	Current account: Bekker	51 000	00
Buildings	100 000	00	Dunn	50 000	00
	529 200	00		529 200	00

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3 Capital: Bekker 236 700
Capital: Dunn 131 500
Total capital: 368 200
Profit-sharing ratio
Bekker 236 700/368 200 × 100 = 64%
Dun 131 500/368 200 × 100 = 36%

Explanation

- When an asset is valued and it is understated, it means that the amount in the general ledger account is too low.
  - A debit entry in the asset account is needed to update the value of the asset.
  - The credit entry of the double-entry is against the revaluation account.
- When an asset is valued and it is overstated, it means that the amount in the general ledger account is too high.
  - A credit entry in the asset account is needed to update the value of the asset.
  - The debit entry of the double-entry is against the revaluation account.
- The R76 000 credit entry in the general journal is the net effect of all the debit and the credit entries in the revaluation account.
- The R47 200 bank account balance is calculated like this:

Balance	275 000	00
Paid out: Capital account: Cross (135 000 + 22 800)	(157 800	00)
Paid out: Current account: Cross	(70 000	00)

You should be able to complete Questions 23.6 to 23.10.

5 Specific issues in partnership accounting

Partnership accounting generally introduces two new areas of accounting:

- The approach to account for financial exchanges between the partners (an individual) and the partnership (*a business*), by using separate capital and current accounts for each partner.
- The fundamental concept that, for any change in the composition of the partnership, assets and liabilities are revalued and goodwill determined.

This is normally achieved through the use of a revaluation account. This entry could be directly between the asset or goodwill account and the capital accounts of the partners. The admission or withdrawal entries are then passed and, if required, goodwill is written off in the new profit-sharing ratio.

The above were dealt with in the previous section. General journal entries were used to explain the principles. In the following section, it will also be demonstrated how these entries are passed in the T-accounts of the partners.

Apart from the T-accounts, there are a number of specific issues in partnership accounting that occur less frequently and require special attention.

Existing partners alter their profit-sharing ratio

Should partners, for whatever reason, decide to alter their profit-sharing ratio, the principles developed earlier in the chapter still apply. Assets must be revalued and goodwill established.

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Each partner's capital account is brought up to date with the agreed values at the time of the change.

If goodwill is only temporarily raised, it may be written off in the new profit-sharing ratio as shown in Example 23.7. The alternative is that partners decide to effect the change (for goodwill) by means of a private cash settlement, thus, avoiding any entries in the books of account.

The only effect on the accounting records will be that profits will be appropriated in the new ratio from the date of the change, as shown in Example 23.9.

Example 23.11

Change to the profit-sharing ratio

Here is the abridged statement of financial position of Wally, Sally and Tammy who have been in partnership for five years, sharing profits and losses in this ratio: 2 : 2 : 1.

Wally, Sally and Tammy
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20*x*0

Buildings	58 000	00	Capital: Wally	50 000	00
Equipment	29 000	00	Sally	40 000	00
Bank	15 000	00	Tammy	10 000	00
Accounts receivable	8 000	00	Accounts payable	10 000	00
	110 000	00		110 000	00

- Wally wishes to spend less time in the partnership and Tammy more time. It is decided to change the profit-sharing ratio to 3 : 4 : 3.
- Wally correctly maintains that the partnership is worth more than is reflected in the statement of financial position and requests that revaluations be made immediately to effect the new profit-sharing ratio from 1 July 20*x*0.
- These valuations were accepted:
  - Buildings R70 000
  - Equipment R28 000
  - Goodwill R40 000
- Goodwill must be written off as soon as the above has been accounted for.

You are required to:

1 Prepare the abridged columnar capital accounts of the partners to show the transactions.

2 Prepare the the abridged statement of financial position of the partnership after taking the transaction into account.

1

Abridged Columnar General Ledger of Wally, Sally and Tammy
CAPITAL ACCOUNTS

Dr. Cr.

	Wally		Sally		Tammy			Wally		Sally		Tammy	
Equipment	400	00	400	00	200	00	Capital	50 000	00	40 000	00	10 000	00
Balance c/d	70 400	00	60 400	00	20 200	00	Buildings	4 800	00	4 800	00	2 400	00
							Goodwill	16 000	00	16 000	00	8 000	00
	70 800	00	60 800	00	20 400	00		70 800	00	60 800	00	20 400	00
Goodwill	12 000	00	16 000	00	12 000	00	Balance b/d	70 400	00	60 400	00	20 200	00
Balance c/d	58 400	00	44 400	00	8 200	00							
	70 400	00	60 400	00	20 200	00		70 400	00	60 400	00	20 200	00
							Balance b/d	58 400	00	44 400	00	8 200	00

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2

Wally, Sally and Tammy
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x0

Buildings	78 000	00	Capital: Wally	58 400	00
Equipment	28 000	00	Sally	44 400	00
Bank	15 000	00	Tammy	8 200	00
Accounts receivable	8 000	00	Accounts payable	10 000	00
	121 000	00		121 000	00

Explanation

- The net effect of the revaluation (including goodwill) is a profit of R51 000 (R12 000 + R40 000 – R1 000). If the transactions were journalised, the total of R51 000 would be divided in the old ratio 2 : 2 : 1 and credited to the respective capital accounts.
- When goodwill is written off, in the new ratio, the total R51 000 would be debited to the respective capital accounts.
- If the partners decided to settle privately, it is necessary to establish the exchange of value required between the partners, based on the R51 000 profit on revaluation and goodwill raised. This may be calculated using percentages as:

Partner	Old ratio	New ratio	Difference
Wally	40%	30%	–10%
Sally	40%	40%	0%
Tammy	20%	30%	+10%

- From the above, it is clear that Sally will continue to receive the same proportion of partnership profits (that is, 40%), whereas Tammy has gained an additional 10% at the expense of Wally. To settle, Tammy will make a cash payment of 10% × R51 000, that is R5 100 to Wally.
- The reason for this was explained earlier, but let us just refresh our memory:
  If, after changing to the new profit-sharing ratio, the assets were to be revalued and goodwill raised, Tammy will be credited with a greater share, for which she has already paid Wally.

You should be able to complete Questions 23.11 to 23.14.

Dissolution causing a partner to have a capital deficiency

Should a partnership decide to liquidate, that is, cease to exist, the possibility exists that losses may be incurred on disposal of assets. Partnership agreements usually include a statement that both profits and losses are borne in the agreed profit-sharing ratio.

If the Partnership Agreement is silent on the distribution of losses, the possibility exists that losses not recovered from an insolvent partner should be covered by the existing partners in proportion to the balances on their capital accounts (refer to *British* case law: Garner vs Murray).

Example 23.12 **Dissolution of a partnership: sufficient funds to cover shortfall**

P, Q and R share profits in the ratio 5 : 3 : 2. On 1 January 20x2 (the dissolution date), the general ledger balances were:

Capital: P			200 000	00
Capital: Q			200 000	00

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Capital: R			50 000	00
Assets	400 000	00		
Bank	50 000	00		

Assets were sold for R50 000. Partner R will pay in money to cover the shortfall on the capital account.

You are required to:
Prepare the capital accounts of the partners in columnar form to show all the necessary entries for the dissolution of the partnership.

Abridged Columnar General Ledger of PQR
CAPITAL ACCOUNTS

Dr. Cr.

	P		Q		R			P		Q		R	
Assets	175 000	00	105 000	00	70 000	00	Capital	200 000	00	200 000	00	50 000	00
Bank	25 000	00	95 000	00			Bank					20 000	00
	200 000	00	200 000	00	70 000	00		200 000	00	200 000	00	70 000	00

The general journal entries for the transactions will be:

GENERAL JOURNAL OF PQR **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Bank	B5	50 000	00		
	Capital: P (350 000 × 5 ÷ 10)	B1	175 000	00		
	Capital: Q (350 000 × 3 ÷ 10)	B2	105 000	00		
	Capital: R (350 000 × 2 ÷ 10)	B3	70 000	00		
	Assets	B4			400 000	00
	Loss on sales of assets					
	Bank	B5	20 000	00		
	Capital: R (70 000 – 50 000)	B3			20 000	00
	R paid in the capital deficit					
	Capital: P (200 000 – 175 000)	B1	25 000	00		
	Capital: Q (200 000 – 105 000)	B2	95 000	00		
	Bank	B5			120 000	00
	Cash paid in final dissolution					

Example 23.13 **Dissolution of a partnership: insufficient funds to cover the shortfall**

This example continues from Example 23.12.

If R has insufficient funds, or no funds at all, the shortfall on the capital account must be borne by the remaining partners. If they have agreed to share profits and losses, the ratio of 5 : 3 will apply.

You are required to:
Prepare the capital accounts in columnar format to show all the entries necessary to dissolve the partnership.

Abridged Columnar General Ledger of PQR
CAPITAL ACCOUNTS

Dr. Cr.

	P		Q		R			P		Q		R	
Assets	175 000	00	105 000	00	70 000	00	Capital	200 000	00	200 000	00	50 000	00
Capital: R	12 500	00	7 500	00			Capital: P & Q					20 000	00
Bank	12 500	00	87 500	00									
	200 000	00	200 000	00	70 000	00		200 000	00	200 000	00	70 000	00

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The general journal entries for the transactions will be:

GENERAL JOURNAL OF PQR **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Bank	B5	50 000	00		
	Capital: P (350 000 × 5 ÷ 10)	B1	175 000	00		
	Capital: Q (350 000 × 3 ÷ 10)	B2	105 000	00		
	Capital: R (350 000 × 2 ÷ 10)	B3	70 000	00		
	Assets	B4			400 000	00
	Loss on sales of assets					
	Capital: P (20 000 × 5 ÷ 8)	B1	12 500	00		
	Capital: Q (20 000 × 3 ÷ 8)	B2	7 500	00		
	Capital: R	B3			20 000	00
	Shortfall on R's capital account					
	Capital: P	B1	12 500	00		
	Capital: Q	B2	87 500	00		
	Bank	B5			100 000	00
	Cash paid in final dissolution					

Example 23.14 **Dissolution of a partnership: Insufficient funds – Garner vs Murray ruling invoked**

This example continues from Examples 23.12 and 23.13.

R has insufficient funds and the Garner vs Murray rule is invoked.

You are required to:

Prepare the capital accounts in columnar format to show all the entries necessary to dissolve the partnership.

Abridged Columnar General Ledger of PQR

CAPITAL ACCOUNTS

Dr. *Cr.*

	P		Q		R			P		Q		R	
Assets	175 000	00	105 000	00	70 000	00	Capital	200 000	00	200 000	00	50 000	00
Capital: R	10 000	00	10 000	00			Capital: P & Q					20 000	00
Bank	15 000	00	85 000	00									
	200 000	00	200 000	00	70 000	00		200 000	00	200 000	00	70 000	00

The general journal entries for the transactions will be:

GENERAL JOURNAL OF PQR **GJ1**

Day	Details	Fol.	Debit		Credit	
01/01	Bank	B5	50 000	00		
	Capital: P (350 000 × 5 ÷ 10)	B1	175 000	00		
	Capital: Q (350 000 × 3 ÷ 10)	B2	105 000	00		
	Capital: R (350 000 × 2 ÷ 10)	B3	70 000	00		
	Assets	B4			400 000	00
	Loss on sales of assets					
	Capital: P (20 000 × 0.5)	B1	10 000	00		
	Capital: Q (20 000 × 0.5)	B2	10 000	00		
	Capital: R	B3			20 000	00
	Shortfall on R's capital account					
	Capital: P	B1	15 000	00		
	Capital: Q	B2	85 000	00		
	Bank	B5			100 000	00
	Cash paid in final dissolution					

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Explanation
The Garner vs Murray ruling states that losses should be shared in relation to the balances of the capital accounts. In this case, the ratio is 200 000 : 200 000 (1 : 1).

You should be able to complete Questions 23.15 and 23.16.

Piecemeal dissolution

The dissolution of any business entity can be a time-consuming exercise. Non-current assets are often not readily liquidated at competitive prices. Accounts receivable are likely to withhold payment in accordance with the credit terms which they were given.

Once it has been decided to dissolve a partnership, partners will wish to receive their share of liquidated assets as soon as possible. However, in the interest of orderly liquidation procedures, it would be unwise to pay amounts to partners as assets are sold.

There is a risk that, because of losses which may be incurred on assets yet to be sold, they may have to repay amounts to the partnership.

To prevent this possibility, a piecemeal liquidation uses the concept of 'maximum possible loss'. This approach assumes that all unsold assets are valued at R0, and distributes the loss amongst the partners. If a partner still has a credit balance after deducting this possible (but unlikely) loss, they may be paid from the cash resources, to a maximum of that credit.

As each asset is sold, the procedure is repeated, thus, distributing funds in a piecemeal way to partners.

Example 23.15 shows the principle, using columnar capital accounts.

Example 23.15

P, M and T were in partnership and shared profits and losses in the ratio 1 : 2 : 1.

On 28 February 20*x*9, the partners decided to dissolve the partnership on these terms:

A Cash is to be distributed as it becomes available.

B Accounts payable are to be repaid in full before any distribution is made to the partners.

C No partner should receive any cash which may subsequently have to be refunded.

D In anticipation of expected dissolution costs, a minimum balance of R200 must be kept in the bank at all times.

On 28 February 20*x*9, the general ledger balances were:

Capital: P			5 000	00
Capital: M			3 600	00
Capital: T			1 400	00
Equipment	12 200	00		
Bank overdraft			200	00
Accounts payable			2 000	00

The piecemeal sale of the equipment took place as follows:

Date of sale	Carrying value		Cash realised	
1 April 20*x*9	1 000	00	1 000	00
14 April 20*x*9	4 400	00	4 000	00
10 May 20*x*9	3 200	00	3 200	00
27 June 20*x*9	3 600	00	4 200	00

On 27 June 20*x*9, the dissolution costs of R160 were paid.

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You are required to:

Draw up the capital accounts of the partners to show the transactions.

Abridged Columnar General Ledger of PMT
CAPITAL ACCOUNTS

Date	Details	Total		P = 1		M = 2		T = 3	
31 March 20x9	Opening balance	(10 000	00)	(5 000	00)	(3 000	00)	(1 400	00)
14 April 20x9	Loss on sale R(4 400 – 4 000)	400	00	100	00	200	00	100	00
		(9 600	00)	(4 900	00)	(3 400	00)	(1 300	00)
14 April 20x9	Cash payments [1]	2 600	00	2 600	00	0	00	0	00
		(7 000	00)	(2 300	00)	(3 400	00	(1 300	00)
10 May 20x9	Cash payments [2]	3 200	00	1 350	00	1 500	00	350	00
		(3 800	00)	(950	00)	(1 900	00)	(950	00)
27 June 20x9	Profit on sale R(4 200 – 3 600)	(600	00)	(150	00)	(300	00)	(150	00)
	Dissolution costs	160	00	40	00	80	00	40	00
		(4 240	00)	(1 060	00)	(2 120	00)	(1 060	00)
	Cash payment	4 240	00	1 060	00	2 120	00	1 060	00
		0	00	0	00	0	00	0	00

Calculations

1

Details	Total		P		M		T	
Opening balance	(9 600	00)	(4 900	00)	(3 400	00)	(1 300	00)
Maximum possible loss								
Equipment R6 800 + costs R200 (total R7 000)	7 000	00	1 750	00	3 500	00	1 750	00
	(2 600	00)	(3 150	00)	100	00	450	00
M and T debit balances			550	00	(100	00)	(450	00)
Cash payment possible	(2 600	00)	(2 600	00)				

2

Details	Total		P		M		T	
Opening balance	* (7 000	00)	* (2 300	00)	(3 400	00)	(1 300	00)
Maximum possible loss								
Equipment R3 600 + costs R200 (total R3 800)	3 800	00	950	00	1 900	00	950	00
Cash payment possible	(3 200	00)	(1 350	00)	(1 500	00)	(350	00)

* (9 600 – 2 600) and (4 900 – 2 600)

Explanation

- Only when the second sale of equipment has taken place, does the possibility of a cash payment to the partners arise, as the payables and bank overdraft must first be settled.
- After the calculation of the maximum possible loss on 14 April, a debit balance on the capital accounts of M and T arises. This must be deducted from the possible cash payout to P, as the possibility exists that M and T may be unable to pay in the amount required.

You should be able to complete Questions 23.17 to 23.19.

6 Chapter illustrative example

A, B, C and D have been in partnership for a number of years. Their partnership agreement stipulates that profits and losses are shared in these ratios:

	A	B	C	D
Profits and losses from the sale of immovable property	5	2	0	1
Profits and losses from all other types of transactions	4	3	2	1

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The partnership agreement also states that:

- Any deficit on an insolvent partner's capital account in the case of a dissolution, should be absorbed by the solvent partners.
- The solvent partners will absorb the deficit in proportion to their capital account balances at the beginning of the period in which the dissolution takes place.

Here is the business's post-closing trial balance as at 31 December 20*x*1:

A to D
POST-CLOSING TRIAL BALANCE AS AT 31 DECEMBER 20*x*1

Details	Fol.	*Dr.*		*Cr.*	
Bank	B13	1 000	00		
Land and buildings	B14	12 000	00		
Vehicles	B15	14 000	00		
Accumulated depreciation on vehicles	B16			4 000	00
Inventory	B17	18 000	00		
Accounts receivable	B18	5 600	00		
Allowance for bad debts	B19			600	00
Mortgage bond	B20			4 000	00
Accounts payable	B21			12 000	00
Capital: A	B1			16 000	00
Capital: B	B2			6 000	00
Capital: C	B3			2 000	00
Capital: D	B4			4 000	00
		49 600	00	49 600	00

During December 20*x*1, the partners made the decision to stop trading from 31 December and to dissolve the partnership and to begin realising the assets from the first day of 20*x*2. It was agreed further that:

- Profits and/or losses on realising the assets should be computed and transferred to capital accounts at the end of each month.
- Accounts payable should be paid in full, as soon as enough cash becomes available.
- After paying the payables all the available cash (except for R500 that was to be kept to meet anticipated costs of realisation), the rest should be distributed to the partners at the end of each month so that no partner would be called upon later to refund any money they had received.

Transaction for January 20x2:

1. Inventory with a carrying value of R15 000 was sold by public auction for R4 000 cash.
2. The accounts receivable were discounted with a merchant bank for R3 000 cash.
3. A purchased the business's only branch as a going concern and paid R7 000 in cash for assets with the following carrying values:
4. Vehicle R2 000 (original cost was R2 500); inventory R3 000. He also took over the branch land and buildings at their book value of R4 000 and in return agreed to assume responsibility for repaying the full mortgage bond.
5. Accounts payable were settled in full by a cash payment of R11 500.
6. Partners withdrew the cash they were entitled to on the last day of the month.

You are required to:

1. Record the entries in the general journal of the partnership to record the realisation of the assets, the settlement of the liabilities, the apportionment of any profit or loss and the cash

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withdrawn by the partners during the month ended 31 January 20*x*2. (Assume that the profit/loss on dissolution should be determined using a realisation profit and loss account.)

2 Draw up a summary statement of financial position (in T-form) as at 31 January 20*x*2.

3 Show how the amounts of cash which each partner withdrew from the business on 31 January 20*x*2 were calculated.

GENERAL JOURNAL OF A TO D **GJ1**

Day	Details	Fol.	Debit		Credit	
31/01	Bank	B19	4 000	00		
	Realisation	N10	11 000	00		
	Inventory	B			15 000	00
	Bank	B19	3 000	00		
	Allowance for bad debts	B	600	00		
	Realisation account	N10	2 000	00		
	Accounts receivable	B			5 600	00
	Bank	B19	7 000	00		
	Accumulated depreciation: Vehicles	B22	500	00		
	Vehicles	B21			2 500	00
	Inventory	B20			3 000	00
	Realisation account	N10			2 000	00
	Mortgage bond	B17	4 000	00		
	Land and buildings	B16			4 000	00
	No entry necessary in capital account: A					
	Accounts payable	B18	12 000	00		
	Bank	B19			11 500	00
	Realisation account				500	00
	Capital: A	B1	4 200	00		
	Capital: B	B2	3 150	00		
	Capital: C	B3	2 100	00		
	Capital: D	B4	1 050	00		
	Realisation account	N10			10 500	00
	No profit or loss on immovable property so ratio is 4 : 3 : 2 : 1					
	Capital: A	B1	600	00		
	Capital: D	B4	400	00		
	Bank	B19			1 000	00
	Maximum cash (R1 500 – R1 000) withdrawn					

A to D
ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 JANUARY 20*x*2

Land and buildings	8 000	00	Capital: A	11 800	00
Vehicles (net)	8 000	00	B	2 850	00
Bank	1 500	00	C	(100	00)
			D	2 950	00
	17 500	00		17 500	00

Abridged Columnar General Ledger of A to D
CAPITAL ACCOUNTS

Details	A		B		C		D	
Balance	16 000	00	6 000	00	2 000	00	4 000	00
Loss on realisation	(4 200	00)	(3 150	00)	(2 100	00)	(1 050	00)
	11 800	00	2 850	00	(100	00)	2 950	00

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Maximum possible loss								
Land and buildings (5 : 2 : 0 : 1)	(5 000	00)	(2 000	00)	0	00	(1 000	00)
Vehicles (4 : 3 : 2 : 1)	(3 200	00)	(2 400	00)	(1 600	00)	(800	00)
Cash retention (4 : 3 : 2 : 1)	(200	00)	(150	00)	(100	00)	(50	00)
	3 400	00	(1 700	00)	(1 800	00)	1 100	00
Partner B & C Insolvency								
A : D as R16 000 : R4 000	(2 800	00)					(700	00)
CASH DISTRIBUTION	600	00	0	00	0	00	400	00

7 Summary

A partnership is an association of two to twenty people who carry on business for profit. Each partner is a co-owner of the business. All the partners are jointly and severally liable for the debts of the partnership, that is, they have an unlimited liability for the partnership's debts.

The accounts of a partnership are very similar to those of a sole proprietor for routine transactions. However, two significant differences are apparent. A very careful record must be maintained of each partner's claim against the partnership. As a result, each partner has a capital account in which the original capital contributed is recorded and a current account for all other matters.

Whenever the composition of a partnership changes through occurrences such as the admission of a new partner or the retirement of an existing partner, the assets must be revalued. This ensures that all partners who have contributed to the growth and development of the partnership, receive the benefit of their efforts.

It is customary at this stage to estimate goodwill which is credited to the capital accounts of the existing partners in their profit-sharing ratio. Should it be decided to write the goodwill off in the newly constituted partnership, the new profit-sharing ratio is used for the write-off.

QUESTIONS

Question 23.1

Name and briefly discuss five factors which should be outlined in a partnership agreement.

Question 23.2

Discuss the circumstances under which it would be equitable to introduce interest on capital in a partnership agreement.

Question 23.3

Explain the purpose of a:

1 Current account for each partner.

2 Statement of changes in equity.

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Question 23.4

Mutt and Jeff are equal partners in a sport shop called Born Losers. These balances appeared in the pre-adjustment trial balance as at 28 February 20*x*3: (Ignore VAT.)

Capital: Mutt	71 500	00
Capital: Jeff	71 500	00
Current account: Mutt (*Cr.*)	500	00
Current account: Jeff (*Dr.*)	2 000	00
Drawings: Mutt	7 100	00
Drawings: Jeff	7 100	00
Office equipment (at cost)	126 000	00
Land and buildings (at cost)	150 000	00
Accumulated depreciation: Land and buildings	40 000	00
Accumulated depreciation: Office equipment	19 200	00
Fixed deposit	14 900	00
Loan from City Bank	45 000	00
Accounts receivable	28 500	00
Allowance for bad debts	1 150	00
Accounts payable	22 100	00
Bank overdraft	25 250	00
Inventory (1 March 20x2)	8 400	00
Sales	83 400	00
Sales returns	4 600	00
Purchases	33 600	00
Purchases returns	2 300	00
Rent paid	7 200	00
Rent income	58 800	00
Interest on loan	2 700	00
Bad debts	2 800	00
Railage inwards	2 500	00
Salaries and wages	38 750	00
Insurance	2 400	00
Stationery	990	00
Customs duties	1 160	00

Adjustments:

1 Depreciation must be provided for on:
- Land and buildings at 8% per annum on the straight-line method.
- Office equipment at 10% per annum on the reducing-balance method.

2 The loan from City Bank was negotiated on 01 March 20*x*2 and interest is payable six-monthly at 12% per annum.

3 An additional amount of R1 500 must be written off from receivables as irrecoverable and the allowance for bad debts must be adjusted to be equal to 5% of 'good receivables'.

4 The balance on the insurance account represents two premiums paid as follows:
- R900 on a one-year fire policy effective from 1 May 20*x*2
- R1 500 on a one-year theft policy effective from 1 August 20*x*2.

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5 Stationery costing R180 was still on hand at 28 February 20*x*3.
6 An account of R240 dated 1 February 20*x*3 for customs duties was only received on 3 March 20*x*3.
7 Inventory costing R6 000 was still on hand at 28 February 20*x*3.
8 According to Mutt, advertisements costing R4 100 were placed before 28 February 20*x*3.
9 Interest on current accounts must be calculated at 6% per annum.
10 Interest on drawings came to R125 for Mutt and R100 for Jeff.
11 Transfer R1 000 to the general reserve.

You are required to:

1 Prepare the statement of profit or loss & other comprehensive income of Born Losers for the year ended 28 February 20*x*3.
2 Prepare the statement of financial position of Born Losers as at 28 February 20*x*3.
3 Prepare the statement of changes in equity of Born Losers for the year ended 28 February 20*x*3.

Question 23.5

Define goodwill and indicate the role it plays when changes in the composition of a partnership occur.

Question 23.6

Apple, Banana and Cherry are partners in a business called Fruit Retailers. The partnership agreement provides:

1 Interest is to be allowed or charged on opening capital/current accounts at 15% per annum.
2 Partners are entitled to these annual salaries:
   – Apple R60 000
   – Banana R48 000
   – Cherry R36 000
3 Profits are to be distributed in the ratio 2 : 2 : 1 after making good any losses brought forward from the previous financial year.
4 Losses (after allowing for interest and salaries) are to be shared by Apple and Banana in the ratio 2 : 1.

Additional information:

1 Capital/current account at beginning of year:
   – Apple R120 000 C*r*.
   – Banana R100 000 C*r*.
   – Cherry R10 000 D*r*.
2 Drawings for the year:
   – Apple R65 000
   – Banana R68 000
   – Cherry R20 000
3 Profit for the year R230 500 (before allowing for interest and partners' salaries).
4 Losses from the previous financial year R30 000 (after allowing for interest and partners' salaries).

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You are required to:
Prepare the partners' capital accounts for the current year. (Workings to be clearly shown.)

Question 23.7

Q, S and T are partners in Quesentee. The partnership agreement provides for the following:

1 Capital remain unchanged at:
- Q R30 000
- S R20 000
- T R5 000

2 When dividing profits and losses, this information must be taken into account:
- **a** Q and S each receive a salary of R2 000 per year. T receives R3 000 plus a bonus of 10% of the profits, after providing for all interests and salaries.
- **b** Each partner earns interest on capital at 6% per annum. Interest on current accounts is calculated at 10% per annum.
- **c** Interest on drawings is calculated at 6% per annum. In the current year, drawings were as follows: Q, R350; S, R200; T, R400.
- **d** R2 250 of the profit must be transferred to the general reserve account.
- **e** The remaining profit must be divided in the ratio 6 : 3 : 1.

Additional information:
- Net profit for the year amounted to R21 850.
- Balance on the current accounts:
  - Q (Dr.) R7 750
  - S (Dr.) R5 100
  - T (Cr.) R6 600

You are required to:
Record all the transactions above in the general journal of Quesentee for the year ending 30 June 20*x*5. (Narrations should be included.)

Question 23.8

Puff and Blow are in a partnership and share profits and losses in the ratio of 3 : 1.

Pant is admitted to the partnership. The new partnership agreement provided for the following:

A Land and buildings are revalued at R12 000. The carrying value at present is R8 000.
B Obsolete inventory to the value of R1 600 must be written off.
C Goodwill appears in the books of the old partnership at R3 000. On admission of Pant, goodwill is valued at R5 000.
D Pant must pay R10 000 in cash for his capital contribution.
E The full R10 000 contributed by Pant must be kept in the business.
F No goodwill must appear on the statement of financial position of the new partnership.
G Puff, Blow and Pant will share profits and losses in the ratio of 2 : 1 : 1.

You are required to:
Prepare the journal entries (cash included) of Puff, Blow and Pant to give effect to the agreement in the books.

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Question 23.9

Long and Short are in partnership, sharing profits and losses in the ratio 3 : 2. Their abridged statement of financial position as at 30 September 20*x*4 was: (Ignore VAT.)

ASSETS			EQUITY & LIABILITIES		
Land and buildings at cost	60 000	00	Capital: Long	100 000	00
Furniture at carrying value	10 000	00	Short	60 000	00
Inventory	118 000	00	Loan secured by a mortgage		
Accounts receivable	24 000	00	over land and buildings	40 000	00
Less: Allowance for bad debts	(2 000	00)	Accounts payable	12 000	00
Bank	2 000	00			
	212 000	00		212 000	00

They did not keep proper accounting records, but you discovered that:

1 R6 800 had been paid on the loan. This amount included interest at a rate of 12% per annum.

2 Accounts payable at 31 March 20*x*5 totalled R16 000, inventory R140 000, and accounts receivable R20 000.

3 R2 000 had been spent on furniture during the six months and it is desired to write off R500 for depreciation.

4 Land and buildings have had no additions and are not depreciated.

5 The bank statement showed an overdraft of R1 000, but there were outstanding cheques totalling R600, and outstanding deposits of R900.

6 An allowance for bad debts of R1 500 is considered adequate at 31 March 20*x*5.

7 Long had drawn R10 000 and Short R8 000 during the six months.

8 They are entitled to interest at the rate of 10% per annum on capital.

You are required to:

Prepare a statement of financial position, in T-form, for Long and Short at 31 March 20*x*5.

Question 23.10

Peter and Paul are partners, sharing profits and losses in the ratio of 2 : 1. On 30 June 20*x*5, their abridged statement of financial position was: (Ignore VAT.)

ASSETS			EQUITY & LIABILITIES		
Land and buildings	100 000	00	Capital: Peter	150 000	00
Vehicles	20 000	00	Paul	75 000	00
Furniture	10 000	00	Loan: ABC Bank	40 000	00
Goodwill	30 000	00	Accounts payable	14 000	00
Inventory	48 000	00			
Accounts receivable	62 000	00			
Bank	9 000	00			
	279 000	00		279 000	00

On 1 July 20*x*5, they decided to admit Gavin as a partner on these terms and conditions:

1 Assets were to be revalued as:

–	Land and buildings	R120 000	–	Vehicles	R18 000
–	Furniture	R8 000	–	Goodwill	R40 000
–	Inventory	R44 000	–	Accounts receivable	R60 000

2 Gavin must make a one-fifth cash contribution share in the partnership's profit and losses.

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3 Peter and Paul would, from today, share profits and losses in the ratio of 3 : 2 and must pay in or withdraw cash to bring their capital balances into the profit-sharing proportion based on Gavin's capital.
4 Goodwill must not be shown as an asset in the statement of financial position of the new partnership.

You are required to:
1 Journalise all the transactions for the events that took place to admit Gavin to the partnership.
2 Draw up the statement of financial position (in T-form) of the new partnership immediately after admitting Gavin.

Question 23.11

A, B and C are in partnership and share profits and losses in the ratio 2 : 2 : 1. The abridged statement of financial position of the partners on 30 June 20*x*1 was: (Ignore VAT.)

ASSETS			EQUITY & LIABILITIES		
Land and buildings	10 000	00	Capital: A	10 000	00
Equipment	6 000	00	B	15 000	00
Inventory	25 000	00	C	20 000	00
Accounts receivable	25 000	00	Current accounts: A	2 000	00
Bank	5 000	00	B	2 500	00
			C	1 500	00
			Accounts payable	20 000	00
	71 000	00		71 000	00

Interest is allowed at 5% per annum on capital, but no interest is charged on drawings. B and C receive salaries of R10 000 each per year, which they withdraw as required.

No proper records were kept by the partnership for the year ended 30 June 20*x*2. This information was, however, made available to you:

1 During the year R10 000 was spent on the property, which is regarded as capital expenditure.
2 A increased his capital by R10 000 on 1 January 20*x*2.
3 Accounts payable amounted to R30 000 on 30 June 20*x*2.
4 Accounts receivable amounted to R32 500 on 30 June 20*x*2 of which R2 500 should be written off as irrecoverable.
5 The value of inventory on 30 June 20*x*2 was R40 000.
6 On 30 June 20*x*2 the bank statement showed a favourable balance of R12 000, but a deposit of R1 000 was only credited in July and outstanding cheques amounted to R3 000.
7 Drawings for the year were:
   – A R5 000
   – B R7 500
   – C R10 000

You are required to:
1 Complete the current accounts (in full detail, in columnar form) in the general ledger of the partnership. Clearly show each partner's share of profit.
2 Prepare the statement of financial position of the partnership as at 30 June 20*x*2.

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Question 23.12

This information concerning the year ended 28 February 20*x*3 was extracted from the books of H. Jump and V. Spring: (Ignore VAT.)

1 Net profit, before taking into account the salaries of partners, interest on capital, interest on current accounts, and interest on drawings, amount to R25 765.

2 Salaries of partners:
- H. Jump R8 200
- V. Spring R6 920

3 Drawings:
- H. Jump R6 000
- V. Spring R4 000

4 Current accounts (as at 1 March 20*x*2):
- H. Jump (Dr.) R4 000
- V. Spring R3 000

These conditions are contained in the partnership agreement of H. Jump and V. Spring:

1 Their capitals are to remain unchanged at these amounts:
- H. Jump R36 000
- V. Spring R18 000

2 Each partner is to receive interest on capital at 12% per annum.

3 Drawings are subject to 10% per annum on daily balances. For the year ended 28 February 20*x*3, this is calculated as:
- H. Jump R600
- V. Spring R400

4 Interest on the balances of current accounts (as they appear at the beginning of each year) is to be calculated at 10% per annum.

5 The remainder of the profit or loss (after the above-mentioned have been brought into account) is to be shared in proportion to capital.

You are required to:
Prepare the current accounts of the partners for the year ended 28 February 20*x*3 as they should appear in the ledger. All the necessary adjustments need to be taken into account.

Question 23.13

The partnership of Alistair, Brian and Clyde does not keep separate capital and current accounts for the partners. The partnership agreement provided for:

1 Annual salaries to be paid to: Alistair R12 000, Brian R10 000 and Clyde R8 000.

2 Interest to be allowed or charged on opening capital account balances at 18% per annum.

3 Profits and losses to be shared in this ratio:
- Alistair 2
- Brian 2
- Clyde 1

This information is for the financial year ended 28 February 20*x*6: (Ignore VAT.)

- Profit for the year before allowing/charging interest on capital accounts but after allowing for partners' salaries amounted to R15 360.

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- The salaries have not yet been withdrawn by the partners.

	Alistair	Brian	Clyde
Opening balance on capital accounts	R24 000 *Dr.*	R30 000 *Cr.*	R4 000 *Dr.*
Drawings for the year	R10 000	R12 000	R6 000

You are required to:
Prepare the partners' capital accounts in the general ledger for the year ended 28 February 20*x*6.

Question 23.14

Eden and Stein were in partnership, sharing profits and losses in the ratio 2 : 1. Their abridged statement of financial position as at 31 March 20*x*5 was:

ASSETS			EQUITY & LIABILITIES		
Equipment at carrying value	5 600	00	Capital: E. Eden	5 000	00
Vehicles at carrying value	1 400	00	S. Stein	4 000	00
Inventory	3 500	00	Current accounts: E. Eden	2 000	00
Accounts receivable	6 500	00	S. Stein	(1 000	00)
Bank	1 500	00	Long-term borrowings	3 000	00
			Accounts payable	5 500	00
	18 500	00		18 500	00

- The partnership was sold to Diamond Ltd as a going concern. The company was incorporated with a registered capital of 20 000 ordinary shares of R1 each.
- The partnership paid R450 and Diamond Ltd R1 000 for expenses for the transfer.

The agreement was as follows:

1. Eden would take over one vehicle at book value, that is, R800, and Stein would take over the other vehicle at R1 100.
2. Diamond Ltd would take over all assets and liabilities with the exception of bank and vehicles.
3. The assets were taken over at these valuation amounts:
   - Goodwill R4 800
   - Equipment R5 000
   - Inventory at carrying value R3 500
   - Accounts receivable at carrying value less an allowance for bad debts at 10%.
4. Diamond Ltd upon taking transfer would immediately pay off the loan.
5. Diamond Ltd would pay R1 650 in cash and the rest in shares. The shares were divided between Eden and Stein in the profit-sharing ratio.
6. The available cash would be divided between Eden and Stein in the profit-sharing ratio. The shares would be divided between Eden and Stein in order to clear the outstanding capital accounts to nil.

You are required to:

1. Draw up the realisation account to show the necessary entries pertaining to the sale of the partnership.
2. Draw up the capital accounts of the partners (in columnar form) in the general ledger.

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Question 23.15

Charles, Diana and William are partners in a family business, CDW Partners. Their abridged statement of financial position as at 30 June 20*x*3 was: (Ignore VAT.)

ASSETS			EQUITY & LIABILITIES		
Land and buildings	25 000	00	Capital: Charles	10 000	00
Vehicles	15 000	00	Diana	20 000	00
Accumulated depreciation:			William	10 000	00
Vehicles	(4 000	00)	Current accounts: Charles	2 000	00
Accounts receivable	8 000	00	Diana	3 000	00
Allowance for bad debts	(900	00)	William	2 000	00
Inventories	11 900	00	Accounts payable	8 000	00
	55 000	00		55 000	00

Their partnership agreement states that Charles, Diana and William will share profits and losses in the ratio 2 : 2 : 1, and that goodwill will not be reflected as an asset.

On 30 June 20*x*3, Diana decided to withdraw from the partnership to start her own manufacturing business, and it was agreed that:

1 Theses assets would be revalued:
- Land and buildings R40 000
- Accounts receivable R7 000

2 The partners cancelled a life policy with a surrender value of R5 000. The proceeds were paid to Diana.

As the partnership did not have sufficient cash to pay Diana for her remaining share of the partnership, it was agreed that a loan account be created and she would be repaid in monthly instalments over the next 14 months, starting on 1 July 20*x*3.

4 It was agreed that the amount owing to Diana would be R29 960.

5 Charles and William agreed to share profits and losses equally in their new partnership.

On 2 July 20*x*3, Charles and William decided to dissolve the partnership.

All assets with the exception of accounts receivable were sold for R70 000.

You are required to:

1 Do the journal entries to record Diana's withdrawal from the partnership.

2 Do a calculation to show how cash should be distributed so that neither Charles nor William would be called upon to refund any cash received.

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Question 23.16

X, Y and Z were partners sharing profits and losses in the ratio 5 : 3 : 2. Their post-closing trial balance as at 30 June 20*x*1was: (Ignore VAT.)

POST-CLOSING TRIAL BALANCE AS AT 30 JUNE 20*x*1

Details	Fol.	Debit		Credit	
Capital: X	B1			4 000	00
Y	B2			490	00
Z	B3			2 000	00
Accounts payable	B4			3 500	00
Vehicles	B5	2 800	00		
Inventory	B6	1 700	00		
Accounts receivable	B7	3 500	00		
Cash in bank	B8	1 990	00		
		9 990	00	9 990	00

On 1 July, the partners decided to dissolve the partnership and, on realising the assets, to immediately distribute cash between themselves in such a way that a partner would under no circumstances be called on to refund any cash received.

In determining the amounts to be distributed, a sum of R100 was to be kept in the bank to meet possible contingencies.

Transactions for July 20x1:

1 Accounts receivable who owed R2 000 settled their accounts in full.
2 The accounts payable were settled in full for R3 400.
3 A car was sold for R400 (which was R300 less than its carrying value).
4 Y took inventory (which had cost R600) for R1 200.

You are required to:
Show how cash should be distributed to the partners on 31 July 20*x*1. As the partnership agreement is silent about an insolvent partner's deficiency, you may assume that the rule in Garner vs Murray applies in South Africa.

Question 23.17

Ron and Don are partners sharing profits and losses in the ratio of 3 : 2. On 30 June 20*x*5, their abridged statement of financial position was: (Ignore VAT.)

ASSETS			EQUITY & LIABILITIES		
Property	40 000	00	Capital: Ron	50 000	00
Machinery	20 000	00	Don	30 000	00
Inventory	24 000	00	General reserves	22 000	00
Accounts receivable	18 000	00	Accounts payable	12 000	00
Bank	12 000	00			
	114 000	00		114 000	00

On 1 July, it was agreed to admit Son into partnership. He was expected to bring in cash for R20 000, plus an additional amount for goodwill.

1 The partners decided to value goodwill at R24 000, but that goodwill was not to be shown as an asset in the statement of financial position and that no account for goodwill would be opened in the ledger. Any adjustment for goodwill, therefore, had to be made directly on capital account.

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2 Property was revalued at R50 000 and inventory at R22 000.
The three partners in the new partnership are to share profits and losses in this ratio: Ron = 5 : Son = 2 : Don = 1.
3 Ron and Don were to change their capital balances to be proportionate to that of Son in profit-sharing ratio. For this purpose separate loan accounts for Ron and Don were to be created.

You are required to:
1 Do the entries in the general journal to record the events described.
2 Prepare the statement of financial position of the new partnership.

Question 23.18

G, J and L were in partnership sharing profits and losses in the ratio 3 : 5 : 2. On 1 January 20*x*2, they decided to dissolve the partnership as J was personally insolvent. The partnership's post-closing trial balance at that date was:

POST-CLOSING TRIAL BALANCE AS AT 1 JANUARY 20*x*2

Details	Fol.	Debit		Credit	
Capital:					
G	B1			19 000	00
J	B2			6 000	00
L	B3			10 000	00
Current accounts:					
G	B4			1 000	00
L	B5			2 000	00
Loan L	B6			2 000	00
8% mortgage bond	B7			6 000	00
Accounts payable	B8			8 800	00
Goodwill (at cost)	B9	12 000	00		
Land and buildings (at cost)	B10	18 000	00		
Fixtures and fittings (at cost)	B11	4 000	00		
Accumulated depreciation: Fixtures	B12			1 600	00
Inventory	B13	10 050	00		
Accounts receivable	B14	6 500	00		
Allowance for bad debts	B15			500	00
Bank	B16	6 350	00		
		56 900	00	56 900	00

The realisation transactions are summarised as follows:
1 G agreed to take over the land and buildings for R20 000 and to assume liability for the mortgage bond.
2 The fixtures and accounts receivable were disposed of for R7 400 cash.
3 Inventory was sold by public auction for R6 350 cash.
4 Paid auctioneer's fee of R100.
5 As the tangible assets have been disposed of separately, the goodwill has no value.
6 Paid payables R8 400 in full settlement of their claims.
7 Divided the loss on realisation amongst the partners.
8 Paid L R2 000 for his loan.

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9 Divided J's deficiency amongst G and L (applying the rule in Garner vs Murray).
10 Distributed the remaining cash to the partners.

You are required to:

1 Assuming that the partnership makes use of a profit and loss on realisation account, prepare entries in the general journal to record:
- **a** The sale of the assets.
- **b** Payment of payables.
- **c** Division of the loss on realisation.
- **d** Payment of partner's loan.
- **e** Division of the insolvent partner's deficiency.
- **f** Distribution of cash to the partners.

2 Set up ledger accounts for cash in the bank, profit and loss on realisation, the partners' capital accounts, and record the appropriate entries for dissolving the partnership.

Question 23.19

This information appeared in the books of Mabel and Mary on 31 March 20*x*5. The partners share profits and losses in the ratio of 2 : 1.

ASSETS			**EQUITY & LIABILITIES**		
Goodwill	1 000	00	Capital		
Machinery	21 500	00	Mabel	80 000	00
Furniture	5 000	00	Mary	40 000	00
Vehicles	9 000	00	Current accounts		
Inventories	58 000	00	Mabel	4 000	00
Accounts receivable	69 500	00	Current liabilities		
			Bank overdraft	9 400	00
			Accounts payable	30 600	00
	164 000	00		164 000	00

On 31 March 20*x*5, the partners decided to dissolve the partnership and to sell its assets to Mark Ltd for R150 000.

1 All liabilities were settled by the partnership.
2 Payables were paid by cheque, R30 000.
3 Dissolution cost was paid by cheque, R100.
4 Mark Ltd paid the purchase price by issuing 12 000 fully paid shares of R10 each to the partners and the difference in cash.
5 The partners are to divide the shares in their profit-sharing ratios.

Cash must be paid in or withdrawn by the partners so that their capital accounts close.

You are required to:

Use these ledger accounts to show the dissolution of the partnership:

1 Bank account.
2 Profit and loss at dissolution.
3 Capital accounts of Mabel and Mary.
4 Mark Ltd's account.

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24 CLOSE CORPORATIONS (CCs)

Note: No new close corporations (CCs) may be registered in accordance with the Companies Act 71 of 2008. However, existing CCs are permitted to continue recording and reporting. Thus, CCs are still relevant.

Chapter objectives

By the end this chapter, you should be able to:

- Describe the characteristics of a close corporation (CC).
- List the requirements for the formation of a CC.
- Compare a CC with a company and a partnership.
- State the circumstances in which a member can lose his limited liability.
- Disclose the financial statements of a CC to comply with the Close Corporations Act and IFRS.

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1 Introduction

The close corporation (CC), introduced by the Close Corporations Act 69 of 1984, is an alternative organisational form. This type of entity provides a simple and relatively inexpensive legal form for small business.

A CC differs from a sole proprietor and partnership as it has a separate legal identity and gives limited liability to its owners. On the other hand, the onerous statutory requirements of a limited company are not required for a CC.

This chapter deals with:

1. The characteristics of a CC. To explain the characteristics, the CC is compared to a private company and a partnership.
2. The formation procedures, the membership requirements and the appointment and duties of the accounting officer, as required by the Close Corporations Act, are summarised and discussed briefly.
3. The accounting and disclosure requirements for a CC are described and shown with an example.

2 Characteristics of a close corporation

The main characteristics of a close corporation are best shown by comparison to a partnership.

Some important differences between these types of entities are highlighted in Figure 24.1, which should be studied in conjunction with the explanation that follows.

Figure 24.1

COMPARISON OF THE MAIN CHARACTERISTICS OF A CLOSE CORPORATION AND A PARTNERSHIP

Close corporation	Partnership
Separate legal identity	Not a legal person
Unlimited life	Limited life
Members have limited liability for debts	No limited liability Partners jointly and severally liable for debts
Potential loss of limited liability in certain cases	Not applicable
Solvency and liquidity requirements	None
Members' interest	Partners' capital accounts
Maximum of 10 members Minimum of 1 member	Maximum of 20 partners Minimum of 2 partners
Members may only be individuals (natural person)	Partners may be individuals (natural person) or companies (juristic person)
Members conduct business	Partners conduct business
Transferability of members' interest restricted	New partnership formed when partners change
Taxation paid at a fixed rate applicable to companies	Individual partners are taxed
Distributions of income to members attract DWT of 15% payable by CC	Income taxed in hands of partners
Dividends received exempt from tax	Partnership not taxed

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Separate legal identity

A close corporation is a separate legal person and all assets and liabilities are registered, and business is conducted in the name of the CC. Consequently, the life of the CC is not affected by the life of its members; it has an unlimited life similar to that of a company. This differs from a partnership where the life of the partnership is directly affected by the life of the partners.

A change in the composition of the partners in a partnership will result in a new agreement and thereby in a new partnership, whereas a change in the members in a CC requires merely the lodging of an Amended Founding Statement.

Limited liability

A close corporation, provides its members/shareholders with a limited liability for the debts of the entity. The liability of the members is limited to their investment in the CC and payables may only lodge claims against the assets of the CC. If the assets are insufficient to cover the claims, the losses are borne by the payables.

The capital maintenance rule, which protects the payables of companies, does not apply to CCs. A CC may, for example, buy its own members' interest. The Close Corporations Act provides for the loss of limited liability, whereby person become jointly and severally liable for the debts of the CC, if certain provisions of the Close Corporations Act are contravened.

The following circumstances are mentioned in the Act:

- Where the name of the CC is in any way used without the abbreviation CC or BK, any member of the CC who is responsible for the omission of such abbreviation shall be liable to any person who enters into any transaction with the CC.
- Where any member fails to pay money or to deliver or transfer property to the CC as a member's contribution, he/she will be liable for every debt of the CC incurred from its registration to the date of the actual payment, delivery or transfer of such money or property.
- Where the number of members of a CC exceeds the maximum of 10 for a period of six months, every such member shall be liable for every debt of the CC incurred while the number of members exceeded 10.
- Where a juristic person holds a member's interest in the CC in contravention with the Act, such juristic person shall be liable for every debt of the CC incurred during the time the contravention continues.
- Where the CC makes a payment for the acquisition of a member's interest in contravention with the Act, every person who is a member at the time of such payment and who is aware of the making of such payment, shall be liable for every debt of the CC incurred prior to the making of such payment.
- Where the CC gives financial assistance in connection with any acquisition of a member's interest in contravention of the Act, every person who is a member at the time of the giving of such assistance and who is aware of the giving of such assistance, shall be liable for every debt of the CC incurred prior to the giving of such assistance.
- Where a person takes part in the management of the business of the CC while disqualified from doing so in terms of the Act, that person shall be liable for every debt of the CC that it incurs as a result of his participation in the management of the CC.
- Where the office of accounting officer of the CC is vacant for a period of six months, any person who at any time during that period was a member and aware of the vacancy, shall be liable for every debt of the CC incurred during the existence of the vacancy.

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Solvency and liquidity

The provision for loss of limited liability protects the payables to some extent, as a CC may not, for example, distribute profits or repay contributions to members when the CC does not meet the solvency and liquidity requirements.

Such payments will result in a loss of limited liability to the members and payables may then recover debts from either the CC or any of the members.

The Close Corporations Act requires specifically that solvency and liquidity requirements be met before certain payments are made. These solvency and liquidity requirements are:

- The CC's assets, fairly valued, should exceed all its liabilities, after such payment is made.
- The CC should be able to pay its debts as they become due in the ordinary course of business.
- Such payments will in the particular circumstances not render the CC unable to pay its debts as they become due in the ordinary course of its business.

Payments made to members by a CC will, therefore, be restricted by the solvency and liquidity requirements. These payments do not include salaries, interest, rentals or payables repayments. A member is liable to refund the CC the amount of any payment made contrary to these requirements.

Members' interest

While a company has shareholders with share capital and reserves and a partnership has partners with capital and current accounts, a CC has members with members' interest.

Members' interest comprises contributions, revaluations and undrawn income. Members' contributions are usually the capital amounts paid by members to the CC as specified in the Founding Statement. Members' contributions may be paid in cash, assets or services rendered to the CC in connection with its formation.

The revaluation surplus arises when certain assets are revalued by the CC. Undrawn income is the balance of accumulated profit or losses at the end of a financial year after taxation and distributions to members.

A member's interest in a CC is expressed as a percentage and the total members' interest is 100%. The percentage interest of a member indicates the percentage share of profits and distributions of profits that the member is entitled to. Members' contributions need not be in the same proportion of members' percentage interest.

Other pertinent characteristics

- The membership of a CC is limited to 10 members. As already mentioned, should a CC have more than 10 members for a period exceeding six months, all members may lose their limited liability.
- The members of a CC, with two minor exceptions identified in Section 29 of the Close Corporations Act, can only be natural persons. A company, which is a juristic person, may not become a member of a CC. A CC may, however, hold shares in a company.
- Each member may act on behalf of the CC and participate in the running of the business. As ownership and management are both vested in the members of the CC, directors are not appointed.
- The transfer of members' interest is restricted, as no person can become a member of a CC without the consent of all members or the meeting of the requirements in the association agreement.

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  - A CC may purchase a member's interest or may give the necessary financial assistance for the purchase of a member's interest.
  - The solvency requirements mentioned earlier must be met when financial assistance is given.
- Both the company and the CC pay taxation at a flat rate, currently 28%. In a company, payments of income after taxation, such as dividends to shareholders, are taxed by way of a withholding tax. While withholding tax is withheld by the CC, it is the responsibility of the shareholder.
  - The payments to members of a CC (also known as distributions) are also taxed.
  - It should be noted, however, that any remuneration such as salaries, interest and rentals paid to members will remain taxable in their hands.
- The amounts paid from profits and undrawn income to the members are at the discretion of the members themselves, restricted by the solvency and liquidity requirements of the Act.

3 Membership

The membership of a CC is limited to a maximum of 10 natural persons. An individual may become a member of a CC on:

- Acquiring the existing interest of a member.
- Making a new contribution to the CC.

An Amended Founding Statement is lodged with the Registrar of close corporations to record changes in members.

Each member may be given a certificate of membership in the CC. Two individuals are prohibited form holding a single member's interest.

The internal relationship among members in the CC is regulated to a large extent by the Close Corporations Act. Members may, however, enter into a written association agreement, the contents of which are similar to a partnership agreement, to regulate any further matters not dealt with in the Act.

You should be able to complete Questions 24.1 to 24.6.

4 Accounting and disclosure requirements

Accounting officer

Every close corporation must appoint an accounting officer, who is a member of a recognised professional acounting body. Dentists and doctors, who are members of a profession, can't necessarily become accounting officers. The professional body must require entrance examinations in accounting and related studies and must have the power to take disciplinary action against members guilty of negligence.

The Minister identifies the professions whose members qualify to be appointed as accounting officers of CCs in the *Government Gazette*. The accounting officer must:

- Determine whether the annual financial statements are in agreement with the accounting records of the CC.
- Determine the accounting policies applied in the preparation of the annual financial statements.
- Report to the members of the CC for the above. Details of any contraventions to the

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Act should be included in the report. If the accounting officer is a member or employee of the CC, this fact should also be included in the report.

Accounting requirements

Each close corporation must maintain the accounting records necessary to fairly present the state of affairs and business of the CC and to explain the past financial performance and present financial position of the business.

These accounting records are similar to those maintained by a company and should also include records relating to:

- Contributions by members.
- Loans to and from members.
- Payments to members and undrawn income.
- The valuation of inventory at year end.
- Vouchers supporting entries in the records.

The annual financial year of a CC is stated in the Founding Statement. No audit is required on the accounting records of a CC. The accounting officer should only ensure that these financial statements are in agreement with the accounting records.

The members of a CC, usually being both the owners and managers, generally constitute the main users of the financial statements. The accounting and reporting requirements of these members will largely determine what information, in addition to the minimum requirements of the Close Corporations Act, will be contained in the financial statements.

The actual accounting entries, specific to a CC, required to record transactions such as members' contributions, members loans and distributions to members are shown in Example 24.1.

Example 24.1

Below is the trial balance of Industrial Laboratories CC (1986/000027/50) for the year ended 30 June 20*x*6.

TRIAL BALANCE INDUSTRIAL LABORATORIES CC AS AT 30 JUNE 20*x*6

Details	Fol.	Debit		Credit	
Real Accounts Section					
Members' contributions	B1			90 000	00
Surplus on revaluation of land and buildings	B2			5 000	00
Loans from members					
Bee	B3			50 000	00
Gee	B4			100 000	00
Long-term loans	B5			45 000	00
Land and buildings (at valuation)	B6	61 000	00		
Furniture (cost was R70 000)	B7	30 000	00		
Inventory	B8	280 000	00		
Accounts receivable	B9	300 000	00		
Investment	B10	50 000	00		
Accounts payable	B11			320 000	00
Bank	B12	115 000	00		
Nominal Accounts Section					
Sales	N1			1 800 000	00
Cost of sales	N2	1 400 000	00		
Accounting officer's fee	N3	5 000	00		

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Administration expenses	N4	12 000	00		
Advertising	N5	15 000	00		
Bad debts	N6	4 000	00		
Depreciation	N7	7 000	00		
Lease costs	N8	22 000	00		
Office expenses	N9	16 000	00		
Salaries and wages (incl. Bee R20 000 & Gee R30 000)	N10	88 000	00		
Travelling costs	N11	11 000	00		
Income from investment	N12			4 000	00
Interest received	N13			15 000	00
Interest paid (including Bee R4 000 & Gee R8 000)	N14	24 000	00		
Undrawn income	N15	11 000	00		
		2 440 000	00	2 440 000	00

This additional information relates to transactions that have not yet been entered in the trial balance:

1 The members' contribution consists of the contributions of members Bee and Gee who each contributed 50%. Profits are also shared in this ratio.

2 Further members' contributions were made during the year in their profit-sharing ratio amounting to R30 000 in cash.

3 During the year land and buildings were revalued to R81 000.

4 An amount of R20 000 was repaid to member G on his loan account.

5 The provision required for taxation for the year was calculated as being R105 000. (Ignore the effect of DWT.)

6 Distributions of profits to members at year end consisted of:

Bee	25 000	00
Gee	25 000	00
	50 000	00

7 An amount of R20 000 of the long-term loans will be repayable in the next financial year.

You are required to:
Complete the journal entries for the above transactions.

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Day	Details	Fol.	Debit		Credit	
30/06	Bank	B12	30 000	00		
	Members' contributions: Bee	B1			15 000	00
	Members' contributions: Gee	B1			15 000	00
	Members made an additional contribution					
	Land and buildings	B6	20 000	00		
	Surplus on revaluation of land and buildings	B2			20 000	00
	Asset revaluation					
	Loans from members: Gee	B3	20 000	00		
	Bank	B12			20 000	00
	Repayment on loan to member					
	Income taxation	N16	105 000	00		
	SARS: Income tax payable	B13			105 000	00
	Provision for taxation					

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	Distribution payable to members: Bee	B14	25 000	00		
	Distribution payable to members: Gee	B14	25 000	00		
	Bank	B12			50 000	00
	Distributions of net income to members					
	Long-term loans	B5	20 000	00		
	Short-term loans	B15			20 000	00
	Transfer of short-term portion of long-term loans					

Disclosure requirements

The Close Corporations Act requires that financial statements should consist of:

- A statement of financial position with notes.
- A statement of profit or loss & other comprehensive income with notes.

A statement of changes in equity, a statement of cash flows, auditors' report and directors' report are not specifically required.

The disclosure of a statement of cash flows and a statement of changes in equity is, however, required indirectly as per Section 58(2)(b).

A CC has no directors and an audit is not required.

The aggregate amounts and movements during the year should be stated for the following:

- Contributions by members.
- Undrawn income.
- Revaluations of fixed assets.
- Amounts of loans to members.
- Amounts of loans from members.

Comparative figures are not required, but may be included in financial statements as good accounting practice and to enhance the use of the financial statements to the members. The financial statements must be signed and approved by each member of the CC.

Although not required as minimum disclosure by the Close Corporations Act, the guide on CCs, issued by the South African Institute of Chartered Accountants (SAICA) recommends further that a note to the statement of profit or loss & other comprehensive income should summarise any transactions with members included in the determination of net income.

These transactions could include interest paid, interest received, rent paid, and salaries paid during the year.

Example of minimum disclosure requirements

The trial balance and adjusting journal entries in Example 24.1 will now be used to illustrate the disclosure requirements of the financial statements of a close corporation (shown in Figure 24.2 on the next page). These financial statements contain more information than required by the Close Corporations Act.

The needs and requirements of the members of the CC, the South African Revenue Service and the members' bankers, being the main users of the financial statements, will be the primary consideration when drafting the financial statements of the CC.

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Figure 24.2

Industrial Laboratories CC (86/00027/50)
FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20*x*6

Contents

1 *Approval*
2 *Accounting Officer's Report*
3 *Statement of Financial Position*
4 *Statement of Profit or Loss & Other Comprehensive Income*
5 *Statement of Changes in Equity*
6 *Notes to Financial Statements*

Approval

The financial statements have been approved by both members on 31 August 20x6 and are signed by them:

Boris Bee	Goran Gee
B. Bee	*G. Gee*

Accounting Officer's Report

I have performed the duties of accounting officer to Industrial Laboratories CC for the year ended 30 June 20x6 in accordance with IFRS appropriate to the business of the CC, and the requirements of the Close Corporations Act of 1984.

No audit has been carried out, and no opinion is expressed as to fair presentation in the financial statements.

Based on the performance of my duties, I report that the financial statements are in agreement with the accounting records at 30 June 20x6 and have been prepared in accordance with the accounting policies set out in Note 1.

I am an employee of Industrial Laboratories CC and all the members have consented in writing to my appointment as accounting officer.

Phil Marx	1 September 20x6
Name	*Date*
	CA (SA)
	Qualification

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Industrial Laboratories CC
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20x6

	Notes	20x6	
Sales (net)		1 800 000	00
Cost of sales		(1 400 000	00)
Gross profit		400 000	00
Other operating income		19 000	00
Income from unlisted investment		4 000	00
Interest income		15 000	00
Gross operating income		419 000	00
Operating expenses		(180 000	00)
Accounting officer's fee		5 000	00
Administrative expenses		12 000	00
Advertising		15 000	00
Bad debts		4 000	00
Depreciation		7 000	00
Lease costs		22 000	00
Office expenses		16 000	00
Salaries and wages	2	88 000	00
Travelling costs		11 000	00
Operating profit before interest and taxation		239 000	00
Interest expense	2	(24 000	00)
Operating profit before taxation		215 000	00
Taxation	1	(105 000	00)
NET PROFIT FOR THE PERIOD		110 000	00

Industrial Laboratories CC
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x6

	Notes	20x6	
ASSETS			
Non-current assets		161 000	00
Property, plant and equipment	4	111 000	00
Investments/Financial assets	5	50 000	00
Current assets		655 000	00
Inventories	6	280 000	00
Accounts receivable		300 000	00
Cash and cash equivalents		75 000	00
TOTAL ASSETS		816 000	00
EQUITY AND LIABILITIES			
Members' interest and reserves		216 000	00
Members' contributions	7	120 000	00
Reserve – revaluation of land and buildings	7	25 000	00
Retained earnings	7	71 000	00
Non-current liabilities		155 000	00
Loans from members	2	130 000	00
Long-term borrowings	3	25 000	00
Current liabilities		445 000	00
Accounts payable		320 000	00
Short-term borrowings		20 000	00
Taxation payable		105 000	00
TOTAL EQUITY AND LIABILITIES		816 000	00

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Industrial Laboratories CC
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20*x*6

	Contribution by:				Revaluation of land and buildings		Undrawn profits		Total	
	Bee		Gee							
Balance 30 June 20x5	45 000	00	45 000	00	5 000	00	11 000	00	106 000	00
New contributions	15 000	00	15 000	00					30 000	00
Net income for the year							110 000	00	110 000	00
Distributions							(50 000	00)	(50 000	00)
Surplus on revaluation					20 000	00			20 000	00
Balance 30 June 20x6	60 000	00	60 000	00	25 000	00	71 000	00	216 000	00

	Balance 30 June 20x5		Advances during year		Repayment during year		Balance 30 June 20x6	
Loans from members								
Bee	50 000	00	0	00	0	00	50 000	00
Gee	100 000	00	0	00	(20 000	00)	80 000	00
	150 000	00	0	00	(20 000	00)	130 000	00

	Bee		Gee		Total	
Comprising						
Members' contributions	60 000	00	60 000	00	120 000	00
Revaluation surplus	12 500	00	12 500	00	25 000	00
Undrawn income	35 500	00	35 000	00	71 000	00
Loans	50 000	00	80 000	00	130 000	00
	158 000	00	188 000	00	346 000	00

Alternatively, the information can be provided in the format of a statement of members' net investment.

Industrial Laboratories CC
STATEMENT OF MEMBERS NET INVESTMENT FOR THE YEAR ENDED 30 JUNE 20*x*6

	Bee		Gee		Total	
Members' interest	50%		50%		100%	
Members' contribution	60 000	00	60 000	00	120 000	00
At beginning of year	45 000	00	45 000	00	90 000	00
New contributions	15 000	00	15 000	00	30 000	00
Surplus on revaluation of land and buildings	12 500	00	12 500	00	25 000	00
Opening balance	2 500	00	2 500	00	5 000	00
Movement for the year	10 000	00	10 000	00	20 000	00
Undrawn income	35 500	00	35 500	00	71 000	00
Net income for the year	55 000	00	55 000	00	110 000	00
Less: Distributions	(25 000	00)	(25 000	00)	(50 000	00)
Add: Undrawn income at beginning of year	5 500	00	5 500	00	11 000	00
Total members' interest	108 000	00	108 000	00	216 000	00
Loans from members	50 000	00	80 000	00	130 000	00
Opening balance	50 000	00	100 000	00	150 000	00
Repayment to member	0	00	(20 000	00)	(20 000	00)
NET INVESTMENT	158 000	00	188 000	00	346 000	00

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Industrial Laboratories CC
NOTES TO THE FINANCIAL STATEMENTS OF 30 JUNE 20*x*6

1 *Accounting policies*

These financial statements are prepared on the historical cost basis, modified by the revaluation of certain land and buildings, in accordance with these principal accounting policies. The accounting policies adopted are consistent with those of the previous year.

Non-current assets
Land and buildings are not depreciated and are revalued by the members every three years. Furniture is valued at cost and is depreciated on a straight-line basis over the useful lives of the assets.

Inventories
Inventory is valued at the lower of cost net realisable value and on a first-in-first-out basis.

Income
Gross income, which excludes value-added tax (VAT), comprise amounts invoiced for goods sold to third parties.

Investments
Investments are shown at cost.

2 *Transactions with members*

	Bee		Gee		Total	
Interest paid	4 000	00	8 000	00	12 000	00
Salaries	20 000	00	30 000	00	50 000	00
	24 000	00	38 000	00	62 000	00

3 *Long-term borrowings*

Note required giving detail of interest rate, instalments, repayment period and whether secured or not and the short-term portion of the loan.

4 *Non-current assets*

Note required giving details of cost price, valuation, accumulated depreciation and book value.

5 *Investments*

Note giving details or type of shares – listed or unlisted, name of company, basis of valuation and amount and members' valuation or market value and whether the basis of valuation is consistent.

6 *Inventories*

Describe the composition of inventory.

Explanation
It may be appropriate to include a statement of cash flows and comparatives.

You should be able to complete Questions 24.7 to 24.14.

Reminder

It is only necessary to disclose the notes for members' contributions, loans to and loans from members.

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5 Chapter illustrative example

These balances and totals were found in the books of Matabele CC as at 31 December 20x7:

Members' contributions	70 000	00
Equipment (at cost)	42 700	00
Accumulated depreciation: Equipment (as at 31 December 20x7)	11 425	00
Land and buildings (at valuation)	70 000	00
Surplus at revaluation of land and buildings	10 000	00
Investment at cost: 7 500 ordinary shares in Oman (Pty) Ltd (members' valuation R10 000)	9 000	00
Loan from member: M. Mans (1 January 20x7)	5 000	00
Interest-free loan to member: L. Koorts (1 January 20x7)	2 000	00
Inventory (as at 31 December 20x7)	10 150	00
Provisional tax payments	1 000	00
Accounts receivable	12 000	00
Accounts payable	9 250	00
Gross sales	63 850	00
Sundry expenses	10 200	00
Rent income	6 200	00
Dividends received from Oman (Pty) Ltd	1 700	00
Accumulated profit (as at 1 January 20x7)	12 975	00
Cost of sales	33 350	00

Additional information:

1 Sundry expenses consist of:

Depreciation: Equipment	1 500	00
Salaries to members	6 000	00
Remuneration to accounting officer	950	00
Interest paid on member's loan	350	00
Interest paid on other loan already redeemed	250	00
Administrative and selling expense (R150 paid on January 20x8)	1 150	00

2 Inventory is valued at the lowest of cost or net realisable value on a FIFO basis.

3 The members have decided to share R4 000 of the income of 20x7 among themselves.

4 Provision for tax amounting to R2 600 must still be made for the present financial year. (Ignore DWT.)

5 The loan to L. Koorts is interest free. During the year the CC lent L. Koorts a further R700 and he repaid R1 100 on the above loan.

6 Interest was paid at 7% per annum on the loan from M. Mans and during the year R400 was paid.

7 The three members of the CC are M. Mans, L. Koorts and N. North. Their members' contributions were in the same ratio as their interest, that is, 1 : 2 : 1 respectively.

The contributions of M. Mans and L. Koorts were fully paid up, but N .North still owed R5 000 for his contribution.

You are required to:
Draft the statement of financial position and statement of profit or loss & other comprehensive income for Matabele CC for the year ended 31 December 20x7 according to IFRS.

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Matabele CC
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20x7

	Notes	20x7	
Sales (net)		63 850	00
Cost of sales		(33 750	00)
Gross profit		30 500	00
Other operating income		7 900	00
Income of unlisted investment: Dividends received		1 700	00
Rent income		6 200	00
Gross operating income		38 400	00
Operating expenses		(9 450	00)
Depreciation		1 500	00
Salaries and wages		6 000	00
Remuneration – accounting officer		950	00
Administration and selling expenses		1 000	00
Operating profit before interest and taxation		28 950	00
Interest expense		(600	00)
Interest on member's loan		(350	00)
Interest on other loan already redeemed		(250	00)
Operating profit before taxation		28 350	00
Taxation		(2 600	00)
NET PROFIT FOR THE PERIOD		25 750	00

Matabele CC
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x7

	Notes	20x7	
ASSETS			
Non-current assets		111 875	00
Property, plant and equipment		101 275	00
Investments/Financial assets – unlisted Oman (Pty) Ltd		9 000	00
Loans to members	3	1 600	00
Current assets		22 300	00
Inventories		10 150	00
Accounts receivable (12 000 + 150)		12 150	00
Cash and cash equivalents		0	00
TOTAL ASSETS		134 175	00
EQUITY AND LIABILITIES			
Members' interest and reserves		114 725	00
Members' contributions		70 000	00
Reserve – revaluation of land and buildings		10 000	00
Retained earnings (25 750 + 12 975 – 4 000)		34 275	00
Non-current liabilities		4 600	00
Loans from members	2	4 600	00
Long-term borrowings		0	00
Current liabilities		14 850	00
Accounts payable		9 250	00
Distribution payable to members		4 000	00
Taxation payable (2 600 – 1 000)		1 600	00
TOTAL EQUITY AND LIABILITIES		134 175	00

* Land and buildings 70 000 + Machinery and equipment 31 275 (42 700 – 11 425) = 101 275

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Notes to the financial statements

1 *Percentage members' interest, interest and contributions made by members are*

Member	Members' interest %	Contribution by members	Contribution owed
M. Mans	25	18 750	–
L. Loots	50	37 500	–
N. North	25	13 750	5 000
	100	70 000	5 000

2 *Loans from members*

7% Interest per annum was paid on the following loan:

	Balance 1 Jan. 20x7	Advances during year	Repayment during year	Balance 31 Dec. 20x7
Loans from members				
M. Mans	5 000 00	0 00	400 00	4 600 00

3 *Loans to members*

The following loan to L. Koorts was interest free:

	Balance 1 Jan. 20x7	Advances during year	Repayment during year	Balance 31 Dec. 20x7
Loans to members				
L. Koorts	2 000 00	700 00	(1 100 00)	1 600 00

6 Summary

The close corporation is an organisational form most suited to small businesses as it gives members the protection of limited liability without the cost and complexity associated with companies.

The Close Corporations Act is to a large extent self-regulating as members of a CC may lose their limited liability and become jointly and severally liable for debts if certain sections of the Act are contravened.

A further restriction is placed on certain payments as the CC is required to meet the solvency and liquidity requirements of the Act. These two requirements safeguard, to a large extent, the interests of the payables of a CC.

One of the main differences between a company and a CC is that shareholders and directors are replaced by members, each of whom may be actively involved in conducting the business of the CC. The membership is restricted to 10 members and they may only be natural persons.

The Close Corporations Act requires the financial statements to consist of a statement of financial position and statement of profit or loss & other comprehensive income with relevant notes. The statement of cash flows and statement of changes in equity are included to conform with IFRS and the Companies Act of 2008.

The balances and movements should also be disclosed in total on the accounts for:

- Contributions by members.
- Undrawn income.
- Revaluation of fixed assets.
- Loans to members.
- Loans from members.

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QUESTIONS

Question 24.1

List the circumstances under which the members of a CC may lose their limited liability as stated in sections 63 and 64 of the Close Corporations Act.

Question 24.2

What information should be contained in the Founding Statement of a CC?

Question 24.3

Discuss the rights of payables in a partnership and a close corporation, if liabilities exceed assets.

Question 24.4

List the advantages and disadvantages of a CC as a form of business entity.

Question 24.5

Define these terms:

- Undrawn income.
- Association agreement.
- Founding Statement.
- Members' interest.
- Limited liability.
- Accounting officer.

Question 24.6

Alpha, Beta and Gamma decided to form Delta CC to market toys. The members' contributions and interests specified in the Founding Statement, are:

Member	Contribution	Interest
Alpha	Cash R60 000	55%
	Land and building valued at R220 000	
Beta	Cash R80 000	20%
	Services in connection with the formation of the CC, valued at R4 000	
Gamma	Cash R120 000	25%

Beta does not have R80 000 available in cash. He will, therefore, contribute R30 000 on the date of incorporation and the balance within two months of this date. The CC was incorporated on 1 July 20*x*5.

You are required to:
Prepare the journal entry for the founding of Delta CC.

Question 24.7

On 1 November 20*x*6, Mr ABC formed ABC Textiles CC. These balances and totals were available on 28 February 20*x*7:

Accounting officer's remuneration	500	00
Accounts receivable	10 530	00
Accounts payable	1 120	00
Advertising	210	00

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Bank balance	8 919	00
Bank charges	30	00
Burglar alarms	214	00
Depreciation	108	00
Formation costs	280	00
Furniture (at cost)	1 108	00
Vehicles (at cost)	3 000	00
Accumulated depreciation: Furniture	8	00
Accumulated depreciation: Vehicles	100	00
Funds at call	51	00
Insurance	200	00
Interest received	500	00
Licences	100	00
Loan from member (interest free)	39 100	00
Maintenance	248	00
Members' contribution	500	00
Vehicle expenses	1 084	00
Printing and stationery	410	00
Purchases	25 700	00
Removal costs	100	00
Rent paid	2 082	00
Gross sales	13 800	00
Sign rental	10	00
Tea and coffee	94	00
Telephone and electricity	150	00

Additional information:

- Closing inventory on 28 February 20*x*7 was valued at R16 500. There was no opening inventory.
- Mr ABC contributed on 1 November 20*x*6:

Members' contribution	500	00
Loan to CC	40 100	00
	40 600	00

- Non-current assets are depreciated on the reducing-balance basis at these rates:
  - Furniture 10%
  - Vehicles 20%
- Formation costs should be written off.

Assume a tax rate of 28% and dividends tax of 15% applies.

You are required to:
Prepare the financial statements for ABC Textile CC for the period ended 28 February 20*x*7.

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Question 24.8

Bob and Rob decided to start their own CD and tape shop and formed a CC, which was incorporated on 1 July 20*x*8. They agreed to invest:

Member	Interest	Initial cash contribution
Bob	70%	40 000
Rob	30%	5 000

In addition:

- Bob is to contribute land and buildings valued at R50 000.
- Rob is to contribute a delivery van valued independently at R14 000.
- It was decided that land and buildings were not to be depreciated, but were to be revalued every year on 31 December.
- Vehicles are to be depreciated on a straight-line basis over five years.

This information is available for their first financial year ended 30 June 20*x*9:

1 On 1 August 20*x*8, the CC bought R15 000 worth of hi-fi and CD equipment to be used in the shop.
- To finance this purchase, Bob made a loan to the CC of R10 000.
- The balance was financed through a bank loan, repayable after three years.
- The equipment is to be depreciated on the straight-line basis over 5 years.

2 On 31 December 20*x*8, Bob made an additional contribution of R5 000.
3 On 31 December 20*x*8, the land and buildings were revalued from R50 000 to R70 000.
4 On 30 June 20*x*9, the CC made a loan to Rob of R1 000, repayable within 12 months.
5 Inventory is valued on the FIFO basis, and shown in the books at the lower of cost or net realisable value. Inventory at 30 June 20*x*9 was valued at R15 000.
6 On closing off the income and expense accounts to the profit and loss account, the net profit before tax was R32 300. The tax rate is 50%. (Ignore DWT.)
7 Distributions for the year totalled R14 000.
8 All transactions were for cash, and the closing bank balance was R52 850.

You are required to:

1 Prepare a statement of financial position for the CC on 1 July 20*x*8 (with a note for the members' net investment statement).
2 Entries for the above transactions for the year (assume entries for depreciation, inventory and interest have already been posted).
3 Statement of financial position and statement of changes in equity at 30 June 20*x*9.

Question 24.9

Below is the trial balance for Rahe CC (for the year ended 31 March 20*x*3):

Rahe CC
TRIAL BALANCE AS AT 31 MARCH 20*x*3

Details	Note	Debit		Credit	
Members' interest					
Rahar				4 500	00
Hennie	(1)			2 500	00
Undrawn income – 1 April 20*x*2				80 000	00

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Loans from members:					
Rahar				250 000	00
Hennie				300 000	00
Equipment					
Valuation		80 000	00		
Accumulated depreciation				16 000	00
Inventory (31 March 20*x*3)		440 000	00		
Revaluation reserve: Equipment				20 000	00
Land and buildings		300 000	00		
Mortgage bond over land and buildings				100 000	00
Accounts payable				674 500	00
Bank and cash balance		30 000	00		
Investment		10 000	00		
Accounts receivable		660 000	00		
Sales				1 774 500	00
Cost of sales		1 400 000	00		
Salaries	(2)	240 000	00		
Interest received				4 000	00
General expenses		30 000	00		
Depreciation: Equipment		6 000	00		
Administration expenses		30 000	00		
		3 226 000	00	3 226 000	00

Additional information:

1. Hennie contributed R2 000 at the beginning of the current year. No entry has been made. As a result, members agreed to share all profit and losses equally, including those relating to prior periods.
2. A non-refundable cash advance of R2 000 was paid to Rahar for his rent. He relocated from Durban to be a participating member of the CC. This was included in general expenses.
3. Interest of 1% per annum on loans from members has to be provided. The members agreed that this interest would be paid out at the beginning of the year ending 31 March 20*x*4 and should not be accrued to a loan account.
4. R10 000 of the mortgage bond is payable during the coming year ending 31 March 20*x*4.
5. Distribution to members for the year amounts to R120 000 (no entry has been made).
6. Income tax is at a rate of 28%.

You are required to:

1. Prepare the statement of profit or loss & other comprehensive income of Rahe CC for the year ended 31 March 20*x*3.
2. Prepare the members' net investment statement for the year ended 31 March 20*x*3.
3. Prepare the statement of financial position of Rahe CC as at 31 March 20*x*3.

Question 24.10

Fairweather CC was incorporated on 30 June 20*x*7.

- The members (Messrs Fairly, Poorly and Mildly) each have a 33.33% interest.
- Profits and losses are shared in the same ratio as the capital contributions.

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Here is the post-adjustment trial balance of Fairweather CC as at 31 December 20*x*7 (financial year end):

Fairweather CC
POST-ADJUSTMENT TRIAL BALANCE AS AT 31 DECEMBER 20X7

Details	Debit		Credit	
Members' contributions			600 000	00
Profit			64 000	00
Land and buildings at valuation	390 000	00		
Revaluation of land and buildings			60 000	00
Machinery and equipment (at cost)	260 000	00		
Vehicles (at cost)	185 000	00		
Mortgage bond			280 000	00
Investments: Fixed deposit	40 000	00		
Loans from members:				
Fairly			36 000	00
Poorly			42 000	00
Mildly			28 000	00
Inventory (31 December 20*x*7)	110 000	00		
Bank	65 000	00		
Accounts receivable	95 000	00		
Accounts payable			35 000	00
	1 145 000	00	1 145 000	00

Additional information:

- These salaries were paid in cash to the members during the year:
  – Fairly R30 000
  – Poorly R30 000
  – Mildly R22 000
- The members' loans are unsecured and earn interest at a rate of 6% per annum based on the year's opening loan balance.
  – The loans for the members were made on the date of incorporation and interest should be credited to the loan accounts.
  – No provision has been made for the interest charged in the current year.
- The current profit represents the balance after distributions had been made to the partners.
  – The distributions of R12 000 per member were paid in cash.
  – No further members' contributions were made during the period.
- The 12% mortgage bond is secured over land and buildings and is repayable in equal instalments over 20 years commencing on 31 October 20*x*8.
  – Interest is payable half-yearly in arrears on 1 January and 1 July.
  – No accrual was made for the year ended 31 December 20*x*7.
- The CC uses the straight-line method of depreciation at 20% on vehicles and 15% on machinery and equipment.
  – All non-current assets were bought on the date of incorporation with the exception of a vehicle that cost R65 000 that was bought on 31 September 20*x*7.
  – Land and buildings are not depreciated.
- During the year, land and buildings were revalued by the members, increasing the original cost by R60 000. It is the policy of the CC to revalue land and buildings every five years.

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- Inventory is valued on the FIFO basis and consists of:

Raw materials	22 000	00
Work-in-progress (WIP)	16 000	00
Finished goods	72 000	00
	110 000	00

You are required to:
Prepare the statement of financial position for Fairweather CC for the period ended 31 December 20*x*7 in compliance with IFRS.

Question 24.11

The balances listed below are from the books of Inventive CC as at 31 December 20*x*7:

Accumulated profit 1 January 20*x*7	19 475	00
Members' contributions	105 000	00
Equipment	64 050	00
Accumulated depreciation: Equipment	17 100	00
Land and buildings	105 000	00
Surplus on revaluation of land and buildings	15 000	00
Investments at cost	13 500	00
Loan from member A. Abacus (1 January 20*x*7)	7 500	00
Loan to member: B. Baracus	3 000	00
Inventory as at 31 December 20*x*7	15 225	00
Accounts receivable	11 000	00
Accounts payable	13 900	00
Provisional tax payments	1 500	00
Gross profit	45 750	00
Sundry expenses	19 300	00
Rent received	9 300	00
Dividends received	2 550	00
Bank	3 000	00

Additional information:

- A distribution of R6 000 of the undrawn income for 20*x*7 is made to the members and credited to the loan accounts.
- Apply a current tax rate of 28%.
- Inventory is valued at the lowest of cost or net realisable value on a FIFO basis.
- Interest of R525 was paid on the member's loan from A. Abacus and an additional R200 should be accrued. The CC repaid R600 on 30 January 20*x*7.
- The loan to B. Baracus is interest free. The CC advanced B. Baracus a further R1 050 during the year, and he repaid R1 650 during the year.
- Income for the year comprised net sales to customers and amounted to R290 000.
- The three members of the CC were A. Abacus, B. Baracus and I. Ilias.
  - Their members' contributions were in the same ratio as their interest, being 25%, 50% and 25% respectively.
  - The contributions of A. Abacus and B. Baracus were fully paid up, but I. Ilias still owed an amount of R7 500 for his contribution.

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- Investments consist of:
  - 7 500 ordinary shares in Alto (Pty) Ltd bought for R10 000 during 20*x*6. (Members' valuation = R10 000.)
  - 3 000 ordinary shares in Efraim Industries (Pty) Ltd bought at a cost of R3 500 during 20*x*5. (Members' valuation = R7 000.)
- Sundry expenses consist of:

Salaries to members	9 000	00
Interest paid on member's loan	525	00
Remuneration to accounting officer	1 425	00
Interest paid	375	00
Administrative and selling expenses (including R225 for January 20*x*8)	1 725	00
Depreciation: Equipment	6 250	00

You are required to:

1 Prepare the statement of financial position and statement of profit or loss & other comprehensive income for Inventive CC for the year ended 31 December 20*x*7 according to IFRS.

Question 24.12

On 1 August 20*x*0, L. Challen and A. Wanyezi formed Technical Services CC to repair TV sets. It was agreed that profits and losses would be shared equally by the two members.

These members' transactions in relation to the CC *took place during the first year of operation*:

- On 1 August 20*x*0, each member agreed to make a capital contribution of R25 000.
  - Challen would contribute cash, whereas Wanyezi would contribute a vehicle valued at R12 000 and the balance in cash.
  - Wanyezi would pay his contribution immediately, whereas Challen would pay half the amount immediately and the balance on 31 October 20*x*0.
  - Challen and Wanyezi agreed that the services that each rendered before the formation of the business should be valued at R5 000. These amounts would be paid as a bonus on 1 August 20*x*1.
  - Challen brought spares valued at R15 000 into the business. This is not to be regarded as a capital contribution.
- On 30 September, Wanyezi advanced a three-year loan of R18 000 at an interest rate of 15% per annum to the business. Interest is to be calculated and capitalised annually on 30 June.
- On 31 October, Challen paid the balance of his capital contribution.
- On 2 January 20*x*1, the CC made a loan to Challen of R10 000.
- On 1 February, the members agreed on advice from their accountant to convert their capital contribution to loans, except for R1 000. An Amended Founding Statement was submitted to the Registrar.
- On 31 March, the members agreed that each would receive a monthly salary of R3 000 from April 20*x*1, payable on the last day of each month.
  - It was also agreed that, with retrospective effect, interest should be calculated at 20% per annum on members' long-term loan balances at the beginning of, and halfway through, each financial year.
  - This interest should be credited to the members' respective long-term loan accounts.

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- On 30 June, each member received a R7 500 distribution of profits.
- On 31 July, net income before members' salaries and interest amounted to R100 000. Taxation should be provided at 28%. A total distribution of R20 000 payable in August 20*x*1 was approved by the members.

For loans to and from members, the association agreement specifies that a short-term and a long-term loan account should be maintained for each member. Furthermore, loans bearing specific interest and repayment terms, such as the loan advanced by Wanyezi on 30 September 20*x*0, should be disclosed separately.

You are required to

1 Prepare journal entries for each of the transactions.

2 Prepare the statement of members' net investment and the statement of members' transactions at 31 July 20*x*1, the financial year end of the business.

Question 24.13

These balances were taken from the books of Amigo CC as at 30 June 20*x*2:

Members' contribution		
Mpho (60%)	300 000	00
Jansen (40%)	200 000	00
Loans to members		
Mpho	100 000	00
Jansen	60 000	00
Long-term loan	200 000	00
Loan from member – Jansen	180 000	00
Property, plant and equipment	700 000	00
Net profit – 1 July 20*x*1	200 000	00
Gross sales	2 000 000	00
Cost of sales	900 000	00
Operating expenses	106 000	00
Long-term investment	500 000	00
Inventories	500 000	00
Accounts receivable	400 000	00
Bank	164 000	00
Accounts payable	250 000	00

Additional information:

1 Mpho and Jansen, the only members, contributed R300 000 and R200 000 respectively during the year. These transactions must still be recorded.

2 Interest on the loans is to be accrued as:

- To members 15% p.a.
- From members 10% p.a.

3 Included in the operating expenses were the salaries of R20 000 and R30 000 paid to Mpho and Jansen respectively.

4 Property, plant and equipment were revalued at R300 000 above their carrying value.

5 Members decided to distribute 80% of the profit. Tax must be provided at 28%.

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You are required to:

1 Prepare the statement of profit or loss & other comprehensive income for Amigo CC for the year ended 30 June 20*x*2.

2 Prepare the members' net investment statement.

3 Prepare the note to the statement of profit or loss & other comprehensive income relating to transactions with members of Amigo CC for the year ended 30 June 20*x*2.

Question 24.14

These balances and totals are taken from the trial balances of Josa CC as at 28 February 20*x*2:

Details	Pre-adj. trial balance 20*x*2		Post-adj. trial balance 20*x*1	
Members interest				
– Joan	9 000	00	9 000	00
– Sam	6 000	00	6 000	00
Undrawn income	?		15 141	00
Member's loan – Joan			31 374	00
Plant and equipment at valuation (20*x*1 cost price)	8 670	00	29 031	00
Accumulated depreciation: Plant and equipment	870	00	21 798	00
Vehicles at cost	3 000	00	4 500	00
Accumulated depreciation: Vehicles	900	00	1 500	00
Inventory at year end	32 665	00	28 211	00
Accounts receivable	32 996	00	49 953	00
Short-term deposits	1 500	00	4 500	00
Bank and cash balance	755	00	936	00
Accounts payable	17 499	00	29 253	00
Provision for tax			3 078	00
Sales	211 500	00		
Purchases	126 000	00		
Purchases returned	740	00		
Sales returns	451	00		
Interest received	375	00		
Advertising	2 850	00		
Insurance	1 805	00		
Lease payments – vehicles	4 425	00		
Rent of premises	4 350	00		
Wages and other expenses	3 013	00		
Provisional tax	4 113	00		
Interest paid	1 760	00		
Salaries of members	48 000	00		
Commission paid	5 124	00		
Travelling expenses	1 145	00		
Depreciation				
Plant and equipment	870	00		
Vehicles	900	00		

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Additional information:

1 Distribution to members for the year, R4 500. (No entry has been made.)

2 The salaries paid to members were:
- Joan R27 000
- Sam R21 000

3 Provision must still be made for the remuneration of the accounting officer in the amount of R4 500.

4 The premises belong to one of the members, Sam.

5 The tax rate is 28% and provision for tax must still be made.

6 During the year, Joan lent R3 000 to the CC and the CC repaid R10 540 at the end of the year. All interest paid was for the loan.

7 The CC lent R7 500 to Sam on 1 March 20*x*2. Interest received relates to this loan. Sam repaid R3 000 on 28 February 20*x*2.

You are required to:

1 Prepare the statement of profit or loss & other comprehensive income of Josa CC for the year ended 28 February 20*x*2.

2 Prepare the note on transactions with members for the year ended 28 February 20*x*2.

3 Prepare the note to members' net investment statement for the year ended 28 February 20*x*2.

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25 MANUFACTURING CONCERNS

Chapter objectives

By the end of this chapter, you should be able to:

- Explain the different manufacturing costs:
  - material
  - labour
  - manufacturing overheads
- Explain the accounting procedures for a manufacturing concern, using the:
  - periodic inventory system
  - perpetual inventory system
- Identify the format of the statement of the cost of goods manufactured.

Chapter outline

1	INTRODUCTION	25 – 2
2	MANUFACTURING COSTS	25 – 3
3	ACCOUNTING PROCEDURES	25 – 4
	The flow of costs	25 – 4
	Periodic inventory system	25 – 7
	Perpetual inventory system	25 – 10
4	REPORTING IN FINANCIAL STATEMENTS	25 – 13
	Statement of the cost of goods manufactured	25 – 15
	Statement of profit or loss & other comprehensive income	25 – 16
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5	CHAPTER ILLUSTRATIVE EXAMPLE	25 – 17
6	SUMMARY	25 – 20

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1 Introduction

The previous chapters dealt with the accounting procedures in service, retail or wholesale concerns. These types of concerns buy inventory for resale (merchandise) or render a service to their clients or customers. The inventory is valued at the actual cost to the concern, usually obtained from the suppliers' invoice.

A manufacturing concern buys raw material, processes them, and sells the manufactured products. For example, a vehicle manufacturer buys steel, rubber, plastic, and so on ,which it then uses to manufacture vehicles that are sold to trading concerns who in turn sell the vehicles to customers.

A manufacturing concern transforms basic raw material into marketable end products. During the manufacturing process, various costs are incurred to complete the product. This end product is valued at actual cost to the business, usually the aggregate of the manufacturing costs. At the end of the financial year, inventory in this type of concern will be at various stages of completion as manufacturing is a continuous process. Three stages of completion are identified:

- Unprocessed and uncompleted inventory – raw material.
- Partly completed inventory – work-in-progress goods.
- Completed inventory – finished goods.

Figure 25.1 summarises the main categories of inventory in a manufacturing concern and in retail and wholesale concerns.

Figure 25.1

CATEGORIES OF INVENTORY

WHOLESALERS AND RETAILERS	MANUFACTURERS
• Merchandise	• Work-in-progress goods • Finished goods • Raw material

The main difference in the statement of profit or loss & other comprehensive income of a manufacturing concern and a retailing concern is the calculation of the cost of the goods manufactured as opposed to the cost of the goods purchased for reselling.

A statement of the cost of goods manufactured is drafted to calculate the cost of the manufactured finished goods. The opening and closing balances of merchandise in the statement of profit or loss & other comprehensive income of a retail concern are replaced with the opening and closing balances of finished goods in a manufacturing concern.

Figure 25.2 shows the differences in the statement of profit or loss & other comprehensive income for retailing concerns and manufacturing concerns.

Figure 25.2

RETAILER

Sales		xx xxx
Cost of sales		x xxx
Opening balance of inventory	xxx	
Cost of purchases	x xxx	
Goods available for sale	x xxx	
Closing balance of inventory	(xxx)	
Gross profit		x xxx

MANUFACTURER

Sales		xx xxx
Cost of sales		x xxx
Opening balance of finished goods	xxx	
Cost of goods manufactured *	x xxx	
Goods available for sale	x xxx	
Closing balance of finished goods	(xxx)	
Gross profit		x xxx

** Cost of goods manufactured is calculated in the statement of the cost of goods manufactured.*

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This chapter explains the types of manufacturing costs with examples. The accounting entries for the manufacturing concern using either the periodic or the perpetual inventory system are explained.

The reporting requirements of a manufacturing concern are discussed with specific reference to the drafting of the statement of the cost of goods manufactured, the statement of profit or loss & other comprehensive income and the statement of financial position.

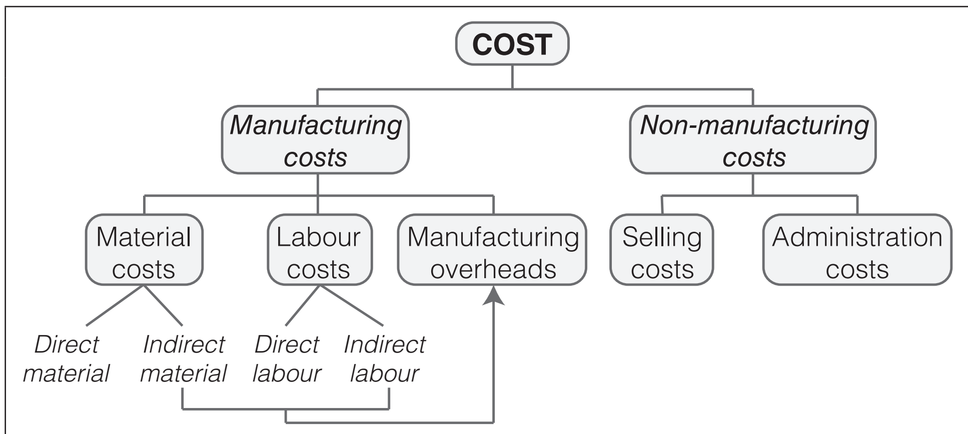
2 Manufacturing costs

Manufacturing costs are the costs incurred by a manufacturer to transform raw material into finished products (shown in Figure 25.3). These manufacturing costs should be distinguished from non-manufacturing costs such as selling expenses and administration expenses that are not directly related to the manufacturing process.

Manufacturing costs are traditionally divided into three types of costs, namely:

1. Material.
2. Labour.
3. Manufacturing overheads.

Figure 25.3



1. Material costs consist of the cost of raw material used in the process of manufacturing. The cost of raw material will usually be the purchase price paid by the concern. Material costs can be either direct costs or indirect costs.
   - Direct material costs are used directly in the process of manufacture and can be identified in the end product, for example, textiles in the manufacture of clothing.
   - The cost of direct material includes the net invoice price, plus delivery costs.
   - Storage costs and handling fees may also be included. Indirect material costs are also used in the manufacturing process, but may not be identified directly to specific product units, for example, the use of thread in the clothing industry.
   - Indirect material costs are treated as an overhead cost.

   The cost of raw materials used in production is calculated like this:

Opening inventory – raw material	x xxx	
Add: Purchases of raw material (less returns)	xx xxx	
Add: Carriage/railage/freight on purchases of raw material	xxx	
Less: Closing raw material inventory	(x xxx)	
Cost of raw material used in production	x xxx	

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Example 25.1

This information is for Jumbo Cranes for the year ended 28 February 20*x*2:

Raw material inventory (1 March 20*x*1)	2 990	00
Raw material purchased during the period	72 800	00
Railway charges paid on raw material purchased	1 014	00
Unprocessed raw material on 28 February 20*x*2	2 561	00

The cost of material used will be calculated like this:

Opening inventory – raw material (1 March 20x1)	2 990	00
Add: Purchases of raw material (less returns)	72 800	00
Add: Railage on purchases of raw material	1 014	00
Less: Closing raw material inventory (28 February 20*x*2)	(2 561	00)
Cost of raw material used in production	74 243	00

2 Labour cost consists of salaries and wages paid to the employees involved in the manufacturing process. The labour costs can be either direct or indirect.
- Direct labour costs are the salaries and wages paid to the employees directly involved in the manufacturing process, for example, the cutters of material in the clothing industry.
- Indirect labour costs would be the salaries and wages of employees not directly involved in the manufacturing process, for example, the supervisors of the manufacturing process.
- Indirect labour costs are treated as an overhead cost.

3 Manufacturing overheads are generally all costs that cannot be identified with specific units of the end product. These costs may include:
- Depreciation on machinery.
- Depreciation on factory building.
- Repairs and maintenance.
- Electricity and water.
- Insurance.
- Indirect labour.
- Indirect material.

- The total of direct labour and direct material costs used in the manufacturing process are referred to as **prime costs**.
- The total cost incurred to convert raw material into finished goods, namely direct labour and manufacturing overheads, is called **conversion costs**.

You should be able to complete Questions 25.1 and 25.2.

3 Accounting procedures

The flow of costs

Material, labour and overhead costs are incurred during the manufacturing process. These costs are accumulated and recorded in the accounting records.

The relationship between the physical movement of inventory through the factory and the recording of the costs in the accounting records, is shown in Figure 25.4.

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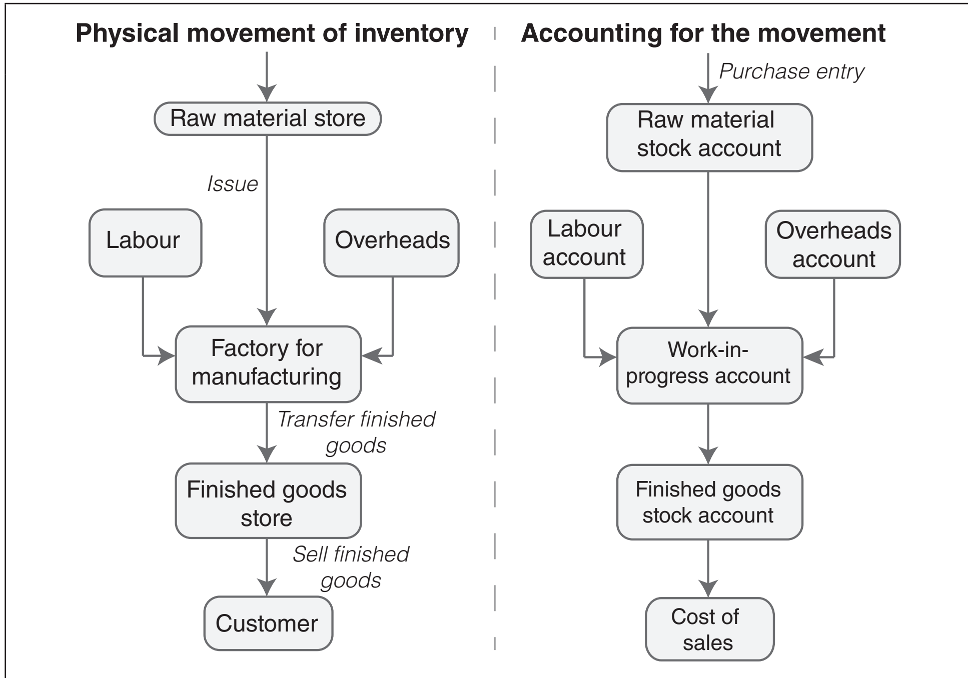
Figure 25.4



The raw material inventory account

The raw material inventory account is similar to a normal raw material inventory account, but deals only with raw material. The balance of this account should always show the value of the raw material that has not yet been assigned to the production process.

Example 25.2

General Ledger of Saturn Manufacturers
Real Accounts Section

Dr. **RAW MATERIAL INVENTORY** **B7** **Cr.**

Jan.	1	Balance	b/d	3 570	00	Jan.	31	Work-in-progress (WIP) inventory	GJ	5 930	00
	15	Accounts payable	APJ	2 600	00			Balance	c/d	2 720	00
		Bank (railage)	CPJ	2 480	00						
				8 650	00					8 650	00
Feb.	1	Balance	b/d	2 720	00						

The work-in-progress (WIP) inventory account

The work-in-progress account is probably the most important inventory account in a manufacturing concern. This account is sometimes called the production account or manufacturing account, and records the cost of raw material and labour, as well as factory overheads.

The balance of the WIP inventory account should, at all times, show the value (in cost terms) of the unfinished goods on hand. All indirect factory costs are included in the cost of work-in-progress.

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Example 25.3

General Ledger of Saturn Manufacturers
Real Accounts Section

Dr. **WORK-IN-PROGRESS (WIP) INVENTORY** **B8** Cr.

Jan.	1	Balance	b/d	420	00	Jan.	31	Inventory (finished goods)	GJ	12 920	00
	31	Direct material cost (raw material)	GJ	5 930	00			Balance	c/d	4 640	00
		Direct labour	GJ	8 000	00						
		Factory overhead cost	GJ	3 210	00						
				17 560	00					17 560	00
Feb.	1	Balance	b/d	4 640	00						

The finished goods inventory account

The finished goods inventory account is similar to the traditional inventory account used by a trading business. The balance of the account should, at all times, show the value (cost price) of the goods that are ready for sale.

Example 25.4

Note the similarity between the inventory account (trading concern) and the finished goods inventory account (manufacturing concern):

Trading concern

General Ledger of Sam's Traders
Real Accounts Section

Dr. **INVENTORY (finished goods)** **B9** Cr.

Jan.	1	Balance	b/d	10 000	00	Jan.	31	Cost of sales		18 500	00
	31	Bank/Accounts payable		12 920	00			Balance	c/d	4 420	00
				22 920	00					22 920	00
Feb.	1	Balance	b/d	4 420	00						

Manufacturing concern

General Ledger of Saturn Manufacturers
Real Accounts Section

Dr. **INVENTORY (finished goods)** **B9** Cr.

Jan.	1	Balance	b/d	10 000	00	Jan.	31	Cost of sales	GJ	18 500	00
	31	WIP inventory	GJ12	12 920	00			Balance	c/d	4 420	00
				22 920	00					22 920	00
Feb.	1	Balance	b/d	4 420	00						

As seen in Chapters 9 and 10, a business can use either the periodic inventory system or the perpetual inventory system.

The type of inventory system used will affect the nature and timing of the journal entries that record the physical movement of inventory in a manufacturing concern.

The information in Example 25.5 will be used to show the general journal entries for the periodic inventory system (Example 25.6) and the perpetual inventory system (Example 25.7).

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Example 25.5

The information was taken from the books of Dube Manufacturing Ltd:

Raw material purchases (on account)			50 000	00
Direct labour costs incurred			14 000	00
Indirect labour costs incurred			6 000	00
Cash payments for repairs and maintenance (overheads)			16 000	00
Water and electricity accrued			8 000	00
Depreciation on machinery			6 000	00
Credit sales			90 000	00
Cost of sales			45 000	00
Inventory balances for May 20*x*5:	**Opening**		**Closing**	
Raw material	15 000	00	40 000	00
Work-in-progress (WIP)	22 000	00	37 000	00
Finished goods	10 000	00	25 000	00
Raw material issued for production:				
Direct			20 000	00
Indirect			5 000	00
Completed work-in-progress			60 000	00
Other expenses:				
Selling cost			10 000	00
Administrative expenses			15 000	00
Interest paid			5 000	00

You are required to:

Record the entries for the inventory movements using the periodic and perpetual inventory systems.

Periodic inventory system

Under the periodic inventory system, an updated record of inventory on hand is not maintained. The gross profit is calculated at year end when a complete inventory count is performed to establish the closing balance of inventory.

During the year the various inventory accounts in the general ledger will contain the opening balances of inventory. The units of inventory on hand are counted at year end. These inventory units are usually valued like this:

- Raw material = the cost on the suppliers invoice × units of raw material counted
- Finished goods = the managers estimates the total cost per completed unit, consisting of raw material, labour and overhead costs × unit of finished goods counted
- Work-in-progress = the percentage completion of each unit is noted during the inventory count × cost per finished unit × units in work-in-progress at the same stage of completion

Example 25.6

The total value of inventory counted is recorded to calculate the gross profit. The general journal entries to record inventory under the periodic inventory system are as follows:

Recording raw material cost, labour cost and overhead cost

GENERAL JOURNAL OF DUBE MANUFACTURING LTD **GJ5**

Day	Details	Fol.	Debit		Credit	
31/05	Raw material inventory	B7	50 000	00		
	Accounts payable	B10			50 000	00
	Purchasing raw material					

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Day	Details	Fol.	Debit		Credit	
	Direct labour cost	C2	14 000	00		
	Indirect labour cost	N7	6 000	00		
	Labour cost payable	B12			20 000	00
	Recording labour costs					
	Repairs	N4	16 000	00		
	Water and electricity	N5	8 000	00		
	Depreciation	N6	6 000	00		
	Recording overhead costs					
	Accummulated depreciation (machinery)	B13			6 000	00
	Bank	B14			16 000	00
	Accrued water and electricity	B15			8 000	00

Explanation

- Issuing raw material to production is not recorded under the periodic inventory system.
- One nominal account can be used for labour costs, but direct and indirect labour costs should be shown separately in the statement of the cost of goods manufactured as labour costs and overhead costs, respectively. Total labour costs incurred for the period are accumulated in the general ledger and then transferred to the WIP inventory account as a closing entry.
- The total overhead costs incurred are accumulated in the overheads account in the general ledger before being transferred to the WIP inventory account as a closing entry.

Recording finished goods

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Day	Details	Fol.	Debit		Credit	
31/05	Accounts receivable	B11	90 000	00		
	Sales	N1			90 000	00
	Recording finished goods sold at selling price					

Explanation

The transfer of finished goods from WIP inventory to finished goods inventory is not recorded. No cost of sales entry is recorded until the closing inventory amounts are available and the cost of sales figure is calculated in the trading account.

Recording the closing entries

GENERAL JOURNAL OF DUBE MANUFACTURING LTD GJ5

Day	Details	Fol.	Debit		Credit	
31/05	Work-in-progress (WIP) inventory	B8	75 000	00		
	Direct material cost (15 000 + 50 000 – 40 000)	C1			25 000	00
	Direct labour cost	C2			14 000	00
	Factory overhead cost (30 000 + 6 000)	C3			36 000	00
	Transfer of cost accounts to the WIP inventory account					
	Trading account	F1	60 000	00		
	WIP inventory (75 000 + 22 000 – 37 000)	B8			60 000	00
	Transfer of the finished goods cost to the trading account					

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	Sales	N1	90 000	00		
	Finished goods inventory (opening inventory)	B9			10 000	00
	Trading account	F1			80 000	00
	Transfer of sales to the trading account					
	Finished goods inventory (closing inventory)	B9	25 000	00		
	Factory overheads	C3	30 000	00		
	Indirect labour costs	N7			6 000	00
	Repairs	N4			16 000	00
	Water and Electricity	N5			8 000	00
	Depreciation	N6			6 000	00
	Trading account	F1			25 000	00
	Recording closing inventory in the trading account					
	Trading account (60 000 – (80 000 + 25 000)	F1	45 000	00		
	Profit and loss account	F2			45 000	00
	Transfer gross profit to the profit and loss account					
	Profit and loss account	F2	30 000	00		
	Selling cost	C4			10 000	00
	Administration cost	C5			15 000	00
	Interest expense	N7			5 000	00
	Transfer of expense accounts to the profit and loss account					

Explanation

- A WIP inventory account is used in the general ledger to accumulate all the entries for the cost of manufacturing.
- The balance of the WIP inventory account is the cost of the finished goods that have been manufactured.
- The balance of the trading account is the gross profit.
- The balance of the statement of profit or loss & other comprehensive income is R15 000 (45 000 – 30 000), which is the net profit.

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The transactions for the periodic inventory system are shown in the general ledger as follows:

General Ledger of Dube Manufacturing Ltd

Direct material cost — C1

Balance b/d	15 000	Balance c/d	40 000
Acc. payable	50 000	WIP inventory	25 000
	65 000		65 000

Direct labour cost — C2

Labour cost payable	14 000	WIP inventory	14 000

Factory overhead cost — C3

Repairs	16 000	WIP inventory	36 000
Water and electricity	8 000		
Depreciation	6 000		
Indirect labour cost	6 000		
	36 000		36 000

Indirect labour cost — N7

Labour cost payable	6 000	WIP inventory	6 000

WIP inventory — B8

Balance b/d	22 000	Trading account*	60 000
Direct material cost	25 000	Balance c/d	37 000
Direct labour cost	14 000		
Factory overhead cost	36 000		
	97 000		97 000

** Cost of finished goods manufactured*

Trading account — F1

Finished goods inventory (opening inventory)	10 000	Sales	90 000
WIP inventory	60 000	Finished goods inventory (opening inventory)	25 000
Profit and loss account	45 000		
	115 000		115 000

Profit and loss account — F2

Selling cost	10 000	Trading account	45 000
Admin. cost	15 000		
Interest expense	5 000		
Capital **	15 000		
	45 000		45 000

*** Net profit is transferred to the capital account*

You should be able to complete Questions 25.3 to 25.6.

Perpetual inventory system

An updated record of all inventory movements and inventory balances is maintained under the perpetual inventory system. The gross profit can be calculated throughout the year by deducting the cost of sales from the sales.

The balances on the inventory accounts in the general ledger represent the actual physical inventory on hand. Inventory counts, performed during the year, are used to check the accuracy of the inventory system.

At the beginning of the year, the managers estimate the cost for each completed unit. This cost will consist of the material, labour and overhead costs. The completed units are transferred out of work-in-progress to finished goods and from finished goods to cost of sales at this cost.

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Example 25.7 The general journal entries to record inventory under the periodic inventory system are:

Recording raw material cost, labour cost and overhead cost

GENERAL JOURNAL OF DUBE MANUFACTURING LTD GJ5

Day	Details	Fol.	Debit		Credit	
31/05	Raw material inventory	B7	50 000	00		
	Accounts payable	B10			50 000	00
	Purchasing raw material					
	WIP inventory	B8	20 000	00		
	Factory overhead cost	C3	5 000	00		
	Raw materials inventory	B7			25 000	00
	Issuing raw material to production					
	Labour cost (14 000 + 6 000)	N8	20 000	00		
	Labour cost payable	B12			20 000	00
	Transfer of labour costs to production					
	WIP inventory	B8	14 000	00		
	Factory overhead cost	C3	6 000	00		
	Labour cost	N8			20 000	00
	Recording labour costs					
	Repairs		16 000	00		
	Water and electricity		8 000	00		
	Depreciation		6 000	00		
	Bank				16 000	00
	Accrued water and electricity				8 000	00
	Accumulated depreciation				6 000	00
	Factory overhead cost	C3	30 000	00		
	Repairs	N4			16 000	00
	Water and electricity	N5			8 000	00
	Depreciation	N6			6 000	00
	Recording overhead costs					
	WIP inventory	B8	41 000	00		
	Factory overhead cost (5 000 + 6 000 + 30 000)	C3			41 000	00
	Transfer of overheads to production					

Explanation

- When raw material is purchased, both direct and indirect material can be recorded in the raw material inventory account. On the issue of raw material to production, direct material is recorded as work-in-progress and indirect material is recorded as overheads.
- Direct labour costs are allocated to work-in-progress, and indirect labour costs to overheads, usually weekly or monthly.
- Individual nominal accounts in the general ledger are used for each overhead cost.

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Recording finished goods

GENERAL JOURNAL OF DUBE MANUFACTURING LTD GJ5

Day	Details	Fol.	Debit		Credit	
31/05	Finished goods	B9	60 000	00		
	WIP inventory	B8			60 000	00
	Transfer of finished units to finished goods account					
	Cost of sales	N2	45 000	00		
	Finished goods	B9			45 000	00
	Recording finished goods sold at cost					
	Accounts receivable	B11	90 000	00		
	Sales	N1			90 000	00
	Recording finished goods sold at selling price					

Explanation

The value of manufactured finished goods to be transferred from WIP to finished goods is calculated as: the number of completed units × the predetermined cost established by the managers.

Recording the closing entries

GENERAL JOURNAL OF DUBE MANUFACTURING LTD GJ5

Day	Details	Fol.	Debit		Credit	
31/05	Sales	N1	90 000	00		
	Trading account	F1			90 000	00
	Closing transfer of sales to the trading account					
	Trading account	F1	45 000	00		
	Cost of sales	N2			45 000	00
	Closing transfer of cost of sales to the trading account					
	Trading account	F1	45 000	00		
	Profit and loss account	F2			45 000	00
	Transfer gross profit to the profit and loss account					
	Profit and loss account	F2	30 000			
	Selling cost	C4			10 000	00
	Administration cost	C5			15 000	00
	Interest expense	N7			5 000	00
	Transfer of expense accounts to the profit and loss account					

Explanation

- As cost of sales is recorded with the sales transaction in the perpetual inventory system, it is not necessary to use the WIP inventory account. This is because the trading account is used to calculate the cost of finished goods manufactured (cost of sales).
- The balances shown in the raw material, work-in-progress (WIP) and finished goods accounts are the closing inventory balances. That is, together they will be shown under current assets (inventories) in the statement of financial position.

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The transactions for the perpetual inventory system are shown in the general ledger as follows:

General Ledger of Dube Manufacturing Ltd

Direct material cost — **C1**

Balance b/d	15 000	Factory o/h cost	[1]5 000
Account payable	50 000	WIP inventory	20 000
		Balance c/d	40 000
	65 000		65 000

WIP inventory — **B8**

Balance b/d	22 000	Trading account *	60 000
Direct material cost	20 000	Balance c/d	37 000
Labour cost	14 000		
Factory overhead cost	41 000		
	97 000		97 000

** Cost of finished goods manufactured*

Labour cost — **N8**

Labour cost payable	20 000	WIP inventory	14 000
		Factory o/h cost	[2]6 000
	20 000		20 000

Trading account — **F1**

Cost of sales	45 000	Sales	90 000
Profit and loss account	45 000		
	90 000		90 000

Finished goods inventory — **B9**

Balance b/d	10 000	Cost of sales	45 000
WIP inventory	40 000	Balance b/d	25 000
	70 000		70 000

Profit and loss account — **F2**

Selling cost	10 000	Trading acc.	45 000
Admin. cost	15 000		
Interest expense	5 000		
Capital **	15 000		
	45 000		45 000

*** Net profit is transferred to the capital account*

Factory overhead cost — **C3**

Indirect material	[1]5 000	WIP inventory	41 000
Indirect labour	[2]6 000		
Repairs	16 000		
Water and electricity	8 000		
Depreciation	6 000		
	41 000		41 000

You should be able to complete Questions 25.7 to 25.9.

Reminder

- Refer to Chapter 15 for a detailed explanation of the trading and profit and loss sections.
- Refer to Chapter 17 for the format of the statement of changes in equity.

4 Reporting in financial statements

The statement of profit or loss & other comprehensive income for a retail concern will normally have two sections:

1. The **trading section** – where the gross profit is calculated.
2. The **profit and loss section** – where all other expenses and incomes are deducted from, or added to, the gross profit to calculate the net profit.

The distribution of net profit as dividends or the reinvestment of profits in the business is shown in the statement of changes in equity.

The manufacturing concern has an additional section in the statement of profit or loss & other comprehensive income, namely, the manufacturing section or the statement of the cost of goods manufactured that precedes the trading section.

Figure 25.2 shows how the cost of goods purchased in the retailing concern is replaced with the cost of goods manufactured in the manufacturing concern. The manufacturing section is used to calculate the cost of manufacturing the finished goods.

Figure 25.5 contrasts the differences in the statement of profit or loss & other comprehensive income and statement of financial position for the different organisational forms.

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Figure 25.5

FINANCIAL STATEMENTS FOR INTERNAL REPORTING

Type of company	Statement of profit or loss & other comprehensive income	SOFP
Service business	● Profit and loss section	● No inventory
Wholesale and retail business	● Trading section	● Closing inventory
	● Profit and loss section	● Inventory
Manufacturing concern	● Manufacturing	● Closing inventory
	● Trading section	● Raw material
	● Profit and loss section	● Work-in-progress

Drafting the statement of the cost of goods manufactured, the statement of profit or loss & other comprehensive income and the statement of financial position of a manufacturing concern can best be explained by using an example.

The financial statements in Example 25.8 are drafted to comply with the minimum disclosure requirements of the Companies Act.

Example 25.8

Below is the trial balance of Fresco Manufacturing Ltd for the year ended 30 September 20*x*5:

Bank	31 000	00		
Accounts receivable	79 000	00		
Prepared expenses	1 000	00		
Inventory (1 October 20*x*4)				
Raw material	20 000	00		
Work-in-progress	42 000	00		
Finished goods	28 000	00		
Non-current assets	350 000	00		
Accounts payable			35 000	00
Long-term loan			100 000	00
Share capital			300 000	00
Accumulated profits (1 October 20*x*4)			55 000	00
Sales			900 000	00
Material purchases: Direct	240 000	00		
Indirect	5 000	00		
Labour: Direct	190 000	00		
Indirect	33 000	00		
Other manufacturing overheads	120 000	00		
Selling cost	100 000	00		
Administration cost	90 000	00		
Interest paid	10 000	00		
Income tax expense	50 000	00		
Bad debts	1 000	00		
	1 390 000	00	1 390 000	00

The closing inventory balances are:

- Raw material R19 000
- Work-in-progress R40 000
- Finished goods R30 000

You are required to:

Prepare the statement of the cost of goods manufactured, the statement of profit or loss & other comprehensive income and the statement of financial position for Fresco Manufacturing Ltd for the year ended 30 September 20*x*5.

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Statement of the cost of goods manufactured

Fresco Manufacturing Ltd
STATEMENT OF THE COST OF GOODS MANUFACTURED
FOR THE YEAR ENDED 30 SEPTEMBER 20*x*5

Raw material				
Opening balance	20 000	00		
Material purchases	240 000	00		
Material available for use	[illegible] 000	00		
Less: Closing balance	(19 000	00)		
Material used in manufacturing			241 000	00
Direct labour			190 000	00
Prime costs			431 000	00
Manufacturing overheads				
Indirect material	5 000	00		
Indirect labour	[illegible] 000	00		
Other manufacturing overheads	[illegible] 000	00	158 000	00
Total cost of goods manufactured			589 000	00
Add: Work-in-progress 1 October 20*x*4			42 000	00
			631 000	00
Less: Work-in-progress 30 September 20*x*5			(40 000	00)
COST OF FINISHED GOODS MANUFACTURED			591 000	00

Explanation

- The statement of the cost of goods manufactured is used mainly for management purposes or internal reporting.
- If 150 000 units were manufactured during the year, the cost per unit would be R3.94 (591 000 ÷ 150 000).
- It should be noted that to simplify the example, manufacturing overheads were given as one amount of R120 000.
  - Businesses use individual ledger accounts for each type of overhead cost.
  - All manufacturing overhead costs should be included in the statement.
- Work-in-progress (WIP) is the total of costs of material, labour and indirect manufacturing costs that have been assigned to goods started but not yet completed.
  - Opening work-in-progress is added to the current cost for the period.
  - Closing work-in-progress is deducted to get the actual cost of the goods manufactured.
- The cost of goods manufactured will appear in the general ledger as follows:

General Ledger of Fresco Manufacturing Ltd
Real Accounts Section

Dr. **WORK-IN-PROGRESS (WIP) INVENTORY B8** **Cr.**

Oct.	1	Balance	b/d	42 000	00	Jan.	31	Trading account	GJ	591 000	00
	31	Direct materials	GJ	241 000	00			Balance	c/d	40 000	00
		Direct labour	GJ	190 000	00						
		Indirect material	GJ	5 000	00						
		Indirect labour	GJ	33 000	00						
		Factory overhead	GJ	120 000	00						
				631 000	00					631 000	00
Nov.	1	Balance	b/d	40 000	00						

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Statement of profit or loss & other comprehensive income

Fresco Manufacturing Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 SEPTEMBER 20x5

	Notes	20x5	
Sales (Net)		900 000	00
Cost of sales		(589 000	00)
Opening balance – finished goods		28 000	00
Cost of finished goods manufactured		591 000	00
Cost of goods available for sale		619 000	00
Less: Closing balance – finished goods		(30 000)	00)
Gross profit		311 000	00
Operating expenses		(201 000	00)
Administration cost		90 000	00
Bad debts		1 000	00
Interest paid		10 000	00
Selling cost		100 000	00
Operating profit before taxation		110 000	00
Income tax		(50 000	00
NET PROFIT FOR THE YEAR		60 000	00

Explanation

- In the statement of profit or loss & other comprehensive income, only the movement of the finished goods are shown (the movements of raw material and work-in-progress are shown in the statement of the cost of goods manufactured).
- The balance of the statement of the cost of goods manufactured is transferred to the trading section of the statement of profit or loss & other comprehensive income.

Statement of financial position

Fresco Manufacturing Ltd
STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20x5

	Notes	20x5	
ASSETS			
Non-current assets		350 000	00
Property, plant and equipment	4	350 000	00
Current assets		200 000	00
Inventories	7	89 000	00
Accounts receivable	8	79 000	00
Prepaid expenses		1 000	00
Cash and cash equivalents		31 000	00
TOTAL ASSETS		550 000	00
EQUITY AND LIABILITIES			
Capital and reserves	2	415 000	00
Ordinary share capital		300 000	00
Retained earnings		115 000	00
Non-current liabilities		100 000	00
Other unsecured interest-bearing borrowings		100 000	00
Current liabilities		35 000	00
Accounts payable		35 000	00
TOTAL EQUITY AND LIABILITIES		550 000	00

* Raw material 19 000 + Work-in-progress 40 000 + Finished goods 30 000 = 89 000

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Explanation
The main difference in the statement of financial position of a manufacturing concern and other types of organisational form, is the inventory balance that consists of raw material, work-in-progress and finished goods.

You should be able to complete Questions 25.10 to 25.15.

5 Chapter illustrative example

This information is for Kwando Manufacturers:

Inventory (1 January 20*x*3):

Raw material	7 140	00
Finished products	3 050	00
Work-in-progress	1 870	00
Consumable stores	2 000	00

Totals for the year ending 31 December 20*x*3:

Direct labour	20 000	00
Indirect labour	11 970	00
Indirect raw material (factory R6 000, offices R4 000)	10 000	00
Depreciation on factory equipment	4 200	00
Purchases of consumable stores for cash	2 800	00
Insurance (factory R2 010, offices R1 460)	3 470	00
Water and electricity (factory R11 550, offices R3 000)	14 550	00
Repairs and maintenance of factory equipment	2 600	00
Sales of finished goods	191 000	00
Salaries – office workers	41 000	00
Salaries – factory workers	25 000	00
Raw material purchased on credit	45 630	00
Import tariffs on raw material purchased	4 480	00
Rent paid (factory 75%, offices 25%)	30 000	00

Inventory (31 December 20*x*3):

Raw materials	1 720	00
Finished goods	3 400	00
Work-in-progress	5 400	00
Consumable goods	1 310	00

You are required to:

1 Prepare these general ledger accounts for the year ended 31 December 20*x*3:
   - **a** Raw material inventory.
   - **b** Factory overhead expenses.
   - **c** Work-in-progress (WIP) inventory.
   - **d** Finished goods inventory.
   - **e** Trading account.
   - **f** Profit and loss account.

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2 Prepare the statement of the cost of goods manufactured of Kwando Manufacturers for the year ended 31 December 20*x*3.

3 Prepare the statement of profit or loss & other comprehensive income of Kwando Manufacturers for the year ended 31 December 20*x*3.

1 *Ledger accounts*

General Ledger of Kwando Manufacturers
Real Accounts Section

Dr. **RAW MATERIAL INVENTORY** **B7** **Cr.**

20x3 Jan.	1	Balance	b/d	7 140	00	20x3 Dec.	31	WIP inventory	GJ12	① 55 530	00
	15	Accounts payable	APJ12	45 630	00			Balance	c/d	1 720	00
		Import tariffs	GJ12	4 480	00						
				57 250	00					57 250	00
20x4 Jan.	1	Balance	b/d	1 720	00						

WORK-IN-PROGRESS (WIP) INVENTORY **B8**

20x3 Jan.	1	Balance	b/d	1 870	00	20x3 Dec.	31	Finished goods inventory	GJ12	③ 161 320	00
Dec.	31	Direct material	GJ12	① 55 530	00			Balance	c/d	5 400	00
		Direct labour	GJ12	20 000	00						
		Factory overhead	GJ12	② 89 320	00						
				166 720	00					166 720	00
20x4 Jan.	1	Balance	b/d	5 400	00						

FINISHED GOODS INVENTORY **B9**

20x3 Jan.	1	Balance	b/d	3 050	00	20x3 Dec.	31	Cost of sales *	GJ12	160 970	00
Dec.	31	WIP inventory	GJ12	③ 161 320	00			Balance	c/d	3 400	00
				164 370	00					164 370	00
20x4 Jan.	1	Balance	b/d	3 400	00						

Cost Accounts Section

FACTORY OVERHEAD COST **C3**

20x3 Dec.	31	Indirect labour	GJ12	11 970	00	20x3 Dec.	31	WIP inventory	GJ12	② 89 320	00
		Indirect material	GJ12	6 000	00						
		Depreciation	GJ12	4 200	00						
		Insurance	GJ12	2 010	00						
		Water and electricity	GJ12	11 550	00						
		Repairs and maintenance	GJ12	2 600	00						
		Salaries	GJ12	25 000	00						
		Rent paid	GJ12	22 500	00						
		Consumable stores	GJ12	3 490	00						
				89 320	00					89 320	00

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Final Accounts Section

TRADING ACCOUNT F1

Dr.						Cr.					
20x3 Dec.	31	Cost of sales *	GJ12	160 790	00	20x3 Dec.	31	Sales	GJ12	191 000	00
		Profit and loss account (gross profit)	GJ12	30 030	00						
				191 000	00					191 000	00

PROFIT AND LOSS ACCOUNT F2

20x3 Dec.	31	Indirect material	GJ12	4 000	00	20x3 Dec.	31	Trading account	GJ12	30 030	00
		Insurance	GJ12	1 460	00			Capital (net loss)	GJ12	26 930	00
		Water and electricity	GJ12	3 000	00						
		Salaries	GJ12	41 000	00						
		Rent paid	GJ12	7 500	00						
				56 960	00					56 960	00

2 *Statement of the cost of goods manufactured*

Kwando Manufacturers Ltd
STATEMENT OF THE COST OF GOODS MANUFACTURED
FOR THE YEAR ENDED 31 DECEMBER 20x3

Cost of raw material used			① 55 530	00
Opening raw material inventory (1 January 20x3)	7 140	00		
Add: Purchases of raw material	45 630	00		
Add: Import tariffs on raw material purchases	4 480	00		
	57 250	00		
Less: Closing raw material inventory (31 December 20x3)	(1 720)	00)		
Direct labour			20 000	00
Primary costs			75 530	00
Add: Factory overheads			② (89 320	00)
Indirect labour	11 970	00		
Indirect raw material	6 000	00		
Depreciation	4 200	00		
Insurance	2 010	00		
Water and electricity	11 550	00		
Repairs and maintenance	2 600	00		
Salaries	25 000	00		
Rent paid	22 500	00		
Consumable stores	3 490	00	164 850	00
Add: Opening work-in-process (1 January 20x3)			1 870	00
Less: Closing work-in-process (31 December 20x3)			(5 400	00)
COST OF GOODS MANUFACTURED			③ 161 320	00

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3 *Statement of profit or loss & other comprehensive income*

Kwando Manufacturers Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20x3

	Notes	20x3			
Sales (net)				191 000	00
Cost of sales				(160 970	00)
Opening balance – finished goods		3 050	00		
Cost of finished goods manufactured		161 320	00		
Cost of goods available for sale		164 370	00		
Less: Closing balance – finished goods		(3 400	00)		
Gross profit				30 030	00
Operating expenses				(56 960	00)
Insurance – offices		1 460	00		
Water and electricity – offices		3 000	00		
Raw material – offices		4 000	00		
Salaries – office workers		41 000	00		
Rent paid – offices		7 500	00		
NET LOSS FOR THE YEAR				(26 930	00)

6 Summary

The accounting entries to record inventory in a manufacturing concern differ from the entries required for service, retail or wholesale concerns, as the manufacturing concern converts raw material into finished products. Raw material, labour and overhead costs are incurred by the concern during the manufacturing process.

A manufacturing concern can use either the periodic inventory system or the perpetual inventory system. The nature and timing of journal entries recording to physical movement of inventory in the manufacturing concern is affected by the type of inventory system in use.

As the manufacturing process is continuous, inventory will be at various stages of completion. Inventory is allocated to three types of inventory account based on the stage of completion:

1. Raw material for unprocessed or uncompleted inventory.
2. Work-in-progress for partly completed inventory.
3. Finished goods for completed inventory.

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QUESTIONS

Question 25.1

Define the following terminology:

- Manufacturing costs.
- Conversion costs.
- Prime costs.
- Manufacturing overheads.
- Indirect labour costs.
- Work-in-progress.

Question 25.2

This information is for Ngama Manufacturers for the year ending 31 December 20*x*1:

Raw material inventory on 1 January 20*x*1	11 000	00
Purchases of raw material	18 700	00
Freight on raw material purchased	1 200	00
Raw material not yet processed on 31 December 20*x*1	5 800	00

You are required to:
Calculate the cost of raw material used as at 31 December 20*x*1.

Question 25.3

These balances were taken from the books of Parrot Elvis as at 30 September 20*x*6:

Inventory (1 October 20*x*5) – raw material	98 000	00
Inventory (1 October 20*x*5) – finished goods	122 500	00
Sales – raw material	600	00
Sales – finished goods	1 649 750	00
Railage – inwards (raw material)	15 620	00
Railage – outwards	12 170	00
Purchases – raw material	784 600	00
Factory wages	365 000	00
Accumulated depreciation: Plant and machinery	65 700	00
Accumulated depreciation: Delivery vehicle	4 840	00
Accumulated depreciation: Office furniture and equipment	1 980	00
Printing and stationery	3 400	00
Advertising	9 600	00
Depreciation – all assets	82 400	00
Bad debts recovered	1 945	00
Discounts allowed for cash	6 940	00
General expenses	1 230	00
Delivery vehicle expenses	9 630	00
Inventory on hand as at 30 September 20*x*6 was:		
Raw material	110 250	00
Finished goods	145 160	00

You are required to:

1. Prepare the work-in-progress inventory account for the year ended 30 September 20*x*6.
2. Prepare the trading account for the year ended 30 September 20*x*6.
3. Prepare the profit and loss account for the year ended 30 September 20*x*6.

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Question 25.4

Remmie and Steel is a company that manufactures steel products. This information is for the production process:

Bank costs			100	00
Raw material purchased			3 000	00
Raw material returned			50	00
Direct labour			500	00
Indirect labour			170	00
Indirect material purchased			770	00
Inventory:	**1 Jan. 20*x*7**		**31 Dec. 20*x*7**	
Completed goods	3 000	00	3 500	00
Work-in-progress	2 250	00	1 250	00
Raw material	1 090	00	0	00
Indirect material	0	00	700	00

You are required to:

1 Prepare the work-in-progress inventory account and trading account.

2 If sales were R10 000, what is the gross profit and net profit?

Question 25.5

These details were taken from the books of Cadbury Manufacturing Ltd as at 31 July 20*x*6:

Inventory on 1 July 20*x*6:		
Raw material (including direct and indirect material)	20 000	00
Work-in-progress	8 000	00
Finished goods (5 000 units)	16 000	00
Raw material purchased	50 000	00
Direct labour	10 000	00
Sales (18 500 units)	160 000	00
Work-in-progress (31 July 20*x*6)	6 000	00
Depreciation on machinery	1 200	00
Indirect material used	1 000	00
Raw material (31 July 20*x*6)	25 000	00
Rent – factory building	2 000	00
Supervision (factory)	1 200	00
Heating, lights and power for manufacturing	1 400	00
Indirect material (31 July 20*x*6)	0	00
Office salaries	1 000	00
Indirect labour	1 600	00
Factory insurance	400	00

Note

- Completed products (31 July 20*x*6) 4 500 units
- Production is transferred to the sales department at cost plus 33.33%.

You are required to:

1 Prepare the statement of the cost of goods manufactured.

2 Prepare the trading account for July 20*x*6.

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Question 25.6

These transactions and balances were extracted from the records of Caskets Ltd, a business that makes coffins.

Balances

Inventory of coffins (1 January 20*x*5) (1 500 units)	412 500	00
Inventory of raw material (1 January 20*x*5)	67 200	00
Work-in-progress (1 January 20*x*5)	14 300	00

Transactions

Raw material purchases	574 169	00
Freight inwards on raw material	18 966	00
Railage inwards on raw material	24 365	00
Railage on sales	36 492	00
Wages	584 000	00
Electricity and power	66 776	00
Depreciation:		
Machinery	22 500	00
Furniture	7 500	00
Credit sales (4 300 units)	1 935 000	00
Maintenance – machinery	18 295	00
Insurance	18 000	00
Rates and taxes	16 400	00
Rent – factory building	25 500	00

Balances

Inventory of coffins (31 December 20*x*5) (1 600 units)	?	
Inventory of raw material (31 December 20*x*5)	69 500	00
Work-in-progress (31 December 20*x*5)	12 700	00

Additional information:

- 20% of wages is non-manufacturing and R36 560 of the balance is indirect labour.
- Electricity and power are allocated 80% to the factory.
- Insurance includes R15 985 that is directly related to the factory.
- The total area of the buildings on which rates and taxes are levied is 2 000 m² of which 1 500 m² are occupied by factory buildings.

You are required to:

1. Record the journal entries to record the above information using the periodic inventory system. (All payments were made in cash and narrations are not required.)
2. Calculate the cost of one coffin.
3. Calculate the gross profit made by Funerals Ltd (the company used the FIFO method of cost assignment).

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Question 25.7

This information for June 20*x*5 is from Zuma (Pty) Ltd:

Direct material purchased on credit			50 000	00
Indirect material purchased for cash			1 500	00
Direct labour costs incurred			25 000	00
Indirect production labour			2 500	00
Factory rent			1 000	00
Water and electricity			3 000	00
Plant depreciation			5 000	00
Overhead variance: Favourable			250	00
Insurance on factory			750	00
Credit sales			160 000	00
Inventory balances for June 20*x*5 are:	**Opening**		**Closing**	
Direct raw material	40 000	00	20 000	00
Indirect material	1 000	00	600	00
Work-in-progress	22 500	00	12 500	00
Finished goods	50 000	00	24 180	00
Other expenses:				
Selling cost			3 000	00
Administrative expenses			1 000	00

You are required to:

Prepare the following accounts in the general ledger of Zuma (Pty) Ltd for June 20*x*5:

1. Raw material inventory.
2. Factory overhead expenses.
3. Work-in-progress.
4. Finished goods inventory.
5. Trading account.
6. Profit and loss account.

Question 25.8

This information is from the books of Joshua & Company Ltd:

Balances on 1 June 20x4:		
Raw material inventory	24 100	00
Work-in-progress inventory	7 970	00
Finished goods inventory	9 500	00
Consumable stores inventory	5 000	00
Transaction totals for June 20x4:		
Cash purchases of raw material	35 000	00
Carriage on purchases of raw material (paid in cash)	3 500	00
Raw material issued to production	27 000	00
Wages:		
Direct labour	32 800	00
Indirect labour	4 300	00
Cash purchases of consumable goods	2 200	00
Rent of factory	12 000	00
Maintenance of plant	1 000	00
Cost of sales of finished goods	68 330	00
Consumable goods issued to the factory	4 750	00
Factory insurance	3 700	00

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Depreciation (relating to factory)	2 500	00
Sales of finished products	98 810	00
Closing work-in-progress – 30 June 20x4	4 060	00

You are required to:

Prepare the following accounts in the general ledger of Joshua & Company Ltd for June 20x4:

1 Raw material inventory.
2 Work-in-progress (WIP) inventory.
3 Finished goods inventory.
4 Consumable stores.
5 Factory overhead expenses.
6 Trading account.
7 Profit and loss account.

Question 25.9

Identify the main differences in accounting for manufacturing concerns using either the periodic inventory system or the perpetual inventory system.

Question 25.10

These balances and totals appeared in the books of Thula Manufacturers Ltd as at 31 December 20x4:

Inventory: Raw material – 1 January 20x4	90 000	00
Raw material purchased during the year	780 000	00
Labour cost	655 000	00
Rent	150 000	00
Electricity	75 000	00
Manufacturing equipment at cost	100 000	00
Delivery vehicles at cost	50 000	00
Accumulated provision for depreciation (1 January 20x4):		
Manufacturing equipment	30 000	00
Delivery vehicles	15 000	00
Uncompleted goods – 1 January 20x4	33 000	00
Inventory of completed goods – 1 January 20x4	315 000	00
Sundry sales and administrative expenses	170 000	00
Inventory on 31 December 20x4:		
Raw material	120 000	00
Uncompleted goods	31 500	00
Completed goods	450 000	00
Purchases (other inventory)	100 000	00

Adjustments and further information:

- An amount of R20 000 is erroneously debited against the purchases account (other inventory), instead of raw material. Correct the error.
- R600 000 is in respect of direct labour costs, whilst the residue is for indirect manufacturing labour.
- The size of the factory is 250 m². The rent amounts to R400/m² per annum.
- 60% of the electricity is in respect of manufacturing.

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- Depreciation is determined as follows:
  - Manufacturing equipment is written off in ten equal payments.
  - Thula Manufacturers Ltd bought the manufacturing equipment on 1 January 20*x*1.
  - 15% per annum on vehicles according to the reducing-balance method.

You are required to:
Prepare the statement of the cost of goods manufactured for the year ended 31 December 20*x*4.

Question 25.11

These balances and totals are from Mark and Brake Ltd who manufactures sport equipment:

Inventory: 1 March 20*x*7		
Raw material	14 400	00
Work-in-progress (WIP)	9 500	00
Finished goods	52 000	00
Delivery vehicles at cost	19 000	00
Plant and machinery at cost	120 000	00
Office furniture at cost	6 000	00
Bank	11 400	00
Accumulated depreciation on 1 March 20*x*7		
Delivery vehicles	3 800	00
Plant and machinery	36 000	00
Office furniture	1 200	00
Water and electricity:		
Factory	6 200	00
Office	320	00
Purchase of raw material	144 000	00
Customs duty on raw material	3 400	00
Freight in on raw material	7 200	00
Insurance paid:		
Factory	2 520	00
Office	840	00
Insurance paid in advance 1 March 20*x*7:		
Factory	960	00
Office	260	00
Allowance for bad debts on 1 March 20*x*7	830	00
Accounts receivable	16 600	00
Factory wages	73 000	00
Indirect labour	9 600	00
Salaries:		
Sale personnel	17 400	00
Office personnel	11 600	00
Factory overheads	4 560	00
Stationery	760	00
Sales	260 400	00

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Additional information:

- Inventory on hand 28 February 20*x*8:
  - Raw material R13 400
  - Work-in-progress R10 700
  - Finished goods R60 000
- Depreciation should be provided for on the reducing-balance method:
  - Delivery vehicles 20% p.a.
  - Plant and machinery 15% p.a.
  - Office furniture 5% p.a.
- Insurance is payable one year in advance on 1 July.
- Finished goods are transferred from the factory to the sales department at production cost plus 25%.

You are required to:
Prepare a work-in-progress inventory account for the year ended 28 February 20*x*8.

Question 25.12

These details were taken from the trial balance of Baxit Ltd as at 31 December 20*x*2.

Advertising	724	00
Sales	99 600	00
Carriage in on raw material	3 000	00
Inventory, 1 January 20*x*2:		
Raw material at cost price	5 000	00
Finished goods	10 600	00
Work-in-progress (WIP)	1 740	00
Stationery	260	00
Office salaries	750	00
Cash discount received	2 420	00
Plant	34 000	00
Sundry debtors	6 200	00
Direct labour costs	11 620	00
Indirect labour costs	6 232	00
Office equipment	6 000	00
Raw material purchased	48 720	00
Rent of offices	1 200	00
Sundry creditors	60 000	00
Insurance (non-factory)	200	00
Carriage on sales	2 432	00
Repairs to plant	156	00

Additional information:

- Inventory as at 31 December 20*x*2 was:
  - Raw material R8 400
  - Work-in-progress R2 000
  - Finished goods R8 500

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- Provide for depreciation for the year:
  - Plant R3 000
  - Office equipment 10% p.a.

You are required to:
Prepare the statement of the cost of goods manufactured and the statement of profit or loss & other comprehensive income for the year ended 31 December 20*x*2.

Question 25.13

Mr Len Naidoo, the owner of Widget Distributors, has in the past imported widgets. However, from 1 January 20*x*8, he decided to manufacture the widgets himself.

Here is the abridged statement of financial position of Widget Distributors at 31 December 20*x*7:

Capital – Len Naidoo	2 000	00	Inventory (1 000 units)	800	00
Accounts payable	1 000	00	Accounts receivable	700	00
			Bank	1 500	00
	3 000	00		3 000	00

From a scrutiny of vouchers and other documents you find that these transactions have taken place during the year ended 31 December 20*x*8:

- Cash transactions as per the cash book:
  - Receipts
    - Capital introduced by Mr Naidoo R10 000
    - Accounts receivable R6 000
    - Cash sales R2 000
  - Payments
    - Accounts payable R7 000
    - Drawings – Mr Naidoo R2 500
    - Wages paid to manufacturing staff R3 000
    - Rent for factory R1 200
    - Hire of specialised machinery R1 300
- Amounts owing, totalling R3 500, were written off as bad debts.
- 5 500 units were sold.
  - A royalty of 10 cents per completed unit manufactured during the year is payable in arrears on 1 January of the following year.
  - In addition, the following balances at 31 December 20*x*8 were determined:
    - Accounts payable – raw material R3 500
    - Accounts receivable – trade debtors R1 200
    - Inventory: Finished goods (4 500 units) R?
    - Work-in-progress (2 000 units) R?
    - Raw material R2 500

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– Inventory is valued at factory cost using the first-in-first-out basis.
– Work-in-progress at 31 December 20*x*8 was 75% complete in respect of raw material, and 45% complete in respect of direct labour and overheads.

You are required to:

1 Prepare the statement of the cost of goods manufactured for Widget Distributors for the year ended 31 December 20*x*8.

2 Calculate the gross profit of Widget Distributors for the year ended 31 December 20*x*8.

Question 25.14

Here is the trial balance as at 30 June 20*x*4, and other information relating to Peninsula Manufacturing Ltd.

Appropriation account at 30 June 20*x*3			6 100	00
Bad debts and allowance for bad debts	2 000	00	1 900	00
Bank	10 560	00		
Accounts payable			12 000	00
Accounts receivable	58 665	00		
Directors' fees	1 500	00		
Factory general expenses	4 675	00		
Factory rent	6 000	00		
Factory power and water	1 600	00		
Furniture and fittings (office and warehouse) at cost 30 June 20*x*3	3 000	00		
Furniture and fittings depreciation provision at 30 June 20*x*3			1 300	00
Indirect factory wages	1 800	00		
Loose tools at 30 June 20*x*3	2 200	00		
Plant (factory) at cost at 30 June 20*x*3	40 000	00		
Plant depreciation provisions at 30 June 20*x*3			14 500	00
Production wages – direct	32 000	00		
Purchases:				
Loose tools	800	00		
Raw material	41 000	00		
Sale (20 000 units)			150 000	00
Share capital, authorised and issued R1 shares			50 000	00
Inventory of finished goods at 30 June 20*x*3 (4 000 units) less provision for unearned profit	18 000	00		
Inventory of raw material at 30 June 20*x*3	9 500	00		
Work-in-progress at 30 June 20*x*3	2 500	00		
	235 800	00	235 800	00

Notes

1 Raw material on hand at 30 June 20*x*4 with a cost R10 400, of which material that cost R400 was damaged in store and has no value.

2 Work-in-progress at 30 June 20*x*4 was valued at R4 100.

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3 18 000 units were manufactured during the year and transferred from factory to warehouse.
- At inventory count on 30 June 20*x*4, a shortage of 100 units was discovered.
- Finished goods inventory is valued on the FIFO basis.

4 Depreciation on furniture and fittings is at 5% per annum. on cost.

5 Depreciation on plant is at 15% per annum on the reducing-balance method.

6 Loose tools inventory at 30 June 20*x*4 was valued at R1 800.

You are required to:
Prepare the statement of the cost of goods manufactured and trading account for the year ended 30 June 20*x*4. (statement of profit or loss & other comprehensive income and statement of financial position not required.)

Question 25.15

This information is from the books of Tools Ltd for the year ended 28 February 20*x*6:

Direct manufacturing wages paid			240 000	00
Indirect manufacturing wages			90 000	00
Administrative salaries			36 000	00
Raw material (1 March 20*x*5)			4 800	00
Raw material purchases			480 000	00
Raw material (28 February 20*x*6)			5 400	00
Raw material sales (cost price R1 200)			1 260	00
Inventory of finished goods (1 March 20*x*5)			198 000	00
Inventory of finished goods (28 February 20*x*6)			191 400	00
Sales			1 210 000	00
Purchases of finished goods			60 000	00
Carriage in on raw material purchases			1 200	00
Carriage in on purchases of finished goods			1 800	00
Plant and machinery at cost			300 000	00
Provision for depreciation: Plant and machinery			30 000	00
Provision for unrealised profit on finished goods			18 000	00
Factory power			4 200	00
Maintenance of machinery			6 000	00
Selling and administration expenses			36 000	00
Work-in-progress (1 March 20*x*5):				
Raw material	1 200	00		
Direct wages	2 600	00		
Factory overhead	1 600	00	5 400	00
Work-in-progress (28 February 20*x*6):				
Raw material	1 400	00		
Direct wages	3 000	00		
Factory overhead	1 600	00	6 000	00
Cash discount received			1 200	00
Cash discount allowed			2 400	00

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Additional information:

- Provide for depreciation on plant and machinery at the rate of 10% per annum on cost.
- Finished goods are transferred to the sales department at cost of manufacture plus 10% and the finished goods above were valued on this basis. Final inventory of finished goods consists of manufactured goods only, as all purchased finished goods are sold.

You are required to:
You are required to draft the statement of the cost of goods manufactured and statement of profit or loss & other comprehensive income for the year ended 28 February 20*x*6, clearly showing the following:

1. Cost of raw material consumed.
2. Cost of manufacture.
3. Profit on manufacture.
4. Cost of sales.
5. Gross profit.
6. Net profit before taxation.

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MODULE H Financial analysis and strategy

This module is divided into two chapters:

Chapter 26 Analysis and interpretation of financial statements
Chapter 27 Planning and budgeting

Together these two chapters achieve the following outcomes:

Outcomes

- Reaffirming the fundamental objective of financial reporting, namely to provide information.
- Using the output of the financial accounting system to calculate indicators of past performance, and using these indicators to predict future trends, to make decisions to improve the business, and plan ahead.
- Selecting appropriate figures from financial statements in order to calculate ratios, evaluate the performance and position of a business, draw comparisons relevant to specified benchmarks, and make decisions about future action.
- Demonstrating an understanding of the limitations of the information contained in financial statements.
- Becoming aware of the crucial role of strategic planning for a business, and the necessity of expressing this in the form of a viable financial plan.

Each chapter will identify its specific objectives that should be mastered by learners in order to achieve chapter objectives and module outcomes.

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26 ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

Chapter objectives

By the end of this chapter, you should be able to:

- Identify the reasons for undertaking a fundamental analysis of financial statements.
- Outline the procedure used when analysing the financial statements of a business.
- List and define the key external variables that are considered in the context of fundamental analysis.
- List and define the key internal variables that are considered in the context of fundamental analysis.
- Outline the process that is used for structured ratio analysis.
- Identify, define, calculate and analyse ratios calculated for the purpose of analysing these main categories of performance:
  - profitability of various aspects of the business
  - liquidity and the ability to meet short-term commitments
  - efficiency of working capital management
  - financial leverage (risk)
  - market performance

Chapter outline

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1 Introduction

The aim of financial reporting is to provide information that is useful for the purpose of making decisions. The primary statements (statement of profit or loss & other comprehensive income, statement of changes in equity and statement of financial position) are crucial elements in analysis and decision-making.

These statements contain numerous line items with the relevant amounts, providing both the descriptive and numeric information. They are ordered into categories and presented in such a way that information about the financial performance and position of the business is accessible to all who have a reasonable understanding of accounting.

For example, the statement of profit or loss & other comprehensive income reports on the operating profit and other items that affect the total income of the business, concluding with the retained earnings at the end of the year. The statement of financial position provides lists of assets divided into categories and shows the people who have claims against those assets.

Financial analysis takes this information one step further. Using techniques to be outlined in this chapter, we shall attempt to identify and interpret relationships between the figures presented in the financial statements. The aim of this is to gain further information that may not be immediately apparent from reading the financial statements in their existing form.

There are numerous approaches to financial analysis. These range from elementary applications to intricate and detailed techniques. In this chapter, we will overview a fairly broad spectrum of commonly used ratios and apply them to financial statements prepared for internal use, which have more detailed information, as well as published financial statements.

2 The aim of analysis

Financial analysis may simply be defined as knowing what to look for and how to interpret it. In this chapter, we shall assume that the entity being analysed is a listed public company.

However, all the techniques are equally applicable to other entity forms, although the analysis of such entities is limited by not having stock market prices that are available only for public listed companies.

The examples on the next page show the different perspectives that various people may have when approaching the analysis of a company.

- The **shareholders and potential shareholders** of the company will be interested in its profitability as measured by the return on their investment in equity. They will also wish to establish the financial stability of the company to assess the risk attached to their investment.
- The **suppliers of short-term credit** such as the bank providing overdraft facilities or payables supplying goods on credit, will be interested in the ability of the company to pay its debts promptly. Their time horizon is much shorter than that of shareholders, as in the normal course of business, 90 days is the usual, maximum credit term allowed by suppliers.
- The **suppliers of long-term credit** such as long-term borrowings, mortgage bonds and debentures, will be interested in the company's ability to meet its annual interest commitments and in its ability to repay the long-term debts on maturity. Their analysis may, thus, be similar to that of the shareholder, as they look to a longer horizon and often have large amounts of money due to them.
- The **managers** are concerned with every aspect of the company, as their mandate is to maximise the wealth of the shareholders and ensure continued operation.

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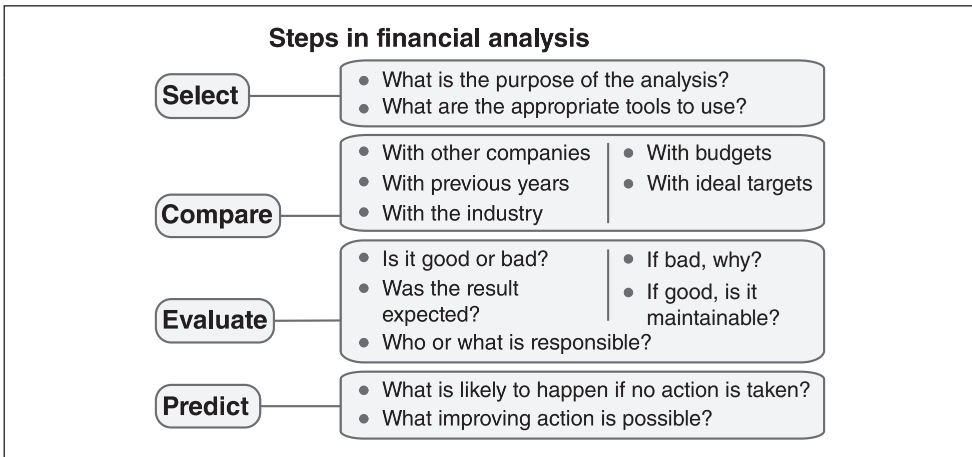
  - They must, thus, ensure that the company is operating efficiently and effectively. Their particular focus will be on the profitability and risk as well as the day-to-day running of the business. They have a distinct advantage over other users of financial information as they have access to the full information set and may, thus, conduct a more detailed analysis.
  - In addition, they are able to classify costs more accurately, placing them in a position to distinguish, for example, between fixed and variable costs that creates additional opportunities for detailed analysis.
- The **auditors** are required to establish whether the company is a going concern and whether the financial statements fairly present the published results of the company.
  - To be in a position to pass this opinion, a number of techniques are used. These include an analytical review of the company.
  - Among other things, the auditor will seek to establish the level of consistency from period to period and investigate any apparent deviations.
- **Many other users** of financial information will also use analytical techniques to assess a business from their perspective. Some examples would be:
  - *Employees* – To ensure that the business has a future, thus, reassuring themselves of continued employment.
  - *Trade unions* – To ensure that workers are not being exploited by highly profitable companies and to enable them to negotiate for better conditions of employment.
  - *Financial analysts* – To assess the future prospects of the business to advise clients whether or not to invest in the business.
  - *Statisticians* – To compile data about corporate activity.

Once the purpose of the analysis has been established, the approach usually follows the typical stages shown in Figure 26.1 below.

Figure 26.1



3 Analysis within the environmental context

There are numerous factors that impact on the business operation of any company. These factors include both variables within the company itself as well as those in its environment. We, thus, distinguish between external factors and internal factors.

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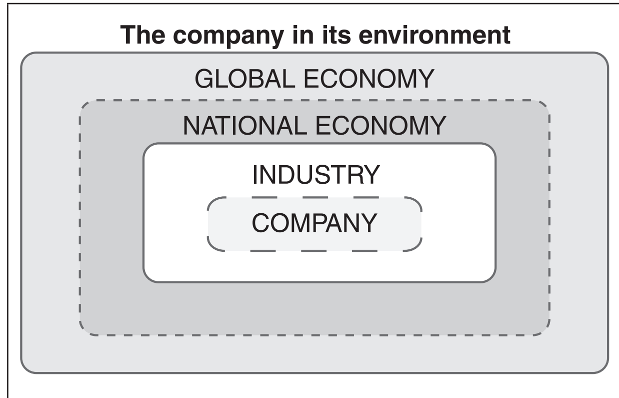
Analysis of external variables

The environment of the company may be analysed in terms of its proximity of effect on the operations of the company. For convenience, it may be sorted into three categories as shown in Figure 26.2.

Figure 26.2



The global economy

Although seemingly remote, the economic conditions that prevail in the world at large are factors that can impact on the performance of a company. The global economy tends to operate in cycles, depending on international conditions such as wars, droughts, inflation, changes in ideologies within individual countries and so on.

Recent history shows that worldwide recessions and depressions occur leaving few, if any, countries unscathed. For this reason, the analyst is constantly in touch with global conditions.

Indicators such as international stock market trends, rates of interest, rates of inflation, foreign exchange rates and other information about expected future conditions are necessary for this analysis.

The national economy

The South African national economy, however, is probably of far greater importance to most companies. These conditions are quite dramatically affected by conditions throughout the world. Factors such as the gold price, interest rates and the rand exchange rate are all crucial variables that have a considerable impact on the South African economy.

For this reason, any financial analysis presupposes that the analyst has some background in economics and is able to interpret the news and other signals from abroad, with a view to predicting how this may impact on the company being analysed.

Once the analyst has some understanding of international conditions, the local economy must be understood. This requires some knowledge of the monetary and fiscal policies of the government, as these play a main role in determining, for example, the supply of money that in turn will affect interest rates.

If interest rates rise, borrowing becomes far more expensive for companies and also places less money in the hands of the consumers who are the market for the product or service. It is, thus, necessary to be able to make an informed prediction regarding future economic conditions and thereby gain a perspective on the prospects of the company.

The industry

The company itself operates within an industry. For example, a retail company operates within a broader industry known as the retail industry. The analyst would need to construct an entity profile of the company within the context of its industry. This requires attention to the following factors:

Type of operation

The legal form of the entity, the industry in which it operates, its main operation,

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distinguishing between manufacturing, wholesale, retail or service type of business, will all be established.

Type of product

The nature of the product or service makes a considerable difference to the perception of the riskiness of the business. The type of product or service shows whether it is likely to create a stable consumer demand, whether there are potential entrants who may easily penetrate into the same industry as competitors, whether the possibility of substitute products or services is high and so on.

Location

The physical location of the outlets for the goods or services of a company is a factor that will, to a large extent, determine the growth potential of the company. It is also a consideration when examining the accessibility to customers and suppliers.

Clientele

The type of clientele usually depends on the nature of goods or services that are provided. Questions to be answered include:

- Do they comprise a growing market?
- Is their spending capacity increasing?
- Do they have bargaining power through consumer boycotts or can they switch to alternative sources?

The answers to these questions assist in identifying the strengths, weaknesses, opportunities and threats of the company being analysed.

Suppliers

In many instances a company depends on suppliers for raw material or other essential components without which the business could not operate. The reliability of the suppliers, as well as their bargaining power is, thus, a consideration when analysing the company within its context.

Competition

Free markets are synonymous with free competition. Free competition should result in the survival of efficient companies and the demise of those that are not efficient. A company is, thus, constantly at risk from competitors who may be operating more effectively and efficiently.

Of course, the key to success is to remain ahead of your competition through productivity and innovation. Some types of goods or services, however, are in industries where the competition is very severe, leaving little room for any relaxation in standards or productivity and quality. Once again this has an impact on the risk of the company.

Analysis of internal variables

Once the entity profile has been completed, it will be necessary to evaluate the prospects of the company. These considerations exclude the financial analysis that will follow but may impact on financial predictions to be made.

Future outlook of the company

The industry analysis provides a benchmark against which to assess the company itself. If the industry prospects are bleak, it is unlikely that the company can anticipate a promising

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future. As a result it will have to engage in strategic planning in an attempt to position itself more favourably. This can be achieved using a number of different strategies.

For example, it may choose to divert a portion of its assets and diversify into a more promising industry. If the industry is buoyant and prospects are bright, growth can be anticipated, although it is likely that competition will increase.

The quality of management

The most frequently quoted reason for company failure is poor management. While the quality of management is difficult to assess, published financial statements often provide details of the age, qualifications and experience of top management.

The future turnover

The single most important variable for virtually every company is its annual turnover. If this variable is expected to increase, then in all probability the bottom line profit will increase, provided gross profits are not eroded.

You should be able to complete Questions 26.1 to 26.5.

4 Ratio analysis

Ratio analysis is undoubtedly the most popular of all analytical techniques. However, it is essential that the strengths and limitations of this technique be explored before an attempt to apply and evaluate its output is made. This will provide a perspective on what this technique does achieve and what it cannot achieve.

Ratio analysis follows the four steps outlined in Figure 26.1. It may be defined as the selection of two line items that have a meaningful relationship and expressing that relationship as a ratio.

The ratio reflects the relative magnitude of one number to another and may be denoted in different ways. For example, if capital and reserves is R80 000 and long-term borrowings are R20 000, the relationship of capital and reserves to long-term borrowings may be expressed as 80 : 20, which can be simplified to 4 : 1.

When interpreted this means that for every R4 of capital and reserves employed to finance a company, R1 of long-term borrowings was used. It may be expressed conversely as 20 : 80, which when simplified is interpreted to mean that for every R1 of long-term borrowings used to finance the company, R4 of capital and reserves was used.

The latter ratio could also be denoted as a fraction, by simplifying 20/80 to $\frac{1}{4}$, which is a fraction of one. It may be expressed as a percentage, 25%, which is a fraction of 100 (hence the percentage), meaning that the relative magnitude is 25 to 100. Thus 20 : 80, 1 : 4, $\frac{1}{4}$, 25%, all have exactly the same connotation, and are mathematical expressions of the same phenomenon.

Before attempting to use ratio analyses as a tool for financial analysis, the following features should be noted at each stage of the analysis.

Selection

Many possible ratios exist that could be selected. The aim of the analysis is the criteria used when deciding upon the relevant ratios to be selected. The analyst must be convinced that the number and denominator line items selected have a relationship that is meaningful.

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It is probable that a number of relevant ratios may be identified and selection from among these will be necessary to avoid information overload.

Comparison

The use of ratios for inter-comparisons is impeded by the existence of different accounting policies and lack of uniformity in disclosure. This is further hampered by ratios that are often poorly defined, thus, detracting from the reliability of the comparison. The figure for return on investment provides a good example of the potential confusion.

Depending on the purpose for which the ratio is being calculated, the numerator may be any one of operating profit before or after interest, taxation or preference share dividends. The denominator could be fixed plus current operating assets, total assets or capital employed.

This ratio alone then has nearly 20 different possible definitions. It is, thus, fundamental that, once selected, the line items being used must be fully defined. Thereafter, for the purpose of comparison, it must be ensured that the same definition has been used for the benchmark against which the ratio is being compared.

The strength of ratio analysis lies in the comparison. Thus the fact that a ratio may be differently defined is not a detracting factor, although it may initially be somewhat confusing.

There are also a number of line items that occur on the financial statements of companies that are beyond the scope of our aims in this text. They include items such as deferred taxation, usually considered to be an interest-free loan from the South African Revenue Service, arising from the difference between accounting profit and taxable income. A further horizon for the use of ratio analysis stems from the consolidated financial report of a group of companies.

Evaluation

The shortcomings of the accounting model should be recognised to ensure that users do not assign more precision to accounting output than is its due. These include factors such as the existence of estimates and judgements, as well as the use of alternative accounting bases. The shortcomings hamper financial analysis, but do not invalidate its usefulness when applied with discretion.

Factors such as the size of a company, outside influences on the company during the period under review, seasonal differences that arose within the period bounded by the two statement of financial position dates and that may not be reflected in either of the two statements of financial position, must enter the evaluation stage.

A further issue in evaluation is that there are many situations in which it is not possible to state with any certainty that a higher number is a better result than a lower number. Generally, a high net profit as a percentage of sales is better than a lower percentage. This may not necessarily be true, however, as the company may be selling only high margin products and would achieve a better return for the shareholders if it increased turnover by reducing the selling price and gaining greater penetration into the market.

Ratios designed to expose other areas requiring analysis, such as the liquidity of the company, also require informed evaluation. A high degree of liquidity, while indicating that cash flow problems are less likely to arise, may also indicate that financial resources are not being efficiently administered.

Most frequently, the ratios selected for analysis comprise two amounts extracted from the financial statements. In certain instances, however, one amount may be a financial statement figure, while the other may be a stock market generated figure. When attempting to evaluate such a ratio, due regard must be had to its limitation. The most frequently

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used ratio of this type is the price/earnings ratio. This expression effectively compares an amount generated by market perceptions of the company as reflected in the share price of a listed company on the JSE Securities Exchange, with the net profit generated within the limitations of the historic cost model of accounting.

Did you know?

There are more than 450 companies listed on the JSE Securities Exchange.

Prediction

The decision to be made resulting from the analysis of historic data will require an extrapolation of the variables being considered into the present and future. The usual judgement must be exercised, as any mechanical application is likely to be questionable.

We are now in a position to explore the relevant ratios for the purpose of a comprehensive financial analysis, using selected ratios.

5 Application of structured ratio analysis

Structured ratio analysis shows that the ratios are classified in accordance with selected criteria used. Structured analysis is appropriate when a comprehensive set of ratios is required that covers the significant aspects of the business operations.

This deviates slightly from our clear injunctions that the user and aim of the analysis must be identified. Instead, we will make available a selection of commonly used ratios from which selection for a specific purpose may be made.

Five main areas of interest to analysis have been identified into which the selected ratios have been classified. The five categories are:

1. Profitability.
2. Liquidity.
3. Efficiency.
4. Financial leverage.
5. Market.

The categories must not be considered to be mutually exclusive, as the selection of a ratio for the primary purpose of establishing liquidity, for example, may include a ratio that we have placed into the efficiency category.

Example 26.1

Music Ltd is a company listed on the JSE Securities Exchange in the retail sector. Its main business is purchasing CDs from manufacturers, which are then sold in bulk to retail outlets and music stores.

The figures provided have not been set out in accordance with IFRS, but rather as an analyst would prepare them, usually on a formularised spreadsheet for easier access to the figures required for the analysis.

The ratios must be carefully defined before calculation is possible. The selection with definitions and figures using the 20*x*4 amounts of Music Ltd form Example 26.1. The calculated ratios for all four years are also provided for the purpose of comparison, evaluation and prediction.

To ensure that you are in a position to calculate the ratio correctly, we suggest that you perform the calculations for the other years and compare your figure with those provided.

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Music Ltd
STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x4

	Notes	20x1		20x2		20x3		20x4	
ASSETS									
Non-current assets		41 476	00	44 380	00	52 010	00	69 655	00
Property, plant and equipment	3	29 444	00	32 499	00	43 908	00	64 047	00
Investments		12 032	00	11 881	00	8 102	00	5 608	00
Current assets		18 216	00	19 894	00	24 746	00	29 686	00
Inventories	4	3 807	00	12 014	00	15 074	00	17 224	00
Accounts receivable	5	8 183	00	5 614	00	8 939	00	11 406	00
Cash and cash equivalents	6	6 226	00	2 266	00	733	00	1 056	00
TOTAL ASSETS		59 692	00	64 274	00	76 756	00	99 341	00
EQUITY AND LIABILITIES									
Capital and reserves		45 745	00	44 651	00	49 225	00	59 218	00
Ordinary share capital	7	30 000	00	30 000	00	30 000	00	30 000	00
Retained profit	8	15 745	00	14 651	00	19 225	00	29 218	00
Non-current liabilities		6 719	00	11 187	00	14 314	00	21 670	00
Long-term borrowings		6 719	00	11 187	00	14 314	00	21 670	00
Current liabilities		7 228	00	8 436	00	13 217	00	18 453	00
Short-term borrowings		2 982	00	3 609	00	4 231	00	5 643	00
Accounts payable	9	4 246	00	4 827	00	8 986	00	12 810	00
TOTAL EQUITY AND LIABILITIES		59 692	00	64 274	00	76 756	00	99 341	00

Music Ltd
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20x4

	Notes	20x1		20x2		20x3		20x4	
Sales (gross)		128 415	00	141 481	00	195 016	00	275 855	00
Cost of sales		(106 634	00)	(125 605	00)	(162 383	00)	(230 822	00)
Gross profit		21 781	00	15 876	00	32 633	00	45 033	00
Other operating income		2 982	00	2 376	00	827	00	897	00
Income from investments		2 982	00	2 376	00	827	00	897	00
Gross operating income		24 763	00	18 252	00	33 460	00	45 930	00
Operating expenses		(12 302	00)	(13 934	00)	(16 939	00)	(18 375	00)
Operating expenses		4 026	00	4 320	00	4 520	00	5 026	00
Selling expenses		2 364	00	3 142	00	3 862	00	4 216	00
Depreciation		5 912	00	6 472	00	8 557	00	9 133	00
Operating profit before interest and taxation		12 461	00	4 318	00	16 521	00	27 555	00
Interest expense	1	(816	00)	(1 454	00)	(2 290	00)	(3 900	00)
Net profit before taxation		11 645	00	2 864	00	14 231	00	23 655	00
Taxation	2	(4 658	00)	(958	00)	(6 057	00)	(9 462	00)
Net profit attributable to ordinary shareholders		6 987	00	1 906	00	8 174	00	14 193	00
Dividends		(3 600	00)	(3 000	00)	(3 600	00)	(4 200	00)
Retained profit/(loss) for the year		3 387	00	(1 094	00)	4 574	00	9 993	00
Retained profit – beginning of year		12 358	00	15 745	00	14 651	00	19 225	00
RETAINED PROFIT – END OF YEAR		15 745	00	14 651	00	19 225	00	29 218	00

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Earnings per share (EPS)		23.29c	6.35c	27.25c	47.31c
Dividends per share (DPS)		12c	10c	12c	14c
Quoted share price (JSE)					
Highest price of the year		206	153	204	254
Lowest price of the year		128	121	121	184
Closing price		135	121	198	254

Additional information:

- All sales and purchases are on credit.
- Information for 20*x*0:
  - Sales R119 122
  - Share price on 1 July 186c
- Issued capital comprises 30 million shares @ R1 each.

Note: The 20*x*4 figures are used in the calculations of all the ratios that follow.

Profitability

We have selected five primary aspects of profitability that are commonly identified.

These aspects attempt to reflect the profit per rand of sales or the profit per rand of capital invested. They are:

- Gross profit.
- Net profit.
- Return on assets before interest and tax.
- Return on capital employed.
- Return on equity.

Gross profit percentage

$$\text{Gross profit \%} = \frac{\text{gross profit}}{\text{sales}} \times 100$$

$$= \frac{45\ 033}{275\ 855} \times 100$$

$$= 16.3\%$$

	20*x*1	20*x*2	20*x*3	20*x*4
Gross profit (GP) %	17.0%	11.2%	16.7%	16.3%

This ratio shows the percentages by which the total selling price is greater than the cost price. A gross profit percentage of 16.3% shows that for every R1 of sales, 16.3c was gross profit. The remaining 83.7c in each rand is the cost price of the goods. When comparing this with previous years, the ratio has dropped from 17.0% in 20*x*1 to the current 16.3%.

It is apparent that Music Ltd had pressure exerted on its gross profit in 20*x*2 as gross profit fell to 11.2%. This could have arisen from two sources:

- Pressure on selling prices as a result of competition in their industry.
- Upward pressure on costs as a result of inflation or other cost factors.

It is important to note, however, that the rand amount of gross profit has more than doubled over the period as a result of the growth in sales.

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Net profit percentage

$$\text{Net profit \%} = \frac{\text{net profit attributable to ordinary shareholders}}{\text{sales}} \times 100$$

$$= \frac{14\ 193}{275\ 855} \times 100$$

$$= 5.2\%$$

	20*x*1	20*x*2	20*x*3	20*x*4
Net profit (NP) %	5.4%	1.3%	4.2%	5.2%

The net profit percentage of 5.2% shows that for every R1 of goods sold, 5.2c eventually becomes profit attributable to the ordinary shareholders. If turnover increases, then each time R1 is received, 5.2c will accrue to ordinary shareholders as net profit.

The faster the turnover, the greater will be the accumulation of 5.2c and the larger the ultimate net profit.

The net profit has followed a similar trend to that of the gross profit with the percentage achieved in 20*x*1 being the high point. It would seem that after the slump in 20*x*2, Music Ltd has recovered well and it is likely that the net profit will increase in 20*x*5.

Return on assets before interest and tax (ROABIT) percentage

$$\text{ROABIT \%} = \frac{\text{net operating profit}}{\text{total assets}} \times 100$$

$$= \frac{27\ 555}{99\ 341} \times 100$$

$$= 27.7\%$$

	20*x*1	20*x*2	20*x*3	20*x*4
ROABIT %	20.9%	6.7%	21.5%	27.7%

Return on assets before interest and tax (ROABIT) shows how well the total assets have been used in earning profit, before any people are rewarded by distribution of the profit (including SARS) in the form of tax and the providers of debt capital by way of interest.

Every rand invested in total assets earned 27.7c and 20*x*4 is the best achievement in the four-year period.

Return on capital employed (ROCE) percentage

$$\text{ROCE \%} = \frac{\text{net operating profit}}{\text{capital and reserves + long-term borrowings}} \times 100$$

$$= \frac{27\ 555}{(59\ 218 + 21\ 670)} \times 100$$

$$= \frac{27\ 555}{80\ 888} \times 100$$

$$= 34.1\%$$

	20*x*1	20*x*2	20*x*3	20*x*4
ROCE %	23.8%	7.7%	26.0%	34.1%

Return on capital employed (ROCE) has been calculated using long-term capital and borrowings to measure the net profit before tax (and before the providers of long-term capital have been rewarded) by using the profit before interest has been deducted.

A return of 34.1% shows that for every R1 of total long-term capital and borrowings

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employed, 34.1c has been earned before tax. This means that 34.1c in every R1 is available to pay interest, tax and shareholders.

Return on equity (ROE) percentage

$$\text{ROE \%} = \frac{\text{net profit attributable to ordinary shareholders}}{\text{capital and reserves}} \times 100$$

$$= \frac{14\ 193}{59\ 218} \times 100$$

$$= 24.0\%$$

	20*x*1	20*x*2	20*x*3	20*x*4
ROE %	15.3%	4.3%	16.6%	24.0%

Return on equity (ROE) is the residual net profit that is available to ordinary shareholders. When net profit is divided by the capital and reserves, the result is the return on the shareholders' investment.

While not arithmetically sound, the net profit for the year attributable to ordinary shareholders is customarily divided by the capital and reserves at the end of the year.

The return for 20*x*4 has provided the best return over the four-year period. A return of 24% is likely to be considered more than satisfactory by the shareholders. It can be seen from scrutinising the figures that interest expense of R3 900 (when compared with long-term borrowings of R21 670) shows an average interest rate of 18% for the year.

As interest is a tax deductible expense, the effective cost to the company is less than 18%, because the interest expense made the amount on which company tax is calculated smaller.

The company, thus, pays less tax than it would have paid had there been no interest. The interest expense has shielded the company from the 28% tax it otherwise would have had to pay, had it not borrowed funds and, thus, been unable to deduct the interest from its taxable income.

Other factors to consider

The profitability ratios focus on the profitability of the business as a whole. They indicate whether the assets of the business are being used effectively to produce a reasonable profit.

Some analysts maintain that the return on assets ratios may be more accurately calculated if the average figure for assets is used (that is, adding the figures for the current and previous year and dividing by two), as the effect of acquiring large assets at the end of the year will be eliminated. This is indeed a consideration that should be taken into account if significant assets have been acquired at the end of the year.

However, the general use of averaged figures may have a distorting effect if consistent growth is being experienced. This is particularly true under inflationary conditions where the assets are more likely to be understated in the financial statements.

A further adaptation that is encountered and that is appropriate under certain conditions, is the reduction of total assets by the amounts of any investments, as these do not contribute to the trading efficiency of the business.

You will notice that Music Ltd has an item 'investments' on the statement of financial position. This will comprise shares that it may own in another company – usually one or more of its suppliers or one or more of the retailers that it supplies. The profitability ratios would then accordingly not treat income from investments as part of profit for the purpose of the calculation, and return on outside investments will then be calculated separately.

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This is shown using the return on assets before interest and tax, excluding the effect of investment income and comparing the return on assets utilised for investments.

Return on assets (ROA) invested in operations before interest and tax percentage

$$\text{ROA (operations) \%} = \frac{\text{net operating profit – income from investments}}{\text{total assets – investments}} \times 100$$

$$= \frac{(27\,555 - 897)}{(99\,341 - 5\,608)} \times 100$$

$$= \frac{26\,658}{93\,733} \times 100$$

$$= 24.8\%$$

Return on assets (ROA) invested outside business operations percentage

$$\text{ROA (investments) \%} = \frac{\text{income from investments}}{\text{investments}} \times 100$$

$$= \frac{897}{5\,608} \times 100$$

$$= 16.0\%$$

	20*x*1	20*x*2	20*x*3	20*x*4
ROA (operations) %	19.9%	3.7%	22.9%	28.4%
ROA (investments) %	24.8%	20.0%	10.2%	16.0%

Investments returns were higher than returns from operations between 20*x*1 and 20*x*2.

When Music Ltd experienced a difficult year in 20*x*2, the return on investments was considerably higher than the returns from operations, demonstrating the advantage of diversifying some funds into assets other than business operations.

Income from investments in the last two years shows a poor return. However, they may be investments accounted for on a cost basis, with only the dividends received being recognised as income.

Reminder

There are many different profitability ratios which can be used. We have identified only five.

We have defined them carefully, calculated them and then compared them over the four years.

Liquidity

These ratios help to determine whether the company will be able to meet its financial obligations in the short term. The difference between current assets and current liabilities is a measure of the liquidity reflected by the working capital.

Two ratios have been selected, both of which are frequently used by management. They are the:

1. Current ratio.
2. Acid-test ratio.

Current ratio

Current ratio = current assets : current liabilities
= 29 686 : 18 453
= 1.61 : 1

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	20x1	20x2	20x3	20x4
Current ratio	2.52	2.36	1.87	1.61

The current ratio has shown a consistent decline over the four-year period from a high of 2.52 in 20*x*1 to a low of 1.61 in 20*x*4.

Looking at the statement of financial position, it is apparent that the current liabilities have increased more than the current assets over the four-year period.

This may be a cause for concern and Music Ltd would be well advised to ensure that they have adequate cash resources on hand to meet their short-term commitments.

Acid-test (or quick) ratio

Acid-test ratio = current assets – inventory : current liabilities
= (29 686 – 17 224) : 18 453
= 12 462 : 18 453
= 0.68 : 1

	20x1	20x2	20x3	20x4
Acid-test (quick) ratio	1.99	0.93	0.73	0.68

The acid-test ratio is the real test of liquidity, as it removes inventory, which is not easily converted into cash, from the calculation of current assets.

The acid-test ratio has also declined dramatically over the last four years from a high of 2.19 to its current low level of 0.68.

To interpret this ratio, it may be said that the company has 68c in cash and near cash to meet every R1 that will require repayment in the short term. Unless it is convinced that liquidity will not be a problem, the company would be well advised to take the necessary steps to redress the trend away from liquidity.

You should be able to complete Questions 26.6 to 26.9.

Efficiency

Five ratios have been selected to assess the efficiency of the company in managing its non-current and current assets. Assets are compared to turnover to see how the relative use of assets over the period has performed in generating sales.

The three most important working capital items are also tested to determine whether they have been efficiently used. The five ratios that will be calculated are:

1 Non-current asset turnover rate.
2 Total asset turnover.
3 Inventory holding period.
4 Accounts receivable collection period.
5 Accounts payable settlement period.

Did you know?
Turnover is another word for sales.

Non-current asset turnover rate

$$\text{Non-current asset turnover} = \frac{\text{turnover (sales)}}{\text{property, plant and equipment}} = \frac{275\ 855}{64\ 047} = 4.31 \text{ times}$$

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	20x1	20x2	20x3	20x4
Non-current asset turnover	4.36	4.36	4.44	4.31

The non-current assets turnover rate shows the extent to which non-current assets have been efficient in generating sales. It shows that for every R1 invested in non-current assets, R4.31 was generated in sales during 20*x*4.

The trend over the four-year period has been consistent and this is a good indicator of stability in non-current tangible asset management.

Total asset turnover rate

$$\text{Total asset turnover} = \frac{\text{turnover (sales)}}{\text{total assets}} = \frac{275\,855}{99\,341} = 2.78 \text{ times}$$

	20x1	20x2	20x3	20x4
Total asset turnover	2.15	2.20	2.54	2.78

The total asset turnover rate is similar to the non-current asset turnover and measures the extent to which total assets have generated sales.

The trend has been more positive than that of the non-current asset turnover ratio and the expectation is that it will continue to increase indicating improvement in the managers of current assets relative to the income from sales.

Inventory holding period

$$\text{Inventory holding period} = \frac{\text{inventory}}{\text{cost of sales}} \times 365 \text{ days} = \frac{17\,224}{230\,822} \times 365 \text{ days} = 27.24 \text{ days}$$

	20x1	20x2	20x3	20x4
Inventory holding period	13.03	34.91	33.88	27.24

The inventory holding period ratio shows you how long inventory is on hand before it is sold.

The inventory holding period has shown considerable fluctuation over the four-year period. The main difference between 20*x*1 and 20*x*2 may have arisen as a result of a change in policy to keep more inventory on hand, or may have resulted from the decline in trading activity in 20*x*2 that is evident in all the ratios for that year.

It appears that inventory is beginning to be sold more quickly and the improvement to 27.24 days in 20*x*4 may show an attempt to return to the efficiency that was achieved in 20*x*1.

Inventory is clearly the most significant current asset. Changes in this ratio have an impact on the current ratio as can be seen from the trends in these two ratios over the last three years.

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Accounts receivable collection period

Accounts receivable collection period $= \frac{\text{accounts receivable}}{\text{credit sales}} \times 365 \text{ days}$

$= \frac{11\,406}{275\,855} \times 365 \text{ days}$

$= 15.09 \text{ days}$

Accounts receivable collection period	**20x1**	**20x2**	**20x3**	**20x4**
	23.26	14.48	16.73	15.09

The accounts receivable collection period shows how long receivables take to pay their accounts, by measuring the number of days from the date of sale to the payment date.

The accounts receivable collection period assumes that all sales are on credit. While this may not always be the case, the comparisons do provide useful information.

This period has fluctuated from a short collection period of 14.48 days in 20*x*2 to a high of 23.26 days in 20*x*1. The current year's figure of 15 days seems to be within the range that they have maintained apart from the unfortunate lapse in 20*x*1.

Accounts payable settlement period

To calculate the time taken to settle debts with payables, the credit purchases for the year must be known.

As the opening and closing inventory as well as the cost of sales for each year are known, it is possible to calculate the credit purchases, assuming that all purchases take place on credit, as follows:

Credit purchases for the year = cost of sales + closing inventory – opening inventory

20*x*4 credit purchases = R(230 822 + 17 224 – 15 074)

= R232 972

Accounts payable settlement period $= \frac{\text{accounts payable}}{\text{credit purchases}} \times 365 \text{ days}$

$= \frac{12\,810}{232\,972} \times 365 \text{ days}$

$= 20.07 \text{ days}$

Accounts payable settlement period	**20x1**	**20x2**	**20x3**	**20x4**
	14.50	13.17	19.82	20.07

The accounts payable settlement period measures how long it takes the firm to pay its payables. It is determined in the same way as the accounts receivable collection period, except that payables and credit purchases are substituted for receivables and credit sales respectively.

Accounts payable are settled promptly although it is apparent that in the last two years Music Ltd has adopted a policy of keeping the payables waiting marginally longer. This may be a symptom of their liquidity problems, and scrutiny of the statement of financial position shows that very low bank and cash resources are currently on hand.

Note that sound management of working capital would endeavour to ensure that the accounts receivable collection period is shorter than the accounts payable payment period, an aim that has only been achieved in recent years.

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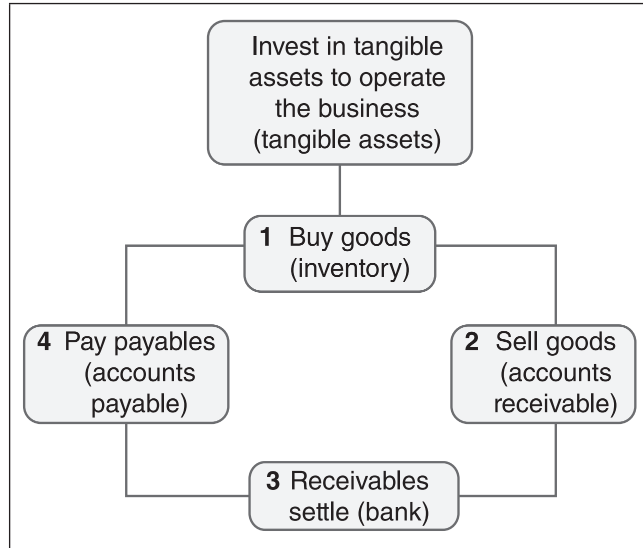
A very simple business cycle is shown in Figure 26.3. It shows the four events in the cycle (numbered 1 to 4) in the ideal order in which the settlement should occur for maximum efficiency. In practice it does not always take place in this order. For example, if payables offer very attractive cash settlement discounts, it is better to pay them before the cash is received.

In some industries, especially in retail, receivables are given up to six months to settle their accounts – changing this to a shorter period may drive customers away to competing stores.

Figure 26.3



The company is, thus, forced to pay payables before the cash is received from receivables.

Financial leverage

These ratios examine the financing structure of the business. They focus on the combination of owner's equity and outside financing (long- and short-term) used by the company.

Three ratios have been selected for this purpose as follows:

- Debt ratio.
- Debt to equity ratio.
- Interest cover.

Debt ratio

$$\text{Debt ratio} = \frac{\text{total debt}}{\text{total assets}} \times 100$$

$$= \frac{(21\,670 + 18\,453)}{99\,341} \times 100$$

$$= \frac{40\,123}{99\,341} \times 100$$

$$= 40.4\%$$

	20x1	20x2	20x3	20x4
Debt ratio	23.4%	31.5%	35.8%	40.4%

The debt ratio has been defined as total debt compared to total assets. The total debt includes long-term borrowings and current liabilities.

The percentage of 40.4% shows that for every R1 used to purchase total assets, 40.4c of the financing was provided by people other than the ordinary shareholders.

It is apparent that over the four-year period Music Ltd has moved towards a policy of using more debt to finance its assets.

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Debt to equity ratio

Debt to equity ratio $= \frac{\text{long-term borrowings}}{\text{capital and reserves}} \times 100$

$= \frac{21\ 670}{59\ 218} \times 100$

$= 36.6\%$

	20*x*1	20*x*2	20*x*3	20*x*4
Debt to equity ratio	14.7%	25.1%	29.1%	36.6%

The debt to equity ratio has attempted to concentrate only on long-term debt, that is debt that requires a reward in the form of interest. The comparison is, thus, between long-term borrowings and capital and reserves.

The ratio may be interpreted to mean that for every R1 of capital provided by ordinary shareholders, 36.6c was raised through long-term borrowings.

The debt to equity ratio has been a little erratic over the four years but a definite trend to increasing this ratio is apparent with the highest percentage of debt to equity over the four years in the most recent year.

This ratio is often defined differently, most popularly by comparing total debt to capital and reserves. Such a definition would provide little additional information to that already available from an intuitive interpretation of the debt ratio.

Comparing only long-term borrowings to capital and reserves provides insight into the capital structure of the company, thus, providing information that will be useful in assessing financial risk.

Interest cover

Interest cover $= \frac{\text{net operating profit before interest and tax}}{\text{interest expense}}$

$= \frac{27\ 555}{3\ 900}$

$= 7.07$ times

	20*x*1	20*x*2	20*x*3	20*x*4
Interest cover	15.27	2.97	7.21	7.07

The interest cover rate (often referred to as the 'times interest earned ratio') shows the number of times that the net profit is able to cover the interest that is due. It is calculated before tax and interest to reflect the position most accurately.

Assume, for example, that the net operating profit before interest and tax in 20*x*4 was R3 900, the exact amount required to meet the interest expense.

The times interest earned ratio would be 1, and so no profit would accrue to shareholders, there would be no liability for tax. As the debt component of capital increases, it would be expected that the interest cover would fall.

This is in fact what has happened for Music Ltd, with an interest cover of only 7.6 times in 20*x*4.

In the company's difficult 20*x*2 year, payables were most at risk of not receiving their interest as net profit achieved less than three times the required interest

Reminder

Ratios are calculated for the main purpose of comparison either over a period of time, or within industry.

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expense. Had it not been for investment income, the profit would only just have covered the interest commitment.

You should be able to complete Questions 26.10 to 26.14.

Market ratios

Market ratios use information from the published stock exchange prices. In some instances a market value is selected and related to a book value to calculate the ratio, while in others two market values are related.

Only ratios where both values are market generated can be classified as true market value ratios:

- Return to shareholder.
- Dividend yield.
- Earnings yield.
- Price earnings ratio.

Return to shareholder (RTS) ratio

$$\text{Return to shareholder} = \frac{\text{share price (end)} - \text{share price (beginning)} + \text{dividends}}{\text{share price at the beginning of the year}} \times 100$$

$$= \frac{(254 - 198 + 14)}{198} \times 100$$

$$= \frac{70}{198} \times 100$$

$$= 35.4\%$$

Return to shareholder (RTS)	**20*x*1**	**20*x*2**	**20*x*3**	**20*x*4**
	(20.0)%	(3.0)%	73.6%	35.4%

The return to shareholder (RTS) ratio is a true market ratio, as it relates the actual cash income that an investor could have realised had the shares been purchased at the beginning of a year and sold at the end of that year. It is unlikely that many investors would have used such an investment strategy, but the ratio will indicate the return that would have been achieved had this strategy been used.

The comparison between years to establish a trend, if any, is of considerable importance to investors and potential investors in shares.

It is apparent from the four-year review of the return to shareholder that it has fluctuated considerably, from a low of minus 21.0% in 20*x*1 to a high of 73.6% in 20*x*3. Of special interest is the fact that 20*x*2 was the least profitable year based on reported profit of Music Ltd. However, the market anticipated the difficult year and the share price had already begun falling in anticipation of the reduced earnings.

Such a market reaction is consistent with theories relating to the behaviour of share prices. A theory known as the efficient markets hypothesis holds that share prices react immediately to all publicly available information. For example, if information with regard to expected economic conditions is gloomy, or if information about the industry in which Music Ltd operates is pessimistic, the market price of shares will react to such negative information.

The information contained in financial statements will usually confirm the expectations of investors, but, if new information is obtained, it will similarly affect the share price.

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Dividend yield (DY)

$$\text{Dividend yield} = \frac{\text{dividends per share declared during the year}}{\text{share price at the end of the year}} \times 100$$

$$= \frac{14}{254} \times 100$$

$$= 5.5\%$$

	20x1	20x2	20x3	20x4
Dividend yield (DY)	8.8%	8.3%	6.1%	5.5%

The dividend yield (DY) is another true market ratio as it relates the cash receivable from dividends to the cash that could be realised if the share is sold. It is different from return on investment and does not measure the success of an investment, as the company may pay small dividends because they wish to retain funds to finance growth opportunities.

Shareholders will benefit from a higher share price and the potential profits from utilisation of the growth opportunities. Many investors, however, for reasons that are not easily explained on rational economic grounds, rate a company highly if it is able to pay large dividends.

The counter argument is that the payment of dividends may be a futile exercise if the company has investment opportunities that it wishes to use, because it will have to raise the funds that it has paid out in the form of dividends, incurring unnecessary effort and expense to raise additional funds.

Nevertheless, the most likely reason for the partiality of investors to dividends is that, by paying a dividend, a company is demonstrating its liquidity and ability to meet its obligations. Tax legislation may also pay a significant role in the partiality of investors toward receiving dividends or not.

Earnings yield (EY)

$$\text{Earning yield} = \frac{\text{earnings per share}}{\text{share price at the end of the year}} \times 100$$

$$= \frac{47.31}{254} \times 100$$

$$= 18.6\%$$

	20x1	20x2	20x3	20x4
Earnings yield (EY)	17.3%	5.2%	13.8%	18.6%

The earnings yield (EY) ratio is similar in principle to the dividend yield ratio, except that it relates earnings per share and not dividends per share to the share price.

This is not a true market ratio as it relates a figure generated by the accounting process to a figure generated by the economic forces of supply and demand, based on the information available to investors. Nevertheless, the trends that may be monitored are meaningful indicators of share performance.

Price earnings (P/E) ratio

$$\text{Price earnings ratio} = \frac{\text{share price at the end of the year}}{\text{earnings per share}}$$

$$= \frac{254}{47.31}$$

$$= 5.4 \text{ times}$$

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	20x1	20x2	20x3	20x4
Price earnings (P/E) ratio	5.8	19.1	7.3	5.4

The price earnings (P/E) ratio compares the book figure for earnings with the market figure for share price. It shows how much investors are prepared to pay per rand of reported profits. It is the inverse of the earnings yield that indicated the earnings per rand of share price.

The price earnings for companies with growth opportunities is generally higher than for mature companies, as the future profits are expected to grow, thus, making investors more prepared to pay a higher price.

You should be able to complete Questions 26.15 to 26.16.

6 Chapter illustrative example

The abbreviated financial statements of Diversified Ltd, a diversified company listed under the Motor Industries sector of the JSE Securities Exchange follow.

Diversified Holdings Ltd
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 SEPTEMBER 20x3

	Notes	20x1		20x2		20x3	
Income from contracts		43 468	00	47 833	00	72 162	00
Cost of material		(21 750	00)	(24 030	00)	(40 090	00)
Gross profit		21 718	00	23 803	00	32 072	00
Other operating income		1 890	00	2 079	00	1 372	00
Income from investments		1 890	00	2 079	00	1 372	00
Gross operating income		23 608	00	25 882	00	33 444	00
Operating expenses		(7 038	00)	(8 276	00)	(10 138	00)
Operating expenses		2 402	00	3 432	00	5 179	00
Selling expenses		3 336	00	3 414	00	1 286	00
Depreciation		1 300	00	1 430	00	3 673	00
Operating profit before taxation		16 570	00	17 606	00	23 306	00
Interest expense	1	(4 220	00)	(4 066	00)	(5 878	00)
Net profit before taxation		12 350	00	13 540	00	17 428	00
Taxation	2	(4 940	00)	(5 144	00)	(7 040	00)
NET PROFIT FOR THE YEAR		7 410	00	8 396	00	10 388	00

STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20x3

	Notes	20x1		20x2		20x3	
ASSETS							
Non-current assets		44 420	00	50 305	00	77 078	00
Property, plant and equipment	3	35 670	00	41 555	00	73 678	00
Investments		8 750	00	8 750	00	3 400	00
Current assets		30 499	00	31 406	00	28 133	00
Inventories	4	13 450	00	15 788	00	12 757	00
Accounts receivable	5	12 455	00	14 678	00	12 943	00
Cash and cash equivalents	6	4 594	00	940	00	2 433	00
TOTAL ASSETS		74 919	00	81 711	00	105 211	00

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EQUITY AND LIABILITIES							
Capital and reserves		42 788	00	46 344	00	58 932	00
Ordinary share capital	7	24 500	00	24 500	00	26 700	00
Retained profit	8	13 288	00	16 844	00	27 232	00
Non-distributable reserve		5 000	00	5 000	00	5 000	00
Non-current liabilities		23 466	00	25 416	00	30 934	00
Long-term borrowings		23 466	00	25 416	00	30 934	00
Current liabilities		8 665	00	9 951	00	15 345	00
Short-term borrowings		2 982	00	3 609	00	2 890	00
Trade and other payables	9	5 683	00	6 342	00	12 455	00
TOTAL EQUITY AND LIABILITIES		74 919	00	81 711	00	105 211	00

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 SEPTEMBER 20*x*3

	Notes	20*x*1		20*x*2		20*x*3	
Balance at the beginning of the year		39 778	00	42 788	00	46 344	00
Profit for the year		7 410	00	8 396	00	10 388	00
Dividends		4 400	00	4 840	00	0	00
Share issue		0	00	0	00	2 200	00
BALANCE AT THE END OF THE YEAR		42 788	00	46 344	00	58 932	00

Diversified Ltd purchases materials, which are used in the construction of plastic moulding and pressed products. All purchases are made on credit. The company enters into contracts with their clients who are given credit terms.

In 20*x*1, it became apparent that there were considerable expansion opportunities that could be profitable.

The financial management team are considering the impact of strategic changes in the company's approach toward working capital management and capital structure, which were introduced at the beginning of the 20*x*2 financial year.

There is also some debate about the impact on income of changes in mark-ups.

You are required to:

1. Explain the changes in strategy implemented by the company relating to the mark-up of materials for the 20*x*2 financial year and indicate the impact that this has had on margin and on return on total assets (net operating profit/total assets) compared to the 20*x*0 financial year. (Maximum of 100 words, excluding calculations.)
2. Explain the changes in working capital management for the 20*x*2 financial year with reference to inventory, receivables and payables and indicate the impact that this has had on liquidity, compared to the 20*x*1 financial year. (Maximum of 100 words.)
3. List the methods used to finance the expansion and explain the impact on capital structure and return on equity for the 20*x*2 financial year, compared to the 20*x*1 financial year. (Maximum of 100 words.)
4. Assume you are now responsible for drafting the 20*x*3 budgeted financial statements. Offer the approximate figure, which you would budget for the following line items, justifying your figure. (Maximum of 30 words per line item.)
   - Capital and reserves.
   - Long-term loans.
   - Gross profit.

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It is sometimes useful to draft a very basic statement of financial position to see the main items more clearly. This may be done as follows:

STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20x3

	Notes	20x1		20x2		20x3	
ASSETS							
Non-current assets		44 420	00	50 305	00	77 078	00
Property, plant and equipment	3	35 670	00	41 555	00	73 678	00
Investments		8 750	00	8 750	00	3 400	00
Net working capital		21 834	00	21 455	00	12 788	00
TOTAL ASSETS		66 254	00	71 760	00	89 866	00
EQUITY AND LIABILITIES							
Capital and reserves		42 788	00	46 344	00	58 932	00
Non-current liabilities		23 466	00	25 416	00	30 934	00
TOTAL EQUITY AND LIABILITIES		66 254	00	71 760	00	89 866	00

On the next page is a list of the main ratios that are calculated to perform a thorough fundamental analysis of this company. Each subsection can be responded to by reference to the numbers.

PROFITABILITY	**20x1**	**20x2**	**20x3**
Mark-up %	99.9%	99.1%	80.0%
Gross profit %	50.0%	49.8%	44.4%
Net profit %	17.0%	17.6%	14.4%
ROA (operations) %	22.1%	21.5%	22.2%
ROA (investments) %	13.3%	13.4%	13.2%
Return on equity	17.3%	18.1%	17.6%
LIQUIDITY	**20x1**	**20x2**	**20x3**
Current ratio	3.52 : 1	3.16 : 1	1.83 : 1
Acid-test ratio	1.97 : 1	1.57 : 1	0.99 : 1
Cash ratio	0.53 : 1	0.09 : 1	0.16 : 1
SOLVENCY (GEARING)	**20x1**	**20x2**	**20x3**
Total debt ratio	42.9%	43.3%	44.0%
Debt to equity ratio	54.8%	54.8%	52.5%
Long-term borrowings to total assets	31.3%	31.1%	29.4%
Interest cover	3.9	4.3	4.0
MANAGEMENT	**20x1**	**20x2**	**20x3**
Inventory holding period	226	240	116
Accounts receivable collection period	105	112	65
Accounts payable settlement period	n/a	99	134
Net working capital turnover	2.0	2.2	5.6
Non-current asset turnover	1.2	1.2	1.0
MARKET	**20x1**	**20x2**	**20x3**
Price earnings (P/E)	7.0	6.3	6.9
Dividend yield (DY)	8.5%	9.1%	0.0%
Earnings yield (EY)	14.3%	15.8%	14.5%
Return to shareholder	n/a	10.4%	39.3%

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1 Materials have been marked up by 80%, instead of 100%.

This reduction in mark-up has led to an increase in income from contracts to 50.8% (R72 162 ÷ R47 833) and an increase in return on assets from 21.5% to 22.2%, which is a reasonable increase considering it is the first year under the new policy.

Lower material mark-up has led to more contracts, thus, increasing the salary and wage expense by 50% (R5 179 ÷ R3 432).

2 Changes in working capital management policy were due to:

- Reduce accounts receivable collection period as above.
- Increase accounts payable settlement period days as above.
- Reduce inventory days as above.

These policies have been implemented successfully, particularly accounts receivable collection period and inventory turnover. The impact has been reduction in liquidity, but not below norms, which is acceptable. Cash resources are considerably improved from 20*x*2.

3 To finance the expansion of non-current assets, which increased by 77% (R73 678 ÷ R41 555), the main sources were used:

- New share issue (350 shares @ R6.28).
- No dividends were paid in 20*x*3.
- Additional long-term borrowings were raised (R5 518).
- Investments were liquidated (R5 350).
- Working capital policy changes (release of R8 667).

The additional financing has, thus, come both from shareholders and from further debt. The debt equity ratio has, thus, remained reasonably constant.

The impact on ROE is not apparent using conventional accounting ratios, because the equity base in 20*x*3 is inflated by the non-payment of dividends. The share market has, however, reacted by discounting expected future profits into the share price.

4 These are estimates and there is no correct response. However, they should be reasonable with some clear statement of why the amount selected was used.

- *Capital and reserves*: R70 000
  Assuming no additional share issue, no dividend payment and a return on equity during 20*x*4 of around 20%
- *Long-term borrowings*: R37 000
  Assuming we retain the present capital structure and growth of around 20%.
- *Gross profit*: R40 000
  The new policy of lower mark-up on material is attracting additional contracts. An increase in gross profit of at least 20% therefore seems appropriate.

7 Summary

The primary financial statements of a company are prepared to provide information to make economic decisions to the users of these statements. Such decisions are made within the context of environmental factors that impact on a company.

The analysis of financial statements must therefore be conducted with insight into the expected economic conditions that will prevail in the global and national economy. Circumstances prevalent in the industry in which the company operates will also have an impact on its future prospects.

The information available in financial statements has many limitations in its usefulness

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for decision-making. Most pertinent is the continued use of the historic cost model of accounting in times of inflation. However, no universally acceptable alternative accounting model has yet been developed and the historic cost model, although modified in some respects, is likely to persist as the primary accounting model. This does not, however, relieve the providers of information of their responsibility to report information that is understandable, relevant, reliable and comparable.

The financial statements, despite their limitations, can be analysed further, with due regard to such limitations and together with relevant information available from other sources. The primary considerations in every analysis is to establish the party for whom the analysis is being conducted and the purpose of the analysis. This will assist in proceeding through the four stages of an analysis that we have suggested.

Reminder

The four stages are:
- Select (the ratio).
- Compare (over time or with other companies).
- Evaluate (good or bad).
- Predict (the action to be taken).

Only when the purpose of the analysis is defined, is it possible to select the appropriate techniques and relevant items for analysis. The results will then be compared and evaluated.

Finally, the decisions required a prediction that will follow from the previous three stages.

Ratio analysis is the most widely used technique for the interpretation of financial statement information. Ratios can be usefully classified into five main categories.

1 **Profitability ratios** express the effectiveness of the company in earning profits and return on capital invested.
2 **Liquidity ratios** indicate the ability of the company to meet its short-term financial obligations.
3 **Efficiency ratios** reflect the managers' ability of the company with regard to its turnover and working capital.
4 **Financial-leverage ratios** show the relative extent to which the capital employed has been provided by shareholders and providers of debt.
5 **Market ratios** reflect the performance of the share price on the stock exchange and the implications for the shareholders of that share.

Figure 26.4 is a summary of the ratios discussed in this chapter.

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Figure 26.4

SUMMARY OF THE FINANCIAL RATIOS

PROFITABILITY

Ratio		Formula
Gross profit %	=	$\frac{\text{gross profit}}{\text{sales}}$
Net profit %	=	$\frac{\text{net profit attributable to ordinary shareholders}}{\text{sales}}$
ROABIT %	=	$\frac{\text{net operating profit}}{\text{total assets}}$
ROCE %	=	$\frac{\text{net operating profit}}{\text{capital and reserves + long-term borrowings}}$
ROE %	=	$\frac{\text{net profit attributable to ordinary shareholders}}{\text{capital and reserves}}$
ROA (operations) %	=	$\frac{\text{net operating profit – income from investments}}{\text{total assets – investments}}$
ROA (investments) %	=	$\frac{\text{income from investments}}{\text{investments}}$

LIQUIDITY

Ratio		Formula
Current ratio	=	current assets : current liabilities
Acid-test ratio	=	current assets – inventory : current liabilities

EFFICIENCY

Ratio		Formula
Non-current asset turnover	=	$\frac{\text{turnover (sales)}}{\text{property, plant and equipment}}$
Total asset turnover	=	$\frac{\text{turnover (sales)}}{\text{total assets}}$
Inventory holding period	=	$\frac{\text{inventory}}{\text{cost of sales}} \times 365 \text{ days}$
Accounts receivable collection days	=	$\frac{\text{accounts receivable}}{\text{credit sales}} \times 365 \text{ days}$
Accounts payable settlement days	=	$\frac{\text{accounts payable}}{\text{credit purchases}} \times 365 \text{ days}$

FINANCIAL LEVERAGE

Ratio		Formula
Debt ratio	=	$\frac{\text{total debt}}{\text{total assets}}$
Debt to equity	=	$\frac{\text{long-term borrowings}}{\text{capital and reserves}}$
Interest cover	=	$\frac{\text{net operating profit before interest and tax}}{\text{interest expense}}$

MARKET RATIOS

Ratio		Formula
Return to shareholder	=	$\frac{\text{share price (end) – share price (beginning) + dividends}}{\text{share price at the beginning of the year}}$
Dividend yield (DY)	=	$\frac{\text{dividends per share declared during the year}}{\text{share price at the end of the year}}$
Earnings yield (EY)	=	$\frac{\text{earnings per share}}{\text{share price at the end of the year}}$
Price earnings (P/E) ratio	=	$\frac{\text{share price at the end of the year}}{\text{earnings per share}}$

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QUESTIONS

Question 26.1

List four different types of stakeholders that could benefit from analysing the financial statements of a business.

Question 26.2

List, in order, four stages that are appropriate in approaching the analysis and interpretation of the financial statements of a business.

Question 26.3

Identify three pertinent sources of information for a comprehensive financial analysis of a public company.

Question 26.4

Define each of these terms. Then discuss why each term is important to consider when analysing the financial statements of a company:

- Global economy.
- National economy.
- The industry.

Question 26.5

Comparisons are made when analysing financial data. Indicate three possible standards that can be used for such comparisons and state the reasons why each will be used.

Question 26.6

The current ratio is an indicator of a company's liquidity and ability to meet its short-term debts. What further information would you require before concluding whether or not a specific company's current ratio is 'good' or 'bad'?

Question 26.7

You are the auditor of Syphele Ltd, a company trading in the motor industry. On examining its latest annual financial statements, you make these observations:

- Its gross profit margin, which had consistently been 30% over the past five years, has dropped to 25%.
- Its current ratio, which in the past has always been at the same level as the industry average of 2:1, has now increased to 4:1.

You are required to:

1. List three possible factors that could have caused the reduction of the gross profit margin.
2. List three possible factors that could have caused the increase in the current ratio.

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Question 26.8

Below is an extract from the annual financial statements of Bontsha Ltd (all figures in R'000):

Turnover (gross sales)	9 000	00
Cost of sales	6 300	00
Gross profit	2 700	00
Operating expenses (no interest)	1 000	00
Net profit before tax	1 700	00
Non-current assets	3 200	00
Total assets	4 300	00
Current liabilities	600	00

You are required to:
Calculate the following ratios:

1. Gross profit %.
2. Net profit %.
3. Return on assets before interest and tax (ROABIT).
4. Current ratio.
5. Total asset turnover.

Question 26.9

The information below was extracted from the books of Bekker Traders, owner J. Bekker, on 30 June 20*x*2. Bekker Traders' accounting period ends annually on 30 June.

You are required to:
Use the given information to find these ratios and then comment on them. Show all your calculations.

1. The gross profit.
2. The net profit.
3. The net working capital.
4. The acid-test ratio.

Information:

- From the statement of profit or loss & other comprehensive income:

Sales (turnover)	51 600	00
Cost of sales	20 640	00
Total current expenses	12 900	00

- List of balances taken from the books (with all adjustments considered and all closing transfers journalised and posted):

Capital	90 300	00
Land and buildings	90 000	00
Equipment	25 000	00
Inventory	20 600	00
Accounts receivable	12 412	00
Bank (overdraft)	2 322	00
Cash float	150	00

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Petty cash	60	00
Accounts payable	13 281	00
South African Revenue Service (SARS)	597	00
Mortgage bond	45 290	00
Accumulated depreciation: Equipment	8 750	00
Allowance for bad debts	470	00
Fixed deposit (matures 30 November 20*x*3)	12 860	00
Accrued expenses	280	00
Prepaid expenses	208	00

Question 26.10

Hie Ha Traders supplies you with this information:

Hie Ha Traders
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20*x*8

Sales (credit)			90 000	00
Opening inventory	5 000	00		
Purchases (credit)	125 000	00		
	130 000	00		
Less: Closing inventory	80 000	00		
Cost of sales			(50 000	00)
Gross profit			40 000	00
Operating expenses			10 000	00
Salaries	4 000	00		
Advertising	6 000	00		
NET INCOME FOR THE YEAR			30 000	00

Hie Ha Traders
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*8

Capital			100 000	00
Non-current assets			30 000	00
Net current assets			70 000	00
Current assets				
Inventories	80 000	00		
Accounts receivable	20 000	00		
Cash and cash equivalents	60 000	00		
Current liabilities				
Accounts payable	90 000	00		
			100 000	00

You are required to:

Calculate the:

1 Gross profit.

2 Net profit.

3 Current ratio.

4 Quick ratio.

5 Accounts receivable collection in days.

6 Inventory holding period.

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Question 26.11

Quo Vadis Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20x0

ASSETS		
Non-current assets	200 000	00
Current assets	110 000	00
	310 000	00
EQUITY AND LIABILITIES		
Share capital	100 000	00
Accumulated profit 1	50 000	00
Capital and reserves	150 000	00
Long-term loan (10%)	150 000	00
Current liabilities	10 000	00
	310 000	00

1	Net profit for the year	40 000	00
	Accumulated profit 1 January 20x0	10 000	00
	Accumulated profit 31 December 20x0	50 000	00

Quo Vadis Ltd would like to purchase additional non-current assets that cost R100 000 and is considering borrowing R100 000 from Ratios Ltd at 10% per annum to finance this.

(Ignore taxation and assume that the present return on assets will be maintained on the new fixed assets.)

You are required to:

1 Calculate these three ratios of relevance to Quo Vadis Ltd, using the present information (before the loan) and after the loan:
- **a** Debt to equity ratio.
- **b** Debt ratio.
- **c** Return on equity.

2 Calculate these two ratios for Ratios Ltd to help them decide whether to grant the loan, using the present information (before the loan) and after the loan:
- **a** Return on assets.
- **b** Interest cover.

3 Based on your calculations in Questions 1 and 2, will Ratios Ltd be prepared to finance Quo Vadis Ltd? State briefly why or why not.

Note
Restrict your written comments to an absolute minimum and base them only on the ratios that you have calculated.

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Question 26.12

This information for Ying Yong (Pty) Ltd was extracted from the company's financial statements on the last day of the financial year, 31 December 20*x*9.

Total issued share capital	500 ordinary R1 shares
Turnover	R100 000
Gross profit %	15%
Non-current asset turnover	1.60 : 1
Net income before interest and after tax to turnover	6%
Return on total assets	9.6%
Working capital	R30 000
Current ratio	2.5 : 1
Quick ratio	1.3 : 1
Debt ratio	0.56 : 1
Dividends paid and proposed	R4,40 per share

Additional information:

- Assume that taxation is calculated at 50% of net profit before taxation.
- Interest expense is 40% of net income after taxation.

You are required to:

In draft form, construct the statement of profit or loss & other comprehensive income of Ying Yong (Pty) Ltd for the year ended 31 December 20*x*9 and the statement of financial position at that date, from the information given.

You need only give the necessary details that you are able to extract from the information supplied above, but your net profit at the end of the year must be accurate and statement of financial position totals must agree.

Question 26.13

Brooks Ltd makes sports shoes. You have been asked to analyse the company's financial position and, in particular, to assess the management of current assets and the use of debt.

Additional information:

1. The company's share capital consists of 675 000 shares of R1 each (market value R4.70).
2. The preference shares are redeemable on 1 September 20*x*9.
3. Industry ratios for 20*x*6:
   - Current ratio: 2 : 1
   - Acid-test (quick) ratio: 1 : 1
   - Inventory turnover (sales/inventory): 6 times
   - Accounts receivable collection period: 40 days
   - Debt ratio: 59%
   - Times interest earned: 6 times

You are required to:

1. Calculate the relevant ratios for 20*x*6 and 20*x*5 to analyse the company's liquidity position and management of current assets. Comment on your findings.
2. Calculate the relevant ratios for 20*x*6 and 20*x*5 to analyse the company's use of debt to finance its operations. Comment on your findings.
3. Calculate the company's earnings and dividend yields for 20*x*6.

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The draft financial statements for 20x6 and 20x5 are presented below:

Brooks Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 AUGUST 20x6

	Notes	20x6		20x5	
Sales (all sales are on credit)		8 532 000	00	7 425 000	00
Cost of sales		(6 399 000	00)	(5 494 500	00)
Gross profit		2 133 000	00	1 930 500	00
Operating expenses		(1 344 600	00)	(1 174 500	00)
Operating expenses		1 263 600	00	1 107 000	00
Depreciation		81 000	00	67 500	00
Operating profit before interest expense and taxation		788 400	00	756 000	00
Interest expense	1	(243 000	00)	(148 500	00)
Net profit before taxation		545 400	00	607 500	00
Taxation	2	(243 000	00)	(216 000	00)
Net profit before extraordinary loss		302 400	00	391 500	00
Extraordinary loss		(108 000	00)	0	00
Net profit attributable to ordinary shareholders		194 400	00	391 500	00
Dividends		(72 900	00)	(72 900	00)
Preference		32 400	00	32 400	00
Ordinary		40 500	00	40 500	00
Retained profit/(loss) for the year		121 500	00	318 600	00
Retained profit – beginning of year		837 000	00	518 400	00
RETAINED PROFIT – END OF YEAR		958 500	00	837 000	00

Brooks Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20x6

	Notes	20x6		20x5	
ASSETS					
Non-current assets		945 000	00	864 000	00
Property, plant and equipment	3	945 000	00	864 000	00
Investments		0	00	0	00
Current assets		3 604 500	00	2 963 250	00
Inventories	4	2 092 500	00	1 485 000	00
Accounts receivable	5	1 215 000	00	999 000	00
Cash and cash equivalents	6	297 000	00	479 250	00
TOTAL ASSETS		4 549 500	00	3 827 250	00
EQUITY AND LIABILITIES					
Capital and reserves		1 903 500	00	1 782 000	00
Ordinary share capital	7	675 000	00	675 000	00
Retained profit	8	958 500	00	837 000	00
Redeemable preference share capital		270 000	00	270 000	00
Non-current liabilities		742 500	00	742 500	00
Long-term borrowings		742 500	00	742 500	00
Current liabilities		1 903 500	00	1 302 750	00
Short-term borrowings		1 417 500	00	870 750	00
Accounts payable	9	486 000	00	432 000	00
TOTAL EQUITY AND LIABILITIES		4 549 500	00	3 827 250	00

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Question 26.14

You have been given these financial statement extracts of Speed Merchants (Pty) Ltd:

STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20x4

	Notes	20x4	
Sales		3 000 000	00
Cost of sales		?	
Opening inventory		355 000	00
Purchases		?	
		?	
Less: Closing inventory		?	
Gross profit		?	
Other operating income		15 000	00
Income from investments		15 000	00
Gross operating income		?	
Operating expenses		?	
Operating expenses		28 000	00
Selling expenses		22 000	00
Administration expenses		45 000	00
Depreciation		?	
Operating profit before interest and taxation		?	
Interest expense	1	(70 000	00)
Net profit before taxation		?	
Taxation		(80 000	00)
Net profit attributable to ordinary shareholders		?	
Dividends		?	
Retained profit/(loss) for the year		?	
Retained profit – beginning of year	2	?	
RETAINED PROFIT – END OF YEAR		400 000	00

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x4

	Notes	20x4	
ASSETS			
Non-current assets		1 300	00
Property, plant and equipment at carrying value	3	1 300	00
Long-term investments		0	00
Current assets		?	
Inventories	4	?	
Accounts receivable	5	200 000	00
Short-term investments		150 000	00
Cash and cash equivalents	6	50 000	00
TOTAL ASSETS		?	
EQUITY AND LIABILITIES			
Capital and reserves		1 000 000	00
Ordinary share capital (600 000 ordinary shares @ R1 each)	7	600 000	00
Retained profit	8	400 000	00
Non-current liabilities		?	
Long-term borrowings		?	
Current liabilities		?	
Short-term borrowings		100 000	00
Accounts payable	9	70 000	00
Taxation		?	
TOTAL EQUITY AND LIABILITIES		?	

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Notes relating to statement of profit or loss & other comprehensive income:

1. Gross profit % = 15%.
2. Tax rate = 40%
3. The dividend paid amounted to 16.67c/share.

Notes relating to the statement of financial position:

1. A taxation liability of R50 000 (the estimated amount due for 20x3, as the company has not yet been assessed for that year) must be included with the taxation liability for the current year.
2. Current ratio = 2.33 : 1.

You are required to:

1. Calculate the missing figures for the statement of profit or loss & other comprehensive income for the year ended 30 June 20*x*4.
2. Calculate the missing figures for the statement of financial position as at 30 June 20*x*4.

Question 26.15

Laser & Tiger Ltd produces specialised machinery used in the car repair industry. These summarised financial statements have been prepared for two financial years.

Laser & Tiger Ltd
STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20*x*6

	Notes	20*x*6		20*x*5	
ASSETS					
Non-current assets		1 950 000	00	1 815 000	00
Property, plant and equipment at carrying value	3	1 950 000	00	1 815 000	00
Long-term investments		0	00	0	00
Current assets		1 050 000	00	1 248 000	00
Inventories	4	450 000	00	532 500	00
Accounts receivable	5	300 000	00	375 000	00
Short-term investments		225 000	00	262 500	00
Cash and cash equivalents	6	75 000	00	78 000	00
TOTAL ASSETS		3 000 000	00	3 063 000	00
EQUITY AND LIABILITIES					
Capital and reserves		1 500 000	00	1 470 000	00
Ordinary share capital (900 000 shares @ R1 each)	7	900 000	00	900 000	00
Retained profit	8	600 000	00	570 000	00
Non-current liabilities		1 050 000	00	1 080 000	00
Mortgage debentures		1 050 000	00	1 080 000	00
Current liabilities		450 000	00	513 000	00
Short-term borrowings		150 000	00	165 000	00
Taxation		195 000	00	202 500	00
Accounts payable	9	105 000	00	145 500	00
TOTAL EQUITY AND LIABILITIES		3 000 000	00	3 063 000	00

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Laser & Tiger Ltd
STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MAY 20*x*6

	Notes	20*x*6	
Sales		4 500 000	00
Cost of sales		(3 832 500	00)
Gross profit		667 500	00
Other operating income		22 500	00
Interest income		22 500	00
Gross operating income		690 000	00
Operating expenses		(285 000	00)
Administration and selling expenses		135 000	00
Depreciation		150 000	00
Operating profit before interest and taxation		405 000	00
Interest expense	1	(105 000	00)
Net profit before taxation		300 000	00
Taxation		(120 000	00)
Net profit attributable to ordinary shareholders		180 000	00
Dividends		(150 000	00)
Retained profit/(loss) for the year		30 000	00
Retained profit – beginning of year	2	570 000	00
RETAINED PROFIT – END OF YEAR		600 000	00

Additional information:

- Times interest earned – 20*x*5: 3.5 times
- Dividend per share – 20*x*5: 15.3c
- Earnings per share – 20*x*5: 17.5c
- Market price per share – 20*x*5: 150c
  – 20*x*6: 180c

You are required to:

1. Calculate the current and acid-test ratios for 20*x*6 and 20*x*5 and comment.
2. Calculate three financial structure ratios for 20*x*6 and 20*x*5 and comment.
3. Calculate the earnings and dividend yields for 20*x*6.

Question 26.16

The new managing director of Eatmore Ltd (a company in the food industry) has asked you to analyse and give your views on the relative profitability and liquidity of its two wholly-owned subsidiaries, Canned Ltd and Frozen Ltd (who process fruit and vegetables). There were no inter-company transactions.

You are required to:
Use the information to write a report to the managing director analysing the results of each company and commenting on any significant trends using these ratios:

Profitability

1. Return on equity.
2. Gross profit margin.
3. Net profit margin.
4. Total asset turnover.

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Liquidity

1 Current ratio

2 Quick ratio.

Information

This information has been extracted from the summarised financial statements of each company for the two years ended 31 December 20*x*8:

ABRIDGED STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20*x*8

	Canned Ltd				Frozen Ltd			
	20*x*8		20*x*7		20*x*8		20*x*7	
Turnover	45 200	00	38 100	00	17 000	00	14 000	00
Cost of sales	(38 400	00)	(30 500	00)	(11 200	00)	(9 400	00)
Gross profit	6 800	00	7 600	00	5 800	00	4 600	00
Depreciation	(500	00)	(400	00)	(500	00)	(300	00)
Other costs	(4 200	00)	(5 800	00)	(3 400	00)	(2 000	00)
PROFIT BEFORE TAX	2 100	00	1 400	00	1 900	00	2 300	00

ABRIDGED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20*x*8

	Canned Ltd				Frozen Ltd			
	20*x*8		20*x*7		20*x*8		20*x*7	
Capital and reserves	10 500	00	9 900	00	7 500	00	6 800	00
Long-term liability	2 100	00	1 800	00	200	00	0	00
Current liabilities	8 500	00	8 200	00	3 200	00	2 200	00
Overdraft	3 400	00	6 700	00	4 600	00	2 100	00
TOTAL EQUITY AND LIABILITIES	24 500	00	26 600	00	15 500	00	11 100	00
Non-current assets	8 300	00	9 200	00	3 500	00	2 500	00
Current assets	9 300	00	10 200	00	1 800	00	2 300	00
Inventories	6 900	00	7 200	00	10 200	00	6 300	00
Accounts receivable	16 200	00	17 400	00	12 000	00	8 600	00
TOTAL ASSETS	24 500	00	26 600	00	15 500	00	11 100	00

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27 PLANNING AND BUDGETING

Chapter objectives

By the end of this, chapter you should be able to:

- Identify the reasons for preparing budgets.
- List the advantages of budgeting.
- Outline the budgeting process.
- Identify the budget structure of a trading business.
- Describe subjective and objective sales forecasting techniques.
- Use the principles of budgeting to draft:
  - cash flow budgets
  - operating budgets
  - capital expenditure budgets
  - budgeted statements of profit or loss & other comprehensive income and statements of financial position
- Identify the limitations of budgeting procedures.
- Explain the behavioural implications of budgeting.

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1 Introduction

A budget is a financial plan. As with all plans it relates to the future and depends to a great extent on forecasts, predictions and targets. Having drafted financial plans in the form of budgets, the real challenge of business is to operate within the budget parameters, that is, containing expenses to remain within the constraints of cost budgets and to generate income that achieves income targets.

The quantitative techniques of budgeting are not difficult to master. However, the budget is not just a statement of numbers. The budgeted numbers have an impact on how people within a business will respond to the plan. Questions such as whether the budget will motivate staff to be productive, whether it will eliminate unnecessary use of resources or whether it will achieve the goals of the managers are all pertinent to the budgeting process.

This chapter deals with the budgeting procedures that require an awareness of some forecasting techniques, knowledge of the principles of budget preparation and some insight into the impact of the budget process on human behaviour.

A number of different types of budgets and the techniques that are used to prepare such budgets are dealt with. An illustrated example is presented towards the end of the chapter.

2 Reasons for budgeting

The well-worn adage that failing to plan is planning to fail reflects the obvious necessity for budgeting. The following are the most significant advantages of having a well-structured budgeting procedure.

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Control is possible

Because a budget gives a figure that must be achieved either by constraining expenditure or achieving income, or a combination of both, the actual results can clearly be measured against that which was planned.

Each budget line item is the responsibility of an individual. Individuals, thus, become accountable to the extent to which they contribute towards achieving the corporate plan. The quantification of the plan in financial terms also leads to cost awareness that may not otherwise be achieved.

Performance can be measured

It is possible to measure the performance of the business, the performance of a division of the business, or the performance of an individual, against a figure set as the responsibility target in the budget. For example, the employee who achieves cost savings without sacrificing quality has made good use of resources and may be rewarded accordingly. The budget, thus, serves as a benchmark.

Quality of planning is enhanced

The preparation of a budget forces consideration of the future. Most budgets would be prepared using a computer spreadsheet package. This enables sensitivity analysis to be applied to the budget. For example, it is possible to immediately programme into the spreadsheet the effects of different levels of sales or different levels of costs.

Spreadsheets can be constructed in such a way that the impact of these changes on the net profit and cash flow can immediately be determined. This has the advantage of being able to ascertain the extent to which unexpected changes or deviations from budgets will affect the ultimate profitability of the business.

The budget will also reveal bottlenecks in the flow of goods, services or cash and enable plans to be adapted to resolve these. It, thus, serves as a valuable tool for co-ordinating business activities.

Management by exception

The budget communicates the targets and financial aims. Once a budget has been constructed and approved, an employee is given responsibility to stay within that budget or achieve the target. Actual figures can be compared against the budget. Provided that the responsible employee has operated within reasonable variance from the budget, no action by the managers is required.

The practice of generating variances from budgets on a regular basis and only responding to variances that are material, enables the managers to concentrate on problem areas, that is, to manage by exception.

Goal orientation

The budget offers positive direction for the energy and activities of all employees. It clearly shows what needs to be achieved and thus, if used correctly, will serve as a motivator for productive activity.

You should be able to complete Questions 27.1 to 27.2.

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3 Budgeting procedures

Budgeting procedures depend to a significant extent on the type of business.

- Manufacturing businesses are required to draft very detailed budgets of costs of material, labour and overheads, as well as sales budgets, cash flow budgets and capital budgets.
- A retail company, on the other hand, is likely to require a less extensive array of budgets.
- The business structure of a business is another factor in determining the type of procedures that will be adopted.

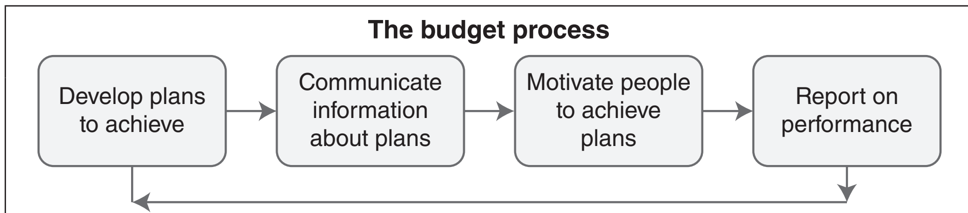
Budget process

The medium-term budget period is usually one year. Within that year, budgets may be drafted on a monthly, weekly or even a daily basis. Because budgeting is a planning exercise, preparation for the next financial year will need to start well before its commencement. In many instances it may commence a full year prior to its implementation.

Large businesses usually have budgeting officers and budgeting committees. Their tasks include collaboration from the highest to the lowest level of the business. They have to ensure that everyone is aware of the budgeting procedure and that there is general consensus that items included in the budget are necessary. The various budgets are then drafted by the managers responsible for administering the budget and then circulated to those who will be driven by the budget for comment and adjustment. Finally, the budget has to receive the managers' approval.

This process may take some time as it is likely that there will be differences of opinion regarding certain budget items. In addition, the dynamic nature of business is such that changing economic climates, consumer trends and other economic factors will constantly have an impact on the planned figures. The process is quite intuitive and the main steps are shown in Figure 27.1.

Figure 27.1



The process begins with the plans. They are quantified in financial terms and employees are encouraged to achieve those targets. Periodically, management information is provided in the form of reports on the performance of operations. These reports are compared to the budget. Corrective action may either be in the form of revising the budget or addressing the areas that were less successful.

The budget structure

Budgets are prepared at different levels of detail. The master budget is a term given to the lowest level of detail or, stated differently, the highest level of summary that is anticipated by the company. In one sense it is no more than a draft statement of profit or loss & other comprehensive income, statement of financial position and statement of cash flows of what the company plans to achieve in the next financial period.

The master budget cannot be drafted, however, without reference to the subsidiary budgets

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that contribute towards achieving the results budgeted for in these financial statements. In the case of a business manufacturing or retailing goods, the most significant budget in this respect is the sales budget. Clearly, once the sales output has been predicted, all costs that must be incurred in achieving those sales can then be more accurately determined.

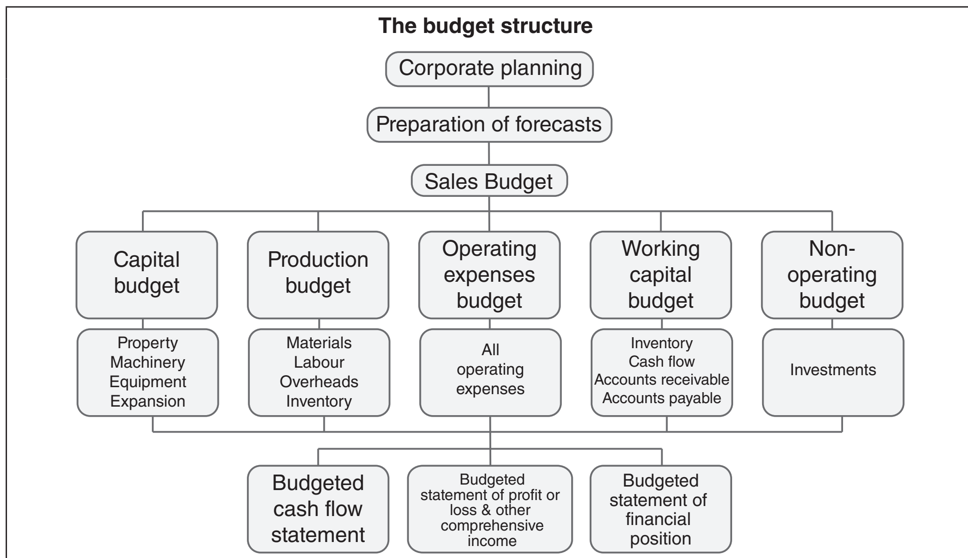
Figure 27.2 shows the various budgets that contribute towards the compilation of a master budget.

The starting point is the corporate planning procedure that determines the direction. This is done by deciding on the broad aims of the company and the strategies needed to achieve those aims. As the sales budget will largely be the determinant of the composition of other budgets, it is usually prepared first. This requires forecasts of anticipated market trends and expected sales volumes. The significant budgets that can be identified are:

The sales budget

This budget is compiled distinguishing each product type, the expected sales volume and the anticipated selling price. In the case of a service business, the sales budget itemises the income expected from each of the services offered.

Figure 27.2



These factors are particularly significant in preparing a sales budget:

- **Past experience.** There are few who would refute that experience about the type of business gained from being actively engaged for some time is a major factor in predicting future income levels.
- **Prospective pricing policy.** A very sensitive decision that must be made by the managers relates to the pricing policy. It is accepted that the higher the price, the lower the likelihood of selling large quantities. However, a higher price offers a higher margin. A trade-off must therefore be made between margins and volumes, which is reflected in the pricing policy.
- **Orders on hand.** The order book that records orders still to be executed is a good indicator of the strength of demand for the goods or services on offer.
- **Market research.** Every large business will engage in market research. This is a scientific approach used to determine customer preferences, trends and the threat of competitive products.

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- **Economic conditions.** It is almost self-evident that most goods and services are affected by the expected economic conditions. An awareness of this factor will have a strong influence on the confidence with which plans to expand can be implemented.
- **Other factors.** Industry conditions, product promotions, the impact of competitors and the existing market share are also factors that to a greater or lesser extent require consideration when preparing the sales budget. In the next section we shall look at some of the techniques that can be used to forecast the future sales volumes.

Capital budgets

These budgets are of a longer-term nature and require planning for future expenditure on tangible assets such as machinery, equipment and vehicles. As each involves significant amounts of funding capital, there must be certainty that such capital expenditure will yield the required return on capital invested.

Capital invested appraisal techniques are used for this purpose. There will also be a substantial impact on the cash flow budget and plans must be in place to ensure that the necessary finance is available when the capital expenditure is incurred.

Production budgets

Once the required control for sales has been determined, the budget for raw material, labour costs, overheads and all production expenses can be constructed.

The timing of these expenses, as well as the inventories to be maintained, are considerations that are related to production schedules.

Operating expense budgets

Budgets can be drafted for each operating expense that will be incurred in normal business operations. The distinction between variable and fixed expenses (within relevant ranges of output) has an impact on the sensitivity analysis (based on different volumes of sales output).

Working capital budgets

Working capital budgets include budgets for inventories on hand, accounts receivable, accounts payable and cash flow.

These budgets play a central role in ensuring that the company continues operating smoothly and that there is no unnecessary investment in idle working capital.

The cash budget is particularly crucial if liquidity problems are to be avoided.

Non-operating budgets

Budgets for items not directly related to operations are included, as they will all impact on the final net profit of the company. These include budgets for items such as interest payable and receivable, research and development expenditure, directors' fees and auditor's fees.

4 Sales forecasting

As the sales budget is of such significance, a great deal of research has been done towards methods of accurately forecasting sales volumes.

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Regardless of how impressive the techniques may seem, it must be emphasised that all techniques are based on predictions of the future which is unknown. Most predictions use the past as the basis and needless to say the past seldom replicates itself.

Sales forecasts may be broadly divided into two categories:

1 Subjective forecasts.

2 Mathematical forecasts.

Subjective forecasts

A subjective forecast is an opinion of an individual or a group. Two useful methods are suggested to assist in arriving at a likely sales figure.

Individual best guess

This technique uses primarily individuals with experience of the product – in particular those who are engaged in the marketing and sales of the product.

Views regarding current trends in the use of the product, the influence of changes in consumption patterns, the general economy and the strength of competing products and businesses are canvassed.

The collection of individual 'best guesses' may then be averaged or statistical techniques such as recording the distribution of personal opinions and using probability distributions applied, to decide on the most likely forecast.

Delphi technique

This is a technique in which a group meets and makes a collective decision regarding the most likely sales volume. A group of people is selected to participate. Each person is issued with a questionnaire requesting their individual opinion of future issues. Their responses are collected and summarised. Each member of the group is then informed of the estimate made by each of the other members.

In the light of this information, each individual is expected to revise their previous estimate. The process is repeated until the group develop a central tendency that points to a most likely predicted figure and until consensus is reached.

Mathematical techniques

Mathematical techniques use recorded figures from the past and attempt to extrapolate into the future.

Short-term probabilistic

Historic data is used and, by means of the statistical properties of a normal distribution, enables probabilities to be assigned to certain sales volumes. This is ideal for sensitivity analysis. Since a single sales forecast is required for production planning, the selection of this figure is based on the highest probability volume.

Linear regression time series

This is a statistical technique designed to make a point forecast from a series of past sales figures. The technique is based on the principle of least squares regression and is geared towards making a point forecast for the next financial year.

A more sophisticated adaptation of this technique enables forecasts to be de-seasonalised

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to quarterly or monthly forecasts. It is highly unlikely that any single forecasting technique will be used. Rather a company will use a number of mathematical forecasting techniques to develop a sense of likely sales.

These will be considered by the managers together with information collected from sales staff operating in the field, market research, and all other variables that are expected to have an impact on the expected sales volumes.

You should be able to complete Questions 27.3 to 27.7.

5 Budget compilation

As shown in Figure 27.2, there are numerous budgets at different levels that need to be compiled prior to the start of the financial year. A fairly comprehensive illustrative example is used to show the technical aspects of budget compilation.

Example 27.1

Harbinger Stores Ltd operates a chain of fashion retail outlets, situated in most major cities. Company policy favours decentralised management.

Head office insists that part of the training process includes the active participation of store managers in the budgeting process.

The budgets for April, May and June must be prepared from this data that is available at 31 March:

1 Abridged statement of financial position as at 31 March 20*x*5:

Non-current assets	200 000	00	Store capital	390 000	00
Inventories	300 000	00	Accounts payable	350 000	00
Accounts receivable	248 000	00	Short-term loan	20 000	00
Bank	12 000	00			
	760 000	00		760 000	00

2 Sales

February	200 000	00	May projected	300 000	00
March	250 000	00	June projected	400 000	00
April projected	500 000	00	July projected	200 000	00

3 Historically, credit sales have averaged 80% of total sales.
- Seventy percent of receivables' accounts are collected in the month following the sale and the remaining 30% in the month thereafter.
- The average gross margin percentage is 40%.
- Bad debts have been negligible and may be ignored.

4 Company policy is to purchase sufficient goods each month to cover the projected sale for the next month. All purchases are paid for in the month following their purchase.

5 Salaries and wages average R20 000 plus 20% of sales.
- Variable expenses excluding depreciation are taken as 4% of sales.
- Fixed expenses, including rent, amount to R40 000 per month. All expenses are paid in the month in which they are incurred.
- Depreciation is written off at the rate of R2 000 per month.

6 In March, R40 000 worth of new fixtures were purchased on 30-day terms and the accounts payable amount at the end of March is included in this figure. No further capital expenditure is planned until August.

7 Company policy is that a cash balance of between R12 000 and R13 000 is to be maintained at the beginning of each month.

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- To achieve this, a short-term loan account is used with a facility of R300 000. Interest is charged at 12% per annum, or 1% per month.
- On the first day of each month, the loan figure is compared with the bank balance and deposited into the current bank account or repaid in tranches of R1 000, depending upon cash requirements for the month as per the cash budget.
- On the last day of each month the interest for the month is paid.

There are a number of approaches that may be taken to the compilation of this budget. Whichever approach is used, it is clear that a number of calculations based on the projections and parameters used for budget preparation must be performed.

We shall proceed, as far as possible, in accordance with the various budgets shown in Figure 27.2.

Sales budget

Fortunately we do not have to embark on techniques to project future sales as this has already been predicted as is shown in Figure 27.3 on the next page.

Figure 27.3

Harbinger Stores Ltd
SALES BUDGET FOR THE QUARTER ENDED 30 JUNE 20*x*5

	April		May		June		Total	
Cash sales (20%)	100 000	00	60 000	00	80 000	00	240 000	00
Credit sales (80%)	400 000	00	240 000	00	320 000	00	960 000	00
	500 000	00	300 000	00	400 000	00	1 200 000	00

It is a source of some concern that this budget fluctuates so widely. The fluctuations will create financing problems as well as management problems. For example, salaries and wages can be problematic because of the need to employ extra staff during the busy months.

Capital budget

There are no items of capital expenditure planned for this quarter. However, an acquisition in March must be included in the cash flow budget as it must be paid for in April. Further acquisitions are only planned for August.

An awareness of this is essential if there are cash flow implications in that month. This depends upon whether the acquisition will be paid for immediately or if extended credit will be granted.

Production budget

As this is not a manufacturing business, no production budget is required.

Operating expenses budget

A number of operating expenses budgets, relating to the various types of expenditure, are required. It is evident that in practice even more such budgets will be necessary.

However, to keep this example uncluttered, only the most significant types of expenditure have been separated (shown in Figure 27.4). The principle of compilation is identical in all cases.

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Figure 27.4

Harbinger Stores Ltd
OPERATING EXPENSES BUDGET FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June		Total	
Cost of sales (60% of sales)	300 000	00	180 000	00	240 000	00	720 000	00
Salaries and wages (R20 000 + 20% of sales)	120 000	00	80 000	00	100 000	00	300 000	00
Variables expenses (4% of sales)	20 000	00	12 000	00	16 000	00	48 000	00
Fixed expenses	20 000	00	20 000	00	20 000	00	20 000	00
Depreciation	2 000	00	2 000	00	2 000	00	6 000	00

In a sense, each of these budgets is a master budget and it is likely that each has a lower level budget with more detail.

- For cost of sales, each product will be itemised.
- For salaries and wages, each employee will be listed.

Other variable expenses will be listed in detail, each with the employee who has the responsibility for meeting the budget. The fixed expenses, apart from depreciation, will be itemised and the depreciation will be associated with a particular asset.

Working capital budget

These budgets, shown in Figure 27.5, indicate the amount that we would like to have reflected at the end of each month for each of the working capital items. If current assets are expected to increase, they will require financing, and the source of such financing will have to be decided.

Current liabilities will indicate the level of commitment of funds that will be required. This may necessitate extending the accounts payable payment period or negotiating additional loan facilities. In this case, Harbinger Stores Ltd has access to a short-term loan that is determined at the beginning of each month.

This is a method of dealing with the large fluctuations in sales that in turn result in fluctuating levels of working capital.

Figure 27.5

Harbinger Stores Ltd
WORKING CAPITAL BUDGET FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June	
Accounts receivable	460 000	00	360 000	00	392 000	00
80% of month	400 000	00	240 000	00	320 000	00
30% of 80% previous	60 000	00	120 000	00	72 000	00
Inventory						
Cost of next month's sales	180 000	00	240 000	00	120 000	00
Bank						
Minimum R12 000	12 550	00	12 170	00	12 690	00
Accounts payable						
Cost of next month's sales + capital expenditure	180 000	00	240 000	00	120 000	00
Short-term loan	245 000	00	138 000	00	148 000	00

The bank account balance at the end of each month is established by first completing the cash flow budget that is shown in Figure 27.6 and using the short-term loan account as per the arrangement.

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Similarly, the short-term loan account balance depends upon the cash flow. The full set of ledger accounts is shown in Figure 27.9.

Non-operating budget

In this case, the only non-operating budget will be the interest budget for short-term loans usually to finance working capital. The interest is charged at 12% per annum or 1% per month and calculated and reported in the statement of cash flows in Figure 27.6.

The accounting treatment of interest expense is shown in Figure 27.9.

Budgeted cash flow

The cash flow budget, based on the information that is available from all the budgets, is shown in Figure 27.6. This is a particularly important budgetary exercise.

Explanation

Harbinger Stores Ltd has a maximum overdraft facility of R300 000. Should its cash needs exceed that amount at some point, this could cause a liquidity crisis.

From the cash flow budget it appears that, as a result of the high level of sales expected in April, which affords considerable credit to receivables, the cash situation in April is particularly poor requiring a large short-term loan at 1% per month.

By the end of May, when most of those receivables will have settled their accounts, the cash position improves considerably, only to worsen again with the high sales in June. Fortunately, Harbinger Stores Ltd has a reliable source of short-term financing and will cope with the fluctuations in cash required.

Figure 27.6

Harbinger Stores Ltd
BUDGETED CASH FLOW FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June	
Cash sales	100 000	00	60 000	00	80 000	00
Accounts receivable	188 000	00	340 000	00	288 000	00
Month following (70% × 80%)	140 000	00	280 000	00	168 000	00
Remaining (30% × 80%)	48 000	00	60 000	00	120 000	00
Budgeted cash inflow	288 000	00	400 000	00	368 000	00
Budgeted cash outflow	512 450	00	293 380	00	377 480	00
Accounts payable	300 000	00	180 000	00	240 000	00
Salaries	120 000	00	80 000	00	100 000	00
Variable expenses	20 000	00	12 000	00	16 000	00
Fixed expenses	20 000	00	20 000	00	20 000	00
Capital repayments	50 000	00	0	00	0	00
Interest expense	2 450	00	1 380	00	1 480	00
Month surplus (deficit)	(224 450	00)	106 620	00	(9 480	00)
Beginning loan balance	(20 000	00)	(245 000	00)	(138 000	00)
Month end surplus (deficit)	(244 450	00)	(138 380	00)	(147 480	00)
Surplus (loan) for the month	(245 000	00)	(138 000	00)	(148 000	00)
Bank balance at beginning of the month	12 000	00	12 550	00	12 170	00
Cash received	288 000	00	400 000	00	368 000	00
Cash paid	(512 450	00)	(293 380	00)	(377 480	00)
Loan received (repaid)	225 000	00	(107 000	00)	10 000	00
Bank balance at end of the month	12 550	00	12 170	00	12 690	00

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Budgeted statement of profit or loss & other comprehensive income

Cash flow and profit are very different concepts. While the cash flow has been negative for two of the three months, the profit for the quarter can now be budgeted. Indications are that this quarter will be successful (see Figure 27.7).

Figure 27.7

Harbinger Stores Ltd
BUDGETED STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June		Total	
Sales (gross)	500 000	00	300 000	00	400 000	00	1 200 000	00
Cost of sales	(300 000	00)	(180 000	00)	(240 000	00)	(720 000	00)
Gross profit	200 000	00	120 000	00	160 000	00	480 000	00
Operating expenses	(162 000	00)	(114 000	00)	(138 000	00)	(414 000	00)
Salaries and wages	120 000	00	80 000	00	100 000	00	300 000	00
Variable expenses	20 000	00	12 000	00	16 000	00	48 000	00
Fixed expenses	20 000	00	20 000	00	20 000	00	60 000	00
Depreciation	2 000	00	2 000	00	2 000	00	6 000	00
Net profit before interest	38 000	00	6 000	00	22 000	00	66 000	00
Interest expense	(2 450	00)	(1 380	00)	(1 480	00)	(5 310	00)
NET PROFIT	35 550	00	4 620	00	20 520	00	60 690	00

Budgeted statement of financial position

Finally, the budgeted statement of financial position can be drafted from the information available. It is possible to process all the transactions in summary to arrive at the same figures.

This may be a useful practice exercise, starting with the draft statement of financial position given in the information as at 31 March and processing all the information.

The nominal accounts that will be created from the income and expenditure will lead to the budgeted statement of profit or loss & other comprehensive income. The balances that remain in the general ledger accounts will provide the information to draft the budgeted statement of financial position shown in Figure 27.8.

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Figure 27.8

Harbinger Stores Ltd
BUDGETED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x5

	Notes	20x5			
ASSETS					
Non-current assets				194 000	00
Property, plant and equipment	3	200 000	00		
Less: Accumulated depreciation		(6 000	00)		
Current assets				524 690	00
Inventories	4	120 000	00		
Accounts receivable	5	392 000	00		
Cash and cash equivalents	6	12 690	00		
TOTAL ASSETS				718 690	00
EQUITY AND LIABILITIES					
Capital and reserves				450 690	00
Ordinary share capital	7	390 000	00		
Retained earnings	8	60 690	00		
Current liabilities				268 000	00
Short-term borrowings		148 000	00		
Accounts payable	9	120 000	00		
TOTAL EQUITY AND LIABILITIES				718 690	00

Once the budgets have been compiled based on forecast estimates, estimation and other necessary subjective judgements, a financial plan is now available. However, it is quite apparent that the future is unlikely to be consistent with all the subjective input.

Now sensitivity analysis can be usefully applied. Using a spreadsheet technique, the impact of changes in sales volume, changes in expenditure and other variables can be programmed.

Figure 27.9

General Ledger of Harbinger Stores Ltd

Non-current assets B3

Dr		Cr	
Balance	200 000		
Balance	200 000		

Cost of sales N2

Dr		Cr	
Inventory	300 000		
Inventory	180 000		
Inventory	240 000		
	720 000		

Inventory B4

Dr		Cr	
Balance	300 000	Cost of sales	300 000
Account payable	180 000	Cost of sales	180 000
Account payable	240 000	Cost of sales	240 000
Account payable	120 000		

Short-term loan B5

Dr		Cr	
Bank	107 000	Balance	20 000
Balance	138 000	Bank	225 000
	245 000		245 000
		Balance	138 000
		Bank	10 000
		Balance	148 000

Accumulated depreciation B3

Dr		Cr	
		Depreciation	2 000
		Depreciation	2 000
		Depreciation	2 000

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Accounts payable — B6

Bank	300 000	Balance	350 000
Bank	50 000		
Bank	180 000	Inventory	180 000
Bank	240 000	Inventory	240 000
		Inventory	120 000

Bank — B7

Balance	12 000	Accounts payable	300 000
Loan	225 000	Accounts payable	50 000
Sales	100 000	Salaries	120 000
Accounts receivable	140 000	Variable expenses	20 000
Accounts receivable	48 000	Fixed expenses	20 000
		Interest	2 450
	525 000		512 450
Balance	12 550	Account payable	180 000
Sales	60 000	Salaries	80 000
Accounts receivable	280 000	Variable expenses	12 000
Accounts receivable	60 000	Fixed expenses	20 000
		Loan	107 000
		Interest	1 380
	412 550		400 380
Balance	12 170	Account payable	240 000
Sales	80 000	Salaries	100 000
Accounts receivable	168 000	Variable expenses	16 000
Accounts receivable	120 000	Fixed expenses	20 000
Loan	10 000	Interest	1 480
	390 170		377 480
Balance	12 690		

Accounts receivable — B8

Balance	248 000	Bank	140 000
Sales	80 000	Bank	48 000
Balance	460 000	Bank	280 000
Sales	80 000	Bank	60 000
Balance	360 000	Bank	168 000
Sales	80 000	Bank	120 000
Balance	392 000		

Salaries and wages — N3

Bank	120 000		
Bank	80 000		
Bank	100 000		
	300 000		

Variable expenses — N4

Bank	20 000		
Bank	12 000		
Bank	16 000		
	48 000		

Fixed expenses — N5

Bank	20 000		
Bank	20 000		
Bank	20 000		
	60 000		

Depreciation — N6

Accumulated depreciation	2 000		
Accumulated depreciation	2 000		
Accumulated depreciation	2 000		
	6 000		

Interest expense — N7

Bank	2 450		
Bank	1 380		
Bank	1 480		
	5 310		

Sales — N1

		Bank	100 000
		Accounts receivable	400 000
		Bank	60 000
		Accounts receivable	240 000
		Bank	80 000
		Accounts receivable	320 000
			1 200 000

You should be able to complete Question 27.8.

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6 Behavioural considerations

Human behaviour is unpredictable and attempting to understand why people act or react as they do, is complex.

As a budget is a plan that people are required to follow, some understanding and sensitivity with regard to human behaviour is necessary.

Human needs

Basic psychology has long been aware of the fact that human beings have unlimited wants and needs, but limited capacity to fulfil those wants and needs. Classical theory in psychology has divided human needs into physical and psychological needs.

Physical needs relate to the need for food and shelter and aspirations to own physical goods. Psychological needs relate to our need to feel a sense of dignity and self-esteem. Even if it were possible to fulfil the physical needs of an individual, it is unlikely that any individual ever has a feeling of total psychological fulfilment. Budget preparation needs to take these issues into consideration. For example, do people respond well to being instructed that they must comply with a budget, or is it likely that greater productivity and harmony will be achieved through employees participating in budget compilation?

Motivation and behaviour

Probably the best known theory of motivation is that propagated by the renowned psychologist Abraham Maslow. Maslow constructed a hierarchy of needs and popularised the view that basic needs must first be satisfied before there is any real interest in satisfying higher needs. He constructed a hierarchy in the form of a pyramid of needs.

At the lower level are the needs for food, shelter and safety, progressing to the need for friendship, love and recognition, culminating in the need for self-actualisation. Fulfilment of the highest needs opens the door to a limitless array of ways in which an individual may feel fulfilled.

Goal congruence

Apart from the fact that a satisfied need is not a motivator of behaviour, it is important that a business be aware of the goals and ambitions of its employees. It is important that the aims of a business be similar to those of the individuals that are employed. The individual is likely to add more value to the business and work in its interest if this is so.

Goal congruence is a term used to describe this similarity in purpose. So, for example, if an individual is ambitious and wants to progress through a business, it is the responsibility of the business to ensure there is a career path, otherwise there is no goal congruence and the individual is unlikely to offer maximum productivity.

7 Conditions for a successful budget

It is unlikely that any list of conditions for a successful budget can claim to be exact or exhaustive. Rather, it seems that some fairly obvious pointers, which in practice seem often to be overlooked, can serve as a checklist for consideration.

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Top management support and involvement

Leadership in any business depends on the example set by top management as their role models. A major procedure like budgeting will not be taken seriously by employees if it is not apparent that the managers consider it important and have indicated this by being involved and committed to budget constraints and targets.

Actual involvement by top management rather than simply delegating has been found to have the most impact.

Line management support and involvement

Line managers are employees in jobs where they report directly up the line ultimately to the managing director. This is contrasted to so-called staff managers who are responsible for support divisions of the company such as human resources management, training, industrial relations and so on.

Line managers usually have significant responsibility for budgets. Therefore, top management will usually take care that line managers are supportive of the budgets that have been set. This is usually achieved by involving line management at budget preparation stage and resolving conflicts prior to the final acceptance of the budget.

Definition and communication of long-term goals

Consistent with behavioural psychology, it is apparent that employees enjoy a feeling of achievement at company level rather than being uninformed about the performance of the company. The long-term goals, both in financial terms and in social terms should be clear to top management and should be communicated down the line to all employees. This offers a sense of direction and purpose that assists in motivating individuals to follow the plan.

Structure responsibility with authority

A very frequent failing in management is to disassociate authority from responsibility. Stated very simply, if an employee is held responsible for a budget, that same employee should have authority to act on all matters that pertain to that budget. The employee should be empowered to make decisions that affect the budget in the course of daily operations.

Any system where an individual is held responsible for outcomes over which authority to change those outcomes cannot be exercised, will lead to dissatisfaction and conflict.

Effective management information systems

The purpose of the budget is to offer a plan that should be followed. Most budgets stretch over a year. Clearly the responsible employee must receive intelligible information on a regular basis to monitor any variance from the budget.

This requires reasonably elaborate systems of management accounting that must offer relevant and reliable information which is sufficiently early.

Regular revision of budgetary targets

Factors such as inflation, changing economic conditions and technological development contribute toward the need for making the budgetary targets flexible. This issue has to be

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handled carefully as changes in budget targets as a result of changes in circumstances have to be convincing and should not be an easy option when budgets are not achieved.

8 Limitations of budgets

The system of working in accordance with budgets and a budgetary process is not without its limitations. It is a significant fact that the budget reflects the priorities of the managers.

The easy answer that a cost cannot be incurred because the budget is already spent is in many instances not acceptable. What it may mean is that the managers have not allocated funds for that item. Faced with difficult resource allocation decisions, they have considered other expenses to be more appropriate to the aims of the business.

On the next page are some inherent limitations of budgets and the budgetary process.

Estimates

As a budget is a futuristic document, all figures are in some sense estimates, based on imperfect information at the time of establishing the budget.

Rigidity

While few would argue that a budget should be a rigid document, it is in practice very difficult to treat it otherwise. A climate of budget revision too often does have the impact of reducing the credibility of the budgetary process. For this reason, the appropriateness of the figures in the budget at the time of compilation must be very carefully considered.

Perception of staff

A common perception of employees is that the budget is a type of reward and punishment document. Care needs to be taken that employees develop an appreciation of the need for a budget and that negative variances from budget are not used too stringently to reprove employees.

Dynamic environment

Finally, a year is a long period in which to have responsibility for a budget that may lose relevance due to changes in the environment. For example, employees frequently find the sales budget exceeding expectations, but the managers still remain reluctant to change the cost budgets accordingly.

A quarterly review of the annual budget as a matter of procedure goes a long way to resolving this problem.

9 Chapter illustrative example

Gilder Electronics Ltd operates a chain of electronic goods retail stores in Durban, Cape Town and Johannesburg. Company policy favours decentralised management. Head office insists that part of the training process include the active participation of store managers in the budgeting process.

The Sandton store manager is concerned about the cash flow prospects for the next few months as the store is already operating on an overdraft. She knows that the bank will not allow an overdraft in excess of R100 000. Should liquidity become a problem, she may have to consider a long-term loan.

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On the other hand, as this is usually an especially profitable period, too much cash on hand may require consideration of how to best invest surplus cash.

The budgets for a store for April, May and June must be prepared from this data available as at 31 March.

The summarised statement of financial position of Gilders Electronics Ltd at Sandton on 31 March 20*x*5:

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20*x*5

Non-current assets	350 000	00	Share capital	439 000	00
Inventories	240 000	00	Accounts payable	280 000	00
Accounts receivable	144 000	00	Bank overdraft	15 000	00
Bank	0	00			
	734 000	00		734 000	00

The brief sales record and projected sales for the next 4 months:

February	160 000	00	April projected	480 000	00
March	240 000	00	May projected	320 000	00
			June projected	380 000	00
			July projected	220 000	00

- Historically, credit sales have averaged 60% of total sales.
  - Sixty percent of receivables' accounts are collected in the month following the sale and the remaining 40% in the month thereafter.
  - The average gross margin percentage is 50%.
  - Bad debts have been negligible and may be ignored.
- Company policy is to purchase sufficient goods each month to cover the projected sales for the next month. All purchases are paid for in the month following their purchase.
- Salaries and wages average = R25 000.
  - Variable expenses excluding depreciation are taken as 5% of sales.
  - Fixed expenses, including rent, amount to R15 000 per month.
  - All expenses are paid in the month in which they are incurred.
  - Depreciation is written off at the rate of R3 000 per month.
- In March, R40 000 of new equipment was purchased on 30-day terms. This amount is included in the accounts payables figure at the end of March. No further capital expenditure is envisaged until August.

You are required to:

1. Prepare the following budgets for each of the three months:
   - **a** Sales budget [distinguishing between cash and credit sales].
   - **b** Operating expenses budget.
   - **c** Cash flow budget.
   - **d** Working capital budget.
2. Prepare the budgeted statement of profit or loss & other comprehensive income for the three-month period ending 30 June 20*x*5.
3. Prepare the budgeted statement of financial position as at 30 June 20*x*5.
4. On the basis of the budgets developed, and assuming that the company is profitable but experiencing liquidity issues, write a brief report recommending the appropriate action.

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1 *Budgets*

	February		March		April		May		June	
Projected sales	240 000	00	480 000	00	320 000	00	380 000	00	220 000	00

Gilder Electronics Ltd

SALES BUDGET FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June		Total	
Cash sales (40%)	192 000	00	128 000	00	152 000	00	472 000	00
Credit sales (60%)	288 000	00	192 000	00	228 000	00	708 000	00
	480 000	00	320 000	00	380 000	00	1 180 000	00
Purchases (50%)	160 000	00	190 000	00	110 000	00	460 000	00

OPERATING EXPENSES BUDGET FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June		Total	
Cost of sales (50% of sales)	240 000	00	160 000	00	190 000	00	590 000	00
Salaries	15 000	00	15 000	00	15 000	00	45 000	00
Variable expenses (5% of sales)	24 000	00	16 000	00	19 000	00	59 000	00
Fixed expenses	25 000	00	25 000	00	25 000	00	75 000	00
Depreciation	3 000	00	3 000	00	3 000	00	9 000	00

WORKING CAPITAL BUDGET FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June	
Accounts receivable	124 800	00	230 400	00	230 400	00
Previous month (60%)	86 400	00	172 800	00	115 200	00
Previous 2 months (40%)	38 400	00	57 600	00	115 200	00
Inventory						
Cost of next month's sales	160 000	00	190 000	00	110 000	00
Bank						
Cash on hand	(2 200	00)	140 200	00	273 600	00
Accounts payable						
Cost of next month's sales (50%)	160 000	00	190 000	00	110 000	00
Short-term loan	0	00	0	00	0	00

BUDGETED CASH FLOW FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June	
Cash sales	192 000	00	128 000	00	152 000	00
Accounts receivable	124 800	00	230 400	00	230 400	00
Month following	86 400	00	172 800	00	115 200	00
Remaining	38 400	00	57 600	00	115 200	00
Budgeted cash inflow	316 800	00	358 400	00	382 400	00
Budgeted cash outflow	304 000	00	216 000	00	249 000	00
Accounts payable	240 000	00	160 000	00	190 000	00
Salaries	15 000	00	15 000	00	15 000	00
Variable expenses	24 000	00	16 000	00	19 000	00
Fixed expenses	25 000	00	25 000	00	25 000	00
Capital repayments	0	00	0	00	0	00
Month surplus (deficit)	12 800	00	142 400	00	133 400	00
Bank balance at beginning of the month	(15 000	00)	(2 200	00)	140 200	00
Bank balance at end of the month	(2 200	00)	140 200	00	273 600	00

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2 *Financial statements*

BUDGETED STATEMENT OF PROFIT OR LOSS & OTHER COMPREHENSIVE INCOME FOR THE QUARTER ENDED 30 JUNE 20x5

	April		May		June		Total	
Sales	480 000	00	320 000	00	380 000	00	1 180 000	00
Cost of sales	(240 000	00)	(160 000	00)	(190 000	00)	(590 000	00)
Gross profit	240 000	00	160 000	00	190 000	00	590 000	00
Operating expenses	(67 000	00)	(59 000	00)	(62 000	00)	(188 000	00)
Salaries	15 000	00	15 000	00	15 000	00	45 000	00
Variable expenses	24 000	00	16 000	00	19 000	00	59 000	00
Fixed expenses	25 000	00	25 000	00	25 000	00	75 000	00
Depreciation	3 000	00	3 000	00	3 000	00	3 000	00
Net profit before interest	173 000	00	101 000	00	128 000	00	402 000	00
Interest expense	(0	00)	(0	00)	(0	00)	(0	00)
NET PROFIT	173 000	00	101 000	00	128 000	00	402 000	00

3

Gilder Electronics Ltd
BUDGETED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20x5

	Notes	31 March 20x5		30 June 20x5	
ASSETS					
Non-current assets		350 000	00	341 000	00
Property, plant and equipment	3	390 000	00	390 000	00
Less: Accumulated depreciation		(40 000	00)	(49 000	00)
Current assets		384 000	00	650 000	00
Inventories	4	240 000	00	110 000	00
Accounts receivable	5	144 000	00	266 400	00
Cash and cash equivalents	6	0	00	273 600	00
TOTAL ASSETS		734 000	00	991 000	00
EQUITY AND LIABILITIES					
Capital and reserves		439 000	00	841 000	00
Ordinary share capital	7	439 000	00	439 000	00
Retained earnings	8	0	00	402 000	00
Current liabilities		295 000	00	150 000	00
Short-term borrowings (bank overdraft)		15 000	00	0	00
Accounts payable	9	280 000	00	150 000	00
TOTAL EQUITY AND LIABILITIES		734 000	00	991 000	00

4 The liquidity issue is that the company is becoming a 'cash cow' and the surplus cash needs to be milked and returned to the shareholders in the form of a special dividend, or new expansion projects need to be initiated to generate a return on the cash that is lying idle.

10 Summary

A budget is a plan expressed in financial terms. The financial plan is drafted within the context of the strategic plan of the company. This requires the company to assess its present situation and set goals and aims for development and growth.

A budget is a strategic plan that gives the company direction and focus and that offers a framework to employees in which to operate in a motivated and goal directed manner.

The master budget is the highest level budget and may be reflected in the statement of profit or loss & other comprehensive income, statement of financial position and the

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statement of cash flows that the company would like to have at the end of the budget year. These will be supported by numerous subsidiary budgets, each under the responsibility of an employee.

The techniques of budget compilation are not complex. The difficulty lies in forecasting the achievable targets and then harnessing the physical and human resources to achieve the budgeted targets.

The starting point in the budgetary process is to predict the sales volumes and construct the sales budget. Most other budgets such as the capital budget, the operating expenses budgets and the working capital budget will flow from the expected income from sales.

A budget is not simply an objective inert document. It must provoke action that results in meeting budget targets. The impact of the budget on human behaviour is not a trivial issue in the budgeting process. It is an issue that receives considerable attention from the managers to ensure that the budget has a positive impact on motivation and that employees do not feel threatened or insecure as a result of budgetary constraints.

QUESTIONS

Question 27.1

1 Discuss the benefits of planning and budgeting.
2 List the most logical sequence in which budgets should be prepared.

Question 27.2

List three recognised sales forecasting techniques.

Question 27.3

Krakto Ltd marks its inventory up by 60% of cost. Inventory at cost at the beginning of May is R120 000 which, as a policy, represents the anticipated sales for May. Management plans as a matter of policy to reduce inventory by 40%. If sales for June are budgeted at R240 000, calculate the May purchases if the new policy is implemented.

Question 27.4

Mazisto Ltd wants to increase its R120 000 cash balance by 20% during the budget period. Projected cash inflows and outflows are, respectively, R748 000 and R762 000. Calculate the amount that will be required on short-term loan during the budget period.

Question 27.5

Prexley Ltd has forecast sales of R480 000 in January, R440 000 in February, R360 000 in March and R400 000 in April. Cash sales comprise 20% of monthly sales. Debtor receivable payments average 70% in the month after sale and the balance in the next month. Calculate the budgeted cash receipts for April resulting from sales.

Question 27.6

Hydro Ltd normally produces and sells 26 000 units of its product each month. In addition to these, it has the capacity to produce and sell on special order, another 4 000 units at a price of R87.50 per unit.

The average full cost of the 30 000 units would be R95, and the incremental cost per unit of the special order is R62.50. Calculate the average full cost per unit for the normal production of 26 000 units.

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Question 27.7

Ripley Ltd manufactures a single product. Budgeted sales for May are R495 000. The gross margin is set at 40%.

If the budgeted net operating profit for May is R84 000, calculate the other total operating expense budgets for May.

Question 27.8

Scramble Supermarket is a cash-sale store in Paarl. The managers expect the next three months (from January to March) to demand cash requirements beyond the normal operational outflows.

A monthly cash budget to identify possible cash needs up to the end of March must therefore be developed from the information and projections that have been made available.

A cash balance of R28 700 is currently on hand and a balance of at least R20 000 must be available at the beginning of each month.

1 Sales forecasts are:
January R180 000, February R240 000, March R210 000, April R240 000.
The store has recently introduced a loyalty card system and 40% of cash from sales each month is only received by the middle of the next month.

2 Cost of goods sold averages 75% of sales.
- Inventory purchased during each month averages the cost of sales for the next month.
- Inventory on hand on 1 December amounted to R270 000.
- Accounts payable payment period averages 15 days, and goods are purchased consistently over the month.

3 Operating expenses are projected as:
- **a** Salaries and wages at 12% of sales, paid in the month of sale.
- **b** Other expenses at an average 10% of sales, paid in the month of sale.
- **c** Cash receipts expected from repayment of a loan to an employee of R6 000 due in March.
- **d** Repayments of short-term loan of R3 000 are due in February.
- **e** Repayments of long-term loans due at R4 000 each in January and March.
- **f** A new refrigerator was purchased for R48 000 and four payments of R12 000 each are due in February, March, April and May.
- **g** Depreciation of all equipment is written off at the rate of R5 000 per month.
- **h** Interest income from an investment of R4 900 per month is expected.
- **i** A bonus of R52 500 is due to staff in January.
- **j** Company tax payment of R14 000 is due in March.

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GLOSSARY

Account stores information in the general ledger relating to transactions of a similar kind, for example, the equipment account relates to equipment bought or sold, the salaries account stores information about all salaries paid.

Accounting controls internal controls used to protect assets and ensure accuracy of Accounting records.

Accounting officer the person who is responsible for drafting the financial statements of a close corporation. Only the members of recognised professions are allowed to become Accounting officers.

Accounts payable journal a special journal to record all purchases on credit.

Accounts receivable journal a special journal to record all sales on credit.

Accumulated fund used in the place of capital and represents all the funds accumulated in a non-profit organisation.

Accumulated profits the cumulative balance of undistributed profits of a company.

Adjustment clause may require that the turnover, on that an insurance claim is based, should be adjusted to take into account the trend in turnover over previous periods. This is done in order to attempt to obtain a realistic estimate for the turnover had the loss not occurred.

Adjustments entries that are not transactions recorded on source documents, but that are necessary to provide meaningful information about financial position and performance.

Agent a person to whom the goods are sent for sale.

Allowance created to record amounts that cannot be established with certainty. For example, the allowance for bad debts is created to record estimates of amounts that will not be collected from receivables.

Allowances Journal a special journal used to record the return of goods and price adjustments.

Annual turnover (*used in insurance claims*) the turnover (*income*) during the twelve months immediately before the date of the loss.

Articles of association a legal document drafted on the formation of a company that regulates the internal affairs of the company.

Asset a resource controlled by the business as a result of past events and from that future economic benefits are expected to flow to the business (see I*ntangible asset*).

Association agreement a contract entered into by the members of a close corporation to regulate internal matters and matters not specifically dealt with in the Close Corporations Act.

Bad debt (also called doubtful or irrecoverable debt) occurs when a receivable cannot pay the amount owing. The account must thus be 'written off', requiring an entry into the personal account and the accounts receivable account in the general ledger.

Bad debts recovered amounts previously considered irrecoverable and written off, now paid.

Bank reconciliation statement a statement detailing the reasons for the differencesbetween the bank balance in the general ledger and the bank balance according tothe bank statement.

Bank statement a copy of the entries recorded by the bank in the current account of the business.

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Budget a financial plan that can be drafted for important areas of a business, such as expected incomes, costs, capital expenditure, cash flows and profits.

Business cycle the normal course of business events from the time goods are **purchased and paid for to the time they are sold and the cash received. The events from the time of purchase may take place in a different order for different types of businesses.**

Business entity an individual or organisation with an identity of its own.

CA(SA) the abbreviation for Chartered Accountant South Africa.

Capital expenditure amounts spent on acquiring tangible assets.

Capitalisation shares shares issued to existing shareholders in the same proportion as the number of shares already held. No payment is received from shareholders for capitalisation shares.

Capitalising expenses when the expenses relating to the preparation of tangible assets are added to the cost price of the asset.

Carrying value the cost less the accumulated depreciation of an asset.

Cash book a book of original entry that doubles as a ledger account, in which all cash transactions are recorded.

Cash equivalents short-term liquid investments that are readily convertible to cash.

Cash payment journal (CPJ) a special journal used to record all cash payments.

Cash receipts journal (CRJ) a special journal used to record all cash receipts.

Cash sale a sale for that payment is made immediately.

Cheque a written order addressed to a bank requesting it to pay the sum of money specified to a specified person or the bearer of the cheque.

Cheque book a number of unused cheques, together with cheque counterfoils, bound in a booklet.

Cheque counterfoil the attachment to a cheque on that details of the amount, date and payee are recorded.

Close corporation a business form with one to ten members owning the business. It is a legal person that complies with the requirements of the *Close Corporations Act*.

Collectively exhaustive classifying something in such a way that every single item can be placed into an existing category.

Commission the remuneration that the agent receives for services in selling the goods.

Consignment the goods sent to an agent to be sold.

Consignor the person who dispatches the goods to be sold by an agent for a **commission.**

Consistency concept make valid comparisons, it is clear that methods and procedures adopted during one period should be adopted during the next.

Control account a single account in the general ledger that is a summary of a number of other accounts, kept in a subsidiary ledger.

Conversion costs the total costs incurred to convert raw materials into finished goods, namely direct labour and manufacturing overheads.

Convertible preference shares shares that may be converted into ordinary shares at a future date.

Cost of sales the price paid for goods sold. Calculated by adding the value of inventory at the beginning of a period, plus all goods bought, less the value of inventory at the end of the period.

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Cost principle accountants do not attempt to reflect assets at real or market values but record them at original cost.

Credit (*noun*) the provision of goods and services on account.

Credit the right-hand side of an account drafted in T-form in the General Ledger. Entries are made on the credit side of an account. Assets decrease, when Owner's Equity accounts and liabilities increase.

Credit note a document prepared by the seller in response to a debit note.

Credit policy the approach and procedures adopted in the granting of credit.

Creditors people/businesses lending money to businesses which, in turn, sell their products to customers.

Cumulative preference shares shares where the right to receive dividend is cumulative.

Current account a ledger account used by partnerships to that the owner's share of net profits or losses, drawings and other specific transactions with the partnership are transferred.

Current assets assets that are used mainly for trading or short-term purposes. They are expected to be realised within the operating cycle of the company, or within twelve months.

Current liabilities debt that will be settled within the company's operating cycle or within twelve months of the statement of financial position date.

Customer (also called a client) a person or entity to whom goods are sold.

Debentures acknowledgements of debt by the company issuing the debentures to the debenture holders.

Debit the left-hand side of an account drafted in T-form in the general ledger. Entries are made on the debit side of an account when assets increase, when owner's equity accounts decrease and liabilities decrease.

Debit note a document sent by the buyer of goods to the seller, indicating intention to debit the account of the seller.

Debit order an authorisation for the regular transfer of funds from one banking account to another.

Deficit (*in a non-profit organisation*) when expenditure exceeds income.

Delivery note a document that must be signed by the recipient of goods or services to indicate acknowledgement of receipt of goods or services.

Delphi technique a subjective method of forecasting expected sales.

Deposit book a bound book of deposit slips.

Deposit slip a document completed when depositing money, cheques, postal orders, and so on, into a bank account.

Depreciable amount the amount on that depreciation is calculated.

Depreciation the amount by that the cost price of an asset is reduced because, being used or older, it is worth less. Depreciation is an expense. It also makes the carrying value of the asset smaller.

Direct costs amounts that can be attributed unerringly to a particular sector because they are clearly related to that sector.

Direct labour costs the salaries and wages paid to the employees directly involved in the manufacturing process.

Direct material costs used directly in the process of manufacture and can be identified in the end product.

Discount a reduction of the amount payable granted by recipient of the amount (*payable*).

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Dishonoured cheque a cheque for that payment is refused by the drawee when presented for payment. Colloquially also known as a bounced cheque.

Dissolution the discontinuance of a partnership as a separate entity due to a change in the original partners.

Doubtful debts see B*ad debts*.

Due date the final date on that something must take place, that is, the due date of a bill is the final date on which that bill must be paid.

Economy the financial situation within a country resulting from its productive and government management of monetary and fiscal policies.

Efficiency broadly the term that relates to achieving an objective using the minimum possible resources. In the context of company management it refers to specific management such as the management of inventory. Any measure used to reflect how well a company has used a specific resource is referred to as an efficiency measurement.

Employees the people working in an business and who receive remuneration for their work contribution.

Employer someone who employs people and pays them for their services by way of remuneration.

Endorsing signing over/transferring ownership.

Entrance fees the initial payment required by clubs when new members join the club.

Equity the residual interest in the assets of the business after deducting all its liabilities.

Expenses decreases in economic benefits during the Accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Expenses accrued expenses that relate to the financial year under review but that are not yet recorded in the General Ledger because the invoices have not yet been received by the last day of the financial year.

Expenses prepaid expenses paid in the current financial year, of that a portion relates to the current year and the balance to the next financial year(s).

FIFO a method of assigning costs to goods sold whereby it is assumed that earliest item purchased (*first in*) is the first item sold (*first out*). The cost of the sale is, therefore, the cost of the oldest item on hand.

Financial assets cash, contractual rights to receive cash or another financial asset or an equity instrument, such as shares, in another business.

Financial liabilities contractual obligations to deliver cash or another financial asset to another business.

Financing activities activities that result in changes in the size and composition of the equity capital and borrowings of the business.

Fixed costs costs incurred that do not increase with additional production and sales, for example, rent.

Founding Statement completed when a close corporation is formed. It requires information about the members, accounting officer, main business and business address.

Free enterprise system the freedom of businesses to operate without government participation or intervention.

Funds defined as the financial resources possessed by a company that flow from transactions concluded with third parties.

Garner versus Murray rule a legal precedent from British case law that holds that losses not recovered from an insolvent partner should be borne by the existing partners in proportion to the balances on their capital accounts.

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General journal a place for recording transactions from source documents, as well as adjustments. It records the date of the transaction as well as the accounts in the general ledger that need to be debited and credit.

General ledger a collection of all the accounts of a business. Traditionally each ledger account has two sides, a debit side (*the left-hand side*) and a credit side (*the right-hand side*).

Going concern concept accepts that the entity expected to continue in operational existence in the foreseeable future.

Goodwill an asset that represents the excess of the real value over the book value of a business entity.

Gross profit (also called gross margin) the difference between selling price (*sales*) and the cost of sales of goods sold before deducting any operating expenses. Whereas, net profit is the difference between sales and all costs. Both gross and net profit may be expressed as a percentage of sales for the purpose of analysis. (See *net profit*.)

Gross remuneration the total remuneration that an employee receives before taxation whether in cash or by way of a fringe benefit.

Historic cost the price paid for an asset.

IASB the abbreviation for the International Accounting Standards Board, an international accounting setting body.

IFRS the abbreviation for the International Financial Reporting Standards and is a set of guidelines to ensure consistency in accounting practice.

Imprest system a system for controlling small cash disbursements by establishing a fund at a fixed amount and periodically reimbursing the fund by the amount necessary to bring the fund back to the fixed amount.

Income increases in economic benefits during the Accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Income accrued income earned for the current financial year but not yet received by the year end.

Income received in advance income received in the current financial year of that a portion relates to the current year and the balance to the next financial year(s).

Income tax assessment the invoice sent by the South African Revenue Service to the company showing the actual company tax payable.

Income tax return the form completed by companies, usually on an annual basis, showing the estimated company tax payable.

Increased cost of working the additional expenditure incurred by the insured to avoid a decrease in turnover which, had it not been this expenditure, would have taken place as a result of the occurrence.

Indemnity amount the maximum amount that the insurer will pay out in the case of loss.

Indemnity period the period of business disruption beginning at the date of the damage and not exceeding the period for that insured (*usually 12 months*).

Indirect costs incurred by the business as a whole and are not directly attributable to an individual sector.

Indirect labour costs the salaries and wages of employees not directly involved in the manufacturing process.

Indirect material costs used in the manufacturing process, but may not be directly identified to specific product units.

Industry a branch of trade or manufacture, for example, a furniture retailer

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Intangible asset an identifiable non-monetary asset without a physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Interest allowance a provision in a partnership agreement that allows for interest on the partners' capital invested.

Inventory goods kept for resale on the shelves or in the warehouse of a wholesaler or retailer.

Inventory in transit items bought for that legal ownership has passed, but because they are still being transported, are not available at the time of the inventory count.

Investing activities the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Investors people or businesses that have placed their money into a business with the expectation of receiving a return on the investment in the form of profit.

Invoice a document indicating the amount owing for the delivery of goods or services (see D*elivery note*).

Irrecoverable debts see B*ad debts*.

Labour costs consist of salaries and wages paid to employees involved in the manufacturing process.

Leverage based on the principle of levers using a fulcrum (*for example, a see-saw is a lever with the fulcrum in the middle*). It refers to increasing the benefit to one party by using the resource of another. Its most popular use is, for example, when a company borrows money at 10% and then earns 15% on that money – it has levered its profits to shareholders up, by borrowing at a lower rate than it earns.

Liability a present obligation of the business arising from past events, the settlement of that is expected to result in an outflow from the business of resources embodying economic benefits.

Limited liability that the members' or owners' responsibility for debts is limited to their investment.

Linear regression a statistical method of forecasting the most likely figure based on a series of past events.

Liquidation a special form of dissolution in which the business ends by selling assets, paying liabilities and distributing remaining assets to the partners.

Liquidity the ability of a company to meet its obligations (*repay its debt*) in the short term.

Loan levy (see L*oan portion of taxation*).

Loan portion of taxation (also called a Loan levy) a forced loan that taxpayers have to make to South African Revenue Service. Currently there is no loan portion of taxation payable to the SARS.

Manufacturing making or assembling of articles, usually in a factory.

Manufacturing concern a business that manufactures (*makes*) items and then sell to either a wholesaler or a retailer.

Manufacturing overheads generally all costs that cannot be identified with specific units of the end product.

Mark-up the amount added to the cost price to establish the selling price. It is often expressed as a percentage, calculated by dividing the gross profit by the cost price.

Matching concept the recognition of expenses in the same Accounting period as the income they helped to produce.

Material costs consist of the cost of raw materials used in the process of manufacturing.

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Members' interest the members' ownership in a close corporation and consists of members' contributions, undrawn income and the revaluation of tangible assets.

Memorandum a legal document drafted on the formation of a company that deals with the external affairs of the company.

Mutually exclusive classifying something so that it can fit into only one category.

Negotiable instruments tradable instruments, that is, transferable from one person or entity to another.

Net realisable value the amount that will be received on the sale of any item after deducting all other costs incurred in finalising the sale (such as advertising and delivery costs).

Nominal accounts statement of profit or loss & other comprehensive income accounts such as salaries and rent. They record the amounts of expenses or incomes that have reduced or increased the owner's equity.

Non-current assets all assets that are not current assets.

Non-current liabilities all liabilities that are not current liabilities.

Non-profit organisation one that obtains funds from either its members or from donations and uses these funds in order to achieve the aims of the organisation.

Operating activities the principal income-producing activities of the business and are activities that are not investing or financing activities.

Ordinary shares the shares issued to the effective owners of the companies.

Overheads expenses that are not directly associated with the particular manufactured product.

Over-subscription (for shares) takes place when a company receives more applications for shares than the shares available for issue.

Owner's equity the amount of the assets less the liabilities that belongs to the owner of the business.

Partner a co-owner in a partnership.

Partnership a business form where two to twenty partners own the business; it is not a legal entity and there are no legal formalities to comply with, but it is necessary to draw up a partnership agreement.

Partnership agreement the contractual relationship among partners setting out the details of the partnership.

Periodic inventory a system used to account for inventory on hand by means of a physical count at the end of a period. Cost of sales is then equal to the value of opening inventory, plus net purchases for the period, less closing inventory.

Perpetual inventory a system used to account for inventory on hand by means of a continuous and detailed record of the goods on hand and the cost of goods sold. This system is especially suitable where inventory consists of large units, often with unique serial numbers. Examples are vehicles, television sets, personal computers.

Personal account the ledger account of an individual – usually a receivable (*accounts receivable*) or a payable (*accounts payable*). Personal accounts are usually kept in a subsidiary ledger, and the summarised version of the whole subsidiary ledger is kept in the general ledger as a control account.

Physical inventory the value of the actual number of items of inventory on hand.

Posting the procedure of recording transactions into the general ledger from the information in the general journal.

Prime costs the total of direct labour and direct material costs used in the

manufacturing process.

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Principle of duality determines that the financial situation of a business be represented in terms of the basic accounting equation.

Private company a business form with minimum of one and a maximum of fifty shareholders. The name will always contain the words Proprietary Limited (*abbreviated as* (*Pty*) *Ltd*). The requirements of the *Companies Act* should be followed.

Profit and loss account the account to that all nominal account balances are posted (*after completing the general journal entry*). This happens prior to reporting in the financial statements. The statement of profit or loss & other comprehensive income is drafted from the information contained in the profit and loss summary account.

Profitability used as an expression of how well a company has performed relative to some benchmark. For example, comparing the net profit to the capital invested is a measure of the profitability of that company.

Profit margin the difference between the cost price and the selling price, expressed as a percentage by dividing the gross profit by the selling price.

Promissory note a promise to pay a stated amount at a stated date in the future.

Prospectus a document that public companies are required to issue in terms of the *Companies Act* when shares are offered to the public.

Prudence concept requires the person who prepares the financial statements to exercise prudence in their preparation, that is, not to overstate assets or income and not to understate liabilities and expenses.

Public company a business form limited by share capital. It consists of a minimum of seven shareholders. The name always contains the word Limited (abbreviated as Ltd). The requirements of the *Companies Act* must be followed.

Ratio the bringing together of two numbers that are relevant to each other (*for example the numbers* a *and* b) and comparing them by expressing them as $a : b$, usually with either a or b being expressed as the number 1. Ratios may easily be converted to percentages by dividing a by b and multiplying by 100. It is important to remember that any two numbers can be expressed as a ratio. However, only the selection of meaningful numbers that relate to each other in some way are of any relevance.

Real accounts refers to a statement of financial position T-account and accounts for assets or liabilities. They are, therefore, reported in the Statement of Financial Position.

Realised amounts debt that has been converted to cash, for example, a receivable is 'realised' as soon as that receivable pays their account.

Receipt a document that acknowledges the acceptance of money.

Redeemable preference shares shares that are redeemable by the company.

Refer to drawer an instruction given by the bank to the depositor in connection with a cheque deposited and subsequently dishonoured.

Relevance defined as the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of present and future events or to confirm or correct prior expectations.

Reliability defined as the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent.

Remittance advice a document accompanying a payment to a payable. It reconciles the balance of the payable's statement with the amount of the payment.

Retailer a business that buys from the manufacturer or wholesaler and then sells to the ultimate user (consumer).

Retailing the sale of goods in relatively small quantities, usually to consumers.

Retired (bills) bills that are paid before due date.

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Return the term widely used to reflect a large number of possible events. It is similar in concept to the number of apples produced from a given number of apple trees being the 'return'. So the profit compared to the equity and converted to a percentage is referred to as the 'Return on equity (ROE)', while if compared to the capital invested is referred to as the 'Return on capital employed (ROCE)'. Each time the word is used two questions should be asked: *Return of what*? *Return on what*? Then it may be expressed as a percentage.

Rights issue a share offer made to existing shareholders of the company to take up new shares in the proportion of shares already held.

SAICA the abbreviation for the South African Institute of Chartered Accountants.

Salaries paid to employees who earn remuneration on a monthly basis.

Salary allowance a provision in a partnership agreement that allows for remuneration for partners' personal services to the partnership.

SARS the South African Revenue Service who collects taxes in South Africa.

Service fee a charge by the bank for the service of operating a current account.

Share capital transferable units of ownership issued to the shareholders of companies.

Share Register a record of existing shareholders and their personal information.

Sole trader a business form where only one person owns the business and there are no legal formalities to comply with.

Source document the document, such as a receipt or cheque counterfoil, which first records the details of a transaction and serves as proof that the transaction took place. Entries are made into accounting records from a source document.

Standard turnover (sales) (*used in insurance claims*) the turnover during the period (*usually twelve months*) immediately before the date of the damage that corresponds with the indemnity period.

Stated capital the account name used for issued no par value shares.

Statement of Account a document (*usually prepared monthly*) that shows all invoices not yet paid (see *Invoice*).

Statement of changes in equity a new statement introduced by AC 101 that reconciles the opening and closing equity of a reporting entity.

Statement of receipt and payments usually a summary of all the cash transactions (see *Cash Book*).

Stock another word for inventory. For reporting purposes, the term inventory is used in practice.

Stop order a document that authorises regular transfers of funds from one banking account to another. A stop order is initiated by the bank.

Subscriptions the annual payments made by all members of a club for membership, usually on an annual basis.

Subsidiary a company that is controlled by another company (*parent company*) through voting rights obtained via the holding of shares.

Subsidiary journals special journals used for repetitive transactions such as cash receipts, cash payments, sales and purchases. Also known as *books of first entry*.

Supplier a business that manufactures specific items and makes the goods available to wholesalers or retailers.

Surplus (*in a non-profit organisation*) when income exceeds expenses.

Taxable income of a company the amount calculated in terms of the *Income tax Act* on that company tax is determined.

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Taxable income of employees the net result of gross earnings less pension fund contributions and qualifying retirement annuity contributions on that tax is payable.

Trade discount a reduction of the retail price offered to dealers and wholesalers. Trade discount is not recorded in the Accounting records.

Trading businesses retailers and wholesalers.

Trading statement a report showing how the gross profit is calculated by reporting the total income less the cost of sales. It is derived from the trading account in the general ledger.

Trial balance a list of all the accounts in the general ledger showing debit and credit balances in two columns alongside each other. It tests (*tries to prove*) whether a debit entry has been made for every credit entry, and whether each account has been correctly balanced. It does not prove that there are no errors for example, a transaction may have been left out altogether.

Turnover has at least two meanings in the context of accounting. Turnover is another word for sales or gross income. It may also be used to state how many times a certain event took place in a given year, for example, the number of times the value of payables were paid in a year is the payables' turnover. For example, if it was twelve times, it may also be converted to a time measurement – accounts payable in the statement of financial position are equal to one month (*one twelfth of a year*).

Under-subscription (for shares) takes place when a company receives fewer applications for shares than the shares available for issue.

Undrawn income the cumulative income remaining in the close corporation after all distributions to members have been paid.

Unlimited liability a characteristic of a partnership whereby each partner has personal liability for the debts of the partnership, regardless of the partner's investment in the partnership.

Value-added tax (VAT) a taxation levied by the government on goods and services. Vendors collect the tax that they charge customers (*output tax*) and reclaim the tax paid (*input tax*). What is submitted to the government each month, is the difference based on the value added.

Variable costs costs that are directly related to volume and that increase as the volume produced or sold increased, for example, sales commission.

Wages paid to employees who earn hourly wages.

Warranty a promise to correct, free of charge, a deficiency in a product sold or service rendered.

Wholesaler a business that buys from the manufacturer and then sells to dealers (retailers).

Work in progress inventory that is only partially complete and is, therefore, still in the process of being manufactured.

Working capital all the current assets and current liabilities that are active every day in the operations of a business (*they flow like a river – hence the term 'current'*). Net working capital is the difference between current assets and current liabilities. As current assets are usually larger for most business than current liabilities, the term 'net current assets' may also be used in this instance.

Worksheets tools used by accountants to pass the final year-end adjustments and to draft the financial statements.

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