About Financial Accounting

VOLUME 2

6th Edition

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Volume 1

Sixth Edition

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ISBN 978 0 409 12463 7
E-Book ISBN 978 0 409 12481 1

First edition 2005, Reprinted 2006
Second edition 2007
Third edition 2008
Fourth edition 2011
Fifth edition 2014

Editor: Lisa Sandford

Technical Editor: Liz Bisschoff

Printed by paarlmedia, a division of Novus Holdings

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Overview of the introduction to the preparation and presentation of financial statements

Introduction to the preparation and presentation of financial statements

In this chapter three aspects that form the basis for the preparation and presentation of financial statements are discussed

1	Conceptual framework for financial reporting	Par 1.2
2	Presentation of financial statements (IAS 1)	Par 1.4
3.	Financial instruments (IAS 32, IAS 39, IFRS 7, IFRS 9)	Par 1.5

1.1 Introduction

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- ☐ describe what the concept the Conceptual Framework entails;
- ☐ list the specific purposes of the Conceptual Framework regarding the preparation and pres*e*ntation of financial statements;
- ☐ explain the main objective of financial reporting according to the Conceptual Framework;
- ☐ explain the underlying assumption when preparing financial statements as discussed in the Conceptual Framework;
- ☐ discuss the qualitative characteristics of financial reporting according to the Conceptual Framework;
- ☐ explain what is implied by the Conceptual Framework when it refers to the constraints in preparing financial statements;
- ☐ discuss the elements of financial statements as explained in the Conceptual Framework and indicate which elements are s**tatement of financial position** elements and which are s**tatement of profit or loss and other comprehensive income** elements;
- ☐ discuss the concepts of recognition of the elements incorporated in the financial statements as explained in the Conceptual Framework;

continued

- ☐ explain what is meant by the measurement of the elements of financial statements by referring to the measurement methods discussed in the Conceptual Framework;
- ☐ explain the acronyms GAAP, IFRSs, APB and SAICA;
- ☐ explain what type of business ownership must comply with the IFRSs;
- ☐ define each of the following terms by referring to IAS 1:
  - fair presentation,
  - reporting period,
  - consistency of presentation,
  - materiality and aggregation,
  - offsetting, and
  - comparative information;
- ☐ list the individual statements that, according to IAS 1, together form the financial statements of a reporting entity;
- ☐ explain what is meant by the identification of financial statements;
- ☐ explain what is meant by the reporting period;
- ☐ explain what is meant by the operating cycle;
- ☐ explain which items comprise current assets and which comprise current liabilities, according to IAS 1;
- ☐ list the items that must be presented on the face of the statement of financial position and statement of profit or loss and other comprehensive income respectively by referring to IAS 1;
- ☐ list the items that can, according to IAS 1, be presented on either the face of the statement of financial position and statement of profit or loss and other comprehensive income or in the notes for the financial period;
- ☐ discuss the purpose of notes by referring to IAS 1;
- ☐ discuss the order in which items, that make up the notes, are normally presented as indicated by IAS 1;
- ☐ explain what is meant by the term "financial instrument";
- ☐ identify the instances when an asset will be classified as a financial asset;
- ☐ identity the instances when a liability will be classified as a financial liability;
- ☐ explain what is meant by the term "equity instrument";
- ☐ explain what the term "fair value" means;
- ☐ explain when an entity must recognise a financial asset and a financial liability;
- ☐ explain what is meant by the term "transaction costs"; and
- ☐ briefly explain the initial and subsequent measurement of a financial instrument with an indication of the accounting treatment of any resulting gain and/or loss on re-measurement.

In *About Financial Accounting Volume 1* the reader was introduced to the subject "Financial Accounting". The Conceptual Framework for Financial Reporting (issued in December 2010 and hereafter referred to as the "Conceptual Framework") was the starting point of study. Various concepts and procedures were introduced and discussed that enabled the reader to record business transactions in journals, post to ledger accounts and prepare trial balances. The collecting, classifying and recording of accounting data enabled the reader to correctly prepare the financial statements of a sole trader. It is thus at this point necessary to emphasise that a thorough knowledge of all the learning content of Volume 1 is essential to continue with the learning content of Volume 2 of this textbook.

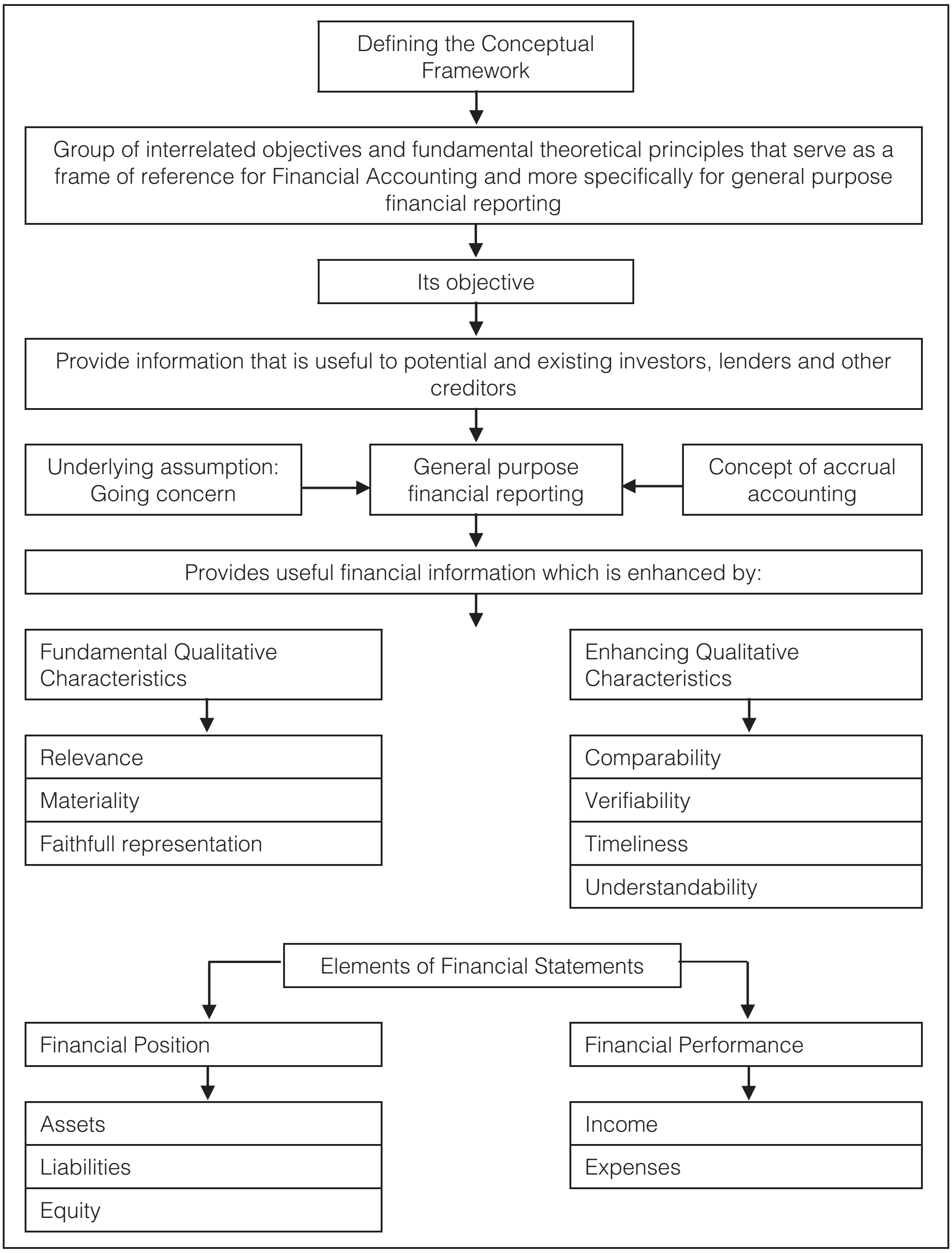
In Volume 2, the Conceptual Framework is again the starting point. However, the angle of the discussion differs largely from that of Volume 1 as an in-depth knowledge of the Conceptual Framework *(December 2010)* and *IAS 1 Presentation of Financial Statements* (June 2011) forms an important part of the learning content of this volume. Volume 2 focuses on the preparation and presentation of the financial statements of partnerships and close corporations, the purpose of which is to enable the reader to correctly prepare a full set of financial statements for these two types of business ownership. Other related and important issues regarding partnerships and close corporations, for example changes in ownership, dissolutions and conversions, are dealt with in detail as these events are reported on in the financial statements. Other topics discussed in Volume 2 are:

- *Statements of cash flows*: Although a statement of cash flow forms part of the financial statements of an entity, it is dealt with separately from the other financial statements due to its complexity.
- *Introduction to companies*: The reader is introduced to the company as a form of business ownership. It is compared to partnerships and close corporations, specifically relating to its capital structure.
- *Analysis and interpretation of financial statements*: The purpose of and the methods used to analyse and interpret the information contained in financial statements are discussed.
- *Branches*: The concept of an entity with branches is discussed, focusing on the recording of the transactions between the head office and its branches.
- *Manufacturing entities*: The concept of manufacturing and all related issues are discussed, with special reference to the recording of transactions that are unique to manufacturing entities.
- *Budgets*: The preparation of various types of budgets used by an entity, mainly to predict future cash flows, are discussed.

The objective of this chapter is to serve as a general introduction for the preparation and presentation of financial statements. In order to achieve its objective, this chapter utilises a thorough discussion of the Conceptual Framework and IAS 1 to equip the reader with the necessary knowledge to prepare the financial statements of partnerships and close corporations.

1.2 Conceptual framework for financial reporting

Overview of the conceptual framework for financial reporting



> **Note:** The Conceptual Framework (December 2010) has not been fully updated with the new terminology used in the revised IAS 1, issued in June 2011 (see below).
>
> Where applicable, the new IAS 1 terminology is indicated in brackets and in bold next to the current Conceptual Framework terminology.

1.2.1 *Introduction*

The Conceptual Framework can be described as a group of interrelated objectives and fundamental theoretical principles that serve as a frame of reference for Financial Accounting and more specifically financial reporting. The Conceptual Framework is both normative (prescriptive) and descriptive (explanatory) in nature, with an overriding requirement for information that is useful in making economic decisions. The Conceptual Framework is not an IFRS (International Financial Reporting Standard) and hence does not define standards for any particular measurement or disclosure issue. The Conceptual Framework does not override any specific IFRS.

According to the International Accounting Standards Board (IASB) the purpose and status of the Conceptual Framework is to:

(a) assist the Board in the development of future IFRSs and in its review of existing IFRSs;

(b) assist the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative treatments permitted by IFRSs;

(c) assist national standard setting bodies in developing national standards;

(d) assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;

(e) assist auditors in performing an opinion on whether financial statements comply with IFRSs;

(f) assist users of financial statements in interpreting the information contained in financial statements compared in compliance with IFRSs; and

(g) provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

The IASB states the scope of the Conceptual Framework as follows:

The Conceptual Framework deals with:

(a) the objective of financial reporting;

(b) the qualitative characteristics of useful financial information;

(c) the definition, recognition and measurement of the elements from which financial statements are constructed; and

(d) concepts of capital and capital maintenance.

The Conceptual Framework, as it is currently presented, was issued by the International Accounting Standards Board (IASB) and adopted by the Accounting Practices Board (APB) in South Africa and applies to the financial statements of all commercial, industrial and business reporting entities, whether in the public or private sector.

1.2.2 *Financial statements as part of financial reporting*

The communication of financial information is referred to as financial reporting. Financial statements form part of the process of financial reporting and the purpose of their preparation is to summarise and present all the transactions recorded in the journals and ledgers of an entity in a useful, logical and understandable way to the users of those financial statements.

A complete set of financial statements normally includes a **statement of financial position**, a **statement of profit or loss and other comprehensive income**, a statement of changes in the financial position (which may be presented in a variety of ways, for example as a statement of cash flows), and those notes and other statements and explanatory material that are an integral part of the financial statements. Excluded from financial statements are such items as reports by directors, statements by the chairperson of a company or similar items that may be included as part of the overall financial report. The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity.

Each component of the financial statements provides the following information about the entity:

☐ **Statement of financial position** (information about the financial position of the entity):
  - the economic resources available to generate future cash flows;
  - the financial structure with emphasis on own and borrowed capital and may be used to predict future borrowing needs;
  - the liquidity position and may be used to predict the availability of cash after settling financial commitments for the same period; and
  - the solvency position and may be used to predict the availability of cash over longer periods to meet financial commitments as they fall due.

☐ **Statement of profit or loss and other comprehensive income** (information about the financial performance of the entity):
  - allows assessment of potential changes in economic resources in the future;
  - permits assessment of potential effective use of additional resources; and
  - is useful in predicting the capacity of the entity to generate cash flows from existing resources.

☐ **Statement of changes in equity** (information about changes in the capital structure of an entity):
  - allows assessment of changes in equity and transactions affecting equity.

    (Note that the statement of changes in equity is not specifically mentioned by name in the Conceptual Framework (refer to Framework .7).)

☐ **Statement of cash flows** (information about changes in the financial position of entity):
  - allows an assessment of the operating, investing and financing activities of an entity and its ability to generate cash and cash equivalents in order to meet its cash flow needs.

☐ **Notes to the financial statements:**

- contain additional information that is relevant to the needs of the users about the items in the balance sheet (**statement of financial position**), income statement (**statement of profit or loss and other comprehensive income**), statement of changes in equity and cash flow statement (**statement of cash flows**).

1.2.3 *The objective of general purpose financial reporting*

According to the Conceptual Framework (.OB2) the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit. Potential and existing investors are interested in the returns they expect while creditors and other lenders are interested in principal repayments, interest payments they expect (Conceptual Framework .OB3).

General purpose financial reports' main limitation is that it cannot provide all the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate and industry and company outlooks (Conceptual Framework .OB6).

The management of a reporting entity is also interested in the financial information about the entity. They however need not rely on general purpose financial reports as they can get all the financial information they need internally.

1.2.4 *Underlying assumption when preparing financial statements*

The Conceptual Framework sets out the following underlying assumption when preparing financial statements:

Going concern

According to the going-concern assumption, the financial statements of an entity are prepared on the basis that it will continue in operation for the foreseeable future. This means that the business has neither the intention nor the need to liquidate or curtail the scale of its operations materially. If such an intention, however, does exist, the financial statements may have to be prepared on a different basis (Conceptual Framework .4.1).

Although paragraph 4.1 of the Conceptual Framework does not specifically mention the accrual basis of accounting as an assumption, .OB17 states that accrual accounting depicts the effects of transactions and other events on a reporting entity's resources in the periods in which those effects occur, even if the cash receipts and payments of those occur in a different period, and is therefore also applicable.

1.2.5 *Qualitative characteristics of useful financial information*

Qualitative characteristics are the attributes that make the financial information useful. To be useful the financial information must be relevant and faithfully represents what it purports to represent and is enhanced if it is comparable, verifiable, timely and understandable (Conceptual Framework .QC4).

1.2.5.1 Fundamental qualitative characteristics

The Conceptual Framework lists the following fundamental qualitative characteristics, namely:

(a) Relevance

Relevant information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both (Conceptual Framework .QC7). Predictive value means that it can be used to predict future outcomes while confirmatory value means that the financial information provides feedback about previous evaluations (Conceptual Framework .QC9).

(b) Materiality

Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity (Conceptual Framework .QC11).

(c) Faithful representation

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would be complete, neutral and free from error (Conceptual Framework .QC12).

A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations (Conceptual Framework .QC13).

A neutral depiction is without bias in the selection or presentation of financial information. It is not slanted, weighted emphasised or manipulated to increase the probability that financial information will be received favourably or unfavourably by users (Conceptual Framework .QC14).

Free from error means there are no errors or omissions in the description of the phenomenon and the process used to produce the reported information has been selected and applied with no errors in the process (Conceptual Framework .QC14).

1.2.5.2 Enhancing qualitative characteristics

(a) Comparability

Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date to enable the user to make an informed decision, for example, in which entity to invest or to keep an investment in a specific entity (Conceptual Framework .QC20). Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. To compare there must be at least two items (Conceptual Framework .Q21).

Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve the goal (Conceptual Framework .QC22).

(b) Verifiability

Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Verifiability helps ensure users that information faithfully represents the economic phenomena it purports to represent (Conceptual Framework .QC26).

(c) Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions (Conceptual Framework .QC29).

(d) Understandability

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyses the information diligently. Classifying, characterizing and presenting information clearly and concisely makes it understandable (Conceptual Framework .QC30, 32).

1.2.5.3 The cost constraint on useful financial reporting

Cost is a pervasive constraint on the information that can be provided by financial reporting. The cost of providing financial reporting must be justified by the benefits of reporting that information. Users ultimately bear those costs in the form of reduced returns (Conceptual Framework .QC35; .QC36). It is obvious that the benefits derived from the information in financial reporting should exceed the cost of providing it.

1.2.6 *Elements of financial statements*

1.2.6.1 Introduction

The recording of transactions in the journals and ledgers of an entity provide the information needed to prepare financial statements. The information that is going to be used in the preparation of financial statements is grouped into elements (according to their economic characteristics) which make up the financial statements. These elements are grouped under two headings, namely the elements that pertain to the financial position in the balance sheet (**statement of financial position**) namely assets, liabilities and equity and the elements that pertain to the financial performance in the income statement (**statement of profit or loss and other comprehensive income**) namely income and expenses. The statements used to reflect changes in the financial position (statement of changes in equity and the cash flow statement (**statement of cash flows**) reflect income statement (**statement of profit or loss and other comprehensive income**) and balance sheet (**statement of financial position**) elements and therefore the Conceptual Framework does not identify any specific elements for these statements. It must be noted that the Conceptual Framework only specifies and defines the elements pertaining to financial statements, and does not venture into the actual composition (layout) of the financial statements. This is done by IAS 1, which is discussed in paragraph 1.4.

1.2.6.2 Financial position (balance sheet) (statement of financial position)

The elements that are directly related to the financial position are assets, liabilities and equity (Conceptual Framework .4.4).

(a) Assets

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

According to paragraph 4.8 of the Conceptual Framework, the future economic benefit embodied in an asset is the potential to contribute directly or indirectly to the flow of cash and cash equivalents to the entity. Paragraph 4.10 explains that the future economic benefit embodied in an asset may flow to the entity in a number of ways. For example, an asset may be used singly or in combination with other assets in the production of goods or services to be sold by the entity, exchanged for other assets, used to settle a liability, or distributed to the owners of the entity.

The physical form of the asset is not essential to the existence of an asset, for example property, plant and equipment can be physically identified whilst patents and copyright, which only exist on paper, are also assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity (Conceptual Framework .4.11).

The Conceptual Framework 4.14 states that there is a close association between incurring expenditure and generating assets, but that the two do not necessarily coincide. When an entity incurs expenditure, this may provide evidence that future economic benefits were sought, but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet (**statement of financial position**), for example, items that have been donated to the entity may satisfy the definition of an asset.

(b) Liabilities

Paragraph 4.15 of the Conceptual Framework states that an essential characteristic of a liability is a present obligation. An obligation is a duty or a responsibility to act or perform in a certain way. A future commitment, for example a decision by management to acquire assets in the future does not, in itself, give rise to a present obligation and is not regarded as a liability because there is no past transaction resulting in a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset (Conceptual Framework .4.16).

According to paragraph 4.17 of the Conceptual Framework, the settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of obligations may occur in a number of ways, for example by payments in cash, transfer of other assets, provision for services, replacement of that obligation with another obligation, and conversion of the obligation to equity or any other means, for example a creditor waiving or forfeiting its rights.

Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan (Conceptual Framework .4.18).

(c) Equity

Equity is the residual interest in the assets of the entity after deducting all liabilities (Conceptual Framework .4.4).

If it is to the benefit of users, equity can be subclassified in the balance sheet (**statement of financial position**) in order to improve understandability (Conceptual Framework .4.20). The amount at which equity is shown in the balance sheet (**statement of financial position**) is dependent on the measurement of assets and liabilities. Paragraph 4.22 of the Conceptual Framework states that it is normally only by coincidence that the aggregate amount of equity corresponds with the aggregate market value of shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis, or the entity as a whole on a piecemeal basis. The Conceptual Framework .4.23 clearly states that commercial, industrial and business activities are often undertaken by means of entities such as sole proprietors, partnerships and trusts of the entities and various types of government business undertakings. The legal and regulatory framework for such entities is often different from that of the entities applying to corporate entities. For example, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Conceptual Framework that deal with equity are appropriate for such entities.

1.2.6.3 Financial performance (income statement) (statement of profit or loss and other comprehensive income)

In paragraph 4.24, the Conceptual Framework specifically notes that profit is frequently used as a measure of performance or as the basis for other measures such as return on investments or earnings per share. The elements directly related to the measure of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concept of capital and capital maintenance used by the entity in preparing financial statements (refer to 1.2.10).

The elements that are directly related to the financial performance are defined as follows:

(a) Income

Income is an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity other than those relating to the contributions from the equity participants (Conceptual Framework .4.25).

The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent (Conceptual Framework .4.29). Gains represent other items that meet the definition of income and may or may not arise in the course of ordinary business activities, for example profit made on the sale of obsolete non-current assets. As gains result in an increase in economic benefit, the result is the same as that of income and is therefore not classified as a separate element. The Conceptual Framework (.4.31) states that gains are reported net of related expenses and when gains are recognised in the income statement (**statement of profit or loss and other comprehensive income**), they are reported separately because knowledge of their existence can be useful in making economic decisions.

(b) Expenses

The Conceptual Framework (.4.25) defines expenses as decreases in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrence of liabilities that result in decreases in equity, other than those relating to a distribution to equity participants.

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. The latter types of expenses usually take the form of an outflow of cash or depletion of assets such as property, plant and equipment and include such items as cost of sales, salaries and wages, and depreciation (Conceptual Framework .4.33). Losses represent decreases in economic benefit that may, or may not, arise in the course of the ordinary activities of the business, for example a loss on the sale of a non-current asset. As losses result in a decrease in economic benefits, the result is the same as that of expenses and is therefore not classified as a separate element (Conceptual Framework .4.34). Losses are reported net of related income and when losses are recognised in the financial statements, they are reported separately because knowledge of them is useful for making economic decisions (Conceptual Framework .4.35).

1.2.7 *Recognition of the elements of financial statements*

Recognition is the process of incorporating an item that meets the definition of an element and satisfies the criteria for recognition in the balance sheet (**statement of financial position**) or income statement (**statement of profit or loss and other comprehensive income**). It involves the depiction of the item in words and in monetary value (as an amount) and the inclusion of that amount in the balance sheet (**statement of financial position**) or income statement (**statement of profit or loss and other comprehensive income**) totals. Items that satisfy the recognition criteria should be recognised in the balance sheet (**statement of financial position**) or income statement (**statement of profit or loss and other comprehensive income**). The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material (Conceptual Framework .4.37). In practice, this means that an item must first be recorded in the journals and ledgers before it can be incorporated in the financial statements.

According to the Conceptual Framework (.4.38), "an item that meets the definition of an element should be recognised if:

(a) It is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) The item has a cost or value that can be measured with reliability."

Probability refers to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity (Conceptual Framework .4.40). An example is sales on credit. The possibility that not all the trade debtors will pay their outstanding accounts is highly likely, therefore an expense (by way of providing for credit losses), representing the expected reduction in economic benefit, is recognised.

If no cost or value can be attached to an item, and it is also not possible to make a reasonable estimate of its cost or value, such an item cannot be recognised in the balance sheet (**statement of financial position**) or income statement (**statement of profit or loss and other comprehensive income**), but can still be disclosed in the notes to the financial statements if the disclosure thereof may influence the decisions of the users of those financial statements (Conceptual Framework .4.41). An example of this would be a pending law suit against the entity which has not been recognised because the financial impact on the entity can't be estimated reliably.

More specifically, the Conceptual Framework (.4.44–.4.53) lays down the following criteria for the recognition of each element of the financial statements:

- *Assets*: An asset is recognised in the balance sheet (**statement of financial position**) when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably (Conceptual Framework .4.44). If however the expenditure has been incurred for which it is considered improbable that economic benefit will flow to the entity beyond the current accounting period, an asset is not recognised in the balance sheet (**statement of financial position**) but it is recognised as an expense in the income statement (**statement of profit or loss and other comprehensive income**) (Conceptual Framework .4.45).
- *Liabilities*: A liability is recognised in the balance sheet (**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 (Conceptual Framework .4.46).
- *Income*: Income is recognised in the income statement (**statement of profit or loss and 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. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities, for example merchandise sold for cash (Conceptual Framework .4.47).
- *Expenses*: Expenses are recognised in the income statement (**statement of profit or loss and other comprehensive income**) when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (Conceptual Framework .4.49). Expenses are recognised in the income statement (**statement of profit or loss and other comprehensive income**) on the basis of direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the "matching of costs with revenues", involves the simultaneous or combined recognition of revenue and expenses that result directly and jointly from the same transaction, for example matching the cost of sales with the income derived from the sale of those goods (Conceptual Framework .4.50). When economic benefits are

expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures, for example depreciation on non-current assets. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits that are associated with these items are consumed or have expired (Conceptual Framework .4.51).

Paragraph 4.52 of the Conceptual Framework states clearly that an expense is recognised immediately in the income statement (**statement of profit or loss and other comprehensive income**) when an expenditure produces no future economic benefits or when and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet (**statement of financial position**) as an asset.

An expense is also recognised in the income statement (**statement of profit or loss and other comprehensive income**) in those cases when a liability is incurred without the recognition of an asset, for example when a liability under a product warranty arises (Conceptual Framework .4.53).

1.2.8 *Measurement of the elements of financial statements*

"Measurement" is defined as the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet (**statement of financial position**) and income statement (**statement of profit or loss and other comprehensive income**) (Conceptual Framework .4.54). The Conceptual Framework lists four bases of measurement: historical cost, realisable value, current cost, and present value. Although the historical cost is the measurement basis most commonly adopted by entities, it is usually combined with other measurements bases, for example, inventories are usually carried at the lower of cost and net realisable value, and property, plant and equipment are reported at their historical cost or revalued (present value) amounts.

The Conceptual Framework describes the four measurement bases as follows (Conceptual Framework .4.55):

- *Historical cost* means that assets are recorded at the amount of cash or cash equivalent paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation or at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business. The drawback of this approach is its inability to deal with the effect of changing prices of non-monetary assets, with the result that some entities prefer the current cost model to measure the elements of the balance sheet (**statement of financial position**) and income statement (**statement of profit or loss and other comprehensive income**).
- *Realisable value (settlement value)* means that assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Liabilities are carried at their settlement values, i.e. the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

- *Current cost* means that assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligations currently.
- *Present value* means that assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Although the Conceptual Framework does not mention fair value as a measurement basis, IAS 1.109 states fair value to be a measurement basis. The Conceptual Framework is not an IFRS and does not override the requirements of a Standard and hence fair value is regarded as a measurement basis. Fair value is defined as the amount for which an asset could be sold or a liability transferred between market participants on the measurement date (IAS 32.11).

1.2.9 *The concepts of capital and capital maintenance*

The Conceptual Framework .4.57 to .4.65 describes two concepts of capital and capital maintenance, namely the financial concept and the physical concept.

1.2.9.1 The concepts of capital

Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity, and is adopted in cases where the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of production per day.

The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. According to the Conceptual Framework (.4.58) a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or purchasing power of invested capital. If the main concern of users is with the operating capability of the entity, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit.

1.2.9.2 The concepts of capital maintenance and the determination of profit

The Conceptual Framework (.4.59) states that the concepts of capital give rise to the following two concepts of capital maintenance:

(a) Financial capital maintenance

Under this concept a profit is only earned if the financial amount of the net assets at the end of the period exceeds the financial amount of the net assets at the beginning of the period, after excluding any distributions to and contributions from owners during the period.

(b) Physical capital maintenance

Under this concept a profit is earned only if the physical productive capacity of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to and contributions from owners during the period.

According to the Conceptual Framework (.4.65), the selection of a measurement basis and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. The Conceptual Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. The Board of IASC has no present intention to prescribe a specific model other than in exceptional circumstances, such as under hyper-inflationary conditions, which fall outside the scope of this textbook.

1.3 The South African regulatory reporting framework

1.3.1 *Introduction*

Before 2005 Statements of Generally Accepted Accounting Practise (GAAP) needed to be adhered to when preparing the financial statements of entities incorporated under the previous Companies Act (Act 61 of 1973) because this Companies Act, by way of paragraph 5 of Schedule 4, required this compliance with the Statements of GAAP. The fact that this compliance is not required by any other form of business ownership did not mean that the requirements of these statements cannot be applied when preparing the financial statements of forms of ownership other than companies.

In South Africa it became common practice to apply these statements, to a certain extent, to other forms of business ownership, although there is no legal requirement that the financial statements of sole traders, partnerships and close corporations must comply with the Statements of GAAP. The problem was that the preparers of the financial statements of entities incorporated under another law (close corporations) or not incorporated at all (sole traders and partnerships) may purport that the financial statements were prepared to comply with the Statements of GAAP. Compliance with the Statements of GAAP meant compliance to all aspects of the standards. If this is not the case, then no statement to this effect can be made by the preparer of financial statements.

South Africa adopted International Financial Reporting Standards (IFRS) in 2003. From 1 January 2005 South African Statements of GAAP were replaced by International Financial Reporting Standards (IFRSs). "IFRSs" are Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise the following:

- International Financial Reporting Standards (deals with recognition, measurement, presentation and disclosure requirements in general purpose financial statements);
- International Accounting Standards; (is a designated part of IFRSs); and

- ☐ Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC) (issues interpretations of IASs and provides guidance on the application of IFRSs).

The relationship between South African Statements of GAAP and International Financial Reporting Standards is discussed in the next paragraph.

1.3.2 *The current South African financial reporting framework*

From 1 January 2005, the Johannesburg Securities Exchange required that all listed companies had to comply with International Financial Reporting Standards (IFRSs).The Companies Act 71 of 2008, which came into effect on 1 May 2011, established a body known as the Financial Reporting Standards Council (FRSC). The FRSC replaced the APB and is now South Africa's constituted governmental accounting standard setting body. For all financial periods commencing on or after 1 December 2012 all companies had to comply with IFRS or IFRS for SMEs (Small and Medium-sized Entities). The Companies Regulations of 2011 (Regulation 27) prescribes financial reporting standards applicable by category of company and is listed in table 1.1 below.

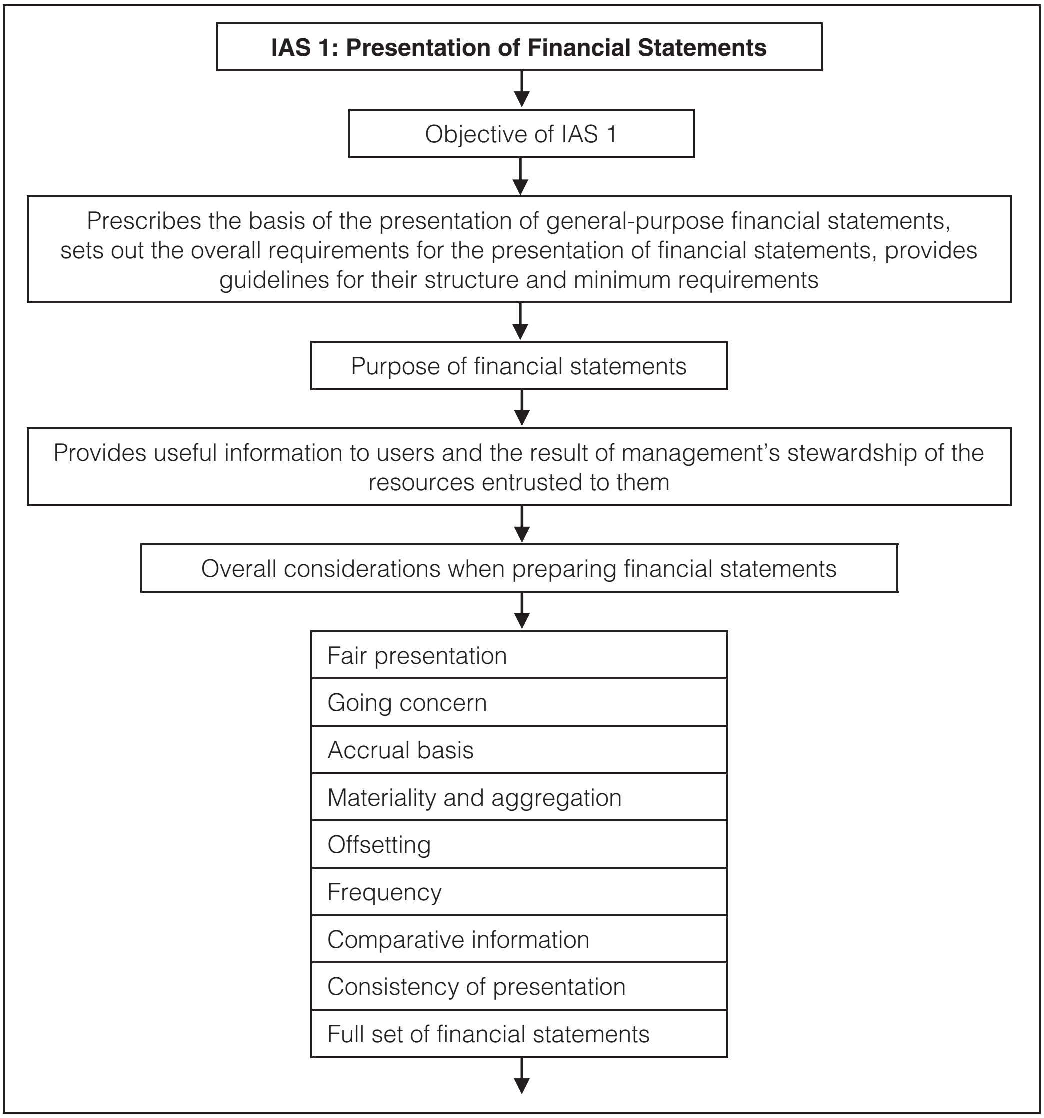
Table1.1 Financial Reporting Standards applicable to category of company

Category of company	Financial Reporting Standard
State-owned companies	IFRS, but in the case of any conflict with any requirements in terms of the Public Finance Management Act, the latter prevails.
Public companies listed on an exchange	IFRS
Public companies not listed on an exchange	One of: (a) IFRS (b) IFRS for SMEs, provided that the company meets the scoping requirements outlined in the IFRS for SMEs.
Profit companies, other than state-owned or public companies, whose public interest score for the particular financial year is at least 350.	One of: (a) IFRS; or (b) IFRS for SMEs, provided that the company meets the scoping requirements outlined in the IFRS for SMEs.
Profit companies, other than state-owned companies: (a) whose public interest score for the particular financial year is at least 100 but less than 350; or	One of: (a) IFRS (b) IFRS for SMEs, provided that the company meets the scoping requirements outlined in the IFRS for SMEs; or
(b) whose public interest score for the particular financial year is less than 100, and whose statements are independently compiled.	(c) IFRS for SMEs.
Profit companies, other than state-owned companies or public companies, whose public interest score for the particular financial year is less than 100 and whose statements are internally compiled.	The Financial Reporting Standard as determined by the company for as long as no Financial Reporting Standard is prescribed.

(Please note that the calculation of the public interest score falls outside the scope of this textbook.)

1.4 Presentation of financial statements (IAS 1)

Overview of the presentation of financial statements (IAS 1)



continued

Statement of Financial Position	→	presenting	→	Property, plant and equipment Investment property Intangible assets Financial assets Inventories Trade and other receivables Cash and cash equivalents Trade and other payables Financial liabilities Issued capital and reserves
Statement of profit or loss and other comprehensive income	→	presenting	→	Revenue Finance costs Tax expenses Profit or loss Other comprehensive income Total comprehensive income
Statement of changes in equity	→	presenting	→	Total comprehensive income Contributions and distributions by owners. For each component of equity, a reconciliation between the carrying amount at the beginning and end of the period
Statement of cash flows	→	presenting	→	Generation of cash and cash equivalents Utilisation of cash and cash equivalents
Notes to the financial statements	→	presenting	→	Information about the basis of preparation of the financial statements and the specific accounting policies applied Present information required by IFRS and not already presented somewhere else Supporting information for items presented in the financial statements Additional information for items not presented in the financial statements

1.4.1 *Introduction*

The objective of IAS 1 is to prescribe the basis for the presentation of general-purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. Remember that general-purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their particular information needs. To achieve this objective, IAS 1 sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content (IAS 1.1 to .3).

IAS 1 uses terminology that is suitable for profit-orientated entities, including public sector business entities. Entities with not-for-profit activities in the private sector, public sector and government seeking to apply this standard can amend the descriptions used for particular line items in the financial statements and for the financial statements themselves (IAS 1.5). Similarly, entities that do not have equity and entities whose share capital is not equity, and entities whose equity does not consist of share capital, may need to adapt the presentation in the financial statements to members' or unit holders' interest (IAS 1.6).

1.4.2 *Definitions*

IAS 1 .7 gives the following definitions of terms used in this Standard:

General purpose financial statements (referred to as financial statements) are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

Impracticable: Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

International Financial Reporting Standards (IFRSs) are Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise:

(a) International Financial Reporting Standards;

(b) International Accounting Standards; and

(c) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

Material: Omissions or misstatements are material if they could individually or collectively influence the economic decisions that users make on the basis of financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances.

Notes contain information in addition to that presented in the statement of financial position, statement of profit or loss and other comprehensive income, separate income statement (if presented), statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements.

Other comprehensive income comprises items of income and expense that are not recognised in profit or loss as required or permitted by other IFRSs.

The components of other comprehensive income include:

(a) changes in revaluation surplus;

(b) actuarial gains and losses on defined benefit plans;

(c) gains and losses arising from translating the financial statements of a foreign operation;

(d) gains and losses on remeasuring investments in equity instruments;

(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge.

Owners are holders of instruments classified as equity.

Profit or loss is the total of income less expenses, excluding the components of other comprehensive income.

Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. It therefore comprises all components of "profit or loss" and of "other comprehensive income".

1.4.3 *The purpose of financial statements*

IAS 1 .9 describes financial statements as structured representations of the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements not only provide information to users but also show the result of management's stewardship of the resources entrusted to them. To meet its purpose, financial statements provide information about an entity's:

- assets;
- liabilities;
- equity;
- income and expenses, including gains and losses;
- other changes in equity; and
- cash flows.

The Standard observes that this information, along with other information in the notes, would assist users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

According to IAS 1.10, a complete set of financial statements comprises:

- a statement of financial position as at the end of the period;
- a statement of profit or loss and other comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period; and
- notes, comprising a summary of significant accounting policies and other explanatory notes.

1.4.4 *Overall considerations when preparing financial statements*

The overall consideration when preparing financial statements, as laid out in IAS 1, is more prescriptive than descriptive in nature. The use of the word "shall" strengthens the prescriptive nature of these considerations, which were also dealt with in the Conceptual Framework, but in a more descriptive way.

1.4.4.1 Fair presentation

IAS 1 .15 states that the financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effect of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Conceptual Framework. The application of the IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

An entity whose financial statements comply with the IFRSs shall make an explicit and unreserved statement of compliance in the notes. Financial statements shall not be described as complying with the IFRSs unless they comply with all the requirements of the IFRSs (IAS 1.16). In practice, this means that if an entity complies with the requirements of IAS 1, but not with any of the other requirements of any of the other standards, it must be silent on expressing its compliance with IFRS.

Paragraphs 19 to 24 of IAS 1 deal with the rare circumstances in which management of an entity concludes that compliance with a requirement in a Standard or an Interpretation would be so misleading that it would be in conflict with the objective of the financial statements, and prescribe the manner in which to present such a departure. The exact specifics fall outside the scope of this textbook.

1.4.4.2 Going concern

IAS 1.25 reminds the preparer of financial statements that these statements shall be prepared on a going-concern basis unless there is an indication that the management of the entity intends to liquidate the entity or to cease trading, or has no other option but to do so. The preparation of financial statements other than for a going concern falls outside the scope of this textbook.

1.4.4.3 Accrual basis

An entity shall prepare its financial statements, except cash flow information, using the accrual basis of accounting (IAS 1.27). When the accrual basis of accounting is used, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements as set out in the Conceptual Framework (IAS 1.28).

1.4.4.4 Materiality and aggregation

According to IAS 1.29, each material class of similar items shall be presented separately in the financial statements. Items of dissimilar nature or function shall be presented separately, unless they are immaterial. This, in effect, means that similar items must be grouped together and presented as a class in the financial statements. Items that cannot be allocated to a specific class must be shown separately if they are material (refer to paragraph 1.4.2).

Financial statements result from processing large numbers of transactions or events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form the line items on the face of the balance sheet (**statement of financial position**), income statement (**statement of profit or loss and other comprehensive income**), statement of changes in equity and cash flow statement (**statement of cash flows**), or in the notes. If a line item is not individually material, it is aggregated with other items on the face of those statements or in the notes. An item that is not sufficiently material to warrant separate presentation on the face of those statements may nevertheless be sufficiently material for it to be presented separately in the notes (IAS 1.30).

1.4.4.5 Offsetting

Paragraph 32 of IAS 1 does not encourage offsetting. It states that assets and liabilities, and income and expenses, shall not be offset unless required or permitted by a Standard or an Interpretation. The exceptions are gains and losses on the disposal of non-current assets, investments and operating assets, which are reported by deducting from the proceeds on disposal, the carrying amount of the asset and related selling expenses. Measuring the assets net of valuation allowances, for example provision for credit losses and depreciation, or showing inventories at a lower value than their cost price, is not seen as offsetting (IAS 1.33 to .35).

1.4.4.6 Frequency of reporting

A complete set of financial statements shall be presented at least annually. When an entity changes the end of its reporting period and the financial statements are presented for a longer or shorter period than one year, the entity must explain the reason for using a longer or shorter period. For example, a new entity that started trading during a financial year will only be able to report on its operations for a shorter period than a year. In such cases, the fact that amounts presented in the financial statements are not entirely comparable must also be mentioned (IAS 1.36).

1.4.4.7 Comparative information

IAS 1.38 states that comparative information shall be disclosed in respect of previous periods for all amounts reported in the financial statements. Comparative information shall also be included for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements. In this volume, however, comparative information, except where it is absolutely necessary for the purpose of an explanation or calculation, is omitted, as the use of comparative figures does not facilitate the learning process.

1.4.4.8 Consistency of presentation

The presentation and classification of items in the financial statements shall be retained from one period to the next (IAS 1.45). An entity changes the presentation of its financial statements only if the changed presentation provides information that is reliable, more relevant to the users of the financial statements and the revised structure is likely to continue, so that comparability is not impaired (IAS 1.46).

1.4.5 *Structure and contents of financial statements*

1.4.5.1 Introduction

IAS 1.47 requires particular disclosures on the face of the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity and requires disclosure of other line items either on the face of those statements or in the notes. With regard to the statement of cash flows, requirements regarding disclosure in this statement are set out in IAS 7, which deals with the statement of cash flows (refer to Chapter 6).

1.4.5.2 Identification of financial statements

IAS 1.51 to .53 require that each component of the financial statements shall be identified clearly so that the users can easily distinguish them from other information supplied in financial reports. In addition, the following information shall be displayed prominently and repeated when it is necessary for a proper understanding of the information presented:

- ☐ the name of the reporting entity;
- ☐ the date at the end of the reporting period or the period covered by the set of financial statements or notes;
- ☐ the presentation currency; and
- ☐ the level of rounding used in presenting amounts in the financial statements.

For the purpose of this volume, only applicable information for an introductory course in accounting is listed.

1.4.5.3 Statement of financial position

As a minimum, the statement of financial position shall include line items that present the following amounts: IAS 1.54 (only those items applicable to this volume are mentioned):

- ☐ property, plant and equipment;
- ☐ investment property;
- ☐ intangible assets;
- ☐ financial assets (for example an equity instrument of another entity held for investment purposes or a cash investment);
- ☐ inventories;
- ☐ trade and other receivables;
- ☐ cash and cash equivalents;
- ☐ trade and other payables;
- ☐ financial liabilities (for example a contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the entity); and
- ☐ issued capital and reserves.

IAS 1.55 to .57 further state that an entity shall present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position. These line items are included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position.

An entity shall present current and non-current assets, and current and non-current liabilities as separate classifications in the statement of financial position (IAS 1.60).

(a) Current assets

According to IAS 1.66, an asset shall be classified as "current" when it satisfies any of the following criteria:

- ☐ it is expected to be realised in, or intended for sale or consumption in the entity's normal operating cycle;
- ☐ it is held primarily for the purpose of being traded;

- ☐ it is expected to be realised within twelve months after the reporting period; or
- ☐ it is cash or a cash equivalent, unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

IAS 1.68 explains the operating cycle of an entity as the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months. Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle, even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets held primarily for the purpose of being traded (financial assets held for trading) and the current portion of non-current financial assets.

All other assets that do not conform to the above criteria shall be classified as "non-current assets" and include tangible, intangible and financial assets of a long-term nature. This Standard does not prohibit the use of alternative descriptions as long as the meaning is clear (IAS 1.57), for example the term "fixed assets" could be used in place of "non-current assets". For the purpose of this textbook (both volumes), the terminology of this Standard is preferred and used.

(b) Current liabilities

A liability shall be classified as "current" when it satisfies any of the following criteria (IAS 1.69):

- ☐ it is expected to be settled in the entity's normal operating cycle;
- ☐ it is held primarily for the purpose of being traded;
- ☐ it is due to be settled within twelve months after the balance sheet (**statement of financial position**) date; or
- ☐ the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet (**statement of financial position**) date.

All other liabilities that do not conform to the above criteria shall be classified as "non-current liabilities".

Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. Such operating items are classified as current liabilities even if they are to be settled more than twelve months after the reporting period. The same normal operating cycle applies to the classification of an entity's assets and liabilities. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months (IAS 1.70). Some current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period. Examples given by this Standard are a bank overdraft, the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (i.e. must not be part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period, are non-current liabilities (IAS 1.62).

(c) Information to be presented either in the statement of financial position or in the notes

According to IAS 1.77, an entity shall disclose, either in the statement of financial position or in the notes, further sub classifications of the line items presented, classified in a manner appropriate to the entity's operations. For example, items of property, plant and equipment are disaggregated into appropriate classes, while receivables are disaggregated into amounts receivable from trade customers, prepayments and other amounts such as accrued income (IAS 1.78).

While IAS 1.79(a) deals with how the share capital and reserves of a company shall be disclosed, which falls outside the scope of this volume, paragraph 80 of IAS 1 clearly states that an entity without share capital, such as a partnership or trust, shall disclose information equivalent to that required by paragraph 79(a), showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attached to each category of equity interest.

1.4.5.4 Statement of profit or loss and other comprehensive income

According to IAS 1.81 an entity shall present all items of income and expense recognised in a period:

(a) in a single statement of profit or loss and other comprehensive income; or

(b) in two statements: a statement displaying components of profit or loss (separate income statement) and a second statement beginning with profit or loss and displaying components of other comprehensive income (statement of comprehensive income).

(a) Information to be presented in the statement of profit or loss and other comprehensive income

As a minimum, the statement of profit or loss and other comprehensive income shall include line items that present the following amounts for the period (IAS 1.82) (only those items that are applicable to this volume are mentioned):

- revenue;
- finance costs;
- tax expense;
- profit or loss;
- each component of other comprehensive income classified by nature; and
- total comprehensive income.

Additional line items, headings and subtotals shall be presented in the statement of profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance (IAS 1.85).

(b) Information to be presented either in the statement of profit or loss and other comprehensive income or in the notes

According to IAS 1.97 to .98, when items of income and expenses are material, their nature and amount shall be disclosed separately, for example:

- the write-down of inventories to the net realisable value and reversal of such write-downs;

- ☐ the disposal of items of property, plant and equipment; and
- ☐ the disposal of investments.

IAS 1.99 further states that an entity shall present an analysis of expenses using a classification based on either the nature of the expense or its function within the entity, whichever provides information that is reliable and more relevant. In this volume, we will use the method where expenses are analysed according to their function (also called the cost of sales method). It also classifies expenses according to their function as part of cost of sales or, for example, the cost of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses (IAS 1.103). An example of such a classification is:

	R
Revenue	XXX XXX
Cost of sales	(XX XXX)
Gross profit	XX XXX
Other income	XXX
Distribution costs	(XXX)
Administration expenses	(XXX)
Other expenses	(XXX)
Profit	X XXX

IAS 1.104 also states that entities classifying expenses by function shall disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee-benefit expense.

1.4.5.5 Statement of changes in equity

(a) Information to be presented in the statement of changes in equity

According to IAS 1.106, an entity shall present a statement of changes in equity showing in the statement (only those items that are applicable to this volume are mentioned):

- ☐ total comprehensive income for the period;
- ☐ the amounts of transactions with owner(s) acting in their capacity as owners, showing contributions by and distribution to owners separately; and
- ☐ for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each change.

(b) Information to be presented in the statement of changes in equity or in the notes (IAS 1.107)

The amount of dividends recognised as distribution to owners during the period, and the related amount per share.

1.4.5.6 Statement of cash flows

According to IAS 1.111, cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. IAS 7 Statement of cash flows sets out the requirements for the presentation of Statements of cash flows and related disclosures. Statements of cash flows are discussed in Chapter 6.

1.4.5.7 Notes

(a) Introduction

Notes contain information in addition to that presented in the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregation of items disclosed in those statements and information about items that do not qualify for recognition in those statements (IAS 1.7).

(b) Structure

IAS 1.112 states that the notes shall:

- ☐ present information about the basis of preparation of the financial statements and the specific accounting policies used;
- ☐ disclose the information required by the IFRSs that is not presented elsewhere in the financial statements; and
- ☐ provide additional information that is not presented elsewhere in the financial statements, but is relevant to understanding any of them.

Notes must, as far as practicable, be presented in a systematic manner. Each item in the statements of financial position and of comprehensive income, in the separate income statement (if presented), and in the statements of changes in equity and of cash flows shall be cross-referenced to any related information in the notes (IAS 1.113).

According to IAS 1.114, notes are normally presented in the following order, which assists the users in understanding the financial statements and comparing them to financial statements of other entities:

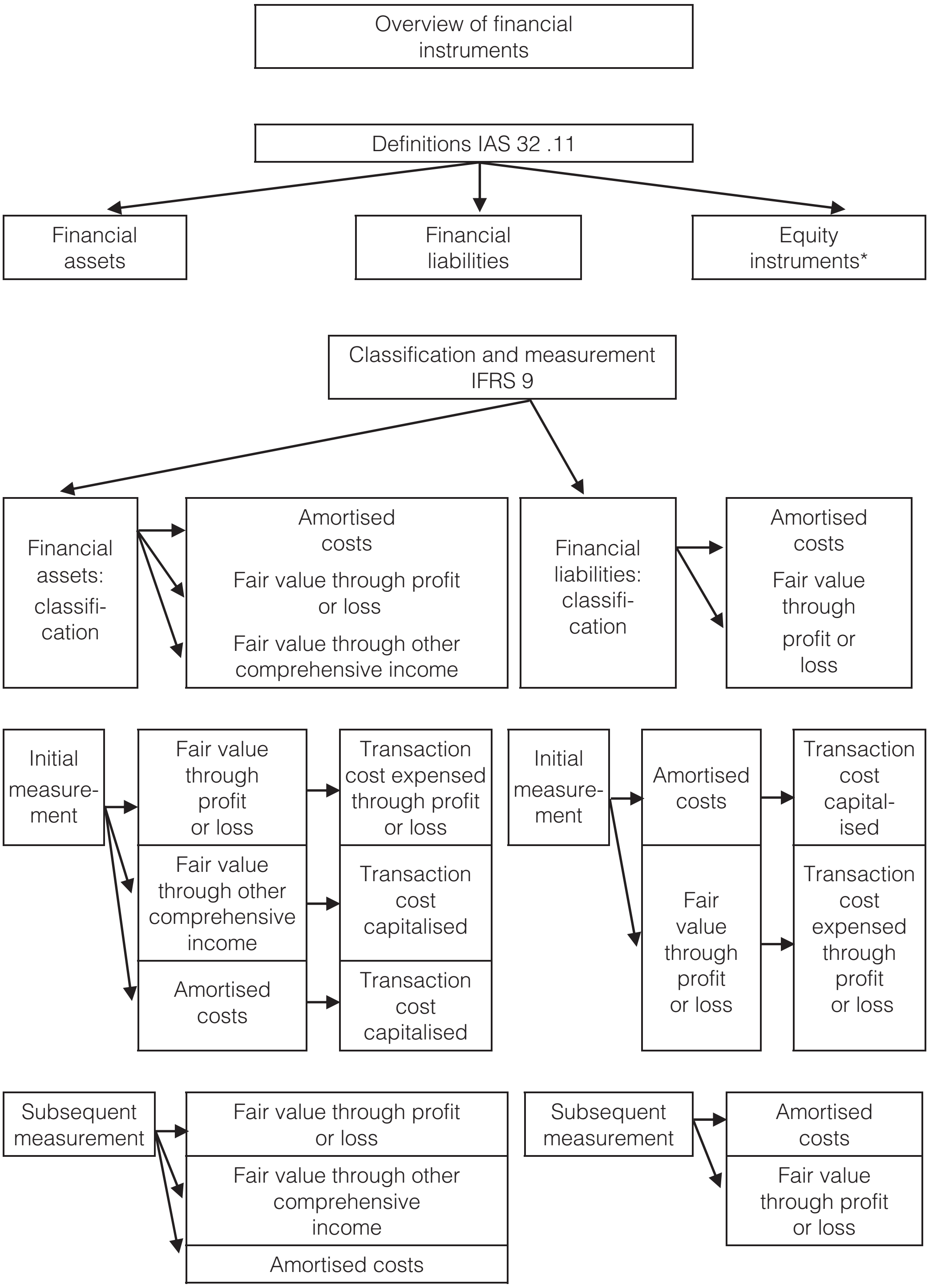
- ☐ a statement of compliance with the IFRSs;
- ☐ a summary of the significant accounting policies applied;
- ☐ the supporting information for items presented in the statements of financial position and of comprehensive income, in the separate income statement (if presented), and in the statements of changes in equity and of cash flows, in the order in which each statement or line item is presented; and
- ☐ other disclosures.

(c) Disclosure of accounting policies

Paragraph .117 of IAS 1 deals specifically with the disclosure of accounting policies and states that an entity shall disclose in the summary of significant accounting policies:

- ☐ the measurement basis (or bases) used in preparing the financial statements; and
- ☐ the other accounting policies used that are relevant to an understanding of the financial statements.

1.5 Financial instruments



*Not covered in this textbook.

1.5.1 *Introduction*

In “About Financial Accounting Volume 1” the concept of financial instruments was already touched on. Due to this topic’s importance it is elaborated on here, with specific emphasis placed on the reporting thereof. The concept of financial instruments is complicated and will be covered in depth in later years of study.

It is not the purpose of this section of the textbook to give a lengthy discussion on all the aspects regarding financial instruments covered in the various standards, but rather to extract those aspects that are of importance for the level of accounting dealt with in this textbook, to enable the reader to report correctly on financial instruments in financial statements. Currently there are two International Accounting Standards (IASs) and two International Financial Reporting Standards (IFRS) that deal with financial instruments. They are:

- ☐ IAS 32: Financial instruments: Presentation. The objective of this standard is to establish principles for presenting financial instruments as assets, liabilities or equity and for offsetting financial assets and financial liabilities (IAS 32.2). It complements the principles contained in IAS 39, IFRS 7 and IFRS 9.
- ☐ IAS 39: Financial instruments: Recognition and Measurement. This standard only applies to hedge accounting requirements with regard to financial instruments which fall outside the scope of this textbook.
- ☐ IFRS 7: Financial Instruments: Disclosures. The objective of this Standard is to require entities to provide disclosure in their financial statements to enable users to evaluate the significance of financial instruments for an entity’s financial position and performance and to inform users of the nature and extent of related risks of financial instruments and how those risks are managed (IFRS 7.1).
- ☐ IFRS 9: Financial Instruments. The objective of this Standard is to establish principles for the financial reporting of financial assets that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of the entity’s future cash flows.

The requirements surrounding financial instruments are not only applicable to companies. Paragraph 14 of IAS 32 clearly states that the concept of “entity” (as used in the Standards) includes individuals, partnerships, incorporated bodies, trusts and government agencies.

1.5.2 *Definitions*

1.5.2.1 Financial instrument

According to IAS 32.11, a financial instrument is any **contract** that gives rise to a **financial asset** for one entity and a **financial liability or equity instrument** for another entity. All the above elements must be present in order to classify an item as a financial instrument. IAS 32 further distinguishes between primary financial instruments and derivative financial instruments. Primary financial instruments are the basic instruments, such as receivables, payables and equity (IAS 32.AG15). Derivative financial instruments are more advanced instruments, such as futures, forwards, options, swaps and currency swops (IAS 32.AG15). In this textbook we will mainly concern ourselves with measurement and presentation, and primary financial instruments.

1.5.2.2 Financial asset (IAS 32.11)

A financial asset is any asset that is:

(a) cash (e.g. current account with a favourable balance, a cash deposit with a bank or similar financial institution, or cash on hand (petty cash));

(b) an equity instrument of another entity (e.g. investment in the shares of another entity);

(c) a contractual right:

   (i) to receive cash or another financial asset from another entity (e.g. trade debtors, interest receivable, loans receivable and debtors that will settle their debts by issuing shares); or

   (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity (e.g. a purchase option under condition where the Rand deteriorates); or

(d) a contract that will or may be settled in the entity's own equity instruments (e.g. a trade debtor can undertake to settle its account (a fixed amount) by issuing a number of ordinary shares equal to the amount of the outstanding debt).

In this textbook you will mostly encounter examples of paragraphs (a) to (c)(i) of the above definition.

1.5.2.3 Financial liability (IAS 32.11)

A financial liability is any liability that is:

(a) a contractual obligation:

   (i) to deliver cash or another financial asset to another entity (e.g. trade creditors, loans payable, interest payable and notes payable in government bonds); or

   (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments (e.g. a contract that provides that an entity must issue a variable number of its own ordinary shares to settle the fixed contract amount).

In this textbook the emphasis will only fall on paragraph (a)(i) of the above definition.

1.5.2.4 Equity instrument (IAS 32.11)

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. This is represented by the equation "E = A – L" as dealt with in Volume 1 of *About Financial Accounting*. The reader must note that an entity's own equity instrument (capital, members' contributions and shares issued) is never a financial asset or liability.

1.5.2.5 Fair value (IAS 32.11)

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

1.5.2.6 Contract

In all of the abovementioned definitions, the concept of a contract or a contractual obligation is of the utmost importance. According to IAS 32.13 "contract" and "contractual" refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts may be in a variety of forms and need not be in writing.

1.5.3 *Identification of financial assets and financial liabilities*

- ☐ Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements (IAS 32.AG3).
- ☐ As mentioned, cash in itself constitutes a financial asset, but any other type of asset that can be interchanged for cash or a cash equivalent should be classified as a financial asset if a contractual right to receive cash or any other financial instrument exists. A cash deposit with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability. In each case one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).
- ☐ It is because of this contractual right requirement that inventory (merchandise) held at balance sheet date cannot be regarded as a financial asset, because the entity has no right to expect an inflow of cash for the inventory at some future date. It is only when the inventory is sold to a customer that the inventory is removed from the balance sheet (**statement of financial position**) and replaced by either cash received or trade receivables.
- ☐ Trade receivable accounts, trade payable accounts and loans receivable and payable, bank borrowings and bank overdrafts are common examples of financial instruments that represent a right to receive cash in future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future. In line with the requirements of the Standard, these contracts need not be in writing. In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive) (IAS 32.AG4).
- ☐ Physical assets (such as inventories and property, plant and equipment), leased assets and intangible assets (such as goodwill, patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but does not give rise to a present right to receive cash or another financial asset (IAS 32.AG10). Amounts payable arising from the acquisition of physical assets are obligations to deliver cash and are thus financial liabilities.
- ☐ Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets (IAS 32.AG11).

- ☐ Liabilities (such as income received in advance, for example rental income) can be argued along the same lines as prepaid expenses and are thus not financial liabilities.
- ☐ Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or assets (IAS 32.AG12).

1.5.4 *Classification, recognition and measurement of financial instruments*

Before the reader can endeavour to prepare the financial statements of an entity, the concept of recognition, classification and measurement of financial instruments must be dealt with.

1.5.4.1 Classification of financial assets

According to IFRS 9.4.1.1 an entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both the entity's business model for managing the financial asset and the contractual cash flow characteristics of the financial asset.

A financial asset shall be measured at amortised cost if both of the following conditions are met IFRS 9.4.1.2:

(a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and

(b) the contractual terms of the financial asset gives rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. For the purpose of applying paragraph 4.1.2 (b) interest is a consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time (IFRS 9 .4.1.3).

IAS 39.9 defines the amortised cost of a financial asset or a financial liability as the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

Examples of financial assets that can be classified and accounted for at amortised cost under IFRS 9 include:

- ☐ trade receivables;
- ☐ loan receivables;
- ☐ investments in government bonds not held for trading; and
- ☐ investments in term deposits at standard (normal) interest rates.

A financial asset shall be measured at fair value unless it is measured at amortised cost as set out in paragraph 4.1.2 (IFRS 9.4.1.4). This means that if the financial asset is not an equity instrument and it is not measured at amortised cost it must be measured at fair value through profit or loss. If the financial asset is an equity instrument and it is held for trading, it must be measured at fair value through profit or loss. If it is not held for trading, the entity must decide whether the equity investment will be measured at fair value through other comprehensive income or at fair value through profit or loss. The choice made is irrevocable (IFRS 9.4.1.5).

Examples of financial assets that can be classified and accounted for at fair value through profit or loss under IFRS 9 include:

- ☐ investments in the shares of a listed company;
- ☐ investments in the shares of unlisted companies only if the investment was designated to be at fair valued through profit or loss. If this was not the case the investment must be valued at fair value through other comprehensive income; and
- ☐ investments in government bonds that are held for trading (stand ready sell).

The three categories for the classification of financial assets can be summarised as follows:

Financial assets at fair value through profit or loss (FVTPL)	Financial assets at amortised costs	Equity investments at fair value through other comprehensive income (FVTOCI)

1.5.4.2 Classification of financial liabilities

Paragraph 4.2.1 of IFRS 9 states that an entity shall classify all financial liabilities as subsequently measured at amortised cost using the effective interest method, except for financial liabilities at fair value through profit or loss.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument, to the net carrying amount of the asset or liability (IFRS 9 Appendix A).

Examples of financial liabilities that can be classified as measured at amortised costs under IFRS 9 include:

- ☐ trade payables;
- ☐ loans payable with standard (normal) interest rates; and
- ☐ bank borrowings.

The two categories for the classification of financial assets can be summarized as follows:

Financial liabilities at amortised costs	Financial liabilities at fair value through profit or loss (fall outside the scope of this textbook)

1.5.4.3 Recognition

The action of recording and measurement of financial assets and liabilities is referred to as the recognition of the financial asset or liability.

In terms of IFRS 9.3.1.1, an entity shall recognise a financial liability in its statement of financial position only when the entity becomes a party to the contractual provisions of the instrument.

1.5.4.4 Classification and measurement

(a) Initial classification and measurement of financial assets and liabilities

When an entity first recognises a financial asset, the entity must classify it in accordance with the information provided in paragraph 1.5.4.1. When an entity first recognises a liability it must be classified in accordance with the information provided in paragraph 1.5.4.2.

At initial recognition an entity shall measure a financial asset or financial liability at its fair value (IFRS 9 .5.1.1). Fair value is the consideration given or received, i.e. normally the transaction price (IFRS 9 .B5.1.2A).

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (IFRS 9 Appendix A). Transaction costs include fees and commissions paid to agents, advisors, brokers and dealers, levies by regulatory agencies and security exchanges and transfer taxes and duties. Financing costs and internal administrative costs are specifically excluded from transaction costs (IFRS 9 Appendix A).

Transaction costs incurred in relation to all financial assets and financial liabilities measured at fair value through profit or loss are accounted for as an expense. Transaction costs incurred in relation to financial assets and financial liabilities measured at amortised cost and financial assets measured at fair value through other comprehensive income are capitalised against the carrying amount of the asset or liability (IFRS 9.5.1.1).

(b) Subsequent measurement of financial assets

After initial recognition, an entity shall measure a financial asset at fair value or amortised cost (IFRS 9.5.2.1) in accordance with their classification (refer paragraph 1.5.4.1).

(c) Gains and losses on the subsequent measurement of financial assets

For financial assets at fair value through profit or loss, all realised or unrealised gains, or losses calculated on the subsequent measurement of these instruments, are recorded directly in profit or loss (IFRS 9 .5.7.1). Gains are those income items that do not arise from the ordinary operating activities of an entity and do not meet the definition of revenue as defined in IFRS 15. Losses are negative gains.

In the case of financial assets at fair value through other comprehensive income, all realised or unrealised gains or losses calculated on the subsequent measurement of these instruments will be taken to equity via other comprehensive income in the statement of profit or loss and other comprehensive income (IFRS 9 .5.7.5).

Finally gains or losses on financial assets at amortised costs that arise through the amortisation process, or when the financial asset is derecognised or impaired, are recognised in profit or loss (IFRS 9 .5.7.2).

(d) Subsequent measurement of financial liabilities

After initial recognition, an entity shall measure a financial liability at fair value or amortised cost (IFRS 9 .5.2.1) in accordance with their classification (refer paragraph 1.5.4.2).

(e) Gains and losses on the subsequent measurement of financial liabilities

For financial liabilities at fair value through profit or loss, all realised or unrealised gains or losses calculated on the subsequent measurement of these instruments are recorded directly in profit or loss (IFRS 9.5.7.1) except if it is an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive income (IFRS 9.5.7.1 (b)).

In the case of financial liabilities at amortised costs, gains or losses arising through the amortisation process, or when the financial liability is derecognised or impaired, are recognised in profit or loss (IFRS 9.5.7.2).

Example 1.1: Measurement and subsequent measurement of a financial asset

On 2 January 20.1 Example Traders CC purchased 10 000 ordinary shares for a consideration of R10 000 from National Ltd, a company listed on the Johannesburg Securities Exchange (JSE). The purpose of this investment was purely speculative in nature. The broker's expenses (transaction costs) amounted to R1 500.

On 31 December 20.1, the market value of these shares were established on the JSE to be R12 000.

Required:

Record the above transactions in the general journal of Example Traders CC.

Solution:

Example Traders CC

General Journal

			Debit	**Credit**
20.0			**R**	**R**
Jan	2	Investment: Shares in National Ltd	10 000	
		Investment expenses (transaction costs)	1 500	
		Bank		11 500
		Initial recognition of investment at cost and recording of investment expenses		
Dec	31	Profit or loss account	1 500	
		Investment expenses		1 500
		Closing off of investment expenses		
		Investment: Shares in National Ltd	2 000	
		Gain on financial asset at fair value through profit or loss		2 000
		Gain on subsequent measurement of investment in the shares of National Ltd at year end		
		Gain on financial asset at fair value through profit or loss	2 000	
		Profit or loss account		2 000
		Closing off of gain on financial asset at fair value through profit or loss		

1.6 Practical applications of IAS 1 and financial instruments

The financial statements of an entity are *presented* in the order indicated in paragraph 1.4.3. When the financial statements are however being *prepared*, it is easier and more logical to prepare the statements in the order indicated below:

- ☐ statement of profit or loss and other comprehensive income;
- ☐ statement of changes in equity;
- ☐ statement of financial position;
- ☐ statement of cash flows; and
- ☐ notes.

The following example is a framework of the financial statements of an entity that is prepared according to the descriptions and prescriptions of IAS 1. These financial statements do not apply to a specific type of entity. Only those line items that are of importance to the learning content of this volume are shown.

Example Traders CC *(Name of reporting entity)*

Statement of profit or loss and other comprehensive income for the year ended 31 December 20.1

(Name of component of financial statements) + (Period covered by this component) (Presentation currency)

	Note	R 20.1	R 20.0
Revenue *(This number refers to the note number in the component: "Notes for the year ended . . .")*	3		*(Figures of previous year to assist with comparability)*
Cost of sales			
Gross profit			
Other income			
Profit on sale of non-current asset: Vehicle			
Dividend income[1]	4		
Interest income			
Fair value adjustments[2]	5		
(Expenses listed according to their function in the entity)			
Distribution, administrative and other expenses			
Advertising			
Bank charges			
Telephone expenses			
Water and electricity			
Salaries			
Insurance			
Delivery expenses			
Credit losses			
Stationery consumed			
Investment expenses			
Depreciation			
Loss on sale of non-current asset: Machinery			
Fair value adjustments[2]	5		

continued

	Note	R 20.1	R 20.0
Finance costs			
Interest on long-term loan			
Interest on mortgage			
Interest on bank overdraft			
Profit before tax[3]			
Income tax expense[3]			
Profit for the year			
Other comprehensive income for the year			
Fair value adjustments[2]	5		
Total comprehensive income for the year			

Comment:

1. Dividends received (from listed and unlisted shares).
2. Increase/decrease in fair value of listed investments. An increase and decrease in the fair value of unlisted investments shall only be disclosed here if the unlisted investment was designated at fair value through profit or loss. If it is not the case, any fair value adjustment in unlisted shares must be disclosed through other comprehensive income.
3. Depending on the type of ownership of the entity, income tax expense can or cannot be part of the statement of profit or loss and other comprehensive income.

Example Traders CC *(name of reporting entity)*

Statement of financial position as at 31 December 20.1

(Name of component of financial statements) + (Period covered by this component) (Presentation currency)

	Note	R 20.1	R 20.0
ASSETS			
Non-current assets (Classified according to the criteria set out in IAS 1 .66)			
Property, plant and equipment			
Fixed deposit	7		
Unlisted investment	7		
Current assets (Classified according to the criteria set out in IAS 1 .66)			
Inventories			
Trade and other receivables[1]	7		
Prepayments			
Callable fixed deposit	7		
Listed investment	7		
Cash and cash equivalents	7		
Current tax receivable			
Total assets			

continued

	Note	R 20.1	R 20.0
EQUITY AND LIABILITIES			
Total equity (Classified according to the specific criteria of the entity. Refer to IAS 1 .79 and .80)			
Members' contributions			
Retained earnings			
Other components of equity			
Total liabilities			
Non-current liabilities (Classified according to the criteria set out in IAS 1 .69)			
Long-term borrowings	10		
Current liabilities (Classified according to the criteria set out in IAS 1 .69)			
Income received in advance			
Trade and other payables	10		
Short-term borrowings	10		
Current portion of long-term borrowings	10		
Bank overdraft			
Current tax payable			
Total equity and liabilities			

Comment:

For Accounting level 1: The test for non-current and current as laid down in IAS 1.66 and .69 will apply when deciding how financial assets and financial liabilities will be classified and disclosed.

1. Trade receivables will include any accrued income items.

Example Traders CC
Statement of changes in equity for the year ended 31 December 20.1

Comment:

As the statement of changes in equity for each type of business ownership differs substantially, it will be shown when the financial statements of partnerships and close corporations are addressed. The reader must refer to Volume 1 for the presentation of this statement for sole traders. The minimum requirements of IAS 1.106 must be adhered to when preparing a statement of changes in equity.

Example Traders CC
Notes for the year ended 31 December 20.1

Comment:

Only the notes regarding to some of the accounting policies and financial assets and liabilities are shown. Other notes will be discussed when the financial statements of partnerships and close corporations are prepared.

Accounting policy

1. Basis of presentation

   The annual financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) appropriate to the business of the entity and the Close Corporations Act 69 of 1984. The annual financial statements have been prepared on the historical cost basis, modified for the fair valuation of certain financial instruments, and incorporate the principal accounting policies set out below. The financial statements are presented in South African Rand.

2. Summary of significant accounting policies

   The annual financial statements incorporate the following significant accounting policies which are consistent with those applied in previous years except where otherwise stated.

   2.1 Property, plant and equipment

   Property, plant and equipment are initially recognised at cost price. No depreciation is written off on land. Plant, equipment and vehicles are subsequently measured at cost less accumulated depreciation and accumulated impairment losses.

   Depreciation on plant, equipment and vehicles are written off at a rate deemed to be sufficient to reduce the carrying amount of the assets over their estimated useful life to their estimated residual value. The depreciation rates are as follows:

   Plant: 2% per annum according to the straight line method;
   Equipment: 10% per annum according to the straight line method;
   Vehicles: 20% per annum according to the diminishing balance method.

   Depreciation is charged to profit or loss for the period. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

   2.2 Financial instruments

   Financial instruments are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of an instrument.

   Financial instruments are initially measured at the transaction price, which is fair value plus transaction costs, except for "Financial assets at fair value through profit or loss" which is measured at fair value, transaction costs excluded. The entity's classification depends on the purpose for which the entity acquired the financial instruments. Financial instruments are subsequently measured at fair value unless it is measured at amortised cost as required by IFRS.

   Financial instruments that are subsequently measured at amortised cost are done so using the effective interest rate method.

   Debt instruments that are classified as current assets or current liabilities are measured at the undiscounted amount of the cash expected to be received or paid, unless the arrangement effectively constitutes a financing transaction.

2.3 Inventories

Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. Cost is calculated using the first-in, first-out method. Net realisable value is the estimated selling price in the ordinary course of business less any costs of completion and disposal.

2.4 Revenue

Revenue is measured at the fair value of the consideration received or receivable. Revenue from the sale of goods consists of the total net invoiced sales excluding value added tax, settlement discount granted and any allowance for settlement discount. The revenue from sales is recognised when control of the goods is transferred to the customer.

3. Revenue

	R	R
	20.1	20.0
Sale of goods		
Settlement discount granted	( )	( )
Allowance for settlement discount granted	( )	( )

4. Dividend income

	R	**R**
	20.1	**20.0**
Listed investments		
Unlisted investments		
Total dividend income		

5. Fair value adjustments

	R	**R**
	20.1	**20.0**
Unlisted investment designated as at fair value through profit or loss		
Listed investment held for trading		
Net fair value adjustments		

7. Financial assets

	R 20.1	R 20.0
Non-current financial assets		
Fixed deposit at amortised cost: ABS Bank at 12% p.a. callable at 31 December 20.4		
Unlisted investment designated at fair value through profit or loss: 1 000 ordinary shares in CAAP (Pty) Ltd (consideration R50 000)		
Current financial assets		
Trade and other receivables:		
Trade receivables control		
Allowance for credit losses [amount must be between ()]		
Allowance for settlement discount granted [amount must be between ()]		
Callable fixed deposit: WILL Investment Ltd at 14% p.a. callable at 30 June 20.2		
Listed investment held for trading at fair value through profit or loss: 10 000 ordinary shares in ABB Limited (consideration R12 000)		
Cash and cash equivalents:		
Bank		
Petty cash		

10. Financial liabilities

	R 20.1	R 20.0
Non-current financial liabilities at amortised cost		
Long-term borrowings: Mortgage:		
The mortgage was acquired from Main Bank Ltd at 1 March 20.0 at an interest rate of prime plus 1,5%. The loan is repayable in monthly instalments and the final payment is due on 31 March 20.9.The loan is secured by a first mortgage over land and buildings (refer note xx).[1, 2]		
Current financial liabilities		
Trade and other payables:		
Trade payables control		
Short-term borrowings		
Current portion of long-term borrowings at amortised cost		
Bank overdraft[3]		

Comment:

1. Mortgage: If a fixed annual interest rate was negotiated, the word “equal” must be inserted before the words “monthly instalments”.
2. The cross reference to note “xx” will be a reference to the note pertaining to property, plant and equipment. This will be illustrated in Chapter 2.
3. A bank overdraft facility does not represent a financial liability. It is only when the entity uses the facility that an obligation arises to repay and thus a financial liability is created.

4. Settlement discount granted is the actual discount granted to debtors who paid their accounts within the required time frame. The allowance for settlement discount granted is the amount of discount included in credit sales in the current financial year. Because the debtor will only pay in the following financial year (and will only then qualify for the discount if payment is timely) an allowance is created in the current year to rectify the overstatement of sales. The entity must make an objective estimation of the amount of settlement discount that debtors might take up based on their past payment history and journalise the estimation as follows: dr sales and cr allowance for settlement discount granted.

1.7 Special notes to the reader of Volume 2

1.7.1 *Cash transactions*

Cash transactions would normally be entered in the cash receipts and cash payments journals respectively. The fact that cash transactions are recorded in the general journal is for the purpose of illustrating debits and credits only. This will apply to all examples in this volume.

1.7.2 *Calculations*

Calculations are indicated by an encircled figure, for example "①". Where there is reference to another calculation within a calculation, such a calculation is indicated as "❶". Calculations between brackets do not form part of the journal or ledger entries or the disclosures in the financial statements and are used to illustrate the calculation of the amount(s) disclosed.

1.7.3 *References to gender*

Words importing the masculine gender include the female gender. Masculine gender will also be used when referring to another legal entity, i.e. a close corporation or a company. Thus "he"/"him" also refers to she/her and/or a close corporation or a company when such a reference is deemed to be necessary.

1.7.4 *Taxation rates*

Due to constant changes in the tax rates of entities, as well as the difference in tax rates between incorporate and non-incorporated entities, this volume uses a tax rate of 30% in applicable examples when illustrating the principles of providing for taxation in financial statements.

1.7.5 *The use of account names in comparison with financial statement terminology*

When preparing ledger accounts in the different ledgers of an entity, each account is assigned with a distinctive name to identify and classify it. After completing the ledgers for a specific period, the accounts are balanced or totalled and these account names, together with their respective balances or totals, are used to prepare a trial balance. For example, sales, bank and petty cash and SARS (South African Revenue Service) are the names of ledger accounts and are recorded as such in the trial balance. Remember that the trial balance is not a financial statement and is mainly used to test or verify the correctness of entries in the ledger accounts.

When preparing financial statements, the names of ledger accounts are seldom used. In financial statements, these accounts are recorded by using their designated statement names as explained in IAS 1. For example, sales will become "Revenue" when recorded in the statement of profit or loss and other comprehensive income and bank and petty cash will be grouped together under "Cash and cash equivalents" in the statement of financial position. SARS will become current tax payable/receivable depending on its balance (credit or debit). Another example is ledger accounts like vehicles, office equipment, machinery and buildings, which will be grouped under the name of "property, plant and equipment" in the statement of financial position.

Avail yourself of the correct terminology in financial statements according to IAS 1 and do not use the account names in financial statements.

1.7.6 *Interest calculations*

1.7.6.1 Simple interest rates

Simple interest is calculated on the original principal at the end of a period, for example a year. It does not take into account interest calculated during previous periods.

1.7.6.2 Compound interest rates

Compound interest is calculated each period on the original principal and all interest accumulated during past periods. Although interest may be stated as annually (yearly), the compounding periods can be annually, semi-annually, quarterly, or even continuously.

1.7.6.3 Effective interest rates

The effective interest rate is the actual rate that is earned on an investment or paid on a loan after the effects of compounding frequency are considered, and is regarded as the true rate of interest earned or paid. The effective interest rate is also referred to as the market interest rate.

For the purpose of this textbook only simple interest calculations will be used and the assumption will be made that all stated interest rates are market-related to the investment risk.

1.8 Summary

In this chapter, the reader was introduced to the preparation and presentation of general-purpose financial statements of an entity, using the Conceptual Framework and IAS 1 as points of reference. The Conceptual Framework consists of a group of interrelated objectives and theoretical principles that serve as a frame of reference for Financial Accounting. The main purpose of the Conceptual Framework is to set out the objectives and concepts that underlie the preparation and presentation of financial statements.

The objective of financial statements is to report on the financial position and financial performance in such a way that the information it provides will be useful to a wide variety of users who rely on the information in the financial statements to make economic decisions.

When preparing financial statements, the preparer assumes that the effect of transactions are recognised when they occur and that these transactions are recorded in the financial statements of the period to which they relate, and that the entity will continue its operations in the foreseeable future.

In order to provide useful information, financial statements must have the following qualitative characteristics (as listed in the Conceptual Framework): understandability, relevance, reliability, and comparability. In practice, however, the constraints of timeliness and costliness impact heavily on these characteristics, to such an extent that the preparer of financial statements must sometimes balance or trade off the characteristics against each other in order to meet the objectives of financial statements.

The information in financial statements is grouped into elements that make up the financial statements. These elements are further grouped into those that pertain to the financial position (assets, liabilities and equity) and those that pertain to the financial performance (income and expenses). Before these elements can be entered in the financial statements, they must first be recognised according to the recognition guidelines and measured according to the criteria described in this chapter.

"IFRSs" refers to the "International Financial Reporting Standards", of which IAS (International Accounting Standards) forms a major part.

IAS 1 deals with the presentation of financial statements and uses the Conceptual Framework as its point of reference. The main objective of IAS 1 is to prescribe the basis for the preparation of general-purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. Financial statements can be described as a structured representation of the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

When preparing the financial statements of an entity, the preparer must ensure that the overall considerations, as required by IAS 1, are adhered to. These considerations are:

- ☐ Financial statements must present the financial position, financial performance and cash flows of an entity fairly.
- ☐ Financial statements must be prepared on a going-concern basis.
- ☐ Financial statements must be prepared using the accrual basis of accounting.
- ☐ The presentation and classification of items in the financial statements must be consistent with those of previous periods.
- ☐ Each material class of similar items must be presented separately. Items of a dissimilar nature must be presented separately if they are material, and items that cannot be allocated to a specific class must also be shown separately if they are material.
- ☐ Offsetting of assets, liabilities, income and expenses is normally not allowed.
- ☐ Comparative information of previous periods must be disclosed.

According to IAS 1, a complete set of financial statements consists of the following components:

- ☐ a statement of financial position;
- ☐ a statement of profit or loss and other comprehensive income;
- ☐ a statement of changes in equity;

- a statement of cash flows; and
- notes, comprising a summary of significant accounting policies and other explanatory notes.

Each component of the financial statements must be identified by providing it with a name of the reporting entity, the specific name of the component being prepared, the statement of financial position date or period covered by the specific financial statement and the presentation currency.

When preparing a statement of financial position, all assets must be classified as either current or non-current assets and all liabilities must be classified as either current or non-current liabilities. For the purpose of this volume, equity will be equal to the net assets (assets minus liabilities). When preparing a statement of profit or loss and other comprehensive income, expenses for the purpose of this volume are classified according to their function as part of cost of sales or as part of the cost of distribution or administrative activities.

IAS 1 is also very specific as to which items should be presented on the face of each of the components of the financial statements, and those which can be disclosed either on the face of the particular component or in the notes to the financial statements. The requirement of IAS 1 must in all such cases be complied with.

In addition to the Conceptual Framework and IAS 1, the reader was also introduced to financial instruments as discussed in IAS 32, IFRS 7 and IFRS 9. According to IAS 32, financial instruments can be classified as financial assets and/or financial liabilities. The consequence of this is that in preparing financial statements, assets and liabilities will have to be further divided into being of a financial or non-financial nature and presented accordingly in the financial statements. The concepts of contract, fair value, transaction costs, and the recognition and measurement of financial instruments, were also discussed.

CHAPTER **2**

Establishment and financial statements of a partnership

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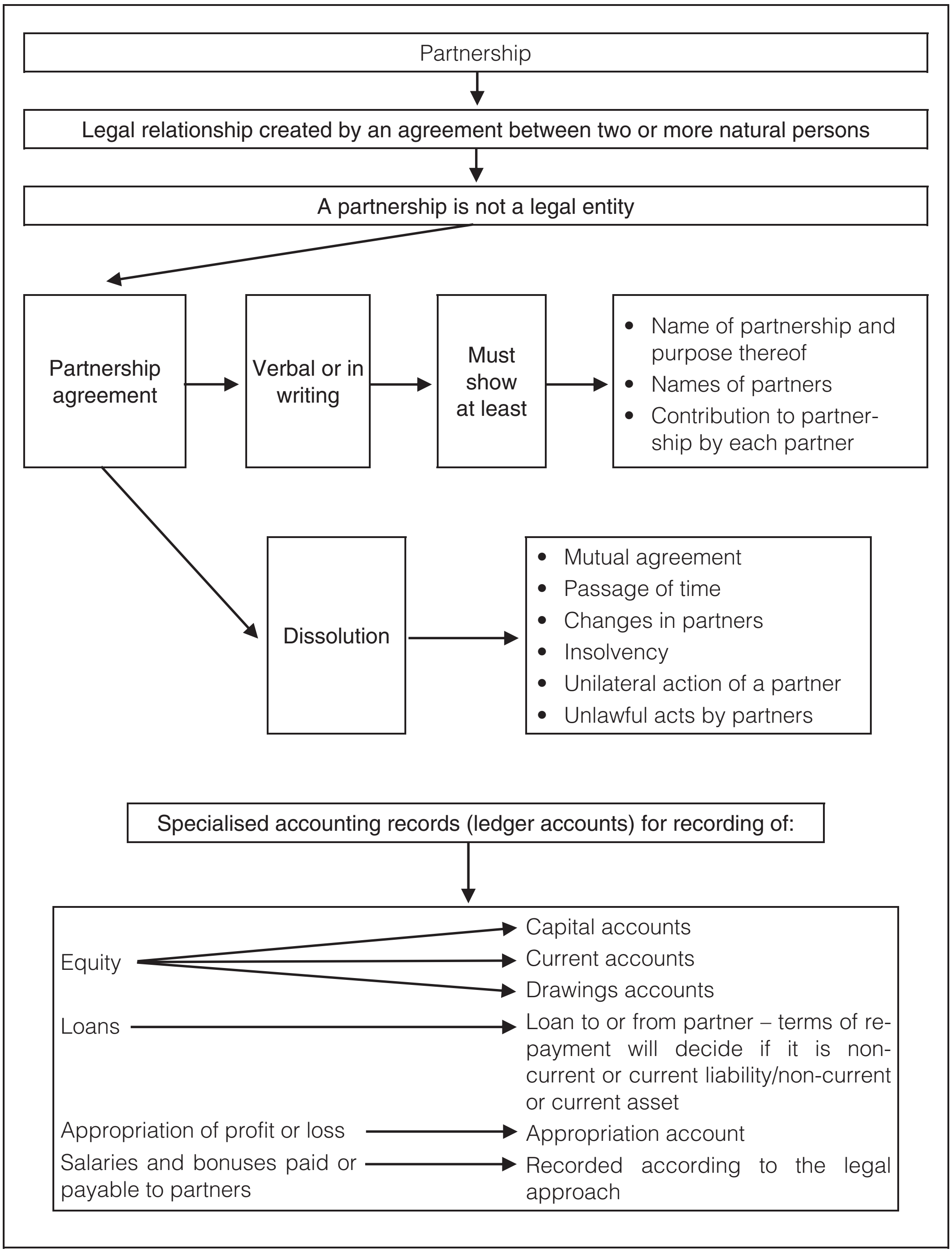
Overview of the establishment and financial statements of a partnership



2.1 Introduction

STUDY OBJECTIVES
After studying this chapter, you should be able to: ☐ define a partnership; ☐ explain the reasons why partnerships are formed; ☐ list the contents of the partnership agreement; ☐ explain the ways in which a partnership can be established; ☐ explain the factors which can lead to the dissolution of a partnership; ☐ prepare the specialised ledger accounts needed to record the transactions of a partnership; and ☐ prepare the financial statements of a partnership in accordance with the requirements of International Financial Reporting Standards (IFRS) appropriate to a partnership.

In Volume 1, the sole proprietor as a form of business ownership was discussed. The main feature of a sole proprietor is that the entity belongs to one person only. All decisions regarding the business are taken by the owner, and all the profits or losses accrue to him. The owner is personally liable for all the obligations of the entity and he is the sole owner and disposer of the assets of the business.

Due to the limitations (financial and managerial) of a sole trader, it is common practice for two or more persons to start a business. If these entrepreneurs do not want to get involved in the complicated juridical proceedings required to start a company or close corporation, they will find it more convenient to form a partnership. This form of business entity, which is suitable for small to medium-sized businesses, is frequently found among the professions, for example engineers, architects, accountants, medical doctors and lawyers.

By definition, a "partnership" can be described as a legal relationship created by an agreement between two or more natural persons. In terms of this agreement, each person (called a "partner") contributes either cash, merchandise, property, plant, equipment or expertise to the entity for the purpose of conducting a lawful business and making a profit, which is then divided amongst the partners in a pre-arranged ratio or according to common law principles (if no pre-arranged ratio exists).

Although the partnership agreement creates a legal relationship between the partners, the partnership itself is not a legal entity. The property of an entity which is not a legal entity, also known as a "non-incorporated entity", belongs to the owner(s) of the entity and the owner(s) is personally liable for the entity's obligations. All legal actions of such an entity are conducted through its owner(s). Sole proprietorships and partnerships are the most common forms of entities without legal status.

An entity with legal status, which is an incorporated entity, on the other hand, may own property, incur debts and execute all other legal actions in its own right as if it were a natural person. Companies and close corporations fall into this category. The formation of a partnership requires few or no formalities. The agreement between the partners, called a “partnership agreement”, can be oral or in writing. For obvious reasons, however, it is more customary to have a written agreement, especially if disputes between partners have to be resolved.

2.2 Reasons for the formation of partnerships

Although there can be various reasons why persons would prefer to form partnerships, these reasons can be summarised under the following four main headings:

2.2.1 *Increasing the amount of capital in the business*

It is highly likely that two or more people will be able to contribute more capital than one person. With more capital, the operating activities of the business can be more readily financed, which in turn can result in a higher turnover and greater profits.

2.2.2 *Eliminating competition*

If two people run separate but identical business entities in near vicinity to each other, the competition between them can reduce each entity’s profit. The reason for this is that they have to spend additional operating capital, for example, on attracting customers and reducing selling prices to stay competitive. However, if these persons enter into a partnership and combine all their efforts and capital in a single business, it may result in greater profits in future. The higher profit is mainly brought about by lower operating expenses such as reduced marketing costs and proportionally fewer personnel.

2.2.3 *Uniting capital and technical expertise*

If a person has the necessary technical expertise but no capital to develop and market it, he can form a partnership with another person who does have the capital to fund his expertise.

2.2.4 *Retaining skills and technical expertise*

Another possible reason to form a partnership is to retain the services of a skilled and efficient person, for example to give or sell a manager an interest in a business in order to ensure that he runs the business as profitably as possible and his expertise remains in the entity.

2.3 Legal position of a partner

South Africa has no specific legislation aimed at controlling partnerships and, accordingly, common law principles apply. A partnership is not a legal entity (juristic person) and has no independent legal existence separate from that of its constituent members. Therefore, the partners are jointly and severally responsible for the rights and obligations (debts) of the partnership. This implies that the partners have mutual rights to all the assets and are jointly responsible for all the obligations of the partnership. On liquidation, should the assets of the partnership yield less than what is owed to the creditors, the creditors have the right to liquidate the assets of the individual partners to pay for the debts of the partnership.

Because a partnership is not a legal entity, it is also not a separate tax entity. This implies that the partnership as such is not taxed but that the partners are taxed on their share of the profits distributed by the partnership in their capacity as individual taxpayers.

2.4 Establishment of a partnership

There are two principal ways of establishing a partnership:

2.4.1 *Action*

It is possible to establish a partnership by tacit agreement. This implies that if the actions (conduct) of two or more people are such that it gives rise to the assumption that the people are in partnership, then a partnership is automatically established between them.

2.4.2 *Agreement*

A partnership is established when people agree in words to form a partnership. There is no indication in the law that the agreement to enter into a partnership should be in writing and a verbal agreement is therefore sufficient. All that is necessary is an agreement on the general requirements for the existence of a partnership, namely contributions in money, goods and/or labour, the intention to generate profit, and agreement on how this profit should be distributed between the partners.

2.5 The partnership agreement

Although a partnership can be formed by verbal agreement, it is strongly recommended that the agreement be in writing. The contents of the agreement will in each case depend on the individual circumstances applicable to the partnership. Where an agreement is silent on any specific aspect, common law principles will apply. For example, in terms of the common law, partners have equal rights in the management of the entity and their ownership in the partnership is in the same ratio as the ratio in which they share the profits/losses of the partnership. If the agreement does not specify the ratio in which the profits/losses should be shared, the partners will share the profits/losses in the same ratio as their contributions of capital to the partnership. If such capital contributions have not been specified, the presumption is that the partners share equally in the profits/losses. The terms and conditions of the partnership agreement may at any time be changed by mutual consent of the partners.

The following is a list of essential matters which ought to be specified in the partnership agreement:

- the name, purpose, nature and scope of the partnership;
- the address or addresses where the business will be conducted;
- the names of the parties entering into the partnership;
- the date of commencement and provisions regarding the expected duration of the partnership and the dissolution of the partnership;
- the contribution of each partner to the capital of the partnership;
- the rights, powers and duties of each partner as well as any restrictions thereon;
- decisions regarding the financial year-end and accounting records to be kept by the partnership;
- the ratio of profit/loss distribution;
- the applicable interest on capital, loans, withdrawals and current accounts and provisions regarding the revision of interest rates, should it be deemed necessary;

- ☐ salaries and bonuses payable to partners for services rendered to the partnership;
- ☐ provisions in respect of withdrawals by the partners;
- ☐ provisions for the retirement, admission and death of the partners;
- ☐ procedures for settling any disputes between the partners;
- ☐ provisions with regard to life insurance policies for partners, the treatment of insurance premiums and the proceeds of such policies; and
- ☐ provisions with regard to the valuation of assets and in particular the valuation of goodwill and the treatment thereof in the accounting records of the partnership.

2.6 Dissolution of a partnership

Unlike a company and a close corporation, a partnership has a limited lifespan. The following is a list of some of the factors which can lead to the dissolution of a partnership:

- ☐ **Mutual agreement**

  The partners could voluntarily decide to terminate their association.
- ☐ **Attainment of the purpose for which the partnership was originally formed**

  The partners may have undertaken to build and sell a house in partnership. Upon completion of the house and its consequent sale, the partnership is automatically dissolved.
- ☐ **Passage of time**

  A partnership may be formed for a certain period, for example ten years. When this period has elapsed, the partnership is automatically dissolved.
- ☐ **Change in partners**

  When there is a change in partners, for example as a result of the death of a partner, retirement of a partner or admission of a new partner, the current partnership is dissolved and a new partnership is formed. In practice, however, the business of a partnership frequently continues, seemingly without disruption, even when a change occurs in the membership of the partners.
- ☐ **Insolvency**

  Insolvency of a partnership or of one of the partners dissolves the partnership.
- ☐ **The unilateral action of one partner**

  A partner may unilaterally declare the partnership dissolved, but this may render him liable to breach of contract, depending on the circumstances.
- ☐ **Illicit or unlawful acts by partners**

  When one of the partners commits an act which is contrary to the provisions of the partnership agreement, or which is illegal and can damage the good name of the partnership, the other parties are entitled to insist on the dissolution of the partnership or alternatively on the expulsion of the guilty partner.

2.7 Accounting procedures and specialised accounts

A partnership, as a separate accounting entity, must keep record of its day-to-day transactions (just like a sole proprietor) by using various subsidiary journals and ledgers.

At least once a year (usually at the end of the financial year), the partnership must prepare a full set of financial statements as explained in Chapter 1 paragraph 1.4.2.

Although the accounting procedures of a partnership are very similar to those of a sole proprietor, there are certain special ledger accounts and procedures which are unique to a partnership. Before the use of these accounts is illustrated, it is important to note the two different approaches in preparing the partnership accounts.

The first approach is called the "entity approach" towards accounting for partnerships. The entity approach treats the partners and the partnership as separate accounting entities. In applying this approach, the interest on capital and partners' salaries would be treated as expenses in the calculation of profit/loss in the statement of profit or loss and other comprehensive income. The capital invested by the partners is regarded as finance from a separate accounting entity (the partner) and the related interest is treated as finance costs in the same way as the interest on any other liability.

Following the same argument, salaries and bonuses that were paid or became payable to partners during the financial year for services rendered to the partnership are regarded as ordinary operating expenses incurred in the production of the income of the partnership. These salaries and bonuses must therefore be disclosed in the statement of profit or loss and other comprehensive income as operating expenses similar to the salaries paid to the employees.

The second approach is the "legal approach" towards accounting for partnerships. The partners and the partnership are treated as the same legal entity. The law does not recognise the partnership as an entity distinct from the partners and the partners can therefore not be debtors and/or creditors of the partnership. The partners are the owners of the partnership and can therefore not employ themselves. Following this argument, salaries and bonuses are an appropriation of the profit of a partnership and not an operating expense. Interest on capital, according to this argument, is a distribution of profits to the partners and not a finance cost to the partnership.

In this volume, the legal approach to accounting for partnerships is adopted. From a taxation point of view, it does not really matter which approach is followed, as each partner will end up with the same taxable income received from the partnership, on which he will be taxed in his personal capacity.

2.7.1 *Recording of equity*

As with any type of entity, the equity of a partnership is represented by the net assets of the partnership. In partnerships, the equity of each partner must be recorded separately. The recording of equity in a partnership is done mainly through the use of capital accounts, current accounts and drawings accounts.

2.7.1.1 Capital accounts

The capital accounts are used to record the initial investment by each partner in the partnership. A separate capital account must be opened for each partner and this account represents the monetary value of the contributions made by each partner in the partnership. This implies that if the contribution was not in cash, a value must be placed on the partner's contribution and recorded as his capital contribution. The capital account shows each partner's permanent fixed investment in the partnership and can only be increased by an additional contribution of capital or decreased by a withdrawal of capital by a partner.

In order to compensate a partner who has made a larger capital contribution than another partner, the partnership agreement can stipulate that interest on capital must be paid to the partners. Should the partners agree to calculate the interest on capital, the partners will have to stipulate in the partnership agreement, not only the interest rate, but also the basis for the calculation of interest on the capital accounts. For example, interest on capital should be calculated at a specified rate on the average, opening or closing balances of the capital accounts of the partners.

2.7.1.2 Current accounts

In addition to the capital account of a partner, a current account for each partner must be opened. This account is a record of the transactions affecting the partner's interest in the partnership during the current financial period. Transactions which will be recorded in the current account include the partner's share in profits/losses, interest on capital accounts, interest on current accounts, interest on drawings and other amounts (for example, salaries or bonuses) which are due to the partners but not yet paid at the end of the financial year. If the partners decide not to record any drawings in a separate account (refer to paragraph 2.7.1.3), drawings will also be debited to the current accounts of the partners. In short, this account records all the transactions between the partners and the partnership.

The current account of a partner can have either a debit or a credit balance. The current account of a partner will reflect a debit balance when the partner owes money to the partnership, while a credit balance in the current account of a partner indicates that the partnership owes money to the partner. The partners can decide whether or not to pay or receive interest on debit/credit balances on their current accounts and this must be stipulated in the partnership agreement together with the basis of calculation.

2.7.1.3 Drawings accounts

A drawings account may also be opened for each partner to record any withdrawals. This would reflect, for example, the cash withdrawal of salaries, interest earned, share of profits as well as merchandise taken for private use by a partner during the current financial period. However, it excludes the withdrawal of capital, as this is recorded directly in the capital account of the partner. A drawings account for each partner is used only if the partners stipulated the use thereof in the partnership agreement, otherwise drawings are recorded in the current account of a partner (refer to paragraph 2.7.1.2). At the end of the financial period, the balance on the drawings account of a partner (if such an account was used) is transferred to the current account of the partner.

2.7.2 *Loan accounts*

If a partner, in his personal capacity, grants a loan to the partnership and the loan agreement stipulates that the partnership must repay the loan to the partner over a period of time or at a predetermined date, the partner is regarded as a creditor of the partnership. The true nature of this transaction is to lend money (debt financing) to the partnership and not to contribute towards the capital thereof. The loan does not form part of the equity of the partnership and is either reflected as a non-current or current liability in the balance sheet of the partnership, depending on the repayment terms of the loan. Interest payable on such a loan is therefore a finance cost, and is disclosed as such in the income statement.

On the other hand, a partnership can also lend money to a partner. Depending on the terms of repayment of the loan, it is either reflected as a non-current asset or as a current asset. The interest receivable on such a loan is disclosed under "other income" in the income statement.

2.7.3 *The appropriation account*

The appropriation account is a final account which is used to appropriate the profit or loss of the partnership at the end of the financial year to the partners according to the predetermined profit-sharing ratio stipulated in the partnership agreement.

If there is no definite written agreement between the partners regarding the appropriation of profit/loss, it is assumed that the profits/losses will be apportioned to the partners in the ratio of their capital contributions. If such capital contributions have not been specified, it is assumed that the partners share equally in the profits/losses (refer to paragraph 2.5).

2.7.4 *Recording of salaries and bonuses paid or payable to partners*

With regard to the recording of salaries and bonuses paid or payable to partners, the following approach is suggested.

During the financial year, when a partner withdraw part of his salary/bonus in cash, the drawings account (or salary/bonus account, if no drawings account is kept) is debited and the bank account credited. The latter set of entries are recorded when they occur. At the end of the financial year, the amount payable as a salary/bonus to a partner is debited to the salary account/bonus account of the partner and credited to his current account. If a drawings account is not used, only the remainder of the total salary/bonus payable for the year is debited to the salary/bonus account and the current account credited with the remainder amount that has not been withdrawn in cash already. These entries are regarded as year-end adjustments.

The accounting principles discussed in paragraph 2.7 applicable to partnerships using the legal approach are illustrated in the following example.

Example 2.1 Specialised ledger accounts used when recording transactions between the partners and the partnership

On 21 February 20.5, A Apple and P Pie decided to form a partnership trading as Applepie Furniture and Fittings. The partnership will commence trading on 1 March 20.5 and both partners will be actively involved in the partnership. Apple and Pie accordingly drew up the partnership agreement stipulating the following:

1. Apple will contribute R100 000 in cash towards the capital of the business. Pie will contribute R40 000 in cash, a delivery vehicle with a fair market value of R60 000 and office equipment worth R50 000.
2. Each partner will receive a monthly salary of R5 000.

3. Interest on relevant accounts at year-end will be charged as follows:
   - 10% per annum on the opening balance of the capital accounts;
   - 12% per annum on the opening balance of the current accounts; and
   - no interest will be charged on drawings.

   Interest, with regard to the above, must be capitalised against the current accounts of the partners.

On 1 March 20.5, the partners deposited their respective cash capital contributions, recorded the non-cash contributions towards capital and commenced trading. The business uses a periodic inventory system.

The following is a summary of the transactions which Applepie Furniture and Fittings entered into during the financial year ended 28 February 20.6. (For purposes of this example, a summary of the transaction data during the year is provided and dates are therefore omitted.)

1. Cash withdrawn for salaries:

   A Apple, R45 000
   P Pie, R45 000
2. Drawings of merchandise:

   A Apple, R4 000
   P Pie, R6 000
3. Cash purchases of merchandise, R110 000
4. Cash sales of merchandise, R400 000
5. Salaries paid to sales personnel, R60 000
6. Rent paid, R36 000
7. Other operating expenses paid in cash, R40 000
8. On 1 September 20.5, A Apple granted a loan of R20 000 to the partnership. The terms of the loan state that interest on the loan will be calculated at 14% per annum payable in March of each year and the loan will be repaid in full on 31 December 20.9. The loan was used to finance the purchase of additional office equipment on 1 September 20.5.
9. Depreciation must be provided as follows:

   Office equipment at 10% per annum, according to the straight line method; and

   Vehicles at 20% per annum, according to the diminishing balance method.
10. On 28 February 20.6, the closing inventory amounted to R15 000.

Required:

(a) Record all the above transactions, including all adjustments and closing transactions, in the general journal of Applepie Furniture and Fittings for the year ended 28 February 20.6.

(b) Post the general journal to the following accounts in the general ledger of the partnership:

- ☐ Capital accounts, current accounts and drawings accounts of the partners;
- ☐ Bank;

- ☐ Interest on capital;
- ☐ Salary: A Apple;
- ☐ Salary: P Pie;
- ☐ Trading account;
- ☐ Profit or loss account; and
- ☐ Appropriation account.

All ledger accounts must be balanced/closed off on 28 February 20.6. Folio references are not required and dates in the general journal and ledger accounts can be ignored.

Solution:

(a)

Applepie Furniture and Fittings
General journal

	Debit	Credit
	R	**R**
Bank (R100 000 + R40 000)	140 000	
Capital: A Apple		100 000
Capital: P Pie		40 000
Cash capital contributions deposited		
Vehicles	60 000	
Office equipment	50 000	
Capital: P Pie		110 000
Recording of non-cash capital contributions		
Drawings: A Apple	45 000	
Drawings: P Pie	45 000	
Bank		90 000
Cash withdrawal of salaries by partners		
Drawings: A Apple	4 000	
Drawings: P Pie	6 000	
Purchases		10 000
Merchandise withdrawn by partners		
Purchases	110 000	
Bank		110 000
Recording of cash purchases		
Bank	400 000	
Sales		400 000
Recording of cash sales		
Salaries	60 000	
Bank		60 000
Recording of salaries paid to employees		
Rental expenses	36 000	
Bank		36 000
Recording of rent paid		

continued

	Debit	Credit
	R	R
Sundry operating expenses	40 000	
Bank		40 000
Recording of operating expenses paid		
Bank	20 000	
Long-term loan: A Apple		20 000
Loan acquired from A Apple		
Office equipment	20 000	
Bank		20 000
New office equipment purchased for cash		
Interest on long-term loan: A Apple (R20 000 × 14% × 6/12)	1 400	
Interest payable		1 400
Recording of interest payable on long-term loan		
Depreciation ①	18 000	
Accumulated depreciation: Office equipment		6 000
Accumulated depreciation: Vehicles		12 000
Provision for depreciation: Office equipment at 10% per annum according to the straight-line method and vehicles at 20% per annum according to the diminishing-balance method		
Salary: A Apple	60 000	
Salary: P Pie	60 000	
Current account: A Apple		60 000
Current account: P Pie		60 000
Recording of salaries payable to partners		
Interest on capital ②	25 000	
Current account: A Apple		10 000
Current account: P Pie		15 000
Recording of interest on capital		
Trading account	100 000	
Purchases (R110 000 – R10 000)		100 000
Closing transfer		
Sales	400 000	
Inventory	15 000	
Trading account		415 000
Closing transfer		
Trading account (R415 000 – R100 000)	315 000	
Profit or loss account		315 000
Closing transfer of gross profit		
Profit or loss account	155 400	
Salaries		60 000
Rental expenses		36 000
Sundry operating expenses		40 000
Depreciation		18 000
Interest on long-term loan: A Apple		1 400
Transfer of expenses to profit or loss account		

continued

	Debit	Credit
	R	R
Profit or loss account (R315 000 – R155 400)	159 600	
Appropriation account		159 600
Closing transfer of profit for year		
Current account: A Apple	49 000	
Current account: P Pie	51 000	
Drawings: A Apple (R45 000 + R4 000)		49 000
Drawings: P Pie (R45 000 + R6 000)		51 000
Closing transfer of drawings to current accounts		
Appropriation account	25 000	
Interest on capital		25 000
Closing transfer of interest on capital		
Appropriation account	120 000	
Salary: A Apple		60 000
Salary: P Pie		60 000
Transfer of salaries to partners		
Appropriation account ③	14 600	
Current account: A Apple		5 840
Current account: P Pie		8 760
Appropriation of available profit for the year		

Comment:

No interest was calculated on the current accounts as there were no opening balances on these accounts because trading only commenced during the financial year.

(b) **Applepie Furniture and Fittings**
General ledger

Dr **Capital: A Apple** **Cr**

								R
							Bank	100 000

Dr **Capital: P Pie** **Cr**

				R					**R**
		Balance	c/d	150 000			Bank		40 000
							Vehicles		60 000
							Office equipment		50 000
				150 000					150 000
							Balance	b/d	150 000

continued

Dr **Current account: A Apple** **Cr**

				R					**R**
		Drawings: A Apple		49 000			Interest on capital		10 000
		Balance	c/d	26 840			Salary: A Apple		60 000
							Appropriation account		5 840
				75 840					75 840
							Balance	b/d	26 840

Dr **Current account: P Pie** **Cr**

				R					**R**
		Drawings: P Pie		51 000			Interest on capital		15 000
		Balance	c/d	32 760			Salary: P Pie		60 000
							Appropriation account		8 760
				83 760					83 760
							Balance	b/d	32 760

Dr **Drawings: A Apple** **Cr**

				R					**R**
		Bank		45 000			Current account: A Apple		49 000
		Purchases		4 000					
				49 000					49 000

Dr **Drawings: P Pie** **Cr**

				R					**R**
		Bank		45 000			Current account: P Pie		51 000
		Purchases		6 000					
				51 000					51 000

continued

Dr **Bank** **Cr**

				R					**R**
		Capital: A Apple		100 000			Drawings: A Apple		45 000
		Capital: P Pie		40 000			Drawings: P Pie		45 000
		Sales		400 000			Purchases		110 000
		Loan: A Apple		20 000			Salaries		60 000
							Rental expenses		36 000
							Sundry operating expenses		40 000
							Office equipment		20 000
							Balance	c/d	204 000
				560 000					560 000
		Balance	b/d	204 000					

Dr **Interest on capital** **Cr**

				R					**R**
		Current account: A Apple		10 000			Appropriation account		25 000
		Current account: P Pie		15 000					
				25 000					25 000

Dr **Salary: A Apple** **Cr**

				R					**R**
		Current account: A Apple		60 000			Appropriation account		60 000

Dr **Salary: P Pie** **Cr**

				R					**R**
		Current account: P Pie		60 000			Appropriation account		60 000

continued

Dr **Trading account** **Cr**

				R					R
		Purchases		100 000			Inventory		15 000
		Profit or loss account		315 000			Sales		400 000
				415 000					415 000

Dr **Profit or loss account** **Cr**

				R					R
		Salaries		60 000			Trading account		315 000
		Rental expenses		36 000					
		Sundry operating expenses		40 000					
		Depreciation		18 000					
		Interest on long-term loan: A Apple		1 400					
		Appropriation account		159 600					
				315 000					315 000

Dr **Appropriation account** **Cr**

				R					R
		Interest on capital		25 000			Profit or loss account		159 600
		Salary: A Apple		60 000					
		Salary: P Pie		60 000					
		Current account: A Apple		5 840					
		Current account: P Pie		8 760					
				159 600					159 600

Calculations:

① **Depreciation**	**R**
Depreciation on office equipment:	6 000
R50 000 × 10%	5 000
R20 000 × 10% × 6/12	1 000
Depreciation on vehicles:	12 000
R60 000 × 20%	12 000
Total depreciation	18 000

② **Interest on capital**	**R**
A Apple	10 000
R100 000 × 10/100	10 000
P Pie	15 000
R150 000 × 10/100	15 000
Total interest on capital	25 000

③ **Appropriation of profit**

Because the partnership agreement does not stipulate the appropriation of profits/losses, common law principles apply and the profit/loss for the year must be shared in the same ratio as their capital contributions (refer to paragraphs 2.5 and 2.7.4).

A Apple : P Pie

100 000 : 150 000

10 : 15

2 : 3

	R
A Apple's share: R14 600 × 2/5	5 840
P Pie's share: R14 600 × 3/5	8 760
	14 600

2.8 Financial statements of a partnership

Although the partnership is not a separate legal entity, it is a separate accounting entity. The partnership must keep a full set of accounting records and must prepare a set of financial statements at the end of the financial period to comply with International Financial Reporting Standards appropriate to the business of the partnership.

Because a partnership has more than one "owner", the financial statements of a partnership will differ slightly from those of a sole trader. In Example 2.1, it was indicated how the accounting records are expanded to accommodate the multiple ownership of a partnership. The following examples will demonstrate the preparation of the financial statements of a partnership. Remember that the legal approach is applied in preparing the financial statements of a partnership (refer to paragraph 2.7).

Example 2.2 Financial statements of a partnership operating at a profit

The following information relates to the partnership Vanilla Traders with partners A Van and E Nilla:

Vanilla Traders
Pre-adjustment trial balance as at 31 December 20.1

	Debit	Credit
	R	R
Capital: A Van (1 January 20.1)		100 000
Capital: E Nilla (1 January 20.1)		150 000
Current account: A Van (1 January 20.1)	7 000	
Current account: E Nilla (1 January 20.1)		9 000
Drawings: A Van	58 140	
Drawings: E Nilla	70 860	
Mortgage		120 000
Long-term loan: A Van		30 000
Trade payables control		59 000
Bank		11 000
Land and buildings (at cost)	500 000	
Equipment (at cost)	70 000	
Vehicles (at cost)	80 000	
Accumulated depreciation: Equipment (1 January 20.1)		21 000
Accumulated depreciation: Vehicles (1 January 20.1)		39 040
Allowance for credit losses		600
Inventory	7 500	
Trade receivables control	18 000	
Petty cash	350	
Sales		595 000
Cost of sales	195 990	
Advertising	7 400	
Bank charges	2 300	
Telephone expenses	9 800	
Water and electricity	12 100	
Salaries	80 400	
Insurance	4 000	
Delivery expenses	3 900	
Credit losses	500	
Interest on bank overdraft	600	
Stationery consumed	6 300	
Settlement discount received		500
	1 135 140	1 135 140

Additional information:

Abstract from terms of the partnership agreement:

1. Interest on capital will be calculated at a rate of 10% per annum on the opening balances of the capital accounts and at a rate of 8% per annum on the opening

balances of the current accounts. The interest on capital and current accounts must be capitalised to the current accounts of the partners.

2. Interest will be charged at a rate of 5% per annum on the balance of the drawings accounts at the end of each month. The interest must be capitalised against the current accounts of the partners.
3. A Van is entitled to an annual salary of R60 000 and E Nilla is entitled to an annual salary of R80 000.
4. The partners will share profits and losses in the following ratio: A Van,1/3 and E Nilla, 2/3.

Year-end adjustments:

1. An outstanding debt of R300 is irrecoverable and must be written off.
2. The allowance for credit losses must be adjusted to R708.
3. Depreciation must be provided as follows:

   Equipment: 10% per annum according to the straight line method; and

   Vehicles: 20% per annum according to the diminishing balance method.
4. The terms of the mortgage provide for interest on the loan to be calculated at a rate of 15% per annum on the outstanding amount of the loan at the end of the financial year. Interest is payable in the first week of January of the following year. During the 20.2 financial year, the partnership will start repaying the loan at an amount of R20 000 per annum payable on 2 January of every year until the loan is fully paid. The loan is secured by a mortgage over land and buildings and was originally granted to the partnership by Capital Bank Limited on 2 January 20.0.
5. A Van granted an unsecured loan to the partnership on 1 September 20.1. According to the terms of the loan agreement, interest at 9% per annum will be charged and is payable in January of every year. The total amount of the loan will be repaid in full on 30 June 20.5.
6. Advertising expenses include an amount of R400 which was prepaid for January 20.2.
7. The amount paid for water and electricity excludes an amount of R2 300 still payable for December 20.1.
8. During the year, the following cash salaries were withdrawn by the partners:

   A Van, R47 140; and

   E Nilla, R62 860.
9. Interest calculated on the partners' drawings accounts, as per the partnership agreement, amounted to R230 for A Van and R145 for E Nilla for the current financial year. The interest was not yet recorded in the books of the partnership at the end of the financial year.
10. Provisions to comply with the terms of the partnership agreement must still be made.

Required:

Prepare the following in respect of Vanilla Traders to comply with the requirements of International Financial Reporting Standards appropriate to the business of the partnership:

(a) Statement of profit or loss and other comprehensive income for the year ended 31 December 20.1;

(b) Statement of changes in equity for the year ended 31 December 20.1;

(c) Statement of financial position as at 31 December 20.1;

(d) Notes for the year ended 31 December 20.1.

Comparative figures can be ignored. Where necessary, amounts must be rounded off to the nearest Rand.

Solution:

(a) Vanilla Traders

Statement of profit or loss and other comprehensive income for the year ended 31 December 20.1

	Note	R
Revenue	3	595 000
Cost of sales (R195 990 – R500)		(195 490)
Gross profit		399 510
Distribution, administrative and other expenses		(144 200)
Advertising①		7 000
Bank charges		2 300
Telephone expenses		9 800
Water and electricity②		14 400
Salaries		80 400
Insurance		4 000
Delivery expenses		3 900
Credit losses③		908
Stationery consumed		6 300
Depreciation④	4	15 192
Finance costs⑤		(19 500)
Interest on long-term loan: A Van		900
Interest on mortgage		18 000
Interest on bank overdraft		600
Profit for the year		235 810
Other comprehensive income for the year		–
Total comprehensive income for the year		235 810

(b)

Vanilla Traders
Statement of changes in equity for the year ended 31 December 20.1

	Capital		Current accounts		Appro-	
	A Van	**E Nilla**	**A Van**	**E Nilla**	**priation**	**Total**
	R	**R**	**R**	**R**	**R**	**R**
Balances at 1 January 20.1	100 000	150 000	(7 000)	9 000	–	252 000
Total comprehensive income for the year					235 810	235 810
Salaries to partners			60 000	80 000	(140 000)	
Interest on capital ⑥			10 000	15 000	(25 000)	
Interest on current accounts ⑦			(560)	720	(160)	
Interest on drawings			(230)	(145)	375	
Partners' share of total comprehensive income⑧ ⑨			23 675	47 350	(71 025)	
Drawings			(58 140)	(70 860)	–	(129 000)
Balances at 31 December 20.1	100 000	150 000	27 745	81 065	–	358 810

(c)

Vanilla Traders
Statement of financial position as at 31 December 20.1

	Note	R
ASSETS		
Non-current assets		574 768
Property, plant and equipment	4	574 768
Current assets		25 242
Inventories		7 500
Trade and other receivables	5	16 992
Prepayments		400
Cash and cash equivalents	5	350
Total assets		600 010
EQUITY AND LIABILITIES		
Total equity		358 810
Capital (R100 000 + R150 000)		250 000
Current accounts (R27 745 + R81 065)		108 810
Total liabilities		241 200
Non-current liabilities		130 000
Long-term borrowings	6	130 000
Current liabilities		111 200
Trade and other payables	6	80 200
Current portion of long-term borrowings	6	20 000
Bank overdraft	6	11 000
Total equity and liabilities		600 010

(d) **Vanilla Traders**
Notes for the year ended 31 December 20.1

Accounting policy

1. Basis of presentation

   The annual financial statements have been prepared in accordance with International Financial Reporting Standards appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis, modified for the fair valuation of certain financial instruments and incorporate the principle accounting policies set out below. The statements are presented in South African Rand.

2. Summary of significant accounting policies

   The annual financial statements incorporate the following principal accounting policies which are consistent with those applied in previous years except where otherwise stated.

   2.1 Property, plant and equipment

   Property, plant and equipment are initially recognised at cost price. No depreciation is written off on land and buildings. Equipment and vehicles are subsequently measured at cost less accumulated depreciation and accumulated impairment losses.

   Depreciation on equipment and vehicles are written off at a rate deemed to be sufficient to reduce the carrying amount of the assets over their estimated useful life to their estimated residual value. The depreciation rates are as follows:

   Equipment: 10% per annum according to the straight line method; and

   Vehicles: 20% per annum according to the diminishing balance method.

   Depreciation is charged to profit or loss for the period. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

   2.2 Financial instruments

   Financial instruments are recognised in the entity's balance sheet when the entity becomes a party to the contractual provisions of an instrument.

   Financial instruments are initially measured at the transaction price, which is fair value plus transaction costs, except for "Financial assets at fair value through profit or loss" which is measured at fair value, transaction costs excluded. The entity's classification depends on the purpose for which the entity acquired the financial instruments. Financial instruments are subsequently measured at fair value unless it is measured at amortised cost as required by IFRS.

   Financial instruments that are subsequently measured at amortised cost are done so using the effective interest rate method.

   Debt instruments that are classified as current assets or current liabilities are measured at the undiscounted amount of the cash expected to be received or paid, unless the arrangement effectively constitutes a financing transaction.

2.3 Inventories

Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. Cost is calculated using the first-in, first-out method. Net realisable value is the estimated selling price in the ordinary course of business less any costs of completion and disposal.

2.4 Revenue

Revenue is measured at the fair value of the consideration received or receivable. Revenue from the sale of goods consists of the total net invoiced sales excluding value added tax and settlement discount granted. The revenue from sales is recognised when control of the goods is transferred to the customer.

3. Revenue

	R
Sale of goods	595 000

4. Property, plant and equipment

	Land and buildings	**Equip-ment**	**Vehicles**	**Total**
	R	**R**	**R**	**R**
Carrying amount at 1 January 20.1	500 000	49 000	40 960	589 960
Cost	500 000	70 000	80 000	650 000
Accumulated depreciation	–	(21 000)	(39 040)	(60 040)
Depreciation for the period	–	(7 000)	(8 192)	(15 192)
Carrying amount at 31 December 20.1	500 000	42 000	32 768	574 768
Cost	500 000	70 000	80 000	650 000
Accumulated depreciation	–	(28 000)	(47 232)	(75 232)

The partnership has pledged land and building with a carrying amount of R500 000 (20.0: R500 000) as security for the mortgage obtained from Capital Bank Ltd.

5. Financial assets

Current financial assets	**R**
Trade and other receivables:	16 992
Trade receivables control	17 700
Allowance for credit losses	(708)
Cash and cash equivalents:	350
Petty cash	350

6. Financial liabilities

	R
Non-current financial liabilities at amortised costs	
Long-term borrowings: Mortgage	130 000
The mortgage was acquired from Capital Bank Ltd on 2 January 20.0 at an interest rate of 15% per annum calculated on the outstanding amount at the end of the financial year. The loan is repayable in equal annual instalments of R20 000 each payable on 2 January of each year and the final payment is due on 2 January 20.7. This loan is secured by a first mortgage over land and buildings (refer note 3).	
Mortgage	120 000
Current portion	(20 000)
Non-current portion	100 000
Long-term loan: A Van: The loan is unsecured and was granted on 1 September 20.1 at an interest rate of 9% per annum payable in January of every year. The loan will be repaid in full on 30 June 20.5	
Long-term loan: A Van	30 000
Current portion of loan	–
Non-current portion of loan	30 000
Current financial liabilities	111 200
Trade and other payables:	80 200
Trade payables control	59 000
Accrued expenses:	
Interest on loan: A Van	900
Water and electricity	2 300
Interest on mortgage	18 000
Current portion of long-term borrowings at amortised costs	20 000
Bank overdraft	11 000

Calculations:

		R
①	**Advertising**	
	R(7 400 – 400)	7 000
②	**Water and electricity**	
	R(12 100 + 2 300)	14 400
③	**Credit losses and allowance for credit losses**	
	Trade receivables control R(18 000 – 300)	17 700
	Allowance for credit losses	708
	Previous year allowance	(600)
	Increase in allowance for credit losses	108
	Total credit losses R(500 + 300 + 108)	908

		R
④	**Depreciation on equipment (straight line method)**	
	R70 000 × 10%	7 000
	Depreciation on vehicles (diminishing balance method):	
	R(80 000 – 39 040) × 20%	8 192
	Total depreciation	15 192
⑤	**Finance costs**	
	Interest on long-term loan R30 000 × 4/12 × 9/100	900
	Interest on mortgage R120 000 × 15%	18 000
	Interest on bank overdraft	600
	Total finance costs	19 500
⑥	**Interest on capital**	
	R(100 000 + 150 000) × 10%	25 000
⑦	**Interest on current accounts**	
	Interest income: A Van (R7 000 × 8%)	560
	Interest expense: E Nilla (R9 000 × 8%)	720
⑧	**Partner's share of profit**	
	A Van: R71 025 × 1/3	23 675
	E Nilla: R71 025 × 2/3	47 350

Example 2.3 Financial statements of a partnership trading at a loss

To illustrate the applicable principles when a partnership trades at a loss, use the same information as in Example 2.2 but change the Sales to R335 500 and Land and buildings to R240 500. For purposes of this example, only the income statement and statement of changes in equity are shown.

Required:

Prepare the following in respect of Vanilla Traders to comply with the requirements of International Financial Reporting Standards appropriate to the business of the partnership:

(a) Statement of profit or loss and other comprehensive income for the year ended 31 December 20.1;

(b) Statement of changes in equity for the year ended 31 December 20.1.

Notes to the financial statements and comparative figures are not required.

Solution:

(a)

Vanilla Traders
Statement of profit or loss and other comprehensive income for the year ended 31 December 20.1

	Note	R	
Revenue			335 500
Cost of sales (195 990 – 500)			(195 490)
Gross profit			140 010
Distribution, administrative and other expenses			(144 200)
Advertising		7 000	
Bank charges		2 300	
Telephone expenses		9 800	
Water and electricity		14 400	
Salaries		80 400	
Insurance		4 000	
Delivery expenses		3 900	
Credit losses		908	
Stationery consumed		6 300	
Depreciation		15 192	
Finance costs			(19 500)
Interest on long-term loan: A Van		900	
Interest on mortgage		18 000	
Interest on bank overdraft		600	
Loss for the year			(23 690)
Other comprehensive income for the year			–
Total comprehensive loss for the year			(23 690)

(b)

Vanilla Traders
Statement of changes in equity for the year ended 31 December 20.1

	Capital A Van	Capital E Nilla	Current accounts A Van	Current accounts E Nilla	Appropriation	Total
	R	R	R	R	R	R
Balances at 1 January 20.1	100 000	150 000	(7 000)	9 000	–	252 000
Total comprehensive loss for the year					(23 690)	(23 690)
Salaries to partners			60 000	80 000	(140 000)	
Interest on capital			10 000	15 000	(25 000)	
Interest on current accounts			(560)	720	(160)	
Interest on drawings			(230)	(145)	375	
Partners' share of total comprehensive loss ①			(62 825)	(125 650)	188 475	
Drawings			(58 140)	(70 860)	–	(129 000)
Balances at 31 December 20.1	100 000	150 000	(58 755)	(91 935)	–	99 310

Calculation:

① **Partner's share in loss**	**R**
A Van: 1/3 × R188 475	62 825
E Nilla: 2/3 × R188 475	125 650
Total loss	188 475

Example 2.4

The following information relates to the partnership S & W Patio Furniture with partners S Simi and W Wihan:

S & W Patio Furniture
Pre-adjustment trial balance as at 28 February 20.8

	Debit	**Credit**
	R	**R**
Capital: S Simi (1 March 20.7)		200 000
Capital: W Wihan (1 March 20.7)		100 000
Current account: S Simi (1 March 20.7)	12 000	
Current account: W Wihan (1 March 20.7)		19 000
Drawings: S Simi	24 800	
Drawings: W Wihan	30 000	
Mortgage		180 000
Long-term loan: S Simi		97 000
Trade payables control		79 000
Bank	9 000	
Bank savings account	12 000	
Land and buildings (at cost)	600 000	
Equipment (at cost)	250 000	
Vehicles (at cost)	320 000	
Accumulated depreciation: Equipment (1 March 20.7)		75 000
Accumulated depreciation: Vehicles (1 March 20.7)		115 200
Inventory	49 500	
Petty cash	500	
Cash sales		1 193 840
Cost of sales	369 250	
Advertising	27 800	
Bank charges	12 900	
Telephone expenses	19 300	
Cell phone expenses	12 000	
Water and electricity	31 700	
Salaries and commissions	248 000	
Insurance	9 000	
Delivery expenses (on merchandise sold)	15 700	
Cleaning materials used	7 090	
Settlement discount received		1 500
	2 060 540	2 060 540

Additional information:

S & W Patio Furniture sells merchandise on a cash basis only.

Abstract from terms of the partnership agreement:

1. Interest on the opening balances of the capital accounts will be calculated at a per annum rate of twice the average prime lending rate,* as determined by the SA Reserve Bank. During the financial year the prime lending rate was as follows: first quarter of the financial year; 6.0%; second quarter; 5.5%; third quarter: 5.0% and fourth quarter; 4.5%. Interest is calculated at a rate of 8.0% per annum on the opening balances of the current accounts. The interest on capital and current accounts must be capitalised to the current accounts of the partners.
2. Interest will be charged at a rate of 10% per annum on the balance of the drawings accounts at the end of each month. The interest must be capitalised against the current accounts of the partners.
3. S Simi is entitled to an annual salary of R75 000 and W Wihan is entitled to an annual salary of R65 000.
4. The partners share profits and losses equally.

Year-end adjustments:

1. Depreciation must be provided as follows:

   Equipment: 15% per annum according to the straight line method; and
   Vehicles: 20% per annum according to the diminishing balance method.
2. The terms of the mortgage provide for interest on the loan to be calculated at a rate of 10% per annum on the outstanding amount of the loan at the end of the financial year. Interest is payable in the first week of March of the following year. On 5 March 20.8, the partnership must repay an amount of R35 000 of the loan. The loan is secured by a mortgage over land and buildings and was granted to the partnership by Bond Bank Limited on 1 March 20.6. The balance of the loan is repayable in full in March 20.15.
3. S Simi granted an unsecured loan to the partnership on 1 September 20.7. According to the terms of the loan agreement, interest at 12% per annum will be charged and is payable in March of every year. An amount equal to 40% of the loan is repayable on 1 September 20.8. The remaining balance of this loan is repayable in full in September 20.10.
4. Advertising expenses exclude an amount of R1 200 which is still payable for the current financial year.
5. The amount paid for water and electricity includes an amount of R3 000 paid for March 20.8.
6. Cell phone expenses incurred by the partners are paid for by the partnership due to the fact that the partners Simi and Wihan use their cell phones mainly for business purposes. The amount payable for February 20.8 towards the cell phone expenses of Simi is R1 000 and towards the cell phone expenses of Wihan, R700 and must still be provided for.

7. An amount of R26 000 for commission to sales representatives for February 20.8 still has to be accounted for.
8. During the year, the following cash salaries were withdrawn by the partners:

   S Simi, R14 900 and
   W Wihan, R23 100.
9. Interest calculated on the partners' drawings accounts, as per the partnership agreement, amounted to R1 490 for Simi and R2 500 for Wihan for the current financial year and must still be recorded.
10. Provisions/adjustments to comply with the terms of the partnership agreement must still be made.

* You can google "prime lending rate" to learn more.

Required:

Prepare the following in respect of S & W Patio Furniture Traders to comply with the requirements of International Financial Reporting Standards appropriate to the business of the partnership:

(a) Statement of profit or loss and other comprehensive income for the year ended 28 February 20.8;

(b) Statement of changes in equity for the year ended 28 February 20.8;

(c) Statement of financial position as at 28 February 20.8;

(d) The note for property, plant and equipment for the year ended 28 February 20.8. No other notes are required.

Comparative figures can be ignored.

Solution:

(a)

S & W Patio Furniture
Statement of profit or loss and other comprehensive income for the year ended 28 February 20.8

	Note	R	R
Revenue			1 193 840
Cost of sales (R369 250 – R1 500)			(367 750)
Gross profit			826 090
Distribution, administrative and other expenses			(487 850)
Advertising①		29 000	
Bank charges		12 900	
Telephone expenses		19 300	
Water and electricity②		28 700	
Salaries and commissions③		274 000	
Insurance		9 000	
Delivery expenses		15 700	
Cell phone expenses④		13 700	
Cleaning materials used		7 090	
Depreciation⑤	3	78 460	
Finance costs⑥			(23 820)
Interest on long-term loan: S Simi		5 820	
Interest on mortgage		18 000	
Profit for the year			314 420
Other comprehensive income for the year			–
Total comprehensive income for the year			314 420

(b)

S & W Patio Furniture
Statement of changes in equity for the year ended 28 February 20.8

	Capital S Simi	Capital W Wihan	Current accounts S Simi	Current accounts W Wihan	Appro-priation	Total
	R	R	R	R	R	R
Balances at 1 March 20.7	200 000	100 000	(12 000)	19 000	–	307 000
Total comprehensive income for the year					314 420	314 420
Salaries to partners			75 000	65 000	(140 000)	
Interest on capital ⑦			21 000	10 500	(31 500)	
Interest on current accounts ⑧			(960)	1 520	(560)	
Interest on drawings			(1 490)	(2 500)	3 990	
Partners' share of total comprehensive income ⑨			73 175	73 175	(146 350)	
Drawings			(24 800)	(30 000)	–	(54 800)
Balances at 28 February 20.8	200 000	100 000	129 925	136 695	–	566 620

(c)

S & W Patio Furniture
Statement of financial position as at 28 February 20.8

	Note	R
ASSETS		
Non-current assets		901 340
Property, plant and equipment	3	901 340
Current assets		74 000
Inventories		49 500
Prepayments		3 000
Cash and cash equivalents R(9 000 + 12 000 + 500)		21 500
Total assets		975 340
EQUITY AND LIABILITIES		
Total equity		566 620
Capital R(200 000 + 100 000)		300 000
Current accounts R(129 925+ 136 695)		266 620
Total liabilities		408 720
Non-current liabilities		203 200
Long-term borrowings R[180 00 – 35 000 + (60% × 97 000)]		203 200
Current liabilities		205 520
Trade and other payables ⑩		131 720
Current portion of long-term borrowings R[35 000 + (40% × 97 000)]		73 800
Total equity and liabilities		975 340

(d)

S & W Patio Furniture
Notes for the year ended 28 February 20.8

3. Property, plant and equipment

	Land and buildings	**Equip-ment**	**Vehicles**	**Total**
	R	**R**	**R**	**R**
Carrying amount at 1 March 20.7	600 000	175 000	204 800	979 800
Cost	600 000	250 000	320 000	1 170 000
Accumulated depreciation	–	(75 000)	(115 200)	(190 200)
Depreciation for the period	–	37 500	40 960	78 460
Carrying amount at 28 February 20.8	600 000	137 500	163 840	901 340
Cost	600 000	250 000	320 000	1 170 000
Accumulated depreciation	–	(112 500)	(156 160)	(268 660)

The partnership has pledged land and building with a carrying amount of R600 000 (20.7: R600 000) as security for the mortgage obtained from Bond Bank Ltd.

Calculations:

		R
①	**Advertising**	
	R(27 800 + 1 200)	29 000
②	**Water and electricity**	
	R(31 700 + 3 000)	28 700
③	**Salaries and commissions**	
	R(248 000 + 26 000)	274 000
④	**Cell phone expenses**	
	2 (12 000 + 1 000 + 700)	13 700
⑤	**Depreciation on equipment (straight line method)**	
	R250 000 × 15%	37 500
	Depreciation on vehicles (diminishing balance method):	
	R(320 000 – 115 200) × 20%	40 960
	Total depreciation	78 460
⑥	**Finance costs**	
	Interest on long-term loan from Simi R97 000 × 6/12 × 12%	5 820
	Interest on mortgage R180 000 × 10%	18 000
	Total finance costs	23 820
⑦	**Interest on capital**	
	Calculation of average prime lending rate:	
	6 + 5,5 + 5 + 4,5 = 21/4 = 5,25 × 2 = 10,5%	
	Interest on capital: Simi R200 000 × 10,5%	21 000
	Interest on capital: Wihan R100 000 × 10,5%	10 500
	Total interest on capital	31 500
⑧	**Interest on current accounts**	
	Interest income: S Simi (R12 000 x 8%)	960
	Interest expense: W Wihan (R19 000 x 8%)	1 520
⑨	**Partner's share of profit**	
	S Simi: R146 350 × 1/2	73 175
	W Wihan: R146 350 × 1/2	73 175
⑩	**Trade and other payables**	
	Trade payables control	79 000
	Advertising payable	1 200
	Cell phone expenditures payable	1 700
	Interest on mortgage payable	18 000
	Interest on long-term loan payable	5 820
	Commissions payable	26 000
	Total	131 720

2.9 Summary

In this chapter, the formation of the partnership as a form of business ownership was introduced. Partnerships are formed for many reasons, the main reason being to attract more capital and expertise in a business, as an unlimited number of natural persons can constitute a partnership. A partnership can be formed by way of action or by an agreement that should preferably be in writing.

The relationship between partners and between partners and the partnership are noted in the partnership agreement. The necessity for such a document lies in the fact that a partnership is not a legal entity and the partners are responsible for all actions of the partnership. There is no specific act which deals with partnerships and for disputes which cannot be resolved by the partners themselves, common law principles will apply.

Because a partnership implies multiple ownership, adjustments to the basic accounting system, introduced in the sole proprietor, are necessary to cope with this demand of multiple ownership. Except for the fact that the capital contribution of each partner must be separately recorded, accounts must also be opened to record the drawings of each partner as well as the current accounts to record transactions between each partner and the partnership. A special account, the appropriation account, is also needed to record the apportionment of profits and losses amongst the partners.

Profits/losses are shared amongst the partners according to the terms of the partnership agreement. If the partnership agreement is silent on the appropriation of profits/losses, it must be apportioned in the ratio of the respective capital contributions of the partners. If, however, these contributions are not specified, the profits/losses must be shared equally.

The format of the financial statements of a partnership is the same as that of a sole proprietor. It is only the statement of changes in equity and the statement of financial position that reflect slight changes due to multiple ownerships. Strictly speaking, the statement of cash flows also forms part of the financial statements, but this will be discussed in detail in Chapter 7. Chapters 3 and 4 will deal with further aspects of partnerships.

CHAPTER 3

Changes in the ownership structure of partnerships

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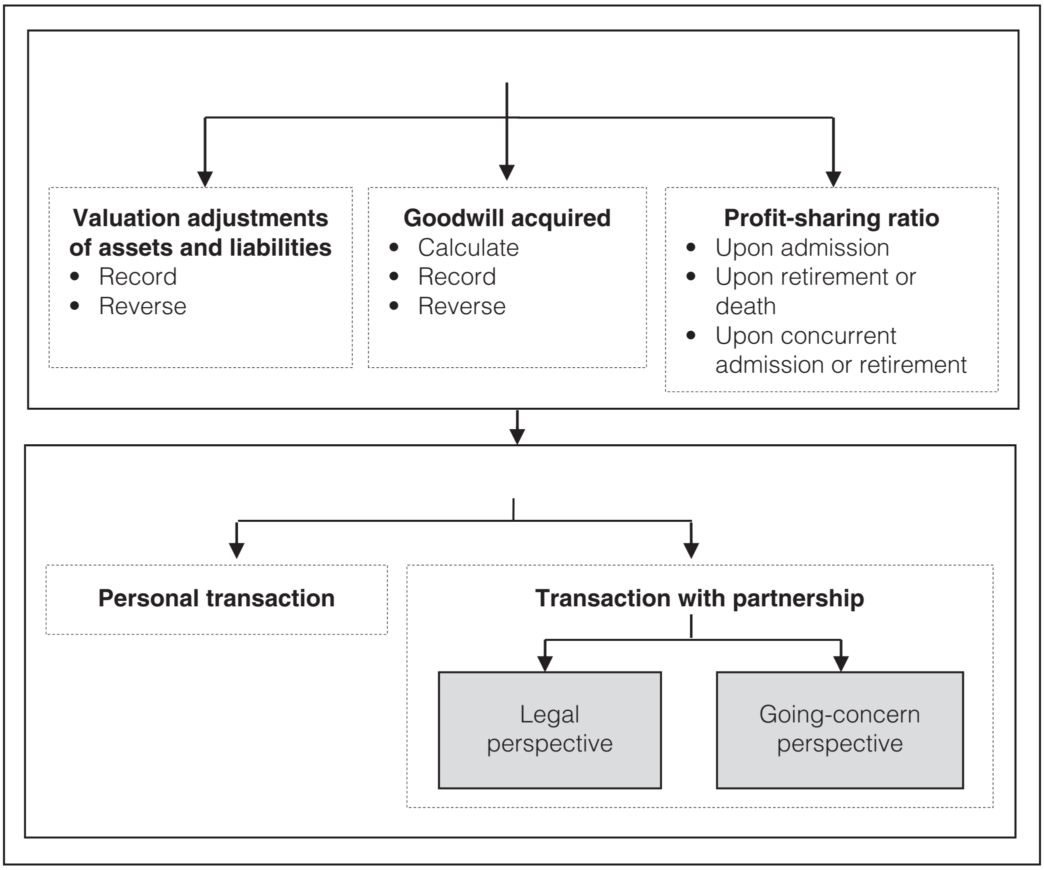
Overview: Changes in the ownership structure of partnerships



3.1 Introduction

STUDY OBJECTIVES
After studying this chapter, you should be able to: ☐ briefly describe what a change in the ownership structure of a partnership entails; ☐ cite events that cause a change in the ownership structure of a partnership; ☐ calculate the profit-sharing ratio of a new partnership; ☐ record a change in the ownership structure of a partnership by way of a personal transaction; ☐ record a change in the ownership structure of a partnership by way of a transaction with the partnership by applying an accounting procedure which is based on the legal or on the going-concern perspective; ☐ if an accounting procedure based on the legal perspective was applied, prepare a statement of financial position of a new partnership at the date of its formation according to the requirements of IFRS, appropriate to the business of the partnership; and ☐ if an accounting procedure based on the going-concern perspective was applied, prepare a statement of profit or loss and other comprehensive income for the financial year during which the change in ownership structure took place, according to the requirements of IFRS, appropriate to the business of the partnership.

In Chapter 2, the formation, advantages, disadvantages and general aspects regarding the activities of a partnership, as well as the preparation of the financial statements thereof, are discussed. Chapter 3 deals mainly with the recording of changes in the ownership structure of partnerships and the subsequent formation of new partnerships when a partner is admitted to a partnership, or when a partner retires or dies.

In this chapter, a change in the ownership structure of a partnership is regarded as a change in the contractual relationship between the partners of a partnership which affects the profit-sharing ratio of the partners. Examples include when a partner is admitted to a partnership, or when a partner retires or dies, or when the profit-sharing ratio of the partners changes. The retirement of a partner is regarded as the withdrawal of a partner from a partnership, irrespective of the reason. For example, a partner may retire to go on pension, or simply to invest in another business.

A written partnership agreement plays a significant role in the settlement of a transaction pertaining to a change in the ownership structure of a partnership. Should a partnership agreement not include sufficient stipulations in this regard, the partners should come to a suitable arrangement amongst themselves.

Since a partnership is not an independent legal entity, the ownership of a partnership is vested in the partners, and not in the partnership. Therefore, the activities of a partnership fall under the jurisdiction of common law, and not under an Act exclusively pertaining to partnerships. The contractual aspects between the partners of a partnership are usually stipulated in a written partnership agreement. When a change in the ownership structure of a partnership occurs, a new partnership agreement is entered into by the new partners (or between the existing partners when only the profit-sharing ratio changed), which causes the existing partnership to dissolve. Due to the various circumstances which can bring about a change in the ownership structure of a partnership, different procedures exist according to which it can be recorded. For this reason, and since partnerships are not governed by a law requiring that IFRS be applied, it is not possible to introduce a standardised accounting procedure according to which changes in the ownership structure of partnerships ought to be recorded.

In this chapter, the recording of changes in ownership resulting from transactions by partnerships *as business entities*, and from personal (direct) transactions by *individual partners,* are addressed.

To simplify matters, two distinct accounting procedures are suggested to record a change in the ownership structure of a partnership as a result of a transaction entered into by the partnership (as a business entity), namely a procedure based on a legal perspective and another on a going-concern perspective. The nature of the partnership, the kind of change that took place in the ownership structure, the accounting policy and the partnership agreement of the dissolved and the new partnership, will indicate which perspective must be or was applied. From the legal perspective, each partnership (the dissolved and the subsequent new partnership) is regarded as a separate business entity, and the activities of these partnerships are therefore separately recorded and reported on. From the going-concern perspective, the activities of a dissolved and a subsequent new partnership are not separately accounted for and reported on; the two partnerships are perceived to have operated as a single entity during the financial year wherein the change in the ownership structure took place. The accounting procedure based on a going-concern perspective does not disregard the fact that two partnerships are actually involved – it simply does not record such a clear distinction between the two partnerships as the procedure based on the legal perspective.

Regardless of the perspective applied, the following may be included in the accounting records of an existing partnership in preparation of a change in its ownership structure:

- ☐ the recording of valuation adjustments; and
- ☐ the calculation and recording of goodwill acquired.

If the going-concern perspective is applied, the partners of the new partnership will write back (reverse) the above:

- ☐ valuation adjustments; and
- ☐ goodwill acquired.

A change in the ownership structure of a partnership usually requires the calculation of a new profit-sharing ratio.

3.2 Valuation adjustments

The selling price of a partnership is determined by the fair value thereof. In Chapter 1 fair value is described as the amount for which an asset could be sold or a liability transferred between market participants at the measurement date (IAS 32.11).

In this chapter, the fair value of a partnership refers to the fair value of its net assets (including goodwill). The fair value of the *net* assets (including goodwill) of a partnership is equal to the fair value of its assets *minus* the fair value of its liabilities. The fair value of the net assets is thus equal to the total equity of a partnership.

The calculation of the fair value of a partnership falls outside the scope of this chapter. However, note that the nature of the business activities of a partnership, the size thereof and the goodwill acquired, will largely determine the items to be valued. For example, a small manufacturing entity will most likely emphasise the valuation of its tangible assets, whereas a large, reputable service entity with a growing clientele and insignificant tangible assets will emphasise the valuation of its goodwill.

As explained in paragraph 3.1, the financial statements of partnerships do not have to be prepared according to IFRS, and therefore assets and liabilities do not have to be disclosed at fair value. Should the accounting policy of a partnership not require that the assets and liabilities be disclosed at fair value, valuation adjustments are usually recorded in preparation of a change in the ownership structure of the partnership. In this chapter, a valuation adjustment is considered to be any such adjustment recorded in an *existing* asset or liability account of an existing partnership in preparation of its dissolution.

3.2.1 *Recording valuation adjustments in the books of an existing partnership*

One method of recording valuation adjustments is by using a valuation account. For example, if the value of an asset must be increased, the relevant asset account is debited and the valuation account credited with the amount of the increase. If the value of an asset must be decreased, the relevant asset account is credited and the valuation account debited with the amount of the decrease. If the value of a liability must be decreased, the relevant liability account is debited and the valuation account credited with the amount of the decrease.

The balancing amount of a valuation account is closed off to the capital accounts of each existing partner (including to the capital account of a retired or deceased partner) by apportioning the balancing amount to the partners according to their profit-sharing ratio. The advantage of applying a valuation account when valuation adjustments are recorded, is that a single *net* amount on valuation is closed off to the capital accounts of the partners, instead of recording each valuation entry directly in the capital accounts. In this chapter, valuation adjustments are recorded in the accounting records of an existing partnership by way of a valuation account.

Example 3.1 Recording of valuation adjustments in respect of assets

Andrews and Bevan are in a partnership, trading as Andrews & Bevan Partners, and they share profits/losses in the ratio of 3:2 respectively. The financial year-end of the partnership is 28 February. They agreed to admit Collins as a partner with effect from 1 March 20.3. It was decided that Collins must contribute R90 000 in cash on 1 March 20.3 for a $^1/_6$ share in the fair value of the new partnership, and that the profit-sharing ratio of Andrews, Bevan and Collins will be 3:2:1 respectively.

It was not the accounting policy of Andrews and Bevan to record the fair value of the partnership in the accounting records. On 28 February 20.3, after the usual year-end adjustments were recorded according to the accounting policy of the partnership, and the nominal accounts were closed off, the following statement of financial position was prepared (that is, prior to any valuation adjustments that were recorded specifically in preparation of the change in the ownership structure of the partnership):

Andrews & Bevan Partners
Statement of financial position as at 28 February 20.3

	R
ASSETS	
Non-current assets	200 000
Property, plant and equipment	200 000
Current assets	160 000
Inventories	58 000
Trade and other receivables (Trade receivables control)	52 000
Cash and cash equivalents	50 000
Total assets	360 000
EQUITY AND LIABILITIES	
Total equity	300 000
Capital	300 000
Total liabilities	60 000
Current liabilities	60 000
Trade and other payables	60 000
Total equity and liabilities	360 000

Additional information:

1. In the above statement, the balances of the capital accounts of Andrews and Bevan were R180 000 and R120 000 respectively.
2. Andrews and Bevan decided to record the following valuations in preparation of the admission of Collins:
   - Property, plant and equipment: Included in the property, plant and equipment of R200 000 are land and buildings to the amount of R100 000. The market value of the land and buildings is R112 000.
   - Trade receivables control: An allowance for credit losses to the amount of R5 200 must be created.

Required:

(a) Record the valuation adjustments in the general journal of Andrews & Bevan Partners on 28 February 20.3 in preparation of the admission of Collins by way of a valuation account.

(b) Prepare the valuation account (properly closed off), as well as the land and buildings and capital accounts, in the general ledger of Andrews & Bevan Partners, after the above journal entries were posted to the appropriate general ledger accounts.

***Solution*:**

(a) **Andrews & Bevan Partners**
General journal

			Debit	Credit
20.3			R	R
Feb	28	Land and buildings	12 000	
		Valuation account R(112 000 – 100 000)		12 000
		Adjustment of the balance of the land and buildings account according to the valuation thereof in preparation of the change in the ownership structure of the partnership		
		Valuation account	5 200	
		Allowance for credit losses		5 200
		Creation of an allowance for credit losses in preparation of the change in the ownership structure of the partnership		
		Valuation account R(12 000 – 5 200)	6 800	
		Capital: Andrews (R6 800 × 3/5)		4 080
		Capital: Bevan (R6 800 × 2/5)		2 720
		Closing off the balancing amount in the valuation account to the capital accounts of Andrews and Bevan according to their profit-sharing ratio		

Comments:

☐ In the examples of this chapter, with exception of Example 3.14, non-current assets are disclosed in the books of the partnerships without indicating whether they are at cost price, carrying or valued amounts. The reason for this is that the legal and going-concern perspectives complicate these disclosures. Since the objective of this chapter is to discuss basic guidelines, such detailed disclosure is omitted.

☐ The valuation adjustments, which in this example are recorded in the first two journal entries, can be combined into a single journal entry because the valuation adjustments are recorded by applying the valuation account as the *contra* account. In such a combined journal entry, the net amount pertaining to the adjustments of the land and buildings and the allowance for credit losses, namely R6 800 (R12 000 – R5 200), will be disclosed as the amount that must be posted to the valuation account. In this example, the following combined journal entry could have been prepared:

Andrews & Bevan Partners
General journal

			Debit	Credit
20.3			R	R
Feb	28	Land and buildings	12 000	
		Allowance for credit losses		5 200
		Valuation account		6 800
		Recording the valuation adjustments in preparation of the change in the ownership structure of the partnership		

(b) **Andrews & Bevan Partners**
General ledger

Dr **Valuation account** **Cr**

20.3				R	20.3				R
Feb	28	Allowance for credit losses		5 200	Feb	28	Land and buildings		12 000
		Capital: Andrews		4 080					
		Capital: Bevan		2 720					
				12 000					12 000

Dr **Land and buildings** **Cr**

20.3				R					
Feb	28	Balance	b/d	100 000					
		Valuation account		12 000					
				112 000					

Dr **Capital: Andrews** **Cr**

					20.3				R
					Feb	28	Balance	b/d	180 000
							Valuation account		4 080
									184 080

Dr **Capital: Bevan** **Cr**

					20.3				R
					Feb	28	Balance	b/d	120 000
							Valuation account		2 720
									122 720

3.2.2 *Reversing valuation adjustments in the books of a new partnership*

When the going-concern perspective is applied to record a change in the ownership structure of a partnership, the transactions of the new partnership continue to be recorded in the books that were used by the dissolved partnership, usually under the same trading name. Therefore, the valuation adjustments that were recorded in the books of the dissolved partnership in preparation of its change in ownership structure are reversed in the books of the new partnership because these adjustments do not pertain to the continuity of the business activities of the two partnerships that are involved. These reversal entries deviate from the "fair value" disclosure required by IFRS.

In this chapter, valuation adjustments are reversed by way of a valuation account. The balancing amount of the account is closed off to the capital accounts of the new partners according to the profit-sharing ratio of the new partners.

From the legal perspective, the business activities of a new partnership commence at the date of its formation, and at this date, it cannot have any accounts that are carried forward from a previous accounting period. Seen from this perspective, the fair value of the assets and liabilities that are recorded on the date of the formation of a new partnership, can also be regarded as the "cost price" thereof. Any valuation adjustments that were specifically recorded in the books of a partnership in preparation of a change in its ownership structure should, from the legal perspective, not be reversed in the books of the new partnership, because the "cost price" of assets cannot be reversed. This bookkeeping method is more in agreement with the "fair value" disclosure required by IFRS.

Example 3.2 Reversal of valuation adjustments in the books of a new partnership

Use the same information as in Example 3.1. Further assume that Collins paid R90 000 into the bank account of the partnership on 1 March 20.3, and that Andrews, Bevan and Collins decided to reverse the valuation adjustments that were recorded in the books of Andrews & Bevan Partners.

Required:

(a) Prepare the journal entries in the books of Andrews & Bevan Partners on 1 March 20.3 to reverse the valuation adjustments that were recorded (refer to the solution of Example 3.1 for the entries that were made to record the valuation adjustments).

(b) Post the above relevant journal entries to the valuation, land and buildings, and the capital accounts in the general ledger of Andrews & Bevan Partners on 1 March 20.3. (For illustrative purposes, disclose these accounts as from 28 February 20.3.)

***Solution*:**

(a)

Andrews & Bevan Partners
General journal

			Debit	Credit
20.3			**R**	**R**
Mar	1	Valuation account	12 000	
		Land and buildings		12 000
		Reversal of the valuation adjustment that was recorded in respect of land and buildings		
		Allowance for credit losses	5 200	
		Valuation account		5 200
		Reversal of the allowance for credit losses that was created		
		Capital: Andrews (R6 800 × 3/6)	3 400	
		Capital: Bevan (R6 800 × 2/6)	2 267	
		Capital: Collins (R6 800 × 1/6)	1 133	
		Valuation account		6 800
		Closing off the balancing amount in the valuation account to the capital accounts of Andrews, Bevan and Collins according to their profit-sharing ratio		

(b)

Andrews & Bevan Partners
General ledger

Dr — Valuation account — Cr

20.3				**R**	20.3				**R**
Feb	28	Allowance for credit losses		5 200	Feb	28	Land and buildings		12 000
		Capital: Andrews		4 080					
		Capital: Bevan		2 720					
				12 000					12 000
Mar	1	Land and buildings		12 000	Mar	1	Allowance for credit losses		5 200
							Capital: Andrews		3 400
							Capital: Bevan		2 267
							Capital: Collins		1 133
				12 000					12 000

Dr — Land and buildings — Cr

20.3				**R**	20.3				**R**
Feb	28	Balance	b/d	100 000	Feb	28	Balance	c/d	112 000
		Valuation account		12 000					
				112 000					112 000
Mar	1	Balance	b/d	112 000	Mar	1	Valuation account		12 000
							Balancing amount		*100 000*

continued

Dr **Capital: Andrews** **Cr**

20.3				**R**	20.3				**R**
Feb	28	Balance	c/d	184 080	Feb	28	Balance	b/d	180 000
							Valuation account		4 080
				184 080					184 080
Mar	1	Valuation account		3 400	Mar	1	Balance	b/d	184 080
		Balancing amount		*180 680*					

Dr **Capital: Bevan** **Cr**

20.3				**R**	20.3				**R**
Feb	28	Balance	c/d	122 720	Feb	28	Balance	b/d	120 000
							Valuation account		2 720
				122 720					122 720
Mar	1	Valuation account		2 267	Mar	1	Balance	b/d	122 720
		Balancing amount		*120 453*					

Dr **Capital: Collins** **Cr**

20.3				**R**	20.3				**R**
Mar	1	Valuation account		1 133	Mar	1	Bank		90 000
		Balancing amount		*88 867*					

Comment:

In this example, the books of the dissolved partnership continue to be used by the new partnership. The entries that were made in the above accounts on 28 February 20.3 pertain to the dissolved partnership, and the entries made on 1 March 20.3 pertain to the new partnership. Note that the accounts that were carried forward by the dissolved partnership were balanced on 28 February 20.3, since this was the financial year-end of the partnership, and not because of the change that took place in its ownership structure. If Collins was admitted during the financial year, it would have been unnecessary to balance these accounts. Since 1 March 20.3 is the formation date of the new partnership, the above accounts are not balanced on this date. Therefore, balancing amounts were disclosed.

3.3 Goodwill

When the books of an existing partnership are prepared for a change in its ownership structure, goodwill is usually determined and, if significant, included in the disclosure of the fair value of its net assets. Past financial performance indicators, such as the total comprehensive income in respect of previous financial periods, are ordinarily used to determine goodwill. A discussion on the calculation of goodwill by means of past performance indicators falls outside the scope of this chapter.

3.3.1 *Description of goodwill*

Goodwill can be ascribed to the sound reputation of a business, which is influenced by factors such as the quality of the products or services rendered, efficient management, valuable patent rights or trademarks. In short, goodwill represents the value attached to those factors that enable a business to increase its turnover beyond the industry norm.

Appendix A of IFRS 3 defines goodwill as "future economic benefits arising from assets that are not capable of being individually identified and separately recognised." IFRS distinguishes between two types of goodwill, namely goodwill acquired (paragraph 51 of IFRS 3) and internally generated goodwill (paragraph 48 of IAS 38). According to these Standards, goodwill acquired is recognised as an intangible asset (an intangible asset is an identifiable non-monetary asset without physical substance), but internally generated goodwill is not. In this chapter, only goodwill acquired is dealt with.

3.3.2 *Calculation of goodwill acquired*

Goodwill acquired is initially recognised at cost, being the excess of the cost of the business (combination), over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. After initial recognition, goodwill acquired is measured at cost less any accumulated impairment losses. Goodwill acquired is disclosed separately as a non-current asset on the statement of financial position.

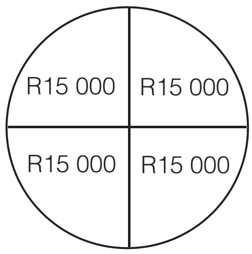
In this chapter, the calculation of goodwill is discussed only under the circumstance where a new partner is going to be admitted to a partnership and where no goodwill was recorded in the books of the existing partnership immediately prior to the admittance of the new partner. The following formula is applied:

> (The capital contribution of the new partner *multiplied* by the inverse of the partner's share in the equity of the new partnership)
>
> *minus*
>
> the equity of the new partnership (on the date of formation, prior to the recording of goodwill acquired)
>
> *equals*
>
> goodwill acquired

Comment:

Note that "The capital contribution of the new partner multiplied by the inverse of the partner's share in the equity of the new partnership" is equal to the equity (or the fair value of the net assets) of the entire new partnership.

For example, if a new partner purchased a $^1/_4$ share of the equity of a new partnership for R15 000, the equity of the entire new partnership is equal to R60 000 (R15 000 × $^4/_1$ (the inverse of $^1/_4$ is $^4/_1$)). The illustration below clarifies the calculation by showing that four quarters (which is equal to a whole: $^4/_4$ = 1) of R15 000 each is equal to R60 000.



The calculation of goodwill acquired according to the above method is illustrated in Examples 3.10 to 3.13.

3.3.3 *Initial recognition of goodwill acquired*

When goodwill acquired is initially recorded (that is for the first time), in preparation of a change in the ownership structure of a partnership, the amount of goodwill is debited to the goodwill account and credited to the capital accounts of the existing partners according to their profit-sharing ratio.

When goodwill acquired was recorded in the books of a partnership in preparation of a change in the ownership structure thereof, the partners of the new partnership, when reporting to comply with the requirements of IFRS, may not reverse such goodwill with immediate effect.

3.4 The calculation of new profit-sharing ratios

A partner shares in the profits/losses of a partnership according to an agreed upon ratio. This ratio is referred to as a partner's interest (or share) in the profits/losses, or simply as a partner's profit share.

When a change in the ownership structure of a partnership occurs, it usually is necessary to determine a new profit-sharing ratio for the partners of the subsequent new partnership. Paragraphs 3.4.1 to 3.4.3 deal with such calculations under different circumstances.

3.4.1 *Calculation of a new profit-sharing ratio on admission of a partner*

On admission, a partner acquires an interest in the profits/losses of a partnership. This interest is *relinquished* to the new partner by the previous partners. The previous partners thus have to subtract the new partner's profit share from their previous profit shares. This subtraction is done according to a given ratio, as decided by the previous partners. Examples 3.3 to 3.5 illustrate such calculations.

Example 3.3 Calculation of a new profit-sharing ratio where the previous partners relinquished the new partner's profit share according to their previous profit-sharing ratio

Da Silva and Ehlers were in a partnership with a profit-sharing ratio of 2:3 respectively. They formed a new partnership by admitting Frasier. Frasier obtained a $^1/_5$ share in the profits/losses of the new partnership. Da Silva and Ehlers relinquished the $^1/_5$ share to Frasier according to their previous profit-sharing ratio, namely 2:3 respectively.

Required:

Calculate the profit-sharing ratio of the partners of the new partnership.

Solution:

Frasier's $^1/_5$ profit share must be subtracted from the previous profit shares of Da Silva and Ehlers according to an agreed upon ratio. In this example the agreed upon ratio of was given as the previous profit-sharing ratio of Da Silva and Ehlers, namely $^2/_5$ and $^3/_5$ respectively.

The calculation of the new profit-sharing ratios of Da Siva and Ehlers can be formulated as follows:

	Individual previous profit-sharing ratio	***minus***	**Profit-sharing ratio of new partner**	***times***	**Ratio according to which the new partner's profit share is relinquished**
Da Silva	$^2/_5$	–	($^1/_5$	×	$^2/_5$)
Ehlers	$^3/_5$	–	($^1/_5$	×	$^3/_5$)

According to the above, the new profit-sharing ratios of Da Silva and Ehlers are:

Da Silva $= {}^2/_5 - ({}^1/_5 \times {}^2/_5) = {}^2/_5 - {}^2/_{25}{}^* = {}^{10}/_{25}{}^* - {}^2/_{25} = {}^8/_{25}$

* The denominators of $^2/_5$ and $^2/_{25}$ are not equal. Before subtraction, the ratio with the smaller denominator, ie $^2/_5$, is adjusted to have the same denominator as $^2/_{25}$, as follows:

$$\frac{2 \times 5}{5 \times 5} = \frac{10}{25}$$

Ehlers $= {}^3/_5 - ({}^1/_5 \times {}^3/_5) = {}^3/_5 - {}^3/_{25} = {}^{15}/_{25} - {}^3/_{25} = {}^{12}/_{25}$

Frasier's profit share is given as $^1/_5 = {}^5/_{25}$. Therefore, the profit-sharing ratio of Da Silva, Ehlers and Frasier is 8:12:5 respectively.

Note that the sum of the individual profit-sharing ratios of all the partners of a partnership pertains to the entire partnership, and therefore always adds up to one. For example, in the above case of Da Silva, Ehlers and Frasier, the sum of their individual profit-sharing ratios is equal to:

$^8/_{25} + {}^{12}/_{25} + {}^5/_{25} = {}^{25}/_{25} = 1$

Example 3.4 Calculation of a new profit-sharing ratio where the previous partners relinquished the new partner's profit shares equally

Da Silva and Ehlers were in a partnership with a profit-sharing ratio of 2:3 respectively. They formed a new partnership by admitting Frasier. Frasier obtained a $^1/_5$ share in the profits/losses of the new partnership. Da Silva and Ehlers relinquished the $^1/_5$ share to Frasier equally.

Required:

Calculate the profit-sharing ratio of the partners of the new partnership.

Solution:

Da Silva and Ehlers relinquished Frasier's profit share equally. In other words, the ratio according to which they relinquished is 1:1. Da Silva and Ehlers therefore each relinquished $^1/_5 \times {}^1/_2 = {}^1/_{10}$ of their profit shares. By applying the above formula, the new profit-sharing ratio is calculated as follows:

Da Silva $= {}^2/_5 - ({}^1/_5 \times {}^1/_2) = {}^4/_{10} - {}^1/_{10} = {}^3/_{10}$
Ehlers $= {}^3/_5 - ({}^1/_5 \times {}^1/_2) = {}^6/_{10} - {}^1/_{10} = {}^5/_{10}$

Frasier's profit share is given as $^1/_5 = {}^2/_{10}$. The profit-sharing ratio of Da Silva, Ehlers and Frasier is thus 3:5:2 respectively.

Example 3.5 Calculation of a new profit-sharing ratio where the previous partners relinquished the new partner's profit share according to a ratio other than a previous profit-sharing or equal ratio

Da Silva and Ehlers were in a partnership with a profit-sharing ratio of 2:3 respectively. They formed a new partnership by admitting Frasier. Frasier obtained a $^1/_5$ share in the profits/losses of the new partnership. Da Silva and Ehlers relinquished the $^1/_5$ share to Frasier according to a ratio of 1:2 respectively.

Required:

Calculate the profit-sharing ratio of the partners of the new partnership.

Solution:

Da Silva and Ehlers relinquished Frasier's profit share according to the ratio of 1:2 respectively. In other words, Da Silva relinquished $^1/_3$ of Frasier's $^1/_5$ profit share, and Ehlers relinquished $^2/_3$ of Frasier's profit share.

Da Silva $= {^2/_5} - ({^1/_5} \times {^1/_3}) = {^6/_{15}} - {^1/_{15}} = {^5/_{15}}$
Ehlers $= {^3/_5} - ({^1/_5} \times {^2/_3}) = {^9/_{15}} - {^2/_{15}} = {^7/_{15}}$

Frasier's profit share was given as $^1/_5 = {^3/_{15}}$. The profit-sharing ratio of Da Silva, Ehlers and Frasier is 5:7:3 respectively.

3.4.2 *Calculation of a new profit-sharing ratio on the retirement or death of a partner*

When a partner has retired or died, and the remaining partners decide to proceed with the business activities of the partnership, they must take over the retired or deceased partner's profit share according to an agreed upon ratio.

Example 3.6 Calculation of a new profit-sharing ratio where the profit share of a deceased partner was taken over by the remaining partners according to their previous profit-sharing ratio

Murray, Smith and Louw were in a partnership with a profit-sharing ratio of 5:4:1 respectively. Louw died in a car accident. Murray and Smith decided to continue with the business activities of the partnership and hence a new partnership between Murray and Smith was formed. They agreed to take over Louw's profit share according to their previous profit-sharing ratio (Murray:Smith = 5:4).

Required:

Calculate the profit-sharing ratio of the partners of the new partnership.

Solution:

When a partner is admitted to a partnership, the existing partners each relinquish a portion of their profit share. When a partner retires or dies, the remaining partners each take over a portion of the retired or deceased partner's profit share.

The formula used in the above examples can also be applied to calculate a new profit-sharing ratio on the death or retirement of a partner. The only difference is that the retired or deceased partner's profit share that is taken over by the remaining partners is added to their profit shares.

	Individual previous profit-sharing ratio	***plus***	**Profit-sharing ratio of deceased partner**	***times***	**Ratio according to which profit share is taken over**
Murray	$^5/_{10}$	+	($^1/_{10}$	×	$^5/_9$)
Smith	$^4/_{10}$	+	($^1/_{10}$	×	$^4/_9$)

Murray $= {^5/_{10}} + ({^1/_{10}} \times {^5/_9}) = {^{45}/_{90}} + {^5/_{90}} = {^{50}/_{90}} = {^5/_9}$
Smith $= {^4/_{10}} + ({^1/_{10}} \times {^4/_9}) = {^{36}/_{90}} + {^4/_{90}} = {^{40}/_{90}} = {^4/_9}$

The profit-sharing ratio of Murray and Smith is 5:4 respectively.

Comment:

From the above solution, it can be noted that when a partner's profit share was taken over by the remaining partners according to the profit-sharing ratio which existed between the remaining partners, the new profit-sharing ratio of the remaining partners is the same as the ratio according to which the profit share was taken over. In this example, the ratio according to which Murray and Smith took over Louw's profit share (the last column in the above formula) was 5:4 respectively. Since this ratio is the same as the ratio that previously existed between Murray and Smith, (5:4:1 for Murray, Smith and Louw respectively, but 5:4 when considering only Murray and Smith) the new profit-sharing ratio remains the same.

3.4.3 *Calculation of a new profit-sharing ratio on the concurrent admission and retirement of a partner*

A partner is often admitted to a partnership to fully or partially obtain the interest of a retired (or deceased) partner. In such a case, a new profit-sharing ratio must be calculated to accommodate both the profit share that was gained on the retirement of a partner, and the profit share that was relinquished on the admission of a new partner.

Example 3.7 Calculation of a new profit-sharing ratio where a new partner was admitted to partially obtain the interest of a retired partner

Thava, Pinky and Thuli were in a partnership with a profit-sharing ratio of 2:2:1 respectively. Thava and Thuli admitted Eunice to the partnership the day after Pinky retired. Thava, Thuli and Eunice agreed that Eunice will take over half of Pinky's profit share, and that Thava and Thuli will take over the remaining half of Pinky's profit share equally.

Required:

Calculate the profit-sharing ratio of the partners of the new partnership.

Solution:

Pinky relinquished her entire profit share to Thava, Thuli and Eunice. Therefore, Pinky's entire profit share was subtracted from her existing profit share. Thava and Thuli each took over a portion of Pinky's share. These portions were thus added to their profit shares. Eunice was admitted as a new partner, and therefore her share of Pinky's profit was not added to a previous profit share.

Thava = $^{2}/_{5} + [(^{1}/_{2} \times ^{2}/_{5}) \times ^{1}/_{2}] = ^{2}/_{5} + ^{1}/_{10} = ^{4}/_{10} + ^{1}/_{10} = ^{5}/_{10}$
Thuli = $^{1}/_{5} + [(^{1}/_{2} \times ^{2}/_{5}) \times ^{1}/_{2}] = ^{1}/_{5} + ^{1}/_{10} = ^{2}/_{10} + ^{1}/_{10} = ^{3}/_{10}$
Eunice = $^{1}/_{2} \times ^{2}/_{5} = ^{2}/_{10}$
[Pinky = $^{2}/_{5} - ^{2}/_{5} = 0$]

The profit-sharing ratio of Thava, Thuli and Eunice is 5:3:2 respectively.

3.5 Recording a change in ownership structure by way of a personal transaction

A partner can, with the prior consent of the other existing partners, retire from a partnership by selling his interest personally (directly) to a new and/or existing partner(s). A personal transaction is a transaction that is made with an existing partner in his personal capacity, and not with the partnership as a business entity. Therefore, no valuation adjustment or goodwill acquired is recorded in the books of an existing partnership when a change in its ownership structure takes place by way of a personal transaction. However, the fair value of the partnership is still determined to set a selling price for the interest of the retiring partner in the partnership.

The only accounting entries that are usually made to record a change in the ownership structure of a partnership by way of a personal transaction, are the closing off of the applicable capital, current and drawings accounts of the retiring partner, and the opening of such accounts for the new partner.

When the entire interest of a partner was sold directly to a new partner, the profit-sharing ratio of the partners of the new partnership remains the same. For example, if Zack, Mack and Jack are in a partnership, sharing profits and losses in the ratio of 2:2:1 respectively, and Mack decides to sell his entire interest to Black, the profit-sharing ratio of Zack, Black and Jack will be 2:2:1 respectively. If two or more partners sell their entire interest directly to one new partner, the profit-sharing ratio of the new partnership will change, since the number of partners in the partnership has changed. For example, if Zack, Mack and Jack are in a partnership, sharing profits and losses in the ratio of 2:2:1 respectively, and Mack and Jack decide to sell their entire interest directly to Black, Black will obtain a total interest in the profit share of $^{2}/_{5} + ^{1}/_{5} = ^{3}/_{5}$. The profit-sharing ratio of Zack and Black will be 2:3 respectively.

Example 3.8 Recording the admission of a partner who purchased an interest from one partner by way of a personal transaction

Fisher and Green were in a partnership and had a profit-sharing ratio of 2:3 respectively. The partnership traded as Fisher & Green Partners. On 31 December 20.3, the financial year-end of the partnership, the books of the partnership were closed off, where after the credit balances of the current accounts of Fisher and Green amounted to R12 500 and R15 000 respectively, and the credit balances on the capital accounts of Fisher and Green amounted to R40 000 and R60 000 respectively. On 1 January 20.4, with the approval of Fisher, Green personally sold half of the balances on his capital and current accounts in the partnership to Hudson for a cash amount of R43 125. Hudson paid the R43 125 into the personal bank account of Green. The new partnership continued trading under the name of Fisher & Green Partners, and the accounting records of the dissolved partnership were continued to be used by the new partnership.

Required:

(a) Prepare the journal entry in the general journal of Fisher & Green Partners on 1 January 20.4 to record the transfer of the portion of the interest that was sold by Green to Hudson.

(b) Calculate the profit-sharing ratio of Fisher, Green and Hudson.

(c) Prepare the capital and current accounts of Fisher, Green and Hudson in the general ledger of Fisher & Green Partners on 1 January 20.4, after the above journal entry was posted to the general ledger.

Solution:

(a) **Fisher & Green Partners**
General journal

			Debit	Credit
20.4			R	R
Jan	1	Capital: Green (R60 000 × $^1/_2$)	30 000	
		Current account: Green (R15 000 × $^1/_2$)	7 500	
		Capital: Hudson		30 000
		Current account: Hudson		7 500
		Recording the purchase of half of Green's interest by Hudson by way of a personal transaction		

Comments:

☐ In this example, it can be concluded that Green determined that the fair value of the partnership is greater than the recorded net assets. (Recall that recorded net assets are equal to recorded equity.) He therefore charged more for half of the balances on his capital and current accounts. (Hudson paid R43 125 into the personal bank account of Green, but only R30 000 and R7 500 respectively were transferred to a capital and current account in his name.) Since Hudson was admitted by way of a personal transaction, the fair value of the partnership is not recorded in the books of the partnership. Note that the excess of R5 625 (R43 125 – R37 500) which Hudson paid is not forfeited by him, since he acquired a share in the fair value of the net assets, which can be realised in the future.

☐ If the current account of Green had a debit balance in closing, Green's current account would have been credited and Hudson's current account debited.

(b) Calculation of the profit-sharing ratio of Fisher, Green and Hudson

Fisher = $^2/_5 = ^4/_{10}$
Green = $^3/_5 - (^1/_2 \times ^3/_5) = ^6/_{10} - ^3/_{10} = ^3/_{10}$
Hudson = $^1/_2 \times ^3/_5 = ^3/_{10}$

The profit-sharing ratio of Fisher, Green and Hudson is 4:3:3 respectively.

(c) **Fisher & Green Partners**
General ledger

Dr **Capital: Fisher** **Cr**

					20.4 Jan	1	Balance	b/d	**R** 40 000

Dr **Capital: Green** **Cr**

20.4 Jan	1	Capital: Hudson		**R** 30 000	20.4 Jan	1	Balance	b/d	**R** 60 000

Dr **Capital: Hudson** **Cr**

					20.4 Jan	1	Capital: Green		**R** 30 000

Dr **Current account: Fisher** **Cr**

					20.4 Jan	1	Balance	b/d	**R** 12 500

Dr **Current account: Green** **Cr**

20.4 Jan	1	Current account: Hudson		**R** 7 500	20.4 Jan	1	Balance	b/d	**R** 15 000

Dr **Current account: Hudson** **Cr**

					20.4 Jan	1	Current account: Green		**R** 7 500

Comment:

The sum of the capital and current account balances of Fisher and Green prior to the admission of Hudson is R127 500 (R40 000 + R60 000 + R12 500 + R15 000). This amount is equal to the sum of the capital and current account balances of Fisher, Green and Hudson (R40 000 + R30 000 + R30 000 + R12 500 + R7 500 + R7 500 = R127 500), because Hudson purchased a portion of Green's interest and therefore did not make an *additional* contribution to the assets of the partnership.

Example 3.9 Recording the admission of a new partner who purchased an interest from more than one partner by way of a personal transaction

Fisher and Green were in a partnership trading as Fisher & Green Partners, with a profit-sharing ratio of 2:3 respectively. The financial year-end of Fisher & Green Partners is 31 December. On 31 December 20.3, after the books of Fisher & Green Partners were closed off according to the accounting policy of the partnership, the following accounts were recorded in the trial balance of Fisher & Green Partners:

	R
Furniture and equipment	65 000
Vehicles	70 000
Trade receivables control	8 500
Bank (favourable)	19 000
Capital: Fisher	40 000
Capital: Green	60 000
Current account: Fisher (Cr)	12 500
Current account: Green (Cr)	15 000
Trade payables control	35 000

Fisher and Green decided to each sell a $1/3$ share of their equity in Fisher & Green Partners to Hudson in their personal capacity for a total cash amount of R48 875. On 1 January 20.4, Hudson deposited the amounts due to Fisher and Green into their personal bank accounts. The new partnership continued to trade as Fisher & Green Partners, and the books of the dissolved partnership were continued to be used by the new partnership.

Required:

(a) Prepare the journal entry in the general journal of Fisher & Green Partners on 1 January 20.4 to record the change in the ownership structure of the partnership.

(b) Calculate the profit-sharing ratio of Fisher, Green and Hudson.

(c) Prepare the capital and current accounts of Fisher, Green and Hudson in the general ledger of Fisher & Green Partners on 1 January 20.4, after the journal entry to record the change in the ownership structure of the partnership was posted to the general ledger.

Solution:

(a)

Fisher & Green Partners
General journal

			Debit	Credit
20.4			R	R
Jan	1	Capital: Fisher (R40 000 × $1/3$)	13 333*	
		Capital: Green (R60 000 × $1/3$)	20 000	
		Current account: Fisher (R12 500 × $1/3$)	4 167*	
		Current account: Green (R15 000 × $1/3$)	5 000	
		Capital: Hudson R(13 333 + 20 000)		33 333
		Current account: Hudson R(4 167 + 5 000)		9 167
		Recording the purchase of $1/3$ of Fisher's and $1/3$ of Green's equity in Fisher & Green Partners by Hudson by way of a personal transaction		

* Rounded off to the nearest Rand.

(b) Calculation of the profit-sharing ratio of Fisher, Green and Hudson

Fisher $= \frac{2}{5} - (\frac{2}{5} \times \frac{1}{3}) = \frac{6}{15} - \frac{2}{15} = \frac{4}{15}$
Green $= \frac{3}{5} - (\frac{3}{5} \times \frac{1}{3}) = \frac{9}{15} - \frac{3}{15} = \frac{6}{15}$
Hudson $= (\frac{2}{5} \times \frac{1}{3}) + (\frac{3}{5} \times \frac{1}{3}) = \frac{2}{15} + \frac{3}{15} = \frac{5}{15}$

The new profit-sharing ratio of Fisher, Green and Hudson is 4:6:5 respectively.

(c) **Fisher & Green Partners**
General ledger

Dr **Capital: Fisher** **Cr**

20.4				**R**	20.4				**R**
Jan	1	Capital: Hudson		13 333	Jan	1	Balance	b/d	40 000

Dr **Capital: Green** **Cr**

20.4				**R**	20.4				**R**
Jan	1	Capital: Hudson		20 000	Jan	1	Balance	b/d	60 000

Dr **Capital: Hudson** **Cr**

					20.4				**R**
					Jan	1	Capital: Fisher		13 333
							Capital: Green		20 000

Dr **Current account: Fisher** **Cr**

20.4				**R**	20.4				**R**
Jan	1	Current account:			Jan	1	Balance	b/d	12 500
		Hudson		4 167					

Dr **Current account: Green** **Cr**

20.4				**R**	20.4				**R**
Jan	1	Current account:			Jan	1	Balance	b/d	15 000
		Hudson		5 000					

Dr **Current account: Hudson** **Cr**

					20.4				**R**
					Jan	1	Current account:		
							Fisher		4 167
							Current account:		
							Green		5 000

3.6 Recording a change in ownership structure by way of a transaction with the partnership

Recording a change in the ownership structure of a partnership by way of a transaction that was made with the partnership is more comprehensive than recording a change in ownership that took place by way of a personal transaction. In this chapter, two accounting procedures are suggested as guidelines to record a change in the ownership structure of a partnership when the transaction was made with the partnership. Each procedure is based on a distinct perspective, namely the legal and the going-concern perspective. These perspectives were referred to in some of the previous paragraphs, and are hereby shortly explained:

- *The legal perspective*: From this perspective, the dissolved and the subsequent new partnership are viewed and accounted for as two separate business entities. According to this viewpoint, in this chapter, the books of an existing partnership are closed off entirely and the new partnership commences with a new set of books. The new partnership does not reverse the valuation adjustments or other accounting entries that were made in the books of the dissolved partnership specifically in preparation of its change in ownership structure. An exception in this regard is the reinstatement of a revaluation surplus because it forms part of the equity of a partnership – the reinstatement thereof will not change the equity interest of a partner in a partnership. In this chapter, to draw a clear distinction between a dissolved and a subsequent new partnership, each partnership trades under a different name.
- *The going-concern perspective*: From this perspective, the business activities of the dissolved and the new partnership are reported on as if the partnerships are a single business entity. According to this viewpoint, in this chapter, the books of the dissolved partnership are continued to be used by the new partnership.

  If a change in the ownership structure of an existing partnership takes place during a financial year, no interim adjustments are made in order to close off the books according to normal accounting procedure. The only entries that are made in the books of the existing partnership are those that pertain to the recording of the preparation of the change in its ownership structure.

  If the change takes place at the end of a financial year, the books of the existing partnership are closed off according to normal accounting procedure. In addition, the entries that pertain to the preparation of the change in its ownership structure are made, where after the balances of the statement of financial position accounts are brought down as the opening balances of the new partnership.

  In this chapter, the new partnership trades under the same name as the previous partnership, and all valuation adjustments and goodwill recorded in preparation of the change in the ownership structure, are reversed.

  A discrepancy in this approach is that the accounting transactions of two partnerships are recorded in one set of books. For this reason it is recommended that, if a change in ownership structure took place during a financial year, the statement of profit or loss and other comprehensive income in respect of that financial year differentiates between the two partnerships. Example 3.14 illustrates the preparation of such a statement.

3.6.1 *Accounting procedure based on the legal perspective*

In this chapter, this accounting procedure is applied to record the admission, retirement or death of a partner. Examples 3.10 to 3.12 illustrate the recording of changes in the ownership structure of partnerships from the legal perspective.

☐ **Accounting entries to be made in the books of the existing partnership**

Comment:

It is assumed that these entries are made on the last date of the partnership's existence. The last date of a partnership's existence is regarded as the date of the dissolution thereof. For example, if a partner is going to be admitted to a partnership on 1 January 20.5, the last date of the existence of the partnership, and therefore the date of its dissolution, is regarded as 31 December 20.4. The retirement date (or the date of death) of a partner is regarded as the last date on which such a partner will function as a partner in the partnership. This date is thus the last date of the existing partnership. For example, if a partner retired (or died) on 31 December 20.5, the last date of the existence of the partnership, or the date of its dissolution, is 31 December 20.5.

Step 1: Close off the books of the existing partnership and prepare a preliminary statement of financial position.

To simplify matters, this step is not required in the relevant examples. However, for background purposes, note that such a closing off procedure includes:

☐ the recording of any necessary financial period or year-end adjustments according to the accounting policy of the partnership, such as the recording of depreciation, prepayments or accrued amounts; and thereafter

☐ the closing off of the nominal accounts of the partnership; and

☐ the closing off of any drawings accounts to the current accounts of the partners.

After the above closing off procedure is completed, only accounts to be disclosed on the statement of financial position remain in the general ledger of the existing partnership. A preliminary statement of financial position can thus be prepared as the starting point from which any further accounting entries can be made in the books of the existing partnership in preparation of its change in ownership structure.

Step 2: Close off the balances of any current accounts to the capital accounts of the partners.

Should a current account have a credit balance in closing, this amount is debited in the current account and the relevant capital account is credited. Should a current account have a debit balance in closing, this amount is credited in the current account and the relevant capital account is debited.

Step 3: Apportion any revaluation surplus to the capital accounts of the partners according to their profit-sharing ratio.

The balance of a revaluation surplus account is debited in the revaluation surplus account and credited to the capital accounts of the existing partners (including to the capital account of a retired/deceased partner) according to the profit-sharing ratio of the partners.

Step 4: Record any valuation adjustments of recorded assets and liabilities in a valuation account.

If necessary, refer to paragraph 3.2, where valuation adjustments are discussed.

Step 5: Record goodwill, initially acquired.

Goodwill is discussed in paragraph 3.3.

Step 6: Record the dissolution of the partnership.

☐ In the case of the admission of a partner, the accounts to be disclosed on the statement of financial position are closed off to a transferral account.

☐ In the case of the retirement (or death) of a partner:

- the capital account (this chapter deals only with favourable capital accounts) of the retired (or deceased) partner is closed off in the books of the existing partnership on the date of its dissolution. The balance of the capital account of the retired (or deceased) partner can be settled on this date. For example, if a capital account is settled with a cash repayment, the capital account is debited with the closing balance thereof, and the bank account of the partnership credited. If the settlement of the capital account is postponed, the balance of the capital account is closed off to a loan (or estate) account in the name of the retired (or deceased) partner by debiting the capital account with the balance thereof, and crediting a loan (or estate) account in the name of the retired (or deceased) partner with this amount; and
- thereafter the accounts to be disclosed on the statement of financial position are closed off to a transferral account.

☐ **Accounting entries to be made in the books of the new partnership**

Comment:

In this chapter, the following entries are made on the date of the formation of the new partnership, which is the day after the existing partnership dissolved.

Step 7: Record the formation of the new partnership.
Record the assets, equity and liabilities that were contributed by the remaining partners of the dissolved partnership. Since this step deals with the recording of *capital* contributions, each asset and liability is apportioned according to the capital ratio of the contributing partners, and not according to their profit-sharing ratio.

In the case of the admission of a partner, the contribution of this partner is also recorded.

Step 8: Adjust the applicable capital account balances of the partners of the new partnership to the same ratio as their profit-sharing ratio, if so decided by the partners of the new partnership.

The calculation and recording of such adjustments are illustrated in Examples 3.10 and 3.11.

Example 3.10 The purchase of an interest in a partnership from the partnership without recording valuation adjustments

Ismael and Julyan traded as Ismael & Julyan Partners, and they shared profits/losses in the ratio of 2:3 respectively. They decided to admit Khoza as a partner as from 1 July 20.3. It was arranged that Khoza would pay R67 500 in cash for a $^1/_3$ interest in the net assets (equity) and a $^1/_3$ interest in the profits/losses of the new partnership. Ismael and Julyan agreed to each relinquish a portion of their interest in the profits/losses of Ismael & Julyan Partners to Khoza according to their profit-sharing ratio of 2:3, respectively.

At 30 June 20.3, the books of Ismael & Julyan Partners were closed off, where after the following preliminary statement of financial position was prepared:

Ismael & Julyan Partners
Statement of financial position as at 30 June 20.3

	R
ASSETS	
Non-current assets	95 000
Property, plant and equipment (Furniture and equipment)	95 000
Current assets	80 000
Inventories	22 000
Trade and other receivables (Trade receivables control)	28 000
Cash and cash equivalents (Bank)	30 000
Total assets	175 000
EQUITY AND LIABILITIES	
Total equity	135 000
Capital	98 500
Current accounts	36 500
Total liabilities	40 000
Current liabilities	40 000
Trade and other payables (Trade payables control)	40 000
Total equity and liabilities	175 000

The above balances of the capital and current accounts of Ismael and Julyan were compiled as follows:

Capital accounts		**Current accounts**	
Ismael	**Julyan**	**Ismael**	**Julyan**
R	**R**	**R**	**R**
39 400	59 100	28 100	8 400

According to the accounting policy of Ismael and Julyan Partners, the property, plant and equipment were recorded at historical cost and not at fair value. Credit losses were not provided for. After the above statement of financial position was prepared, Ismael and Julyan decided, in preparation for the admission of Khoza, to value the property, plant and equipment and the debtors. An appraiser determined that the fair values thereof were equal to the amounts at which these assets were disclosed. It was decided that the books of Ismael & Julyan Partners would not be used by the new partnership.

On 1 July 20.3, Khoza paid R67 500 into the bank account of the partnership, and the new partnership started to trade as Ismael, Julyan & Khoza Partners. Ismael, Julyan and Khoza decided to keep their capital account balances in the same ratio as their profit-sharing ratio. Any refunds or contributions to the capital accounts must be made in cash.

Required:

(a) Prepare the journal entries on 30 June 20.3 in the general journal of Ismael & Julyan Partners to prepare for the admission of Khoza as a partner, and to record the dissolution of Ismael & Julyan Partners. (Apply and indicate Steps 2 to 6 of the accounting procedure based on the legal perspective.)

(b) Prepare the transferral account in the general ledger of Ismael & Julyan Partners on 30 June 20.3, after the above journal entries were posted to the general ledger.

(c) Prepare the journal entries on 1 July 20.3 in the general journal of Ismael, Julyan & Khoza Partners to record the formation of the new partnership and to give effect to the decisions which pertain to the accounting policy of the new partnership, and/or to the new partnership agreement. (Apply and indicate Steps 7 and 8 of the accounting procedure based on the legal perspective.)

(d) Prepare the capital accounts of the partners in the general ledger of Ismael, Julyan & Khoza Partners on 1 July 20.3, after the journal entries as required in (c) were posted to the relevant general ledger accounts.

Solution:

(a) Journal entries to prepare for the admission of Khoza as a partner, and to record the dissolution of Ismael & Julyan Partners

Step 2: Close the balances of the current accounts of Ismael and Julyan off to their capital accounts.

Ismael & Julyan Partners
General journal

			Debit	Credit
20.3			**R**	**R**
Jun	30	Current account: Ismael	28 100	
		Current account: Julyan	8 400	
		Capital: Ismael		28 100
		Capital: Julyan		8 400
		Closing off the balances of the current accounts of Ismael and Julyan to their capital accounts		

Comment:

After the above journal entry is posted to the general ledger, the credit balances of the capital accounts of Ismael and Julyan amount to:

		R
Capital: Ismael	R(39 400 + 28 100)	67 500
Capital: Julyan	R(59 100 + 8 400)	67 500

Step 3: Apportion any revaluation surplus to the capital accounts of Ismael and Julyan according to their profit-sharing ratio.

There is no revaluation surplus, therefore this step is not applicable.

Step 4: Record any valuation adjustments in a valuation account.

Since the fair value and the disclosed amounts of the assets on the statement of financial position are equal, no valuation adjustments have to be recorded.

Step 5: Record goodwill, initially acquired.

Firstly, the amount of goodwill must be calculated. According to the formula given in paragraph 3.3.2, the goodwill acquired is calculated as follows:

> (The capital contribution of the new partner *multiplied* by the inverse of the partner's share in the equity of the new partnership)
>
> *minus*
>
> the equity of the new partnership (on the date of formation, prior to the recording of goodwill acquired)
>
> *equals*
>
> goodwill acquired

(R67 500 × 3) – R(67 500 + 67 500 + 67 500) = R(202 500 – 202 500) = nil

No goodwill was acquired; therefore no journal entry is made in this regard.

Step 6: Record the dissolution of Ismael & Julyan Partners.

Ismael & Julyan Partners
General journal

			Debit	Credit
20.3			R	R
Jun	30	Transferral account	175 000	
		Furniture and equipment		95 000
		Inventory		22 000
		Trade receivables control		28 000
		Bank		30 000
		Closing off the balances of the asset accounts to the transferral account to record the dissolution of the partnership		
		Capital: Ismael	67 500	
		Capital: Julyan	67 500	
		Trade payables control	40 000	
		Transferral account		175 000
		Closing off the balances of the equity and liability accounts to the transferral account to record the dissolution of the partnership		

(b) **Ismael & Julyan Partners**
General ledger

Dr **Transferral account** **Cr**

20.3				R	20.3				R
Jun	30	Furniture and equipment		95 000	Jun	30	Capital: Ismael		67 500
		Inventory		22 000			Capital: Julyan		67 500
		Trade receivables control		28 000			Trade payables control		40 000
		Bank		30 000					
				175 000					175 000

(c) Journal entries to record the formation of Ismael, Julyan & Khoza Partners, and to give effect to any further decisions pertaining to the accounting policy of the new partnership and/or to the new partnership agreement

Step 7: Record the formation of Ismael, Julyan & Khoza Partners.

Ismael, Julyan & Khoza Partners
General journal

			Debit	Credit
20.3			R	R
Jul	1	Furniture and equipment (R95 000 × 1/2*)	47 500	
		Inventory (R22 000 × 1/2)	11 000	
		Trade receivables control (R28 000 × 1/2)	14 000	
		Bank (R30 000 × 1/2)	15 000	
		Trade payables control (R40 000 × 1/2)		20 000
		Capital: Ismael		67 500
		Recording the capital contribution of Ismael		
		Furniture and equipment (R95 000 × 1/2)	47 500	
		Inventory (R22 000 × 1/2)	11 000	
		Trade receivables control (R28 000 × 1/2)	14 000	
		Bank (R30 000 × 1/2)	15 000	
		Trade payables control (R40 000 × 1/2)		20 000
		Capital: Julyan		67 500
		Recording the capital contribution of Julyan		
		Bank	67 500	
		Capital: Khoza		67 500
		Recording the cash capital contribution of Khoza		

* The contributions of Ismael and Julyan are apportioned according to their capital ratio. With reference to the second journal entry of Step 6, their capital accounts are R67 500 each; R135 000 in total. The capital ratio of Ismael and Julyan is thus 1:1 (R67 500 / R135 000 = 1/2).

Step 8: Adjust the capital account balances of the partners to be in the same ratio as their profit-sharing ratio, if so decided by Ismael, Julyan and Khoza.

Ismael, Julyan & Khoza Partners
General journal

			Debit	Credit
20.3			R	R
Jul	1	Capital: Ismael	13 500①	
		Bank		13 500
		Recording the cash repayment to Ismael so as to bring the capital account ratio in the same ratio as the profit-sharing ratio		
		Bank	13 500①	
		Capital: Julyan		13 500
		Recording the contribution of Julyan so as to bring the capital account ratio in the same ratio as the profit-sharing ratio		

Calculation:

① Amount to be adjusted in the capital account balances of Ismael and Julyan

The sum of the capital contributions of Ismael, Julyan and Khoza is R202 500 (R67 500 + R67 500 + R67 500). Note that in the case of an admission, the sum of the capital contributions can also be calculated by multiplying the contribution of the new partner with the inverse of his share in the net assets (equity) of the new partnership (R67 500 × 3 = R202 500). This amount must be apportioned according to the profit-sharing ratio of the partners of the new partnership to calculate what the capital account balances of the partners must be so that their capital ratio is equal to their profit-sharing ratio:

		R
Capital: Ismael	R202 500 × $^4/_{15}$❶ =	54 000
Capital: Julyan	R202 500 × $^6/_{15}$❶ =	81 000
Capital: Khoza	R202 500 × $^5/_{15}$❶ =	67 500
		202 500

Should any of the *recorded* capital account balances in the general ledger of Ismael, Julyan and Khoza differ from the amounts *as calculated* above, the capital account balances must be adjusted.

Difference between the recorded and calculated capital account balances:

	Recorded capital account balance	Calculated capital account balance according to profit-sharing ratio	Difference
	R	R	R
Ismael	67 500	54 000	13 500
Julyan	67 500	81 000	(13 500)
Khoza	67 500	67 500	–

The balances of Ismael and Julyan differ. The recorded capital account balance of Ismael must be decreased by refunding R13 500 to him. The recorded capital account balance of Julyan must be increased by receiving a cash contribution of R13 500 from him.

Calculation:

❶ The profit-sharing ratio of Ismael, Julyan and Khoza

Ismael = $^2/_5 - (^1/_3 \times {}^2/_5) = {}^6/_{15} - {}^2/_{15} = {}^4/_{15}$
Julyan = $^3/_5 - (^1/_3 \times {}^3/_5) = {}^9/_{15} - {}^3/_{15} = {}^6/_{15}$
Khoza = $^1/_3$ [or $(^1/_3 \times {}^2/_5) + (^1/_3 \times {}^3/_5) = {}^2/_{15} + {}^3/_{15}$] = $^5/_{15}$

The profit-sharing ratio of Ismael, Julyan and Khoza is 4:6:5 respectively.

(d) Ismael, Julyan & Khoza Partners

General ledger

Dr **Capital: Ismael** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Trade payables control		20 000	Jul	1	Furniture and equipment		47 500
		Bank		13 500			Inventory		11 000
		Balancing amount		*54 000*			Trade receivables control		14 000
							Bank		15 000

Dr **Capital: Julyan** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Trade payables control		20 000	Jul	1	Furniture and equipment		47 500
		Balancing amount		*81 000*			Inventory		11 000
							Trade receivables control		14 000
							Bank R(15 000 + 13 500)		28 500

Dr **Capital: Khoza** **Cr**

					20.3				**R**
					Jul	1	Bank		67 500

Example 3.11 The purchase of an interest in a partnership from the partnership with the recording of goodwill, initially acquired

Use the same information as given in Example 3.10, but with the exception that Khoza has to pay R75 000 for his interest in the new partnership.

Required:

Use the same requirements as in Example 3.10.

Solution:

(a) Journal entries to prepare for the admission of Khoza as a partner, and to record the dissolution of Ismael & Julyan Partners

Steps 2 to 4: These solutions are the same as the solutions to Steps 2 to 4 in respect of (a) in Example 3.10.

Step 5: Record goodwill, initially acquired.

Ismael & Julyan Partners

General journal

			Debit	**Credit**
20.3			**R**	**R**
Jun	30	Goodwill	15 000①	
		Capital: Ismael (R15 000 × $^2/_5$)		6 000
		Capital: Julyan (R15 000 × $^3/_5$)		9 000
		Recording goodwill in preparation of the admission of Khoza		

Calculation:

① **Goodwill**

R(75 000 × 3) – R(67 500* + 67 500* + 75 000) = R(225 000 – 210 000) = R15 000

* Refer to the comment after the application of Step 2 in the solution to Example 3.10.

Comment:

After the journal entries in respect of Steps 2 and 5 are posted to the general ledger, the credit balances of the capital accounts of Ismael and Julyan amount to:

		R
Capital: Ismael	R(67 500 + 6 000)	73 500
Capital: Julyan	R(67 500 + 9 000)	76 500

Step 6: Record the dissolution of Ismael & Julyan Partners.

Ismael & Julyan Partners
General journal

			Debit	Credit
20.3			R	R
Jun	30	Transferral account	190 000	
		Furniture and equipment		95 000
		Goodwill		15 000
		Inventory		22 000
		Trade receivables control		28 000
		Bank		30 000
		Closing off the balances of the asset accounts to the transferral account to record the dissolution of the partnership		
		Capital: Ismael	73 500	
		Capital: Julyan	76 500	
		Trade payables control	40 000	
		Transferral account		190 000
		Closing off the balances of the equity and liability accounts to the transferral account to record the dissolution of the partnership		

(b)

Ismael & Julyan Partners
General ledger

Dr **Transferral account** **Cr**

20.3				R	20.3				R
Jun	30	Furniture and equipment		95 000	Jun	30	Capital: Ismael		73 500
		Goodwill		15 000			Capital: Julyan		76 500
		Inventory		22 000			Trade payables control		40 000
		Trade receivables control		28 000					
		Bank		30 000					
				190 000					190 000

(c) Journal entries to record the formation of Ismael, Julyan & Khoza Partners, and to give effect to any further decisions pertaining to the accounting policy of the new partnership and/or to the new partnership agreement

Step 7: Record the formation of Ismael, Julyan & Khoza Partners.

Ismael, Julyan & Khoza Partners
General journal

			Debit	Credit
20.3			R	R
Jul	1	Furniture and equipment	46 550	
		(R95 000 × 73 500/150 000)		
		Goodwill (R15 000 × 73 500/150 000)	7 350	
		Inventory (R22 000 × 73 500/150 000)	10 780	
		Trade receivables control	13 720	
		(R28 000 × 73 500/150 000)		
		Bank (R30 000 × 73 500/150 000)	14 700	
		Trade payables control		19 600
		(R40 000 × 73 500/150 000)		
		Capital: Ismael		73 500
		Recording the capital contribution of Ismael		
		Furniture and equipment	48 450	
		(R95 000 × 76 500/150 000)		
		Goodwill (R15 000 × 76 500/150 000)	7 650	
		Inventory (R22 000 × 76 500/150 000)	11 220	
		Trade receivables control	14 280	
		(R28 000 × 76 500/150 000)		
		Bank (R30 000 × 76 500/150 000)	15 300	
		Trade payables control		20 400
		(R40 000 × 76 500/150 000)		
		Capital: Julyan		76 500
		Recording the capital contribution of Julyan		
		Bank	75 000	
		Capital: Khoza		75 000
		Recording the cash capital contribution of Khoza		

Step 8: Adjust the capital account balances of the partners to be in the same ratio as their profit-sharing ratio, if so decided by Ismael, Julyan and Khoza.

Ismael, Julyan & Khoza Partners
General journal

			Debit	Credit
20.3			R	R
Jul	1	Capital: Ismael	13 500①	
		Bank		13 500
		Recording the cash repayment to Ismael so as to bring the capital account ratio in the same ratio as the profit-sharing ratio		

continued

			Debit	Credit
20.3			R	R
Jul	1	Bank	13 500①	
		Capital: Julyan		13 500
		Recording the contribution of Julyan so as to bring the capital account ratio in the same ratio as the profit-sharing ratio		

Calculation:

① **Amount to be adjusted in the capital account balances of Ismael and Julyan**

The sum of the capital contributions of Ismael, Julyan and Khoza is R225 000 [(R73 500 + R76 500 + R75 000) or (R75 000 × 3)]. This amount must be apportioned according to the profit-sharing ratio of the partners of the new partnership to calculate what the capital account balances of the partners must be so that their capital ratio is equal to their profit-sharing ratio:

		R
Capital: Ismael	R225 000 × $^4/_{15}$❶ =	60 000
Capital: Julyan	R225 000 × $^6/_{15}$❶ =	90 000
Capital: Khoza	R225 000 × $^5/_{15}$❶ =	75 000
		225 000

Should any of the *recorded* capital account balances in the general ledger of Ismael, Julyan and Khoza differ from the amounts *as calculated* above, the capital account balances must be adjusted.

Difference between the recorded and calculated capital account balances:

	Recorded capital account balance	Calculated capital account balance according to profit-sharing ratio	Difference
	R	R	R
Ismael	73 500	60 000	13 500
Julyan	76 500	90 000	(13 500)
Khoza	75 000	75 000	–

The balances of Ismael and Julyan differ. The recorded capital account balance of Ismael must be decreased by refunding R13 500 to him. The recorded capital account balance of Julyan must be increased by receiving a cash contribution of R13 500 from him. This adjustment is the same as the adjustment that was calculated in Step 8 of the solution to Example 3.10. The reason for this is that the goodwill was contributed to the partnership according to the capital ratio of the partners of the new partnership.

Calculation:

❶ **The profit-sharing ratio of Ismael, Julyan and Khoza**

Ismael = $^2/_5 - (^1/_3 \times ^2/_5) = ^6/_{15} - ^2/_{15} = ^4/_{15}$
Julyan = $^3/_5 - (^1/_3 \times ^3/_5) = ^9/_{15} - ^3/_{15} = ^6/_{15}$
Khoza = $^1/_3$ [or $(^1/_3 \times ^2/_5) + (^1/_3 \times ^3/_5) = ^2/_{15} + ^3/_{15}$] = $^5/_{15}$

The profit-sharing ratio of Ismael, Julyan and Khoza is 4:6:5 respectively.

(d)

Ismael, Julyan & Khoza Partners
General ledger

Dr **Capital: Ismael** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Trade payables control		19 600	Jul	1	Furniture and equipment		46 550
		Bank		13 500			Goodwill		7 350
		Balancing amount		*60 000*			Inventory		10 780
							Trade receivables control		13 720
							Bank		14 700

Dr **Capital: Julyan** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Trade payables control		20 400	Jul	1	Furniture and equipment		48 450
		Balancing amount		*90 000*			Goodwill		7 650
							Inventory		11 220
							Trade receivables control		14 280
							Bank R(15 300 + 13 500)		28 800

Dr **Capital: Khoza** **Cr**

					20.3				**R**
					Jul	1	Bank		75 000

Example 3.12 Recording the retirement and subsequent admission of a partner

Lock, Stock and Barrel were in a partnership, trading as Lock, Stock & Barrel Traders and sharing profits/losses in the ratio of 5:3:2 respectively. Barrel's retirement date was set as 30 June 20.4, which was also the financial year-end of Lock, Stock & Barrel Traders. Lock, Stock and Barrel agreed that the capital account of Barrel would be settled in full with a cash repayment on 30 June 20.4. Lock and Stock decided to take over Barrel's profit share according to their existing profit-sharing ratio of 5:3 respectively. Lock and Stock also decided to admit Jock to the partnership as from 1 July 20.4. It was agreed that Jock would pay R80 125 in cash for a $^1/_3$ of the equity of the new partnership, and that he would share in a $^1/_4$ of the profits/losses of the new partnership. Lock and Stock decided to relinquish the $^1/_4$ profit share to Jock equally.

On 30 June 20.4, the books of Lock, Stock & Barrel Traders were closed off, where after the following abridged preliminary statement of financial position was prepared:

Lock, Stock & Barrel Traders
Statement of financial position as at 30 June 20.4

	R
ASSETS	
Non-current assets	200 000
Property, plant and equipment	200 000
Current assets	100 000
Inventories	50 000
Trade and other receivables (Trade receivables control)	30 000
Cash and cash equivalents (Bank)	20 000
Total assets	300 000
EQUITY AND LIABILITIES	
Total equity	170 000
Capital	152 000
Current accounts	18 000
Total liabilities	130 000
Non-current liabilities	120 000
Long-term borrowings (Mortgage)	120 000
Current liabilities	10 000
Trade and other payables (Trade payables control)	10 000
Total equity and liabilities	300 000

The above balances of the capital and current accounts of Lock, Stock and Barrel were compiled as follows:

Capital accounts			**Current accounts**		
Lock R	**Stock R**	**Barrel R**	**Lock R**	**Stock R**	**Barrel R**
43 500	54 100	54 400	9 000	5 400	3 600

The property, plant and equipment of Lock, Stock & Barrel Traders were not recorded at fair value; the inventory was recorded at cost price, and no credit losses were provided for. In preparation of the dissolution of Lock, Stock & Barrel Traders, the following valuations/decisions were made:

- ☐ land and buildings, R240 000 (the property, plant and equipment as disclosed in the above statement of financial position consist of land and buildings at cost price, R180 000, and furniture and equipment at carrying amount, R20 000);
- ☐ inventory, R46 000 (net realisable value); and
- ☐ an allowance for credit losses to the amount of R1 500 must be created.

On 1 July 20.4, Jock's capital contribution of R80 125 was paid into the bank account of the partnership. The partners of the new partnership, namely Lock, Stock and Jock, decided to record the formation of their partnership from the legal perspective, trading as Lock, Stock & Jock Traders, and opened a new set of books for the partnership.

Required:

(a) Prepare the journal entries in the general journal of Lock, Stock & Barrel Traders on 30 June 20.4 to prepare for and record the dissolution of the partnership.

(b) Prepare the journal entries in the general journal of Lock, Stock & Jock Traders on 1 July 20.4 to record the formation of the new partnership and to give effect to the decisions of the partners of the new partnership.

(c) Prepare the statement of financial position of Lock, Stock & Jock Traders as at 1 July 20.4 according to the requirements of IFRS, appropriate to the business of the partnership. Notes and comparative figures are not required.

Solution:

Comment:

This example does not require disclosing the steps of the accounting procedure applied; they are nonetheless included for illustrative purposes.

(a) **Lock, Stock & Barrel Traders**
General journal

Step 1: Close off the books of the existing partnership and prepare a preliminary statement of financial position.

According to the given information, the books were closed off and the statement of financial position was prepared.

Step 2: Close off the balances of the current accounts to the capital accounts of the partners.

			Debit	Credit
20.4			**R**	**R**
Jun	30	Current account: Lock	9 000	
		Current account: Stock	5 400	
		Current account: Barrel	3 600	
		Capital: Lock		9 000
		Capital: Stock		5 400
		Capital: Barrel		3 600
		Closing off the balances of the current accounts of Lock, Stock and Barrel to their capital accounts		

Step 3: Not applicable.

Step 4: Record the valuation adjustments of the assets in a valuation account.

			Debit	Credit
20.4			R	R
Jun	30	Land and buildings R(240 000 – 180 000)	60 000	
		Inventory R(50 000 – 46 000)		4 000
		Allowance for credit losses		1 500
		Valuation account		54 500
		Recording the valuation adjustments in preparation of the change in ownership structure		
		Valuation account	54 500	
		Capital: Lock (R54 500 × 5/10)		27 250
		Capital: Stock (R54 500 × 3/10)		16 350
		Capital: Barrel (R54 500 × 2/10)		10 900
		Closing off the balancing amount of the valuation account to the capital accounts of Lock, Stock and Barrel according to their profit-sharing ratio		

Comment:

After the journal entries in respect of Steps 2 and 4 are posted to the general ledger, the credit balances of the capital accounts of Lock, Stock and Barrel amount to:

		R
Capital: Lock	R(43 500 + 9 000 + 27 250)	79 750
Capital: Stock	R(54 100 + 5 400 + 16 350)	75 850
Capital: Barrel	R(54 400 + 3 600 + 10 900)	68 900

Step 5: Record goodwill, initially acquired.

			Debit	Credit
20.4			R	R
Jun	30	Goodwill	4 650①	
		Capital: Lock (R4 650 × 5/10)		2 325
		Capital: Stock (R4 650 × 3/10)		1 395
		Capital: Barrel (R4 650 × 2/10)		930
		Recording goodwill in preparation of the retirement of Barrel and the admission of Jock		

Calculation:

① **Goodwill**

R(80 125 × 3) – R(79 750* + 75 850* + 80 125) = R(240 375 – 235 725) = R4 650

* Refer to the comment after the application of Step 4.

Comment:

After the journal entries in respect of Steps 2 to 5 are posted to the general ledger, the credit balances of the capital accounts of Lock, Stock and Barrel amount to:

		R
Capital: Lock	R(79 750 + 2 325)	82 075
Capital: Stock	R(75 850 + 1 395)	77 245
Capital: Barrel	R(68 900 + 930)	69 830

Step 6: Record the dissolution of the partnership. (Record the settlement of Barrel's capital account and close off all accounts to a transferral account.)

			Debit	Credit
20.4			R	R
Jun	30	Capital: Barrel	69 830	
		Bank		69 830
		Recording the cash paid to Barrel to settle his capital account		
		Transferral account	340 650	
		Land and buildings		240 000
		Furniture and equipment		20 000
		Goodwill		4 650
		Inventory		46 000
		Trade receivables control		30 000
		Closing off the balances of the asset accounts to the transferral account to record the dissolution of the partnership		
		Capital: Lock	82 075	
		Capital: Stock	77 245	
		Mortgage	120 000	
		Trade payables control	10 000	
		Allowance for credit losses	1 500	
		Bank [overdraft R(69 830 – 20 000)]	49 830	
		Transferral account		340 650
		Closing off the balances of the equity and liability accounts to the transferral account to record the dissolution of the partnership		

(b)

Lock, Stock & Jock Traders
General journal

Step 7: Record the formation of the new partnership.

			Debit	Credit
20.4			R	R
Jul	1	Land and buildings	123 638	
		(R240 000 × 82 075/159 320)		
		Furniture and equipment	10 303	
		(R20 000 × 82 075/159 320)		
		Goodwill (R4 650 × 82 075/159 320)	2 396	
		Inventory (R46 000 × 82 075/159 320)	23 697	
		Trade receivables control	15 455	
		(R30 000 × 82 075/159 320)		
		Mortgage (R120 000 × 82 075/159 320)		61 819
		Trade payables control		5 152
		(R10 000 × 82 075/159 320)		
		Bank [overdraft (R49 830 × 82 075/159 320)]		25 670
		Allowance for credit losses		773
		(R1 500 × 82 075/159 320)		
		Capital: Lock		82 075
		Recording the contribution of Lock		
		Land and buildings	116 362	
		(R240 000 × 77 245/159 320)		
		Furniture and equipment	9 697	
		(R20 000 × 77 245/159 320)		
		Goodwill (R4 650 × 77 245/159 320)	2 254	
		Inventory (R46 000 × 77 245/159 320)	22 303	
		Trade receivables control	14 545	
		(R30 000 × 77 245/159 320)		
		Mortgage (R120 000 × 77 245/159 320)		58 181
		Trade payables control		4 848
		(R10 000 × 77 245/159 320)		
		Bank [overdraft (R49 830 × 77 245/159 320)]		24 160
		Allowance for credit losses		727
		(R1 500 × 77 245/159 320)		
		Capital: Stock		77 245
		Recording the contribution of Stock		
		Bank	80 125	
		Capital: Jock		80 125
		Recording the contribution of Jock		

Comment:

Where necessary, the amounts in the above journal entries were rounded off to the nearest Rand.

Step 8: Adjust the applicable capital account balances of the partners of the new partnership to be in the same ratio as their profit-sharing ratio, if so decided by the partners of the partnership.

Since the ratio of the capital contribution of Jock ($1/3$ of the equity of the new partnership) is not equal to his profit-sharing ratio ($1/4$ of the profits/losses of the new partnership), it is concluded that the partners of the new partnership decided not to adjust their capital account balances to be in the same ratio as their profit-sharing ratio. Therefore, this step is not applied.

(c) Lock, Stock & Jock Traders
Statement of financial position as at 1 July 20.4

	R
ASSETS	
Non-current assets	264 650
Property, plant and equipment①	260 000
Goodwill②	4 650
Current assets	104 795
Inventories②	46 000
Trade and other receivables③	28 500
Cash and cash equivalents④	30 295
Total assets	369 445
EQUITY AND LIABILITIES	
Total equity	239 445
Capital⑤	239 445
Total liabilities	130 000
Non-current liabilities	120 000
Long-term borrowings⑥	120 000
Current liabilities	10 000
Trade and other payables⑥	10 000
Total equity and liabilities	369 445

Calculations:

① **Property, plant and equipment**

	R
Land and buildings	240 000
Furniture and equipment	20 000
	260 000

Refer to the journal entry of Step 6 for the amounts.

② **Goodwill and Inventories**

Refer to the journal entry of Step 6 for the amounts.

③ **Trade and other receivables**

	R
Trade receivables control	30 000
Allowance for credit losses	(1 500)
	28 500

Refer to the journal entries of Step 6 for the amounts.

④ **Cash and cash equivalents**

	R
Bank:	
Contribution by Jock	80 125
Overdraft of Lock and Stock	(49 830)
	30 295

Refer to the journal entries of Steps 6 and 7 for the amounts.

⑤ **Capital**

	R
Capital: Lock	82 075
Capital: Stock	77 245
Capital: Jock	80 125
	239 445

Refer to the journal entries of Step 7 for the amounts.

⑥ **Long-term borrowings and Trade and other payables**

	R
Long-term borrowings:	
Mortgage	120 000
Trade and other payables:	
Trade payables control	10 000

Refer to the journal entries of Step 6 for the amounts.

3.6.2 *Accounting procedure based on the going-concern perspective*

To simplify the illustration of this procedure, it is applied to deal only with the admission of a partner.

Comment:

Steps 1 to 4 of this procedure are recorded on the date of the dissolution of the existing partnership. Steps 5 to 9 are recorded on the date of the formation of the new partnership, ie the date on which the capital contribution (the admission) of the new partner is recorded.

Step 1: Prepare a pre-adjustment trial balance or a preliminary statement of financial position.

☐ **If the change in the ownership structure takes place during a financial period**

If a change in the ownership structure of a partnership takes place during a financial period, the books of the existing partnership are not closed off. (In this regard, "closed off" means closing off the accounts according to the accounting policy and procedures of the existing partnership as if administered at the end of a financial year/period. Refer to the description of the closing off procedure in paragraph 3.6.1, Step 1.) However, all the accounts are balanced in order to prepare a *pre-adjustment trial balance* which serves as a starting point in the recording of the fair value of the net assets of the existing partnership in preparation of its change in ownership structure.

Since the business activities of the two partnerships are recorded as a single business entity, the new partnership continues to use the books of the previous partnership. Therefore, accounting entries that pertain to the previous and the new partnerships are recorded in the same set of books, and reported on in the same set of financial statements.

☐ **If the change in the ownership structure takes place at the end of a financial period**

If a change in the ownership structure of a partnership takes place at the end of a financial period, the books of the existing partnership are closed off and the financial statements prepared accordingly. (In this regard, "closed off" means closing off the accounts according to the accounting policy and procedures of the existing partnership as if administered at the end of a financial year/period. Refer to the description of the closing off procedure in paragraph 3.6.1, Step 1.)

Since the business activities of the two partnerships are recorded as a single business entity, the new partnership will continue to use the books (which at this stage will only be the accounts to be disclosed on the statement of financial position) of the previous partnership. The balances of these accounts are therefore not closed off to a transferral account (as was the case with the accounting procedure which was applied according to the legal perspective), but brought down in the books as the opening balances of the new partnership. Note that the current accounts of the existing partners are not closed off to their capital accounts, as is the case with the accounting procedure based on the legal perspective. (Refer to paragraph 3.6.1, Step 2.)

To simplify matters, Step 1 is not required and is presented as part of the given information.

Step 2: Apportion (close off) the revaluation surplus to the capital accounts of the partners according to the existing profit-sharing ratio.

There are various methods according to which a revaluation surplus can be dealt with from a going-concern perspective. For example, the surplus account need not necessarily be closed off. To simplify matters, a revaluation surplus account is closed off when the going-concern perspective is applied.

Step 3: Record any valuation adjustments of the assets and liabilities in a valuation account.

Valuation adjustments are discussed in paragraph 3.2; please refer to this paragraph if necessary.

Step 4: Record goodwill, initially acquired.

Goodwill is discussed in paragraph 3.3; please refer to this paragraph if necessary.

Step 5: Record the change in the ownership structure of the partnership.

The contribution of the new partner is recorded in the relevant asset and liability account(s), as well as in the capital account of the new partner.

Step 6: Reinstate the revaluation surplus that was closed off in preparation of the change in ownership structure.

When a partnership undergoing a change in ownership structure is regarded as the same going concern before and after the change, the accounting policy and/or procedures of the partnership should not be adjusted solely to record a change that took place in the ownership structure thereof. Therefore, in this chapter, a revaluation surplus that was closed off is reinstated when the accounting procedure based on the going-concern perspective is applied. The surplus is debited to the capital accounts of the new partners according to the new profit-sharing ratio, and credited to the revaluation surplus account.

Step 7: Write back (reverse) the valuation adjustments that were made in the books of the partnership.

Similar to the reasoning in Step 6, in this chapter, any valuation adjustments that were recorded are reversed when an accounting procedure based on the going-concern perspective is applied. The reversal of valuation adjustments are discussed in paragraph 3.2.2.

Step 8: Write back the goodwill that was recorded.

In this chapter, the goodwill that was recorded in Step 4 is written back. Such reversal is done according to the new profit-sharing ratio.

Step 9: Adjust the capital ratio of the partners of the new partnership to be in the same ratio as their profit-sharing ratio, if so decided by the partners of the new partnership.

The objective of this step is to bring the equity (the interest of the partners in the partnership) of the partners in the same ratio as their profit-sharing ratio. Hereby, the partners will share in the total comprehensive income of the partnership according to their respective interests in the equity of the partnership. In this step, the capital ratio of the partners is determined only by their capital and current account balances, after the books of the partnership were closed off. It is unnecessary to apportion a revaluation surplus.

This step cannot be applied when a partner is admitted during a financial year, since the total comprehensive income pertaining to the dissolved partnership is only apportioned to the capital accounts of the partners (according to the previous profit-sharing ratio) at the financial year-end of the partnership. For example, when the financial year-end of a partnership is 31 December, and a change in its ownership structure takes place on 30 June, viewed from the going-concern perspective, the financial year-end of the partnership remains 31 December.

Example 3.13 Recording the purchase of an interest in a partnership from the going-concern perspective

Lamola and Meyer were trading as Lamola & Meyer Partners and they shared in the profits/losses in the ratio of 3:2 respectively. They decided to admit Nell as a partner as from 1 April 20.8, the date on which Nell would pay R25 500 into the bank account of the partnership and thereby acquire a $1/5$ interest in the profits/losses, as well as a $1/5$ interest in the equity of the new partnership. Lamola and Meyer decided that they would relinquish the $1/5$ interest in the profits/losses to Nell in the ratio of 3:1 respectively.

The financial year-end of the partnership is on 30 June. Lamola, Meyer and Nell decided to continue to use the books of Lamola and Meyer. Lamola and Meyer did not close off the books of the partnership on 31 March 20.8. The following list of balances was extracted from a pre-adjustment trial balance that was prepared for Lamola & Meyer Partners at 31 March 20.8:

List of balances as at 31 March 20.8

	R
Land and buildings	90 000
Furniture and equipment	13 000
Inventory	13 500
Trade receivables control	9 000
Bank (Favourable)	61 945
Capital: Lamola	36 000
Capital: Meyer	27 000
Current account: Lamola (Credit balance)	8 100
Current account: Meyer (Credit balance)	5 400
Revaluation surplus	10 000
Long-term loan	35 000
Trade payables control	10 725

Comment:

Since the nominal accounts of the partnership were not closed off, the sum of the debit balances and the sum of the credit balances of the accounts in the above list are unequal.

After the above list of balances was prepared, an appraiser made the following valuations on 31 March 20.8 in preparation of Nell's admission to the partnership:

- ☐ land and buildings, R90 000
- ☐ furniture and equipment (increase in valuation of office paintings), R27 700;
- ☐ inventory, R12 600;
- ☐ trade receivables control, R7 200 (to provide for credit losses); and
- ☐ trade payables control, R10 225 (due to a settlement discount offer which Lamola and Meyer intend to take up on 15 April 20.8).

On 1 April 20.8, Nell paid R25 500 into the bank account of the partnership. The new partnership continued to trade as Lamola & Meyer Partners. The partners of the new partnership decided on the following:

- ☐ the revaluation surplus of R10 000 must be reinstated;
- ☐ the valuation adjustments that were recorded must be written back (the new partners decided to forfeit the settlement discount that was offered);
- ☐ the goodwill that was recorded must be written back (reversed); and
- ☐ their capital ratio need not be the same as their profit-sharing ratio.

Required:

(a) Prepare the journal entries on 31 March 20.8 in the general journal of Lamola & Meyer Partners to prepare for the admission of Nell as a partner. (Apply and indicate Steps 2 to 4 of the accounting procedure based on the going-concern perspective.)

(b) Prepare the capital accounts of Lamola and Meyer in the general ledger of Lamola & Meyer Partners on 31 March 20.8, properly balanced, after the journal entries as required in (a) were posted to the relevant general ledger accounts.

(c) Prepare the journal entries on 1 April 20.8 in the general journal of Lamola & Meyer Partners to record the admission of Nell and to give effect to the decisions which pertain to the accounting policy and/or the new partnership agreement. (Apply and indicate Steps 5 to 8 of the accounting procedure based on the going-concern perspective.)

(d) Prepare the valuation account and the capital accounts of Lamola, Meyer and Nell in the general ledger of Lamola & Meyer Partners on 1 April 20.8, after the journal entries as required in (c) were posted to the relevant general ledger accounts. (For illustrative purposes, disclose these accounts as from 31 March 20.8.)

Solution:

Comment:

Since the partners of the new partnership decided:

- ☐ not to close off the books of the dissolved partnership;
- ☐ to reinstate the revaluation surplus, to reverse all the valuation adjustments and the goodwill that was created in preparation of the change in the ownership structure of the partnership; and
- ☐ to continue to trade under the same name as the dissolved partnership,

it is clear that the change in the ownership structure of the partnership must be recorded from the going-concern perspective.

(a) Journal entries to prepare for the admission of Nell as a partner

Lamola & Meyer Partners
General journal

Step 2: Apportion the revaluation surplus to the capital accounts of Lamola and Meyer.

			Debit	Credit
20.8			**R**	**R**
Mar	31	Revaluation surplus	10 000	
		Capital: Lamola (R10 000 × 3/5)		6 000
		Capital: Meyer (R10 000 × 2/5)		4 000
		Revaluation surplus apportioned to the capital accounts of Lamola and Meyer according to their profit-sharing ratio		

Step 3: Record the valuation adjustments of the assets in a valuation account.

			Debit	Credit
20.8			R	R
Mar	31	Furniture and equipment R(27 700 – 13 000)	14 700	
		Allowance for settlement discount received R(10 725 – 10 225)	500	
		Inventory R(13 500 – 12 600)		900
		Allowance for credit losses R(9 000 – 7 200)		1 800
		Valuation account		12 500
		Recording the valuation adjustments in preparation of the change in ownership structure		
		Valuation account	12 500	
		Capital: Lamola (R12 500 × 3/5)		7 500
		Capital: Meyer (R12 500 × 2/5)		5 000
		Closing off the balancing amount of the valuation account to the capital accounts of Lamola and Meyer according to their profit-sharing ratio		

Comment:

After the journal entries in respect of Steps 2 and 3 are posted to the general ledger:

☐ the credit balances of the capital accounts of Lamola and Meyer amount to:

	R
Capital: Lamola R(36 000 + 6 000 + 7 500)	49 500
Capital: Meyer R(27 000 + 4 000 + 5 000)	36 000

☐ the equity (in this example, the sum of the capital and the current account balances) of Lamola and Meyer are:

	R
Equity: Lamola R(49 500 + 8 100)	57 600
Equity: Meyer R(36 000 + 5 400)	41 400

Step 4: Record goodwill, initially acquired.

			Debit	Credit
20.8			R	R
Mar	31	Goodwill	3 000①	
		Capital: Lamola (R3 000 × 3/5)		1 800
		Capital: Meyer (R3 000 × 2/5)		1 200
		Recording goodwill in preparation of the admittance of Nell		

Calculation:

① **Goodwill**

R(25 500 × 5) – R(57 600* + 41 400* + 25 500) = R(127 500 – 124 500) = R3 000

* Refer to the comment after the application of Step 3.

(b)

Lamola & Meyer Partners
General ledger

Dr **Capital: Lamola** **Cr**

20.8				**R**	20.8				**R**
Mar	31	Balance	c/d	51 300	Mar	31	Balance	b/d	36 000
							Revaluation surplus		6 000
							Valuation account		7 500
							Goodwill		1 800
				51 300					51 300
					Apr	1	Balance	b/d	51 300

Dr **Capital: Meyer** **Cr**

20.8				**R**	20.8				**R**
Mar	31	Balance	c/d	37 200	Mar	31	Balance	b/d	27 000
							Revaluation surplus		4 000
							Valuation account		5 000
							Goodwill		1 200
				37 200					37 200
					Apr	1	Balance	b/d	37 200

(c)

Lamola & Meyer Partners
General journal

Step 5: Record the change in the ownership structure of the partnership. (Record the capital contribution made by Nell.)

			Debit	**Credit**
20.8			**R**	**R**
Apr	1	Bank	25 500	
		Capital: Nell		25 500
		Recording the cash capital contribution of Nell		

Step 6: Reinstate the revaluation surplus that was closed off in preparation of the change in ownership.

			Debit	**Credit**
20.8			**R**	**R**
Apr	1	Capital: Lamola (R10 000 × 9/20①)	4 500	
		Capital: Meyer (R10 000 × 7/20①)	3 500	
		Capital: Nell (R10 000 × 4/20①)	2 000	
		Revaluation surplus		10 000
		Revaluation surplus reinstated to the capital accounts of Lamola, Meyer and Nell according to their profit-sharing ratio		

continued

Calculation:

① **The profit-sharing ratio of Lamola, Meyer and Nell**

Lamola = $3/5 - (1/5 \times 3/4) = 12/20 - 3/20 = 9/20$
Meyer = $2/5 - (1/5 \times 1/4) = 8/20 - 1/20 = 7/20$
Nell = $1/5 = 4/20$

The profit-sharing ratio of Lamola, Meyer and Nell is 9:7:4 respectively.

Step 7: Write back the valuation adjustments that were recorded in the books of the partnership.

			Debit	Credit
20.8			R	R
Apr	1	Inventory	900	
		Allowance for credit losses	1 800	
		Valuation account	12 500	
		Furniture and equipment		14 700
		Allowance for settlement discount received		500
		Writing back the valuation adjustments		
		Capital: Lamola (R12 500 × 9/20)	5 625	
		Capital: Meyer (R12 500 × 7/20)	4 375	
		Capital: Nell (R12 500 × 4/20)	2 500	
		Valuation account		12 500
		Closing off the balancing amount of the valuation account to the capital accounts of the new partners according to the new profit-sharing ratio		

Step 8: Write back the goodwill that was recorded.

			Debit	Credit
20.8			R	R
Apr	1	Capital: Lamola (R3 000 × 9/20)	1 350	
		Capital: Meyer (R3 000 × 7/20)	1 050	
		Capital: Nell (R3 000 × 4/20)	600	
		Goodwill		3 000
		Writing back goodwill to the capital accounts of the new partners according to the new profit-sharing ratio		

(d)

Lamola & Meyer Partners
General ledger

Dr **Valuation account** **Cr**

20.8				R	20.8				R
Mar	31	Inventory		900	Mar	31	Furniture and equipment		14 700
		Allowance for credit losses		1 800			Allowance for settlement discount received		500
		Capital: Lamola		7 500					
		Capital: Meyer		5 000					
				15 200					15 200

continued

Dr **Valuation account** **Cr**

20.8				**R**	20.8				**R**
Apr	1	Furniture and equipment		14 700	Apr	1	Inventory		900
		Allowance for settlement discount received		500			Allowance for credit losses		1 800
							Capital: Lamola		5 625
							Capital: Meyer		4 375
							Capital: Nell		2 500
				15 200					15 200

Comment:

The entries on 31 March 20.8 pertain to the entries made in the books of the dissolved partnership, and the entries on 1 April 20.8 pertain to the new partnership.

Dr **Capital: Lamola** **Cr**

20.8				**R**	20.8				**R**
Mar	31	Balance	c/d	51 300	Mar	31	Balance	b/d	36 000
							Revaluation surplus		6 000
							Valuation account		7 500
							Goodwill		1 800
				51 300					51 300
Apr	1	Revaluation surplus		4 500	Apr	1	Balance	b/d	51 300
		Valuation account		5 625					
		Goodwill		1 350					
		Balancing amount		*39 825*					

Dr **Capital: Meyer** **Cr**

20.8				**R**	20.8				**R**
Mar	31	Balance	c/d	37 200	Mar	31	Balance	b/d	27 000
							Revaluation surplus		4 000
							Valuation account		5 000
							Goodwill		1 200
				37 200					37 200
Apr	1	Revaluation surplus		3 500	Apr	1	Balance	b/d	37 200
		Valuation account		4 375					
		Goodwill		1 050					
		Balancing amount		*28 275*					

Dr **Capital: Nell** **Cr**

20.8				**R**	20.8				**R**
Apr	1	Revaluation surplus		2 000	Apr	1	Bank		25 500
		Valuation account		2 500					
		Goodwill		600					
		Balancing amount		*20 400*					

Comment:

1 April 20.8 is the formation date of the new partnership. The capital accounts will thus not be balanced at this stage.

Example 3.14 Preparation of a statement of profit or loss and other comprehensive income when a change in the ownership structure took place during a financial year: going-concern perspective

The following pre-adjustment trial balance was prepared for Lamola & Meyer Partners at the financial year-end, 30 June 20.8.

Lamola & Meyer Partners
Pre-adjustment trial balance as at 30 June 20.8

	Debit	Credit
	R	R
Land and buildings	90 000	
Furniture and equipment at carrying amount	13 000	
Vehicle at cost (1 June 20.8)	48 000	
Inventory (1 July 20.7)	13 500	
Trade receivables control	12 000	
Bank	56 880	
Capital: Lamola		39 825
Capital: Meyer		28 275
Capital: Nell		20 400
Current account: Lamola		8 100
Current account: Meyer		5 400
Revaluation surplus		10 000
Long-term loan		35 000
Trade payables control		14 300
Sales		270 600
Sales returns	17 508	
Purchases	88 860	
Purchases returns		1 728
Salaries and wages	46 200	
Insurance expense	2 400	
Water and electricity	9 624	
Credit losses	1 600	
Rental expense	480	
General administrative expenses	21 936	
Stationery consumed	7 440	
Interest expense (Long-term loan)	4 200	
	433 628	433 628

Additional information:

1. On 30 June 20.8, the inventory on hand was R12 800.
2. Included in the salaries and wages is an amount of R3 000 paid as a salary to Nell for the financial year.
3. The credit losses were recorded on 1 March 20.8.

4. On 1 April 20.8, a rental agreement for storage space was entered into by the partnership with Rent-a-Space CC. The rental fee payable by Lamola & Meyer Partners amounted to R240 per month.
5. On 30 June 20.8 the partners of the new partnership decided to create an allowance for credit losses to the amount of R960.
6. Depreciation for the financial year on furniture and equipment, namely R1 300, and on the vehicle, namely R400, must still be recorded.
7. Interest on the long-term loan is charged at 12% per annum. The loan was obtained on 1 July 20.6 from Loyale Bank. The interest was paid on 1 July 20.7 and 1 January 20.8.
8. Interest on the average balance of each of the capital accounts over the financial year is payable at 12% per annum. Lamola and Meyer made no capital contributions or capital withdrawals during the financial year. Interest on the opening balances of the current accounts are payable at 10% per annum.

Required:

Prepare the statement of profit or loss and other comprehensive income of Lamola & Meyer Partners for the year ended 30 June 20.8 according to the requirements of IFRS, appropriate to the business of the partnership. Disclose two additional columns on the statement to differentiate between the statements of the new and the dissolved partnerships by apportioning the balances of the relevant items of Lamola & Meyer Partners between these two partnerships. Notes and comparative figures are not required. (Unless otherwise indicated, all the items must be apportioned to the dissolved and the new partnership on a time-proportionate basis.)

Solution:

(a) **Lamola & Meyer Partners**
Statement of profit or loss and other comprehensive income for the year ended 30 June 20.8

					Additional columns			
		Lamola & Meyer Partners (1/07/20.7 – 30/06/20.8)		**New partner-ship** (1/4/20.8 – 30/06/20.8)			**Dissolved partnership** (1/07/20.7 – 31/03/20.8)	
		R		**R**			**R**	
Revenue R(270 600 – 17 508)		253 092		63 273			189 819	
Cost of sales		(87 832)		(21 958)			(65 874)	
	Inventory (1 July 20.7)		13 500		12 975	①	13 500	
	Purchases R(88 860 – 1 728)		87 132		21 783		65 349	
			100 632		34 758		78 849	
	Inventory (30 June 20.8)		(12 800)		(12 800)		(12 975)	①
Gross profit		165 260		41 315			123 945	
Distribution, administrative and other expenses		(89 580)		(23 555)			(66 025)	
	Salaries and wages R(46 200 – 3 000)		43 200		10 800		32 400	
	Insurance expense		2 400		600		1 800	
	Water and electricity		9 624		2 406		7 218	
	Credit losses R(1 600 + 960)		2 560		960	②	1 600	②
	Rental expense R(480 + 240) or (R240 × 3)		720		720	③	–	③
	General administrative expenses		21 936		5 484		16 452	
	Stationery consumed		7 440		1 860		5 580	
	Depreciation R(1 300 + 400)		1 700		725	④	975	④
Finance costs		(4 200)		(1 050)			(3 150)	
	Interest on long-term loan (R35 000 × 12%)		4 200		1 050	⑤	3 150	⑤
Profit for the year/period		71 480		16 710			54 770	
Other comprehensive income		–		–			–	
Total comprehensive income for the year/period		71 480		16 710			54 770	

Comments:

- ☐ The calculations after the entries (first column) pertain to the whole financial year.
- ☐ The items that were apportioned on a time-proportionate basis were apportioned according to the ratios of $3/12$ (from 1 April 20.8 to 30 June 20.8; which is equal to three months) and $9/12$ (from 1 July 20.7 to 31 March 20.8; which is equal to nine months). For example, the cost of sales was apportioned as follows:

  1 April 20.8 – 30 June 20.8: R87 832 × $3/12$ = R21 958
  1 July 20.7 – 31 March 20.8: R87 832 × $9/12$ = R65 874

- ☐ Recall that income and expenses which pertain to the partners of a partnership are disclosed in the appropriation account. Therefore, the R3 000 included in the salaries and wages had to be subtracted because it pertains to the salary of a partner, which is disclosed on the statement of changes in equity for the financial year/period. Likewise, the interest on the capital and current accounts of the partners are not disclosed on the statement of profit or loss and other comprehensive income, but on the statement of changes in equity.
- ☐ The statement does not comply to all IFRS requirements, as the partnership does not disclose all assets and liabilities at fair value.

Calculations:

① **Inventory (31 March 20.8/1 April 20.8)**

The opening and closing balances of the inventory for the financial year were given as R13 500 and R12 800 respectively. The cost of sales and the purchases are calculated on a time-proportionate basis. Therefore, the closing balance of the inventory on 31 March 20.8 is calculated as follows: [Inventory (1 July 20.7) + Purchases] – Cost of sales R(78 849 – 65 874) = R12 975.

② **Credit losses**

☐ 1 July 20.7 – 31 March 20.8:

The given information states that R1 600 was written off as credit losses on 1 March 20.8. This amount therefore pertains to the above period.

☐ 1 April 20.8 – 30 June 20.8:

The given information states that an allowance for credit losses to the amount of R960 was created on 30 June 20.8. Since the R960 is based on the debtors as at 30 June 20.8, the entire amount is disclosed in the above period.

③ **Rental expense**

☐ 1 July 20.7 – 31 March 20.8:

Since the rental contract was entered into on 1 April 20.8, the rental expense does not pertain to Lamola and Meyer.

☐ 1 April 20.8 – 30 June 20.8:

The rental agreement was entered into for a period of three months, at R240 per month. Therefore, the rental expense that incurred is equal to R240 × 3 = R720. R480 of this amount was paid and R240 is accrued.

④ **Depreciation**

☐ 1 July 20.7 – 31 March 20.8:

Since the vehicle was purchased on 1 June 20.8, the depreciation in respect of the vehicle does not pertain to the above period.

Appropriation of the depreciation on the furniture and equipment:

R1 300 × $^{9}/_{12}$ = R975

- ☐ 1 April 20.8 – 30 June 20.8:

Vehicle: R400

Furniture and equipment: R1 300 × $^3/_{12}$ = R325

Total depreciation: R(400 + 325) = R725

⑤ **Interest on long-term loan**

Comment:

According to the accrual method of disclosure, the interest incurred for each period is disclosed, and not the interest paid.

- ☐ 1 July 20.7 – 31 March 20.8:
  R4 200 × $^9/_{12}$ = R3 150
- ☐ 1 April 20.8 – 30 June 20.8:
  R4 200 × $^3/_{12}$ = R1 050

3.7 Abridged case studies

Case study 1: Recording a change in the ownership structure of a partnership upon the admission of a partner at financial year-end by transacting with the partnership

Punch and Judy were in a partnership until 28 February 20.4, the financial year-end of the entity. They traded as Your Puppet Show and shared in the profits/losses of the partnership in the ratio of 2:1 for Punch and Judy respectively. Punch and Judy decided to admit Puppet as a partner from 1 March 20.4.

After the year-end adjustments were recorded according to the accounting policy of the partnership, and the nominal accounts closed off, the following preliminary statement of financial position was prepared [prior to the recording of the valuation adjustment (mentioned below) and the goodwill initially acquired]:

Your Puppet Show
Statement of financial position as at 28 February 20.4

	R
ASSETS	
Non-current assets	585 000
Property, plant and equipment	585 000
Current assets	143 625
Trade and other receivables (Trade receivables control)	3 125
Cash and cash equivalents	140 500
Total assets	728 625

continued

	R
EQUITY AND LIABILITIES	
Total equity	684 875
Capital	648 000
Current accounts	14 375
Other components of equity (Revaluation surplus)	22 500
Total liabilities	43 750
Current liabilities	43 750
Trade and other payables	43 750
Total equity and liabilities	728 625

In preparation of the change in the ownership structure of the partnership, an appraiser valued the equipment as R15 000 higher than the recorded carrying amount in the above statement of financial position, given an increase in the value of the entity's antique collection of puppets.

The balances of the capital and current accounts of Punch and Judy as disclosed in the above statement of financial position were compiled as follows:

Capital accounts		**Current accounts**	
Punch	**Judy**	**Punch**	**Judy**
R	**R**	**R**	**R**
447 500	200 500	(41 250)	55 625

On 1 March 20.4 Puppet deposited R178 000 into the bank account of the partnership for a 20% share in the net assets (equity), and a 10% interest in the profits/losses of the partnership between Punch, Judy and Puppet. Punch and Judy ventured into this new partnership with the same profit-sharing ratio as they had before 1 March 20.4, and relinquished the 10% interest of Puppet according to this ratio on this date.

Required:

(a) In preparation of the recording of the admission of Puppet, prepare the journal entry (narrative excluded) to account for the valuation of the equipment.

(b) In preparation of the recording of the admission of Puppet, calculate the goodwill acquired.

(c) Calculate the profit-sharing ratio of Punch, Judy and Puppet, respectively.

(d) On which date does the application of the profit-sharing ratio between Punch, Judy and Puppet take effect?

(e) After the admission of Puppet is recorded, according to the going-concern perspective, prepare the journal entries (narratives excluded) to:

   (i) record the reinstatement of the revaluation surplus of R22 500.

   (ii) record the reversal of the valuation adjustment of the equipment (of R15 000).

Solution:

(a)

Your Puppet Show
General journal

			Debit	Credit
20.4			**R**	**R**
Feb	28	Equipment	15 000	
		Valuation account		15 000

(b) Formula:

> (The capital contribution of the new partner *multiplied* by the inverse of the partner's share in the equity of the new partnership)
>
> *minus*
>
> the equity of the new partnership (on the date of formation, prior to the recording of goodwill acquired)
>
> *equals*
>
> goodwill acquired

(R178 000 × $^{100}/_{20}$) *minus* R(684 875 + 15 000 + 178 000)
= R(890 000 – 877 875)
= R12 125

(c) Punch = $^{2}/_{3} - (^{10}/_{100} \times {}^{2}/_{3}) = {}^{2}/_{3} - {}^{20}/_{300} = {}^{200}/_{300} - {}^{20}/_{300} = {}^{180}/_{300}$
Judy = $^{1}/_{3} - (^{10}/_{100} \times {}^{1}/_{3}) = {}^{1}/_{3} - {}^{10}/_{300} = {}^{100}/_{300} - {}^{10}/_{300} = {}^{90}/_{300}$
Puppet = $^{10}/_{100} = {}^{30}/_{300}$

The profit-sharing ratio of Punch, Judy and Puppet is 180:90:30 = 6:3:1 respectively.

(d) On 1 March 20.4, the admission date of Puppet.

(e)

Your Puppet Show
General journal

(i)

			Debit	Credit
20.4			**R**	**R**
Feb	28	Capital: Punch (R22 500 × $^{6}/_{10}$)	13 500	
		Capital: Judy (R22 500 × $^{3}/_{10}$)	6 750	
		Capital: Puppet (R22 500 × $^{1}/_{10}$)	2 250	
		Revaluation surplus		22 500

(ii)

20.4			**R**	**R**
Feb	28	Valuation account	15 000	
		Equipment		15 000

Comment:

A valuation account is used in this chapter to record and reverse valuation adjustments. The balance of the valuation account is closed off to the capital accounts of the partners concerned according to their profit-sharing ratio.

Case study 2: Recording a change in the ownership structure of a partnership upon the retirement of a partner at financial year-end by transacting with the partnership

Jade, Jock and Joan were in a partnership until 31 July 20.4, the financial year-end of the partnership, and the last date in partnership for Jade as her retirement took effect as from 1 August 20.4. Jade, Jock and Joan traded as The Golden Oldies and shared profits/losses in the ratio of 3:2:1 respectively.

Jock and Joan decided to continue with the activities of the partnership as from 1 August 20.4, trading as The Young Ones. It was agreed that the capital account of Jade be settled by two equal monthly cash instalments, payable on 31 July 20.4 and 30 August 20.4 by the partnership.

On 31 July 20.4, prior to recording any valuation adjustments and the settlement of Jade's capital account as per agreement, the books of The Golden Oldies were closed off, and the following preliminary statement of financial position prepared:

The Golden Oldies
Statement of financial position as at 31 July 20.4

	R
ASSETS	
Non-current assets	240 000
Property, plant and equipment	240 000
Current assets	120 000
Inventories	60 000
Trade and other receivables (Trade receivables control)	36 000
Cash and cash equivalents (Bank)	24 000
Total assets	360 000
EQUITY AND LIABILITIES	
Total equity	186 000
Capital	164 400
Current accounts	21 600
Total liabilities	174 000
Non-current liabilities	162 000
Long-term borrowings (Mortgage)	162 000
Current liabilities	12 000
Trade and other payables (Trade payables control)	12 000
Total equity and liabilities	360 000

The above balances of the capital and current accounts were compiled as follows:

Capital accounts			**Current accounts**		
Jade	**Jock**	**Joan**	**Jade**	**Jock**	**Joan**
R	**R**	**R**	**R**	**R**	**R**
43 200	59 520	61 680	(5 800)	14 780	12 620

On 31 July 20.4, after the preparation of the above statement of financial position, the following occurred:

☐ In preparation of the dissolution of The Golden Oldies, the land and buildings, disclosed at a cost price of R216 000 in the above statement of financial position, were valued at R540 000; and the net realisable value of the inventory was determined as R55 200.

☐ As per agreement, a repayment was made to Jade towards settling her capital account.

As from 1 August 20.4, Jock and Joan calculated the new profit-sharing ratio between them by using the ratio existing between them prior to 1 August 20.4 (2/6:1/6 respectively), and adjusting it by taking over Jade's profit share equally.

Required:

(a) In preparation of the dissolution of The Golden Oldies on 31 July 20.4, according to the legal perspective,

   (i) calculate the balances of the capital accounts of the partners after the balances of their current accounts were closed off thereto.

   (ii) prepare the journal entry (narrative excluded) to close off the balance of the valuation account to the capital accounts of the partners.

   (iii) which accounts and amount are involved to record the payment made to Jade on 31 July 20.4.

   (iv) prepare the journal entry (narrative excluded) to close off the balance of Jade's capital account after the payment in (iii) above was recorded.

(b) Concerning The Young Ones, calculate the profit-sharing ratio of Jock and Joan, respectively.

Solution:

(a) (i) Jade: R(43 200 – 5 800) = R37 400, credit
Jock: R(59 520 + 14 780) = R74 300, credit
Joan: R(61 680 + 12 620) = R74 300, credit

(ii)

The Golden Oldies
General journal

			Debit	Credit
20.4			**R**	**R**
Jul	31	Valuation account R(324 000 – 4 800)*	319 200	
		Capital: Jade (R319 200 × 3/6)		159 600
		Capital: Jock (R319 200 × 2/6)		106 400
		Capital: Joan (R319 200 × 1/6)		53 200

* After recording the valuation adjustments, the balance of the valuation account is R319 200, credit. To close off the balance, R319 200 is debited in the valuation account. The valuation account in the general ledger shows this debit entry by means of apportioning R319 200 to the capital accounts of the partners, namely R(159 600 + 106 400 + 53 200) = R319 200.

Preparation of the valuation account, for illustrative purposes:

The Golden Oldies
Valuation account

Dr | Cr

20.4				**R**	20.4				**R**
Jul	31	Inventory R(60 000 – 55 200)		4 800	Jul	31	Land and buildings R(540 000 – 216 000)		324 000
		Capital: Jade		159 600					
		Capital: Jock		106 400					
		Capital: Joan		53 200					
				324 000					324 000

(iii)

The Golden Oldies

			Debit	Credit
20.4			**R**	**R**
Jul	31	Capital: Jade (R(37 400* + 159 600**)/2)	98 500	
		Bank		98 500

* See solution (a)(i)
** See solution (a)(ii)

Comment:

As per agreement, half of the outstanding balance was paid on 31 July 20.4.

(iv)

The Golden Oldies
General journal

			Debit	Credit
20.4			**R**	**R**
Jul	31	Capital: Jade	98 500	
		Loan: Jade		98 500

(b) Jock $= 2/6 + (3/6 \times 1/2) = 2/6 + 3/12 = 4/12 + 3/12 = 7/12$
Joan $= 1/6 + (3/6 \times 1/2) = 1/6 + 3/12 = 2/12 + 3/12 = 5/12$

The new profit-sharing ratio of Jock and Joan is 7:5 respectively.

3.8 Summary

Goal of chapter

To discuss and illustrate the recording of changes in the ownership structure of partnerships due to the admission, retirement or death of a partner.

Description of change in ownership structure

A change in the ownership structure of a partnership is regarded as a change in the contractual relationship between the partners of a partnership which affects the profit-sharing ratio of the partners.

When a change in the ownership structure of a partnership occurs, the partnership dissolves, irrespective of whether the business activities of the partnership are continued.

Ownership and management of a partnership

Since a partnership is not an independent legal entity, the ownership of a partnership is vested in the partners, and not in the partnership. Therefore, the activities of a partnership fall under the jurisdiction of common law. More specifically, the partners of a partnership manage the partnership by means of a partnership agreement.

Selling price of a partnership

The selling price of a partnership is usually determined by the fair value of its net assets (equity). The fair value of the net assets of a partnership is not necessarily reflected in the accounting records thereof.

Valuation adjustments

If the fair value of an asset or liability is not reflected in the accounting records, the selling price of a partnership is determined by making appropriate valuation adjustments.

Goodwill acquired

Goodwill can be ascribed to the sound reputation of a business and represents the value attached to those factors that enables a business to increase its turnover beyond the expected industry norm.

Goodwill is acquired or internally generated.

In this chapter, goodwill acquired is calculated as follows:

(The capital contribution of the new partner *multiplied* by the inverse of the partner's share in the equity of the new partnership)

minus

the equity of the new partnership (on the date of formation, prior to the recording of goodwill acquired)

equals

goodwill acquired

continued

Change in ownership by personal transaction

An admission to, or a retirement from a partnership can take place by way of a personal transaction with a partner(s).

A personal transaction is made directly with an existing partner, and not with the partnership as a business entity.

No valuation adjustments or other accounting entries pertaining to the preparation of a change in the ownership are made.

Cash paid to acquire a share in a partnership is paid to the partner, and not to the partnership.

The only accounting entries that are usually made when a change in ownership structure occurs by personal transaction, are the closing off of the capital, current and drawings (if not yet closed off) accounts of one partner and the opening (or adjustment) of such accounts for another partner.

Change in ownership by transacting with the partnership

LEGAL PERSPECTIVE	**GOING-CONCERN PERSPECTIVE**
Overview	Overview
A dissolved partnership and a partnership subsequently formed due to the **admission, retirement or death** of a partner are reported on as two separate business entities.	A dissolved partnership and a partnership subsequently formed due to the **admission** of a partner are reported on as a single business entity.
The books of an existing partnership are closed off in their entirety and a **new set of books** is opened for the new partnership.	The new partnership **continues to use the books** of the dissolved partnership.
Valuation adjustments are not reversed in the books of the new partnership.	**All entries** made in preparation of a change in the ownership structure of the partnership (Steps 2 to 4 of the procedure based on the going-concern perspective), are **reversed** (Steps 6 to 8 of the procedure based on the going-concern perspective).

continued

<table>
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LEGAL PERSPECTIVE
<u>Steps</u>
A: In books of EXISTING partnership
1. Close off books and prepare preliminary statement of financial position
2. Close off current accounts to capital accounts
3. Apportion revaluation surplus to capital accounts (existing profit-sharing ratio)
4. Record valuation adjustments, close off valuation account to capital accounts (existing profit-sharing ratio)
5. Record goodwill, if initially acquired, against the capital accounts (existing profit-sharing ratio)
6. Record the dissolution of partnership by means of transferral account (differs between admission and retirement or death)

B: In books of NEW partnership
7. Record the formation of partnership (assets, equity and liabilities of all partners in new partnership)
8. Align the capital account balance ratio with the new profit-sharing ratio, if so decided
</td>
<td>
GOING-CONCERN PERSPECTIVE
<u>Steps</u>
1. Prepare pre-adjustment trial balance or preliminary statement of financial position (differs when during or at end of financial period)
2. Apportion revaluation surplus to capital accounts (existing profit-sharing ratio)
3. Record valuation adjustments, close off valuation account to capital accounts (existing profit-sharing ratio)
4. Record goodwill, if initially acquired, against the capital accounts (existing profit-sharing ratio)
5. Record the change in ownership structure of the partnership by recording the contribution of the entering partner
6. Reinstate the revaluation surplus as apportioned in 2 above (new profit-sharing ratio)
7. Reverse the valuation adjustments as recorded in 3 above, close off valuation account to capital accounts (new profit-sharing ratio)
8. Reverse the goodwill as recorded in 4 above (new profit-sharing ratio)
9. Align the capital account balance ratio with the new profit-sharing ratio, if so decided
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CHAPTER **4**

The liquidation of a partnership

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Overview of the liquidation of a partnership

Description: Liquidation

- A form of dissolution by selling/realising assets for cash, settling debts, and distributing any remaining cash to the partners according to their capital account balances.
- Results in the complete termination of business activities.
- Not necessarily compulsory due to insolvency, also voluntary, by mutual agreement between partners.

Liquidation methods

Simultaneous
No interim repayments

or

Piecemeal
Interim repayments

Simultaneous – No interim repayments:

With profit on liquidation

With loss on liquidation where:

- all partners **have** enough personal funds to cover shortages on their capital accounts.
- all partners **do not have** enough personal funds to cover shortages on their capital accounts.

  Shortages apportioned to solvent partners according to
  - Garner vs Murray rule
  - Profit-sharing ratio

Piecemeal – Interim repayments:

Interim repayments to partners according to:
- surplus-capital

  or
- loss-absorption-capacity

4.1 Introduction

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- ☐ describe the term "liquidation" from the perspective of this chapter;
- ☐ distinguish between a simultaneous and a piecemeal liquidation;
- ☐ record the simultaneous liquidation of a partnership with a:
  - profit on liquidation;
  - loss on liquidation, where all the partners have sufficient personal funds to cover any shortages (deficits) on their capital accounts;
  - loss on liquidation, where all the partners do not have sufficient personal funds to cover any deficits on their capital accounts and where the capital deficits must be apportioned to the capital accounts of the solvent partners according to either the *Garner versus Murray* rule or their profit-sharing ratio; and
- ☐ record the piecemeal liquidation of a partnership, and calculate the interim repayments to be made to the partners according to both the surplus-capital and the loss-absorption-capacity method.

In general terms, liquidation is usually associated with insolvency. An insolvent partnership cannot settle its debts according to agreed terms, whereas a solvent partnership can. However, the liquidation of a partnership is not necessarily caused by the insolvency thereof. There are various other reasons for the liquidation of a partnership, such as the death or retirement of a partner, or on the strength of a court order at the request of the partners.

In this chapter, to distinguish between the liquidation of a solvent and insolvent partnership, the liquidation of the latter is referred to as the "sequestration" thereof. In spite of a number of legal aspects attached to a sequestration, there is little difference between the accounting procedures when a solvent partnership is being liquidated and when an insolvent partnership is being sequestrated. A discussion of the accounting procedures during a sequestration process falls outside the scope of this chapter.

From the viewpoint of this chapter, the liquidation of a partnership implies that the assets must be converted into cash (in other words, the assets must be liquidated/realised), the liabilities settled, and the remaining cash paid to the partners according to the balances of their capital accounts. The liquidation of a partnership is a form of dissolution which results in the termination of the business activities thereof.

Basically, there are two methods according to which a partnership can be liquidated, namely by simultaneous or piecemeal liquidation.

4.2 Liquidation methods

A partnership can be liquidated simultaneously or piecemeal. A simultaneous liquidation occurs when the assets of a partnership are sold/liquidated simultaneously or over a relatively brief period, usually by a partnership which has discontinued its trading activities. Simultaneous liquidations seldom occur in practice, as assets are usually liquidated at less favourable amounts, due to the short period available for the liquidation thereof. There are also other factors that could complicate a simultaneous liquidation, such as debtors who may be unwilling or unable to pay their debts over a decreased time span. In contrast to a simultaneous liquidation, a piecemeal liquidation allows a partnership to continue with its business activities, but on a steadily decreasing scale, thereby providing the opportunity to liquidate the partnership at the best possible price.

4.3 The liquidation account

With a simultaneous liquidation, a single liquidation account is prepared to determine the net profit or loss made on the liquidation of the entire partnership. With a piecemeal liquidation, a number of liquidation accounts are prepared to determine the net profits or losses made on the liquidation of portions of the partnership.

There are various methods according to which liquidation accounts are prepared. These methods are determined by preference and circumstance.

Two methods according to which a liquidation account can be prepared in the case of a simultaneous liquidation, are hereby discussed:

- *Method 1*: At the date the liquidation process commences, *all* the asset (with the exception of the bank account), contra-asset (such as accumulated depreciation or allowance for credit losses) and liability accounts are closed off to the liquidation account. The liquidation of the assets and the settlement of the debts are then recorded therein. Any further income received or expenses paid must also be recorded in the liquidation account. Thereafter, the balancing amount of the liquidation account will reflect the net profit/loss made on the liquidation of the entire partnership. This balance is closed off to the capital accounts of the partners according to their profit-sharing ratio.

  As far as the liquidation of an asset is concerned, a profit/loss is reflected in the liquidation account by the difference between the carrying amount of the asset (on the debit side of the liquidation account) and the selling price (on the credit side of the liquidation account) thereof. For example, assume that a vehicle was closed off (debited) to the liquidation account at a carrying amount of R20 000. The vehicle was then sold for R18 000. On the date of the sale the liquidation account is credited with R18 000, and the bank account is debited with R18 000. In the liquidation account, the difference between the debit entry of R20 000 and the credit entry of R18 000 reflects a loss of R2 000. Settlement discounts received when liabilities are settled are reflected in the liquidation account in a similar fashion. For example, assume that the trade payables control account of R15 000 was closed off (credited) to the liquidation account and that it was then settled in full by a cash payment of R13 500. The liquidation account is debited with R13 500 and the bank account credited with R13 500 on the date of settlement.

The difference between the credit entry of R15 000 and the debit entry of R13 500 in the liquidation account reflects a settlement discount received of R1 500. These two examples are shown in the following liquidation account:

Dr **Liquidation account** **Cr**

	R		R
Vehicles*	20 000	Bank*	18 000
Bank**	13 500	Trade payables control**	15 000
		Balancing amount	*500*

* R(20 000 – 18 000) = A loss of R2 000.
** R(15 000 – 13 500) = Settlement discount received of R1 500.

Note that the loss of R2 000 and the settlement discount received of R1 500 are not disclosed as separate entries in this account.

The balancing amount of R500 (R2 000 – R1 500 or R33 500 – R33 000) indicates the *net* loss. Should the above entries pertain to the entire liquidation of the partnership, the net loss is closed off as follows:

Dr **Liquidation account** **Cr**

	R		R
Vehicles	20 000	Bank	18 000
Bank	13 500	Trade payables control	15 000
		Capital A*	250
		Capital B*	250
	33 500		33 500

* Assume the profit-sharing ratio of the partners, A and B, is 1:1.

Note that the liquidation account does not have a balance that is brought down. The balancing amount is closed off to the capital accounts of the partners.

In this chapter, Method 1 is applied.

☐ *Method 2*: Method 2 is similar to Method 1, with the exception that only those liability accounts on which settlement discounts are expected are closed off to the liquidation account. Since non-current liabilities such as mortgages are settled without discounts, they are not closed off to the liquidation account. When such non-current liabilities are settled, the liability accounts are debited and the bank account credited. If no settlement discount on a current liability account is antici–pated, such an account is also not closed off to the liquidation account. Should a settlement discount then be received, the current liability account is debited with the amount paid as well as with the discount received. The bank account is credit-ed with the amount paid and the liquidation account will be credited with the amount of the settlement discount received.

In the case of a piecemeal liquidation, a liquidation account is prepared for each liquidation transaction or for a number of liquidation transactions, as the liquidation process proceeds. The profit/loss determined in each liquidation account is closed off to the capital accounts of the partners according to their profit-sharing ratio.

4.4 Accounting procedure to record the simultaneous liquidation of a partnership

Various accounting procedures exist to record the liquidation of a partnership. The following steps are thus suggested as a guideline to administer and record the simultaneous liquidation of a solvent partnership. These steps are shown in Example 4.1.

Step 1: Close off the balances of the drawings and current accounts (if any) to the capital accounts on the date when the simultaneous liquidation commences.

The drawings and current accounts form part of the equity of a partnership, and are therefore closed off to the capital accounts of the partners. Should a current account have a credit balance in closing, this balance is debited in the current account and credited in the relevant capital account. Should a current account have a debit balance in closing, this balance is credited in the current account and debited in the relevant capital account. Drawings accounts have debit balances. Therefore, a drawings account is credited with the balance thereof and the relevant capital account is debited with this amount.

It can be argued that loans made to the partners by the partnership, or by the partners to the partnership also stand directly to the capital accounts, and should therefore also be closed off to the capital accounts. However, various legal requirements, such as those pertaining to an insolvent partnership, the application of the Garner versus Murray rule, or the stipulations of the loan contracts, may influence the stage at which such loans must be settled or closed off to the capital accounts. The type of liquidation process, namely whether it is a simultaneous or a piecemeal liquidation process, may also impact on this matter. No general guideline can thus be presented in this respect. In order to simplify the discussion on liquidations, such loans are not addressed in this chapter.

Step 2: Close off the balances of the goodwill and revaluation surplus accounts (where applicable) to the capital accounts of the partners according to their profit-sharing ratio on the date when the simultaneous liquidation commences.

Goodwill cannot be sold at liquidation and revaluation surpluses form part of equity. Therefore these items are closed off to the capital accounts.

The balance of a revaluation surplus account is debited in the revaluation surplus account and credited in the capital accounts of the partners. The balance of a goodwill account is credited in the goodwill account and debited in the capital accounts of the partners.

Step 3: Prepare the liquidation account.

The liquidation account is prepared as follows:

- ☐ On the date on which the simultaneous liquidation commences, the liabilities are closed off by debiting the liability accounts with their balances and crediting the liquidation account. The balances of the remaining asset accounts (with the exception of the bank and capital accounts) are also closed off to the liquidation account.

  If an asset was recorded at the carrying amount thereof, the liquidation account is debited and the asset account credited with the closing balance of the asset account.

If an asset was recorded at cost (for example, vehicles at cost), the liquidation account is debited and the asset account is credited with the closing balance of the asset account. Any related contra-asset account (for example, accumulated depreciation) must be closed off to the liquidation account by debiting the contra-asset account and crediting the liquidation account with the closing balance of the contra-asset account.

- ☐ Record the liquidation of the assets.

  When an asset is sold for cash, the bank account is debited and the liquidation account is credited with the selling price (cash amount) of the asset on the date of liquidation.

  Should a partner take over an asset, the amount at which the asset is taken over is debited in the partner's capital account and credited in the liquidation account.

- ☐ Record income received.

  Income received, for example services rendered for cash, is debited in the bank account and credited in the liquidation account on the date of sale.

- ☐ Record the payment of the liquidation costs.

  Usually, the settlement of liquidation costs enjoys preference over all other payments. The liquidation account is debited and the bank account credited with the amount paid on the date of payment.

- ☐ Record the payments of the liability accounts.

  The settlement of the current liabilities is recorded by debiting the liquidation account and crediting the bank account with the payments.

- ☐ Record the payments of any further expenses.

  Any further expenses paid are recorded by debiting the liquidation account and by crediting the bank account on the date of payment.

- ☐ Close off the balance of the liquidation account to the capital accounts of the partners according to their profit-sharing ratio.

  After all the entries in the liquidation account have been made, the balancing amount of the liquidation account represents the net profit/loss made on the liquidation of the partnership.

  If a profit was made, the liquidation account is debited with the profit, and the capital accounts of the partners credited according to their profit-sharing ratio.

  If a loss was made, the capital accounts are debited according to their profit-sharing ratio and the liquidation account is credited.

Step 4: Record the settlement (once-off repayment) of the capital accounts of the partners.

At this stage of the liquidation process, only the bank account and the capital accounts of the solvent partners have balances in the books of the partnership. The balance of the bank account will be equal to the sum of the capital account balances, indicating the liability of the partnership towards each partner. Similar to the settlement of a liability, the balances of the capital accounts, which are not necessarily in the profit-sharing ratio of the partners, are debited and the bank account of the partnership credited. After such settlement is recorded, the liquidation process is finalised and the partnership ceases to exist.

4.4.1 *Profit on liquidation*

The above accounting procedure is illustrated in Example 4.1.

Example 4.1 Simultaneous liquidation of a partnership with a profit on liquidation

Pascoe, Cannon and Fradley were in a partnership which traded as Trio Traders; they shared in the profits and losses equally. The partners decided to liquidate the partnership on 1 August 20.5 by means of a simultaneous liquidation.

The abridged statement of financial position as at 31 July 20.5, the financial year-end of Trio Traders, was as follows:

Trio Traders
Statement of financial position as at 31 July 20.5

	R
ASSETS	
Non-current assets	117 000
Property, plant and equipment	90 000
Goodwill	27 000
Current assets	108 000
Inventories	60 000
Trade and other receivables (Trade receivables control)	40 000
Cash and cash equivalents (Bank)	8 000
Total assets	225 000
EQUITY AND LIABILITIES	
Total equity	155 000
Capital	147 500
Current accounts	7 500
Total liabilities	70 000
Non-current liabilities	39 000
Long-term borrowings (Long-term loan)	39 000
Current liabilities	31 000
Trade and other payables (Trade payables control)	31 000
Total equity and liabilities	225 000

Capital and current account balances of each partner at 31 July 20.5:

	Pascoe	Cannon	Fradley
	R	R	R
Capital account	70 000	50 000	27 500
Current account	12 000	8 500	(13 000)
Total	82 000	58 500	14 500

Extract of the note regarding the property, plant and equipment for the year ended 31 July 20.5:

	Furniture and fittings	Vehicle	Total
	R	R	R
Carrying amount at 31 July 20.5	40 000	50 000	90 000
Cost	60 000	80 000	140 000
Accumulated depreciation	(20 000)	(30 000)	(50 000)

On 1 August 20.5, the furniture and fittings were sold for R60 200 cash. The vehicle was taken over by Pascoe at a mutually agreed value of R48 000. The inventory was sold for R70 000 cash. The debtors settled their debts in full by paying R38 000 to the partnership. All the creditors were paid and a settlement discount of R2 300 was received. R39 000 was repaid in respect of the long-term loan. The liquidation costs amounted to R15 000.

Required:

(a) Prepare the general journal of Trio Traders on 1 August 20.5 to record the liquidation of the partnership by applying the steps given in paragraph 4.4. Indicate the number of the step according to which each journal entry is recorded.

(b) Prepare the liquidation, bank and capital accounts on 1 August 20.5 in the general ledger of Trio Traders.

Solution:

(a) **Trio Traders**
General journal

Step 1:

			Debit	Credit
20.5			R	R
Aug	1	Current account: Pascoe	12 000	
		Current account: Cannon	8 500	
		Capital: Fradley	13 000	
		Capital: Pascoe		12 000
		Capital: Cannon		8 500
		Current account: Fradley		13 000
		Closing off the balances of the current accounts to the capital accounts		

Step 2:

			Debit	Credit
20.5			R	R
Aug	1	Capital: Pascoe (R27 000 × 1/3)	9 000	
		Capital: Cannon (R27 000 × 1/3)	9 000	
		Capital: Fradley (R27 000 × 1/3)	9 000	
		Goodwill		27 000
		Closing off the goodwill to the capital accounts according to the profit-sharing ratio of the partners		

Step 3:

			Debit	Credit
20.5			R	R
Aug	1	Liquidation account	240 000	
		Furniture and fittings at cost		60 000
		Vehicle at cost		80 000
		Inventories		60 000
		Trade receivables control		40 000
		Closing off the assets to be liquidated to the liquidation account		
20.5				
Aug	1	Accumulated depreciation: Furniture and fittings	20 000	
		Accumulated depreciation: Vehicle	30 000	
		Liquidation account		50 000
		Closing off the accumulated depreciation accounts to the liquidation account		
20.5				
Aug	1	Long-term loan	39 000	
		Trade payables control	31 000	
		Liquidation account		70 000
		Closing off the liability accounts to the liquidation account		
20.5				
Aug	1	Bank R(60 200 + 70 000 + 38 000)	168 200	
		Liquidation account		168 200
		Recording of the cash received for the assets sold		
20.5				
Aug	1	Capital: Pascoe	48 000	
		Liquidation account		48 000
		Recording of the vehicle taken over by Pascoe		

continued

			Debit	Credit
20.5			**R**	**R**
Aug	1	Liquidation account R[15 000 + 39 000 + (31 000 – 2 300)]	82 700	
		Bank		82 700
		Recording of the payment of the liquidation costs, long-term loan and creditors		
20.5				
Aug	1	Liquidation account	13 500①	
		Capital: Pascoe (R13 500 × 1/3)		4 500
		Capital: Cannon (R13 500 × 1/3)		4 500
		Capital: Fradley (R13 500 × 1/3)		4 500
		Closing off the balancing figure of the liquidation account to the capital accounts according to the profit-sharing ratio of the partners		

Calculation:

① **Balancing amount of liquidation account**

Credit entries:

R(50 000 + 70 000 + 168 200 + 48 000) = R336 200

Debit entries:

R(240 000 + 82 700) = R322 700

Balancing amount:

R(336 200 – 322 700) = R13 500 = Net profit on liquidation

Step 4:

			Debit	Credit
20.5			**R**	**R**
Aug	1	Capital: Pascoe	29 500①	
		Capital: Cannon	54 000②	
		Capital: Fradley	10 000③	
		Bank		93 500
		Settlement of the closing balances of the capital accounts		

Calculations:

① **Closing balance of Pascoe's capital account**

R(70 000 + 12 000 – 9 000 – 48 000 + 4 500) = R29 500

② **Closing balance of Cannon's capital account**

R(50 000 + 8 500 – 9 000 + 4 500) = R54 000

③ **Closing balance of Fradley's capital account**

R(27 500 – 13 000 – 9 000 + 4 500) = R10 000

(b)

Trio Traders
General ledger

Dr **Liquidation account** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Furniture and fittings at cost		60 000	Aug	1	Accumulated depreciation: Furniture and fittings		20 000
		Vehicle at cost		80 000			Accumulated depreciation: Vehicle		30 000
		Inventory		60 000			Long-term loan		39 000
		Trade receivables control		40 000			Trade payables control		31 000
		Bank (Liquidation costs)		15 000			Bank (Furniture and fittings sold)		60 200
		Bank (Long-term loan repaid)		39 000			Bank (Inventory sold)		70 000
		Bank (Creditors paid)		28 700			Bank (Debtors payments received)		38 000
		Capital: Pascoe		4 500			Capital: Pascoe		48 000
		Capital: Cannon		4 500					
		Capital: Fradley		4 500					
				336 200					336 200

Comment:

The cash payments and cash receipts are disclosed separately for explanatory purposes. It is also correct to disclose the cash payments as a single amount of R82 700, and the cash receipts as a single amount of R168 200.

Dr **Bank** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Balance	b/d	8 000	Aug	1	Liquidation account (Liquidation costs)		15 000
		Liquidation account (Furniture and fittings sold)		60 200			Liquidation account (Long-term loan repaid)		39 000
		Liquidation account (Inventory sold)		70 000			Liquidation account (Creditors paid)		28 700
		Liquidation account (Debtors payments received)		38 000			Capital: Pascoe		29 500
							Capital: Cannon		54 000
							Capital: Fradley		10 000
				176 200					176 200

continued

Dr **Capital: Pascoe** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	70 000
		Liquidation account		48 000			Current account:		
		Bank		29 500			Pascoe		12 000
							Liquidation account		4 500
				86 500					86 500

Dr **Capital: Cannon** **Cr**

				R	20.5				**R**
20.5									
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	50 000
		Bank		54 000			Current account:		
							Cannon		8 500
							Liquidation account		4 500
				63 000					63 000

Dr **Capital: Fradley** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Current account:			Aug	1	Balance	b/d	27 500
		Fradley		13 000			Liquidation account		4 500
		Goodwill		9 000					
		Bank		10 000					
				32 000					32 000

4.4.2 *Loss on liquidation*

A net loss made on the liquidation of a partnership will cause the balances of the capital accounts of the partners to decrease. The balances of the capital accounts of the partners could be either adequate to absorb the loss, or they could be too small. In the latter case, capital deficits (debit balances) arise. Should the capital account of a partner show a deficit after the loss on the liquidation is apportioned thereto, the partnership has a claim against the partner for this amount. If such partner has sufficient personal funds to cover the deficit, the bank account of the partnership is debited and the capital account of the partner credited with the amount of the deficit on the date of the payment thereof by the partner.

Example 4.2 Simultaneous liquidation of a partnership with a net loss on liquidation where partners have sufficient personal funds to cover the final deficits on their capital accounts

Pascoe, Cannon and Fradley were in a partnership which traded as Trio Traders. They shared in the profits and losses equally. The partners decided to liquidate the partnership on 1 August 20.5 by means of a simultaneous liquidation.

The abridged statement of financial position as at 31 July 20.5, the financial year-end of Trio Traders, was as follows:

Trio Traders
Statement of financial position as at 31 July 20.5

	R
ASSETS	
Non-current assets	117 000
Property, plant and equipment	90 000
Goodwill	27 000
Current assets	108 000
Inventories	60 000
Trade and other receivables (Trade receivables control)	40 000
Cash and cash equivalents (Bank)	8 000
Total assets	225 000
EQUITY AND LIABILITIES	
Total equity	155 000
Capital	147 500
Current accounts	7 500
Total liabilities	70 000
Non-current liabilities	39 000
Long-term borrowings (Long-term loan)	39 000
Current liabilities	31 000
Trade and other payables (Trade payables control)	31 000
Total equity and liabilities	225 000

The capital and current account balances of each partner at 31 July 20.5:

	Pascoe	**Cannon**	**Fradley**
	R	**R**	**R**
Capital account	70 000	50 000	27 500
Current account	12 000	8 500	(13 000)
Total	82 000	58 500	14 500

Extract from the note regarding the property, plant and equipment for the year ended 31 July 20.5:

	Furniture and fittings	**Vehicle**	**Total**
	R	**R**	**R**
Carrying amount at 31 July 20.5	40 000	50 000	90 000
Cost	60 000	80 000	140 000
Accumulated depreciation	(20 000)	(30 000)	(50 000)

On 1 August 20.5, the furniture and fittings were sold for R42 000 cash. The vehicle was taken over by Pascoe at a mutually agreed value of R48 000. The inventory was sold for R30 000 cash. The debtors settled their debts in full by paying R35 000 to the partnership. All the creditors were paid and a settlement discount of R2 300 was received. R39 000 was repaid in respect of the long-term loan. The liquidation costs amounted to R15 000.

All the partners have sufficient personal assets to cover any deficits in their capital accounts.

Required:

Prepare the liquidation, bank and capital accounts in the general ledger of Trio Traders on 1 August 20.5.

Solution:

Trio Traders
General ledger

Dr **Liquidation account** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Furniture and fittings at cost		60 000	Aug	1	Accumulated depreciation: Furniture and fittings		20 000
		Vehicle at cost		80 000			Accumulated depreciation: Vehicle		30 000
		Inventory		60 000			Long-term loan		39 000
		Trade receivables control		40 000			Trade payables control		31 000
		Bank (Liquidation costs)		15 000			Bank (Furniture and fittings sold)		42 000
		Bank (Long-term loan repaid)		39 000			Bank (Inventory sold)		30 000
		Bank (Creditors paid)		28 700			Bank (Debtors payments received)		35 000
							Capital: Pascoe		48 000
							Capital: Pascoe①		15 900
							Capital: Cannon①		15 900
							Capital: Fradley①		15 900
				322 700					322 700

Calculation:

① **Appropriation of loss on liquidation**

The balancing amount of the liquidation account, prior to the appropriation of the loss, amounts to R47 700.

Credit entries:
R(20 000 + 30 000 + 39 000 + 31 000 + 42 000 + 30 000 + 35 000 + 48 000) = R275 000

Debit entries:
R(60 000 + 80 000 + 60 000 + 40 000 + 15 000 + 39 000 + 28 700) = R322 700

Balancing amount:
R(322 700 – 275 000) = R47 700

Pascoe: R47 700 × 1/3 = R15 900
Cannon: R47 700 × 1/3 = R15 900
Fradley: R47 700 × 1/3 = R15 900

Dr **Bank** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Balance	b/d	8 000	Aug	1	Liquidation account (Liquidation costs)		15 000
		Liquidation account (Furniture and fittings sold)		42 000			Liquidation account (Long-term loan repaid)		39 000
		Liquidation account (Inventory sold)		30 000			Liquidation account (Creditors paid)		28 700
		Liquidation account (Debtors payments received)		35 000			Capital: Pascoe**		9 100
		Capital: Fradley*		10 400			Capital: Cannon**		33 600
				125 400					125 400

* Fradley's contribution of R10 400 to settle his capital deficit.
** The balancing amount of the bank account prior to the settlement of the capital accounts of Pascoe and Cannon, is R42 700 (R125 400 – R15 000 – R39 000 – R28 700). The closing balances of the capital accounts of Pascoe and Cannon are settled with this amount.

Dr **Capital: Pascoe** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	70 000
		Liquidation account		48 000			Current account: Pascoe		12 000
		Liquidation account		15 900					
		Bank*		9 100					
				82 000					82 000

* Balancing entry

Dr **Capital: Cannon** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	50 000
		Liquidation account		15 900			Current account: Cannon		8 500
		Bank*		33 600					
				58 500					58 500

continued

Dr **Capital: Fradley** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Current account:			Aug	1	Balance	b/d	27 500
		Fradley		13 000			Bank*		10 400
		Goodwill		9 000					
		Liquidation account		15 900					
				37 900					37 900

* Fradley paid R10 400 from his personal funds into the bank account of the partnership to clear the deficit on his capital account.

Should a partner be insolvent and therefore unable to pay the final deficit, the remaining solvent partners must bear the deficit. The settlement of disputes regarding the apportionment of deficits can be resolved by means of court rulings, such as the *Garner versus Murray* rule, which was constituted in England during 1903.

Essentially, the *Garner versus Murray* rule stipulates that, in the absence of a prior agreement, the (actual) final deficit of an insolvent partner's capital account should be paid in cash by the solvent partners according to their last agreed capital account balances, and not according to their profit-sharing ratio, as was the case prior to the ruling. Henceforth, all partnerships that operate under English jurisdiction have to follow this stipulation.

A major problem with the application of the *Garner versus Murray* rule is the ambiguity thereof. For example, the date of the last agreed capitals was indicated as the date of the previous statement of financial position. It is unclear whether this statement pertains to the previous financial year-end, the date immediately prior to liquidation, or to a date during liquidation. According to the ruling in *Garner versus Murray*, it can be interpreted that the date of the last agreed capitals pertains to the balances of the capital accounts immediately prior to the liquidation of a partnership.

To avoid the lack of clarity of the *Garner versus Murray* rule, the method according to which final capital deficits of insolvent partners must be apportioned can be stipulated in a partnership agreement.

It is not the objective to deliver a detailed discussion on the *Garner versus Murray* rule in this chapter, but rather to illustrate that should the rule be applied, the remaining solvent partners must bear the final capital deficit of an insolvent partner according to their capital ratio, and not according to their profit-sharing ratio. For the purpose of this chapter, last agreed capitals are interpreted as being the balances on the capital accounts of the partners immediately prior to the liquidation of the partnership, and that these balances are determined after the balances of the drawings, the current and goodwill accounts, as well as any revaluation surpluses, were closed off to the capital accounts.

Example 4.3 Simultaneous liquidation of a partnership with a net loss on liquidation where all the partners do not have sufficient personal funds to cover the final deficits on their capital accounts

Use the same information as in Example 4.2, with the exception that Fradley is insolvent and unable to repay any amount of his final capital deficit to the partnership.

Required:

(a) Prepare the bank and capital account entries in the general ledger of Trio Traders on 1 August 20.5. Apply the *Garner versus Murray* rule to clear the final capital deficit of Fradley.

(b) Prepare the bank and capital accounts in the general ledger of Trio Traders on 1 August 20.5. Apportion Fradley's final capital deficit according to the profit-sharing ratio of the remaining solvent partners.

Solution:

(a)

Trio Traders
General ledger

Dr **Bank** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Balance	b/d	8 000	Aug	1	Liquidation account (Liquidation costs)		15 000
		Liquidation account (Furniture and fittings)		42 000			Liquidation account (Long-term loan repaid)		39 000
		Liquidation account (Inventory sold)		30 000			Liquidation account (Creditors paid)		28 700
		Liquidation account (Debtors payments received)		35 000			Capital: Pascoe*		2 860
							Capital: Cannon*		29 440
				115 000					115 000

* The closing balance of the bank account is used to settle Pascoe's and Cannon's capital accounts.

Dr **Capital: Pascoe** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	70 000
		Liquidation account		48 000			Current account: Pascoe		12 000
		Liquidation account		15 900					
		Capital: Fradley①		6 240					
		Bank*		2 860					
				82 000					82 000

* Due to 60% (3/5) of Fradley's capital deficit closed off to Pascoe's capital account, the balance of Pascoe's capital account decreased. Thus, instead of receiving R6 240 in cash from Pascoe in respect of Fradley's deficit, and paying R9 100 to Pascoe to settle his capital account, a net amount of R2 860 (R9 100 – R6 240) was paid to Pascoe by the partnership.

Calculation:

① **Portion of Fradley's final capital deficit to be borne by Pascoe**

To apportion the final capital deficit of Fradley, Pascoe's capital account was calculated as the balance of his capital account on 31 July 20.5 (prior to liquidation), after the accounts that stand directly to the capital accounts of the partners were closed off to the capital accounts. Thus, the opening balance of the capital account of Pascoe + the current account balance of Pascoe – Pascoe's portion of the goodwill = R(70 000 + 12 000 – 9 000) = R73 000. Likewise, Cannon's capital account balance was calculated as R49 500 (R50 000 + R8 500 – R9 000).

Therefore, the capital ratio of Pascoe and Cannon is considered to be 73 000/122 500: 49 500/122 500 = 3:2 respectively. Fradley's capital deficit is thus apportioned as follows:

R10 400 × 3/5 = R6 240

Dr **Capital: Cannon** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	50 000
		Liquidation account		15 900			Current account:		
		Capital: Fradley①		4 160			Cannon		8 500
		Bank*		29 440					
				58 500					58 500

* Due to 40% (2/5) of Fradley's capital deficit closed off to Cannon's capital account, the balance of Cannon's capital account decreased. Thus, instead of receiving R4 160 in cash from Cannon in respect of Fradley's deficit, and paying R33 600 to Cannon to settle his capital account, the partnership paid a net amount of R29 440 (R33 600 – R4 160) to Cannon.

Calculation:

① **Portion of Fradley's capital deficit to be borne by Cannon**

R10 400 × 2/5 = R4 160

Dr **Capital: Fradley** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Current account:			Aug	1	Balance	b/d	27 500
		Fradley		13 000			Capital: Pascoe		6 240
		Goodwill		9 000			Capital: Cannon		4 160
		Liquidation account		15 900					
				37 900					37 900

Comment:

The apportionment of Fradley's capital account does not influence the preparation of the liquidation account. Under the circumstances of Example 4.3, the preparation of the liquidation account will be the same as the preparation of the liquidation account in Example 4.2.

(b)

Trio Traders
General ledger

Dr **Bank** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Balance	b/d	8 000	Aug	1	Liquidation account (Liquidation costs)		15 000
		Liquidation account (Furniture and fittings sold)		42 000			Liquidation account (Loan repaid)		39 000
		Liquidation account (Inventory sold)		30 000			Liquidation costs (Creditors paid)		28 700
		Liquidation account (Debtors payments received)		35 000			Capital: Pascoe*		3 900
							Capital: Cannon*		28 400
				115 000					115 000

* The closing balance of the bank account (R32 300) is used to settle the final balances on the capital accounts of Pascoe and Cannon.

Dr **Capital: Pascoe** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	70 000
		Liquidation account		48 000			Current account: Pascoe		12 000
		Liquidation account		15 900					
		Capital: Fradley①		5 200					
		Bank*		3 900					
				82 000					82 000

* Balancing entry, settlement of Pascoe's capital account.

Calculation:

① **Portion of Fradley's capital deficit to be borne by Pascoe**

The profit-sharing ratio of Pascoe, Cannon and Fradley is given as 1:1:1. The profit-sharing ratio of Pascoe and Cannon is thus 1:1. Pascoe: R10 400 × 1/2 = R5 200.

Dr **Capital: Cannon** **Cr**

20.5				**R**	20.5				**R**
Aug	1	Goodwill		9 000	Aug	1	Balance	b/d	50 000
		Liquidation account		15 900			Current account: Cannon		8 500
		Capital: Fradley①		5 200					
		Bank*		28 400					
				58 500					58 500

* Balancing entry, settlement of Cannon's capital account.

Calculation:

① **Portion of Fradley's capital deficit to be borne by Cannon**

The profit-sharing ratio of Pascoe, Cannon and Fradley was given as 1:1:1. The profit-sharing ratio of Pascoe and Cannon is thus 1:1. Cannon: R10 400 × 1/2 = R5 200.

Dr **Capital: Fradley** **Cr**

20.5				R	20.5				R
Aug	1	Current account: Fradley		13 000	Aug	1	Balance	b/d	27 500
		Goodwill		9 000			Capital: Pascoe*		5 200
		Liquidation account		15 900			Capital: Cannon*		5 200
				37 900					37 900

* The closing balance of Fradley's capital account (deficit of R10 400) is closed off to Pascoe's and Cannon's capital accounts according to their profit-sharing ratio (1:1).

4.5 Accounting procedure to record the piecemeal liquidation of a partnership

Similar to simultaneous liquidations, piecemeal liquidations can be conducted and recorded according to various methods. The undermentioned accounting procedure is a suggestion based on the elementary administration of the piecemeal liquidation of a partnership:

Step 1: Close off the balances of the drawings and current accounts (if any) to the capital accounts on the date when the piecemeal liquidation commences.

Step 2: Close off the balances of the goodwill and revaluation surplus accounts to the capital accounts of the partners according to their profit-sharing ratio on the date when the piecemeal liquidation commences.

Step 3: Record the payment of expenses, the settlement of debts, the liquidation of assets, the receipts of any further cash (for example, in respect of income) and the interim repayments made to the partners as they arise.

☐ **Recording of the payment of expenses and the settlement of debts**

Expenses are usually paid as they arise. At the date of payment, the liquidation account is debited and the bank account credited with the amount paid. Liabilities (debts) are usually repaid according to a repayment plan. The recording of the settlement of a liability will depend on the closing off procedure that was applied. The settlement of liquidation expenses should enjoy preference over other payments.

☐ **Recording of the liquidation of assets and of any further cash receipts**

Since liquid assets are usually liquidated at a profit/loss, the liquidation of these assets are recorded in the liquidation account.

☐ **Calculation and recording of the interim repayments to the partners**

Should any cash remain in the partnership after all the debts and expenses have been settled and/or provided for during the liquidation process, interim repayments can be made to the partners in partial settlement of their capital accounts. However, there is a risk involved in making such repayments in a haphazard manner, since assets can thereafter be liquidated at a loss, which may result in final capital deficits. If a partner with such a final capital deficit is declared insolvent, the remaining solvent partners will have to bear the deficit whilst the insolvent partner received a premature interim repayment. Although legal steps can be taken against an insolvent partner to recover the capital deficit, it must be taken into account that legal procedures are costly and time-consuming, and that there is no guarantee as to what the ruling will be. It is also impractical to make interim repayments to partners and to later expect them to repay it to the partnership. Interim repayments should thus be made on the condition that it will not be necessary for a partner to make any repayments thereof in future.

Two methods can be applied to calculate the interim repayments so that no repayments are necessary, namely the surplus-capital and the loss-absorption-capacity method. These methods render the same results, and are discussed in paragraphs 4.5.1 and 4.5.2.

Step 4: Record the settlement (final repayment) of the capital accounts of the partners.

4.5.1 *Calculation of interim repayments according to the surplus-capital method*

When the surplus-capital method is applied within Step 3 of the accounting procedure for the piecemeal liquidation of a partnership (refer to paragraph 4.5), interim cash repayments are calculated according to an *order of preference* which is determined by the ability of the partners to absorb losses. The ability to absorb a loss is determined by the *capital per unit of profit share*. This can also be expressed as the capital account balance of a partner divided by the unit of profit share of the partner. A unit of profit share is equal to the numerator of an individual profit-sharing ratio. For example, if the individual profit-sharing ratio of a partner is 2/3, the unit of profit share is 2. The higher the capital per unit of profit share of a partner, the higher the surplus capital of the partner, and the better the possibility that such a partner will be able to bear future losses. Interim cash repayments are made to the partner(s) with the highest capital per unit of profit share(s) until the capital per unit of profit shares of all the partners are equal. (Bear in mind that a cash repayment decreases the balance of a capital account.) Equal capital per unit of profit shares indicates that the capital ratio of partners is equal to their profit-sharing ratio. Whenever the capital per unit of profit shares of partners are equal and an interim cash repayment needs to be made, the repayment is made according to their profit-sharing ratio.

Assume, for example, that Tom and Dick have favourable capital account balances of R3 000 and R2 500 respectively, and that they share profits/losses in the ratio of 2:1 respectively. The unit of profit share of Tom is thus equal to 2, and the unit of profit share of Dick is equal to 1. Should a loss of R6 000 be apportioned to the capital accounts of Tom and Dick, R4 000 (R6 000 × 2/3) and R2 000 (R6 000 × 1/3) will be debited to these accounts respectively. After this apportionment is recorded, Tom's capital account balance has a deficit of R1 000 (R3 000 – R4 000), whereas Dick's capital account has a favourable balance of R500 (R2 500 – R2 000). From this example it is clear that although Tom had the largest capital account balance prior to the apportionment of the loss, his higher profit-sharing ratio caused the balance on his capital account to turn into a deficit after the loss was apportioned. Since a capital per unit of profit share takes both the capital account balance and the profit share of a partner into account, it is used to calculate a prudent interim repayment.

Dick's capital per unit of profit share, namely R2 500 (R2 500/1), is greater than that of Tom's, which is R1 500 (R3 000/2), which indicates that Dick has surplus capital in comparison to Tom. Dick's capital account is thus less likely to turn into a deficit if a loss should be apportioned thereto. Dick should therefore first and solely receive preference when interim repayments are made until his capital per unit of profit share is equal to that of Tom's. Such equality shows that Dick's surplus capital has been repaid. Thereafter, Tom and Dick must receive interim repayments simultaneously, according to their profit-sharing ratio.

When an order of preference is calculated according to the surplus-capital method, the calculation can be done on the date when the liquidation commences. With the exception of an interim repayment, any amounts posted to the capital accounts of the partners according to a different ratio than their profit-sharing ratio (for example, when assets are taken over by a partner) will require that the order of preference be recalculated because such entries will change the capital per unit of profit shares of the partners, which in turn will affect the order of preference that was initially determined. Such a recalculation is shown in Example 4.8.

According to the surplus-capital method, the order of preference is determined by applying the undermentioned procedure.

Step A: Calculate and rank the capital per unit of profit share of each partner.

After the postings with regard to Steps 1 and 2 (refer to paragraph 4.5) have been made, the capital per unit of profit shares of the partners must be calculated. Rank the highest capital per unit of profit share as "1st", the second highest as "2nd", and so forth. Refer to Step A of Example 4.4 below.

Step B: Calculate and arrange the surplus capital of the partners.

- ☐ Calculation of the surplus capital that must be allocated first (first order of preference):

  The formula for calculating surplus capital is:

  > Capital account balance(s) of the partner(s) with the highest capital per unit of profit share(s) *minus* (the next highest capital per unit of profit share *multiplied by* the unit of profit share of the partner(s) with the highest capital per unit of profit share).

  The partner with the highest capital per unit of profit share has the highest surplus capital. Such a partner must first and solely receive preference during interim repayments until his surplus capital has been reduced to be equal to that of the partner(s) who initially had the next highest capital per unit of profit share (surplus capital). Refer to Step B of Example 4.4 below.

- ☐ Calculation of the surplus capital that must be allocated second (second order of preference):

  Once the surplus capital according to the first order of preference has been allocated, the surplus capital according to the second order of preference must be calculated by using the same formula as given above. The partners who have the highest capital per unit of profit shares at this stage (bear in mind that the capital per unit of profit share of the partner who initially had the highest capital per unit of profit share decreased to that of the next highest capital per unit of profit share as a result of the first allocation) will also have equal amounts of surplus capital. The surplus capital of these partners must then be simultaneously allocated to them until their capital per unit of profit shares are equal to those of the partner(s) who have the next highest capital per unit of profit share(s). Should the cash available for an interim repayment be less than the total amount of the surplus capital of the partners who fall under the second order of preference, the repayments must be made to them according to their profit-sharing ratio.

☐ Calculation of the surplus capital that must be allocated third, fourth, etc. (third or fourth order of preference, etc.):

  This calculation is similar to the calculation of the surplus capital that must be allocated second.

When the above allocations result in the capital per unit of profit shares of all the partners being equal, the calculation of the order of preference is complete.

Note that the calculation of the order of preference indicates how future interim cash repayments must be apportioned according to the surplus capital of the partners. It is not a recording of transactions in the books of a partnership.

Example 4.4 Calculation of the order of preference according to the surplus-capital method

Tom and Dick have favourable capital account balances of R3 000 and R2 500 respectively, and they share profits/losses in the ratio of 2:1 respectively.

Required:

Determine the order of preference according to which interim repayments can be made to the partners by applying the surplus-capital method.

Solution:

Step A: Calculate and rank the capital per unit of profit share of each partner.

Tom: R3 000/2 = R1 500 (2nd)

Dick: R2 500/1 = R2 500 (1st)

Step B: Calculate and arrange the surplus capital of the partners.

Since the capital per unit of profit share of Dick is the highest, Dick has the highest surplus capital. His surplus capital must be repaid first until his capital per unit of profit share is equal to that of Tom's.

Calculation of the amount of surplus capital first payable to Dick:

Formula: Capital account balance of the partner with the highest capital per unit of profit share (Dick's) *minus* [the second highest capital per unit of profit share (Tom's) *multiplied by* the unit of profit share of the partner with the highest capital per unit of profit share (Dick's)]

R2 500 – (R1 500 × 1) = R1 000

After the R1 000 is paid to Dick, the capital per unit of profit shares of Tom and Dick will be equal:

Tom: R3 000/2 = R1 500

Dick: R1 500/1 = R1 500

Since there are only two partners, and their capital per unit of profit shares differ, Dick's surplus capital of R1 000 must first be repaid in full when interim repayments are made. Thereafter, cash available for interim repayments will be paid out simultaneously to Dick and Tom according to their profit-sharing ratio.

The order of preference which is determined according to the above calculations is disclosed in Table 4.1.

Table 4.1 Calculation of the order of preference for interim repayments according to the surplus-capital method

	Tom Unit of profit share = 2		Dick Unit of profit share = 1	
Order of preference	**Capital account balance**	**Capital per unit of profit share**	**Capital account balance**	**Capital per unit of profit share**
	R	**R**	**R**	**R**
	(3 000)	1 500*	(2 500)	2 500*
First			1 000**	
Both partners	(3 000)	1 500***	(1 500)	1 500***

* Step A
** Step B
*** Disclosed to verify that the first order of preference was calculated correctly.

Example 4.5 Calculation of interim repayments according to the surplus-capital method

Ex, Why and Zed are in partnership and share profits/losses in the ratio of 5:4:1 respectively. The favourable (credit) closing balances of their capital accounts, after the balances of the current accounts and the goodwill account were closed off thereto, were R9 700, R3 400 and R1 500 for Ex, Why and Zed respectively. The partnership is in liquidation, and assets are disposed of piecemeal. All the liabilities have been paid. An amount of R6 800 is available for interim repayments to the partners. The unsold assets are recorded as R7 800. The partners decided that any final capital deficit must be apportioned to the capital accounts of the remaining solvent partners according to their profit-sharing ratio.

Required:

(a) Calculate the order of preference according to which cash must be repaid to the partners by applying the surplus-capital method.

(b) Calculate how the R6 800 must be repaid to the partners by applying the order of preference as determined in (a).

Solution:

(a) Calculation of the order of preference

Step A: Calculate and rank the capital per unit of profit share of each partner.

Ex: R9 700/5 = R1 940 (1st)

Why: R3 400/4 = R850 (3rd)

Zed: R1 500/1 = R1 500 (2nd)

Step B: Calculate and arrange the surplus capital of the partners.

Order of preference	**Ex Unit of profit share = 5**		**Why Unit of profit share = 4**		**Zed Unit of profit share = 1**	
	Capital account balance	**Capital per unit of profit share***	**Capital account balance**	**Capital per unit of profit share***	**Capital account balance**	**Capital per unit of profit share***
	R	**R**	**R**	**R**	**R**	**R**
	(9 700)	1 940**	(3 400)	850**	(1 500)	1 500**
First	2 200***					
	(7 500)	1 500	(3 400)	850	(1 500)	1 500
Second	3 250***				650***	
All partners	(4 250)	850	(3 400)	850	(850)	850

* With the exception of the initial calculations of the capital per unit of profit shares of R1 940, R850 and R1 500, the calculations of the capital per unit of profit shares are done to verify that the calculations of the order of preference are correct. For example, after the first order of preference is allocated, the capital per unit of profit share of Ex (R1 500) must be equal to that of Zed (R1 500).

** Step A

*** Step B

The above table is hereby explained:

☐ The surplus capital of Ex must be allocated first and solely to him according to the first order of preference:

Ex has the largest capital per unit of profit share, and a portion of his surplus capital must be allocated first, until his capital per unit of profit share is equal to that of Zed (who has the second largest capital per unit of profit share). The amount of surplus capital to be allocated first is calculated by means of the following formula:

Formula: Capital account balance of the partner with the highest capital per unit of profit share (that of Ex) *minus* [the next highest capital per unit of profit share (that of Zed) *multiplied by* the respective unit of profit share of the partner with the highest capital per unit of profit share (that of Ex)]

Amount of surplus capital to be allocated first to Ex: R9 700 – (R1 500 × 5) = R2 200

After the surplus capital of R2 200 is allocated to Ex, his capital per unit of profit share decreases to R1 500 (R7 500/5). Since no allocations are made to Why and Zed at this stage, their respective initial capital per unit of profit shares of R850 and R1 500 remain unchanged.

Thus, after R2 200 is allocated to Ex, Ex and Zed have equal capital per unit of profit shares of R1 500 each, and their capital ratio is equal to their profit-sharing ratio (R7 500:R1 500 = 5:1).

☐ The surplus capital of Ex and Zed that must be allocated to them according to the second order of preference:

Since there are three partners who initially have different capital per unit of profit shares, a first and second order of preference must be determined.

Formula: Capital account balances of the partners with the highest capital per unit of profit shares (Ex and Zed's) *minus* [the next highest capital per unit of profit share (Why's) *multiplied by* the respective unit of profit shares of the partners with the highest capital per unit of profit shares (Ex and Zed's)]

Ex: R7 500 – (R850 × 5) = R3 250

Zed: R1 500 – (R850 × 1) = R650

The total amount of surplus capital allocated simultaneously to Ex and Zed is R3 900 (R3 250 + R650). Should less cash than R3 900 be available for an interim repayment, the cash must simultaneously be paid out to them according to their profit-sharing ratio.

After the surplus capital amounts of R3 250 and R650 are allocated to Ex and Zed respectively, their capital per unit of profit shares will be equal to that of Why, namely R850 (Ex: R4 250/5 = R850; Zed: R850/1 = R850).

The remaining capital account balances of Ex, Why and Zed will then be R4 250, R3 400 and R850 respectively, and their respective capital ratios will be equal to their profit-sharing ratios (R4 250:R3 400:R850 = 5:4:1). Should less cash be available than the sum of the remaining capital account balances, which is R8 500, it must simultaneously be paid to the partners according to their profit-sharing ratio.

(b) Calculation of the repayments of the available cash (R6 800) according to the order of preference

Bank	Ex Unit of profit share = 5		Why Unit of profit share = 4		Zed Unit of profit share = 1	
	Capital account balance	Capital per unit of profit share*	Capital account balance	Capital per unit of profit share*	Capital account balance	Capital per unit of profit share*
R	R	R	R	R	R	R
6 800	(9 700)	1 940	(3 400)	850	(1 500)	1 500
(2 200)	2200 (1st)					
4 600	(7 500)	1 500	(3 400)	850	(1 500)	1 500
(3 900)	3 250 (2nd)				650 (2nd)	
700	(4 250)	850	(3 400)	850	(850)	850
(700)	350① (3rd)		280① (3rd)		70① (3rd)	
–	3 900	780②	3 120	780②	780	780②

* Disclosed for verification purposes.

Since an amount of R6 800 is available for an interim repayment to the partners, the repayments in respect of the first and second order of preference can be made in full. The remaining amount of R700 must be repaid simultaneously to Ex, Why and Zed according to their profit-sharing ratio of 5:4:1 respectively.

Calculations:

① **Appropriation of the remaining R700 to Ex, Why and Zed**

Ex: R700 × 5/10 = R350

Why: R700 × 4/10 = R280

Zed: R700 × 1/10 = R70

② **The capital per unit of profit shares of Ex, Why and Zed after the R700 was paid to them**

Ex: R3 900/5 = R780

Why: R3 120/4 = R780

Zed: R780/1 = R780

These capital per unit of profit shares are merely calculated to verify the correctness of the calculations. Although the capital per unit of profit shares of Ex, Why and Zed decreased from R850 to R780, they remained equal, which means that the capital ratio of the partners also remained equal to their profit-sharing ratio (R3 900:R3 120: R780 = 5:4:1).

4.5.2 *Calculation of interim repayments according to the loss-absorption-capacity method*

When the loss-absorption-capacity method is applied in Step 3 of the procedure for the piecemeal liquidation of a partnership (refer to paragraph 4.5), the aim is to calculate to what extent the balances of the capital accounts are able to absorb the maximum *anticipated* loss of a partnership.

The steps to be applied in this *calculation* are as follows:

Step A: Determine the actual general ledger account balances in the books of the partnership on the date that cash becomes available for interim repayments.

The capital account balances should include all the applicable accounting entries up to the date of the calculation of the interim repayments of the available cash.

Step B: Debit any budgeted/contingent expenses in the partners' capital accounts according to their profit-sharing ratio and credit bank.

Step C: Close off all unsold assets to the capital accounts according to the profit-sharing ratio of the partners.

This step is based on the assumption that the unsold assets have no recoverable amount.

Step D: Close off any anticipated capital deficit to the capital accounts of the partners who have favourable anticipated capital account balances according to their profit-sharing ratio.

This step is based on the assumption that all the partners with final anticipated capital deficits are insolvent. Since the loss-absorption-capacity method is based on future events or assumptions, the calculated capitals are said to be *anticipated*.

After Steps A–D have been applied, the sum of the anticipated favourable capital account balances must be equal to the amount of cash that is available for interim repayments.

It is important to note that Steps B–D are NOT recorded in the books of the partnership. The only recording in the books are the interim repayments.

Example 4.6 Calculation of interim repayments according to the loss-absorption-capacity method

Ex, Why and Zed are in partnership and share profits/losses in the ratio of 5:4:1 respectively. The favourable (credit) closing balances of their capital accounts, after the balances of the current accounts and the goodwill account were closed off thereto, were R9 700, R3 400 and R1 500 for Ex, Why and Zed respectively. The partnership is in liquidation, and assets are disposed of piecemeal. All the liabilities have been paid. An amount of R6 800 is available for interim repayments to the partners. The unsold assets are recorded as R7 800. The partners decided that, in the event of any final capital deficits, the deficits must be apportioned to the capital accounts of the remaining solvent partners according to their profit-sharing ratio.

Required:

Calculate how the R6 800 must be repaid to the partners by applying the loss-absorption-capacity method.

Solution:

Step	Bank	Assets	Capital account: Ex	Capital account: Why	Capital account: Zed
	R	**R**	**R**	**R**	**R**
A	6 800	7 800	(9 700)	(3 400)	(1 500)
C		(7 800)	3 900①	3 120①	780①
	6 800	–	(5 800)	(280)	(720)

Comment:

Steps B and D are not applicable and are therefore omitted.

Calculation:

① **Appropriation of the unsold assets**

Ex: R7 800 × 5/10 = R3 900

Why: R7 800 × 4/10 = R3 120

Zed: R7 800 × 1/10 = R780

The R6 800 that is available for an interim repayment is paid to the partners according to their capital account balances, namely R5 800 to Ex, R280 to Why and R720 to Zed. The total of the balances is equal to the available cash (R5 800 + R280 + R720 = R6 800).

Comprehensive example 4.7 Piecemeal liquidation of a solvent partnership

Lola, Ruby and Maya were in a partnership, trading as Mayflower Creations; they shared in the profits and losses of the partnership in the ratio of 5:3:2, respectively. At 30 June 20.3, a financial year-end of the partnership, the partners decided to dissolve the partnership piecemeal during July and August. The budgeted liquidation expenses amounted to R4 000. All the partners were able to settle any final deficits on their capital accounts. The following liquidation procedure was applied:

The assets were sold for cash, with exception of those taken over by a partner. The budgeted liquidation expenses had to be provided for and held in the bank account until payment – that is when all the assets have been liquidated. The creditors were paid after the liquidation expenses were provided for in full. As further cash became available, interim repayments were made to the partners in such a manner that no partner had to repay any interim repayment that was received.

On 1 July 20.3, the trial balance of the partnership was as follows:

Mayflower Creations
Trial balance as at 1 July 20.3

	Debit	Credit
	R	R
Capital: Lola		15 500
Capital: Ruby		16 200
Capital: Maya		8 300
Current account: Lola	4 500	
Current account: Ruby		2 700
Current account: Maya		4 000
Revaluation surplus		6 000
Goodwill	5 000	
Trade payables control		25 500
Bank	1 000	
Land and buildings at fair value	20 000	
Furniture and equipment at carrying amount	30 400	
Inventory	17 300	
	78 200	78 200

The assets were liquidated (sold) as follows:

Date of liquidation	Asset	Value	Selling price	Loss/profit
		R	R	R
18 July 20.3 (First liquidation)	Land and buildings	20 000	15 000 (cash)	5 000 (loss)
	Inventory	11 000	13 000 (cash)	2 000 (profit)
				3 000 (loss)

continued

Date of liquidation	Asset	Value	Selling price	Loss/profit
		R	R	R
1 August 20.3 (Second liquidation)	Furniture and equipment	15 000	8 000 (cash)	7 000 (loss)
	Inventory	6 300	6 300 (cash)	–
				7 000 (loss)
9 August 20.3 (Third liquidation)	Furniture and equipment	13 400	12 000 (cash)	1 400 (loss)
16 August 20.3 (Fourth liquidation)	Furniture and equipment	2 000	1 000 (Lola)	–
			1 000 (cash)	

A settlement discount of R250 was received on the first payment to the creditors. On 16 August 20.3, the liquidation expenses, amounting to R2 800, were paid in full.

Required:

Comment:

For illustrative purposes, this example comprises individual entries according to the steps presented in paragraph 4.5, concerning the accounting procedure for the piecemeal liquidation of a partnership. Alternatively, the liquidation process can be recorded without preparing the individual entries, as per the solution shown after (m).

(a) Open the goodwill, the revaluation surplus, the current and the capital accounts in the general ledger of Mayflower Creations. Enter the balances thereof on 1 July 20.3. Close the current accounts (Step 1), the goodwill account (Step 2), and the revaluation surplus account (Step 2) off to the capital accounts of the partners on this date. Calculate the balancing amounts of the capital accounts. (Do not balance the capital accounts, since they will be used throughout the recording of the liquidation process.)

(b) Record the first liquidation of the assets and the first payment to the creditors (Step 3) in the general ledger accounts of Mayflower Creations (after the given opening balances of the accounts were entered). Prepare liquidation account A to record the liquidation of the assets and another (liquidation account B) to record the payment to the creditors. Calculate the balancing amount of the bank account.

(c) Calculate whether there are funds available to make a first interim repayment to the partners on 18 July 20.3.

(d) Record the second liquidation of the assets (in liquidation account C) and the settlement of any remaining debts (Step 3) in the general ledger accounts of Mayflower Creations. Proceed with the accounts that are open, and, if necessary, open any further accounts with the given opening balances. Since no settlement discount was received on the payment of the outstanding creditors, it is not required to record this transaction in a liquidation account. Balance the inventory and the trade payables control accounts. Calculate the balancing amounts of the bank and the capital accounts.

(e) Calculate whether there are funds available to make first interim repayments to the partners on 1 August 20.3.

(f) Calculate the first interim repayments that must be made to the partners on 1 August 20.3 according to the loss-absorption-capacity method.

(g) Record the first interim repayments to the partners on 1 August 20.3 in the general ledger accounts of Mayflower Creations (Step 3).

(h) Record the third liquidation of the assets (in liquidation account D) in the general ledger accounts of Mayflower Creations (Step 3). Calculate the balancing amounts of the furniture and equipment at carrying amount, the bank and capital accounts.

(i) Calculate the second interim repayments that must be made to the partners on 9 August 20.3 according to the loss-absorption-capacity method.

(j) Record the second interim repayments to the partners on 9 August 20.3 in the general ledger accounts of Mayflower Creations (Step 3).

(k) Record the fourth liquidation of the assets (in liquidation account E) in the general ledger accounts of Mayflower Creations (Step 3).

(l) Record the payment of the actual liquidation expenses in the general ledger of the partnership (Step 3). Disclose the liquidation expenses in liquidation account F. Calculate the balancing amounts of the bank and the capital accounts.

(m) Record the final payments to the partners in order to close off the books of the partnership (Step 4).

Solution:

Comment:

The shaded entries in the ledger accounts indicate the entries for the requirement under review. The balancing amounts are indicated to ease calculations.

(a) **Mayflower Creations**
General ledger

Dr **Goodwill** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Balance	b/d	5 000	Jul	1	Capital: Lola①		2 500
							Capital: Ruby①		1 500
							Capital: Maya①		1 000
				5 000					5 000

Dr **Revaluation surplus** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Capital: Lola②		3 000	Jul	1	Balance	b/d	6 000
		Capital: Ruby②		1 800					
		Capital: Maya②		1 200					
				6 000					6 000

continued

Dr **Current account: Lola** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Balance	b/d	4 500	Jul	1	Capital: Lola		4 500

Dr **Current account: Ruby** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Capital: Ruby		2 700	Jul	1	Balance	b/d	2 700

Dr **Current account: Maya** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Capital: Maya		4 000	Jul	1	Balance	b/d	4 000

Dr **Capital: Lola** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill①		2 500			Revaluation surplus②		3 000
		Balancing amount		*11 500*					

Dr **Capital: Ruby** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill①		1 500	Jul	1	Balance	b/d	16 200
		Balancing amount		*19 200*			Current account: Ruby		2 700
							Revaluation surplus②		1 800

Dr **Capital: Maya** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill①		1 000	Jul	1	Balance	b/d	8 300
		Balancing amount		*12 500*			Current account: Maya		4 000
							Revaluation surplus②		1 200

Calculations:

① **Appropriation of goodwill to partners**

Lola: R5 000 × 5/10 = R2 500
Ruby: R5 000 × 3/10 = R1 500
Maya: R5 000 × 2/10 = R1 000

② **Appropriation of revaluation surplus to partners**

Lola: R6 000 × 5/10 = R3 000
Ruby: R6 000 × 3/10 = R1 800
Maya: R6 000 × 2/10 = R1 200

(b)

Mayflower Creations
General ledger

Dr **Land and buildings at fair value** **Cr**

20.3				R	20.3				R
Jul	1	Balance	b/d	20 000	Jul	18	Liquidation account: A		20 000
				20 000					20 000

Dr **Inventory** **Cr**

20.3				R	20.3				R
Jul	1	Balance	b/d	17 300	Jul	18	Liquidation account: A		11 000

Dr **Liquidation account A: Liquidation of assets*** **Cr**

20.3				R	20.3				R
Jul	18	Land and buildings at fair value		20 000	Jul	18	Bank①		28 000
							Capital: Lola②		1 500
							Capital: Ruby②		900
		Inventory		11 000			Capital: Maya②		600
				31 000					31 000

* A single liquidation account can be used to record the entire liquidation of the partnership. In this example, separate liquidation accounts were required to reconcile the individual solutions [(a) – (m)] with the summarised solution as presented after the solution to (m).

Dr **Trade payables control** **Cr**

20.3				R	20.3				R
Jul	18	Liquidation account: B④		25 250	Jul	1	Balance	b/d	25 500

Dr **Liquidation account B: Payment to creditors** **Cr**

20.3				R	20.3				R
Jul	18	Bank③		25 000	Jul	18	Trade payables control④		25 250
		Capital: Lola⑤		125					
		Capital: Ruby⑤		75					
		Capital: Maya⑤		50					
				25 250					25 250

Dr **Bank** **Cr**

20.3				R	20.3				R
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B③		25 000
	18	Liquidation account: A①		28 000			*Balancing amount*		*4 000*

continued

Dr **Capital: Lola** **Cr**

20.3				R	20.3				R
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill		2 500			Revaluation surplus		3 000
	18	Liquidation account: A②		1 500		18	Liquidation account: B⑤		125

Dr **Capital: Ruby** **Cr**

20.3				R	20.3				R
Jul	1	Goodwill		1 500	Jul	1	Balance	b/d	16 200
	18	Liquidation account: A②		900			Current account: Ruby		2 700
							Revaluation surplus		1 800
						18	Liquidation account: B⑤		75

Dr **Capital: Maya** **Cr**

20.3				R	20.3				R
Jul	1	Goodwill		1 000	Jul	1	Balance	b/d	8 300
	18	Liquidation account: A②		600			Current account: Maya		4 000
							Revaluation surplus		1 200
						18	Liquidation account: B⑤		50

Calculations:

① **Cash received during first liquidation of assets**

R(15 000 + 13 000) = R28 000

② **Apportionment of the loss on liquidation of assets to partners**

Lola: R3 000 × 5/10 = R1 500

Ruby: R3 000 × 3/10 = R900

Maya: R3 000 × 2/10 = R600

③ **Amount paid to the creditors**

Cash after the first liquidation of the assets *minus* the provision for the liquidation expenses:

R(1 000 + 28 000) – R4 000 = R25 000

④ **Amount of the trade payables control account settled on the first payment**

Amount available for payment to creditors *plus* settlement discount received on first payment:

R(25 000 + 250) = R25 250

⑤ **Apportionment of settlement discount received to partners**

Lola: R250 × 5/10 = R125

Ruby: R250 × 3/10 = R75

Maya: R250 × 2/10 = R50

(c)

On 18 July 20.3, the bank account has a favourable balance of R4 000 (refer to the solution of (b)), which is the cash that must be set aside for the payment of the budgeted liquidation expenses. Therefore, no funds are available to make a first interim repayment to the partners R(4 000 – 4 000).

(d)

Mayflower Creations
General ledger

Dr — Furniture and equipment at carrying amount — Cr

20.3				R	20.3				R
Jul	1	Balance	b/d	30 400	Aug	1	Liquidation account: C		15 000
							Balancing amount		*15 400*

Dr — Inventory — Cr

20.3				R	20.3				R
Jul	1	Balance	b/d	17 300	Jul	18	Liquidation account: A		11 000
					Aug	1	Liquidation account: C		6 300
				17 300					17 300

Dr — Liquidation account C: Liquidation of assets — Cr

20.3				R	20.3				R
Aug	1	Furniture and equipment at carrying amount		15 000	Aug	1	Bank①		14 300
		Inventory		6 300			Capital: Lola②		3 500
							Capital: Ruby②		2 100
							Capital: Maya②		1 400
				21 300					21 300

Dr — Bank — Cr

20.3				R	20.3				R
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B		25 000
		Liquidation account: A		28 000	Aug	1	Trade payables control*		250
Aug	1	Liquidation account: C①		14 300			*Balancing amount*		*18 050*

* Payment of final outstanding amount R(25 500 – 25 250) after the second liquidation of assets.

Dr **Trade payables control** **Cr**

20.3				**R**	20.3				**R**
Jul	18	Liquidation account:			Jul	1	Balance	b/d	25 500
		B		25 250					
Aug	1	Bank*		250					
				25 500					25 500

* Payment of final outstanding amount R(25 500 – 25 250) after the second liquidation of assets.

Dr **Capital: Lola** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Current account:			Jul	1	Balance	b/d	15 500
		Lola		4 500			Revaluation surplus		3 000
		Goodwill		2 500		18	Liquidation account:		
	18	Liquidation account:					B		125
		A		1 500					
Aug	1	Liquidation account:							
		C②		3 500					
		Balancing amount		*6 625*					

Dr **Capital: Ruby** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 500	Jul	1	Balance	b/d	16 200
	18	Liquidation account:					Current account:		
		A		900			Ruby		2 700
Aug	1	Liquidation account:					Revaluation surplus		1 800
		C②		2 100		18	Liquidation account:		
		Balancing amount		*16 275*			B		75

Dr **Capital: Maya** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 000	Jul	1	Balance	b/d	8 300
	18	Liquidation account:					Current account:		
		A		600			Maya		4 000
Aug	1	Liquidation account:					Revaluation surplus		1 200
		C②		1 400		18	Liquidation account:		
		Balancing amount		*10 550*			B		50

Calculations:

① **Cash received during second liquidation of assets**

R(8 000 + 6 300) = R14 300

② **Apportionment of the loss on liquidation of assets**

Lola: R7 000 × 5/10 = R3 500
Ruby: R7 000 × 3/10 = R2 100
Maya: R7 000 × 2/10 = R1 400

(e) On 1 August 20.3, the bank account has a favourable balance of R18 050 (refer to the solution in (d)), of which R4 000 must be set aside for the payment of the budgeted liquidation expenses. Therefore, R14 050 (R18 050 – R4 000) is available.

(f)

Step	Bank	Assets	Capital: Lola	Capital: Ruby	Capital: Maya
	R	R	R	R	R
A	18 050*	15 400①	(6 625)**	(16 275)**	(10 550)**
B	(4 000)		2 000②	1 200②	800②
C***		(15 400)	7 700③	4 620③	3 080③
	14 050	–	3 075	(10 455)	(6 670)
D***			(3 075)	1 845④	1 230④
	14 050	–	–	8 610	5 440

* See solution to (d).

** At the time when the interim repayments are calculated (on 1 August 20.3), the credit balances on the capital accounts of Lola, Ruby and Maya are R6 625, R16 275 and R10 550 respectively (refer to the balancing amounts of the capital accounts in the solution to (d)).

*** Bear in mind that Steps C and D are based on assumptions. For example, in respect of Step D, Lola is *assumed* to be insolvent, but the given information indicates that all of the partners are in fact solvent.

Calculations:

① **The amount of the unsold furniture and equipment that is considered to be worthless**

As obtained from the given information in respect of the furniture and equipment that was sold during the third and fourth liquidation: R(13 400 + 2 000) = R15 400;

or

refer to the solution for (d) - the balancing amount of the furniture and equipment at carrying amount is R(30 400 – 15 000) = R15 400.

② **The budgeted liquidation expenses apportioned to Lola, Ruby and Maya**

Lola: R4 000 × 5/10 = R2 000
Ruby: R4 000 × 3/10 = R1 200
Maya: R4 000 × 2/10 = R800

③ **The loss of the assumed worthless assets apportioned to Lola, Ruby and Maya**

Lola: R15 400 × 5/10 = R7 700
Ruby: R15 400 × 3/10 = R4 620
Maya: R15 400 × 2/10 = R3 080

④ **The anticipated capital deficit of Lola apportioned to Ruby and Maya**

Ruby: R3 075 × 3/5 = R1 845
Maya: R3 075 × 2/5 = R1 230

Comment:

The anticipated balances on the capital accounts are merely the results of the calculation that was done according to the loss-absorption-capacity method. The final anticipated balances of the capital accounts of the partners (ie the result of Step D), indicate how the cash which is available for the repayments must be paid out. Therefore, Ruby will receive R8 610 and Maya, R5 440. Lola's capital account has no final anticipated balance and she will thus not receive an interim repayment at this stage.

(g) **Mayflower Creations**
General ledger

Dr **Bank** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B		25 000
	18	Liquidation account: A		28 000	Aug	1	Trade payables control		250
Aug	1	Liquidation account: C		14 300			Capital: Ruby*		8 610
							Capital: Maya*		5 440

* Calculated in the solution to (f).

Dr **Capital: Lola** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill		2 500			Revaluation surplus		3 000
	18	Liquidation account: A		1 500		18	Liquidation account: B		125
Aug	1	Liquidation account: C		3 500					

Dr **Capital: Ruby** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 500	Jul	1	Balance	b/d	16 200
	18	Liquidation account: A		900			Current account: Ruby		2 700
Aug	1	Liquidation account: C		2 100			Revaluation surplus		1 800
		Bank*		8 610		18	Liquidation account: B		75

* Calculated in the solution to (f).

Dr **Capital: Maya** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 000	Jul	1	Balance	b/d	8 300
	18	Liquidation account: A		600			Current account: Maya		4 000
Aug	1	Liquidation account: C		1 400			Revaluation surplus		1 200
		Bank*		5 440		18	Liquidation account: B		50

* Calculated in the solution to (f).

(h)

Mayflower Creations
General ledger

Dr **Furniture and equipment at carrying amount** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Balance	b/d	30 400	Aug	1	Liquidation account: C		15 000
						9	Liquidation account: D		13 400
							Balancing amount		*2 000*

Dr **Liquidation account D: Liquidation of assets** **Cr**

20.3				**R**	20.3				**R**
Aug	9	Furniture and equipment at carrying amount		13 400	Aug	9	Bank		12 000
							Capital: Lola①		700
							Capital: Ruby①		420
							Capital: Maya①		280
				13 400					13 400

Dr **Bank** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B		25 000
	18	Liquidation account: A		28 000	Aug	1	Trade payables control		250
Aug	1	Liquidation account: C		14 300			Capital: Ruby		8 610
	9	Liquidation account: D		12 000			Capital: Maya		5 440
							Balancing amount		*16 000*

Dr **Capital: Lola** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill		2 500			Revaluation surplus		3 000
	18	Liquidation account: A		1 500		18	Liquidation account: B		125
Aug	1	Liquidation account: C		3 500					
	9	Liquidation account: D①		700					
		Balancing amount		*5 925*					

continued

Dr **Capital: Ruby** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 500	Jul	1	Balance	b/d	16 200
	18	Liquidation account: A		900			Current account: Ruby		2 700
Aug	1	Liquidation account: C		2 100			Revaluation surplus		1 800
		Bank		8 610		18	Liquidation account: B		75
	9	Liquidation account: D①		420					
		Balancing amount		*7 245*					

Dr **Capital: Maya** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 000	Jul	1	Balance	b/d	8 300
	18	Liquidation account: A		600			Current account: Maya		4 000
Aug	1	Liquidation account: C		1 400			Revaluation surplus		1 200
		Bank		5 440		18	Liquidation account: B		50
	9	Liquidation account: D①		280					
		Balancing amount		*4 830*					

Calculation:

① **Apportionment of the loss on the liquidation of the assets**
Lola: R1 400 × 5/10 = R700
Ruby: R1 400 × 3/10 = R420
Maya: R1 400 × 2/10 = R280

(i)

Step	Bank	Assets	Capital: Lola	Capital: Ruby	Capital: Maya
	R	**R**	**R**	**R**	**R**
A	16 000*	2 000*	(5 925)*	(7 245)*	(4 830)*
B	(4 000)		2 000	1 200	800
C		(2 000)	1 000①	600①	400①
	12 000	–	(2 925)	(5 445)	(3 630)

* Balancing figure carried forward from the solution to (h).

Calculation:

① **Apportionment of the remaining assets assumed to be worthless**
Lola: R2 000 × 5/10 = R1 000
Ruby: R2 000 × 3/10 = R600
Maya: R2 000 × 2/10 = R400

(j)

Mayflower Creations
General ledger

Dr **Bank** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B		25 000
	18	Liquidation account: A		28 000	Aug	1	Trade payables control		250
Aug	1	Liquidation account: C		14 300			Capital: Ruby		8 610
	9	Liquidation account: D		12 000			Capital: Maya		5 440
						9	Capital: Lola*		2 925
							Capital: Ruby*		5 445
							Capital: Maya*		3 630

* Calculated in the solution to (i).

Dr **Capital: Lola** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill		2 500			Revaluation surplus		3 000
	18	Liquidation account: A		1 500		18	Liquidation account: B		125
Aug	1	Liquidation account: C		3 500					
	9	Liquidation account: D		700					
		Bank*		2 925					

* Calculated in the solution to (i).

Dr **Capital: Ruby** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 500	Jul	1	Balance	b/d	16 200
	18	Liquidation account: A		900			Current account: Ruby		2 700
Aug	1	Liquidation account: C		2 100			Revaluation surplus		1 800
		Bank		8 610		18	Liquidation account: B		75
	9	Liquidation account: D		420					
		Bank*		5 445					

* Calculated in the solution to (i).

Dr **Capital: Maya** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 000	Jul	1	Balance	b/d	8 300
	18	Liquidation account: A		600			Current account: Maya		4 000
Aug	1	Liquidation account: C		1 400			Revaluation surplus		1 200
		Bank		5 440		18	Liquidation account: B		50
	9	Liquidation account: D		280					
		Bank*		3 630					

* Calculated in the solution to (i).

(k)

Mayflower Creations
General ledger

Dr **Furniture and equipment at carrying amount** **Cr**

20.3				R	20.3				R
Jul	1	Balance	b/d	30 400	Aug	1	Liquidation account: C		15 000
						9	Liquidation account: D		13 400
						16	Liquidation account: E		2 000
				30 400					30 400

Dr **Liquidation account E: Liquidation of assets** **Cr**

20.3				R	20.3				R
Aug	16	Furniture and equipment at carrying amount		2 000	Aug	16	Capital: Lola		1 000
							Bank		1 000

Dr **Bank** **Cr**

20.3				R	20.3				R
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B		25 000
	18	Liquidation account: A		28 000	Aug	1	Trade payables control		250
Aug	1	Liquidation account: C		14 300			Capital: Ruby		8 610
							Capital: Maya		5 440
	9	Liquidation account: D		12 000		9	Capital: Lola		2 925
	16	Liquidation account: E		1 000			Capital: Ruby		5 445
							Capital: Maya		3 630

Dr **Capital: Lola** **Cr**

20.3				R	20.3				R
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill		2 500			Revaluation surplus		3 000
	18	Liquidation account: A		1 500		18	Liquidation account: B		125
Aug	1	Liquidation account: C		3 500					
	9	Liquidation account: D		700					
		Bank		2 925					
	16	Liquidation account: E		1 000					

(l)

Mayflower Creations
General ledger

Dr **Liquidation account F: Payment of liquidation expenses** **Cr**

20.3				R	20.3				R
Aug	16	Bank		2 800	Aug	16	Capital: Lola①		1 400
							Capital: Ruby①		840
							Capital: Maya①		560
				2 800					2 800

Dr **Bank** **Cr**

20.3				R	20.3				R
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B		25 000
	18	Liquidation account: A		28 000	Aug	1	Trade payables control		250
Aug	1	Liquidation account: C		14 300			Capital: Ruby		8 610
	9	Liquidation account: D		12 000			Capital: Maya		5 440
	16	Liquidation account: E		1 000		9	Capital: Lola		2 925
							Capital: Ruby		5 445
							Capital: Maya		3 630
						16	Liquidation account: F		2 800
							Balancing amount		*2 200*

Dr **Capital: Lola** **Cr**

20.3				R	20.3				R
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill		2 500			Revaluation surplus		3 000
	18	Liquidation account: A		1 500		18	Liquidation account: B		125
Aug	1	Liquidation account: C		3 500					
	9	Liquidation account: D		700					
		Bank		2 925					
	16	Liquidation account: E		1 000					
		Liquidation account: F①		1 400					
		Balancing amount		*600*					

continued

Dr **Capital: Ruby** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 500	Jul	1	Balance	b/d	16 200
	18	Liquidation account: A		900			Current account: Ruby		2 700
Aug	1	Liquidation account: C		2 100			Revaluation surplus		1 800
		Bank		8 610		18	Liquidation account: B		75
	9	Liquidation account: D		420					
		Bank		5 445					
	16	Liquidation account: F①		840					
		Balancing amount		*960*					

Dr **Capital: Maya** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Goodwill		1 000	Jul	1	Balance	b/d	8 300
	18	Liquidation account: A		600			Current account: Maya		4 000
Aug	1	Liquidation account: C		1 400			Revaluation surplus		1 200
		Bank		5 440		18	Liquidation account: B		50
		Liquidation account: D		280					
		Bank		3 630					
	16	Liquidation account: F①		560					
		Balancing amount		*640*					

Calculation:

① **Apportionment of the liquidation expenses**

Lola: R2 800 × 5/10 = R1 400
Ruby: R2 800 × 3/10 = R840
Maya: R2 800 × 2/10 = R560

(m) **Mayflower Creations**
General ledger

Dr **Bank** **Cr**

20.3				**R**	20.3				**R**
Jul	1	Balance	b/d	1 000	Jul	18	Liquidation account: B		25 000
	18	Liquidation account: A		28 000	Aug	1	Trade payables control		250
Aug	1	Liquidation account: C		14 300			Capital: Ruby		8 610
	9	Liquidation account: D		12 000			Capital: Maya		5 440
						9	Capital: Lola		2 925
							Capital: Ruby		5 445

continued

Dr			Bank						Cr
20.3				R	20.3				R
Aug	16	Liquidation account: E		1 000			Capital: Maya		3 630
						16	Liquidation account: F		2 800
							Capital: Lola*		600
							Capital: Ruby*		960
							Capital: Maya*		640
				56 300					56 300

* Remaining cash paid out according to the balancing amount (R2 200) in the solution to (l).

Dr			Capital: Lola						Cr
20.3				R	20.3				R
Jul	1	Current account: Lola		4 500	Jul	1	Balance	b/d	15 500
		Goodwill		2 500			Revaluation surplus		3 000
	18	Liquidation account: A		1 500		18	Liquidation account: B		125
Aug	1	Liquidation account: C		3 500					
	9	Liquidation account: D		700					
		Bank		2 925					
	16	Liquidation account: E		1 000					
		Liquidation account: F		1 400					
		Bank*		600					
				18 625					18 625

* Remaining cash paid out according to the balancing amount of Lola's capital account in the solution to (l).

Dr			Capital: Ruby						Cr
20.3				R	20.3				R
Jul	1	Goodwill		1 500	Jul	1	Balance	b/d	16 200
	18	Liquidation account: A		900			Current account: Ruby		2 700
Aug	1	Liquidation account: C		2 100			Revaluation surplus		1 800
		Bank		8 610		18	Liquidation account: B		75
	9	Liquidation account: D		420					
		Bank		5 445					
	16	Liquidation account: F		840					
		Bank*		960					
				20 775					20 775

* Remaining cash paid out according to the balancing amount of Ruby's capital account in the solution to (l).

Dr **Capital: Maya** **Cr**

20.3				R	20.3				R
Jul	1	Goodwill		1 000	Jul	1	Balance	b/d	8 300
	18	Liquidation account: A		600			Current account: Maya		4 000
Aug	1	Liquidation account: C		1 400			Revaluation surplus		1 200
		Bank		5 440		18	Liquidation account: B		50
	9	Liquidation account: D		280					
		Bank		3 630					
	16	Liquidation account: F		560					
		Bank*		640					
				13 550					13 550

* Remaining cash paid out according to the balancing figure of Maya's capital account in the solution to (I).

The solution to the above example is summarised in columnar format (see below). In this summary, credit balances and credit entries are disclosed in brackets, and the liquidation accounts are not disclosed. Refer to the above solution for calculations.

Mayflower Creations
General ledger in columnar format

Date	Transaction	Bank	Property, plant and equipment	Inventory	Trade payables control	Capital: Lola	Capital: Ruby	Capital: Maya
20.3		R	R	R	R	R	R	R
Jul 1	Balances	1 000	50 400	17 300	(25 500)	(15 500)	(16 200)	(8 300)
	Closed off:							
	Current accounts*					4 500	(2 700)	(4 000)
	Goodwill*					2 500	1 500	1 000
	Revaluation surplus*					(3 000)	(1 800)	(1 200)
	Balances	1 000	50 400	17 300	(25 500)	(11 500)	(19 200)	(12 500)
18	1st liquidation	28 000	(20 000)	(11 000)		1 500	900	600
	Payment to creditors	(25 000)			25 250	(125)	(75)	(50)

continued

Date	Transaction	Bank	Property, plant and equipment	Inventory	Trade payables control	Capital: Lola	Capital: Ruby	Capital: Maya
20.3		R	R	R	R	R	R	R
Aug 1	2nd liquidation	14 300	(15 000)	(6 300)		3 500	2 100	1 400
	Payment to creditors	(250)			250			
	Balances	18 050	15 400	–	–	(6 625)	(16 275)	(10 550)
	1st interim repayments	(14 050)					8 610	5 440
	Balances	4 000	15 400	–	–	(6 625)	(7 665)	(5 110)
20.3 Aug 1	3rd liquidation	12 000	(13 400)			700	420	280
	Balances	16 000	2 000	–	–	(5 925)	(7 245)	(4 830)
	2nd interim repayments	(12 000)				2 925	5 445	3 630
	Balances	4 000	2 000	–	–	(3 000)	(1 800)	(1 200)
16	4th liquidation	1 000	(2 000)			1 000		
	Balances	5 000	–	–	–	(2 000)	(1 800)	(1 200)
	Liquidation expenses paid	(2 800)				1 400	840	560
	Balances	2 200	–	–	–	(600)	(960)	(640)
	Final repayments	(2 200)				600	960	640
	Balances	–	–	–	–	–	–	–

* Due to the limited number of columns available, the current, goodwill and revaluation surplus accounts are not disclosed. Note how the balances of these accounts are apportioned to the capital accounts.

Comprehensive example 4.8 Piecemeal liquidation of a solvent partnership

Bester, Gunter and Venter are in partnership, trading as Hillside Garden Centre and sharing in the profits/losses of the partnership in the ratio of 3:2:1 respectively. When they entered into the partnership, they each made a capital contribution of R10 000. At the financial year-end 31 December 20.3, the balances of the ledger accounts of the partnership were as follows:

Hillside Garden Centre
Trial balance as at 31 December 20.3

	Debit	Credit
	R	R
Capital: Bester		600
Capital: Gunter		8 400
Capital: Venter		10 000
Trade payables control		11 000
Furniture and equipment at carrying amount	21 000	
Inventory	7 000	
Bank	2 000	
	30 000	30 000

The partners decided to liquidate the partnership piecemeal as from 1 January 20.4 and to repay the creditors in full with a once-off payment as soon as sufficient cash is received from the sale of the assets. They further decided that interim repayments will be made to them as cash becomes available in such a way that it would not be necessary to repay any of these amounts to the partnership at a later stage, and that in the case of a final capital deficit of an insolvent partner, it would be borne according to the profit-sharing ratio of the remaining solvent partners.

The assets of the partnership were liquidated as follows:

Date of liquidation	Asset	Carrying amount	Sales transaction
		R	R
7 January 20.4	Furniture and equipment	12 800	10 400 (cash)
1 February 20.4	Furniture and equipment	5 000	5 000 (taken over by Venter)
20 February 20.4	Furniture and equipment	3 200	3 800 (cash)
	Inventory	4 000	4 000 (cash)
3 March 20.4	Inventory	3 000	3 000 (cash)

No settlement discount was received on the payment of the creditors' accounts, and at 3 March 20.4 Bester was declared insolvent. No dividend is receivable from his insolvent estate.

Required:

Record the liquidation transactions of Hillside Garden Centre in columnar format according to the following outlay. Disclose all credit balances and credit entries in brackets. Use the surplus-capital method to calculate the interim repayments to the partners.

Hillside Garden Centre
General ledger

Date	Transaction	Bank	Furniture and equipment	Inven-tory	Trade payables control	Capital: Bester	Capital: Gunter	Capital: Venter
20.4		**R**	**R**	**R**	**R**	**R**	**R**	**R**
Jan 1	Balances	2 000	21 000	7 000	(11 000)	(600)	(8 400)	(10 000)

Solution:

Hillside Garden Centre
General ledger in columnar format

Date	Transaction	Bank	Furniture and equipment	Inven-tory	Trade payables control	Capital: Bester	Capital: Gunter	Capital: Venter
20.4		**R**	**R**	**R**	**R**	**R**	**R**	**R**
Jan 1	Balances	2 000	21 000	7 000	(11 000)	(600)	(8 400)	(10 000)
7	Liquidation	10 400	(12 800)			1 200①	800①	400①
	Creditors	(11 000)			11 000			
	Balances	1 400	8 200	7 000	–	600*	(7 600)	(9 600)
	1st interim repayment	(1 400)						1 400②
20.4								
Feb 1	Liquidation		(5 000)					5 000
20	Liquidation	7 800③	(3 200)	(4 000)		(300)④	(200)④	(100)④
	Balances	7 800	–	3 000	–	300	(7 800)	(3 300)
	2nd interim repayments	(7 800)					5 600⑤	2 200⑤
Mar 3	Liquidation	3 000	–	(3 000)	–			
	Balances	3 000	–	–	–	300	(2 200)	(1 100)
	Deficit transfer					(300)	200⑥	100⑥
	Balances	3 000	–	–	–	–	(2 000)	(1 000)
	Final repayments	(3 000)					2 000**	1 000**
	Balances	–	–	–	–	–	–	–

* Bester's capital account turned into a deficit, but Bester continues to share in the profits/losses of the partnership until the liquidation process is completed.
** The remaining cash in the bank is used to repay the final capital account balances of Gunter and Venter.

Calculations:

① Apportionment of the loss on the liquidation of the assets on 7 January 20.4

Loss: R(12 800 – 10 400) = R2 400
Bester: R2 400 × 3/6 = R1 200
Gunter: R2 400 × 2/6 = R800
Venter: R2 400 × 1/6 = R400

② **First interim repayment according to the surplus-capital method**

Calculation of the order of preference in columnar format:

Order of preference	Bester Unit of profit share = 3		Gunter Unit of profit share = 2		Venter Unit of profit share = 1	
	Capital account balance	**Capital per unit of profit share**	**Capital account balance**	**Capital per unit of profit share**	**Capital account balance**	**Capital per unit of profit share**
	R	**R**	**R**	**R**	**R**	**R**
	(600)	200❶	(8 400)	4 200❶	(10 000)	10 000❶
First					5 800❷	
	(600)	200	(8 400)	4 200	(4 200)	4 200*
Second			8 000❷		4 000❷	
All partners	(600)	200	(400)	200*	(200)	200*

* Disclosed for verification purposes.

❶ **Step A: Calculate and rank the capital per unit of profit share of each partner (on the commencement date of the liquidation, namely 1 January 20.4)**
Bester: R600/3 = R200 (3rd)
Gunter: R8 400/2 = R4 200 (2nd)
Venter: R10 000/1 = R10 000 (1st)

❷ **Step B: Calculate and arrange the surplus capital of the partners**

- ☐ The surplus capital of Venter that must be allocated first and solely to him according to the first order of preference:

  R10 000 – (R4 200 × 1) = R5 800

- ☐ The surplus capital of Venter and Gunter that must be allocated to them according to the second order of preference:
  Venter: (R10 000 – R5 800) – (R200 × 1) = R4 000
  Gunter: R8 400 – (R200 × 2) = R8 000

Venter must first and solely receive R5 800, therefore the whole amount of available cash on R1 400 must be paid to him. When cash becomes available for an interim repayment again, Venter must first receive the amount which is still due to him in respect of the first order of preference, which is R4 400 (R5 800 – R1 400). Thereafter, he and the other partners may receive interim repayments according to the order of preference.

③ **Total amount of cash sales on 20 February 20.4**
R(3 800 + 4 000) = R7 800

④ **Apportionment of the profit on the liquidation of the assets on 20 February 20.4**
Profit: R(7 800 – 7 200) = R600
Bester: R600 × 3/6 = R300
Gunter: R600 × 2/6 = R200
Venter: R600 × 1/6 = R100

⑤ Calculation of the second interim repayments according to the surplus-capital method

Comment:

When entries are made in the capital accounts of the partners, but not according to the profit-sharing ratio of all the partners (and therefore not in all the capital accounts), the order of preference that was calculated at the beginning of the liquidation process will no longer be applicable. Interim repayments will however not affect the order of preference because these payments are being made to equalise the capital per unit of profit shares of the partners. An example of a transaction which affects a previously calculated order of preference, is when an asset is taken over by a partner during the liquidation process. The capital account of a single partner is debited and the liquidation account credited with the selling price of the asset. Since no entries were made in the capital accounts of the other partners, and because the entry was not made according to the profit-sharing ratio of *all* the partners, the order of preference changed. If an interim repayment must be made to the partners after a transaction took place that affected the previously calculated order of preference, the order of preference must be recalculated.

Since Venter took over furniture and equipment to the amount of R5 000 at 1 February 20.4, the order of preference that was calculated on 1 January 20.4 is no longer applicable, and needs to be recalculated to determine the interim repayments of the cash that is available on 20 February 20.4.

Provided that all the actual capital account balances are favourable on 20 February 20.4, they can be used to recalculate the order of preference by simply dividing them with the relevant profit shares of the partners. However, should any of the capital account balances be in deficit at 20 February 20.4, as is the case with Bester's capital deficit of R300, the order of preference cannot be recalculated in this manner. As an alternative, the order of preference can be recalculated by taking the balances of the capital accounts at the commencement of the liquidation process (but after the revaluation surplus, drawings, current accounts, etc. were closed off thereto), and to adjust these balances with those entries that were made in the capital accounts of the partners, but not according to the profit-sharing ratio of all the partners (and therefore not in all of the capital accounts). The adjustments must also include the interim repayments that were made until immediately prior to the recalculation of the order of preference, because these amounts were already paid by the partnership. All the adjustments until immediately prior to the calculation of the interim repayments must be taken into account.

In the case of Hillside Garden Centre, the adjustment period will be from 1 January 20.4 until 20 February 20.4, immediately prior to the interim repayment of R7 800. Since entries made in all of the capital accounts of the partners according to their profit-sharing ratio (such as the apportionment of losses or profits made on the sale of assets) do not affect the order of preference, these entries are not taken into account when the capital accounts are adjusted. In the case of Hillside Garden Centre, only the balance of Venter's capital account must be adjusted by deducting the interim repayment that was made solely to him (R1 400) and the value of the assets which he took over (R5 000). Refer to Calculation ❶ in the undermentioned recalculation of the order of preference.

The recalculation of the order of preference in columnar format is as follows:

Order of preference	Bester Unit of profit share = 3 Capital account balance	Bester Capital per unit of profit share	Gunter Unit of profit share = 2 Capital account balance	Gunter Capital per unit of profit share	Venter Unit of profit share = 1 Capital account balance	Venter Capital per unit of profit share
	R	R	R	R	R	R
	(600)	200❷	(8 400)	4 200❷	(3 600)❶	3 600❷
First			1 200❸			
	(600)	200	(7 200)	3 600*	(3 600)	3 600
Second			6 800❸		3 400❸	
All partners	(600)	200	(400)	200*	(200)	200*

* Disclosed for verification purposes.

Calculations:

❶ **Venter's adjusted capital account balance at 20 February 20.4**

Balance at 1 January 20.4 *minus* the interim repayment *minus* the value of the assets which he took over = R(10 000 – 1 400 – 5 000) = R3 600.

❷ **The capital per unit of profit shares of Bester, Gunter and Venter on the recalculation date, namely 20 February 20.4 (Step A)**

Bester: R600/3 = R200 (3rd)
Gunter: R8 400/2 = R4 200 (1st)
Venter: R3 600/1 = R3 600 (2nd)

❸ **The surplus capital of the partners (Step B)**

- ☐ The surplus capital of Gunter that must be allocated first and solely to him according to the first order of preference:
  R8 400 – (R3 600 × 2) = R1 200
- ☐ The surplus capital of Gunter and Venter that must be allocated to them according to the second order of preference:
  Gunter: (R8 400 – R1 200) – (R200 × 2) = R6 800
  Venter: R3 600 – (R200 × 1) = R3 400

The amount of cash that is available for the interim repayments on 20 February 20.4 is R7 800. According to the recalculated order of preference, the interim repayments must be made as follows:

Recalculated order of preference	Available cash	Interim repayment Bester	Interim repayment Gunter	Interim repayment Venter
	R	R	R	R
	7 800			
First	(1 200)		1 200	
Second	(6 600)		4 400❶	2 200❶
Total	–		5 600	2 200

Calculation:

❶ **Apportionment of R6 600**

Gunter: R6 600 × 2/3 = R4 400
Venter: R6 600 × 1/3 = R2 200

⑥ **Apportionment of the actual final capital deficit of Bester, who is insolvent, to Gunter and Venter**

Gunter: R300 × 2/3 = R200
Venter: R300 × 1/3 = R100

Comment:

Should the *Garner versus Murray* rule have been applied, the actual final capital deficit of Bester would have been apportioned to Gunter and Venter according to their respective capital account balances on 1 January 20.4, namely R8 400 and R10 000:

Gunter: R300 × 84/184 = R137 (rounded off to the nearest Rand)
Venter: R300 × 100/184 = R163 (rounded off to the nearest Rand)

4.6 Summary

In this chapter the term "liquidation" is described as a form of dissolution of a partnership which results in the termination of the business activities thereof. From this perspective, the liquidation of a partnership can be caused by various factors, such as the death or retirement of a partner, when a partnership is insolvent, or when a court order for the liquidation of a partnership has been issued.

In general terms, a liquidation is associated with insolvency. In order to distinguish between the liquidation of a solvent and an insolvent partnership, the liquidation of the latter is referred to as a "sequestration". The accounting procedure in respect of the sequestration of partnerships falls outside the scope of this chapter.

The liquidation of a partnership implies that the assets must be converted into cash (in other words, the assets must be liquidated/realised/sold), the liabilities settled, and the remaining cash paid to the partners in order to close off their capital accounts and thereby the books of the partnership. A partnership can be liquidated simultaneously or piecemeal.

A simultaneous liquidation refers to a situation where the assets of the partnership are sold/liquidated simultaneously or over a relatively brief period, usually by a partnership whose business activities have already been discontinued. Simultaneous liquidations seldom occur in practice, as assets are then usually liquidated at less favourable amounts due to the short liquidation period. A piecemeal liquidation allows a partnership to continue with its business activities, but on a steadily decreasing scale, thereby providing the opportunity to liquidate the assets of the partnership at the best possible recoverable amounts.

The following is an elementary procedure that can be applied to record the simultaneous liquidation of a solvent partnership:

Step 1: Close off the balances of the drawings and current accounts (if any) to the capital accounts on the date when the simultaneous liquidation commences.

Step 2: Close off the balances of the goodwill and revaluation surplus accounts to the capital accounts of the partners according to their profit-sharing ratio on the date when the simultaneous liquidation commences.

Step 3: Prepare the liquidation account.

Step 4: Record the settlement (once-off repayment) of the capital accounts of the partners.

The *Garner versus Murray* rule was discussed to show that according to the rule, the remaining solvent partners must bear the (actual) final capital deficit of an insolvent partner according to their capital ratio immediately prior to the liquidation of the partnership, and not according to their profit-sharing ratio.

The following is an elementary procedure that can be applied to record the piecemeal liquidation of a solvent partnership:

Step 1: Close off the balances of the drawings and current accounts (if any) to the capital accounts on the date when the piecemeal liquidation commences.

Step 2: Close off the balances of the goodwill and revaluation surplus accounts to the capital accounts of the partners according to their profit-sharing ratio on the date when the piecemeal liquidation commences.

Step 3: Record the payment of expenses, the settlement of debts, the liquidation of assets, the receipts of any further cash (for example, in respect of income) and the interim repayments made to the partners as they arise.

After all the liabilities of the partnership are paid, and all the contingent expenses provided for, interim repayments are usually made on the condition that it should not become necessary for a partner to make any repayments to the partnership at a later stage. Two methods according to which the calculation of an interim repayment can be made that will comply with this condition, are the surplus-capital and the loss-absorption-capacity methods. These methods render the same results.

According to the surplus-capital method, the interim repayments are calculated in such a way that the capital per unit of profit shares of the partners will eventually be equal. Equal capital per unit of profit shares indicates that the capital ratio of the partners is equal to their profit sharing ratio. The higher the capital per unit of profit share of a partner, the higher the surplus capital of the partner, and the greater the chances that such a partner will be able to absorb future losses. Once the capital per unit of profit shares of the partners are equal, interim cash repayments must be made to these partners according to their profit-sharing ratio. When applying the surplus-capital method, the undermentioned steps are followed to determine the order of preference according to which interim repayments can be made:

Step A: Calculate and rank the capital per unit of profit share of each partner.

Step B: Calculate and arrange the surplus capital of the partners.

When the surplus-capital method is applied, the order of preference is usually calculated at the beginning of the piecemeal liquidation, and interim repayments are made accordingly. With this method, the profits/losses made during the liquidation process do not have to be determined to calculate how the cash must be repaid to the partners. Should any transaction, apart from an interim repayment, take place that changes the capital ratio according to which the order of preference was calculated (such as when a partner takes over an asset), the order of preference must be recalculated.

According to the loss-absorption-capacity method, the interim repayments of the available cash to the partners are calculated by determining to what extent each of the balances of the capital accounts can absorb the maximum *anticipated* loss during the liquidation of the partnership, by apportioning such losses to the capital accounts according to the profit-sharing ratio of the partners. The available cash is then repaid according to these anticipated balances of the capital accounts. This calculation must be repeated each time cash becomes available for interim repayments.

The loss-absorption-capacity method entails the following:

Step A: Determine the actual general ledger account balances in the books of the partnership on the date that cash becomes available for interim repayments.

Step B: Debit any budgeted/contingent expenses in the partners' capital accounts according to their profit-sharing ratio and credit bank.

Step C: Close off all unsold assets to the capital accounts according to the profit-sharing ratio of the partners.

Step D: Close off any anticipated capital deficit to the capital accounts of the partners who have favourable anticipated capital account balances according to their profit-sharing ratio.

Step 4: Record the settlement (final repayment) of the capital accounts of the partners.

CHAPTER **5**

Close corporations

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Overview of close corporations

Form of business ownership

Simple form of business structure governed in terms of Close Corporations Act, 69 of 1984 and monitored by the Companies Intellectual Property Commission (CIPC)

- Membership limited to natural persons of up to ten members
- Independent juristic personality

In terms of the Companies Act, 71 of 2008, no new Close Corporations will be registered. Close corporations registered before the implementation of the said Companies Act will continue until converted into another form of business entity or dissolution.

Accounting records and financial reporting

Close Corporation Act requirements:
- Keeping accounting records
- Financial year end and financial statements
- The accounting officer

Companies Act Regulations applicable to close corporations:
- Public interest score
- Audit exemption
- Audit requirement
- Independent review
- Trusts as members of a CC

Accounting procedures:
- **Distribution of total comprehensive income:** Require liquidity and solvency test to be met before any distribution is made to members
- **Preparation of financial statements:** Financial statements must provide information about the financial performance and financial position in accordance with the provisions of the Close Corporations Act and International Financial Reporting Standards (IFRS) or (IFRS for SMEs)

continued

Statement of profit or loss and other comprehensive income:

- revenue;
- finance costs;
- tax expense;
- profit or loss;
- each component of other comprehensive income classified by nature; and
- total comprehensive income

Statement of changes in net investment of members:

- total comprehensive income for the period;
- transactions with members;
- reconciliation of equity

Statement of financial position:

- property, plant and equipment
- investment property;
- intangible assets;
- financial assets;
- inventories;
- trade and other receivables;
- cash and cash equivalents;
- members' interest;
- financial liabilities; and
- trade and other payables.

Notes to the financial statements:

- Basis of preparation of the financial statements;
- Specific accounting policies applied;
- Present information required by IFRS not presented elsewhere in the financial statements.

5.1 Introduction

STUDY OBJECTIVES
After studying this chapter, you should be able to: ☐ describe the attributes of a close corporation and convey the major advantages and disadvantages thereof; ☐ name the statutory requirements with regard to the membership of a close corporation; ☐ discuss the internal and external relations of a close corporation in terms of the Close Corporations Act; ☐ give an overview of the circumstances in which members and others are jointly liable for the debts of a close corporation; ☐ briefly explain the tax position of a close corporation and its members; ☐ convey the statutory requirements in respect of the keeping of accounting records and the preparation of financial statements; ☐ convey the statutory requirements in respect of the appointment, qualifications, resignation or dismissal, right of access to accounting records and information, remuneration and duties of the accounting officer; ☐ explain the statutory requirements in respect of the distribution of total comprehensive income; ☐ record distributions of total comprehensive income; ☐ prepare, with the exception of a statement of cash flows, the financial statements of a close corporation according to the provisions of the Close Corporations Act and the requirements of IFRS; (The preparation of a statement of cash flows of a close corporation is addressed in Chapter 7.) and ☐ explain the provisions of the Close Corporations Act with regard to the deregistration of a close corporation.

In the previous chapters, the partnership as a form of business entity was discussed. It was mentioned that one of the disadvantages of a partnership is that it lacks independent legal status as a business entity, thereby causing partners to be personally liable for the obligations of the partnership, disallowing perpetual succession and restricting the alternative resources of capital.

Close corporation, as a form of business ownership, was introduced in South African commerce when the Close Corporations Act, 69 of 1984 (hereinafter referred to as the Close Corporation Act) was passed by parliament. The purpose was to establish a flexible form of business ownership to serve smaller businesses with the advantages of simplified and inexpensive incorporation, separate legal existence, limited liability and less onerous financial reporting requirements. Since the introduction of close corporations as a form of business ownership, small and medium size business entities have enjoyed a combination of advantages similar to that of sole proprietorships, partnerships and companies. The new Companies Act, 71 of 2008 (hereinafter referred to as the Companies Act) came into effect on 1 May 2011 and introduced certain amendments that impacted the existence of close corporations. These amendments included amongst others, the discontinuation of registration of new close corporations with the effect from 1 May 2011. Existing close corporations will however continue to exist under the Close Corporation Act, as amended, until such time their members decide to convert to any other form of business entity.

The main objectives of this chapter are to provide:

☐ an overview of the Close Corporations Act in respect of the attributes, internal and external relations, accounting records and financial statements, joint liability of members and others for certain debts of a close corporation, tax position of a close corporation and its members, as well as the deregistration of a close corporation; and

☐ a comprehensive example in respect of the preparation of the financial statements (with the exception of a report from the accounting officer and a statement of cash flows) of a close corporation according to the provisions of the Close Corporations Act and the requirements of IFRS. Where applicable, the guidelines as presented in the *Guide on Close Corporations* (as issued by SAICA, February 2009) were followed.

5.2 Attributes of a close corporation

The main attributes of a close corporation include the following:

☐ A close corporation may have one to a maximum of ten members, all of whom are usually natural persons. An incorporated entity, for example a company, is not a natural person and may therefore not become a member of a close corporation. The capital which a member contributes to a close corporation is referred to as a "contribution". Such a contribution must be stated in the founding statement of a close corporation.

☐ A close corporation has an independent juristic personality which enables it to:
- have the capacity and powers of a natural person of full capacity in so far as a juristic person is capable of having such capacity or of exercising such powers;
- continue to exist under its registered name, irrespective of changes in its membership. This attribute can be referred to as "unlimited existence". A close corporation thus continues to exist until it is deregistered or liquidated in terms of the Close Corporations Act;
- provide the protection of limited liability to its members. Limited liability means that the members cannot lose more than the amount of their investment (contribution) in a close corporation, unless they have transgressed certain provisions of the Close Corporations Act. Under such circumstances, the members may be held jointly and severally liable for the corporation's debts. The liability of a member towards the debts or obligations of a close corporation is discussed in further detail in paragraphs 5.9.2 and 5.11; and
- acquire rights and obligations, to own assets (including shares in a company) and to sue and be sued in its registered name.

☐ In terms of the Close Corporations Act, a close corporation must comply with specific liquidity and solvency requirements whenever certain payments, such as the distribution of total comprehensive income, are made. A close corporation complies with these requirements when:

- the assets thereof, at fair value, exceed its liabilities after such a payment has been made; and
- the close corporation, before and after such a payment has been made, is able to pay its debts as they become due in the ordinary course of its business.

5.3 Advantages of a close corporation

Advantages of a close corporation include the following:

☐ a close corporation may continue to operate under its registered name, irrespective of changes in its membership;

☐ members have the protection of limited liability, provided that certain provisions of the Close Corporations Act have not been contravened;

☐ a close corporation may give financial assistance to a person in order to acquire an interest in the corporation, and may also acquire the interest of a member. Such transactions are only legitimate if the close corporation meets the solvency and liquidity requirements of the Close Corporations Act, and if the written consent of all of the members was obtained; and

☐ no transfer duties are payable on the transfer of the interest of a member.

5.4 Disadvantages of a close corporation

Disadvantages of a close corporation include the following:

☐ each member of a close corporation has the jurisdiction to act on behalf of the corporation. A member can thus commit the close corporation to injudicious transactions whereby a risk is created for the survival of the corporation and the liability of the members in respect of the debt thereof;

☐ the restriction on the number and natural nature of the members could be an inhibiting factor in respect of the performance of a close corporation. For example:

- since a company cannot become a member of a close corporation, a close corporation cannot benefit from the potential advantages which such a membership could offer; and
- a corporation may not become a subsidiary of a company and therefore it is impossible to include a close corporation into a group structure.

☐ when a member acquires a loan to invest capital in a close corporation, the member is not allowed to deduct the interest paid on such a loan for tax purposes. The reason for this is that the profits that are distributed to members are not taxable in their hands;

☐ the financial statements must be approved and signed by or on behalf of a member holding a member's interest of at least 51%, or by members who together hold members' interests of at least 51% in the close corporation. Members with minority interests may lose their protection with regards to their limited liability; and

☐ in the absence of a contravening stipulation in the association agreement, certain fundamental decisions with regards to the close corporation may be taken by a member(s) who holds a member(s) interest of at least 75%. This means that the opinion of the member(s) who holds the resulting minority interest may be disregarded.

5.5 Prescribed forms of a close corporation

Prior to the implementation of the Companies Act 71 of 2008, a close corporation was formed when the founder member(s) filed a founding statement (CK1) with the then Registrar of Close Corporations. Information that was required in the founding statement included the following:

- ☐ the full name of the proposed close corporation;
- ☐ the principal business in which the proposed close corporation will be engaged;
- ☐ the postal address of the proposed close corporation;
- ☐ the physical address of the anticipated registered office of the proposed close corporation;
- ☐ the full name, residential address and identity number of each proposed member. If a proposed member does not have an identity number, the date of birth of the proposed member must be provided;
- ☐ the size, expressed as a percentage, of each member's interest in the close corporation;
- ☐ particulars of the contribution of each proposed member to the close corporation, including:
  - any amounts of money; and
  - a description, as well as a statement of the fair value, of any property or any service rendered in connection with the formation of the proposed corporation;
- ☐ the name and postal address of the qualified person who (or firm which) has consented in writing to his appointment as the accounting officer of the proposed close corporation; and
- ☐ the date of the financial year-end of the proposed close corporation.

Upon the registration of a founding statement, a close corporation was allocated a registration number which was an endorsement to the effect that the close corporation is duly incorporated.

As it has been mentioned previously, registration of new close corporations ceased when the Companies Act 71 of 2008 came into effect and the use of a CK1 has since been terminated. All changes to existing close corporations are now managed by the Companies Intellectual Property Commission (CIPC). The Commissioner, appointed in terms of Section 189 of the Companies Act, is tasked with managing all the administrative matters that were previously handled by the Registrar of Close Corporations.

Depending on the circumstances that require the completion of a form, currently the prescribed forms that can be filed with the Commissioner are:

- ☐ CK2 Registration of an amended founding statement;
- ☐ CK2A Amendment regarding Accounting Officer and Addresses;
- ☐ CK5 Court order for alteration of founding statement;
- ☐ CK6 Voluntary liquidation;
- ☐ CoR 9.1 Application for name/translated/shortened (only for existing CCs);
- ☐ CoR 40.1 Notice of resolution to wind up solvent CC;
- ☐ CM26 Special resolution to wind up an insolvent close corporation;
- ☐ CoR 40.5 Application for re-instatement of deregistered CC;

- ☐ CoR 123.1 Notice of Start of Business Rescue Proceedings;
- ☐ CoR 123.2 Notice of appointment of Practitioner;
- ☐ CoR 125.1 Notice concerning status of Business Rescue Proceedings;
- ☐ CoR 125.2 Notice of Termination of Business Rescue Proceedings;
- ☐ CoR 125.3 Notice of Substantial Implementation of a Business Rescue Plan.

All the documentation held by the Commissioner is available for public inspection subject to the payment of prescribed fees.

5.6 Name and registration number of a close corporation

A close corporation must add the abbreviation "CC" (or its equivalent in any other official language) in capital letters to its full registered name.

If a close corporation is wound up, the statement "Liquidation" or "Voluntary Liquidation", as the case may be, must be added to the name used by the close corporation for the duration of the winding-up process. A close corporation which fails to comply with this requirement is guilty of an offence.

A close corporation must record its registration number on all the prescribed documents and correspondence sent by the close corporation to the office of the Commission.

A close corporation must also display in a conspicuous position outside its registered office and every office or place in which its business is carried on, its full registered name – which includes the abbreviation "CC" – (or a registered literal translation thereof into any one of the other official languages of the Republic – see table below) as well as its registration number, in characters that are easily legible. The same particulars must also be reflected in legible characters in any notice and other official publications, and on all bills of exchange, promissory notes, endorsements, cheques and orders for money, goods or services purporting to be signed by or on behalf of the corporation, letters, delivery notes, invoices, receipts and letters of credit of the corporation. In addition, the business letters sent by a close corporation to any person must include the forenames or initials and the surnames of each member of the close corporation.

According to the *Guide on Close Corporations*, the terms for "close corporation", together with a suitable abbreviation thereof, in the other official languages are:

Language	**Term for close corporation**	**Abbreviation**
Afrikaans	Beslote Korporasie	BK
English	Close Corporation	CC
isiNdebele	Ikampani yaba-Thileko	KT
isiXhosa	Inkampani yabamBalwa	KB
isiZulu	IKhamphani yabamBalwa	KB
Sepedi	Kgwebo e Kgotlangantswego	KK
Sestwana	Dikoporasi tse di Tswaletsweng	KT
Sesotho	Kgwebo e Lekanyeditsweng	KL
SiSwati	LiBhizinisi leli Valekile	BV
Tshivenda	Dzikoporasie dzo valiwaliwaho	KV
Xitsonga	Ntirhisano wa Nhlangano	NH

5.7 Membership of a close corporation

5.7.1 *Number of members*

A close corporation may have one or more members, but at no time may the number of members exceed ten.

5.7.2 *Membership requirements*

Normally only natural persons may become members of a close corporation. No juristic person or trustee of a trust *inter vivos* in that capacity may directly or indirectly hold a member's interest in a close corporation. A natural person in the capacity of a trustee of a trust *inter vivos* may be a member of a corporation provided that

☐ no juristic person shall directly or indirectly be a beneficiary of that trust;
☐ such a member has all the obligations and rights of a member;
☐ the close corporation has no obligation in respect of any provisions between the trust and the member concerned; and
☐ if the number of natural persons entitled to receive any benefit from the trust exceeds ten, the trustee is disqualified for membership.

According to the Close Corporations Act, the following members qualify for membership of a close corporation:

☐ any natural person who is entitled to a member's interest;
☐ a natural or juristic person who is a trustee of a testamentary trust which is entitled to a member's interest, on the condition that no juristic person is a beneficiary of the trust. If the trustee is a juristic person, such a juristic person may not be directly or indirectly controlled by any beneficiary of the trust; and
☐ a natural or juristic person, who, in the case of a member who is insolvent, deceased, mentally disordered or otherwise incapable or incompetent to manage his affairs, is a trustee of his insolvent estate or an administrator, executor or curator of such a member, or who is otherwise such a member's properly appointed or authorised legal representative.

Note that although the Close Corporations Act stipulates that only natural persons may become members of a close corporation, the above stipulations of the Close Corporations Act indicate circumstances where a juristic person can be allowed to become a member of a close corporation.

Any change in the membership of a close corporation must be registered by the Commissioner. Such a registration is obtained by submitting an Amended Founding Statement (CK2) to the Commissioner.

5.7.3 *Member's interest*

A member's interest usually represents a member's right to share in a certain percentage of the profit(s)/loss(es) of the close corporation. However, this right may be amended in terms of an association agreement. The interest of any member in a close corporation must be a single interest which is expressed as a percentage of the total membership of the close corporation. The term "single interest" means that two or more persons are not allowed to jointly hold the same member's interest in a close corporation. There is no provision in the Close Corporations Act that stipulates that the percentage of a member's interest must be equal to the percentage of such a member's contribution in relation to that of the total members' contributions.

A founding member of a close corporation obtains his member's interest after an initial contribution, as specified in the founding statement, has been made to the close corporation.

A person who wants to become a member of a registered close corporation must obtain a member's interest by:

☐ purchasing it from one or more of the existing members, or from their deceased or insolvent estates; or

☐ making a contribution to the close corporation, in which case the percentage of his interest will be determined by an agreement between him and the existing members. This contribution may consist of an amount of money, or of any property which is valued at an agreed amount between the new member and the existing members.

The recording of the contributions made by the members to a close corporation is illustrated in Example 5.1.

Example 5.1 Contributions made by members

J Botha and M Kent are the only members of Kenbo CC. According to the founding statement of Kenbo CC, a member's interest of 65% is allocated to Botha, and 35% to Kent. The founding statement further indicates that Botha will contribute cash to the amount of R65 000, and Kent will contribute office equipment to the value of R35 000 to the close corporation.

Required:

Record the contribution made by Botha and Kent in the general journal of Kenbo CC.

Solution:

Kenbo CC
General journal

	Debit	**Credit**
	R	**R**
Bank	65 000	
Office equipment	35 000	
Member's contribution: J Botha		65 000
Member's contribution: M Kent		35 000
Recording of members' contributions to CC		

This example illustrates that the members' contributions to the close corporation are in the same ratio as the member's interest in the close corporation. However, such a situation is not required by the Close Corporations Act.

Should a member become insolvent, the trustee of the insolvent estate may sell the member's interest under certain conditions to either the close corporation, the other members of the close corporation, or to any other person who qualifies for membership of a close corporation.

Subject to any other stipulation in the association agreement, the executor of the estate of a deceased member must transfer the member's interest of the deceased member to a person who qualifies for membership of a close corporation in terms of the Close Corporations Act, and who is entitled thereto as legatee or heir or under a redistribution agreement, only if the remaining member(s) of the close corporation consent to such a transfer. If such consent is not given within 28 days after it was requested by the executor, the executor must sell the interest, subject to certain conditions, to the close corporation, or to any other remaining member(s), or to any other person who qualifies for membership of a close corporation in terms of the Close Corporations Act.

Other than the dispositions provided for in the Close Corporations Act in respect of an insolvent or deceased member, or where a membership was ended by virtue of a court order, a member may only dispose of his member's interest or portion thereof in accordance with the association agreement (if any) or with the consent of every other member of the close corporation.

A close corporation may not acquire a member's interest if it does not have any other member(s). A close corporation may also not hold any acquired member's interest. Such interest must be added to the respective interests of the other members in proportion to their existing interests or as they may otherwise agree upon. A close corporation may only buy a member's interest if written consent was previously obtained from each of the members, other than the member from whom the interest is acquired, and if the solvency and liquidity requirements of the Close Corporations Act were adhered to (refer to paragraph 5.2).

A close corporation may give financial assistance to any person for the purpose of acquiring an interest in the close corporation, provided that the close corporation must first obtain the written consent of every existing member for the specific assistance, and that the close corporation meets the solvency and liquidity requirements of the Close Corporations Act (refer to paragraph 5.2).

5.8 Internal relations

5.8.1 *The fiduciary relationship of members*

Every member of a close corporation must stand in a fiduciary relationship to the close corporation. This implies that a member must:

- ☐ act honestly and in good faith and, in particular, exercise the powers at his disposal to manage and represent the close corporation in the interest and for the benefit of the close corporation without exceeding those powers; and
- ☐ avoid any substantial conflict between his own interests and those of the close corporation. In particular, a member:
  - may not obtain any personal economic benefit to which he is not entitled by reason of his membership of or service to the corporation where that benefit is obtained in conflict with the interests of the close corporation;
  - must notify all the other members of the nature and extent of any substantial conflicting interest which he may have in any contract of the close corporation; and
  - may not compete with the close corporation in its business activities in any way.

A member of a close corporation whose act or omission has breached any duty which arises from his fiduciary relationship is liable to the close corporation for any loss suffered, or for any economic benefit derived by the member, as a result of such an act or omission.

5.8.2 *The liability of members in the case of negligent conduct*

A member shall be liable to the close corporation for loss caused by him if such a member failed to act with the degree of care and skill that might be reasonably expected from that person. However, such a liability shall not be incurred if the said negligent conduct was preceded by or followed by the written approval of all the members, provided that the members were or are aware of all the material facts.

5.8.3 *The association agreement*

There are minimum legislative requirements in respect of the managerial duties of members. Therefore, members may decide to conduct the management of the close corporation within a more formal framework by means of a written association agreement.

The members of a close corporation, having more than one member, may at any time enter into a written association agreement. An association agreement fulfills the same function as that of the articles of association of a company. Since entering into an association agreement is not compulsory, there is no prescribed format according to which it must be prepared.

A written association agreement may regulate any matter which may be, in terms of the Close Corporations Act, addressed in such an agreement as well as any other matter relating to the internal relationship between the members, or between the members and the close corporation. These matters must be addressed in a manner that is consistent with the provisions of the Close Corporations Act. A new member of the close corporation shall be bound by an existing association agreement as if the member himself has signed it as a party thereto.

5.8.4 *Variable rules in respect of internal relations*

In terms of the Close Corporations Act, the following rules pertaining to the internal relations within a close corporation must be applied, unless the Close Corporations Act or an association agreement provides otherwise:

- every member is entitled to participate in the carrying on of the business;
- every member has equal rights with regard to the management of the close corporation. However, the written consent of a member holding a member's interest of at least 75%, or of members who together hold at least 75% of the members' interests, is required for:
  - a change with regard to the principal business of the close corporation;
  - a disposal of the whole, or a significant portion of the whole undertaking of the close corporation, a disposal of all the assets of the close corporation, or a greater portion thereof; and
  - any acquisition or disposal of immovable property by the close corporation;
- differences between members concerning matters relating to the business of a close corporation must be resolved by a majority vote at a meeting of the members;
- the number of votes which each member has at any meeting of the close corporation must correspond with the percentage of his interest in the corporation;

- ☐ a close corporation must indemnify every member for expenses incurred by him in the ordinary and proper conduct of the business of the close corporation and with regard to actions pertaining to the maintenance of the business or property of the close corporation; and
- ☐ payments can be made by a close corporation to its members solely due to their membership, provided that they are made at such amounts and at such times that are agreed upon by the members from time to time. In addition, the close corporation must meet the solvency and liquidity requirements of the Close Corporations Act when such payments are made. These payments must be made to the members in proportion to their respective interests in the close corporation and exclude payments made to members in the ordinary conduct of the business, such as salaries and interest paid to the members or the repayment of loans that were granted by the members.

5.8.5 *Prohibition of loans and providing of security to members and others by a close corporation*

A close corporation may not, directly or indirectly, without the prior written consent of all the members, make a loan or provide any security to:

- ☐ any of its members;
- ☐ any close corporation in which one or more of its members jointly holds an interest of more than 50%; or
- ☐ any company or other juristic person (with the exception of a close corporation) which is controlled by one or more members of the close corporation.

5.9 External relations

Any pre-incorporation contract (i.e. a contract entered into in writing before the close corporation was formed) entered into by an agent or trustee on behalf of a close corporation may be ratified or adopted by that corporation as if the corporation was incorporated at the time when the pre-incorporation contract was entered into. Such a ratification or adoption must be in the form of a written consent of all the members. This written consent must be given within the time period specified in the contract or, if no time period was specified, within a reasonable time after incorporation.

As mentioned, each member of a close corporation has an equal right to take part in the carrying on of the business thereof. Each member is considered to be an agent of the close corporation with regard to dealings with the corporation by persons who are not members.

Any act of a member, whether such an act is performed for the carrying on of the business or not, shall bind a close corporation, unless such a member has no power to act on behalf of the close corporation in the particular matter and the person with whom the member deals, has or ought reasonably to have knowledge of the fact that the member has no such power.

A person who is not a member of a close corporation is not entitled to inspect the association agreement, and can therefore not be deemed to have any knowledge of any information contained therein.

5.10 Joint liability of members and others for the debts of a close corporation

Under normal circumstances, the liability of a member towards the obligations of the close corporation is limited to the extent that contributions were made by the member to the close corporation. However, transgressions of certain provisions of the Close Corporations Act may cause members to lose their protection of limited liability and together with the close corporation, to become jointly and severally liable for the debts of the close corporation. Such potential loss of limited liability provides a form of self-regulation in so far as members are encouraged to adhere to set requirements in order to maintain such protection.

According to Section 63 of the Close Corporations Act, the following persons, under the following circumstances, may, together with a close corporation, be held jointly and severally liable for certain debts of that close corporation (these debts are specified in the Close Corporations Act, but fall outside the scope of this chapter. In the below mentioned circumstances, the term "specified debts" is used in those cases where the specifics, as mentioned in the Close Corporations Act, are too elaborate for the purpose of this discussion):

- ☐ where a close corporation entered into a transaction with any other person, from which a debt accrued for the close corporation, and such a person was unaware that the transaction was made with a close corporation because the close corporation failed to subjoin the abbreviation CC in terms of the requirements of the Close Corporations Act to its name. In such a case, any member who is responsible for, or who authorised, or knowingly permitted the omission, is liable for the "specified debts";
- ☐ when a member fails to make his contribution as stipulated in the founding statement, in which case he can be held liable for the "specified debts" of the close corporation;
- ☐ where a juristic person (or a trustee of a trust *inter vivos*) purports to hold a member's interest in a close corporation, in contravention of any relevant provisions of the Close Corporations Act, such a juristic person (or trustee) and any nominee can be held liable for the "specified debts" of the close corporation;
- ☐ where a close corporation makes a payment in respect of the acquisition of a member's interest which does not comply with the requirements of the Close Corporations Act, every person who is a member at the time of such payment and who is aware of the making of such payment as well as a member or former member who receives or received such payment, can be held liable for the "specified debts" of the close corporation;
- ☐ where a close corporation gives financial assistance in respect of any acquisition of a member's interest which does not comply with the requirements of the Close Corporations Act, every person who is a member at the time of giving such assistance and who is aware of the giving of such assistance, and the person who receives such assistance, can be held liable for the "specified debts" of the close corporation;
- ☐ when an unauthorised person participates in the management of the close corporation, that person can be held liable for the "specified debts" of the close corporation; and

- where the office of an accounting officer is vacant for a period of six months, any person, who at any time during that period was a member of the close corporation and aware of the vacancy, and who at the expiration of that period still is a member, is liable for all the debts incurred by the close corporation while the position was vacant. Such a member, if he still is a member, is also liable for every debt incurred by the close corporation after the expiration of that period whilst the vacancy continues.

If it at any time it appears that the business of the close corporation is being carried on in a reckless manner, with gross negligence or with the intent to defraud, any person who was knowingly a party to the conduct of the business of the close corporation in such a manner, can be held personally liable for the debts as specified in terms of the Close Corporations Act.

5.11 The tax position of a close corporation and its members

The Income Tax Act, 58 of 1962, regards a close corporation for income tax purposes as a private company. The taxable income of a close corporation is subject to normal income tax at the rate which is applicable to a company. A close corporation must register as a provisional taxpayer. As a provisional taxpayer, a close corporation must estimate its taxable income in respect of the relevant period of assessment. According to this estimation, two compulsory provisional payments in respect of normal income tax must be made to the South African Revenue Service (SARS) during the applicable financial period. The first provisional payment must be made in the first six months of the year of assessment, and the second provisional payment must be made no later than the year-end of the year of assessment. At the financial year-end, when the actual taxable income for the year is calculated, a third voluntary payment can be made to SARS if the two provisional payments were not sufficient to cover the actual normal income tax payable. (The calculation of estimated and actual taxable income, the calculation of the amounts of the provisional and voluntary payments, and the dates before or on which such payments must be made, fall outside the scope of this chapter.)

To record a provisional tax payment, the journal entry in the books of a close corporation is:

General journal

	Debit	Credit
	R	**R**
SARS (Income tax)	XXX	
Bank		XXX
Recording of provisional tax paid		

At the end of a financial period, the actual normal income tax expense for the period is recorded as follows:

General journal

	Debit	Credit
	R	**R**
Income tax expense (Current)	XXX	
SARS (Income tax)		XXX
Recording of the actual normal income tax expense for the financial period		

Comments:

- ☐ At the financial year-end, the income tax expense account is closed off to the appropriation account.
- ☐ After the two provisional payments and the actual income tax expense were recorded in the SARS (Income tax) account, the account may have either a debit or credit balance. A credit balance will indicate the final payment which must be made to SARS. If the payment was not made before or on the date of the applicable financial year-end, the credit balance will be disclosed under the current liabilities of the balance sheet at the year-end as "Current Tax payable". A debit balance will indicate that the provisional tax payments that were made during the financial period were greater than the actual income tax expense for this period. At the financial year-end, a debit balance will be disclosed under the current assets as "Current Tax receivable".

Any distribution of total comprehensive income made by a close corporation to its members is subject to the payment of Secondary Tax on Companies, which is payable by the close corporation. (Secondary Tax on Companies falls outside the scope of this chapter.) Since profit distributions are taxed in the hands of a close corporation, they are not taxed again in the hands of its members.

A member of a close corporation is regarded by the Income Tax Act as a shareholder of a company. The Act also regards a member of a close corporation who is actively involved in the affairs of the close corporation as a "director". The provisions of the Income Tax Act in respect of PAYE will be applicable to such a member as if he is an employee. A member of a close corporation who is a resident of the Republic of South Africa must register as a provisional taxpayer, unless the Commissioner for South African Revenue Service decides otherwise.

5.12 Accounting records and financial reporting

5.12.1 *Close Corporation Act requirements*

5.12.1.1 Keeping accounting records

A close corporation must keep, in one of the official languages of the Republic, all the accounting records which are necessary to fairly present the state of affairs and business of the corporation, and to explain the transactions and the financial position of the business of the corporation. Some of the accounting records that must be kept according to the Close Corporations Act are:

- ☐ records showing the assets and liabilities of the close corporation, members' contributions, undrawn profits (retained earnings), revaluations of fixed assets (property, plant and equipment) and amounts of loans to and from members;
- ☐ a register pertaining to the fixed assets (property, plant and equipment);
- ☐ records containing the daily entries of all cash received and paid out to the extent that the nature of the transactions and the names of the parties (with the exception of the names of parties in respect of cash sales) to these transactions can be identified;
- ☐ records of all goods purchased and sold on credit, and of services received and rendered on credit, in order to identify the nature of those goods and services and the parties to the transactions;

- ☐ statements of the annual stocktaking (inventory count) and records to enable the value of the stock (inventory) to be determined at the financial year-end; and
- ☐ vouchers supporting the entries in the accounting records.

The terminology shown in brackets reflects the current terminology used in the field of financial accounting whilst the Close Corporation Act (which is quoted) still reflects previous terminology used.

The accounting records must be kept in such a manner that adequate precautions against falsification is provided and that the identification of any falsification is facilitated.

If a close corporation fails to comply with the provisions of the Close Corporations Act in respect of accounting records, every member thereof who is a party to such failure or who failed to take all reasonable steps to ensure the compliance of the close corporation with any of these provisions, shall be guilty of an offence. The members of a close corporation may entrust the duty of ensuring that the close corporation complies with the provisions of the Close Corporations Act in respect of accounting records to a competent and reliable person, such as the appointed accounting officer.

5.12.1.2 Financial year and financial statements

A close corporation must specify the date on which its financial year will end in its founding statement. This date may be changed to any other date by lodging an amended founding statement with the Commissioner for registration. A close corporation may not change the date of its financial year-end more than once in any financial year.

The members of a close corporation must ensure that the financial statements of the close corporation are prepared within nine months after the end of every financial year of the corporation, in respect of that financial year.

The Close Corporations Act requires that annual financial statements shall consist of a statement of financial position and any notes thereto and a statement of profit or loss and other comprehensive income or any similar financial statement where such form is appropriate, any notes thereto, and a report from the accounting officer.

The Close Corporations Act also requires that the annual financial statements be in conformity with IFRS, appropriate to the business of the corporation, and fairly present the state of affairs of the close corporation at the financial year-end, as well as the results of its operations for that year. Since “fair presentation” is specifically required by the Close Corporations Act, it can be regarded as the underlying requirement when the financial statements of a close corporation are prepared.

- ☐ The members of a corporation shall, within nine months after the end of every financial year of the corporation, cause annual financial statements in respect of that financial year to be made out in one of the official languages of the Republic.
- ☐ The annual financial statements of a corporation:
  - shall consist of:
    - a statement of financial position and any notes thereon; and
    - a statement of profit or loss and other comprehensive income or any similar financial statement where such form is appropriate, and any notes thereon;

- shall, in conformity with IFRS, appropriate to the business of the corporation, fairly present the state of affairs of the corporation as at the end of the financial year concerned, and the results of its operations for that year;
- shall disclose separately the aggregate amounts, as at the end of the financial year, of contributions by members, undrawn profits, revaluation of fixed assets and amounts of loans to or from members, and the movements in these amounts during the year;
- shall be in agreement with the accounting records, which shall be summarised in such a form that:
  - compliance with the provisions of this subsection is made possible; and
  - an accounting officer is enabled to report to the corporation in terms of Section 62(1)(c) without it being necessary to refer to any subsidiary accounting records and vouchers supporting the entries in the accounting records;

  Provided that nothing contained in this paragraph shall be construed as preventing an accounting officer, if he deems it necessary, from inspecting such subsidiary accounting records and vouchers; and
- shall contain the report of the accounting officer referred to in Section 62(1)(c).

☐ The annual financial statements shall be approved and signed by or on behalf of a member holding a member' interest of at least 51 per cent, or members together holding members' interests of at least 51 per cent, in the corporation.

Note that the Close Corporations Act does not explicitly require the preparation of a statement of changes in equity or a cash flow statement (IAS 1) statement of cash flows) as part of the annual financial statements of a close corporation. However, the Act does require that the annual financial statements be prepared in conformity with IFRS, appropriate to the business of the close corporation. Since the members of a close corporation are regarded as the primary users of the financial statements, the preparer of these financial statements must take note of the needs of the members when he determines what is implied with "IFRS, appropriate to the business of the close corporation". Furthermore, in order to decide what is appropriate to the business, the trading and operating activities of the close corporation, as well as IFRS of the environment in which the close corporation operates, must be taken into account. In this chapter, the financial statements are, where appropriate, also prepared according to the requirements of IFRS.

According to the Close Corporations Act, at the financial year-end, the annual financial statements must also disclose separately the aggregate amounts of contributions made by members, undrawn profits (retained earnings), revaluations of fixed assets (property, plant and equipment) and amounts of loans to or from members, as well as the movements in these amounts during the year.

The Close Corporations Act further requires that the annual financial statements must contain a report from the accounting officer which discloses whether:

☐ these financial statements are in agreement with the accounting records of the corporation; and

☐ whether the accounting policies that were represented to him as having been applied in the preparation of the annual financial statements, are appropriate.

5.12.1.3 The accounting officer

(a) Appointment and qualifications

The Close Corporation Act requires all close corporations to appoint an accounting officer. Should a vacancy occur in the office of an accounting officer, the close corporation must appoint another accounting officer within 28 days.

A person only qualifies to be appointed as an accounting officer when he is a member of a recognised profession. Such a profession:

- ☐ as a condition for membership, requires that its members have passed examinations in accounting and related fields of study which in the opinion of the Minister would qualify such members to perform the duties of an accounting officer;
- ☐ has the power to exclude those persons from membership who were found guilty of negligence in the performance of their duties or of discreditable professional conduct; and
- ☐ be named in the *Government Gazette* as a profession whose members are qualified to perform the duties of an accounting officer.

Members of the following professions/professional bodies are qualified to be appointed as accounting officers:

- The South African Institute of Chartered Accountants (SAICA)
- Auditors registered in terms of the provisions of the Auditing Profession Act, 2005(IRBA)
- Chartered Secretaries Southern Africa (CSSA)
- The Chartered Institute of Management Accountants (CIMA)
- The South African Institute of Professional Accountants (SAIPA)
- The IAC who have obtained the Diploma in Accountancy (IAC)
- The Association of Chartered Certified Accountants (ACCA)
- The Chartered Institute of Business Management (MCIBM)
- The South African Institute of Business Accountants (SAIBA)
- The South African Institute of Government Auditors (SAIGA)

(b) Resignation or dismissal

A close corporation must inform an appointed accounting officer in writing of his removal (dismissal) from office.

On resignation or removal, an accounting officer must without delay inform every member of the corporation in writing of such resignation or removal and also send a copy of the letter to the latest known address of the registered office of the corporation. The accounting officer must also inform the Commissioner without delay by registered post:

- ☐ about such resignation or removal from office;
- ☐ of the date of such resignation or removal from office;
- ☐ of the date up to which the duties of the accounting officer were performed; and

- ☐ whether, at the time of the resignation or removal from office, the accounting officer was aware of any matters pertaining to the financial affairs of the corporation which contravened the provisions of the Close Corporations Act. If this is the case, the accounting officer must submit the full particulars thereof in writing to the Commissioner.

The Close Corporations Act stipulates that a new accounting officer should be appointed within 28 days of the resignation of the existing accounting officer. If the office of an accounting officer is vacant for a period of six months, any person who at any time during that period was a member of the close corporation and aware of the vacancy and who at the expiration of that period still is a member, is liable for all the debts incurred by the close corporation while the position was vacant. Such a member, if he still is a member, is also liable for every debt incurred by the close corporation after the expiration of that period and whilst the vacancy continues.

(c) Right of access and remuneration

An accounting officer has the right of access to the accounting records and all the books and documents of the close corporation. An accounting officer also has the right to require such information and explanations which he deems necessary from members for the performance of his duties as an accounting officer. The remuneration of an accounting officer must be determined by agreement with the close corporation.

(d) Duties

An accounting officer must, not later than three months after completion of the financial statements:

- ☐ determine whether the financial statements agree with the accounting records;
- ☐ review the appropriateness of the accounting policies which were represented to the accounting officer as having been applied in the preparation of the financial statements; and
- ☐ report to the close corporation on the above matters.

Should an accounting officer find any contravention of a provision of the Close Corporations Act, he must describe the nature of such contravention in his report, irrespective of whether it is material or not.

An accounting officer must also state in his report if he is a member or employee of the close corporation. Where the accounting officer is a firm of which a partner or employee is a member or employee of the close corporation, the report of such accounting officer must state that fact.

Should an accounting officer at any time know or have reason to believe that the close corporation is not carrying on business or is not in operation and does not plan to resume its business or operations within the foreseeable future, he should immediately report such a situation to the Commissioner by registered post.

If an accounting officer, during the performance of his duties, finds that any change in the relevant founding statement during a relevant financial year has not been registered, or that the financial statements indicate that the liabilities of the close corporation exceed its assets at the end of the financial year concerned, he must immediately report thereon to the Commissioner by registered post. The accounting officer shall also report to the Commissioner by registered post if the financial statements incorrectly indicate that the assets of the close corporation exceed its liabilities at the end of the financial year concerned.

5.12.2 *Companies Act Regulations applicable to close corporations*

5.12.2.1 Public interest score

The Regulations states that every close corporation shall calculate its "public interest score" (PIS) at the end of each financial year.

The "public interest score" is calculated as the sum of the following:

(a) a number of points equal to the average number of employees of the close corporation during the financial year;

(b) one point for every R1 million (or portion thereof) in third-party liabilities of the close corporation at the financial year-end;

(c) one point for every R1 million (or portion thereof) in turnover of the close corporation during the financial year; and

(d) one point for every individual who, at the end of the financial year, is known by the close corporation to directly or indirectly have a beneficial interest in the close corporation.

"Employee" is as defined in the Labour Relations Act, 1995.

"Turnover" is not defined in the context of the PIS, but is defined elsewhere as the gross income derived from the sale of goods, the rendering of services or the use by other persons of the close corporation's assets yielding interest, royalties, or dividends.

The close corporation's public interest score will then determine whether or not it requires audited financial statements and will also determine the financial reporting framework (IFRS for SME's or IFRS) applicable to the close corporation.

5.12.2.2 Audit exemption

The Amendment Act provides for the exemption with regards to an audit of financial statements. The exemption states the following:

> "30 (2A) If, with respect to a particular company, every person who is a holder of, or has a beneficial interest in, any securities issued by that company is also a director of the company, that company is exempt from the requirements in this section to have its annual financial statements audited or independently reviewed, but this exemption—
>
> (a) does not apply to the company if it falls into a class of company that is required to have its annual financial statement audited in terms of the regulations contemplated in subsection (7*)(a);* and
>
> (b) does not relieve the company of any requirement to have its financial statements audited or reviewed in terms of another law, or in terms of any agreement to which the company is a party."

As "company" also includes a close corporation, this would imply that all close corporations/companies that meet the requirement to be audited in terms of the public interest score or activity test would require an audit. Should an audit of the close corporation not be required in terms of the Regulations, the requirement is waived unless the financial statements are internally (not independently) compiled.

An audit involves tests of controls and substantive procedures and provides an opinion that has the highest level of assurance on an entity's financial statements. An independent review, on the other hand, involves only an enquiry and analytical procedures and provides limited assurance of an entity's financial statements.

5.12.2.3 Audit requirement

The Regulations provide for both activity and size criteria to be used to determine whether or not close corporations require audited financial statements.

The requirements for close corporations to have their financial statements audited are as follows:

- if any close corporation in the ordinary course of its primary activities, holds assets in a fiduciary capacity for persons who are not related to the close corporation, and the aggregate value of such assets held at any time during the financial year exceeds R5 million (activity test);
- if any close corporation has a public interest score in that financial year of
  - (i) 350 or more; or
  - (ii) at least 100 but less than 350, and its annual financial statements for that year were internally compiled.

The activity test relates to the primary activities of the close corporation, not incidental/resulting activities, and specifically states "in a fiduciary capacity". For example, assume a close corporation operates as an estate agency – the holding of funds in trust is incidental to the primary business and not in a fiduciary capacity. The Companies Act would thus not require an audit on this basis, but laws applicable to Estate Agents might well require an audit.

Where the accounting officer is not related to the close corporation, an audit is not required as the statements were not internally compiled as stated in (ii) above.

5.12.2.4 Independent review

As previously mentioned, if a close corporation obtains a PIS of 100 to 350, an audit is required if the annual financial statements were internally compiled. However should the close corporation not require an audit in terms of the regulations, the requirement for an independent review is not applicable as the new section 58(2A) states the sections applicable to close corporations and the exemption in section 30(2A) is not included. Close corporations are not scoped into the independent review requirement.

5.12.2.5 Trusts as members of close corporations

The Regulation requires close corporations to assess the specific circumstances where a trust is a member of a close corporation. The trust deed must be evaluated to confirm whether the trustees, benefactors and/or beneficiaries have a beneficial interest in the close corporation and are members of the close corporation. Whichever party/(ies) are deemed to have a direct or indirect interest in the close corporation would need to be included in the computation of the public interest score.

5.12.2.6 Financial Reporting Standards

The Regulations make provision for IFRS or IFRS for SMEs and also state that the Financial Reporting Standards apply to every close corporation with a financial year end starting on or after the effective date of the Act. Therefore close corporations with a year end after 1 May 2011 are required to prepare annual financial statements in line with the following table:

Public Interest Score (PIS)	Financial Reporting Standard	Audit	Independent Review	Accounting Officer's Report
PIS ≥ 350	IFRS / IFRS for SMEs	YES	NO	YES
PIS ≥ 100 and < 350 and AFS internally compiled	IFRS / IFRS for SMEs	YES	NO	YES
PIS ≥ 100 and < 350 and AFS independently compiled	IFRS / IFRS for SMEs	NO	NO	YES
PIS < 100 and AFS independently compiled	IFRS / IFRS for SMEs	NO	NO	YES
PIS < 100 and AFS internally compiled	The Financial Reporting Standard as determined by the close corporation for as long as no specific Financial Reporting Standard is prescribed	NO	NO	YES

5.12.3 *Accounting procedures*

5.12.3.1 Recording of the distribution of total comprehensive income

A distribution of total comprehensive income is made to a member by reason only of his membership to the corporation. A close corporation may only pay total comprehensive income to its members if the solvency and liquidity requirements of the Close Corporations Act are met (refer to paragraph 5.2). If this stipulation is not adhered to, a member shall be liable to the corporation for such payment received. A payment made to a member as remuneration for services rendered as an employee or as the officer of the close corporation, or a repayment of a loan that was granted by a member or a payment in respect of the interest thereon, or a payment in respect of a rental expense to a member, or a payment made to a member in his capacity as a creditor of the relevant close corporation, is excluded from a payment that is made to a member by reason only of his membership, i.e. a distribution.

When a distribution is provided for, the distribution to members account is debited and the distribution to members payable account credited. The distribution to members account is closed off to the retained earnings account by debiting the retained earnings account and crediting the distribution to members account. At the date of payment, the distribution to members payable account is debited and the bank account credited with the amount paid. These three journal entries are reflected below:

General journal

	Debit	Credit
	R	**R**
Distribution to members	XXX	
Distribution to members payable		XXX
Recording of the provision for a distribution of total comprehensive income to members		
Retained earnings	XXX	
Distribution to members		XXX
Closing off the distribution to members account to the retained earnings account		
Distribution to members payable	XXX	
Bank		XXX
Recording of the payment of a distribution of total comprehensive income to members		

When it is decided to capitalise the distribution of total comprehensive income of a member, the distribution is recorded against a loan from the member's account. Such a loan is then administered according to a loan agreement which is entered into by the close corporation and the member. The capitalisation of a distribution of total comprehensive income is recorded in the general journal as follows:

General journal

	Debit	Credit
	R	**R**
Distribution to members	XXX	
Loan from member: A		XXX
Loan from member: B		XXX
Transfer of distribution of total comprehensive income to the loan from member's accounts		

5.12.3.2 Preparation of financial statements

The following example, with the exception of a statement of cash flows and the report of the accounting officer, illustrates the annual financial statements that a close corporation must prepare in terms of the provisions of the Close Corporations Act and in accordance with IFRS. The preparation of the report of an accounting officer falls outside the scope of this chapter.

Example 5.2 Comprehensive example – annual financial statements of a close corporation

Y Craig, D Zeelie and S Hill are the only members of Crazehill Enterprises CC. As members, they each hold a third interest in the close corporation. On 28 February 20.5, the financial year-end of the close corporation, the bookkeeper presented the following trial balance, together with additional information, to the accounting officer, who is also required to prepare the financial statements of Crazehill Enterprises CC.

Crazehill Enterprises CC
Pre-adjustment trial balance as at 28 February 20.5

	Debit	Credit
	R	R
Member's contribution: Y Craig		31 250
Member's contribution: D Zeelie		31 250
Member's contribution: S Hill		31 250
Loans to member: Y Craig	62 500	
Loans to member: S Hill	87 500	
Loan from member: D Zeelie (1 March 20.4)		37 500
Land and buildings at valuation	550 000	
Equipment (at cost)	118 750	
Accumulated depreciation: Equipment (1 March 20.4)		20 000
Mortgage		75 000
Trade receivables control	32 813	
Trade payables control		31 188
Retained earnings (1 March 20.4)		446 912
Revaluation surplus (1 March 20.4)		20 000
Bank	5 125	
Petty cash	250	
Investment in Watsons Ltd at fair value	100 000	
Inventory (1 March 20.4)	21 250	
Allowance for credit losses		2 500
Sales		874 700
Purchases	300 000	
Telephone expenses	11 750	
Stationery consumed	4 937	
Salaries (employees)	150 000	
Salaries (members)	90 000	
Remuneration: Accounting officer	17 500	
Carriage on purchases	10 250	
Credit losses	3 875	
Settlement discount received		525
Carriage on sales	11 250	
SARS (Income tax)	23 075	
Settlement discount granted	1 838	
Interest income (on favourable bank balance)		288
Allowance for settlement discount granted (1 March 20.4)		300
	1 602 663	1 602 663

Additional information:

1. Provision must still be made for depreciation on equipment at 20% per annum according to the diminishing balance method. Included in the equipment at cost account is a machine which was purchased on 1 September 20.4 for R18 750 cash, and immediately put to use. No other purchases or sales of equipment occurred during the year.
2. On 31 January 20.5, expansions to the building were completed and paid for. The total cost of the expansions amounted to R50 000. Land and buildings consist of a shop and offices on Plot No. 40, situated in Menlyn, and purchased on 4 July 20.2

for R480 000. It is the policy of the close corporation not to depreciate land and buildings.

3. Interest on the mortgage from City Bank at 18% per annum must still be taken into account. The interest is payable on 1 March 20.5. The mortgage was obtained on 1 March 20.4 and is secured by a first mortgage over land and buildings. The mortgage is repayable in five equal installments as from 1 January 20.8.
4. Transactions in respect of R312 for carriage on sales and R938 for carriage on purchases have not yet been recorded in the books of the close corporation. These accounts are still payable by the close corporation during March 20.5.
5. A debtor who owes the business R1 553 was declared insolvent and his debt must be written off as irrecoverable.
6. The allowance for credit losses must be adjusted to R1 563.
7. The members decided that for the 20.5 financial year, interest must be recorded on the loan accounts to members at a rate of 15% per annum on the opening balances of any existing loans as well as on any additional loans granted. On 1 July 20.4, an additional loan of R25 000 was granted to S Hill and recorded in the books. Interest on the loans to members is capitalised. All loans are unsecured and immediately callable.
8. Interest is charged at 20% per annum on the opening balance of the loan from D Zeelie and is payable on 1 March 20.5.

   On 27 February 20.5, the members decided that an amount of R75 000 of the total comprehensive income for the year must be equally distributed to them on 28 February 20.5. It was further decided that these amounts will not be paid out in cash, but will remain in the close corporation as loans from the members.

   Sixty percent of all the loans from the members must be repaid on 1 May 20.5. The balances of these loans are repayable in February 20.10. All these loans are unsecured.
9. The investment in Watsons Ltd consists of 50 000 ordinary shares bought for R90 000 and was acquired in 20.1.Watsons Ltd is a listed company and the investment was acquired for trade purposes. On 15 February 20.5, Watsons Ltd declared a dividend of 30 cents per share, payable on 15 March 20.5. On 28 February 20.5, the fair value of the investment amounted to R120 000.
10. Each member received a monthly salary of R2 500, which was paid in cash. S Hill, as managing member, must still receive an additional amount (as salary) of R15 000. This amount will be paid during the course of March 20.5, and has not been recorded in the books.
11. No additional members' contributions were made during the year.
12. On 28 February 20.5 the land and buildings were revalued upwards by R40 000 by an independent appraiser. This information must still be entered in the accounting records of Crazehill Enterprises CC.
13. The closing inventory amounted to R12 625 and is valued at the lower of cost or net realisable value according to the first-in, first-out method.
14. The balance of the allowance for settlement discount granted account on 1 March 20.4 must be written back since the trade debtor to whom the discount

offering pertained did not settle his account as required. On 28 February 20.5 a trade debtor who owes R3 400 was offered a 5% settlement discount, on condition that she settles her account before 15 March 20.5. This offering must still be provided for.

15. Crazehill Enterprises CC was offered a discount of 4% on an amount of R1 300 owing to a supplier provided it pays the supplier before 15 March 20.5. At the date of the transaction, the close corporation did not intend to take the settlement discount offer. However at year-end and due to sufficient cash flow, the close corporation decided to take advantage of this offer.
16. The current income tax in respect of the financial year amounted to R67 042 and must still be recorded.

Required:

With regard to Crazehill Enterprises CC, prepare:

(a) The statement of profit or loss and other comprehensive income for the year ended 28 February 20.5.

(b) The statement of changes in net investment of members for the year ended 28 February 20.5.

(c) The statement of financial position as at 28 February 20.5.

(d) The notes for the year ended 28 February 20.5.

Your solution must comply with the provisions of the Close Corporations Act, 69 of 1984, and the requirements of IFRS. Comparative figures are not required.

Solution:

(a) **Crazehill Enterprises CC**
Statement of profit or loss and other comprehensive income for the year ended 28 February 20.5

	Note	R	
Revenue①	9		872 992
Cost of sales			(319 236)
Inventory (1 March 20.4)		21 250	
Purchases②		299 423	
Carriage on purchases R(10 250 + 938)		11 188	
		331 861	
Inventory (28 February 20.5)		(12 625)	
Gross profit			553 756
Other income			56 538
Dividend income: Listed shares ③		15 000	
Interest income ⑩	5, 8	21 538	
Fair value adjustment: Listed shares R(120 000-100 000)		20 000	
			610 294

continued

	Note	R
Distribution, administrative and other expenses		(323 115)
Credit losses⑤		4 491
Carriage on sales R(11 250 + 312)		11 562
Salaries to employees		150 000
Salaries to members R(90 000 + 15 000)	3	105 000
Telephone expenses		11 750
Stationery consumed		4 937
Remuneration: Accounting officer		17 500
Depreciation⑥	2, 3	17 875
Finance costs⑦		(21 000)
Interest on mortgage	6	13 500
Interest on loan from member	8	7 500
Profit before tax		266 179
Income tax expense		(67 042)
Profit for the year		199 137
Other comprehensive income for the year		40 000
Revaluation surplus		40 000
Total comprehensive income for the year		239 137

(b)

Crazehill Enterprises CC
Statement of changes in net investment of members
for the year ended 28 February 20.5

	Members' contributions	**Retained earnings**	**Revaluation surplus**	**Loans from members**	**Loans to members**	**Total**
	R	**R**	**R**	**R**	**R**	**R**
Balances at 1 March 20.4	93 750	446 912	20 000	37 500	(125 000)	473 162
Changes in accounting policy*						
Adjusted balances	93 750	446 912	20 000	37 500	(125 000)	473 162
Members' contributions*	–					–
Total comprehensive income for the year		199 137	40 000			239 137
Profit for the year		199 137				199 137
Other comprehensive income for the year			40 000			40 000
Distribution to members		(75 000)		75 000		–
Loans to members					(46 250)	(46 250)
Balances at 28 February 20.5	93 750	571 049	60 000	112 500	(171 250)	666 049
Non-current liability				45 000		
Current liability (R112 500 × 60%)				67 500		

* Since the information is not applicable in this example, these items are included for illustrative purposes only.

Comment:

In compliance with paragraph .81 of the *Guide on Close Corporations*, the members' contributions and the movements that pertain thereto are not disclosed per member, as is the case with partners in a partnership. The reason for this is that a close corporation is regarded as an independent legal entity. The ownership of the assets which were contributed as capital by the members to the close corporation is therefore vested in the close corporation, and not in the individual members thereof.

(c) **Crazehill Enterprises CC**

Statement of financial position as at 28 February 20.5

	Note	R
ASSETS		
Non-current assets		
Property, plant and equipment	2, 3	670 875
Current assets		353 777
Inventories	2	12 625
Trade and other receivables⑧	2, 4	44 527
Loans to members	2, 4, 5	171 250
Listed investment	2, 4	120 000
Cash and cash equivalents	2, 4	5 375
Total assets		1 024 652
EQUITY AND LIABILITIES		
Total equity		724 799
Members' contributions		93 750
Retained earnings		571 049
Other components of equity		60 000
Total liabilities		299 853
Non-current liabilities		120 000
Long-term borrowings	6	120 000
Current liabilities		179 853
Trade and other payables⑨	6	68 386
Current portion of long-term borrowings	6	67 500
Current tax payable R(67 042 – 23 075)		43 967
Total equity and liabilities		1 024 652

(d) **Crazehill Enterprises CC**

Notes for the year ended 28 February 20.5

Accounting policy

1. Basis of presentation

   The financial statements have been prepared in accordance with IFRS appropriate to the business of the close corporation. The financial statements have been prepared on the historical cost basis, modified by the revaluation of financial assets and financial liabilities at fair value through profit or loss.

2. Summary of significant accounting policies

   The financial statements incorporate the following principle accounting policies which are consistent with those applied in previous years except where otherwise stated.

   2.1 Property, plant and equipment

   Property, plant and equipment are initially recognised at cost price. No depreciation is written off on land and buildings. Land and buildings are revalued at regular intervals by an independent appraiser. Equipment is subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses.

   Depreciation on equipment is written off at a rate deemed to be sufficient to reduce the carrying amount of the assets over their estimated useful life to their estimated residual value. The depreciation rate is as follows:

   Equipment: 20% per annum according to the diminishing balance method.

   Depreciation is charged to profit or loss for the year. Profits or losses on disposal are determined by comparing the proceeds with the carrying amount of the assets. The net amount is included in profit or loss for the year.

   2.2 Financial Instruments.

   Financial instruments are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of an instrument.

   Financial instruments are initially measured at the transaction price, which is fair value plus transaction costs, except for "Financial assets at fair value through profit or loss" which is measured at fair value, transaction costs excluded. The entity classification depends on the purpose for which the entity acquired the financial assets. Financial instruments are subsequently measured at fair value unless it is measured at amortised cost as required by IFRS.

   Financial instruments that are subsequently measured at amortised cost are done so using the effective interest rate method.

   Debt instruments that are classified as current assets or current liabilities are measured at the undiscounted amount of the cash expected to be received or paid, unless the arrangement effectively constitutes a financing transaction.

   2.3 Inventories

   Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. Cost is calculated using the first-in, first-out method. Net realisable value is the estimated selling price less any cost of completion and disposal.

   2.4 Revenue

   Revenue is measured at the fair value of the consideration received or receivable. Revenue from the sale of inventory consists of the total net invoiced sales, excluding value added tax and settlement discount granted. The revenue from sales is recognised when control of the goods is transferred to the customer.

3. Property, plant and equipment

	Land and buildings	Equipment	Total
	R	R	R
Carrying amount at 1 March 20.4	500 000	80 000	580 000
Valuation/Cost	500 000	100 000	600 000
Accumulated depreciation	–	(20 000)	(20 000)
Revaluation surplus for the year	40 000		40 000
Additions	50 000	18 750	68 750
Depreciation for the year	–	(17 875)	(17 875)
Carrying amount at 28 February 20.5	590 000	80 875	670 875
Valuation/Cost	590 000	118 750	708 750
Accumulated depreciation	–	(37 875)	(37 875)

The land and buildings consist of a shop and offices on Plot No. 40, Menlyn, purchased on 4 July 20.2. Land and buildings were revalued by an independent valuer during the year. The land and buildings serve as security for the mortgage (refer to Note 6).

4. Financial assets

	20.5
	R
Trade and other receivables:	44 527
Trade receivables control	31 260
Allowance for credit losses	(1 563)
Allowance for settlement discount granted	(170)
Accrued income (dividends receivable)	15 000
Loans to members.	171 250
The loans are unsecured and carry interest at 15% per annum. The loans are immediately callable.	
Listed investment held for trading at fair value through profit or loss:	120 000
50 000 ordinary shares in Watsons Limited (consideration R90 000)	
Cash and cash equivalents:	5 375
Bank	5 125
Petty cash	250
	341 125

5. Loans to members

	Y Craig	S Hill	Total
	R	R	R
Balance at 1 March 20.4	62 500	62 500	125 000
Advances during the year	–	25 000	25 000
Repayments during the year	–	–	–
Interest capitalised	9 375	11 875	21 250
Balance at 28 February 20.5	71 875	99 375	171 250

6. Financial liabilities

	20.5
	R
Non-current financial liabilities at amortised cost	120 000
Long-term borrowings: Mortgage	75 000
The mortgage was acquired from City Bank at 1 March 20.4 at an interest rate of 18% per annum. The loan is repayable in five equal instalments as from 1 January 20.8. The loan is secured by a first mortgage over land and buildings (refer to Note 3)	
Loans from members:	45 000
The loans from members are unsecured and carry interest at 20% per annum. The loans are repayable in February 20.10	
Current financial liabilities	135 886
Trade and other payables	68 386
Trade payables control	31 188
Allowance for settlement discount received	(52)
Accrued expenses	37 250
Current portion of loans from members at amortised cost	67 500
	255 886

7. Loans from members

	Y Craig	**D Zeelie**	**S Hill**	**Total**
	R	**R**	**R**	**R**
Balance at 1 March 20.4	–	37 500	–	37 500
Advances during the year	25 000	25 000	25 000	75 000
Repayments during the year	–	–	–	–
Balance at 28 February 20.5	25 000	62 500	25 000	112 500
Current portion	(15 000)	(37 500)	(15 000)	(67 500)
Non-current portion	10 000	25 000	10 000	45 000

8. Transactions with members

	Y Craig	**D Zeelie**	**S Hill**	**Total**
	R	**R**	**R**	**R**
Salaries	30 000	30 000	45 000	105 000
(R2 500 × 12) (R30 000 + R15 000)				
Interest earned on loans to members	(9 375)	–	(11 875)	(21 250)
Interest incurred on loan from member	–	7 500	–	7 500
	20 625	37 500	33 125	91 250

9. Revenue

	R **20.5**
Sale of goods	874 700
Forfeited settlement discount written back	300
Settlement discount granted	(1 838)
Allowance for settlement discount granted – 2.05	(170)
	872 992

Calculations:

① **Revenue**

	R
Sales	874 700
Settlement discount granted [R1 838 + (R3 400 × 5%)]	(2 008)
Allowance for settlement discount granted – 20.4	300
	872 992

② **Purchases**

Purchases	300 000
Settlement discount received (R525 + R1 300 × 4%)	(577)
	299 423

③ **Dividend income**

50 000 shares × R0,30	15 000

④ **Income (loans to members)**

Y Craig	
R62 500 × 15%	9 375
S Hill	
R62 500 × 15%	9 375
R25 000 × 15% × 8/12	2 500
	21 250

⑤ **Credit losses and allowance for credit losses**

Allowance for credit losses: Opening balance (given)	2 500
Allowance for credit losses: Closing balance (given)	(1 563)
Decrease in the allowance for credit losses	937
Calculation of credit losses:	
Credit losses per trial balance	3 875
Additional amount written off	1 553
Decrease in allowance for credit losses	(937)
Total	4 491

⑥	**Depreciation: Equipment**	
	R18 750 × 20% × 6/12	1 875
	R(118 750 – 18 750 – 20 000) × 20%	16 000
	Total	17 875
⑦	**Finance costs**	
	Interest on mortgage (R75 000 × 18%)	13 500
	Interest on loan from member: D Zeelie (R37 500 × 20%)	7 500
	Total	21 000
⑧	**Trade and other receivables**	
	Trade receivables control R(32 813 – 1 553)	31 260
	Allowance for credit losses	(1 563)
	Allowance for settlement discount granted	(170)
		29 527
	Accrued income (dividends receivable)	15 000
	Total	44 527
⑨	**Trade and other payables**	
	Trade payables control	31 188
	Allowance for settlement discount received	(52)
		31 136
	Accrued expenses:	37 250
	Carriage on purchases	938
	Carriage on sales	312
	Interest on loan from member (R37 500 × 20%)	7 500
	Salary: Hill	15 000
	Interest on mortgage (R75 000 × 18%)	13 500
	Total	68 386
⑩	**Interest income**	
	Interest on loans to members (Refer to calculation ④)	21 250
	Interest on bank account	288
	Total	21 538

Example 5.3 Comprehensive example – annual financial statement of a close corporation

Soccer Traders CC is a close corporation entity formed by Mr Dean Fairman and Mr Itumeleng Khume with the business objective to sell soccer kits. Mr Arendse, the accounting officer, partially prepared the financial statements but was unable to complete the project due to a contractual dispute with the members of the close corporation. The members approached you to assist them in finalising the financial statements. The following information pertaining to Soccer Traders CC, for the year ended 28 February 20.2, is presented to you:

1. Balances as at 28 February 20.2:

	R
Member's contribution: Dean Fairman	200 000
Member's contribution: Itumeleng Khume	150 000
Retained earnings (1 March 20.1)	138 600
Loan from member: Dean Fairman	70 000
Distribution to member: Dean Fairman	32 000
Distribution to member: Itumeleng Khume	48 000
Loan to member: Itumeleng Khume	120 000
Allowance for credit losses	3 000
Land and buildings at cost	210 000
Equipment at cost	165 000
Fixed deposit: Safa Bank	50 000
Trading inventory	140 500
Consumable inventory	6 200
Long-term loan: UAE Bank	60 000
Accumulated depreciation: Equipment	62 320
Interest received	4 000
Accrued expenses	6 800
Prepaid expenses	3 500
Bank overdraft	21 120
Petty cash	700
Trade receivables control	70 440
Trade payables control	31 540
Profit before tax *(before any applicable additional information)*	169 380
SARS (Income Tax) (Dr)	70 420

2. Additional information:

2.1 The depreciation on equipment for the year amounted to R41 250 and was correctly accounted for in the records of the entity.

2.2 There were no disposals of, or additions to the land and buildings and equipment during the year.

2.3 The investment at Safa Bank was made on 1 May 20.0 for 24 months at 12% interest per annum. The interest is receivable in cash, every six months, on 31 October and 30 April. Mr Arendse correctly accounted for the interest received in the accounting records but left the close corporation before completing any interest provision.

2.4 The loan from Dean Fairman is unsecured and the first instalment of R15 000 is payable on 28 February 20.3.

2.5 Current income tax for the year amounts to R50 570 and must still be recorded.

2.6 A further profit distribution of R20 000 must be made to each member.

2.7 The long-term loan from UAE Bank was obtained on 1 March 20.0 at 15% interest per annum and is secured by a first mortgage over land and buildings. The capital amount of the loan is repayable in total on 28 February 20.9. Interest on the loan is payable in cash on 2 March every year until the loan is repaid but must still be accounted for.

2.8 The loan to Itumeleng Khume is unsecured, interest free and immediately callable.

Required:

With regard to Soccer Traders CC, prepare:

(a) The statement of changes in net investment of members for the year ended 28 February 20.2.

(b) The statement of financial position as at 28 February 20.2.

(c) The following notes for the year ended 28 February 20.2:

(i) Property, plant and equipment

(ii) Financial assets

(iii) Financial liabilities.

Your solution must comply with the requirements of the Close Corporations Act, 69 of 1984, and the requirements of IFRS. Comparative figures are not required.

Solution:

(a) **Soccer Traders CC**

Statement of changes in net investment of members for the year ended 28 February 20.2

	Members' contributions	**Retained earnings**	**Loan from member**	**Loan to member**	**Total**
	R	**R**	**R**	**R**	**R**
Balances at 1 March 20.1	350 000	138 600	70 000	(120 000)	438 600
Total comprehensive income for the year		①115 810			115 810
Distribution to members		②(120 000)			(120 000)
Balances at 28 February 20.2	350 000	134 410	70 000	(120 000)	434 410
Non-current liability			55 000		
Current liability			15 000		

Calculations

① **Total comprehensive income for the year**

	R
Profit before tax *(before any applicable additional information)*	169 380
Interest income R(4 000 + (12% × 50 000 × $^4/_{12}$))	6 000
Interest paid R(60 000 × 15%)	(9 000)
Profit before tax	166 380
Income tax expense	(50 570)
Profit for the year/Total comprehensive income for the year	115 810

② **Distribution to members**

R(32 000 + 48 000 + 40 000) = R120 000

(b) **Soccer Traders CC**
Statement of financial position as at 28 February 20.2

	Note	R
ASSETS		
Non-current assets		312 680
Property, plant and equipment		312 680
Current assets		410 190
Inventories R(140 500 + 6 200)		146 700
Trade and other receivables R(70 440 – 3 000 + 2 000 + 3 500)	2	72 940
Fixed deposit	2	50 000
Loan to member	2	120 000
Cash and cash equivalents	2	700
Taxation receivable R(70 420 – 50 570)	2	19 850
Total assets		722 870
EQUITY AND LIABILITIES		
Total equity		484 410
Members' contributions		350 000
Retained earnings		134 410
Total liabilities		238 460
Non-current liabilities		115 000
Long-term borrowings	3	115 000
Loan from a member	3	55 000
Current liabilities		123 460
Trade and other payables R(31 540 + 6 800 + 9 000)	3	47 340
Current portion of loan from a member	3	15 000
Bank overdraft	3	21 120
Distribution to members payable		40 000
Total equity and liabilities		722 870

(c) **Soccer Traders CC**
Extract from the notes for the year ended 28 February 20.2

(1) Property, plant and equipment

	Land and buildings	Equipment	Total
	R	R	R
Carrying amount at 1 March 20.1	210 000	143 930	353 930
Cost	210 000	165 000	375 000
Accumulated depreciation	–	(21 070)	(21 070)
Depreciation for the year	–	(41 250)	(41 250)
Carrying amount at 28 February 20.2	210 000	102 680	312 680
Cost	210 000	165 000	375 000
Accumulated depreciation	–	(62 320)	(62 320)

The land and buildings serve as security for the long-term loan (refer note 3).

(2) Financial assets

Current financial assets	**R**
Trade and other receivables:	72 940
Trade receivables control	70 440
Allowance for credit losses	(3 000)
Accrued income: Interest on fixed deposit	2 000
Prepaid expenses	3 500
Loan to member: The loan is unsecured, interest free and callable	120 000
Fixed deposit:	50 000
The fixed deposit at Safa Bank was made at 1 May 20.0 for 24 months at 12% interest per annum.	
Cash and cash equivalents	700
Petty cash	700

(3) Financial liabilities

	R
Non-current financial liabilities at amortised cost	
Long-term borrowings:	115 000
The long-term loan was acquired from UAE Bank at 1 March 20.0 at an interest rate of 15% per annum. The loan is secured by a first mortgage over land and buildings (refer note 1) and is repayable on 28 February 20.9.	60 000
Loan from member:	55 000
The loan is unsecured, interest free and repayable in instalments of R15 000, the first on 28 February 20.3	

continued

	R
Current financial liabilities	
Trade and other payables:	47 340
Trade payables control	31 540
Accrued expenses R(6 800 + 9 000)	15 800
Current portion of loan from a member at amortised cost	15 000
Financial liabilities at fair value through profit or loss:	21 120
Bank overdraft	21 120

5.13 Deregistration of a close corporation

The Commissioner must notify a close corporation by registered post to its postal address that the close corporation will be deregistered (unless good cause is shown to the contrary) if the Commissioner is not within 60 days from the date of the registered letter informed in writing that the close corporation is carrying on business or is in operation. Such a registered letter will be served on a close corporation when

- a close corporation has failed, for a period of more than six months, to lodge an Annual Return in compliance with the provisions of the Close Corporations Act (an Annual Return is submitted to the Commissioner to confirm that the close corporation is still in business and that certain provided information is still valid), or when
- the Commissioner has reason to believe that a close corporation is not carrying on business or is not in operation.

When the abovementioned period of 60 days has expired, and the Commissioner has received no written reply from the close corporation to the effect that it is still carrying on business or is in operation, the Commissioner may deregister the close corporation. The Commissioner may also deregister the close corporation if a written statement, signed by or on behalf of every member, has been received from the close corporation to the effect that the close corporation has ceased to carry on its business or is not in operation, and that the close corporation has no assets or liabilities.

When a close corporation is deregistered, the Commissioner cancels the registration of its founding statement and gives notice thereof in the *Government Gazette*. The date of deregistration will be the date on which the *Government Gazette* was published.

Deregistration of a close corporation does not affect any liability of a member of the close corporation, to the close corporation or to any other person. Such a liability may be enforced as if the close corporation was still registered.

Should a close corporation be deregistered whilst having outstanding liabilities, the members of the close corporation at the time of its deregistration shall be jointly and severally liable for such liabilities.

5.14 Summary

In this chapter, the close corporation as a form of business entity was discussed. Contrary to a sole proprietor and a partnership, a close corporation is an independent juristic person which ensures that it does not cease to exist merely because of a change in the ownership thereof, provided that such a change is in conformity with the requirements of the Close Corporations Act. Since a close corporation is regarded as a juristic person, it provides limited liability to its members. In addition, a close corporation is, in comparison to a company, relatively simple to administer and the members thereof are, in contrast to the shareholders of a limited company, in the position to personally manage the close corporation.

The members of a close corporation are usually only natural persons, and the number of members may never exceed ten. A close corporation must always have at least one member. The above attributes of a close corporation suit the needs of a small business enterprise which predominantly requires stability as a going concern, protection to its owners in respect of the liabilities of the enterprise, relatively simple administration and, to a certain extent, flexibility. These attributes apply specifically to a close corporation, since neither a sole proprietor, nor a partnership or a company can meet all of these needs. A close corporation also has disadvantages, for example, a member can commit the close corporation to injudicious transactions, and the restricted number of members can inhibit the growth of a close corporation.

The Close Corporations Act, 69 of 1984 concurrent with the Companies Act, 71 of 2008, provides the legislative requirements pertaining to close corporations. An overview of the following parts of the Acts were given in this chapter: the formation and juristic personality of a close corporation; Companies Act Regulations applicable to close corporations and deregistration thereof; the requirements in respect of membership; the internal and external relations of a close corporation; the accounting and disclosure requirements of a close corporation; and the liability of members and others towards the debts thereof.

A clear distinction between a member's interest and a member's contribution was made. A member's interest is always expressed as a percentage, and usually indicates the manner in which distributions of total comprehensive income will be apportioned. The total of all the members' interests must add up to 100%. A member's contribution refers to the capital investment which a member must make in the close corporation. Both the members' interests and the members' contributions must be disclosed in the founding statement of a close corporation.

With regard to the internal relations of a close corporation, it was made clear that every member of a close corporation stands in a fiduciary relationship to the close corporation. The Close Corporations Act allows ample flexibility in respect of the internal relations within a close corporation, and therefore only basic requirements exist in this regard. Should the members prefer to operate according to a more formal approach, they may enter into a written association agreement. An association agreement fulfils the same function as that of the articles of association of a company. Since entering into an association agreement is not mandatory, no prescribed format exists according to which it must be prepared.

The main point to take note of in respect of the external relations of a close corporation is that each member has an equal right to partake in the carrying on of the business, provided that certain requirements of the Close Corporations Act are met.

A close corporation must keep, in one of the official languages of the Republic, all the accounting records which are necessary to fairly present the state of affairs and business of the corporation, and to explain the transactions and the financial position of the business. The accounting records must be kept in such a manner that adequate precautions against falsification is provided and that the identification of any falsification is facilitated.

The Close Corporations Act requires that the financial statements of a close corporation shall consist of a statement of financial position and any notes thereto, and a statement of profit or loss and other comprehensive income (or any similar financial statement where such form is appropriate) and any notes thereto. The Close Corporations Act also requires that the financial statements must be in conformity with IFRS, appropriate to the business of the corporation, and fairly present the state of affairs of the close corporation at the financial year-end as well as the results of its operations for that year.

The Close Corporations Act does not explicitly require that a statement of changes in equity or a statement of cash flows must form part of the financial statements of a close corporation. However, the *Guide on Close Corporations* suggests that a statement of changes in net investment of members (which in this chapter replaces the statement of changes in equity) and a statement of cash flows also be prepared, if appropriate to the information needs of the members of the close corporation.

The Close Corporations Act further requires that the financial statements must contain a report from the accounting officer which, amongst others, discloses whether these financial statements are in agreement with the accounting records of the corporation, and whether the accounting policies that were represented to him as having been applied in the preparation of the annual financial statements are appropriate. Should an accounting officer find any contravention, irrespective of the significance thereof, to a provision in the Close Corporations Act, he must describe the nature of such contravention in his report.

It is the responsibility of the members of a close corporation to ensure that the financial statements are prepared within nine months after the end of every financial year of the corporation, in respect of that financial year.

In conclusion, certain statutory requirements in respect of deregistration of a close corporation were discussed. Under normal circumstances, a close corporation which ceases to carry on business or which is no longer in operation, will be deregistered. If a close corporation has failed to lodge an Annual Return in compliance with the provisions of the Close Corporations Act for a period longer than six months, it may also be deregistered. When a close corporation is deregistered, the registration of its founding statement is cancelled. Deregistration of a close corporation may not affect any liability of a member of the close corporation to the close corporation or to any other person. Should a close corporation be deregistered whilst having outstanding liabilities, the members of the close corporation at the time of its deregistration are jointly and severally liable for the payment of such liabilities.

CHAPTER 6

Introduction to companies

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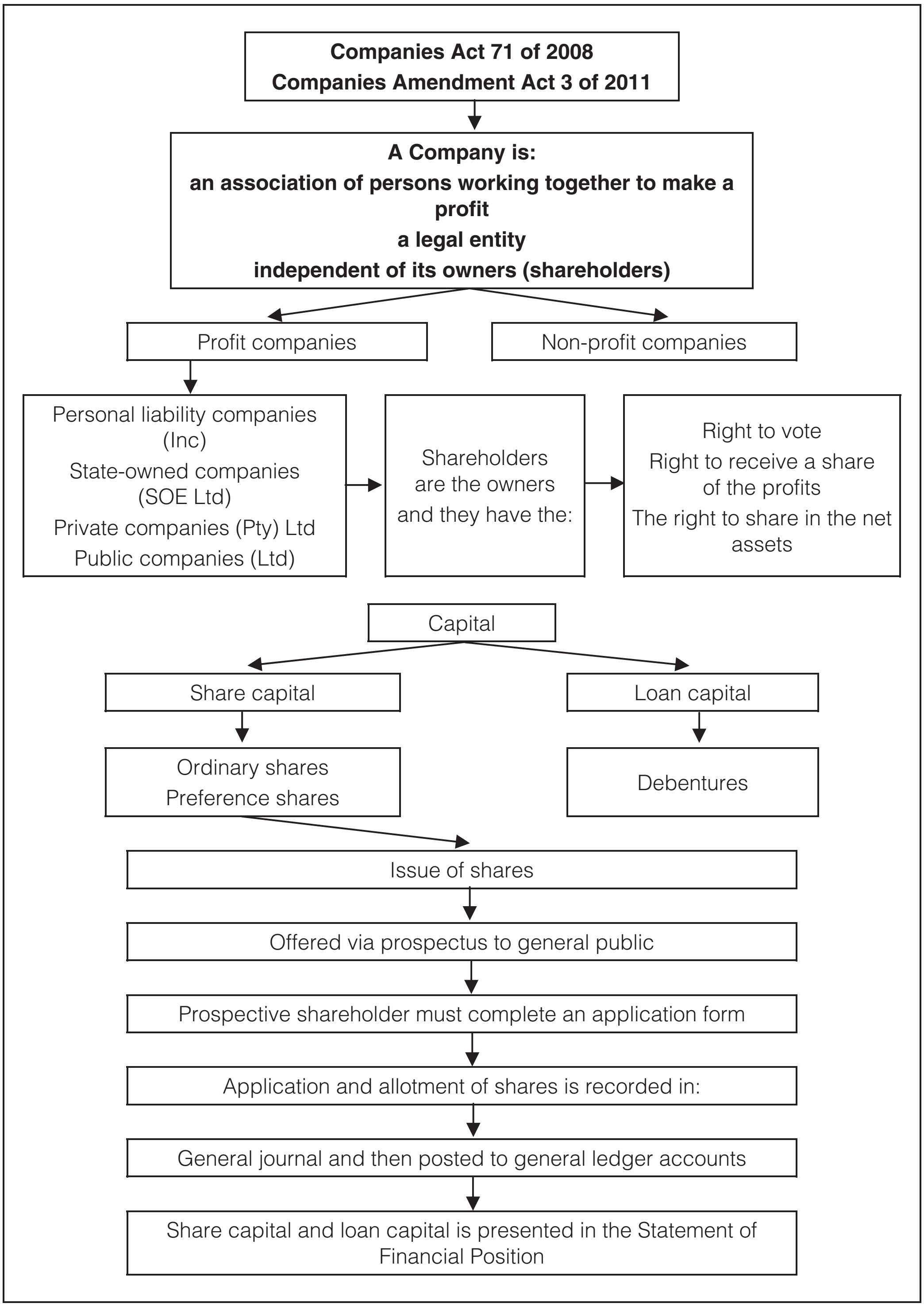
Overview of the introduction to companies



6.1 Introduction

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- ☐ describe the characteristics of a profit company;
- ☐ explain the difference between the different types of companies;
- ☐ explain the rights of shareholders;
- ☐ distinguish between authorised and issued securities;
- ☐ distinguish between ordinary shares and preference shares;
- ☐ explain the different types of preference shares;
- ☐ record transactions pertaining to the issue of shares;
- ☐ record the issue of capitalisation shares;
- ☐ prepare an allotment schedule;
- ☐ record the underwriting of shares;
- ☐ explain dividends and the calculation thereof;
- ☐ record dividend transactions;
- ☐ discuss the general aspects of debentures;
- ☐ discuss the different types of debentures;
- ☐ record the issue of debentures; and
- ☐ discuss the general aspects regarding the financial statements of companies.

Of all the forms of business ownership, companies are the dominant form. The ability of a company to attract and accumulate large amounts of capital, together with other attributes such as the limited liability of its owners, unlimited life span and comprehensive corporate legislation, contributes largely to this dominant role.

The purpose of this chapter is to serve as an introduction to companies. It is not intended to be a comprehensive approach to this topic. The scope of this textbook does not cover the financial statements of companies, as this and other complicated issues about companies will be dealt with in later years of accounting studies. In this chapter, the important aspect of share capital as the main equity instrument of a company is discussed in full, as this is the aspect where companies differ mainly from other forms of business ownership and it is the starting point when a company is registered.

A company may be described as an association of persons working together with a view to making a profit. A company is a legal entity incorporated in terms of legislation and is independent of its owners, who are called shareholders. Being a legal entity, a company has continuous existence which is separate from that of its shareholders. The legal status of a company means that by law it has the same legal status as that of a natural person with contractual capacity. The company can have rights and obligations in its own name, it can enter into contracts with other persons (natural or legal) and it can be sued or sue other persons. As a separate legal entity, the company is a taxpayer and pays tax at the prescribed rate for companies.

In South Africa, all matters pertaining to companies are regulated by the Companies Act, 71 of 2008 (hereafter referred to as the "Companies Act"). The Companies Act came into effect on 1 May 2011. The Companies Act, in terms of which a company is established, consists of nine chapters containing 225 sections. In addition to the initial nine chapters there are five schedules. The purpose of these schedules is to give guidelines, procedures and additional requirements regarding various aspects of companies.

In addition to the Companies Act, the Companies Amendment Act, 3 of 2011 (hereafter referred to as the Amendment Act) was assented by the presidency and was published in the *Government Gazette* on 26 April 2011. This amendment Act needs to be read together with the Companies Act as no consolidated version is yet available.

Over and above the two acts mentioned above, the Minister of Trade and Industry has published the Companies Regulations which took effect on the same day as the Companies Act.

The purpose of the Companies Act is to:

☐ list the requirements for the establishment of a company;

☐ list the classification of companies;

☐ prescribe the requirements for the administration of companies (accounting, legal and general requirements) and to provide for stricter accountability and transparency requirements;

☐ protect the interests of shareholders;

☐ to codify the standard for directors' conduct and strict director liability provisions;

☐ to ensure a capital maintenance regime based on solvency and liquidity that abolishes the concept of par value shares and nominal value shares; and

☐ protect the interests of third parties who deal with the company, for example trade and other creditors.

The Companies Act, 71 of 2008, is characterised by flexibility, simplicity, transparency corporate efficiency and regulatory certainty and is drafted in plain language for ease of understanding.

The Companies Act is administered by the Companies and Intellectual Property Commission (CIPC) who is responsible for registering companies and must also ensure that that all the legal requirements with regards to companies are adhered to.

To put companies as a form of business ownership in perspective, the following table illustrates the main differences between a company and other forms of business ownership.

Table 6.1 The company as a form of business ownership compared to other forms of business ownership

Criterion	Sole trader	Partnership	Close corporation	Company
Number of members	1	2 to unlimited	1 to 10	1 to unlimited, but in practice it is determined by the number of shares issued. The minimum number of members is dependent upon the type of company formed.– refer to par. 6.4
Member(s) referred to as	Owner	Partners	Members	Shareholders
Special Act for type of ownership	None. Common law principles apply	None. Common law principles apply	Close Corporations Act, 69 of 1984, as amended by the Companies Act, 71 of 2008	Companies Act, 71 of 2008; the Companies Amendment Act 3 of 2011 and the Companies Regulations of 2011
Separate legal entity	No	No	Yes	Yes
Managed by	Owner	Partners	Members	Board of directors – refer to par 6.2
Life span	Limited to lifespan of owner	Each time there is a change in partners, the partnership must be dissolved and a new partnership is established	Unlimited	Unlimited
Tax status	Entity is not taxed Owner is taxed	Entity is not taxed Partners are taxed	Taxable entity	Taxable entity
Suitable for	Small entities	Small entities	Small to medium entities	Small to very large and international entities
Special accounting requirements	Need not comply with IFRS	Need not comply with IFRS	Must comply with IFRS or IFRS for SMEs, appropriate to the entity and the requirements of the Close Corporations Act, 69 of 1984, as amended by the Companies Act – must appoint an accounting officer. In some cases compliance with IFRS/IFRS for SMEs is not necessary depending on the public interest score – see Chapter 5.	Must comply with IFRS or IFRS for SMEs and the requirements of the Companies Act, 71 of 2008. The Companies amendment Act 3 of 2011 and the Companies Regulations of 2011. In some cases compliance with IFRS/IFRS for SMEs is not necessary depending on the public interest score – see Chapter 5.

6.2 Characteristics of a profit company (Refer to paragraph 6.4)

☐ A profit company may be able to acquire more capital than is usually possible in the case of a sole proprietor, partnership or close corporation, mainly because it may have a very large number of people (shareholders) who contribute to the capital of a company.

☐ It is a means of ensuring the continuity and permanency of the entity because the company has a separate legal existence. Assets are registered or acquired in the name of the company and liabilities are incurred in its name. Profits and losses also belong to the company and the shareholders can have no claim to either the profit (unless it is declared as a dividend), or the net assets (unless the company is liquidated or wound up).

☐ It is a convenient and easy method of exchanging ownership because the capital of the company is divided into transferable units of ownership called "shares". It further ensures that a company has perpetual succession, meaning that the individual owners of the company may change and that the company will continue to exist.

☐ The financial liability of the owners toward the company is limited to their original investments in the company. Creditors may only lodge claims against the assets of the company, but if these assets are insufficient to meet the liabilities, the losses are borne by the creditors.

☐ Large companies are professionally managed because ownership and management is separated. The management of the company is vested in the board of directors, which is appointed by the shareholders in terms of the provisions of the Companies Act. In small private companies, ownership and management functions are similar to those of a close corporation, meaning that these functions are not always clearly separated.

6.3 The formation (incorporation) of a profit company

One or more persons must take the initiative to form (incorporate) a profit company, while at least three persons may incorporate a non-profit company. The first task of these incorporators of a profit company is to reserve a name for the company with the Commission, but this is not mandatory. Name reservation is not a separate, formal pre-registration process. If a proposed name is rejected then the registration number becomes the name of the company. The next step will be to complete a form referred to as the Memorandum of Incorporation. This form (CoR 15.1) is issued in terms of Section 13 of the Companies Act and Regulation 15 of the Companies Regulations, and is prescribed by the Minister of Trade and Industry in terms of Section 223 of the Companies Act. There are different forms for profit companies and non-profit companies as well as short and long versions of these forms. Once this form is completed, it is filed together with form CoR 14.1 (Notice of Incorporation) and together with the required annexures and prescribed fees. On acceptance of the documents by the Commission, the company's name is entered in the Companies Register. A certificate of registration is then issued to the company. The most important aspects set out in the Memorandum of Incorporation are the following:

- the name of the company;
- particulars of the securities of the company, for example the classes of shares and the number of shares that it is authorised for issue as well as the rights, limitations and other terms of those shares;
- the rights, duties and responsibilities of the shareholders; and
- particulars regarding the directors and officers of the company.

[Securities, according to Section 1 (aa) of the Amendment Act, means "any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company".]

The incorporators must all sign the Memorandum of Incorporation and is referred to as the "subscribers to the memorandum". They are the original owners subscribing to start (incorporate) the company.

6.4 Types of companies

Two types of companies can be formed in terms of Section 8 of the Companies Act:

- profit companies; and
- non-profit companies

6.4.1 *Profit companies*

Profit companies are those companies incorporated for the financial gain of their shareholders. Profit companies can take on any of the four following forms:

6.4.1.1 Personal liability companies

According to Section 8 (c) a company is a personal liability company if it meets the criteria for a private company and its memorandum of Incorporation states that it is a personal liability company. The name of this type of company must end with the word "Incorporated" or its abbreviation "Inc.".

6.4.1.2 State-owned companies

The name of state-owned companies must end with the expression "SOE Ltd".

6.4.1.3 Private companies

A company is a private company if it is not a state-owned company and its Memorandum of Incorporation prohibits it from offering any of its securities to the public and restricts the transferability of its securities. The name of a private company must end with the expression "Proprietary Limited" or its abbreviation "(Pty) Ltd." The board of a private company must comprise of at least one director. Each incorporator is a first director of the company.

6.4.1.4 Public companies

A company is a public company if its Memorandum of Incorporation permits it to offer shares to the general public and which allows the transferability of those shares. The name of a public company must end with the word "Limited" or its abbreviation "Ltd.".

The incorporators of a public company must at least be one person and this person can, according to Section 1, also be a juristic person. This type of company must at least have three directors. A public company can also be listed on the JSE Securities Exchange (abbreviated as JSE) where trading of shares and other security commodities normally takes place. A public company that trades its shares on the JSE is also referred to as a "listed company".

6.4.2 *Non-profit companies*

A non-profit company is a company that is usually incorporated for public benefit. Its income and property are not distributable to its incorporators, members, officers or persons related to any of them. The name of a non-profit company must end with the expression "NPC".

For the purpose of this textbook the discussions and examples will be limited to public companies.

6.5 Shareholders

In order to raise capital, a profit company issues securities, usually in the form of shares, to investors. According to Section 1 of the Companies Act, a share means one of the units into which the proprietary interest in a profit company is divided. The term "securities" are defined in the Securities Services Act 36 of 2004 and is a much wider concept. Securities include shares but shares do not include securities. By purchasing shares, an investor becomes a shareholder of the company and thus acquires equity (proprietary interest) in the company. Any person with contractual capacity may become a shareholder of a company. This includes other legal persons, which implies that one company may become a shareholder in another company. According to the share structure of a company, all or at least a very large percentage of the shares of a company will be ordinary shares held by ordinary shareholders (refer to paragraph 6.7.4.1 for a discussion on ordinary shares).

6.6 The rights of shareholders

6.6.1 *The right to sell or buy shares in the company*

A shareholder's interest in a company is represented by the number of shares that the shareholder holds in the company in relation to the total number of shares issued by the company. Since shares are negotiable documents, every shareholder can sell his shares or part thereof to other persons with contractual capacity, or can buy more shares from such persons. Trading in shares takes place on a securities exchange (refer to paragraph 6.4.1.4), with a securities broker acting on the instructions of the shareholder. (Please note that overseas securities exchanges, for example New York and London, are referred to as "stock exchanges".)

6.6.2 *The right to vote*

A shareholder has a right to vote on policy matters at annual general meetings of the company in which he holds shares. Voting rights are usually limited to the holders of ordinary shares and are proportional to the number of shares a shareholder holds. By voting, shareholders decide on matters regarding financial statements, declaration of dividends as well as the directors to whom they entrust the management of the company. Under certain circumstances, preference shareholders can also vote (refer to paragraph 6.7.6.2).

6.6.3 *The right to receive a share of the profits*

A shareholder is entitled to a proportional share of those profits which are distributed in the form of dividends (refer to paragraph 6.8).

6.6.4 *The right to share in the net assets*

Subject to provisions specifying otherwise, a shareholder has the right, upon liquidation of the company, to a proportional share in the distribution of the assets after all the creditors' claims have been satisfied.

6.7 Share transactions

6.7.1 *Introduction*

A public company usually obtains the greater part of its share capital by inviting the general public to buy shares and in this way to become shareholders of the company. The document used to invite the public to buy shares is known as a "prospectus" and the content thereof is prescribed by the Companies Act. A prospectus introduces the company to prospective investors and therefore contains information which will not only enable the prospective investor to decide on the value of the investment, but also whether the investment is an attractive proposition or not. The prospectus may be advertised in the general press or obtained from financial institutions, stockbrokers or from the company itself by prospective investors.

Once a shareholder has made an investment in the share capital of the company, a securities certificate indicating the number of shares the shareholder is entitled too, is issued to the shareholder. The name of the shareholder and the number of shares held is also entered in the securities register of the company. The securities certificate serves as proof of the shareholder's proportional interest in the net assets of the company. If the company is listed on the JSE, securities certificates are not issued because proof of ownership is recorded electronically. This process is known as "STRATE", which stands for Share Transfer Records All Transactions Electronic. A detailed discussion of the latter falls outside the scope of this textbook.

6.7.2 *Authorised share capital*

When a company is incorporated, it is registered with an authorised share capital which must be disclosed in its Memorandum of Incorporation. The authorised share capital is the maximum number of shares which may be issued to shareholders of the company. A company is under no obligation to issue all the authorised share capital. If the authorised share capital is inadequate for the needs of the company, or for some reason too large, the shareholders of a company can increase or decrease the authorised share capital by way of a special resolution at a general meeting of shareholders. The Memorandum of Incorporation must however provide for the increase or decrease of such authorised share capital.

6.7.3 *Issued share capital*

The issued share capital is the actual number of shares issued to shareholders. The difference between the authorised share capital and the issued share capital is called the "unissued share capital". Shares are issued at a price considered to be appropriate by the board of directors at the date of issue.

6.7.4 *Classes of shares*

Shares are classified into different classes according to the rights and privileges assigned to them. The two main classes of shares that we usually encounter are ordinary shares and preference shares.

6.7.4.1 Ordinary shares

Ordinary shares are held by ordinary shareholders who are in effect the owners of the company. Ordinary shareholders are usually the only ones with voting rights at the annual general meeting of shareholders and in effect control the company. Ordinary shares do not bear a fixed dividend and shareholders are guaranteed neither dividends nor assets upon dissolution. They however profit the most when the company is successful.

6.7.4.2 Preference shares

Preference shares are held by preference shareholders. This class of shares bears a fixed dividend percentage, i.e. a fixed regular amount (dividend) will be paid to preference shareholders on their investment. If sufficient profits are available, these shares enjoy a preferential right in respect of the payment of dividends and the repayment of capital. An investor who buys preference shares in a company is assured of a fixed income and a high degree of security. Where preference shareholders receive a fixed dividend on their investment, ordinary shareholders share in the profit of the entity and their dividend varies from year to year. The terms of the issue of preference shares normally provide that preference shareholders will only be entitled to vote at general meetings if the preference dividend is in arrears or if their rights are invoked. Under normal circumstances, they have no voting rights. The fact that these shareholders can vote in certain circumstances should not be overlooked, because in such cases their votes could materially alter the voting strength of ordinary shareholders and could be decisive in the passing of resolutions.

Preference shares can further be distinguished between:

- *Ordinary preference shares*: This class of preference share confers the same rights as those held by ordinary shareholders, except that their dividends are fixed. If the company decides not to declare a dividend in any year, these shareholders will forfeit any income earned on their shares in that year.
- *Cumulative preference shares*: This class of preference shares is entitled to a fixed dividend, which accrues if not declared and paid in a specific financial year, thus resulting in a contingent liability against the company in the form of arrear preference dividends. If the Memorandum of Incorporation does not mention whether the shares are cumulative or not, it is legally assumed that the shares are cumulative.
- *Participating preference shares*: These preference shares receive the normal fixed dividend percentage and then participate further with ordinary shareholders in a share of the profits according to the terms of their issue. A detailed discussion on participating preference shares falls outside the scope of this chapter.

- *Redeemable preference shares*: The capital invested in redeemable preference shares is for a limited period and this period is decided on when the shares are issued. This means that the company has to repay the holders of redeemable preference shares the capital they have invested within this predetermined period. Although this chapter does not cover the topic of redeemable preference shares, it is important to note that redeemable preference shares can be classified in the statement of financial position of the issuing company as equity or as a liability. The focus is on the substance of the preference share, rather than its legal form. In substance, a redeemable preference share is a financial liability if there is a contractual obligation on the issuing company to deliver cash to the holder of the preference shares and the holder has the right to demand redemption at a time of his choosing. The classification of these shares as liabilities results in the classification of dividends on this type of redeemable preference shares as "finance costs". Those dividends must be included with other interest expenses in the statement of profit or loss and other comprehensive income, and not with dividends in the statement of changes in equity. If the redemption date of the redeemable preference shares is at the discretion of the company and not predetermined, the shares are classified as equity and disclosed as such in the statement of financial position of the company. Dividends on this type of redeemable preference shares must be disclosed in the statement of changes in equity together with other dividends declared and/or paid.

6.7.5 *The issue of shares*

6.7.5.1 General aspects

It is important to remember that the first issue of shares will always be to the incorporators of the company. After the initial issue of shares to the incorporators, the remaining unissued shares are then offered to the public for subscription to the extent, that the shares have been authorised by or in terms of the company's Memorandum of Incorporation, in accordance with Section 36 of the Companies Act.

The procedure for issuing shares is laid down by the Companies Act. An investor wishing to subscribe to the shares in a company must complete an application form, which is usually included in the prospectus. The completed application form, together with a payment for the full issue value of the shares for which the applicant is subscribing, must be sent to the company to reach them before the closing date stipulated in the prospectus. Applications received after the closing date will be returned to the subscribers, together with the money they sent in payment of their applications.

When the applications have been accepted, the shares are allotted to the new shareholders. The new shareholders are issued with securities certificates and their names entered in the securities register (refer to paragraph 6.7.1).

If a company receives more applications than there are shares available for issue, the company has an over-subscription for its shares and the money of the unsuccessful applicants must be refunded. If a company however receives fewer applications than there are shares available for issue, the company has an under-subscription of its shares. This means that the company is unable to issue the required number of shares to obtain the necessary capital. To overcome this risk, a company can make use of underwriters (refer to paragraph 6.7.8).

The Companies Act prohibits the company from allocating shares for which the full purchase price has not been received and also prohibits the company from allocating more shares than were originally offered to the public, even if the authorised capital is more than the shares offered for issue.

6.7.5.2 Recording the issue of shares

There are three basic transactions which must be recorded when shares are issued:

- ☐ recording of the receipt of applications to subscribe for shares – remember that the applicants must submit full payment together with their application forms;
- ☐ allotting shares to successful applicants; and
- ☐ returning the money of unsuccessful applicants.

Also remember that, in the case of a new company, the first issue of shares must always be to the incorporators and that only after allotment of these shares can the company proceed to issue shares to the public.

The basic account used to record all applications for the shares offered and eventually the allotment of the shares to shareholders, is the application and allotment account. The application and allotment account is an interim account which is only used to record the subscription money received from potential shareholders and eventually to allot shares to shareholders. After the allotment of shares and the refund to unsuccessful applicants, this account is closed off to the applicable share capital account. The following examples will illustrate the recording of the issue of shares in the books of a public company.

Example 6.1 Issue of different classes of shares

Sparkle Ltd was registered on 1 June 20.5 with an authorised share capital consisting of the following:
350 000 ordinary shares;
100 000 10% preference shares.

The company offered 50 000 ordinary shares, valued by the board of directors at R50 000, to the incorporators of the company, all of which was taken up and paid for on 1 June 20.5.

The company offers the following shares for subscription to the public:
200 000 ordinary shares, valued by the board of directors at R200 000.
50 000 10% preference shares, valued by the board of directors at R100 000.

The application closed on 1 August 20.5. The public took up the full offering of shares which was allotted on 3 August 20.5.

Required:

Record the issue of the shares in the general journal of Sparkle Ltd. Post the journal to the relevant accounts in the general ledger. Balance/close off all accounts.

Solution:

Sparkle Ltd
General journal

			Debit	Credit
20.5			R	R
Jun	1	Bank	50 000	
		Incorporators: Ordinary shares		50 000
		Receipt of application money from founders of the company		
		Incorporators: Ordinary shares	50 000	
		Share capital: Ordinary shares		50 000
		Allotment of 50 000 ordinary shares to the incorporators of the company		
Aug	1	Bank	300 000	
		Application and allotment: Ordinary shares		200 000
		Application and allotment: 10% preference shares		100 000
		Receipt of application money from the public		
	3	Application and allotment: Ordinary shares	200 000	
		Application and allotment: 10% preference shares	100 000	
		Share capital: Ordinary shares		200 000
		Share capital: 10% preference shares		100 000
		Allotment of 200 000 ordinary shares and 50 000 10% preference shares		

Sparkle Ltd
General ledger

Dr **Bank** **Cr**

20.5				R	20.5				R
Jun	1	Incorporators: Ordinary shares		50 000	Aug	31	Balance	c/d	350 000
Aug	1	Application and allotment: Ordinary shares		200 000					
		Application and allotment: 10% preference shares		100 000					
				350 000					350 000
Sep	1	Balance	b/d	350 000					

continued

Dr **Incorporators: Ordinary shares** **Cr**

20.5				**R**	20.5				**R**
Jun	1	Ordinary share capital		50 000	Jun	1	Bank		50 000

Dr **Application and allotment: Ordinary shares** **Cr**

20.5				**R**	20.5				**R**
Aug	3	Share capital: Ordinary shares		200 000	Aug	1	Bank		200 000

Dr **Application and allotment: 10% preference shares** **Cr**

20.5				**R**	20.5				**R**
Aug	3	Share capital: 10% preference shares		100 000	Aug	1	Bank		100 000

Dr **Share capital: Ordinary shares** **Cr**

20.5				**R**	20.5				**R**
Aug	31	Balance	c/d	250 000	Jun	1	Incorporators: Ordinary shares		50 000
					Aug	3	Application and allotment: Ordinary shares		200 000
				250 000					250 000
					Sep	1	Balance	b/d	250 000

Dr **Share capital: 10% preference shares** **Cr**

					20.5				**R**
					Aug	3	Application and allotment: 10% preference shares		100 000

Example 6.2 Issue of shares (over application by public)

On 1 March 20.6, Pinco Ltd was registered with an authorised share capital of 500 000 ordinary shares and 100 000 8% preference shares. On the same day, the company offered 20 000 ordinary shares at a value of R60 000 and 10 000 preference shares at a value of R50 000 to the incorporators of the company. All the shares offered were taken up and paid for on 2 March 20.6.

The following transactions occurred in connection with the issue of shares to the public during March 20.6:

March 7 The company offered 250 000 ordinary shares at a value of R750 000 and 50 000 8% preference shares at a value of R250 000 to the public.

30 Applications were received for 260 000 ordinary shares, (R780 000) and 50 000 preference shares. The full offering of the 250 000 ordinary shares and 50 000 preference shares was allotted and excess application moneys repaid.

31 The company paid R10 000 towards share-issue expenses.

Required:

Record the transactions with regard to the issue of the shares in the general journal of Pinco Ltd for March 20.6. Post the journal to the relevant accounts in the general ledger. Balance/close off all accounts.

Solution:

Pinco Ltd
General journal

			Debit	Credit
20.6			R	R
Mar	2	Bank	110 000	
		Incorporators: Ordinary shares		60 000
		Incorporators: Preference shares		50 000
		Receipt of application money from incorporators of the company		
20.6				
Mar	2	Incorporators: Ordinary shares	60 000	
		Incorporators: Preference shares	50 000	
		Share capital: Ordinary shares		60 000
		Share capital: 8% preference shares		50 000
		Allotment of 20 000 ordinary shares and 10 000 8% preference shares to incorporators of the company		
	30	Bank	1 030 000	
		Application and allotment: Ordinary shares		780 000
		Application and allotment: 8% preference shares		250 000
		Receipt of application money from the public		
		Application and allotment: Ordinary shares	750 000	
		Application and allotment: 8% preference shares	250 000	
		Share capital: Ordinary shares		750 000
		Share capital: 8% preference shares		250 000
		Allotment of 250 000 ordinary shares and 50 000 8% preference shares		
		Application and allotment: Ordinary shares (R780 000 – R750 000)	30 000	
		Bank		30 000
		Cash refunded to unsuccessful applicants		
	31	Share-issue expenses	10 000	
		Bank		10 000
		Payment of share-issue expenses		

Pinco Ltd
General ledger

Dr **Bank** **Cr**

20.6				**R**	20.6				**R**
Mar	2	Incorporators: Ordinary shares		60 000	Mar	30	Application and allotment: Ordinary shares		30 000
		Incorporators: Preference shares		50 000		31	Share-issue expenses		10 000
	30	Application and allotment: Ordinary shares		780 000			Balance	c/d	1 100 000
		Application and allotment: 8% preference shares		250 000					
				1 140 000					1 140 000
Apr	1	Balance	b/d	1 100 000					

Dr **Incorporators: Ordinary shares** **Cr**

20.6				**R**	20.6				**R**
Mar	2	Share capital: Ordinary shares		60 000	Mar	2	Bank		60 000

Dr **Incorporators: 8% preference shares** **Cr**

20.6				**R**	20.6				**R**
Mar	2	Share capital: 8% preference shares		50 000	Mar	2	Bank		50 000

Dr **Application and allotment: Ordinary shares** **Cr**

20.6				**R**	20.6				**R**
Mar	30	Share capital: Ordinary shares		750 000	Mar	30	Bank		780 000
		Bank		30 000					
				780 000					780 000

Dr **Application and allotment: 8%-preference shares** **Cr**

20.6				**R**	20.6				**R**
Mar	30	Share capital: 8% preference shares		250 000	Mar	30	Bank		250 000

continued

Dr **Share capital: Ordinary shares** **Cr**

20.6				**R**	20.6				**R**
Mar	31	Balance	c/d	810 000	Mar	2	Incorporators: Ordinary shares		60 000
						30	Application and allotment: Ordinary shares		750 000
				810 000					810 000
					Apr	1	Balance	b/d	810 000

Dr **Share capital: 8% preference shares** **Cr**

20.6				**R**	20.6				**R**
Mar	31	Balance	c/d	300 000	Mar	2	Incorporators: 8% preference shares		50 000
						30	Application and allotment: 8% preference shares		250 000
				300 000					300 000
					Apr	1	Balance	b/d	300 000

Dr **Share-issue expenses** **Cr**

20.6				**R**					
Mar	31	Bank		10 000					

6.7.6 *Schedule for the allotment of shares*

In the case where a company needs to make a large issue of shares and the company expects to receive a large number of applications, the use of an allotment schedule can simplify the task of the issuing company. The following example will demonstrate the use of an allotment schedule.

Example 6.3 Preparing an allotment schedule

SAT Limited is a company which was registered with an authorised share capital of R300 000 consisting of 300 000 ordinary shares. The issued share capital of the company amounted to R120 000, consisting of 120 000 ordinary issued shares. The company, which is also listed on the JSE, manufactures clay bricks used in the building of houses and other structures.

Due to the decline in the interest rate of home loans, the demand for new houses and additions to existing houses rose sharply. In order to meet the increasing demand for clay bricks, the company decided to expand its operations. The capital needed would be obtained from issuing all the unissued shares to the public at a total value of R216 000. These shares were offered to the general public for subscription on 1 March 20.9.

On 1 April 20.9, the company had received applications for 242 000 shares (total value R290 400). With a view of retaining control and in order to ensure an active market for the shares, the following allotment schedule was approved and ratified at a meeting of the board of directors. Shares will be allotted in units of 100 shares per unit.

Group 1: Applications for 100 to 400 shares each will be granted in full.

Group 2: Applications for 500 to 900 shares each will be granted at 60% of the shares applied for.

Group 3: Applications of 1 000 shares and more each will be granted at 50% of the shares applied for.

The following is a breakdown of the applications received.

Number of shares per application	Number of applications received	Number of shares
100	250	25 000
200	200	40 000
300	80	24 000
400	20	8 000
600	100	60 000
900	50	45 000
1 000	40	40 000
Total		242 000

On 15 April 20.9, all the available shares were allotted and the money repaid to unsuccessful applicants.

Required:

(a) Prepare the allotment schedule for the allocation of the 180 000 ordinary shares.

(b) Record the application, allotment and issue of the shares in the general journal of the company for April 20.9.

Solution:

(a) **Allotment schedule: Ordinary shares**

Group	Number of applications in group	Total number of shares applied for	Received from applicants	Shares allotted	Cash repaid to unsuccessful applicants
			R		R
1	550 ①	97 000 ③	116 400 ⑤	97 000 ⑧	
2	150 ②	105 000 ④	126 000 ⑥	63 000 ⑨	50 400 ⑪
3	40	40 000	48 000 ⑦	20 000 ⑩	24 000 ⑫
Totals		242 000	290 400	180 000	74 400

* Shown for calculation purposes.

Calculations:

① 250 + 200 + 80 + 20 = 550
② 100 + 50 = 150
③ 25 000 + 40 000 + 24 000 + 8 000 = 97 000
④ 60 000 + 45 000 = 105 000
⑤ 97 000/180 000 × 216 000 = 116 400
⑥ 105 000/180 000 × 216 000 = 126 000
⑦ 40 000/180 000 × 216 000 = 48 000
⑧ 97 000 × 100% = 97 000
⑨ 105 000 × 60% = 63 000
⑩ 40 000 × 50% = 20 000
⑪ 126 000 – (63 000/180 000 × 216 000) = 50 400
⑫ 48 000 – (20 000/180 000 × 216 000) = 24 000

(b) SAT Limited

General journal

			Debit	Credit
20.9			**R**	**R**
Apr	1	Bank	290 400	
		Application and allotment: Ordinary shares		290 400
		Receipt of application money from the public		
	15	Application and allotment: Ordinary shares	216 000	
		Share capital: Ordinary shares		216 000
		Allotment of 180 000 ordinary shares		
	15	Application and allotment: Ordinary shares	74 400	
		Bank		74 400
		Application money repaid to unsuccessful applicants		

6.7.7 *The issue of capitalisation shares*

Section 47 of the Companies Act states that the board of a company may by way of a resolution, to the extent that the company's Memorandum of Incorporation states otherwise, approve the issuing of any authorised shares of the company as capitalisation shares on a pro rata basis to the shareholders of one or more classes of shares. It is also possible that shares of one class may be issued as capitalisation shares in respect of shares of another class. The board may also resolve to permit any shareholder entitled to receive such an award to elect instead to receive a cash payment at a value determined by the board. The board of a company may however not resolve to offer cash payment in lieu of awarding a capitalisation share unless the company has complied with the solvency and liquidity test. For the purpose of this textbook a cash payment in lieu of the issue of issuing capitalisation share will not be dealt with as the solvency and liquidity test falls outside the scope of this textbook.

Capitalisation shares, often referred to as "bonus shares", are issued to existing shareholders in the same proportion as their current shareholding. Since the issue of capitalisation shares is regarded as a bonus to shareholders, no payment is received from shareholders for these shares and only a book entry is necessary to record their issue.

Capitalisation shares can be issued by utilising distributable reserves and retained earnings. If a company has built up large distributable reserves over the years, it may not be desirable to distribute these reserves as dividends to shareholders, if these dividends have to be paid in cash (refer to paragraph 6.8) and might negatively affect the cash-flow position of the company. To enable shareholders to derive a tangible benefit from these distributable reserves, the company can decide to distribute some of it to the shareholders in the form of capitalisation shares. In effect, it means that the distributable reserves are capitalised and will now form part of the share capital of the entity. The capitalised reserves will in future not be available for distribution. The immediate benefit for the shareholders is that they acquire additional shares in the company without having to pay for them.

Example 6.4 Issue of capitalisation shares – utilising retained earnings

Echo Ltd, with an issued share capital of 10 000 8% preference shares and 30 000 ordinary shares, had a credit balance at 30 September 20.7 of R10 000 in the retained earnings account. At a general meeting of the company it was decided that, in order to protect the liquidity of the company, there will be no cash pay-out of dividends. Instead, the company will issue capitalisation shares to shareholders in the ratio of one capitalisation share for every five preference shares held, and one additional capitalisation share for every six ordinary shares held. The board of the company deemed that a fair consideration for the preference shares would be R2 000 and that of the ordinary shares would be R5 000.

Required:

(a) Calculate the number of capitalisation shares of each class which must be issued to shareholders.

(b) Calculate the amount of distributable reserves that would be needed by the company to fulfil its obligation to shareholders.

(c) Record the capitalisation issue in the general journal of the company.

Solution:

(a) Number of capitalisation shares to be issued

Preference shares:
10 000/5 = 2 000 shares to be issued

Ordinary shares:
30 000/6 = 5 000 shares to be issued

(b) Reserves required

	R
2 000 preference shares	2 000
5 000 ordinary shares	5 000
	7 000

(c) **General journal**

	Debit	Credit
	R	**R**
Retained earnings	7 000	
Share capital: 8% preference shares		2 000
Share capital: Ordinary shares		5 000
Issue of fully paid up capitalisation shares in the ratio of one capitalisation share for every five preference shares and one capitalisation share for every six ordinary shares previously held		

6.7.8 *Underwriting of shares*

When a public company engages in a share issue, there is always the risk that the company may receive fewer applications than the number of shares being issued. In order to prevent the risk of under-subscription, a company can decide to use underwriters. Underwriters provide a guarantee to a company that the share issue will be fully subscribed. If the share issue is indeed under-subscribed by the general public, the underwriters take up the shares not subscribed for by the public at the share-issues price or price stipulated in the agreement with the company. Underwriters are paid a commission by the company for this service. The commission is usually calculated on the total value of the shares they underwrite. If there is an over-subscription of shares, the company must still pay the underwriters their commission. The commission is treated as an expense which is written off against the profit or loss account. A company can also use joint underwriters when they want to make use of the services of more than one underwriter. By using more than one underwriter, the risk of the underwriters is reduced to an acceptable level and they may be more willing to underwrite the share issue of the company.

Example 6.5 Underwriting of share issue

Benson Ltd was formed on 1 August 20.7 with an authorised capital of 110 000 ordinary shares. On 1 September 20.7, the incorporators of the company subscribed to 10 000 ordinary shares at a deemed value of R10 000 and paid it in full. On 15 September 20.7, the remaining shares were offered to the public. The board of the company deemed that a fair consideration for these shares is R125 000.

The full public issue is underwritten by Abco Underwriters Ltd for a 1% underwriter's commission. The public subscribed to 90 000 shares and the full amounts payable were received on the closing date of 15 October 20.7. All the shares were allotted on 18 October 20.7. Share-issue expenses of R4 000 were paid and all transactions with the underwriter were concluded by 31 October 20.7. All expenses regarding the issue of shares must be written off against the profit or loss account.

Required:

Record the above transactions in the general journal of Benson Ltd. Post the journal to the appropriate ledger accounts. Balance/close off all ledger accounts at 31 October 20.7.

Solution:

Benson Ltd
General journal

			Debit	Credit
20.7			R	R
Sep	1	Bank	10 000	
		Incorporators: Ordinary shares		10 000
		Receipt of application money from the incorporators of the company		
		Incorporators: Ordinary shares	10 000	
		Share capital: Ordinary shares		10 000
		Allotment of 10 000 ordinary shares to the incorporators of the company		
Sep	5	Underwriters' commission (R125 000 × 1%)	1 250	
		Abco Underwriters Ltd		1 250
		1% underwriters' commission due on R125 000 in terms of underwriter's agreement		
Oct	15	Bank	* 112 500	
		Application and allotment: Ordinary shares		112 500
		Receipt of application money from the public		
	18	Application and allotment: Ordinary shares	112 500	
		Share capital: Ordinary shares		112 500
		Allotment of 90 000 ordinary shares		
		Abco Underwriters Ltd	** 12 500	
		Share capital: Ordinary shares		12 500
		Allotment of 10 000 ordinary shares to Abco Underwriters Ltd		
	31	Bank	11 250	
		Abco Underwriters Ltd (12 500 – 1 250)		11 250
		Balance paid by Abco Underwriters		
		Share-issue expenses	4 000	
		Bank		4 000
		Share-issue expenses paid		
		Profit or loss	5 250	
		Underwriters' commission		1 250
		Share-issue expenses		4 000
		Expenses written off		

* 90 000 / 100 000 × 125 000 = 112 500
** 10 000 / 100 000 × 125 000 = 12 500

Benson Ltd
General ledger

Dr **Bank** **Cr**

20.7				**R**	20.7				**R**
Sep	1	Incorporators: Ordinary shares		10 000	Oct	31	Share-issue expenses		4 000
Oct	15	Application and allotment: Ordinary shares		112 500			Balance	c/d	129 750
	31	Abco Underwriters Ltd		11 250					
				133 750					133 750
Nov	1	Balance	b/d	129 750					

Dr **Incorporators: Ordinary shares** **Cr**

20.7				**R**	20.7				**R**
Sep	1	Share capital: Ordinary shares		10 000	Sep	1	Bank		10 000

Dr **Application and allotment: Ordinary shares** **Cr**

20.7				**R**	20.7				**R**
Oct	18	Share capital: Ordinary shares		112 500	Oct	15	Bank		112 500
				112 500					112 500

Dr **Share capital: Ordinary shares** **Cr**

20.7				**R**	20.7				**R**
Oct	31	Balance	c/d	135 000	Sep	1	Incorporators: Ordinary shares		10 000
					Oct	18	Application and allotment: Ordinary shares		112 500
							Abco Underwriters Ltd		12 500
				135 000					135 000
					Nov	1	Balance	b/d	135 000

Dr **Abco Underwriters Ltd** **Cr**

20.7				**R**	20.7				**R**
Oct	18	Share capital: Ordinary shares		12 500	Sep	15	Underwriters' commission		1 250
					Oct	31	Bank		11 250
				12 500					12 500

continued

Dr **Underwriters' commission** **Cr**

20.7				**R**	20.7				**R**
Sep	15	Abco Underwriters Ltd		1 250	Oct	31	Profit or loss		1 250

Dr **Share-issue expenses** **Cr**

20.7				**R**	20.7				**R**
Oct	31	Bank		4 000	Oct	31	Profit or loss		4 000

6.8 Dividends

6.8.1 *Introduction*

A dividend is a return on the shareholder's original investment and is a distribution of profits of the company to shareholders in the ratio in which shares are held. A dividend can only be paid from profits that are available for distribution. The profit made during previous trading periods and credited to retained earnings may be added to the profit of the current year to arrive at a sum on which the dividends can be based. The company's solvency and liquidity test should verify the fact that it has adequate cash resources to pay the dividends. However, dividends need not necessarily be paid out in cash, as discussed in paragraph 6.7.7.

A dividend is only due once it has been declared by the company. Before a dividend can be declared, it must first be proposed by the directors of the company and ratified by the shareholders at the annual general meeting. The directors also have to announce a closing date for the share register and dividends are only payable to shareholders whose names appear in the share register at the closing date of the dividend declaration. These shareholders are referred to as the "registered shareholders of the company at the particular date".

6.8.2 *Preference dividends*

Preference shareholders have a preferential right to dividends. This means that before an ordinary dividend can be declared, preference shareholders have to receive their dividend first. The dividend represents a fixed percentage of the nominal value of preference share capital (refer to paragraph 6.7.4.2). If no distributable reserves are available in the particular year to declare a dividend, both ordinary and preference shareholders forego their right to dividends, unless the preference shares are cumulative. A cumulative preference shareholder retains the right to dividends from year to year, even if no dividends are declared. When the company has sufficient distributable reserves available to declare a dividend, arrear and current cumulative preference dividends must first be paid in full, thereafter ordinary preference dividends, and only then can a dividend on ordinary share capital be paid.

Preference dividends are quoted as a fixed percentage of preference share capital and the calculation of the dividend is done on the same principle as the calculation of interest (period × dividend rate per annum × amount of issued preference share capital). For example, if a preference shareholder holds 200 10%-preference shares of R5 each and acquired these shares six months before the closing of the share register, the dividend he will receive amounts to R50 (200 × R5 × 10/100 × 6/12).

6.8.3 *Ordinary dividends*

When calculating an ordinary dividend, it makes no difference how long the holder of a share certificate has held the shares. As soon as a dividend is declared to all registered shareholders, an ordinary shareholder is entitled to the full ordinary dividend, even if he or she only became a registered shareholder the previous day. The calculation of dividends on ordinary shares differs from the calculation of preference dividends. The preference dividend is quoted as a fixed percentage, while the ordinary dividend is quoted as cents per share (number of ordinary shares issued × dividend per share). For example, if an ordinary shareholder holds 200 shares of R1 each and acquired these shares six months before the closing of the share register, the dividend the shareholder will receive, should the company declare a dividend of 20 cents per ordinary share, amounts to R40 (200 × 20 cents).

6.8.4 *Interim, final and annual dividends*

An interim dividend is one which is declared halfway through the year, usually when a company discloses its interim results, from either profit carried over from the previous year (retained earnings), or profit which accumulated during the current period. The declaration of interim dividends is subject to the same requirements regarding solvency and liquidity as in the declaration of annual dividends. The right to declare interim dividends is usually reserved for the board of the company, but any such declaration must be ratified at the annual general meeting by the shareholders of the company. No interim dividends can be paid by a company before all outstanding declared dividends from previous years have been paid.

A final dividend is declared at the end of the financial year from available profit. If the company has declared an interim dividend, the interim dividend and the final dividend together form the annual dividend. If no interim dividend was declared, the final dividend is correctly referred to as the "annual dividend".

The following example will demonstrate how the declaration and payment of dividends are recorded in the books of a company.

Example 6.6 Declaration and payment of dividends

The financial year of ABC Ltd ends on the last day of February. The company has the following share capital structure:

Authorised share capital:

200 000 ordinary shares
100 000 10% preference shares

Issued share capital:

180 000 ordinary shares, valued by the board of directors at R180 000 (150 000 of these shares remained unchanged for the full year while the other 30 000 were allotted and issued on 1 September 20.6); and 100 000 10% preference shares, valued by the board of directors at R100 000 (50 000 of these shares remained unchanged for the full year while the other 50 000 were allotted and issued on 1 September 20.6)

On 15 February 20.7, the board of ABC Ltd declared an ordinary dividend of R0,25 per share payable during March 20.7. The company's profit for the year ended 28 February 20.7 amounted to R350 000. According to the company's solvency and liquidity test, it had sufficient cash resources to pay the dividends to ordinary and preference shareholders.

On 15 March 20.7, the company issued the necessary cheques to its shareholders in payment of the declared dividends.

Required:

Record the transactions with regard to the declaration and payment of dividends in the general journal of ABC Ltd.

Solution:

ABC Ltd
General journal

			Debit	Credit
20.7			**R**	**R**
Feb	15	Preference dividends [(50 000 × 10/100) + (50 000 × 10/100 × 6/12)]	7 500	
		Ordinary dividends (180 000 × R0,25 per share)	45 000	
		Dividends payable		52 500
		Declaration of preference and ordinary dividends		
Mar	15	Dividends payable	52 500	
		Bank		52 500
		Payment of dividends to preference and ordinary shareholders		

Comments:

- Although no specific mention was made about the declaration of a dividend to preference shareholders in the question, a company cannot declare a dividend to ordinary shareholders unless it has declared a preference dividend. If a company does not declare a preference dividend in any one year, it cannot declare an ordinary dividend. The fact that a dividend was declared to ordinary shareholders implies that the dividend to preference shareholders was also declared.
- With regard to the total dividends payable to ordinary shareholders, it does not matter when the shares were issued because the dividend is declared as cents per share to all registered shareholders on the declaration date. In the case of preference shares, the dividend is declared at a predetermined rate per annum. Preference shares not held for a full year will only receive a dividend proportional to the time the shares were issued.
- Entries for the declaration and payment of interim dividends are done during the financial year and not at year-end. The entry to record an interim dividend is: debit dividend paid and credit bank account. It is not necessary to credit the dividend payable account because entries are only made when the interim dividend is paid to shareholders.

6.9 Debenture transactions

6.9.1 *Introduction*

Sole proprietors, partnerships and even close corporations have a narrow scope of available options to acquire loan capital. For example, a sole trader can obtain loan capital only by borrowing from another individual or from a financial institution such as a bank. Companies have a much wider range of options for raising loan capital than any other form of business ownership. A company has the option to publicly issue loan capital or debentures, thereby broadening its base for obtaining loan finance.

A debenture is a debt owed by a company to a debenture holder on the conditions specified in the debenture deed. A debenture is a written acknowledgement of debt by the company issuing the debentures. The debenture deed contains the conditions upon which the debentures are issued. Items that can be included in the debenture deed are:

- whether or not the debentures are secured, and if secured, the assets encumbered;
- the interest rate payable on the debentures;
- the period of the debenture loan;
- repayment conditions;
- the possibility of converting debentures into shares; and
- the rights of the debenture holder, should the company default in keeping the agreement.

Debentures do not form part of the equity of a company and are classified under non-current or current liabilities, depending on the repayment period stipulated in the debenture deed. Debenture holders receive a fixed interest irrespective of whether or not the company is making a profit. Interest on debentures may be paid, for example quarterly, half-yearly or annually. Interest on debentures is a finance cost and disclosed as such in the statement of profit or loss and other comprehensive income.

6.9.2 *Types of debentures*

Different kinds of debentures can be distinguished, depending on the rights attached to them. The following are a few examples of different types of debentures:

- *Secured debentures*: Debentures secured by either movable or immovable assets. This means that if the company is liquidated, the debenture holder has the right to claim repayment from the proceeds of the sale of those assets.
- *Unsecured debentures*: Debentures not secured by any asset. The debenture holders have the same rights as any other creditor in the case of liquidation.
- *Redeemable debentures*: Debentures may be redeemed prior to the maturing date or at dates specified in the debenture deed.
- *Convertible debentures*: Debenture holders have the option to convert their debentures into specific shares, usually ordinary shares, after a specified period.

6.9.3 *The issue of debentures*

As in the case with shares, debentures are offered to the public for subscription. The public must apply for debentures, which are allotted after the closing date of the applications. Money received from unsuccessful applicants is refunded after the allotment. Debentures are normally traded in the marketplace in the same way as shares.

The debenture deed specifies the nominal value of the debenture as well as the interest payable on the debentures. This interest is called the "nominal interest rate" (debenture interest rate). The annual interest payable is calculated by multiplying the nominal or face value of the debenture by the nominal interest rate per annum. If the debentures were issued for a period less than a full year, the interest calculation will be proportional. The market interest rate is the rate that is determined by the supply and demand for funds in the money market. The difference between the nominal rate of interest and the market interest rate determines whether the debentures are issued at nominal value, at a premium or at a discount. If the prevailing market interest rate on similar instruments is higher than the nominal interest rate being offered to debenture holders, the debentures will be issued at a discount because the investors will want to pay less than nominal value because of the lower interest rate. If the prevailing market interest rate on similar instruments is lower than the nominal interest rate being offered to debenture holders, the issue will take place at a premium because the debenture holders will be prepared to pay more for an instrument which carries the same risk but yields a higher profit (interest rate). As in the case with a shares issued, the directors may also decide to underwrite the debenture issue in order to ensure a full subscription.

The following table summarises the influence of interest rates on the issue of debentures:

Table 6.2 Influence of interest rates on the issue of debentures

Rate of interest			**Debentures issued at**
Nominal rate	=	Market rate	Nominal value
Market rate	<	Nominal rate	A premium
Market rate	>	Nominal rate	A discount

The premium or discount which arises from the debenture issue must be allocated to the statement of profit or loss and other comprehensive income over the period during which the debentures are in issue. This corresponds to the matching concept which was introduced in Accounting Standard IAS 1 Accounting Standard IAS 1 states that related income and expense items should be accounted for in the same accounting period. The premium or discount should be deferred in the books of the company which issued the debentures and systematically written off or added to the interest in the statement of profit or loss and other comprehensive income over the period during which the debentures are in issue.

The abovementioned procedure with regard to the handling of a premium or a discount on the issue of debentures is called the "amortisation" (writing off) of the premium or discount using the straight-line method, i.e. amortised over the duration of the debenture life.

Remember that:

- ☐ when debentures are issued, it is necessary to distinguish between the nominal (face) value and the actual issue price of the debentures; and
- ☐ the issue price represents the actual amount paid for the debenture and is sometimes indicated as a percentage of the nominal value, for example a R100 debenture issued at 105% (or R105) or issued at 97% (or R97).

Example 6.7 The issue of debentures at nominal value (nominal interest rate is equivalent to the market-related interest rate)

On 1 March 20.1, Beehive Limited issued 4 000 12% debentures of R100 each at their nominal value. The nominal value of these debentures are repayable by 1 March 20.11 and interest is payable annually on 28 February of every year. The security for the debentures is a mortgage on land and buildings. Beehive Limited's year-end is 28 February.

Required:

Prepare the general journal of Beehive Ltd for the financial year ended 28 February 20.2. Show only the journal entries with regard to the issue of the debentures and the payment of interest on these debentures. Post the journal to the appropriate ledger accounts. Close off/balance the accounts at 28 February 20.2

Solution:

Beehive Ltd
General journal

			Debit	Credit
20.1			**R**	**R**
Mar	1	Bank	400 000	
		12% debentures (4 000 × R100)		400 000
		Issue of 4 000 12% debentures at a nominal value of R100 each		
20.2				
Feb	28	Interest on debentures (400 000 × 12%)	48 000	
		Bank		48 000
		Interest paid to debenture holders		

Beehive Ltd
General ledger

Dr **Bank** **Cr**

20.1				**R**	20.2				**R**
Mar	1	12% debentures		400 000	Feb	28	Interest on debentures		48 000
							Balance	c/d	352 000
				400 000					400 000
Mar	1	Balance	b/d	352 000					

Dr **12% debentures** **Cr**

					20.1				**R**
					Mar	1	Bank		400 000

Dr **Interest on debentures** **Cr**

20.2				**R**	20.2				**R**
Feb	28	Bank		48 000	Feb	28	Profit or loss account		48 000

Example 6.8 The issue of debentures at a premium (nominal interest rate is higher than the market-related interest rate)

On 1 March 20.1, Blue Limited issued 1 000 10% debentures of R200 each at R210. The debentures are repayable at nominal value on or before 28 February 20.11 and interest is payable annually on 28 February of every year. A mortgage on land and buildings serves as security for the debentures. The amortisation of the premium on debentures over the term of the debenture issue must be according to the straight-line method. Blue Limited's year-end is 28 February.

Required:

Prepare the general journal of Blue Limited for the financial year ended 28 February 20.2. Show only the journal entries with regard to the debentures transactions. Post the journal to the appropriate ledger accounts. Close off/balance the accounts at 28 February 20.2

Solution:

Blue Ltd
General journal

			Debit	Credit
20.1			**R**	**R**
Mar	1	Bank	210 000	
		10% debentures (1 000 × R200)		200 000
		Premium on issue of debentures		10 000
		[1 000 × (R210 – R200)]		
		Issue of 1 000 10% debentures at a nominal value of R100 each and a premium of R10,00 per debenture		
20.2				
Feb	28	Interest on debentures (200 000 × 10%)	20 000	
		Bank		20 000
		Interest paid to debenture holders		
		Premium on issue of debentures (R10 000 × 1/10)	1 000	
		Interest on debentures		1 000
		Amortisation of premium on issue of debentures over term of debentures using the straight-line method		

Blue Ltd
General ledger

Dr **Bank** **Cr**

20.1				**R**	20.2				**R**
Mar	1	10% debentures		200 000	Feb	28	Interest on debentures		20 000
	28	Premium on issue of debentures		10 000			Balance	c/d	190 000
				210 000					210 000
20.2									
Mar	1	Balance	b/d	190 000					

continued

Dr **10% debentures** **Cr**

					20.1				**R**
					Mar	1	Bank		200 000

Dr **Premium on issue of debentures** **Cr**

20.2				**R**	20.1				**R**
Feb	28	Interest on debentures		1 000	Mar	1	Bank		10 000
		Balance	c/d	9 000					
				10 000					10 000
					Mar	1	Balance	b/d	9 000

Dr **Interest on debentures** **Cr**

20.2				**R**	20.2				**R**
Feb	28	Bank		20 000	Feb	28	Premium on issue of debentures		1 000
							Profit or loss account		19 000
				20 000					20 000

Comment:

The interest paid is based on the nominal value of the debenture. When debentures are issued at a premium, the debenture premium is amortised over the life of the debenture and reduces the interest expense by an amount of R1 000 (R10 000/10 years). The debenture liability is reported at nominal value irrespective of the issue price. The balance of the premium on issue of debentures account (unamortised premium) is added to the debenture liability in the statement of financial position. At the end of the debenture term, only the nominal value will remain to be repaid.

Example 6.9 The issue of debentures at a discount (nominal interest rate is lower than the market-related interest rate)

On 1 March 20.0, Waters Limited issued 1 000 10% debentures of R100 each at 95%. The debentures are repayable at par on or before 28 February 20.10 and interest is payable annually on 28 February of every year. A mortgage on land and buildings serves as security for the debentures. The discount on the debenture issue should be amortised over the term of the debenture issue according to the straight-line method. Waters Limited's year-end is 28 February.

Required:

Prepare the general journal of Waters Limited for the financial year ended 28 February 20.1. Show only the journal entries with regard to the debentures transactions. Post the journal to the appropriate ledger accounts. Close off/balance the accounts at 28 February 20.1

Solution:

Waters Ltd
General journal

			Debit	Credit
			R	R
20.0 Mar	1	Bank (1 000 × R100 × 95%)	95 000	
		Discount on issue of debentures	5 000	
		10% debentures (1 000 × R100)		100 000
		Issue of 1 000 10% debentures at a nominal value of R100 each and a discount of R5,00 per debenture		
20.1 Feb	28	Interest on debentures (100 000 × 10%)	10 000	
		Bank		10 000
		Interest paid to debenture holders		
		Interest on debentures	500	
		Discount on issue of debentures (5 000 × 1/10)		500
		Amortisation of premium on issue of debentures over term of debentures using the straight-line method		

Waters Ltd
General ledger

Dr — Bank — Cr

				R					R
20.0 Mar	1	10% debentures		95 000	20.1 Feb	28	Interest on debentures		10 000
							Balance	c/d	85 000
				95 000					95 000
20.1 Mar	1	Balance	b/d	85 000					

Dr — 10% debentures — Cr

				R					R
20.1 Feb	28	Balance	c/d	100 000	20.0 Mar	1	Bank		95 000
							Discount on issue of debentures		5 000
				100 000					100 000
					20.1 Mar	1	Balance	b/d	100 000

continued

Dr **Discount on issue of debentures** **Cr**

20.0				**R**	20.1				**R**
Mar	1	10% debentures		5 000	Feb	28	Interest on debentures		500
							Balance	c/d	4 500
				5 000					5 000
20.1									
Mar	1	Balance	b/d	4 500					

Dr **Interest on debentures** **Cr**

20.1				**R**	20.1				**R**
Feb	28	Bank		10 000	Feb	28	Profit or loss account		10 500
		Discount on issue of debentures		500					
				10 500					10 500

Comment:

The interest paid is based on the nominal value of the debenture. When debentures are issued at a discount, the discount is amortised over the life of the debenture and increases the interest expense by an amount of R500 (R5 000/10 years). The debenture liability is reported at nominal value irrespective of the issue price. The balance of the discount on issue of debentures account (unamortised discount) is subtracted from the debenture liability in the statement of financial position. At the end of the debenture term, only the nominal value will remain to be repaid.

Example 6.10 Comprehensive example – share transactions

KZN Limited, trading in computer equipment, was formed on 1 July 20.6 with an authorised share capital of 500 000 ordinary shares and 80 000 8% preference shares. The financial year end of KZN Limited is the last day of February of every year. On 15 July 20.6, the company offered 40 000 ordinary shares and 20 000 8% preference shares to the incorporators of the company. The ordinary shares were offered at R80 000 and the 8% preference shares were offered at R60 000. All these shares were taken up and paid for by 17 July 20.6.

The following transactions occurred in connection with the issue of shares to the public during July and August 20.6:

July 20: The company offered 200 000 ordinary shares and 50 000 8% preference shares to the public. The board of directors deemed that an appropriate consideration for the ordinary shares to be R500 000 and for the preference shares, R250 000. The full issue is underwritten by Sharp Underwriters Ltd for a 1,5% underwriter's commission.

August 10: Applications were received for 190 000 ordinary shares and 56 000 preference shares.

August 15: The full offering of the ordinary shares and 50 000 preference shares was allotted and the excess application money repaid.

August 20: The share-issue expenses of R15 000 were paid and all transactions with the underwriters were concluded. All expenses regarding the issue of shares must be written off against the profit or loss account.

The following transactions occurred during the 20.8 financial year:

At an annual general meeting of shareholders on 1 June 20.7, the directors proposed that no dividends be paid for the financial period that ended 28 February 20.7, but that the company would issue capitalisation shares to its shareholders. The profit for the year, amounting to R2 100 000, would rather be used to expand the business's operations in a fast growing market and the capitalisation issue would also safeguard the company's cash flow. The shareholders approved the following capitalisation issue:

1 capitalisation share for every 4 ordinary shares held; and
1 capitalisation share for every 7 preference shares held.

The issue of these capitalisation shares must be done from retained earnings. The capitalisation issue of ordinary and preference shares will take place at their current market value of R2 and R5 per share respectively. All the capitalisation shares were allotted on 31 August 20.7.

On 26 February 20.8, the company declared a dividend of R0,20 per ordinary share to all shareholders registered in the share register on 28 February 20.8. The dividend will be paid on 15 April 20.8. This proposal was ratified by the shareholders at the annual general meeting of the company at which the financial statements disclosed a profit for the year of R5 000 000. The company met the necessary solvency and liquidity requirements. At the same meeting, the chairman of the board stated that the company is experiencing an ever-increasing demand for its products and that the expansion of its manufacturing facilities was inevitable. To help finance this expansion, the directors decided to issue 200 000 ordinary shares. The directors deemed that an appropriate consideration for ordinary shares for this issue is R520 000. Due to the anticipated high demand for the shares of the company, it was decided not to use the services of underwriters for this issue. To guard against the over-allotment of shares to shareholders and thereby jeopardising control of the company, the shares will be allotted in units of 100 shares per unit as follows:

Group A: Applications for 100 to 500 shares will be granted in full.

Group B: Applications for 600 to 1 000 shares will be granted at 60% of the shares applied for.

Group C: Applications for 1 100 to 1 500 shares will be granted at 40% of the shares applied for.

Group D: Applications for 1 600 and more shares will be granted at 30% of the shares applied for.

The following transactions occurred during June 20.8 with regard to this issue:

June 1: The company offered 200 000 ordinary shares to the public.

June 15: The following applications were received:

Number of shares per application	Number of applications received	Number of shares applied for
100	70	7 000
200	88	17 600
300	30	9 000
400	49	19 600
500	68	34 000
600	30	18 000
700	20	14 000
800	22	17 600
900	10	9 000
1 000	25	25 000
1 100	20	22 000
1 200	15	18 000
1 300	10	13 000
1 400	14	19 600
1 500	40	60 000
1 600	20	32 000
Total	531	335 400

On 30 June 20.8, all the available shares were allotted and the money refunded to unsuccessful applicants. On 15 July, the company paid R12 000 towards share-issue expenses, which was written off against the profit or loss account.

Required:

(a) Record all the transactions regarding the issue of shares for the period 1 July 20.6 to 30 June 20.8 in the general ledger of KZN Limited.

(b) Record the transactions regarding the declaration and payment of dividends in the appropriate ledger accounts.

(c) Prepare an allotment schedule for the share issue in June 20.8.

All ledger accounts must be balanced/closed off at the end of each financial period. Assume the closing balances of each section of the question as opening balances for the following section of the question.

Solution:

(a) and **(b)**

KZN Limited
General ledger

Dr **Bank** **Cr**

20.6				**R**	20.6				**R**
Jul	17	Incorporators: Ordinary shares		80 000	Aug	15	Application and allotment: 8% preference shares ①		30 000
		Incorporators: Preference shares		60 000		20	Shares expenses		15 000
Aug	10	Application and allotment: Ordinary shares ①		475 000	20.7 Feb	28	Balance	c/d	863 750
		Application and allotment: 8% preference shares ①		280 000					
	20	Sharp Underwriters		13 750					
				908 750					908 750
20.7 Mar	1	Balance	b/d	863 750	20.8 Apr	15	Dividends payable		86 800
20.8 Jun	15	Application and allotment: Ordinary shares		872 040	Jun	30	Application and allotment: Ordinary shares		352 040
							Share-issue expenses		12 000
					20.9 Feb	28	Balance	c/d	1 284 950
				1 735 790					1 735 790
20.9 Mar	1	Balance	b/d	1 284 950					

Dr **Incorporators: Ordinary shares** **Cr**

20.6				**R**	20.6				**R**
Jul	17	Share capital: Ordinary shares		80 000	Jul	17	Bank		80 000

continued

Dr **Incorporators: 8% preference shares** **Cr**

20.6				**R**	20.6				**R**
Jul	17	Share capital: 8% preference shares		60 000	Jul	17	Bank		60 000

Dr **Application and allotment: Ordinary shares** **Cr**

20.6				**R**	20.6				**R**
Aug	15	Share capital: Ordinary shares		475 000	Aug	10	Bank ①		475 000
				475 000					475 000
20.8					20.8				
Jun	30	Share capital: Ordinary shares		520 000	Jun	15	Bank		872 040
		Bank		352 040					
				872 040					872 040

Dr **Application and allotment: 8%-preference shares** **Cr**

20.6				**R**	20.6				**R**
Aug	15	Share capital: 8% preference shares		250 000	Aug	10	Bank ①		280 000
		Bank ①		30 000					
				280 000					280 000

Dr **Share capital: Ordinary shares** **Cr**

20.7				**R**	20.6				**R**
Feb	28	Balance	c/d	580 000	Jul	17	Incorporators: Ordinary shares		80 000
					Aug	15	Application and allotment: Ordinary shares		380 000
						20	Sharp Underwriters Ltd		20 000
				580 000					580 000
20.8					20.7				
Feb	28	Balance	c/d	700 000	Mar	1	Balance	b/d	580 000
					Aug	31	Retained earnings ②		120 000
				700 000					700 000

continued

Dr **Share capital: Ordinary shares** **Cr**

20.9					20.8				
Feb	28	Balance	c/d	1 220 000	Mar	1	Balance	b/d	700 000
					Jun	30	Application and allotment: Ordinary shares		520 000
				1 220 000					1 220 000
					20.9				
					Mar	1	Balance	b/d	1 220 000

Dr **Share capital: 8% preference shares** **Cr**

20.7				R	20.6				R
Feb	28	Balance	c/d	310 000	Jul	17	Incorporators: 8% preference shares		60 000
					Aug	15	Application and allotment: 8% preference shares		250 000
				310 000					310 000
20.8					20.7				
Feb	28	Balance	c/d	360 000	Mar	1	Balance	b/d	310 000
					Aug	31	Retained earnings ②		50 000
				360 000					360 000
					20.8				
					Mar	1	Balance	b/d	360 000

Dr **Sharp Underwriters Ltd** **Cr**

20.6				R	20.6				R
Aug	20	Share capital: Ordinary shares		25 000	Aug	20	Underwriter's commission ③		11 250
							Bank		13 750
				25 000					25 000

Dr **Underwriter's commission** **Cr**

20.6				R	20.6				R
Aug	20	Sharp Underwriters Ltd ③		11 250	Aug	20	Profit or loss		11 250

Dr **Share-issue expenses** **Cr**

20.6				R	20.6				R
Aug	20	Bank		15 000	Aug	20	Profit or loss		15 000
20.8					20.8				
Jul	15	Bank		12 000	Jul	15	Profit or loss		12 000

continued

Dr **Retained earnings** **Cr**

				R					R
20.7 Aug	31	Share capital: Ordinary shares		120 000	20.7 Feb	28	Appropriation account		2 100 000
		Share capital: 8% preference shares		50 000					
20.8 Feb	28	Balance	c/d	1 954 000					
				2 100 000					2 100 000
20.8 Feb	28	Balance	c/d	6 867 200	20.7 Mar	1	Balance	b/d	1 954 000
					20.8 Feb	28	Appropriation account		4 913 200
				6 867 200					6 867 200
					20.8 Mar	1	Balance	c/d	6 916 950

Dr **Ordinary dividends** **Cr**

				R					R
20.8 Feb	26	Dividends payable (300 000 × R0,20)		60 000	20.8 Feb	28	Appropriation account		60 000

Dr **Preference dividends** **Cr**

				R					R
20.8 Feb	26	Dividends payable (R310 000 × 8/100) + (R50 000 × 8/100 × 6/12)		26 800	20.8 Feb	28	Appropriation account		26 800

Dr **Dividends payable** **Cr**

				R					R
20.8 Feb	28	Balance	c/d	86 800	20.8 Feb	26	Ordinary dividends		60 000
							Preference dividends		26 800
				86 800					86 800
20.8 Apr	15	Bank		86 800	20.8 Mar	1	Balance	b/d	86 800

continued

Dr **Appropriation account** **Cr**

				R					R
20.7 Feb	28	Retained earnings		2 100 000	20.7 Feb	28	Profit or loss		2 100 000
20.8 Feb	28	Ordinary dividends		60 000	20.8 Feb	28	Profit or loss		5 000 000
		Preference dividends		26 800					
		Retained earnings		4 913 200					
				5 000 000					5 000 000

(c) Allotment schedule: Ordinary shares

Group	Number of applications in group	Total number of shares applied for	Received from applicants	Shares allotted	Cash repaid to unsuccessful applicants
			R		R
A	305 ④	87 200 ⑧	226 720 ⑪	87 200 ⑭	
B	107 ⑤	83 600 ⑨	217 360 ⑫	50 160 ⑮	86 944 ⑱
C	99 ⑥	132 600 ⑩	344 760 ⑬	53 040 ⑯	206 856 ⑲
D	20 ⑦	32 000	83 200	9 600 ⑰	58 240 ⑳
Totals		335 400	872 040	200 000	352 040

* Shown for calculation purposes.

Calculations:

① 1 August 10: Applications received

190 000/200 000 × 500 000 = R475 000

56 000/50 000 × 250 000 = R280 000

10 000/200 000 × 500 000 = 25 000 (ordinary shares taken up by underwriters)

② **Capitalisation issue – 31 August 20.7**	**R**
Number of issued shares	
Ordinary shares (40 000 + 200 000)	240 000
Preference shares (20 000 + 50 000)	70 000
Capitalisation issue	
Ordinary shares (240 000/4)	60 000
Preference shares (70 000/7)	10 000
Capitalisation issue funded	
Ordinary shares (60 000 × R2)	120 000
Funded by retained earnings	120 000
Preference shares (10 000 × R5)	50 000
Funded by retained earnings	50 000

③ **Underwriters' commission**	**R**
Subscription	
200 000 ordinary shares	500 000
50 000 preference shares	250 000
Full issue underwritten by Sharp Underwriters Ltd	750 000
Underwriters' commission (750 000 × 1,5%)	11 250

④ **Number of applications in group A:** 70 + 88 + 30 + 49 + 68 = 305

⑤ **Number of applications in group B:** 30 + 20 + 22 + 10 + 25 = 107

⑥ **Number of applications in group C:** 20 + 15 + 10 + 14 + 40 = 99

⑦ **Number of applications in group D:** 20

⑧ 7 000 + 17 600 + 9 000 + 19 600 + 34 000 = 87 200

⑨ 18 000 + 14 000 + 17 600 + 9 000 + 25 000 = 83 600

⑩ 22 000 + 18 000 + 13 000 + 19 600 + 60 000 = 132 600

⑪ 87 200/200 000 × 520 000 = 226 720

⑫ 83 600/200 000 × 520 000 = 217 360

⑬ 132 600/200 000 × 520 000 = 344 760

⑭ Group A: All applications received were allotted

⑮ Group B: 83 600 × 60% = 50 160

⑯ Group C: 132 600 × 40% = 53 040

⑰ Group D: 32 000 × 30% = 9 600

⑱ 83 600 - 50 160 = 33 440/200 000 × 520 000 = 86 944

⑲ 132 600 - 53 040 = 79 560/200 000 × 520 000 = 206 856

⑳ 32 000 - 9 600 = 22 400/200 000 × 520 000 = 58 240

6.10 Annual financial statements of companies

6.10.1 *Introduction*

The annual financial statements of a company provide valuable information not only to the management of the company, but also to shareholders, investors, creditors, bankers and other interested parties. For example, to shareholders, these financial statements project the accountability of the board of directors for the resources entrusted to them and enable the shareholders to assess the quality of the management. On the grounds of the information in these statements, the shareholders can decide whether or not to replace or re-appoint the management and whether or not to retain or sell their investment.

The annual financial statements must first be approved by the board of directors. After approval, a copy of the annual financial statements must be sent to each shareholder, each holder of debentures and to the Companies and Intellectual Property Commission (CIPC). These statements must also be presented at the annual general meeting of shareholders.

The actual preparation of company annual financial statements falls outside the scope of this chapter. The purpose of this discussion is to introduce the reader to an early understanding of how the content of financial statements of companies is influenced by IFRS and the Companies Act.

6.10.2 *Content of the annual financial statements*

Regulations 28 and 29 respectively indicate those companies that must be audited and those companies that must have an independent review instead of a formal audit. Regulation 27 of the Companies Regulations prescribes the financial reporting standards of companies (refer to paragraph 1.3.2).

As indicated earlier IAS 1 (refer to Chapter 1 paragraph 1.4) explains the preparation of annual financial statements and tries to achieve uniformity in presentation. In this regard, IAS 1 fulfils an important role in making financial statements understandable to shareholders.

IAS 1 .8, stipulates that the financial statements of a company should consist of:

- a statement of financial position as at the end of the period;
- a statement of profit or loss and other comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period;
- notes to the annual financial statements.

Although the actual preparation of the annual financial statements falls outside the scope of this chapter, the general content and format thereof are similar to the financial statements of sole traders, partnerships and close corporations discussed in various chapters of this book.

6.11 Summary

In this chapter, the reader was introduced to the company as a form of business ownership. The importance of this form of entity in the business community is its ability to attract large amounts of capital, making large trading and manufacturing entities possible, and as such, having a positive influence on the economy as a whole. Companies must abide by strict juridical and accounting requirements.

The procedures for starting a company involve a very important document that must be registered with the Companies and Intellectual Property Commission (CIPC), namely the Memorandum of Incorporation. After all formalities have been adhered to, the Commission issues a registration certificate to commence business.

Although there are different kinds of companies, this chapter concentrated on profit companies. This type of company mainly obtains its capital by issuing shares to the public and/or by issuing debentures. Investors who buy shares in the company become the shareholders of the company, while investors buying debentures become creditors of the company.

A shareholder's interest in a company is represented by the number of shares he/she holds and has the right to vote on policy matters at annual general meetings of the company. If the profit company is a listed company, shareholders can sell their shares (or buy additional shares) on the Johannesburg Securities Exchange (JSE).

Strict rules, laid down by the Companies Act, not only regulate the formation and working of a company, but also the issue of shares and debentures. Shares can be classified as either ordinary or preference shares. Most of the shares issued are ordinary shares and the ordinary shareholders are the owners of the company. Preference shareholders normally have no voting rights and therefore cannot be regarded as the "owners" of the company. Although there are many kinds of preference shares, the basic principle regarding their issue, allotment and dividend policy are the same. It is important to note that some preference shares can be redeemed if this was stated when the company issued the shares.

With regard to the issue of shares, the accounting entries needed to record these transactions were dealt with. In complicated or large share issues, an allotment schedule is prepared. To ensure a full subscription of its shares, a company can use the service of underwriters. Underwriters charge a commission for the service they offer and are obliged to take up any shares not requested by the public.

For their effort and risk, shareholders receive a dividend on their investment in the shares of a company. The calculation of the dividend a shareholder will receive depends on the class of share. The dividend on ordinary shares is calculated as cents per share and the dividend on preference shares is calculated at a fixed percentage.

Debentures differ from shares in that the debenture holders are creditors of the company and debentures are therefore not part of the equity of a company. The issue of debentures is done in much the same way as the issue of shares and the issue can also be underwritten. Debenture holders earn interest on their investment. Debentures can be issued either at nominal value, at a premium or at a discount.

Finally, this chapter also gave the reader some theoretical background as to the requirements and content of company financial statements. The chapter did not touch on the preparation of the annual financial statements of companies as this issue belongs in more advanced work concerning companies and is best dealt with in intermediate and advanced accounting textbooks.

CHAPTER 7

Statement of cash flows

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Overview of the statement of cash flows

Accounting standard

IAS 7

Main objective (of a statement of cash flows)

To disclose how the cash and cash equivalents of a business entity are generated and used

Main advantages

- To show:
  - changes in net assets
  - the ability to affect the timing and the amounts of cash flows
  - financial structure components
  - imminent financial problems
  - accuracy of previous assessments (for example cash budgets)
- To enhance the comparability of operating performance disclosures

Basic format

Cash flows from operating activities
- Cash generated from/(used in) operations (direct or indirect)
- Other items

\+

Cash flows from investing activities

\+

Cash flows from financing activities

\+

Cash and cash equivalents: beginning of year

=

Cash and cash equivalents: end of year

Relationship with other financial

Complementary:
- Statement of cash flows: cash-based
- Other statements: accrual-based

7.1 Introduction

STUDY OBJECTIVES
After studying this chapter, you should be able to: ☐ convey the purpose and importance of a statement of cash flows; ☐ explain the relationship between a statement of cash flows and the other financial statements that were prepared on the accrual basis of accounting; and ☐ prepare a statement of cash flows as well as the basic notes thereto, in respect of a sole proprietor, partnership and close corporation according to the requirements of IAS 7.

The existence of a business without cash flows is impossible. Cash is considered to be the lifeblood of a business, and in the business world it is often mentioned that "cash is king". Strangely enough, the disclosure of cash flow information was initially not required, leaving the users of financial statements, such as shareholders and the issuers of financing debt, in the dark about this fundamental aspect. The following overview of the history of W.T. Grant Company, the largest retailer in the United States of America at its time, shows how the lack of cash flow information can cause the performance of a business to be misinterpreted.

In 1906, W.T. Grant opened his first store in Massachusetts. During 1928, W.T. Grant Company made its first public share offering. By 1950, the company had expanded to approximately 500 stores. The company's expansion continued well into the 1960s, over which period another 410 new stores were opened. During 1973, the shares of the company were selling at almost 20 times its earnings and peaked at around $71 per share. To safeguard their interest in W.T. Grant Company, a group of banks, in spite of being aware that the company's growth was being financed by debt, loaned the company $600 million during September 1974 to boost its ailing performance at the time. From 1966 to 1975, the cash flows from the operating activities of W.T. Grant Company were almost always negative. Once the shareholders realised that the company could no longer honour its increasing debt responsibilities, they traded their shares without delay, causing an oversupply thereof in the equity market. During December 1974, the share price dropped to $2 per share, a mere two months after the loan of $600 million was granted. W.T. Grant Company reported profits of over $20 million for more than ten consecutive years, up to 1973. Yet, the sharp decline in its performance henceforth due to lacking cash largely contributed to its bankruptcy in April 1976.

The misleading perception that the profit and working capital of the company were sufficient to evaluate its business performance, led to the seriousness of its cash flow problems being unrecognised by most of its stakeholders, mainly because no cash flow information was disclosed. A thorough analysis of the company's cash flows would have raised concern from as early as the 1970s, a considerable time before its collapse.

To avoid problems occurring as in the above, it is required by IAS 7 that a business entity shall prepare a statement of cash flows as an integral part of its financial statements. In this chapter, a statement of cash flows is prepared according to this Standard, regardless of whether a business entity has to adhere to the requirements of IFRS.

The main objectives of this chapter are to present an overview on the importance and purpose of a statement of cash flows, and to discuss and illustrate the preparation of an elementary statement of cash flows according to IAS 7. The examples in this chapter pertain to the statements of cash flows of a partnership and close corporations.

7.2 Main objective and advantages of a statement of cash flows

The main objective of a statement of cash flows is to disclose how the cash and cash equivalents of a business entity were generated and utilised. IAS 7 therefore requires that information about the historical changes in the cash and cash equivalents of a business entity over a financial period be provided by means of a statement of cash flows, which distinguishes between cash flows from operating, investing and financing activities.

A statement of cash flows, when used in conjunction with the other financial statements, enables users to evaluate:

- changes in the net assets of a business entity;
- the ability of a business entity to affect the timing and the amounts of its cash flows; and
- the financial structure (such as its liquidity) of a business entity.

Cash flow information is also useful in detecting imminent financial problems by examining the relationship between profitability and net cash, as could have been done in the case of W.T. Grant Company, had sufficient cash flow information been available at the time. Cash flow information enables users to develop models to assess and compare the present value of the future cash flows of business entities. According to IAS 7.4, a statement of cash flows also enhances the comparability of the operating performance of entities because cash flow information eliminates the effect of using different recording methods for the same transactions and events. According to paragraph 5 of the Standard, historical cash flow information can be used as an indicator of the amount, timing and certainty of future cash flows. It is also useful to evaluate the accuracy of past estimates of future cash flows and the impact of changing prices over time.

7.3 Format of a statement of cash flows

Paragraphs 10 and 11 of IAS 7 require that a statement of cash flows:

- report on the cash flows of an entity during a designated financial period; and
- distinguish between the cash flows from operating, investing and financing activities of the entity in a manner most appropriate to its business.

The following are definitions of terms used in a statement of cash flows (IAS 7.6):

Cash: Cash on hand and demand deposits.

Cash equivalents: Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows: Inflows and outflows of cash and cash equivalents.

Operating activities: Principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Investing activities: The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities: Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Negotiable instruments, such as certified cheques and money orders, are viewed as cash. A highly liquid investment is considered an investment with a maturity period of a maximum of three months.

Only amounts that were *actually* received and/or paid in cash are disclosed in a statement of cash flows. However, such a strict adherence may in certain instances distort the interpretation of the statement.

For example, assume that Joe, a sole proprietor, purchased a vehicle for R150 000 from Jenny. He paid a deposit of R30 000 to Jenny from the funds of his business, and obtained a loan of R120 000 from Community Bank to settle the outstanding balance. Community Bank paid the R120 000 directly to Jenny on Joe's behalf. In the books of Joe's business, if strictly adhered to the definition of cash flows, only *the cash outflow of R30 000 must be disclosed as an investing activity, and no cash inflow pertaining to the loan of R120 000 must be shown as a financing activity*, since the amount of the loan was not deposited into the bank account of Joe's business. However, assume that Community Bank paid the R120 000 into the bank account of Joe's business, and that Joe thereafter paid the R120 000 over to Jenny. In such a case, *a cash outflow of R150 000 in respect of an investing activity and a cash inflow of R120 000 with regards to a financing activity would have been disclosed.*

To enhance the usefulness of a statement of cash flows, in application of substance over form, the latter manner of disclosure is more informative than the first case scenario.

The following format of a statement of cash flows (notes thereto excluded) is prepared according to the basic requirements of IAS 7. The entries that pertain to the direct and indirect method in the cash flows from operating activities section are shaded for clarification purposes. Note that the values pertaining to cash *outflows* and bank *overdrafts* are shown in brackets. To maintain consistency, the format as required by IAS 7 is applied in the preparation of a statement of cash flows for all business entities in this chapter.

Name of business entity
Statement of cash flows for the year ended . . .

	R		R
CASH FLOWS FROM OPERATING ACTIVITIES			
Direct method			
Cash receipts from customers (all entities)	Inflow*		
Cash paid to suppliers and employees (all entities)..	(Outflow)*		
	Answer		
Cash generated from operations	If net inflow		
or	or		
Cash used in operations	If net (outflow)		
OR			
Indirect method			
Profit/(Loss) for the year (sole proprietor/ partnership) or Profit/(Loss) before tax (close corporation)	**If Profit**	**If (Loss)**	
Add back: Non-cash expenses in S of PL**	Add	Subtract	
Non-cash income in S of PL...........	(Subtract)	(Add)	
Operating expenses in S of PL to be disclosed after this (shaded) section (eg. Interest and tax).	Add	Subtract	
Operating income in S of PL to be disclosed after this (shaded) section..	(Subtract)	(Add)	
	Answer:		
	If +	If –	
Decreases in applicable current assets	Add	Subtract	
Increases in applicable current assets	Subtract	Add	
Decreases in applicable current liabilities...	Subtract	Add	
Increases in applicable current liabilities...	Add	Subtract	
	Answer:		
Cash generated from operations	If + [= Inflow]		
or			
Cash used in operations	If – [= (Outflow)]		
Dividends received (all entities)	Inflow		
Interest received (all entities)	Inflow		
Interest paid (all entities)	(Outflow)		
Income tax paid (close corporation)	(Outflow)		
Drawings (sole proprietor/partnership)	(Outflow)		
Distribution to members paid (close corporation)	(Outflow)		
Proceeds from the sale of financial assets at fair value through profit or loss: Held for trading (such as listed shares) (all entities)	Inflow		
Acquisition of financial assets at fair value through profit or loss: Held for trading (such as listed shares) (all entities)	(Outflow)		
Net cash from/(used in) operating activities			In-/(Outflow)

Difference between the in- and outflow.

See paragraph 7.6.1.2 (c) for applicable accounts.

Answers of direct and indirect methods are the same.

continued

	R	R	
CASH FLOWS FROM INVESTING ACTIVITIES			
Investments in property, plant and equipment to maintain operating capacity	(Outflow)		Result of shaded area.
Replacement of property, plant and equipment (all entities)	(Outflow)		
Investments in property, plant and equipment to expand operating capacity........................	(Outflow)		Result of shaded area.
Additions to property, plant and equipment (all entities)	(Outflow)		
Proceeds from the sale of property, plant and equipment (all entities)	Inflow		
Acquisition of investments – such as investments in equity shares and loans and receivables (all entities)..	(Outflow)		
Proceeds from the sale/collection/maturity of investments – such as investment in equity shares and loans and receivables (all entities)..	Inflow		
Net cash from/(used in) investing activities		In-/ (Outflow)	
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from capital contributions (sole proprietor/partnership)	Inflow		
Proceeds from members' contributions (close corporation)	Inflow		
Proceeds from loans from members (close corporation)...	Inflow		
Proceeds from loans, debentures, mortgages, etc. (all entities).......................	Inflow		
Repayments of short-term borrowings (all entities)..	(Outflow)		
Repayments of long-term borrowings (all entities)..	(Outflow)		
Repayments of the capital elements of finance lease liabilities (all entities)............	(Outflow)		
Net cash from/(used in) financing activities		In-/ (Outflow)	
Net increase/(decrease) in cash and cash equivalents		In-/ (Outflow)	
Cash and cash equivalents at beginning of year..		Asset/ (Liability)	Answer must be the same as the opening balance in statement of financial position.
Cash and cash equivalents at end of year....		Asset/ (Liability)	Answer must be the same as the closing balance in statement of financial position.

* Cash inflows are shown without brackets, and cash outflows with brackets.

** S of PL = Statement of profit or loss and other comprehensive income

7.4 Relationship between a statement of cash flows and other financial statements

The most important distinction between a statement of cash flows and the other financial statements is that a statement of cash flows is prepared on a cash basis of accounting, whereas the other statements are prepared on the accrual basis of accounting. According to paragraph OB 17 of the IASB Conceptual Framework for Financial Reporting, accrual accounting "depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period". This description shows that financial statements prepared on the accrual basis of accounting can include both cash and non-cash entries, whereas a statement of cash flows discloses cash transactions only. This difference results in the statement of cash flows being complementary to the other financial statements. Since a statement of cash flows reports on the cash flows of items that are disclosed in the other financial statements, it is possible to prepare a statement of cash flows from these statements.

7.5 Identification of non-cash entries in financial statements prepared on the accrual basis of accounting

Reporting on the accrual basis of accounting requires, for example, that in respect of a specific financial period:

- ☐ income be recorded although it was not yet received in cash during that period (for example, credit sales);
- ☐ income be recorded although it was already received in cash during a previous financial period (for example, when income was received in advance during a previous financial period);
- ☐ expenses be recorded although they were not yet paid during that period (for example, credit purchases);
- ☐ expenses be recorded although they were already paid during a previous financial period (for example, when an expense was prepaid during a previous financial period);
- ☐ revaluations of non-current assets be recorded if a revaluation policy is adopted;
- ☐ depreciation of a property, plant and equipment item be recorded; and
- ☐ the net realisable value of current assets be disclosed, for example by means of an allowance for credit losses.

None of the above entries are recorded in cash or cash equivalent accounts. They are therefore referred to as non-cash entries. Since a statement of cash flows reports on cash transactions only, non-cash entries must be identified in the other financial statements so that they can be omitted when a statement of cash flows is prepared.

For example, rental expenses of R600 paid and recorded in respect of the financial year ended 31 December 20.3, and an additional amount of R100 recorded as in arrears for the year, is disclosed on the statement of profit or loss and other comprehensive income for the year ended 31 December 20.3 as rental expenses of R700 (R600 cash and R100 in arrears). The statement of financial position as at

31 December 20.3 would include the rental expenses in arrears of R100 in the trade and other payables figure. To calculate the cash paid in respect of rental expenses during the 20.3 financial year, 1) the amount in arrears (the non-cash amount) of R100 must be identified by referring to the trade and other payables on the statement of financial position as at 31 December 20.3, and 2) subtracted from the R700. R600 (R700 – R100) is disclosed as a cash outflow on the statement of cash flows for the year ended 31 December 20.3. Likewise, income in arrears pertaining to income earned during the 20.3 financial year will not be disclosed on the statement of cash flows for the year ended 31 December 20.3 because no cash was received during this period. However, prepaid expenses and income received in advance during the 20.3 financial year will be disclosed on the statement of cash flows because cash flows occurred during the 20.3 financial year.

The statement of profit or loss and other comprehensive income and the statement of changes in equity (or net investment) disclose entries pertaining to a financial period and not to a single date. Since the statement of cash flows also pertains to a financial period, it is only necessary to determine the cash amounts included in the statements of profit or loss and other comprehensive income and the statement of changes in equity (or net investment).

A statement of financial position is prepared on a specific date and not for a financial period. Therefore, in order to identify cash flows from statements of financial position, two subsequent statements are required, and the differences between the corresponding balances calculated. For example, when a statement of cash flows for the year ended 31 December 20.3 is prepared, the differences between the corresponding entries of the statements of financial position as at 31 December 20.2 and 31 December 20.3 are calculated, and then the cash amounts included in these differences are calculated and disclosed in the statement of cash flows.

Assume, for example, that the only difference pertaining to the vehicles at cost account was caused by the sale of a vehicle with a cost price of R100 000 during the financial year, say Y_1. The R100 000 does not indicate whether the vehicle was sold for cash or what the selling price of the vehicle was. Let us assume that the vehicle was sold for R50 000. An analysis of the trade and other receivables as disclosed on the statement of financial position at the end of Y_1 will reveal whether there is a debtor pertaining to this transaction. If there is a relevant trade receivables account, amounting to R50 000 for example, no payment was received from the debtor during Y_1, and no cash received concerning the sale of the vehicle will be disclosed on the statement of cash flows for Y_1. Should the debtor have paid a portion of this debt during Y_1, say R25 000, the R25 000 will be disclosed on the statement of cash flows for Y_1. If no trade receivables account is found concerning this transaction, one can conclude that the entire selling price of R50 000 was received. R50 000 is then disclosed on the statement of cash flows for Y_1 as proceeds received from the sale of the vehicle.

Identify the non-cash entries (when no cash or cash equivalent account is used to record an entry) in the following list:

No	Entry	Tick
1	Cash journal entry	
2	An entry in the sales, purchases, sales returns or purchases returns journal	
3	Accrual based year-end adjustment	
4	An asset purchased on credit	
5	Revenue: cash sales	
6	Revenue: credit sales	
7	A payment made to a creditor	
8	The recording of depreciation	
9	The creation or adjustment of an allowance for credit losses account	
10	A payment received from a debtor who's account was written off as irrecoverable	
11	Drawings of inventory by a sole proprietor	
12	The recording of rental expenses in arrears at the end of a financial year	
13	The recording of salaries attributable to partners according to the partnership agreement	
14	The payment of a salary to a partner	
15	A capital contribution of cash by a member of a close corporation	
16	The recording of rental income in arrears at the end of a financial year	
17	The closing off of a prepaid expense to a related expense account at the beginning of a financial year	
18	A profit or loss made on the sale of a non-current asset	
19	Writing off a trade receivables account as irrecoverable	
20	The recording of settlement discount transactions	
21	**In respect of Y_1:** Rental expenses in arrears (for Y_0) paid in Y_1	
22	**In respect of Y_1:** A payment received in advance during Y_0 for rental income pertaining to Y_1	

Answer:

Non-cash entries: 2, 3, 4, 6, 8, 9, 11, 12, 13, 16, 17, 18, 19, 20, 22

Explanation:

No 2. Sales, purchases, sales returns and purchases returns journal entries pertain to credit entries. All cash transactions are recorded in the cash journals.

No 3. Accrual based year-end adjustments are non-cash entries.

No 4. The recording of an asset purchased on credit, for example, equipment purchased on credit for R20 000:

Journal entry (extract)

	Debit	Credit
	R	**R**
Equipment at cost	20 000	
Trade payables control		20 000

A cash outflow occurs when a payment is made to the creditor (debit: Trade payables control, **credit: Bank**).

No 6. Revenue: credit sales. Credit sales are included in the revenue as shown on the statement of profit or loss and other comprehensive income. The credit sales must be excluded from the cash receipts from customers, and the cash received from debtors (pertaining to credit sales) during the period, included.

No 8. The recording of depreciation, for example, the depreciation of furniture for R10 000:

Journal entry (extract)

	Debit	Credit
	R	**R**
Depreciation	10 000	
Accumulated depreciation: Furniture		10 000

As with all non-cash entries, no cash or cash equivalent account is used to record depreciation.

No 9. The creation or adjustment of an allowance for credit losses account. The balance of an allowance for credit losses account represents an estimate of future credit losses. When the account is created, for example at R5 000, the journal entry is:

Journal entry (extract)

	Debit	Credit
	R	**R**
Credit losses	5 000	
Allowance for credit losses		5 000

When the balance of the allowance for credit losses account is adjusted, for example decreased by R2 000, the journal entry is:

Journal entry (extract)

	Debit	Credit
	R	**R**
Allowance for credit losses	2 000	
Credit losses		2 000

No 11. Drawings of inventory by a sole proprietor, for example, drawings of R3 000 by I Draw, when the periodic inventory system is applied:

Journal entry (extract)

	Debit	Credit
	R	**R**
Drawings: I Draw	3 000	
Purchases		3 000

Since the owner did not pay for the inventory, no cash flow occurred.

No 12. The recording of rental expenses in arrears at the end of a financial year, for example, rental expenses in arrears for R8 000:

Journal entry (extract)

	Debit	Credit
	R	**R**
Rental expenses	8 000	
Rental expenses in arrears		8 000

A cash outflow occurs when a payment is made towards the rental expenses in arrears (debit: Rental expenses in arrears, **credit: Bank**).

No 13. The recording of salaries attributable to partners according to the partnership agreement, for example R10 000 each for partner A and B:

Journal entry (extract)

	Debit	Credit
	R	**R**
Appropriation	20 000	
Current account: Partner A		10 000
Current account: Partner B		10 000

All cash payments to partners, including salaries, are recorded by means of the drawings account (debit: Drawings, **credit: Bank**).

No 16. The recording of rental income in arrears at the end of a financial year, for example, rental income in arrears for R3 000:

Journal entry (extract)

	Debit	Credit
	R	**R**
Rental income in arrears	3 000	
Rental income		3 000

A cash inflow occurs when a payment is received in respect of the rental income in arrears (**debit: Bank**, credit: Rental income in arrears).

No 17. The closing off of a prepaid expense to a related expense account at the beginning of a financial year, for example, Y_1 salaries of R1 000 prepaid during Y_0:

Journal entry: Beginning of Y_1 (extract)

	Debit	Credit
	R	**R**
Salaries	1 000	
Salaries prepaid		1 000

The cash outflow of R1 000 occurred during Y_0, although the expense pertains to Y_1.

No 18. A profit or loss made on the sale of a non-current asset, for example, a profit of R5 000 made on the sale of a vehicle (sold for R35 000, cash):

Journal entry (extract)

	Debit	Credit
	R	**R**
Vehicle realisation	5 000	
Profit on sale of vehicle		5 000

A cash inflow of R35 000 occurred on the date of sale (**debit: Bank**, credit: Vehicle realisation).

No 19. Writing off a trade receivables account as irrecoverable, for example, an irrecoverable trade receivables account of R10 000 written off against credit losses:

Journal entry (extract)

	Debit	Credit
	R	**R**
Credit losses	10 000	
Trade receivables control		10 000

No cash is received from such debtor, and therefore it is a non-cash entry.

No 20. The recording of settlement discount transactions, for example, a settlement discount of R1 000 is offered to a debtor on 31 January 20.7, the financial year-end of the business, provided that the debtor settles his account of R14 000 in full within six months. The debtor accepted this offer and paid R13 000 to settle his account in full on 30 June 20.7:

Journal entries (extract)

	Debit	Credit
	R	R
20.7		
Jan 31		
Settlement discount granted	1 000	
Allowance for settlement discount granted		1 000
20.7		
Jun 30		
Allowance for settlement discount granted	1 000	
Trade receivables control		1 000

The bank account is not used when recording settlement discount transactions. Therefore, they are non-cash entries. A cash inflow of R13 000 is recorded when the debtor pays his account. (**debit: Bank**, credit: Trade receivables control).

No 22. **In respect of Y_1:** A payment received in advance during Y_0 for rental income pertaining to Y_1, for example to the amount of R12 000. The cash outflow occurred during Y_0, and not during Y_1, although the rental income is earned in $Y_{1.}$

7.6 Preparation of a statement of cash flows from financial statements prepared on the accrual basis of accounting

It is possible to prepare a statement of cash flows from the cash journals or the cash and cash equivalent accounts of a business. A statement of cash flows can also be prepared from:

- the statements of financial position pertaining to the beginning and end of a financial period under review;
- the statement of profit or loss and other comprehensive income pertaining to the financial period under review;
- the statement of changes (in equity or in net investment of members) pertaining to the financial period under review;
- the notes thereto; and
- any further information which cannot be obtained from the above.

7.6.1 *Cash flows from operating activities*

According to paragraph 13 of IAS 7, the cash flows arising from operating activities is a key indicator of the extent to which the operations of a business entity have generated sufficient cash to maintain its operating capability, repay loans, pay dividends and make new investments without recourse to external sources of financing.

Paragraph 14 of IAS 7 states that cash flows from operating activities are primarily derived from the principal revenue-producing activities of an entity. Therefore, operating activities pertain mainly to the entries as disclosed on the statement of profit or loss and other comprehensive income for the financial period under review.

The cash generated from or used in operations can be prepared by using either the direct or indirect method. IAS 7.19 encourages disclosure according to the direct method because it provides information which may be useful in estimating future cash flows which is not provided under the indirect method. In this chapter, both methods are illustrated.

7.6.1.1 Cash generated from or used in operations according to the direct method

Format of disclosure:

Name of business entity
Statement of cash flows for the year ended . . .

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers (all entities)	Inflow*	
Cash paid to suppliers and employees (all entities)..	(Outflow)*	
	Answer	
Cash generated from operations....................... or Cash used in operations....................................	If net inflow or If net (outflow)	

Difference between the in- and outflow.

* Cash inflows are shown without brackets, and cash outflows with brackets.

Main source of information:

The **statement of profit or loss and other comprehensive income**, as the operating activities of a business entity are disclosed in this statement.

Recall that non-cash items in the statement of profit or loss and other comprehensive income are not shown in the statement of cash flows. Examples of non-cash items clearly disclosed in the statement of profit or loss and other comprehensive income are:

- depreciation; and
- profit or loss on sale of a non-current asset.

When non-cash items are not clearly disclosed, for example, revenue including cash and credit sales, the following additional information is taken into account:

- the closing balances of the relevant current assets and current liabilities on the statements of financial position under review (since the closing balance of Y_0 is the opening balance of Y_1.);
- notes thereto; and
- any further additional information.

Calculations of non-cash items not clearly disclosed are shown in later examples.

Items on the statement of profit or loss and other comprehensive income relating to items on the statement of cash flows *after* the cash generated from/used in operations, for example, interest earned or incurred, or dividend income, are not shown on the cash generated from/used in operations section of the statement of cash flows.

(a) Cash receipts from customers

Formula:

Step 1: Identify the relevant income items on the statement of profit or loss and other comprehensive income for the financial period under review, for example, revenue.

Step 2: Adjust each item to a cash amount if necessary, by using the related items in the statements of financial position.

These steps, the sources of financial information used, and the reasons for application are shown in Table 7.1.

Table 7.1 Calculation of income received in cash

Step (How)	Source of information	Reason (Why)
1. *IDENTIFY* the income items for the year under review (for Y_1 ended)	Statement of profit or loss and other comprehensive income for Y_1	The income was earned during Y_1 and could include cash amounts
2. *ADJUST* the identified items to cash amounts:		
2.1 *Add* the income in arrears AND *subtract* the income received in advance at the beginning of Y_1 (end of Y_0)	Statement of financial position as at Y_0	To calculate the *income receivable* in cash during Y_1
2.2 *Subtract* the income in arrears AND *add* the income received in advance at the end of Y_1	Statement of financial position as at Y_1	To calculate the *income received* in cash during Y_1

Income received in cash during the year under review (Y_1)

Example 7.1 The calculation of cash receipts

The following information pertains to Apache Close Corporation:

In the **statement of profit or loss and other comprehensive income for the year ended 30 June 20.4 (for Y_1)**:

Revenue, R70 000

Rental income, R6 800

In the **statement of financial position as at 30 June 20.3 (end of Y_0)**

Trade and other receivables (trade receivables pertaining to the sales of trading inventory, R15 800; rental income in arrears, R500)

In the **statement of financial position as at 30 June 20.4 (end of Y_1)**

Trade and other receivables (trade receivables pertaining to the sales of trading inventory, R17 300; rental income received in advance, R1 000)

Required:

Calculate the cash receipts from customers by Apache Close Corporation for the year ended 30 June 20.4.

Solution:

Steps to follow (see Table 7.1; shown for explanatory purposes):

Step	Source of information
1. *IDENTIFY* the income items for the year under review (for Y_1 ended)	Statement of profit or loss and other comprehensive income for the year ended 30 June 20.4
2. *ADJUST* to cash amounts:	
2.1 *Add* the income in arrears (receivable) at the beginning of Y_1 (end of Y_0)	Statement of financial position as at 30 June 20.3
Income receivable during the year	
Subtract the income in arrears (receivable) and add the rental income received in advance at the end of Y1	Statement of financial position as at 30 June 20.4

Calculation:

Cash receipts from customers during the year ended 30 June 20.4 (Y_1)				
Step 1 Identify (for Y_1 ended) **Item**		**Step 2.1 Adjust** (end of Y_0)	**Step 2.2 Adjust** (end of Y_1)	**Cash receipts from customers**
	R	**R***	**R***	**R**
Revenue	70 000	+ 15 800	– 17 300	= 68 500
Rental income (earned)	6 800	+ 500	+ 1 000	= 8 300
				76 800

* Since revenue pertains to sales, including the credit sales, the opening and closing balances of the trade receivables pertaining to the sales of trading inventory are used to calculate the cash received from the debtors during the year.

Alternative scenarios concerning the rental income:

If no rental income was earned during Y_1 (for 20.4 ended):
R(500 + 1 000) = R1 500 (exclude the R6 800).

If no rental income was receivable at the end of Y_0 (beginning of 20.4):
R(6 800 + 1 000) = R7 800 (exclude the addition of R500).

If no rental income was received in advance at the end of Y_1 (end of 20.4):

R(6 800 + R500) = R7 300 (exclude the addition of R1 000).

(b) Cash paid to suppliers and employees

Formula:

Step 1: Identify the relevant expense items in the statement of profit or loss and other comprehensive income for the financial period under review, for example salaries and wages.

Step 2: Adjust each item to a cash amount if necessary, by using the related items in the statements of financial position.

These steps, the sources of financial information used, and the reasons for application are shown in Table 7.2.

Table 7.2 Calculation of expenses paid for in cash

Step (How)	**Source of information**	**Reason (Why)**
1. *IDENTIFY* the expense items for the year under review (Y_1)	Statement of profit or loss and other comprehensive income for Y_1 ended	The expenses incurred during Y_1 and could include cash amounts
2. *ADJUST* the identified items to cash amounts:		
2.1 *Add* the expenses in arrears AND *subtract* the prepaid expenses at the beginning of Y_1	Statement of financial position as at Y_0	To calculate the *expenses payable* in cash during Y_1
2.2 *Subtract* the expenses in arrears AND *add* the expenses prepaid at the end of Y_1	Statement of financial position as at Y_1	To calculate the *expenses paid* in cash during Y_1

Expenses paid in cash during the year under review (Y_1)

Example 7.2 The calculation of cash paid

The following information pertains to Apache Close Corporation:

In the **statement of profit or loss and other comprehensive income for the year ended 30 June 20.4 (for Y_1 ended)**

Salaries and wages, R31 700
Rental expense, R7 500

In the **statement of financial position as at 30 June 20.3 (end of Y_0)**

Trade and other payables (rent payable, R650)

In the **statement of financial position as at 30 June 20.4 (end of Y_1)**

Prepayments (salaries and wages, R1 000)
Trade and other payables (rent payable, R400)

Required:

Calculate the cash paid to suppliers and employees by Apache Close Corporation for the year ended 30 June 20.4.

Solution:

Steps to follow (see Table 7.2; shown for explanatory purposes):

Step	Source of information
1. *IDENTIFY* the expense items for the year under review (for Y_1 ended)	Statement of profit or loss and other comprehensive income for the year ended 30 June 20.4
2. *ADJUST* to cash amounts:	
2.1 *Add* the rent payable/in arrears at the beginning of Y_1 (end of Y_0)	Statement of financial position as at 30 June 20.3
Expenses payable during the year	
2.2 *Subtract* the rent payable/in arrears and *add* the salaries and wages prepaid at the end of Y_1	Statement of financial position as at 30 June 20.4

Calculation:

Expenses paid in cash during the year ended 30 June 20.4 (Y_1)				
Item	**Step 1 Identify** (for Y_1 ended)	**Step 2.1 Adjust** (end of Y_0)	**Step 2.2 Adjust** (end of Y_1)	**Cash paid to suppliers and employees**
	R	**R**	**R**	**R**
Salaries and wages	31 700	–	+ 1 000	= 32 700
Rental expenses	7 500	+ 650	– 400	= 7 750
				40 450

Alternative scenarios concerning the rental expenses:

If no rent was payable at the end of Y_0 (beginning of 20.4):
R(7 500 – 400) = R7 100 (exclude the addition of R650).

If no rent was payable at the end of Y_1 (end of 20.4):

R(7 500 + R650) = R8 150 (exclude the subtraction of R400).

Example 7.3 Disclosure of cash generated from or used in operations according to the direct method

The following information pertains to Cleo CC:

Cleo CC
Statement of profit or loss and other comprehensive income for the year ended 30 April 20.3

		R
Revenue		253 440
Cost of sales		(144 000)
Gross profit		109 440
Other income		19 600
Profit on sale of non-current assets: Furniture	400	
Dividend income: Listed investments	8 640	
Fair value adjustment: Listed investments held for trading	10 560	
		129 040
Distribution, administrative and other expenses		(45 840)
Salaries to members	30 000	
Remuneration: Accounting officer	8 400	
Depreciation (Furniture and equipment)	2 400	
Water and electricity	1 440	
Credit losses	1 500	
General expenses	2 100	
Finance costs		(6 000)
Interest on long-term loan	6 000	
Profit before tax		77 200
Income tax expense		(20 568)
Profit for the year		56 632
Other comprehensive income for the year		–
Total comprehensive income for the year		56 632

Cleo CC
Statement of changes in net investment of members for the year ended 30 April 20.3

	Members' contributions	**Retained earnings**	**Total**
	R	**R**	**R**
Balances at 1 May 20.2	144 000	25 650	169 650
Members' contributions	48 000		48 000
Total comprehensive income for the year		56 632	56 632
Distribution to members		(24 000)	(24 000)
Balances at 30 April 20.3	192 000	58 282	250 282

Cleo CC
Statement of financial position as at 30 April 20.3

	20.3 R	20.2 R
ASSETS		
Non-current assets	141 125	93 600
Property, plant and equipment	141 125	93 600
Current assets	142 080	128 850
Inventories	45 120	48 000
Trade and other receivables	17 760	14 400
Listed investments	79 200	52 800
Cash and cash equivalents	–	13 650
Total assets	283 205	222 450
EQUITY AND LIABILITIES		
Total equity	250 282	169 650
Members' contributions	192 000	144 000
Retained earnings	58 282	25 650
Total liabilities	32 923	52 800
Non-current liabilities	9 600	28 800
Long-term borrowings	9 600	28 800
Current liabilities	23 323	24 000
Trade and other payables	14 400	13 670
Distribution to members payable	3 440	10 330
Current portion of long-term borrowings	2 400	–
Bank overdraft	3 083	–
Total equity and liabilities	283 205	222 450

Additional information:

1. During the financial year under review, the cash sales amounted to R61 800.
2. Inventory is purchased on credit and held for trading.
3. The following information was extracted from the note on property, plant and equipment:

	20.3 R	20.2 R
Land and buildings at cost	129 525	76 800
Furniture and equipment at carrying amount	11 600	16 800
	141 125	93 600

No land and buildings were sold, and no furniture and equipment were purchased. It is business policy not to sell any furniture and equipment on credit.

4. Listed investments pertain to:
   - 3 520 ordinary shares with a fair value of R52 800 on 1 May 20.2, purchased from ILend Limited on 30 April 20.2. None of the shares were sold during the financial year under review.
   - 5 280 ordinary shares with a fair value of R15 840, purchased from Ticki Limited on 30 April 20.3 for this amount.

   Listed shares are held for short-term profit taking (trading) and forms part of the business model of Cleo CC.
5. The trade and other receivables include the following:

	20.3	**20.2**
	R	**R**
Trade receivables control (in respect of trading inventory sold)	17 760	13 680
Income in arrears (rent)*	–	720

* The rental contract expired on 30 April 20.2.

6. No allowance for credit losses was created.
7. The members' contributions were made in cash.
8. The trade and other payables represent creditors pertaining to the purchases of trading inventory only.

Required:

Prepare the cash generated from or used in operations section in the statement of cash flows of Cleo CC for the year ended 30 April 20.3 according to the direct method to comply with the requirements of IFRS. Comparative figures are not required.

Solution:

Cleo CC
Extract from the statement of cash flows for the year ended 30 April 20.3

	R	**R**
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers①	248 580	
Cash paid to suppliers and employees②	(182 330)	
Cash generated from operations	66 250	

Calculations:

① **Cash receipts from customers**

IDENTIFY (In the statement of profit or loss or other comprehensive income for the year ended 30 April 20.3 – see extract below)

Revenue, R253 440

Cleo CC
Statement of profit or loss and other comprehensive income for the year ended 30 April 20.3 (relevant extract)

	R
Revenue	253 440 √
Cost of sales	(144 000)
Gross profit	109 440
Other income	19 600
Profit on sale of non-current assets: Furniture **[Non-cash item: Not pertaining to revenue]**	400
Dividend income: Listed investments **[Taken into account after cash generated from operations]**	8 640
Fair value adjustment: Listed investments held for trading **[Non-cash item: Not pertaining to revenue]**	10 560
	129 040
Credit losses **[Non-cash item: Pertaining to revenue: *Subtract from revenue*]**	1 500

ADJUST: (Refer to the statements of financial position as at 30 April 20.2 and 30 April 20.3.)

Trade and other receivables*

	20.3 R	20.2 R
Trade receivables control (in respect of the sales of trading inventory)	17 760	13 680
Income in arrears (rent)**	–	720

* See paragraph 5 under the additional information.
** The rental contract expired on 30 April 20.2.

Calculation:

Cash receipts from customers during the year ended 30 April 20.3

Step 1 **Identify** (for 20.3 ended) **Item**		**Step 2.1** **Adjust** (end of 20.2) **+ Income in arrears** **– Income received in advance**	**Step 2.2** **Adjust** (end of 20.3) **– Income in arrears** **+ Income received in advance**	**Cash receipts from customers**
	R	R	R	R
Revenue	253 440	+ 13 680*	– 17 760* – 1 500**	= 247 860
Rental income		+ 720		= 720
				248 580

* Trade receivables control balances are similar to income in arrears.
** See comment in the S of PL above.

Comment:

The cash received from the debtors can also be calculated by reconstructing the trade receivables control account (see below). With the exception of the bank entry (cash received from the debtors), all the necessary information was given to reconstruct the account. The balancing entry of R186 060 shows the cash received from the debtors. The sum of the cash sales (Additional information 1) and the cash received from the debtors during the year is equal to R247 860 (R61 800 + R186 060).

Dr **Trade receivables control (reconstructed for calculation purposes)** **Cr**

20.2				**R**					**R**
May	1	Balance	b/d	13 680			Credit losses		1 500
		Sales		191 640			Bank*		186 060
					20.3 Apr	30	Balance	c/d	17 760
				205 320					205 320
20.3 May	1	Balance	b/d	17 760					

* Balancing entry

② **Cash paid to suppliers and employees**

IDENTIFY (in S of PL – see below):

Purchases of trading inventory (included in the cost of sales) must be calculated
Salaries to members, R30 000
Remuneration: Accounting officer, R8 400
Water and electricity, R1 440
General expenses, R2 100

Cleo CC
Statement of profit or loss and other comprehensive income for the year ended 30 April 20.3 (relevant extract)

	R	
Cost of sales **[Use to calculate the purchases of trading inventory]**	(144 000)	√
Distribution, administrative and other expenses	(45 840)	
Salaries to members	30 000	√
Remuneration: Accounting officer	8 400	√
Depreciation (Furniture and equipment) **[Non-cash item]**	2 400	
Water and electricity	1 440	√
Credit losses **[Non-cash item – taken into account with the cash received from revenue calculation]**	1 500	
General expenses	2 100	√
Finance costs	(6 000)	
Interest on long-term loan **[Taken into account after cash generated from operations]**	6 000	
Profit before tax	77 200	
Income tax expense **[Taken into account after cash generated from operations]**	(20 568)	

The purchases of trading inventory were not disclosed separately on the statement of profit or loss and other comprehensive income and are calculated:

	Source	R
Cost of sales	Statement of profit or loss and other comprehensive income for the year ended 30 April 20.3	144 000
Adjust Cost of sales to purchases of trading inventory		
Subtract: Inventories *Add*: Inventories	Statement of financial position as at 30 April 20.2 Statement of financial position as at 30 April 20.3	(48 000) 45 120
Purchases of trading inventory*		**141 120****

* Given in paragraph 2 of the additional information as made on credit.
** The reconstructed trading inventory account below illustrates an alternative method for the calculation of the purchases of trading inventory.

Dr — Trading inventory (reconstructed for calculation purposes) — Cr

				R					R
20.2 May	1	Balance	b/d	48 000			Cost of sales		144 000
		Purchases: Trading inventory*		141 120	20.3 Apr	30	Balance	c/d	45 120
				189 120					189 120
20.3 May	1	Balance	b/d	45 120					

* Balancing entry

ADJUST: (Use statements of financial position as at 20.2 and 20.3)

Calculation:

Cash paid to suppliers and employees during the year ended 30 April 20.3 **Step 1** **Identify** (for 20.3 ended) **Item**		**Step 2.1** **Adjust** (end of 20.2) **+ Expenses in arrears** **– Prepayments**	**Step 2.2** **Adjust** (end of 20.3) **– Expenses in arrears** **+ Prepayments**	**Cash paid to suppliers and employees**
	R*	**R**	**R**	**R**
Purchases: Trading inventory	141 120	+ 13 670*	– 14 400*	= 140 390**
Salaries to members	30 000			= 30 000
Remuneration: Accounting officer	8 400			= 8 400
Water and electricity	1 440			= 1 440
General expenses	2 100			= 2 100
				182 330

* Similar to expenses in arrears, the opening balance of the trade payables control account is added to purchases: trading inventory and the closing balance is subtracted.
** The reconstructed trade payables control account below illustrates an alternative method for the calculation of the cash paid in respect of the purchases of trading inventory.

Trade payables control
(reconstructed for calculation purposes)

Dr				R					R Cr
					20.2				
		Bank*		140 390	May	1	Balance	b/d	13 670
20.3 Apr	30	Balance	c/d	14 400			Purchases: Trading inventory**		141 120
				154 790					154 790
					20.3 May	1	Balance	b/d	14 400

* Balancing entry
** See calculation above

7.6.1.2 Cash generated from or used in operations according to the indirect method

Format of disclosure:

Name of business entity
Statement of cash flows for the year ended . . .

Profit/(Loss) for the year (sole proprietor/partnership) or Profit/(Loss) before tax (close corporation)....	**If** **Profit**	**If** **(Loss)**
Add back: Non-cash expenses in S of PL............	Add	Subtract
Non-cash income in S of PL............	(Subtract)	(Add)
Operating expenses in S of PL to be disclosed after this section (eg. Interest and tax)..........	Add	Subtract
Operating income in S of PL to be disclosed after this section..........	(Subtract)	(Add)
	Answer: If +	If –
Decreases in applicable current assets	Add	Subtract
Increases in applicable current assets	Subtract	Add
Decreases in applicable current liabilities	Subtract	Add
Increases in applicable current liabilities	Add	Subtract
	Answer:	
Cash generated from operations	If + [= Inflow]	
or		
Cash used in operations.....	If – [= (Outflow)]	

See paragraph 7.6.1.2 (c) for applicable accounts.

Answers of direct and indirect methods are the same.

According to the indirect method:

- ☐ The starting point of disclosure is either the profit before tax (in the case of a CC) or the profit for the year (in the case of a sole proprietor or partnership). All *non-cash entries* and *items disclosed after the cash generated from or used in operations* that are shown on the statement of profit or loss and other comprehensive income must be added back to the profit before tax/profit for the year (see paragraphs (a) and (b) below).
- ☐ Then the *differences* between the applicable current assets and current liabilities are taken into account (see paragraph (c) below).

(a) Adding back the non-cash entries

Adding back means that an amount with a debit balance shown for example on the statement of profit or loss and other comprehensive income is cancelled by adding an equal credit amount, and vice versa.

For the purpose of this calculation, the "non-cash entries" that are individually disclosed on the statement of profit or loss and other comprehensive income, for example, depreciation and credit losses, are added back. Non-cash entries not individually disclosed, such as credit sales included in revenue, are dealt with in paragraph (c) below.

When credit losses are added back, two calculations (not book entries) are made. Firstly, the credit losses are added to the profit, and secondly, the credit losses are added to the closing balance of the trade receivables control account. The increase of the profit (which is an increase of a credit balance) is cancelled out by the increase of the trade receivables control account (which is an increase of a debit balance). Due to this cancelling out effect, the credit losses do not have to be added back under the indirect method. Consider the following:

Dr **Trade receivables control** **Cr**

20.2				**R**	20.2				**R**
		Balance	b/d	8 000			Credit losses		500
		Sales		2 500			Balance	c/d	10 000
				10 500					10 500
20.3		Balance	b/d	10 000					

The profit for the year under review is R65 000.

The calculations below show that the cash generated from operations is the same, irrespective of whether the credit losses are added back (reversed):

Credit losses added back	**R**
Profit for the year	65 000
Credit losses added back	**500**
	65 500
Increase in trade receivables control [R(10 000 **+ 500**) – R8 000]*	(2 500)
Cash generated from operations	**63 000**

* The credit losses of R500 are added to the closing balance of the trade receivables control account. An increase in the trade receivables control account is similar to a cash outflow (refer to paragraph (c)).

Credit losses not added back	R
Profit for the year	65 000
Increase in trade receivables control R(10 000 – 8 000)	(2 000)
Cash generated from operations	**63 000**

In this chapter, credit losses are not added back.

For revision purposes, identify the individually disclosed non-cash expenses in the extract of the statement of profit or loss and other comprehensive income below, and add back if necessary:

Cleo CC
Statement of profit or loss and other comprehensive income for the year ended 30 April 20.3 (extract)

	R
Gross profit and other income	129 040
Distribution, administrative and other expenses	(45 840)
Salaries to members	30 000
Remuneration: Accounting officer	8 400
Depreciation (Furniture and equipment)	2 400
Water and electricity	1 440
Credit losses	1 500
General expenses	2 100
Finance costs	(6 000)
Interest on long-term loan	6 000
Profit before tax	77 200

There are two individually disclosed non-cash expenses, namely depreciation and credit losses.

By adding back the depreciation, the depreciation is cancelled out, causing the profit to increase by R2 400 (R79 600 - R77 200):

	R
Gross profit and other income	129 040
Distribution, administrative and other expenses	(43 440)
Salaries to members	30 000
Remuneration: Accounting officer	8 400
Depreciation (Furniture and equipment) R2 400 (dr) + R2 400 (cr)	–
Water and electricity	1 440
Credit losses	1 500
General expenses	2 100
Finance costs	(6 000)
Interest on long-term loan	6 000
Profit before tax	79 600

As explained, in this chapter, the credit losses are not added back under the indirect method, although it is a non-cash entry.

(b) Adding back the items disclosed after the cash generated from or used in operations

Dividends received, interest received, interest paid, income tax paid, drawings, distribution to members paid, proceeds from the sale, and the acquisition of assets and financial assets are disclosed individually, *after* the cash generated from or used in operations. These and related items must therefore be excluded from the cash generated from or used in operations by adding them back to the profit/loss.

(c) Differences in current accounts

After applying paragraphs (a) and (b), included in the remaining entries on the statement of profit or loss and other comprehensive income, are non-cash amounts that are not individually disclosed – for example credit sales included in revenue. These non-cash amounts are now added back.

To determine these non-cash amounts, the differences between the opening (end of Y_0 = beginning of Y_1) and closing balances (end of Y_1) of the applicable current accounts are calculated. The applicable current accounts are the current assets and current liabilities that form part of the cash generated from or used in operations. Generally, they comprise trade receivables pertaining to the sales of trading inventory, inventories, and trade payables pertaining to the purchases of trading inventory.

The differences between the current assets and the current liabilities pertaining to items that are disclosed *after* the cash generated from or used in operations, are taken into account when those items are disclosed. Examples of such current assets and current liabilities are:

- ☐ dividends receivable, prepaid interest or interest in arrears, current tax receivable or payable, and distribution to members payable;
- ☐ the current portion of a long-term borrowing; and
- ☐ the cash and cash equivalents as well as a bank overdraft.

In the given format of the statement of cash flows pertaining to the cash generated from or used in operations, the differences between each of the applicable current assets and each of the applicable current liabilities are disclosed individually for explanatory purposes. They may be collectively disclosed as 1) increase/decrease in trade and other receivables, 2) increase/decrease in inventories and 3) increase/decrease in trade and other payables.

Table 7.3 illustrates the effect of the changes in the current assets and the current liabilities on working capital and cash flow.

Table 7.3 The effect of the changes in the current assets and the current liabilities on working capital and cash flow

Change in current asset	**Effect on**		**Change in current liability**	**Effect on**	
	working capital	**cash flow**		**working capital**	**cash flow**
Increase	Increase	(Outflow)	Increase	Decrease	Inflow
Decrease	Decrease	Inflow	Decrease	Increase	(Outflow)

Since current assets have debit balances and current liabilities credit balances, a change in a current asset has an opposite effect on the working capital and cash flow as a similar change in a current liability. For example, an increase in a current asset is/has to be financed, thereby causing a cash outflow. An increase in a current liability indicates that cash was received (for example, by means of a loan) or withheld (for example, as a result of credit purchases).

Example 7.4 Disclosure of cash generated from or used in operations according to the indirect method

Use the information given in Example 7.3.

Required:

Prepare the cash generated from or used in operations section in the statement of cash flows of Cleo CC for the year ended 30 April 20.3 according to the indirect method to comply with the requirements of IFRS. Comparative figures are not required.

Solution:

Cleo CC
Extract from the statement of cash flows for the year ended 30 April 20.3

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Profit before tax	77 200	
Adjustments for (add back)*:		
Interest on long-term loan **(because the cash flow of this item is disclosed after the cash generated from operations)**	6 000	
Depreciation **(because it is a non-cash entry)**	2 400	
Fair value adjustment: Listed investments held for trading **(because it is a non-cash entry)**	(10 560)	
Dividend income: Listed investments **(because the cash flow of this item is disclosed after the cash generated from operations)**	(8 640)	
Profit on sale of non-current assets: Furniture **(because it is a non-cash entry)**	(400)	
	66 000	
	250	
Decrease in inventories R(48 000 – 45 120)	2 880	
Increase in trade and other receivables** R(17 760 – 14 400)	(3 360)	
Increase in trade and other payables*** R(14 400 – 13 670)	730	
Cash generated from operations	66 250	

* The credit losses are not added back. (Refer to paragraph 7.6.1.2(a)).

** The trade receivables and rental income in arrears pertain to the cash generated from operations, and are therefore taken into account.

*** Paragraph 8 under the additional information in Example 7.3 states that the trade and other payables pertain solely to creditors from whom trading inventory was purchased. Therefore the balances of the trade and other payables were used without making any adjustments. For example, creditors pertaining to the purchase of non-current assets would have been excluded from this calculation.

7.6.1.3 Operating activity items disclosed after cash generated from or used in operations

These items are identified on the statement of profit or loss and other comprehensive income and the statement of changes in equity (or net investment of members). All amounts must be disclosed as cash amounts by excluding any non-cash entries according to the methods shown in Tables 7.1 and 7.2.

(a) Disclosure of dividends received

Dividends received are disclosed as cash inflows from either operating or investing activities, depending on it being returns on operating or investing activities. In this chapter, to simplify matters, dividends received are disclosed in the cash flows from operating activities section.

(b) Disclosure of interest received and interest paid

Interest received is disclosed as a cash inflow from either an operating or investing activity, depending on the source of income. Likewise, finance costs paid (such as interest paid) are disclosed as cash outflows from either operating or financing activities, depending on the nature of the transactions causing the finance costs. For example, interest paid to obtain a financial resource can be classified as a cash outflow from a financing activity. In this chapter, to simplify matters, interest received and interest paid are disclosed in the cash flows from operating activities section. The total interest received and the total interest paid must be disclosed individually; that is, these two amounts may not be netted off as a single amount.

Example 7.5 Disclosure of operating activity items after the cash generated from or used in operations

Use the information given in Example 7.3.

Required:

Disclose the operating activity items after the cash generated from operations, and the net cash from operating activities, in the statement of cash flows of Cleo CC for the year ended 30 April 20.3, to comply with the requirements of IFRS. Comparative figures are not required.

Solution:

Cleo CC
Extract from the statement of cash flows for the year ended 30 April 20.3

	R	R
Cash generated from operations*	66 250	
Dividends received**	8 640	
Interest paid**	(6 000)	
Income tax paid**	(20 568)	
Distribution to members paid①	(30 890)	
Acquisition of financial assets at fair value through profit or loss:		
Held for trading: Listed investments②	(15 840)	
Net cash from operating activities		1 592

* Carried forward from Example 7.3 or 7.4.

** Since the dividend income and the interest and income tax expenses have no related account(s) in the current assets and/or the current liabilities, it is concluded that these items were received/paid.

Calculations:

① **Distribution to members paid**

	Source	R
Distribution to members	Statement of changes in net investment of members	24 000
Adjust to a cash amount		
Add: Distribution to members payable	Statement of financial position as at 30 April 20.2	10 330
Subtract: Distribution to members payable	Statement of financial position as at 30 April 20.3	(3 440)
Distribution to members paid in cash		**30 890**

② **Acquisition of listed investments**

Refer to the statements of financial position (listed investments are disclosed as current assets when held for trading) to determine whether any purchases occurred by calculating the difference between the opening and closing balances of the item. In additional information 4 it is stated that the trading in shares is part of the business model of Cleo CC. If this were not the case, the investment in listed shares held for trading would have been treated as an increase in an investment in the cash flows from investing activities.

Step 1: Calculate the difference between the opening and closing balances of the assets.

R(79 200 – 52 800) = R26 400

Step 2: Determine whether cash flow is included in the difference.

In the statement of profit or loss and other comprehensive income, R10 560 is disclosed as a fair value adjustment: listed investments held for trading. This is a non-cash entry that must be deducted from the difference:

R(26 400 – 10 560) = R15 840

The amount of R15 840 pertains to the acquisition of financial assets. Since listed shares are purchased with cash, the R15 840 is a cash outflow.

The investment account below illustrates the calculation of the acquisition by means of the balancing figure on the account.

Dr — Listed investments: Held for trading (reconstructed for calculation purposes) — Cr

20.2				**R**	20.3				**R**
May	1	Balance	b/d	52 800	Apr	30	Balance	c/d	79 200
		Gain (non-cash entry)		10 560					
		Bank (acquisition)		15 840*					
				79 200					79 200
20.3									
May	1	Balance	b/d	79 200					

* R(79 200 – 52 800 – 10 560) = R15 840

Shares can also be purchased without the intention of short-term profit taking (trading) as part of a business model, for example the purchase of unlisted shares. Shares not held for trading are classified as financial assets at amortised cost and disclosed as non-current assets in the statement of financial position. In such a case the purchase thereof is disclosed in the cash flows from investing activities section.

7.6.2 *Cash flows from investing activities*

IAS 7.21 states that an entity shall report separately on the major classes of gross cash receipts and gross cash payments arising from investing activities. (Exceptions, pertaining to reporting on a net basis, fall outside the scope of this chapter.) Relevant items are generally disclosed as non-current assets.

IAS 7 does not require distinguishing between property, plant and equipment purchased to *maintain* and *expand* the operating capacity of a business. Since such distinction could be useful, it is made in this chapter.

Formula:

Step 1: Determine the differences between the opening and closing balances of the investing activity items.

Step 2: Determine whether cash flows are included in the differences.

To determine whether a difference includes cash flow, the specifics of each item must be considered.

For example, if there was an increase in the vehicles at cost price, there is a possibility that the increase pertains to a cash outflow. The movements throughout the year in respect of the vehicles must be analysed to confirm this possibility. If the increase was caused solely by a purchase, a cash outflow occurred if it was a cash purchase. If the increase was the net result of a cash purchase and a cash sale, a cash outflow as well as a cash inflow occurred.

If an asset is disclosed at carrying amount, the difference between the opening and closing balances will not directly indicate a transaction that could have caused a cash flow, as was the case with an asset disclosed at cost, because asset accounts at carrying amounts include non-cash entries such as depreciation. Similarly, asset accounts at fair value include non-cash entries such as revaluations.

The financing method of the purchase of an investment indicates the cash outflow that occurred:

- ☐ If a purchase is made on credit, no cash flow occurs. The relevant asset account is debited and a liability account credited with the amount of the purchase. Although an investing activity takes place, it is not a cash activity, and therefore not disclosed on the statement of cash flows. Significant credit purchases must be disclosed in a note (refer to paragraph 7.6.5).

  When payments towards investing-related liability accounts are made, they are disclosed on the statement of cash flows as either investing or financing activities. To simplify matters, such payments are disclosed as investing activities in this chapter.
- ☐ If a purchase is made in cash, it is disclosed as a cash outflow on the statement of cash flows. If a loan was obtained to finance the purchase of an investment, two cash flow activities took place, namely the acquisition of the loan (being a cash inflow from a financing activity), and the cash purchase of the investment (being a cash outflow from an investing activity). The cash inflow that occurred when the loan was obtained may not be netted off against the cash outflow that occurred upon the purchase of the investment.

In a statement of cash flows, the cash inflow on the sale of an investment is disclosed. For example, if equipment with a carrying amount of R2 000 was sold on credit for R1 500, and R1 000 of the R1 500 was received in cash during the financial year under review, only the cash received, namely R1 000, is disclosed as a cash inflow on the statement of cash flows. The selling price of R1 500 and the loss of R500 on the sale of the equipment are not disclosed on the statement of cash flows because no bank account entries are made when the sale and the loss are recorded. Should the equipment have been sold for R1 500, cash, the cash received is equal to the selling price thereof and shown as a cash inflow on the statement of cash flows.

Calculation of the selling price of an asset sold at a profit:

Carrying amount + Profit on sale = Selling price

Calculation of the selling price of an asset sold at a loss:

Carrying amount – Loss on sale = Selling price

The carrying amounts of the non-current assets that were sold are disclosed in the note pertaining to property, plant and equipment. Any profits or losses made are disclosed on the statement of profit or loss and other comprehensive income.

Example 7.6 Preparation of cash flows from investing activities

Use the information given in Example 7.3.

Required:

Prepare the cash flows from investing activities section of the statement of cash flows of Cleo CC for the year ended 30 April 20.3 to comply with the requirements of IFRS. Comparative figures and notes thereto are not required.

Solution:

Cleo CC
Extract from the statement of cash flows for the year ended 30 April 20.3

CASH FLOWS FROM INVESTING ACTIVITIES	**R**	**R**
Investment in property, plant and equipment to expand operating capacity – additions to land and buildings①	(52 725)	
Proceeds from the sale of furniture②	3 200	
Net cash used in investing activities		(49 525)

Calculations:

① **Additions to land and buildings**

Step 1: Determine the difference.

	R
Land and buildings at cost (Statement of financial position; note on property, plant and equipment – 20.3)	129 525
Subtract: Land and buildings at cost (Statement of financial position; note on property, plant and equipment – 20.2)	(76 800)
Increase in land and buildings	**52 725**

Step 2: Determine whether cash flow is included in the difference.

Since the trade and other payables in this example pertain only to creditors from whom trading inventories were purchased, it is concluded that land and buildings were purchased with cash. Because no land and buildings were sold or scrapped during the financial year, the increase is disclosed as an expansion of the operating capacity, and not as the maintenance thereof due to replacement.

② **Proceeds from the sale of furniture**

Step 1: Determine the difference.

The carrying amount of the sold furniture can be calculated by reconstructing the furniture and equipment at carrying amount account:

Dr **Furniture and equipment at carrying amount (reconstructed for calculation purposes)** **Cr**

				R					**R**
20.2 May	1	Balance	b/d	16 800			Realisation*		2 800
					20.3 Apr	30	Depreciation		2 400
							Balance	c/d	11 600
				16 800					16 800
20.3 May	1	Balance	b/d	11 600					

* Balancing entry

A similar calculation can be made in columnar format:

		R
Furniture and equipment at carrying amount (Statement of financial position; note on property, plant and equipment – 30 April 20.2)		16 800
Subtract:	Depreciation	(2 400)
	Furniture and equipment at carrying amount (Statement of financial position; note on property, plant and equipment - 30 April 20.3)	(11 600)
Carrying amount of furniture sold		**2 800**

The selling price of the sold furniture is:

Carrying amount + Profit on sale = Selling price
R(2 800 + 400) = R3 200

Alternatively, reconstruct the realisation account pertaining to the sales transaction:

Realisation of furniture
Dr (reconstructed for calculation purposes) Cr

				R					R
		Furniture and equipment at carrying amount		2 800			Bank*		3 200
		Profit on sale of furniture		400					
				3 200					3 200

* Balancing entry. Refer to Step 2 below for a discussion on the cash flow of this transaction.

Step 2: Determine whether cash flow is included in the difference.

According to paragraphs 3 and 5 of the additional information, it is business policy not to sell any furniture and equipment on credit, and the trade receivables control account pertains to debtors who purchased trading inventory. It is therefore concluded that the furniture was sold for R3 200, cash.

7.6.3 *Cash flows from financing activities*

Cash flows from financing activities disclose future claims on cash and how activities were financed.

IAS 7.21 states that an entity shall report separately on the major classes of gross cash receipts and gross cash payments arising from financing activities. (Exceptions, pertaining to reporting on a net basis, fall outside the scope of this chapter.)

Items taken into account are equity, non-current and current liabilities. Regarding equity, note that:

- In the case of a close corporation, the change in the retained earnings is not taken into account because the transactions that cause the change are disclosed in the other sections of the statement of cash flows, mainly in the cash flows from operating activities.

☐ A transfer to or from a revaluation surplus does not involve cash and is therefore not disclosed on a statement of cash flows.

Formula:

Step 1: Determine the differences between the opening and closing balances of the financing-activity items.

A difference will indicate that movement took place.

In respect of long-term borrowings, the current portion thereof is added to the non-current portion when a difference is calculated.

Illustration:

	20.5 **R**	**20.4** **R**
Non-current liabilities	140 000	150 000
Long-term borrowings	140 000	150 000
Current liabilities	10 000	
Current portion of long-term borrowings	10 000	–

The difference between the long-term borrowings at 20.4 and 20.5 is Rnil [R150 000 – R(140 000 + 10 000)], showing that no movement occurred.

Step 2: Determine whether cash flow is included in the difference.

To determine whether a difference pertains to a cash flow, specifics must be considered. For example, by means of information obtained from accounting records or notes to the financial statements.

Example 7.7 Preparation of cash flows from financing activities

Use the information given in Example 7.3.

Required:

Prepare the cash flows from financing activities section of the statement of cash flows of Cleo CC for the year ended 30 April 20.3 to comply with the requirements of IFRS. Comparative figures and notes thereto are not required.

Solution:

Cleo CC

Extract from the statement of cash flows for the year ended 30 April 20.3

CASH FLOWS FROM FINANCING ACTIVITIES	**R**	**R**
Proceeds from members' contributions①	48 000	
Repayment of long-term borrowing②	(16 800)	
Net cash from financing activities		31 200

Calculations:

① **Proceeds from members' contributions**

Step 1: Determine the difference.

	R
Members' contributions (Statement of financial position as at 30 April 20.3)	192 000
Subtract: Members' contributions (Statement of financial position as at 30 April 20.2)	(144 000)
Increase in members' contributions*	**48 000**

* The statement of changes in net investment of members also shows the contribution of R48 000.

Step 2: Determine whether cash flow is included in the difference.

Paragraph 7 of the additional information states that the members' contributions were made in cash. The increase is thus a cash inflow.

② **Repayment of long-term borrowing**

Step 1: Determine the difference.

	R
Long-term borrowings (Statement of financial position as at 30 April 20.2)	28 800
Subtract: Long-term borrowings (Statement of financial position as at 30 April 20.3: R9 600 + R2 400*)	(12 000)
Decrease in long-term borrowings	**16 800**

* The current portion of the long-term borrowing is added to the non-current portion when calculating the difference. Remember that the closing balance of the long-term loan in the general ledger is R12 000.

Step 2: Determine whether cash flow is included in the difference.

In the absence of further information, it is assumed that a repayment was made. The decrease is thus a cash outflow.

7.6.4 *Cash and cash equivalents*

IAS 7.45 requires that an entity shall disclose the components of cash and cash equivalents in its statement of cash flows. The meanings of "cash" and "cash equivalents" are given in paragraph 7.3.

The format of the statement of cash flows in paragraph 7.3 shows:

Net cash from/used in operating activities **+** *Net cash from/used in investing activities* **+** *Net cash from/used in financing activities* **=**
Net increase/decrease in cash and cash equivalents + **Cash and cash equivalents at beginning of financial period =**
Cash and cash equivalents at end of financial period

Example 7.8 Presentation of cash and cash equivalents

Use the information given in Example 7.3.

Required:

Disclose the net decrease in cash and cash equivalents, as well as the cash and cash equivalents at the beginning and end of the year on the statement of cash flows of Cleo CC for the year ended 30 April 20.3 to comply with the requirements of IFRS. Comparative figures and notes thereto are not required.

Solution:

Cleo CC
Extract of the statement of cash flows for the year ended 30 April 20.3

	R	R
*Net cash from operating activities**		1 592
*Net cash used in investing activities**		(49 525)
*Net cash from financing activities**		31 200
Net decrease in cash and cash equivalents		(16 733)
Cash and cash equivalents at beginning of year		13 650
Cash and cash equivalents at end of year		(3 083)

* The shaded area is not required and given for illustrative purposes. The amounts pertaining to operating, investing and financing activities were obtained from the solutions to Examples 7.5, 7.6 and 7.7.

The cash and cash equivalents at the beginning (R13 650) and end ((R3 083)) of the year are equal to the amounts disclosed on the statements of financial position:

Cleo CC
Extract of the statement of financial position as at 30 April 20.3

	20.3 R	20.2 R
Current assets		
Cash and cash equivalents	–	13 650
Current liabilities		
Bank overdraft	3 083	–

7.6.5 *Notes pertaining to a statement of cash flows*

IAS 7 requires that under certain circumstances additional information to a statement of cash flows be prepared.

Only the requirements of IAS 7.43, namely that non-cash investing and financing activities must be disclosed elsewhere on the financial statements in a way that provides all the relevant information about these activities, are illustrated in this chapter. An example is the purchase of a non-current asset on credit with no repayment made during the financial year. In the case of a partial repayment, the repayment is disclosed as a cash outflow, and the outstanding amount as additional information.

Although the other disclosure requirements are not addressed in this chapter, note that paragraph 45 of the Standard requires a reconciliation of the components of the cash and cash equivalents as disclosed on the statement of cash flows with the equivalent items as disclosed on the statements of financial position. IAS 7.46 states that in view of the variety of cash management practices and banking arrangements around the world, an entity must disclose the policy which it adopts in determining the composition of its cash and cash equivalents. According to IAS 7.47, the effect of any change in such a policy must be reported in agreement with IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors*.

Example 7.9 Comprehensive example – statement of cash flows of a partnership

The following financial statements pertain to a partnership trading as Ukubuya Traders:

Ukubuya Traders
Statement of profit or loss and other comprehensive income for the year ended 31 December 20.9

		R
Revenue		550 000
Cost of sales		(360 350)
Inventory (1 January 20.9)	240 500	
Purchases	300 250	
	540 750	
Inventory (31 December 20.9)	(180 400)	
Gross profit		189 650
Other income		11 500
Interest income: Fixed deposit	5 500	
Rental income	6 000	
		201 150
Distribution, administrative and other expenses		(200 325)
Transport expenses	29 950	
Salaries and wages	75 975	
Stationery consumed	10 900	
Insurance	21 050	
Depreciation (Furniture and equipment)	20 000	
Water and electricity	18 400	
Credit losses	5 000	
Loss on sale of non-current asset: Furniture	1 300	
Internet and telephone expenses	12 000	
General expenses	5 750	
Finance costs		(7 425)
Interest on mortgage	7 425	
Loss for the year		(6 600)
Other comprehensive income for the year		–
Total comprehensive loss for the year		(6 600)

Ukubuya Traders
Statement of changes in equity for the year ended 31 December 20.9

	Capital		Current accounts		Revaluation surplus	Appropriation	Total equity
	S Zulu	W Phezi	S Zulu	W Phezi			
	R	R	R	R	R	R	R
Balances at 1 January 20.9	100 000	200 000	(5 500)	2 600	10 000	–	307 100
Capital contribution	310 000	25 000					335 000
Total comprehensive loss for the year						(6 600)	(6 600)
Interest on capital*			7 000	15 400		(22 400)	–
Interest on current accounts*			(350)	130		220	–
Salaries*			120 000	120 000		(240 000)	–
Partners' share of total comprehensive loss for the year			(134 390)	(134 390)		268 780	–
Drawings (in cash)**			(50 350)	(60 900)			(111 250)
Balances at 31 December 20.9	410 000	225 000	(63 590)	(57 160)	10 000	–	524 250

* These amounts are determined as per partnership agreement. Therefore the amounts do not represent whether they have been paid/received in cash.

** All withdrawals (cash or non-cash) by partners are recorded in the drawings account. In this example, all the drawings were made in cash.

Ukubuya Traders
Statement of financial position as at 31 December 20.9

	Note*	20.9	20.8
ASSETS		R	R
Non-current assets		460 500	251 500
Property, plant and equipment	1	411 500	212 500
Fixed deposit		49 000	39 000
Current assets		235 300	263 110
Inventories		180 400	240 500
Trade and other receivables		42 800	22 610
Prepayments (general expenses)		1 700	–
Cash and cash equivalents		10 400	–
Total assets		695 800	514 610
EQUITY AND LIABILITIES			
Total equity		524 250	307 100
Capital		635 000	300 000
Current accounts		(120 750)	(2 900)
Other components of equity (revaluation surplus)		10 000	10 000
Total liabilities		171 550	207 510
Non-current liabilities		150 000	–
Long-term borrowings (mortgage)		150 000	–
Current liabilities		21 550	207 510
Trade and other payables		21 550	29 500
Income received in advance (rental income)		–	700
Bank overdraft		–	177 310
Total equity and liabilities		695 800	514 610

Amounts shown in brackets are debit balances.

* With exception of the note pertaining to property, plant and equipment, all notes are excluded.

Ukubuya Traders
Note for the year ended 31 December 20.9

Property, plant and equipment

	Land and buildings	**Furniture and equipment**	**Total**
	R	**R**	**R**
Carrying amount at 1 January 20.9	90 000	122 500	212 500
Cost/Valuation	90 000	175 000	265 000
Accumulated depreciation	–	(52 500)	(52 500)
Additions	200 000	25 000	225 000
Disposals	–	(6 000)	(6 000)
Depreciation for the year	–	(20 000)	(20 000)
Carrying amount at 31 December 20.9	290 000	121 500	411 500
Cost/Valuation	290 000	190 000	480 000
Accumulated deprecation	–	(68 500)	(68 500)

Additional information:

1. All sales of trading inventory are on credit. Only the purchases and sales of trading inventory are recorded in the purchases and sales accounts of Ukubuya Traders.
2. The trade and other receivables comprise:

	20.9 **R**	**20.8** **R**
Trade receivables control (debtors pertaining to the sales of trading inventory)	44 000	23 740
Allowance for credit losses	(2 200)	(1 130)
Income in arrears (rental)	1 000	–
Total	42 800	22 610

3. The trade and other payables comprise:

	20.9 **R**	**20.8** **R**
Trade payables control (creditors pertaining to the purchases of trading inventory)	21 000	28 700
Expenses in arrears (water and electricity)	550	800
Total	21 550	29 500

4. The furniture was sold/disposed of for cash.
5. On 1 January 20.9, Phezi contributed furniture with a value of R25 000 to the partnership. On 31 December 20.9, Zulu contributed R310 000 in cash to the partnership.
6. All the proceeds from the mortgage were used to pay for a portion of the additions to the land and buildings. No repayments were made on the mortgage during the financial year.

Required:

(a) Prepare the statement of cash flows of Ukubuya Traders for the year ended 31 December 20.9 to comply with the requirements of IFRS, appropriate to the business of the partnership. The cash generated from or used in operations must be disclosed according to the *direct* method. Only the note pertaining to non-cash investing transactions must be disclosed. Comparative figures are not required.

(b) Prepare the statement of cash flows of Ukubuya Traders for the year ended 31 December 20.9 to comply with the requirements of IFRS, appropriate to the business of the partnership. The cash generated from or used in operations must be disclosed according to the *indirect* method. Notes and comparative figures are not required.

Solution:

(a) Direct method

Ukubuya Traders
Statement of cash flows for the year ended 31 December 20.9

	Note	R	R
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash receipts from customers①		530 110	
Cash paid to suppliers and employees②		(483 925)	
Cash generated from operations		46 185	
Interest received*		5 500	
Interest paid*		(7 425)	
Drawings		(111 250)	
Net cash used in operating activities			(66 990)
CASH FLOWS FROM INVESTING ACTIVITIES**			
Investment in property, plant and equipment to expand operating capacity – additions to land and buildings③	1	(200 000)	
Proceeds from the sale of furniture④		4 700	
Acquisition: Fixed deposit R(49 000 – 39 000)		(10 000)	
Net cash used in investing activities			(205 300)
CASH FLOWS FROM FINANCING ACTIVITIES			
Capital contribution		310 000	
Proceeds from mortgage		150 000	
Net cash from financing activities			460 000
Net increase in cash and cash equivalents			187 710
Cash and cash equivalents at beginning of year			(177 310)
Cash and cash equivalents at end of year			10 400

* Since no current asset or current liability account pertains to the interest income and the interest on the mortgage, it is concluded that the interest income was received and that the interest on the mortgage was paid.

** The furniture contributed by Phezi is a non-cash transaction and therefore excluded from the investing and financing activities.

Ukubuya Traders
Note for the year ended 31 December 20.9

1. Non-cash transaction pertaining to investing and financing activities

   Furniture to the value of R25 000 was contributed by Phezi on 1 January 20.9.

Calculations:

① **Cash receipts from customers**

Step 1 **Identify** (From statement of profit or loss and other comprehensive income for 20.9 ended) **Item**		**Step 2.1** **Adjust** (From statement of financial position as at 20.8) **+ Income in arrears** **– Income received in advance**	**Step 2.2** **Adjust** (From statement of financial position as at 20.9) **– Income in arrears** **+ Income received in advance**	**Cash receipts from customers**
	R	**R**	**R**	**R**
Revenue	550 000	+ 23 740	– 44 000 – 3 930	= 525 810
Rental income	6 000	– 700	– 1 000	= 4 300
				530 110

Comment:

The interest income is taken into account after the cash generated from or used in operations.

For explanatory purposes, a more detailed calculation of the cash inflows from revenue is given:

☐ Cash inflows from revenue:

		R
Revenue		550 000
Add: Trade receivables control (opening balance)		23 740
Subtract:	Credit losses*	(3 930)
	Trade receivables control (closing balance)	(44 000)
Cash inflows from revenue		**525 810**

* The credit losses on the statement of profit or loss and other comprehensive income are disclosed as R5 000. This amount comprises those trade receivables accounts that were written off during the year and the increase in the allowance for credit losses account (the increase of the allowance account is R2 200 – R1 130 = R1 070). To calculate the cash flows from revenue, only credit losses pertaining to those trade receivables accounts that were written off must be taken into account. That is R(5 000 – 1 070) = R3 930. The cash flows from revenue can also be calculated by reconstructing the credit losses and trade receivables control accounts:

Credit losses (reconstructed for calculation purposes)

Dr									Cr
20.9				R	20.9				R
Dec		Trade receivables control*		3 930	Dec	31	Profit or loss		5 000
	31	Allowance for credit losses		1 070					
				5 000					5 000

* Balancing entry

Trade receivables control (reconstructed for calculation purposes)

Dr									Cr
20.8				R					R
Jan	1	Balance	b/d	23 740			Credit losses		3 930
		Sales		550 000			Bank*		525 810
					20.8 Dec	31	Balance	c/d	44 000
				573 740					573 740
20.9 Jan	1	Balance	b/d	44 000					

* Balancing entry

② Cash paid to suppliers and employees

Step 1 Identify (From statement of profit or loss and other comprehensive income for 20.9 ended) **Item**		**Step 2.1 Adjust** (From statement of financial position as at 20.8) **+ Expenses in arrears − Prepayments**	**Step 2.2 Adjust** (From statement of financial position as at 20.9) **− Expenses in arrears + Prepayments**	**Cash paid to suppliers and employees**
	R	**R**	**R**	**R**
Purchases	300 250	+ 28 700	– 21 000	= 307 950
Transport expenses	29 950			= 29 950
Salaries and wages	75 975			= 75 975
Stationery consumed	10 900			= 10 900
Insurance	21 050			= 21 050
Water and electricity	18 400	+ 800	– 550	= 18 650
Internet and telephone expenses	12 000			= 12 000
General expenses	5 750		+ 1 700	= 7 450
				483 925

The depreciation, credit losses, and the loss on sale of furniture are excluded because they are non-cash entries. The interest on the mortgage is excluded because it is taken into account after the cash generated from or used in operations.

③ **Additions to land and buildings**

According to the note pertaining to property, plant and equipment, additions to the land and buildings amount to R200 000. Paragraph 6 of the additional information states that all the proceeds (R150 000) from the mortgage were used to pay for a portion of the additions to the land and buildings. Since there is no liability pertaining to the balance of R50 000 (R200 000 – R150 000), in respect of the additions to the land and buildings, it is concluded that this amount (R50 000) was paid. Therefore R200 000 R(150 000 + 50 000) is disclosed as a cash outflow in the Cash Flows from Investing Activities section. The proceeds from the mortgage is shown as a cash inflow of R150 000 in the Cash Flows from Financing Activities section.

④ **Proceeds from the sale of furniture**

Carrying amount – Loss on sale of furniture = Selling price

R(6 000 – 1 300) = R4 700

(b) Indirect method

Ukubuya Traders
Statement of cash flows for the year ended 31 December 20.9

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Loss for the year	(6 600)	
Adjustments for:		
Interest on mortgage*	7 425	
Loss on sale of non-current asset: Furniture	1 300	
Depreciation (Furniture and equipment)	20 000	
Interest income*	(5 500)	
	16 625	
Decrease in inventories R(240 500 – 180 400)	60 100	
Increase in trade and other receivables R(42 800 – 22 610)	(20 190)	
Increase in prepayments (general expenses)	(1 700)	
Decrease in trade and other payables R(29 500 – 21 550)	(7 950)	
Decrease in income received in advance (rental income)	(700)	
Cash generated from operations	46 185	
Interest received	5 500	
Interest paid	(7 425)	
Drawings	(111 250)	
Net cash used in operating activities		(66 990)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in property, plant and equipment to expand operating capacity – additions to land and buildings	(200 000)	
Proceeds from the sale of furniture	4 700	
Acquisition: Fixed deposit R(49 000 – 39 000)	(10 000)	
Net cash used in investing activities		(205 300)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital contribution	310 000	
Proceeds from mortgage	150 000	
Net cash from financing activities		460 000
Net increase in cash and cash equivalents		187 710
Cash and cash equivalents at beginning of year		(177 310)
Cash and cash equivalents at end of year		10 400

* To be disclosed after the cash generated from operations.

Comment:

Concerning the increase in trade and other receivables, note that the credit losses were not added back (refer to paragraph 7.6.1.2(a)).

Example 7.10 Comprehensive example – statement of cash flows of a close corporation

The following financial statements pertain to Crazehill Enterprises CC:

Crazehill Enterprises CC
Statement of profit or loss and other comprehensive income for the year ended 28 February 20.5

	Note*		R
Revenue			872 992
Cost of sales			(319 236)
Inventory (1 March 20.4)		21 250	
Purchases		299 423	
Carriage on purchases		11 188	
		331 861	
Inventory (28 February 20.5)		(12 625)	
Gross profit			553 756
Other income			56 538
Dividend income: Listed shares		15 000	
Interest income		21 538	
Fair value adjustment: Listed investment		20 000	
			610 294
Distribution, administrative and other expenses			(323 115)
Credit losses		4 491	
Carriage on sales		11 562	
Salaries to employees		150 000	
Salaries to members		105 000	
Telephone expenses		11 750	
Stationery consumed		4 937	
Remuneration: Accounting officer		17 500	
Depreciation		17 875	
Finance costs			(21 000)
Interest on mortgage		13 500	
Interest on loan from member		7 500	
Profit before tax			266 179
Income tax expense			(67 042)
Profit for the year			199 137
Other comprehensive income for the year			40 000
Revaluation surplus		40 000	
Total comprehensive income for the year			239 137

* For the purpose of this example, only the note pertaining to property, plant and equipment is disclosed. All further necessary information to prepare the statement of cash flows is given as additional information.

Crazehill Enterprises CC
Statement of changes in net investment of members
for the year ended 28 February 20.5

	Members' contributions	Retained earnings	Revaluation surplus	Loans from members	Loans to members	Total
	R	R	R	R	R	R
Balances at 1 March 20.4	93 750	446 912	20 000	37 500	(125 000)	473 162
Changes in accounting policy						
Adjusted balances	93 750	446 912	20 000	37 500	(125 000)	473 162
Members' contributions	–					–
Total comprehensive income for the year		199 137	40 000			239 137
Profit for the year		199 137				199 137
Other comprehensive income for the year			40 000			40 000
Distribution to members		(75 000)		75 000		
Loans to members					(46 250)	(46 250)
Balances at 28 February 20.5	93 750	571 049	60 000	112 500	(171 250)	666 049
Non-current liability				45 000		
Current liability				67 500		

Crazehill Enterprises CC
Statement of financial position as at 28 February 20.5

	Note*	20.5	20.4
		R	R
ASSETS			
Non-current assets			
Property, plant and equipment		670 875	580 000
Current assets		353 777	281 237
Inventories		12 625	21 250
Trade and other receivables		44 527	27 957
Loans to members		171 250	125 000
Listed investment		120 000	100 000
Cash and cash equivalents		5 375	7 030
Total assets		1 024 652	861 237

continued

	Note*	20.5 R	20.4 R
EQUITY AND LIABILITIES			
Total equity		724 799	560 662
Members' contributions		93 750	93 750
Retained earnings		571 049	446 912
Other components of equity		60 000	20 000
Total liabilities		299 853	300 575
Non-current liabilities		120 000	37 500
Long-term borrowings		120 000	37 500
Current liabilities		179 853	263 075
Trade and other payables		68 386	48 150
Current portion of long-term borrowings		67 500	168 000
Current tax payable		43 967	46 925
Total equity and liabilities		1 024 652	861 237

* For the purpose of this example, only the note pertaining to property, plant and equipment is disclosed. All further necessary information to prepare the statement of cash flows is given as additional information.

Crazehill Enterprises CC
Notes for the year ended 28 February 20.5 (Extract)

Property, plant and equipment

	Land and buildings	Equipment	Total
	R	R	R
Carrying amount at 1 March 20.4	500 000	80 000	580 000
Cost/Valuation	500 000	100 000	600 000
Accumulated depreciation	–	(20 000)	(20 000)
Revaluation surplus for the year	40 000	–	40 000
Additions	50 000	18 750	68 750
Depreciation for the year	–	(17 875)	(17 875)
Carrying amount at 28 February 20.5	590 000	80 875	670 875
Cost/Valuation	590 000	118 750	708 750
Accumulated depreciation	–	(37 875)	(37 875)

The land and buildings consist of a shop and offices on Plot No. 40, Menlyn, and were purchased on 4 July 20.2. On 31 January 20.5, expansions to the building were completed and paid for. The total cost of the expansions amounted to R50 000. The land and buildings were re-valued by an independent appraiser during 20.5. The land and buildings serve as security for the mortgage. The additions to the equipment were cash transactions.

Additional information:

1. Trade and other receivables

	20.5 R	20.4 R
Trade receivables control (debtors pertaining to the sales of trading inventory)	31 260	20 457
Allowance for credit losses	(1 563)	(2 500)
Allowance for settlement discount granted	(170)	–
	29 527	17 957
Income in arrears (dividends receivable)	15 000	10 000
	44 527	27 957

2. The interest on the loans to members for the 20.5 financial year amounted to R21 250. The interest was capitalised.
3. Trade and other payables

	20.5 R	20.4 R
Trade payables control (creditors pertaining to the purchases of trading inventory)	31 188	40 650
Allowance for settlement discount received	(52)	–
Accrued expenses	37 250	7 500
Carriage on purchases	938	–
Carriage on sales	312	–
Salary: Hill	15 000	–
Interest on mortgage	13 500	–
Interest on loan from member	7 500	7 500
	68 386	48 150

4. Loans to members

	20.5 R	20.4 R
Loans to members*	171 250	125 000

* The members of the close corporation are Y Craig, D Zeelie and S Hill. During the 20.5 financial year a further loan was made to Hill. The loans granted to the members are regarded as operating activities.

5. Listed investment

   The listed investment is held for trading at fair value through profit or loss. The investment comprises 50 000 ordinary shares in Watsons Ltd (consideration R90 000).
6. The entry: *Other components of equity* pertains to the revaluation surplus.
7. Long-term borrowings (statement of financial position)

	20.5 R	20.4 R
Mortgage	75 000	–
Loans from members	45 000	37 500
	120 000	37 500

8. Current portion of long-term borrowings

	20.5 **R**	**20.4** **R**
Loans from members	67 500	–
Long-term loan (from General Bank)	–	168 000

Required:
Prepare the statement of cash flows of Crazehill Enterprises CC for the year ended 28 February 20.5 to comply with the requirements of IFRS. The cash generated from or used in operations must be disclosed according to the indirect method. Only the note pertaining to the non-cash financing transaction must be disclosed. Comparative figures are not required.

Solution:

Crazehill Enterprises CC
Statement of cash flows for the year ended 28 February 20.5

	Note	R	R
CASH FLOWS FROM OPERATING ACTIVITIES			
Profit before tax		266 179	
Adjustments for:			
Interest on loan from member		7 500	
Interest on mortgage		13 500	
Depreciation		17 875	
Fair value adjustment: Listed investment		(20 000)	
Interest income		(21 538)	
Dividend income		(15 000)	
		248 516	
Decrease in inventories R(21 250 – 12 625)		8 625	
Increase in trade and other receivables①		(11 570)	
Increase in trade and other payables②		6 736	
Cash generated from operations		252 307	
Dividends received③		10 000	
Interest received R(21 538 – 21 250*)		288	
Interest paid④		(7 500)	
Income tax paid⑤		(70 000)	
Loan to member⑥		(25 000)	
Net cash from operating activities			160 095
CASH FLOWS FROM INVESTING ACTIVITIES			
Investments in property, plant and equipment to expand operating capacity		(68 750)	
Addition to land and buildings		(50 000)	
Additions to equipment		(18 750)	
Net cash used in investing activities			(68 750)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from mortgage		75 000	
Loans from members⑦	1	–	
Repayment of long-term borrowing		(168 000)	
Net cash used in financing activities			(93 000)
Net decrease in cash and cash equivalents			(1 655)
Cash and cash equivalents at beginning of year			7 030
Cash and cash equivalents at end of year			5 375

* See paragraph 2 under Additional Information.

Crazehill Enterprises CC
Note for the year ended 28 February 20.5

1. Non-cash transaction pertaining to a financing activity
   The distribution to the members was capitalised against the loans from the members.

Calculations:

① **Increase in trade and other receivables**
R[(44 527 – 15 000*) – (27 957 – 10 000*)]
= R(29 527 – 17 957)
= R11 570

* The trade and other receivables include dividends receivable. The dividends received must be disclosed after the cash generated from operations, and are therefore excluded.

② **Increase in trade and other payables**
R[(68 386 – 21 000*) – (48 150 – 7 500*)]
= R(47 386 – 40 650)
= R6 736

* Since interest paid must be disclosed after the cash generated from operations, the interest payable is excluded.

③ **Dividends received**

	R
Dividend income	15 000
Add: Dividends receivable (opening balance)	10 000
Subtract: Dividends receivable (closing balance)	(15 000)
Dividends received	**10 000**

④ **Interest paid**

	R
Interest on mortgage plus interest on loan from member R(13 500 + 7 500)	21 000
Add: Interest payable (opening balance – interest on loan from member)	7 500
Subtract: Interest payable (closing balance – interest on mortgage plus interest on loan from member)	(21 000)
Interest paid	**7 500**

⑤ **Income tax paid**

	R
Income tax expense	67 042
Add: Current tax payable (opening balance)	46 925
Subtract: Current tax payable (closing balance)	(43 967)
Income tax paid	**70 000**

⑥ **Loan to member**

	R
Loans to members (closing balance)	171 250
Subtract: Loans to members (opening balance)	(125 000)
Increase	46 250
Subtract: Interest capitalised (non-cash entry)	(21 250)
Granting of loan to member (Hill)	**25 000**

⑦ **Loans (borrowings) from members**

	R
Loans from members [closing balance: R(45 000 + 67 500)]	112 500
Subtract: Loans from members (opening balance)	(37 500)
Increase	75 000
Subtract: Distribution to members (non-cash entry)	(75 000)
	Nil

7.7 Summary

IAS 7

Requires that information about the historical changes in the cash and cash equivalents of a business entity over a specific financial period be provided by means of a statement of cash flows.

Cash and cash equivalents

- **Cash**
  Cash on hand and demand deposits.
- **Cash equivalents**
  Short-term, highly liquid investments readily convertible to known amounts of cash which are subject to an insignificant risk of changes in value.

Main objective of a statement of cash flows

To disclose how the cash and cash equivalents of a business entity were generated and utilised.

Cash basis

The statement of cash flows discloses information according to a cash basis of accounting, whereas the other financial statements are prepared according to the accrual basis of accounting. This means that when a statement of cash flows is prepared from the other financial statements, the accrued amounts must be adjusted to cash amounts.

Usefulness

Information disclosed on a statement of cash flows is useful to assess the soundness of the financial performance of a business and therefore complements the other financial statements.

Period

A statement of cash flows is prepared for a financial period, and not on a specific date.

Three main sections

A statement of cash flows comprises:

- **Cash flows from operating activities**
- **Cash flows from investing activities**
- **Cash flows from financing activities**

Notes

IAS 7 requires that additional information to the statement of cash flows be disclosed as notes, for example non-cash transactions in respect of investing and financing activities.

continued

Presentation

NAME OF ENTITY

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED...

CASH FLOWS FROM OPERATING ACTIVITIES • **Cash generated from/(used in) operations** DIRECT OR INDIRECT • **Specific items** *Net cash from/(used in) operating activities* *Plus/minus*
CASH FLOWS FROM INVESTING ACTIVITIES • Investments in property, plant and equipment (PPE) to maintain operating capacity • Investments in PPE to expand operating capacity • Proceeds from the sale of PPE • Acquisition of investments • Proceeds from the realisation of investments *Net cash from/(used in) investing activities* *Plus/minus*
CASH FLOWS FROM FINANCING ACTIVITIES • Proceeds from capital contributions • Proceeds from loans, debentures, mortgages, etc. • Repayments of short-term borrowings • Repayments of long-term borrowings • Repayments of the capital elements of finance lease liabilities *Net cash from/(used in) financing activities* *Equals*
Net increase/(decrease) in cash and cash equivalents *Plus/minus* **Cash and cash equivalents at beginning of year** *Equals*
Cash and cash equivalents at end of year

continued

Links (where to identify the items to disclose on the statement of cash flows)

Main section of statement of cash flows		Other financial statements
CASH FLOWS FROM OPERATING ACTIVITIES *Cash generated from/ (used in) operations*	→	***Statement of profit or loss and other comprehensive income*** All items that determine the profit (before tax) for the year Exceptions: Non-cash entries Specific items
Specific items	→	***Statement of profit or loss and other comprehensive income*** • Other income • Finance costs • Income tax expense
	→	***Statement of changes in equity/ net investment of members*** • Drawings • Distribution to members
	→	***Statements of financial position*** • Current assets (Equity held for trading)
CASH FLOWS FROM INVESTING ACTIVITIES	→	***Statements of financial position*** • Non-current assets
CASH FLOWS FROM FINANCING ACTIVITIES	→	***Statements of financial position*** • Total equity • Non-current liabilities • Current liabilities
CASH AND CASH EQUIVALENTS	→	***Statements of financial position*** • Current assets • Current liabilities

CHAPTER **8**

Analysis and interpretation of financial statements

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Overview of analysis and interpretation of financial statements

Financial statement analysis entails the examination of financial statements with the objective of disclosing significant relationships and trends in the activities of the entity to establish if the entity is profitable, liquid and solvent.

Application of financial statement analysis

Profitability ratios: Measure the ability to generate profits
- Return on equity
- Return on assets
- Gross profit percentage
- Profit margin
- Financial leverage and leverage effect

Liquidity ratios: Measure the ability to pay short-term obligations on time
- Current ratio
- Acid test or quick ratio
- Trade receivables collection period
- Trade payables settlement period
- Inventory turnover rate
- Inventory-holding period

Solvency ratios: Measure the ability to pay long-term obligations on time and to remain solvent
- Debt-equity ratio
- Times interest earned ratio

8.1 Introduction

STUDY OBJECTIVES

After studying this chapter, you should be able to:

☐ explain what is meant by ratio analysis;

☐ briefly explain the nature and scope of financial analysis;

☐ explain the objectives of financial statement analysis and interpretation; and

☐ describe, calculate and interpret the following groups of financial ratios:
- profitability ratios:
  return on equity;
  return on total assets;
  gross profit percentage;
  profit percentage;
  financial leverage and leverage effect.
- liquidity ratios:
  current ratio;
  acid test or quick ratio;
  trade receivables collection period;
  trade payables settlement period;
  inventory turnover rate;
  inventory-holding period.
- solvency ratios:
  debt-equity ratio;
  times interest earned ratio.

An entity uses its annual financial statements to convey information about its financial activities to the users of such financial statements. Financial statements are the most used and comprehensive way of communicating information about the financial performance and financial position of an entity. Although financial statements provide information about the performance (statement of profit or loss and other comprehensive income), financial position (statement of financial position) and cash flow (statement of cash flows) of an entity for a specific financial period, information about the risks and future prospects of its business activities cannot be immediately obtained by merely reading the financial statements. To make a thorough evaluation of and to come to a meaningful conclusion about an entity's financial performance and financial position, the user needs to look at more than just easily available figures like sales, profits, total assets and liabilities. The user of financial information must be able to read "between the lines" of an entity's financial statements to make more informed decisions about the financial performance and financial position of an entity. Meaningful information from financial statements can be obtained by analysing the data in financial statements and interpreting the analysed data in relation to previous years and/or comparing it with norms and standards set for the industry in which the entity operates. The purpose of financial statement analysis is to examine the past and current financial data, presented in the financial statements of an entity, with the aim of evaluating the performance and predicting the future prospects of the entity.

8.2 The nature and scope of financial statement analysis

The analysis of financial statements refers to the examination of statements for the purposes of acquiring additional information regarding the activities of the entity. The process involves the reclassification of accounting data and the calculation of ratios. The objective is to disclose significant relationships and trends that are not immediately evident from the examination of individual amounts for items appearing in the financial statements of the current and previous financial periods. Each ratio emphasises a particular aspect of the statement of financial position or statement of profit or loss and other comprehensive income. An accounting ratio is calculated by comparing two or more financial balances between which there exists some identifiable economic relationship, such as profit and sales. The calculated ratio must be interpreted and compared with the entity's own standard or those that are deemed to be representative of the industry in which the entity operates. The advantage of making comparisons is that it enables the users of an entity's financial statements to classify the entity's performance as good, average or poor in certain key areas. However, when interpreting the results it is important that an analyst takes into account external factors that might have an influence on an entity's performance and financial position. Such factors include inflation, increased competition and changes in the socio-economic environment.

8.3 The objectives of financial statement analysis

Many diverse groups of users have an interest in the information contained in an entity's financial statements. These users analyse the entity's financial statements and interpret the information that relates to their particular interest in the entity. The specific objectives of the analysis therefore depend on the information needs of the users of the entity's financial statements.

Investors and potential investors are primarily interested in evaluating the investment characteristics of an entity. Investment characteristics of an entity include factors such as risk and return on the invested funds. Investors analyse an entity's financial statements with the objective of determining future risks and returns on their investment.

Creditors and potential creditors analyse the financial statements of an entity to assess the entity's creditworthiness. Short-term creditors are concerned primarily with the entity's liquidity, where liquidity refers to the entity's ability to pay debts as they arise. Similarly, long-term creditors are interested in the entity's ability to pay the interest and principal repayments on the due dates.

The entity's management also has interest in the analysis of financial statements. Although management, unlike investors and creditors, has internal reports at its disposal, the analysed financial statements do add considerable information about the strengths and weaknesses of the entity. The management uses this information to monitor the entity's activities and to ensure that its policy decisions are implemented by subordinate units within the entity.

Employees analyse financial statements with the objective of assessing employment prospects and also for the purposes of collective bargaining.

8.4 Application of financial statement analysis

In this section various ratios, under various classes, are discussed, calculated and interpreted using the financial statements of Dee-Chili CC as an example. The financial statements of this business entity exclude certain details and notes to the financial statements for the sake of simplicity. Due to the fact that in this book the preparation and presentation of financial statements for companies is not dealt with, the computation and discussion of ratios for entities classified as companies is excluded. For the sake of conciseness, the interpretation of ratios is general in nature. The following financial statements relate to business activities of Dee-Chili, a close corporation, for the year ended 31 December 20.2.

Dee-Chili CC
Statement of profit or loss and other comprehensive income for the year ended 31 December 20.2

	20.2 **R**	**20.1** **R**
Revenue	1 312 500	909 000
Cost of sales	(475 720)	(319 813)
Gross profit	836 780	589 187
Other income	22 500	1 432
Interest income: Fixed deposit	2 500	1 432
Profit on sale of non-current asset: Equipment	20 000	–
	859 280	590 619
Distribution, administrative and other expenses	(709 199)	(474 732)
Credit losses	6 737	4 940
Administrative expenses	68 110	45 407
Rental expenses	21 300	14 200
Salaries and wages	303 708	238 708
Salaries to members	157 500	60 250
Telephone expenses	17 625	11 750
Depreciation	126 813	94 540
Stationery consumed	7 406	4 937
Finance costs	(31 500)	(21 000)
Interest on mortgage	20 250	13 500
Interest on loan from member	11 250	7 500
Profit before tax	118 581	94 887
Income tax expense	(34 388)	(27 517)
Profit for the year	84 193	67 370
Other comprehensive income	–	–
Total comprehensive income for the year	84 198	67 370

Dee-Chili CC
Statement of financial position as at 31 December 20.2

	20.2 R	20.1 R
ASSETS		
Non-current assets	717 050	512 690
Property, plant and equipment	697 050	484 690
Fixed deposit	20 000	28 000
Current assets	177 236	102 157
Inventories	15 150	12 100
Trade and other receivables	153 636	85 757
Cash and cash equivalents	8 450	4 300
Total assets	894 286	614 847
EQUITY AND LIABILITIES		
Total equity	589 584	422 486
Members' contributions	112 500	112 500
Retained earnings	405 084	263 286
Other components of equity	72 000	46 700
Total liabilities	304 702	192 361
Non-current liabilities	144 000	96 000
Long-term borrowings: Mortgage	90 000	60 000
Loans from members	54 000	36 000
Current liabilities	160 702	96 361
Trade and other payables	82 126	55 765
Current portion of loans from members	21 000	34 000
Current tax payable	57 576	6 596
Total equity and liabilities	894 286	614 847

8.4.1 *Profitability ratios*

Profitability ratios measure an entity's profit for a specific period relative to sales, assets, or equity for that period. An entity's profitability is of particular interest to investors or potential investors because information that relates to profitability assists in estimating future returns on invested funds and growth potential of an entity. Entities that generate higher profits, generally have higher returns on invested funds and greater growth potential. Profitability ratios are usually expressed in percentages. The higher the profitability ratio, the more attractive an investment in that entity would be. The following are the most common measures of profitability:

- return on equity;
- return on assets;
- gross profit percentage;
- profit percentage; and
- financial leverage and leverage effect.

8.4.1.1 Return on equity (ROE)

The *return on equity* indicates the rate of return earned on funds invested in an entity by its owners. Equity is defined as the owner's(s') residual interest in the assets of an entity after deducting all of its liabilities. Equity is disclosed as a separate section on the statement of financial position of a reporting entity and varies between different forms of ownership. For example, the equity of a sole proprietor is comprised of the capital contribution by the owner, plus total comprehensive income less drawings for the accounting period concerned. For a partnership, the equity consists of the partners' capital contributions, the balances on partners' current accounts and other components of equity (reserves). The equity of a close corporation consists of members' contributions, retained earnings and any other components of equity (reserves). A company's equity would usually include ordinary issued share capital, retained earnings, and any other components of equity (different types of reserves).

The return on equity ratio measures how successful an entity is in using equity to attain its key financial objectives, that is, to remain viable in the long run and to increase the wealth of its owners. From the owner's(s') point of view, the return on equity is deemed to be a crucial calculation as it measures the return on their investment. In its simplest form the return on equity ratio is calculated by dividing the profit before tax by total equity. The logic behind the use of profit before tax is to facilitate the effective comparison of different forms of ownership that have different tax implications on their profits. The return on equity for Dee-Chili CC is calculated as follows:

$$\begin{array}{lcc} & \textbf{20.2} & \textbf{20.1} \\ \textit{Return on equity} = \dfrac{\text{Profit before tax}}{\text{Total equity}} \times 100 & = \dfrac{\text{R118 581}}{\text{R589 584}} \times 100 & : \dfrac{\text{R94 887}}{\text{R422 486}} \times 100 \\ & = 20{,}11\% & : = 22{,}46\% \end{array}$$

When compared with year 20.1, the return on equity for Dee-Chili decreased in year 20.2. Generally, decreases in the return on equity ratio are attributed to increases in expenses, decreases in profit mark-ups, and increases in equity (additional contribution by the owners) without a corresponding increase in profits or a combination of all these aspects.

8.4.1.2 Return on total assets (ROA)

Although the return on equity measures the return on owner/s funds invested, it does not reflect the profitability of an entity as a whole. To get a better picture of the use of total funds employed in an entity, the *return on total assets* is used. The return on total assets measures the profitability of an entity as a whole in relation to the total assets employed. In essence, the return on assets ratio is a measure of how effectively the entity's total assets are being used to generate profits. The return on total assets ratio is calculated by dividing the profit for the year before interest and tax by total assets. The idea behind using profit before the deduction of interest and tax is to relate the profit derived from operations to invested capital (borrowed funds and equity) prior to the allocation of profits to cover the expenses of invested capital.

The return on equity for Dee-Chili CC is calculated as follows:

$$\textit{Return on total assets} = \frac{\text{Profit before interest and tax}}{\text{Total assets}} \times 100 = \overset{\textbf{20.2}}{\frac{\text{R150 081①}}{\text{R894 286}}} \times 100 : \overset{\textbf{20.1}}{\frac{\text{R115 887②}}{\text{R614 847}}} \times 100$$

$$= 16{,}78\% \quad : = 18{,}85\%$$

① R(118 581 + 31 500) = R150 081

② R(94 887 + 21 000) = R115 887

Dee-Chili CC recorded a decrease in the return on total assets. A decrease in the return on total assets can indicate a lack of managerial commitment to using total assets optimally to earn profit for the year. Acquiring assets just before the end of the financial year can also result in a decrease in the return on total assets ratio because assets cannot be properly deployed to earn profits.

8.4.1.3 Gross profit percentage

The *gross profit percentage* is a measure of the entity's ability to generate gross profit from sales. It is often used to assess the intent of an entity's management to control inventory costs, for example, by bargaining for lower purchase prices. The gross profit percentage also indicates the percentage of income that is left from sales to meet other operating expenses after deducting the cost of sales. The gross profit percentage is calculated by dividing the gross profit by sales. The gross profit percentage for Dee-Chili CC is calculated as follows:

$$\textit{Gross profit percentage} = \frac{\text{Gross profit}}{\text{Sales}} \times 100 = \overset{\textbf{20.2}}{\frac{\text{R836 780}}{\text{R1 312 500}}} \times 100 : \overset{\textbf{20.1}}{\frac{\text{R589 187}}{\text{R909 000}}} \times 100$$

$$= 63{,}70\% \quad : = 64{,}82\%$$

The gross profit percentage declined slightly in 20.2. Changes in the gross profit percentage are usually linked to variations in sales volumes, selling prices and cost of sales.

8.4.1.4 Profit margin

The *profit margin* ratio expresses profit before tax for the year as a percentage of sales. The profit margin indicates management's ability to operate an entity with sufficient success, not only to recover the cost of inventories purchased, expenses of operating a business, and the interest payable on borrowed funds, but also to ensure that a reasonable amount of profit is available to the owners as compensation for investing in the entity. The profit margin is calculated by dividing the profit before tax by sales. The profit margin percentage for Dee-Chili CC is calculated as follows:

$$\textit{Profit margin} = \frac{\text{Profit before tax}}{\text{Sales}} \times 100 = \overset{\textbf{20.2}}{\frac{\text{R118 581}}{\text{R1 312 500}}} \times 100 : \overset{\textbf{20.1}}{\frac{\text{R94 887}}{\text{R909 000}}} \times 100$$

$$= 9{,}03\% \quad : = 10{,}44\%$$

The profit margin declined in year 20.2, which can be attributed to an increase in one or more of the components that make up distribution, administrative and other expenses, without a corresponding increase in sales or/and selling prices.

8.4.1.5 Financial leverage and financial leverage effect

The *financial leverage ratio* measures the extent to which an entity is using borrowed funds successfully, that is, whether it is generating positive returns on those funds that are higher than the cost of the borrowed funds. The ratio is calculated by dividing the return on equity by the return on total assets. The result will indicate whether an entity is benefiting from the use of borrowed funds or not. A leverage ratio of one is generally regarded as an acceptable norm because that is where the entity breaks even between the cost on borrowed funds (interest) and the benefits (return) of using borrowed funds. A leverage ratio that exceeds one indicates that an entity is generating higher returns on the borrowed funds than the cost thereof. Conversely, a leverage ratio of less than one indicates that the cost on borrowed funds exceeds the return thereon.

The financial leverage effect is expressed as the difference between the return on equity and return on assets. The analysis of the leverage effect is important to equity investors as it provides an indication of the return that is attributable to them from the use of borrowed funds. Entities borrow funds with the intention of advancing business initiatives that will render higher returns than the cost (interest) on borrowed funds. The following is the analysis of financial leverage and leverage effect for Dee-Chili CC:

		20.2		**20.1**
Financial leverage =	$\frac{\text{Return on equity}}{\text{Return on assets}}$ =	$\frac{20{,}11\%}{16{,}78\%}$	:	$\frac{22{,}46\%}{18{,}85\%}$
	=	1,20	:	= 1,19

The leverage ratio increased during 20.2. Improvement in the financial leverage ratio is normally attributed to a more efficient use of borrowed funds, that is, borrowed funds used in the entity are producing higher returns than the cost (interest) thereof. The analysis of the leverage effect will further assist in explaining how much equity investors benefited from the efficient use of borrowed funds.

		20.2		**20.1**
Leverage effect =	Return on equity	20,11%	:	22,46%
	Less: Return on total assets	(16,78%)		(18,85%)
		3,33%	:	3,61%

The leverage effect indicates that equity investors received 3,33% more on their investment in 20.2 and 3,61% more in 20.1. The deterioration in the leverage effect can be attributed to an increase in interest rates, together with higher loan amounts, without a corresponding increase in profit.

8.4.2 *Liquidity ratios*

Liquidity refers to the ability of an entity to meet its short-term financial obligations when they fall due. Liquidity ratios measure the extent to which an entity can pay its short-term financial obligations. The liquidity of an entity is of interest to short-term credit providers, especially suppliers of goods and services, banks and other institutions that provide short-term unsecured loans. Long-term providers of credit also assess the liquidity position of an entity because liquidity has a direct influence on the ability of an entity to make interest payments on long-term borrowings. The following ratios are commonly used as a measure of liquidity:

- ☐ current ratio;
- ☐ acid test ratio or quick ratio;
- ☐ trade receivables collection period;
- ☐ trade payables settlement period;
- ☐ inventory turnover rate; and
- ☐ inventory-holding period.

8.4.2.1 Current ratio

The *current ratio* measures the extent to which current assets can be used to meet current liabilities. The current assets include items such as cash and cash equivalents, inventories, trade receivables and pre-payments. Current liabilities include items such as trade and other payables, short-term borrowings and the current portion of long-term borrowings. The current ratio is calculated by dividing the current assets by the current liabilities. Acceptable current ratios vary from industry to industry, but a current ratio of 2:1 is generally regarded as an acceptable norm or standard for all entities. If an entity's current ratio is in the range of 2:1, it is considered to be a good short-term financial prospect. If current liabilities exceed current assets, that is, the current ratio is below 1, then the entity may have problems in meeting its short-term obligations. A too high current ratio is also not desirable because it is an indication that the entity is not using its current assets efficiently to generate more income. The current ratio for Dee-Chili CC is calculated as follows:

$$\begin{array}{lcccccc} & & & & \textbf{20.2} & & \textbf{20.1} \\ \textit{Current ratio} & = & \dfrac{\text{Current assets}}{\text{Current liabilities}} & = & \dfrac{\text{R177 236}}{\text{R160 702}} & : & \dfrac{\text{R102 157}}{\text{R96 361}} \\ & & & = & 1{,}10 : 1 & : & = 1{,}06 : 1 \end{array}$$

The current ratio is below the acceptable standard of 2:1 although it has slightly improved in year 20.2. An improvement in the current ratio can be attributed to increases in one of the components that make up the current assets or decreases in the components that make up the current liabilities, or a combination of both, and needs to be investigated further by calculating other liquidity ratios such as trade receivables collection period, trade payable payment period and inventory turnover rate.

8.4.2.2 Acid test or quick ratio

The *acid test ratio*, also called the *quick ratio*, is a modification of the current ratio and is a very useful measure of the liquidity. By excluding inventory, the acid test ratio only considers that part of current assets that can be turned into cash immediately. This ratio tells short-term providers of credit how much of the entity's short-term debt can be met by selling all the entity's current assets at very short notice without relying on the sale of inventory. Inventory is excluded in the determination of the acid test ratio mainly because it normally takes longer to convert into cash. Inventory is often sold on credit and gives rise to accounts receivable, which are usually settled some time after the inventory was sold. This in a sense delays the conversion of inventory into a quick liquid asset. The acid test ratio is calculated by dividing current assets less inventory by current liabilities. An acid test ratio of 1:1 or higher is generally regarded as good, and indicates that an entity does not have to rely on the sale of inventory to raise money to meet its short-term obligations. The acid test ratio for Dee-Chili CC is calculated as follows:

$$\begin{array}{llll} & & \textbf{20.2} & \textbf{20.1} \\ \textit{Acid test ratio} & = \dfrac{\text{Current assets } \textit{less inventory}}{\text{Current liabilities}} & = \dfrac{R(177\,236 - 15\,150)}{R160\,702} & : \dfrac{R(102\,157 - 12\,100)}{R96\,361} \\ & & = 1{,}01\text{: } 1 & : = 0{,}93 : 1 \end{array}$$

The acid-test ratio improved to an acceptable level in year 20.2. Improvement in the acid-test ratio can be attributed to either an increase in current assets, excluding inventory, or a decrease in current liabilities, or a combination of both and, as already explained, needs to be analysed further by calculating other liquidity ratios.

8.4.2.3 Trade receivables collection period

The trade receivables (trade debtors) collection period measures the efficiency of the entity's debt collection policy by showing how long it takes for trade debtors to be converted into cash receipts. The collection period is the time period between the date of the credit sales and receipt of payment from trade debtors for those sales. The significance of this ratio as a liquidity ratio is that it gives an indication of the time an entity has to wait before receiving cash from trade debtors. The ratio is calculated by multiplying the average of trade receivables balances with the number of days in a year (365) and dividing the answer by the total credit sales for that period. The shorter the collection period, the faster is the collection of cash from credit sales, and the better the liquidity position of the entity. Assuming that all sales by Dee-Chili are credit sales and that the opening balance of trade receivables at the beginning of the 20.1 financial period amounted to R91 600, the trade receivables collection period is calculated as follows:

$$\begin{array}{llll} & & \textbf{20.2} & \textbf{20.1} \\ \textit{Trade receivables collection period} & = \dfrac{\text{Average trade receivables}}{\text{Credit sales}} \times 365 & = \dfrac{R119\,697①}{R1\,312\,500} \times 365 & : \dfrac{R88\,679②}{R909\,000} \times 365 \\ & & = 33{,}29 \text{ days} & : = 35{,}61 \text{ days} \end{array}$$

① R(153 636 + 85 757) ÷ 2 = R119 697
② R(85 757 + 91 600) ÷ 2 = R88 679

The collection period improved slightly in 20.2 when compared with 20.1. An improvement in the collection period ratio is usually associated with good management of trade debtors, which could in turn affect the availability of cash to meet the entity's short-term financial obligations. In the absence of more information in this example, trade and other receivables are assumed to consist of trade debtors only.

8.4.2.4 Trade payables settlement period

The trade payables settlement period ratio measures the time period it takes an entity to settle its trade creditors. Entities in general strive to extend this period to longer than the trade receivables collection period. This is because the cash that is received from trade debtors is often used to settle trade creditors. The longer the payment period, the more time is available for an entity to generate cash to settle its trade creditors. The trade payables settlement period is calculated by multiplying the average trade payables balances with the number of days in a year (365) and dividing the answer by the total credit purchases for that period. Assuming that trade creditors at the beginning of the 20.1 financial period amounted to R60 155, that all purchases are made on credit, and that credit purchases for the 20.1 financial period amounted to R323 180, the payables settlement for Dee-Chili CC is calculated as follows:

$$\textit{Trade payables settlement period} = \frac{\text{Average trade payables}}{\text{Credit purchases}} \times 365 = \frac{\text{R68 946①}}{\text{R478 770③}} \times 365 \;:\; \frac{\text{R57 960②}}{\text{R323 180}} \times 365$$

	20.2	**20.1**
	= 52,56 days	: = 65,46 days

① R(82 126 + 55 765) ÷ 2 = R68 946
② R(55 765 + 60 155) ÷ 2 = R57 960
③ Purchases for 20.2: = R(475 720 + 15150 – 12 100) = R478 770

The trade payables settlement period of Dee-Chili for 20.2 deteriorated, which indicates that the entity is expected to settle its creditors accounts 12,90 days (65,46 – 52,56) earlier than it was in 20.1. However, when compared to the trade receivables collection period, Dee-Chili's payables settlement period for both years can be regarded as favourable because the entity has enough time to collect payments from trade debtors before it settles its trade creditors. In the absence of more information in this example, trade and other payables are assumed to consist of trade creditors only.

8.4.2.5 Inventory turnover rate

The inventory turnover rate measures the approximate number of times inventory acquired is converted into sales in a specific financial period. This provides an indication of the efficiency with which the entity manages its inventory levels. The management of inventory levels is crucial to an entity because inadequate inventory levels can result in a decline in sales volumes due to inventory shortages. Conversely, high inventory levels expose an entity to excessive storage costs, insurance costs, and risks associated with the loss of inventory. An entity is expected to maintain moderate inventory levels that are proportional to its activities. The inventory turnover rate is calculated by dividing the cost of sales for a specific financial period by the average inventory for that period. The average inventory is calculated by adding the opening and closing balances of inventory for that period and dividing it by 2. A high inventory turnover is suggestive of good inventory management, while a low turnover could suggest excessive inventory levels, the presence of damaged inventory and low sales volumes. The inventory turnover rate for Dee-Chili CC is calculated as follows:

$$\textit{Inventory turnover rate} = \frac{\text{Cost of sales}}{\text{Average inventory}} = \frac{\text{R475 720}}{\text{R13 625①}} \;:\; \frac{\text{R319 813}}{\text{R10 417②}}$$

	20.2	**20.1**
	= 34,92 times	: = 30,70 times

① Average inventory: R(15 150 + 12 100) ÷ 2 = R13 625
② Opening inventory = Cost of sales + Closing inventory – Purchases (all on credit)
R(319 813 + 12 100 – 323 180) = R8 733
Average inventory: R(12 100 + 8 733) ÷ 2 = R10 417

The inventory turnover rate improved in year 20.2 when compared with year 20.1. Generally, an improvement in the inventory turnover ratio is considered to be a positive indicator of efficiency in the management of inventory, since an investment in inventory produces no revenue and increases the cost associated with holding the inventory.

8.4.2.6 Inventory-holding period

The inventory-holding period measures the number of days it takes to convert inventory into sales. The higher this period, the higher the investment in inventory, which indicates that funds that could be used to improve the entity's ability to meet its short-term obligations are tied up in inventory. The inventory-holding period is calculated by multiplying the average inventory by the number of days in a year (365), and dividing the result by the cost of sales for that period. The inventory-holding period for Dee-Chili CC is calculated as follows:

		20.2		**20.1**
Inventory-holding period	$= \dfrac{\text{Average inventory}}{\text{Cost of sales}} \times 365$	$= \dfrac{\text{R13 625}}{\text{R475 720}} \times 365$	:	$\dfrac{\text{R10 417}}{\text{R319 813}} \times 365$
		= 10,45 days	:	= 11,89 days

The inventory-holding period improved in 20.2 when compared with 20.1. The improvement in the inventory-holding period is generally associated with an increase in the demand of the product being sold.

8.4.3 *Solvency ratios*

Solvency refers to the ability of an entity to pay its debts with available cash. The concern, which solvency ratios seek to address, is the amount of borrowed funds (debt financing) an entity is using and its ability to repay this debt and the interest thereon. Debt financing increases the risk that an entity may not be able to honour its interest payments in times of increasing interest rates. This might lead to cash flow problems, which could eventually lead to the liquidation of an entity. A wide variety of ratios is used to measure the solvency of an entity; however, in this text book the discussion on solvency ratios is limited to the following ratios:

- ☐ debt-equity ratio; and
- ☐ times interest earned ratio.

8.4.3.1 Debt-equity ratio

The debt-equity ratio measures the percentage of total debt, both long-term and short-term, to the equity of the entity. This ratio is calculated by dividing the total of borrowed funds (debt) by the equity of the entity. A debt-equity ratio of over 100% means that an entity has used more borrowed funds than equity to finance its assets. A larger proportion of debt financing might affect the solvency of an entity in times of rising interest rates, as an entity may be unable to generate enough profits to cover interest obligations. The debt-equity ratio for Dee-Chili CC is calculated as follows:

		20.2		**20.1**
Debt-equity ratio	$= \dfrac{\text{Total debt}}{\text{Total equity}} \times 100$	$= \dfrac{\text{R304 702}}{\text{R589 584}} \times 100$	:	$\dfrac{\text{R192 361}}{\text{R422 486}} \times 100$
		= 51,68%	:	= 45,53%

The debt-equity ratio of Dee-Chili CC deteriorated in 20.2 when compared with 20.1, which indicates an increase in the level of financial risk for the entity. Deterioration in the debt-equity ratio is generally associated with increased levels of borrowed funds without a corresponding increase in the level of equity funding.

8.4.3.2 Times interest earned ratio

The times interest earned ratio measures the ability of an entity to meet its interest obligations from available profits. This ratio provides an indication of whether an entity is earning enough profits to cover the interest payment on its debt. The importance of this ratio as a measure of solvency is that it indicates if the entity, given the amount of debt proportion, will be able to meet its interest obligations as they come due. Failure on the part of an entity to meet this obligation could lead to legal action being taken against the entity and consequently liquidation of the entity. The ratio is calculated by dividing the profit before interest and tax by finance costs (total interest payments).

$$\begin{array}{llcccc} & & & \textbf{20.2} & & \textbf{20.1} \\ \textit{Times interest earned ratio} & = \dfrac{\text{Profit before interest and tax}}{\text{Finance costs}} & = & \dfrac{\text{R150 081①}}{\text{R31 500}} & : & \dfrac{\text{R115 887②}}{\text{R21 000}} \\ & & & = 4{,}76 \text{ times} & : & = 5{,}52 \text{ times} \end{array}$$

① R(118 581 + 31 500) = R150 081
② R(94 887 + 21 000) = R115 887

The times interest earned ratio deteriorated in 20.2 when compared with 20.1. In spite of the deterioration of this ratio for Dee-Chili CC, the profit that is generated by the entity is still 4,76 times more than its interest obligations.

8.5 Limitations of financial statements analysis

In spite of its usefulness, financial ratio analysis has limitations that analysts should consider when interpreting the results of a calculated ratio:

- ☐ In times of inflation (rising prices), profits may be overstated due to the low depreciation charge, while asset prices at cost may be understated. The resulting rate of return on assets can be misleading in such circumstances.
- ☐ At the time of the financial analysis, it is possible that the amounts used are already outdated and this might limit its usefulness. To increase its usefulness, analysis of financial results should be done regularly from internally generated reports.
- ☐ Financial ratios can be used to assess whether the performance of an entity is satisfactory, by comparing it with other entities operating in the same industry, and by comparing current period results with those achieved in the previous accounting periods. However, ratios do not always provide explanations for observed changes, and further inquiry is sometimes needed. Therefore, the interpretation of calculated ratios requires a certain level of knowledge about the entity and the industry in which the entity operates to arrive at an informed decision.

The above limitations do not render ratio analysis less useful, but highlight problems that the analysts should be aware of when interpreting the ratios. Ratio analysis conducted in a blunt manner can be dangerous, but if used carefully it can provide useful insight into an entity's performance and financial position.

Example 8.1

Boom and Shaka are in partnership trading as Boom-Shaka Traders. The following information relates to Boom-Shaka Traders at 28 February 20.5, the end of the financial period.

Abstract from the financial statements of Boom-Shaka Traders as at 28 February 20.5

	20.5	**20.4**
Capital accounts:	**R**	**R**
Boom	225 000	225 000
Shaka	150 000	150 000
Current accounts:		
Boom (Cr)	26 400	9 000
Shaka (Cr)	21 600	6 000
Long-term borrowing	70 000	100 000
Land and buildings at cost	240 000	276 000
Machinery and equipment at cost	177 000	191 000
Accumulated depreciation	43 000	49 000
Unlisted investments	35 000	50 000
Inventory – 28 February	25 000	21 000
Trade receivables	36 000	37 000
Bank	47 000	–
Trade payables	24 000	34 000
Bank overdraft	–	2 000
Sales	234 000	179 800
Purchases	74 500	57 400
Administrative expenses	27 500	19 250
Interest on long-term borrowing	8 400	12 000
Profit for the year	123 600	91 150

Industry averages as at 28 February 20.5

Return on equity	18,30%
Return on total assets	15,80%
Gross profit percentage	53,55%
Profit margin	53,69%
Financial leverage	1,16
Current ratio	2,53 : 1
Acid test ratio	1,96 : 1
Trade receivables collection period	80,04 days
Trade payables settlement period	85,11 days
Inventory turnover rate	6,01 times
Inventory-holding period	105,20 days
Debt-equity ratio	57%
Times interest earned ratio	13,24 times

Additional information:

1. All sales and purchases are on credit. The trade debtors and trade creditors, at the beginning of the 20.4 financial year, amounted to R27 500 and R29 000 respectively.
2. Inventory at the beginning of the 20.4 financial year amounted to R15 000.
3. The unlisted investment is designated as at fair value through profit or loss.

Required:

Calculate the following ratios and interpret the calculated ratios for Boom-Shaka Traders in relation to the industry averages. Assume 365 days in a year.

(a) Profitability ratios;

(b) Liquidity ratios; and

(c) Solvency ratios.

Solution:

(a) Profitability ratios:

$$\text{Return on equity} = \frac{\text{Profit for the year*}}{\text{Total equity}} \times 100 = \overset{\textbf{20.5}}{\frac{\text{R123 600}}{\text{R423 000③}}} \times 100 \ : \ \overset{\textbf{20.4}}{\frac{\text{R91 150}}{\text{R390 000③}}} \times 100$$

$$= 29{,}22\% \ : \ = 23{,}37\%$$

The return attributed to partners improved in 20.5 when compared with 20.4. When compared to the industry average of 18,30%, the partners are earning above average returns on their invested funds.

$$\text{Return on total assets} = \frac{\text{Profit before interest*}}{\text{Total assets}} \times 100 = \overset{\textbf{20.5}}{\frac{\text{R132 000①}}{\text{R517 000⑥}}} \times 100 \ : \ \overset{\textbf{20.4}}{\frac{\text{R103 150①}}{\text{R526 000⑥}}} \times 100$$

$$= 25{,}53\% \ : \ = 19{,}61\%$$

Boom-Shaka Traders recorded an improvement in the return on total assets in 20.5 when compared with 20.4. The return on assets is also relatively higher than the industry average of 15,80%, which is an indication of good management skills in the deployment of assets by the entity.

$$\text{Gross profit percentage} = \frac{\text{Gross profit}}{\text{Sales}} \times 100 = \overset{\textbf{20.5}}{\frac{\text{R163 500②}}{\text{R234 000}}} \times 100 \ : \ \overset{\textbf{20.4}}{\frac{\text{R128 400②}}{\text{R179 800}}} \times 100$$

$$= 69{,}87\% \ : \ = 71{,}41\%$$

When compared to 20.4, the gross profit percentage deteriorated by 1,54% (71,41 – 69,87). At 69,87% for 20.5 it is still higher than the industry average of 53,55%. It is possible that the entity achieved a better gross profit percentage than the industry as a result of a higher mark-up on inventory, or that inventory was obtained at a lower cost, or a combination of both.

$$\text{Profit margin} = \frac{\text{Profit for the year*}}{\text{Sales}} \times 100 = \overset{\textbf{20.5}}{\frac{\text{R123 600}}{\text{R234 000}}} \times 100 \ : \ \overset{\textbf{20.4}}{\frac{\text{R91 150}}{\text{R179 800}}} \times 100$$

$$= 52{,}82\% \ : \ = 50{,}70\%$$

* A partnership does not pay tax, as the partners are taxed in their personal capacity. As a result, profit for the year is used in the calculations instead of profit before tax.

Boom-Shaka Traders recorded a lower profit margin than the industry average of 53,69%. It slightly increased from 20.4 to 20.5. The deviation from the industry average can possibly be attributed to higher distribution, administrative and general expenses.

$$\begin{array}{llll} & & \textbf{20.5} & & \textbf{20.4} \\ \textit{Financial leverage} = & \dfrac{\text{Return on equity}}{\text{Return on assets}} = & \dfrac{29{,}22\%}{25{,}53\%} & : & \dfrac{23{,}37\%}{19{,}61\%} \\ & = & 1{,}14 & : & = 1{,}19 \end{array}$$

The financial leverage for Boom-Shaka Traders deteriorated in 20.5 when compared with 20.4. The financial leverage of the entity is also slightly below the industry average of 1,16. However the entity's financial leverage still exceeds one, which indicates that the entity is generating positive returns on borrowed funds.

		20.5		20.4
Leverage effect =	Return on equity	29,22%	:	23,37%
	Less: Return on total assets	(25,53%)		(19,61%)
		3,69%	:	3,76%

The effect of financial leverage gives an indication of the surplus amount of profit that is attributable to the partners from the use of borrowed funds. In spite of a decline in the leverage effect, the partners are still generating positive returns from the use of borrowed funds.

(b) Liquidity ratios:

$$\begin{array}{llll} & & \textbf{20.5} & & \textbf{20.4} \\ \textit{Current ratio} = & \dfrac{\text{Current assets}}{\text{Current liabilities}} = & \dfrac{\text{R108 000⑤}}{\text{R24 000⑧}} & : & \dfrac{\text{R58 000⑤}}{\text{R36 000⑧}} \\ & = & 4{,}50 : 1 & : & = 1{,}61 : 1 \end{array}$$

Boom-Shaka Traders recorded a significant improvement of the current ratio in 20.5 when compared with 20.4. In comparison with the industry average of 2,53:1, the entity seems to be more liquid than other entities in the same industry.

$$\begin{array}{llll} & & \textbf{20.5} & & \textbf{20.4} \\ \textit{Acid test ratio} = & \dfrac{\text{Current assets } \textit{less inventory}}{\text{Current liabilities}} = & \dfrac{\text{R}(108\ 000 - 25\ 000)}{\text{R24 000}} & : & \dfrac{\text{R}(58\ 000 - 21\ 000)}{\text{R36 000}} \\ & = & 3{,}46 : 1 & : & = 1{,}03 : 1 \end{array}$$

The acid test ratio also improved significantly since the previous year and also compared favourably to the industry average of 1,96:1. This is an indication that Boom-Shaka Traders is managing its liquid assets better than other entities in the industry.

$$\begin{array}{llll} & & \textbf{20.5} & & \textbf{20.4} \\ \textit{Trade receivables collection period} = & \dfrac{\text{Average trade receivables}}{\text{Credit sales}} \times 365 = & \dfrac{\text{R36 500*}}{\text{R234 000}} \times 365 & : & \dfrac{\text{R32 250**}}{\text{R179 800}} \times 365 \\ & & = 56{,}93 \text{ days} & : & = 65{,}47 \text{ days} \end{array}$$

* R(36 000 + 37 000) ÷ 2 = R36 500
** R(37 000 + 27 500) ÷ 2 = R32 250

Boom-Shaka Traders recorded an improvement in the collection of debt during 20.5 when compared with 20.4. The entity's collection period is even better than that of the industry (80,04 days), which implies that the collection strategy of the entity is more effective than that of the industry.

Trade payables settlement period

$$= \frac{\text{Average trade payables}}{\text{Credit purchases}} \times 365 = \frac{\text{R29 000*}}{\text{R74 500}} \times 365 : \frac{\text{R31 500**}}{\text{R57 400}} \times 365$$

	20.5		**20.4**
	= 142,08 days	:	= 200,30 days

* R(24 000 + 34 000) ÷ 2 = R29 000
** R(34 000 + 29 000) ÷ 2 = R31 500

The trade payables settlement period of 142,08 for 20.5 is favourable when compared with the industry average of 85,11 days. Though there has been a deterioration in the payment period in 20.5, the entity is still in a favourable position when the receivables collection period is taken into consideration. Creditors are paid 85,15 (142,08 – 56,93) days after debtors are collected.

Inventory turnover rate

$$= \frac{\text{Cost of sales}}{\text{Average inventory}} = \frac{\text{R70 500②}}{\text{R23 000*}} : \frac{\text{R51 400②}}{\text{R18 000**}}$$

	20.5		**20.4**
	= 3,07 times	:	= 2,86 times

* R(21 000 + 25 000) ÷ 2 = R23 000
** R(15 000 + 21 000) ÷ 2 = R18 000

The inventory turnover rate for Boom-Shaka Traders slightly improved in 20.5 when compared with 20.4. However, in comparison with the industry average of 6,01 times, the entity's inventory turnover rate is slower.

Inventory-holding period

$$= \frac{\text{Average inventory}}{\text{Cost of sales}} \times 365 = \frac{\text{R23 000}}{\text{R70 500}} \times 365 : \frac{\text{R18 000}}{\text{R51 400}} \times 365$$

	20.5		**20.4**
	= 119,08 days	:	= 127,82 days

On average, Boom-Shaka Traders takes 119,08 days to sell its inventory in comparison with the industry average of 105,20 days. This indicates that the entity is unable to sell its inventory quicker than most of the other entities operating in its industry. This can be interpreted as unfavourable for Boom-Shaka Traders as it increases inventory holding costs as well as the risks of inventory becoming obsolete.

(c) Solvency ratios:

Debt-equity ratio

$$= \frac{\text{Total debt}}{\text{Total equity}} \times 100 = \frac{\text{R94 000⑨}}{\text{R423 000③}} \times 100 : \frac{\text{R136 000⑨}}{\text{R390 000③}} \times 100$$

	20.5		**20.4**
	= 22,22%	:	= 34,87%

The debt-equity ratio of Boom-Shaka Traders improved significantly in 20.5 when compared with 20.4. The entity's ratio is however significantly lower than that of the industry in which it operates. This indicates that Boom-Shaka Traders has a lower financial risk than the industry in general, as a smaller percentage of its assets are financed by borrowed funds.

			20.5		**20.4**
Times interest earned ratio	= $\frac{\text{Profit before interest}}{\text{Interest expense}}$	=	$\frac{\text{R132 000①}}{\text{R8 400}}$	:	$\frac{\text{R103 150①}}{\text{12 000}}$
			= 15,71 times	:	= 8,60 times

The times interest earned ratio is slightly better than that of the industry average of 13,24. It also improved during 20.5 when compared with 20.4.

Calculations:

① **Profit for the year before interest:**

	20.5	**20.4**
	R	**R**
Profit for the year	123 600	91 150
Interest on long term borrowings	8 400	12 000
	132 000	103 150

② **Cost of sales and gross profit:**

	R	**R**
Sales	234 000	179 800
Cost of sales	(70 500)	(51 400)
Opening inventory	21 000	15 000
Purchases	74 500	57 400
Closing inventory	(25 000)	(21 000)
Gross profit	163 500	128 400

③ **Equity**

		R	**R**
Capital R(225 000 + 150 000)		375 000	375 000
Current accounts	R(26 400 + 21 600)	48 000	
	R(9 000 + 6 000)		15 000
		423 000	390 000

④ **Non-current assets**

		R	**R**
Property, plant and equipment	R(240 000 + 177 000 – 43 000)	374 000	
	R(276 000 + 191 000 – 49 000)		418 000
Unlisted investment at fair value through profit or loss		35 000	50 000
		409 000	468 000

⑤ **Current assets**

	R	**R**
Inventories	25 000	21 000
Trade receivables	36 000	37 000
Cash and cash equivalents	47 000	–
	108 000	58 000

⑥ **Total assets**

	R	R
Non-current assets	409 000	468 000
Current assets	108 000	58 000
	517 000	526 000

⑦ **Non-current liabilities**

	R	R
Long-term borrowing	70 000	100 000
	70 000	100 000

⑧ **Current liabilities**

	20.5	**20.4**
	R	**R**
Trade payables	24 000	34 000
Bank overdraft	–	2 000
	24 000	36 000

⑨ **Total liabilities (Debt)**

	R	R
Non-current liabilities	70 000	100 000
Current liabilities	24 000	36 000
	94 000	136 000

8.6 Summary

The purpose of financial statement analysis is to examine the past and current financial data presented in the financial statements of an entity, with the aim of evaluating the performance and predicting the future prospects of the entity. It is often associated with ratio analysis, which examines the relationships among various financial statement items both at a point in time and over time. Financial ratios are useful indicators of an entity's performance and financial position and are grouped according to the information they provide. The three groups of financial ratios discussed in this chapter are profitability, liquidity and solvency ratios. Profitability ratios measure the ability of an entity to generate profits. Liquidity ratios measure the entity's ability to pay its short-term financial obligations on time. Solvency ratios measure the ability of an entity to pay its long-term financial obligations and thereby remain solvent and avoid cash flow problems, which may consequently lead to liquidation if not managed appropriately.

The determined ratios are only useful when compared with specific industry standards, as well as with past performances of the entity with regard to each specific ratio. This is referred to as trend analysis and compares ratios over time. Ratios, however, have limitations which the analyst should take cognisance of when interpreting the results to draw meaningful conclusions.

CHAPTER 9

Branches

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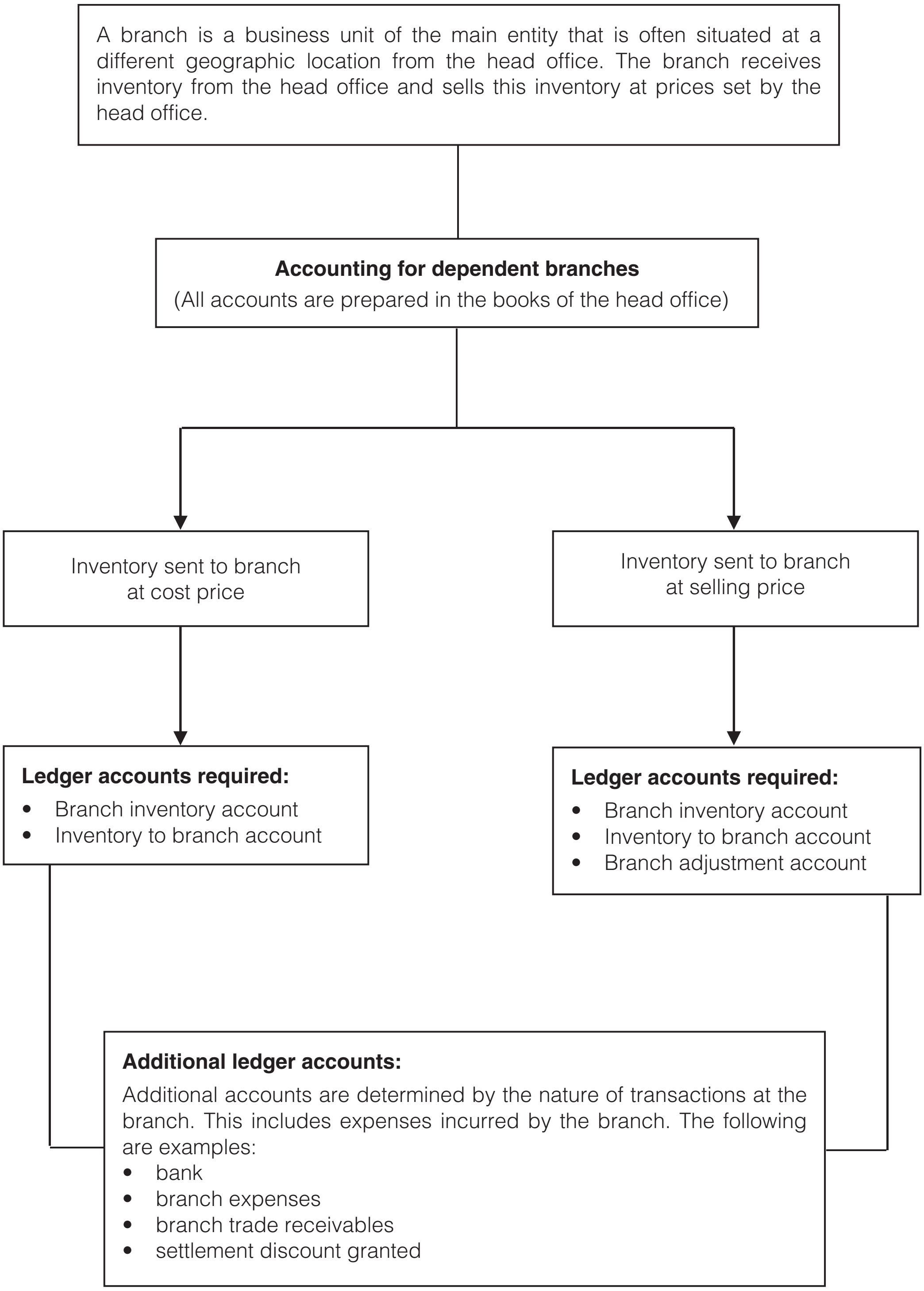
Overview of accounting for branches



9.1 Introduction

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- ☐ explain the concept of "branches";
- ☐ explain the differences between dependent and independent branches;
- ☐ identify the information to be included in the reports submitted by the branch to the head office;
- ☐ record the transactions between the head office and the branch in the books of the head office where inventory sent to the branch is invoiced at cost price;
- ☐ record the transactions between the head office and the branch in the books of the head office where inventory sent to the branch is invoiced at selling price;
- ☐ record the transactions of the branch relating to the following where inventory is invoiced at cost price or at selling price:
  - purchases by the branch;
  - sales of inventory by the branch;
  - inventory marked down;
  - inter-branch inventory transactions;
  - settlement discount granted to debtors by the branch;
  - cash embezzled at the branch; and
  - inventory in transit between the branch and the head office; and
- ☐ identify and record shortages and surpluses in the inventories of the branch.

Trading and service entities in search of wider markets establish branches in suburbs, towns and cities which operate separately from the central (main) entity. The concept of "branches" implies that there is one managing entity, referred to as the "head office", which is remote from the branches. "Branches" are business centres which are established with the aim of increasing turnover and ultimately the profitability of the business entity. Other reasons why business entities might want to establish branches are to reduce administrative costs by centralising administration at head office, and to negotiate better purchase discounts when buying is centralised and on a large scale. The manner in which branches are organised and operated differs from entity to entity, ranging from dependent branches (managed and controlled by the head office) to independent branches (managed as separate business entities that report their financial results periodically to the head office).

The method of branch organisation and operation adopted by an entity depends on the requirements of the business organisation. Some entities operate branches which merely display inventory samples and accept sales orders which are sent to the head office for further processing. Other entities operate branches at which only certain types of inventories are kept. Inventories not on hand can be ordered at the branch and are sent to customers from the head office. Most entities, however, permit branches to have a full selling function, that is, all types of inventories are kept at the branch and the branch is even allowed to make a limited amount of its own purchases if the need arises. Because there is no uniformity in branch organisation and operation, accountants and bookkeepers must adopt an accounting system that will suit the needs of the head office and the conditions under which the branch operates. The discussion in this chapter will only cover the accounting procedures for dependent branches that have a full selling function and are permitted to make a limited amount of their own purchases. The accounting records of a dependent branch are kept by the head office and it is from that perspective that all transactions of the branch are recorded.

9.2 Accounting for dependent branches

As indicated in the introduction, dependent branches are managed as centrally controlled business units of which the head office maintains all formal accounting records of the branches. Cash received from sales and debtors' payments are deposited by the branches directly in the bank account of the head office. Branches are usually allowed to keep a petty cash which is used to disburse minor expenses. Major expenses of the branches are paid for by the head office. Inventory is provided by the head office and sold at prices set by the head office. Depending on the requirements set by head office, branches must furnish (on a daily, weekly or monthly basis), a report of transactions that have occurred over a given period. Information contained in such a report is a summary of transactions taken from the source documents. The following are examples of the information that must be included in the report that is submitted by the branch to the head office:

- particulars of cash and credit sales;
- particulars of debtors who paid their accounts;
- cash received, discounts allowed and inventory returned by customers;
- a list of debtors on the date of the report;
- particulars of debtors whose accounts are doubtful or irrecoverable; and
- particulars of purchases made by the branch.

Depending on the policy of the head office, inventory sent to the branches can be invoiced either at cost or at selling price. Each of these invoicing methods requires a unique set of accounts and is discussed individually.

9.3 Recording of transactions where inventory sent to the branch is invoiced at cost price

9.3.1 *Introduction*

When the head office issues inventory to its branch(es) invoiced at cost price, the head office will maintain the following two accounts to record all inventory transactions with its branch:

- branch inventory account; and
- inventory to branch account.

The abovementioned accounts are exclusively used to record all inventory transactions of the head office with its branch. A branch inventory account and inventory to branch account will have to be opened for every branch of the entity. Other types of transactions that involve, for example, the settlement of branch debtors' accounts or payment of branch expenses that may be incurred in the operation of the branch, are recorded in the accounts that are specifically opened for these transactions and will again be for every branch the entity has.

Where inventory is invoiced to the branch at cost price, the branch inventory account serves the same purpose as the normal trading account because when balanced at the end of the accounting period, the balance represents the gross profit or loss of the branch. The gross profit or loss is the result of the difference between the price at which inventory is received from the head office and the price at which it is sold by the branch. The gross profit or loss is transferred to the credit side (when a profit is made) or debit side (when a loss is made) of the branch expense account to balance the branch inventory account.

At the end of the accounting period, the inventory to branch account is closed off to the head office trading account. This entry is necessary in order to record inventory that was purchased by the head office but subsequently sent to the branch.

Examples 9.1 to 9.9 will illustrate the basic concepts underlying the recording of branch transactions in the books of the head office of AB Traders when inventory is invoiced to the branch at cost price. The compilation of branch accounts will progress with every example, as transactions occur. The recording of new transactions, illustrated in the examples, will be highlighted as opposed to information that originated in subsequent examples.

9.3.2 *Inventory sent to the branch and purchases by the branch*

When inventory is sent by head office to the branch, the branch inventory account is debited with the cost price and the inventory to branch account is credited with the same amount.

If the branch is authorised to purchase from other suppliers, the branch inventory account is debited with the cost price of these purchases and either the bank account or trade payables control account is credited, depending on whether the purchases are for cash or on credit.

Example 9.1 Inventory sent to the branch and purchases of inventory by the branch

Inventory with a cost price of R50 000 was dispatched by head office to its Aye branch. In addition, the branch purchased inventory from a local supplier and payment of R10 500 was made by cheque.

Required:

Record the above transactions in the general ledger of head office.

Solution:

AB Traders (Head office)
General ledger

Dr — Branch inventory: Aye (at cost price) — Cr

	R		
Inventory to branch: Aye (Deliveries at cost)	50 000		
Bank (Branch local purchases at cost)	10 500		

Dr — Inventory to branch: Aye (at cost price) — Cr

			R
		Branch inventory: Aye (Deliveries at cost)	50 000

Dr — Bank — Cr

			R
		Branch inventory: Aye (Branch local purchases at cost)	10 500

9.3.3 *Inventory returned to head office*

When inventory is returned by the branch to the head office, the branch inventory account is credited and inventory to branch account debited with the cost price of inventory returned.

Example 9.2 Inventory returned to head office

Inventory costing R2 000 received by Aye branch from head office was defective and consequently returned to head office.

Required:

Record the above transaction in the general ledger of head office.

Solution:

AB Traders (Head office)
General ledger

Dr — Branch inventory: Aye (at cost price) — Cr

	R		R
Inventory to branch: Aye (Deliveries at cost)	50 000	Inventory to branch: Aye (Returns at cost)	2 000
Bank (Branch local purchases at cost)	10 500		

Dr — Inventory to branch: Aye (at cost price) — Cr

	R		R
Branch inventory: Aye (Returns at cost)	2 000	Branch inventory: Aye (Deliveries at cost)	50 000

9.3.4 *Sale of inventory by the branch*

When inventory is sold for cash, the amount of the sale is recorded on the credit side of the branch inventory account and debited to the bank account.

Where inventory is sold on credit, the sale transaction is also recorded on the credit side of the branch inventory account but debited to the trade receivables control account.

Example 9.3 Sale of inventory by the branch

Aye branch sold inventory with a selling price of R25 000 for cash and inventory with a selling price of R21 500 on credit.

Required:

Record the above transactions in the general ledger of head office.

Solution:

AB Traders (Head office)
General ledger

Dr **Branch inventory: Aye (at cost price)** **Cr**

	R		R
Inventory to branch: Aye (Deliveries at cost)	50 000	Inventory to branch: Aye (Returns at cost)	2 000
Bank (Branch local purchases at cost)	10 500	Bank (Cash sales)	25 000
		Branch trade receivables control: Aye (Credit sales)	21 500

Dr **Bank** **Cr**

	R		R
Branch inventory: Aye (Cash sales)	25 000	Branch inventory: Aye (Branch local purchases at cost)	10 500

Dr **Branch trade receivables control: Aye** **Cr**

	R		
Branch inventory: Aye (Credit sales)	21 500		

9.3.5 *Settlement discount granted to debtors*

Discounts may be granted by a branch to its debtors for prompt payment of outstanding amounts. Settlement discount granted on branch debtors accounts results in a reduction in the cash amount that is received from debtors. To record the settlement discount granted to debtors, the settlement discount granted account is debited and the trade receivables control account credited. At the end of the accounting period, the settlement discount granted account is closed off to the branch inventory account.

Example 9.4 Settlement discount granted to branch debtors

A debtor owing R5 000 for inventory sold by Aye branch, settled the account in full with a cash payment of R4 900.

Required:

Record the above transaction in the general ledger of head office.

Solution:

AB Traders (Head office)
General ledger

Dr **Bank** **Cr**

	R		R
Branch inventory: Aye (Cash sales)	25 000	Branch inventory: Aye (Branch local purchases at cost)	10 500
Branch trade receivables control: Aye (Debtors' payments)	4 900		

Dr **Branch trade receivables control: Aye** **Cr**

	R		R
Branch inventory: Aye (Credit sales)	21 500	Bank (Debtors' payments)	4 900
		Settlement discount granted: Aye	100

Dr **Settlement discount granted: Aye** **Cr**

	R		
Branch trade receivables	100		

9.3.6 *Inventory marked down*

In order to entice customers to buy its products, the branch can decide to mark-down some of its inventory. This implies that inventory may be sold at a discount on the normal selling price or, in some instances, at a price lower than the cost price of the inventory. If inventory is invoiced at cost price and is sold at a price either lower than the normal selling price or cost price, the mark-down on such sale does not require any entry in the books. The sales transaction is recorded in the same way as discussed in paragraph 9.3.4. A loss will, however, be suffered by the branch when inventory is sold below cost, but this loss will automatically be reflected in a lower gross profit or a higher gross loss in the branch inventory account.

9.3.7 *Cash embezzled or stolen*

Cash received from the proceeds of sales of inventory or received from the settlement of debtors accounts may be embezzled or misappropriated at the branch.

Where cash is embezzled from proceeds of cash sales, two entries will be necessary on the credit side of the branch inventory account. The first entry is in respect of the amount of cash banked from cash sales and the second entry relates to cash that is embezzled. The bank account is debited with cash that is banked and the branch expense account debited with the cash that is embezzled.

In cases where cash embezzled consists of monies received in settlement of debtors' accounts, the bank account is debited with the actual amount banked, that is, payments received from debtors less cash embezzled. The branch expense account is debited with the cash that is embezzled. The trade receivables control account is credited with the amount of cash available for banking and also credited with the cash that has been embezzled. The entries in the branch trade receivables control account are necessary to reflect the payment by a debtor. The bank account is debited with the amount of cash banked.

Example 9.5 Cash embezzled or stolen

After an investigation, it was discovered that R500 cash received from cash sales of R2 000 and R250 cash received from a debtor in full settlement of his account of R3 250 was stolen at Aye branch. Due to the pending investigation, the transactions were not as yet accounted for.

Required:

Record the above transactions in the general ledger of head office.

Solution:

AB Traders (Head office)
General ledger

Dr **Branch inventory: Aye (at cost price)** **Cr**

	R		R
Inventory to branch: Aye (Deliveries at cost)	50 000	Inventory to branch: Aye (Returns at cost)	2 000
Bank (Branch local purchases at cost)	10 500	Bank (Cash sales)	25 000
		Branch trade receivables control: Aye (Credit sales)	21 500
		Bank (Cash sales)	1 500
		Branch expenses: Aye (Cash embezzled from cash sales)	500

Dr **Branch trade receivables control** **Cr**

	R		R
Branch inventory: Aye (Credit sales)	21 500	Bank (Debtors' payments)	4 900
		Settlement discount granted: Aye	100
		Bank (Debtors' payments)	3 000
		Branch expenses: Aye (Cash embezzled from debtor's payment)	250

Dr **Bank** **Cr**

	R		R
Branch inventory: Aye (Cash sales)	25 000	Branch inventory: Aye (Branch local purchases at cost)	10 500
Branch trade receivables control: Aye (Debtors' payments)	4 900		
Branch inventory: Aye (Cash sales)	1 500		
Branch inventory: Aye (Debtors' payments)	3 000		

continued

Dr **Branch expenses: Aye** **Cr**

	R		
Branch inventory: Aye (Cash embezzled from cash sales)	500		
Branch trade receivables control: Aye (Cash embezzled from debtors' payments)	250		

Note that in both instances, cash embezzled is debited to the branch expenses account to reflect the loss on the part of Aye branch.

9.3.8 *Inter-branch inventory transactions*

In most cases, inventory transactions consist mainly of transactions between the head office and its branch(es). If more than one branch exists, the branches are allowed to deal directly with each other. For example, a branch which has a temporary shortage of a particular item can obtain it from the nearest branch if the head office does not have the inventory in stock. Because the head office keeps a separate set of accounting records for each branch, the entries will merely reflect the transfer of inventory in the branch inventory accounts of the affected branches. The branch inventory account of the transferring branch is credited with the cost price of inventory transferred and the branch inventory account of the receiving branch is debited.

Example 9.6 Inter-branch inventory transactions

Inventory costing R2 000 is transferred from Aye branch to Bee branch.

Required:

Record the above transaction in the general ledger of head office.

Solution:

AB Traders (Head office)
General ledger

Dr **Branch inventory: Bee (at cost price)** **Cr**

	R		
Branch inventory: Aye (Inventory transferred from Aye branch)	2 000		

Dr **Branch inventory: Aye (at cost price)** **Cr**

	R		R
Inventory to branch: Aye (Deliveries at cost)	50 000	Inventory to branch: Aye (Returns at cost)	2 000
Bank (Branch local purchases at cost)	10 500	Bank (Cash sales)	25 000
		Branch trade receivables control: Aye (Credit sales)	21 500
		Bank (Cash sales)	1 500
		Branch expenses: Aye (Cash embezzled from cash sales)	500
		Branch inventory: Bee (Inventory transferred to Bee branch)	2 000

9.3.9 *Branch expenses*

Major expenses of the branch are normally paid by head office and minor expenses by the branch from its petty cash. If an expense of the branch is paid for by the head office, the bank account is credited with the amount paid and the branch expense account debited. When the branch pays minor expenses from its petty cash, the branch petty cash account is credited and the branch expense account debited.

Example 9.7 Branch expenses

Maintenance work, at a cost of R4 500, was carried out at Aye branch and was paid for in cash by head office. Aye branch paid R50 from petty cash as a donation to a local charity.

Required:

Record the above transactions in the general ledger of head office.

Solution:

AB Traders (Head office)
General ledger

Dr **Branch expenses: Aye** **Cr**

	R		
Branch inventory: Aye (Cash embezzled from cash sales)	500		
Branch trade receivables control: Aye (Cash embezzled from debtors' payments)	250		
Bank (Branch maintenance expenses)	4 500		
Petty cash: Aye (Branch donations)	50		

Dr **Bank** **Cr**

	R		R
Branch inventory: Aye (Cash sales)	25 000	Branch inventory: Aye (Branch local purchases at cost)	10 500
Branch trade receivables control: Aye (Debtors' payments)	4 900	Branch expenses: Aye (Branch maintenance)	4 500
Branch inventory: Aye (Cash sales)	1 500		
Branch inventory: Aye (Debtors' payments)	3 000		

Dr **Petty cash: Aye** **Cr**

			R
		Branch expenses: Aye (Branch donations)	50

9.3.10 *Inventory in transit*

It may happen that on the last day of the financial period, inventory is in transit between the branch and the head office. Because the branch keeps inventory records in the form of inventory sheets, this means that one party has dispatched the inventory to the other party and recorded the transaction in its records whilst the other party, not aware of the transaction, will have no entry in its records. The inventory in transit from head office to the branch must be recorded as a separate balance carried down on the credit side of the branch inventory account. At the beginning of the new accounting period, the inventory in transit from head office to the branch is recorded on the debit side as a separate balance brought down.

The opposite is the case where inventory is in transit from the branch to head office, i.e. the inventory in transit is recorded as a separate balance carried down on the debit side of the branch inventory account. At the beginning of the new accounting period, the inventory in transit from the branch to head office is recorded on the debit side as a separate balance brought down.

9.3.11 *Inventory on hand*

A physical inventory count will confirm the amount of inventory on hand at year-end. Provided that the differences between the physical inventory count and the inventory records have been resolved or recorded, the value of unsold closing inventory is recorded on the credit side of the branch inventory account. This amount is brought down on the debit side of this account and becomes the opening balance for the following accounting period. When preparing the financial statements of the head office and its branch(es), the closing inventory of the branch(es) is added to the head office inventory account and the total amount disclosed on the statement of financial position of the head office. The actual preparation of a statement of financial position by the head office falls outside the scope of this chapter.

9.3.12 *Inventory shortages and surpluses at the branch*

As mentioned in paragraph 9.3.11, the physical inventory count is undertaken at the branch to determine whether it corresponds with the monetary value of inventory at the branch. If the balance of the branch inventory account does not agree with the physical inventory count, the difference is indicative of a shortage or surplus in inventory. Shortages and surpluses can *inter alia* be caused by:

- ☐ incorrect inventory counting;
- ☐ missing inventory due to theft;
- ☐ incorrect recording of inventory transactions; or
- ☐ insignificant differences of which the origin cannot be established.

Where inventory is invoiced to the branch at cost price, no entry is required to record a shortage or surplus of inventory. A shortage is automatically absorbed by a lower gross profit or higher gross loss in the branch inventory account. Similarly, a surplus is automatically absorbed by a higher gross profit or a lower gross loss in the branch inventory account.

9.3.13 *Balancing of branch accounts*

The following example illustrates the recording of entries relating to the closing inventory at the branch, inventory in transit between the branch and the head office, and inventory shortages and surpluses at the branch:

Example 9.8 Recording of the closing inventory and inventory in transit

1. Inventory costing R2 500 was still in transit to the branch at the end of the accounting period. This inventory was included in the inventory of R50 000 that was invoiced to the branch. It was further established that part of the inventory, to the amount of R1 000 returned to head office by Aye branch, was still at the warehouse of a courier service company.
2. At the end of the financial period, the physical inventory count undertaken at Aye branch revealed that inventory with a cost price of R15 750 was on hand.

Required:

(a) Record the above information in the general ledger of head office.

(b) Balance and close off all the accounts except for the petty cash account and the branch inventory account of Bee branch.

Solution:

(a) and **(b)**

AB Traders (Head office)
General ledger

Dr **Branch inventory: Aye (at cost price)** **Cr**

		R			R
Inventory to branch: Aye (Deliveries at cost)		50 000	Inventory to branch: Aye (Returns at cost)		2 000
Bank (Branch local purchases at cost)		10 500	Bank (Cash sales)		25 000
Settlement discount granted		100	Branch trade receivables control: Aye (Credit sales)		21 500
Balance (Inventory in transit from branch to head office)	c/d	1 000	Bank: Cash sales		1 500
Branch expenses: Aye (Branch gross profit for the year)		9 150	Branch expenses: Aye (Cash embezzled from cash sales)		500
			Branch inventory: Bee (Inventory transferred to Bee branch)		2 000
			Balance (Inventory in transit from head office to branch)	c/d	2 500
			Balance	c/d	15 750
		70 750			70 750
Balance (Inventory in transit from head office to branch)	b/d	2 500	Balance (Inventory in transit from branch to head office)	b/d	1 000
Balance	b/d	15 750			

Comments:

- ☐ At the end of the accounting period, inventory in transit from the branch to head office (R1 000), is recorded as a balance carried down on the debit side of the branch inventory account. This becomes the opening balance for the new accounting period on the credit side of the branch inventory account.

- ☐ Inventory in transit from head office to the branch (R2 500) is recorded as a separate balance carried down on the credit side of the branch inventory account. At the beginning of the new accounting period, it becomes the opening balance that is recorded on the debit side of the branch inventory account.
- ☐ When the branch inventory account is balanced, the branch gross profit of R9 150 is obtained. The gross profit is as a result of the difference between the prices at which inventory was received by the branch (cost price) and the prices at which inventory was sold by the branch (selling price). The gross profit is transferred to the credit side of the branch expense account.

Dr **Inventory to branch: Aye (at cost price)** **Cr**

	R		R
Branch inventory: Aye (Returns at cost)	2 000	Branch inventory: Aye (Deliveries at cost)	50 000
Head office trading account	48 000		
	50 000		50 000

Dr **Settlement discount granted: Aye** **Cr**

	R		R
Branch trade receivables control: Aye (Settlement discount granted)	100	Branch inventory: Aye	100
	100		100

Dr **Branch expenses: Aye** **Cr**

	R		R
Branch inventory: Aye (Cash embezzled from cash sales)	500	Branch inventory: Aye (Branch gross profit for the year)	9 150
Branch trade receivables control: Aye (Cash embezzled from debtors' payments)	250		
Bank (Branch maintenance)	4 500		
Petty cash: Aye (Branch donations)	50		
Head office: Profit or loss (Branch profit for the year)	3 850		
	9 150		9 150

Comment:

The branch expenses account serves the same function as the profit or loss account and records all expenses incurred by the branch. The balance on this account represents the branch profit for the year of R3 850, which is incorporated into the head office profit or loss account.

Dr **Bank** **Cr**

		R			**R**
Branch inventory: Aye (Cash sales)		25 000	Branch inventory: Aye (Branch local purchases at cost)		10 500
Branch trade receivables control: Aye (Debtors' payments)		4 900	Branch expenses: Aye (Branch maintenance)		4 500
Branch inventory: Aye (Cash sales)		1 500	Balance	c/d	19 400
Branch trade receivables control: Aye (Debtors' payments)		3 000			
		34 400			34 400
Balance	b/d	19 400			

Dr **Branch trade receivables control: Aye** **Cr**

		R			**R**
Branch inventory: Aye (Credit sales)		21 500	Bank (Debtors' payments)		4 900
			Settlement discount granted: Aye		100
			Bank (Debtors' payments)		3 000
			Branch expenses: Aye (Cash embezzled from debtors' payments)		250
			Balance	c/d	13 250
		21 500			21 500
Balance	b/d	13 250			

Example 9.9 Comprehensive example – inventory sent by head office to its branch and invoiced at cost price

Country Trading CC deals in general merchandise and has a single branch in a neighbouring town trading under the same name. The following information relates to the branch and head office of Country Trading CC:

1.	**Balances at 1 January 20.1:**	**R**
	Inventory on hand (branch)	5 000
	Bank (favourable)	1 000
	Branch trade receivables control	2 500
2.	**Transactions of the branch during the year ended 31 December 20.1:**	
	Inventory sent to branch	20 000
	Inventory returned by branch to head office	1 000
	Cash sales by branch	16 000
	Credit sales by branch	9 300
	Sundry expenses of branch (paid by head office)	400
	Cash received from branch debtors and paid into head office bank account	6 000
	Settlement discount granted	200

Additional information:

1 Inventory is invoiced to the branch at cost price.

2 Inventory at 31 December 20.1 amounted to R2 200 which was in agreement with the inventory count.

Required:

Prepare the following accounts in the general ledger of Country Trading CC:

(a) Branch inventory;

(b) Inventory to branch;

(c) Bank;

(d) Branch trade receivables control;

(e) Branch expenses; and

(f) Settlement discount granted.

Balance and close off all the accounts at 31 December 20.1.

Solution:

(a)

Country Trading CC (Head office)
General ledger

Dr **Branch inventory (at cost price)*** **Cr**

20.1				**R**	20.1				**R**
Jan	1	Balance	b/d	5 000	Dec	31	Inventory to branch (Returns at cost)		1 000
Dec	31	Inventory to branch (Deliveries at cost)		20 000			Bank (Cash sales)		16 000
		Settlement discount granted		200			Branch trade receivables control (Credit sales)		9 500
		Branch expenses (Branch gross profit for the year)		3 500			Balance		2 200
				28 700					28 700
20.2									
Jan	1	Balance	b/d	2 200					

* In the case where the head office has a single branch, it is not necessary to identify each branch account by adding the name of the branch to the ledger account, as was the case in the previous examples (refer to Aye and Bee branches).

(b)

Dr **Inventory to branch (at cost price)** **Cr**

				R					R
20.1 Dec	31	Branch inventory (Returns at cost)		1 000	20.1 Dec	31	Branch inventory (Deliveries at cost)		20 000
		Head office trading account		19 000					
				20 000					20 000

(c)

Dr **Bank** **Cr**

				R					R
20.1 Jan	1	Balance	b/d	1 000	20.1 Dec	31	Branch expenses		400
Dec	31	Branch inventory (Cash sales)		16 000			Balance	c/d	22 600
		Branch trade receivables control (Debtors' payments)		6 000					
				23 000					23 000
20.2 Jan	1	Balance	b/d	22 600					

(d)

Dr **Branch trade receivables control** **Cr**

				R					R
20.1 Jan	1	Balance	b/d	2 500	20.1 Dec	31	Bank (Debtors' payments)		6 000
Dec	31	Branch inventory (Credit sales)		9 500			Settlement discount granted		200
							Balance	c/d	5 800
				12 000					12 000
20.2 Jan	1	Balance	b/d	5 800					

(e)

Dr **Branch expenses** **Cr**

				R					R
20.1 Dec	31	Bank (Sundry expenses)		400	20.1 Dec	31	Branch inventory (Branch gross profit for the year)		3 500
		Head office: Profit or loss (Branch profit for the year)		3 100					
				3 500					3 500

(f)

Dr		Settlement discount granted: Aye	Cr
	R		**R**
Branch trade receivables control: (Settlement discount granted)	200	Branch inventory	200
	200		200

9.4 Recording of transactions where inventory sent to the branch is invoiced at selling price

9.4.1 *Introduction*

This method of recording branch transactions differs from the method discussed in paragraph 9.3 in the sense that inventory is invoiced to the branch at selling price instead of cost price. When this method is applied, inventory invoiced to the branch at selling price must be divided into a cost price element and profit mark-up element before the transaction can be recorded.

Because the profit mark-up is recorded separately from the cost price, a new account called the "branch adjustment account" is opened. This is in addition to the branch inventory account and inventory to branch account. The purpose of the branch adjustment account is to record the profit mark-up on all inventory transactions between the branch and head office as well as on purchases by the branch from other suppliers. At the end of the accounting period, when this account is balanced, a gross profit or loss is calculated, which implies that this account functions as the trading account of the branch.

The branch inventory account records the selling price of inventory sent to the branch in such a way that the cost price and profit mark-up are recorded separately in the branch inventory account. It will be remembered that when inventory was invoiced to the branch at cost price, the branch inventory account served the purpose of a trading account (refer to paragraph 9.3.1). Since inventory is now invoiced to the branch at selling price, that purpose will no longer be served by the branch inventory account but by the branch adjustment account. The branch inventory account now functions as a control account of all inventory transactions of the branch.

The inventory to branch account still serves the same purpose of recording inventory transactions between the head office and the branch at cost prices (refer to paragraph 9.3.1).

9.4.2 *Calculation of the profit mark-up in branch inventory*

The selling price at which inventory is invoiced to the branch is inclusive of the profit mark-up. To record transactions in the branch inventory account, the selling price must be split into a cost and a profit mark-up amount. The cost price portion of the selling price is posted to the inventory to the branch account and the profit mark-up portion of the selling price is posted to the branch adjustment account. If inventory is, for example, invoiced to the branch at cost plus 25%, it implies that inventory with a cost price of R200 is invoiced to the branch at R250 (R200 + 25%).

If an invoiced amount only shows the selling price at which inventory is sent to the branch, the profit mark-up percentage can be used to calculate the cost price. For example, if inventory is invoiced at a selling price of R250 and the profit mark-up is 25% on cost, the cost price is calculated as follows:

	%
Cost price	100
Profit mark-up	25
Selling price	125

The selling price includes the profit mark-up. In order to determine profit mark-up, the following calculation is necessary:

25/125 × R250 = R50

The cost price is therefore:

R250 – R50 = R200

The cost price can also be determined directly as a percentage of the selling price. Using the above example, the cost price can be calculated as follows:

100/125 × R250 = R200

Examples 9.11 to 9.16 illustrate the basic concepts underlying the recording of branch transactions, in the books of XYZ Traders (the head office), when inventory is invoiced to the branch at selling price. The compilation of branch accounts will progress with every example as transactions occur. The recording of new transactions, illustrated in the examples, will be, highlighted as opposed to information that originated in subsequent examples.

9.4.3 *Inventory sent to the branch and purchases by the branch*

When inventory is sent by head office to its branch at selling price, the following entries must be made in the appropriate ledger accounts: Debit the branch inventory account with the cost price of the inventory and credit the inventory to branch account with the cost price of the inventory. Debit the branch inventory account with the profit mark-up amount and credit the branch adjustment account with the profit mark-up amount.

If the branch is authorised to make purchases from other suppliers, the branch inventory account is also separately debited with the cost price and the profit mark-up. As explained in paragraph 9.3.2, the cost price of inventory purchased by the branch from other suppliers is not recorded in the inventory to branch account as the inventory has not been sent from head office. Instead, the trade payables control or bank account (depending on whether the inventory was purchased on credit or for cash), must be credited with the total cost price of the inventory purchased. The profit mark-up which the branch will add to the cost price of the inventory purchased from other suppliers is recorded on the credit side of the branch adjustment account and the debit side of the branch inventory account.

Example 9.10 Inventory sent to the branch and purchases by the branch

Inventory with a cost price of R100 000 is invoiced from head office to Omega branch at cost plus 25%. The branch also bought inventory with a cost price of R20 000 on credit from a nearby supplier. The mark-up on purchases by the branch from other suppliers is also 25%.

Required:

Record the above transactions in the general ledger of head office.

Solution:

XYZ Traders (Head office)
General ledger

Dr **Branch inventory: Omega (at selling price)** **Cr**

	R		
Inventory to branch: Omega (Deliveries at cost)	100 000		
Branch adjustment: Omega (Mark-up on deliveries)	①25 000		
Branch trade payables control: Omega (Local purchases at cost)	20 000		
Branch adjustment: Omega (Mark-up on local purchases)	②5 000		

Dr **Inventory to branch: Omega (at cost price)** **Cr**

			R
		Branch inventory: Omega (Deliveries at cost)	100 000

Dr **Branch trade payables control: Omega** **Cr**

			R
		Branch inventory: Omega (Local purchases at cost)	20 000

Dr **Branch adjustment: Omega (mark-up at 25% on cost)** **Cr**

			R
		Branch inventory: Omega (Mark-up on deliveries)	①25 000
		Branch inventory: Omega (Mark-up on local purchases)	②5 000

Calculations:

① R100 000 × 25% = R25 000

② R20 000 × 25% = R5 000

9.4.4 *Inventory returned to head office*

When inventory is returned to head office by the branch, the branch inventory account must be separately credited with the cost price of the inventory returned and the profit mark-up thereon. The inventory to branch account is debited with the cost price of the inventory returned and the branch adjustment account is debited with the profit mark-up on the inventory returned.

Example 9.11 Inventory returned to head office

Inventory with a selling price of R15 000 was returned to head office by Omega branch. Inventory is invoiced by head office to the branch at 25% on cost.

XYZ Traders (Head office)
General ledger

Dr — Branch inventory: Omega (at selling price) — Cr

	R		R
Inventory to branch: Omega (Deliveries at cost)	100 000	Inventory to branch: Omega (Returns at cost)	①12 000
Branch adjustment: Omega (Mark-up on deliveries)	25 000	Branch adjustment: Omega (Mark-up on returns)	②3 000
Branch trade payables control: Omega (Local purchases at cost)	20 000		
Branch adjustment: Omega (Mark-up on local purchases)	5 000		

Dr — Inventory to branch: Omega (at cost price) — Cr

	R		R
Branch inventory: Omega (Returns at cost)	①12 000	Branch inventory: Omega (Deliveries at cost)	100 000

Dr — Branch adjustment: Omega (mark-up at 25% on cost) — Cr

	R		R
Branch inventory: Omega (Mark-up on returns)	②3 000	Branch inventory: Omega (Mark-up on deliveries)	25 000
		Branch inventory: Omega (Mark-up on local purchases)	5 000

Calculations:

① R15 000 × 100/125 = R12 000

② R15 000 × 25/125 = R3 000 or R15 000 – R12 000 = R3 000

9.4.5 *Sale of inventory by the branch*

The sale of inventory, whether for cash or credit, is dealt with in the same way as discussed in paragraph 9.3.4. The only difference is that inventory is now sold at the same price (selling price) at which it was delivered by head office to the branch. When inventory is sold for cash, the amount of the sale is recorded on the credit side of the branch inventory account and debited to the bank account. When inventory is sold on credit, the sale transaction is still recorded on the credit side of the branch inventory account but debited to the branch trade receivables control account.

Example 9.12 Sale of inventory by the branch

Omega branch sold inventory with a selling price of R75 000 for cash and inventory with a selling price of R18 750 on credit.

Required:

Record the above transactions in the general ledger of head office.

Solution:

XYZ Traders (Head office)
General ledger

Dr — Branch inventory: Omega (at selling price) — Cr

	R		R
Inventory to branch: Omega (Deliveries at cost)	100 000	Inventory to branch: Omega (Returns at cost)	12 000
Branch adjustment: Omega (Mark-up on deliveries)	25 000	Branch adjustment: Omega (Mark-up on returns)	3 000
Branch trade payables control: Omega (Local purchases at cost)	20 000	Bank (Cash sales)	75 000
Branch adjustment: Omega (Mark-up on local purchases)	5 000	Branch trade receivables control: Omega (Credit sales)	18 750

Dr — Bank — Cr

	R		
Branch inventory: Omega (Cash sales)	75 000		

Dr — Branch trade receivables control: Omega — Cr

	R		
Branch inventory: Omega (Credit sales)	18 750		

9.4.6 *Settlement discount granted to debtors*

When inventory is invoiced to the branch at selling price, the settlement discount granted to debtors in settlement of their outstanding accounts is recorded in a similar manner as discussed in paragraph 9.3.5. The difference is only on the closing off procedure of the settlement discount granted account. When inventory is invoiced to the branch at selling price, the settlement discount granted account is closed off to the branch adjustment account.

9.4.7 *Inventory marked down*

When inventory is invoiced to the branch at selling price, a mark-down or discount on the normal selling price of inventory will reduce the normal profit mark-up on inventory. If the mark-down is only limited to the normal profit mark-up on inventory, the branch adjustment account must be debited and the branch inventory account credited with the amount marked down. The purpose of these entries is to adjust the initial profit that was recorded when inventory was received by the branch from the head office so that the branch inventory account maintains its function as a control account over the inventory transactions of the branch.

Example 9.13 Inventory marked down

Inventory is invoiced to Omega branch at selling price, which is cost plus 25%. During the year, Omega branch sold inventory at a discount of 20% on selling price for R3 200 cash.

Required:

Record the above transaction in the general ledger of head office.

Solution:

The discount on the normal selling price can be determined as follows:

	%
Cost price	100
Profit mark-up	25
Original selling price	125
Mark-down (20% × 125)	(25)
Sold at	100

The original selling price is:

R3 200 × 125/100 = R4 000

The mark-down on the original selling price is therefore:

R4 000 – R3 200 = R800

or

25/125 × R4 000 = R800

The mark-down is recorded in the books as follows:

XYZ Traders (Head office)
General ledger

Dr — Branch inventory: Omega (at selling price) — Cr

	R		R
Inventory to branch: Omega (Deliveries at cost)	100 000	Inventory to branch: Omega (Returns at cost)	12 000
Branch adjustment: Omega (Mark-up on deliveries)	25 000	Branch adjustment: Omega (Mark-up on returns)	3 000
Branch trade payables control: Omega (Local purchases at cost)	20 000	Bank (Cash sales)	75 000
Branch adjustment: Omega (Mark-up on local purchases)	5 000	Branch trade receivables control: Omega (Credit sales)	18 750
		Bank (Cash sales)	3 200
		Branch adjustment: Omega (Mark-down on sales)	800

Dr — Branch adjustment: Omega (mark-up at 25% on cost) — Cr

	R		R
Branch inventory: Omega (Mark-up on returns)	3 000	Branch inventory: Omega (Mark-up on deliveries)	25 000
Branch inventory: Omega (Mark-down on sales)	800	Branch inventory: Omega (Mark-up on local purchases)	5 000

Dr — Bank — Cr

	R		
Branch inventory: Omega (Cash sales)	75 000		
Branch inventory: Omega (Cash sales)	3 200		

It may also happen that the inventory is marked down or discounted to below cost. Remember that when inventory was invoiced to the branch at cost price, the mark down of inventory to below cost required no entry in the books because the branch inventory account fulfilled the purpose of a trading account. When inventory is invoiced to the branch at selling price, the branch inventory account now functions as a control account of all inventory transactions of the branch. Thus, the mark down to below cost price must be recorded on the credit side of the branch inventory account, or else the branch inventory account will reflect a shortage of inventory. The second account that is affected by the mark down on cost is the branch expense account, which is credited with the amount of the mark down on cost.

Note that the accounting treatment of a mark down below cost consists of two parts, namely, (1) a mark down on the normal selling price to cost, and (2) an additional mark down on the cost of the inventory.

Example 9.14 Inventory marked down below cost

Inventory is invoiced to Omega branch at selling price, which is cost plus 25%. During the year, inventory was sold at a discount of 30% for R2 940 cash.

Required:

Record the above transaction in the general ledger of head office.

Solution:

The normal selling price can be calculated as follows:

	%
Cost price	100
Profit mark-up	25
Original selling price	125
Mark-down (30% × 125)	(37,5)
Sold at	87,5

The original selling price is:
R2 940 × 125/87,5 = R4 200

The cost price is:
R4 200 × 100/125 = R3 360

Therefore, the mark-down on cost is:
R3 360 – R2 940 = R420

The mark-down in this case is divided into two parts:

(1) a mark-down on sales of R840 (R4 200 – R3 360) (the normal profit mark-up) which must be recorded in the branch adjustment account; and

(2) a mark-down on cost of R420 (R3 360 – R2 940) which must be taken into account and which represents a loss. This loss is debited to the branch expenses account.

The entries to account for the two amounts are as follows:

XYZ Traders (Head office)
General ledger

Dr **Branch inventory: Omega (at selling price)** **Cr**

	R		R
Inventory to branch: Omega (Deliveries at cost)	100 000	Inventory to branch: Omega (Returns at cost)	12 000
Branch adjustment: Omega (Mark-up on deliveries)	25 000	Branch adjustment: Omega (Mark-up on returns)	3 000
Branch trade payables control: Omega (Local purchases at cost)	20 000	Bank (Cash sales)	75 000
Branch adjustment: Omega (Mark-up on local purchases)	5 000	Branch trade receivables control: Omega (Credit sales)	18 750
		Bank (Cash sales)	3 200
		Branch adjustment: Omega (Mark-down on sales)	800
		Bank (Cash sales)	2 940
		Branch adjustment: Omega (Mark-down on sales)	840
		Branch expenses: Omega (Mark-down on cost)	420

continued

Dr	Bank		Cr
	R		
Branch inventory: Omega (Cash sales)	75 000		
Branch inventory: Omega (Cash sales)	3 200		
Branch inventory: Omega (Cash sales)	2 940		

Dr	Branch adjustment: Omega (mark-up at 25% on cost)		Cr
	R		R
Branch inventory: Omega (Mark-up on returns)	3 000	Branch inventory: Omega (Mark-up on deliveries)	25 000
Branch inventory: Omega (Mark-down on sales)	800	Branch inventory: Omega (Mark-up on local purchases)	5 000
Branch inventory: Omega (Mark-down on sales)	840		

Dr	Branch expenses		Cr
	R		
Branch inventory: Omega (Mark-down on cost)	420		

9.4.8 *Cash embezzled*

When inventory is invoiced to the branch at selling price, the cash embezzled is recorded in the same way as discussed in paragraph 9.3.7.

9.4.9 *Inter-branch inventory transactions*

Inter-branch inventory transactions are treated in the same way as discussed in paragraph 9.3.8. The only difference is that when inventory is delivered to branches at selling prices, the profit mark-up must also be accounted for.

The branch inventory account of the transferring branch is credited with the cost price of inventory transferred and with the profit mark-up thereon. The branch adjustment account of the transferring branch is debited with the profit mark-up on inventory transferred.

The branch inventory account of the receiving branch is debited with the cost price of inventory transferred and with the profit mark-up thereon. The branch adjustment account of the receiving branch is credited with the profit mark-up on inventory transferred.

Example 9.15 Inter-branch inventory transactions

Inventory is invoiced to branches at selling price, which is cost plus 25%. Inventory with a selling price of R13 000 is transferred from the Alpha branch to the Omega branch.

Required:

Record the above transaction in the general ledger of head office.

Solution:

XYZ Traders (Head office)
General ledger

Dr — Branch inventory: Omega (at selling price) — Cr

	R		R
Inventory to branch: Omega (Deliveries at cost)	100 000	Inventory to branch: Omega (Returns at cost)	12 000
Branch adjustment: Omega (Mark-up on deliveries)	25 000	Branch adjustment: Omega (Mark-up on returns)	3 000
Branch trade payables control: Omega (Local purchases at cost)	20 000	Bank (Cash sales)	75 000
Branch adjustment: Omega (Mark-up on local purchases)	5 000	Branch trade receivables control: Omega (Credit sales)	18 750
Branch inventory: Alpha (Inventory transferred from Alpha branch)	①10 400	Bank (Cash sales)	3 200
Branch adjustment: Omega (Mark-up on inventory transferred from Alpha branch)	②2 600	Branch adjustment: Omega (Mark-down on sales)	800
		Bank (Cash sales)	2 940
		Branch adjustment: Omega (Mark-down on sales)	840
		Branch expenses: Omega (Mark-down on cost)	420

Dr — Branch adjustment: Omega (mark-up at 25% on cost) — Cr

	R		R
Branch inventory: Omega (Mark-up on returns)	3 000	Branch inventory: Omega (Mark-up on deliveries)	25 000
Branch inventory: Omega (Mark-down on sales)	800	Branch inventory: Omega (Mark-up on local purchases)	5 000
Branch inventory: Omega (Mark-down on sales)	840	Branch inventory: Omega (Mark-up on inventory transferred from Alpha branch)	②2 600

Dr — Branch inventory: Alpha (at selling price) — Cr

			R
		Branch inventory: Omega (Inventory transferred to Omega branch)	①10 400
		Branch adjustment: Alpha (Mark-up on inventory transferred to Omega branch)	②2 600

Dr — Branch adjustment: Alpha (mark-up at 25% on cost) — Cr

	R		
Branch inventory: Omega (Mark-up on inventory transferred to Omega branch)	②2 600		

Calculations:

① R13 000 × 100/125 = R10 400

② R13 000 × 25/125 = R2 600

9.4.10 *Branch expenses*

Expenses incurred by the branch, when inventory is invoiced to the branch at selling price, are dealt with in the same way as discussed in paragraph 9.3.9.

9.4.11 *Inventory in transit*

If inventory is invoiced to the branch at selling price and if this inventory is still in transit on the last day of the financial period, the selling price of inventory in transit from head office to the branch is recorded, at selling price, as a separate balance carried down on the credit side of the branch inventory account. This becomes the opening balance brought down at the beginning of the new accounting period which is recorded on the debit side of the branch inventory account. The profit mark-up thereon is also recorded in the branch adjustment account as a separate balance carried down on the debit side. At the beginning of the new accounting period, the profit mark-up becomes the opening balance brought down which is recorded separately on the credit side of the branch adjustment account.

9.4.12 *Inventory on hand*

The balance of closing (unsold) inventory is entered on the credit side of the branch inventory account and is brought down on the debit side of this account, and represents the opening balance for the next accounting period. Since all entries in the branch inventory account are made at selling price, the value of closing inventory will therefore be at selling price.

The profit mark-up on the closing inventory is recorded as a balance on the debit side of the branch adjustment account as it represents the unrealised profit (profit not yet earned) in the closing inventory. This balance is brought down on the credit side of the branch adjustment account and represents the opening balance for the next accounting period.

When preparing financial statements, the balance of the closing inventory is reduced to its cost price by deducting the balance on the branch adjustment account. The cost price of closing inventory is added to the head office inventory account and the total amount disclosed as inventory on the statement of financial position of the head office. The actual preparation of financial statements by the head office falls outside the scope of this chapter.

9.4.13 *Inventory shortages and surpluses at the branch*

Where inventory is invoiced to the branch at selling price, the function of the branch inventory account is that of a control account over receipts and sales of inventory sent to the branch (refer to paragraph 9.4.1). Inventory is sold at the same price as that at which it was received from head office. The balance (at selling price) on the branch inventory account should at any given moment correspond to the monetary value of physical inventory on hand at the branch. If the balance of the branch inventory account does not agree with the physical inventory count, the difference is indicative of a shortage or surplus of inventory. Shortages and surpluses can, amongst other things, be caused by:

- ☐ incorrect inventory counting;
- ☐ missing inventory due to theft;
- ☐ incorrect recording of inventory transactions; and
- ☐ insignificant differences, the origin of which cannot be established.

The cost price of missing inventory is credited to the branch inventory account and debited to the branch expenses account. The profit mark-up thereon is credited to the branch inventory account and debited to the branch adjustment account.

If the source of a shortage or a surplus cannot be established, but the amount is insignificant in relation to the total amount of inventory transactions with the branch, the following entries must be made:

- ☐ in the case of a shortage, debit the branch adjustment account with the total amount of the shortage and credit the branch inventory account; and
- ☐ in the case of a surplus, debit the branch inventory account with the amount of the surplus and credit the branch adjustment account with the same amount.

If the shortage or surplus is significant, the reason for the discrepancy must be investigated in order to account for it correctly and to avoid future occurrence of such shortages or surpluses.

9.4.14 *Balancing of branch accounts*

The following example illustrates the recording of entries relating to the closing inventory at the branch, inventory in transit between the branch and the head office, and inventory shortages and surpluses at the branch.

Example 9.16 Recording of the closing inventory, inventory in transit, and inventory shortages and surpluses

- ☐ Inventory on hand at the end of the accounting period, as revealed by a physical inventory count, amounted to R34 160 (at selling price).
- ☐ Inventory invoiced to Omega branch at a selling price of R11 500, included in the amount of R100 000, is still in transit at the end of the accounting period.

Required:

(a) Record the above information in the general ledger of head office.

(b) Balance and close off the following accounts:

- ☐ Branch inventory: Omega (at selling price);
- ☐ Branch adjustment: Omega (mark-up at 25% on cost);
- ☐ Inventory to branch: Omega (at cost price);
- ☐ Branch expenses.

Solution:

(a) and **(b)**

XYZ Traders (Head office)
General ledger

Dr **Branch inventory: Omega (at selling price)** **Cr**

		R			R
Inventory to branch: Omega (Deliveries at cost)		100 000	Inventory to branch: Omega (Returns at cost)		12 000
Branch adjustment: Omega (Mark-up on deliveries)		25 000	Branch adjustment: Omega (Mark-up on returns)		3 000
Branch trade payables control: Omega (Local purchases at cost)		20 000	Bank (Cash sales)		75 000
Branch adjustment: Omega (Mark-up on local purchases)		5 000	Branch trade receivables control: Omega (Credit sales)		18 750
Branch inventory: Alpha (Inventory transferred from Alpha branch)		10 400	Bank (Cash sales)		3 200
Branch adjustment: Alpha (Mark-up on inventory transferred from Alpha branch)		2 600	Branch adjustment: Omega (Mark-down on sales)		800
			Bank (Cash sales)		2 940
			Branch adjustment: Omega (Mark-down on sales)		840
			Branch expenses: Omega (Mark-down on cost)		420
			Balance (Inventory in transit)	c/d	11 500
			Balance (Closing inventory)	c/d	34 160
			Branch adjustment: Omega (Inventory shortage)*		390
		163 000			163 000
Balance (Inventory in transit)	b/d	11 500			
Balance (Opening inventory)	b/d	34 160			

* The inventory shortage amounting to R390 is a balancing figure calculated after recording the inventory on hand and inventory in transit.

Dr **Branch adjustment: Omega (mark-up at 25% on cost)** **Cr**

		R			R
Branch inventory: Omega (Mark-up on returns)		3 000	Branch inventory: Omega (Mark-up on deliveries)		25 000
Branch inventory: Omega (Mark-down on sales)		800	Branch inventory: Omega (Mark-up on local purchases)		5 000
Branch inventory: Omega (Mark-down on sales)		840	Branch inventory: Omega (Mark-up on inventory transferred)		2 600
Branch inventory: Omega (Inventory shortage)		390			
Balance (Mark-up on inventory in transit)	c/d	①2 300			
Balance (Mark-up on closing inventory)	c/d	②6 832			

continued

Dr **Branch adjustment: Omega (mark-up at 25% on cost)** **Cr**

		R			R
Branch expenses: Omega (Branch gross profit for the year)		18 438			
		32 600			32 600
			Balance (Mark-up on inventory in transit)	b/d	①2 300
			Balance (Mark-up on opening inventory)	b/d	②6 832

Calculations:

① R11 500 × 25/125 = R2 300

② R34 160 × 25/125 = R6 832

Comment:

The gross profit of R18 438 is a balancing figure and can only be obtained after recording the balance carried down (unrealised profit in closing inventory) of R6 832, and profit mark-up on inventory in transit of R2 300. This gross profit represents the profit derived from the branch's trading activities and is transferred to the branch expenses account.

Dr **Inventory to branch: Omega (at cost price)** **Cr**

	R		R
Branch inventory: Omega (Returns at cost)	12 000	Branch inventory: Omega (Deliveries at cost)	100 000
Head office trading account	88 000		
	100 000		100 000

Dr **Branch expenses: Omega** **Cr**

	R		R
Branch inventory: Omega (Mark-down on cost)	420	Branch adjustment: Omega (Branch gross profit for the year)	18 438
Head office: Profit or loss (Branch profit for the year)	18 018		
	18 438		18 438

Example 9.17 Comprehensive example – inventory sent by head office to its branch and invoiced at selling price

The following information relates to the branch and head office of Fish CC:

		R
1.	**Balances at 1 January 20.1:**	
	Bank (favourable)	10 000
	Inventory (at cost price)	9 200

2. **Transactions of the branch during the year ended 31 December 20.1:**

	R
Inventory sent to branch at cost	108 000
Credit sales	38 400
Cash sales	88 000
Inventory returned to head office at cost	2 400
Payments by branch debtors	20 000
Settlement discount granted to branch debtors	600
Damaged inventory written off at cost	2 000

Additional information:

1 Inventory supplied to the branch is invoiced at selling price, which is cost plus 20%.

2 An amount of R15 000, included in cash sales, was in respect of sales of inventory purchased from other suppliers and paid for by head office. The profit mark-up on inventory purchased from other suppliers is also 20% on cost.

3 A sales person embezzled cash amounting to R750 received from cash sales and the transaction is still to be recorded in the books.

4 In order to boost December sales, a special sales promotion was held at the branch where inventory was sold at selling price less 25%. Proceeds from the special promotion amounted to R22 500 and the amount is included in the cash sales figure.

5 When a physical inventory count was undertaken at the branch, it was discovered that inventory with a cost price of R4 000 was missing. The matter was investigated and it was established that inventory was stolen.

6 The branch donated inventory with a selling price of R1 800 to a local charitable organisation.

7 Inventory on hand at 31 December 20.1, according to the physical inventory count, amounted to R9 600 (at selling price).

Required:

Prepare the following accounts in the general ledger of Fish CC:

(a) Branch inventory;

(b) Inventory to branch;

(c) Branch adjustment;

(d) Trade receivables control;

(e) Bank;

(f) Settlement discount granted; and

(g) Branch expense.

Balance and close off all the accounts at 31 December 20.1.

Solution:

(a) **Fish CC (Head office)**

General ledger

Dr **Branch inventory (at selling price)*** **Cr**

				R					R
20.1 Jan	1	Balance	b/d	①11 040	20.1 Dec	31	Branch trade receivables control (Credit sales)		38 400
Dec	31	Inventory to branch (Deliveries at cost)		108 000			Bank (Cash sales)		88 000
		Branch adjustment (Mark-up on deliveries)		②21 600			Inventory to branch (Returns at cost)		2 400
		Bank (Local purchases at cost)		⑤12 500			Branch adjustment (Mark-up on returns)		③480
		Branch adjustment (Mark-up on local purchases)		⑤2 500			Branch expenses (Damaged inventory at cost)		2 000
		Branch adjustment (Inventory surplus)**		490			Branch adjustment (Mark-up on damaged inventory)		④400
							Branch expenses (Cash embezzled)		750
							Branch adjustment (Mark-down on sales)		⑥5 000
							Branch expenses (Mark-down on cost)		⑦2 500
							Branch expenses (Stolen inventory at cost)		4 000
							Branch adjustment (Mark-up on stolen inventory)		⑧800
							Branch expenses (Donated inventory at cost)		⑨1 500
							Branch adjustment (Mark-up on donated inventory)		⑨300
							Balance	c/d	9 600
				156 130					156 130
20.2 Jan	1	Balance	b/d	9 600					

* In the case where the head office has a single branch, it is not necessary to identify each branch account by adding the name of the branch to the ledger account as was the case in the previous examples (refer to Alpha and Omega branches).

** Inventory surplus amounting to R490 is a balancing figure calculated after recording the inventory on hand.

(b)

Dr **Inventory to branch (at cost price)** **Cr**

20.1				**R**	20.1				**R**
Dec	31	Branch inventory (Returns at cost)		2 400	Dec	31	Branch inventory (Deliveries at cost)		108 000
		Head office trading account		105 600					
				108 000					108 000

(c)

Dr **Branch adjustment (mark-up at 20% on cost)** **Cr**

20.1				**R**	20.1				**R**
Dec	31	Branch inventory (Mark-up on returns)		480	Jan	1	Balance (Mark-up on opening inventory)		①1 840
		Branch inventory (Mark-up on damaged inventory)		400	Dec	31	Branch inventory (Mark-up on deliveries)		21 600
							Branch inventory (Mark-up on local purchases)		2 500
		Branch inventory (Mark-down on sales)		5 000					
							Branch inventory (Inventory surplus)		490
		Branch inventory (Mark-up on stolen inventory)		800					
		Branch inventory (Mark-up on donated inventory)		300					
		Settlement discount granted		600					
		Branch expenses		17 250					
		(Branch gross profit for the year)							
		Balance (Mark-up on closing inventory)	c/d	⑩1 600					
				26 430					26 430
					20.2				
					Jan	1	Balance (Mark-up on opening inventory)	b/d	1 600

(d)

Dr **Branch trade receivables control** **Cr**

20.1				**R**	20.1				**R**
Dec	31	Branch inventory (Credit sales)		38 400	Dec	31	Bank (Debtors' payments)		20 000
							Settlement discount granted		600
							Balance	c/d	17 800
				38 400					38 400
20.2									
Jan	1	Balance	b/d	17 800					

(e)

Dr **Bank** **Cr**

20.1				**R**	20.1				**R**
Jan	1	Balance	b/d	10 000	Dec	31	Branch inventory (Local purchases at cost)		12 500
Dec	31	Branch inventory (Cash sales)		88 000			Balance	c/d	105 500
		Branch trade receivables control (Debtors' payments)		20 000					
				118 000					118 000
20.2									
Jan	1	Balance	b/d	105 500					

(f)

Dr **Settlement discount granted** **Cr**

	R		**R**
Branch trade receivables control (Settlement discount granted)	600	Branch adjustment	600
	600		600

(g)

Dr **Branch expenses** **Cr**

20.1				**R**	20.1				**R**
Dec	31	Branch inventory (Damaged inventory at cost)		2 000	Dec	31	Branch adjustment (Branch gross profit for the year)		17 250
		Branch inventory (Cash embezzled)		750					
		Branch inventory (Mark-down on cost)		2 500					

continued

Dr **Branch expenses** **Cr**

20.1				**R**	20.1				**R**
		Branch inventory (Stolen inventory at cost)		4 000					
		Branch inventory (Donated inventory at cost)		1 500					
		Head office: Profit or loss (Branch profit for the year)		6 500					
				17 250					17 250

Calculations:

①

	%
Cost	100
Profit mark-up	20
Selling price	120

Opening balance of branch inventory: R9 200 × 120/100 = R11 040
Opening balance of branch adjustment: R9 200 × 20% = R1 840

② **Profit mark-up on deliveries:** R108 000 × 20% = R21 600

③ **Profit mark-up on returns:** R2 400 × 20% = R480

④ **Profit mark-up on damaged inventory:** R2 000 × 20% = R400

⑤ **Local purchases at cost:** R15 000 × 100/120 = R12 500

Mark-up on local purchases: R12 500 × 20% = R2 500
or
R15 000 × 20/120 = R2 500

⑥ **Mark-down on selling price:**

	%
Cost	100
Profit mark-up	20
Original selling price	120
Mark-down (25% × 120)	(30)
Sold at	90

Original selling price: R22 500 × 120/90 = R30 000
Mark-down on sales: R30 000 × 20/120 = R5 000

⑦ **The cost price of inventory:** R30 000 × 100/120 = R25 000

Inventory sold at: R22 500

Therefore, the mark-down on cost is: R25 000 – R22 500 = R2 500

⑧ **Mark-up on stolen inventory:** R4 000 × 20% = R800

⑨ **Cost price of donated inventory:** R1 800 × 100/120 = R1 500

Profit mark-up on donated inventory: R1 800 × 20/120 = R300

⑩ **Profit mark-up on closing inventory:** R9 600 × 20/120 = R1 600

9.5 Summary

In order to expand business activities and improve profitability, business entities establish branches in areas where there are markets that can be penetrated. Branches are business centers that operate remotely from the main entity, the head office. Branches can be classified as either dependent or independent branches. Dependent branches are centrally controlled branches and rely on the head office for the provision of inventory and payment of the major expenses. Accounting records of dependent branches are kept by the head office. In contrast, independent branches are managed as separate business entities and report their financial results periodically to the head office. The discussion in this chapter was confined to dependent branches only.

Inventory can be sent and invoiced by head office to the branch either at cost or selling price. Where inventory is invoiced to the branch at cost price, the branch inventory and inventory to branch accounts are opened to record all inventory transactions between the head office and its branch. Additional accounts are also opened to deal with the specific transactions of the branch, for example a trade receivables control account to record all debtor transactions of the branch and a branch expenses account to record all expenses that may be incurred by the branch in its operations. The purpose of the branch inventory account is to record all inventory transactions, at cost price, between the head office and its branch as well as purchases by the branch from third parties. The branch inventory account is also used to record all the inventory transactions between the branch and its customers. All transactions that may have an influence on the inventory of the branch are recorded in the branch inventory account. It follows that if inventory is invoiced at cost price, the branch inventory account functions as a trading account, which is balanced to obtain a gross profit or loss. The gross profit or loss is as a result of the difference between the prices at which inventory is received by the branch and the prices at which it is sold.

If inventory is sent to the branch and invoiced at the selling price, the head office will need an additional account, the branch adjustment account, over and above the branch inventory account and inventory to branch account to record inventory transactions with the branch. When inventory is invoiced to the branch at selling price, the purpose of the branch inventory account changes from that of a trading account (where inventory is invoiced at cost) to that of an inventory control account. All entries in this account are made at selling prices but are split into a cost price element and a profit mark-up element. All transactions that may have an influence on inventory of the branch are also recorded in the branch inventory account. The cost price on all inventory transactions between the branch and head office is recorded in the inventory to branch account. The branch adjustment account represents a trading account when inventory is invoiced at selling price. The profit mark-up on all inventory transactions between the branch and head office, and when the branch makes its own purchases, is recorded in the branch adjustment account. When balanced, a gross profit or loss is calculated. In both instances, when inventory is invoiced at cost price and when inventory is invoiced at selling price, the gross profit or loss is transferred to the branch expenses account. The branch expenses account deals with all expenses of the branch paid for by the branch or head office. When the branch expenses account is balanced, a profit or loss of the branch is obtained. This profit or loss of the branch is incorporated on the statement of profit or loss and other comprehensive income of the head office when financial statements of the head office are prepared. The preparation of the financial statements of the head office, however, falls outside the scope of this chapter.

CHAPTER **10**

Manufacturing entities

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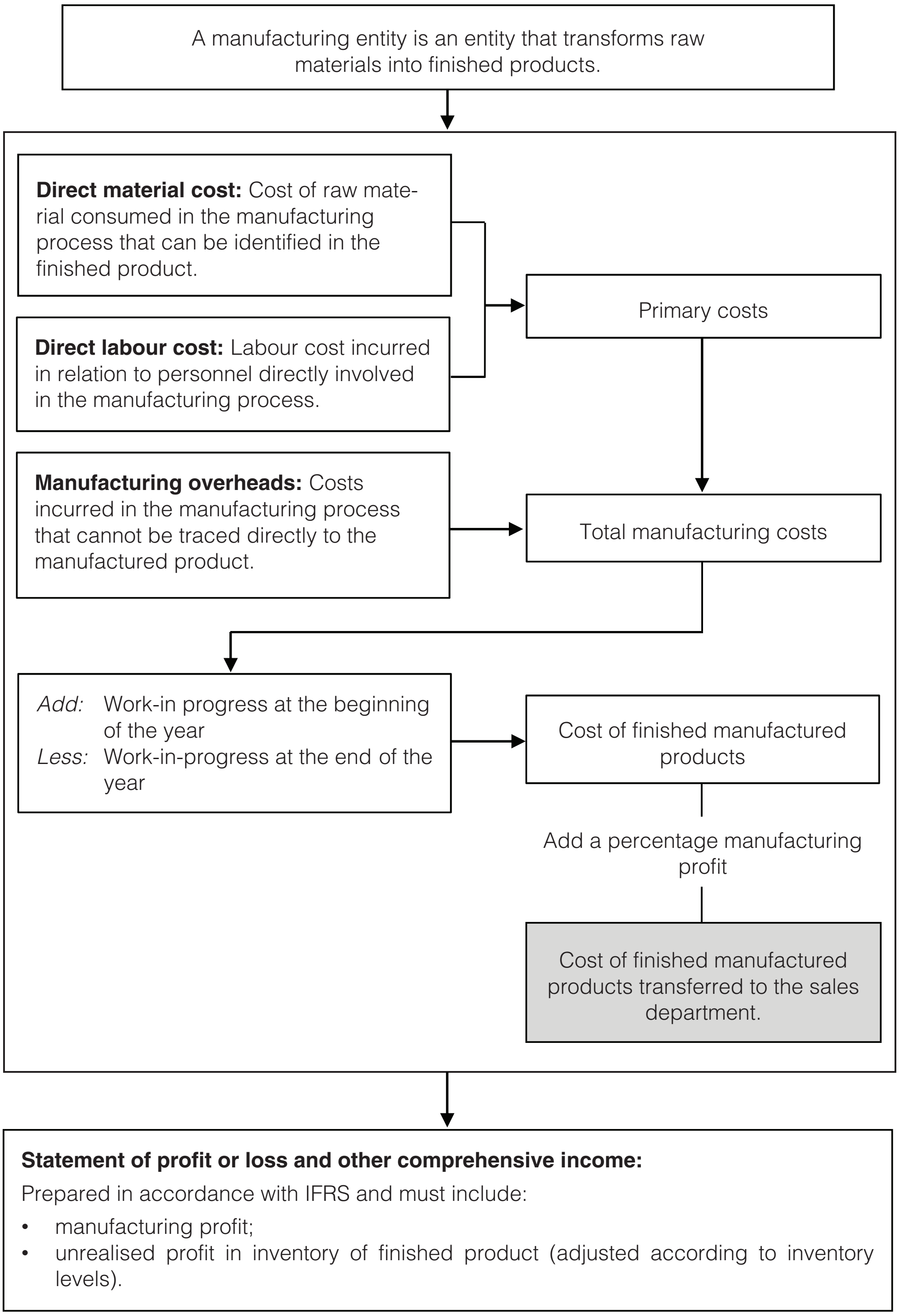
Overview of an accounting system for manufacturing entities



10.1 Introduction

STUDY OBJECTIVES
After studying this chapter, you should be able to: ☐ discuss the concept of "manufacturing" and distinguish between a manufacturing entity and a trading entity; ☐ describe what manufacturing costs entail; ☐ describe the different components of manufacturing costs; ☐ distinguish between direct and indirect manufacturing costs; ☐ list the specialised accounts needed to record the transactions of a manufacturing entity; ☐ record the inventory and cost transactions in the general journal of a manufacturing entity and post the general journal to the appropriate ledger accounts; ☐ classify and do cost allocations between the manufacturing and administrative departments of the manufacturing entity; ☐ prepare a manufacturing cost statement; ☐ calculate and record the unrealised profit in the finished products inventory; and ☐ prepare a statement of profit or loss and other comprehensive income of a manufacturing entity to comply with the requirements of IFRS.

In the preceding chapters, the discussion of accounting systems and procedures was devoted to service and trading entities whose activities are conducted through different types of ownership, for example sole traders, partnerships and close corporations. In contrast to the activities of a trading entity, which buys manufactured products and sells them at a profit, a manufacturing entity manufactures the products that the trading entities buy and sell. A manufacturing entity transforms basic raw materials into marketable products, for example a manufacturer of motorcars buys steel, rubber, aluminium, plastics and other materials, from which it manufactures motorcars. These materials are called "raw materials" and during the manufacturing process they change form and shape to become marketable products. The manufactured cars are delivered to car dealers and the trading entities who sell them to the customers.

Although keeping a set of accounting records for a manufacturing entity does not differ markedly from that of a trading entity, the unique characteristics of a manufacturing entity require additional accounting applications and procedures with regard to cost allocations. In the case of a trading entity, the cost of purchases can easily be determined by adding the purchase invoices. The cost of sales and closing inventories are therefore easy to calculate. On the other hand, the cost of finished products for a manufacturing entity cannot be calculated from invoices alone. The manufacturing costs include other items, for example materials used, labour and other manufacturing costs that must be taken into account before the cost of a finished product can be determined. The objective of accounting for manufacturing entities is to ensure that accurate cost allocations are made so that the entity can determine the manufacturing cost of its products accurately. Accurate cost allocations will also ensure that closing inventories of finished products are shown at the correct cost price. In most manufacturing entities there are three main stages for which the inventory must be accounted for, at the end of the financial period. These stages are:

- ☐ unprocessed inventory (raw materials);
- ☐ partly completed inventory (work-in-progress); and
- ☐ completed inventory (finished products).

10.2 Introducing a manufacturing cost statement

A manufacturing cost statement is used by the management of the entity for the purposes of assessing the manufacturing efficiency and determining the cost of finished manufactured products. The manufacturing cost statement is not a financial statement and, as such, the format and preparation thereof is not prescribed by IFRS. However, information disclosed in the manufacturing cost statement is used in the preparation of the annual financial statements of a manufacturing entity. The following is an illustration of the framework of a manufacturing cost statement.

Framework of a manufacturing cost statement

ABC Manufacturers
Manufacturing cost statement for the year ended 31 December 20.1

	R
Direct materials used	XXXX
Inventory: Raw materials (1 January 20.1)	XXXX
Purchases: Raw materials	XXXX
	XXXX
Inventory: Raw materials (31 December 20.1)	(XXXX)
Direct labour	XXXX
Primary costs	XXXX
Manufacturing overheads	XXXX
Indirect material used	XXXX
Indirect labour (for example, factory cleaning and maintenance workers)	XXXX
Depreciation (on factory plant and equipment)	XXXX
Rental expenses (allocated to the factory)	XXXX
Water and electricity (allocated to the factory)	XXXX
Salaries (factory foreman and supervisors)	XXXX
Rates and taxes (allocated to the factory)	XXXX
Total manufacturing costs	XXXX
Inventory: Work-in-progress (1 January 20.1)	XXXX
	XXXX
Inventory: Work-in-progress (31 December 20.1)	(XXXX)
Cost of finished products manufactured	XXXX
Manufacturing profit	XXXX
Cost of finished manufactured products transferred to the sales department	XXXX

10.3 Defining manufacturing costs

The above framework highlights the three elements which make up the total manufacturing costs, namely: direct material used, direct labour and manufacturing overheads. Material and labour costs can either be a direct or an indirect cost. Direct costs are those costs which are possible to trace to the manufactured product. An example would be the cost of steel plates used in the manufacturing of cars and wages paid to employees working on the assembly line. Indirect costs are usually referred to as "manufacturing overheads," and represent the manufacturing costs that cannot be specifically traced to individual units of finished products, for example water and electricity consumed in the factory during the manufacturing process.

10.3.1 *Direct material*

Direct material is raw material which is consumed in the manufacturing process and is physically incorporated in the finished product. It can be identified and measured as an integral part of the finished product. For example, the wood that is used to manufacture a desk can easily be traced as part of the finished product and can therefore be classified as direct material. The cost of direct material includes the purchase price, import duties, other non-recoverable taxes, transport costs, handling costs, and any other directly attributable costs of acquisition, less trade discounts and rebates. Direct material used is recorded as a separate cost element in the manufacturing cost statement (refer to the Framework in paragraph 10.2).

10.3.2 *Direct labour*

Direct labour consists of the cost of salaries and wages as well as other salary-related expenses of personnel directly involved in the manufacturing process. Examples of direct labour costs include the wages of workers who assemble parts of the manufactured product and operators of machines engaged in the manufacturing process, as well as salary-related expenses for the mentioned workers, such as unemployment insurance fund contributions, skills development levies and pension fund contributions paid by the employer. Direct labour is recorded as a separate cost element in the manufacturing cost statement (refer to the Framework in paragraph 10.2).

10.3.3 *Primary costs*

"Primary costs" refer to total direct costs, ie the total monetary value of direct material used and direct labour costs. Primary costs are usually the major part of total manufacturing costs (refer to the Framework in paragraph 10.2).

10.3.4 *Manufacturing overheads*

Manufacturing overheads consist of that portion of manufacturing costs which cannot be directly traced to the final product. The concept "manufacturing overheads" is an encompassing term which includes all other manufacturing costs with the exception of primary costs. Manufacturing overheads can be divided into three main categories:

- ☐ *Indirect materials* include those material items used in the manufacturing process which cannot be directly and accurately traced to a specific product or which are so insignificant in value that it may not be cost-effective to trace it to a specific finished product. For example, nails and screws used in the manufacture of wooden furniture can be so inexpensive in relation to other direct material costs that it may be uneconomical to trace their costs to a specific finished product. These items, however, still form part of the cost of manufacturing of that product (refer to the Framework in paragraph 10.2).

- *Indirect labour* includes the wages of all employees who do not work on the manufactured product itself, but who assist in the overall manufacturing operation. Examples of indirect labour are the wages of factory cleaners, security and maintenance personnel as well as the salary-related expenses rather as you use it throughout of these employees such as unemployment insurance fund contributions, skills development levies and pension fund contributions paid by the employer. The salary of a production supervisor or foreman is also indirect by nature, as this person's role in the manufacturing process is to control and oversee the whole manufacturing process. For information purposes, however, these salaries and salary-related expenses are normally disclosed separately in the manufacturing cost statement (refer to the Framework in paragraph 10.2).
- *Other manufacturing overheads* consist of that portion of the costs, other than indirect materials and indirect labour, that are linked to the manufacturing process, but which cannot be directly allocated to a specific product. This includes costs such as factory insurance, maintenance and depreciation of factory equipment. In certain instances, it may be necessary to allocate certain shared cost items between the manufacturing and other administrative departments, such as the general administration and sales departments housed within the entity. Examples of shared costs are rent, water and electricity and telephone expenses. Normally management formulates allocation criteria that are used to allocate these types of costs to the administrative and manufacturing departments of the entity. For example, the floor space occupied by each department could be used as the basis to allocate the cost of rent for the entire premises between the administrative and the manufacturing departments. A fixed percentage allocation can also be used, for example 60% of water and electricity consumed by the entity is allocated to the administrative department and 40% to the manufacturing department. Selling, administrative and other general non-production costs do not form part of the manufacturing process and are not included in manufacturing overheads. These costs are incurred by the selling and administrative departments of the entity and are reported on the statement of profit or loss and other comprehensive income as distribution, administrative and other expenses.

10.4 Stages of the manufacturing process

Raw materials pass through various stages of manufacturing before the finished product is ready for sale. The first stage occurs when raw materials are purchased and stored ready for production but not yet released to the production process. The cost of these materials is recorded in the inventory: raw materials account.

The second stage of manufacturing is uncompleted work somewhere in the production process, referred to as "work-in-progress". The inventory: work-in-progress account is opened to record all the manufacturing costs that are incurred in transforming raw materials into finished products. These include direct material costs – raw materials that are consumed in the manufacturing process; direct labour costs – salaries, wages and fringe benefits for personnel who work directly on the manufactured product; and manufacturing overhead costs – all other manufacturing costs other than direct material and direct labour cost.

As products are completed, the final stage of manufacturing is reached. Completed products are then moved to the finished products warehouse. The accumulated allocated costs of the finished products are recorded in the inventory: finished products account. In practice, manufacturing entities add a manufacturing profit to the cost of completed manufactured products in order to arrive at a price approximating that which the entity would have paid if the products were to be purchased externally (refer to the Framework in paragraph 10.2). This manufacturing profit is also recorded in the inventory: finished products account.

10.5 Recording the transactions of a manufacturing entity

Example 10.1 will illustrate and explain the recording of the transactions relating to manufacturing entities. The example emphasises two aspects in the manufacturing process, namely:

☐ the compilation of manufacturing costs; and

☐ keeping track of the manufacturing costs through the consecutive stages of:

- work-in-progress;
- finished products; and
- cost of goods sold.

For the purposes of this example, only those accounts that are unique to manufacturing entities are dealt with.

Example 10.1 Recording the transactions relating to the manufacturing activities of a manufacturing entity

The following is an extract from the accounting records of Khaya Manufacturers, a sole trader, for the year ended 31 December 20.8:

Inventory balances	**1 January 20.8**	**31 December 20.8**
	R	**R**
Raw materials	90 000	45 900
Work-in-progress	28 000	43 000
Finished products	65 000	88 400

Transactions for the year ended 31 December 20.8:	**R**
Raw materials purchased on credit	52 000
Railage paid on purchases of raw materials	1 000
Returns of raw materials	7 500
Direct materials issued to production	79 600
Indirect materials issued to production	10 000
Direct and indirect labour cost	15 500
Water and electricity	500

	R
Repairs to factory machinery	1 000
Depreciation (factory machinery)	20 000
Credit sales	150 000
Salaries and wages (administrative personnel)	5 000
Cost of sales	115 975

Additional information:

1. The total of raw materials purchased on credit includes indirect materials amounting to R10 000, all of which was issued to the manufacturing process.
2. The factory manager's remuneration amounts to 35% of the total labour cost and represents the only indirect labour cost.
3. It is estimated that 80% of the water and electricity is used in the factory.
4. Finished products are transferred to the sales department at cost plus 25%.
5. On 1 January 20.8, the allowance for unrealised profit in finished products inventory reflected a balance of R13 000.
6. Khaya Manufacturers uses a perpetual inventory system.

Required:

Record the transactions relating to the manufacturing activities in the general journal of Khaya Manufacturers for the year ended 31 December 20.8. Post the general journal to the following accounts in the general ledger of Khaya Manufacturers:

- ☐ inventory: raw materials;
- ☐ railage: raw materials;
- ☐ labour costs;
- ☐ manufacturing overheads;
- ☐ inventory: work-in-progress;
- ☐ inventory: finished products; and
- ☐ manufacturing profit mark-up.

Close off and balance all the accounts at 31 December 20.8.

Solution:

Purchase of raw materials, railage cost incurred, returns and issuing of raw materials to production:

Khaya Manufacturers
General journal

			Debit	Credit
			R	R
20.8 Dec	31	Inventory: Raw materials	52 000	
		Trade payables control		52 000
		Purchases of raw materials		
		Railage: Raw materials	1 000	
		Bank		1 000
		Railage paid on purchases of raw materials		

continued

			Debit	Credit
			R	**R**
		Trade payables control	7 500	
		Inventory: Raw materials		7 500
		Raw materials returned		
		Inventory: Work-in-progress	79 600	
		Manufacturing overheads – indirect material	10 000	
		Inventory: Raw materials		89 600
		Issue of direct and indirect materials		
		Inventory: Raw materials	1 000	
		Railage: Raw materials		1 000
		Transfer of railage cost to inventory of raw materials		

Khaya Manufacturers
General ledger

Dr **Inventory: Raw materials** **Cr**

20.8				**R**	20.8				**R**
Jan	1	Balance	b/d	90 000	Dec	31	Trade payables control		7 500
Dec	31	Trade payables control		52 000			Inventory: Work-in-progress		79 600
		Railage: Raw materials		1 000			Manufacturing overheads		10 000
							Balance	c/d	45 900
				143 000					143 000
20.9									
Jan	1	Balance	b/d	45 900					

Dr **Railage: Raw materials** **Cr**

20.8				**R**	20.8				**R**
Dec	31	Bank		1 000	Dec	31	Inventory: Raw materials		1 000

Comment:

When raw materials are purchased, both the direct and indirect materials are recorded in the inventory: raw materials account. The inventory: raw materials account is debited with the cost price of inventory purchased (R52 000). The cost of transporting the purchased raw materials to the production site is debited in the railage: raw materials account (R1 000). When issuing direct materials to the manufacturing process, the inventory: raw materials account is credited with the direct materials issued to manufacturing (R79 600) and a new account, unique to manufacturing entities, the inventory: work-in-progress account, is debited with direct materials costs (R79 600). The indirect materials which were issued to the production process must be transferred to the manufacturing overheads account. Therefore, the inventory: raw materials account is credited with R10 000 and manufacturing overheads debited. At the end of the accounting period, the railage: raw materials account is closed off to the inventory: raw materials account to record the total cost of raw materials purchased during the accounting period.

Incurrence of labour cost:

Khaya Manufacturers
General journal

			Debit	Credit
20.8			**R**	**R**
Dec	31	Labour costs	15 500	
		Bank		15 500
		Payment of direct and indirect labour costs		
		Inventory: Work-in-progress (direct labour cost)	10 075	
		Manufacturing overheads (salary of a factory manager)	5 425	
		Labour costs		15 500
		Allocation of labour costs between direct and indirect costs		

Khaya Manufacturers
General ledger

Dr **Labour costs** **Cr**

20.8				**R**	20.8				**R**
Dec	31	Bank		15 500	Dec	31	Inventory: Work-in-progress		10 075
							Manufacturing overheads		5 425
				15 500					15 500

Comment:

When labour costs are incurred, the total R15 500 is recorded in the labour costs account. Labour costs are then allocated according to the nature of labour, ie R10 075 (R15 500 × 65%) direct labour cost is allocated to the inventory: work-in-progress account and the salary of R5 425 (R15 500 × 35%) paid to the factory manager is recorded in the manufacturing overheads account.

Incurrence of other manufacturing expenses and allocation thereof to manufacturing overheads:

Khaya Manufacturers
General journal

			Debit	Credit
20.8			**R**	**R**
Dec	31	Water and electricity	500	
		Repairs: Factory machinery	1 000	
		Bank		1 500
		Recording of payments		

continued

			Debit	Credit
			R	**R**
		Depreciation: Factory machinery	20 000	
		Accumulated depreciation on factory machinery		20 000
		Recording of annual depreciation		
		Manufacturing overheads	21 400	
		Water and electricity (factory) (R500 × 80%)		400
		Repairs: Factory machinery		1 000
		Depreciation: Factory machinery		20 000
		Transfer of other manufacturing expenses to manufacturing overheads		

Khaya Manufacturers
General ledger

Dr **Manufacturing overheads** **Cr**

20.8				**R**	20.8				**R**
Dec	31	Inventory:			Dec	31	Inventory:		
		Raw materials		10 000			Work-in-progress		36 825
		Labour costs: Salary factory foreman		5 425					

Dr **Manufacturing overheads** **Cr**

20.8				**R**					**R**
Dec	31	Water and electricity		400					
		Repairs: Factory machinery		1 000					
		Depreciation: Factory machinery		20 000					
				36 825					36 825

Comment:

The allocation of other manufacturing costs (excluding indirect material and indirect labour already dealt with) to production, is recorded in the manufacturing overheads account. This account is a control account for all indirect manufacturing costs. The total expense incurred in respect of water and electricity is R500, of which R400 relates to the manufacturing activity and is therefore treated as manufacturing overheads. The difference of R100 (R500 – R400) is a general expense which must be disclosed on the statement of profit or loss and other comprehensive income as part of selling, administrative and general expenses. Repairs and depreciation on factory machinery are also factory-related costs, and therefore form part of manufacturing overheads.

At the end of the accounting period, the total of the manufacturing overheads account (R36 825), is transferred to inventory: work-in-progress by debiting the inventory: work-in-progress account and crediting the manufacturing overheads account.

This is illustrated as follows:

Transferring manufacturing overheads to inventory – work in progress:

Khaya Manufacturers
General journal

			Debit	Credit
20.8			R	R
Dec	31	Inventory: Work-in-progress	36 825	
		Manufacturing overheads		36 825
		Allocation of manufacturing overheads		

Khaya Manufacturers
General ledger

Dr **Inventory: Work-in-progress** **Cr**

20.8				R	20.8				R
Jan	1	Balance	b/d	28 000	Dec	31	Inventory: Finished		
Dec	31	Inventory: Raw					products		111 500
		materials		79 600			Balance	c/d	43 000
		Direct labour costs		10 075					
		Manufacturing							
		overheads		36 825					
				154 500					154 500
20.9									
Jan	1	Balance	b/d	43 000					

Comment:

The inventory: work-in-progress account is used to accumulate the total manufacturing cost as it is incurred in the manufacturing process. This account shows that R154 500 worth of resources was put into the production process. This amount is represented by the opening balance of inventory: work-in-progress (production not completed in the previous production cycle) of R28 000, raw materials issued to production of R79 600, direct labour cost incurred of R10 075, and manufacturing overheads of R36 825. At the end of the current production cycle, production amounting to R43 000 is still incomplete, which implies that R111 500 (R154 500 – R43 000) production resources put into the manufacturing process, was completed and transferred to the sales department. The following journal entries illustrate the recording of the transfer of completed products from inventory: work-in-progress account to the inventory: finished products account.

Transfer of costs of completed products to inventory – finished products:

Khaya Manufacturers
General journal

			Debit	Credit
20.8			R	R
Dec	31	Inventory: Finished products	111 500	
		Inventory: Work-in-progress		111 500
		Transfer to finished products		

It was mentioned previously that when finished products are transferred from the manufacturing department to the sales department, a profit mark-up is added to the cost of products manufactured (refer to paragraph 10.4). In this example, products are transferred to the sales department at cost plus 25%. To account for the profit mark-up on manufactured products, the following entry is necessary:

Adding the profit mark-up to inventory – finished products:

Khaya Manufacturers
General journal

			Debit	Credit
20.8			**R**	**R**
Dec	31	Inventory: Finished products	27 875	
		Manufacturing profit mark-up R(111 500 × 25%)		27 875
		Recording of profit mark-up		

Khaya Manufacturers
General ledger

Dr **Inventory: Finished products** **Cr**

20.8				**R**	20.8				**R**
Jan	1	Balance	b/d	65 000	Dec	31	Cost of sales		115 975
Dec	31	Inventory: Work-in-progress		111 500			Balance	c/d	88 400
		Manufacturing profit mark-up		27 875					
				204 375					204 375
20.9									
Jan	1	Balance	b/d	88 400					

Dr **Manufacturing profit mark-up** **Cr**

20.8				**R**	20.8				**R**
Dec	31	Profit and loss		27 875	Dec	31	Inventory: Finished products		27 875

Comment:

The profit mark-up on finished products is recorded on the debit side of the inventory: finished products account. This will in effect adjust the cost of finished products to approximate the cost at which similar products can be purchased externally by the entity. The manufacturing profit mark-up account is credited with the profit mark-up of R27 875 on manufactured products. At the end of the financial period, the manufacturing profit mark-up account is normally closed off to the profit and loss account. For the sake of simplicity, the profit and loss account is not prepared in this chapter. The manufacturing profit mark-up is therefore directly disclosed on the statement of profit or loss and other comprehensive income.

10.6 Preparing a manufacturing cost statement

In paragraph 10.2, the use of the manufacturing cost statement was discussed and the type of information that must be included in this statement was outlined in the framework. In this section, the preparation of a manufacturing cost statement is illustrated. The manufacturing cost statement is prepared after all the transactions related to the manufacturing process have been recorded in the general journal and posted to the general ledger. The statement summarises the information in the ledger accounts. That is, it shows the specific costs incurred in the manufacturing process during the period and identifies costs of completed products that are transferred to inventory: finished products and the cost of products remaining in the inventory: work-in-progress.

Example 10.2 Preparation of a manufacturing cost statement

To illustrate the preparation of a manufacturing cost statement, use the information supplied in Example 10.1.

Required:

Prepare the manufacturing cost statement of Khaya Manufacturers for the year ended 31 December 20.8

Solution:

Khaya Manufacturers
Manufacturing cost statement for the year ended 31 December 20.8

	R
Direct materials used	79 600
Inventory: Materials (1 January 20.9)	90 000
Purchases: Raw materials (R52 000 – R7 500 – R10 000)*	34 500
Railage: Raw materials	1 000
	125 500
Inventory: Raw materials (31 December 20.9)	(45 900)
Direct labour	10 075
Primary costs	89 675
Manufacturing overheads	36 825
Indirect materials used*	10 000
Salary: Factory manager	5 425
Water and electricity: Factory	400
Repairs: Factory machinery	1 000
Depreciation: Factory machinery	20 000
Total manufacturing costs	126 500
Inventory: Work-in-progress (1 January 20.9)	28 000
	154 500
Inventory: Work-in-progress (31 December 20.9)	(43 000)
Cost of finished products manufactured	111 500
Manufacturing profit (R111 500 × 25%)	27 875
Cost of finished products manufactured transferred to the sales department	139 375

* The amount of direct raw materials purchased is calculated by subtracting the amount of indirect raw materials of R10 000 (disclosed as manufacturing overheads), and raw materials returned of R7 500.

10.7 Recording the transactions relating to the sale of finished products inventory and the incurrence of administrative expenses by a manufacturing entity

The sale of finished products inventory and the incurrence of administrative and selling expenses by a manufacturing entity are dealt with in the same way as in the case of a trading entity. The only difference is the treatment of the unrealised profit on unsold inventories at the end of the accounting period and is discussed in paragraph 10.8.

Example 10.3 Sale of finished products inventory and the incurrence of administrative expenses

To illustrate the sale and the incurrence of administrative expenses, use the same information as supplied in Example 10.1.

Required:

Record the transactions relating to the sale of finished products inventory and the incurrence of administrative expenses in the general journal of Khaya Manufacturers for the year ended 31 December 20.8. Post the general journal to the following accounts in the general ledger of Khaya Manufacturers:

- ☐ cost of sales;
- ☐ sales; and
- ☐ trade receivables control.

Close off and balance the accounts at 31 December 20.8.

Solution:

Khaya Manufacturers
General journal

			Debit	Credit
			R	R
20.8 Dec	31	Cost of sales	115 975	
		Inventory: Finished products		115 975
		Recording the cost of sales		
		Trade receivables control	150 000	
		Sales		150 000
		Recording of sales		
		Salaries and wages (administrative personnel)	5 000	
		Bank		5 000
		Recording of salaries and wages		

Khaya Manufacturers
General ledger

Dr **Cost of sales** **Cr**

				R					R
20.8 Dec	31	Inventory: Finished products		115 975	20.8 Dec	31	Trading account		115 975

continued

Dr **Sales** **Cr**

20.8				**R**	20.8				**R**
Dec	31	Trading account		150 000	Dec	31	Trade receivables control		150 000

Dr **Trade receivables control** **Cr**

20.8				**R**					
Dec	31	Sales		150 000					

Comment:

When products are sold, the cost thereof is debited to the cost of sales account (perpetual inventory system) and the inventory: finished products account is credited. At the same time, the selling price of the products sold on credit is debited to the trade receivables control account and credited to the sales account. The cost of sales and sales accounts are normally closed off to the trading account. However, in this chapter, the trading account is not prepared and therefore the cost of sales and sales are directly disclosed on the statement of profit or loss and other comprehensive income.

10.8 Adjusting the allowance for unrealised profit in finished products inventory

Finished products that are transferred to the sales department are normally inclusive of the profit mark-up added by the manufacturing department. This profit, however, is only realised when these products are sold by the entity. If at the end of the accounting period there is finished products inventory on hand, the cost of this closing inventory will be inclusive of the profit mark-up. This profit is referred to as "unrealised profit" because it relates to profit that has not yet materialised.

When the financial statements of a manufacturing entity are prepared, an allowance for the unrealised profit in the closing inventory of finished products is created in order to ensure that the profit made by the entity is stated correctly. The creation of the allowance for the unrealised profit in the closing inventory of finished products is intended to adjust the value of the closing inventory of finished products to the manufacturing cost price thereof.

At the beginning of each accounting period there will be a balance on the allowance for unrealised profit in finished products inventory that relates to the profit mark-up in the opening inventory of finished products. Because of the changes in inventory levels during the year, the balance on the allowance for unrealised profit in finished products inventory must be adjusted to equal the unrealised profit in the finished products closing inventory at the end of the financial period.

Example 10.4 Adjusting of the allowance for unrealised profit in finished products inventory

The same information supplied in Example 10.1 is used to illustrate the adjustment of the allowance for unrealised profit in finished products inventory.

Required:

Adjust the allowance for unrealised profit in finished products inventory in the general journal of Khaya Manufacturers for the year ended 31 December 20.8. Post the general journal to the following accounts in the ledger of Khaya Manufacturers:

- ☐ allowance for the unrealised profit in inventory: finished products; and
- ☐ unrealised profit in inventory: finished products.

Close off and balance the accounts at 31 December 20.8.

Solution:

In order to determine whether the balance of the allowance for unrealised profit in the closing inventory of finished products must increase or decrease in Example 10.1, the following calculation is necessary:

Adjustment of the allowance for unrealised profit in finished products inventory at the end of the year:

	R
Allowance for unrealised profit in inventory: Finished products (opening inventory)	13 000
Allowance for unrealised profit in inventory: Finished products (closing inventory) (R88 400 × 25/125)	(17 680)
Adjustment – increase in the allowance	(4 680)

At the beginning of the current year, the accounting records of Khaya Manufacturers indicate a balance of R13 000 as the allowance for unrealised profit in the inventory of finished products. At the end of the current year, the inventory level of finished products is different. Therefore, the balance of R13 000 must be adjusted to reflect a correct allowance for unrealised profit in the inventory of finished products at the end of the current year. The allowance for unrealised profit in inventory of finished products must be increased by R4 680 (R17 680 – R13 000). To record an increase in the allowance for unrealised profit in the inventory of finished products, the unrealised profit in inventory: finished products account is debited and the allowance for unrealised profit: finished products account is credited.

Khaya Manufacturers
General journal

			Debit	Credit
			R	**R**
20.8 Dec	31	Unrealised profit in inventory: Finished products	4 680	
		Allowance for unrealised profit in inventory: Finished products		4 680
		Adjustment of the allowance for unrealised profit in finished products inventory		

continued

Khaya Manufacturers
General ledger

Dr Allowance for the unrealised profit in inventory: Finished products Cr

20.8				**R**	20.8				**R**
Dec	31	Balance	c/d	17 680	Jan	1	Balance	b/d	13 000
					Dec	31	Unrealised profit in inventory: Finished products		4 680
				17 680					17 680
					20.9				
					Jan	1	Balance	b/d	17 680

Dr Unrealised profit in inventory: Finished products Cr

20.8				**R**	20.8				**R**
Dec	31	Allowance for the unrealised profit in inventory: Finished products		4 680	Dec	31	Profit and loss account		4 680
				4 680					4 680

Comment:

The unrealised profit in inventory: finished products account is a normal account that is closed off to the profit and loss account at the end of the accounting period. The allowance for unrealised profit in inventory: finished products account is a contra asset account which is not closed off. The balance of this account is deducted from the cost of finished products inventory figure for disclosure purposes on the statement of financial position.

10.9 Preparing the statement of profit or loss and other comprehensive income of a manufacturing entity

The statement of profit or loss and other comprehensive income of a manufacturing entity is prepared in the same format as that of a trading entity and must be in compliance with the requirements of IFRS. Because a trading entity purchases completed products for resale, in comparison with a manufacturing entity that converts raw materials into completed products, the statement of profit or loss and other comprehensive income of a manufacturing entity contains the cost of finished products transferred from the manufacturing department to the sales department. This cost of finished products in a manufacturing entity is, however, substituted by purchases in a trading entity.

Example 10.5 Preparation of a statement of profit or loss and other comprehensive income of a manufacturing entity

The information supplied in Example 10.1 is used to illustrate the preparation of a statement of profit or loss and other comprehensive income of a manufacturing entity.

Required:

Prepare the statement of profit or loss and other comprehensive income of Khaya Manufacturers for the year ended 31 December 20.8 in compliance with the requirements of IFRS. Notes and comparative figures can be ignored.

Solution:

Khaya Manufacturers
Statement of profit or loss and other comprehensive income for the year ended 31 December 20.9

	R
Revenue	150 000
Cost of sales	(115 975)
Inventory: Finished products (1 January 20.9)	65 000
Cost of finished products transferred	139 375
	204 375
Inventory: Finished products (31 December 20.9)	(88 400)
Gross profit	34 025
Manufacturing profit	27 875
	61 900
Distribution, administrative and other expenses	(9 780)
Water and electricity (R500 × 20%)	100
Salaries and wages	5 000
Unrealised profit in inventory: Finished products*	4 680
Profit for the year	52 120
Other comprehensive income	–
Total comprehensive income for the year	52 120

* The unrealised profit in the finished products inventory is disclosed as a deduction in statement of profit or loss and other comprehensive income because the finished products inventory level increased during the year, resulting in an increase in the allowance for unrealised profit in inventory: finished products (refer to paragraph 10.8).

Example 10.6 Preparing a manufacturing cost statement and a statement of profit or loss and other comprehensive income statement of a manufacturing entity

The following information appeared in the accounting records of Zombo CC, a manufacturing entity, at 28 February 20.9, the end of the financial year.

Extract from balances at 28 February 20.9:	R
Inventory balances – 1 March 20.8	
Raw materials	15 750
Work-in-progress	22 500
Finished products	46 000
Raw materials purchased	50 130
Indirect materials issued to production	630
Raw materials issued to production	31 800

		R
Wages and salaries paid (factory personnel)		33 000
Rent expenses:	Factory	4 950
	Offices	3 300
Insurance expense:	Factory	2 145
	Offices	825
Water and electricity:	Factory	26 730
	Offices	4 785
Depreciation:	Manufacturing equipment	3 000
	Office furniture	900
Sales during the year		150 000
Provisional income tax payments		16 000

Additional information: **R**

1. Inventory balances – 28 February 20.9:

Raw materials	33 450
Work-in-progress	52 455
Finished products	32 200

2. All indirect materials issued were used in the production process.
3. 30% of salaries and wages is an indirect labour cost of which R3 900 was paid to the factory supervisor.
4. Products are transferred to the sales department at cost plus 15%.
5. At 1 March 20.8, the allowance for the unrealised profit in finished products inventory amounted to R6 000.
6. Income tax for the year amounted to R16 767 and must still be provided for.

Required:

(a) Prepare the manufacturing cost statement of Zombo Manufacturers CC for the year ended 28 February 20.9.

(b) Prepare the statement of profit or loss and other comprehensive income of Zombo Manufacturers CC for the year ended 28 February 20.9 to comply with the requirements of IFRS. Notes and comparative figures can be ignored.

Solution:

(a) Zombo Manufacturers CC

Manufacturing cost statement for the year ended 28 February 20.9

		R
Direct materials used		31 800
Inventory: Raw materials (1 March 20.8)	15 750	
Purchases R(50 130 – 630)	49 500	
	65 250	
Inventory: Raw materials (28 February 20.9)	(33 450)	
Direct labour R(33 000 × 70%)		23 100
Primary costs		54 900
Manufacturing overheads		47 355
Indirect material	630	
Indirect labour [R(33 000 × 30%) – R3 900]	6 000	
Salary: Factory supervisor	3 900	
Rent expense	4 950	
Insurance expense	2 145	
Water and electricity	26 730	
Depreciation	3 000	
Total manufacturing costs		102 255
Inventory: Work-in-progress (1 March 20.8)		22 500
		124 755
Inventory: Work-in-progress (28 February 20.9)		(52 455)
Cost of finished products manufactured		72 300
Manufacturing profit (R72 300 × 15%)		10 845
Cost of finished products manufactured transferred to the sales department		83 145

(b) Zombo Manufacturers CC

Statement of profit or loss and other comprehensive income for the year ended 28 February 20.9

		R
Revenue		150 000
Cost of sales		(96 945)
Inventory: Finished products (1 March 20.8)	46 000	
Cost of finished products transferred	83 145	
	129 145	
Inventory: Finished products (28 February 20.9)	(32 200)	
Gross profit		53 055
Manufacturing profit		10 845
Unrealised profit in inventory: Finished products ①		1 800
		65 700

continued

	R
Distribution, administrative and other expenses	(9 810)
Rent expense	3 300
Insurance	825
Water and electricity	4 785
Depreciation	900
Profit before tax	55 890
Income tax expense	(16 767)
Profit for the year	39 123
Other comprehensive income	–
Total comprehensive income for the year	39 123

Calculation:

① **Adjustment of the unrealised profit in inventory of finished products**

	R
Allowance for unrealised profit in inventory: Finished products (opening inventory)	6 000
Allowance for unrealised profit in inventory: Finished products (closing inventory) (R32 200 × 15/115)	(4 280)
Adjustment – decrease in the allowance	1 800

10.10 Summary

In this chapter, accounting systems and procedures for manufacturing entities are discussed. A manufacturing entity is described as a business entity that transforms basic raw materials into marketable products. It differs from a trading entity in that a trading entity buys finished products and sells it at a profit.

Manufacturing costs in a manufacturing entity relate to the cost of resources put into the production process and consist of three categories: direct material, direct labour, and manufacturing overheads. Direct material cost comprises the cost of raw materials consumed in the manufacturing process, which can be traced to specific completed products. Direct labour cost comprises the cost of salaries, wages and fringe benefits for personnel who work directly on the manufactured product. All other manufacturing costs that cannot be traced directly to a specific product are classified as manufacturing overheads. Manufacturing overheads are normally classified into three types of costs: indirect material, indirect labour, and other manufacturing overhead costs. Indirect materials are required for the production process but cannot be traced to a specific product. Indirect labour costs are incurred for personnel who are not directly involved in the manufacturing of the product, but whose services are necessary in the manufacturing process. All other manufacturing costs that are neither material costs nor labour costs are classified as "other manufacturing overheads". Other manufacturing overheads include, for example, depreciation on plant and equipment, factory insurance, and factory water and electricity.

When direct material is allocated to the manufacturing process, its cost is added to inventory: work-in-progress. Similarly, the costs of direct labour and manufacturing overheads are accumulated in the inventory: work-in-progress account. When products are completed, their costs are transferred from the inventory: work-in-progress account to the inventory: finished products account. A manufacturing cost statement is prepared to determine the cost of completed manufactured products. When finished, products are transferred to the sales department, and a certain profit mark-up is normally added to the cost of manufactured products to align the cost of manufactured products with the cost of purchased products.

The statement of profit or loss and other comprehensive income of a manufacturing entity is prepared in the same way as that of a trading entity and must be in compliance with the requirements of IFRS. However, the statement of profit or loss and other comprehensive income of a manufacturing entity must contain information about the cost of manufactured products transferred to the sales department as opposed to the cost of purchases found on the statement of profit or loss and other comprehensive income of a trading entity. The cost of manufactured products that is disclosed on the statement of profit or loss and other comprehensive income of a manufacturing entity is inclusive of a profit mark-up, as already mentioned. This profit mark-up constitutes a profit made by the manufacturing department but is only realised on the statement of profit or loss and other comprehensive income once products have been sold by the sales department. If the transferred products are still part of the closing inventory of finished products, the profit mark-up included therein is referred to as "unrealised profit in finished products inventory" which must be eliminated in the profits of a manufacturing entity at the end of the accounting period. The elimination of the unrealised profit in finished products inventory is disclosed on the statement of profit or loss and other comprehensive income in order to reflect the realised profit earned by the manufacturing entity.

CHAPTER 11

Budgets

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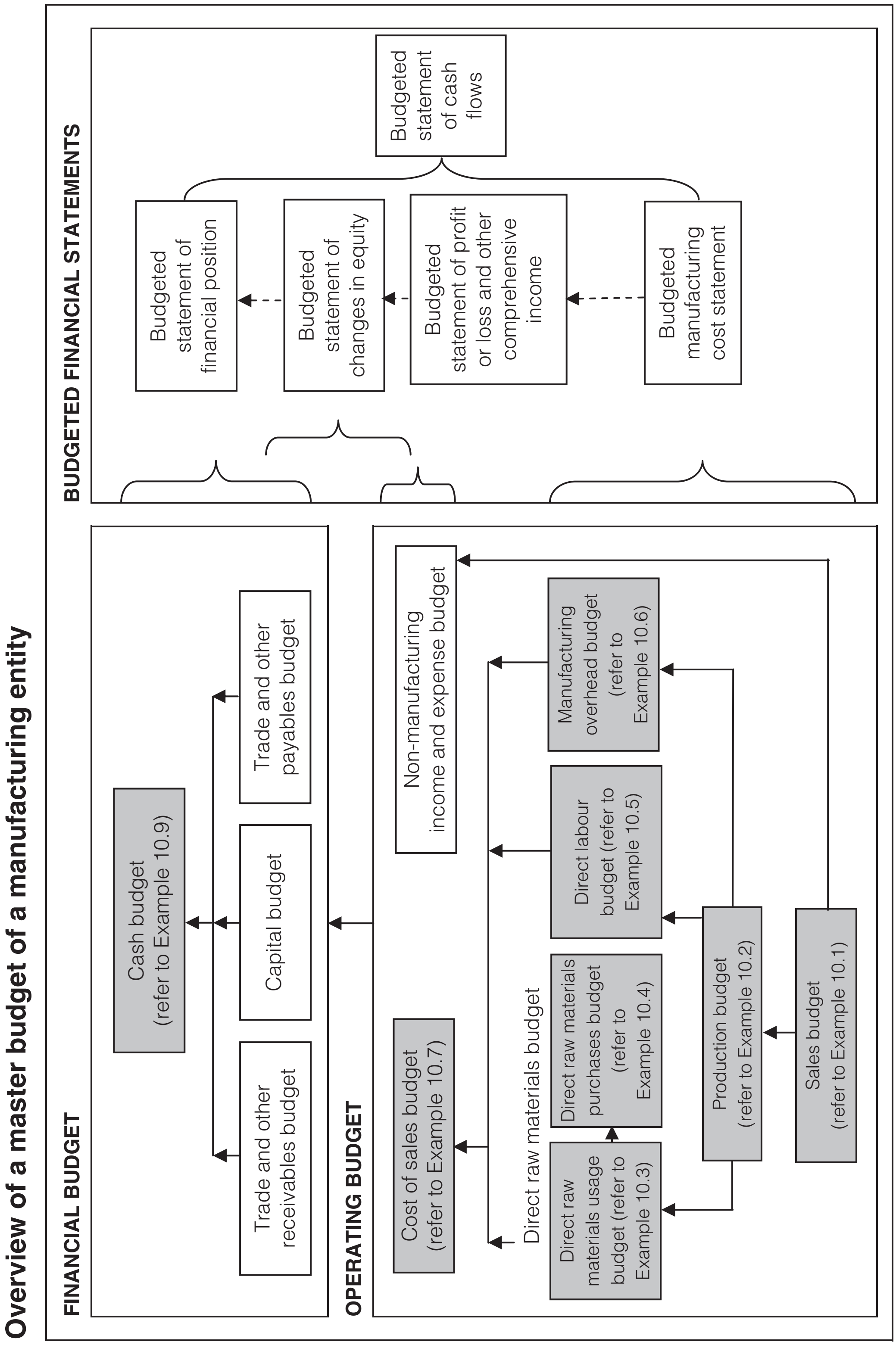
Overview of a master budget of a manufacturing entity
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Cash budget (refer to Example 10.9)
Capital budget
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Non-manufacturing income and expense budget
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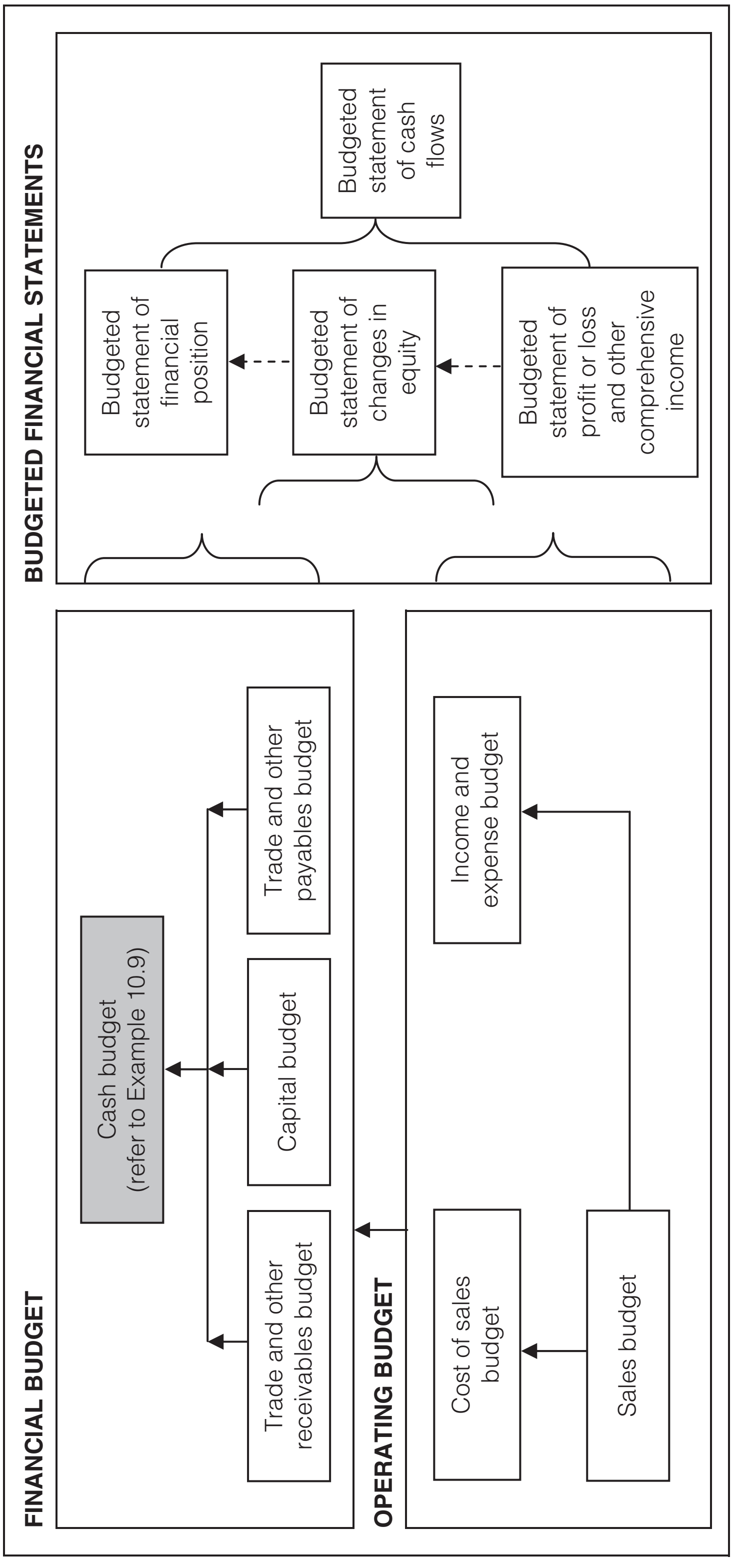
Overview of a master budget of a trading entity



11.1 Introduction

STUDY OBJECTIVES
After studying this chapter, you should be able to: ☐ describe what a budget entails and its main function; ☐ discuss the influence that a budget can have on managerial activities; ☐ discuss the importance of employee participation during the budgeting process; ☐ explain the advantages and limitations of budgets; ☐ mention the role that accounting information plays in the preparation of budgets; ☐ briefly explain the budgeting procedure; ☐ discuss the structure of an elementary master budget; ☐ distinguish between the master budget of a trading and a manufacturing entity; ☐ prepare a basic operating budget, i.e. the main as well as the subsidiary operating budgets, of a manufacturing entity; and ☐ prepare a cash budget.

Managerial efficiency requires proper planning, organisation, staffing and control. Since these activities have a significant impact on the performance of a business, the quality of management is recognised as one of the most influential factors that determines the long-term success of the business.

To enable the business to bear such a decisive responsibility, management needs to put formalised and systematic systems in place to aid them in the performance of their duties. One such system is the budgetary system, which is primarily linked to the planning and control activities within a business.

In essence, a budgetary system is a structured and time-related process whereby business plans are defined and measurable standards are set to aid objective control within each department of an entity and for the business as a whole. Therefore, an effective budgetary system is considered to be an invaluable managerial tool with which to enhance business performance.

11.2 Description and main function of a budget

A budget can be described as a quantitative estimate of the future results of a business. It is usually structured according to the planned activities of the entity that were determined according to the overall organisational objectives and goals. The main function of a budget can be considered to be the facilitation of the planning and controlling activities of management in order to accomplish the objectives and goals of the business as efficiently as possible. An effective budgetary system will, during the design and application thereof, enhance the overall communication procedures within a business and also the manner according to which the other managerial duties are performed.

In order to accomplish the above, budgets should be perceived by the work force as attainable and crucial directives which must be adhered to as far as possible.

Complex or over-regulated budgets may cause the rigid performance of tasks according to set standards and schedules which will cloud the creativity and motivation of personnel. On the other hand, over-simplified or casually applied budgets may lead to the omission of core directives and can cause workers to perceive budgets as of lesser importance which may readily be deviated from.

11.3 The relationship between budgets and managerial activities

The effectiveness with which a business is managed is usually recognised as the single most important factor in its long-term success. Success is measured in terms of accomplishment of the entity's goals. Management can be defined as the process of defining entity goals and implementing activities to attain those goals by efficient use of human, material and capital resources. The managerial process is a set of interdependent activities used by the management of an entity to perform the following functions: planning, coordination and control.

11.3.1 *Planning*

Planning entails the formulation of objectives and goals for a business as a whole and for each section of a business entity and the selection of the most appropriate activity plan to attain these objectives and goals. Plans are influenced by the environment of a business and are based on forecasts pertaining to aspects such as demand, supply and expected technological improvements.

Objectives can be distinguished from goals in that objectives are representative of the expected broad long-term future position of a business, whereas goals are set to attain objectives by focusing on shorter periods, delegating responsibilities and setting quantitative standards. Planning therefore encompasses strategic (long-term) activities, such as investment management, as well as tactical (short-term) activities, such as setting monthly sales targets.

Since planning sets requirements, budgetary calculations are formulated based on the planning. For example, the setting of required sales and inventory levels of finished products during the planning process will influence the preparation of the production budget of a business. Thus, planning and budgetary processes are interrelated and complementary. The direction towards the attainment of goals of a business is largely influenced by a strong execution of these processes.

11.3.2 *Coordination*

Limited resources, such as cash and production capacity, and the interrelatedness of business activities necessitate the task of coordination. Coordination is the synchronisation of individual actions with the result that each subdivision of an entity effectively works toward the common objective, with due regard for all other subdivisions and with united effort. Each member of the management team must be informed of the strategic and tactical plans of the business as a whole in order for them to align their individual plans with those pertaining to the rest of the business.

Since plans usually have a direct effect on more than one section or subdivision of a business, they need to be coordinated, and the related budgets structured accordingly. The design of a budgetary system is thus dependent on the quality of the coordination activities of management.

11.3.3 *Control*

Control can be considered as the process of measuring actual performance against a quantified and/or qualified standard in order to determine any significant differences (variances) according to which appropriate steps must be taken. Since budgets are quantitative performance standards which relate to specific time periods in the future, they can serve as frameworks against which objective controlling activities can be performed. A sound budgetary system will be embedded within the planning and controlling activities of management. As such it serves as an organised link between these two activities, sustaining co-ordination and continuity.

11.4 Employee participation

The manner in which the budgetary system of a business is compiled and implemented indicates the managerial style adopted by an entity. This has a strong impact on the morale of employees, and eventually on the overall performance of the business. For example, a budget that is prepared without the consideration of the organised labour demands and enforced on employees may be open to resistance. Organised labour might challenge the good intentions of the budget by embarking on some form of industrial action.

In order to enhance the effectiveness of a budgetary system, it is thus of great importance to obtain the maximum participation from the employees on all levels during the preparation thereof so as to gain their support, especially during the implementation phase. By obtaining their input, management has the opportunity to identify and incorporate their needs and ambitions into the budgets, thereby increasing their sense of belonging and commitment to the entity. Such a cooperative approach can result in budgets being more attainable and the control function thereof less daunting to the labour force. Thus, if structured according to a democratic managerial style, the implementation of budgetary systems can substantially improve employee motivation and performance.

11.5 Advantages and limitations of budgets

Budgets have numerous advantages which can be indispensable to the effective management of a business. For example, budgets can

- enforce and improve on strategic and tactical planning;
- enhance communication and motivation;
- promote the implementation of more objective control mechanisms by comparing measurable budgeted results with actual results; and
- assist in the taking of prompt action when significant deviations occur.

However, budgets also have limitations, such as the following:

- A budget is merely a planned estimate. The accuracy of the budget plan depends on the accuracy of these estimates.
- A budget can be applied too rigidly, thereby decreasing the utilisation of unforeseen opportunities as they arise.
- A budget programme requires additional administrative work and can thus end up being an expensive system to implement.

- ☐ Budgets are management tools and do not replace management or administrative functions.

11.6 The role of accounting information in the budgetary process

Since accounting information is predominantly presented in monetary terms, it can be used to set objective and measurable standards against which results can be measured. It can also assist in the identification and structuring of budgets, since budgets are often based on the contents and the format of the financial statements of a business.

11.7 The budgeting procedure

Since budgets pertain to plans which are related to specific periods in the future, the budgeting process can commence once such plans have been formalised. Usually a master budget, which represents a broad overview of the budgeted activities of an entity as a whole, is prepared first in order to serve as a starting point for the preparation of more distinctive budgets which relate to the departments or sections of a business. The structure of an elementary master budget is discussed in paragraph 11.8.

The following steps constitute basic budgeting procedure:

Step 1: Identify the key performance areas.

A budget sets performance standards according to objectives and goals. These performance standards are based on critical or key performance areas which specify the crucial aspects of the activities to be performed. These areas need to be as specific, measurable, attainable and objective as possible.

Step 2: Determine the budget period(s).

The selection of a budget period can be influenced by various factors, such as the nature and structure of a business, the economic circumstances thereof, and the necessity of periodic budgeting reviews. Consider, for example, a business entity which linked its key performance areas to its operational cycle, which is one month. In such a case, it would be more effective to budget in monthly rather than quarterly periods. The type of budget to be prepared can also influence the budget period. For example, it will be feasible to prepare a cash budget for an entity with a high volume of daily cash flow activities to pertain to a relative short period of time, such as one month. However, an investment budget will usually extend over a longer period of time, such as a year, because the cycles of investments typically extend over longer periods. A budget can thus be prepared for any period of time, depending on the specific attributes of the entity.

A budget which pertains to a budget period of a year is referred to as an "annual budget". Annual budgets can be subdivided into quarterly or monthly periods. Since the preparation of budgets can be time consuming and costly, most business entities find it practical to apply annual budgetary systems. One of the major disadvantages of an annual budgetary system is that it deters flexibility due to the relative long time span thereof. Under volatile trading conditions, a business entity might prefer to endorse a more lenient planning and budgeting approach, so as to be more efficient in dealing with unanticipated events. Accordingly, such a business will plan and reschedule on a more frequent basis, and consider applying a continuous budgetary system.

A continuous budgetary system requires that existing budgets be revised repeatedly, so as to allow for appropriate and timely adjustments. As such, it is more flexible than an annual budgetary system. However, it should be noted that the flexibility induced by a continuous budgetary system should not impede its controlling advantages. To attain the objective of enhanced flexibility, continuous budgets are prepared for shorter periods than a year, usually on a quarterly basis, divided into months. A continuous budget does not expire in its entirety. It is sustained by replacing an expired period of the budget (such as a monthly period within a quarterly budget) by a future period of the budget which is of equal length as the expired period. For example, if a quarterly continuous budget is prepared on a monthly basis, say for January, February and March, and the first month of the budget (January) has expired, then the budget for January will be deleted and the budget for April will be added to the budget.

Budgetary systems are time related, and a selected budget period will thus direct the budgetary system to be applied. When determining a budget period, the advantages and disadvantages of the different budgetary systems must thus be considered. For example, a continuous budgetary system might not induce sufficient financial benefits to carry the cost of sustaining it.

Step 3: Prepare the necessary budgets.

Once the key performance areas and the budget period(s) have been determined, a master budget can be prepared. Any further budgets deemed necessary, should then be based on the master budget.

Step 4: Implement, evaluate and revise the budgets.

The implementation of budgets should neither be too rigid, so as to discourage the taking of unforeseen opportunities, nor too flexible, so as to vindicate a casual approach towards the importance of budgetary control. In order to maintain the practicality of budgets, they should be evaluated frequently, but revisions should be made with caution.

11.8 The structure of an elementary master budget

The structure and contents of a master budget cannot be standardised because it should pertain to the unique attributes of the entity for which it is prepared. A master budget is prepared from the various operating and financial budgets, as well as from the related working papers and analyses embracing all the activities of the entity. The following is a suggested structure of an elementary master budget of a manufacturing entity, compiled to consist of three main budgets, namely:

- ☐ An *operating budget* is prepared according to the set objectives and goals of an entity. The focus of the operating budget is on the operations of the entity. The operations of a manufacturing entity include sales, production, marketing, distribution, research and development, and administration.
- ☐ A *financial budget* is predominantly prepared according to the operating budget of an entity. The focus of this budget is on the financial effects of planned operations, capital investments on assets, liabilities and equities.

- *Budgeted financial statements* are prepared according to the operating and the financial budget of an entity. These budgeted financial statements usually pertain to a manufacturing cost statement – in the case of a manufacturing entity – a statement of profit or loss and other comprehensive income, a statement of changes in equity, a statement of financial position and a statement of cash flows.

Master budgets indicate only the basic operating and financial budgets which pertain to the entity, and the way these budgets are linked to each other. In this chapter we will only focus on the shaded budgets indicated in the overview. Since the master budget of a manufacturing entity is more comprehensive than that of a trading entity, the discussion will further focus on the budgets of a manufacturing entity.

11.8.1 *The operating budget*

The operating budget of a manufacturing entity comprises of a set of all the individual operating budgets, such as the sales, the production, the cost of sales and the non-manufacturing income and expense budget.

The individual operating budgets of a manufacturing entity pertain to the manufacturing and operating activities thereof, and therefore to items that are disclosed in a manufacturing cost statement and in a statement of profit or loss and other comprehensive income.

The structure and preparation of an operating budget of a manufacturing entity are discussed in paragraph 11.9.

With regard to the successive preparation of the different operating budgets, it should be noted that a viable starting point in the compilation of the operating budget is the estimation of future sales according to which a sales budget is prepared. A production budget and a non-manufacturing expense budget are normally based on the sales budget and a cost of sales budget can be prepared from a production budget, and so forth.

On completion of the operating budget, it can be used as a basis to prepare the financial budget as well as the budgeted manufacturing cost statement, the budgeted statement of profit or loss and other comprehensive income and certain parts of the budgeted statement of changes in equity.

11.8.2 *The financial budget*

Financial budgets pertain predominantly to items disclosed in a statement of financial position. Examples of financial budgets are the capital, the trade and other receivables/payables, and the cash budget. The only financial budget that will further be discussed in this chapter is the cash budget.

11.8.3 *The budgeted financial statements*

Budgeted financial statements are derived from the operating and/or the financial budget of an entity and summarise the details contained in these two budgets. For example, where a budgeted statement of profit or loss and other comprehensive income discloses only a single amount with regard to salary expenses, a separate salary expense budget usually presents a detailed analysis of the basic salaries, fringe benefits and other related matters per operating unit, section or department. Since the operating budget of a manufacturing entity deals with manufacturing and operating activities, a budgeted manufacturing cost statement, a budgeted statement of profit or loss and other comprehensive income and a budgeted statement of changes in equity (as far as the transfer of the total comprehensive income or loss for the year is concerned) can be prepared from the operating budget.

In similar fashion, a budgeted statement of changes in equity (in part) and a budgeted statement of financial position can be prepared from a financial budget. A budgeted statement of cash flows can primarily be prepared from the other budgeted financial statements. It is also possible to prepare a budgeted statement of cash flows according to the direct method from a cash budget. The preparation of budgeted financial statements falls outside the scope of this chapter.

11.9 The structure and preparation of the operating budget of a manufacturing entity

Since the structure of a master budget is dependent on the nature and the needs of the entity for which it is prepared, the structure of the operating budget, which forms part of the master budget, will also vary according to the specifics of the entity. The suggested structure of the operating budget presented in this chapter is based on the most common features thereof.

11.9.1 *Main operating budgets*

With regards to a manufacturing entity, the sales and the production budget are usually considered to be the main operating budgets, whilst the other operating budgets are usually referred to as "subsidiary operating budgets".

11.9.1.1 The sales budget

Since a sales budget usually functions as the starting point in the preparation of a master budget, it influences the effectiveness of all the other budgets and is therefore an extremely important budget to prepare. A thorough investigation into sales-related matters such as anticipated government policies, competition, the buying power and preferences of consumers, marketing strategies, sales techniques and production capacity needs to be made.

These factors can be addressed in a sales forecast, which is broad and elementary by nature. It concludes with a quantified assumption of the future sales in units for a specific budget period. For example, the sales for the next three months are expected to amount to 10 000 units.

A sales plan can be described as a plan that is developed to meet the sales forecast. It may include aspects such as a marketing strategy, anticipated selling prices, the necessary number of outlets, etc.

A sales budget is based on a sales plan, and deals with measurable quantities. It indicates the expected sales in units as well as in monetary terms. A possible layout of a sales budget is given in Example 11.1.

Example 11.1 Layout of a sales budget (units and value)

Sales budget for the year ended 31 December 20.6 (units and value)

Product	Budgeted units	Budgeted selling price	Budgeted sales
		R	R
Product X	18 450	90	1 660 500
Product Y	36 150	38	1 373 700
			3 034 200

11.9.1.2 The production budget

The production budget is based on the sales budget because the objective of a production budget is to ensure that a sufficient amount of products is manufactured to meet the anticipated sales as reflected in the sales budget.

Any requirements set by management with regard to the inventory levels of finished products must also be taken into account when the production levels are determined. It is important that the required closing inventory levels are set economically, as too little or too much inventories can adversely affect the profit of a business entity.

Whilst preparing a production budget, the production manager must also take factors, such as seasonal fluctuations, into consideration so as to maintain the inventory at the required levels, and to sustain the labour force that will be responsible for the production activities.

Should the sales budget indicate that more units may be sold than can be manufactured, it may be decided that additional resources must be acquired to increase the production levels accordingly. If the expected increase in the sales is considered to be temporary, the increased demand should be met by using the existing inventories and/or by working overtime, rather than by making capital investments. Ideally, the production capacity of a business should match the expected sales thereof.

A typical production budget concludes with the quantities (in units) of each of the finished products that must be manufactured. As Example 11.2, illustrates, it may also include the calculation of these budgeted quantities. Take note how the budgeted units to be produced are based on the sales budget and the required inventory levels. In Example 11.2, the information with regard to the inventory levels is assumed, whereas the information pertaining to the sales budget is carried forward from Example 11.1.

Example 11.2 Layout of a production budget (units)

Production budget for the year ended 31 December 20.6 (units)

Product	Required closing inventory of finished products	Budgeted sales for the year (refer to Example 11.1)	Budgeted amount of units required	Required opening inventory of finished products	Budgeted amount of units to be produced
	A*	B*	A + B*	C*	(A + B) – C*
X	15 450	18 450	33 900	16 650	17 250
Y	31 650	36 150	67 800	35 250	32 550

* These entries do not form part of the budget and are shown for calculation purposes only.

11.9.2 *Subsidiary operating budgets*

Subsidiary operating budgets are based on the information obtained from the production budget. The type and size of an entity will, to a large extent, determine the subsidiary budgets that need to be prepared.

The direct raw materials usage budget, the direct raw materials purchases budget, the direct labour budget and the manufacturing overhead budget are subsidiary operating budgets which are typically prepared by manufacturing entities. These budgets are hereby briefly discussed.

11.9.2.1 The direct raw materials usage budget

The direct raw materials usage budget is based on the production budget because the required units of finished products that need to be produced indicate the quantities of direct raw materials which will be used to attain such a production level.

The contents of the direct raw materials usage budget disclose the calculation of the quantity as well as of the cost price of the direct raw materials which are needed to manufacture the budgeted units of finished goods. As the name of the budget indicates, it deals with the *use* of direct raw materials and not with the purchases thereof.

Example 11.3 Layout of a direct raw materials usage budget (units and value)

Direct raw materials usage budget for the year ended 31 December 20.6 (units and value)

Product	**Budgeted amount of units to be produced (refer to Example 11.2)** A*	**Quantity of direct raw materials required to produce one unit** B*	**Budgeted quantity of direct raw materials usage** A × B*	**Estimated cost price per kg/ℓ** C*	**Budgeted cost price of direct raw materials usage** (A × B) × C*
	Units	**Kg**	**Kg**	**R**	**R**
X	17 250	30	517 500	1,50	776 250
		ℓ	**ℓ**		
Y	32 550	10	325 500	2,25	732 375
Total					1 508 625

* These entries do not form part of the budget and are shown for calculation purposes only.

11.9.2.2 The direct raw materials purchases budget

The direct raw materials purchases budget is derived from the direct raw materials usage budget as well as from the required opening and closing inventories of direct raw materials. As mentioned earlier, it is important that required inventory levels be economically feasible. If the required direct raw material inventory levels are too high, it can decrease profits due to factors such as unnecessary storage costs and damage, whilst if the required inventory levels are too low, it may cause a delay in the manufacturing process due to out-of-stock situations, which induces manufacturing costs.

The direct raw materials purchases budget contains both the quantities and the cost price of the direct raw materials to be purchased. Example 11.4 illustrates a direct raw materials purchases budget.

Example 11.4 Layout of a direct raw materials purchases budget (units and value)

Direct raw materials purchases budget for the year ended 31 December 20.6 (units and value)

Direct raw materials	**Required closing inventory of direct raw materials**	**Budgeted quantity of direct raw materials usage (refer to Example 11.3)**	**Budgeted quantity of direct raw materials to be available**	**Required opening inventory of direct raw materials**	**Budgeted quantity of direct raw materials to be purchased**	**Estimated cost price per unit**	**Budgeted cost price of direct raw materials to be purchased**
	A*	B*	A + B*	C*	(A + B) – C*	D*	[(A + B) – C] × D*
	Kg	**Kg**	**Kg**	**Kg**	**Kg**	**R**	**R**
Material P-1005 Product X	70 500	517 500	588 000	65 500	522 500	1,50	783 750
Material Q-1006 Product Y	ℓ 24 900	ℓ 325 500	ℓ 350 400	ℓ 22 900	ℓ 327 500	2,25	736 875
							1 520 625

* These entries do not form part of the budget and are shown for calculation purposes only.

11.9.2.3 The direct labour budget

Since the direct labour budget is based on the number of finished products (units) to be manufactured, it is also derived from the production budget. A direct labour budget usually contains the number and type of employees necessary to perform the work, the amount of necessary direct labour hours, and the budgeted cost of such labour. The cost of indirect labour should be included in the manufacturing overhead budget, which is discussed in paragraph 11.9.2.4.

In Example 11.5, it must be assumed that the budgeted number of workers, the budgeted number of hours and the anticipated tariffs are given amounts. In practice, these amounts are based on the budgeted amount of finished products to be manufactured because this information will indicate the type of worker and the amount of direct labour hours necessary to manufacture the budgeted finished products.

Example 11.5 Layout of a direct labour budget (hours and value)

Direct labour budget for the year ended 31 December 20.6 (hours and value)

	Budgeted number of workers	**Budgeted number of direct labour hours**	**Budgeted tariff per direct labour hour**	**Budgeted direct labour costs**
	A*	B*	C*	B × C*
			R	**R**
Dept A (production of product X)		57 000		253 500
Skilled	16	48 000	5,00	240 000
Unskilled	3	9 000	1,50	13 500
Dept B (production of product Y)		45 000		150 000
Skilled	10	30 000	4,00	120 000
Unskilled	5	15 000	2,00	30 000
		102 000		403 500

* These entries do not form part of the budget and are shown for calculation purposes only.

11.9.2.4 The manufacturing overhead budget

The manufacturing overhead budget is also based on the production budget of a business entity. Manufacturing overhead expenses are costs that cannot be linked to the completion of specific goods, as is the case with direct labour and direct material, or it may be impractical to do so. It therefore pertains to indirect expenses such as indirect labour, indirect raw materials, depreciation of machinery, the salary of the supervisory personnel of the factory, and factory-related rental expenses. A manufacturing overhead budget may also distinguish between budgeted fixed and variable overhead expenses.

Fixed overhead expenses are costs which remain unchanged for a particular period, regardless of any changes in the production rate. Examples are rental and insurance expenses that are fixed by a contract, depreciation and fixed maintenance costs.

Variable overhead expenses are costs such as indirect wages that change in direct proportion to the production rate. For example, if the production rate increased by 10%, the variable overhead expenses will, *mutatis mutandis*, also increase by 10%.

Budgeted overhead expenses are usually allocated to the budgeted manufacturing or non-manufacturing expenses of a business on a prescribed basis, such as according to direct labour hours, machine hours, number of employees, value of machinery, floor area or material usage, in order to determine the budgeted manufacturing overhead for the period. Depreciation on machinery, as well as maintenance and insurance expenses with regard to machinery, are normally allocated according to the value of the machinery, whilst the maintenance expenses of a building can be allocated according to the floor area thereof.

The layout of a manufacturing overhead budget (per product) is presented in Example 11.6.

Example 11.6 Layout of a manufacturing overhead budget (per product)

The fixed overhead and the variable overhead expenses amounted to R83 880 and R36 150 respectively and are allocated to the manufacturing costs per product on the basis of direct labour hours (refer to Example 11.5).

Manufacturing overhead budget for the year ended 31 December 20.6 (per product)

	Product X	Product Y	Total
	R	R	R
Fixed overhead expenses	46 874①	37 006①	83 880
Variable overhead expenses	20 202②	15 948②	36 150
Total manufacturing overhead expenses	67 076③	52 954③	120 030

Calculations:

① Product X: R83 880 × 57 000/102 000 = R46 874
Product Y: R83 880 × 45 000/102 000 = R37 006

② Product X: R36 150 × 57 000/102 000 = R20 202*
Product Y: R36 150 × 45 000/102 000 = R15 948*
* Rounded off

③ Product X: R120 030 × 57 000/102 000= R67 076
Product Y: R120 030 × 45 000/102 000= R52 954

11.9.2.5 The cost of sales budget

The cost of sales budget is prepared from the required values of the inventories of opening and closing finished goods, as well as from the budgeted manufacturing costs of the finished goods over a specific budget period. The budgeted manufacturing costs of the finished goods pertain to the budgeted direct raw materials usage, the direct labour and the manufacturing overhead expenses. The layout of a cost of sales budget is illustrated in Example 11.7.

Example 11.7 Layout of a cost of sales budget

Assume that the budgeted opening inventory of finished goods amounted to R873 623 in respect of product X and to R893 940 in respect of product Y. The budgeted manufacturing costs can be carried forward from Examples 11.3, 11.5 and 11.6.

Cost of sales budget for the year ended 31 December 20.6

	Product X	Product Y	Total
	R	R	R
Required opening inventory – finished products (given)	873 623	893 940	1 767 563
Budgeted manufacturing costs	1 096 826	935 329	2 032 155
Direct raw materials usage (refer to Example 11.3)	776 250	732 375	1 508 625
Direct labour (refer to Example 11.5)	253 500	150 000	403 500
Manufacturing overhead expenses (refer to Example 11.6)	67 076	52 954	120 030
	1 970 449	1 829 269	3 799 718
Required closing inventory – finished products①	(982 311)	(909 621)	(1 891 932)
Cost of sales	988 138	919 648	1 907 786

Calculations:

① **Value of the budgeted closing inventory of finished products**

Required number of finished products in closing inventory × manufacturing cost per unit

Product X: R63,58① × 15 450* = R982 311
Product Y: R28,74① × 31 650* = R909 621

* Refer to Example 11.2.

Manufacturing cost per unit

	Product X		Product Y	
	Cost divided by number of units manufactured	**Manu-facturing cost per unit**	**Cost divided by number of units manufactured**	**Manu-facturing cost per unit**
		R		**R**
Direct raw materials usage (refer to Example 11.3)	R776 250/17 250	45,00	R732 375/32 550	22,50
Direct labour:				
Skilled (refer to Examples 11.2 and 11.5)	R240 000/17 250	13,91	R120 000/32 550	3,69
Unskilled (refer to Examples 11.2 and 11.5)	R13 500/17 250	0,78	R30 000/32 550	0,92
Manufacturing overhead expenses (refer to Examples 11.5 and 11.6)	R67 076/17 250	3,89*	R52 954/32 550	1,63*
		63,58		28,74

* These amounts can also be calculated as follows:
Product X: R120 030/102 000 × 57 000/17 250 = R3,89
Product Y: R120 030/102 000 × 45 000/32 550 = R1,63

Example 11.8 Comprehensive example – operating budgets

The following budgeted information in respect of Wonderworld CC, an entity manufacturing products Hero and Zero, for the budget year ended 31 December 20.8 was obtained:

1. Budgeted sales:

   Product Hero 125 000 units @ R50,00 each
   Product Zero 100 000 units @ R80,00 each

2. The budgeted cost price composition per unit of the two products is as follows:

	Product Hero	Product Zero
Direct raw materials:	3 kg @ R3,50 per kg	5 l × R2,50 per litre
Direct labour:	2 hours @ R5,00 per hour	4 hours @ R4,00 per hour

3. Budgeted factory overhead expenses:

	R
Fixed	637 500
Variable	127 500

4. Factory overhead expenses are allocated on the basis of the budgeted direct labour hours.

5. Required inventory levels:

		1 January 20.8	31 December 20.8
Direct raw materials:	Product Hero	25 000 kg	29 350 kg
	Product Zero	18 000 litres	22 000 litres
Finished products:	Product Hero	12 500 units	15 000 units
	Product Zero	9 000 units	10 000 units

6. The budgeted value of the opening inventory in respect of the finished products Hero and Zero amounts to R734 375 and R486 000 respectively.

Required:

Prepare the following operating budgets for Wonderworld CC for the budget year ended 31 December 20.8:

(a) The sales budget (units and value)
(b) The production budget (units)
(c) The direct raw materials usage budget (units and value)
(d) The direct raw materials purchases budget (units and value)
(e) The direct labour budget (hours and value)
(f) The manufacturing overhead budget (per product – value)
(g) The cost of sales budget

Solution:

(a) The sales budget (units and value)

Wonderworld CC
Sales budget for the year ended 31 December 20.8 (units and value)

Product	Budgeted units	Budgeted selling price per unit	Budgeted sales
		R	R
Hero	125 000	50	6 250 000
Zero	100 000	80	8 000 000
Total			14 250 000

(b) The production budget (units)

Wonderworld CC
Production budget for the year ended 31 December 20.8 (units)

Product	Required closing inventory of finished products	Budgeted sales for the year	Budgeted amount of units required	Required opening inventory of finished products	Budgeted amount of units to be produced
Hero	15 000	125 000	140 000	12 500	127 500
Zero	10 000	100 000	110 000	9 000	101 000

(c) The direct raw materials usage budget (units and value)

Wonderworld CC
Direct raw materials usage budget for the year ended 31 December 20.8 (units and value)

Product	Budgeted amount of units to be produced	Quantity of direct raw materials required to produce one unit	Budgeted quantity of direct raw materials usage	Estimated cost price per kg/ℓ	Budgeted cost price of direct raw materials usage
Hero	127 500	3 kg	382 500 kg	R3,50	R1 338 750
Zero	101 000	5 ℓ	505 000 ℓ	R2,50	R1 262 500
Total					R2 601 250

(d) The direct raw materials purchases budget (units and value)

Wonderworld CC
Direct raw materials purchases budget for the year ended 31 December 20.8 (units and value)

Product	Required closing inventory of direct raw materials	Budgeted quantity of direct raw materials usage	Budgeted quantity of direct raw materials to be available	Required opening inventory of direct raw materials	Budgeted quantity of direct raw materials to be purchased	Estimated cost price per unit	Budgeted cost price of direct raw materials to be purchased
Hero	29 350 kg	382 500 kg	411 850 kg	25 000 kg	386 850 kg	R3,50	R1 353 975
Zero	22 000 ℓ	505 000 ℓ	527 000 ℓ	18 000 ℓ	509 000 ℓ	R2,50	R1 272 500
Total							R2 626 475

(e) The direct labour budget (hours and value)

Wonderworld CC
Direct labour budget for the year ended 31 December 20.8 (hours and value)

Product	Budgeted units to be produced	Budgeted number of direct labour hours per unit	Budgeted number of direct labour hours	Budgeted tariff per direct labour hour	Budgeted direct labour costs
Hero	127 500	2	255 000	R5	R1 275 000
Zero	101 000	4	404 000	R4	R1 616 000
Total			659 000		R2 891 000

(f) The manufacturing overhead budget (per product – value)

Wonderworld CC
Manufacturing overhead budget for the year ended 31 December 20.8
(per product – value)

	Product Hero	Product Zero	Total
	R	R	R
Fixed overhead expenses	246 681①	390 819①	637 500
Variable overhead expenses	49 336②	78 164②	127 500
Total manufacturing overhead expenses	296 017	468 983	765 000

Calculations:

① Product Hero: R637 500 × 255 000/659 000* = R246 681

① Product Zero: R637 500 × 404 000/659 000* = R390 819

② Product Hero: R127 500 × 255 000/659 000* = R49 336

② Product Zero: R127 500 × 404 000/659 000* = R78 164

* Refer to Solution (e).

or

① Product Hero: R637 500/659 000 × 2 × 127 500* = R246 681

① Product Zero: R637 500/659 000 × 4 × 101 000* = R390 819

② Product Hero: R127 500/659 000 × 2 × 127 500* = R49 336

② Product Zero: R127 500/659 000 × 4 × 101 000* = R78 164

* Refer to Solution (e).

(g) The cost of sales budget

Wonderworld CC
Cost of sales budget for the year ended 31 December 20.8

	Product Hero	Product Zero	Total
	R	R	R
Required opening inventory – finished products (given)	734 375	486 000	1 220 375
Budgeted manufacturing costs:	2 909 767	3 347 483	6 257 250
Direct raw materials usage	1 338 750	1 262 500	2 601 250
Direct labour	1 275 000	1 616 000	2 891 000
Manufacturing overhead expenses	296 017	468 983	765 000
	3 644 142	3 833 483	7 477 625
Required closing inventory – finished products①	(342 300)	(331 400)	(673 700)
Cost of sales	3 301 842	3 502 083	6 803 925

Calculations:

① **Value of the budgeted closing inventory of finished products**

Required number of finished products in closing inventory × manufacturing cost per unit

Product Hero: 15 000 × R22,82① = R342 300
Product Zero: 10 000 × R33,14① = R331 400

Manufacturing cost per unit

	Product Hero		**Product Zero**	
	Cost divided by number of units manufactured	**Manu-facturing cost per unit**	**Cost divided by number of units manufactured**	**Manu-facturing cost per unit**
		R		**R**
Direct raw materials usage	R1 338 750/127 500	10,50	R1 262 500/101 000	12,50
Direct labour	R1 275 000/127 500	10,00	R1 616 000/101 000	16,00
Manufacturing overhead expenses	R296 017/127 500	2,32*	R468 983/101 000	4,64*
		22,82		33,14

* These amounts can also be calculated as follows:
Product Hero: R765 000/659 000 × 2 hours = R2,32
Product Zero: R765 000/659 000 × 4 hours = R4,64

11.10 Preparation of a cash budget

Since sound cash flow is crucial to the survival of any business entity, a cash budget is considered to be very important because it enables management to manage cash more effectively. A cash budget is considered to be a financial budget (refer to paragraph 11.8.2), and is prepared from the operating as well as the other financial budgets.

The starting point of a cash budget is the balance of the bank account at the beginning of a budget period. Thereafter, the budget is presented in two sections, namely the budgeted cash receipts section and the budgeted cash payments section. The budgeted cash receipts section will increase a favourable opening bank balance (or decrease an opening bank overdraft), and the budgeted cash payments section will decrease a favourable opening bank balance (or increase an opening bank overdraft). Usually the budgeted cash receipts section is disclosed before the budgeted cash payments section. As Example 11.9 illustrates, the net effect of the budgeted cash receipts and the budgeted cash payments over the budget period on the opening bank balance is equal to the budgeted bank balance at the end of the budget period.

As the name of the cash budget indicates, a cash budget includes only the budgeted cash transactions of an entity. All expected non-cash transactions, such as credit losses written off, depreciation and the profit/loss on the sale of non-current assets, are therefore excluded from a cash budget.

Example 11.9 Preparation of a cash budget

The following information relates to Abakar CC, an entity which manufactures small electrical scooters:

1. On 1 April 20.6, the favourable bank balance amounted to R22 500.
2.

Month	Sales	Cost of materials (purchases)	Manufacturing overhead expenses	Labour costs
20.6	**R**	**R**	**R**	**R**
Actual amounts:				
January	67 500	36 000	5 775	10 500
February	63 000	34 500	6 600	12 000
March	72 000	39 000	7 425	13 500
Budgeted amounts:				
April	90 000	45 000	7 755	14 100
May	99 000	54 000	7 920	14 400
June	87 000	46 500	8 662	15 750

3. Approximately 50% of the goods are sold on credit. This percentage must be used to calculate the budgeted credit sales.
4. It was decided to budget for the cash receipts from the debtors according to the following analysis of the payments which were previously made by the debtors:

During the month of sale	5%
During the first month after the month of sale	50%
During the second month after the month of sale	30%
During the third month after the month of sale	10%
Irrecoverable	5%

5. The rental income for the financial year amounts to R750 per month, and is receivable before the fifth of every month.
6. Expense items in the abovementioned table will be paid as follows:
   - Materials and manufacturing overhead expenses – during the month after the month in which these expenses incur.
   - Labour costs – during the month in which these expenses incur.
7. Distribution and administrative expenses must be calculated at 5% of the total sales for a month, and must be paid during the next month.
8. It is envisaged that a distribution of total comprehensive income to the amount of R8 500 will be paid to the members during May 20.6.
9. The purchase of machinery to the amount of R46 500 is planned for April 20.6, and it will be paid in full on 15 May 20.6.
10. A long-term loan of R15 000 was granted to the close corporation during 20.2. Interest at 15% per annum on the capital amount is payable half-yearly on 1 December and 1 June. The capital amount of the loan is repayable during 20.8.

Required:

Prepare the cash budgets of Abakar CC for the months April, May and June 20.6.

Solution:

Abakar CC
Cash budgets for April, May and June 20.6

Details	April R	May R	June R
Bank balance at beginning of month	22 500	37 200*	(280)*
Cash receipts	78 825	89 175	88 275
Cash sales①	45 000	49 500	43 500
Receipts from debtors②	33 075	38 925	44 025
Rent	750	750	750
Cash available during the month	101 325	126 375	87 995
Cash payments	(64 125)	(126 655)	(83 745)
Materials	39 000	45 000	54 000
Manufacturing overhead expenses	7 425	7 755	7 920
Labour costs	14 100	14 400	15 750
Distribution and administrative expenses③	3 600	4 500	4 950
Distribution to members	–	8 500	–
Machinery	–	46 500	–
Interest (R15 000 × 15% × 6/12)	–	–	1 125
Bank balance at end of month	37 200	(280)	4 250

* Carried forward from the budgeted bank balance at the end of the previous month.

Calculations:

① **Sales**

	January R	February R	March R	April R	May R	June R
Cash (50%)	33 750	31 500	36 000	45 000	49 500	43 500
Credit (50%)	33 750	31 500	36 000	45 000	49 500	43 500
Total sales	67 500	63 000	72 000	90 000	99 000	87 000

② **Receipts from debtors**

In order to determine the cash receivable from debtors for a budget period, the credit sales that took place during each month that affects the budget period, must first be calculated (refer to Calculation ①).

Thereafter, the debtors' payments which are receivable during the budget period must be determined according to the analysis of the expected payments by the debtors
(refer to paragraph 4 of the given information). For example, the budgeted cash receivable in respect of the January credit sales can be analysed as follows:

The credit sales that took place during January amounted to R33 750. According to the analysis, 5% of the credit sales is expected to be received during the month of the credit sale. In other words, 5% of the January credit sales will be received in January. The analysis further indicates that 50% is expected to be received during the first month after the month during which the credit sales took place. In respect of the January credit sales of R33 750, 50% thereof is thus expected to be received during February. Likewise, 30% is expected to be received during March and 10% during April. The irrecoverable amount must be excluded in the cash budget, since it is neither an expected cash receipt nor an expected cash payment. Take note that the only amount that pertains to the budget period is R3 375. This analysis is illustrated in Table 11.1.

Table 11.1 Analysis of budgeted cash receipts from debtors in respect of the January credit sales

Analysis of payments by debtors	**Actual amounts***			**Budget period**			**Future unbudgeted period**	
	Jan	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**
	R	**R**	**R**	**R**	**R**	**R**	**R**	**R**
Jan credit sales: R33 750								
5% during month of credit sales (5% × R33 750)	1 688							
50% – 1st month after (50% × R33 750)		16 875						
30% – 2nd month after (30% × R33 750)			10 125					
10% – 3rd month after (10% × R33 750)				3 375				

* For the purpose of the analysis from January to March, which is based on actual amounts, assume that the anticipated cash receipts were equal to the amounts actually received.

The budgeted cash receipts from the debtors in respect of the credit sales from February to June can be calculated in similar fashion:

Table 11.2 Analysis of budgeted cash receipts from debtors in respect of the actual or budgeted credit sales from February to June

Analysis of payments by debtors	**Actual amounts***		**Budget period**			**Future unbudgeted period**		
	Feb	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**
	R	**R**	**R**	**R**	**R**	**R**	**R**	**R**
Feb credit sales: R31 500								
5% during Feb	1 575							
50% – 1st month after		15 750						
30% – 2nd month after			9 450					
10% – 3rd month after				3 150				
Mar credit sales: R36 000								
5% during Mar		1 800						
50% – 1st month after			18 000					
30% – 2nd month after				10 800				
10% – 3rd month after					3 600			

continued

Analysis of payments by debtors	**Actual amounts***		**Budget period**			**Future unbudgeted period**		
	Feb	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**
	R	**R**	**R**	**R**	**R**	**R**	**R**	**R**
Apr credit sales: *R45 000*								
5% during Apr			2 250					
50% – 1st month after				22 500				
30% – 2nd month after					13 500			
10% – 3rd month after						4 500		
May credit sales: *R49 500*								
5% during May				2 475				
50% – 1st month after					24 750			
30% – 2nd month after						14 850		
10% – 3rd month after							4 950	
Jun credit sales: *R43 500*								
5% during June					2 175			
50% – 1st month after						21 750		
30% – 2nd month after							13 050	
10% – 3rd month after								4 350

* For the purpose of the analysis from January to March, which is based on actual amounts, assume that the anticipated cash receipts were equal to the amounts actually received.

The above calculations reflect the actual and budgeted cash receipts from the debtors in respect of all of the credit sales that took place from January until June. However, only the budgeted cash receipts from the debtors for the periods April, May and June are required. The following table is a summary of the calculations given in the shaded areas (which pertain to the budgeted periods of April, May and June) above.

			April		**May**		**June**
	R	**%**	**R**	**%**	**R**	**%**	**R**
Credit sales in:							
January	33 750	10	3 375		–		–
February	31 500	30	9 450	10	3 150		–
March	36 000	50	18 000	30	10 800	10	3 600
April	45 000	5	2 250	50	22 500	30	13 500
May	49 500		–	5	2 475	50	24 750
June	43 500		–		–	5	2 175
			33 075		38 925		44 025

③ **Distribution and administrative expenses**

Month	Total sales		April		May		June
	R	%	R	%	R	%	R
March	72 000	5	3 600				
April	90 000			5	4 500		
May	99 000					5	4 950

11.11 Summary

It is the responsibility of management to direct a business entity in such a manner that it attains its objectives and goals as cost efficiently as possible. Managerial activities such as planning, organising, staffing and controlling largely determine whether a business is properly managed or not, and whether it will be able to attain its objectives and goals. Since budgets can be used to substantially increase the effectiveness with which such managerial duties are performed, they are regarded as instruments of vital importance.

In essence, a budget can be regarded as a set of standards that directs the quantity and quality of the activities of an entity in order to meet set standards.

Budgets have both advantages and limitations which must be borne in mind. It is important to balance the rigidity that budgets can instill on the activities of a business with the flexibility needed to react timeously and appropriately under unforeseen circumstances.

Accounting information can contribute substantially to the preparation, implementation and evaluation of budgets, especially when it is used to set standards against which actual performance can be measured for control purposes.

The basic budgeting procedure is fairly simple: it implies identifying the key performance areas, determining the budget period, preparing the necessary budgets accordingly, and implementing, evaluating and revising the budgets according to any variances.

A master budget presents a broad overview of the anticipated activities of a business entity and is structured according to specific needs. Therefore, the layout or format of master budgets may vary. Possible layouts of elementary master budgets for a manufacturing and a trading entity were illustrated. These illustrations are based on the approach that a master budget of a business entity can consist out of three sets of budgets, namely an operating budget, a financial budget, and budgeted financial statements.

The major difference between an operating budget of a manufacturing entity and an operating budget of a trading entity is that the latter does not include manufacturing-related budgets. Since the preparation of an operating budget of a manufacturing entity is more comprehensive and includes most of the budgets of a trading entity, only the preparation of an operating budget of a manufacturing entity was discussed and illustrated. The sales and production budgets are usually considered to be the main operating budgets, whilst the other operating budgets, such as the direct raw materials usage, the direct raw materials purchases, the direct labour, the manufacturing overhead and the cost of sales budgets, are usually referred to as "subsidiary operating budgets".

The financial budget of a business is primarily based on its operating budget. The position thereof within the structure of a master budget, as well as its contents, was briefly discussed. The only financial budget illustrated, was the cash budget.

The budgeted financial statements are based on the operating and the financial budgets. The position of the budgeted financial statements in the master budget was illustrated and briefly discussed.

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