2010

Only study guide for

FAC1601

Accounting reporting

Department Financial Accounting

Printed and published by the
University of South Africa
Muckleneuk, Pretoria

FAC1601/1/2010

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CONTENTS

INTRODUCTION AND OVERVIEW OF THE MODULE

1 Word of welcome

Before proceeding with a discussion for the objective of FAC1601, we, as the lecturers for this module, would like to extend a sincere welcome to you as a student in this challenging module. As you may have been told by fellow students or by a lecturer, this module requires a great deal of dedication and practice if you intend to pass well, especially if you do not have a significant related academic background.

We hope that you will experience this module as challenging, but we must caution you that you will have to put in a great deal of time to prepare thoroughly for the examination. There are many reasons why students find it difficult to pass FAC1601, or to obtain the mark they are aiming at. One of the major reasons why students are unsuccessful is that they do not allow themselves enough time to cover the tutorial matter thoroughly and revise the exercises and examples. FAC1601 is a practical module, and therefore requires as much practice as possible. However, without a sound theoretical background, it is likely that you will experience problems with the practical sections. It is not possible to study FAC1601 through rote learning. Therefore, it is extremely important that you obtain a sound understanding of the theory before you try to apply it by doing the examples and exercises. Students often skip these critical theoretical discussions, and opt to prepare for the examination by memorising the solutions to the given examples and exercises. Obviously, this approach will be unsuccessful because the theory relates to an infinite number of possible practical scenarios which cannot all be studied. By approaching FAC1601 in a positive, proactive manner, you will improve your chances of success. Hopefully, you will become interested in the subject of Accounting, and gain knowledge and skills that you will find very useful later on.

We, the lecturers for FAC1601, will do our very best to assist you as far as possible with your studies. Do not hesitate to contact us with any queries regarding the content of this module.

Lecturers: FAC1601

"It is difficult to say what is impossible,
for the dream of yesterday is the hope of today
and the reality of tomorrow."

Robert Goddard

2 Overview

FAC1601 concerns itself with the issues of accounting reporting, as indicated in paragraph 3 of this study unit, and builds on the learning outcomes of FAC1501. In turn, this module serves as the basis for more advanced studies in financial accounting at Unisa, namely FAC2601 and FAC2602.

This module is divided into 9 study units. The topics of these study units are presented in the Contents section at the beginning of the study guide, and should give you an overview of the syllabus. In addition, the contents of each study unit are shown at the beginning of each study unit.

3 Module objective

The main objective of the module FAC1601 is to teach you certain aspects of financial accounting and reporting so that you are able to do the following:

- discuss specified aspects of the Framework for the Preparation and Presentation of Financial Statements
- understand and apply the concept of Generally Accepted Accounting Practice
- prepare financial statements for sole proprietors, partnerships and close corporations according to certain of the requirements of International Accounting Standard 1 [IAS 1 (AC101)]
- apply the accounting procedures to record changes in the ownership structure of partnerships on the admittance, retirement or death of partners
- apply the accounting procedures to record the simultaneous and piecemeal liquidation of partnerships
- record transactions pertaining to the capital structure of companies
- prepare statements of cash flows for sole proprietors, partnerships and close corporations according to certain of the requirements of International Accounting Standard 7 [IAS 7 (AC118)]
- analyse and interpretate financial statements
- explain how a business entity with branches operates, and record the transactions between head offices and their branches

4 Tutorial Letter 101 and prescribed textbook

Before you start studying, please read the discussion in Tutorial Letter 101. This tutorial letter contains valuable guidelines on how to go about studying this module, as well as suggested time specifications pertaining to each study unit in order to ensure that you cover the whole syllabus in time. Tutorial Letter 101 also contains information about the prescribed textbook (About Financial Accounting, Volume 2, 3rd edition; Berry PR, de Klerk ES, Doussy F, du Plooy SM, Jansen van Rensburg JS, Ngcobo RN, Rehwinkel A, and Scheepers D) that you must purchase. The prescribed textbook forms the major learning content of this module, and must be used according to the directives given in the study guide. For example the guide will indicate that certain sections of the prescribed textbook need only be read, whereas other sections must be studied thoroughly.

5 Learning outcomes and self-assessment

Learning outcomes are presented at the start of each study unit in the study guide. At the end of each study unit there is an elementary self-assessment questionnaire which you must complete in order to evaluate your knowledge of the learning content of each study unit and to monitor your progress. These questionnaires are presented in the form of questions to which you must answer either "yes" or "no". If you have answered "yes" to all the questions you may proceed with the next study unit. If you have any "no" answers, you must study that particular section of the work again. Since a clear understanding of certain aspects in a study unit may be essential for your further understanding of the course, you are advised not to go on to the next study unit until you have resolved all your problems in the preceding one.

6 Interpretation of terminology

6.1 References to the prescribed textbook

The prescribed textbook is referred to throughout the study guide. Such references usually include action words. In this regard, the following action words should be interpreted as follows:

Action word	Interpretation
Read	Read so as to obtain a broad and basic background knowledge of the subject under discussion.
Read attentively	Read the theory that needs to be clearly understood. You may be assessed on this theory by means of short questions in the assignments.
Study	Learn with a view to gaining the highest level of understanding which is necessary to solve problems in exercises, assignments and in the examination. This level of knowledge will also be necessary for further studies in financial accounting and/or your career. You will never be required to give a definition of a concept or to discuss theory in the examination. You will, however, be required to apply the theory in the correct accounting format and to apply the correct steps/procedures. For example, the layout and terminology to be used in the preparation of financial statements are prescribed by the International Accounting Standards. You may not use any other format.
Prepare	Compile or complete what is required on the basis of previous study.

6.2 Examples, exercises, self-assessment criteria, assignments and examination questions

To indicate the length, scope and format of answers to questions, action verbs have been deliberately applied. An analysis of the action verbs in a question should enable you to

- plan the answer systematically
- ensure that you comply with the lecturer's/examiner's requirements

In order for you to correctly interpret the examples, exercises, self-assessment criteria, assignments and examination questions, a clear understanding of the meaning of certain words is required.

For the purpose of this module, the following interpretations are given:

Word	Interpretation
Adjust	To adapt to new conditions/environment; to put in order; add; change
Apply	Use in a practical manner; use as relevant or suitable
Calculate	Ascertain by mathematical procedure/exact reckoning
Clarify	Make clear the meaning of; explain the intention of; show by reasoning/evidence
Compare	Examine in order to observe resemblances, relationships and differences
Complete	Finish/add what is required; show the necessary detail
Define	State precisely the meaning/scope/total character of; make clear (especially the outline of); give a concise description of the distinguishing features of
Describe	Give clearly the distinguishing details or essential characteristics of
Discuss	Examine by argument, debate, hold conversation about
Explain	Set out in detail (interpret); the meaning of account for something; make something understandable
List	Record/itemise names or things belonging to a class
Mention/name/state	Specify by name; cite names, characteristics, items, elements of facts
Prepare	Make ready/complete for a particular purpose; to put together using parts; compose, construct
Reconcile	To make compatible or consistent with each other
Record	Put in writing; set down for reference or retention
Show	To make or become visible, noticeable; to exhibit or present; to indicate

7 References to calculations

It is very important that you show all your calculations in your answers to exercises and questions. In the study guide and the prescribed textbook, short calculations are disclosed in brackets after an entry in a journal, ledger account or financial statement. Note that these calculations do not form part of the actual accounting entries. They are disclosed as such for practical illustrative purposes only. More elaborate calculations are referred to by encircled symbols, for example "①". Subcalculations are referred to by shaded encircled symbols, for example "❶". You may follow the same or a similar approach when preparing your answers.

8 References to cash transactions

You should be aware that the books of first entry in respect of cash transactions are the cash receipts journal and the cash payments journal. However, to simplify matters in this module, cash transactions are disclosed in the general journal.

9 Feedback request

If there is anything discussed in the prescribed textbook or the study guide which in your opinion needs to be explained in more detail or in a different fashion, please notify us accordingly by post or e-mail. The postal and e-mail addresses of the lecturers are given in Tutorial Letter 101.

STUDY UNIT

1

Introduction to the preparation of financial statements

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- describe what the concept "the 'Framework'" entails
- list the specific purposes of the Framework regarding the preparation and presentation of financial statements
- explain the main objective of financial statements according to the Framework
- explain the underlying assumptions when preparing financial statements as discussed in the Framework
- discuss the qualitative characteristics of financial statements according to the Framework
- describe what the Framework means when it refers to the constraints in preparing financial statements
- discuss the elements of financial statements as explained in the Framework, and indicate which elements pertain to the statement of financial position and which to the statement of comprehensive income
- discuss the concepts of recognition and disclosure of the elements incorporated in the financial statements, as explained in the Framework

- explain what is meant by the measurement of the elements of financial statements by referring to the measurement methods that are discussed in the Framework
- define the acronyms, GAAP, IFRSs, APB and SAICA, and know what they entail
- explain what type of business ownership must comply with the IFRSs
- explain what each of the following terms imply according to IAS 1 (AC 101):

  — fair presentation
  — going concern
  — accrual basis of accounting
  — materiality and aggregation
  — offsetting
  — frequency of reporting
  — comparative information
  — consistency of presentation

- list the individual statements that, according to IAS 1 (AC 101), together form the complete set of financial statements of a reporting entity
- explain what the identification of financial statements means
- explain what reporting period means
- explain according to IAS 1 (AC 101), which items current assets and current liabilities generally consist of
- list the items that must, according to IAS 1 (AC 101), be presented on the face of the statement of financial position and the statement of comprehensive income
- list the items that can, according to IAS 1 (AC 101), be presented on either the face of the statement of financial position and the statement of comprehensive income or in the notes to these statements for the particular reporting period
- discuss the purpose of notes, according to IAS 1 (AC 101)
- discuss, according to IAS 1 (AC 101), the order in which items are disclosed as notes to financial statements
- define
  — a financial instrument
  — a financial asset
  — a financial liabililty
  — fair value
  — a contract
- distinguish between the four categories of financial instruments
- recognise and initially measure financial assets and financial liabilities
- subsequently measure financial assets at fair value through profit or loss

Key concepts

- Framework
- Underlying assumptions
- Qualitative characteristics
- Components of financial statements
- Elements of financial statements

- Recognition and disclosure
- Measurement of elements
- Capital
- Capital maintenance
- Overall considerations
- Reporting period
- Financial instruments
- Financial assets
- Financial liabilities
- Fair value
- Categories of financial instruments

1.1 Introduction

Each business entity usually has some sort of accounting system that it uses to collect data and process information about its financial performance, position and cash flows. Such information is then communicated to the users thereof by means of financial reporting, of which financial statements form an integral part.

The purpose of this study unit is to explain the key concepts regarding the preparation and presentation of financial statements according to the Framework for the Preparation and Presentation of Financial Statements and International Accounting Standard 1.

Read paragraph 1.1 of the prescribed textbook which highlights the learning outcomes of an introductory study of the preparation of financial statements.

1.2 Framework for the preparation and presentation of financial statements

1.2.1 Introduction

The Framework for the Preparation and Presentation of Financial Statements (hereafter referred to as the Framework) is a document issued by the International Accounting Standards Board (IASB) and is a group of interrelated objectives and theoretical principles that serves as a frame of reference for financial accounting. The contents of the Framework is discussed in sufficient detail in the prescribed textbook and for the purpose of your studies it is unnecessary to obtain a copy of the Framework.

Read paragraphs 1.2.1 and 1.2.2 of the prescribed textbook to determine the purpose and relevance of the Framework.

1.2.2 Objective of financial statements

The objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an entity to the users of such information. You must study paragraph 1.2.3 of the prescribed textbook and ensure that you understand the objective of financial statements, as well as the information that is provided by each component of the financial statements.

1.2.3 Underlying assumptions when preparing financial statements

The Framework sets out two underlying assumptions that must be taken into consideration when preparing financial statements. These two assumptions, namely the *accrual basis* and the *going concern*, make it possible to prepare financial statements that will meet the needs of the users of financial statements. Study paragraph 1.2.4 of the prescribed textbook which explains these assumptions in detail.

1.2.4 Qualitative characteristics of financial statements

Qualitative characteristics refer to those aspects, applicable to all information contained in financial statements, that make the information in financial statements useful to users. The four principal qualitative characteristics are:

- understandability
- relevance
- reliability
- comparability

Study paragraph 1.2.5 of the prescribed textbook, which explains these qualitative characteristics in detail.

You should also read paragraph 1.2.6 of the prescribed textbook, which explains the constraints that affect these qualitative characteristics.

1.2.5 Elements of financial statements

The necessary information for preparing the financial statements of a business entity is gathered from book entries that are made during a financial period in the journals and ledgers of the business entity. This information is grouped into elements, which are in turn grouped under two headings, namely those elements that pertain to the *financial position*, and those that pertain to the *financial performance* of the entity.

Paragraph 1.2.7 of the prescribed textbook discusses these elements in detail. Study them carefully.

1.2.6 Recognition and disclosure

Read attentively through paragraph 1.2.8 of the prescribed textbook, which explains the meaning of recognition and disclosure. The important thing to understand is that before an item can be disclosed in a financial statement, it must first be recognised. However, all recognised items need not be disclosed. Take note of when an element of the financial statements should be recognised, and what the criteria for the recognition of each element are.

1.2.7 Measurement of the elements in financial statements

In this respect, measurement means the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and disclosed. The Framework lists four bases of measurement, namely historical costs, realisable value, current costs and present value. Take note that fair value is also regarded as a basis of measurement. Paragraph 1.2.9 of the prescribed textbook explains each of these measurement bases. Read through it attentively.

1.2.8 The concepts of capital and capital maintenance

The measurement basis and the concepts of capital and capital maintenance determine the model according to which financial statements are prepared. There are two basic concepts of capital and capital maintenance, namely the *financial* and the *physical* concepts.

The financial concept is synonymous with the net assets or equity of a business entity. The physical concepts pertains to the productive capacity of the entity, for example, the units of production per day.

Read attentively through paragraph 1.2.10 of the prescribed textbook, which explains these two concepts in detail.

1.3 Generally accepted accounting practice, Statements of Generally Accepted Accounting Practice and International Accounting Standards

GAAP is the acronym for Generally Accepted Accounting Practice. Generally accepted accounting practice refers to practices (recording and reporting) that are deemed by accountants to be acceptable when reporting on the financial position and financial performance and changes in the financial position of a business entity. The Statements of Generally Accepted Accounting Practice are the documented generally accepted accounting standards and practices as approved by the Accounting Practices Board in South Africa (APB) and are issued by the South African Institute of Charted Accountants (SAICA).

The Statements of GAAP need only be applied when the financial statements of entities that are incorporated under the Companies Act 61 of 1973 are prepared because the Companies Act, in paragraph 5 of Schedule 4, requires compliance with the Statements of GAAP. The fact that such compliance is not required by any other form of business ownership does not mean that the requirements of these statements cannot be applied when the financial statements of business entities other than companies are prepared. The South African Statements of GAAP were recently revised to comply with the International Financial Reporting Standards (IFRSs). These revised statements had to be complied with as from 1 January 2005.

In South Africa we apply a dual numbering system to simultaneously refer to the IFRSs and the Statements of GAAP. For example, IAS 1 (AC 101) refers to International Accounting Standard 1 and to the corresponding South African Statement of GAAP, AC 101.

Read paragraph 1.3 of the prescribed textbook, which presents an interesting background and facts about GAAP as it is currently applied in South Africa. Ensure that you understand why a dual numbering system is used in South Africa.

1.4 Presentation of financial statements: IAS 1 (AC 101)

1.4.1 Introduction

The objective of IAS 1 (AC 101) is to prescribe the basis for the presentation of general purpose financial statements so as to ensure comparability with

- an entity's financial statements pertaining to previous financial periods, and with
- the financial statements of other comparable entities.

Read paragraph 1.4.1 of the prescribed textbook to learn more about the objective and purpose of IAS 1 (AC 101).

1.4.2 Definitions

Certain accounting terms are used in IAS 1 (AC101). Paragraph 1.4.2 in the prescribed textbook lists some of the terms with their definitions. Read through this paragraph attentively and refer back to it when you encounter a term during your studies.

1.4.3 The purpose of financial statements

The main purpose of financial statements is to provide useful information to the users thereof. To meet this purpose, financial statements must provide information about each of the elements as listed by the Framework in a specific format. Read attentively through paragraph 1.4.3 of the prescribed textbook, which explains the elements that need to be reported on, as well as what IAS 1 (AC 101) regards as a complete set of financial statements.

1.4.4 General features of financial statements

IAS 1 (AC 101) lists the following eight items that must all be considered when preparing financial statements:

- Fair presentation
- Going concern
- Accrual basis of accounting
- Materiality and aggregation
- Offsetting
- Frequency of reporting
- Comparative information
- Consistency of presentation

Paragraph 1.4.4 of the prescribed textbook explains each of these items in detail and must be studied carefully.

1.4.5 Structure and contents of financial statements

1.4.5.1 Introduction

Structure and contents have to do with the format in which financial statements must be presented and with the items that must be disclosed. Structure and contents are essential aspects that pertain to the preparation of financial statements and need to be studied carefully. Read paragraph 1.4.5.1 of the prescribed textbook.

1.4.5.2 Identification of financial statements

Each financial statement and component thereof must be identified by giving it a name that pertains to its particular function. Study paragraph 1.4.5.2 of the prescribed textbook.

1.4.5.3 Statement of financial position

Study paragraph 1.4.5.3 of the prescribed textbook. This paragraph highlights the classification of assets into non-current and current assets, and liabilities into non-current and current liabilities. It also indicates

- which information must be presented on the face of a statement of financial position, and
- which information must be presented either on the face of the statement of financial position or in the notes to the financial statements

1.4.5.4 Statement of comprehensive income

Study paragraph 1.4.5.4 of the prescribed textbook, as it indicates which items must be presented on the face of the statement of comprehensive income and which items can be presented either on the face of the statement of comprehensive income, or in the notes to the financial statements.

Note that, for the purpose of studying FAC1601, expenses will be disclosed in a statement of comprehensive income according to their function, and that IAS 1 (AC 101) requires certain minimum disclosures when this method is applied.

1.4.5.5 Statement of changes in equity

Paragraph 1.4.5.5 of the prescribed textbook indicates the items that must be disclosed on the face of the statement of changes in equity, and the items that can be disclosed either on the face of the statement of changes in equity or in the notes to the financial statements.

Note that the format (layout) of the statement of changes in equity depends on the type of business ownership for which it is prepared. Also note that if this statement is prepared for a close corporation, the name of the statement is shown as: "Statement of changes in net investment of members."

1.4.5.6 Statement of cash flows

Although a statement of cash flows forms part of the financial statements, statements of cash flows are discussed separately in study unit 7. Read paragraph 1.4.5.6 of the prescribed textbook to determine the reason why statements of cash flows are dealt with separately in FAC1601.

1.4.5.7 Notes

Paragraph 1.4.5.7 of the prescribed textbook indicates which items must be presented as notes to the financial statements. One of these notes must be an affirmation that the financial statements were prepared according to the requirements of GAAP (IFRSs). A summary of the significant accounting policies must also be given in a note. Furthermore, as mentioned previously certain items can be disclosed either on the face of a financial statement, or as notes, depending on the instructions given to the preparer of the financial statements. Study this paragraph.

Please take note that a calculation, for example the calculation of depreciation, is NOT a note to a financial statement and must not be indicated as such.

1.5 Financial instruments

1.5.1 Introduction and definitions

Financial instruments are defined as IAS 32 (AC 125) .11 as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Read paragraph 1.5.1 of the prescribed textbook where the references to IAS 32 (AC 125), IAS 39 (AC 133) and IFRS 7 (AC 144) that deals with financial instruments are given. In paragraph 1.5.2 the definitions of the elements of financial instruments, fair value and a contract are given. Study these definitions to enable you to identify the elements and know what fair value and a contract is.

1.5.2 Identification, recognition and measurement of financial instruments

In paragraphs 1.5.3 and 1.5.4 the identification of financial assets and financial liabilities and the recognition and measurement of financial instruments are explained. Read these paragraphs attentively to ensure you can identify financial assets and financial liabilities, distinguish between the four categories of financial instruments and know how financial instruments are initially and subsequently measured.

Study example 1.1. It is very important to understand the entries as explained in this example and be able to record the necessary entries given in similar exercises.

1.6 Practical applications of IAS 1 (AC 101)

In paragraph 1.6 of the prescribed textbook the theory discussed in this study unit is applied in the preparation and presentation of financial statements. Although IAS 1 (AC 101) requires a specific order in which financial statements must be presented, FAC1601 presents the statements in a different order. The reason for this is that for study purposes it is easier to make it clear how statements are linked to each other when they are presented in a different order. The following table indicates the order of presentation as required by IAS 1 (AC 101), and the order in which the financial statements are presented in FAC1601:

Order of presentation [required by IAS 1 (AC 101)]	**Order of presentation [as illustrated in FAC1601]**
1. Statement of financial position as at the end of the period 2. Statement of comprehensive income for the period 3. Statement of changes in equity (sole proprietors, partnerships and companies)/Statement of changes in net investment of members (close corporations) 4. Statement of cash flows for the period 5. Notes	1. Statement of comprehensive income for the period 2. Statement of changes in equity (sole proprietors, partnerships and companies)/Statement of changes in net investment of members (close corporations) 3. Statement of financial position as at the end of the period 4. Notes For the purpose of FAC1601, the statement of cash flows, although part of the financial statements, is dealt with separately and will also be examined separately from the other financial statements.

Study the example in paragraph 1.6 of the prescribed textbook.

1.7 Exercise and solution

REQUIRED

Answer the following:

(a) List the main users of financial statements.
(b) Name two specific purposes of the Framework.
(c) What, according to the Framework, is the objective of financial statements?

(d) Discuss briefly what is meant by the accrual and the going concern assumptions of accounting. Refer to the textbook.
(e) List the qualitative characteristics of financial statements.
(f) When will each of the following elements be recognised in the appropriate financial statement?

Assets
Liabilities
Income
Expenses

(g) Name five measurement bases.
(h) What does GAAP stand for?
(i) When are items considered to be material?
(j) When are assets regarded as being current in nature?
(k) When are liabilities regarded as being current in nature?
(l) Which items must, as a minimum requirement, be disclosed on the face of a statement of financial position?
(m) On 1 March 20.2 Louis CC purchased 100 ordinary shares of R100 each in Marble Ltd, a company listed on the JSE Securities Exchange. The purpose of this investment was speculative in nature. The transaction costs amounted to R500.

On 28 February 20.3, the end of the financial year of Louis CC, the shares were trading at R125 per share on JSE Securities Exchange.

Record the above transactions in the general journal of Louis CC.

Solution

(a) Present and potential investors, employees and people seeking employment with the entity, lenders, trade and other creditors, customers, the government and its agencies, as well as the general public.

(b) To assist the accountant in the preparation and presentation of financial statements and to serve as a general guideline to the users of financial statements in the interpretation thereof.

(c) The objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an entity that is useful to a wide range of users in making economic decisions.

(d) The accrual assumption of accounting entails that the effect of transactions and other events are recognised when they occur and that these transactions are recorded in the accounting records and reported in the financial statements of the periods to which they relate. "Occur", in this respect, means when a transaction initially takes place and not necessarily when cash or a cash equivalent was received or paid. The going concern assumption means that 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.
(e) Understandability, relevance, reliability and comparability.

(f) *Assets*: An asset is recognised in the statement of financial position when it is probable that the future economic benefits thereof will flow to the entity, and when the asset has a cost or a value that can be measured reliably.

Liabilities: A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation, and the amount at which the settlement will take place can be measured reliably.

Income: Income is recognised in the statement of 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 that the recognition of income occurs simultaneously with the recognition of increases in assets or decrease in liabilities, for example merchandise sold for cash.

Expenses: Expenses are recognised in the statement of comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means that the recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets. Expenses are recognised in the statement of comprehensive income on the basis of a direct association between incurred costs and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenue, involves the simultaneous or combined recognition of revenue and expenses that result directly and jointly from the same transaction, for example, matching revenue with the cost of sales (in respect of trading merchandise), where the revenue is derived from the sale of such merchandise.

(g) Historical costs, realisable value, current costs, present value and fair value.

(h) Generally Accepted Accounting Practice.

(i) Items are material if they could, individually or collectively, and as a result of their omission or misstatement, influence the economic decisions of users taken on the basis of the information in the financial statements. Materiality depends on the size and nature of the omission of misstated judgement in the surrounding circumstances. The size or nature, or a combination of both, could be the determining factor.

(j) An asset is 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 statement of financial position date.
- 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 statement of financial position date.

(k) A liability is classified as current when it satisfies any of the following criteria:

- 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 statement of financial position date.
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the statement of financial position date.

(l)
- property, plant and equipment
- intangible assets
- financial assets
- inventories
- trade receivables
- cash and cash equivalents
- trade and other payables
- financial liabilities
- issued capital and reserves attributable to owners

(m)

LOUIS CC

GENERAL JOURNAL

		Debit	Credit
		R	**R**
20.2 Mar 1	Investment: Shares in Marble Ltd (R100 × 100) Investment expenses (transaction costs) Bank *Initial recognition of investment at cost and recording of investment expenses*	10 000 500	 10 500
20.3 Feb 28	Profit or loss account Investment expenses *Closing off of investment expenses*	500	 500
	Investment: Shares in Marble Ltd (R25 × 100) Gain on financial asset at fair value through profit or loss *Gain on subsequent measurement of investment in the shares of Marble Ltd at the financial year end*	2 500	 2 500
	Gain on financial asset at fair value through profit or loss Profit or loss account *Closing off of gain on financial asset at fair value through profit or loss*	2 500	 2 500

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• describe what the concept the "Framework" entails?		
• list the specific purposes of the Framework regarding preparation and presentation of financial statements?		
• explain the main objective of financial statements according to the Framework?		
• explain the underlying assumptions when preparing financial statements as discussed in the Framework?		
• discuss the qualitative characteristics of financial statements according to the Framework?		
• describe what the Framework means when it refers to constraints when financial statements are prepared?		
• discuss the elements of financial statements as explained in the Framework, and indicate which elements pertain to the statement of financial position and which to the statement of comprehensive income?		

	Yes	No
• discuss the concepts of recognition and disclosure of the elements incorporated in the financial statements as explained in the Framework?		
• explain what is meant by the measurement of the elements of financial statements by referring to the Framework?		
• explain what the acronyms: GAAP, IFRSs, APB and SAICA stand for?		
• explain what type of business ownership must comply with the IFRSs?		
• explain what each of the following terms means by referring to IAS 1 (AC 101)? — fair presentation — going concern — accrual basis of accounting — materiality and aggregation — offsetting — frequency of reporting — comparative information — consistency of presentation		
• list the individual statements that, according to IAS 1 (AC 101), together form a complete set of financial statements of a reporting entity?		
• explain what the identification of financial statements means?		
• explain what items are current assets and current liabilities, according to IAS 1 (AC 101)?		
• list the items that must be presented on the face of a statement of financial position, statement of changes in equity and a statement of comprehensive income, according to IAS 1 (AC 101)?		
• list the items that can, according to IAS 1 (AC 101), be presented on either the face of the referred to financial statements or in the notes for the financial period?		
• discuss the purpose of notes to financial statements, according to IAS 1 (AC 101)?		
• discuss the order in which notes are normally presented, as indicated by IAS 1 (AC 101)?		
• define a financial instrument, financial asset, financial liability, fair value and a contract?		
• distinguish between the four categories of financial instruments?		
• subsequently measure a financial asset at fair value through profit or loss?		

If you answered "yes" to all of the above assessment criteria, you can move on to study unit 2. If your answer was "no" revise that section before progressing to study unit 2.

STUDY UNIT

2

Establishment and financial statements of a partnership

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- define a partnership
- explain the reasons why partnerships are formed
- discuss the contents of a partnership agreement
- explain the ways in which a partnership can be established
- explain the factors which can lead to the dissolution of a partnership
- record the transactions of a partnership in its books
- prepare the financial statements of a partnership in accordance with the requirements of Generally Accepted Accounting Practice, appropriate to the business of a partnership

Key concepts

- Partnership
- Partners
- Partnership agreement
- Profit-sharing ratio
- Dissolution
- Legal approach
- Entity approach
- Equity
- Appropriation account
- Financial statements

2.1 Introduction

Because a sole proprietorship (tradership) has only one owner, and therefore usually a limited capital resource, persons often decide to form a business entity with more than one owner. Should these persons opt to establish a business entity with the minimum of complicated legal proceedings, the natural choice of business ownership would be a partnership. Read paragraph 2.1 of the prescribed textbook attentively. Pay special attention to the definition of a partnership and the difference between a business entity with and without legal status.

2.2 Reasons for the formation of partnerships

The main reason for the formation of a partnership is to start a business entity with a stronger capital structure than that of a sole proprietorship. Read attentively through paragraph 2.2 of the prescribed textbook, which explains the reasons for the formation of a partnership.

2.3 The legal position of a partner

In South Africa there is no specific legislation which pertain to partnerships. The operations of partnerships are mainly conducted according to common law. A partner in a partnership has the same legal status as the owner of a sole proprietorship. Read paragraph 2.3 of the prescribed textbook. This paragraph discusses the legal position of a partner and a partnership.

2.4 Establishment of a partnership

Read paragraph 2.4 of the prescribed textbook. Note how a partnership can be established by action and agreement.

2.5 The partnership agreement

In order for the business operations of a partnership to run smoothly, certain rules of conduct which form the basis of a partnership agreement must be decided on. A partnership agreement should preferably be in written form. Read paragraph 2.5 of the prescribed textbook attentively and pay special attention to the appropriation of profits and losses between partners.

2.6 Dissolution of a partnership

The dissolution of a partnership can be caused by a number of circumstances. Being an unincorporated form of business ownership, a partnership has a lifespan which is limited to the constancy of its ownership structure. For example, if a partner dies or retires, or if a new partner is admitted, the existing partnership is dissolved and a new partnership may be formed. From a technical point of view, even a change in the profit-sharing ratio between partners changes the ownership structure of the partnership and causes the dissolution of the partnership. Read paragraph 2.6 of the prescribed textbook for more information on the dissolution of a partnership.

2.7 Accounting procedures and specialised accounts

Having more than one owner in a business makes it necessary to adopt accounting procedures and records that will suit the needs of multiple ownership. Basically, there are two approaches when an accounting system is developed for a partnership, namely a legal and a (business) entity approach. Study paragraph 2.7 of the textbook carefully, and ensure that you understand the difference between these two approaches. In FAC1601 the legal approach is followed.

Study paragraphs 2.7.1 to 2.7.4 of the prescribed textbook carefully, taking special note of the application of the accounts referred to. In paragraph 2.7.4 the recording of salaries and bonuses to partners are explained. It is very important to take note of the entries as explained in this paragraph.

Study example 2.1. Note how transactions that are unique to a partnership are recorded in the journals and ledgers of a partnership.

2.8 Financial statements of a partnership

Since a partnership has more than one owner, its financial statements differ slightly from the financial statements of a sole proprietorship. You must remember that the financial statements of a partnership are prepared according to the legal approach. Read paragraph 2.8 and study example 2.2 in the prescribed textbook. (If you experience difficulties with the adjustment entries, please revise the section on adjustments in the FAC1501 study guide.)

After having worked through example 2.2, you must study example 2.3, which represents the accounting procedure to be followed when a partnership has been trading at a loss.

2.9 Exercises and solutions

Exercise 2.1

Preparation of the financial statements of a partnership

Work through the following, taking special note of how to make year-end adjustments and to prepare the financial statements of a partnership by utilising your knowledge of FAC1501, the Framework, IAS 1 (AC 101), GAAP and partnerships in general.

Given information

The undermentioned information was taken from the accounting records of Bluered Traders, a partnership with B Blue and R Red as partners, at 30 September 20.1, the financial year-end of the partnership.

BLUERED TRADERS

PRE-ADJUSTMENT TRIAL BALANCE AS AT 30 SEPTEMBER 20.1

	Debit	Credit
	R	R
Capital (fixed):		
B Blue		20 000
R Red		5 000
Current accounts (1 October 20.0)		
B Blue		1 060
R Red		2 800
Drawings (during the year):		
B Blue	9 000	
R Red	3 000	
Mortgage		10 000
Creditors control		24 150
Bank overdraft		6 160
Land and buildings at cost	19 500	
Equipment at cost	19 840	
Accumulated depreciation: Equipment (1 October 20.0)		5 000
Motor vehicles at cost	900	
Accumulated depreciation: Motor vehicles (1 October 20.0)		500
Office furniture at cost	350	
Accumulated depreciation: Office furniture (1 October 20.0)		50
Inventory (30 September 20.1)	21 069	
Debtors control	16 020	
Allowance for credit losses (1 October 20.0)		600
Petty cash	32	
Sales		340 628
Cost of sales	306 000	
Advertising costs	4 409	
Office salaries and wages	12 189	
Administrative expenses	622	
Insurance expense	364	
Delivery expenses	2 203	
Interest on mortgage	450	
	415 948	415 948

Additional information

1 Terms of the partnership agreement

1.1 The partners B Blue and R Red share profits and losses in the ratio of their (fixed) capital.

1.2 Interest at 5% per annum is to be allowed on the opening balances of the partners' capital and current accounts.

1.3 Interest is to be charged at 5% per annum on the average monthly amount outstanding on the partners' drawings accounts. (Amounts are given, see paragraph 2.7 under "Year-end adjustments" below.)

1.4 R Red is entitled to a salary of R1 000 per annum plus a management commission of

10% on the comprehensive income for the financial year after his salary has been debited and after adjustments for the interest on the capital, current and drawings accounts.

2 Year-end adjustments

2.1 An outstanding debt of R20 is irrecoverable and must be written off.

2.2 The allowance for credit losses must be adjusted to R800.

2.3 Depreciation is to be provided for as follows:

Equipment:	15% per annum according to the diminishing-balance method. (**NB:** A new machine was purchased on 1 April 20.1 for R1 560.)
Motor vehicles:	20% per annum according to the straight-line method
Office furniture:	10% per annum according to the diminishing-balance method

2.4 Interest on the mortgage up to 30 September 20.1 amounts to R600.

R4 000 of the loan is repayable during the 20.2 financial year. The loan is secured by a mortgage over land and buildings. The loan was granted by Corner Bank on 1 October 20.0. The terms of the loan provide for interest on the loan to be charged at a rate of 6% per annum.

2.5 Office salaries of R69 have not been paid or taken into account.

2.6 The following expenses have been prepaid:

Insurance	R62
Advertising	R948

2.7 Interest calculated on the partners' drawings accounts amounted to R320 for B Blue and R80 for R Red.

2.8 In terms of the partnership agreement, the following must still be provided for:

— interest on the partners' capital and current accounts
— R Red's salary and management commission

REQUIRED

(a) Prepare the following in respect of Bluered Traders to comply with the requirements of Generally Accepted Accounting Practice (comparative figures are not required), appropriate to the business of the partnership:

(i) Statement of comprehensive income for the year ended 30 September 20.1
(ii) Statement of changes in equity for the year ended 30 September 20.1
(iii) Statement of financial position as at 30 September 20.1
(iv) Notes for the year ended 30 September 20.1

(b) Prepare the current accounts of the partners, properly balanced, in the general ledger of Bluered Traders for the year ended 30 September 20.1. Show the correct contra ledger accounts.

NB: Show all calculations.

(a)(i)

BLUERED TRADERS

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 SEPTEMBER 20.1

	Note	R
Revenue	2	340 628
Cost of sales		(306 000)
Gross profit		34 628
Distribution, administrative and other expenses		(21 385)
Salaries and wages R(12 189 + 69)		12 258
Advertising costs R(4 409 – 948)		3 461
Delivery expenses		2 203
Administrative expenses		622
Insurance expense R(364 – 62)		302
Credit losses ①		220
Depreciation ②	3	2 319
Finance costs		(600)
Interest on mortgage R(450 + 150 ③)		600
Profit for the year		12 643
Other comprehensive income for the year		—
Total comprehensive income for the year		12 643

* In FAC1601 an item may be excluded if it has no value. General Accepted Accounting Practice requires us to show a complete statement of comprehensive income and for this reason other comprehensive income will be indicated throughout this study guide without any value.

(a)(ii)

BLUERED TRADERS

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 SEPTEMBER 20.1

	Capital		Current accounts			
	B Blue	R Red	B Blue	R Red	Appro-priation	Total equity
	R	R	R	R	R	R
Balances at 1 October 20.0	20 000	5 000	1 060	2 800	—	28 860
Total comprehensive income for the year					12 643	12 643
Salaries to partners				1 000	(1 000)	
Interest on capital ④			1 000	250	(1 250)	
Interest on current accounts ⑤			53	140	(193)	
Interest on drawings			(320)	(80)	400	
Commission to partners ⑥				1 060	(1 060)	
Partners' share of total comprehensive income ⑦			7 632	1 908	(9 540)	
Drawings			(9 000)	(3 000)		(12 000)
Balances at 30 September 20.1	20 000	5 000	425	4 078	—	29 503

(a)(iii)

BLUERED TRADERS

STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20.1

	Note	R
ASSETS		
Non-current assets		32 721
Property, plant and equipment	2, 3	32 721
Current assets		37 311
Inventories		21 069
Trade receivables R(16 000 – 800)	4	15 200
Prepayments R(948 + 62) 8	4	1 010
Cash and cash equivalents		32
Total assets		70 032
EQUITY AND LIABILITIES		
Total equity		29 503
Capital R(20 000 + 5 000)		25 000
Current accounts R(425 + 4 078)		4 503
Total liabilities		40 529
Non-current liabilities		6 000
Long-term borrowings	5	6 000
Current liabilities		34 529
Trade and other payables	5	24 369
Current portion of long-term borrowings	5	4 000
Other financial liabilities	5	6 160
Total equity and liabilities		70 032

(a)(iv)

BLUERED TRADERS

NOTES FOR THE YEAR ENDED 30 SEPTEMBER 20.1

1. Basis of presentation

The financial statements have been prepared in accordance with Generally Accepted Accounting Practice appropriate to the business of the entity. 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 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 and buildings. Equipment, vehicles and furniture are subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses.
Depreciation on equipment, vehicles and furniture 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:	15% per annum according to the diminishing-balance method;
Motor vehicles:	20% per annum according to the straight-line method;
Furniture:	10% per annum according to the diminishing-balance method.

Depreciation is charged to profit or loss for the year. 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 year.

2.2 Financial assets

Financial assets 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 cost which is fair value plus transaction costs, except for "Financial assets at fair value through profit or loss" which are measured at cost, transaction costs excluded.

The entity classifies its financial assets in the following categories: at fair value through profit or loss and loans and receivables. The entity's classification depends on the purpose for which the entity acquired the financial assets.

Cash and cash equivalents are classified as "Financial assets at fair value through profit or loss". Cash and cash equivalents consists of cash on hand.

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 Financial liabilities

Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the purpose for which the financial liabilities were obtained.

2.5 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 settlement discount granted. The entity is not registered as a VAT vendor. The revenue from sales is recognised when the ownership is transferred to the customer.

3. Property, plant and equipment

	Land and buildings	Equip-ment	Motor vehicles	Office furniture	Total
	R	R	R	R	R
Carrying amount at 1 October 20.0	19 500	13 280	400	300	33 480
Cost	19 500	18 280	900	350	39 030
Accumulated depreciation	(—)	(5 000)	(500)	(50)	(5 550)
Additions	—	1 560	—	—	1 560
Disposals*	(—)	(—)	(—)	(—)	(—)
Depreciation for the year	—	(2 109)	(180)	(30)	(2 319)
Carrying amount at 30 September 20.1	19 500	12 731	220	270	32 721
Cost	19 500	19 840	900	350	40 590
Accumulated depreciation	(—)	(7 109)	(680)	(80)	(7 869)

The partnership has pledged land and buildings with a carrying amount of R19 500 (20.0 : R19 500) as security for the mortgage obtained from Corner Bank.

* Included for ilustrative purposes. If there were no disposals, this item must be excluded from the note. Disposals are disclosed at their carrying amount.

4. Financial assets

	20.1 R
Current financial assets	
Trade receivables:	15 200
Debtors control	16 000
Allowance for credit losses	(800)
Other financial assets:	
Financial assets at fair value through profit or loss:	
Cash and cash equivalents:	32
Petty cash	32

5. **Financial liabilities**

	20.1 R
Non-current financial liabilities	
Long-term borrowings:	6 000
Mortgage: The mortgage was acquired from Corner Bank on 1 October 20.0 at an interest rate of 6% per annum. According to the terms of the loan R4 000 is repayable during the 20.2 financial year. This loan is secured by a first mortgage over land and buildings (refer note 3).	
Mortgage	10 000
Current portion of loan	(4 000)
Non-current portion	6 000
Current financial liabilities	
Trade and other payables:	24 369
Creditors control	24 150
Accrued expenses:	
Office salaries payable	69
Interest on mortgage	150
Current portion of long-term borrowings	4 000
Other financial liabilities:	
Financial liabilities at fair value through profit or loss	6 160
Bank overdraft	6 160

Calculations

① **Credit losses**

	R
Credit losses written off	20
Increase in allowance for credit losses ❶	200
Credit losses	220

❶ **Increase in allowance for credit losses**

	R
Allowance for credit losses (30 September 20.1):	800
Allowance for credit losses (1 October 20.0)	(600)
Increase in allowance for credit losses	200

② **Depreciation**

	R
On equipment:	
Old equipment R(19 840 – 1 560) = R18 280	
R(18 280 – 5 000) x 15% = R1 992	1 992
New equipment R1 560 x 15% x $^6/_{12}$	117
On office furniture: R(350 – 50) x 10%	30
On motor vehicles: R900 x 20%	180
	2 319

③ **Interest payable on mortgage**

R(600 – 450) = R150

④ **Interest on capital accounts**

	R
B Blue — R20 000 x 5%	1 000
R Red — R5 000 x 5%	250
	1 250

⑤ **Interest on current accounts**

	R
B Blue — R1 060 x 5%	53
R Red — R2 800 x 5%	140
	193

⑥ **Management commission: R Red**

	R
Total comprehensive income for the year	12 643
Less: Salary to R Red	(1 000)
Interest on capital	(1 250)
Interest on current accounts	(193)
Add: Interest on drawings	400
Comprehensive income before commission	10 600

∴ R10 600 x 10% = R1 060

⑦ **Partners' share of total comprehensive income**

	R
Comprehensive income before commission (calculation ⑥)	10 600
Commission	(1 060)
Comprehensive income available for distribution	9 540

B Blue — R9 540 x 20 000/25 000 = R7 632
R Red — R9 540 x 5 000/25 000 = R1 908

⑧ **Prepayments**

	R
Advertising costs	948
Insurance expenses	62
	1 010

Comment

Note that when preparing financial statements for a partnership business entity, the format and the terminology used must comply with the requirements of GAAP for study purposes.

(b)

BLUERED TRADERS

GENERAL LEDGER

Dr **Current account** **Cr**

		B Blue	R Red			B Blue	R Red
20.1		R	R	**20.0**		R	R
Sep 30	Interest on drawings	320	80	Oct 1	Balance b/d	1 060	2 800
	Drawings (for the year)	9 000	3 000	**20.1** Sep 30	Salary to partner		1 000
	Balance c/d	425	4 078		Interest on capital	1 000	250
					Interest on current account	53	140
					Commission		1 060
					Appropriation account	7 632	1 908
		9 745	7 158			9 745	7 158
				20.1 Oct 1	Balance b/d	425	4 078

Comment

The current accounts were prepared in columnar format. If you prepared a separate account for each partner, this is also acceptable.

Exercise 2.2

Preparation of the financial statements of a partnership

Work through the exercise, taking special note of how to make year-end adjustments and to prepare the financial statements of a partnership by utilising your knowledge of FAC1501, the Framework, IAS 1 (AC 101), GAAP and partnerships in general.

Given information

The information provided below were taken from the accounting records of Toypork Traders, a partnership with T Toy and P Porky as partners, at 28 February 20.3, the financial year-end of the partnership.

BALANCES AS AT 28 FEBRUARY 20.3

	Debit	Credit
	R	R
Sales		100 000
Settlement discount received		1 450
Purchases returns		850
Administrative expenses	33 750	
Sales returns	860	
Purchases	44 000	
Settlement discount granted	2 400	
Credit losses	2 440	
Drawings: T Toy	3 880	
P Porky	1 800	
Depreciation: Furniture and fittings	940	
Motor vehicles	3 000	
Land and buildings	20 000	
Motor vehicles at cost	36 000	
Furniture and fittings at cost	12 000	
Inventory (1 March 20.2):	21 530	
Debtors control	23 520	
Allowance for settlement discount received	400	
Current account balances (1 March 20.2):		
T Toy	500	
P Porky	600	
Capital account balances (1 March 20.2):		
T Toy		40 000
P Porky		20 000
Bank overdraft		4 922
Accumulated depreciation:		
Furniture and fittings		5 298
Motor vehicles		14 800
Allowance for settlement discount granted		500
Allowance for credit losses		2 300
Creditors control		17 500
	207 620	207 620

Additional information

1. T Toy and P Porky share profits and losses in the ratio of 2:1 repectively.
2. On 28 February 20.3, salaries for services rendered according to the partnership agreement were **paid** to the partners as follows: T Toy: R6 000, and P Porky, R4 000. Both these amounts were recorded as administrative expenses.
3. Inventory on 28 February 20.3 amounted to R19 100.
4. Interest calculated on the partners' capital accounts amounted to R2 140 for T Toy and R1 070 for P Porky.

REQUIRED

(a) Prepare the following in respect of Toypork Traders to comply with the requirements of Generally Accepted Accounting Practice (comparative figures are not required), appropriate to the business of the partnership:

(i) Statement of comprehensive income for the year ended 28 February 20.3
(ii) Statement of changes in equity for the year ended 28 February 20.3
(iii) Statement of financial position as at 28 February 20.3
(iv) The note pertaining to property, plant and equipment for the year ended 28 February 20.3

(b) Prepare the appropriation account, properly closed off, in the general ledger of Toypork Traders for the year ended 28 February 20.3. Show the correct contra ledger accounts.

(c) Prepare the partners' current accounts, properly balanced, in the general ledger of Toypork Traders for the year ended 28 February 20.3. Show the correct contra ledger accounts.

NB: Show all calculations.

Solution 2.2

(a)(i)

TOYPORK TRADERS

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 20.3

	Note	R
Revenue R(100 000 – 860 – 2 400)		96 740
Cost of sales		(44 130)
Inventory (1 March 20.2)		21 530
Purchases R(44 000 – 850 – 1 450)		41 700
		63 230
Inventory (28 February 20.3)		(19 100)
Gross profit		52 610
Distribution, administrative and other expenses		(30 130)
Administrative expenses R(33 750 – 10 000)		23 750
Credit losses		2 440
Depreciation	2	3 940
Profit for the year		22 480
Other comprehensive income for the year		—
Total comprehensive income for the year		22 480

(a)(ii)

TOYPORK TRADERS

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 28 FEBRUARY 20.3

	Capital		Current accounts		Appro-priation	Total Equity
	T Toy	P Porky	T Toy	P Porky		
	R	R	R	R	R	R
Balances at 1 March 20.2	40 000	20 000	(500)	(600)	—	58 900
Total comprehensive income for the year					22 480	22 480
Salaries to partners			6 000	4 000	(10 000)	
Interest on capital			2 140	1 070	(3 210)	
Partners' share of total comprehensive income ①			6 180	3 090	(9 270)	
Drawings ②			(9 880)	(5 800)		(15 680)
Balances at 28 February 20.3	40 000	20 000	3 940	1 760	—	65 700

(a)(iii)

TOYPORK TRADERS

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20.3

	Note	R
ASSETS		
Non-current assets		47 902
Property, plant and equipment	3	47 902
Current assets		39 820
Inventories		19 100
Trade receivables R(23 520 – 2 300 – 500)		20 720
Total assets		87 722
EQUITY AND LIABILITIES		
Total equity		65 700
Capital R(40 000 + 20 000)		60 000
Current accounts R(3 940 + 1 760)		5 700
Total liabilities		22 022
Current liabilities		22 022
Trade and other payables R(17 500 – 400)		17 100
Other financial liabilities		4 922
Total equity and liabilities		87 722

(a)(iv)

TOYPORK TRADERS

NOTE FOR THE YEAR ENDED 28 FEBRUARY 20.3

3. Property, plant and equipment

	Land and buildings	Furniture and fittings	Motor vehicles	Total
	R	R	R	R
Carrying amount at 1 March 20.2	20 000	7 642	24 200	51 842
Cost	20 000	12 000	36 000	68 000
Accumulated depreciation	(—)	(4 358)	(11 800)	(16 158)
Depreciation for the year	(—)	(940)	(3 000)	(3 940)
Carrying amount at 28 February 20.3	20 000	6 702	21 200	47 902
Cost	20 000	12 000	36 000	68 000
Accumulated depreciation	(—)	(5 298)	(14 800)	(20 098)

Calculations

① **Partners' share of total comprehensive income** **R**

T Toy:	R9 270 x ⅔ =	6 180
P Porky:	R9 270 x ⅓ =	3 090
		9 270

② **Drawings**

		R
T Toy:	R (3 880 + 6 000*) =	9 880
P Porky:	R (1 800 + 4 000*) =	5 800

* Salaries paid to partners.

(b)

TOYPORK TRADERS

GENERAL LEDGER

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

20.3		R	20.3		R
Feb 28	Interest on capital: T Toy	2 140	Feb 28	Profit or loss account	22 480
	Interest on capital: P Porky	1 070			
	Salary: T Toy	6 000			
	Salary: P Porky	4 000			
	Current account: T Toy	6 180			
	Current account: P Porky	3 090			
		22 480			22 480

(c)

TOYPORK TRADERS

GENERAL LEDGER

Dr			**Current account**							**Cr**
			T Toy	**P Porky**				**T Toy**	**P Porky**
			R	**R**				**R**	**R**
20.2					**20.3**				
Mar 1	Balance	b/d	500	600	Feb 28	Interest on capital		2 140	1 070
						Salary: T Toy		6 000	
						Salary: P Porky			4 000
20.3						Appropriation account		6 180	3 090
Feb 28	Drawings		9 880	5 800					
	Balance	c/d	3 940	1 760					
			14 320	8 160				14 320	8 160
					20.3				
					Mar 1	Balance	b/d	3 940	1 760

Exercise 2.3

Preparation of the financial statements of a partnership

Work through the exercise, taking special note of how to make year-end adjustments and to prepare the financial statements of a partnership by utilising your knowledge of FAC1501, the Framework, IAS 1 (AC 101), GAAP and partnerships in general.

Given information

Hunting Friends Trading is a partnership with partners F Fox and J Jakkals, who share profits and losses equally. The information below pertains to the business activities of the partnership for the year ended 31 March 20.1.

BALANCES AS AT 31 MARCH 20.1

	R
Capital (fixed): F Fox	50 000
Capital (fixed): J Jakkals	60 000
Current account: F Fox (Dr; 1 April 20.0)	2 000
Current account: J Jakkals (Cr; 1 April 20.0)	5 000
Long-term loan: J Jakkals	40 000
Debtors control	53 300
Accumulated depreciation: Furniture and equipment (1 April 20.0)	3 500
Furniture and equipment at cost	35 000
Allowance for credit losses (1 April 20.0)	2 000
Credit losses recovered	105
Inventory (merchandise) (1 April 20.0)	80 500
Purchases	200 500
Interest expense (long-term loan)	1 800
Stationery consumed	600
Salaries and wages	6 500
Rental expenses	2 000
Bank (favourable)	53 405

Additional information

1 Make provision for the following according to the partnership agreement:
   - interest on capital at 9% per annum
   - interest on current accounts (opening balances) at 7% per annum
   - a managerial salary of R6 000 per annum to J Jakkals
   - a bonus of R1 952 to F Fox
2 Credit losses to be written off, R300.
3 The allowance for credit losses must be increased with R650.
4 It was agreed that interest on the long-term loan from J Jakkals would amount to R4 800 per annum.
5 Provide for depreciation at 15% per annum on furniture and equipment according to the diminishing-balance method.
6 Inventories on hand at 31 March 20.1:

	R
Merchandise	61 000
Stationery (stationery purchased is recorded in the stationery consumed account)	100

7 The profit mark-up is 20% on sales.

REQUIRED

Prepare the following in respect of Hunting Friends Trading to comply with the requirements of Generally Accepted Accounting Practice (notes and comparative figures are not required), appropriate to the business of the partnership:

(a) Statement of comprehensive income for the year ended 31 March 20.1
(b) Statement of changes in equity for the year ended 31 March 20.1

NB: Show all calculations.

(a)

HUNTING FRIENDS TRADING

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20.1

		R
Revenue ①		275 000
Cost of sales		(220 000)
Inventory (1 April 20.0)	80 500	
Purchases	200 500	
	281 000	
Inventory (31 March 20.1)	(61 000)	
Gross profit		55 000
Other income: Credit losses recovered		105
		55 105
Distribution, administrative and other expenses		(14 675)
Stationery consumed R(600 – 100)	500	
Salaries and wages	6 500	
Rental expenses	2 000	
Credit losses R(300 + 650) ②	950	
Depreciation ③	4 725	
Finance costs		(4 800)
Interest on long-term loan	4 800	
Profit for the year		35 630
Other comprehensive income for the year		—
Total comprehensive income for the year		35 630

(b)

HUNTING FRIENDS TRADING

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 20.1

	Capital		Current accounts			
	F Fox	J Jakkals	F Fox	J Jakkals	Appro- priation	Total equity
	R	R	R	R	R	R
Balances at 1 April 20.1	50 000	60 000	(2 000)	5 000	—	113 000
Total comprehensive income for the year					35 630	35 630
Salary to partner				6 000	(6 000)	
Interest on capital ④			4 500	5 400	(9 900)	
Interest on current accounts ⑤			(140)	350	(210)	
Bonus to partner			1 952		(1 952)	
Partners' share of total comprehensive income ⑥			8 784	8 784	(17 568)	
Balances at 31 March 20.1	50 000	60 000	13 096	25 534	—	148 630

Calculations

① **Revenue**

Given: The profit mark-up is 20% on sales.
Therefore, the cost price is 80% on sales. (Remember that Cost price + Mark-up = Selling price; thus 80% + 20% = 100%. Sales are equal to 100% because the mark-up is calculated on the sales.)

Therefore,	80% x Sales = R220 000
	Sales = R220 000/.80
	Sales = R275 000

② **Credit losses**

Refer to additional information 2 and 3.

③ **Depreciation**

	R
Furniture and equipment at cost	35 000
Accumulated depreciation	(3 500)
Carrying amount	31 500

Depreciation = R31 500 x 15% = R4 725

④ **Interest on capital**

F Fox:	R50 000 x 9%	=	R4 500
J Jakkals:	R60 000 x 9%	=	R5 400

⑤ **Interest on current accounts**

F Fox:	R2 000 (dr) x 7%	=	R140 (receivable)
J Jakkals:	R5 000 (cr) x 7%	=	R350 (payable)

⑥ **Partners' share of total comprehensive income**

R35 630 – R(6 000 + 9 900 + 210 + 1 952) = R17 568
R17 568/2 = R8 784

Exercise 2.4

Preparation of the financial statements of a partnership

Work through the exercise, taking special note of how to make year-end adjustments and to prepare the financial statements of a partnership by utilising your knowledge of FAC1501, the Framework, IAS 1 (AC 101), GAAP and partnerships in general.

Given information

Shoestring Corner Shop is a partnership with S Shoe and S String as partners. The information below pertains to the business activities of the partnership for the year ended 28 February 20.2.

BALANCES AS AT 28 FEBRUARY 20.2:

	R
Land and buildings at cost	100 000
Motor vehicles at cost	99 000
Debtors control	82 000
Inventory	135 000
Bank (Dr)	98 000
Accumulated depreciation: Motor vehicles (1 March 20.1)	49 000
Allowance for credit losses (1 March 20.1)	1 000
Capital (fixed): S Shoe	240 000
Capital (fixed): S String	160 000
Current account: S Shoe (Cr; 1 March 20.1)	50 000
Current account: S String (Dr; 1 March 20.1)	40 000
Drawings: S Shoe	55 000
Drawings: S String	11 000
Administrative expenses	80 000
Trading account (gross profit for the year)	200 000

Additional information

1 The partnership agreement stipulates the following:

- Interest is to be calculated at 7,5% per annum on the opening balances of the capital accounts.
- Interest is to be calculated at 10% per annum on the opening balances of the current accounts.
- Interest on drawings, as per partners' decision.
- S String is entitled to a monthly salary of R1 250.
- Profit/losses are to be shared equally.

2 The following must still be accounted for:

- Depreciation on motor vehicles. Provide for 30% per annum according to the diminishing-balance method.
- Credit losses to the amount of R2 000.
- Interest on drawings. In respect of the current financial year, the interest amounted to R5 000 for S Shoe and R1 000 for S String.

3 An investigation indicated that credit losses could be R4 000 during the next financial period and the allowance for credit losses must be adjusted accordingly.

REQUIRED

Prepare the following in respect of Shoestring Corner Shop to comply with the requirements of Generally Accepted Accounting Practice (notes and comparative figures are not required), appropriate to the business of the partnership:

(a) Statement of comprehensive income for the year ended 28 February 20.2 (Start with the gross profit.)

(b) Statement of changes in equity for the year ended 28 February 20.2

NB: Show all calculations.

(a)

SHOESTRING CORNER SHOP

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 20.2

		R
Gross profit		200 000
Distribution, administrative and other expenses		(100 000)
Administrative expenses	80 000	
Depreciation (R50 000 x 30%)	15 000	
Credit losses ①	5 000	
Profit for the year		100 000
Other comprehensive income for the year		—
Total comprehensive income for the year		100 000

(b)

SHOESTRING CORNER SHOP

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 28 FEBRUARY 20.2

	Capital		Current accounts			
	S Shoe	**S String**	**S Shoe**	**S String**	**Appro-priation**	**Total equity**
	R	**R**	**R**	**R**	**R**	**R**
Balances at 1 March 20.1	240 000	160 000	50 000	(40 000)	—	410 000
Total comprehensive income for the year					100 000	100 000
Salary to partner ②				15 000	(15 000)	
Interest on capital ③			18 000	12 000	(30 000)	
Interest on current accounts ④			5 000	(4 000)	(1 000)	
Interest on drawings			(5 000)	(1 000)	6 000	
Drawings			(55 000)	(11 000)		(66 000)
Partners' share of total comprehensive income ⑤			30 000	30 000	(60 000)	
Balances at 28 February 20.2	240 000	160 000	43 000	1 000	—	444 000

Calculations

① **Credit losses**

	R
Written off (refer additional information 2)	2 000
Increase in allowance for credit losses ❶	3 000
	5 000

❶ **Increase in allowance for credit losses**

	R
Closing balance (refer additional information 3)	4 000
Opening balance	(1 000)
Increase in allowance for credit losses	3 000

② **Salary to partner (S String)**

R1 250 x 12 = R15 000

③ **Interest on capital**

S Shoe: R240 000 x 7,5% = R18 000
S String: R160 000 x 7,5% = R12 000

④ **Interest on current accounts**

S Shoe: R50 000 (Cr) x 10% = R5 000 (payable)
S String: R40 000 (Dr) x 10% = R4 000 (receivable)

⑤ **Partners' share of total comprehensive income**

S Shoe: R60 000 x $\frac{1}{2}$ = R30 000
S String: R60 000 x $\frac{1}{2}$ = R30 000

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• define a partnership?		
• explain the reasons why partnerships are formed?		
• discuss the contents of a partnership agreement in general?		
• explain the ways in which a partnership can be established?		
• explain the factors which can result in the dissolution of a partnership?		
• record the transactions of a partnership in its books?		
• prepare the financial statements of a partnership to comply with the requirements of Generally Accepted Accounting Practice, appropriate to the business of the partnership?		

If you answered "yes" to all of the above assessment criteria, you can move on to study unit 3. If your answer was "no" revise that section before progressing to study unit 3.

STUDY UNIT

3

Changes in the ownership structure of partnerships

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- briefly describe what a change in the ownership structure of a partnership entails
- mention events that cause a change in the ownership structure of a partnership
- calculate the new profit-sharing ratio of a 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 as a business entity by applying the accounting procedure which is based on the legal perspective
- prepare a statement of financial position for a new partnership at the date of its formation according to the requirements of GAAP, appropriate to the business of the partnership, based on the legal perspective

Key concepts

- Change in ownership structure
- Dissolution
- Valuation adjustments
- Goodwill acquired
- Adjustment of profit-sharing ratio
- Personal transaction
- Transaction with a partnership as a business entity
- Accounting procedure based on the legal perspective

3.1 Introduction

A change in the ownership structure of a partnership is regarded as a change in the business relationship between the partners of a partnership. For example, the ownership structure changes when a partner is admitted to a partnership, when a partner retires or dies, or when the profit-sharing ratio of a partnership changes. When a change in the ownership structure of a partnership takes place, the existing partnership is dissolved. When a partnership is dissolved, 1) a new partnership may be formed subsequently, or 2) the partnership may be liquidated. The liquidation of a partnership means that its business activities are being terminated. In this study unit, only the dissolution of partnerships that pertain to the subsequent formation of new partnerships is addressed.

A change in the ownership structure of a partnership can take place as a result of 1) a personal (direct) transaction by one or more of the partners, or as a result of 2) a transaction entered into by the partnership as a business entity. Two accounting procedures are suggested according to which a change in the ownership structure of a partnership as a result of a transaction entered into by the partnership as a business entity is recorded, namely a procedure based on a legal perspective and a second procedure based on a going-concern perspective.

From the legal perspective, each partnership [that is the existing and the subsequent new partnership] is regarded as a separate business entity, and the activities of these partnerships are therefore accounted for and reported on independently. From the going-concern perspective, the activities of an existing and a subsequent new partnership are accounted for and reported on as though the two partnerships are operating as a single going-concern. **(The going-concern perspective does not form part of the syllabus.)**

Paragraph 3.1 of the prescribed textbook addresses these issues and provides some perspective on the scope of this study unit. Read through the paragraph attentively.

3.2 Valuation adjustments

In respect of valuation adjustments, the most important point to take note of is that the selling price of a partnership is determined by the fair value, and not the cost price or any other kind of value of the partnership. (Recall that fair value is the amount for which an asset can be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.) As the prescribed textbook indicates, the fair value of a *partnership* refers to the fair value of the *net* assets (including goodwill) of the partnership. (Net assets = Assets – Liabilities)

Often, the assets and liabilities of a partnership are not recorded at fair value. When a change in the ownership structure of a partnership takes place under such circumstances, the assets and liabilities of the existing partnership must first be valued. Any differences between these valued amounts and the recorded amounts must then be recorded. The recordings of these differences are referred to as valuation adjustments. For the purpose of FAC1601, valuation adjustments are made in a valuation account. Read paragraphs 3.2 and 3.2.1 in the prescribed textbook attentively so as to broaden your understanding of valuation adjustments and the recording thereof in the books of an existing partnership. Study example 3.1 in the prescribed textbook.

3.3 Goodwill

Read paragraphs 3.3 and 3.3.1 of the prescribed textbook attentively. Make sure that you know what is meant by the term "goodwill", and more specifically "goodwill acquired".

Study paragraph 3.3.2 of the prescribed textbook, and memorise the formula for the calculation of goodwill acquired. Do not work through examples 3.10 to 3.12 at this stage.

Study paragraphs 3.3.3 and 3.3.4 of the prescribed textbook. You will be required to create (record) goodwill acquired.

3.4 The calculation of profit-sharing ratios

Paragraph 3.4 and sub-paragraphs 3.4.1 to 3.4.3 deal with the calculation of new profit-sharing ratios under different circumstances. Read through these paragraphs attentively and do all the examples.

Note that there are various methods according to which the profit-sharing ratio of the partners in a new partnership can be calculated. After you have mastered the method that was applied in the prescribed textbook (refer to examples 3.1 to 3.7), you may attempt the other methods which are included as exercises in paragraph 3.7 of the study guide (refer to exercises 3.2 and 3.4).

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

Study paragraph 3.5 of the prescribed textbook. Make sure that you know what is meant by a personal transaction, and that no valuation adjustments or goodwill acquired are recorded when a change in the ownership structure of a partnership takes place by way of a personal transaction. Take note of the entries that are recorded under these circumstances, and study examples 3.8 and 3.9 of the prescribed textbook.

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

Paragraph 3.6 of the prescribed textbook discusses two accounting procedures according to which a change in the ownership structure of a partnership can be recorded when such a change resulted from a transaction that was made by the partnership as a business entity. These procedures are each based on a distinct perspective, namely the legal and the going-concern perspective. The legal perspective is summarised in paragraph 3.6 of the textbook, which you must read attentively. Do NOT study example 3.14 as it does not form part of the syllabus.

3.6.1 Accounting procedure based on the legal perspective

This procedure is discussed in detail in paragraph 3.6.1 of the prescribed textbook, and can be applied to record the admission, retirement or death of a partner. Study this paragraph, and note that the steps are intended to enable you to understand and systematically apply this accounting procedure.

It is important to note that steps 1 to 6 are carried out in the books of the *existing* partnership, and that steps 1 to 5 are carried out to prepare for its dissolution. It will not be required of you to apply step 1. Steps 7 to 9 are recorded in the books of the *new* partnership, and are carried out mainly to record the formation thereof. Also take note of the dates on which these entries are recorded.

Note that the calculation of the ratio according to which the assets and liabilities of the dissolved partnership are apportioned in the books of the new partnership (step 7), is based on the closing balances of the capital accounts of the previous partners as determined in step 6.

Examples 3.10 to 3.12 of the prescribed textbook illustrate the recording of changes in the ownership structure of partnerships from the legal perspective. Study these examples.

3.6.2 Accounting procedure based on the going-concern perspective

For the purpose of FAC1601, you will not be required to study this procedure.

3.7 Exercises and solutions

Exercise 3.1

Recording valuation adjustments in the books of an existing partnership

Work through the exercise, taking note of how valuation adjustments are recorded in the books of an existing partnership in preparation of its change in ownership structure.

Given information

Stevie and Bob are in a partnership, Wonder Traders, and they share profits and losses in the ratio of 3:2 respectively. They decided to admit Tina as a partner as from 1 March 20.6. The profit-sharing ratio for Stevie, Bob and Tina will be 3:2:1 respectively. The statement of financial position of Wonder Traders, immediately prior to the recording of any valuation adjustments, was as follows:

WONDER TRADERS

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20.6

	R
ASSETS	
Non-current assets	30 000
Property, plant and equipment (Land and buildings)	30 000
Current assets	90 000
Inventories	44 000
Trade receivables (Debtors control)	26 000
Cash and cash equivalents	20 000
Total assets	120 000
EQUITY AND LIABILITIES	
Total equity	100 000
Capital (Stevie: R60 000; Bob: R40 000)	100 000
Total liabilities	20 000
Current liabilities	20 000
Trade and other payables	20 000
Total equity and liabilities	120 000

Additional information

To prepare for the change in the ownership structure of Wonder Traders, the following agreement was reached on 28 February 20.6:

1 An allowance of R2 600 must be created for credit losses.
2 Inventories must be valued at R50 000.
3 Land and buildings must be valued at R50 000.

REQUIRED

Prepare the following accounts, properly balanced or closed off, in the general ledger of Wonder Traders to record the valuation adjustments on 28 February 20.6:

- Land and buildings
- Inventory
- Debtors control
- Allowance for credit losses
- Valuation account
- Capital: Stevie
- Capital: Bob

Solution 3.1

WONDER TRADERS

GENERAL LEDGER

Dr — Land and buildings — Cr

20.6		**R**			
Feb 28	Balance b/d	30 000			
	Valuation account R(50 000 – 30 000)	20 000			
		50 000			

Dr — Inventory — Cr

20.6		**R**			
Feb 28	Balance b/d	44 000			
	Valuation account R(50 000 – 44 000)	6 000			
		50 000			

Dr — Debtors control — Cr

20.6		**R**			
Feb 28	Balance b/d	26 000			

Dr — Allowance for credit losses — Cr

			20.6		**R**
			Feb 28	Valuation account	2 600

Dr — Valuation account — Cr

20.6		**R**	**20.6**		**R**
Feb 28	Allowance for credit losses	2 600	Feb 28	Land and buildings	20 000
	Capital: Stevie ($\frac{3}{5}$)	14 040		Inventory	6 000
	Capital: Bob ($\frac{2}{5}$)	9 360			
		26 000			26 000

Dr		Capital: Stevie			Cr
			20.6		**R**
			Feb 28	Balance b/d	60 000
				Valuation account	14 040
					74 040

Dr		Capital: Bob			Cr
			20.6		**R**
			Feb 28	Balance b/d	40 000
				Valuation account	9 360
					49 360

Exercise 3.2

Adjustment of a profit-sharing ratio

Work through the exercise, taking special note that when partners relinquish a profit share according to their existing profit-sharing ratio, the new profit-sharing ratio between these (existing/previous) partners remains the same. In addition, note how alternative methods can be applied to calculate the new profit-sharing ratio.

Given information

Joe and Boe were in partnership; they shared profits and losses equally (1:1). They decided to admit Zoe to the partnership, and to relinquish $\frac{1}{5}$ of the profits and losses to her equally.

REQUIRED

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

Solution 3.2

Joe = $\frac{1}{2} - (\frac{1}{5} \times \frac{1}{2}) = \frac{1}{2} - \frac{1}{10} = \frac{5}{10} - \frac{1}{10} = \frac{4}{10} = \frac{2}{5}$

Boe = $\frac{1}{2} - (\frac{1}{5} \times \frac{1}{2}) = \frac{1}{2} - \frac{1}{10} = \frac{5}{10} - \frac{1}{10} = \frac{4}{10} = \frac{2}{5}$

Zoe = $\frac{1}{5}$

The profit-sharing ratio of Joe, Boe and Zoe is 2:2:1 respectively.

The above calculation can also be done in percentages:

Joe = 50% – (20% x 50%) = 50% – 10% = 40%

Boe = 50% – (20% x 50%) = 50% – 10% = 40%

Zoe = 20%

40% : 40% : 20%
= 20% : 20% : 10%
= 2:2:1

Alternative method of calculating the profit-sharing ratio:

Given: Zoe will obtain a $\frac{1}{5}$ profit share, which is going to be relinquished by Joe and Boe according to their existing profit share.

Since Joe and Boe will relinquish a $\frac{1}{5}$ profit share to Zoe, Joe and Boe will together have a $\frac{4}{5}$ profit share (that is $\frac{5}{5} - \frac{1}{5} = \frac{4}{5}$). Joe and Boe will relinquish Zoe's profit share according to their *existing* profit share (1:1). The profit-sharing ratio between Joe and Boe in the new partnership thus remains the same (1:1 or let us say "equal"). Joe thus receives $\frac{1}{2}$ of the $\frac{4}{5}$, and Boe receives the other $\frac{1}{2}$ of the $\frac{4}{5}$. Thus:

Joe = $\frac{1}{2} \times \frac{4}{5} = \frac{4}{10} = \frac{2}{5}$

Boe = $\frac{1}{2} \times \frac{4}{5} = \frac{4}{10} = \frac{2}{5}$

Zoe = $\frac{1}{5}$

Exercise 3.3

Adjustment of a profit-sharing ratio

Work through the following exercise, taking note of how to calculate a new profit-sharing ratio when the existing partners relinquish a portion of their profit share to a new partner according to a different ratio from their existing profit-sharing ratio.

Given information

Dickson and Erikson were in a partnership and they shared profits and losses equally; they decided to admit Frederikson as a partner and to relinquish $\frac{1}{5}$ of the profits and losses to him according to the ratio of 1:5 respectively.

REQUIRED

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

Solution 3.3

Dickson $= \frac{1}{2} - (\frac{1}{5} \times \frac{1}{6}) = \frac{1}{2} - \frac{1}{30} = \frac{15}{30} - \frac{1}{30} = \frac{14}{30} = \frac{7}{15}$

Erikson $= \frac{1}{2} - (\frac{1}{5} \times \frac{5}{6}) = \frac{1}{2} - \frac{5}{30} = \frac{15}{30} - \frac{5}{30} = \frac{10}{30} = \frac{5}{15}$

Frederikson $= \frac{1}{5} = \frac{3}{15}$

The profit-sharing ratio of Dickson, Erikson and Frederikson is 7:5:3 respectively.

Exercise 3.4

Adjustment of a profit-sharing ratio

Work through the exercise, taking note of how the profit-sharing ratio of a new partnership can be calculated when the new profit-sharing ratio (in the new partnership) is given for the previous partners.

Given information

Goya and Picasso were in a partnership and they shared profits and losses equally. They decided to admit Renoir as a partner and to relinquish $\frac{1}{5}$ of the profits and losses to him in such a way that the profit-sharing ratio between Goya and Picasso in the new partnership would be 3:2 respectively.

REQUIRED

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

Solution 3.4

Given: Renoir will obtain a $\frac{1}{5}$ profit share. The profit-sharing ratio between Goya and Picasso in the new partnership is 3:2 respectively.

Conclusion: Goya and Picasso will share in the remaining $\frac{4}{5}$ according to the new profit-sharing ratio of 3:2 respectively. Thus:

Goya $= \frac{3}{5} \times \frac{4}{5} = \frac{12}{25}$

Picasso $= \frac{2}{5} \times \frac{4}{5} = \frac{8}{25}$

Renoir $= \frac{1}{5} = \frac{5}{25}$

The profit-sharing ratio of Goya, Picasso and Renoir is 12:8:5 respectively.

Exercise 3.5

Recording a change in the ownership structure of a partnership by applying the accounting procedure which is based on the legal perspective

Work through the following exercise, taking note of how to create goodwill and to record valuation adjustments in the books of an existing partnership.

Given information

Mahatma and Lerato were trading as The House Care Specialists, and they shared profits/losses equally. They decided to admit Enoch as a partner as from 1 July 20.6, and to trade as Home Care and Butler Services as from this date. According to the partnership agreement of Home Care and Butler Services, Enoch had to deposit a capital sum of R6 500 into the partnership's bank account for a ⅓ share in the net assets (equal to the equity) of the new partnership, the partners will share in the profits/losses equally, and the capital ratio of the partners must be in the same ratio as their profit-sharing ratio. On 1 July 20.6 Enoch deposited R6 500 into the bank account of the partnership, and in order to ensure that the capital ratio of the partnership is in the same ratio as their profit-sharing ratio, the capital account balances were adjusted by means of cash refunds and payments.

At 30 June 20.6 the books of The House Care Specialists were closed off. At this date the following items appeared in the preliminary statement of financial position of the partnership, and the assets of The House Care Specialists were valued in preparation of the change in its ownership structure:

Items in preliminary statement of financial position and valued amounts

Items	**Statement of financial position**	**Valued amounts**
	R	**R**
Capital: Mahatma	4 200	
Capital: Lerato	3 200	
Current account: Mahatma (dr)	100	
Current account: Lerato (cr)	200	
Asset replacement reserve (equipment)	1 000	
Land and buildings	4 500	7 500
Goodwill	Nil	2 100
Inventory: Cleaning materials	1 500	1 200
Debtors control	2 000	2 000
Bank (favourable)	500	500
Allowance for credit losses	Nil	300

REQUIRED

(a) Prepare the journal entries on 30 June 20.6 in the general journal of The House Care Specialists to prepare for the admission of Enoch as a partner and to record the dissolution of the partnership. (Apply steps 2 to 6 of the accounting procedure based on the legal perspective.)

(b) Prepare the journal entries on 1 July 20.6 in the general journal of Home Care and Butler Services to record its formation and to give effect to the decisions which pertain to the accounting policy and/or the new partnership agreement. (Apply steps 7 to 9 of the accounting procedure based on the legal perspective.)

(c) Prepare the statement of financial position of Home Care and Butler Services as at 1 July 20.6 according to the requirements of GAAP, appropriate to the business of the partnership. Notes and comparative figures are not required.

Solution 3.5

(a)

THE HOUSE CARE SPECIALISTS

GENERAL JOURNAL

		Debit	Credit
		R	R
20.6			
Jun 30	Capital: Mahatma	100	
	Current account: Lerato	200	
	Current account: Mahatma		100
	Capital: Lerato		200
	Closing off the balances of the current accounts of Mahatma and Lerato to their capital accounts (step 2)		
	Asset replacement reserve (equipment)	1 000	
	Capital: Mahatma (R1 000 x ½)		500
	Capital: Lerato (R1 000 x ½)		500
	Asset replacement reserve apportioned to the capital accounts of Mahatma and Lerato according to their profit-sharing ratio (step 3)		
	Land and buildings R(7 500 – 4 500)	3 000	
	Inventory: Cleaning materials R(1 500 – 1 200)		300
	Allowance for credit losses		300
	Valuation account		2 400
	Recording the valuation adjustments (step 4)		
	Valuation account	2 400	
	Capital: Mahatma (R2 400 x ½)		1 200
	Capital: Lerato (R2 400 x ½)		1 200
	Closing off the balancing amount of the valuation account to the capital accounts of Mahatma and Lerato according to their profit-sharing ratio (step 4)		
	Goodwill	2 100	
	Capital: Mahatma (R2 100 x ½)		1 050
	Capital: Lerato (R2 100 x ½)		1 050
	Recording goodwill in preparation for the admission of Enoch (step 5)		
	Transferral account	13 300	
	Land and buildings		7 500
	Goodwill		2 100
	Inventory: Cleaning materials		1 200
	Debtors control		2 000
	Bank		500
	Closing off the balances of the asset accounts to the transferral account to record the dissolution of the partnership (step 6)		

		Debit	Credit
		R	R
20.6			
Jun 30	Capital: Mahatma ①	6 850	
	Capital: Lerato ①	6 150	
	Allowance for credit losses	300	
	Transferral account		13 300
	Closing off the balances of the equity and allowance accounts to the transferral account to record the dissolution of the partnership (step 6)		

Comment

The steps are indicated for illustrative purposes only.

Calculation

① **Capital account balances of partners**

		R
Mahatma:	R(4 200 – 100 + 500 + 1 200 + 1 050) =	6 850
Lerato:	R(3 200 + 200 + 500 + 1 200 + 1 050) =	6 150
		13 000

(b)

HOME CARE AND BUTLER SERVICES

GENERAL JOURNAL

		Debit	Credit
		R	R
20.6			
Jul 1	Land and buildings (R7 500 x 6 850/13 000)	3 952	
	Goodwill (R2 100 x 6 850/13 000)	1 107	
	Inventory: Cleaning materials (R1 200 x 6 850/13 000)	632	
	Debtors control (R2 000 x 6 850/13 000)	1 054	
	Bank (R500 x 6 850/13 000)*	263	
	Allowance for credit losses (R300 x 6 850/13 000)		158
	Capital: Mahatma		6 850
	Recording the capital contribution of Mahatma (step 7)		
	Land and buildings (R7 500 x 6 150/13 000)	3 548	
	Goodwill (R2 100 x 6 150/13 000)*	993	
	Inventory: Cleaning materials (R1 200 x 6 150/13 000)	568	
	Debtors control (R2 000 x 6 150/13 000)	946	
	Bank (R500 x 6 150/13 000)	237	
	Allowance for credit losses (R300 x 6 150/13 000)		142
	Capital: Lerato		6 150
	Recording the capital contribution of Lerato (step 7)		
	Bank	6 500	
	Capital: Enoch		6 500
	Recording the capital contribution of Enoch (step 7)		

		Debit	Credit
		R	R
20.6 Jul 1	Capital: Mahatma ① Bank ① *Recording the cash repayment to Mahatma so as to bring the capital account ratio in the same ratio as the profit-sharing ratio (step 9)*	350	 350
	Bank ① Capital: Lerato ① *Recording the contribution of Lerato so as to bring the capital account ratio in the same ratio as the profit-sharing ratio (step 9)*	350	 350

Comment

In the above first two journal entries, the amounts allotted were rounded off to the nearest Rand, with exception of those indicated with an asterisk. The reason why the R263 and the R993 were not rounded off, is because the allotted amounts in each journal entry must add up to the amount of the capital account in that journal entry.

Calculation

① **Adjustment of capital account balances of Mahatma and Lerato**

Calculation of capital account balances according to profit-sharing ratio.

		R
Capital: Mahatma	R19 500 ❶ x ⅓ =	6 500
Capital: Lerato	R19 500 ❶ x ⅓ =	6 500
Capital: Enoch	R19 500 ❶ x ⅓ =	6 500
		19 500

❶ **Total amount of capital in the new partnership**

R(6 850 + 6 150 + 6 500) = R19 500

or

Enoch's capital contribution x the inverse of his share in the net assets of the new partnership (R6 500 x 3) = R19 500

Difference between recorded and calculated capital account balances:

	Recorded capital account balance	Calculated capital account balance according to profit-sharing ratio	Difference
	R	R	R
Mahatma	6 850	6 500	350
Lerato	6 150	6 500	(350)
Enoch	6 500	6 500	—

The balances of Mahatma and Lerato differ. Mahatma's capital account must be reduced by refunding R350 to him. Lerato's capital account must be increased by receiving a cash contribution of R350 from her.

(c)

HOME CARE AND BUTLER SERVICES

STATEMENT OF FINANCIAL POSITION AS AT 1 JULY 20.6

		R
ASSETS		
Non-current assets		9 600
Property, plant and equipment R(3 952 + 3 548)	7 500	
Goodwill R(1 107 + 993)	2 100	
Current assets		9 900
Inventories R(632 + 568)	1 200	
Trade receivables R(1 054 + 946 – 158 – 142)	1 700	
Cash and cash equivalents R(263 + 237 + 6 500 – 350 + 350)	7 000	
Total assets		19 500
EQUITY AND LIABILITIES		
Total equity		19 500
Capital R(6 850 + 6 150 + 6 500 – 350 + 350)	19 500	
Total equity and liabilities		19 500

Exercise 3.6

Recording the capital contribution of a partner who was admitted to a partnership

Work through the following exercise, taking note of how the formula for calculating a new profit-sharing ratio can be used to calculate other related ratios, and that a partner who is admitted to a partnership does not necessarily have to contribute cash in order to purchase a share in the net assets (equity) of the partnership.

Given information

Lucky and Packet are in a partnership, and they share profits and losses in the ratio of 3:2 respectively. They decided to admit Surprise to their partnership as from 1 January 20.5. The new partnership will trade as Sweet Sensations. Surprise will acquire a $\frac{1}{4}$ interest in the profit-sharing ratio of Sweet Sensations. The profit-sharing ratio of Lucky, Packet and Surprise will be 2:1:1 respectively. Surprise is a sole trader and is going to contribute the assets and liabilities, at fair value, of his business to the partnership on 1 January 20.5. The only asset that the new partnership is not going to take over from Surprise is the debtors. On 1 January 20.5 the following pertained to the business of Surprise:

Asset/Liability	Carrying amount	Agreed upon value
	R	R
Motor vehicle	6 500	5 200
Furniture and equipment	1 600	1 300
Goodwill	—	3 000
Inventory (merchandise)	8 000	7 800
Debtors control	4 200	4 200
Allowance for credit losses	—	600
Bank (favourable)	800	800
Creditors control	5 100	5 100

REQUIRED

(a) Prepare the journal entries on 1 January 20.5 in the general journal of Sweet Sensations to record Surprise's capital contribution to the partnership.

Solution 3.6

(a)

GENERAL JOURNAL

SWEET SENSATIONS

		Debit	Credit
		R	R
20.6			
Jan 1	Motor vehicles	5 200	
	Furniture and equipment	1 300	
	Goodwill	3 000	
	Inventory (merchandise)	7 800	
	Bank	800	
	Creditors control		5 100
	Capital: Surprise		13 000
	Recording the capital contribution of Surprise		

Exercise 3.7

Preparation of partners' capital accounts and valuation account in preparation of the change in the ownership structure of a partnership

Work through the exercise; note that when goodwill is *created*, it is not recorded in the valuation account, since goodwill that was previously unrecorded, cannot be revalued. Also note of how the valuation and capital accounts are closed off to a transferral account when an accounting procedure based on the legal perspective is applied. Take note that a retired partner's capital account is closed off to a loan account on the last date of the existing p\artnership if the capital account was not settled by the partnership.

Given information

Kally, Rocky and Mike are in a partnership, trading as Fighting Fists, and share profits and losses in the ratio of 2:2:1 respectively. Kally decided to retire from the partnership. His last day as a partner in the partnership will be 31 May 20.6, which is also the financial year-end of Fighting Fists. The new partnership will pay out Kally's capital in cash on 30 November 20.6. Rocky and Mike decided to admit Gerrie as a partner as from 1 June 20.6. The new partnership will trade as Fighting Fit. The profit-sharing ratio between Rocky, Mike and Gerrie will be 3:2:1 respectively. Gerrie will contribute R80 000 in cash for a $\frac{1}{6}$ share in the equity (net assets) of the new partnership.

The statement of financial position of Fighting Fists as at 31 May 20.6, immediately prior to the recording of valuation adjustments in preparation of the change in the ownership structure of the partnership is as follows:

FIGHTING FISTS

STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20.6

	R
ASSETS	
Non-current assets	80 000
Property, plant and equipment (Land and buildings)	80 000
Current assets	102 000
Inventories	48 000
Trade receivables (Debtors control)	36 000
Cash and cash equivalents	18 000
Total assets	182 000
EQUITY AND LIABILITIES	
Total equity	168 000
Capital (Kally: R56 000; Rocky: R74 000; Mike: R38 000))	168 000
Total liabilities	14 000
Current liabilities	14 000
Trade and other payables (Creditors control)	14 000
Total equity and liabilities	182 000

Additional information

1 To prepare for the change in the ownership structure of Fighting Fists, the following agreement was reached on 31 May 20.6:

1.1 Goodwill must be recorded in the books.
1.2 An allowance for credit losses must be created at R3 600.
1.3 Inventories must be valued at R60 000.
1.4 Land and buildings must be valued at R140 000.

2 The change in the ownership structure of the partnership is viewed from a legal perspective.

REQUIRED

Prepare the valuation account and the capital accounts of Kally, Rocky and Mike, properly closed off, in the general ledger of Fighting Fists at 31 May 20.6.

Solution 3.7

FIGHTING FISTS

GENERAL LEDGER

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

20.6		**R**	**20.6**		**R**
May 31	Allowance for credit losses	3 600	May 31	Land and buildings	60 000
	Capital: Kally ①	27 360		R(140 000 – 80 000)	
	Capital: Rocky ①	27 360		Inventories	12 000
	Capital: Mike ①	13 680		R(60 000 – 48 000)	
		72 000			72 000

Dr **Capital: Kally** **Cr**

20.6		**R**	**20.6**		**R**
May 31	Loan: Kally	182 144	May 31	Balance b/d	56 000
				Valuation account	27 360
				Goodwill ②	98 784
		182 144			182 144

Dr	Capital: Rocky				Cr
20.6		**R**	**20.6**		**R**
May 31	Transferral account	200 144	May 31	Balance b/d	74 000
				Valuation account	27 360
				Goodwill ②	98 784
		200 144			200 144

Dr	Capital: Mike				Cr
20.6		**R**	**20.6**		**R**
May 31	Transferral account	101 072	May 31	Balance b/d	38 000
				Valuation account	13 680
				Goodwill ②	49 392
		101 072			101 072

Dr	Loan: Kally				Cr
20.6		**R**	**20.6**		**R**
May 31	Transferral account	182 144	May 31	Capital: Kally	182 144
		182 144			182 144

Comment

The loan account was not required, and is given as an additional illustration.

Calculations

① **Apportionment of the balance of the valuation account to the capital accounts of the partners of the existing partnership**

Balance of valuation account to be apportioned: R(72 000 – 3 600) = R68 400

Kally: R68 400 x $\frac{2}{5}$ = R27 360
Rocky: R68 400 x $\frac{2}{5}$ = R27 360
Mike: R68 400 x $\frac{1}{5}$ = R13 680

② **Goodwill**

Goodwill acquired: = (Capital contribution of new partner x inverse of new partner's share in the equity [net assets] of new partnership) – Equity of new partnership.
= (80 000 x $\frac{6}{1}$) – (101 360* + 51 680* + 80 000)
= 480 000 – 233 040
= 246 960

*Balances of capital accounts:

Rocky = Opening balance + apportionment of profit of valuation account
= R(74 000 + 27 360)
= R101 360

*Mike = Opening balance + apportionment of profit of valuation account
= R(38 000 + 13 680)
= R51 680

Please note that the capital account balance of Kally is excluded from the calculation of goodwill, because Kally will not be part of the new partnership. Kally will however be included in the recording of the goodwill in the books of the old partnership, as he is still viewed as a partner.

Goodwill apportioned to the capital accounts:

Kally:	R246 960 x $\frac{2}{5}$ = R98 784
Rocky:	R246 960 x $\frac{2}{5}$ = R98 784
Mike:	R246 960 x $\frac{1}{5}$ = R49 392

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• briefly describe what a change in the ownership structure of a partnership entails?		
• mention events that cause a change in the ownership structure of a partnership?		
• calculate the new profit-sharing ratio of a 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 as a business entity by applying the accounting procedure which is based on the legal perspective?		
• if an accounting procedure is based on the legal perspective, prepare a statement of financial position of a new partnership at the date of its formation according to the requirements of GAAP, appropriate to the business of the partnership?		

Revise the criteria indicated with a "No". Once you have answered "Yes" to all of the above assessment criteria, you may proceed to study unit 4.

STUDY UNIT

4

The liquidation of a partnership

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- describe the meaning of the term: "liquidation" from the perspective of this study unit
- distinguish between a simultaneous and a piecemeal liquidation
- apply the accounting procedure in the case of a simultaneous liquidation of a partnership
  - — with a profit on liquidation
  - — with a loss on liquidation, where all of the partners have sufficient personal funds to cover the shortages on their capital accounts
  - — with a loss on liquidation, where one or more of the partners do not have sufficient personal funds to cover the shortfalls on their capital accounts and where the capital deficits must be apportioned to the remaining solvent partners according to their profit-sharing ratio
- apply the accounting procedure in the case of a piecemeal liquidation of a partnership, and to calculate the interim repayments of available cash between partners according to the loss-absorption-capacity method

Key concepts

- Dissolution
- Liquidation
- Liquidation account
- Simultaneous liquidation
- Piecemeal liquidation
- Loss-absorption-capacity method

4.1 Introduction

Read paragraph 4.1 of the prescribed textbook attentively. Ensure that you understand what a liquidation, for the purposes of this study unit, entails.

Note that, for the purposes of this study unit, a liquidation is regarded as a form of dissolution which results in the termination of the activities of a *solvent* partnership, whereas a sequestration is regarded as a form of dissolution of an *insolvent* partnership. The accounting procedures that pertain to sequestrations fall beyond the scope of this syllabus.

Also note that the liquidation of a partnership basically implies that the assets of the partnership must be converted into cash (in other words, the assets must be liquidated), the liabilities must be settled, and the remaining cash be paid to the partners in keeping with the closing balance of their capital accounts. After the balances on the capital accounts have been settled, there are no remaining accounts in the books of the partnership.

4.2 Liquidation methods

Read paragraph 4.2 of the prescribed textbook attentively. Ensure that you understand what the differences between a simultaneous and a piecemeal liquidation are.

4.3 The liquidation account

Read paragraph 4.3 of the prescribed textbook attentively.

Note that a liquidation account can also be referred to as a dissolution or realisation account. In this study unit, the term ''liquidation account'' is used because the term pertains specifically to the liquidation of a partnership, which makes it less confusing than the term ''realisation account'', which is used by a going-concern when an asset is sold.

Take special note of the function of a liquidation account; it is used to determine the *net* profit or loss on liquidation, and it aids in the closure of the ledger accounts of the partnership. The balancing amount thereof is closed off to the capital accounts of the partners according to their profit-sharing ratio.

In paragraph 4.3 of the prescribed textbook, two methods are presented according to which a liquidation account can be prepared in the case of a simultaneous liquidation. If you are asked to prepare a liquidation account in an assignment or in the examination, you must prepare the account according to Method 1.

Liquidation accounts are also prepared for piecemeal liquidations. With piecemeal liquidations, a separate liquidation account can be prepared for each liquidation transaction, in which case the balancing amount of the liquidation account is the profit or loss made on the liquidation transaction. A liquidation account can also be prepared for more than one liquidation transaction. For example, all the liquidation transactions that took place on a specific date can be recorded in a single liquidation account, in which case the balancing amount of the liquidation account is the *net* profit or loss made on all the recorded liquidation transactions.

4.4 Accounting procedure to record the simultaneous liquidation of a partnership

Read paragraphs 4.4 and 4.4.1 of the prescribed textbook attentively. Then, whilst referring to the steps in paragraph 4.4, work through example 4.1. Note that you will not be required to prepare a theoretical answer in respect of the steps. The object of using the steps is simply to guide you towards a systematic approach in the preparation of solutions to practical questions on simultaneous liquidations.

Read through paragraph 4.4.2 of the prescribed textbook to determine how to record a loss on a liquidation. As a matter of interest, you can read the discussion pertaining to the *Garner versus Murray* rule. You will not be required to apply the *Garner versus Murray* rule in the assignments or in the examination. Study examples 4.2 and 4.3(b) in the prescribed textbook.

4.5 Accounting procedure to record the piecemeal liquidation of a partnership

Read through paragraphs 4.5 and 4.5.2 of the prescribed textbook attentively, and study example 4.6. Take note that the calculation of interim repayments by applying the surplus-capital method does NOT form part of the syllabus.

Study example 4.7 in the prescribed textbook. Note how the recordings in the solution to example 4.7 can be summarised in columnar format. Also note that each column represents a ledger account, or a group of ledger accounts. Remember to apply the double entry principle when a piecemeal liquidation is recorded in columnar format. Remember that when a piecemeal liquidation is recorded in columnar format, debit balances and debit entries are disclosed without brackets, whereas credit balances and credit entries are disclosed in brackets.

4.6 Exercises and solutions

Exercise 4.1

Recording of a simultaneous liquidation

Work through the exercise, taking special note of how the required accounts are recorded according to Method 1 as discussed in paragraph 4.3 in the prescribed textbook. Also note that the remaining cash after liquidation is not apportioned to the capital accounts of the partners according to their profit-sharing ratio, but according to their outstanding capital account balances.

Given information

Penn and Penzil were in partnership for 38 years, trading as Manual Accounting Services and sharing in the profits and losses of the partnership equally. Owing to a steady decline in their clientéle and profits, they decided to liquidate the partnership at a public auction on 30 June 20.5. On this date, prior to the auction, the following trial balance was prepared by them for Manual Accounting Services:

MANUAL ACCOUNTING SERVICES

TRIAL BALANCE AS AT 30 JUNE 20.5

	Debit	Credit
	R	R
Land and buildings at valuation	500 000	
Furniture at cost	102 000	
Vehicles at cost	215 000	
Accumulated depreciation: Furniture		20 000
Accumulated depreciation: Vehicles		15 000
Goodwill	120 000	
Inventory	45 000	
Debtors control	75 000	
Allowance for credit losses		7 000
Capital: Penn		150 000
Capital: Penzil		80 000
Current account: Penn	30 000	
Current account: Penzil		10 000
Asset replacement reserve		60 000
Revaluation reserve of land and buildings		210 000
Mortgage (in respect of land and buildings)		300 000
Bank overdraft		90 000
Creditors control		145 000
	1 087 000	1 087 000

Additional information

On 30 June 20.5 the following transactions took place:

1. The land and buildings were sold for R849 500, cash.
2. The furniture was sold for R60 200, cash.
3. The inventory was sold for R50 050, cash.
4. All the debtors (as recorded in the above trial balance) settled their accounts, and received a discount of 20% on their accounts.
5. A previous client, whose outstanding debtor's account of R650 was written off as irrecoverable, paid R500 to the partnership.
6. There were two vehicles in the partnership. Penn took over one of these vehicles at a fair value of R60 000, and Penzil the other at a fair value of R70 000.
7. The liquidation costs amounted to R10 000 and were paid.
8. The mortgage was paid in full.
9. All the creditors were paid. A settlement discount of R29 000 was received on these payments.
10. Penzil paid R250 for a farewell luncheon out of the funds of the partnership.

REQUIRED

Prepare the liquidation account, the bank account, and the partners' capital accounts in the general ledger of Manual Accounting Services in order to record its liquidation at 30 June 20.5.

NB: Show all calculations.

MANUAL ACCOUNTING SERVICES

GENERAL LEDGER

Dr **Liquidation account** **Cr**

20.5		R	20.5		R
Jun 30	Land and buildings at valuation	500 000	Jun 30	Accumulated depreciation: Furniture	20 000
	Furniture at cost	102 000		Accumulated depreciation: Vehicles	15 000
	Vehicles at cost	215 000		Mortgage	300 000
	Inventory	45 000		Creditors control	145 000
	Debtors control	75 000		Allowance for credit losses	7 000
	Bank (Liquidation costs)	10 000		Bank (Land and buildings)	849 500
	Bank (Mortgage)	300 000		Bank (Furniture)	60 200
	Bank [Creditors control R(145 000 – 29 000)]	116 000		Bank (Inventory)	50 050
	Bank (Luncheon)	250		Bank (Debtors control) ①	60 000
	Capital: Penn ②	137 000		Bank (Credit losses recovered)	500
	Capital: Penzil ②	137 000		Capital: Penn	60 000
				Capital: Penzil	70 000
		1 637 250			1 637 250

Calculations

① **Cash received from debtors**

Discount = R75 000 x 20% = R15 000
Cash received = R(75 000 – 15 000) = R60 000

② **Apportionment of profit made on liquidation**

R(1 637 250❶ – 1 363 250❷) = R274 000❸

Penn: R274 000 x ½ = R137 000
Penzil: R274 000 x ½ = R137 000

❶ The total of the credit side.
❷ The total of the debit side before the apportionment of the profit.
❸ The balancing amount of the liquidation account that must be apportioned to the partners according to their profit-sharing ratio.

Bank

Dr					Cr
20.5		**R**	**20.5**		**R**
Jun 30	Liquidation account (Land and buildings)	849 500	Jun 30	Balance b/d	90 000
	Liquidation account (Furniture)	60 200		Liquidation account (Mortgage)	300 000
	Liquidation account (Inventory)	50 050		Liquidation account (Liquidation costs)	10 000
	Liquidation account (Debtors control)	60 000		Liquidation account (Creditors control)	116 000
	Liquidation account (Credit losses recovered)	500		Liquidation account (Luncheon)	250
				Capital: Penn*	272 000
				Capital: Penzil*	232 000
		1 020 250			1 020 250

* The settlement of the outstanding balances on the capital accounts of Penn and Penzil. The capital accounts must first be prepared in order to determine these balances. Note how the balance of the bank account (prior to this settlement) is equal to the sum of the outstanding capital account balances (R272 000 + R232 000 = R504 000).

Capital: Penn

Dr					Cr
20.5		**R**	**20.5**		**R**
Jun 30	Current account: Penn	30 000	Jun 30	Balance b/d	150 000
	Liquidation account (Vehicle)	60 000		Asset replacement reserve (R60 000 x ½)	30 000
	Goodwill (R120 000 x ½)	60 000		Revaluation reserve of land and buildings (R210 000 x ½)	105 000
	Bank*	272 000		Liquidation account	137 000
		422 000			422 000

* Balancing amount (outstanding balance)

Capital: Penzil

Dr					Cr
20.5		**R**	**20.5**		**R**
Jun 30	Liquidation account (Vehicle)	70 000	Jun 30	Balance b/d	80 000
	Goodwill (R120 000 x ½)	60 000		Current account: Penzil	10 000
	Bank*	232 000		Asset replacement reserve (R60 000 x ½)	30 000
				Revaluation reserve of land and buildings (R210 000 x ½)	105 000
				Liquidation account	137 000
		362 000			362 000

* Balancing amount (outstanding balance)

Exercise 4.2

Piecemeal liquidation: Calculation of interim repayments according to the loss-absorption-capacity method

Given information

Sause, Age and Roll are in a partnership, sharing in the profits and losses in the ratio of 5:3:2 respectively. The following is relevant statement of financial position information pertaining to the partnership at 31 December 20.8:

SAUSE, AGE AND ROLL SERVICES

STATEMENT OF FINANCIAL POSITION INFORMATION AS AT 31 DECEMBER 20.8

	R		R
Equipment	42 000	Capital: Sause	7 000
Goodwill	3 000	Capital: Age	14 000
Bank	5 000	Capital: Roll	18 000
		Creditors control	11 000
	50 000		50 000

The partners decided to liquidate the partnership piecemeal as from 1 January 20.9. The net proceeds will be apportioned amongst the partners in such a way that no partner will find it necessary to repay any amount which was received.

Liquidation of assets	Carrying amount R	Proceeds R
1 February 20.9	13 000	9 000
2 July 20.9	29 000	33 000

REQUIRED

(a) Calculate the amount of cash that is available for an interim repayment after the first liquidation of the assets and the settlement of the liabilities on 1 February 20.9.

(b) Calculate how the cash as determined in (a) must be repaid to the partners by applying the loss-absorption-capacity method. Disclose the calculation in a columnar format.

(a)

CASH AVAILABLE FOR DISTRIBUTION

Bank = Opening balance + Cash sales – Payment of liabilities
Bank = R(5 000 + 9 000 – 11 000)
Bank = R3 000

(b)

CASH REPAYMENT (LOSS-ABSORPTION-CAPACITY METHOD)

Step*	Bank	Equipment	Capital: Sause	Capital: Age	Capital: Roll
	R	R	R	R	R
A	3 000	29 000 ①	(3 500)①	(11 900)①	(16 600)①
C		(29 000)	14 500 ②	8 700 ②	5 800 ②
	3 000	—	11 000	(3 200)	(10 800)
D			(11 000)	6 600 ③	4 400 ③
	3 000	—	—	3 400	(6 400)
D				(3 400)	3 400
	3 000			—	(3 000)

* The steps, as discussed in paragraph 4.5.2 of the prescribed textbook, are referred to for illustrative purposes only.

Comment

Since the anticipated capital accounts of Sause and Age went into a deficit, the amount of available cash, namely R3 000, must be paid solely to Roll. Note that the amount of available cash is equal to the amount that must be paid to Roll.

Calculations

① **Balances before first interim repayment**

SAUSE, AGE AND ROLL SERVICES

GENERAL LEDGER (EXTRACT) (SUMMARISED IN COLUMNAR FORMAT)

Transactions	Bank	Creditors control	Equip-ment	Capital: Sause	Control: Age	Capital: Roll
	R	R	R	R	R	R
Balances at the commencement of liquidation 1 January 20.9	5 000	(11 000)	42 000	(5 500) ❶	(13 100) ❶	(17 400) ❶
Payment of creditors	(5 000)	5 000				
Sale of assets	9 000		(13 000)	2 000 ❷	1 200 ❷	800 ❷
Payment of creditors	(6 000)	6 000				
	3 000	—	29 000	(3 500)	(11 900)	(16 600)

❶ **Capital account balances on 1 January 20.9 (after the apportionment of the goodwill)**

Sause:	R7 000 – (R3 000 x $^5\!/_{10}$)	= R5 500
Age:	R14 000 – (R3 000 x $^3\!/_{10}$)	= R13 100
Roll:	R18 000 – (R3 000 x $^2\!/_{10}$)	= R17 400

❷ **Allocation of loss on first liquidation**

	R
Proceeds (selling price)	9 000
Carrying amount	(13 000)
Loss on liquidation	(4 000)

Sause:	R4 000 x $^5\!/_{10}$ =	R2 000
Age:	R4 000 x $^3\!/_{10}$ =	R1 200
Roll:	R4 000 x $^2\!/_{10}$ =	R800

② **Apportionment of the anticipated loss as a result of the remaining equipment being *assumed* to be worthless**

Sause:	R29 000 x $^5\!/_{10}$	= R14 500
Age:	R29 000 x $^3\!/_{10}$	= R8 700
Roll:	R29 000 x $^2\!/_{10}$	= R5 800

③ **Apportionment of the anticipated capital deficit of Sause, who must be *assumed* to be insolvent, to Age and Roll**

Age:	R11 000 x $^3\!/_5$	= R6 600
Roll:	R11 000 x $^2\!/_5$	= R4 400

Exercise 4.3

Recording piecemeal liquidation transactions in columnar format (loss-absorption-capacity method)

Given information

Patrys, Pine and Promise are in partnership, trading as African Timber and sharing in the profits and losses in the ratio of 5:3:2 respectively. The following statement of financial position information in respect of the partnership was prepared at 30 June 20.9:

AFRICAN TIMBER

STATEMENT OF FINANCIAL POSITION INFORMATION AS AT 30 JUNE 20.9

	R
Property, plant and equipment	18 000
Capital: Patrys	8 000
Capital: Pine	5 000
Capital: Promise	2 000
Creditors control	3 000

Due to increasing liquidity problems the partners decided to liquidate the partnership piecemeal, as from 1 July 20.9. As soon as cash becomes available from the liquidation of assets, it must be paid to the partners in such a manner that no partner will have to refund money to the partnership at a later stage.

The property, plant and equipment was liquidated as follows:

	Carrying amount	Cash received
	R	R
First liquidation	2 500	2 500
Second liquidation	5 600	5 000
Third liquidation	6 000	6 000
Fourth liquidation	3 900	4 000
	18 000	17 500

REQUIRED

Record the liquidation of African Timber in columnar format according to the undermentioned outlay. Disclose the credit balances of the ledger accounts and the credit entries in the ledger accounts in brackets. Apply the loss-absorption-capacity method to calculate the interim repayments to the partners.

REQUIRED OUTLAY:

AFRICAN TIMBER

GENERAL LEDGER (SUMMARISED IN COLUMNAR FORMAT)

Transaction	Bank	Creditors control	Property, plant and equipment	Capital: Patrys	Capital: Pine	Capital: Promise
	R	R	R	R	R	R
Balances at 1 July 20.9						

AFRICAN TIMBER

GENERAL LEDGER (SUMMARISED IN COLUMNAR FORMAT)

Transaction	Bank	Creditors control	Property, plant and equipment	Capital: Patrys	Capital: Pine	Capital: Promise
	R	R	R	R	R	R
Balances at the commencement of liquidation: 1 July 20.9	—	(3 000)	18 000	(8 000)	(5 000)	(2 000)
Sale of assets (1st liquidation)	2 500		(2 500)			
Payment of creditors	(2 500)	2 500				
Sale of assets (2nd liquidation) and allocation of loss	5 000		(5 600)	300 ①	180 ①	120 ①
Payment of creditors	(500)	500				
	4 500	—	9 900	(7 700)	(4 820)	(1 880)
1st Interim repayments	(4 500)			2 688 ②	1 812 ②	
	—		9 900	(5 012)	(3 008)	(1 880)
Sale of assets (3rd liquidation)	6 000		(6 000)			
	6 000		3 900	(5 012)	(3 008)	(1 880)
2nd Interim repayments	(6 000)			3 062 ③	1 838 ③	1 100 ③
	—	—	3 900	(1 950)	(1 170)	(780)
Sale of assets (4th liquidation) and allocation of profits	4 000		(3 900)	(50) ④	(30) ④	(20) ④
	4 000	—	—	(2 000)	(1 200)	(800)
Settlement of capital accounts	(4 000)			2 000	1 200	800

Calculations

① **Allocation of loss (R600)**

Patrys: R600 x $\frac{5}{10}$ = R300
Pine: R600 x $\frac{3}{10}$ = R180
Promise: R600 x $\frac{2}{10}$ = R120

② **Interim repayments (loss-absorption-capacity method)**

Step*	Bank	Property, plant and equipment	Capital: Patrys	Capital: Pine	Capital: Promise
	R	R	R	R	R
A	4 500	9 900	(7 700)	(4 820)	(1 880)
C		(9 900)	4 950 ❶	2 970 ❶	1 980 ❶
	4 500	—	(2 750)	(1 850)	100
D			62 ❷	38 ❷	(100) ❷
	4 500	—	(2 688)	(1 812)	—

* The steps, as discussed in paragraph 4.5.2 of the prescribed textbook, are referred to for illustrative purposes only.

❶ **Allocation of the loss as a result of the remaining property, plant and equipment being *assumed* to be worthless**

Patrys: R9 900 x $\frac{5}{10}$ = R4 950
Pine: R9 900 x $\frac{3}{10}$ = R2 970
Promise: R9 900 x $\frac{2}{10}$ = R1 980

❷ **Allocation of the anticipated capital deficit of Promise, who must be *assumed* to be insolvent, to Patrys and Pine**

Patrys: R100 x $\frac{5}{8}$ = R62 (Rounded off to the nearest lower R)
Pine: R100 x $\frac{3}{8}$ = R38 (Rounded off to the nearest higher R)

③ **Interim repayments (loss-absorption-capacity method)**

Step*	Bank	Property, plant and equipment	Capital: Patrys	Capital: Pine	Capital: Promise
	R	R	R	R	R
A	6 000	3 900	(5 012)	(3 008)	(1 880)
C		(3 900)	1 950 ❶	1 170 ❶	780 ❶
	6 000	—	(3 062)	(1 838)	(1 100)

* The steps, as discussed in paragraph 4.5.2 of the prescribed textbook, are referred to for illustrative purposes only.

❶ **Allocation of the loss as a result of the remaining property, plant and equipment being *assumed* to be worthless**

Patrys: R3 900 x $\frac{5}{10}$ = R1 950

Pine: R3 900 x $^3/_{10}$ = R1 170
Promise: R3 900 x $^2/_{10}$ = R780

④ **Allocation of profit (R100)**

Patrys: R100 x $^5/_{10}$ = R50
Pine: R100 x $^3/_{10}$ = R30
Promise: R100 x $^2/_{10}$ = R20

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• describe the meaning of the term: "liquidation" from the perspective of this study unit?		
• distinguish between a simultaneous and a piecemeal liquidation?		
• apply the accounting procedure in the case of a simultaneous liquidation of a partnership with a profit or loss on liquidation?		
• apply the accounting procedure in the case of a piecemeal liquidation of a partnership, and to calculate the interim repayments of available cash between partners according to the loss-absorption-capacity method?		

If you answered "no" to any of these questions, it would be in your best interest to revise the relevant section(s) of the study material thoroughly before proceeding to study unit 5.

STUDY UNIT

5

Close corporations

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- briefly discuss the Close Corporations Act in respect of matters concerning the attributes, registration, internal and external relations, accounting records and annual financial statements, joint liability of members and others for certain debts of a close corporation, tax positions of a close corporation and its members, conversion of a private company into a close corporation, as well as the deregistration of a close corporation.
- prepare the financial statements (with the exception of a statement of cash flows) of a close corporation according to the provisions of the Close Corporations Act and the requirements of GAAP. Where applicable, the guidelines as presented in the *Guide on Close Corporations* (as issued by SAICA, December 2001) must be applied.
- journalise the conversion of a private company into a close corporation in the books of the close corporation if the accounting records of the converted company will continue to be used by the close corporation.
- prepare a statement of financial position of a close corporation immediately after its conversion from a private company according to the provisions of the Close Corporations Act and the requirements of GAAP.

Key concepts

- The Close Corporations Act, No 69 of 1984
- Juristic person
- Unlimited existence
- Limited liability
- Member's contribution
- Member's interest
- Accounting officer
- Financial statements
- Profit distribution
- Loan to member
- Loan from member
- Retained earnings
- South African Revenue Service (SARS)
- Profit before tax
- Conversion

5.1 Introduction

In view of the disadvantages of a partnership as a business entity, such as dependent corporate status and restricted capital resources, the close corporation as a form of business entity was introduced when the Close Corporations Act, No 69 of 1984, was legislated. In terms of this Act a business entity, registered as a close corporation, is allowed to acquire independent corporate status and unlimited existence (among others).

Read through paragraph 5.1 of the prescribed textbook for further background on the establishment of close corporations as business entity.

5.2 Attributes, advantages and disadvantages

The attributes, advantages and disadvantages of a close corporation are discussed in detail in the prescribed textbook. Please read through paragraphs 5.2 to 5.4 of the prescribed textbook.

5.3 Prescribed forms and registration

As mentioned in the prescribed textbook certain prescribed forms must be filed with the Registrar of Close Corporations. More information on these forms is given in paragraph 5.5 of the prescribed textbook.

To register a close corporation the requirements of the Close Corporations Act have to be complied with. A CK7 form has to be completed to register the name of the close corporation with the Registrar of Close Corporations after which a founding statement (CK1) has to be completed and submitted to the Registrar for approval. Upon the registration of the founding statement a registration number is allocated to the close corporation concerned.

The registration procedure of a close corporation, and the application of its name and registration number, are discussed thoroughly in paragraphs 5.6 to 5.7 of the prescribed textbook. Read through these paragraphs.

5.4 Membership

The Close Corporations Act sets specific requirements in respect of the number of members that a close corporation may have, and the qualifications for membership. A close corporation may have one or more members, but at no time may the number of members exceed ten. With certain exceptions, only a natural person can become a member of a close corporation. Read more about the legal requirements pertaining to membership in paragraph 5.8 of the prescribed textbook.

5.5 Internal and external relations

The internal relations of a close corporation pertain mainly to the fiduciary relationship of members and their liability in the case of negligent conduct. The minimum legislative requirements exist in respect of the managerial duties of members. Therefore, the members may decide to manage the close corporation within a more formal framework by means of a written association agreement, which may be entered into at any time. Another important aspect that must be taken note of is the fact that the granting of loans and the providing of security to members and others by a close corporation may only take place when certain legislative requirements have been met. Read more about the internal relations of close corporations in paragraph 5.9 of the prescribed textbook.

The external relations of a close corporation pertain mainly to the carrying on of the business thereof. Each member of a close corporation has an equal right to take part in the business of the close corporation, and is considered to be an agent of the close corporation with regard to dealings with the corporation by persons who are not members. Read more about the external relations of close corporations in paragraph 5.10 of the prescribed textbook.

5.6 The tax position of a close corporation and its members

Read through paragraph 5.12 of the prescribed textbook attentively. Please note that you will not be required to calculate the provisional tax or the tax for a financial year of a close corporation. You will only be required to know how provisional tax payments are recorded, and how matters pertaining to tax are disclosed in the financial statements of a close corporation. Such recordings are illustrated in the prescribed textbook as well as in the examples in this study unit.

5.7 Accounting records and financial reporting

The keeping of accounting records and financial reporting in respect of close corporations make up the most important section of this study unit. Read through paragraph 5.13 of the prescribed textbook attentively and take note of the statutory requirements in this regard. Note that in FAC1601 the financial statements of a close corporation are prepared in terms of the provisions of the Close Corporations Act and the requirements of GAAP. Study examples 5.1 and 5.2. Take note of the following:

- A close corporation discloses its normal income tax expense in the statement of comprehensive income.
- The statement of changes in equity, which you studied in the section dealing with the preparation of the financial statements of partnerships, is replaced by a similar statement, namely the statement of changes in net investment of members. Take note of how the outlay of the statement of changes in net investment of members differs from the outlay of statement of changes in equity. Note how the profits of a close corporation can be retained in a retained earnings account, and how the statement of changes in net investment of members does not distinguish between the members as the statement of changes in equity distinguishes between the partners.
- Note how the total equity section of the statement of financial position of a close corporation differs from that of a partnership.

The reason for the above differences in disclosure between a partnership and a close corporation is that a partnership is not a legal entity, whereas a close corporation is.

Study the notes to the financial statements of a close corporation. Notes are also a component of financial statements, and they form an important part of the FAC1601 syllabus with regard to financial reporting.

5.8 Conversion of a private company into a close corporation

In terms of the Close Corporations Act, a private company can be converted into a close corporation or *vice versa.* For the purpose of your studies, you only need to be able to

- explain the provisions of the Close Corporations Act with regard to the conversion of a private company into a close corporation

- journalise the conversion of a private company into a close corporation in the books of the close corporation in the case where the accounting records of the converted company will continue to be used by the close corporation
- prepare a statement of financial position of a close corporation immediately after its conversion from a private company according to the provisions of the Close Corporations Act and the requirements of GAAP

Read about the statutory requirements in respect of conversions in paragraph 5.14.1 of the prescribed textbook, and study the accounting procedures in respect of conversions in paragraph 5.14.2. Pay special attention to example 5.3.

5.9 Deregistration

To round off your studies of close corporations, read more about the deregistration of a close corporation in paragraph 5.15 of the prescribed textbook.

5.10 Exercises and solutions

Work through the following exercises, taking special note of how to make year-end adjustments and how to prepare the financial statements of a close corporation by utilising your knowledge of FAC1501, the Framework, IAS 1 (AC 101), GAAP, the Close Corporations Act and the *Guide on Close Corporations*.

Exercise 5.1

Preparation of the financial statements of a close corporation

Given information

Mr L Left and Mr R Right are the only two members of Centre CC with an equal interest of 50% each. On 30 June 20.2, the end of the financial year, the bookkeeper presented the following trial balance, together with additional information, to you the accounting officer.

CENTRE CC

TRIAL BALANCE AS AT 30 JUNE 20.2

	Debit	Credit
	R	R
Member's contribution: Mr L Left		10 000
Member's contribution: Mr R Right		10 000
Loan to member: Mr L Left (30 June 20.2)	18 000	
Loan to member: Mr R Right (1 July 20.1)	6 000	
Machinery at cost price (30 June 20.2)	51 000	
Accumulated depreciation: Machinery (1 July 20.1)		7 000
Mortgage (1 July 20.1)		40 000
Land and buildings	200 000	
Improvements to buildings (31 January 20.2)	55 000	
Debtors control	16 000	
Telephone expenses	1 260	
Stationery consumed	380	
Petrol	4 000	
Services rendered		382 000
Water and electricity	5 800	
Salary: Mr L Left (paid)	24 000	
Salary: Mr R Right (paid)	36 000	
Remuneration: Accounting officer	12 000	
Deposit: Petrol	1 500	
Retained earnings (1 July 20.1)		9 200
Bank	6 260	
SARS (income tax)	21 000	
	458 200	458 200

Additional information

1 Provision must still be made for depreciation on the machinery at 10% per annum calculated according to the straight-line method. Machinery with a cost price of R16 000 was purchased on 30 September 20.1 and recorded in the books.

2 The members decided to capitalise the improvements to the buildings. Land and buildings consist of Plot 166, Op-die-plek, purchased on 1 August 20.0 for R200 000. No depreciation is provided for on land and buildings.

3 Interest on the mortgage (from T Bank) at 20% per annum must still be taken into account. The interest is payable on 1 July 20.2. The loan was obtained on 1 July 20.1 and is secured by a first mortgage over land and buildings. The loan is repayable on 1 July 20.9.

4 The following accounts were received and were payable at 30 June 20.2:

Telkom, for telephone expenses, R150
Pen & Pencil Stationery, for stationery, R120

These accounts must still be recorded in the books and were not paid timeously.

5 Mr D Down, a debtor of the close corporation, had a balance of R2 500 on his account at 30 June 20.2. This amount has to be written off as irrecoverable.

6 The members decided that as from 1 July 20.1 interest at a rate of 18% per annum will be taken into account on their loan accounts. A new loan of R10 000 was granted to Mr Left at 31 January 20.2. Interest on these loans are capitalised. Both loans are unsecured and immediately callable.

7 The actual income tax for the year amounted to R83 044 and must still be recorded.

8 The members decided to distribute R60 000 of the total comprehensive income of the close corporation, for the year ended 30 June 20.2 equally between them. These amounts will not be paid out in cash but will be left in the close corporation as loans to the corporation. These loans are unsecured and an interest rate of 20% per annum is applicable. It was further decided that 50% of these loans must be repaid on 31 March 20.3. The balances on these accounts are repayable on 31 December 20.9.

9 The members' contributions were paid in full and no additional contributions were made during the year.

REQUIRED

With regard to Centre CC:

(a) Prepare the statement of comprehensive income for the year ended 30 June 20.2.
(b) Prepare the statement of changes in net investment of members for the year ended 30 June 20.2.
(c) Prepare the statement of financial position as at 30 June 20.2.
(d) Prepare the notes for the year ended 30 June 20.2.

Your answer must comply with the provisions of the Close Corporations Act, No 69 of 1984, and the requirements of GAAP. Comparative figures are not required.

NB: Show all calculations.

(a)

CENTRE CC

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.2

	Note	R	
Revenue	2, 5		382 000
Other income			3 270
Interest income: Loans and receivables: Loans to members ①	4	3 270	
			385 270
Administrative and other expenses			(90 910)
Depreciation ②	2.1, 3	4 700	
Telephone expenses R(1 260 + 150)		1 410	
Stationery consumed R(380 + 120)		500	
Petrol		4 000	
Salaries to members	8	60 000	
Remuneration: Accounting officer		12 000	
Credit losses		2 500	
Water and electricity		5 800	
Finance costs			(8 000)
Interest on mortgage ①	5	8 000	
Profit before tax			286 360
Income tax expense			(83 044)
Profit for the year			203 316
Other comprehensive income for the year			—
Total comprehensive income for the year			203 316

Comment

Because there is no cost of sales, there can be no gross profit or any distribution expenses. Remember that this is a service entity and not a retail entity.

(b)

CENTRE CC

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 30 JUNE 20.2

	Members' contributions	Retained earnings	Loans from members	Loans to members	Total
	R	R	R	R	R
Balances at 1 July 20.1	20 000	9 200	—	(14 000)	15 200
Total comprehensive income for the year		203 316			203 316
Distribution to members		(60 000)	60 000		
Loans to members				(13 270)	(13 270)
Balances at 30 June 20.2	20 000	152 516	60 000	(27 270)	205 246
Non-current liability			30 000		
Current liability			30 000		

(c)

CENTRE CC

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.2

	Note	R
ASSETS		
Non-current assets		294 300
Property, plant and equipment	2, 3	294 300
Current assets		48 530
Trade receivables ③	4	13 500
Other financial assets	4	27 270
Cash and cash equivalents	4	7 760
Total assets		342 830
EQUITY AND LIABILITIES		
Total equity		172 516
Members' contributions		20 000
Retained earnings		152 516
Total liabilities		170 314
Non-current liabilities		70 000
Long-term borrowings	5, 7	70 000
Current liabilities		100 314
Trade and other payables ④	5	8 270
Current portion of long-term borrowings	5, 7	30 000
Current tax payable ⑤		62 044
Total equity and liabilities		342 830

(d)

CENTRE CC

NOTES FOR THE YEAR ENDED 30 JUNE 20.2

1. Basis of presentation

The financial statements have been prepared in accordance with Generally Accepted Accounting Practice appropriate to the business of the entity. The annual 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 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 and buildings. Machinery is subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses.

Depreciation on machinery 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:

Machinery: 10% per annum according to the straight-line method.

Depreciation is charged to profit or loss for the year. 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 year.

2.2 Financial assets

Financial assets 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 cost which is fair value plus transaction costs, except for ''Financial assets at fair value through profit or loss'' which are measured at cost, transaction costs excluded.

The entity classifies its financial assets in the following categories: at fair value through profit or loss and loans and receivables. The entity's classification depends on the purpose for which the entity acquired the financial assets.

Cash and cash equivalents are classified as ''Financial assets at fair value through profit or loss''. Cash and cash equivalents consists of cash in bank and short-term deposits.

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 Financial liabilities

Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the purpose for which the financial liabilities were obtained.

2.5 Revenue

Revenue is measured at the fair value of the consideration received or receivable. The revenue is recognised when net income is received for services rendered.

3. Property, plant and equipment

	Land and buildings	Equipment	Total
	R	R	R
Carrying amount at 1 July 20.1	200 000	28 000	228 000
Cost	200 000	35 000	235 000
Accumulated depreciation	—	(7 000)	(7 000)
Additions	55 000	16 000	71 000
Depreciation for the year	—	(4 700)	(4 700)
Carrying amount at 30 June 20.2	255 000	39 300	294 300
Cost	255 000	51 000	306 000
Accumulated depreciation	—	(11 700)	(11 700)

The land and buildings consist of offices on Plot 166, Op-die-plek, and was purchased on 1 August 20.0. The CC has pledged land and buildings with a carrying amount of R255 000 (20.1: R200 000) as security for the mortgage obtained from T Bank.

4. Financial assets

	20.2 R
Current financial assets	
Trade receivables:	
Debtors control ③	13 500
Other financial assets:	
Loans and receivables: Loans to members: The loans are unsecured and carry interest at 18% per annum. The loans are immediately callable.	27 270
Financial assets at fair value through profit or loss:	
Cash and cash equivalents:	7 760
Bank	6 260
Short-term deposit: Petrol	1 500

5. Financial liabilities

	20.2 R
Non-current financial liabilities	
Long-term borrowings:	70 000
Mortgage: The mortgage was acquired from T Bank on 1 July 20.1 at an interest rate of 20% per annum. This loan is secured by a first mortgage over land and buildings (refer to note 3) and is repayable on 1 July 20.9.	
Mortgage	40 000
Current portion of loan	0
Non-current portion	40 000
Loans and receivables: Loans from members: The loans are unsecured and carry interest at 20% per annum. Fifty percent of the loans are repayable on 31 March 20.3 and the remainder on 31 December 20.9.	
Loans from members	60 000
Current portion of loan	(30 000)
Non-current portion	30 000
Current financial liabilities	
Trade and other payables:	8 270
Accrued expenses:	
Interest on long-term loan	8 000
Telephone expenses	150
Stationery	120
Current portion of long-term borrowings: Loans from members	30 000

6. Loans to members

	Mr L Left	Mr R Right	Total
	R	R	R
Balance at 1 July 20.1	8 000	6 000	14 000
Advances during the year	10 000	—	10 000
Repayments during the year	—	—	—
Interest capitalised	2 190	1 080	3 270
Balance at 30 June 20.2	20 190	7 080	27 270

7. **Loans from members**

	Mr L Left	Mr R Right	Total
	R	R	R
Balance at 1 July 20.1	—	—	—
Advances during the year	30 000	30 000	60 000
Repayments during the year	—	—	—
Balance at 30 June 20.2	30 000	30 000	60 000
Current portion	(15 000)	(15 000)	(30 000)
Non-current portion	15 000	15 000	30 000

8. **Transactions with members**

	Mr L Left	Mr R Right	Total
	R	R	R
Salaries	24 000	36 000	60 000
Interest earned on loans to members	(2 190)	(1 080)	(3 270)
	21 810	34 920	56 730

Calculations

① **Interest on loans**

	Mortgage	Loans to members	
		Mr L Left	Mr R Right
	R	R	R
Balance (1 July 20.1)	40 000	8 000	6 000
Interest			
(R40 000 x 20%)	8 000		
(R 6 000 x 18%)			1 080
(R 8 000 x 18%)		1 440	
(R10 000 x $\frac{5}{12}$ x 18%)		750	
Interest expense	8 000		
Interest income		2 190	1 080

R(2 190 + 1 080) = R3 270

② **Depreciation**

	Old Machinery	New Machinery
	R	R
Cost price	35 000	16 000
Depreciation		
(R35 000 x 10%)	(3 500)	
(R16 000 x 10% x $\frac{9}{12}$)		(1 200)
Accumulated depreciation (1 July 20.1)	(7 000)	
Carrying amount (30 June 20.2)	24 500	14 800

③ **Debtors control**

	R
Debtors control: 30 June 20.2	16 000
Credit losses written off	(2 500)
	13 500

④ **Trade and other payables**

The amount on the statement of financial position was calculated as follows:	R
Interest in arrears on long-term loan	8 000
Telephone expenses in arrears	150
Stationery in arrears	120
	8 270

⑤ **Current tax payable**

	R
Income tax expense for the year	83 044
Current tax paid during the year	(21 000)
Current tax payable	62 044

Exercise 5.2

Preparation of the financial statements of a close corporation

Given information

The bookkeeper presented you with the following information relating to Note Book CC for the financial year ended 31 December 20.2:

NOTE BOOK CC

BALANCES AS AT 31 DECEMBER 20.2

	R
Member's contribution: N Note (60%)	120 000
Member's contribution: B Book (40%)	80 000
Land and buildings at cost	560 000
Equipment at cost	40 000
Vehicles at cost	200 000
Accumulated depreciation on equipment (1 January 20.2)	12 000
Accumulated depreciation on vehicles (1 January 20.2)	72 000
Debtors control	35 000
Creditors control	48 000
Bank (Dr)	14 000
Fixed deposit	80 000
Mortgage	320 000
Allowance for credit losses	1 500
Retained earnings (31 December 20.1)	18 000
SARS (income tax) (Dr)	52 000
Loan to N Note	40 000
Loan from B Book	60 000
Sales	670 000
Purchases	210 000
Inventory (1 January 20.2)	30 000
Salaries and wages	96 000
Water and electricity	16 000
Settlement discount granted	1 700
Stationery consumed	2 900
Carriage on purchases	6 500
Telephone and fax expenses	8 200
Insurance expenses	4 000
Maintenance of vehicles	4 400
Credit losses	800

Additional information

1. The inventory on 31 December 20.2 amounted to R42 000.
2. An additional amount of R2 000 must be written off as irrecoverable. The allowance for credit losses must be adjusted to R1 650.
3. The land and buildings consist of a shop and offices on Plot No 157, situated in Mainland, and were purchased on 8 January 20.0 for R560 000. It is the policy of the close corporation not to depreciate land and buildings.

4 Depreciation must be provided for as follows:

Vehicles: 20% per annum according to the diminishing-balance method
Equipment: 10% per annum (fixed) on the cost price

5 All the settlement discounts that were provided for at 31 December 20.1 were claimed. On 31 December 20.2, a trade debtor who owes R1 600 will be entitled to a 10% discount if he settles his account before 15 January 20.3.
6 Provision still has to be made for interest on the fixed deposit at 14% per annum receivable on 1 January of each year. The fixed deposit was made on 1 January 20.2 at Fair Bank for a period of three years.
7 During the financial year an amount of R15 000 was paid to member N Note as remuneration for specialised services rendered to the corporation. This amount was included in salaries and wages.
8 Interest on the mortgage from CT Bank at 12% per annum must still be taken into account. The interest is payable on 2 January 20.3. The loan was obtained on 2 January 20.0 and is secured by a mortgage over land and buildings. The loan is repayable on 2 January 20.9.
9 The loan to member N Note was granted on 1 April 20.0. Interest is calculated at 12% per annum and has to be paid by the member in January. The loan is unsecured and immediately callable.
10 On 1 July 20.2 an amount of R60 000 was borrowed from member B Book. The first repayment of R20 000 will be made on 30 June 20.3 and the remainder on 30 June 20.6. Interest is calculated on 31 December at a rate of 10% per annum and is paid in January. The loan is unsecured.
11 Provision must be made for a distribution of 80% of the total comprehensive income for the financial year to the members.
12 The actual normal income tax for the financial year amounted to R79 515 and must still be recorded.

REQUIRED

With regard to Note Book CC:

(a) Prepare the statement of comprehensive income for the year ended 31 December 20.2.
(b) Prepare the statement of changes in net investment of members for the year ended 31 December 20.2.
(c) Prepare the statement of financial position as at 31 December 20.2.
(d) Prepare the notes for the year ended 31 December 20.2.

Your answer must comply with the provisions of the Close Corporations Act, No 69 of 1984, as well as the requirements of Generally Accepted Accounting Practice. Comparative figures are not required.

NB: Show all calculations.

(a)

NOTE BOOK CC

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.2

	Note	R	
Revenue R(670 000 – 1 860 ⑬)	2		668 140
Cost of Sales			(204 500)
Inventory (1 January 20.2)		30 000	
Purchases		210 000	
Carriage on purchases		6 500	
		246 500	
Inventory (31 December 20.2)		(42 000)	
Gross profit			463 640
Other income			16 000
Interest income: Loans and receivables: Loans to members ①	8	4 800	
Interest income: Loans and receivables: Fixed deposit ②	4	11 200	
			479 640
Distribution, administrative and other expenses			(164 050)
Salaries R(96 000 – 15 000)		81 000	
Salaries to members	8	15 000	
Water and electricity		16 000	
Credit losses ③		2 950	
Depreciation ④	2.1, 3	29 600	
Stationery consumed		2 900	
Telephone and fax expenses		8 200	
Maintenance of vehicles		4 400	
Insurance expenses		4 000	
Finance costs			(41 400)
Interest on mortgage ⑤		38 400	
Interest on loan from member ⑥	8	3 000	
Profit before tax			274 190
Income tax expense			(79 515)
Profit for the year			194 675
Other comprehensive income for the year			—
Total comprehensive income for the year			194 675

(b)

NOTE BOOK CC

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 31 DECEMBER 20.2

	Members' contributions	Retained earnings	Loans from members	Loans to members	Total
	R	R	R	R	R
Balances at 1 January 20.2	200 000	18 000		(40 000)	178 000
Total comprehensive income for the year		194 675			194 675
Distribution to members		(155 740)			(155 740)
Loans from members			60 000		60 000
Balances at 31 December 20.2	200 000	56 935	60 000	(40 000)	276 935
Non-current liability			40 000		
Current liability			20 000		

(c)

NOTE BOOK CC

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.2

	Note	R
ASSETS		
Non-current assets		766 400
Property, plant and equipment	3	686 400
Financial assets	4	80 000
Current assets		143 190
Inventories		42 000
Trade receivables	4	47 190
Other financial assets	4	40 000
Cash and cash equivalents	4	14 000
Total assets		909 590
EQUITY AND LIABILITIES		
Total equity		256 935
Members' contributions		200 000
Retained earnings		56 935
Total liabilities		652 655
Non-current liabilities		360 000
Long-term borrowings ⑧	5, 7	360 000
Current liabilities		292 655
Trade and other payables	5	89 400
Current portion of long-term borrowings ⑨	5, 7	20 000
Distribution to members payable ⑩		155 740
Current tax payable ⑪		27 515
Total equity and liabilities		909 590

(d)

NOTEBOOK CC

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.2

1. Basis of presentation

The financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. 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 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 and buildings. Equipment and vehicles are subsequently measured at historical 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 on the cost price;
Vehicles: 20% per annum according to the diminishing-balance method.

Depreciation is charged to profit or loss for the year. 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 year.

2.2 Financial assets

Financial assets 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 cost which is fair value plus transaction costs, except for "Financial assets at fair value through profit or loss" which is measured at cost, transaction costs excluded.

The entity classifies its financial assets in the following categories: at fair value through profit or loss and loans and receivables. The entity's classification depends on the purpose for which the entity acquired the financial assets.

Cash and cash equivalents are classified as "Financial assets at fair value through profit or loss". Cash and cash equivalents consists of cash in bank.

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 Financial liabilities

Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the purpose for which the financial liabilities were obtained.

2.5 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 settlement discount granted. The entity is not registered as a VAT-vendor. The revenue from sales is recognised when the ownership is transferred to the customer.

3. Property, plant and equipment

	Land and buildings	Vehicles	Equip-ment	Total
	R	R	R	R
Carrying amount at 1 January 20.2	560 000	128 000	28 000	716 000
Cost	560 000	200 000	40 000	800 000
Accumulated depreciation	—	(72 000)	(12 000)	(84 000)
Depreciation for the year	—	(25 600)	(4 000)	(29 600)
Carrying amount at 31 December 20.2	560 000	102 400	24 000	686 400
Cost	560 000	200 000	40 000	800 000
Accumulated depreciation	—	(97 600)	(16 000)	(113 600)

The land and buildings consist of a shop and offices on Plot No 157, Mainland, and were purchased on 8 January 20.0. The CC has pledged land and buildings with a carrying amount of R560 000 (20.1: R560 000) as security for the mortgage from CT Bank.

4. Financial assets

	20.2 R
Non-current financial assets	
Loans and receivables: A fixed deposit was made on 1 January 20.2 for a period of three years at Fair Bank at 14% interest per annum. The deposito is callable at 31 December 20.4.	80 000
Current financial assets	
Trade receivables:	47 190
Debtors control ⑦	32 840
Allowance for credit losses	(1 650)
Accrued income:	
Interest on loan to member	4 800
Interest on fixed deposit	11 200
Other financial assets:	
Loans and receivables: Loans to members: The loans are unsecured and carry interest at 12% per annum. The loans are immediately callable.	40 000
Financial assets at fair value through profit or loss:	
Cash and cash equivalents:	14 000
Bank	14 000

5. Financial liabilities

	20.2 R
Non-current financial liabilities	
Long-term borrowings:	360 000
Mortgage: The mortgage was acquired from T Bank on 1 July 20.1 at an interest rate of 20% per annum. This loan is secured by a first mortgage over land and buildings (refer to note 3) and is repayable on 2 January 20.9.	
Mortgage	320 000
Current portion of loan	0
Non-current portion	320 000
Loans and receivables: Loans from members: The loans are unsecured and carry interest at 10% per annum. R20 000 of the loans are repayable on 30 June 20.3 and the remainder on 30 June 20.9.	
Loans from members	60 000
Current portion of loan	(20 000)
Non-current portion	40 000
Current financial liabilities	
Trade and other payables:	89 400
Creditors control	48 000
Accrued expenses:	
Interest on mortgage	38 400
Interest on loan from member	3 000
Current portion of long-term borrowings: Loans from members	20 000

6. Loans to members

	N Note	B Book	Total
	R	R	R
Balance at 1 January 20.2	40 000	—	40 000
Advances during the year	—	—	—
Repayments during the year	—	—	—
Balance at 31 December 20.2	40 000	—	40 000

7. Loans from members

	N Note	B Book	Total
	R	R	R
Balance at 1 January 20.2	—	—	—
Advances during the year	—	60 000	60 000
Repayments during the year	—	—	—
Balance at 31 December 20.2	—	60 000	60 000
Current portion	—	(20 000)	(20 000)
Non-current portion	—	40 000	40 000

8. Transactions with members

	N Note	B Book	Total
	R	R	R
Salaries	15 000	—	15 000
Interest incurred on loan from member	—	3 000	3 000
Interest earned on loan to member	(4 800)	—	(4 800)
	10 200	3 000	13 200

Calculations

① **Interest on loan to member**

R40 000 x $\frac{12}{100}$
= R4 800

② **Interest on fixed deposit**

R80 000 x $\frac{14}{100}$
= R11 200

③ **Credit losses**

	R
Original amount written off	800
Additional amount written off	2 000
Increase in allowance for credit losses ❶	150
	2 950
❶ New allowance	1 650
Old allowance	(1 500)
Increase in allowance	150

④ **Depreciation**

Vehicles = R (200 000 – 72 000) x 20%
= R128 000 x $\frac{20}{100}$
= R25 600

Equipment = R40 000 x $\frac{10}{100}$
= R4 000

Total = R (25 600 + 4 000) = R29 600

⑤ **Interest on mortgage**

R320 000 x $\frac{12}{100}$
= R38 400

⑥ **Interest on loan from member**

R60 000 x $\frac{10}{100}$ x $\frac{6}{12}$
= R3 000

⑦ **Debtors control**

	R
Balance given	35 000
Additional credit losses written off	(2 000)
Allowance for settlement discount granted (R1 600 x 10%) ⑫	(160)
	32 840

⑧ **Long-term borrowings**

		R
Mortgage		320 000
Loan from B Back	60 000	
Portion to be repaid in 20.3 financial year	(20 000)	40 000
		360 000

⑨ **Current portion of loans from members**

The current portion of loans from members represents that portion of the loan of R60 000 that will be repaid in the 20.3 financial year (refer to calculation ⑧).

⑩ **Distribution to members payable**

R194 675 × $^{80}/_{100}$
= R155 740

⑪ **Current tax payable**

	R
Income tax for the year	79 515
SARS (income tax)	(52 000)
Current tax payable	27 515

⑫ **Allowance for settlement discount granted**

R1 600 × $^{10}/_{100}$
= R160

⑬ **Settlement discount granted**

	R
Settlement discount granted for the year	1 700
Allowance for settlement discount granted ⑫	160
	1 860

Exercise 5.3

Preparation of the annual financial statements of a close corporation

Given information

After the bookkeeper had recorded the transactions during the year, he handed you the following trial balance and additional information with regard to Trade Acc CC.

TRADE ACC CC

TRIAL BALANCE AS AT 31 DECEMBER 20.1

	Debit	Credit
	R	R
Land and buildings at cost	95 000	
Furniture and equipment at cost	33 000	
Vehicles at cost	21 000	
Accumulated depreciation: Furniture and equipment (1 January 20.1)		6 700
Accumulated depreciation: Vehicles (1 January 20.1)		8 400
Inventory (31 December 20.0)	54 600	
Mortgage		50 000
Debtors control	20 500	
Allowance for credit losses (31 December 20.0)		955
Bank	24 000	
Creditors control		37 100
SARS (income tax)	6 900	
Sales		321 300
Purchases	224 700	
Import duty on purchases	1 550	
Railage on purchases	2 500	
Repairs and maintenance	1 315	
Assessment rates	1 710	
Commission on sales	1 500	
Delivery expenses	650	
Settlement discount granted	1 350	
Salaries and wages	36 615	
Stationery consumed	520	
Credit losses	460	
Loss on sale of equipment	220	
Insurance expenses	475	
Water and electricity	2 100	
Dividends received		450
Settlement discount received		1 000
Investment	10 000	
Loan from member: A Adam		10 000
Loan from member: C Charles		8 000
Interest expenses (iro loans)	9 660	
Member's contribution: A Adam		40 000
Member's contribution: B Ben		35 000
Member's contribution: C Charles		25 000
Retained earnings (31 December 20.0)		6 220
Forfeited settlement discount granted		200
	550 325	550 325

Additional information

1. The interest of the members in the CC is in the same ratio as their contributions.
2. The land and buildings consist of a shop and offices on Plot No 32, situated in Dorpshuis, and were purchased on 15 March 20.0 for R95 000. It is the policy of the close corporation not to depreciate land and buildings.
3. The investment in Vicks Limited consists of 10 000 ordinary shares of R1 each and was acquired in 20.0. On 31 December 20.0 the fair value of the investment was determined at R10 000. On 31 December 20.1 the fair value was determined at R11 000 and is still to be recorded.
4. Included in salaries and wages is an amount of R10 000 which was paid to member B Ben as remuneration for his special contribution to the management of the enterprise.
5. Provision for depreciation of R1 650 on furniture and equipment and R2 100 on vehicles must still be made.
6. The interest paid includes R2 160, which represents 12% interest paid to A Adam and C Charles in respect of the loans they made to the close corporation. The loans are unsecured and are repayable on 31 December 20.5.
7. The mortgage was acquired on 2 January 20.1 from Bug Bank at 15% interest per annum. Interest is payable on 31 December. The loan is secured by a first mortgage over land and buildings and is repayable in five equal annual installments as from 2 January 20.4.
8. The allowance for credit losses must be adjusted to R1 025.
9. On 31 December 20.1 the inventory on hand amounted to R58 300.
10. The actual normal income tax in respect of the financial year amounted to R11 166 and must still be recorded.
11. A distribution of income of R20 000 must be made to the members.
12. On 31 December 20.1 a trade debtor who owes R1 500 is entitled to a 5% discount provided he settles his account before 10 January 20.2.
13. Trade Acc CC was offered a discount of 6% on an amount of R 1 200 owing to a supplier provided the supplier is paid before 15 January 20.2. The close corporation intends taking advantage of the discount offered.

REQUIRED

With regard to Trade Acc CC:

(a) Prepare the statement of comprehensive income for the year ended 31 December 20.1.
(b) Prepare the statement of changes in net investment of members for the year ended 31 December 20.1.
(c) Prepare the statement of financial position as at 31 December 20.1.
(d) Prepare the notes for the year ended 31 December 20.1.

Your answer must comply with the provisions of the Close Corporations Act, No 69 of 1984, as well as the requirements of Generally Accepted Accounting Practice. Comparative figures are not required.

NB: Show all calculations.

(a)

TRADE ACC CC

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.1

	Note		R
Revenue R(321 300 – 1 425①+ 200)	2		320 075
Cost of sales			(223 978)
Inventory (1 January 20.1)		54 600	
Purchases R(224 700 – 1 072③)		223 628	
Import duty		1 550	
Railage on purchases		2 500	
		282 278	
Inventory (31 December 20.1)		(58 300)	
Gross profit			96 097
Other income			1 450
Dividend income: Financial assets at fair value through profit or loss: Held for trading: Listed investment		450	
Gain on financial assets at fair value through profit or loss: Held for trading: Listed investment		1 000	
			97 547
Distribution, administrative and other expenses			(49 385)
Repairs and maintenance		1 315	
Assessment rates		1 710	
Commission on sales		1 500	
Delivery expenses		650	
Salaries and wages R(36 615 – 10 000)		26 615	
Salary to member	7	10 000	
Stationery consumed		520	
Credit losses ⑤		530	
Loss on sale of equipment		220	
Insurance expenses		475	
Water and electricity		2 100	
Depreciation ⑥	2.1, 3	3 750	
Finance costs			(9 660)
Interest on mortgage	5	7 500	
Interest on loans from members	5, 7	2 160	
Profit before tax			38 502
Income tax expense			(11 166)
Profit for the year			27 336
Other comprehensive income for the year			—
Total comprehensive income for the year			27 336

(b)

TRADE ACC CC

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 31 DECEMBER 20.1

	Members' contributions	**Retained earnings**	**Loans from members**	**Total**
	R	**R**	**R**	**R**
Balances at 1 January 20.1	100 000	6 220	18 000	124 220
Total comprehensive income for the year		27 336		27 336
Distribution to members		(20 000)		(20 000)
Balances at 31 December 20.1	100 000	13 556	18 000	131 556

(c)

TRADE ACC CC

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.1

	Note	**R**
ASSETS		
Non-current assets		130 150
Property, plant and equipment	3	130 150
Current assets		112 700
Inventories		58 300
Trade receivables 7	4	19 400
Other financial assets	4	11 000
Cash and cash equivalents	4	24 000
Total assets		242 850
EQUITY AND LIABILITIES		
Total equity		113 556
Members' contributions		100 000
Retained earnings		13 556
Total liabilities		129 294
Non-current liabilities		68 000
Long-term borrowings	5, 6	68 000
Current liabilities		61 294
Trade and other payables 8	5	37 028
Distribution to members payable		20 000
Current tax payable 9		4 266
Total equity and liabilities		242 850

(d)

TRADE ACC CC

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.1

1. Basis of presentation

The financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. The financial statements have been prepared on the historical cost basis, modified by the revaluation of financial asssets and financial liabilities at fair value through profit or loss.

2. Summary of significant accounting policies

The 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 and buildings. Vehicles and furniture and equipment are subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses.

Depreciation on vehicles and furniture and equipment 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 is as follows:

Vehicles: Over a period of 10 years at R2 100 per annum. There is no scrap (residual) value anticipated.

Furniture and equipment: Over a period of 20 years at R1 650 per annum. There is no scrap value anticipated.

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

2.2 Financial assets

Financial assets 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 cost which is fair value plus transaction costs, except for ''Financial assets at fair value through profit or loss'' which are measured at cost, transaction costs excluded.

The entity classifies its financial assets in the following categories: at fair value through profit or loss and loans and receivables. The entity's classification depends on the purpose for which the entity acquired the financial assets.

Cash and cash equivalents are classified as ''Financial assets at fair value through profit or loss''. Cash and cash equivalents consists of cash in bank.

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 Financial liabilities

Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the purpose for which the financial liabilities were obtained.

2.5 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 settlement discount granted. The entity is not registered as a VAT vendor. The revenue from sales is recognised when the ownership is transferred to the customer.

3. Property, plant and equipment

	Land and buildings	Furniture and equipment	Vehicles	Total
	R	R	R	R
Carrying amount at 31 January 20.1	95 000	26 300	12 600	133 900
Cost	95 000	33 000	21 000	149 000
Accumulated depreciation	—	(6 700)	(8 400)	(15 100)
Depreciation for the year	—	(1 650)	(2 100)	(3 750)
Carrying amount at 31 December 20.1	95 000	24 650	10 500	130 150
Cost	95 000	33 000	21 000	149 000
Accumulated depreciation	—	(8 350)	(10 500)	(18 850)

The land and buildings consist of a shop and offices on Plot No 32, Dorpshuis, and were purchased on 15 March 20.0. The CC has pledged land and buildings with a carrying amount of R95 000 (20.0: R95 000) as security for the mortgage from Bug Bank.

4. Financial assets

	20.1 R
Current financial assets	
Trade receivables:	19 400
Debtors control	20 425
Allowance for credit losses	(1 025)
Other financial assets:	
Financial assets at fair value through profit or loss:	
Held for trading: Listed investment: 10 000, R1 ordinary shares in Vicks Limited	11 000
Cash and cash equivalents:	24 000
Bank	24 000

5. Financial liabilities

	20.1 R
Non-current financial liabilities	
Long-term borrowings:	68 000
Mortgage: The mortgage was acquired from Bug Bank on 2 January 20.1 at an interest rate of 15% per annum. The loan is repayable in five equal annual instalments as from 2 January 20.4. This loan is secured by a first mortgage over land and buildings.	
Mortgage	50 000
Current portion of loan	0
Non-current portion	50 000
Loans and receivables: Loans from members: The loans are unsecured and carry interest at 12% per annum. The loans are repayable on 31 December 20.5	
Loans from members	18 000
Current portion of loan	0
Non-current portion	18 000
Current financial liabilities	
Trade and other payables:	37 028
Creditors control	37 028

6. Loans from members

	A Adam	B Ben	C Charles	Total
	R	R	R	R
Balance at 1 January 20.1	10 000	—	8 000	18 000
Advances during the year	—	—	—	—
Repayments during the year	—	—	—	—
Balance at 31 December 20.1	10 000	—	8 000	18 000

7. Transactions with members

	A Adam	B Ben	C Charles	Total
	R	R	R	R
Interest on loans from members	1 200	—	960	2 160
Salaries	—	10 000	—	10 000
	1 200	10 000	960	12 160

Calculations

① **Settlement discount granted**

	R
Settlement discount granted for the period	1 350
Allowance for settlement discount granted ②	75
	1 425

② **Allowance for settlement discount granted**

$R1\ 500 \times \frac{5}{100}$
$= R75$

③ **Settlement discount received**

	R
Settlement discount received for the period	1 000
Allowance for settlement discount received ④	72
	1 072

④ **Allowance for settlement discount received**

$R1\ 200 \times \frac{6}{100}$
$= R72$

⑤ **Credit losses**

R[460 + (1 025 − 955)]
= R(460 + 70)
= R530

⑥ **Depreciation**

R(1 650 + 2 100)
= R3 750

⑦ **Trade receivables**

	R
Debtors control	20 500
Allowance for settlement discount granted ②	(75)
	20 425
Allowance for credit losses	(1 025)
	19 400

⑧ **Trade and other payables**

	R
Creditors control	37 100
Allowance for settlement discount received	(72)
	37 028

⑨ **Current tax payable**

	R
Income tax for the year	11 166
Current tax paid during the year	(6 900)
Current tax payable	4 266

Exercise 5.4

Preparation of the financial statements of a close corporation

Given information

The bookkeeper has provided you with the following trial balance and additional information with regards to Loga CC for the year ended 28 February 20.4:

LOGA CC

TRIAL BALANCE AS AT 28 FEBRUARY 20.4

	Debit	Credit
	R	**R**
Member's contribution: L Lock		72 000
Member's contribution: G Gate		65 000
Vehicles at cost	54 000	
Equipment at cost	18 000	
Inventories (28 February 20.4)	172 080	
Debtors control	50 184	
Creditors control		83 304
Loan to G Gate	12 000	
Investment (fixed deposit at ABC bank)	25 000	
Bank	6 956	
Accumulated depreciation: Equipment (1 March 20.3)		3 600
Sales		1 168 236
Cost of Sales	778 812	
Retained earnings (28 February 20.3)		6 420
Rental expenses	14 400	
Advertising expense	4 800	
Salaries and wages	168 020	
Water and electricity	8 640	
Telephone expenses	2 160	
Income from investment		1 500
Credit losses	540	
Administrative expenses	2 868	
Remuneration: Accounting officer	4 320	
SARS (income tax)	30 000	
Interim profit distribution to members	48 000	
Interest income		720
	1 400 780	1 400 780

Additional information

1 A debtor cannot be traced and his debt of R184 must be written off as irrecoverable. The members decided to create an allowance for credit losses of R1 000.
2 The electricity account for February, R785, was received on 20 March 20.4.
3 On 1 June 20.3 an insurance contract was entered into. The premium of R800, payable annually on 1 June, is included in administrative expenses.
4 The loan to G Gate was made on 1 March 20.3 at 12% interest per annum, payable every six months. The loan is unsecured and immediately callable.
5 Included in salaries and wages is an amount of R20 000, paid to L Lock as remuneration for his special contribution to the management of the enterprise.

6 The investment in ABC Bank was made on 1 May 20.3 for 60 months at 12% interest per annum, which is receivable every six months on 31 October and 30 April.

7 Provision must still be made for the following:

- Depreciation on the vehicle and equipment at 20% per annum on the diminished balance. The vehicle was acquired on 1 September 20.3.
- Actual normal income tax for the financial year amounted to R51 494.
- An additional distribution to members of R36 000. Members share profits equally.

REQUIRED

With regard to Loga CC:

(a) Prepare the statement of comprehensive income for the year ended 28 February 20.4.
(b) Prepare the statement of changes in net investment of members for the year ended 28 February 20.4.
(c) Prepare the statement of financial position as at 28 February 20.4.
(d) Prepare only the following notes for the year ended 28 February 20.4:

- accounting policy
- property, plant and equipment
- transactions with members

Your answer must comply with the provisions of the Close Corporations Act, No 69 of 1984, as well as the requirements of Generally Accepted Accounting Practice. Comparative figures are not required.

NB: Show all calculations.

(a)

LOGA CC

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 20.4

	Note	R
Revenue	2	1 168 236
Cost of sales		(778 812)
Gross profit		389 424
Other income		3 940
Interest income: Loans and receivables: Loans to members ①		1 440
Interest income: Loans and receivables: Fixed deposit ②		2 500
		393 364
Distribution, administrative and other expenses		(215 797)
Rental expenses		14 400
Advertising expense		4 800
Salaries and wages R(168 020 – 20 000)		148 020
Salary to member	4	20 000
Water and electricity ③		9 425
Telephone expenses		2 160
Credit losses ④		1 724
Administrative expenses ⑤		2 068
Insurance expense ⑥		600
Remuneration: Accounting officer		4 320
Depreciation ⑦	3	8 280
Profit before tax		177 567
Income tax expense		(51 494)
Profit for the year		126 073
Other comprehensive income for the year		—
Total comprehensive income for the year		126 073

(b)

LOGA CC

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 28 FEBRUARY 20.5

	Members' contributions	Retained earnings	Loans to members	Total
	R	R	R	R
Balances at 1 March 20.3	137 000	6 420	(12 000)	131 420
Total comprehensive income for the year		126 073		126 073
Distribution to members ⑫		(84 000)		(84 000)
Balances at 28 February 20.4	137 000	48 493	(12 000)	173 493

(c)

LOGA CC

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20.4

	Note	R
ASSETS		
Non-current assets		85 120
Property, plant and equipment	3	60 120
Financial assets		25 000
Current assets		241 956
Inventories		172 080
Trade receivables ⑧		50 720
Prepayments ⑨		200
Other financial assets		12 000
Cash and cash equivalents		6 956
Total assets		327 076
EQUITY AND LIABILITIES		
Total equity		185 493
Members' contributions		137 000
Retained earnings		48 493
Total liabilities		141 583
Current liabilities		141 583
Trade and other payables ⑩		84 089
Distribution to members payable ⑫		36 000
Current tax payable ⑪		21 494
Total equity and liabilities		327 076

(d)

LOGA CC

NOTES FOR THE YEAR ENDED 28 FEBRUARY 20.4

1. Basis of presentation

The financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. 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 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. Equipment and vehicles are subsequently measured at historical 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: 20% per annum according to the diminishing-balance method;
Vehicles: 20% per annum according to the diminishing-balance method.

Depreciation is charged to profit or loss for the year. 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 year.

2.2 Financial assets

Financial assets 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 cost which is fair value plus transaction costs, except for "Financial assets at fair value through profit or loss" which is measured at cost, transaction costs excluded.

The entity classifies its financial assets in the following categories: at fair value through profit or loss and loans and receivables. The entity's classification depends on the purpose for which the entity acquired the financial assets.

Cash and cash equivalents are classified as "Financial assets at fair value through profit or loss". Cash and cash equivalents consists of cash in bank.

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 Financial liabilities

Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the purpose for which the financial liabilities were obtained.

2.5 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 the ownership is transferred to the customer.

3. Property, plant and equipment

	Equipment	Vehicles	Total
	R	R	R
Carrying amount at 1 March 20.3	14 400	—	14 400
Cost	18 000	—	18 000
Accumulated depreciation	(3 600)	—	(3 600)
Additions	—	54 000	54 000
Depreciation for the year	(2 880)	(5 400)	(8 280)
Carrying amount at 28 February 20.4	11 520	48 600	60 120
Cost	18 000	54 000	72 000
Accumulated depreciation	(6 480)	(5 400)	(11 880)

4. Transactions with members

	L Lock	G Gate	Total
	R	R	R
Salary	20 000	—	20 000
Interest on loan to member	—	(1 440)	(1 440)
	20 000	(1 440)	18 560

Calculations

① **Interest on loan to member**

R12 000 x 12% = R1 440

② **Interest on investment**

R25 000 x 12% x $^{10}/_{12}$ = R2 500

③ **Water and electricity**

R (8 640 + 785)
R9 425

④ **Credit losses**

	R
Original amount written off	540
Further amount written off	184
Allowance for credit losses	1 000
	1 724

⑤ **Administrative expenses**

R(2 868 – 800) (R800 = insurance premium)
= R2 068

⑥ **Insurance**

The R800 was paid for a period of one year starting on 1 June 20.3. Only 9 months of this period falls within the current financial year. Therefore only R800 x 9/12 = R600 of the expense was incurred during the current financial year. The R200 that falls outside this financial period must be shown in the statement of financial position as a prepayment for the next financial period.

⑦ **Depreciation**

	R
Equipment	18 000
Accumulated depreciation	(3 600)
Diminished balance (carrying amount)	14 400

14 400 x 20% = R2 880

Vehicle
R54 000 x 20% x 6/12
= R5 400

Total = R(2 880 + 5 400) = R8 280

⑧ **Trade receivables**

	R
Debtors control	50 000
Allowance for credit losses	(1 000)
	49 000
Accrued interest on loan to member R(1 440 – 720)	720
Accrued interest on investment R(2 500 – 1 500)	1 000
	50 720

⑨ **Prepayments**

Prepayments represent insurance prepaid (refer to ⑥)	R200

⑩ **Trade and other payables**

	R
Creditors control	83 304
Accrued expenses (water and electricity)	785
	84 089

⑪ **Current tax payable**

	R
Income tax for the year	51 494
SARS: Income tax paid during the year	(30 000)
Current tax payable	21 494

⑫ **Distribution to members payable**

	R
Distribution to members R(48 000 + 36 000)	84 000
Interim distribution paid to members	(48 000)
	36 000

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• briefly discuss the Close Corporations Act in respect of matters concerning the attributes, registration, internal and external relations, accounting records and annual financial statements, joint liability of members and others for certain debts of a close corporation, tax position of a close corporation and its members, conversion of a private company into a close corporation, as well as the deregistration of a close corporation?		
• prepare the financial statements (with the exception of a statement of cash flows) of a close corporation according to the provisions of the Close Corporations Act and the requirements of GAAP and, where applicable, the guidelines as presented in the *Guide on Close Corporations* (as issued by SAICA, December 2001)?		
• journalise the conversion of a private company into a close corporation in the books of the close corporation in the case where the accounting records of the converted company will continue to be used by the close corporation?		
• prepare a statement of financial position of a close corporation immediately after its conversion from a private company according to the provisions of the Close Corporations Act and the requirements of GAAP?		

If you answered "yes" to all of the above assessment criteria, you have completed your studies on close corporations and can move on to study unit 6. If you answered "no" to any of the above criteria, you must revise that section before progressing to the next study unit.

You have now completed your studies on close corporations. Do you think that you would prefer to establish a partnership if you had the opportunity or establish a close corporation instead?

STUDY UNIT

6

Introduction to companies

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- distinguish between authorised and issued share capital
- distinguish between par value and no par value shares
- explain what a share premium is and the application of the share premium account
- distinguish between ordinary shares and preference share
- record transactions pertaining to the issue of shares
- prepare an allotment schedule
- record the issue of capitalisation shares
- record the underwriting of shares

- explain dividends and the calculation thereof
- record dividend transactions
- record transactions pertaining to the issue of debentures
- calculate and record interest on debentures

Key concepts

- Companies Act
- Public company
- Private company
- Shareholders
- Authorised share capital
- Issued share capital
- Par value shares
- No par value shares
- Share premium
- Share capital account
- Stated capital account
- Ordinary shares
- Preference shares
- Capitalisation shares
- Underwriting share issues
- Interim dividends
- Final dividends
- Debenture issue
- Debenture interest

6.1 Introduction

Sole traders, partners of partnerships and members of close corporations provide their own capital or borrow money from financial institutions to finance their businesses with. Such financing methods are limited, and therefore entities that need large sums of money, such as mines, establish public companies in order to issue shares to the public so as to increase their financing resources.

Companies came into existence during the Industrial Revolution to meet the following needs:

- to acquire more capital
- to ensure the continued existence of the entity
- to limit the financial liability of the owners

To help you learn more about the way companies work, a theoretical background on companies is given in chapter 6 of the prescribed textbook. We do not expect of you to memorise the theory as there will be no theoretical questions in the examination. However, you will have to apply certain of the theoretical aspects when you are required to prepare practical questions, such as the recording of transactions that pertain to the issue of shares, preparing allotment schedules, calculating and recording dividends, etc. In general, a company can be described as an association of persons who work together with the aim of making a profit. You can read more about the characteristics of companies as a form of business ownership and the differences between sole traders, partnerships, close corporations and companies in paragraphs 6.1 and 6.2 of the prescribed textbook.

6.2 Formation of a company

A company is established by complying with specific legal requirements. The first step in the process of establishing a company is to apply for the registration of its proposed name by the Registrar of Companies. Once the name has been approved, the memorandum of association, the articles of association and other prescribed forms and declarations must be submitted to and approved by the Registrar. Read paragraph 6.3 of the prescribed textbook to acquaint yourself with further details pertaining to the procedure that must be followed to register a company, and with regard to the information that must be disclosed in the required documents.

The main reason behind the formation of a company usually determines the type of company that will be established. If the aim of the company is to make a profit, a private or a public company can be formed. You can read more about the different types of companies in paragraph 6.4 of the prescribed textbook.

After a company has been registered by the Registrar, it can start trading.

6.3 Shareholders and the rights of shareholders

To enable members of the public, who generally have limited financial resources available for investment, to invest in a large business enterprise such as a public company, the capital of a company is divided into more affordable units, called shares. Shares of public companies are traded on securities (stock) exchanges. Share prices fluctuate according to supply and demand. The supply and demand of shares are determined by various factors, such as the financial performance of a company, the future prospects in the marketplace, legislation, etc. The financial statements of a company should be meticulously analysed when choosing a company to invest in. The riskier the investment, the higher the proceeds on the investment usually are because of the high degree of uncertainty involved in an estimate of future business performance. An investment in a company is usually perceived as an investment with a relatively high risk.

Prospective investors in companies are usually advised not to fund their investments with money that they cannot afford to risk. The analyses of financial statements are complex, and the general public usually do not have the knowledge to perform such analyses. For this reason, a prospective buyer of shares may prefer to make use of the services of a financial analyst in order to decide which company to invest in and how much money to risk.

The shareholders of a company may share in the profits of the company, and under certain circumstances they have voting rights in relation to the number of shares that they have purchased. For instance, ordinary shareholders may vote on the directors to be appointed in the company.

Since a company is regarded as a legal person, the trading of shares, which changes the ownership of a company, will not influence the continued existence of the company, as is the case with a sole trader or a partnership. You can read more about shareholders and their rights in paragraphs 6.5 and 6.6 of the prescribed textbook.

6.4 Share transactions

To enable a company to attract the public as investors, it issues a prospectus. A prospectus must contain a reasonable representation of the affairs of the company and it must comply with certain requirements prescribed by the Companies Act 61 of 1973, as amended (hereafter referred to as the Companies Act). Read more about the prospectus and how shareholders obtain proof of their shareholdings in a company in paragraph 6.7.1 of the prescribed textbook.

6.4.1 Authorised and issued share capital

The founders of a company will, as part of their preparation for the establishment of the company, estimate how much money is required to expand the company to its maximum potential. The Registrar must approve the maximum amount of money that may be obtained from shareholders by means of issuing shares. Such approved amounts of shares are referred to as the authorised share capital of a company. A company must disclose its authorised share capital in its memorandum of association. The authorised shares are issued, that is sold to the shareholders, according to the financial needs of the company. All of the authorised shares do not have to be issued immediately. The shares which are sold to the public represent the issued share capital of a company. The monetary value of the issued share capital is used in the calculation of the total equity that is disclosed in the statement of financial position.

Read through paragraphs 6.7.2 and 6.7.3 of the prescribed textbook attentively.

6.4.2 Par value and no par value shares and share premium

A par value (PV) share has a nominal value assigned to it. For instance, an ordinary share may have a par value of R1. Such a share will be referred to as an ordinary share of R1. When par value shares are sold for a higher price than the par value thereof, the difference between the selling price and the par value is referred to as a share premium. When par value shares are sold at less than the par value thereof, the difference is referred to as a discount. Ordinarily, par value shares are not sold at a discount.

If shares do not have a nominal value assigned to them, they are referred to as a no par value (NPV) shares. A no par value share will simply be referred to as an ordinary share. Since a no par value share does not have a par value, no difference can be calculated between the selling price and a predetermined value of the share. A no par value share can thus not be issued at par, a premium or a discount.

Read through paragraphs 6.7.4 and 6.7.5 of the prescribed textbook attentively.

6.4.3 Classes of shares

Companies usually distinguish between two main classes of shares, namely ordinary and preference shares. The ordinary shareholders are in effect the owners of the company and usually have more rights than the preference shareholders. Preference shares can be classified as either ordinary preference shares, cumulative preference shares, non-cumulative preference shares, participating preference shares or redeemable preference shares.

Read through paragraphs 6.7.6, 6.7.6.1 and 6.7.6.2 of the prescribed textbook attentively.

6.5 The issue of shares

The reason for the registration of a public or private company is that the founders thereof are of the opinion that the company will be a successful and sustainable business. For this reason, the first issue of share is usually made to the founders of the company. However, public companies usually obtain the greater part of their capital by inviting the public to buy shares in the company by issuing a prospectus.

Read more about the general aspects on the issuing of shares in paragraph 6.7.7.1 of the prescribed textbook.

6.5.1 Recording the issue of shares

When a prospective investor wants to buy shares in a company, an application form must be completed and the money for the number of shares applied for must accompany the application form. A company may not issue or even allocate any shares unless the full issue price (selling price) has been received by the company. Since a company can only allocate the number of shares it offered, the shares will have to be allotted according to a predetermined formula if more applications have been received than the number of shares advertised (offered) in the prospectus. The money received from the unsuccessful applicants must be refunded to them.

The prospectus must indicate the last date on which applications for the purchase of shares will be considered for acceptance. Since the applications are received over a period of time, the money that accompanies the applications must, for security reasons, be banked in the name of the company. Because the company does not know how many applications will be received by the closing date, the money received must be recorded in an interim account before it can be recorded as capital in the books of the company. Once the shares have been allotted, the interim accounts are closed off by recording the issued capital or by recording the repayment of funds to unsuccessful applicants.

The accounts used to record the applications received from the founders of the company are different from the accounts used to record the applications received from the public. Because shares may only be allocated and issued after the full issue price has been received by the company, the money received will be recorded in the cash receipts journal (CRJ).

From the CRJ money received from the founders will be

- debited to the *bank* account and
- credited to the *subscribers to the memorandum: Ordinary shares account*

From the CRJ money received from the public will be

- debited to the *bank* account and
- credited the *application and allotment: Ordinary shares account.*

If ordinary and preference shares are issued simultaneously, separate accounts must be opened for the subscribers to the memorandum, and for the application and allotment of ordinary and preference shares.

Read paragraph 6.7.7.2 of the prescribed textbook attentively, and study examples 6.1, 6.2 and 6.3.

Pay special attention to the following:

- Where *par value shares* are issued, the subscribers to the memorandum and the application and allotment accounts must be closed off to the *share capital* account.
- Only par value shares can be issued at a premium. Premiums are recorded in a share premium account.
- Where *no par value* shares are issued, the subscribers to the memorandum, and the application and allotment accounts must be closed off to a *stated capital* account.

6.5.2 Schedule for the allotment of shares

When more applications have been received than the share offering, it becomes necessary to make use of a formula to allocate the shares in an objective manner. This is referred to as the allotment of shares. Read paragraph 6.7.8 of the prescribed textbook and study example 6.4.

6.6 Conversion of shares

Under certain circumstances companies are allowed to convert shares from par value to no par value shares or *vice versa.* A company that had registered shares at a par value of R1 each at its incorporation, say a few years ago, may find that its shares are currently trading well above par. When deciding to issue more of the authorised shares, the shares may be converted into no par value shares prior to the share offering. These shares, when issued, will be recorded as stated capital. Since companies are not permitted to have a combination of shares of the same class at par and no par value, any shares of the same class that were first issued as par value shares must also be recorded as stated capital when the same class of shares is converted to NPV shares at a later stage. Such a conversion is recorded by transferring the balances on the applicable share capital and share premium accounts to a stated capital account. Read paragraphs 6.7.9, 6.7.9.1 and 6.7.9.2 of the prescribed textbook attentively and study examples 6.5 and 6.6.

6.7 Issue of capitalisation shares

Occasionally companies retain income for future use. The ''Retained income'' can be used to pay dividends, but the payment of dividends can adversely affect the cash position of a company. However, the retained earnings can be capitalised by distributing them among the shareholders in the form of capitalisation shares. No cash is paid out, but each shareholder receives his rightful share of the retained earnings in the form of additional shares given to him as a bonus. The shares are issued in the same proportion as the existing shareholding and the recording of such share issues requires only a book entry which converts the retained earnings into share capital. The share premium can also be used for the issue of capitalisation shares.

Read paragraph 6.7.10 of the prescribed textbook attentively, and study examples 6.7 and 6.8.

6.8 Underwriting of shares

When a company offers shares, they would normally avail themselves of the services of a financial institution to underwrite the offering. An underwriter guarantees that if the whole issue of shares is not taken up by the public, the financial institution will itself take up all of the shares that were not subscribed. For furnishing a guarantee to a company that the whole offering of shares will be taken up, the underwriter receives a commission. The commission is calculated on the total value of the shares underwritten, irrespective of whether the underwriter has personally taken up some of the shares.

Read paragraph 6.7.11 of the prescribed textbook attentively and study example 6.9.

6.9 Dividends

One of the reasons why a shareholder invests his money in a company is to share in the growth and profits thereof. If a company has made a significant profit and the directors are satisfied that the cash flow position of the company can bear both in growth and its dividend declarations, they may decide to declare dividends. Dividends on ordinary shares are calculated per share, whereas dividends on preference shares are calculated on the monetary value thereof. Dividends need not necessarily be paid out in cash. Capitalisation shares, as discussed in paragraph 6.7 of the prescribed textbook, can be issued instead of paying dividends in cash to shareholders.

Read more about dividends in paragraph 6.8.1 of the prescribed textbook.

6.9.1 Preference dividends

If dividends are declared on preference shares, a preference shareholder will receive a fixed dividend on his share. Such a fixed dividend is disclosed as a percentage in the description of the share, for example, a 10% preference share. Preference shareholders therefore know in advance what the amount of dividends would be that they would receive if dividends were declared.

With preference shares, the calculation of dividends is done on the same basis as the calculation of interest, taking the period that the shares are in the possession of the shareholder into account.

Read paragraph 6.8.2 of the prescribed textbook attentively, taking special note of how dividends are calculated on preference shares.

6.9.2 Ordinary dividends

No surety is given by a company to an ordinary shareholder about whether dividends are going to be declared, or what the dividend per share will be. Dividends may not be declared on ordinary shares if dividends on preference shares have not been declared. The risk attached to the investment in a preference share is therefore less than the risk attached to the investment in an ordinary share. For this reason, ordinary shareholders have more rights than the preference shareholders with regard to participating in certain of the business activities of a company.

Read paragraph 6.8.3 of the prescribed textbook attentively, taking special note of how dividends are calculated on ordinary shares.

6.9.3 Interim, final and annual dividends

An interim dividend is usually declared during the financial year when the interim financial results of the company are favourable, such as when the interim results exceed the expected norm. To determine the annual dividends declared, the interim dividends are added to the final dividends which are declared at the end of a financial year. If a company did not declare interim dividends, the dividends declared at the end of the financial year will be equal to the annual dividends declared.

Read paragraph 6.8.4 of the prescribed textbook, and study examples 6.10 and the comprehensive example 6.15.

6.10 Debenture transactions

A company can, apart from acquiring capital from the public, also borrow money from the public by issuing debentures. Debentures are, like shares, divided into affordable units that enable the public to lend money to a company at a fixed interest rate. The interest on debentures is a financing expense and must be paid, irrespective of whether a company is making a profit. A dividend, on the other hand, is usually only declared if a company is making a profit and, even if a profit has been made, the directors are under no obligation to declare a dividend.

Debentures do not form part of the equity of a company, but are classified as non-current liabilities, if repayable after the end of the next 12-month period or as a current liability if repayable within or up to the end of the next 12-month period.

Read more about debentures in paragraph 6.9.1 of the prescribed textbook.

6.10.1 Types of debentures

Different types of debentures exist, depending on the rights attached to them. Read about the different types of debentures in paragraph 6.9.2 of the prescribed textbook.

6.10.2 The issue of debentures

Debentures have a nominal value, which indicates the face value of a single debenture unit. The nominal value is not necessarily the same as the issue price of the debentures. The prevailing market interest rate usually has an influence on the price of a debenture. One example of a method of calculating the prevailing market rate is to take the interest rate paid by a bank for an investment of the same value invested for the same period, and the risk of buying debentures in a specific company, into account.

If the interest rate offered by the company on the debentures that it wants to issue is the same as the prevailing market rate, the debentures will be issued at the nominal (face) value thereof. If the interest rate on the issued debentures, referred to as the nominal interest rate, is higher than the current market interest rate on the date of the issue, the debentures will be issued at a premium. For example, if the nominal value of a debenture is R100, and the debenture was sold for say R105, the debenture was sold at a premium. As in the case of par value shares that were sold at a premium, the R5 will be recorded and disclosed as a premium on the issue of debentures. The premium on debentures must, however, be "written off" over the borrowing period of the debentures. In accounting terms, we refer to the writing off of the premium on debentures as the amortisation of the premium.

When the prevailing market interest rate is higher than the interest rate offered on the debentures (in other words, the nominal interest rate of the debentures is lower than the prevailing market rate), the debentures will usually be offered to the public at a discount in order to make it more attractive for the public to purchase the debentures. A R100 debenture could, for example, be sold for R95.

Irrespective of whether the debentures are sold at par, at a premium or at a discount

- the interest is always calculated on the face value of the debentures, and
- the face value is repaid after the term of the debentures has expired.

Read paragraph 6.9.3 of the prescribed textbook attentively, and study examples 6.11, 6.12 and 6.13.

6.11 Financial statements of companies

The financial statements which a company prepares can be divided into two categories, namely:

- **Internal statements**

Internal statements are detailed financial and cost statements that pertain to a company and that are intended for managerial use (internal use) in the company.

- **Published statements (or external) statements**

These statements are not as detailed as internal statements. The Companies Act requires that these statements

- be prepared at least once a year and be presented to shareholders, and that they
- include the minimum information as specified in the Companies Act.

The fact that the Companies Act requires companies to disclose certain minimum information is in the interests of the external users of financial statements of a company, such as its shareholders, investors, creditors, bankers, etc.

Schedule 4 to the Companies Act regulates the contents of financial statements in detail. Further disclosure and format requirements are addressed in IAS 1 (AC101).

The Companies Act ensures that companies disclose their latest financial statements (and preliminary financial statements) and interim reports to external parties. Companies have to send copies of their financial statements to their shareholders, the holders of their debentures, and to the Registrar of Companies. They also have to discuss their financial statements at the annual general meeting of their shareholders.

Read paragraphs 6.10.1 and 6.10.2 of the prescribed textbook.

6.12 Exercises and solutions

Exercise 6.1

Preparation of the general journal entries and the general ledger accounts to record the process of the issue of ordinary and preference shares at par

Work through the exercise, taking special note of how to record the

- applications for par value ordinary shares received from the founders of a company
- allotment of par value ordinary shares applied for by the founders of a company
- applications for par value ordinary shares received from the public
- applications for par value preference shares received from the public
- allotment of par value ordinary shares applied for by the public
- allotment of par value preference shares applied for by the public

Make sure, too, that you know how to post the above journal entries to the relevant general ledger accounts.

Given information

Doby Limited was registered on 1 July 20.6 with an authorised share capital consisting of the following:

100 000 ordinary shares of R2 each
10 000 10% preference shares of R10 each

The company offered 20 000 ordinary shares at par to the founders of the company, all of which were taken up and paid for on 1 August 20.6.

The company offered the following shares for subscription to the public:

40 000 ordinary shares at par
5 000 10% preference shares at par

The application closed on 1 September 20.6. The public took up the full share offering. The shares were allotted on 5 September 20.6.

REQUIRED

Record the application and the allotment of the shares in the general journal of Doby Ltd for the period 1 August 20.6 to 5 September 20.6. Post these general journal entries to the relevant general ledger accounts. Balance/close off all the ledger accounts. Assume that the public applied for the shares on 1 September 20.6.

NB: Show all calculations.

DOBY LTD

GENERAL JOURNAL

		Debit	Credit
		R	R
20.6			
Aug 1	Bank (20 000 x R2)	40 000	
	Subscribers to the memorandum: Ordinary shares		40 000
	Receipt of application money from the founders of the company		
	Subscribers to the memorandum: Ordinary shares	40 000	
	Ordinary share capital		40 000
	Allotment of 20 000 ordinary shares of R2 each to the founders of the company		
Sep 1	Bank	130 000	
	Application and allotment: Ordinary shares (40 000 x R2)		80 000
	Application and allotment: 10% Preference shares (5 000 x R10)		50 000
	Receipt of application money from the public		
5	Application and allotment: Ordinary shares	80 000	
	Application and allotment: 10% Preference shares	50 000	
	Ordinary share capital		80 000
	10% Preference share capital		50 000
	Allotment of 40 000 ordinary shares of R2 each and 5 000 10% preference shares of R10 each		

Comment

- Remember that the term ''share capital'' is used when par value shares are allotted.
- Cash received will actually be entered in the CRJ. The general journal was used as a book of first entry for the cash transactions to simply illustrate all the accounts that are involved.
- The figures in brackets are calculations.

DOBY LTD

GENERAL LEDGER

Dr **Bank** **Cr**

20.6		R	**20.6**		R
Aug 1	Subscribers to the memorandum: Ordinary shares	40 000	Sep 30	Balance c/d	170 000
Sep 1	Application and allotment: Ordinary shares	80 000			
	Application and allotment: 10% Preference shares	50 000			
		170 000			170 000
Oct 1	Balance b/d	170 000			

Dr **Subscribers to the memorandum: Ordinary shares** **Cr**

20.6		R	20.6		R
Aug 1	Ordinary share capital	40 000	Aug 1	Bank	40 000

Dr **Application and allotment: Ordinary shares** **Cr**

20.6		R	20.6		R
Sep 5	Ordinary share capital	80 000	Sep 1	Bank	80 000

Dr **Application and allotment: 10% Preference shares** **Cr**

20.6		R	20.6		R
Sep 5	10% Preference share capital	50 000	Sep 1	Bank	50 000

Dr **Ordinary share capital** **Cr**

			20.6		R
			Aug 1	Subscribers to the memorandum: Ordinary shares	40 000
			Sep 5	Application and allotment: Ordinary shares	80 000
					120 000

Dr **10% Preference share capital** **Cr**

			20.6		R
			Sep 5	Application and allotment: 10% Preference shares	50 000

Comment

The subscribers to the memorandum and application and allotment accounts are interim accounts that close off once the shares have been allotted.

Exercise 6.2

Preparation of the general journal entries and the general ledger accounts to record the process of the issue of ordinary shares at a premium

Work through the exercise, taking special note of how to record the

- applications received from the public for ordinary shares issues at a premium
- allotment or ordinary shares issues at a premium

Make sure, too, that you know how to post the above journal entries to the relevant general ledger accounts.

Given information (continuation of exercise 6.1)

On 1 April 20.7 Doby Ltd decided to offer 20 000 of its unissued ordinary shares at a premium of R0,50 per share.

When the date for the applications closed on 1 June 20.7, applications for 25 000 shares were received.

On 3 June 20.7, 20 000 shares were allotted to the public and the excess application money was repaid.

REQUIRED

Record the application and the allotment of the shares in the general journal of Doby Ltd for the period 1 April 20.7 to 3 June 20.7. Post these general journal entries to the relevant general ledger accounts. Balance/close off all the ledger accounts. Assume that the public applied for the shares on 1 June 20.6. It is not necessary to carry forward any balances from exercise 6.1.

NB: Show all calculations.

Solution 6.2

DOBY LTD

GENERAL JOURNAL

		Debit	Credit
		R	**R**
20.7			
Jun 1	Bank (25 000 x R2,50)	62 500	
	Application and allotment: Ordinary shares		62 500
	Receipt of application money from the public		
3	Application and allotment: Ordinary shares	50 000	
	Ordinary share capital (20 000 x R2)		40 000
	Share premium (20 000 x R0,50)		10 000
	Allotment of 20 000 ordinary shares of R2 each at a premium of R0,50 per share		
	Application and allotment: Ordinary shares (5 000 x R2,50)	12 500	
	Bank		12 500
	Cash refund to unsuccessful applicants		

DOBY LTD

GENERAL LEDGER

Dr **Bank** **Cr**

20.7		**R**	**20.7**		**R**
Jun 1	Application and allotment: Ordinary shares	62 500	Jun 3	Application and allotment: Ordinary shares	12 500
			30	Balance c/d	50 000
		62 500			62 500
Jul 1	Balance b/d	50 000			

Dr **Application and allotment: Ordinary shares** **Cr**

20.7		**R**	**20.7**		**R**
Jun 3	Ordinary share capital	40 000	Jun 1	Bank	62 500
	Share premium	10 000			
	Bank	12 500			
		62 500			62 500

Dr **Ordinary share capital** **Cr**

			20.7		**R**
			Jun 3	Application and allotment: Ordinary shares	40 000

Dr **Share premium** **Cr**

			20.7		**R**
			Jun 3	Application and allotment: Ordinary shares	10 000

Comment

Although the share premium forms part of the total equity of the company, it must be shown in a separate account. The share premium can, *inter alia,* be used to write off share issue expenses.

Exercise 6.3

Preparation of the general journal and general ledger to record the process of the issue of no par value shares

Work through the exercise, taking special note of how to record the

- applications for no par value ordinary shares received from the founders of the company
- applications for no par value preference shares received from the founders of the company
- allotment of no par value ordinary shares applied for by the founders of the company
- allotment of no par value preference shares applied for by the founders of the company
- applications for no par value ordinary shares received from the public

- applications for no par value preference shares received from the public
- allotment of no par value ordinary shares applied for by the public
- allotment of no par value preference shares applied for by the public

Make sure, too, that you know how to post the above journal entries to the relevant general ledger accounts.

Given information

Molo Ltd was registered on 1 February 20.8 with an authorised share capital consisting of the following:

200 000 no par value ordinary shares
100 000 9% no par value preference shares

On 1 February 20.8 the company offered 20 000 no par value ordinary shares at R10 each and 10 000 no par value preference shares at R15 each to the founders of the company. All the shares were taken up and paid for on 5 February 20.8.

On 9 February the company offered 100 000 ordinary shares at R10 each and 50 000 preference shares at R15 each for subscription to the public.

By close of business on the closing date, namely 1 May 20.8, applications had been received for the full number of shares that were offered. On 8 May 20.8 all the shares were allotted.

On 31 May 20.8 the company paid R15 000 towards share issue expenses.

REQUIRED

Record the application and allotment of the ordinary and preference shares in the general journal of Molo Ltd for the period 1 February 20.8 to 8 May 20.8. Record the payment of the share issue expenses in the general journal of Molo Ltd. Post the journal entries to the relevant accounts in the general ledger. Assume that the public applied for the shares on 1 May 20.8. Balance/close of all the ledger accounts.

NB: Show all calculations.

Solution 6.3

MOLO LTD

GENERAL JOURNAL

		Debit	Credit
		R	R
20.8			
Feb 1	Bank	350 000	
	Subscribers to the memorandum: Ordinary shares (20 000 x R10)		200 000
	Subscribers to the memorandum: 9% Preference shares (10 000 x R15)		150 000
	Receipt of application money from the founders of the company		
5	Subscribers to the memorandum: Ordinary shares	200 000	
	Subscribers to the memorandum: 9% Preference shares	150 000	
	Stated capital: Ordinary shares		200 000
	Stated capital: 9% Preference shares		150 000
	Allotment of 20 000 no par value ordinary shares and 10 000 no par value 9% preference shares to the founders of the company		
May 1	Bank	1 750 000	
	Application and allotment: Ordinary shares (100 000 x R10)		1 000 000
	Application and allotment: 9% Preference shares (50 000 x R15)		750 000
	Receipt of application money from the public		
8	Application and allotment: Ordinary shares	1 000 000	
	Application and allotment: 9% Preference shares	750 000	
	Stated capital: Ordinary shares		1 000 000
	Stated capital: 9% Preference shares		750 000
	Allotment of 100 000 no par value ordinary shares and 50 000 no par value 9% preference shares		
31	Share-issue expenses	15 000	
	Bank		15 000
	Share-issue expenses paid		

Comment

Remember that the term "stated capital" is used when no par value shares are recorded as capital.

MOLO LTD

GENERAL LEDGER

Dr **Bank** **Cr**

20.8		**R**	**20.8**		**R**
Feb 5	Subscribers to the memorandum: Ordinary shares	200 000	May 31	Share-issue expenses	15 000
	Subscribers to the memorandum: 9% Preference shares	150 000		Balance c/d	2 085 000
May 1	Application and allotment: Ordinary shares	1 000 000			
	Application and allotment: 9% Preference shares	750 000			
		2 100 000			2 100 000
Jun 1	Balance b/d	2 085 000			

Dr **Subscribers to the memorandum: Ordinary shares** **Cr**

20.8		**R**	**20.8**		**R**
Feb 5	Stated capital: Ordinary shares	200 000	Feb 5	Bank	200 000

Dr **Subscribers to the memorandum: 9% Preference shares** **Cr**

20.8		**R**	**20.8**		**R**
Feb 5	Stated capital: 9% Preference shares	150 000	Feb 5	Bank	150 000

Dr **Application and allotment: Ordinary shares** **Cr**

20.8		**R**	**20.8**		**R**
May 8	Stated capital: Ordinary shares	1 000 000	May 1	Bank	1 000 000

Dr **Application and allotment: 9% Preference shares** **Cr**

20.8		**R**	**20.8**		**R**
May 8	Stated capital: 9% Preference shares	750 000	May 1	Bank	750 000

Dr **Stated capital: Ordinary shares** **Cr**

			20.8		**R**
			Feb 5	Subscribers to the memorandum: Ordinary shares	200 000
			May 8	Application and allotment: Ordinary shares	1 000 000
					1 200 000

Dr		Stated capital: 9% Preference shares			Cr
			20.8		**R**
			Feb 5	Subscribers to the memorandum: 9% Preference shares	150 000
			May 8	Application and allotment: 9% Preference shares	750 000
					900 000

Dr		Share-issue expenses			Cr
20.8		**R**			
May 31	Bank	15 000			

Comment

The subscribers to the memorandum and application and allotment accounts are temporary accounts that close off once the shares have been allotted.

Exercise 6.4

The issue of capitalisation shares by utilising the share premium to have the minimum effect on the utilisation of retained earnings

Work through the exercise, taking special note of how to

- calculate the number of shares that must be issued
- utilise the share premium
- calculate the effect on the retained earnings

Given information

The following balances appeared, *inter alia*, in the books of Zodiac Ltd on 30 November 20.3:

	R
Ordinary share capital (R2 shares)	400 000
Share premium	40 000
Retained earnings	160 000

On 1 December 20.3 the directors decided to issue capitalisation shares at par in the ratio of one capitalisation share for every four ordinary shares held by the shareholders as on 30 November 20.3. The directors decided that the issue of the capitalisation shares should have a minimum effect on the retained earnings.

REQUIRED

Record the issue of the capitalisation shares in the general journal of Zodiac Ltd.

Solution 6.4

ZODIAC LTD

GENERAL JOURNAL

		Debit	Credit
		R	**R**
20.3 Dec 1	Share premium	40 000	
	Retained earnings R(100 000 – 40 000)	60 000	
	Ordinary share capital ①		100 000
	Capitalisation issue of one share for every four shares held		

Calculation

① **Calculation of the number and value of shares to be issued**

Number of ordinary shares issued on 30 November 20.3
R(400 000 ÷ 2) = 200 000 shares

Number of capitalisation shares to be issued:
200 000 ÷ 4 = 50 000 shares

Value of shares (per value of R2 each)
50 000 x R2 = R100 000

Exercise 6.5

Preparation of the allocation table, journal entries and general ledger accounts to record the application and allotment (the issue of shares)

Work through the following exercise, taking special note of how to

- prepare an allotment schedule,
- record all the transactions related to the issue of shares in the general journal

Make sure, too, that you know how to post from the journal to the relevant general ledger accounts.

Given information

SA Cement Ltd is a company which was registered on 1 January 20.7 with an authorised share capital of 200 000 ordinary shares of R10 each.

The company offered 20 000 of the shares at par to the founders of the company, all of which were taken up and paid for on 15 January 20.7.

On 16 January 20.7 the company applied to the JSE Securities Exchange for a listing and appointed General Merchant Bank as the underwriters of the share issue at a commission of 2%. On the basis of favourable prospecting reports, the directors decided to offer 100 000 of the shares to the public at R12 per share.

By 1 March 20.7 applications were received for 180 000 shares. The JSE Securities Exchange granted the listing and during the first week the price of SA Cement Ltd increased to R13. The shares were received as follows between 15 January 20.7 and 1 March 20.7:

Number of shares per application	Number of applications received	Number of shares applied for
100	400	40 000
200	100	20 000
500	20	10 000
1 000	30	30 000
2 000	20	40 000
4 000	10	40 000
Total	580	180 000

In order to retain control and to ensure an active market for the shares, the following allotment schedule was approved and ratified on 10 March 20.7 at a meeting of the board of directors:

Group A: Applications for 100 to 200 shares will be granted in full.

Group B: Applications for 500 to 1 000 shares will be granted at 50% of the shares applied for.

Group C: Applications for 1 000 and more will be granted at 25% of the shares applied for.

At the beginning of 20.9, owing to the boom in the building industry, the shares were trading at R25 per share on the JSE Securities Exchange. Additional capital was urgently needed to expand the business. On 20 March 20.9 the board of directors decided to convert the shares into no par value shares and to offer the 80 000 unissued shares at R25 per share to the public. Underwriting was arranged with General Merchant Bank at a commission of 4% which had to be settled by 31 May 20.9. Applications were received for 75 000 shares on 30 April 20.9, the closing date for applications. All the transactions were finalised by 31 May 20.9.

REQUIRED

(a) Prepare the allotment schedule for the share issue in March 20.7.
(b) Record the issue of the shares and the related transactions in the general journal of SA Cement Ltd for the period 1 January 20.7 until 31 May 20.9.
(c) Post the journal entries in (b) to the relevant general ledger accounts of SA Cement Ltd for the period 1 January 20.7 until 31 May 20.9. The financial year of the company ends on 31 December.

Solution 6.5

(a)

PREPARATION OF THE ALLOTMENT SCHEDULE FOR THE SHARE ISSUE IN MARCH 20.7

Allotment schedule: For ordinary share issue

Group	Number of applications in group	Total number of shares applied for	Cash received			Shares allotted	Cash repaid	
			Capital R	Premium R	Total R		Capital R	Premium R
A	500 ①	60 000 ②	600 000 ③	120 000 ④	720 000 ⑤	60 000 ⑥	—	—
B	50 ⑦	40 000 ⑧	400 000 ⑨	80 000 ⑩	480 000 ⑪	20 000 ⑫	200 000 ⑬	40 000 ⑭
C	30 ⑮	80 000 ⑯	800 000 ⑰	160 000 ⑱	960 000 ⑲	20 000 ⑳	600 000 ㉑	120 000 ㉒
Totals	580	180 000	1 800 000	360 000	2 160 000	100 000	800 000	160 000

Calculations

① 400 + 100 = 500
② 40 000 + 20 000 = 60 000
③ 60 000 × R10 = R600 000
④ 60 000 × R2 = R120 000
⑤ R600 000 + R120 000 = R720 000
⑥ 60 000 × 100% = 60 000
⑦ 20 + 30 = 50
⑧ 10 000 + 30 000 = 40 000
⑨ 40 000 × R10 = R400 000
⑩ 40 000 × R2 = R80 000
⑪ R400 000 + R80 000 = R480 000
⑫ 40 000 × 50% = 20 000
⑬ 20 000 × R10 = R200 000
⑭ 20 000 × R2 = R40 000
⑮ 20 + 10 = 30
⑯ 40 000 + 40 000 = 80 000
⑰ 80 000 × R10 = R800 000
⑱ 80 000 × R2 = R160 000
⑲ R800 000 + R160 000 = R960 000
⑳ 80 000 × 25% = 20 000
㉑ 60 000 × R10 = R600 000
㉒ 60 000 × R2 = R120 000

(b)

SA CEMENT LTD

GENERAL JOURNAL

		Debit	Credit
		R	R
20.7			
Jan 15	Bank (20 000 x R10)	200 000	
	Subscribers to the memorandum: Ordinary shares		200 000
	Receipt of application money from the founders of the company		
	Subscribers to the memorandum: Ordinary shares	200 000	
	Ordinary share capital		200 000
	Allotment of 20 000 ordinary shares of R10 each to the founders of the company		
16	Underwriter's commission (100 000 x R12 x 2%)	24 000	
	General Merchant Bank		24 000
	2% underwriter's commission due on R1 200 000 in terms of the underwriting agreement		

		Debit	Credit
		R	R
20.7			
Mar 1	Bank (180 000 x R12)	2 160 000	
	Application and allotment: Ordinary shares		2 160 000
	Receipt of application money from the public		
10	Application and allotment: Ordinary shares	1 200 000	
	Ordinary share capital (100 000 x R10)		1 000 000
	Share premium (100 000 x R2)		200 000
	Allotment of 100 000 ordinary shares of R10 at a premium of R2 per share		
	Application and allotment: Ordinary shares (80 000 x R12)	960 000	
	Bank		960 000
	Cash refund to unsuccessful applicants		
	General Merchant Bank	24 000	
	Bank		24 000
	Underwriter's commission paid		
20.9			
Mar 20	Ordinary share capital	1 200 000	
	Share premium	200 000	
	Stated capital: Ordinary shares		1 400 000
	Converting the par value shares into no par value shares		
	Underwriter's commission (80 000 x R25 x 4%)	80 000	
	General Merchant Bank		80 000
	4% underwriter's commission payable on R2 000 000 in terms of the underwriting agreement		
Apr 30	Bank (75 000 x R25)	1 875 000	
	Application and allotment: Ordinary shares		1 875 000
	Receipt of application money from the public		
	Application and allotment: Ordinary shares	1 875 000	
	General Merchant Bank (5 000 x R25)	125 000	
	Stated capital: Ordinary shares		2 000 000
	Allotment of 80 000 ordinary no par value shares		
May 31	Bank R(125 000 – 80 000)	45 000	
	General Merchant Bank		45 000
	Settlement by the underwriters		

(c)

SA CEMENT LTD

GENERAL LEDGER

Dr **Bank** **Cr**

20.7		**R**	**20.7**		**R**
Jan 15	Subscribers to the memorandum: Ordinary shares	200 000	Mar 10	Application and allotment: Ordinary shares	960 000
				General Merchant Bank	24 000
Mar 1	Application and allotment: Ordinary shares	2 160 000			
20.9					
Apr 30	Application and allotment: Ordinary shares	1 875 000			
May 31	General Merchant Bank	45 000			

Dr **Subscribers to the memorandum: Ordinary shares** **Cr**

20.7		**R**	**20.7**		**R**
Jan 15	Ordinary share capital	200 000	Jan 15	Bank	200 000

Dr **Application and allotment: Ordinary shares** **Cr**

20.7		**R**	**20.7**		**R**
Mar 1	Ordinary share capital	1 000 000	Mar 1	Bank	2 160 000
	Share premium	200 000			
10	Bank	960 000			
		2 160 000			2 160 000
20.9			**20.9**		
Apr 30	Stated capital: ordinary shares	1 875 000	Apr 30	Bank	1 875 000

Dr **Ordinary share capital** **Cr**

20.9		**R**	**20.7**		**R**
Mar 20	Stated capital: Ordinary shares	1 200 000	Jan 15	Subscribers to the memorandum: Ordinary shares	200 000
			Mar 1	Application and allotment: Ordinary shares	1 000 000
		1 200 000			1 200 000

Dr **Share premium** **Cr**

20.9		**R**	**20.7**		**R**
Mar 20	Stated capital: Ordinary shares	200 000	Mar 10	Application and allotment: Ordinary shares	200 000

Dr **General Merchant Bank** **Cr**

20.7		**R**	**20.7**		**R**
Mar 10	Bank	24 000	Jan 16	Underwriter's commission	24 000
20.9			**20.9**		
Apr 30	Stated capital: Ordinary shares	125 000	May 31	Underwriter's commission	80 000
				Bank	45 000
		125 000			125 000

Dr **Underwriter's commission** **Cr**

20.7		**R**	**20.7**		**R**
Jan 16	General Merchant Bank	24 000	Dec 31	Profit and loss	24 000
20.9					
May 31	General Merchant Bank	80 000			

Dr **Stated capital: Ordinary shares** **Cr**

			20.9		**R**
			Mar 20	Ordinary share capital	1 200 000
				Share premium	200 000
			Apr 30	Application and allotment: Ordinary shares	1 875 000
				General Merchant Bank	125 000
					3 400 000

Comment

Only the transactions relating to the issue of the shares for the two periods were recorded in the general journal and the general ledger.

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• distinguish between authorised and issued share capital?		
• distinguish between par value and no par value shares?		
• explain what a share premium is and are you able to record the issue of shares at a premium?		
• distinguish between ordinary and preference shares?		
• record transactions pertaining to the issue of shares?		
• prepare an allotment schedule?		
• record the issue of capitalisation shares?		
• record the underwriting of shares?		
• explain dividends and the calculation thereof?		
• calculate dividends?		
• record dividend transactions?		
• record transactions pertaining to the issue of debentures?		
• calculate and record interest on debentures?		

If you answered "no" to any of these questions, revise the applicable section of the study unit and work through the relevant exercise(s).

STUDY UNIT

7

Statement of cash flows

CONTENTS

Learning outcomes

After studying this study unit you must be able to

- discuss, in general terms, the purpose and importance of a statement of cash flows
- explain the relationship between a statement of cash flows and the other financial statements
- prepare a statement of cash flows and the note in respect of non-cash transactions pertaining to investing and financing activities of a sole proprietor, partnership and close corporation according to the requirements of Standard IAS 7 (AC 118) by utilising information which is mainly obtained from the other financial statements and any relevant notes thereto

Key concepts

- Cash and cash equivalents
- Non-cash transactions
- Operating activities
- Direct and indirect method
- Investing activities
- Financing activities

7.1 Introduction

According to the IASB *Framework for the preparation and presentation of financial statements*, the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. The information reported on in a statement of comprehensive income, a statement of financial position and a statement of changes in equity (in respect of a sole trader or a partnership) or a statement of changes in net investment of members (in respect of a close corporation) cannot meet all the informational needs of the users, and especially cannot provide all the necessary information in respect of the liquidity of a business entity. A liquidity analysis of a business entity, *inter alia,* indicates how a business is managing its cash flows. Such information is of great importance, since it shows, for example, from which resources the transactions of a business entity is financed. The sustainability of a business, for example, will be questioned when its operating activities is predominantly financed with external funds (such as long-term loans) over too long a period. The purpose of a statement of cash flows is to disclose information on such aspects. Read paragraph 7.1 of the prescribed textbook to see how the financial results of an illustrious American company were misinterpreted, mainly because the cash flows and the financing sources of the business were overlooked.

7.2 Main objective and advantages of a statement of cash flows

Read about the main objective and advantages of a statement of cash flows in paragraph 7.2 of the prescribed textbook.

7.3 Format of a statement of cash flows

The statement of cash flows is dealt with by IAS 7 (AC 118). Similar to a statement of comprehensive income, a statement of changes in equity (in respect of a sole trader and partnership) and a statement of changes in net investment of members (in respect of a close corporation), a statement of cash flows contains information in respect of a financial *period.* Therefore, the heading of a statement of cash flows also indicates that it is prepared *"for the year/period ended ..."*

A statement of cash flows is divided into three activity-based sections (elements), namely the cash flows from operating, investing and financing activities. The net result of these three elements determines the net movement in the cash and cash equivalents for the period. By adding the cash and cash equivalents at the beginning of the period to this net movement, the cash and cash equivalents at the end of the period are disclosed. The cash and cash equivalents at the end of the period should be equal to the cash and cash equivalents as disclosed in the statement of financial position in respect of the financial period which is reported on.

It is important to take note that in a statement of cash flows, cash outflows and bank overdrafts are shown in brackets. Cash inflows are shown without brackets.

Read paragraph 7.3 of the prescribed textbook attentively, and study the format of a statement of cash flows. Note that the format shown in paragraph 7.3 is a comprehensive illustration of the entries that can be included in a statement of cash flows (all further references to the format of a statement of cash flows pertain to the format in this paragraph of the prescribed textbook), and that the *"Cash flows from operating activities"* section can be disclosed according to either the direct *or* the indirect method.

7.4 Relationship between a statement of cash flows and other financial statements

The statement of comprehensive income, the statement of changes in equity, the statement of changes in net investment of members and the statement of financial position are prepared according to the accrual basis of accounting, which implies that income is accounted for when it is earned and expenses when they are incurred. In other words, income and expenses are recorded when a transaction is entered into, and not only when cash is received or paid. For example, a sales transaction will be recorded when merchandise is sold on credit, and not when the debtors pay their accounts. These financial statements may thus include amounts that result from non-cash transactions.

The statement of cash flows, however, discloses only *cash* received and *cash* paid *during* the financial period under review, regardless of whether the receipts or the payments pertain to another financial period. For example, when a prepayment was made in respect of a 20.6 expense during the 20.5 financial year, the prepaid amount will not be disclosed in the statement of comprehensive income (a prepaid expense account would have been debited and the bank account credited) for the year ended 30 June 20.5, but it will be disclosed as a cash outflow in the statement of cash flows for the year ended 30 June 20.5.

Read more about the relationship between a statement of cash flows and other financial statements in paragraph 7.4 of the prescribed textbook. If you understand how recordings are made on the accrual basis of accounting you should easily grasp the adjustment of an accrued to a cash amount.

7.5 Identification of non-cash entries in financial statements prepared on the accrual basis of accounting

Non-cash entries are those entries that do not pertain to any movement in cash or cash equivalents during a specific financial year or period. Since a statement of cash flows discloses only cash transactions, these non-cash entries must be omitted when a statement of cash flows is prepared from financial statements that were prepared on the accrual basis of accounting.

Examples of non-cash entries/non-cash transactions

- depreciation
- the profit or loss made on the sale of property, plant and equipment
- property, plant and equipment purchased on credit
- the recording of credit losses
- the creation of an allowance for credit losses
- year-end adjustments where accrued expenses and income are taken into account and prepaid amounts and amounts received in advance are deducted
- credit purchases and credit sales
- settlement discounts granted or received

To obtain a clear understanding of the identification of non-cash entries, read paragraph 7.5 of the prescribed textbook attentively.

7.6 Preparation of a statement of cash flows from financial statements prepared on the accrual basis of accounting

In order to prepare a statement of cash flows from the other financial statements which are prepared on the accrual basis of accounting, the following information is required:

- the statement of comprehensive income and the statement of changes in equity (or the statement of changes in net investment of members) for the current financial period
- the statements of financial position at the beginning and the end of the financial period under review
- the notes to the financial statements
- any relevant additional information which may be required, for example, the method according to which the purchases of non-current assets were financed. Applicable journals or ledger accounts can also be used to ease the preparation of a statement of cash flows.

Read paragraph 7.6 of the prescribed textbook attentively.

7.6.1 Cash flows from operating activities

Operating activities represent the main activities that a business entity performs to generate revenue, and therefore profits. For example, a partnership of accounting officers mainly earn revenue by rendering services to clients that pertain to the preparation of bookkeeping records, financial statements and tax returns of close corporations, partnerships and sole traders, whereas a supermarket earns revenue by selling a variety of products to clients. The payments received from clients are referred to as the *cash receipts from customers,* and the payments made to perform the operating activities of a business, for example the payments made in respect of the purchases of inventories and the payment of salaries, are referred to as the *cash paid to suppliers and employees.*

As mentioned previously, the *cash flows from operating activities* section of a statement of cash flows can be reported on according to either the direct or the indirect method. You must be able to apply either. Read paragraph 7.6.1 of the prescribed textbook attentively.

7.6.1.1 Reporting on cash generated from/used in operations according to the direct method

According to the format, when the direct method is used to report on cash generated from/used in operations, the cash receipts from customers and the cash paid to suppliers and employees must be disclosed separately.

Should the cash receipts from customers be greater than the cash paid to suppliers and employees, cash was *generated from* operations, and is therefore disclosed as a (net) cash inflow:

NAME OF BUSINESS ENTITY

STATEMENT OF CASH FLOWS FOR THE YEAR/PERIOD ENDED ...

Note	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers (all entities)	Inflow	
Cash paid to suppliers and employees (all entities)	(Outflow)	
Cash generated from operations	Inflow	

Should the cash paid to suppliers and employees be greater than the cash receipts from customers, cash was *used* in operations, and therefore disclosed as a (net) cash outflow:

NAME OF BUSINESS ENTITY

STATEMENT OF CASH FLOWS FOR THE YEAR/PERIOD ENDED ...

Note	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers (all entities)	Inflow	
Cash paid to suppliers and employees (all entities)	(Outflow)	
Cash used in operations	(Outflow)	

The calculation of cash receipts from customers and cash paid to suppliers and employees is explained in detail in paragraph 7.6.1.1 and subparagraphs 7.6.1.1(a) and (b) of the prescribed textbook. Study these paragraphs and work through the examples. Take note that the financial period during which an accrued or prepaid amount was recorded, plays an important role when cash receipts and cash payments are calculated.

7.6.1.2 Reporting on the cash generated from or used in operations according to the indirect method

According to the format, the disclosure of cash generated from or used in operations according to the indirect method must be as follows:

NAME OF BUSINESS ENTITY

STATEMENT OF CASH FLOWS FOR THE YEAR/PERIOD ENDED ...

Note	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Profit/(Loss) for the year (sole proprietor/partnership) or		
Profit/(Loss) before tax (close corporation)	Profit/(Loss)	
Adjustments for:		
Non-cash expenses	add*	
Non-cash income	subtract*	
Expenses disclosed after cash generated from/(used in) operations	add*	
Income disclosed after cash generated from/(used in) operations	subtract*	
	Profit/(Loss)	
Decreases in applicable current assets	add*	
Increases in applicable current assets	subtract*	
Decreases in applicable current liabilities	subtract*	
Increases in applicable current liabilities	add*	
Cash generated from/(used in) operations	From/(Used)	

* Adjustments in respect of a profit.

When the indirect method is used to report on cash generated from/used in operations, the first figure that is needed for the disclosure is the profit (or loss) for the financial year (in the case of a sole proprietorship/partnership) or the profit (or loss) before tax (in the case of a close corporation). This figure is then adjusted on the face of the statement of cash flows to omit

- any non-cash entries
- any items that must be disclosed on the face of the statement of cash flows *after* the cash generated from/(used in) operations section has been prepared.

Hereafter, the *relevant* changes in the working capital (that is the changes in the current assets and current liabilities that pertain to these operating activities of the business entity) are disclosed. Read paragraph 7.6.1.2 of the prescribed textbook attentively.

Examples of non-cash entries that are disclosed in a statement of comprehensive income and therefore included in the calculation of the profit (or loss) are depreciation and the profit or loss made on the sale of a non-current asset. If the amount that must be added back is an expense (such as depreciation), it must be remembered that it was subtracted from a profit amount when a statement of comprehensive income was prepared. Assume for example, that depreciation (a non-cash entry) was disclosed in a statement of comprehensive income. When the depreciation must be added back, the opposite of subtraction must be done.

Depreciation must therefore be *added* to a profit (or *subtracted* from a loss). If a non-cash entry that must be added back is an income, such as a profit made on the sale of a non-current asset, it must be *subtracted* from a profit (or *added* to a loss). Credit losses is another example of a non-cash entry which is disclosed in the statement of comprehensive income. Credit losses, however, do not have to be added back. Study paragraph 7.6.1.2(a) in the prescribed textbook, which amongst others, explains why.

Examples of entries that are disclosed in a statement of comprehensive income and therefore included in the calculation of the profit (or loss), but of which the cash flows must be disclosed *after* the cash generated from/(used in) operations in the statement of cash flows, are dividend income, interest income, finance costs and the income tax expense (if applicable). As in the case of the non-cash entries, these items must also be omitted from the profit (or loss) figure. Read paragraph 7.6.1.2(b) of the prescribed textbook attentively.

Paragraph 7.6.1.2(c) of the prescribed textbook discusses the disclosure of working capital. Read through this paragraph attentively and study example 7.4.

7.6.1.3 Reporting on the operating activity items that must be disclosed after the cash generated from or used in operations

According to the format, the operating activity items that must be disclosed after the cash generated from or used in operations are:

- Dividends received (all entities)
- Interest received (all entities)
- Interest paid (all entities)
- Income tax paid (close corporation)
- Drawings (sole proprietor/partnership)
- Distribution to members paid (close corporation)
- Proceeds from the sale of financial assets at fair value through profit or loss: Held for trading (all entities)
- Purchase of financial assets at fair value through profit or loss: Held for trading (all entities)

In this regard, read paragraph 7.6.1.3 of the prescribed textbook attentively and study example 7.5.

7.6.2 Cash flows from investing activities

According to the format, the disclosure of the cash flows from investing activities section must be as follows:

NAME OF BUSINESS ENTITY

STATEMENT OF CASH FLOWS FOR THE YEAR/PERIOD ENDED ...

	Note	R	R
CASH FLOWS FROM INVESTING ACTIVITIES			
Investments in property, plant and equipment to maintain operating capacity	1	(Outflow)	
Replacement of property, plant and equipment (all entities)		(Outflow)	
Investments in property, plant and equipment to expand operating capacity	1	(Outflow)	
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 available-for-sale financial assets, and loans and receivables (all entities)		(Outflow)	
Proceeds from the sale/collection/maturity of investments – such as available-for-sale financial assets, and loans and receivables (all entities)		Inflow	
Net cash from/(used in) investing activities			In/(Out)

The cash flows from investing activities result primarily from the acquisition or disposal of non-current assets, for example, property, plant and equipment and available-for-sale investments.

The cash flows from investing activities can be calculated by using the relevant information given in the statements of financial position for the current and the preceding financial year. If there is a difference between the amounts of an entry from year to year, it is possible that a cash flow took place. Such a difference must be analysed further to determine whether a *cash* flow occurred.

As far as the disposal of an investment is concerned, note that only the *cash receipt* must be recorded. Profits or losses made on the sale of property, plant and equipment, or on the sale/collection/maturity of investments are non-cash entries and are therefore not taken into account. Also note that, for the purpose of your studies, you must disclose interest and dividends received in the cash flows from operating activities-section.

Read paragraph 7.6.2 of the prescribed textbook attentively and study example 7.6.

7.6.3 Cash flows from financing activities

- According to the format, the disclosure of the cash flows from financing activities section must be as follows:

NAME OF BUSINESS ENTITY

STATEMENT OF CASH FLOWS FOR THE YEAR/PERIOD ENDED ...

Note	R	R
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/(Out)

As mentioned in paragraph 7.3 of the prescribed textbook, financing activities are activities that result in changes in the size and composition of contributed equity and borrowings (*that is mainly the non-current liabilities*) of a business entity. The cash flows from financing activities can be determined by comparing the statements of financial position of the current year and of the preceding year and/or by using the information given in the statement of the changes in equity (or the statement of changes in net investment of members). Read paragraph 7.6.3 of the prescribed textbook attentively.

Note that the current portion of a long-term borrowing is regarded as a financing activity. In this study unit, short-term borrowings, except where indicated otherwise, are also regarded as financing activities.

Study example 7.7. Bear in mind that transfers to reserves do not indicate cash outflows, as no cash was paid to external parties.

7.6.4 Cash and cash equivalents

Once the cash flows from the operating, investing and financing activities-sections have been prepared, the *net increase/(decrease)* in cash and cash equivalents is calculated (by adding the net cash flows of the operating, investing and financing activities sections). The cash and cash equivalents at the *beginning* of the financial period must then be added to this net increase/(decrease). The answer of this calculation is equal to the cash and cash equivalents *at the end* of the financial period. This amount must be equal to the cash and cash equivalents as disclosed in the statement of financial position pertaining to the same period for which the statement of cash flows is prepared. In other words, if the statement of cash flows is prepared *for the year ended 31 December 20.6*, the cash and cash equivalents at the end of the period must be equal to the cash and cash equivalents as disclosed in the statement of financial position *as at 31 December 20.6.*

According to the format, the disclosure of the cash and cash equivalents (excluding any referrals to notes) must be as follows:

NAME OF BUSINESS ENTITY

STATEMENT OF CASH FLOWS FOR THE YEAR/PERIOD ENDED ...

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Net cash from/(used in) operating activities		Inflow/(Outflow)
CASH FLOWS FROM INVESTING ACTIVITIES		
Net cash from/(used in) investing activities		Inflow/(Outflow)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net cash from/(used in) financing activities		Inflow/(Outflow)
Net increase/(decrease) in cash and cash equivalents		Inflow/(Outflow)
Cash and cash equivalents at beginning of year		Asset/(Liability)
Cash and cash equivalents at end of year		Asset/(Liability)

Read paragraph 7.6.4 of the prescribed textbook attentively and study example 7.8.

7.6.5 Notes pertaining to a statement of cash flows

Read paragraph 7.6.5 of the prescribed textbook attentively. You only need to be able to prepare the note in respect of a non-cash transaction pertaining to an investing or financing activity.

IAS 7 (AC 118) does not require a reconciliation note pertaining to cash generated from/(used in) operations. However, Schedule 4 to the Companies Act requires the disclosure of such information. For the purpose of your studies, you will not be required to prepare this note, since it is the same as when the cash generated from/(used in) operations is prepared according to the indirect method.

7.7 Comprehensive examples and summary

Study examples 7.9 and 7.10 in the prescribed textbook. Thereafter, read through the summary in paragraph 7.7 of the prescribed textbook.

7.8 Exercises and solutions

Exercise 7.1

Preparation of a statement of cash flows in respect of a sole trader

Work through the exercise, taking special note of how to

- calculate payments to creditors when the purchases figure was not given
- disclose an investment in property, plant and equipment to expand operating capacity

Given information

The following financial statements were prepared for a sole trader, trading as Cat Services:

CAT SERVICES

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 JULY 20.2

		R
Revenue		30 000
Administrative and other expenses		(14 800)
Consumable inventory consumed	7 000	
Rental expenses	1 000	
Wages	3 100	
Water and electricity	1 700	
Telephone expenses	300	
Insurance expense	200	
Depreciation	1 500	
Finance costs		(625)
Interest on long-term loan	625	
Profit for the year		14 575
Other comprehensive income for the year		—
Total comprehensive income for the year		14 575

CAT SERVICES

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 JULY 20.2

	Total equity	
	20.2	**20.1**
	R	**R**
Capital		
Balances at 1 August 20.1	40 625	30 000
Capital contribution	5 000	—
Total comprehensive income for the year	14 575	13 625
Drawings	(5 000)	(3 000)
Balances at 31 July 20.2	55 200	40 625

CAT SERVICES

STATEMENT OF FINANCIAL POSITION AS AT 31 JULY 20.2

	Note*	20.2	20.1
		R	R
ASSETS			
Non-current assets		98 500	90 000
Property, plant and equipment		98 500	90 000
Current assets		30 000	23 625
Inventories (consumable)		9 000	6 000
Trade receivables		19 000	14 000
Prepayments		1 525	—
Cash and cash equivalents		475	3 625
Total assets		128 500	113 625
EQUITY AND LIABILITIES			
Total equity		55 200	40 625
Capital		55 200	40 625
Total liabilities		73 300	73 000
Non-current liabilities		55 000	50 000
Long-term borrowings		55 000	50 000
Current liabilities		18 300	23 000
Trade and other payables		18 300	23 000
Total equity and liabilities		128 500	113 625

* All notes are excluded.

Additional information

1 The revenue figure represents services rendered:

for cash	R18 000
on credit	R12 000

2 The trade receivables pertain solely to debtors to whom services were rendered on credit (in other words, the trade debtors).

3 The prepayments comprise the following:

	R
Interest expense	625
Wages	500
Insurance expense	400
	1 525

4 The trade and other payables comprise the following:

	31 July 20.2	31 July 20.1
	R	R
Creditors control (iro the purchases of inventory*)	18 000	23 000
Accrued (in arrears) telephone expenses	300	—
	18 300	23 000

* Cat Services does not sell any merchandise. The purchased inventory pertains to consumable inventory.

5 The depreciation recorded in respect of vehicles amounted to R800, and in respect of machinery, R700.
6 The addition to property, plant and equipment was paid in full. No property, plant and equipment were sold during the financial year ended 31 July 20.2.
7 The carrying amounts in respect of vehicles and machinery are as follows:

	31 July 20.2	31 July 20.1
	R	R
Vehicles	39 200	40 000
Machinery	59 300	50 000
Total	98 500	90 000

8 The drawings and the additional capital contribution made by the owner were in cash.
9 The long-term borrowings pertain to a long-term loan. The interest on the loan is not capitalised.
10 The inventories (consumable material) was disclosed at cost.

REQUIRED

Prepare the statement of cash flows of Cat Services for the year ended 31 July 20.2 to comply with those requirements of GAAP which are appropriate to the business of the sole trader. The cash generated from/(used in) operations must be disclosed according to the direct method. Comparative figures and notes are not required.

Solution 7.1

CAT SERVICES

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 JULY 20.2

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers ①	25 000	
Cash paid to suppliers and employees ②	(21 900)	
Cash generated from operations	3 100	
Interest paid ③	(1 250)	
Drawings	(5 000)	
Net cash used in operating activities		(3 150)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in property, plant and equipment to expand operating capacity	(10 000)	
Addition to machinery ④	(10 000)	
Net cash used in investing activities		(10 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from capital contribution ⑤	5 000	
Proceeds from long-term borrowing ⑥	5 000	
Net cash from financing activities		10 000
Net decrease in cash and cash equivalents		(3 150)
Cash and cash equivalents at beginning of year		3 625
Cash and cash equivalents at end of year		475

Calculations

Comment

The following calculations are not required by Standard IAS 7 (AC 118), but you must be able to do them in order to prepare a statement of cash flows. Remember that all calculations must be shown in your answers to questions in the assignments as well as in the examination. When showing a *calculation*, it is not necessary to indicate cash outflows in brackets and cash inflows without brackets, as is required when cash inflows and cash outflows are disclosed in a statement of cash flows. You must, however, indicate clearly whether the *answer* to a *calculation* represents a cash inflow or a cash outflow.

① **Cash receipts from customers**

The item in the statement of comprehensive income that pertains to cash receipts from customers is Revenue.

	R
Services rendered for cash	18 000
Cash receipts from trade debtors*	7 000
Services rendered on credit	12 000
Add: Debtors control (opening balance)	14 000
Subtract: Debtors control (closing balance)	(19 000)
Services rendered for cash and cash receipts from trade debtors	**25 000**

* Note that a debtor pertaining to an investing activity is not considered to be a *trade* debtor. Trade debtors are those debtors to whom a trading entity sells trading inventory (or to whom a service entity renders a specific service) on credit. Cash receipts from trade debtors are recorded in the cash flows from operating activities section. Transactions with debtors pertaining to investing activities are disclosed in the cash flows from investing activities section. Exercise 7.8 in the guide illustrates how the debtors (as presented in the given information) are divided into trade debtors and a debtor with whom an investing activity has been entered into, and how a non-cash transaction with an "investing" debtor is disclosed as a note to a statement of cash flows.

The cash receipts from the trade debtors can also be calculated by reconstructing the debtors control account:

Debtors control

Dr (reconstructed for calculation purposes) **Cr**

			R				R
20.1				**20.2**			
Aug 1	Balance	b/d	14 000	Jul 31	Bank*		7 000
20.2					Balance	c/d	19 000
Jul 31	Services rendered		12 000				
			26 000				26 000
20.2							
Aug 1	Balance	b/d	19 000				

* Balancing entry

Comment

As the following calculation shows, it is not necessary to distinguish between the services rendered for cash and the services rendered on credit when the cash receipts from customers are calculated:

	R
Total services rendered R(18 000 + 12 000)	30 000
Add: Debtors control (opening balance)	14 000
Subtract: Debtors control (closing balance)	(19 000)
Services rendered for cash and cash receipts from trade debtors	**(25 000)**

② Cash paid to suppliers and employees

The items in the statement of comprehensive income that pertains to cash paid to suppliers and employees are consumable inventory consumed, rental expenses, wages, water and electricity, telephone expenses, and insurance expense. The sum of the cash flows from these items must be calculated.

Items in statement of comprehensive income		20.1 +Accrued expenses – Prepayments	20.2 – Accrued expenses + Prepayments	Cash paid to suppliers and employees during 20.2
	R	R	R	R
Consumable inventory consumed (to obtain payments in respect of the purchases of the inventory)	7 000	–6 000 + 23 000	+9 000 – 18 000	= 15 000*
Rental expenses	1 000	—	—	= 1 000
Wages	3 100	—	+500	= 3 600
Water and electricity	1 700	—	—	= 1 700
Telephone expenses	300	—	– 300	= —
Insurance expense	200	—	+ 400	= 600
				21 900

* For explanatory purposes, the payments made to trade creditors are calculated in more detail as follows:

Payments made to trade creditors

	R
Purchase of consumable inventory ❶	10 000
Add: Creditors control (opening balance)	23 000
Subtract: Creditors control (closing balance)	(18 000)
Payments made to trade creditors*	**15 000**

* Note that a creditor pertaining to an investing/financing activity is not considered to be a *trade* creditor. Trade creditors are those creditors from whom an entity purchases sales merchandise or consumable inventory on credit. Cash payments to trade creditors are recorded in the cash flows from operating activities section. Transactions with creditors pertaining to investing activities are disclosed in the cash flows from investing activities section. Exercise 7.4 illustrates how the creditors (as presented in the given information) are divided into trade creditors and creditors with whom an investing transaction has been entered into, and how a credit transaction with an "investment" creditor is disclosed as a note to a statement of cash flows.

❶ Purchase of consumable inventory

	R
Inventory consumed	7 000
Subtract: Inventories (opening balance)	(6 000)
Add: Inventories (closing balance)	9 000
Purchase of consumable inventory	**10 000**

Comment

The amount of inventory consumed, as disclosed in the statement of comprehensive income, will not necessarily be equal to the inventory purchased or to the payments that were made to the trade creditors during the financial period. In order to calculate the amount actually paid to the trade creditors, the amount of inventory purchased must first be determined.

The payments made to the trade creditors can also be calculated by reconstructing the consumable inventory and the creditors control accounts:

Consumable inventory

Dr (reconstructed for calculation purposes) **Cr**

20.1			**R**	**20.2**			**R**
Aug 1	Balance	b/d	6 000	Jul 31	Inventory consumed		7 000
20.2							
Jul 31	Creditors control*		10 000		Balance	c/d	9 000
			16 000				16 000
Aug 1	Balance	b/d	9 000				

* Balancing entry

Creditors control

Dr (reconstructed for calculation purposes) **Cr**

20.2			**R**	**20.1**			**R**
Jul 31	Bank*		15 000	Aug 1	Balance	b/d	23 000
				20.2			
	Balance	c/d	18 000	Jul 31	Consumable inventory		10 000
			33 000				33 000
				Aug 1	Balance	b/d	18 000

* Balancing entry

③ **Interest paid**

	R
Interest on long-term loan	625
Add: Interest prepaid at end of year (31 July 20.2)	625
Interest paid	**1 250**

④ **Addition to machinery**

Step 1: Determine the difference between the opening and closing balances of the machinery at carrying amount.

(Refer to paragraph 7.6.2 in the prescribed textbook for a discussion of this step, and to example 7.6, calculation 2, for an illustration and discussion of a similar calculation.)

	R
Carrying amount (31 July 20.1)	50 000
Subtract: Depreciation	(700)
Carrying amount (31 July 20.2)	(59 300)
Increase in (purchase of) machinery	**(10 000)**

Step 2: Determine whether the increase pertains to a cash flow.

Paragraph 6 of the additional information indicates that the addition to the property, plant and equipment were paid in full and that no property, plant and equipment were sold during the financial year ended 31 July 20.2. Therefore it can be concluded that the increase in the machinery pertains to a cash outflow of R10 000.

Comment

If Step 1 had been applied to determine any movements in the vehicles account, the following results would have been obtained:

	R
Carrying amount (31 July 20.1)	40 000
Subtract: Depreciation	(800)
Carrying amount (31 July 20.2)	(39 200)
Increase/decrease in vehicles	**—**

Since no movement took place in respect of vehicles, it was unnecessary to apply Step 2.

⑤ **Proceeds from capital contribution**

Since the difference between the opening and closing balances of the capital account of a sole trader is influenced by the profit (or loss) for the year, any drawings that were made, as well as any capital contributions that were made, the difference between the opening and closing balances of the capital account must be analysed to determine what caused the difference. In this exercise, the statement of changes in equity was given. This statement discloses the movements in the capital account. The amount given in the statement of changes in equity for the year ended 31 July 20.2 as a capital contribution was R5 000. The additional information (refer to paragraph 8 of the additional information) stated that the contribution was made in cash.

⑥ **Proceeds from long-term borrowing**

Step 1: Determine the difference between the opening and closing balances of the long-term borrowing.

	R
Long-term borrowings (Statement of financial position as at 31 July 20.2)	55 000
Subtract: Long-term borrowings (Statement of financial position as at 31 July 20.1)	(50 000)
Increase in long-term borrowing	**5 000**

Step 2: Determine whether the increase pertains to a cash flow.

Since there was an increase in the long-term borrowing to the amount of R5 000, and since the interest charged on the borrowing was not capitalised (refer to paragraph 9 of the additional information), the R5 000 must have been received by the business in cash.

Comment

The steps that are indicated in the solutions to exercises 7.1 to 7.4 in respect of the investing and financing activities are for illustrative purposes only. You do not have to show these steps in your answers to such questions. As from exercise 7.5, the disclosure of the steps are omitted.

Exercise 7.2

Preparation of a statement of cash flows in respect of a close corporation

Work through the exercise, taking special note of

- how to disclose an investment in property, plant and equipment to maintain operating capacity
- how to calculate the cash receipts from the sale of machinery
- the non-cash entry pertaining to the revaluation of the financial assets at fair value through profit or loss: Held for trading: Listed investment (listed shares)

Given information

The following information pertains to Cash CC:

CASH CC

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.8

		R
Revenue		490 000
Cost of sales		(282 500)
Inventory (1 January 20.8)	31 000	
Purchases	301 500	
	332 500	
Inventory (31 December 20.8)	(50 000)	
Gross profit		207 500
Other income		28 000
Dividend income: Financial assets at fair value through profit or loss: Held for trading: Listed investment	13 000	
Gain on financial assets at fair value through profit or loss: Held for trading: Listed investment	15 000	
		235 500
Distribution, administrative and other expenses		(99 000)
Depreciation	19 000	
Salaries to members	24 000	
Administrative expenses	20 000	
Wages	36 000	
Finance costs		(14 000)
Interest on long-term loan	14 000	
Profit before tax		122 500
Income tax expense		(36 000)
Profit for the year		86 500
Other comprehensive income for the year		—
Total comprehensive income for the year		86 500

CASH CC

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 31 DECEMBER 20.8

	Members' contributions	Retained earnings	Total
	R	R	R
Balances at 1 January 20.8	355 000	8 000	363 000
Members' contributions	20 000		20 000
Total comprehensive income for the year		86 500	86 500
Distribution to members		(47 500)	(47 500)
Balances at 31 December 20.8	375 000	47 000	422 000

CASH CC

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.8

	Note*	20.8	20.7
		R	R
ASSETS			
Non-current assets		448 500	394 000
Property, plant and equipment	1	448 500	394 000
Current assets		151 000	103 000
Inventories		50 000	31 000
Trade receivables		35 000	30 000
Prepayments		2 000	—
Other financial assets		50 000	35 000
Cash and cash equivalents		14 000	7 000
Total assets		599 500	497 000
EQUITY AND LIABILITIES			
Total equity		422 000	363 000
Members' contributions		375 000	355 000
Retained earnings		47 000	8 000
Total liabilities		177 500	134 000
Non-current liabilities		100 000	70 000
Long-term borrowings		100 000	70 000
Current liabilities		77 500	64 000
Trade and other payables		31 000	38 000
Distribution to members payable		37 500	15 000
Current tax payable		9 000	11 000
Total equity and liabilities		599 500	497 000

* With the exception of the note pertaining to property, plant and equipment, all notes are excluded.

CASH CC

NOTE FOR THE YEAR ENDED 31 DECEMBER 20.8

1. Property, plant and equipment

	Land and buildings	**Machinery and equipment**	**Total**
	R	**R**	**R**
Carrying amount at 1 January 20.8	260 000	134 000	394 000
Cost	260 000	177 000	437 000
Accumulated depreciation	—	(43 000)	(43 000)
Additions	—	77 500	77 500
Disposals	—	(4 000)	(4 000)
Depreciation for the year	—	(19 000)	(19 000)
Carrying amount at 31 December 20.8	260 000	188 500	448 500
Cost	260 000	237 500	497 500
Accumulated depreciation	—	(49 000)	(49 000)

Additional information

1 During the year machinery with a cost price of R17 000 was sold for cash at the carrying amount thereof and replaced with new machinery. Depreciation to the amount of R13 000 was recorded in respect of the sold machinery, as from the date of purchase to the date of sale thereof.
2 An additional machine was purchased for R40 000 to expand the operating capacity of the business.
3 All machinery was purchased for cash.
4 No equipment was purchased or sold during the financial year ended 31 December 20.8.
5 The other financial assets pertain to financial assets at fair value through profit or loss: Held for trading: Listed investments (shares were purchased on the JSE Securities Exchange). No shares were sold during the current year ended 31 December 20.8.
6 All inventories are purchased and sold on credit.
7 Inventory is recorded at cost.
8 Trade and other payables include:

	20.8	**20.7**
	R	**R**
Creditors control (trade creditors)	25 000	33 000
Accrued wages	6 000	5 000

9 The close corporation will be renting additional premises as from 1 January 20.9.
10 The trade receivables pertain to the trade debtors to whom trading inventory was sold on credit.
11 The prepayments were in respect of a rental expense.
12 The long-term borrowings pertain to a long-term loan. The interest on the loan is not capitalised.

REQUIRED

Prepare the statement of cash flows of Cash CC for the year ended 31 December 20.8 to comply with those requirements of GAAP which are appropriate to the business of the close corporation. The cash generated from/(used in) operations must be disclosed according to the direct method. Comparative figures and notes are not required.

Solution 7.2

CASH CC

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20.8

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES*		
Cash receipts from customers ①	485 000	
Cash paid to suppliers and employees ②	(390 500)	
Cash generated from operations	94 500	
Dividends received ③	13 000	
Interest paid ④	(14 000)	
Income tax paid ⑤	(38 000)	
Distribution to members paid ⑥	(25 000)	
Net cash from operating activities		30 500
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in property, plant and equipment to maintain operating capacity	(37 500)	
Replacement of machinery ⑦	(37 500)	
Investment in property, plant and equipment to expand operating capacity	(40 000)	
Addition to machinery ⑦	(40 000)	
Proceeds from sale of machinery ⑧	4 000	
Net cash used in investing activities		(73 500)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from members' contributions ⑨	20 000	
Proceeds from long-term borrowing ⑩	30 000	
Net cash from financing activities		50 000
Net increase in cash and cash equivalents		7 000
Cash and cash equivalents at beginning of year		7 000
Cash and cash equivalents at end of year		14 000

* The difference of R15 000 (R50 000 – R35 000) in the other financial assets pertains to the revaluation of the assets (see statement of comprehensive income). The increase in the statement of financial position is thus due to a non-cash entry.

Calculations

① **Cash receipts from customers**

	R
Revenue (sales)	490 000
Add: Debtors control (opening balance)	30 000
Subtract: Debtors control (closing balance)	(35 000)
Cash receipts from customers	**485 000**

Items		**20.7 +Accrued expenses – Prepayments**	**20.8 – Accrued expenses + Prepayments**	**Cash paid to suppliers and employees during 20.8**
	R	**R**	**R**	**R**
Statement of comprehensive income				
Purchases (for payments made to trade creditors)	301 500	+33 000	–25 000	= 309 500
Salaries to members	24 000	—	—	= 24 000
Administrative expenses	20 000	—	—	= 20 000
Wages	36 000	+5 000	– 6 000	= 35 000
Statements of financial position				
Rental expense	—	—	+ 2 000	= 2 000
				390 500

③ **Dividends received**

No dividends are indicated as receivable at the beginning or at end of the financial year under review. Therefore it can be concluded that the dividend income for the year ended 31 December 20.8, namely R13 000, was received in cash during the financial year ended 31 December 20.8.

④ **Interest paid**

No accrued or prepaid amounts were indicated in respect of an interest expense. Therefore it can be concluded that the interest as disclosed in the statement of comprehensive income for the year ended 31 December 20.8, namely R14 000, was paid during the financial year ended 31 December 20.8.

⑤ **Income tax paid**

	R
Income tax expense	36 000
Add: Current tax payable (opening balance)	11 000
Subtract: Current tax payable (closing balance)	(9 000)
Income tax paid	**38 000**

⑥ **Distribution to members paid**

	R
Distribution to members	47 500
Add: Distribution to members payable (opening balance)	15 000
Subtract: Distribution to members payable (closing balance)	(37 500)
Distribution to members paid	**25 000**

⑦ **Replacement of and addition to machinery**

Step 1: Determine the difference between the opening and closing balances of the machinery and equipment at cost account.

The note in respect of property, plant and equipment shows that there were additions to the amount of R77 500, therefore it is unnecessary to calculate any differences. In the additional information, paragraph 2, it was mentioned that additional machinery to the amount of R40 000 was purchased to expand the operating capacity of the business. The total amount of additions was given as R77 500, therefore it can be concluded that machinery to the amount of R37 500 was purchased to replace the machinery that had been sold.

Step 2: Determine whether the additions pertain to a cash flow.

Paragraph 3 of the additional information states that the purchases of machinery were paid for in cash.

⑧ **Proceeds from the sale of machinery**

Cost price – Accumulated depreciation = Carrying amount
R17 000 – R13 000 = R4 000

Paragraph 1 of the additional information states that machinery was sold for cash at the carrying amount thereof, therefore the carrying amount is equal to the selling price of the machinery.

⑨ **Proceeds from members' contributions**

Step 1: Determine the difference between the opening and closing balances of the members' contributions account.

	R
Members' contributions (Statement of financial position as at 31 December 20.8)	375 000
Subtract: Members' contributions (Statement of financial position as at 31 December 20.7)	(355 000)
Increase in members' contributions*	**20 000**

* Also refer to the statement of changes in net investment of members for the year ended 31 December 20.8. The members' contributions of R20 000 is disclosed therein.

Step 2: Determine whether the increase pertains to a cash flow.

No further information was given in respect of members' contributions. It can therefore be concluded that the increase in the members' contributions was due to a cash contribution.

⑩ **Proceeds from long-term borrowing**

Step 1: Determine the difference between the opening and closing balances of the long-term borrowing.

	R
Long-term borrowings (Statement of financial position as at 31 December 20.8)	100 000
Subtract: Long-term borrowings (Statement of financial position as at 31 December 20.7)	(70 000)
Increase in long-term borrowings	**30 000**

Step 2: Determine whether the increase pertains to a cash flow.

Since there was an increase in the long-term borrowing to the amount of R30 000, and the interest charged on the borrowing is not capitalised, the R30 000 must have been received by the business in cash.

Exercise 7.3

Preparation of a statement of cash flows in respect of a close corporation

Work through the exercise, taking special note of how to calculate the profit before tax and how to disclose the adjustments thereto in order to determine the cash generated from operations.

Given information

The following information pertains to Greengrow CC:

Statement of financial position information as at 31 December

	20.9 R	20.8 R
Members' contributions	375 000	375 000
Retained earnings	48 000	15 000
Long-term loan (Cr)	70 000	100 000
Land and buildings at cost	260 000	260 000
Machinery and equipment at cost	177 000	220 500
Accumulated depreciation	43 000	49 000
Fixed deposits	35 000	50 000
Inventory	31 000	50 000
Debtors control (trade debtors)	30 000	35 000
Bank (Dr)	47 000	—
Prepaid rental expense	—	3 000
Creditors control (trade creditors)	13 000	25 000
Bank overdraft	—	2 000
SARS (Income tax) (Cr)	11 000	9 000
Distribution to members payable	15 000	37 500
Interest payable	5 000	6 000

Extract of items disclosed in the statement of comprehensive income for the year ended 31 December 20.9:

	R
Interest income: Loans and receivables: Fixed deposits	13 000
Depreciation	19 000
Loss on sale of machinery and equipment	500
Interest on long-term loan	14 000
Income tax expense	43 000
Profit for the year	70 500

Information from the statement of changes in net investment of members for the year ended 31 December 20.9:

	R
Distribution to members	37 500

Additional information

1 No machinery and equipment were purchased during the financial year. Machinery and equipment were sold for cash.
2 Inventory is disclosed at cost.
3 A fixed deposit was realised during the financial year.
4 The interest on the long-term loan is not capitalised.

REQUIRED

Prepare the statement of cash flows of Greengrow CC for the year ended 31 December 20.9 to comply with those requirements of GAAP which are appropriate to the business of the close corporation. The cash generated from/(used in) operations must be disclosed according to the indirect method. Comparative figures and notes are not required.

GREENGROW CC

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20.9

	R	R
CASH FLOW FROM OPERATING ACTIVITIES		
Profit before tax ①	113 500	
Adjustments for:		
Interest on long-term loan	14 000	
Loss on sale of machinery and equipment	500	
Depreciation	19 000	
Interest income: Loans and receivables: Fixed deposit	(13 000)	
	134 000	
Decrease in inventories R(50 000 – 31 000)	19 000	
Decrease in debtors control R(35 000 – 30 000)	5 000	
Decrease in prepaid rent R(3 000 – Nil)	3 000	
Decrease in creditors control R(25 000 – 13 000)	(12 000)	
Cash generated from operations	149 000	
Interest received ②	13 000	
Interest paid ③	(15 000)	
Income tax paid ④	(41 000)	
Distribution to members paid ⑤	(60 000)	
Net cash from operating activities		46 000
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from the sale of machinery and equipment ⑥	18 000	
Proceeds from the maturity of loans and receivables: Fixed deposit ⑦	15 000	
Net cash from investing activities		33 000
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayment of long-term borrowing ⑧	(30 000)	
Net cash used in financing activities		(30 000)
Net increase in cash and cash equivalents		49 000
Cash and cash equivalents at beginning of year		(2 000)
Cash and cash equivalents at end of year		47 000

Calculations

① **Profit before tax**

	R
Total comprehensive income for the year	70 500
Add: Income tax expense	43 000
	113 500

② **Interest received**

No interest is indicated as receivable at the beginning or at the end of the financial year under review. Therefore it can be concluded that the interest earned for the year ended 31 December 20.9, namely R13 000, was received during the financial year ended 31 December 20.9.

③ **Interest paid**

	R
Interest on long-term loan	14 000
Add: Interest payable (opening balance)	6 000
Subtract: Interest payable (closing balance)	(5 000)
Interest paid	**15 000**

④ **Income tax paid**

	R
Income tax expense	43 000
Add: [SARS (income tax) opening balance]	9 000
Subtract: [SARS (income tax) closing balance]	(11 000)
Income tax paid	**41 000**

⑤ **Distribution to members paid**

	R
Distribution to members	37 500
Add: Distribution to members payable (opening balance)	37 500
Subtract: Distribution to members payable (closing balance)	(15 000)
Distribution to members paid	**60 000**

⑥ **Proceeds from the sale of machinery and equipment**

Step 1: Determine the difference between the opening and closing balances of the machinery and equipment at cost account.

	R
Machinery and equipment at cost (31 December 20.8)	220 500
Subtract: Machinery and equipment at cost (31 December 20.9)	(177 000)
Decrease in machinery and equipment at cost	**43 500**

Step 2: Determine whether the decrease pertains to a cash flow.

Paragraph 1 of the additional information states that no machinery and equipment were purchased during the year, therefore the difference pertains solely to the sale of machinery and equipment. Paragraph 1 also states that machinery and equipment were sold for cash. Therefore, the decrease in the machinery and equipment was caused by a cash sale of machinery and equipment with a cost price of R43 500.

In this case the relevant cash flow pertains to the proceeds that were received in respect of the sales transaction. The selling price (proceeds) can be calculated as follows:

Carrying amount of machinery and equipment sold – Loss on sale of machinery and equipment = Selling price

Therefore:

Carrying amount of machinery and equipment sold (unknown) – R500 = Selling price (unknown)

The carrying amount is calculated as follows:

Cost price of the machinery and equipment sold – Accumulated depreciation of the machinery and equipment sold = Carrying amount of the machinery and equipment sold

R43 500 – Accumulated depreciation of the machinery and equipment sold (unknown) = Carrying amount of the machinery and equipment sold (unknown)

The calculation of the accumulated depreciation is best illustrated by the reconstruction of the accumulated depreciation account:

Accumulated depreciation

Dr (reconstructed for calculation purposes) **Cr**

20.9		**R**	**20.9**		**R**
Dec 31	Realisation account*	25 000	Jan 1	Balance *(given)* b/d	49 000
	Balance *(given)* c/d	43 000	Dec 31	Depreciation *(given)*	19 000
		68 000			68 000

* Balancing entry (This figure pertains to the accumulated depreciation in respect of the sold machinery and equipment.)

The carrying amount can now be calculated:

Cost price of the machinery and equipment sold – Accumulated depreciation of the machinery and equipment sold = Carrying amount of the machinery and equipment sold

R43 500 – R25 000 = R18 500

And now the selling price can be calculated:

Carrying amount of machinery and equipment sold – Loss on sale of machinery and equipment = Selling price

R18 500 – R500 = R18 000

The relevant cash flow in this regard pertains to the cash that was received on the sale of the machinery and equipment, namely R18 000.

⑦ **Proceeds from the maturity of loans and receivables: Fixed deposit**

Step 1: Determine the difference between the opening and closing balances of the investments.

	R
Fixed deposits (31 December 20.8)	50 000
Subtract: Fixed deposits (31 December 20.9)	(35 000)
Realisation of fixed deposit	**15 000**

Step 2: Determine whether the decrease pertains to a cash flow.

Paragraph 3 of the additional information mentioned that a fixed deposit was realised during the financial year. Cash was thus received.

⑧ **Repayment of long-term borrowing**

Step 1: Determine the difference between the opening and closing balances of the long-term borrowing.

	R
Long-term borrowings (Statement of financial position as at 31 December 20.8)	100 000
Subtract: Long-term borrowings (Statement of financial position as at 31 December 20.9)	(70 000)
Decrease in long-term borrowings	**30 000**

Step 2: Determine whether the decrease pertains to a cash flow.

Since there was a decrease in the long-term borrowing to the amount of R30 000, and the interest charged on the borrowing is not capitalised, a capital amount of R30 000 must have been repaid by the business.

Exercise 7.4

Preparation of a statement of cash flows in respect of a sole trader

Work through the exercise, taking special note of

- the calculation of a decrease in the trade creditors when only a creditors' figure is given
- the disclosure of the purchase of equipment on credit, in respect of which no payment was made

Given information

The following information pertains to L Leyds, a general dealer:

Statement of financial position information as at

	28 Feb 20.2 R	28 Feb 20.1 R
Land and buildings at cost	100 000	90 000
Equipment at cost	72 000	60 000
Inventory at cost	20 000	16 000
Debtors control (trade debtors)	17 000	19 000
Bank (Dr)	2 000	—
Creditors control	19 000	20 000
Bank (overdraft)	—	6 000
Capital — L Leyds	84 200	58 400
Long-term loan (Cr)	80 000	75 000
Accumulated depreciation (equipment)	12 000	9 800

Additional information

1. The total comprehensive income for the year amounted to R26 000, and has already been closed off against the capital account of L Leyds. (There were no items pertaining to other comprehensive income.)
2. No property, plant or equipment was sold or scrapped during the year ended 28 February 20.2. Equipment with a cost price of R7 000 was purchased on credit during the year. This amount is included in the creditors control figure. By the end of the year, no payments in respect of the equipment were made. (The amount of this purchase is significant.) All of the other additions to property, plant and equipment were obtained from third parties and paid for.
3. The interest expense on the long-term loan during the year amounted to R12 000. The interest is not capitalised.
4. The creditors in respect of 28 February 20.2 pertain to trade creditors and the creditor referred to in paragraph 2.
5. Cash withdrawals (closed off against the capital account) by L Leyds during the year ended 28 February 20.2 amounted to R10 200.
6. L Leyds makes all capital contributions in cash.

REQUIRED

Prepare the statement of cash flows of L Leyds for the year ended 28 February 20.2 to comply with those requirements of GAAP which are appropriate to the business of the sole trader. Comparative figures are not required. The cash generated from/(used in) operations must be disclosed according to the indirect method.

Disclose only the note in respect of the non-cash transaction pertaining to the investing activity.

Solution 7.4

L LEYDS

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 28 FEBRUARY 20.2

	Note	R	R
CASH FLOWS FROM OPERATING ACTIVITIES			
Profit for the year		26 000	
Adjustments for:			
Interest on long-term loan		12 000	
Depreciation R(12 000 – 9 800)		2 200	
		40 200	
Increase in inventories R(20 000 – 16 000)		(4 000)	
Decrease in debtors control R(19 000 – 17 000)		2 000	
Decrease in creditors control (iro trade creditors) R[20 000 – (19 000 – 7 000*)]		(8 000)	
Cash generated from operations		30 200	
Interest paid		(12 000)	
Drawings		(10 200)	
Net cash from operating activities			8 000
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in property, plant and equipment to expand operating capacity		(15 000)	
Additions to land and buildings ①		(10 000)	
Additions to equipment ②	1	(5 000)	
Net cash used in investing activities			(15 000)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from capital contribution ③		10 000	
Proceeds from long-term borrowing ④		5 000	
Net cash from financing activities			15 000
Net increase in cash and cash equivalents			8 000
Cash and cash equivalents at beginning of year			(6 000)
Cash and cash equivalents at end of year			2 000

* Refer to the discussion under step 2 of calculation 2 for an explanation of the deduction of the R7 000.

L LEYDS

NOTE FOR THE YEAR ENDED 28 FEBRUARY 20.2

1. Non-cash transaction pertaining to the investing activity

Equipment with a cost price of R7 000 was purchased on credit during the year. No payments were made in this regard.

Comment

Since the above credit purchase is regarded as significant (refer to paragraph 2 of the additional information), the transaction is disclosed in a note to the statement of cash flows.

Calculations

① **Additions to land and buildings**

Step 1: Determine the difference between the opening and closing balances of the land and buildings at cost account.

	R
Land and buildings at cost (note to statement of financial position as at 28 February 20.2)	100 000
Subtract: Land and buildings at cost (note to statement of financial position as at 28 February 20.1)	(90 000)
Increase in (purchase of) land and buildings	**10 000**

Step 2: Determine whether the increase pertains to a cash flow.

Paragraph 2 of the additional information states that all property, plant and equipment, with the exception of the purchase of equipment from a creditor, was purchased from third parties and paid for. Therefore we know that the additions to the land and buildings were paid for.

② **Additions to equipment**

Step 1: Determine the difference between the opening and closing balances of the equipment at cost account.

	R
Equipment at cost (note to statement of financial position as at 28 February 20.2)	72 000
Subtract: Equipment at cost (note to statement of financial position as at 28 February 20.1)	(60 000)
Increase in (purchase of) equipment	**12 000**

Step 2: Determine whether the increase pertains to a cash flow.

Paragraph 2 of the additional information states that all property, plant and equipment, with the exception of the purchase of equipment with a cost price of R7 000 from a creditor, was paid for. Therefore, for calculation purposes, the accounting entry that pertains to this transaction must be "reversed" (added back). (That is, the creditors' account is "debited" and the equipment at cost account is "credited". In other words, the closing balances of these accounts must each be reduced by this amount. Note that this "reversal" is not an actual accounting entry. It pertains solely to a calculation to prepare the statement of cash flows.) The effect of such a "reversal" is that the increase in the equipment reduces to R5 000 (R12 000 – R7 000), which pertains to the *cash* purchases of equipment.

③ **Proceeds from capital contribution**

Step 1: Determine the difference between the opening and closing balances of the capital account.

	R
Capital (Statement of financial position as at 28 February 20.2)	84 200
Add: Drawings	10 200
Subtract: Capital (Statement of financial position as at 28 February 20.1)	(58 400)
Total comprehensive income for the year	(26 000)
Increase in capital	**10 000**

The above calculation could also have been made by reconstructing the capital account of Leyds:

Capital: L Leyds

Dr (reconstructed for calculation purposes) **Cr**

20.2			**R**	**20.1**			**R**
Feb 28	Drawings		10 200	Mar 1	Balance	b/d	58 400
	Balance	c/d	84 200		Profit or loss account		26 000
					Bank*		10 000
			94 400				94 400
				20.2			
				Mar 1	Balance	b/d	84 200

* Balancing entry

Step 2: Determine whether the increase pertains to a cash flow.

Paragraph 6 of the additional information indicates that all capital contributions by Leyds are made in cash.

④ **Proceeds from long-term borrowing**

Step 1: Determine the difference between the opening and closing balances of the long-term borrowings.

	R
Long-term borrowings (Statement of financial position as at 28 February 20.2)	80 000
Subtract: Long-term borrowings (Statement of financial position as at 28 February 20.1)	(75 000)
Increase in long-term borrowings	**5 000**

Step 2: Determine whether the increase pertains to a cash flow.

Since there was an increase in long-term borrowings to the amount of R5 000, and the interest expense on the borrowing is not capitalised, the R5 000 must have been received by the business in cash.

Exercise 7.5

Preparation of a statement of cash flows in respect of a close corporation

Work through the exercise, taking special note of how to calculate the cash receipts from customers when credit losses were recorded during the financial year. Also take note that the difference between the listed investments (financial assets at fair value through profit or loss: Held for trading) was due to a revaluation, and that the recording thereof is a non-cash entry.

Given information

The following information pertains to City Traders CC:

BALANCES AT

	28 Feb 20.3 R	28 Feb 20.2 R
Members' contributions	154 000	132 000
Retained earnings	17 106	5 800
Long-term loan	33 600	80 000
Creditors control (trade creditors)	3 000	2 300
Bank	1 300 (Cr)	800 (Cr)
Land and buildings at cost	150 000	150 000
Machinery at cost	60 000	60 000
Furniture and equipment at cost	4 000	3 000
Listed investments (at fair value)	18 700	19 500
Debtors control (trade debtors)	2 340	2 800
Inventory (merchandise)	9 000	8 000
Distribution to members payable	6 000	3 000
SARS (income tax) (Cr)	16 000	13 000
Allowance for credit losses	234	—
Accumulated depreciation (machinery)	12 000	6 000
Accumulated depreciation (furniture and equipment)	800	400

ACCOUNT BALANCES WHICH PERTAIN TO THE STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 20.3

	R
Sales	142 000
Purchases	82 500
Administrative expenses	10 000
Dividends earned	2 500
Interest on long-term loan	12 000
Credit losses	494
Depreciation (machinery)	6 000
Depreciation (furniture and equipment)	400
Loss on financial assets at fair value through profit or loss: Held for trading:	
Listed investments	800
Income tax expense	16 000

Additional information

1 The interest on the long-term loan is not capitalised.
2 On 28 February 20.3 a distribution to memers for the amount of R6 000 was provided for.
3 Inventory is recorded at cost.
4 The listed investments (financial assets at fair value through profit or loss: Held for trading) pertain to shares that were purchased on the JSE Securities Exchange. No shares were purchased or sold during the financial year.
5 All members' contributions were made in cash.

REQUIRED

Prepare the statement of cash flows of City Traders CC for the year ended 28 February 20.3 to comply with the requirements of GAAP which are appropriate to the business of the close corporation. The cash generated from/(used in) operations must be disclosed according to the direct method. Comparative figures and notes are not required.

CITY TRADERS CC

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 28 FEBRUARY 20.3

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES*		
Cash receipts from customers ①	142 200	
Cash paid to suppliers and employees ②	(91 800)	
Cash generated from operations	50 400	
Dividends received ③	2 500	
Interest paid ④	(12 000)	
Income tax paid ⑤	(13 000)	
Distribution to members paid ⑥	(3 000)	
Net cash from operating activities		24 900
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in property, plant and equipment to expand operating capacity	(1 000)	
Additions to furniture and equipment R(4 000 – 3 000)	(1 000)	
Net cash used in investing activities		(1 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from members' contributions R(154 000 – 132 000)	22 000	
Repayment of long-term borrowing R(80 000 – 33 600)	(46 400)	
Net cash used in financing activities		(24 400)
Net decrease in cash and cash equivalents		(500)
Cash and cash equivalents at beginning of year		(800)
Cash and cash equivalents at end of year		(1 300)

*Since no listed shares were purchased or sold during the financial year, it can be concluded that the difference of R800 (R19 500 – R18 700) pertains to a non-cash entry due to a revaluation of the shares.

Calculations

① **Cash receipts from customers**

	R
Sales	142 000
Add: Debtors control (opening balance)	2 800
Subtract: Debtors control (closing balance)	(2 340)
Credit losses	(260)
Cash receipts from customers	**142 200**

Comment

The given information shows that the following were recorded in the credit losses account:

- *The creation of an allowance for credit losses account to the amount of R234.* (See list of balances in the given information.) The accounting entry for the creation of such an allowance is recorded by debiting the credit losses account and crediting the allowance for credit losses account with the amount provided for. Note that the debtors control account is not influenced by this entry.

- *The recording of credit losses.* The amount of credit losses as shown in the statement of comprehensive income is R494. (See extract of balances in the given information.) This amount is R260 greater than R234. (R494 – R234 = R260. The R234 pertains to the creation of the allowance for credit losses.) In other words, during the financial year the credit losses account was debited with a further amount of R260. With no further information available, it can be concluded that the R260 pertains to credit losses that were recorded. (To account for credit losses, the credit losses account is debited and the debtors control account is credited.) Since this accounting entry influences the debtors control account, the amount of credit losses that were recorded must be taken into account when the cash receipts from customers are calculated.

The cash receipts from customers can also be calculated by reconstructing the debtors control account:

Debtors control

Dr (reconstructed for calculation purposes) **Cr**

		R			R
Balance	b/d	2 800	Credit losses		260
Sales		142 000	**Bank***		**142 200**
			Balance	c/d	2 340
		144 800			144 800
Balance	b/d	2 340			

* Balancing entry

② Cash paid to suppliers and employees

Items in statement of comprehensive income		20.2 +Accrued expenses – Prepayments	20.3 – Accrued expenses + Prepayments	Cash paid to suppliers and employees during 20.3
	R	R	R	R
Purchases	82 500	+ 2 300	– 3 000	= 81 800
Administrative expenses	10 000	—	—	= 10 000
				91 800

③ **Dividends received**

No dividends are indicated as receivable at the beginning or at end of the financial year under review. Therefore it can be concluded that the dividends earned as disclosed in the information pertaining to the statement of comprehensive income for the year ended 28 February 20.3, namely R2 500, were received during the financial year ended 28 February 20.3.

④ **Interest paid**

No accrued or prepaid amounts were indicated in respect of interest paid. Therefore it can be concluded that the interest as disclosed in the information pertaining to the statement of comprehensive income for the year ended 28 February 20.3, namely R12 000, was paid during the financial year ended 28 February 20.3.

⑤ **Income tax paid**

	R
Income tax expense	16 000
Add: SARS (income tax) — opening balance	13 000
Subtract: SARS (income tax) — closing balance	(16 000)
Income tax paid	**13 000**

⑥ **Distribution to members paid**

	R
Distribution to members	6 000
Add: Distribution to members payable (opening balance)	3 000
Subtract: Distribution to members payable (closing balance — after adjustment)	(6 000)
Distribution to members paid	**3 000**

Exercise 7.6

Preparation of a statement of cash flows in respect of a close corporation

Work through the exercise, taking special note of how to calculate

- payments made to trade creditors when the purchase figure was not given
- the movement in a long-term borrowing when a portion thereof is disclosed as a current liability

Given information

The following information pertains to Mango CC:

MANGO CC

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20.4

	Note*	20.4	20.3
		R	R
Revenue		110 000	90 000
Cost of sales		(60 000)	(55 000)
Gross profit		50 000	35 000
Other income		3 600	3 900
Rental income		—	300
Interest income: Loans and receivables: Fixed deposit		3 600	3 600
		53 600	38 900
Distribution, administrative and other expenses		(19 100)	(19 100)
Salaries and wages		16 000	15 000
Depreciation		1 000	1 000
Insurance		600	500
Other administrative expenses		1 500	2 600
Finance costs		(2 500)	(1 800)
Interest on long-term loan		2 500	1 800
Profit before tax		32 000	18 000
Income tax expense		(10 000)	(8 000)
Profit for the year		22 000	10 000
Other comprehensive income for the year		—	—
Total comprehensive income for the year		22 000	10 000

* All notes are excluded.

MANGO CC

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 30 JUNE 20.4

	Members' contributions	Retained earnings	Total
	R	R	R
Balances at 1 July 20.3	60 000	—	60 000
Members' contributions	20 000		20 000
Total comprehensive income for the year		22 000	22 000
Distribution to members		(12 000)	(12 000)
Balances at 30 June 20.4	80 000	10 000	90 000

MANGO CC

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20.4

	Note*	20.4	20.3
		R	R
ASSETS			
Non-current assets		79 000	61 000
Property, plant and equipment		46 000	39 000
Financial assets		33 000	22 000
Current assets		26 200	26 000
Inventories		18 800	20 000
Trade receivables		7 400	6 000
Total assets		105 200	87 000
EQUITY AND LIABILITIES			
Total equity		90 000	60 000
Members' contributions		80 000	60 000
Retained earnings		10 000	—
Total liabilities		15 200	27 000
Non-current liabilities		4 000	12 000
Long-term borrowings		4 000	12 000
Current liabilities		11 200	15 000
Trade and other payables		6 000	10 000
Current portion of long-term borrowings		1 000	—
Other financial liabilities		4 200	5 000
Total equity and liabilities		105 200	87 000

* All notes are excluded.

Additional information

1 All purchases were made on credit, whereas all other expenses were paid for in cash.
2 Inventory is disclosed at cost.
3 Property, plant and equipment consist of:

	20.4 R	20.3 R
Land and buildings at cost	40 000	32 000
Machinery at carrying amount	6 000	7 000
Total	46 000	39 000

4 The increase in the land and buildings was paid in full. No machinery was purchased or sold during the period.
5 The financial assets pertain to loans and receivables: Fixed deposits. Another fixed deposit was made on 30 June 20.4.
6 The trade receivables include the following:

	20.4 R	20.3 R
Debtors control	7 400	5 700
Accrued income (rent)	—	300
	7 400	6 000

7 All members' contributions were made in cash.
8 The long-term borrowings pertain to a long-term loan. The interest on the loan is not capitalised.
9 Trade and other payables represent trade creditors only.
10 The other financial liabilities pertain to a bank overdraft.

REQUIRED

Prepare the statement of cash flows of Mango CC for the year ended 30 June 20.4 to comply with the requirements of GAAP which are appropriate to the business of the close corporation. The cash generated from/(used in) operations must be disclosed according to the direct method. Comparative figures and notes are not required.

Solution 7.6

MANGO CC

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 30 JUNE 20.4

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from customers ①	108 600	
Cash paid to suppliers and employees ②	(80 900)	
Cash generated from operations	27 700	
Interest received ③	3 600	
Interest paid ④	(2 500)	
Income tax paid ④	(10 000)	
Distribution to members paid ④	(12 000)	
Net cash from operating activities		6 800
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in property, plant and equipment to expand operating capacity	(8 000)	
Additions to land and buildings R(40 000 – 32 000)	(8 000)	
Acquisition of loans and receivables: Fixed deposit R(33 000 – 22 000)	(11 000)	
Net cash used in investing activities		(19 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from members' contributions	20 000	
Repayment of long-term borrowing R[(12 000 – (4 000 + 1 000*)]	(7 000)	
Net cash from financing activities		13 000
Net increase in cash and cash equivalents		800
Cash and cash equivalents at beginning of year		(5 000)
Cash and cash equivalents at end of year		(4 200)

* The current portion of the long-term borrowing (R1 000) must be added to the outstanding amount of the long-term borrowing (R4 000) in order to calculate the total amount due on 30 June 20.4 (R5 000).

Calculations

① Cash receipts from customers

Items		20.3 +Accrued income – Income received in advance	20.4 – Accrued income + Income received in advance	Cash receipts from customers during 20.4
	R	R	R	R
Statement of comprehensive income				
Revenue	110 000	+ 5 700	– 7 400	= 108 300
Statement of financial position				
Rental income	—	+300	—	= 300
				108 600

② Cash paid to suppliers and employees

Items		20.3 +Accrued expenses – Prepayments	20.4 – Accrued expenses + Prepayments	Cash paid to suppliers and employees during 20.4
	R	R	R	R
Cost of sales	60 000	– 20 000 + 10 000	+ 18 800 – 6 000	= 62 800
Salaries and wages	16 000	—	—	= 16 000
Insurance	600	—	—	= 600
Other administrative expenses	1 500	—	—	= 1 500
				80 900

For explanatory purposes, the calculation of the payments to trade creditors are further clarified:

Payments made to trade creditors

	R
Purchases of inventory ❶	58 800
Add: Creditors control (opening balance)	10 000
Subtract: Creditors control (closing balance)	(6 000)
Payments made to trade creditors	**62 800**

❶ Purchases of inventory

	R
Cost of sales	60 000
Subtract: Inventories (opening balance)	(20 000)
Add: Inventories (closing balance)	18 800
Purchases of inventory	**58 800**

③ **Interest received**

No interest is indicated as receivable at the beginning or at end of the financial year under review. Therefore it can be concluded that the interest income as disclosed in the statement of comprehensive income for the year ended 30 June 20.4, namely R3 600, were received during the financial year ended 30 June 20.4.

④ **Interest, income tax and distribution to members paid**

No accrued or prepaid amounts in respect of these items are indicated, therefore it can be concluded that the interest and income tax expenses as indicated in the statement of comprehensive income for the year ended 30 June 20.4, and the distribution to members as indicated in the statement of changes in net investment of members for the year ended 30 June 20.4, were paid during the financial year ended 30 June 20.4.

Exercise 7.7

Preparation of a statement of cash flows in respect of a close corporation

Work through the exercise, taking special note of how to disclose the net cash used in operating activities.

Given information

The following information pertains to Joho Close Corporation:

JOHO CLOSE CORPORATION

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.6

	Note	20.6	20.5
		R	R
Revenue		360 000	300 000
Cost of sales		(270 000)	(225 000)
Inventory (1 January 20.6)		45 000	30 000
Purchases		285 000	240 000
		330 000	270 000
Inventory (31 December 20.6)		(60 000)	(45 000)
Gross profit		90 000	75 000
Distribution, administrative and other expenses		(35 000)	(29 000)
Depreciation		9 000	8 000
Administrative expenses		26 000	21 000
Finance costs		(1 000)	(1 000)
Interest on loan from member		1 000	1 000
Profit before tax		54 000	45 000
Income tax expense		(21 000)	(18 000)
Profit for the year		33 000	27 000
Other comprehensive income for the year		—	—
Total comprehensive income for the year		33 000	27 000

* All notes are excluded.

JOHO CLOSE CORPORATION

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 31 DECEMBER 20.6

	Members' contributions	Retained earnings	Asset replacement reserve	Loan from member	Total
	R	R	R	R	R
Balances at 1 January 20.6	150 000	10 000	30 000	6 000	196 000
Members' contributions	20 000				20 000
Total comprehensive income for the year		33 000			33 000
Transfer to asset replacement reserve		(3 000)	3 000		
Distribution to members		(20 000)			(20 000)
Loan from member				1 000	1 000
Balances at 31 December 20.6	170 000	20 000	33 000	7 000	230 000
Non-current liability				7 000	
Current liability				—	

STATEMENT OF FINANCIAL POSITION ACCOUNTS AS AT 31 DECEMBER

	20.6	20.5
	R	R
Members' contributions	170 000	150 000
Retained earnings	20 000	10 000
Asset replacement reserve	33 000	30 000
Loan from member	7 000	6 000
Creditors control (trade creditors)	25 000	30 000
SARS (income tax)	2 000	3 000
	257 000	229 000
Furniture and equipment at cost	95 000	74 000
Accumulated depreciation (furniture and equipment)	(21 000)	(12 000)
Inventory	60 000	45 000
Debtors control (trade debtors)	116 000	90 000
Bank	7 000	32 000
	257 000	229 000

Additional information

1. No furniture or equipment was sold or scrapped during the financial year ended 31 December 20.6.
2. All purchases of inventory were made on credit and all other purchases and expenses (except income tax) were paid for in full.
3. Inventory is disclosed at cost.
4. The interest on the loan from the member is not capitalised.

REQUIRED

Prepare the statement of cash flows of Joho Close Corporation for the year ended 31 December 20.6 to comply with the requirements of GAAP which are appropriate to the business of the close corporation. The cash generated from/(used in) operations must be disclosed according to the indirect method. Comparative figures and notes are not required.

Solution 7.7

JOHO CLOSE CORPORATION

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20.6

	R	R
CASH FLOWS FROM OPERATING ACTIVITIES		
Profit before tax	54 000	
Adjustments for:		
Interest on loan from member	1 000	
Depreciation	9 000	
	64 000	
Increase in inventories R(60 000 – 45 000)	(15 000)	
Increase in debtors control R(116 000 – 90 000)	(26 000)	
Decrease in creditors control R(30 000 – 25 000)	(5 000)	
Cash generated from operations	18 000	
Interest paid ①	(1 000)	
Income tax paid ②	(22 000)	
Distribution to members paid ①	(20 000)	
Net cash used in operating activities		(25 000)
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in property, plant and equipment to expand operating capacity	(21 000)	
Additions to furniture and equipment R(95 000 – 74 000)	(21 000)	
Net cash used in investing activities		(21 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from members' contributions R(170 000 – 150 000)	20 000	
Proceeds from borrowing [loan from member R(7 000 – 6 000)]	1 000	
Net cash from financing activities		21 000
Net decrease in cash and cash equivalents		(25 000)
Cash and cash equivalents at beginning of year		32 000
Cash and cash equivalents at end of year		7 000

Calculations

① **Interest and distribution to members paid**

No accrued or prepaid amounts in respect of these items are indicated, therefore it can be concluded that the interest expense and the distribution to members as indicated in the statement of comprehensive income and the statement of changes in net investment of members for the year ended 31 December 20.6 respectively, were paid during the financial year ended 31 December 20.6.

② **Income tax paid**

	R
Income tax expense	21 000
Add: SARS (income tax) — opening balance	3 000
Subtract: SARS (income tax) — closing balance	(2 000)
Income tax paid	**22 000**

As an additional explanation, the SARS (income tax) ledger account is given:

SARS (income tax)*

Dr (reconstructed for calculation purposes) **Cr**

20.6			R	**20.6**			R
	Bank**		22 000	Jan 1	Balance	b/d	3 000
Dec 31	Balance	c/d	2 000	Dec 31	Income tax expense		21 000
			24 000				24 000
				20.7			
				Jan 1	Balance	b/d	2 000

* Revise paragraph 5.12 of the prescribed textbook.
A credit balance of the SARS (income tax) account is disclosed as "Current tax payable" in the statement of financial position at the year-end, whereas a debit balance is disclosed as "Current tax receivable" in the statement of financial position at the year-end.

** Balancing entry

Exercise 7.8

Preparation of a statement of cash flows in respect of a partnership

Work through the exercise, taking note of how to calculate and disclose a non-cash transaction in respect of an investing activity.

Given information

The following information pertains to the partnership, Bluemax:

BLUEMAX

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 20.6

	Note*		R
Revenue			500 600
Cost of sales			(196 360)
Inventory (1 March 20.5)		100 400	
Purchases		191 960	
		292 360	
Inventory (28 February 20.6)		(96 000)	
Gross profit			304 240
Other income			14 800
Profit on sale of non-current asset (land and buildings)		10 000	
Rental income		4 800	
			319 040
Distribution, administrative and other expenses			(71 200)
Administrative expenses (wages included)		70 000	
Depreciation		1 200	
Profit for the year			247 840
Other comprehensive income for the year			—
Total comprehensive income for the year			247 840

* Notes excluded

BLUEMAX

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 28 FEBRUARY 20.6

	Capital		Current accounts		Appro-priation	Total equity
	B Blue	M Max	B Blue	M Max		
	R	R	R	R	R	R
Balances at 1 March 20.5	193 800	193 800	50 400	(400)	—	437 600
Capital contribution	26 200	26 200				52 400
Total comprehensive income for the year					247 840	247 840
Interest on capital			13 200	13 200	(26 400)	
Interest on current accounts			5 040	(40)	(5 000)	
Interest on drawings			(13 440)	(11 720)	25 160	
Partners' share of total comprehensive income			120 800	120 800	(241 600)	
Drawings			(134 400)	(117 200)		(251 600)
Balances at 28 February 20.6	220 000	220 000	41 600	4 640	—	486 240

STATEMENT OF FINANCIAL POSITION INFORMATION AS AT 28 FEBRUARY

	20.6 R	20.5 R
Capital: B Blue	220 000	193 800
Capital: M Max	220 000	193 800
Current account: B Blue	41 600 (Cr)	50 400 (Cr)
Current account: M Max	4 640 (Cr)	400 (Dr)
Land and buildings at cost	240 000	360 000
Furniture and equipment at cost	12 800	12 000
Accumulated depreciation (furniture and equipment)	3 200	2 000
Inventory	96 000	100 400
Bank	67 240 (Dr)	10 000 (Cr)
Debtors control	146 600	74 000
Creditors control (trade creditors)	112 400	97 200
Accrued income (rent receivable)	400	800
Accrued expenses (wages)	1 200	400
Fixed deposit	40 000	—

Additional information

1 The fixed deposit was made on 28 February 20.6.
2 No land and buildings were purchased during the year. Fifty percent of the selling price of the land and buildings was received in cash, whereas the outstanding amount was given on credit. This amount will be received during the 20.7 financial year.
3 No furniture or equipment was sold or scrapped during the year. All purchases were paid for in cash.
4 All purchases of inventory were on credit. All of the other expenses, except the accrued expenses, were paid in full.
5 The drawings of the partners were made in cash.
6 Inventory is disclosed at cost.
7 There were only trade debtors at 28 February 20.5. The debtors at 28 February 20.6 pertain to trade debtors and the debtor in respect of the sale of land and buildings.
8 All capital contributions were made in cash.

REQUIRED

Prepare the statement of cash flows of Bluemax for the year ended 28 February 20.6 to comply with the requirements of GAAP which are appropriate to the business of the partnership. The cash generated from/(used in) operations must be disclosed according to the direct method. Comparative figures are not required.

Disclose only the note in respect of the non-cash transaction pertaining to the investing activity.

Solution 7.8

BLUEMAX

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 28 FEBRUARY 20.6

	Note	R	R
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash receipts from customers ①		498 200	
Cash paid to suppliers and employees ②		(245 960)	
Cash generated from operations		252 240	
Drawings R(134 400 + 117 200)		(251 600)	
Net cash from operating activities			640
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in property, plant and equipment to expand operating capacity		(800)	
Additions to furniture and equipment R(12 800 – 12 000)		(800)	
Proceeds from the sale of land and buildings	1	65 000	
Acquisition of loans and receivables: Fixed deposit R(40 000 – Nil)		(40 000)	
Net cash from investing activities			24 200
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from capital contributions [R(220 000 – 193 800) × 2]		52 400	
Net cash from financing activities			52 400
Net increase in cash and cash equivalents			77 240
Cash and cash equivalents at beginning of year			(10 000)
Cash and cash equivalents at end of year			67 240

BLUEMAX

NOTE FOR THE YEAR ENDED 28 FEBRUARY 20.6

1. Non-cash transaction pertaining to the investing activity

Land and buildings with a cost price of R120 000 were sold for R130 000. An amount of R65 000 is receivable in the next financial year.

Calculations

① **Cash receipts from customers**

Items in statement of comprehensive income		20.5 +Accrued income – Income received in advance	20.6 – Accrued income + Income received in advance	Cash received from customers during 20.6
	R	R	R	R
Revenue	500 600	+ 74 000	– 81 600 ❶	= 493 000
Rental income	4 800	+ 800	– 400	= 5 200
				498 200

❶ **Trade debtors (closing balance)**

A debtor included in the amount of R146 600 does not pertain to *trade* debtors, but to a debtor who purchased land and buildings from the entity (refer to additional information, paragraph 7). The closing balance of this debtor's account must be excluded from R146 600. The closing balance is calculated as follows:

- The selling price of the sold land and buildings:

  Carrying amount + Profit on sale
  R(360 000 – 240 000) + R10 000
  = R130 000

- According to paragraph 2 of the additional information, 50% of R130 000 is still outstanding at the end of 20.6:

  ∴ R130 000/2 = R65 000 = closing balance.
  Therefore, R65 000 must be excluded from R146 600:
  R(146 600 – 65 000) = R81 600 = closing balance of trade debtors.

② **Cash paid to suppliers and employees**

Items in statement of comprehensive income		20.5 +Accrued expenses – Prepayments	20.6 – Accrued expenses + Prepayments	Cash paid to suppliers and employees during 20.6
	R	R	R	R
Purchases	191 960	+ 97 200	– 112 400	= 176 760
Administrative expenses	70 000	+ 400	–1 200	= 69 200
				245 960

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• briefly discuss the purpose and importance of a statement of cash flows? • briefly explain the relationship between a statement of cash flows and the other financial statements that were prepared on the accrual basis of accounting, and to describe how this relationship impacts on the preparation of a statement of cash flows? • prepare a statement of cash flows and the note in respect of non-cash transactions pertaining to investing and financing activities according to the requirements of Standard IAS 7 (AC 118) by utilising information which is mainly obtained from the other financial statements and any relevant notes thereto, for each of the following business entities? — sole proprietor — partnership — close corporation		

If you answered "no" to any of these questions, it would be in your best interest to revise the relevant section(s) of the study material thoroughly.

STUDY UNIT

8

Analysis and interpretation of financial statements

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- discuss the nature, scope and objectives of financial statement analysis
- explain the need for financial statement analysis
- define, calculate and interpret the following ratios:
  - — return on equity
  - — return on total assets
  - — gross profit percentage
  - — profit margin
  - — financial leverage and leverage effect
  - — current ratio
  - — acid test ratio
  - — trade receivables collection period
  - — trade payables settlement period
  - — inventory turnover rate
  - — inventory holding period
  - — debt-equity ratio
  - — times interest earned ratio
- discuss the limitations of financial statement analysis

Key concepts

- Financial statement analysis
- Ratio analysis
- Profitability ratios
- Liquidity ratios
- Solvency ratios
- Limitations of financial statement analysis

8.1 Introduction

Financial statements summarise the financial performance and financial position of an entity for a period in the past. For the information to be useful to the various users of the statements, various formulas are used to analyse and interpret it.

Read through paragraph 8.1 in the prescribed textbook to familiarise yourself with the background on financial statement analysis.

8.2 The nature and scope of financial statement analysis

Read through paragraph 8.2 in the prescribed textbook about the nature and scope of financial statement analysis.

8.3 The objective of financial statement analysis

The main objective of financial statement analysis is to assess the entity's performance and financial position in relation to risk. The information gathered from the analysis of the financial statements can be used to pinpoint areas that require further investigation and to plan for the future.

Read through paragraph 8.3 of the prescribed textbook about the objective of financial statement analysis.

8.4 The application of financial statement analysis

Ratios are classified according to the information they provide. The following ratios are dealt with in this module:

- Profitability ratios
- Liquidity ratios, and
- Solvency ratios

Profitability ratios provide several different measures of the success of an entity in generating comprehensive income. In this course, the following ratios are used to measure the profitability of an entity:

- The *return on equity* measures how profitable the investment of capital is for the owners of the entity.
- The *return on total assets* is a measure of how effectively an entity's assets are being used to generate comprehensive income.
- The *gross profit percentage* is a measure of the gross profit earned on sales. The gross profit margin considers the entity's cost of goods sold, but does not include any selling costs.
- The *profit margin* measures how much comprehensive income an entity makes for every Rand it generates in revenue.
- The *financial leverage* and *leverage effect* are measures of the extent to which an entity benefits from of the use of debt in contrast to equity.

Study paragraph 8.4.1 in the prescribed textbook and pay particular attention to the definition of the different types of profitability ratios and the way in which they are calculated and interpretated.

Liquidity ratios provide information about the entity's ability to meet its short-term (current) financial obligations with its current assets as they become due. These ratios are of particular interest to those extending short-term credit to an entity. In this course the following ratios are used to measure the liquidity position of an entity:

- The *current ratio* contrasts current assets with current liabilities in order to assess the extent to which current liabilities are covered by current assets.
- The *acid test* ratio has the same objective as the current ratio but the ratio excludes inventories.
- The *trade receivables collection* period measures the time period for which accounts receivable are outstanding.
- The *trade payables settlement period* measures how long it takes an entity to settle its creditors.
- The aim of the *inventory turnover rate* is to assess whether an entity is investing too much in inventories.
- The *inventory holding* period measures the number of days it takes an entity to convert invertory into sales.

Study paragraph 8.4.2 in the prescribed textbook and pay particular attention to the definitions of the different types of liquidity ratios and the way in which they are calculated and interpretated.

Solvency ratios measure the extent to which an entity is able to meet its long term obligations and remain solvent. An entity's financing is obtained from equity and the borrowing of money. The greater the proportion of the loans (debt) in relation to the equity, the greater the risk will be for the entity and the financier.

In this course, we use the following ratios to measure the solvency of an entity:

- The *debt-equity ratio* measures the proportion of equity and debt used by the entity to finance its assets.
- The *times interest earned ratio* measures the ability of the entity to generate comprehensive income to cover the interest obligations on outstanding debt. This ratio is also known as the *interest coverage ratio.*

Study paragraph 8.4.3 in the prescribed textbook. Focus on the definitions of the different types of solvency ratios and the way in which they are calculated and interpretated.

8.5 The limitations of financial statement analysis

It is important to take note of the limitations of financial statement analysis when the information is used for decision making purposes.

Study paragraph 8.5 in the prescribed textbook. Can you think of any other limitations of financial statement analysis and why it should be used with caution when making predictions?

Work through example 8.1. Note how the different ratios are calculated and interpreted. In conclusion, read the summary in paragraph 8.6 of the prescribed textbook.

8.6 Exercise and solution

Exercise 8.1

Analysis and interpretation of financial statements

Work through the exercise, noting how the different ratios are calculated and the very basic interpretation of the ratios when comparing them with those for the previous year.

Given information

The following information pertains to Golden Arrow CC:

GOLDEN ARROW CC

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 28 FEBRUARY 20.1

	20.1	20.0
	R	R
Revenue	360 000	307 500
Cost of sales	(270 000)	(225 000)
Inventory (1 March 20.0)	66 000	58 000
Purchases	273 000	233 000
	339 000	291 000
Inventory (28 February 20.1)	(69 000)	(66 000)
Gross profit	90 000	82 500
Other income	1 000	1 000
Interest income: Loans and receivables: Fixed deposit	1 000	1 000
	91 000	83 500
Distribution, administrative and other expenses	(69 000)	(61 000)
Administration expenses	45 000	43 000
Depreciation	9 000	8 000
Remuneration: Accounting officer	15 000	10 000
Finance costs	(15 000)	(10 000)
Interest on long-term loan	15 000	10 000
Profit before tax	7 000	12 500
Income tax expense	(2 000)	(3 600)
Profit for the year	5 000	8 900
Other comprehensive income for the year	—	—
Total comprehensive income for the year	5 000	8 900

GOLDEN ARROW CC

STATEMENT OF CHANGES IN NET INVESTMENT OF MEMBERS FOR THE YEAR ENDED 28 FEBRUARY 20.1

	Members' contributions	Retained earnings	Total
	R	R	R
Balances as at 1 March 20.0	100 000	19 000	119 000
Members' contributions	23 000		23 000
Total comprehensive income for the year		5 000	5 000
Balances as at 28 February 20.1	123 000	24 000	147 000

GOLDEN ARROW CC

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20.1

	20.1 R	20.0 R
ASSETS		
Non-current assets	115 000	100 000
Property, plant and equipment	107 000	92 000
Financial assets (Loans and receivables)	8 000	8 000
Current assets	137 000	123 000
Inventories	69 000	66 000
Trade receivables (Trade debtors)	68 000	57 000
Total assets	252 000	223 000
EQUITY AND LIABILITIES		
Total equity	147 000	119 000
Members' contribution	123 000	100 000
Retained earnings	24 000	19 000
Total liabilities	105 000	104 000
Non-current liabilities	50 000	50 000
Long-term borrowings	50 000	50 000
Current liabilities	55 000	54 000
Trade and other payables (Trade creditors)	41 000	36 000
Other financial liabilities (Bank overdraft)	14 000	18 000
Total equity and liabilities	252 000	223 000

Additional information

1 R270 000 of the 20.0 and R330 000 of the 20.1 sales were on credit.
2 All the purchases for both years were on credit.
3 The financial asset consists of a fixed deposit at the Second National Bank at 12,5% interest per annum. The money was invested on 1 March 19.9 for a five-year period.
4 Trade debtors amounted to R55 000 in 19.9 and trade creditors to R34 000 in 19.9.
5 The closing balance of the inventory account amounted to R63 000 in 19.9.

REQUIRED

As a potential investor determine the profitability, liquidity and solvency position of Golden Arrow CC.

1 Profitability

Return on equity:

			20.1		20.0	
$\frac{\text{Profit before tax}}{\text{Total equity}}$	x 100	=	$\frac{\text{R7 000}}{\text{R147 000}}$	x 100	$\frac{\text{R12 500}}{\text{R119 000}}$	x 100
		=	4,76%		10,50%	

There is a remarkable deterioration in the return on equity in 20.1 of 5,74% (10,5 – 4,76%).

Return on total assets:

$\frac{\text{Profit before interest and tax}}{\text{Total assets}}$	x 100	=	$\frac{\text{R22 000①}}{\text{R252 000}}$	x 100	$\frac{\text{R22 500①}}{\text{R223 000}}$	x 100
		=	8,73%		10,09%	

① Profit before interest

	R	R
Profit before tax	7 000	12 500
Interest expense	15 000	10 000
	22 000	22 500

There was a deterioration in the return on assets of 1,36% (10,09% – 8,73%) in 20.1.

Gross profit percentage:

$\frac{\text{Gross profit}}{\text{Sales}}$	x 100	=	$\frac{\text{R90 000}}{\text{R360 000}}$	x 100	$\frac{\text{R82 500}}{\text{R307 500}}$	x 100
		=	25,00%		26,83%	

The gross profit margin deteriorated by 1,83% (26,83% – 25,00%) in 20.1 which is one of the reasons why the other profitability ratios deteriorated.

Profit margin:

$\frac{\text{Profit before tax}}{\text{Sales}}$	x 100	=	$\frac{\text{R7 000}}{\text{R360 000}}$	x 100	$\frac{\text{R12 500}}{\text{R307 500}}$	x 100
		=	1,94%		4,07%	

The profit margin deteriorated by 2,13% (4,07 – 1,94%) which can be attributed to an increase in expenses and the decrease in the gross profit percentage.

Financial leverage:

	20.1	20.0
Return on equity: Return on assets	4,76 : 8,73	10,50 : 10,09
	0,54 : 1	1,04 : 1
	[OR]	*[OR]*

$$\frac{\text{Return on equity}}{\text{Return on assets}} \quad \frac{4{,}76\%}{8{,}73\%} \quad \frac{10{,}50\%}{10{,}09\%}$$

$$= \quad 0{,}55 \quad 1{,}04$$

The financial leverage declined to a very low level in 20.1, which is an indication of inefficient use of borrowed funds during the year.

Leverage effect:

	20.1	20.0
Return on equity	4,76%	10,50%
Less: Return on assets	(8,73)%	(10,09)%
	(3,97)%	0,41%

The members of the corporation received a negative return of 3,97% on their investment in 20.1 indicating that the borrowed money was not effectively used. The situation was better in 20.0 because a positive return of 0,41% was received.

2 Liquidity

Current ratio: **20.1** **20.0**

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\text{R137 000}}{\text{R 55 000}} \quad \frac{\text{R123 000}}{\text{R 54 000}}$$

$$= \quad 2{,}49 : 1 \quad 2{,}27 : 1$$

The current ratio of Golden Arrow CC indicates a healthy liquidity position. However, it is increasing and is higher than the standard of 2:1, thus indicating a larger than necessary investment in current assets.

Acid test ratio: **20.1** **20.0**

$$\frac{\text{Current assets less inventory}}{\text{Current liabilities}} = \frac{\text{R(137 000 – 69 000)}}{\text{R55 000}} \quad \frac{\text{R(123 000 – 66 000)}}{\text{R54 000}}$$

$$= \quad 1{,}24 : 1 \quad 1{,}06 : 1$$

The acid test ratio of Golden Arrow CC is good although it is higher than the standard of 1:1, which indicates that the CC's investment in current assets is higher than necessary.

Trade receivables collection period: **20.1** **20.0**

$$\frac{\text{Average trade receivables x 365}}{\text{Credit sales}} = \frac{\text{R62 500}^{①}\text{ x 365}}{\text{R330 000}} \quad \frac{\text{R56 000}^{②}\text{ x 365}}{\text{R270 000}}$$

$$= \quad 69{,}13 \text{ days} \quad 75{,}70 \text{ days}$$

① Average trade receivables 20.1 R(68 000 + 57 000) = R125 000 ÷ 2 = R62 500.
② Average trade receivables 20.0 R(57 000 + 55 000) = R112 000 ÷ 2 = R56 000.

The collection period improved from 75,70 days in 20.0 to 69,13 days in 20.1. Debtors paid their accounts 6,57 days earlier in 20.1 compared with 20.0.

Trade payables payment period:

		20.1	**20.0**
$\dfrac{\text{Average trade payables x 365}}{\text{Credit purchases}}$	=	$\dfrac{\text{R38 500}^{①} \text{ x 365}}{\text{R273 000}}$	$\dfrac{\text{R35 000}^{②} \text{ x 365}}{\text{R233 000}}$
	=	51,47 days	54,83 days

① Average trade payables 20.1 R(41 000 + 36 000) = R77 000 ÷ 2 = R38 500.
② Average trade payables 20.0 R(36 000 + 34 000) = R70 000 ÷ 2 = R35 000.

Golden Arrow CC settled the accounts of creditors in 51,47 days in 20.1 and in 54,83 days in 20.0. This is 3,36 days earlier in 20.1. Comparing this information with the trade receivables collection period, the CC settled the creditors accounts before they received payment from the debtors. This could have a negative effect on an entity's cash flow and is one of the reasons why the acid test ratio revealed a higher than necessary investment in current assets.

Inventory turnover rate:

		20.1	**20.0**
$\dfrac{\text{Cost of sales}}{\text{Average inventory}}$	=	$\dfrac{\text{R270 000}}{\text{R67 500}^{①}}$	$\dfrac{\text{R225 000}}{\text{R64 500}^{②}}$
	=	4 times	3.49 times

① Average inventory 20.1 R(69 000 + 66 000) = R135 000 ÷ 2 = R67 500.
② Average inventory 20.0 R(66 000 + 63 000) = R129 000 ÷ 2 = R64 500.

Golden Arrow CC improved the inventory turnover rate from 20.0 to 20.1. Improvement in the inventory turnover rate is generally associated with good management of inventory which usually leads to the saving of cost associated with keeping inventory for longer periods.

Inventory holding period:

		20.1	**20.0**
$\dfrac{\text{Average inventory x 365}}{\text{Cost of sales}}$	=	$\dfrac{\text{R67 500}^{①} \text{ x 365}}{\text{R270 000}}$	$\dfrac{\text{R64 500}^{②} \text{ x 365}}{\text{R225 000}}$
	=	91,25 days	104,63 days

① and ② Refer previous calculations.

The inventory holding period indicates the number of days that inventory is on hand — in other words, how long it takes an entity to sell inventory purchased. Golden Arrow CC recorded a decrease in the number of days it keeps its inventory. This can be interpreted as an improvement in the management of inventory by the entity.

3 Solvency

Debt-equity ratio:

		20.1	**20.0**
$\dfrac{\text{Total debt}}{\text{Total equity}} \text{ x 100}$	=	$\dfrac{\text{R105 000}}{\text{R147 000}} \text{ x 100}$	$\dfrac{\text{R104 000}}{\text{R119 000}} \text{ x 100}$
	=	71,43%	87,39%

The level of debt in the entity's financial structure decreased from 87,39% in 20.0 to 71,43% in 20.1. A high level of debt-equity ratio generally means that an entity has been aggressive in financing its growth with debt.

Times interest earned ratio:

		20.1	**20.0**
Profit before interest and tax / Finance costs	=	R22 000 / R15 000	R22 500 / R10 000
	=	1,47 times	2,25 times

The number of times profit generated was able to cover the interest payment on its debt, decreased from 2,25 times in 20.0 to 1,47 times in 20.1, which confirms the CC's poor profitability during the year.

Taking this basic analysis into account would you invest in Golden Arrow CC?

SELF-ASSESSMENT

After having worked through this study unit

	Yes	No
• are you able to discuss the nature, scope and objectives of financial statement analysis?		
• do you understand the need for financial statement analysis?		
• are you able to define, calculate and interpret the following ratios? — return on equity — return on total assets — gross profit percentage — profit margin — financial leverage and leverage effect — current ratio — acid test ratio — trade receivables collection period — trade payables settlement period — inventory turnover rate — inventory holding period — debt-equity ratio — times interest earned ratio		
• are you able to discuss the limitations of financial statement analysis?		

If you answered "yes" to all the above assessment criteria, you have completed your studies on the analysis and interpretation of financial statements. If your answer was "no" revise that section before proceeding to the next study unit.

STUDY UNIT

9

Branches

CONTENTS

Learning outcomes

After studying this study unit you should be able to

- explain the concept of branches
- briefly explain the difference between dependent and independent branches
- identify the information to be included in the reports submitted by a dependent branch to the head office
- record the transactions between a head office and a dependent branch in the books of the head office where inventory sent to the branch is invoiced at cost price
- record the transactions between a head office and a dependent branch in the books of the head office where inventory sent to the branch is invoiced at selling price
- record the transactions of a dependent branch pertaining to the following where inventory is invoiced at cost price or at selling price:

  — purchases of inventory by the branch
  — sales of inventory by the branch
  — inventory damaged or stolen at the branch
  — inventory sold by the branch at a discount
  — inter-branch inventory transactions
  — settlement discount granted to debtors of the branch
  — donations made by the branch
  — cash embezzled at the branch
  — inventory in transit between the branch and the head office

- identify and record a shortage or surplus in the inventory of a branch where inventory is invoiced by the head office at selling price

Key concepts

- Head office
- Dependent branches
- Branch inventory
- Inventory to branch
- Branch adjustments
- Branch gross profit (or loss)
- Branch profit (or loss)
- Inventory transactions
- Other branch transactions

9.1 Introduction

A business entity can establish a branch (or branches) which is geographically separated from the central (main) enterprise, but which still forms part of the business entity. One of the reasons why business entities establish branches is to broaden their markets. Thereby increasing their potential revenues so as, ultimately, to maximise their profitability. Branches can be managed as dependent or independent entities, each with its own distinct accounting requirements. In this module only dependent branches are addressed.

Read through paragraph 9.1 in the prescribed textbook for an introductory discussion on branches.

9.2 Accounting for dependent branches

The head office of a dependent branch is responsible for supplying inventory to the branch, and for recording all of the accounting transactions of the branch in its books (that is, the books of the head office). The head office can invoice inventory to the branch at either cost or selling price. Each method of invoicing requires a different accounting recording procedure. A branch may also purchase inventory from other suppliers. Usually, the head office of a dependent branch is responsible for the payment of the major expenses of the branch. The head office may also decide to provide the branch with petty cash for the payment of minor expenses that are incurred by the branch.

Since the activities of a dependent branch are recorded in the books of its head office, a dependent branch is usually required to submit a report to the head office in respect of the transactions that have occurred at the branch over a given financial period.

Study paragraph 9.2 in the prescribed textbook.

9.3 Recording of transactions where inventory sent to the branch is invoiced by the head office at cost price

When this method of bookkeeping is followed, two accounts must be opened in the books of the head office, namely:

- a branch inventory account, and
- an inventory to branch account

These accounts are concerned specifically with the recording of transactions that pertain to the inventory of the branch. The other business activities of a branch are recorded in other accounts in the books of the head office, for example, a branch debtors control account, a branch asset account or a branch expenses account.

Paragraph 9.3 of the prescribed textbook discusses the recording of transactions where inventory was invoiced at cost price in detail. Study this paragraph, and make sure that you understand each of the examples included therein.

9.4 Recording of transactions where inventory sent to the branch is invoiced by the head office at selling price

When inventory is invoiced to the branch at selling price, the branch inventory account will not reflect the gross profit of the branch, as was the case when the inventory was invoiced to the branch at cost price. An additional account, namely a "branch adjustment account", is required to reflect the gross profit. The branch inventory account (at selling price) functions as an inventory control account.

The recording of all inventory transactions in the branch inventory account (at selling price) is done at selling price. Each selling price is divided into two amounts, namely the cost price and the profit mark-up of the inventory. These two amounts are disclosed separately in the branch inventory account (at selling price), and must add up to the selling price. The reason for this separate disclosure in the branch inventory account is that the entries pertaining to the cost price and the entries pertaining to the profit mark-up have different contra accounts. For example, when inventory that is sent to the branch is recorded (assume a cost of R100 and a mark-up of R50), the branch inventory account is debited (separately) with the cost price (R100) and the profit mark-up thereof (R50) against different contra accounts, namely the inventory to branch account (R100) and the branch adjustment account (R50), respectively. The inventory to branch account is credited with the cost price (R100), and the branch adjustment account is credited with the profit mark-up (R50). The branch inventory account was debited with R150 (in total).

Study paragraph 9.4.1 of the prescribed textbook.

The calculation of the profit mark-up in branch inventory is discussed in paragraph 9.4.2 of the prescribed textbook. Study this paragraph and ensure that you can calculate the profit mark-up and the selling price when given the cost price, and that you can calculate the profit mark-up and the cost price when given the selling price.

Paragraphs 9.4.3 to 9.4.13 of the prescribed textbook discuss the recording of transactions where inventory was invoiced at selling price. Study these paragraphs, and make sure that you understand each of the examples included therein.

9.5 Exercises and solutions

Exercise 9.1

Preparation of general ledger accounts in the books of head office in respect of a branch where inventory is invoiced to the branch at cost price

Work through the exercise. Take note that the gross profit is the balancing figure in the branch inventory account (at cost).

Given information

The following information pertains to the head office and branch of Boom CC:

Transactions during the year ended 31 December 20.1		R
Inventory sent to branch		4 800
Inventory returned to head office by the branch		80
Sales by branch for the year:	cash	2 000
	credit	3 290
Cash received from branch debtors and paid into the head office bank account		2 890
Sundry expenses paid by head office		600

Additional information

1. The branch began trading on 2 January 20.1 and inventory is invoiced to the branch at **cost price**.
2. An amount of R50 must be written off as a credit loss.
3. Discount on selling prices granted to clients in respect of cash sales amounted to R30.
4. Inventory at 31 December 20.1 amounted to R480.

REQUIRED

Prepare the following accounts properly balanced/closed off, in the general ledger of the head office for the year ended 31 December 20.1:

(a) Branch inventory account
(b) Inventory to branch account
(c) Branch debtors control account
(d) Branch expenses account
(e) Bank account (partly)

Solution 9.1

BOOM CC (HEAD OFFICE)

GENERAL LEDGER

(a)

Dr **Branch inventory (at cost price)** **Cr**

20.1		**R**	**20.1**		**R**
Dec 31	Inventory to branch (Deliveries at cost)	4 800	Dec 31	Inventory to branch (Returns at cost)	80
	Branch expenses (Branch gross profit for the year*)	1 050		Bank (Cash sales)	2 000
				Branch debtors control (Credit sales)	3 290
				Balance c/d (Closing inventory)	480
		5 850			5 850
20.2					
Jan 1	Balance b/d (Opening inventory)	480			

* Balancing entry

(b)

Dr **Inventory to branch (at cost price)** **Cr**

20.1		**R**	**20.1**		**R**
Dec 31	Branch inventory (Returns at cost)	80	Dec 31	Branch inventory (Deliveries at cost)	4 800
	Head office: Trading account*	4 720			
		4 800			4 800

* Balancing entry

(c)

Dr **Branch debtors control** **Cr**

20.1		**R**	**20.1**		**R**
Dec 31	Branch inventory (Credit sales)	3 290	Dec 31	Bank (Collections deposited by branch)	2 890
				Branch expenses (Credit losses)	50
				Balance c/d	350
		3 290			3 290
20.2					
Jan 1	Balance b/d	350			

(d)

Dr **Branch expenses** **Cr**

20.1		**R**	**20.1**		**R**
Dec 31	Bank (Sundry expenses)	600	Dec 31	Branch inventory (Branch gross profit for the year)	1 050
	Branch debtors control (Credit losses)	50			
	Head office: Profit or loss (Branch profit for the year*)	400			
		1 050			1 050

* Balancing entry

(e)

Dr **Bank (extract)** **Cr**

20.1		**R**	**20.1**		**R**
Dec 31	Branch debtors control (Collections deposited by branch)	2 890	Dec 31	Branch expenses (Sundry expenses)	600
	Branch inventory (Cash sales)	2 000			

Comment

- The cash discount on sales of R30 will not be recorded, because the cash sales of R2 000 already excludes this amount.
- Only cash transactions with the branch are shown in the bank account. In practice the bank account will contain the cash transactions of the branch as well as those of the head office.
- In the above solution we see that the branch inventory is brought down as a balance in the branch inventory account at the end of the financial period. The balances of the branch debtors control and the branch asset accounts are added to the head office balances and disclosed as a total amount in the statement of financial position.

Exercises 9.2 to 9.5 pertain to situations where inventory is invoiced at selling price. Take note that the gross profit of the branch is not calculated as the balancing figure in the branch inventory account (at selling price). Since the branch inventory account (at selling price) functions as an inventory control account, the balancing figure in the branch inventory account (at selling price) reflects either an inventory surplus or a shortage.

Exercise 9.2

Preparation of general ledger accounts in the books of head office in respect of a branch where inventory is invoiced to the branch at selling price

Given information

The following information pertains to the head office and branch of Check CC:

Transactions during the year ended 31 December 20.2		**R**
Inventory sent to branch (cost price)		4 800
Inventory returned to head office by the branch (cost price)		80
Sales by branch for the year:	cash	2 000
	credit	3 290
Cash received from branch debtors and paid into the head office bank account		2 890
Sundry expenses paid by head office		600

Additional information

1. The branch commenced business on 2 January 20.2 and goods are invoiced to the branch at **selling price**, which is cost plus 25%.
2. After consulting the branch manager, it was decided to write off an amount of R50 as irrecoverable.
3. Discount on selling prices granted to clients in respect of cash sales amounted to R30.
4. Inventory at 31 December 20.2 (cost price) amounted to R480.

REQUIRED

Prepare the following accounts properly balanced/closed off, in the general ledger of the head office for the year ended 31 December 20.2:

(a) Branch inventory account
(b) Inventory to branch account
(c) Branch adjustment account
(d) Branch debtors control account
(e) Branch expenses account
(f) Bank account

CHECK CC (HEAD OFFICE)

GENERAL LEDGER

(a)

Dr **Branch inventory (at selling price)** **Cr**

20.2		**R**	**20.2**		**R**
Dec 31	Inventory to branch (Deliveries at cost)	4 800	Dec 31	Inventory to branch (Returns at cost)	80
	Branch adjustment (Mark-up on deliveries) ①	1 200		Branch adjustment (Mark-up on returns) ②	20
	Branch adjustment (Inventory surplus*)	20		Branch adjustment (Discount on cash sales)	30
				Bank (Cash sales)	2 000
				Branch debtors control (Credit sales)	3 290
				Balance c/d (Closing inventory) R(480 + 120) ③	600
		6 020			6 020
20.3					
Jan 1	Balance b/d (Opening inventory)	600			

* Balancing entry

(b)

Dr **Inventory to branch (at cost price)** **Cr**

20.2		**R**	**20.2**		**R**
Dec 31	Branch inventory (Returns at cost)	80	Dec 31	Branch inventory (Deliveries at cost)	4 800
	Head office: Trading account*	4 720			
		4 800			4 800

* Balancing entry

(c)

Dr **Branch adjustment** **Cr**

20.2		R	20.2		R
Dec 31	Branch inventory (Mark-up on returns) ②	20	Dec 31	Branch inventory (Mark-up on deliveries) ①	1 200
	Branch inventory (Discount on sales)	30		Branch inventory (Inventory surplus)	20
	Balance c/d (Mark-up on closing inventory) ③	120			
	Branch expenses (Branch gross profit for the year*)	1 050			
		1 220			1 220
			20.3		
			Jan 1	Balance b/d (Mark-up on opening inventory)	120

* Balancing entry

(d)

Dr **Branch debtors control** **Cr**

20.2		R	20.2		R
Dec 31	Branch inventory (Credit sales)	3 290	Dec 31	Bank (Collections deposited by branch)	2 890
				Branch expenses (Credit losses)	50
				Balance c/d	350
		3 290			3 290
20.3					
Jan 1	Balance b/d	350			

(e)

Dr **Branch expenses** **Cr**

20.2		R	20.2		R
Dec 31	Bank: (Sundry expenses)	600	Dec 31	Branch adjustment (Branch gross profit for the year)	1 050
	Branch debtors control (Credit losses)	50			
	Head office: Profit or loss (Branch profit for the year*)	400			
		1 050			1 050

* Balancing entry

(f)

Dr **Bank (extract)** **Cr**

20.2		**R**	**20.2**		**R**
Dec 31	Branch debtors control (Collections deposited by the branch)	2 890	Dec 31	Branch expenses (Sundry expenses)	600
	Branch inventory (Cash sales)	2 000			

Comments

- A *cash discount* on sales is referred to in the prescribed textbook as a *mark-down* on sales. Both these words are accepted as correct.
- The inventory surplus is the balancing entry in the branch inventory account.
- The gross profit is calculated in the branch adjustment account, contrary to where inventory is supplied at cost.
- The inventory to branch account, the branch debtors control account, the branch expenses account and the bank account remain unchanged. Refer to exercise 9.1 where the same information was used, except that inventory is supplied to the branch at cost.
- Take note that the same branch gross profit (R1 050) and branch profit (R400) was calculated, regardless of whether the inventory was supplied at cost or at selling price.
- To convert the inventory of the branch to cost price, the balance of the branch adjustment account must be deducted from the balance on the branch inventory account (R600 – R120). In the statement of financial position the inventory of the branch is added to the inventory of the head office at cost (R480).
- The closing inventory at 31 December 20.2 is the opening inventory at 1 January 20.3.

Calculations

① **Profit mark-up on inventory sent to branch**

	%
Cost	100
Profit mark-up	25
Selling price	125

Mark-up on deliveries = R 4 800 x $^{25}/_{100}$ = R1 200.

Comment: Take note that the cost price of the inventory was given.

② **Profit mark-up on returns**

R80 x $^{25}/_{100}$ = R20

③ **Profit mark-up on closing inventory**

R480 x $^{25}/_{100}$ = R120

Exercise 9.3

Preparation of general ledger accounts in the books of head office in respect of a branch where inventory is invoiced to the branch at selling price

Given information

The following information pertains to the head office and the branch of Pama CC:

Transactions for the year ended 31 December 20.3	**R**
Inventory sent to branch (selling price)	18 750
Cash sales (deposited in bank)	17 918
Returns to head office (selling price)	186
Sundry expenses paid by head office	4 760

Additional information

1 All purchases are made by head office and all goods required by the branch are supplied by head office at selling price, that is cost price plus 50%.
2 A burglary took place during the year and R55 in cash (cash sales) and inventory to the value of R36 (selling price) were stolen, but no entries were made in the books.
3 The net proceeds of the annual sale amounted to R360. Inventory was sold at selling price less 10% and no entries were made in the books concerning this price reduction.
4 Inventory invoiced to the branch at R75 (included in the amount of R18 750 above) were still in transit at 31 December 20.3 and were therefore not included in the branch's inventory at 31 December 20.3.
5 Inventory at selling price:

	R
31 December 20.2	1 500
31 December 20.3	1 950

REQUIRED

Prepare the following accounts properly balanced/closed off, in the general ledger of the head office for the year ended 31 December 20.3:

(a) Branch inventory account
(b) Inventory to branch account
(c) Branch adjustment account
(d) Branch expenses account

NB: The date columns of the accounts are not required.

PAMA CC (HEAD OFFICE)

GENERAL LEDGER

(a)

Dr		**Branch inventory**	**Cr**
	R		**R**
Balance b/d		Bank (Sales)	17 918
(Opening inventory)	1 500	Inventory to branch	
Inventory to branch		(Returns at cost) ③	124
(Deliveries at cost) ①	12 500	Branch adjustment	
Branch adjustment		(Mark-up on returns) ④	62
(Mark-up on deliveries) ②	6 250	Branch expenses	
Branch adjustment		(Cash stolen)	55
(Inventory surplus*)	10	(Inventory stolen at cost) ⑤	24
		Branch adjustment	
		(Mark-up on inventory stolen) ⑥	12
		Branch adjustment	
		(Discount on sales) ⑦	40
		Balance c/d	
		(Inventory in transit)	75
		(Closing inventory)	1 950
	20 260		20 260
Balance b/d			
(Inventory in transit)	75		
(Opening inventory)	1 950		

* Balancing entry

(b)

Dr		**Inventory to branch**	**Cr**
	R		**R**
Branch inventory		Branch inventory	
(Returns at cost) ③	124	(Deliveries at cost) ①	12 500
Head office: Trading account*	12 376		
	12 500		12 500

* Balancing entry

(c)

Dr — Branch adjustment — Cr

Dr	R	Cr	R
Branch inventory (Mark-up on returns) ④	62	Balance b/d (Mark-up on opening inventory) ⑩	500
Branch inventory (Mark-up on inventory stolen) ⑥	12	Branch inventory (Mark-up on deliveries) ②	6 250
Branch inventory (Discount on sales) ⑦	40	Branch inventory (Inventory surplus)	10
Balance c/d (Mark-up on inventory returned) ⑧	25		
(Mark-up on closing inventory) ⑨	650		
Branch expenses (Branch gross profit for the year*)	5 971		
	6 760		6 760
		Balance b/d (Mark-up on inventory in transit) ⑧	25
		(Mark-up on opening inventory) ⑨	650

* Balancing entry

(d)

Dr — Branch expenses — Cr

Dr	R	Cr	R
Sundry expenses (paid by head office)	4 760	Branch adjustment (Branch gross profit for the year)	5 971
Branch inventory (Cash stolen)	55		
Branch inventory (Inventory stolen) ⑤	24		
Head office: Profit or loss (Branch profit for the year*)	1 132		
	5 971		5 971

* Balancing entry

Calculations

① **Cost of inventory sent to branch**

	%
Cost	100
Profit mark-up	50
Selling price	150

Deliveries at cost = R18 750 x $^{100}/_{150}$ = R12 500.
Comment: Take note that the selling price was given.

② **Profit mark-up on deliveries**

R18 750 x $^{50}/_{150}$ = R6 250

③ **Cost of returns to head office**

R186 x $^{100}/_{150}$ = R124

④ **Profit mark-up on returns to head office**

R186 x $^{50}/_{150}$ = R62

⑤ **Cost of inventory stolen**

R36 x $^{100}/_{150}$ = R24

⑥ **Profit mark-up on inventory stolen**

R36 x $^{50}/_{150}$ = R12

⑦ **Discount on sale**

R360 = 90% of original selling price

Original selling price $= \frac{R360}{1} \times \frac{100}{90}$

= R400

Discount = R(400 – 360) = R40

or

	%
Cost price	100
Profit mark-up	50
Original selling price	150
Mark-down (10% x 150)	(15)
Sold at	135

Original selling price
R360 x $^{150}/_{135}$ = R400
Mark-down on the original selling price
R(400 – 360) = R40
or
R400 x $^{15}/_{150}$ = R40

⑧ **Profit mark-up on closing inventory in transit**
R75 x $^{50}/_{150}$ = R25

⑨ **Profit mark-up on closing inventory**
R1 950 x $^{50}/_{150}$ = R650

⑩ **Profit mark-up on opening inventory**
R1 500 x $^{50}/_{150}$ = R500

Exercise 9.4

Preparation of general ledger accounts in the books of head office in respect of a branch where inventory is invoiced to the branch at selling price

Given information

The following information pertains to the head office and the Bloemfontein branch of Hope CC:

Transactions for the year ended 28 February 20.5	R
Settlement discount granted to debtors	
— Head office	700
— Branch	180
Credit losses recovered	
— Head office	140
— Branch	60
Inventory to branch (at selling price)	102 000
Sales (cash)	
— Head office	215 000
— Branch	93 750
Purchases	180 000
Sundry selling and administrative expenses	
— Head office	51 200
— Branch	13 100
Returns from branch (at selling price)	2 000

Additional information

1 All purchases are made by the head office and supplied to the branch at cost price plus 25%.

2 Inventory at:

	Head office (at cost)	Branch (at selling price)
	R	R
28 February 20.4	20 000	15 000
28 February 20.5	25 000	16 000

3 Inventory returned by the branch to the head office, in transit at 28 February 20.5, amounted to R4 000 (selling price).

4 R150 cash was embezzled by the cashier at the branch by altering sales invoices. This figure has not yet been recorded in the books.

5 During the year a burglary took place at the branch and inventory at a cost price of R120 was stolen. Included in the branch sales is an amount of R110 which was received from an insurance company in full settlement of the company's claim regarding the theft.

6 The branch's annual sale took place in January 20.5 and inventory was sold at selling price less 10%. The total proceeds of the sale amounted to R9 000, which was included in the sales amount.

7 All the branch expenses are paid by the head office.

REQUIRED

Prepare the following accounts properly balanced/closed off, in the general ledger of the head office for the year ended 28 February 20.5:

(a) Branch inventory account
(b) Branch adjustment account
(c) Branch expenses account

NB: The date columns of the accounts are not required.

Solution 9.4

HOPE CC (HEAD OFFICE)

GENERAL LEDGER

(a)

Dr **Branch inventory** **Cr**

Dr	R	Cr	R
Balance b/d		Bank (cash sales) ③	93 640
(Opening inventory)	15 000	Inventory to branch	
Inventory to branch		(Returns at cost) ④	1 600
(Deliveries at cost) ①	81 600	Branch adjustment	
Branch adjustment		(Mark-up on returns) ⑤	400
(Mark-up on deliveries) ②	20 400	Branch expenses	
		(Cash embezzled)	150
		(Inventory stolen at cost) ⑥	120
		Branch adjustment	
		(Mark-up on inventory stolen) ⑦	30
		Branch adjustment	
		(Discount on sales) ⑧	1 000
		Inventory to branch	
		(Inventory returned at cost) ⑨	3 200
		Branch adjustment	
		(Mark-up on inventory returned) ⑨	800
		Branch adjustment	
		(Inventory shortage*)	60
		Balance c/d	
		(Closing inventory)	16 000
	117 000		117 000
Balance b/d			
(Opening inventory)	16 000		

* Balancing entry

(b)

Dr **Branch adjustment** **Cr**

	R		R
Branch inventory		Balance b/d	
(Mark-up on returns) ⑤	400	(Mark-up on opening inventory) ⑩	3 000
Branch inventory		Branch inventory	
(Mark-up on inventory stolen) ⑦	30	(Mark-up on deliveries) ②	20 400
Branch inventory			
(Discount on sales) ⑧	1 000		
Branch inventory			
(Mark-up on inventory returned) ⑨	800		
Branch inventory			
(Inventory shortage)	60		
Settlement discount granted	180		
Balance c/d			
(Mark-up on closing inventory) ⑪	3 200		
Branch expenses			
(Branch gross profit for the year*)	17 730		
	23 400		23 400
		Balance b/d	
		(Mark-up on opening inventory)	3 200

* Balancing entry

Comment:

Refer to example 9.17, in the prescribed textbook, with regard to the closing off procedure of the settlement discount granted account.

(c)

Dr **Branch expenses** **Cr**

	R		R
Branch inventory		Branch adjustment	
(Cash embezzled)	150	(Branch gross profit for the year)	17 730
Branch inventory		Credit losses recovered	60
(Inventory stolen) ⑥	120	Bank (proceeds from insurance	
Selling and administrative		claim) ⑥	110
expenses	13 100		
Head office: Profit or loss			
(Branch profit for the year*)	4 530		
	17 900		17 900

* Balancing entry

Calculations

① **Cost of inventory sent to branch**

	%
Cost	100
Profit mark-up	25
Selling price	125

R102 000 x $^{100}/_{125}$ = R81 600

② **Profit mark-up on inventory sent to branch**

R102 000 x $^{25}\!/_{125}$ = R20 400

③ **Cash sales**

	R
Sales	93 750
Payment received from insurance company	(110)
	93 640

④ **Cost of returns from branch**

R2 000 x $^{100}\!/_{125}$ = R1 600

⑤ **Profit mark-up on returns from branch**

R2 000 x $^{25}\!/_{125}$ = R400

⑥ **Inventory stolen at cost**

Inventory stolen at cost	120
Proceeds from insurance plan	(110)
	10

⑦ **Profit mark-up on inventory stolen**

R120 x $^{25}\!/_{100}$ = R30

⑧ **Discount on sales**

Proceeds of R9 000 are equal to 90% of the original selling price, thus

Original selling price $= \frac{R9\,000}{1} \times \frac{100}{90}$ (or R9 000 ÷ 0,9)
= R10 000

Discount = R(10 000 – 9 000)
= R1 000

or

	%
Cost price	100
Profit mark-up	25
Original selling price	125
Mark-down (10% × 125)	12,5
Sold at	112,5

Original selling price R9 000 x $^{125}\!/_{112,5}$ = R10 000
Mark-down on the original selling price R(10 000 – 9 000) = R1 000
or
R10 000 x $^{12,5}\!/_{125}$ = R1 000

⑨ **Markup on inventory returned (in transit)**

Cost price = R4 000 x $^{100}\!/_{125}$ = R3 200
Mark-up = R4 000 x $^{25}\!/_{125}$ = R800

The inventory in transit from the branch to head office (cost price, R3 200) was debited to the inventory to branch account and will be disclosed as part of the closing inventory of the head office.

⑩ **Profit mark-up on opening inventory**

R15 000 x $^{25}\!/_{125}$ = R3 000

⑪ **Profit mark-up on closing inventory**

R16 000 x $^{25}\!/_{125}$ = R3 200

Exercise 9.5

Preparation of general ledger accounts is in the books of head office in respect of a branch where inventory is invoiced to the branch at selling price

Given information

The following information pertains to the head office and branch of Sucro Confectionary CC:

Transactions during the year ended 28 February 20.2	R
Inventory to branch at selling price	64 500
Inventory returned to head office at selling price	1 800
Cash sales of branch embezzled by cashier	375
Administrative expenses of branch paid by head office	5 000
Discount granted to branch debtors for early settlement	150
Cash sales by branch (after deducting local purchases — cost price R500)	41 500
Credit sales of branch	20 000
Rent of branch paid by head office	1 800
Inventory damaged — selling price	300
Credit losses of branch written off	50

Additional information

1 Inventory was supplied to the branch by head office at selling price, ie at cost price plus 50%.

2 Inventory at selling price at:

28 February 20.1 — R4 500
28 February 20.2 — R4 800

3 It is estimated that theft of inventory amounting to R360 (selling price) occurred during the year. This amount must be taken into account during inventory reconciliations.

4 During the year the branch donated inventory (cost R60) towards a local charity fund-raising campaign.

5 Inventory purchased locally was also sold at cost price plus 50%.

REQUIRED

Prepare the following accounts properly balanced/closed off, in the general ledger of the head office for the year ended 28 February 20.2:

(a) Branch inventory account
(b) Branch adjustment account
(c) Branch expenses account

NB: The date columns of the accounts are not required.

Solution 9.5

SUCRO CONFECTIONERY CC (HEAD OFFICE)

GENERAL LEDGER

(a)

Dr **Branch inventory** **Cr**

	R		R
Balance b/d		Inventory to branch	
(Opening inventory)	4 500	(Returns at cost) ④	1 200
Inventory to branch		Branch adjustment	
(Deliveries at cost) ①	43 000	(Mark-up on returns) ⑤	600
Branch adjustment		Branch expenses	
(Mark-up on deliveries) ②	21 500	(Cash embezzled)	375
Bank (Local purchases)	500	Bank (Cash sales) ⑥	42 000
Branch adjustment		Branch debtors control	
(Mark-up on local purchases) ③	250	(Credit sales)	20 000
		Branch expenses	
		(Cost of inventory damaged) ⑦	200
		Branch adjustment	
		(Mark-up on inventory damaged) ⑧	100
		Branch expenses	
		(Cost of inventory stolen) ⑨	240
		Branch adjustment	
		(Mark-up on inventory stolen) ⑩	120
		Branch expenses	
		(Inventory donated at cost)	60
		Branch adjustment	
		(Mark-up on inventory donated) ⑪	30
		Branch adjustment	
		(Inventory shortage*)	25
		Balance c/d	
		(Closing inventory)	4 800
	69 750		69 750
Balance b/d			
(Opening inventory)	4 800		

* Balancing entry

(b)

Dr **Branch adjustment** **Cr**

	R		R
Branch inventory		Balance b/d	
(Mark-up on returns) 5	600	(Mark-up on opening inventory) 12	1 500
Branch inventory		Branch inventory	
(Mark-up on inventory damaged) 8	100	(Mark-up on deliveries) 2	21 500
Branch inventory		Branch inventory	
(Mark-up on inventory stolen) 10	120	(Mark-up on local purchases) 3	250
Branch inventory			
(Mark-up on inventory donated) 11	30		
Settlement discount granted	150		
Branch inventory			
(Inventory shortage)	25		
Balance c/d			
(Mark-up on closing inventory) 13	1 600		
Branch expenses			
(Branch gross profit for the year*)	20 625		
	23 250		23 250
		Balance b/d	
		(Mark-up on opening inventory)	1 600

* Balancing entry

(c)

Dr **Branch expenses** **Cr**

	R		R
Branch inventory		Branch adjustment	
(Cash sales embezzled)	375	(Branch gross profit for the	
Administrative expenses	5 000	year)	20 625
Rent expense	1 800		
Branch inventory			
(Inventory damaged) 7	200		
Credit losses	50		
Branch inventory	240		
(Inventory stolen) 9			
Branch inventory			
(Inventory donated)	60		
Head office: Profit or loss			
(Branch profit for the year*)	12 900		
	20 625		20 625

* Balancing entry

Calculations

① **Cost of inventory sent to branch**

	%
Cost	100
Profit mark-up	50
Selling price	150

Deliveries at cost R64 500 x $^{100}/_{150}$ = R43 000

② **Profit mark-up of inventory sent to branch**

R64 500 x $^{50}/_{150}$ = R21 500

③ **Profit mark-up on local purchases**

R500 x $^{50}/_{100}$ = R250

④ **Cost of returns from branch**

R1 800 x $^{100}/_{150}$ = R1 200

⑤ **Profit mark-up on returns from branch**

R1 800 x $^{50}/_{150}$ = R600

⑥ **Bank (Cash sales)**

	R
Cash sales by branch (after deduction of R500)	41 500
Cash used for local purchases	500
Total cash sales	42 000

⑦ **Cost of inventory damaged**

R300 x $^{100}/_{150}$ = R200

⑧ **Profit mark-up on inventory damaged**

R300 x $^{50}/_{150}$ = R100

⑨ **Cost of inventory stolen**

R360 x $^{100}/_{150}$ = R240

⑩ **Profit mark-up on inventory stolen**

R360 x $^{50}/_{150}$ = R120

⑪ **Profit mark-up on inventory donated**

R60 x $^{50}/_{100}$ = R30

⑫ **Profit mark-up on opening inventory**

R4 500 x $^{50}/_{150}$ = R1 500

⑬ **Profit mark-up on closing inventory**

R4 800 x $^{50}/_{150}$ = R1 600

SELF-ASSESSMENT

After having worked through this study unit, are you able to

	Yes	No
• briefly discuss the concept of branches?		
• briefly explain the differences between dependent and independent branches?		
• briefly discuss the information to be included in the reports submitted by a dependent branch to a head office?		
• record the transactions between a head office and a dependent branch in the books of the head office where inventory sent to the branch is invoiced at cost price?		
• record the transactions between a head office and a dependent branch in the books of the head office where inventory sent to the branch is invoiced at selling price?		
• record the transactions of a dependent branch pertaining to the following where inventory is invoiced at cost price or at selling price?		
— Purchases of inventory by the branch		
— Sales of inventory by the branch		
— Inventory sold by the branch at a discount		
— Inventory damaged or stolen at the branch		
— Inter-branch inventory transactions		
— Settlement discount granted to debtors of the branch		
— Donations made by the branch		
— Cash embezzled at the branch		
— Inventory in transit from the branch to the head office and from the head office to the branch		
• identify and record a shortage or surplus in the inventory of a branch where inventory is invoiced by the head office at selling price?		

If you answered "yes" to all the above assessment criteria, you have completed your studies on branches. If you answered "no" to any of the above criteria, you must revise that section before starting a revision programme in preparation for the examination.

Like many academic journeys, your's started with your acquisition of knowledge and understanding of accounting. By studying Accounting 1, you have obtained a first glimpse of the way accountants reflect on the realities of the business world.

If you have worked through all the study units in the study guide, you have completed your studies for this module. You now need to do as many exercises as possible in preparation for the examination. Good luck!