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Code Letter : AL6.

T H E R A P I D R E S U L T S C O L L E G E.

This set of lectures contains:-

The test on AL6. is bound in at the back of the book.

RRC. 8988

THE ACCOUNTING SIGNIFICANCE OF VARIOUS RESERVES AND PROVISIONS.

In this lecture, we are concerned with the accounting significance of:

- provisions
- reserves
- reserve funds
- sinking funds
- redemption funds
- amortisation funds

We are also concerned with how these balances are built "2 0nd utilised. Before we do this, it is necessary to study the various provisions of the Companies Act, 1973, which govern them. Let us see what these provisions are:

Section 98 lays down the following:

A company having a share capital (if so authorised by its articles) may issue preference shares which are to be redeemed : Provided that-

(a) where any such shares are redeemed otherwise than out of the proceeds of a Fresh issue, there shell, out of profits which would otherwise have been available for dividends, be transferred to 0 reserve fund, to be called the "capital redemption reserve fund" a sum equal to the nominal amount of the shores redeemed. If they are shores of no par value, a sum equal to the book value of the shores redeemed, and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as it the capitol redemption reserve fund were share capital of the company.

Furthermore, the capital redemption reserve fund may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid-up capitalization shores.

If a company has redeemed any redeemable preference shares, it shall within one month thereafter give notice thereof in the prescribed form to the Registrar specifying the shores so redeemed.

Note that "book value" in respect of preference shares of no par value, means that port of the stated capitol contributed by the preference shores redeemed or to be redeemed.

The Fourth Schedule, which sets out the Requirements for Annual Financial Statements and Interim Reports, also lays down certain provisions as follows:

(a) A company may, in addition to matters expressly permitted by this

(b)

Schedule, give any information required by this Schedule to be stated in a balance sheet or income statement, in the form of a note or onnexure thereto if such presentation would be more efrective or convenient. This is relevant for the topic of Redeemable Preference Shares.

For the purpose of the Schedule, unless the context otherwise indicates:-

(i)

"distributable reserve" means, subject to (iii) below, any amount which has been carried to reserves and which may, in accordance with generally accepted accounting practice and legal principles, be taken to the credit of the income statement and distributed by way of dividend, and does not include any amount retained by way of providing for any known liability; and "non-distributoble reserve" shall be construed accordingly;

(ii) "provision" means any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability, including the liability for income tax, the amount of which cannot be determined with substantial accuracy.

(iii) Where-

(a) any amount written off or retained by way of provision for depreciation, renewals or diminution in value of assets; or

(b) any amount retained by way of provision for any known liability,

is in excess of that which (in the opinion of the directors and the auditor) is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision, and if, contrary to the Opinion of the directors, the auditor considers that an amount should be treated as a reserve, he shall report specifically on the subject to the shareholders.

The Fourth Schedule also provides that in respect of the Balance Sheet:

(0)

(b)

The respective aggregate amounts, if material, of reserves and provisions (other than provisions for depreciation, or diminution in value of assets) shall be stated under separate headings and suboheadings indicating the types of reserves and provisions.

In respect of the financial year concerned there shall be stated (unless it is shown in the income statement or a statement or report annexed thereto, or the amount involved is not material)-

(i) the source of and the amount of any transfers to reserves and aforesaid provisions; and

(ii) the amount and the application of any transfer from reserves and aforesaid provisions.

(C) The liabilities shall be summarized with such particulars as are necessary to disclose their general nature and shall be classified under headings and sub-headings appropriate to the company's business and where the amount of any class of liability is not material, it may be included under the same heading as some other class.

And in respect of Fixed Assets, the following provisions are important:

(A) The method or methods used to arrive at the amount of the fixed assets and the assets which are neither fixed nor current, under each heading, shall be stated.

(B)(l) The method of arriving at the amount of any fixed asset (and asset neither fixed nor current) shall, subject to subparagraph (2), be to take the difference between-

(0) its cost, or if it stands in the company's books at a valuation, the amount of the valuation;
and

(b) the aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution of value.

(2) Subporagroph (1) shall not apply-

(a) to assets the replacement of which is provided for wholly or portly-

(i) by making provision for renewals and charging the cost of replacement against the provision so made;
or,

(ii) by charging the cost of replacement direct to revenue;

(b) to any listed and unlisted investments;
(c) to interests of the company in its subsidiaries; or
(d) to goodwill, patents or trade marks.

(3) In respect of the assets under each heading whose amount is arrived at in accordance with subparagraph (1) of this pora-Igruph, there shall be shown-
(0) the aggregate of the amounts referred to in paragraph (a) of that subparagraph; and
(b) the aggregate of the amounts referred to in paragraph (b) thereof.

(4) As regards the assets under each heading whose amount is not arrived at in accordance with the said subparagraph (1) be-cause their replacement is provided for as mentioned in sub-paragruph (2)(o) of this paragraph, there shall be stated-
(a) the means by which their replacement is profided For; and
(b) the aggregate amount of the provision, if any, mode for renewals and not used.

Under Current Assets, these provisions of the Fourth Schedule should be noted:-

(1) For the purposes of this paragraph "stock", means bny property, whether corporeal or incorporeal, which the company buys, or manu-factures, or processes, or develops or sells in the ordinary course of its business.
I
(2) The amount of stock shall be shown as 0 separate item and, where the amount of stock and work in progress is material in relation to either the trading results or the financial position, it shall be classified under appropriate sub-heodings which shall include, where applicable-
(0) raw materials (includina component parts);
(b) finished goods;
(c) merchandise which shall include any form of stock not mentioeed in subparagraph (1) and which may itself be shown under opprn priate subheadings;

(d) consumable stores (including maintenance spores);
(e) work in progress (including standing crops);
(f) contracts in progress:
Provided that where the Directors are of the opinion that classification into some or all of the categories referred to would result in a failure to present a fair view, then the classification should be reduced to those categories where a fair view would be obtained and the reasons given for not indicating all categories.
(3) In regard to the method of determining the value of stock, there shall be stated-
(a) whether it is consistent with the method of the previous year;
(b) whether it is the lower of cost or net realizable or replacement value or other expressly specified value;
(c) the accounting basis which has been used in determining the value of stock on hand. Where several different bases of determining the value of stock have been used and, in the opinion of the directors, 0 statement of all the bases used would be of little value to the shareholders, an intelligible summary of the bases used must be stated;
(d) in the case of work in progress and contracts in progress, whether the value includes both direct costs and overheads;
(e) in the case of spores held for maintenance purposes, the method of providing for obsolescence employed.
(4) There shall be stated any additional information required fairly to present the value of the stock, including in the case of contracts in progress, whether net income or losses have been taken into account and, if so, to what extent.
(5) If in the opinion of the directars any of the current assets have not a value on realization in the ordinary course of the company’s business at least equal to the amount at which they are stated, the fact that the directors are of that opinion and the extent of the

estimated shortfall shall be stated.

The following points must be shown by way of note (it not otherwise shown):

(1) If provision for depreciation, replacement or the diminution in value of fixed assets is made by some method other than a depreciation charge or provision for renwwals or diminution in value or is not provided for, the method by which it is provided for or the fact that it is not provided for, shall be stated.

(2) If no provision for taxation has been made, that fact, the reason therefore and the Financial year in respect of which no provision has been made, shall be stated.

Now that we have studied the formal requirements of the Act regarding provisions and reserves, let us now work through some practical aspects and examples.

A Provision is made by debiting the Income Statement and crediting the Provision Account. Provision for liabilities will be shown with the liabilities in the Balance Sheet while provisions for depreciation, etc., of assets must be deducted from the respective assets on the assets side.

Amounts set aside to regay liabilities or capital, e.g. Reserve for Redemption of Debentures or Reserve for Redemption of Redeemable Preference Shares are "Reserves" and not provisions.

EXAPPLE 1:

Provisions for renewing a lease on Brogerty:

The term "Amortisation Fund" is applied to a specific provision of this type. (N.B. If the word "Fund" is used, the account will be represented by outside investments, otherwise the account will be called simply "Lease Amortisotion Provision"). The method of accumulating such a provision is similar to the provision for depreciation of an asset. The Income Statement is debited (since a Lease is an Asset) and the Amortisation Provision (or Fund as the case may be) is credited at the end of each year (or hclf-yeur, or whatever the period is) with the instalment decided upon. Thus the provision grows, until at the end of the term of the lease (i.e. the "life" of the asset), it is oqu to the book value (i.e. the original cost) of the lease, and is transferred to the Lease Account to cancel it. As I have already stated, funds will be required to purchase a new lease - hence the specific provision in this case will in all prudent firms be backed up by outside investments.

In the case of a lease, however, the calculation of the annual instalment to be credited to the Amortisation Provision (or Fund), is somewhat different. The cost of a lease is actually the payment of rent in advance - such rent covering the whole of the term of years of the lease. For this reason, the original expenditure should be equalised, or spread over the "life" of the lease. If a lease cost, say R1 000 for a term of five years, it would not be strictly correct to charge R200 against net income each year for five years, without tak into account the factor of interest, since R1 000 paid now, is of greater value than R1 000 paid in five equal annual instalments.

EMWEZ:

Provisions for Losses on Contracts:

In some cases a firm may expect to make a certain loss in the future, but this loss cannot be estimated correctly. There is too, t possibility that the loss will not arise. However, a prudent firm would leave nothing to chance but would make provision for any expects loss. For instance, a firm of builders may have contracted to erect a certain building, as specified, for a stated sum of money. Whilst the work is being carried out some unforeseen difficulty may arise so that the contractors may sustain a loss on the contract, instead of their estimated net income. In a case of this type, where the controc is not finished on the date of the Balance Sheet, the firm of contractors would create a provision to meet their possible loss. In normal circumstances, such a company would take credit (in the Income Statement) for a portion of their estimated profit on uncompleted contracts, so it is only right that they should allow for a portion of an estimated loss.

. The portion of the estimated loss will be calculated as follows: First, the total expected loss on the contract is estimated. The amount of this is then apportioned on either a time basis, or an the basis of total cost (according to the circumstances of the particular case) so that the financial period under review is allocated its carre share of the expected loss. The necessary proportion of the estimated loss must be debited to Income Statement, and a specific provision account credited. The specific provision account should have a title which adequately describes its purpose (e.g. Provision for EXpected Loss on Contracts). This process has the effect of reducing the net profits of the trading period concerned - the specific provision being shown with the liabilities in the Balance Sheet. This specific provision remains as a credit balance in the ledger until it is needed. For example, in the above case, the Provision for Expected Loss on Contracts would remain untouched until the contract concerned was completed. Then and only then - would the account be closed; it would be transferred to reduce the actual loss (if any) on the contract concerned.

Where a provision is created for future expenses no Special account is opened, as the provision is created in the expense account itself. Rent due but unpaid is an example of this type.

EXAMPLE 3:

Provisions for degreciotion and the egualisotion of cogitol exgenditure:

It is only equitable that the "wasting away" of a fixed asset should be provided for when the net profit of a firm for the year (or trading period) is being computed. This is done by debiting the Income Statement with the estimated depreciation, and crediting (i.e. reducing) the asset account concerned. In this manner as the asset depreciates year by year, the Balance Sheet or book value of the asset decreases. This method is used by many firms, but there are some who object to it on the grounds that the Balance Sheet does not disclose the original cost of any fixed asset which is being "written down" year by year. These firms provide for depreciation in a different manner. The Income Statement is debited as usual, with the estimated amount of depreciation, but, instead of the asset account bein credited a specific provision account is credited.

This method is comgulsory
for comEanies.

The name of this account will depend upon the asset concerned. For example, if the asset consisted of Plant Machinery, the provision would be known as "Accumulated Depreciation of Plant and Machinery". This Provision will grow year ha year, but the asset account itself witx remain constant - at the original cost of the asset (unless odditio have been made to the onset, when the account will increase). The provision itself is shown (with title in full) as a deduction (net - in the Balance Sheet itself), from the book value of the asset. -w this manner, the original cost of the asset is disclosed in the 801; Sheet, together with accumulated depreciation on such plant. (The: are several methods of calculating the amounts which are debited ae depreciation, to the Income Statement, either yearly or half-yeorly) Under this method of providing for depreciation, the depreciation pg. vision, which has been allowed to accumulate, is transferred, when asset concerned ceases to be of use, to the credit side of the asset account. If the estimates of the amounts of depreciation have been correct, the asset account should be almost eliminated. Any bolane. which remains should be written off (as an expense) to the Incoee 5.. ment.

Thus, the ultimate result is the some as it is in those cases where depreciatien is credited to the asset account annually in- , stead of to a specific provision account. In both cases, when a 5,? asset ceases to be of use to the firm, it disappears from the book. Balance Sheet. When an obsolete asset is replaced, the bookkeepin ’ entries are the some as they are on the purchase of an asset. In . words, first the old asset account is closed (as described above); secondly, cash (or bank) is credited and the new asset account is debited with the cost of the asset. For this reason it can be 3t0: that a depreciation provision is a no i cern, set aside for the purpose of re placing an asset. This characteristic, however , is merely of an incidental nature - the 9 entries connected with depreciation bei that the "wasting away" of any Fixed asset is a definite chorgg 0901: Where 0 Firm wishes to replace an asset it may have diffiCUIty in finding sufficient money to effect the purchase. To avoid thil difficulty, some firms made investments outside (or other financial period). be equal to the amount of depre account. In this manner these the Firm every year The amount of the annual investment ciation credited to the depreciation sperial investments grow, side by I3

with the depreciation account. In other wordsI the degreciotion account is regresented by investments. The depreciation account, in such a case, should have the word "Fund" at the end of its title, to distinguish it from provisions which are not backed up by "outside" investments. Sometimes, these periodic investments are known as the accumulation of a Sinking Fund.
It is possible for a firm to have other capital expenditure besides expenditure on fixed assets. Where it is desired to "spread" this capital expenditure over a number of years, the process is exactly the some as in the cases of providing For depreciation of fixed assets.
It is of great importance that you should realise the distinction between provisions for Taxation and Reserves tor the Redemption of Capital, and provisions which are created for the purpose of providing for depreciation of fixed assets and the equalisotion of capital expenditure. The latter - which have just been discussed in detail - accumulate from periodic charges to the Income Statement (depreciation, etc., being a definite charge against profits).
You have already been shown how, when an asset ceases to be of value, it disappears from the books and Balance Sheet of the firm together with the specific account for depreciation. Where a reserve is created for the purpose of redeeming capital, however, the booke keeping entries are not quite the same. A Specific Reserve Account is credited with the annual instalment, as usual, and this account appears with the liabilities in the Balance Sheet. The debits are charged to the Income Statement after arriving at Net Income after taxation, since such instalments are not real expenses connected with the working side of the firm - they are merely appropriations of part of the profits. Perhaps you will understand better the reason for this if I complete my description of the bookkeeping entries involved in an account of this type. By debiting the Income Statement and L crediting the Reserve Account, the Reserve grows until it equals the amount of the capital to be redeemed. The capital will be shown on the same side of the Balance Sheet us the Reserve itself, and it will disappear only when it is paid off - by crediting cash (or bank) and debiting the capital account. The Reserve itself still remains in the Balance Sheet, however. This means that the creation of the reserve has enabled the firm to dispense with some of the shareholders, and has provided capital (in the shape of the specific reserve) from

within the firm itself. Thus a reserve of this nature is similar to an ordinary General Reserve in that it is merely an accumulation of appropriations from trading profits. It is most imgortont that you should realise this distinction between a provision for depreCiation or replacement of an asset, and a reserve for the repayment of capital or liabilities, e.g. debentures. Do not continue with this lecture until xou are suite clear on this 20int.

EXAMPLE 4:

Provisions for Bad Debts:

Where a company knows that a certain loss will be incurred in the future, it must make provision for the loss before-hond. For example, every firm knows that it is bound to incur losses in the shape of bad debts. For this reason, it would be improper to show the total 0f thO accounts receivable in the Balance Sheet, at the actual book figure, as the asset will not realise this amount. From previous experience, the company will have a good idea of the amount of bad debts expected. (This usually takes the Form of a percentage on the total of accounts receivable). Having computed this amount, the company will debit the Income Statement and credit Bad Debts Provision Account. The Bad Debts Provision, instead of being shown with the liabilities in the Balance Sheet (as a General Reserve is), is shown as a deduction from the amount of accounts receivable in the Balance Sheet. Thus the provision itself is disclosed and the asset itself is shown at its approximate real value.

This is just one example of o provision created to meet a known loss, but there are others. Each must be dealt with according to the circumstances, the main procedure being as outlined above. The only differences will be in the names of the accounts, and the manner in which they are disclosed.

ISINKING FUNDS:I

A "Sinking Fund" is yet another type of specific provision and is represented by outside investments. Such an account may be accumulate for the purpose of replacing an asset at the end of its estimated "life’

We are not concerned with the purpose of a sinking fund at the moment, however, but with the method by which it is accumulated. The book value of the asset to be replaced, is known. Tables are consulted to find what sum, invested annually, will produce - at compound interest at a certain fixed rate per cent - the amount required to replace the asset at the end of its life. The sum so computed is debited to the Income Statement annually, and credited to the Sinking Fund Account itself. (This, being a specific provision, is shown in the Balance Sheet as a deduction From the asset). An equal sum is invested in gilt-edged stocks at the rate previously decided upon - cash being credited and Sinking Fund Investments Account being debited. (The latter, being an asset, in the Balance Sheet - being equal to the Sinking Fund itself). This takes place every year, and, at the end of each year, interest is received from the investments.

Study the following example very carefully and do not go on until you thoroughly understand it.

EXAMPLE:

A company has an asset which cost R500 on the lst January, 1995,
In order to replace this asset when it ceases to be of use (estimated life of asset being 5 years), a Sinking Fund is created by annual instalments on 3lst December each year. The annual instalment to the Sinking Fund is invested 0t 5 per cent. (N.B. Investment tables show that R90,49 invested annually at 5 per cent per annum will produce R500 in 5 years - at compound interest). The Sinking Fund Account and the Sinking Fund Investments Account will appear as follows:-

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-W_-
1995
Dec.
1996
31: P. a L. A/c
Doc. 31 Balance c/d
Dec..31j Cosh - Int.
’ received (on
. i R90.49)
" " : Income Stat.
1997
Dec.
31 Balance c/d Balance b/f l 185
; Dec. 31 Cash - Int. 5
received (oni
R185,50) l
Income Stat.
1998
Dec.
31 Balance c/d Balance b/f
Cosh - Int.
, received (on
R285,26)
Income Stat.
1999
Dec.
Balance b/f
Cash - Int.
received (on
R390,01)
Income Sto .
Balance b/f

_ SINKING FUND INVESTMENT A/C _
Dec. Cosh . Balance
1997 ’
Dec. Cash
1996 .
Dec. Balance 1 ’ . Balance
1998
Dec. Cash
1997 :
Dec. Balance 1 Balance
1998
Dec. Cash
1998
Dec. Balance 5 Balance
1999
Dec. Cash
1999
Dec. Balance

NOTE:

At the end of the first year (1995) R90,49 is invested, but in succeeding years R90,49 plus interest received is invested. For example, in the third year R99,76 is invested being R90,49 (the annual instalment), plus R9,27 interest received from investments already made.

Where an asset is to be replaced at the end of five years, the balance of the Sinking Fund Account would be transferred to the credit of the asset account itself - both accounts being extinguished. The investments are sold - the proceeds being credited to the Sinking Fund Investments Account (Cash being debited, of course). The Cash then available is utilised in the purchase of a new asset. (The entries are: credit Cash and debit the new Asset Account). DEE; The Sinking Fund itself (i.e. the specific provision) disaeeeors in this case.

Examine xourself to see whether zou understand all the above entries.

We may define "Reserves" as amounts which are set aside out of profits and other surpluses which are not designed to meet any liability contingency, commitment, or diminution in value of assets known to exist at the date of the Balance Sheet.

EXAMPLE 5:

Reserves made for the reeozment of liabilities or the redemgtion of coeitol:

(a) Redemption of Debentures.
(b) Redemption of Redeemable Preference Shares.

Debentures can be redeemed in various ways - e.g.,

(a) Purchase in the stock market, from tine to time;
(b) a certain proportion paid off each year (out of profits): or
(c) paid off in total, on a fixed date. In this case the accumulation of a Sinking Fund would be necessOty. This will be dealt with later in the lecture.

Let us discuss these various methods of redeeming debentures in some detail.

(0) Where debentures are purchased in the open market, Cash (or Bank) will be credited with the cost; Discount on Rede-ption of Do-benture Account will be credited with the discount obtained

from purchasing in the Open market. (N.B. A firm would hardly purchase their own debentures 0t 0 premiums; and the Debentures Account will be debited (i.e. reduced) by the total of these two.

Examgle:

A company purchases R1 500 of its 5% Debentures in the open market, at 96 on Slst December, 1998. There were R5 000 Debentures outstanding before the transaction took place. The entries are as follows:

- 5% DEBENTURES -

Discount on
Redemption
Balance c/d
5% Debenture
(R1 500)

- DISCOUNT ON REDEMPTION 0F DEBENTURES -

1999
Dec.h3l 5% Debenture
(Bought
R1 500 at
96)

- ., uamIWW -
(b)
Whrw v -’ ___’ .’:t3

When debentures are redeemed out of pet income 7 by annual portion the entries are similar to the above, except that it may be necessary to open a Premium on Redemption of Debenture Account, ineteadt of a Discount on Redemption Account - where the debentures are redeemed at a premium instead of a discount. Furthermore in either case the Income Statement is debited each year (or half-yeat as the case may be) with the amount of profit to be set aside for the redemption of debentures. The same amount is credited to Reserve for Redemption of Debentures Account - thus completing the double entry. In this manner the specific reserve grows whilst the debentures themselves decrease. When the debentures have all been redeemed, we are left with the Reserve for Redemption Account which is equal to the original amount of the debentures. This reserve, if the company so desires, can be transferred to the credit of the General Reserve since it represents un- ! distributed net income. i

Perhaps you are wondering why it is considered necessary to open and accumulate a reserve account for the repayment of such liobilities os debentures, when the amounts accumulated still appear in the Balance Sheet after the liabilities have been discharged. The reason is that if a certain proportion of the profits were not set aside, the greater part or whole of the net income may be distributed as dividends thus reducing the bank balance. If this went on year after year, the company perhaps would not be able to accumulate cash for the purpose of paying off the liability. This retention of part of the net income, within the firm (and in the shape of a specific reserve) must, of necessity, assist the firm in saving funds to pay off such liabilities as debentures. Some companies go even further than this, and, instead of accumuloting a bank balance for this purpose, they make annual investments (equal to the amounts placed to the Redemption Reserve Account annually) in gilteedged securities. This, however, only applies when debentures are to be paid off in total at a certain future date. Where a specific reserve is represented by outside investments, in this manner it should be described by the word" FUND to distinguish it from reserves which are not so represented Ze.g., Reserve for Debenture Redemption Fund. N.B. The investments themselves would appear on ’he assets side of the Balance Sheet as "Investments for the Re;.hpti0n of Debentures").

When debentures are paid off in full on a fixed date the Sinking Fund Method is used.

Tables orn consulted to Find what sum,
pdeULO n at compound inre
e 1L0
invested annually, will
rest and a certain fixed rate per cent
HieHwt quuxlvd 1w wnv off the liability on due date.

Thus if R6 000 Debentures are to be redeemed in six years' time, it can be proved from tables that R927,58 is the amount which, invested annually at 3%, will amount to R6 000 in six year's time. This amount is debited to the Income Statement annually and credited to the Sinking Fund Account.

The main points are, when the interest is received, cash is debited and the Sinking Fund credited (i.e., increased).. The interest is immediately re-invested, however - together with the annual instalment, cash being credited and the Sinking Fund Investments Account debited. Thus, at the end of the life of the asset concerned, 25 on the date the liability is due to be repaid, cash will be available (from the sale of the Sinking Investments) for the necessary purpose. Any profit on realisation of the Investments should be credited to the Sinking Fund Account, but any loss should be debited to the Income Statement. A Sinking Fund differs from an ordinary Depreciation Provision Fund in that it takes into account the factor of interest. (N.B. Investment tables which I mentioned above may not be supplied in the Examination but you will be given all the details necessary in any question dealing with Sinking Funds).

NOTE:

The Redemetion of Redeemable Preference Shares is carried out in accordance with the Companies Act, as described previously.

A company which intends to redeem preference shares out of net income should annually place a certain amount from the Income Statement to the credit of "Reserve for Redemption of Redeemable Preference Shares Account", it would be advisable to invest a corresponding amount outside the concern so that liquid resources are available when the time for redemption arrives. This Reserve Account should E91 be called "Capital Redemption Reserve Fund". The Capital Redemption Reserve Fund is an account which comes into existence onlx when the preference shares have actuallx been redeemed.

Its uses have already been described.

EROFITS 0N UNCOHPLETED CONTRACTSJ

Businesses which execute numerous small contracts in the course of trading do not, in accordance with conservative commercial practice, take accrued earnings on uncompleted contracts into account. If a builder or other contractor enters into a long-term contract, however, the circumstances may require careful consideration at the end of the financial year. The contract may, for example, take a number of years to complete, and it may be the only one the contractor has on hand. In this case, if the contractor adheres to the general accounting principle of not taking profits into account until they have been realised, recorded profits will be nil for each year that the contract remains uncompletod, and will then jump to an abnormally high level (unless a loss is realised).

In the case of large-scale joint stock concerns which enter frequently into long-term contracts, it is clear that the policy of not taking net income into account until they are realisedr would cause marked fluctuations in annual net income and probably dividends, and hence the market price of the Company’s shares. The The effect on income tax can also be considerable. It is the usual practice, therefore, to take some account of accrued net in income on uncompleted contracts. Great care should be taken, however, to avoid any possibility of on over-estimate of such accrued net income. For this reason, the following "golden rules" are usually adapted in calculating accrued net income on uncompleted contracts:-

(1) 52 net income should be taken into account unless the contract is sufficiently advanced to make it clear that some net income is likely to be realised.

(2) Only work certified as comglete bx an architect or other authority should be taken into account. Hark completed but not certified should be valued at cost. I

(3) Suitable allowances should be made for such contingencies as:- i
i

(a) Late completion resulting in fines.

(b) Labour difficulties.

(c) Increased cost of labour and materials.

(4) Provision should be made for Retention Monexs.

NOTE: It is usual in the case of a long-term contract for the contractee to pay the contractor periodical sums on account. These periodical payments are often based on j the value of the work certified (by an architect, surveyor or engineer) as completed.

But to protect the contractee against the risk of subsequent faulty work, he is often permitted by the terms of the contract to retain from the value of such certified work a certain percentage until the contract is finally completed, and even for some years afterwards. The percentage thus retained is known as Retention Monex.

How to Calculate the Accrued Profit:

(1) Take the total expenditure to date.
(2) Deduct the cost of work uncertified.
(3) Deduct the remainder of (l) - (2) from the value of the work certified. This gives the profit to date. From this deduct -
(0) Say one-third as provision against future losses.
(b) A proportion on account of retention money.

EXAMPLE 1:

Total Expenditure to date Rl48,000
Less Cost of Work not yet certified 10 000
Cost of Work Certified R138 000
Net income to date 12 000
Value of Work Certified R150 000
Z x Net Income to date : R8 000
3
Cash received : R112 500 (Retention Money : R37 500)
Proportion of Net income to be credited to Income Statement
R112 500
A : -
ccount R8 000 x R150 000 _ R6 000

EXAWLE 2:
A firm of builders contract to erect a building for a contract
price of R450 000. The ledger discloses the following expenditure:-
Haterials R90 000; Plant R15 000; _
Wages R123 300; Overhead Expenses R6 450.
The cash received on account was R180 000 or 80% of Surveyor’s
Certificate while the cost of work completed but not certified amounted
to R7 500.
After allowing 10% for depreciation of Plant you are required to
prepare an account showing what net income has been made to date and how
much of this net income could justifiably be transferred to the Income
Statement.
- CONTRACT ACCOUNT -
R
Materials 90 000 Value of Plant in
Plant 15 000 hand c/d 13 500
Wages 123 300 Cost of Work fini-
Overhead Expenses 6 450 shed but not certi-
234 750 Fied c/d 7 500
Cost of work certi-
Income Statement 6 000 fied c/d 213 750
Net income on work
certified c/d
R_24_07_50
m
13 500
Plant b/f
Cost of Work finished
but not certified b/F
Cost of work certified
b/f
Profit Suspense b/f
7 500
213 750
6 000
R
Total Expenditure 234 750
Less Plant on Hand 13 500
Cost of work to date 221 250
Cost of work uncertified 7 500
Cost of work certified 213 750
Contract value of work
certified
Nu? 1HCO’H" fa) date m (’_86

Since the work is still in progress, only about two-thirds of the profit to date should be taken into account.

2 x R11 250
3
R7 500

This should be further reduced to the same proportion as the cash received bears to the total value of certified work.

_g9 x R7 500 : R6 000
100

NOTE: When plant is employed on a contract for a lengthy period, it is usual to debit the Contract Account with the value of the plant, and upon completion of the contract the plant should be revalqed and the Contract Account credited.

The Balance Sheet:

Contractees should never be shown as debtors for the full amount of the contract unless the work has been completed. The total expenditure to date, plus any net income taken as accrued on uncompleted contracts, should be shown in the Balance Sheet under the heading "Hork-in-Progress". Any cash received on account should then be deducted from the value of the Hork-in-Progress, and the net amount extended.

PROVISIONS FOR PROFIT-LOADING 0N MANUFACTURED STOCK:

A firm which sells goods manufactured in its own factory, as well as goods purchased in a finished condition, may prepare 0 Manufacturing Account as distinct from 0 Trading Account. Any difference between the cost of manufacturing the output for the period under review and what it would have cost to buy the same amount of finished goods from outside sources is then regarded as net income on manufacture. Finished stock transferred from the factory is shown at the same value per unit as finished stock purchased from outside sources.

Now it is clear that if some of the finished stock which has been transferred to the warehouse from the factory remains unused at the end .of the accounting period, it would be contrary to the principle of showing closing stocks at the lower of cost or market price if they are shown in the annual financial statements at the same unit cost as that applied to finished stocks purchased from outside sources. This would that the unsold stock manufactured by the firm itself is being shown - cost plus a factory income. In order to adhere to the abovenentionee principle, therefore, it is a common practice to create for final acc' purposes a provision to adjust the value of closing stock nonufucturo-i by the firm itself. This provision will normally be deducted from "gross income on manufacture" on the credit side of the Income State and from the value of the closing stock in the balance sheet.

Consider the following example:-

Redraft the following accounts:-

_ MANUFACTURING ACCOUNT FOR YEAR TO 30TH SEPTEMBERI 1999 -

Stock of Raw Materials, lst October, 1998

Purchases of Raw Materials

Goods Transferred to Warehouse (Trade Price)

Less Stock of Raw Materials 30th September, 1999

Manufacturing Wages

Gross Income on Manufacture, transferred to Income Statement

-___._.______J_____
- TRADING ACCOUNT FOR YEAR TO 30TH SEPTEMBER 1999 -
Goods Transferred
from Factory (at
Trade Price)
Less Stock of
Finished Goods, 30th
September, 1999 (at
Trade Price :
Warehouse Cost)
Gross Income on
Trading, transferred
to Income Statement.
R10 000
- INCOME STATEMENT FOR YEAR TO 30TH SEPTEMBER 1999 -
__.________________l__
hGross Income on
Manufacture
’Gross Income on
Trading
2 100

Note that closing stock in the Trading Account is valued "at ware-house cost". It is clear that this closing stock represents, in Ehxsicol guantitx,one-third of the stock transferred from the factory; it is equally clear, then, that the correct valuation of this stock for balance sheet purposes would be one-third of the total costs incurred by the factory, i.e.,

% (R1 900 4’ R2 400 4. R1 600 - R500) : R1 800

In other words, the Trading Account overvalues the closing stock of finished goods by R700. OR to work it another way:-

______________-----.-'_""

Unearned Net Income : 91955_22_hgni x Gross Income on Monufoct Production

2500 x 2100 : R700.
7 500 #

This should be adjusted in the annual financial statements as follows:-

- INCOME STATEMENT FOR YEAR TO 30TH SEPTEMBERI 1999 -

R ' R R R
Gross Income on
Manufacture 2 100
Less Provision for
reduction of
value of Warehouse
Stock of Finished
Goods to actual
cost price
(Uneorned Income
on stock on hand) 700
l 400
Gross Income on
Trading 5 000 6 400
l

A second adjustment would appear in the Balance Sheet, as follow:

- BALANCE SHEETI AS AT 30TH SEPTEMBERI 1999 -

CURQLNT ASSETS
(including Stocks
in Hand):
F09 Av (Row
Mv"ri0153
Wuaehquse (Finishe
woods Ct Narehous
2 500

- BALANCE SHEETl AS AT 30TH SEPTEMBERI l999gCONT.2-
Less Provision
for unearned
Net Income on
Stock in hand Z99
l 800 2 300
NOTE: As the Manufacturing and Trading Accounts are left unchanged, comparisons of gross income for each from year to year may still be made. It must be remembered that it would cost R2 500 to buy the closing stock from any other factory.

S U M M A R Y.

Provisions can be classified as follows:
(0) Provisions for known requirements.
(b) Provisions for known contingencies or depreciation, the amount of which is incapable of being calculated accurately.

N.B. The vital distinction between Provisions and Reserves is that Provisions ore amounts set aside out of profits for contingencies or the diminution in value of assets whereas Reserves ore Brofits which have been appropriated for the use of shareholders.

Sinking Funds are provisions or reserves which are represented by outside investments.

Various terms have been applied to provisions and reserves generally and there are many differences of opinion amongs accountants as to the use of these terms. The majority, however, favour the following:-

THE ACCOUNTING SIGNIFICANCE OF VARIOUS RESERVES AND PROVISIONS.
PAGE 28.

(1) Revenue Reserve or Egggggl_gggggxg usually noon; the accumulation of undistributed Net Income
(Other than non-distributable Net Income vide (4) below).

(2) When the word "Fund" is added to the name of a provision or reserve, it means that the Provision or reserve itself is actually represented by investments outside the firn. Such investments will be shown as an asset in the Balance Sheet, with a special note as to their purpose.
The word "Fund" should onlx be used in such cases as this, except in the case of the Capital Redemption Reserve Fund where the law lays down its use, whether represented by investments or not.

(3) Any specific provision should have a title which shows the purpose of its existence (e.g., Provision for Bad Debts).

(4) The term Non-distributable Reserve usually neon: capital profits, or profits made prior to incorporation.

It is essential that xou should learn these termsl and 0221! the- in all future cases.

Study carefully the notes on uncompleted contracts.

LIKELY EXAMINATION QUESTIONS:

1. Fxplain the meaning of the following terms:-
Non-distributable.
General Reserve.
Reserve Fund.
Depreciation Provision.

Explain clearly the distinction between a reserve created for the purpose of repaying a liability, and a provision created for the purpose of replacing a fixed asset.
What is the general significance of the word "Fund" when used to describe a reserve?
State briefly what you understand by a Sinking Fund. How is the interest from Sinking Fund Investments dealt with?
A Limited Company borrows on the lst January, 1970, R4 246,46 on a debenture, for a term of four years. It sets up a sinking fund (to be invested to yield 4 per cent per annum), for the purpose of redeeming the debenture. Prepare the Sinking Fund Account and the Sinking Fund Investments Account. You may assume that R1 000 invested at 4 per cent per annum (compound interest), at par, at the end of each year, will produce R4 246,46 at the end of four years. In each account show the final entries on the assumption that the investments are sold at par on 3lst December, 1970, and the Sinking Fund itself is transferred to General Reserve.
From the following Trial Balance and notes of adjustment you are required to produce the Annual Financial Statement for the year ended 30th June, 1999.
TRIAL BALANCE OF A. SMYTHEI BUILDER AND CONTRACTORI
AS AT 30TH JUNE 1999.
__l_.___
Investments (temporary)

Debits	R	Credits	R
Land	5 15 000	Capital	75 000
Machinery & Plant	E 20 480	Depreciation Fund	2 050
Goodwill	i 5 000	Current Account	2 458
Cash	1 50 -	Bills Payable	2 438
Bank	! 12 316 ;	Trade Creditors	10 410
s			
I			
I			
	3 400 3	Advances by contrac- : tees in respect of i uncompleted contracts	2 250

W

TRIAL BALANCE OF A. SHYTHE BUILDER AND CONTRACTOR
W 1mm.)
Debits
Bills Receivable
Debtors for completed
contracts
Rolling Stock
Loose Plant and Tools
(30/6/98)
do. Purchased
Office Furniture
Materials 30/6/98
do Purchased
do Returned from
and credited to
contracts
EXpenses (after
crediting amounts
charged to contracts)
Salaries
Losses on completed
contracts 98/99
Contracts uncompleted
Repairs
Sundry jobs -
cost of
Wages accrued 30/6/99
Credits,
Debits to contracts fOo
loss of or dosage to
Loose Plant and Tools
Materials charged:-
to contracts and jobs
at cost
To repairs and
expenses at cost
Materials sold
(cost R1 489)
Net Income on complet .
contracts 98/99
Net Income in Suspense
Discounts received
Charges made for
sundry jobs
R
Contracts 256
Sundry Jobs 56
(all wages and expenses Raid had been charged to jobs, contracts, etc.)
EXpenses accrued 30/6/99
R
Contracts 157
General 66

Interest on investment has been credited to Depreciation Fund.
Depreciation Office Furniture 5%
Provision For Bad Debts (excluding Bills Receivable) R5 000
Value of materials on hand 30/6/99 8 845
Value of Loose Plant and Tools 30/6/99 2 060
Cost of sundry jobs not completed 104
Value of sundry jobs completed and not charged 540
Value of contracts in progress 6 100
Credit Depreciation Fund with depreciation R1 000 on Plant and Machinery and 10% on R olling Stock (these are additional to depreciation already charged to contracts).
One-third of any Net Income on uncompleted contracts may be credited to the Income Statement and the remainder held in suspense.
70% of Net Income in $uspense to be credited to the Income Statement in respect of contracts uncompleted at 30/6/99 but completed during the year 98/99.

ANSWERS TO LIKELY EXAMINATION QUESTIONS.

ANSWER TO QUESTION NO. 2.

The distinction between a reserve created For the purpose of repaying a liability, and a provision created for the purpose of replacing a fixed asset can best be explained by considering an example. Let us suppose that a company borrows R10 000 to buy an asset which costs R10 000.

Unless the loan is to be of a permanent nature, the company will have to provide both For the replacement of the asset and for the repayment of the loan. Let us assume that the asset is left in the books at cost price. Two sinking funds will then be necessary, No. l to replace the asset and No. 2 to repay the liability.

Now the asset is being used for purposes of production, and instalments to Sinking Fund No. l are in effect an assessment of the wear and tear involved. These sinking Fund charges are therefore an expense of the undertaking and should be debited to the Income Statement. The expense of the loan, however, is represented by the interest payments made to the lender; these will also appear in the Income Statement, but any proviSion for the reocyment of the loan is an oEEroeriatian of Net Income. TL;:h:an perhCLS b9 appreciated better if the loan is considered to be ropoyoblo at the option of the company; in no way is it "dininished" or "worn" in the process of production, and the company need repay it only when sufficient funds are available. To ensure that such funds will be available the company withholds Net Income from distribution.

Some yours later the asset will have depreciated to scrap value and at the same time the company may be prepared to repay the loan. Lot us see what book entries will be necessary when this happens and a now asset is bought, both Sinking Funds being represented by invostlonts of a market value of R10 000.

First, there will be a debit balance on the asset account of R10 000, although the asset is actually worth nothing. To adjust this:-

R
Dr. Sinking Fund No. 1 A/c 10 000
Cr. Asset Account 10 000

When the new asset is purchased:-

R
(Cr. Sinking Fund No. 1 Investment A/c 10 000
(Dr. Cash 10 000
(Cr. Cash 10 000
(Dr. Asset 10 000

To repay the loan:-

(Cr. Sinking Fund No. 2 Investment A/c 10 000
(Dr. Cash 10 000
(Cr. Cash 10 000
(Dr. Loon Account 10 000

This oxomplv shown that when a provision is used to replace an asset, nu bnlnnco romoins on tho Sinking Fund Account, but when a reserve is cxuoted to rupoy a liability, 0 credit balance remains on tho Sinking Fund Account. This latter balance represents undistributod profits and should be transferred to the General Reserve Account. It is a "reserve" and not a "provision".

MODEL ANSWER TO QUESTION NO. 5.
SINKING FUND ACCOUNT
2 040liil
31 Balance c/d A/c
Cosh - Int.
Received
Appropn. A/c
. 31 Appropn.
R2 Jim
1972
Dec. 31 Balance c/d 3 121 Balance b/f 00
Cash - Int. H
Received (1 81260
Appropn. A/c :, 1 ooo!oo
R3 121a1 R3 121 60
1973 3
Dec. 31 General Balance b/f 3 121’60
Reserve 4 246 46
Cash - Int.
Received ’ 124 86
Appropn. A/c i
l
I
--

SINKING FUND INVESTMENTS E(C.
1971
Dec. 31 Balance b/f
1972'
Dec.l3l Cash
1
1972
Dec.
1973
Dec.
31 Cash (Sale of
Investlents)

THE ACCOUNTING SIG
NIFICANCE OF VARIOUS RESERVES AND PROVISIONS.
PAGE 35.
MODEL ANSWER TO QUESTION N0. 6:
A. SMYTHE.
INCOME STATEMENT FOR THE YEAR ENDED 30TH JUNE 1999.
--------________________________________L_____
Salaries
Repairs
Sundry Expenses
Provision for Bad
Debts
Depreciation:-
Machinery &
Plant 1 000
Rolling Stock 340
Furniture 34
Loose Plant 225
Materials Shortage
Balance being Net
Profit for year,
carried to
Current Account
R
3 285
l 843
3 330
Net Income on completed
19 480
contracts
Less Losses on com-
pleted contracts
l
5 000
Net Income taken on
contracts
uncompleted at
30/6/99. j
i
lNet Income taken on
contracts
uncompleted at
30/6/98 but
completed at
30/6/99
Net Income on Sundry jobs!
.Discounts Received
l
R27 459
Net Income on Sale of ?
Materials

THE A(IJOINTIME SIGNIFICAMZE OF VARIWS RESERVES ND PWSICNS
PAGE 36.
BALANCE SHEET AS AT 30TH .IJNE 1999
75 000
CAPITAL ACCOUNT
CURRENT ACCOUNT
Balance as at 30/6/98
Ag! Net Income for year
NET INCOME IN SUSPENSE
QEPRECIATIW FLN)
Goodwill at cost
Land at cost
Rolling Stock at cost 3
Machinery & Plant at cost ’ :20
Loose Tools at valuation 2
Furniture ’
Balance as at 30/6/98
Less
Depreciation
FIXED ASSETS: l ’
I
lrg
CURRENT ASSETS:
Stocks:-
Materials
Work in Progress:
Contracts
egg profit to date
a
calm 0
D-CDM r-
88 8
U
0
UI
#
%_-:
Less
Advances received
Jobs
0
g.
l

BALANCE SHEET AS AT 30TH JUNE 1999 (Contd.)
Debtors for:-
Completed contracts
Completed jobs
Less
Prov'n for Bad Debts
Investments
Bills Receivable
Cash
Bank
Less CURRENT LIABILITIES
Creditors - Trade
Wages
Expenses
Bills payable

61 930
108 516

NOTES ON ABOVE:
1. A11 expenses, wages, depreciation etc., incurred on contracts have been charged to the contract accounts Eriot to the taking out of the Trial Balance. The only exception to this are the amounts accrued due at 30/6/99 for wages and expenses, these clearly relating to uncomgleted contracts.
2. The credit in the Trial Balance for "Materials charged to contracts and jobs, at cost, R89 476" means that individual contracts have been debited with R89 476 and Materials Account credited with R89 476. It is necessary to draw up a Material: Account to ascertain the stock shortage:-
HATERIALS ACCOUNT
Balance 30/6/98 Charges to Contracts
Cosh etc. - and Jobs etc. 89 476
Purchases Charges to Repairs 1 433
Returns from contracts8 Cost of Materials
sold 1 489
Stock 30/6/99 c/d 8 845
101 243
801. being shortage
Stock 30/6/99 b/f 8 845
R101 883
The Stock Shortage is debited to Profit and Loss Account.
The Net Income on materials sold (R1 876 - R1 489 : R387) is credited to Income Statement.
3. The Net Income on Jobs can be ascertained by drawing up 0 Jobs Account:-

JOBS ACCOUNT.
Cost etc. Charges to customers 10 596
Wages accrued c/d Sundry Debtors - jobs
Net Income 0n Jobs to completed and not
Income Statement charged 540
Cost of uncompleted
jobs c/d 104
R11 240
lRll 240i
104
Cost of uncompleted
Wages accrued b/f
jobs b/f -
4. The profits on uncompleted contracts are:-
Value of contracts in progress 6 100
Less cost to date 4 220
" Wages accrued 256
" Expenses accrued 157 4 633
R1 467
One third of this R489 is credited to Profit and Loss Account, the balance of R978 being credited to "Profits in Suspense".
5- "Net Income in Suspenss" (a credit balance) is one method of dealing with profits on uncompleted contracts which it is not considered desirable to credit at this stage to income Statement. The balance of R5 156 rEpresents a provision for unrealised Net Income at 30/6/98. 70% of this R3 605) iS now credited to Income Statement as certain of the contracts will have been completed in the year 98/99. This leaves R1 545 to which is added R978 in respect of new contracts uncompleted at 30/6/99 making R2 523.

6. It is necessary to calculate the depreciation of Loose Plant and Tools:-

LOOSE PLANT AND TOOLS.

Charges to Contracts
Value 30/6/99 c/d
Balance being
Depreciation
Balance 30/6/98
Purchases
Balance 30/6/99 b/f

7. The question indicates that the Depreciation Fund exists to provide for the depreciation and renewal of Plant and Machinery and Rolling Stock. The amounts decided upon as depreciation are credited to the Depreciation Fund and debited to Income Statement. The Asset accounts are unaltered, although the Depreciation Fund could be shown as a deduction from their combined values on the Balance Sheet. As the name suggests, the Depreciation Fund is represented by outside investments.

8. When dealing with a problem of this type show your workings as footnotes to your answer.

DIVlDENDS.

WHAT IS A DIVIDEND?

In commercial practice the term indicates the total sum divided among the stockholders or shareholders of a company. Loosely, the term is also employed to indicate the individual Eortions payable to each shareholder.

HOW IS A DIVIDEND DECLARED?

A dividend does not become a liability of the company until it is declared by the comeany. Dividends are recommended by the directors (who are guided by the trading result of the company), and declared by the company in general meeting. The shareholders, at this meeting, pass a resolution sanctioning the payment of the dividend, and it only then becomes due and payable by the company, but it does not bear interest against the company.

WHAT IS AN INTERIM DIVIDEND?

This is a dividend which is declared before the close of the Financial year, either out of accruing Erofits to date, or East Brofits brought forward. The declaration is made by the directors and not by the company in general meeting. The dividend can be withheld at any time before it is actually paid. Note that the power to pay an Interim Dividend is usually provided in the Company’s Articles of Association.

HOW ARE DIVIDENDS SHOWN IN THE BOOKS?

As soon as the dividend has been sanctioned by the shareholders, the following Journal entry is passed

- JOURNAL -

Appropriation Account Dr.
To Pref./0rd. Share dividend
Being dividend on Shores at % payable
as per Resolution dated ....

WYJWWL. L L 2-
0" puymun! u! aha dlvidund, Oha (allowing aner to pauood through
Oho hunLIe
m.tJom. 5mm
Uividand
In pvnntluu, putliLulntly in lnygn cnmuunion, IQ is u-uol vhnr. tho nuurl omnunt n! the d(vldqnd to known, On ann-6at 1h: loin! amount to ’hu ured!0 of n spacial dividend ncruun! q! thq hank. Ag d&vldand vor-nunig urn pralnnted int pnymnni th hunk dqbblu hum in thin account. and ch: hnluhea ah (ha uenuunl at any 0 mu raptananto 9h; annunt a! that put-tlculur dividend which rnmolng unniotmad. thin onuunt o! unclotnod dividend must be shuwn in thy Compony’n Hulunce shonQ, for l renal". a liability uni$l Che unclukqu divhdunds nun Inglottod. Unluol ".
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Up $0 this point we have tukun it (or granted tho! only thou. profltu, uhown (n (ha Incnmn Stotnmont proper, or. available ’or the payment uf dividendu. I on ufro!d $ tu no! quit. a. otnplo no chit, hnvpvnn, I0 you wltl bu well udvlnnd tn study cnrofully tho lnporton$ points brought out In vhu fulluwl.
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company an. t ti o a trust - I urns or anoo uon!I bola. hold Ln othcr uonpunlan. and the dividend: (run thou. aouponloo bola. crodliod to the Income 3%ntununt of tho Trunt. AgeinOQ .houo crudl u wort 00 ho

office expeneee of the Truet, and the balance remaining was considered available for the payment of dividends on the share of the Trust itself. The aeeete (i.e., eharee or other investments) fell considerably in value, but thie depreciation was not provided for in the Income Statement. The case was brought to attempt to restrain the Trust from distributing ite current profits as dividends, until the depreciation had been provided for. It was held, however, that as long as the current income exceeded the current expenditure, the excess could be distributed lrreepective of whether depreciation had been provided for or not. It ie mast imgortant, however, that you should know that this decision appliee only to fixed assets --- the shares in question being fixed assets when held by a trust company, since they are intended to be held more or lees permanently for the purpose of producing revenue.

In the Verne: case it was Specifically laid down that while depreciation of fixed assets need not be considered, depreciation of current or floating assets must be provided for before a dividend can be paid. One further point of importance is in the fact that the Articles of Aeeociatian of the Trust company did not require the directors to provide for the depreciation of the fixed assets before ascertaining the amount of profit available for dividend.

Another important case was that of Lee vs. Neuchatel Asghalt Comganx Ltd., 1889. The Company’s chief asset was a concession to extract asphalt from mines on the Continent. The main items of expenditure of the Company were wages, and other expenses connected with the extraction. It ie obvioue, however, that the chief asset of the company was being consumed each day the extracting was carried out. Here again, an ine)unction was sought to restrain the Company from paying a dividend to its members until the "wasting away" of the main asset had been provided for in the Income Statement. It was held, however, that such an injunction could not be granted as it was not legally necessary to provide for such "waeting away". The reason for this decision is that the eharehoildere are presumed to know what is taking place. A shareholder would, therefore, be aware that his dividend received from such a company ae the Neuchatel Aephalt Company Ltd., was composed partly of income and partly of a return of a portion of his original investment. Naturally when the main aeeet is exhausted, such a company must be wound-up and the shareholders will receive little (if anything) in the way of return of ’ capital, after the external creditors have been paid. They will have received their original capital back again in the dividends paid during the life of the main aeeet. The decieion in this case applies to similar companiee formed for the e ecific ur oee of workin such a wastin asset euch ae mlnee or quarriee, provided the Memorandum or Article: do not require provision for depreciation to be made. The main asset in each of these companies is known as a "wasting" asset. In this country, of course, we have the excellent example of the gold mines.

If, however, the wasting asset is a mere incidental to the con-pany’s working, then depreciation of that asset must be provided before profits are divided. This decision was made in the case of Bond vs. Barrow Haematite Steele Co. Ltd. Here, the main object of the coapany was to conduct an iron smelting works. For the convenience of those works and by way of economy, they acquired the leases of certain iron mines in order to obtain their own are. Subsequently, the mines were flooded and became useless. The learned Judge ruled that the money in-vested in the mines must be regarded as circulating capital (i.e., working capital) as the stock of are in the mines merely took the place of stocks which the company would ordinarily have purchased. In this light, there-fore, the capital lost when the mines were flooded, had to be replaced before any profits could be divided. It is doubtful, however, whether this is good law today. It is not at all easy to separate the main fro-the incidental objects of a company. The objects clause in the aeloran-dum (on which the learned Judge mainly relied in giving his decision) merely gives an indication of the main object. What is the main object, is a question of fact, and it is possible for a company to have several main objects. If the case came before the Courts now, it would probably be decided that the mines were as much a fixed asset as the iron works. The principle remains, however, that all losses of current assets must be made good before a dividend can be paid.

In Foster vs. The New Trinidad Lake Asghalt Coueanz Ltd., 1901, the availability of a capital profit for dividend purposes was considered. Here, one company purchased the assets of another company. One of these assets was regarded by the purchases as being of no value. Later, how-ever, the asset (actually a large book debt) realised a substantial sun and it was held that this sum, 0 capital profit, was not available for dividend purposes unless the company could prove that the surplus remained after a revaluation of the whole of the assets.

A similar case was Lubbock vs. The British Bank of South America 232’! 1892. Here the profit was made on the sale of a portion of the goodwill of the company. Since this appreciationin value was realised, the Articles permitted such a distribution, and it remained after a re-valuation of all the assets, the profit was held to be available for dis-tribution as a dividend.

Considering the judgments in the above cases it may be said that capital profits are not available for dividend unless:
(I) The Articles of Association permit such distribution.
(2) The surplus is realised; and
(3) Such surplus remains after a proper valuation of the whole of the assets has been fairly made.
Another very important case was The Ammonia Soda Comeany Ltd.z vs. Chamberlain, 1918. In this case it was held that dividends could be paid out of current profits without making up losses incurred in previous years. The Court made it quite clear, however, that this did not create a precedent for future cases. In this particular case the directors had acted honestly in what they considered were the best interests of the company, and the Court refused to interfere. It was stated that dividends could not always be paid without making good the previous losses --- the nature of these losses and the type of business concerned would have to be carefully considered in each case.
Perhaps the widest legal definition of "profit" was given in the Seanish Prosgecting Co., case. Here it was said that profit is the increase in net assets which has taken place during any period, due allowance being made for any capital introduced into or withdrawn from the business in the meanwhile. But, when the rights of third earties intervene, profit must be strictly ascertained and in the absence of special stipulations actual profit is to be taken.
With regard to the distribution of profits generally, the Articles usually provide:
(1) that the right to declare dividends rests with the company in general meeting;
(2) the directors may declare and pay an interim dividend if they so desire;
(3) the company in general meeting may not declare a dividend at a higher rate than that recommended by the directors;
(4) before paying any dividend the directors may place to reserve such sums as they consider necessary;

(5) dividends can be paid only out of profits. I(This is a Yery wide provision and cannot be said to exclude profxts of a copxtal nature.)
From the rulings given in the foregoing cases and other less in-portant cases, we are able to summarise the legal views as to the availa-bility of profits for dividend, as follows:
(Memorise.)
(l) Dividends cannot be paid out of the shareholders' capital, only out of real surplus of profit. This profit, however, nay in certain cases include profits which are of a capital nature, provided that the Articles permit this and such profits are actuall realised and remain after revaluation of the whole of the assets. ?Foster vs. The New Trinidad Lake Asghalt Co. Ltd.). Thus unless the Articles forbid it, premiums on shares and profits on forfeited shares may be distributed. Note that in South Africa, Shore Premiums received after 1/1/53 may not be distributed. In fact they must be regarded in the same light as paid-up Share Capital.
(2) Any dividend declared must not only be within the law, but also within the provisions of the Hencrandun and Articles of Association. The Memorandum and Articles cannot give wider powers than the law, but may restrict them.
(3) Dividends can, unless the Memorandum and Articles provide to the contrary, be paid out of current profits without either
(0) Providing for depreciation of the fixed assats. (Vetner vs. The General and Commercial Investlent Trust Ltd.$. Lee vs. Neuchatel Asgholt Co.I Ltd.).
(b) In certain cases, making good losses sustained in trading in previous years. (Annonia Soda Co. Ltd. vs. Chonberloin.)
(N.B.: Degreciation of current assets must be provided for out of profit; before a dividend can be paid. Bond vs. Borroa Haematite Steel Co.I Ltd.).
(4) Capital profits are available only if:
(a) the memorandum and article: authorise the payuent;
(b) the profit is actually realised;

(c) all the assets are revalued to establish that a definite capital surplus exists.

Having studied the legal views as to the availability of profits for dividend, we can pass on to the commercial views. I must tell you at once that these are somewhat different. It is due to the differences between the legal and commercial views that it is possible for a company to pay a dividend which, although quite legal, would be considered by prudent business men to be the height of folly. Perhaps the best way of examining the commercial views is by considering them in the order of the summary of legal views given above.

To consider the first heading of the summary --- no prudent company would pay, in normal circumstances, adividend out of the shareholders' capital --- supposing there were no legal bar in existence. Also, any profit of a capital nature even though realised, would not be distributed as dividend, but the tendency would be to place it to reserve.

With the second heading we already know that it is not legal to go beyond the powers conferred by the Memorandum and Articles of Association when paying a dividend. These powers may be exceedingly wide, but, providing they keep within the limits set by the law, the law will not interfere. A prudent company, however, would, as a general rule, restrict the powers of the Memorandum and Articles in order that no dividend could be paid unless real trading profits had been earned and realised.

With regard to the third heading, you are already aware that it is customary to provide for the depreciation of fixed assets as well as of current assets, before computing the profits available for distribution. This custom is Founded on common sense and foresight, as it is obvious that fixed assets cannot last for ever ___ they are being consumed gradually, and it is essential that this depreciation should be allowed for as an expense before the profit is ascertained.' The some remarks apply to sub-heading (b). If losses have been sustained in the past the net assets of the company must have been reduced. It is, therefore, improper (from a commercial point of view) to pay a dividend until losses from previous years have been written off.

PRE-INCORPORATION PROFITS.

One point which frequently arises in the case of a new company is the availability of profits made prior to incorporation. For instance, a com on no A.B.C. Ltd.) may be formed to purchase the business of a portnzrlhi: (ray Meters. X. and Y.) on the Slut March, 1999. Now if the firm only prepares final accounts for the year on 31It chelber, the question arises: how are the profits for 1999 to be dealt with? Obviously a portion of the profits were made prior to incorporation, and since a company cannot legally make profit. before incorporation, Inch portion must have been included in the purchase price of the bueineee from the partnership. Theee profits node prior to incorporation cannot, therefore, be distributedamongst the shareholder. en dividends, but should be credited to Non-dietributable Reserve Account and Appropriation Account debited. The method of dividing the yeor’l profits in such cichIIton-ces varies according to the cone involved. Soeetilel they are divided on a time basis, e.g., in the case quoted above the profit: mode prior to incorporation would be a quarter of the profits for the whole year. In other cases, the profits for the year would be divided on the belie of turnover (i.e., ealel). Thus, if in the example quoted, the Sale. for the first three months of 1999 amounted to R2 000, and for the lost nine months to R8 000, then the profits made prior to incorporation would be calculated as one fifth of the profits for the full year. Perhope the best method is a combination of the basis of tile and turnover. The Gross Profit is apportioned on the basin of turnover, and the it... in the Income Statement, on the basis of time --- with the exception of such items as Directora’ Fees which are obviously incurred by the company after incorporation.

EXAWLE:

Messrs. N. 0010 and A. Tatch prepare their account: each year at 30th June. 0n Glut December, 1998, the Multiple Shop Co. Ltd., porChOIO their business, and the accounts for the year ended 30th June, 1999, dil-cluaed the following particulars:

	R
Groxs Profit	50 000
Sales to Slat December 1998 (% year)	30 000
Sales to 30th June, 1999 (% year)	70 000
Interest on purtnurs’ Capital (to Slst December 1998)	200
l); mu tors’ Fees	1 000
Hagan and 511101 ios	16 W
Advertising	2 000
Bad Debt. (to 3lat December, 1998, R290)	760
Preliminary Expenae- (1/3rd to be written off)	1 800

The net Profit for the full year would be apportioned as follows:
Prior to Subsequent to
Incorporation Incorporation
R R
15 000 35 000
Gross Profit (apportioned
according to turnover)
(Ratio 3 : 7)
Less Expenses:
Interest on Partners' Capitol
(actual)
Directors' Fees (actual)
Wages and Salaries (Time basis)
Bad Debts (actual)
Advertising (Time basis)
Net Profit
Amounts written off Preliminary Expenses are on uegrogriation of net profits.
In this case on amount of R5 510 would be transferred from the total net profit of the year (30 040), to the credit Non-Distributcble Reserve Account. If a loss had been incurred prior to incorporation, such loss should be debited to Goodwill Account, as it has had the effect of increasing the purchase price of the concern purchased by the company.
For example, if a company paid, say R40 000 for a business, and when the final accounts were prepared, it was calculated that a loss of R2 000 had been incurred prior to incorporation, then the total cost of the business is R42 000. As the net assets are already shown in the books of the company at R40 000, they must be increased to R42 000, by debiting Goodwill Account with R2 000 (this being shown in the Balance Sheet as an asset), and crediting Appropriation Account with the same amount.
But it is generally more prudent to write off any losses prior to incorporation out of profits after incorporation.
An exception to the general rule as to the availability of profits for dividend is provided for in the Companies Acts of England, Southern Rhodesia and South Africa. These Acts make provision for the payment of interest out of caeitcL

BONUS SHARES.
Where a company has made a large profit, it may not wish to pay a large dividend, as such a course,vould greatly reduce the bank balance. Also, a high dividend would cause the Stock Exchange value of the con-pcny’s shares to soar --- which may not be desired. In these, and other circumstances, a company may decide to capitalise its profits (or at least a portion of them), by the issue of fully paid bonus shares, or by utilising the profits to "pay up" the uncalled portion of the copi-tgl on behalf of the shareholders, instead of paying a dividend. (Partly paid shares are no longer permitted under the Conponies Act of 1973. Where a company has been registered after lst January, 1974, the "paying up" of the uncalled portion of share capital will not arise). The authority for either of these courses, must, of course, be included in the Memorandum or Articles of Association.
On the issue of Bonus Shares, each shareholder receives bonus shares in a proportion relative to his holding of original shares, in-stead of receiving a dividend at a certain rate per cent. This is perhaps best illustrated by an example in the for. of Journal entries.
ISSUE OF BONUS SHARES AT PAR.
EXAMPLE:
A company with a poid-up capital of R100 000 in R1 shares having accumulated a Reserve of R35 000 resolves to capitalise R25 000 of it by issuing to shareholders 25 000 bonus shares of R1 each fully paid, each shareholder to receive one bonus share for every four shares held in the company. Show the Journal entries required to record the transactiont.
- NAL-
__
Reserve Account
To Bonus Account Dr
Being bonus payable out of Reserve
in fully-paid shares as per
Directors’ Resolution No. 60
dated ....

- JOURNAL SContinuedZ -

Bonus Account
To Share Capital Account
Being issue of 25 000 bonus shares
numbered ...... to .... of R1
each fully paid in payment of
bonus, at the rate of one bonus
share for every four shares held in
the company as per Resolution of
Directors dated ....

All profits that are held in reserve are transferred to a Reserve Account from the Appropriation Account. This explains why we first debit the Reserve Account and not the Appropriation Account. Note also that correct accounting requires the transfer From Reserve Account to Bonus Account so that a record of the allocating of the declared bonus is kept in the books.

ISSUE OF BONUS SHARES AT A PREUlQE’

Should the shares of the company be quoted on the Stock Exchange at a premium, it is 33: considered good financial policy to issue the Bonus Shares at par. The explanation being that an increased number of shares will rank for dividend, and, if the company’s profit has not expanded, then the dividend rate will naturally decline and cause a drop in the market price of the shares. In order to overcome this difficulty, the bonus shares are issued at a premium and thus a fewer number of shares are issued to the shareholders than would otherwise be the case.

EXAMPLE.

A company having a Capital of R50 000 in fully paid shares of R1 each, quoted at R3 per share, distributes a bonus of one fully paid share for existing share at a premium of Rl,25 per share. Show the Journal entries necessary to record these transactions.

W-

- JOURNAL -

Reserve Account
To Bonus Account
Being bonus payable out of Reserve
in fully paid shores of R1 each at
a premium of Rl,25 as per Directors'
Resolution No. 60 dated

Bonus Account
To Share Capital Account
To Share Premium Account
Being issue of 50 000 bonus shores
numbered .
each fully paid at a premium of
Rl,25 in payment of bonus at the
the rate of 1 share for every
existing share held in the com-
pany, as per Resolution of Direc-
tors dated .

NOTE.

Hod these shares been issued at par, 62 500 more shares would have ranked for dividend, and this would undeniably affect the Iorket value of the company's shares unless considerably increased profits were node. The effect would of course have been the some had only R50 000 been 01-locoted from Reserve for issuing bonus shares at par.

5 U H M A R Y.

ISIBLE PROFITS.

Legal Views:

(1) (Verner vs. The General and Commercial Investment Trust Ltd. AND Lee vs. Neuchatel Asgholt Co.)

In declaring dividends without first writing down the book values of certain fixed assets the company does not exceed its powers, unless the Articles provide to the contrary (commercially unsound).

(2) Bond vs. Barrow Haemotite Steel Co. Ltd.:

When the asset is only an incidental to the main object of the company, depreciation must be provided before profits are divided, as it is legallx a current asset.

(3) Foster vs. The New Trinidad Lake As halt Co. Ltd.:

J1 .

An appreciation in the value of assets, if dulx realised (by sale for example), may be treated as available for purposes of dividend, if the surplus exists after revaluation of all the assets, and this is permitted by the Articles. (Commercially unsound --- profit would be credited to Capital Reserve.)

(4) Lubbock vs. the British Bank of South America Ltd.:

A profit made on the sale of part of an undertaking is available for dividend if the company’s Articles so permit and there is a net profit after revaluation of all assets. (Commercially unsound --- profit should be credited to Capitol Reserve.)

(5) Ammonia Soda Co. vs. Chamberlain:

It is not necessarily illegal for directors of a company to pay dividends out of the profits of a company during a current year without making good existing deficiencies in paid-up capital or without writing off a debit to the company’s Income Statement occ051oned by losses in previous years. (Commercially unsound).

PROFITS PRIOR TO INCORPORATION.

May not be distributed as dividends.

Discovered by division of year’s profits on:

(a) time basis;
(b) turnover; and
(c) combination of both.

BONUS SHARES.

Sharo- moy be ilnuod at par, or at a premium.

A

In every can. entries should be pulsed through a Bonus Account.

EXAMINATION TYPE QQESTIONS:

1. Give briefly the facts and legal ruling. in the following cases:

(o) The Ammonia Soda Co. Ltd. vs. Chamberlain.

____.___L_-_-_-_

(b) Verne: vs. the General and Commercial Inventiont Truut Ltd.

(c) Lee vs. Neuchotol Asghult Co. Ltd.

(d) Foster vs. The Now Trinidad Angholt Co. Ltd.

(a) Bond vs. Barrow Hoomotite Stool Co. Ltd.

2. What are "Profits prior to incorporation" and how are they on-certainod?

3. Give an oxanplo of the Journal ontrio: necessary upon the isuuo of Bonus Shares to b. not out of o Rotorvo Account.

NOTE: The onlworn to thou. question: are contained in the body of the lecture. Chock your onlvoru yourself. If you hovo not grouped tholo principle: fully, road the lecture again.

THE COMPANIES ACT OF 1973

The Companies Act, 1973 (and especially Schedule 4 of the Act) lays down the minimum requirements for Annual Financial Statements and Interim Reports. It is essential to study these requirements so without further ado let us see what they are.

BMS OF ACCOUNT.

Every company (both private and public) must keep in one of the official languages of the Republic such accounting records as are necessary to fairly Bresent the state of the company’s affairs and to explain the transactions and financial position of the business of the company. Such fair presentation must be in conformity with generally accegted accounting Eractice. These records must show, inter alia:

(l) Particulars of the assets and liabilities, of the company;
(2) Details of all cash received and cash Raid;
(3) Detailed statements of the annual stocktakings;
(4) details of all goods bought or sold, showing the buyers and sellers in sufficient detail to enable them to be identified, except goods sold by way of ordinary retail trade.
(5) Details of all fixed assets, showing the respective dates of acquisition and the cost thereof, depreciation, if any, the respective dates of any disposals and the consideration received in respect thereof.

These books must be kept either at the registered office of the company or at such other place as the directors think fit and shall at all times be oeen to insgection by any director.

These books may be kept by making entries in bound books or in any other manner (e.g., in loose-leaf books or cards, etc.), but if they are not kept by bound books then adequate precautions must be taken to guard against falsification and to facilitate its discovery.

If the books are kept outside the Reeublic there must be kept in the Republic such accounts and returns with respect to the business of the company as shown by the books outside the Republic, as will enable the financial position of that business to be ascertained with reasonable accuracy at intervals not exceeding twelve months, and which will enable Income Statements and Balance Sheets to be drawn up in accordance with the Companies Act. These accounts and returns kept in the Republic must at all times be open to the inspection of any director. ’ The responsibility of seeing that proper books are kept falls on the directors, managers, secretaries and accountants of the company.

ANNUAL FINANCIAL STATEMENTS
At each Annual General Meeting of a Company the Directors aunt lay before the meeting an Income Statement, Balance Sheet and Source and Application of Funds Statement made up to the end of the financial year together with 0 Director's report and Auditor's report. The Annual General Meeting must be held within six months of the end of the financio year but still within 15 months of the date of the preceding Annual General Meeting.
The Directors' Report must deal:
(1) Generally,with a review of the business and operations of the co.-pany during the accounting period and must disclose any material facts relevant to the appreciation of the state of the company's t affairs. This applies equally to material facts occuring between the accounting date and the date of the report.
(2) Sgecifically with the following, unless such information is alread given in any document annexed to the annual financial statements:
(a) the nature of the company's business and any major change therein during the accounting period;
(b) the aggregate amounts of any shares or debentures issued during the accounting period and the purpose thereof (e.g. 70 000 ordinary shares of R1 each were issued at par to acquire 281 Shapedlika Crescent, Moontovn, being the Company present business premises);
D
(c) any major change in the nature of the company's fixed asset. or the use thereof during the accounting period;
(d) any amount proposed, declared or paid by way of dividend in respect of each class of shares;
(e) the fact that the business of the company has been nenaged (under any agreement) by a third person or a company in Hhi a director has an interest; also the name of such person a company and the director's interest in such company,if material:
(f) the names of the directors and the secretary, the latter'e business and postal address, and any changes during the accounting period;

(g) the name of the company's holding company and ultimate holding company, and if the holding company has been incorporated in a foreign country, the name of that foreign country.
Every Income Statement or Income and Expenditure Account must fairly Bresent the profit or loss or Income and Expenditure for the year.
Particulars which must be shown separately are required by the Fourth Schedule and are as follows:
(1)
(2)
(6)
(7)
(8)
Profits or Losses on share transactions, showing the application of profits to write down the amount of the remaining investments.
Income from Investments, distinguishing between:
(0) Listed Investments;
(b) Unlisted Investments;
The aggregate amount of dividends eoid and erogosed, and if such dividends are provided wholly or partly from capital profits, 0 statement to that effect.
Profits or Losses on the sale or scrapping of non-trading, fixed and other non-trading assets;
Provisions for deereciotion, renewal or diminution in value of fixed assets;
The amount charged to revenue by way of provisions (other than provisions for diminution in values of current assets) specifying the nature of each provision or the amount withdrawn from such provisions and not applied for the purpose thereof.
Provision for taxation (specifying the taxes) in respect of the financial year by the account, and any such amount in respect of any other financial year.
Provision for the redemgtion of:
(a) Share Capital;
(b) Loans.

fl
(9)
(10)
(11)
(12)
(l3)
(14)
(15)
(16)
(17)
(18)
(19)
(20)
some paid by way of expenses allowance, any contribution paid in resp

Any material amount proposed or set aside to, or withdrawn fro-
reserves;
The Auditor’ s remuneration, (distinguishing between the feel for
the audit, expenses of the auditors and fees for other eerviggi
rendered, e.g., tux consulting or management fees). _
, 4
Except for the first income statement, the corresgonding ugggetll
for the immediately greceding f1nonc1al year for each itel in th
Income Statement.
The aggregate amount of income from subsidiaries, stating whethe
dividends, fees or other specified income.
The amount of interest (or other consideration) on any
loans, including debentures and bank overdrafts made to the
company.
Any material item arising in consequence of an event in the prev
financial year.
The amount of interest (and the rate thereof) on share capital
out of capital during the financial year concerned.
The amount paid by way of leasing charges for the use of any can
(except immovable property), which would have been subject to a
charge for depreciat1an if owned by the company (e.g., motor
vehicles).
The amounts paid as remuneration for managerial, technical, odli
trative or secretor1al fees, however described, other than to
ployees of the company.
The aggregate amount of the Directors’ Emoluments;
The aggregate amount of the Directors’ or past Directors’
The aggregate amount of any compensation paid to directors or pa
directors as congensation for loss of office.
The word "Emoluments" used in 18 includes fees and percentages,

of a director under a pension scheme and the estimated money value of any benefits received by him otherwise in cash.

The amount to be shown under 18 includes any emolument paid to or receivable by any person in respect of his services as director of the company or in respect of his services, while director of the company, as director of any subsidiary thereof, or otherwise in connection with the carrying on of the affairs of the company or any subsidiary thereof and must distinguish between emoluments in respect of services as director, whether of the company or its subsidiary, and other emoluments.

The amount to be shown under 19 must not include any amount paid by a pension scheme, it the scheme is such that the contributions payable to the scheme are substantially adequate for the maintenance of the scheme; but must otherwise include any pension paid or receivable in respect of any such services of a director or past director as are mentioned above, (i.e., services to the company or subsidiaries otherwise than as director) and must distinguish between pensions in respect of services as director, whether of the company or its subsidiary, and other pensions.

The amount to be shown under 20 includes any sums paid to or receivable by a director or past director by way of compensation for the loss of office as director of the company or for loss, while director of the company or on or in connection with his ceasing to be a director of the company, of any other office in connection with the carrying on of the affairs of the company or of any office as director or otherwise in connection with the management of the affairs of any subsidiary of the company and must distinguish between compensation in respect of the office of director, whether of the company or its subsidiary, and compensation in respect of other offices.

"Compensation For loss of office" includes any sums paid as consideration for or in connection with a person’s retirement from office.

The amounts shown under l8, l9 and 20 must include all relevant sums paid by:

(a) The company; and
(b) The company’s subsidiaries; and
(c) Any other person;

and in the case of 20 must distinguish between sums paid under (a), (b) and (c) above.

In addition to the above the following must be shown by way of not unless otherwise shown:

(1) (a) If depreciation of fixed assets is not Bravided far, a eta ment to that effect;

(b) If depreciation is provided for by a method other than a d preciation charge or provision for renewals, a statement a how it is provided for (e.g., by debiting replacements dir to revenue).

(2) If no provision For taxation is made, a statement of that fact, reason therefor and the period for which such provision is not I

(3) Any material effect on any of the items in the income statement (stating in each case the amount involved) of:

(a) transactions not usually undertaken by the company of an exceetional or non-recurrent nature including the amounts paid as fines in respect of contraventions of the Act;

(b) any change in the basis of accounting;

(c) any change in the methods for the determination of the amo of any assets.

(4) Turnover: There must be shown either the aggregate amount of t turnover or the percentage increase or decrease compared with th previous financial year. Any change in the method of computing turnover must be shown and where, by nature of the company's a business, there could be doubt as to the meaning of turnover, th, basis on which turnover has been determined must be disclosed.

:ALANCE SHEET

Every Balance Sheet must fairly gresent the state of the company! affairs as at the end of its financial year.

The Fourth Schedule requires that every Balance Sheet shall conf to the following:

The Authorised Share Capital, Issued Share Capital, liabilities and
assets must be summarised so as to show their general nature and these
shall be shown separately:
(1) The Authorised Share Caeital showing the different classes into
which it is divided, and the amount of each class, and in the case
ofshares of no par value, the number of such shares.
(2) (a)
(b)
(e)
The amount of the Issued Share Caeital in each class;
The earliest and latest dates and the price at which the com-
pany can redeem any Redeemable Preference Shares, whether
they must be redeemed in any event or are liable to be re-
deemed at the option of the company.
The stated capital account, setting out the expenses of issue
of no par value shores charged against such account during
the T1nanc1al perloa.
The Share eremium account which may be used only for:
(i) paying up unissued shares to be issued as fully paid
capitalization shares.
(ii) in writing off preliminary expenses;
(iii) in writing off the expenses of or commission paid or
discount allowed on the creation or issue of shares or
debentures; or
(iv) for providing any premium on the redemption of deben-
tures or redeemable preference shares.
Preference shares convertible into ordinary shares --- state
the conditions of conversion rights of conversion or a note
where these may be inspected.
(3) By way of note or in a statement or reeort attached:
(a)
The number, description and amount of any shares in the com-
pany which any person has an option to subscribe for or has
any preferential right of subscription and the period during
which and the price at which such rights can be exercised’

(c)
(4) Liabilities:
Generally, liabilities must be summarised under headings appro to the company’s business and where amounts of a particular c1 of liability are not material they may be included under the s heading as some other class.
Items which must be shown under separate headings, are:
(c)
(b)
(C)
(d)
(f)
(5) Reserves and Provisions:
Provisions are defined as "any amount written off or retained
.5-
4i

The amount of any share capital, which the directors are entitled to issue by virtue of the articles or shareholdet resolution, details of such authority and the period For , which granted;
The period and the amount that any fixed cumulative divi are in arrear, separately if there is more than one class such shares.
Particulars of any redeeted debentures which the company power to re-issue (by way of note);
The amounts and classes of debentures issued and, if con tible into shares, conditions of conversion and dates of redemption of debentures. (This can be shown by way of note.)
Where any liability is secured on any asset the fact mus be stated and the asset specified (by way of note);
The aggregate amount of bank overdrafts;
The nominal amount of any of the company’s debentures hol by a nominee for the company and their book value must b stated (by way of note).
The amounts of loans made to the company and where the of repayment is more than a year after the accounting do details of the terms of repayment must be shown (interes rote, dates, etc.).

way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability (including the liability for income tax), the amount of which cannot be determined with substantial accurary". I have given the full definition here as it is important.

Provisions for depreciation, etc., of fixed assets must be deducted from the fixed assets (see below) and those in respect of current assets may also be deducted. Provisions may be shown as an aggregate amount.

Any increase or decrease of the provisions from one year to the next must be explained (unless shown in the profit and loss account). If the provisions are shown separately the individual changes must be explained.

A "Distributable reserve" is defined as "any amount which has been carried to reserves and which may, in accordance with generally accepted accounting practice and legal principles, be taken to the credit of the income statement and distributed by way of dividend, and does not include any amount retained by providing for any known liability; and "non-distributable reserve" shall be construed accordingly.

That is, a Reserve is any amount on the liabilities side of the Balance Sheet (excluding Share Capital) which belongs to the shareholder and which will ultimately be paid to them.

Where a provision is in excess of that which in the opinion of the directors and the auditor is reasonably necessary for the purpose, the excess is to be treated for the purposes of the Fourth Schedule as a reserve and not as a provision. If, however, the auditors consider any provision excessive, while the directors do not, the auditors must report specifically on the subject to the shareholders.

Any amount written off or providing for depreciation etc., of assets must be treated as a provision.

The respective aggregate amounts, if material, of reserves and provisions (other than provisions for depreciation) must be stated under separate headings indicating the types of reserves and provisions.

In respect of the financial year concerned there must also be 3 (unless shown in the income statement or a note attached theret or the amounts involved is not material):
(a) the source of and amounts transferred to reserves and the provisions mentioned above; and
(b) the amount of any transfer from reserves and provisions what it was used for.
(6) Dividends:
The aggregate amount that has been declared or is recommended distribution as dividends must be shown separately.
(9) Contingent Liabilities:
The following must be shown by way of note:
(a) Particulars of any charge on assets to secure the liabil of any other Eerson including where practicable the anou secured.
(b) The general nature of other contin ent liabilities not provided for and where practicable and;or material the t or estimated total amount.
(c) Where practicable and/or material the total amount or es timated amount of contracts for caeital exeenditure not provided for.
mae-
Assets must be summarised with such detail
as is necessary to
their general nature.
Where the amounts of any class of assets is not material it an included under the same heading as some other class.
Fixed assets, current assets and those which are neither fixed current must be separately identified.

Fixed Assets:
The method or methods used to arrive at the amount of the fixed assets or the assets which are neither fixed nor current, must be stated.
With certain exceptions detailed below, the value of all fixed assets (and assets neither fixed nor current) must be arrived at as follows: At cost or if in the books at a valuation, that valuation; less the total provided or written off for depreciation, etc., since the date of acquisition or valuation as the case may be.
The aggregate amounts of cost and depreciation must be shown.
The exceptions are:
(a) Assets the replacement of which is provided for wholly or partly:
(i) by making provision for renewals and charging the cost of replacement against the provision or;
(ii) by charging the cost of replacement direct to revenue.
(b) Investments where the market value or in the case of unlisted investments, the estimated value is shown.
(c) Goodwill, Patents or Trade Marks.
In respect of assets under (a) above, it must be stated:
(i) the means by which their replacement is provided for and
(ii) the total amount of the provision mode for renewals and not used (if any).
(d) The following details must be shown in respect of land and buildings:
(i) a description of the property and the situation thereof;
(ii) date of acquisition by the company;

(2)

(iii) purchase price;
(iv) cost of improvements and additions since acquisition or valuation giving the years in which the additions and improvements warn carried Out; provided that, where there are more than five different items of land and buildings, a separate register may be kept which must be left open for inspection.

Where proceeds on the realisation of any investment 1 applied to write down the remaining investments, thin must be noted on the Balance Sheet indicating the anql so applied. .i
)
Where such fixed assets are arrived at by reference a valuation, the provisions of (ii) and (iii) above not apply. Hut therw must be stated the years in uh? the assets were sevoxolly xalued and the several vol and, in the case of assets that have been valued dur the Financial year concerned, the names and qualifi-cations of the persons who valued them and the basis of valuation used by them.

The amount of goodwill, patents and trade marks must be shv under a separate heading. Their total value can be shown one amount or they can be shown separately.

Investments:

Investments must be classified as listed or unlisted.

A listed investment is one which is dealt in on any recognised stock exchange; and an "unlisted investment" shall be construed accordingly.
’c
The aggregate amounts respectively of the company’s listed and unlisted investments must be shown unde
r separate headings excop5
for interests in subsidiaries dealt wit
h in the group accounts.

There must be shown:

(a) the aggregate market value of listed investments whore thin differs from the amount as stated (9.9. cost);

(b) the aggregate directors’ valuation in respect of unlisted investments. Where a directors’ valuation is not given a large amount of additional information in reSpect of the investments must be given so it is usual to give a directors’ valuation.

Except if not material, the company must disclose the names of all companies (excluding subsidiaries) in which it beneficially holds shares and the number or percentage of such shares.

Preliminarx Exgenses:

The following must be shown under separate headings in so far as they have not been written off:

(a) Preliminary Expenses;
(b) Share or debenture issue expenses;
(c) Commission paid in respect of shares or debentures;
(d) Discount allowed on any issue of shares or debentures.

Reulisable Value of Current Assets:

If the directors are of the opinion that any of the current assets have not a realisable value in the ordinary course of business at least equal to the value at which they appear in the Balance Sheet, that fact must appear as a note on the Balance Sheet or in an attached report and the extent of the shortfall must be stated.

CorresEonding Figures:

A Balance Sheet, except for the first one after the coming into force of the Schedule, must show the corresponding amounts at the end of the previous year for all items shown.

Basis of Conversion of Foreign Currencx:

The basis of conversion of foreign currencies into South African currency must be stated if the amount is material.

ISTATEMENT 0F SOURCE AND APPLICATION OF FUNDSJ
A statement of source and application of funds must be annexed to the Balance Sheet, specifying at least:
(1) Funds derived from:
(0) net income (before the deduction of taxes, dividends paid an preposed, and internal provisions and tetentions, 9.9., current year’s depreciation provision or transfer to reserves.
(b) the disposal of fixed and other non-curtent assets.
(c) the proceeds of loans raised and shares and debentures issuh
(d) repayments received on loans and advances made.
(e) any reduction in net working capital (i.e., current assets less current liabilities); and
(2) Funds applied to:
(a) meeting any loss;
(b) the acquisition of fixed and other non-current assets;
(c) the redemption of any loans and debentures;
(d) loans and advances made and the purposes for which made;
(8) liability for taxes;
(f) dividends paid and proposed; and
(9) any increase in net working capital (being current assets less current liabilities).
shares are issued.

Save as set out above, no company can apply any of its shares or :apital money in the way of commission for procuring subscriptions, 4hether the shares or money are added to the purchase money of any prOperty acquired by the company or to the contract price of work to be executed for the company, or in any other way.

r Nothing in this section, however, affects the power of any company 10 pay ordinary brokerage, or the power of a person who receives payment in money or shares from a company to apply any part of the money or shares so received in payment of any commission.

LOANS TO CONTROLLING COMPANIESJ

Section 37 prohibits the use by a company of any of its funds for the purpose of loans to its holding company unless all its members consent to the loan. Provided that this shall not be construed as prohibiting the lending of money in the ordinary course of business by a company whose main business is the lending of money.

Also no company may either directly or indirectly, by means of a loan, guarantee, the provision of security or otherwise, give any financial assistance for the purpose of or in connection with any purchase of or subscription for any shares in itself or in its holding company. (Section 38.)

Nothing in this section prohibits the above:

’(1) where the lending of money is the main business of the company, any loan in the ordinary course of business;

,(2) providing funds (on loan or otherwise) for the purchase of shares by or on behalf of employees of the company.

tISSUE OF SHARES AT A DISCOUNT

l In the ordinary way it is illegal for a company to issue shares at a discount, and when a new public company offers shares to the public for subscription, it must fix the issue price at not less than the nominal value of the shares, e.g., R1 shares cannot be offered for 85c --- the minimum price is R1, though the company may issue the shares at a premium, e.g., R1,10.

In the case of new companit there is no reason why shares should

be offered at less than their nominal value. Unless the promoters off the company can show in the prospectus that a reasonably attractive L dividend can be paid by the company, it is inconceivable that they w%& 90 to the trouble and expense of inviting public subscriptions. hr
The position is, however, somewhat different in the case of a d. pany that has already been carrying on business for some time and than finds itself in need of further capital. Of course, provided the q pany has met with success and has paid good dividends there will be ;i difficulty in obtaining applications for further shares. But if the company has passed through difficult times and its 50c shares do not' command a higher price on the market than, say, 35c, it is unlikely th the company will be able to obtain subscribers willing to pay the full nominal value (50:) for new shares.
Recognising this difficulty, the law has now made provisions for the issue of shares at a discount, i.e., at less than their nominal value. Section 81 provides that a company may issue at a discount shares of a class alread issued, provlded:

. X

(1) This issue of the shares at a discount has been authorised bx sgecial resolution of the company, and sanctioned bx the Court.
NOTE: A special resolution is said to have be
less than three-fourths of those member
their representatives who are
of the company, (each member 0
en passed when not
s of a company or
that resolution. Not less than one-fou
strength of the company must be present
at the meeting,
otherwise the meetin
g is automatically adjourned until the
(2) The resolution specifies the
shares are to be issued.
(3) Not less than one xear has, at the
date on which the company was entit
date of the First issue of the clas
date of issue, elapsed since t
led to commence business or th
s of the shares.

(4) The shares to be issued at a discount are issued within one month after the date on which the issue is sanctioned by the Court or within such extended time as the Court may allow.
Once the company has passed the necessary sgecial resolution, it may apply to the Court for an order sanctioning the issue. If the Court approves of the company’s petition, it will make an order embodying any terms and conditions under which it authorises the issue (e.g., the Court may allow the company two months instead of one month for issuing the shares).
If a company issued shares at a discount, every Erosgectus issued subsequently by it must contain particulars of the discount allowed or so much of it as has not yet been written off.
PAYMENT OF INTEREST OUT OF CAPITAL.
l
Section 79 of the Act provides for on exception to the rule that dividends can be paid only out of profits.
Where a company issued shares in order to obtain money to provide buildings and plant which cannot be made profitable for a considerable time, the Act allows the company to pay interest on the share capital so obtained. The reason is obvious: an issue of shares on which a dividend is unlikely for some years is not an attractive proposition to investors, and unless the company can offer them some early return on their money, subscriptions will not be forthcoming and the issue will be a failure.
.
Not only may the company pay interest, but it may also charge it to tCaEital Account as part of the cost of the building or plant. Certain fformalities must, however, be complied with. These are:
(l) The payment must be authorised either by the company’s Articles or by special resolution;
(2) The sanction of the Minister of Economic Affairs must be obtained;
(3) Before giving his sanction the Minister may, at the company’s expense, aeeoint a gerson to enquire into all the facts of the case and report back to him;
(4) The payment of interest may be made only for a period to be decided

by the Minister: in no case may gt extend beyond the close of the holf-year following upon that during which the works or buildings were completed or the plant provided. "Half-yeor" means the period of six months commencing on the first or ending on the last day of the financial year.

(5) The Minister may fix the rate of interest, but this cannot exceed 31x Eer cent.

(6) The payment of the interest shall not operate as a reduction of' the amount paid up on the shares in respect of which 1t 15 pald.

S U M M A R Y

The requirements of the Act in respect of the books and accounts 0 a company have been summarised and tabulated in this lecture, and it is not considered necessary or desirable to summarise them further.

The provisions of the Fourth Schedule to the Companies Act are of PARAMOUNT IMPORTANCE! You are urged to be thoroughlx familiar with them.

EXAMINATION TYPE QUESTIONS:

1. What information must, in terms of the Act, be disclosed in the Income Statement laid before a company in general meeting?
2. What are the requirements of the Act regarding the books a company must keep?
3. When may a company issue shares at a discount, and what are the formalities required?
4. What are the provisions of the law relating to the payment of commission in respect of the issue of shares in a company?
5. What information must be disclosed in the Balance Sheet of a company under the Act?

NOTE: The answers to these questions can be found in the body of the
lecture. Check your answers.
rules, read the lecture again.
these requirements.
If you have not grasped these
It is imperative that you know

COMPANY SOURCE AND APPLICATION OF FUNDS STATEMENTS.

An accountant, with his expert knowledge, can study the final accounts of a business, and can deduce from them how various projects have been financed, and why unappropprioted profits have increased or decreased. To the layman, however, the Balance Sheet and Income Statement of a business may appear as a bewildering array of figures.

He may want to know the answers to a host of questions, of which the following are typical:-

"The profits have risen, but the cash resources are lower. Why?"

"There are ample profits but none available for distribution. Why?"

"The business has erected its own factory. Where did the money come from?"

The most simple way in which an accountant can answer these and similar questions is to attach to the Financial Statements 0 SOURCE AND APPLICATION OF FUNDS STATEMENT. In America such a statement is known as 0 "Where from - where gone Statement" and this term aptly describes its nature and purpose.

How to gregare a Statement of Source and Aeglication of Funds.

There are several methods of preparing the Statement but we will describe the quickest for examination purposes, this being the best adapted to your needs.

The raw material from which the Statement will be produced is the current and previous year’s Balance Sheet and the current Profit and Loss Appropriation Account of the business. The reason for this should be obvious. IF the figure for Furniture and Fixtures for last year was R10 000 and the figure on this year’s Balance Sheet is R20 000, then (ignoring depreciation) you know that Furniture and Fixtures to the value of R10 000 were purchased during the year. Since we are concerned with the funds involved in this transaction, the purchase (an increase in assets) is a use (or application) of funds. In this way the Source and Application of Funds Statement is prepared. Let us study this in detail.

Referring firstly to the Balance Sheet, prepare a two-column schedule listing the differences between the previous and present figures.

COMPANY SOURCE AND APPLICATION OF FUNDS STATEMENTS. PAGE 2.
The two columns are headed respectively "Source" and "Application".
In allocating the differences between the columns, follow the rule:-
Liobilities: an increase over last period allocate to SOURCE.
a decrease from last period allocate to APPLICATION.
Assets: an increase over last period allocate to APPLICATION.
a decrease From last period allocate to SOURCE.
Consider the Following example very carefully:-
BALANCE SHEET
X CO. LTD.
05 at 30th JuneI 1999.
Share Capital
Preference Capitol
Appropriation A/C
Capitol Redemption Res.
Fund
Regresented b2:
FIXED ASSETS
Plant
Premises
CURRENT ASSETS
Debtors
Stock
Cosh
LE-LS
CURRENT LIABILITIES
S. Creditors 2 500
Taxation 500

COMPANY SOURCE AND APPLICATION OF FUNDS STATEMENTS. PAGE 3.
INCOME APPROPRIATION
for the Year ended 30th JuneI 1999
Net
Income
Balance 0-
beginning
of year
2 000 00 Dividends
5 000 00 Taxation
Capital Red
emption ’
Reserve
Balance to
B/Sheet
Source Agelicution
R R
Preference Shares 1 000
Capital Reserve (contra) l 000
Appropriation l 000
Creditors 500
Plant 1 500
Premises 5 000
Debtors 500
Stock 1 000
Cash 8 500
R10 000 R10 000
This statement is not yet a Stat: wt of Source and Application of Funds,
but is merely the preliminary VOrh 19 schedule.

The lgggnd_3ggn is to analyse the Appropriation Account. The rule to be observed here is that Net Profit and other revenue is allocated to the "Source" column, while expenditure and appropriations of pgofit are allocated to the "Application" column. IN THIS ANALYSIS, THE PREVIOUS YEAR’S FIGURES ARE IGNORED.

The schedule produced from our example would be as follOwsz-

Source Aeglicutiog
R c R
Net Profit 7000 00
Dividends Paid 6 500
Taxation ....
500
l 000
Capitol Redemption Reserve ......
R 7 000 00

You will see that there has been on over-applicotion of R1 000,00 and this is the reason for the decrease in the balance of Appropriation account, as shown on the Balance Sheet. Look back at our first schedule (produced from the Balance Sheet). There you will see the decrease in Appropriation Account represented by a figure of R1 000,00 in the Application column.

The third stag we must follow is to combine our two schedules, re-plac1ng the R1 000,00 "Application" figure in the first schedule with the details of the second schedule, (which detail amplifies and explains this figure).

At the same time we eliminate any figures which cancel each other out Thus the Capital Redemption Reserve, which appears as a "Source" item in our Balance Sheet schedule, and as on "Application" item in our Appropriation Account schedule, must be omitted from our final statement.

Our final etotement will look like this:-

X CO. LIMITED
STATEMENT OF SOURCE AND APPLICATION OF FUNDS
for the year ended 30th Junel 1999
Source AQElication
R c R c
Net Profits 7 000 00
Sundry Creditors 500 00 l
Bank 00 :
00
Agglied as follows: i
Redemption of Preference Shares 1 000’ 00
Purchase of Plant 1 500’ 00
PurchaSe of Premises 5 000 00
Increase in Debtors 500 00
Increase in Stock 1 000’ 00
Dividends Paid 6 500 00
Taxation 500 00
R16 000 00
(Although not a requirement of the Companies Actlcomporative figures, i.e. the previous years’ figureslare often recorded.)
Turn back to the Balance Sheet and Appropriation Account of X Co., Ltd., and, without referring to any other text, prepare your own two preliminary schedules, and yggg final Statement of Source and Application of Funds. Do not be discouraged if you find yourself perplexed. This is a subject which appears difficult but is, in fact, quite easy if you think clearly about what you are doing. Persist until you can prepare the schedules without hesitation. Be quite sure you understand the rules for allocating a figure to a source or use.

WORKING CAPITAL:

As you know, current assets are acquired for resale and are comprised of assets which are at various stages of "conversion into cos These assets are constantly changing form in the process of trading - thus cosh may be applied in purchasing goods; the goods are sold and replaced by debtors; the debtors are converted to cash and so on.

Workin co ital is the term used to describe the net current as. (or liabilities; of a business i.e. current assets less current liabilitles.

An increase in net working capital represents a net increase of current assets over current liabilities or a net decrease in current liabilities.

Conversely, a decrease in net working capital shows a net increa: of current liabilities over current assets or a net decrease in currel assets.

A statement of changes in working capital is usually prepared to reflect these changes.

Taking the example of X. Co. above, we have:-

STATEMENT OF CHANGES IN WORKING CAPITAL.

gDebitsz - $Credit82
Debtors R500
Stock R1000
Cash R8 500
Creditors 500
R1 500 R9 000
1 500
Net decrease in working capital. R7 500

This net decrease in working capital represents a source of funds. This is simple to follow - if assets have decreased, we must have disposed of some assets; the amounts we have received represents a source

of funds. The same applies to an increase in liabilities.
By the same token, if net working capital has increased - representing a net increase of current assets (or decrease of current liobilities) - funds must have been oEElied to achieve this net increase.
If you think carefully about the previous two paragraphs you will have no difficulty in answering any questions set. Remember, we wish to show how FUNDS were received and how FUNDS were used.
Now, the statement of source and application of funds in respect of X Co. Limited would take the following form:

X. COMPANY LIMITED.
STATEMENT OF SOURCE AND APPLICATION OF FUNDS
for the year ended 30th JuneI 1999.

Source of Funds.

Net Income	R7 000
Decrease in net working capital	7 500
	R14 500
Agglied as follows:	
Redemption of Preference Shores	1 000
Purchase of Plant	1 500
Purchase of Premises	5 000
Dividends Paid	6 500
Taxation	500
	R14 300

The Companies Act does not require a statement of chon es in working capital - only the increase or decrease in net working capitol is required to be shown.
. A statement of changes in working capital (as shown on page 6) 15, however, sometimes asked for in examinations. Even if not specxflcally asked for, it is recommended that it be included as

part of your working: so that the examiner can easily see how you i arrived at the increase (or decrease) in net working capital in your source and application of funds statement.

Have you understood everything covered up to this point?
If "yes", continue with the lecture. If "no", go back to the beginning and work through the lecture again. Do not become discouraged, you can do it!

Work carefully through the examples given - do not simply read them.

Remember, you are required to prepare a statement of source and application of FUFDS. It is the funds received and used which we are concerned with in this lecture.

We have, up to this point, studied the basic features of source and application of funds statements. What follows in no way changes the basic principles already outlined. It should be obvious to you by now that there are many book entries which in no way bring in funds nor which use funds. These book entries distort the picture unless we make allowance for them. The most important example it depreciation and we will now proceed to discuss these aspects.

THE PROBLEM OF DEPRECIATION.

It can be argued that Depreciation is neither a source nor an application of funds, since funds are neither gained nor lost through this book entrx.
However, if depreciation is omitted from the statement then it will not be as informative as possible. This can be corrected as follows:-
EITHER Net Profit must be increased in the Source Column by the addition to it of any Brovision for degreciotion,
93 the Net Assets Figure must be taken from the Balance Sheet instead of the Asset Cost Figure (when shading asset increase in the "Application" column).
Consider the following example:-
Balonce Sheet of ABC Business

as at 30th JuneI 1999
Capitol t! 4 000 Plant at Cost
Loan A/C 3 000 Less Depreciation
Appropriatiodt 4 500
Loan I
Redemption
Reserve 3 000
Creditors 4 800
Income Aggrogriation Account
for the ear ended 30th June 1999
Drawings 1 Balance b/f
Loan Redemption Reserv; ’ Net Profit
Balance b/f

Note that the cost of Plant purchased during the year is the difference between R7 000 and R9 000; that is R2 000. This is the correct amount of funds agelied in purchasing the Plant, and it would be incorrect to show the figure as the difference between the get Plant figures ZR6 300 and R7 800).

NOTE however, that the Net Profit figure of R5 500 is the result after deducting depreciation of R500 (R1 200 less R700) for the year, and it would be incorrect to state this figure as R6 000 as if depreciation had not been provided for.

The solution to the problem is to show the correct figures in both cases and to show depreciation as added back to the Net Profit in the "Source" Column.

Thus our Statement of Source and Application of Funds produced from the example above would be as follows:-

ABC BUSINESS

STATEMENT OF SOURCE AND APPLICATION OF FUNDS

for the xear ended 30th JuneI 1999

Source Agglication

R R

Net Profits 5 500

odd back Depreciation 500

Increase in Creditors ..... l 900

Bank 300

R8 200

AQElied os Follows:-

Repoyment of Loan 1 000

Purchase of Plant 2 000

Increase in Debtors 900

Increase in Stocks 300

Drawings 4 000

R8 200

This is the logical way to treat depreciation, because, although it is a very real expense to a business, it is not an actual poy-out of fundt.

Remember particularly that in arriving at the Application of Funds incurred in purchasing assets, find the difference between the COST of assets at the beginning and the end of the year. NOT the difference between their NET figures.
When an item of plant is revalued this is not a flow of funds, the revaluation is merely a book entry.
Also remember that the Depreciation for the year will be the difference between the accumulated depreciation figures for the beginning and the end of the year.
WHAT HAPPENS IF THE "PLANT AT COST" FIGURE FOR THE CURRENT YEAR 15 LESS THAN THAT FOR THE PREVIOUS YEAR?
The only reasons for such a decrease in Plant at Cost are either:-
(0) Plant has been sold, or
(b) Plant has been scrapped (written off)
In an examination question you will probably be told the reason For the decrease. Whatever the reason, the rule you have learned will apply.
That is:- A decrease in Asset value is allocated to "Source" column.
If the Asset has been sold, it can be shown in the Source column simply as .... Plant (or other name) sold .... Rx xxx
If the Asset has been written off, the value written off will have reduced the Net Profit. Therefore the entry in the Source column can follow the same lines as we learned For Depreciation. It will be shown thus:-
Source
Net Profit .... Rx xxx
add back asset(s) scrapped ...... Rx xxx
Should the examination question not reveal the reason For the decrease, either of these methods may be used.
RESERVES FOR BAD DEBTS.
The net result of increases or decreases in Reserves for Bad Debts is the same as in the case of Depreciation. An increase in the Reserve results in a decrease in asset value, and thus represents a "Source" item, whilst a decrease in the reserve is an "Application" item.

However, it is considered unneccessary to record such fluctuatxons 1n
_____._.
Bud Debts Reserves in the Statement. Accordingly cougars onlz the
NET debtor figuresI after deduction of the reserve .
Be wary of the case where the Bad Debts Reserve is not shown as a
deduction from the Debtor figure, but as a separate item on the
Liability side of the Balance Sheet. In such a case, be careful to
deduct the Reserve from the Debtors figure, for both past and current
years, before arriving at the variation in Debtor value.
(i) Plant or building revolved.
1986 I987
Buildilngs KI) (II) 150 (XX)
from the above it seems that buildings have been purchases
during the year and thus an application of funds.
However during the year the company revolves its existing
building by R50 000.
The journal entry for this would have been:
Dr Buildings R50 000
Ct Non Distributive reserve R50 000

(ii)

Clearly the increase in buildings is a consequence of a book entry and no funds have flowed from the above.

Therefore the increase in buildings would not be shown as on application of funds.

Bonus or coeitalisation of shares issued

	1986	1987
Share capital	100 000	150 000

Again it seems that funds have flowed to the company as a result of increasing its share capital and R50 000 should be shown as a source of funds.

However during the year the company made a capitalisation issue of R50 000 by issuing 50 000 ordinary shares of R1,00 each by utilising the capitol redemption reserved fund.

The journal entry would have been:

Capitol redemption reserve fund R50 000

Ordinary share capital R50 000

Clearly this is a book entry and there is no movement of funds. Thus nothing would be shown in funds statements.

INTERPRETATION OF RESULTS.

You may be asked in the examination to prepare a Statement of Source and Application of Funds, and to comment on the results there shown. These comments will call for your careful analysis of the Statement. As an example of what is required, the following comments are based on the first Statement shown in this lecture:-

The company, after a successful year’s trading, has decided to utilise its surplus cash resources. The Preference Shares were redeemed and the company acquired new premises and Plant.

This expansion necessitated an increase in Stock and Debtors.
A very large dividend was paid to shareholders which was, perhaps, unwise. Future statements of Source and Application of Funds will reveal whether the dividend payment will prejudice the Company in any way.
It appears that the company has expanded its operations on the basi of efficient management.
The raw material for the Statement is:-
(a) The Balance Sheet with previous year's comparative figures.
(b) The Income Appropriation Account.
A preliminary schedule is produced from the Balance Sheet, obeying the rules:-
(a) Liabilities an increase over previous year allocate to SOURCE
a decrease from previous year allocate to APPLICATION
(b) Ageets An increase over previous year allocate to APPLICATION
a decrease from previous year allocate to SOURCE.
A preliminary schedule is produced from the Appropriation Account, following the rules:-
(0) Net Profit and other revenue allocate to Source
Application.
Wu third step is to combine the two schedules, cancelling out contra tems.
In calculating the variation in value of depreciated assets, the original cost figures Should be used.

Working Capital : Current Assets - Current Liabilities.
The variation in accumulated Depreciation will be shown under SOURCE as an addition to Net Profit (BUT MUST BE INDICATED SEPARATELY).
Reserves for Bad Debts should be deducted from Debtors figures before arriving at variation between years.
If called for,an intelligent analysis of or comment of the Statement will enhance your examination marks.
Only actual cash received (or Raid) comprises the source (or application) of funds, NOT any value an asset may have attached to it.
PROGRESS QUESTIONS
1. Deereciation is not strictly a Source of funds, neither is it an Application of Funds. Describe how it should be handled in preparing a Statement of Source and Application of Funds.
2. From the following Balance Sheet and Appropriation Account, prepare a Statement of Source and Application of Funds.

BAIANCE SHEET OF A B AND C. AS AT 30TH JUNE 1999.
__________________L_____-___-----------
Capital
Appropriation A/C
Ten year loan at 8%
Working Capital
Regresented bx:
FIXED ASSETS
Machinery at Cost
Less Depreciation
CURRENT ASSETS
Stock
Debtors
Cosh
EE29 CURRENT
LIABILITIES
Creditors 4 900 6 400
Loan Redem-
ption Res. 1 000 -
Bad Debt
Res. 400 200
Income Aggroeriotion Account
for the ear ended 30th June 1999
Loan Rodemp Bolonco
tion Reserv. I
Drawings Net Profit
Balance c/f
3. Comment on the business of A, B and C as disclosed by the State-
ment of Source and Application of Funds.

4.

COMPANY SOURCE AND APPLICATION OF FUNDS STATEMENTS. PAGE 17.

The following are the summarized financial statements of CUM SANGOES Ltd., (whose year end is 30th June each year) for the years shown.

BALANCE SHEET.

Capital
General Reserve
Undistributed Profits
Regresented bx:
FIXED ASSETS
Plants & Machinery at cost
Less Acc. Depreciation
CURRENT ASSETS
Stock
Debtors
Bank
LES.
CURRENT LIABILITIES
Dividends Proposed 750 600
Creditors 4 900 2 800 5 650 18 500 3 400

INCOME STATEMENT.

Wages 7 250 Gross Profit 26 325
General Expenses 15 000 Profit on sale of plant
plant 150
Depreciation 875
Net Profit c/d 3 350
R26 475 R26 475
Dividend Proposed 750 Balance b/d 5 000
General reserve 1 500 Net Profit 3 350
Balance 6 100
R8 350 R8 350
suaaaa-ngzg Ezf$F$F9

NOTE: During 1999, a machine costing R1 500 and having a book value of R425 had been sold for R575.

From the above information xou are reguired to prepare a source and appllcatlon of Funds statement for the year ended 30th June 1999! Showinq details Of ChGHCP: an unrbinn nnn4&n.

- ANSWERS T0 PROGRESS QUESTIONS
Question 1 may be answered from the lecture notes.
A: B and C Business
Statement of Source and Aeglicotion of Funds
for the zeor ended 30th Junel 1999
Source agglication.
Net Profit 6 000
add back Depreciation . 700
Ten year Loan 10 000
R16 700
Applied as follows:-
Hachinery purchased 3 000
Increase in stock held 500
Increase in Debtors 2 000
Decrease in creditors 1 500
Increase in cash at bank ... 700
Drawings 4 000
R16 700
Notes. Loon Redemption Reserve in Balance Sheet and Appropria-
tion accounts have been cancelled out.
Bod debts reserves have been deducted from Debtors figures
before arriving at variation of R2 000.
The business has embarked on a vigorous expansion progroa-e by
more than doubling its production capacity.
This expansion has been financed by a ten your loan, which has
also been used to reduce current liabilities (creditors) to a
healthier figure.
The expansion has caused an increase in stocks and debtors but it

appears that the expansion has been justified by an increase in profits.

Management has followed the wise course of providing for repayment of the loan in the required period, and also has exercised restraint in keeping drawings to a reasonable figure, thus allowing the increase in the Appropriation Account balance to assist in the financing of expansion.

The position of the business appears healthy.

Solution to example 4.

SOURCE OF FUNDS

; Net income from operations 3 350
3 Add: Items not affecting the flow of funds 725
Funds from operations 4 075
Other sources of funds
Shares issued 3 OOO
Proceeds from plant sold 575
7 650

APPLICATION OF FUNDS

Plant purchases 3 OOO
Dividends to shareholders 750
Increase in working capital 3 900
7 650

Workings:

(1) Summary of changes in working capital
Increase in current assets is on application
of funds and a decrease is a source of funds.

Increase in current liabilities is a source of funds and decrease is an application of funds.

Source 52%

Current assets

(i) Stock (7200 - 5000) 2 2CD
(ii) Debtors(8900 - 8700) 200
(iii) Bank (8050 - 411)) 3 750

Current Liabilities

(i) Dividends proposed (750 - 600) 150
(ii) Creditors (4900 - 2800) 2 100

6 I50 2 250

Net change in working capital 3 900
(6150 - 2250)

This year 1999 Last year 1998
Current asset 24 I50 18 000
Current liabilities 5 650 3 400
Net working capital 18 500 14 600
Difference (18 500 - I4 600) : R3900

If the exam question does not require a analysis of changes in working capital as the above method saves considerable time.

Items not affecting the flow of funds:

As states in the discussion depreciation although not an actual outlay of cash it is still an expense. Therefore to avoid confusion it is shown as a source of funds, as an item not affecting the flow of funds.

Similarly the profit on the sale of plant is not a source of funds, the source of funds is the proceeds received from the sale. Thus the profit must be removed from the funds statement.

Amount shown as item not affecting flow of funds R725.

Comprising:

Depreciation: add as a source 875
Profit on plant sold deduct as not (150)
a source of funds _____
725

PLANT AND MACHINERY ACCOUNT SAT COST)
1 July 1998 Balance b/d 8 000 Disposal 1 500
.t. PURCHASES 3 000 30th June 1999 Balance 9 500
R11 000 C/d R11 000

NOTE: Fill in the known figures and complete the picture by boloncingt

PROVISION FOR DEPRECIATION.
DiSposal Account 1 075 lst July 1998 Balance b/d 3 600
30th June Balance c/d 3 400 Income State- 875
1999 R4 475 ment R4 475

DISPOSAL ACCOUNT.
Plant and Machinery 1 500 Depreciation l 075
Income Statement (Profit 150 Cash (or Debtors) 575
on sale)
R1 650 R1 650

---oOo---

’ ’:_;T.T_

COMPANY SOURCE AND APPLICATION OF FUNDS STATEMENTS. PAGE 22.
ADVANCES QUESTION
EMPHASIS 0N LEDGER ACCOUNTS.
Balance sheets at 31/12/
CAPITAL EMPLOYED
Share capital
(ordinary shares of
R1,00 each)
Non Distributive Reserve
Capital redemption
reserve fund
Retained income
Convertible Preference
shares
Long Term Loan
Emeloxmont of coeital
Fixed assets
Buildings
Plant at Net book
value
Net current assets

Additional information:
(1)
(2)
(3)
(4)
(5)
Ordinarx share caeital:
(i) During the year the company utilised the capital redemption reserve fund to issue 50 000 ordinary shares to members as fully paid bonus shares.
(ii) The holders of the R50 000 R1,00 convertible preference shores converted these preference shares into ordinary shares on the basis of one ordinary share for each preference share.
(iii) During the year the company also issued ordinary shares for cash.
Non Distributive Reserve
This reserve represents the surplus of R50 000 upon the revaluation of Buildings which were revulued during the year.
Long term Loon
This long term loan of R60 000 was repaid during the year. The company then obtained another loan of R40 000 from a different institution.
Buildings
As stated the Company revolved certain buildings by R50 000 during the year.
No buildings were sold during the year.
Plant and eguiEment
T986 1987
Plant at cost 90 000 140 000
Accumulated depreciation 30 000 40 000
Net book value R60 000 R100 000

U

During the your the company sold plant with a book value of RIO 000 for a profit of R5 000. The original cost of the plant was R20 000.

Plant was also purchased during the year.

The company had no liability for taxation.

No dividends were paid, the convertible preference shares were converted on the lst January 1987.

Solution:

Statement of Source and agelication of funds.

Net income for the year R20 000
Items not affecting the flow of funds 15 000
Funds from operations R35 000
other sources of funds
Proceeds from plant sold R15 000
Proceeds from Shores issued R50 000
Long Term loan obtained R40 000
Decrease in working capital R40 000
R180 000
Agelication of funds
Long term loan redommod R 60 000
Buildings purchased R 50 000
Plant purchased R 70 000
R180 000

Plant and eguiEment
Balance b/d 90 000 Plant sold 20 000
’. Plant bought 70 000 Balance c/d 140 000
160 000 160 000
Balance b/d 140 000
Accumulated Depreciation
Plant sold 10 000 Balance b/d 30 000
Balance C/d 40 000 I Depreciation 20 000
50 000 50 000
Balance b/d R40 000
Notes stated that the plant sold had a book Value of R10 000, if the cost was R20 000 the accumulated depreciation must have been R10 000. The plant was sold at a profit of R5 000. Thus the proceeds must have been R15 000.

Ordinarz share caeital
Balance b/d
Convertible
preference shares
Capital Redemption
Reserve fund
Cash
Balance c/d 250 000
250 000
Balance b/d

(i) The convertible preferences shares were converted into ordinary shares this is a book entry and there is no flow of funds.

(ii) The capital redemption reserve fund was utilised to issue fully paid bonus shares, again this is just a book entry and there is no flow of funds.

(iii) By using the ledger accounts the value of shares issued for cash can be determined.

Long term loans

Although it seems that long term loans have only decreased by R20 000 and thus only 20 000 should be shown as an application. What has in fact happened is that the company paid off the 86 loan of R60 000 thereby applying funds to pay off this loan. A new loan of R40 000 was received, this being a source of funds.

Although the Net effect is only R20 000, it would be incorrect to show on amount of R20 000 as an application of funds.

The objective of the funds statement is to show the sources and application of funds.

Net current assets

Net current assets have decreased by R40 000 thus funds have flowed to the company, hence the decrease in working capital is shown as a source of funds.

WORKINGS AND EXPLANATIONS

Buildings

Balance b/d 100 000
Non Distributive
reserve 50 000
' COSh 50 000 Balance c/d 200 000
200 000 200 000
Balance b/d 200 000

As stated in the question in Note 2 the company revalued buildings by R50 000.

Note 4, stated that no buildings were sold during the year.

The revaluation is not a flow or application of funds, it is merely a book entry.

By using the ledger account method the opening or closing balances can be reconciled and the building purchased is the balancing figure.

, ..
_t - .t ._ - ,_ .. .. _ - . .n- 35%!
.

w
Retained Income
The opening balance was R40 000
The closing balance was R60 000
f. the increase was R20 000
as the question states nothing about the transferring of amounts to and from the retained income account it would be correct to assume that this increase is attributable to the net income of the company for the year.
Items not affecting the flow of funds
(i) Depreciation: this charge is R20 000 and as it does not affect the flow of funds it must increase Funds from operations.
(ii) Profit on sale of plant. This profit of R50 00 is a book profit, the source of funds is the proceeds, thus the amount of R50 00 must be removed from the funds flow statement it is not a source of funds.
8992

FINANCIAL STATEMENTS OF LIMITED COMPANIES I.
FE"WNmm7m-W5FTT_KWIOE?KCTGUNT.
INCOME STATEMENT).

In dealing with the final accounts of companies, a distinction must be drawn between what is meant by detailed "internal" accounts and published accounts.

Detailed internal accounts are mainly for the information of the directors, the Receiver of Revenue and anyone else who the directors feel should see the accounts. These accounts contain for more details than the Qublished accounts which generally contain gnix the information required by Companies Act 1973.

We will be dealing with detailed internal accognts in this and the following lecture.

The Manufacturing, Trading and Profit and Loss Accounts of limited companies are basically the some as the Trading and Profit and Loss Accounts of sole traders and partnerships. A difference arises where a business both manufactures 229 sells goods. In such a case it is usual to split the Trading Account into two ports:

(1) The Manufacturing Account which shows the normal cost of producing goods. Any abnormal costs (e.g., costs arising from the use of faulty materials) should be dealt with in the Income Statement (i.e. the Profit and Loss Account; "Income Statementnis the new name for the Profit and Loss Account).

(2) The Trading Account shows the ross rofit realised on the normal sales of goods. Any abnormal sales Ze.g. soles of damaged goods) should be dealt with in the Income Statement.

The Manufacturing Account is debited with:

(a) The cost of raw materials used, which is arrived at as Follows:

Opening stock of raw materials
e Purchases
e Carriage inwards, etc.
- Closing stock of raw materials
: Raw Materials used

This figure must now be adjusted for "rejects" (1.0., spoilt or defective materials,) which amount must be debited directly to the Income Statement.

(b) Direct Broductive wages --- that is, wages that can be directly identified with production. This does not include remuneration to foreman or supervisors.

(c) Overheads or indirect foctorx exgenses. This heading incorpora all other expenses attributable to the eanufocturing procese such as supervisory salaries and wages IN the factogx (e.g., not the managing director’s salary), power, fuel, rent, rates, insurance of factory buildings and depreciation of plant.

The Manufacturing Account should be set out in o for. which will show:

(1) Prime Cost --- being the total of (o) and (b) above, i.e., the total cost of materials, productive wages and other expenses directly identifiable with production.

(2) Factor! or Works Cost --- being prime cost plus overhead: or indi expenses, i.e., expenses incurred in production generally but can-not be attributed to any particular items of production.

All expenses, direct and indirect, which contribute to the norlal cost of production of goods (excluding selling, distribution and aduini trotion expenses) are debited to the manufacturing account. The hold on the account, after eliminating the cost of work in progress at the end of the period, represents the cost of production for that period, is carried down to the debit of the Trading Account. This cost of production represents the Burchoses figure in the Trading Account.

The mechanism of the Trading Account and Income Stutenent re-oine the some as for sole traders and partnerships as can be teen free the following example:

ADAM NEW CENTS LIMITED.
EXTRACT FROM THE TRIAL BALANCE : 315T DECEMBERI 1999.

	Dr.	Cr.
	R	R
Advertising	830	
Bad Debts	605	
Bank charges	120	
Discount	412	
Factory power	3 614	
Furniture	900	
General Expenses : factory	205	
office	346	
Insurance	902	
Light and Heat	472	
Plant and Machinery : lst January 1999	15 000	
Purchased 30th June, 1999	2 OOO	
Purchases	33 668	
Packing and Transport	960	
Rent	1 486	
Repairs to Plant	785	
Salaries : Administration	3 690	
Sales		79 714
Stock : at lst January 1999		
Raw Materials	5 230	
Finished Goods	7 380	
Work in progress (at prime cost)	1 670	
Wages : Factory	20 700	

NOTES:
(1) Stocks at 3lst December 1999 were: R
Raw Materials 3 560
Work in progress (at prime cost) 1 740
Finished Goods 9 650
Packing Materials 125
(2) The following liabilities had not been provided for:

7 ____..,___. r" _ .,.- _ -....-4. . . p . ,

R
Factory power 562
Rent 386
Light and heat 170
General Expenses : Factory 25
Office 40

(3) Insurance paid in advance amounted to R170.

(4) Rent, Light and heat and Insurance ore to be allocated at to five-sixths to the factory and one-sixth to the office.

(5) Depreciation is to be provided as follows:
Plant and Machinery : 10%
Furniture : 5%

From the above information, prepare 0 Manufacturing and Trading Account and Income Statement at 3lst December, 1999. (

SUGGESTED ANSWER:
ADAM VEW CENTS LIMITED.
MANUFACTURING ACCOUNT FOR THE YEAR ENDED 3lST DEC. 1999.
R
Raw Materials: Transfer to
Trading Account
Factory cost of
goods produced 65 464
Opening Stock lst January
Purchases
Less: Closing Stock
Slst December
Direct Productive Wages
Aid: Work in Progress,
lst January
Less: Work in Progress,
Slst December
PRIME COST
Indirect Expenses:
Factory : Power
Rent
Insurance
Light & Heat
General Expenses
Plant : Repairs
Depreciation
FACTORY COST R65 464

FINANCIAE STATQMQTS 0F LIMITEQ mamas h P&E 6.
TRADING ACCOUNT AND INCOME STATEMENT
FOR THE YEAR ENDED 315T DEEEHBER 1999
SALLS
Oponknq Stock 1/1/99
Cont of Finished good: producod
Lalo Cloning Stock
Dilcnun! Racoivod
LL55
EXPLNDITURE
Sularinu
Run!
Light and Hunt
Inuurnncu
General txpenuo
Depreciation: Furniture
Advortiling
Packing and Hannpnrt.
Rank Charon-
"0d DoMI
NuQ Incuma fur your
Sumn!imnn, unndu pluducad uro chorgud to tho Iolllno doportmont at
u plico in axcnun ul munu'ucQUrnd (ermo) colt. Hhon 9hll XI the cat.
will hn nnrnnIUIy, in oxdor to arrive at tho truo accounting profit,
. pxuvidn In (hp urcuuntu for unrooliuod profiQ (includod in tho
.luning utuvk u. 'iuilhad guodu) 0! (hi ond of ouch accounting 90:106.

EXAMPLE:
In the previous example, assume that goods were charged to the selling department at cost plus 10%. A provision for unrealised profit would have to be made for stock still unsold at 3lst December, thus:
PROVISION FOR UNREALISED PROFIT.
1999
1 Balance (10% x
R7380)
Dec. Income State-
ment: increase
:! in provision
(1) A provision for unrealised profit account is prepared in the some way as a provision for bad debts account.
31 Balance (10%
on stock at 738
3lst December
10% x R9 650
227
Note that:
(2) The balance on the provision for.uneorned profit account must be deducted from the closing stock of finished goods on the Balance Sheet at 3lst December,l999, thus:
Current Assets:
Stock of finished goods R9 650
Less: Provision for unrealised profit 965
R8 685
THE TREATMENT OF INCOME TAX IN FINAL ACCOUNTS.
You are not expected to have a detailed knowledge of Income Tax at this stage of your studies, but you are required to understand how it is treated in the year-end accounts of a company.
The 4th Schedule of the Companies Act, 1973, states (paragraph 36(9):

"There ehall be :hown separately in the Income Statement --- the amount provided for taxation (specifying, vhete material, the origin and different claneeu of taxes) in respect of the financial year concerned, and the amount, if any, as provided in reepect of any other financial year."
Then, paragraph 42 of this Schedule states:
"If no provision for taxation has been node, that fact, the reason therefor, and the financial year in respect of which no provieion has been made shall be stated."
You will see from the above that a company is normally required to provide for taxation in its current year'e accounts, 92: if, for ecle special reason, no provision has been node, a note to that effect Dost be made on the accounts in terms of paragraph 42.
The Income Tax Act provides that a conpany's financial year shall be its year of assessment for income tax purposes as well, i.e;, if a company closes its annual accounts on 30th September, its incoue tax year will also end on that date.
Furthermore, a company must pay its income tax on its eetiloted taxable income in two instalments during its current year of operotlone and then a final adjustment is made after yeor-end accounts have been finalised.
The result is that a company should have paid most of its income a tax by the end of it: financial year, and the only provision to be node will be for the final adjustment (if any).
There is, unfortunately, no generally'occepted method of showing Taxation in the Income Statement --- some companies show it in the Income Statement itself, but most show it in the appropriation section of thin statement.
Often, taxation ie shown in a separate eection by lteelf.

FINANCIAL STATEMENTS OF LIMITED COMPANIES I.
INCOME STATEMENT
FOR THE YEAR ENDED ......
EXAMPLE:
Profit before Taxation RX
Deduct:
Taxation --- Republic Normal Tax based
on the current year's operations RY
Net Profit for the year after taxation RX-Y
&:
t (previous year's end) R-
Unappropprioted Profit 0
cture as regards profits before
As this method sets out the whole pi
its use is recommended.
Ind after taxation clearly and concisely,
to be made at the year-end
when the year-end accounts
nol tux calculated.
the only provision
be calculated,
lreody paid and the fi
As mentioned above,
es from any adjustment to
nris
tween the tax a
are finalised, be
reflected under Curren
has been on over-poyment, this amoun
Assets.

NW:-

S U H H A R Y._

Where 0 business both manufactures and sells goods, the trading account is split into two parts:

(a) The Manufacturing account - which shows the normal catt o! producing goods; and T

(b) The Trading account - which shows the gross profit real! on the normal sales of goods.

Any abnormal costs or sales, respectively, must be dealt in the Income Statement.

The Manufacturing Account is debited with:

(o) the cost of raw materials used (adjusting for rejects):
(b) direct productive wages;
(c) overheads i.e. indirect Factory expenses;

and must show:

(1) Prime cost - i.e. the total of (a) and (b) above.
(2) Factor! or Works cost - i.e. prime cost and overheads.

The balance on the manufacturing account (after adjusting for w in progress,$ represents the cost of groduction which is debited to trading account. This cost of production figure represents urcho in the trading account.

The mechanism of the trading account and income statement renal the some as for sole traders or partnerships.

Taxation:

A company must provide for taxation. If n6 provision is made, a note, stating the reason why no provision has been made, must be appended to the financial statements.

Taxation is usually dealt with in the appropriation section of

the Income Statement. In respect of final tax calculations:
under current liabilities.
An underpayment is shown
der current assets.
An overpayment is shown un
J

LIKELY EXAMINATION QUESTIONS:

QUESTION 1:

The following balances have been extracted from the books of Lotto Latkes (Pty) Ltd. as at 3lst December, 1999.
You are required to prepare a manufacturing account for the year ended 3lst December, 1999.

Raw materials purchased 250 000
Salaries and Wages 256 000
Factory overhead 210 000
Sales 805 000
Depreciation - plant and machinery 7 100

Note:
1. Wages consisted of:-
Foctory wages and salaries 170 000
1 Administrative wages & salaries 39 000
F’ Soles staff salaries 33 000
14 000
Factory management
1..
R256 000

W

M
2. Stock on hand was as follows:-
lst January
1999
Raw materials 42 000
Hork-in-progress 9 600
Raw materials 3 000 2 800.
Direct labour 2 600 2 200
Factory over-
head 4 000 3 700
ANSWER:
LOTTA LATKES SPTY) LIMITED.
MANUFACTURING ACCOUNT FOR THE YEAR ENDED
___.______________________________________
315T DECEMBERI 1999.
Raw materials:
Opening stock: on hand 42 000
work in progress 3 000
Purchases 250 000 295 000
Less: Closing stock: on hand 39 000
work in progress 2 800 41 800
Direct labour:
Wages 170 000
odd: opening work-in-progress 2 600
less: closing work-in-progress 2 200 400
PRIME COST
Factor! overheads:
General
210 000
222i opening uork-in-progress 4 000
less: closing work-in-progress Q 700 300
Depreciation - plant machinery 7 100
Wages - factory management 14 000
Finished goods produced (Factory cost)
Slst Decoubot
1999
39 000
8. 700
1
1
i
253 200 i
170 400
423 600
231
g
R655 (DO

9Q ,

(MESTION 2 :

7 From the following balances in the books of Howie Duzzit Ltd.,
-you are required to prepare an Income Statement for the year ended
30th June, 1999.

Unappropriated profit at 31.7.1998 5
Trading profit (before dealing with items below) 47
Director fees 1 000
Directors' salary 6
Directors' pension paid 1
2
Loan from director 000
Interest on above loan from director 120
Staff salaries 11 960
Interest on debentures 2 000
Interest received on investments 1 600
Dividend received on investments 1 460
Interest on overdraft 100
Interest on long-term loan 1 400
Provision for taxation (1999) 10 500
Transfer to Plant Replacement Reserve 4 720
Transfer to General Reserve 5 000
Proposed dividend 7 (DO
Bad debt written off 240

ANSWER:

HWIE DUZZIT LIMITED.
1% STATEMENT F(R THE YEAR ENDED
30TH JJNEI 1999.

Trading profit for the year R47 906
Add: Income from investments
Listed 1 460
Unlisted m 3 060
50 966
Less: Bod debts 240
Directors' Remuneration
Fees 1 000

Salary 6 000
Pensions l 900
Interest on Debentures and loans
(12092000910091400) 3620
Staff salaries 11 960 24 720
Profit for the year before taxation 26 246
Less: South African Normal tax for the
current year 10 500
Net profit for the year after taxation 15 746
UnapprOptiated profit brought forward 5 094
20 840
Appropriations:
Transfers to reserves (4720 # 5 000) 9 720
Proposed dividend 7 000 16 720 ’
Unappropriated profit as shown in Balance Sheet R4 120
QUESTION 3:
From the following information taken from the books of c.1E Threw
Manufacturing Company Limited, xou ore reguiteg to prepare a manufac-
turing and trading account and income statement for the year ended
3lst December, 1999.
Sales R72 100
Unappropriated profit - lst January 1999 1 976
Plant, at cost 16 000
Stock - lst January 1999
Raw materials 6 419
Nork-in-progress 3 701
Finished goods 5 500
Purchases 34 685
Factory wages 18 692
Factory expenses 2 650
Salaries 2 000
Sundry expenses 4 443
5% Debentures 10 000
NOTES:
(a) Depreciation on plant machinery - 10% on cost - has not been
provided.

(b) Accrued salaries of R284 must be provided for.
(c) Debenture interest must be provided for.
(d) Transfer R2 000 to general reserve.
(e) Stock on hand at 3lst December, 1999 was as follows:
Raw materials R5 964
Work-in-progress 5 619
Finished goods 6 820
ANSWER:
C.U. THREW MANUFACTURING COMPANY LTD.
MANUFACTURING AND TRADING ACCOUNT FOR THE YEAR
ENDED 315T DECEMBER 1999.
Raw materials Transfer to
Stock 1 l 1999 6 419 trading o/c... 56 164
Purchases 34 685
41 104
Less: Stock 31/12/1999 5 964 35 140
Factory wages 18 692
Prime Cost 53 832
Fuctorz overheads
Depreciation of plant 1 600
Factory expenses 2 650 4 250
58 082
Adjustment for work-in-progress - l 918
(5619-3701)
R56 164 R56 164
Finished goods ___-.7
Stocks 1/1/1999 5 500 Sales 72 100
Transfer from manufacturing
account 55 164
61 664
Less: Stock 31/12/1999 6 820
54 844

1

M

Gross Profit transferred
to income statement 17 256

R72 100 R72 100

l

I

ll

C.U. THREH MANUFACTURING.CO. LTD.

INCOME STATEMENT FOR THE YEAR ENDED 315T DECEMBER 1999.

GROSS PROFIT

LESS EXPENDITURE

Salaries

Sundry Expenses

Debenture Interest

Net Profit

Transfer to Reserve

Add Unappropriated Profits b/f

Balance Carried Forward

FINANCIAL STATEMENTS OF LIMITED COMPANIES II.
HE APPROPRIATION ACCOUNTJ
The Trading Account and I
cally the some as those applica
except that the Net Profit is tron
"Appropriation Account", and not the Current Accounts us is the practice
in other cases. This is necessary as o Company’s Capital is fixed by
the Memorandum of Association and can only be altered in accordance
with the Act.
ncome Statement of a company are fundamen-
ble to Sole Ttaderships or Partnerships,
sferred to an account designated
is merely that section of the Income
e net profits are disposed of (i.e.,
It commences
The Appropriation Account
Statement which indicates how th
appropriated) in terms of the Directors’ recommendations-
with the previous year’s balance to which the current year’s profit is
added. Against this would be debited transfers to Reserves, Dividends,
The balance remaining represents
and any other uggroeriutions of profit.
ggpppropriоted profit, and will remain to the credit of the Appropriation
Account.
The balance of last zeor’s
Statement, as this would nullify the object 0
show the true net profit for the eeriod under reviews
profit must not be shown in the Income
f this account which is to
INCOME STATEMENT AND APPROPRIATION
DIFFERENCE BETWEEN THE
ACCOUNT DEBITS.
All expenses which are incurred in the process of making profit ore
’ broadly known as char es 0 oinst Profit, and, therefore, chargeable to
l the Income Statement. All amounts concerned with the disgosal or up-
nrogriation of such profits are debited to the Appropriation Account.
The following is in the nature of a guide and should be referred
to whenever necessary:
INCOME STATEMENT APPROPRIATION ACCOUNT.
Income Tax. (This is not an
expense; it is the State’s
shore of profits already made).
There is no hard ahd fast rule
(1) All items of expenses that (l)
normally would appear in a
partnership’s Income
Statement.

(2)
Amounts provided for
"specific" provisions,
such as bad debts, dis-
count, etc.
Normal depreciation of
fixed assets.
(4)
Directors' Fees in nor-
mal cases.
(5)
Interest on mortgages and
bonds.
(6)
(7)
Debenture Interest.
Bonuses to employees.
(8)
Sinking Fund charges for
the replacement of an asset.
H
PRELIMINARY EXPENSES;
This term is applied to all the expenses incidental to the
(2)
(5)
(6)
(7)
(8)
or to Appropriation Account,
you will see from a study of
various Conpanies' published
Accounts. However, some c
ponies carry forward their
Profit before Taxation" to a
separate section, to which t
debit "Income Tax" and then
carry "Net Profit after Toxa
to the credit of Approprioti
I think this net
is the clearest, and would r
mend that you use it in Futul
Transfers to General Reservel
Am0unts written off goodwill
preliminary expenses.
Directors' Fees (where based
upon profits or dividends do-
clored).
Transfers to Superannuation
Funds.
Dividends.
Bonuses to employees where
directly based on profits.
Sinking Fund charges for the
payment of a liability.

formation and registration of a company. Without these expenses being incurred, the company could not have come into existence. There is, therefore, no legal necessity to write the amount off (through the Appropriation Account), but it is prudent to do so.

DIRECTORS’ FEES.

Always debit Directors’ Fees to Income Statement, unless the Fees vary with the profits or are based on dividends.

I

EXAMPLE:

A company brought forward on the lst January, 1999, a credit balance on Appropriation Account of R600, and the net profit for the year ended, Slst December, 1999 was RlO 000. The following Directors’ recommendations were fully approved by the shareholders:

(1) R2 000 to be transferred to Reserve Account.

(2) 10% of the current year’s net profit to be paid to the Managing Director as remuneration. (This remuneration is not to be con-
t
i sidered as a charge against Net Profit.)

I

P (3) R1 000 to be transferred to the Employees’ Superannuation Fund.

(4) The following dividends be declared:

Preference Shares : R3 000

Ordinary Shares : R2 000

t (5) Provision for Income Tax agreed at R1 000.

(6) The unappropriated balance to be carried forward.

You are required to frame the Appropriation Account in the company’s Ledger.

- APPROPRIATION ACCOUNT -
1999
Dec.
Income Tax
Managing
Director’s
remuneration
Employees’
Superannua-
tion Fund
Reserve a/c
Dividends:
Pref. R3 000
0rd. R2 000
Balance
Balance
Net Profit
for the year
NOTE:
This account would a
ppear immediately beneath your Income State-.:
in the Ledger.
DEBENTURE INTEREST
U
This is the interest payable on the money borrowed by the company
on debenture bonds, and forms a distinct charge against, and not an h
oeeroeriation of, the profits of the company.
paid on due date, it is quite sufficient to
treat the entry through the Cash Book thus:
CASH BOOK
h 1999
I June 30 Debenture
f Interest

Should, however, the interest be paid after due date it is advisable -to treat the entry in the following manner:

- JOURNAL -

3O Debenture Interest Account
To Debenture Holders
Being Interest now due at 5% on
R20 000 for six months.

NOTE:

This entry, it will be observed, is passed on the day on which the interest becomes due and Boxoble.

Until payment of the interest, the Debenture Holders will feature on the liabilities side of the Balance Sheet.

The following entry is passed on payment of the interest.

- CASH BOOK -

Holders

Profit and Loss Account. Do not debit it to the A to riation Account.

DEBENTURES AS COLLATERAL SECURITY FOR LOAN.

A collateral security is a subsidiary or secondary security, i.e., a security in addition to the principal security. A collateral security is not intended to be realised, except in the event of the principal security proving insufficient. Some joint stock companies issue debentures as collateral security for a bank overdraft or a bank loan. Interest is not payable on such debentures, as the bank charges interest on the overdraft. It is not necessary to pass any entries in respect of such Debentures, through the financial books, as the matter can be satisfactorily treated in the Balance Sheet as shown in the example giv below.

EXAMPLE:

A Limited Company issued to the public R50 000 Debenture Bonds_nt pot in respect of which all the money was received. R8 000 Debont?;e Bands were also issued at par to its bankers a: collateral securitr'for a Loan of R6 000. How would you record these facts in the company's Balance Sheet?

- BALANCE SHEET -
AS AT .... 19....
- CAPITAL 6 LIABILITIES -

Debenture Bonds
Loans From Bankers
ZColloterally secured by
issue of R8 000 Deben-
tures)
m

Up to this point in your studies you have been accustomed to see the headings "Assets" and "Liabilities" at the top of every Balance Sheet. In some cases alternative descriptions have been used such as "Assets and Property" and "Capitol and Liabilities". These headings have been used to help you to understand the general layout of a 8010 rh Sheet and the form that is still current with nany companies. These headings, however, are out-of-dote if not actually misleading. It wot; of course, essential that you should be acquainted with the terms, but from now onwards you will see different examples of Balance Sheet layouts.

Balance Sheets should be drawn up in a more informative manner, as to disclose in separate totals, the amounts of fixed assets, current

assets and fictitious assets, fixed liabilities (meaning long-term liabilities such as debentures) and current liabilities.
This is illustrated below.

N.U. RULES sPROPRIETARY! LIMITED
BALANCE SHEET AS AT lST JULYI 1999

SHARE CAPITAL
AUTHORISED AND ISSUED
100 000 6% Preference Shares of Rl-OO each fully paid
100 000 Ordinary Shares of Rl-OO each fully paid
100 000
100 000
LONG TERM LIABILITIES
500 5% Debentures of R100 each
Regresented bx:
FIXED ASSETS AT COST
Goodwill
Land and Buildings
Machinery and Plant
Office Furniture
CURRENT ASSETS
Stock
Sundry Debtors
Bills Receivable
Cash
Preliminary Expenses
LESS
CURRENT LIABILITIES
Bills Payable 2 000
Sundry Creditors 5 000

You will see at once h0w the modern Balance Sheet, while using exactly the same figure: as the old, tells you more "at a glance" and is more useful in many ways.

When you draw up a Balance Sheet in this way always remember to , leave space for the Directors’ signatures. These must always be included in a comeonz’s balance sheet, but need not be included for excl tion purposes, unless specifically asked for.

The assets and liabilities of a limited company were shown in a different order to that odOpted by sole traders and partnerships, but under modern practice the grouping under "Fixed Assets", "Current A830 etc., remains the some. The order of assets is "from most fixed to , fluid" (e.g., from Goodwill or Freehold Property to Cash). Fictitiou Assets being Shaun lost in order. For liabilities the following orde is adopted:

(1) Authorised Share Capital.
(2) Issued Share Capital.
(3) Reserves.
(4) Appropriation Account.
(5) Secured Loans, Mortgages and Debentures.
(6) Bills Payable.
(7) Sundry Creditors.
(8) Accrued Expenses.

Numbers (1) to (5) are "Long-torm Liabilities", and (6), (7) and (8) are "Current Liabilities".

Be careful not to group items in incorrect sections --- 9.9., do not include Machinery and Plant under Current Assets.

Let us now work through some examples together.

EXAMPLE No. l:

The R.T. F shel Manufacturing Cc., Ltd., is registered with an

Authorised Capital of 50 000 Ordinary Shares of R1 each, and by its Memorandum and Articles of Association has power to issue 200 Debentures of R50 each, bearing interest at 4% per cent. per annum.
On June 30, 1999, the Ledger balances were extracted as follows:
R
Share Capital (issued 40 000 Shores of R1 each) 40 000
Debentures issued, 100 at R50 5 000
Stock (July lst, 1998) 6 537
Purchases 22 448
Returns to Creditors 1 745
Sales 46 728
Returns from customers 1 174
General Trade Expenses 1 014
Wages 13 632
Salaries 2 042
Travelling Expenses 758
Advertising 870
Rents, Rates, Taxes and Insurance 858
Discounts Dr. Balance 314
Bank Interest and Commission Dr. 114
Bad Debts written off 238
Premises 12 450
Machinery and Plant 18 750
Fixtures and Fittings 3 750
Sundry Debtors 12 160
Sundry Creditors 7 728
Interest paid on Debentures 225
Dividend paid (in August, 1998) 1 415
Reserve 5 000
Provision for Bad Debts (Balance at lst July 1998) 760
Cash in Hand 43
Balance at Bank 11 632
Balance of Appropriation Account (lst July 1998) Cr. 3 463
Stock-on-hund --- on 30th June 1999 : R6 900
Draw up 0 Trading Account and Income Statement, after making the following adjustments:
(1) Depreciote the machinery and plant by 10 per cent. the fixtures and fittings by 10 per cent.

(2) Make up the Provision for Bad Debts to 7&5 of the Book Dobtl.
(3) Insurance: are paid in advance to the extent of R96.
(4) Make out a Balance Sheet as at 30th June, 1999.

THE R.T. FISHEL MANUFACTURING COMPANY LIMITED.
TRADING ACCOUNT AND INCOME STATEMENT FOR THE
YEAR ENDED 3OTH JUNE 1999.

Sales
Less Returns
Opening Stock
Purchases
Less Returns
Less Closing Stock
Wages
Gross Profit
LESS EXPENDITURE
Salaries
Travelling Expenses
Advertising
Rents, Rates, Taxes, Insurance
Less Ins. Prepaid
General Trade Expenses
Bank Charges
Debonture Interest
Discounts
E21 Bad Debt Provision
Leas Balance 9&1 Provision
Depreciation:
Machinery, Plant 10%
Fixtures and Fittings 10%
Net Income Transfer Appropriation
A/C

- APPROPRIATION ACCOUNT -
Balance at 30/6/99
Net Income for the
year ended 30th
June, 1999
Dividend
Balance
Balance

.________________.___________________________..___.____

THE R.T. FISHEL MANUFACTURING COMPANY LIMITED.

BALANCE SHEET AS AT 30TH JUNE 1999.

.____________________________________

R R

SHARE CAPITAL

Authorised:

50 000 Ordinary shores of R1 each 50 000

m

Issued:

40 000 Ordinary shores of R1 each 40 000

DISTRIBUTABLE RESERVES

General Reserves 5 000

Appropriation Account 4 891 9 891

Share Holders Equity 49 891

LONG TERM LIABILITY ’

100 4.5% Debentures of R50 each 5 000

54 891

3

CAPITAL EMPLOYED

Regresented bx:

FIXED ASSETS COST

CURRENT ASSETS

Stock in Trade

DEPR.

Premises 12 450 - 12 450

Machinery & Plant 18 750 1 875 16 875

Fixtures and Fittings 3 750 375 3 375

2

6 900

Sundry Debtors 12 160

Less Bad Debt Provision 91 11 248

Cash in Hand 43

in Bank ll Q32 11 675

Prepaid Insurance 96

29 919

LESS

CURRENT LIABILITIES

Sundry Creditors 7 728 22 191

54 891

FINANCIAL STATEMENTS OF LIMITED COMPANIES II.
EXAMPLE N0. 2:
Try to work this example yourself,
answer.
The Cysten Boot Co. Ltd.,
tol of R50 000, divided into 10 0

before referring to the model
was registered with an Authorised Capi-
400 000 Ordinary Shares of 10c each.
00 Preference Shares of R1 each and
On December Slst 1999, a Trial Balance, containing the following
balances,
Ordinary Share Capital A/c
Pref. Share Capital A/C
Pension Fund
Goodwill Account
Debentures (100 5% deben-
tures of R50 each)
Pension Fund Investments
Garage Expenses
Machinery 6 Plant A/c
Transfer fees received
General Expenses
Cost of Trade Catalogues
Bank Charges
Company's Contribution to
the Pension Fund
Bonus paid to employees
Gus, Electricity and Water
Manager's Salary
Purchases
Purchases Returns
Interest Paid on Debentures
Directors' Fees
Boxes and Packing
Bills Payable
Discounts allowed
Discounts received
Sales
Sales Returns
was extracted from the Books of the Company:
LEDGER BALANCES.
R
35 820
10 000
4
5
5
4
7
N
r-w-dv-
980
000
000
540
421
450
2
939
256
17
500
763
567
500
651
243
250
239

674
162
251
973
276
946
Carriage In
Stock-in-hand (1/1/1999)
Repairs to Machinery &
Plant
Debtors as per Sales
Ledger
Creditors as per Bought
Ledger
Bad Debts written off
Factory Wages
Postage and Stationery
Cars and Lorries
Audit Fee and Legal
Charges
Rent, Rates, Taxes and
Insurance
Office Salaries
Bills Receivable
Advertising
Freehold Land and
Buildings
Cash at Bank
Cash at Bank (Pension
Fund)
Cash in Hand
Profit and Loss (Debit
Balance, brought for-
ward from last year)
3
19
16
ll
p-lzmr-a
R
460
721
293
245
747
315
299
444
948
274
173
216
931
470
440
259
440
75
236

Before closing the books, the following adjustments are necessary:
(1) One month’s carriage is Owing and has not been passed R
through the bookt 472
(2) Rent due to landlord but not provided for 150
(3) Value of unexpired insurance premium 197
(4) Huge: paid in advance 84
(5) Provision to be created for bad debts 750
(6) Write off the following depreciations:
(0) Machinery and Plant 10K
(b) Cars and Lorrie: R146
(c) Land and Buildings 211
The Stock at 313i December, 1999, was valued at R18,433.
You are required to prepare Trading Account and Income Stutelent
for the year ended 3lst December, 1999, and a Balance Sheet as on that
date.

FINANCIAL STATEMENTS OF LIMITED COMPANIES II.
SYSTEN COMPANY LIMITED
TRADING ACCOUNT AND INCOME STATEMENT FOR THE
YEAR ENDED 315T DECEMBER 1999.
Sales
Less Returns
Opening Stock
Purchases
Less Returns
Carriage in
Add Amount due - not paid
Less Closing Stock
Wages (7 299 - 84)
GROSS PROFIT
Transfer fees
Discounts Received
LESS EXPENDITURE
Rent, Rates, Taxes, Insurance
Add Rent Unpaid
Less Insurance Prepaid
Gas, Electricity & Hater
Office Salaries
Pension Fund Cont.
Manager’s Salary
Postage and Stationery
Audit Fee 4 Legal Charges
Bank Charges
General Charges
Discounts Allowed
Bud Debts
Ag! Bad Debt Provision
Advertising
Trade Catalogues
Boxes and Packing
Garage Expenses
Repairs to Machinery
Debenture Interest
Directors Fees
Bonus paid to Employees
Depreciation: Machinery 10%
Cars
Land 4 Buildings
KEY INCOME
97 651
l 243
1 173
150
1 323
197
315
m
745
146
:L61_
131
19
18
101
7
p.

276
946
721
408
460
472
061
120
433
628

215
126
567
216
500
500
444
274
17
939
251
065
470
256
674
421
293
250
239
763
352
R
130 330
108 843
21 487
1 973
23 462
12.0.11

APPROPRIATION ACCOUNT
Balance at 1/1/1999
Balance
Net Profit for year
ended 31/12/1999

CYSTEN COMPANY LIMITED
BALANCE SHEET AS AT 31212z99
SHARE CAPITAL
Authorised
10 000 Preference Shares of R1 each
400 000 Ordinary Shares of 10c each
Issued
10 000 Preference Shares of R1 each
358 200 Ordinary Shares of lOc each
APPROPRIATION ACCOUNT
SHAREHOLDERS EQUITY
LONG TERM LIABILITIES
100 5% Debentures of R50 each
TOTAL CAPITAL EMPLOYED
Regresented bx:
FIXED ASSETS
Freehold Land and Buildings
Machinery and Plant
Cars and Lorries
Goodwill at Cost
CURRENT ASSETS
Stock
Debtors 16 245
Less Bad Debt Prov. 750
Bills Receivable
Pension Fund Investment
Cash in Hand 75
at Bank 3 259
at Bank Pension fund 440
Repayments
LESS CURRENT LIABILITIES
Bills Payable
Sundry Creditors
Accrued Expenses
Pension Fund

ADDITIONAL Nofs ABOUT APPROPRIATION
ACCOUNTS.
It was a long honoured practice of accountants never to show dividend: recommended by the directors in the Appropriation Account. The reasons for this were as follows:
(1) The payment of dividends depends on two factors:
(a) The earning of sufficient profit to pay the dividend; and
(b) the declaration of the dividend by the company in general meeting.
Until the dividend has been declared by the Company in general meeting, it is not a debt due by the Company to the members, and should not, therefore, be shown as a liability in the Balance Sheet. Further, although the Articles of most companies provide that dividends may be declared by the general meeting not exceedin those recommended by the directors, the company may, if it chooses
!
declare a lower rate than that recommended, or even pass the 1
i
dividend altogether without payment.
(2) The Appropriation Account should show only ttansoctione taking place in the year or period of the accounts. It is evident that a dividend can only be declared after the year end, and it should, therefore, appear in the succeeding year's account.
You must, however, show recommended dividends in the Appropriation Account and as a liability in the Balance Sheet, showing of course that
I
they are subject to the approval of the general meeting, for the fol- I
lowing reasons: 1
(1) Modern accounting practice tends more and more to turn from the purely legal viewpoint to a practical viewpoint, i.e., the facts are fully investigated, and legal "fictions" distegarded. An excellent example of this arises in connection with cheques. 1
Legally, cheques are bills of exchange. To all intents and purposes, however, they represent cash, and that is how we deal with them in the books. We do not record cheques in our bill books.
(2) Accountants recognise that the recommendation of a dividend by

______________________.___-.-

the directors will invariably be accepted by the company in general meeting.

(3) A dividend is usuall paid because a rofit has been earned in
Y P
a certain period. To show the dividend in the accounts of that period aids comparison of accounts.

(4) A company may have considerable liquid assets and its financial position as shown by its Balance Sheet may appear very strong if the proposed dividend is not shown, but the inclusion of the proposed dividend may have the ultimate effect of dissipating all the liquid resources and rendering the position for interior.

(5) The above are given as good reasons, from an accounting point of view, why recommended dividends should appear in the actual accounts, but this is now a legal reguirement in terms of the 4th Schedule of the Companies Act, 1973 (Paragraph 36(d)).

S U M M A R Y.

The balance of the Income Statement (being the net profit or net loss of the undertaking) is carried in the case of companies to the credit or debit of the "Appropriation Account". The shareholders then decide upon the disposal of the balance remaining on this account after the State’s share has been debited (under the heading Income Tax). Some may be carried to reserve, some written off intangible or fictitious assets, some transferred to Superannuation Funds and the remainder dis-tributed as directors’ fees, bonuses to employees, or dividends. If directors’ fees are a fixed annual amount (as they usually are) these are debited to the Income Statement.

An Appropriation Account should always be opened to complete the final accounts of companies, even when the question does not ask for it, as there is usually a balance brought forward from the previous period and this must on no account be entered in the first section of the Income Statement.

Remember that Interest on Debentures is a definite charge against profits, not an appr0priation, but Preliminary Expenses should be written off on the Appropriation Account.

A Collateral Security is one which is secondary to the main security. When a debenture is given by a company to its bank as collateral security, it is secondary to the main security, viz., the company’s credit.

Order of Assets and Liabilities:

Assets : Fixed to Fluid.

Liabilities:

(l) Authorised Share Capital.
(2) Issued Share Capital.
(3) Reserves.
(4) Appropriation Account.
(5) Secured Loans, Mortgages and Debentures.
(6) Bills Payable.
(7) Sundry Creditors.
(8) Accrued Expenses.

LIKELY EXAMINATION QUESTIONS:
QUESTION 1:
On 30th June 1999, the balances in the books of Hugh Dunnit (Pty) Ltd., (before taking into account the notes below), were:
Share capital R360 000
Land and buildings - at cost 300 000
Furniture and fittings - at cost 10 000
Plant and machinery - at cost 50 000
Provision for depreciation: Furniture and
fittings 1 000
Plant and
machinery 5 000
Debtors 48 700
Investments (listed) at cost 25 000
Stocks 72 000
Cash on hand 2 500
Creditors 38 000
Provisional tax payments 3 000
Bank overdraft 4 000
Mortgage bond over fixed property 120 000
Trading profit 39 550
Dividends Paid 500
Audit fee 300
Shares in subsidiary company 30 000
Amount owing by subsidiary company 12 000
Directors’ salaries 6 000
NOTES:
(i) The company’s authorised share capital consists of 500 000 ordinary shares of R1 each.
(ii) Listed investments have a market value of R50 000.
(iii) Trading profit is before charging depreciation on fixed assets, interest on overdraft of R250 and interest on mortgage bond of R1 300.
(iv) This is the company’s first year of trading.
(v) The following provisions and oppr0priations must be made:-
(0) provision for doubtful debts R3 000
(b) provision for taxation 7 000
(c) transfer to general reserve 3 000

w
You are required to prepare an income statement and balance shoe
for management at 30th June 1999.
ANSKR:
_a-
HUGH WMIT SPRCPRIETGRY! LIMITED.
Im STATEMENT FOR THE YEAR ENDED 30TH m 1999.
M
Net trading profit
Less: Audit fee
Depreciation
Directors’ salaries
Interest on loan
Interest on overdraft
Provision for doubtful debts
Net profit before taxation
Provision for Republic normal tax
Transfer to General Reserve
DIVIDENDS PAID
BALANCE OF PROFITS UNAPPRGDRIATED
HUGH WNNIT SPRWRIETGQYZ LIMITED.
BALANCE SHEET AS AT 30TH m
1999.
Share Cagital
Authorised
500 0C!) ordinary shares of R1 each
Issued and Fullx gaid
360 000 ordinary shares of R1 each
R39 550
16 850
22 700
7000
R15 700
3 000
R12 700
R12 200

FINANCIAL STATEMENTS OF LIMITED COMPANIES II.
HUGH WNNIT SPROPRIETORY! LIMITED
BALANCE SHEET AS AT 30TH JUNE 1999. CONT.
Distributable Reserves.
General reserve 3 000
200
Unopproprioted profit 12 200 15
Total Shareholders' equity R375 200
Long Term Liability (see note) 120 000
Total Capital Employed R495 200
Reeresented bx:
Fixed Assets Aggregate
At cost Degreciotion
Land and buildings (see note) 300 000 -
Plant and Machinery 50 000 5 000
Furniture and fittings 10 000 l 000
R360 000 6 000 354 000
#:5' ,
W
Shores at cost 30 000
Amount owing 12 000 42 000
Listed investment, at cost (Market Value R50 000) 25 000
Current Assets:
Stock 72 000
Debtors (48 700 - 3 000) 45 700
Cash 2 500
R120 200
Less: Current Liabilities
Creditors 38 000
Bank Overdraft 4 000
Taxation (7 000 _ 3 000 paid) 4 000 46 000 74 200
R495 200
NOTE: Land and buildings are secured by a mortgage bond of R120 000.

QUESTION 2:

From the following trial balance of T.U. Forsyx, Limited, you are required to prepare final accounts for the year ended 313t Ducal-ber 1999 and a balance sheet at that date.

Trial Balance - 3lst December 1999.

Share capitol - Authorised and Issued
Rl Ordinary shares 50 000
R1 5% debentures 10 000
Sales 85 250
General Reserve 2 000
Unappropricted profit (31/12/1998) 2 668
Trade creditors 6 582
Provision for depreciation 500
Provision for doubtful debts l 000
Land and buildings 41 000
Plant 18 000
Stock
Raw Materials 8 650
Hork-in-progress 3 750
Finished goods 7 600
Debtors 8 570
Cash on hand 4 072
Purchases 36 874
Factory wages 17 598
Factory expenses 2 453
Salaries 5 000
Sundry expenses 4 433
R158 000 R158 000

NOTES: (1) Stocks on hand - 31/12/1999
Raw materials 4 964
Nork-in-progress 3 661
Finished goods 2 454
(11) Provide for deprecia-
tion on plant and
mochineryAT 10$ p.a.
(iii) Accrued sundry expenses at
31/12/1999 amounted to R500
(iv) Provide for interest on deben-
tures.

(v)
ANSWER:
Transfer R2 000 to general reserve.
T.U. FORSYX LIMITED.
MANUFACTURING AND TRADING ACCOUNT FOR THE
YEAR ENDED 315T DECEMBER 1999.
Raw materials
Stock 1.1.1999
Purchases
Less: Stock 31.12.1999
Factory Wages
Prime Cost
Depreciation of Plant
Factory expenses
Work-in-progress decrease
(3750 - 3661)
Finished oods
Stock - 1.1.1999
Transfer from Manufacturing
Account
Stock 31.12.1999
Less:
8 650
36 874
45 524
4 964
Gross Profit transferred to income
statement.
Transfer to
Trading Account
62 500
40 560
17 598
58 158
4 253
62 411
89
R62 500
R62 500
7 600 Sales 85 250
62 500
70 100
2 454
67 646
17 604
R85 250 R85 250

T.U. FORSYX LIMITED
IMZOHE STATEPENT F(R Tlf YEAR
EPDED 318T (ICEHBER 1999.
Gross Profit
Less: Salaries
Sundry expenses (4433&500)
Debenture interest
Net profit for the year
Unappropriote profit brought forward
Profit available for appropriation
Transfer to general reserve
Unopproprioted profit as per balance sheet
ggg
T.U. FORSYX LIMITED
BALANCE SHEET AS AT 315T DECEMBER 1999.
Share Cogitol - Authorised, issued and fully
paid.
50 000 ordinary shares of R1 each
Distributable Reserves.
General reserve
Unappropriated profit
%%
Shareholders' equity
10 000 5% debentures of R1 each
Total capital employed
17 604
10 433
7 171
2 668
9 839
2 000
R7 839
50 000
11 839
61 839
10 000
R71 839
:

Regresented bx:
Aggregate
Fixed assets At cost DeBreciution.
Land and buildings 41 000
Plant 18 000 2 300
59 000 2 300 R56 700
Current Assets
Stocks
Raw Materials 4 964
Work-in-progress 3 661
Finished goods 2 454 11 079
Debtors 8 570
Less: Provision for doubtful
debts l 000 7 570
Cash on hand 4 072
22 721
Less: Current Liabilities
Trade creditors 6 582
Interest accrued 500
Expenses accrued 500 7 582 15 139
R71 839

QUESTION 3:
I
The following is the balance sheet of C.G.Limitod at 31 Doccmbor 1977:-
Share Caeital: Authorised and Issued
100 000 Ordinary shores of no par value - R175 (XX)
Stated Capital Account
Distributable Reserves
General reserve R25 000
Unappropriated profits 5 3) W
205 W
Lon -Term Liabilities
1a Secured debentures of R10 each 40 W
8513 000
Represented by:-
Fixed Assets Cost Dggrociation E
Land R I!) (X30 - R :13 (XX)
Leasehold property 50 000 25 (XX) 25 (XI)
Plant 100 (DO 40 (XX) 60 000
Delivery vehicles 40 (X30 10 W :n W
Furniture 5 (XX) 1 W 4 (IX)
R225 000 R 76 (DO R149 (X10
Investments - at cost
Listed 50 000
Unlisted 25 (XD 75 (XX)
Net Current Assets 19 500
Current Assets
Stock 40 (XX)
Debtors 30 (XX)
Bank 10 W
R 80 000
Current Liabilities
Creditors 15 XX)
Shareholders for dividend 25 (XX)
Debentures 20 000
R 60 500

Preliminorx and Share Issue Exgenses
Preliminary expenses 1 000
Share Issue expenses 500 l 500
R245 000
(The notes to the above balance sheet have been omitted).
The following is a summarised statement of Source and Application of
funds for the year ended 31 December 1978:-
Source Agelicotion
Net profit before taxation R29 000 Purchases of plant R16 000
Less: Profit on sale of Purchase of delivery
investments 1 000 vehicle 5 000
28 000 Redemption of 2 000
Egg: Loss on sale of plant 2 000 debentures of R10
Depreciation: each at a premium of
Leasehold Redemption Fund 5 000 R1 per debenture 22 000
Plant 15 000 Interim dividend paid 6 000
Delivery vehicles 12 000 Final dividend declared 20 000
Furniture 250 Taxation 9 000
Leasehold Redemption
62 250 Fund investments 5 OOO
Proceeds from sale of listed
investments 3 000
Proceeds from sale of plant 5 000
12% loan raised - secured by
second mortgage of land 10 000
Decrese in working capital 2 750
R83 000 R83 000
Schedule of changes in Working Cugital
Cash withdrawn . R11 900 Increase in debtors R 7 650
Increase in creditors 2 000 Decrease in share
Increase in loan interest holders for dividends 5 000
accrued 250 Decrease in working
Decrease in stock 1 250 capital 2 750
R15 400 R15 400

Notes:
1. Plant which had cost R11 000 was sold on 2 January 1978.
2. It was decided that half of the preliminary and share issue expenses were to be written off. The directors decided not to use distributable reserves for this purpose.
3. An amount of R10 000 was transferred out of general reserve during the year to meet various appropriations.
4. The debentures are being redeemed by equal annual drawings on 31 December at a premium of R1 each and are secured by a first mortgage over the land owned by the company.
5. The 121 loan of R10 000 raised during the year is repayable on 30 June 1984.
6. The land owned by the company is an industrial site, Stand No. 234 in Ernton Township and Ho: purchased in 1954. No other property has since been purchased.
7. The leasehold property, acquired under a ten year lease which expires on 31 December 1982, consists of o ucrehouse and office block on Stand 235 in Ernton Township.
8. At 31 December 1977 the investments consisted of the following:-
R25 000 Government 101 Stock 1991 R25 000
12 500 shares in A.A.Limited 25 000
25 000 shares of R1 each in D.?.(Pty.)Ltd 25 000
m-
Only Government stocks are being acquired in respect of Leasehold Redemption Fund Investments. During the year 1 000 shares in A.A.Limited were sold. The market values at 31 December 1978 were as follows:-
Government 10% stock 1991 R1021
A.A.Limited R 3 per share
The directors valued the investment in D.?.(Proprietary)Limited at cost.

Notes:-
9. Stock consists of merchandise only and was valued by the F.I.F.O method as in previous years at the lower of cost and net realisable . value.
YOU ARE REQUIRED to prepare a Balance Sheet with appropriate notes of 31 December 1978.
ANSWER TO QUESTION 3
C. G. LIMITED.
BALANCE SHEET AS AT 31 DECEMBER iQZg
CAPITAL EMPLOYED
SHARE CAPITAL : AUTHORISED AND ISSUED.
100 000 ordinary shares of no par value STATED CAPITAL 175 000
less preliminary and share issue expenses written off 750
174 250
DISTRIBUTABLE RESERVES
General Reserve 15 000
Unappropriated profits 7 000 22 000
SHARE CAPITAL AND RESERVES 196 250
LONG TERM LIABILITIES (2)
16% secured debentures of R10 each 20 000 30 000
127: loan 10 ooo_/276-2’50
EMPLOYMENT OF CAPITAL
FIXED ASSETS Cost Deereciotion Book Value
Land (4) 30 000 - 30 000
Leasehold property (5) 50 000 30 000 20 000
Plant 105 000 51 000 54 000
Delivery vehicles 45 000 22 000 23 000
Furniture 5 000 1 250 3 750
235 000 104 250 130 750
INVESTMENTS (3)
Listed 53 000
Unlisted 25 000 78 000
16 750
NET CURRENT ASSETS.
CURRENT ASSETS.
Stock 38 750
Debtors 37 650 76 400

CURRENT LIABILITIES.
Creditors 17 500
Expenses accrued 250
Debentures 20 000
Shareholders for dividend 20 000
Bank overdraft 1 900 59 650
PRELIMINARY AhD SHARE ISSUE EX -
PENSES. 750
226 250
9.:ng
NOTES: 1 ACCOUNTING POLICIES 1.1 FIXED ASSETS.
Land is not depreciated. Plant, delivery vehicles and furniture are depreciated on a straight line basis at rate: considered appropriate to reduce book values over the useful lives of the assets to estimated residual values. 1.2 STOCK
Stock is valued at lower of cost and net reolisoble value. Cost is determined by using first in, first out method, on a basis consistent with that of the previous year.
2. LONG TERM LIABILITIES.
2. l DEBENTURES R40 000. The debentures are secured by first mortgage over land and are redeemable at a premium of 101 in equal annual instalments. The next instalment is due on 31.12.1979. The interest is also secured.
2. 2 LOAN R10 000. The loan is secured by a second mortgage bond and is repoyoble on 30 June 1984. The interest is also socurod.
3. INVESTMENTS. LISTED.
NAME OF COMPANY N0.0F SHARES C T MARKET VALUE.
Government stock 30 000 R1) 000 30 6m
A.A.Limited 11 500 23 000 34 500
53 000 65 100
UNLISTED. Directors Valuation
D.P.ZPty.)Ltd. 25 000 25 000 25 000
E

4. .LAND
The land owned by the company is situated at Stand No 234 in Ernton Township and was purchased in 1954.
5. LEASEHOLD PROPERTY
This is situated at Stand 235 in Ernton Township and consists of a warehouse and office block acquired under a ten year lease expiring on 31 December 1982.
WORKINGS:
Plant 100 000 1 16 000 - 11 000 : 105 000
Prov.for depreciation of plant 40 000 - 4 000 1 15 000 : 51 000
Vehicles 40 000 1 5 000 : 45 000
Listed investments 50 000 1 l 000 - 3 000 1 5000 : 53 000
PROFIT & LOSS APPROPRIATION.
Taxation 9 000 Balance 5 000
Dividends (6 000 Net Profit 29 000
(20 000 General Reserve 10 000
Premium on deb.red. 2 000
Balance 7 000
12-000 44 000

FINANCIAL STATEMENTS OF LIMITED COMPANIES III.

In terms of the Companies Act 1973, it is a requirement to provide for taxation in the financial statements of a company.

The term of reference is the 4th Schedule of the Comganies Act, Earogragh 36 gal which reads as follows:

"there shall be shown separately in the income statement:-
The amount provided for taxation (specifying, where
material, the origin and different classes of taxes)
in respect of the financial year concerned and the amount,
if any, so provided in respect of any other financial
year".

Before embarking on the lecture itself, note that in view of the frequent changes in tax rates and allowances, the following will apply to the lecture material: tax rate of 40%; loan levy of 5%.

In any examination question which includes reference to taxatiom the rates or actual amounts will be given.

WHAT IS INCOME TAX?

Income tax is an annual tax levied on the taxable income of a company for the tax xeor under review. The obligation to pay tax also carries with it an additional Financial burden known as loan levy.

The loan levy portion of the tax payment is merely a loan to the government for a prescribed number of years, and is refundable at the expiration of that period.

TAXABLE INCOME

To arrive at the taxable income it is necessary to make certain adjustments to the accounting Erofit&loss before tax, as indicated by the financial accounts. The adjustments which are necessary may be due to the following:

1. Income which i: exempt from income tax, e.g. dividende.
2. Deductions which are allowed by the Receiver of Revenue but are not recorded as expenditure in the financial accounts, 0.9. capital allowance: in respect of manufacturing equipment.
3. Expenditure not allowed, e.g. donations.

TAX YEAR

The tax year of a company coincides with its financial year, so it may happen that a company has a tax year which differ; from the normal individual's tax year, which end: 28 February of each year.

In order to reinforce the comments on taxable income and the tax year, consider the following:-

Exomgle:

Company A has a financial yeor-end on 30 June 1999. The accountant hos calculated the accounting profit before tax to be R100 000.

In arriving at the R100 000, he has included as revenue, dividend income of R25 000 and has deducted donations of R5 000.

The additional information provided indicates that the Receiver of Revenue will allow the company on Investment allowance of R30 000 in view of expenditure incurred by the company on manufacturing buildings.

Reguired: Calculate the taxable income of the company at 30 June.

Solution:
Accounting profit per accounts: R100 000
Less:
(i) Capitol allowance granted: (30 000)
(ii) Exempt dividend income: (25 000)
Add:
(iii) Non-deductible donations: 5 000
R50 000
’. Taxable Income is
CALCULATION OF TAX AND LOAN LEVY
come is arrived at the nex
lity will be for taxation and
Having seen how the taxable in t step
is to calculate what the liobi
loan levy.
Using the given rates of tax and loan levy and the taxable
income of R50 000, the following is evident:-
R20 000 (40% of R50 000)
Tax Liability:
R 2 500 (5% of R50 000)
Loan Levy:
Total Liability: R22 500
loted the tax liability it is now necessary to
Having calcu
oks of account as follows:
record the detail in the be
Journal:
1. 30/6/1999 Taxation Dr R20 000
Dr 2 500
Loan Levy
To: Receiver of Revenue
Being provision for taxation for year en
R22 500
ded 30 June 1999.

Note that at this stage the record shown above is a provision, and that the taxation account debited with R20 000 is on income account item (expense) whilst the other two accounts are balance sheet items.

It would now be useful to view the presentation in the statutory accounts of the taxation items:

COMPANY A

BALANCE SHEET AT 30 JUNE 1999.

Liabilities Assets

___-_

Loon Levy R2 500

Provision for taxation R20 000

Income Account for the rear ended 30 June 1999.

Net profit before tax: R100 000

Less: S.A. Normal tax: 20 000

Net profit after tax R80 000

_

HOW IS TAX PAID?

In order to understand fully how to record items related to taxation in the financial statements, it is necessary to review the system of payment.

Every company which is likely to end up with taxable income is required to make 2 grovisionol tax eozments in respect of each year’s trading. The first provisional payment is to be made no later than the end of the first 6 months of the financial and tax year, whilst the second provisional payment must be made by the last day of the financial and tax year. A provisional payment represents half the estimated tax liability for the year (i.e. two provisional payments (first and second) ehould clear the tax liability For the year under review).

lgynvnwrm-w

Once the financial statements of the company are completed
and audited they must be submitted to the Receiver of Revenue
for him to assess the true tux position based on the audited accounts.
Once the accounts have been assessed, the Receiver of Revenue will
then notify the company of its true tax liability and it will then
know whether its provisional payments have been sufficient or
otherwise.

Examgle:

In our example of company A, let us assume that the company had
estimated its tax liability to be:

Taxation : 19 000
Loan Levy: 2 375
Total R21 375
____-
_____-

Reguired:

What would the provisional payments have been? Also, show
the effects on the accounts.

Solution:

R10 687,50 (% of R21 375)
lst Provisional Payment:
R10 687,50 (% of R21 375)
2nd Provisional Payment:
w.
31/12/1998 Receiver of Revenue R1
30/6/1999 Receiver of Revenue R1 R10 687,50
RECEIV ER OF REVENUE
31/12/1998 Cash - lst Provisional
Payment C81 R10 687,50
31/6/1999 Cosh - 2nd Provisional
Payment CB5 R10 687,50
R10 687,50

’ f
h! ’ t4 e; x; -v

From the foregoing it will be apparent that the provisional payments mode may not always tie in with the eventual provision for taxation. This is because the provision is norlally created some months after the year end when the accounts are being finalized, whilst the provisional pay-ents ore node on estimated income - the estimates being carried out during the course of the financial year. Furthermore, it lay happen that the assessment for taxes by the Receiver of Revenue differs from the provision actually node in the accounts. If this does occur then it means that an adjustlent has to be effected to the accounts of the previous year in respect of the difference between the provision and the assesslent.

Examgle:

Let us assume company A’s provision to be as before, viz:

Taxation R20 000
Loan Levy R 2 500

the assessment for the company is received in Nove-ber 1999 and reads as follows:-

Taxation Liability R21 000
Loan Levy R 2 625
Total Liability R23 625

The amount already paid was R21 375 (let and 2nd provisional payments).

Action Reguired:

Steg l: Settlement of the tax liability by paying to the Receiver of Revenue a further R2 250 (i.e. R23 625 - R21 375).

Step 2: Adjust the accounts to take account of the additional tax and loan levy as assessed by the Receiver of Revenue over and above the provision mode:

Taxation Loan Levx
Original Provision R20 000 R2 500
Assessment 21 000 2 625
.'. Additional
liability to be re-
corded is 9R 1 000 erlg?
JOURNAL
30/11/1999 Distribution Reserves Dr R1 000
Dr 125
Loan Levy
Receiver of Revenue
R1 125
Being an adjustment in respect of taxation and loan levy for the year ended 30/6/1999.
onal taxation of R1 000 will not be debited
Note: The odditi
serves as it is in respect
to taxation, but to distributable re
of the previous year and not the current year.
The presentation of the Income Statement for the year ended 30 June 2000 (the current year) will be as follows:
Net Profit before tax xxx
Less: $.A. Normal tox-Current xx
Net profit after tax x
Add:
Accumulated Reserves Bf xx
Less: Taxation adjustment (1 000) x
Distributable Reserves xx
DEFERRED TAX
In terms of generally accept
should consider a number of
statements.
ed accounting practice, companies
concepts when preparing f

The matching concegt in the one that contribute. to the necessity for deferred tax, a: the idea is to relate the tax charge to the accounting income as for as in practicable.
It in often found that the accounting income and taxable income varies for different roouons, one of which being diffoxont rate. applied by the Receiver in allowing V00! and tour when compared to the depreciation rates of tho conpony.
Examglo:
Company B has made a not profit before tax of R100 000.
Included as an expense i: depreciation of R30 000 which represents 33V3X of the cost of Iochinory.
Tho Receiver of Revenue will only allow 25$ p.o. on the lone machinery.
Roguirod:
Calculate (i) Taxable Income
(ii) Tax liability
(iii) Deferred tax
and thou the presentation of the income account.
Solution:
Tax 0 2g!
(i) Profit per Account: R100 000 R40 000
Egg: Depreciation R30 000
Less: Near and Tour (R25 000) 5 000 2 000
Toxablo Income: R105 000 R42 000
_
(ii) lax liability as above: R42 000
(iii) Deferred tax a: above : R 2 000
(lhiu ropronont: the tax or the difference between the depreciation and the Hour and tour allowance granted).

__.______.___..
COMPANY 8.
Income Account for the Year ended 30 June 2000.
Net Income before tax : R100 000
Less: S.A. Normal Tax: 40 000
- Current 42 000
- Deferred (2 000)
Net Profit after tax: R60 000
f
n be seen that the tax charge of R40 000
From the above it ca
000 accounting profit.
relates to the R100
n taxable income.
Income Tax: A charge levied o
Taxable Income: Accou
Tax Year: A company’s tax year corresponds with its financial
year.
Provisional Tax Poxments:
payment by year end.
Arising when expense of income a
of Revenue.
lst payment by half year. 2nd
llowed at o
Deferred Tax:
different level by Receiver

LIKELY EXAMINATION QUESTION

QUESTION

Makers (Pty) Limited commencedbusiness on lst July, 1999 and on lst October of that year purchased and put into use a new machine costing R211 755.

The estimated working life of the machine is five years, at the end of which period it is expected to be sold as scrap iron for R7 500. The company depreciate; the machine on the fixed instalment method, while the Secretary for Inland Revenue allows wear and tear at 20% per annum on the reducing balance.

The net (taxable) profit for the financial year ended 28th February, 2000, before charging depreciation, is R92 021.

The provisional tax payment for 2000 V08 R3 000.

Assume that

(o) taxation rate is 40c in the R for the year ended 28th February, 2000.

(b) the investment allowance on machinery is 20%.

(c) the initial allowance on machinery is 15X.

(d) a loan levy is not required.

YOU ARE REQUIRED:

To show how taxation and related items (other than depreciation and machinery) should be recorded in the financial statement of Makers (Pty) Limited for the year ended 28th February, 2000.

SHOW WORKINGS IN DETAIL.

SOLUTION TO LIKELY EXAMINATION QUESTION
SOLUTION;
MAKERS SPROPRIETARYZ LIMITED
INCOME STATEMENT FOR YEAR
ENDED 28TH FEBRUARYI 2000.
R
Net income before tax 75 000
Normal tax on profit For year: (Note0)
Current 1 163
Deferred 11 896 13 059
Net income for year after tax R61 941
BALANCE SHEET AS AT 28TH FEBRUARYI 2000
Share capital xx
Reserves 5:
Total shareholders' interest xx
Long term liabilities xx
Deferred taxation (Credit balance) 11 896
Current assets:
Recoverable tax overpaid l 837
aNOTE: Deferred taxation
Provision has been made for future liability
for tax at the current rate on:
written down value for tax purposes.
NOTE TO EXAMINER: If recoverable tax is unlikely to be
recovered within twelve months it should be shown as a
current asset.

WORKINGS:
1/10/1999 Cost of machine
Less scrap value
Depreciation to 28/2/2000 1% x g x 204 255
: 17 021
Initial allowance 15
Investment allowance 20
100 x 211 755 : 42 351
Wear and tear allowance:
Cost 211 755
Less Initial allowance 31 763
179 992
_
Wear and tear:
20 5
166 XI? x 179 992 : 14 999
Comgutotion of tax:
Per accounts
28th February, 2000, Net profit
before tax (92 021 - 17 021) 75 000
Permanent difference:
Investment allowance 42 351
32 649
Timing difference
(17 021 - 81 763 - 14 999) 29 741
l 2 908
Initial Hear and Tear :-::::::
Allowance Allowance

R
211 755
7 500
204 255
Tax at 40c
13 059
11 896
1 163

NOTE:
FINANCIAL ACCOUNTING.
TEST AL6.
(Time Allowed : 3 hours)
(1) Credit will be given for neotness and method.
(2) Scale of marks is indicated at the end of each
question.
(3) Leave sufficient space at the head of your answer
paper for tutor’s comments.
(4) Answer all questions.
The following information has been extracted from the books of
G.U.D. Evans & Co. for the year ended 30th June, l999:
R
Advertising 4 630
Administration expenses 425
Audit fee (not fixed at annual general meeting) 105
Auditors’ Expenses 26
Bad Debts 4 508
Balance on Income Statement at lst July, 1998 3 000
Carriage inwards 654
Carriage outwards 312
Commissions Received 13 500
Debenture Interest 600
Depreciation : Plant 796
Office Furniture 98
Directors’ Fees 25
Directors’ Salaries l 500
(Cr.)

R
Dividends (Listed Investments) 200
Interest on Investments (unlisted) 30
Office Salaries 1 244
Ordinary Dividend Proposed 2 100
Purchases of Raw Materials 56 800
Preference Share (5%) Dividend paid 630
Printing and Stationery 382
Rates : Factory 1 496
Office 276
Rent : Factory 600
Office 300
Salesmen’s Salaries 3 611
Stock, lst July, 1998 8 256
30th June, 1999 7 872
Sundry Expenses : Factory 335
Office 323
Telephones 6 Postoges 365
Taxation 3 400
Power 1 924
Stock of Raw Materials : lst July, 1998 7 481
30th June, 1999 5 784
Repairs to Plant 436
Hoges: Factory 21 262
Sales 96 834
Reguired: Manufacturing, Trading Account 5 Income Statement for the
year ended 30th June, 1999, showing net income for the year
before taxation and appropriation.
(25 lurks)
2. The following are the Balance Sheets of Sorasinop Limited at
3lst December:

___________---#--
SORESINAP LIMITED
BALANCE SHEET AS AT 315T DECEMBER
1999
1998
SHARE CAPITAL
Authorised
Shares of R1 each 70 000 70 000
g: ___-_
, ISSUED
9 Shares of R1 each 50 000 70 000
Non Distributable Reserve
Share premium A7c 10 000 20 000
Distributable Reserves
General Reserve 20 000 25 000
Retained Net Income 7 000 15 000
87 000 130 000
Long Term Liobilitx
Debentures 20 000 40 000
Loan at 8% p.0. ;0 000 15 000
117 000 185 000
Represented by:
Less Depreciation 20 000 90 000 30 000 110 000
Current Assets
Stock 30 000 50 000
Debtors 24 000 40 00
Bank .13 000 15 000
.67 000 105 000
Less Current Liabilities
Creditors 40 000 27 000 30 000 75 000

You are given the following additional information.

(a) 0n 3lst December, 1999, Fixed Assets which had cost R10 000 were sold for R1 500 cash. The assets in question had been purchased on lst January, 1996 and had been depreciated at 20% per annum straight line.

(b) During 1999, 20 000 Ordinary Shares of R1 each had been issued at Rl,50 per share.

You are reguired:

To prepare a Source and Application of Funds Statement for the year ended 3lst December, 1999, indicating clearly the change in working capital. (20 marks)

3. The following is the draft balance sheet of Peck and lack Linited at 30th September 1999:

R R
SHARE CAPITAL
100 000 Ordinary Shares of Land 5 Buildings at cost 70 000
R1 each 100 000 Plant 6 Machinery at cost
60 000 Preference Shares less depreciation 35 000
of R1 each 60 000 Motor Vehicles at cost
Share Premium (1998) 12 500 less depreciation 8 000
Income Statement 30 255 Investment 10 000
6% Debentures 20 000 Stock 65 360
Creditors 38 245 Debtors 58 540
Bank 14 100
R261 000 R261 000
m m

NOTES:

(c) There are 25 000 Ordinary Shares unissued which are under option to Kenodle (Pty.) Ltd. at R1,25 per share until Slat December, 2000.

(b) All the Preference Shares have been issued and may be re-deemed by the company on or after lst January, 2000

(c) Included in the creditors' balances is on amount of R12 000 owing to Hamman, Tassen and Co., which is secured by notorial bond over the company's stock.
(d) Land and Buildings are mortgaged as security for the debentures.
(e) On 15th September, 1999, the directors signed a contract for extensions to factory buildings which will cost R9 800.
(f) The plant and machinery and motor vehicles were purchased on lst October, 1996 and depreciation at 10% of cost has been written off the former annually and 20% of cost has been written off the latter annually.
(9) The investment, consists of 10 000 shares of R1 each in T. Simmis (Pty.) Ltd.
(h) Included in debtors at 30th September 1998, were loans to a director, the company secretary and a chemist of R4 500, R750 and R550 respectively. During the post financial year, the director had increased his loan by R500, but the loan to the secretary and the chemist had been repaid.
(1) The directors have passed a resolution declaring a 10% dividend on the ordinary shares and o 6% dividend on the preference shares for the year ended 30th September, 1999. No entries have been put through for these dividends.
(j) The company conducts its main banking account with Schleppers Bank Limited, but it is ascertained that, included in the net bank balance of R14 100 in the draft Balance Sheet, is on overdraft at Nemmers Bank Limited of R5 257.

You are reguired:

To prepare a Balance Sheet at 30th September, 1999 in full compliance with the Companies Act, 1973.

You may assume any further information you deem necessary to comply with the Act and max ignore the auditors' report.

(30 marks.)

TEST AL6. PAGE 6.
The following is a list of the balances in the Trial Balance of tho Underan Dover Company Limited as at 30th June, 1999 which will balance when the bank balance is inserted.

R
Bad debts 175
Bank balance
Bills payable 6 415
Bills receivable 7 945
Carriage inwards 500
Creditors 3 330
Customs duty 480
Debtors 10 100
Discount received 634
Dividends paid:
Preference to 31 December, 1998 300
Interim ordinary 1 500
Furniture and fittings at cost:
at 30th June, 1998 l 000
added on 1st March, 1999 240
Furniture sold on lst July, 1998 for (see note (e)) 120
General expenses 420
General reserve 5 000
Land and buildings 20 000
Printing and stationery 245
Property expenses 247
Provision for bad debts as at lst July, 1998 600
Purchases 56 915
Return: Inwards 725
Salaries and wages 14 490
Sales 83 110
Share capital 40 000
Stock on hand: lst July, 1998 7 995
Stock in transit: lst July 1998 (debit) 2 600
Stock lost by fire (debit) 560
Stock in transit: 30th June, 1999 (debit) 2 760
Travelling expenses 840
Unappropriated profits: lst July, 1998 12 620
igagision for depreciation to furniture as at 1 July 440

e following additional information is obtained:
(0) Further bad debts totalling R320 nust be written off.

(b)
(d)
(e)
(f)
(9)
(i)
(i)
(k)

The provision for bad debts must be 4% of the debtors and bills receivable.

The directors’ fees of R800 per annum fixed in the articles, and the audit fees of R625 must be provided for.

Depreciation is provided on the fixed-instalment method.

The amount to be provided for 1998/99 in respect of the furniture acquired in previous years is R100. The additions during 1999 are estimated to last 10 years at which date their scrap value will be R90.

The fittings sold on lst July, 1998, originally cost R130 on lst July, 1991. Depreciation of R8 per annum has been written off this item since that date. N.B.: The R100 in (d) does not include the R8 in (e).

The stocks in transit at both the beginning and end of the year consist of the overseas cost of the goods.

In addition to the R560 goods lost by fire, goods which cost R440 during the year failed to arrive at the warehouse and cannot be traced; no entry has been made in the books for the purchase or loss of these goods which must be borne by this company.

0n re-checking the books it was found that further goods, the overseas cost of which was R345 and on which customs duty had been paid totalling R66, were in transit at 30th June, 1999. The entries in respect of the purchase had been made, the bookkeeper being of the opinion at the time, that the goods had already arrived.

The stocks on hand at 30th June, 1999 cost R12 040.

Provide for normal tax 1998/99 of R1 980.

The authorised capital of the company is R40 000, in no par value shares of which R10 000 consists of 6% preference shares and the remainder of ordinary shares.

The "final" dividends for the year must be provided for:

on the ordinary shares at 12% to be approved at
the Annual General Meeting;
on the preference shares at the rate of 6% per onnum,
the dividend having been declared on 29th June, 1999.
(m) The directors recommend that R3 500 be transferred to general
reserve.

You are reguired:
to prepare the Trading Account and Income Statement for the year
ended 30th June, 1999, together with the balance sheet as at that
date for presentation to the directors.
(25 marks)

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