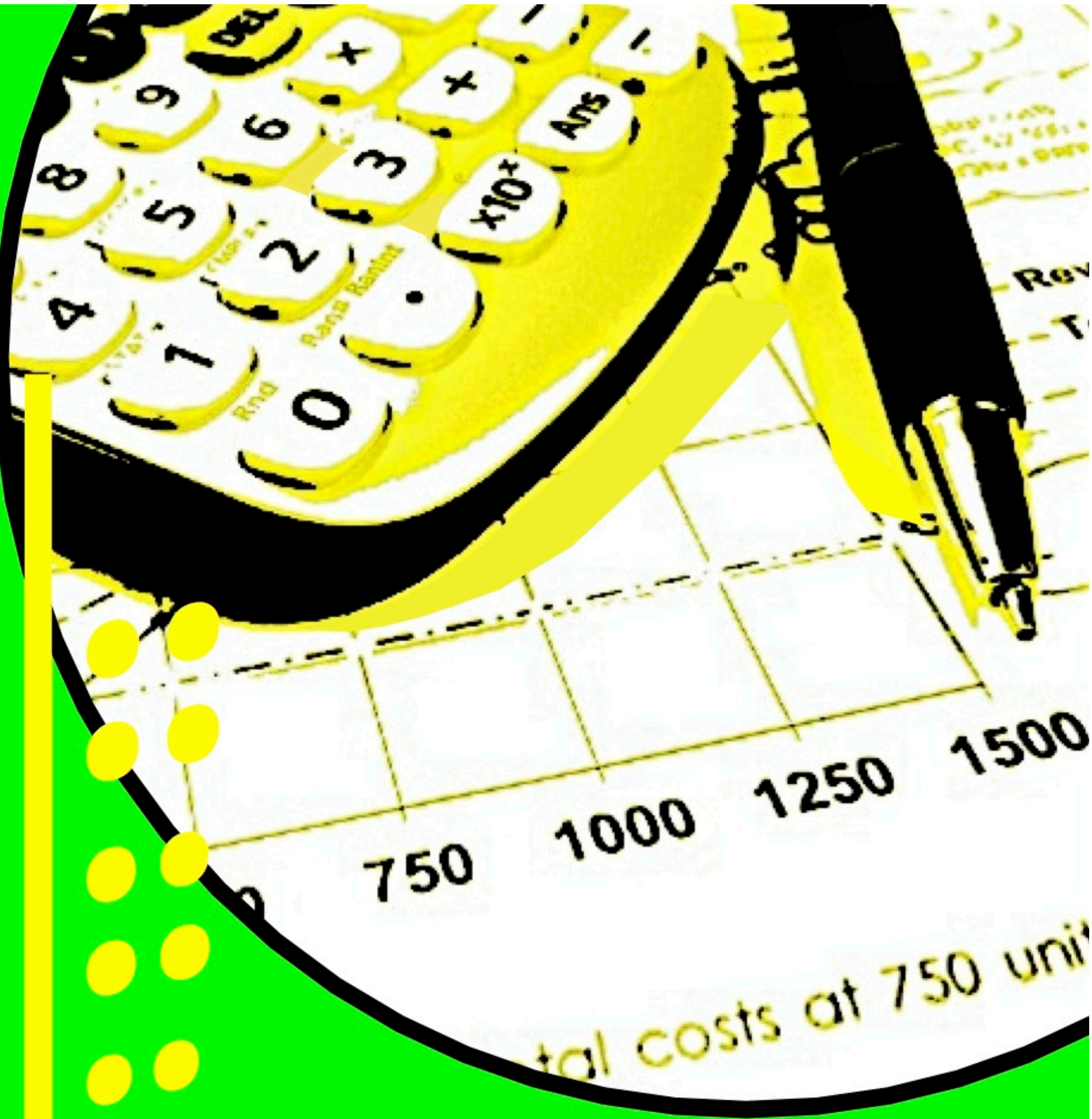
ACCOUNTING



EZ Revision Accounting

Grade 10

Written by Barbara Williamson

EZ Learn

Contents

9. Year-end reporting

Basic financial statements

Financial statements are drawn up at the end of the financial year to see how well the business has done over the year i.e. profit made (Statement of Income), and the financial position at that point in time (Statement of Financial Position). Comparative financial statements compare the current year's results with the previous year.

You will usually be asked to draw up only parts of the financial statements due to time constraints. It is therefore important for you to have a clear understanding of how each part works. Once you have dealt with all the adjustments (either in T-accounts or directly into brackets), the final figures need to appear in the correct places in the financial statements. You may find that only one account of the two affected by an adjustment needs to be shown, but sometimes you will need both, so ALWAYS identify BOTH accounts!

The Statement of Income

- This is made up of all the **Nominal Accounts** (with the only exception being Dividends for companies and Distributions for close corporations, which appear in the Accumulated Profits note).
- Amounts to be subtracted are shown in brackets.
- The basic layout is as follows:

Sales (Cost of Sales)
Gross profit Other operating income (Operating expenses)
Operating profit Interest income (Interest expense)
Net profit for the year

- **Notes** are shown for interest, and the net profit appears in the note for Owner's Equity/Current accounts/Accumulated profits.

Statement of Financial Position

- This is made up of all the **Statement of Financial Position Section accounts**
- It represents the **accounting equation**, and classifies assets and liabilities according to whether they are **current** (will be paid / turn into cash within the next 12 months) or **non-current**
- The basic layout is as follows:

ASSETS Non-current assets (Tangible assets & Financial assets i.e. investments) Current assets (Inventory, Trade and other receivables & Cash)
Total assets
EQUITY AND LIABILITIES Owner's equity Non-current liabilities (i.e. loans) Current liabilities (Trade and other payables & Bank overdraft)
Total equity and liabilities

Notes are used for all entries which need elaboration (i.e. include a number of accounts). The owners' equity notes include net profit and any withdrawals by the owners. See Chapter 2 for the Tangible assets note. All other notes at this point simply include all the relevant accounts added together.

Analysis of financial statements

The whole point of keeping records of business transactions is to provide useful information to management. The process of recording these transactions and summarising them into financial statements must be followed up by analysis and interpretation, to identify possible problems, causes and solutions, i.e. provide useful information for management decision making.

You will usually be asked to calculate and comment on certain aspects of given financial statements, possibly for consecutive periods. You will need to have a good understanding of what the financial statements and different calculations actually mean in order to comment properly. Your comment can also include comparisons with similar businesses, previous years, etc.

You could also be given certain ratios, and then be required to work these backwards to calculate missing figures. For example, if you know the value of current assets and are given the current ratio, you can determine current liabilities.

Analysis of the Statement of Income

Basically, these calculations compare expenses and profits to turnover. They are very easy to remember, as you simply convert the figures asked in the question to a percentage. E.g. gross profit as a percentage of sales = GP/sales x 100. Mark up percentages can also be checked using these calculations.

Financial indicator	Formula	Compare to	What it means
Percentage gross profit on sales (gross profit margin)	$\frac{gross\ profit}{sales} \times 100 = \%$	Previous years, intended gross profit margin	Portion of sales earned as gross profit, available to cover operating expenses and net profit
Percentage gross profit on cost of sales	$\frac{gross\ profit}{cost\ of\ sales} \times 100 = \%$	Intended mark-up on cost.	This is the actual mark-up achieved. A difference from intended mark-up could indicate stock loss due to theft (if periodic inventory is used), or trade or other discounts given, incorrect mark-up calculations etc.
Operating profit percentage on sales	$\frac{operating\ profit}{sales} \times 100 = \%$	Previous years, net profit	Portion of sales earned as operating profit, before interest.
Net profit percentage on sales (profit margin)	$\frac{profit\ before\ tax}{sales} \times 100 = \%$	Previous years, Operating profit	Portion of sales earned as net profit, after interest
Operating expenses as a percentage of sales	$\frac{operating\ expenses}{sales} \times 100 = \%$	Previous years, gross profit margin	Portion of sales used to cover operating expenses.

Return

The owner will want to see how successful the business actually is i.e. whether the return he gets is worth the investment he made, and so profits are compared to capital invested in the business. This figure can be compared to the possible return on other investment options, i.e. prevailing interest rates offered.

Financial indicator	Formula	Compare to	What it means
Return on owner's equity	$\frac{net\ \ profit}{average\ \ owner's\ equity} \times 100 = \%$	Return on other investment e.g. interest on fixed deposit	Whether or not the investment in the business is worthwhile.

Solvency

Total assets must exceed total liabilities for a business to be solvent. The smaller the owners' equity compared to borrowed monies (i.e. gearing - the ratio of own to borrowed, long term, capital), the higher the risk of bankruptcy (insolvency). Banks will consider this risk when deciding whether or not to lend money to a business.

Financial indicator	Formula	Compare to	What it means
Solvency ratio	$total\ assets\ \ :\ total\ liabilities$	Less than 1 : 1 means insolvency (bankruptcy) 2 : 1 is usually considered safe	Whether or not the business is solvent, and the risk of **bankruptcy**. The higher the ratio, the safer the business.

Liquidity

Liquidity is the ability of a business to pay its debts as they become due. A liquid business will have a healthy cash flow. As this looks at short-term cash flow, current assets are compared to current liabilities. However, stock may not necessarily be easy to sell, and so an acid test ratio can also be calculated, which excludes stock.

Financial indicator	Formula	Compare to	What it means
Current ratio	$current\ assets : current\ liabilities$	2 : 1 would generally be considered safe	How easily debts are able to be paid (from cash, debtors and stock) as they become due
Acid test ratio	$(current\ assets - inventory) :$ $current\ liabilities$	1 : 1 would be considered safe	Stock is excluded as it is not always easy to sell. This shows how easily debts can be paid without selling stock.

9.9. Barbara Williamson Paper 1 (50 marks; 30 minutes) [3]

Clark Traders
Pre-adjustment trial balance on 30 September 20_2

	Debit R	Credit R
Capital		830 000
Drawings	200 000	
Loan: Botha Bank		360 000
Land and buildings	800 000	
Vehicles	500 000	
Accumulated depreciation on vehicles		100 000
Equipment	80 000	
Accumulated depreciation		16 000
Trading stock	50 000	
Debtors' control	34 000	
Bank		7 000
Creditors' control		50 000
Sales		1 550 000
Cost of sales	600 000	
Debtors' allowances	50 000	
Commission income		14 000
Rent income		11 000
Advertising	48 000	
Administration	100 000	
Finance cost	1 000	
Vehicle expenses	25 000	
Salaries and wages	450 000	
	2 938 000	2 938 000

Adjustments to be made:

1. Commission of R1 500 has been overpaid in error. This amount will be offset against future commission.
2. Rent for September has not yet been received.
3. An advertising campaign running from 1 September to 31 October has already been paid, R11 000.
4. R30 000 of the loan is payable before 30 September 20_3. All interest on the loan is paid to date.
5. A casual worker's wages for the last week of September have not yet been recorded. He worked 20 hours at R50 per hour. PAYE at 25% is payable.
6. The owner took stock costing R2 000 for her own use.
7. C Chen's account of R1 000 must be written off as irrecoverable.
8. A physical stock take showed the following on hand:
   - 8.1. Trading inventory R45 000.
   - 8.2. Stationery (administrative cost) R5 000.
9. Depreciation must be calculated as follows:
   - 9.1. On vehicles at 20% p.a. on carrying value.
   - 9.2. R8 000 on equipment.

[3] Self-marking Excel template available for this question on DropBox – see link in chapter 1.

Required:

1. Prepare the following financial statements for Clark Traders for the year ended 30 September 20_2 (comparative figures for 20_1 have already been inserted):

1.1. Statement of Income (25)

	20_2	20_1
Sales		1 400 000
Cost of sales		(560 000)
Gross profit		840 000
Other income		27 000
Commission income		15 000
Rent income		12 000
Operating expenses		(509 000)
Advertising		45 000
Administration		20 000
Vehicle expense	25 000	24 000
Salaries and wages		420 000
Trading stock deficit		
Depreciation		
Operating profit		358 000
Finance cost		(1 000)
Net profit		357 000

1.2. Statement of Financial Position (3)

		20_2	20_1
ASSETS			
Non-current assets			
Tangible assets		1 176 000	1 264 000
Current assets		89 500	128 000
Inventory	1	50 000	80 000
Trade receivables	2	39 500	48 000
Total assets			1 392 000
EQUITY AND LIABILITIES			
Owner's equity	3	846 000	830 000
Non-current liabilities			
Loan: Botha Bank			500 000
Current liabilities			62 000
Trade payables	4	82 500	50 000
Bank overdraft			12 000
Total equity and liabilities			1 392 000

(Please turn over for notes and questions)

1.3. Notes to the financial statements (17)

2. Inventory

	20_2	20_1
Trading inventory		76 000
Consumable stores on hand		4 000
		80 000

3. Trade and other receivables

	20_2	20_1
Trade debtors		43 000
Accrued income		3 000
		2 000
		48 000

4. Owner's equity

	20_2	20_1
Balance at 1 October 20_1		653 000
Net profit		357 000
		(180 000)
Balance at 30 September 20_2		830 000

5. Trade and other payables

	20_2	20_1
Trade creditors		48 000
Income received in advance		2 000
Current portion of loan		
Creditors for wages		
SARS (PAYE)		
		50 000

6. Answer the following questions.

6.1. Clark Traders' return on equity was 48% for 20_1, but only 26% for 20_2. What item requires further investigation in order to explain why her net profit and return dropped when sales increased? (1)

6.2. Consider the liquidity of Clark Traders on 30 September 20_2

6.2.1. Calculate the current ratio on 30 September 20_2. (2)

6.2.2. The acid test ratio is 0,44 : 1. What item in the financial statements is responsible for the difference between the current and acid test ratios? (1)

6.2.3. If stock takes on average 14 days to sell, and she offers her debtors 30 days to pay, what terms (i.e. how many days to pay) should she negotiate with her suppliers in order to sustain these lower liquidity ratios? (1)

50

My notes

9.10. Barbara Williamson Paper 2 (20 marks; 24 minutes)

Molose Traders is owned by Lesedi Molose. She is very pleased that she has made a healthy profit for the financial year ended 30 September 20_2. However, when you look at her financial statements, you notice some problem areas.

Information relating to Molose Traders:

1. Lesedi marks up her goods by approximately 100% on cost.
2. The net profit margin (i.e. on sales) for 20_1 was 29%.
3. Both the solvency and current ratios on 30 September 20_2 were 2 : 1.
4. Lesedi took out a new loan on 1 July 20_2 when she bought new premises in order to expand her business.

Statement of income for the year ended 30 September 20_2

	20_2	20_1
Sales	1 500 000	1 000 000
Cost of sales	(1 000 000)	(600 000)
Gross profit	500 000	400 000
Operating profit	350 000	300 000
Net profit	300 000	290 000

Statement of financial position as at 30 September 20_2

	20_2	20_1
ASSETS		
Non-current assets	2 780 000	1 100 000
Current assets	120 000	100 000
Inventory	90 000	50 000
Trade and other receivables	20 000	30 000
Cash and cash equivalents	10 000	20 000
Total assets	3 000 000	1 200 000
EQUITY AND LIABILITIES		
Owners' equity	600 000	600 000
Non-current liabilities	2 360 000	550 000
Current liabilities	40 000	50 000
Total equity and liabilities	3 000 000	1 200 000

Required:

1. Calculate the mark-up achieved by Molose Traders for the year ended 30 September 20_2. (3)

2. Calculate the net profit margin for 20_2. (3)

3. What do you notice about operating profit compared to net profit? (2)

4. Calculate the solvency of Molose Traders on 30 September 20_2. (3)

5. Calculate the acid test ratio on 30 September 20_2. (3)

6. What problems should you discuss with Lesedi? Explain at least THREE areas of concern. (6)

-
-
-

20

9.11. Barbara Williamson Paper 2 (30 marks; 35 minutes)

Question 1 **ANALYSIS OF INCOMES AND EXPENDITURE** **(15 marks, 17 minutes)**

Refer to the **Group Statement of Comprehensive Income** of Dis-Chem Pharmacies Limited for the year ended 28 February 2019 and the expense details that follow.

1. # Group statement of comprehensive income

for the year ended 28 February 2019

	2019 R'000
Revenue from contracts with customers (Sales)	**21 420 023**
Cost of sales	**(16 197 190)**
Gross profit	**5 222 833**
Other income	**1 010 258**
Total income	**6 233 091**
Other expenses	**(5 015 225)**
Operating profit	**1 217 866**
Net financing costs	**(162 254)**
Finance income	**20 183**
Finance costs	**(182 437)**
Profit before taxation	**1 055 612**
Taxation	**(291 040)**
Total comprehensive income for the year	**764 572**

2. Expenses include the following items:

Expenses			
Depreciation of property, plant and equipment	12	**159 305**	158 846
Amortisation of intangible assets	13	**27 293**	14 606
Computer expenses		**175 140**	160 687
Advertising expenses		**369 543**	280 974
Commission		**108 286**	97 318
Bank charges		**52 604**	46 935
Donations		**18 130**	18 418
Security		**100 144**	81 011
Occupancy costs		**701 536**	601 463
- Lease payments		**455 501**	383 662
- Other (including electricity and rates)		**246 035**	217 801
Employee benefits		**2 825 350**	2 488 280
- Salaries and benefits		**2 488 034**	2 254 773
- Pension costs		**99 308**	74 962
- Medical aid		**48 508**	41 273
- Leave pay		**7 210**	15 781
- Share-based payment		**7 130**	-
- Other		**175 160**	101 491

Required:

1.1. The Dis-Chem group consists of both retail (selling directly to the consumer) and wholesale activities (selling to other businesses). The wholesale segment achieved a mark-up of only 9,13% on cost for the 2019 financial year.

1.1.1. What mark-up on cost was achieved by the whole Dis-Chem group for the latest financial year? (3)

1.1.2. Why do you think there is such a difference between the wholesale and retail segments? (1)

1.1.3. The wholesale segment made an overall loss for the year. Why, then, do you think the Dis-Chem group might continue operating in this segment? (1)

1.2. Consider the expenses for the 2019 year.

1.2.1. Calculate the operating expenses margin. (3)

1.2.2. What is the biggest expense incurred by Dis-Chem? (1)

1.2.3. Justify why this expense is acceptable, or even important, for Dis-Chem. (1)

1.3. Should the shareholders (owners) of Dis-Chem be concerned by the investing and financing activities for the 2019 year? Explain, considering the net finance costs in support of your answer. (3)

1.4. Dis-Chem Pharmacies Limited is a public company. Because it is a legal entity, it has to pay tax on its profits. Calculate the effective tax rate (percentage) for the 2019 year. (2)

(Please turn over)

Question 2 **RETURNS AND FINANCIAL POSITION** **(15 marks, 18 minutes)**

Refer to the **Group Statement of Income** from Question 1 AND the **Group Statement of Financial Position** of Dis-Chem Pharmacies Limited as at 28 February 2019.

1. # Group statement of financial position

as at 28 February 2019

	2019 R'000	2018 R'000
ASSETS		
Non-current assets	**1 987 167**	1 664 700
Current assets	**6 849 048**	5 470 665
Inventories	**5 115 579**	3 947 937
Trade and other receivables	**1 556 037**	1 242 729
Cash and cash equivalents	**177 432**	279 999
Total assets	**8 836 215**	7 135 365
EQUITY AND LIABILITIES		
Equity	**2 105 984**	1 686 139
Non-current liabilities	**1 266 115**	1 388 846
Current liabilities	**5 464 116**	4 060 380
Trade and other payables	**4 634 657**	3 554 068
Loans payable	**170 989**	198 798
Bank overdraft	**658 470**	307 514
Total equity and liabilities	**8 836 215**	7 135 365

2. Financial indicators:

	2019	2018
Return on equity	**?**	50,02%
Current ratio	**1,25 : 1**	1,35 : 1
Acid test ratio	**?**	0,38 : 1

3. Trade receivables are generally on terms of 7 to 60 days.

4. Trade and other payables are generally on terms of 7 to 90 days. Other payables consist of payables relating to payroll as well as general accruals.

Required:

2.1.

2.1.1. Calculate the return on average equity for 2019. (4)

2.1.2. If you were a shareholder (owner), would you be happy with this return earned by Dis-Chem Pharmacies Limited? Explain. (3)

2.2.

2.2.1. Calculate the acid-test ratio for 2019. (4)

2.2.2. Evaluate Dis-Chem's liquidity, taking the additional information provided into account. (4)

(Please turn over)

Question 3 **BONUS QUESTION** **(5 marks, 0 minutes)**

Information relating to Dis-Chem's customer loyalty programme:

The following information was extracted from the notes to the financial statements of Dis-Chem Pharmacies Limited for the year ended 28 February 2019.

Loyalty benefit point scheme

The Group operates a loyalty scheme which allows retail customers to accumulate points that entitle them, subject to certain criteria, to use these points in the future in any store in exchange for goods or services.

The fair value which includes the expected redemption rate attributed to the points awarded, is deferred as a liability and recognised as revenue on redemption of the points by customers. The Group experiences low levels of unredeemed loyalty points due to the ease with which customers can redeem them at point of sale.

27. Deferred revenue continued

	2019 R'000	2018 R'000
Loyalty benefit points scheme	**32 650**	52 497
Gift vouchers	**11 148**	28 795
	43 798	81 292
Loyalty points		
Opening balance	**52 497**	49 806
Points issued*	**156 445**	159 749
Revenue recognised	**(176 292)**	(157 058)
Closing balance	**32 650**	52 497

Required:

3.1. Consider the customer loyalty programme, whereby Dis-Chem customers earn points with their purchases that can be used when they buy products in the future. What adjustment do you think would need to be made for these points in the financial statements? (2)

Debit:

Credit:

3.2. What percentage of revenue (sales) consisted of points redeemed during the 2019 financial year? (2)

3.3. Do you think this programme is worthwhile for Dis-Chem? Explain. (1)

30