Examination preparation guide

FAC1601

Financial Accounting Reporting

October/November 2015

Department of Financial Accounting

IMPORTANT INFORMATION:
This tutorial letter contains important information about your module.

BAR CODE

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Dear Student,

Hereby enclosed is information pertaining to the examination and quick references (guidelines) to the application of certain principles and presentation of accounting information in the financial statements covered in the module FAC1601.

We will attempt to have all the lecturers available between 08:00 and 13:00; and at least one lecturer available between 13:00 and 16:00 for telephonic enquiries during this time until the day before the exam date.

With kind regards

FAC1601: Lecturers

OCTOBER 2015 EXAMINATION SCOPE

The October 2015 examination paper will consist of four questions with a total of 100 marks. All these questions **must** be answered. There will be no multiple choice or theoretical questions; however you must be able to apply the acquired theoretical knowledge in practical questions.

POSSIBLE ARRANGEMENT OF THE FOUR QUESTIONS IN THE EXAM PAPER

Approximately 85% of the questions will relate to the preparation and presentation of financial statements of partnerships and close corporations, i.e.

- Statement of profit or loss and other comprehensive income
- Statement of cash flows
- Statement of financial position and also changes in equity

As far as the notes to the financial statements are concerned, you need to study the following:

- Property, plant and equipment (partnerships and close corporations)

Above topics are covered in study units 1, 2, 5 and 7 of the study guide.

The rest of the paper, approximately 15%, will cover the ancillary topics (study units 3, 4, 6, 8, 9 and 10) of the study guide. **NB!** You need to ensure that you understand the logic of journal entries in the entire scope of ancillary topics.

TOPICS NOT TO BE EXAMINED

- Accounting policy notes in study units 2 and 5 of the study guide.
- All debenture transactions in study unit 6 (refer to paragraph 6.10 in the study guide).

STUDY UNIT 1

Introduction to the preparation of financial statements

Financial statements →

- Statement of profit or loss and other comprehensive income,
- Statement of changes in equity,
- Statement of financial position,
- Statement of cash flows, and
- Notes to the financial statements.

Statement of profit or loss and other comprehensive income

Revenue:
This is income that arises from transactions or other events in the course of the day-to-day or ordinary business activities of an entity.

- ***Calculation:***
  Sales *minus* (sales returns, settlement discount granted/creation/increase in allowance for settlement discount granted) *plus* forfeited settlement discount granted.

Cost of sales:
Costs connected to inventory to the point of sale.

- ***Calculation:*** *(if not given)*
  Opening inventory (inventory at beginning of reporting period) *plus* purchases (less purchases returns) *plus* other costs incurred on purchases (for example, transportation, storage, insurance, duties and other related costs) *minus* closing inventory.

  NB: The settlement discount received is deducted from the purchases figure and forfeited settlement discount received added to the purchases figure.

Other income:
This income that arises from transactions that are not connected to day-to-day activities of an entity. For example; rental income, dividend income, interest income, gains on financial assets at fair value through profit or loss.

Distribution, administrative and other expenses:
These are expenses incurred in the course of the day-to-day or ordinary business activities of an entity. Refer to page 35 of the prescribed textbook for the type of items that fall under this category.

Finance costs:

This relates to the costs involved in the borrowing of money to build or purchase assets and maintain operations of an entity. It includes the interest on loans, mortgage, bank overdraft, etc.

The **statement of changes in equity** for each type of business ownership differs substantially. Refer to study units 2 and 5 for the presentation of this statement.

Statement of financial position

Assets:

Non-current assets

- Property, plant and equipment
  *(refers to all **tangible assets** at carrying amounts)*

- Financial assets
  *(refer to all **intangible assets** that derives value because of a contractual claim).* For example, equity instruments of an unlisted entity, fixed deposits that will mature beyond the one year period, etc.)

Current assets

Assets that can be converted into cash within one year in the normal course of business.

NB: Equity instruments of a listed entity at fair value and fixed deposits (due to mature in one year) are disclosed as part of "**Other financial assets**".

Equity and liabilities:

Equity

Equity is what the owners of an entity have invested in a business. Components of equity differ with the type of business ownership. The components of equity of a partnership are different from that of a close corporation. Refer to study unit 2 and 5 of the study guide.

Non-current liabilities

Refers to entity's obligations that are not payable within a period of one year.

Current liabilities

Refers to entity's obligations that are payable within a period of one year. Note that a **"bank overdraft"** is disclosed as **"other financial liabilities"** in this section.

STUDY UNIT 2

Establishment and financial statements of a partnership

IMPORTANT

Interest on partner(s) loans:

- Interest on loans to partners is presented as **other income** in the statement of profit or loss and other comprehensive income,
- Interest on loans from partners is presented as **finance costs** in the statement of profit or loss and other comprehensive income.

Salaries, bonuses and commissions paid or payable to partners:

- Salaries, bonuses and commissions **payable** to partners are credited in the current account of individual partner and debited to appropriation account *(refer to example 2.2 of the prescribed textbook and all examples in study unit 2 of the study guide)*
- Any amounts that have actually been **paid** to partners as salaries, bonuses and commissions are debited to the:
  - Current account *(refer to question 6 of assignment 1)*
  OR
  - Drawings account (if the entity has drawings account). *Refer to exercise 2.2 on the study guide.*

Share of profits or losses:

If there is no agreement on how profits/losses are shared, profits or losses must be apportioned to partners according to their capital contributions.

STUDY UNIT 3

Changes in the ownership structure of partnerships

Calculation of new profit sharing ratio:

Information to be considered:

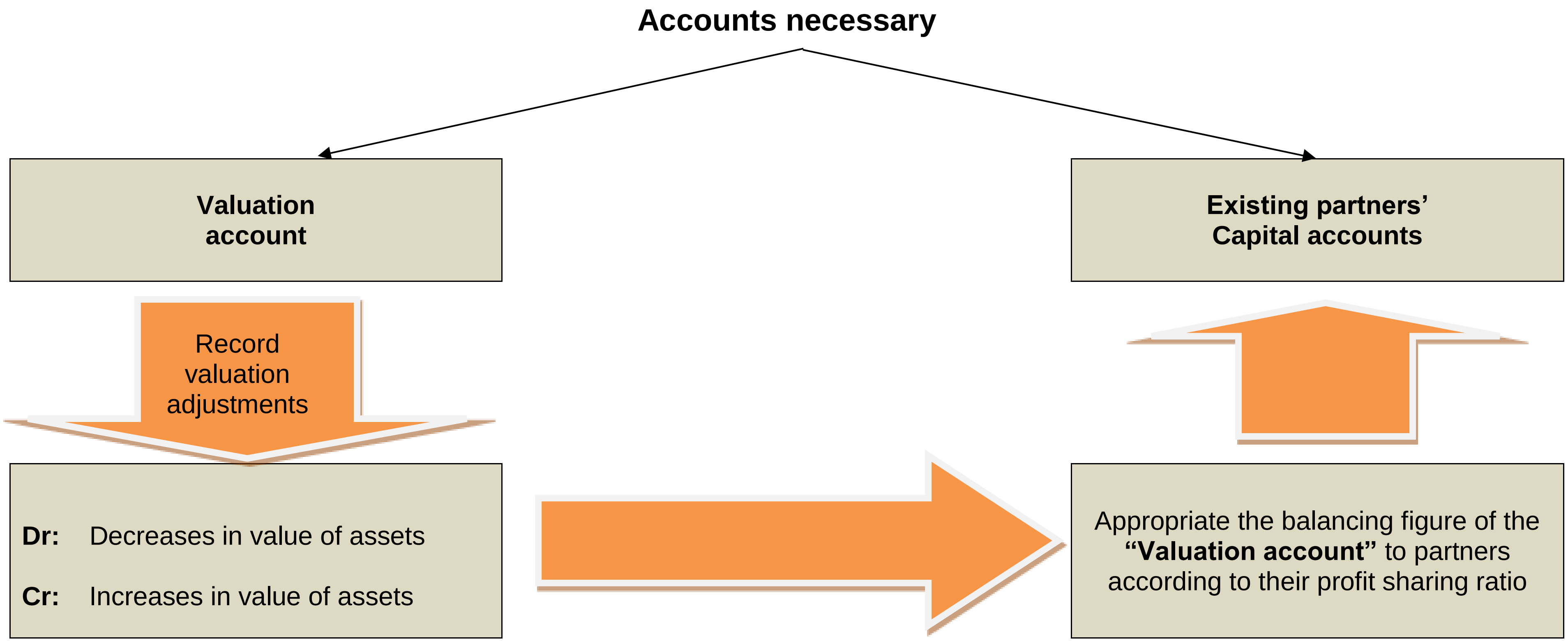
a. Current profit sharing ratio of partner(s),
b. Ratio/portion to be relinquished, and
c. Ratio in which it is relinquished.

- Note that the sum of profit sharing ratios for all the partners must be 1,
- If you are given a percentage, convert it into fraction.

Refer to examples in chapter 3, paragraph 3.4 of the prescribed textbook.

Preparation of a valuation account:

When preparing a valuation account, consider the following sequence as guideline



Calculation of goodwill:

The following steps must be followed to determine the "goodwill" in instances where goodwill is not given and if there is no guideline on how goodwill should be arrived at in the question.

The capital contribution of the incoming partner

multiplied by

Inverse of the incoming partners' share in net asset value

minus

Total equity of a **NEW** partnership

=

GOODWILL

The amount of "Goodwill" created must then be debited to "**goodwill account**" and credited to old partners "**capital accounts**"

Comment:

Where goodwill is given in the list of balances, the change in value thereof must be dealt with in the same way as other assets through the valuation account.

STUDY UNIT 4

The liquidation of a partnership

Simulteneous liquidation golden rules:

The following set of accounts is necessary to record the liquidation of a partnership when the simultaneous liquidation method is applied:

Liquidation account	Bank account	Partners capital accounts
Transfer all assets except "**Bank"** to the debit side of this account, Transfer all liabilities to the credit side of this account,	Dr: Amounts received on sale of assets Cr: Amounts paid in settlement of liabilities	*Debit:* Liquidation of **goodwill** account *Credit:* Liquidation of **asset replacement reserve** account *Debit:* Assets taken over by a partner *Credited:* Liabilities taken over by a partner Share of profit/loss on liquidation of partnership
Debit: Liabilities taken over by partners		
Credit: Assets taken over by partners		
Debit: Cash settlement of liabilities:		
Credit: Sale of assets and cash settlement of debtors account		
Balancing figure can indicate profit or loss on liquidation: Debit balance = Loss Credit balance = Profit		Dr: Loss on liquidation Cr: Profit on liquidation (balancing figure in the liquidation account allocated according to profit sharing ratio)

Comment:
A credit balance in the partners' capital account indicates an amount due to a partner whereas a debit balance indicates an amount owing by the partner. *Refer to examples 4.2 of the prescribed text book and exercise 4.1 of the study guide*.

Piecemeal liquidation golden rules:

- Open the applicable accounts in columnar form with balances;
- Close off "Reserve and Goodwill" accounts to partners' capital accounts;
- Apportion profits or losses from each realisation of assets to capital accounts;
- When cash becomes available, all liabilities must be paid until they are fully settled before partners get any amount as capital repayment;
- Once the liabilities are fully settled, a calculation is done to determine how **interim repayments** must be made to partners, if cash is available:

    - Commence with the balances at the date when cash is available for distribution;
    - Assume that unsold assets are worthless and apportion the potential deficit to the partners' capital accounts according to their profit-sharing ratio;
    - If a partner's capital account results in a deficit, assume that the partner is insolvent and transfer the deficit to the other partners according to *their* profit-sharing ratio;
    - The sum of the balances of the solvent partners' capital accounts should equal the cash that is available for distribution to the solvent partners.

STUDY UNIT 5

Close corporations

Interest on member(s) loans:

- Interest on loans to member is presented as **other income** in the statement of profit or loss and other comprehensive income,

- Interest on loans member partners is presented as **finance costs** in the statement of profit or loss and other comprehensive income.

Salaries payable to members:

Annual salary payable to members is presented in the statement of profit or loss and other comprehensive income as separate line item. ***Refer to exercise 5.2 of the study guide.***

Income tax

- Normal income tax for the year is presented as an expense in the statement of profit or loss and other comprehensive income
- The difference between normal income tax for the year and income tax already paid (provisional tax) is presented in the statement of financial position as:
  - Income tax payable (current liability) ***refer to exercise 5.1-5.4 in the study guide***
    or
  - Income tax receivable (current asset)

Retained earnings:

Retained earnings to be disclosed in the statement of financial position is calculated as follows:

- Opening balance, **plus/(less)**,
- Total comprehensive income/(loss) for the year (from statement of profit or loss and other comprehensive income), **less**
- Amount to be transferred to reserves, **less**
- Distribution to members (distributed during the year plus final distribution).

STUDY UNIT 6

Introduction to companies

Accounting for the issue of shares:

Receipt of money, as payment must accompany the application for the subscription of shares:

Dr: Bank account
Cr: Application and allotment (class of share) account

Upon allotment:

Dr: Application and allotment (class of share) account
Cr: Share capital account

In cases where there is oversubscription, oversubscribed applications:

Dr: Application and allotment (class of share) account
Cr: Bank account

Refer to exercise 6.1 of the study guide and examples 6.1 & 6.2 of the prescribed text book.

Subscribers to the memorandum:

The first issue of shares must always be to the incorporators of the company, and the journal entries will be:

Dr: Bank account
Cr: Application and allotment (class of share) account

then

Dr: Application and allotment (class of share) account
Cr: Share capital account

Refer to exercise 6.1 of the study guide and examples 6.1 & 6.2 of the prescribed text book.

Commission payable to the underwriter:

- An expense that must be provided first, to create the liability and is paid after the issue of shares,
- The commission is calculated as follows:

Calculation: Total number of shares offered ***x*** issue price per share ***x*** % of commission

OR

As a % of the R-value of the total issue,

Refer to exercise 6.3 of the study guide and example 6.5 of the prescribed textbook

Issue of capitalisation shares

A bonus issue (no payment is received) of fully paid shares to shareholders. Distributable reserves are utilised – only a book entry is made.

Accounting procedure to record capitalisation of shares:

Where capitalisation issue is from retained earnings –

Dr	-	Retained earnings
Cr	-	Ordinary share capital

Refer to exercise 60. Of the study guide and example 6.4 of the prescribed text book

STUDY UNIT 7

Statement of cash flows

<table>
<tr><th colspan="3">Presentation of statement of cash flows</th></tr>
<tr><td colspan="3">Operating activities +- investing activities +- financing activities = movement in cash and cash equivalents</td></tr>
<tr><td>Operating activities

Principle: revenue producing activities, e.g.
Receipts from customers
Payments to suppliers and employees
Purchase/sale of financial assets at fair value through profit or loss/ held for trading (e.g. investments in public company)
Income tax
Interest received/ dividends received/interest paid/distribution paid/drawings</td><td>Investing activities

Present acquisition and disposal of non current assets
Acquisition of furniture/equipment/vehicles/land/buildings
Proceeds on sale of furniture/equipment/vehicles/land/buildings
Acquisition of financial assets not held for trading (e.g. investments in private company, fixed deposit)
Proceeds on sale of financial assets not held for trading (e.g. investments in private company, fixed deposit)
Loans granted and repayable (loans to members/partners)</td><td>Financing activities

Changes in size or composition of equity or long term borrowings
Cash contribution to capital/members contribution
Proceed on acquisition of long term borrowings
Repayment of long term borrowings</td></tr>
</table>

Comment:

The cash flows from operating activities can be presented according to the direct or indirect method.

The **direct method** for presenting a statement of cash flows reports major classes of gross cash receipts and payments.

The **indirect method** for presenting a statement of cash flows involves reconciling comprehensive income to a cash basis. It shows how non-cash flows affect comprehensive income. The indirect method uses net-income as a starting point, makes adjustments for all transactions for non-cash items, then adjusts for all cash-based transactions.

Framework for the presentation of the statement of cash flows from operating activities according to the **direct method**:

CASH FLOWS FROM OPERATING ACTIVITIES

	R	
Cash receipts from customers	**0000**	
Cash paid to suppliers and employees	**(0000)**	
Cash generated from operations	**0000**	
Drawings (partnerships & sole proprietor)	(000)	
Interest received	000	
Interest paid	(000)	
Income tax paid	(000)	
Distribution to members paid	(000)	
Net cash from operating activities		0000

Framework for the presentation of the statement of cash flows from operating activities according to the **indirect method**:

CASH FLOW FROM OPERATING ACTIVITIES

	R
Comprehensive income for the year **or** Profit before tax - CC	000
Non-cash items ***(refer to paragraph 7.6.1.2 (a): Prescribed Textbook)***	+/-
Items disclosed after cash generated from/(used) in operations ***(refer to paragraph 7.6.1.2 (b): Prescribed Textbook)***	+/-
	=
Changes in current assets and liabilities:	
Decrease in current assets	+
Increase in current assets	-
Decrease in current liabilities	-
Increase in current liabilities	+
Cash generated from operations	=
Items disclosed after cash generated from/(used) in operations ***(refer to paragraph 7.6.1.2 (b): Prescribed Textbook)***	+/-
Net cash flow from operating activities	**=**

Refer to examples 7.9 and 7.10 of the prescribed text book, exercises 7.1 to 7.4 of the study guide as well as the assignment s.

STUDY UNIT 8

Analysis and interpretation of financial statements

CATAGORIES OF FIANCIAL RATIOS	
PROFITABILITY	• Return on equity • Return on assets • Gross profit percentage • Profit margin • Financial leverage and leverage effect
LIQUIDITY	• Current ratio • Acid test ratio • Trade receivables collection period • Trade payables payment period • Inventory turnover rate • Inventory holding period
SOLVENCY	• Debt equity ratio • Times interest earned ratio

Refer to example 8.1 of the prescribed textbook for formulae

IMPORTANT:

When answering a question on ratios:

- Write down the formula for required ratios
- Calculate the ratios
- Comment on the ratios (**only when required by the question**)

When calculating the ratio, you must show all workings. For example, if required to calculate current ratio and you were not given the amount for total current assets, the calculation for total current assets must be shown.

Refer to exercise 8.6 of the study guide and examples 8.1 of the prescribed text book as well as the assignments.

STUDY UNIT 9

Branches

Calculation of cost and profit mark-up:

CALCULATION OF PROFIT MARK-UP BASED ON THE COST PRICE

Determination of the selling price: (where cost price is given)

Inventory is invoiced to the branch at cost plus **25%** and inventory with a cost price of **R200**, is invoiced to the branch. Determine the selling price and profit mark-up.

	%
Cost price	100
Profit mark-up	+25
Selling price	125

The selling price is: R200 x 125/100 = R250
The profit mark-up is: R200 x 25/100 = R50
OR
R250 - R200 = R50

Refer to chapter 9, example 9.10 in the prescribed textbook.

CALCULATION OF PROFIT MARK-UP BASED ON THE COST PRICE

Determination of the cost price: (where selling price is given)

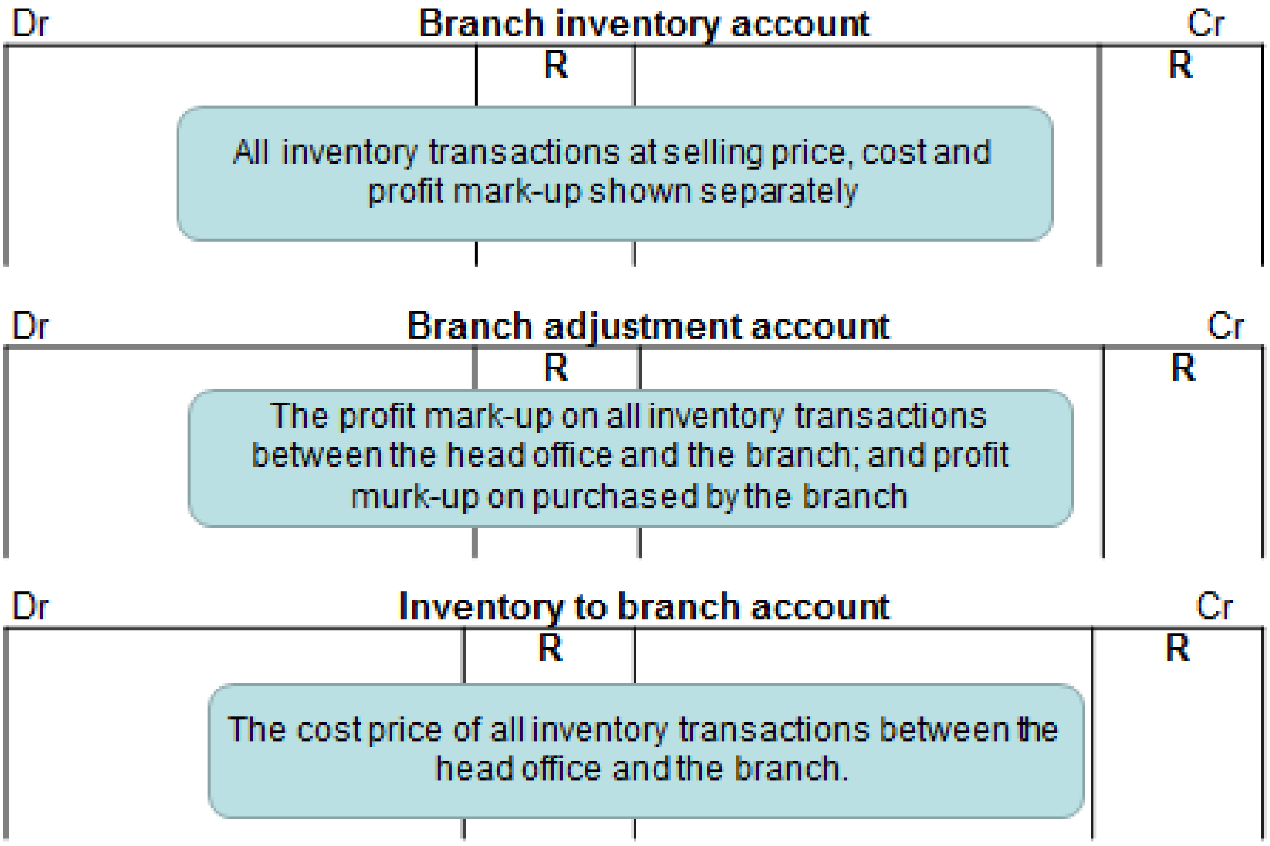
Inventory is invoiced to the branch at cost plus **25%** and inventory with a selling price of **R250**, is invoiced to the branch. Determine the cost and profit mark-up.

	%
Selling price	125
Profit mark-up	-25
Cost price	100

The cost price is: R250 x 100/125 = R200
The profit mark-up is: R250 x 25/125 = R50
OR
R250 - R200 = R50

Refer to chapter 9, example 9.11 in the prescribed textbook.

ACCOUNTS NECESSARY TO RECORD INVENTORY TRANSACTIONS



Work through examples 9.10 to 9.17 in the prescribed textbook.

STUDY UNIT 10

The time value of money

Important terms to remember:

Interest
Simple interest
Compound interest
Principal amount
Annuity
Present value of R1
Present value of an annuity
Future value of R1
Future value of an annuity
Period

Refer to study unit 10 of the study guide for definition and explanation of these terms.

Consider the following when answering a question on time value of money:

- Read what is required in the question,
- Read and understand a given scenario or case study,
- Identify and asses available information, for example;
    - Principal amount,
    - Interest (how it is compounded), *refer to exercise 10.6 of the study guide to see how interest and period are treated when not compounded annually*
    - Period

Refer to exercises 6.1 to 10.10 of the study guide and the assignments