

Office Finance

Second Edition

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Preface

This book will be useful to students who are currently involved in handling financial issues in any office environment. The aim of this module is to equip office employees with the necessary skills and knowledge to manage financial issues in the office relating to budgeting, buying and selling, wages and salaries, petty cash, banking and insurance.

The credit calculation is based on the assumption that students are already competent in terms of the following outcomes or areas of learning when starting to learn towards this section standard, namely:

- a senior certificate or equivalent NQF level 4 qualification;
- the ability to study independently and communicate effectively in the language of instruction; and
- the ability to perform basic arithmetic calculations.

The scope and context of this section focuses on the business environment in all the economic sectors in South Africa.

This module will enable you to:

- understand the financial function of an organisation;
- understand the basic concepts of financial management;
- draw up and manage the office budget;
- manage the buying and selling activities in an office;
- manage the wages and salaries in an office;
- manage the petty cash in an office;
- understand the banking issues related to an organisation; and
- understand the basics of insurance in an organisation.

The financial function of an organisation



Learning outcomes

At the end of this chapter, you should be able to:

- identify the activities of the financial function;
- discuss the basic concepts of financial management;
- explain the essence of financial management;
- explain the objectives and duties of the financial manager; and
- draw up a basic income statement and balance sheet.

1.1 Introduction

Every organisation should carry out a large variety of activities in order to achieve its primary objective of making money or of rendering a service. It makes no difference whether the organisation is a sole proprietor, such as a green grocer, or a large company, such as Sasol, the financial function is one of the functions of any organisation.

The person who heads up this function is usually called the financial manager. This person is responsible for managing the financial function, division or department. In this section we will look at the essence of financial management, the different objectives that have to be achieved, the duties of the financial manager, important concepts in financial management and a few basic accounting concepts.

The **financial function** refers to all the activities in the organisation involved in obtaining capital and the optimal use of the capital. These activities need to be managed properly.

Financial management refers to the management of the organisation's financial activities. The financial manager is responsible for the effective planning, organisation, coordination, delegation and control of all the financial activities in the organisation as he or she strives to achieve the organisation's primary objective.

All the financial activities work together to determine the capital requirements (money that the organisation needs to buy things) of the organisation and how best to finance (pay for) these requirements.

Financial management involves constantly making decisions about how the financial activities of an organisation should be planned and controlled with the help of information that is available at that moment. No one knows exactly what the future holds, so there is always a certain element of risk involved in financial decisions. The organisation does not function in isolation. Each organisation functions in a constantly changing economic environment. One example of how the economic environment influences financial decisions is the way that interest rates influence a loan; if interest rates rise, the organisation



has to pay more for the money it has borrowed (loan capital). So, internal and external environmental factors have to be taken into consideration.

The activities of the financial function can also not be planned and executed in isolation within the organisation. Close liaison with the other functions of the organisation is a prerequisite for the successful execution of the financial activities. The marketing division, for example, cannot draw up the marketing budget without the help of the financial division.

1.2 Basic concepts of financial management

In order to understand the financial function and implement it successfully, the following important concepts should be understood: capital, financial structure, investment, financing, dividends, profitability, liquidity and solvency.

1.2.1 Capital

Capital consists of all the goods and services an organisation has at its disposal to obtain an income or return by means of the activities of the organisation (buying and selling). Capital, in other words, is equal to the monetary value (value in terms of money) of the total assets of the organisation. We differentiate between:

- **fixed capital**, which is the capital invested in fixed assets such as land, buildings, machinery and equipment; and
- **operating capital** (working capital), which is that part of the capital that is invested in current assets like stock and debtors.

Capital can also be subdivided on the basis of its origin:

- **Own capital** – This refers to that portion of the total capital that is provided by the owners of the organisation, such as the shareholders of the company.
- **Loan capital** – This refers to that portion of the total capital that is provided by non-owners, such as a bank. The organisation pays for the use of this capital in the form of interest.
- **Controlling capital** (owner's equity) – This is the contribution of those providers of capital who have a right to vote, such as the ordinary shareholders.

Capital is usually made available to organisations over the following terms:

- **Short-term capital** – This is capital that is made available for a period of up to one year.
- **Medium-term capital** – This is capital that is made available for a period of between one and five years. In certain cases the period may be 10 years.
- **Long-term capital** – This is capital that is made available for periods longer than five to 10 years.

Capital for financing purposes is made available on the **capital market** over the medium and long term, such as a long-term loan over 20 years at a commercial bank. The **money**



market makes capital or funds available over the short term, such as a one-year bank overdraft facility or a personal loan over six months.

Questions

Complete the following with regard to capital:

We differentiate between fixed and _____ capital.

The sources of capital: _____ capital.

_____ capital.

_____ capital.

Capital is available over the following terms: _____

1.2.2 Financial structure

The financial structure is a combination of the asset and capital structures and appears in the balance sheet of the organisation (which is discussed later in this chapter).

- **Asset structure** – This refers to how the total assets of the organisation are composed and includes all fixed and current assets.
- **Financing or capital structure** – This refers to how the total capital of the organisation is composed. It will indicate the sources of financing.

1.2.3 Investment

Investment is the use of capital for the acquisition of fixed assets, such as land and buildings, and current assets, such as stock, so that these assets can generate an income for the organisation.

1.2.4 Financing

Financing refers to the provision of capital to the organisation by suppliers of capital. There are different types or forms of financing.

Example

You wish to buy a car for business-related matters. The car will cost you R330 000. You need capital to pay for the car. You can either use your own savings or you can make use of a motor-vehicle financing facility from a bank. There are also other financing options, such as lease and contract purchase, but these will not be discussed here.

You will have to decide which option would suit you the best. This is the type of decision organisations must make all the time. It is important to remember that the form of financing must suit the need for which it will be employed. For example, when you buy a house, you will make use of a mortgage bond and not a short-term loan or an overdraft.



The following are the different types of financing that are available to meet the needs of an organisation:

- **Short-term finance** – This refers to capital that is normally available for a period of one year or less.
- **Medium-term finance** – This covers the period between one and five years.
- **Long-term finance** – This makes capital available for 10 years or more.

There are also different forms of short-, medium- and long-term finance. Examples of short-term finance are suppliers' credit (credit given by a supplier), bank overdraft and short-term bank loans. Examples of medium-term finance are term loans, financial leasing and hire-purchase financing (instalment credit). Examples of long-term finance are ordinary share capital, preference share capital, a long-term loan from a commercial bank and retained income (the income that is available after cost of sales, all expenses, other income, interest, tax and share dividends have been calculated).

1.2.5 Dividends

Dividends refer to that portion of the net income after tax that is paid out to shareholders. Dividends are the earnings that shareholders receive on their share capital.

A share is the part of the capital of a company belonging to the shareholders. There are two types of shareholders: ordinary shareholders and preference shareholders (there are four different types of preferential shares). The main difference between them is that preference shareholders must receive dividends before ordinary shareholders.

1.2.6 Profitability

The concept of profitability, also called return on investment (ROI), is related to the return an organisation earns on a certain amount of capital, expressed as a percentage.

1.2.7 Liquidity

Liquidity is the continued ability of an organisation to make all payments regularly and on time. Examples include rent, interest payments and settlement of creditors. This means that an organisation has cash (money) to pay their debts.

1.2.8 Solvency

Solvency is the ability of the organisation to pay all its debts even if the organisation ceases to exist (liquidation). Solvency means that the total assets of the organisation exceed the total liabilities.

Note

Make sure that you understand the difference between profitability, liquidity and solvency.



1.2.9 Financial decisions

The approach to financial management is directed at both the raising and the application of funds. The nature and extent of the capital requirements of an organisation are investigated systematically, and methods are developed to meet these requirements. The modern approach to financial management encompasses three overall questions, namely:

- Which, and how many, assets should the organisation acquire? This concerns the **investment decision**.
- How should the assets be financed? This concerns the **financing decision**.
- How will the net income after tax be divided? This concerns the **dividend decision**.

Question

Which questions would you ask to explain the following concepts?

- Investment decision
- Financing decision
- Dividend decision

1.3 The primary objective of financial management

The organisation must determine, by means of planning, the primary objective and what should be done to achieve this objective. A business strategy is absolutely essential for achieving the objective of the organisation and for the survival and growth of the business. The business strategy spells out the financial objectives as well as how the organisation plans to achieve them. These objectives and plans of action are directly linked to investment, financing and dividend decisions.

The overall objectives of the organisation are used as a point of departure for the formulation of financial objectives. Planning objectives cannot be done in isolation, because each individual objective must fit into the framework of the objectives of the organisation. All the objectives of financial management must support the primary objective of the organisation, which is the maximisation of wealth.

The primary objective of financial management is the maximisation of wealth, or the maximisation of shareholders' prosperity. This objective is aimed at ensuring the continued existence and growth of the organisation, or increasing the value of the organisation for its owners in the long term.

The maximisation of wealth or the maximisation of shareholders' prosperity means that the interests of the owners of an organisation must be promoted to increase the value of the organisation. This occurs when the return or income from a particular investment project is greater than the cost of the capital invested in that specific project.

Profitability is related to the return that the organisation earns on a specific amount of capital. It is the ratio, expressed as a percentage, of the net income earned during a specific period to the capital (fixed and current assets, such as plant and equipment) used during this period to generate the income (earned by selling the product).



$$\text{Profitability} = \frac{\text{net income before interest and taxation}}{\text{total capital (total assets)}} \times \frac{100}{1} = \%$$

The concept of profitability relates income to the capital required to generate this income.

1.4 The secondary objectives of financial management

Secondary objectives are identified and pursued to achieve the primary objective.

Examples of secondary objectives for financial management include the following:

- The optimal utilisation of limited resources – In this specific case we mean the resource ‘capital’. The organisation tries to attain the highest possible return on capital, with due consideration of the risk attached to each project. If an organisation has to choose between two projects, it will choose the project that will provide the best return on capital.
- Negotiating the lowest interest rates on the money and capital markets – The organisation tries to minimise costs with regard to its capital and this is directly influenced by the ‘price of money’ (the interest rate).
- Maintaining a position of optimal liquidity – The organisation must constantly be in a position to meet its financial obligations, for example interest payments and payments to creditors.
- Maintaining a competitive position in the market – The organisation can achieve this by granting credit. Some South African clothing stores, for example, maintain and strengthen their competitive position by offering their clients a credit facility. At the same time, the financial manager pursues the secondary goal of minimum bad debts.
- Meeting the social responsibilities of the organisation towards the community – This includes aspects such as providing safe products, involvement in environmental conservation, paying market-related salaries and supporting literacy programmes and education.

Question

List five secondary objectives of the financial manager.

1.5 The tasks of the financial manager

The task of the financial manager involves not only carrying out activities, but also planning and controlling them. In other words, the task of the financial manager involves the management of the financial matters of the organisation to contribute to an increase in the value of the organisation in the long term.

This task requires the financial manager to be familiar with the internal and external environment within which the organisation functions. The financial manager carries out his or her duties in the broad business environment. External tasks include liaising with financial institutions in the money and capital market (such as commercial banks).



The primary tasks of the financial manager are therefore concerned with:

- determining the optimal capital requirements of the organisation; and
- providing for the capital requirements of the organisation.

However, the duties of the financial manager are broader in scope than these two primary tasks. The financial manager is also responsible for the following:

- financial analysis;
- financial planning and control;
- determining the extent of capital requirements;
- determining the way in which financing should be arranged; and
- determining the extent of dividend pay-outs.

1.5.1 Financial analysis

By regularly measuring and evaluating the financial performance and status of the organisation, information is gathered regarding its financial position. This includes information about the liquidity and solvency position. The financial manager is then able, with the help of the financial analysis, to determine to what extent the organisation is succeeding in the application of its limited resources (the application of capital).

1.5.2 Financial planning and control

■ Financial planning

Both long- and short-term planning are vitally important for setting and achieving objectives. Planning is therefore an integral part of the financial manager's duties. Financial planning is concerned with setting up the most appropriate plans of action for the long and short term that are directed at achieving the predetermined financial objectives effectively. The objectives provide an explanation of what the organisation hopes to achieve, while the planning process constitutes an explanation of how the objectives should be achieved.

One of the tools the financial manager might use during this process is budgeting. A budget is an example of a plan of action used by the organisation to achieve certain objectives. It is a monetary plan for a future period.

■ Financial control

The part of the financial manager's task in which he or she controls the execution of the plans of action and determines whether the predetermined objectives have been achieved refers directly to financial control. The process of financial control includes four steps:

1. Setting specific standards.
2. Comparing the actual performance with the predetermined standards.
3. Evaluating the differences (which may be positive or negative).
4. If necessary, instituting corrective measures.

The financial manager may use the budget to compare the actual results with forecasted results.



Question

What is the difference between financial planning and financial control? Can you see that one cannot take place without the other?

1.5.3 Determining the extent of capital requirements

The extent of capital requirements is directly related to which and how many assets should be acquired. It therefore relates to the investment decisions that have to be made by the financial manager.

In the first place, the investment decision is concerned with tangible fixed and current assets, such as a piece of land to be used for expansion that must be acquired by the organisation.

Secondly, it is concerned with investments in external financial assets of the organisation, such as investments and shareholding in other organisations. It is advisable to choose those investments that will contribute most towards the value of an organisation. If an organisation has to choose between two projects that produce returns on capital of 20% and 25% respectively, the project with a return of 25% will be chosen (assuming that the costs and risks are the same for both projects).

Lastly, the investment must also contribute towards achieving the primary objective of the organisation.

1.5.4 Determining how financing should take place

The financial manager must investigate the supply of capital and then decide from which sources and in what forms capital should be acquired. Here we refer to reinvested income or new capital provided by owners or acquired from external sources. A combination of internal and external sources should therefore be found. In addition, the financial manager should determine for what period the capital will be required (long, medium or short term).

1.5.5 Determining the extent of dividend pay-outs

The financial manager is involved in decisions concerning the distribution of income in the organisation. The net income after interest and tax is normally divided between the organisation and the shareholders or owners according to specific guidelines. It must be decided which portion of the income will be paid out as dividends and which portion will be ploughed back into the organisation as reserves and reinvestments. Reinvestment concerns income ploughed back into the organisation to yield greater long-term returns.

Note

If you have problems with terminology at this stage, please continue. As you work through the chapter, the meaning of the terms will become clear.



1.5.6 Additional responsibilities of the financial manager

Various other responsibilities and tasks of the financial manager include:

- interacting between the organisation and the money and capital markets – the financing sources from which the organisation can attract capital are the financial institutions on the money and capital markets;
- managing the investment portfolio – acquiring financial assets results in the creation of an investment portfolio;
- ensuring that the organisation has an effective and integrated budget system;
- the management of credit in the organisation, which includes credit and debt collection policies;
- the responsibility for drawing up financial statements;
- the responsibility for establishing systems and methods for costing, determination of income, financial accounting and internal auditing;
- providing the other divisions in the organisation with financial expertise; and
- the responsibility for all tax and insurance matters.

| FINANCIAL MANAGEMENT DECISIONS | | | | | |
|---|--------------------------------------|---|----------------------------------|-----------------|--------------------------|
| Investment decision Seek optimal opportunities | | Financing decision Seek sources of finance | | | |
| Investment in current assets | Investment in financial assets | Money market (Short-term) | Capital market (Long-term) | Trade credit | Unappropriated income |

Figure 1.1 The responsibilities of the financial manager

1.6 Basic accounting concepts

The financial manager has a certain task to perform. To ensure that this is done effectively and the right decisions are made, information regarding the general financial position of the organisation should be obtained. This includes information about the profitability of the organisation and the financial position of the organisation at a particular point.

The financial statements of an organisation provide a lot of this information, which is essential for effective financial control. The financial statements are also used to draw up cash-flow statements and for determining the expected capital requirements for a future period. These aspects are directly related to financial planning. The financial statements are therefore a useful tool for the financial manager, ensuring that he or she obtains the information necessary for decision-making processes within the organisation. Annual financial statements include the following:

- an income statement;
- a balance sheet; and
- a cash-flow statement.



Note

In the rest of this section we will concentrate on the income statement and balance sheet. Using these two documents, we will introduce you to a number of important basic accounting concepts.

1.6.1 Income statement

An **income statement** provides a summary of the income that an organisation earns and the expenses incurred over a specific period (called the accounting period).

Note

Figure 1.2 on page 12 is an example of the income statement of Humpty Dumpty (Pty) Ltd for the period 1 January 2016 to 31 December 2016. Keep this example at hand while you study the following section of your work.

An income statement is prepared for a specific period, called a financial year.

■ **Sales**

Sales represents the total net sales (cash and credit) of goods and/or services by the organisation.

■ **Gross income**

Gross income is net sales less the cost of the goods sold. The cost of goods sold includes all the costs that the organisation incurred to prepare the products or services for final sale. In the case of a manufacturer, for example, this will include the costs of materials, labour and direct manufacturing costs. For a supermarket retailer this will include the costs of all the products purchased, for example soap powder, canned goods, sugar, flour, vegetables and fruit.

■ **Operating costs**

Operating costs include costs such as administrative costs, cost of sales and depreciation on assets. Other income, such as dividends, interest earned and profit from the sale of fixed assets (which is not directly related to sales) are also taken into account.

■ **Depreciation**

Depreciation of fixed assets is written off at the end of the financial year. In the course of the life of a building or of machinery and equipment, the organisation makes provision, in the form of depreciation, for the replacement of the asset concerned at the end of its useful life. The value of plant and equipment, for example, as it appears on the balance sheet, is the book value. The book value on a particular day is the value obtained after the accumulated depreciation (the sum of the depreciation written off annually since the date of purchase) is deducted from the cost price.



■ Interest payable

This is interest on a long-term loan, for example, and is first deducted from the net income before calculating the tax that the organisation has to pay.

■ The net income after tax

This represents the income that is available for dividend pay-outs and transfers to reserves.

■ Balance of the unappropriated income/retained earnings

After all the dividends have been declared and the transfer to reserve fund has been completed, the income statement ends with a balance for the unappropriated income in a particular financial year. The balance for unappropriated income, as shown at the beginning of the year, is now added to this balance to calculate the amount of unappropriated income for the balance sheet. The unappropriated income forms part of own capital and is indicated under the distributable reserves. It is also part of the capital structure of the organisation. The unappropriated income is an internal source of finance for the organisation.

Remember

- SALES minus cost of sales gives you GROSS INCOME
- GROSS INCOME minus operating costs gives you NET INCOME BEFORE INTEREST AND TAX
- NET INCOME BEFORE INTEREST AND TAX minus interest payable gives you NET INCOME BEFORE TAX
- NET INCOME BEFORE TAX minus tax gives you NET INCOME AFTER TAX
- NET INCOME AFTER TAX minus dividends and reserves give you UNAPPROPRIATED INCOME FOR THE YEAR



| Humpty Dumpty (Pty) Ltd | | |
|--|-----|--------|
| Income statement for the year ended 31 December 2016 | | |
| | | R '000 |
| SALES | | 5 500 |
| Minus: Cost of sales | | 4 500 |
| GROSS INCOME | | 1 000 |
| Minus: Operating costs | | 500 |
| Selling costs | 200 | |
| Administrative costs | 300 | |
| NET INCOME BEFORE TAX AND INTEREST | | 500 |
| Minus: Interest | | 75 |
| NET INCOME BEFORE TAX | | 425 |
| Minus: Tax | | 204 |
| NET INCOME AFTER TAX | | 221 |
| Minus: Dividends to shareholders | | 20 |
| RETAINED INCOME | | 201 |
| Minus: Reserves | | 50 |
| UNAPPROPRIATED INCOME | | 151 |
| | | |
| Sales | | |
| Credit sales | | 3 500 |
| Cash sales | | 2 000 |
| | | 5 500 |

Figure 1.2 Income statement of Humpty Dumpty (Pty) Ltd

1.6.2 Balance sheet

A balance sheet is a summary of the financial position of the organisation at a particular time/date. It is not prepared for a period, as is the case of an income statement. For example, the balance sheet prepared for 31 December 2016 may differ from the one prepared for 30 November 2016. This is because the financial position of the organisation changes constantly.

Question

What is the main difference between an income statement and a balance sheet?

The financial position of the organisation reflects the following:

- The total disposable means of the organisation – This is an indication of the total capital that an organisation has at its disposal (own, long-term, loan and operating capital).



- The application of the disposable means – This determines how the organisation uses the capital at its disposal to acquire fixed and current assets.

Note

Figure 1.3 on page 14 is a balance sheet in diagram form and gives an explanation of the entries on it. Figure 1.4 on page 15 is an example of Humpty Dumpty (Pty) Ltd's balance sheet as at 31 December 2016. As with the income statement, you should keep the examples at hand.

■ Ordinary shareholders' interest

This consists of the ordinary share capital, the reserves (distributable and non-distributable) plus the unappropriated income.

■ Loan capital

This is long-, medium- or short-term capital made available to the organisation by external persons or institutions such as banks. The providers of loan capital are not the owners of the organisation.

■ Total disposable means of the organisation

This is the total capital of the organisation and is expressed in terms of own capital and loan capital.

■ Fixed assets

This is the first group of assets identified in the balance sheet. It includes assets such as land and buildings, plant and equipment, vehicles and goodwill. Fixed assets are those assets that may be used by an organisation for a relatively long period. In other words, they have a relatively long lifespan. The fixed assets in an organisation may be divided into:

- tangible assets, which are assets that can be physically touched, such as land and buildings, plant and equipment; and
- intangible assets, which are assets such as goodwill and trademarks. Trademarks such as Koo, Gants or Coca-Cola are great assets to the organisations that own them.

■ Investments

An organisation makes an investment in a financial asset, for example buying shares in another company or investing an amount of money or capital in a bank. The organisation then earns an income on the investment in the form of dividends, which are paid out or interest earned.

■ Current assets

These refer to all the assets that can be converted to cash in a short period (within one year) or which already exist as cash. Current assets refer to debtors (people buying on



credit), cash in the bank and stock. The current assets are supplementary to the fixed assets and are used to ensure the effective utilisation of the fixed assets. Without the necessary raw materials and material (part of stock) the plant and equipment (part of fixed assets) cannot be operated.

■ Current liabilities

On the balance sheet for Humpty Dumpty Ltd the current liabilities are entered on the assets side of the balance sheet although this is part of the short-term loan capital of the organisation. Operating capital (current liabilities) is the capital that is invested in the current assets of an organisation, and consists mainly of creditors, short-term loans and overdrawn bank accounts.

| Balance sheet for an organisation as at 31 December 2016 | | | |
|--|-----|---------------------------|-----|
| CAPITAL EMPLOYED | | EMPLOYMENT OF CAPITAL | |
| | | | |
| | | FIXED ASSETS | |
| Ordinary shares | 000 | Land and buildings | 000 |
| Reserves | 000 | Plant and equipment | 000 |
| Unappropriated income | 000 | Vehicles | 000 |
| Ordinary shareholders' interest | 000 | Total fixed assets | 000 |
| Preference shares | 000 | Minus: Depreciation | 000 |
| Total own capital | 000 | Total net fixed assets | 000 |
| | | | |
| | | | |
| LOAN CAPITAL | | INVESTMENTS | |
| Long-term loan | 000 | Shares | 000 |
| Bonds | 000 | | |
| Total loan capital | 000 | | |
| | | | |
| | | CURRENT ASSETS | |
| | | Debtors | 000 |
| | | Cash | 000 |
| | | Stock | 000 |
| | | Total current assets | 000 |
| | | | |
| | | CURRENT LIABILITIES | |
| | | Creditors | 000 |
| | | Short-term loan | 000 |
| | | Total current liabilities | 000 |

Figure 1.3 A balance sheet



| Balance sheet for Humpty Dumpty (Pty) Ltd as at 31 December 2016 | | |
|--|-----------------|---------------|
| CAPITAL EMPLOYED | | |
| Own capital (shares) | | 8 000 |
| Reserves | | 5 000 |
| Unappropriated income | | 2 000 |
| Total own capital | | 15 000 |
| Loan capital | | |
| Long-term loan | | 5 000 |
| | | 20 000 |
| EMPLOYMENT OF CAPITAL | | |
| Fixed assets | | 21 000 |
| Minus: Depreciation | | 5 000 |
| Net fixed assets | | 16 000 |
| Current assets | | 9 000 |
| Cash | 1 000 | |
| Debtors | 4 500 | |
| Stock | 3 500 | |
| Current liabilities | | 5 000 |
| Creditors | 2 200 | |
| Tax payable | 800 | |
| Shore-term loan | 2 000 | |
| NET CURRENT ASSETS | (9 000 – 5 000) | 4 000 |
| | | 20 000 |

Figure 1.4 Balance sheet for Humpty Dumpty (Pty) Ltd

When preparing an income statement and balance sheet, notes are made to the documents. These notes contain additional information regarding, for example, the authorised capital (that which may be distributed and that which is already distributed), the conditions of long-term loans, the nature of investments and the composition of the stock.

1.7 Conclusion

The financial function of an organisation involves more than just financial activities, and the managerial dimension must be taken into account.

The essence of financial management may be represented in three groups of decisions, namely investment decisions, financing decisions and dividend decisions. These three groups are closely related and therefore require an integrated approach with regard to problem-solving. The various decisions cannot be made in isolation. Solutions to



investment, finance and dividend problems are based on the primary objective of the organisation and are therefore aimed at maximising the value of an organisation for its owners. The primary objective of financial management is the same as that of the enterprise. In addition to the primary objective there are also various secondary objectives of financial management.

The tasks of the financial manager flow directly from the essence of financial management. All the decisions to be made regarding the issues mentioned constitute his or her task. The tasks of the financial manager must be carried out in such a way that they will result in an increase in the value of the owners' investment in the long term.

Further insight into the task of the financial manager is gained from the discussion of the income statement and balance sheet of an organisation as well as a description of the basic items that appear on these documents.

1.8 Self-assessment

1. Explain the difference between the concepts 'financial function' and 'financial management'.
2. Peter Tshabalala is the prospective owner of a sole proprietorship manufacturing and selling wooden furniture. Explain the following concepts to Peter and give a suitable example of each:
 - Capital
 - Financial structure
 - Investment
 - Finance
 - Profitability
 - Liquidity
 - Solvency
3. Discuss maximisation of profitability as the primary objective of Peter's shop in Question 2.
4. List at least five secondary objectives involved in financial management.
5. Describe to a colleague who does not have any idea about finance what the role and tasks of the financial manager in an organisation are.
6. Tabulate the difference between the income statement and the balance sheet.
7. Explain to a friend how a company calculates the unappropriated income at the end of the financial year using an income statement.
8. Briefly state what is meant by the following items on a balance sheet:
 - Ordinary shareholder's interest
 - Loan capital
 - Fixed assets
 - Current assets

The budget



Learning outcomes

At the end of this chapter, you should be able to:

- explain the different types of budgets;
- explain and draw up a budget for the office;
- explain zero-based budgeting; and
- list the reasons for drawing up a budget.

2.1 Introduction

A budget is the embodiment of the department's operational planning in terms of money. It consists of all the planned expenses and revenues for a certain period, usually one year. It is an organisational plan (or office plan) stated in monetary terms.

The purpose of budgeting is to:

- provide the organisation with a forecast of expenses and revenues;
- construct a model of how the business might perform financially; and
- enable the actual financial operation of the business to be measured against the forecast.

A budget is only a management instrument; it does not work automatically. The data must be brought up to date periodically so that a meaningful interpretation of the comparisons is possible. The office budget also forms part of the organisation's total budget. The units used in a budget are usually rands, but physical units can also be used together with the rand values. The following section describes some of the different types of budgets found in an organisation.

2.2 Different types of budgets

The **sales budget** is an estimate of sales figures and is usually broken down into units and rand values. It is used to create the sales objectives of the organisation.

The **production budget** is created by product-oriented organisations. It is an estimate of the number of units that must be produced or manufactured to meet the sales objectives. This budget will also include the estimated costs involved (such as labour and material) in the manufacturing process.

The **cash-flow budget** is a prediction of future cash receipts and expenditures for a particular time period. Examples of cash receipts include cash sales, collection of accounts receivable and interest, while examples of expenditures include payments of interest, wages, creditors and rent.



Any organisation needs to know whether there is enough money to continue with business on a daily basis. A cash-flow budget helps the organisation determine when income will be sufficient to cover expenses and when the organisation will need to seek additional financing. Shortages can lead to liquidation, while excessive means (too much cash available) can influence the rate of return negatively. Shortages can be financed by short-term loans and overdraft facilities, while a surplus of cash could be used for short-term investments. See Figure 2.1 below for an example of a cash-flow budget.

The **marketing budget** is an estimate of the funds needed for marketing such as promotions and advertising.

The **capital budget** is a prediction of the needs of the organisation in regard to fixed assets, such as buildings, machinery and other equipment. It includes the cost of upgrading assets, acquiring new assets and maintenance of the assets.

The **master budget** is a summary of all the budgets of the subunits of the organisation. It is used to create projected financial statements. A pro forma income statement (or budgeted income statement) and a pro forma balance sheet (or budgeted balance sheet) are created.

| Cash budget for January 2017 to March 2017 | | | | | | |
|---|----------------|----------------|----------------|--------|-------|---|
| | January | | February | | March | |
| | Budgeted | Actual | Budgeted | Actual | B | A |
| Cash on hand (A) | | R500 | R1 000 | R500 | R0 | |
| Cash deficit (A) | (1 000) | | | | | |
| Receipts: | | | | | | |
| Cash sales | R12 000 | R13 000 | R13 000 | ... | | |
| Recoveries (debts) | R1 000 | R1 000 | R1 500 | ... | | |
| Other (specify, e.g. loans, issue of shares) | R4 000 | R3 000 | R2 500 | ... | | |
| Total (B) | R17 000 | R17 000 | R17 000 | ... | | |
| Payments: | | | | | | |
| Trading creditors | R3 000 | R4 000 | R5 000 | ... | | |
| Salaries and wages | R5 000 | R5 000 | R4 000 | ... | | |
| Taxes | R1 500 | R2 000 | R2 000 | ... | | |
| Payment of debts | R1 500 | R1 000 | R2 000 | ... | | |
| Dividends | R1 000 | R1 000 | R1 000 | ... | | |
| Other (specify, e.g. purchase of fixed assets) | R3 000 | R3 000 | R4 000 | ... | | |
| Total (C) | R15 000 | R16 000 | R18 000 | ... | | |
| Liquid means at end of the month (A + B – C) | R1 000 | R500 | R0 | ... | | |

Figure 2.1 Example of a cash budget



2.3 The preparation of the budget

The preparation of the budget includes three elements: the budget period, the development of the budget and the revision of the budget.

2.3.1 Budget period

The budget period is the period covered by the budget and usually corresponds with the fiscal period (or the financial year) of the organisation. It usually covers one year and is drawn up a month or two before the beginning of the period.

2.3.2 Development of the budget

Much time is spent on the development or preparation of the budget. Usually the line managers would be responsible for the budgets of the different sections. Once their budgets have been drawn up, the higher-level manager will coordinate and prepare a budget for the entire functional area or section.

When preparing a budget, the managers need to be familiar with the policy, direction and prospects of the organisation and the section. Many managers have traditionally just added 10 per cent to the figures for the preceding year and used the newly calculated figures for their budget. However, this method assumes that all expenditures of the previous year will again be needed in the following year, and that only the amounts by which the budget is increased have to be justified. In a changing environment, this is not the best method.

Nowadays, the **zero-based budget** is used as an alternative. With this method of budget preparation, all programmes and expenses are re-evaluated with every budget period. This budget requires that all section heads justify their section's existence during each budget preparation. If this is not done, they could lose a lot of money.

Zero-based budgeting comprises three steps:

1. Describe each separate organisation activity in a decision package. A decision package describes the nature and costs of the activities for which the department is budgeting. This includes the description of what they are planning to do and what they need money for. It also spells out the consequences if a task is not done.
2. Evaluate and rank these packages in terms of a cost-benefit analysis, which is an analysis by which the anticipated costs are compared with the benefits obtained from them.
3. Allocate revenues on the basis of need. Decision packages provide the manager with a mechanism for evaluating and comparing various organisation activities. They also evaluate and describe a functional activity or a departmental structure. They enable the manager to rank activities in an order of priority so that resources can be allocated realistically. The preparation of these packages starts with the comprehensive analysis of the status of current activities in the department by the manager or supervisor. The manager considers the alternatives available for executing the functions and selects the most suitable plan of action.



The section is now analysed from a zero base. The most important activity is now regarded as top priority and the list is completed in order of importance. The ranking lists of the different sections are now sent to the manager. The manager and supervisors involved in the process then determine which activities will be funded and which will not. Funds are now allocated to each section in keeping with the priorities. Only those activities that can be justified are included in the budget, which helps to eliminate the wasting of financial resources. The budget is therefore used to compare the actual expenditure with the planned expenditure and to expose any deviations monthly. This can be done weekly, depending on the various factors already discussed.

Questions

- What is meant by a zero-based budget?
- What are the three steps in zero-based budgeting?

2.3.3 Revision of the budget

Unforeseen circumstances sometimes make it necessary to revise the budget. Operating or other expenses can rise and internal and external circumstances can change. Salary increments, rent increases and telephone rates can change during the year. Such changes may force you to make adjustments that have to be reflected in the budget.

The following three methods of review can be used:

1. Review can be built into the system. For example, it can be decided that the budget has to be reviewed every two months, for example, for the remainder of the year. This is called the **periodic review**.
2. The budget can also be subjected to a **progressive review**. This means, for example, that every two months the budget is reviewed in advance for the following six months.
3. With **moving review**, the budget is reviewed each month for the following year. As soon as one month has passed, budgeting is done for the same month of the following year.

The review method used depends on what best suits the organisation's circumstances.



| OFFICE BUDGET SHEET FOR THE 6 MONTHS ENDING 31 DECEMBER 2016 | | | | | | | |
|--|------|-----|-----|-----|-----|-----|-------|
| | July | Aug | Sep | Oct | Nov | Dec | TOTAL |
| EXPENDITURE | R | R | R | R | R | R | R |
| Salaries | | | | | | | |
| Pension fund contribution | | | | | | | |
| Medical aid contribution | | | | | | | |
| UIF | | | | | | | |
| Accrued pay for leave | | | | | | | |
| Office rent | | | | | | | |
| Water and electricity | | | | | | | |
| Stationery | | | | | | | |
| Printing | | | | | | | |
| Postage | | | | | | | |
| Telephone | | | | | | | |
| Maintenance of equipment | | | | | | | |
| Depreciation of equipment | | | | | | | |
| Leases | | | | | | | |
| <i>General</i> | | | | | | | |
| Etc. | | | | | | | |
| TOTAL EXPENDITURE | | | | | | | |
| | | | | | | | |
| INCOME | | | | | | | |
| Sales | | | | | | | |
| Rental | | | | | | | |
| Services rendered | | | | | | | |
| TOTAL INCOME | | | | | | | |
| TOTAL NET EXPENDITURE | | | | | | | |

Figure 2.2 Example of a form that can be used for an office budget

A 'General' column in the budget should be used carefully. By using it, it is possible to incur significant but unauthorised expenditure. All expenditure entered under 'General' must always be specified.

Questions

Name the three methods for reviewing budgets.
Explain the differences between the three methods.



2.4 The reasons for drawing up a budget

The following are the reasons for drawing up a budget:

- It is a formal framework that an organisation can use to make forecasts and sets goals.
- It can be used as a control mechanism for comparing actual and budgeted results.
- It serves as an aid to financial planning. Capital requirements are determined in the budget. This enables the organisation to make provision for its financial needs at an early stage.
- It creates cost-awareness among staff and contributes to the effective utilisation of resources.
- It is an aid to financial control.

Financial managers are fully aware of the costs associated with the different functions, and by controlling these costs the profit of the organisation can be increased. Difficult economic situations arise when resources, especially money, are limited. Financial managers must therefore do the best they can with the resources available.

2.5 Conclusion

Any business should plan and control its expenses and revenues. This is done by making use of a budget. As an aid to financial planning, a budget provides a forecast of expenses and revenues, and informs decision makers whether the business is performing according to plan. Different budgets are used for different areas of the business. Preparing a budget includes the budget period, the development of the budget and the revision of the budget. Although it is often not easy to make forecasts when preparing a budget, it remains a useful tool in managing the finances of a business.

2.6 Self-assessment

1. Explain the different types of budgets.
2. Prepare an example of a one-year budget for the office.
3. Explain why it is better to use zero-based budgeting rather than the traditional way of budgeting.
4. 'Revising the budget is not possible.' Critically discuss this statement.
5. List the reasons for drawing up a budget.

Buying and selling



Learning outcomes

At the end of this chapter, you should be able to:

- describe the business transaction in detail;
- discuss the purpose of commercial documents;
- discuss the conditions of sale in detail;
- discuss the calculation of the selling price of goods; and
- calculate discount allowed to the buyer.

3.1 Introduction

The main objective of any organisation is to make a profit by selling products or providing a service. In order to reach the profit objective, organisations are involved in a network of transactions. These transactions require the constant communication of information about prices, costs, orders, deliveries, payments and related issues. All this information is contained in business documents, which serve as records and proof of the transactions.

In this section we will focus on the business transaction of buying and selling of products and the documentation that accompanies it.

3.2 The business transaction

A business transaction is an economic activity or event that initiates the accounting process of recording it in the accounting system of the organisation. The seller of a product offers goods or services for sale and the buyer offers or agrees to pay the specified price for the product.

The details of a business transaction are always noted down by completing a document. These documents are usually filled out at least in duplicate because they need to serve as the basis for recording transactions in the accounting system of the organisation. Documents are classified as internal and external documents:

- **Internal documents** are all documents completed by the organisation and will be in the form of duplicates (copies). An example of this is the copy of the invoice the organisation retains when selling goods. The original invoice and goods are delivered to the buyer.
- **External documents** are documents received from other organisations and will be the original documents. An example of this is the original order the organisation receives from the buyer when purchasing goods.

The flow of internal and external documents in a buying and selling transaction is illustrated in Figure 3.1.

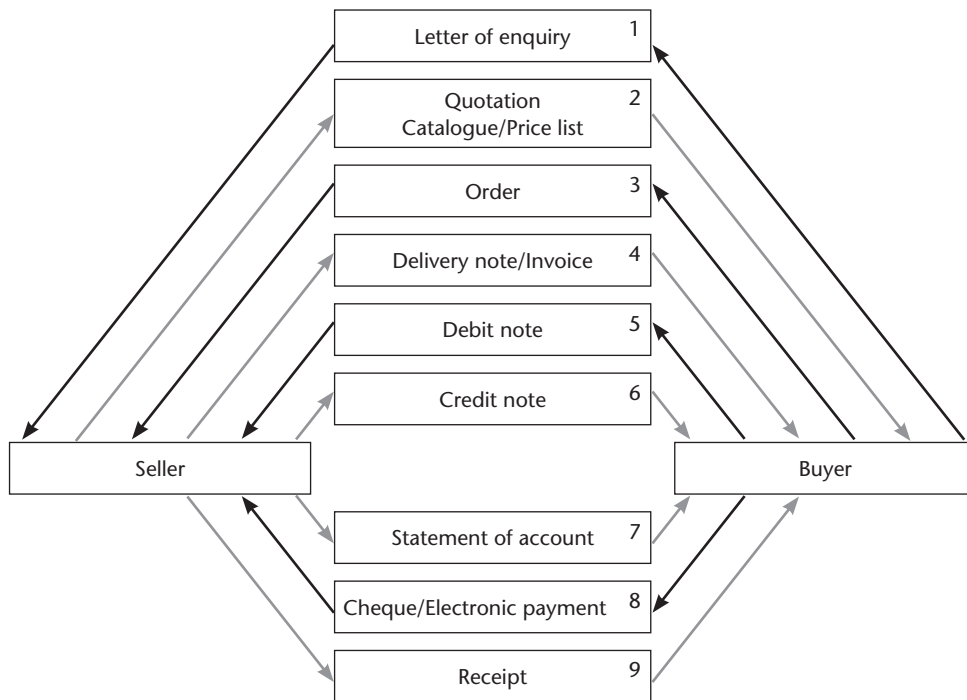


Figure 3.1 Flow of documents in buying and selling transactions

3.3 Commercial documents

The commercial documents described in Figure 3.1 and the purpose of each document will be discussed in this section.

3.3.1 Letter of enquiry

A letter of enquiry is sent to various suppliers of a specific product. The letter of enquiry requests information about the product, including the product specifications, prices, delivery dates, and availability of stock. Sometimes a letter is not necessary; an organisation can obtain this information by calling the supplier or sending an email to request such information. The information can also be obtained from price lists, catalogues and representatives.

3.3.2 Quotation

The quotation is a reply from a potential seller in response to the letter of enquiry that was received from a potential buyer. The quotation is a written and binding offer to sell the goods mentioned in it. If the potential buyer accepts the conditions and places an order, the potential seller may not refuse to deliver the goods according to the mentioned conditions. The quotation can also be referred to as a bid, quote, estimate, tender or proposal.



The quotation usually contains the following conditions of sale:

- the quantity;
- the quality of the goods or service;
- the price;
- the date of delivery;
- the date and method of payment; and
- the tenor of the quotation (the expiry date of the quotation).

Note

See section 3.4 for further discussion on the conditions of sale.

3.3.3 Order

A price quotation is a potential seller's written and binding offer to sell the goods and an order is a potential buyer's written acceptance of the offer. The order concludes the contract between the two parties and officially qualifies them as 'seller' and 'buyer' respectively. Legal action may be taken against either party that does not fulfil the conditions of the contract.

The order is placed once the buyer has decided from which supplier to buy. An order is a request or an instruction to the seller to deliver the goods specified on the order. An order is usually made on a printed form and is completed in duplicate. The seller receives the original, while the buyer keeps the copy. Each order form has an order number, which is used as a reference number. The order should be completed by using the exact particulars quoted in the quotation and should reach the seller within the time limit of the stated expiry date.

The seller will check the information on the order against the conditions of sale as stated in the quotation. If it is correct, the seller will send the buyer an acknowledgement of the order. This indicates that the order has been received and that the goods will be supplied.

3.3.4 Invoice

The invoice is issued by the seller to the buyer. It identifies both the seller and the buyer and lists, describes, and quantifies the items sold, their prices and discounts (if any), and the delivery and payment terms. The invoice is also called a bill of sale or a contract of sale.

If an organisation has given a quotation to a potential buyer and receives the potential buyer's order, an employee in the organisation's sales department drafts an invoice from the order that was received. The invoice is drafted in duplicate and the original is always sent to the buyer with the ordered goods. The copy of the invoice is forwarded to the debtor's ledger clerk who debits the customer's (buyer's) account in the ledger with the total amount stated on the invoice. The copy of the invoice is retained until the buyer has settled the account, as it serves as proof that the buyer purchased the goods.



The invoice is then forwarded to the warehouse manager who gathers the goods and forwards them to the packing and dispatch department, where they are packaged into containers along with the invoice. If more than one container is used for the goods, the containers will be numbered and the invoice is usually packed into the box marked 'No. 1', as it is easier for the buyer to locate it when unpacking the goods. A delivery note is also prepared.

3.3.5 Delivery note

The seller completes a delivery note when the goods are delivered. The delivery note is similar to the invoice, except that it does not show any prices. The delivery note, together with the containers, is carried by the driver of the delivery vehicle and serves as the delivery instructions. The delivery note shows the name and address of the buyer in order to ensure the correct delivery of the goods. The delivery note is made out in duplicate, and the buyer is required to ensure that all the containers mentioned on the delivery note are received. The buyer keeps the original copy of the delivery note and the driver returns with a signed copy as proof of delivery. The buyer does not sign as proof of satisfaction with the contents of the containers but only to confirm receipt of the containers.

3.3.6 Debit note

If the buyer opens the containers after delivery and finds that some of the goods are broken or not what was ordered, the goods should be returned to the seller. As the seller's account has been debited in the buyer's books, a debit note should accompany the goods that are being returned, indicating that the account has been debited, as well as the reason for the action. A similar routine should be followed if the seller's calculations are incorrect or when empty containers are returned to the seller.

3.3.7 Credit note

When the seller receives the buyer's debit note with the damaged goods, proof of overcharge or undamaged containers, a credit note or credit memo is used to adjust or rectify errors made in a sales invoice that has already been processed and sent to a customer. It is like a 'negative' invoice. A credit note is sent to the buyer indicating that the account of the buyer has been credited in the seller's ledger.

3.3.8 Statement of account

A statement of account is a copy of the buyer's ledger account in the seller's debtor's ledger. The statement of account is a record of the buyer's transactions with the seller that occurred during the month. The statement of account may be compared against the buyer's own record of the transactions that appear in an account for the seller in the buyer's creditor's ledger. This action of comparing the statement of account against the seller's account in the buyer's own ledger is referred to as reconciling the account.



3.3.9 *Payment*

On receipt of the statement of account, the creditor's ledger clerk reconciles it with the account of the seller. If all transactions are in order, the clerk signs the statement and forwards it to the firm's cashier for payment. Organisations can effect payment by writing a cheque, making an electronic transfer or using an online payment system like PayPal.

A cheque is a negotiable instrument that can be issued by the buyer to pay money to the seller. The seller is entitled to receive the sum mentioned in the cheque from the bank where the buyer holds his account.

Electronic funds transfers (EFT) is a convenient method of payment whereby the buyer can pay the seller without issuing a cheque or using cash. Funds are moved between different accounts in the same or different commercial banks, through the use of wire transfer, automatic teller machines or computers.

Online payment systems (such as PayPal) can be used to send and receive payments through the Internet. A user has to sign up for an account. The approved systems are safe since no credit card or bank account numbers are visible to the person receiving money online. When sending money, a user can choose to fund payments from the payment system's account balance, a credit card or bank account. Recipients are then notified via an email from the online system that they have received a payment from the user. To be able to receive money, users have to supply their user address to the individual or business who owes the user money. Once the money arrives, the user will get an email stating that funds have been received and the user will see the transaction in the account history.

3.3.10 *Receipt*

On receipt of payment for goods and/or services, a receipt is issued by the seller as proof of payment. The original is given to the customer and the seller keeps a copy. The customer's account is credited with the amount paid.

3.4 *Conditions of sale*

The quotation is a written and binding offer to sell the goods mentioned in it. If the potential buyer accepts the conditions and places an order, the potential seller may not refuse to deliver the goods according to the mentioned conditions of sale. This section covers the conditions of sale stated in the quotation in more detail.

3.4.1 *The quantity*

This is self-explanatory and refers to the quantity of products that the buyer buys or seller sells. Often discounts are given when larger quantities are bought. Services provided must be explained in detail, referring to the time taken and what exactly needs to be accomplished.



3.4.2 The quality of the goods or service

Quality refers to peculiar and essential characteristics of goods that have been ordered. Quality is not always easy to describe, so it must be ensured that the buyer and seller have the same quality in mind when buying goods. Quality can be indicated in the following ways:

- **Description** (also called **specification**) – The product is described accurately in terms of content, specifications, performance, durability, outcome and size. The specification lists the raw materials used in the manufacture of the product, for example in canned fruit it could specify ‘only first-grade fruit used’ or in curtaining fabric it could say ‘pure mohair used’.
- **Trademark** – A trademark is a registered name, design or a symbol the owner or producer places on the product. This distinguishes the specific product from other similar products or products produced by competitors. A product with a specific trademark proves that the product is of the specific quality associated with that trademark. Consider the different trademarks used in clothing, for example Nike, Adidas, Puma and Roxy.
- **Sample** – A part of a product or one example of a product is representative of the entire product or the entire batch. The seller thus guarantees that the entire batch has the same quality as the sample. Consider the following two examples:
 - A buyer interested in purchasing carpeting could be sent a sample of the carpet to examine in detail at leisure.
 - A business enquiring about staff uniforms may be sent a sample uniform by a clothing factory in order to establish the quality of the fabric and craftsmanship.
- **Grade** – Some products, such as agricultural and mining products, are graded according to the quality of that product. Such grades are set by control boards that enforce the grading regulations. For example, meat is graded in A, B, C and D grades, while potatoes are graded as first, second and third grade.

Suppliers may use more than one of the abovementioned methods to indicate the quality of a product in order to convince potential buyers to purchase it.

3.4.3 The price

The price is what the buyer pays for the product or service. It is important to be specific about what is included and what is not included in a price quoted or charged. Both parties must know exactly what the situation is. The following prices will be quoted for local trade:

- **Loco price** – The loco price is the price on the premises of the seller (over the counter). The buyer has to organise and pay for packing and transporting the goods to his premises. For example, if the loco price reads ‘loco price = R30’, the buyer pays the seller R30 and the buyer is responsible for packing and transporting the goods to the final destination.



- **Free on rail (FOR) price** – In this case the seller is responsible for packaging and transferring the goods to the railway station nearest to the seller's place of business. The packing and transportation of the goods to this station is included in the price quoted to the prospective buyer. This price will be higher than the loco price. For example, if the seller's business premises are located in Mabopane, the quotation for the same goods mentioned under the loco price would read as follows: 'Free on rail price Mabopane = R42', which would include the loco price of R30, the packing cost of R5 and the transfer fees from the seller's premises to Mabopane station of R7. The buyer is responsible for the railage and delivery costs from the station to the buyer's business premises.
- **Railage paid price** – This price includes the free on rail price as well as the railage costs between the seller's nearest station and the station closest to the buyer, which means it will be more expensive than the FOR price. The buyer does not have to pay for the transportation separately; it is included in the railage paid price. The buyer is responsible for transport charges from the station to his/her own business premises. For example, if the buyer's business premises are located at 22 Malerato Road, Polokwane, the seller may submit the following quotation: 'Railage paid to Polokwane = R50'. The seller is responsible for the R8 charged for raling the goods between Mabopane station and Polokwane station.
- **Franco (or free) price** – When this price is quoted to a potential buyer, it indicates to the buyer that no additional charges will be charged, as this price includes all costs from the seller's premises to the buyer's premises. This is the most expensive type of quotation. The quotation may read as follows: 'Franco price = R55'. This means that the delivery cost from Polokwane station to 22 Malerato Road amounts to R5.

Questions

Explain the difference between free on rail price and railage paid price.

What are the reasons why organisations do not always pay the loco price for goods.

Pricing is the process of applying prices to products, purchase and sales orders. The price of a product is determined by factors such as the fixed cost of production, the quantity produced, promotion or sales campaign and the prices of other similar products.

In any organisation where goods are bought with the idea of selling them at a profit, the selling (loco) price has to be calculated carefully. The following example will illustrate how to calculate the selling price of products.



Example

Making a profit is your objective. This means that you have to sell a product for more than what it cost you, including all the costs involved in obtaining and having the product available.

You buy a product for R20 000. This is the purchase price. You sell it for R25 000. What is your profit? Is it R5 000? Surely not! What about all the other costs, such as transport, electricity, rent of the warehouse/office space, insurance, salaries, etc.? You need to incorporate all your expenses, otherwise where will the money come from to pay them?

Let us do a simple calculation.

| | |
|---|----------------|
| Purchase price of a product: | R20 000 |
| Plus all other costs involved with the product: | R11 000 |
| Transport | R200 |
| Electricity | R200 |
| Rent | R500 |
| Insurance | R100 |
| Salaries | <u>R10 000</u> |
| Equals the cost price of the product: | R31 000 |

If this product costs you R31 000, you will have to sell it for more than R31 000 in order to make a profit. Profit is the money that is left over when all the expenses (called overheads) are paid, including salaries. If your profit margin is 20%, then the selling price would be the cost price plus 20%. In this example the selling price would be:

$$\begin{aligned} & \text{R31 000} + 20\% \text{ of R31 000} \\ &= \text{R31 000} + \text{R6 200} \\ &= \underline{\text{R37 200}} \end{aligned}$$

The price of anything is usually negotiable, and as the price of goods has a direct influence on the organisation's profit, the buyer should negotiate the best price. The price of goods can be influenced in the following ways:

- Larger order quantities are sometimes cheaper.
- Long-term relationships with suppliers also create a situation where discounts are possible.
- The closer a supplier is to your premises, the cheaper the transport costs.
- The higher the demand for a certain product, the higher the price.
- The exchange rate will influence the price if products are imported.
- The means and speed of transport usually have an effect on the price. To fly a product in from another country is quicker, but much more expensive, than shipping it.
- The quality of the goods will influence the price.



3.4.4 *The date of delivery*

The buyer and the seller must agree on the date of delivery. This date is indicated on the quotation. This is very important, as ownership usually passes to the buyer on delivery. If anything happens to the goods after delivery, it is the buyer's responsibility. The following delivery options are available:

- **Immediate delivery** – Goods must be delivered when ordered. Of course, the supplier must have sufficient stock to match the order.
- **Delivery on a stipulated future date** – The buyer requests in the letter of enquiry that the order be executed on a specific future date. For example, a person arranging a wedding may direct a letter of enquiry to a florist requesting delivery of flowers on a specific date.
- **Forward or instalment delivery** – This type of delivery is requested by a buyer who requires goods to be supplied at regular intervals. For example, a restaurant may require ten dozen eggs to be delivered each week for a period of a year.

It may however, also be quoted by a seller that cannot deliver the complete order in one lot but could deliver a portion of the order at regular intervals in equal batches. For instance, if a factory's capacity to manufacture shoes amounts to 400 pairs per week and it receives an order to supply 3 200 pairs, the quotation may read as follows: 'Delivery: in instalments of 400 pairs per week over eight weeks, the first delivery to take place on Friday, 7 November 2016'.

- **On arrival** – The supplier does not have sufficient stock and delivers as soon as the stock is received. This often happens when goods have to be imported.

3.4.5 *The date and method of payment*

The date and method of payment are agreed upon by both the seller and the buyer. The specific method of payment quoted will depend on whether the buyer is known to the seller and on the creditworthiness of the potential buyer. Creditworthiness means whether the buyer has a good record for settling accounts and is known as an honest and reliable person, particularly in the business world. The quotation stipulates when and where the payment must be made. The following agreements are possible:

- **Cash** – The buyer must pay the seller in cash within a specified time.
- **Cash with order (CWO)** – Payment is made when the order is placed. This will be quoted to a potential buyer who has failed in the past to make payment on the due date or is not known to the supplier and not able to present reliable references of creditworthiness.
- **Cash on delivery (COD)** – Payment is made when the goods are delivered. This method of payment is quoted to a buyer who has a record for not making payment by the due date, is not known to the seller and/or does not have proof of creditworthiness.
- **Cash against invoice (CAI)** – This method of payment is quoted in reply to a letter of inquiry, where the customer has previously been supplied with goods against the CWO or COD methods of payment. The customer has made payment



according to the quotation and has created a record of creditworthiness. A creditworthy customer may be supplied with goods, to be checked against the enclosed invoice, before settling the quoted price. The period allowed for making payment is within seven days of delivery.

- **Thirty days less 10%** – The number of days and the percentage need not be 30 days and 10%; these are decided upon by the seller when quoting. This type of payment is quoted to known and trusted customers – customers that the seller wants to retain.

This type of payment means that the buyer will be given 30 days, from the date on the invoice, in which to settle the account. The customer will be given 10% discount, when payment is made within 30 days. The buyer is encouraged to purchase from the seller in order to use the 30 days to sell the goods and then to use the money earned to settle the amount owing, while qualifying for a 10% discount.

This type of contract offers the seller the benefits that payment is almost guaranteed and that the customer often buys on a large scale.

The following is an example of how to calculate discount.

Example

| | | |
|---------------------|---------------|------------------|
| Gross invoice value | R10 000 | |
| Less 15% discount | – R1 500 | (0.15 × R10 000) |
| Net value of goods | <u>R8 500</u> | |
| Plus 14% VAT | + R1 190 | |
| Total amount due | <u>R9 690</u> | |

- **Thirty, sixty or ninety days bill against invoice** – The buyer has to accept a bill of exchange when the invoice is received. The draft bill is usually enclosed with the invoice and must be returned to the seller after acceptance. Payment must occur within 30, 60 or 90 days after acceptance of the bill.

The payment details are usually also given on the quotation or on the invoice. This will include the bank, branch number, account number and of course all the details of the payment (such as deposits, final payment, etc.). In the case of online system payments, the email address should also be provided.

3.4.6 Expiry date

A seller should quote an expiry date on the quotation to prevent the buyer from retaining the quotation for a lengthy period and then placing an order, expecting to receive the conditions offered in the quotation. If no expiry date is mentioned, then the buyer may place an order after a price increase and may expect to purchase the goods at the initial quoted price.

This condition of sale may be quoted as follows: ‘Expiry date: 26 June 2016’ or ‘This quotation is valid for 10 days from date of issue.’



3.5 Conclusion

Buying and selling are integral parts of most businesses. A seller offers goods or services for sale and a buyer pays a specified price for the products or services. The two parties usually agree on the quantity, price, method of payment, due date, the date of delivery, and the expected quality of the goods or services. A variety of internal and external documents are used to conclude such business transactions.

3.6 Self-assessment

1. Discuss all the commercial documents used in a business transaction according to their purpose for both the seller and the buyer.
2. Discuss the conditions of sale under the following headings. Give examples where applicable.
 - The quantity
 - The quality of the goods or service
 - The price
 - The date of delivery
 - The date and method of payment
 - The expiry date
3. Discuss the calculation of the selling price of goods.
4. Calculate a discount of 20% on a gross invoice value of R400.
5. What is the difference between a quotation, an order and an invoice? Answer this question by giving a brief explanation of the use of these commercial documents.

Wages and salaries



Learning outcomes

At the end of this chapter, you should be able to:

- differentiate between wages and salaries;
- distinguish between gross and net salary;
- identify various options used in the business environment for remuneration;
- explain the methods for calculating wages and salaries and complete a statement;
- explain the types of deductions; and
- discuss the features of a payroll system and list the advantages.

4.1 Introduction

Wages and salaries are forms of remuneration (payment or compensation), which is a method of payment for the time and effort spent by an employee to do work for an organisation. There is a difference between wages and salaries. An individual who is paid a salary receives a predetermined fixed amount for each specific pay period (weekly or monthly). The salary is the total of all these fixed payments over a period of twelve months. This person is considered to be an 'exempt' employee, with no connection between the amount paid to the person and the number of hours he or she worked. An employee who receives a salary is paid throughout a specific period and is paid on a specific pay date, because it is easy for the payroll staff to calculate the salary, which is a fixed rate of pay.

An individual who receives wages is remunerated per hour multiplied by the number of hours worked. This person is considered to be a 'non-exempt' employee. If a person earns a wage, he or she is usually paid for the days worked, prior to the pay date. This is because their hours may vary and the payroll staff need a number of days to calculate the earnings involved. If there is a gap between the last day worked and the pay date, that gap is paid during the next period. This gap does not exist for workers who earn a salary as they are paid on a specific date.

Employees sacrifice their personal time to work for an organisation and in return they expect to be rewarded for the work that they have done. In this chapter we will also look at the methods used to calculate the remuneration (wages or salaries), including the possible deductions.

4.2 Employee records

Employee records are private and confidential and nobody should have access to them except the employee, their employer and relevant payroll staff. Copies of employee records can be made for reference by future employers and be provided to employees or former



employees. The following records contain private information regarding employees and are used to compile the labour records in the South African business environment:

- **Personnel records** – The personnel department is responsible for all the administration of personnel records (also referred to in organisations as personnel files) such as job applications, qualifications, the employment contract, salaries, job descriptions, leave and termination.
- **Clock cards** – The clock card is an official document and is used by the payroll department to calculate the actual hours worked (including overtime) by an employee and the gross pay. There are electronic clock cards available where the card is inserted in a machine referred to as a clock card machine. The machine punches in or prints the time the employee attends work (time in) and leaves work (time out) for each day worked. Other methods of recording the time employees clock in and clock out are fingerprint scanners or software that allows employees to clock in and out by either using a keyboard or by the click of a mouse button.
- **Job cards** – This document contains information regarding the actual job and the time it took an employee to execute the task and what materials were used.
- **Time sheets** – This is a sheet that an employee completes daily containing information about the hours worked. Time sheets are used to calculate the number of hours that an employee has worked per day. These sheets are mainly used by the payroll department to calculate the number of overtime hours and gross pay.

4.3 Labour remuneration

An employee receives compensation in the form of remuneration for work done or services rendered. Remuneration comes in a form of monetary value, such as wages, salaries, bonuses and cash incentives, but can also be in the form of fringe benefits, such as company vehicles, insurance and housing subsidies. This section covers how remuneration can be paid or calculated.

4.3.1 *Monthly salary or fixed rate method*

This type of payment refers to a fixed amount that is paid monthly on a fixed date by the employer to the employee. The employee who falls into this category will receive the same amount regardless of the hours worked or any overtime done. If a fixed amount is paid on a weekly basis, it is called wages.

4.3.2 *Time rate salary method*

The employee will be paid according to the amount of hours spent at work. The employee receives payment by the hour and not a fixed amount. To calculate the remuneration of such employees, the number of hours worked will be multiplied by the wage rate (pay per hour).

These types of employees work eight hours daily, for example, and when they are required to work more than eight hours a day, they receive what is known as overtime. The maximum hours that an employee may work in South Africa is 45 hours per week.



Overtime is the amount of time that an employee has worked over and above their normal hours or, more specifically, it refers to extra hours of work. The payment for overtime is usually more than the normal hourly rate. For example, overtime on normal working days is the usual rate plus half of the usual rate. Overtime on Sundays and public holidays is double the usual rate according to the South African Employment Act of 2002 (South African Labour Guide, 2014).

Example

An employee works 11 hours of the day instead of only 8 hours, working 3 additional hours overtime on a normal day. Calculate the payment for this day if the employee is paid at R30 per hour.

| | |
|--------------------------------|---|
| Normal hours: | 8 hours × R30 = R240 |
| Overtime calculation per hour: | R30 × 1.5 (half of normal payment) = R45 per hour |
| Overtime: | 3 hours × R45 = R135 |
| Total payment | = normal hours paid + overtime paid |
| | = R240 + R135 |
| | = <u>R375</u> for the day |

4.3.3 Piece rate method

The employee is remunerated according to the number of units produced or for a piece of work done. A wage rate is set for every unit produced. Employees could also qualify for some kind of bonus payment to serve as motivation. Employees working for commission only fall under this category where they receive only commission.

Example

Thabo is remunerated at R1.50 for every unit produced. He produces 100 units a day. Calculate his payment for a day's work:

$$100 \text{ units} \times R1.50 = R150.00 \text{ per day}$$

4.3.4 Fixed salary plus commission method

Under this method of remuneration the employee receives a commission, normally a predetermined percentage on all sales in addition to a base salary. This method is used successfully in industries that fall under retail and services in the beauty industry, for example.



4.3.5 *Performance pay method*

When employers commit to a performance-based remuneration structure, they make payments to their employees purely based on certain completion points, performance ratings or project metrics. These types of pay structures focus mainly on employee performance, giving employees a greater level of control over their own earnings by meeting specific goals and deadlines.

Questions

What is the difference between a wage and a salary?

What are the advantages of being paid by the piece rate method?

4.4 Gross and net salaries

Gross salary is the exact amount of money due to the employee before any deductions. Net salary means that all the deductions were made and that the amount shown at the net salary section on the payslip is the actual amount that the employee will receive. Employees often refer to their net salary as the 'take-home' pay. This will become clearer in the example that follows later in this section.

4.5 Deductions

Deductions are those amounts that are deducted from an employee's income. The amount that is left after deductions is the net wage or salary that is payable to the employee. Some of the deductions are compulsory and others are not. Generally, an employer does not have the right to make any deductions from an employee's remuneration without the written consent of the employee, excluding any statutory deductions such as PAYE, UIF, deductions required by Court Order and retirement fund and medical aid contributions (South African Labour Guide, 2014). An example of a compulsory deduction is tax. Examples of non-compulsory deductions are payments to life policies and subscriptions to belong to unions. Employees do not have to pay for non-compulsory deductions if they do not wish to do so.

Examples of deductions that are found in the contemporary business environment are discussed below.

4.5.1 *PAYE – personal income tax*

PAYE is the term used for 'pay-as-you-earn' tax. This tax must be deducted from the gross salary of the employee. The more the employee earns the more he or she will pay in the form of tax. The deduction of tax must be done after the pension fund contribution has been deducted. The Receiver of Revenue sets the tax rates (the amount of tax employees have to pay).



4.5.2 Medical aid

Medical aid contributions can also be deducted from an employee's pay (see paragraph 4.7.1). Medical aids cover or partly cover employees (and their families) financially in the event of any health-related issues. When an employee contributes to a medical aid and it reaches a point where the benefits are used up, the employee is responsible for covering any medical expenses. A certain part of these extra payments can form part of tax relief at the end of that particular financial year.

4.5.3 Unemployment Insurance Fund (UIF)

Employers are obliged by law to pay unemployment insurance contributions of 2% of the value of each employee's earnings per month. The employer and the worker equally contribute 1%. Contributions are paid to the Unemployment Insurance Fund (UIF) or the South African Revenue Services (SARS). Contributions to the UIF ensure that employees will still receive an income in the event of losing their jobs, pregnancy or because of illness. The UIF is a compulsory payment that is calculated on the gross wage of the employee.

4.5.4 Pension

This is a contribution that is made by either the employee or both the employee and the employer. The pension fund contribution is tax deductible, meaning that the pension fund contributions are deducted before tax is calculated. This only refers to normal time worked and does not include money for overtime worked. The purpose of a retirement fund is to provide members and their dependants an income once they retire. A member of a pension fund is entitled to receive up to a maximum of one third of his or her retirement benefit as a cash pay-out (lump sum) on retirement and the remaining funds (two-thirds) to be paid out monthly thereafter. If a member decides not to take a cash pay-out, the full benefit will be paid to the member on a monthly basis, meaning that the monthly amount received will be higher. The contributions made to a fund may also be taken by employees when they resign and leave an organisation.

4.5.5 Provident fund

The purpose of a provident fund is to provide employees and their dependants (if any) with an income once they retire. Members of provident funds can choose to receive the entire retirement benefit as a once-off lump sum. Although they will be taxed on a portion of the contributions, a certain portion may be regarded as tax free. Provident funds allow members to make additional contributions to their retirement savings, unlike pension funds, and they also offer greater flexibility.

4.5.6 Sundry deductions

Some larger organisations also deduct 'stop order' payments or similar monthly instalments that may be made on behalf of the employee. These deductions will differ from employer



to employer. Examples of such payments are group insurance and social club contributions. Personal deductions can also be made, such as home loan instalments.

Questions

What is the difference between a pension fund and a provident fund?
Is PAYE deducted from the gross salary or the net salary?
Which deductions are compulsory?

4.6 Alternative income methods

There is a variety of methods that people can use to earn extra income, over and above their salary. People can do this 'on the side', meaning outside their working environment, or the organisation can provide means for employees to earn additional income within their organisation. Some examples of ways to earn extra income are:

- cover your car with advertisements for promotional purposes;
- act as an agent for a direct selling company; and
- do freelance work.

The list of possibilities for earning extra money is limitless. Research on the Internet can produce a variety of ideas. The golden rule here is to be creative. Remember that any additional income that is made must be declared for tax purposes.

4.7 Documents involved during the payment of employees

In this section we will look at the different documents that are used in organisations to act as proof that employees are paid and to balance the organisation's books at the end of each financial period.

4.7.1 The wage sheet

The wage sheet is mostly used for the **time rate** category employees. The wage sheet should reflect the following: general information, wages, duration of work, indemnities and any possible deductions. Wages are generally calculated as follows:

Wages
+ other components (such as bonuses and allowances)
+ indemnities (such as annual leave)
= Gross wages
– deductions
= Net wages

Figure 4.1 on page 40 reflects the different matters of importance that should be reflected on a wage sheet.



| | |
|--|-------------|
| WAGE SHEET OF _____ (complete the information for the employee) | |
| Normal wage (____ hours @ R ____ p/h) | <div></div> |
| + Overtime wage (normal ____ hours @ R ____ p/h) | |
| (Sundays and public holidays (____ hours @ R ____ p/h) | |
| + Bonus | _____ |
| + Car allowance (also a form of income and is taxable) | _____ |
| = GROSS WAGE (INCOME BEFORE DEDUCTIONS) | _____ |
| - Pension (remember, pension must be deducted before taxation for PAYE and only on normal working hours, not on overtime) | _____ |
| = TAXABLE INCOME | _____ |
| - Deductions | _____ |
| Tax [____ % of R ____ (taxable income)] | <div></div> |
| Loans | |
| Medical aid [____ % of R ____ (normal wage)] | |
| UIF (Unemployment Insurance Fund) | |
| = NET WAGE | <div></div> |

Figure 4.1 An example of a blank wage sheet

Test your knowledge

One of the employees of TK TRADERS, Mrs Sarah Ndube, is remunerated @ R25 per hour. When working overtime, she is remunerated at one and a half times the normal hourly rate and on Sundays at two times the normal hourly rate. The following weekly deductions are made:

- | | |
|----------------|------|
| ▪ Tax | 35% |
| ▪ UIF | R10 |
| ▪ Medical aid | 5% |
| ▪ Pension fund | 7.5% |

During the week ending 6 September 2016, Sarah worked 47 hours. She worked 2 hours on that Sunday. A normal working week consists of 40 hours for this example. Complete the wage sheet for Sarah Ndube.



Answers

WAGE SHEET OF Sarah Ndube (complete the information for the employee)

| | |
|---|------------------|
| Normal wage (40 hours @ R 25 p/h) | R1 000.00 |
| + Overtime wage (normal 7 hours @ R 37.50 p/h) | R262.50 |
| (Sundays and public holidays (2 hours @ R 50 p/h) | R100.00 |
| = GROSS WAGE (INCOME BEFORE DEDUCTIONS) | R1 362.50 |
| – Pension | – R75.00 |
| = TAXABLE INCOME | R1 287.50 |
| – Deductions | – R510.63 |
| Tax [35% of R 1 287.50 (taxable income)] | R450.63 |
| Medical aid [5% of R 1 000.00 (normal wage)] | R50.00 |
| UIF (Unemployment Insurance Fund) | R10.00 |
| = NET WAGE | R776.87 |

4.7.2 Salary statement

A salary statement is used to calculate manually the net salaries for the **fixed rate** (monthly salaries) category employees. This method is mainly used in smaller companies and businesses. The following is an example of a salary statement:

Example

The following figures are the salaries and deductions for the three employees of JK TRADERS. You should be able to complete a salary sheet like the one below for these employees (Thabo, Nel and Kotze) for February 2016.

| Employee number | Name | Gross salary | Medical aid | PAYE | Pension | Sundry expenses |
|-----------------|----------|--------------|-------------|------|---------|-----------------|
| | | R | R | % | % | R |
| 16 | J. Thabo | 2 600 | 105 | 15 | 8 | 22.20 |
| 17 | K. Nel | 3 200 | 75 | 18 | 8 | 18.00 |
| 18 | P. Kotze | 2 400 | 84 | 19 | 8 | |





| Salary Statement for JK TRADERS for FEBRUARY 20.. | | | | | | | | | | |
|---|----------|--------------|--------------|---------|----------------|------------|---------|--------|------------------|-----------------|
| No | Employee | Gross salary | Total income | Pension | Taxable income | Deductions | | | Total deductions | Net salary |
| | | R | R | R | R | PAYE | Medical | Sundry | R | R |
| 16 | J. Thabo | 2 600 | 2 600 | 208 | 2 600 | 358.80 | 105.00 | 22.20 | 486.00 | 1 906.00 |
| 17 | K. Nel | 3 200 | 3 200 | 256 | 2 944 | 529.92 | 75.00 | 18.00 | 622.92 | 2 321.08 |
| 18 | P. Kotze | 2 400 | 2 400 | 198 | 2 202 | 330.30 | 84.00 | | 414.30 | 1 787.70 |

4.7.3 Payslip

According to the Basic Conditions of Employment Act (South African Labour Act, 2014) every employee should receive a payslip after each pay period. Government departments refer to a payslip as a salary advice. The payslip can be weekly or monthly, according to the contract between the employer and employee. It is the employer's duty to supply its workers with the following information in writing when they receive remuneration:

- details of the employer – name and address;
- details of the employee – name and occupation (position);
- payment period;
- gross salary package (before deductions);
- South African Revenue Services (SARS) tax number if the employee is registered to pay tax;
- all the deductions;
- the final amount that the employee will receive after deductions (net pay);
- if relevant to the calculation of the remuneration amount:
 - the employee's remuneration and overtime rates (if any);
 - the number of hours, both ordinary and overtime, worked;
 - the actual hours worked on a public holiday or a Sunday; and
- any other means of income (such as bonuses, allowances, incentives etc).

The purpose of a payslip is firstly to ensure that an employee actually receives the correct amount of remuneration and, secondly, it gives him or her the rightful opportunity to keep accurate and complete records of his or her earnings. Payslips can be issued to employees either electronically or as a hard copy. Electronic payslips should contain the same information that is on hard copies. It is popular in bigger organisations to issue electronic payslips to save on paperwork and so that the employees can easily keep track digitally of their own payslips.

Questions

Is it compulsory for an employer to give out a payslip?
What are the purposes of payslips?



| PAYSLIP | | | | BIG BUBBLE DOMESTIC INC. | | | | |
|-------------------------|-------------------------------|----------------|--------|---------------------------------|-------------|------------|--------------------------|--------|
| | | | | Date of payment: _____ | | | | |
| | | | | Pay period: _____ to _____ | | | | |
| Employee's name: _____ | | | | Tax number: _____ | | | | |
| Position: _____ | | | | Pension number: _____ | | | | |
| Leave days: _____ | | | | Sick leave days: _____ | | | | |
| EARNINGS | | | | DEDUCTIONS | | | | |
| Item | Description | Arrears | Amount | Item | Description | Reference | Arrears | Amount |
| | | | | | | | | |
| | | | | | | | | |
| Deposit institution | | Account number | Branch | Gross salary | Deductions | Net salary | | |
| | | | | | | | | |
| MESSAGE | | | | | | | | |
| | | | | | | | | |
| IRP5 PARTICULARS | | | | | | | | |
| 100 | Income (PAYE) | xxxx | 300 | Total employee tax | xxxx | 390 | Other allowances | xxxx |
| 108 | Pension contribution | xxxx | 432 | Pension fund contribution | xxxx | 154 | Medical aid contribution | xxxx |
| 445 | Medical aid | xxxx | 543 | Current retirement contribution | xxxx | 657 | Gross retirement income | xxxx |
| 435 | Capped amount | xxxx | 528 | Overtime (PAYE) | xxxx | | | |
| 431 | Subsistence allowance (excl.) | xxxx | | | | | | |

Figure 4.2 An example of a blank payslip

4.8 Payroll

In a technology-driven era, it is not surprising that digital ways of controlling the record-keeping of wages and salaries have taken the world by storm. Employees who work with personnel records and remuneration are specifically trained to use the software programs available in organisations.



4.8.1 The payroll system

A payroll system involves everything regarding the payment of employees and the filing of employment taxes. The system reflects the hours that an employee worked, calculates wages and salaries, calculates deductions and taxes, prints and delivers cheques and ensures that the employment taxes are paid to the government. It is thus a sum total of all the compensation that should be paid to the company's employees for a set period of time or on a predetermined date. When an employer withholds tax, the onus lies on that company to pay the necessary taxes to the relevant government departments (such as SARS and UIF) or the deductions (such as medical aid and pension) to the relevant companies (such as medical aids and pension fund providers).

4.8.2 Benefits of a payroll system

The use of payroll software in the organisation has numerous advantages to the organisation. These benefits include the following:

- **Calendars** – This feature assists with the management of sick leave, overtime and absences of employees.
- **Cost saving** – A trained employee can manage the system, meaning that it does not have to be outsourced to professional companies dealing with human resources matters.
- **Tax updates** – Payroll software informs the user if any mistakes were made during the capturing process and also issues alerts when possible new tax updates are available.
- **Creation of payslips** – There are a number of free software payroll packages available on the market but they have limited features. A purchased package has built-in templates to generate payslips. These templates can be adapted to meet the organisation's needs.
- **Built-in reminders** – This feature reminds the compiler of payslips about important dates when information should be processed. This feature is handy for ensuring that due dates are not missed and ensures the smooth running of the company's finances.
- **Time and cost saving** – Time and money are saved when the payroll is done within the organisation and not outsourced. The digital management of employee records is so much easier and saves time with payroll systems.
- **Security** – Payroll software has added security. Using payroll systems within the organisation eliminates the possibility of unnecessary errors that might occur by sending private information externally. It is easier to manage internal security systems.
- **Eliminate mistakes** – Human error is possible when handling payrolls manually, but built-in validation procedures in payroll software prevents the user from entering the wrong data.
- **Experts are not needed** – An organisation can train an employee to operate the software program.
- **Up to date** – Payroll software can be updated when new editions are available.



Question

Name four benefits of a payroll system.

4.8.3 Payroll software packages

There is quite a number of software packages designed specifically for doing payroll. The packages commonly used in South Africa include: QuickBooks, Pastel, CRS (Integrated HR and Payroll Software Solutions) and Abacus Payroll Software.

4.9 Conclusion

In smaller businesses, the manager or owner usually controls all transactions. However, in larger businesses, it is impossible for one person to exercise such personal control and the accounting system of the business should be adjusted to include adequate measures for controlling transactions. Systems should be such that they ensure accuracy, honesty, efficiency and speedy execution.

A business also needs a very effective accounting system not only to ensure accurate record-keeping, but also to reduce opportunities for theft and possible mismanagement.

This chapter has covered the different ways organisations remunerate their employees and the documents used for remuneration. It is a good idea to become familiar with a payroll system in the contemporary business environment.

4.10 Self-assessment

1. Compile a wage sheet like the one on the next page with the information available. Kimalo CC has only one time rate worker, Johan Bester. He is remunerated @ R50 per hour. Overtime is remunerated @ 1.5 (1½) times the normal rate and on Sundays it is twice (double) the normal rate.
 - Tax 40%
 - UIF R20
 - Medical aid 7%
 - Pension 9%

During the week ending 8 October 2016 Johan worked 52 hours and a normal week consists of 40 hours. He worked 2.5 hours on Sunday.



| | |
|---|--|
| WAGE SHEET OF _____ | |
| Normal wage (____ hours @ R ____ p/h) | |
| + Overtime wage (normal ____ hours @ R ____ p/h) | |
| (Sundays and public holidays (____ hours @ R ____ p/h) | |
| + Bonus | |
| + Car allowance (also a form of income and is taxable) | |
| = GROSS WAGE (INCOME BEFORE DEDUCTIONS) | |
| - Pension (remember, pension must be deducted before taxation for PAYE and only on normal working hours, not on overtime) | |
| = TAXABLE INCOME | |
| - Deductions | |
| Tax [____ % of R ____ (taxable income)] | |
| Loans | |
| Medical aid [____ % of R ____ (normal wage)] | |
| UIF (Unemployment Insurance Fund) | |
| = NET WAGE | |

2. Kgomotso CC has three employees. Compile a salary statement with the information provided.

| Employee number | Name | Gross salary | Medical aid | PAYE | Pension | Sundry expenses |
|-----------------|--------------|--------------|-------------|------|---------|-----------------|
| | | R | R | % | % | R |
| 12 | J. Bester | 3 800 | 200 | 18 | 8 | 90 |
| 13 | K. Swart | 4 100 | 300 | 14 | 8 | 120 |
| 14 | P. Koekemoer | 5 300 | 250 | 17 | 8 | 150 |

3. Identify the various employee records that are used in industry.
4. Distinguish between gross and net salaries.
5. Discuss the difference between a pension and a provident fund.
6. What should be reflected on a payslip?
7. Discuss the concept of a payroll system and list the advantages.

Petty cash



Learning outcomes

At the end of this chapter, you should be able to:

- understand the use of petty cash in the office;
- set up an imprest petty cash system;
- complete a petty cash voucher;
- complete and balance the petty cash book; and
- identify possible risks involved with petty cash.

5.1 Introduction

Petty cash is money that is kept on hand rather than deposited into the organisation's bank account. Petty cash serves as a ready source of cash to pay for minor expenses incurred during everyday business operations, for example for milk, coffee, freight, office supplies, flowers, stamps and delivery of parcels. Issuing a cheque for such small payments is impractical and involves unnecessary additional bank costs. It is inconvenient and it overloads the payment side of the cashbook, therefore a small amount of cash is kept to pay for minor expenses.

Petty cash can be kept in the cash register, in an envelope or a box for all the occasions where only a small amount needs to be paid. Cash forms part of the assets of any business, irrespective of the amount, and must be properly managed and controlled. This chapter will focus on how to maintain a petty cash system in the office environment.

Read the following scenario and see how the problem can be solved by reading the rest of the chapter.



Scenario

'Hey, Catherine, I have 30 minutes before I see my next client. I am running out of staples,' Khaya says on his way out to the stationery shop just two blocks away. He returns 25 minutes later with not only the staples, but also a newspaper and sticky notes. He is also balancing two cups of take-away coffee, one for him and one for Catherine.

'Khaya, wait a moment, give me all the receipts of the things you bought,' Catherine requests. He searches through his pocket and gives her one crumpled receipt from the stationery shop. 'Where is the receipt for the coffee that you bought?' Catherine asks.

'Ahw, sorry man, they did not give me one. All of this came out my own pocket anyway, so don't worry about it, you do not have to write it down in your book.'

Catherine thinks that there has to be a simpler way to track all these tiny receipts that keep slipping through the cracks. She remembers Bongi's comments about this type of issue: 'If you do not save any evidence of the purchase, it cannot be claimed.' Catherine knows there has to be a system of some kind to capture these types of transactions, but is not sure what it was. She decides to discuss it with Bongi at their next meeting.

5.2 Managing the petty cash in the office

In order to manage the petty cash in a office, the following concepts relating to a petty cash system must be understood.

5.2.1 The cash float

The cash float is the amount of money that is kept within the petty cash fund. It is a set amount of money that is maintained and topped up to this set amount regularly. The cash float is also referred to as the imprest amount.

The cash float system describes how the cash float in the petty cash is kept at a pre-set level. It works in a similar way to how water of a cistern is topped up after being flushed, it is always filled it up to a consistent pre-set level. Look at the following example.

Example

ABC Traders is a company that wishes to maintain a cash float of R400 in their petty cash box. Due to expenses incurred, the money in the petty cash box decreases. Their expenses amounted to R150, which means that they only have R250 left in their petty cash box.

$$R400 \text{ (opening balance)} - R150 \text{ (expenses)} = R250 \text{ (balance available)}$$

As the money in the petty cash box decreases, the person in charge of the petty cash draws enough money to top it up to R400 (the imprest amount). The amount of money that is drawn must be equal to the petty cash payments that were made.



It is a good idea to replenish petty cash on a monthly basis. The imprest limit that is predetermined by the business should be reviewed periodically to determine if the cash float is enough to meet the expenses that might occur and whether the amount should be adjusted.

The best way to control petty cash is to assign one person (the custodian) in the office to manage the use of the petty cash. This person should take full responsibility of the fund and should be able to prove what the cash was used for and why. It is also advisable to discuss with the custodian how to safeguard the money. Businesses usually have rules about where it is kept, for example the cash must be kept in a lockable container, and the petty cash must be properly secured according to these stipulations.

Questions

What is the imprest amount?

What happens when the money in the petty cash is used up?

5.2.2 Evidence of purchases

All the expenditures that are funded by the petty cash have to be accompanied by receipts. Receipts should have an official company imprest or stamp on it. Users of petty cash will only be reimbursed when the original receipt is submitted. Certain cash register dockets may not meet this requirement, and therefore the name of the business should be included on the petty cash voucher.

5.2.3 Petty cash voucher

This is a very important source document and is proof of what the money from the petty cash was used for and by whom it was used. A petty cash voucher must be completed for every transaction. It does not matter what amount is kept in petty cash, there must be a good control system that ensures that anyone who needs and uses cash writes a voucher that specifies exactly how much money was used and the reason for the expenditure. Petty cash vouchers and receipts of funds spent serve as source documents for auditing purposes and should be retained for a specific period (normally one financial year).

When completing a petty cash voucher, the following information must be specified:

- reason for the payment;
- amount paid;
- name and signature of the person receiving the cash;
- authorising signature;
- issue date of the document;
- voucher number;
- the cost centre it must be allocated to; and
- vendor name.



| | |
|-----------------------------|----------------------------------|
| PETTY CASH VOUCHER NO _____ | |
| Date: | _____ |
| Vendor: | _____ |
| For: | _____ |
| Expense account: | _____ |
| Amount: | R _____ |
| Less change: | R _____ |
| Net amount spent: | R _____ |
| Signed by: | _____ |
| | (Employee who made the purchase) |
| Approved by: | _____ |

Figure 5.1 An example of a petty cash voucher

There are a number of software programs that can be used to design petty cash vouchers. Accounting software packages as well as spreadsheet software also offer built-in options. They have various examples to choose from and templates can be adapted to suite the organisation's specific needs.

5.2.4 Receipts into petty cash

Money can also be received into the petty cash fund. Firstly, money can be received in order to replenish the petty cash fund. A cheque can be drawn from the business bank account to meet the imprest amount (cash float). Secondly, money can also be received from staff members when they make personal use of business equipment and facilities, for example, making photocopies for own use. The person responsible for the payment into the petty cash fund issues a cash receipt, stating the amount paid, who received it and for what purpose.

The person responsible for the petty cash must complete and sign a receipt and keep a copy of the document, which serves as a proof of the amount paid.

5.2.5 Recording petty cash transactions

All transactions regarding the petty cash must be entered into the petty cash book, and this includes both payments and cash receipts. The purpose of the petty cash book is to provide a record of all petty cash transactions.

Each time a payment is made or cash is received, it must be recorded on a separate line in the petty cash book. A new page in the cash book will be used whenever the float is topped up or at the end of each month.



The petty cash book consists of two sides, namely a debit and a credit side. The debit side, which you would find on the far left-hand side, contains information such as cash received into the petty cash box (for example the top-up float). The columns consist of:

- date of receipt;
- description indicating where a record of the money drawn from the bank can be found; and
- amount received.

The credit side (on the right) records all transactions pertaining to payments that were made from the petty cash. This side (credit) consists of columns that contain the:

- date and details on the petty cash voucher;
- total amount stipulated on the voucher;
- voucher number;
- analysis of each item on the voucher;
- sundries (all payments that cannot be classified in existing columns);
- remarks (giving more information about the sundries);
- VAT (not included here); and
- folio for cross referencing to ledger accounts.

Example

The administrative employee at TK TRADERS starts a petty cash book on 1 February 2016 with a cash float of R50.00. During the month of February the following transactions took place:

| Date | Details | Voucher no. | Amount |
|--------|---|-------------|--------|
| Feb-01 | Stamps from post office | 1 | R12.00 |
| Feb-10 | Casual labour | 2 | R7.00 |
| Feb-12 | Coffee from cafeteria | 3 | R9.00 |
| Feb-15 | Repairs (glass) | 4 | R8.00 |
| Feb-20 | Paper | 5 | R11.00 |
| Feb-20 | Receive a cheque from the accountant to replenish the advance | | R47.00 |

Now that all the elements of petty cash have been discussed, try the following exercise.



Enter the transactions of TK TRADERS for February (from the previous example) into the petty cash book and balance it.

[illegible]



Solution

| Petty cash book of TK TRADERS for February 2016 | | | | | | | | | | | | |
|---|--------------|--------|------|---------|-------------|-------|--------------|---------|---------------|------------|--------|-------------|
| a | b | c | d | e | f | g | h | i | j | k | l | m |
| Date | Details | Amount | Date | Voucher | Details | Total | Refreshments | Postage | Casual labour | Stationery | Sundry | Description |
| Feb 1 | CB8 | 50.00 | 1 | 1 | Stamps | 12.00 | | 12.00 | | | | |
| | | | 10 | 2 | Wages | 7.00 | | | 7.00 | | | |
| | | | 12 | 3 | Coffee | 9.00 | 9.00 | | | | | |
| | | | 15 | 4 | Glass | 8.00 | | | | | 8.00 | Repairs |
| 20 | CB10 | 47.00 | 20 | 5 | Paper | 11.00 | | | | 11.00 | | |
| | | | | | | | | | | | | |
| | | | | | | 47.00 | 9.00 | 12.00 | 7.00 | 11.00 | 8.00 | |
| | | | | | Balance c/o | 50.00 | | | | | | |
| | | 97.00 | | | | 97.00 | | | | | | |
| Mar 1 | Balance b\ f | 50.00 | | | | | | | | | | |

Source: Example adapted from Bosua, De Beer & Scheepers (2009)



5.2.6 How to balance the petty cash book

Follow these easy steps to balance the petty cash book. Refer to the 'Test your knowledge' exercise to help understand the steps.

1. Total the payment column (g). This is R47.00 in the exercise.
2. Add the totals in the payment columns (h, i, j, k, and l) and compare it with the total column (g). This should be the same amount.
3. Total the receipts column (c). In the exercise, this is only R50.00 at this time.
4. Calculate the difference between the total payments (g: 47.00) and the total receipts (c: R50.00). $R50 - R47 = R3$. This should be the amount of cash left in the petty cash box.
5. Draw a cheque for the exact amount to top up the cash float (R47.00) to the imprest amount (R50.00).
6. Record the cheque in the receipts side (debit) of the cash book (20 February).
7. Calculate the difference between the total receipts (R97.00) and total payments (47.00). $R97 - R47 = R50$. This amount (R50.00) is written beneath total payments as the balance carried forward and added to it. The R50.00 is also added to the sundries column (l) for balancing purposes.
8. Ensure that the total in the payments column (g) is the same as the total in receipts column (c).
9. The opening balance is the same amount as the balance carried forward in step 7, but will now be recorded in the receipts column (c) as the balance brought down.
10. The balance brought down is the amount of money in the cash box.

5.2.7 Payments prohibited from petty cash reimbursement

Each business will specify which goods and services may be reimbursed from the petty cash fund. It will depend on the type and nature of the business. Examples of payments that may not be made from petty cash funds can include: wages or related allowances (such as overtime meal allowances), meals, fares, vehicle maintenance and operational expenses regarding fleet or private vehicles that include fuel and distances travelled (mileage).

5.2.8 Risks associated with petty cash

Petty cash is a system that is widely used by organisations of all sizes, and internal auditors should be well aware of possible risks with petty cash and have controls in place to address these risks. These risks can include the following:

- **Waste** – Resources are wasted on activities that are not in line with the business's objectives and policies.
- **Misuse of funds** – Employees might have the urge or temptation to use the funds for personal use or borrow money with the intention of returning it before the petty cash book is finalised.
- **Human mistakes** – The wrong amount may be mistakenly captured in the petty cash book or mistakes may be made when the adjustment of paid funds is done at



a later date, and these mistakes may go undetected until the date of the actual adjustment.

5.3 Conclusion

Businesses have to make small purchases from time to time that do not really justify the need to write out a cheque or to make credit card payments. The amount is just too small. These expenses can include buying stamps, buying groceries, such as milk and tea for the office, travel expenses and buying gifts, among others. This chapter dealt with the use of petty cash, the purpose of using a petty cash voucher and how to capture the expenses in a petty cash book.

5.4 Self-assessment

1. What is the purpose of petty cash in the business environment?
2. Where should you keep petty cash? Motivate your answer.
3. Describe the concept of cash float.
4. Discuss the importance of using a petty cash voucher in a business.
5. Design a petty cash voucher and complete it by using the following information:
Use today's date. Authorising person: Mrs K Kunene. You will be receiving cash (R150.00) to buy sugar (R22.50), tea (R19.00) and milk (R60.00). Voucher number is 101. You normally buy the goods at the local SPAR.
6. Explain why there are risks involved when dealing with petty cash and identify possible risks.



Learning outcomes

At the end of this chapter, you should be able to:

- discuss the different services banks offer;
- discuss the operation of banks;
- discuss Internet banking and all the features thereof; and
- open and manage a cheque account.

6.1 Introduction

A bank is a financial institution, licensed by the government to act as a receiver of deposits. In most countries, the national government or central bank regulates the different banks that operate in the country. Although many other additional financial activities have been added over time, with technology that crosses borders, the primary activities of banks are to borrow and lend money. They are institutions where money can be deposited, interest earned on the money and withdrawn again when the need arises. Funds can also be borrowed from a bank at a cost, called the interest rate. These funds must be paid back over a period of time. Funds can also be transferred from one person to another, as long as the receiver has an account at a registered bank. Funds can also be transferred to people across the globe through Internet facilities by the click of a button. Banks ensure that our money ‘passes hands’ in a legal and structured manner.

There are two main categories of banks, namely commercial or retail banks and investment or corporate banks.

Table 6.1 The differences between types of banks

| | Corporate and investment banks | Commercial or retail banks |
|----------------|--|---|
| Core functions | Services such as financing and corporate reorganisation to institutional clients | <ul style="list-style-type: none">▪ The management of withdrawals and deposits▪ Supplying short-term loans to qualifying clients and small businesses▪ Clients primarily use these types of banks for savings, deposits (own funds and salaries), electronic services and home mortgages. |
| Examples | Rand Merchant Bank, ABSA, Standard Bank and First National Bank | Capitec, Standard Bank, ABSA, Bidvest Bank, First National Bank and Nedbank |



The following are definitions of commonly used banking terminology:

- **Bank** – A bank is an institution that is licensed to receive deposits and conduct financial transactions on behalf of its clients. It also lends money to approved borrowers. Anyone can lend money, but you have to be registered as a bank or exempted by the Registrar of Banks to take deposits and handle transactions. Banks provide a variety of services to their clients.
- **Reserve bank** – The South African Reserve Bank (SARB) is the central bank of South Africa. Its main objective is to protect the value of our money. The Registrar of Banks, which operates from within the SARB, also tries to make sure that all registered banking and savings organisations in South Africa operate in an orderly and legal way. The SARB is governed by the governor, appointed by parliament.
- **Bank cards** – The most popular bank card is the debit card. It offers quick, safe and convenient access to funds. A debit card can be used to withdraw money and pay for goods and services, for example at supermarket till points. Other banking cards include a credit card (which is given to people who have acceptable credit ratings) and specialised cards such as garage cards (which are used to pay for fuel and other car-related expenses).
- **Loan** – The bank can lend money to a client if the borrower agrees to pay the money back, usually with interest. The money that has been lent is referred to as a loan. The bank will go through a process to determine whether the borrower will be able to repay it. This process involves checking that the client has a good track record with the bank and a steady income so that the loan can be repaid.
- **Interest** – Interest is the money that a client needs to pay if he or she borrows money from a bank or other financial institution. The amount of interest paid can add quite a considerable amount to the amount that must be repaid.

On the other hand, the bank will pay interest on money in certain accounts if there is a positive bank balance. The interest paid is expressed as a percentage, and this percentage is referred to as the interest rate.

- **Invest** – Investing money is similar to saving it, but usually the money is saved for a longer period. Investing is done to increase the savings and create financial wealth.
- **Deposit** – When money is put into an account at the bank, this is called a deposit. The money can be deposited into the person's own account or someone else's.
- **Inflation** – This is the measure of how the average prices of goods and services have increased over time. Inflation affects the value of money in a negative way, as it means that the value of the money decreases. With inflation the same amount of money buys fewer goods than before. Inflation rates are regulated by the SARB. Investors normally study the inflation rates carefully before they invest their money.



Note

It is important to understand the difference between the real interest rate and the nominal interest rate. The nominal interest rate is the rate quoted by the bank. Say this is 15% per year. If R1 000 was deposited for one year at this rate, there would be R1 150 ($R1\ 000 + R150$ [15% of R1 000]) in the account at the end of the year. Assume that the inflation rate was 5% for the same period. While the nominal interest rate was 15%, the real interest rate that was earned on the money was only 10% ($15\% - 5\%$). So the real interest earned on the money was only 10%, which is R100. The reason for this is that inflation reduces the value of the interest earned since everything is now on average 5% more expensive.

- **Banking costs** – The banks get paid for the different services that they render by means of banking costs. There is usually a predetermined fee for each type of transaction. The banking costs are deducted from accounts on a monthly basis. The new generation of South African banks offers services at much lower costs but only offer limited services.

6.2 The services that banks offer

Every client of a bank has specific needs and there are different types of accounts to cater for these different needs. Anyone wishing to open a bank account should consult the customer services or financial consultants at the chosen bank.

The main services that banks offer are:

- **Debit cards** – When goods are bought with a debit card, the money comes directly from the account attached to the card and the account is debited immediately. A debit card is a form of electronic access to the funds in the account. A debit card is convenient and quick and is accepted at the majority of till points and automatic teller machines (ATMs), both locally and globally. A debit card is safer than cash because it can be cancelled immediately when it is lost or stolen, and it is protected with a personal identity number. You can only spend money that is in the account, meaning that there must be a positive bank balance.
- **Credit card** – The main characteristic of a credit card is that it is a payment card that is issued to the borrower as a system of payment. Cardholders can pay for services and goods on the promise to pay for it at a later stage. Credit cards may be used to access money even though the account has a negative bank balance. This means that people with credit cards can spend money that does not actually belong to them, but to the banking institution. Credit cards can be used when travelling in other countries and the exchange rate on the particular date of the transaction is used to convert the currencies.
- **Savings account** – Savings accounts are used mainly for saving purposes, but some savings accounts allow other transactions, such as cash withdrawals. Interest is paid on the money in the account, and the higher the account balance, the more



interest that is earned. Electronic banking enables instant access to the account 24 hours a day. A number of banks offer fixed-term or flexible savings accounts.

- **Notice deposit** – A notice deposit is an investment account that pays high interest rates but has certain restrictions. The account holder must give the bank notice (usually 32 days) before being able to withdraw the money.
- **Fixed deposit** – This account is an investment account that allows the client to secure a lump sum with a guaranteed interest rate that does not fluctuate over a fixed period of time. The money must remain in the account for this fixed period.
- **Cheque account** – A cheque or current account allows the account holder to make payments with cheques. The account holder receives a personal chequebook from the bank. Every transaction has a fee attached to it. A cheque account usually pays little or no interest, but the bank may allow the account holder to negotiate an overdraft on the account (see the paragraph on overdrafts in section 6.6).
Nowadays, with electronic banking, clients prefer to do Internet transfers to pay for goods and services rather than use cheques. It is easier for banks to manage the Internet transfers and less paperwork is involved.
- **Home loan account ('bond')** – This is a long-term agreement between an account holder and the bank. If a person qualifies, the bank lends him or her money to buy or build a home. The loan, with interest, is repaid over a long period, normally between 20 and 30 years. When the base interest rates fluctuate, instalments will increase or decrease with these fluctuations.
- **Personal loan** – If someone has a good track record with a bank, the bank may offer the account holder a personal loan. Banks have certain criteria (which can differ between different banking institutions) for qualifying for a personal loan, for example you need to be a South African citizen, between the ages of 18 and 65 years, formally employed, have a consistent monthly income, earn a minimum of approximately R3 000 a month (before deductions) and have a bank account with a debit order facility. Personal loans are a suitable option to finance large payments or purchases, such as furniture, school fees or appliances, or if you require credit over an extended period. A bank might offer a loan, for example, from R3 000 to R150 000 and the account holder can choose the repayment period to be between 12 and 72 months.
- **Online banking** – A computer or smart phone can be used to do most banking transactions online from any convenient location (such as home, office or restaurant). The bank account holder must register at the bank for the service and thereafter will be able to log into his/her account. The majority of banking transactions can be performed online, such as balance enquiries, statement enquiries, applying for loans, paying bills and money transfers to beneficiaries. The account holder is also able to see account information, purchase airtime and see the transaction log for a specific period of time. This service has a cost attached to it but it is much lower than what is paid when the transactions are done inside the bank. Internet technology can also be used for online payment systems



such as PayPal. These systems use encryption software that permits people to make financial transfers between computers. Electronic fund transfers (EFT) is a common term used for the electronic exchange (the transfer of funds from one account to another), either within one financial institution (bank group) or across multiple institutions through computer-based systems. Salaries of employees in large companies or businesses are normally paid in this way, meaning that salaries are directly transferred from the companies' accounts to those of the employees.

- **Automatic teller machines (ATMs)** – An ATM is an electronic banking outlet in the form of a machine, usually installed in a mall or busy place where clients can do some banking transactions, provided they have their card and personal identity number (PIN). Anybody with a debit or credit card automatically has access to ATMs. It is a current trend to have ATMs inside the convenience shops at garages and grocery stores.

It is important to be alert when using ATMs as they are a target for theft. Look out for ATMs that look as though they have been vandalised. Criminals damage an ATM to force users to use another one, which they then target. Criminals also watch users enter their PIN, distract users and try to switch cards. The criminals can then use the stolen card to withdraw the money from the person's account. Finally, criminals can copy a card's magnetic strip by using a card-skimming device. This allows them to make a duplicate card and if they have the PIN too, they can draw all the money from the account.

Questions

Create a table to show the differences between credit and debit cards.

What is the difference between a notice deposit account and a fixed deposit account?

6.3 Benefits of a bank account

A business should have a bank account for many reasons. Money deposited in a bank account is safer. With South Africa's high crime rate, it is not advisable to keep cash anywhere else. Just keep the maximum amount of cash in the office that is absolutely necessary. Banks safeguard not only money but also valuables and they provide loans, credit and payment services. Banks also offer investment and insurance products.

A business needs to have a paper trail to document transactions. Cheques can be used to make payments, but doing business online also leaves a well-documented trail of transactions, and it is the quickest and easiest way to do transactions. More and more businesses today prefer to use online banking because it is convenient and safe.

6.4 How banks operate

In addition to providing a safe place for money, banks also loan money to businesses and consumers. A large portion of a bank's business is lending, and the money they lend comes from the deposits from individuals and organisations. The banking fees for having



an account and doing transactions enable banks to reinvest in themselves, giving them more money to lend to clients at a cost (interest).

Banks are businesses and their main objective is to make a profit. Their profit generally comes from the difference in interest paid to depositors and the interest earned on loans and investments. Banks cannot legally lend all of their deposited money all at once. They retain a certain percentage of their deposits in reserve at all times so their clients can draw money from their accounts.

Banks offer many different services, as discussed in section 6.2. They offer a variety of saving strategies with different features and benefits designed to accommodate client requirements. Transactions can be done in the bank, where the client can receive personal attention from a teller or a personal banker, or they can be done electronically. Today there are a wide range of banks to choose from with different services and products available. Do proper research with regard to the different banks and their services to match the needs and requirements of the organisation with the correct bank.

In South Africa there is a range of traditional banking groups (such as ABSA, FNB and Standard Bank) and there are also some so-called 'new-generation' banks (such as Capitec and African Bank), which offer limited services but at affordable prices. One of the trademarks of the new-generation banks is their more convenient operating times.

There is also a range of products and services available to meet business needs. Financial institutions offer financial solutions to assist people who are starting their own or expanding their businesses. One of these products is business insurance. It is important to take out the right insurance in order to protect the business owner, his or her family and the business in the event of an unexpected loss of income to the business. (Insurance will be discussed in detail in Chapter 7.)

6.5 Internet banking

The following section discusses the online services offered by South African banks. These services have been designed to optimise personal financial management and administration. Electronic banking services include a range of effective and time-saving solutions.

- **Location-based services** – Cell phone service providers (such as MTN, Vodacom and Cell C) in conjunction with different banks developed a service that will enable clients to locate their nearest ATM or branch anywhere, anytime using their cell phone.
- **Prepaid top-up of cell phone airtime** – Banks offer a comprehensive range of prepaid top-up solutions, where clients can buy prepaid cellular airtime from their cell phone, the Internet or any ATM that offer these services.
- **Traffic fines** – Traffic fines can be paid via online banking sites.
- **Investments** – Investment account holders can freely access their information without needing a linked transactional account such as a current or savings account.



- **Home loans** – Account holders have the convenience of accessing and maintaining all their account details online by viewing statements and balances.
- **Payment verifications** – Payment verification services give clients from different banks the opportunity to verify their payments from their bank on the Internet banking website of their particular bank.
- **View failed prepaid transactions** – Using online banking, users can view and rectify the reason for any failed prepaid airtime transactions, making it easier to top-up airtime or buy SMS or data bundles again.
- **Balance enquiries** – By simply logging on to the Internet or using mobile banking users can view all their account balances from their phone, tablet or computer.
- **Statements (e-Statements)** – Users can view all their statements for all the accounts that are linked to their banking profile, such as a garage card, credit card, current or savings accounts or home loans. These statements are also referred to as e-Statements. Statements can be downloaded in various formats and the user can also choose how they want their statement to be delivered. The majority of people prefer to have their statements emailed to them. In this way, businesses and individuals can save their statements electronically.
- **Transfers** – Transfers of money between all linked accounts are easy and convenient.
- **Payments** – Users can make almost any payment online, whether they are to beneficiaries or once-off payments.
- **Beneficiaries** – The details of people or organisations that are paid on a regular basis can be saved as ‘beneficiaries’. This means that once a beneficiary has been created, their details do not have to be entered again. Users can view their beneficiaries’ payment history.
- **Notifications** – Payment notification details are captured at a beneficiary level, which saves the time of entering the details every time payment notifications must be sent. Customers have the added convenience of being able to easily capture the payment notification delivery options when they set up a beneficiary, rather than having to re-enter the information every time they want to send a notification. Information that forms part of a notification is the date of payment, reference number, account number and the total amount involved in the transaction.
- **SMS authorisation** – Certain banks offer the feature that for certain transactions an SMS is sent to the account holder before the transaction is completed so that the transaction can be authorised. Once the bank approves the transaction, the account holder receives an SMS in return as proof.
- **Multiple payments and transfers** – Users can make up to 20 payments or transfers at once with the click of a button. The number will differ depending on the bank.
- **Future dated payments and transfers** – Users have the option to set up payments, prepaid recharges and transfers in the future on a specified date up to a year in advance.



- **UIF and tax payments** – Tax and UIF payments set up on SARS e-Filing can now be processed using Internet banking.

The advantages of online banking are:

- It is safer, as there is less danger of being robbed. There is no cash involved and it is not so easy to abuse the electronic system. There is less danger of a payment going missing, in the way that a cheque might get lost or stolen.
- It is easier because paying an account or transferring funds can be done from the home or office.
- It is cheaper than doing transactions over the counter.
- It is much quicker and more convenient. Users do not have to stand in queues or wait for the banks to open before they can do transactions.

The disadvantages of online banking are:

- It may be time consuming to set up because an account must be held at a bank before anyone can do online banking with it.
- If a married couple wants to have dual access to one account, one of them has to sign a power of attorney letter before the bank will allow dual access.
- Banking websites change from time to time and it might be frustrating to users to get acquainted with the new online environment. If a site changes or upgrades, it might be necessary to re-enter and register your details.
- Some online users find that they miss the personal contact that banks offer when they need assistance.
- The user has to pay for access to the Internet before doing any online banking.
- Internet security might be difficult to guarantee because hackers are always looking for ways to get access to personal information.
- If the bank's computer systems are not working, no transactions can be made.

6.6 Opening and operating a cheque account

A cheque is an order, signed by the account holder, instructing the bank to pay the amount that is written on the cheque to the person or entity named on the cheque. Although cheques are not in use as much today as in the past, many people still believe that they are ideal. The older generation, especially, are comfortable with this way of dealing with their finances. Internet banking might be a difficult concept for them to get used to. A cheque account, also known as a current account, is a bank account into which the account holder's income can be deposited and from which finances can be managed during the month. Account holders can make payments by cheque for anything from stock to electricity bills without having to physically go into a bank to draw cash.

When opening a cheque account, the client is issued with a cheque book as well as an ATM card. Through this account the client can also make payments using a stop order or a debit order. A stop order is an instruction to the bank to pay a company or an individual an amount of money on a certain day each month. A debit order is the



permission the account holder gives to an organisation to deduct money that he or she owes from the account holder's account each month. Both stop orders and debit orders have high banking fees attached to them.

There are different types of cheque accounts for different types of people and businesses. The differences are mainly based on professions and income levels. As mentioned before, banks have basic criteria for opening a cheque account, such as a credit record and a basic monthly income. As the account holder's income and professional qualifications improve, he or she could qualify for special cheque account packages with quite a number of benefits included.

6.6.1 Writing cheques

No alterations may be made on a cheque. If a mistake is made, rather cancel the cheque or tear it into pieces and write a new one. A cheque may be crossed, marked 'not negotiable' or 'not transferable'. These concepts and others relating to cheques will now be discussed in detail:

- **Crossing a cheque** – To cross a cheque two parallel lines are drawn on the face of the cheque. Once this is done, this crossing can never be cancelled or deleted.

Crossing a cheque indicates that the cheque can never be endorsed in favour of another party and the cheque cannot be paid into an account other than the one belonging to beneficiary written on the cheque. This means that the name appearing on the cheque must hold an account at the bank in exactly the same name as printed on the cheque. So make sure that the name of the beneficiary written on the cheque is complete and correct. Use all the initials of a person, if possible. If this is not possible, make sure that the initial of the person's first name is written otherwise the cheque will not be accepted by the bank. Crossing a cheque serves as protection to the account holder. In case of a dispute in respect of such a cheque, the bank will be able to rely on the protection available to them.

To prevent risk and exposure, the bank will not accept, clear or honour any uncrossed cheques with the following markings thereon: 'not transferable', 'not negotiable', and 'account payee only'. Cheques that are not crossed and that do not contain any of these markings will be accepted.

- **Not negotiable** – If you cross a cheque and write the words 'not negotiable' between the parallel lines, the person to whom the cheque has been made out may still transfer the cheque to somebody else. However, if this cheque is stolen, there can be no claim against the account holder. The account holder simply stops the cheque at the bank and nobody can successfully sue him or her for payment. It is recommended that cheques are marked 'not negotiable'.



- **Transferable cheques** – The following three ways of filling out cheques make them transferable:
 - Cheques can be made out to, for example, 'J Lebo or bearer'. This means that payment can be made to either J Lebo or any other person who presents the cheque. 'Or bearer' is usually pre-printed on cheques.
 - If 'or bearer' is crossed out, the bank will pay J Lebo or any other person to whom he may have signed the cheque over.
 - A cash cheque is not made out to any person, but only to 'Cash' and is payable to anyone who comes into possession of the cheque, even if the words 'or order' appear on the cheque.
- **Not transferable** – If 'not transferable' between two lines is written on the cheque, this instruction overrides any other endorsement or crossing on the cheque. This should ensure that no one other than the payee receives payment and the account holder will have a claim against the bank if they pay the money to the wrong person.
- **Overdrafts** – A cheque should never be written out if there is not enough money in the account to cover it. If the account holder needs to do this, he or she has to apply for an overdraft facility. An overdraft works like a loan and the interest rate is usually high. The bank also puts a limit on this facility, such as R20 000. If the client exceeds this amount they will be penalised by having to pay over and above the interest already charged.
- **Cheque account fees** – It costs nothing to open an account, but thereafter the account holder must pay a monthly fee as well as an amount for every transaction and cheque issued. Different pricing options are available.

It is a good idea to go to a few different banks to negotiate the best deal to suit the client's personal needs once the decision has been made to open a cheque account.

6.7 Conclusion

This chapter looked briefly at some of the concepts of banking that will be encountered. Banking terminology, types of banks, services they offer and how they operate were also discussed. Finally, it looked at the purpose of cheques and how they should be completed.



6.8 Self-assessment

1. Give a brief description of the following words:
 - Bank
 - Reserve Bank
 - Bank cards
 - Loan
 - Interest
 - Invest
 - Deposit
 - Inflation
2. Discuss at least three of the main services that banks offer.
3. Discuss the advantages and disadvantages of Internet banking in a tabular format.
4. Briefly discuss eight different services offered to Internet banking users.
5. Explain why or why you would not open a cheque account for the organisation you work for.



Learning outcomes

At the end of this chapter, you should be able to:

- explain how insurance works;
- identify the factors influencing the premium;
- apply the principles of insurance;
- identify the different types of insurance;
- argue for or against insurance; and
- apply the process of taking out insurance.

7.1 Introduction

Most people have come across insurance of one sort or another in their lives. It could have been car insurance, household insurance or life insurance, for example. This chapter will cover how insurance works, insurance concepts and principles, kinds of insurance, the advantages and disadvantages of insurance, alternatives to insurance and how to choose an insurer. The objective is to give enough information so that informed decisions can be made with regard to insurance. Decisions about insurance can have major financial implications for individuals and organisations.

Insurance is about risk. Risk refers to the potential variation in outcomes. Any person or organisation is exposed to risks to some extent and these risks need to be managed. People and organisations are faced daily with the fact that some catastrophe may unexpectedly happen. The occurrence may be loss or damage to property, death of people, illness and even living longer than anticipated. These things can happen at any stage and, if they do, they will undoubtedly cost the individual or organisation money. Thus, money needs to be available to replace possessions, fix breakdowns and meet obligations. These risks drive the short and long term types of insurance.

Potential risks can be financed by an organisation in two ways:

- Risk can be retained by the organisation, which means that the organisation finances the losses as part of operating costs and bears the financial impact of the losses itself.
- Risk can be insured. Insuring risk means that the organisation has protection or cover against, or compensation for, loss or damage. It may also be regarded as the transference of the risk of loss or damage to someone else.
- Insurance is the most common form of protection against risks. Virtually any contingency can be insured. The question is what to insure and how to insure it.



7.2 How insurance works

Insurance is an agreement where, for a stipulated payment (the **premium**), one party (the **insurer**) agrees to compensate another (the **insured**) a defined amount for contingencies or losses, called the risk. By doing this, the insured (**policyholder**) transfers the monetary responsibility regarding the outcome of a specific contingency to the insurer (insurance company). A contract regarding the details of this agreement, called the **policy**, is drawn up between the insurer and the insured.

The insurance contract can be either a written or verbal contract. In the case of a verbal contract, for example by telephone, the conversation and all the details are recorded. The insurance policy is a binding agreement concluded in good faith, in which the insurer undertakes to compensate the insured, if the insured pays regular premiums, for any losses the insured suffers owing to a particular event for which provision was made in the contract. Both parties must adhere to the conditions and the requirements set out in the policy wording. Many unpaid claims are due to misrepresentation on the side of the insured or ignorance regarding the policy wording. Breach of the contract occurs if either of the two parties does not comply with the conditions as stated in the contract.

The insurer receives premiums from various insured parties and deposits this money into a fund from which the claims, upon the occurrence of a specific risk, are paid. These claims are paid from the total pool of premiums as contributed by all the policyholders. The entire pool's contributions are therefore available to compensate the unfortunate few who suffer losses. If there are no claims, or the insured decides to change to another insurer, the premiums paid remain the property of the insurer. The premiums that were paid covered the insured for a specific period. It can be said that the insured paid the insurer to carry the risk for a specific period of time. If nothing goes wrong, the insurer will make more money. Insurance is not an investment or savings for the insured. The insured simply buys protection against a specific economic risk for a specific time period. If the risk that is covered never happens, the insured has no claim to the premiums paid.

**Example**

There are 1 000 houses in a given community, and each house is worth approximately R600 000. Each owner runs the risk of his or her house burning down. If a fire breaks out and an entire house is destroyed, the loss will amount to R600 000. One or more houses may burn down, but it is unlikely that all the houses will burn down at the same time. The owners of these houses decide to enter into an agreement to share the cost of their loss if any of the houses are destroyed. If this occurs, no single individual will suffer the entire loss of R600 000. When a house burns down, all 1 000 homeowners contribute their proportionate amount towards the loss. If the house is completely destroyed, each of these 1 000 owners will contribute R600 to cover the loss. Those who do not suffer the loss will willingly pay because in this way they ensure that they will not have to carry the complete loss of R600 000 if their own house burns down. This is an example of how insurance works.

7.3 Insurance principles

Insurance is based on six principles as described in this section.

7.3.1 *Utmost good faith*

The principle of utmost good faith means that the insurer and the insured are under a common law duty to reveal all vital information (called material facts) to the other party, whether or not that other party specifically requests such information. A breach of utmost good faith can be in the form of either a misrepresentation, such as giving false information, or a non-disclosure, meaning failure to give material information (Office of the Commissioner of Insurance, 2013).

Utmost good faith means that absolute honesty is required by both the insurer and the insured when supplying information. The information supplied (such as age and state of health of the insured) is used to determine the risks, which influence the premium or the insured amount. In the case of an organisation, information such as the nature of the production process or the environment in which the organisation is situated is relevant. If false information is given and is discovered when a claim is lodged, the claim may be called invalid because of the false information and the insured or assured will sacrifice the paid-up premiums and suffer the loss of not receiving the insured or assured amount.

Note

See sections 7.4 and 7.5 for an explanation on the difference between the insured and assured.



7.3.2 Insurable interest

The law requires that the insured must have an insurable interest in what is insured. This means that the person has to be affected negatively if the thing insured is damaged or lost and the person must obtain advantage from its existence. As an example, a married woman has an insurable interest in her husband's life if she and their children are dependent on his income, and a man has an interest in his wife's life under the same circumstances.

Example

A taxi owner can prove that a financial loss of a vehicle, for which an amount of R110 000 was paid, is suffered when the vehicle is destroyed by fire or an accident. However, the owner can also prove that the existence of the vehicle provides financial gain, as it renders a daily income from the transport fares collected from the passengers (Kalyan City Life, 2011).

An assured (life assurance) can easily prove insurable interests in his or her own life, but it is possible that a person/institution can prove an insurable interest in the life of another person.

Example

If a bank grants Mr Mabaso a bond of R800 000 to purchase a property, the bank can prove insurable interest in the life of Mr Mabaso to the value of R800 000 as the bank will suffer a loss if Mr Mabaso dies before repaying the loan.

Proving insurable interest in someone's life makes it impossible to take assurance on the life of a person and then kill the person to claim the assurance money.

7.3.3 Proximate cause

The **proximate cause** of a loss is its effective or dominant cause. The dominant or effective reason for a loss must be ascertained to determine whether that loss constitutes a valid claim under an insurance contract.

It is important to find out which of the causes involved in an accident is the proximate cause because a loss might be the combined effect of a number of causes. For the purposes of an insurance claim, one dominant cause must be singled out because not every cause of loss will be covered (Office of the Commissioner of Insurance, 2013).

Example

A fire broke out in a house and caused a water pipe to burst. The carpets in the house are ruined due to water damage. The water damage is the **resultant damage**. The fire would be the **proximate cause** of the damage. If the proximate cause of the damage is not covered in the current insurance policy terms and conditions, the insurer has no obligation to provide financial compensation to the insured for the damages to the carpets.



7.3.4 Indemnification

The purpose of insurance is not to enrich the insured but to restore the insured to the immediate position held before the damage or loss occurred. Indemnification means the making good of losses or restoring the insured's financial position to what it was immediately before the damage to or loss of property. It is only applicable to insurance (property), as it is only with insurance that the insurer carries the risk. The insurer will indemnify the losses suffered by the insured due to any reason mentioned in the policy. An exact financial compensation to the insured may be provided by means of a cash payment, by repair or replacement or by reinstatement.

Example

Assume that someone insures his car, which is worth R50 000, with his insurer for R50 000. The insured is involved in an accident and the damages to the car amounts to R30 000. The insured will not be able to claim more than the amount of damage, namely R30 000. If the car was insured for R20 000 only, the insured's claim against his insurer will be limited and he will in most cases be able to claim a maximum of R20 000. A claim will only be paid out proportionally if the car was not insured for its actual value.

With indemnity insurance, the amount that the insured can claim from the insurer is directly proportional to the actual damage that was suffered or to the amount of insurance that was taken out. The amount received will never exceed the actual damage.

However, indemnity cannot apply to all types of insurance. Some types of insurance deal with 'losses' that cannot be measured precisely in financial terms. Life assurance and personal accident insurance deal with death of or injury to human beings, and there is no way that the loss of a beloved person or, for that matter a finger, can be measured precisely in money terms (Office of the Commissioner of Insurance, 2013).

Example

Assured A takes out life assurance to the amount of R400 000 and assured B takes out life assurance to the amount of R800 000. Both of them die. The insurer will pay out R400 000 and R800 000 respectively. The life of B was not worth more than the life of A. The insurer will pay out the amount that was contractually agreed upon. With non-indemnity insurance, there is no relation between the damage caused and the amount that the insured can recover from the insurer.

7.3.5 Contribution

Contribution is the term used for the amount that an insurer has to make towards a claim where the insured took out insurance on the same property from different insurance companies and therefore claims from more than one insurer. The law states that the insured may not benefit to the point that the value of the amounts claimed is greater than the initial value of the amount insured (principle of indemnity). Therefore the insured



may not be remunerated twice for the same claim. When property is damaged or destroyed the insurer must register the claim with the Insurance Union and should the same claim be registered again, the Union will refuse the second claim and instruct the second insurer to repay the first insurer a proportionate amount of the claim paid out. This is known as contribution because each makes a contribution depending on the policy and the cover taken out.

Example

Suppose a husband and wife each insure their home and contents, each thinking that the other will forget to do it. If a fire occurs and R200 000 damage is sustained, they will not receive R400 000 compensation. The respective insurers will share the R200 000 loss. Apart from any policy provisions, any one insurer is bound to pay to the insured the full amount for which he would be liable had other policies not existed. After making an indemnity in this manner, the insurer is entitled to call upon other insurers similarly (but not necessarily equally) liable to the same insured to share (or to contribute to) the cost of the payment (Office of the Commissioner of Insurance, 2013).

7.3.6 Subrogation

Subrogation is the right of the insurance company to take the place of the insured *after* they remunerate the person for any loss of or damage to property caused by another (third) person. This right may however, only be used when the insurer can prove that they have already remunerated the loss or damage of the insured.

Example

If farmer A burns a piece of land and the fire gets out of control and destroys farmer B's shed on his farm, farmer B will claim from his insurance company, which will remunerate farmer B's loss and then claim the amount from farmer A, who initially caused the loss of farmer B's shed. If farmer A has 'public liability' insurance, he need not pay the amount himself but can claim it back from the public liability insurance. If in the above case, the fire was started on farmer A's farm by lightning, subrogation would not apply, since farmer A was not responsible for the damage or loss of farmer B's shed.

Questions

Explain in your own words the meanings of the following concepts:

- Proximate cause
- Indemnification
- Subrogation



7.4 Short-term insurance

Short-term insurance is linked to certain risks that may occur with property. In short-term insurance there is no certainty that damage or loss will occur; there is only a possibility that it may occur. Short-term insurance contracts, such as fire, theft, property, car, personal accident, warranty and marine insurance, apply only for a certain term, often one year or less.

Example

John, the owner of the business you work for, wishes to insure the contents of the office against fire and theft. The actual value of the contents is R80 000. He decides to insure it for R80 000. This means that he will be 100% insured and that he will be 100% refunded if any losses occur. He phones an insurer and finds out that he will be paying a premium of R150 per month. A contract is drawn up and as soon as he pays his first premium, the office contents will be insured.

Short-term insurance is linked to certain risks that may occur. The risk influences the determination of the premium to be paid by the insured. For example, to take out comprehensive insurance for a car, the premium to be paid depends mainly on:

- **The value of the assets insured (the car)** – The higher the value of the property, the higher the premium.
- **The area of residence (where the car will be kept)** – The crime rate in some areas is higher and therefore the risk of losses is higher in those areas. In the case of an organisation, the area in which the organisation is located will determine the risk.
- **The age of the applicant** – Older people are perceived to drive more carefully and take fewer risks; therefore the premium will be lower than that for younger people.
- **Safety features of the car (such as an alarm or an anti-theft device)** – The risk of a loss is lower if a car is fitted with an anti-theft device.
- **The historical insurance record of the applicant** – The assumption is that if the insured had many claims in the past, the insured would probably have many in the future and it would result in a higher premium.

7.5 Long-term insurance

Long-term insurance (also called assurance) is linked to the certainty of an event and usually stretches over longer terms. All people are going to die sometime in the future, but no one knows when this will happen. So, people plan ahead to ensure that the financial responsibilities that they have are met by taking out insurance. The purpose could be to make provision for the family of the assured person (life policy) or for the future of the assured person (endowment policy). Another example of a long-term insurance is a disability policy in case a person should become disabled.

Unlike short-term insurance, a long-term insurance policy is an investment. At some point in the future the insured or the insured's next of kin will benefit from this investment.



Long-term insurance cannot be bought as easily as short-term insurance. The insured needs to apply for it and it may be turned down, for example because of health reasons.

Indemnification does not apply to life assurance. With life assurance it is impossible to restore the life of the assured after death, thus the risk only applies for the calculation of the premium but not for making good any losses (indemnification).

7.5.1 Life assurance

This is taken on a person's life and only applies to the life that is assured. The policy cannot be carried over to cover the life of another person. Life assurance can be taken out at any age and parents may take out a policy on a child at birth. The premium is then very low since the term of payment is potentially long. A life policy is a policy taken out by the assured to be paid out on the date the assured dies. This is a method by which the assured can make provision for a family after death. The amount is paid to the family on receipt of a death certificate issued in the name of the deceased by a registered medical practitioner. The policy is valid from the time that the first premium is paid. For example, if Mr Nkosi takes out a policy today and is killed outside the door of the insurance company, the policy will pay the full amount due to the beneficiaries.

The risk influences the determination of the premium to be paid by the assured. The premium to be paid on a life policy depends mainly on:

- **The age of the assured** – The younger the assured, the lower the premium because the amount of time until the insurance is paid out is assumed to be long.
- **The state of health of the assured** – This needs to be certified by a medical doctor, who will complete a medical questionnaire and a thorough examination of the assured. The medical doctor will be appointed by the insurance company.
- **The health history of the family** – For example, should both the father and mother of the assured have died from a hereditary illness before the age of 40 years, the assured would have to pay a higher premium than if the parents were both living and aged more than 80 years.
- **The type of work the assured does** – If the assured's job is considered to be high risk (such as a policeman or a taxi driver), the premium will be higher than that of a member of parliament at the same age, whose job is regarded as less risky.

Advantages of life policies:

- The assured can provide for his or her family after death. The proceeds from the policy will prevent the family from suffering financially after the assured's death.
- The family can use a portion of the assurance money to pay the funeral expenses.
- A much lower premium is paid than on an endowment policy, as the time of payout of the policy is not stated. The time of death is not specified.
- The minimal monthly premium grows into a large amount that will be paid out when the assured dies, as profits are added throughout the length of the life policy to the assured amount.



- The policy can be used as security for a loan, by ceding it to the party that grants the loan.
- When premiums are not paid for a certain period, arrangements can be made with the assurer, who will allow the policy to lapse temporarily and to reinstate it at a later stage (usually not longer than two years).
- Business partners can take a joint policy that covers the lives of both partners and the surviving partner may use the money to buy the deceased's share in a business.

7.5.2 *Endowment policies*

Endowment policies are also a form of life assurance, but the policy is paid out after a specified number of years, when the assured reaches the specified age. The assured usually takes out the policy with a specific objective in mind, such as an international holiday. Many parents take out an endowment policy on a child at birth, with the maturity date on the child's eighteenth birthday, to be used for tertiary education. If, however, the assured dies before the specified age, the policy will pay out to the beneficiaries, as with a life policy. The endowment policy holds similar advantages to that of a life policy, except that the premiums will be slightly higher than those of a similar life policy. The only extra influential factor regarding the premium, other than those that affect the premium of a life policy, is the length of the endowment policy – the shorter the length of time until maturity the higher the premium.

Additional advantages of endowment policies include:

- The assured may personally benefit from the policy.
- The amount that is paid out on maturity may be invested and the interest earned from the investment could provide additional income on a monthly basis for the beneficiary (assured).

7.5.3 *Retirement annuity*

A retirement annuity is a form of life assurance combined with a pension scheme. It is similar to an endowment policy, as it is paid out on a specific date. However the total assured amount is not paid out on the maturity date. Only one-third of the assured amount is paid out; the other two-thirds are invested by the assurer and the interest earned on the investment is paid to the assured on a monthly basis, similar to a pension.

Advantages of a retirement annuity include:

- The premiums paid can be deducted from the assured's income before income tax is calculated, which reduces the income tax calculated on the income.
- Payment of the pension does not cease when the assured dies, but will continue until the assured's partner also dies. It will still continue if there are dependants who are not self-supporting.

Question

What is the difference between an endowment policy and a retirement policy?



7.6 Voluntary insurance

As the term indicates, this is insurance that the individual or organisation may choose to take out. It is not possible for organisations to insure themselves against all imaginable risks. Insurers are not willing to accept all risks, and there are certain risks that are non-insurable. These are also known as **economic risks**. The most common of these is monetary loss suffered by an organisation because of price fluctuations.

Such losses may be caused by factors including:

- **Passage of time** – This is where the prices of goods may change over a period of time. The price may be different today from the time an order was placed.
- **Price fluctuations** – These may be caused by fluctuations in the exchange rate and this plays an influential role when trading with foreign countries. Prices may also be different in other areas because of scarcity or abundance.
- **Changing fashions** – An organisation is at risk if an organisation still has outdated fashions in stock.
- **Changes in technology** – Rapid changes in technology may cause losses because some organisations cannot change as often or as fast.
- **Bad debts** – Organisations may suffer losses because of bad debts.

7.7 Compulsory insurance

There are certain types of insurance that are compulsory. The following types of insurance have been created by legislation to give security to specific groups in society.

7.7.1 Unemployment insurance

Unemployment insurance (UIF) insures employees against the risk of loss of income as a result of termination of service, illness, pregnancy or death. The purpose of the Unemployment Insurance Act is to establish an unemployment insurance fund to which employers and employees contribute and from which employees who become unemployed or their beneficiaries, as the case may be, are entitled to benefits and in so doing to alleviate the harmful economic and social effects of unemployment (Department of Labour, 2015). The Unemployment Insurance Act provides protection to workers who become unemployed. It prescribes claiming unemployment benefits for unemployment, maternity benefits, illness benefits, adoption benefits and dependents' benefits.

The Unemployment Insurance Act applies to all employers and workers, but not to:

- workers working less than 24 hours a month for an employer;
- learners;
- public servants;
- foreigners working on contract;
- workers who get a monthly state (old age) pension; or
- workers who only earn commission.

Domestic employers and their workers are included under the Act since 1 April 2003 (Department of Labour, 2015).



Payments to the Fund are deducted from the salary and are equal to 1% for the total of all earnings, excluding commission. In addition to the 1% that is paid by the worker, the employer also contributes 1% for the worker. The total contribution that is paid to the Fund is therefore 2% (Department of Labour, 2015).

7.7.2 Insurance against occupational injuries and diseases

Accidents happen in the workplace. Employers can insure their employees against disabilities or death as a result of accidents or illnesses suffered in the course of their work. The Compensation for Occupational Injuries and Diseases Act provides compensation for employees' loss of earnings because of disablement or death caused by an accident at work or the effects of an industrial disease contracted at work. Usually the employer would carry the total contribution to the fund.

7.7.3 Third-party insurance

This covers the organisation or individual against any legal liability it may have in the case of injury or damage to the property of a third party. The third party refers to innocent members of the public who suffer loss while being on the premises of the insured or premises managed by the insured. Third-party insurance does not provide any benefit to the insured. This insurance only covers the insured's legal liability for death or disability of the third party or any damages to the third party's property.

Third-party car insurance is a compulsory insurance for all vehicle owners; the premium is included in the petrol price, so for every litre of fuel purchased, a percentage of the petrol price is paid to the Road Accident Fund. The Road Accident Fund is responsible for providing compulsory social insurance cover to all users of South African roads; to assist and compensate persons injured as a result of the negligent driving of motor vehicles; and to actively promote the safe use of all South African roads. It is referred to as a 'third-party' cover since the beneficiary of the policy is someone other than the two parties involved in the contract (the car owner and the insurance company). It covers all persons injured or killed in an accident who were not passengers in the vehicle responsible for the accident. Claims against the Fund may be for medical expenses, pain and suffering as well as death. Claims cannot be made by these persons against the driver of the vehicle responsible for the accident. This policy does not cover damage to the insured's car.

Questions

- What is third-party insurance?
- Who pays for third-party insurance?
- Who benefits from third-party insurance?



7.8 Advantages and disadvantages of insurance

The advantages of insurance include the following:

- It covers the insured against any possible losses they may suffer.
- It provides security to employers by covering them against any damage that may arise from irresponsible behaviour by employees during working hours.
- It gives greater peace of mind to the insured.
- Insurance may be used to:
 - provide for certain future events, such as retirement;
 - provide financially for the insured and/or the family; and
 - provide for the possibility of any disability or partial disability.
- Life insurance policies may be offered as security for a loan.
- Premiums for retirement annuities are tax deductible.
- Benefits are calculated from the payment of the first premium.
- Certain policies can serve as a form of compulsory saving.

There are no real disadvantages of insurance, except that it costs money. Of course, as described in the introduction, the losses can be retained by the organisation. When losses are covered by the organisation, it will have to build up a fund for this purpose. It is really like having its own insurance. The risk is carried by the organisation or individual.

Of course, this can be a risky exercise. Take the example of an organisation having a major loss in the first few months of retaining its own losses. The loss might be of such an extent that it is not possible for the organisation to cover the loss and it could mean the end of the organisation. So, it is quite a serious decision that has to be made.

Some organisations and individuals have found that they can achieve better benefits through self-insured programmes. In certain cases, the alternatives were adopted as a result of a perceived failure in the commercial insurance market.

7.9 Alternatives to insurance

Other forms of commercial insurance and the traditional forms of retention have also been developed. These other forms include:

- **Self-insurance programmes** – This is practical only for larger organisations with widespread risks. The self-insured must be prepared to pay losses as they occur but may purchase excess insurance to avoid the effect of catastrophic losses.
- **Captive insurance** – In this case, an organisation or group of businesses commissions an insurer to stand surety for the risks of that organisation or group.
- **Risk-pool insurance** – A number of participating insurers unite their interests in one area and all share in the result.

7.10 Choosing an insurer

It is advisable to contact different insurers and 'shop around' to find one that suits the needs of the individual or organisation. Another option is to contact an insurance broker and let that person do the shopping around. However, when a broker is used, a commission



must be paid to the broker, which is part of the monthly premium. This is for services rendered by the broker.

7.11 Conclusion

As shown in this chapter, insurance is voluntary in most cases. Individuals and organisations need to decide whether to take out insurance for a specific contingency or finance the risk themselves.

This chapter covered how insurance works and the principles that apply. Which factors influence the premiums and the different types of insurance were also discussed. The advantages and disadvantages of insurance were also listed.

At some point everyone is confronted with a decision regarding insurance. There are many factors that influence this decision. It is a good idea to involve the specialists, especially the financial manager in the organisation, obtain different opinions and quotations and talk to people who have gone through the process in order to make an informed decision.

7.12 Self-assessment

1. Explain two ways in which risk financing can be done.
2. What is the purpose of insurance?
3. What is the insurer's role in the policy and what is the role of the insured?
4. How does an insured prove insurable interest on the house he wants to insure?
5. Why do insurance premiums differ from one person to another?
6. One of the principles of insurance is 'utmost good faith'. Why is good faith necessary?
7. 'All risks are insurable.' Do you agree with this statement? Motivate your answer.
8. Distinguish between assurance and insurance.
9. What factors would influence the premium on a life policy?
10. What is compulsory insurance? Discuss three examples.
11. Why would you or would you not take out insurance on the office furniture?
12. Imagine that you do not believe that insurance is a good thing and explain two alternatives to it.
13. You must insure the vehicle that the office personnel are using for work purposes comprehensively. When the vehicle is not in use, it is locked up in a garage. Your organisation is located in Lynnwood, a suburb of Pretoria.
 - What questions would the insurer ask you in order to work out your monthly premium?

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