

FAC 1503 – SUMMARISED NOTES:

What is accounting

Accounting is a process consisting of three activities, namely:

- Identifying those events that are evidence of economic activity (transactions) relevant to the particular business or entity.
- Recording the monetary value of the economic events (transactions) so as to provide a permanent history of the financial activities of the business. Recording consists of keeping a chronological diary of measured events in an orderly and systematic manner. Recording implies that economic events are also classified and summarised.
- The third activity encompasses the communication of the recorded information to interested users. The information is communicated through the preparation of and distribution of accounting reports, the most common of which are known as financial statements.

The Nature of Accounting

Accounting is a specialised means of communication which is used to convey a specialised message about the finances of an entity. It is essential that the recipient of this specialised message (the user of financial information) should understand it, otherwise the information which is conveyed has no value.

Accounting is therefore a “language” which is used to convey financial information to interested parties.

Users of financial information

- Investors
- Creditors
- Employees
- Government
- Management

Users of financial information can be divided into two categories, namely:

- internal users — eg management, employees
- external users — eg investors, creditors, government

The fields of accounting

1 Financial accounting

This field of accounting is concerned with the recording of transactions and the preparation of the financial statements regarding the entity as a whole. Financial accounting is governed by Generally Accepted Accounting Practice (GAAP), which consists of external standards which must be adhered to. These standards assure the comparability of financial statements between entities.

2 Management accounting

Management accounting provides financial information for specific purposes. Managers use this information in their decision making, which leads to the attainment of the objectives of the entity. Without this financial information, it would be difficult for management to manage effectively.

Study unit 2: The nature of accounting theory

1 Accounting principles

The techniques used in the practice of accounting are based on conceptual and theoretical ideas. These ideas are generally known as accounting principles.

2 Accounting policy

We encounter precisely the same situation in accounting. Transactions of a repetitive nature frequently occur, and the requirement of consistency means that an entity has to establish an accounting policy which determines how such transactions will be treated. Accounting policy is thus a set of decisions about how the entity will treat the same type of transactions in order to achieve a consistent performance.

3 Disclosure of accounting policy

Since an accounting policy represents an entity's decisions about situations which it could deal with in various ways, it has to disclose its accounting policy in its financial statements.

4 Generally accepted accounting practice (GAAP)

If each entity were to prepare financial reports according to its own accounting rules and its interpretation of accounting theory and principles, chaos would exist in the world of economics and business.

A **foundation** has therefore been developed over the years for the measurement and disclosure of the results of financial events (transactions).

This foundation is a general framework and encompasses, in broad terms, accounting concepts, principles, methods and procedures, which are collectively known as GAAP.

5 Accounting standards and statements

Framework for the preparation and presentation of financial statements

The framework is not a statement but a framework, "... which sets out the concepts that underlie the preparation and presentation of financial statements ..." The framework is a group of interrelated objectives and theoretical principles that serves as a frame of reference for financial accounting.

The objective of financial statements

The objective of preparing financial statements is to provide information about the financial position (assets, liabilities and equity), performance (income and expenses, including gains and losses), and cash flows of an entity in order to provide useful information to the users of the financial statements in making economic decisions. It also serves as proof of the results of management's stewardship of the resources of the entity.

Underlying assumptions

- **Accrual basis of accounting**

Financial statements, except for cash flow information, are prepared using the accrual basis of accounting. When the accrual basis of accounting is used, an entity recognizes the elements of the financial statements when they satisfy the definitions and recognition criteria.

- **Going concern**

This consideration is based on the fundamental accounting concept that the entity will continue to exist in the foreseeable future.

When management assesses whether the going concern assumption is appropriate, it takes all the relevant information for at least twelve months from the statement of financial position reporting period into account.

When financial statements are not prepared on a going concern basis that fact should be disclosed together with the basis on which the financial statements are prepared and the reason why the entity is not considered to be a going concern.

Qualitative characteristics of financial statements

The four main qualitative characteristics are:

- (1) Understandability
- (2) Relevance
- (3) Reliability
- (4) Comparability

The elements of financial statements

The following are elements of financial statements:

- Elements by which the financial position (assets = equity plus liabilities) is measured:
 - (1) Assets
 - (2) Liabilities
 - (3) Equity
- Elements that measure profitability (profit or loss = increase or decrease in equity):
 - (4) Income
 - (5) Expenses

Assets

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity

Liabilities

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Equity

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Income

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants

Expenses

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants (e.g. shareholders).

Study unit 3: The financial position

The financial position of the entity is described in terms of assets and interests at a **given time**. They are reflected in a statement of financial position, which is essentially an accounting report that communicates relevant financial information to the owners, creditors and other interested parties.

Net asset value

$\text{ASSETS} - \text{LIABILITIES} = \text{NET ASSET VALUE}$

The net asset value represents the portion by which the assets exceed the liabilities. Net asset value is therefore also called equity.

The double-entry system

The double-entry system is based on the fact that every transaction affects two or more items in the BAE. In principle it means that each transaction must be recorded in such a way that the equation remains in balance. The dual effect which each transaction has on the elements of the BAE is the fundamental principle on which all entries in an accounting system are based.

Study unit 4: The financial performance

The financial performance of an entity is measured in terms of the profit or loss which the entity has made over a specific period, which is referred to as the **financial period** and which is normally a year. An entity makes a profit when the income it has earned is more than the expenditure it has incurred in generating or producing that income. The difference between the income and expenditure is known as the profit or loss. Profit is the owner's reward for the capital he or she has invested and the entrepreneurial spirit he or she has shown. It therefore increases the equity.

The financial performance is measured in the statement of comprehensive income of an entity.

Study unit 5: The double-entry system and the accounting process

At this stage we are simply using the accounting equation as a teaching aid to explain the analysis of transactions. The BAE **does not** form part of a formal accounting system.

To make a double-entry you must:

- Think about what the effect of the transaction is going to be on the BAE, in other words, how it is going to affect the financial position of the entity.
- Identify the components which are involved, that is the components which will have the desired effect on the equation.
- Determine which component will increase and which component will decrease.
- Be sure that the amount(s) decreased are equal to the amount(s) increased.

The effect of transactions on the basic accounting equation (BAE)

A transaction is an agreed upon transfer of value from one party to another which affects (changes) the amount, nature or composition of an entity's assets, liabilities or equity. In other words it affects the BAE. Entering into a transaction gives rise to the first step in the accounting cycle, namely the completion of a source document.

Transactions may

- affect assets and/or equity and/or liabilities
- generate income or give rise to expenditure

QUESTION 1 (20 marks) (24 minutes)

Commence this question on a new (separate) page.

PK Traders entered into the following transactions during April 2011. The entity uses a periodic inventory system and is not registered as a VAT vendor.

- 1 Paid R2 580 with a business cheque for a printer purchased for the owner's son.
- 3 B Kenyeza who owed R1 480 paid R1 200 on 15 May 2011 in full settlement of his account. The cheque was returned on 3 April 2011 marked R/D. No entries were made in the books to record the cheque returned.
- 6 Paid the telephone account of the entity by cheque, R1 560.
- 8 A delivery vehicle was purchased on credit from Auto Motors for R85 000. A deposit of R35 000 was paid immediately and the outstanding balance is still due to Auto Motors.
- 12 Inventory purchased from LA Traders for R975 was incorrectly posted to the repairs account.
- 14 Received a cheque from M Moyo, R2 375. His debt was written off as irrecoverable during December 2010.
- 15 Received an invoice from ST Suppliers for stationary ordered, R1 450.
- 18 Sold inventory on credit to M Maluleka, R1 400.

REQUIRED:

Analyse the above transactions of PK Traders in tabular format as follows:

Date	Account to be debited	Account to be credited	Effect on the basic accounting equation		
			Assets	Equity	Liabilities
Example: April 1 The owner deposited R50 000 into the business's bank account as his capital contribution.					
Apr 2	Bank	Capital	R + 50 000	R + 50 000	R

- NB:**
1. The columns in respect of the accounting equation must **NOT** be totalled.
 2. Each amount **MUST** be preceded by a plus sign (+) for an increase or a minus sign (–) for a decrease.
 3. Show all calculations.

Solution:

Date	Account Debited	Account Credited	Effect on the Basic Accounting Equation		
			Assets	Equity	Liabilities
2-Apr	Printer	Capital	+ 2,580	- 2,580	
3-Apr	Bank	Debtor - B Khanyeza	+ 1,200 - 1,200		
3-Apr	Debtor - B Khanyeza	Bank	+ 1,200 - 1,200		
6-Apr	Creditor	Bank	- 1,560		- 1,560
8-Apr	Motor Vehicle - Assets	Bank Auto Motors	+ 85,000 - 35,000		+ 50,000
12-Apr	Inventory	Repairs	+ 975	+ 975	
14-Apr	Bank	Bad debts recovered	+ 2,375	+ 2,375	
15-Apr	Stationery	ST Stationers (Creditors)	+ 1,450		+ 1,450
18-Apr	A Maluleka (Debtor)	Inventory	+ 1,400 - 1,400		

The general ledger account

An account is opened in the general ledger for every asset, liability and equity item. Every account appears on its own on a page in the ledger and each account is given a number, which is known as a **folio number**.

An account is an accounting record in which all transactions relating to a specific item are recorded. Only one account is opened, for example, for equipment, and all the transactions relating to equipment is recorded in one equipment account.

Balancing an account

NB:

The closing balance of the previous period becomes the opening balance of the next period.

- c/d = carried down, which indicates the amount to be carried down to the following month
- b/d = brought down, which indicates that the amount has been brought down from the previous month

Schematic representation

ASSETS		=	EQUITY		+	LIABILITIES	
Dr	Asset accounts		Equity accounts			Dr	Liability accounts
+	–		Decrease equity	Increase equity		–	+
<i>Debit to increase</i>	<i>Credit to decrease</i>					<i>Debit to decrease</i>	<i>Credit to increase</i>
Balance = debit						Balance = credit	
			Dr	Drawings	Cr	Dr	Capital
+	–		–	+		–	+
<i>Debit to increase</i>				<i>Credit to increase</i>			
Balance = debit Close off to Capital			Balance = credit				
Expenditure accounts			Income accounts				
+	–		–	+		–	+
<i>Debit to increase</i>				<i>Credit to increase</i>			
Balance = debit Close off to Profit or Loss			Balance = credit Close off to Profit or Loss				
Dr			Profit or Loss			Cr	
Expenditure accounts			Income accounts				
			Close off to Capital				

The trial balance

A trial balance is a list of the balances brought down (b/d) of the accounts in the general ledger on a specific date.

TRIAL BALANCE AS AT 28 FEBRUARY 20.1

	Debit	Credit
	R	R
Bank	54 200	
Equipment	100 000	
Furniture	2 000	
Debtors control	4 000	
Capital		130 000
Drawings	1 000	
Loan		25 000
Creditors control		200
Wages	800	
Advertisements	200	
Fees earned		7 000
	162 200	162 200

Preparing financial statements

The Statement of profit or loss and other comprehensive income

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STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE MONTH ENDED 28 FEBRUARY 20.1

	Note	R
Revenue		7 000
Distribution, administrative and other expenses		(1 000)
Wages		800
Advertisements		200
Profit for the month		6 000

The statement of changes in equity

This statement shows all the changes in equity which have occurred during the financial period. The purpose of the statement of changes in equity is to reconcile the equity at the beginning of the financial period with the equity at the end of the financial period. The balance of the equity at the end of the financial period is then shown in the statement of financial position.

STATEMENT OF CHANGES IN EQUITY FOR THE MONTH ENDED 28 FEBRUARY 20.1

	Total equity
	R
Capital	
Balance at 1 February 20.1	130 000
Profit for the month	6 000
Drawings	(1 000)
Balance at 28 February 20.1	135 000

The statement of financial position

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 20.1

ASSETS	Note	R
Non-current assets		102 000
Property, plant and equipment	3	102 000
Current assets		58 200
Trade and other receivables		4 000
Cash and cash equivalents (bank)		54 200
Total assets		160 200
EQUITY AND LIABILITIES		
Total equity		135 000
Capital		135 000
Total liabilities		25 200
Non-current liabilities		25 000
Long-term borrowings		25 000
Current liabilities		200
Trade and other payables		200
Total equity and liabilities		160 200

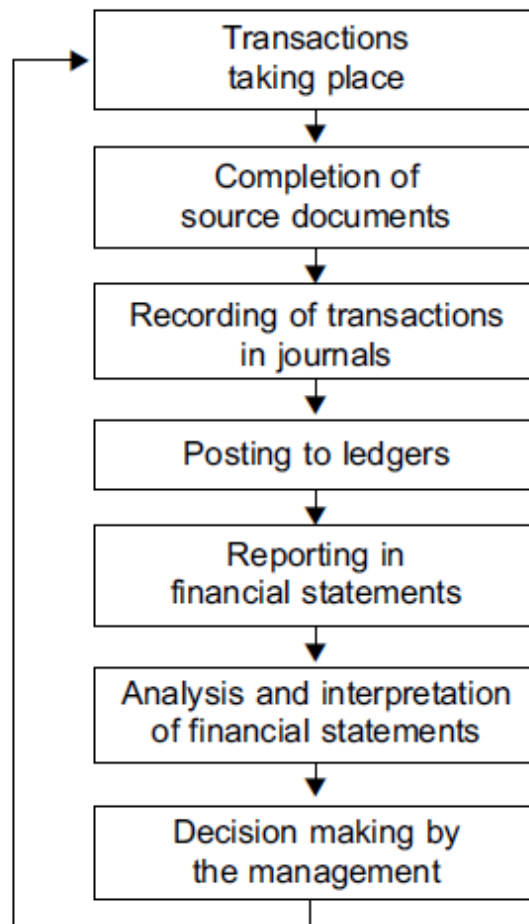
TOPIC B

Collecting and processing the accounting data of entities

The accounting cycle

Accounting data are processed within a definite framework which is known as the accounting cycle.

The following diagram shows the accounting cycle:



Books of first entry: journals

There are two books of original / prime / first entry, namely;

- ❖ Journal book
- ❖ Cashbook

JOURNAL

Types of journals

There are various types of journals or books of first entry but for the time being we will be concentrating on the following:

- **the cash receipts and cash payments journals** in which all cash transactions are recorded
- **the purchases journal and purchases returns journal** in which all credit purchases and returns of credit purchases are recorded
- **the sales journal and sales returns journal** in which all credit sales and returns of credit sales are recorded
- **the general journal** in which transactions are recorded which are not recorded in one of the other journals, for example the correction of errors and the writing off of credit losses

Cash receipts journal

All moneys received which is deposited in the entity's bank account is recorded in the cash receipts journal. At the end of the month only one amount, which represents the entire month's cash receipts, is debited to the bank account. The other column headings represent the contra accounts and the totals of these columns are credited to those accounts. The amounts in the sundry accounts column are credited individually to the relevant accounts, on the date the transaction occurred.

Cash payments journal

All cash payments, that is payments by cheque or electronic fund transfers, are recorded in the cash payments journal. At the end of the month only one amount, which represents the entire month's cash payments, is credited to the bank account. The other column headings represent the contra accounts and the totals of the columns are debited to those accounts. The amounts in the sundry accounts column are debited individually to the relevant accounts.

Credit journals and the general journal

Purchases journal and purchases returns journal

Merchandise purchased on credit is recorded in the purchases journal. At the end of the month only the total credit purchases for the month are debited to the purchases account and credited to the creditors control account. If some of the goods are returned, they are recorded in the purchases returns journal.

Trade discount is never recorded in the books of the purchaser but a cash / settlement discount must be recorded.

Sales journal and sales returns journal

Merchandise sold on credit is recorded in the sales journal. At the end of the month only the total credit sales for the month are credited to the sales account and debited to the debtors control account. If the debtors return some of the goods, these returns are recorded in the sales returns journal.

General journal

The general journal is for recording transactions which can't be captured in any of the above journals.

QUESTION 2 (23 marks) (27 minutes)

Commence this question on a new (separate) page.

The following information pertains to the accounting records of Optical Solutions Ltd. The entity is registered as a VAT vendor and uses the periodic inventory system. The VAT period of the entity ends on equal months. The following balances appeared in the books:

2.1 TRAIL BALANCE AS AT 31 MARCH 2011

	Debit	Credit
	R	R
Capital		90 000
Bank	85 717	
VAT Input	1 610	
VAT Output		1 745
P Heyns	1 580	
Piper Traders		2 100
M&M Wholesalers		1 850
R Kriel	2 171	
Salaries & wages	17 400	
Water and electricity	36 000	
Sales		149 550
Purchases	90 200	
Sundry expenses	10 567	
	245 245	245 245

2.2 Transactions, 14% VAT inclusive, for April 2011:

- Apr 1 The owner, B Bolozi, increased his capital contribution with R12 500.
- 4 Purchased merchandise on credit from M&M Wholesalers, R3 534.
- 7 Issued an invoice to P Heyns for goods sold to him, R1 140.
- 8 Issued a cheque for R1 815 to Piper Traders in full settlement of the entity's account.
- 12 Issued a credit note for R228 to P Heyns for an overcharge on the invoice of 7 April 2011.
- 14 Cash sales of merchandise, R2 394.
- 20 Received a cheque of R2 000 from a debtor, R Kriel, in full settlement of his account.
- 26 Cash purchases of merchandise, R1 026.
- 29 Drew a cash cheque of R4 500. R3 000 was for wages and the balance for the personal use of the owner.
- 30 Received interest on the favourable bank balance of the entity, R285.

REQUIRED:

Enter the applicable transactions **ONLY** in the following subsidiary journals of Optical Solutions Ltd for April 2011:

- 2.1 Cash receipts journal with the following columns: day, details, bank, debtors control, settlement discount granted, sales, VAT output, VAT input and sundry accounts. Do not total the columns. (10)
- 2.2 Cash payments journal with the following columns: day, details, bank, creditors control, settlement discount received, purchases, VAT input, VAT output and sundry accounts. Do not total the columns. (9)
- 2.3 Purchases journal with the following columns: day, details, creditors control, purchases and VAT input. Do not total the columns. (2)
- 2.4 Sales journal with the following columns: day, details, debtors control, sales and VAT output. Do not total the columns. (2)

[23]

NB: Show all calculations.

[TURN OVER]

Solutions:

2.1 Optical Solutions Ltd
Cash Receipts Journal - April 2011

Document Type	Day	Details	Analysis of Receipts	Bank	Debtors control	Settlement Discount	Sales	VAT Output	VAT Input	Sundry Accounts		
										Amount	Folio	Details
Rec 1	1-Apr	B. Baloyi	12,500	12,500						12,500		Capital
Rec 2	14-Apr	Sales	2,394	2,394			2,100	294				
Rec 3	20-Apr	R. Kriel	2,000	2,000	2,171	171			21			

2.2 Optical Solutions Ltd
Cash Payments Journal - April 2011

Document Type	Day	Details	Analysis of Receipts	Bank	Creditors control	Settlement Discount	Purchases	VAT Output	VAT Input	Sundry Accounts		
										Amount	Folio	Details
Chq 1	8-Apr	Piper Traders	1,815	1,815	2,100	285		35				
Chq 2	26-Apr	Purchases	1,026	1,026			900		126			
Chq 3	29-Apr	Cash cheque	4,500	4,500	-	-				(3,000 ; 1,500)		Wages & Drawings

2.3 Purchases Journal

Day	Details	Creditors control	Purchase	VAT Input
4-Apr	M & M Wholesalers	3,534	3,100	434

2.4 Sales Journal

Day	Details	Creditors control	Purchase	VAT Output
7-Apr	P Heyns	1,140	1,000	140

The trial balance

For each transaction, the debit entries must equal the credit entries. The total of all the debit balances should, therefore, correspond to the total of all the credit balances. A list of balances is prepared periodically to determine whether any errors have been made. This list of balances is called a trial balance.

TOPIC C

Accountability for current and non-current assets

Study unit 7: Cash and cash equivalents

1 The nature of cash and cash equivalents

Cash in accountancy includes not only coins and notes but also postal orders, cheques, electronic fund transfers and credit card transactions. As money is the primary legal tender, every transaction eventually leads to either an outflow or an inflow of money for an entity. Cash equivalents include savings accounts or any investment that can be converted into cash in a period shorter than 12 months. This qualifies cash and cash equivalents as current assets.

Internal control over cash

As money is necessary for survival, the internal controls applicable to cash are very important for a business. The following are measures that can be used by a business for control purposes:

- Employees' duties should be divided in such a way that an error by one employee will be detected by another employee in the normal performance of his duties. It should take at least two employees to embezzle cash.
- Cash receipts should be recorded in such a way that the actual cash received can be checked against an independent daily record.
- Cash received should be banked daily.
- All payments except petty cash payments (see paragraph 7.4) should be made by cheque, or proper documentation must be in place for electronic fund transfers.
- The bank statement should be compared with the cash receipts and cash payments journals.
- The bank statement balance should be reconciled with the bank account balance.

Reconciliation of the bank statement balance with the bank account balance

If the bank and the business keep record of the same transactions the balance of the bank statement and the bank account in the books of the business must be the same.

In order to ascertain that the bank account in the books of the business corresponds to the bank statement, a **bank reconciliation statement** is prepared. This means the balance of the bank account in the books of the business is reconciled with the balance on its bank statement.

The reconciliation process has two steps: first the business's records are updated to account for actual transactions reflected on the bank statement, and secondly record those transactions to which the bank must still attend to in the **bank reconciliation statement**.

The bank reconciliation could be seen as an extension of the bank statement. An outstanding item that will be credited on the bank statement, must be credited on the bank reconciliation statement and vice versa.

Procedure to follow in the reconciliation process

- Where a bank reconciliation statement was completed for the previous month the bank statement must first be compared with that bank reconciliation statement to ascertain whether the outstanding items and corrections have been done by the bank. Remember to compare the items on the debit side of the bank reconciliation statement with entries on the debit side of the bank statement and credit entries on the reconciliation with credit entries on the statement.
- Compare the amounts in the cash receipts journal for the current month with the entries on the credit side of the bank statement.
- Compare the amounts in the cash payments journal for the current month with entries on the debit side of the bank statement.

The petty cash journal

All transactions which are small in value that it makes it very expensive to pay them by cheque are paid out of the petty cash.

Items purchased out of the petty cash float are recorded in the petty cash journal, which is part of the cash records but is separate from the cash payments journal. Recording is done from suitable petty cash vouchers authorised by responsible officials of the entity.

QUESTION 3 (21 marks) (25 minutes)

Commence this question on a new (separate) page.

The following information for March 2011 pertains to Protea Traders:

	R
1. Totals of the cash journals at 31 March 2011:	
Cash receipts journal	15 685
Cash payments journal	13 236
2. Favourable balance of the bank account in the general ledger at 28 February 2011...	760
3. Favourable balance according to the bank statement at 31 March 2011	7 493
4. Item appearing on the bank reconciliation statement as at 28 February 2011 but not on the bank statement for March 2011:	
Cheque no 345 issued to creditor Duminy Shelving on 8 September 2010	1 650
5. Items appearing in the cash journals but not on the bank statement:	
Cheque no 856, dated 28 March 2011, issued to creditor W Parnell	2 400
Cheque no 863, dated 29 March 2011, issued to Comp-Tel for communication expenses	1 659
A deposit made on 31 March 2011. On enquiring at the bank it was established that the money was incorrectly entered into the account of another client of the bank	3 460
6. Items appearing on the bank statement but not in the cash journals:	
Bank charges	250
Cash handling fee	65
A deposit by L Tsotsobe for rent	4 000
A cheque received from debtor H Gibbs returned by the bank marked R/D	940
Interest received on fixed deposit	200
A deposit from a debtor, H Amla, paid directly into the bank account	1 000
A cheque issued by G Smith, another client of the bank	580
7. A cheque for R1 500 issued during the month as payment for cash purchases was entered into the cash payments journal as R150. This mistake must still be corrected.	

REQUIRED:

- 3.1 Complete the cash receipts and cash payments journals of Protea Traders, bank columns only, at 31 March 2011. (10)
 - 3.2 Prepare the bank account in the general ledger of Protea Traders, properly balanced, on 31 March 2011. (5)
 - 3.3 Prepare the bank reconciliation statement of Protea Traders as at 31 March 2011. Begin with the balance as per bank statement. (6)
- [21]

NB: Show all calculations.

Solutions:

3.1 Protea Traders

Cash Receipts Journal - March 2011

Document Type	Details		Bank
	Rent		4,000
	Interest		200
	H Amla		1,000
	G Smith		580
			<u>5,780</u>
Cash receipts journal			<u>15,685</u>
			<u><u>21,465</u></u>

3.1 Protea Traders

Cash Payments Journal - March 2011

Document Type	Details		Bank
	Bank Charges		250
	Cash handling fee		65
	H Gibbs - RD Cheque		910
	Undercast error		1,350
			<u>2,575</u>
Cash payments journal			<u>13,236</u>
			<u><u>15,811</u></u>

Protea Traders

3.2

Bank Account

1/3/2011 Balance b/d	750	Cash Payments	15,811
Cash Receipts	21,465	31/3/2011 Balance c/d	6,404
	<u><u>22,215</u></u>		<u><u>22,215</u></u>
1/4/2011 Balance b/d	6,404		

Protea Traders

Bank Reconciliation statement as at 31 March 2011

	DR	CR
Balance as per bank account		7,493
Bank error		3,460
Cheques not yet presented for payment:		
345 - Dated 8/09/2010	-	
586 - Dated 28/03/2011	2,400	
863 - Dated 29/03/2011	1,659	
Balance as per bank account	6,894	
	10,953	10,953

Study unit 8: Trade and other receivables

A sale made without the buyer paying at the time of the sale is known as a credit transaction. The person or business owing money to an entity which originates from a credit sale is known as a trade debtor. A debtor accepts responsibility for paying the debt within a specific period. The period is known as a credit term and is predetermined in accordance with the credit policy of the entity making the sale. Because some debtors do not pay their accounts, many firms make allowance for credit losses.

Settlement discount granted

A settlement discount is often offered to debtors in order to encourage a quick settlement of their debts within the stated credit term. The credit term will be shown on the credit invoice, for example, 30 days from the date of sale.

Interest charged

Interest is charged on outstanding balance if a debt is not paid within a credit term.

The interest increases the outstanding balance on the individual debtor's account as well as the balance in the debtors control account. This transaction is recorded by means of a general journal entry.

Credit losses

When a credit transaction occurs there is always a possibility that the debt might not be paid. These debts which are never paid are known as credit losses or irrecoverable debts. Because there is always the possibility that some debts will not be paid, most entities have a policy of creating an allowance for credit losses.

The amount of the credit loss will be debited to the credit losses account and credited to the debtor's personal account as well the debtors control account.

Allowance for credit losses

In line with the prudence concept an allowance for credit losses is raised whenever there is uncertainty that income or an asset won't be realized.

When an entity decide to increase the allowance for credit losses, the credit losses account will be debited and the allowance for credit losses will be credited.

If management decides to decrease the allowance for credit losses, the allowance for credit losses must be debited and the credit losses account credited.

The accounting entries are as follows;

GENERAL JOURNAL

Date	Details	Fol	Debit	Credit
20.0 Jun 30	Credit losses Allowance for credit losses <i>Allowance for credit losses created</i>		R 800	R 800

Accounting entries of credit losses when an allowance for credit losses exists

METHOD 1:

As credit losses occur, the credit losses can be written off against the allowance account: debit the allowance account and credit the debtor's personal account and the debtors control account.

Method 2:

The allowance for credit losses account remains unchanged during the year. Credit losses that occur during the year are debited against the credit losses account.

Recovery of credit losses previously written off

When money is recovered that was previously written off as irrecoverable it must be recorded and disclosed separately. An account, **credit losses recovered**, will be opened for this purpose. The money recovered will be debited against the bank account and the credit losses recovered account will be credited. Credit losses recovered are seen as an income and are added to other operating income in the statement of profit or loss and other comprehensive income. This is to cancel the expense written off previously.

VAT, credit losses and credit losses recovered

The amount owed by a debtor always includes VAT. The VAT collected on credit sales is paid over every second month to the SARS. If a debt is not paid and has to be written off, the seller is entitled to claim the VAT portion that was included in the credit losses back from SARS.

Similarly, when a debt which was previously written off as irrecoverable is recovered, the seller is responsible for paying over the VAT component of that sale to SARS.

Disclosure in the statement of financial position

Debtors and bills receivable are current assets. Current assets are assets which the entity can reasonably expect to realise within the normal business cycle of one year.

According to GAAP, current assets must be disclosed as follows on the statement of financial position:

Debtors control account

A separate ledger is then kept in which an account for every debtor is listed. Posting from the journals to the debtors ledger takes place on a daily basis.

To obtain a complete record of all the transactions, a control account is kept in the general ledger. The debtors control account contains a **summary** of all the entries made in the individual debtors accounts. Posting to the debtors control account takes place once a month when the totals of all the subsidiary journals are finalised.

Study unit 9: Inventory

Classification of inventory:

- merchandise which are kept to be sold in the normal course of business
- merchandise which are in the process of being manufactured for sale
- raw materials which are used during the manufacture of inventory for sale (eg manufacturing material)
- consumables used in the normal business activities (eg stationery)

The importance of correct inventory valuation

It is very important that inventory is valued correctly. A mistake in the inventory figure will affect the calculation of cost of sales, the gross profit and subsequently profit in the statement of profit or loss and other comprehensive income. On the statement of financial position the total of the current assets as well as the equity will be incorrect. This mistake will also affect the figures for the following year, because the closing inventory for one year is the opening inventory for the next year.

Disclosure of inventory in the financial statements

Inventory is a current asset. In this course inventory consists mainly of finished products. In addition, there may be other inventory items such as packaging material, stationery and cleaning materials. All the different inventories are added together and shown as one amount under inventories in the statement of financial position. The accounting policy applied for the valuation of inventory must be disclosed in a note to the statement of financial position.

Study unit 10: Property, plant and equipment

Tangible non-current assets are assets such as buildings, machinery, vehicles and furniture. They are assets which you can see and touch. They are shown in the statement of financial position under the heading "Property, plant and equipment".

Because property, plant and equipment become obsolete after several years, they must be written off over their expected economic life. This is referred to as depreciation. The annual amount written off is treated as an expense in the profit or loss account.

Determination of the cost price of property, plant and equipment

The cost price of property, plant and equipment consists of:

- the purchase price, including all expenses incurred in getting the asset to the premises
- all the installation costs including, for example, the wages of the entity's own technical personnel
- any other expenses incurred in getting the asset operational

The cost price will remain constant throughout the life of the asset and is referred to as the historical cost price.

Safeguarding and control of property, plant and equipment

An assets register is used in which the following important information regarding the asset is recorded:

- location
- serial number
- cost price
- date of acquisition
- expected lifespan
- carrying amount
- current year's depreciation
- accumulated depreciation

The concept of depreciation

Assets are acquired to generate income. Because income is generated, the cost of owning the asset can be written off against income earned over the useful life of the asset.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Methods of calculating depreciation

(1) Straight line method

The cost price is written off over the expected useful life (in years) of the asset.

This method is also known as the **fixed instalment** method.

(2) Diminishing balance method

In this case a fixed percentage of the **carrying amount** is written off annually. Assume that a percentage of 20% is given.

TOPIC D Accountability for current and non-current liabilities

A liability is a claim which a party other than the owner/s has on the assets of the entity. It usually originates from a transaction in the past but it can also be the result of legal action. It is expected that the payment of a liability will lead to an outflow of resources.

Study unit 11: Current liabilities

The following items are usually classified as current liabilities:

- trade creditors
- accrued expenses
- income received in advance
- instalments payable on interest bearing borrowings
- value added tax payable to the SA Revenue Services
- bank overdraft

Trade creditors

This type of creditor results from the purchase of trading inventory, consumables and services on credit.

When creditors are paid within a specific period according to an agreement, the entity may get a discount on the outstanding account. A settlement discount received represents an income to the entity.

Sundry current liabilities

There are several types of current liabilities. At the end of the financial year a business must provide for accrued expenses or losses and VAT payable to the SA Revenue Service. Income received in advance is also classified as a current liability.

Disclosure in the statement of financial position

According to generally accepted accounting practice in South Africa, the current liabilities are disclosed as follows in the statement of financial position:

Creditors control account

The creditors control account is in the general ledger and it represents all the individual creditors in the creditors (subsidiary) ledger.

Study unit 12: Non-current liabilities

A non-current liability is a liability which is payable after a period of more than one year. The entity usually provides security for this type of loan.

Recording of a non-current liability in the books and its disclosure in the financial statements

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.1 (extract)

ASSETS	R
EQUITY AND LIABILITIES	
Non-current liabilities	1 140 000
Long-term borrowings	
Long-term loan from ABC Bank secured by a first mortgage over land and buildings. Repayable in four equal five-yearly instalments of R285 000. The first instalment is due on 1 January 20.6.	1 140 000

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.1 (extract)

EQUITY AND LIABILITIES	R
Non-current liabilities	2 000 000
Long-term borrowings	
2 000, 15% R1 000 debentures redeemable on 31 December 20.9	2 000 000

TOPIC E Financial accounting reporting

Study unit 13: Financial statements of a sole proprietorship

A sole proprietorship (also known as a sole trader) is the simplest form of business ownership and is often managed by the owner himself. There is no legislation prescribing how a sole proprietorship should be established.

Establishment of a sole proprietorship

A sole proprietor usually contributes capital in the form of cash, and/or non-current assets in the form of property, plant and equipment towards the starting of the business.

Additional capital contribution and profit for the year increase the capital of the business.

Drawings from the business reduce the capital of the business.

TOPIC F Financial accounting for law practitioners

Study unit 14: General aspects pertaining to financial accounting for law practitioners

Transactions encountered in a law practice

The main difference between the accounting records of a law practice and those of other professional enterprises is the way in which trust money is handled and recorded. Each transaction must be identified as either a business transaction or a trust transaction. Business money represents the own funds of the law practice whilst trust money is money received to be held in trust and handled according to the client's instructions. Business transactions are therefore transactions that takes place in the books of the law practice for his own benefit. Trust transactions are transactions in the law practice to the benefit of the client. The following transactions may be encountered in an attorney's practice:

A client offers to purchase a piece of land subject to the granting of a building society bond of at least 80% of the purchase price. The client entrusts all his or her affairs to his or her attorney, and hands the attorney a cheque to cover the deposit and other possible expenses.

The attorney is now responsible for the safekeeping of such money until the transaction is concluded or the offer lapses. Furthermore, he or she has to act in accordance with his or her client's instructions.

In the case of the above example, the following situations may occur:

- the offer lapses and the money which has been deposited has to be refunded to the client after the attorney has allowed for his or her expenses and fees
 - the registration of transfer, as well as the registration of the approved mortgage, are entrusted to another attorney. The deposit and related expenses must then be paid over to the transferring attorney on request
 - the registration of transfer as well as the registration of the approved mortgage takes place. The related expenses are charged and transferred from trust funds and the necessary payments made to the seller. Surplus funds are paid to the client.
- **Cash received from clients as payment of fees which they were charged, and for expenses incurred on their behalf**

Sometimes expenses are incurred on behalf of a client which are paid from the attorney's business bank account, and fees are charged to the client for services rendered. The client's account is then debited with these amounts and a monthly statement is issued to him or her for settlement of the account.

- **Trust money paid to clients, or the rightful recipients, after fees and expenses rightfully due to the attorneys have been deducted**
- **Expenses paid on behalf of clients which must subsequently be recovered from such clients**
- **Payment of general office expenses, and personal withdrawals**

These expenses are paid from the business bank account and must in no circumstances be paid from the trust bank account. The same applies to the daily, monthly or annual requirements of the attorney himself or herself. If an attorney draws a cheque for personal use, it must be drawn from the business bank account and never from the trust bank account.

- **Charging of fees for services rendered**

An attorney's income is derived from fees charged for services rendered. It is therefore essential to have an effective system for charging such fees, so as to ensure that the charging of fees for certain services is not neglected.

- **Transfer of money from the trust bank account to the business bank account**

Usually money which is received from clients is deposited in the trust bank account. When fees are charged, a transfer has to be made from the particular client's trust account to his or her debtor's account, on the explicit understanding that no transfer may be effected for an amount in excess of the credit balance on his or her trust account. It is therefore obvious that a trust account may never have a debit balance.

- **Transactions with correspondents**

Attorneys often appoint other attorneys to do certain work on their behalf and this can result in both business and trust transactions. These transactions are referred to as transactions with correspondents. The law practice issuing instructions is called the instructing attorney whereas the attorney's practice receiving orders is referred to as the executive (or instructed) attorney.

The handling of trust money in a law practice

Trust money, as the name indicates, is money entrusted to an attorney, to be held in trust by the attorney and to be dealt with according to the client's instructions. Money received by an attorney in respect of a matter for which the final fee cannot be accurately calculated until date of receipt of the deposit, for example a property transaction, forms part of trust monies according to section 78 (1) of the Attorneys Act 53 of 1979. The attorney must ensure that this position of trust is not abused; hence the reason for all the rules and regulations relating to the handling of trust money.

Trust money remains the property of the client or another party until the instruction is conducted or the fees in that regard debited to the client as long as it is in the attorney's possession, and the attorney must safeguard such money to the best of his or her ability. Trust monies do not form part of the assets of the practitioner and may therefore not be claimed by a creditor of the practitioner.

Bank charges and interest on the trust bank account

As you already know, bank charges are debited to a firm's bank statement. A law practice always has two accounts with the bank, that is, a business bank account and a trust bank account. Bank charges in respect of a trust bank account can be dealt with in two ways, namely by debiting the trust bank statement with the bank charges in respect of the trust bank account, or by debiting the business bank statement with the bank charges in respect of the trust bank account.

If the trust bank statement is debited with bank charges, the firm must transfer money from the business bank account to the trust bank account to cover these bank charges and thus prevent a deficit on the trust bank account.

Transfers

A practitioner is entitled to levy fees when he has fulfilled his responsibility towards his client. These transactions are recorded in the fees journal and the clients control account is debited and the fees earned account credited in the general ledger. The client's account is debited in the clients ledger. If the practitioner has previously received money in trust from this client, he is entitled to transfer funds from the client's trust creditors account to his business account provided the transfer requirements are met.

Transfers in this respect imply that credit balances on trust creditors accounts must be transferred to the clients ledger accounts.

Before a transfer is made from the trust to the business account, the following requirements should be met:

- The client should owe an amount to the practice on his business account and funds should simultaneously be available on his trust account in order to do the transfer.
- If the amount owing on the client's business account exceeds the amount available on his trust account, the amount transferred is limited to the amount available on the client's trust creditors account.
- When the amount available on the client's trust creditors account exceeds the amount owing on the client's business account, the amount transferred is limited to the amount owing on the client's business account.
- The client should give the necessary consent that funds be transferred from his trust creditor's account to his business account. The trust funds may not be transferred if they were earmarked for another specific purpose, eg a deposit for transfer duties relating to a property transaction may not be used to cover fees.

As soon as the credit balance is transferred from the trust creditors ledger to the clients ledger, the trust bank account will disagree with the trust creditors total. This must be rectified by means of a transfer from the trust bank account to the business bank account.

Trust creditors ledger

At the end of each month, a list of trust creditors must be compiled, the total of which must agree with the balance of the trust creditors control account in the general ledger. If there is any difference, the latter must be rectified in the control account and/or the individual accounts. The correct balance on the control account must be compared with the balance on the trust bank account. These balances must tally. Where there is a difference, the balance of the trust bank account must always **exceed** the total of the list of trust creditors' accounts.

TOPIC G Financial statement analysis

The purpose of financial analysis is to provide information as a basis for making future decisions. The analysis can be used to evaluate the previous period, whilst at the same time to pinpoint areas that require further investigation and to plan for the future.

A ratio expresses a relationship between one or more figures or groups of figures. Ratio analysis involves identifying, measuring and evaluating the relationships in order to assess the performance and financial position of the entity or part of it. Relationships can then be expressed as simple numbers which can be reviewed over time to show trends, or be used to compare with similar entities.

Types of ratios

1 Liquidity ratios

Liquidity is the potential ability of the entity to continue to pay its short-term liabilities.

1.1 Current ratio

The current ratio is a measure of the entity's ability to pay its creditors in the short term. It indicates by how much the business's **current assets** exceed its **current liabilities**, expressed in monetary terms.

The current ratio is calculated as follows:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

1.2 Quick ratio or acid test ratio

This ratio serves almost the same purpose but only taking into account current assets which are in liquid or near liquid form. Therefor excludes inventory from current assets.

$$\text{Acid test ratio} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}}$$

1.3 Trade receivables collection period

This ratio represents the average length of time **in days** that the entity must wait for cash after making a credit sale, that is, the number of days that debtors take on average to pay their accounts.

$$\text{Trade receivables collection period} = \frac{\text{Average trade receivables}}{\text{Credit sales}} \times 365$$

1.4 Inventory turnover rate

An entity should hold an adequate but not excessive amount of inventories.

$$\text{Inventory turnover rate} = \frac{\text{Cost of sales}}{\text{Average inventory}}$$

$$\text{Average inventory} = \frac{\text{Opening inventory plus closing inventory}}{2}$$

1.5 Inventory holding period

$$\text{Inventory holding period} = \frac{\text{Average inventory}}{\text{Cost sales}} \times 365$$

1.6 Trade payables settlement period

Shows the number of days it takes for the entity to pay its trade payables.

$$\text{Trade payables payment period} = \frac{\text{Average trade payables}}{\text{Credit purchases}} \times 365$$

2 Profitability ratios

2.1 Gross profit percentage

The gross profit percentage is the entity's gross profit calculated as a percentage of sales. The gross profit percentage would be calculated as follows:

$$\text{Gross profit percentage} = \frac{\text{Gross profit}}{\text{Sales}} \times \frac{100}{1}$$

2.2 Profit margin

The profit before tax is used.

$$\text{Profit margin} = \frac{\text{Profit before tax}^*}{\text{Sales}} \times \frac{100}{1}$$

2.3 Return on assets ratio

$$\frac{\text{Profit before interest and tax}}{\text{Total assets}} \times \frac{100}{1}$$

This measures the entity's ability to generate profit from its assets.

2.4 Interest cover

The measures the risk of the entity's ability to pay interest out the available profit.

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Finance costs}}$$

3 Solvency ratio

Solvency refers to the extent to which an entity's assets exceed its liabilities. Solvency relates not only to the current situation, but also to the ability to maintain solvency in the long term and thus to be able to continue business. If liabilities exceed assets then the entity is insolvent. In solvency, we consider all assets and liabilities, that is, both non-current and current.

The solvency ratio is calculated as follows:

$$\frac{\text{Total assets}}{\text{Total liabilities}}$$

QUESTION 5 (18 marks) (22 minutes)

Commence this question on a new (separate) page.

The following information pertains to Bingo Traders:

BINGO TRADERS
ABBREVIATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED
28 FEBRUARY 2011

	R
Revenue	1 600 000
Cost of sales	(782 250)
Inventory (1/3/2010)	212 600
Purchases	860 000
Inventory (28/2/2011)	(290 350)
Gross profit	817 750
Other income	18 510
Distribution, administrative and other expenses	(519 270)
Profit for the year	316 990
Other comprehensive income for the year	-
Profit/Total comprehensive income for the year	316 990

BINGO TRADERS
STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 2011

ASSETS

Non-current assets

Property plant and equipment

Current assets

Inventories

Trade receivables

Cash and cash equivalents

Total assets

R

454 000

454 000

749 850

290 350

385 000

74 500

1 203 850

EQUITY AND LIABILITIES

Equity

Capital

Total liabilities

Non-current liabilities

Long-term borrowings (Mortgage)

Current liabilities

Trade and other payables

Total equity and liabilities

654 850

654 850

549 000

360 000

360 000

189 000

189 000

1 203 850

Additional information:

1. Credit sales represent 65% of total sales (revenue).
2. Credit purchases represent 45% of total purchases.

Solution:

$$5.1 \text{ Acid test ratio} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}}$$

$$= \frac{749850 - 290,350}{189,000}$$

$$= 2.43$$

$$5.2 \text{ Profit margin} = \frac{\text{Profit before tax}^*}{\text{Sales}} \times \frac{100}{1}$$

$$= \frac{316990}{1,600,000} \times 100$$

$$= 20\%$$

$$\begin{aligned}
 5.3 \text{ Trade payables payment period} &= \frac{\text{Average trade payables}}{\text{Credit purchases}} \times 365 \\
 &= \frac{189,000}{387,000} \times 365 \\
 &= 178 \text{ days}
 \end{aligned}$$

$$\begin{aligned}
 5.4 \text{ Inventory turnover rate} &= \frac{\text{Cost of sales}}{\text{Average inventory}} \\
 \text{Average inventory} &= \frac{\text{Opening inventory plus closing invent}}{2} \\
 &= \frac{782,250}{[(212,600 + 290,350) / 2]} \\
 &= 3 \text{ times}
 \end{aligned}$$

$$\begin{aligned}
 5.5 \text{ Return on assets ratio} &= \frac{\text{Profit before interest and tax}}{\text{Total assets}} \times \frac{10}{1} \\
 &= \frac{316,990}{1,203,850} \times 100 \\
 &= 26\%
 \end{aligned}$$

$$\begin{aligned}
 5.6 \text{ Solvency ratio} &= \frac{\text{Total assets}}{\text{Total liabilities}} \\
 &= \frac{1,203,850}{549,000} \\
 &= 2
 \end{aligned}$$