



**basic education**

Department:  
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REPUBLIC OF SOUTH AFRICA

# **ACCOUNTING REVISION NOTES AND ASSESSMENT TASKS – GRADE 10**

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# *Bookkeeping systems of the formal and informal Sectors*

Basic Concepts	
<b>Formal sector</b>	Formal sector is an organised sector which covers those enterprises of work where the terms of employment are regular and where people have assured employment. It is registered, follows government rules and regulations, and has employees and employers union. It is called organised as it has some formal processes and procedures.
<b>Informal sector</b>	Informal sector refers to that part of an economy that is not taxed, monitored by any form of government. The informal sector under any governing system is diverse and includes small-scaled, occasional members like street vendors and garbage recyclers. It includes garment workers working from their homes, caterers and artisans. It also includes sectors which encompasses all jobs which are not recognized as normal income sources, and on which taxes are not paid. For practical reasons, the scope of the informal sector may be limited to household enterprises. The enterprises meet the conditions of non-registration and lack of formal bookkeeping.
<b>Bookkeeping</b>	Bookkeeping is the process of recording and classifying business financial transactions (activities). In simple language-maintaining the records of the financial activities of a business or an individual. Bookkeeping's objective is simply to record and summarize financial transactions into a usable form that provides financial information about a business or an individual.
<b>Bookkeeping systems</b>	Formal and informal sectors determine the type of bookkeeping system that will be used for recording their business transactions. Many small informal businesses start out using the "single entry system" and the formal businesses use "double entry system".
<b>Informal or indigenous bookkeeping system</b>	<b>Informal or indigenous bookkeeping system</b> is the system where a user of this system makes only <b>one entry</b> to enter a business financial transaction. This is regarded as a " <b>single entry system</b> ". It generally includes a daily summary of cash receipts and a monthly record of receipts and expenses.

The way a single entry bookkeeping system is maintained is very similar to that way a chequebook register is maintained. In the single entry bookkeeping method, only one line, for each transaction is entered in the day book / journal. All the transactions, both positive and negative are recorded in one column. The columns in a single entry bookkeeping system are usually date, description and amount. Although the single entry

bookkeeping system is fairly a simple system, the drawback is that only the difference between the expenses and revenues are totalled and the individual values of each are left out.

The books or records maintained in a single-entry bookkeeping system are daily summary of cash receipts, as well as monthly summary of cash receipts and disbursements, which represents the **revenue and expense**, respectively. However, even with columns to classify the revenues and expenses, single-entry bookkeeping is limited in its ability to provide detailed financial information.

For example:

**Single Column System (revenue and expenses)**

Date	Description	Amount
Jan 1	Beginning Balance	R100 000
Jan 2	Purchased shop supplies	(150.00)
Jan 4	Performed repair service	275.00
Jan 7	Performed repair service	125.00
Jan 15	Paid phone bill	(50.00)
Jan 30	Ending balance	120 000

**Separating Revenues and Expenses (Two Column System)**

Date	Description/Type of Transaction	Revenue	Expense
01/01/10	Fuel: Trip to Bank		100
01/01/10	Borrow: Loan from ABSA Bank	R100 000	
01/01/10	Advertising: Printing		250
01/01/10	Loan to Mrs. X		4 500
01/01/10	Loan to Mr. Y		2 500
15/01/10	Received: Mrs. X's First Payment	450	
15/01/10	Received: Mr. Y's First Payment	250	
29/01/10	Received: Mrs. X Payment	450	
29/01/10	Received: Mr. Y Payment	250	

As a general rule under the single entry practice **only the personal aspects** of the transactions are recorded and the **nominal and real aspects are omitted altogether**. Correct final accounts of a business can be prepared if the records are maintained under the double entry system. However, where the record is incomplete, and it is not all possible to complete it by double entry, in such cases the final accounts can be only approximately prepared by means of a **statement of affairs**.

1. Where fresh capital has been introduced into the business during the account period, the closing capital may be taken to have been increased to that extent. To arrive at the true profit or loss, therefore, the amount of fresh capital introduced is deducted from the closing assets as determined under such circumstances.
2. Where drawings have been made by the proprietor during the accounting period, such drawings reduce the amount of capital at the close. In order to calculate net profit, it is necessary; therefore, that amount withdrawal should be added to the capital at the close before deducting from it the capital at the beginning.

**Formula:**

Formula for determining the net profit is put as follows:

**(Capital at the end + Drawings - Additional capital introduced) - Capital in the beginning**

**Note:**

1. True profits cannot be known – since detailed information about the expenses etc. is not available and true profits cannot known.
2. Financial position of the business cannot be ascertained – under this system statement of affairs is prepared in an unsatisfactory manner thus exact position of total net assets cannot be known.
3. No internal control and check – in this system the room for frauds and errors is very large and due to lack of internal control system their detection is very difficult.
4. Valuation of assets becomes difficult at the time of sale of business.
5. Inadequate for planning and control – accounting information supplied by this system is inadequate for planning and control.
6. Comparative study is difficult – due to incomplete information regarding the business transactions the comparative study of two years becomes difficult.

**What is statement of affairs?**

As real or property accounts are not maintained and also because a capital account does not exist under the single entry system, a balance sheet cannot be prepared in the same way as is done under the double entry system. However, in order to have an idea about the financial position on a particular date, information concerning the available assets and liabilities is gathered and a statement is prepared setting in it assets and liabilities on the date; **this statement is called a statement of affairs**. The assets and liabilities are set out in the form of a balance sheet. The excess of assets over liabilities is shown as capital.

**The difference between statement of affairs and balance sheet.**

Statement of Affairs	Balance Sheet
1. It is a statement of assets and liabilities (including capital) prepared under the single entry system	1. It is statement of assets and liabilities (including capital) prepared under the double entry system.
2. It is prepared partly from a trader's books, partly from other sources of information and sometimes from memory	2. It is prepared with data available from the books of accounts only.
3. It is compiled from an incomplete books and information, the accuracy of which cannot be relied upon	3. It is prepared from a set of books kept according to the double entry system, the arithmetical accuracy of which can be proved.

**Note:**

In appearance the statement of affairs is similar to a balance sheet. The two comparative statements of affairs are prepared - **one at the commencement of the year and other at the end of the year**. The excess of the assets over the liabilities as shown by the statement will represent the capital of the firm. **If capital at the end shows an increase as compared to the amount of capital at the start the difference will represent profit and if the capital at the end is less than the capital at the beginning the difference will be loss.**



## Assessment Tasks

### Activity 1

Define the following concepts:

	CONCEPT	DEFINITION
a.	Capital	
b.	Fixed assets	
c.	Stock	
d.	Cost price	
e.	Labour cost	
f.	Selling price	
g.	Income	
h.	Expenses	
i.	Profit	
j.	Loss	

## Activity 2

1. Tabulate the comparison between the bookkeeping systems of formal and informal sectors.
2. Compare the management of resources (capital, fixed assets, stock, etc.) using a formal and an informal bookkeeping systems.

## Activity 3

1. Which method is used for the calculation of profit or loss under informal or single entry system?
2. Give the formula for determining the net income.
3. What is the statement of assets and liabilities (including capital) prepared under the informal or single entry system.
4. What shall be the profits of the concern if beginning capital is R8 000 and capital at the end R9 000 drawing during the year is R1 800 fresh capital Introduce R500?
5. Calculate the missing figures profits made during the year R2 400 Drawing R1 200 capital at the end R8 000 opening capital? Fresh capital introduced during the year R2 000?
6. Calculate the Net income/Loss: Opening capital R5 000, capital introduced R1 000
7. Calculate the drawings during the year:
  - a. Capital in the beginning R20 000
  - b. Capital introduced R25 000
  - c. Profit made during the year R15 000

## Activity 4

1. Under the net worth method of single entry the net profit is calculated by comparing capital in the beginning and capital.....
2. A business has a capital of R40 000 at the end. It had earned profits of R5 000 during the year. Hence, the average capital of the business will be —
  - i. R42 500
  - ii. R37 500
  - iii. R35 000
3. Amount of Drawings is added at the time of finding out profit in single entry system:
  - i. In closing capital
  - ii. In opening capital
  - iii. Not in any capital.
4. The amount of additional capital is deducted at the time of finding out profit in single entry system:
  - i. from closing capital
  - ii. from opening capital
  - iii. not from any capital.

5. Following records are made in single entry system, give correct answer:
- Only in cash book
  - In ledger, posting of personal accounts only
  - records in cash book showing only revenue and expenses.
6. The meaning of single entry system of Bookkeeping is:
- Two entries for each transaction.
  - Incomplete double entry system
  - Both entries only in accounts
7. Single entry system of bookkeeping system:
- is best system
  - is scientific system
  - is incomplete system
  - is most popular system.
8. To find out the opening and closing capitals, ----- statement of affairs are prepared:
- One
  - Two
  - Four.
9. Under the net worth method the bases for ascertaining the profit is
- the difference between the capital on two dates
  - the difference between the gross assets on two dates
  - the difference between the liabilities on two dates.
  - the difference between capital assets and liabilities at close
10. Under the net worth method any additions to capital during the accounting period must be
- added to profit
  - subtracted from profit
  - added to capital
  - deducted from capital.
11. Which one of the following is an example of a direct cost of a contract?
- selling costs
  - research and development costs
  - cost of hiring plant and equipment for the contract
  - general administration cost
12. A fixed asset originally acquired for resale at R10 000. The carriage on purchases was R5000 and the installation fee was R5 000. The mark up was R10 000. How much was the selling price of the fixed asset?
- R20 000

- ii. R10 000
  - iii. R30 000.
13. A fixed asset originally acquired for resale at R10 000. The carriage on purchases was R5 000 and the installation fee was R5 000. The mark up was R10 000. How much was the cost price of the fixed asset?
- i. R20 000
  - ii. R50 000
  - iii. R30 000.
14. Legal fees in respect of claims are shown in—
- (i) Revenue column
  - (ii) Profit and loss account
  - (iii) Profit and loss appropriation account.
15. Calculate the basic Cost of Goods Sold for a retail business:  
Beginning inventory is R500; inventory at the end is R700, cost of goods purchased R800

#### Activity 5

1. Net worth method is also called statement of affairs method or capital comparison method. According to this method profit or loss of the business is determined by making comparison between the capital of **two dates** of a period. From the given information calculate profit for the year, 2009.
  - Capital as on 1st January 2009 = R150 000
  - Capital as on 31st December 2009 = R200 000
2. Rashid keeps his book on single entry system. His position on **1st January, 1991** was as follows:  
Cash in hand R200, cash at bank R3000; stock in trade R20 000; customers R8 500; furniture R1 800; machinery R15 000; suppliers R22,000.  
**On 31st December, 1991** the financial position was as follows:  
Cash in hand R300; cash at bank R2 000; machinery R27 000; furniture R1 500; customers R14 000  
stock in trade R19 000 suppliers R29 000.  
During the year Rashid introduced a new capital of R5 000 and withdrew for his personal expenditure R9 000.  
From the above figures, prepare a statement showing the **profit or loss** made by him during 1991.
3. If an entrepreneur Mohan starts a business with R60 000 and at the end of the year he had R70 000 it would mean that he had earned a profit of R10 000 and if on the other hand he had only R50 000 at the end of the year, it would mean a loss of R10 000 to him. Normally small businessman maintains some personal accounts and cash book and records all types of transaction in the same book i.e. they don't differentiate between their personal transactions and business transactions. R60 000 Drawings during 2005 R50 000 Additional Capital introduced during 2005 R40 000

You are required to calculate profit or loss made by Mohan during the year 2005.

4. State with reasons whether the following statements are **true** or **false**.
  - i. If the opening capital is more than the closing capital it would indicate profit.
  - ii. Drawings are the amount used by the businessman for meeting his business expenses.
  - iii. Arithmetical accuracy can be checked by preparing Trail Balance under double entry system.
  - iv. A Trail Balance is prepared under single entry system also.
  - v. Nominal and real accounts are also maintained under single entry system.



## Solutions

### Activity 1

	CONCEPTS	DEFINITION / EXPLANATION
a.	Capital	Money invested in the business by the owners. Also called equity.
b.	Fixed assets	Items owned by the business which have an enduring benefit to the business and form part of the infrastructure. They are assets that are generally not converted to cash within one year. Examples are equipment and vehicles.
c.	Stock	Materials that a business holds, either waiting to be used in the production process, or finished stock waiting to be delivered to its customer.
d.	Cost price	Cost price is the price that it cost to make a product or buy the product, without a profit being added
e.	Labour cost	The sum of all wages paid to employees, as well as the cost of employee benefits and payroll taxes paid by an employer. The cost of labour is broken into direct and indirect costs. Direct costs include wages for the employees physically making a product, like workers on an assembly line. Indirect costs are associated with support labour, such as employees that maintain factory equipment but don't operate the machines themselves.
f.	Selling price	A selling price is the market value, or agreed exchange value, that will purchase a definite quantity, weight, or other measure of a good or service.
g.	Income	The number of units sold multiplied by unit price.
h.	Expenses	An <b>expense</b> or <b>expenditure</b> is an outflow of money to another person or group to pay for an item or service, or for a category of costs. For a tenant, rent is an expense.
i.	Profit	If income is more than expenses, the result is profit or gain. This is determined

		by the difference between the income and expenses.
j.	Loss	If expenses are more than income, the result is a loss or a deficit. This is determined by the difference between expenses and income.

## Activity 2

Tabulate the comparison of the bookkeeping systems of the informal and formal sectors

Informal Bookkeeping	Formal Bookkeeping
Each entry is recorded only once.	Each entry is recorded twice.
Record each transaction only once as either revenue (deposit) or as an expense	Debits and credits are the device that provide the ability to record the entries twice
Debits and credits (recording method required for the double entry system) are not used to record a financial event. Errors cannot easily be detected. A trial balance cannot be drawn up to test the arithmetical accuracy of the records	Double entry bookkeeping <b>using debits and credits</b> , is used to show this two-fold effect. The system improves accuracy and errors can be easily detected by preparing a trial balance.
The emphasis of this system is placed on determining the profit or loss of a business for a period based on the cash received and the cash spent.	This system, when used along with the accrual method of accounting, is a <b>complete accounting system</b> and focuses on the income statement and balance sheet.
Bookkeeping system is used along with the <b>Cash Method</b> of accounting. Debits and Credits <b>are not used</b> to record financial events.	Bookkeeping system can be used with <b>both the Cash and Accrual</b> methods of accounting. Debits and Credits <b>are used</b> to record financial events.
It <b>does not provide</b> a business with all the financial information needed to <b>adequately report</b> the financial affairs of a business.	This system, when used along with the accrual method of accounting, is a <b>complete accounting system</b> and focuses on the income statement and balance sheet.
Single-entry records do not provide a check against clerical error, as does a double-entry	The double entry system also has built-in checks and balances. The double-entry system is self-balancing. The total of the debit values recorded must equal the total of the credit values recorded.
This system is suitable only for small business concerns with a limited number of transactions and very few assets and liabilities. The system is not practical for those organizations having thousands of transactions in a reporting period, significant assets,	This system is suitable for big and formal business concerns with a number of transactions.

and external suppliers of capital.	
Only personal accounts are prepared and real and nominal accounts are avoided.	Personal accounts, real and nominal accounts are taken into account.
A cashbook is prepared which records both business as well as personal transactions.	Cash book, debtors and creditors journal, other assets account and liabilities, etc. Are recorded.
No set rules of accounting are followed.	It is governed by rules, i.e. GAAP
As no real accounts are maintained the preparation of balance sheet is not possible. In order to have an idea about the financial position, a statement called a "statement" or a "net worth" is prepared.	The profit and loss account (income statement) and the Balance sheet are prepared to determine the financial results and position of the business.

**The management of resources using a formal and an informal bookkeeping systems.**

<b>Formal bookkeeping system</b>	<b>Informal bookkeeping system</b>
<p>Management of resources include an accounting process that seeks to track resources for the purposes of financial accounting, preventive maintenance, and theft deterrence. The following accounting process should take place in order to manage resources:</p> <ul style="list-style-type: none"> <li>▪ Record transactions in the subsidiary journals and ledgers, utilising the periodic and perpetual inventory system, e.g. transactions for assets, liabilities and capital. Use assets register for fixed assets.</li> <li>▪ Validate and calculate inventories using the different inventory valuation methods, e.g. Weighted average method and FIFO method.</li> <li>▪ Record depreciation, the acquisition and disposal of assets, and interprets and reports on asset disposal.</li> <li>▪ Code of ethics, disciplinary and punitive measures to be applied for non-compliance to the code of ethics.</li> <li>▪ Apply internal control and internal audit processes in a business environment</li> <li>▪ Find an "optimal" capital structure - the right mix of</li> </ul>	<p>There are no asset, liability or equity accounts as per double entry bookkeeping so single entry bookkeeping cannot be used to produce a balance sheet. This system cannot track liability and asset accounts, such as inventory, accounts receivable and accounts payable including the capital due to the absence of detailed records of all those transactions. These must be tracked separately.</p> <p>In the absence of detailed records of all assets, lax administration of those resources may occur and this makes it difficult for the management of resources and difficult to track them. Theft and other losses are less likely to be detected.</p> <p>Data may not be available to management for effectively planning and controlling the resources and this may lead to inefficient administration and reduced control over the affairs of the business.</p> <p>Only revenue and expenses are recorded and issues like valuation of assets, shares, etc. are not taken into</p>

capital sources (debt and equity) that minimizes the overall cost of capital and maximizes values to the shareholders (owners of the business). When we raise capital, we have two choices - issue debt or issue shares and this need to be recorded.	account.  Neither periodic nor perpetual inventory system is used to calculation stock.
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### Activity 3

1. Net worth method also called statement of affairs method or capital comparison method is used to calculate the profit or loss of an informal business.

2. Net income = capital at the end (Ending Capital)  
 (+) Drawings  
 (-) Additional capital (Fresh capital) introduced  
 (-) Capital at the beginning (Beginning capital)

3. Statement of affairs Net worth.

4. Net income = capital at the end (Ending Capital)	R 9 000
(+) Drawings	1 800
	<hr/>
	R10 800
(-) Additional capital (Fresh capital) introduced	500
(-) Capital at the beginning (Beginning capital)	8 000
	<hr/>
	<b>R 2 300</b>

5. Net income = capital at the end (+) Drawings (-) Additional capital (-) Capital at the beginning  
 $R2\ 400 = 8\ 000 + 1\ 200 - 2\ 000 - \text{Capital at the beginning}$   
 Capital at the beginning =  $R8\ 000 + 1\ 200 - 2\ 000 - 2\ 400 = \mathbf{R4\ 800}$

6. Net income = capital at the end (+) Drawings (-) Additional capital (-) Capital at the beginning  
 Net Loss =  $0 + 0 - 1\ 000 - 5\ 000 = \mathbf{-R6\ 000}$

7. Net income = capital at the end (+) Drawings (-) Additional capital (-) Capital at the beginning  
 $R15\ 000 = 0 + \text{Drawings} - 25\ 000 - 20\ 000$   
 Drawings =  $R15\ 000 + 25\ 000 + 20\ 000 = \mathbf{R60\ 000}$

### Activity 4

1.	at the end
2.	(ii) R37 500
3.	(i) In closing capital
4.	(i) from closing capital
5.	(iii). records in cash book – showing only the revenue and expenses.
6.	(ii). Incomplete double entry system

7	(iii) is incomplete system
8	(ii) Two.
9	(i) the difference between the capitals on two dates
10	(ii) subtracted from profit
11	(iii) cost of hiring plant and equipment for the contract
12	(iii) R30 000
13	(i) R20 000
14	(i) Revenue column
15	Beginning inventory ..... R500 Plus cost of goods purchased ..... R800 = Equals goods available for sale .....R1 300 _ Less ending inventory (at the end of the accounting year) .....R700 = Equals Cost of Goods Sold .....R600

#### Activity 5

- Profit for the year 2009 = Closing capital - Opening capital  
= R200 000 - R150 000 = R50 000.
- 

#### Rashid

##### Statement of Affairs as at 1st January, 1991.

Liabilities	R	Assets	R
Sundry creditors	22 000	Cash in hand	200
Capital ( <u>balancing figure</u> *)	26 500	Cash at bank	3 000
		Sundry debtors	8 500
		Stock in trade	20 000
		Furniture	1 800
		Machinery	15 000
	<b>48 500</b>		<b>48 500</b>
* R48 500 - 22 000 = 26 500			

#### Rashid

##### Statement of Affairs as at 1st December, 1991.

Liabilities	R	Assets	R
Sundry creditors	29 000	Cash in hand	300
Capital ( <u>balancing figure</u> *)	34 800	Cash at bank	2 000

		Sundry debtors	14 000
		Stock in trade	19 000
		Furniture	1 500
		Machinery	27 000
	<b>63 800</b>		<b>63 800</b>
*R 63 800 - 29 000 = 34 800			

**Statement of Profit for the year ending 31st December, 1991.**

Capital 31st December, 1991	R34 800
Add drawings during the year	9 000
	43 800
Less capital introduced during the year	5 000
	38 800
Less capital as at 1st January, 1991	26 500
Net profit during the year	<b>12 300</b>

3.

**Statement of Profit or loss For the year ended 31st Dec 2005.**

Particulars	Amount (R)
Capital as on 1.1.2006	360 000
Add : Drawings during 2005	(+) 50 000
Less : Additional capital introduced during 2005	(-) 40 000
Less : Capital as on 1.1.2005	(-) 340 000
Profit made during 2005	<b>30 000</b>

State with reasons whether the following statements are **true** or **false**

i.	If the opening capital is more than the closing capital it would indicate profit.	<b>False</b>
ii.	Drawings are the amount used by the businessman for meeting his business expenses.	<b>False</b>
iii.	Arithmetical accuracy can be checked by preparing Trail Balance under double entry system.	<b>True</b>
iv.	A Trail Balance is prepared under single entry system also.	<b>False</b>
v.	Nominal and real accounts are also maintained under single entry system.	<b>False</b>

# Application of Accounting Principles and Concepts

In order to become effective in carrying out the accounting procedure, as well as in communicating the financial information of the business, there is a widely accepted set of rules, concepts and principles that governs the application of the accounting procedures, and it is referred to as the Generally Accepted Accounting Principles or GAAP. (Refer to the self-study guide "Accounting Principles and Concepts – Application: Grade 10 – 12".)



## Assessment Tasks

### Activity 1

Give the Accounting concept defined/explained below.

	Question	Concept
1.	The same accounting concepts are applied in the same way in each accounting period.	
2.	Always relate revenue earned in a period with expenses incurred to generate this revenue	
3.	A business's financial performance is recorded and reported separately from the owner's personal financial statement	
4.	Business is expected to remain in operations indefinitely	
5.	Similar items should receive similar accounting treatment	
6.	Use a common unit of measurement for reporting financial activity	
7.	Profits should not be overstated and loss must not be understated	
8.	Due to the high inflation rate, the replacement cost of the existing raw material has gone up by 30%. The company ignores this inflationary factor and records it at the original value.	
9.	A company has bought this property for R1million in year 2003 but now the property has appreciated to R5 million. The company is recording the property at R1 million.	
10	Which principle/guideline requires the company's financial statements to have footnotes containing information that is important to users of the financial statements?	
11	Which principle/guideline directs a company to show all the expenses related to its revenues of a specified period even if the expenses were not paid in that period?	
12	A fixed asset with a cost of R50 000 is depreciated over its useful life of 7 years rather than expensing the entire amount when it is purchased.	

13	A company borrowed R60 000 on December 1, 2005 and will make its only payment for interest when the note is paid off on June 1, 2006. The total interest for the six months will be R6 000. On the December 2005 income statement the accountant reported Interest Expense of R1 000.	
14	The success of the company is mainly attributed to the invaluable qualities of three employees, X, Y & Z. However, employees X, Y & Z are not recorded as an assets in the balance sheet of the company.	
15	The company has received goods valued at R200 000 and have already billed the customers for all these goods but so far has only received suppliers invoices for R50 000. The balance of R150 000 is taken up into the books of account. What concept is this?	
16	A large company purchases a R150 chair and expenses it immediately instead of recording it as an asset and depreciating it over its useful life. This practice may be acceptable because of which principle/guideline?	
17	For the December year-end close, the utilities bills have not been received for the month of November & December. However, based on previous average month trends, take up R20 000 X 2 = R40 000 as utilities expenses as estimates for November & December.	
18	The management has decided on a twelve-month financial reporting period. They have just started on the 1 <sup>st</sup> January so they will complete the twelve months reporting period by 31 <sup>st</sup> December.	
19	During the audit, auditors have discovered that certain portion of the company sales are not true sales as they have evidence that the sales are financed by the company itself.	
20	In the Notes to the financial statements, Management disclosed that an earthquake has destroyed one of their factories in Thailand, hence stopping production and affecting the revenue of the company.	
21	Once a particular financial period is adopted by a business, it is not changed from one period to the next period	
22	The cost of a dust bin in an office is treated as an expense rather depreciating its cost over its useful life	
23	Expenses are recognize in the same accounting period as the revenues which result from the incurrence of these expenses	
24	Each transaction is described by a business document that proves the transaction did occur.	
25	The actual amount paid or received is the amount recorded in the books of accounts.	

## Activity 2

1. The coffeehouse orders 100 coffee mugs from a coffee wholesaler in June. The coffee house takes delivery of the new mugs in July and pays for the order in August.

- a. Name the principle.
  - b. When is the wholesaler going to realize revenue?
2. An attorney is hired with an agreed upon retainer fee of R2 500 in May, and the services are not performed until July.
  - a. When is the attorney going to earn the income?
  - b. Which principle is this?
3. The coffee wholesaler purchased an office building in 1990 for R1.2 million. Over time this asset has most likely appreciated in value.
  - a. Which principle is this?
  - b. At what value will the building be recorded in the books of the business, the appreciated value or the cost?
4. When the 100 coffee mugs were delivered in July they changed from being a part of inventory (asset) to a cost of goods sold entry (expense) in the month that the revenue from the sale was recognized. At this point, the difference between the revenue and expense is determined as the gross profit from the sale.
  - a. Name the principle.
  - b. In which account or statement is this determined?
5. The coffeehouse has a pending or current lawsuits and this transaction could severely impact a company's bottom line and its performance because of incomplete financial transactions unless the entire financial picture of a company is shown in the books.
  - a. Name the principle.
  - b. How is the transactions going to be shown and where?
  - c. Why is it important to show the pending transactions?
6. The business activities of the coffeehouse are to be kept separate from the financial activities of its owners or managers.
  - a. Which principle is this?
  - b. Whose revenue and expenses are included in the financial statement of coffeehouse?
  - c. Why is it so important to have those revenue and expenses in the financial statement of coffeehouse?
7. The coffeehouse has being operating for a very long term and was going to be sold. Its assets would be valued at their disposal or liquidation value (sales price less expense of disposal). The assets depreciated, but the coffee house values them at their original cost.
  - a. Mention the principle.
  - b. Why are the assets valued at historical cost less aggregate depreciation and **not** at disposable value?
8. The intrinsic value of the best coffee server in the coffeehouse cannot be valued in the financial statements, regardless of how many customers frequent the coffeehouse due to this individual. The

inherent value of this person cannot be quantified in the financial statements as an asset because it cannot be expressed in monetary unit.

- a. Which principle must apply in this case relevant?
  - b. Why is this principle more relevant, universally available, and understandable?
9. The coffeehouse can record information on a daily, weekly, monthly, quarterly and yearly basis during a time frame they deem relevant.
- a. Mention the principle.
  - b. Why is it so important to allow the division of businesses operational activities into artificial time periods for reporting purpose?
10. The coffeehouse has documented 8% return rate for coffee during the past two years, but the coffee brewers insists this return rate is just a statistical anomaly and less than 2% of coffee served in the coffeehouse will require new methods of brewing during the coming year. Unless the coffee brewer provides compelling **evidence to support its estimate**, the company's accountant must follow the same principle and plan for 8% return rate.
- a. Mention the principle
  - b. What is the assumption of the principle mentioned above?
11. The coffeehouse purchase 100 coffeehouse chairs at R15 000 and the coffeehouse **expenses** the transaction immediately instead of recording it as **an asset and depreciating it over its useful life**.
- a. Name the principle that needs to be used.
  - b. What is the principle requiring the accountant of coffeehouse to do?
12. The coffeehouse has assets with a life span of 10 years. From its inception the company adopted a straight line method of depreciating its assets and after 3 years of operation the accountant changed the straight line method to adopt reducing balance method in period 4 and 5. He argued that he will return back to straight line method in period 6 to 10.
- a. Which principle needs to be introduced to the accountant?
  - b. Why is it important to understand the above mentioned principle?

### Activity 3

1.	The personal assets of the owner of a company will <b>not</b> appear on the company's balance sheet because of which principle/guideline?  A. Historical Cost B. Business / Economic Entity C. Monetary Unit
2.	Which principle requires a company's balance sheet to report its land at the amount the company paid to acquire the land, even if the land could be sold today at a significantly higher amount?

	<p>A. Historical Cost</p> <p>B. Business / Economic Entity</p> <p>C. Monetary Unit</p>
3.	<p>Which principle allows a company to ignore the change in the purchasing power of the rand over time?</p> <p>A. Historical Cost</p> <p>B. Business / Economic Entity</p> <p>C. Monetary Unit</p>
4.	<p>Which principle requires the company's financial statements to have footnotes containing information that is important to users of the financial statements?</p> <p>A. Prudence / Conservatism</p> <p>B. Business / Economic Entity</p> <p>C. Full Disclosure</p>
5.	<p>Which principle justifies a company violating an accounting principle because the amounts are immaterial?</p> <p>A. Prudence / Conservatism</p> <p>B. Full Disclosure</p> <p>C. Materiality</p>
6.	<p>Which principle is associated with the assumption that the company will continue on long enough to carry out its objectives and commitments?</p> <p>A. Business / Economic Entity</p> <p>B. Going Concern</p> <p>C. Time Period</p>
7.	<p>A very large corporation's financial statements have the rand amounts rounded to the nearest R1 000. Which accounting principle justifies not reporting the amounts to the cent?</p> <p>A. Full Disclosure</p> <p>B. Materiality</p> <p>C. Monetary Unit</p>
8.	<p>Accountants might recognize losses but not gains in certain situations. For example, the company might write-down the cost of inventory, but will not write-up the cost of inventory. Which principle is associated with this action?</p> <p>A. Prudence / Conservatism</p> <p>B. Materiality</p> <p>C. Monetary Unit</p>
9.	<p>Which principle directs a company to show all the expenses related to its revenues of a</p>

	<p>specified period even if the expenses were not paid in that period?</p> <p>A. Historical Cost</p> <p>B. Matching</p> <p>C. Monetary Unit</p>
10	<p>When the accountant has to choose between two acceptable alternatives, the accountant should select the alternative that will report less profit, less asset amount, or a greater liability amount. This is based upon which principle?</p> <p>A. Prudence / Conservatism</p> <p>B. Historical Cost</p> <p>C. Materiality</p>
11	<p>A large company purchases a R250 digital camera and expenses it immediately instead of recording it as an asset and depreciating it over its useful life. This practice may be acceptable because of which principle?</p> <p>A. Historical Cost</p> <p>B. Matching</p> <p>C. Materiality</p>
12	<p>A corporation pays its annual property tax bill of approximately R12 000 in one payment each December 28. During the year, the corporation's monthly income statements report Property Tax Expense of R1 000. This is an example of which accounting principle?</p> <p>A. Prudence / Conservatism</p> <p>B. Matching</p> <p>C. Monetary Unit</p>
13	<p>A company sold merchandise of R8 000 to a customer in December. The company's sales terms require the customer to pay the company in 30 days. The company's income statement reported the sale in December. This is proper under which accounting principle?</p> <p>A. Full Disclosure</p> <p>B. Monetary Unit</p> <p>C. Revenue Recognition / Realisation</p>
14	<p>Accrual accounting is based on this principle.</p> <p>A. Historical Cost</p> <p>B. Full Disclosure</p> <p>C. Matching</p>
15	<p>The creative chief executive of a corporation who is personally responsible for numerous inventions and innovations is not reported as an asset on the corporation's balance sheet. The accounting principle that prevents the corporation for reporting this person as an asset is:</p>

	<p>A. Prudence / Conservatism</p> <p>B. Historical Cost</p> <p>C. Going Concern</p>
16	<p>An asset with a cost of R120 000 is depreciated over its useful life of 10 years rather than expensing the entire amount when it is purchased. This complies with which principle?</p> <p>A. Historical Cost</p> <p>B. Full Disclosure</p> <p>C. Matching</p>
17	<p>Near the end of the current year, a company required a customer to pay R200 000 as a deposit for work that is to begin in the following year. At the end of the current year the company reported the R200 000 as a liability on its balance sheet. Which accounting principle prevented the company from reporting the R200 000 on its income statement for the current year?</p> <p>A. Going Concern</p> <p>B. Materiality</p> <p>C. Revenue Recognition / Realisation</p>
18	<p>A retailer wishes to report its merchandise inventory on its balance sheet at its retail value. This would violate which accounting principle?</p> <p>A. Historical Cost</p> <p>B. Full Disclosure</p> <p>C. Monetary Unit</p>
19	<p>A company borrowed R100 000 in December and will make its only payment for interest when the note comes due six months later. The total interest for the six months will be R3 600. On the December income statement the accountant reported Interest Expense of R600. This action was the result of which accounting principle?</p> <p>A. Historical Cost</p> <p>B. Matching</p> <p>C. Revenue Recognition / Realisation</p>

#### Activity 4

Indicate whether the following are True or False.

	Principles / Concepts	True	False
1.	Accounting Principle is general law or rule followed in the preparation of financial statements		

2.	Usefulness, objectivity and feasibility are the three basic norms generally found in accounting principles		
3.	The entity concept considers the business and the proprietor as distinct from each other		
4.	In accountancy, all business transactions are recorded as having dual aspect		
5.	It is on the basis of going concern concept that the asset are always valued at market value		
6.	Since the life of the business is assumed to be indefinite, the financial statement of the business should be prepare only when it goes into liquidation		
7.	According to money measurement concept, the efficiency of the top management of the business must be clearly recorded in the books of accounts		
8.	According to periodic matching of cost and revenue concept, a business man is not only to measure revenues in a particular accounting period but also has to calculate expenses which can be assigned in earning such revenues		
9.	Cash basis considers the revenue as realized when the goods are produced		
10	The losses from sale of capital assets need not be deducted from revenue to ascertain the net income		
11	The convention of disclosure implies that all material information should be disclosed in the accounts		
12	In keeping with the principle of materiality, important items must be recorded instead of being left out or merged with other items		
13	The comparison of the results of one accounting period with that in the past is possible when the convention of consistency is adhered to by the business		
14	The convention of conservation takes into account all prospective profits and all prospective losses.		

### Activity 5

Fill in the blanks with suitable word/words:

- i. Expenses are matched with ..... generated during a period.
- ii. Goods of R50 000 are sold on 25th March 2006 but payment is received on 10th April 2006. It will be a revenue for the year ending .....
- iii. If accounting year begins from 1st of January, and ends on 31st of December, it is known as .....
- iv. Income is the excess of ..... over .....

- v. .... concept states that the revenue and the expenses incurred to earn the revenue must belong to the same accounting period
- vi. If accounting year begins from 1st of April and ends on 31st of March, then accounting year is known as .....

**Activity 6**

**A.**

Ascertain the amount of current revenue realized for the year ending 31<sup>st</sup> December 2006

- a. An order, to supply goods for R2 000 000 is received in the year 2006. The goods have been supplied only for R1 000 000 in 2006.
- b. What will be the revenue if the payment of R600 000 is received in cash in 2006 and the balance payment of R400 000 received in 2007.
- c. What will be the revenue if the goods have been sold on credit and the payment of R1 500 000 is received in the year 2007, while all the goods of R2 000 000 are supplied in the year 2006.
- d. What will be the revenue if an advance payment of R100 000 is received in the year 2006 and the balance received in the year 2007.

**B.**

Put a tick mark (√) against the information that should be recorded in the books of accounts and cross mark (X) against the information that should not be recorded

- a. Health of a managing director
- b. Purchase of factory building R10 million
- c. Rent paid R100 000
- d. Goods worth R10 000 given as charity
- e. Delay in supply of raw materials

**Activity 7**

Fill in the missing word and unscramble the answers:

	Word Clue	Scrambled Answer	Unscrambled Answer
1.	General rules and guidelines.	CREPISNPIL	
2.	The _____ unit assumption means transactions of the South African companies are reported in rands.	TORENYAM	
3.	Adjusting entries help to achieve the _____	NTAGHMIC	

	principle.		
4.	The cost principle is often described as the _____ cost principle.	THLSCOIARI	
5.	_____ practices allows the format of a public utility's balance sheet to be different from that of a manufacturer.	UTIRNYSD	
6.	The concept of _____ allows for the violation of an accounting principle when the amounts are insignificant.	IYARMILETAT	
7.	The _____ entity assumption results in business transactions being kept separate from a sole proprietor's personal transactions.	IOCENOCM	
8.	In cases of uncertainty, less profit is reported under this concept.	RVETMCSOINSA	
9.	Full _____ is achieved through the notes to the financial statements.	ODRCSILUSE	
10	This assumption justifies quarterly financial statements.	IRDOCYIPIET	
11	Defined as the cash or cash equivalent amount at the time of a transaction.	TOCS	
12	Accrual accounting is related to this principle.	NAGMITCH	
13	Results in the reporting of contingent losses, but not contingent gains.	VESTMIRNASOC	
14	Permits the immediate expensing of insignificant assets.	TRIALITAEMY	
15	FASB is the acronym for _____ Accounting Standards Board	AFAILNCIN	
16	The _____ concern assumption is that an enterprise will continue on long enough to carry out its objectives and commitments.	OGIGN	
17	Communicating the significant accounting policies in the first note to the financial statements is related to the full _____ principle.	SECLUDORIS	
18	The South African institution responsible for listing and selling of the share of big corporations whose shares is publicly traded is the Johannesburg Securities _____ .	HXGAENEC	
19	Under the _____-basis of accounting, revenues are reported on the income statement in the period in which they	CUCLARA	

	are earned.		
20	Part of the _____ unit assumption is that the South African rand retains its purchasing power over time.	ATORMNYE	

### Activity 8

Read the scenarios below and name the principle used.

1. Let's say a company is named in a lawsuit that demands a significant amount of money. When the financial statements are prepared it is not clear whether the company will be able to defend itself or whether it might lose the lawsuit. As a result of these conditions and because of the full disclosure principle the lawsuit will be described in the notes to the financial statements.
2. Sales commission expense should be reported in the period when the sales were made (and not reported in the period when the commissions were paid).
3. Wages to employees are reported as an expense in the week when the employees worked and not in the week when the employees are paid.
4. If a company agrees to give its employees 1% of its 2012 revenues as a bonus on 15 January, 2013, the company should report the bonus as an expense in 2012 and the amount unpaid at December 31, 2012 as a liability. (The expense is occurring as the sales are occurring.)
5. If ABC Consulting completes its service at an agreed price of R1 000, ABC should recognize R1 000 of revenue as soon as its work is done—it does not matter whether the client pays the R1 000 immediately or in 30 days.
6. A big company purchase a R1 500 printer. Because the printer will be used for five years, the *matching* principle directs the accountant to expense the cost over the five-year period. Another guideline allows this company to violate the matching principle and to expense the entire cost of R1 500 in the year it is purchased. The justification is that no one would consider it misleading if R1 500 is expensed in the first year instead of R300 being expensed in each of the five years that it is used.
7. *Potential* losses from lawsuits will be reported on the financial statements or in the notes, but *potential* gains will not be reported. Also, an accountant may write inventory *down* to an amount that is lower than the original cost, but will not write inventory *up* to an amount higher than the original cost.



**Solutions**

### Activity 1

ITEM	CONCEPT / PRINCIPLE	ITEM	CONCEPT / PRINCIPLE
1.	Consistency principle	14	Business Entity principle
2.	Matching principle	15	Accrual principle
3.	Business entity concept	16	Materiality principle
4.	Going concern concept	17	Accrual principle
5.	Consistency principle	18	Accounting period concept
6.	Money measurement / monetary stability concept	19	Substance Over Form principle
7.	Conservative or Prudence principle	20	Disclosure principle
8.	Historical cost principle	21	Consistency principle
9.	Historical cost principle	22	Materiality principle
10.	Disclosure principle	23	Matching principle
11.	Accrual principle	24	Objectivity principle
12.	Matching principle	25	Historical cost principle
13.	Accrual principle		

## Activity 2

1.
  - a. Revenue Recognition / revenue realisation Principle
  - b. The wholesaler does not recognize the revenue from this sale in June, when the order was placed, or in August, when the cash was received. For recording purposes, the revenue is recognized by the wholesaler in July, when the coffee mugs were delivered to the coffeehouse.
2.
  - a. Revenue Recognition / revenue realisation Principle
  - b. The attorney does not recognize the revenue until July. The attorney must earn the income before it can be recorded as such, even though he/she received cash for the service at an earlier date.
3.
  - a. Historical Cost Principle
  - b. In accordance with the cost principle, the original (historical) price of the building is what is recorded as the cost of the building in the books of the business.
4.
  - a. Matching Principle
  - b. Trading account or Income Statement
5.
  - a. Full Disclosure Principle
  - b. Most of these transactions are disclosed in the footnotes to the financial statements.

- c. It is important to disclose the pending transactions because the financial statements should reflect a true and fair view of the financial position and performance of the enterprise
- 6.
- a. Business / Economic Entity concept
  - b. The financial statements for the coffee house will only reflect the revenue and expenses for the coffee house.
  - c. It is important to have those revenue and expenses in the financial statement of coffeehouse in order to facilitates the recording and reporting of business transactions from the business point of view and thus make it possible to compare the financial statements of the coffeehouse with its competitors' reports, since these statements should be reported separately under the economic entity assumption.
- 7.
- a. Going Concern principle.
  - b. Assets are valued at historical cost because there was no intention to dispose of the assets. Assets are assumed to be used for an indefinite period of time and not intended to be sold immediately.
- 8.
- a. Monetary Unit principle
  - b. The principle is important because it states that information in the financial statements must be expressed in monetary units. The reason is that economic activity is expressed in monetary unit, and thus, it makes sense to apply the same basis for accounting purposes.
- 9.
- a. Time period principle
  - b. It is important to allow the division of businesses operational activities into artificial time periods for reporting purpose and because there is a trade-off between the accuracy (reliability) and relevancy in preparing financial statements: the more quickly a company presents financial data, the more likely such data contains errors (i.e. less reliable information).
- 10.
- a. The principle of prudence
  - b. The principle of prudence provides that **accounting for a business should be fair and reasonable**. The accounting for coffee house is faire and reasonable. The Accountants of the coffee house are required in their work to make evaluations and estimates, to **deliver opinions, and to select procedures**. They should do so in a way that **neither overstates nor understates the affairs of the business or the results of operation**, i.e. Profits should not be overstated and loss must not be understated.
- 11.
- a. The materiality principle

- b. The principle of materiality requires accountants to use **generally accepted accounting principles** except when to do so would be expensive or difficult, and where it makes no real difference if the rules are ignored. If a rule is temporarily ignored, the net income of the company must not be significantly affected, nor should the reader's ability to judge the financial statements be impaired.

12.

- a. The consistency principle
- b. The consistency principle requires accountants to apply the same methods and procedures from period to period, i.e. **the same accounting concepts are applied in the same way in each accounting period**. When they change a method from one period to another they must explain the change clearly on the financial statements. **Variations or changes in accounting policy and procedures must be justifiable**. The readers of financial statements have the right to assume that consistency has been applied if there is no statement to the contrary.
- Standards used to value inventory, depreciation assets, or accrued expenses must be consistent from one accounting period to the next. Similar items should receive similar accounting treatment.

### Activity 3

1.	2.	3.	4.	5.	6.	7.	8.	9.	10	11	12	13	14	15	16	17	18	19	20
B	A	C	C	C	B	B	A	B	A	C	B	C	C	B	C	C	A	B	

### Activity 4

	True	False
1.	X	
2.	X	
3.	X	
4.	X	
5.		X
6.		X
7.		X
8.	X	
9.		X
10		X
11	X	
12	X	
13	X	
14	X	

### Activity 5

- i. revenue
- ii. 31<sup>st</sup> March, 2006

- iii. calendar year
- iv. revenue, expenses
- v. matching
- vi. financial year

### Activity 6

#### A

- a. R1 000 000
- b. R1 000 000
- c. R2 000 000
- d. R100 000

#### B.

- a. X
- b. √
- c. √
- d. √
- e. X

### Activity 7

Fill in the missing word and unscramble the answers:

	Word Clue	Scrambled Answer	Unscrambled Answer
1.	General rules and guidelines.	CREPISNPIL	PRINCIPLES
2.	The _____ unit assumption means transactions of the South African companies are reported in rands.	TORENYAM	MONETARY
3.	Adjusting entries help to achieve the _____ principle.	NTAGHMIC	MATCHING
4.	The cost principle is often described as the _____ cost principle.	THLSCOIARI	HISTORICAL
5.	_____ practices allows the format of a public utility's balance sheet to be different from that of a manufacturer.	UTIRNYSD	INDUSTRY
6.	The concept of _____ allows for the violation of an accounting principle when the amounts are insignificant.	IYARMILETAT	MATERIALITY
7.	The _____ entity assumption results in business transactions being kept separate from a sole proprietor's personal	IOCENOCM	ECONOMIC

	transactions.		
8.	In cases of uncertainty, less profit is reported under this concept.	<b>RVETMCSOINSA</b>	CONSERVATISM
9.	Full _____ is achieved through the notes to the financial statements.	<b>ODRCSILUSE</b>	DISCLOSURE
10	This assumption justifies quarterly financial statements.	<b>IRDOCYIPIET</b>	PERIODICITY
11	Defined as the cash or cash equivalent amount at the time of a transaction.	<b>TOCS</b>	COST
12	Accrual accounting is related to this principle.	<b>NAGMITCH</b>	MATCHING
13	Results in the reporting of contingent losses, but not contingent gains.	<b>VESTMIRNASOC</b>	CONSERVATISM
14	Permits the immediate expensing of insignificant assets.	<b>TRIALITAEMY</b>	MATERIALITY
15	FASB is the acronym for _____ Accounting Standards Board	<b>AFAILNCIN</b>	FINANCIAL
16	The _____ concern assumption is that an enterprise will continue on long enough to carry out its objectives and commitments.	<b>OGIGN</b>	GOING
17	Communicating the significant accounting policies in the first note to the financial statements is related to the full _____ principle.	<b>SECLUDORIS</b>	DISCLOSURE
18	The South African institution responsible for listing and selling of the share of big corporations is the Johannesburg Securities _____ .	<b>HXGAENEC</b>	EXCHANGE
19	Under the _____ basis of accounting, revenues are reported on the income statement in the period in which they are earned.	<b>CUCLARA</b>	ACCRUAL
20	Part of the _____ unit assumption is that the South African rand retains its purchasing power over time.	<b>ATORMNYE</b>	MONETARY

### Activity 8

1. Full disclosure
2. Matching principle
3. Matching principle
4. Matching principle
5. Revenue realisation / recognition principle
6. Materiality principle
7. Prudence / Conservatism principle

# Accounting Equation

The accounting equation is  $\text{Assets} = \text{Liabilities} + \text{Owner's (Shareholders') Equity}$ . The accounting equation should remain in balance at all times because of double-entry accounting or bookkeeping. Double-entry means that every transaction will affect at least two accounts in the general ledger.

Accounting equation is the base of accounting. If you are new in learning of accounting you should learn the **accounting equation example**. With this accounting equation example, you can clear your fundamentals in accounting. Accounting equation is the equation which tells us that assets will always be equal to the liabilities plus owner's equity. The equation will always be the same in every transaction. First we explain its formula and then we prove it with examples.

## Formula of Accounting Equation

Total Assets = Total Outside liabilities + total owner's liabilities

or

Total Assets = Total creditor's equity + total owner's equity

or

Total Assets = Total creditor's equity + (Owner's capital + total incomes - total expenses)

## How the accounting equation remains in balance

1. An owner's investment into the company will increase the company's assets and will also increase owner's equity.
2. When the company borrows money from its bank, the company's assets increase and the company's liabilities increase.
3. When the company repays the loan, the company's assets decrease and the company's liabilities decrease.
4. If the company pays cash for a new delivery van, one asset (cash) will decrease and another asset (vehicles) will increase.
5. If a company provides a service to a client and immediately receives cash, the company's assets increase and the company's owner's equity will increase because it has earned revenue.
6. If the company provides a service and allows the client to pay in 30 days, the company has increased its assets (Accounts Receivable) and has also increased its owner's equity because it has earned service revenue.
7. If the company runs a radio advertisement and agrees to pay later, the company will incur an expense that will reduce owner's equity and has increased its liabilities.

From our examples, you can see that owner's equity increased when the owner made an investment in the business and also when revenues were earned. Owner's equity decreased when the owner withdrew assets from the business and when expenses were incurred. This leads us to the expanded accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity} + \text{Revenues} - \text{Expenses} - \text{Drawings}$$

### Accounting Equation Examples

#### 1. Mohan commenced business with cash R30 000

- Business of Mohan receives cash as asset, Cash asset will be R30 000
- Mohan gives this cash in the form of capital = Owner's equity will be

Total Assets = Total Liabilities + Total Capital			
Cash	R30 000	Total Liabilities	Nil
		Capital	R30 000
	<b>R30 000</b>		<b>R30 000</b>

#### 2. Mohan Purchased furniture for cash R10 000

- When we bought furniture with cash, our cash will decrease with R10 000. It means one asset will decrease.
- Our furniture asset will increase in business, so we add R10 000 as furniture asset. There will no effect on liability side of accounting equation.

Total Assets = Total Liabilities + Total Capital			
Cash	R30 000	Total Liabilities	Nil
Less payment for furniture	(10 000)	Capital	R30 000
Add furniture	20 000 10 000		
	<b>R30 000</b>		<b>R30 000</b>

#### 3. Mohan Purchased Goods from Sham on credit of R5 000

- With this there will no effect on cash but new goods asset will increase. This is called inventory or stock asset. So, we will show more R5 000 in asset side of accounting equation.
- With we have to pay to sham R5 000, so he is our creditor. This will increase our liability.

Total Assets = Total Liabilities + Total Capital			
Cash	R20 000	Total Liabilities	5 000
Furniture	10 000	Capital	R30 000
Inventory	5 000		
	<b>R35 000</b>		<b>R35 000</b>

**4. Mohan Sold goods (Cost R1 000) at R2 000 on credit to Sohan**

- Inventory asset will decrease (cost R1 000)
- We have to get money of R2 000. So, account receivable will increase with R2 000.
- By this dealing we gained R1 000. So, this will increase our initial capital.

Total Assets = Total Liabilities + Total Capital			
Cash	R20 000	Total Liabilities: Creditor	5 000
Furniture	10 000	Capital	R30 000
Inventory	5 000	Add Profit on sales	1 000
Less Sold Stock (Cost)	(1 000)		
Debtors	2 000		
	<b>R36 000</b>		<b>R36 000</b>

**5. Mohan sold goods (Cost R3 000) at R2 000 with cash**

- Inventory asset will decrease with cost R3 000
- Cash will increase with sale of R2 000 goods.
- Capital will decrease with the loss of R1 000

Total Assets = Total Liabilities + Total Capital			
Cash + sales on	R20 000	Total Liabilities: Creditor	5 000
Furniture	2 000	Capital	R31 000
Inventory	10 000	Less loss on sales	(1 000)
Less Sold	4 000		
Stock (Cost)	(3 000)		
Debtors	2 000		
	<b>R35 000</b>		<b>R35 000</b>

**6. Mohan has to pay rent to landlord R1 000 but not yet paid.**

- Liability of rent will increase with R1 000
- Capital will decrease due to expense of business with R1 000

Total Assets = Total Liabilities + Total Capital			
Cash + sales on	R22 000	Total Liabilities: Creditor	5 000
Furniture	10 000	O/S Rent	1 000
Inventory	1 000	Capital	R30 000
Debtors	2 000	Less rent expenses	(1 000)
	<b>R35 000</b>		<b>R35 000</b>

**7. Mohan has to receive commission of R1 000 but not yet received.**

- a. Our asset of receivable commission will increase because we have to get R1 000.
- b. Our capital will increase with R1 000 because this commission is our income.

Total Assets = Total Liabilities + Total Capital			
Cash + sales on	R22 000	Total Liabilities: Creditor	5 000
Furniture	10 000	O/S Rent	1 000
Inventory	1 000	Capital	R29 000
Debtors	2 000	Commission income	1 000
Commission Receivable	1 000		
	<b>R36 000</b>		<b>R36 000</b>

**8. Mohan has received advance fees R6 000 from client before providing service to him.**

- a. This advance fees of R6 000 will our liability. Because if we will not complete our service, other person has to get money from us.
- b. Cash will increase with R6 000

Total Assets = Total Liabilities + Total Capital			
Cash + cash of	R22 000	Total Liabilities: Creditor	5 000
advanced fee	6 000	O/S Rent	1 000
Furniture	10 000	Advanced fee	6 000
Inventory	1 000	Capital	R30 000
Debtors	2 000		
Commission Receivable	1 000		
	<b>42 000</b>		<b>R42 000</b>

**9. Mohan has paid advance insurance of R7 000 before due date.**

- a. Cash will decrease with R7 000
- b. A new asset of advance insurance will create with R7 000 because we has right to get back same amount before due date of premium of insurance.

Total Assets = Total Liabilities + Total Capital			
Cash - less payment of advanced insurance	R28 000 (7 000)	Total Liabilities: Creditor	5 000
Furniture	10 000	O/S Rent	1 000
Inventory	1 000	Advanced fee	6 000
Debtors	2 000	Capital	R30 000
Commission Receivable	1 000		
Advance Insurance Payment	7 000		
	<b>42 000</b>		<b>R42 000</b>

10. Mohan purchased Computer of R3 000 with business cash for personal use.

- a. Cash will decrease R3 000 for payment for buying computer.
- b. Capital will decrease because he withdraws money for personal use. No, business will get power for not R3 000 capital in future to businessman Mohan.

Total Assets = Total Liabilities + Total Capital			
Cash - less purchase of computers for personal use	R21 000 (3 000)	Total Liabilities: Creditor	5 000
Furniture	10 000	O/S Rent	1 000
Inventory	1 000	Advanced fee	6 000
Debtors	2 000	Capital	R30 000
Commission Receivable	1 000	Less drawings (Purchasing of computers for personal use)	(3 000)
Advance Insurance Payment	7 000		
	<b>39 000</b>		<b>R39 000</b>



## Assessment Tasks

### Activity 1

1. Which of the following items would not fall under the definition of an asset?
  - a. Land
  - b. Machinery
  - c. Cash
  - d. Owner's equity
  - e. Debtors
2. Which one of the following items would fall under the definition of a liability?
  - a. Cash
  - b. Debtors
  - c. Owner's equity
  - d. Goods owed
  - e. None of the above
3. A business has the following items in it:
  - i. Land R1 000 000
  - ii. Machinery R20 000
  - iii. Cash R10 000
  - iv. Debt R0
  - v. Owner's equity?

What is the value of the owner's equity?

- a. R1 000 000
- b. R1 020 000
- c. R1 010 000
- d. R1 030 000
- e. None of the above.

4. A business has the following items in it:
  - i. Land R1 000 000
  - ii. Machinery R20 000
  - iii. Cash R10 000
  - iv. Loan R500 000
  - v. Owner's equity?

What is the value of the owner's equity?

- a. R500 000
- b. R1 000 000
- c. R530 000
- d. R1 030 000

e. None of the above.

5. A business has the following items in it:

- i. Owners equity R600 000
- ii. liabilities R1 400 000
- iii. Assets?

What is the value of the assets in this business?\*

- a. R600 000
- b. R800 000
- c. R1 400 000
- d. R2 000 000
- e. None of the above.

6. A business has the following items in it:

- i. Land R1 500 000
- ii. Machinery R80 000
- iii. Cash R20 000
- iv. Owners equity R900 000
- v. Loan R500 000
- vi. Creditors?

What is the value of the creditors?

- a. R200 000
- b. R700 000
- c. R800 000
- d. R1 100 000
- e. None of the above.

7. A business has the following items in it:

- i. Land?
- ii. Vehicles R600 000
- iii. Debtors R120 000
- iv. Cash R30 000
- v. Owners equity R1 000 000
- vi. Loan R500 000
- vii. Creditors R50 000

What is the value of the land?

- a. R1 000 000
- b. R1 550 000
- c. R800 000

- d. R750 000
  - e. None of the above.
8. Which of the following statements are true?
- a. A business whose liabilities are greater than its assets has a bad financial position.
  - b. A business whose liabilities are greater than its owner's equity has a bad financial position.
  - c. A business whose assets are greater than its owner's equity has a bad financial position.
    - a. and b)
  - d. All the above

### Activity 2

1. What are the main elements of a Balance Sheet?
2. What is the Accounting Equation?
3. Define: Asset, Liability and Equity.
4. Put (✓) in the appropriate column:

ITEMS	ASSETS	LIABILITIES	EQUITY
Cash			
Equipment			
Client Savings			
Net Deficit - current year			
Restricted/Deferred Revenue			
Building			
Loans Outstanding - current			
Loan Fund Capital			
Long-term Investments			
Long-term Debt (concessional)			
Loans Outstanding - Past Due			
Loan Loss Reserve*			
Restructured Loans			

### Activity 3

#### Transactions:

1. Mr. Riaz commences his business with cash R50 000.
2. Purchased furniture on cash R10 000.
3. Purchased merchandise for cash R10 000.
4. Purchased merchandise on account (on credit) R5 000.

5. Sold merchandise for cash R2 000 cost of these merchandise were R1 500.
6. Sold merchandise on credit for R4 000 costing R3 000.
7. Paid R1 000 to creditors for merchandise purchased.
8. Received cash from a debtor R1 000 whom a sale on credit was made earlier.
9. Paid salaries R1 000 in cash.

Show the effects of transactions on the accounting equation.

#### Activity 4

Mike Peddler decides to open a bicycle repair shop. To get started he rents some shop space, purchases an initial inventory of bike parts, and opens the shop for business. Here is a listing of the transactions that occurred during the first month:

Date	Transaction
Sep 1	Owner contributes R7 500 in cash to capitalize the business.
Sep 8	Purchased R2 500 in bike parts on account, payable in 30 days.
Sep 15	Paid first month's shop rent of R1 000.
Sep 17	Repaired bikes for R1 100; collected R400 cash; billed customers for the R700 balance.
Sep 18	R275 in bike parts were used.
Sep 25	Collected R425 from customer accounts.
Sep 28	Paid R500 to suppliers for parts purchased earlier in the month.

Show how these transactions affect the accounting equation.

#### Activity 5

1. Show that the accounting equation is satisfied after taking into consideration each of the following transactions in the books of Mr. N
  - a. Started business with capital R100 000
  - b. Bought furniture R25 000
  - c. Bought goods for cash R20 000
  - d. Bought goods from Ram on Credit R5 000
  - e. Sold goods for cash for R15 000
  - f. Sold goods to Shyam on credit R8 000
  - g. Paid cash to Ram R4 000
  - h. Received cash from Shyam R5 000
  - i. Paid Cash into Bank R25 000
  - j. Withdrawn from bank R1000

2. Following are the accounting transactions relating to Mr. P's business. Use the accounting equation to show their effect on his assets, liabilities and capital.
- Commenced business with a Capital of R50 000
  - Bought Machinery for cash R10 000
  - Purchased goods for cash R15 000
  - Purchased goods from A on credit R5 000
  - Sold goods for cash R10 000
  - Paid to A R2 000
  - Sold goods to B on credit R3 000
  - Paid into Bank R6 000
  - Paid to A by cheque R1 000
  - Received from B a cheque for R2 000

### Activity 6

For the following transactions, show how these affect the Balance Sheet:

i. Purchase land on credit (one year)	vi. Purchase a Treasury Bill for cash
ii. Disburse loan to client	vii. Client withdraws savings
iii. Purchase motorcycles for staff - pay half cash; half short-term credit	viii. Receive an unrestricted donation
iv. Purchase office furniture on short-term credit	ix. A Current loan becomes past due
v. Take loan from bank at commercial rate of interest (> one year)	x. Receive a restricted donation for operations (3 years)



### Activity 1

1.	D
2.	D
3.	D
4.	C
5.	D
6.	A

7.	C
8.	D

### Activity 2

1. The main elements of a Balance Sheet are: Assets, Liabilities and Equity.
2. TOTAL ASSETS = TOTAL LIABILITIES + EQUITY
3. Define: Asset, Liability and Equity.

**Assets** represent what is owned by the organization or owed to it. Assets are those items in which an organization has invested its funds for the purpose of generating future receipts of cash. On the Balance Sheet, total assets are always equal to the sum of liabilities plus equity.

**Liabilities** represent what is owed by the organization to others either in the form of a loan which has been extended to it or obligations for the organization to provide goods and services in the future.

**Equity** is equal to assets less liabilities. Unlike liabilities, the Equity of an organization does not have to be repaid. It therefore represents the value or net worth of the organization. Equity includes capital contributions of any investors or donors, retained earnings, and the current year surplus.

ITEMS	ASSETS	LIABILITIES	EQUITY
Cash	√		
Equipment	√		
Client Savings		√	
Net Deficit - current year			√
Restricted/Deferred Revenue		√	
Building	√		
Loans Outstanding - current	√		
Loan Fund Capital			√
Long-term Investments	√		
Long-term Debt (concessional)		√	
Loans Outstanding - Past Due	√		
Loan Loss Reserve*	√		
Restructured Loans	√		

### Activity 3

The effects of transactions on the accounting equation.

	Assets				=	Liabilities	+	Proprietorship
	Cash	+ Furniture	+ Merchandise	+ Debtors		Creditors		+ Riaz, Capital
1	+ 50 000							+50 000

	50 000				=		+	50 000
2	- 10 000	+ 10 000						
	40 000	10 000			=		+	50 000
3	- 10 000		+ 10 000					
	30 000	10 000	10 000		=		+	50 000
4			+ 5 000			+ 5 000		
	30 000	10 000	15 000		=	5 000	+	50 000
5	+ 2 000		- 1 500					+ 500 (Profit)
	32 000	10 000	13 500		=	5 000	+	50 500
6			- 3 000	+ 4 000				+ 1 000 (Profit)
	32 000	10 000	10 500	4 000	=	5 000	+	51 500
7	- 1 000					- 1 000		
	31 000	10 000	10 500	4 000	=	4 000	+	51 500
8	+1 000			1 000				
	32 000	+ 10 000	+ 10 500	+ 3 000		4 000	+	51 500
9	1 000							1 000
	31 000	10 000	10 500	3 000	=	4 000	+	50 500

#### Activity 4

The effect of the accounting equation.

	Assets			=	Liabilities +	Owner's Equity	
	Cash +	Bike Parts +	Accounts Receivable	=	Accounts Payable + Peddler	Capital +	Revenue (Expenses)
Sep 1	7500			=		7500	
Sep 8		2500		=	2500		
Sep 15	(1000)			=			(1000)
Sep 17	400		700	=			1100
Sep 18		(275)		=			(275)
Sep 25	425		(425)	=			
Sep 28	(500)			=	(500)		
<b>Totals:</b>	<b>6825 +</b>	<b>2225 +</b>	<b>275</b>	<b>=</b>	<b>2000 +</b>	<b>7500 +</b>	<b>(175)</b>
	<b>R9 325</b>			<b>=</b>	<b>R9 325</b>		

#### Activity 5

1. Accounting equation

Capital	+	Liabilities	=	Assets
---------	---	-------------	---	--------

(a)	R100 000	+	0	=	Cash (100 000)
(b)	100 000	+	0	=	Cash (75 000) + Furniture (25 000)
(c)	100 000	+	0	=	Cash (55 000) + Furniture (25 000) + Goods (20 000)
(d)	100 000	+	Ram (5 000)	=	Cash (55 000) + Furniture (25,000) + Goods(25 000)
(e)	100 000	+	Ram (5 000)	=	Cash (70 000) + Furniture (25 000) + Goods(10 000)
(f)	100 000	+	Ram (5 000)	=	Cash (70,000) + Furniture (25 000) + Goods (2 000) + Shyam (8 000)
(g)	100 000	+	Ram (1 000)	=	Cash (66 000) + Furniture (25 000) + Goods (2 000) + Shyam (8 000)
(h)	100 000	+	Ram (1 000)	=	Cash (71 000) + Furniture (25 000) + Goods (2 000) + Shyam (3 000)
(i)	100 000	+	Ram (1 000)	=	Cash (46 000) + Furniture (25 000) + Goods (2 000) + Shyam (3 000) + Bank (25 000)
(j)	100 000	+	Ram (1 000)	=	Cash (56 000) + Furniture (25 000) + Goods (2 000) + Shyam (3 000) + Bank (15 000)

## 2. Accounting Equation

	<b>Capital</b>	+	<b>Liabilities</b>	=	<b>Assets</b>
(a)	R50 000	+	0	=	Cash (50 000)
(b)	50 000	+	0	=	Cash (40 000) + Machinery (10 000)
(c)	50 000	+	0	=	Cash (25 000) + Machinery (10 000) + Goods (15 000)
(d)	50 000	+	A (5 000)	=	Cash (25 000) + Machinery (10 000) + Goods (20 000)
(e)	50 000	+	A (5 000)	=	Cash (35 000) + Machinery (10 000) + Goods (10 000)
(f)	50 000	+	A (3 000)	=	Cash (33 000) + Machinery (10 000) + Goods (10 000)
(g)	50 000)	+	A (3 000)	=	Cash (33 000) + Machinery(10 000) + Goods (7 000) + B (3 000)
(h)	50 000	+	A (3 000)	=	Cash (27 000) + Machinery (10 000) + Goods (7 000) + B (3 000) + Bank (6 000)
(i)	50 000	+	A (2 000)	=	Cash (27 000) + Machinery (10 000) + Goods (7 000) + B (3 000) + Bank (5 000)
(j)	50 000	+	A (2 000)	=	Cash (27 000) + Machinery (10 000) + Goods (7 000) + B (1 000) + Bank (7 000)

### Activity 6

	Assets =					Liabilities +				Equity
	Cash	Current Loans Outstan ding	Loans Past Due	Invest ment s	Property & Equipme nt	Short- term Borrow ing	Client Savings	Long- term Debt	Restrict ed / Deferred Revenue	Equity
Purchase land on credit (> one year)					↑			↑		
Disburse loan to client	↓	↑								
Purchase motorcycles for staff - pay half cash; half short-term credit	↓				↑	↑				
Purchase office furniture on short-term credit					↑	↑				
Take loan from bank at commercial rate of interest (> one year)	↑							↑		
Purchase a Treasury Bill for cash	↓			↑						
Client withdraws savings	↓						↓			
Receive an unrestricted donation	↑									↑
A Current loan becomes past due		↓	↑							
Receive a restricted donation for operations (3 years)	↑								↑	

# Fixed Assets and Depreciation

## Accounting for fixed assets

### Introduction

An important distinction is made in accounting between "current assets" and "fixed assets".

**Current assets** are those that form part of the circulating capital of a business. They are replaced frequently or converted into cash during the course of trading. The most common current assets are stocks, trade debtors, and cash.

Compare current assets with fixed assets. A **fixed asset** is an asset of a business **intended for continuing use**, rather than a short-term, temporary asset such as stocks.

Assets must be classified in a company's balance sheet as **intangible, tangible, or investments**. Examples of intangible assets include goodwill, patents, and trademarks. Examples of tangible fixed assets include land and buildings, plant and machinery, fixtures and fittings, motor vehicles and IT equipment.

### How should the changing value of a fixed asset be reflected in a company's accounts?

The benefits that a business obtains from a fixed asset extend over several years. For example, a company may use the same piece of production machinery for many years, whereas a company-owned motor car used by a salesman probably has a shorter useful life.

By accepting that the life of a fixed asset is limited, the accounts of a business need to recognise the benefits of the fixed asset as it is "consumed" over several years.

This consumption of a fixed asset is referred to as **depreciation**.

## Accounting for Depreciation on fixed assets

### Definition of depreciation

*"the wearing out, using up, or other reduction in the useful economic life of a tangible fixed asset whether arising from use, effluxion of time or obsolescence through either changes in technology or demand for goods and services produced by the asset."*

A portion of the benefits of the fixed asset will be used up or consumed in each accounting period of its life in order to generate revenue. To calculate profit for a period, it is necessary to match expenses with the revenues they help earn.

In determining the expenses for a period, it is therefore important to include an amount to represent the consumption of fixed assets during that period (that is, depreciation).

In essence, depreciation involves allocating the cost of the fixed asset (less any residual value) over its useful life. To calculate the depreciation charge for an accounting period, the following factors are relevant:

- the cost of the fixed asset;
- the (estimated) useful life of the asset; and
- the (estimated) residual value of the asset.

### **What is the relevant cost of a fixed asset?**

The cost of a fixed asset includes all amounts incurred to acquire the asset and any amounts that can be directly attributable to bringing the asset into working condition.

Directly attributable costs may include:

- Delivery costs
- Costs associated with acquiring the asset such as stamp duty and import duties
- Costs of preparing the site for installation of the asset
- Professional fees, such as legal fees and architects' fees

Note that general overhead costs or administration costs would not be included as part of the total costs of a fixed asset (e.g. the costs of the factory building in which the asset is kept, or the cost of the maintenance team who keep the asset in good working condition)

The cost of subsequent expenditure on a fixed asset will be added to the cost of the asset provided that this expenditure enhances the benefits of the fixed asset or restores any benefits consumed.

This means that major improvements or a major overhaul may be capitalised and included as part of the cost of the asset in the accounts.

However, the costs of repairs or overhauls that are carried out simply to maintain existing performance will be treated as expenses of the accounting period in which the work is done, and charged in full as an expense in that period.

### **What is the Useful Life of a fixed asset?**

An asset may be seen as having a physical life and an economic life.

Most fixed assets suffer physical deterioration through usage and the passage of time. Although care and maintenance may succeed in extending the physical life of an asset, typically it will, eventually, reach a condition where the benefits have been exhausted.

However, a business may not wish to keep an asset until the end of its physical life. There may be a point when it becomes uneconomic to continue to use the asset even though there is still some physical life left.

The economic life of the asset will be determined by such factors as technological progress and changes in demand. For purposes of calculating depreciation, it is the estimated economic life rather than the potential physical life of the fixed asset that is used.

### What about the Residual Value of a fixed asset?

At the end of the useful life of a fixed asset the business will **dispose of it and any amounts received from the disposal will represent its residual value**. This, again, may be difficult to estimate in practice. However, an estimate has to be made. If it is unlikely to be a significant amount, a residual value of zero will be assumed.

The cost of a fixed asset less its estimated residual value represents the total amount to be depreciated over its estimated useful life.

### Depreciation Methods

The total amount to be depreciated over the life of a fixed asset is determined by the following calculation:

#### *Cost of the fixed asset less residual value*

The period over which to depreciate a fixed asset is known as the "**useful economic life**" of the asset

So how much of this depreciable amount is charged against profits in each accounting period?

A depreciation method is required to allocate, in a systematic way, the total amount to be depreciated between each accounting period of the asset's useful economic life.

There are various methods of depreciation available. However, most businesses appear to adopt one of the two methods described below.

#### **Straight Line Method / Fixed Instalment Method / Original Cost Method**

The straight-line method of depreciation is widely used and simple to calculate. It is based on the principle that each accounting period of the asset's life should bear an **equal amount of depreciation**.

As a result, the depreciation charge for the asset can be calculated using the following formula:

$$\text{Depreciation (Dpn)} = (C - R) / N$$

where:

Dpn = Annual straight-line depreciation charge

C = Cost of the asset

R = Residual value of the asset

N = Useful economic life of the asset (years)

Whilst it is simple and popular, is the straight line depreciation method the most appropriate way of calculating depreciation?

The answer lies in understanding that depreciation is a process of allocation, not valuation.

The pattern of annual depreciation charges for a fixed asset should attempt to match the pattern of benefits derived from that asset. Therefore, where the benefits from an asset are likely to be reasonably constant over its life the straight-line method of depreciation would be appropriate as it results in a constant annual depreciation charge.

In practice it may be difficult to assess the pattern of benefits relating to an asset. In such cases the straight-line method may often be chosen simply because it is easy to understand and calculate.

### **Reducing balance Method/Diminishing balance Method/written Down Value Method**

The reducing balance or diminishing method of depreciation provides a high annual depreciation charge in the early years of an asset's life but the annual depreciation charge reduces progressively as the asset ages.

To achieve this pattern of depreciation, a fixed annual depreciation percentage is applied to the written-down value of the asset. Thus, depreciation is calculated as a percentage of the reducing balance.

For certain fixed assets, the benefits derived may be high in the early years, but may decline as the asset ages. For such assets, the reducing-balance method of depreciation would be appropriate insofar as it matches the depreciation expense with the pattern of benefits.

Once a particular method of depreciation has been chosen for a fixed asset, the method should be applied consistently over its life. It is only permissible to switch from one method to another if the new method provides a fairer presentation of the financial results and financial position.

### **Total depreciation charged**

It should be noted that, whichever method of depreciation is selected, the total depreciation to be charged over the useful life of a fixed asset will be the same.

It is simply the allocation of the total depreciation charge between accounting periods that is affected by the choice of method.

### **Depreciation - straight line example**

In our introduction above, we indicated that there are two main methods that companies choose to calculate depreciation, namely:

- Straight- line depreciation
- Reducing balance method

We emphasised the point that these two methods simply provide an alternative way of allocating the total depreciation charge over several accounting periods. The total depreciation charge using either method will be the same over the total useful economic life of the asset.

To illustrate the straight line depreciation method, we have calculated the depreciation charge for the following asset:

"A business purchases a new machine for R75 000 on 1 January 2003. It is estimated that the machine will have a residual value of R10 000 and a useful economic life of five years. The business has an accounting year end of 31 December".

### **Straight line depreciation method**

Using the straight line depreciation method, the calculation of the annual depreciation charge is as follows:

$$\text{Depreciation (Dpn)} = (C - R) / N$$

where:

Dpn = Annual straight-line depreciation charge

C = Cost of the asset

R = Residual value of the asset

N = Useful economic life of the asset (years)

So the calculation is:

$$\text{Depreciation} = (R75\ 000 - R10\ 000) / 5$$

$$\text{Depreciation} = R13\ 000$$

In the accounts of the business a depreciation charge of R13 000 will be expensed in the profit and loss account for each of the five years of the asset's useful economic life.

In the annual balance sheet, the machine would be shown at its original cost less the total accumulated depreciation for the asset to date.

### **Example of how this would be disclosed in the accounts**

At the end of the third year of ownership of the machine, the financial accounts of the business would include the following items in relation to the machine:

#### ***In the Profit and Loss Account:***

Depreciation of Machinery - Charge: R13 000

#### ***In the Balance Sheet at 31 December 2005:***

	R	R
Machine at Cost	75 000	
less: Accumulated Depreciation	39 000	
Machine at net book value		36 000

The figure for accumulated depreciation of R39 000 at 31 December 2005 represents three years' worth of depreciation at R13 000 per year.

The cost of the machine (R75 000) less the accumulated depreciation charged on the machine (R39 000) is known as the **"net book value" ("NBV")** or **"net carrying value / cost ("NCV")**.

It should be noted that NBV is simply an accounting value that is the result of a decision about which method is used to calculate depreciation. It does not necessarily mean that the machine is actually worth more or less than the NBV.

### Depreciation - reducing balance example

To illustrate the reducing balance depreciation method, we have calculated the depreciation charge for the following asset:

"A business purchases a new machine for R75 000 on 1 January 2003. It is estimated that the machine will have a residual value of R10 000 and a useful economic life of five years. The business decides to calculate annual depreciation at the rate of 40% of the written-down value. The business has an accounting year end of 31 December".

### Reducing balance depreciation method

Using the reducing balance depreciation method, the calculation of the annual depreciation charge is as follows:

31 December		R
	Original machine cost	75 000
2003	Depreciation in 2003 (40% cost)	30 000
	Net Book Value at 31 December 2003	45 000
2004	Depreciation in 2004 (40% of NBV @ 31 December 2003)	18 000
	Net Book Value at 31 December 2004	27 000
2005	Depreciation in 2005 (40% of NBV @ 31 December 2004)	10 800
	Net Book Value at 31 December 2005	16 200
2006	Depreciation in 2006 (40% of NBV @ 31 December 2005)	6 480
	Net Book Value at 31 December 2006	9 720
2007	Depreciation in 2007 (40% of NBV @ 31 December 2006)	3 888

The reducing balance method can result in significant differences in the annual depreciation charge, depending on the "percentage" of net book value that is used to calculate the charge.

In the example above, the total amount charged to depreciation in the first three years of owning the machine (2003-2005) was R58 800 (compared with R39 000 if a straight line depreciation method has been used).



## Assessment Tasks

### Activity 1

Indicate the alternative which you consider to be correct.

1. Depreciation is a process of:
  - A. Valuation.
  - B. Allocation.
  - C. Both valuation and allocation.
  - D. None of these.
2. The main objective of providing depreciation is:
  - A. To allocate true profit.
  - B. To show the true financial position in the balance sheet.
  - C. To reduce tax burden.
  - D. To provide funds for replacement of fixed assets.
3. Depreciation arises because of:
  - A. Fall in the market value of an asset.
  - B. Physical wear and tear.
  - C. Fall in the market value of money.
4. Under the straight line method of charging depreciation, it:
  - A. Increases every year.
  - B. Decreases every year.
  - C. Is constant every year.
5. Under the diminishing balance method, the depreciation is calculated on:
  - A. Original cost.
  - B. Written down value.
  - C. The scrap value

6. A diminishing balance method of providing depreciation is one according to which:
  - A. The amount of depreciation is reduced year to year.
  - B. The rate percent of depreciation declines from year to year.
  - C. The rate percent as well as the amount reduces every year.
7. Depreciation on diminishing balance method of R2 000 at the rate of 10% p.a. after three years will be:
  - A. R1 400
  - B. R1 458
  - C. R542
  - D. None of the above.
8. The amount of depreciation charged on a machinery will be debited to:
  - i. Machinery a/c.
  - ii. Depreciation account.
  - iii. Cash account.
9. Loss on the sale of machinery should be written off against:
  - A. Share premium account.
  - B. Sales account
  - C. Depreciation fund account

## Activity 2

**A.**

A motor vehicle bought for R100 000 is expected to have a useful lifespan of 5 years. Calculate depreciation on fixed or straight line method. You must also calculate depreciation rate on the motor vehicle.

**B.**

The cost price of equipment R90 000 on 1 March 2001. Depreciation rate on the equipment is 10% pa on the diminishing balance. Calculate depreciation on equipment.

## Activity 3

**A.**

Napoleon purchased a machine for R15 000. The transportation costs were R1 500 and installation costs were R750. The machine broke down at the end of the first month in use and cost R400 to repair. N plc depreciates machinery at 10% each year on cost, assuming no residual value.

What is the net book value of the machine after one year, to the nearest rand? Show the workings.

**A** R13 500

**B** R14 850

**C** R15 525

**D** R15 885

**B.**

A fixed asset register is

- A an alternative name for the fixed asset ledger account.
- B a list of the physical fixed assets rather than their financial cost.
- C a schedule of planned maintenance of fixed assets for use by the plant engineer.
- D a schedule of the cost and other information about each individual fixed asset.

**C.**

A fixed asset register had a balance of R125 000. A fixed asset, which had cost R12 000, was sold for R9 000 at a profit of R2 000. What is the revised balance on the fixed asset register? Show the workings.

- A R113 000
- B R118 000
- C R125 000
- D R127 000

#### Activity 4

- A. If the purchase price of asset is 1.5million, and residual value after 5 years is R300 000, what is the net book value at the end of each year up to 5 years?
- B. The purchase price of an asset is R20 million. using 25% per annum reducing balance method, calculate:
  - 1. annual depreciation over 5 years
  - 2. net book value at the end of each year
- C. The purchase price of an asset is R600 000 and annual depreciation using the straight line method, is R80 000 calculate:
  - 1. **net book value** after 4 years
  - 2. **expected life** of asset assuming a residual value of R200 000
  - 3. **expected life** assuming a **residual value of zero**

#### Activity 5

A car was purchased for R12 000 on 1 April 1997 and has been depreciated at 20% each year straight line, assuming no residual value. The company policy is to charge a full year's depreciation in the year of purchase and no depreciation in the year of sale. The car was traded in for a replacement vehicle on 1 August 2000 for an agreed figure of R5 000. What was the profit or loss on the disposal of the vehicle for the year ended 31 December 2000? Show the workings.

- A Loss R2 200
- B Loss R1 400

- C Loss R200
- D Profit R200

**Activity 6**

A company bought a machine on 1 October 1996 for R52 000. The machine had an expected life of eight years and an estimated residual value of R4 000. On 31 March 2001, the machine was sold for R35 000. The company's yearend is 31 December. The company uses the straight-line method for depreciation and it charges a full year's depreciation in the year of purchase and none in the year of sale. What is the profit or loss on disposal of the machine? Show the workings.

- A Loss R13 000
- B Profit R7 000
- C Profit R10 000
- D Profit R13 000

**Activity 7**

Chris Hani Baragwanath Hospital purchased a special X-ray machine. The machine, which cost R311 560, was **expected to last ten years**, with an estimated residual value of R31 560. **After two years** of operation (and depreciation charges using the **straight-line method**), it became evident that the X-ray machine would **last a total of only seven years**. The estimated residual value, however, would remain the same.

Given this information, determine the new depreciation charge for the **third year** on the basis of the revised estimated useful life.



**Activity 1**

1	2	3	4	5	6	7	8	9
B	A	B	C	B	A	D	B	C

**Activity 2**

A

Depreciation on vehicle:

$$\frac{R100\,000}{5}$$

OR

$$\frac{R20\,000}{R100\,000} \times \frac{100}{1}$$

= R20 000 pa

= 20% pa

**B**

**Depreciation on 28 February each year:**

**Year 1:**

$$\frac{R90\,000}{1} \times \frac{10}{100} = R9\,000$$

**Year 2:**

$$R90\,000 - R9\,000 = R81\,000$$

$$\frac{R81\,000}{1} \times \frac{10}{100} = R8\,100$$

**(Accumulated depreciation R9 000 + R8 100 = R17 100)**

**Year 3:**

$$R90\,000 - R17\,100 = R72\,900$$

$$\frac{R72\,900}{1} \times \frac{10}{100} = R7\,290$$

**(Accumulated depreciation R9 000 + R8 100 + R7 290 = R24 390)**

### Activity 3

**A.**

The answer is C.

Workings

Cost of machine	R15 000
Transportation	1 500
Installation	750
	17 250
Depreciation at 10%	(1 725)
Net book value	15 525

**B.**

The answer is D.

**C.**

The answer is B.

Workings

Balance on fixed asset register	R125 000	
Net book value of assets sold		
Proceeds R9 000 less profit R2 000	(7 000)	
	<b>118 000</b>	

#### Activity 4

A.

If the original cost is R1 500 000 and at the end of 5 years the residual value is R300 000, then the depreciation is  $R1\ 500\ 000 - R300\ 000 = R1\ 200\ 000$ . Divide that by 5 and the value reduces by R240 000 each year.

Year	Depreciation	Net Book value
1	$R1\ 200\ 000 / 5 = R240\ 000$ $R1\ 500\ 000 - R240\ 000 = R1\ 260\ 000$	R1 260 000
2	$R1\ 200\ 000 / 5 = R240\ 000$ $R1\ 260\ 000 - R240\ 000 = R1\ 020\ 000$	R1 020 000
3	$R1\ 200\ 000 / 5 = R240\ 000$ $R1\ 020\ 000 - R240\ 000 = R780\ 000$	R780 000
4	$R1\ 200\ 000 / 5 = R240\ 000$ $R780\ 000 - R240\ 000 = R540\ 000$	R540 000
5	$R1\ 200\ 000 / 5 = R240\ 000$ $R540\ 000 - R240\ 000 = R300\ 000$	R300 000

B.

Year	Depreciation	Net Book value
1	$R20\ 000\ 000 \times 0.25 = R5\ 000\ 000$ $R20\ 000\ 000 - R5\ 000\ 000$	R15 000 000.
2	$R15\ 000\ 000 \times 0.25 = R3\ 750\ 000$ $R15\ 000\ 000 - R3\ 750\ 000$	R11 250 000
3	$R11\ 250\ 000 \times 0.25 = R2\ 812\ 500$ $R11\ 250\ 000 - R2\ 812\ 500$	R8 437 500
4	$R8\ 437\ 500 \times 0.25 = R2\ 109\ 375$ $R8\ 437\ 500 - R2\ 109\ 375$	R6 328 125
5	$R6\ 328\ 125 \times 0.25 = R1\ 582\ 031$ $R6\ 328\ 125 - R1\ 582\ 031$	R4 746 094

C

1	$R600\ 000 - (4 \times 80\ 000) = 600\ 000 - 320\ 000 = R280\ 000$
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2	$R600\,000 - 200\,000 = 400\,000 / 80\,000$ (annual depreciation) = 5 years
3	$R600\,000 / 80\,000 = 7.5$ years

### Activity 5

The answer is D.		
<b>Workings:</b>		
	<b>R</b>	<b>R</b>
1 April 1997 Cost		12 000
Depreciation charge at 20%		(7 200)
1997	2 400	
1998	2 400	
1999	2 400	
Net book value 1 August 2000		4 800
Proceeds 1 August 2000		5 000
Profit		200

### Activity 6

The answer is D.		
<b>Workings</b>		
Cost machine 1 October 1996		52 000
Residual value		(4 000)
		48 000
Depreciation charge per year =	$R48\,000 / 8 =$	6 000
Cost machine		52 000
Depreciation 5 years x R6 000		(30 000)
Net book value		22 000
Proceeds on sale		35 000
Profit		13 000

### Activity 7

**Expected time: to last 10 years**

$$R311\,560 - 31\,560 = 280\,000 / 10 = R28\,000$$

**Actual time of machine only 7 years: realized after 2 years of operation**

$$R255\,560 - 31\,560 = 224\,000 / 5 \text{ years} = R44\,800$$

For year 3 and on the depreciation charge is **R44 800**.

Year	Cost of Machine	Less depreciation per year	Accumulated depreciation	Book Value
1	311 560	28 000	28 000	R283 560
2	283 560	28 000	56 000	R255 560
3	255 560	44 800	100 800	R210 760
4	210 760	44 800	145 600	R165 960
5	165 960	44 800	190 400	R121 160
6	121 160	44 800	235 200	R76 360
7	76 360	44 800	280 000	R31 560

# Debtors and Creditors lists To Reconcile Debtors and Creditors Control Account – Grade 10

From CAPS: "Preparation of debtors' and creditors' lists to reconcile with the debtors' and creditors' control accounts (including correction of errors and omissions)".

## Meaning:

In Grade 10 learners only prepare the **debtors or creditors lists to reconcile** with the **control accounts**. If the two don't agree, look for **errors and omissions** that cause the differences and **journalize** to correct them.

The same content is also repeated in Grade 12. Learners may be requested to prepare a **statement reconciling** the original **net balances extracted from the debtors / creditors ledger** with the adjusted final balance on the **debtors / creditors control account**, e.g. after identifying the errors and omissions, journalise, adjust the debtors / creditors accounts and reconcile the adjusted personal account with the control account.

Another reconciliation statement in Grade 11 and 12: **Reconcile the Creditors' Monthly Statement with the personal accounts** (Creditors Account) and prepare the **Creditors Reconciliation Statement**.

## Control Accounts

If a firm has a large number of debtors and/or creditors the process of taking a trial balance can become prolonged. With a large number of accounts there is also a greater possibility of an error occurring within one of the individual debtor's or creditor's accounts.

It would be of great assistance, therefore, if the debtors ledger could be agreed or balanced separately and similarly the creditors ledger. In this way an error, on say a debtor's account will be isolated, rather than appear as an unidentifiable error on the full trial balance.

## The advantages of maintaining a system of control accounts are:

1. As control accounts substitute the totals from schedules of debtors and creditors, a complete trial balance may be compiled before the individual personal ledger balances are abstracted. Thus it lessens the time and labour involved in preparing a trial balance.
2. As errors are localised, differences on a trial balance can be traced to the particular ledger where the errors exist and the work of checking can be restricted to that ledger. It saves time, money and labour and delay in balancing is minimised.
3. The system operates as a control over the personal ledgers and constitutes a valuable feature of the system of internal check. It safeguards the records from unintentional errors or fraudulent entries.
4. Control accounts provide management with immediate access to current totals of debtors and creditors, and furthermore it reduces risk of error by posting totals rather than individual items.

Not all the transactions done in a business are in cash. Now days, businesses do a lot more transactions in credit and thus there is a long list of debtors and creditors. Since the bulk of entries are made in the accounts of debtors and creditors, these two classes of accounts are taken out of the **General Ledger and put in a subsidiary ledger.**

**Subsidiary ledgers include:**

- **Debtors or Sales Ledger:** Which contains all debtors accounts
- **Creditors or Purchases Ledger:** contains all creditors' accounts.

*This is where control account comes in...* **Control account is a summary of all the accounts in the subsidiary ledgers.**

**Meaning:**

*"Summary of all accounts in the **Debtors / Sales ledger** makes up the **Debtors control account** and the summary of all accounts in the **Creditors / Purchase Ledger** is known as the **Creditors control account**".*

*Control accounts belong to the **General Ledger (GL)**.*

**How to complete Debtors Accounts, Creditors Accounts and Control Accounts: (Refer to pages 12 to 18 of the "National Curriculum Statement Accounting Guide Grade 10" self study guide.**

**Setting up Debtors and Creditors Accounts:**

**Enter opening balances (in case the accounts are old)**

- Record the opening balances in the General Journal.
- Post the opening balance to the General Ledger.
- Post the opening balances to the individual Creditor and Debtor accounts.

**Recording Debtors (Accounts Receivable) transactions**

**1. Enter credit Sales and Sales Returns**

- Using information from the duplicate of the Invoices and Adjustment Notes given to your customers enter the transactions in the Sales Journal and Sales Returns and allowances journal.

Or

- Note: Adjustment Notes will be entered as a negative as this will reduce the Sales, e.g. entered in the Sales Journal in brackets i.e. (R234.00).
- The Sales Journal is used to record the sale of goods on credit, inventory or stock for resale only.

**2. Post the totals to the General Ledger**

- Post the totals for each column to the ledger account.

**3. Post to Debtors Subsidiary Ledger**

- What is posted in the control account must also be posted in the subsidiary account on the same side.

#### 4. Record Receipts from Debtors

- All receipts from debtors should be recorded in the Cash Receipts Journal. The amount should be entered in the column headed **Debtors** or **Accounts Receivable**, and the debtors name in the **details** or **particulars** columns.

#### 5. Post Payment

- Post the payments and discounts to the General Ledger and Subsidiary Ledgers.

#### 6. Create a schedule of debtors

- A Schedule (reconciliation) of Debtors is the total of all debtors in the subsidiary ledger, showing their name, account number and the amount owed. The **total of this list will equal the balance of the Debtors Control Account** in the General Ledger.

### Recording Creditors (Accounts Payable) transactions

#### 1. Enter credit Purchases and Purchase Returns

- Using information from the Invoices and Adjustment Notes received from your suppliers enter the transactions in the Purchases journal and Purchases returns and allowances journal.

Or

- Note: Adjustment Notes should be entered as a negative as this will reduce the purchases, e.g. they should be entered in the Purchases Journal using brackets i.e. (R234.00).

#### 2. Post the totals to the General Ledger

- Post the total of each column in the Purchases Journal to the appropriate ledger account.

#### 3. Post to Creditors Subsidiary Ledger

- Unlike the general ledger, there is no double entry posting to the subsidiary ledgers. The control for subsidiary ledger is, the total of the accounts in the subsidiary ledger will equal the balance of the control account.
- What is posted in the control account must also be posted in the subsidiary account on the same side.

#### 4. Record Payments to Creditors

- Record all payments (including discounts) made to creditors in the Cash Payments Journal.
- Note: The debtors name should appear in the details/particulars column, and the amount should appear in the Creditors/Accounts Payable column.

#### 5. Post Payment

1. Post the payments and discounts to the General Ledger and Subsidiary Ledgers.

#### 6. Create a schedule of creditors

- A Schedule (reconciliation) of Creditors is the total of all creditors in the subsidiary ledger, showing their name, account number and the amount owed. The **total of this list will equal the balance of the Creditors Control Account** in the General Ledger.

**Example:**

Balances in debtors/sales and creditors /purchases ledger

1. Transactions for the year:
2. Credit sales to **A, B, C** were R100, R200 and R300 respectively.
3. After the full payment, **A** returned part of the goods and full allowance of R50 was given.
4. Credit purchases to **X, Y, Z** were R200, R400 and R600 respectively.
5. After full payment to **X**, we returned goods worth R100 to him.

**You are required to prepare:**

- a. The accounts in sales ledger and purchases ledger.
- b. The list of debtors and the list of creditors at the year end.
- c. The sales ledger control account and the purchases ledger control account.
- d. The debtors and creditors balances in the trial balance.

**A.**

**DEBTORS LEDGER**

A Account					
	Sales	100		Cash	100
				Sales Returns	50

B Account					
	Sales	200			

C Account					
	Sales	300			

**CREDITORS LEDGER**

X Account					
	Cash	200		Purchases	200
	Purchases Returns	100			

Y Account					
				Purchases	400

Z Account					
				Purchases	600

B.

List of Debtors			List of Creditors		
	A	(50)		X	(100)
	B	200		Y	400
	C	<u>300</u>		Z	<u>600</u>
		<u>450</u>			<u>900</u>

C.

#### GENERAL LEDGER

Debtors Control Account					
	Sales	600		Sales Returns	50
	Balance c/d	50		Cash	100
				Balance c/d	<u>500</u>
		<u>650</u>			<u>650</u>
	Balance b/d	500		Balance b/d	50

Creditors Control Account					
	Purchases Returns	100		Purchases	1200
	Cash	200		Balance c/d	100
	Balance c/d	<u>1000</u>			
		<u>1300</u>			<u>1300</u>
	Balance b/d	100		Balance b/d	1000

D.

Trial Balance (Extract)					
				Dr.	Cr.
	Debtors (500+100)			600	
	Creditors (50 + 1000)				1050

Preparation of control accounts:

**From where do you get information to draw Debtors Control Accounts?**

The information required for the preparation of the debtors control account (total debtors account/debtors control account) can be found as follows:

<u>Debits</u>	<u>Source</u> (Subsidiary journal / book of prime entry)
Total Opening Balance	Trial Balance at close of previous period
Credit sales / Total sales	Sales journal
Bad debts recovered	General Journal
Dishonoured cheques	Cash journal
Dishonoured bills	Journal
Refunds to debtors	Cash journal
Correction of errors	General Journal
Discount allowed withdrawn	General Journal
Any charges to debtors	General Journal

<u>Credits</u>	<u>Source</u> (Subsidiary journal / book of prime entry)
Sales returns / Returns inwards and allowances	Sales returns journal / Returns Inwards journal
Cash and cheque received from debtors	Cash journal
Cash received from bad debts recovered	Cash journal
Discounts allowed	Cash journal - discount column
Bad debts written off	General Journal
Bills receivable	General Journal
Contra entries	General Journal
Correction of errors	General Journal

**From where do you get information to draw Creditors Control Accounts?**

The Creditors control account (bought ledger control account/total creditors account/creditors control account) would be built up from the following sources:

<u>Debits</u>	<u>Source</u> (Subsidiary journal / book of prime entry)
Purchases returns>Returns outwards and allowances	Purchases returns journal / Returns Outwards Journals
Payments to creditors	Cash journal
Discounts received	Cash journal - discount column
Bills payable	General Journal
Contra entries	General Journal
Correction of errors	General Journal

<u>Credits</u>	<u>Source</u> (Subsidiary journal / book of prime entry)
Total opening balances	Trial Balance at close of previous period
Credit purchases / Total purchases	Purchases journal
Refunds from creditors	Cash journal
Dishonoured bills payable	General Journal
Correction of errors	General Journal
Total cash and cheques paid to creditors	Cash journal
Any charges by creditors	General Journal

### Summary

1. We learned that all individual *debtor* T-accounts go in the *debtors ledger* and all individual *creditor* T-accounts go in the *creditors ledger*. No debtor or creditor T-accounts go in the general ledger. They only go in the debtor and creditor ledgers. The general ledger also contains two special accounts relating to the above, called **control accounts**. There is a control account for debtors and a control account for creditors:
2. The reason they are called *control accounts* is because one uses them to ensure there **are no errors or mistakes** in our records relating to debtors and creditors. Thus one gets more *control*. Note that the entries in the control accounts of "total sales", "total purchases" as well as "bank" come from the relevant accounting journals.  
**So, how do these *control* accounts ensure that there are no errors or mistakes?**
3. Let's take debtors. For debtors, we compare the closing balance of the debtors control account in the general ledger to the total of all the closing balances of all the individual debtor accounts in the debtors ledger. If the debtor T-accounts came to a different figure – we would know for sure that there was some error, either in one of the individual debtor accounts in the debtors ledger or in the debtors control account (general ledger).
4. Traditionally bookkeepers or other accounts personnel perform a reconciliation on a regular basis between the control accounts (general ledger) and the total of the debtors or creditors ledger. (The

word *reconciliation* comes from *reconcile*, which means to make two amounts agree in value.) Accounts personnel may even produce a debtors or creditors reconciliation statement, which is a report showing the discrepancies between the control account (general ledger) and the totals of the individual T-accounts in the debtors or creditors ledger. **Note: the reconciliation statement is done in Grade 12.**

### Example of how to balance debtors control account

In a debtors control account, the total of outstanding invoices at the beginning of the period and invoices raised during the period, less payments received for invoiced income, will give a balancing figure of invoices still outstanding at the end of the period - your debtors. You can then compare this figure with that of invoices outstanding and thereby detect any errors.

The control account		
	Debit R	Credit R
Debtors at beginning of period (Outstanding invoices at beginning of period equal to closing balances for previous period)	6 589.36	
Total invoices in period (Total of sales day book - your list of invoices - gross figure)	13 848.25	
Total receipts in period (Total from cash book of invoiced income)		11 250.57
Debtors at end of period (Balancing figures, which should agree with prepared list)		9187.04
	<b>20 437.61</b>	<b>20 437.61</b>

**If your debtors list does not agree with the control account, check the following points:**

- Have you listed all your debtors, including invoices only partly paid or outstanding from the beginning of the period, and invoices paid directly after the end of the period, because these receipts would not be in the cash journal?
- Are there any invoices you will never receive payment for - bad debts - that you have not included in your debtors figure? These should be entered as a separate credit in your control account.
- Credit notes - does your total of invoices in the period include credit notes issued? If not, these must be included on the credit side of the account.
- Receipts from cash journal should be only those that relate to invoiced sales or work done, not for the sale of a vehicle, loans, refunds etc. If included, these figures should be taken off the receipts figure in the control account.
- Un-invoiced sales - sales that should have had an invoice raised but by error did not - should be added to the invoice total.
- Receipts for sales that were not entered into the cash journal will have to be included as a receipt on the control account.

- Addition errors of receipts, invoices or debtors totals, or duplication of invoices, receipts, or debtors in listings.

The amended debtors control might look as follows:

	R	Debit R	Credit R
Debtors at beginning of period		6 589.36	
Total invoices	13 848.25		
Sales not invoiced in error	521.20	14 369.45	
Credit notes			210.40
Total receipts	11250.57		
Sales of vehicle	(3 200.00)		
Addition error	(29.06)		8 021.51
Receipts banked in private account			2 100.00
Bad debts			86.00
Debtors at end of period			10 540.90
		<b>20 958.81</b>	<b>20 958.81</b>
Original debtors figure per list	8 064.23		
Debtor paid after period not on list	2 526.00		
Debtor included twice	(80.00)		
Invoice paid short, amount still outstanding	30.67		
Reconciled debtors as above	<b>10 540.90</b>		

There are **four types of errors** that affect control account and debtors ledger and creditors ledger:

1. Casting error in books of prime entry affects only control account and is therefore rectified through control accounts. Examples may include any of the following:
  - a. Sales / purchase journal overcast or under cast.
  - b. Returns Journal overcast or under cast.
  - c. Discounts column in cash book overcast or under cast.
2. Complete omission of a transaction affects control accounts and debtors / creditors ledgers and is therefore rectified through adjusted control accounts and debtors / creditors reconciliation statement. Examples may include of the following:
  - a. Sales / purchase invoice was entirely omitted from books.
  - b. Debit / credit note not entered anywhere.

3. Errors in the personal accounts affect only the debtors / creditors and are therefore rectified through debtors / creditors reconciliation statements. Examples may include any of the following:
  - a. Incorrect value of purchase / sale posted to creditors / debtors personal accounts.
  - b. Correct amount entered on the wrong side of personal account.**
4. Incorrect amount entered on the invoice will affect control accounts and sales / purchase and is therefore rectified through adjusted control and debtors / creditors reconciliation statements. Examples may include any of the following:
  - a. An invoice of R350 was incorrectly totalled as R305.
  - b. An invoice of R482 was incorrectly recorded in the journal as R428

**Note:**

### Reconciling the lists of balances with the control accounts

After preparing the debtors control account and the creditors control account, list of debtors and list of creditors will be extracted from the sales ledger and purchases ledger respectively. Reconcile the balances from the lists of debtors/creditors with the debtors / creditors control accounts in order to uncover and locate errors in the books.



## Assessment Tasks

### Activity 1

When reconciling the creditors' ledger control account with the list of creditors' ledger balances of M, the following errors were found:

- the purchase journal had been overstated by R500 and
- the personal ledger of a supplier had been understated by R400.

What adjustment must be made to correct these errors? Choose the correct answer.

	<i>Control account</i>	<i>List of creditor balances</i>
<b>A</b>	Cr R500	decrease by R400
<b>B</b>	Dr R500	increase by R400
<b>C</b>	Dr R400	increase by R500
<b>D</b>	Cr R400	decrease by R500

## Activity 2

1. Is it correct to have both debtors and creditors balances in control accounts?
2. If the above answer is yes, why do we sometimes have balances on both sides of the debtors control account or creditors account?

## Activity 3

Mr. A extracted a Trial Balance at 31<sup>st</sup> December 2005 and found that it did not balance. He posted the difference to a Suspense Account. Later he found the following errors which accounted for the difference:

1. The total of R365 for Discount Allowed for the month of July 05 had been posted to the credit side of Discount Received Account.
2. A payment of R 210 to Mr A from a debtor Mr XY had been posted to the credit of Mr TEY in error.
3. Mr A had paid R2 640 wages and supplied materials costing R960 to his own employees in building a store at the rear of his factory. No adjustment had been made.
4. A payment of R56 for Postage had been posted to that account as R65
5. Mr A bought new fitting for his factory costing R1 800 but this transaction had been posted to the Purchases Account
6. A payment of R96 for an electricity bill had been entered in the Cash Journal but the double entry had not been made.

### Required:

- a. Prepare the journal entries necessary to correct the errors and omission

## Activity 4

The Creditors' Control Account and Creditors' List of Supa Savings were prepared by an inexperienced bookkeeper. She identified the following figures at the end of the month:

- Creditors' Control balance: R62 660
- Creditors' List total: R46 230

### Required:

- a. Why should these two figures agree?
- b. Calculate the amended balance of the Creditors' Control Account and Creditors' List.

### INFORMATION:

An investigation revealed the following:

- (a) An adding error in the Creditors' List resulted in the total being under-cast by R480.
- (b) A credit purchase of letterheads from EeziPrint for R2 440 was left out of the books in error.
- (c) Trading stock returned to Used Less Ltd., R720, was entered correctly in the Creditors'

Allowances Journal (CAJ) but was posted as R270 to the creditors' account of Used Less Ltd.

(d) The Creditors' Control total in the Cash Payments Journal is R8 200. The bookkeeper credited this to the Creditors' Control Account by mistake.

### Activity 5

The following information has been extracted from the books of account of Alpha Engineering at 30 April 2007.

Debtors at 1 April 2007	R44 267
Sales journal total	93 882
Sales returns journal total	884
Receipts from credit customers entered in the cash book	95 501
Debit balance in sales ledger transferred to purchase ledger	235
Cash sales	2 276
Bad debt written off on 20 April 2007	150
Discount allowed	1 788
Customer's dishonoured cheque	107

You discover the following.

- a. A sales invoice totalling R545 was entered in the sales journal or day book as R554.
- b. The sales returns journal total had been under-cast by R100.
- c. A cheque received from a customer on 30 April 2007 for R2 339 had not yet been entered in the cash book.

#### Required:

- a. Taking account of all of the above information, prepare debtors control account for the month of April 2007.
- b. Control accounts can help in identifying some errors. Explain **two** other benefits to the management of a business from preparing a debtors control account.
- c. State and explain **two** types of error that would not be revealed by a control account.

### Activity 6

#### A

The net total of balances in the trial balance which was extracted from the sales ledger as on 31st March, 1993 amounted to R50 659 which did not agree with the balance on the debtors control account, R49 880. On checking, the following errors were discovered:

1. The list of balances had been overcast by R200.
2. The sales day book had been under-cast by R1 000.

3. A sales return of R600 was completely omitted from the books.
4. A balance owing by Alan had been written off as irrecoverable and debited to bad debts, but no entry had been made in the control account.

You are required to prepare the journal entries to correct the above errors.

**B.**

National Industries Limited maintains subsidiary ledgers for debtors and creditors and control accounts in the General Ledger.

On October 31, 1993, the net total of balances extracted from the purchases ledger amounted to R19 452, included a debit balance of R600, which did not agree with the balance on the creditors control account. The following matters were discovered:

1. Credit purchase of goods from White, R250 had been posted to the wrong side of his account.
2. A return of R330 to Smith was debited to his account but no other entry had been made in the books.
3. A debit balance of R70 in the purchase ledger had been taken out as a credit balance.
4. A transfer of R110 from Fred's account in the purchase ledger to the credit of his account in the sales ledger had not been entered in either control accounts.

You are required to prepare the journal entries where necessary, to correct the errors.

**C.**

Kim maintains control accounts in the General Ledger in respect of both debtors and creditors. The net total of balances extracted from the sales ledger as on 31st March, 1975 amounted to R50 659 which did not agree with the balance on the Debtors Control Account. On checking, the following errors were discovered, after the adjustment of which the books balanced and the correct net total of the Sales Ledger balances agreed with the amended Control Account balance:

- i. Sales return book had been under-cast by R1 000.
- ii. R500 for goods sold to Jim had been correctly entered and debited to his account. The goods were returned by Jim a faulty and the only record in Kim's book was the crossing out of the original entry in Jim's account.
- iii. A credit balance of R60 in the Sales Ledger had been taken out as a debit balance.
- iv. A balance owing by Boon of R1 062 had been written off as irrecoverable on 31st March, 1975 and debited to bad debts account but no entry had been made in the Control Account.
- v. A bill receivable for R2 600, received from Hall Oake, had been dishonoured on maturity on 30th March, 1975. Kim had earlier discounted the bill with Chartered Bank Limited and received R2 450. The bank debited the account of Kim with R2 700 (inclusive of charges) on 30th March, 1975. The entry recording this fact in the Cash Book had not been posted to Hall Oake's Account although dealt with in the Control Account.
- vi. Leng's account showed a debit balance of R300. On 28th March, 1975 he paid R50 in cash which was recorded in the Petty cash Book, no other entry being made.

You are required to give the Journal Entries where necessary, to correct these errors.

### Activity 7

The debtors control account and debtors list of Westwood Trading Company do not balance. The debtors' clerk was asked to check source documents, journals and the ledger to find the mistakes and to reconcile the debtors control account balance with the debtors list.

Debtors control account							
May 1	Balance	b/d	R10 350	May 31	Bank & discount allowed	CRJ	R16 104
31	Sales	DJ	17 318		Debtors allowances	DAJ	100
	Bank (r/d)	CPJ	120		Journal credits	Gj	70
	Petty cash	PCJ	0		Balance	C/d	12 858
	Journal debits	GJ	250				
			<b>29 130</b>				<b>29 130</b>
June 1	Balance	b/d	12 856				

### Debtors list on 31 May 2010

Debtors	Debit	Credit
D Anthony	R2 170	
M Achmat	1 900	
T Behardien		100
J Kaoma	8 505	
D van der Linde	0	
A Shin	0	
<b>Total</b>	<b>12 575</b>	<b>100</b>

The following errors and omissions were discovered upon investigation:

1. The action of D Anthony was cast by R100 too much.
2. The total of the debtors allowance journal was under-cast by R10.
3. An invoice issued to D Anthony for R1 054 was correctly entered in the debtors journal, but was posted to his account as R1 045.
4. An invoice for R400 issued to D van der Linde was incorrectly posted to the account of J Kaoma.
5. A receipt issued to M Achmat for R830 was correct in the cash receipts journal, but was posted as R380 to his account.
6. The account of M. Achmat must still be charged with R45 interest.

7. The bank returned A Shin's dishonoured cheque marked R/D. This cheque was for R300 and R30 discount was allowed to him. This entry has not yet been made.

8. The credit balance on the account of T Bahardien occurred when he paid his account, which had been written off as irrecoverable.

### Activity 8

Internal Control Practises		
1.	Payable Subsidiary Ledgers are reconciled to the control accounts monthly.	True / False
2.	Accounts receivable records are adequately safeguarded and access to these records restricted to only authorized employees.	True / False
3.	Why receivable accounts are reviewed periodically for credit balances?	
4.	Control accounts must be balanced with the detailed ledgers at least monthly.	True / False
5.	Supporting documentation should be available for all accounts receivable activity.	True / False
6.	Why should blank invoices, credit notes, and cancellation forms be controlled?	
7.	Different persons should be responsible for different duties when dealing with receivables? Which are those duties?	
8.	How should the Invoices be issued?	
9.	When should receipt of goods and services be verified?	
10.	A subsidiary ledger is a group of control accounts which provides information to the managers for controlling the operation of the company.	False, a subsidiary ledger has one control account)
11.	An accounts receivable subsidiary ledger has all the detailed information about the cash sales to individual customers.	True / False
12.	The accounts payable subsidiary ledger provides detailed information about amounts owed to creditors.	True / False
13.	Control accounts are always located in the general ledger.	True / False
14.	The responsibility for ordering, receiving, and paying for merchandise should be assigned to different individuals.	True / False
15.	When checking an invoice for accuracy, the accountant must make sure that extensions and totals are -----	A. verified B. identified

		C. balanced D. acknowledged
--	--	--------------------------------



### Activity 1

The answer is B.
------------------

### Activity 2

1. Yes is correct to have both debtors and creditors balances in control accounts. We need to understand the nature of a control account. It is an account that shows the total of amount due to and from the supplier and customers. The details of which must be in agreement with the list extracted from the subsidiary ledger.
2. When a list of subsidiary ledger balances is prepared, you may find that a few accounts have opposite balances, such as credit balances in debtors ledger and debit balances in creditors ledger.
  - a. A credit balance in a debtors ledger **may arise when a customer who has paid his amount due, returns the goods. In this case there will be credit balance for goods returned.** Opposite may be the case when the company **returns goods to the supplier** after the amount due has been paid off.
  - b. There can also be instances where a customer has paid for the goods in advance and the goods have not yet been delivered.
  - c. A control account will not show the debit balances in creditors account or credit balances in the debtors account. The account shows only the net balances. However, in order to make a fair representation such debit and credit balances are taken from the list of subsidiary ledger accounts and inserted in the control accounts.
  - d. In preparing a balance sheet, credit balances of customers are reported as current liability and debit balances of creditors are reported as current assets.

### Activity 3

A.

		Journal Entries		
Item No	Date	Particulars	Dr R	Cr R

1	Dec 31	Discount Received A/c	365	
		Discount Allowed A/c	365	
		Suspense A/c		730
		Being correction of Discount Allowed R365 wrongly credited to Discount Received Account		
2	Dec 31	Mr TEY Account	210	
		Mr XY Account		210
		Being correction of payments R2 100 by Mr XY wrongly credited to Mr TEY account		
3	Dec 31	Drawings Account	3 600	
		Wages Account		2 640
		Purchases Account		960
		Being correction of error on Wages paid R2 640 and material used R960 for own store)		
4	Dec 31	Suspense Account	9	
		Postage Account		9
		Being correction of Postage overstated R9 in Postage Account)		
5	Dec 31	Fittings Account	1 800	
		Purchases Account		1 800
		Being correction of new fittings purchased wrongly debited to Purchases account		
6	Dec 31	Drawings Account	3 600	
		Wages Account		2 640
		Purchases Account		960
		Being correction of error on Wages paid R2 640 and material used R960 for own store)		
6	Dec 31	Electricity Account	96	
		Suspense Account		96
		Being correction of electricity paid R96 not posted to that account		

#### Activity 4

##### A.

Various responses acceptable, e.g.

- Figures in General Ledger should correspond with figures in Creditors' Ledger
- This is the internal control procedure – one process is a check on another.

##### B.

Transaction	Creditors' Control	Creditors' List
Provisional balance/total	R62 660	R46 230
Transaction (a)		+ 480
Transaction (b)	+ 2 440	+ 2 440

Transaction (c)		- 450
Transaction (d)	- 16 400	
	<b>48 700</b>	<b>48 700</b>

### Activity 5

A.

Dr				Debtors Control Account				Cr			
Date		Details	R	Date		Details	R				
Apr	1	Balance B/D	44 267	Apr	30	Sales Ret DB (W2)	984				
Apr	30	Sales DB (W1)	93 873	Apr	30	Cheques (W3)	97 840				
Apr	30	Dishonoured Cheque	107	Apr	30	Contra charges	235				
				Apr	30	Bad debt w/o	150				
				Apr	30	Discount allowed	1 788				
				Apr	30	Balance c/d	37 250				
			<b>138 247</b>				<b>138 247</b>				
May	1	Balance b/d	<b>37 250</b>								

#### Workings:

W1:  $R93\ 882 - 9 = R\ 93\ 873$

W2:  $R884 + 100 = R\ 984$

W3:  $R95\ 501 + 2\ 339 = R\ 97\ 840$

B.

Two other benefits to the management of a business from preparing a debtors control account.

- Instant information enables total debtors to be ascertained at a glance thus helping with the production of final accounts.
- Prevention of fraud: managers have access to control accounts, restricting the possibility of fraudulent entries.

C.

Two types of error that would not be revealed by a control account.

- Omission where a transaction has been completely omitted from the accounting records.
- Original entry where an incorrect amount has been entered in the book of prime entry and processed through the subsidiary books.
- Commission where an entry is made in the wrong person's account in the correct ledger.
- Compensating error where one error is cancelled out by another in the same ledger.

## Activity 6

A.

Journal			
Date	Particular	Dr.	Cr.
1	Suspense a/c	200	
	Debtors (Trial Balance)		200
2	Suspense a/c	1000	
	Sales		1000
3	Sales Returns	600	
	Debtors		600
4	No entry		

B.

Journal			
Date	Particular	Dr.	Cr.
1	No entry		
2	Creditors control	330	
	Purchases returns		330
3	No entry		
4	Creditors Control	110	
	Debtors Control		110

C.

Journal			
Date	Particular	Dr	Cr
(i)	Sales Returns	1 000	
	Debtors Control		1 000

(ii)	Sales Returns		500	
	Sales Ledger Control			500
(iii)	No Entry			
(iv)	Suspense		1 062	
	Sales Ledger Control			1 062
(v)	No Entry			
(vi)	Suspense		50	
	Sales Ledger Control			50

### Activity 7

Debtors control account							
May 1	Balance	b/d	10 350	May 31	Bank & Discount Allowed	CRJ	16 004
31	Sales	DJ	17 318		Debtors' allowances	DAJ	110
	Bank (R/D)	CPJ	420		Journal credits	GJ	70
	Petty cash	PCJ	0		Balance C/d		12 409
	Journal debits	GJ	325				
			<b>28 593</b>				<b>28 593</b>
June 1	Balance	b/d	<b>12 409</b>				

### Workings:

W1. Bank & discount allowed (16104-100 = 16 004)

W2. Debtors' allowances (100+10 = 110)

W3. Bank (R/D) (120+300 = 420)

W4. Journal debits (250+45+30 = 325)

### DEBTORS LIST ON 31 MAY 2010

Debtors	Debit	Credit
D Anthony	2 079	
M Achmat	1 495	

T Behardien	0	
J Kaoma	8 105	
<b>D van der Linde</b>	<b>400</b>	
A Shin	330	
<b>Total</b>	<b>12 409</b>	

**Workings:**

W1.  $(2107-100+9 = 2\ 079)$

W2.  $(1900-450+45 = 1\ 495)$

W3.  $(-100+100 = 0)$

W4.  $(8505-400 = 8\ 105)$

**Activity 8**

Internal Control Practises		
1.	Payable Subsidiary Ledgers are reconciled to the control accounts monthly.	True
2.	Accounts receivable records are adequately safeguarded and access to these records restricted to only authorized employees.	True
3.	Why receivable accounts are reviewed periodically for credit balances.	1. In order to check returned goods. 2. Check the goods paid for in advance and have not yet been delivered
4.	Control accounts must be balanced with the detailed ledgers at least monthly.	True
5.	Supporting documentation should be available for all accounts receivable activity.	True
6.	Why should blank invoices, credit notes, and cancellation forms be controlled?	To prevent misuse
7.	Different persons should be responsible for different duties when dealing with receivables? Which are those duties?	1. Billing and maintaining accounts receivable records. 2. Receiving or handling incoming payments. 3. Reconciling receivable records to the general ledger.

8.	How should the Invoices be issued?	In numerical sequence.
9.	When should receipt of goods and services be verified?	Prior to approving invoices for approval
10.	A subsidiary ledger is a group of control accounts which provides information to the managers for controlling the operation of the company.	False, a subsidiary ledger has one control account)
11.	An accounts receivable subsidiary ledger has all the detailed information about the cash sales to individual customers.	True
12.	The accounts payable subsidiary ledger provides detailed information about amounts owed to creditors.	True
13.	Control accounts are always located in the general ledger.	True
14.	The responsibility for ordering, receiving, and paying for merchandise should be assigned to different individuals.	True
15.	When checking an invoice for accuracy, the accountant must make sure that extensions and totals are -----	A. verified

# Salaries and Wages

## Features of Salaries

Salaries are usually paid monthly. An employee's basic salary is calculated on a YEARLY basis, but is paid monthly.

**Example:** R120 000 pa. **OR** R10 000 pm.

A **salary scale** is an illustration of the minimum STARTING POINT (NOTCH) on a scale to the maximum as well as the increase (increments) that will be paid between these two points.

**Example:** R42 000 x R6 000 - R60 000 x R12 000 - R96 000

Starting salary R42 000

Commencing increments R6 000 pa.

Maximum salary before future increments R60 000

Future increments R12 000

Maximum salary R96 000

YEAR	INCREMENT	ANNUAL SALARY	MONTHLY BASIC SALARY
1		42 000	3 500
2	6 000	48 000	4 000
3	6 000	54 000	4 500
4	6 000	60 000	5 000
5	12 000	72 000	6 000
6	12 000	84 000	7 000
7	12 000	96 000	8 000

**Gross salary** = Basic salary plus incentives bonuses e.g. 13<sup>th</sup> cheque / Christmas bonus.

**Deductions** are amounts deducted from the employees gross salary and then paid over to the institutions concerned.

- SARS (PAYE)
- Pension fund
- Medical aid schemes
- Unemployment Insurance Fund (U.I.F)

- Other deductions:
  - Staff associations
  - Union fees
  - Mortgage loan repayments
  - Insurance etc.

**TO REMEMBER:**

**NET SALARY = GROSS SALARY LESS DEDUCTIONS = TAKE HOME PAYMENT**

**1. Features of wages**

Wages are usually paid weekly and in cash.

**Basic wages** is fixed per hour or per week.

(Excludes over-time wages)

**Working week** can consists of 40 hours (normal hours) any additional hours per day worked, will qualify for **overtime wages**. Overtime rates are higher than normal time rates.

**Gross wages = Basic wages + overtime / or incentive bonuses.**

**Explanation of the process of recording:**

**Steps to follow when recording the salaries and wages:**

1. Complete the wages journal and salaries journal by using the necessary information given in the question.
2. Post the relevant columns from the journals to the general ledger accounts as indicated by the ledger folios in the ledger.
3. At the end of each week the employees are paid their net wages in cash. One cash cheque is drawn and each employee is then paid the amount due to him in cash. Entry to record this transaction is made in the cash payments journal.
4. At the end of each month cheques will be drawn in respect of each employee's salary.
5. At the end of each month cheques will be drawn to pay the various payables, e.g. SARS, pension fund, Medical aid fund, etc.



## *Assessment Tasks*

### Activity 1

In tabular form, calculate the increment, annual salary and gross monthly salary from the following salary scale.

R96 000 x R9 000 - R123 000 x R13 500 - R150 000

### Activity 2

Record the following particulars in a suitable salaries journal for April 20.1

EMPLOYEES	A. ABEL	B. BAM	C. COOPER
Basic salary	R6 000	R4 800	R5 800
<b>Deductions:</b>			
S.A Pension fund	8 %	8 %	8 %
Medical fund	R480	R480	R590
PAYE	R1 200	R960	R1 160
Staff association	R45	R45	R45
Cheques issued (numbers)	C7561	C7562	C7563

The employer contributed 12% of its employees' basic salaries to the S.A Pension Fund and Rand-for-Rand basis to the medical aid fund.

**Calculations:** Pension fund

NAME	EMPLOYEE	EMPLOYER
A. Abel	8% x =	12% x =
B. Bam	8% x =	12% x =
C. Cooper	8% x =	12% x =

**Note:** Pension fund is calculated on **basic salary!**

### Activity 3

Use the information from the salary journal in Activity 2 and complete the posting to the general ledger accounts. Do not use the alternative method.

### Activity 4

Use the following information to prepare the wages journal of Union Butchery, which has a working week of 44 hours. The week ended 16 April 20.1.

Information of the weekly employees of Union Butchery.

EMPLOYEES	MALEMA	MAPANLA	PANDLA
Basic wage per hour	R18,00	R17,00	R14,00
Overtime rate per hour	R22,50	R21,25	R17,50
Hours worked: Normal	44	44	44
Overtime	5	6	5
<b>Deductions:</b>			
P.A.Y.E	R130,50	R131,25	R117,50
Medical aid fund	R29,00	R26,00	R23,00

Pension fund - 8% of basic (normal) wages.

Unemployment Insurance Fund - 1% of basic (normal) wages.

Staff association - R8 per employee per week.

**Contribution by Union Butchery:**

Pension fund 8% of the employees' basic wage.

Medical aid fund - on the R-for-R basis.

Unemployment Insurance Fund - 1% of the employees' basic wages.

**Activity 5**

The following information has been extracted from the records of Earth Stores:

For the week ending 31 July 20.1

Employee	Normal rate per hour	Hours worked
M. Ars	R30	49
P. Luto	R24	40
J. Upiter	R32	52

Normal time is 40 hours per week. Any extra hours worked are classed as overtime.

Overtime rates are based on one and a half times the worker=s normal rate per hour.

The following deductions are applicable:

- PAYE:

  - M. Ars R340
  - P. Luto R260
  - J. Upiter R370
- Pension fund (Galaxy Pension Fund): 8% of gross wages.

The firm contributes on a R1 for R1 basis.

3. Medical aid (Star Medical Aid):

M. Ars R35 per week

P. Luto R30 per week

J. Upiter R25 per week

The firm contributes on a R1 for R1 basis.

4. Unemployment Insurance Fund - 0,7% of the normal wages.

The firm contributes on a R1 for R1 basis.

For the month ending 31 July 20.1

Employee	Salary per annum
M. Ercury	R72 000
S. Aturn	R84 000
U. Ranus	R54 000

The following deductions are applicable:

1 PAYE: M. Ercury R 2 000 per month

S. Aturn R 2 200 per month

U. Ranus R 1 200 per month

2. Pension fund: 8 % of the gross salary

The firm contributes on a R1 for R1 basis.

3. Medical aid: M. Ercury R 150 per month

S. Aturn R 160 per month

U. Ranus R 100 per month

The firm contributes on a R1 for R1 basis.

The following balances/totals appeared in the books on 31 July 20.1

Wages	R14 560,20
Salaries	NIL
SARS - PAYE	2 890,00
Pension fund	1 900,08
Medical aid	540,00
Unemployment Insurance Fund	144,48
Creditors for wages	9 085,64

On 31 July 20.1 the amounts due to creditors are paid starting with cheque no. 06.

The financial year ends on 30 June 20.1.

### REQUIRED

1. Complete the wages journal and salary journal by using the necessary information given in the question.
2. Post the relevant columns from the journals to the general ledger accounts as indicated by the ledger folios in the journals.
3. Complete the cash payment journal.

### Activity 6

The given information was taken from the books of Tradenet Traders on 29 February 2000.

### INSTRUCTION

1. Show the journal entries for the adjustment on Salaries and Pension Fund Contribution for the year ended 29 February 2000.
2. Prepare the note of Trade and other payables to the Balance sheet at 29 February 2000.

### INFORMATION

#### TRADENET TRADERS

#### PRE-ADJUSTMENT TRIAL BALANCE ON 29 FEBRUARY 2000

Balance sheet accounts section	R	R
SARS (PAYE)		3 245
Pension Fund		790
Creditors		20 685
Accrued expenses		640
Income received in advanced		1 595
<b>Nominal accounts section</b>		
Salaries	142 500	
Pension fund contribution	4 620	

## ADJUSTMENT

1. An employee was on leave and his salary was omitted from the Salaries journal for February.
2. No cheque was issued to them. His details are as follows.
3. Gross salary R67 200 per annum
4. PAYE deductions 27%
5. Pension fund deduction R420 per month
6. Tradenet Traders contributes R1,50 to the pension fund for every R1,00 contributed by the employee.



*Solutions*

### Activity 1

YEAR	INCREMENT	ANNUAL SALARY	MONTHLY BASIC SALARY
	R	R	R
1		96 000	8 000
2	9 000	105 000	8 750
3	9 000	114 000	9 500
4	9 000	123 000	10 250
5	13 500	136 500	11 375
6	13 500	150 000	12 500

Activity 2

SALARIES JOURNAL FOR THE MONTH ENDED 30 APRIL 20.1

Employees	Gross salary	Deductions					Net salary	Cheque no.	Employer=s contribution		
		Pension fund	Medical aid	P A Y E	Staff ass.	Total			Pension fund	Medical aid	Total
A. Abel	6 000	480	480	1 200	45	2 205	3 795	C7561	720	480	1 200
B. Bam	4 800	384	480	960	45	1 869	2 931	C7562	576	480	1 056
C. Cooper	5 800	464	590	1 160	45	2 259	3 541	C7563	696	590	1 286
	16 600	1 328	1 550	3 320	135	6 333	10 267		1 992	1 550	3 542

ALTERNATIVE METHOD

Employees	Gross salary	Deductions					Net salary	Cheque no.
		Pension fund	Medical aid	P A Y E	Staff ass.	Total		
A. Abel	6 000	480	480	1 200	45	2 205	3 795	C7561
B. Bam	4 800	384	480	960	45	1 869	2 931	C7562
C. Cooper	5 800	464	590	1 160	45	2 259	3 541	C7563
	16 600	1 328	1 550	3 320	135	6 333	10 267	
Employer's contribution:								
A. Abel	1 200	720	480	--	--	--	--	--
B. Bam	1 056	576	480	--	--	--	--	--
C. Cooper	1 286	696	590	--	--	--	--	--
	20 142	3 320	3 100	3 320	135	--	10 267	-

Calculations: Pension fund

NAME	EMPLOYEE	EMPLOYER
A. Abel	8% x 6 000 = <b>R480</b>	12% x 6 000 = <b>R720</b>
B. Bam	8% x 4 800 = <b>R384</b>	12% x 4 800 = <b>R576</b>
C. Cooper	8% x 5 800 = <b>R464</b>	12% x 5 800 = <b>R696</b>

Activity 3

Balance sheet accounts section

Dr Creditors for salaries B Cr

		20.1									
		April	30								
				Salaries	SJ	10 267	-				

Dr Pension fund B Cr

		20.1									
		April	30								
				Salaries	SJ	1 328	-				
				Pension fund contribution	SJ	1 992	-				
						3 320	-				

Dr Medical aid fund B Cr

		20.1									
		April	30								
				Salaries	SJ	1 550	-				
				Medical aid contribution	SJ	1 550	-				
						3 100	-				

Dr SARS - PAYE B Cr

		20.1									
		April	30								
				Salaries	SJ	3 320	-				

Dr		<b>Staff association</b>						B		Cr	
						20.1 April	30	Salaries	SJ	135	-

**Nominal accounts section**

Dr		<b>Salaries</b>						N		Cr	
20.1 April	30	Gross salaries	SJ	16 600	-						

Dr		<b>Pension fund contributions</b>						N		Cr	
20.1 April	30	Pension fund	SJ	1 992	-						

Dr		<b>Medical aid contribution</b>						N		Cr	
20.1 April	30	Medical aid fund	SJ	1 550	-						

Activity 5

ALTERNATIVE METHOD

SALARIES JOURNAL OF EARTH STORES FOR THE MONTH ENDING 31 JULY 20.1

Details	Gross salary	Deductions				Net salary	Cheque No.
		PAYE	Pension fund	Medical aid	Total		
M. Ercury	6 000	2 000	480	150	2 630	3 370	07
S. Aturn	7 000	2 200	560	160	2 920	4 080	08
U. Ranus	4 500	1 200	360	100	1 660	2 840	09
	<b>17 500</b>	<b>5 400</b>	<b>1 400</b>	<b>410</b>	<b>7 210</b>	<b>10 290</b>	
Employer=s contribution:							
M. Ercury	630		480	150			
S. Aturn	720		560	160			
U. Ranus	460		360	100			
	<b>19 310</b>	<b>5 400</b>	<b>2 800</b>	<b>820</b>		<b>10 290</b>	
	N2	B3	B4	B5		B2	

CASH PAYMENTS JOURNAL OF EARTH STORES FOR JULY 20.1

Doc.	Day	Name of payee	Fol.	Bank		Creditors for wages		Sundry accounts					
								Amount		Fol	Details		
		Totals	b/d	61 544	13	9 085	64						
06	31	Cash		2 983	24	2 983	24						
07 – 09		Employees		10 290	00			10 290	00	B2	Creditors for salaries		
10		SARS		9 260	00			9 260	00	B3	SARS (PAYE)		
11		Galaxy Pension Fund		5 407	44			5 407	44	B4	Pension fund		
12		Star Medical Aid		1 540	00			1 540	00	B5	Medical aid		
13		Unemployment Insurance Fund		192	64			192	64	B6	Unemployment Insurance Fund		
						12 068	88						

GENERAL LEDGER OF EARTH STORES

ALTERNATIVE METHOD

Balance sheet accounts section

Dr				Creditors for wages				B1		Cr	
20.1 July	31	Bank	CP J	12 068	88	20.1 July	31	Balance	b/d	9 085	64
								Wages	WJ	2 983	24
				12 068	88					12 068	88

Dr				Creditors for salaries				B2		Cr	
20.1 July	31	Bank	CP J	10 290	00	20.1 July	31	Salaries	SJ	10 290	00

Dr				SARS - PAYE				B3		Cr	
20.1. July	31	Bank	CP J	9 260	00	20.1 July	31	Balance	b/d	2 890	00
								Wages	WJ	970	00
								Salaries	SJ	5 400	00
				9 260	00					9 260	00

Dr				Pension fund				B4		Cr	
20.1 July	31	Bank	CP J	5 407	44	20.1 July	31	Balance	b/d	1 900	08
								Wages	WJ	707	36
								Salaries	SJ	2 800	00
				5 407	44					5 407	44

Dr				Medical				B5		Cr	
20.1 July	31	Bank	CP J	1 540	00	20.1 July	31	Balance	b/d	540	00
								Wages	WJ	180	00
								Salaries	SJ	820	00
				1 540	00					1 540	00

Dr		Unemployment Insurance						B6		Cr	
20.1 July	31	Bank	CP J	192	64	20.1 July	31	Balance	b/d	144	48
								Wages	WJ	48	16
				192	64					192	64

### Nominal accounts section

Dr		Wages				N1				Cr	
20.1 July	31	Totals	b/d	14 560	20						
		Gross wages	WJ	4 888	76						
				19 448	96						

Dr		Salaries				N2				Cr	
20.1 July	31	Gross salaries	SJ	19 310	00						

### Activity 6

#### JOURNAL ENTRIES

			Fol.	Debit	Credit
	29	Salaries (67 200 ) 12)		5 600	
		SARS (PAYE) (5 600 H 27%)			1 512
		Pension Fund			420
		Creditors for salaries			3 668
	29	Pension Fund Contribution		630	
		Pension Fund (R420 H R1,50)			630

Notes to the Balance sheet

Trade and other payables	R
Trade creditors	20 685
Accrued expenses	640
Income received in advance	1 595
SARS (PAYE) (3 245 + 1 512)	4 757
Pension Fund (790 + 420 + 630)	1 840
Creditors for salaries	3 668
	33 185

Activity 7

Internal Control Practises		
1.	Different employees should be responsible for preparing employment documents and reviewing payroll reports.	True / False
2.	Payroll records should be filed in a secure location with access limited to authorized personnel.	True / False
3.	Presentation of ID should be required when releasing cheques to employees not known to the person distributing cheques.	True / False
4.	Payroll cheques should be kept in a locked, secure area pending distribution.	True / False
5.	Why is it important for payroll expense reports to be reviewed and approved monthly?	To check on any questionable or irregular entries
6.	The responsibilities for supervision and time keeping, personnel, payroll processing, disbursements, and general ledger functions assigned to provide.....	division of duties
7.	Confidential payroll records and reports are adequately safeguarded.	True / False
8.	The detailed records of hours worked must always be maintained and approved, when appropriate.	True / False
9.	Are there written ..... for approving, recording, and controlling sick leave, vacations, holidays, overtime, compensatory time, and stand-by time?	procedures

10.	..... are established to ensure that all attendance reports and payroll reports are verified by supervisory personnel.	Procedures
11.	<p>Read the scenario below and indicate whether the actions by two officials are appropriate or not.</p> <p>Motivate your answer.</p> <p>“The treasurer has had to go to a lot of conferences, and has not been able to check and authorise the salary payments before they are made. The salaries cheques have frequently been signed by just the coordinator, to ensure that salaries are paid on time. The treasurer has subsequently gone to the bank and added her signature to the cheques”.</p>	<p>Part of ensuring security over cash assets is the requirement that each cheques be signed by <b>two authorised officers</b>. At the time of signing it is expected that those officers will, by reference to the documentation supporting the payments and to their own knowledge of the workings of the organisation, satisfy themselves that the payments are legitimate.</p> <p>Having signatures added to a cheque after the event does not achieve this.</p>

### *SUMMARY AND ANALYSIS*

#### WAGES JOURNAL

	General ledger		Accounting equation		
	Account debit	Account credit	A	E	L
<b>GROSS WAGES</b>	Wages	Pension fund	0	-	+
	Wages	Medical aid fund	0	-	+
	Wages	SARS - PAYE	0	-	+
	Wages	UIF	0	-	+
	Wages	Creditors for wages	0	-	+
<b>EMPLOYERS CONTRIBUTION</b>	Pension fund contribution or Wages	Pension fund	0	-	+
	Medical aid fund contribution or Wages	Medical aid fund	0	-	+
	UIF contribution or Wages	UIF	0	-	+

PAYMENTS	Creditors for wages	Bank	-	0	-
	Pension fund	Bank	-	0	-
	Medical aid fund	Bank	-	0	-
	UIF	Bank	-	0	-
	SARS - PAYE	Bank	-	0	-

Assume the bank balance to be favourable

### SALARIES JOURNAL

	General ledger		Accounting equation		
	Account debit	Account credit	A	E	L
GROSS SALARY	Salaries	Pension fund	0	-	+
	Salaries	Medical aid fund	0	-	+
	Salaries	SARS - PAYE	0	-	+
	Salaries	UIF	0	-	+
	Salaries	Creditors for salaries	0	-	+
EMPLOYERS CONTRIBUTION	Pension fund contribution or Salaries	Pension fund	0	-	+
	Medical aid fund contribution or Salaries	Medical aid fund	0	-	+
PAYMENTS	Creditors for salaries	Bank	0	0	±
	Pension fund	Bank	0	0	±
	Medical aid fund	Bank	0	0	±
	SARS - PAYE	Bank	0	0	±

Assume the bank balance to be unfavourable

# Internal Control and Ethics

**Remember: This section is integrated with all other topics in Accounting.**

## What is Internal Control?

Internal control in its broader sense is defined as a process affected by an organization's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of reporting
- Compliance with applicable rules, laws and regulations

## Internal Control components include:

- Control Environment;
- Risk Assessment;
- Control Activities;
- Information and Communication and
- Monitoring.

## Internal Control components

### 1. Control Environment - Integrity and Ethical Values

This is the attitude and actions of the board and management regarding the significance of control within the organization. The control environment is the "tone at the top" of the business (the owner and the top managers).

Control environment include the following:

- Provides the discipline and structure for the overall system of internal controls
- Established and maintained by management - *Should foster control conscientiousness*
- Includes the overall "tone at the top" set by people in positions of authority - *Based on the attitudes and habits of those in authority*
- Management's Philosophy & Operating Style
- Organizational Structure
- Assignment of Authority & Responsibility
- Human Resource Policies & Practices
- Competence of Personnel
- They need to behave honourably to set a good example for company employees.
- Integrity and ethical values must be communicated.

- Code of conduct must be defined in written policy and procedures.
- The owner must demonstrate the importance of internal controls.
- Commitment to competence.

## 2. Risk Assessment

Risk assessment is the identification, measurement, and analysis of risks, internal and external, controllable and uncontrollable, at individual business levels. Management must assess all risks facing the business because uncontrolled risk-taking can prevent the business from reaching its objectives or can jeopardize its operations. Effective risk assessments help determine what the risks are, what controls are needed, and how they should be managed. It includes:

- Analyse the control environment.
- A company must identify its risks..
- The identification of areas where the risks of losses or inaccuracies are high.
- Take appropriate action
  - ◆ Manage/Reduce risk
  - ◆ Avoid/Transfer risk
  - ◆ Accept risk

## 3. Control Activities

Control activities are the policies, procedures, and practices established to help ensure that business personnel carry out board and management directives at every business level throughout the business. These activities help ensure that the board and management act to control risks that could prevent a business from attaining its objectives. These are the procedures designed to ensure that the business's goals are achieved. Control activities are actions, supported by policies and procedures that, when carried out properly and in a timely manner, manage or reduce risks. They should include:

1. **Authorization** of transactions
2. **Assigning** responsibilities.
3. **Segregation** of duties;
4. **Recording**: Transactions should be properly documented;
5. **Safeguarding**: Assets should be physically secured.
6. **Reconciliation**: The person performing the reconciliation (or verification procedures) should be independent from the individuals originally responsible for preparing the data; written procedures/policies, etc.

## 4. Information and Communication

Information and communication are essential to effecting control; information about an organization's plans, control environment, risks, control activities, and performance must be communicated up, down, and across an organization. Information and Communication includes the following aspects:

- The owner of a business needs accurate information to keep track of assets and measure profits and losses.
- The administrators must be provided with reports - operational, financial, and compliance information.
- Systems established to identify, assemble, analyze, classify, record, and report a company's transactions.
- Policies/procedures the employees need to know to perform their jobs
- Operating information the employees need to know to perform their jobs.

## 5. Monitoring.

Monitoring is the assessment of internal control performance over time; it is accomplished by ongoing monitoring activities and by separate evaluations of internal control such as self-assessments, peer reviews, and internal audits. This includes the following:

- Companies hire auditors to monitor their controls.
- Internal auditors monitor company controls to safeguard the company's assets.
- External auditors monitor the controls to ensure that the accounting records are accurate.
- Monitoring includes:
  - Supervising
  - Observing
  - Testing
  - Reporting to Responsible Individuals

### The Assets Register

- An Assets Register records details of each *valuable* item of capital equipment owned by an organisation. It is an inventory of equipment. The assets register is a valuable tool for forecasting expenditure as it provides organisations with a means of estimating maintenance and replacement costs.
- The assets register should be updated whenever assets are obtained or disposed of. Generally, items valued at a lower amount are not included in an assets register.
- Usually, an assets register contains details of valuable assets owned by the organisation, such as:
  - motor vehicles
  - office equipment and furniture
  - kitchen equipment
  - classroom equipment and furniture
  - computer equipment and software
  - buildings.
- ◆ The following checklist will help you to use your assets register effectively:

- There should be regular monitoring of the existence of the assets register and its condition.
- Assets should be tracked (i.e. if someone moves them, takes them away, borrows them, this should be recorded).
- There should be **policies on private use** of assets and asset security.
- All items on the assets register should be **depreciated each year**. Essentially, depreciation is based on the useful life of equipment.

## Internal Control Practices

### 1. Activities for Effective Internal Control over Cash receipt and payment

#### Cash Receipt

##### Authorization

- Develop procedures to specify how the department is to comply with business requirements and department expectations.
- Supervisors should verify cash deposits, voided transactions, and cash overages and shortages.
- Separate authorization, recordkeeping, and custodianship functions

##### Segregation of Duties

- Establish a chain of accountability immediately upon initial receipt of cash. Individual accountability should be maintained at all times. Transfers between two people should be jointly verified and documented.
- Each cashier should prepare an independent record of cash receipts which should be turned in with cash receipts.
- Limit the number of people with access to cash.
- Different employees should be responsible for (1) receiving and recording cash collections, (2) balancing daily cash receipts to related cash recordings, and (3) verifying that the deposit amounts reflected in the general ledger are in agreement with departmental records. In businesses where staffing levels do not permit this amount of segregation, senior management must be aware of this limitation and perform additional reviews of the records to ensure that funds are adequately protected.
- Bond employees who have access to cash.

##### Safeguarding

- Separate, lockable containers or compartments should be available to each person collecting money. The money should be locked when the cashier is not available. Keys to the cash box should be limited only to the cashier and the supervisor. Physically protect cash on hand.
- Cheques should be restrictively endorsed upon receipt.

- Cash counting area should be reasonably secure and free of interruptions.
- Cash should be kept in a safe or locked drawer overnight.
- Cash should be deposited weekly or immediately. Use banking facilities when possible; keep cash on hand to a minimum.
- Safe combination should be changed regularly.
- The safe should be physically suitable for its purposes.
- Make payments by cheque rather than cash.

#### **Recording and depositing**

- Deposits should be presented intact. Deposit all cash receipts promptly.
- All cash receipts should be recorded on a cash receipt form, cash register, or a properly controlled computer database at the time of receipt. Record all cash receipts promptly.

#### **Reconciliation and Review**

- All receipt numbers should be accounted for.
- Detail of Advantage records should match deposit records.
- Reconcile the Cash account independently.
- Make unannounced audits of cash on hand.

#### **Control of Cash over the counter**

- Cash register record transactions
- Receipts issued to customer
- Manager compares cash in drawer to cash register record
- Receipts deposited at least daily

#### **Control of Cash by mail**

- Cheques and remittance advice separated
- Cheques sent to treasurer for deposit
- Remittance advice sent to accounting to record
- Bank deposit slip compared with debit to cash

#### **Control of Cash Sales Receipts**

- Cash is received either by mail or over the counter. In either case it should be recorded immediately in the cash receipts journal in order to establish a written record of cash receipts.
- Control of cash received through the mail.
- ♦ Encourage customers to pay by cheque

#### **Cash Payments**

1. Payment by cheque
  - Provides record of payment
  - Must be signed by authorized official

- Official should study evidence supporting payment

### **Bank Account as Control**

- ◆ Keeping cash in a bank account safeguards the asset
- ◆ Bank account documents provide controls
  - Signature card
  - Deposit tickets
  - Cheques
  - Bank Statements
  - Electronic Funds Transfer (EFT)

### **Control of cash by preparing a Bank Reconciliation**

- The Cash account balance on the books rarely agrees with that on the bank statement. Transactions may appear on one but not the other.
- Bank reconciliations are carried out at least monthly, all variations are investigated and all adjustments are checked and authorised.
- *Bank reconciliations* account for the differences between the company's records and the bank statement is prepared.

## **2. Activities for Effective Internal Control over Petty Cash – Imprest system**

### **Authorization**

- Petty cash funds should be authorized and established by the authorities.
- Funds should only be used for appropriate business purposes as identified in the Petty Cash Fund Manual.

### **Segregation of Duties**

- When possible, separate individuals should be responsible for maintaining the fund and review and approval of replenishment of the fund.

### **Safeguarding**

- Funds should be maintained in a secure location accessible only by the fund custodian.

### **Recording and depositing**

- Petty cash fund should be replenished as necessary. Periodically the fund is reimbursed, based upon the vouchers, to its original fixed amount.
- All disbursements from the fund should be supported by an original receipt documenting the expenditure.
- As disbursements are made vouchers are prepared to support the payment
- Petty cash is established for a fixed amount and each disbursement is documented by a voucher.
  - Moving Disbursements from the Petty Cash Fund
  - Custodian and Payee must sign a *Petty Cash voucher*.

- Make occasional unannounced audits of fund.

### **Reconciliation and Review**

- A supervisory employee with signature authority and not responsible for custody of the fund should review the documentation, verify that the total fund amount is accounted for and approve requests for fund replenishment.
- The petty cash fund should be periodically reviewed to determine if it is necessary, or if the activity would be more appropriately accomplished by use of procurement cards
- Often an *imprest system* is used to monitor petty cash.

## **3. Activities for Effective Internal Control over Account Receivable**

### **Authorization**

- Invoices should be prepared for all charges and issued on a timely basis.
- Invoices should be issued in numerical sequence.

### **Segregation of Duties**

- Different persons should be responsible for (1) billing and maintaining accounts receivable records, (2) receiving or handling incoming payments, and (3) reconciling receivable records to the general ledger.

### **Safeguarding**

- Blank invoices, credit memos, and cancellation forms should be controlled to prevent misuse.

### **Recording and depositing**

- Supporting documentation should be available for all accounts receivable activity.

### **Reconciliation and Review**

- Receivable reports should include aged listings of all amounts due, should be reviewed at least monthly, and should be balanced to the related accounts.
- Delinquent account balances should be examined and follow-up with customers should be initiated on a timely basis to facilitate payment.
- The department should establish and follow a specific set of procedures for determining bad debts and collection actions.
  - Keep credit losses as low as possible by making credit sales only to customers who are likely to pay on time.
  - Keep enough inventory on hand to sell to customers without overstocking.
  - Provide accurate records of merchandising transactions and account balances.

## **4. Activities for Effective Internal Control over Account Payable**

### **Authorization**

- All authorizations for disbursement of funds should have the required signatures. Procurement card records should have appropriate management review.
- Current signature cards should be on file with the Controller's Office

#### **Segregation of Duties**

- To the extent practical, different individuals should be assigned responsibility for (1) approving purchase orders and requisitions, (2) receiving ordered materials, and (3) reviewing and reconciling the general ledger reports.

#### **Safeguarding**

- Receipt of goods and services should be verified prior to approving invoices for approval.

#### **Recording and depositing**

- Provide accurate records of merchandising transactions and account balances.

#### **Reconciliation and Review**

Verification should be made that invoiced amounts are correct, accounts charged are correct, object coding is correct, and payment has not already been made.

- Keep enough cash on hand to pay for purchases in time to receive discounts.
- Prevent losses of cash or inventory owing to theft or fraud.

Make payments only after specific authorization

### **5. Activities for Effective Internal Control over Assets**

#### **Authorization**

- Purchase requisitions should be approved by a person delegated approval authority.

#### **Segregation of Duties**

- Employees assigned to perform physical inventories to confirm that materials and equipment listed on inventory records or asset register are actually on hand should be persons other than those responsible for maintaining custody of the items or subordinates of the custodian.
- Property movement requests should be approved by someone not directly responsible for custody or disposal of equipment.

#### **Safeguarding**

- Security arrangements for safeguarding inventory should be proportional to its value and removability
- Use of assets outside the business should be allowed for business purposes only, should be approved by the appropriate authority, and a written record should be maintained.

#### **Recording and depositing**

- Items should be inspected for condition prior to their inclusion in the inventory.
- Obsolete, inactive or damaged items should be removed from the inventory.

#### **Reconciliation and Review**

- Physical counts of supply assets should be taken at least annually.

- A full review of assets should be performed at least annually.

## 6. Activities for Effective Internal Control over Payroll

### Authorization

- Forms should be approved only by persons with signature authority.
- Employees should not approve actions affecting their own pay.
- Supervisors should approve any time recording or reporting alterations.

### Segregation of Duties

- Different employees should be responsible for preparing employment documents and reviewing payroll reports.

### Safeguarding

- Payroll records should be filed in a secure location with access limited to authorized personnel.
- Presentation of ID should be required when releasing checks to employees not known to the person distributing checks.
- Payroll checks should be kept in a locked, secure area pending distribution.

### Reconciliation and Review

- Payroll expense reports should be reviewed and approved monthly. Any questionable or irregular entries should be addressed.

## Accounting Ethics

Accounting is an integral part of a business and finance world. However, there are some accounting ethics to be kept in mind for all financial transactions made. Wherever there are investors and creditors involved, ethical codes in accounting can never be ignored.

Accounting ethics can be defined as a set of distinct guidelines for a business to maintain clean balance sheets, accounting for their profits, losses, and expenses incurred and prevent it from mishandling financial reports and statements. For an accountant, it is very important to understand the rules and regulations of his position in an organization. Any deviation from the moral code of conduct or abusing the ethics can result in dire consequences for him, such as suspension of license, termination of right to practice, and severe penalties.

### Business and Accounting Ethics

To combat unwelcome ethical issues in business, ethics in accounting have been made more stringent and explicit than ever:

#### *Code of Ethics*

Code of ethics in every organization has become stringent. The Code of Professional Conduct of The South African Institute of Chartered Accountants (SAICA) has set explicit rules and regulations (Code of Professional

Conduct) which provides guidelines for ethical and professional behaviour. The Institute of Internal Auditors South Africa (IIA SA) is part of an international network representing the interests of Internal Auditors worldwide.

### *Ethical Responsibilities*

Accounting code of ethics is a major responsibility for an organization. The ethical responsibilities include accounting and auditing as the information generated by them is accepted by clients, employers, governments, investors, credit grantors and the business and financial community. The accounting code of ethics is an integration of the **five important qualities: Confidentiality, Integrity, Competence, Professional Competence and Due Care, Objectivity and Professional Behaviour**. Hence, accounting professionals undertake the tasks, adhering to the code of ethics defined by SAICA.

### *Enforcement of Ethics*

Ethics enforcement is a primary concern of any organization as it is as important as making code of ethics. Violations of ethics important in business, can lead to expelling the person from the organization and black listing him. Many a time, violating ethics in accounting can actually lead to more stringent disciplinary measures, involving state and central laws. The auditors specially have to be more serious when it comes to auditing financial statements of public corporation as any case of fraudulent conditions can result in revoking their license (which could be temporary or permanent).

*"Ethics in its broader sense, deals with human conduct in relation to what is morally good and bad, right and wrong. It is the application of values to decision-making. These values include honesty, fairness, responsibility, respect and compassion."* ~ Rushworth Kidder (President, Institute for Global Ethic).

The above lines just summed it all. Ethics in accounting is as important as ethics followed in personal life. This is because one fraudulent affair caused in accounting can possibly derail the bulwark of any organization. Accounting ethics is definitely an unavoidable aspect of any organization, which must be followed at any cost.

**The South African Institute of Chartered Accountants (SAICA)** serves the interests not only of the Chartered Accountancy profession, but also of society in general through its key objective of upholding professional standards and integrity. The pre-eminence of South African Chartered Accountants [CAs(SA)] nationally and internationally attests to the success achieved by SAICA on a broad global canvas. Members of SAICA are subjected to a Code of Professional Conduct, which provides guidelines for ethical and professional behaviour. Fundamental ethical principles to which CAs(SA) are expected to achieve include:

1. Integrity;
2. Objectivity;
3. Professional Competence and Due Care;

4. Confidentiality; and
5. Professional Behaviour.

### **The Institute of Directors (IoDSA) – authors of King Code**

The Institute of Directors (IoDSA) is the only organisation in southern Africa that represents directors, professionals, business owners and leaders in their individual capacities. As the custodians of corporate governance, the IoDSA is committed to the development of those charged with governance duties through educating and improving governance structures within small, medium and large organisations.

The Institute of Directors in Southern Africa is:

- A leading, credible institute
- Provides unique networking opportunities
- Is a custodian of corporate governance
- Provides director development and board learning
- Provides Board advisory services
- Non-executive director appointments
- Leadership publications and updates.

### **Association of Certified Fraud Examiners**

The Association of Certified Fraud Examiners (ACFE) is a member-based global association dedicated to provide anti-fraud education and training. Together with its members, the ACFE is reducing business fraud worldwide and inspiring public confidence in the integrity and objectivity of our profession.

### **The Institute of Internal Auditors South Africa (IIA SA)**

The Institute of Internal Auditors South Africa (IIA SA) is part of an international network representing the interests of Internal Auditors worldwide. As a part of this international network, the IIA SA upholds and supports the fundamental tenets of the profession - the Code of Ethics and the International Standards for the Professional Practice of Internal Auditing.



## *Assessment Tasks*

### **Activity 1**

- a. What is Accounting ethics?
- b. List the five fundamental Accounting principles as prescribed by SAICA Code of Professional Conduct.
- c. Give examples of the acts which the company may consider unacceptable.

## Activity 2

1.	Management is responsible for establishing a system of internal control.	True / False
2.	The responsibility for keeping the records for an asset should be separate from the physical custody of that asset.	True / False
3.	The responsibility for ordering, receiving, and paying for merchandise should be assigned to different individuals.	True / False
4.	The custodian of the petty cash fund has the responsibility of recording a journal entry every time cash used from the fund.	True / False
5.	Firms use physical, mechanical, and electronic controls primarily to safeguard its assets.	True / False
6.	The petty cash fund eliminates the need for a bank (cheque) account.	True / False
7.	If a company deposits all its receipts in the bank and pays all its bills by cheque, then the monthly bank statement balance will always agree with the business's record of its bank account balance.	True / False
8.	To obtain maximum benefit from bank reconciliation, the reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash.	True / False
9.	A highly automated computerized system of accounting eliminates the need for internal control.	True / False
10.	What is the importance of establishing and maintaining a variety of accounting control systems?	
11.	What will help reduce transaction errors and inconsistencies, thereby resulting in less time spent solving errors and simultaneously more reliable accounting data?	
12.	What will lead to more reliable accounting data and consistency in the ways various transactions and expenses are recorded?	
13.	Accurate reporting of certain items helps to quickly identify any discrepancies between the recorded amounts and actual amounts, thereby quickly identifying theft or fraud. Which are those items?	
14.	What is a system that does not allow any single person to record and process all stages of a transaction?	
15.	How can the system mentioned above assist the business?	
16.	An effective internal control system requires that the material risks that could adversely affect the achievement of the business's goals are being recognised and continually assessed.	True / False
17.	The employees are responsible for promoting high ethical and integrity standards,	True / False

	and for establishing a culture within the organisation that emphasises and demonstrates to all levels of personnel the importance of internal controls.	
18.	Senior management should have responsibility for implementing strategies and policies approved by the board and setting appropriate internal control policies.	True / False
19.	Control activities should be an integral part of the daily activities of a business.	True / False
20.	An effective internal control system requires that an appropriate control structure is set up, with control activities defined at every business level.	True / False
21.	An effective internal control system does not require effective channels of communication	True / False
22.	The overall effectiveness of the business's internal controls should be monitored randomly after some years.	True / False
23.	Material internal control deficiencies should be reported in a timely manner to the appropriate senior management and the board of directors.	True / False

### Activity 3

Gerard Murray was recently appointed manager of the Phalaborwa branch of *General Office Supplies*, a business that supplied stationery and office equipment to about 75% of the businesses in Phalaborwa. He was appalled at the lack of professionalism in the office. Not surprisingly, the branch was often facing cash shortages. Some of the practices that Gerard found were:

- A Cash received from customers was kept in the office until the cashier had the time to deposit the money in the bank. Often this meant that cash was on the premises for more than a week before it was deposited.
- B Payments to suppliers were often made out of the pool of cash made available from that received from customers.
- C Payments for minor but necessary office expenses, such as tea and coffee for office staff, were made out of the same pool.
- D Bank statements, when received, were thrown away without any action.
- E Individual debtors' and creditors' accounts were opened in the general ledger.

#### Required:

Recommend steps that Gerard can take to improve the level of internal control over cash in *General Office Supplies*, Phalaborwa branch, explaining how the existing situation will be improved.

### Activity 4

1. Explain why a subsidiary ledger system is an important means of internal control and suggest two internal control procedures that should be followed.
2. "Control systems in accounting are fundamental for the financial health of an organisation".

With the above statement in mind, discuss what constitutes financial control and how it is achieved.

3. Which other aspects of control system should be taken into account? Give five.



## *Solutions*

### Activity 1

- a. What is Accounting ethics?

Accounting ethics can be defined as a set of distinct guidelines for a business to maintain clean balance sheets, accounting for their profits, losses and expenses incurred and prevent it from mishandling financial reports and statements.

- b. List the five fundamental Accounting principles as prescribed by the Code of Professional Conduct.

1. Integrity;
2. Objectivity;
3. Professional Competence and Due Care;
4. Confidentiality; and
5. Professional Behaviour.

- c. Give examples of the acts which the company may consider unacceptable.

1. wilfully damaging, destroying or stealing property belonging to fellow employees or the company
2. intentionally giving any false or misleading information to obtain a leave of absence
3. not taking proper care of, neglecting or abusing company equipment or tools
4. using company equipment in an unauthorised manner
5. fighting or engaging in horseplay or disorderly conduct
6. refusing to follow or failing to carry out the reasonable instructions of a supervisor
7. ignoring work duties or wasting time during working hours
8. coming to work under the influence of alcohol or any drug, or bringing alcoholic beverages or drugs on to company property
9. using threatening or abusive language towards a fellow employee
10. smoking contrary to established policy or violating any fire protection regulation
11. wilfully or habitually violating health and safety regulations
12. failing to wear clothing conforming to standards set by the company
13. being late or taking unexcused absences from work
14. possessing firearms or weapons of any kind on company property.

## Activity 2

1.	Management is responsible for establishing a system of internal control.	True
2.	The responsibility for keeping the records for an asset should be separate from the physical custody of that asset.	True
3.	The responsibility for ordering, receiving, and paying for merchandise should be assigned to different individuals.	True
4.	The custodian of the petty cash fund has the responsibility of recording a journal entry every time cash used from the fund.	False - recording journal entries may not be the responsibility of the custodian of petty cash
5.	Firms use physical, mechanical, and electronic controls primarily to safeguard its assets.	True
6.	The petty cash fund eliminates the need for a bank (cheque) account.	False - not all vendors will accept cash)
7.	If a company deposits all its receipts in the bank and pays all its bills by cheque, then the monthly bank statement balance will always agree with the business's record of its bank account balance.	False - some cheques may have been written but not presented for payment)
8.	To obtain maximum benefit from bank reconciliation, the reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash.	True
9.	A highly automated computerized system of accounting eliminates the need for internal control.	False - internal control is always a requirement of an accounting system)
10.	What is the importance of establishing and maintaining a variety of accounting control systems?	<ol style="list-style-type: none"> <li>1. To minimise the risks of fraud and error</li> <li>2. To maximise opportunities to ensure that the organisation remains in good financial health.</li> </ol>
11.	What will help reduce transaction errors and inconsistencies, thereby resulting in less time spent solving errors and simultaneously more reliable accounting data?	Clearly written accounting procedures and regular reconciliations
12.	What will lead to more reliable accounting data and consistency in the ways various transactions and expenses are recorded?	Clearly defined accounting policies

13.	Accurate reporting of certain items helps to quickly identify any discrepancies between the recorded amounts and actual amounts, thereby quickly identifying theft or fraud. Which are those items?	<ul style="list-style-type: none"> <li>▪ Cash;</li> <li>▪ Inventory and fixed assets; and</li> <li>▪ Reconciliations between factory records and accounting records.</li> </ul>
14.	What is a system that does not allow any single person to record and process all stages of a transaction?	System for requiring segregation of duty
15.	How can the system mentioned above assist the business?	The system helps to eliminate the risk of errors or fraud resulting from one person.
16.	An effective internal control system requires that the material risks that could adversely affect the achievement of the business's goals are being recognised and continually assessed.	True
17.	The employees are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organisation that emphasises and demonstrates to all levels of personnel the importance of internal controls.	False - board of directors and senior management
18.	Senior management should have responsibility for implementing strategies and policies approved by the board and setting appropriate internal control policies.	True
19.	Control activities should be an integral part of the daily activities of a business.	True
20.	An effective internal control system requires that an appropriate control structure is set up, with control activities defined at every business level.	True
21.	An effective internal control system does not require effective channels of communication	False - it requires effective channels of communication
22.	The overall effectiveness of the business's internal controls should be monitored randomly after some years.	False - on an ongoing basis
23.	Material internal control deficiencies should be reported in a timely manner to the appropriate senior management and the board of directors.	True

### Activity 3

A.	Cash received from customers was kept in the office until the cashier had the time to deposit the money in the bank. Often this meant that cash was on the premises for more than a week before it was deposited.	<ul style="list-style-type: none"> <li>▪ Establish a chain of accountability immediately upon initial receipt of cash.</li> <li>▪ Each cashier should prepare an independent record of cash receipts which should be turned in with cash receipts.</li> <li>▪ Limit the number of people with access to cash.</li> <li>▪ Cheques should be restrictively endorsed upon receipt.</li> <li>▪ Cash should be kept in a safe or locked drawer overnight.</li> <li>▪ Cash should be deposited weekly or immediately. <ul style="list-style-type: none"> <li>○ Cash is easily stolen or misappropriated. Keeping cash in a bank account safeguards the asset. Implement adequate accountability, security and control systems will help to reduce the risk of loss of cash.</li> </ul> </li> </ul>
B.	Payments to suppliers were often made out of the pool of cash made available from that received from customers.	<ul style="list-style-type: none"> <li>▪ All payments are made by cheque (the only exception is for cash payments from petty cash) <ul style="list-style-type: none"> <li>○ Record of payment is provided and official can study evidence supporting payment. The record of payment must be signed by authorized official</li> </ul> </li> </ul>
C.	Payments for minor but necessary office expenses, such as tea and coffee for office staff, were made out of the same pool.	<ul style="list-style-type: none"> <li>▪ Petty cash funds should be authorized and established by the authorities.</li> <li>▪ Petty cash fund should be replenished as necessary. Periodically the fund is reimbursed, based upon the vouchers, to its original fixed amount.</li> <li>▪ All disbursements from the fund will be supported by an original receipt documenting the expenditure.</li> <li>▪ As disbursements are made, vouchers are prepared to support the payment. <ul style="list-style-type: none"> <li>○ It is important to maintain tight control over the use of petty cash to prevent over-spending or unauthorised expenses being incurred.</li> </ul> </li> </ul>
D.	Bank statements, when received, were thrown away without any action.	<ul style="list-style-type: none"> <li>▪ The Cash account balance on the books rarely agrees with that on the bank statement. Transactions may appear on one but not the other.</li> <li>▪ Bank reconciliations are carried out at least monthly, all variations are investigated and all adjustments are checked and authorised.</li> <li>▪ <i>Bank reconciliations</i> account for the differences between the company's records and the bank statement is prepared. <ul style="list-style-type: none"> <li>○ The regular completion of bank reconciliations enhances control of cash assets in bank accounts. The process of reconciling the bank account provides a mechanism for cross-checking the organisation's own accounting records and those of its bank, item by item. If there are</li> </ul> </li> </ul>

		differences or irregularities they are detected at this point, and can be investigated.
E.	Individual debtors' and creditors' accounts were opened in the general ledger.	<ul style="list-style-type: none"> <li>▪ Individual debtors and creditors accounts are kept in the subsidiary ledger.</li> <li>▪ A subsidiary ledger contains the details to support a general ledger control accounts, i.e. Debtors and Creditors control accounts. For instance, the subsidiary ledger for accounts receivable contains all of the information on each of the credit sales to customers, each customer's remittance, return of merchandise, discounts, and so on. With these details in the subsidiary ledger, the Accounts Receivable account in the general ledger can be a control account.</li> <li>▪ A control account, in the general ledger, will simply report the aggregate amounts of the accounts receivable activity.</li> </ul>

#### Activity 4

1. Explain why a subsidiary ledger system is an important means of internal control?
  - a. A Financial Analysis is an internal control activity that include an overall assessment of the financial position related to a specific subsidiary ledger account. This includes the comparison of actual budget for all revenue and expense categories.
  - b. A subsidiary ledger contains the details to support a general ledger control account, e.g. the subsidiary ledger for accounts receivable contains all of the information on each of the credit sales to customers. By having the details of the accounts activities in a subsidiary ledger, a company can better control its financial information. For example, the credit manager and others in the credit department of a company will have access to any and all of the credit sales information through the subsidiary ledger without having access to any other account in the company's general ledger.
  - c. A Subsidiary Ledger Reconciliation: Internal control activity where the line items within the monthly subsidiary ledger reports are agreed to the respective supporting documentation.
2. "Control systems in accounting are fundamental for the financial health of an organisation".  
With the above statement in mind, discuss what constitutes financial control and how it is achieved.
  - a. Control requires a fully transparent financial management framework in which duties and responsibilities for all aspects of financial management are clearly separated. No single employee should have responsibility for ordering, receiving, processing and finalising the organisation's transactions and this is particularly important where cash is concerned.
  - b. Control must also be exercised over **all assets**. Fixed or non-current assets frequently comprise a major portion of the assets of an organisation and should be carefully and accurately recorded.
  - c. Control should also be exercised over **accounts receivable and accounts payable**, to monitor the flow of funds in and out of the organisation.

3. Which other additional aspects of control system should be taken into account? Give five.
- a. Make sure controls include checks on:
- i. use of credit cards
  - ii. periodic payments – for private use
  - iii. one-off or extraordinary payments to staff
  - iv. unusual variations in hourly rates
  - v. payment for hours not worked
  - vi. actual or potential conflicts of interest of committee members and staff
  - vii. private expenses charged to the organisation
  - viii. one part of the organisation charging a fee for service to another part of the organisation
  - ix. bogus employees
  - x. understating Fringe Benefit Tax
  - xi. incorrect allocations on Basic Accounting System (BAS)

## Basic VAT Concepts

VAT stands for *Value Added Tax*. **Value Added Tax (VAT)** is levied on the supply of goods and services by vendors or it is a tax businesses charge when they supply their goods and services. This tax is collected at each stage of the production and distribution chain. We have to pay VAT on most of the things that we buy. Currently the Standard rate of VAT in South Africa is 14% and **this is the rate to be used when calculating VAT**. (Refer to page 10 of NCS Accounting guide for Grade 10).



### Assessment Tasks

#### Activity 1

Give the VAT concept defined or explain below:

ITEM	DEFINITION / EXPLANATION	CONCEPT
1	Tax levied on the supply of goods and services by vendors.	
2	Goods or services which are taxed at a rate of 0%, e.g. milk, brown bread, maize, fruits, etc.	
3	These items involve services that are not subjected to VAT at either the standard rate or zero rate, e.g. childcare services, educational service, etc.	
4	In South Africa items are taxed at the rate of 14%	
5	Goods or services that is subject to VAT.	
6	VAT which your company would charge on items which it, sells. Thus a company could wish to sell an item and added to the amount a standard rate tax would be charged.	
7	VAT that you pay on all your business expenses and for which you have a tax invoice. It also relate to VAT that is paid on other goods and services bought or rented for the business.	
8	Is a summary of the VAT Input and Output and shows whether the business owes SARS money or whether SARS owes the business money.	

#### Activity 2

- a. explain the following concepts:
  1. The need for VAT.
  2. The purpose of VAT.

- b. Discuss the principles of VAT.



### Activity 1

ITEM	CONCEPT
1	Value Added Tax
2	Zero-rated items
3	VAT exempted items
4	Standard rate
5	VAT-able items
6	Output VAT
7	Input VAT
8	VAT Control

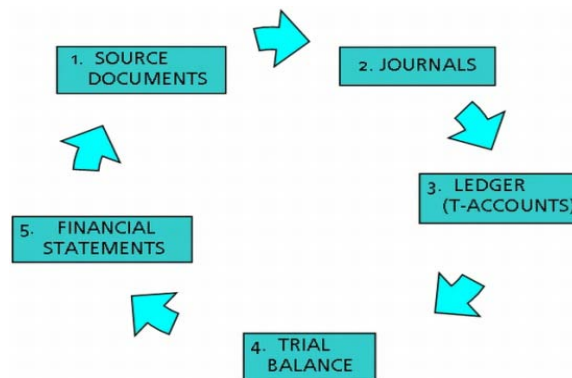
### Activity 2

Need for VAT	<ol style="list-style-type: none"> <li>1. Through VAT revenue is raised for the government by requiring <b>certain traders or vendors to register and to charge VAT on taxable supplies of goods or services.</b></li> <li>2. VAT is a business charge on products or provided services which <b>aims to improve the economic state of a State.</b></li> <li>3. VAT is a clear and transparent <b>method of tax collection, which broadens the tax net,</b> and helps to monitor a large number of people.</li> <li>4. It is also a <b>rationalised tax structure; practised and proven to be successful in many leading economies.</b></li> <li>5. It is an <b>indirect, multi-stage method of tax collection</b> which results in the tax burden ultimately being borne by the final consumer and is levied on the value added to the product by the vendor.</li> </ol> <p>Persons who make <b>taxable supplies in excess of R300 000</b> in any 12 month consecutive period are <b>liable for compulsory VAT registration,</b> but a person may also <b>choose to register voluntarily</b> provided that the <b>minimum threshold of R20 000</b> has been exceeded in the past 12 month period.</p>
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Purpose of VAT	<ol style="list-style-type: none"> <li>1. The classical purpose of taxation, including VAT is to raise revenue to meet government expenditure. It generates income for the government.</li> <li>2. It is a source of revenue for public spending. It simply generates income for the government. Like any tax, VAT is a source of revenue for public spending.</li> <li>3. VAT is not used by one business to pay for the labour or other business expenses, but is used by the government to pay for the state expenditures.</li> </ol>
Discuss the principles of VAT	<ol style="list-style-type: none"> <li>1. <b>All prices charged, advertised or quoted by a vendor must include VAT at the applicable rate.</b> (Presently 14% for standard rated supplies).</li> <li>2. <b>Vendors collect VAT on behalf of the State</b> – VAT must be paid over on time, otherwise penalties and interest will be charged.</li> <li>3. VAT charged on supplies made (output tax) <i>less</i> VAT paid to your suppliers (input tax) = the amount of <b>VAT payable/refundable</b>.</li> <li>4. <b>A valid tax invoice with a VAT number indicated</b> on it as proof of any input tax deductions which you want to make is needed. You must also <b>keep records</b> of all your tax invoices and other records of transactions for <b>at least five (5) years</b>.</li> <li>5. <b>Goods exported</b> to clients in an export country are charged with VAT at 0%. However, if delivery takes place in RSA, you must charge VAT at 14% to your client.</li> <li>6. <b>You may not register for VAT or deduct any input tax</b> on goods or services acquired to make <b>exempt supplies</b>, for private use or other non-taxable purposes. Also, as a general rule, <b>input tax may not be claimed</b> where the expense incurred is for the acquisition of a <b>motor car</b> or <b>entertainment</b>, even if utilised for making taxable supplies.</li> <li>7. You are required to <b>advise the South African Revenue Service (SARS) within 21 days of any changes in your registered particulars</b>, including any change in your authorised representative, business address, banking details, trading name, or if you cease trading.</li> <li>8. If you have <b>underpaid VAT as a result of a mistake, report it to your SARS branch office as soon as possible</b>, rather than leaving it for the SARS auditors to detect.</li> <li>9. You can <b>pay your VAT by using various electronic methods</b>, including e-filing, internet banking, debit order and electronic funds transfer (EFT). You may also pay at any of the four major banks.</li> <li>10. <b>Report fraudulent activities</b> to SARS by calling the Fraud and Anti-Corruption Hotline on 0800 00 28 70. You may report an incident anonymously if you wish.</li> </ol>

# *Analysis and Interpretation of Financial Statements of a Sole Trader*

The Accounting Cycle is a series of steps which are repeated every reporting period. The process starts with making accounting entries for each transaction and goes through closing the books. These accounting cycle steps occur during the accounting period, as each transaction occurs. This cycle is depicted diagrammatically below:



These accounting cycle steps occur at the beginning of the accounting period:

1. **Source Documents:**
  - **Identify the transaction** through an original source document (such as an invoice, receipt, cancelled cheque, deposit slip, purchase order) which provides:
    1. date
    2. amount
    3. description (account or business purpose)
    4. name and address of other party (if practical)
  - **Analyze the transaction** – determine which accounts are affected, how (increase or decrease), and how much.
2. **Journal entries** – record the transaction in the journal as both a **debit** and a **credit**
  - journals are kept in chronological order
  - journals may include **sales / debtors journal, purchases / creditors journal, cash receipts journal, cash payments journal, debtors and creditors returns and allowances journals** and the **general journal**
3. **Post to ledger** – transfer the journal entries to ledger accounts
  - ledger is kept by account
  - ledger accounts may be T-account form or include balances

These accounting cycle steps occur at the end of the accounting period:

4. **Trial Balance** – this is a calculation to verify the sum of the debits equals the sum of the credits. If they don't balance, you have to fix the **unbalanced trial balance** before you go on to the rest of the accounting cycle. (If they do balance you could still have a problem, but at least it balances!)
  - **Adjusting entries** – prepare and post accrued and deferred items to journals and ledger T-accounts
  - **Adjusted trial balance** – make sure the debits still equal the credits after making the period end adjustments
5. **Financial Statements** – prepare **income statement, balance sheet, statement of retained earnings, and statement of cash flows** (this can occur at other points in time with appropriate adjustments)
  - **Closing entries** – prepare and post closing entries to transfer the balances from temporary accounts (such as the revenue and expenses from the income statement to owner's equity on the balance sheet).
  - **After-Closing trial balance** – final trial balance after the closing entries to make sure debits still equal credits.

### Preparing a financial Statements

One of the final steps in the accounting cycle is the preparation of the financial statements. The information from the accounting journal and the general ledger is used to develop the income statement, statement of retained earnings, balance sheet, and statement of cash flows -- in that order. Information from the previous statement is used to develop the next statement.

#### 1. How to Prepare an Income Statement

The income statement is the first financial statement you prepare at the end of the accounting cycle. The information on **sales revenue and expenses from the accounting journals and the general ledger are used to prepare the income statement**. One item of note is depreciation. The income statement is related to the accounting equation through revenue, which increases owner's equity, and expenses, which decrease owner's equity.

The bottom line of the income statement is net income or profit. Net income is either retained by the firm for growth or paid out to the owner of the firm.

#### 2. Prepare the Balance Sheet

The balance sheet is the financial statement that is prepared to illustrate the firm's financial position at a point in time -- on the last day of the accounting cycle. The entries on the balance sheet come from the general ledger and the format mirrors the accounting equation. Assets, liabilities, and owner's equity on the last day of the accounting cycle are stated on the balance sheet.

#### 3. Prepare the Statement of Cash Flows

The Statement of Cash Flows shows the firm's financial position on a cash basis rather than an accrual basis. The Statement of Cash Flows has to be prepared last as it takes information from all previous

financial statements. Two time periods of comparative balance sheets are examined in order to prepare a statement of cash flows.

### Ratio Analysis

Ratio analysis is a management tool for analysing and judging the financial performance of a business. This is done by calculating and judging financial ratios using final accounts (profit and loss and balance sheets).

These figures can be compared with previous years and with competitors' figures in order to analyse financial performance of a business.

### The purpose of ratio analysis

- To aid analysis of a firm's financial position, such as its short term and long term liquidity positions
- To assess a firm's financial performance
- To compare actual figures with projected/budgeted figures
- To aid decision making

### Comparison of results

We can't say, whether results of the ratio value is good or bad. We need more information to determine that.

There are two ways to tell whether ratio result is good or bad:

- find ratio values for the business we are looking at for three, four or more year, preferably more: this is known as **trend analysis**;
- find ratio values for other businesses in the same industry: this is known as inter firm comparison

### Ratios are compared in two ways

- Historical comparisons – the same ratio over two different periods of time
- Inter-firm comparisons – comparing the ratios of businesses in the same industry.

### NOTE:

- *Compare organisations of the same size, i.e. would not compare ratios of a big business with a small business (sole trader).*
- *When looking at ratios, try to remember the various units of measurements used. The important thing is to try to understand what the ratio means and put it into context!!*

Learners are expected to appraise the performance of a reporting entity over different reporting periods, the performances of different entities over the same period or compare the performance of an entity with the industry norm (which will be given if required to answer a question).

Learners will normally calculate ratios and comment on them. The particular ratios may be specified or it may be left to the learner to select.

The normal approach to the interpretation of financial statements is to select suitable accounting ratios and to comment on them. These questions often guide the student on the ratios to be selected by specifying aspects of performance or financial position to be analysed. Sometimes the ratios themselves are specified; sometimes a learner is asked to select the ratios without any indication as to which category is required.

The following are some of the ratios most likely to be in Grade 10 - Sole Trader.

1. gross profit on sales
2. gross profit on cost of sales
3. net profit on sales
4. operating expenses on sales
5. operating profit on sales
6. return on equity
7. current ratio
8. acid test ratio
9. solvency ratio

#### SUMMARY OF FINANCIAL ACCOUNTING RATIO

PROFITABILITY RATIO		
Financial Ratio	Formula	Measurements
Gross Profit on Sale	$\frac{\text{Gross profit}}{\text{Net sales}} \times \frac{100}{1}$	Profitability of trading and mark-up
Gross profit on cost of sales	$\frac{\text{Gross profit}}{\text{Cost of sales}} \times \frac{100}{1}$	Measures the percentage added to trading costs in order to arrive at the selling price. Improvement is a positive sign which will be due to increased sales/selling price or falling trading costs, and vice versa.
Net profit on sales	$\frac{\text{Net profit}}{\text{Sales}} \times \frac{100}{1}$	Measures how much of each rand earned by the company is translated into profits. A low profit margin indicates a low margin of safety: higher risk that a decline in sales will erase profits and result in a net loss.

Operating expenses on sales	$\frac{\text{Total expenses}}{\text{Sales}} \times \frac{100}{1}$	Measures the contribution of operating expenses to the overall generation of income
Operating profit on Sale	$\frac{\text{Operating profit}}{\text{Sales}} \times \frac{100}{1}$	Measures net profitability of each dollar of sales
Return on owner's equity (use average equity)	$\frac{\text{Net profit}}{\text{Average owner's equity}} \times \frac{100}{1}$	Measures rate of return earned on assets provided by owners
<b>LIQUIDITY RATIO</b>		
Current Ratio	Current Assets / Current liabilities	A measure of short-term liquidity. Indicates the ability of entity to meet its short-term debts from its current assets
Acid-test ratio	Current assets - Trading stock : Current liabilities	A more rigorous measure of short-term liquidity. Indicates the ability of the entity to meet unexpected demands from liquid current asses
Solvency ratio	Total assets : Total liabilities	The solvency ratio measures the size of a company's after-tax income, excluding non-cash depreciation expenses, as compared to the firm's total debt obligations. It provides a measurement of how likely a company will be to continue meeting its debt obligations.



## Assessment Tasks

### Activity 1

Indicate whether the following statement are True or False		
1	Ratio analysis involves a comparison of the relationships between financial statement accounts so as to analyze the financial position and strength of a firm.	True / False

2	The current ratio and inventory turnover ratio measure the liquidity of a firm. The current ratio measures the relationship of a firm's current assets to its current liabilities and the inventory turnover ratio measures how rapidly a firm turns its inventory back into a "quick" asset or cash.	True / False
3	If a firm has high current and acid ratios, this is always a good indication that a firm is managing its liquidity position well.	True / False
4	Profitability ratios show the combined effects of liquidity, asset management, and debt management on operations.	True / False
5	If the current ratio of Firm A is greater than the current ratio of Firm B, we cannot be sure that the quick ratio of Firm A is greater than that of Firm B. However, if the quick ratio of Firm A exceeds that of Firm B, we <u>can</u> be assured that Firm A's current ratio also exceeds B's current ratio.	True / False

## Activity 2

Multiple Choice:		
1.	Other things held constant, which of the following will <u>not</u> affect the <b>current ratio</b> , assuming an initial current ratio greater than 1.0? <ul style="list-style-type: none"> <li>a. Fixed assets are sold for cash.</li> <li>b. Long-term debt is issued to pay off current liabilities.</li> <li>c. Accounts receivable are collected.</li> <li>d. Cash is used to pay off accounts payable.</li> <li>e. A bank loan is obtained, and the proceeds are credited to the firm's checking account.</li> </ul>	
2.	Other things held constant, which of the following will not affect the acid ratio? (Assume that current assets equal current liabilities.) <ul style="list-style-type: none"> <li>a. Fixed assets are sold for cash.</li> <li>b. Cash is used to purchase inventories.</li> <li>c. Cash is used to pay off accounts payable.</li> <li>d. Accounts receivable are collected.</li> <li>e. Long-term debt is issued to pay off a short-term bank loan.</li> </ul>	

3	<p>Which of the following statements is most correct?</p> <ul style="list-style-type: none"> <li>a. If a company increases its current liabilities by R1 000 and simultaneously increases its inventories by R1 000, its current ratio must rise.</li> <li>b. If a company increases its current liabilities by R1 000 and simultaneously increases its inventories by R1 000, its acid ratio must fall.</li> <li>c. A company's acid ratio may never exceed its current ratio.</li> <li>d. Answers b and c are correct.</li> <li>e. None of the answers above is correct.</li> </ul>	
4	<p>Which of the following actions can a firm take to increase its <b>current ratio</b>?</p> <ul style="list-style-type: none"> <li>a. Issue short-term debt and use the proceeds to buy back long-term debt with a maturity of more than one year.</li> <li>b. Reduce the company's days sales outstanding to the industry average and use the resulting cash savings to purchase plant and equipment.</li> <li>c. Use cash to purchase additional inventory.</li> <li>d. Statements a and b are correct.</li> <li>e. None of the statements above is correct.</li> </ul>	
5	<p>Which of the following actions will cause an increase in the <b>acid ratio</b> in the short run?</p> <ul style="list-style-type: none"> <li>a. R1 000 worth of inventory is sold and an account receivable is created. The receivable exceeds the inventory by the amount of profit on the sale, which is added to retained earnings.</li> <li>b. A small subsidiary which was acquired for R100 000 two years ago and which was generating profits at the rate of 10 percent is sold for R100 000 cash. (Average company profits are 15 percent of assets.)</li> <li>c. Marketable securities are sold at cost.</li> <li>d. All of the answers above.</li> <li>e. Answers a and b above.</li> </ul>	

6	<p>Which of the following statement/s is most correct?</p> <ul style="list-style-type: none"> <li>a. An increase in a firm's debt ratio, with no changes in its sales and operating costs, could be expected to lower its profit margin on sales.</li> <li>b. An increase in the Daily Sales Outstanding (DSO), other things held constant, would generally lead to an increase in the total asset turnover ratio.</li> <li>c. An increase in the DSO, other things held constant, would generally lead to an increase in the ROE.</li> <li>d. In a competitive economy, where all firms earn similar returns on equity, one would expect to find lower profit margins for airlines, which require a lot of fixed assets relative to sales, than for fresh fish markets.</li> <li>e. It is more important to adjust the Debt/Assets ratio than the inventory turnover ratio to account for seasonal fluctuations.</li> </ul>	
7	<p>Which of the following statement/s is most correct?</p> <ul style="list-style-type: none"> <li>a. If Company A has a higher debt ratio than Company B, then we can be sure that A will have a lower times-interest-earned ratio than B.</li> <li>b. Suppose two companies have identical operations in terms of sales, cost of goods sold, interest rate on debt, and assets. However, Company A uses more debt than Company B; that is, Company A has a higher debt ratio. Under these conditions, we would expect B's profit margin to be higher than A's.</li> <li>c. The ROE of any company which is earning positive profits and which has a positive net worth (or common equity) must exceed the company's ROA.</li> <li>d. Statements a, b, and c are true.</li> <li>e. Statements a, b, and c are false.</li> </ul>	
8	<p>Assume Meyer Corporation is 100 percent equity financed. Calculate the <b>return on equity</b>, given the following information:</p> <ul style="list-style-type: none"> <li>i. Earnings before taxes = R1 500</li> <li>ii. Sales = R5 000</li> <li>iii. Dividend payout ratio = 60%</li> <li>iv. Total assets turnover = 2.0</li> <li>v. Applicable tax rate = 30%</li> </ul> <ul style="list-style-type: none"> <li>a. 25%</li> <li>b. 30%</li> <li>c. 35%</li> <li>d. 42%</li> <li>e. 50%</li> </ul>	

9	<p>The Merriam has determined that its return on equity is 15 percent. Management is interested in the various components that went into this calculation. You are given the following information: total debt/total assets = 0.35 and total assets turnover = 2.8. <b>What is the profit margin?</b></p> <ul style="list-style-type: none"> <li>a. 3.48%</li> <li>b. 5.42%</li> <li>c. 6.96%</li> <li>d. 2.45%</li> <li>e. 12.82%</li> </ul>	
10	<p>Harvey Supplies has a current ratio of 3.0, a quick ratio of 2.4, and an inventory turnover ratio of 6. Harvey's total assets are R1 million and its debt ratio is 0.20. The firm has no long-term debt. What is Harvey's sales figure?</p> <ul style="list-style-type: none"> <li>a. R 720 000</li> <li>b. R 120 000</li> <li>c. R1 620 000</li> <li>d. R360 000</li> <li>e. R 880 000</li> </ul>	
11	<p>Last year, Quayle Energy had sales of R200 million, and its inventory turnover ratio was 5.0. The company's current assets totalled R100 million, and its current ratio was 1.2. What was the company's <b>acid ratio</b>?</p> <ul style="list-style-type: none"> <li>a. 1.20</li> <li>b. 1.39</li> <li>c. 0.72</li> <li>d. 0.55</li> <li>e. 2.49</li> </ul>	

### Activity 3

Given below is the information from the books of Lethole at 31 December 2005

Account Detail	Trial balance		Adjustments		Profit and loss		Balance sheet	
	DR R	CR R	DR R	CR R	DR R	CR R	DR R	CR R
Capital		7 830						7 830
Cash	2 010						2 010	
Fixed assets	9 420						9 420	
Accumulated depreciation		3 470		942				4 412
Trade debtors	1 830						1 830	
Opening stock	1 680				1 680			
Trade Creditors		390						390
Sales		14 420				14 420		
Purchases	8 180			1 500	6 680			
Rent	1 100		100		1 200			
Electricity	940		400		1 340			
Rates	950			200	750			
Depreciation expense			942		942			
Allowance for doubtful debts adjustments			55		55			
Allowance for doubtful debts				55				55
<b>Drawings</b>			1 500				1 500	
<b>Accruals</b>				500				500
<b>Prepayments</b>			200				200	
Closing stock BS			1 140				1 140	
Closing stock P&L				1 140		1 140		
Profit (15,560 –12,647)					2 913			2 913
	<b>26 110</b>	<b>26 110</b>	<b>4 337</b>	<b>4 337</b>	<b>15 560</b>	<b>15 560</b>	<b>16 100</b>	<b>16 100</b>

You are required to prepare:

- a. Income Statement for 31 December 2005
- b. Balance Sheet at 31 December 2005

#### Activity 4

##### Trial balance of M. Matuba at 31 March 2004

	R	R
Sales ledger control account	30 000	
Telephone	1 620	
Purchases ledger control account		25 680
Heat and light	2 480	
Motor vehicles at cost	53 900	
Computer equipment at cost	4 500	
Carriage inwards	1 840	
Carriage outwards	3 280	
Wages	67 440	
Loan interest	300	
Capital		48 000
Drawings	26 000	
Allowance for doubtful debts		600
Bank overdraft		2 880
Purchases	126 800	
Petty cash	50	
Sales		256 400
Insurance	2 720	
Accumulated depreciation – motor vehicles		26 670
Accumulated depreciation – computer equipment		3 540
Stock at 1 April 2003	13 200	
Loan		8 000
Rent	23 760	
Stock at 31 March 2004	14 400	14 400
Depreciation expense – motor vehicles	11 670	
Depreciation expense – computer equipment	900	
Accruals		180
Prepayments	640	
Allowance for doubtful debt adjustment	150	
Irrecoverable debts expense	700	
	<b>386 350</b>	<b>386 350</b>

Use the information above to prepare:

- Income Statement for 31 March 2004
- Balance Sheet at 31 March 2004

### Activity 5

Given below is the list of ledger balances for a sole trader at 30 June 2004 after all of the yearend adjustments have been put through.

	R
Sales	165 400
Sales ledger control account	41 350
Wages	10 950
Bank	1 200
Rent	8 200
Capital	35 830
Purchases ledger control account	15 100
Purchases	88 900
Electricity	1 940
Telephone	980
Drawings	40 000
Stock at 1 July 2003	9 800
Motor vehicles at cost	14 800
Accumulated depreciation – motor vehicles	7 800
Fixtures at cost	3 200
Accumulated depreciation – fittings	1 800
Accruals	100
Prepayments	210
Stock at 30 June 2004 – balance sheet	8 300
Stock at 30 June 2004 – profit and loss	8 300
Depreciation expense – motor vehicles	3 700
Depreciation expense – fittings	800

**You are required to:**

- (i) Draw up a trial balance to check that it balances (you should find that the trial balance does balance).
- (ii) Prepare the financial statements of the sole trader for the year ending 30 June 2004.

### Activity 6

Given below are parts of the Income Statement for the Cellphone Warehouse. Use the information to calculate its **gross and net profit on sale**.

Cellphone Warehouse		
Consolidated Income Statement for the year ended	31 March 2001	25 March 2000
	R	R
Turnover	1 110 678	697 720
Cost of sales	830 126	505 738
Gross profit	280 552	191 982
Operating expenses	176 960	129 359
Operating profit	66 016	41 389
Other costs/income	6 555	-5 132
Profit before interest and taxation	<b>45 012</b>	<b>25 300</b>

### Activity 7

Use the information given below to find the data you need to:

- Calculate the **gross and net profit on sale** for Vodafone.
- Compare and interpret the ratio value of Cellphone Warehouse and Vodafone.

Consolidated Profit & Loss Account of <b>Vodafone</b> for the year ended		
	2002	2001
	R	R
Turnover / Sales	22 845	15 004
Cost of sales	(13 446)	(8702)
Gross Profit	9 399	6 302
Operating Expenses	-21 233	-13 291
Operating Profit	-11834	-6 989
Other costs/income	-860	80
Profit before interest and taxation	-12 694	-6 909

### Activity 8

Here is part of the Income Statement for Mark Spencer for two years. Compare these results by calculating the ratios named below and discuss what you find.

- a. Gross profit on sale
- b. Operating profit on sale

Consolidated profit and loss for the year	Marks & Spencer plc	
	2002	2001
	R	R
Turnover / Sales	8 135.4	8 075.7
Cost of sales	(6 862.5)	(7 154.3)
Gross profit	1 272.9	921.4
Operating expenses	(629.1)	(480.9)
Operating profit	643.8	440.5

### Activity 9

J Sainsbury has published the following two years' worth of turnover and profit information. Calculate the following ratios and make comments on what you find.

- a. Gross profit margin
- b. Operating profit margin
- c. Net profit before interest and taxation margin

Consolidated profit and loss account of J Sainsbury for the year ended		
	30-Mar-02	30-Mar-01
	R	R
Turnover / Sales	17 162	17 244
Cost of sales	-15 905	-16 082
Gross profit	1 257	1 162
Other selling and distribution costs	-632	-629
Operating profit	625	533
Other costs/income	-5	-20
Profit before interest and taxation	620	513

### Activity 10

Use the following information of the Cellphone Warehouse to work out its current ratio.

Consolidated Balance Sheet	31 March 2001	25 March 2000
	R	R
Total Current Assets	315 528	171 160
Creditors: Amounts falling due within one year	222 348	173 820

### Activity 11

Current assets	2002	2001
Stock	513	316
Debtors due within one year	7 053	4 587
Short-term investments	1 792	13 211
Cash at bank and in hand	80	68
Total Current Assets	9 438	18 182
Creditors: Amounts falling due within one year	13 455	12 377
Net current assets (liabilities)	-4 017	5 805

The following information is extracted from the Vodafone current assets schedule above. Use the information to:

- Work out its current ratio
- Interpret the current ratio value of Vodafone.

Consolidated Balance Sheet of Vodafone	31 March 2002	31 March 2001
	R	R
Total Current Assets	9 438	18 182
Creditors: Amounts falling due within one year	13 455	12 377



# Solutions

## Activity 1

Indicate whether the following statement are True or False		
1	Ratio analysis involves a comparison of the relationships between financial statement accounts so as to analyze the financial position and strength of a firm.	True
2	The current ratio and inventory turnover ratio measure the liquidity of a firm. The current ratio measures the relationship of a firm's current assets to its current liabilities and the inventory turnover ratio measures how rapidly a firm turns its inventory back into a "quick" asset or cash.	False
3	If a firm has high current and acid ratios, this is always a good indication that a firm is managing its liquidity position well.	False
4	Profitability ratios show the combined effects of liquidity, asset management, and debt management on operations.	True
5	If the current ratio of Firm A is greater than the current ratio of Firm B, we cannot be sure that the acid ratio of Firm A is greater than that of Firm B. However, if the acid ratio of Firm A exceeds that of Firm B, we <u>can</u> be assured that Firm A's current ratio also exceeds B's current ratio.	False

## Activity 2

Multiple Choice:		
1.	Other things held constant, which of the following will <u>not</u> affect the current ratio, assuming an initial current ratio greater than 1.0? c. Accounts receivable are collected..	C
2.	Other things held constant, which of the following will not affect the quick ratio? (Assume that current assets equal current liabilities.) d. Accounts receivable are collected.	D
3	Which of the following statements is most correct? Answers b and c are correct.	D
4	Which of the following actions can a firm take to increase its current ratio? None of the statements above is correct.	E

5	Which of the following actions will cause an increase in the quick ratio in the short run? Answers a and b above.	E
6	Which of the following statement/s is most correct? An increase in a firm's debt ratio, with no changes in its sales and operating costs, could be expected to lower its profit margin on sales.	A
7	Which of the following statements is most correct? Suppose two companies have identical operations in terms of sales, cost of goods sold, interest rate on debt, and assets. However, Company A uses more debt than Company B; that is, Company A has a higher debt ratio. Under these conditions, we would expect B's profit margin to be higher than A's.	B
8	Assume Meyer Corporation is 100 percent equity financed. Calculate the return on equity, given the following information: Earnings before taxes = R1 500, Sales = R5 000, Dividend payout ratio = 60%, Total assets turnover = 2.0 and Applicable tax rate = 30% Profit margin = $(R1\ 500(1 - 0.3)) / R5\ 000 = 21\%$ . Equity multiplier = 1.0 since firm is 100% equity financed. ROE = (Profit margin)(Assets turnover)(Equity multiplier) = $(21\%)(2.0)(1.0) = 42\%$ . Alternate solution: ROE = $EBT(1 - T) / (Sales/2.0)$ = $R1\ 500(0.7) / R5\ 000 / 2.0$ = $R1\ 050 / R2\ 500 = 42\%$ .	D
9	The Merriam has determined that its return on equity is 15 percent. Management is interested in the various components that went into this calculation. You are given the following information: total debt/total assets = 0.35 and total assets turnover = 2.8. What is the profit margin? Equity multiplier = $1/(1 - 0.35) = 1.54$ . ROE = (Profit margin)(Assets utilization)(Equity multiplier) $15\% = (PM)(2.8)(1.54)$ PM = 3.48%.	A
10	Harvey Supplies Inc. has a current ratio of 3.0, a quick ratio of 2.4, and an inventory turnover ratio of 6. Harvey's total assets are R1 million and its debt ratio is 0.20. The firm has no long-term debt. What is Harvey's sales figure? Current liabilities: $(0.2)(R1\ 000\ 000) = R200\ 000$ . Current assets: $CA / R200\ 000 = 3.0$ ; CA = R600 000. Inventory: $(R600\ 000 - I) / R200\ 000 = 2.4$ ; I = R120 000.	A

	Sales: $S / R120\ 000 = 6$ ; $S = R720\ 000$ .	
11	<p>Last year, Quayle Energy had sales of R200 million, and its inventory turnover ratio was 5.0. The company's current assets totalled R100 million, and its current ratio was 1.2. What was the company's acid ratio?</p> <p>Step 1 Calculate inventory: Quayle Energy has R40 million in inventory because the inventory turnover ratio is equal to 5.</p> $S/Inv = 5; Inv = R200\ 000\ 000 / 5 = R40\ 000\ 000.$ <p>Step 2 Calculate current liabilities: From the current ratio, we can conclude that they have R83.33 million in current liabilities.</p> $CR = R100\ 000\ 000 / CL = 1.2; CL = R83.33\ \text{million}.$ <p>Step 3 Find acid ratio: <math>CA - Inv / CL = R100\ 000\ 000 - R40\ 000\ 000 / R83\ 333\ 333 = 0.72.</math></p>	C

### Activity 3

NAME OF SOLE TRADER: LETHOLE TRADERS

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2005

	Note	R
Sales		14 420
Cost of sales	2	(7 220)
<b>Gross profit</b>		<b>7 200</b>
<b>Operating expenses</b>		<b>(4 287)</b>
Rent		1 200
Electricity		1 340
Rates		750
Depreciation		942
Allowance for doubtful debts increase		55
<b>Net profit for the year</b>		<b>2 913</b>

NAME OF SOLE TRADER: LETHOLE TRADERS

BALANCE SHEET AT 31 DECEMBER 2005

	Note	R
<b>ASSETS</b>		
<b>NON-CURRENT ASSETS</b>		
Fixed / Tangible assets	1	5 008
<b>CURRENT ASSETS</b>		
Inventories		1 140
Trade & other receivables		1 775
Prepayments		200
Cash		2 010
Total Current Assets		5 125
<b>TOTAL ASSETS</b>		<b>10 133</b>
<b>EQUITY &amp; LIABILITIES</b>		
<b>OWNERS' EQUITY</b>		
Capital	3	9 243
<b>CURRENT LIABILITIES</b>		
Trade & other payables	4	890
<b>TOTAL EQUITY &amp; LIABILITIES</b>		<b>10 133</b>

NAME OF SOLE TRADER: LETHOLE TRADERS

NOTES TO THE FINANCIAL STATEMENTS AT 31 DECEMBER 2005

1 FIXED/TANGIBLE ASSETS

Fixed assets	Fixed asset	Total
Cost	9 420	9 420
Accumulated depreciation	4 412	4 412
Carrying value at end of year	5 008	5 008

## 2 INVENTORIES

Opening stock	1 680
Purchases	6 680
Less Closing Stock	(1 140)
Cost of Sales	<u>7 220</u>

## 3 OWNER'S EQUITY

Balance at beginning of year	7 830
Net profit for the year	2 913
Less: Drawings	<u>(1 500)</u>
Balance at end of year	<u>9 243</u>

## 4 TRADE & OTHER PAYABLES

Trade creditors	390
Expenses accrued (payable)	<u>500</u>
	<u>890</u>

### Activity 4

#### NAME OF SOLE TRADER: M. MATUBA FOR THE YEAR ENDED INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 2004

	Note	R
Sales		256 400
Cost of sales	2	127 440
Gross profit		<u>128 960</u>
Less: Expenses		
Telephone		1 620
Heat and light		2 480
Carriage outwards		3 280
Wages		67 440
Loan interest		300
Insurance		2 720
Rent		23 760
Depreciation expense – motor vehicles		11 670
Depreciation expense – computer equipment		900
Irrecoverable debts		700
Allowance for doubtful debts adjustment		150
Total expenses		<u>115 020</u>
Net profit (loss) for the year		<u>13 940</u>

NAME OF SOLE TRADER: M. MATUBA

BALANCE SHEET OF M. MATUBA AS AT 31 MARCH 2004

	Note	R
<b>ASSETS</b>		
<b>NON-CURRENT ASSETS</b>		
Fixed / Tangible assets	1	28 190
<b>CURRENT ASSETS</b>		
Inventories		14 400
Trade & other receivables	3	30 040
Petty Cash		50
<b>TOTAL ASSETS</b>		<b>72 680</b>
<b>EQUITY &amp; LIABILITIES</b>		
<b>OWNERS' EQUITY</b>		
Capital	4	35 940
<b>NON-CURRENT LIABILITIES</b>		
Loan		8 000
<b>CURRENT LIABILITIES</b>		
Trade & other payables	5	25 860
Bank overdraft		2 880
<b>TOTAL EQUITY &amp; LIABILITIES</b>		<b>72 680</b>

NAME OF SOLE TRADER: M. MATUBA

NOTES TO THE FINANCIAL STATEMENTS AT 31 MARCH 2004

**1 FIXED/TANGIBLE ASSETS**

	Vehicles	Equipment	Total
Carrying value at beginning of year			
Cost	53 900	4 500	58 400
Accumulated depreciation	26 670	3 540	30 210
Carrying value at end of year	27 230	960	28 190

**2 INVENTORIES**

Opening stock	13 200
Carriage inwards	1 840
Purchases	126 800
	141 840

Less Stock on Hand	(14 400)
Cost of Sales	<u>127 440</u>

### 3 TRADE & OTHER RECEIVABLES

Trade debtors	30 000
Less: Allowance for doubtful debts	(600)
Expenses prepaid	640
	<u>30 040</u>

### 4 OWNER'S EQUITY

Balance at beginning of year	48 000
Net profit (loss) for the year	13 940
Less drawings	(26 000)
Balance at end of year	<u>35 940</u>

### 5 TRADE & OTHER PAYABLES

Trade creditors	25 680
Expenses accrued (payable)	180
	<u>25 860</u>

## Activity 5

### (i) Trial balance as at 30 June 2004

	R	R
Sales		165 400
Sales ledger control account	41 350	
Wages	10 950	
Bank	1 200	
Rent	8 200	
Capital		35 830
Purchases ledger control account		15 100
Purchases	88 900	
Electricity	1 940	
Telephone	980	
Drawings	40 000	
Stock at 1 July 20X3	9 800	
Motor vehicles at cost	14 800	
Accumulated depreciation – motor vehicles		7 800
Fixtures at cost	3 200	
Accumulated depreciation – fittings		1 800
Accruals		100
Prepayments	210	
Stock at 30 June 20X4 – balance sheet		8 300
Stock at 30 June 20X4 – profit and loss	8 300	
Depreciation expense – motor vehicles	3 700	
Depreciation expense – fittings	800	
	<u>234 330</u>	<u>234 330</u>

(ii)

INCOME STATEMENT FOR THE YEAR ENDED 30 JUNE 2004

	Note	R
Sales		165 400
Cost of sales	2	(90 400)
Gross profit		75 000
Less: Expenses		26 570
Wages		10 950
Rent		8 200
Electricity		1 940
Telephone		980
Depreciation – motor vehicles		3 700
Depreciation – fittings		800
Net profit for the year		48 430

BALANCE SHEET AS AT 30 JUNE 2004

	Note	R
<b>ASSETS</b>		
<b>NON-CURRENT ASSETS</b>		
Fixed / Tangible assets	1	8 400
<b>CURRENT ASSETS</b>		
Inventories	2	8 300
Trade & other receivables	3	41 560
Bank		1 200
<b>TOTAL ASSETS</b>		<b>59 460</b>
<b>EQUITY &amp; LIABILITIES</b>		
<b>OWNERS' EQUITY</b>		
Capital	4	44 260
<b>CURRENT LIABILITIES</b>		
Trade & other payables	5	15 200
<b>TOTAL EQUITY &amp; LIABILITIES</b>		<b>59 460</b>

NOTES TO THE FINANCIAL STATEMENTS AT 30 JUNE 2004

1 FIXED/TANGIBLE ASSETS

	Vehicles	Equipment	Total
Carrying value at beginning of year			
Cost	14 800	3 200	18 000
Accumulated depreciation	7 800	1 800	9 600
Carrying value at end of year	7 000	1 400	8 400

2 INVENTORIES

Opening stock	9 800
Purchases	88 900
	98 700
Less: Closing stock	(8 300)
Cost of sales	90 400

3 TRADE & OTHER RECEIVABLES

Trade debtors	41 350
Expenses prepaid	210
	41 560

4 OWNER'S EQUITY

Balance at beginning of year	35 830
Net profit (loss) for the year	48 430
Less Drawings	(40 000)
Balance at end of year	44 260

5 TRADE & OTHER PAYABLES

Trade creditors	15 100
Expenses accrued (payable)	100
	15 200

## Activity 6

Profitability Ratios for the Cell phone Warehouse			
Ratio Name	Ratio Formula	Calculation	
Profitability		31 March 2001	25 March 2000
Gross Profit sales	$\frac{\text{Gross Profit}}{\text{Sale}} * 100$	R280 552 ÷ 1 110 678*100 25.26%	191 982 ÷ 697 720 *100 27.52%
Net Profit sales	$\frac{\text{Net Profit}}{\text{Sale}} * 100$	R45 012 ÷ 1 110 678*100 4.05%	25 300 ÷ 697 720 *100 3.63%

1. The Cell phone Warehouse has given us almost the same profitability results for the two years. This suggests the business is being managed in a stable way.
2. From what we know about the mobile phone industry, we might say that it is good that they have been so stable because the industry has been changing and growing so quickly.
3. We still can't say, though, whether a gross profit margin of about 25% is good or bad and we can't say whether a net profit margin of around 4% is good or bad: we still need even more information.

There are two ways to tell whether ratio result is good:

- find ratio values for the business we are looking at for three, four or more year, preferably more: this is known as trend analysis;
- find ratio values for other businesses in the same industry: this is known as inter firm comparison.

## Activity 7

Profitability Ratios for Vodafone			
Ratio Name	Ratio Formula	Calculation	
Profitability		31 March 2001	25 March 2000
Gross Profit on sale	$\frac{\text{Gross Profit}}{\text{Sale}} * 100$	R9 399 ÷ 22 845*100 41.14%	6302 ÷ 15 004*100 42.00%
Net Profit on sale	$\frac{\text{Net Profit}}{\text{Sale}} * 100$	-R12 694 ÷ 22 845*100 -55.57%	-6 909 ÷ 15 004*100 -46.05%

Comparison between Cellphone Warehouse and Vodafone				
	Cellphone Warehouse		Vodafone	
Profitability	31 March 2001	25 March 2000	31 Mar 2002	31 Mar 2001
Gross Profit Margin	25.26%	27.52%	41.14%	42.00%
Operating Profit Margin	4.05%	3.63%	-55.57%	-46.05%

1. Firstly, Vodafone as, compared to the Cellphone Warehouse, an apparently healthy gross profit margin: Vodafone's gross profit margin is around 40% compared to the Cellphone Warehouse's gross profit margin of around 25%.
2. However, look at the net profit margin: something strange is happening to Vodafone because it has made a net loss for both of the two years. Take a look at Vodafone in the Income Statement for more information on what might have gone wrong. Vodafone's operating expenses have increased by R 7 972 over the year whilst turnover has increased by R7 841; and the cost of sales has increased by R4 744. The net effect of these changes is that losses have gone from -R6.909 to -R12 694: a huge increase in the net loss.
3. So, even though the businesses are in the same industry, they have very different results, we can say they have very different 'profiles'.

### Activity 8

Profitability Ratios for Mark Spencer			
Ratio Name	Ratio Formula	Calculation	
Profitability		2002	2001
Gross Profit Margin	$\frac{\text{Gross Profit}}{\text{Sales}} * 100$	$1\ 272.9 \div 8\ 135.4 * 100$ 15.65%	$921.4 \div 8\ 075.7 * 100$ 11.41%
Operating Profit Margin	$\frac{\text{Operating Profit}}{\text{Sales}} * 100$	$643.8 \div 8\ 135.4 * 100$ 7.91%	$440.5 \div 8\ 075.7 * 100$ 5.45%

**Mark Spencer** has had a successful year in 2002 as its rates of gross and operating profitability have increased. Whilst turnover has increased only slightly over the two year period, profits have grown more quickly.

### Activity 9

Profitability Ratios for J Sainsbury			
Ratio Name	Ratio Formula	Calculation	
Profitability		30-Mar-2002	30-Mar-2001
Gross Profit on Sales	$\frac{\text{Gross Profit}}{\text{Sales}} * 100$	$1\,257 \div 17\,162 * 100$ 7.32%	$1\,162 \div 17\,244 * 100$ 6.74%
Operating Profit on sales	$\frac{\text{Operating Profit}}{\text{Sales}} * 100$	$625 \div 17\,162 * 100$ 3.64%	$533 \div 17\,244 * 100$ 3.09%
Net profit on sales	$\frac{\text{Net Profit}}{\text{Sales}} * 100$	$620 \div 17\,162 * 100$ 3.61%	$513 \div 17\,244 * 100$ 2.97%

Although Sainsbury's have increased their profitability ratios, they have not done so by very much margin.

### Activity 10

Current Ratio For the Cellphone Warehouse			
31 March 2001	Current Assets: Current Liabilities $\frac{\text{current assets}}{\text{current liabilities}} = \frac{315\,528}{222\,348} = 1.42$	R315 528 : 222 348	1.42: 1
25 March 2000	Current Assets: Current Liabilities $\frac{\text{current assets}}{\text{current liabilities}} = \frac{171\,160}{173\,820} = 0.98$	R171 160 : 173 820	0.98: 1

## Activity 11

Current Ratio For the Vodafone			
31 March 2001	Current Assets: Current Liabilities $\frac{\text{current assets } 9\,438}{\text{current liabilities } 13\,455} = 0.70$	9 438: 13 455	<b>0.70: 1</b>
25 March 2000	Current Assets: Current Liabilities $\frac{\text{current assets } 18\,182}{\text{current liabilities } 12\,377} = 1.47$	18 182: 12 377	<b>1.47: 1</b>

Vodafone has liquidated, or sold, many of its short-term investments. This business has grown at a very rapid rate and has possibly used the cash from having sold its investments to finance that expansion. Overall, Vodafone has lost R9 822 of working capital as it has fallen from R5 805 to -R4 017. This has left Vodafone in a weak working capital position as its creditors are large but its cash and short-term assets balances are small by comparison.