

Accounting Grade 10 Notes

1. Generally accepted accounting practice (GAAP)

If each person were to develop his or her own language or grammar rules, it would cause communication chaos.

For this reason we have generally applicable grammar rules. Accounting, as a special system of communication, has exactly the same problem.

If each business were to present Financial Statements according to its own theory and principles, chaos would erupt in the economic and business world.

For this reason a basis has been developed for measuring and presenting the results of financial events (transactions).

This basis is a general framework and includes accounting concepts, principles, methods and actions known as Generally Accepted Accounting Practice (GAAP).

From now on we are going to use the abbreviation GAAP. In RSA the Accounting Standards Board plays an important role in the development of GAAP by setting certain accounting standards.

By setting these standards for certain events (e.g. presenting tax in the Financial Statements), the objective is to limit the variety of available accounting practices without striving towards strict uniformity or a set of rigid rules.

The objective of accounting standards is to promote general application of certain issues in Financial Statements and to eliminate unacceptable alternatives.

After being approved by the Accounting Standards Board the standards are published in a series of publications, called accounting standards.

After 1994 we became part of the International Financial Reporting Standards (IFRS).

A business will use the IFRS to prepare their Financial Statements.

It is important to note that that GAAP/Accounting Standards change constantly in order to keep up with changes in the business world.

These statements are issued by the South African Institute of Chartered Accountants (SAICA). SAICA is a professional body that is responsible for training and developing the accounting profession.

The following factors affect the way in which the Financial Statements are presented.

You must ensure that you understand these concepts clearly as they will assist you when you have to draw up the Financial Statements of a sole trader.

2 GAAP Principles

2.1 Historical cost The concept historical a cost means that assets purchased by a business must be recorded in the books at cost price (purchased price). Example: If we bought Land and buildings three years ago at a total cost of R500 000 and entered it into the books at that price and the asset is re-valued today at R650 000, the amount that will be entered in the Financial Statements will still be R500 000 (the price that we originally bought it for).

2.2 Prudence This is also known as the principle of conservatism. When the accountant is uncertain about the value of an element or event (assets/liabilities/income/expenses), the prudence principle must be applied. This means that the accountant who prepares the Financial Statements should be conservative in their approach to these uncertainties. The value that has the least influence on the equity of the business must be used. Example: If a debtor is in financial difficulty, the accountant may write his account off even though the business will continue to do everything possible to receive the money the debtor owes them.

2.3 Materiality The materiality principle demands that all important (large) transactions and events should be indicated separately in the Financial Statements, as these may influence decision-making. Unimportant amounts need not to be indicated separately, but should be added to other amounts of similar nature or functions. Here is also another part that is important. The accountant will be conscious of whether an adjustment entry will be important (material) to the financial results of a business. An adjusting entry might be omitted if the amount is regarded as insignificant. Example: All interest expense items should be shown separate in the Financial Statements as this will be important (material) to a decision on how to raise additional funds.

2.4 Business entity rule The objective of accounting is to present information about the financial situation of a specific business or individual. Such a business or individual is known as an entity. The concept entity refers to a unit that exists independently and can be clearly defined. The financial affairs of the business must be kept separately from the financial affairs of the owners. The business must have a separate bank account and in the Financial Statements of the business no transactions of the personal affairs of the owner will be showed. Example: If the owner inherited R500 000 from his/her grandfather, the money will be deposited in the owner’s personal bank account and not in the business’s bank account.

2.5 Going concern The concept going-concern means that an entity (business) will continue to exist for a certain period and that the Financial Statements of a business are prepared as though the business will continue to exist for some time. Example: Stock, fixed deposit and land and buildings are not valued on the basis of the amount that would be received for them if they were sold immediately. 2.6 Matching All transactions or events that take place during a certain financial period must be recorded in the books during that financial period – irrespectively of when the cash is received or paid. Income and expenses incurred in order to receive such income, need to be brought into account during the same period. This implies that expenses incurred in order to create income, must be ‘matched’ to that income during the present financial period. Example: If a building is rent from somebody and we only paid R55 000 (R5 000 per month) for 11 months, the R5 000 will be match with the R55 000 because it is part of this financial year. The amount recorded in the Financial Statements will be R60 000.

These GAAP principles will be integrated with all the topics and will continuously be assessed as we advance with the Study Guide.

• Make sure you understand all the GAAP principles because they form the base of all accounting activities.

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| --- | --- |
| Column A Column B | Column A Column B |
| 1. All transactions or events that take place during a certain financial period must be recorded in the books during that financial period – irrespectively of when the cash is received or paid.  2. An entity (business) will continue to exist for a certain period and that the Financial Statements of a business are prepared as though the business will continue to exist for some time.  3. Assets purchased by a business must be recorded in the books at cost price (purchased price).  4. The accountant preparing the Financial Statements should be conservative in their approach to uncertainties by using the value that has the least influence on the equity of the business.  5. The financial affairs of the business must be kept separately from the financial affairs of the owners.  6. All important (large) transactions and events should be indicated separately in the Financial Statements, as these may influence decision-making.  7. Bad Debts written off is an example of this principle.  8. Interest expense has to appear separate to a Bank overdraft account in the Financial Statements.  9. Vehicles recorded at cost price.  10. The owner of the business cannot list his Mercedes for personal use as a business asset. | A Going concern  B Historic cost  C Business entity rule  D Matching principle  E Prudence principle  F Principle of materiality |

1 Definition and explanation:

What is internal control?

Internal means it is within itself, in other words, what can the management do within a business. Control means to have full authority something. Internal control in the business is what management can do to exercise authority over all activities within the business so that maximum profit can be obtained. It is not only the managers/owners responsibility to have control over the business, but all employees have the responsibility. Everybody in a business must be involved in putting successful control measures in place. To apply control, the following processes must be followed:

• Decide on short-term and long-term objectives.

• Gather information about the strong points and the shortcomings of the business.

• Analyse the strong points and the shortcomings of the business.

• Act against shortcomings.

Activity 1 (Internal control)

Moses Mngadi has a delivery service business called MM Deliveries. He has five drivers who deliver orders for businesses to customers. Some drivers also run personal errands with the business transport. This increases fuel cost and risks of theft and damage for Moses’ business. Suggest which control measures Moses can put in place to save on expenses and also reduce risk.

Important:

• These internal control measures will be integrated with all the topics and will continuously be assessed as we advance with the Study Guide.

• Make sure you understand all the internal control measures.

• Don’t try to study all the internal control measures all at once. Study two or three and make sure that you can apply it before you attempt to study more.

• When you answer questions on internal control measures, try to pretend that you are working in the business to apply the measures that you have learnt. Think logically.

1.2 Accounting concepts

In 3, we stipulated that accounting has certain rules to follow. In accounting there are three broad concepts, assets, owners’ equity and liabilities. Before we discuss these concepts, you have to have clarity on the concepts accounting period, current financial year, short-term and long-term. The accounting (financial) period is a period of twelve months. The period does not have to coincide with a calendar year, but it may. An accounting period can be from the 1 July one year and ends on the 30June the following year. The government financial year starts on the 1 March and ends on 28 February. A lot of businesses use this period for tax purposes.

To explain the concepts current financial year, short-term and long-term, we use the following example. Suppose that the accounting period of a business is from 1 January 2011 to 31 December 2011.

• The current financial year = 1 January 2011 to 31 December 2011.

• Short-term = 1 January 2012 to 31 December 2012. (within a financial year of 12 months)

• Long-term = 1 January 2013 onwards. (longer than a financial year of 12 months)

1.2.1 Assets

Assets are the possessions of a business.

There are two types of assets:

Non-current assets = long term

Current assets = short term

Non-current assets Non-current assets consist of fixed assets/tangible assets and financial assets.

Fixed assets/Tangible assets Fixed assets are possessions purchased by the business with the aim of using them for longer than a year.

These assets are permanent in nature and are not purchased for the purpose of resale.

They are also used in the process of generating an income for the business.

• Land and buildings – factory, store room, house, house, shop, etc. • Vehicles – motor cycle, motor vehicle, delivery vehicles, etc.

• Equipment – furniture, cash register, computer, shelves, etc.

Important:

Fixed assets are always entered in the books at cost price (purchased price). This is an important accounting principle. If the business purchased Land and Buildings on 1 March 2008 for R500 000 and the Land and Buildings are re-valued on 1 March 2011 at R650 000, the original (historical) amount of R500 000 will still be entered in the books. Installation costs are part of the cost price. Example: If a business purchased computers for R32 000 and there are installation costs of R5 000 involved, the amount entered in the Equipment account will be R37 000 (R32 000 + R5 000).

Financial assets If the business is doing well and there are cash to spare, this money can be invested for a certain period at a fixed interest rate. This asset is called a fixed deposit or an investment. The original amount invested at a financial institution will be the financial asset and the interest earned on the fixed deposit will be an income for the business.

Current assets

Current assets are assets that can be converted to cash within one year. These assets are short-term assets and are temporary in nature.

• Trading stock – goods or merchandise acquired at a specific price and sold at a specific price after profits have been added. Trading stock is always entered in the business books at cost price.

• Debtors – when the business sells goods on credit, the debtors are the people who owe money to the business.

• Bank – the money in the business’s bank account referred to as a favourable/debit bank balance.

• Cash float – this is cash, in small denominations, kept in the cash register and used to give change to the customers.

• Petty cash – cash used to make small payments.

1.2.2 Liabilities Money owed to an enterprise or a financial institution.

There are two types of liabilities:

• Non-current liabilities = long term

• Current liabilities = short term

Non-current liabilities Should the business need money to buy, for example, a vehicle, it may borrow the money from a financial institution. It usually takes longer than a year to repay this liability and it would be repaid at a certain interest rate per year. A loan is an example of a long-term liability. Interest is payable on a loan. The original loan amount is a liability and the interest on paid on the loan, is an expense. Current liabilities These liabilities are usually paid for within one year.

The following are examples of current liabilities:

• Creditors – if the business purchases trading stock on credit, the supplier to which the money is owed is called a creditor.

• Bank overdraft – should the business experience a cash flow problem, an overdraft facility is negotiated with the bank. In this instance, the bank is a liability to the business.

Owner’s Equity

/capital invested in the business by the owner. This is the owner’s interest in the business. The owner can increase his capital contribution by depositing cash in the business, fixed assets or trading stock. Money, fixed assets or trading stock withdrawn by the owner during the year is called drawings. Drawings decrease the owner’s equity. The aim of the business is to make a profit. In order to make a profit, the business must do business or deliver a service in order to generate a certain income. In order to gain this income, the business should incur certain expenses. The income and expenses will have an influence on the owner’s equity in the business.

Important:

An important accounting principle is applicable here, namely the business entity principle. The owner and the business are two separate entities. Thus, the bookkeeping of the business and that of the owner should be kept strictly separate. Example: The owner wants to take out insurance for his wife’s vehicle. He is not allowed to pay this out of the business funds; he has to pay it out of his personal funds.

Operating expenses

One needs money in order to run a business. Employees should be remunerated. Necessary services also need to be paid for, e.g. water and electricity and telephone bills. If the business does not own a building, a building needs to be rented. Operating expenses consists of:

• Payments for services delivered to the business, such as rent, wages and salaries.

• Consumables used in the business, such as stationery, packing material and fuel.

• Cost of sales – the cost price of goods sold is an expense and decreases the profits and eventually the equity. Operating expenses have an influence on the profit of the business. Operating expenses decreases owner’s equity.

Income

There are two ways in which a business can gain income:

• Current income – by delivering a service, e.g. plumbers, doctors, etc.

• Sales – a trader delivers a service by purchasing goods and selling the same goods at a profit, e.g. a grocery store.

The two ways in which a business can gain an income, will be the main source of income. There can be other ways that a business can gain income.

An example is that the business can rent out part of the building to a third party. The income gained will be an operating income. The takings received from the income influences the business’s profits. Income increases profits, resulting in an increase of owner’s equity.

Important:

In the discussion about income and expenses we talked about operating income and operating expenses.

What does the word operating mean?

“Operating” refers to the daily transactions that happen in the business.

Example: Expense The water and electricity used in the business is a daily expense and therefore an operating expense.

But, if the business took out a loan and the interest paid on the loan is not a daily expense, this expense is not part of the operating expense of the business.

This will be discussed in depth when we do the Financial statements.

Example: Income If a business renders a service, the income received is a daily income and will be an operating income.

But, if the business invests money on a fixed deposit, the interest received from the fixed deposit is not part of the daily activities of a business and interest on fixed deposit is therefore not an operating income. This will be discussed in depth when we do the Financial statements.

1.3 Accounting equation

The following equation can be deduced from the accounting concepts:

ASSETS = OWNER’S EQUITY + LIABILITIES

OR OWNER’S EQUITY = ASSETS – LIABILITIES

OR LIABILITIES = ASSETS – OWNER’S EQUITY

Complete the following activity to fill in the missing words.

1. Trading stock is always entered in the books at .........................

2. Land and buildings will be shown in the books of a business at the purchased price. Which accounting principle is this based on? ………………

3. Income and expenses have an influence on the ............................... of the business.

4. Persons to whom the business owe money are known as ...................

5. An asset purchased by the business with the aim of changing it into cash within one year, is a .................... asset.

6. If bank is overdrawn, it is .........................................

7. Which accounting principle does the following statement apply to? “The bookkeeping of the business and that of the owner should be kept strictly separate” ............................

8. The aim of any business is to make ....................

9. A .............................. buys finished products (products that are manufactured and ready to be sold), adds a profit and sells it to make a profit.

10. Non-current assets consist of ........................ and .................................

Explanation of a General Journal

1 The day the transactions occurred.

2 The account that will be debited in the General Ledger and the subsidiary ledger.

3 The account that will be credited in the General Ledger and the subsidiary ledger.

4 A description of the transaction and the voucher.

5 The total of the Debtors’ control account that will be debited in the General Ledger. Journal debits/Sundry accounts will be written in the details column.

6 The total of the Debtors’ control account that will be credited in the General Ledger. Journal credits/Sundry accounts will be written in the details column.

7 The total of the Creditors’ control account that will be debited in the General Ledger. Journal debits/Sundry accounts will be written in the details column.

8 The total of the Creditors’ control account that will be credited in the General Ledger. Journal credits/Sundry accounts will be written in the details column.

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| Transaction | Account debited | Account credited |
| Cancellation of discount on dishonoured cheque | Debtor’s name and Debtors’ control | Discount allowed |
| nterest charged on overdue debtors account | Debtor’s name and Debtors’ control | Interest on overdue debtors |
| Interest paid on overdue creditors account | Interest on overdue creditors | Creditor’s name and Creditors’ control |
| Written a debtors’ account off as irrecoverable | Bad debts | Debtor’s name and Debtors’ control |
| Donation of stock at cost price | Donations | Trading stock |
| Drawings of trading stock at cost price | Drawings | Trading stock |
| Drawings of consumables (example: stationery) at cost price. | Drawings | Stationery |
| Capitalisation of interest on loan at MB Bank | Interest on loan | Loan: MB Bank |
| Capitalisation of interest on fixed deposit at XY Bank | Fixed deposit: XY Bank | Interest on fixed deposit |

**Correction of errors**

It may happen that source documents are written into the journals incorrectly or posting errors may be made to the General Ledger, Debtors’ ledger and Creditors’ ledger.

It may happen that the errors are not immediately traced because they have been posted to the correct side of the account.

These errors are only traced when the books are checked. In accounting it is not correct simply to draw a line through the recording.

Another recording must be done in order to correct the error.

Most errors are corrected in the General Journal.  
 If an error has been made in a subsidiary journal, the following should happen:

• Transaction is omitted = do a recording in the relevant journal.

• If the amount is too small = put the difference between the amounts in the subsidiary journal.

• If the amount is too big = put the difference between the amounts in the subsidiary journal.

**Posting errors**

• The wrong amount to the correct account = do a single journal recording.

• The correct amount to the wrong side of the account = do a single journal recording.

• If posting to the wrong account = take the amount out of the account and place it in the correct account. This is done in the General Journal.

It is impossible to explain all the errors that may occur. It is important, however, to see where the error has occurred, and do the corrections accordingly. To help you, it would be wise to draw a T-account. Write the error in, and then do the correction.

Activity 13 (General Journal)

Required Record the following transactions in the General Journal of Davido Traders for May 2011. Note: Don’t do any narrations.

Transactions: May 2011

4 Charge G. Patella’s (a debtor) overdue account with 6% interest per annum for three months. G. Patella owes R8 200.

6 A. Mosterd (a debtor) who owes R1 200 is declared insolvent. Receive a first and final dividend of 30 cents in the rand (this is already recorded in the books). Write his account off as bad debt.

9 Receive R. Ndlovu’s cheque back from the bank with a bank debit note for R980 (this is already recorded in the books). R20 discount was given to R. Ndlovu when he settled his account earlier.

14 The owner, G. Nel takes merchandise for personal use. The selling price of the goods is R500 (cost price, R300).

16 Mercandise bought on credit from Storm Traders for R3 400 has been recorded correctly in the journal, but it was posted to Stork Traders by mistake. Correct the error.

24 Trading stock of R1 600 was bought from Schaik Traders and it was posted to the Stationery account in the General ledger. Correct the error.

28 Donate R4 000 (cost price) worth of trading stock to the local old age home.

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| ANSWER BOOK | | | | | | | | |
| General Journal May 2011 | | | | | | | | |
| Day | Details | Folio | Debit | Credit | Debtors’ control | | Creditors’ control | |
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Classification of General ledger accounts The table below is a summary of the accounts and their classification:

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| DAX (Debit accounts) | CIL (Credit accounts) |
| Drawings (OE – Balance sheet)  Assets (Balance sheet)  Expenses (Nominal) | Capital (OE –Balance sheet)  Income (Nominal)  Liabilities (Balance sheet) |

The following table is an expanded version that will give you more information on the various types of accounts under each classification. It is important to know this table so that you can be confident with General ledger accounts and analysis of information according to the accounting equation, A=OE + L

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| --- | --- | --- | --- |
| All the accounts listed on the debit side, start with a debit balance. An increase in these accounts will also be debited and a decrease will be credited. | | All the accounts listed on the credit side, start with a credit balance. An increase in these accounts will also be credited and a decrease will be debited. | |
| Debit Accounts (DAX) | | Credit Accounts (CIL) | |
| Debit Increase | Credit Decrease | Debit Decrease | Credit Increase |
| Owner’s Equity (Balance Sheet) | | Owner’s Equity (Balance Sheet) | |
| • Drawings | | • Capital | |
| Assets (Balance sheet) | | Income (Nominal) | |
| Tangible Assets     * Land and buildings * Vehicles * Machinery * Equipment * Computers   Financial Assets  • Fixed Deposits  • Investments  • Shares  • Unit Trusts  Current Assets  • Trading Stock  • Debtors/ Accounts Receivable  • Bank  • Cash Float  • Petty Cash  • Savings Account  • Accrued Income  • Prepaid Expenses  • Consumables on hand | | * Sales   • Current Income/ Service Fees/Fee Income  • Rent Income  • Commission Income  • Interest on current bank account  • Interest on investment/ fixed deposits  • Interest on savings account | |
| Expenses (Nominal) | | Liabilities (Balance Sheet) | |
| * Cost of Sales   • Interest on loans  • Bank Charges  • Interest on Overdraft  • Debtors Allowances  • Other daily or monthly expenses like  salaries and wages, water and electricity,  stationery … | | Current  • Creditors/ Accounts Payable  • Bank Overdraft  • Loans  • Accrued Expenses  • Income received in advance  Non- Current (Long Term 12 months +) Loans > 12 months | |