About Financial Accounting

VOLUME 1

Fifth edition

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Volume 2

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Preface

The accelerating globalisation of business has affected South Africa in many ways and the discipline of accounting has not been left untouched. Accounting is a challenging subject because it is always changing. These changes are reflected in this book, but the authors have not lost sight of the fact that the basic principles of accounting have not altered since the invention of double-entry bookkeeping centuries ago.

One has to learn to crawl before one can learn to walk. This is a fact of life and a reflection of life itself. With this in mind, many aspects of the intricacies of disclosure and the exact or complete disclosure requirements of generally accepted accounting practice were left for the more advanced student of accounting. This book is not intended to be a reference book. Rather, the following guidelines were adopted by the authors:

- simplicity
- basic principles
- creating knowledge blocks
- practical application
- demonstration by way of examples.

To achieve this goal, the focus is on a handwritten system, thus avoiding the notion that the basics of accounting, like the processing of data and closing-off procedures, are mysterious activities that take place inside a computer. This notion seems to be a growing problem for serious students of accounting.

The book is divided into two volumes. Volume 1 deals with the financial accounting concepts, principles and procedures. Volume 2 deals with the accounting for partnerships, close corporations, branches and manufacturing entities. Volume 2 also covers some management accounting principles such as budgets and the analysis and interpretation of financial statements. It introduces the reader to companies and to the accounting framework and statement of cash flows for the entities mentioned.

The authors of this book represent a large pool of lecturing and practical experience gained over many years of work and study. This book reflects the hard work and determination of these authors, for which we are very grateful.

The editors
November 2014

Table of abbreviations

APB	Accounting Practices Board
FRS	Financial Reporting Standard
GAAP	Generally Accepted Accounting Practice
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
JSE	JSE Limited
SAICA	South African Institute of Chartered Accountants

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CHAPTER **1**

The basic concepts, principles and objectives of accounting

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1.1 Introduction

Study objectives

After studying this chapter you should be able to

- ☐ describe how accounting developed over the ages;
- ☐ define accounting;
- ☐ describe the function of accounting;
- ☐ explain the entity concept;
- ☐ explain why an accounting framework is necessary;
- ☐ describe the nature of and the need for financial information;
- ☐ identify the various users of financial information;
- ☐ describe what the objectives of financial statements are;
- ☐ explain what is meant by financial performance, changes in equity, financial position and cash flow;
- ☐ describe what the accounting process entails;
- ☐ distinguish between the two main types of financial information;
- ☐ describe the assumptions underlying the preparation of financial statements;
- ☐ explain what the qualitative characteristics of financial statements are;
- ☐ identify the elements of financial statements;
- ☐ describe the recognition of the elements of financial statements; and
- ☐ explain what is meant by the measurement of the elements of financial statements.

Accounting is a means of communication. To communicate, one must know at least the basics or the foundation of the language of the party with whom one is communicating. The first two chapters of this book deal mainly with accounting history and theory, providing a foundation of the basics of the accounting "language". Without the theory regulating the subject of accounting, it would be very difficult, perhaps impossible, to communicate in accounting terms.

In accounting, the conceptual framework and other rules are laid down by the South African Institute of Chartered Accountants (SAICA) after approval by the Accounting Practices Board (APB). To comply with international accounting standards the Conceptual Framework for Financial Reporting 2010 (the IFRS Framework) was approved by the International Accounting Standards Board (IASB). Although these rules are important, the detail presented in the framework is not required for understanding the basic accounting concepts, principles and procedures. The present volume of *About Financial Accounting* will therefore only make limited reference to the framework.

The purpose of this chapter is to explain the function and objectives of accounting, the need for financial information, who the users of the financial information are, the processes by means of which this information is generated and how this information is communicated to the users thereof.

1.2 What is bookkeeping and what is accounting?

Bookkeeping involves the identification and recording of economic events. This is only one part of the accounting process.

Accounting can be defined as the orderly and systematic *identification* and *recording* of the monetary values of the economic transactions of an individual entrepreneur (person) or a business enterprise (entity or institution), the *reporting* on the results of these transactions and the *provision* of financial information by submitting financial statements which information is used as a basis for decision-making. Accounting therefore includes bookkeeping.

The above definition indicates that accounting must fulfil the following requirements:

- the orderly and systematic recording of
- the monetary values of
- economic transactions of
- an individual person or an institution (entity);
- the reporting on the results of these transactions; and
- the provision of the information in financial statements,
- which information is used as a basis for decision-making by the users of the information.

1.3 Why study accounting?

Knowledge of accounting is needed

- by the users of financial information; and
- by the preparers of financial information.

All *users* of financial information need not be trained accountants. Anyone who has to make financial decisions, based on information disclosed by the accounting process, should, however, at least have a basic knowledge of accounting. The decision-maker must have an understanding of the information disclosed in the financial statements in order to make proper decisions. The more complex the information on which the decision is to be based, the greater the required knowledge of accounting. Knowledge of accounting will also enable any individual to manage his or her personal financial affairs more effectively.

The *preparer* of financial information, ie the accountant who accepts responsibility for the design of accounting systems, the processing of financial information in the accounting process and the preparation and interpretation of financial reports, requires a profound knowledge of the theory and practice of the subject.

In addition, a wide variety of career opportunities exist for those with accounting training. The accounting profession enjoys a high level of prestige in society and provides a great deal of job satisfaction and security. The accountant, in the performance of normal responsibilities, acquires a thorough insight into all the aspects of the activities of a business. An accounting qualification is an excellent entry opportunity into the business world.

1.4 Developments in accounting

Accounting had been developed over many centuries as a result of the need to account for assets entrusted to people and/or entities who have the responsibility of dealing with these assets in a particular manner.

Although evidence exists that business transactions were recorded more than 6 000 years ago, Benedetto Cotrugli was probably the first person who wrote a chapter on accounting, in a book published in 1458 about the commercial function. In that chapter, he presented a brief discussion of bookkeeping. The first published work with a full description of the double-entry system was completed by Luca Pacioli in his *Summa de arithmetica geometria proportioni et proportionalitate*, which was published in 1494 in Venice. His *Summa*, which was a mathematical work, contained a section on the Venetian method of double-entry bookkeeping. In the rest of Europe, the first works on double-entry bookkeeping appeared towards the middle of the sixteenth century in Antwerp in 1543, in London in 1547 and in Germany in 1549.

The 300 years between Pacioli's *Summa* and the more scientific accounting of the nineteenth century was a period of refinement and elaboration of the procedures described by Pacioli. The *Summa* became the standard reference work for bookkeepers and a model for numerous textbooks that provided a record of bookkeeping innovations between the fifteenth and the nineteenth centuries.

The development of bookkeeping can be divided into three phases:

- The period from 1450 to 1560: Business practices were more sophisticated than textbooks, and authors tried to promote bookkeeping mechanics as developed by merchants.
- The period from 1560 to about 1800: Major improvements were made to the bookkeeping model and theoretical research on bookkeeping began, especially with the emergence of financial statements and the acknowledgement of enterprises as being separate and distinct from their owners.
- The period since 1800: Manufacturing operations, income tax and the emerging accounting profession have acted as major stimulants to the development of bookkeeping.

The early literature mainly described the technique of *bookkeeping*, ie how transactions could be recorded according to the double-entry system. The development of the theory of *accounting*, ie the why as opposed to the how, began only in the nineteenth century.

Towards the middle of the nineteenth century, the formation of professional accounting societies began in many countries. The purpose of the various institutes and societies was to make recommendations on accounting practice to their members. This was to improve uniformity in dealing with financial transactions and to formulate basic principles applicable to financial statements. Today, the issuing of recommendations on accounting practice is one of the most important functions of professional societies of accountants and auditors throughout the world.

The first organised society of accountants in South Africa came into being in 1894, with the formation of the Institute of Accountants in the then South African Republic (the ZAR). Today, the profession in South Africa is organised into various provincial

and national accounting institutes and societies, the most prominent being the South African Institute of Chartered Accountants (SAICA).

Currently, the Auditing Profession Act 26 of 2005 controls the practising section of the accountancy profession in South Africa. This legislation regulates the Public Accountants' and Auditors' Board, whose functions include registering accountants and auditors who are permitted to practice in public, ensuring discipline in the profession and training accountants.

1.5 The function of accounting

The main goal of accounting is to capture information about a business and its financing activities so that it can be reported to decision-makers, both inside and outside the business.

A trading entity purchases merchandise which is sold at a price higher than the purchase price plus other related costs. The difference between the purchase price and costs on the one hand and the higher selling price on the other is called a profit. The proceeds from the profit increase the assets of the entity and are available for use. The financial results of economic activities therefore have two aspects:

- ☐ the value added to the net worth of a person or an entity during a particular period; and
- ☐ the accumulated net worth of that person or entity.

A single statement may not be enough to fulfil all the needs of a user of the information since information about one transaction may be included in different statements. For example, the information disclosed on the statement of profit or loss and other comprehensive income may give an incomplete picture of the entity's performance and the information in the statement of financial position and statement of cash flows, or even that disclosed in the notes or schedules, may be necessary.

The notes and schedules include aspects such as risks and uncertainties that may influence the future results or position of the entity. Resources and obligations not disclosed on the statement of financial position (such as insurance claims against or by the institution) are also included in the notes. It would therefore be necessary to make a study of the complete set of financial statements before a decision can be made.

Information about the financial results of an entity is provided in a complete set of financial statements consisting of

- ☐ a statement of financial position as at the end of the period;
- ☐ a statement of profit or loss and other comprehensive income for the period;
- ☐ a statement of changes in equity for the period;
- ☐ a statement of cash flows for the period;
- ☐ notes comprising a summary of significant accounting policies and other explanatory information; and
- ☐ a statement of financial position as at the beginning of the earliest comparative period, when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements.

1.6 The entity concept

An *entity* is an economic unit whose financial results are determined on its own. In practice, all economic activities are undertaken by a single person, a group of persons in partnership, a business undertaking or group of business undertakings, a church, school, university, or any other institution for which it is necessary to report separately on the finances thereof. Accounting reports on the financial results and position of an entity. All transactions relating to a specific entity are recorded in the accounting records of that entity; *transactions not relating to that entity are thus excluded*.

The accounting process treats an accounting entity as a unit independent of its owners. A business owned by a particular person is thus regarded as being a separate entity from the owner. The person owning the business is in turn regarded as being separate from the business. For the financial information to be meaningful, the entity to which the information relates must be clearly defined. A person using the financial information must be sure about the identity of the entity concerned.

Most entities are defined legally, ie by statute – for example, companies registered in terms of the Companies Act or close corporations registered in terms of the Close Corporations Act – or by common law, and can be identified fairly easily. In terms of the Companies Act, an incorporated (registered) company is a legal person and is therefore an independent entity.

Specifications regarding the accounting concepts, principles, procedures and methods are not given in the Act. These have been laid down by the accounting profession. The same requirement applies to close corporations and other institutions created by statute.

An accounting entity does not necessarily have to be an acknowledged legal entity. Any economic entity, whether it exists as an individual legal entity or not, for which separate financial statements must be prepared, can be considered to be an accounting entity.

In the private sector, there are mainly four types of business organisations *with profit motives* that can be considered as individual entities:

- ☐ sole traders (or sole proprietors);
- ☐ partnerships;
- ☐ close corporations; and
- ☐ companies.

A wide variety of private-sector organisations with various objectives and *without a profit motive* can be regarded as individual entities:

- ☐ clubs;
- ☐ charitable organisations;
- ☐ churches;
- ☐ educational institutions;
- ☐ associations; and
- ☐ trusts.

In the public sector, the state as a whole or individual government establishments such as provinces, state departments, municipalities, boards and commissions are all regarded as accounting entities.

1.7 The nature of and the need for financial information

The main function of information is to support decision-making. Financial information supplied by the accounting process is primarily used for decisions directed at planning or at exercising control.

- ☐ For *planning decisions*, financial information is used in determining future actions to be taken, often based on what happened in the past. The accounting process provides historical information – it records what happened in the past and reports on this. Decision-makers often require information in order to forecast future financial results. The historical information provided by the accounting process serves as a basis for forecasting the future.

  Planning decisions are sometimes very simple as in, for example, the case of routine activities, sometimes very complex when, for example, decisions regarding the financial strategy and planning of an entity for the next financial year are to be made.
- ☐ *Control* decisions entail using financial information to evaluate the results of financial activities. A control decision can be that the decision-maker is satisfied with the results and that no further action is required. If the decision-maker is not satisfied with the results, action, which will lead to additional corrective steps being taken, may be necessary.

  The most important control function of financial information is the provision of accountability and stewardship. Financial accountability is the responsibility of a person to whom assets have been entrusted and entails giving account to the provider of the assets regarding the use of the assets. The provider of the assets exercises control over the use of the assets through the enforcement of accountability.

The different decision-makers have different needs and use the information disclosed in the financial statements differently.

1.8 Users of financial information

The *users* of financial information as presented in the financial statements include

- ☐ *Investors*: Investors are the providers of capital. They are concerned with the risk involved in their investment and the return (interest or dividends) they will receive on their investment. They need information to decide whether they should invest (buy), hold or withdraw (sell) shares.
- ☐ *Employees*: Employees are interested in information about the stability and profitability of the business. They also want to know whether the entity will be able to pay remuneration and retirement benefits and whether there are any employment opportunities.
- ☐ *Lenders*: Lenders need information to determine whether their loans and the interest on the loans will be paid on due dates.
- ☐ *Suppliers and other trade creditors*: These users need information that will assure them that amounts owed to them will be paid when due.
- ☐ *Customers*: Customers want to know whether the business will continue to exist, especially when they will be involved with the entity for a long time or are dependent on it.

- *Government and their agencies*: These users are interested in the allocation of resources and therefore in the activities of the entity. They also need information in order to regulate the activities of entities, determine taxation policies and use the information as a basis for national income and similar statistics.
- *Public*: Members of the public are affected in several ways. Entities often contribute to the local economy by employing people and supporting local suppliers.

It is the primary responsibility of the management of an entity to prepare and present the financial statements. Since management is also a decision-maker, it needs the information disclosed in the financial statements. Management has, in addition, access to other management and financial information that helps it to carry out its planning, decision-making and control functions. For this, it has the ability to determine the format and content of the additional information to meet its own needs. Published financial statements are based on the information used by management about the financial position, performance and changes in equity and the cash flows of the entity.

1.9 The objective of financial statements

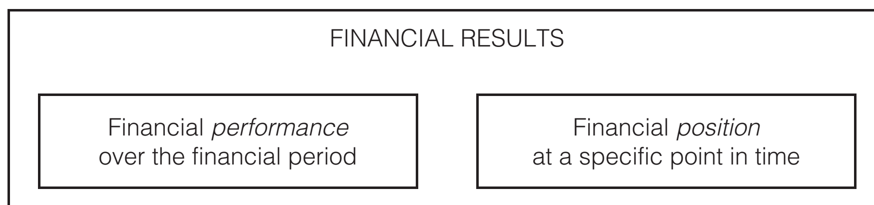
The objective of financial statements is to provide users with useful information about the financial performance, financial position and changes in the financial position to enable them to make economic decisions. Financial statements meet the common needs of most users but do not always provide all the information that users may need. Financial statements largely disclose the financial effects of past events, but do not necessarily provide relevant non-financial information.

1.10 Financial performance, changes in equity, financial position and cash flow

1.10.1 *Statement of profit or loss and other comprehensive income*

The *financial results* of an entity consist of economic activities which are measured in two ways: firstly, the *financial performance* for a particular period and, secondly, the *financial position* at a particular point in time. This is illustrated in diagram 1.1.

Diagram 1.1



The *financial performance* reflects the profit made or the loss incurred by the entity *over a specific period of time*. It is reported in a *statement of profit or loss and other comprehensive income*. A statement of profit or loss and other comprehensive income reports the two elements of financial performance, ie *revenue* that was earned and *expenses* that were incurred to earn the revenue. The difference between the revenue and the expenses results in the *profit* or *loss* for that specific period. The various types of revenue and expenses are shown as separate items on the statement of profit or loss and other comprehensive income.

Information about the performance of an entity is required to assess potential changes in the economic resources that the entity may control in the future. This type of information is useful in predicting the capacity of the entity to generate cash flows from its existing resources. It may also help in assessing the effectiveness of the way in which new resources will be managed. Example 1.1 shows the statement of profit or loss and other comprehensive income of Alpha Services.

Example 1.1

Alpha Services
Statement of profit or loss and other comprehensive income for the year ended 31 March 20.2

	R
Revenue	850 000
Income from services rendered	850 000
Distribution, administrative and other expenses	(579 000)
Salaries	520 000
Wages	50 000
Telephone expenses	4 000
Stationery	2 000
Insurance	3 000
Profit/Total comprehensive income for the year	271 000

1.10.2 *Statement of changes in equity*

Information regarding changes in the equity of an entity must be reported in a statement specially formatted to show those changes. This statement also forms a "link" between the statement of profit or loss and other comprehensive income (reflecting the profit or total comprehensive income for the year) and the statement of financial position (reflecting the capital or equity) of the entity.

In its simplest form, a statement of changes in equity starts with the balance of the capital at the beginning of the financial period and ends with the balance of the capital at the end of the financial period. Example 1.2 shows the statement of changes in equity of Alpha Services.

Example 1.2

Alpha Services
Statement of changes in equity for the year ended 31 March 20.2

	R
Balance at 1 April 20.1	409 000
Additional capital invested	100 000
Profit/Total comprehensive income for the year	271 000
Drawings	(90 000)
Balance at 31 March 20.2	690 000

1.10.3 *Statement of financial position*

The *financial position* is usually determined at the end of the period, ie *after* the financial performance for that period has been determined on the statement of profit or loss and other comprehensive income. The financial position reflects the *net worth* of the entity *at a specific point in time*. This position is determined in terms of *assets* and, against that, the *interests* of the various parties that funded the assets.

The financial position is reflected in a financial report known as a *statement of financial position*. The financial position of an entity is affected by the entity's

- ☐ economic resources;
- ☐ financial structure;
- ☐ liquidity;
- ☐ solvency; and
- ☐ capacity to adapt to changes in the environment in which it operates.

The statement of financial position of a small entity, Alpha Services, is shown in Example 1.3.

Example 1.3

Alpha Services
Statement of financial position as at 31 March 20.2

	R
Assets	
Property, plant and equipment	500 000
Trade and other receivables (Debtors)	100 000
Cash and cash equivalents	300 000
	900 000
Equity and liabilities	
Equity: Capital	690 000
Long-term borrowings: Sand Bank	150 000
Trade and other payables (Creditors)	60 000
	900 000

The first part of the statement of financial position reflects the assets of the entity, while the second part reflects the sources from which the assets were financed.

The first part of the statement of financial position in Example 1.3 shows that assets to the value of R900 000 were in the possession of Alpha Services as at 31 March 20.2. The statement of financial position also shows a breakdown of the total assets into the various types of assets.

The second part of the statement of financial position shows the sources from which the assets were financed. The owner, Mr Alpha, made a personal contribution of R690 000 which he invested in Alpha Services. The entity therefore owes this amount to the personal account of Mr Alpha. Alpha Services also borrowed an amount of R150 000 from the bank. Creditors supplied goods and/or services to Alpha Services to the value of R60 000. Alpha Services must repay these amounts in future.

Two main types of sources of finance are distinguished, namely *equity* and *liabilities*. The contribution by the owner is the equity. Equity represents the interest of the owner(s) in the assets of the entity. Liabilities are the amounts owing to creditors, for purchases or services received which are to be paid for at a later stage, or financial institutions from which the entity borrowed money. Liabilities reflect the claims of creditors against the assets of the entity. The statement of financial position therefore reflects the three elements of the financial position – assets, equity and liabilities, as indicated in diagram 1.2:

Diagram 1.2

The preparation of financial statements is discussed in detail in later chapters of this book.

1.10.4 *Statement of cash flows*

The economic decisions taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of such generation. Without cash, no entity can survive. Therefore the ability to generate cash will eventually determine whether the entity will be able to meet its commitments, such as the ability to pay its employees, suppliers, to make interest payments, repay loans and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and changes in cash flow of the entity.

Cash equivalents are short-term investments that can easily be withdrawn (converted into cash) without any meaningful risk of changes in value. This means that the investment can be withdrawn from the financial institution (bank) at short notice at the same amount that was invested.

The cash flow of an entity is useful when the investing, financing and operating activities during the financial period are assessed. It provides the user with a basis on which to assess the ability of the entity to generate cash and cash equivalents and the need of the entity to utilise such cash flows.

All entities must prepare a statement of cash flows. The statement of cash flows reflects inflows and outflows of cash during the financial period. The preparation of a statement of cash flows will be discussed in detail in volume 2 of this book.

In order to be able to prepare the financial statements at the end of the financial period, the accounting process must be exercised throughout the financial period.

1.11 The accounting process

The definition of accounting given in paragraph 1.2 above means that the accounting process comprises methods and procedures for the *identification*, *recognition*, *measurement* and *recording* of financial transactions and events that change the financial results and position of an entity. This includes the *processing*, *presentation*, *interpretation* and *use* of the information supplied, which is a result of the economic transactions related to the particular entity.

All transactions and events that have an impact on the financial position of an entity must first be identified before they can be *recognised*, *measured* and *recorded* in the accounting process. *Recognition* is a process of deciding whether an element or item is valid (applicable to that particular entity) and that it should be included in the accounts of the entity. *Measurement* is the process of determining what monetary amounts are to be disclosed for each item in the financial statements. Accounting systems have been developed and designed to identify, recognise, measure and record all routine transactions at the amounts at which they are concluded, as they occur.

As soon as transactions and events have been recognised and measured, they should be *recorded* in the accounting records. A proper accounting system consists of various types of records in which the information is initially recorded and processed. The design of the accounting records and accounting system is very important as the information recorded is processed in the accounting records by collecting, classifying, sorting and summarising it into a format in which it will serve as useful information.

The information processed in the accounting records is then presented in the financial statements and *communicated* to the users of the information. The accounting process will be explained in detail from chapter 2.

1.12 The domains of accounting

Accounting can be divided according to the nature of the information it provides into

- financial accounting; and
- management accounting.

Financial accounting deals primarily with the *external* users of financial information. External users are people and institutions who exist outside the entity and who are not directly involved in the management and day-to-day operations of the entity. They may be outside owners, creditors, clients, or other institutions that have no direct financial interest in the entity. The latter may include government institutions, the community within which the entity functions, interest groups, or even the general public.

Financial accounting produces the formal financial statements (ie statement of profit or loss and other comprehensive income, statement of changes in equity, statement of financial position and statement of cash flows, and notes to the statements) which contain financial information about the entity as a whole.

Management accounting caters mainly for the internal users of financial information of the entity. These users may include the internal management and operational personnel of the entity, who require a wide variety of financial information in order to manage the entity on a day-to-day basis. Management accounting produces reports about specific aspects of the entity's business according to the needs of the various internal users. A study of management accounting falls outside the scope of this book.

1.13 Underlying assumption – Going concern

The "going concern" assumption refers to an entity's ability to continue functioning as a business entity. It is the responsibility of owners (directors) to assess whether the

going concern assumption is appropriate the financial statements are being prepared. A company is required to disclose in the notes to the financial statements whether there are any factors that may put the entity's status as a going concern in doubt.

Financial statements are prepared on the assumption that the entity is a going concern – that is, that the entity will continue in operation for the foreseeable future and will be able to realise assets and discharge liabilities in the normal course of operations. This underlying assumption is a fundamental concept in accounting. Different bases of measurement may be appropriate when the entity is not expected to continue in operation for the foreseeable future.

The entity's auditor must consider whether the use of the going concern assumption is appropriate and whether there are material uncertainties about the entity's ability to continue to operate as a going concern that need to be disclosed in the financial statements. An auditor considers such items as negative trends in operating results, loan defaults and denial of trade credit from suppliers in deciding whether there is a significant going concern issue and issues an opinion reflecting this.

So, the going concern assumption assumes that the business will remain in existence long enough for all the assets of the business to be fully utilised – in other words, long enough for complete benefit to be obtained from the assets' earning potential. For example, if you recently purchased equipment costing R50 000 that had 5 years of productive or useful life, under the going concern assumption the accountant would write off only one year's value R10 000 ($^1/_5$ of the cost) in the first year, leaving R40 000 to be treated as a fixed asset with future economic value for the business.

The going concern concept supports the assumption that when a business buys assets like land, equipment or buildings, it does so intending that these assets will produce income over a number of years. In other words, the business did not purchase these assets with the intention of closing operations soon afterwards and then reselling them.

The going concern assumption can be summarised as follows:

GOING CONCERN ASSUMPTION			
Assumes an entity will continue to trade or do business for the foreseeable future.	Allows costs and revenue to be allocated to future accounting periods.	Provides a more realistic value of the entity's assets.	Allows fixed assets to be written off proportionally over their useful life.

1.14 Qualitative characteristics of financial statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.

Users of the information supplied by the accounting process and in financial statements would like to be certain that the information given accurately portrays the

results and financial position presented. For this reason, information disclosed in the financial statements must comply with the fundamental qualitative characteristics, namely relevance and faithful representation.

1.14.1 *Relevance*

For financial statements to be useful to their users, the information included must be *relevant*. Users must be able to use the particular information to make decisions based on it.

Relevant information plays both a forecasting or predictive role and a confirming role. It serves as the basis on which forecasts can be made, and can be used to confirm to what extent the previous forecast has materialised.

Materiality is an entity-specific aspect of relevance. It is judged in relation to the nature and extent of the activities of the entity. When the economic results of transactions are immaterial to the overall activities of the entity, they can be treated in any way the accountant deems fit. Deciding whether an issue is material is a matter of professional judgement.

Thus, if an entity with an annual turnover of R50 million purchases merchandise at R1 000 per unit and if, at the end of the financial year, there are 2 000 of these items in stock, the inventory will be valued according to the historical cost basis at R2 million. This value is material and must be disclosed separately in the financial statements. If the same entity buys 100 pencils for R100, and at the end of the financial year there are only 20 of these pencils in stock, the inventory of pencils (20 @ R1 = R20) will, in accordance with the materiality principle, not be disclosed separately (because the value is immaterial).

1.14.2 *Faithful representation*

Information must represent transactions and other events faithfully. Most financial information, however, is subject to the risk that it represents less than faithfully that which it means to reflect.

1.14.3 *Further enhancements to the qualitative characteristics of financial information*

1.14.3.1 Comparability

Users must be able to compare the information disclosed in the financial statements of an entity over time, in order to identify trends in the entity's financial position and performance. Comparison of different entities must also be possible, so that their relative financial positions, performances and changes in financial position can be evaluated. Similar transactions must be disclosed consistently in an entity from one period to another. Different entities must disclose similar transactions in a similar way for comparison purposes.

For this reason, the accounting policies used in the preparation of the financial statements should be disclosed as well as any changes and their effect on those policies. Users must be able to identify differences between policies followed by an entity for similar transactions from one period to another. This will help when entities are compared with one another.

The need for comparability should not be confused with a need for uniformity and should not be allowed to become the reason for a change in accounting standards. The accounting policy applied must be for the sake of relevance and reliability. When more reliable alternatives exist, entities should change their policies accordingly.

Corresponding information for the preceding periods must be included in financial statements to enable users to compare the financial position, performance and changes in the cash position of an entity. Thus, to be useful, information in financial statements should be *comparable* to information from prior periods and to corresponding information of similar entities. There must therefore be consistency in the way in which similar transactions or items are dealt with in financial statements both within an accounting period and from one period to the next. The presentation and classification of items in the financial statements of consecutive periods should therefore be the same, unless

- significant changes have occurred in the activities of the entity;
- a change will result in better disclosure; or
- a new IFRS is published.

In such cases, the comparative figures should also be disclosed on the new basis.

1.14.3.2 Verifiability

Different analysts and independent observers should come to the same conclusions regarding the representation in the financial statements.

1.14.3.3 Timeliness

Financial statements must provide useful information to interested parties. It can be assumed that the longer it takes to make the information available, the less useful the information becomes. Information should be made available on time, as and when required, but still be reliable.

1.14.3.4 Understandability

Users of financial statements must be able to understand them otherwise such statements serve no purpose. This means that financial statements should be such that an average person with a reasonable knowledge of business and accounting will have no problem understanding them. This does not mean, however, that complex information that should be included in financial statements must be omitted solely on the grounds that it might not be understood by some users.

1.14.4 *Constraints on relevant and reliable information*

Cost can be a pervasive constraint on the quality of financial information. When statements are prepared, the benefits derived from the information should exceed the cost of providing it. The weighing up of benefits and costs is mainly a judgement process. The cost to some users may be to the benefit of other users.

1.15 The elements of financial statements

Grouping transactions and other events in the financial statements into broad classes, according to their economic characteristics, reflects their financial effects. These

broad classes are termed the *elements of financial statements*. The elements used to measure the *financial position* on the statement of financial position of an entity are

- *assets*;
- *liabilities*; and
- *equity*.

The elements that measure the *financial performance* on the statement of profit or loss and other comprehensive income are

- *income*; and
- *expenses*.

The disclosure of these elements on the statement of financial position and statement of profit or loss and other comprehensive income requires some sub-classification in most cases: for example, assets and liabilities may be classified according to their nature or function as non-current or current, depending on the business of the entity.

These elements will be discussed in detail in later chapters.

1.16 Recognition of the elements of financial statements

The materiality considerations discussed in paragraph 1.14.3 should be taken into account when deciding whether an item should be disclosed separately on the statements. Since there is a relationship between the elements, the recognition of one element, for example an asset, requires the recognition of another element, for example income or a liability.

- *The probability of future economic benefit*: The concept of *probability* is used in the recognition criteria to refer to the degree of certainty with which future economic benefits associated with the item will flow to or from the entity. When it is probable that there will be a future inflow or outflow of resources, the influence must be recognised. When there is no evidence that a debtor will *not* pay his or her account, the total debtors amount must be disclosed as an asset. If non-payment is probable, an expense that represents the reduction in economic benefits (for example, credit losses) must be recognised.
- *Reliability of measurement*: An item must also possess a cost or value that can be measured reliably before it can be recognised, as is discussed in paragraph 1.14.3. The fact that cost or value must sometimes be estimated reasonably will not undermine reliability. If a reasonable estimate cannot be made, the item must not be disclosed on the statements but should be included in a note to the financial statements.

If an item does not meet the recognition criteria at a certain date, it can be recognised at a later stage. When an item fails to meet the criteria, but still possesses the characteristics of an element, it should be disclosed in the notes to the statements in order to provide the users of the statements with the relevant information.

1.17 Measurement of the elements of financial statements

Measurement is the process of determining the amounts to be disclosed for each item in the financial statements. There are several ways in which the amounts can be determined:

- ☐ *Historical cost* is the actual amount paid in cash (or cash equivalents) for the particular asset, or the fair value of the item at the time it was acquired. The historical cost of liabilities is the amount of the proceeds received in exchange for the obligation. In some cases, it will be the amount to be paid to satisfy the liability.
- ☐ *Current cost* is the amount that an entity would have to pay currently to acquire the same type of asset as that which it carries in the normal course of business. Liabilities are shown as the amount of cash that will be required to settle the amount currently.
- ☐ *Realisable (settlement) value* is the amount of cash (or cash equivalent) that will be received currently if the asset is sold (disposed of) in an ordinary disposal. Liabilities are shown at their settlement values, ie as the amounts to be paid in order to satisfy liabilities in the normal course of business.
- ☐ The *present value* of an asset is the current discounted value of the net cash inflows which the asset should generate in the future in the normal course of business. Discounted value is the present value of an amount at a specific rate of interest over the specified period to an end value.

The *historical cost* basis is the most common basis for the measurement of assets and liabilities. It must be combined with other measurement bases in subsequent measurements.

1.18 Summary

The functions and objectives of accounting are important, since they indicate what the subject of accounting entails. The subject of accounting includes an explanation of why it is important, even for individuals for private use, to study accounting. It also includes a description of how accounting has developed through the ages. It answers the questions of what the function of accounting is and what the entity concept entails. These rules and concepts are in line with the *Conceptual Framework for Financial Reporting 2010* approved by the IASB.

The nature of and need for financial information have been explained as has been the nature and needs of users of financial information and the consequent objectives of financial statements.

A complete set of financial statements of an entity comprises

- ☐ a statement of profit or loss and other comprehensive income (to report on financial performance);
- ☐ a statement of changes in equity (to report on such changes);
- ☐ a statement of financial position (to report on the financial position of the entity); and
- ☐ a statement of cash flows.

These statements are accompanied by notes to support the amounts disclosed in the statements or to give more information thereon.

The going-concern assumption as well as the qualitative characteristics of financial statements, have been discussed. These characteristics include relevance, materiality, faithful representation, comparability, verifiability, timeliness and understandability. There is, however, a cost constraint on the provision of quality financial reporting.

Each component of financial statements serves a particular purpose when reporting on the financial position and financial performance of the entity. In order to report on the financial position, assets, liabilities and equity elements must be included on the statement of financial position. In the statement of profit or loss and other comprehensive income the financial performance is indicated by the income, expenses and capital maintenance adjustments that are reported.

CHAPTER 2

The financial position

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2.1 Introduction

Study objectives

After studying this chapter you should

- ☐ understand what is meant by the financial period concept;
- ☐ be able to discuss the elements of the statement of financial position;
- ☐ understand the double-entry system;
- ☐ be able to calculate the elements of the basic accounting equation; and
- ☐ be able to describe the financial position of an entity.

The objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an entity. This information helps a wide range of users make economic decisions. The *financial results* of an entity are reported in the financial statements. A complete set of financial statements includes the following components:

- ☐ a statement of financial position;
- ☐ a statement of profit or loss and other comprehensive income;
- ☐ a statement of changes in equity;
- ☐ a statement of cash flows; and
- ☐ accounting policies and explanatory notes.

The *financial position* will be discussed in this chapter and the *financial performance* in chapter 3.

2.2 The financial period

Financial statements can be prepared annually, six-monthly, quarterly or even on a monthly basis. The financial statements prepared for periods of six months and less are usually for internal use by management, for planning and control purposes. Annual financial statements are compiled on the same date each year and are used by internal (planning and control) and external parties. The period from that date in one year to the day preceding it in the following year is a financial year. Financial statements must, by law, be compiled annually for companies and close corporations. The closing date of the financial year usually coincides with the closing date of the tax year of the entity. The closing dates most frequently used are 31 December, 28 or 29 February (to coincide with the tax year for most individuals) and 30 June.

2.3 The elements of financial statements

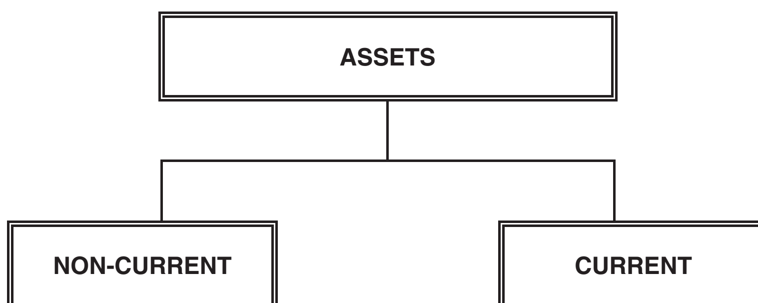
Assets, liabilities and equity are the elements which are found on the statement of financial position. The statement of financial position reflects the *financial position* at a *specific point in time*. Income and expenses are the elements found on the statement of profit or loss and other comprehensive income, which reflects the *financial performance* for a *particular period of time*. The financial performance indicates the change in equity over a particular period as a result of the profit made or the loss incurred during that period. In this chapter, assets, liabilities and equity will be discussed. The elements of the statement of profit or loss and other comprehensive income, namely income and expenses, will be discussed in chapter 3.

2.3.1 *Assets*

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

For a *resource* to be *controlled* by an entity, it does not have to be owned by the entity. A resource also does not need to have physical form, for example, intangible assets (which will be discussed in a later chapter) are resources. The *future economic benefit* expected from assets is the capability they have of directly or indirectly providing an inflow of cash or cash equivalents. An item can be classified as an asset only if it has already been acquired by the entity as a result of *past events*.

Assets are therefore the possessions of the entity. Assets can be either non-current or current, depending on the permanence of the asset.



Non-current assets are those resources of a more permanent nature which are essential in the process of earning income. It is not the intention of the entity to sell non-current assets, but to use these assets over the long-term in its business operations. Non-current assets are those assets with a useful life of longer than one year.

Assets can therefore be classified as non-current when they

☐ were not acquired for the main purpose of resale;
☐ are to be used in the business; and
☐ have a lifespan of longer than twelve months.

The following are examples of non-current assets:

☐ land and buildings;
☐ furniture and equipment;
☐ vehicles; and
☐ financial assets.

Current assets are assets which have a short lifespan and continually change in the normal course of business.

An asset shall be classified as current when it satisfies any of the following criteria:

☐ it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
☐ it is held primarily for the purpose of being traded;
☐ it is expected to be realised within twelve months after the reporting period; or

- ☐ it is cash or a cash equivalent (as defined in IAS 7 *Statement of Cash Flows*) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

All other assets shall be classified as non-current.

The following are examples of current assets:

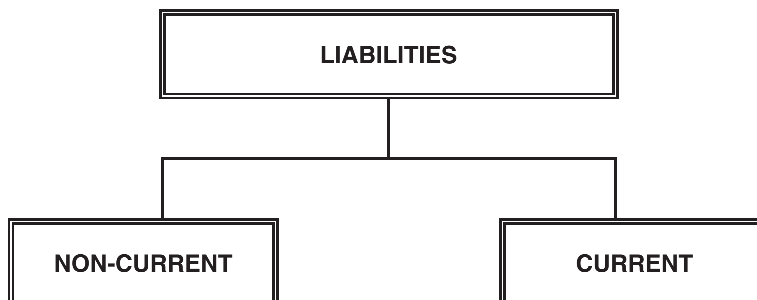
- ☐ inventories;
- ☐ debtors;
- ☐ bills receivable; and
- ☐ cash at bank.

Assets are to be listed in a specific order on the statement of financial position. Firstly, non-current assets are shown, followed by the current assets.

2.3.2 *Liabilities*

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

For an item to be classified as a liability, an obligation towards another party must already exist: this means that there must be a *present obligation*. An obligation is a duty or responsibility to act or perform in a certain way. Only obligations that have arisen from *past events* or transactions can be recognised as liabilities. Future commitments cannot be recognised as liabilities until the entity has received an asset or until an irrevocable agreement has been entered into by the entity to acquire an asset. Obligations are *settled* by cash payments; by means of the transfer of other assets; by the provision of services; or by any other specified performance. The settlement of liabilities arising from the normal course of business often has specified conditions, for example, suppliers may require that accounts be settled within a specified period of time. In many cases, the settlement of an obligation is enforced by contractual agreements or by statutory or other authoritative regulations. These obligations are known as legal obligations; this means that they are enforceable by law. Income taxes payable to government or municipal rates and taxes payable to local governments are examples of obligations that arise from statutory or other authoritative regulations. Liabilities can be non-current or current, depending on when the liability must be settled.



Non-current liabilities are long-term debts, which have to be settled *after* one year of the date of the statement of financial position.

The following are examples of non-current liabilities:

- ☐ long-term loans;
- ☐ mortgages; and
- ☐ debentures.

Current liabilities are debts that have to be settled in the short-term, usually *within* a year of the date of the statement of financial position.

A liability shall be classified as current when it satisfies any of the following criteria:

- ☐ it is expected to be settled in the entity's normal operating cycle;
- ☐ it is held primarily for the purpose of being traded;
- ☐ it is due to be settled within twelve months after the reporting period; or
- ☐ the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

All other liabilities shall be classified as non-current.

The following are examples of current liabilities:

- ☐ creditors; and
- ☐ bank overdrafts.

2.3.3 *Equity*

Equity is the residual interest in the assets of the entity after deducting all its liabilities. Equity represents the interest of the owners in the net assets of an entity, which means the part of the assets against which there is no claim from other parties. The equity of an entity can be obtained from two sources, namely contributions by the owners of the entity and any net profit made in the periods during which the entity is conducting business. Contributions by the owners of the entity are usually in the form of cash, but owners may also contribute other assets, such as land and buildings or machinery and equipment, to the entity. The equity which the owner(s) contribute toward the funding of a sole trader or partnership is known as capital. In close corporations, it is known as members' interests and, in companies, as share capital. Equity is therefore the amount the entity owes to its owners.

Equity differs from liabilities in that liabilities are obligations which must be settled out of the assets of the entity, while equity is not an obligation which has to be settled. Equity is not a claim against assets; it is what is left over after all liabilities are deducted from assets. This can be expressed in terms of the following equation:

Equity = Assets – Liabilities

Written differently:

Assets = Equity + Liabilities

or A = E + L

This equation is known as the basic accounting equation or *BAE*.

2.4 The double-entry system

There are always two sides to a transaction. When a transaction occurs, some form of value is exchanged for another form of value. Every transaction therefore has an influence on two or more items in the BAE and, after each transaction has been recorded, the equation must still balance. The double-entry system is based on this

dual nature of transactions. There are different ways in which transactions can affect the BAE, but the equation must always remain in balance.

2.5 The basic accounting equation (BAE)

As can be seen from paragraph 2.3,

Assets	=	what the entity owns
Equity and Liabilities	=	what the entity owes
What the entity owns	=	what the entity owes

Therefore **Assets = Equity + Liabilities**

The financial position of an entity is indicated by this equation. By using this equation, any unknown elements can be calculated.

Example 2.1

B Buckingham runs a small service business from home. On 30 April 20.2, he tells you that his interest in the business is R28 000 and the value of his assets is R40 000.

Required

Calculate the liabilities of B Buckingham's business.

A = E + L

A – E = E + L – E (subtract E from both sides)

∴L = A – E

= R40 000 – R28 000

= R12 000

The liabilities of the business on 30 April 20.2 amount to R12 000.

Example 2.2

N Nicks is the owner of Nicks Plumbing. The following is a list of the assets and liabilities as at 31 May 20.2:

	R
Vehicles	54 000
Tools and equipment	15 000
Creditors	6 500
Debtors	3 700
Cash in bank	4 300
Long-term loan	20 000

Required

Calculate the equity of Nicks Plumbing.

Identify assets:

Vehicles	54 000
Tools and equipment	15 000
Debtors	3 700
Cash in bank	4 300

Identify liabilities:

Long-term loan	20 000
Creditors	6 500

Using the BAE,

A = E + L

A – L = E + L – L

∴E = A – L

= R(54 000 + 15 000 + 3 700 + 4 300) – R(20 000 + 6 500)

= R77 000 – R26 500

= R50 500

The equity of Nicks Plumbing is therefore R50 500, which means that N Nicks has that amount of capital invested in the business.

2.6 The statement of financial position

The financial position of an entity changes with each transaction or event; therefore the financial position is always measured at a specific point in time. The statement of financial position reflects the financial position of an entity in terms of the basic accounting equation on a specific date. The financial position is always reflected in terms of the three elements in the basic accounting equation, namely, assets, liabilities and equity.

The statement of financial position must have a heading, indicating the name of the entity and the date on which the financial position was measured. The reporting currency must also be indicated, which in the Republic of South Africa is rands. A statement of financial position may be compiled whenever someone wants to determine what the financial position of an entity is; however, a statement of financial position must be drawn up at the end of each financial period.

In the BAE, assets are shown on the left-hand side. Assets can be either non-current or current and are subdivided further to show the various types of assets. (This will be discussed later in the textbook.) The source of the funds that were used to finance the assets – the equity and liabilities – are shown on the right-hand side of the BAE. Non-current liabilities and current liabilities should be identified as such and must be shown separately on the statement of financial position. The total of the right-hand side must always be equal to the total of the left-hand side, that is **Assets = Equity + Liabilities** or, shown differently,

Figure 2.1

BAE as at . . . (specific point in time)

ASSETS	**R**	**EQUITY AND LIABILITIES**	**R**
Non-current assets	X XXX	**Capital***	X XXX
Land and buildings	XXX		
Furniture and equipment	XXX	**Non-current liabilities**	X XXX
Vehicles	XXX	Long-term borrowings	X XXX
Financial assets	XXX		
Current assets	X XXX	**Current liabilities**	X XXX
Inventories	XXX	Creditors	XXX
Debtors	XXX	Bank overdraft	XXX
Cash in bank	XXX		
Total assets	XX XXX	**Total equity and liabilities**	XX XXX

* The equity of a sole proprietor is called capital.

The statement of financial position should be prepared in narrative form, ie vertically. A statement of financial position is not part of the double-entry system but a statement of balances. No entries are made in the accounts when a statement of financial position is compiled. All that happens is that the balances on the accounts are listed. The following is a framework for the *vertical presentation* of the statement of financial position.

Figure 2.2

Statement of financial position as at . . . (specific point in time)

	R
ASSETS	
Non-current assets	XXX XXX
Property, plant and equipment	XXX XXX
Financial assets	XX XXX
Current assets	XX XXX
Inventories	XX XXX
Trade and other receivables	XX XXX
Prepaid expenses	X XXX
Cash and cash equivalents	X XXX
Total assets	XXX XXX
EQUITY AND LIABILITIES	
Total equity	XX XXX
Capital	XX XXX
Total liabilities	XXX XXX
Non-current liabilities	XX XXX
Long-term borrowings	XX XXX
Current liabilities	XXX XXX
Bank overdraft	X XXX
Trade and other payables	XX XXX
Current portion of mortgage loan	X XXX
Total equity and liabilities	XXX XXX

As a minimum, the statement of financial position must include line items that present the following amounts:

(a) property, plant and equipment;
(b) investment property;
(c) intangible assets;
(d) financial assets (excluding amounts shown under (e), (h) and (i));
(e) investments accounted for using the equity method;
(f) biological assets;
(g) inventories;
(h) trade and other receivables;
(i) cash and cash equivalents;
(j) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*;
(k) trade and other payables;

(l) provisions;
(m) financial liabilities (excluding amounts shown under (k) and (l));
(n) liabilities and assets for current tax, as defined in IAS 12 *Income Taxes*;
(o) deferred tax liabilities and deferred tax assets, as defined in IAS 12;
(p) minority interest, presented within equity; and
(q) issued capital and reserves attributable to equity holders of the parent.

Example 2.3

Using the information in Example 2.2, we have the following balances:

	R		**R**
Vehicles	54 000	Cash in bank	4 300
Tools and equipment	15 000	Long-term borrowings	20 000
Creditors	6 500	Equity	50 500
Debtors	3 700		

Required

Compile the statement of financial position for Nicks Plumbing as at 31 May 20.2.

Nicks Plumbing
Statement of financial position as at 31 May 20.2

	R
ASSETS	
Non-current assets	69 000
Property, plant and equipment R(54 000 + 15 000)	69 000
Current assets	8 000
Trade and other receivables	3 700
Cash and cash equivalents	4 300
Total assets	77 000
EQUITY AND LIABILITIES	
Total equity	50 500
Capital	50 500
Total liabilities	26 500
Non-current liabilities	20 000
Long-term borrowings	20 000
Current liabilities	6 500
Trade and other payables	6 500
Total equity and liabilities	77 000

2.7 Summary

The financial position of an entity is shown on the statement of financial position, which is made up of three elements, namely

- ☐ assets;
- ☐ equity; and
- ☐ liabilities.

The statement of financial position shows the financial position at a specific point in time. With every transaction, the financial position of an entity changes, thereby changing the value of one or more of the elements.

CHAPTER 3

The financial performance

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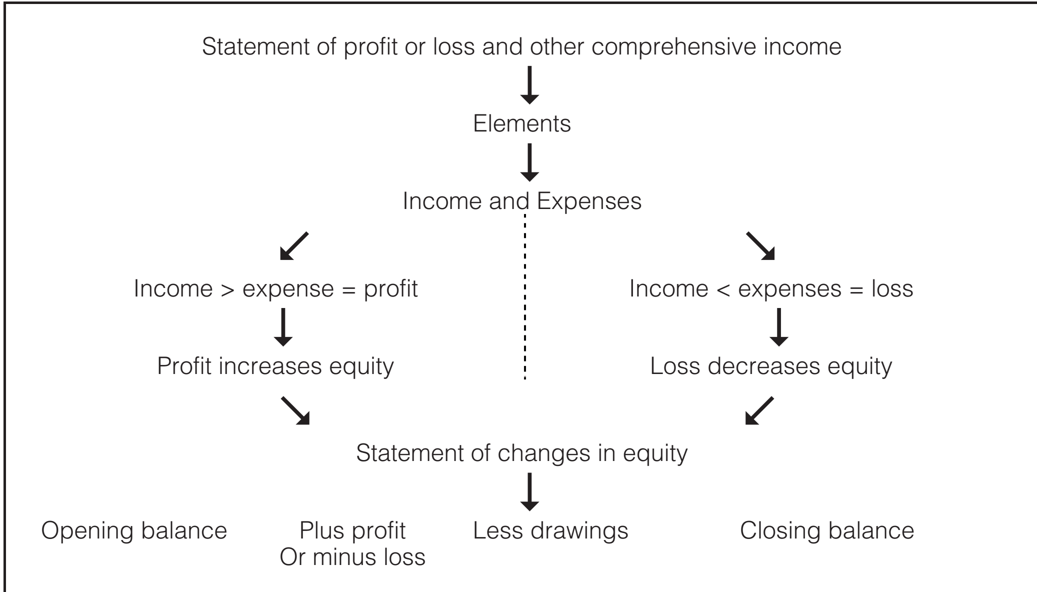
Overview of the financial performance



3.1 Introduction

Study objectives

After studying this chapter you should

- ☐ be able to discuss the elements of the statement of profit or loss and other comprehensive income;
- ☐ understand the influence of profit and loss on equity;
- ☐ be able to determine the financial performance of a sole proprietorship;
- ☐ be able to compile a statement of changes in equity for a sole proprietorship; and
- ☐ be able to discuss and compile certain notes to the financial statements.

The statement of profit or loss and other comprehensive income provides information about the financial performance of an entity for a specific period of time, the financial period. Income and expenses are the elements on the statement of profit or loss and other comprehensive income by which financial performance is measured. This leads to the following equation:

Financial performance = Income – Expenses

Financial performance is measured in terms of the profit or loss which an entity makes over a specific period of time. Therefore

Profit or loss = Income – Expenses

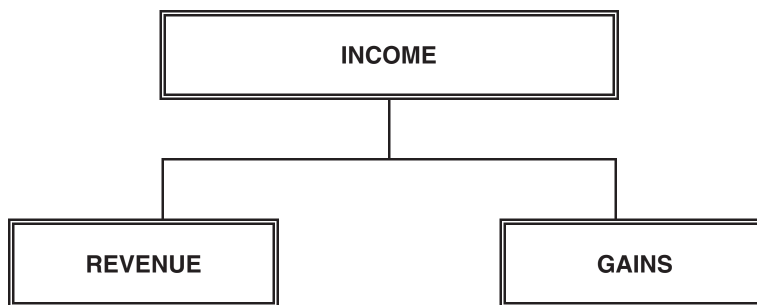
3.2 Elements of the statement of profit or loss and other comprehensive income

The two elements found on the statement of profit or loss and other comprehensive income are income and expenses.

3.2.1 *Income*

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

It is important to remember that when the owner(s) make(s) direct contributions to equity, it is *not* classed as income. Income includes both revenue and gains.



- ☐ *Revenue*

  Revenue is earned from the entity's ordinary activities, for example

  - fees earned;
  - sales;
  - interest income;
  - dividend income;
  - rent income;
  - commission income; and
  - credit losses recovered.

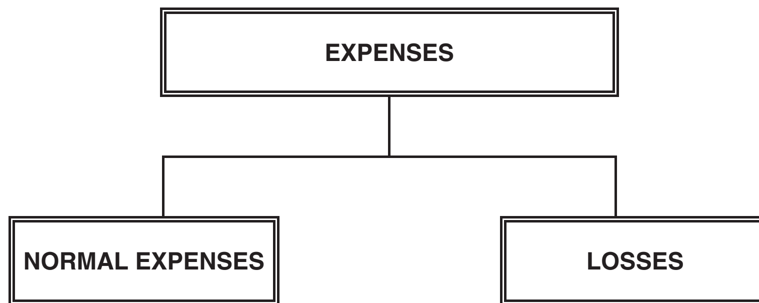
- ☐ *Gains*

  Gains are increases in economic benefits which *do not* arise from the normal activities of the entity, for example profit made on the sale of a non-current asset.

3.2.2 *Expenses*

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

Losses are also included in the definition of expenses.



☐ *Normal expenses*

Expenses are incurred in the normal course of the entity's activities. They arise from the production of income, for example

- purchases of inventory;
- customs and excise duty;
- carriage on purchases;
- carriage on sales;
- rent expenses;
- salaries and wages;
- cost of raw materials;
- depreciation;
- administrative expenses;
- water and electricity;
- advertising;
- interest expenses;
- bank charges;
- credit losses; and
- insurance.

☐ *Losses*

Losses are decreases in economic benefit which do not arise from the normal activities of the entity, for example damage caused by a fire or loss on the sale of a non-current asset.

3.3 Influence of profit or loss on equity

Income increases equity, whereas expenses decrease equity. We can say therefore that

Equity = Capital + Income – Expenses

When income is greater than expenses a profit is made and when expenses are greater than income a loss is made. This implies that a profit will increase equity and that a loss will decrease equity. Therefore

Equity = Capital + Net profit

Equity = Capital – Net loss

Example 3.1

Using the information in Example 2.2, the financial position of Nicks Plumbing as at 31 May 20.2 is as follows:

	R
Assets	77 000
Equity	50 500
Liabilities	26 500

During the financial year 1 June 20.2 to 31 May 20.3, N Nicks had the following income and expenses with regard to Nicks Plumbing:

	R
Fees earned	89 000
Wages paid	12 000
General expenses	18 000
Interest expense	3 000

Required

Calculate Nicks Plumbing's equity as at 31 May 20.3.

Net profit	=	Income	–	Expenses
	=	R89 000	–	(12 000 + 18 000 + 3 000)
	=	R89 000	–	33 000
	=	R56 000		

The equity as at 31 May 20.3 is calculated as follows:

Equity	=	Capital + Income – Expenses
	=	Capital + Net profit
	=	R50 500 + 56 000
	=	R106 500

The equity as at 31 May 20.3 is therefore R106 500. This is the balance on the capital account because Nicks Plumbing is a sole proprietorship.

3.4 Statement of profit or loss and other comprehensive income (financial performance)

The aim of the statement of profit or loss and other comprehensive income is to reflect the financial performance for a financial period. The statement of profit or loss and other comprehensive income lists all revenues and expenses and the net profit or loss for the period. Every statement of profit or loss and other comprehensive income must show the name of the business and the period for which the statement has been compiled.

Statement of profit or loss and other comprehensive income for the year ended . . . (period of time)

	R
Revenue	XXX XXX
Cost of sales	(XXX XXX)
Gross profit	**XXX XXX**
Other income	X XXX
	XXX
	XXX
	XXX XXX
Distribution, administrative and other expenses	(XX XXX)
	XX XXX
	X XXX
Finance costs	(X XXX)
	(X XXX)
Profit/Total comprehensive income for the year	XXX XXX

As a minimum, the statement of profit or loss and other comprehensive income shall include line items that present the following amounts for the period:

(a) revenue;

(b) finance costs;

(c) share of the profit or loss of associates and joint ventures accounted for using the equity method;

(d) tax expense; and

(e) a single amount comprising the total of

  (i) the post-tax profit or loss of discontinued operations; and

  (ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operations;

(f) profit or loss;

(g) each component of other comprehensive income classified by nature (excluding amounts in (h));

(h) share of other comprehensive income of associates and joint ventures accounted for using the equity method; and

(i) total comprehensive income.

The following are examples of items which will appear under the different sub-headings on the statement of profit or loss and other comprehensive income:

Revenue	**Other income**	**Distribution, administrative and other expenses**	**Finance costs**
Fees earned Net sales	Credit losses recovered Commission income Dividend income Interest income Profit on sale of asset Rent income	Advertising Credit losses Bank charges Carriage on sales Delivery expenses Depreciation Insurance Postage Rent expenses Repairs Salaries Stationery consumed Telephone expenses Water and electricity	Interest on bank overdraft Interest on mortgage Interest on long-term loan Interest paid on capital/savings accounts in a partnership

Example 3.2

Required

Prepare the statement of profit or loss and other comprehensive income of Nicks Plumbing for the year ended 31 May 20.3.

Nicks Plumbing
Statement of profit or loss and other comprehensive income for the year ended 31 May 20.3

	Notes*	**R**
Revenue	2	89 000
Distribution, administrative and other expenses		(30 000)
Wages		12 000
General expenses		18 000
Finance costs		(3 000)
Interest expense		3 000
Profit/Total comprehensive income for the year		56 000

* Notes to the financial statements will be explained at the end of the chapter.

3.5 Statement of changes in equity

An entity shall present a statement of changes in equity showing in the statement

(a) total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to minority interest;

(b) for each component of equity, the effects of retrospective application or retrospective restatement;

(c) the amounts of transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners; and

(d) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each change.

The profit or loss determined on the statement of profit or loss and other comprehensive income is added to or subtracted from the equity, as the case may be. Additional capital contributions made to or withdrawals made from equity by the owners also affect the equity. The statement of changes in equity is the financial statement that reflects these changes. In this statement, the equity at the beginning of the period is reconciled with the equity at the end of the period. The net profit or loss for the period and any capital contributions or withdrawals of equity made by the owners are shown in this statement.

Example 3.3

N Nicks, owner of Nicks Plumbing, withdrew R65 000 during the financial year ended 31 May 20.3.

Required

Prepare the statement of changes in equity of Nicks Plumbing.

Nicks Plumbing
Statement of changes in equity for the year ended 31 May 20.3

	R
Balance as at 1 June 20.2	50 500
Profit/Total comprehensive income for the year	56 000
Drawings	(65 000)
Balance as at 31 May 20.3	41 500

3.6 Notes to the financial statements

Accounting policies and notes are prepared to give additional information on items appearing in the financial statements. These notes are usually shown after the statement of cash flows.

As was mentioned in chapter 2, there are five components in a set of financial statements. We have already discussed the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. The statement of cash flows will be discussed later in this textbook. So, we will now deal with the notes to the financial statements after the statement of financial position. These notes include the following:

☐ *Accounting policy note*: This note must state whether the financial statements comply with IFRS, and the bases of measurement and other policies must be disclosed.

- ☐ *Additional information on items in the financial statements*: There must be a note disclosing the source of revenue. Another important note is the note on property, plant and equipment, which reconciles the carrying amount of these assets at the beginning of the period with the carrying amount at the end of the period.
- ☐ *Other disclosures*: Contingencies are an example of another disclosure.

Example 3.4

The notes to the financial statements of Nicks Plumbing for the year ended 31 May 20.3 will be as follows:

Nicks Plumbing
Notes for the year ended 31 May 20.3

1. Basis of presentation

   The annual financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.

2. Revenue is measured at the fair value of the consideration received or receivable. Revenue from fees earned for services rendered to clients consists of the total net invoiced fees excluding value-added tax (VAT) and settlement discount granted.

Example 3.5

M McVie runs a dressmaking business from home. The following information relates to the business:

Balances as at 31 December 20.2

	R
Capital	21 350
Furniture and equipment	15 000
Debtors	1 800
Cash in bank	5 100
Creditors	550

Income and expenses for the year ended 31 December 20.3

	R
Services rendered	22 000
Wages	4 400
Telephone expenses	1 580
Other expenses	17 660

Additional information:

M McVie withdrew R15 000 during the financial year from the business for personal use.

Required

Prepare the statement of profit or loss and other comprehensive income, statement of changes in equity, and the applicable notes to the financial statements for the year ended 31 December 20.3.

M McVie
Statement of profit or loss and other comprehensive income for the year ended 31 December 20.3

	Note*	R
Revenue	2	22 000
Distribution, administrative and other expenses		(23 640)
Wages		4 400
Telephone expenses		1 580
Other expenses		17 660
Loss/total comprehensive loss for the year		(1 640)

M McVie
Statement of changes in equity for the year ended 31 December 20.3

	R
Balance as at 1 January 20.3	21 350
Loss/total comprehensive loss for the year	(1 640)
Drawings	(15 000)
Balance as at 31 December 20.3	4 710

M McVie
Notes for the year ended 31 December 20.3

1. Basis of presentation

   The annual financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.
2. Revenue is measured at the fair value of the consideration received or receivable. Revenue from fees earned for services rendered to clients consists of the total net invoiced fees, excluding value-added tax (VAT) and settlement discount granted.

3.7 Summary

The financial performance is depicted on the statement of profit or loss and other comprehensive income of an entity. The elements shown on that statement are income and expenses. The difference between income and expenses gives the profit or loss of the entity for a financial period (which is usually a year). If income exceeds expenses, a profit is made, which increases equity; if expenses exceed income, a loss is made, which decreases equity. The statement of changes in equity reflects these changes and reconciles the equity at the beginning of the financial period with the equity at the end of the financial period.

CHAPTER **4**

The recording of transactions

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Overview of the recording of transactions

TYPES OF TRANSACTIONS

Assets and equity	↗	Capital contributions
	↗	Drawings by owner
	→	Cash income
	↘	Credit income
	↘	Cash expenses
Assets and liabilities	↗	Purchasing asset on credit
	→	Payment to creditors
	↘	Acquisition of loan
Only assets	→	Purchasing asset for cash
	↘	Payments from debtors
Only equity and liabilities	→	Credit expenses

TYPES OF ACCOUNTS

Dr	**ASSETS** Cr
Increase	Decrease

Dr	**LIABILITIES** Cr
Decrease	Increase

Dr	**CAPITAL (Equity)** Cr
Decrease	Increase

Dr	**INCOME** Cr
Decrease	Increase

Dr	**EXPENSES** Cr
Increase	Decrease

TRIAL BALANCE

All debits = **All credits**

4.1 Introduction

Study objectives

After studying this chapter you should

- ☐ understand and record the effect of transactions on the BAE;
- ☐ be able to post transactions to the ledger accounts;
- ☐ be able to extract a trial balance; and
- ☐ be able to compile the financial statements of a sole proprietorship.

The accounting process starts once a transaction has taken place. In chapter 2, it was stated that the financial position of an entity changes with each transaction. Also, each transaction has an effect on two or more items in the basic accounting equation (BAE), which is the basis of the double-entry system. Therefore transactions must be recorded in ledger accounts using the double-entry system. After all the ledger accounts have been balanced, a list of balances called a trial balance can be drawn. From the trial balance, the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of financial position can be compiled.

4.2 The effect of transactions on the basic accounting equation

All transactions that can be measured in monetary terms have an impact on the financial results of an entity. With every transaction, there will be a change in the financial position of the entity; therefore a change in the basic accounting equation (BAE).

The BAE (Assets = Equity + Liabilities) is an equation that must stay in balance after each transaction. The assets are on the left-hand side of the equation, while the equity and liabilities are on the right-hand side. There are four different ways in which the equation can change but still remain in balance:

☐ an increase on the left-hand side with a corresponding increase on the right-hand side;

Left-hand side	=	Right-hand side
ASSETS	=	EQUITY + LIABILITIES
"+"		"+"

☐ a decrease on the left-hand side with a corresponding decrease on the right-hand side;

Left-hand side	=	Right-hand side
ASSETS	=	EQUITY + LIABILITIES
"–"		"–"

☐ a corresponding increase and decrease on the left-hand side,

Left-hand side	=	Right-hand side
ASSETS	=	EQUITY + LIABILITIES
"+" and "–"		

and

☐ a corresponding increase and decrease on the right-hand side.

Left-hand side	=	Right-hand side
ASSETS	=	EQUITY + LIABILITIES
		"+" and "–"

Before reading further, please refer back to paragraph 3.3 on how income and expenses influence equity.

The following example will explain the effect of transactions on the BAE.

Example 4.1

S Stipe started REM Removal Services on 1 July 20.3. The following is a list of transactions entered into by the business during July 20.3:

No	Date		Details
1	20.3 July	1	S Stipe deposited R50 000 into the bank account of the business as capital.
2		3	He bought a second-hand removal van on credit from M Mills for R80 000.
3			Filled the removal van with petrol and paid cash, R700.
4		4	Placed an advertisement in the Eye News for R250 on credit.
5			Paid his personal telephone account of R460 for June 20.3 with a business cheque.
6		7	Obtained a loan from Rapid Bank for R25 000.
7		10	Transported furniture for B Berry on credit, R2 000.
8		14	He transferred personal equipment to the value of R10 000 to the business.
9		17	Paid R15 000 to M Mills, as first payment on the removal van.
10		18	Bought a computer for R6 000 from Movement Ltd and paid by cheque.
11		22	Received R800 from B Buck for the transport of equipment.
12		25	Received a payment from debtor, B Berry, R1 000.

Transaction 1

S Stipe deposited R50 000 into the bank account of the business as capital.

With this transaction, assets and equity increase. This means that the left-hand side and the right-hand side of the BAE are each increased by R50 000.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	0	0	0	0		0	0	0		0	0
Transaction 1				+ 50 000		+ 50 000					
Closing balance	0	0	0	+ 50 000		+ 50 000	0	0		0	0

Transaction 2

He bought a second-hand removal van on credit from M Mills for R80 000.

The removal van is an asset for the business, and the business now owes M Mills R80 000 (he becomes a creditor). The left-hand side and the right-hand side are each increased by R80 000.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	0	0	0	+ 50 000		+ 50 000	0	0		0	0
Transaction 2	+ 80 000										+ 80 000
Closing balance	+ 80 000	0	0	+ 50 000		+ 50 000	0	0		0	+ 80 000

Transaction 3

Filled the removal van with petrol and paid cash, R700.

The purchase of petrol is an expense to the entity, which decreases equity. Assets also decrease as there has been an outflow of cash from the bank.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	+ 80 000	0	0	+ 50 000		+ 50 000	0	0		0	+ 80 000
Transaction 3				– 700				– 700			
Closing balance	+ 80 000	0	0	+ 49 300		+ 50 000	0	– 700		0	+ 80 000

Transaction 4

Placed an advertisement in the Eye News for R250 on credit.

Advertising is also an expense, which decreases equity. The entity now owes Eye News R250, and Eye News thus becomes a creditor. The right-hand side is therefore increased and decreased by R250.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	+ 80 000	0	0	+ 49 300		+ 50 000	0	– 700		0	+ 80 000
Transaction 4								– 250			+ 250
Closing balance	+ 80 000	0	0	+ 49 300		+ 50 000	0	– 950		0	+ 80 250

Transaction 5

Paid his personal telephone account of R460 for June 20.3 with a business cheque.

Drawings are when the owner pays personal accounts through the business or takes goods or cash for his own use. Drawings decrease equity because the owner is taking something out of the business. Assets also decrease as the bank balance is thereby reduced.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	**R**	**R**	**R**		**R**	**R**	**R**		**R**	**R**
Opening balance	+ 80 000	0	0	+ 49 300		+ 50 000	0	– 950		0	+ 80 250
Transaction 5				– 460		– 460					
Closing balance	+ 80 000	0	0	+ 48 840		+ 49 540	0	– 950		0	+ 80 250

Transaction 6

Obtained a loan from Rapid Bank for R25 000.

In this transaction, money is coming into the business, which means that the bank and assets increase. Because R25 000 is owed to Rapid Bank liabilities also increase.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	**R**	**R**	**R**		**R**	**R**	**R**		**R**	**R**
Opening balance	+ 80 000	0	0	+ 48 840		+ 49 540	0	– 950		0	+ 80 250
Transaction 6				+ 25 000						+ 25 000	
Closing balance	+ 80 000	0	0	+ 73 840		+ 49 540	0	– 950		+ 25 000	+ 80 250

Transaction 7

Transported furniture for B Berry on credit, R2 000.

Income is being earned, which increases equity. B Berry owes the entity R2 000 (he becomes a debtor); therefore assets increase.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	**R**	**R**	**R**		**R**	**R**	**R**		**R**	**R**
Opening balance	+ 80 000	0	0	+ 73 840		+ 49 540	0	– 950		+ 25 000	+ 80 250
Transaction 7			+ 2 000				+ 2 000				
Closing balance	+ 80 000	0	+ 2 000	+ 73 840		+ 49 540	+ 2 000	– 950		+ 25 000	+ 80 250

Transaction 8

He transferred personal equipment to the value of R10 000 to the business.

S Stipe is transferring assets to the business in the form of equipment. Equity also increases as the equipment is from him personally and not acquired through the business itself.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	**R**	**R**	**R**		**R**	**R**	**R**		**R**	**R**
Opening balance	+ 80 000	0	+ 2 000	+ 73 840		+ 49 540	+ 2 000	– 950		+ 25 000	+ 80 250
Transaction 8		+ 10 000				+ 10 000					
Closing balance	+ 80 000	+ 10 000	+ 2 000	+ 73 840		+ 59 540	+ 2 000	– 950		+ 25 000	+ 80 250

Transaction 9

Paid R15 000 to M Mills, as first payment on the removal van.

Assets decrease because money is being paid out and the creditor M Mills decreases because the business now owes him R15 000 less.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	+ 80 000	+ 10 000	+ 2 000	+ 73 840		+ 59 540	+ 2 000	– 950		+ 25 000	+ 80 250
Transaction 9				– 15 000							– 15 000
Closing balance	+ 80 000	+ 10 000	+ 2 000	+ 58 840		+ 59 540	+ 2 000	– 950		+ 25 000	+ 65 250

Transaction 10

Bought a computer for R6 000 from Movement Ltd and paid by cheque.

This transaction only affects assets. The asset equipment is increased, whereas the asset bank is decreased by R6 000.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	+ 80 000	+ 10 000	+ 2 000	+ 58 840		+ 59 540	+ 2 000	– 950		+ 25 000	+ 65 250
Transaction 10		+ 6 000		– 6 000							
Closing balance	+ 80 000	+ 16 000	+ 2 000	+ 52 840		+ 59 540	+ 2 000	– 950		+ 25 000	+ 65 250

Transaction 11

Received R800 from B Buck for the transport of equipment.

This is a cash income transaction. The asset bank increases and equity increases.

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	+ 80 000	+ 16 000	+ 2 000	+ 52 840		+ 59 540	+ 2 000	– 950		+ 25 000	+ 65 250
Transaction 11				+ 800			+ 800				
Closing balance	+ 80 000	+ 16 000	+ 2 000	+ 53 640		+ 59 540	+ 2 800	– 950		+ 25 000	+ 65 250

Transaction 12

Received a payment from debtor, B Berry, R1 000.

Receiving a payment from a debtor only affects the assets. The asset bank is increased (money coming in), while the asset debtors is decreased (the debtor now owes the business less).

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	+ 80 000	+ 16 000	+ 2 000	+ 53 640		+ 59 540	+ 2 800	– 950		+ 25 000	+ 65 250
Transaction 12			– 1 000	+ 1 000							
Closing balance	+ 80 000	+ 16 000	+ 1 000	+ 54 640		+ 59 540	+ 2 800	– 950		+ 25 000	+ 65 250

Summary of all transactions

	ASSETS				=	EQUITY			+	LIABILITIES	
	Vehicles	Equipment	Debtors	Bank		Capital	Income	Expenses		Loan	Creditors
	R	R	R	R		R	R	R		R	R
Opening balance	0	0	0	0		0	0	0		0	0
Transaction 1				+ 50 000		+ 50 000					
Transaction 2	+ 80 000										+ 80 000
Transaction 3				– 700				– 700			
Transaction 4								– 250			+ 250
Transaction 5				– 460		– 460					
Transaction 6				+ 25 000						+ 25 000	
Transaction 7			+ 2 000				+ 2 000				
Transaction 8		+ 10 000				+ 10 000					
Transaction 9				– 15 000							– 15 000
Transaction 10		+ 6 000		– 6 000							
Transaction 11				+ 800			+ 800				
Transaction 12			– 1 000	+ 1 000							
Closing balance	+ 80 000	+ 16 000	+ 1 000	+ 54 640		+ 59 540	+ 2 800	– 950		+ 25 000	+ 65 250

The total of the assets is

R(80 000 + 16 000 + 1 000 + 54 640)

= R151 640

The total of the equity and liabilities is

R(59 540 + 2 800 – 950 + 25 000 + 65 250)

= R151 640

The BAE is in balance after all the transactions have been recorded.

The above transactions can also be classified as follows:

4.2.1 *Transactions which affect only assets*

With transactions like these, one asset is being replaced by another; therefore one asset will increase and one asset will decrease by the same amount.

☐ **Buying an asset for cash**

The asset bank will decrease, whereas the particular asset purchased will increase. An example of this type of transaction is transaction 10.

☐ **Payments received from debtors**

Here, the asset bank will increase and the particular debtor will decrease. Transaction 12 is an example of this type of transaction.

4.2.2 *Transactions which affect both assets and liabilities*

There are three types of transactions which fall into this category.

☐ **Buying an asset on credit**

The particular asset will increase and a liability (creditor) will increase. Transaction 2 is an example.

☐ **Payments to creditors**

The asset bank will decrease and the liability (creditor) will also decrease. This can be seen in transaction 9.

☐ **Acquisition of loans**

Here, the asset bank will increase by the loan amount. A liability (loan) will increase by the same amount. Transaction 6 is an example.

4.2.3 *Transactions which affect both assets and equity*

There are three types of transactions in this category:

☐ **Capital contributions**

With these transactions, assets will increase and capital will increase by the same amount. Transactions 1 and 8 belong to this type.

☐ **Withdrawals by the owner**

When the owner takes cash or goods for his own use, an asset decreases and equity will decrease by the same amount. Transaction 5 is an example of this type of transaction.

☐ **Income and expense transactions**

Income can be *earned* in cash or on credit terms, whereas expenses can be *incurred* in cash or on credit terms. Income and expense transactions will *always* affect equity, that is, cash and credit income and expenses will have an influence on equity. The cash transactions will always affect the asset bank and the credit transactions will have an influence on the asset debtors (credit income) or the liability creditors (credit expense).

Cash income

The asset bank increases and equity increases (income). Transaction 11 reflects this type of transaction.

Credit income

The asset debtors and equity both increase (income). Transaction 7 is an example.

Cash expenses

The asset bank and equity both decrease (expenses). An example of this type of transaction is transaction 3.

4.2.4 *Transactions which affect both equity and liabilities*

This happens when an expense is being made on credit.

Credit expenses

The equity decreases and a liability (creditor) increases. Transaction 4 is an example.

4.3 Recording of transactions into ledger accounts

The BAE does not form part of the accounting system. If transactions were captured in this way, the accounting system would be very cumbersome and difficult to interpret. When a transaction takes place, it is recorded in a source document, from which the data is captured and posted to the specific ledger accounts. The information on the source document gives details of the transaction, including the date, the amount, the type of transaction and with whom the transaction has taken place.

The following is a list of typical source documents:

Invoices	–	Credit transactions
Receipts	–	Cash transactions
Cheque counterfoils	–	Cash payments
Cash slips (till slips)	–	Cash purchases or sales
Petty cash vouchers	–	Proof of small cash payments
Debit and credit notes	–	Goods returned

A ledger account is an individual record of a specific item. It is shown in the form of a capital T and is referred to as a T-account. The left-hand side is the debit side and the right-hand side is the credit side. The terms debit and credit refer to the side of the account and not to whether the account increases or decreases. Every transaction will have an effect on at least two accounts in the ledger; the amount debited to an account must always equal the amount credited to another account. This is the basis of the double-entry system. If the transactions are posted correctly, the total of the debit balances must equal the total of the credit balances. The following is an example of an account:

Dr **Name of account** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R

The details column is for the cross-reference account, called the contra account. The folio (fol) column is used to indicate the page in the subsidiary journals, which will be discussed in chapter 5.

There are five main groups of accounts, namely

- ☐ asset accounts;
- ☐ liability accounts;
- ☐ owner's equity accounts;
- ☐ income accounts; and
- ☐ expense accounts.

4.3.1 *Asset accounts*

In the BAE used until now, where A = E + L, assets are on the left-hand side, whereas an asset account in the ledger has a debit balance. Something that must be emphasised here is that, in the BAE, when an asset account increases, you show the transaction as a "+" sign. When the transaction is recorded in the ledger account, the asset account is debited, that is, it is entered on the left-hand side of the T-account. When an asset decreases, a "–" sign is shown in the BAE, whereas when the transaction is recorded in the ledger account, the asset account is credited and it is entered on the right-hand side of the T-account.

Dr Assets Cr

Increase	Decrease

4.3.2 *Liability accounts*

Liabilities are on the right-hand side of the BAE. A liability account has a credit balance in the ledger. When a liability account increases, the account is credited; when a liability account decreases, the account is debited.

Dr	Liabilities	Cr
Decrease		Increase

4.3.3 *Equity accounts*

Equity accounts, like liabilities, are on the right-hand side of the BAE. Equity accounts include the following accounts: capital, drawings, income and expenses.

☐ **Capital**

In a sole proprietorship, when the owner deposits cash into the business or transfers other assets to the business, the capital account is affected. Capital is increased on the credit side and decreased on the debit side.

Dr	Capital	Cr
Decrease		Increase

☐ **Drawings**

Withdrawals by the owner (drawings) decrease the equity of the owner and are transferred to the capital account at the end of the period. The drawings account therefore has a debit balance.

Dr	Drawings	Cr
Increase		Decrease

4.3.4 *Income accounts*

Income increases equity; therefore income accounts have a credit balance. Income accounts increase on the credit side and decrease on the debit side.

Dr	Income	Cr
Decrease		Increase

4.3.5 *Expense accounts*

Expenses decrease equity; therefore expense accounts have a debit balance. Expense accounts increase on the debit side and decrease on the credit side.

Dr	Expenses	Cr
Increase		Decrease

Once a transaction has taken place, the information on the source document is recorded into subsidiary journals which will be discussed in chapter 5. From there, the amounts are posted to the general ledger accounts. The term general ledger is used here, as there are also subsidiary ledgers, for example, debtors' and creditors' ledgers. For a better understanding of the accounting system, the transactions are, for now, going to be recorded straight into the general ledger accounts.

Example 4.2

Using the information in Example 4.1, we will now post the transactions into the relevant ledger accounts.

Transaction 1

1 July 20.3: S Stipe deposited R50 000 into the bank account of the business as capital.

The two accounts involved in this transaction are bank and capital. Money in the bank is an asset and therefore increases on the debit side. Capital is an equity account, which increases on the credit side. The transaction will be entered into the accounts as follows:

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 July	1	Capital		50 000					

Dr **Capital** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 July	1	Bank		50 000

Transaction 2

3 July 20.3: He bought a second-hand removal van on credit from M Mills for R80 000.

The removal van is an asset for the business; therefore the asset account vehicles is debited. The business now owes M Mills R80 000 and his account is credited.

Dr **Vehicles** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 July	3	Creditor: M Mills		80 000					

Dr **Creditor: M Mills** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 July	3	Vehicles		80 000

Transaction 3

3 July 20.3: Filled the removal van with petrol and paid cash, R700.

Petrol is an expense and the petrol expense account is debited. The bank decreases by R700 and the bank account is credited.

Dr **Petrol** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 July	3	Bank		700					

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 July	1	Capital		50 000	20.3 July	3	Petrol		700

Transaction 4

4 July 20.3: Placed an advertisement in the Eye News for R250 on credit.

Dr **Advertising** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 July	4	Creditor: Eye News		250					

Dr **Creditor: Eye News** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 July	4	Advertising		250

Transaction 5

4 July 20.3: Paid his personal telephone account of R460 for June 20.3 with a business cheque.

Dr **Drawings** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 July	4	Bank		460					

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 July	1	Capital		50 000	20.3 July	3 4	Petrol Drawings		700 460

Transaction 6

7 July 20.3: Obtained a loan from Rapid Bank for R25 000.

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	1	Capital		50 000	July	3	Petrol		700
	7	Loan:				4	Drawings		460
		Rapid Bank		25 000					

Dr **Loan: Rapid Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	7	Bank		25 000

Transaction 7

10 July 20.3: Transported furniture for B Berry on credit, R2 000.

Dr **Debtor: B Berry** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	10	Services							
		rendered		2 000					

Dr **Services rendered** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	10	Debtor: B Berry		2 000

Transaction 8

14 July 20.3: He transferred personal equipment to the value of R10 000 to the business.

Dr **Equipment** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	14	Capital		10 000					

Dr **Capital** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	1	Bank		50 000
						14	Equipment		10 000

Transaction 9

17 July 20.3: Paid R15 000 to M Mills as first payment on the removal van.

Dr **Creditor: M Mills** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	17	Bank		15 000	July	3	Vehicles		80 000

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	1	Capital		50 000	July	3	Petrol		700
	7	Loan:				4	Drawings		460
		Rapid Bank		25 000		17	Creditor: M Mills		15 000

Transaction 10

18 July 20.3: Bought a computer for R6 000 from Movement Ltd and paid by cheque.

Dr **Equipment** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	14	Capital		10 000					
	18	Bank		6 000					

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	1	Capital		50 000	July	3	Petrol		700
	7	Loan:				4	Drawings		460
		Rapid Bank		25 000		17	Creditor: M Mills		15 000
						18	Equipment		6 000

Transaction 11

22 July 20.3 Received R800 from B Buck for the transport of equipment.

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	1	Capital		50 000	July	3	Petrol		700
	7	Loan:				4	Drawings		460
		Rapid Bank		25 000		17	Creditor: M Mills		15 000
	22	Services				18	Equipment		6 000
		rendered		800					

continued

Dr **Services rendered** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	10	Debtor: B Berry		2 000
						22	Bank		800

Transaction 12

25 July 20.3: Received a payment from debtor, B Berry, R1 000.

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	1	Capital		50 000	July	3	Petrol		700
	7	Loan:				4	Drawings		460
		Rapid Bank		25 000		17	Creditor: M Mills		15 000
	22	Services				18	Equipment		6 000
		rendered		800					
	25	Debtor: B Berry		1 000					

Dr **Debtor: B Berry** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	10	Services			July	25	Bank		1 000
		rendered		2 000					

4.4 Balancing an account

As accounts can have entries on both the debit and credit sides, a calculation needs to be done to determine the balance. When balancing an account, take note of the following:

4.4.1 *Only one entry in the account*

Dr **Insurance** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
Jan	10	Bank		740					

Where there is only one entry in the account, leave it as is, as this amount is the balance.

4.4.2 *The same amount entered on both sides of the account*

Dr **Debtor: M Mike** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
Jan	15	Services			Jan	28	Bank		1 850
		rendered		1 850					

The balance on this account is nil (zero). A double line is drawn on either side to indicate that the account has been closed off.

4.4.3 *More than one entry on only one side of the account*

Dr **Services rendered** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					Jan	10	Bank		1 200
						15	Debtor: M Mike		1 850
						23	Bank		670
									3 720

The amounts must be added together and the total entered underneath. This amount (R3 720) is the balance on the account. Note that a double line is not drawn under the total as the account is not closed off.

4.4.4 *More than one entry on both sides of the account*

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
Jan	10	Services rendered		1 200	Jan	10	Insurance		740
	23	Services rendered		670		27	Petty cash		150
						31	Balance	c/d	980
				1 870					1 870
Feb	1	Balance	b/d	980					

To balance an account which has more than one entry on both sides, do the following:

- ☐ Add up the debit side of the account and enter the total in pencil.
- ☐ Add up the credit side of the account and enter the total in pencil.
- ☐ Subtract the smaller total from the larger total. The difference between the two totals is the balance of that account. This balance is entered on the side of the account that has the smaller total.
- ☐ After entering the balance on the side with the smaller total, the totals of both sides will be the same and can now be entered in pen. Draw a double line under the totals to indicate that the account has been balanced.
- ☐ The last step is to carry the balance calculated over to the opposite side of the account and enter it under the total. This is then the opening balance of the account for the next period.

When the debits total is larger than the credits total on an account, the account has a debit balance; when the credits total is larger than the debits total on an account, the account has a credit balance.

Example 4.3

All the transactions in Example 4.2 have been posted to the accounts and we can now balance them.

Dr **Capital** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	1	Bank		50 000
						14	Equipment		10 000
									60 000

Dr **Drawings** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	4	Bank		460					

Dr **Vehicles** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	3	Creditor: M Mills		80 000					

Dr **Equipment** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	14	Capital		10 000					
	18	Bank		6 000					
				16 000					

Dr **Loan: Rapid Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	7	Bank		25 000

Dr **Bank** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	1	Capital		50 000	July	3	Petrol		700
	7	Loan:				4	Drawings		460
		Rapid Bank		25 000		17	Creditor: M Mills		15 000
	22	Services				18	Equipment		6 000
		rendered		800		31	Balance	c/d	54 640
	25	Debtor: B Berry		1 000					
				76 800					76 800
Aug	1	Balance	b/d	54 640					

continued

Dr **Debtor: B Berry** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	10	Services rendered		2 000	July	25	Bank		1 000
						31	Balance	c/d	1 000
				2 000					2 000
Aug	1	Balance	b/d	1 000					

Dr **Creditor: M Mills** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
July	17	Bank		15 000	July	3	Vehicles		80 000
	31	Balance	c/d	65 000					
				80 000					80 000
					Aug	1	Balance	b/d	65 000

Dr **Creditor: Eye News** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	4	Advertising		250

Dr **Services rendered** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					July	10	Debtor: B Berry		2 000
						22	Bank		800
									2 800

Dr **Advertising** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	4	Creditor: Eye News		250					

Dr **Petrol expense** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
July	3	Bank		700					

4.5 The trial balance

A trial balance is a list of all the debit and credit balances in the ledger. It is compiled

- ☐ to test the arithmetic correctness of the entries;
- ☐ to test whether the double entries have been entered correctly; and

☐ to serve as a basis for preparing the statement of profit or loss and other comprehensive income, statement of changes in equity and the statement of financial position.

The arithmetical correctness of the recording of transactions in the ledger must be tested on a regular basis. This usually takes place once all the transactions up to and including a certain date have been recorded in the ledger and before any final financial statements are prepared.

The total of all debit balances of the accounts in the ledger should be equal to the total of all credit balances in the ledger, because all the transactions should have been recorded in compliance with the double-entry system. To determine whether the total debit and total credit balances are in fact equal, the balances of all accounts are determined and recorded in a statement known as the trial balance. A trial balance is a list of all the balances of all the accounts in the ledger on a particular date. The names and balances are recorded in the trial balance in the order in which they appear in the ledger. There are two columns: debit balances are recorded in the left-hand (debit) column and credit balances in the right-hand (credit) column. The totals of the two columns should always be the same.

Example 4.4

The following is the trial balance that has been prepared from the ledger accounts in Example 4.3:

REM Removal Services
Trial balance as at 31 July 20.3

	Debit	**Credit**
	R	**R**
Capital		60 000
Drawings	460	
Vehicles	80 000	
Equipment	16 000	
Loan: Rapid Bank		25 000
Bank	54 640	
Debtor: B Berry	1 000	
Creditor: M Mills		65 000
Creditor: Eye News		250
Services rendered		2 800
Advertising	250	
Petrol	700	
	153 050	153 050

Although the debit and credit columns of a trial balance agree, it does not prove the accuracy of the accounting records, as it does not provide indisputable evidence that no errors have occurred in the records.

4.5.1 *Errors not revealed by a trial balance*

☐ **Errors of omission**

This is where a transaction is omitted completely; in other words, neither the debit nor the credit entry of the transaction has been recorded.

☐ **Posting to the wrong account**

This occurs when an item is posted to the correct side of the ledger, but to the wrong account, for example, if the water and electricity account has been debited instead of the rates and taxes account for annual rates and taxes. This is usually a once-off error.

☐ **Compensating errors**

An addition, balancing or posting error on one side of the ledger may coincidentally be compensated for by an identical error on the other side of the ledger.

☐ **Errors of principle**

In these cases, the principle underlying the recording of the transaction is faulty, and this error is often repeatedly recorded incorrectly. An example is the debiting of repair costs to the motor vehicle account instead of to the repair costs account.

4.5.2 *Errors which will be revealed by a trial balance*

Failure of a trial balance to balance can be attributed to one or more of the following errors:

☐ The trial balance has been cast (added) incorrectly.

☐ An error has been made in transferring the ledger balances to the trial balance, for example
- the incorrect amount has been transferred to the correct side of the trial balance;
- debit balances in the ledger were transferred to the credit side of the trial balance and *vice versa*;
- a balance in the ledger has been entirely omitted from the trial balance; or
- a balance in the ledger has been entered twice in the trial balance.

☐ The debit and/or credit amounts of one or more journal entries may be incorrect.

☐ The balances of the ledger accounts have been incorrectly calculated, for example
- either the debit or the credit side or both sides have been added incorrectly and the balance of the account is therefore incorrect; or
- the debit and credit sides have been added correctly, but the balance has been incorrectly calculated.

☐ Postings to the ledger from the journal may be incorrect. Journals will be explained in chapter 5.

4.5.3 *Tracing errors in a trial balance*

Discrepancies in a trial balance can be traced with greater ease if trial balances are drawn up on a monthly basis. If the trial balance was correct at the end of the previous month, the error must have occurred during the current month. To trace a discrepancy in a trial balance, the following consecutive steps should be taken. The general approach is to work back, in other words, to check first the last step performed in the preparation of the trial balance and so forth until the error has been traced. If there is a

difference between the debit and credit sides of the trial balance, the procedure is as follows:

- ☐ Cast each column of the trial balance again.
- ☐ Make sure that all the balances in the ledger have been transferred correctly and to the correct side of the trial balance.
- ☐ Confirm the balances of the ledger accounts by recalculating all the balances.
- ☐ Check the transfers from the journals to the ledger. (The use of journals will be discussed in chapter 5.)
- ☐ Check the accuracy of the amounts. In this regard, the following may serve as guidelines:
  - if the difference in the figures columns is, for example, 1 000, 100, 10, 1, 0.1 or 0.01, the difference is likely to be a casting error in the trial balance, ledger or journal;
  - a difference between the two columns that can be divided by 2 may indicate that a debit balance equal to half the difference has been entered as a credit balance or *vice versa*. If a debit balance is transferred to the trial balance as a credit, the debit side will reflect a shortfall of that amount, while the credit side will be overstated by the same amount. Therefore the difference will be twice the amount that has been incorrectly stated;
  - if the difference between the two columns is divisible by 9, the error may be due to a transposition of numbers. In other words, the digits do not appear in the correct order, so that, for example, 53 is written as 35, or 270 as 720. If the difference is divisible by 9, the resulting quotient will represent the difference between the digits which have been reversed. If R36 has, for example, been written as R63, the difference on the trial balance will be 27 and the quotient will be 3 (27 ÷ 9). This represents the difference between 6 and 3 in the transposed amount. If the quotient is a single digit, the transposition occurred in the units and tens column. If the quotient has two digits, the transposition occurred in the tens and hundreds columns, for example, R360 was written as R630. The difference is R270 and the quotient is 30 (270 ÷ 9), which represents a transposition between 6 and 3 in the tens and hundreds column;
  - alternatively, if the difference is divisible by 9, the discrepancy may be the result of a one-column shift, that is, a digit may have been moved one place to either the right or left, without an accompanying change in the order of the digits (as was the case above). If, for example, R48,60 is written as R4,86, the difference in the trial balance will be R43,74 (R48,60 – R4,86) and if this is divided by 9, the quotient is R4,86. Similarly, if the difference in the trial balance is divisible by 99, a two-column shift might have occurred – ie R48,60 might have been written as R4 860.

4.6 Preparing the financial statements of a sole proprietor

The information in the ledger is represented in the trial balance. From this information, a statement of profit or loss and other comprehensive income, statement of changes in equity and statement of financial position can be compiled. In chapter 3, the statement of profit or loss and other comprehensive income and statement of changes in equity were discussed; in chapter 2, the statement of financial position was discussed. Using what we have discussed in the previous chapters together with the information in Example 4.4, we can compile the financial statements of REM Removal Services.

Example 4.5

REM Removal Services
Statement of profit or loss and other comprehensive income for the month ended 31 July 20.3

	Note	R
Revenue	2	2 800
Distribution, administrative and other expenses		(950)
Petrol		700
Advertising		250
Profit/Total comprehensive income for the month		1 850

REM Removal Services
Statement of changes in equity for the month ended 31 July 20.3

	R
Contribution at 1 July 20.3	50 000
Additional capital contribution	10 000
Profit/Total comprehensive income for the month	1 850
Drawings	(460)
Balance at 31 July 20.3	61 390

REM Removal Services
Statement of financial position as at 31 July 20.3

	R
ASSETS	
Non-current assets	96 000
Property, plant and equipment ①	96 000
Current assets	55 640
Trade and other receivables (Debtors)	1 000
Cash and cash equivalents (Bank)	54 640
Total assets	151 640
EQUITY AND LIABILITIES	
Total equity	61 390
Capital	61 390
Total liabilities	90 250
Non-current liabilities	25 000
Long-term borrowings:	
Loan: Rapid Bank	25 000
Current liabilities	65 250
Trade and other payables (Creditors) ②	65 250
Total equity and liabilities	151 640

① Property, plant and equipment consists of

	R
Vehicles	80 000
Equipment	16 000
	96 000

② Trade and other payables consists of

	R
Creditor: M Mills	65 000
Creditor: Eye News	250
	65 250

Notes:

1. Basis of presentation

   The annual financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.

2. Revenue is measured at the fair value of the consideration received or receivable. Revenue from fees earned for services rendered to clients consists of the net invoiced fees, excluding value-added tax (VAT) and settlement discount granted.

Please note: There are other notes that you are required to know at this level. These notes will be discussed in later chapters.

4.7 Summary

The accounting process starts once a transaction has taken place. Each transaction has an influence on the BAE, which means the elements of the BAE are affected. The BAE does not form part of the accounting system and transactions have to be recorded in ledger accounts. A trial balance is a list of all account balances in the ledger. If the transactions have been recorded correctly, the debit balances should equal the credit balances. The financial statements can be drawn up from a trial balance.

CHAPTER 5

Processing accounting data

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Overview of processing accounting data

Group		Journal		Records		Posting
Cash journals	↗	Cash receipts journal (CRJ)	→	Records all receipts into bank account	→	Totals posted monthly to ledger accounts, sundries posted as they arise
	↘	Cash payments journal (CPJ)	→	Records all payments from bank account	→	Totals posted monthly to ledger accounts, sundries posted as they arise
Credit journals	↗	Purchases journal	→	Records returns on purchases to suppliers	→	Totals posted monthly to ledger accounts
	↗	Purchases returns journal	→	Records purchases returns to suppliers on credit	→	Totals posted monthly to ledger accounts
	→	Sales journal	→	Records sales to customers on credit	→	Totals posted monthly to ledger accounts
	↘	Sales returns journal	→	Records returns on credit sales from customers	→	Totals posted monthly to ledger accounts
	↘	General journal	→	All other credit transactions	→	Posted to ledger accounts as they arise
Value-added tax (VAT)	→	VAT output	→	Credit with VAT received from customers	→	Close-off to VAT control (payable to SARS)
	→	VAT input	→	Debit with VAT paid to suppliers	→	

5.1 Introduction

Study objectives

After studying this chapter you should

- ☐ know which source document to complete for each different transaction;
- ☐ be able to record the source documents in the correct subsidiary journals;
- ☐ be able to balance and post from the different subsidiary journals to the ledger; and
- ☐ be able to apply the basic principles of value-added tax (VAT) and know how to record VAT in the books of an entity.

In chapter 4, transactions were entered directly into the general ledger. In the normal course of business, entities enter into a large number of transactions. If every transaction is recorded directly into the ledger, the ledger could become bulky and unmanageable. In a manual system, in which only one person can work on the ledger, it could eventually become an impossible task to record transactions in this manner.

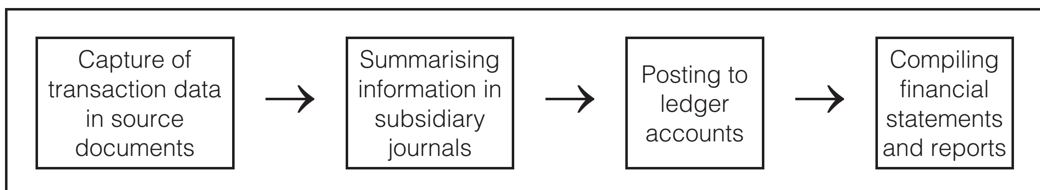
To overcome this problem, subsidiary journals, also referred to as books of first entry, were developed. The purpose of subsidiary journals is to group transactions of the same kind together and to record and analyse them in date and/or document sequence. To further assist in the analysing and recording of transactions, specific source documents were developed for different types of transactions. When a transaction takes place, the information should be captured in the source document developed for the particular transaction. The source document used should clearly distinguish between cash and credit transactions and should indicate the ledger accounts affected by the transaction. Source documents of the same kind are grouped together and are recorded and analysed in subsidiary journals. The information is then transferred to the general ledger. This procedure is known as posting. The purpose of subsidiary journals is to summarise information and to reduce the number of postings to the general ledger.

Please take note of the following:

- ☐ *Every transaction must first be recorded in a subsidiary journal before it is posted to the general ledger.*
- ☐ *Subsidiary journals do not replace the general ledger.*
- ☐ *The double-entry system has to be applied in the general ledger.*

The purpose of developing the accounting system in this way is to process transaction data into the refined information that is needed for financial reporting. This process is illustrated in diagram 5.1.

Diagram 5.1 The process of developing transaction data into useful information



An accounting system can be designed once the output that must be provided by the process is known. The source documents, the journals and the ledger accounts should be designed to process the accounting data in order to supply the information needed for compiling financial statements and reports, taking the requirements of IFRS into account.

5.2 The design and use of subsidiary journals

Different journals were developed to group transactions of the same kind together. This practice facilitates the allocation of duties, in that more than one person can work on different subsidiary journals simultaneously. Journals also provide more information about a transaction than ledger accounts, which provide only limited information.

A subsidiary journal has a separate amount column for each ledger account which is repeatedly affected by a series of transactions. The primary purpose of a journal is to record transactions chronologically from source documents as they occur. Each transaction is analysed and entered into the columns that represent the ledger

accounts that are affected by the transactions. The summarised information is then posted to the general ledger.

The following journals are most frequently used:

- ☐ cash receipts journal;
- ☐ cash payments journal;
- ☐ sales journal;
- ☐ sales returns journal;
- ☐ purchases journal;
- ☐ purchases returns journal; and
- ☐ general journal.

These are not the only subsidiary journals that can be used. An entity can decide what its needs are and which journals it wants to use. However, in this chapter, specific attention is given to the design and completion of the journals mentioned. VAT, introduced in 1991, is levied at every point in the chain of production and distribution. As VAT would first be captured in a subsidiary journal, there is a section in this chapter on how to enter VAT in the various journals and how to post it to the general ledger.

5.3 Cash journals

5.3.1 *Cash receipts journal (CRJ)*

Before an entity commences with business, the owner usually opens a bank account in the name of the business. For security purposes only a small amount of cash should be kept on the premises of the business and cash should be banked, preferably on a daily basis. Cash is received in different forms and from different sources. It includes cash received for services rendered, sales, rent income, interest income, membership fees, payments from debtors, loans, investments realised and assets sold. Because of the high risk of theft and fraud involving cash before it is banked, cash should be subject to proper internal control.

In many retail businesses, all the cash received is recorded in a cash register. The cash register normally records the transaction continuously on an audit roll in addition to the cash slip that is printed for the client. Depending on the cash register used, the amount of each transaction and the total cash received for a period, or total for each cashier who works on the same cash register, is recorded on the audit roll. A cash register audit roll provides sufficient information to determine the date, the amount of the receipt and which accounts to credit. The audit roll, either printed or in the form of an electronic record, serves as the source document for the entries. Since many cash registers used today are linked to computer systems, the cash received can be analysed and categorised according to the needs of the entity when the transaction is recorded.

Where cash is received from a third party, for example a debtor or tenant, a receipt may be issued. Where a cheque is used as payment, the details of the payment are recorded in the cash register and the cashed cheque serves as a receipt for the payer.

Where the payment is done electronically, the debtor provides an account number as a reference to assist in identifying from whom the payment was received. It is customary for an organisation that allows electronic bank transfers to first consult with its bank, which will then program its computers to prompt for an account number and,

if one is not supplied, to reject the transfer. The bank statement then serves as a proof of payment.

All cash receipts, which include cash, cheques, credit card payments and electronic transfers, are recorded from the appropriate source documents into the cash receipts journal (CRJ). In a manual system, the CRJ is normally designed in columnar form, where each column represents a ledger account and the amounts are analysed according to the reason for the cash receipt (refer to paragraph 5.3.1.1, column headings). In larger organisations with more than one bank account, or in more complex systems, a separate CRJ is often used for each account or for each type of cash receipt.

The summarised information is then posted from the CRJ to the general ledger and the relevant subsidiary ledgers, applying the double-entry system in the general ledger. Refer to Example 5.1(a).

A cash receipts journal should provide for the recording of

- ☐ the serial number of the source document;
- ☐ the date of the cash receipt;
- ☐ the name of the person from whom the cash was received;
- ☐ the amount;
- ☐ the date and amount of all deposits into the bank account; and
- ☐ the account or accounts to be credited.

5.3.1.1 Column headings

A column represents a specific account in the general ledger. Therefore column headings can differ from entity to entity depending on the needs of the entity. Where money is received on a regular basis for the same purpose, for example, if an entity renders services on a cash and credit basis, separate columns can be opened for income from services rendered and for debtors. When money is received that cannot be analysed in a column representing a specific ledger account, such a receipt must be analysed in the sundries column and the account(s) affected must be specified in the details column of sundry accounts. Every receipt analysed in the sundries column is posted individually to the account specified in the details column of sundry accounts on the date of the transaction. Where receipts during the month are analysed to columns that represent specific ledger accounts, only the totals of the columns are posted to the specified ledger accounts at the end of the month.

If cash received from debtors is analysed to a separate debtors control column, the individual debtors' accounts in the debtors subsidiary ledger must be updated on a daily basis. A control account for debtors is kept in the general ledger and the total receipts from debtors are posted to the debtors control account at the end of the month. Refer to chapter 9 where this concept is explained in detail.

Before posting to the general ledger at the end of the month, the totals of the columns must be cross-checked (cross-balanced) to ensure that the correct amounts are transferred to the ledger.

5.3.1.2 Columns for non-cash transactions

Columns can also be opened in the CRJ for non-cash transactions to assist in reducing posting to the general ledger. An example of such a column is settlement discount granted. When inventory to the amount of R13 680 is sold on credit, the amount is reflected as outstanding (a debit balance) on the debtor's account. (This entry is first entered in the sales journal as explained in paragraph 5.3.3.3.)

To encourage debtors to settle their accounts promptly, a discount (for example, 5%) can be offered if the account is paid within a certain period (for example, 30 days). If the debtor then pays the account within the specified period, the amount offered as a discount (R684) can be subtracted from the amount the debtor owes (R13 680 – 684 = R12 996). The amount received from the debtor (R12 996) is credited to his/her account, but since this is less than the amount recorded in his/her account (R13 680), the debtor's account remains in debit unless the settlement discount is recorded. To give effect to this entry, the settlement discount granted must be debited and the debtor's account credited. This entry is usually recorded in the general journal as book of first entry (explained in paragraph 5.3.3.5 and Example 5.3).

Where settlement discount is granted to debtors on a regular basis, a column can be opened for this purpose in the CRJ, instead of using the general journal to record the discount. However, the discount is a non-cash transaction that is entered in the CRJ and represents an expense for the entity. The total of the settlement discount granted column should thus be debited to the settlement discount granted account in the general ledger. When such a column is provided for in the CRJ and the debtor pays his/her account, the actual amount of the transaction (R13 680) is entered in the debtors column, the discount (R684) is entered in the settlement discount granted column and the amount received as payment (R12 996) is entered in the bank column. At the end of the month, the total of the bank column is debited to the bank account, the total of the settlement discount granted column is debited to the settlement discount granted account and the total of the debtors column is credited to the debtors control account. (For an example of how to record such an entry refer to the entry on 15 August 20.3 in Example 5.1(a).)

Other examples of non-cash transactions are cost of sales, which is explained in paragraph 5.3.3.1, and the reversal of value-added tax due to discount, explained in Example 5.3. When the totals of all the columns in the CRJ are cross-checked (cross-balanced), the columns for non-cash transactions should be deducted from the total of all the analysis columns (or added to the total of the bank column) to verify the arithmetical correctness of the totals of the columns.

5.3.1.3 Folio columns

Folio columns are for reference purposes. Subsidiary journals are books of first entry, where transactions are entered from source documents before posting is done to the general ledger. When the subsidiary journals are completed and the summarised information is transferred to the general ledger, the number of the page where the entry was made in the general ledger is entered in the folio column of the journal, to serve as proof that the entry was posted and to serve as reference to where the entry was made if any queries should arise. Each general ledger account also has a folio

column indicating the page of the journal from which the amount has been posted, thus providing a complete cross-reference.

In the CRJ, the first folio column is used for reference to the accounts of individual debtors to which cash received from the debtors was posted. When the posting to the general ledger account stipulated in the details of sundry accounts column is completed, the number of the account is entered in the second folio column provided for this purpose in the CRJ. The folio numbers of the general ledger accounts to which the totals of the columns were posted are entered below the total of each analysis column in the CRJ.

Example 5.1(a)

D Moja started the Vision Camera Centre on 1 August 20.3 and entered into the following transactions during August 20.3:

Aug 2 D Moja opened a bank account in the name of the business and deposited R100 000 into the account. He entered into a lease agreement with Northern Shopping Centre and paid R21 400, being a deposit of R10 000 and the first month's rent of R11 400.

3 Paid the water and electricity deposit of R1 000 to Northern Municipality.

4 Purchased equipment to the value of R79 800 on credit from Kojak Suppliers (invoice 0769) and paid a deposit of R8 000.

5 Purchased stationery from Pen & Paper, R1 140 and paid by cheque.

6 Purchased merchandise on credit from Foto Corporation (invoice 1325), R72 732. Returned a camera, invoiced at R456, that was damaged in transit from Foto Corporation and received their credit note number C0172.

7 Cashed a cheque and paid the weeks wages, R1 200. Banked the cash sales for the week, R6 384.

9 Sold merchandise on credit to Rayon Photo Centre for R13 680 (invoice 001).

11 Purchased merchandise on credit from Foto Corporation (invoice 1473), R14 478.

12 Issued a cheque for R855 to Express Printers for advertising brochures printed.

13 Purchased merchandise from Moi Suppliers and paid by cheque, R5 700.

14 Cashed a cheque and paid the weeks wages, R1 200. Cash sales for the week to the value of R13 224 were banked.

15 D Moja allowed a discount of 5% on the account of Rayon Photo Centre when they issued a cheque to settle their account (refer 9 August).

17 Sold goods to Leake Studios on credit for R9 804, per invoice 002.

18 Received R456 for photos taken for the Northern Rugby Club.

19 Received a cheque for R57 from Express Printers with a note that indicated that a calculation error had been made on their invoice (refer 12 August).

21 The week's cash sales to the value of R14 706 were banked. Cashed a cheque and paid the weeks wages, R1 200.

22 Sold goods on credit to Jays Photo Services for R4 446, per invoice 003.

23 Issued a cheque for goods purchased from Fiji Enterprises, R16 530.

25 Jays Photo Services returned a defective camera to the value of R1 026 (refer 22 August). Issued credit note number SCN001. Returned the defective camera, purchased for R513, to Foto Corporation and received their credit note number C0183.

26 Paid the telephone account of R969 received from the Telephone Company. Installation fees included in the R969 amounted to R342.

27 Paid the water and electricity account of R1 596 for the month to the Northern Municipality.

28 Cash sales for the week to the value of R15 048 were banked. The owner cashed a cheque for R6 200 for the week's wages of R1 200; the balance was for his own use.

30 Sold goods to the value of R1 710 on credit to Rayon Photo Centre per invoice 004.

Leake Studios paid R9 690 in full settlement of their account (refer 17 August).

31 Issued a cheque of R6 000 to Kojak Suppliers as a payment on their account. Issued a cheque of R20 000 to Foto Corporation. Received a discount of R171 (refer 6 August).

Required

(a) Prepare the cash receipts journal of Vision Camera Centre for August 20.3 with analysis columns for sales, debtors control, settlement discount granted and sundry accounts.

(b) Post the individual items on a daily basis and the appropriate totals at the end of the month to the applicable accounts in the general ledger of Vision Camera Centre.

Solution

Vision Camera Centre

(a) Cash receipts journal – August 20.3 **CRJ1**

Doc no	Day	Details	Fol	Bank	Sales	Debtors control	Settlement discount granted	Sundry accounts Amount	Sundry accounts Fol	Sundry accounts Details
				R	R	R	R	R		
Rec 1	2	D Moja		100 000				100 000	GL1	Capital
CRR 1	7	Cash sales		6 384	6 384					
CRR 2	14	Cash sales		13 224	13 224					
Rec 2	15	Rayon Photo Centre		12 996		13 680	(684)			
CRR 3	18	Northern Rugby Club		456	456					
Rec 3	19	Express Printers		57				57	GL2	Advertising
CRR 4	21	Cash sales		14 706	14 706					
CRR 5	28	Cash sales		15 048	15 048					
Rec 4	30	Leake Studios		9 690		9 804	(114)			
				172 561	49 818	23 484	(798)	100 057		
				GL3	GL4	GL5	GL6			

(b) General ledger

Dr **Capital** **1** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	2	Bank	CRJ1	100 000

Dr **Advertising** **2** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	19	Bank	CRJ1	57

Dr **Bank** **3** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Receipts	CRJ1	172 561					

Dr **Sales** **4** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	31	Bank	CRJ1	49 818

Dr **Debtors control** **5** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	31	Bank and settlement discount granted	CRJ1	23 484

Dr **Settlement discount granted** **6** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Debtors control	CRJ1	798					

Items in the sundries column are posted individually to the appropriate general ledger accounts on the date on which the transaction occurs. At the end of the month, the columns are totalled. The total of the bank column is debited to the bank account and the total of the settlement discount granted column (a non-cash transaction) is debited to the settlement discount granted account (an expense account) in the general ledger. The total of the sales column is credited to the sales account and the total of the debtors control column is credited to the debtors control account in the general ledger. The amount paid by each debtor should be credited to the individual debtor's account in the debtors ledger on the date of the transaction. This has not been done in this example, as the debtors ledger is only discussed in chapter 9. Take note of the use of folio numbers for cross-reference purposes and proof that the entry was posted.

The general ledger entries in Example 5.1(a) show only the posting from the CRJ. For this reason, the debtors control account and advertising account (an expense account that should have a debit balance) currently reflect credit balances. When all the subsidiary journals have been explained and the postings to the general ledger have been completed, the debtors control account and advertising should have debit balances.

Although the correct contra account must be used in the ledger, the entry in the details column of the bank account is "receipts" or "total receipts", representing the total receipts for the month. In the other accounts, the correct contra account (the account where the double entry is completed) should be used. In this example, the contra account is "bank" in the accounts that are credited and "debtors control" in the settlement discount granted account.

The total debits should add up to the total credits:

Total debits: R(172 561 + 798) = R173 359

Total credits: R(100 000 + 57 + 49 818 + 23 484) = R173 359

This is proof that the double-entry system was completed in the general ledger.

5.3.2 *Cash payments journal (CPJ)*

The bank that handles the cash affairs of an entity supplies its clients with cheques with which to make payments. A cheque, which is a legal tender, is used to transfer money from the current account of an entity to the other party involved in the transaction.

Cheques can be used to pay for goods and services purchased; in settlement of creditors' accounts for goods and services purchased on credit; for wages and salaries; for the redemption of loans; for the payment of profit to owners; and for any other payment that needs to be made.

Cheques are usually detachable and are pre-numbered and printed with counterfoils with corresponding serial numbers. The information entered on the cheque is duplicated on the counterfoil, which serves as the source document for cheque payments. Some cheques are printed in duplicate; the duplicate is then the source document. Payments are usually made on the basis of accounts received from third parties, for example, on receipt of a telephone account or statements received from suppliers. These accounts initiate the payment and are referred to as supporting documents. A payment to a supplier should usually be supplemented by internal documents, for example, a signed delivery note or goods received note.

Where an entity has internet banking facilities, money can be transferred electronically to the bank account of a third party. The bank statement of the payee will indicate the amount of the transfer and the name of the beneficiary. The supporting documents will be similar to those used for cheque payments and the source document is either the printed proof of payment or the bank statement. Electronic transfers can also be used for payments to multiple beneficiaries, for example, the payment of salaries and wages to employees. An entity will, in such cases, supply its bank with an electronic or hard copy list of amounts to be paid to designated beneficiaries. In such a case, only the total amount of the multiple payments will be indicated on the bank statement. The complete list of payments will then serve as the source document for the payment.

Banking practice allows direct charges against a bank account without the necessity of issuing a cheque or an electronic transfer. All direct charges against a bank account will be shown on the bank statement. The item on the bank statement initiates the recording of the transaction in the CPJ. Payments that can be charged directly against a bank account are debit orders and stop orders. For more information on this form of payment, refer to chapter 8 on cash and cash equivalents.

Payment from a bank account can thus be made by

- cheque;
- electronic transfer;
- stop order or debit order; or
- a direct debit by the bank.

A cash payments journal should provide for the recording of

- the serial number of the cheque or other payment voucher;
- the date of payment;
- the name of the beneficiary;
- the amount of the transaction;
- the account or accounts to be debited; and
- the account or accounts to be credited.

In a manual system, the CPJ is usually designed with columns, each representing a general ledger account. Where payments are made during the month that affect the

same ledger account repeatedly, a column can be utilised for the purpose of recording them. Where payments affecting the same ledger account occur only once or twice a month, these entries are usually analysed to the sundries column. If an entity has more than one bank account, a separate CPJ is kept for each bank account. If an entity makes cash payments, a petty cash journal should be kept.

To have proper internal control over cash, all payments should be authorised, if possible, by two people, one of whom should be a senior person. Cheques should be entered in number sequence in the CPJ. If a cheque was cancelled, it must be indicated as such in the CPJ and the cancelled cheque must be filed for reference purposes. Both Internet transfers and cheque payments are usually entered in date sequence as they occur. Stop orders, debit orders and direct debits by the bank are usually entered at the end of the month when the bank statement is received.

Because both the bank and the entity record the same transactions and those balances are reconcilable, an added control measure over cash is created.

Example 5.1(b)

Use the information in Example 5.1(a).

Required

(a) Prepare the CPJ for August 20.3 of Vision Camera Centre, with analysis columns for wages, purchases, creditors control, settlement discount received and sundry accounts.

(b) Post the individual items on a daily basis and the appropriate totals at the end of the month to the applicable accounts in the general ledger of Vision Camera Centre.

Solution

Vision Camera Centre

(a) Cash payments journal – August 20.3 **CPJ1**

Doc no	Day	Details	Fol	Bank	Wages	Purchases	Creditors control	Settlement discount received	Sundry accounts		
									Amount	Fol	Details
				R	R	R	R	R	R		
									10 000	GL7	Rent deposit
001	2	Northern Shopping Centre		21 400					11 400	GL8	Rent expense
002	3	Northern Municipality		1 000					1 000	GL9	Water and electricity deposit
003	4	Kojak Suppliers		8 000			8 000				
004	5	Pen & Paper		1 140					1 140	GL10	Stationery
005	7	Cash		1 200	1 200						
006	12	Express Printers		855					855	GL2	Advertising
007	13	Moi Suppliers		5 700		5 700					
008	14	Cash		1 200	1 200						
009	21	Cash		1 200	1 200						
010	23	Fiji Enterprises		16 530		16 530					
011	26	Telephone Company		969					969	GL11	Telephone expense
012	27	Northern Municipality		1 596					1 596	GL12	Water and electricity
013	28	Cash		6 200	1 200				5 000	GL13	Drawings
014	31	Kojak Suppliers		6 000			6 000				
015		Foto Corporation		20 000			20 171	(171)			
				92 990	4 800	22 230	34 171	(171)	31 960		
				GL3	GL14	GL15	GL16	GL17			

The amount written on the cheque is the amount that should be entered in the bank column. Refer to the entries on 2 August 20.3 and 28 August 20.3.

(b) General ledger

Dr **Advertising** **2** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	12	Bank	CPJ1	855	20.3 Aug	19	Bank	CRJ1	57

Dr **Bank** **3** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Receipts	CRJ1	172 561	20.3 Aug	31	Payments	CPJ1	92 990

Dr **Rent deposit** **7** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	2	Bank	CPJ1	10 000					

Dr **Rent expense** **8** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	2	Bank	CPJ1	11 400					

Dr **Water and electricity deposit** **9** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	3	Bank	CPJ1	1 000					

Dr **Stationery** **10** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	5	Bank	CPJ1	1 140					

Dr **Telephone expense** **11** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	26	Bank	CPJ1	969					

Dr **Water and electricity** **12** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	27	Bank	CPJ1	1 596					

Dr **Drawings** **13** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	28	Bank	CPJ1	5 000					

Dr **Wages** **14** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank	CPJ1	4 800					

Dr **Purchases** **15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank	CPJ1	22 230					

Dr **Creditors control** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank and settlement discount received	CPJ1	34 171					

Dr **Settlement discount received** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	31	Creditors control	CPJ1	171

The following should be noted:

- ☐ The general ledger entries in Example 5.1(b) reflect only the posting from the CRJ and CPJ. For this reason, the creditors control account currently reflects a debit balance. When all the subsidiary journals have been explained and all the postings to the general ledger are complete, the creditors control account should have a credit balance.
- ☐ The account numbers indicate the number of the page on which the account appears. The accounts have been arranged in date sequence and not in the correct sequence of ledger accounts as discussed in chapter 4, paragraph 4.3.
- ☐ The water and electricity deposit differs from the installation costs of the telephone in that the deposit is refundable and is classified as an asset, whereas the installation costs are non-refundable and are written off as an expense.
- ☐ The same principles as were explained under the CRJ apply to posting from the CPJ, except that the total of the bank column is credited to the bank account as "payments" or "total payments" and the accounts affected by the payment must be debited in the general ledger. The settlement discount received account is an income account and it is credited, with "creditors control" as the contra account.

The total debits posted should add up to the total credits posted from the CPJ:

Total debits: R(10 000 + 11 400 + 1 000 + 1 140 + 855 + 969 + 1 596 + 5 000 + 4 800 + 22 230 + 34 171)
= R93 161

Total credits: R(92 990 + 171)
= R93 161

This is proof that the double-entry system was completed in the general ledger.

5.3.3 *Credit journals and the general journal*

The main aim of business entities is to make a profit. If an entity is a trading concern, inventory is bought and sold at a profit. The transactions arising from the purchase and sales activities are the basis for the design of the relevant journals and accounts. Business entities and clients do not always have the necessary cash immediately available; consequently transactions are then negotiated on a credit basis. The aim of a sale transaction is to receive money for the inventory sold. Thus, the debtors' and creditors' accounts can be seen as interim accounts between the original transaction and the realisation of money from the transaction.

When credit transactions take place, accounts should be opened for every debtor and creditor of the entity. To keep the general ledger manageable, separate ledgers are opened for debtors and creditors in which records are kept of the accounts of individual debtors and creditors. A single account summarising all the transactions with debtors and a single account summarising the transactions with creditors are then kept in the general ledger. These accounts are referred to respectively as debtors and creditors control accounts. Credit sales, purchases, payments and receipts are entered in separate subsidiary journals and totals for the month are then posted to the control accounts for debtors and creditors. This system has already been applied in the CRJ and CPJ explained in the previous paragraphs. Debtors control accounts are explained in more detail in chapter 9 and creditors control accounts in chapter 13.

When merchandise is purchased on credit on a regular basis, a purchases journal is used as subsidiary journal. Only merchandise purchased on credit for resale purposes is entered in this journal. When an entity has the need to enter all its credit transactions into the same subsidiary journal, that journal is referred to as a creditors subsidiary journal. This journal differs from the purchases journal in that all merchandise, assets, consumable inventories such as stationery and other expenses incurred on credit are entered in this journal. Only the purchases journal will be discussed in detail in this book. Any other transactions incurred on credit should be entered in the general journal.

5.3.3.1 Purchases journal

☐ **Objective of a purchases system**

The purpose of a purchasing system is to record accurately purchase transactions which provide information on the availability of merchandise needed to run the business and to record obligations to suppliers to ensure that accounts are settled on time.

☐ **Inventory systems**

There are two different systems for recording merchandise purchased for resale purposes, namely the *perpetual inventory system* and the *periodic inventory system*. In the *perpetual inventory system*, inventory records are continuously updated with each sale. The balance on the inventory account reflects the inventory that is available for resale. A physical count of inventory is necessary to control the correctness of the perpetual inventory records.

In the *periodic inventory system*, inventory purchased is entered in a purchases account. The cost of goods sold is determined at the end of the financial period, when the inventory is physically counted, and deducted from the total of opening inventory and the inventory purchased during the period. The inventory account (with an opening balance that remains unchanged during the financial period) is then updated with the value of the closing inventory. Practical considerations, such as the relative simplicity and low cost of implementing the periodic system, have resulted in this system being extensively used by small entities. In the *periodic inventory system,* where merchandise purchased is debited to a *purchases* account, provision must be made for a purchases column in the subsidiary journals.

When the *perpetual inventory* system is used, provision must be made for an inventory column in the subsidiary journals. Merchandise purchased for resale must be debited to the inventory account. Since the inventory account is updated with every sale of merchandise, provision must also be made for a cost of sales column in both the cash receipts and sales journals. A complete double entry must be performed from the cost of sales column, as cost of sales is not taken into account in any other column. The column total is debited to the cost of sales account and credited to the inventory account. The cost of sales column in the CRJ is another example of a column for non-cash transactions. The cost of sales column differs from the settlement discount granted column (refer to paragraph 5.3.1.2) in that a single entry needs to be made from the total of the settlement discount granted column to complete the double entry since the discount has been taken into account in the debtors column.

These two inventory systems are discussed in more detail in chapter 7.

☐ Design of a purchases journal

The purchasing procedure commences when the need arises for a certain product. When the necessary authorisations are obtained, the merchandise is ordered. Although the invoice from the supplier is the source document used to record the transaction, there must be proof of delivery before the invoice can be recorded. The numbers printed on the invoices can usually not be used as reference numbers, as they differ from transaction to transaction and from supplier to supplier. For this reason, either the invoices must be renumbered in sequence or the inventory received notes can be numbered. These numbers can be used as reference numbers.

The purchases journal is used specifically for recording credit purchases of merchandise purchased for resale purposes. The minimum information necessary to identify a transaction is the invoice number, the date of the transaction, the creditor's name and the amount of the invoice. A *trade discount* is deducted from the original selling price on the invoice and the amount shown as outstanding on the invoice is the amount that must be recorded in the purchases journal. Therefore a trade discount is not recorded in the books of the entity. This differs from *settlement discount received*, in that settlement discount is received after the original transaction has been recorded. When the creditor allows the entity to pay less than the recorded amount of the transaction, the difference is shown as settlement discount received in the books of the entity.

The layout of a simple purchases journal is as follows:

Purchases journal – Month and year **PJ no**

Invoice number	Day	Details	Fol	Purchases	Creditors control
				R	R

From the entries in the purchases journal, the individual accounts of creditors are updated on a daily basis in the creditors ledger. The columns are usually totalled at the end of the month. If the periodic system is in use, the total of the purchases column is debited to the purchases account. If the perpetual inventory system is in use, the heading of the column would be inventory and the inventory account would be debited. The creditors control account is credited with the total of the creditors control column.

Refer to the purchases journal in Example 5.1(c).

5.3.3.2 Purchases returns journal

It often happens that incorrect inventory is delivered, or that some of the inventory has been damaged in transit, or that inventory has been incorrectly priced by the supplier. In such cases, the entity will request that the supplier issue it with a credit note.

Where returns or other allowances on purchases occur regularly, a journal for purchases returns can be used. A credit note should first be received from the supplier before the entry is captured in the purchases returns journal.

The purchases returns journal is similar to a purchases journal, with columns for purchases returns and creditors control. The purchases returns account is credited and the creditors control account is debited with the totals of this journal. It is appropriate to record returns separately and not as a credit on the purchases account. This helps to identify suppliers who constantly deliver inventory of inferior quality.

Refer to the purchases returns journal in the following example.

Example 5.1(c)

Use the information in Example 5.1(a).

Required

(a) Prepare the purchases journal for August 20.3 of Vision Camera Centre with analysis columns for purchases and creditors control.

(b) Prepare the purchases returns journal for August 20.3 of Vision Camera Centre with analysis columns for purchases returns and creditors control.

(c) Post the totals at the end of the month to the applicable accounts in the general ledger of Vision Camera Centre.

Solution

Vision Camera Centre

(a) Purchases journal – August 20.3 **PJ 1**

Invoice number	Day	Details	Fol	Purchases	Creditors control
				R	R
P001	6	Foto Corporation		72 732	72 732
P002	11	Foto Corporation		14 478	14 478
				87 210	87 210
				GL15	GL16

(b) Purchases returns journal – August 20.3 **PRJ 1**

Invoice number	Day	Details	Fol	Purchases returns	Creditors control
				R	R
PCN001	6	Foto Corporation		456	456
PCN002	25	Foto Corporation		513	513
				969	969
				GL18	GL16

(c) General ledger

Dr **Purchases** **15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank	CPJ1	22 230					
		Creditors control	PJ1	87 210					

Dr **Creditors control** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank	CPJ1	34 171	20.3 Aug	31	Purchases	PJ1	87 210
		Purchases returns	PRJ1	969					

Dr **Purchases returns** **18** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	31	Creditors control	PRJ1	969

5.3.3.3 Sales journal

☐ Objective of a sales system

The purpose of a sales system is to accurately record a sales transaction. If the perpetual inventory system is in use, the cost of sales is credited to the inventory account when the sale takes place. The current level of inventory is thus constantly updated, but a physical inventory count is necessary to confirm this amount.

The sales system records mainly the obligations of debtors. If it is a new client, the credit control department determines the credit rating of the client and, if approved, the conditions of credit will be finalised with the client. If it is an existing client, the debtor's account will be evaluated to determine the collectability of outstanding amounts before another transaction can be approved and recorded.

☐ Design of a sales journal

The credit sales procedure starts when a sales transaction is concluded with a client after the credit rating of the client has been confirmed. The sales journal is used specifically for recording credit sales. The minimum information necessary to identify a transaction is the invoice number, the date of the transaction, the name and address of the customer, the amount of the invoice and the terms of the settlement.

The layout of a simple sales journal is as follows:

Sales journal – Month and year **SJ no**

Invoice number	Day	Details	Fol	Sales	Debtors control
				R	R

From the entries in the sales journal, the individual accounts of debtors are updated on a daily basis in the debtors ledger. The columns are usually totalled at the end of the month. The total of the sales column is credited to the sales account and the total of the debtors control column is debited to the debtors control account. If the perpetual inventory system is in use, provision should be made for a column for cost of sales. From this column, cost of sales is debited and inventory credited.

Refer to the sales journal in Example 5.1(d).

5.3.3.4 Sales returns journal

When inventory is sold on credit, it is invoiced to the client at selling price. If, after it has been delivered, the inventory is unacceptable to the client because of its inferior quality or for other acceptable reasons, it is usually returned by the debtor. The debtor will be issued with a credit note informing him/her that his/her account has been reduced by the amount indicated on the credit note.

Where returns on sales occur regularly, a sales returns journal can be used. The sales returns journal is similar to the sales journal, with columns for sales returns and debtors control. The sales returns account is debited and the debtors control account is credited from this journal. It is appropriate to record returns separately and not as a debit on the sales account, as this helps to identify reasons for returns of inventory and to identify suppliers who deliver inventory of inferior quality.

Refer to the sales returns journal in the following example.

Example 5.1(d)

Use the information in Example 5.1(a).

Required

(a) Prepare the sales journal for August 20.3 of Vision Camera Centre, with analysis columns for sales and debtors control.

(b) Prepare the sales returns journal for August 20.3 of Vision Camera Centre, with analysis columns for sales returns and debtors control.

(c) Post the totals at the end of the month to the applicable accounts in the general ledger of Vision Camera Centre.

Solution

Vision Camera Centre

(a) Sales journal – August 20.3 **SJ 1**

Invoice number	Day	Details	Fol	Sales	Debtors control
				R	R
S001	9	Rayon Photo Centre		13 680	13 680
S002	17	Leake Studios		9 804	9 804
S003	22	Jays Photo Services		4 446	4 446
S004	30	Rayon Photo Centre		1 710	1 710
				29 640	29 640
				GL4	GL5

(b) Sales returns journal – August 20.3 **SRJ 1**

Invoice number	Day	Details	Fol	Sales returns	Debtors control
				R	R
SCN001	25	Jays Photo Services		1 026	1 026
				1 026	1 026
				GL19	GL5

(c) General ledger

Dr **Sales** **4** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					Aug	31	Bank	CRJ1	49 818
							Debtors control	SJ1	29 640

continued

Dr **Debtors control** **5** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Sales	SJ1	29 640	20.3 Aug	31	Bank Sales returns	CRJ1 SRJ1	23 484 1 026

Dr **Sales returns** **19** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Debtors control	SRJ1	1 026					

5.3.3.5 General journal

Every transaction can be recorded in the general journal as book of first entry. If, however, an entity finds that transactions of a similar nature repeatedly affect a specific general ledger account, it usually designs a subsidiary journal to record these transactions. If a specific journal does not exist for a transaction, the general journal should be used to record such a transaction.

When the general journal is used as the subsidiary journal, the account(s) that should be debited in the general ledger must be entered first. The amount of the transaction is entered in the first amount column, known as the debit column. The account that should be credited in the general ledger is indented in the details column and the amount is entered in the second column, known as the credit column. The folio column is used for reference purposes. A narration (a brief explanation) of the transaction, with reference to the source document number, is entered below the account titles in the details column.

The layout of the general journal is as follows:

Name

General journal **J10**

Month	Day	Details	Fol	Debit	Credit
20.0				**R**	**R**
Jan	1	Account debited		xxx xxx	
		Account credited			xxx xxx
		Narration			

When entries affecting debtors and creditors form a major part of the entries made in the general journal, analysis columns for debtors and creditors can be added to the journal, thus reducing the number of postings to the debtors and creditors control accounts. This is then referred to as an analysis general journal.

Example 5.1(e)

Use the information in Example 5.1(a).

Required

(a) Prepare the general journal of Vision Camera Centre for August 20.3.

(b) Post the entries to the applicable accounts in the general ledger of Vision Camera Centre.

Solution

Vision Camera Centre

(a) General journal **J1**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Aug	4	Equipment at cost	GL20	79 800	
		Creditors control/Kojak Suppliers	GL16		79 800
		Equipment purchased on credit from Kojak Suppliers (Invoice 0769)			

(b) General ledger

Dr **Equipment at cost** **20** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
Aug	4	Creditors control	J1	79 800					

Dr **Creditors control** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
Aug	31	Bank	CPJ1	34 171	Aug	4	Equipment at cost	J1	79 800
		Purchases returns	PRJ1	969		31	Purchases	PJ1	87 210

Example 5.1 will be done in its entirety, taking value-added tax (VAT) into account, at the end of this chapter. It is necessary, however, first to explain what VAT is and how it should be recorded in the books.

5.4 Value-Added Tax (VAT)

5.4.1 *Background*

VAT is a tax levied by the government on the *supply* of *goods* and *services* in the course of the business of an enterprise. It is a comprehensive tax which is levied on virtually all goods and services, from the provision of raw materials in the production process and at each stage thereafter, until the product or service is made available to the customer. The rate at which VAT is levied may vary from time to time, depending on the government's required income from this form of taxation. The rate currently in effect is 14%.

In section 1 of the Value-Added Tax Act, No 89 of 1991 (the VAT Act), certain words are comprehensively defined. It is necessary to take note of the following:

- ☐ *Supply* includes all forms of supply whether voluntary or compulsory, irrespective of place. Any derivation of the word *supply* is included.
- ☐ *Goods* includes corporeal moveable things and fixed property.
- ☐ *Services* includes anything done or to be done and the making available of any facility or advantage, excluding the supply of money.

- ☐ *Enterprise* embraces various types of activities carried on on a regular or continuous basis where goods or services are supplied for a consideration whether for a profit or not.
- ☐ A *vendor* is a person (not an enterprise) who is registered or is required to register for VAT.
- ☐ *Taxable supplies* means any supply of goods or services which is chargeable with tax including tax chargeable at the rate of zero percent.

The amount at which an entity is required to register as a *vendor* is defined in the VAT Act. Although an enterprise may apply for voluntary registration (taxable supplies must exceed R50 000 in a 12-month period), the enterprise must register as a vendor if its *taxable supplies* exceeded R1 000 000 in the preceding period of 12 months or if there are reasonable grounds for believing that the total taxable supplies in the following 12 months will exceed R1 000 000. The onus is on the business to register, where necessary, within 21 days of becoming liable to register. A tax period is allocated by the South African Revenue Services (SARS) and can be for example 1, 2, 4, 6 or 12 months, indicating when vendors must submit their returns to cover the period.

There are two types of supplies:

- ☐ taxable supplies that can either be at
  - a standard rate (currently 14%); or
  - zero-rated (0%) supplies;
- ☐ exempt supplies.

Some examples of zero-rated supplies are

- ☐ brown bread, samp, lentils, unflavoured milk powder, graded maize meal for human consumption, etc as specified in part B of Schedule 2;
- ☐ certain goods used for agricultural purposes;
- ☐ petrol, diesel and crude oil; and
- ☐ certain exported goods or services.

Exempted supplies include

- ☐ certain educational services;
- ☐ the transport of passengers by road or rail;
- ☐ members' contributions to a trade union;
- ☐ the supply of accommodation in a dwelling; and
- ☐ the supply of financial services.

Exempt goods are exempted from VAT and differ from zero-rated supplies in that no output tax is charged and the supplier is unable to claim input tax on such goods. Thus, a vendor who supplies zero-rated goods can claim a deduction for input tax paid by him, while a vendor that makes exempted supplies cannot claim any input tax paid by him as a deduction.

A detailed study of VAT is beyond the scope of this text. However, it is necessary that you understand the basic principles underlying this form of taxation, because accounting systems must provide for the receipt and payment of VAT. VAT will be illustrated in this chapter and only where necessary in later chapters.

5.4.2 *The collection, payment and settlement of VAT*

When a vendor is supplied with goods or services by another vendor, VAT will be levied by the supplier of those goods or services. The VAT on those goods or services received is the *input tax* of the vendor who receives those goods or services. When that vendor in turn supplies goods or services to other persons (or vendors), VAT must be included in the price charged for those goods or services. This is the *output tax* of the vendor.

The tax is only levied on the *value added* by each producer or distributor through whose hands the goods or services have passed, before reaching the end user. This means that the *input tax* that was previously paid by the business and for which a tax invoice was issued can be deducted from the *output tax* to calculate the amount payable to SARS, therefore

Output tax on goods or services *supplied*	–	*Input tax* on goods or services *received*	=	VAT payable to SARS

When input tax exceeds output tax, a refund will be made to the vendor by SARS.

Example 5.2 illustrates how VAT is charged as goods move from one vendor to the next in the manufacturing and distribution chain until they reach the final consumer.

Example 5.2

Vendor	Sold to	Purchase value (VAT excluded)	VAT input (a)	Selling value (VAT excluded)	VAT output (b)	Selling price	VAT payable (b) – (a)
		R	R	R	R	R	R
Raw material merchant	Manufacturer	–	–	1 000	140	1 140	140
Manufacturer	Wholesaler	1 000	140	4 000	560	4 560	420
Wholesaler	Retailer	4 000	560	9 000	1 260	10 260	700
Retailer	Consumer	9 000	1 260	10 000	1 400	11 400	140
							1 400

The total tax paid to SARS by the vendors in the chain is equal to the VAT paid by the consumer on the final selling price, namely 14% × R10 000 = R1 400

5.4.3 *Accounting procedures for the recording of VAT*

Payment of VAT to SARS must be made according to the period allocated to the entity. The completed VAT201 return must be submitted to SARS by the twenty-fifth day of the month following the end of the tax period month detailing the output and input tax for the period. It is therefore necessary that the accounting records of a registered vendor make provision for the separate recording of VAT input and VAT output. To calculate the amount owing to SARS, the VAT input and VAT output accounts are closed off against a VAT control account.

VAT is levied on behalf of the government by the vendors. The VAT added to the selling price belongs to the government and does not form part of the income of the

vendor. Purchases and sales should be reflected at the value of the goods excluding VAT. In Example 5.2, the retailer paid a net amount of R10 260 to the wholesaler for the goods. The value of purchases for the retailer is R9 000. The R1 260 is VAT input that should, at the end of the VAT period, be transferred to the VAT control account. When the goods are sold, the value of sales for the retailer is R10 000 and the R1 400 is VAT output that should, at the end of the VAT period, be transferred to the VAT control account. If the VAT control account has a credit balance, the business owes SARS money; a debit balance is an indication that SARS owes the business money. In Example 5.2, the amount payable by the retailer to SARS amounts to R140.

Although all transactions should first be entered in a subsidiary journal, the net result of the purchase and sale transactions and how VAT should be recorded in the general ledger of the retailer are illustrated in Example 5.2(a). If it is assumed that both of these were credit transactions, the entries would be as follows:

Example 5.2(a)

Dr	**Purchases**		**Cr**
	R		**R**
W Wholesaler	9 000		

Dr	**Sales**		**Cr**
	R		**R**
		C Consumer	10 000

Dr	**W Wholesaler**		**Cr**
	R		**R**
		Purchases and VAT	10 260

Dr	**C Consumer**		**Cr**
	R		**R**
Sales and VAT	11 400		

Dr	**VAT input**		
	R		**R**
W Wholesaler	1 260		

Dr	**VAT output**		**Cr**
	R		**R**
		C Consumer	1 400

It is clear from the above entries that the amounts of VAT input and VAT output are recorded separately from the purchases and sales amounts. The retailer will thus apply his profit margin on the net purchase price of R9 000.

If it is assumed that the above were the only transactions in the retailer's two-month VAT period, he would have to pay R140 to SARS by the twenty-fifth of the following month. The accounting entries for the calculation of this amount are explained in Example 5.2(b).

Example 5.2(b)

Dr	**VAT input**		**Cr**
	R		**R**
W Wholesaler	1 260	VAT control	1 260

Dr	**VAT output**		**Cr**
	R		**R**
VAT control	1 400	C Consumer	1 400

Dr	**VAT control**		**Cr**
	R		**R**
VAT input	1 260	VAT output	1 400
Bank (SARS)	140		
	1 400		1 400

Any credit balance on the VAT control account at the end of any financial period should be reflected as a current liability on the statement of financial position of the entity. A debit balance on the VAT control account will be shown as a current asset.

If a vendor is not registered for VAT purposes, input VAT is not recoverable and should be included in the cost of the item and forms part of the purchase price. It will be assumed throughout this chapter that all enterprises are registered as vendors, that all goods and services are supplied at the standard rate (currently 14%) and that tax invoices are issued with all transactions.

Example 5.3 shows how VAT should be recorded by an entity that is registered as a VAT vendor.

Example 5.3

Use the information in Example 5.1(a), taking the following additional information into account. Vision Camera Centre is registered as a VAT vendor. The VAT period of the business ends on unequal months.

Required

(a) Record the transactions in the following subsidiary journals of Vision Camera Centre for August 20.3:

- ☐ Cash receipts journal with analysis columns for bank, sales, VAT output, debtors control, settlement discount granted, VAT input and sundry accounts.
- ☐ Cash payments journal with analysis columns for bank, wages, purchases, creditors control, settlement discount received, VAT input, VAT output and sundry accounts.
- ☐ Sales journal with analysis columns for VAT output, sales and debtor control.
- ☐ Purchases journal with analysis columns for VAT input, purchases and creditors control.
- ☐ Sales returns journal with analysis columns for VAT output, sales returns, and debtors control.
- ☐ Purchases returns journal with analysis columns for VAT input, purchases returns and creditors control.
- ☐ General journal.

(b) Post the entries to the general ledger of Vision Camera Centre. All the accounts must be properly balanced at 31 August 20.3.

(c) Prepare the trial balance of Vision Camera Centre at 31 August 20.3.

Solution

Vision Camera Centre

(a) Cash receipts journal – August 20.3 **CRJ1**

Doc no	Day	Details	Fol	Bank	Sales	VAT output	Debtors control	Settle-ment discount granted	VAT input	Sundry accounts		
										Amount	Fol	Details
				R	R	R	R	R	R	R		
Rec 1	2	D Moja		100 000						100 000	GL1	Capital
CRR 1	7	Cash sales		6 384	5 600	784						
CRR 2	14	Cash sales		13 224	11 600	1 624						
Rec 2	15	Rayon Photo Centre		12 996			13 680	(600)	(84)			
CRR 3	18	Northern Rugby Club		456	400	56						
Rec 3	19	Express Printers		57		7				50	GL2	Advertising
CRR 4	21	Cash sales		14 706	12 900	1 806						
CRR 5	28	Cash sales		15 048	13 200	1 848						
Rec 4	30	Leake Studios		9 690			9 804	(100)	(14)			
				172 561	43 700	6 125	23 484	(700)	(98)	100 050		
				GL3	GL4	GL22	GL5	GL6	GL21			

Vision Camera Centre

Cash payments journal – August 20.3 **CPJ1**

Doc no	Day	Details	Fol	Bank	Wages	Pur-chases	Creditors control	Settle-ment discount received	VAT input	VAT output	Sundry accounts		
											Amount	Fol	Details
				R	R	R		R	R	R	R		
001	2	Northern									10 000	GL7	Rent deposit
		Shopping Centre		21 400					1 400		10 000	GL8	Rent expense
002	3	Northern		1 000							1 000	GL9	Water and
		Municipality											electricity
													deposit
003	4	Kojak Suppliers		8 000			8 000						
004	5	Pen & Paper		1 140					140		1 000	GL10	Stationery
005	7	Cash		1 200	1 200								
006	12	Express Printers		855					105		750	GL2	Advertising
007	13	Moi Suppliers		5 700		5 000			700				
008	14	Cash		1 200	1 200								
009	21	Cash		1 200	1 200								
010	23	Fiji Enterprises		16 530		14 500			2 030				
011	26	Telephone		969					119		850	GL11	Telephone
		Company											expense
012	27	Northern		1 596					196		1 400	GL12	Water and
		Municipality											electricity
013	28	Cash		6 200	1 200						5 000	GL13	Drawings
014	31	Kojak Suppliers		6 000			6 000						
015		Foto Corporation		20 000			20 171	(150)		(21)			
				92 990	4 800	19 500	34 171	(150)	4 690	(21)	30 000		
				GL3	GL14	GL15	GL16	GL17	GL21	GL22			

Vision Camera Centre

Sales journal – August 20.3 **SJ1**

Invoice number	Day	Details	Fol	VAT output	Sales	Debtors control
				R	R	R
S001	9	Rayon Photo Centre		1 680	12 000	13 680
S002	17	Leake Studios		1 204	8 600	9 804
S003	22	Jays Photo Services		546	3 900	4 446
S004	30	Rayon Photo Centre		210	1 500	1 710
				3 640	26 000	29 640
				GL22	GL4	GL5

Vision Camera Centre

Purchases journal – August 20.3 **PJ1**

Invoice number	Day	Details	Fol	VAT input	Purchases	Creditors control
				R	R	R
P001	6	Foto Corporation		8 932	63 800	72 732
P002	11	Foto Corporation		1 778	12 700	14 478
				10 710	76 500	87 210
				GL21	GL15	GL16

Vision Camera Centre

Sales returns journal – August 20.3 **SRJ1**

Invoice number	Day	Details	Fol	VAT output	Sales returns	Debtors control
				R	R	R
SCN001	25	Jays Photo Services		126	900	1 026
				126	900	1 026
				GL22	GL19	GL5

Vision Camera Centre

Purchases returns journal – August 20.3 **PRJ1**

Invoice number	Day	Details	Fol	VAT input	Purchases returns	Creditors control
				R	R	R
PCN001	6	Foto Corporation		56	400	456
PCN002	25	Foto Corporation		63	450	513
				119	850	969
				GL21	GL18	GL16

Vision Camera Centre

General journal **J1**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Aug	4	Equipment at cost	GL20	70 000	
		VAT input	GL21	9 800	
		Creditors control/Kojak Suppliers	GL16		79 800
		Equipment purchased on credit from Kojak Suppliers			
	31	VAT control	GL23	25 179	
		VAT input	GL21		25 179
		Transfer of VAT input to the VAT control account			
		VAT output	GL22	9 660	
		VAT control	GL23		9 660
		Transfer of VAT output to the VAT control account			

The transfer of VAT input and VAT output to the VAT control account (entries on 31 August 20.3 above) can only be done once the VAT input and VAT output accounts have been completed in the general ledger.

Vision Camera Centre

(b) General ledger

Dr **Capital** **1** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					Aug	2	Bank	CRJ1	100 000

Dr **Advertising** **2** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
Aug	12	Bank	CPJ1	750	Aug	19	Bank	CRJ1	50
						31	Balance	c/d	700
				750					750
Sep	1	Balance	b/d	700					

Dr **Bank** **3** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
Aug	31	Receipts	CPJ1	172 561	Aug	31	Payments	CRJ1	92 990
							Balance	c/d	79 571
				172 561					172 561
Sep	1	Balance	b/d	79 571					

continued

Dr **Sales** **4** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	31	Bank	CRJ1	43 700
							Debtors control	SJ1	26 000
									69 700

Dr **Debtors control** **5** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Sales & VAT output	SJ1	29 640	20.3 Aug	31	Bank & Settlement discount granted	CRJ1	23 484
							Sales returns & VAT output	SRJ1	1 026
							Balance	c/d	5 130
				29 640					29 640
Sep	1	Balance	b/d	5 130					

Dr **Settlement discount granted** **6** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Debtors control	CRJ1	700					

Dr **Rent deposit** **7** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	2	Bank	CRJ1	10 000					

Dr **Rent expense** **8** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	2	Bank	CRJ1	10 000					

Dr **Water and electricity deposit** **9** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	3	Bank	CRJ1	1 000					

Dr **Stationery** **10** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	5	Bank	CRJ1	1 000					

continued

Dr **Telephone expense** **11** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	26	Bank	CRJ1	850					

Dr **Water and electricity** **12** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	27	Bank	CRJ1	1 400					

Dr **Drawings** **13** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	28	Bank	CRJ1	5 000					

Dr **Wages** **14** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank	CRJ1	4 800					

Dr **Purchases** **15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank	CRJ1	19 500					
		Creditors control	PJ1	76 500					
				96 000					

Dr **Creditors control** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Bank & Settlement discount received	CPJ1	34 171	20.3 Aug	4	Equipment at cost & VAT input	J1	79 800
		Purchases returns & VAT input	PRJ1	969		31	Purchases & VAT input	PJ1	87 210
		Balance	c/d	131 870					
				167 010					167 010
					Sep	1	Balance	b/d	131 870

Dr **Settlement discount received** **17** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	31	Creditors control	CPJ1	150

continued

Dr **Purchases returns** **18** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3 Aug	31	Creditors control	PRJ1	850

Dr **Sales returns** **19** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Debtors control	SRJ1	900					

Dr **Equipment at cost** **20** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	4	Creditors control	J1	70 000					

Dr **VAT input** **21** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	4	Creditors control	J1	9 800	20.3 Aug	31	Creditors control	PRJ1	119
	31	Bank	CPJ1	4 690			VAT control	J1	25 179
		Bank	CRJ1	98					
		Creditors control	PJ1	10 710					
				25 298					25 298

Dr **VAT output** **22** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	Debtors control	J1	126	20.3 Aug	31	Bank	CRJ1	6 125
		VAT control	J1	9 660			Debtors control	SJ1	3 640
							Bank	CPJ1	21
				9 786					9 786

Dr **VAT control** **23** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Aug	31	VAT input	J1	25 179	20.3 Aug	31	VAT output	J1	9 660
							Balance	c/d	15 519
				25 179					25 179
Sep	1	Balance	b/d	15 519					

The accounts in the general ledger are in transaction sequence. When a new entity starts with a new set of books, the accounts must be arranged in the correct sequence. For the correct sequence of accounts refer to chapter 4, paragraph 4.3.

Vision Camera Centre

(c) Trial balance at 31 August 20.3

	Fol	Debit	Credit
		R	R
Capital	GL1		100 000
Advertising	GL2	700	
Bank	GL3	79 571	
Sales	GL4		69 700
Debtors control	GL5	5 130	
Settlement discount granted	GL6	700	
Rent deposit	GL7	10 000	
Rent expense	GL8	10 000	
Water and electricity deposit	GL9	1 000	
Stationery	GL10	1 000	
Telephone expense	GL11	850	
Water and electricity	GL12	1 400	
Drawings	GL13	5 000	
Wages	GL14	4 800	
Purchases	GL15	96 000	
Creditors control	GL16		131 870
Settlement discount received	GL17		150
Purchases returns	GL18		850
Sales returns	GL19	900	
Equipment at cost	GL20	70 000	
VAT control	GL23	15 519	
		302 570	302 570

5.5 Summary

Transactions should first be recorded in subsidiary journals before they are posted in a summarised form to the general ledger. The repetitive nature of transactions in an entity usually determines the subsidiary journals used. A source document should be completed for every transaction. Sufficient information should be captured on the source document to identify the subsidiary journal in which the transaction should be recorded and to recognise the accounts affected by the transaction. The details of the transaction are recorded in the subsidiary journal, from where they are analysed and summarised to minimise the number of entries in the general ledger. The totals on journals are posted to the general ledger in compliance with the double-entry system.

VAT, currently levied at 14% on taxable supplies, is collected on behalf of SARS. Vendors, who are entities registered for VAT purposes, submit a VAT return at the end of the VAT period. To record VAT, additional columns are opened in the subsidiary journals for this purpose. VAT on sales, ie VAT output, is levied on behalf of SARS and must be paid over to SARS, while VAT paid on purchases, ie VAT input, can be deducted from this amount. The amount due to or by SARS is calculated in the VAT control account. A credit balance on the VAT control account at the end of the financial year, before the next payment is due to SARS, is shown under current liabilities as VAT payable, while a debit balance is shown under current assets as VAT receivable.

CHAPTER 6

Adjustments

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Overview of adjustments

ACCRUAL BASIS OF ACCOUNTING

		Income or expense account	Statement of financial position account
• Depreciation	→	Dr Depreciation	Cr Accumulated depreciation
• Consumable inventory	→	Cr Specific expense account	Dr Inventory of specific expense
• Credit losses	→	Dr Credit losses	Cr Debtor/Debtors control
• Accrued income	→	Cr Income account	Dr Accrued income account
• Income received in advance	→	Cr Income account	Dr Income received in advance
• Accrued expenses	→	Dr Specific expense account	Cr Accrued expenses
• Prepaid expenses	→	Cr Specific expense account	Dr Prepaid expenses

6.1 Introduction

Study objectives

After studying this chapter you should be able to

☐ identify the accounts that have to be adjusted;
☐ calculate and record the adjustments in the subsidiary journal;
☐ post the adjustments to the ledger; and
☐ prepare a post-adjustment trial balance.

The financial performance of an entity for a financial period is measured in the statement of profit or loss and other comprehensive income. This was explained in chapter 3, where it was stated that

☐ financial performance is measured over a specific period of time, but can be measured as often as required by the management of the entity, usually once every twelve months (the financial year); and
☐ financial performance = profit (total comprehensive income)/loss for the period = income – expenses.

In order to understand adjustments, it is important to know exactly what assets, liabilities, income and expenses are. For this purpose, review the definitions of these elements in chapter 1 and the financial performance and financial position in chapters 2 and 3.

Until now, the transactions that were recorded were applicable to the specific period under review. As business is conducted without interruption and on a continuous basis, some of the transactions recorded are not applicable to the particular accounting period in which they are recorded. Payments can be made in advance, or expenses incurred can be paid for after the end of a financial period. A water and electricity account serves as an example. The municipality makes a reading of the units of water and electricity used during a specific period, at the end of that period. This information is then processed and accounts are sent to the users to be paid by the end of the following month. Thus, the water and electricity used, for example in April, will only be paid for in May or June. If the financial year of the entity ends at the end of April, the actual usage for April will be known, but it will not have been paid for yet. This then needs to be recorded before the water and electricity usage for the financial year can be determined. As other accounts could be affected in a similar manner, the balances of all the accounts in the ledger should be examined with care and, if necessary, adjusted to ensure that the actual income and expenses for the period under review and the exact value of assets and liabilities at the end of the period are reflected.

Adjusting entries form an integral part of the accounting cycle and are recorded only at the end of a financial period, when the accounts are examined and adjusted to ensure that the information is applicable to the particular period under review. Adjustments are internal transactions that are usually recorded in the general journal as book of first entry. The source documents used to give effect to the recording of these transactions are usually internal vouchers specifically developed for this purpose, which should be properly signed by an authorised person.

Adjustments are not corrections of mistakes. Corrections are recorded when they are detected and could influence a wide variety and numerous combinations of accounts, while adjusting entries always influence at least one statement of financial position account and one income or expense account. There is also a difference between adjustments and closing entries. Once the accounts have been adjusted and the accountant is satisfied that the correct information is reflected in all the accounts, closing off can be done. Closing off is done to determine the profit (total comprehensive income) or loss of the entity for a financial period. The closing-off procedure is discussed in chapter 7.

6.2 The necessity for adjustments

Although other parties are also interested in the financial results of an entity (refer to chapter 1, paragraph 1.10), the owners of an entity need to know whether they have reached the goals set for a specific period. Adjustments can be taken into account for interim reporting but the actual entries must be done at the end of the financial year, when the financial statements are being compiled. The accounting records should then be analysed and adjusted to reflect only the information of the period under review.

The *accrual basis of accounting* influences the reporting on income and expenses during a specific financial period. According to this basis, the effect of transactions must be recognised when they occur (and not when cash is realised from the transaction) and recorded in the accounting records of the periods to which they relate. To give effect to this process, the adjustment of accounts is necessary to ensure that the correct financial position and financial result are reported in financial statements.

The following are examples of adjustments:

- the depreciation of the assets used to produce the income of the entity;
- recording the value of consumable inventory on hand;
- the writing off of credit losses; and
- accrued and prepaid income and expenses.

The adjustments made at the end of the financial year are to determine the correct profit (total comprehensive income) or loss for the period and to reflect the correct financial position of the entity on the statement of financial performance. Unused consumable inventory and accrued and prepaid income and expenses are usually of a temporary nature: the consumable inventory would most probably be consumed in the next financial period, accrued expenses would be paid, accrued income would be received, services would be rendered for income received in advance, and prepaid expenses would be expended. The adjustments that were done to reflect a temporary situation should therefore be reversed at the beginning of the new financial year. Owing to the continuous nature of the business, the original situation should be reinstated. If it is not, the income and expense accounts of the next financial period would reflect the wrong information.

6.3 The recording of adjustments

The double-entry system is also applicable to the recording of adjustments, where the total of the debit entries made for one adjustment should be equal to the credit entries in another account or accounts. The one leg of the entry would usually affect an income or expense account and would thus affect the calculation of the profit/total comprehensive income for the period. The other leg of the entry would usually have an effect on a statement of financial position account.

Adjustments usually involve the following four steps:

Step 1: Identify the accounts that must be adjusted.

Step 2: Determine how the accounts would be affected and what the balances of these accounts should be.

Step 3: Calculate the amount of the adjustment.

Step 4: Record the necessary adjustments in the general journal and post the entries to the ledger(s).

6.3.1 *Depreciation*

When an asset is purchased, it is expected to produce income over a certain period, usually longer than one year. The asset gradually loses value over its useful life, which cannot always be determined precisely and has to be estimated. The estimation of the

portion of the cost of an asset used in the production of income is known as depreciation. *Depreciation is thus the accounting process by means of which the cost of an asset is fairly and systematically allocated to expenses over the economic life of that asset*. Writing off depreciation would ensure that the income generated by the asset in that period is suitably associated with the expenses of that period. There are various methods of calculating depreciation which will be discussed in more detail in chapter 11. In this chapter, attention is given to the accounting entries of depreciation as an adjustment entry.

Assets are originally recorded in the books at historical cost, which is the amount actually paid in cash for the asset. Because depreciation represents a calculation and not an accurate valuation, an interim account, known as the accumulated depreciation account, is created to record the total depreciation that has been written off since the asset was purchased. The accumulated depreciation account is a contra-asset account that is not reflected on the face of the statement of financial position, but is used to determine the depreciated value of assets in the property, plant and equipment note to the statement of financial position. This depreciated value is known as the carrying amount.

Example 6.1

Boulder Enterprises purchased equipment to the value of R30 000 on 1 May 20.2. On 30 April 20.3, the end of the financial year, it was estimated that the value of the equipment was R24 000.

Required

Record the depreciation of equipment in the books of Boulder Enterprises at 30 April 20.3.

Solution

Steps 1 and 2: Identify the accounts and how they would be affected. The effect of the entry on the financial statements is also shown:

ADJUSTMENT	ACCOUNTS AFFECTED	TYPE OF ACCOUNT	FINANCIAL STATEMENT AFFECTED
Depreciation	*Debit*: Depreciation	Expense (increase)	Statement of profit or loss and other comprehensive income
	Credit: Accumulated depreciation: Equipment	Contra-asset (decreases the asset)	Statement of financial position (deducted from cost of asset in notes)

Step 3: Calculate the amount of the adjustment:

	R
Original value at 1 May 20.2	30 000
Estimated value at 30 April 20.3	24 000
Adjustment amount	6 000

Step 4: Record the adjustment:

Boulder Enterprises

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Apr	30	Depreciation	GL25	6 000	
		Accumulated depreciation: Equipment	GL15		6 000
		Provision for depreciation on equipment for the year			

Post to the ledger:

Dr **Depreciation** **25** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
Apr	30	Accumulated depreciation: Equipment	J12	6 000					

Dr **Accumulated depreciation: Equipment** **15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					Apr	30	Depreciation	J12	6 000

The depreciation calculated for all the assets for the financial year must be totalled and shown as one amount under distribution, administrative and other expenses on the statement of profit or loss and other comprehensive income. The balance on the accumulated depreciation: equipment account is subtracted from equipment at cost in the notes to the statement of financial position to determine the carrying amount of equipment. The carrying amount of equipment is included in the property, plant and equipment indicated under non-current assets on the statement of financial position. The closing-off procedure is explained in the next chapter.

6.3.2 *Consumable inventory on hand*

Adjustments of consumables, for example stationery, arise when an entity purchases consumables during a financial year and they are not completely consumed by the end of the period. Expenditure on the item becomes an expense only when the item has in fact been *consumed*. The consumables on hand are classified as inventory on hand.

Example 6.2

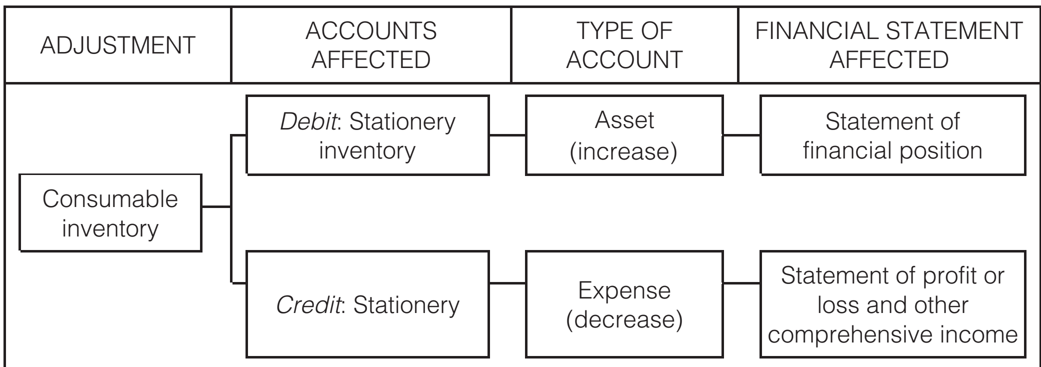
During the year Boulder Enterprises purchased stationery to the value of R13 700. On 30 April 20.3, the end of the financial year, stationery to the value of R2 500 was on hand.

Required

Record the stationery on hand in the books of Boulder Enterprises at 30 April 20.3.

Solution

Steps 1 and 2: Identify the accounts and how they would be affected. The effect of the entry on the financial statements is also shown:



Step 3: Calculate the amount of the adjustment:
Stationery on hand is valued at R2 500 (given).

Step 4: Record the adjustment:

Boulder Enterprises

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.3				**R**	**R**
Apr	30	Stationery inventory	GL16	2 500	
		Stationery	GL24		2 500
		Recording of stationery inventory on hand			

Post to the ledger:

Dr **Stationery inventory** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
Apr	30	Stationery	J12	2 500					

continued

Dr **Stationery** **24** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Apr	30	Balance	b/d	13 700	20.3 Apr	30	Stationery inventory Balance	J12 c/d	2 500 11 200
				13 700					13 700
Apr	30	Balance	b/d	11 200					

If stationery purchased is originally classified as stationery inventory and the value of the consumed inventory is determined at the end of the financial year, the entries would differ, but the net result would be the same:

Boulder Enterprises

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Apr	30	Stationery consumed Stationery inventory *Recording of stationery consumed during the year*	GL24 GL16	11 200	 11 200

Post to the ledger:

Dr **Stationery inventory** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Apr	30	Balance	b/d	13 700	20.3 Apr	30	Stationery consumed Balance	J12 c/d	11 200 2 500
				13 700					13 700
Apr	30	Balance	b/d	2 500					

Dr **Stationery consumed** **24** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Apr	30	Stationery inventory	J12	11 200					

The stationery consumed is included in distribution, administrative and other expenses on the statement of profit or loss and other comprehensive income. The balance on the stationery inventory account is included in inventories, a current asset, on the statement of financial position. This is part of the closing-off procedure, explained in the next chapter.

6.3.3 *Writing off credit losses*

The allowance for credit losses and how it is created and adjusted are explained in more detail in chapter 9. In this chapter, attention is given to the accounting entries of credit losses as an adjustment entry.

Before a credit sale takes place, the credit rating of a debtor is determined. When the debtor is approved, the sale takes place and the income is recognised and recorded as such in the books of the entity. Irrespective of the method used to do the credit rating, some debtors fail to pay their accounts. When it is clear that a debtor is not in a position to pay his account, the income recorded from the sale is not going to realise. The sale transaction cannot be reversed as the inventory was sold or the service rendered. This loss affects the financial results negatively. A credit losses account is opened to record the loss.

Example 6.3

The balance on the debtors control account of Boulder Enterprises was R12 385 on 30 April 20.3. An investigation revealed that S Stone, who owed R235 to Boulder Enterprises, was insolvent. It was decided to write this amount off as irrecoverable on 30 April 20.3.

Required

Write the amount owed by S Stone off in the books of Boulder Enterprises at 30 April 20.3.

Solution

Steps 1 and 2: Identify the accounts and how they would be affected. The effect of the entry on the financial statements is also shown:

ADJUSTMENT	ACCOUNTS AFFECTED	TYPE OF ACCOUNT	FINANCIAL STATEMENT AFFECTED
Bad debts	*Debit*: Credit losses	Expense (increase)	Statement of profit or loss and other comprehensive income
	Credit: Debtors control	Asset (decrease)	Statement of financial position

Step 3: Calculate the amount of the adjustment:

The irrecoverable amount is R235 (given).

Step 4: Record the adjustment:

Boulder Enterprises

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Apr	30	Credit losses	GL23	235	
		Debtors control/S Stone	GL13		235
		The account of S Stone written off as irrecoverable			

Post to the ledger:

Dr **Credit losses** **23** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Apr	30	Debtors control	J12	235					

Dr **Debtors control** **13** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Apr	30	Balance	b/d	12 385	20.3 Apr	30	Credit losses	J12	235
							Balance	c/d	12 150
				12 385					12 385
Apr	30	Balance	b/d	12 150					

The credit losses account is included in distribution, administrative and other expenses on the statement of profit or loss and other comprehensive income. Since the amount to be received from debtors is less than expected, the contra entry is in the debtors control account. Debtors control is reflected as part of trade and other receivables, a current asset, on the statement of financial position.

6.3.4 *Accrued income and income received in advance*

6.3.4.1 Accrued income

Accrued income is income earned, but not yet received. An example of accrued income is interest earned on an investment, where the interest is paid at the end of the investment period. When interest is to be calculated on the original investment at the end of the period, it is referred to as simple interest. Alternatively, interest can be calculated on the original investment plus the total interest earned thereon (referred to as compound interest) or it can be calculated at the effective interest rate (also referred to as the market interest rate). For the purposes of this textbook, only simple interest calculations will be used. It is also assumed that all stated interest rates are market-related to the investment risk.

Income must be recorded in the financial period in which it was earned (refer to paragraph 6.2). Income earned for which no cash has been received would not have been recorded in the books of the entity. The main reason for the omission is that the information was not captured on a source document.

If money is invested for a twelve-month period during a financial year and the interest is receivable at the end of the period, interest was earned for the months of the financial period under review, but has not yet been received.

The interest earned on the investment (accrued income) is calculated as follows:

Interest = Invested amount × interest rate × time

Commission earned, but not yet received, is also an example of accrued income.

Example 6.4

On 1 September 20.2, Boulder Enterprises invested R15 000 at the Real Bank for twelve months, at an interest rate of 10%, payable on expiry.

Required

Calculate and record the accrued interest at 30 April 20.3.

Solution

Steps 1 and 2: Identify the accounts and how they would be affected. The effect of the entry on the financial statements is also shown:

ADJUSTMENT	ACCOUNTS AFFECTED	TYPE OF ACCOUNT	FINANCIAL STATEMENT AFFECTED
Accrued income	*Debit*: Accrued interest/income	Asset (increase)	Statement of financial position
	Credit: Interest income	Income (increase)	Statement of profit or loss and other comprehensive income

Step 3: Calculate the amount of the adjustment:

Calculation of accrued interest:

Interest = Capital amount × interest rate × time

= R15 000 × 10% × $8/12$

= R1 000

Step 4: Record the adjustment:

Boulder Enterprises

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Apr	30	Accrued income	GL17	1 000	
		Interest income	GL26		1 000
		Accrued interest calculated at 10% p.a. on R15 000 for 8 months			

Post to the ledger:

Dr **Accrued income** **17** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
Apr	30	Interest income	J12	1 000					

Dr			**Interest income**					**26**	**Cr**
Month	**Day**	**Details**	**Fol**	**R**	**Month**	**Day**	**Details**	**Fol**	**R**
					20.3 Apr	30	Accrued income	J12	1 000

The interest income account is shown under other income as interest income: loans and receivables: fixed deposit on the statement of profit or loss and other comprehensive income. (Refer to chapter 15, Example 15.2.) Accrued income is money that is owed to the entity and shown as a financial asset under current assets on the statement of financial position.

6.3.4.2 Income received in advance

Income received in advance usually relates to cash received for goods or services that have not yet been delivered. Examples are rental received in advance, magazine subscriptions and the sale of tickets by airlines. Receipts of this nature cannot be recognised as income before the sale of inventory or the rendering of the service. Income received in advance can be seen as the direct opposite of accrued income. With accrued income, money is owed to the entity for inventory sold or services already rendered, whereas with income received in advance money has already been received but the inventory or service has not yet been delivered.

Example 6.5

On 28 April 20.3, Boulder Enterprises received a deposit of R5 000 from Rock Breakers to remove boulders from a site during May 20.3. The balance will be paid once the work is completed. The deposit received was included in the balance on the income from services rendered account of R895 000 at 30 April 20.3.

Required

Adjust the income from services rendered account to reflect the correct income amount for the year.

Solution

Steps 1 and 2: Identify the accounts and how they would be affected. The effect of the entry on the financial statements is also shown:

ADJUSTMENT	ACCOUNTS AFFECTED	TYPE OF ACCOUNT	FINANCIAL STATEMENT AFFECTED
Income received in advance	*Debit*: Income from services rendered	Income (decrease)	Statement of profit or loss and other comprehensive income
	Credit: Income received in advance	Liability (increase)	Statement of financial position

Step 3: Calculate the amount of the adjustment:
A R5 000 deposit was received (given).

Step 4: Record the adjustment:

Boulder Enterprises

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Apr	30	Income from services rendered	GL21	5 000	
		Income received in advance	GL19		5 000
		Income received in April 20.3 for work to be done in May 20.3			

Post to the ledger:

Dr **Income from services rendered** **21** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
Apr	30	Income received in advance	J12	5 000	Apr	30	Balance	b/d	895 000
		Balance	c/d	890 000					
				895 000					895 000
					20.3				
					Apr	30	Balance	b/d	890 000

Dr **Income received in advance** **19** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					Apr	30	Income from services rendered	J12	5 000

The income from services rendered account is shown as revenue on the statement of profit or loss and other comprehensive income and income received in advance is shown as a separate line item under current liabilities on the statement of financial position. The income received for services not yet rendered is repayable if the work is not done; it is therefore a liability at the end of the financial year.

6.3.5 *Accrued and prepaid expenses*

6.3.5.1 Accrued expenses

Accrued or arrear expenses are expenses that were incurred during a particular financial year, but which have not yet been paid or recorded in the books of the entity. The water and electricity account example, referred to in the introduction to this chapter, is an accrued expense as at 30 April 20.3, which is the end of the financial year. In order to determine the correct profit/total comprehensive income or loss for the year, the expense must be taken into account and the corresponding financial liability

must be recorded in order to ensure that the statement of financial position fairly reflects the financial position of the entity.

Example 6.6

On 14 May 20.3, Boulder Enterprises received a water and electricity account of R1 130 for April 20.3. The balance on the water and electricity account at 30 April 20.3 was R11 490.

Required

Adjust the water and electricity account to reflect the correct amount for water and electricity usage for the year ended 30 April 20.3.

Solution

Steps 1 and 2: Identify the accounts and how they would be affected. The effect of the entry on the financial statements is also shown:

ADJUSTMENT	ACCOUNTS AFFECTED	TYPE OF ACCOUNT	FINANCIAL STATEMENT AFFECTED
Accrued expenses	*Debit*: Water and electricity	Expense (increase)	Statement of profit or loss and other comprehensive income
	Credit: Accrued expenses	Liability (increase)	Statement of financial position

Step 3: Calculate the amount of the adjustment:

The amount of the water and electricity account was R1 130 (given).

Step 4: Record the adjustment:

Boulder Enterprises

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Apr	30	Water and electricity	GL27	1 130	
		Accrued expenses	GL20		1 130
		Water and electricity account for April 20.3 received in May 20.3			

Post to the ledger:

Dr **Water and electricity** **27** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3									
Apr	30	Balance	b/d	11 490					
		Accrued expenses	J12	1 130					
				12 620					

Dr **Accrued expenses** **20** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.3				
					Apr	30	Water and electricity	J12	1 130

The balance on the water and electricity account is included in distribution, administrative and other expenses on the statement of profit or loss and other comprehensive income. The accrued expenses account consists of various amounts owed to the entity and is therefore a liability at the end of the financial year. At the end of the financial year, all the accrued expenses are reflected on the accrued expenses account and must be shown as part of trade and other payables on the statement of financial position.

6.3.5.2 Prepaid expenses

A prepaid expense is an item that was paid for and recorded during a certain financial period but which pertains to one or more future periods. However, only those expenses relevant to or consumed during the period under review can be taken into account during that particular period. Some examples of prepaid expenses are rental, insurance and advertisements.

The nature of a prepaid expense is similar to that of an asset because the enterprise will only consume or utilise it during the next period or subsequent periods. Thus, where an expense account includes a prepayment, the prepaid portion should be identified and transferred to the prepaid expenses account, which is classified as an asset account.

Example 6.7

On 28 April 20.3, Boulder Enterprises entered into an agreement with Spot Cleaners to render cleaning services for a fee of R1 500 per month for the next twelve months. On the same date, Boulder Enterprises made a payment of R4 500 for cleaning services for the next three months. This amount was debited to the cleaning expenses account and included in the balance of R18 100 at 30 April 20.3.

Required

Adjust the cleaning expenses account to reflect the correct amount for the year ended 30 April 20.3.

Solution

Steps 1 and 2: Identify the accounts and how they would be affected. The effect of the entry on the financial statements is also shown:

ADJUSTMENT	ACCOUNTS AFFECTED	TYPE OF ACCOUNT	FINANCIAL STATEMENT AFFECTED
Prepaid expenses	*Debit*: Prepaid expense	Asset (increase)	Statement of financial position
	Credit: Cleaning expenses	Expense (decrease)	Statement of profit or loss and other comprehensive income

Step 3: Calculate the amount of the adjustment:

The amount of R4 500 was prepaid and is applicable to the next accounting period.

Step 4: Record the adjustment:

Boulder Enterprises

General journal **J12**

Month	**Day**	**Details**	**Fol**	**Debit**	**Credit**
20.3				**R**	**R**
Apr	30	Prepaid expenses	GL14	4 500	
		Cleaning expenses	GL28		4 500
		Cleaning expenses prepaid for the next financial year			

Post to the ledger:

Dr **Prepaid expenses** **14** **Cr**

Month	**Day**	**Details**	**Fol**	**R**	**Month**	**Day**	**Details**	**Fol**	**R**
20.3									
Apr	30	Cleaning expenses	J12	4 500					

continued

Dr **Cleaning expense** **28** **Cr**

Month	**Day**	**Details**	**Fol**	**R**	**Month**	**Day**	**Details**	**Fol**	**R**
20.3					20.3				
Apr	30	Balance	b/d	18 100	Apr	30	Prepaid expenses	J12	4 500
							Balance	c/d	13 600
				18 100					18 100
April	30	Balance	b/d	13 600					

The cleaning expenses for the current financial year are included in distribution, administrative and other expenses on the statement of profit or loss and other comprehensive income. Prepaid expenses are shown as a separate line item under the heading of current assets on the statement of financial position.

6.4 The post-adjustment trial balance

Once all the adjustments have been journalised and posted to the general ledger, a new trial balance is prepared. Because the trial balance now contains the adjusted balances, it is known as a post-adjustment trial balance. The post-adjustment trial balance contains all the information necessary for the preparation of the statement of profit or loss and other comprehensive income and statement of financial position. The closing off of accounts will be discussed in the next chapter.

6.5 Summary

At the end of the financial period, when all transactions have been journalised and posted to the general ledger and a trial balance drawn to confirm that the double-entry principle has been applied, a further accounting step is necessary before the financial statements for that particular period can be prepared. Each ledger account has to be analysed with great care to determine whether the balance on that account needs to be adjusted to ensure that the income, expense, asset, liability and equity accounts are correctly stated.

The accrual basis of accounting gives rise to adjustment entries resulting in the recognition of prepaid and accrued items on the statement of financial position. Although certain accounts need to be adjusted with prepaid and arrear (accrued) amounts, it is also necessary to distribute systematically the cost price of assets used to produce income (depreciation). Certain factors such as passage of time, utilisation or consumption often cannot be measured on a daily basis. They can, however, be calculated or estimated at the end of a financial period. Therefore adjustments are made at the end of the financial year.

CHAPTER 7

The closing-off procedure, determining profit and preparing financial statements

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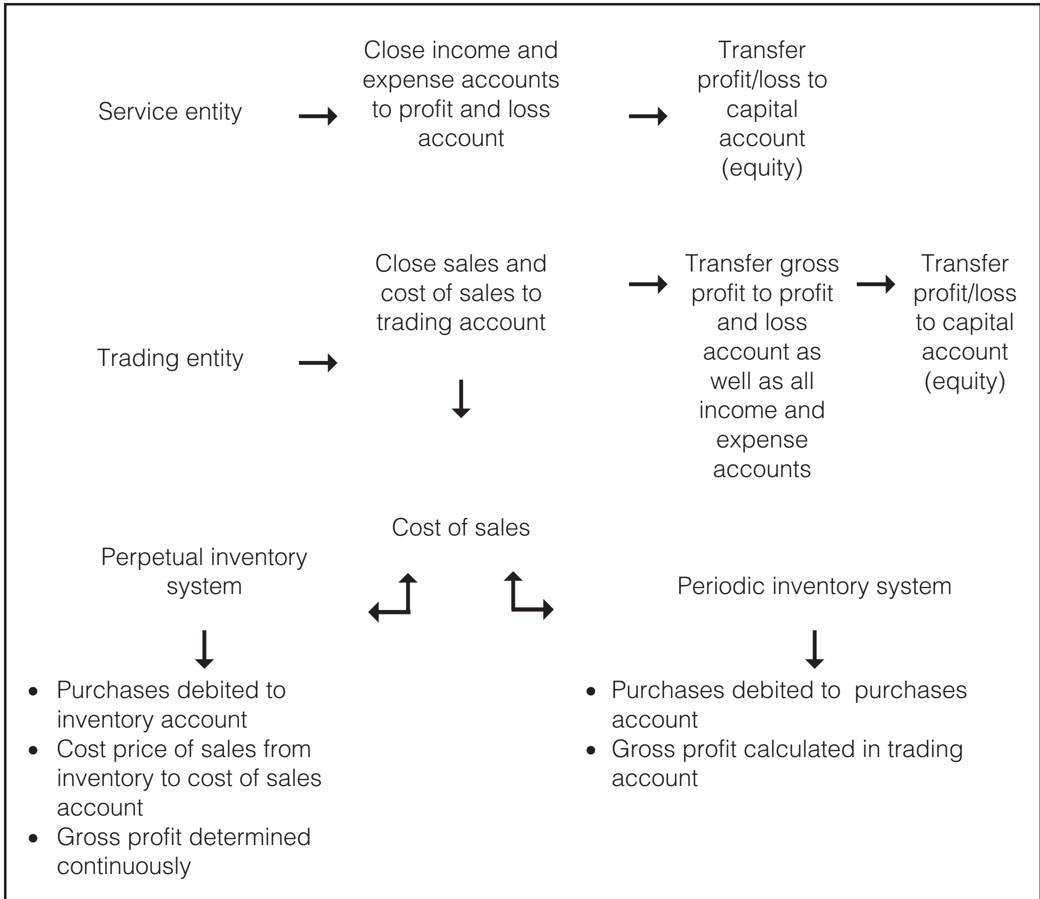
Overview of the closing-off procedure, determining profit and preparing financial statements



7.1 Introduction

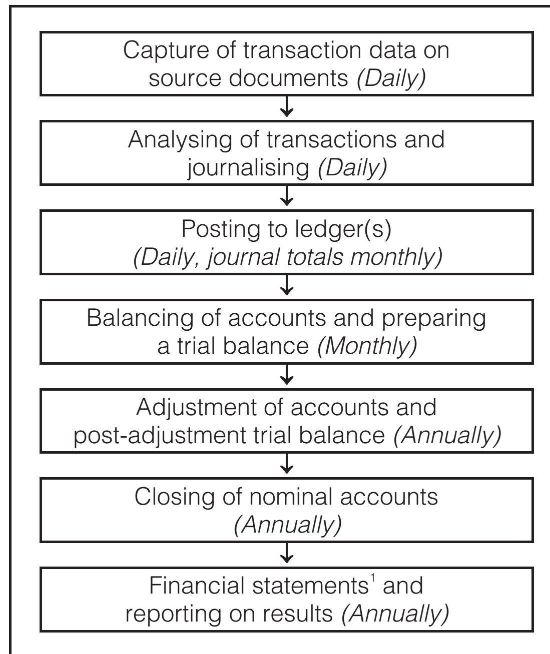
Study objectives

After studying this chapter you should be able to

- ☐ journalise and post the closing entries;
- ☐ calculate the profit/total comprehensive income or loss for the year of a service entity;
- ☐ record transactions according to the perpetual inventory system;
- ☐ record transactions according to the periodic inventory system;
- ☐ calculate the gross profit and the profit/total comprehensive income or loss for the year of a trading entity;
- ☐ prepare the statement of profit or loss and other comprehensive income;
- ☐ prepare the statement of changes in equity;
- ☐ prepare the statement of financial position; and
- ☐ calculate appropriate percentages for evaluation purposes.

From the previous chapters it is evident that the life of an entity can be divided into accounting periods and that each period constitutes a repetitive accounting cycle. In diagram 5.1 in chapter 5, the compiling of financial reports was shown as the step after posting to the ledger. There are, however, a few other steps that must first be completed before the financial reports can be compiled. Diagram 7.1 illustrates the different steps in the accounting cycle and how often they are usually done:

Diagram 7.1 The accounting cycle



In chapter 6, the adjusting process was explained. In this chapter, the remaining two steps, ie the closing of nominal accounts to determine the profit/total comprehensive income or loss for the year and the compiling of the financial statements and report on the results, are explained. Only the very basics of analysing results will be explained.

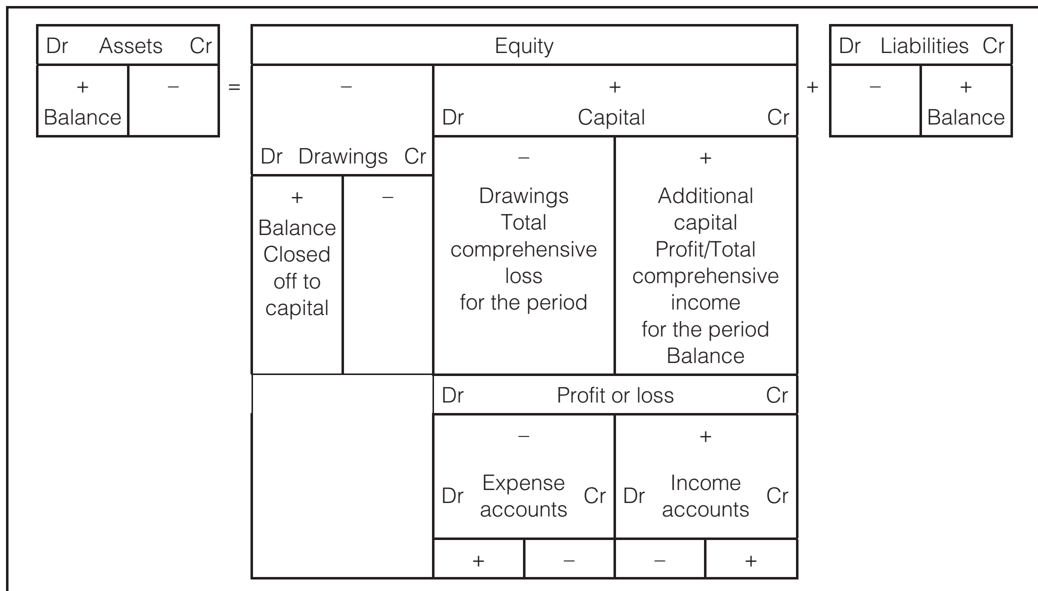
7.2 The closing procedure of a service entity

Service entities, which include professional entities (such as attorneys, accountants, medical practitioners and architects), transport entities (for example, air, road and sea transport entities) and personal service entities (for example, hairdressers, mechanics and cleaning services) earn income by delivering a service during the course of a financial period. The expenses incurred to earn the income should be subtracted to determine the profit/total comprehensive income or loss for the year. This is usually done in a profit or loss account that is designed to suit the requirements of the particular entity.

1 Financial statements can be prepared as often as management requires, but must be prepared at least annually.

The capital with which a business commences changes as profits or losses are made and as money is withdrawn by the owner for personal use. Diagram 7.2 illustrates the main categories of accounts and how equity is influenced by income, expenditure and drawings:

Diagram 7.2 Main categories of accounts



Drawings and the profit/total comprehensive income or loss for the year, determined in the profit or loss account, are closed off to the capital account. Drawings, income and expense accounts are therefore subcategories of the capital account.

7.2.1 *The profit or loss account of a service entity*

Income and expense accounts are referred to as *nominal accounts* or *temporary accounts* because they pertain to only a particular accounting period. After the adjustments have been completed at the end of the accounting period, the nominal accounts are closed off to a profit or loss account, the account in which the profit/total comprehensive income or loss for the year is determined.

To transfer the balances from the nominal accounts to the profit or loss account, *closing entries* must be done. Closing entries are recorded in the general journal before they are posted to the general ledger. It is important to note that the double-entry system is also applicable to closing entries. To close off the accounts, income accounts should be debited and the profit or loss account credited. The profit or loss account should be debited with expenses and the expense accounts credited. The nominal accounts are thus closed off to determine the financial performance of an entity for a particular period. If the credit side of the profit or loss account adds up to more than the debit side, income is in excess of expenses and a profit is made. A profit increases equity, and the profit or loss account should be debited and the capital account credited to close off the profit or loss account. An excess of expenses over income represents a loss that has a negative effect on equity and is credited to

the profit or loss account and debited to the capital account. To finalise closing entries, the balance on the drawings account is closed off (debited) against the capital account.

The closing-off procedure is explained in Example 7.1.

Example 7.1

At 31 July 20.5, the end of the financial year, Watt Electrical had the following balances:

	R
Drawings: V Watt	24 000
Capital: V Watt	30 000
Vehicles	65 000
Tools and equipment	17 000
Creditors control	8 700
Debtors control	2 300
Bank (dr)	9 900
Long-term loan	40 000
Income from services rendered	77 300
Wages paid	18 000
General expenses	15 000
Interest expense	4 800

Required

Journalise the closing entries and prepare only the accounts in the general ledger that are affected by the closing entries.

Solution

Watt Electrical

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.5				R	R
Jul	31	Income from services rendered	GL15	77 300	
		Profit or loss	GL19		77 300
		Closing entry			
		Profit or loss	GL19	37 800	
		Wages paid	GL16		18 000
		General expenses	GL17		15 000
		Interest expense	GL18		4 800
		Closing entry			

continued

The profit or loss account must first be completed before the next journal entry can be made to transfer the profit/total comprehensive income for the year to the capital account:①

Month	Day	Details	Fol	Debit	Credit
		Profit or loss Capital *Transfer of profit/total comprehensive income for the year to the capital account*	GL19 GL13	39 500	 39 500
		Capital Drawings *Transfer of drawings to the capital account*	GL13 GL12	24 000	 24 000

General ledger

Dr **Drawings** **12** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Jul	31	Balance	b/d	24 000	20.5 Jul	31	Capital	J12	24 000

Dr **Capital** **13** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Jul	31	Drawings	J12	24 000	20.5 Jul	31	Balance	b/d	30 000
		Balance	c/d	45 500			Profit or loss ①	J12	39 500
				69 500					69 500
					Aug	1	Balance	b/d	45 500

Dr **Income from services rendered** **15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Jul	31	Profit or loss	J12	77 300	20.5 Jul	31	Balance	b/d	77 300

Dr **Wages paid** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Jul	31	Balance	b/d	18 000	20.5 Jul	31	Profit or loss	J12	18 000

Dr **General expenses** **17** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Jul	31	Balance	b/d	15 000	20.5 Jul	31	Profit or loss	J12	15 000

continued

Dr **Interest expense** **18** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Jul	31	Balance	b/d	4 800	20.5 Jul	31	Profit or loss	J12	4 800

Dr **Profit or loss account** **19** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Jul	31	Wages paid	J12	18 000	20.5 Jul	31	Income from services rendered	J12	77 300
		General expenses	J12	15 000					
		Interest expense	J12	4 800					
		Capital (profit/ total com prehensive income for the year) ①	J12	39 500					
				77 300					77 300

The profit/total comprehensive income for the period, ie the balancing figure on the profit or loss account, is transferred to the capital account.

7.2.2 *The statement of profit or loss and other comprehensive income*

The closing off of the nominal accounts is only done at the end of the financial year. This does not mean, however, that an entity can determine its profit/total comprehensive income or loss only once a year. A statement of profit or loss and other comprehensive income can be compiled as often as required by the entity's management to determine the financial performance. This is possible because *a statement does not form part of the double-entry system*. The balances reflected on the trial balance can be used to calculate the profit/total comprehensive income or loss for the period in a statement of profit or loss and other comprehensive income.

The information used to compile the profit or loss account at the end of the financial year is also reflected on the year-end statement of profit or loss and other comprehensive income of an entity. Although the layout differs, the profit/total comprehensive income or loss for the year should therefore be the same.

The statement of profit or loss and other comprehensive income for Watt Electrical is as follows:

Watt Electrical
Statement of profit or loss and other comprehensive income for the year ended 31 July 20.5

	Notes	R
Revenue		77 300
Administrative and other expenses		(33 000)
Wages paid		18 000
General expenses		15 000
Finance costs		(4 800)
Interest expense		4 800
Profit/total comprehensive income for the year		39 500

In table 7.1, the difference between a statement of profit or loss and other comprehensive income and the profit or loss account is explained.

Table 7.1 Differences between a statement of profit or loss and other comprehensive income and a profit or loss account

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME	PROFIT OR LOSS ACCOUNT
No entries are made in the general ledger	The double-entry principle is applied
According to IAS 1	According to the requirements of the entity
Compiled when required by management	Compiled only at the end of the financial year
Profit/total comprehensive income or loss used to calculate the current state of equity	Profit/total comprehensive income or loss credited/debited to capital account

7.2.3 *The statement of changes in equity*

The statement of changes in equity is compiled to determine the current state of equity. In this statement, the profit/total comprehensive income for the year is added to the opening balance of capital (a loss is subtracted) and drawings are subtracted. Additional capital contributed should also be added, as it increases equity.

The statement of changes in equity for Watt Electrical is as follows:

Watt Electrical
Statement of changes in equity for the year ended 31 July 20.5

	R
Capital:	
Balance as at 1 August 20.4	30 000
Profit/total comprehensive income for the year	39 500
Drawings	(24 000)
Balance as at 31 July 20.5	45 500

7.2.4 *The statement of financial position*

The financial position of an entity is determined by the asset, liability and capital accounts. These accounts are known as *permanent* or *statement of financial position accounts*, as the balances on these accounts are carried over to the next financial year and are used to compile the statement of financial position.

The statement of financial position for Watt Electrical is as follows:

Watt Electrical
Statement of financial position as at 31 July 20.5

	Notes	R
ASSETS		
Non-current assets		82 000
Property, plant and equipment R(65 000 + 17 000)		82 000
Current assets		12 200
Trade and other receivables		2 300
Cash and cash equivalents		9 900
Total assets		94 200
EQUITY AND LIABILITIES		
Total equity		45 500
Capital		45 500
Total liabilities		48 700
Non-current liabilities		40 000
Long-term borrowings		40 000
Current liabilities		8 700
Trade and other payables	4	8 700
Total equity and liabilities		94 200

According to IFRS, notes form part of the financial statements. The notes introduced so far are shown in Example 7.5.

7.3 The closing procedure of a trading entity

7.3.1 *Profit determination of a trading entity*

Although the steps in the accounting cycle of a trading entity are in essence similar to those of a service entity, additional entries and accounts are required to record the transactions of trading entities.

Trading entities also render a service in that they usually purchase a variety of products from different producers and bring the merchandise within reach of the consumer. To pay for its expenses and initiative to provide the service, a trading entity sells the merchandise at a higher price than what it paid for it. The entity's price policy usually determines the mark-up percentage that should be added to the cost price of the merchandise to determine the selling price of an article. The source of income of a trading concern is thus the profit made on buying and selling merchandise.

The income of a trading concern is usually entered in the sales account and is generally described as *revenue* on the statement of profit or loss and other comprehensive income. The expenses can be divided into three groups, namely

- ☐ cost of sales;
- ☐ distribution, administrative and other expenses; and
- ☐ finance costs.

The difference between the proceeds from sales (revenue) and the cost of goods sold equals the *gross profit*. At the end of the financial year, the gross profit is calculated in a trading account. The gross profit is transferred to a profit or loss account, where other income is added (credited) and distribution, administrative and other expenses and finance costs are deducted (debited) to determine the *profit/total comprehensive income or loss* for the year.

If merchandise purchased for R600 is sold for R900 and the expenses incurred in selling the product amount to R100, the gross profit is R300 and the profit (total comprehensive income) R200. The mark-up can be expressed as a percentage on cost or as a percentage of sales. The mark-up on cost is calculated using the difference between the purchase price and the selling price (R900 – R600 = R300) in relation to the cost price (R600). The mark-up on selling price is the difference between the purchase price and the selling price (R900 – R600 = R300) in relation to the selling price (R900).

The mark-up percentage on cost: $\frac{300}{600} \times \frac{100}{1} = 50\%$

The mark-up percentage on the selling price: $\frac{300}{900} \times \frac{100}{1} = 33\,^1/_3\%$

7.3.2 *Cost of sales*

To meet the demand for inventory, a trading concern will have to keep merchandise in inventory. This means that the inventory which is purchased during a financial year is not necessarily sold in that year. Therefore the expenses incurred during a particular financial year in purchasing merchandise will not necessarily be the same as the cost of goods sold during the same year. Thus, one of the most important elements of profit/total comprehensive income determination in trading concerns is the

determination of the cost of sales. The *cost of sales* includes all the costs of bringing the goods to their present location and condition and represents the total cost of the merchandise sold during the particular financial year.

The inventory system used in the entity would determine whether the cost of sales should be calculated at the end of the financial year or whether a cost of sales account exists and is updated with every sales transaction.

The cost of sales can be determined according to one of the following two methods:

- the perpetual inventory system; or
- the periodic inventory system.

The inventory system determines the way in which inventory purchased and sold is recorded. It does not affect the eventual cost price of inventory that is determined at the end of the financial year when a physical inventory count is usually done. How to calculate the value of inventory on hand will be explained in chapter 10.

7.3.2.1 The perpetual inventory system

When the perpetual inventory system is used, the merchandise purchased is debited to the *inventory* account. If the merchandise was purchased for cash, the cash payments journal (CPJ) should be used as book of first entry. From the CPJ, the inventory account is debited and the bank account credited. If the merchandise was purchased on credit, the purchases journal is the book of first entry. From the purchases journal, the inventory account is debited and the creditors control and individual creditors' accounts are credited. Although VAT will not be taken into account in this chapter, the VAT input account should be debited with VAT if the entity is registered as a VAT vendor. If the entity is not registered as a VAT vendor, VAT forms part of the purchase price of inventory.

Any expenses incurred to bring the merchandise to its present location and condition, for example, import duties and freight on purchases, should be debited to the inventory account, as these expenses form part of the cost price of the merchandise purchased. When merchandise is sold, the cost price of the sales is transferred from the inventory account to a *cost of sales* account. If provision was made for a cost of sales column in the cash receipts journal and the sales journal, the cost of sales can be calculated per transaction or the total cost of sales can be calculated at the end of the month. The totals of the cost of sales columns from both these journals are debited to the cost of sales account and credited to the inventory account in the general ledger. *A sales transaction would thus result in two double entries being made*. The first entry is to record the sale, while the second is to update the inventory account by recording the cost of sales. The inventory account would therefore at all times show the cost of merchandise still on hand. It would, however, be necessary to verify the actual value of inventory at least once a year with a physical inventory count.

When the selling price of a transaction is given without indicating the cost price and the mark-up percentage is known, the cost price can be calculated. The mark-up percentage given should, however, clearly indicate whether the mark-up is on cost or on sales.

☐ **Mark-up as a percentage of cost**

In the example in paragraph 7.3.1, the mark-up on cost was calculated at 50%. If the mark-up (50%) and the selling price (R900) were given and the cost of merchandise sold unknown, the cost of sales could be calculated as follows:

Assume the cost price	=	100
Mark-up percentage on cost	=	50
∴ Selling price	=	150

To calculate the cost: $\frac{100}{150} \times \frac{900}{1}$

$= \frac{90\ 000}{150}$

= R600

☐ **Mark-up as a percentage of selling price**

In the example in paragraph 7.3.1, the mark-up on selling price was calculated at $33\frac{1}{3}$%. If the mark-up ($33\frac{1}{3}$%) and the selling price (R900) were given and the cost of merchandise sold unknown, the cost of sales could be calculated as follows:

Assume the selling price	=	100
Mark-up percentage on selling price	=	$33\frac{1}{3}$
∴ cost price	=	$66\frac{2}{3}$

To calculate the cost: $\frac{66\frac{2}{3}}{100} \times \frac{900}{1}$

$= \frac{60\ 000}{100}$

= R600

When the cost price of the goods has been calculated, the two double entries from the sale should be recorded. If the sale was on credit and the balance on the inventory account was R5 400, the entries would be recorded as follows:

Example 7.2

Abe Discount Stores

Sales journal – April 20.5 **SJ1**

Invoice number	Day	Details	Fol	Cost of sales	Sales	Debtors control
				R	**R**	**R**
S001	9	R Rupert		600	900	900
				600	900	900
				GL18/GL11	GL19	GL10

continued

Abe Discount Stores

General ledger

Dr **Debtors control** **10** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Apr	30	Sales	SJ1	900					

Dr **Inventory** **11** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Apr	01	Balance	b/d	5 400	20.5 Apr	30	Cost of sales	SJ1	600

Dr **Cost of sales** **18** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Apr	30	Inventory	SJ1	600					

Dr **Sales** **19** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.5 Apr	30	Debtors	SJ1	900

When the perpetual inventory system is used, the gross profit can be determined *continuously*, by deducting the cost of sales from the sales. At the end of the financial year, the sales and cost of sales accounts, being nominal accounts, are closed off to the *trading account*, where the gross profit is determined. The closing entries are recorded in the general journal before they are posted to the general ledger.

If the given entries were the only entries for the year, the two accounts are closed off to the trading and profit or loss accounts as follows:

General journal **J1**

Month	Day	Details	Fol	Debit	Credit
20.5				R	R
Apr	30	Trading account	GL25	600	
		Cost of sales	GL18		600
		Closing entry			
		Sales	GL19	900	
		Trading account	GL25		900
		Closing entry			
The trading account must first be completed before the next journal entry can be made to transfer the gross profit to the profit or loss account:①					
		Trading account	GL25	300	
		Profit or loss account	GL26		300
		Transfer of the gross profit to the profit or loss account			

continued

General ledger

Dr **Cost of sales** **18** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Apr	30	Inventory	SJ1	600	20.5 Apr	30	Trading account	J1	600

Dr **Sales** **19** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Apr	30	Trading account	J1	900	20.5 Apr	30	Debtors	SJ1	900

Dr **Trading account** **25** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Apr	30	Cost of sales	J1	600	20.5 Apr	30	Sales	J1	900
		Profit or loss account (Gross profit) ①	J1	300					
				900					900

Dr **Profit or loss** **26** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.5 Apr	30	Trading account (Gross profit) ①	J1	300

7.3.2.2 The periodic inventory system

☐ The purchases account

A prerequisite for the application of the perpetual inventory system is that each item should be identifiable and measurable. It would obviously be very difficult for entities that deal with large volumes of merchandise to manually keep track of the buying and selling of every item. Entities that are not able to update their inventory records with every sales transaction usually wait until the end of the financial year to calculate the cost of sales. All the merchandise purchased during the year is entered into a purchases account. At the end of the financial year, a physical inventory count is done to determine the value of inventory on hand. The cost price of inventory sold is then calculated by deducting the monetary value of the closing inventory from the total monetary value of the inventory available for sale. Inventory available for sale comprises inventory at the beginning of the period (opening inventory), net purchases for the period and the total purchasing costs for the period.

Inventory is an asset account that cannot be closed off. The value of inventory on hand at the end of the financial year is recorded by means of an adjusting entry and the opening inventory is closed off to the trading account by means of a closing entry.

The accounting procedure of an entity that uses the periodic inventory system is illustrated in Example 7.3.

Example 7.3

Rainbow Traders uses the periodic inventory system and, *inter alia*, had the following balances at 30 June 20.6, the end of the financial year:

	R
Inventory: 1 July 20.5	7 000
Cash purchases	24 000
Credit purchases	32 000
Cash sales	29 000
Credit sales	43 000

An inventory count on 30 June 20.6 revealed that there was inventory to the value of R9 000 on hand.

Required

Open the general ledger with the balances given and record the entries necessary to determine the gross profit in the books of Rainbow Traders.

Rainbow Traders

General journal **J24**

Month	Day	Details	Fol	Debit	Credit
20.6				R	R
Jun	30	Inventory	GL6	9 000	
		Trading account	GL31		9 000
		Cost price of closing inventory on hand brought into account			
		Trading account	GL31	7 000	
		Inventory	GL6		7 000
		Closing entry			
		Trading account	GL31	56 000	
		Purchases R(24 000 + 32 000)	GL21		56 000
		Closing entry			
		Sales R(29 000 + 43 000)	GL22	72 000	
		Trading account	GL31		72 000
		Closing entry			
The trading account must first be completed before the next journal entry can be made to transfer the gross profit to the profit or loss account:①					
		Trading account	GL31	18 000	
		Profit or loss account	GL32		18 000
		Transfer of the gross profit to the profit or loss account			

continued

General ledger

Dr **Inventory** **6** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5					20.6				
Jul	1	Balance	b/d	7 000	Jun	30	Trading account	J24	7 000
20.6						30	Balance	c/d	9 000
Jun	30	Trading account	J24	9 000					
				16 000					16 000
Jul	1	Balance	b/d	9 000					

Dr **Purchases** **21** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.6				
Jun	30	Balance	b/d	56 000	Jun	30	Trading account	J24	56 000

Dr **Sales** **22** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.6				
Jun	30	Trading account	J24	72 000	Jun	30	Balance	b/d	72 000

Dr **Trading account** **31** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.6				
Jun	30	Inventory	J24	7 000	Jun	30	Inventory	J24	9 000
		Purchases	J24	56 000			Sales	J24	72 000
		Profit or loss (Gross profit) ①	J24	18 000					
				81 000					81 000

Dr **Profit or loss** **32** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.6				
					Jun	30	Trading account (Gross profit) ①	J24	18 000

① R81 000 (R9 000 + R72 000) – R63 000 (R7 000 + 56 000) = R18 000.

When a trading entity uses the periodic inventory system, a cost of sales account is usually not maintained in the general ledger. The figure is, however, calculated on the statement of profit or loss and other comprehensive income.

☐ Purchases returns, allowances and settlement discount received

If merchandise is returned to a seller, a debit note is usually attached, to indicate to the creditor that its account has been debited in the purchaser's books. The purchaser may use the debit note to record the returns, but usually waits for confirmation from the seller in the form of a credit note. Purchases returns are a contra to purchases and are recorded in a separate account.

If the quality of the merchandise delivered is not up to standard, the seller may offer the merchandise at a lower price to the purchaser. If the purchase price has already been recorded, the amount with which the price has been decreased is recorded as an allowance. Purchases returns and allowances decrease both the cost of goods purchased and the amount due to the creditor.

Allowances differ from settlement discount received in that the settlement discount is only recorded when it is actually utilised within the scope of the seller's credit terms. Settlement discount received should then be recorded by debiting the creditors control account (and the creditors account) and crediting the settlement discount received account. Settlement discount must be deducted from purchases (credited against the purchases account) when the periodic inventory system is in use. When the perpetual inventory system is in use, the cost of sales account must be credited. The settlement discount received account, similar to purchases returns and allowances, decreases both the cost of goods purchased and the amount due to the creditor.

Trade discount is not recorded in the books at all, as it is deducted from the purchase price on the invoice and the net amount of the purchase is recorded in the books as purchases.

☐ Transport costs

The transport costs of merchandise, if paid by the purchaser, form part of the cost of the merchandise. The transport costs are debited to a separate account, often referred to as a *freight in* account (or freight on purchases), and should be added to the purchase price of merchandise to determine the cost of inventory purchased. The account should thus be closed off to the trading account.

If the seller incurs transport costs, the cost is debited to a *freight out* or freight on sales account. This is an ordinary expense and does not reduce the sales figure. The account should be closed off to the profit or loss account.

☐ Import duties

Any costs incurred before the merchandise is delivered to the premises from where it will be sold form part of the cost of merchandise. Although these costs must be debited to a separate account, the account must be closed off to the trading account.

☐ Assembling costs

If merchandise must be assembled before it can be sold, the assembling costs incurred would also form part of the cost of merchandise. This account should also be closed off to the trading account.

Example 7.4

Use the information in Example 7.3. The following additional information should be taken into account:

	R
Import duties	5 000
Freight in	2 600
Freight out	500
Purchases returns	3 000
Settlement discount received	1 500
Assembling costs (of merchandise)	1 800

Required

Prepare the trading account of Rainbow Traders.

Solution

The additional information in this example should first be recorded in the general journal. The posting to the trading account in the general ledger as follows:

Dr **Trading account** **31** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.6				
Jun	30	Inventory	J24	7 000	Jun	30	Inventory	J24	9 000
		Purchases①	J24	54 500			Sales	J24	72 000
		Import duties	J24	5 000			Purchases		
		Freight in	J24	2 600			returns	J24	3 000
		Assembling							
		costs	J24	1 800					
		Profit or loss							
		(Gross profit)	J24	13 100					
				84 000					84 000

① R56 000 – R1 500 = R54 500.

The settlement discount account (R1 500) must be closed off to the purchases account and the new balance of the purchases account (R54 500) is closed off to the trading account.

Freight out does not form part of the cost of merchandise purchased and is closed off to the profit or loss account.

7.3.2.3 Differences between the perpetual and periodic inventory systems

From a recording point of view, the main differences between the periodic and the perpetual inventory systems are summarised in table 7.2.

Table 7.2 Differences between the perpetual and periodic inventory systems

PERPETUAL SYSTEM	PERIODIC SYSTEM
All merchandise purchased is debited to the inventory account.	All merchandise purchased is debited to the purchases account.
All purchasing expenses are debited to the inventory account.	Purchasing expenses are debited to a specific expense account.
Purchases returns are credited to the inventory account.	Purchases returns are credited to the purchases returns account.
A cost of sales account is maintained, thus updating the inventory account with sales.	The cost price of merchandise is *not* recorded at the time of sale.
Sales returns are recorded as sales returns. Inventory and cost of sales must also be updated.	Sales returns are only recorded in the sales returns account.
At any point in time, the cost of inventory on hand is known.	Inventory must be counted periodically to determine the inventory on hand.
The gross profit can be determined for every sale.	The gross profit can be determined only after the cost of sales has been calculated.

Example 7.5

The following transactions were recorded in the accounting records of Sunshine Traders (control accounts are in use):

20.4

Jan. 5 Purchase merchandise from ABC Traders for cash, R9 000.

9 Sold one-third of the merchandise purchased on 5 January on credit to Multimedia at cost price plus 25%.

12 Purchase goods from EFJ on credit for R15 000.

14 Returned merchandise costing R1 500, to EFJ.

16 Sold goods for cash to XYZ Traders at cost price plus 25%. Selling price, R4 500.

19 Returned merchandise from Multimedia, selling price R75.

Required:

Analyse the transactions above, using the framework given below:

1. The perpetual inventory system.
2. The periodic inventory system.

GENERAL LEDGER ACCOUNTS			
Date	*Account debited*	*Account credited*	*Amount*

Suggested solution:

Perpetual inventory system

GENERAL LEDGER ACCOUNTS				
Date		***Account debited***	***Account credited***	***Amount***
20.4				
Jan	5	Inventory	Bank	9 000
	9	Debtors control	Sales	3 750
		Cost of sales	Inventory	3 000
	12	Inventory	Creditors control	15 000
	14	Creditors control	Inventory	1 500
	16	Bank	Sales	4 500
		Cost of sales	Inventory	3 600
	19	Sales returns	Debtors control	75
		Inventory	Cost of sales	60

1. Periodic inventory system

GENERAL LEDGER ACCOUNTS				
Date		***Account debited***	***Account credited***	***Amount***
20.4				
Jan	5	Purchases	Bank	9 000
	9	Debtors control	Sales	3 750
	12	Purchases	Creditors control	15 000
	14	Creditors control	Purchases returns	1 500
	16	Bank	Sales	4 500
	19	Sales returns	Debtors control	75

7.3.3 *The gross profit percentage*

The gross profit is the difference between net sales (sales – sales returns – settlement discount granted) and cost of sales. Gross profit is calculated separately to determine the entity's performance with regard to its most important activity, namely the sale of inventory at a profit, irrespective of all the other activities that are necessary to support its primary activity. Although the mark-up percentage should theoretically be the same as the gross profit percentage, there is usually a difference between these two percentages. Because of these deviations, the gross profit percentage must be calculated periodically so that management can take note of the reasons for the deviations.

The gross profit percentage can be calculated as a percentage of sales or as a percentage of cost of sales as follows:

AS A PERCENTAGE OF SALES	AS A PERCENTAGE OF COST OF SALES
$\frac{\text{Gross profit} \quad 100}{\text{Sales}}$	$\frac{\text{Gross profit} \quad 100}{\text{Cost of sales}}$

The following factors could be reasons for the difference between the mark-up percentage and gross profit percentage:

☐ settlement discounts granted and received;

☐ the method used to calculate the cost of goods;

☐ loss, shrinkage, waste, pilferage;

☐ the accuracy of the physical inventory count; or

☐ the method used to calculate the value of the inventory on hand.

7.3.4 *The financial statements of a trading entity*

The trading and profit or loss accounts are accounts in the general ledger and are not financial statements. When the financial statements of an entity are prepared at the end of the financial year, the details reflected in the trading and profit or loss accounts are used to compile the year-end statement of profit or loss and other comprehensive income.

Both the gross profit and the profit/total comprehensive income for the year are reflected on the statement of profit or loss and other comprehensive income. To determine the gross profit, cost of sales is deducted from net sales. Net sales are indicated as *revenue* on the statement. The calculation of cost of sales is shown on the face of the statement of profit or loss and other comprehensive income of a sole trader. Other income is added, and distribution, administrative and other expenses as well as finance costs, if any, should be deducted to determine the profit/total comprehensive income for the year.

The statement of changes in equity and statement of financial position are the same as those of a service entity. Notes form part of financial statements and will gradually be introduced as the various topics are explained.

The financial statements of a trading entity are illustrated in Example 7.5.

Example 7.6

The following balances appeared in the books of Cosmos Traders at 31 July 20.7, the end of the financial year, before any adjustments were made:

Cosmos Traders
Trial balance as at 31 July 20.7

	Fol	Debit	Credit
		R	R
Capital: M Fish			120 000
Drawings: M Fish		24 000	
Equipment		80 000	
Accumulated depreciation: Equipment (1 August 20.6)			8 000
Inventory (1 August 20.6)		13 300	
Debtors control		54 200	
Creditors control			47 600
Bank		35 120	
Sales			568 350
Sales returns		8 350	
Purchases		321 290	
Purchases returns			3 290
Settlement discount received			6 400
Freight in		8 650	
Rental expense		19 500	
Salaries		148 000	
Communication expenses		13 450	
Municipal expenses		12 640	
Stationery		4 690	
General expenses		10 450	
		753 640	753 640

Additional information:

1. Inventories at 31 July 20.7:

	R
Merchandise	18 700
Stationery	810

2. Provide for R8 000 depreciation on equipment.
3. The telephone account of R1 280 for July 20.7 was received on 15 August 20.7.
4. Rental amounted to R1 500 per month.

Required

(a) Open the accounts in the general ledger of Cosmos Traders.
(b) Journalise the adjustments.
(c) Balance the accounts and prepare a post-adjustment trial balance.
(d) Journalise the closing entries and prepare a post-closing trial balance.
(e) Prepare the following financial statements of Cosmos Traders:
   (i) the statement of profit or loss and other comprehensive income for the year ended 31 July 20.7

(ii) the statement of changes in equity for the year ended 31 July 20.7
(iii) the statement of financial position as at 31 July 20.7.

(f) Prepare the notes to the statement of financial position of Cosmos Traders for the year ended 31 July 20.7.

Solution

Cosmos Traders

General ledger

Dr — Capital: M Fish — 1 — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7					20.7				
Jul	31	Drawings ②	J12	24 000	Jul	31	Balance	b/d	120 000
		Balance	c/d	125 450			Profit or loss ②	J12	29 450
				149 450					149 450
					Aug	1	Balance	b/d	125 450

Dr — Drawings: M Fish — 2 — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7					20.7				
Jul	31	Balance	b/d	24 000	Jul	31	Capital ②	J12	24 000

Dr — Equipment — 3 — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7									
Jul	31	Balance	b/d	80 000					

Dr — Accumulated depreciation: Equipment — 4 — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.7				
					Jul	31	Balance	b/d	8 000
							Depreciation ①	J12	8 000
									16 000

Dr — Inventory — 5 — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.7				
Aug	1	Balance	b/d	13 300	Jul	31	Trading account ②	J12	13 300
20.7							Balance	c/d	18 700
Jul	31	Trading account ①	J12	18 700					
				32 000					32 000
Aug	1	Balance	b/d	18 700					

continued

Dr **Debtors control** **6** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	54 200					

Dr **Creditors control** **7** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.7 Jul	31	Balance	b/d	47 600

Dr **Bank** **8** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	35 120					

Dr **Sales** **9** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7		Sales returns		8 350	20.7				
Jul	31	Trading account ②	J12	560 000	Jul	31	Balance	b/d	568 350

Dr **Sales returns** **10** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	8 350	20.7 Jul	31	Sales ②	J12	8 350

Dr **Purchases** **11** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7					20.7	31	Purchase returns		3 290
Jul	31	Balance	b/d	321 290	Jul		Settlement discount received ②		6 400
							Trading account ②	J12	311 600
				321 290					321 290

continued

Dr **Purchases returns** **12** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Purchases ②	J12	3 290	20.7 Jul	31	Balance	b/d	3 290

Dr **Settlement discount received** **13** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Purchases ②	J12	6 400	20.7 Jul	31	Balance	b/d	6 400

Dr **Freight in** **14** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	8 650	20.7 Jul	31	Trading account ②	J12	8 650

Dr **Rental expense** **15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	19 500	20.7 Jul	31	Prepaid expenses ①	J12	1 500
							Profit or loss ②	J12	18 000
				19 500					19 500

Dr **Salaries** **16** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	148 000	20.7 Jul	31	Profit or loss ②	J12	148 000

Dr **Communication expenses** **17** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	13 450	20.7 Jul	31	Profit or loss ②	J12	14 730
		Accrued expenses ①	J12	1 280					
				14 730					14 730

continued

Dr **Municipal expenses** **18** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	12 640	20.7 Jul	31	Profit or loss ②	J12	12 640

Dr **Stationery** **19** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	4 690	20.7 Jul	31	Stationery inventory ①	J12	810
							Profit or loss ②	J12	3 880
				4 690					4 690

Dr **General expenses** **20** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Balance	b/d	10 450	20.7 Jul	31	Profit or loss ②	J12	10 450

Dr **Stationery inventory** **21** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Stationery ①	J12	810					

Dr **Depreciation** **22** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Accumulated depreci-ation ①	J12	8 000	20.7 Jul	31	Profit or loss ②	J12	8 000

Dr **Accrued expenses** **23** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.7 Jul	31	Communication expenses ①	J12	1 280

continued

Dr **Prepaid expenses** **24** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Rental expense ①	J12	1 500					

NB: ① Adjustment entries
② Closing entries

Dr **Trading account** **25** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Inventory	J12	13 300	20.7 Jul	31	Inventory	J12	18 700
		Purchases	J12	311 600			Sales	J12	560 000
		Freight in	J12	8 650					
		Profit or loss (gross profit)	J12	245 150					
				578 700					578 700

Dr **Profit or loss** **26** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.7 Jul	31	Rental expense	J12	18 000	20.7 Jul	31	Trading account (gross profit)	J12	245 150
		Salaries	J12	148 000					
		Communication expenses	J12	14 730					
		Municipal expenses	J12	12 640					
		Stationery	J12	3 880					
		General expenses	J12	10 450					
		Depreciation	J12	8 000					
		Capital (profit/ total com-prehensive income)	J12	29 450					
				245 150					245 150

continued

Cosmos Traders

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.7				**R**	**R**
Jul	31	Stationery inventory	GL21	810	
		Stationery	GL19		810
		Stationery on hand brought into account			
		Depreciation	GL22	8 000	
		Accumulated depreciation: Equipment	GL4		8 000
		Depreciation on equipment for the year			
		Communication expenses	GL17	1 280	
		Accrued expenses	GL23		1 280
		Telephone account for July 20.7 brought into account			
		Prepaid expenses	GL24	1 500	
		Rental expense ③	GL15		1 500
		Rental prepaid			

③ Refer to the calculations after the statement of profit or loss and other comprehensive income.

Cosmos Traders
Post-adjustment trial balance as at 31 July 20.7

	Fol	Debit	Credit
		R	R
Capital: M Fish	GL1		120 000
Drawings: M Fish	GL2	24 000	
Equipment	GL3	80 000	
Accumulated depreciation: Equipment	GL4		16 000
Inventory (1 August 20.6)	GL5	13 300	
Debtors control	GL6	54 200	
Creditors control	GL7		47 600
Bank	GL8	35 120	
Sales	GL9		568 350
Sales returns	GL10	8 350	
Purchases	GL11	321 290	
Purchases returns	GL12		3 290
Settlement discount received	GL13		6 400
Freight in	GL14	8 650	
Rental expense	GL15	18 000	
Salaries	GL16	148 000	
Communication expenses	GL17	14 730	
Municipal expenses	GL18	12 640	
Stationery	GL19	3 880	
General expenses	GL20	10 450	
Stationery inventory	GL21	810	
Depreciation	GL22	8 000	
Accrued expenses	GL23		1 280
Prepaid expenses	GL24	1 500	
		762 920	762 920

Closing inventory can only be recorded when the trading account is completed. Because inventory is an asset account (a permanent account), the opening balance of inventory remains in the books until the closing entries are recorded. The value of closing inventory is then recorded with an adjusting entry and the opening balance on the inventory account is closed off to the trading account.

Cosmos Traders

General journal **J12**

Month	Day	Details	Fol	Debit	Credit
20.7				R	R
Jul	31	Settlement discount received	GL13	6 400	
		Purchases	GL11		6 400
		Closing entry			
		Inventory	GL5	18 700	
		Trading account	GL25		18 700
		Cost price of closing inventory on hand brought into account			
		Trading account	GL25	333 550	
		Inventory	GL5		13 300
		Purchases	GL11		311 600
		Freight in	GL14		8 650
		Closing entry			
		Sales	GL9	560 000	
		Trading account	GL25		560 000
		Closing entry			
		Trading account	GL25	245 150	
		Profit or loss account	GL26		245 150
		Transfer of the gross profit to the profit or loss account			
		Profit or loss	GL26	215 700	
		Rental expense	GL15		18 000
		Salaries	GL16		148 000
		Communication expenses	GL17		14 730
		Municipal expenses	GL18		12 640
		Stationery	GL19		3 880
		General expenses	GL20		10 450
		Depreciation	GL22		8 000
		Closing entry			
		Profit or loss	GL26	29 450	
		Capital	GL1		29 450
		Transfer of the profit/total comprehensive income for the year to the capital account			
		Capital	GL1	24 000	
		Drawings	GL2		24 000
		Transfer of the balance on the drawings account			

Cosmos Traders
Post-closing trial balance as at 31 July 20.7

	Fol	Debit	Credit
		R	R
Capital: M Fish	GL1		125 450
Equipment	GL3	80 000	
Accumulated depreciation: Equipment	GL4		16 000
Inventory	GL5	18 700	
Debtors control	GL6	54 200	
Creditors control	GL7		47 600
Bank	GL8	35 120	
Stationery inventory	GL21	810	
Accrued expenses	GL23		1 280
Prepaid expenses	GL24	1 500	
		190 330	190 330

Cosmos Traders
Statement of profit or loss and other comprehensive income for the year ended 31 July 20.7

	Notes	R
Revenue ①	2.5	560 000
Cost of sales		(314 850)
Inventory (1 August 20.6)		13 300
Purchases ②		311 600
Freight in		8 650
		333 550
Inventory (31 July 20.7)		(18 700)
Gross profit		245 150
Distribution, administrative and other expenses		(215 700)
Rental expense ③		18 000
Salaries		148 000
Communication expenses ④		14 730
Municipal expenses		12 640
Stationery ⑤		3 880
General expenses		10 450
Depreciation	2.1	8 000
Profit/total comprehensive income for the year		29 450

Calculations:

		R
①	Revenue	
	Sales	568 350
	Sales returns	(8 350)
		560 000
②	Purchases	314 890
	Purchases returns	(3 290)
		311 600
③	Rental expense	19 500
	12 × R1 500	(18 000)
	Prepaid	1 500
④	Communication expenses	13 450
	Account for July 20.7	1 280
	Total for the year	14 730
⑤	Stationery	4 690
	Stationery inventory	(810)
	Stationery consumed	3 880

Cosmos Traders
Statement of changes in equity for the year ended 31 July 20.7

	R
Capital:	
Balance as at 1 August 20.6	120 000
Profit/total comprehensive income for the year	29 450
Drawings	(24 000)
Balance as at 31 July 20.7	125 450

Cosmos Traders
Statement of financial position as at 31 July 20.7

	Notes	R
ASSETS		
Non-current assets		64 000
Property, plant and equipment	3	64 000
Current assets		110 330
Inventories ⑥	2.3	19 510
Trade and other receivables	4	54 200
Prepayments		1 500
Cash and cash equivalents	4	35 120
Total assets		174 330
EQUITY AND LIABILITIES		
Total equity		125 450
Capital		125 450
Total liabilities		48 880
Current liabilities		48 880
Trade and other payables	5	48 880
Total equity and liabilities		174 330

Calculations:

⑥ Inventories	R
Merchandise	18 700
Stationery	810
	19 510

Cosmos Traders
Notes for the year ended 31 July 20.7

1. Basis of presentation

   The annual financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.

2. Summary of significant accounting policies

   The annual financial statements incorporate the following significant accounting policies, which are consistent with those applied in previous years, except where otherwise stated:

   2.1 Property, plant and equipment

   Property, plant and equipment are initially recognised at cost price. Equipment is subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses.

   Depreciation on equipment is written off at a rate deemed to be sufficient to reduce the carrying amount of the asset over its estimated useful life to its estimated residual value.

   Depreciation is charged to profit or loss for the year.

2.2 Financial assets

Cash and cash equivalents are classified as "Financial assets at fair value through profit or loss". Cash and cash equivalents consists of cash in bank.

2.3 Inventories

Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. Cost is calculated using the first-in, first-out method. Net realisable value is the estimated selling price in the ordinary course of business less any costs of completion and disposal.

2.4 Financial liabilities

Financial liabilities are recognised when the entity becomes contractually liable.

2.5 Revenue

Revenue is measured at the fair value of the consideration received or receivable. Revenue from the sale of goods consists of the total net invoiced sales excluding the settlement discount granted. The revenue from sales is recognised when ownership is transferred to the customer.

3. Property, plant and equipment

	Equipment
	R
Carrying amount at 1 August 20.6	72 000
Cost	80 000
Accumulated depreciation	(8 000)
Depreciation for the year	(8 000)
Carrying amount at 31 July 20.7	64 000
Cost	80 000
Accumulated depreciation	(16 000)

4. Financial assets ①

	20.7
	R
Current financial assets	
Trade and other receivables:	54 200
Debtors control	54 200
Other financial assets	
Financial assets at fair value through profit or loss:	
Cash and cash equivalents:	35 120
Bank	35 120

5. Financial liabilities ①

	20.7
	R
Current financial liabilities	
Trade and other payables:	48 880
Creditors control	47 600
Accrued expenses: Communication expenses	1 280

① These notes are explained in chapters 12 and 14.

7.4 Summary

The gross profit of a trading entity is calculated in a trading account. Gross profit is the difference between sales and cost of sales. The closing procedures of a service entity and a trading entity are closely related, except for the calculation of gross profit.

When a trading entity uses the perpetual inventory system, it maintains a cost of sales account and inventory purchased is recorded in the inventory account. If the periodic inventory system is used, inventory purchased is recorded in the purchases account and cost of sales is calculated at the end of the financial year. The gross profit calculated is transferred to the profit or loss account. The different income and expense accounts of both service entities and trading entities are transferred to the profit or loss account, when the profit/total comprehensive income or loss for the year is determined. The profit/total comprehensive income or loss for the period for both service entities and trading entities is transferred to the capital account of the owner.

Financial statements are prepared separately from the ledger accounts and do not form part of the double-entry system. Financial statements can be compiled whenever the information is needed by management, while the closing off of accounts is done only at the end of the financial year, after adjustments have been completed.

CHAPTER 8

Cash and cash equivalents

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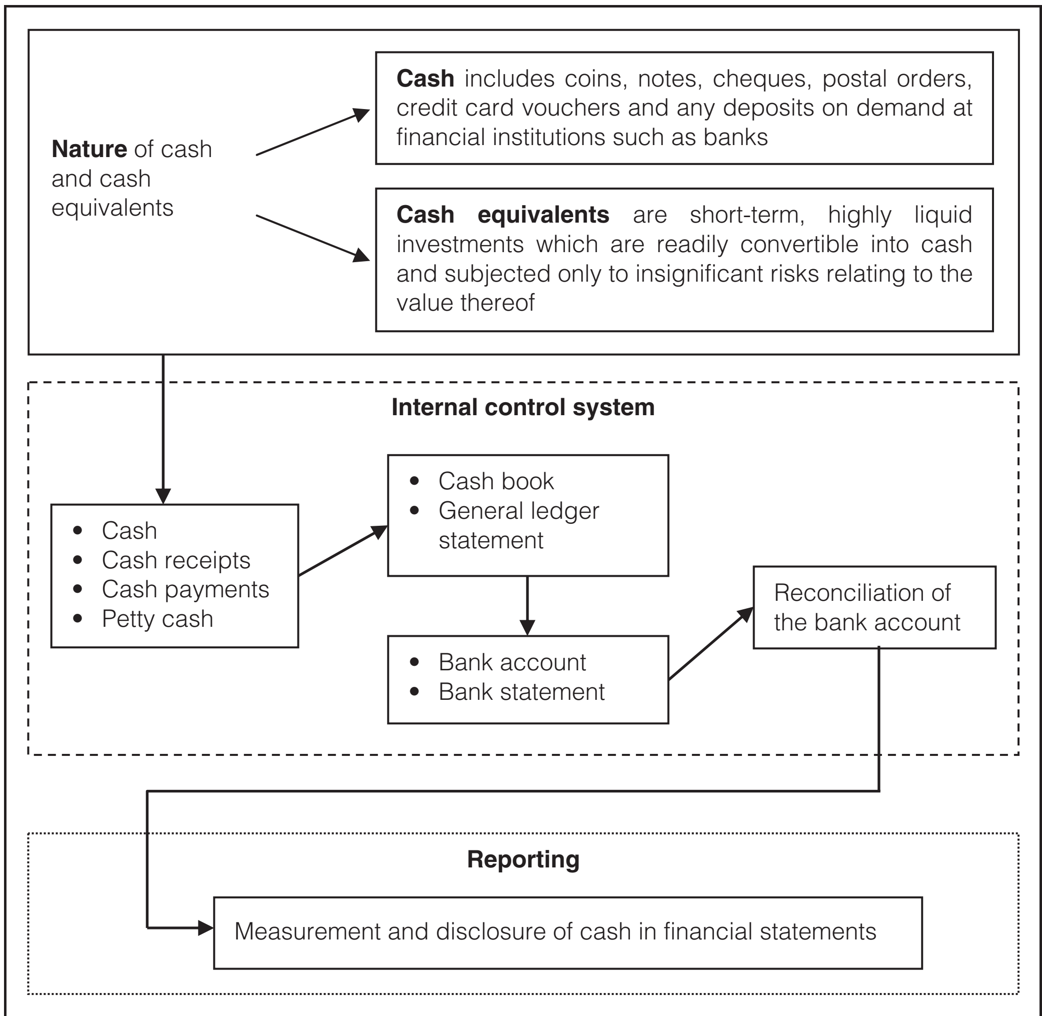
Overview of cash and cash equivalents



8.1 Introduction

Study objectives

After studying this chapter you should be able to

- ☐ disclose transactions with the bank on the bank statement;
- ☐ update the two cash journals of the entity whose books you are preparing;
- ☐ reconcile the balance of the bank account with the balance reflected on the bank statement;
- ☐ prepare a petty cash journal; and
- ☐ show how cash and cash equivalents are disclosed on the statement of financial position.

The processing of cash transactions, namely cash receipts and payments, has been explained in detail in previous chapters. It was explained, for example, that when cash is received, the asset “Bank” increases and the bank account is debited. When cheques are issued, the asset “Bank” decreases and is therefore credited. Cash receipts are recorded in the cash receipts journal (CRJ), while cash payments are recorded in the cash payments journal (CPJ). The totals of these journals are posted to the debit and credit sides respectively of the bank account in the general ledger.

The purpose of this chapter is to explain what is included in cash and cash equivalents, what entries may appear in the books of the bank regarding transactions by the bank with the particular entity, how to reconcile the *balance* of the *bank account* in the books of the *entity* with the *balance* according to the *bank statement*, that is, the way it is reflected in the books of the *bank*. Lastly, we will explain how to prepare a petty cash journal.

Entities must comply with inter alia the requirements of faithful representation, prudence and fair presentation when it comes to cash and cash equivalents. This means that entities, and in particular accountants, must ensure that the balances of cash and cash equivalents, as they are disclosed on the statement of financial position, are correct. If you cannot remember the contents of these requirements, refresh your memory and study them in chapter 1. One way of ascertaining whether the balance of the bank account is correct is to reconcile the balance as per the bank account with the balance as per the books of the bank.

8.2 Nature of cash and cash equivalents

Cash can be defined as any legal means of payment that can immediately be used as a means to pay someone else.

Cash includes coins, notes, cheques, postal orders, credit card vouchers and any deposits on demand at financial institutions such as banks.

Cash equivalents are short-term, highly liquid investments which are readily convertible into cash and subjected only to insignificant risks relating to the value thereof.

Money market instruments, such as treasury bonds and bankers acceptances, are examples of cash equivalents. It is not required of you to study these concepts at this stage.

Liquidity indicates the availability of cash for payment of claims against the entity. Cash and cash deposits are liquid because they are immediately available for payment. As cash is the most liquid form of money, it is therefore the primary legal tender in the economic system. By contrast, a fixed deposit which can only be withdrawn after twelve months, is less liquid.

As it is the primary liquid legal tender, cash is the most active asset in an entity. All expenses are eventually paid in cash (mainly by cheque or electronic transfer) and all income is eventually received in cash. This implies that, after each cash receipt or payment, the liquidity of the entity changes.

In every entity there is a constant stream of cash flowing in and flowing out. Whenever the cash inflow exceeds the outflow, a cash surplus is created, which should be invested if not needed for payment in the near future. Whenever cash outflow exceeds the cash inflow, it may be necessary for the entity to withdraw available investments or to borrow money to cover the shortage. Money that is invested earns interest and interest must be paid on money that is borrowed. The rate of interest on borrowed money is usually higher than the rate of interest on investments. It is therefore unwise to borrow money when investments can be converted into cash.

The management of an entity must ensure that the entity constantly has sufficient cash available to meet its obligations. At the same time, management must ensure that maximum interest is earned on investments and that unnecessary loans and interest on loans are limited to the minimum.

Because cash is highly liquid and cash instruments (notes and coins) are not individually identifiable (except with great effort), the risk of loss through theft, fraud and other causes is high. Management therefore also has a responsibility to ensure that effective internal control measures over cash exist.

8.3 Internal control over cash

8.3.1 *Nature of internal control over cash*

The purpose of internal control over cash is to ensure that all cash that should be paid to an entity has been received and recorded; that all cash that should be deposited in a bank account has indeed been deposited; and that all cash payments have been duly authorised and verified.

In smaller entities, the owner or manager personally exercises control over all cash transactions. In larger entities, it is often impossible for a single person to exercise all the necessary control. The accounting system should therefore be designed to include proper internal control measures. The system should be designed to control data at various points to enable the checking of the correctness of a series of items or transactions.

As cash forms the starting point of the operating cycle in an entity, it can also be the starting point of the internal control system. Cash is easily concealed and moved and can easily be converted into other assets.

On account of these characteristics, cash is most vulnerable to theft and fraud. Because the volume of cash transactions is usually high, the probability of error in handling cash and recording cash transactions is also high. An effective system of internal control over cash is an absolute necessity.

8.3.2 *Internal control over cash receipts*

Cash can be generated from various sources, such as cash sales, collections from debtors, rentals received, loans, proceeds from the sale of assets, and so forth. The principles of internal control applicable to cash receipts transactions are as follows:

Principle	Application to cash receipts
1. Determination of responsibility	Only specified personnel, such as cashiers and their control officers should be authorised to handle cash.
2. Allocation of duties	The functions of receiving, recording and safe-keeping of cash should be allocated to different persons. This prevents the concealment of fraud through false entries in the books of account. These functions should be allocated in such a way that errors made by one person will be detected by another in the normal course of duties. This will require collusion between at least two persons in order to embezzle cash.
3. Documentation procedures	The accounting process for the recording of cash transactions should provide for the checking of daily cash receipts against independent records. For this purpose, it is necessary to prepare source documents for the receipt of cash. The source document should indicate the amount, the date of receipt, purpose and, where applicable, from whom it was received. Examples of such source documents are receipts, cash slips, invoices and cash register control and audit rolls. Source documents should be kept under control.
4. Physical, mechanical and electronic controls	Cash should be kept in safes until it can be deposited at the bank. Only authorised personnel should have access to safes. Appropriate equipment should be used for receipts over the counter.
5. Independent internal verification	Cash counts should be done by supervisors at the close of cashiers' shifts. All cash received should be deposited in total daily. No payment should be made out of cash receipts. Cash deposits should be checked daily against receipts by responsible officials.
6. Other control measures	All personnel who handle cash should be covered by fidelity insurance guarantees and should be obliged to take periodic leave.

8.3.3 *Internal control over cash payments*

In any entity, cash payments are made for a wide variety of purposes. All payments, excluding petty cash payments, should be made by cheque. Usually payments by cheque can be done only after certain control measures have been complied with. Paid cheques returned by the bank to the drawer after payment also serve as proof of payment.

The principles of internal control in respect of cash payments are as follows:

Principle	Application to payments
1. Determination of responsibility	Only specific senior officials should be authorised to sign cheques.
2. Allocation of duties	The responsibility for the authorisation of payment should be delegated to different persons (excluding those with authority to sign cheques) in charge of those who incur expenditure.
3. Documentation procedure	Pre-numbered cheques must be used and all cheques must be accounted for. All cheques presented for payment should be supported by documentation that verifies the authorisation. Blank cheques should be in safe-keeping, to which only authorised personnel have access. In larger organisations, automatic cheque-writing machines should be used.
4. Independent internal control	All cheques must be checked against supporting documents before they are issued. The bank balance should be reconciled regularly.
5. Other controls	After payment, supporting documents should be marked as “Paid”.

8.4 The use of a bank account

8.4.1 *Opening of a bank account*

All entities that receive and disburse cash should open a current account, into which cash can be deposited and out of which payments can be made, with a bank.

> A *current bank account* (also referred to as a cheque account) is an account into which money is deposited and from which money is withdrawn mainly by means of cheques issued by the entity.

This account is also used for payments by means of debit or stop orders or electronic transfers.

The provision of credit facilities is a primary function of banks. In practice, banks provide clients with a facility to borrow money by allowing payments in excess of cash deposits. Such loans are called *bank overdrafts*. In granting overdraft facilities, a bank agrees with the entity on a maximum facility (the maximum amount that can be borrowed); the rate of interest that the bank will charge on the overdraft and, where

applicable, repayment conditions. Some banks may charge a penalty rate of interest when this overdraft facility is misused, that is, when the overdraft is exceeded.

A bank overdraft is a "current" liability in the books of the entity, because it is likely that the balance of the overdrawn bank account will change within the next twelve months. As a matter of fact, this will happen after each cash transaction with the bank.

The use of a current account with a bank contributes materially to sound internal control over cash. If all cash receipts are regularly deposited in total and all payments (excluding petty cash payments) are made by cheque, the amount of cash on hand on the premises of the entity is limited. The use of a bank cheque account creates an added control measure, because a twofold record of transactions is kept – in the records of the entity and in the records of the bank. These two accounts must agree, or it must be possible to reconcile differences between their balances.

When the arrangements with a bank for the opening of a bank account are concluded and proof signatures of persons authorised to operate the bank account have been delivered to the bank, the bank will provide deposit slips and cheque books to the client. The cheques are numbered in sequence and the name, address and telephone number of the client is usually printed by the bank on the cheques. Some banks also print the name and address of the client on the deposit slips. The bank account number of the client and the identification number of the bank are usually printed on cheques and deposit slips in machine-readable form to allow the electronic processing of these documents.

8.4.2 *Depositing of money*

☐ **Nature of deposits**

It is sound accounting practice to deposit all cash receipts on a regular basis – preferably daily – into a bank account. This is to ensure effective control over cash.

Cash deposits into bank accounts can be done in various ways:

☐ deposits of cash by the entity;

☐ amounts credited by the bank into the bank account of the entity, for instance interest on favourable balances;

☐ payments by third parties, deposited directly into the bank account of the entity; and

☐ electronic transfers.

The accounting system should be designed to ensure that all amounts paid into the bank account are accounted for in the CRJ.

☐ **Cash deposits**

When cash is deposited into a bank account, a deposit slip containing full information about the deposit must accompany the deposit. The bank retains the original deposit slip and acknowledges receipt thereof by returning a stamped copy of the deposit slip to the client. This serves as proof that the bank has received the amount of money deposited by the client.

The stamped deposit slip also serves as the source document for the recording of the deposit in the CRJ. Diagram 8.1 shows an example of a bank deposit slip:

Diagram 8.1

CHEQUE ACCOUNT DEPOSIT

ABC Bank[1]
Church Street
0001 PRETORIA
Credit: A Johnson[3]

226-638[2]
Date: 30 June 20.2
Account Number: 316/1286

Teller's date stamp and signature	Drawer's name	Branch clearance number	Cash	R 210,00
	B Cook..............	448-821...		R 300,00
	....	....		R
				R 510,00

'J 0084: 226638 3161286'[4]

1 Name and branch of bank.
2 Branch clearance number.
3 Name of bank account holder (sometimes pre-printed on deposit slips issued by the bank).
4 Machine-readable branch clearance and account numbers.

Note that the instruction is to "*Credit*" the particular bank account. A deposit into a bank account means that the bank will debit its CRJ and credit the bank account of the client. In other words, it also means that the bank owes the amount of the deposit to the client. The entries in the books of the client are therefore the opposite of the same entry in the books of the bank.

☐ Direct deposits by third parties into a bank account

Where clients are spread over a wide area, an entity can arrange with the clients to deposit monies due to the entity at any other branch of the bank. This is done because the electronic transfer of money from one bank to another is much faster and more economical than, for example, the client mailing a cheque or postal order.

At the bank where the deposit is made, the client completes a special deposit slip which contains, apart from the date and amount of the deposit, the name and address or other identification of the client and the purpose of the payment.

The amounts that are transferred in this manner from various branches to the bank where the entity keeps its account are then credited in the books of the bank to the account of the entity. Full particulars of all deposits are shown separately on the bank statement of the entity. Some banks also send a copy of the deposit to the particular client.

The bank statement (or, where applicable, the copy of the deposit slip) serves as the source document in respect of all amounts deposited directly into the bank account for the benefit of the entity. The CRJ is updated from the bank statement.

It is important that the party depositing the money furnishes full and accurate particulars of the transaction on the deposit slip. Incomplete information on the deposit slip may result in incomplete information in the bank statement, with the result that it will be difficult to make correct entries in the books (such as the CRJ) and postings to the entity's ledger accounts.

☐ **Electronic data transfer**

Electronic data transfer technology is often used in cases where a large number of similar payments are made on a regular basis. An insurance company which collects monthly premiums from a large number of policy holders may, for example, arrange to have the premiums deducted electronically through debit orders from policy-holders' bank accounts and transferred to the bank account of the insurance company. For the insurance company, these collections are receipts. For the client, the entries on its bank statement must be regarded as payments. This practice of collecting money is also followed by a wide range of business entities, such as municipalities and telephone companies.

The source document in this case is the bank statement showing the deposits (in the case of the receiving entity) and the record of the amounts collected from the accounts of the clients. In the case of the entity from whose account the payment was collected, the bank statement of that entity will reflect the payment. In such a case, that entry on the bank statement will serve as the source for the payment and the CPJ of the paying entity must be updated.

It will be necessary to regularly reconcile the records of the amounts deducted with the actual amounts deposited into the receiving entity's bank account. The CRJ must also be updated with such amounts paid into the bank account of the receiving entity.

8.4.3 *Issuing of cheques*

The cheque is the instrument for the transfer of money from the current bank account of a client of a bank to another party.

> A cheque is an unconditional order in writing addressed and signed by a person (the drawer) to his banker to pay on demand a certain sum of money to a specific person (the beneficiary).

Cheques are usually pre-numbered and printed with counterfoils, with corresponding serial numbers and which remain in the cheque book. The information entered on a cheque is also entered on the counterfoil, which then serves as a source document to prepare the CPJ. Some banks issue cheque books with a duplicating facility to their clients; the duplicate then serves as the source document.

8.4.4 *The bank statement*

Banks furnish their clients periodically (usually monthly) with a *bank statement.* The bank statement reflects all transactions on the client's account in the books of the bank (ie deposits made, cheques paid, other debits and credits (see paragraph 8.4.5)) and usually shows the daily balance of the account. Usually banks return all paid cheques to the client.

The format of bank statements and the symbols used differ from one bank to another. A typical bank statement is illustrated in diagram 8.2.

Diagram 8.2

Sand Bank Limited

Sand Bank Limited
Registered Bank
Reg No 393/2571
VAT-Reg No: 3600101111

Tel: (012) 555-5555
Fax: (012) 555-5556

JH SMIT TRADERS
P O Box 12345
PRETORIA
0001

Account No 01/200/998/9 **Statement No 1** **May 20.0**

Details	Cheque No	Fee	Date	Debit	Credit	Balance
		R		R	R	R
Deposit			02:05		10 000	10 000 Cr
Deposit		9,40	15:05		2 800	12 800 Cr
Cheque	1	1,20	18:05	1 200		11 600 Cr
Cheque	3	0,90	20:05	900		10 700 Cr
SO: Nico Shops		0,50	23:05	500		10 200 Cr
Deposit			25:05		1 250	11 450 Cr

PLEASE NOTE: The bank will assume that the statement as rendered is correct unless notice of any discrepancies in connection with entries is received within 14 days of delivery hereof.

EXPLANATION OF ABBREVIATIONS:

SO = Stop order	DO = Debit Order	LF = Ledger fees	EC = Error corrected
IN = Interest	CB = Cheque book	UN = Unpaid cheque	BC = Bank charges

Items such as the "SO", which is a stop order paid by the bank to the entity mentioned, (in this case "Nico Shops"), should be *updated* in the *CPJ* (for amounts *debited* to the bank statement). In the case of a debit order collected, it must be *updated* in the *CRJ* (for amounts *credited* to the bank statement). The bank statement is the source document for all items debited or credited by the bank that are not yet reflected in the cash journals.

8.4.5 *Debit and credit memos*

Banks usually issue debit memos for debits against a client's account for services rendered (for instance, the cost of deposit slips and cheque books) and for sundry other debits, such as the amount payable by the entity if a cheque deposited into the account is unpaid and returned by the bank on which it was drawn as a result of insufficient funds or an error or alteration on the cheque.

In some cases, banks also issue credit memos in respect of amounts credited to a client's account – for example, when a direct deposit into the account has been made by a client of the entity (see paragraph 8.4.2 above).

8.5 Reconciling the bank account with the bank statement

8.5.1 *Reasons for differences in balances*

If all the transactions between the entity and the bank happen on the same day, the balance of the bank account in the books of the entity would theoretically correspond with the balance of the bank account (as reflected on the bank statement) in the books of the bank. The only difference should be that the one balance would be a debit balance and the other a credit balance. This seldom happens in practice, however. The more transactions the entity has with the bank, the more likely it is that the balances will not correspond. It is possible, however, to reconcile these two balances in the event of their not corresponding. This process is known as *the reconciliation of the bank account* with the *bank statement*.

The following are the most common causes of differences between the balance shown in the records of the entity and those of the bank:

☐ Items appearing in the entity's books but not yet reflected in the bank's records, for example:
  - Outstanding cheques. These are cheques that have been drawn by the entity, but have not yet been presented to the bank for payment.
  - Deposits not yet credited by the bank.

☐ The bank's books may show various items not yet recorded by the entity, for example:
  - Direct deposits made into the bank account of the entity.
  - Charges for services rendered by the bank (ledger fees).
  - Interest charged on an overdrawn balance or granted on a favourable balance.
  - Commission on cheques and cash deposit fees.
  - Unpaid cheques (referred to drawer – "R/D").
  - Money recovered or paid by the bank on behalf of the entity. Although the bank notifies the entity immediately of unpaid cheques received and of amounts paid or recovered via debit or credit notes, the entity usually records these items only when the bank reconciliation statement is prepared.

☐ Errors made by either the entity or the bank.

Where the differences necessitate adjustments in the books of the entity, that is, when the cash journals of the entity are incorrect, the cash journals must be updated. All direct deposits, interest earned and so on, ie all *credit* entries on the bank statement that do not appear in the CRJ, must be updated in the CRJ. Similarly, all *debit* entries on the bank statement that do not appear in the CPJ must be updated in the CPJ.

The *bank reconciliation statement* will consist of all the items in the cash journals which *do not appear on the bank statement*, such as deposits not yet received by the bank or cheques not yet paid by the bank on the last date of the bank statement. The purpose of the bank reconciliation is therefore to reconcile the balance of the bank account in the general ledger of the entity (hereafter referred to as the bank *account* balance), with the balance shown in the bank's books (hereafter referred to as the bank *statement* balance).

8.5.2 *Reconciliation procedure*

The principle of an independent internal audit must be adhered to. This is to ensure that the official who does the reconciliation is, if possible, not involved with receipts or payments of cash. If this is not done, it will be difficult to detect cash fraud.

The following bank statement and cash journals are used to explain the procedure of reconciling the bank account balance with the bank statement balance. The first step is to *compare* the bank statement of the *current* month with the cash journals (CRJ and CPJ) of the *current* month. This is done to ascertain which transactions appearing on the bank statement are *not* in the cash journals. These transactions are then used to *update* the cash journals.

☐ **CRJ**

The amounts in the CRJ are compared with the amounts on the *credit* side of the bank statement. Each amount in the bank column of the *CRJ* that corresponds to the amount on the bank statement is marked with a distinct tick (✓) in both the CRJ and the bank statement. The same distinct tick can be used to mark the same amount on the bank *statement.*

Example 8.1

On 1 May 20.0, Ben Smith starts a trading business, Smitties Traders. The CRJ for May 20.0 of Smitties Traders reflected the following (analysis columns are excluded since they are not important for this exercise):

Smitties Traders

Cash receipts journal for May 20.0 **CRJ5**

Doc No	Date	Details	Analysis	Bank
			R	**R**
1	1	B Smith: Capital	10 000	10 000 ✓
2	7	Cash sales	1 450	
3	14	Cash sales	1 350	2 800 ✓
4	21	Cash sales	900	
5	24	R Charles: Rent	350	1 250 ✓
6	31	Cash sales	850	850
				14 900
				B 15

Having posted the bank column in the CRJ to the debit side of the bank account in the general ledger (B 15), the bank account should have the following entry only:

General Ledger

Dr **Bank** **B15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.0 May	31	Total receipts	CRJ5	14 900					

The bank statement for May 20.0, received from the bank (Sand Bank) reflects the following:

Sand Bank Limited
Registered Bank

Reg No 93/2571
VAT-Reg No: 2600101432

Tel: (012) 555-5555
Fax: (012) 555-5556

Smitties Traders
P O Box 12345
PRETORIA
0001

Account No 01/200/998/9 Statement No 1 May 20.0

Details	Cheque No	Fee	Date	Debit	Credit	Balance
		R		R	R	R
Deposit			02:05		10 000 ✓	10 000 Cr
Deposit		10,40	15:05		2 800 ✓	12 800 Cr
Deposit			25:05		1 250 ✓	14 050 Cr

It is obvious that the debit balance of the bank account (R14 900) differs from the credit balance on the bank statement (R14 050). All the amounts in the credit column of the statement, have been marked (✓), but the deposit of R850 (31 May) in the CRJ has not been marked. No changes to the CRJ need to be done for this month. The reason is that this deposit will be received by the bank on 1 June and will appear on the bank statement of June. In order to *reconcile* the two balances, the following bank reconciliation is prepared. Since the bank will *credit* the account of the entity with the deposit, the amount is shown in the *credit column* of the reconciliation. A separate sheet of paper (or book), ruled in a similar manner to a general journal, is usually used for this purpose.

Smitties Traders
Bank reconciliation statement at 31 May 20.0

		Fol	Debit	Credit
			R	R
	Debit (favourable) balance as per Bank *Account* (B15)		14 900	
	Credit outstanding deposit (deposited 01 Jun 20.0)			850
	Credit (favourable) balance as per Bank *Statement*			14 050
			14 900	14 900

☐ CPJ

The amounts in the CPJ are compared with the amounts on the *debit* side of the bank statement. Each amount in the bank column of the *CPJ* that corresponds with the amount on the bank statement is marked with a distinct mark (✓). The same distinct mark can be used to mark the same amount on the bank *statement*.

The CPJ for May 20.0 of Smitties Traders reflected the following transactions (bank column only):

Smitties Traders

Cash payments journal for May 20.0 **CPJ5**

Doc no	Date	Details	Bank
			R
1	1	Municipality	1 000 ✓
2	7	ABC Stores	2 500 ✓
3	15	John's Wholesalers	1 200
4	27	Cash: (Wages)	450 ✓
5	30	ABC Stores	350
6		Cash: (Wages)	450 ✓
			5 950
			B 15

Having posted the bank column in the CPJ to the credit side of the bank account in the general ledger, the bank account should have the following entries:

General Ledger

Dr **Bank** **B15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.0					20.0				
May	31	Total receipts	CRJ5	14 900	May	31	Total payments	CPJ5	5 950
							Balance	c/d	8 950
				14 900					14 900
Jun	1	Balance	b/d	8 950					

The bank statement for May 20.0, received from the bank (Sand Bank), reflects the following:

Sand Bank Limited
Registered Bank

Reg No 93/2571
VAT-Reg No: 2600101432

Tel: (012) 555-5555
Fax: (012) 555-5556

Smitties Traders
P O Box 12345
PRETORIA
0001

Account No 01/200/998/9 Statement No 1 May 20.0

Details	**Cheque No**	**Fee**	**Date**	**Debit**	**Credit**	**Balance**
		R		**R**	**R**	**R**
Deposit			02:05		10 000 ✓	10 000
Cheque	2	2,90	02:05	2 500 ✓		7 500
Cheque	1	1,20	08:05	1 000 ✓		6 500
Deposit		1,50	15:05		2 800 ✓	9 300
Cheque	4	1,20	15:05	450 ✓		8 850
Deposit			25:05		1 250 ✓	10 100
Cheque	6	1,20	30:05	450 ✓		9 650

The amounts in the "Fee" column and interest on the credit balance will be debited and credited (for explanation purposes) in the discussion of the reconciliation for June 20.0.

The debit balance of the bank account (R8 950) differs from the credit balance on the bank statement (R9 650). All the amounts in the debit and credit column of the statement have been marked (✓), but the deposit of R850 (31 May) in the CRJ has not been marked; nor have the two cheques (No 3 for R1 200 and No 5 for R350) in the CPJ.

The CRJ or the CPJ need not be updated for May 20.0 as all the amounts in the debit and credit columns of the bank statement have been marked. The deposit will be received by the bank on 1 June and should appear on the bank statement for June, while the two cheques were not presented to the bank for payment during May 20.0. In order to *reconcile* the two balances as at 31 May 20.0, the following bank reconciliation has to be prepared.

The balance on the bank account is a debit (favourable) balance and is therefore shown on the debit side of the reconciliation. The balance on the bank statement is a credit (favourable) balance (the bank owes the balance to the entity) and it is thus shown on the credit side of the reconciliation. Since the bank will credit the bank account of the entity with the deposit, the amount is shown in the credit column of the reconciliation. The bank will debit the account of the entity as soon as the cheques are paid; therefore the total of the outstanding cheques is shown in the debit column.

Smitties Traders
Bank reconciliation statement at 31 May 20.0

		Fol	Debit	Credit
			R	R
	Debit (favourable) balance as per Bank *Account* (B15)		8 950	
	Credit outstanding deposit (deposited 01 Jun 20.0)			850
	Debit outstanding cheques: No 3 dd 15 May 20.0 R1 200			
	No 5 dd 30 May 20.0 R 350		1 550	
	Credit (favourable) balance as per Bank *Statement*			9 650
			10 500	10 500

In the above example, we have only dealt with items in the cash journals that do or do not appear on the bank statement. In the paragraphs that follow, items that *may* appear on the bank statement, but not in the cash journals, will be dealt with.

☐ **Bank charges**

Some of the bank charges are shown on the previous bank statement (in the "Fee" column). As the bank incurs costs to keep the bank accounts of its clients, these costs are recovered from the clients. Usually these costs are accumulated by the bank throughout the month and then debited in total to the account (deducted from a credit balance or added to a debit balance) at the end of the month. This procedure may, however, differ from one bank to another. The terms used by various banks may also differ.

Bank charges include

☐ charges for handling cash (that is, cash notes and coins) included in deposits;
☐ charges for paying a cheque on behalf of the entity;
☐ charges for paying a cheque in cash;
☐ charges for deposit and/or cheque books, interim or provisional bank statements or balances supplied to the entity;
☐ government levies on debit transactions (a tax on debit transactions, imposed by government);
☐ charges for guaranteeing the payment of a particular cheque (that is, when the bank certifies that money is available in the bank and that the bank will pay the amount stipulated on that particular cheque);
☐ service or ledger fees (that is, for keeping the ledger account in the books of the bank); and
☐ charges for processing debit orders and/or stop orders.

All these bank charges should include VAT. The VAT portion must be debited to the VAT input account if the entity is registered as a VAT vendor.

These charges are in effect collected from the bank account of the entity (reflected on the statement) by the bank and paid to the same bank. Such charges must therefore also be taken into account in the books of the entity.

There are several ways in which bank charges can be taken into account. In this course, we will use the method whereby bank charges are regarded as amounts paid and the total amount charged is merely entered as one of the last entries for the month in the CPJ. The bank statement is the source document for the recording of this transaction.

In the general ledger, bank charges will be debited and the bank account (via the total payments in the CPJ) will be credited with the bank charges.

☐ **Interest charged on debit bank balance**

Interest on an overdrawn balance (debit balance on the statement), charged by the bank and also debited to the bank statement, must *never* be included in bank charges. Interest is a cost for using someone else's (the bank's) money and is therefore a finance cost.

There are many reasons why banks charge interest on overdrawn (debit) balances or pay interest on favourable (credit) bank balances. In the case of interest on a debit balance (paid), the interest is regarded as a finance cost and is usually charged at a much higher rate than that at which a favourable (credit) balance earns (receives) interest.

To record the interest charged, the bank account in the general ledger is credited (included in the bank column in the CPJ) and the account "Interest paid (on current account)" is debited. The bank statement will be the source document.

☐ **Stop orders and debit orders**

A *stop order* is used where *the entity* instructs *its bank* to pay a certain amount on a specific date to a specified person or business or into a certain bank account. The amount does not change often and, if it must change, the entity will have to go to the bank, cancel the current stop order and furnish the bank with a new stop order. This method of payment is often used for the payment of rent, periodic contributions to a church, club or charity and even for instalments on insurance policies. In such cases, the paying entity pays the bank charges.

Many service providers use *debit order* facilities to collect monies owed to them. In such cases, the entity gives permission to the particular service provider to *collect* the money from its bank account. The service provider (such as a municipality, telephone or insurance company) will need the permission of the entity to debit its bank account with the amount due to it. In such cases, the amount to be paid can differ from one month to the next. The service provider will use electronic devices to get the money from the bank account of the entity. When the bank statement is received, the entity must ascertain whether the amount collected from its bank account equals the amount of the account received from the service provider. In this case, the receiving entity pays the bank charges.

The amounts paid by either method are debited to the bank account (statement) in the books of the bank, as they reduce a credit bank balance or increase an overdrawn balance.

In order to bring the cash journals of the entity in line with the bank statement, an entry or entries in the CPJ will be necessary. This will credit (reduce) the favourable balance of the bank account and debit the type of expense (electricity and water or telephone) paid in this manner.

☐ **Interest received on credit balances**

Some banks pay interest (sometimes at a very low interest rate) on credit (favourable) bank balances. In such cases, the bank will credit the account of the entity in the

books of the bank. The entity must, in turn, debit its bank account in its books with the amount of interest earned. This is in line with the accounting equation, in which an asset account (bank account) is debited when it increases.

Interest income (credited to the bank statement) is included in the CRJ at the end of the month in which the interest was earned (at the same time as bank charges are entered in the CPJ).

The bank account in the general ledger is debited (included in the bank column in the CRJ) and the account "Interest income (on current account)" is credited with the interest received on the current account. The bank statement will again be the source document.

☐ **Direct deposits**

Some clients of the entity may instruct *their* banks to pay monthly amounts into the bank account (by means of a *stop order*) of the entity (for example, someone renting offices). They may also prefer to pay amounts directly into the bank account themselves. Such direct deposits into the bank account of the entity will be reflected on the bank statement, where the deposit will increase a credit (favourable) balance in the bank's books or decrease a debit balance (an overdraft).

To update the books of the entity, an entry or entries in the CRJ will be necessary. This will debit the bank account in the general ledger and credit the appropriate income or debtor account.

8.5.3 *Bank reconciliations in following months*

Example 8.2

The bank reconciliation for May 20.0 and the CPJ, CRJ, bank account and bank statement of Smitties Traders for June 20.0 reflect the following:

Smitties Traders
Bank reconciliation statement as at 31 May 20.0

		Fol	Debit	Credit
			R	R
	Debit (favourable) balance as per Bank Account (B15)		8 950	
	Credit outstanding deposit (deposited 01:06:20.0)			850
	Debit unpaid cheques: No 3 dd 15 May 20.0 R1 200			
	No 5 dd 30 May 20.0 R 350		1 550	
	Credit (favourable) balance as per bank statement			9 650
			10 500	10 500

Smitties Traders
Cash receipts journal for June 20.0 **CRJ6**

Doc No	Date	Details	Analysis	Bank	
			R	R	
–	1	Cash sales	900		
–	8	Cash sales	1 700		
–	15	Cash sales	1 200	3 800	✓
–	23	Cash sales	1 100		
–	27	Cash sales	2 100	3 200	✓
–	30	Cash sales	2 000	2 000	
		R Charles: Rent	*850*	*850*	
		Sand Bank: Interest Earned	50	*50*	
				9 900	
				B 15	

Amounts in italics are amounts entered as a result of amounts being reflected on the bank statement that are not yet reflected in the CRJ. This updates the CRJ.

The total of the bank column in the CRJ is posted to the debit side of the bank account in the general ledger.

Smitties Traders
Cash payments journal for June 20.0 **CPJ6**

Doc No	Date	Details	Bank	
			R	
7	5	Municipality	700	✓
8	7	John's Wholesalers	1 500	✓
9	9	ABC Stores	2 200	✓
10	15	Cash: (Wages)	450	✓
11	23	Telkom	200	
12	30	Cash: (Wages)	450	✓
		XYX Insurance Company	500	
		Sand Bank: Bank charges	50	
			6 050	
			B 15	

Amounts in italics are amounts entered as a result of amounts being reflected on the bank statement that are not yet reflected in the CPJ. This updates the CPJ.

Having posted the total of the bank column in the CPJ to the credit side of the bank account in the general ledger, the bank account should have the following entries:

General Ledger

Dr **Bank** **B15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.0					20.0				
May	31	Total receipts	CRJ5	14 900	May	31	Total payments	CPJ5	5 950
							Balance	c/d	8 950
				14 900					14 900
Jun	1	Balance	b/d	8 950	Jun	30	Total payments	CPJ6	6 050
	30	Total receipts	CRJ6	9 900			Balance	c/d	12 800
				18 850					18 850
Jul	1	Balance	b/d	12 800					

When a bank reconciliation has to be completed for a month preceded by a reconciliation with entries other than the two balances, such a reconciliation will be the point of departure. First ascertain what entries on the previous reconciliation correspond with those on the bank statement. Those that are not ticked (✓) *must be carried forward to the following reconciliation*. The bank reconciliation statement for May 20.0 shows that one item, cheque No 5, was not presented to the bank for payment in June 20.0. This entry will therefore appear again in the reconciliation for June 20.0.

The bank statement for June 20.0 received from Sand Bank reflects the following (amounts in curled brackets { }, square brackets [ ] or underlined are indicated thus for explanation purposes):

Sand Bank Limited
Registered Bank

Reg No 93/2571
VAT Reg No: 2600101432

Tel: (012) 555-5555
Fax: (012) 555-5556

Smitties Traders
P O Box 12345
PRETORIA
0001

Account No 01/200/998/9 Statement No 2 June 20.0

Details	**Cheque No**	**Fee**	**Date**	**Debit**	**Credit**	**Balance**
		R		**R**	**R**	**R**
Balance b/f			01:06			9 650
Deposit			01:06		850 ✓	10 500
Service fees: May 20.0			01:06	{17}		10 483
Interest on debit balance: May 20.0			01:06		[50]	10 533
Cheque	3	2,50	02:06	1 200 ✓		9 333
Cheque	8	2,80	07:06	1 500 ✓		7 833
Cheque	9	3,30	09:06	2 200 ✓		5 633
Cheque	7	1,50	09:06	700 ✓		4 933
Cheque	10	1,20	15:06	450 ✓		4 483
Deposit			16:06		3 800 ✓	8 283
Deposit			29:06		3 200 ✓	11 483
Deposit: R Charles			30:06		[850]	12 333
Cheque	12	1,20	30:06	450 ✓		11 883
XYX Insurance Co		0,50	30:06	500		11 383
Administration fees				{20}		11 363
Service fees: June 20.0				{13}		11 350

Findings: From the books of the bank (these must be updated in the books of the entity):

(1) Four amounts in the debit column of the *statement*, being service fees for May {R17}, service and administration fees {R13} and {R20} respectively for June (all regarded as bank charges and totalling R50) and the insurance premium of R500, have not been marked. These expenses reduce the balance of the bank account of the entity; therefore, to update the books of the entity, the amounts of R50 and R500 must be entered in the CPJ *before the CPJ is finally totalled and posted to the bank account* in the entity's books. The bank account will then be credited (the R550 will be included in the total of the bank column of the CPJ) and the bank charges and insurance accounts will be debited with R50 and R500 respectively.

(2) Two amounts in the credit column of the *statement* have not been marked, namely the interest income [R50] and the direct deposit from R Charles [R850]. To update the books of the entity, these amounts should be entered in the CRJ, *before the CRJ is finally totalled and posted to the bank account*, in the books of the entity. The bank account will then be debited (the R50 and the R850 will be included in the total of the bank column of the CRJ) and the interest earned and the rent income accounts credited with R50 and R850 respectively.

The above transactions correspond with the accounting equation. The asset, ie bank, is credited with the amounts paid (the bank balance decreases) and the equity decreases by the amount of the expenditure (R550). Bank is furthermore debited with amounts received (the bank balance increases) and the equity increases by the amount of the income (R50 + R850).

Findings: In the books of the entity the cash journals are now correct, although the bank must still react, that is, the following items will appear in the bank reconciliation for the month:

(1) One cheque (No 5 for R350) is still outstanding from the bank reconciliation of May and must be included in the bank reconciliation for June, since the bank will react (debit the bank account of the entity) when this cheque is presented to the bank for payment.

(2) The deposit of R2 000 will be received by the bank during July and will appear on the bank statement for July.

(3) One cheque, No 11 for R200, has not yet been presented to the bank for payment. The bank will react (debit the bank account of the entity) when this cheque is presented to the bank for payment.

At the end of June, the debit balance (favourable) of the bank account is R12 800, while the credit balance (favourable) on the bank statement is R11 350. In order to reconcile these two balances, the following bank reconciliation is prepared. Since the bank will credit the account of the entity with the deposit in the next month, the amount is shown in the credit column of the reconciliation. The bank will debit the account when the cheques are paid; therefore the total of the outstanding cheques is shown in the debit column.

Smitties Traders
Bank reconciliation statement at 30 June 20.0

			Fol	Debit	Credit
				R	R
	Debit (favourable) balance as per Bank *Account* (B15)			12 800	
	Credit outstanding deposit (deposited 01 Jul 20.0)				2 000
	Debit outstanding cheques: No 5 dd 30 May 20.0	R350			
	No 11 dd 23 Jun 20.0	R200		550	
	Credit (favourable) balance as per Bank *Statement*				11 350
				13 350	13 350

8.5.4 *Cheques referred back to drawer and outdated cheques*

☐ **Cheque referred to drawer (dishonoured cheques)**

A cheque referred to the drawer (R/D cheque) is one *received back from the bank*, being unpaid by the bank of the client who originally presented the cheque for payment for cash sales or to pay his debts. Cheques are referred to the drawer, via the bank account of the entity, for one of the following reasons:

- cheque not signed (the drawer did not sign his/her cheque);
- amounts in words and figures differ (R45,00 against fifty four rand, nil cents);
- changes have been made on the cheque;
- insufficient cash (the drawer does not have enough money in his/her bank account at his/her bank to pay the amount stipulated on the cheque);
- the cheque is post-dated; or
- the cheque is outdated (older than six months or older than the period of validity stipulated on the cheque).

In the case of a cheque not signed, it can be returned to the drawer to sign it. Where there are any changes or the amounts differ, the cheque must be replaced and can then be re-deposited (*without* any new receipts or other entries in the books). A re-deposit is merely a deposit with an indication on the deposit slip that it is a re-deposit. It is better to keep such a deposit separate from other (ordinary) deposits. If the cheque is returned and can not be re-deposited in the same month as the original deposit, the unpaid cheque should be included in the *bank reconciliation* for that month.

In the case of insufficient monies, the cheque may be re-deposited as described above, *after* consultation with the drawer, and included in the *bank reconciliation* where applicable. If this is not possible, it can be "written back" (the original entry is reversed, that is, the effect of the receipt thereof is cancelled). This is done by entering the amount of the cheque and particulars about the debtor in the CPJ to cancel the original entry in the CRJ. If a debtors control account column is used in the CPJ, the entries in the CPJ will be more or less the same as was the case when the cheque was receipted: the amount of the cheque in the bank column, the total of the cheque and settlement discount originally granted (if any) in the debtors control account column and the amount of settlement discount granted in either the settlement discount granted column *or* in the sundry accounts column. Where a debtors control account column is not used, the amount of the cheque will be entered in the sundry accounts column. The amount of settlement discount granted must then be written back by means of a general journal entry: debit the debtors' personal (and debtors control) accounts and credit settlement discount granted with the amount of the settlement discount originally granted.

If the cheque was received in respect of cash sales or from a person or business who is not one of the usual debtors, a debtors account should be opened for that drawer and the amount of the cheque (and, where applicable, settlement discount granted) should be debited to that account in order to have a record of the money that has to be recovered.

In all these cases, the original cheque referred to drawer, received back from the bank, should be kept as proof of the "non-payment" of the transaction.

☐ Outdated cheques

A cheque is outdated when it is either post-dated, in which case *no entries* should be made until the date of the cheque, or older than six months (such a cheque is also referred to as "stale"). If the period of validity is stipulated on the face of the cheque, as in, for example, "Valid for three months only", a cheque older than three months will be outdated.

- A post-dated cheque receipted erroneously and banked (a substantial penalty is usually imposed by the bank for such a transaction) and returned by the bank should be kept until the due date and should then be re-deposited. Remember, if the date of the receipt is in one month and the due date of the cheque is in the next (or a number of months later), this cheque should be included on the credit side of the *bank reconciliation* until it is re-deposited (similar to deposits not yet made).
- When a post-dated cheque is received but *not* receipted, this should *not* be included in the bank reconciliation.
- When a cheque, *issued* by the entity, becomes older than the validity period (usually six months) and it has not been presented to the bank for payment, the cheque (and settlement discount received) should be written back (reversed). This means the opposite of the original entry should be made. At the time when the cheque was issued, the creditor was debited and bank was credited. To write the cheque back, the bank account must be debited and the creditor (and creditors control account) must be credited. This is done by entering the amount of the cheque and particulars of the creditor in the CRJ to cancel the original entry in the CPJ. The sundry accounts column is used for this purpose: the amount of the cheque is entered in the bank column as well as the sundry accounts column. Any settlement discount received should be reversed by means of a general journal entry: debit settlement discount received and credit the creditor (and creditors control account) with the amount of the settlement discount originally deducted.

Remember that the cheque written back must be *excluded* from the next bank reconciliation.

☐ Cheques damaged or lost

It often happens that a cheque received or issued gets lost in the post or becomes so damaged that the bank will not accept it as a legal document. Such cheques must be replaced.

- If the entity *issued* the cheque: inform the bank, by stopping the payment thereof and issue a new cheque to the person, business or creditor to whom the original cheque was issued. Since the old cheque was not paid by the bank, *no* entries regarding the *amount* of the new cheque are made. An entry referring to the number and client will suffice, for example, "Cheque No 123 P Viljoen (Replaces cheque No 100)". No amount(s) should be entered in the CPJ. If cheque No 100 was entered in the bank reconciliation of the previous month, a note about the replacement will help when the bank reconciliation of the current month is prepared.

- If the entity *received* a cheque, but it is damaged: inform the drawer about the situation, requesting a replacement of the cheque. In his books, he will do the same as described above. A receipt must be issued only when the replacement cheque is received. A note about the situation can be made on the account of the drawer to prevent steps being taken against the drawer (the debtor of the entity).

Example 8.3

The bank reconciliation for June 20.0 and the CPJ, CRJ, bank account and bank statement of Smitties Traders for July 20.0 reflect the following:

Smitties Traders
Bank reconciliation statement as at 30 June 20.0

			Fol	Debit	Credit
				R	R
	Debit (favourable) balance as per Bank *Account* (B15)			12 800	
	Credit outstanding deposit (deposited 01 Jul 20.0)				✓ 2 000
	Debit unpaid cheques: No 5 {now 13} dd 1 Jul 20.0	R350	✓		
	No 11 dd 23 Jun 20.0	R200		550	
	Credit (favourable) balance as per Bank *Statement*				11 350
				13 350	13 350
	Cheque No 5 is replaced by Cheque No 13				

Smitties Traders
Cash receipts journal for July 20.0 **CRJ7**

Doc No	Date	Details	Analysis	Bank
			R	R
–	7	Cash sales	1 900	
–	9	Cash sales	2 200	
–	14	Cash sales	2 600	6 700 ✓
–	18	Cash sales	900	
–	24	Cash sales	2 400	3 300 ✓
–	30	Cash sales	1 800	1 800
	31	*R Charles: Rent*	*850*	*850*
		Sand Bank: Interest Earned	*80*	*80*
				12 730
				B15

Amounts in italics are amounts entered as a result of the amounts reflected on the bank statement, but not yet in the CRJ. This updates the CRJ.

Note: A cheque for R350 was received from R Rex for cash sales, but it is dated for 1 August 20.0. This amount is excluded from the cash sales of 30 July.

Smitties Traders
Cash payments journal for July 20.0 **CPJ7**

Doc No	Date	Details	Bank
			R
13	1	ABC Stores (Replace Cheque No 5)	–
14	7	Municipality	900 ✓
15	8	John's Wholesalers	2 500 ✓
16	15	ABC Stores	1 200 ✓
–		S Swan (R/D cheque)*	200 ✓
17		Cash: (Wages)	450 ✓
18	25	Telkom	180
19	30	Cash: (Wages)	450 ✓
	31	P Saxo (R/D cheque)*	*300*
		XYX Insurance Company	*500*
		Sand Bank: Bank charges	*43*
			6 723
			B 15

Note: Cheque No 20 is dated 15 August 20.0 and should only be recorded in the CPJ for August 20.0.

* Since S Swan now owes the business R200 and P Saxo owes R300 (plus any settlement discount granted on the cash sales to them), accounts in the debtors ledger should be opened for them. These accounts must be debited with the R200 and R300 respectively (plus settlement discount granted – if any – and interest may be charged). For the discount and/or interest, a general journal entry will be necessary: debit S Swan and P Saxo (and the debtors control account), and credit settlement discount granted and/or interest income (charged).

General Ledger

Dr **Bank** **B15** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.0					20.0				
May	31	Total receipts	CRJ5	14 900	May	31	Total payments	CPJ5	5 950
							Balance	c/d	8 950
				14 900					14 900
Jun	1	Balance	b/d	8 950	Jun	30	Total payments	CPJ6	6 050
	30	Total receipts	CRJ6	9 900			Balance	c/d	12 800
				18 850					18 850
Jul	1	Balance	b/d	12 800	Jul	31	Total payments	CPJ7	6 723
	31	Total receipts	CRJ7	12 730			Balance	c/d	18 807
				25 530					25 530
Aug	1	Balance	b/d	18 807					

The bank statement for July 20.0, received from the Sand Bank, reflects the following (again the brackets { }, [ ] and [_] are for explanatory purposes only):

Sand Bank Limited
Registered Bank

Reg No 93/2571
VAT-Reg No: 2600101432

Tel: (012) 555-5555
Fax: (012) 555-5556

Smitties Traders
P O Box 12345
PRETORIA
0001

Account No 01/200/998/9 Statement No 3 July 20.0

Details	Cheque No	Fee	Date	Debit	Credit	Balance
		R		R	R	R
Balance b/f			01:07			11 350
Deposit			01:07		2 000 ✓	13 350
Cheque	13	1,20	02:07	350 ✓		13 000
Unpaid cheque: S Swan		1,00	07:07	200 ✓		12 800
Cheque	15	3,50	09:07	2 500 ✓		10 300
Deposit		7,00	15:07		6 700 ✓	17 000
Cheque	14	1,50	15:07	900 ✓		16 100
Cheque	17	1,20	15:07	450 ✓		
Cheque	16	1,20	20:07	1 200 ✓		14 450
Deposit		3,10	25:07		3 300 ✓	17 750
Unpaid cheque: P Saxo		1,60	30:07	[300]		17 450
Interest			30:07		[80]	17 530
Deposit: R Charles			30:07		[850]	18 380
Cheque	19	1,20	30:07	450 ✓		17 930
XYX Insurance Co		0,50	30:07	[500]		17 430
Deposit book				{20}		17 410
Service fees: July				{23}		17 387

Smitties Traders
Bank reconciliation as at 31 July 20.0

		Fol	Debit	Credit
			R	R
	Debit (favourable) balance as per Bank *Account* (B15)*		18 807	
	Credit outstanding deposit (deposited 01 Aug 20.0)			1 800
	Debit unpaid cheques: No 11 dd 23 Jun 20.0 R200			
	No 18 dd 25 Jul 20.0 R180		380	
	Credit (favourable) balance as per Bank *Statement*			17 387
			19 187	19 187

* The opening balance of the bank account must be the same as the closing balance at the end of the previous month.

8.6 The petty cash journal

8.6.1 *Format of the petty cash journal*

In an earlier paragraph, the use of cheques was recommended as a means of payment because it reduces the handling of cash, thereby serving as an additional control measure. However, an entity may need to pay cash for certain smaller items such as postage, day-workers, cleaning materials, and so forth. Therefore most entities keep a *petty cash float*.

A cheque for a specific amount known as a *petty cash float* is drawn and cashed for this purpose. The float is kept entirely separate from the monies received by the entity in the normal course of its business. These receipts, as stated earlier, must be banked in full.

A separate journal, known as the *petty cash journal*, is used to record all payments made from the petty cash float. Payments are confirmed by sequentially numbered petty cash slips, usually signed by both the persons authorising and receiving the payment. Alternatively, petty cash slips may be countersigned by two officials. A responsible official periodically compares the total payments to the supporting documents and the cash on hand is counted and compared to the balance that should be available. The petty cash float is then restored to its original balance by drawing a cheque for the precise amount paid out during the period. This system of restoring the petty cash float to the original balance is known as the *imprest system.* The amount of the float is determined by the needs of the entity.

It is important that the official responsible for keeping and administering the petty cash float does not handle other cash as well. If the size of the entity allows it, the petty cash journal should be written up by someone other than the cashier in charge of petty cash. The initial cheque drawn for the petty cash float is entered in the cash payments journal. Example 8.4 illustrates the way in which the cheque is issued initially to provide for a petty cash float and to restore the amount of the petty cash float in the cash payments journal.

Example 8.4

Assume that a cheque for R500 is cashed. This cash must be used as a petty cash float. The petty cash float is reinstated on 20 July 20.0 according to the imprest system.

Smitties Traders
Cash payments journal for July 20.0 **CPJ9**

Date	Details	Fol	Bank	Petty cash	Other analysis columns			
			R	R				
1	Cash	GL10	500	500				
20	Cash	GL10	470	470				

If a column is not allocated for petty cash, the amounts can be allocated to the sundry accounts column of the CPJ. The amounts paid are posted to the debit side of the *petty cash control account* in the general ledger. Both the receipt of the float and the restoring amount are recorded in the special subsidiary journal, ie the petty cash journal. Columns are allocated in the petty cash journal for repetitive transactions. A sundries column (with a column for particulars) is used for those transactions that do not occur very often.

The cash on hand (which should be R30, ie the R500 received less the R470 paid) and the payments (R470) were checked on 20 July. On the same date, a cheque was drawn to restore the float, bringing the cash on hand again back to R500.

8.6.2 *Posting from the petty cash journal*

The receipts side of the petty cash journal serves purely as a memorandum column. As was explained above, petty cash cheques are posted from the cash payments journal to the debit side of the petty cash control account in the general ledger.

Smitties Traders
Petty cash journal for July 20.0 **PCJ7**

RECEIPTS			PAYMENTS								
Date	**Fol**	**Amount**	**Date**	**Details**	**No**	**Fol**	**Total**	**Postage**	**Wages**	**Sundries**	**Details**
		R					**R**	**R**	**R**	**R**	
1	CPJ9	500	1	Wages	1		100		100		
20	CPJ9	470	10	Stamps	2		80	80			
				Wages	3		100		100		
			15	Stamps	4		40	40			
			18	Wages	5		70		70		
			19	Advertisement	6	N9	80			80	
						B7	470	120	270	80	
			31	Cash on hand			500			500	
		970					970	120	270	580	
1	Cash on hand	500						N 30	N 34		

All items in the sundries column are posted individually to the debit side of the relevant accounts, for instance "Advertisements" (R80). The *totals* of all the other payment analysis columns are posted to the debit side of the account concerned, for instance "Postage" (R120) and "Wages" (R270). The total of all *payments* (R470) is posted to the *credit side* of the petty cash control account (B7).

General Ledger

Dr **Petty cash control** **B7** **Cr**

				R					R
20.0 Jul	1	Bank	CPJ9	500	20.0 Jul	31	Petty cash payments	PCJ7	470
	20	Bank	CPJ9	470			Balance	c/d	500
				970					970
Aug	1	Balance	b/d	500					

Dr **Advertising** **N9** **Cr**

				R					
20.0 Jul	20	Petty cash	PCJ7	80					

Dr **Postage** **N30** **Cr**

				R					
20.0 Jul	31	Petty cash	PCJ7	120					

Dr **Wages** **N34** **Cr**

				R					
20.0 Jul	31	Petty cash	PCJ7	270					

8.7 The measurement and disclosure of cash in financial statements

The measurement of cash poses no problems, since the cash value always equals its realisable value. Cash is a current asset. It is general practice to show the amount of cash in bank accounts, petty cash balances and any other form of cash on demand combined in a single total in a statement of financial position under the heading *cash and cash equivalents*.

According to the definition of financial instruments explained in chapter 12, cash and cash equivalents are financial assets. For an example of how the details of cash and cash equivalents must be disclosed in the notes to the financial statement, refer to chapter 12.

A bank overdraft is shown as a current liability. In cases where an entity has a cash balance in one bank account and an overdraft in another account, both accounts should be shown separately.

8.8 Revision example

On 1 March 20.0, the bank account of Brand Services has a favourable balance of R3 370. The provisional totals of the CRJ and CPJ on 31 March 20.0 are R35 350 and R32 230 respectively, while the bank statement shows a balance of R7 598 on the same date. You have identified the following differences between the cash journals and the bank statement:

1) A deposit of R1 590 made on 31 March 20.0 is not shown on the bank statement.
2) The bank has erroneously debited a stop order for R100 against the bank account.
3) The following cheques issued by the entity have not yet been presented for payment:

Cheque No	Date	Amount
		R
637	15 March 20.0	286)
640	20 March 20.0	319)
641	25 March 20.0	83

4) B Brooks, a debtor, paid an amount of R2 110 directly into the entity's bank account. The transaction has not yet been recorded in the entity's books.
5) The bank credited R30 interest to the entity's account.
6) Cheque No 633 for R150, issued to Josmas Limited, was entered as R510 in the CPJ.
7) Bank charges for March 20.0 amount to R140.
8) A cheque for R250 received from A Wilson was unpaid and is shown as such on the bank statement.

Required

(a) Update the cash journals (bank columns only) and post these totals to the bank account and show the bank account.

(b) Prepare a bank reconciliation statement as at 31 March 20.0.

Solution

(a)(1) Cash receipts journal: March 20.0 **CRJ03**

Date	Doc No	Details	Bank
			R
		Subtotal	35 350
		Debtors	2 110
		Interest income	30
		Josmas Limited (Cheque 633) (R510 – R150)	360
		Total	37 850

(2) Cash payments journal: March 20.0 **CPJ03**

Date	Doc No	Details	Bank
			R
		Subtotal	32 230
		Bank charges	140
		A Wilson (R/D cheque)	250
		Total	32 620

(3) **General Ledger**

Dr **Bank** **Cr**

20.0				R	20.0				R
Mar	1	Balance	b/d	3 370	Mar	31	Total payments	CPJ3	32 620
	31	Total receipts	CRJ3	37 850			Balance	c/d	8 600
				41 220					41 220
Apr	1	Balance	b/d	8 600					

(b) Bank reconciliation statement at 31 March 20.0

			Fol	Debit	Credit
				R	R
	Debit (favourable) balance as per Bank *Account*			8 600	
	Credit outstanding deposit: 31 Mar 20.0				1 590
	Credit amount erroneously debited by bank				100
	Debit unpaid cheques: No 637 dd 15 Mar 20.0	R286			
	640 dd 20 Mar 20.0	R319			
	641 dd 25 Mar 20.0	R 83		688	
	Credit (favourable) balance as per Bank *Statement*				7 598
				9 288	9 288

Note that the error made by the bank is not corrected in the books of the entity, but is shown in the reconciliation statement. The bank must be informed of the error and the bank must correct it in its records.

8.9 Summary

Cash is one of the most important assets of an entity. If no cash is available, goods and services rendered to the entity cannot be paid for. Cash is also very easily stolen. It is therefore important for all entities to properly record and control cash. Cash should be banked regularly in order to ensure that it is safeguarded. Payments should, as far as practical, be made by means of cheques or electronically.

The bank will regularly submit bank statements to the entity, reflecting all transactions of the bank with the entity. These bank statements must be reconciled at least once a month with the bank account (as reflected in the books of the entity). In the case of small, irregular payments, a petty cash imprest can be installed for this purpose.

This chapter has dealt with the treatment of cash receipts and payments through a bank account only; reconciliation of a bank statement with the bank account only; petty cash journals; and with the measurement and disclosure of cash in the financial statements.

CHAPTER 9

Credit granted: Debtors and other receivables

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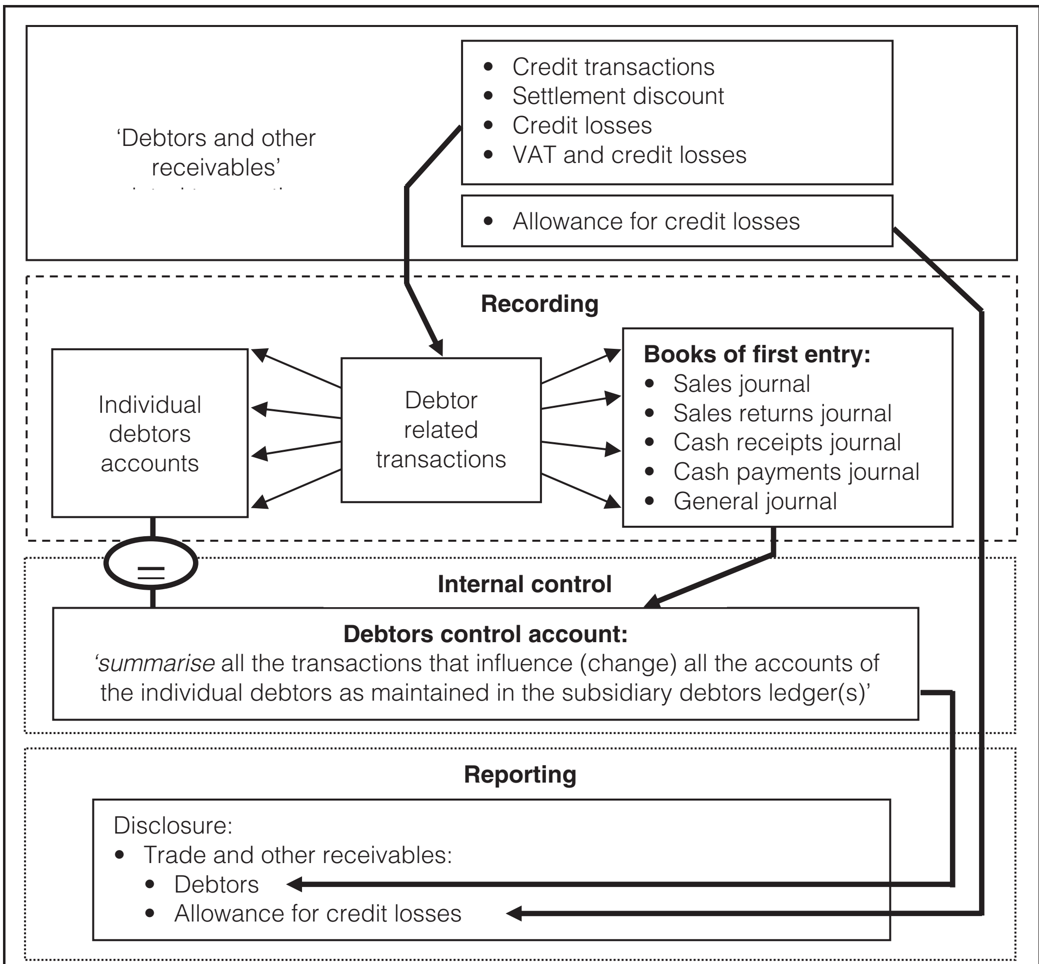
Overview of credit granted: debtors and other receivables



9.1 Introduction

Study objectives

The purpose of this chapter is to explain certain aspects of debtors.

After studying this chapter you should be able to record transactions related to debtors.

As was mentioned in chapter 8, entities must comply with, amongst other things, the requirements regarding faithful representation, prudence and fair presentation. This means that accountants must ensure that the balances of debtors as disclosed on the statement of financial position are correct. Furthermore, debtors and other receivables must also comply with the requirements regarding assets.

9.2 Credit transactions and credit terms

9.2.1 *Credit transactions*

A credit transaction arises from a purchase or sale or from the lending or borrowing of money which results in a debt payable at a later date. In terms of the underlying assumption of the *accrual* basis, any income *earned* (such as sales and rent receivable) during a specific period should be taken into account during that same period, irrespective of when *payment* is received. Similarly, value sacrificed (such as an expense) during a certain period must be taken into account as an expense during the same period in which the income was earned, irrespective of when *payment* is made.

In other words, if the accrual basis is applied to credit transactions, the transactions must be recorded in the period in which they occurred. This in turn gives rise to debts (assets) that are receivable and obligations (liabilities) that are payable. Any individual or undertaking that owes money to an entity is known, in the eyes of that particular entity, as a *trade debtor* (in the case of credit sales) or a *loan debtor* (in the case of loans granted). Some entities refer to smaller types of debtors (arising from renting, investments and other smaller transactions) combined as *sundry debtors* to distinguish them from trade debtors.

The recording of credit sales and the origin of and payments by debtors are discussed in a previous chapter. This chapter deals with the credit terms, settlement discount granted, credit losses, valuation of debtors, the application of VAT and the internal control applicable to the granting of credit.

9.2.2 *Credit terms*

An entity usually follows a specific credit policy (laid down by the owner(s), director(s) or management of the entity) governing the amount of credit that may be granted to a client and the time the client will be allowed to pay the account. This may vary from client to client – the entity may require certain clients to pay immediately, while others may be allowed 30 or 60 days (the credit term) to pay a particular invoice. These conditions are usually recorded on the invoice. If the seller demands immediate payment upon delivery of the goods, the conditions specified on the invoice will be *cash* or *net cash.*

If the client has been granted credit, the credit term will be specified on the invoice. Although the credit term commences on the date of the invoice in most entities, it may also begin on the date of the monthly statement that is forwarded to the client. If the invoice is payable within a specified number of days, for example, 30 days after the date of the invoice, the term is known as *30 days net*. This is often abbreviated to *n/30*.

9.3 Settlement discount granted

9.3.1 *Discount terms*

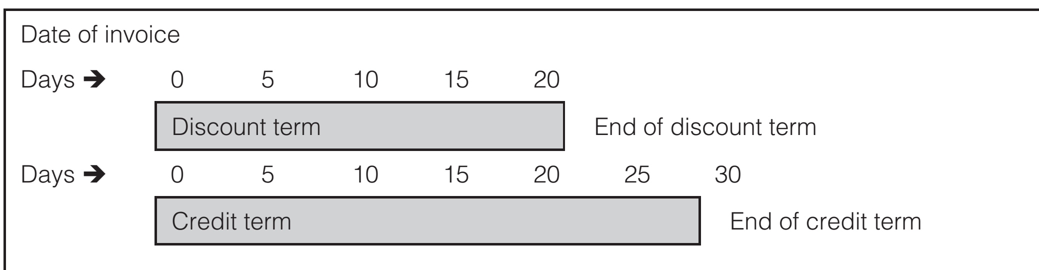
In order to encourage prompt payment of credit sales, many entities offer their clients a settlement discount. These discounts allow clients to deduct a certain amount from an invoice that is settled within the prescribed period, namely the discount term. The conditions for the settlement discount are usually indicated on the sales invoice. Thus,

the notation 1/20 n/30 means that although the credit term is 30 days, the buyer may deduct 1% of the invoice amount if payment is made within 20 days of the date of the invoice.

Take note of the difference between a settlement discount, which is dealt with here, and a trade discount. The latter is a discount granted by a wholesaler or manufacturer to retailers as a decrease on their list prices. For example, if the list price is R1 200 and a trade discount of R200 is negotiated, the net invoice price will be R1 000. The settlement discount is taken on the latter amount. On the whole, a trade discount is not recorded at all.

Example 9.1

A client purchases goods valued at R1 000 on credit. His credit term is 30 days. He is entitled to subtract 1% discount if he pays the invoice within 20 days.



Thus, provided the client settles the account within the first 20 days, he may subtract R10 (= 1% × R1 000) as discount and pay only R990.

The settlement discount allowed in the case of credit sales is known as the sales discount or *settlement discount granted*. A settlement discount received on credit purchases is the *settlement discount received*. The settlement discount is deducted directly from sales or purchases on the statement of profit or loss and other comprehensive income (in the trading section).

Never lose sight of the principal objective of accounting, namely the provision of meaningful information to decision-makers. The sole objective for allowing settlement discount is to recover debts as early as possible and, accordingly, to have cash available as soon as possible.

9.3.2 *Settlement discount granted and value-added tax*

When a client receives a settlement discount, the value-added tax (VAT) owing to the Receiver of Revenue or South African Revenue Services (SARS) as a result of the initial sales transaction should be reduced by the VAT relating to the settlement discount. This is explained in the next examples, in which the VAT rate is assumed to be 10%.

Example 9.2

J Swart buys goods valued at R1 100 (including VAT of R100) on credit (invoice No 329) from Sun Products on 3 May 20.1. Sun Products grants him a credit term of 30 days. If the amount is paid within 15 days, he may deduct a discount of 5%. Swart pays the invoice on 13 May (thus settling the amount within the prescribed discount period) and receipt 1234 is issued.

Sun Products will receive only R1 100 – (1 100 × 5%) = R1 045 from Swart in full settlement of the invoice.

The amount of the discount, ie R55, must still be split between settlement discount granted and the VAT on the discount:

Settlement discount granted will be R55 × 100 ÷ 110 = R50 and the VAT will be R5 (= R50 × 10%). This is usually reflected in two additional columns in the cash receipts journal (CRJ), namely a VAT input column and the Settlement discount granted column. At the same time, the amount shown in the Debtors column in the CRJ is changed to reflect the full amount to be credited to the debtor (J Swart).

The sale and discount transactions as well as the relevant VAT will be recorded as follows in the books of Sun Products:

General ledger

Dr — Bank — B10 — Cr

20.1 May	31	Debtors control	CRJ 5	**R** 1 045					

Dr — Debtors control — B16 — Cr

20.1 May	31	Sales (including VAT)	SJ5*	**R** * 1 100	20.1 May	31	Bank and discount	CRJ5	**R** 1 100

* This amount will be included in the total amount received for the month.

Dr — Sales — N15 — Cr

					20.1 May	31	Debtors	SJ5	**R** 1 000

Dr — VAT input — N16 — Cr

20.1 May	31	Bank		**R** 5					

Dr — VAT output — N17 — Cr

					20.1 May	31	Debtors	SJ5	**R** 100

Dr — Settlement discount granted — N19 — Cr

20.1 May	31	Bank	CRJ5	**R** 50					

Debtors ledger

J Swart — DL12

Date		Doc No	Particulars	Fol	Debit	Credit	Balance
20.1					**R**	**R**	**R**
May	3	329	Sales	SJ5	1 100		1 100
	13	1234	Received	CRJ5		1 045	55
	13	1234	Discount	CRJ5		55	0

Example 9.3

On 20 May 20.1, goods to the value of R2 200 were sold on credit to J Flint (invoice No 21). This transaction includes VAT at 10%. (The entry for the transaction in May is recorded in the sales journal and the personal account of Flint and in the debtors control account.)

Sales journal: May 20.1 **SJ 5**

Day	Doc no	Debtor	Fol	Sales	VAT output	Debtors
				R	R	R
20	21	J Flint	DL1	2 000	200	2 200

Flint settles his account (receipt No 101) on 10 June. He receives a discount of *5%*. A cash receipts journal for June 20.1 is used.

The *settlement discount* is calculated as follows:

5% × R2 200 = R110

The VAT component included in this discount:

As the initial sales transaction included VAT, it is therefore included in the amount owed by Flint:

R110 × 10 ÷ 110 = R10

Flint's settlement and discount transactions can be recorded as follows in a general journal format:

20.1			R	R
Jun	20	Bank R(2 200 – 110)	2 090	
		Settlement discount granted R(110 – 10)	100	
		VAT input	10	
		J Flint (and Debtors control)		2 200

The same entry will be recorded as follows in a CRJ. Additional columns are used to record the discount granted and the VAT input component of the discount. (Other cash sales transactions are also included in the CRJ to make it more realistic.)

Cash receipts journal: June 20.1 **CRJ 6**

Day	Doc no	Details	Fol	Bank	Cash sales	VAT output	Debtors	VAT input	Settlement discount granted
				R	R	R	R	R	R
7		Cash sales		220	200	20			
10	101	J Flint	DL1	2 090			2 200	(10)	(100)
14		Cash sales		770	700	70			
20		Cash sales		330	300	30			
25		Cash sales		990	900	90			
				4 400	2 100	210	2 200	(10)	(100)
				B 10	N 1	B 14	B 12	B 13	N 10

Note:

1. Transactions are posted daily to the accounts of individual debtors in the debtors ledger.
2. Totals of columns are posted monthly to the accounts in the general ledger.
3. The amounts in brackets in the totals are deducted when cross-casting the journal (that is when the totals of the columns are added to result in the total of the Bank column).
4. When payments are made by debtors at a later stage, the VAT will have been recorded on the date of the sales. The receipt of the payment by the debtor therefore already includes the applicable VAT; therefore VAT should not be calculated on the amount received again. The discount granted and accompanying VAT portion on the discount will be recorded in the following month. This will thus be included in the balance of the debtors brought down at the end of the month of the sales.

Debtors ledger

J Flint **DL1**

Date		Doc no	Particulars	Fol	Debit	Credit	Balance
20.1					R	R	R
May	20	21	Sales	SJ5	2 200		2 200
Jun	10	101	Receipt and discount	CRJ6		2 200	0

General ledger

Dr **Bank** **B10** **Cr**

20.1				R					
Jun	30	Total receipts	CRJ6	4 400					

Dr **Debtors control** **B12** **Cr**

20.1				R	20.1				R
May	31	Sales (including VAT)	SJ5	2 200	Jun	30	Bank and discount	CRJ6	2 200

Dr **VAT input** **B13** **Cr**

20.1				R					
Jun	30	Bank	CRJ6	10					

Dr **VAT output** **B14** **Cr**

					20.1				R
					May	31	Debtors	SJ5	200
					Jun	30	Bank	CRJ6	210

Dr **Sales** **N1** **Cr**

					20.1				R
					May	31	Debtors	SJ5	2 000
					Jun	30	Bank	CRJ6	2 100

Dr **Settlement discount granted** **N10** **Cr**

20.1				**R**					
Jun	30	Bank	CRJ6	100					

The number and types of columns used in the CRJ are determined by the nature and requirements of the entity and may differ from one entity to another.

9.3.3 *Allowance for settlement discount to be granted in future*

Settlement discount granted may be claimed in an accounting period later than the one in which the sale was initially recorded. This results in an inappropriate revenue recognition technique, particularly at the end of the financial year. To avoid this problem, an *allowance* of the estimated discount that may be claimed by the debtors in the following financial period will be created (if the amounts are material). The actual discounts claimed in the following financial period are then offset against the allowance.

On 15 February 20.1, a client purchased goods to the value of R1 600 on credit from BB Dealers. If the client settles his account in one month, he is entitled to a 10% discount. The financial year-end of BB Dealers is 28 February 20.1. BB Dealers expect this client to settle his account before 15 March 20.1.

The above transaction will be accounted for as follows (using the general journal for explanation purposes):

			Debit	**Credit**
20.1			**R**	**R**
15 Feb	Debtors		1 600	
	Sales			1 600
	Accounting for credit sale on 15 February 20.1			
20.1				
28 Feb	Settlement discount granted (R1 600 × 0.1)		160	
	Allowance for settlement discount granted			160
	Allowance for settlement discount expected to granted in next financial year			

The allowance for settlement discount to be granted in the next financial year should be determined at year-end for *all* debtors.

Closing journal entries:

			Debit	**Credit**
20.1			**R**	**R**
28 Feb	Sales		160	
	Settlement discount granted			160
	Closing transfer of settlement discount granted			
20.1				
28 Feb	Sales (R1 600 – R160)		1 440	
	Trading account			1 440
	Closing transfer of sales			

BB Dealers
Statement of profit or loss and other comprehensive income for the year ended 28 February 20.1 (extract)

	R
Revenue (R1 600 – R160)	1 440

BB Dealers
Statement of financial position at 28 February 20.1 (extract)

Current Assets	R
Trade and other receivables (R1 600 – R160)*	1 440

* Debtors balance (R1 600) – Allowance for settlement discount granted (R160)

If the client decides to settle his outstanding account on 10 March 20.1, the entry will be as follows (using the general journal for explanation purposes):

			Debit	Credit
20.1			R	R
10 March	Bank		1 440	
	Allowance for settlement discount granted		160	
	Debtor			1 600
	Settlement of account			

If the client decides to settle his outstanding account on 1 April 20.1, he will forfeit the 10% discount he was entitled to. The entries will be as follows (using the general journal for explanation purposes):

			Debit	Credit
20.1			R	R
15 March	Allowance for settlement discount granted		160	
	Settlement discount granted forfeited			160
	Write back expected settlement discount that did not realise			
20.1				
1 April	Bank		1 600	
	Debtor			1 600
	Settlement of account			

9.4 Measurement of debtors: Credit losses and allowance for credit losses

9.4.1 *The necessity for measurement*

Debtors are an asset because they hold future economic advantages for the entity and have values that can be measured reliably. Debtors must be measured, that is, the monetary amounts at which debt should be recorded (as an asset) on the statement of financial position, must be determined. The best basis for the measurement of debtors is the realisable (settlement) value, that is, debtors are shown at the cash amount they are expected to yield.

When goods are sold and services rendered on credit, there is always the risk that some clients will not pay their debts. In order to ensure that debtors are not overstated on the statement of financial position, they are shown at their *cash (net) realisable value.* This is the net amount the entity expects to receive from debtors in cash. In order to determine this amount, the amount of the debtors on the statement of financial position is reduced by the estimated amount that will not be recovered.

The statement of profit or loss and other comprehensive income is also influenced by the estimated irrecoverable amount. A separate expense item is used to record this amount, to ensure that expenses are not understated and that they are matched to the related sales or other revenue. Irrecoverable debts or credit losses are thus treated as a separate item on the statement of profit or loss and other comprehensive income for two reasons.

- They are not subtracted from sales because they specifically concern the credit control department and have nothing to do with the performance of the sales department.
- The credit control department must approve credit transactions after evaluating the creditworthiness of the clients and take responsibility for the collection of debts once the sales transactions have been completed. The effectiveness of the credit control department (and not that of the sales department) largely determines the degree to which credit losses are limited.

Furthermore, credit losses are treated as a separate item in order to provide meaningful information to the different decision-makers. Although entities are well aware of the danger of credit losses, they will be prepared to sell products on credit if the credit losses can be kept within reasonable limits. Credit sales increase total sales and therefore also profit, while credit losses reduce the profit. The increase in profits as a result of credit sales usually outweighs the reduction in profit as a result of credit losses.

9.4.2 *Allowance for credit losses*

A distinction is made between *irrecoverable* debts and *doubtful* debts. Credit losses are debts which the entity knows will not be recovered and which are regarded as an expense of the period in which the credit sales transactions occurred. It is not always possible to apply this concept strictly in practice. The writing off of credit losses may only be known some months after the end of the financial year in which the sales have been recorded and reported on the statement of profit or loss and other comprehensive income. To provide for debts that may possibly not be recovered, an allowance for credit losses is created and maintained.

The possibility that credit losses may arise means that the actual irrecoverable amounts will only become known at a later stage. As a credit loss is an expense that relates to the period during which the sale took place, it means that credit losses will have to be estimated during the same period. The estimate of the expense for the period is then brought into account as an *allowance for credit losses*. There are two advantages to allowing for credit losses:

- the estimated loss is provided for during the period in which the corresponding income was earned; and

- the debtors balance is shown on the statement of financial position at net realisable value, since the allowance is deducted from the gross amount of the outstanding debtors.

In larger entities, estimating and allowing for credit losses are usually done on a monthly basis, while allowing for credit losses is calculated and brought into account at the end of the financial period in smaller entities.

The allowance for credit losses is determined ***after*** all known credit losses have been written off. This implies that the allowance is determined on only those debtor balances that are to be carried forward to the next financial year, by assessing each debtor's account.

9.4.3 *Estimating allowance for credit losses*

Doubtful debts are based on an age analysis. An age analysis entails preparing a schedule of outstanding amounts (debtors' balances) classified according to the period for which the debt has been outstanding. To determine whether a balance is recoverable each balance is evaluated separately. This is illustrated in Example 9.4.

Example 9.4

ABS STORES
DEBTORS AGE ANALYSIS SCHEDULE AS AT 31 DECEMBER 20.5

Customer	Total due	Current balance	Period in arrears (months)			
			1	2	3	More than 3
	R	R	R	R	R	R
J Flint	1 000	500	300	150	50	–
S Stone	1 800	200	100	400	500	600
R Naidoo	1 500	300	1 200	–	–	–
J Smith	700	–	–	–	–	700
Others	95 000	14 000	29 400	12 450	22 450	16 700
Total	100 000	15 000	31 000	13 000	23 000	18 000
% of total	100	15	31	13	23	18

Competent staff will consider each debtor individually and decide on the basis of past experience whether a particular debt is doubtful. Those balances that have been overdue the longest will obviously be given the most attention. Based on this evaluation, a list of doubtful debts will be compiled and its total will serve as the allowance for credit losses for the year.

9.5 Recording the allowance for credit losses

9.5.1 *Creation of the allowance*

Once the amount of the *possible doubtful debts* has been determined according to one of the above methods, the amount is recorded as follows by means of an adjusting entry in the general journal:

			R	R
		Credit losses	XXXX	
		Allowance for credit losses		XXXX
		Allowance for credit losses based on an assessment of outstanding debtors		

When closing the books at the end of the period, the debit balance on the credit losses account is transferred (closed off) to the profit or loss account as a loss. This balance will thus include the actual credit losses written off during the financial year as well as the allowance for credit losses. The credit balance on the allowance for credit losses account is a contra item to an asset account and is shown on the statement of financial position as a reduction of the value of the asset, debtors. An asset contra account is used instead of a direct credit to the debtor account, because at the time of creating the allowance, the entity does not yet know which customers will not pay. Furthermore, the balance of the debtors control account must equal the total of all the balances of the individual debtor accounts.

Example 9.5

On 31 May 20.1, the end of its first financial year, the trade debtors of Flint Traders amounted to R60 800. The balance of the account of P Stone (R800, ignore VAT) must still be written off. The business decides to create an allowance for credit losses to the amount of R1 800.

The following presentation shows how the entry for the writing off of the credit loss and the creation of the allowance is recorded in the general journal and general ledger and eventually on the statement of financial position of Flint Traders:

General journal **J 5**

				R	R
20.1 May	31	Credit losses	N25	800	
		P Stone (and debtors control)	B10		800
		Account written off as irrecoverable			
		Credit losses	N25	1 800	
		Allowance for credit losses	B12		1 800
		Allowance for possible credit losses created			

General ledger

Dr **Debtors control** **B10** **Cr**

20.1				R	20.1				R
May	31	Balance	b/d	60 800	May	31	Credit losses	J5	800
							Balance	c/d	60 000
				60 800					60 800
Jun	1	Balance	b/d	60 000					

Dr **Allowance for credit losses** **B12** **Cr**

					20.1				R
					May	31	Credit losses	J5	1 800

Dr **Credit losses** **N25** **Cr**

20.1				R					
May	31	Debtors	J5	800					
		Allowance for credit losses	J5	1 800					

In the closing process, the balance on the credit losses account (R800 + R1 800 = R2 600) is transferred to the profit or loss account by means of a closing journal entry:

General journal: Closing entries **J 6**

20.1				R	R
May	31	Profit or loss account	N30	2 600	
		Credit losses	N25		2 600
		Closing off of credit losses account			

Presentation on the statement of financial position

Current assets	
Inventories	XX
Trade and other receivables R(60 000 – 1 800)	58 200
Prepaid expenses	X
Cash and cash equivalents	XXX

Some aspects must be clarified at this point:

- ☐ Although no income tax considerations have been discussed thus far, it should be pointed out that a mere *allowance* for credit losses is not an allowable expense in the determination of the taxable income of an entity. SARS allows only credit losses that have in fact been written off. The financial statements of an entity are not prepared primarily for SARS but for use by management and the owners of the entity. The debtors must therefore be valued accurately, even though SARS does not allow the allowance.
- ☐ From the consistent application of the accrual basis, it also follows that (a) an asset should be properly valued and (b) allowance should be made for all expenses/

losses (such as doubtful debts) which must be brought into account against the income (sales/debtors) that was generated during the same period. The asset (debtors) that arises from the sale of the merchandise will be overvalued if an entity knows from experience that a certain percentage of the debts will not be recovered and does not allow (provide) for this contingency. An allowance is thus in the first place created to reflect debtors at a realistic (recoverable) amount on the statement of financial position.

- At the time of creating the allowance, no entry is made in the debtors control account or the debtors ledger, as it is not yet known who the debtors to be written off will be.

9.5.2 *Increasing the allowance*

Two methods may be used when recording an increase in the allowance for credit losses:

- Only the *net increase* (that is the *difference* between the balance on the existing allowance and the *new allowance*) is recorded. This method is shown in Example 9.6(1).
- The existing allowance is written back in full and a new allowance is created. This method is shown in Example 9.6(2).

Example 9.6

On 31 May 20.2, ie a year later, the outstanding debtors of Flint Traders increases to R70 000. The allowance for credit losses must be increased to R2 100.

The new allowance will now be R2 100 (= R1 800 + R300), which means that the existing allowance is increased by R300. In this case, the entry will be recorded as follows (assuming that no debts had to be written off as irrecoverable during the financial year):

Example 9.6(1)

General journal: Adjustment of existing allowance **J 8**

20.2				**R**	**R**
May	31	Credit losses	N25	300	
		Allowance for credit losses	B12		300
		Adjustment of allowance for credit losses			

General ledger

Dr **Debtors control** **B10** **Cr**

20.2				**R**					
May	31	Balance	b/d	70 000					

Dr **Allowance for credit losses** **B12** **Cr**

					20.1				**R**
					May	31	Credit losses	J5	1 800
					20.2				
					May	31	Credit losses	J8	300
									2 100

continued

Dr **Credit losses** **N25** **Cr**

				R					R
20.1 May	31	Debtors	J5	800	20.1 May	31	Profit or loss	J ..	2 600
		Allowance for credit losses	J5	1 800					
				2 600					2 600
20.2 May	31	Allowance for credit losses	J ..	300	20.2 May	31	Profit or loss	J ..	300

The balance of R300 on the credit losses account is transferred to the profit or loss account, while, on the statement of financial position, the debtors will be shown at R67 900 (R70 000 less the new allowance for credit losses, ie R2 100).

Example 9.6(2)

General journal:
Writing back the existing allowance and creating a new allowance **J 8**

				R	R
20.2 May	31	Allowance for credit losses	B12	1 800	
		Credit losses	N25		1 800
		Writing back of allowance at 31 May 20.1			
		Credit losses	N25	2 100	
		Allowance for credit losses	B12		2 100
		New allowance for credit losses			

Regardless of which of the two methods illustrated in Examples 9.6(1) and 9.6(2) is used, the same amount of doubtful debt will be transferred to the profit or loss account in 20.2, namely R300 (method 1) and R300 (method 2, where R2 100 – R1 800 = R300). The balance of the allowance for credit losses at the end of the year is also the same for the two methods.

9.5.3 *Decreasing the allowance*

A decrease in the allowance for credit losses can result in a credit item in the profit or loss account.

Example 9.7

On 31 May 20.3, the balance of debtors of Flint Traders amounts to R65 000. The allowance for credit losses must be adjusted to R1 950.

The reduction in the allowance for credit losses means that the allowance (which has a credit balance of R2 100) must be debited with R150. The method of recording the difference in the balance of the allowance account is shown in this example.

General journal **J 9**

				R	R
20.3 May	31	Allowance for credit losses	B12	150	
		Credit losses	N25		150
		Allowance for credit losses adjusted to R1 950			

General ledger

Dr **Debtors control** **B10** **Cr**

				R					
20.3 May	31	Balance	b/d	65 000					

Dr **Allowance for credit losses** **B12** **Cr**

				R					R
					20.1 May	31	Credit losses	J5	1 800
					20.2 May	31	Credit losses	J8	300
20.3 May	31	Credit losses	J9	150	20.2 Jun	1	Balance	b/d	2 100
		Balance	c/d	1 950					
				2 100					2 100
					20.3 Jun	1	Balance	b/d	1 950

Dr **Credit losses** **N25** **Cr**

				R					R
20.1 May	31	Debtors	J5	800	20.1 May	31	Profit or loss	J ..	2 600
		Allowance for credit losses	J5	1 800					
				2 600					2 600
20.2 May	31	Allowance for credit losses	J8	300	20.2 May	31	Profit or loss	J ..	300
20.3 May	31	Profit or loss	J ..	150	20.3 May	31	Allowance for credit losses	J9	150

The credit balance on the credit losses account is transferred to the credit side of the profit or loss account, while the debtors will be disclosed on the statement of financial position as follows:

Presentation on the statement of financial position

Current assets	
Inventories	XX
Trade and other receivables R(65 000 – 1 950)	63 050
Cash and cash equivalents	XXX

If the method by which the existing allowance is written back and the new allowance is created is followed, the result will be the same. It will only result in an extra general journal entry and the postings to the general ledger. The credit balance of R150 (= R2 100 – R1 950) on the credit losses account is transferred to the profit or loss account (general journal, dr credit losses, cr profit or loss) and the amount at which the debtors is shown on the statement of financial position is exactly the same as in the case of the first method.

9.6 Writing off of actual credit losses

In the previous paragraph, the creation and adjustment of an *allowance for possible credit losses* was discussed. The creation or adjustment of an allowance for possible credit losses does not require any entry in the debtors control account or in the individual debtor's accounts in the debtors ledger. The reason for this is that the allowance is merely an estimate of the actual credit losses that *may* materialise. At the time the allowance is created, the amount cannot be allocated to the separate debtors.

Once an allowance has been created, however, the theoretically correct method would be to charge (debit) all debts which prove to be irrecoverable against the allowance. This procedure is illustrated in Example 9.8(1). In practice, however, the actual credit losses are sometimes debited directly to the credit losses account, even though an allowance for credit losses may exist. The viewpoint in this alternative method is that the allowance for credit losses is used simply as a "valuation" account to show debtors at a more realistic (recoverable) amount on the statement of financial position. This method is illustrated in Example 9.8(2).

It does not matter which method is used since the result will be the same, as will become clear from the examples.

Example 9.8

At 31 May 20.3, the balance of the allowance for credit losses of Flint Traders amounts to R1 950 (see Example 9.7). During the year ended 31 May 20.4, the following debtors went insolvent and the outstanding balances, which originated in this financial year, must be written off as irrecoverable:

	Amount
	R
J Smit	300
P Swart	70
S Rowland	130
	500

The total debtors on 31 May 20.3 was R65 000. During 20.4, credit sales amounted to R900 000 and R907 500 was collected from debtors. The allowance for credit losses must be changed to R1 710.

The following entries are necessary to record the above information:

Example 9.8(1)

Credit losses must be charged against the allowance:

General journal **J 10**

				R	R
20.4 May	31	Allowance for credit losses	B12	500	
		Debtors control	B10		500
		Writing off of the following debtors as irrecoverable:			

continued

				R			
		J Smit	*DL 3*	*300*			
		P Swart	*DL 5*	*70*			
		S Rowland	*DL 9*	*130*			
				500			

General ledger

Dr — **Debtors control** — **B10** — **Cr**

20.3				**R**	20.4				**R**
Jun	1	Balance	b/d	65 000	May	31	Bank	CRJ5	907 500
20.4							Allowance for		
May	31	Sales	SJ5	900 000			credit losses	J10	500
							Balance	c/d	57 000
				965 000					965 000
20.4									
Jun	1	Balance	b/d	57 000					

Dr — **Allowance for credit losses** — **B12** — **Cr**

20.4				**R**	20.3				**R**
May	31	Debtors	J10	500	Jun	1	Balance	b/d	1 950

The total credit of R500, which is posted to the debtors control account, is also posted from the above journal entry to the individual accounts of the relevant debtors in the debtors ledger.

The next step is to adjust the allowance for credit losses to the "new" balance (R1 710) of outstanding debtors. This means that the following calculation must be made:

	R	**R**
Allowance must be adjusted to:		1 710
Present balance of allowance:	1 950	
Less: Credit losses written off	500	1 450
Amount to be adjusted (increase)		260

General journal — J 11

				R	**R**
20.4 May	31	Credit losses	N25	260	
		Allowance for credit losses	B12		260
		Adjusting of allowance for credit losses to R1 710			

General ledger

Dr			Allowance for credit losses				B12		Cr
20.4				**R**	20.3				**R**
May	31	Debtors	J10	500	Jun	1	Balance	b/d	1 950
		Balance	c/d	1 710	20.4				
					May	31	Credit losses	J11	260
				2 210					2 210
					20.4				
					Jun	1	Balance	b/d	1 710

Dr			Credit losses				N25		Cr
20.4				**R**	20.4				**R**
May	31	Allowance for credit losses	J 11	260	May	31	Profit or loss	J ..	260

Credit losses are written off against the allowance provided. From the particulars above, it can be seen that debts that have proved to be irrecoverable originated during a previous financial year. Since it would be inappropriate to write them off against the income of the current year, the entry is made against the allowance which is based on the outstanding debts of the previous year.

Example 9.8(2)

Writing off of the doubtful debts *directly* against the credit losses account. The same particulars as those of Example 9.8(1) are used.

General journal **J 10**

				R	**R**
20.4					
May	31	Credit losses	N25	500	
		Debtors control	B10		500
		Writing off of the following debtors as irrecoverable:			
		R			
		J Smit DL 3 300			
		P Swart DL 5 70			
		S Rowland DL 9 130			
		500			
		Allowance for credit losses	B12	240	
		Credit losses	N25		240
		Reduction of allowance for credit losses to R1 710 (R1 950 – R1710)			

General ledger

Dr **Debtors control** **B10** **Cr**

				R					R
20.3					20.4				
Jun	1	Balance	b/d	65 000	May	31	Bank	CRJ5	907 500
May	31	Sales	SJ5	900 000			Credit losses	J10	500
							Balance	c/d	57 000
				965 000					965 000
20.4									
Jun	1	Balance	b/d	57 000					

Dr **Allowance for credit losses** **B12** **Cr**

				R					R
20.4					20.3				
May	31	Credit losses	J10	240	Jun	1	Balance	b/d	1 950
		Balance	c/d	1 710					
				1 950					1 950
					20.4				
					Jun	1	Balance	b/d	1 710

Dr **Credit losses** **N25** **Cr**

				R					R
20.4					20.4				
May	31	Debtors control	J10	500	May	31	Allowance for credit losses	J10	240
							Profit or loss	J . .	260
				500					500

As was the case in Examples 9.6(1) and (2), Examples 9.8(1) and (2) show that it does not matter which method is used: in either case the final debit to the profit or loss account for credit losses is the same (R260), as is the amount at which the debt is shown on the statement of financial position (ie R57 000 – R1 710 = R55 290).

In some entities, the *direct writing off method* is used exclusively: no allowance account is created and the possible irrecoverable debts are not estimated. If this method is used, the credit losses account will show only the actual losses resulting from the irrecoverable amounts. The expense (doubtful debts) may furthermore be recorded in a different accounting period from the one in which the debt originated. This approach is not preferable, unless the losses arising from doubtful debts are not material.

9.7 Recovery of credit losses already written off

Entities may act on an ongoing basis to recover debts written off, either by means of their own credit recovery department or, if this is unsuccessful, by legal recourse. As in the case of the allowance for credit losses and writing off of credit losses, any debts that are recovered should also be recorded and disclosed separately. If an amount that was previously written off as irrecoverable is later partially or totally recovered, the following entries are made:

Example 9.9

Assume that the amount of R300 in respect of J Smit, which was written off on 31 May 20.4, is recovered on 30 June 20.4. The receipt of the cash will be recorded in the cash receipts journal, but in general journal format it will be the same as

General journal **J 12**

20.4				**R**	**R**
Jun	30	Bank	B5	300	
		Credit losses recovered	N30		300
		Credit losses, written off 31 May 20.4, recovered from J Smit			

Note that the credit losses recovered is credited to a distinct account and *not* to the credit losses account, nor to the account of the former debtor.

It sometimes happens that the insolvent estate of a debtor pays only part of the outstanding debt. This payment may be indicated as a percentage of the outstanding amount or as a number of cents in the rand outstanding. If, for example, it is stated that the insolvent estate of S Rowland (which owed R130 in the previous example) pays 20% of the amount written off, it means that the estate pays 20 cents in each rand he owed. The amount the entity will receive will then be R26 (= R130 × 20%). Only the amount received is then recorded. Such cases may also occur even before the outstanding balance of a debtor has been written off. In this case, the amount received will be recorded in the CRJ and the new balance still outstanding will be written off as a credit loss.

9.8 Value-added tax (VAT) and credit losses

9.8.1 *VAT and credit losses written off*

In order not to cloud the discussion of the allowance for and the writing off of credit losses with other issues, VAT has not been taken into account thus far. However, since debtors arise from credit sales, ie the supply of goods on which VAT is charged, the amounts owing by debtors always include VAT if the entity is registered as a VAT vendor. This fact must be taken into account in cases when credit losses are written off.

As the previous discussion of VAT showed, VAT inputs and outputs must be accounted for on a regular basis (usually every two months) to SARS. In most cases, vendors are registered to pay over VAT on the invoice basis. This means that VAT is payable even if all the amounts owing, including VAT, have not yet been received from debtors.

If it later transpires that some of the debts are irrecoverable and should be written off as credit losses, the VAT component of the credit loss can be claimed from SARS in the next VAT return. This is illustrated in Example 9.10 (VAT rate assumed to be 10%).

Example 9.10

XY Traders started business on 1 April 20.3 and is registered as a VAT vendor on the invoice basis. The VAT period ends on odd months (this means that VAT *must be paid to SARS after the end of* the first, third, fifth, and so on, month of the *calendar* year).

During April and May 20.3, the business sold goods valued at R330 000 (including VAT) on credit. The entity paid the VAT due to SARS on 25 June 20.3.

Thus, 10 ÷ 110 × R330 000 = R30 000 was paid.

A debtor, J Flint, to whom goods were sold in April 20.3 for R55 000, is sequestrated on 15 July 20.3. He has not paid anything on his account as yet. The estate of the debtor paid 30 cents in the rand (this is equal to 30%) of the amount owed. It is decided to write off the amount he owes as irrecoverable (credit loss).

These transactions can be journalised as follows (for the sake of simplicity no other transactions for the period are taken into account):

To record the amount received (only those columns which are involved are shown):

Cash receipts journal: July 20.3 **CRJ 7**

Date	Details	Folio	Bank	Debtors control	VAT output	VAT input	Sundries
20.3			R	R	R	R	R
Jul 7							
15	J Flint	DL3	16 500	16 500			
21							
			16 500	16 500			
				B 10			

Note that no entry is made in the VAT columns at this stage, since the VAT was recorded during April when the sales transaction was recorded in the Sales Journal for April.

To record the amount to be written off and other transactions:

General journal **J 9**

				R	R
20.3					
Apr/ May		Debtors control		330 000	
		Sales			300 000
		VAT output			30 000
		Sales to debtors during April/May 20.3 (usually recorded in the sales journal)			
20.3					
May	31	VAT output		30 000	
		VAT control			30 000
		Transfer of balance			
20.3					
Jun	25	VAT control		30 000	
		Bank			30 000
		Payment made (usually recorded in the CPJ)			
20.3					
Jul	15	Credit losses	N25	35 000	
		VAT input	B14	3 500	
		J Flint (and Debtors control)	DL3/ B10		38 500
		Credit losses, written off			

From the last entry, it is obvious that there is now a debit amount of R3 500 on the VAT input account. This account is set off against the VAT output amount in the VAT control account. The amount of R3 500 will thus be "deducted" from the next amount to be paid to SARS, because it has already been paid over to SARS (as part of the R30 000).

9.8.2 *VAT and recovering credit losses already written off*

If an amount that has been written off as irrecoverable is partially or fully recovered, the VAT component should also be taken into account when recording the amount recovered.

It may be reasoned that the VAT component should also be taken into account in the allowance for credit losses, but because the entries required can become fairly complicated and VAT does not really have a material influence on the amount of the debtors reflected on the statement of financial position the matter is not pursued any further in this book.

9.9 Disclosure of debtors in the financial statements

9.9.1 *Disclosure in the financial statements*

The purpose of the allowance for credit losses is twofold: it allows for possible losses in the year in which the income is reported and brings the total amount owing by debtors into line with the amount that the business can expect to receive. This means that debtors is measured reliably. The debtors item on the statement of financial position is accordingly shown as follows at its net realisable value:

Presentation on the statement of financial position

Current assets	**R**
Inventories	XXX
Trade and other receivables*	58 200
Cash and cash equivalents	XX

* R60 000 (debtors) – R1 800 (allowance for credit losses)

According to the definition of financial instruments, explained in chapter 12, trade debtors are financial assets. Trade debtors will thus be included in the note for financial assets. Refer to chapter 12 and the comprehensive example in chapter 15 for examples of how trade and other receivables must be disclosed in the financial assets notes.

When trade and other receivables consists of several items such as debtors and VAT control items are included in the financial assets note.

If the debtors have been pledged or used as surety for a debt incurred by the business, this fact should be disclosed by means of a note to the financial statements. If an entity sells goods in terms of instalment sale (hire purchase) transactions, the *instalment sale debtors* should be shown separately from the trade debtors. This distinction is made because the amount of the instalment sale debtors is not realisable immediately.

9.9.2 *Debtors with credit balances*

A debtor's account may sometimes have a credit instead of a debit balance because, for example, excess payment is made on the account, goods are returned or a discount is granted after settlement of the account. In the case of such credit balances, care should be taken to ensure that debtors are reflected at the correct amount on the statement of financial position. If the total of these credit balances is *substantial* (material), the amount should be shown with trade creditors since it constitutes a liability. It should thus not be disclosed as a reduction to the debit balances. This is illustrated in Example 9.11.

Example 9.11

Assume that an entity has 260 debtors' accounts, as follows:

	R
255 accounts with debit balances, in total amounting to	220 000
5 accounts with credit balances, in total amounting to	20 000
Net debtors balance (Debtors control account)	200 000

The entity should not show its debtors at R200 000, but at R220 000, because the debtors with credit balances in fact represent a liability and should be disclosed under current liabilities, as amounts received in advance (R20 000) on the statement of financial position.

9.10 Internal control measures regarding debtors

The following control measures should be applied if an entity is to maintain adequate control over debtors:

☐ the entity should have a proper credit policy that takes its ability to grant credit into account;

☐ clients' creditworthiness should be determined before credit is granted taking applicable legislation into account. Credit control sections should carry out this function and follow up cases of non-payment;

☐ clients should be supplied with regular (monthly) statements to keep them informed of amounts owing and the terms of settlement;

☐ duties involving approving of credit, recording transactions, compiling statements and handling cash receipts should as far as possible be separated;

☐ if numerous transactions are dealt with, subsidiary journals and ledgers with a control account in the general ledger should be used;

☐ only authorised people may approve the writing off of credit losses;

☐ only authorised people may approve allowances for credit losses;

☐ loose-leaf debtors' accounts, debtors' cards or computerised systems make it possible for the accounting work relating to debtors to be divided among a number of employees; and

☐ debtors should be contacted from time to time to determine whether they agree with the balances on their accounts.

These internal control measures also apply to sundry accounts in the discussion that follows.

9.11 Credit card sales and charges

The modern business world makes extensive use of credit, with most sales of goods or services rendered on a credit basis. The majority of credit sales are done on an "open account" basis: in other words, there is merely an agreement between the seller and buyer that the seller's conditions regarding settlement of the amount owing (usually within 30 days), will be honoured by the buyer. In recent years, the tremendous increase in the use of *credit cards* issued by financial institutions to their customers has helped to simplify these transactions.

As a result, at least part of the sales in retail entities nowadays take place via credit cards such as *MasterCard* or *Visa cards*, which are issued by banks. The banks bear the costs of processing the information and collecting outstanding amounts and also absorb any losses arising from credit losses.

For these services, banks charge entities a fee based on a percentage of the credit card sales. The entity deposits the credit card debit notes with its bank which then credits the entity's bank account with the total amount of the debit notes deposited less the credit card charge. Nowadays these transactions are electronically processed immediately after the credit card has been swiped through a dedicated credit card terminal. The entity will record the transactions as follows:

				R	R
		XY Bank		300 000	
		Credit sales			300 000
		Credit card debit notes deposited			
		Credit card charge		3 000	
		XY Bank			3 000
		Fee charged on credit card sales			

Credit card sales are also made to customers who present credit cards that are not issued by a bank, such as *American Express* and *Diners Club cards*. In such cases, the business will send the debit notes to the credit card company concerned and will in turn receive a cheque from that company for the net amount (that is, the sales less any credit card charges). Here the credit card companies are treated as ordinary debtors in the books of the entity:

				R	R
		Credit card company		20 000	
		Credit sales			20 000
		Sales per credit cards			
		Credit card charge		200	
		Credit card company			200
		Fees charged on amounts claimed			

The amount received from the credit card company (R19 800) will, of course, be recorded in the CRJ and posted to the credit side of the account of the credit card company.

9.12 Debtors control account

References to a *debtors control account* have been made throughout this chapter. The purpose of this control account is to *summarise* all the transactions that influence (change) all the accounts of the individual debtors as maintained in the subsidiary debtors ledger(s). It is impractical to have a large number of individual debtors' accounts in the general ledger. Most entities therefore keep subsidiary debtors ledgers with a debtors control account in the general ledger.

Transactions are recorded in the books of first entry, that is, in the various journals (CRJ, CPJ, SJ, PJ, SRJ, PRJ, Petty cash journal, and others). Transactions relating to the individual debtors and creditors (in other words, personal accounts) are posted on a daily basis to these accounts. At the end of the month, the totals of such transactions are posted to the control account(s) when all the subsidiary journals have been finalised.

The procedure can be summarised as follows:

Individual entries to be posted *daily* to the individual debtors accounts:

- ☐ *Sales journal*: Post to the debit side of the individual debtors accounts.
- ☐ *Sales returns journal*: Post to the credit side of the individual debtors accounts.
- ☐ *Cash receipts journal*: Post to the credit side of the individual debtors accounts.
- ☐ *Cash payments journal*: Post to the debit side of the individual debtors accounts (this type of transaction seldom occurs and is used mainly to refund credit balances to debtors).
- ☐ *General journal*: Post to the debit or credit side of the individual debtors accounts, whatever is required in that journal.

Totals of columns in journals to be posted at the *end of the month* (or other period) to the debtors control account:

- ☐ *Sales journal*: Total of debtors control column to the debit side of the debtors control account (remember: individual accounts were also debited).
- ☐ *Sales returns journal*: Total of debtors control column to the credit side of the control account (remember: individual accounts were also credited).
- ☐ *Cash receipts journal*: Total of debtors control column to the credit side of the control account (individual accounts were also credited).
- ☐ *Cash payments journal*: Total of debtors control column to the debit side of the debtors control account. If no debtors control column exists, post the individual transactions related to debtors in the sundry accounts column.
- ☐ *General journal*: Post to the debit or credit side of the debtors control account, whichever is related to debtors.

Some entities provide analysis columns in their general journals for debtors and creditors control accounts. Only those entries that affect debtors must be posted to the individual debtors (daily) and the totals of the columns to the debtors control account (monthly).

After all the accounts in all the ledgers have been balanced, the balance of the debtors control account should correspond with the total of all the debit balances of

the individual debtors, *less* the total of all the credit balances of debtor accounts. Where this is not the case, an error was made during the process. Such errors may include

- ☐ mistakes in postings to the individual accounts in the subsidiary ledger or the control account (such as a posting to the debit side of an account instead of to the credit side or a transposing error where R359 was posted as R395 or R953);
- ☐ mistakes in the balancing off of accounts or in which a balance is brought down incorrectly or to the wrong side of the account;
- ☐ errors in the totalling of one or more journals;
- ☐ mistakes in the calculation of the total amount outstanding of the individual debtor accounts (list of debtor balances) or the omission of a balance;
- ☐ errors in the allocation of transactions in the journals, for example, an amount that should be in the debtors column of the CRJ was posted to the individual account, but was entered in the sales column of the CRJ; and
- ☐ omission of a posting, such as where an entry in a journal was not posted to the ledger account(s).

Example 9.12 illustrates the way in which a debtors control account should be prepared (VAT is 14%):

Example 9.12

On 1 April 20.1, the debtors ledger of Johns Trading revealed the following balances:

Folio no		R
DL 1	A Louw	900
DL 2	B Moloi	1 360
DL 3	C Singh	440
	Total	2 700

The following entries appeared in the journals of Johns Trading:

Sales journal: April 20.1 **SJ 4**

Date	Debtor	Folio	Sales	VAT output	Debtors
			R	R	R
02	A Louw	DL1	400	56	456
	B Moloi	DL2	800	112	912
	C Singh	DL3	600	84	684
			1 800	252	2 052
					GL 5

Sales returns journal: April 20.1 **SRJ 4**

Date	Debtor	Folio	Sales	VAT output	Debtors
			R	R	R
10	B Moloi	DL2	50	7	57
	C Singh	DL3	50	7	57
			100	14	114
					GL 5

Cash receipts journal: April 20.1 **CRJ 4**

Date	Details	Fol	Bank	Debtors	Settlement discount granted	VAT input
			R	R	R	R
3	A Louw	DL1	1 242	1 356	(100)	(14)
3	B Moloi	DL2	800	800		
14	C Singh	DL3	600	657	(50)	(7)
			2 642	2 813	(150)	(21)
				GL 5		

General journal: April 20.1 **J 1**

Date	Details	Fol	TOTAL		Debtors control		Sundry accounts	
			Dr	Cr	Dr	Cr	Dr	Cr
			R	R	R	R	R	R
15	C Singh	DL3	798		798			
	Furniture			700				700
	Vat output			98				98
	Sold furniture on credit							
18	Furniture		250				250	
	VAT output		35				35	
	C Singh	DL3		285		285		
	Furniture returned							
			1 083	1 083	798	285	285	798
					GL 5	GL 5		

Required

(a) Prepare the debtors control account for April 20.1 in the general ledger of Johns Trading.

(b) Prepare the individual debtors' accounts for April 20.1 in the debtors ledger of Johns Trading.

(c) Prepare a list of balances of debtor accounts and ensure that it reconciles with the balance of the debtors control account.

Solution

(a) General ledger

Dr **Debtors control** **B 5** **Cr**

20.1				**R**	20.1				**R**
Apr	1	Balance	b/d	2 700	Apr	30	Sales returns	SJ4	114
	30	Sales	SJ4	2 052			Bank and discount	CRJ4	2 813
		Sundry journal debits	J1	798			Sundry journal credits	J1	285
							Balance	c/d	2 338
				5 550					5 550
May	1	Balance	b/d	2 338					

(b) Debtors ledger

A Louw **DL 1**

Date		Details	Fol	Debit	Credit	Balance
20.1				**R**	**R**	**R**
Apr	1	Balance				900
	2	Sales	SJ4	456		1 356
	3	Bank and discount	CRJ4		1 356	0

B Moloi **DL 2**

Date		Details	Fol	Debit	Credit	Balance
20.1				**R**	**R**	**R**
Apr	1	Balance				1 360
	2	Sales	SJ4	912		2 272
	3	Bank and discount	CRJ4		800	1 472
	8	Sales returns	CRJ4		57	1 415

C Singh **DL 3**

Date		Details	Fol	Debit	Credit	Balance
20.1				**R**	**R**	**R**
Apr	1	Balance				440
	2	Sales	SJ4	684		1 124
	8	Sales returns	SRJ4		57	1 067
	14	Bank and discount	CRJ4		657	410
	15	Furniture	J1	798		1 208
	18	Furniture returns	J1		285	923

(c) List of individual debtor balances

Folio no		**R**
DL 1	A Louw	0
DL 2	B Moloi	1 415
DL 3	C Singh	923
	Balance: Debtors control	2 338

9.13 Revision examples

Revision example 1

Dania Traders estimates that its credit losses may amount to R15 000 at the year ended 30 April 20.3.

Additional information:

1. On 30 April 20.3, the entity created an allowance for credit losses.
2. On 30 June 20.3, the account of J Swan, amounting to R800, is written off as irrecoverable.
3. On 10 September 20.3, J Swan settles his account in full.

Required

Journalise all the above transactions, including the receipt of the cash.

Solution

General journal

				R	R
20.3 Apr	30	Credit losses Allowance for credit losses *Allowance created*		15 000	 15 000
20.3 Jun	30	Allowance for credit losses J Swan and Debtors control *J Swan's account is irrecoverable*		800	 800
20.3 Sep	10	Bank Credit losses recovered *Credit losses (J Swan) recovered*		800	 800

Revision example 2

The financial records of Manatu Traders disclosed, among other things, the following information in respect of April 20.0:

	R
Balance of the debtors control account at 1 April 20.0	15 400
Totals of journals for the month:	
Columns in the cash receipts journal:	
Cash sales	200 000
Debtors control	63 400
Settlement discount granted	1 600
Columns in the cash payments journal:	
Creditors control	34 000
Settlement discount received	900
Debtors control (credit balance repaid)	600
R/D cheque from debtor P Smith	800
Sales journal: Debtors control	65 000
Sales returns journal (all on credit sales)	400
General journal: Interest charged to debtors	300

Required

Prepare a debtors control account, properly balanced for April 20.0.

Solution

General ledger

Dr **Debtors control** **B ..** **Cr**

20.0				**R**	20.0				**R**
Apr	1	Balance	b/d	15 400	Apr	30	Sales returns	SJ ..	400
	30	Sales	SJ ..	65 000			Bank and		
		Repayment	CPJ ..	600			discount	CRJ ..	63 400
		P Smith (R/D)	CPJ ..	800			Balance	c/d	18 300
		Interest	J ..	300					
				82 100					82 100
May	1	Balance	b/d	18 300					

9.14 Summary

Debtors are in many cases an important current asset of an entity. Before credit can be granted to prospective clients, the owner of an entity should decide on matters such as credit terms, discount granted and the actual writing off of credit losses and allowing for doubtful debts. It is sound policy to allow for doubtful debts and to adjust this amount annually, especially where outstanding debtors are substantial. The creation and adjustment of such an allowance is explained in this chapter.

Outstanding debtors must be disclosed on the statement of financial position at the end of the financial year. The way in which this is done has been explained. Control measures regarding debtors should be in place.

Sales can be paid for by means of credit cards. Finally, where the entity uses a debtors ledger to record transactions with individual debtors in individual accounts, a debtors control account must be kept in the general ledger. The main purpose of this control account is to summarise all the transactions relating to the individual debtors, as reflected in the individual debtors accounts. The balance on the control account must be reconciled periodically, at least once a month, with the total of the balances of the individual accounts as kept in the debtors ledger.

CHAPTER 10

Inventory

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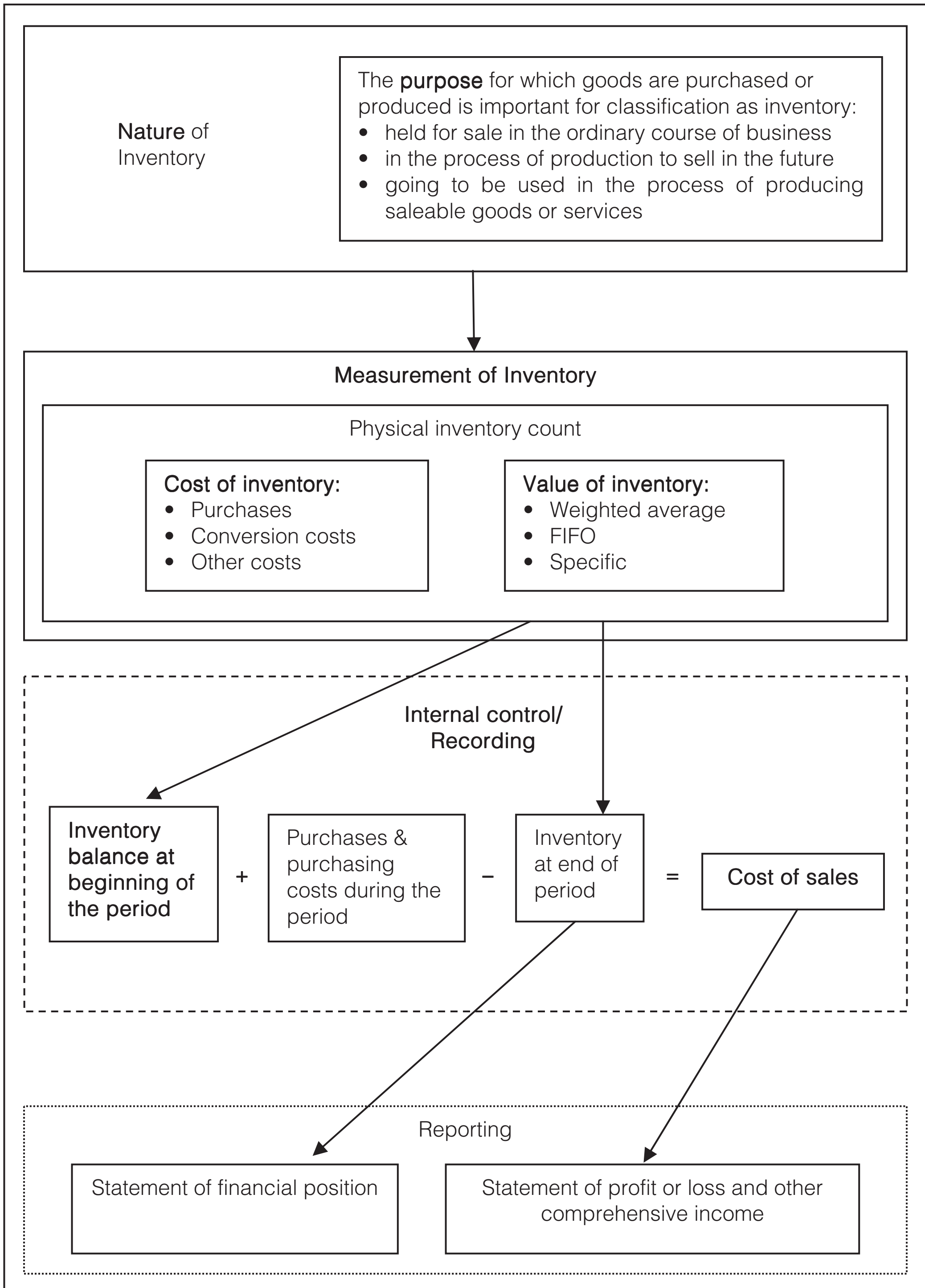
Overview of the inventory



10.1 Introduction

Study objectives

After studying this chapter you should be able to

☐ measure inventory;

☐ estimate the value of inventory; and

☐ disclose inventory in financial statements.

Assets have the potential to contribute directly or indirectly to the flow of cash and cash equivalents to an entity. For this reason, unsold inventories form part of the assets of an entity, and because they are usually sold or consumed within one year they are classified as current assets. Hence, the unsold inventory disclosed on the statement of financial position has a direct impact on reporting the solvency of an entity. When inventory is sold, it becomes an expense in the period sold. The carrying amount of the inventory sold is used to calculate the cost of sales. The inventory figure thus has a direct impact on the profitability reported in the entity's statement of profit or loss and other comprehensive income. (Solvency and profitability are discussed in Volume 2 in the chapter on the analysis and interpretation of financial statements.)

From this it is clear that the valuation of inventory should not be underestimated, as it influences both the financial performance and the financial position of an entity.

In this chapter, specific attention is given to the nature, measurement and disclosure of inventory. In chapter 7 the perpetual and periodic systems for keeping record of inventory were explained. To summarise, when the *perpetual inventory* system is used, inventory purchased is recorded in the inventory account. All costs incurred in bringing the inventory to its current location and condition are also recorded in the inventory account. Each time a sale is made, the inventory account is updated by crediting the inventory account with the cost price of the sale and debiting the cost of sales account. When the *periodic inventory* system is used, the cost of sales is calculated at the end of the financial period. This is done by adding purchases and all costs incurred in bringing the inventory to its current location and condition (specified in separate accounts) to the opening value of inventory. The closing value of inventory, which is determined after a physical inventory count, is then subtracted to calculate cost of sales.

10.2 The nature of inventory

Inventory comprises assets that

☐ are held for sale in the ordinary course of business, such as groceries in a supermarket;

☐ are in the process of production to sell in the future, such as partially completed cars at a motor manufacturer; and

☐ are going to be used in the process of producing saleable goods or services (such as the material of which the cars are made) or are going to be consumed in rendering of a service (referred to as consumables).

Although consumables are classified as assets on the statement of financial position as part of inventories, they do not influence the gross profit and should not be included in the calculation of a retailer's cost of sales. The consumables used by a service provider usually form part of the costs of production.

The purpose for which goods are purchased or produced is important in determining whether the item can be classified as inventory. Motor vehicles that are purchased by a motor dealer form part of his inventory held for sale, but for a taxi entity, vehicles are classified as non-current assets since they will usually contribute to future economic benefits.

The inventory of retailers and wholesalers consists mainly of merchandise. The inventory of a service provider usually consists of consumables. A manufacturer has different types of inventory, the detail of which is beyond the scope of this text. The emphasis in this chapter is on finished goods (inventory) that are purchased with the intention of being sold.

10.3 Measurement of inventory

The measurement of inventory comprises the following aspects:

- ☐ physically counting the inventory;
- ☐ determining the cost price of the inventory that must be recognised as an expense;
- ☐ applying a chosen cost formula which will be used in measuring the value of inventory; and
- ☐ determining the net realisable value of the inventory to be disclosed on the statement of financial position.

These aspects are discussed separately in the following paragraphs.

10.3.1 *Physical inventory count*

The extent of unsold inventory is usually determined by means of a physical inventory count. Although entities can do a physical inventory count (often referred to as stocktaking) several times in the course of a financial year, a physical inventory count should be done at least once per annum, usually at the end of the financial year. This is necessary to calculate the cost of sales (where the periodic inventory system is in use) and for inventory control purposes. During an inventory count, the condition of the items can be observed and shortcomings in the recording system, storage and handling of the inventory revealed.

The physical inventory on hand must be adjusted, if necessary, in order to determine the inventory that belongs to the entity. Only the value of the inventory that belongs to the entity should be reflected on the statement of financial position. What should or should not be included in the inventory depends on the passing of the right of ownership of the inventory. According to the law, the right of ownership generally passes from the seller to the purchaser when the transaction is completed. The purchases or sales entry is made as soon as the risk and reward associated with the ownership of the inventory passes from the seller to the purchaser. Thus, if the

purchase transaction has been recorded, the inventory *must* be added to the closing inventory, *irrespective of whether it is physically on the premises.* Likewise, if the *sale transaction* has been recorded, the inventory concerned must *not* be added, *irrespective of whether the inventory is physically on the premises.*

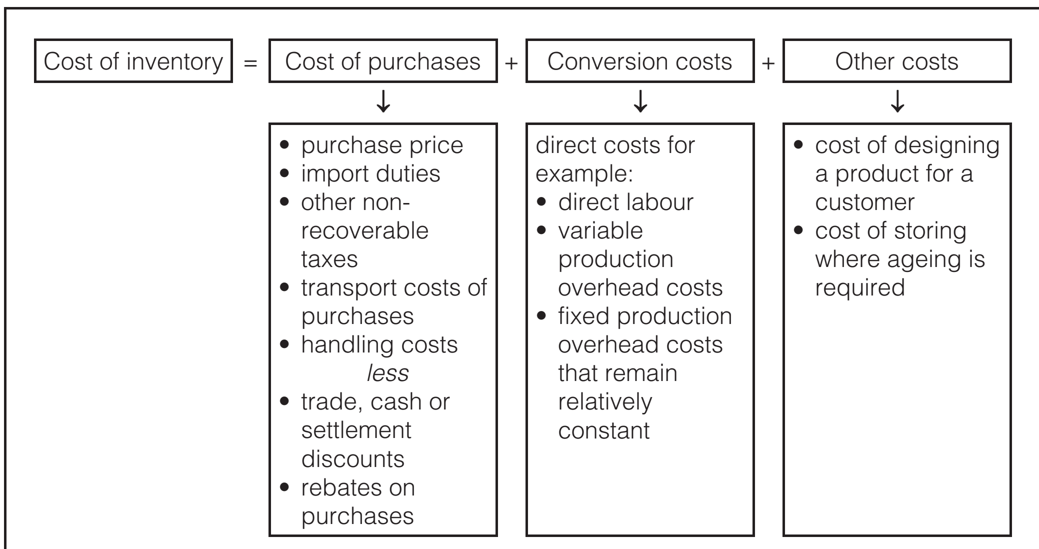
10.3.2 *Cost of inventory*

The following, if applicable, must be added to determine the cost of inventory:

- the cost of purchases;
- conversion costs in the case of a manufacturing concern; and
- other costs incurred in bringing the inventory to its present location and condition.

The costs that must be included as part of the cost of inventory are illustrated in diagram 10.1.

Diagram 10.1 The calculation of the cost of inventory



The applicable costs indicated in diagram 10.1 are added together to determine the total value of inventory purchased. The cost of inventory calculated in this manner is added to the opening value of inventory. The closing value of inventory is then deducted to calculate the cost of sales. As the cost of inventory sold is recognised at the same time as the income derived from the sale of the inventory, the cost of sales must be deducted from sales to calculate the gross profit for the year. If these costs are not included in the cost of inventory, they are classified as ordinary expenses and form part of the calculation of the total comprehensive income for the year. This would mean that the costs would not be *matched* with *the income they produced*.

If the entity is registered as a VAT vendor, the cost price of purchases is the amount excluding VAT, as VAT may be reclaimed as input tax. If the entity is not registered as a VAT vendor, the cost price of purchases should include VAT.

10.3.3 *Cost formulae to value inventory*

When an entity purchases various batches of an inventory item at different prices and not all the items are sold at the end of a financial period, the question of the price at which the inventory on hand should be valued arises. At present, various techniques and methods exist to value inventory, with varying results.

The following techniques can be used to *estimate* the value of inventory in an indirect way (refer to paragraph 10.6):

- ☐ *Standard cost method*: Predetermined standards are used to determine the cost of inventory.
- ☐ *Retail method*: The gross profit percentage is used to deduce the cost of the inventory from the selling price. (Refer to the explanation in paragraph 10.6.)

The results of these techniques are to approximate costs, but inventory must still be valued using a method based on the actual costs incurred. The following methods can be used to value inventory:

- ☐ *Weighted average method*: The total cost of the inventory available for sale is divided by the total number of units in order to determine an average cost per unit.
- ☐ *First-in, first-out (FIFO) method*: According to this method, it is assumed, for cost purposes, that the items that were purchased first are sold first. This does not necessarily refer to the physical flow of inventory, but is used to value unsold inventory at the latest prices.
- ☐ *Specific identification method*: The actual cost of a particular item is allocated to that item.

The method which brings about the most realistic determination of profit in the particular entity should be the preferred way to value the inventory. An entity must use the same cost formula for inventories of similar nature and use to the entity. With the specific identification method the actual costs are used, while valuing inventory according to the other two methods produces slightly different results which will be explained in the paragraphs that follow.

(a) The weighted average method

The weighted average method, also referred to as the average cost method, is generally used by entities that retain goods for a relatively long period and by entities that purchase large quantities of goods with a relatively low value at different times and at different prices. It tends to lessen the influence of increases and decreases in cost and hence on the profit.

The weighted average cost is calculated by dividing the cost of sales by the number of units purchased. Although this calculation can be done as often as needed, the weighted average cost for the financial year must be calculated after the inventory count, to determine the value of closing inventory. In Example 10.1, the weighted average cost is calculated for one month.

Example 10.1

SRC Traders commenced business on 1 April 20.6.

The following data for April 20.6 are available for inventory item A:

INVENTORY DATA: ITEM A
April 20.6

(a) Date purchased	Purchases Units	Unit price R	Cost of sales R
1 April 20.6	200	1,00	200
8 April 20.6	600	1,10	660
15 April 20.6	400	1,20	480
22 April 20.6	600	1,30	780
29 April 20.6	200	1,40	280
	2 000		2 400

(b) Sales: 1–30 April 20.6: 1 200 units
(c) On hand: 30 April 20.6: 800 units

The weighted average cost is R2 400 ÷ 2 000 = R1,20. The cost of sales according to the weighted average method is R1 440 (1 200 × R1,20) and the closing inventory is R960 (800 × R1,20).

Criticism brought against the method is that the value of inventory is not determined by using the current cost and that therefore the value of the inventory on the statement of financial position does not reflect the latest replacement cost. In the above example, the value of inventory at 30 April 20.6 is R1,20 per unit, while the latest replacement cost is already R1,40 per unit.

(b) The first-in, first-out (FIFO) method

This method assumes, for cost calculation purposes, that the older inventory is usually sold first. Using the same data as in the previous example, the cost of goods on hand and the cost of goods sold are calculated as follows:

Example 10.2

Date	Purchases	Unit price	Sales	On hand	Cost of sales	Cost of goods on hand
	Units	R	Units	Units	R	R
01/04	200	1,00	200		200,00	
08/04	600	1,10	600		660,00	
15/04	400	1,20	400		480,00	
22/04	600	1,30		600		780,00
29/04	200	1,40		200		280,00
					1 340,00	1 060,00

Like the weighted average cost, the FIFO method of valuation measures the inventory on hand at lower than replacement cost. Profits calculated in both cases could be seen as artificial, existing only on paper. In Example 10.2, the value of the closing inventory is R1 060, while R1 120 (800 × R1,40) is needed to replace 800 units of item A.

The difference of R60 (R1 120 – R1 060) is referred to as inventory or paper profits, because the profit is not available for distribution to the owner(s). It will have to be retained in the business to replace inventory.

The FIFO and weighted average formulae will have different results when the gross profit is calculated as illustrated by the following example in which a selling price of R4,00 per unit is assumed:

	Weighted average	**FIFO**
	R	**R**
Sales (1 200 × R4,00)	4 800	4 800
Cost of sales	(1 440)	(1 340)
Gross profit	3 360	3 460

Irrespective of the cost formula chosen, it is important to apply the chosen procedure consistently. Inconsistency in the valuation of inventory would render the comparison of the operating results and the financial position of the entity worthless. If financial reporting can be improved with another valuation method, the entity may change to this method, but it must be fully disclosed in a note to the financial statements, in which the nature and effect of the change is set out. However, the cost formula chosen should not be changed frequently, especially if the goal is to report higher income.

10.3.4 *Net realisable value (NRV)*

Unsold inventory is measured at the lower of cost and net realisable value. The cost of inventory comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventory to its present location and condition. If there is a possibility that inventory will not be realised at its calculated cost – because, for example, the selling price of the inventory has declined or inventory has been damaged or become partially or totally obsolete – the inventory is reflected on the statement of financial position at its *net realisable value*.

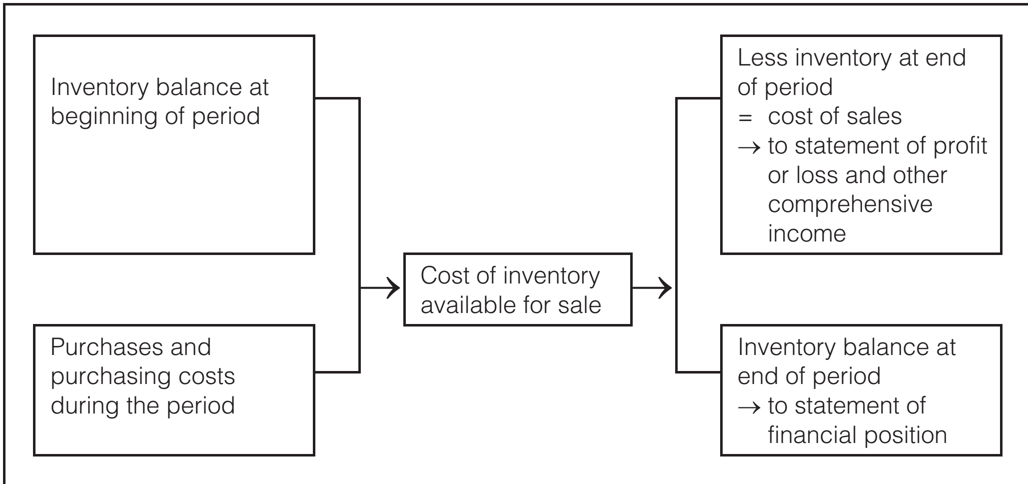
The net realisable value of inventory is the estimated selling price in the normal course of business, less the estimated cost required to sell the inventory. For financial statements to be reliable, prudence must be exercised. Thus, if uncertainty exists about the nature and extent of an element that is reflected in the financial statements or various values for the element are possible, the element is measured at the value that will have the most *unfavourable* effect on the equity of the entity. When the value of the inventory declines during a particular year, the decline must be reflected item by item on the statement *of profit or loss and other comprehensive income of that year*.

It is beyond the scope of this chapter to calculate net realisable value.

10.4 Disclosure

After the cost of the unsold inventory has been determined in accordance with the chosen cost formula, the NRV principle is applied. The amount at which inventory is valued for financial statement purposes is then known. Thereafter, it is disclosed in the financial statements. Diagram 10.2 illustrates the effect of inventory on the statement of profit or loss and other comprehensive income and statement of financial position.

Diagram 10.2 The effect of inventory on the statement of profit or loss and other comprehensive income and statement of financial position



The way that inventory is disclosed on the statement of financial position or in notes to the financial statements depends on the type of entity concerned. Inventory can include the following:

- merchandise;
- consumables in a service entity, including maintenance spares;
- raw materials;
- work-in-progress;
- finished goods; and
- contracts-in-progress.

The accounting policy applied to the valuation of the inventory should be disclosed, with an indication of which cost formula was used and whether the valuation was done at cost or at net realisable value.

Example 10.3 Disclosure of inventory in the financial statements

BEADS SUPPLIERS

Shown under the accounting policy:

Inventories

Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. The following cost formulae were applied:

Raw materials:	First-in, first-out
Work-in-progress:	Standard cost
Finished goods:	Standard cost
Merchandise:	Weighted average
Consumables:	First-in, first-out

Excess and slow-moving inventory were identified and written off to their estimated net realisable values.

continued

Shown under the notes to the financial statements after financial assets:

5. Inventories

Inventories consist of	**20.2 R 'm**	**20.1 R 'm**
Raw materials	720	660
Work-in-progress	140	130
Finished goods	960	900
Merchandise	480	350
Consumables	180	120
	2 480	2 160

A change in accounting policy in respect of inventory that has a significant effect should be disclosed and quantified under the accounting policy.

10.5 The importance of the correct valuation of inventory

The correct valuation of inventory is very important. Diagram 10.2 makes it clear that inventory has an effect on both the statement of profit or loss and other comprehensive income and the statement of financial position. An incorrect valuation of inventory would influence the cost of goods sold, the gross profit, and profit/total comprehensive income for the applicable financial period. This would affect the equity as well as the current assets on the statement of financial position. As the closing inventory of one financial period is the opening inventory of the following period, any incorrect valuation of the closing inventory in a particular period will also influence the cost of the goods sold and the gross profit and profit/total comprehensive income of the subsequent period.

Example 10.4

The following is the statement of profit or loss and other comprehensive income of a merchandising entity for 20.3 and 20.2:

Notes	**20.3**	**20.2**
	R	**R**
Revenue	600 000	480 000
Cost of sales	(320 000)	(180 000)
Inventory (beginning of the period)	180 000	140 000
Purchases	360 000	220 000
	540 000	360 000
Inventory (end of the period)	(220 000)	(180 000)
Gross profit	280 000	300 000
Distribution, administrative and other expenses	(180 000)	(150 000)
Profit/total comprehensive income for the year	100 000	150 000

If the closing inventory for 20.2 was determined incorrectly and should have been R120 000 instead of R180 000, the result would be as follows:

	Notes	20.3	20.2
		R	**R**
Revenue		600 000	480 000
Cost of sales		**(260 000)**	**(240 000)**
Inventory (beginning of the period)		**120 000**	140 000
Purchases		360 000	220 000
		480 000	360 000
Inventory (end of the period)		(220 000)	**(120 000)**
Gross profit		**340 000**	**240 000**
Distribution, administrative and other expenses		(180 000)	(150 000)
Profit/total comprehensive income for the year		**160 000**	**90 000**

The influence of this error is as follows:

	20.3			**20.2**		
	Incorrect inventory	**Correct inventory**	**Influence of incorrect inventory**	**Incorrect inventory**	**Correct inventory**	**Influence of incorrect inventory**
	R	**R**		**R**	**R**	
Cost of sales	320 000	260 000	overstated	180 000	240 000	understated
Gross profit	280 000	340 000	understated	300 000	240 000	overstated
Profit/total comprehensive income for the year	100 000	160 000	understated	150 000	90 000	overstated

Total profit/total comprehensive income for the two years with incorrect inventory = R150 000 + 100 000 = R250 000

Total profit/total comprehensive income for the two years with correct inventory = R90 000 + 160 000 = R250 000.

Although the closing inventory for 20.2 and the opening inventory for 20.3 are incorrect, the total profit for the two years is not affected. This fact does not lessen the importance of an error in the inventory figure.

For example, according to the incorrect inventory, the gross profit percentage on sales for 20.2 is

$$\frac{300\ 000}{480\ 000} \times \frac{100}{1} = 62.5\%$$

With the correct inventory figure, it is

$$\frac{240\ 000}{480\ 000} \times \frac{100}{1} = 50\%$$

An incorrect inventory figure would lead to an incorrect analysis and interpretation of information on the statement of profit or loss and other comprehensive income in each of the financial years and may cause incorrect management decisions to be made.

10.6 Estimating the value of inventory

An entity using the periodic inventory method may need to estimate the value of its inventory for any of the following reasons:

- ☐ to calculate the cost of sales for monthly or quarterly financial statements without a physical inventory count;
- ☐ to compare with the physical inventory count to determine whether shortages exist; or
- ☐ to determine the amount recoverable from an insurance company when a fire or other catastrophe has destroyed the inventory or the inventory has been stolen.

Although various techniques exist to do this calculation, the retail method (refer to paragraph 10.3.3), also referred to as the gross profit method, is used most often and needs some explanation.

The gross profit can be expressed either as a percentage of sales or as a percentage of cost of sales. When expressed as a percentage of sales, the gross profit percentage is calculated as follows:

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

When expressed as a percentage of cost of sales it is calculated as follows:

$$\text{Gross profit percentage on cost of sales} = \frac{\text{Gross profit}}{\text{Cost of sales}} \times \frac{100}{1}$$

To estimate the value of the closing inventory with the gross profit technique, the following steps must be followed:

- ☐ calculate the average gross profit percentage on sales for the preceding (+/–) 3 accounting periods;
- ☐ use the average percentage to estimate the gross profit;
- ☐ deduct the estimated gross profit from sales to determine the value of cost of sales; and
- ☐ deduct the cost of sales from the value of the inventory available for sale (inventory at the beginning of the period and purchases) to estimate the value of the closing inventory.

Example 10.5

The trading summary of Tulbach Enterprises for the preceding three years is as follows:

Notes	Dec 20.3	Dec 20.2	Dec 20.1	Total
	R	R	R	R
Revenue	450 000	300 000	150 000	900 000
Cost of sales	(333 000)	(228 000)	(114 000)	(675 000)
Gross profit	117 000	72 000	36 000	225 000
Gross profit % on sales	26%	24%	24%	25%
Gross profit % on cost of sales	35%	32%	32%	33 1/3%

continued

The average gross profit percentage on sales over the past three years was 25%. The average gross profit percentage on cost of sales over the past three years was 33 1/3%.		
The following information is available for 20.4:	**R**	
Inventory (1 January 20.4)	75 000	
Purchases	750 000	
Sales	600 000	

Using the average gross profit percentage on sales, the estimated closing inventory is calculated as follows:

Tulbach Enterprises
Partial statement of profit or loss and other comprehensive income for the year ended 31 December 20.4

Notes	R	% of sales	R
Revenue	600 000)	100	600 000
Cost of sales	(?)	75	(450 000) ②
Inventory (1 January 20.4)	75 000		75 000
Purchases	750 000		750 000
Cost of goods available for sale	825 000		825 000
Estimated inventory (31 December 20.4)	(?)		(375 000) ③
Gross profit	?	25	150 000 ①

① The gross profit is 25% of R600 000 = R150 000
② Cost of sales is R600 000 – 150 000 = R450 000
③ Estimated inventory is R825 000 – 450 000 = R375 000

Using the average gross profit percentage on cost of sales, the estimated closing inventory is calculated as follows:

Tulbach Enterprises
Partial statement of profit or loss and other comprehensive income for the year ended 31 December 20.4

Notes	R	% of cost of sales	R
Revenue	600 000	133 1/3	600 000
Cost of sales	(?)	100	(450 000) ①
Inventory (1 January 20.4)	75 000		75 000
Purchases	750 000		750 000
Cost of goods available for sale	825 000		825 000
Estimated inventory (31 December 20.4)	(?)		(375 000) ②
Gross profit	?	33 1/3	150 000

① Cost of sales is R600 000 × 100 ÷ 133 1/3 = R450 000
② Estimated inventory is R825 000 – 450 000 = R375 000

Only *one* of these techniques is used to calculate the estimated closing inventory.

The calculation of cost of sales using either of these techniques is based on the assumption that the gross profit percentage is essentially the same over the various years. For this reason, the gross profit percentage can be applied in entities in which the relationship between the cost of sales and sales is reasonably stable. It should be noted that the figure obtained in this manner is an *estimate* of the value of the inventory and not the actual value of inventory.

10.7 Summary

Inventory is an asset and must therefore fulfil the *definition* and *recognition criteria* applicable to assets. By exercising *prudence* in the preparation of financial statements, inventories are valued at the *lower of the cost or the net realisable value*.

All costs incurred in bringing the inventory to its current location and conditions are *part of the cost of inventory*. By means of these costs, the cost of inventory is accumulated to calculate. When inventory is sold, it becomes an expense that forms part of the calculation of cost of sales; applying the accrual basis of accounting, it is associated with the related income from the sales in the trading account.

CHAPTER 11

Property, plant and equipment

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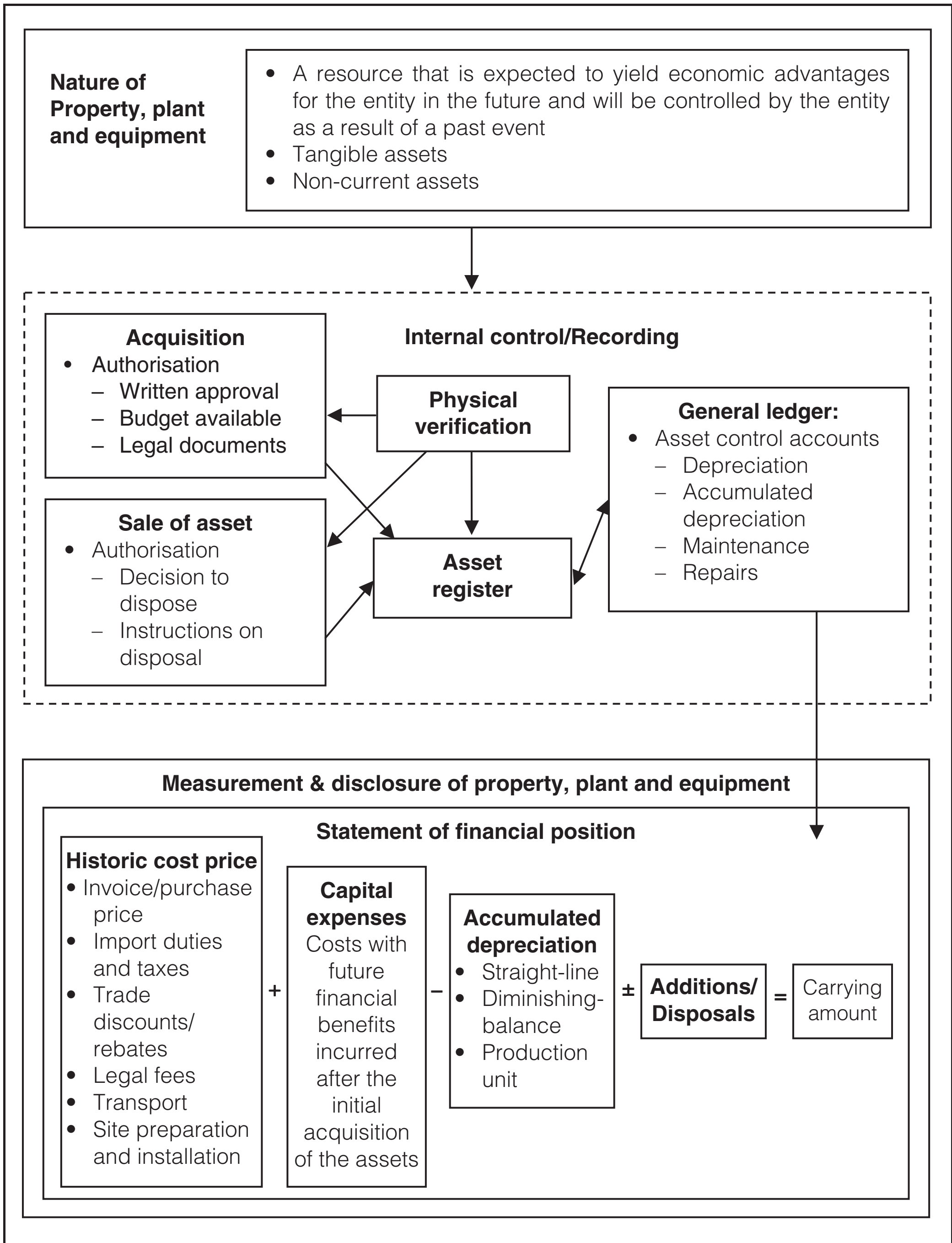
Overview of property, plant and equipment



11.1 Introduction

Study objectives

After studying this chapter you should be able to

- ☐ explain how the cost basis is applied in recording property, plant and equipment in the books;
- ☐ explain the concept of depreciation;
- ☐ calculate periodic depreciation by means of different methods;
- ☐ describe the procedure for reviewing the periodic depreciation;
- ☐ distinguish between current expenses and capital expenditure and explain the entries for both; and
- ☐ show how property, plant and equipment should be disclosed in the financial statements of an entity.

The purpose of this chapter is to explain the accounting treatment of property, plant and equipment. The principal issues in accounting for property, plant and equipment are the recognition of the assets; the determination of their carrying amounts and the depreciation charges to be recognised.

11.2 Nature of an asset

In chapter 3, an asset was defined as a resource that is expected to yield economic advantages for the entity in the future and will be controlled by the entity as a result of a past event.

Legal ownership is *not* the only criterion for classifying something as an asset; in the case of an item bought on hire purchase, for instance, the buyer does not become the owner before the full purchase price has been paid. Nevertheless, the item is recorded as an asset, with the corresponding liability. Similarly, although a lessee may in some cases never become the owner of the leased item, he may indeed record the item as an asset, provided the corresponding obligation is also shown.

The main function of accounting is the determination of profit. However, the generation of income requires capital expenditure in order to provide the facilities needed by an entity to operate continuously and indefinitely.

Historically, expenses that are incurred but not allocated as expenses during a period are known as *deferred expenses.* From an accounting point of view, deferred expenses represent an asset (for example, prepaid expenses). If these expenses can be recovered within a year, they are current assets, whereas, if they will be recovered over a longer period, they are non-current assets (for example, loan accounts).

This classification of assets is essential in the process of profit determination and also to show the entity's position at a specific point in time, in other words, the composition of its assets and liabilities.

Non-current assets are acquired with the purpose of *using* them to generate income. Thus, the non-current assets as such are not acquired for the purposes of *resale.* They must produce goods which in turn generate income or, stated differently, are used in the business operations.

The largest group of non-current assets is that of physically *tangible* assets such as land, buildings, machinery and vehicles. *Intangible* non-current assets include, for example, patents, copyrights, trademarks and goodwill. In addition, there are non-current financial assets, which will be explained in chapter 12.

11.3 The classification of non-current assets

11.3.1 *Tangible non-current assets*

- ☐ Land, which is not subject to depreciation or depletion through use, since no portion of it is ever consumed.
- ☐ Manufactured assets, such as buildings, machinery and vehicles, whose value decreases in the course of time as a result of usage. These assets are subject to depreciation which must be apportioned annually as an expense.
- ☐ Natural resources which are subject to depletion through use, such as mines, oil and gas wells, and plantations.

11.3.2 *Intangible non-current assets*

- ☐ Rights such as copyrights, patents, trademarks and goodwill.
- ☐ Deferred expenses and debits, such as the costs of incorporation of a company.

11.4 The historic cost price of non-current assets

The cost price of a non-current asset is calculated in terms of the cash (or equivalent money value) necessary to purchase the asset and all additional expenses that may be necessary to transform the asset into a condition and location so that it is ready for use. For this reason, all expenses relating to the acquisition of the asset and its preparation for productive use are considered to be part of the cost of the asset and are capitalised by debiting the asset account.

These expenses comprise the purchase price, including import duties and non-refundable purchase taxes after deducting trade discounts and rebates as well as legal, transport, site preparation and installation costs. Financing costs, in cases where loans are raised to acquire the assets, are generally not included.

11.4.1 *Land*

All expenses incurred in acquiring land and converting it to a condition suited to its intended use, must be regarded as the cost of the land. Therefore all costs incurred from the date of the purchase until it is ready for use form part of the cost of the land.

The cost of the land may therefore include the option cost; the purchase price; legal fees and transfer duties; the registration of servitudes; the settlement of outstanding costs (such as municipal rates) relating to the land; the cost of clearance and levelling; and any cost involved in demolishing existing structures. In short, it includes all costs incurred in acquiring possession, access and the right of disposal and in ensuring that the land is in a usable condition.

If land is purchased for the purpose of erecting a building, all costs incurred up to the commencement of excavations will be regarded as costs related to the land. Income generated by the sale of material obtained from demolitions will serve to reduce the cost price.

Example 11.1

Assume that an entity acquires premises with an existing building at a cost of R150 000, with the intention of erecting a factory on the site. According to the agreement of sale, the agent's commission of R5 000 is to be paid by the purchaser, over and above the purchase price of R150 000. Transfer and other legal costs in connection with the transaction amount to R10 000. Demolition costs will amount to R2 000, while scrap materials from the demolished building will be sold for R500. The cost of excavating the site in preparation for the erection of the new building amounts to R25 000. The entity raised a mortgage bond of R100 000 to purchase the land, with bond costs amounting to R4 000.

The cost price of the site is R166 500, which is determined as follows:

	R
Net purchase price	150 000
Add: Agent's commission	5 000
Transfer and other legal costs	10 000
Net demolition costs (R2 000 – R500)	1 500
Total cost price	166 500

The excavation costs form part of the cost price of the building which is to be erected and not of the site. The bond charges are a financing cost which is also not included in the cost price of the land.

If land is purchased with the intention of using it for a specific purpose at a later date, then all costs incurred during the holding period form part of the cost price and must be capitalised.

Costs involved in landscaping the property, ie the layout of gardens and paths, are capital costs which form part of the cost of the land. However, the initial outlay must be distinguished from maintenance, which will be written off as an expense.

If several properties are bought at the same time for a single amount, the reasonable market value of each property is used as the basis for calculating the proportional allocation of the purchase price to each piece of land.

Land may be acquired without paying cash for it: it may be exchanged for another asset, purchased by the issuing of shares or inherited. In such cases, the reasonable market value of the other asset is taken as the purchase price of the land. Inherited land must be recorded at reasonable market value, the credit being taken to a non-distributable reserve account.

11.4.2 *Manufactured and self-erected assets*

The cost price of non-current assets constructed by the entity itself or purchased in final form, such as buildings, machinery, equipment and vehicles, also includes all costs involved in converting the asset into a condition suited to its intended purpose.

The determination of the cost price of a building is influenced by the way in which it is acquired. If an existing building is purchased, the cost price, apart from the purchase price, will include all repair costs incurred initially to convert the building into a usable condition.

If a building is still to be erected, the entity may either engage a building contractor or undertake to do the construction itself. If a building contractor is used, the cost price will include the contract price, plus all necessary additional expenses incurred to make

the building suitable for the entity's needs. If the entity erects the building itself, the cost price will include such expenses as labour, materials, professional fees payable to architects and quantity surveyors and insurance payable during the erection period.

The cost price of machinery, equipment and vehicles includes all expenses relating to the acquisition and preparation of these assets for use. The expenses include, amongst others, the following:

- invoice price (less discount);
- transport and clearance costs; and
- installation costs.

Example 11.2

Assume that an entity purchases a vehicle for a cash price of R150 000 and receives a cash discount of 10% on the purchase price. It then installs an air conditioner at a cost of R6 000 and a sound system to the value of R4 000. The total cost price of the vehicle will be calculated as follows:

	R
Net purchase price R[150 000 – (10% × 150 000)]	135 000
Add: Air conditioner	6 000
Add: Sound system	4 000
Total purchase price	145 000

11.4.3 *Natural resources*

Natural resources may be divided into three groups:

- Mineral resources which may be exploited by means of mining.
- Liquid resources, such as oil and gas, which may be exploited through boreholes.
- Harvested products such as food crops, orchards, fisheries and plantations. This category is more agricultural in nature and differs from the exploitable resources in that the agriculturalist has to make an input before he can expect a return. Thus, harvests are not purely natural resources.

The exploitation of natural resources involves three steps:

- Prospecting for, finding and acquiring an exploitable property. Prospecting costs and the cost of testing samples form part of the cost price of the natural resource. If the property is purchased, the purchase price will also form part of the cost of the resource. If the property is leased, the periodic lease payments usually form part of the operating costs, although they may be discounted and capitalised at current value.
- The development of the property. Once the resource has been found and the right of disposal has been obtained, the property must first be developed before exploitation becomes possible. The development may entail the sinking of boreholes, shafts and tunnels; all these development costs form part of the cost of the resource. Obviously, the development costs will also include the costs of machinery and equipment that has to be installed.
- The actual exploitation costs are, however, regarded as *operating expenses* which do *not* form part of the capital costs.

11.4.4 *Intangible assets*

As has already been indicated, this type of asset is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods and services and therefore does not have a physical nature; rather, it is classified as an asset because of the rights or advantages it has for the owner. The value of this type of asset is often determined by general business factors, as the asset may have an uncertain existence. Examples are patents, copyrights, trademarks and trade names.

If the asset is purchased, the purchase price and all costs relating to the purchase, such as legal costs, constitute the cost price of the asset.

Sometimes the asset is not purchased from an outsider, but the entity itself undertakes the development of the project. In this case, the cost is more difficult to determine and all costs incurred during the development must be recorded accurately. However, if the project should prove to be useless and unlikely to produce an asset, the cost should be written off as a loss.

It may even be impossible to determine the cost of an intangible asset. In this case, the recommended procedure is to record the asset at a nominal value of R1, to have it valued, or to quantify the advantages arising from the asset and then to capitalise it.

See chapter 12 for a further discussion of assets of this nature.

11.5 The treatment of costs incurred after the initial acquisition of the assets

The process whereby an expense is debited to an asset account is described as capitalisation of the expense, which is then known as a capital expense. All expenses related to the acquisition of an asset should be capitalised. However, this is not necessary if the expenses were incurred after the initial acquisition of the asset. Some of these expenses can rightly be treated as operating expenses.

The following are examples of expenses incurred in respect of an asset after its initial acquisition:

- Continuous maintenance costs incurred in keeping an asset functioning in good condition and maintaining its productive capacity.
- Costs related to the periodic, large-scale repairs to an asset.

If the benefit derived from some of these expenses also extends to future financial periods, it should be capitalised. However, if it only benefits the period in which it was incurred, it should be treated as an operating expense for that specific period.

If related income and expenses are to be matched accurately – an essential prerequisite for effective profit determination – then it is important to distinguish between capital and operating expenses. If capital expenses are erroneously treated as operating expenses, both the entity's assets and profit for the current year will be understated.

Furthermore, the same error will also influence future financial periods, resulting in the profit being overstated while the assets will remain understated. Conversely, the erroneous capitalisation of operating expenses will have the opposite effect.

It is therefore essential that an entity establishes a realistic policy for differentiating between capital and operating expenses and that it applies the policy consistently. The following factors must be taken into consideration in the formulation of such a policy.

- ☐ **Probable useful lifespan of the item purchased in relation to the normal financial period of the entity**

If the item is expected to have a useful lifespan longer than the current financial period and it is probable that future economic benefits associated with the asset will flow to the entity, and the cost of the asset to the entity can be measured reliably, the asset should be capitalised and brought into account as an expense on an acceptable and appropriate basis during each financial period in which it is used (see depreciation procedures in paragraph 11.7).

- ☐ **Material and repetitive nature of the expense**

Items with a relatively short lifespan and relatively low value may be treated as operating expenses without having a material influence on the profits of the concern, particularly if such items are purchased regularly.

- ☐ **Influence of the expense on the asset's estimated useful lifespan**

If an expense prolongs the useful lifespan of an asset beyond initial expectations, it should be capitalised. If this is not the case, it should be treated as an operating expense.

One of the factors determining the estimated useful lifespan of an asset is the maintenance policy followed with regard to the asset during its lifespan. Accordingly, maintenance costs incurred by the entity during the normal course of business are regarded as operating expenses, while the cost of large-scale repairs to prolong the lifespan of the asset are capitalised.

11.6 Recording the purchase of a non-current asset

When an asset is purchased, the appropriate asset account is debited with the cost price. General ledger accounts are kept for each separate type of asset, such as land, buildings and machinery. These accounts fulfil a control function which should be supported by *asset registers*, containing full particulars of all the items in each asset account kept in the general ledger.

11.7 Decreases in value and depreciation of non-current assets

11.7.1 *Word definitions*

At the beginning of the book, it was shown that most non-current assets used in an entity are subject to reductions in value. This is caused by a variety of factors, such as changes in the open market values.

Depreciation, on the other hand, is the systematic allocation of the depreciable amount of an asset over its useful life.

The *depreciable amount* is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value. The residual value is that value of the asset which may remain at the end of its useful life.

The *useful life* of an asset is either

- ☐ the period of time over which an asset is expected to be used by the entity; or
- ☐ the number of production or similar units expected to be obtained from the asset by the entity.

A *depreciable asset* is an asset which

- ☐ is expected to be used during more than one accounting period;
- ☐ has a limited *useful life* (the period over which a depreciable asset is expected to be used by an entity); and
- ☐ is held by an entity for use in the production or supply of goods or services, for rental to others or for administrative purposes.

11.7.2 *The necessity of depreciation*

A characteristic of any depreciable asset is that it is held for the purpose of earning income and not for the purpose of resale in the normal course of business. The amount at which it is shown on the statement of financial position is normally the historical cost *less amounts provided for depreciation.* This amount is known as the book value or carrying amount of the non-current asset.

The recording of non-current assets and the related periodic writing off of depreciation are based on the concept of an accounting entity as a going concern with an indefinite lifespan. Depreciation is the process of systematically distributing the cost price of a non-current asset over its useful life to ensure that the cost of using the asset is suitably paired or matched with the income generated by that use.

From this point of view, non-current assets merely represent deferred expenses and the depreciation process is simply a method of allocating the deferred expenses to the relevant financial periods. Accordingly, the emphasis of the depreciation process is on the systematic and fair allocation of the expenses relating to the use of the non-current assets.

The depreciation write-off (or provision) is simply the process by which that portion of the total cost price of an asset considered the depreciation amount for the period is allocated to the period under discussion.

11.7.3 *The determination of depreciation*

It is not always easy to determine what portion of the depreciable amount of a non-current asset should be allocated to any specific period, since a variety of factors have to be taken into consideration. The following are the significant factors:

- ☐ *Cost price*: As was stated earlier in this chapter, this is the net purchase price, plus any additional expenses necessary to prepare an asset for use.
- ☐ *Useful life of the asset*: As the exact life of an asset cannot be determined in advance, it must be estimated. This requires judgement, which is usually based on

experience with similar assets. The present condition of the asset as well as the entity's policy regarding the replacement of assets will also be determining factors.

The useful life of an asset can be measured in terms of *time* (duration of the asset's estimated use), *production* (the total number of units an asset is expected to produce), *service* (for example the distance travelled) or some other applicable criterion.

It is usual to distinguish between the technical and economic life of a non-current asset. The technical life is determined by factors relevant to the particular asset and comes to an end when the asset can no longer provide the service for which it was acquired. The economic life is determined by external factors such as technological advancements (for instance, modernised production methods and changing trends) and will terminate when, for example, the asset's capacity becomes uneconomical because of technological advancements.

As a result of rapid technological development, the economic life of an asset is often shorter than its technical life. However, an asset whose economic life has expired may be used for other purposes. The shorter of either the economic or the technical life of an asset is regarded as the life of that asset. For our purposes "life" will from now on be referred to as a comprehensive concept and no distinction will be made between technical and economic life.

It should be clear by now that the following factors should be taken into consideration in estimating the useful life of an asset:

- expected physical wear-and-tear;
- technological obsolescence; and
- legal, contractual or other restrictions on the use of the asset. These include the due dates of applicable lease contracts.

The useful life of important depreciable assets should be *reviewed* regularly. Depreciation rates for current and future periods should be adjusted if the reviewed estimated useful life differs materially from the previous estimate.

☐ *Estimated residual value*: The residual value is the amount that the entity expects to obtain for an asset at the end of its useful life, after deducting the expected costs of disposal.

As was explained in paragraph 11.7.1, the depreciable amount of an asset is its historical cost (or another value which has replaced historical cost) less the scrap value of the asset.

The residual value of an asset is often insignificant and, when it is, should be ignored in the determination of the depreciable amount. However, if the residual value is expected to be material, it should be estimated at the date of acquisition of the asset.

Of all the factors that play a role, the cost price is the only one that can be determined with certainty. All other factors must be estimated by means of careful judgement, based on experience, so that the depreciation determined is as realistic as possible.

11.7.4 *Recording of depreciation*

That portion of any depreciable amount of an asset that is apportioned as a cost during a specific period is debited to a *depreciation expense account.* (At the end of the financial period, the depreciation expense account is closed off to the profit or loss account by means of a general journal entry.)

To balance the double entry, the asset account should accordingly be credited with the same amount. However, in practice, the asset account as such is not credited with the periodic depreciation, because a separate account, the *accumulated depreciation account*, is opened and the depreciation credited to it. Thus there are two relevant accounts in the general ledger, namely the asset account in which the cost price of the asset remains unchanged as long as the asset is in the entity's possession and the accumulated depreciation account which at any given time shows the total depreciation written off.

The difference between the debit balance on the asset account and the credit balance on the accumulated depreciation account is the *carrying amount* of the non-current asset, which represents that portion of the depreciable amount of the non-current asset which has not yet elapsed and therefore has not been apportioned as an expense to any period.

11.7.5 *Methods for the calculation of depreciation*

Various methods can be used to calculate periodic depreciation. Because each method may differ significantly from the others, all factors must be evaluated carefully before any specific method is selected. The most important factor is to obtain a proper match of the expenses relating to the service capacity of the particular asset with the income generated by its use.

It is essential to apply the method of depreciation *consistently* to ensure comparability of the results of the operations of the entity from one period to another, unless a change in circumstances justifies a change in method.

The following are the most generally used methods.

11.7.5.1 The straight-line method

According to this method, depreciation is regarded as a function of time. Equal portions of the amount subject to depreciation are allocated to each accounting period over the total life of the asset. This method may be illustrated as follows:

Example 11.3

Assume that on 1 January 20.1 the cost price of a certain machine amounts to R16 700 and that the useful life of the asset is estimated to be four years. The estimated trade-in value at the end of the fourth year will be R700. Then the annual depreciation will be

$$\frac{16\,700 - 700}{4} = \text{R4 000 per annum}$$

From this data, the following asset and depreciation schedule may be prepared for the four years:

ASSET AND DEPRECIATION SCHEDULE: STRAIGHT-LINE METHOD				
Date of purchase	**Cost price** **R**	**Annual depreciation** **R**	**Accumulated depreciation** **R**	**Net carrying amount** **R**
1 Jan 20.1	16 700	–	–	16 700
End year 1	16 700	4 000	4 000	12 700
End year 2	16 700	4 000	8 000	8 700
End year 3	16 700	4 000	12 000	4 700
End year 4	16 700	4 000	16 000	700
TOTAL DEPRECIATION:		R16 000		

The table shows that when the straight-line method is used

- the annual provision for depreciation remains the same;
- the accumulated depreciation is increased annually by equal amounts; and
- the carrying amount is decreased annually by the same amount until the estimated residual value is reached at the end of the last year of the asset's life.

11.7.5.2 Diminishing-balance method

This method is also known as the *accelerated method* of calculating depreciation and is based on the premise that the decrease in an asset's value is greater in the first years of use than in later years. This method usually results in a consistently decreasing depreciation write-off from year to year and is therefore known as the *diminishing-balance method.*

- **The fixed percentage on the diminishing-balance method**

When this method is used, a *fixed percentage* of the *carrying amount* (that is, cost less accumulated depreciation) is written off in each accounting period. The fixed percentage is selected so that the cost of the asset is almost totally written off during its life. In Example 11.3, a percentage (rate) of 25% was used automatically since the estimated life of the asset was four years. If the fixed percentage method is applied to the same data, a fixed percentage of 50% will be written off at the end of each of the consecutive years. The percentage will be calculated on the reduced opening balances at the beginning of the years in question. The asset and depreciation schedule will be as follows:

Example 11.4

ASSET AND DEPRECIATION SCHEDULE: DIMINISHING-BALANCE METHOD					
Date of purchase	**Cost price** **R**	**Calculation of depreciation** **R**	**Annual depreciation** **R**	**Accumulated depreciation** **R**	**Net carrying amount** **R**
1 Jan 20.1	16 700	–	–	–	16 700
End year 1	16 700	50% × 16 700	8 350	8 350	8 350
End year 2	16 700	50% × 8 350	4 175	12 525	4 175
End year 3	16 700	50% × 4 175	2 088	14 613	2 087
End year 4	16 700	50% × 2 087	1 043	15 656	1 044
TOTAL DEPRECIATION:			R15 656		

The journal and ledger entries for the four years will be as follows:

General journal **J 1**

Month	Day	Details	Fol	Debit R	Credit R
20.1 Dec	31	Depreciation: Machinery		8 350	
		Accumulated depreciation: Machinery			8 350
		Provision for depreciation for the year ended 31 December 20.1			
	31	Profit or loss		8 350	
		Depreciation: Machinery			8 350
		Closing entry			
20.2 Dec	31	Depreciation: Machinery		4 175	
		Accumulated depreciation: Machinery			4 175
		Provision for depreciation for the year ended 31 December 20.2			
	31	Profit or loss		4 175	
		Depreciation: Machinery			4 175
		Closing entry			
20.3 Dec	31	Depreciation: Machinery		2 088	
		Accumulated depreciation: Machinery			2 088
		Provision for depreciation for the year ended 31 December 20.3			
	31	Profit or loss		2 088	
		Depreciation: Machinery			2 088
		Closing entry			

continued

Month	Day	Details	Fol	Debit R	Credit R
20.4 Dec	31	Depreciation: Machinery		1 043	
		Accumulated depreciation: Machinery			1 043
		Provision for depreciation for the year ended 31 December 20.4			
	31	Profit or loss		1 043	
		Depreciation: Machinery			1 043
		Closing entry			

The ledger accounts will be as follows:

Dr **Machinery** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.1 Jan	1	Bank		16 700					

Dr **Accumulated depreciation: Machinery** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.1 Dec	31	Balance	c/d	8 350	20.1 Dec	31	Depreciation: Machinery		8 350
				8 350					8 350
20.2 Dec	31	Balance	c/d	12 525	20.2 Jan	1	Balance	b/d	8 350
					20.2 Dec	31	Depreciation: Machinery		4 175
				12 525					12 525
20.3 Dec	31	Balance	c/d	14 613	20.3 Jan	1	Balance	b/d	12 525
					20.3 Dec	31	Depreciation: Machinery		2 088
				14 613					14 613
20.4 Dec	31	Balance	c/d	15 656	20.4 Jan	1	Balance	b/d	14 613
					20.4 Dec	31	Depreciation: Machinery		1 043
				15 656					15 656
					20.5 Jan	1	Balance	b/d	15 656

continued

Dr **Depreciation: Machinery** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.1 Dec	31	Accumulated depreciation		8 350	20.1 Dec	31	Profit or loss		8 350
20.2 Dec	31	Accumulated depreciation		4 175	20.2 Dec	31	Profit or loss		4 175
20.3 Dec	31	Accumulated depreciation		2 088	20.3 Dec	31	Profit or loss		2 088
20.4 Dec	31	Accumulated depreciation		1 043	20.4 Dec	31	Profit or loss		1 043

11.7.5.3 Production unit method

This method is based on the premise that depreciation should be linked strictly to the use of the asset. Unlike the methods discussed above, time is not the determining factor here. The same data that was used in the previous examples are used again here to illustrate the production unit method. However, the life of the asset is expressed not in years, but in terms of the estimated number of *units* it will produce (say 40 000):

Example 11.5

$$\frac{\text{Cost price less scrap value}}{\text{Estimated number of units to be produced during the lifetime}} = \text{Depreciation per unit}$$

$$= \frac{16\ 700 - 700}{40\ 000} = \text{R0,40 per unit}$$

ASSET AND DEPRECIATION SCHEDULE: PRODUCTION UNITS METHOD						
Date of purchase	**Cost price R**	**Annual units produced**	**Depreciation per unit R**	**Annual depreciation R**	**Accumulated depreciation R**	**Net carrying amount R**
1 Jan 20.1	16 700	–	–	–	–	16 700
End year 1	16 700	10 000	0,40	4 000	4 000	12 700
End year 2	16 700	12 000	0,40	4 800	8 800	7 900
End year 3	16 700	13 000	0,40	5 200	14 000	2 700
End year 4	16 700	5 000	0,40	2 000	16 000	700
TOTAL DEPRECIATION:				R16 000		

The schedule shows the following:

- ☐ The annual provision for depreciation is linked directly to the number of units produced during that year.
- ☐ The accumulated depreciation increases in direct proportion to the number of units produced during a specific year.
- ☐ The carrying amount decreases correspondingly, in direct proportion to the number of units produced in a specific year.

Variations of the production method include hours worked (for heavy vehicles or machinery), distance travelled (for vehicles) and so forth; again time is not the determining factor. The basic premise remains the same and the asset will be written off proportionally according to the hours it has worked or the distance it has travelled.

The depreciation rate will be calculated and expressed in terms of cents per hour or cents per kilometre.

11.7.6 *Reviewing depreciation rates*

The depreciation rate applied to an asset that has been in use for some time may have been either too high or too low, as a result of, for example, an incorrect estimate of the life or scrap value of the asset. If a correction based on the new information involves a material change to the annual provision for depreciation, the rate must be revised.

11.7.7 *Depreciation on assets acquired in the course of a financial period*

Although there are several methods that could be used to calculate depreciation on assets acquired during the course of an entity's financial period, the most commonly used method is to base the calculation on the (closest) number of months that the asset was in use during the period concerned. This is illustrated by the following example:

Example 11.6

> Assume that an entity, whose financial year ends on 31 December, purchases an asset for R5 500 on 1 October. The asset's scrap value is estimated at R500 and its useful life at ten years. The annual depreciation to be written off in the next financial year is R500 (R5 000/10). In the year of purchase, however, it will amount to R500 × $^3/_{12}$ (ie for the three months from 1 October to 31 December) = R125.

11.7.8 *The treatment of land and buildings*

Depreciation is usually not provided for on real estate. However, if the value of *freehold land* has been affected by adverse circumstances, it may be necessary to make a write-off to recognise the decrease in value.

Buildings have a limited life that may be affected by technological and area changes, which may result in a reduction in their value.

11.8 Scrapping or disposal of non-current assets

In this paragraph, reference to an "asset" refers to a "non-current asset".

11.8.1 *Introduction*

If an entity wishes to dispose of an asset, it may demolish the asset, sell it outright or trade it in as partial payment on the purchase of a new asset.

Regardless of the way in which the asset is disposed of, the relevant entries must be recorded. This entails the following:

- ☐ recording the proceeds of the sale of the asset;
- ☐ updating the interim depreciation for part of the year which has elapsed (where applicable) since the end of the last financial year;
- ☐ removal of both the cost of and accumulated depreciation on the asset (that is, the carrying amount) from the books; and
- ☐ determining and recording any profit or loss resulting from the demolition or alienation of the asset.

11.8.2 *Scrapping an asset without disposal*

In the case of an asset that is no longer economically serviceable and can neither be sold nor traded in, but must simply be dismantled or disposed of as scrap, the recording procedure depends on whether the asset was, at that time, already written off in full. If this was the case, there will be no loss when the asset is scrapped. However, a loss may arise if the asset was not written off; in such cases the loss will be transferred to the profit or loss account at the end of the financial period.

☐ **If the asset has been written off entirely**

Example 11.7

An asset that was purchased for R6 000 some time ago and has already been written off entirely, is dismantled and disposed of as scrap. The scrapping will be recorded by means of the following journal entry:

General journal

Month	Day	Details	Fol	Debit R	Credit R
		Accumulated depreciation Asset *Scrapped asset written off*		6 000	 6 000

The ledger accounts will be as follows:

Dr **Asset** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Balance (cost price)	b/d	6 000			Accumulated depreciation		6 000
				6 000					6 000

continued

Dr **Accumulated depreciation** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Asset (scrapping)		6 000			Balance (total depr)		6 000

The cost price and accumulated depreciation relating to the asset are thus removed entirely from the general ledger.

☐ **If the asset has not been written off entirely**

Example 11.8

The same particulars as those in Example 11.7 are applicable, except that only R5 000 has been provided for depreciation to date. The scrapping of the asset therefore causes a loss of R1 000, the position being as follows:

	R
Original cost price of asset	6 000
Total depreciation provided	5 000
Carrying amount written off as a loss	1 000

The journal entry on scrapping of the asset is as follows:

General journal

Month	Day	Details	Fol	Debit R	Credit R
		Accumulated depreciation		5 000	
		Loss on scrapping of asset		1 000	
		Asset			6 000
		Scrapped asset written off			

The ledger accounts will be as follows:

Dr **Asset** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Balance (cost price)	b/d	6 000			Accumulated depreciation		5 000
							Loss on scrapping asset		1 000
				6 000					6 000

Dr **Accumulated depreciation** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Asset (scrapping)		5 000			Balance (total depr)	b/d	5 000

continued

Dr **Loss on scrapping of asset** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Asset		1 000			Profit or loss		1 000

11.8.3 *Sale of an asset*

The procedure for recording the sale of an asset subject to depreciation is very similar to that described above, except that the receipt of cash or another asset at the time of sale must be recorded. The asset can be sold at a profit or a loss, or without making either. If an asset is sold for *more than the carrying amount,* a profit is made. If it is sold for *less than the carrying amount*, the entity suffers a loss. A realisation account is used to determine the profit or loss on each type of asset sold.

☐ **Sale of an asset for more than the carrying amount**

Example 11.9

A motor vehicle purchased by an entity several years ago for R60 000 is sold on 31 December 20.6 for a cash price of R12 000. On that date, the accumulated depreciation amounted to R50 000.

The profit or loss on the sale of the asset is the difference between the carrying amount of the asset and the selling price received for it:

	R
Original cost price of asset	60 000
Accumulated depreciation on date of sale	50 000
Carrying amount	10 000
Selling price	12 000
Profit on sale of the asset	2 000

The entries in respect of the sale of the asset (including the cash transaction) are journalised as follows:

Month	Day	Details	Fol	Debit	Credit
				R	R
20.6 Dec	31	Bank		12 000	
		Motor vehicle realisation account			12 000
		Receipt of selling price (usually recorded in the CRJ)			
	31	Motor vehicle realisation account		60 000	
		Motor vehicle account			60 000
		Transfer of original cost price of vehicle sold to the realisation account			

continued

Month	Day	Details	Fol	Debit	Credit
				R	R
	31	Accumulated depreciation: Motor vehicle Motor vehicle realisation account *Transfer of accumulated depreciation on vehicle sold realisation account*		50 000	 50 000
	31	Motor vehicle realisation account Profit on sale of non-current asset account *Transfer of profit on sale of vehicle*		2 000	 *2 000

* This amount is eventually transferred to the profit or loss account.

The relevant ledger accounts will be as follows after the above journal entries have been posted:

Dr **Motor vehicle** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6 Dec	31	Balance (cost price)	b/d	60 000	20.6 Dec	31	Motor vehicle realisation account		60 000
				60 000					60 000

Dr **Accumulated depreciation: Motor vehicle** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6 Dec	31	Motor vehicle realisation account		50 000	20.6 Dec	31	Balance (total depreciation	b/d	50 000
				50 000					50 000

Dr **Motor vehicle realisation** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6 Dec	31	Motor vehicle: cost price		60 000	20.6 Dec	31	Bank (selling price)		12 000
		Profit on sale of non-current asset		2 000			Accumulated depreciation: Motor vehicle		50 000
				62 000					62 000

Dr **Profit on sale of non-current asset** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
					20.6 Dec	31	Motor vehicle realisation account		2 000

☐ Sale of an asset for less than the carrying amount

Example 11.10

An entity owns ten delivery vehicles, all bought on 1 March 20.2 at R80 000 each. The annual depreciation provided is 20% per annum on the original cost price. On 28 February 20.5, one of the vehicles is sold for R25 000 cash.

The following journal entries are made:

General journal

Month	Day	Details	Fol	Debit	Credit
				R	**R**
20.5 Feb	28	Bank		25 000	
		Vehicle realisation account			25 000
		Receipt of selling price (usually recorded in the CRJ)			
		Vehicle realisation account		80 000	
		Delivery vehicles account			80 000
		Transfer of cost price of delivery vehicle sold at 28 February 20.5			
		Accumulated depreciation: Delivery vehicles		48 000	
		Vehicle realisation account			48 000
		Transfer of accumulated depreciation to 28 February 20.5 on vehicle sold (refer calculation 2)			
		Loss on sale of non-current assets		7 000	
		Vehicle realisation account			7 000
		Transfer of loss on vehicle sold (refer calculation 3)			

Calculations:

(1) The total accumulated depreciation on ten delivery vehicles on 28 February 20.5 is calculated as follows:

20% per annum for three years on R80 000 (cost price) × 10 (vehicles)	R480 000

(2) Accumulated depreciation on one vehicle ($^1/_{10}$ × R480 000) — R 48 000

(3) Loss on sale

Cost price of vehicle	R80 000
Accumulated depreciation to date of sale	R48 000
Carrying amount	R32 000
Selling price	R25 000
Loss on sale	R7 000

The relevant ledger accounts will be as follows:

Dr **Delivery vehicles** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Mar	1	Balance [10 vehicles @ R80 000 (each)]	b/d	800 000	20.5 Feb	28	Vehicle realisation account		80 000
							Balance	c/d	720 000
				800 000					800 000
20.6 Mar	1	Balance	b/d	720 000					

Dr **Accumulated depreciation: Delivery vehicles** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Feb	28	Vehicle realisation account		48 000	20.5 Mar	1	Balance	b/d	480 000
		Balance	c/d	432 000					
				480 000					480 000
					20.6 Mar	1	Balance	b/d	432 000

Dr **Vehicle realisation** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.5 Feb	28	Delivery vehicles (cost price)		80 000	20.5 Feb	28	Bank		25 000
							Accumulated depreciation		48 000
							Loss on sale of asset		7 000
				80 000					80 000

11.8.4 *Trading-in of assets*

It is general practice to trade in an old asset when acquiring a new one (usually of the same type). The trade-in value allowed by the seller is deducted from the selling price of the new asset and the purchaser pays, or undertakes to pay, the balance owing. As with the sale of an asset, trading-in an old asset can give rise to either a profit or a loss, depending on whether the trade-in value is higher or lower than the carrying amount.

☐ **Trading-in an asset for more than the carrying amount**

Example 11.11

A new machine (ACN) is purchased for R20 000. An old machine (CNA), which cost R10 000 and on which depreciation amounting to R8 000 has been provided for, is traded in on the new machine. A trade-in value of R2 500 is received and the balance of the purchase price of the new machine is paid in cash.

The transactions are recorded by means of the following journal entries:

General journal

Month	Day	Details	Fol	Debit	Credit
				R	R
		Machinery		20 000	
		Creditor			20 000
		New machine ACN purchased			
		Machinery realisation account		10 000	
		Machinery account			10 000
		Transfer of original cost price of machine sold to the realisation account			
		Accumulated depreciation: Machinery		8 000	
		Machinery realisation account			8 000
		Transfer of accumulated depreciation on machinery sold to the realisation account			
		Creditor		17 500	
		Bank			17 500
		Settlement of purchase price (usually recorded in the CPJ)			
		Creditor		2 500	
		Machinery realisation account			2 500
		Trading-in of machine CNA			
		Machinery realisation account		500	
		Profit on trade-in of non-current asset			500
		Transfer of profit on trade-in of machine CNA			

The relevant ledger accounts will be as follows after the above journal entries have been posted:

Dr Machine CNA Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Balance	b/d	10 000			Machinery realisation account		10 000
				10 000					10 000

Dr Accumulated depreciation: Machine CNA Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Machinery realisation account		8 000			Balance	b/d	8 000
				8 000					8 000

continued

Dr — Machinery realisation — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Machine CNA (cost)		10 000			Accumulated depreciation: Machine		8 000
		Profit on sale of non-current asset		500			Creditor		2 500
				10 500					10 500

Dr — Creditor — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Machinery realisation account		2 500			Machine ACN		20 000
		Bank		17 500					
				20 000					20 000

Dr — Machine ACN — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
		Creditor		20 000					

Dr — Bank — Cr

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
							Creditor		17 500

When an asset is traded in for less than its carrying amount, basically the same entries are made. The only difference is that the trade-in results in a loss, not a profit.

11.9 Depreciation: Managerial and other considerations

11.9.1 *Choice of depreciation method*

The decision about which depreciation method(s) an entity should adopt is important, since the provision for depreciation exercises a significant influence on the determination of realistic profit figures.

The *straight-line method* is simple to apply and is satisfactory when assets are used consistently. However, the following objections are raised against this method:

- A fixed amount is debited against income as depreciation, regardless of fluctuations in the volume of production or actual usage of the asset.
- Repair costs generally increase as assets age and the annual amount debited against income for repairs plus depreciation becomes steadily larger.

The production unit method, which provides for depreciation in direct proportion to production or usage of the asset, is preferable in cases where the decrease in the value of the asset is principally due to usage.

The *diminishing-balance method* is based on the assumption that an asset provides more service during the first few years of its life and that the depreciation provided according to this method results in a more equitable distribution of income and expenditure. This method is also used to counteract the second disadvantage listed above, namely that of rising repair costs in later years. Increased maintenance costs are partially counteracted by calculating the annual depreciation on a decreasing balance, the end result being a more proportional debit in respect of expenses.

Every entity will have to select the method most suited to its own particular circumstances.

11.9.2 *Depreciation and income tax*

The state may grant special *tax incentives* in respect of *investment* in production facilities. Thus, when calculating taxable income, entrepreneurs have the opportunity to claim an amount that exceeds the provision for depreciation in some years, especially during the first year of the investment, as wear-and-tear. SARS uses the term “wear-and-tear” instead of depreciation.

From an accounting point of view, however, the principles outlined in this chapter regarding the determination of profit must still be applied, regardless of how taxable income is determined. As was stated, the entity must choose a fair and reasonable depreciation method that is suited to its own particular circumstances and should not adapt the method to accommodate tax considerations.

11.10 Internal control over non-current assets

The basic components of an effective system of control over current assets, as discussed previously, by and large also apply to non-current assets. The most important features are outlined below.

- Proper control must be exercised over the acquisition and, wherever necessary, sale of non-current assets. Control over non-current assets begins when the acquisition of a particular asset is considered. First, a proper *system of authorisation* must exist: management must give written approval for the proposed investment and a specific amount must be budgeted for each asset.

  Since the decision to purchase a new asset or to replace an existing one will have a long-term effect on the adaptability and earning capacity of an entity, careful consideration must be given to the income that may be generated by the investment in the asset and to related costs. These decisions are usually known *as capital budgeting decisions* and, amongst others, include a consideration of the project’s return on capital. If the investment can provide a satisfactory profit, the project will probably be approved.

  Similarly, management’s written approval must be obtained for the sale of any asset.

- The person or persons who *order(s)* the asset must have full authority to do so. All orders must be meticulously controlled and all goods received should be carefully checked against the relevant orders. Similarly, the sale of any asset must be handled by a properly authorised official, who should carry out the decision to dispose of the asset according to instructions.

☐ The relevant *legal documents*, for example deeds, investment certificates, sales contracts and other proofs of ownership, should be *stored* safely.

☐ All assets must be properly accounted for by means of control accounts, supported by appropriate asset registers. In other words, the general ledger will have a control account for each type of asset, while particulars of each asset are detailed in the asset register. For example, separate control accounts will be kept in the ledger for machinery and equipment, furniture and motor vehicles. In addition, separate accounts are kept showing the accumulated depreciation on each of these items. An asset register will also be kept for each type of asset.

  The asset register should contain particulars of the purchase price, maintenance, and depreciation of and repairs to, as well as a complete description of, the asset.

Example 11.12 shows the entries made in an asset register.

Example 11.12

Assume that an entity has only two types of machines, namely an X and a Y type, and that the following particulars apply to the machines:

Date		Type X	Type Y
		R	R
20.3 Mar 11	Purchases	4 000	
20.4 Mar 11	Purchases		6 000
20.4 Feb 28	Depreciation provided	400	
20.5 Feb 28	Depreciation provided	400	600
20.6 Feb 28	Depreciation provided	400	600

The relevant ledger accounts on 1 March 20.6 will be as follows:

Dr **Machinery** **B20** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Mar	1	Bank		4 000	20.6 Feb	28	Balance	c/d	10 000
20.4 Mar	1	Bank		6 000					
				10 000					10 000
20.6 Mar	1	Balance	b/d	10 000					

continued

Dr **Accumulated depreciation: Machinery** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6 Feb	28	Balance	c/d	2 400	20.4 Feb	28	Depreciation		400
					20.5 Feb	28	Depreciation		1 000
					20.6 Feb	28	Depreciation		1 000
				2 400					2 400
					20.6 Mar	1	Balance	b/d	2 400

The asset register should contain the following information:

ASSET REGISTER AND DEPRECIATION REPORT

Folio 1

Item: Machine type X
Identification number: X43
Estimated life: 10 years
Depreciation per annum: R400

General ledger account: Machinery (a/c B20)
Purchased from: X Manufacturers Limited
Estimated scrap value: Rnil

Date	Details	Fol	Asset record			Depreciation record		
			Debit	Credit	Balance	Debit	Credit	Balance
			R	R	R	R	R	R
20.3 Mar 1	Purchased (cheque no 709)	C30	4 000		4 000			
20.4 Feb 28	Provision for depreciation: 20.3/4	J10					400	400
20.5 Feb 28	Provisions for depreciation: 20.4/5	J20					400	800
20.6 Feb 28	Provisions for depreciation: 20.5/6	J28					400	1 200

ASSET REGISTER AND DEPRECIATION REPORT

Folio 2

Item: Machine type Y
Identification number: X77
Estimated life: 10 years
Depreciation per annum: R600

General ledger account: Machinery (a/c B20)
Purchased from: R Engineers Limited
Estimated scrap value: Rnil

Date	Details	Fol	Asset record			Depreciation record		
			Debit	Credit	Balance	Debit	Credit	Balance
			R	R	R	R	R	R
20.4 Mar 1	Purchased (cheque no 919)	C44	6 000		6 000			
20.5 Feb 28	Provision for depreciation: 20.4/5	J20					600	600
20.6 Feb 28	Provisions for depreciation: 20.5/6	J28					600	1 200

- ☐ Assets must be comprehensively *insured* and the insurance policy should be reviewed regularly.
- ☐ A stock count of non-current assets should be carried out regularly. The results of the physical count must be compared with and checked against the records.
- ☐ Where possible, non-current assets should have an *identification mark* such as an asset number and must be properly supervised, stored and maintained.

11.11 The disclosure of property, plant and equipment in the financial statements

The financial statements should disclose for each class of property, plant and equipment

- ☐ the measurement bases used for determining the gross carrying amount. When more than one basis has been used, the gross carrying amount for that basis in each category should be disclosed;
- ☐ the depreciation methods used;
- ☐ the useful lives or the depreciation rates used;
- ☐ the gross carrying amount and the accumulated depreciation (aggregate with accumulated impairment losses) at the beginning and end of the period; and
- ☐ a reconciliation of the carrying amount at the beginning and end of the period, showing the following:
  - additions;
  - disposals;

- acquisitions through business combinations;
- increases or decreases in value resulting from revaluations;
- impairment losses recognised on the statement of profit or loss and other comprehensive income during the period;
- impairment losses reversed on the statement of profit or loss and other comprehensive income during the period;
- depreciation;
- the net exchange differences arising on the translation of the financial statements of a foreign entity; and
- other movements.

The financial statements should also disclose

☐ the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

☐ the accounting policy for the estimated costs of restoring the site of items of property, plant or equipment;

☐ the amount of expenditures on account of property, plant and equipment in the course of construction; and

☐ the amount of commitments for the acquisition of property, plant and equipment.

Example 11.13

The following is an example of the disclosure of property, plant and equipment in the financial statements.

The register of non-current assets of Miem Trading on 1 July 20.4 is as follows:

	R
Land and buildings:	
Cost	150 000
Vehicles:	
Cost	60 000
Accumulated depreciation	31 000
Machinery:	
Cost	33 000
Accumulated depreciation	10 000
Furniture	
Cost	22 000
Accumulated depreciation	8 000

The following rates and methods of depreciation apply:

Land and buildings	—	no depreciation
Vehicles	—	20% per annum – straight-line method
Machinery	—	20% per annum – diminishing-balance method
Furniture	—	10% per annum – straight-line method

(1) Erf no. 7, Miemville, with buildings, was bought in 20.0.

(2) On 31 December 20.4, a delivery vehicle with an original cost of R18 000 was sold for R7 500. On 1 July 20.4, the accumulated depreciation of the vehicle amounted to R11 000.

(3) On 31 January 20.5, a new machine with a cost price of R30 000 was purchased.

(4) No purchases or sales of non-current assets were made in the previous year.

Solution

The property, plant and equipment will be disclosed as follows on 30 June 20.5:

MIEM TRADING
Statement of financial position as at 30 June 20.5

ASSETS	**Notes**	**20.5** **R**	**20.4** **R**
Non-current assets	1.2 & 6	xxx xxx	xxx xxx
Property, plant and equipment		221 300	216 000
Other financial assets		xxx xxx	xxx xxx

MIEM TRADING
Notes for the year ended 30 June 20.5

1. Basis of presentation

   The annual financial statements have been prepared in accordance with generally accepted accounting practices appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.

2. Summary of significant accounting policies

   The annual financial statements incorporate the following significant accounting policies which are consistent with those applied in previous years, except where otherwise stated:

   2.1 Property, plant and equipment

   Property, plant and equipment is initially recognised at cost price. No depreciation is written off on land and buildings. Vehicles, machinery and furniture are subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses.

   Depreciation on vehicles, machinery and furniture is written off at a rate deemed to be sufficient to reduce the carrying amounts of the assets over their estimated useful life to their estimated residual values. The deprecation rates are as follows:

   Vehicles – 20% per annum on the straight-line method;
   Machinery – 20% per annum on the diminishing-balance method and
   Furniture – 10% on the straight-line method.

   Depreciation is charged to profit or loss for the period. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in the profit or loss for the period.

3. Property, plant and equipment

	Land and buildings R	Vehicles R	Machinery R	Furniture R	Total R
Carrying amount: 1 Jul 20.4	150 000	29 000	23 000	14 000	216 000
Cost	150 000	60 000	33 000	22 000	265 000
Accumulated depreciation	–	(31 000)	(10 000)	(8 000)	(49 000)
Additions			30 000		30 000
Disposals		(5 200)			(5 200)
Depreciation for the year		(10 200)	(7 100)	(2 200)	(19 500)
Carrying amount: 30 Jun 20.5	150 000	13 600	45 900	11 800	221 300
Cost	150 000	42 000	63 000	22 000	277 000
Accumulated depreciation	–	(28 400)	(17 100)	(10 200)	(55 700)

Land and buildings consist of Erf 7, Miemville, with buildings, purchased for R150 000 in 20.0

Calculations:

Depreciation:			R	R
Furniture: R22 000 × 10%		=	2 200	
Total				2 200
Vehicles:	Old R(60 000 – 18 000) × 20%	=	8 400	
	Sold: R18 000 × 20% × 6/12	=	1 800	
Total				10 200
Machinery:	Old R(33 000 – 10 000) × 20%	=	4 600	
	New R(30 000 – 0) × 20% × 5/12	=	2 500	
Total				7 100
Disposal of vehicle:				
R18 000 – (11 000 + 1 800)		=	5 200	

11.12 Summary

Non-current assets are acquired with the purpose of using them to generate income. Thus, the non-current assets as such are not acquired for the purpose of resale. They must produce goods which in turn generate income or, stated differently, are used in the business operations. Non-current assets may be classified as tangible or intangible.

All expenses relating to the acquisition of the asset and its preparation for productive use are considered to be part of the cost of the asset. The treatment of costs incurred after the initial acquisition of the asset, the recording of those costs, as well as the decrease in value and depreciation of non-current assets and the disclosure of property, plant and equipment have also been dealt with in this chapter.

CHAPTER 12

Other non-current assets and financial assets

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12.1 Introduction

Study objectives

After studying this chapter you should be able to

- ☐ explain and account for other non-current assets in an accounting context;
- ☐ explain and know what a financial instrument is; and
- ☐ explain and account for financial assets in an accounting context.

The purpose of this chapter is to explain other non-current assets and financial assets and how they are dealt with in an accounting context. Most of the assets whose accounting procedures have been discussed thus far have been of a material nature and therefore tangible. Land, buildings, equipment and cash are examples of assets that are tangible. However, it is not a requirement that an element of a financial statement be tangible before it may be deemed an asset. Any item that has the characteristics of an asset is included on the statement of financial position if it satisfies the criteria for recognition as an asset.

The characteristics of all assets are that they must be under the control of the entity, have originated from occurrences in the past and hold future economic benefits for the entity. An entity that has built up an excellent reputation for outstanding workmanship and superb service will probably be able to demonstrate that this reputation has all the characteristics of an asset. Whether it should be included as an asset on the statement of financial position will depend on whether it satisfies the criteria for recognition as an asset. It will often be concluded that it is difficult to measure this reputation and that it is therefore not possible to give recognition to it on the statement of financial position. If, however, it has been acquired for a particular amount, there is no reason why it should not be reflected as an asset. It usually appears as “goodwill” on the statement of financial position.

Goodwill is, however, only one example of the assets that are known as “intangible assets”. Development costs that are incurred during the period in which a new product is being developed can also qualify as an asset. The same applies to a well-known trade name: consider the well-known brands of cold drink that are familiar to people across the world and bring in millions of rands for their manufacturers.

12.2 Intangible assets

Intangible assets are identifiable, non-monetary and lack physical substance. Examples of intangible assets include

- ☐ brands;
- ☐ computer software;
- ☐ copyrights;
- ☐ franchises;
- ☐ licences;
- ☐ models;
- ☐ patents;
- ☐ prototypes; and
- ☐ trademarks.

An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of time or number of production or similar units constituting that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life should be amortised (depreciated) on a systematic basis over the best estimate of its useful life, while an intangible asset with an indefinite useful life is not. The accounting entry for the amortisation of an intangible asset is as follows:

Dr Amortisation

Cr Accumulated amortisation

At the end of the financial period, the amortisation account is closed off to the profit or loss account. The carrying amount of the intangible asset, which is the cost price less accumulated amortisation, is shown as other intangible assets under non-current assets on the statement of financial position.

Goodwill, on the other hand, must be tested for impairment and must be written off accordingly. Goodwill is classified separately from other intangible assets under non-current assets on the statement of financial position.

12.3 Financial instruments

A financial instrument can be defined as any contract that results in a financial asset to one entity and a financial liability or equity instrument to another entity. These three elements must be present for an item to be classified as a financial instrument.

The three elements can be defined as follows:

- A *financial asset* is any asset that is
  - cash;
  - any equity instrument of another entity;
  - a contractual right to receive cash or other financial asset from another entity;
  - an exchange of financial assets or financial liabilities with another entity under potentially favourable conditions; or
  - a contract that will or may be settled in the entity's own equity instruments.
- A *financial liability* is
  - a contractual obligation to deliver cash or other financial asset to another entity;
  - an exchange of financial assets or financial liabilities with another entity under conditions that are potentially unfavourable; or
  - settlement of a contract in the entity's own equity instruments.
- An *equity instrument* is any contract that proves to have a residual interest in the assets of an entity after all of that entity's liabilities have been deducted. If an element has the characteristics of a financial asset or a financial liability, it cannot be an equity instrument. If the entity can reacquire its own equity instruments or

deliver its own equity instruments, the element can be classified as an equity instrument. The three most common equity-type instruments are

- ordinary shares;
- preference shares/convertible preference shares; and
- convertible debentures.

12.3.1 *Categories of financial instruments*

The most recent accounting standard on financial instruments distinguishes only between financial assets and financial liabilities.

12.3.1.1 Financial assets or financial liabilities

A financial asset or financial liability at fair value[1] through profit or loss can be described as a financial asset or financial liability that is classified as held for trading or is designated by the entity upon initial recognition as at fair value through profit or loss. A financial asset or financial liability is classified as held for trading if it is acquired or incurred principally for the purpose of selling or repurchasing it in the near future. A financial asset at fair value through profit or loss is always classified as a current asset, since the entity can sell it whenever the opportunity arises.

Shares purchased in a company listed on the JSE Limited (JSE) are an example of a financial asset at fair value through profit or loss – held for trading.

According to the definition of financial assets, cash and cash equivalents are also classified as financial assets at fair value through profit or loss.

Held-to-maturity investments are financial assets with fixed or determinable payments and a fixed maturity that an entity has the positive intention and ability to hold to maturity, other than those that the entity designates upon initial recognition as at fair value through profit or loss; those that the entity designates as available for sale and those that meet the definition of loans and receivables.

An example of a held-to-maturity investment is an entity's investment in debentures with the intention and the ability to hold the debentures until maturity. Held-to-maturity investments fall outside the scope of this chapter.

Loans and receivables are financial assets with fixed or determinable payments that are not quoted in an active market, other than those assets the entity intends to sell immediately or in the near future (which assets must be classified as held for trading), those that the entity designates upon initial recognition as at fair value through profit or loss or as available for sale and those for which the holder may not recover substantially all of its initial investment other than because of credit deterioration (which assets shall be classified as available for sale).

Loans and receivables include fixed investments in financial institutions (such as banks) and loans granted. These assets are not active in the operations of the entity itself, but are possessions held outside the entity's operating sphere. Interest is usually earned on the investment or loan granted. If the money is invested for longer than 12 months, it is classified as non-current. Interest will be calculated using the simple interest rate method. (Refer to the use of interest rates as explained in paragraph 6.3.4.1.)

---

1 Fair value is defined as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction

Investments in equity instruments are those financial assets that are designated as available for sale or not classified as loans and receivables, held-to-maturity investments or financial assets at fair value through profit or loss.

Investment in shares of an unlisted company is an example of an investment in an equity instrument financial asset. Investment in unlisted companies is classified as non-current since the intention is to hold such an investment over a longer term (more than 12 months) but not until maturity.

12.3.2 *Measurement of financial assets*

The initial (cost) price and all the expenses relating to the acquisition of non-current assets form part of the cost price of non-current assets (refer to paragraph 11.4). Except for financial assets at fair value through profit or loss, the transaction costs of acquiring financial assets are also included in the initial price at which financial assets are measured. In other words, the value at which the financial asset must initially be recorded in the books of the entity consists of the cost price and transaction costs. The initial measurement of financial assets at fair value through profit or loss is at cost, excluding transaction costs.

The subsequent measurement of held-to-maturity investments, loans and receivables is done at amortised costs, while available for sale financial assets are measured at fair value. The subsequent measurement of these three categories of financial assets falls outside the scope of this chapter.

Financial assets at fair value through profit or loss are subsequently measured at fair value. Fair value, as defined earlier, is usually the current market value at which the shares trade on the JSE. If the fair value at the end of the financial period differs from the value reflected in the books, the value of the investment must be adjusted accordingly. An increase in the value of an investment is a gain, while a decrease in the value is a loss on financial assets at fair value through profit or loss.

12.4 Recording and disclosure of other financial assets

A financial asset can be either non-current or current, depending on what the entity intends to do with it. The distinction between non-current and current, as explained in paragraph 2.3.1, also applies to financial assets.

As in the case of non-current assets, the cost concept should be applied to financial assets. The cost price will include all transaction costs incurred, such as broker's fees and commission, except for financial assets at fair value through profit or loss, where transaction costs do not form part of the cost price.

Non-current assets and financial assets must be disclosed as follows on the statement of financial position and in the notes to the financial statements:

Megan Stores
Statement of financial position as at 28 February 20.5 (Extract)

	Notes	R
ASSETS		
Non-current assets		xxx xxx
Property, plant and equipment	3	xxx xxx
Goodwill		xx xxx
Other intangible assets		xx xxx
Financial assets	4	xx xxx
Current assets		xxx xxx
Inventories		xx xxx
Trade and other receivables	4	xxx xxx
Prepayments		x xxx
Other financial assets	4	xx xxx
Cash and cash equivalents	4	x xxx

Megan Stores
Notes for the year ended 28 February 20.5 (Extract)

4. Financial assets

	20.3 R
Non-current financial assets	
Loans and receivables: Fixed deposit at AZ Bank at 9% p.a. callable at .... (date).	xx xxx
Available for sale: Unlisted shares: 1 000 ordinary shares in BBC (Pty) Ltd	xx xxx
Current financial assets	
Trade and other receivables:	xx xxx
Debtors control	xx xxx
Allowance for credit losses	(x xxx)
Other financial assets	
Loans and receivables: Fixed deposit: AA Bank at 10% p.a. callable at .... (date)	xx xxx
Financial assets at fair value through profit or loss:	xx xxx
Held for trading: Listed shares: 10 000 ordinary shares in CCA Limited	xx xxx
Cash and cash equivalents:	xx xxx
Bank	xx xxx

12.4.1 *Investments in financial institutions*

The following example illustrates how transactions relating to investments in financial institutions must be recorded.

Example 12.1

On 1 March 20.1, Morney Enterprises invested R10 000 in a three-year fixed deposit account with Heidi Bank at 10% interest per annum.

On 28 February 20.2, Morney Enterprises received R1 000 interest in cash from Heidi Bank.

☐ **Recording of the initial investment**

The journal entries in the books of Morney Enterprises are as follows:

General journal

Month	Day	Details	Fol	Debit	Credit
20.1				**R**	**R**
Mar	11	Fixed deposit in Heidi Bank		10 000	
		Bank			10 000
		Invest R10 000 @ 10% in Heidi Bank			
		(usually recorded in the CPJ)			
20.2					
Feb	28	Bank		1 000	
		Interest income			1 000
		Receipt of interest of R1 000			
		(usually recorded in the CRJ)			
		Interest income		1 000	
		Profit or loss			1 000
		Closing entry			

☐ **Disclosure of the investment on the statement of financial position and notes to the financial statements**

Morney Enterprises
Statement of financial position as at 28 February 20.2 (Extract)

	Notes	R
ASSETS		
Non-current assets		xxx xxx
Property, plant and equipment	3	xxx xxx
Financial assets	4	10 000

Morney Enterprises
Notes for the year ended 28 February 20.2 (Extract)

4. Financial assets

		20.2 R
Non-current financial assets		
Loans and receivables:	Fixed deposit at Heidi Bank at 10% p.a. callable at 28 February 20.4	10 000

If Morney Enterprises does not receive the interest in cash, but capitalises (reinvests) it instead, a general journal entry like the following will be necessary:

Dr Fixed deposit in Heidi Bank (instead of Bank)
Cr Interest income

The amount shown on the statement of financial position would then be R11 000 (instead of R10 000) and the balance of the bank account would be R1 000 less. Interest calculated on the R11 000 will then be on the compound interest rate method.

12.4.2 *Investments in shares*

It often happens that one business invests money by purchasing shares in another company. Possible reasons for investing in the shares of companies are

- The purpose for the investment may be speculative. The investor's main reason for investing may be the profit he or she may gain when buying and selling shares.
- The sound growth in the value of the investment and the satisfactory return on the investment in the form of dividends. Dividends are not taxable (except under certain conditions which are beyond the scope of this textbook) and this is an additional advantage.
- When an entity wants to expand, it may decide to take over an existing company. This can be done by buying most (the majority) of the shares of a company. It is often better to take over an existing company than to start a new business. This results in the holding company and subsidiary company relationship. The holding company is the one having most (the majority) of the shares of the subsidiary company.
- Shares may be acquired in a company with the intention of diversifying operations. X Limited may be a good marketing company and Z Limited may benefit by acquiring shares in X Limited for marketing purposes.

A company that owns a sufficient number of shares in another company to ensure that it has the majority of the voting rights also holds the controlling interest in that company. The company with the controlling interest is known as the holding company and the other company as the subsidiary. Together, they form a "group" which must prepare annual group financial statements in terms of the Companies Act. The financial statements of companies fall outside the scope of this chapter.

When the extent of the investment in the shares of a company does not involve a holding and subsidiary company relationship, one usually distinguishes between two categories, namely investments in listed and unlisted shares. Listed shares are shares that are traded on a securities (stock) exchange.

12.4.2.1 Recording of an investment in shares

Investments in shares are recorded in the same way as are acquisitions of any other asset, in the ledger accounts. Shares can be bought on the JSE or in private companies. Investment in shares in a private company is classified as an investment in equity instrument that falls outside the scope of this chapter. Shares bought on the JSE are classified as financial assets at fair value through profit or loss. Since these shares can be traded at any time, they are always classified as current assets.

Example 12.2

On 1 October 20.7, Marcell CC buys 10 000 ordinary shares in Chaney Limited for R25 000 and pays R300 in broker's fees.

Marcell CC

General journal

Month	Day	Details	Fol	Debit	Credit
20.7				R	R
Oct	1	Investment in Chaney Limited		25 000	
		Investment expenses (transaction cost)		300	
		Bank			25 300
		Purchase of 10 000 shares for R25 000 plus broker's fees of R300			
		(usually recorded in the CPJ)			

12.4.2.2 The adjustment of an investment in listed companies to its fair value

The value of investments in listed companies may fluctuate during the period in which they are held as a result of market conditions. The quoted market price at statement of financial position date is the fair value of the investment. The investment must be adjusted to its fair value and reflected as such on the statement of financial position.

Example 12.2 (continued)

On 30 September 20.8, the shares in Chaney Limited traded at R2,70 per share. Marcell CC must adjust the value of the investment to its fair value for inclusion on the statement of financial position as at 30 September 20.8, ie the end of the financial year.

Marcell CC

General journal

Month	Day	Details	Fol	Debit	Credit
20.8				R	R
Sep	30	Investment in Chaney Limited		2 000	
		Gain on financial assets at fair value through profit or loss			2 000
		Adjusting the value of the investment in Chaney Limited to the fair value			

The gain on financial assets at fair value through profit or loss is shown as other income in Marcell CC's statement of comprehensive income for the year ended 30 September 20.8.

The investment in Chaney Limited is disclosed as follows on the statement of financial position:

Marcell CC
Statement of financial position as at 30 September 20.8 (Extract)

	Notes	R
ASSETS		
Non-current assets		xxx xxx
Current assets		xxx xxx
Inventories		xx xxx
Trade and other receivables	3	xxx xxx
Other financial assets	4	27 300

Marcell CC
Notes for the year ended 30 September 20.8 (Extract)

4. Financial assets

Current financial assets	**20.8** **R**
Other financial assets:	
Financial assets at fair value through profit or loss:	
Held for trading: Listed shares: 10 000 ordinary shares in Chaney Limited	27 300

Example 12.2 (continued)

On 30 September 20.9, the shares in Chaney Limited traded at R2,30 per share. Marcell CC must adjust the value of the investment to its fair value for inclusion on the statement of financial position as at 30 September 20.9, ie the end of the financial year.

Marcell CC

General journal

Month	Day	Details	Fol	Debit	Credit
20.9				R	R
Sep	30	Loss on financial assets at fair value through profit or loss		4 000	
		Investment in Chaney Limited			4 000
		Adjusting the value of the investment in Chaney Limited to R2,30 per share			

The loss on financial assets at fair value through profit or loss is shown as distribution, administrative and other expenses in Marcell CC's statement of comprehensive income for the year ended 30 September 20.9.

The investment in Chaney Limited is disclosed as follows on the statement of financial position:

Marcell CC
Statement of financial position as at 30 September 20.9 (Extract)

	Notes	R
ASSETS		
Non-current assets		xxx xxx
Current assets		xxx xxx
Inventories		xx xxx
Trade and other receivables	3	xxx xxx
Other financial assets	4	23 300

Marcell CC
Notes for the year ended 30 September 20.9 (Extract)

4. Financial assets

Current financial assets	**20.8** **R**
Other financial assets:	
Financial assets at fair value through profit or loss:	
Held for trading: Listed shares: 10 000 ordinary shares in Chaney Limited	23 300

12.5 Summary

Most of the assets whose accounting procedures have been discussed thus far have a common characteristic: they are all of a material nature and therefore tangible. The value of tangible assets such as land and buildings and equipment can easily be determined and recorded. In this chapter, it was explained that certain intangible assets such as patents, brands and trademarks can also be included as assets on the statement of financial position. Like property, plant and equipment, intangible assets must be amortised (depreciated) over their useful life, which will usually not exceed 20 years.

An entity should recognise a financial asset or a financial liability in its statement of financial position only when the entity becomes a party to the contractual provisions of the financial instrument.

CHAPTER 13

Current liabilities

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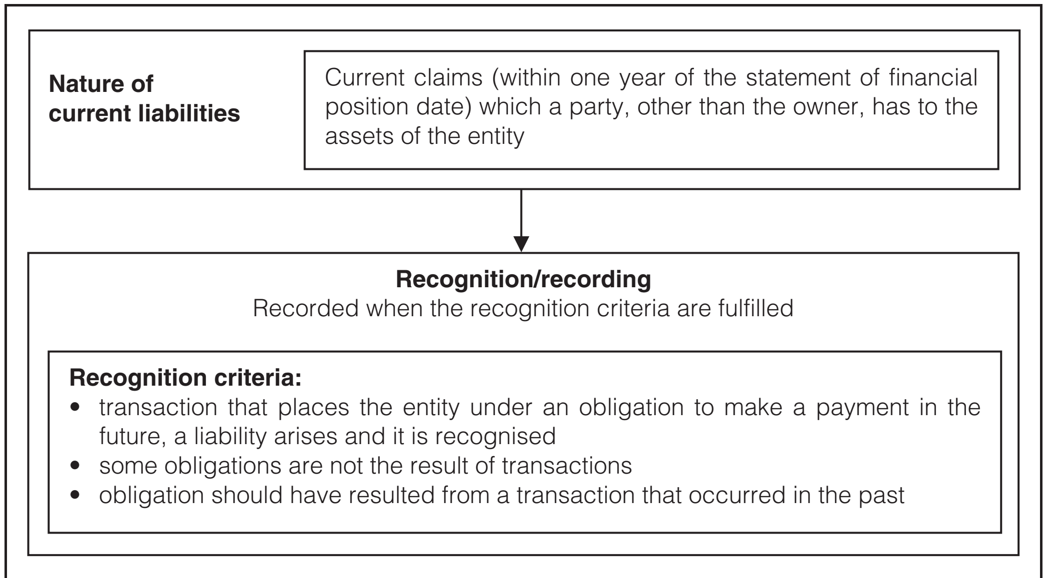
Overview of current liabilities



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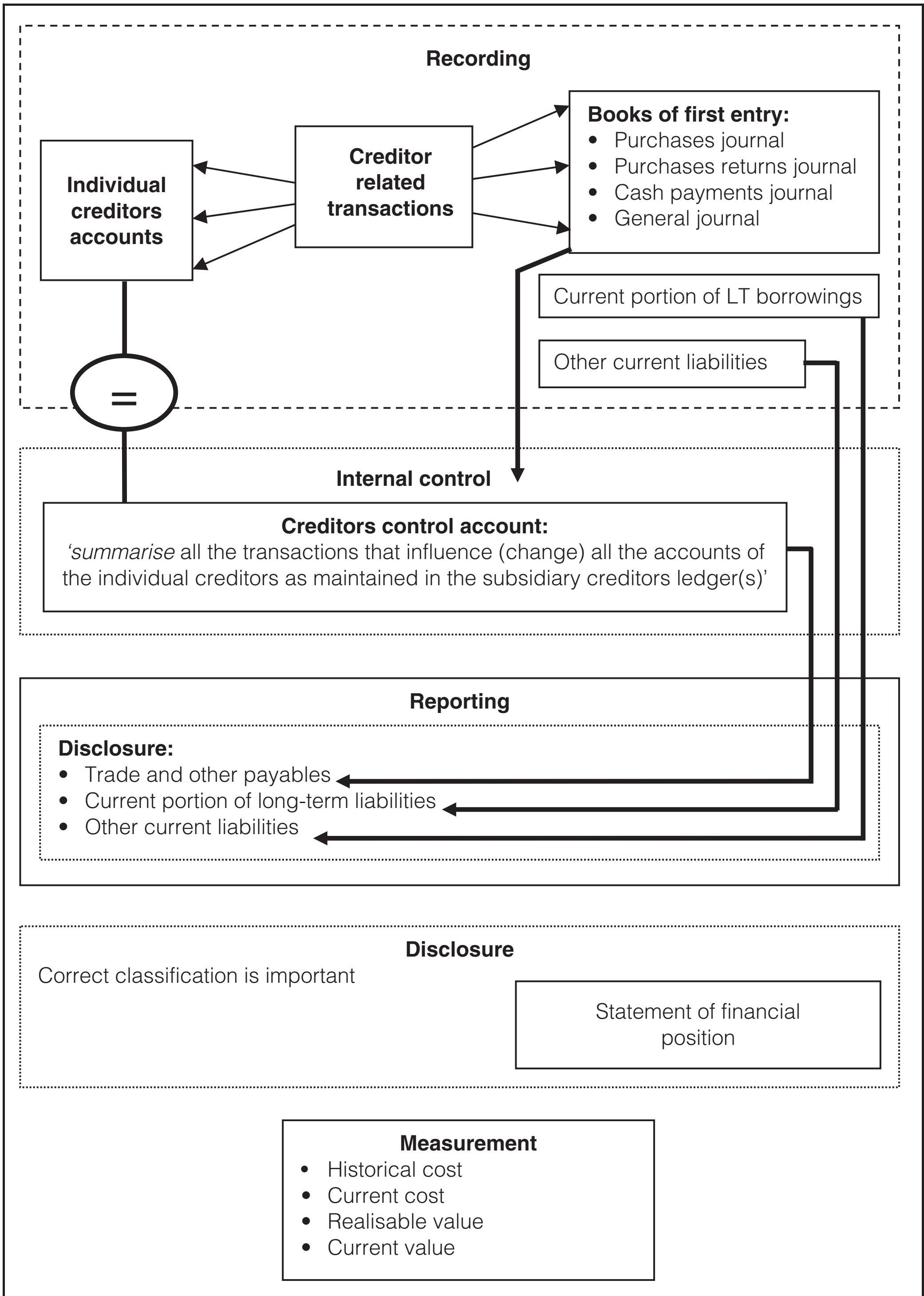
Recording
Individual creditors accounts
Creditor related transactions
Books of first entry:
• Purchases journal
• Purchases returns journal
• Cash payments journal
• General journal
Current portion of LT borrowings
Other current liabilities
=
Internal control
Creditors control account:
'summarise all the transactions that influence (change) all the accounts of the individual creditors as maintained in the subsidiary creditors ledger(s)'
Reporting
Disclosure:
• Trade and other payables
• Current portion of long-term liabilities
• Other current liabilities
Disclosure
Correct classification is important
Statement of financial position
Measurement
• Historical cost
• Current cost
• Realisable value
• Current value

13.1 Introduction

Study objectives

After studying this chapter you should be able to explain current liabilities in an accounting context.

The purpose of this chapter is to explain how current liabilities are dealt with in accounting. A liability is a claim which a party other than the owner has to the assets of the entity (discussed in paragraph 1.4.3). Like any other liability, a current liability represents a current obligation of an entity resulting from preceding events, the payment of which is expected to lead to an outflow of resources from the entity. For the obligation to be considered a current liability, the date on which it must be paid should be within one year of the statement of financial position date or within the completion of the normal operating cycle of the entity.

13.2 Recognition of current liabilities

Timing is an important factor in the recognition of liabilities. Often the failure to record an obligation in a particular accounting period is accompanied by a failure to record an appropriate expenditure for that period. Consequently, the operating result determined for the period is incorrect.

Liabilities are recorded when the recognition criteria are fulfilled. However, it is more difficult to maintain this rule than it appears to be. If a transaction that places the entity under an obligation to make a payment in the future, for example, when goods are bought on credit, occurs, a liability arises and it is recognised as such. However, some obligations are not the result of transactions. One of the most important reasons for adjustment entries at the end of an accounting period is to acknowledge obligations that have not been recorded (such as unpaid wages and interest payable). The criterion is that the obligation should have resulted from a transaction that occurred in the past.

An entity can also conclude an agreement in respect of future transactions, for example, an entity may agree to pay an employee a particular salary for the following year. Although this agreement leads to a particular commitment, it is not a liability, because it does not fit the definition, nor does it fulfil the recognition criteria for a liability. It is a future-oriented transaction.

Current liabilities often represent legal obligations, but legal enforceability is not a requirement for recognition as a liability. Such recognition always requires the sacrifice of economic benefits in the future.

13.3 Measurement of current liabilities

Liabilities are usually noted (measured) in accordance with one of the recognised bases of measurement, such as historical cost, current cost, realisable value or current value. For the purpose of this book, the basis of recognition will be restricted to the historical cost basis.

13.4 Disclosure of current liabilities

The correct classification of liabilities is as important as the correct classification of assets. Besides its importance in the proper disclosure of liabilities in financial statements, correct classification is also an important factor in the analysis and interpretation of financial statements.

Current liabilities must be disclosed as follows on the statement of financial position:

Doreen Traders
Statement of financial position as at 31 December 20.1

	Notes	R
EQUITY AND LIABILITIES		
Total equity		xx xxx
Total liabilities		xx xxx
Non-current liabilities		xx xxx
Long-term borrowings		xx xxx
Current liabilities		xx xxx
Trade and other payables		xx xxx
Current portion of long-term borrowings		xx xxx
Other current liabilities		xx xxx
Total equity and liabilities		xxx xxx

According to the definition of financial instruments, which is explained in chapter 12, trade and other payables and the current portion of long-term borrowings are financial liabilities. These items are therefore included in the note for financial liabilities. Refer to chapter 14 and the comprehensive example in chapter 15 for examples of how trade and other payables and the current portion of long-term borrowings must be disclosed in the notes to financial statements.

13.5 Trade creditors and creditors control account

This type of creditor results from the purchase of goods and services on credit. Credit purchase transactions are recorded in the purchases journal, the creditors ledger and the creditors control account.

As is the case with debtors' accounts in manual or mechanised systems, creditors accounts are usually kept in a separate subsidiary creditors ledger. It is impractical to have a large number of individual creditors' accounts in the general ledger. Therefore most entities keep subsidiary creditors ledgers, with a creditors control account in the general ledger. The purpose of the creditors control account is to summarise all the transactions that influence (change) the accounts of the individual creditors.

13.5.1 *The purchases journal*

Transactions are recorded in the books of first entry, that is, in the various journals (CRJ, CPJ, SJ, PJ, SRJ, PRJ, petty cash journal and others). For example, the information from the source documents is used to record credit purchases in the purchases journal (PJ). From the PJ, the entries are credited to the individual creditor

accounts in the creditors ledger and to the creditors control account, and debited to the purchases (or inventory) account in the general ledger.

In other words, the invoice amounts are posted individually, on a daily basis, from the PJ to the appropriate creditor accounts in the creditors ledger. The total of the creditors column is credited to the creditors control account at the end of the applicable accounting period (usually a month). The total purchases for the period is debited to either the purchases or the inventory account in the general ledger. The double-entry system is thus maintained as follows:

Dr Purchases (or inventory) account (in the general ledger).
Cr Creditors control account (in the general ledger).
Cr Individual creditor accounts (in the creditors ledger).

If individual and control accounts are kept, it is important that the creditors control account is kept up to date and that the balance of the control account in the general ledger is compared regularly with the total of the balances of the individual accounts in the creditors ledger(s). This ensures that all transactions relating to the creditors have been recorded.

13.5.2 *The purchases returns journal*

It often happens that the supplier delivers incorrect goods, that some goods have been damaged in transit or that goods have been priced incorrectly by the supplier. In such cases, the purchaser will request the supplier to issue him with a credit note for the amount upon which they agree. A credit note can be recorded in the books of the purchaser to give effect to the transaction as follows:

Dr Individual creditor accounts (in the creditors ledger).
Dr Creditors control account (in the general ledger).
Cr Purchases (or inventory) account (in the general ledger).

Where such "adjusting" of credit note transactions in respect of return or other allowances on purchases occurs regularly, a special journal for such transactions, ie a purchases returns journal (PRJ), should be prepared.

Example 13.1 illustrates how a creditors control account should be prepared.

Example 13.1

On 1 April 20.6, the list of balances taken from the creditors ledger of Dabisa Big Store was as follows:

Fol no	Creditor	Amount R
C6	Cathy Suppliers	8 000
J3	Johnnies Wholesalers	6 000
		14 000

The following entries appeared in the journals of Dabisa Big Store for April 20.6:

Purchases journal: April 20.6 **PJ10**

Date	Creditor	Invoice no.	Fol	Creditors	Purchases	Sundries		
				R	R	Details	Fol	R
7	Johnnies Wholesalers	101	J3	4 500	4 500			
9	Cathy Suppliers	714	C6	5 000	5 000			
16	Johnnies Wholesalers	136	J3	2 600	2 600			
				12 100	12 100			
				GL8	GL15			

Purchases returns journal: April 20.6 **PRJ4**

Date	Creditor	Credit note no.	Fol	Creditors	Purchase returns	Sundries		
				R	R	Details	Fol	R
18	Johnnies Wholesalers	71	J3	400	400			
				400	400			
				GL8	GL15			

Cash payments journal: April 20.6 **CPJ7**

Cheque no.	Day	Details	Fol	Bank	Creditors control	Sundries		
				R	R	R	Fol	Details
735	2	Johnnies Wholesalers	J3	6 000	6 000			
736	2	BB Buildings		8 000		8 000	GL10	Rent
737	5	Cathy Suppliers	C6	7 000	7 000			
738	17	Airfield Garage		180		180	GL18	Petrol
739	30	Cash		2 000		2 000	GL25	Wages
				23 180	13 000	10 180		
				GL2	GL8			

Required

(a) Prepare the creditors control account for April 20.6 in the general ledger of Dabisa Big Store.

(b) Prepare the individual creditors' accounts for April 20.6 in the creditors ledger of Dabisa Big Store.

(c) Prepare a list of balances of creditors accounts, and ensure that it reconciles with the balance of the creditors control account.

Solution

(a) General ledger

Dr **Creditors control** **GL8** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.6				
Apr	30	Purchases ret.	PRJ4	400	Apr	1	Balance	b/d	14 000
	30	Bank	CPJ7	13 000		30	Purchases	PJ10	12 100
	30	Balance	c/d	12 700					
				26 100					26 100
					20.6				
					May	1	Balance	b/d	12 700

(b) Creditors ledger

Dr **Johnnies Wholesalers** **J3** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.6				
Apr	2	Bank	CPJ7	6 000	Apr	1	Balance	b/d	6 000
	18	Purchases ret.	PRJ4	400		7	Purchases	PJ10	4 500
	30	Balance	c/d	6 700		16	Purchases	PJ10	2 600
				13 100					13 100
					20.6				
					May	1	Balance	b/d	6 700

Dr **Cathy Suppliers** **C6** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.6					20.6				
Apl	5	Bank	CPJ7	7 000	Apr	1	Balance	b/d	8 000
	30	Balance	c/d	6 000		9	Purchases	PJ10	5 000
				13 000					13 000
					20.6				
					May	1	Balance	b/d	6 000

(c) List of individual creditors balances at 30 April 20.6

Fol no	Creditor	Amount R
C6	Cathy Suppliers	6 000
J3	Johnnies Wholesalers	6 700
		12 700

The list of the individual creditors balances, as at 30 April 20.6, adds up to R12 700, which agrees with the balance of the creditors control account of R12 700 on the same date.

13.6 Settlement discount received

As is the case with debtors to whom discount may be granted for payment within a prescribed period, discount may be received if creditors are paid within a particular period.

A discount received represents an income to the entity because of a reduction of the purchases. Suppose, for example, that Des Nail Stores purchased merchandise on 7 May 20.3 to the value of R800 from Stefan Suppliers, on credit. The purchase is recorded in the purchases journal (PJ) by debiting the purchases (or inventory) account (in total at the end of the month) and crediting Stefan Suppliers (on 7 May 20.3, in the creditors ledger) and also crediting the creditors control account (in total, at the end of the month) in the general ledger.

On 26 May 20.3, Des Nail Stores issued a settlement cheque for R760, in full settlement of Stefan Suppliers' account. This implies that a discount of R40 is, in effect, received. The payment transaction will be recorded as follows in the CPJ: bank column – R760 (the amount of the cheque); settlement discount received column – R40 (which is R800 – R760) and in the creditors control column – R800. Des Nail Stores does not owe any more money to Stefan Suppliers – indicated by the words "full settlement". The ultimate result is that the liability, the creditor and creditors control are debited and the asset, bank and income account, settlement discount received, are credited.

If the financial year ends on 28 February and VAT is ignored, the entries in the general ledger of Des Nail Stores would be as follows:

Dr **Creditor: Stefan Suppliers** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3					20.3				
May	26	Bank		760	May	7	Purchases		800
	26	Settlement discount received		40					
				800					800

Dr **Settlement discount received** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.4					20.3				
Feb	28	Purchases		40	May	26	Stefan Suppliers		40

The settlement discount received account is debited and the purchases account is credited by means of a closing general journal entry. The entry closes the nominal account called settlement discount received and recognises the income with a credit to the purchases account.

13.7 Other current liabilities

13.7.1 *Value-added tax (VAT) payable*

The levying of VAT was discussed in previous chapters. A registered entity must submit a VAT return periodically to SARS.

Owing to the ongoing nature of an entity's activities, there may be an obligation at the end of the financial period in respect of VAT that must be remitted. The amount is a current liability, because the entity owes the VAT to SARS, and should be shown as part of trade and other payables on the statement of financial position.

13.7.2 *Current portion of long-term borrowings*

If any portion of a long-term obligation must be paid from current assets during the next twelve months, that portion should be classified as a current liability. For example, if an entity has a loan of R500 000 which must be paid in five equal annual instalments of R100 000, the first instalment of R100 000 will be classified as a current liability and the balance of the loan as a long-term obligation.

13.7.3 *Accrued expenses (arrears or accumulated obligations)*

Accumulated (accrued) obligations (expenses) arise from transactions that have already been concluded and are usually payable in the near future. Therefore they are classified as current liabilities. For example, telephone costs incurred by an entity during the last month of its financial year will not be paid before the end of the financial year, because the account will not have been received at that stage. The same applies to the entity's account for water and electricity consumed in the last month of the financial year. There are other possibilities, too.

The above expenditure was incurred during the current financial year and must appear on the statement of profit or loss and other comprehensive income of the current financial year. The following journal entry will be made in respect of the expenditure:

General journal

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Feb	28	Telephone		2 150	
		Water and electricity		3 500	
		Accrued expenses			5 650
		Accrued expenses at the end of the financial year			

In the following financial year, the above entry is reversed:

General journal

Month	Day	Details	Fol	Debit	Credit
20.3				**R**	**R**
Mar	1	Accrued expenses		5 650	
		Telephone			2 150
		Water and electricity			3 500
		Reversal of accrued expenses at the end of the previous financial year			

When the obligations are paid, they are debited to the expenditure accounts in the usual way.

13.7.4 *Provisions*

Provisions are obligations of which the precise amount will only be known at a later date. The immediate accounting problem is to estimate the amount of the obligation.

An example of an estimated obligation of this nature is the guarantee that a dealer gives on a product he sells. He has an obligation for the duration of the guarantee. The amount of the guarantee is not known. It should be estimated on the basis of past experience and, at the time of the sale, debited to an expenditure (or a product guarantee cost) account. The corresponding credit should be credited to the provision for product guarantee account. Most types of guarantee are valid for twelve months or less; therefore the provision is a current liability.

13.8 Internal control measures regarding creditors

The most important aspect of internal control over creditors is the approval for obtaining credit and ensuring that payment is made timeously to the correct creditor. Timeous payment ensures that discounts can be obtained and contributes to the enhancement of the reputation of the entity.

Where possible employees who are responsible for recording credit transactions should not be involved in the actual payment of the accounts. These functions should be performed separately. By means of loose-leaf creditors' accounts or creditors' cards, the accounting work in connection with creditors can be divided amongst several employees.

In the case of multiple transactions, subsidiary books and a control account in the general ledger should be used.

The balance of each creditor's account should be compared and reconciled regularly with the applicable statements of account received monthly from creditors.

13.9 Comprehensive example

The following comprehensive example illustrates the way in which a creditors control account should be prepared. (VAT is 14%.)

On 1 May 20.4 the creditors ledger of Esther Fashions revealed the following balances:

Fol no	Creditor	Amount
		R
D2	Danelle Boutique	800
D4	Danie Creations	300
M7	Michelle Warehouse	1 000
N8	Nadine Fashions	500
		2 600

The following entries appeared in the journals of Esther Fashions for May 20.4:

Purchases journal: May 20.4 **PJ11**

Date	Creditor	Invoice no	Fol	Creditors	VAT input	Men's clothing	Ladies' clothing	Sundries		
				R	R	R	R	Details	Fol	R
7	Nadine Fashions	1234	N8	342	42	100	200			
9	Michelle Warehouse	258	M7	684	84	450	150			
12	Danie Creations	654	D4	114	14			Packing material	GL84	100
16	Danelle Boutique	3698	D2	399	49	50	300			
22	Michelle Warehouse	289	M7	1 026	126	300	600			
				2 565	315	900	1 250			100
				GL14	GL8	GL4	GL5			

Purchases returns journal: May 20.4 **PRJ9**

Date	Creditor	Credit note no	Fol	Creditors	VAT input	Men's clothing returns	Ladies' clothing returns	Sundries		
				R	R	R	R	Details	Fol	R
9	Nadine Fashions	34	N8	57	7		50			
24	Michelle Warehouse	86	M7	114	14	80	20			
				171	21	80	70			
				GL14	GL8	GL6	GL7			

Cash payments journal: May 20.4 **CPJ14**

Cheque no	Day	Details	Fol	Bank	Creditors control	VAT in-put	VAT out-put	Settlement discount received	Sundries		
				R	R	R	R	R	R	Fol	Details
116	2	Michelle Warehouse	M7	943	1 000		7	50			
117	6	Danelle Boutique	D2	400	400						
118	8	Nadine Fashions	N8	200	200						
119	15	Danie Creations	D4	300	300						
120	17	Ben's Garage		150					150	GL20	Petrol
121	23	Dolly Computers		114		14			100	GL29	Computer repairs
122	31	Cash		860					860	GL75	Wages
				2 967	1 900	14	(7)	(50)	1110		
					GL14	GL8	GL8	GL12			

Required

(a) Prepare the creditors control account for May 20.4 in the general ledger of Esther Fashions.

(b) Prepare the individual creditors' accounts for May 20.4 in the creditors ledger of Esther Fashions.

(c) Prepare a list of balances of creditors accounts and ensure that it reconciles with the balance of the creditors control account.

Solution

(a) General ledger

Dr **Creditors control** **GL14** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.4 May	31	Purchases ret.	PRJ9	171	20.4 May	1	Balance*	b/d	2 600
	31	Bank	CPJ14	1 900		31	Purchases	PJ11	2 565
	31	Balance	c/d	3 094					
				5 165					5 165
					20.4 Jun	1	Balance	b/d	3 094

* If it is assumed that the balance of the creditors control account was reconciled on 30 April 20.4 with the total of balances of the individual creditors accounts, this total will be the same as the balance of the creditors control account on 1 May 20.4.

(b) Creditors ledger

Dr **Danelle Boutique** **D2** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.4					20.4				
May	6	Bank	CPJ14	400	May	1	Balance	b/d	800
	31	Balance	c/d	799		16	Purchases	PJ11	399
				1 199					1 199
					20.4				
					Jun	1	Balance	b/d	799

Dr **Danie Creations** **D4** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.4					20.4				
May	15	Bank	CPJ14	300	May	1	Balance	b/d	300
	31	Balance	c/d	114		12	Purchases	PJ11	114
				414					414
					20.4				
					Jun	1	Balance	b/d	114

Dr **Michelle Warehouse** **M7** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.4					20.4				
May	2	Bank	CPJ14	1 000	May	1	Balance	b/d	1 000
	24	Purchases ret.	PRJ9	114		9	Purchases	PJ11	684
	31	Balance	c/d	1 596		22	Purchases	PJ11	1 026
				2 710					2 710
					20.4				
					Jun	1	Balance	b/d	1 596

Dr **Nadine Fashions** **N8** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.4					20.4				
May	9	Purchases ret.	PRJ9	57	May	1	Balance	b/d	500
	8	Bank	CPJ14	200		7	Purchases	PJ11	342
	31	Balance	c/d	585					
				842					842
					20.4				
					Jun	1	Balance	b/d	585

(c) List of individual creditors balances as at 31 May 20.4

Fol no	Creditor	Amount
		R
D2	Danelle Boutique	799
D4	Danie Creations	114
M7	Michelle Warehouse	1 596
N8	Nadine Fashions	585
		3 094

The list of the individual creditors' balances as at 31 May 20.4 adds up to R3 094, which agrees with the balance of the creditors control account of R3 094 on the same date.

13.10 Summary

An item should fulfil the definition of and the recognition criteria for a liability before it is included on the statement of financial position. In this sense, liabilities are not necessarily the same as legal liabilities. For example, although no obligation exists at the statement of financial position date in respect of the fulfilment of guarantee claims whose terms have expired, the entity will include the obligation in its statement of financial position if it is standard practice to pay such claims in order to protect its reputation.

Current liabilities are usually liabilities that should be paid within one year of the statement of financial position date.

CHAPTER 14

Non-current liabilities

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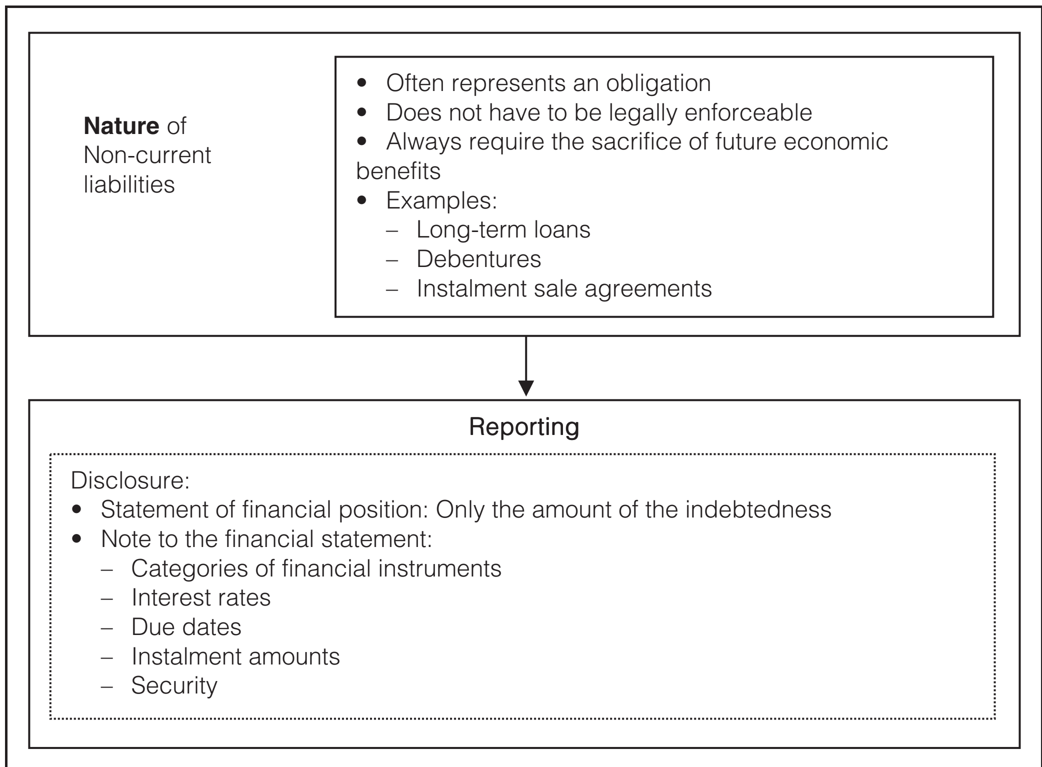
Overview of non-current liabilities



14.1 Introduction

> **Study objectives**
> After studying this chapter you should be able to account for non-current liabilities.

Non-current liabilities, like current liabilities, represent obligations of the entity originating from past events whose payment is expected to lead to an outflow of resources from the entity. In order to qualify as a non-current liability, the date on which the obligation must be paid should be later than one year after the statement of financial position date.

Naturally, liabilities must fulfil the applicable recognition criteria before being included on the statement of financial position.

14.2 The nature of non-current liabilities

A non-current liability often represents an obligation, but it does not have to be legally enforceable in order to qualify as a liability. It does, however, always require the sacrifice of future economic benefits.

An entity is often required to provide security for long-term obligations. This means that, if the borrower is unable to repay the loan, the lender can claim the security in order to sell it and redeem the loan from the proceeds. For example, in the case of a mortgage, the property of the entity is the security over which the mortgage is held.

Various types of long-term borrowings are to be found in practice, the most important being ordinary long-term loans, debentures and instalment sale agreements.

In general, long-term borrowings are included in the financial statements of entities at the redeemable amount. The necessary details of their general nature, interest rate, dates of repayments and final payment date are shown in the financial liability note to the financial statements. Furthermore, whether any obligation of the entity is secured by a specific asset should be indicated, while the obligation and the encumbered asset should also be mentioned. If there are several long-term obligations, the details of each liability must be specified in the financial liability note.

14.3 Borrowings and mortgages

Long-term borrowings are usually made for the purpose of acquiring non-current assets and are therefore mostly secured liabilities. In cases of property, a loan can be obtained by registering a bond over the property concerned at the Registrar of Deeds. After registration, the bond is known as a mortgage bond. The loan is referred to as a mortgage.

The following minimum details of long-term borrowings and mortgages should be shown in the notes to the financial statements:

- the categories of financial instruments;
- the various interest rates;
- the various due dates;
- the amounts of the instalments, if the loans are repayable in instalments; and
- the security for the liability.

Only the amount of the indebtedness is shown on the statement of financial position; the additional details must be provided by means of a note.

When an instalment is payable within a year of the statement of financial position date, this should be shown as the current portion of long-term liabilities under current liabilities. The note should indicate the current and non-current portion of the loan.

Example 14.1

On 2 January 20.3, Sipho Trading concluded an agreement for the acquisition of land and buildings to the value of R800 000. The transaction is financed by AC Bank at 10% interest per annum on a mortgage of 80% of the purchase price. The remaining 20% is paid in cash. The loan is repayable as follows: on 31 December of each year (commencing on 31 December 20.3) R128 000 of the loan must be repaid, plus interest at 10% on the outstanding capital. The financial year of Sipho Trading ends on 31 December.

Required

(a) Prepare journal entries to record the above transactions (including cash) for the year ended 31 December 20.3 in the general journal of Sipho Trading.

(b) Show the following general ledger accounts in the books of Sipho Trading for the year ended 31 December 20.3, properly balanced:
- land and buildings;
- mortgage; and
- interest on mortgage.

(c) Show how the above information would be reflected in Sipho Trading's financial statements as at 31 December 20.3.

(a)

Sipho Trading
General journal **J10**

Month	Day	Details	Fol	Debit	Credit
20.3				R	R
Jan	2	Land and buildings at cost	GL4	640 000	
		Mortgage	GL7		640 000
		80% of purchase price of land and buildings (80% × R800 000)			
		Land and buildings at cost	GL4	160 000	
		Bank			160 000
		20% of purchase price paid cash (20% × R800 000) (usually recorded in the CPJ)			
Dec	31	Mortgage	GL7	128 000	
		Interest on mortgage	GL9	64 000	
		Bank			192 000
		Payment of first instalment plus 10% interest (10% × R640 000) (usually recorded in the CPJ)			
		Profit or loss		64 000	
		Interest on mortgage	GL9		64 000
		Closing entry			

(b)

Sipho Trading
General ledger

Dr **Land and buildings** **GL4** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Jan	2	Mortgage	J10	640 000					
	2	Bank	J10	160 000					
				800 000					

Dr **Mortgage** **GL7** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Dec	31	Bank	J10	128 000	20.3 Jan	2	Land and buildings	J10	640 000
	31	Balance	c/d	512 000					
				640 000					640 000
					20.4 Jan	1	Balance	b/d	512 000

Dr **Interest on mortgage** **GL9** **Cr**

Month	Day	Details	Fol	R	Month	Day	Details	Fol	R
20.3 Dec	31	Bank	J10	64 000	20.3 Dec	31	Profit or loss	J10	64 000

(c)

Sipho Trading
Statement of profit or loss and other comprehensive income for the year ended 31 December 20.3

	Note	R	
Revenue	8		xxx xxx
Cost of sales			(xxx xxx)
Inventory (1 January 20.3)		xx xxx	
Purchases		xxx xxx	
Carriage on purchases		xx xxx	
		xxx xxx	
Inventory (31 December 20.3)		(xx xxx)	
Gross profit			xxx xxx
Other income			xx xxx
Interest income: Loans and receivables: Fixed deposit		xxx	
Rent received		xxx	
			xxx xxx
Distribution, administrative and other expenses			(xxx xxx)
Advertising costs		x xxx	
Carriage on sales		xx xxx	
Entertainment costs		x xxx	
Salaries to employees		xxx xxx	
Telephone expenses		xx xxx	
Depreciation	3	xx xxx	
Finance costs			(xx xxx)
Interest on mortgage		64 000	
Interest on bank overdraft		x xxx	
Profit/Total comprehensive income for the year			xxx xxx

Sipho Trading
Statement of financial position as at 31 December 20.3

	Notes	R
ASSETS		
Non-current assets		xxx xxx
Property, plant and equipment	3	xxx xxx
Financial assets	4	xxx xxx
Current assets		xxx xxx
Inventories		xx xxx
Trade and other receivables		xx xxx
Cash and cash equivalents		x xxx
Total assets		xxx xxx
EQUITY AND LIABILITIES		
Total equity		xxx xxx
Capital		xxx xxx
Total liabilities		xxx xxx
Non-current liabilities		384 000
Long-term borrowings	5	384 000
Current liabilities		xxx xxx
Trade and other payables	5	x xxx
Current portion of long-term borrowings	5	128 000
Other financial liabilities	5	xx xxx
Total equity and liabilities		xxx xxx

Sipho Trading
Notes for the year ended 31 December 20.3

1. Basis of presentation

   The annual financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.

2. Summary of significant accounting policies

   The annual financial statements incorporate the following significant accounting policies which are consistent with those applied in previous years, except where otherwise stated:

   2.1 Property, plant and equipment

   Property, plant and equipment are initially recognised at cost price. Equipment is subsequently measured at historical cost, less accumulated depreciation and accumulated impairment losses.

   Depreciation on equipment is written off at a rate deemed to be sufficient to reduce the carrying amount of the assets over their estimated useful life to their estimated residual value. The depreciation rates are as follows:

   Equipment: x % per annum according to the straight-line method;

Depreciation is charged to profit or loss for the period. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

2.2 Financial assets

Financial assets are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of an instrument.

Financial instruments are initially measured at cost, which is fair value plus transaction costs, except for financial assets at fair value through profit or loss, which is measured at cost, transaction costs excluded.

The entity classifies its financial assets in the following categories: at fair value through profit or loss; held-to-maturity; loans and receivables; and investment in equity instruments. The entity's classification depends on the purpose for which the entity acquired the financial assets.

2.3 Inventories

Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. Cost is calculated using the first-in, first-out method. Net realisable value is the estimated selling price in the ordinary course of business, less any costs of completion and disposal.

2.4 Financial liabilities

Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the purpose for which the financial liabilities were obtained.

2.5 Revenue

Revenue is measured at the fair value of the consideration received or receivable. Revenue from the sale of goods consists of the total net invoiced sales, excluding value-added tax (VAT) and settlement discount granted. The revenue from sales is recognised when the risk and rewards of ownership are transferred to the customer.

3. Property, plant and equipment

	Land and buildings	**Equipment**	**Total**
	R	**R**	**R**
Carrying amount: 1 Jan 20.3	–	xx xxx	xxx xxx
Cost	–	xxx xxx	xxx xxx
Accumulated depreciation	–	(xx xxx)	(xx xxx)
Additions	800 000	–	800 000
Depreciation for the year	–	(xx xxx)	(xx xxx)
Carrying amount: 31 Dec 20.3	800 000	xx xxx	xxx xxx
Cost	800 000	xxx xxx	xxx xxx
Accumulated depreciation	–	(xx xxx)	(xx xxx)

Land and buildings on Erf 747, Star Park, Pretoria, with a carrying amount of R800 000, have been pledged as security for the mortgage in favour of XX Bank.

4. Financial assets

	20.3
Non-current financial assets	**R**
Loans and receivables: Fixed deposit at XX Bank at x % p.a. callable at 31 December 20.x	xx xxx
Current financial assets	
Trade and other receivables:	xx xxx
Debtors control	xx xxx
Allowance for credit losses	(x xxx)

5. Financial liabilities

	20.3
Non-current financial liabilities	**R**
Long-term borrowings:	384 000
Mortgage: The mortgage was acquired from AC Bank on 2 January 20.3 at an interest rate of 10% per annum. The loan is repayable in annual instalments at R128 000 per year, with the first instalment due on 31 December 20.3. This loan is secured by a bond over land and buildings.	
Long-term borrowings	512 000
Current portion of loan	(128 000)
Non-current portion	384 000
Current financial liabilities	
Trade and other payables:	xx xxx
Creditors control	xx xxx
Current portion of long-term borrowings	128 000
Other financial liabilities	
Financial liabilities at fair value through profit or loss	xx xxx
Bank overdraft	xx xxx

14.4 Debentures

Debentures, like shares, are a way of obtaining long-term capital for investment in an entity. Whereas shares are classified as owners' equity, debentures are mostly non-current liabilities. Debentures are generally divided into units – usually R100 per debenture. Debentures are subject to contractually stated conditions. They are usually secured and interest is paid on them periodically. The capital sum is normally repaid after the expiry of the due date.

Debentures differ from ordinary liabilities in that the borrower offers the debentures for sale to the public in terms of a debenture deed and with a trustee who protects the interest of the debenture holders. Debentures differ from share capital in the following respects: they do not ensure that their holder has a vote; they have a fixed interest obligation; and they are redeemable at a certain price and in a certain way. In terms of the law, a debenture is a debt of a company which is owed to the debenture holder on the conditions stated in the debenture deed.

Details of the type of debenture, the date and price at which the debenture is redeemable, the interest rate, and the security provided for the debenture must be stated in the financial statements.

Recording of the issue of debentures falls outside the scope of this book.

The interest due on debentures and the debentures themselves are disclosed as follows on the statement of financial position and notes to the financial statements:

Henklea Wholesalers
Statement of financial position as at 31 December 20.3

	Note	R
ASSETS		
Non-current assets		xxx xxx
Property, plant and equipment	3	xxx xxx
Financial assets		xxx xxx
Current assets		xxx xxx
Inventories		xx xxx
Trade and other receivables		xx xxx
Prepaid expenses		xx xxx
Cash and cash equivalents		x xxx
Total assets		xxx xxx
EQUITY AND LIABILITIES		**R**
Total equity		xxx xxx
Capital		xxx xxx
Total liabilities		xxx xxx
Non-current liabilities		
Long-term borrowings	5	2 500 000
Current liabilities		xxx xxx
Trade and other payables	5	300 000
Other financial liabilities		xx xxx
Total equity and liabilities		xxx xxx

Henklea Wholesalers
Notes for the year ended 31 December 20.3

5. Financial liabilities

	20.3 R
Non-current financial liabilities	
Long-term borrowings:	2 500 000
Debentures: 25 000 R100 debentures at 12% interest per annum payable annually on the outstanding debentures. The debentures are redeemable at par on 2 January 20.8. The debentures are secured by a mortgage over land and buildings in favour of the trustee for the debenture-holders.	2 500 000
Current financial liabilities	
Trade and other payables:	xx xxx
Creditors control	xx xxx
Accrued expenses	
Interest on debenture	300 000

14.5 Summary

An item must fulfil the definition of and the recognition criteria for non-current liabilities before it can be included as a non-current liability on the statement of financial position. A financial instrument can be defined as any contract that results in a financial asset for one entity and a financial liability or equity instrument for another. The non-current liabilities discussed in this chapter can all be classified as financial liabilities, since there is a contracted obligation to deliver cash or another financial asset to another entity.

Long-term loans, mortgages and debentures that must be paid more than one year after the statement of financial position date are examples of non-current liabilities.

CHAPTER **15**

Financial statements of a sole proprietorship

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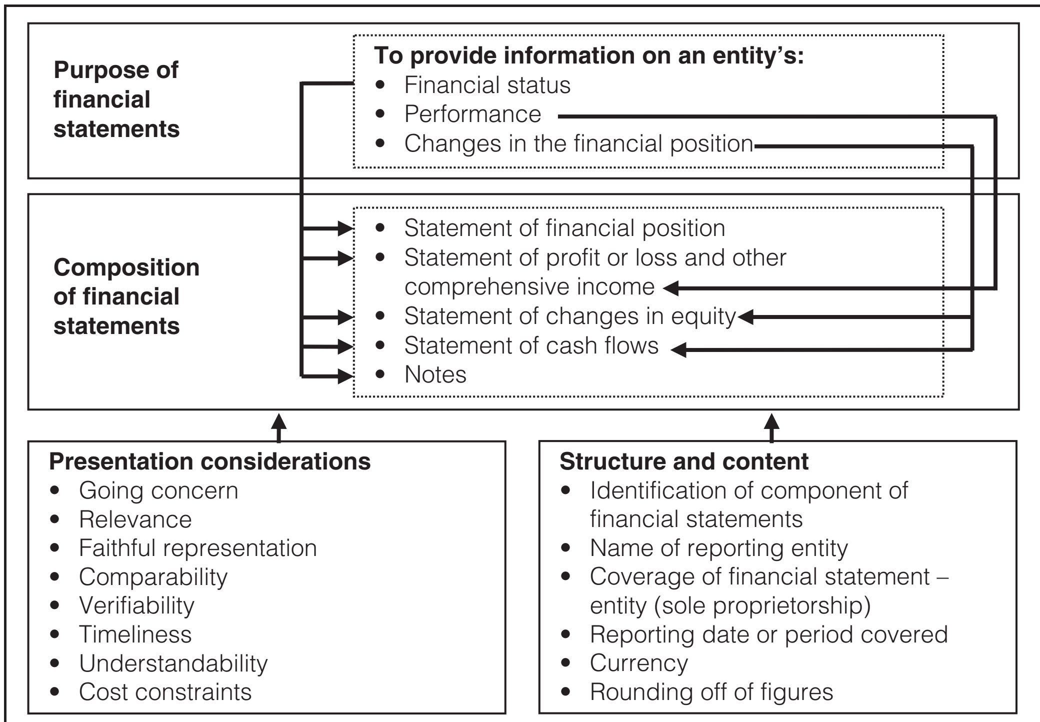
Overview of the financial statements of a sole proprietorship



15.1 Introduction

Study objectives

After studying this chapter you should be able to compile the financial statements of a sole proprietorship in accordance with International Financial Reporting Standards (IFRSs).

Although the format in which financial statements are presented has been mentioned repeatedly thus far, the aim thereof was usually to illustrate a specific facet of the financial statements.

This chapter focuses on the structure and content of general financial statements, not on the financial statements of specialised institutions such as banks and similar institutions. Certain underlying terms in respect of financial statements, most of which you are already familiar with, are discussed and summarised in this chapter.

The words that are used are intended for entities that have a profit motive. The words will therefore have to be adapted for other entities. In this chapter we will concentrate on the financial statements of a sole proprietorship. A sole proprietorship (or sole trader) is the simplest form of business ownership and is often managed by the owner himself. There is no legislation prescribing how a sole proprietorship should be established, other than the requirement that a trade licence be obtained in certain cases.

15.2 Purpose and composition of financial statements

The purpose of financial statements is to provide information on the financial status, performance and changes in the financial position of an entity. This information is provided in the

- ☐ statement of financial position;
- ☐ statement of profit or loss and other comprehensive income;
- ☐ statement of changes in equity;
- ☐ statement of cash flows; and
- ☐ notes.

Optional additional reports include a statement of added value, an environmental report and a financial overview of the entity's activities.

In this chapter, we will concentrate on the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity and deal with some of the notes to the financial statements.

15.3 Overall considerations

The following overall considerations (which will be discussed in detail in chapter 1 of volume 2 of this textbook) should be borne in mind in the presentation of financial statements:

- ☐ going concern;
- ☐ relevance;
- ☐ faithful representation;
- ☐ comparability;
- ☐ verifiability;
- ☐ timeliness;
- ☐ understandability; and
- ☐ cost constraints.

15.3.1 *The going concern assumption*

This concept means that it is accepted that the entity will continue to exist for the foreseeable future.

15.3.2 *Relevance*

Financial information is relevant when it is capable of making a difference in decisions. It should thus have predictive and/or confirmatory value.

An entity-specific aspect of relevance is *materiality*. Generally, an item is considered material if its non-disclosure would change the opinion of a user of the financial statements about those statements. (See paragraph 1.14.1 for a more detailed explanation.)

15.3.3 *Faithful representation*

Financial statements should provide a faithful (fair) presentation of the financial position, financial performance and cash flow of an entity. This fundamental requirement seeks to maximise the characteristics of completeness, neutrality and freedom from error.

15.3.4 *Comparability*

Information is more useful if it can be compared with similar information from other similar entities, or compared for the same entity, over time. These comparisons enable tendencies and trends to be determined and could be valuable in decision-making

There should also be consistency in the way in which similar items are dealt with in financial statements both within each accounting period and from one period to the next. The implication of this requirement is, among other things, that the presentation and classification of items in the financial statements of one period to the following should be the same.

15.3.5 *Verifiability*

When we say that something is verifiable we mean that different analysts and independent observers would reach consensus that a particular depiction is a faithful representation. The information presented can thus prove to represent the status of the entity or issue faithfully.

15.3.6 *Timeliness*

Good decision-making depends not only on the quality of information but also on the availability of that information. Financial information must therefore be available on or before the agreed deadlines.

15.3.7 *Understandability*

Although financial reports are prepared for users from a relatively broad range of backgrounds, it is assumed that most users have a reasonable knowledge of business and economic activities. Information, even that relating to more complex issues, must be processed and presented in such a way that it is understandable but never incomplete or potentially misleading.

15.3.8 *Cost constraints*

General purpose financial reporting imposes costs which should be justified by the benefits of reporting the information. This opens the debate on whether the reporting requirements for smaller entities should be the same as those for larger ones.

Cost can be a pervasive constraint on the quality of financial information. When statements are prepared, the benefits derived from the information should exceed the cost of providing it. Weighing up the benefits and costs entails the exercise of judgement. The cost to some users may be to the benefit of other users.

15.4 Structure and content

15.4.1 *Introduction and identification of the financial statements*

It should be possible to differentiate clearly between the various financial statements and to identify them separately. Each component of the financial statements must be identified clearly. In addition, the following information must be displayed prominently and repeated when repetition is necessary for a proper understanding of the information presented:

- ☐ the name of the reporting entity;
- ☐ whether the financial statements cover the individual entity or a group of entities;
- ☐ the statement of financial position date or period covered by the financial statements;
- ☐ the currency (for example, rand) in which the statements are reflected; and
- ☐ the extent to which the figures are rounded off – to the nearest million or thousand rand, for example.

Financial statements should not be issued later than six months after the financial year-end.

15.4.2 *Statement of financial position*

As previously stated, the main components of the statement of financial position are *current assets* and *non-current assets* (regarding assets), *current liabilities* and *non-current liabilities* (regarding liabilities) and, of course, equity. The question to be answered is, what is the difference between current liabilities/assets in comparison with non-current liabilities/assets?

Current assets are assets that

- ☐ will be realised or are held for sale or use in the normal course of the operating cycle of the entity; or
- ☐ are primarily held for trading purposes in the short-term and are expected to be realised within twelve months of the statement of financial position date; or
- ☐ are cash or cash equivalents, without limitations on the use thereof.

All other assets are classified as non-current assets.

Current liabilities are liabilities

- ☐ that are expected to be settled in the normal course of the operating cycle of the entity; or
- ☐ that are held primarily for the purpose of being traded; or
- ☐ that should be settled within twelve months of the statement of financial position date; or
- ☐ in respect of which the entity does not have an unconditional right to defer settlement for at least twelve months after the statement of financial position date.

All other liabilities are classified as non-current liabilities.

The following items should, for the purpose of this book, appear separately on the statement of financial position:

- ☐ property, plant and equipment;
- ☐ intangible assets;
- ☐ financial assets;
- ☐ inventories;
- ☐ trade and other receivables;
- ☐ cash and cash equivalents;
- ☐ trade and other payables; and
- ☐ financial liabilities.

The above-mentioned items do not constitute a comprehensive list. Additional items can be added if necessary and descriptions adapted to suit the activities of the entity. If the amount of an item is not material, it is aggregated with other similar items and declared separately in the notes to the statement of financial position.

The following is an example of the layout of a statement of financial position:

Example 15.1

Francois Enterprises
Statement of financial position as at 28 February 20.5

ASSETS	**Notes**	**R**
Non-current assets		xxx xxx
Property, plant and equipment	2	xxx xxx
Financial assets	3	xxx xxx
Current assets		xxx xxx
Inventories		xx xxx
Trade and other receivables		xx xxx
Cash and cash equivalents		x xxx
Total assets		xxx xxx
EQUITY AND LIABILITIES		
Total equity		xxx xxx
Capital		xxx xxx
Total liabilities		xxx xxx
Non-current liabilities		xxx xxx
Long-term borrowings		xxx xxx
Current liabilities		xxx xxx
Trade and other payables		xx xxx
Current portion long-term borrowings	4	xx xxx
Total equity and liabilities		xxx xxx

15.4.3 *Statement of profit or loss and other comprehensive income*

Expenditure can be presented on the statement of profit or loss and other comprehensive income in accordance with either its *function* or its *nature*. The usual method of presentation, with which you are familiar, is presentation in accordance with the nature of the expenditure. In accordance with this method, items such as wages, salaries and depreciation are reflected on the statement of profit or loss and other comprehensive income.

The following is an example of the layout of a statement of profit or loss and other comprehensive income in which the income and expenditure are presented in accordance with their nature:

Example 15.2

Francois Enterprises
Statement of profit or loss and other comprehensive income for the year ended 28 February 20.5

	Notes	R
Revenue	2.5	xxx xxx
Cost of sales		(xxx xxx)
Inventory (1 March 20.4)		xx xxx
Purchases		xxx xxx
Carriage on purchases		xx xxx
		xxx xxx
Inventory (28 February 20.5)		(xx xxx)
Gross profit		xxx xxx
Other income		xxx
Interest income: Loans and receivables: Fixed deposit		xxx
		xxx xxx
Distribution, administrative and other expenses		(xxx xxx)
Carriage on sales		xx xxx
Credit losses		x xxx
Entertainment		x xxx
Salaries to employees		xxx xxx
Telephone		xx xxx
Stationery consumed		x xxx
Remuneration: Accounting officer		xx xxx
Depreciation	3	xx xxx
Finance costs		(xx xxx)
Interest on long-term loan		xx xxx
Interest on bank overdraft		x xxx
Profit/Total comprehensive income for the year		xxx xxx

It is not intended that the above layout should be applied rigidly. Additional items can be added, if necessary. Definitions are also not rigid, but can be adapted to suit the activities of the entity.

15.4.4 *Statement of changes in equity*

The aim of this statement is to reconcile the balance of the equity (owner's equity) at the beginning of the financial year with the equity at the end of the financial year. The following is an example of such a statement:

Example 15.3

Francois Enterprises
Statement of changes in equity for the year ended 28 February 20.5

	Total **R**
Balance as at 1 March 20.4	xxx
Profit/Total comprehensive income for the year	xxx
Additional investment	xxx
Drawings	(xxx)
Balance as at 28 February 20.5	x xxx

15.4.5 *Notes*

The notes to the financial statements provide additional information on the items that appear in the financial statements. The notes present information about the basis of the preparation of the financial statements and about the specific accounting policies used. They disclose the information required by IFRSs (International Financial Reporting Standards) that is not presented on the face of the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity or statement of cash flows. They also provide additional information which is not presented on the face of those statements but which is relevant to an understanding of them. Notes must, as far as practicable, be presented in a systematic manner. Each item on the face of the financial statements must be cross-referenced to related information in the notes.

Notes concerning the accounting policy that the entity followed in the compilation of the financial statements – including, among other things, the measurement basis (or bases) and other accounting policies used that are relevant to an understanding of the financial statements – are always required.

15.5 Comprehensive example

The following is the post-adjustment trial balance of Jackson Stores as at 28 February 20.4:

	Debit R	Credit R
Accounting fees	14 000	
Advertising	10 500	
Allowance for credit losses		2 800
Bank charges	2 800	
Bank interest	2 900	
Bank overdraft		26 500
Capital		50 000
Carriage on purchases	9 000	
Cleaning materials	1 800	
Credit losses	3 400	
Creditors control		63 000
Debtors control	56 000	
Delivery charges	14 800	
Depreciation – machinery	7 000	
Depreciation – vehicles	4 000	
Drawings	12 500	
Entertainment	3 000	
Fixed deposit	50 000	
Insurance	14 800	
Interest on fixed deposit		5 000
Interest on long-term borrowing	3 820	
Inventory – 1 March 20.3	72 000	
Long-term borrowing		38 200
Machinery at cost	35 000	
Accumulated depreciation: Machinery		14 000
Printing and stationery	4 300	
Purchases	390 000	
Rent paid	72 000	
Repair and maintenance	3 880	
Salaries and wages	144 000	
Sales		765 000
Telephone	12 900	
Vehicles at cost	20 000	
Accumulated depreciation: Vehicles		8 000
Vehicle expenses	8 100	
	972 500	972 500

Additional information:

1. Inventory on 28 February 20.4 amounted to R83 000.
2. No property, plant or equipment was purchased during the year.
3. The long-term borrowing is from Sun Bank and is repayable in four equal annual payments, with the first payment on 28 February 20.5. The interest rate is 10% per annum and is secured by a personal guarantee of the owner.
4. The owner deposited an additional amount of R5 000 during the year.
5. Depreciation on machinery and vehicles is calculated at 20% per annum on the straight-line method.
6. The fixed deposit is with AAA Bank for 24 months at 10%.

Required

Prepare the statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity and the accompanying notes of Jackson Stores as at 28 February 20.4.

Solution

Jackson Stores
Statement of profit or loss and other comprehensive income for the year ended 28 February 20.4

	Note	R	R
Revenue			765 000
Cost of sales			(388 000)
Inventory (1 March 20.3)		72 000	
Purchases		390 000	
Carriage on purchases		9 000	
		471 000	
Inventory (28 February 20.5)		(83 000)	
Gross profit			377 000
Other income			5 000
Interest income: Loans and receivables: Fixed deposit		5 000	
			382 000
Distribution, administrative and other expenses			(321 280)
Accounting fees		14 000	
Advertising		10 500	
Bank charges		2 800	
Cleaning materials		1 800	
Credit losses		3 400	
Delivery charges		14 800	
Depreciation	2	11 000	
Entertainment		3 000	
Insurance		14 800	
Printing and stationery		4 300	
Rent paid		72 000	
Repairs and maintenance		3 880	
Salaries and wages		144 000	
Telephone		12 900	
Vehicle expenses		8 100	
Finance costs			(6 720)
Interest on bank overdraft		2 900	
Interest on long-term borrowing		3 820	
Profit/Total comprehensive income for the year			54 000

Jackson Stores
Statement of changes in equity for the year ended 28 February 20.4

	Total equity R
Balance as at 1 March 20.3 R(50 000 – 5 000)	45 000
Profit/Total comprehensive income for the year	54 000
Additional investment	5 000
Drawings	(12 500)
Balance as at 28 February 20.4	91 500

Jackson Stores
Statement of financial position as at 28 February 20.4

	Notes	R
ASSETS		
Non-current assets		83 000
Property, plant and equipment	3	33 000
Financial assets	4	50 000
Current assets		136 200
Inventories	2.3	83 000
Trade and other receivables	4	53 200
Total assets		219 200
EQUITY AND LIABILITIES		
Total equity		91 500
Capital		91 500
Total liabilities		127 700
Non-current liabilities	5	28 650
Long-term borrowings		28 650
Current liabilities		99 050
Trade and other payables	5	63 000
Current portion of long-term borrowings	5	9 550
Other financial liabilities	5	26 500
Total equity and liabilities		219 200

Jackson Stores
Notes for the year ended 28 February 20.4

1. Basis of presentation

   The annual financial statements have been prepared in accordance with generally accepted accounting practice appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.

2. Summary of significant accounting policies

   The annual financial statements incorporate the following significant accounting policies, which are consistent with those applied in previous years, except where otherwise stated.

   2.1 Property, plant and equipment

   Property, plant and equipment are initially recognised at cost price. Machinery and vehicles are subsequently measured at historical cost, less accumulated depreciation and accumulated impairment losses.

   Depreciation on machinery and vehicles is written off at a rate deemed to be sufficient to reduce the carrying amount of the assets over their estimated useful life to their estimated residual value. The depreciation rates are as follows:

   Machinery: 20% per annum according to the straight-line method.

   Vehicles: 20% per annum according to the straight-line method.

   Depreciation is charged to profit or loss for the period. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in profit or loss for the period.

   2.2 Financial assets

   Financial assets are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of an instrument.

   Financial instruments are initially measured at cost, which is fair value plus transaction costs, except for financial assets at fair value through profit or loss, which is measured at cost, transaction costs excluded.

   The entity classifies its financial assets in the following categories: at fair value through profit or loss; held-to-maturity; loans and receivables; and investments in equity instruments. The entity's classification depends on the purpose for which the entity acquired the financial assets.

   2.3 Inventories

   Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. Cost is calculated using the first-in, first-out method. Net realisable value is the estimated selling price in the ordinary course of business, less any costs of completion and disposal.

   2.4 Financial liabilities

   Financial liabilities are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The classification depends on the purpose for which the financial liabilities were obtained.

2.5 Revenue

Revenue is measured at the fair value of the consideration received or receivable. Revenue from the sale of goods consists of the total net invoiced sales, excluding value-added tax (VAT) and settlement discount granted. The revenue from sales is recognised when the risk and rewards of ownership is transferred to the customer.

3. Property, plant and equipment

	Machinery	**Vehicles**	**Total**
	R	**R**	**R**
Carrying amount: 1 March 20.3	28 000	16 000	44 000
Cost	35 000	20 000	55 000
Accumulated depreciation	(7 000)	(4 000)	(11 000)
Depreciation for the year	(7 000)	(4 000)	(11 000)
Carrying amount: 28 Feb 20.4	21 000	12 000	33 000
Cost	35 000	20 000	55 000
Accumulated depreciation	(14 000)	(8 000)	(22 000)

4. Financial assets

	20.4
Non-current financial assets	**R**
Loans and receivables: Fixed deposit at AAA Bank at 10% p.a. callable at 28 February 20.6	50 000
Current financial assets	
Trade and other receivables:	53 200
Debtors control	56 000
Allowance for credit losses	(2 800)

5. Financial liabilities

	20.4
Non-current financial liabilities	**R**
Long-term borrowings:	28 650
The mortgage was acquired from Sun Bank on 1 March 20.3 at an interest rate of 10% per annum. The loan is repayable in four equal annual instalments with the first instalment due on 28 February 20.5. This loan is secured by a personal guarantee of the owner.	
Long-term borrowings	38 200
Current portion of borrowings	(9 550)
Current financial liabilities	
Trade and other payables:	63 000
Creditors control	63 000
Short-term borrowings	9 550
Current portion of long-term borrowings	9 550
Other financial liabilities	
Financial liabilities at fair value through profit or loss	26 500
Bank overdraft	26 500

15.6 Summary

The financial statements of a sole proprietor consist of a statement of profit or loss and other comprehensive income, a statement of changes in equity, a statement of financial position and the accompanying notes. These financial statements must be compiled in accordance with the accrual basis of accounting; they should be consistent and provide a fair presentation of the financial position and financial performance of the entity.

CHAPTER 16

Non-profit entities

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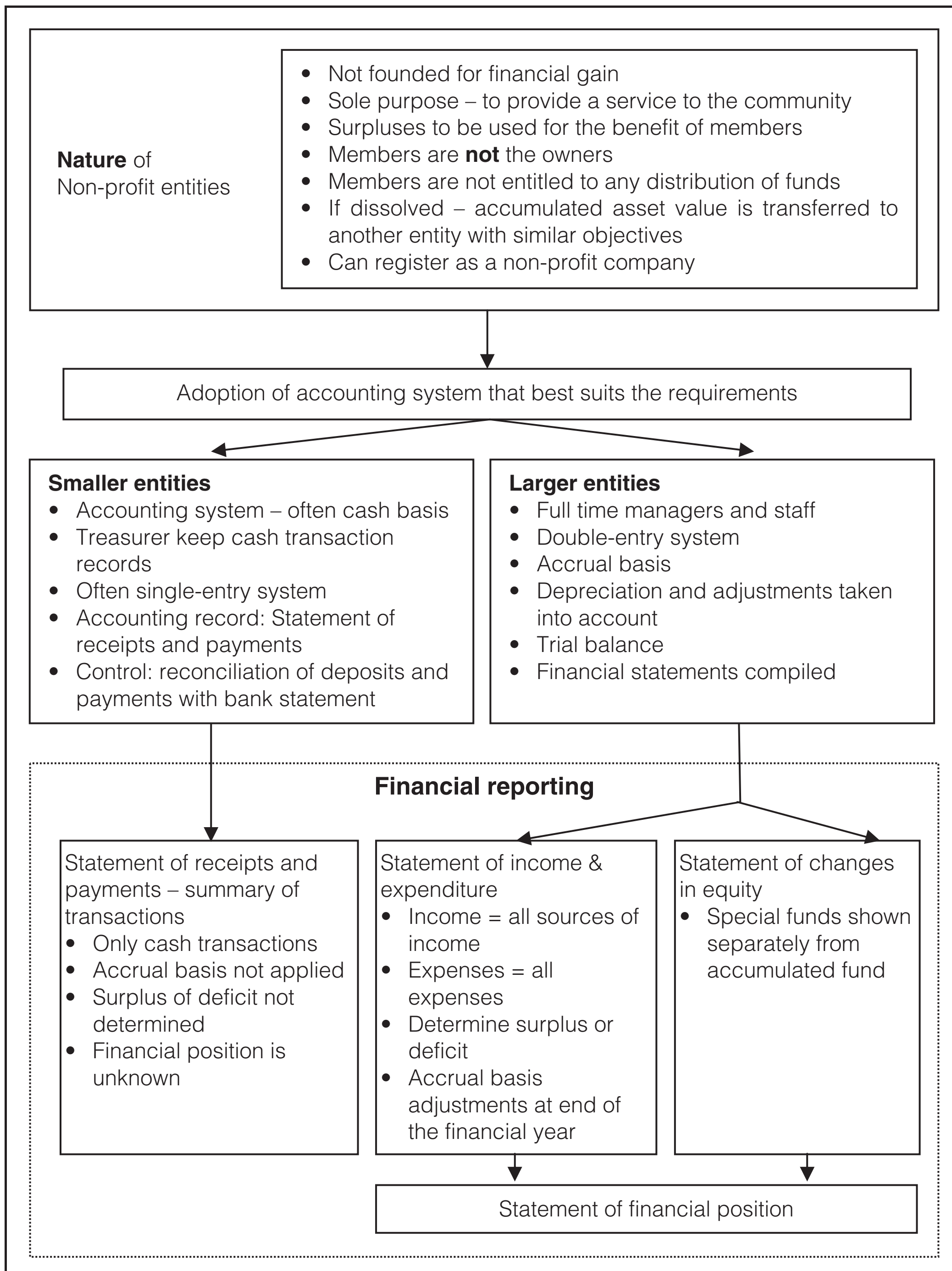
Overview of non-profit entities



16.1 Introduction

Study objectives

After studying this chapter you should be able to prepare

- ☐ statements of receipts and payments;
- ☐ membership fees accounts;
- ☐ fund accounts;
- ☐ trading statements;
- ☐ statements of income and expenditure;
- ☐ statements of changes in equity; and
- ☐ statements of financial position of non-profit entities.

The sole purpose of non-profit entities is to provide a service to the community. Non-profit entities vary from small informal social clubs to sport clubs, churches, educational institutions, government bodies and professional societies. The members are not the owners of the entity and are not entitled to any distribution during the year or on termination of the activities of the entity. The constitution of an entity of this nature usually contains a clause providing that if the entity should be dissolved, its accumulated net asset value must be transferred to another entity with similar objectives.

Although these entities are not founded for financial gain, the term "non-profit" does not mean they may not trade or make a profit; it means that surpluses should be used for the benefit of the members of these entities. A non-profit entity can also, in accordance with the Companies Act, register as a non-profit company. The main objective of such a company would be to promote religion, art, science, charity, education, recreation, cultural, social activities, communal or group interests. Payment of dividends from the profits of a non-profit company is not allowed, because income and profits must be used to promote the company's objectives.

Non-profit entities must apply to SARS to be exempted from income tax. They must, however, register for VAT purposes if their income (taxable supplies) exceeds or will exceed R1 000 000 per annum and may register for VAT purposes if their income is less than R1 000 000, but R50 000 or more per annum.

In this chapter, specific attention is given to the organisation and control of non-profit entities, their sources of income and how information is disclosed in their financial statements.

16.2 Organisational and control characteristics of non-profit entities

Smaller clubs are often organised on an informal basis. Many of the administrative and financial tasks are performed by a committee chosen by the members. These committees serve voluntarily and are unpaid. The accounting system is often on a cash basis and is sometimes incomplete. Larger clubs such as country clubs and larger non-profit entities usually operate with full-time managers and staff who are paid employees of the entity.

In smaller entities, the treasurer is likely to keep record of the cash transactions in a statement of receipts and payments instead of using more sophisticated accounting systems. A single-entry system is applied when the statements of receipts and payments is the only accounting record kept. The only control is to reconcile the deposits and payments with the bank statement to ensure that all cash receipts and payments were recorded.

If the double-entry system is used, the normal accounting procedures are followed with the accrual basis as underlying assumption. This means that depreciation and adjustments are taken into account, a trial balance can be extracted and financial statements can be compiled.

Each entity usually adopts the accounting system that best suits the requirements of the institution or the people for whom the financial statements are drafted. For this reason, the financial statements of an informal social club usually differ from the statements of a university, which would be subject to more comprehensive control systems and would have to disclose more information to enhance the usefulness of the financial statements. However, in principle, there is no difference between the accounts of a non-profit entity and a trading entity.

16.3 Sources of income for non-profit entities

A non-profit entity does not have owners who contribute capital. The members of non-profit entities usually pay an entrance fee and thereafter pay annual subscriptions.

Other sources of income include

- ☐ tuck shops, bars, restaurants;
- ☐ donations;
- ☐ bequests;
- ☐ fund-raising projects;
- ☐ government subsidies; and
- ☐ loans from financial institutions.

Profit-making, and consequently a return on capital, is not the aim of non-profit entities. For this reason, a capital account is not appropriate and is replaced by an accumulated fund account. The profit or loss account and statement of profit or loss and other comprehensive income are replaced by an income and expenditure account and a statement of income and expenditure. An excess of income over expenditure is referred to as a surplus, not a profit, and an excess of expenditure over income is called a deficit, not a loss. The surplus (or deficit) is added to (or subtracted from) the accumulated fund account.

The accounting equation of a non-profit entity can therefore be restated as

ASSETS = FUNDS + LIABILITIES

The sources of income and how they affect the funds section of the accounting equation will be discussed in more detail in the following paragraphs.

16.3.1 *Entrance fees*

Entrance fees, which are a form of non-recurring income, are usually capitalised and form part of the accumulated fund account. (When an item is capitalised, it means that it is not treated as an income for the period, but is transferred directly to the accumulated fund account.) These fees are therefore directly credited to the accumulated fund account and must not be added to revenue on the statement of income and expenditure.

Example 16.1

On 2 January 20.2, 16 members founded the Checkmate Chess Club and agreed to each pay R100 entrance fees. The accounting entries are as follows:

Dr **Bank** **Cr**

20.2			**R**				**R**
Jan	2	Entrance fees	1 600				

Dr **Entrance fees** **Cr**

20.2			**R**	20.2			**R**
Dec	31	Accumulated fund	1 600	Jan	2	Bank	1 600

Dr **Accumulated fund** **Cr**

			R	20.2			**R**
				Dec	31	Entrance fees	1 600

16.3.2 *Membership fees*

Non-profit entities should do an estimate (budget) of how much money they will need in the next year to cover their expenses. The annual fee is calculated by dividing the total budgeted expenses by the number of members.

Most members of clubs pay their membership fees, also referred to as subscriptions, on time. Some members may be in arrears with their fees which could later become irrecoverable, while other members pay their fees in advance. If the double-entry system and accrual basis of accounting are applied, only the income receivable from membership fees for the particular financial year must be taken into account as revenue for that year. Amounts that are in arrears must be added to the membership fees for that year and any fees received in advance must be subtracted. Separate accounts must be opened for fees in arrears and fees received in advance. The membership fees in arrears account indicates the income in arrears and must be shown under current assets, as part of trade and other receivables, on the statement of financial position. The membership fees received in advance account is reflected as a current liability under trade and other payables on the statement of financial position.

Example 16.2

The 16 members of the Checkmate Chess Club agreed to pay R40 membership fees per month. At 31 December 20.2, the end of the financial year, the fees of 2 members have been outstanding for 3 months and 5 members have already paid their fees for January 20.3. One of the members whose fees were outstanding paid his fees in

January 20.3. The other member had a disagreement with some of the members and joined another club. His fees were written off as irrecoverable on 30 June 20.3. In January 20.3, 5 new members joined the club and paid their entrance fees of R100 each. At the end of December 20.3, 7 members were in arrears with their membership fees for December 20.3 and 4 members had already paid their fees for January 20.4.

The ledger entries to record the membership fees received from January 20.2 to December 20.2 are as follows:

Dr **Bank** **Cr**

			R				R
20.2							
Jan	2	Entrance fees	1 600				
Dec	31	Membership fees	① 7 640				

Calculations:

① Total number of members for 20.2 = 16

Details	Calculation	Received	In arrears
		R	
16 – 2 paid in full	14 × 40 × 12	6 720	
2 were in arrears for 3 months	2 × 40 × 9	720	2 × 40 × 3 = R240
5 paid in advance for 20.3	5 × 40 × 1	200	
		7 640	

Dr **Membership fees** **Cr**

			R				R
20.2				20.2			
Dec	31	Income received in advance	200	Dec	31	Bank	7 640
		Income and expenditure	7 680			Accrued income	240
			7 880				7 880

Dr **Accrued income (membership fees)** **Cr**

			R				R
20.2							
Dec	31	Membership fees	240				

Dr **Income (membership fees) received in advance** **Cr**

			R				R
				20.2			
				Dec	31	Membership fees	200

Dr **Income and expenditure account** **Cr**

			R				R
				20.2			
				Dec	31	Membership fees	7 680

The accrued income and income received in advance accounts must be closed off against the membership fees account at the beginning of the next financial year, to ensure that the membership fees account for the following financial year reflects the correct income for that year. The entries are as follows:

Dr — Accrued income (membership fees) — Cr

			R				R
20.2 Dec	31	Membership fees	240	20.3 Jan	1	Membership fees	240

Dr — Income (membership fees) received in advance — Cr

			R				R
20.3 Jan	1	Membership fees	200	20.2 Dec	31	Membership fees	200

The ledger entries to record the membership fees received from January 20.3 to December 20.3 are as follows:

Dr — Bank — Cr

			R				R
20.3							
Jan	2	Entrance fees	500				
Dec	31	Membership fees	① 9 400				

Calculations:

① Total number of members for 20.3: 16 – 1 + 5 = 20

Details	Calculation	Received	In arrears
		R	
1 paid arrears of 3 months	1 × 40 × 3	120	
20 – 7 paid in full	13 × 40 × 12	6 240	
7 paid for 11 months	07 × 40 × 11	3 080	7 × 40 × 1 = R280
4 paid in advance	4 × 40 × 1	160	
Received during December 20.2		(200)	
		9 400	

Dr — Membership fees — Cr

			R				R
20.3				20.3			
Jan	1	Accrued income	240	Jan	1	Income received in advance	200
Dec	31	Income received in advance	160	Jun	30	Credit losses	120
		Income and expenditure	9 600	Dec	31	Bank	9 400
						Accrued income	280
			10 000				10 000

Dr — Income and expenditure — Cr

			R				R
				20.3 Dec	31	Membership fees	9 600

The entries at 31 December 20.3 and 1 January 20.4 in the accrued income (or accrued membership fees) and income received in advance (or membership fees received in advance) accounts are as follows:

Dr **Accrued income (membership fees)** **Cr**

			R				R
20.3 Dec	31	Membership fees	280	20.4 Jan	1	Membership fees	280

Dr **Income (membership fees) received in advance** **Cr**

			R				R
20.4 Jan	1	Membership fees	160	20.3 Dec	1	Membership fees	160

Dr **Membership fees** **Cr**

			R				R
20.4 Jan	1	Accrued income	280	20.4 Jan	1	Income received in advance	160

16.3.3 *Income from tuck shops, bars and restaurants*

To generate additional income, non-profit entities can provide tuck-shop, bar and/or restaurant facilities for their members. The gross profit of each such activity must be calculated separately. Since trading takes place, the format of the trading account and trading statement is the same as that of a trading concern. A gross profit, not a "surplus", is determined. It is shown as income on the statement of income and expenditure. Expenses incurred in generating the income are subtracted from the gross profit in the statement of income and expenditure. (Refer to the comprehensive example in paragraph 16.5.)

16.3.4 *Donations and bequests*

Donations and bequests can be treated as revenue. The amount received is debited to the bank account and credited to the donations received account. When there are no terms or conditions, the donations received account is closed off against the income and expenditure account and shown under income on the statement of income and expenditure. (Refer to Example 16.5.)

Depending on any terms and conditions and the size of the donation or bequest, it could be decided to capitalise the amount, instead of treating it as revenue. If capitalised, it is set aside for a specific purpose and is classified as a special fund, which is accounted for separately from the accumulated fund.

16.3.5 *Special funds*

If a non-profit entity sets aside money for a specific purpose, or if certain terms or conditions apply to a donation or bequest, a special fund is established. The money is usually invested to earn interest. A separate investment account should be opened for each special fund that comes into existence. Special funds are accounted for separately from the accumulated fund.

If it is stipulated that the income from the investment should be used for general expenses, that income is shown as revenue on the statement of income and expenditure. Usually, it is stipulated that the fund and/or the income from the fund be used for a purpose other than general expenses. Income from the investment should then be credited to the fund account and, if it is not used, reinvested. Thus, if the fund is intended for a specific purpose, the income should not be shown on the statement of income and expenditure.

When the fund account and any income earned on the fund are set aside for a specific purpose, the fund is referred to as expendable. When only the income earned from a special fund may be used for a specific purpose, the fund is referred to as non-expendable.

16.3.5.1 Expendable fund

When money is set aside for a specific purpose, or when the terms of a legacy or donation stipulate that the capital amount and any income earned from the investment of the amount be used for a specific purpose, a special fund is established for this purpose. An expendable fund is usually established to acquire assets for the non-profit entity. Donations made to this fund and interest on the investment are credited to the fund until the desired amount is raised to buy the asset or to complete a specific project. When the asset belongs to the entity or the specific project is complete, the special fund account must be closed off against the accumulated fund account.

Example 16.3

On 1 July 20.2, the Chequer company donated R100 000 to the Checkmate Chess Club on the express condition that the money be invested until enough is available to purchase a suitable property on which to build a clubhouse and that the clubhouse be named after the company. On the same date, a fixed deposit was made for a year at Kings Bank at 10% interest per annum payable at the end of the year. On 30 June 20.3, the money was reinvested for another year at the same interest rate.

On 15 June 20.4, an offer of R80 000 was made on a property. A building plan was approved by the municipality. Tenders were acquired and Knight Builders, who tendered to complete the building for R40 000, was appointed. On 30 June 20.4, the property was purchased from Queens Properties, and the builders started working on 2 July 20.4. The building was completed in November 20.4, but, owing to small changes in the plans, the total building costs amounted to R45 000. This amount was paid by the club.

The financial year end of Checkmate Chess Club is 31 December.

The general ledger entries to record the transactions that pertain to the establishment of the Chequer Special Fund are as follows:

Dr **Bank** **Cr**

Date		Details	R	Date		Details	R
20.2 Jul	1	Special fund: Chequer Fund	100 000	20.2 Jul	1	Fixed deposit: Kings Bank	100 000
- - - -	- -	- - - - - - - -	- - - -	- - - -	- -	- - - - - - - -	- - - -
20.3 Jun	30	Special fund: Chequer Fund (interest on fixed deposit)	10 000	20.3 Jun	30	Fixed deposit: Kings Bank	10 000
- - - -	- -	- - - - - - - -	- - - -	- - - -	- -	- - - - - - - -	- - - -
20.4 Jun	30	Special fund: Chequer Fund (interest on fixed deposit)	11 000	20.4 Jun	30	Land and buildings (Queens Properties)	80 000
		Fixed deposit: Kings Bank	110 000	Nov	30	Land and buildings (Knight Builders)	45 000

NB: The dotted lines [---------] separate financial years.

Dr **Special fund: Chequer Fund** **Cr**

Date		Details		R	Date		Details		R
20.2 Dec	31	Balance	c/d	105 000	20.2 Jul	1	Bank (donation)		100 000
					Dec	31	Accrued income		5 000
				105 000					105 000
20.3 Jan	1	Accrued income		5 000	20.3 Jan	1	Balance	b/d	105 000
Dec	31	Balance	c/d	115 500	Jun	30	Bank (interest)		10 000
					Dec	31	Accrued income		5 500
				120 500					120 500
20.4 Jan	1	Accrued income		5 500	20.4 Jan	1	Balance	b/d	115 500
Nov	30	Accumulated fund		121 000	Jun	30	Bank (interest)		11 000
				126 500					126 500

Dr **Fixed deposit: Kings Bank** **Cr**

Date		Details	R	Date		Details	R
20.2 Jul	1	Bank	100 000	20.4 Jun	30	Bank	110 000
20.3 Jun	30	Bank	10 000				
			110 000				110 000

continued

Accrued income (interest)

Dr							Cr
			R				**R**
20.2 Dec	31	Special fund: Chequer Fund	5 000	20.3 Jan	1	Special fund: Chequer Fund	5 000
20.3 Dec	31	Special fund: Chequer Fund	5 500	20.4 Jan	1	Special fund: Chequer Fund	5 500

Land and buildings at cost

Dr							Cr
			R				**R**
20.4 Jun	30	Bank	80 000				
Nov	30	Bank	45 000				
			125 000				

Accumulated fund

Dr							Cr
			R				**R**
				20.4 Nov	30	Special fund: Chequer Fund	121 000

NB: The entries in the accounts are not necessarily the only entries to date. Only the entries that pertain to the special fund established to build a clubhouse are reflected.

The fund and investment will be reflected as follows on the statements of financial position as at 31 December 20.2, 20.3 and 20.4:

Checkmate Chess Club
Statement of financial position as at 31 December 20.2

	Notes	R
ASSETS		
Non-current assets		
Financial assets: Loans and receivables: Chequer Fund: Fixed deposit at 10% per annum at Kings Bank		100 000
Current assets		
Trade and other receivables		5 000
Total assets		
FUNDS AND LIABILITIES		
Total funds		
Special funds		
Expendable funds		
Chequer Fund		105 000
Total liabilities		
Total funds and liabilities		

Checkmate Chess Club
Statement of financial position as at 31 December 20.3

	Notes	R
ASSETS		
Non-current assets		
Financial assets: Loans and receivables: Chequer Fund:		
Fixed deposit at 10% per annum at Kings Bank		110 000
Current assets		
Trade and other receivables		5 500
Total assets		
FUNDS AND LIABILITIES		
Total funds		
Special funds		
Expendable funds		
Chequer Fund		115 500
Total liabilities		
Total funds and liabilities		

Checkmate Chess Club
Statement of financial position as at 31 December 20.4

	Note	R
ASSETS		
Non-current assets		
Property, plant and equipment	3	125 000
Total assets		
FUNDS AND LIABILITIES		
Total funds		
Accumulated fund		xxx xxx
Balance: 1 January 20.4		xxx xxx
Land and buildings bought		121 000
Total liabilities		
Total funds and liabilities		

Checkmate Chess Club
Notes for the year ended 31 December 20.4 (Extract)

3. Property plant and equipment (Extract)

	Land and buildings
	R
Additions	125 000
From own funds	4 000
Chequer Fund	121 000

16.3.5.2 Non-expendable fund

When a donation or a bequest is made with the stipulation that only the income earned from the investment must be used for a specific purpose, the fund is referred to as a non-expendable fund. The income earned on the investment can be used either to pay for expenses or to purchase an asset. The expenses incurred may not be more than the income earned from the investment. Should the income be insufficient to pay for the expense or the asset, the entity must either use its own resources or find alternative means to finance the outstanding amount.

The income from the investment of the fund should be credited to the fund account and should not be reflected in the income and expenditure account. Likewise, when the expense is paid or the asset is acquired, the entry should be reflected through the fund account and not through the income and expenditure account.

Example 16.4

On 1 April 20.2, the Checkmate Chess Club received a donation of R20 000 from C Castle, on the express condition that the income received from the donation be used to pay for the expenses of club members who take part in competitions away from home. On the same date, a fixed deposit was made for two years at Kings Bank at 10% interest per annum. The interest is calculated at the end of the year and is received annually on 1 April. One member took part in a competition during October 20.2 in Bishops Town and his total expenses amounted to R1 450. The surplus interest was invested on 1 April 20.3 at 10% interest per annum.

The financial year-end of Checkmate Chess Club is 31 December.

The general ledger entries to record the transactions that pertain to the establishment of the Castle special fund are as follows:

Dr **Bank** **Cr**

			R				R
20.2				20.2			
Apr	1	Special fund: Castle Fund	20 000	Apr	1	Fixed deposit: Kings Bank	20 000
				Oct	31	Special fund: Castle Fund (competition expenses)	1 450
20.3				20.3			
Apr	1	Special fund: Castle Fund (interest on fixed deposit)	2 000	Apr	1	Fixed deposit: Kings Bank (surplus interest invested)	550

NB: The dotted lines [----------] separate financial years.

Dr **Special fund: Castle Fund** **Cr**

			Expendable	Non-expendable				Expendable	Non-expendable
20.2			R	R	20.2			R	R
Oct	31	Bank	1 450		Apr	1	Bank (donation)		20 000
Dec	31	Balance c/d	50	20 000	Dec	31	Accrued income	1 500	
			1 500	20 000				1 500	20 000
20.3					20.3				
Jan	1	Accrued income	1 500		Jan	1	Balance b/d	50	20 000
					Apr	1	Bank (interest income)	2 000	

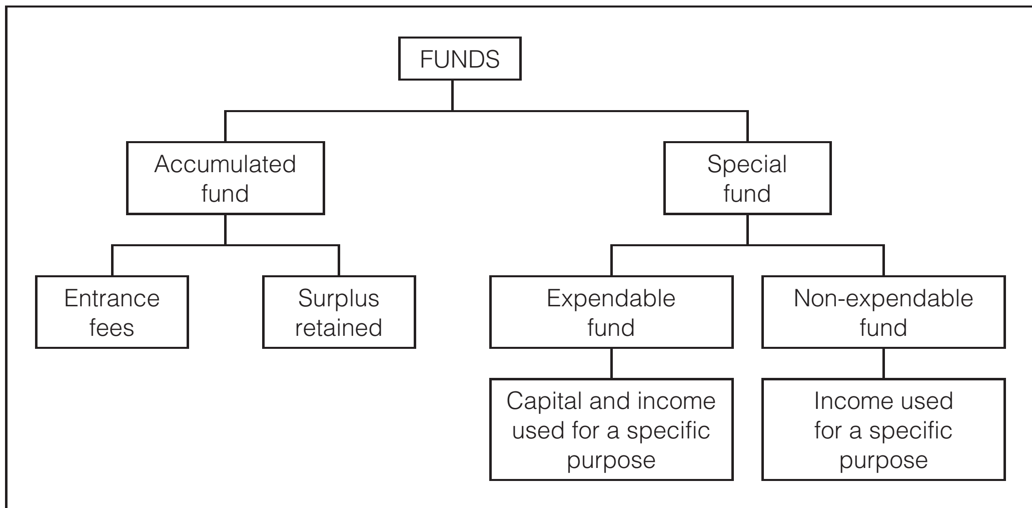
Dr **Fixed deposit: Kings Bank** **Cr**

			R				R
20.2							
Apr	1	Bank	20 000				
20.3							
Apr	1	Bank	550				
			20 550				

16.3.5.3 The difference between the accumulated fund and special funds

The funds of non-profit entities consist of two types of funds, namely, the accumulated fund and special funds, which can be summarised as follows:

Diagram 16.1



16.4 Financial reporting by non-profit entities

16.4.1 *Statement of receipts and payments*

When a non-profit entity has no assets other than cash funds, the statement of receipts and payments is often the only financial statement presented at the annual general meeting. This statement is merely a summary of the cash transactions for the financial period. The opening balance of the bank account at the beginning of the accounting period is entered above the receipts (if unfavourable, it is shown in brackets). All the cash received during the financial year is listed as receipts and actual payments for the year are listed as payments. The difference between the receipts and payments should reflect the balance of the bank account. This statement is presented in vertical (narrative) format.

The main disadvantages of only presenting a statement of receipts and payments are that

- ☐ only cash transactions are recorded;
- ☐ the statement may include receipts and payments of income, expenses, assets, liabilities and fund accounts;
- ☐ the accrual basis assumption is not applied because income received in advance, prepayments and accrued amounts received or paid are all included;
- ☐ a surplus or deficit cannot be determined; and
- ☐ the financial position of the entity is unknown.

Depending on the size and needs of the entity, a statement of receipts and payments would not supply sufficient financial information; therefore a statement of income and expenditure and statement of financial position are usually also required.

16.4.2 *Statement of income and expenditure*

The statement of income and expenditure is similar to the statement of profit or loss and other comprehensive income of a trading concern. The layout may differ, however, because all the sources of income may be shown under the heading "Income" and all expenses under the heading "Expenses". The statement is intended to determine the surplus or deficit of a non-profit entity for a financial year. A surplus is added to the accumulated fund and a deficit deducted.

The recording procedures in the books are the same as those of profit-making entities applying the double-entry system. By applying the accrual basis assumption, the necessary adjustments are made at the end of the financial year, taking outstanding and prepaid income and expenditure at the beginning and end of the financial year into account. Once the adjustments have been completed, all the accounts are closed off to the income and expenditure account. If the revenue during a financial period is in excess of expenditure for that period, it is regarded a surplus and is credited to the accumulated fund account. Similarly, expenses incurred in excess of revenue are regarded as a deficit and are debited to the accumulated fund account. A statement of income and expenditure can then be completed using the information in the income and expenditure account.

16.4.3 *Statement of changes in equity and the statement of financial position*

Special funds must be shown separately from the accumulated fund in a statement of changes in equity of a non-profit entity.

The statement of changes in equity of the Checkmate Chess Club for the financial year ended 31 December 20.2 is presented as follows:

Checkmate Chess Club
Statement of changes in equity for the year ended 31 December 20.2

	Accumulated Fund	Castle Fund	Chequer Fund	Total
	R	R	R	R
Entrance fees	1 600			1 600
Surplus for the year	936			936
Funds invested		20 000	100 000	120 000
Accrued interest income		50	5 000	5 050
Balances at 31 December 20.2	2 536	20 050	105 000	127 586

When a statement of income and expenditure and a statement of changes in equity are prepared, they must be accompanied by a statement of financial position.

Example 16.5

The Action Tennis Club came into existence on 1 May 20.4 with 20 members. Each member paid R250 entrance fees and agreed to pay R100 per month membership fees. They rented an existing club house and tennis courts from the local municipality for R1 500 per month. On 1 July 20.4, the Action Tennis Club received a donation of R20 000 and, with the necessary permission from the municipality, erected a lapa with bar facilities. The lapa was completed at the end of September 20.4. These facilities are available for private functions at R1 000 per day, on condition that the bar supplies any liquor needs. The lapa was let 25 times until the end of April 20.5.

Other cash receipts from 1 May 20.4 until 30 April 20.5:

	R
Membership fees	28 400
Bar cash sales	167 460
Bar debtors	48 230
Sale of old tennis balls	350

The following payments were made from 1 May 20.4 until 30 April 20.5:

	R
Caretaker's salary	19 200
Rent deposit	1 500
Rent expense	19 500
Building costs of lapa	25 500
Wages for bar personnel	36 000
Payments to bar creditors	86 450
Glassware purchased	50 630
Furniture and fittings	27 800
General expenses	4 870
Painting of tennis courts	2 150
Tennis court nets purchased on 1 May 20.4	7 200
Repairs to club house on 1 June 20.4	3 890
Tennis balls	2 950
Water and electricity	5 810

Additional information:

1. Ten new members joined the club during the year.
2. Membership fees in arrears amounted to R700 at April 20.5, while fourteen members paid their fees for May 20.5. R300 of the membership fees in arrears is considered irrecoverable and must be written off.
3. Bar inventory at 30 April 20.5 amounted to R14 280.
4. Glassware was valued at R45 200 at 30 April 20.5.
5. Furniture and fittings must be depreciated at 15% per annum on the diminishing-balance method. Furniture to the value of R5 000 was purchased on 1 May 20.4, while the other furniture and fittings were purchased on 1 September 20.4.
6. The tennis court nets must be depreciated at $33\frac{1}{3}$% per annum on the cost price.
7. Bar creditors amounted to R2 670 at 30 April 20.5.
8. Members' bar accounts amounted to R3 740 at 30 April 20.5.

Required

Prepare the following for the Action Tennis Club:

(a) The statement of receipts and payments for the year ended 30 April 20.5.

(b) The trading statement of the club's bar for the year ended 30 April 20.5.

(c) The membership fees account in the general ledger properly balanced at 30 April 20.5.

(d) The statement of income and expenditure for the year ended 30 April 20.5.

(e) The statement of changes in equity for the year ended 30 April 20.5.

(f) The statement of financial position as at 30 April 20.5.

(g) Show only the note on property, plant and equipment.

Solution

(a)

Action Tennis Club

Statement of receipts and payments for the year ended 30 April 20.5

	R
Receipts	296 940
Entrance fees R(250 × 30)	7 500
Membership fees	28 400
Donation for lapa	20 000
Letting income from lapa	25 000
Bar cash sales	167 460
Bar debtors	48 230
Sale of old tennis balls	350
Payments	(293 450)
Caretaker's salary	19 200
Rent deposit	1 500
Rent expense	19 500
Building costs of lapa	25 500
Wages for bar personnel	36 000
Payments to bar creditors	86 450
Glassware purchased	50 630
Furniture and fittings	27 800
General expenses	4 870
Painting of tennis courts	2 150
Tennis court nets	7 200
Repairs to club house	3 890
Tennis balls	2 950
Water and electricity	5 810
Bank balance at 30 April 20.5	3 490

(b)

Action Tennis Club

Bar trading statement for the year ended 30 April 20.5

	R
Revenue R(167 460 + 48 230 + 3 740)	219 430
Cost of sales	(74 840)
Purchases R(86 450 + 2 670)	89 120
Inventory (30 April 20.5)	(14 280)
Gross profit	144 590

(c)

Action Tennis Club

General ledger

Dr **Membership fees** **Cr**

			R				R
20.5 Apr	30	Income received in advance	1 400	20.5 Apr	30	Bank	28 400
		Income and expenditure	27 700			Credit losses	300
						Accrued income	400
			29 100				29 100

(d)

Action Tennis Club
Statement of income and expenditure for the year ended 30 April 20.5

		R
Income		161 640
Membership fees	27 700	
Lapa letting income	25 000	
Income from bar	108 590	
Gross profit	144 590	
Wages	(36 000)	
Sale of old tennis balls	350	
Expenses		(68 030)
Salaries	19 200	
Rent expense R(1 500 × 12)	18 000	
General expenses	4 870	
Painting of tennis courts	2 150	
Repairs to club house	3 890	
Tennis balls	2 950	
Water and electricity	5 810	
Credit losses	300	
Depreciation ①	10 860	
Surplus for the year		93 610

Calculations:

① Depreciation

	R
Furniture and fittings:	
R5 000 × 15% × $^{12}/_{12}$	750
R(27 800 – 5 000) = R22 800 × 15% × $^{8}/_{12}$	2 280
	3 030
Glassware	
R(50 630 – 45 200)	5 430
Tennis court nets	
R7 200 × 33 $^{1}/_{3}$% × $^{12}/_{12}$	2 400
	10 860

(e)

Action Tennis Club
Statement of changes in equity for the year ended 30 April 20.5

	Accumulated Fund
	R
Entrance fees	7 500
Lapa built from donation	20 000
Surplus for the year	93 610
Balance as at 30 April 20.5	121 110

(f)

Action Tennis Club
Statement of financial position as at 30 April 20.5

	Note	R
ASSETS		
Non-current assets		100 270
Property, plant and equipment	1	100 270
Current assets		24 910
Inventories		14 280
Trade and other receivables ①		5 640
Prepayments ②		1 500
Cash and cash equivalents		3 490
Total assets		125 180
FUNDS AND LIABILITIES		
Total funds		121 110
Accumulated fund		121 110
Total liabilities		4 070
Current liabilities		4 070
Trade and other payable		2 670
Membership fees received in advance		1 400
Total funds and liabilities		125 180

Action Tennis Club
Notes for the year ended 30 April 20.5

1. Property, plant and equipment

	Lapa	Furniture and fittings	Glass-ware	Tennis-court nets	Total
	R	**R**	**R**	**R**	**R**
Additions during the year	25 500	27 800	50 630	7 200	111 130
From own funds	5 500				
From donation	20 000				
Depreciation for the year	–	(3 030)	(5 430)	(2 400)	(10 860)
Carrying amount at 30 April 20.5	25 500	24 770	45 200	4 800	100 270
Cost	25 500	27 800	50 630	7 200	111 130
Accumulated deprecation	–	(3 030)	(5 430)	(2 400)	(10 860)

① Trade and other receivables consist of

	R
Members' bar accounts	3 740
Rent deposit	1 500
Accrued membership fees	400
	5 640

② Prepayments represents the prepaid rent of R1 500

16.5 Comprehensive example

The following trial balance has been prepared from the books of Knowledge College as at 30 November 20.3:

Knowledge College
Trial balance as at 30 November 20.3

	Debit	Credit
	R	R
Accumulated fund		465 725
Lecture fees		1 554 400
Special funds – Expendable funds (interest income)		
Moody Bursary Fund		4 500
Campbell Library Fund		1 800
Special funds – Non-expendable funds		
Moody Bursary Fund		50 000
Campbell Library Fund		20 000
Tuck shop		
Inventory (01/12/20.2)	2 350	
Sales		125 500
Purchases	57 840	
Wages	29 860	
Salaries	955 630	
Printing and stationery	35 460	
Administration costs	12 740	
Water and electricity	126 440	
Rent expense	240 000	
Library books at cost (01/12/20.2)	258 640	
Library books purchased	35 480	
Equipment (at cost)	260 000	
Vehicles (at cost)	150 000	
Vehicle repairs and fuel	15 420	
Investments in AZ Bank:		
Campbell Library Fund	20 000	
Moody Bursary Fund	50 000	
Debtors (lecture fees)	87 690	
Bank	50 430	
General expenses	24 560	
Insurance	15 680	
Telephone expense	17 350	
Donation		2 000
Accumulated depreciation: library books (01/12/20.2)		74 045
Accumulated depreciation: equipment (01/12/20.2)		93 600
Accumulated depreciation: vehicles (01/12/20.2)		54 000
	2 445 570	2 445 570

Additional information:

1. The Bursary Fund was established on 1 December 20.2 when C Moody donated R50 000 on the express condition that the income from the fund may only be used for bursaries. The money was invested on the same date at 9% interest per

annum, calculated on the last day of each year, at AZ Bank. At a meeting held on 15 July 20.2, the board of the college decided to award the interest to be earned on the Bursary Fund in the current financial year to two students who performed well in their first semester. The students who qualified for the bursaries were informed of the decision and that their accounts would be credited with R2 250 each on 30 November 20.3.

2. The Library Fund was established on 1 December 20.2 when D Campbell donated R20 000 on the express condition that only the income from the fund be used to purchase books for the library. The money was invested on the same date at 9% interest per annum, calculated on the last day of each financial year, with AZ Bank. Books to the value of R20 480 were purchased on 1 February 20.3 and to the value of R13 200 on 1 June 20.3. The interest earned on the investment was used to pay for books purchased on 30 November 20.3.
3. On 30 November 20.3, the tuck shop inventory amounted to R2 740.
4. Depreciation must be provided for as follows:

   Library books – 15% per annum on cost
   Equipment – 20% per annum on the diminished balance
   Vehicles – 20% per annum on the diminished balance

Required

Prepare the following for Knowledge College:

(a) The trading statement of the tuck shop for the year ended 30 November 20.3.
(b) The Moody and Campbell special fund accounts in the general ledger properly balanced at 30 November 20.3.
(c) The statement of income and expenditure for the year ended 30 November 20.3.
(d) The statement of changes in equity for the year ended 30 November 20.3.
(e) The statement of financial position as at 30 November 20.3.

Solution

(a) **Knowledge College**

Tuck shop: Trading statement for the year ended 30 November 20.3

	R
Revenue	125 500
Cost of sales	(57 450)
Inventory (1 December 20.2)	2 350
Purchases	57 840
	60 190
Inventory (30 November 20.3)	(2 740)
Gross profit	68 050

(b)

Knowledge College
General ledger

Dr **Special fund: Moody Fund** **Cr**

			Ex-pend-able	Non-expend-able				Ex-pend-able	Non-expend-able
20.3			R	R	20.2			R	R
Nov	30	Debtors	4 500		Dec	1	Bank (donation)		50 000
		Balance c/d		50 000	20.3				
					Nov	30	Bank (interest income)	4 500	
			4 500	50 000				4 500	50 000
					20.3				
					Dec	1	Balanceb/d		50 000

Dr **Special fund: Campbell Fund** **Cr**

			Ex-pend-able	Non-expend-able				Ex-pend-able	Non-expend-able
20.3			R	R	20.2			R	R
Nov	30	Accumulated fund ①	1 800		Dec	1	Bank (donation)		20 000
		Balancec/d		20 000	20.3				
					Nov	30	Bank (interest income)	1 800	
			1 800	20 000				1 800	20 000
					20.3				
					Dec	1	Balanceb/d		20 000

① Books purchased

(c) **Knowledge College**

Statement of income and expenditure for the year ended 30 November 20.3

	R
Income	1 594 590
Lecture fees	1 554 400
Income from tuck shop	38 190
Gross profit	68 050
Wages	(29 860)
Donation received	2 000
Expenses	(1 538 106)
Salaries	955 630
Printing and stationery	35 460
Administration costs	12 740
Water and electricity	126 440
Rent expense	240 000
Vehicle repairs and fuel	15 420
General expenses	24 560
Insurance	15 680
Telephone	17 350
Depreciation ①	94 826
Surplus for the year	56 484

Calculations:

① Depreciation

	R
Library books	
R258 640 × 15%	38 796
R20 480 × 15% × $^{10}/_{12}$	2 560
R13 200 × 15% × $^{6}/_{12}$	990
	42 346

No depreciation is written off on the books purchased on 30/11/20.3.

	R
Equipment	
R(260 000 – 93 600) × 20%	33 280
Vehicles	
R(150 000 – 54 000) × 20%	19 200
	94 826

(d)

Knowledge College
Statement of changes in equity for the year ended 30 November 20.3

	Accumulated Fund	Campbell Library Fund	Moody Bursary Fund	Total
	R	R	R	R
Balances as at 1 December 20.2	465 725	20 000	50 000	535 725
Library books from Campbell Fund	1 800			1 800
Surplus for the year	56 484			56 484
Balances as at 30 November 20.3	524 009	20 000	50 000	594 009

(e)

Knowledge College
Statement of financial position as at 30 November 20.3

	Notes	R
ASSETS		
Non-current assets		457 649
Property, plant and equipment	3	387 649
Financial assets	4	70 000
Current assets		136 360
Inventories	2.3	2 740
Trade and other receivables R(87 690 – 4 500)	4	83 190
Cash and cash equivalents	4	50 430
Total assets		594 009
FUNDS AND LIABILITIES		
Total funds		594 009
Accumulated fund		524 009
Special funds		
Non-expendable funds		
Campbell Library Fund		20 000
Moody Bursary Fund		50 000
Total funds and liabilities		594 009

Knowledge College
Notes for the year ended 30 November 20.3

1. Basis of presentation

   The annual financial statements have been prepared in accordance with International Financial Reporting Standards appropriate to the business of the entity. The annual financial statements have been prepared on the historical cost basis.

2. Summary of significant accounting policies

   The annual financial statements incorporate the following significant accounting policies, which are consistent with those applied in previous years, except where otherwise stated:

   2.1 Property, plant and equipment

   Property, plant and equipment are initially recognised at cost price. Library books, equipment and vehicles are subsequently measured at historical cost less accumulated depreciation and accumulated impairment losses.

   Depreciation on library books, equipment and vehicles is written off at a rate deemed to be sufficient to reduce the carrying amount of the assets over their estimated useful life to their estimated residual value. The depreciation rates are as follows:

   Library books: 15% per annum according to the straight-line method;

   Equipment: 20% per annum according to the diminishing-balance method;

   Vehicles: 20% per annum according to the diminishing-balance method.

   Depreciation is charged to income and expenditure for the year. Gains or losses on disposal are determined by comparing the proceeds with the carrying amount of the asset. The net amount is included in income and expenditure for the year.

   2.2 Financial assets

   Financial assets are recognised in the entity's statement of financial position when the entity becomes a party to the contractual provisions of an instrument.

   Financial instruments are initially measured at cost, which is fair value plus transaction costs, except for "Financial assets at fair value through profit or loss" which is measured at cost, transaction costs excluded.

   The entity classifies its financial assets in the following categories: at fair value through profit or loss, and loans and receivables. The entity's classification depends on the purpose for which the entity acquired the financial assets.

   Cash and cash equivalents are classified as "Financial assets at fair value through profit or loss". Cash and cash equivalents consists of cash in bank.

   2.3 Inventories

   Inventories are initially measured at cost and subsequently valued at the lower of cost or net realisable value. Cost is calculated using the first-in, first-out method. Net realisable value is the estimated selling price in the ordinary course of business, less any costs of completion and disposal.

3. Property, plant and equipment

	Library books	Equipment	Vehicles	Total
	R	R	R	R
Carrying amount at 1 December 20.02	184 595	166 400	96 000	446 995
Cost	258 640	260 000	150 000	668 640
Accumulated depreciation	(74 045)	(93 600)	(54 000)	(221 645)
Additions during the year	35 480	–	–	35 480
From own funds	33 680			33 680
From Campbell Fund	1 800			1 800
Depreciation for the year	(42 346)	(33 280)	(19 200)	(94 826)
Carrying amount at 30 November 20.3	177 729	133 120	76 800	387 649
Cost	294 120	260 000	150 000	704 120
Accumulated depreciation	(116 391)	(126 880)	(73 200)	(316 471)

4. Financial assets

	20.3
Non-current financial assets	R
Loans and receivables:	70 000
Campbell Library Fund – Fixed deposit at AZ Bank at 9% p.a.	20 000
Moody Bursary Fund – Fixed deposit at AZ Bank at 9% p.a.	50 000
Current financial assets	
Trade and other receivables:	
Debtors control	83 190
Other financial assets	
Financial assets at fair value through profit or loss:	
Cash and cash equivalents:	50 430
Bank	50 430

16.6 Summary

The main purpose of non-profit entities is to render a service to their members or the community. Membership, not ownership, is usually acquired through the payment of an entrance fee and annual subscriptions. Other forms of income may be from donations, fund-raising projects, bequests and government subsidies. They can also generate income by trading or borrow funds from financial institutions. A non-profit entity has either a surplus or a deficit for a financial year. The surpluses generated by the entity may, however, not be distributed amongst the members, but must be applied for the benefit of the members. If there is a surplus of income over expenditure, the surplus will be transferred to the accumulated fund account.

When funds are needed for a specific purpose, a special fund can be established. If the fund and the income from it are intended for a specific purpose, it is referred to as an expendable fund. When only the income from a special fund is set aside for a specific purpose, it is referred to as a non-expendable fund. Special funds are accounted for separately from the accumulated fund.

The financial statements presented to the members will depend on the size and requirements of the entity. This can vary from presenting only a statement of receipts and payments to a complete set of financial statements. The format of the statements is similar to that of entities that trade for profit.

CHAPTER 17

Incomplete records

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17.1 Introduction

Study objectives

After studying this chapter you should be able to

- ☐ calculate the profit or loss from incomplete records; and
- ☐ prepare the final accounts.

When accounting transactions have not been recorded according to the double-entry system, the records are incomplete. Sometimes, the owners or management of small businesses, non-profit organisations and occasionally even larger firms know very little about basic accounting and either keep no records at all or keep some records on a single-entry basis. Incomplete records also occur when financial data has been lost, stolen or destroyed by fire. A thorough knowledge of the accounting concepts taught up to now is necessary to calculate profit or loss and to prepare accounts from incomplete records.

17.2 Calculation of estimated profit or loss from incomplete records

There is no statutory obligation on partnerships or sole proprietorships to keep accounting records. There are times when the profit or loss of a business needs to be calculated – when, for example, the business applies for a loan or bank overdraft for taxation purposes or wants to sell a business. When accounting records are inadequate, the profit or loss for a period can be calculated by means of the basic accounting equation. (The basic accounting equation is discussed in chapters 2 and 3.) By comparing the equity at the beginning of a period with the equity at the end of that period and by taking into account any drawings or additional capital contributions made, the profit or loss for the period can be determined. A statement of assets and liabilities must be prepared for the beginning and for the end of the applicable financial period. The equity is then calculated by using the basic accounting equation:

Equity = Assets – Liabilities

Where there are no ledger accounts, the value of all the assets and liabilities can be determined in the following ways:

- ☐ By referring to the original purchase contracts, the cost price of non-current assets can be determined. When calculating the value of non-current assets at the end of a period, start with the amount determined for the beginning of the period. Any additional assets bought during the period must be added to this amount and disposals must be subtracted. The value thus determined will be the value of the non-current assets at the end of the period.
- ☐ One can use invoices, credit notes, debit notes and receipts to establish the amount that debtors owe the business. These documents must be carefully scrutinised to ascertain all amounts owing by debtors. Any settlement discount granted and credit losses must also be included.

- ☐ By counting the cash on hand and referring to the bank statements, bank deposit books and cheque book counterfoils one can determine cash and cash equivalents.
- ☐ By consulting the original agreements of non-current liabilities one can find out the details. Any repayments made or new loans incurred must be taken into account when determining these liabilities.
- ☐ One can determine amounts owing to creditors by referring to invoices, credit notes, debit notes, cheque book counterfoils and other documentation. These amounts should be compared to the monthly statements received from creditors to verify correctness.

The profit or loss for the period can be calculated by subtracting the equity at the beginning of the period from the equity at the end of the period. Adjustments must then be made for any income or expenditure not yet accounted for and for drawings or additional capital contributions made by the owner(s). The following formula can be used:

Equity at the end of the period (before adjustments)

minus

equity at the beginning of the period

plus

income not yet accounted for

minus

expenses not yet accounted for

plus

drawings

minus

additional capital contributions

equals

estimated net profit or loss for period.

For obvious reasons, this method of calculating profit or loss is not very satisfactory and must only be used where inadequate accounting data is available. It is, however, used by SARS to determine the income of taxpayers who have not kept proper records.

Example 17.1

On 1 March 20.1, J John started a small business, Julian's Jams. On the same day, he deposited R50 000 into the business bank account. He also contributed a delivery vehicle valued at R35 000.

J John did not keep proper records for the year and asks you to help him determine his profit or loss. After thorough investigation of the assets and liabilities for the year ended 28 February 20.2, you find the following:

	R
Delivery vehicle	35 000
Furniture and equipment	15 000
Inventory	12 500
Debtors	3 200
Bank	26 700
Creditors	1 700

Additional information:

(a) Depreciation must be provided for as follows:

	R
Delivery vehicle	7 000
Furniture and equipment	625

(b) J John took R2 000 per month for own use.

Required

Calculate the profit or loss of Julian's Jams for the year ended 28 February 20.2.

Solution

Step 1 Prepare a statement of assets and liabilities for the beginning of the financial period.

Julian's Jams
Statement of assets and liabilities as at 1 March 20.1

	R
Assets	
Delivery vehicle	35 000
Bank	50 000
Total assets	85 000
Liabilities	–
Total liabilities	–

Step 2 Calculate the equity as at the beginning of the period.

Equity	=	Assets	–	Liabilities
	=	R85 000	–	nil
	=	R85 000		

Step 3 Prepare a statement of assets and liabilities for the end of the financial period.

Julian's Jams
Statement of assets and liabilities as at 28 February 20.2

	R
Assets	
Delivery vehicle	35 000
Furniture and equipment	15 000
Inventory	12 500
Debtors	3 200
Bank	26 700
Total assets	92 400
Liabilities	
Creditors	1 700
Total liabilities	1 700

Step 4 Calculate the equity, before adjustments, as at the end of the period.

Equity	=	Assets	–	Liabilities
	=	R92 400	–	R1 700
	=	R90 700		

Step 5 Calculate the estimated profit or loss for the financial period.

		R
Equity as at 28 February 20.2 (before adjustments)		90 700
Equity as at 1 March 20.1		(85 000)
		5 700
Adjustments:	Depreciation R(7 000 + 625)	(7 625)
	Drawings R(2 000 × 12)	24 000
Estimated profit for the year		22 075

Example 17.2

L Lennon is running a small business from home. He knows nothing about bookkeeping and just uses a notebook to record amounts payable and amounts receivable. He asks for your assistance in calculating his profit for the year. After thorough investigation, you establish the following:

Balances:

	30 April 20.1	**1 May 20.0**
	R	**R**
Loan: Y Yoko	30 000	30 000
Equipment	40 000	40 000
Inventory	21 500	18 700
Debtors	5 000	6 100
Bank (favourable)	3 900	2 400
Creditors	6 600	7 300

Additional information:

1. The telephone account of R220 for April 20.1 has not yet been taken into account.
2. Interest of 14% per annum payable on the loan from Y Yoko has not yet been taken into account.
3. The equipment must be depreciated by R10 000 for the year.
4. During the year, L Lennon took R36 000 for own use.

Required

Calculate the profit or loss of L Lennon for the year ended 30 April 20.1.

Solution

L Lennon
Statement of assets and liabilities as at 1 May 20.0

Assets	**R**
Equipment	40 000
Inventory	18 700
Debtors	6 100
Bank	2 400
Total assets	67 200
Liabilities	
Loan: Y Yoko	30 000
Creditors	7 300
Total liabilities	37 300

Equity = Assets – Liabilities
= R67 200 – R37 300
= R29 900

L Lennon
Statement of assets and liabilities as at 30 April 20.1

Assets	**R**
Equipment	40 000
Inventory	21 500
Debtors	5 000
Bank	3 900
Total assets	70 400
Liabilities	
Loan: Y Yoko	30 000
Creditors	6 600
Total liabilities	36 600

Equity (before adjustments) = Assets – Liabilities
= R70 400 – R36 600
= R33 800

		R
Equity as at 30 April 20.1 (before adjustments)		33 800
Equity as at 1 May 20.0		(29 900)
		3 900
Adjustments:	Telephone expense	(220)
Adjustments:	Interest expense (R30 000 × 14%)	(4 200)
Adjustments:	Depreciation	(10 000)
Adjustments:	Drawings	36 000
Estimated profit for the year		25 480

17.3 Preparation of accounts from incomplete records

It is sometimes necessary to prepare accounts from incomplete records. To do this, details of cash receipts and cash payments are needed as well as details of the movements of debtors and creditors during the period under review. By using this information and preparing a statement of assets and liabilities as at the beginning of the period, a set of accounts can be constructed. This is achieved by using the following steps:

Step 1

Prepare a statement of assets and liabilities as at the beginning of the period to determine the equity as at the beginning of the period.

Step 2

The first account to be reconstructed should be the bank account. Make a summary of the bank account for the financial period. The counterfoils of cheques, deposit slips and the bank statements can be used as reference.

Step 3

Establish whether a float or petty cash is in use. If one is, summarise all receipts and payments in the float or petty cash account and determine any cash on hand.

Step 4

Calculate the purchases and sales figures for the period. This is done by preparing T-accounts for total debtors and total creditors. All items that would affect the debtors and creditors control accounts – for example, settlement discount granted or received, sales or purchases returns, credit losses and dishonoured cheques – must also be recorded in the applicable control account.

Example 17.3

The following information of P Paul, for the year ended 31 January 20.1, is available to you:

	R
Creditors 1 February 20.0	8 750
Creditors 31 January 20.1	10 900
Cash paid to suppliers	23 700
Debtors 1 February 20.0	14 500
Debtors 31 January 20.1	12 900
Cash received from debtors	30 800

According to the accrual basis assumption, a transaction or event must be recorded in the financial period in which it occurs, irrespective of when the cash is received or paid. Therefore the amount actually paid to the suppliers during the financial period does not necessarily represent the purchases for that period. The amount actually paid to suppliers must therefore be adjusted to calculate the purchases figure.

We can now calculate the purchases for the period:

Dr **Total creditors** **Cr**

				R					R
20.1 Jan	31	Bank		23 700	20.0 Feb	1	Balance Creditors	b/d	8 750
		Balances Creditors	c/d	10 900	20.1 Jan	31	Purchases*		25 850
				34 600					34 600
					20.1 Feb	1	Balances Creditors	b/d	10 900

* Balancing figure

Similarly, the money actually received from debtors during the financial period can be used to ascertain the sales figure.

We can now calculate the sales for the period:

Dr **Total debtors** **Cr**

				R					R
20.0 Feb	1	Balances Debtors	b/d	14 500	20.1 Jan	31	Bank		30 800
20.1 Jan	31	Sales*		29 200			Balances Debtors	c/d	12 900
				43 700					43 700
20.1 Feb		Balances Debtors	b/d	12 900					

* Balancing figure

Step 5

It seldom, if ever, occurs that the total inflow and total outflow of cash are equal to the total income and total expenses of the current financial period. There are non-cash transactions, for example credit losses, depreciation, settlement discount granted and received, accruals and prepayments at the end of a financial period. The actual income or expenditure that must be shown on the statement of financial performance will therefore have to be calculated. The following example will explain the procedure.

Example 17.4

R Ringo runs a small business in the shopping centre near his home. The following information relates to the year ended 30 April 20.1:

	R
Rent paid	22 000
Interest received	1 375

You ascertain that the rent payable for the period amounted to R2 000 per month, for the full year.

R Ringo informs you that interest income of R375, payable on 30 April 20.1, has not yet been received. You also discover that interest income of R250, received on 4 May 20.0, was for the previous financial period.

The rent expense to be shown on the statement of profit or loss and other comprehensive income is calculated as follows:

Dr **Rent expense** **Cr**

20.1				R	20.1				R
Apr	30	Bank		22 000	Apr	30	Profit or loss		24 000
		Accrued expenses		2 000					
				24 000					24 000

The balance of R24 000 on the rent expense account is the total rent expense for the financial year ended 30 April 20.1. This is the amount that must be debited in the profit or loss account and shown as an expense on the statement of profit or loss and other comprehensive income.

The interest income to be shown on the statement of profit or loss and other comprehensive income is calculated as follows:

Dr **Interest income** **Cr**

20.0				R	20.1				R
May	1	Accrued income		250	Apr	30	Bank		1 375
20.1							Accrued income		375
Apr	30	Profit or loss		1 500					
				1 750					1 750

The balance of R1 500 on the interest income account is the amount that must be credited in the profit or loss account and must be shown as an income on the statement of financial performance.

Step 6

Post all the other items to the ledger accounts and prepare a trial balance.

Step 7

Prepare the financial statements.

17.4 Comprehensive example

G George, the owner of Pattie's Pastries, keeps records of the business's transactions on the single-entry basis. The following information is available:

List of balances:

	30 September 20.1	1 October 20.0
	R	R
Equipment	15 500	15 500
Shop-fittings	23 000	23 000
Debtors	3 100	3 150
Creditors	14 300	17 300
Inventory	9 100	8 500
Bank (favourable)	–	4 300
Bank overdraft	?	–

Summary of receipts and payments:

	R
Receipts	
Cash sales	48 670
Receipt from debtors	7 700
Payments	
Payments to creditors	13 290
Insurance	800
Rent expense	19 800
Municipal expenses	5 090
Telephone expense	2 710
Sundry expenses	4 560
Drawings	15 000

Additional information:

1. On 2 January 20.1, G George entered into a contract to insure the business' assets. The premium is payable annually in advance on 2 January each year.
2. Rent of R1 800 for September has not yet been paid.
3. Depreciation, on the straight-line method, must be provided for as follows:

   Equipment – 20% per annum

   Shop-fittings – 25% per annum.

Required

Prepare the following for Pattie's Pastries for the year ended 30 September 20.1:

(a) statement of profit or loss and other comprehensive income;

(b) statement of changes in equity;

(c) statement of financial position; and

(d) note on property, plant and equipment.

Solution

Pattie's Pastries
Statement of assets and liabilities as at 1 October 20.0

Assets	**R**
Equipment	15 500
Shop-fittings	23 000
Inventory	8 500
Debtors	3 150
Bank	4 300
Total assets	54 450
Liabilities	
Creditors	17 300
Total liabilities	17 300

Equity = Assets – Liabilities
= R54 450 – R17 300
= R37 150

Dr **Bank** **Cr**

				R					R
20 Oct	1	Balance	b/d	4 300	20.1 Sep	30	Creditors		13 290
20.1							Insurance		800
Sep	30	Cash sales		48 670			Rent expense		19 800
		Debtors		7 700			Municipal expenses		5 090
		Balance	c/d	580			Telephone expense		2 710
							Sundry expenses		4 560
							Drawings		15 000
				61 250					61 250
					Oct	1	Balance	b/d	580

Dr **Total debtors** **Cr**

				R					R
20 Oct	1	Balances Debtors	b/d	3 150	20.1 Sep	30	Bank		7 700
							Balances Debtors	c/d	3 100
Sep	30	Credit sales*		7 650					
				10 800					10 800
Oct	1	Balances Debtors	b/d	3 100					

* Balancing figure

continued

Dr **Total creditors** **Cr**

				R					R
20.1					20				
Sep	30	Bank		13 290	Oct	1	Balance	b/d	17 300
		Balance	c/d	14 300	20.1				
					Sep	30	Purchases*		10 290
				27 590					27 590
					Oct	1	Balance	b/d	14 300

* Balancing figure

Dr **Insurance** **Cr**

				R					R
20.1					20.1				
Sep	30	Bank		800	Sep	30	Prepaid expenses		200
							Profit or loss		600
				800					800

Calculation:

Insurance for 12 months (1 January – 31 December 20.1) = R800

Insurance per month R800/12 = R66,67

∴ insurance for 9 months (1 January – 30 September 20.1) = R600

Dr **Rent expense** **Cr**

				R					R
20.1					20.1				
Sep	30	Bank		19 800	Sep	30	Profit or loss		21 600
		Accrued expenses		1 800					
				21 600					21 600

Calculate the depreciation for the year:

		R
Equipment:	20% × R15 500	3 100
Shop-fittings:	25% × R23 000	5 750
		8 850

Trial balance as at 30 September 20.1

	Debit	Credit
	R	**R**
Capital		37 150
Drawings	15 000	
Equipment	15 500	
Shop-fittings	23 000	
Accumulated depreciation: Equipment		3 100
Accumulated depreciation: Shop-fittings		5 750
Debtors control	3 100	
Creditors control		14 300
Inventory – 1 October 20.0	8 500	
Bank overdraft		580
Prepaid expense	200	
Accrued expense		1 800
Sales R(48 670 + 7 650)		56 320
Purchases	10 290	
Insurance	600	
Rent expense	21 600	
Municipal expenses	5 090	
Telephone expense	2 710	
Sundry expenses	4 560	
Depreciation	8 850	
	119 000	119 000

(a)

Pattie's Pastries
Statement of profit or loss and other comprehensive income for the year ended 30 September 20.1

	R
Revenue	56 320
Cost of sales	(9 690)
Inventory: 1 October 20.0	8 500
Purchases	10 290
	18 790
Inventory: 30 September 20.1	(9 100)
Gross profit	46 630
Distribution, administrative and other expenses	(43 410)
Insurance	600
Rent expense	21 600
Municipal expenses	5 090
Telephone expense	2 710
Sundry expenses	4 560
Depreciation	8 850
Profit/Total comprehensive income for the year	3 220

(b) **Pattie's Pastries**

Statement of changes in equity for the year ended 30 September 20.1

	R
Balance as at 1 October 20.0	37 150
Estimated profit for the period	3 220
Drawings	(15 000)
Balance as at 30 September 20.1	25 370

(c) **Pattie's Pastries**

Statement of financial position as at 30 September 20.1

	Note	R
ASSETS		
Non-current assets		29 650
Property, plant and equipment	3	29 650
Current assets		12 400
Inventories		9 100
Trade receivables		3 100
Prepayments		200
Total assets		42 050
EQUITY AND LIABILITIES		
Total equity		25 370
Capital		25 370
Total liabilities		16 680
Current liabilities		16 680
Trade and other payables R(14 300 + 1 800)		16 100
Other financial liabilities		580
Total equity and liabilities		42 050

(d) **Notes to the financial statements**

Note 3

Property, plant and equipment	**Equipment**	**Shop fittings**	**Total**
	R	**R**	**R**
Carrying amount: Beginning of year	15 500	23 000	38 500
Cost	15 500	23 000	38 500
Accumulated depreciation	–	–	–
Depreciation for the year	(3 100)	(5 750)	(8 850)
Carrying amount: End of year	12 400	17 250	29 650
Cost	15 500	23 000	38 500
Accumulated depreciation	(3 100)	(5 750)	(8 850)

17.5 Conversion to a double-entry system

The above process can be used when converting from a single-entry system to a double-entry system of bookkeeping. Once the accounts have been prepared from incomplete records and financial statements for the period compiled, these balances can be used to open a set of books using the double-entry system. If you have prepared financial statements from incomplete records for a client, you should encourage your client to use these balances and continue to record all transactions in a general ledger, applying the double-entry system.

17.6 Summary

Incomplete records occur when transactions have not been recorded using the double-entry system. If the double-entry system has not been used, the profit or loss for a period can be calculated using the BAE. It is also possible to prepare accounts from incomplete records and then to prepare financial statements based on these accounts.

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