



GRADE 12

# ACCOUNTING

## MODULE 1: FINANCIAL ACCOUNTING



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# UNIT 1: ESSENTIAL BASIC KNOWLEDGE

## LEARNING OBJECTIVES

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

- Define accounting.
- Understand the basic principles that govern accounting.
- List the forms of ownership and name their respective characteristics.
- Name the users of financial statements and the reason for their interest in these statements.



**You should spend more or less 8 hours on this unit.**

# 1. INTRODUCTION

The Accounting Examination consists of one three - hour paper of 300 marks.

The number of questions may vary from five to eight in total. There is no stipulation as to the specific total of marks per question. All questions are compulsory and are to be answered in a specially prepared answer book.

## 1.1. Definition of Accounting

Accounting can be defined as the methodical recording of the relevant transactions of a business enterprise, the reporting on the results of these transactions and the provision of financial information in the financial statements. These financial statements are used for decision making for internal and external factors affecting the business enterprise. Accounting includes Bookkeeping, which is the identification and recording of transactions. However, Bookkeeping is just one part of the accounting process.

## 1.2. The Nature and Purpose of Accounting

Accounting is a means of communication in a business environment. Accounting is a “language” used to communicate both the financial performance and financial position of a business enterprise. It is very important that the information in the financial statements is understandable, relevant and reliable because many people, both inside and outside the enterprise, use this information in order to make complicated decisions.

- Internally, managers use accounting daily to budget and control their finances.
- Externally potential investors must decide whether or not to invest in the business.

However, there are many other users of these statements and examples of its uses. In every situation (in a business environment or a personal capacity) financial resources are scarce and hard to come by. Their use must be thoroughly planned and controlled. Accounting knowledge is therefore of utmost value.

## 1.3. Basic Concepts of Accounting

The following concepts and their definitions are important in accounting and you need to know all of them to understand accounting principles:





<b>Keyword &amp; Concept</b>	<b>Meaning</b>
Accrued expenses/expenses payable	Expenses that are still owed at the end of the financial year
Accrued income/income receivable	Income that is still owing to the business at the end of the financial year
Asset	Item of value owned by a person or business which enables a profit to be made
Bad debts	Debts written off as the debtors are unlikely to settle their accounts
Cost of sales	Cost of sales is the cost price of all goods that have been sold
Creditors	People/suppliers the business owes money to
Debtors	People who owe the business money for goods bought on credit
Depreciation	The amount by which fixed assets reduce in value over time due to use
Income received in advance/deferred income	Income that has already been received by a business but which is for the next financial year
Liability	An amount owed by a person or business to another person or business
Loss	When the expenses are more than the income
Mark-up	The percentage added to the cost price to calculate the selling price, i.e. the profit %
Owners' equity	The net worth (value) of the business at any given time. Or, <b>assets less liabilities</b>
Prepaid expenses	Expenses that have already been paid but which are for the next financial year.
Profit	When the income is more than the expenses
Trading stock deficit	This amount is calculated when the physical stock-take figure is less than the figure for trading stock in the general ledger
Trading stock surplus	This amount is calculated when the physical stock-take figure is more than the figure for trading stock in the general ledger





## 1.4. The Rules of Accounting

The following rules of accounting needs to be remembered as they never change:

Assets		Owner's Equity				Liability			
DR	A	CR	DR drawing	CR	DR capital	CR	DR	L	CR
			+	-	-	+			
			DR expenses				CR	DR income	CR
+		-	+	-	-	+	-		+
			If expenses increase, profit decrease	If expenses decrease, profit increase	If income decrease, profit decrease	If income increase, profit increase			

## 1.5. Classification of Accounts

NON-CURRENT ASSETS	OWNER'S EQUITY	NON-CURRENT LIABILITIES				
<b>Tangible/fixed assets:</b> <ul style="list-style-type: none"> <li>• Land and buildings</li> <li>• Equipment</li> <li>• Vehicles</li> </ul>	<table border="1"> <thead> <tr> <th>Expenses</th> <th>Income</th> </tr> </thead> <tbody> <tr> <td> <ul style="list-style-type: none"> <li>• Cost of sales</li> <li>• Interest expense</li> <li>• Rent expense</li> <li>• Salaries and wages</li> <li>• Stationery</li> <li>• Fuel</li> <li>• Packing material</li> <li>• Repairs</li> <li>• Insurance</li> <li>• Advertising</li> <li>• Discount allowed</li> <li>• Telephone</li> <li>• Water and electricity</li> </ul> </td> <td> <ul style="list-style-type: none"> <li>• Sales</li> <li>• Current income</li> <li>• Interest income</li> <li>• Rent income</li> <li>• Discount received</li> <li>• Bad debts recovered</li> <li>• Profit on sale of asset</li> <li>• Trading stock surplus</li> <li>• Provision for bad debts adjustment (-)</li> </ul> </td> </tr> </tbody> </table>	Expenses	Income	<ul style="list-style-type: none"> <li>• Cost of sales</li> <li>• Interest expense</li> <li>• Rent expense</li> <li>• Salaries and wages</li> <li>• Stationery</li> <li>• Fuel</li> <li>• Packing material</li> <li>• Repairs</li> <li>• Insurance</li> <li>• Advertising</li> <li>• Discount allowed</li> <li>• Telephone</li> <li>• Water and electricity</li> </ul>	<ul style="list-style-type: none"> <li>• Sales</li> <li>• Current income</li> <li>• Interest income</li> <li>• Rent income</li> <li>• Discount received</li> <li>• Bad debts recovered</li> <li>• Profit on sale of asset</li> <li>• Trading stock surplus</li> <li>• Provision for bad debts adjustment (-)</li> </ul>	<b>CURRENT LIABILITIES</b> (to be paid over more than 12 months) <ul style="list-style-type: none"> <li>• Mortgage bond</li> <li>• Loans</li> </ul>
Expenses	Income					
<ul style="list-style-type: none"> <li>• Cost of sales</li> <li>• Interest expense</li> <li>• Rent expense</li> <li>• Salaries and wages</li> <li>• Stationery</li> <li>• Fuel</li> <li>• Packing material</li> <li>• Repairs</li> <li>• Insurance</li> <li>• Advertising</li> <li>• Discount allowed</li> <li>• Telephone</li> <li>• Water and electricity</li> </ul>	<ul style="list-style-type: none"> <li>• Sales</li> <li>• Current income</li> <li>• Interest income</li> <li>• Rent income</li> <li>• Discount received</li> <li>• Bad debts recovered</li> <li>• Profit on sale of asset</li> <li>• Trading stock surplus</li> <li>• Provision for bad debts adjustment (-)</li> </ul>					
<b>Financial assets:</b> <ul style="list-style-type: none"> <li>• Fixed deposit (longer than 12 months)</li> </ul>		<b>CURRENT LIABILITIES</b> (to be paid in less than 12 months) <ul style="list-style-type: none"> <li>• Trade creditors</li> <li>• Bank overdraft (CR)</li> <li>• Short term portion of loan</li> <li>• Accrued expenses/expenses payable</li> <li>• Income received in advance/deferred</li> </ul>				
<b>CURRENT ASSETS</b>						
<b>Inventories:</b> <ul style="list-style-type: none"> <li>• Trading stock</li> <li>• Consumable stores on hand</li> </ul>						
<b>Trade and other receivables:</b> <ul style="list-style-type: none"> <li>• Debtors' control</li> </ul>						



<ul style="list-style-type: none"> <li>• Accrued income/income receivable</li> <li>• Prepaid expenses</li> </ul> <p><b>Cash and cash equivalents:</b></p> <ul style="list-style-type: none"> <li>• Bank (DR)</li> <li>• Petty cash</li> <li>• Cash float</li> <li>• Fixed deposit (less than 12 months)</li> </ul>	<ul style="list-style-type: none"> <li>• Loss on sale of asset</li> <li>• Bad debts</li> <li>• Depreciation</li> <li>• Trading stock deficit</li> <li>• Provision for bad debts adjustment (+)</li> </ul>	income
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## 1.6. Steps in Recording Transactions

1. Read the transaction/adjustment.  
**Bought stationery and paid by cheque, R150.**
2. Identify the two accounts affected – (double entry principle).
  1. **Stationery**
  2. **Bank**
3. Decide what type of accounts these are (classify).  
**Stationery = expense and therefore affects owner's equity**  
**Bank = current asset**
4. Decide which account is debited and which account is credited.  
**The expense is increasing therefore DR stationery**  
**The asset is decreasing therefore CR bank**
5. Record your answer showing the effect on Assets (A), Owners' equity (O) and Liabilities (L):

Account Debit	Account Credit	A=	O+	L
Stationery	Bank	-150	-150	0

**(0 = Indicates no effect, do not leave blank)**



Three questions that will assist you with number 4:

1. If an Asset: is it increasing or decreasing my possessions?
2. If a liability: is it increasing or decreasing my debt?
3. If an Owners' equity: it is increasing or decreasing the interest of the owner?

## ACTIVITIES 1 - 3

Perform the following activities:

### ACTIVITY 1: MATCHING COLUMNS WITH THE CORRECT DEFINITION

COLUMN A	COLUMN B
1. Fixed/tangible assets	A This increases profit and therefore increases owner's equity.
2. Current assets	B This decreases profit and therefore decreases owner's equity.
3. Non-current liabilities	C Amounts owing that will take longer than 12 months to pay off.
4. Current liabilities	D Assets which are expected to be kept for a long period of time, usually longer than a year. Without them the business will not exist or earn a profit.
5. Income	E The value (net worth) of the business at any point in time (total assets – total liabilities).
6. Expenses	F Amounts owing that will be paid back within 12 months.
7. Owner's equity	G Assets which are expected to be converted into cash in a short period of time (i.e. less than a year).

### ANSWER TO ACTIVITY 1:

- 1 D
- 2 G
- 3 C
- 4 F
- 5 A
- 6 B
- 7 E



## ACTIVITY 2: MULTIPLE CHOICE QUESTION

Three options are provided for the following two statements. Circle the correct letter:

1. Bank overdraft is classified as a...
  - A Non-current liability
  - B Current asset
  - C Current liability
2. Consumable stores on hand is classified as...
  - A Owner's equity
  - B Current asset
  - C An expense

### ANSWERS TO ACTIVITY 2:

1. C: This is a current liability because it will be paid back within 1 year (short-term).
2. B: This is a current asset because the business will use them within the next 12 months.

## ACTIVITY 3: ACCOUNTING EQUATION

Record the transactions in the Table below assuming bank is favourable (Dr) at all times. (When a bank is favourable it means it is an asset of the business and remains in a debit balance.)

1. Wrote off a debtor's account of R500 as a bad debt.
2. Sent a cheque to a creditor to settle our account of R2 000.
3. Received rent of R5 000 from a tenant.
4. Bought trading stock on credit for R1 800.
5. Bought equipment for R600 and paid by cheque.

	Account Debit	Account Credit	A=	O+	L
1					
2					
3					
4					
5					



### ANSWER TO ACTIVITY 3:

	Account Debit	Account Credit	A=	O+	L
1	Bad debts (expense increase)	Debtors Control (Asset decrease)	-500	-500	0
2	Creditors Control (liability decrease)	Bank (Asset decrease)	-2000	0	-2000
3	Bank (Asset increase)	Rent income (income increase)	+5000	+5000	0
4	Trading Stock (Asset increase)	Creditor control (liability increase)	+1800	0	+1800
5	Equipment (Asset increase)	Bank (Asset decrease)	±600	0	0

## 2. FORMS OF OWNERSHIP

There are many organisations that operate without a profit motive in the private sector. These are organisations such as clubs, charities, churches, associations, trusts etc. In the RSA, however, there are four main forms of ownership that operate with a profit motive:

### 2.1. Sole Trader

A sole trader is an organisation that consists of one entrepreneur, whose financial requirements are not large. He will undertake to risk all the losses of the business and gain all the profit. His liability is therefore unlimited, and tax will be paid in his personal capacity. Financial statements in a sole proprietorship are not compulsory, however extremely helpful in decision-making.

### 2.2. Partnership

A partnership consists of 2 -20 people. The financial requirements are not that large, partners are jointly and severally liable for the losses of the business. Profits are divided amongst them according to a partnership agreement that is drawn up beforehand. Liability is unlimited, partners are taxed in their personal capacity and the preparation of financial statements is not compulsory, however they are helpful for decision-making.



## **2.3. Closed Corporations**

This is a fairly new type of enterprise created for the advantage of unlimited liability without the tedious rules of a company. It consists of 1-10 members, all of whom have contributed to the capital. Their risk, as well as their profit (known as member's interest), is a direct percentage of their contribution. Financial statements are required. Members enjoy limited liability

## **2.4. Private Company**

A maximum of 50 shareholders put together share capital. Share capital is raised privately and shares are not sold to the public. Their liability is limited to the amount they have contributed. Their profit or dividend received is a percentage of this contribution. Financial statements are required because financial requirements are major and must be accounted for.

## **2.5. Public Company**

A minimum of 7 shareholders is required whilst the maximum is determined by number of shares available for sale. Liability is once again limited to the shares owned by the shareholder and profit percentage or dividend is also determined by this. Financial requirements are major and a public company must disclose financial statements to the public, as shares are bought by the public.

# **3. FINANCIAL STATEMENTS**

The financial results of registered entities (more specifically of companies) are compiled or communicated in the financial statements according to pre-determined requirements.

Financial statements must consist of:

- a balance sheet
- an income statement
- a cash flow statement
- a statement of changes in equity and notes

Before these statements are presented, the entire accounting cycle must be completed. Every step must be handled carefully: from source documents, to subsidiaries, to the ledger, to the trial balance, to the adjustments, to the closing entries, all the way to the financial statements. All transactions relating to the enterprise must be disclosed in



these statements. The enterprise is treated as an entity separate to that of the owner/s, due to the entity concept. According to the Companies Act: “Financial statements must fairly represent the financial state of affairs of the business.” As stated before, users of financial statements must be able to read and fully understand the information contained.



**NB!**

**INTERESTING FACT**

The accounting cycle is governed by Generally Accepted Accounting Practise (GAAP). GAAP includes many principles that will be explained later and must be adhered to. It is all about fair presentation; nothing important must be hidden or omitted!



## **4. USERS OF FINANCIAL STATEMENTS**

### **4.1. Investors**

This includes current investors or shareholders of a company as well as potential investors. They must always be aware of the financial position of the enterprise and the state of their current investments. They are the most important users as they provide the capital that keeps the business going.

### **4.2. Management**

This as managers set goals for the company, they need to know whether goals have been attained and whether or not they need to put in control measures. Their purpose is the planning and control of financial resources in an enterprise. They must also plan for the future according to past occurrences or repetitive patterns illustrated or recorded in the financial statements.

### **4.3. Employees**

These people work for the company and are concerned with job security and wage negotiation. Financial statements are also used for trade union purposes.

### **4.4. Creditors**

People or organisations that have lent money to, or sold merchandise to the company (on a credit basis) are always weary of the current and past financial performance of the enterprise.

### **4.5. Government**

The government uses these statements for tax purposes as well as for statistical analysis used in development and planning.





## ACTIVITY 4

Try the following. You will find the solutions at the end of this Activity.

**1.1** What, from your understanding, is the importance of drawing up the financial statements of a business enterprise?

**1.2** List the users of financial statements.

**1.3** What is the difference between accounting and bookkeeping?

### ANSWERS TO ACTIVITY 4:

1.1 A wide range of users (for very important decision-making) uses financial statements. Users include: creditors, management, employees, investors and the government. Accounting practice stipulates that financial statements are drawn up in order to fairly present the financial performance and position of the enterprise.

1.2

- 1.2.1 Investors
- 1.2.2 Management
- 1.2.3 Employees
- 1.2.4 Creditors
- 1.2.5 Government

1.3. Bookkeeping is just one part of the accounting process.



# UNIT 2: REVISION OF CONCEPTS

## LEARNING OBJECTIVES

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

- Name and define the various types of accounts.
- Master the effects of debits and credits.
- Recall the fundamental accounting equations.
- Manipulate and substitute into these equations.
- Recall the subsidiary books and source documents.
- Point out the errors revealed by the trial balance.
- Define and substantiate on GAAP and its principles.
- Master the methods and key aspects of depreciation.
- Record the transactions of an asset disposal.
- Recall the concept of Bank reconciliation.
- Provide for the year - end adjustments.
- Understand the difference between the periodic and perpetual inventory systems.
- Analyse and interpret the financial statements of a sole proprietor and a partnership.



**You should spend more or less 4 hours on this unit.**



Now that we understand the importance of the financial statements, let us review the basics of the accounting cycle.



**NB!**

You may already be familiar with some of the following topics. However, this is a revision section. Don't just browse through these items if you've seen them before

The intention of this unit is to build a strong foundation.

This section is a basis for you to fall back on and look through when you feel the need to revise. This section contains advanced exercises that are similar to exam examples.

Go through these exercises and follow the memo at the end very closely.

Remember, once you master the basic techniques, Accounting will become an enjoyable challenge.

## 1. EFFECTS OF DEBITS AND CREDITS



**Example:**

This is a capital account in the general ledger of an enterprise.

Dr	CAPITAL	Cr
----	---------	----

Debits are on the left-hand side of a ledger. 'T' account and credits are to the right.

Let us look at the effects of each type of account when it is debited or credited:

	ASSETS	LIABILITIES	INCOME	EXPENSE
DEBIT SIDE	INCREASE	DECREASE	DECREASE	INCREASE
CREDIT SIDE	DECREASE	INCREASE	INCREASE	DECREASE



Now let us refresh our memories as to the types of the many different accounts:

## 2. DEFINITIONS AND RECOGNITION CRITERIA

### 2.1. Assets

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

### 2.2. Liability

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

- **FIXED ASSET / LIABILITY:** Has a lifespan of more than a year.
- **CURRENT ASSET / LIABILITY:** Has a lifespan of less than a year.

### 2.3. Expenses

Is a decrease in economic benefits during the financial year in the form of decreases of assets, or increases liabilities, resulting in decreases in equity other than distributions or drawings.

## 3. DEFINITIONS AND RECOGNITION CRITERIA

<b>ASSETS:</b>	<b>LIABILITIES:</b>	<b>INCOME:</b>	<b>EXPENSES:</b>	<b>FINANCE COSTS:</b>
<b>Land and buildings</b>	Mortgage bonds	Bad debts recovered	Advertising	<b>Interest on bank overdraft</b>
<b>Equipment</b>	Bank overdraft	Commission income	Bad debts	<b>Interest on mortgage loan</b>
<b>Trading inventory</b>	Creditors control	Discount received	Bank charges	<b>Interest on long term loan</b>



<b>Debtors control</b>	SARS (income tax)	Dividend income	Carriage on sales	<b>Interest paid on capital accounts (Partnership)</b>
<b>Bank</b>	Debentures	Interest income	Delivery expense	<b>Interest on savings accounts (Partnership)</b>
<b>Fixed deposit</b>	Loans	Profit on sale of asset	Depreciation	
<b>Vehicles</b>		Rent income	Insurance	
<b>Cash float</b>			Rent expense	
<b>Investments</b>			Repairs	
		<b>REVENUE:</b>	Discount allowed	
		Fees earned	Postage	
		Net Sales	Salaries/ Wages	
			Telephone	
			Water and electricity	
			Stationery consumed	

## 4. FUNDAMENTAL EQUATIONS

<b>PROFIT = INCOME - EXPENDITURE</b> <b>GROSS PROFIT = SALES – COST OF SALES</b>
---



## 5. OWNER'S EQUITY

$$OE = A + L$$

Also:

$$\text{OWNER'S EQUITY} = \text{CAPITAL} + \text{INCOME} - \text{DRAWINGS} - \text{EXPENSES}$$

## 6. YOUR TURN - EXERCISE 1

Try the following.

You will find the solutions at the end of this unit.

### 1.1

On 31 March, Romeo Traders had equipment worth R116 000, vehicles worth R66 000 and stock worth R10 000. Creditors were owed R15 000 and cash in the bank totalled R5 000.

**REQUIRED: What is the total of Owners Equity?**

### 1.2

On 28 February, Mustang Traders possessed a capital account worth R150 000, rent income worth R14 000, water and electricity worth R4 000, repairs worth R5 000, and drawings worth R10 000.

**REQUIRED: What is the net worth of the business at this stage?**

Now let US look at various source documents (vouchers and supporting vouchers), their respective subsidiary journals and the transactions that they arise from. Subsidiary books are used to group similar transactions together, in order to make posting to the ledger easier.

## 7. SUBSIDIARY JOURNALS AND SOURCE DOCUMENTS

SUBSIDIARY BOOKS	SOURCE DOCUMENTS
Cash receipts journal (crj)	Duplicate receipts
Cash payments journal (cpj)	Cheque counterfoil



Debtors journal (dj)	Invoice
Creditors journal (cj)	Invoice
Debtors allowances journal (daj)	Debit note
Creditors allowances journal (caj)	Credit note
Petty cash journal (pcj)	Petty cash voucher
Salaries journal (sj)	Cheque counterfoil
Wages journal (wj)	Cheque counterfoil
General journal (gj)	Journal voucher

**Explanations:**

1. In the cash receipts journal, cash or cheques are received.
2. In cash payments journal, cheques are issued as payments.
3. In the debtor's journal, credits sales of goods are recorded.
4. In the creditors' journal, credit purchases (only goods to be resold) are recorded.
5. In the debtor's allowances journal, returns of goods, inwards, are recorded.
6. In the petty cash journal, daily cash payments of small quantities of necessities are recorded.
7. In the salaries journal, payments of monthly salaries are recorded.
8. In the wages journal, payments of weekly wages are recorded.
9. In the general journal, transactions that do not belong in any of the subsidiary journals are recorded.

## 8. YOUR TURN - EXERCISE 2

Try the following.

You will find the solutions at the end of this unit.

**REQUIRED:** Give one example of a transaction that would be recorded in the general journal.



## 9. DRAWING UP A TRAIL BALANCE

After journals are totalled, posting to the ledger begins. Remember to apply the double entry principle...always. Monthly a trial balance is drawn up. A trial balance is a list of the totals of the ledger control accounts. The trial balance helps us alleviate some of the errors that may have been a result of the posting to the ledger or the journal entries from source documents. Basically, the debit side of the list must equal the credit side. Remember the trial balance does not reveal all the errors that may have been made.



**NB!**

The summarised totals of the subsidiaries are found in the Control accounts. For instance, a debtor's personal account is found in the Debtors journal, which shows every transaction of the particular debtor. However, the total owed by all debtors is found in the Debtors control account in the ledger. The same applies with creditors

### 9.1. Errors revealed by the Trail Balance

If the trial balance does not balance:

- The trial balance may not have been properly cast.
- Posting from the subsidiary journal to the general ledger may have gone wrong.
- The debit or credit amounts in the journals may have been wrong.
- When balancing the ledger, there may have been a miscalculation.



**NB!**

If errors are revealed, carefully go back step-by-step and recheck all figures and casting!

### 9.2. Errors NOT revealed by the Trail Balance

If the trial balance does not balance:

- Where a transaction has been completely left out or not recorded.
- Repetitive errors due to a lack of knowledge of accounting principles.
- The posting of the correct figure, to the correct side of the wrong account in the general ledger.







**NB!**

When casting the journals and posting to the ledger, folio numbers are extremely important. A folio number in the journal will tell us exactly where to find a control account in the ledger and where to place the total

## 10. GAAP

The Accounting Practises Board (APB) of South Africa assisted the development of GAAP (stipulating account standards). Due to the fact that each enterprise has its own financial requirements and resource management, the Board cannot enforce companies to draw up financial statements that are exactly the same. However, for the sake of comparison, the aim of GAAP is to create a set of principles that financial accountants must conform to when drawing up financial statements. This provides an international set of standards that allows different enterprises to compare their financial statements and financial results.

### The main assumptions are:

- Accrual basis: transactions must be recorded when they occur and not when the cash is paid or received. Also involves the matching concept: transactions are matched to the period which they occur. In order to give the correct overview of the financial position, all transactions that occur must be recorded whether or not there is an inflow or outflow of cash.
- Going concern: financial statements are drawn up according to the assumption that the enterprise will continue to exist in the foreseeable future. Assets must be recorded at their carrying value. If there is the possibility of insolvency, financial statements will be drawn up differently.

### Some of the other characteristics that financial statements must adhere to:

- Relevance
- Reliability
- Understandable
- Comparable
- Timeliness
- Materiality
- Prudence



- Entity concept

## 11. DEPRECIATION

When the enterprise purchases a fixed asset, it is an unwritten rule that during the course of its lifespan, the value of the asset will be written off due to obsolescence or wear and tear. This is called depreciation of a fixed asset.



**NB!**

The value of land and buildings **appreciates** over time and the value of the other fixed assets like vehicles and equipment **depreciates** over time!

### 11.1. Recall of Depreciation Terminology

- **Cost Price:**  
The price that the asset is originally purchased for, also known as the principle amount in the formula for depreciation.
- **Rate of depreciation:**  
Depending on the method of depreciation used by the enterprise, the rate refers to the percentage of the cost price that must be written off as depreciation.
- **Useful lifespan:**  
The amount of time for which an enterprise deems the asset useful. This may depend on a number of factors. The number of years the enterprise assumes the asset will last, the quantity of units that the asset is expected to produce etc.
- **Carrying value:**  
The cost price minus the depreciable amount (determined by the depreciation formula) is known as the carrying value, the present value of the asset at a given time.
- **Estimated residual value:**  
The amount that the enterprise assumes the asset will be worth at the end of its useful life, the amount that the asset will then be sold/scrapped/traded in for. This amount must be pre-determined and subtracted from the cost price before the depreciation formula is used. Refer to the example below.



- **Accumulated Depreciation:**

When the depreciable amount is calculated, it is recorded in the general journal and thereafter must be posted to the ledger.

Dr     Depreciation (an imputed expense),  
Cr     Accumulated Depreciation (a negative asset).



**NB!**

An imputed expense is an expense that does not involve cash. Accumulated depreciation is a negative asset as it decreases the value of the asset being depreciated. Also, it is the opposite of an asset, it is not a liability, but it increases on the credit side and decreases on the debit side therefore it is a negative asset

## 11.2. Depreciation Formulae

### 11.2.1. Straight Line

This method is used when assets are subjected to high rate of wear and tear. The cost price of the asset is equally divided over its useful lifespan. The depreciable amount is equal every year, accumulated depreciation increases by the same amount every year until the estimated residual value is reached.

**Straight Line Depreciation =  $\frac{\text{Cost of Asset}}{\text{Life of Asset}}$**

See example on the next page.





## Example:

A motor vehicle worth R70 000 is purchased by Alto Traders. At the end of 8 years, the business estimates that the car will be sold for R6 000.

### REQUIRED:

Calculate the depreciable amount that will be credited to accumulated depreciation every year, using the straight-line method.

**REMEMBER: Carrying Value= Cost price – Residual value**

### SOLUTION:

$$\begin{aligned}\text{Depreciation} &= (\text{Carrying value}) / \text{number of years} \\ &= \text{R70 000} - \text{R6 000} \\ &= \text{R64 000} / 8 \\ &= \text{R8 000}\end{aligned}$$

**The depreciable amount for this year is R8 000**

### 11.2.2. Diminishing Balance

The depreciable amount is directly related to the carrying value.

**Diminishing Balance Depreciation = (Cost price - Accumulated depreciation) x a fixed percentage.**

If there is an estimated residual amount it must also be subtracted.

The depreciable amount will always be greater at the beginning and continue to decrease over time.





## Example:

Grizzly Enterprise just purchased machinery to the value of R50 000. The residual value will be R5 000 at the end of its lifespan. The fixed percentage of depreciation is 10%. This is the third year that the business has owned the asset.

### REQUIRED:

What is the depreciable amount for the current year according to the diminishing balance method and what is the accumulated depreciation amount?

**HINT: Use a timeline or ensure that solution is done on a yearly basis.**

### SOLUTION:

**Depreciation** = (Cost price - Residual value) - Accumulated depreciation] x fixed percentage.

= (Carrying Value - Accumulated depreciation) x fixed percentage.

**Carrying value** = Cost price - Residual value  
= R50 000 - R5 000  
= R45 000

**Year 1: Depreciation** = {R45 000 - 0} x 10%  
= R45 000 x 10%  
= R4 500

**Year 2: Depreciation** = {R45 000 - R4 500} x 10%  
= R40 500 x 10%  
= R4 050

Now that there are 2 years of depreciable amounts, these must be added and subtracted from cost price!

$$R4\ 050 + R4\ 500 = R8\ 550$$

**Year 3: Depreciation** = {R45 000 - R8 550} x 10%  
= R36 450 x 10%  
= R3 645

The depreciable amount is: **R3 645**.



Amount of accumulated depreciation is:  
**R4 500+R4 050+R3 645= R12 195.**

This will be subtracted from the carrying value next year in order to determine depreciation for year 4.

### 11.2.3. Production Unit Method

The last method is based on an estimation of the number of units produced in entire lifespan. No time is involved.

$$\text{Depreciation per unit} = \frac{\text{(Cost Price-Residual Value)}}{\text{Estimated number of units produced in lifespan}}$$



### Example:

Rocco Traders bought a machine that is estimated to produce 110 000 units in its lifespan. It cost R60 000 and will be scrapped at R5 000.

REQUIRED:  
What is the depreciable amount per unit for the asset?

### SOLUTION:

$$\begin{aligned} \text{Depreciation} &= \text{Carrying value/number of units} \\ &= \text{R60 000 - R5 000/110 000} \\ &= \text{R55 000/110 000} \\ &= \text{0.5 per unit} \end{aligned}$$

The depreciable amount is 0.5 per unit.



As the lifespan of the machine continues, its production can be recorded:

Purchase date	Cost (R)	Annual units	Depreciation per unit (R)	Annual depreciation (R)	Accumulated depreciation (R)	Net carrying amount
1 Feb 20.2	60000	-	-	-	-	60000
Year 1	60000	45000	0.5	22500	22500	37500
Year 2	60000	35000	0.5	17500	40000	20000
Year 3	60000	15000	0.5	7500	47500	12500
Year 4	60000	15000	0.5	7500	55000	5000

It is made clear from the table that total depreciation is R55 000 and scrapping value of R5 000 still remains.

## 12. YOUR TURN - EXERCISE 3

Try the following.

You will find the solutions at the end of this unit.

Alto Traders bought a new vehicle at 01/03/03 at an amount of R15000. This vehicle depreciates at 20% on cost. Equipment was also bought on this date for an amount of R35 000. Equipment depreciates at 10% according to the diminishing balance method. Provide for depreciation at 28/02/05.

REQUIRED:

1. Record all transaction in the General Journal.
2. Show the relevant ledger accounts.

See next page.



Write your answers here:

**The General Journal of Alto Traders at 28/02/05**

<b>Doc No.</b>	<b>Day</b>	<b>Details</b>	<b>Fol.</b>	<b>DR</b>	<b>CR</b>





**The General Ledger of Alto Traders**

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## 13. ASSET DISPOSAL

Do you recall what happens when there is a sale of a fixed or non-current asset?

The ways of getting rid of an asset:

- sale of asset
- trade-in

If an asset is sold, in the general journal, remember to:

1. Update the depreciation up until the date of sale. For example, if the asset is sold halfway through the year, depreciation for the six months preceding the sale must be accounted for.
2. Dr Depreciation and Cr Accumulated Depreciation with the figure calculated above.
3. If the asset was Equipment: Dr Asset Disposal and Cr Equipment with the cost price of the asset.
4. Next, Dr Accumulated Depreciation and Cr Asset Disposal with the amount of Accumulated depreciation of the asset.
5. Dr Bank and Cr Asset Disposal with the proceeds from the sale.
6. Finally, balance the Asset disposal account and work out whether the sale resulted in a profit or a loss to the firm. This figure must be taken to the Profit and loss account at year end.



**NB!**

1. Due to the fact that depreciation rates differ, separate accumulated depreciations accounts are used.
2. Asset accounts will contain only the cost price of assets and not the carrying value.
3. Depreciation is a nominal account and only one depreciation account is required. The annual, total depreciation of all assets is reflected in this account.



**NB!**

A profit made on the sale of an asset will appear on the debit side of the asset disposal account. A loss will appear on the credit side of the asset disposal account. This must be transferred to the profit and loss account.



If the asset was traded in, it means that a new asset has been purchased and the old one that you trade in, will be given a 'trade in' value which is subtracted from the price of the new purchase, however the balance must be paid in cash.

**If an asset is traded in, in the general journal, remember to:**

1. As in step 1 above, work out the depreciation. (See paragraph 11.2)
2. Follow step 2 above. (Paragraph 11.2)
3. If the asset was Equipment: Dr Equipment and Cr Creditors Control with the cost price of the new Equipment.
4. Dr Accumulated depreciation and Cr Asset Disposal with amount of depreciation.
5. Dr Asset Disposal and Cr Equipment with the original cost price of the old machine that was traded in or "sold".
6. Dr Creditors Control and Cr Asset Disposal with the 'trade in' value or residual value.
7. Balance the Asset Disposal Account and transfer the profit or loss to the Profit and loss account.
8. Also remember that when you have paid the creditor the balance of the purchase price: Dr Creditors Control and Cr Bank with the amount paid, in the CPJ.

## 14. YOUR TURN - EXERCISE 4

Try the following.

You will find the solutions at the end of this unit.

1. In the books of Dru Traders, the total of the equipment column reflected R200000 at 01/03/04.
2. Accumulated depreciation totalled R68780 at 01/03/04. All this equipment was bought at 01/03/00.
3. At 01/06/04 Dru Traders bought equipment worth R16000.
4. At 01/09/04 a machine, worth R20000, was sold for R15000.
5. All equipment depreciates at 10% p.a. according to the diminishing balance method.
6. In this example, round off to the nearest decimal place.



## REQUIRED:

1. Provide for depreciation at 28/02/05.
2. Provide for the Asset Disposal transactions.
3. Show all General Journal transactions.
4. Show all relevant ledger accounts.

## 15. BANK RECONCILIATIONS

Both the business and the bank record the daily transactions however, on the last day of the month; there will always be transactions that are recorded in only one set of books. These transactions include stop orders, bank transfers, cancelled or stale cheques, bank charges etc. This is the reason that the balance of the bank account may not correspond to the balance on the bank statement.



**NB!**

Both the business and the bank record the transactions that take place every day. A debit entry in the books of the business (current account holder) is a credit entry in the books of the bank and vice versa. So a favourable balance in the books of the business is a debit entry, which is a credit to the banks books.

We must therefore reconcile both balances through comparison.

A comparison between the bank statement and the bank account must be done. The items that are the same must be ticked off. The outstanding amounts represent the differences that must be recorded in either document.

### The differences in the bank statement and the bank account include:

1	<b>DIFFERENCE</b>	Credits on the bank statement that don't appear in the CRJ.
	<b>EXAMPLE</b>	These include interest on a current account or a direct transfer into the businesses bank account.
	<b>SOLUTION</b>	Entry in the CRJ.

2	<b>DIFFERENCE</b>	Debits on the bank statement that don't appear in the CPJ
	<b>EXAMPLE</b>	Bank charges, unpaid cheques, stop or debit orders
	<b>SOLUTION</b>	Entry in the CPJ



<b>3</b>	<b>DIFFERENCE</b>	Entries in the bank column of the CRJ that don't appear in the bank statement
	<b>EXAMPLE</b>	Deposits that have not yet been credited by the bank.
	<b>SOLUTION</b>	Must be included in the actual Bank Reconciliation statement

<b>4</b>	<b>DIFFERENCE</b>	Entries in the bank column of the CPJ that don't appear in the bank statement.
	<b>EXAMPLE</b>	Cheques issued but not yet presented to the bank for payment
	<b>SOLUTION</b>	Must be included in the actual Bank Reconciliation Statement

The Bank Reconciliation Statement is a “calculation” that proves that although balances differ, they are in agreement.



**NB!**

You must always compare the current bank statement to the bank reconciliation statement of the previous month. There are certain items that will appear on the bank statement of this month that previously had to be included in the bank reconciliation statement. These items can now be cancelled.

## 16. YOUR TURN - EXERCISE 5

Try the following.

You will find the solutions at the end of this unit.

### REQUIRED

Prepare the bank reconciliation of B&S Traders on 31 July 2003.

Use the table provided to indicate the amounts and details that would appear in the:

1. Cash Receipts Journal (CRJ)
2. Cash Payments Journal (CPJ)
3. Bank Reconciliation Statement
4. If no entry is required, place an X in the No Entry column.





## Example:

Cheque no. 705, issued for R690 to a creditor, Lucas Roberts appears neither in the CPJ nor in the Bank Statement.

### SOLUTION:

No.	No entry	Entry in CRJ		Entry in CPJ		Entry in Bank Reconciliation Statement	
		Amount	Details	Amount	Details	Amount	Details
example				690	Creditors' control	690	Outstanding cheque no. 705

See Additional Information on the next page



## ADDITIONAL INFORMATION:

1. An amount of R43 for interest on bank overdraft appears only on the Bank Statement of July 2003.
2. Cheque No. 732 for R4700 dated 23 August 2003, appears only in the Cash Payments Journal for July 2003.
3. A deposit of R472 by a tenant appears only on the Bank Statement of July 2003.
4. The deposit of R6420 which appeared in the Cash Receipts Journal on 31 July 2003 did not appear on the Bank Statement of July 2003.
5. Cheque No. 694 for R700 appears on the Bank Statement, but not in the Cash Payments Journal for July 2003. The cheque appeared on the Bank Reconciliation Statement of June 2003.
6. Cheque No. 684 issued as a payment to a supplier, Maiden Traders, was reflected in the Cash Payments Journal as R360. The correct amount of R330 appears on the Bank Statement.
7. Cheque No. 718 for R340 issued to the owner for drawings appears in the Cash Payments Journal but not on the Bank Statement.
8. Cheque No. 741 for R160 appears in the Cash Payments Journal as well as on the Bank Statement.
9. A debit order for the monthly payment of insurance of R400 only appears on the Bank Statement.
10. Service fees of R67 were debited on the Bank Statement.
11. Cheque No. 728 for R767, issued in favour of Thornton Traders for repairs must be cancelled.
12. A new cheque No. 762 was issued, but this has not yet been recorded in the books and it has not yet appeared on the Bank Statement.
13. Received a cheque from a debtor, T. Hall for R700 in full settlement of his debt of R750.
14. The cheque was dated for 31 August 2003. No entry was made in the books of the business, nor on the bank statement.



## 17. YEAR-END ADJUSTMENTS

According to the accrual and matching concepts, the bookkeeper must calculate whether amounts truly reflect the actual financial position of the business with regard to income and expenses for the relevant of accounting period.

Now, taking into account the exact dates of the financial year, certain accounts must either be increased or decreased because they may overestimate or underestimate the profit for the current year.

- **Pre-paid Expenses:**

If a certain part of an expense has been paid for a future accounting period, that portion is known as a prepaid expense. The expense itself must be decreased by that portion in order to fairly represent the profit of that period. This is an asset account. It increases on the debit side.

- **Accrued Expenses**

Cr Expense Account (Without prepaid Option): If a certain expense owed has not been paid in full, that expense must be increased in order to fairly state the profit of that period. This is a liability account. It increases on the credit side.

Dr Expense account, Cr Accrued expense. (With amount owed)

- **Accrued Income:**

If a certain income has not been received in full, the income account must be increased in order to fairly state the profit for that particular period. This is an asset account. It increases on the debit side.

- **Income Received in Advance:**

Dr Accrued income, Cr Income account. (With outstanding amount)

If a certain portion of income has been received in advance, that is, received without having been earned, the income account must be decreased by that portion in order to fairly state the profit for that period. This is a liability account. It increases on the credit side.

Dr Income account, Cr Income received in advance.

- **Consumable stores on hand:**

If materials such as stationery or packing materials have not been fully used or consumed then, for the expense to be correctly stated, the expense account must be decreased by the amount of the unused portion. This is an asset account; it increases on the debit side.





Dr Consumable stores on hand, Cr Expense account.

- **Provision for Bad Debt Adjustment:**

When allowing customers to buy on credit, we must always be aware that certain debtors will not be able to pay their debt due to insolvency or liquidity.

We must now examine debtors' accounts and estimate or create a provision for bad debt account for the following financial year. This is the percentage of debtors control that we estimate will be written off in the following year.

Our estimation will be considered in the next financial period and either increased or decreased.

This process takes place after bad debts have been written off for the current period.

When writing off bad debts:

Dr Bad Debts, Cr Debtors Control.

When creating a provision:

Dr Provision for bad debts adjustment account.

Cr Provision for bad debt (an asset account).

When adjusting provision:

To increase:

Dr Provision for bad debt adjustment, Cr Provision for bad debt.

To decrease:

Dr Provision bad debt, Cr Provision for bad debt adjustment.

Adjusting Trading Inventory:

A business must always be aware of the value of stock on hand, whether there is a surplus or a deficit. The types of inventory systems are the perpetual and periodic inventory system. The trading stock account in the ledger reflects the amount that should be available for trade. However, the stock must be counted to verify this amount. During stock take, a physical count of the inventory must be done. If we compare this number to the number reflected in our books, we decipher whether there is a surplus or deficit of inventory in the business.

In the event of a deficit, trading stock must be decreased to fairly represent the asset in the financial statements:

Dr Trading inventory deficit, Cr Trading inventory.



### **IMPORTANT NOTE**

After the balance sheet is drawn up and the next financial period has started the adjustment accounts have served their purpose and can now be written back to their original accounts. They don't last the entire year. The only reason for drawing them up is to fairly present the financial state of affairs. At the beginning of the next financial period, these accounts must be reversed.

## **18. YOUR TURN - EXERCISE 6**

Try the following.

You will find the solutions at the end of this unit.

### **ACCRUED INCOME**

The following totals appear in the ledger of Gus Traders at 28/02/03.

Rent Income: R3600

Interest on Investment: R5000

### **INFORMATION:**

Rent has only been received for 9 months.

The fixed deposit of R44000 matures at a rate of 15% p.a.

### **REQUIRED:**

1. Provide for adjustments at the end of the financial year, 28/02/03.
2. Journalise the above adjustments and their respective closing transfers.
3. Show the relevant accounts in the general ledger.
4. Where, in the financial statements, would I find Accrued income?
5. If I were to look through the general ledger during the year, would I find the Accrued Income account?

## **19. YOUR TURN - EXERCISE 7**

Try the following.

You will find the solutions at the end of this unit.



At 28/02/03, in the books of Gus Traders, totals on the telephone account reflected R9150. Totals on the water and electricity account reflected R1100.

**ADDITIONAL INFORMATION:**

An amount of R850 is still payable for February's telephone account.

Water and electricity have been paid for only 11 months of the year.

**REQUIRED:**

1. Provide for adjustments
2. Journalise the entries and closing transfers
3. Show the relevant ledger accounts
4. Where, in the financial statements, would I find Accrued expenses?
5. If I were to look in the ledger, during the year, would I find the Accrued expenses account?



## 20. YOUR TURN - EXERCISE 8

Try the following.

You will find the solutions at the end of this unit.

### PRE-PAID EXPENSES:

The total in the insurance account reflects an amount of R7500. Insurance was paid on 28/02/02. The accountant paid the instalments for 14 months in advance. However, the amount of the insurance premium was increased by 20% on 01/12/02. Gus Traders would like your help!

### REQUIRED:

1. Remove the pre-paid portion in order to fairly represent the expense.
2. Journalise the entries and respective closing transfers.
3. Show the relevant ledger accounts.
4. Where, in the financial statements, would I find pre-paid expenses?
5. If I were to look in the ledger during the financial year, would I find pre-paid expenses?

## 21. YOUR TURN - EXERCISE 9

22. Try the following. You will find the solutions at the end of this unit.

### INCOME RECEIVED IN ADVANCE:

Gus Traders rent a part of their premises to two different tenants. Rent must be paid a month in advance, according to the rent agreement. Therefore, on 28/02/03, the rent for March has already been paid. The rent was decreased by 20% on 01/12/03.

Rent income accounts totalled as follows:

Tenant 1: R12480

Tenant 2: R10920

## 23. YOUR TURN - EXERCISE 10

Try the following. You will find the solutions at the end of this unit.



### **CONSUMABLE STORES ON HAND:**

Packing materials for the financial year, in the books of Gus Traders, totalled: R9500. The stationery account totalled R6300. However, after the physical stock take was done, the following were revealed to be on hand:

Packing material: R1500, and Stationery: R300.

### **REQUIRED:**

1. Provide for the necessary adjustments at year-end, at 28/02/03.
2. Journalise the entries and closing transfers.
3. Show the relevant ledger accounts.
4. Where, in the financial statements, would I find consumable stores on hand?
5. If I were to look through the ledger, during the year, would I find the consumable stores on hand account?

## **24. YOUR TURN - EXERCISE 11**

Try the following. You will find the solutions at the end of this unit.

### **PROVISION FOR BAD DEBTS:**

At 28/02/03, the end of financial year, the balance on the Debtors Control account is R65000. Last year, the provision for bad debts was R2000. It has been decided that the provision must now be 5% of the current balance on the Debtors Control account.

### **REQUIRED:**

- 1 Provide for the necessary adjustments in the books of Gus Traders.
- 2 Journalise the transactions and closing transfers.
- 3 Show the relevant ledger accounts.
- 4 Where, in the financial statements, would I find the provision for bad debts adjustment? (Name two places!)
- 5 If I were to look through the ledger, during the financial year, would I find the provision for bad debt adjustment?



## 25. YOUR TURN - EXERCISE 12

Try the following. You will find the solutions at the end of this unit.

### ADJUSTING TRADING INVENTORY:

At 28/02/03, the balance on the Trading Stock account reflects a value of R46000. However, a physical count reveals that only R44250 of trading stock is on hand

#### REQUIRED:

- 1 Provide for the necessary adjustments in the books of Gus Traders.
- 2 Journalise the transactions and closing transfers.
- 3 Show the relevant ledger accounts.
- 4 Where, in the financial statements, would this adjustment be found!
- 5 Give a few examples of the reasons that a company would have to endure a trading stock deficit.
6. What is the advantage of the perpetual inventory?



**NB!**

Deficits must be approved by the owner. Include the approval in the explanation of the general journal entry.

## 26. PERIODIC INVENTORY

Businesses using the periodic inventory system record merchandise bought by debiting the purchases account. Cost of sales are not recorded on a daily basis; it is calculated on the last day of the accounting period.

**Cost of sales = Opening stock+ Purchases - Closing stock.**

On the first day of the accounting period:

**Dr Opening inventory, Cr Trading inventory (with balance of trading inventory)**

On the last day of the accounting period:

**Dr Trading inventory, Cr Closing inventory (with balance of trading inventory)**



## 27. YOUR TURN - EXERCISE 13

Try the following. You will find the solutions at the end of this unit.

### CALCULATION OF COST OF SALES:

The following totals appeared in the books of Kruger Traders.

1. Opening stock: R30000 (01/03/02)
2. Closing stock: R33000 (28/02/03)
3. Purchases: R227000
4. Carriage on purchases: R26000

### REQUIRED:

Calculate the Cost of sales of Kruger Traders for the year ended 28/02/03. Kruger Traders make use of the periodic inventory system (5)

## 28. PERPETUAL INVENTORY

Businesses that operate on a perpetual inventory system calculate the Cost of sales with every transaction that takes place.

With every double entry depicting a sale, there is a double entry depicting the Cost of sale.

Therefore 4 entries are made in the journals of the business and posted to the ledger.

Dr Bank, Cr Sales (With amount of sale)

Dr Cost of Sales, Cr Trading stock (With amount of Cost of sale)

At the very end of the year, a physical count is done and, as above, if the totals from the physical count don't correspond with the totals in the books, an adjustment for a deficit or a surplus must be put through.



**NB!**

The financial statements of businesses that use the periodic and perpetual inventory methods are exactly the same except businesses that use the periodic system must calculate the Cost of sales and show the amount in the Income statement or as a note to the Income statement



## 29. ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS (sole proprietorships)

The financial performance for a specific period is recorded in the Income statement and the financial position at the end of the period is recorded in the balance sheet. These statements should be drawn up at the end of the financial period however most businesses draw them up more often, like at the end of every month.

Financial statements can be compared, and percentages or ratios can be used to analyse and interpret them. These ratios enable the results of various businesses and of various accounting periods to be compared. The following ratios were studied previously and must now be compared:

1. **Gross profit percentage on turnover =**

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

2. **Gross profit percentage on cost of sales =**

$$\frac{\text{Gross profit}}{\text{Cost of Sales}} \times \frac{100}{1}$$

3. **Net profit percentage on turnover =**

$$\frac{\text{Net profit after tax}}{\text{Sales}} \times \frac{100}{1}$$

4. **Total operating expenses as a percentage of turnover =**

$$\frac{\text{Operating Expenses}}{\text{Sales}} \times \frac{100}{1}$$

5. **Return on Owner's Equity =**

$$\frac{\text{Net profit after tax}}{\text{Average owner's equity}}$$

6. **Liquidity using current ratio and acid test ratio. The current ratio enables businesses to measure their ability to meet current liabilities:**

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$





The Acid test ratio is a refined version of the current ratio. It excludes inventory and prepayments from current assets.

**Acid test ratio: (Current assets-inventory-prepayments):  
Current Liabilities**

7. **Rate of inventory turnover, showing the efficiency of the enterprise in selling their merchandise. An increased rate of turnover indicates efficient inventory management.**

$$\frac{\text{Cost of goods sold}}{0.5 \times (\text{opening inventory} + \text{closing inventory})}$$

8. **Working Capital = Current Assets-Current Liabilities**
9. **Solvency = Total Assets: Total Liabilities**
10. **Profitability = Profitability = Net profit/Owner's equity**

### **30. YOUR TURN - EXERCISE 14**

Try the following. You will find the solutions at the end of this unit.

#### **ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS:**

Consider the extracts from the financial statements of Drake Traders for the year ended 28 February 2003.

#### **REQUIRED:**

1. Use the information supplied to calculate and comment on the following ratios.
2. Ensure that your answers are correct to two decimal places.
3. Use the following format:
  - 3.1 Ratio
  - 3.2 Formula
  - 3.3 Calculation
  - 3.4 Answer/result
  - 3.5 Comments/interpretation

#### **REQUIRED RATIOS:**

1. Gross profit as a percentage of turnover
2. Gross profit as a percentage of cost of sales
3. Net profit as a percentage of sales
4. Returns on owner's equity
5. Amount of net assets



6. Degree of solvency
7. Current ratio (Norm being 2:1)
8. Acid test ratio (Norm being 1:1)
9. The rate of stock turnover



## ADDITIONAL INFORMATION:

Trading stock for 20.2 is R20000.

## INCOME STATEMENT OF DRAKE TRADERS FOR YEAR ENDED 28/02/03:

	Notes		R
Sales			630000
Cost of Sales			(330000)
Gross profit			300000
Other operating income			1040
Discount received		200	
Profit on sale of asset		540	
Bad debts recovered		320	
Gross operating income			301060
Operating expenses			(149800)
Bank charges		1500	
Salaries and wages		96000	
Advertising		6900	
Water and electricity		4700	
Depreciation		7500	
Provision for bad debt (inc)		100	
Consumable stores		2500	
Bad debts		600	
Sundry expenses		30000	
Operating profit			151260
Interest income			
Profit before interest expense			153260
Interest expense			(15000)
Net profit for the year			138260

**BALANCE SHEET OF DRAKE TRADERS FOR YEAR ENDED 28/02/03 –  
See next page**



## BALANCE SHEET OF DRAKE TRADERS FOR YEAR ENDED 28/02/03

	Notes		R
<b>ASSETS</b>			
Non-current assets			
Tangible assets	3		376000
Financial assets (investments>12mth)			8000
Fixed Deposits : BS Bank		8000	
Current assets			125400
Inventories	4	56000	
Trade and other receivables	5	42000	
Cash and cash equivalents	6	27400	
<b>Total Assets</b>			<b>509400</b>
<b>EQUITY AND LIABILITIES</b>			
Owner's equity	7		383400
Non-current liabilities			96000
Mortgage loan (SP Bank)		80000	
Loan: Rand Bank		16000	
Current liabilities			30000
Trade and other payables	8	30000	
Bank overdraft		-	
<b>Total Equity and Liabilities</b>			<b>509400</b>

## NOTES TO THE FINANCIAL STATEMENTS OF DRAKE TRADERS (28/02/03)

See next page



## NOTES TO THE FINANCIAL STATEMENTS OF DRAKE TRADERS (28/02/03)

1.	Interest income				
	From investments (fixed deposits)				2000
	From overdue debtors				-
	From current account				-
					2000
2.	Interest expense				
	Interest on mortgage loans				15000
	Interest on overdraft				-
					15000
3.	Tangible assets	Land & Buildings	Equipment	Vehicles	Total
	Cost	367500	50000		417500
	Accumulated depreciation		(34000)		(34000)
	Carrying Value(last date of previous year)	367500	16000		383500
	Movements				
	Addition at cost		-		
	Disposal at carrying value		-		
	Depreciation for the year		(7500)		(7500)
		367500	8500		376000
	Cost	367500	50000		417500
	Accumulated depreciation		(41500)		(41500)
	Carrying value(last date of current year)	367500	8500		376000
4.	Inventories				
	Trading inventory				54600
	Consumable stores on hand				1400
					56000
5.	Trade and other Receivables				
	Trade debtors				40000
	Provision for bad debts				(2300)
	Net trade debtors				37700
	Deposit on electricity				2600



	Accrued income				500
	Prepaid expenses				1200
					42000
6.	Cash and cash equivalents				
	Fixed deposits (maturing<12mth)				
	Savings accounts				
	Bank				26600
	Cash float				600
	Petty cash				200
					27400
7.	Owner's equity				
	Balance (last date of previous yr)				300000
	Net profit for the year				138260
	Additional capital contribution				-
					438260
	Drawings				(54860)
	Balance (last date of current yr)				383400
8.	Trade and other payables				
	Trade creditors				27000
	Accrued expenses				2000
	Income received in advance				1000
	Creditors for wages				-
	Pension fund				-
	Medical aid fund				-
	SARS – PAYE				-
					30000



## 31. ANALYSING FINANCIAL STATEMENTS OF PARTNERSHIPS

The financial statements of partnerships require an analysis that differs slightly. The actual statements differ with respect to the owner's equity accounts and the appropriation of profit.

We record each partner's equity separately. The ledger provides for a separate capital account, current account, and salary account for each partner.

The allocation of net profit as calculated in the profit and loss account at the end of the accounting period is shown in the appropriation account. The total amount earned by a partner including their salary, interest on capital and their profit appropriation is credited to the current account. Their withdrawals for personal use are debited to their current account, as drawings.

Drawings are usually lower than earnings therefore the current accounts normally have a credit balance. The capital contributions remain separately in their capital accounts. The balance on the capital accounts added to the balance on their current accounts form what is known as the partner's investment in the business.



**NB!**

Interest on capital is provided for in the partnership agreement. If the capital contributions are not equal, partners are compensated for the capital that they distribute by means of interest on their capital which is calculated as a percentage of their capital contribution

The percentage return by each partner is calculated using the average investment of the partner.

**Average investment**

**=  $0.5(\text{investment at beginning of year} + \text{investment at end of year.})$**

When the average investment is calculated, we can now calculate percentage return by each partner.

**Total amount earned by partner**  
**Average investment of partner**



Debt equity ratio gives an indication of the creditworthiness of a business.

**Debt equity ratio = Long term liabilities: Owners' equity**

The rest of the ratios remain the same as that of the sole proprietorship.





# SOLUTIONS FOR UNIT 2 EXERCISES

## 1. EXERCISE 1

$$\begin{aligned} 1.1 \quad \text{OWNERS EQUITY} &= \text{ASSETS} - \text{LIABILITIES} \\ &= \text{R}116\,000 + \text{R}66\,000 + \text{R}10\,000 + \text{R}5\,000 - \text{R}15\,000 \\ &= \text{R}197\,000 - \text{R}15\,000 \\ &= \text{R}182\,000 \end{aligned}$$

$$\begin{aligned} 1.1. \quad \text{OWNERS EQUITY} &= \text{CAPITAL} + \text{INCOME} - \text{DRAWINGS} - \text{EXPENSES} \\ &= \text{R}150\,000 + \text{R}14\,000 - \text{R}10\,000 - \text{R}4\,000 - \text{R}5\,000 \\ &= \text{R}164\,000 - \text{R}19\,000 \\ &= \text{R}145\,000 \end{aligned}$$

## 2. EXERCISE 2

Answer must be carefully thought out, make sure that the transaction you choose does not belong in any of the subsidiary journals.

1. The purchase of equipment on credit (not for resale.)
2. The reversal of a discount allowed of a dishonoured cheque.

## 3. EXERCISE 3

### REMEMBER

You are working out the depreciation for 2005, which is two years after the purchase date.

### Calculation

$$\text{STRAIGHT LINE METHOD} \qquad \text{R}15\,000 \times 20\% \qquad = \qquad \text{R}3\,000$$

### DIMINISHING BALANCE METHOD

$$\begin{array}{l} \text{Year 1} \qquad \text{R}35\,000 \times 10\% \qquad = \qquad \text{R}3\,500 \\ \text{Year 2} \qquad (\text{R}35\,000 - \text{R}3\,500) \times 10\% \qquad = \qquad \text{R}3\,150 \end{array}$$



## The General Journal of Alto Traders at 28/02/05

Doc No.	Day	Details	Fol.	DR	CR
1	28	Depreciation	N12	6150	
		Accumulated depreciation on vehicles	B10		3000
		Accumulated depreciation on equipment	B11		3150
		Depreciation at 20% on cost on vehicles and 10% diminishing balance on equipment.			

### REMEMBER

When recording transactions in the General Journal, if the total amount of a debit has many credit contra accounts, the total can be placed in the debit column and the credit entries can be listed below or vice versa. This will save time in the exams!

## The General Ledger of Alto Traders

Ledger of Alto Traders  
Balance Sheet Accounts Section

DR		Motor Vehicles				B6		CR	
20.3									
Mar	1	Balance	b/d	15000	-				

Ledger of Alto Traders  
Balance Sheet Accounts Section

DR		Equipment				B7		CR	
20.3									
Mar	1	Balance	b/d	35000	-				

Ledger of Alto Traders  
Balance Sheet Accounts Section

DR		Accumulated Depreciation on Vehicles				B7		CR	
					20.4				
					Mar	1	Balance	b/f	3000
									-
					20.5				
					Mar	1	Depreciation	J10	3000
									-

Ledger of Alto Traders  
Balance Sheet Accounts Section

DR		Accumulated Depreciation on Equipment				B7		CR	
					20.4				
					Mar	1	Balance	b/f	3500
									-
					20.5				
					Mar	1	Depreciation	J10	3150
									-



Ledger of Alto Traders  
Nominal Accounts Section

	DR	Depreciation					N12		CR
20.5									
Mar	1	Balance	b/d	6500					
		Accumulated							
		Depreciation on							
		Vehicles	J10	3000					
		Accumulated							
		Depreciation on							
		Equipment	J10	3150					

## 4. EXERCISE 4

### Calculation

#### DEPRECIATION ON OLD

<b>28/02/01: R200000</b>	<b>x 10%</b>		<b>=</b>	<b>R20000</b>
<b>28/02/02: (R200000-R20000)</b>	<b>x 10%</b>		<b>=</b>	<b>R18000</b>
<b>28/02/03: (R200000-R38000)</b>	<b>x 10%</b>		<b>=</b>	<b>R16200</b>
<b>28/02/04: (R200000-R54200)</b>	<b>x 10%</b>		<b>=</b>	<b>R14580</b>
<b>TOTAL</b>			<b>=</b>	<b>R68780</b>

In order to work out the depreciation for the current year, we follow the exact same method, however, the cost price of the equipment that was sold must be subtracted from the cost price of old equipment to be depreciated.

The accumulated depreciation amount also differs. Remember that when an asset is disposed of, the accumulated depreciation of that asset is taken out of the accumulated depreciation account and transferred to the asset disposal account.

For this reason, we must first calculate the accumulated depreciation of the sold asset.



## DEPRECIATION ON SOLD

28/02/01: R20000	x 10%	=	R2000
28/02/02: (R20000-R2000)	x 10%	=	R1800
28/02/03: (R20000-R3800)	x 10%	=	R1620
28/02/04: (R20000-R5420)	x 10%	=	R1458
<b>TOTAL</b>		<b>=</b>	<b>R6878</b>

So, when calculating the depreciation of the old equipment, we subtract this amount from accumulated depreciation. We will use the following figures.

COST PRICE	<b>R200000 - R20000 = R180000</b>
ACCUMULATED DEPRECIATION	<b>R68780 - R6878 = R61902</b>

1. CURRENT DEPRECIATION ON OLD  
28/02/05 **(R180000 - R61902) x 10% = R11810 (rounded off)**
2. CURRENT DEPRECIATION ON SOLD  
28/02/05 **(R20000-R6878) x 10% x (6/12) = R656 (rounded off)**
3. CURRENT DEPRECIATION ON NEW  
28/02/05 **16000 x 10% x (9/12) = R1200**

DEPRECIATION ON EQUIPMENT **R11810 + R656 + R1200 = R13666**



## General Journal of Dru Traders at 28/02/05

Doc no	Date	Details	Fol.	DR	CR
1	28	Depreciation	N13	13666	
		Accumulated Depreciation on Equipment	B8		13666
		Depreciation on Equipment at 10% diminishing balance.			
2	28	Asset Disposal	N19	20000	
		Equipment	B4		20000
		Transferral of cost price of sold equipment			
3	28	Accumulated Depreciation on Equipment	B8	7534	
		Asset Disposal	N19		7534
		Transferral of the accumulated depreciation on sold equipment			
4	28	Bank	B1	15000	
		Asset Disposal	N19		15000
		Recording of the selling price of asset			
5	28	Asset Disposal	N19	2534	
		Profit and Loss	N20		2534
		Transferral of the profit on sale of asset			

(15)

## The General Ledger of Dru Traders

Ledger of Dru Traders  
Nominal Accounts Section

DR				Asset Disposal				N19				CR			
						20.5									
						Feb	28	Accumulated							
20.5								Depreciation on							
Feb	28	Equipment	J9	20000				Equipment	J9	7534					
	28	Profit on Sale	J9	2534			28	Bank	J9	15000					
				22534						22534					

Ledger of Dru Traders  
Balance Sheet Accounts Section

DR				Equipment				B4				CR			
20.4						20.5									
Mar	1	Balance	b/d	200000	-	Feb	28	Asset Disposal	J9	20000					
June	1	Bank	CRJ1	16000				Balance	c/d	196000					
				216000						216000					
20.5															
Mar	1	Balance	b/d	196000											



Ledger of Dru Traders  
Balance Sheet Accounts Section

DR		Accumulated Depreciation on Equipment				B8		CR		
20.5 Feb	28	Asset Disposal	J9	7534	-	20.4 Mar	1	Balance	b/d	68780
						20.5				
	28	Balance	c/d	74912		Feb	28	Depreciation	J9	13666
				82446						82446
						Mar	1	Balance	b/d	74912

Ledger of Dru Traders  
Nominal Accounts Section

DR		Depreciation				N13		CR	
Feb	28	Accumulated							
		Depreciation on							
		Equipment		13666					

**REMEMBER:**

Always record the depreciation of sold equipment as well

## 5. EXERCISE 5

	No.	No entry	Entry in CRJ		Entry in CPJ		Entry in Bank Reconciliation	
			Amount	Details	Amount	Details	Amount	Details
1					63	Interest on Overdraft		
2							4700	Outstanding cheque no. 732
3			472	Rent income				
4							6420	Outstanding Deposit
5		X						



6		390	Credit ors Control/ M. Traders	360	Credit ors Contro l/ M. Trader s		
7						340	Outstan ding cheque no. 718
8	X						
9				400	Insura nce, debit order		
10				67	Bank charg es		
11		767	Repairs / Creditor s Control/ Thornto n Traders (cancell ation of cheque 728)	767	Repair s/ Creditor s Contro l/ Thornt on Trader s (issue of new chequ e 762)	767	Outstan ding cheque no. 762
12	X						



## 6. EXERCISE 6

### Calculation

1. Rent Income  $R3600/9 = R400$  per month  
 $R400 \times 3 = R1200$  (3 months outstanding)
2. Interest on Investment  $R44000 \times 15\% = R6600$

$$R6600 - R5000 = R1600 \text{ (amount outstanding)}$$

### General Journal of Gus Traders at 28/02/03

Doc no.	Date	Details	Fol.	DR	CR
1	28	Accrued Income	B15	4800	
		Rent Income	N12		1200
		Interest on Investment	N13		1600
		Year-end adjustments for amounts receivable			
2	28	Rent Income	N12	4800	
		Interest in Investment	N13	6600	
		Profit and Loss	N19		11400
		Closing Transfers			

### General Ledger of Gus Traders

Ledger of Gus Traders  
Balance Sheet Accounts Section

DR		Accrued Income				B15		CR	
20.3									
Feb	28	Rent Income	J6	1200	-				
		Interest on							
		Investment	J6	1600					
				4800					

Ledger of Gus Traders  
Nominal Accounts Section

DR		Rent Income				N7		CR	
20.3						20.3			
Feb	28	Profit and Loss	J6	4800	-	Feb	28	Balance b/f	3600
								Accrued	
								Income	J6 1200
				4800					4800





Ledger of Gus Traders  
Nominal Accounts Section

DR		Interest on Investment				N7		CR	
20.3						20.3			
Feb	28	Profit and Loss	J6	6600	-	Feb	28	Balance	b/f 5000
								Accrued	
								Income	J6 1600
				6600					6600

4. I would find Accrued Income in the notes to the financial statements, under the heading Trade and Other Receivables.
5. No, the adjustments are reversed at the beginning of the year and are only applicable at year end.

## 7. EXERCISE 7

### Calculation

$$R1100 / 11 = R100 \text{ (only received 11 monthly payments)}$$

Therefore, the outstanding rental is R100

(2)

### General Journal of Gus Traders at 28/02/03

Doc no	Date	Details	Fol.	DR	CR
1	28	Telephone	N14	850	
		Water and Electricity	N13	100	
		Accrued expenses	B18		950
		Provision for expenses payable			
2	28	Profit and Loss	N19	11200	
		Telephone	N14		10000
		Water and Electricity	N13		1200
		Closing Transfers			



## General Ledger of Gus Traders

Ledger of Gus Traders Nominal Accounts Section															
DR				Telephone				N14				CR			
20.3								20.3							
Feb	28	Total	b/f	9150	-	Feb	28	Profit and Loss	J6	10000					
		Accrued expenses	J6	850											
				10000						10000					

Ledger of Gus Traders Balance Sheet Accounts Section															
DR				Accrued expenses				B18				CR			
						20.3									
						Feb	28	Telephone	J6	850					
								Water and Electricity	J6	100					
										950					

4. I would find Accrued expenses in the notes to the financial statements, under the heading Trade and other payables.

5. No, adjustments are reversed at the beginning of the year and only applicable at year end.

## 8. EXERCISE 8

### Calculation

If  $x$  is the value of insurance before it is increased, then  $x + 0.2x = 1.2x$  is the value of the increased insurance.

The equation is as follows:

$$\begin{aligned}
 &= 9x + 5(1.2x) \\
 &= 9x + 6x \\
 &= 15x \text{ \{9 months at the normal rate, 5 months at the increased rate\}}
 \end{aligned}$$

If the total received was **R7500**, then

$$\begin{aligned}
 15x &= \mathbf{R7500} \\
 x &= \mathbf{R7500 / 15} \\
 x &= \mathbf{R500} \quad \text{and} \quad 1.2x = \mathbf{R600}
 \end{aligned}$$

If 14 months of insurance was paid then the premiums for the last two months must be subtracted as a pre-paid expense, in order to fairly represent the expense. Remember, the rent has already been increased for the period that we must subtract.



R600x2 = R1200 (pre-paid expense)

**General Journal of Gus Traders at 28 February 2003**

Doc no.	Date	Details	Fol.	DR	CR
1	28	Pre-paid Expenses	B10	1200	
		Insurance	N12		1200
		Removal of pre-paid portion of expense			
2	28	Profit and Loss	N17	6300	
		Insurance	N12		6300
		Closing Transfer			

**General Ledger of Gus Traders**

Ledger of Gus Traders  
Balance Sheet Accounts Section

DR		Prepaid Expenses		B10		CR	
				20.3			
				Feb	28	Insurance	J6 1200

Ledger of Gus Traders  
Nominal Accounts Section

DR		Insurance		N12		CR	
20.3				20.3			
Feb	28	Total	J6 7500	Feb	28	Pre-paid expenses	J6 1200
						Profit and Loss	J6 6300
			7500				7500

4. In the notes to the financial statements, under the heading Trade and other Receivables.

5. No, adjustments are reversed on the first day of the next financial year. The adjustments are for year-end purposes only.



## 9. EXERCISE 9

### Calculation

If the rent received before the decrease was  $x$ , then the rent after the decrease is  $x - 0.2x = 0.8x$ .

The equation is as follows

$$\begin{aligned} & 9x + 5(0.8x) \\ = & 9x + 4x \\ = & 13x. \end{aligned}$$

$$\begin{aligned} \text{Tenant 1 } 13x &= \text{R12480} \\ x &= \text{R960} \end{aligned}$$

$$\begin{aligned} \text{Tenant 2 } 13x &= \text{R10920} \\ x &= \text{R840} \end{aligned}$$

### General Journal of Gus Traders at 28/02/03

Doc no.	Date	Details	Fol.	DR	CR
1	28	Rent Income	N4	960+840=1800	
		Income Received in advance	B13		1800
		Removal of deferred portion of rent income			
2	28	Rent Income	N4	21600	
		Profit and Loss	N18		21600
		Closing Transfers			

### General Ledger of Gus Traders

#### Ledger of Gus Traders Nominal Accounts Section

DR		Rent Income				N12		CR	
20.3					20.3				
Feb	28	Income Received in advance	J6	1800	Feb	28	Total	J6	23400
		Profit and Loss	J6	21600					
				23400					23400

#### Ledger of Gus Traders Balance Sheet Accounts Section

DR		Income Received in Advance				B13		CR	
					20.3				
					Feb	28	Rent Income	J6	1800



4. I would find Consumable stores on hand in the financial statements, under the heading Trade and Other Payables.

5. No, the adjustment accounts can only be found at the end of the financial year. They are reversed at the beginning of the next financial period and can't be found during the year.

## 10. EXERCISE 10

### General Ledger of Gus Traders at 28/02/03

Doc no.	Date	Details	Fol.	DR	CR
1	28	Consumable stores on hand	B16	1800	
		Packing materials	N12		1500
		Stationery	N11		300
		Physical count of stationery and packing materials			
2	28	Profit and Loss	N19	14000	
		Packing materials	N12		8000
		Stationery	N11		6000
		Closing transfers			

### General Ledger of Gus Traders

Ledger of Gus Traders  
Balance Sheet Accounts Section

DR		Consumable stores on hand				B16		CR	
20.3									
Feb	28	Packing materials	J6	1500					
		Stationery	J6	300					

Ledger of Gus Traders  
Nominal Accounts Section

DR		Stationery				N11		CR	
20.3					20.3				
Feb	28	Consumable Stores on hand	J6	300	Feb	28	Total	b/f	6300
		Profit and Loss	J6	6000					



Ledger of Gus Traders  
Nominal Accounts Section

DR		Packing Materials				N12		CR		
20.3						20.3				
Feb	28	Consumable Stores on hand	J6	1500		Feb	28	Total	b/f	9500
		Profit and Loss	J6	8000						
				9500						9500

4. I would find Consumable stores on hand in the notes to the financial statements, under the heading Inventories, as it is a temporary asset.

5. No, the account cannot be found during the year as it is a year - end adjustment and must be reversed at the beginning of the next year.

## 11. EXERCISE 11

### Calculation

$$R65000 \quad \times \quad 5\% \quad = \quad R3250$$

The provision must be R3250.

However, the provision is currently R2000. Therefore, the provision must be increased.

$$R3250 - R2000 \quad = \quad R1250$$

The provision must be increased by R1250.

### General Journal of Gus Traders at 28/02/03

Doc no.	Date	Details	Fol.	DR	CR
1	28	Provision for bad debts adjustment	N10	1250	
		Provision for bad debts	B8		1250
		Increasing the provision for bad debts to 5% of debtors			
2	28	Profit and Loss	N18	1250	
		Provision for bad debt adjustment	N10		1250
		Closing Transfer			

### General Ledger of Gus Traders

Ledger of Gus Traders  
Nominal Accounts Section

DR		Provision for bad debts adjustment				N10		CR		
20.3						20.3				
Feb	28	Provision for bad debts	J6	1250		Feb	28	Profit and Loss	J6	1250



Ledger of Gus Traders  
Balance Sheet Accounts Section

DR		Provision for bad debts				B8		CR	
20.3					20.2				
Feb	28	Balance	c/d	3250	Mar	1	Balance	b/d	2000
					20.3				
					Feb	28	Provision for bad debt	J6	1250
				3250			adjustment		3250
					20.3				
					Mar	1	Balance	b/d	3250

4. I would find Provision for bad debts adjustment in the Income Statement. If the adjustment is being increased, it is an expense. If it is being decreased, it becomes an income. The adjustment can also be found in the notes to the financial statements, beneath Debtors Control, under the heading Trade and other Receivables.

5. No, I would not find the adjustment during the year, because it is reversed at the beginning of the new financial year.

## 12. EXERCISE 12

### The General Journal of Gus Traders at 28/02/03

Doc no.	Date	Details	Fol.	DR	CR
1	28	Trading stock deficit	N13	1750	
		Trading stock	B3		1750
		A physical count was done and a deficit was revealed. Authorised by owner: A. C. Evans			
2	28	Profit and Loss	N19	1750	
		Trading stock deficit	N13		1750
		Closing transfer			



## The General Ledger of Gus Traders

Ledge of Gus Traders											
Balance Sheet Accounts Section											
DR				Trading Stock				B3		CR	
20.2						20.3					
Feb	28	Balance	b/d	46000		Feb	28	Trading stock deficit	J6	1750	
							28	Balance	c/d	44250	
				46000						46000	
20.3											
Mar	1	Balance	b/d	44250							

4. I would find the adjustment in the Income Statement. A deficit is shown as an expense. A surplus is an income.
5. No, the adjustments are reversed at the beginning of the next financial year.
6. Theft of goods, fires, incorrect calculation or posting, shrinkage etc.
7. The perpetual inventory system because a deficit can be readily identified and rectified.

### 13. EXERCISE 13

Opening stock (01/03/02)	30000
Purchases	227000
Carriage on purchases	26000
Value of merchandise available to be sold during the year	283000
Less: Closing stock (28/02/03)	(33000)
Cost of sales	250000

(Guidelines will be given with regards to comments and interpretation because a variety of answers are possible. However, be sure to be thorough and logical in your approach to the question.)





## 14. EXERCISE 14

### REMEMBER THE APPROACH:

1	Ratio
2	Formula
3	Calculation
4	Answer
5	Comment

1. Gross profit as a percentage of turnover

$$\begin{aligned} &= \frac{\text{Gross profit}}{\text{turnover}} \times 100 / 1 \\ &= \frac{300000}{630000} \times 100 / 1 \\ &= 47.62\% \end{aligned}$$

Comment on profitability: How does 47.62% compare to the mark-up policy of the business? Is the business operating efficiently? Could turnover be increased, or expenses decreased? How do you think the business compares to its competition? If you are given last year's figures, compare your answers to those figures and comment on that. Compare to other economical climates and other financial indicators if possible.

2. Gross profit as a percentage of cost of sales

$$\begin{aligned} &= \frac{\text{Gross profit}}{\text{Cost of sales}} \times 100 / 1 \\ &= \frac{300000}{330000} \times 100 / 1 \\ &= 91.00\% \end{aligned}$$

Comment on profitability. How does 91% compare to the mark-up policy of the business? Is the business operating efficiently? Could gross profit be increased by increasing income or decreasing expenses? How does the business compare to its competitors? If you are given last year's figures, compare your answers to those figures and comment on that. If you can, compare to other economical climates and financial indicators.

3. Net profit as a percentage of sales

$$\begin{aligned} &= \frac{\text{Net profit}}{\text{Sales}} \times 100 / 1 \\ &= \frac{138260}{630000} \times 100 / 1 \\ &= 22\% \end{aligned}$$



Comment on profitability. How does 22% compare to the businesses mark-up policy? Is the business operating efficiently? Could sales be increased, in order to increase the result? How does the business compare to its competition? If you are given last years statistics, compare and comment on the comparison. If possible, examine other economical climates and financial indicators.

4. Return on owner's equity

$$\begin{aligned}
 & \text{Net profit} \quad / \quad \text{Average owner's equity} \times 100 / 1 \\
 = & \quad \frac{\text{Net profit}}{[(\text{Owner's equity beg. of yr} + \text{Owner's equity end of yr})/2]} \times 100 \\
 = & \quad 138260 / [(300000 + 383400) / 2] \times 100 / 1 \\
 = & \quad 40.5\%
 \end{aligned}$$

Comment on the return on investment. Comment on the profitability of the business. Is the business operating efficiently? In order to increase net profit, can the business reduce expenses or increase income? How does the business compare to competition? Use last year's figures to compare the result. Compare the result, if possible, to other economic climates and financial indicators.

5. Amount of Net assets

$$\begin{aligned}
 & \text{Assets} \quad - \quad \text{Liabilities} \quad = \quad \text{Owner's equity} \\
 & [376000 + 8000 + 125400] - [96000 + 30000] = 383400
 \end{aligned}$$

Comment this result to previous years and competitors' figures, if possible. Comment on the solvency of the business.

6. Degree of solvency

$$\text{Assets} \quad - \quad \text{Liabilities} \quad = \quad \text{Owner's equity}$$

The same equation and result as above.

Comment on solvency. Does the business have a strong financial position? Compare to previous years and competitors if possible.



## 7. Current Ratio

<b>Current Assets</b>	<b>:</b>	<b>Current Liabilities</b>
<b>125400</b>	<b>:</b>	<b>30000</b>
<b>4.18</b>	<b>:</b>	<b>1</b>

The norm is 2:1. The ratio is therefore very favourable. The business can easily settle debts and is therefore very liquid. The business will easily be able to acquire loans from financial institutions. However, the business must seek to invest their money further in order to grow their assets quickly. Money should never be idle!!!

## 8. Acid Test Ratio

<b>(Current Assets – Trading stock)</b>	<b>:</b>	<b>Current Liabilities</b>
<b>(125400 – 56000)</b>	<b>:</b>	<b>30000</b>
<b>2.31</b>	<b>:</b>	<b>1</b>

The norm is 1:1. The ratio is therefore very favourable. The business can easily settle its debts and is very liquid. Banks and other financial institutions will easily consider funding a business with such a liquidity position. Further investment should be considered though!

## 9. The rate of stock turnover

**Cost of sales / Average stock**

**$\frac{\text{Cost of sales}}{[(\text{Stock at the beg. of yr} + \text{Stock at end of yr})/2]}$**

**$\frac{330000}{([20000 + 56000]/2)}$**

**= 8.68 times per year**

This ratio indicates how often stock is turned over and must be replenished. Comment on the liquidity of stock. Is the business operating efficiently? A business that orders more stock, more frequently is a very competitive business. Comment on profitability. The above ratio enables us to compare the business to its competition and determine the financial position and future estimates of the business.

