CCMM 517 EC

FINANCIAL REPORTING

Faculty of Economic and Management Sciences

Study guide compiled by: MJ Botha

North-West University

It all starts here

- Ranked in the top 5% of universities globally by the QS-rankings
- Contributes the second largest number of graduates annually to the labour market

Dit begin alles hier

- As een van die top 5% universiteite wêreldwyd deur die QS-ranglys aangewys
- Lewer jaarliks die tweede meeste graduandi aan die arbeidsmark

Gotlhe go simolola fano

- Re beilwe mo gare ga diyunibesiti tse 5% tse di kwa godimo go ya ka peo ya maemo ya QS
- Ngwaga le ngwaga go abelwa palo ya bobedi ka bogolo ya badiri mo maketeng ya badiri

MODULE CONTENTS

Module information

Module code	CCMM 517
Module credits	12
Module name	Financial reporting
Name of lecturer(s)	Dr Martin Botha
Office telephone	018 285 2320
Email address	martin.botha@nwu.ac.za
Building and Office nr	E3, 255
Consulting hours	Appointment

Welcome

Welcome to the module Financial Reporting (CCMM 517). I trust that you will have a meaningful and relevant experience of this module. The current economic climate presents a lot of challenges to the business manager. The purpose of this module is to provide the business manager with basic financial background in order to make financial decisions. I trust you will enjoy and actively engage in the learning process.

Work programme

Class opportunities	Textbook chapter	Estimated study hours	Date for completion	Assessment	Estimated level of completion
Introduction and framework The accounting equation	1 11	2 4			
The account The general journal	2 3	2 2			
The general ledger and trial balance	4	3			
Owner's interest Non-current assets Current assets	5 6 7	5 2 4			

Class opportunities	Textbook chapter	Estimated study hours	Date for completion	Assessment	Estimated level of completion
Liabilities Income and expenditure Completion of the accounting process	8 9 10	2 4 3			
Presentation of financial statements	12	14			
Cash flow statement	14	14			
The analysis and interpretation of financial statements	15	14			

Study material

The textbook that we use in this module is “Accounting: All-in-1”, 4th Edition by L. Cornelius and M. Weyers, LexisNexis. Other sources that can be consulted include: “Financial Accounting: A Global Perspective, 5th Edition. Short, Libby & Libby, “A concepts based introduction to accounting”, McGraw-Hill, 4th Edition. “Introduction to Financial Accounting Fresh Perspectives”, 2nd edition, Pearson.

The prescribed textbook is a practical textbook which provides you with the necessary information to understand the accounting process. The level you reach as business manager will be determined by your own research. You will receive the necessary guidance in the study guide and assignments presented to you.

Action words

The following action words are used regularly in the study guide and during assessments. The list provided ensures that you know what is expected of you when a particular action word appears in a question/assignment. The action word is also an indication of whether lower or higher order cognitive skills are required to answer the question/carry out the assignment. Make sure that you know the meaning of each action word well!

- **Describe**

  Say exactly what something is like; give an account of the characteristics or nature of something; explain how something works. No opinion or argument is needed.

- **Discuss**

  Argue the issue or phenomenon with reference to existing literature. Draw a conclusion, which must be given in your own words. A critical discussion may include the following:

  * Your own interpretation of the phenomenon.

* The indication of relationships and differences in existing arguments on the phenomenon.

- **Explain**

  Clarify a concept or phenomenon with insight in your own words. You must prove that you understand the concept and are able to show the connection between the different variables. The use of examples or illustrations is recommended.

- **Motivate**

  Give reasons or criteria for the point of view that you take regarding a particular issue. Your motivation must follow a logical line of reasoning and must be stated clearly.

- **Evaluate**

  Give your own opinion concerning the advantages and disadvantages of a particular concept/idea/process. Based on your theoretical knowledge you must also be able to indicate why you evaluate a particular idea/concept/process negatively or positively.

- **Criticise**

  Criticise someone else's work. This means that you highlight the strengths and weaknesses of someone else's work based on your knowledge and supported by research conducted on the specific matter.

- **Distinguish**

  When you distinguish, you must state the characteristics that are unique to something and compare these to other issues. When you distinguish, you may do so in table or paragraph format.

- **Analyse**

  When you analyse, you must identify the core elements of something and describe each core element.

- **Design**

  When you design, you must create something new. When you are requested to design a questionnaire, for example, you must create a unique questionnaire that meets your requirements.

- **Examine**

  When you have to examine, you must be able to describe a particular matter with reference to research that has been done on it and by consulting literature or utilising any other source of information.

- **Report on**

  When you have to report on something, this means that you have to show your communication skills. The format in which you must report will be communicated to you by your lecturer and may be in writing, verbal or visual. Overall it means that you must communicate the knowledge that you have acquired in a particular format to others.

- **Evaluate critically**

  Here you are not only expected to give your own opinion concerning the advantages and disadvantages of a particular concept/idea/process. You must also critique someone else's work. This means that you point out the advantages and disadvantages and strengths and weaknesses of someone else's work based on your knowledge and supported by research that has been conducted on the specific matter.

- **Demonstrate**

  The skill to demonstrate can take on many dimensions. You will usually be pointed in the direction of the way in which the demonstration must be conducted. In this module demonstrate means that you must provide an extensive explanation of a particular matter **and** you must substantiate your explanation with real-life examples.

- **Interpret**

  To interpret means that you set out/explain a particular issue within a specific context. When you interpret, you usually say what something means in a particular context.

Assessment

Formative assessment

Participation mark

You require a participation mark of at least 40% to obtain admission to the examination.

You obtain a participation mark by completing assignments that will be provided to you and your group. The questions contained therein are typical examples of the kinds of questions that you may expect in the examination. The compilation of assignments and tests which will form your participation mark will be provided and discussed in the first contact session. By working consistently, you obtain the mark that you deserve and at the same time you are preparing for the examination.

Summative assessment

Examination mark

You will write your examination in June. Your question paper counts out of 100 marks and is 180 minutes long. You require a subminimum of 40% for your exam paper to come into consideration for a pass mark in the module. For example, if your participation mark is 75% and you achieve 35% for your examination paper, you will receive a total mark of 55% (75 + 35 ÷ 2) but you will still not pass the module because the subminimum of 40% for the examination paper was not achieved.

Module mark

Your module mark is calculated by taking your participation mark and your examination mark into account. The ratio according to which the module mark is calculated is:

Participation mark	50%
Examination mark	50%

In order to pass the module CCMM 517 you require a module mark of at least 50%.

Module outcomes

After completion of this module you should be able to

- Understand financial statements;
- Analyse and interpret financial statements in order to make management decisions;
- Fulfil your stewardship function as manager by means of reporting financial information to stakeholders; and
- Understand how the role of financial accounting as the collection and processing of transactional information lead to financial reporting.

General overview of this study guide

It is important that you achieve the outcomes of each study unit. To achieve these outcomes it is expected of you to work through each study unit in order to construct your own knowledge and to develop skills. The lecturer is available telephonically and by email should you experience any problems during the learning process. In this module you will not only construct theoretical knowledge but will also acquire cognitive skills, such as the solving of problems and higher order cognitive skills. After completion of this module you will therefore have the ability to analyse, synthesise and evaluate within the context of this module; in other words must be able to think critically and creatively.

Icons

Time allocation

Learning outcomes

Study material

Assessment / Assignments

Individual exercise

Group Activity

Example

Reflection

Warning against plagiarism

ASSIGNMENTS ARE INDIVIDUAL TASKS AND NOT GROUP ACTIVITIES. (UNLESS EXPLICITLY INDICATED AS GROUP ACTIVITIES)

Copying of text from other learners or from other sources (for instance the study guide, prescribed material or directly from the internet) is **not allowed** – only brief quotations are allowed and then only if indicated as such.

You should **reformulate** existing text and use your **own words** to explain what you have read. It is not acceptable to retype existing text and just acknowledge the source in a footnote – you should be able to relate the idea or concept, without repeating the original author to the letter.

The aim of the assignments is not the reproduction of existing material, but to ascertain whether you have the ability to integrate existing texts, add your own interpretation and/or critique of the texts and offer a creative solution to existing problems.

Be warned: students who submit copied text will obtain a mark of zero for the assignment and disciplinary steps may be taken by the Faculty and/or University. It is also unacceptable to do somebody else's work, to lend your work to them or to make your work available to them to copy – be careful and do not make your work available to anyone!

Plagiarism is a serious offence and you should familiarise yourself with the plagiarism policy of the NWU. http://library.nwu.ac.za/copyright-and-plagiarism

Please refer to the *Policy on Academic Integrity* which is found on the following website: http://www.nwu.ac.za/sites/www.nwu.ac.za/files/files/i-governance-management/policy/2P-2.4.3.2_Academic%20integrity_e.pdf

Study unit 1

INTRODUCTION AND FRAMEWORK

Study material

The Study Unit is based on:

Chapter 1. Explore the terrain of Financial Accounting because this is the field in which you will work as a result of the transactions that take place in it.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

1. Refer to the textbook for the assignments that have to be completed for this Study Unit.
2. Refer to the section below. Use it as a framework for a complete explanation of what Financial Accounting will mean to you as manager.

Study outcomes

After completion of the Study Section you should be able to:

- identify the need for accounting;
- explain the purpose of each of the annual financial statements of management;
- explain the aim of accounting with a view to the use thereof for management;
- name and discuss the users of financial statements and their need for financial information;
- explain why the qualitative characteristics and the compliance therewith is of the utmost importance to interested parties; and
- identify the kinds of businesses with a view to the choice by the entrepreneur of the most suitable for his purpose.

1.1 Purpose and domains of accounting

1.1.1 Definition of accounting

Identify a transaction, determine the value involved, do the entry in the accounting records and report on the results. This report on the results is called the annual financial statements where the results of the entity for a given period, are disclosed.

1.1.2 Purpose of accounting

To provide financial information regarding the economic activities of the entity to the users of the financial statements.

Note what is meant by financial results, who the users of this financial information are and what financial management entails. (Textbook p. 3)

1.1.3 The domain of accounting

The need for information with the aim of decision making by the external and internal business environments leads to the development of management accounting from financial accounting. Management Accounting is dealt with in broad terms in section 2 of this module.

The role of financial accounting (FA) has expanded over time to focus on various goals, such as:

Accounting and stewardship

Stewardship is about being accountable for receipts and payments, the safekeeping of and reporting on assets and liabilities of an organisation/business to the interested parties. Accounting fulfils this role. Where FA provides the records to make the task of stewardship possible, self-regulating measures as contained in the King I, II and III reports are considered necessary to carry out the task properly. More about the King reports later.

Accounting and control

Part of management's task/duty/responsibility is to exercise control over the activities of a business. FA records provide the means with which to accomplish control over appropriation of assets, the safekeeping thereof, as well as completeness of income and responsibility of expenditure.

Accounting and planning

The role of FA records as a basis for measurement of performance in the past that serves as a basis for planning for the future.

Accounting and information

Take note of the difference between "data" and "information". Information is data that is in a form of processing that is useful to certain interested parties for decision making.

The origin and role of financial markets

Financial markets are the largest source of finance for current business' capital needs. Take note of this section, especially with a view to financial management.

1.2 The accounting framework

The format of annual financial statements (AFS) is prescribed to limit the differences and diversity between the financial statements of different entities. Internationally the format of AFS is prescribed by the International Reporting Standards (IFRS).

Important information

> The illustration of the characteristics of financial statements on p. 11 of the textbook, is important.

1.3 Annual financial statements (afs)

1.3.1 Contents of AFS

1.3.1.1 Statement of profit or loss and other comprehensive income

Income generated and expenses incurred during the year, are matched.

When the income exceed the expenses a net profit will result.

When the expenses exceed the income the result will be a net loss.

1.3.1.2 Statement of changes in equity

Equity is the owner's interest in the entity.

Equity is increased with the net profit and capital introduced by the owner.

Equity is decreased with a net loss and drawings by the owner.

1.3.1.3 Statement of financial position

The assets and liabilities of an undertaking at year-end are disclosed in the statement of financial position.

Assets minus liabilities equals owner's interest [equity].

Equity at the end of the year is disclosed in the statement of financial position.

1.3.1.4 Statement of cash flow

Show the cash inflow and cash outflow during the year

1.3.1.5 Notes to the AFS

Describe the accounting policies followed by the entity in compiling the annual financial statements.

Explain the contents of AFS by supplying more detailed information.

1.3.2 Elements of AFS

1.3.2.1 Income

1.3.2.2 Expenses

1.3.2.3 Assets

1.3.2.4 Liabilities

1.3.2.5 Equity

1.3.3 Integrated reporting

King III defines integrated reporting as a holistic and integrated presentation of a company's performance of both its finance and sustainability. King III supports the notion of sustainability, but makes the case that it should be part of integrated reporting.

The Integrated Reporting Committee of South Africa, suggested eight elements to be part of the integrated report, namely:

1. Report Profile;
2. Organisational overview, business model, and governance structure;
3. Understanding the operating context;
4. Strategic objectives and competencies;
5. Account of the organisations performance;
6. Future performance objectives;
7. Remuneration policies; and
8. Analytical commentary.

Individual activity

We are going to identify a specific company's integrated report and use it as reference to work from through the rest of this module. The company we are going to work through will be communicated to you.

1.4 Underlying assumptions

Reflection

Revise the illustration of the underlying assumptions on p. 10

1.4.1 Going concern

The business will not cease operations in the foreseeable future. If the business it is not a going concern, the AFS should be adjusted to reflect liquidation values.

1.4.2 Accrual concept

Transactions are recorded when the transaction occurs and not only when cash is received or paid.

1.5 Qualitative characteristics of financial statements

1.5.1 Financial statements must possess the following characteristics:

AFS should be understandable, relevant, reliable, accurate, and complete. It should be compiled in accordance with recognised accounting principles, and it should be comparable to other similar entities and with previous years.

1.5.2 Financial statements should always adhere to the requirements of IFRS.

1.6 Different kinds and forms of business organisations

Business organisations are categorised in three different ways that will be considered by die prospective entrepreneur in order to establish which one will best suit his business goal.

The kind of business that it operates

Distinguish the different kinds of business by referring to “Activities” and “Kinds of income”.

The size of the business

In South Africa size of businesses is distinguished in respect of “number of employees”, “turnover” and “total assets” excluding fixed property.

The legal form of a business

One-man business, Partnerships and Companies.

In accordance with section 8 of the Companies Act 2008 provision is made for two kinds of companies, namely profit-seeking companies and non-profit companies. Profit-seeking companies comprise the following categories:

1. Companies owned by the State
2. Private companies
   * that are not companies owned by the State, and
   * whose Memorandum of Incorporation
   * prohibits the company from offering any of its securities to the public; and
   * restricts the transfer of its securities.
3. A personal liability company, if
   * it meets the criteria for a private company; and
   * its Memorandum of Incorporation indicates that it is a personal liability company.
4. A public company that comprises all other profit-seeking companies.

According to section 10 all provisions contained in the Act are also applicable to non-profit companies, except the provisions that are excluded in terms of the section.

Regarding the name of the companies, the provisions of section 11 apply. Section 11(3) provides that the name of companies as mentioned above must end with

* in the case of a company owned by the State, the expression "SOC Limited" (which stands for "State Owned Company");
* in the case of a private company, the words "Proprietary Limited" or abbreviated "(Pty) Ltd";
* in the case of a public company, the word "Limited" or abbreviated "Ltd";
* in the case of a personal liability company, the word "Incorporated" or abbreviated "Inc"; and
* in the case of a non-profit company, the expression "NPC" (which stands for "Non-profit Company").

Reflection

At this stage it may be a good idea to ask yourself: "What am I doing here and why this subject?" As prospective manager it is essential that you understand what value Accounting holds for you.

We hope that you will realise that just as learning a language improves your ability to communicate, accounting is the language of the business world. It is an international language that is used across the world and enables you to understand anything, from your own financial position to that of large multinational companies, such as Microsoft, SAB, KWV, Telkom and Goldfields, etc.

Studiemateriaal

Study Chapter 1 and supplement as indicated.

Study time

Write down what your personal needs in terms of accounting knowledge are. Do not just think of the university's requirements for your degree; also think of your needs three, five or ten years from now.

Individual activity

Answer the self-evaluation questions at the end of the particular chapter. Substitute the instruction “Name” in sub-questions 9 and 10 with “Briefly discuss”.

2

Study unit 2

THE ACCOUNTING EQUATION

Study material

Study Material

This Study Section is based on:

Chapter 11. Knowledge and understanding of the meaning of the accounting equation form the scientific basis for the double entry. It provides you as prospective entrepreneur/manager with the skill to anticipate the outcome of a decision under consideration and thus enables you to make a better decision followed by the application in the accounting records, which brings you placing the transactions on record, the basis of financial reporting, which will be referred to and discussed in Study Section 2.2.

Study time

Time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Individual Activity

Refer to the work programme for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

Study outcomes

Outcomes

After completion of the Study Section you should be able to understand, explain and/or carry out the outcomes included in Chapter 11 point 11.1 and Chapter 2 point 2.1 that are summarised as follows:

- understand the need for an accounting processing system as a basis for reporting;
- understand the concepts debit, credit and balance and apply these concepts in the context of an account by placing on record transactions from all kinds of businesses in accounts and be able to establish the result per account; and
- understand that the results of the processing processes as explained above form the basis of the financial statements.

2.1 The accounting equation

Study material

This Study Section is based on:

Chapter 11.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Study the following attentively

Study Chapter 11 and the following notes carefully. Take special care that you understand the accounting equation and know what the elements of financial statements are.

2.1.1 The accounting equation

- Assets minus liabilities = owner's equity
- It can also be stated as follows:

  Assets = liabilities plus owner's interest or

  Assets minus Equity = liabilities

  Owner's interest is the equity of the business.

2.1.2 Assets

- Assets are the possessions of the business which were obtained in the past and will yield a future economic benefit for the business.
- Distinguish between current and non-current assets

Current assets will probably be converted into cash within the next accounting year. All other assets are non-current assets

2.1.3 Liabilities

- Liabilities are amounts owing by the business payable to a person or instance who is not the owner of the business.
- Differentiate between current and non-current liabilities.

Current liabilities are payable within the next financial year. All other liabilities are non-current liabilities.

2.1.4 Income

- Supply of goods or services which will increase the equity.

2.1.5 Expenses

- Goods purchased or services rendered to the business which will decrease the owner's interest.

All transactions have an effect on the financial position of the business because it has an effect on assets, liabilities and equity.

Individual activity

After you studied Chapter 2, you MUST do practical example (11.4) p. 176 - 179 in the text book. The suggested answer is on p. 445 - 446 in the text book.

2.2 The account (T-account)

Study material

This Study Section is based on:

Chapter 2.

Study Chapter 2 and ensure that you know the format of the ledger account and understand the debit and credit procedures.

2.2.1 The ledger account

A ledger account is a formal record of every asset, liability, income, expense and equity item. Increases and decreases in every account should be carefully recorded.

2.2.2 Format of a ledger account

Two formats of the ledger account are commonly used.

- **T-account format**
  Debit side [left]

  Credit side [right]

  The columnar headings on p.22 are important

- **Three column format**
  Date, details and folio as in T-accounts

  Dr-column, Cr-column, balance

2.2.3 Debit and credit procedures

Debit

An account is debited by entering the amount on the left-hand side

Credit

An account is credited by entering the amount on the right-hand side

Each account must be numbered - Diagram 2.1 p.24.

If the debits exceed the credits, the account will have a debit balance. If the credits are more than the debits, the account will have a credit balance.

2.2.4 The duality concept

Accounting entries - debits

When an expense is recorded for the first time

When an expense account is increased

When an income account is decreased

When an asset is recorded for the first time

When an asset increases

When a liability decreases

When equity is decreased

Accounting entries - credits

When an income is recorded for the first time

When an income account increases

When an expense account decreases

When a liability is recorded for the first time

When a liability increases

When an asset is decreased

When equity is increased

Individual activity

Assignment

Mr E Green is a general dealer and his transactions for the month ended 31 January 20x1 (the first month of trading)

1.	Mr Green started the business with the following:	
	* Cash deposited at SABA Bank	R 60,000
	* Merchandise	R 30,000
	* Furniture and equipment	R 10,000
	* Loan from E N Viro (Repayable after 2 years)	R 15,000
2.	Withdrew a cheque for petty cash purposes	R 3,500
3.	Sold goods (merchandise) on credit to V. Iro	R 5,000
4.	Paid for stationery by cheque	R 2,000
5.	Sold goods for cash and deposit the proceeds in the bank	R 20,000
6.	Bought inventory and paid by an internet transfer	R 15,000
7.	Bought office furniture and paid by cheque	R 5,000
8.	Withdrew a cheque for personal use	R 5,000
9.	Sold goods for cash and deposit the proceeds in the bank	R 25,000
10.	Paid salaries per internet	R 10,000
11.	Paid wages from the petty cash	R 2,000
12.	Paid for postage from the petty cash	R 1,000
13.	Restored the petty cash balance per cheque	
14.	Bought goods on credit from G. Reen	R 10,000
15.	Paid E N Viro interest on the loan per internet transfer	R 150
16.	Paid rent of the premises per internet bank	R 7,850
17.	Paid G. Reen with an internet transfer from his cell phone	R 5,000

Inventory on hand at 31 January 20x1 (physical count) R 17,500

REQUIRED:

Show the influence of each transaction on the accounting equation.

Use the following format for your answer:

	ACCOUNT DR	ACCOUNT CR	ASSETS		=	EQUITY		+	LIABILITIES	
			DR	KR		DR	KR		DR	KR
			+	-		-	+		-	+
1.	Bank	Capital	60 000				60 000			
	Inventory	Capital	30 000				30 000			
	Furniture and equipment	Capital	10 000				10 000			
	Capital	Loan from E N Viro				15 000				15 000
2.	X	X								
3.	X	X								
4.	X	X								
5.	X	X								
6.	X	X								
7.	X	X								
8.	X	X								
9.	X	X								
10.	X	X								
11.	X	X								
12.	X	X								
13.	X	X								
14.	X	X								
15.	X	X								
16.	X	X								
17.	X	X								
	Cost of sales	Inventory [begin]		30 000		30 000				
	Inventory [end]	Cost of sales	17 500				17 500			
			179000	84 500		98 000	172500		5 000	25 000
			94 500		=	**74 500**		+	**20 000**	

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 3

THE GENERAL JOURNAL

Study material

This Study Section is based on:

Chapter 3. The theme deals with the book of first entry. It does not form part of the double entry, but is a method to write down all transactions as they take place according to the analysis thereof, for inclusion in the ledger later. Modern computer software for transaction processing is based on the general journal methodology.

Individual activity

Refer to the textbook for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

Individual activity

Answer the self-evaluation questions at the end of the particular chapter and make sure that you now fully understand the progress as far as block 3 on the diagram on p 32 of the textbook.

Study outcomes

After completion of the Study Unit you should be able to

- Execute the outcomes as defined in the textbook "3.1 OUTCOMES".

3.1 Source documents

Information from which the accounting books are compiled, is obtained from source documents. Examples are invoices (when the undertaking buys or sells goods) and receipts (when cash is paid)

3.2 Journal entries

The first entries in an entity's books are done through journal entries. This process is called JOURNALISING and it entails that a chronological record of each day's transactions are kept.

3.3 Format of the journal

Note the column headings (p. 32 of the text book).

A journal entry gives the instruction as to which account should be debited and which account is to be credited.

The narration (explanation) is important as it explains the reason for the particular entry.

Ensure that you understand the diagram on p.32 and the manner in which the journal entry is recorded.

3.4 Posting to the ledger

The journal gives the instruction to debit and to credit specific accounts in the ledger.
If the journal instructs that Equipment is to be debited, the amount as indicated in the journal (R15 000) must be entered on the debit side (left) of the Equipment T-account
Similarly, if the journal indicates that Bank is to be credited, the amount (R15 000) is entered on the credit side (right) in die Bank T-account.

Individual activity

Individual Activity

Practical example 1 (3.4) p. 33 - 35

Journalise the entries on the worksheet on p.33 - 35. Compare your answer to the suggested answer on p. 411.

Individual activity

Individual Activity

Assignment

Use the same information as in the assignment in study unit 2 (E Green General Dealers).

Required

Do the general journal entries of E Green General Dealers for the month ended 31 January 20x1 and post the journal to the general ledger.

Reflection

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 4

THE GENERAL LEDGER AND PRE-ADJUSTMENT TRIAL BALANCE

Study material

This Study Section is based on:

Chapter 4. Time and again it is asked which ledger accounts must be opened. The answer is:

- it will contain those accounts that must convey the uniqueness of a particular business's transactions;
- keep accounts that can accumulate the necessary management information for decision making;
- keep accounts that enable management to control essential elements.

In essence it is that part of the accounting processing process that is aimed at the complete notation/writing down of external transactions.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the textbook for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

Study outcomes

After completion of the Study Section you should be able to

- Understand, explain and apply the first three outcomes in the textbook, p. 47, chapter 4.

4.1.1 Posting

Execution of the instruction given by the journal.

Example 4.1 p. 48 - 49 illustrates the posting to the ledger.

4.1.2 The different ledgers

Distinguish between three ledgers:

- The general ledger which contains all the asset-, liability- and equity accounts.
- The debtor's ledger which contains the accounts of all the individual debtors.
- The creditors' ledger which contains the accounts of all the individual creditors.

4.1.3 Balancing the T-account in the ledger

The totals of the debit side and credit side of an account at the end of the accounting period, should correspond. If the debit side is more than the credit side, the difference is then added to the credit side. This process is called **balancing**. The amount so added to the credit side is the "balance". This amount is then "brought forward" to the debit side and this account will then have a final "debit balance" due to the fact that the debits are more than the credits.

If the credits are more than the debits, the difference is added to the debit side and brought forward to the credit side. The final balance on this account will then be a credit.

Ensure that you understand the concept of "balance carried forward" and "balance brought forward"

Individual activity

Practical example 1 (textbook p. 51 - 53)

The journal as done in chapter 3 are posted to the ledger (p. 52 – 53).

Ensure you understand this process!!

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

4.2 Trading entities

Study material

This Study Section is based on:

Chapter 4 paragraphs 4.5 to 4.6.

Study time

Refer to the work programme for the time allocated to this Study Section.

4.2.1 Inventory

Inventory denotes the goods [merchandise] purchased by the entity for resale at a profit.

[Cost price + mark-up = selling price]. Unsold inventory at the beginning of the year will be the opening inventory at the end of the year and inventory at year end [unsold] will be transferred to the next year and is known as the closing inventory.

Inventory is always valued at the lower of cost price or net realisable value.

4.2.2 The continuous inventory system

When the continuous inventory system is used by a business operation, the inventory records are referred to with each sale transaction to determine the cost price of the sales and to enter this in the inventory account as a reduction (credit) in the asset. In the same way every purchase of inventory is also entered in the inventory account as increase (debit) of the asset. These actions mean that the physical movement (in and out) of stock and the notation thereof, the correctness of the physical stock in hand may be determined at all times by comparison with the book inventory.

Before the introduction of computer inventory systems, this stock was kept by hand and only for goods/products with a low turnover value and high product value. Current computer software is, however, economically available for the smallest business and therefore we will use this system for this course. Do, however, take note of the periodic system.

As it is necessary in the periodic system to physically count stock for financial reporting, in the same way it is also necessary in the continuous system, but then to determine if the physical stock corresponds with the records and if not, to make the necessary corrections, to determine the reasons for the differences and to implement measures to overcome this.

The abovementioned is noted as follows. Make use of the information in 4.5.5 on p. 56 – 57 of the textbook, with the additional item where we assume that the purchases in April amounted to R60 000. (The last mentioned item can also be done in the explanation of the periodic system on p. 54 which will cause you to also understand it better).

Name of the entity – Ledger

Inventory

April	1	Balance	b/d	10 000	30 April	Cost of sales		55 000
	30	Bank (purchases)		60 000	30 April	Balance	b/d	15 000
				70 000				70 000
Mei	1	Balance	b/d	15 000				

Cost of sales

April 30	Inventory		55 000				

The gross profit for the period (April in the case of the abovementioned example) is determined by carrying the balance (debit) on the cost of sales account forward to the Income account where it is played off against the sales income. It amounts to the same basis according to which the gross profit is calculated in point 4.5.6 of the textbook on p. 57.

In order to comply with reasonable value, trading inventory is always valued at "the lowest of cost price or realisable value". The intention here is to avoid that an asset be overvalued and the loss in value is then carried forward to the next financial period.

4.2.3 Periodical inventory system

Closing inventory is determined at the end of the financial period by way of a physical inventory count. When merchandise (inventory) is bought is referred to as "purchases" and when sold, it is termed "sales".

Closing inventory is brought into the books by debiting "inventory" [asset] and crediting cost of sales.

Opening inventory will be sold out at the end of the period. This is cancelled by crediting inventory [decrease of an asset] and debiting cost of sales.

Individual activity

Practical example 2 (p. 61 in the text book)

Complete the answer sheets on p. 62 and mark your answer by referring to the suggested answer on p. 415.

Ensure that you understand the work!

Study outcomes

After completion of the Study Section you should be able to

enter the transactions for the purchase and sale of stock in the general journal according to the periodic inventory system, but especially according to the continuous inventory system and transfer these transactions to the general ledger;

- calculate the gross profit of a commercial entity; and
- calculate gross profit growth.

Reflection

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

4.3 The pre-adjustment trial balance

Study material

Study Material

This Study Section is based on:

Chapter 4, sections 4.7 and 4.8.

Study time

Time

Refer to the work programme for the time allocated to this Study Unit.

Study material

Study Material

Study Chapter 4, sections 4.7 and 4.8.

Individual activity

Individual Activity

1. Answer the self-evaluation questions at the end of the particular chapter.
2. Write short, explanatory notes on
   - 2.1 How is it determined which ledger accounts must be opened?
   - 2.2 Draw up a list of source documents needed for all the transactions mentioned on p. 70.
   - 2.3 How can management ensure that all transactions are noted?
   - 2.4 Why, would you say, are there all the above-mentioned management functions/ responsibilities?

4.3.1 Double entry system

For every debit entry, there should be a credit entry with equal value, and vice versa.

The implication is thus that the total debits should always be equal to the total credits.

The **trial balance** is compiled to test this principle

- The trial balance has a debit column and a credit column.
- The ledger accounts with debit balances are written in the debit column of the TB and ledger accounts with credit balances are entered in the credit column.
- The total of the debit column should **ALWAYS** be the same as the total of the credit column.

Reflection

If the TB does not balance, you will have to find the error and do the correction BEFORE the annual financial statements are compiled.

4.3.2 Compiling the annual financial statements

Do the journal (You must know when an item is an expense, income, asset, liability or equity and which account should be debited or credited).

Post the journal to the ledger and balance the ledger.

Compile the trial balance. All accounts with debit balances are entered in the debit column and accounts with credit balances are entered in the credit column. The total of the debit column and the total of the credit column MUST BE THE SAME (in balance).

Only if the trial balance balances, you may proceed with the annual financial statements.

Individual activity

Practical example 3 (p. 63) in the textbook

Complete the answer sheet on p. 63 - 64 and compare your answer with the suggested answer on p. 417.

Make sure that you understand the work!

Individual activity

Assignment 4.1

Use the same information as the example in study unit 2 (E Green General Dealers).

Required:

Compile the trial balance of Green General Dealers for the month ended 31 January 20x1.

Assignment 4.2

Textbook chapter 4, assignment 4 [Xavier dealers p. 73 - 74]

Also do the journal entries for this exercise

- **You must do the following:**
  - Journal
  - Ledger
  - Trial balance

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 5

OWNER'S INTEREST (EQUITY)

Study material

This Study Section is based on:

Chapter 5. Ownership interest is also known as the net asset value of a business. What influences it is the growth in assets (reasonably valued) or the decline thereof and the change in the amounts of liabilities, by means of profits, which is the main financial aim of any profit-seeking business. Always keep the relationship between these elements in mind when studying this section.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the textbook for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

5.1 Owner's interest

Study outcomes

After completion of the Study Section you should be able to

understand the outcomes as contained in Chapter 5, section 5.1 and explain why it conveys the financial position of a business on a given date.

Study material

Study Chapter 5

5.1.1 Capital and drawings

Capital [equity or ownership] of a business consists of the initial contribution by the owner plus additional amount(s) invested plus net profit [or less net loss if applicable] less amounts withdrew from the business [drawings].

Individual activity

Individual Activity

Practical example 5.1 illustrates the above.

- Note the reference to source documents.
- Note the entries in the journal, ledger and trial balance.
- The statement of financial position (p. 92) is important. Do you recognise the accounting equation – assets equal equity plus liabilities. The format of the statement of financial position is important!

Individual activity

Individual Activity

Assignment 5.1

Do the practical example on p. 93. Complete the answer sheets on p. 93 - 96 and compare your answer with the suggested answer on p. 420 - 423.

If you experience difficulty in completing the assignment, review the chapter again.

Assignment 5.2

Chapter 5, assignment 1, p. 97.

Reflection

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

5.2 Equity of companies

Study material

Study Material

This Study Section is based on:

Applicable sections from the Companies Act 74/2008 and the identified integrated report.

Study time

Time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the work programme for the time to be spent on this Study Section.

Study outcomes

After completion of the Study Section you should be able to

- understand the nature and place of companies in the business world and why it is an important form of business;
- be aware of the required regulations of the Companies Act that you as business manager need to know about should you wish to utilise this form of ownership for your business;
- be aware of the particular provisions of the Companies Act in respect of the equity of companies.
- Understand the requirements of integrated reporting.

5.2.1 Introduction

Accounting is accounting, irrespective of the type of business. Therefore the accounting principles that apply to one-man businesses or partnerships will in no way differ from those that are applied to companies.

Companies do, however, have specific unique characteristics that require special processing, such as recording the issue and redemption of shares, compliance with the provisions of the Companies Act 71/2008 regarding accounting matters and the Johannesburg Securities Exchange, should the company wish to be listed. A company is surely the most important form of business in the current business world.

5.2.2 The characteristics of a limited company

On account of their nature and as a result of provisions in the Companies Act, companies offer the business manager features that are particularly advantageous as a form of business.

The limited liability offers protection in the sense that the creditors of the company do not have an unlimited claim **against the owners and management** of the company.

In accordance with the Companies Act, companies are obliged to regularly (at least every financial year), answer to their shareholders and other stakeholders by means of prescribed financial reports (Income Statement, Statement of Changes in Equity, Statement of Financial Position, Statement of Cash Flow, Auditors' Report and Directors' Report).

At incorporation and every year thereafter public companies and State companies must appoint an auditor. The auditor must be a registered accountant and auditor who confirms independently in his report concerning the annual financial statements that they are a reasonable account of the business and that disclosure took place in accordance with IFRS requirements.

In view of its corporate capacity a company is a taxpayer in own right and it is able as contractor to enter into contracts with third parties. This particular characteristic also brings about that companies' lifetime is not bound to that of their shareholders and it is theoretically possible for companies to continue existing for an unlimited period.

5.2.3 The legal framework that regulates companies

From April 2011 companies had to comply with the provisions of the Companies Act of 2008 that replaces the existing Companies Act at that time. Besides this, there is also other legislation that regulates matters, such as labour, affirmative action, health, safety, etcetera and with which not only companies but also other entities must comply.

5.2.4 Ordinary and preference shareholders

This section is important. Take special note thereof, especially of the difference in the classes of shares, namely ordinary and preference shares. Last-mentioned are determined by section 37 of the Companies Act 71/2008.

5.2.5 The issue of ordinary shares

In terms of section 35 of the Companies Act 71/2008 companies will only be able to be founded and registered with no par value (NPV) shares. Share premiums therefore fall away. NPV shares mean that a company is only registered with a limited number of shares, without mention of a value per share. At the issue thereof, the amount at which it is issued is determined by the Board. The following sections of the Companies Act 71/2008 are applicable:

- Section 35 - The legal nature of shares
- Section 36 - Authorisation of shares
- Section 37 - Preference rights, and other rights and discussions of shares
- Section 38 - Issue of shares

Look up the abovementioned sections in the Act, it is of practical value when you enter the business world. You will not be examined on this.

5.2.6 Financial records and financial statements

Take due note of the whole section. The particular sections in the Companies Act 71/2008 are:

- Section 24 - Form and standard of financial records
- Section 28 - Financial records
- Section 29 - Financial statements
- Section 30 - Annual financial statements

5.2.7 Listing of a company's shares

This section deals with the process that must be followed to have a public company listed and also the reasons for that. For listing on a specific exchange, whether the Johannesburg Securities Exchange and/or foreign exchange, for example the London exchange or the exchange in New York, the company must comply with the particular exchange's listing requirements and rules.

5.2.8 The requirements of integrated reporting

The first attempt in South Africa to enforce integrated reporting across all listed companies was introduced in 2010 by the Johannesburg Stock Exchange JSE Limited (JSE), which mandated integrated reporting. The listing requirements of the JSE compel compliance via the King III Report and therefore most companies produce an integrated report.

Revisit study unit 1, paragraph 3.3 to familiarise yourself with the definition and broad contents of an integrated report.

Study unit 6

NON-CURRENT ASSETS

Study material

This Study Section is based on:

Chapter 6. One of the most worrying questions that the manager has to answer is how much should be invested in fixed assets, and secondly, how this must be financed? The financing question in turn leads to the composition of the capital structure – how much own capital and how much foreign capital – each with its own advantages and risks.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the work programme for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

Study material

1. Study Chapter 6 in the textbook.
2. Study "Decrease in value/depreciation for Tangible non-current assets" supplementary to section 6.3 in the textbook pp. 101 - 105.

6.1 Non-current assets and depreciation

These are assets with a long life expectancy and are not acquired with the intent to resale the asset at a profit. Assets are entered in the books at cost minus discount receive plus costs incurred in bringing the asset to its current location.

Assets with a life expectancy of more than one year, is written off as an expense over the period of the useful life of that asset. This process is called "**Depreciation**". The asset is entered at cost and the depreciation per annum is allocated to the accumulated depreciation account.

The accounting entry to account for depreciation is:

- Dr Depreciation [expense] and Cr Accumulated depreciation

The carrying value [Book value] of a non-current asset is the cost price of the asset less its accumulated depreciation.

6.2 Methods of calculating depreciation

For the purpose of this course, only two methods of calculating depreciation is discussed. However, in your workplace you will probably come across other methods as well. For the sake of completeness, some other methods are discussed at the end of this study unit.

6.2.1 Straight line basis

A fixed percentage of the cost price of the asset is written off annually to the accumulated depreciation after the residual value has been taken into account. The same amount per annum will thus be written off over the useful life of the asset. If the asset was acquired during the year, deprecation is written off only for the portion of the year that the asset was available for use. **Example 6.1on p. 101 and 6.3 on p. 103 illustrates this method.**

6.2.2 Decreasing (reducing) balance method

A decreasing amount per annum is written off over the useful life of the asset.

In year 1 a fixed percentage of the cost price is written off. From year 2 a fixed percentage of the cost price minus accumulated depreciation [carrying value] is written off. If the asset was acquired during the year, deprecation is written off only for the portion of the year that the asset was available for use.

Example 6.2 on p.102 illustrates the reducing balance method.

6.2.3 Land and buildings [property]

Land generally has an unlimited life and is therefore not depreciated. Buildings are written off over its useful life if it can be determined.

6.3 Disposal [sale] of non-current assets

The disposal of non-current assets is not in the normal course of business. The asset at cost and its accumulated depreciation must be cancelled and removed from books.

6.3.1 Accounting entries

Make use of a realisation account

Cancel the asset at cost and transfer the balance to the realisation account.

Dr Realisation account

Cr Asset [decrease the asset]

Cancel the accumulated depreciation on the asset and transfer the balance to the realisation account

Dr Acc Depreciation

Cr Realisation account

Enter the proceeds

Dr Bank

Cr Realisation account

6.3.2 Profit on the sale of a non-current asset

Balance the realisation account. If the credits are more than the debits, (profit) the difference is added to the debit side of the realisation account.

Entry

Dr Realisation account

Cr Profit on the sale of assets

6.3.3 Loss on the sale of a non-current asset

Balance the realisation account. If the debits are more than the credits, (loss) the difference is added to the credit side of the realisation account

Entry

Dr Loss on the sale of assets

Cr Realisation account

Individual activity

Example 6.4 and 6.5 illustrates the profit/loss on the sale of non-current assets and is very important. Do the example and then compare your answer with the suggested answer.

6.4 Investments

Surplus cash invested to obtain interest.

Dr Investment [Example Money Market]

Cr Bank

Disclosed in statement of financial position as a non-current asset

Example 6.6

Note the disclosure of investments in the statement of financial position.

6.5 Additional notes on depreciation and tangible assets

Tangible assets include assets that are tangible, irrespective of whether they were classified as non-current assets or current assets in the Statement of Financial Position. In this section we will pay attention to valuation of and writing-off of the use/appropriation of assets in earning income. Attention is therefore given to the handling of non-current assets, such as machinery, equipment, vehicles, and so forth.

6.5.1 Depreciation

Deprecation is the systematic writing off of a non-current asset as a result of the use thereof in earning income.

For the calculation of depreciation of an asset the following information with regard to the asset is essential:

(a) the useful economic life of the asset;

(b) cost of the asset;

(c) the residual value of the asset; and

(d) the depreciation method that will be used.

Make sure that you know what each of the above entails and where and how the information may be obtained, because the ultimate choice of (a), (b), (c) and (d) above rests with management.

Study the methods of calculating depreciation described in the textbook and also take note of the following in conjunction therewith.

(1) The straight-line method

This is the most popular method because it is so simple to calculate. Take note that the depreciable amount is calculated as the cost price minus the residual value. The asset is therefore depreciated over its useful life for not less than its residual value.

(2) The reducing-balance method

This is a more complex calculation, where a constant depreciation percentage is determined according to a formula, depreciated annually over the useful economic life of the asset against the cost price of the asset for year 1, and then on the reducing balance (i.e., cost price minus accrued depreciation up to date).

The asset is only depreciated until the residual value has been reached.

There is also a quicker and more practical alternative to the above method, whereby the same result is reached. (Although the formula referred to above is constantly quoted in the literature, the application thereof is complicated and in no way does it deliver a more reasonable result.)

The method more or less follows the same process described above. The only difference is that the depreciation percentage is calculated as follows:

- Determine the depreciation rate as it would be used in the straight-line method, example for a life of 4 years a depreciation percentage of 25% would apply.
- Double the rate, example 2 x 25% = 50%.
- Use the rate for the annual depreciation.

(3) Sum-of-the-years-digits

It is a method that is used to calculate the reducing or increasing depreciation based on changing market conditions. It is not a method that enjoys great practical following because the change in the market seldom corresponds with the fixed nature of the decrease or increase. Not necessary for this course.

(4) Unit-production method

This is an important method that links the simplicity of the straight-line method with a variable earning capacity of the asset.

Briefly the method works as follows:

- Determine the number of units that the asset will deliver over its expected useful life.
- Divide the cost price of the asset by the expected number of production units over the life thereof in order to determine depreciation per unit in R-value.
- Multiply the actual production units per year (or any other period) with the depreciation amount per unit as above in order to calculate the depreciation expenditure for the year or other period.

Example: Depreciation on the unit-production method

A machine is purchased by A Ltd for an amount of R1 800 000. The installation costs amount to R260 000. The expected life is 4 years, with an expected production capacity of 100 000 units per year. The actual production was 80 000 units in year 1, 120 000 units in year 2, 140 000 units in year 3, and 60 000 units in year 4. Calculate the decrease in value for the 4 years. The residual value is estimated at R60 000.

Answer – unit-production method

Purchase price of machine	R1 800 000
Installation costs	260 000
	2 060 000
Less residual value	60 000
Depreciable amount	R2 000 000

Depreciation amount per unit:

Depreciation amount	R2 000 000
Number of production units over the life of 4 years	400 000
Depreciation per unit	2 000 000
	400 000
	= R5

	Initial investment	Year 1	Year 2	Year 3	Year 4
Acquisition costs	R2 060 000	2 060 000	2 060 000	2 060 000	2 060 000
Depreciation		80 000 x 5	120 000 x 5	140 000 x 5	60 000 x 5
		= 400 000	= 600 000	700 000	300 000
Accumulated Depreciation		400 000	1 000 000	1 700 000	2 000 000
Carrying amount (Book value)		1 660 000	1 060 000	360 000	60 000

You as prospective manager, who has to make the final decision, must determine which factors you will consider in order to decide on the most appropriate depreciation method. Also take note of the use of an asset register to keep a record of material assets. This requirement also applies for South Africa and is prescribed by the Companies Act.

Factors that will have to be considered in this regard are:

- fixed or fluctuating production demand
- rate of diminution of the production unit's productivity.

Group activity

Class activity

Now that we have covered the non-current assets, let's view how non-current assets are disclosed in the integrated report.

Individual activity

Assignment 6.1

Chapter 6 Assignment 1 [Umfula Lodge p. 115 - 116]

Study outcomes

After completion of the Study Section you should be able to

- understand and explain the outcomes contained in the textbook in chapter 6, paragraph 6.1 and apply them when compiling and/or reading financial statements with a view to:
  - ∗ understanding the reason for the writing-off of depreciation;
  - ∗ the choice of an 'appropriate depreciation method' for certain assets by management;
  - ∗ the determination and disclosure of a reasonable value for non-current assets.

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 7
CURRENT ASSETS

Study material

This Study Section is based on:

Chapter 7. Current assets are those assets in which a business trades. It differs from non-current assets in that they will be converted in cash in the next accounting period. Current assets generally consist of:

- Items already cash - Bank, cash on hand, petty cash, short term investments, savings accounts.
- Items which will be converted to cash in the next accounting period - Inventory, debtors, prepaid expenses and accrued income

If there is no movement, it means that it stagnates and delivers no return on the funds invested in it. This section should provide you as manager with the information to carry out control over these assets in order to ensure that they are productive. You will therefore want to take note of information concerning amounts invested, performance (profit) and liquidity (ability to convert it to cash).

Individual activity

Refer to the textbook for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

7.1 Debtors

Study material

This Study Section is based on:

Chapter 7, paragraph 7.3.1 in the textbook p. 118 – 124.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Study material

Study chapter 7, paragraph 7.3.1 and keep in mind that debtors only have value when the amount owed to the business can be collected (recovered). It is therefore important that the manager must make sure that all transactions are recorded correctly.

Study outcomes

After completion of the Study Section you should be able to:

- Identify the source documents involved and to put measures in place to make sure that all transactions are recorded;
- Record transactions between a company and its debtors;
- Determine the fair value of debtors, and write off bad debts;
- Determine the allowance for bad debts;
- Identify the relevant accounts involved in the financial statements.

7.2 Debtors

Debtors are customers who bought merchandise on credit. Payment from the debtor is expected within normal credit period, usually 30 days.

7.2.1 Trade discount

Trade discount is allowed to the client when the transaction takes place and is not entered in the books.

7.2.2 Settlement discount

This is a discount allowed to the debtor for early settlement of his account before the due date and is entered in the books as follows:

Dr bank	R 90
Dr discount allowed	R 10
Cr debtor	R100

7.2.3 Credit losses (bad debts)

If for some or other reason, the debtor cannot pay his account his account will be written off as irrecoverable [bad debt].

Dr Credit losses [expense]

Cr Debtor

7.2.4 Provision for credit losses

It is common for larger entities to make provision for the fact that some debtors might not be able to pay their accounts. A provision for credit losses is then created and future bad debts are written off against this account.

Dr Credit losses

Cr Allowance for credit losses

The allowance for credit losses will be deducted from total debtors in the statement of financial position.

- **If the debt turns out to be actually irrecoverable at some future date:**

  Dr Allowance for bad debts

  Cr Debtor's account

Individual activity

Individual Activity

Example 7.4 and 7.5 (p. 120 – 123) illustrate the allowance for credit losses. Do the examples and then compare your answer with the suggested answer.

7.3 Inventory

Study material

Study Material

This Study Section is based on:

Chapter 7, par 7.3.2 in the textbook on p. 125 - 128.

Study time

Time

Refer to the work programme for the time allocated to this Study Section.

Study material

Study Material

1. Study Chapter 7.
2. Add “Accounting for inventories” to, paragraph 7.3.2 in the textbook. Keep in mind that stock can only earn a profit if it is sold. Therefore quantities and kind are of great importance. In order to manage this, management needs the necessary and relevant.

Inventory

Inventory (merchandise) refers to goods bought for resale at a profit. The most common method of valuation inventory is the FIFO [First-in-first-out] method. For the purpose of this course, you should also take note of some other recognised methods discussed at the end of this study unit.

7.3.1 Periodical inventory system

Inventory is valued at end of the accounting period by a physical count. The opening inventory is cancelled and closing inventory taken into account only at the END of the reporting period. The accounting entries are as follows:

- **Purchase of goods**
  Dr. Purchases
  Cr. Bank/creditors.
- **At the end of the financial period**
  Dr. Cost of sales
  Cr. Purchases
- **Cancel the opening inventory**
  Dr. Cost of sales
  Cr. Inventory [decrease of the asset]
- **Bring closing inventory into account**
  Dr. Inventory [increase of assets)
  Cr. Cost of sales.

7.3.2 Continuous inventory system

The theoretical inventory is continuously disclosed in the book. A physical inventory count is done periodically and the theoretical inventory is adjusted if necessary.

Inventory can also be stationary on hand, consumables on hand or refreshments on hand at the end of the reporting period.

Individual activity

Individual Activity

Example 7.6 illustrates the application of the periodical inventory system. Do the example and then compare your answer with the suggested answer.

7.3.3 Accounting for inventories (Application of the cost formulas)

There would be no problem if prices of inventory items purchased remained the same over a period. It is, however, part of the current economic reality that prices fluctuate, mostly higher rather than lower. The question that arises is which price must be used to determine "Cost of Goods Sold" (COGS) and which price must be used to determine inventory at hand.

To answer the question, the accounting standards IAS 2, paragraphs 23 and 25 allow the following 3 cost formulas for the valuation of inventory:

(a) The First-In First-Out method (FIFO)

(b) The "Weighted Average Costing" method

(c) Specific identification method. The textbook does not require knowledge of the three costing formulae; this course, however, does.

Refer to example 7.1 hereafter where the application of the 3 cost formulas is explained. Take note of how the results differ.

The unique specific costs of inventory items that are normally not exchangeable and items that are manufactured for and assigned to specific projects, purposes or needs will, for accounting purposes during processing, be assigned to these specific items. In other words, the unique costs of a certain item are used as COS when the item is sold or as value of the item when inventory is valued.

This method is applied by businesses that trade in high-value items with a relatively low trade frequency, such as jewellers, car dealers, etc.

7.3.4 The 'net realisable' rule in the valuation of inventory

The requirement of IAS 2 paragraph 28 is that inventory value be shown at the lower of cost price or net realisable value (NRV). It has to do with the accepted principle that assets will not be carried at a value higher than the expected economic benefits thereof. Last-mentioned refers to the net realisable value thereof. The result is that if the NRV has decreased below cost price, the value thereof is written down to the NRV as an inventory loss.

Practical example 7.1 – Application of cost formulas

FIFO and Weighted average

Bright Life's inventory records, kept according to the continuous system, show the following transactions for the three-month period ending on 30 September 20x5:

Transaction	Date	Quantity	R/per unit
Opening inventory	1/7/x5	150	R11
Purchases	15/7/x5	150	12
Sales	10/8/x5	200	?
Purchases	8/9/x5	150	13
Sales	20/9/x5	90	20

You are expected to

Calculate the cost of sales and the value of the closing inventory on 30/09/x5

(I) if the inventory is kept according to FIFO,

(II) if the inventory is kept according to the weighted average method, and

(III) if the inventory is kept according to the specific identification method. You determined that the sales were as follows:

a) 10/8/x5 - 150 items from the opening inventory

- 50 items from the purchases of 15/7/x5 purchases

b) 20/9/x5 - 90 items from the purchases on 8/9x5

Practical example 7.1 - Solution

	(I) FIFO			**(II) Weighted average**		
	Quantity	**R**	**Total**	**Quantity**	**R**	**Total**
01/07 Opening inventory	150	11,00	1 650	150	11,00	1 650
15/7 Purchases	150	12,00	1 800	150	12,00	1 800
15/07 Balance	300		3 450	300	11,50	3 450
10/8 Sales (1)	(200)		(2 250)	(200)	11,50	(2 300)
10/08 Balance (2)	100		1 200	100	11,50	1 150
08/09 Purchases	150	13,00	1 950	150	13,00	1 950
20/09 Sales (3)	(90)		(1 080)	(90)	12,40	(1 116)
30/09 Balance inventory	160		2 070	160	12,40	1 984
COS			3 330			3 416
Calculations (1)	150	11,00	1 650	3 450/300 =	11,50	
	50	12,00	600			
	200		2 250	200	11,50	2 300
Calculations (2)	100	12,00	1 200	100	11,50	1 150
Calculations (3)	90	12,00	1 080	100	11,50	1 150
				150	13,00	1 950
	90		1 080	250	12,40	3 100
				90	12,40	1 116
Calculations (4)	10	12,00	120			
	150	13,00	1 950			
	160		2 070	160	12,40	1 984
	(III) Specific identification			**Calculations**		
01/07 Opening inventory	150	11	1 650			
15/7 Purchases	150	12	1 800	250	11	1 650
15/7 Balance	300		3 450	50	12	600
10/8 Sales	(200)		(2 250)	200		2 250
8/9 Purchases	150	13	1 950			
20/9 Sales	(90)		(1 170)	90	13	1 170
30/9 Balance inventory	160		1 980	100	12	1 200
				60	13	780
30/9 COS			3 420			

Kollitz, Quinne, McAllister. A concepts Based introduction to Financial Accounting, 4th ed. (amended)

Study outcomes

Outcomes

After completion of the Study Section you should be able to:

- identify the source documents and put measures in place to ensure that it is fully recorded;
- record inventory transactions in the accounting records;
- explain how it is reconciled with the individual inventory records;
- recognise inventory as an expenditure at the correct time, that is to say, when it is sold to earn income; and
- identify the relevant accounts in the financial statements and disclose them at a reasonable value as determined according to prescribed costing formulae.

Reflection

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

7.4 Cash and cash equivalents (bank, petty cash, etc.)

Study material

Study Material

This Study Section is based on:

Chapter 7, paragraph 7.3.3 and 7.3.4 in the textbook, p. 128 – 130.

Study time

Time

Refer to the work programme for the time allocated to this Study Section.

Study material

Study Material

Study Chapter 7.

7.4.1 Bank

A debit balance [asset] denotes that there is a favourable bank balance and that the bank owes the money to the entity. A credit balance is an overdrawn bank account [liability] and the entity owes that amount to the bank.

7.4.2 Petty cash

Cash on hand on the premises and used to pay in cash for petty expenses. The petty cash balance must be restored on a regular basis.

Group activity

Class activity

Now that we have covered the current assets, let's view how current assets are disclosed in the integrated report.

Individual activity

Assignment

Do the practical example 7.4 on p. 130. Complete the answer sheets on p.131 - 135 and compare your answer with the suggested answer on p. 416 - 420.

If you experience difficulty in completing the assignment, review the chapter again.

Study outcomes

After completion of the Study Section you should be able to

- identify and complete the source documents;
- record cash transactions in the accounting records; and
- identify the relevant accounts in the financial statements.

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 8

LIABILITIES

Study material

This Study Section is based on:

Chapter 8. Borrowed funds are part of today's financing structure. It is also good business to make use of this, especially if:

- there is sufficient security to cover the debt;
- interest and redemption can be paid on time; and
- the cost of debt (interest) is lower that the return that may be earned with it in the business.

Knowledge of the particular liability transactions in the accounting records is therefore of great importance to management, to make choices and decisions.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Study material

Study Chapter 8.

It is sometimes necessary to borrow money from banks, other institutions or people. Any money borrowed or credit received from a person or institution that is not the owner of the entity, is a liability. Distinguish between non-current liabilities and current liabilities

8.1 Non-current liabilities

These liabilities are refundable over a period of LONGER than the next financial period. The portion of the long-term loan that is repayable within the next financial period is known as "the current portion of long-term loans" and is disclosable as a current liability in the statement of financial position.

Examples are long-term loans repayable over a period of more than one year and mortgaged bonds over property.

8.2 Current liabilities

This debt is repayable within 12 months after the entity's financial year-end. Examples are creditors, bank overdraft, taxation payable to SARS, expenses in arrears.

Individual activity

Example 8.1 (p. 139 - 142) illustrates the entries and disclosure of liabilities. Do the example and compare your answer with the suggested answer. Note the disclosure of the “short-term portion of long-term loan” in the statement of financial position.

Group activity

CLASS ACTIVITY

1. Now that we have covered the liabilities, let’s view how liabilities are disclosed in the integrated report.
2. Use excel amortization schedule to illustrate the effect of interest rates and payments made on a loan.

Individual activity

Practical example 8.4 (p. 142 – 145)

Complete the answer sheets on p. 143 - 145 and compare your answer with the suggested answer on p. 432 - 435.

If you experience difficulty in completing the assignment, review the chapter again.

Study outcomes

After completion of the Study Section you should be able to:

- in addition to the outcomes in par. 8.1 in the textbook, p. 137:
- determine the cost of liabilities – interest on long-term and short-term liabilities;
- record the transactions in respect of liabilities in the accounting records; and
- identify the relevant accounts in the financial statements and ensure that liabilities are not understated.

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 9

INCOME AND EXPENDITURE

Study material

This Study Unit is based on:

Chapter 9. In order to understand this learning content properly, it is necessary that you do not regard it as separate from Study Unit 10. Study both concepts, “income” and “expenditure” together as a unit to understand it better.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the work programme for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

Study outcomes

After completion of the Study Section you should be able to:

- identify the source documents and ensure that they are fully recorded;
- classify income according to source;
- recognise income and expenditure at the right time according to GAAP and record it;
- identify the relevant accounts in the financial statements and disclose income correctly according to GAAP; and
- understand the meaning of the result of the above-mentioned, viz “Profit” or “Loss” as the remuneration for ownership interest and understand the implications thereof for planning.

Study material

Study Chapter 9.

9.1 Income

Income is the inflow of economic benefits during a financial period which leads to an increase in equity (owner's interest) as a result of an increase in assets or a decrease in liabilities **excluding** contributions by owners.

Examples: Sales, services rendered, rent and interest received

Income is disclosed in the statement of comprehensive income.

9.2 Expenses

Expenses are the outflow of economic benefits during a financial period that leads to a decrease in equity as a result of a decrease in assets or an increase in liabilities, **excluding** withdrawals by owners.

Examples; Telephone, salaries, rent and interest paid

Expenses are disclosed in the statement of comprehensive income.

9.3 Cost of sales

Cost of sales consist of the opening inventory plus net purchases (total purchases less purchases returns = net purchases) plus freight on purchases/custom duties/ import duty less closing inventory.

Cost of sales is disclosed separately in the statement of comprehensive income.

Individual activity

Example 9.1 illustrates the entries of income and expense items. Answer the question and compare your answer with the suggested answer. Pay particular attention to the treatment of the inventory account – the opening inventory is cancelled and the closing inventory is brought into the books.

Also note the FORMAT of the statement of comprehensive income.

Group activity

Class activity

Integrated reporting pays a lot of attention towards the disclosure of the expense director's remuneration, let's view how remuneration (salaries of directors) are disclosed in the integrated report.

Individual activity

Practical example 9.4 (p. 153 – 154)

Complete the answer sheets on p. 154 - 158 and compare your answer with the suggested answer on p. 436 - 440.

If you experience difficulty in completing the assignment, review the chapter again.

Individual activity

Assignment 9.1

Do assignment 1 p. 159 - 160 (Dirk's Steelworks). He suggested answer will be discussed during the next contact session. If you experience difficulty in completing the assignment, review this and previous chapters again.

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 10

COMPLETION OF THE ACCOUNTING CYCLE

Study material

This Study Unit is based on:

Chapter 10. The essence of this Study Unit lies in fulfilment/accomplishment of outcome 1 according to par. 10.1 in the textbook on p. 161. It entails the adjustment of information in the ledger accounts in order to comply with the accrual concept in order to compile annual financial statements with this as basis, and then to close the accounts finally for the year. Refer to the discussion in par. 10.3 on p 161 - 165 of the textbook. The other outcomes are merely for the practical execution thereof.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the textbook for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

Adjustments

The purpose of adjustments is to ensure that income and expenses, and consequently the profit or loss, for the relevant financial period is accurately reported.

The following adjustments are made at the end of each financial period:

- Closing inventory (already explained in chapter 4);
- Depreciation (already explained in chapter 6);
- Allowance for credit losses (already explained in chapter 7);
- Material consumed (already explained in chapter 7);
- Income received in advance;
- Accrued income;
- Prepaid expenses; and
- Accrued expenses

10.1 Income received in advance

Income received in advance represents income for the next financial period that has already been received during the current financial period. The accrual principle requires that the transaction must be recorded. Consequently, this income is not shown as income for the current period, but as income received in advance under current liabilities in the statement of financial position.

Example: rent received in advance.

10.2 Accrued income

Accrued income represents income that has already been earned but is still owed to the entity for the current financial period and must therefore be recognised as income.

The entity must also create a debtor (current asset) to indicate that money is owed to the entity

Example: Rent in arrears.

10.3 Prepaid expenses

Prepaid expenses represent expenses for the following financial period that have been paid during the current financial period. The portion of the expenses that has been paid in advance is shown as prepaid expenses under current assets in the statement of financial position.

Examples: Insurance prepaid, rates and taxes prepaid, rent expense prepaid.

10.4 Accrued expenses

Accrued expenses represent expenses that have been incurred but must still be paid by the entity for the current financial period and must therefore be recognised as expenses. The entity must also create a creditor to indicate that money is owed by the entity. Accrued expenses are shown under current liabilities in the statement of financial position.

Examples: Electricity payable, wages payable.

Individual activity

Individual Activity

Practical example 1 (10.4)

Complete the answer sheets on p. 165 - 166 and compare your answer with the suggested answer on p. 441. Note the narrations (description) to the journal entries.

Ensure that you understand the work!

10.5 Post-adjustment journal

The post-adjustment trial balance is prepared once all the adjustments have been processed.

Individual activity

Practical example 2 (10.6)

Complete the answer sheet on p. 168 and compare your answer with the suggested answer on p. 442.

Ensure that you understand the work!

10.6 Closing journal entries

The recording of adjustments ensures that each income and expense account includes only entries with respect to the current financial period. At the end of each financial period, the income and expense accounts, also called nominal accounts, must be closed off in order to determine the profit or loss for the period.

The "cost of sales accounts" and the sales account are transferred [closed] to the Trading Account.

The other nominal accounts [expenses and income] are transferred to the Profit and Loss Account.

The balance of the trading account [gross profit] is transferred to the profit and loss account.

The balance of the profit and loss account [net profit or net loss] is transferred to the capital account [owner].

The drawings account is transferred to the capital account.

Individual activity

Practical example 3 (10.8)

Complete the answer sheet on p. 169 and compare your answer with the suggested answer on p. 443. Note the transfers to cost of sales, trading account, profit and loss account and capital account.

If you experience difficulty in completing the assignment, review the chapter again.

10.7 The post-closing trial balance

Once the closing journal entries have been journalised, it must be posted to the general ledger and the nominal accounts closed off. The post-closing trial balance is prepared once all the closing entries have been processed. The only items remaining will be assets, liabilities and the owner’s capital.

Individual activity

Practical example 4 (10.10)

Complete the answer sheet on p. 171 and compare your answer with the suggested answer on p. 444.

If you experience difficulty in completing the assignment, review the chapter again.

Individual activity

Assignment 10.1

Do assignment 2, p. 173 - 174 (Rex Traders). The suggested answer will be discussed during the next contact session. If you experience difficulty in completing the assignment, review the chapter again.

Study outcomes

After completion of the Study Section you should be able to

- besides the outcomes in paragraph 10.1:
- understand what the adjustment journals are;
- understand why it is essential to make adjustments;
- understand the accrual concept, the realisation concept and the matching concept;
- calculate the amounts of the adjustments, identify the accounts that must be adjusted, record the adjustments in the general journal and transfer to the general ledger; and
- draw up the post-adjustment trial balance in order to ensure that all income earned and all expenditure incurred to earn the income is recorded in a certain reporting period, with corresponding influence on the financial position, followed by the closing of the income and expenditure accounts and the transfer of asset, liability and equity accounts to the next year/period.

Study unit 11

FINANCIAL STATEMENTS

Study material

This Study Unit is based on:

Chapter 12. Fulfilment of outcome 1, par. 12.1 in the textbook p. 183 is the essence of this Study Unit. Fulfilment thereof as indicated in the sequential outcomes and discussed in par 12.3 are essential to make the annual financial statements qualify as a basis for accountability and as a basis for planning for the future.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the work programme for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that the assignment may be taken in for evaluation at will.

1) Study Chapter 12.
2) Study "The preparation of annual financial statements".
3) Study IAS1 paragraphs 47 to 138 as well as IAS 1, last-mentioned appended as a supplement with regard to form of presentation.

The accounting cycle

The accounting process can be summarised as follows:

- Transactions takes place
- Journalise the transaction - assets, liabilities, income, expenses and equity
- Post to the ledger and balance the accounts
- Prepare the trial balance
- Record adjustments in the journal and post to ledger
- Prepare post-adjustment trial balance
- Do the closing journal entries and post to ledger
- Prepare the post-closing trial balance - only assets, liabilities and equity accounts remain.

Compile the annual financial statements

11.1 Features of annual financial statements

- **Fair presentation - in accordance with IFRS**
- **Materiality and aggregation**

  If the exclusion of information would influence the financial decisions of management, such information is deemed to be material and should be disclosed. Items in the same category may be aggregated and disclosed as a single amount.
- **Offsetting**

  Items may not be offset against each other and must be disclosed separately.
- **Comparative information**

  The information of the previous year is also disclosed to assist in determining trends
- **Frequency**

  Financial statements should be prepared at least annually
- **Going concern**

  It is assumed that the entity will remain in business for the foreseeable future
- **Accrual basis**

  Transactions are recorded when they occur
- **Consistency**

  Basis of preparation [accounting policy] must remain consistent from year to year.

11.2 Notes to the financial statements

The accounting policy consists of principles, bases of measurement and practices adopted by the entity in the presentation of its financial statements and are usually the first note to the annual financial statements.

Study material

Study Material

In the textbook p. 198 - 199 is an example of the notes that accompany the financial statements of an entity. Commonly, information such as the address, bank, auditor's name, and directors are disclosed in the financial statements.

Individual activity

Individual Activity

Practical example 1 (12.11 in textbook)

Complete the answer sheets on p. 200 - 204 and compare your answer with the suggested answer on p. 447 – 450. If you experience difficulty in completing the assignment, review the chapter again.

Individual activity

Individual Activity

Assignment 11.1

Use the information given in the assignment in study unit 2 (E Green General Dealer).

Required:

Compile the financial statements of E Green General Dealers.

Individual activity

Individual Activity

Assignment 11.2

Do assignment 6 on p. 217 - 218 (Betula Dealers). The suggested answer will be discussed during the next contact session. If you experience difficulty in completing the assignment, review the chapter again.

ADDENDUM TO THE TEXTBOOK CHAPTER 12

The purpose and characteristics of accounting information

Financial accounts are summarised statements of the performance of a business over a given period of time prepared for use by the external stakeholders of the business. The financial accountant makes comparisons between the revenue and costs incurred by a business in order to measure the surplus earned over that period. This surplus is what the accountant calls 'profit'. The estimation of accounting profit involves the following four stages:

1. Specifying the period over which the firm's profit will be measured. This is usually a year, but it may be a month or 6-month period. This is termed the period of account.
2. Identifying to which period of account the revenues earned by the business should he attributed. This involves what accountants refer to as a "revenue recognition concept", i.e., a set of principles for deciding, in any given case, into which period the revenue should be counted.
3. Matching the cost which can be fairly attributed to the effort involved in earning that revenue in the period concerned. The problem the accountant has to solve is how best to match the varying expenditure made by the business to the revenue it has earned. Expenditure on such things as plant, buildings and land may occur in years different from those in which they were used in the process of earning revenue. This problem is what accountants refer to as "cost recognition".
4. Finally, when the clearest and most logical matching has been achieved between revenues in a given period and the costs which can be fairly charged against those revenues then a figure for profit (accounting revenues minus accounting costs) can be calculated.

The accounting statement of matched costs against revenues is referred to as the "income statement". However, at any point in time certain expenditures and receipts will not have been matched to a given period. The list of unmatched balances forms the "balance sheet" at a specific date.

The decision-oriented approach to accounting

The creation of a firm's profit and loss account and balance sheet is intended to provide a statement of the financial performance of the business over time in order to help the stakeholders of that firm make their own financial decisions.

This decision-oriented approach is fundamental because all of the other purposes to which accounting can be put, and as outlined at the beginning of this chapter, can be reduced to one of decision making. For example, it could be argued that accounts are prepared as part of the stewardship function of management, by ensuring that the managers of the company exercise their roles in ways that the principal stakeholders, the owners, or government expect. But the stewardship function of management involves decision, namely has a particular individual, or part of the firm, managed its resources properly and in ways that were expected? If not, what remedial action can be taken to correct matters? These are all decisions so, arguably, the stewardship function of accounting is simply part of its wider purpose of supporting the decision-making needs of users.

In applying the decision-oriented approach it is necessary to:

1. Identify the user, whether they are a shareholder, manager, employee, or any of the others mentioned above.
2. Ascertain the decision maker's financial objective: this could be, to give just two examples, to maximise the value of a shareholder's investment, or to increase the take-home pay in the case of an employee or manager.
3. Specify the decision: buy, hold or sell the company's shares as a shareholder, sell a product to the company concerned as a supplier for example.
4. Identify the information required to support the decision: projection of future distributable profits for the shareholder or projections of trading profit before salaries are charged for the employee.
5. Decide upon the most suitable form in which the information can he provided.

Although the above may appear like a statement of the obvious there are a number of problems with this decision-oriented approach.

- The decision-oriented approach can be so widely defined that it becomes a truism that the only value possessed by accounting information is that it supports someone's decision in some way or other. The trouble with truisms is that they rarely get us very far. To be effective a definition of the purpose of accounting must have limited applicability.
- Applying the approach to user groups entails identifying groups that have common information needs. The classification of groups outlined above hides important sub-groups: for example, owners of shares in companies range from institutional investors to those who own shares in their private capacity. Others hold shares for long-term capital growth and others for more immediate speculative purposes. Does it make sense to lump them together into a single category?
- The user group analysis ignores the fact that any given individual may fall within more than one category of user. A particular individual may be an employee of British Airways, for example, and also a shareholder in the company. She may also own shares in a bank that lends money to Virgin Atlantic (which competes with BA) and in another company that supplies it with machine parts. She is also a member of society and a taxpayer. This one individual straddles a number of

different user groups. In such a situation her information requirements may well conflict with one another.

However, the decision-oriented approach has been very influential amongst accounting academics and accounting policy makers. Over the last twenty years, accounting policy makers have been searching for a conceptual framework for defining the nature of accounting information. The decision-oriented approach has been central in that search.

The nature of accounting information

Accounting information is data that has financial significance for users who need it for their own decision-making purposes. The crucial distinction between data and information is that information is any data which changes an individual's beliefs about the future. Because we make decisions upon the basis of our beliefs about the consequences of those decisions then information is necessarily data that can influence the outcomes of the decisions we wish to make.

The search for a conceptual framework for accounting has been a search for some set of overriding principles that would allow those that regulate the work of accountants to deduce a set of accounting standards specifying how financial information should be disclosed to users. Underlying this search has been the idea that there is a set of principles for judging whether accounting information will be useful to any given user or user group. In the end the UK's Accounting Standards Board (the ASB) produced a set of five quality criteria for testing the usefulness of accounting information and any standards regulating how it should be disclosed.

These criteria are:

- materiality
- relevance
- reliability
- comparability
- understandability

Study outcomes

Outcomes

After completion of the Study Section you should be able to:

compile the financial statements of a one-man business and a company that comply with the necessary disclosure requirements and that enable users to judge for themselves as a basis for accountability and decision making.

Reflection

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 12

CASH FLOW STATEMENT

Study material

This Study Unit is based on:

Chapter 14. When studying a business, keep outcomes 1 and 2 par. 14.1 Chapter 14 in the textbook on p. 249 in mind. Because it happens in so many businesses that earning revenue and incurring expenditure do not always take place at the same time (inflow and outflow of money), cash control by management is of the utmost importance. Hence the reason why cash flow statements are so important.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the work programme for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that it will be taken in for evaluation every time.

Study material

Study textbook chapter 14.

12.1 Movement of cash during the financial year

Cash is needed to pay for expenses, buy merchandise, pay liabilities, buy assets, pay interest and to make investments. The opening balance of cash plus ALL cash received during the year minus ALL cash paid out during the year equal cash balance at the end of the financial year. All cash flows are taken into account even if it is a result of transactions which occurred in the previous year or transactions relating to the next year.

12.2 Format of the statement of cash flow

The statement of cash flow consists of four sections:

Cash flow from operating activities

Shows the net cash inflow or net cash outflow of the operating activities during the year and relates mainly to the items in the trading account and profit and loss account [statement of comprehensive income].

Pay particular attention to the treatment of depreciation.

Cash flow from investment activities

Cash flows from the sale and purchase of non-current assets and other investments.

Cash flow from financing activities

Cash flows from financing obtained by the business and loans repaid and also the capital introduced by the owner minus his drawings.

Movement of cash and cash equivalents

Total of above three sections are net cash inflow (surplus) or net cash outflow (deficit). Cash Balance at the beginning of the year plus surplus or minus deficit is the balance of cash at the end of the year

Important information

The schematic representation of the format on p. 252 - 253 is very important

12.3 The necessity of Cash Flow Statements: A management perspective.

Although it may seem puzzling, growing profitable operations does not always ensure positive cash flow. Also, seasonal fluctuations in sales, purchases of inventory and advertising expenditures may bring **high profits** and **net cash outflows** in some quarters and **losses** and **net cash inflows** in others. As we have seen in earlier chapters, this occurs because the timing of revenues and expenses does not always match cash inflows and outflows. As a consequence, companies must carefully manage cash flows as well as profits. For the same reasons, financial analysts must consider the information provided in company’s cash flow statement in addition to its income statement and balance sheet.

Understanding the business

Clearly, net income is important, but cash flow is also critical to a company’s success. Cash flow permits a company to expand operations, replace worn assets, take advantage of new investment opportunities, and pay dividends to its owners. Some Wall Street analysts go so far as to say “cash flow is king”. Both managers and analysts need to understand the various sources and uses of cash that are associated with business activity.

The cash flow statement focuses attention on a firm's ability to generate cash internally, its management of current assets and current liabilities, and the details of its investments and its external financing. It is designed to help both managers and analysts answer important cash-related questions such as these:

- Will the company have enough cash to pay its short-term debts to suppliers and other creditors without additional borrowing?
- Is the company adequately managing its accounts receivable and inventory?
- Has the company made necessary investments in new productive capacity?
- Did the company generate enough cash flow internally to finance necessary investments in new productive capacity?
- Did the company generate enough cash flow internally to finance necessary investments, or did it rely on external financing?
- Is the company changing the makeup of its external financing?

Boston Beer is a particularly good example to illustrate the importance of the cash flow statement for two reasons. First, like all companies in its industry, Boston Beer's inventory purchases and sales vary with the seasons. This seasonal variation has surprising effects on cash flows and net income. Second, an important element of Boston Beer's business strategy is the outsourcing of much of its product manufacturing. The decision to outsource dramatically affects investments in plant and equipment and the need for external financing.

Financial Accounting: A Global Perspective. Short, Libby & Libby. 5th Ed. Note: Replace Boston Beer with SAB.

12.4 Class example

ELSA'S BOUTIQUE

STATEMENT OF FINANCIAL POSITION

AT 31 DECEMBER	**20x9**		**20x8**	
ASSETS				
Non-current assets				
Equipment at bookvalue		35,000		45,000
Current assets		205,000		155,000
Inventory	80,000		60,000	
Debtors	100,000		35,000	
Marketable securities	15,000		20,000	
Cash	10,000		40,000	
		R 240,000		R 200,000
EQUITY AND LIABILITIES				
Capital		195,000		145,000
Balance	145,000		130,000	
Capital introduced	33,000		-	
Net profit	39,500		20,000	
	217,500		150,000	
Drawings	-22,500		-5,000	
Non-current liabilities		-		12,500
Bank loan	-		12,500	
Current liabilities		45,000		42,500
Accrued expenses	8,000		2,500	
Creditors	37,000		40,000	
		R240,000		R 200,000

STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20x9

Sales		400,000
Cost of sales		300,000
Gross profit		100,000
Trade expenses (including R10,000 depreciation)	60,000	
Loss on the sale of investments	500	60,500
NET PROFIT for the year		R 39,500

Elsa is concerned about the liquidity position of her business. Apart from the fact thatthe business generated a net profit of R39,500 for the year and that she introduced an additional amount of R33,000 as capital, the cash position weakened.

She wants to know if she should terminate the business as it is insolvent.

You are required to complete the framework regarding

The statement of cash flow for Elsa's Boutique;

Answers

ELSA'S BOUTIQUE

STATEMENT OF CASH FLOW

FOR THE YEAR ENDED 31 DECEMBER 20x9

CASH GENERATED FROM OPERATIONS				
Cash received from customers		*		
Cash paid to suppliers and employees				*
Cost of sales			*	
Opening inventory			*	
Closing inventory			*	
Creditors - begin			*	
Creditors - end			*	
Operating expenses			*	
Expenses in arrears - begin			*	
Expenses in arrears - end			*	
Cash applied in operations				*
INVESTING ACTIVITIES				*
Proceeds on sale of shares			*	
FINANCING ACTIVITIES				*
Owner	Capital introduced		*	
	Drawings		*	
Bank loan repaid			*	
CASH AND CASH EQUIVALENTS				
Decrease for the year				*
Balance at beginning of year				*
Balance at end of year				*

Individual activity

Practical example (14.5)

Complete the answer sheets on p. 256 - 257 and compare your answer with the suggested answer on p. 458 - 459. If you experience difficulty in completing the assignment, review the chapter again.

Individual activity

Assignment 12.1

Do assignment 1 op p. 258 - 259 (Postma Dealers). The suggested answer will be discussed during the next contact session. If you experience difficulty in completing the assignment, review the chapter again.

Study outcomes

After completion of the Study Section you should be able to

Apply the outcomes set in Chapter 14, paragraph 14.1 of the textbook. It will not be expected of you to compile a cash flow statement in the examination, but it will be expected of you to be able to analyse such a statement with the view to management decision making.

Reflection

Read through the outcomes of the Study Unit. Have you achieved them yet? If not, revise the Study Unit.

Study unit 13

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

Study material

This Study Unit is based on:

Chapter 15. When studying this theme you must always keep in mind that here it is about the eventual goal of Financial Accounting, namely to account for the financial performance and position, but on the other hand to also be the basis for **decision making**. Millions of rand are spent annually by businesses to do this disclosure as well as possible, yet the annual financial statements remain "general goal statements", everything that is necessary for the different users is contained therein, but it requires processing to fulfil these particular information needs of the various users. The techniques in this chapter exchanges guess work by users for methods to fulfil their particular information needs.

Study time

Refer to the work programme for the time allocated to this Study Unit.

Individual activity

Refer to the work programme for the assignments that have to be completed for this Study Unit. The programme indicates the assignment that must be carried out on the particular day. Remember that it will be taken in for evaluation every time.

Study outcomes

After completion of the Study Section you should be able to

- Achieve the outcomes in paragraph 15.1 in the textbook, p. 271 by applying the ratio analysis mentioned there, as well as the further ratios mentioned hereafter. The interpretation of the results and the advice, which follows must, as a golden rule, always rest on the following:
  - always take the natural year of the business being analysed into account;
  - take the economic circumstances and strategy of the business into account; and
  - never form an opinion on one ratio result or one aspect of the analysis, but rather on an overarching overview, because, remember, all elements are related because they are part of one accounting ratio as we learnt in the beginning.

Study material

Study:

1. Textbook: Chapter 15.
2. Analytical process
3. List of financial ratios with formulae – Appendix A

13.1 Users of financial statements

The users of the financial statements of an entity includes inter alia:

- Management
- Owners
- Investors
- Employees
- Lenders of funds
- Creditors and suppliers
- Customers
- Authorities [SARS]
- Public

13.2 Ratio analysis

The textbook discusses the following financial ratios from p. 273. The appendix at the end of the study unit refers to additional ratios of which you should take note.

Current ratio

Current assets to current liabilities

Will the entity be able to pay short-term obligations?

The generally accepted norm is 2:1

Acid test ratio [quick test]

Current assets - inventory to current liabilities

Assets that can easily be converted into cash expressed as a ratio to liabilities which must be paid on the short-term

The accepted norm is 1:1

Gross profit percentage

Gross profit divided by net sales

Compare from year to year and with other similar undertakings

Indication of "mark-up percentage"

Different from business to business and type of undertaking

Net profit percentage

Net profit after interest divided by net sales

Indicates yield to owners

Compare from year to year and other similar undertakings

Different from business to business and type of undertaking

Return on capital

Net profit after interest divided by equity

Measures the profitability of the business. (Should we stay in business?)

Inventory turnover rate

Cost of sales divided by average inventory [indicates the number of times per annum that inventory is sold].

Inventory [unsold merchandise] is always disclosed at cost - therefore COST of sales and NOT sales.

Indication of the rate at which inventory is turned over

It can also be expressed in days [365 / inventory turnover] and in months [12 / inventory turnover].

Debtors collection period

Average debtors divided by CREDIT sales x 12 = number of months

Average debtors divided by credit sales x 365 = number of days.

Use total sales if credit sales are not available.

Indication of the time taken to collect amounts owing by debtors.

Normal credit term is 30 days.

Creditors payment period

Average creditors divided by CREDIT purchases x 12 = number of moths

Average creditors divided by credit purchases x 365 = number of days

Use total purchases if credit purchases are not known

Indication of the time taken to pay the creditors

Normal payment period is 30 days - a discount may be received if paid before due date

13.3 Comparable ratios

Financial ratios are meaningless if not compared to other ratios - previous years, similar undertakings, industry norm.

Reflection

The ratios summarised on p. 279 is very important and you must memorise them.

13.4 An analytical process

1. The Investment Decision	2. Understan-ding Company's Strategy	3. Financial Statements	4. Ratio Percentage Analysis	Interpreting ratios and other analytical considerations

Test of Profitability

1. Return on equity (ROE)
2. Return on Assets (ROA)
3. Financial Leverage Percentage
4. Earnings per Share (EPS)
5. Quality of income
6. Profit Margin
7. Fixed Asset Turnover

7.(b) Labour asset turnover

Test of Liquidity

13. Cash Ratio
14. Current Ratio
15. Quick Ratio (Acid Test)
16. Receivable Turnover
17. Inventory Turnover (b) Cash exhaustion

Test of Solvency

8. Times interest earned ratio
9. Cash coverage ratio
10. Debt-to-equity ratio
11. Price/Earnings ratio
12. Dividend yield

15a. Beaver failure

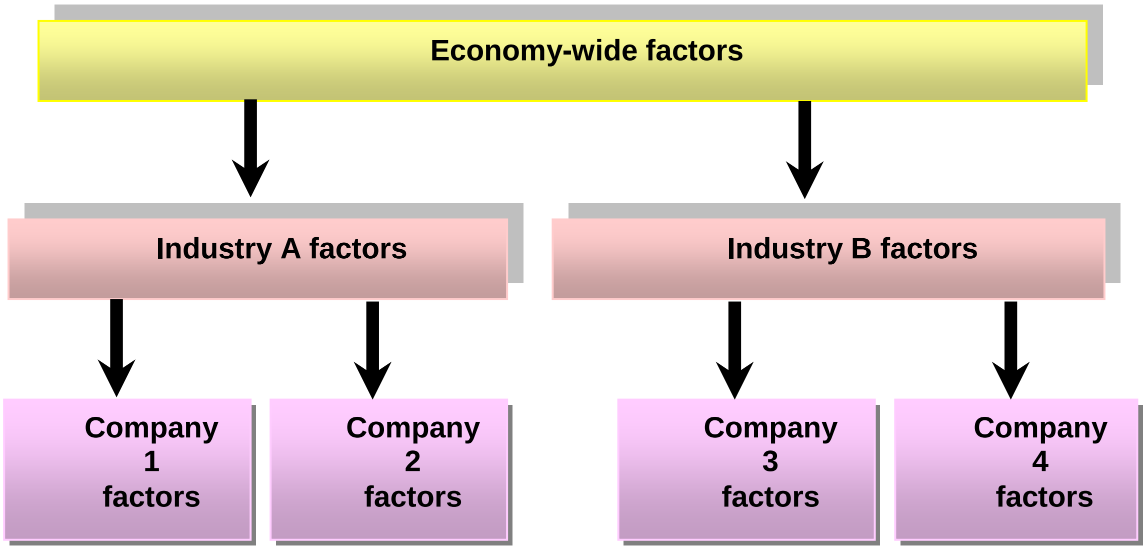
Other financial Information

Information in an efficient market

13.5 The Investment Decision

Of the people who use financial statements, investors are perhaps the single largest group. They often rely on the advice of professional analysts, who develop recommendations on widely held stocks.

In considering an investment in stock, investors should evaluate the company's future income and growth potential on the basis of three factors:



1. **Economy-wide factors.** Often the overall health of the economy has a direct impact on the performance of an individual business. Investors should consider data such as the unemployment rate, general inflation rate, and changes in interest rates.
2. **Industry factors.** Certain events have a major impact on each company within an industry, but only a minor impact on other companies outside the industry.
3. **Individual company factors.** To properly analyse a company, good analysts do not rely only on the information contained in the financial statements. They visit the company, buy its products, and read about it in the business press. If you evaluate McDonald's, it is equally important to assess the quality of its balance sheet and the quality of its Big Mac.

Besides considering these factors, investors should understand a company's business strategy when evaluating its financial statements. Before discussing analytical techniques, we will show you how business strategy affects financial statement analysis.

13.6 Understanding a company's strategy

Financial statement analysis involves more than just "crunching numbers." Before you start looking at numbers, you should know what you are looking for. While financial statements report on transactions, each of those transactions is the result of a company's operating decisions as it implements its business strategy.

Business Strategy → **Operating Decisions** → **Transactions** → **Financial Statements**

The DuPont model helps us understand that a number of business strategies affect the profitability of a business. The model follows:

ROE = **Net Profit Margin** x **Asset Turnover** x **Financial Leverage**

$$\frac{\text{Net income}}{\text{Average Stockholder's Equity}} = \frac{\text{Net income}}{\text{Net Sales}} \times \frac{\text{Net sales}}{\text{Average Total Assets}} \times \frac{\text{Average Total Assets}}{\text{Average Stockholder's Equity}}$$

Businesses can earn a high rate of return by following different strategies. These are two fundamental strategies:

1. **Product differentiation.** Under this strategy, companies offer products with unique benefits, such as high quality or unusual style or features. These unique benefits allow a company to charge higher prices. In general, higher prices yield higher profit margins, which lead to higher returns on equity (as shown in the ROE model).

2. **Cost advantage.** Under this strategy, companies attempt to operate more efficiently than their competitors, which permit them to offer lower prices to attract customers. The efficient use of resources is captured in the asset turnover ratio, and as the ROE model illustrates, higher asset turnover ratio leads to higher return on investment.

You can probably think of a number of companies that have followed one of these two basic strategies. Here are some examples:

Differentiation on Quality

Cars:

* Cadillac
* Mercedes
* Jaguar

Retail Stores:

* Nordstrom
* Tiffany
* Saks
* Woolworths

Differentiation on Cost

Cars:

* Ford Escort
* Dodge Neon
* Kia Rio

Retail Stores:

* Kmart
* Wal-Mart
* Dollar General
* Pep Stores

The best place to start financial analysis is with a solid understanding of a company's business strategy. To evaluate how well a company is doing, you must know what managers are trying to do. You can learn a great deal about a company's business strategy by reading its annual report, especially the letter from the president. It also is useful to read articles about the company in the business press.

13.7 Read Financial Statements

Read the full set of statements including the accompanying notes, auditors report and directors' report. Acquaint yourself also with the contents of any overview of CEO's and time series analysis.

13.8 Ratio and percentage analysis

Apply the ratio analysis and interpret the results, keeping the purpose of the analysis and interpretation in mind, i.e. to satisfy the specific information requirements of the stakeholder involved.

13.9 Write and complete the analysis report

Write and complete the analysis report with your ratio analysis and interpretation. Be aware of any limitations.

"Financial Accounting: A Global Perspective". Short, Libby & Libby. 5^{th} Ed. (713-716:2007). McGraw Hill (amended and shortened).

Individual activity

Class activity

Use the financial statements in the integrated report and do a financial analysis using the ratio's summarised on p. 279 in the textbook.

Class example

Use the same information as in the class example in study unit 12 (Elsa's Boutique).

You are requird to complete the following framework relating to:

1. The statement of cash flow for Elsa's Boutique;
2. The following financial ratios:
   - Current ratio;
   - Acid test (quick ratio);
   - Gross profit %;
   - Net income %;
   - Return on capital;
   - Inventory turnover;
   - Debtor's turnover.
3. A report to Elsa explaining the financial position of the business and comment on her statement that the business is insolvent.

ELSA'S BOTIQUE
CASH FLOW STATEMENT
FOR THE YEAR ENDING 31 DECEMBER 20x9

CASH GENERATED FROM OPERATIONS:		
Cash received from customers		*
Cash paid o suppliers and employees		*
Cost of sales	*	
Opening inventory	*	
Closing inventory	*	
Creditors – begin	*	
Creditors – end	*	
Operating expenses	*	
Expenses in arrears - begin	*	
Expenses in arrears – end	*	
Cash utilised in operating activities		*
INVESTING ACTIVITIES		*
Proceeds on the sale of shares	*	
FINANCING ACTIVITIES		*
Owner: Capital introduced	*	
Drawings	*	
Bank loan repaid	*	
CASH AND CASH EQUIVALENTS		
Decrease during the year		*
Balance at the beginning of the year		*
Balance at the end of the year		*

FINANCIAL RATIOS	**20x9**
1. Current ratio	*
2. Acid test	*
3. Gross profit %	*
4. Nett profit %	*
5. Return on capital	*
6. Inventory turnover	*
7. Debtor's turnover	*

ELSA'S BOUTIQUE

REPORT

Letter head, date, address of Elsa, introduction.

Answer: **1.** **Comments on cash flow (Refer to the cash fow statement)**

* Reasons for cash decrease
*
*
*.

2. **Comments on solvency (Ratios)**

*
*
*
*

3. **Conclusion**

*

Close: Do not hesitate to contact me ....

Signature.

Individual activity

Practical example 1 (15.7) in the textbook p. 280 - 281

Complete the answer sheet on p. 282 and compare your answer with the suggested answer on p. 460. If you experience difficulty in completing the assignment, review the chapter again.

Individual activity

Assignment 13.1

Do assignment 2 on p. 285 - 286 (OZ Dealers). The suggested answer will be discussed during the next contact session. If you experience difficulty in completing the assignment, review the chapter again

Reflection

Read through the outcomes of the Study Unit and write short notes on your experience studying it. (1). How you understood it, (2) how, in your opinion it makes a contribution, which leads to a better understanding of the business and (3) which aspects you think must be kept in mind – possible shortcomings – before you voice an opinion.

If you are unable to do the above without reserve, work through the chapter again.