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Now that Judy has created a system for recording transactions, it is a lot easier to focus on the business. She has learnt how to prepare financial statements, which have been useful in showing the effect of all the decisions made in her business. She is still eager to move to the Waterfront, as this will give her business a lot more exposure to the market and increase her sales. She is now ready to take out the loan from the bank, so that she can start planning the move to the Waterfront. She has collected all of the information that the bank manager asked her to compile.

On Monday morning Judy was waiting at the bank to see the bank manager, Mr Falcon. She was a bit uncomfortable because she was sitting in the waiting room with three huge boxes full of purchase invoices, sales invoices, receipts and returned cheques which she had brought, as she thought Mr Falcon would want to know how her business was doing.

As expected, during the meeting Mr Falcon said, “Judy, please tell me a bit about your business. I will also need you to give me the financial statements I asked you to complete so that I can analyse and review how the business is doing.”

Once Judy had told Mr Falcon about her business and her future plans she said, “I have also brought all the purchase invoices, sales invoices, cheques and receipts for the whole year for you to review! I thought this was the best way of explaining how the business is doing. You can see how well the stall has done by how many sales invoices there are.”

After quite a long pause Mr Falcon replied, “I need to decide if the bank should lend you the money to start your leather goods chain. My decision depends on whether I think your business will make enough cash in the future to repay the loan instalment and the interest charges every month. There are a lot of businesses competing for the funding available and so you need to communicate the information about your business performance to me to help me make this decision. Going through three boxes of slips will not help me get a clear picture of how your business has performed. I need to understand the past trends so that I can try to estimate what future cash flow your business will have.”

Judy, looking embarrassed, answered: “Now that I see what information you need to help you with your decision, I understand that the slips in these boxes are not very useful. Will the financial statements show you all the information you need to make your decision?”
Mr Falcon immediately replied, “Financial statements will show me the information in a way that will help me make the decision efficiently and effectively. Perhaps I should qualify that and say that financial statements prepared using the conceptual framework of generally accepted accounting practice will be a good way to communicate financial information about your business.”

Judy presented the financial statements she had completed at the end of January to Mr Falcon. “I’m not sure if these financial statements have been prepared using the framework you referred to, but here they are anyway.”

Let’s see if we can help Judy understand what it means to prepare these financial statements using the conceptual framework that is the basis of generally accepted accounting practice.

Learning objectives

By the end of this chapter, you will be able to:

- Understand what is meant by generally accepted accounting practice
- Understand the objective of financial reporting
- Know who the primary users of financial statements are
- Understand the going concern concept, which is the basic assumption that underlies the preparation of all financial statements
- Appreciate that all transactions are recorded in the general ledger as one of the five elements: asset or liability, income or expense, and equity
- Know how to apply the definition of elements to different transactions
- Recognise a transaction in the accounting records using the recognition criteria
- Realise that information in financial statements should have certain qualitative characteristics that assist financial statements in achieving their objective
- Understand how qualitative characteristics enhance the usefulness of financial information
- Understand the accrual concept.

Understanding Judy’s problem

Judy is not familiar with the conceptual framework of generally accepted accounting practice. She knows that it is important because Mr Falcon finds that financial statements are most useful when they have been prepared using this framework.

How are we going to help Judy solve her problem?

Let’s see if we can find out more about the conceptual framework and its impact on how we should prepare financial statements.

Let’s look at what we have already learnt in Chapter 3.

So far we have learnt that all transactions are recorded in the general ledger. When we want to see how the business has performed and how profitable the business has been during the year, we prepare a report of all income and expense accounts in the general ledger. This report is referred to as the profit or loss section of the statement of comprehensive income (also known as the extended income statement). When we want to see the financial position of the business, what assets are controlled, liabilities are owed and capital is held by the business on a particular day, we prepare a report of all asset, liability and equity (capital) accounts in the general ledger. This report is called the statement of financial position.
These two reports, the statement of comprehensive income and statement of financial position, are part of the reports included in the annual financial statements.

### 4.1 Generally accepted accounting practice

Many people may need or want to look at financial reports that a business prepares. If reports are used by many different users, there needs to be a general understanding of the basis used to prepare these reports. If every organisation developed their own rules for how to prepare these reports, you would need to understand the rules used by each organisation before you could understand the information presented in their reports.

Financial reports that are prepared for a variety of users (known as general purpose financial reports) need to make sense to all these users. To do this, the first principle is that the reports must achieve “fair presentation”. That means that the reports must accurately convey what the company has achieved. The second principle is that they must be prepared in terms of principles that are widely understood and consistently applied.

To ensure that the financial reports of businesses are prepared in terms of principles that are widely understood, accountants have written a set of principles to follow when preparing financial reports. These principles are called generally accepted accounting practice. **Generally accepted accounting practice (GAAP)** provides the underlying principles applied when preparing financial reports, as well as additional standards that indicate how the principles are applied in specific situations. The “Conceptual Framework for Financial Reporting” is the foundation on which GAAP is based. The Framework sets out the concepts that underlie the preparation and presentation of financial statements in South Africa. This framework has been issued by the International Accounting Standards Board (IASB) and is widely used internationally (well over 100 countries now use the standards issued by the IASB, including the majority of the G20, which is the group of 20 countries with significant economic power).

The Framework explains in a general sense how financial reports should be prepared. If these general principles are properly followed, the resulting financial reports will achieve fair presentation and will be widely understood. As some areas of accounting can be quite complex, additional standards are issued to explain how these general principles apply in more specific situations. These are known as International Financial Reporting Standards, and they have a reference number starting with IAS or IFRS. The principles for each topic are written up in a separate document called a standard. At the time of writing this book, about 40 standards have been issued. These include IAS 2 “Inventories”, which Judy could use for guidance on calculating the closing inventory (also known as stock) on her statement of financial position, and IAS 18 “Revenue”, which would help Judy to understand how to recognise sales.

### 4.2 The objective of financial reporting

According to the “Conceptual Framework for Financial Reporting”, the objective of financial reporting is to provide financial information about the business that is useful to existing and potential investors, lenders and other creditors when they make decision about providing resources to a business. Mr Falcon is an example of a lender who is deciding whether to provide resources (that is, cash in the form of a loan) to Judy’s business. Financial statements report the impact that management decisions have had on a business’s resources, claims on these resources, changes in its resources and claims, and cash flows for the year.

The statement of financial position provides information about a business’s resources
and claims (assets, liabilities, and equity). Changes in the business’s resources and claims can come about because of the business’s performance (shown on the statement of comprehensive income) and/or from other transactions, such as taking out more debt or raising more capital.

Something to do 1

Having thought about the conversation between Judy and Mr. Falcon and read the Framework, can you explain why Mr. Falcon wants Judy to provide him with financial statements?

Check your answer

Mr. Falcon needs to make a decision about whether to lend Judy money. He will lend Judy the money only if he thinks her business will produce enough cash to meet the loan repayments each month and the monthly interest repayments. Mr. Falcon will use the financial statements to help him make this economic decision. He needs the financial statements to be drawn up on a basis that he can understand and which will make it possible for him to compare the results of two different businesses.

The profit calculation on the statement of comprehensive income will show Mr. Falcon information about the performance of Judy's business – the profitability of the business. He will use the current profit to predict what the future cash flow of the business will be. In making his estimation of the future cash flows, Mr. Falcon will take into account any trend shown in the profit figure on the statements of comprehensive income from the past few years. For example, if sales have been increasing each year by 10%, he will use this in his projections and increase the current year's sales value by 10% when estimating the future cash flow.

A business uses assets it owns (and/or controls) to try to make a profit. Judy's profit figure on the statement of comprehensive income will show Mr. Falcon how effectively Judy has used her business assets to produce a profit. He will use this as a basis for predicting how successful Judy may be in the future in using the assets she currently controls to make a profit.

The statement of financial position provides a lot of information that is useful to Mr. Falcon. He will look at the total assets on the statement of financial position when assessing how well Judy has used these assets to make a profit.

The statement of financial position also shows Mr. Falcon the financial structure of the business. “Financial structure” is the term used to describe where the business obtained the funds to buy assets and pay for expenses, usually from the owner him- or herself (called capital), from outside parties in the form of long- and short-term loans (called liabilities), and from the business itself, the profit earned and kept in the business (called accumulated profit or retained profit). The financial structure shows who has funded the business and will help Mr. Falcon to see how the cash made by the business in the future will be distributed among all these parties. For example, if Judy's financial structure showed she had borrowed funds from another bank, Mr. Falcon would have to take into account the cash outflow needed to repay this loan when preparing his estimation of future cash flows.

These are just a few illustrations of how the financial statements are used to help the users to make economic decisions. Economic decisions are based on an estimation of what cash the business will generate in the future and when the business will generate these cash flows. The information provided in the statement of comprehensive income and statement of financial position help to estimate the amount and timing of the future cash flows of the business.
4.2.1 **Who are the users of financial statements?**
Existing and potential investors, lenders, and creditors have been identified as the primary users of financial information provided by an entity. Financial statements are a way of communicating financial information to users who make economic decisions. Financial statements present financial information in a manner that is most useful in helping these people make their respective economic decisions.

4.2.2 **Who else would be interested in the financial statements?**

**Something to do 2**
Can you think of any other people who would want to use the financial statements of a business to make various economic decisions? What financial information do you think these interested parties will need to help them with their decisions?

**Check your answer**

**Customers**
When a customer is dependent on a business for the supply of goods, the customer wants to know whether the business is going to continue to operate in the future. He wants a dependable supplier. Otherwise he has to plan to buy his goods from another supplier.

**South African Revenue Service (SARS)**
In South Africa, a business will pay income tax on the profit it earns for the year. The government agency, SARS, needs to check how the profit for the year was calculated and how the business calculated its income tax liability.

**Employees**
Employees of the business are interested in whether the business is going to continue to operate in the future and be able to pay their salaries. Very often in South Africa, trade unions are interested in the performance and position of a business because they want to determine whether the wages being paid by the business are fair.

4.3 **The going concern assumption**
Financial statements prepared on the basis of generally accepted accounting practice assume that the business is a going concern.

So what does the going concern assumption mean? This means that the business will continue to trade in the foreseeable future at the same or on a larger scale of operations. This assumption is relevant because it impacts on how we measure the elements. We are able to use the normal measurement bases such as historic cost and fair value only if we assume the business will continue to trade in the future. We will look at the measurement of the elements later in this chapter.

If the statements have not been prepared on the **going concern** basis, this fact must be stated in the financial statements, and an explanation of the basis that was used must be included. If the business is no longer a going concern, we have to use a special measurement basis that is a **break-up valuation** of the assets and liabilities.
**Question 4.1 (A)**

A fellow student by the name of Claire is studying music and has just started a small business in tutoring and selling musical instruments, called *Wingzing Ltd*. Most of her pupils pay cash upon completion of each lesson, whereas some have an agreement to pay at a later stage. Claire has prepared a summary of her cash transactions and asks you for assistance in preparing financial statements. You need to tell her that the financial statements should be on an accrual basis.

Included in the payments are monthly instalments for the piano she has purchased on instalment sale. She tells you that, according to the agreement, ownership passes only when the final instalment is paid in the following year.

**You are required to:**

1. Explain the accrual concept of accounting and explain why the statement of financial position, the statement of comprehensive income and the statement of changes in equity are prepared on this basis rather than the cash basis.
2. Give an adjusting journal entry that you are likely to prepare that affects the tutoring income, and explain the reason for the entry.
3. Advise her on the treatment of the piano in the financial statements, giving reasons for your answer.

**Question 4.2 (C)**

**Part A**

Andrew is the owner of a business called *Focus Supplies*, which buys and sells different types of lamps. The business has become extremely profitable and requires an additional warehouse in which to store the lamps.

Andrew’s friend, Nilesh, owns various properties. On 1 January X0 Andrew signed a sale agreement with Nilesh for a warehouse. The sale price of the warehouse is R800 000, payable to Nilesh on 1 April X0.

The transfer of ownership of the warehouse into the name of the business Focus Supplies is completed on 1 February X0, on which date the warehouse is available for occupation by Focus Supplies.

**You are required to:**

1. Prepare the journal entry to record the purchase of the warehouse by Focus Supplies. Your journal entry must clearly show the date that this transaction should be recognised in the general ledger.
2. Briefly justify the element you have chosen to debit in the journal entry above. Use the element definition and recognition criteria in your answer.
3. State whether you think this transaction (the purchase of the warehouse) has affected the financial worth of Andrew’s business. Briefly justify your answer.
Part B
Let’s imagine that on 31 March X0 Nilesh decides that he does not want any payment for the warehouse. He decides to give the warehouse as a gift to Focus Supplies by writing off the R800 000 debt owed to him by the business.

You are required to:
1. State whether you think this transaction (the waiving of the debt of R800 000) affects the financial worth of Andrew’s business. Briefly justify your answer.
2. Prepare any journal entry in the books of Focus Supplies that you think might be required in the light of Nilesh’s decision on 31 March X0.

Question 4.3 (B)
Kayak Cape Town is a business offering kayaking (canoeing) lessons. Their most popular course runs over two months, 1 December to 31 January, as the weather in Camps Bay is perfect. As the course is extremely popular, Kayak Cape Town insists that clients pay for the entire course upfront. The course costs R8 000 per person. Kayak Cape Town has a year-end of 31 December. The maximum number of clients per course is ten people.

The course starting on 1 December X0 was fully subscribed. The owner has asked for some advice while drawing up her financial statements.

You are required to:
1. Advise the owner how the R80 000 received on 1 December should be reflected in the financial statements (statement of financial position and/or statement of comprehensive income) as at 31 December X0. (Ensure that you explain fully all concepts or terms used in your explanation.)
2. Prepare, in general journal format, the entry that would be recorded on 1 December X0.
3. Prepare the adjusting journal entry as at 31 December X0. If you feel that no adjusting entry is required, justify your decision.