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Elsabe Conradie, Amanda Marais and mandy Moyce
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# Module 1 • Financial Accounting

Below is an overview of the work covered in this module.


| UNIT | | |
|---|---|---|
| 1 | The accounting equation, cash journals, General Ledger and Trial Balances | The accounting equation • 3<br>Cash journals • 10<br>Trial Balance • 24 |
| 2 | Debtors, Creditors and Petty Cash Journal | What is a credit transaction? • 30<br>Recording credit sales • 30<br>Payments from debtors • 33<br>Credit purchases from a creditor • 39<br>Payments to a creditor • 43<br>The Petty Cash Journal • 47 |
| 3 | Debtors' and creditors' discount and allowances | Introduction • 54<br>Debtors • 54<br>Discount allowed to debtors • 63<br>Creditors • 67<br>Discount received from a creditor • 73<br>Internal control of debtors and creditors • 83 |
| 4 | Cash journals (new transactions) | Introduction • 86<br>Credit card transactions • 86<br>Discount allowed • 87<br>Discount received • 90<br>Fixed deposits • 96<br>Loans • 99<br>Bank overdraft • 102<br>Interest on overdraft • 103<br>Interest on current account • 103<br>Bank charges • 104<br>Stop orders/debit orders • 105<br>Dishonoured cheques • 105<br>Freight on purchases • 107 |
| 5 | General Journal | Introduction • 113<br>Cancellation of discount • 114<br>Interest on overdue accounts of debtors • 115<br>Interest on overdue accounts of creditors • 117<br>Writing off bad debts • 119<br>Bad debts recovered • 121<br>Withdrawal of goods by the owner • 124<br>Correction of errors • 129 |
| 6 | Comprehensive exercises | Comprehensive exercises of all the work that has been done so far, covering transactions from all the journals.<br>• Cash Receipts Journal<br>• Cash Payments Journal<br>• Debtors Journal<br>• Creditors Journal<br>• Debtors Allowances Journal<br>• Creditors Allowances Journal<br>• General Journal |
| 7 | Final accounts and year-end adjustments | Generally Accepted Accounting Practice • 144<br>Closing transfers and final accounts • 145<br>The accounting cycle • 152<br>Year-end adjustments • 153<br>Closing transfers, final accounts and post-closing Trial Balance • 175<br>Reversal of adjustments • 186 |
| 8 | Final statements of a sole trader | Introduction • 191<br>Revision: Financial statements • 191<br>Financial statements and adjustments • 194<br>Analysis and interpretation of financial statements • 212 |
| 9 | Value-added tax (VAT) | Introduction • 220<br>Basic principles of VAT • 222<br>Calculating VAT • 223<br>VAT inclusive or VAT exclusive • 224 |


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# Unit 1 • The accounting equation, cash journals, General Ledger and Trial Balances

## Revision of Grades 8 and 9 work

This unit deals with the following:

- Assets, liabilities and owners equity
- Cash journals
- Posting to the ledger
- Balancing accounts
- Drawing up Trial Balances
- Basic accounting concepts studied in Grade 8 and 9

## Learning Outcomes and Assessment Standards

This chapter revises the Learning Outcomes and Assessment Standards required for Accounting Grades 8 and 9. Refer to the Learning Programme for Accounting in the National Curriculum Statement if more information is required.

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## 1.1 The accounting equation

The starting point for all accounting is the accounting equation. In accounting language we write this as follows:

**Assets = Owners Equity + Liabilities**

### What is an asset?

An asset is items owned by the business. Assets can be classified into three groups, as follows:

| Assets | | |
|---|---|---|
| **Tangible assets** | **Investments** | **Current assets** |
| Land and buildings<br>Equipment<br>Vehicles<br>Machinery | Fixed deposits<br>Savings account | Trading Inventory<br>Bank<br>Cash float<br>Petty cash |

### What is owners equity?

This is the interest (equity) the owner has in the business. It also includes anything that could increase or decrease the owner's equity.

| Owners Equity | |
|---|---|
| **Drawings** | **Capital contribution** |
| **Expenses/losses (decrease)** | **Income/profit (increase)** |
| Salaries and Wages<br>Water and Electricity<br>Rent Expense<br>Telephone<br>Insurance<br>Stationery<br>Cost of Sales<br>Interest on Loan<br>Packing Material<br>Bank Charges<br>Advertising<br>Tax<br>Repairs<br>Interest on Overdraft | Sales<br>Current Income<br>Rent Income<br>Commission Received<br>Interest on Current Account<br>Interest on Savings Account |

### What is a liability?

This is money owed by the business to other parties, in other words, borrowed money.

| Liabilities | |
|---|---|
| **Long-term liabilities** | **Short-term liabilities** |
| Loan | Overdraft |

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## Activity 1

Copy the table into your workbook and indicate where each item on the list below should go.

| Assets | | Owners Equity | Liabilities |
|---|---|---|---|
| Tangible | Current | | |
| | | | |

1 Delivery bicycle
2 Money in the bank
3 Telephone account
4 Donation received from the local government
5 Photocopy paper
6 Electricity account
7 Sales of T-shirts
8 Paid for repairs to the vehicle
9 Interest paid on the short-term loan from FNB
10 Cleaning material for the office
11 School fees of the owner's son
12 Sorting tables for the factory
13 Farming equipment
14 The office building
15 Cash in petty cash
16 Money received from a hairdresser for services rendered
17 Insurance premium paid to Santam
18 Advertisement in the newspaper
19 Tea and coffee for the office staff
20 Spare parts for the truck

### 1.1.1 Effect on the accounting equation

Each single transaction that takes place in a business has an effect on the accounting equation.

After each transaction this equation should still balance.

***Example***

The owner deposited R10 000 in the bank to start his/her business.

| Assets = | Owners Equity + | Liabilities |
|---|---|---|
| + R10 000 | + R10 000 | 0 |

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## Activity 2

Use the table to indicate the effect of the transactions below on the accounting equation.

*Example:* Bought a delivery bicycle for R2 000, and paid by cheque.

| Assets = | Owners Equity + | Liabilities – |
|---|---|---|
| +R2 000<br>–R2 000 | | |

1. Paid the telephone account by debit card at Pick 'n Pay, R450.
2. Received R3 000 for fish and chips sold at the kiosk on the beach.
3. Paid Eskom by cheque for electricity, R2 350.
4. Bought packing material from Makro and paid by cheque, R400.
5. Bought pens and pencils for the office from Waltons using cash from petty cash, R220.
6. Paid the weekly wages directly into the bank accounts of the workers, R4 000.
7. Bought a new computer for the office and paid by cheque, R8 000.
8. Paid the owner's TV licence by cheque, R280.
9. Cash register roll of cash sales for the day, R5 500.
10. Received R2 200 from the tenants renting the office.

### Double entry principle

It should be clear by now that Assets, Owners Equity or Liabilities will be affected by each transaction. These will either increase or decrease, and the effect is indicated as follows:

| Assets | |
|---|---|
| **Dr** | **Cr** |
| Increases | Decreases |

| Owners Equity | |
|---|---|
| **Dr** | **Cr** |
| Decreases | Increases |

| Liabilities | |
|---|---|
| **Dr** | **Cr** |
| Decreases | Increases |

## Activity 3

Show the effect of each of the transactions below on the accounting equation. In each case provide the amount, effect and reason.

*Example:* Bought a new cash register and paid by cheque, R6 000.

| Assets | | Owners Equity | |
|---|---|---|---|
| **Effect** | **Reason** | **Effect** | **Reason** |
| +R6 000 | Equipment increases | | |
| –R6 000 | Bank decreases | | |

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1. Paid the telephone account by debit card at Pick 'n Pay, R450.
2. Received R3 000 for fish and chips sold at the kiosk on the beach.
3. Paid Eskom by cheque for electricity, R2 350.
4. Bought packing material from Makro, R400, and paid by cheque.
5. Bought pens and pencils for the office at Waltons, and paid cash from petty cash, R220.
6. Paid the weekly wages directly into the bank accounts of the workers, R4 000.
7. Bought a new computer for the office and paid by cheque, R8 000.
8. Paid the owner's TV licence by cheque, R280.
9. Cash register roll showing cash sales for the day, R5 500.
10. Received R2 200 from the tenants renting the office.

## 1.1.2 Cash transactions

### Cash transactions of a service enterprise

Remember that the main source of income for a service enterprise is the service rendered. This is called **current income**.

Examples of service enterprises are plumbers, electricians, hairdressers, garden services, painters, and so on.

### Cash transactions of a trading enterprise

Trade is one word meaning both "buying" and "selling". A trading enterprise buys items at a certain price and sells them at a higher price. The difference between these two amounts is the enterprise's income/profit.

The owner of the business determines in advance what percentage profit he or she wants to earn. The profit made must be enough to cover the cost price of the article as well as all other expenses. After this, there should still be something left to serve as an income. This profit percentage is also called the profit mark-up.

### Cost price, selling price and profit mark-up

A retailer will determine the selling price of an article by adding a profit mark-up to the cost price of the article.

cost price + profit mark-up = selling price

*Example:* A retailer buys an article for R18. He wants to make 10% profit, and thus adds R1,80 (10% of R18). He must therefore sell the article at R19,80.

There are *three* very important calculations that you must be able to do:

1. calculation of the selling price of trading inventory
2. calculation of the cost price (cost of sales) of trading inventory sold
3. the profit mark-up/profit percentage earned on trading inventory sold.

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Let us first look at the following concepts:

### Trading inventory

These are items purchased with the purpose of selling them again. Such items are referred to as goods. Trading inventory is an *asset*. Note that stationery is an expense for most businesses, but will be trading inventory for a stationery store.

### Cost of sales

This is the cost price of trading inventory that has already been sold.

### Calculation of the selling price

When the selling price of trading inventory is calculated, the cost price and profit/profit mark-up must be given.

***Example***

Bought an item for R150. A profit percentage of 20% must be taken into account.
20% of R150 = R30, thus the selling price will be R180.

**Another option**

| | |
|---|---|
| Assume the cost price percentage is: | 100% |
| Profit percentage: | 20% |
| Assume the selling price percentage is: | 120% |

$\frac{\text{cost price}}{1} \times \frac{\text{selling price \%}}{\text{cost price \%}} = \text{selling price}$

$= \frac{150}{1} \times \frac{120}{100} = \text{R}180$

### Calculation of the cost price/cost of sales

When the cost price of trading inventory is calculated, the selling price and profit percentage must be given. The cost price of an article is not indicated on the price tag, but it is important for the enterprise to record it in their books.

***Example***

Sold an article for R240. The profit percentage on this article was 20%.

| | |
|---|---|
| Assume the cost price percentage is: | 100% |
| Profit percentage: | 20% |
| Assume the selling price percentage is: | 120% |

$\frac{\text{selling price}}{1} \times \frac{\text{cost price \%}}{\text{selling price \%}} = \text{cost price}$

$= \frac{240}{1} \times \frac{100}{120} = \text{R}200$

### Calculation of the profit percentage

When the profit percentage on trading inventory is calculated, the selling price and the cost price of the article must be given.

***Example***

An article that originally cost R200, was sold for R300.
The amount of profit is R300 – R200 = R100

$\frac{\text{profit}}{\text{cost price}} \times \frac{100}{1} = \text{profit percentage}$

$= \frac{100}{200} \times \frac{100}{1} = 50\%$

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## Activity 4

Calculate the cost of sales (cost price) or the selling price (sales) in each of the cases below.

| No. | Selling price | Profit % | Calculation | Cost price |
|---|---|---|---|---|
| **Example 1** | 280 | 40% | $280 \times \frac{100}{140}$ (to find cost price) | 200 |
| **Example 2** | 1 350 | 50% | $900 \times \frac{150}{100}$ (to find selling price) | 900 |
| 1 | 750 | 50% | | |
| 2 | 240 | 20% | | |
| 3 | | 25% | | 200 |
| 4 | 390 | 30% | | |
| 5 | 728 | 40% | | |
| 6 | | 100% | | 150 |
| 7 | | 200% | | 390 |
| 8 | 160 | $33\frac{1}{3}\%$ | | |
| 9 | | $66\frac{2}{3}\%$ | | 360 |

### 1.1.3 Purchasing trading inventory and the effect on the accounting equation in the General Ledger

Since trading inventory is an asset to the business, you are in effect exchanging one asset for another, namely Bank (cash) for another asset, namely Trading Inventory.

***Example***

Issued a cheque for the purchase of merchandise to the value of R1 500.

| | Assets | Owners Equity |
|---|---|---|
| –1 500 | Cash decreases | No effect |
| +1 500 | Trading Inventory increases | |

Remember that assets must still equal Owners Equity.

In the General Ledger the principle of the double entry must always be followed.

The *two* accounts affected by the purchase of merchandise are Bank and Trading Inventory.

Bank is an **asset** that decreases and is thus **credited**.
Trading Inventory is an **asset** that increases and is thus **debited**.

***Example***

Issued a cheque for the purchase of merchandise to the value of R1 500.

| Account debited | Account credited |
|---|---|
| Trading Inventory | Bank |

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## Activity 5

Show the effect of each of the two transactions below on Assets and/or Owners Equity. In each case, give the amount, effect and reason. Also show the account(s) in the General Ledger to be debited and credited.

**Transactions**

1 Bought merchandise to the value of R2 400 and issued a cheque.
2 Received goods for R1 450 and issued a cheque.

| | Assets | | Owners Equity | |
|---|---|---|---|---|
| No. | Effect | Reason | Effect | Reason |
| 1 | | | | |
| 2 | | | | |

| | General Ledger | |
|---|---|---|
| No. | Account debited | Account credited |
| 1 | | |
| 2 | | |

### 1.1.4 The sale of merchandise and the effect on the accounting equation in the General Ledger

When trading inventory is sold, there are always *two* amounts involved: One is the **cost price** of the items, and the other is the **selling price** of the items.

Do you remember that the difference between these two is the profit that the owner makes in the business?

When we want to show the effect of this transaction on the accounting equation, it is important to remember the following:

- Firstly, the goods on the shelves/in the storeroom decrease when someone buys them, and for this we use the **cost price**.
- Secondly, the money in the cash register increases when someone pays for the goods, and for this we use the **selling price**.
- Thirdly, we want to determine the profit made on this transaction, and for this we do a calculation. The profit belongs to the owner.

***Example***

Sold goods for R550 cash. The cost price of the goods was R380.

| | Assets | Owners Equity | |
|---|---|---|---|
| –380 | Trading Inventory decreases | +170 | Profit earned |
| +550 | Cash increases | | |

Remember that Assets must still equal Owners Equity.

In the General Ledger, always follow the **principle of the double entry**.

Remember that there are two amounts (cost price and selling price) and for each of these two amounts there will be two accounts in the General Ledger. In the General Ledger we do not record the profit of the transactions.

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The two accounts affected by the cost price are Trading Inventory and Cost of Sales.

Trading Inventory is an **asset** that decreases and must therefore be **credited**.
Cost of Sales decreases Owners Equity and must therefore be **debited**.

The two accounts affected by the selling price are Bank and Sales.
Bank is an **asset** that increases and must therefore be **debited**.
Sales increases Owners Equity and must therefore be **credited**.

***Example***

Sold goods for R550 cash. The cost price of the goods was R380.

| **Account debited** | **Account credited** |
|---|---|
| Cost of Sales | Trading Inventory |
| Bank | Sales |

## Activity 6

Show the effect of each of the two transactions below on the Assets and/or Owners Equity. In each case give the amount, effect and reason. Also show the account(s) in the General Ledger to be debited and credited.

**Transactions**

1 Sold trading inventory for R230 cash (cost price R100).
2 Issued a cash register slip for the sale of goods to the value of R368.

The business maintains a profit margin of 60% on cost price.

| | **Assets** | | **Owners Equity** | |
|---|---|---|---|---|
| No. | Effect | Reason | Effect | Reason |
| 1 | | | | |
| 2 | | | | |

| | **General Ledger** | |
|---|---|---|
| No. | Account debited | Account credited |
| 1 | | |
| 2 | | |

## 1.2 Cash journals

The books the business uses to record its transactions are called journals. First we will consider cash transactions – referred to as cash journals. A cash journal is therefore a “diary” of all the cash transactions of the enterprise.

There are *two* kinds of cash transactions:

- cash received
- cash paid

Therefore we make use of a Cash Receipts Journal (CRJ) and a Cash Payments Journal (CPJ).

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