Name

1 Accounting policy

In our everyday life we often come across circumstances that are repetitive in nature (always the same) but may in each instance have different results if we were to act differently. If we do not have guidelines to indicate how we should act, our actions may be inconsistent.

If we have guidelines as to how we should act in certain circumstances, we are determining a policy which will result in consistent actions.

The same applies to accounting. We often find repetitive transactions and consistency require that a business should determine an accounting policy according to which they can manage such transactions. Thus, accounting policy is a set of decisions about the way in which a business will manage the same types of transactions in order to achieve consistent results.

1.1 Publicising the accounting policy

As the accounting policy represents a business's decisions on factors that could be managed in different ways, it is necessary that the business publicises the accounting policy it will use in its Financial Statements. A business should for example, indicate how depreciation of Vehicles and Equipment will be calculated.

1.2 Generally accepted accounting practice (GAAP)

If each person were to develop his or her own language or grammar rules, it would cause communication chaos. For this reason we have generally applicable grammar rules.

Accounting, as a special system of communication, has exactly the same problem. If each business were to present Financial Statements according to its own theory and principles, chaos would erupt in the economic and business world.

For this reason a basis has been developed for measuring and presenting the results of financial events (transactions).

This basis is a general framework and includes accounting concepts, principles, methods and actions known as **Generally Accepted Accounting Practice (GAAP)**. From now on we are going to use the abbreviation GAAP.

In RSA the Accounting Standards Board plays an important role in the development of GAAP by setting certain accounting standards. By setting these standards for certain events (e.g. presenting tax in the Financial Statements), the objective is to limit the variety of available accounting practices without striving towards strict uniformity or a set of rigid rules. The objective of accounting standards is to promote general application of certain issues in Financial Statements and to eliminate unacceptable alternatives.

After being approved by the Accounting Standards Board the standards are published in a series of publications, called accounting standards. After 1994 we became part of the **International Financial Reporting Standards (IFRS)**. A business will use the IFRS to prepare their Financial Statements. It is important to note that that GAAP/Accounting Standards change constantly in order to keep up with changes in the business world.

These statements are issued by the **South African Institute of Chartered Accountants (SAICA)**. SAICA is a professional body that is responsible for training and developing the accounting profession.

The following factors affect the way in which the Financial Statements are presented. You must ensure that you understand these concepts clearly as they will assist you when you have to draw up the Financial Statements of a sole trader.

2 GAAP Principles

2.1 Historical cost

The concept historical a cost means that assets purchased by a business must be recorded in the books at cost price (purchased price).

Example:
If we bought Land and buildings three years ago at a total cost of R500 000 and entered it into the books at that price and the asset is re-valued today at R650 000, the amount that will be entered in the Financial Statements will still be R500 000 (the price that we originally bought it for).

2.2 Prudence

This is also known as the principle of conservatism. When the accountant is uncertain about the value of an element or event (assets/liabilities/income/expenses), the prudence principle must be applied. This means that the accountant who prepares the Financial Statements should be conservative in their approach to these uncertainties. The value that has the least influence on the equity of the business must be used.

Example:
If a debtor is in financial difficulty, the accountant may write his account off even though the business will continue to do everything possible to receive the money the debtor owes them.

2.3 Materiality

The materiality principle demands that all important (large) transactions and events should be indicated separately in the Financial Statements, as these may influence decision-making. Unimportant amounts need not to be indicated separately, but should be added to other amounts of similar nature or functions.

Here is also another part that is important. The accountant will be conscious of whether an adjustment entry will be important (material) to the financial results of a business. An adjusting entry might be omitted if the amount is regarded as insignificant.
Example:
All interest expense items should be shown separate in the Financial Statements as this will be important (material) to a decision on how to raise additional funds.

2.4 Business entity rule

The objective of accounting is to present information about the financial situation of a specific business or individual. Such a business or individual is known as an entity. The concept entity refers to a unit that exists independently and can be clearly defined.

The financial affairs of the business must be kept separately from the financial affairs of the owners. The business must have a separate bank account and in the Financial Statements of the business no transactions of the personal affairs of the owner will be showed.

Example:
If the owner inherited R500 000 from his/her grandfather, the money will be deposited in the owner's personal bank account and not in the business's bank account.

2.5 Going concern

The concept going-concern means that an entity (business) will continue to exist for a certain period and that the Financial Statements of a business are prepared as though the business will continue to exist for some time.

Example:
Stock, fixed deposit and land and buildings are not valued on the basis of the amount that would be received for them if they were sold immediately.

2.6 Matching

All transactions or events that take place during a certain financial period must be recorded in the books during that financial period – irrespectively of when the cash is received or paid. Income and expenses incurred in order to receive such income, need to be brought into account during the same period. This implies that expenses incurred in order to create income, must be 'matched' to that income during the present financial period.

Example:
If a building is rent from somebody and we only paid R55 000 (R5 000 per month) for 11 months, the R5 000 will be match with the R55 000 because it is part of this financial year. The amount recorded in the Financial Statements will be R60 000.

Important:

- These GAAP principles will be integrated with all the topics and will continuously be assessed as we advance with the Study Guide.
- Make sure you understand all the GAAP principles because they form the base of all accounting activities.

Activity 1 (Accounting principles – Matching columns)

Choose a word or term from column B that best suits the definition in column A. A word or term may be chosen more than once.

	Column A		Column B
1	All transactions or events that take place during a certain financial period must be recorded in the books during that financial period – irrespectively of when the cash is received or paid.	A	Going concern
2	An entity (business) will continue to exist for a certain period and that the Financial Statements of a business are prepared as though the business will continue to exist for some time.	B	Historic cost
3	Assets purchased by a business must be recorded in the books at cost price (purchased price).	C	Business entity rule
4	The accountant preparing the Financial Statements should be conservative in their approach to uncertainties by using the value that has the least influence on the equity of the business.	D	Matching principle
5	The financial affairs of the business must be kept separately from the financial affairs of the owners.	E	Prudence principle
6	All important (large) transactions and events should be indicated separately in the Financial Statements, as these may influence decision-making.	F	Principle of materiality
7	Bad Debts written off is an example of this principle.		
8	Interest expense has to appear separate to a Bank overdraft account in the Financial Statements.		
9	Vehicles recorded at cost price.		
10	The owner of the business cannot list his Mercedes for personal use as a business asset.		