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Support Pack | Grade 12

CAPS

Accounting

Theory of Accounting

This revision pack for **Accounting Grade 12** provides support for learners revising the most important concepts and principles covered in the CAPS curriculum. These include concepts relating to companies, the acquisition of Fixed assets, inventories, VAT, Manufacturing and cost accounts, and budgeting. Summaries of the GAAP principles, theory of Accounting, and the format of Debtors and Creditors control accounts are provided. Furthermore, a detailed table to summarise the interpretation of Financial Statements is provided.

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Revision 11
Theory of Accounting

1. Ethics

- **The role of professional bodies**
  Professional bodies are organisations whose members are individual professionals such as accountants, lawyers, doctors, etc. The primary role of a professional body is to provide:
  - **Quality assurance:** By setting appropriate qualification standards, to ensure that their members are suitably qualified and highly skilled
  - **On-going support and training:** To ensure that their members remain up to date with the latest developments in their profession
  - **Regulation of professional and ethical conduct:** To ensure that their members adhere to the standards of professional and ethical conduct required by their profession.
- **Professional bodies for the accounting profession in South Africa**

Professional body	Abbreviation	Professional title	Designation
South African Institute of Chartered Accountants	SAICA	Chartered Accountant	CA(SA)
South African Institute of Professional Accountants	SAIPA	Professional Accountant	Professional Accountant (SA)
Independent Regulatory Board for Auditors	IRBA	Registered Auditor	RA
Institute of Internal Auditors South Africa	IIA SA	Internal Auditor	CIA
Chartered Institute of Management Accountants	CIMA	Management Accountant	ACMA

- **King Code III – policies governing ethical behaviour in the corporate environment**
  Key principles and policies of the King Code III:
  - **Ethical leadership:** The board (of directors) should provide effective, responsible and ethical leadership.
  - **Ethical corporate culture:** The board should ensure that an ethical culture exists throughout the company.
  - **Sustainability:** The board should integrate economic, environmental and social considerations into their decision making to ensure that the company operates in a sustainable manner.
  - **Corporate citizenship:** The board should ensure that the company is and is seen to be a responsible corporate citizen, with a social and moral responsibility towards society.
  - **Integrated reporting:** The board should ensure that an integrated report, disclosing the company's social, environmental and economic performance, is prepared annually.
  - **Risk governance:** The board should ensure that risks are governed, managed and controlled effectively.
  - **Directors' performance evaluation and remuneration:** This should be evaluated annually and the directors should be remunerated fairly and responsibly.

- **The Companies Act – legislation governing companies**
  The Companies Act (71 of 2008) contains the laws that companies in South Africa are required to comply with and includes laws relating to the formation, financing, governance and financial reporting requirements of companies.

  Key aspects of the Companies Act relating to directors:
  - **Standards of director's conduct:** A director of a company must act in good faith, in the best interest of the company, and with the degree of care, skill and diligence that may reasonably be expected of a director.
  - **Conflict of interest:** If a director has a personal financial interest in a matter relating the company, the director must disclose the interest as well as any material information relating to the matter, and must not take part in the consideration of the matter.
  - **Liability of directors:** A director may be held personally liable for any loss, damage or costs sustained by the company as a result of a breach of the director's duty to act in the best interest of the company and with care, skill and diligence.
  - **Directors' remuneration:** A company may pay remuneration to its directors, provided that such remuneration is approved by the shareholders within the preceding two-year period. If the annual financial statements are required to be audited, they must contain detailed information about any remuneration received by each director of the company.

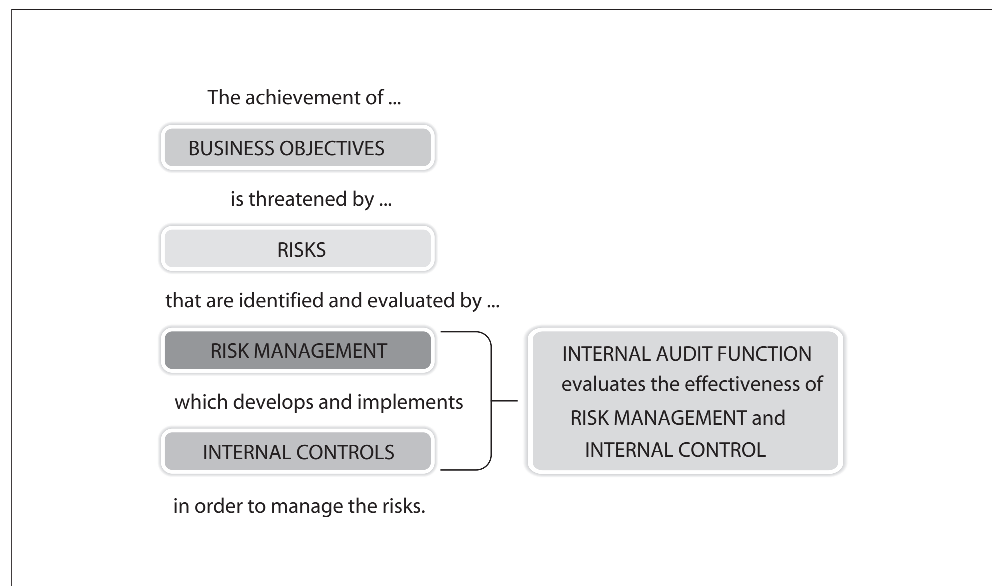
  Other important provisions of the Companies Act:
  - **Business rescue:** This is the process of attempting to rescue a potentially viable company that is experiencing financial difficulties, by placing it under temporary supervision and thereby preventing it from going into liquidation.
  - **Dispute resolution:** There are several procedures that may be used to resolve disputes involving companies. This includes **alternative dispute resolution** (ADR), which is a method of resolving disputes with the assistance of a third party, rather than by conventional legal action through the courts. Two ADR methods that are commonly used are known as mediation and arbitration.
  - **Social and ethics committee:** All public companies and state-owned companies must appoint a social and ethics committee. This committee is required to monitor the company's activities relating to, amongst others, social and economic development; good corporate citizenship; the environment; consumer relationships and certain employment-related matters.
  - **Transparency and accountability:** Companies are required to operate and report in a transparent manner and to be accountable for their actions and decisions.

2. Internal control and auditing

- **The relationship between risk, risk management, internal control and internal auditing**

  - **Risks:** Uncertain future events that may have a negative impact on business operations and thus a detrimental effect on the business achieving its objectives
  - **Risk management:** The process of identifying, assessing and managing risk
  - **Internal control:** The systems, processes and measures implemented by management to protect the business against risk and thus help to ensure that the business objectives are met
  - **Internal auditing:** An independent internal assessment of the effectiveness of the risk management and internal control of a business, in order to ensure that the business is managing risk effectively.

  The relationship between the risk, risk management, internal control and internal auditing may be summarised as follows:



- **Audit evidence**
  Audit evidence is the information that internal auditors gather during the course of an audit, and use to draw conclusions and to support their opinions and recommendations.

- **Compliance and substantive tests**
  The types of tests that are performed by internal auditors to obtain audit evidence may be broadly classified as compliance tests (tests of control) and substantive tests (tests of detail).

  - **Compliance tests:** The review of internal control processes to determine whether the controls are working as intended and are being adhered to and applied correctly
  - **Substantive tests:** Testing, checking and verifying the detail and accuracy of financial and operating information

- **Audit procedures**
  Audit procedures are various methods and techniques that internal auditors use to gather audit evidence and perform compliance and substantive tests.

  Some of the more commonly used methods of gathering audit evidence include:

  - **Inspection:** The physical examination of documents, records, reconciliations and assets in order to ascertain whether the internal control procedures are being carried out correctly and are operating efficiently
  - **Observation:** When internal auditors observe employees carrying out specific processes to determine whether the internal control procedures are being complied with and to assess the effectiveness of the controls
  - **Inquiry:** When internal auditors ask questions to obtain information from people both inside and outside the business. Although inquiry is generally considered to provide weak evidence, it is often a useful means of acquiring supporting evidence or of identifying deficiencies in the internal control systems.
  - **Re-performance or computation:** Re-performing tasks that have already been performed to test for accuracy, correctness and completeness
  - **Confirmation or corroboration:** Verifying internal information by obtaining confirmation or corroborative evidence from an independent source
  - **Analytical review:** Examining financial and operating information by performing ratio analysis, trend analysis and comparisons with budgets and information from previous financial periods. The aim of this analysis is to identify any unusual items or unexpected fluctuations that require further investigation.
  - **Reconciliation:** Comparing two sets of figures that are based on similar information and then accounting for the differences by balancing the one set of figures back to the other. Where there are differences that cannot be simply accounted for, internal auditors will conduct further investigations.

- **Audit sampling**
  Audit sampling is a process whereby internal auditors select and test a sample of items from a large group of items and then use those test results to draw conclusions and express an opinion about the entire group.

  Two fundamental approaches to audit sampling:

  - **Statistical sampling:** An objective scientific approach that uses mathematics as a basis for selecting an audit sample that can be expected to be representative of the entire population
  - **Non-statistical sampling:** (or judgemental sampling) A subjective approach that is not mathematically or statistically based, in which internal auditors determine sample sizes and select audit samples based on their judgement or at random. A sample selected using this approach is not intended to be representative of the population.

- **Internal audit reports**
  Internal audit reports are used by internal auditors to present the audit findings, express their opinions and provide recommendations for improvement. They are usually addressed to senior management, the audit committee or the board of directors.

  Interim reports are reports that are made during the course of the audit. These reports may either be provided in writing or performed orally, and are normally used to:
  – **inform** management of a significant finding that requires immediate attention (for example, a serious control weakness or a suspicion of fraud)
  – **update** management on the progress of a lengthy audit
  – **notify** management of a significant change in the scope of the audit.

- **Management of internal audit resources**
  The chief audit executive (CAE) is responsible for ensuring that internal audit resources are effectively managed. The CAE must ensure that internal audit resources are:
  – **Appropriate:** The internal auditors must be suitably skilled.
  – **Sufficient:** There must be an adequate number of internal auditors.
  – **Effectively deployed:** The internal auditors must be assigned to activities that best suit their skills.

- **Differences between the roles of internal and external auditors**

Criteria	Internal auditing	External auditing
Objective	To evaluate the company's risk management and control systems; and provide assurance and recommendations for improvement	To assess the company's financial records and provide an independent opinion on the accuracy of the financial statements
Employee / contractor	Internal auditors are usually employees of the company.	External auditors are independent contractors.
Serves	Serves the needs of the company and its management or board	Serves the interests of shareholders and other external stakeholders
Scope of work	Covers all aspects and operations of the company	Focuses primarily on financial aspects of the company
Independence	Independent from the activities audited	Independent from the company
Fraud	Concerned with all forms of fraud relating to any activity	Mostly concerned with financial fraud
Frequency of audit	Performed continuously throughout the year	Performed periodically, usually once a year
Legal requirement	Generally not a legal requirement in South Africa	Legal requirement for all public companies and many other businesses

3. External auditing

- **Independent auditor (external auditor)**
  All public companies are required to appoint a registered independent external auditor. The independent auditor provides an objective opinion on the accuracy and reliability of financial statements of the company.

- **Independent auditor's report**
  This is a formal report drawn up by the independent auditors, in which they express their opinion on the accuracy and reliability of financial statements of the company being audited.

  Independent auditor's reports may be divided into the following three categories:
  - **An unqualified audit report** (or clean report) is issued when the external auditor finds the financial statements to be free from discrepancies and that they give a true and fair view of the financial reporting framework used in preparing and presenting the financial statements. It will contain the following comment:

  In our opinion, the financial statements fairly present, in all material respects, the financial position of the company at 28 February 20… and the results of their operations and cash flows for the year then ended in accordance with International Financial Reporting standards (IFRS) and in the manner required by the Companies Act in South Africa.

  - **A qualified audit report** is issued when the external auditor encounters one or two situations that do not comply with the prescribed accounting standards (IFRS/ GAAP). However, the rest of the financial statements are fairly presented. It will contain the following comment:

  In our opinion, the financial statements fairly present the financial position of the company at 28 February 20…, except for the effects of ………………

  - **An adverse audit report** is issued when the external auditor determines that the financial statements of the company being audited are materially misleading and when considered as a whole do not conform to the prescribed accounting standards (IFRS/GAAP). It will contain the following comment:

  In our opinion, because of the significance of ………..., the financial statements DO NOT fairly present, in all material respects.......

4. Comparison of a company and a close corporation

Characteristic	Company	Close corporation
Registered legal entity?	Yes	Yes
Owners	Shareholders	Members
Liability of owners	Limited	Limited
Continuity of ownership?	Yes	Yes
Number of owners	Private: 1 or more Public: 7 or more	1 to 10
Founded by completing a:	Memorandum of Incorporation	Founding Statement
Ownership represented by:	Shares	Members' interest
Owners' investment is called:	Share capital	Members' contributions
Owners earn profits according to:	Number of shares owned	% member's interest
Owners' share of profits is called:	Dividends	Distribution to members
Business taxed on net profit:	Before dividends	Before distributions to members
Required to hold an AGM?	Yes	No
Managed by:	Directors	Members
Required to appoint an:	External auditor	Accounting Officer
Audit of Annual Financial Statements:	Required	Not required