Name

1 Definition and explanation of accounting concepts

1.1 Forms of ownership

When an individual decides to open a business, he/she has to consider the capital available and the capital needed to choose the form of ownership of the business. Other factors such as the control over the business as well as liability of the owner and continuity of the business also need to be considered. Some forms of ownership include:

- Sole proprietor (trader) – this is a one man business which means that the owner has full control over the business. One person cannot contribute a lot of capital on their own. The profit made goes to the owner.
- Partnership – 2 to 20 partners can start a partnership which means that all partners who are involved have a say in the business. The business can have more capital because more partners can put their money together to start a partnership. Profit is shared amongst the partners.
- Companies – People who are the owners of a company buy a part of the company. This is commonly known as buying shares. Many shareholders make up the owners of a company. A company can therefore have a lot more capital because so many people can contribute. Profit is known as dividends and shared amongst the shareholders.

In grade 10 we are going to concentrate on a sole proprietor. One person brings in all the money and share all the profits or losses.

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A person who wants to start a sole proprietor has to choose between a business that renders a service or a business that sells goods. It all depends on what the main source of income is. In a service business, the main source of income is fee income or commission income (for example, doctors, plumbers, garden services, etc.)

A retailing business buys finished products (products that are manufactured and ready to be sold), adds a profit and sells it to make a profit (for example, a grocery store, clothing business, etc.)

1.2 Accounting concepts

In 3, we stipulated that accounting has certain rules to follow. In accounting there are three broad concepts, assets, owners' equity and liabilities. Before we discuss these concepts, you have to have clarity on the concepts accounting period, current financial year, short-term and long-term.

The **accounting (financial) period** is a period of twelve months. The period does not have to coincide with a calendar year, but it may. An accounting period can be from the 1 July one year and ends on the 30June the following year. The government financial year starts on the 1 March and ends on 28 February. A lot of businesses use this period for tax purposes.

To explain the concepts **current financial year, short-term** and **long-term**, we use the following example. Suppose that the accounting period of a business is from 1 January 2011 to 31 December 2011.

- The current financial year = 1 January 2011 to 31 December 2011.
- Short-term = 1 January 2012 to 31 December 2012. (within a financial year of 12 months)
- Long-term = 1 January 2013 onwards. (longer than a financial year of 12 months)

The concepts Assets, Liabilities and Owners' equity:

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1.2.1 Assets

Assets are the possessions of a business. There are two types of assets:
Non-current assets = long term
Current assets = short term

Non-current assets

Non-current assets consist of **fixed assets/tangible assets** and **financial assets**.

Fixed assets/Tangible assets

Fixed assets are possessions purchased by the business with the aim of using them for longer than a year. These assets are permanent in nature and are not purchased for the purpose of resale. They are also used in the process of generating an income for the business.

- Land and buildings – factory, store room, house, house, shop, etc.
- Vehicles – motor cycle, motor vehicle, delivery vehicles, etc.
- Equipment – furniture, cash register, computer, shelves, etc.

Important:

Fixed assets are always entered in the books at cost price (purchased price). This is an important **accounting principle**. If the business purchased Land and Buildings on 1 March 2008 for R500 000 and the Land and Buildings are re-valued on 1 March 2011 at R650 000, the original (historical) amount of R500 000 will still be entered in the books. Installation costs are part of the cost price. Example: If a business purchased computers for R32 000 and there are installation costs of R5 000 involved, the amount entered in the Equipment account will be R37 000 (R32 000 + R5 000).

Financial assets

If the business is doing well and there are cash to spare, this money can be invested for a certain period at a fixed interest rate. This asset is called a fixed deposit or an investment. The original amount invested at a financial institution will be the financial asset and the interest earned on the fixed deposit will be an income for the business.

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Current assets

Current assets are assets that can be converted to cash within one year. These assets are short-term assets and are temporary in nature.

- Trading stock – goods or merchandise acquired at a specific price and sold at a specific price after profits have been added. **Trading stock is always entered in the business books at cost price.**
- Debtors – when the business sells goods on credit, the debtors are the people who owe money to the business.
- Bank – the money in the business's bank account referred to as a favourable/debit bank balance.
- Cash float – this is cash, in small denominations, kept in the cash register and used to give change to the customers.
- Petty cash – cash used to make small payments.

1.2.2 Liabilities

Money owed to an enterprise or a financial institution. There are two types of liabilities:

- Non-current liabilities = long term
- Current liabilities = short term

Non-current liabilities

Should the business need money to buy, for example, a vehicle, it may borrow the money from a financial institution. It usually takes longer than a year to repay this liability and it would be repaid at a certain interest rate per year. A loan is an example of a long-term liability. Interest is payable on a loan. The original loan amount is a liability and the interest on paid on the loan, is an expense.

Current liabilities

These liabilities are usually paid for within one year. The following are examples of current liabilities:

- Creditors – if the business purchases trading stock on credit, the supplier to which the money is owed is called a creditor.
- Bank overdraft – should the business experience a cash flow problem, an overdraft facility is negotiated with the bank. In this instance, the bank is a liability to the business.

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1.2.3 Owner's Equity

Money/capital invested in the business by the owner. This is the owner's interest in the business. The owner can increase his capital contribution by depositing cash in the business, fixed assets or trading stock. Money, fixed assets or trading stock withdrawn by the owner during the year is called drawings. Drawings decrease the owner's equity.

The aim of the business is to make a profit. In order to make a profit, the business must do business or deliver a service in order to generate a certain income. In order to gain this income, the business should incur certain expenses. The income and expenses will have an influence on the owner's equity in the business.

Important:

An important accounting principle is applicable here, namely the **business entity** principle. The owner and the business are two separate entities. Thus, the bookkeeping of the business and that of the owner should be kept strictly separate.

Example:

The owner wants to take out insurance for his wife's vehicle. He is not allowed to pay this out of the business funds; he has to pay it out of his personal funds.

Operating expenses

One needs money in order to run a business. Employees should be remunerated. Necessary services also need to be paid for, e.g. water and electricity and telephone bills. If the business does not own a building, a building needs to be rented.
Operating expenses consists of:

- Payments for services delivered to the business, such as rent, wages and salaries.
- Consumables used in the business, such as stationery, packing material and fuel.
- Cost of sales – the cost price of goods sold is an expense and decreases the profits and eventually the equity.

Operating expenses have an influence on the profit of the business. Operating expenses decreases owner's equity.

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Income

There are two ways in which a business can gain income:

- Current income – by delivering a service, e.g. plumbers, doctors, etc.
- Sales – a trader delivers a service by purchasing goods and selling the same goods at a profit, e.g. a grocery store.

The two ways in which a business can gain an income, will be the main source of income. There can be other ways that a business can gain income. An example is that the business can rent out part of the building to a third party. The income gained will be an operating income.

The takings received from the income influences the business's profits. Income increases profits, resulting in an increase of owner's equity.

Important:

In the discussion about income and expenses we talked about operating income and operating expenses. What does the word **operating** mean? "Operating" refers to the daily transactions that happen in the business.

Example: Expense

The water and electricity used in the business is a daily expense and therefore an operating expense. But, if the business took out a loan and the interest paid on the loan is not a daily expense, this expense is not part of the operating expense of the business. This will be discussed in depth when we do the Financial statements.

Example: Income

If a business renders a service, the income received is a daily income and will be an operating income. But, if the business invests money on a fixed deposit, the interest received from the fixed deposit is not part of the daily activities of a business and interest on fixed deposit is therefore not an operating income. This will be discussed in depth when we do the Financial statements.

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Activity 1		
Complete the following table. Indicate whether the concept is an income, expense, fixed asset, financial asset, current asset, non-current liability or current liability.		
Nr	Concepts	Answer
1	Vehicles	
2	Capital	
3	Cost of sales	
4	Packing material	
5	Bank overdraft	
6	Fixed deposit	
7	Drawings	
8	Equipment	
9	Stationery	
10	Loan	
11	Favourable bank balance	
12	Sales	
13	Land and buildings	
14	Cash float	
15	Debtors' control	
16	Trading stock	
17	Interest on fixed deposit	
18	Creditors' control	
19	Interest on loan	
20	Services rendered	

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