Topic 1

Basic accounting concepts

After studying this chapter, you should be able to:

- define accounting,
- explain the purpose of accounting,
- explain and apply the different accounting concepts,
- name the elements that will affect the financial position, and
- name the elements that will measure the financial result.

1.1 What is accounting

Accounting can be defined as:

- The process of collecting and processing financial data,
- the orderly and systematic recording of financial transactions,
- the reporting of the financial results and financial position in the financial statements,
- the provision of financial information as a basis for decision making.

The nature of accounting:

Accounting reduces the risks and uncertainties that investors and lenders must deal with because accounting provides relevant and reliable information about transactions.

Data is selected that has an economic impact on the entity, for example the purchase or sales of goods and services, etc. The data is processed through the accounting process.

Bookkeeping is used to record transactions into the book of original entry (subsidiary journals) from where it is transferred to accounts in the ledger.

Accounting is used to convey information about the finances of an enterprise. It is essential that the users of this financial information should understand it.

The framework for the preparation and presentation of financial statements "Generally Accepted Accounting Practice" (GAAP) and various other "International Financial Reporting

Standards" (IFRS) was created to present financial statements in such a manner to improve the decision-making.

1.2 Double entry principle

Luca Pacioli designed the double entry principle whereby a:

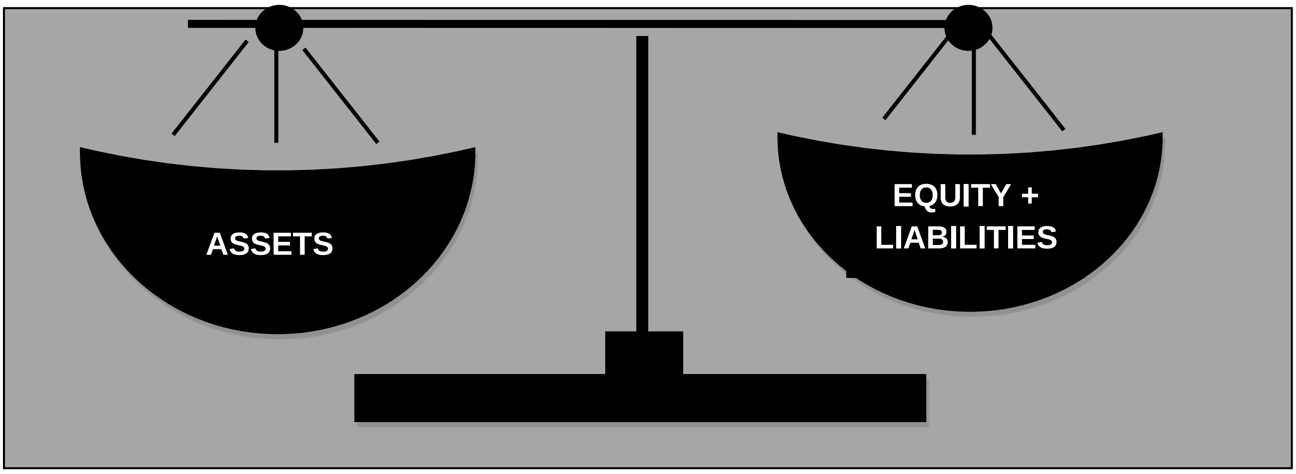
- equal credit entry will be completed for every debit entry in the general ledger,
- equal debit entry will be completed for every credit entry in the general ledger.

In accounting debit refers to the "left hand side" of the general ledger account while credit refers to the "right hand side" of the general ledger account.

We will pay attention to the general ledger in chapter 4.

1.3 Classification of ledger accounts

The accounts in the general ledger are classified according to the accounting equation. We will use a scale to explain this concept.



According to the scale assets on the right-hand side of the scale must be equal to the owner's equity and liabilities on the left-hand side of the scale. To buy assets the business must have money provided by the owner or money must be borrowed. If the owner provides the money, we call it owner's equity. If the money is borrowed, we call it liabilities.

Own capital : When the owner provides the money. - Equity

Borrowed capital : When the money is borrowed. - Liability

According to the information on the scale we can form the following equation:

Assets = Owner's equity + Liabilities

The different concepts are used in the financial statements:

- Income and expenses are used in the income statement/statement of comprehensive income to determine the financial result.
- Assets, liabilities and owner's equity are used in the balance sheet/statement of financial position to determine the financial position.

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1.4 Financial statements

Financial statements form part of the process of financial reporting and normally include the following components:

- Income statement – information on the entity's income and expenses to determine the profit or loss for a specific period.
- Balance sheet – shows the financial position of the entity at a specific point of time:
  - assets are disclosed in the top section;
  - equity (owner's interest) and liabilities are disclosed in the bottom section of the statement.

The **balance sheet** is a representation of the financial position of an entity on the last day of the financial year.
The income statement is a measure of the performance (profit or loss) of the entity for the financial year.

1.4.1 Elements of financial statements

- Elements by which the financial position is measured: Assets, liability and equity are disclosed in the balance sheet.
- Elements by which the financial result and profitability is measured: Income and expenses are disclosed in the income statement.

1.4.1.1 Owner's equity

Definition of equity:

Equity is the assets or money provided by the owner to start the business. Profits increase equity and losses decrease equity. Drawings of money or assets decreases equity.

Equity consist of capital and drawings:

Capital

When the owner gives money or assets to the business, owner's equity increases.

Owner gives money or assets to the business.	→	The business uses the money to buy assets for the business.

Drawings

When the owner takes money or assets from the business for his own use, owner's equity decreases.

Owner withdraws money or assets from the business.	→	The owner uses the money or assets for his own use.

Income

Income increase profits and therefore increases the owner's equity in the business, because the owner is entitled to the profit.

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Expenses

Expenses decrease profits and therefore decreases the owner's equity in the business, because the owner will receive less profit.

Owner's equity

Owner's equity is the interest that the owner has in the net asset value of the entity. Net asset value are the assets less liabilities.

Owner's equity = Net asset value = Assets – Liabilities

1.4.1.2 Assets

***Definition of an asset*:**

Assets refer to the possessions of the business and can be divided in two categories: fixed or tangible assets, financial assets and current assets.

Non-current assets (the value/carrying amount will reduce over a period longer than 12 months in the future)

- Fixed or tangible assets: Land and buildings; equipment; furniture, vehicles.
- Financial assets: Fixed deposits in a bank.

- **Current assets (the value will change in the future shorter than 12 months)**
  - Inventory (trading stock, goods and consumable stores on hand). The inventory purchased by the business to sell to make a profit is called trading stock (asset). The business purchase consumable stores (expense) to use in the business, for example stationery, packing material, cleaning materials, petrol, oil, refreshments. Consumable stores available at the end of the year is an asset.
  - Trade debtors (a person or business that owes money to our business for goods sold on credit). The business will receive the outstanding amount in the future.
  - Money in the bank, petty cash (money used to pay small expenses) and cash float (change in the cash register).

The value of non-current assets changes over a period longer than 12 months in the future.
The value of current assets changes over a period shorter than 12 months in the future.
Trading stock is purchased with the purpose to sell.
Consumable stores are purchased to use in the business.
Trade debtors owe money to the business that will cause an inflow of money in the future.

1.4.1.3 Liabilities

Definition of a liability:

Liabilities refer to the debt the business has incurred and is therefore liable to repay and will lead to an outflow of money in the future. Liabilities and can be divided in two categories:

- **Non-current liabilities** (the amount will be paid over a period longer than 12 months in the future)
  - Mortgage loan obtained from the bank to purchase property. The property is given as security to the bank and is repayable over a period of 20 – 30 years.
  - Long-term loan repayable over a period of 12 - 60 months.
- **Current liabilities** (the value will be paid over a period shorter than 12 months in the future)
  - Bank overdraft is arranged with the bank when more money is withdrawn from the current bank account than was deposited in the current bank account.
  - Trade creditors that the business owes money to because goods were bought on credit. The debt will be paid over a period of one to six months.

A liability of an entity is a present obligation to pay for all goods purchased or services rendered on credit whereby the entity agreed to pay the supplier cash for the goods at a date in the future.

1.4.1.4 Income

Definition of income:

Income is received when money is received for goods sold or services rendered. Income increases the profit.

Examples of income items:

Sales	Services rendered/current income	Rent received
Interest income	Commission received	

Income increases the profit of the business and will increase owner's equity because the owner is entitled to more profit.

1.4.1.5 Expenses

Definition of an expense:

Expenses causes an outflow of money to pay for services received. Expenses decrease the profit. The owner's equity will decrease because the owner will receive less profit.

Examples of expenses:

Cost of sales	Stationery	Advertising	Salaries and wages
Purchases	Packing materials	Bad debts	Water and electricity
Rent expense	Consumable stores	Telephone	Insurance
Interest expense	Petrol and oil	Commission paid	

Expenses are paid every month and will reduce the profit and owner's equity. Income is received every month and will increase the profit and owner's equity.

Example 1

The following information was obtained from Tinie Stores for December 2021.
The insurance premium of R600 is paid.
Stationery was purchased for R200 from the CAN on credit.
Equipment was purchased for R4 000 on credit from Menlyn Equipment.
Commission was received R3 000.
An EFT was used to pay R2 000 for salaries.

Required

Determine the amounts that will be recognised as expenses, income, assets and liabilities for December 2021.

Solution

	Expenses	Income	Assets	Liabilities
Insurance	+600		-600	
Stationery	+200			+200
Equipment			+4 000	+4 000
Commission		+3 000	+3 000	
Salaries	+2 000		-2 000	
	+2 800	+3 000	+4 400	+4 200

Question 1

The following information was obtained from Larry Stores for June 2021:

1. An EFT was used to pay R600 for the rent of the premises.
2. Received an invoice for R2 000 from Quality Stores for furniture purchased on credit.
3. An EFT was used to transfer R3 000 to purchase trading stock from COM Stores.
4. Issued a receipt for R300 received Speedy Stores for commission.
5. An EFT for R280 was issued to pay for delivery cost to a customer.
6. Transfer an EFT for R1 800 in settlement of the account of Olivetti Stores.
7. Services rendered according to the cash register rolls, R1 400.

Required

Determine the amounts that will be recognised as expenses, income, assets and liabilities for December 2021.

Solution

	Expenses	Income	Assets	Liabilities
1.				
2.				
3.				
4.				
5.				
6.				
7.				

Question 2

2.1 Indicate four items in your home that will be classified as non-current assets.

2.2 Indicate one item in your home that will be classified as a current asset.

2.3 Indicate four items in your home that will be classified as expenses.

2.4 Indicate two items in your home that will be classified as income.

Question 3

Go to a shop in your vicinity and identify 10 articles. Indicate the item, price and how you will classify the item in your home. Four items must be classified as assets and four items as expenses.

Example: Cold drink, R14,99

ITEM	PRICE	ASSET/EXPENSE
Cold drink	**14,99**	**Expense**

Question 4

Match the correct answer in column 2 with column 1.

Column 1		Column 2		Answer
1.	Currents assets	A.	Loan	
2.	Income	B.	Stationery	
3.	Owner's equity	C.	Equipment	
4.	Fixed assets	D.	Creditors	
5.	Expenses	E.	Bank	
6.	Financial assets	F.	Capital	
7.	Non-current liabilities	G.	Fixed deposits	
8.	Current liabilities	H.	Discount received	

Question 5

Butly Hairdresser started a business on 1 May 2021. The following transactions occurred during May 2021:

1. The owner deposited R90 000 in the bank account of the business.
2. An EFT for R30 000 was transferred to purchase equipment.
3. Bought hair products that will be used in the business for R18 000 on credit.
4. Deposit R22 000 in the bank for services rendered.
5. Issued an EFT for R900 to pay the electricity.
6. Obtain a loan for R10 000 from ABSA Bank.
7. Used an EFT to transfer R2 000 for the private use of the owner.

Required

Indicate if the transactions will affect equity, assets, liabilities, income or expenses in the appropriate column.

Example 1: Issued a cheque for R1 800 for wages.

No	Equity	Assets		Liabilities		Income	Expenses
		Current assets	Non-current assets	Current liabilities	Non-current liabilities		
Ex		Bank					Wages
1.							
2.							
3.							
4.							
5.							
6.							
7.							

Question 6

Use the information in the information pages to match the correct answer in Column 2 with Column 1. You must only provide the correct letter of the alphabet in Column 2.

Column 1		Column 2		Answer
1.	Currents assets	A.	Long-term loan must be paid over a period of 5 years.	
2.	Income	B.	Money provided by the owner to start the business.	
3.	Owner's equity	C.	Assets with a useful life of more than a year.	
4.	Fixed assets	D.	Debt that must be paid back within a year.	
5.	Expenses	E.	Used to record a transaction in the accounting records of the business.	
6.	Transaction	F.	Money received for providing a service.	

7.	Current liabilities	G.	Paid to run a business.	
8.	Capital	H.	Assets increasing or decreasing within a year.	
9.	Non-current liabilities	I.	Total assets minus total liabilities.	
10.	Source document	J.	Exchange between two parties.	

Question 7

Use the information in the information pages to match the correct answer in Column 2 with Column 1. You must only provide the correct letter of the alphabet in Column 2.

Column 1		Answer	Column 2	
1.	Mortgage loan		A.	Used to record a transaction in the accounting records of the business.
2.	Expenses		B.	Debt that must be paid back within a year.
3.	Owner's equity		C	Assets with a useful life of more than a year.
4.	Fixed assets		D	Assets increasing or decreasing within a year.
5.	Transaction		E.	Total assets, less total liabilities.
6.	Receipt		F.	Money received for providing a service.
7.	Current liabilities		G	Exchange between two parties.
8.	Current assets		H	Debt that is paid over a period more than one year.
9.	Income		I.	Cost of sales
10.	Source document		j.	Are used to proof that a debt was paid.

1.5 Profit motive

Profitability is the ability of the business to make a profit with the capital that was invested in the business. Own capital is capital provided by the owner. Borrowed capital is capital provided by a financial institution.

- The owner establishes a business with the aim to make a profit.
- The **gross profit** is the difference between the sales price and the cost price that was paid for the goods.
- After all the other income is added and expenses deducted, the **net profit** is determined.
- The net profit is the amount that the owner receives for his investment and hard work in the business.

When you invest money in a bank, you earn interest on your investment. If you invest money in a business, you receive the profit. The owner wants the profit to be as high as possible.

The following formula is used to determine the **return on investment**. The return on investment is the percentage profit the owner will make.

$$\text{Profitability} = \frac{\text{Net profit}}{\text{Capital}} \times \frac{100}{1}$$

If the percentage profit the owner receive is lower that the interest he can receive at the bank for a fixed deposit, it is not worth carrying on with the business. He can rather invest the money at the bank without any risk or work to receive more money.

Example 2

Jan Smit, the owner of Smit Stores, invested R60 000 in the business as his capital contribution.

The following information is available for the financial year ended 30 June 2021:

Services rendered	6 000
Other income	3 700
Rent	3 700
Other expenses	(4 000)
Wages	1 800
Administrative expenses	1 600
Insurance	600
Net profit	5 700

Required

Determine the return on investment (profit percentage).

Solution

$$\text{Profitability} = \frac{\text{Net profit}}{\text{Capital}} \times \frac{100}{1}$$
$$= \frac{5\ 700}{60\ 000} \times \frac{100}{1}$$
$$= 9{,}5\%$$

Example 3

A businessman starts two businesses, Computer Equipment and Computer Repairs with a capital of R20 000 each. Computer Equipment sells computers while Computer Repairs repair computers. The nett profit of Computer Equipment was R8 000 while the nett profit of Computer Repairs was R2 000.

Required

How will the owner decide if it is profitable to carry on with Computer Repairs?

Solution

The owner will calculate the profitability of both businesses. The profitability of Computer Equipment is higher than the profitability of Computers Repairs.

Computer Equipment	Computer Repairs
$\text{Profitability} = \frac{\text{Net profit}}{\text{Capital}} \times \frac{100}{1}$ $= \frac{8\ 000}{20\ 000} \times \frac{100}{1}$ $= 40\%$	$\text{Profitability} = \frac{\text{Net profit}}{\text{Capital}} \times \frac{100}{1}$ $= \frac{2\ 000}{20\ 000} \times \frac{100}{1}$ $= 10\%$

Although the profit of Computer Repairs is 10%, it is still higher than the interest received on a fixed deposit. He may decide to carry on with Computer Repairs to see if the profitability will increase in the future.
OR
The owner may decide to close Computer Repairs because the profitability is only 10% and rather invest the money in Computer Equipment making a profit of 40%.

Example 4 (For enrichment)

The following information was obtained from Stella Stores:

Capital	R200 000
Sales	450 000
Cost of sales	300 000
Rent income	15 000
Interest on fixed deposit	7 000
Administration expenses	80 000
Interest on loan	3 000

Complete the calculations for the following:

(a) Calculate the gross profit.

Sales	450 000
Cost of sales	(300 000)
Gross profit	150 000

(b) Calculate the net profit.

Gross profit	150 000
Income (15 000 + 7 000)	22 000
Expenses (80 000 + 3 000)	(83 000)
Net profit	89 000

(c) Calculate the profit percentage added to the cost price.

$\frac{\text{Gross profit}}{\text{Cost of sales}} \times \frac{100}{1}$
$\frac{150\ 000}{300\ 000} \times \frac{100}{1}$
50%

(d) Calculate the profitability.

$\frac{\text{Net profit}}{\text{Capital}} \times \frac{100}{1}$
$\frac{89\ 000}{200\ 000} \times \frac{100}{1}$
44,5%

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Question 8

Calculate the profitability if:

(a) Services rendered R180 000 Other income R14 000
Other expenses R34 000 Capital investment R100 000

(b) Services rendered R80 000 Net profit R24 000 Capital R200 000

(c) Current income R40 000 Capital R160 000
Other income R20 000 Expenses R24 000

Question 9 (For enrichment)

The following information was obtained from Nel Stores.

Sales	60 000
Cost of sales	40 000
Rent income	4 000
Administrative expense	7 000
Salaries	6 000

Required

Use the information obtained from Nel Stores, in the information pages, to determine the gross profit and net profit.

Sales	
Cost of sales	
Gross profit	
Income	
Expenses	
Net profit	

Question 10

The following information was obtained from Nel Stores.

Services rendered	62 000
Rent income	4 000
Commission income	12 000
Administrative expense	12 000
Salaries	7 000

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Required

Calculate the net profit.

Services rendered	
Rent income	
Commission received	
Administration expenses	
Salaries	
Net profit	

1.6 Accounting cycle

There are a variety of transactions in the business that must be recorded in the financial records of the business, in a specific order, known as the accounting cycle/process.

Step 1	For every transaction a source document must be completed.
Step 2	The source documents are used to record all the transactions in the subsidiary journals.
Step 3	At the end of the month, all the transactions in the source documents, must be posted to the accounts in the general ledger.
Step 4	After all the entries were posted, the accounts in the general ledger must be balanced. The balances in the accounts are recorded in a trial balance to ensure that a double entry was recorded for each entry.
Step 5	The trial balance is used to prepare the income statement and balance sheet.
Step 6	The information in the financial statements are analysed and interpreted, by using ratios, to make decisions for the future.

Accounting cycle - order

1. Source document
2. Subsidiary journals
3. General ledger
4. Trial balance
5. Financial statements
6. Analysis and interpretations

1.7 Users of financial statements

A variety of people are interested in the accounting information of the business. This information is used for future financial decisions.

1. Owner of the business

The owner of the business needs the accounting information to determine whether the business is making a profit or sustain a loss. He will use this information to make decisions for the future and to improve the profit of the business.

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2. Financial institutions

If the owner applies for a loan or bank overdraft, the financial institution will need the financial statements of the business to determine if the business will be able to settle their current liabilities, instalments on any loans and interest, on a regular basis.

3. Creditors

Creditors will determine, from the financial statements, if the assets of the business will meet the current liabilities. Creditors will not sell to the business on credit if they can't ensure that they will recover the outstanding debt.

4. Employees and trade unions

Employees and trade unions are interested to determine if the business will be able to provide job security and salary increases.

5. South African Revenue Service

SARS must ensure that annual profit is recorded correctly to ensure that income tax can be levied on the correct taxable income.

6. Competitors

Competitors are interested to compare their financial results with other businesses in the same field.

1.8 Forms of ownership

There are a variety of types of businesses, for example:

- Service undertakings – only render services to receive an income, for example plumbers.
- Retail businesses – sells products to receive an income for example, a greengrocer.
- Combination of a service undertaking and retail business – sells products and renders a service to receive an income for example, a hairdresser.

The form of ownership refers to the number of people that are owners of the business and procedures that must be followed to establish the business.

- In a sole trader only one person owns the business. The owner provides all the capital and receives all the profits or are liable for all the losses.
- A partnership consists of anything between two or twenty partners. All partners contribute the capital, assets or skills to the business. Partners share in profits or losses according to the partnership agreement.
- In a company shares are sold to people outside of the company. All the shareholders are co-owners of the business and share in the profits of the business according to the number of their shares in the business.

Question 11

	Column 1	Answer		Column 2
1.	Service undertaking		A.	A business that buys goods to sell at a higher price to make a profit.
2.	Income		B.	Debt that must be paid back within a year.

3.	Owner's equity		C.	The order in which transactions takes place in a business.
4.	Fixed assets		D.	Assets increasing or decreasing within a year.
5.	Transaction		E.	The business can have between two and twenty owners.
6.	Source document		F.	Money received for providing a service.
7.	Current liabilities		G.	Exchange between two parties.
8.	Current assets		H.	A business can have thousands of owners.
9.	Trading concern		I.	Used to record a transaction in the accounting records of the business.
10.	Accounting cycle		J.	Total assets, less total liabilities.
11.	Partnership		K.	A business that renders a service to receive an income.
12.	Company		L.	Assets with a useful life of more than a year.

Question 12

1. Distinguish between a service undertaking and a trading concern.

2. Distinguish between a sole trader and a partnership.

3. Distinguish between an income and an expense.

4. Name three people/businesses that will be interested in the financial statements of a business. Explain why they will be interested.

5. What is the difference between drawings and capital?

6. Name two non-current assets.

7. Name two current assets.

8. Name two non-current liabilities.

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9. Name two current liabilities.

10. Name three income.

11. Name four expenses.

Questions

1. Name the financial statement completed to determine the profit or loss for the period.
2. Name the financial statement completed to determine the financial position of the entity at a specific point of time.
3. Capital and drawings determine the __________ in the business.
4. Name the three categories of assets.
5. What are fixed assets, intangible assets and financial assets called?
6. Name three current assets.
7. What is a mortgage loan and long-term loan called?
8. Name two current liabilities.
9. Name three income items.
10. Name three expenses.

Solutions

1. Income statement
2. Balance sheet
3. Equity
4. Fixed assets, financial assets and current assets.
5. Non-current assets
6. Inventory, debtors, bank, petty cash and cash float.
7. Non-current liabilities
8. Bank overdraft and creditors.
9. Sales, services rendered, interest income, rent received, commission received.
10. Cost of sales, stationery, telephone, insurance, packing material.

Terms and concepts:

Accounting:	It is the orderly and systematic recording of financial transactions.
Accounting cycle:	The order in which the transactions are recorded in the financial records of the business.
Assets:	Belong to the business that will be used to create an income in the future.
Balance sheet:	The assets, equity and liabilities are disclosed in the balance sheet.
Capital:	Money provided by the owner to the business.
Creditors:	Suppliers who offer goods or services on credit to businesses.
Current assets:	Belong to the business and the value changes within twelve months in the future.
Debtors:	People or businesses who owe money to the business for sales or services rendered on credit.
Drawings:	Money or assets taken by the owner for his own use.
Equity:	The interest that the owner has in the business that increases with income and decreases when expenses are paid.
Expenses:	Expenses are paid out and reduces the profit of the business.
Income:	Income received from sales or services rendered that will increase the profit of the business.
Income statement:	Information on the income and expenses of the business to determine the profit or loss for a specific period.
Liabilities:	A liability is a debt that must be paid in the future.
Non-current assets:	It belongs to the business and the value will change more than twelve months in the future.
Non-current liabilities:	A liability that will be paid longer than twelve months in the future.