FAC1502

STUDY UNIT 3

THE FINANCIAL PERFORMANCE (RESULT)

Financial Accounting I:

Financial Accounting Concepts, Principles and Procedures

STUDY UNIT

3

The financial performance (result)

Learning outcome

You should be able to apply the concepts of income and expenditure to determine the gross and net profits (or losses) and their effect on equity.

Contents

KEY CONCEPTS

- financial result
- profit/loss
- income
- expenditure

3.1 Introduction

In section 2.3 we discussed the **first component of the primary goal of accounting**, which is **to determine the financial position of an entity as it is reflected in the statement of financial position**. In this study unit we discuss the **second component of this primary goal**, namely, the **financial performance** of the entity, and indicate how it is **reflected in** the form of a **statement of profit or loss and other comprehensive income**.

3.2 The financial performance (result)

The financial result of an entity is measured in terms of the profit or loss that the entity has made over a specific period, which is referred to as the **financial period** and which is normally a year. An entity makes a profit when the income it has earned is more than the expenditure it has incurred in generating or producing that income. The difference between income and expenditure is known as a profit or a loss. Profit is a business owner's reward for the capital he/she has invested and the entrepreneurial spirit he/she has shown. It therefore increases the equity of the business.

The statement of profit or loss and other comprehensive income of a business provides information about the results of the operating activities of the business **in a specified period**, that is, its performance. The heading of the statement of profit or loss and other comprehensive income identifies the **period on which it is reporting**, for example:

XYZ TRADERS

Statement of profit or loss and other comprehensive income **for the year** ended 30 September 20.2

The statement of profit or loss and other comprehensive income of an entity reports its income and expenses, including its gains and losses.

3.3 Income

Profit or loss is frequently **used as a measure of performance**. The elements directly related to the measurement of an entity's financial performance for a period in the statement of profit or loss and other comprehensive income are income and expenses.

Income less expenses = profit/loss for the year

The objective of every entity is to earn as large an **income** as possible.

Income is the income that an entity earned through its normal everyday business activities in a financial accounting period (normally a year). Examples are sales, rent income, interest income and credit losses recovered.

Expenses are the running expenses that an entity incurred to earn an income in a financial accounting period (normally a year). Example are purchases, rent expenses, telephone expenses, water and electricity and salaries and wages.

INCOME
Profit/income refers to increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims.

REVENUE	**PROFIT/GAINS**
Revenue is income earned through an entity's normal activities (daily operating activities), for example,	Gains are increases in economic benefits that do not arise from the normal activities of an entity, for example,
• fees earned	• profit on the sale of non-current assets
• sales	
• interest income	
• rental income	
• commission income	
• credit losses recovered	

When the double-entry principle is applied, the following rules have to be followed:

Dr (debit side)	**Equity, Liabilities & Income**	(credit side) Cr
-		+

- Income **increases** on the (right) **credit** side and **decreases** on the (left) **debit** side of the T-account because income increases the profit for the year.

Income is recognised when

- an increase in economic benefits through an increase in assets or a decrease in liabilities of an entity has arisen for the entity
- it can be measured reliably (Koppeschaar et al, 2017:21)

Income is therefore recognised simultaneously with an increase in assets or a decrease in liabilities. In practice, it is normally required that **revenue be earned before it is recognised**.

3.4 Expenditure

Expenditure is incurred to earn income.

EXPENSES

Losses/expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to contributions to holders of equity claims.

EXPENDITURE | **LOSSES**

Expenses are incurred in the normal course of an entity's activities. They arise from the generation of income. Examples of expenses are:	Losses are decreases in economic benefits that do not arise from the normal activities of an entity, for example,
• cost of sales	• a loss on the sale of a non-current asset
• wages and salaries	
• interest expenses	
• rental expenses	
• advertising	
• credit losses	
• insurance	
• repairs and maintenance	
• telephone expenses	
• water and electricity	
• postage	
• rates and taxes	
• stationery	
• consumables	
• packing materials	
• bank charges	
• depreciation	
• administrative expenses	

When the double-entry principle is applied the following rules have to be followed:

Dr (debit side)	**Expenses**	**(credit side) Cr**
+		-

The above can be summarised as follows:

- Expenses **increase** on the (left) **debit** side and **decrease** on the (right) **credit** side of the T-account because expenses decrease the profit for the year.

Expenses are regarded as

- a decline in economic benefits resulting from a decrease in assets, or an increase in liabilities
- that can be measured reliably (Koppeschaar et al: 2017:22)

Expenses are therefore recognised simultaneously with an increase in liabilities or a decrease in existing assets.

3.5 Influence of profit or loss on equity

Equity refers to the wealth of the owner of an entity. One can say that if the owner of a business closed down the entity at a particular date, sold all the valuables (assets) in the entity and paid all the liabilities, the amount left would constitute the equity. There are two methods by which equity can be calculated, namely, by means of the accounting equation and by means of income and expenses.

Income (profit) increases and expenditure (losses) decreases the owner's interest.

Equity can be calculated by the following two methods:

- Method A: – by using the accounting equation

  Equity = Assets – Liabilities

- Method B: – by using equity accounts

Dr (debit side)	**Capital**	**(credit side) Cr**
-		+

BUSINESS TRADERS

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20.9

	R
Capital (Opening balance)	xx xxx
Plus: Additional capital contributions during the year	xx xxx
Plus: Total comprehensive income for the year	xx xxx
Less: Drawings	(xx xxx)
Capital (closing balance)	xx xxx

EXERCISE

The financial position (BAE) of T Payn, an attorney, on 28 February 20.0 is as follows:

Assets =	E +	L
R50 000	R30 000	R20 000

For the year ended 28 February 20.1 he had the following income and expenditure:

	R
Services rendered	180 000
Salaries	100 000
Administrative costs	20 000
Insurance expenses	10 000

Calculate T Payn's equity on 28 February 20.1.

SOLUTION

We use the equation that we discussed in section 3.5:

Profit = Income – Expenditure
= Services rendered – (Salaries + administrative costs + insurance expenses)
= R180 000 – R(100 000 + 20 000 + 10 000)
= R180 000 - R130 000
= R50 000

E = R30 000 + R50 000
= R80 000

COMMENTS

- *Capital plus profit form the equity of the owner. See the above exercise – R(30 000 + 50 000) = R80 000.*
- *Profit is income minus expenditure.*

3.6 Statement of profit or loss and other comprehensive income (financial performance)

The financial performance of an entity is measured in the statement of profit or loss and other comprehensive income (previously known as the income statement).

The correct statement of profit or loss and other comprehensive income for Business Traders is as follows:

BUSINESS TRADERS

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20.9

	Notes	R
Services rendered		xx xxx
Other income		x xxx
Rental income		x xxx
		xx xxx
Distribution, administrative and other expenses		(x xxx)
Telephone expenses		x xxx
Salaries		x xxx
Profit for the year		xx xxx
Other comprehensive income for the year *		-
Total comprehensive income for the year		xx xxx

* Other comprehensive income for the year falls outside the scope of the FAC1502 syllabus.

Refer to an example of the statement of profit or loss and other comprehensive income in section 4.15.1 of study unit 4.

3.7 Statement of changes in equity

The purpose of the statement of changes in equity of an entity (refer to the example of Method B in section 3.5) is to reconcile the equity at the beginning of the financial period with the equity at the end of the financial period. The balance of the equity at the end of the financial period is then shown in the statement of financial position.

Refer to an example of a statement of changes in equity in section 4.15.2 of study unit 4.

3.8 Accounting policies and explanatory notes

Additional information on items appearing in the financial statements of an entity is given in the notes to the financial statements. Refer to an example of notes to the financial statements in section 4.15.4 of study unit 4.

3.9 Revision exercises and solutions

3.9.1 Revision exercise 1

(1) How is the financial performance (result) of an entity calculated in accounting terms? Which financial report reflects the financial performance?

(2) Give three examples of income.

(3) Give three examples of expenditure.

(4) How is profit/loss determined for a financial period?

(5) Does a loss increase or decrease the equity of the owner of an entity?

Solution: Revision exercise 1

(1) Income minus expenditure. The statement of profit or loss and other comprehensive income reflects the financial performance.

(2) Refer to section 3.3.

(3) Refer to section 3.4.

(4) Expenditure is subtracted from income. Refer to section 3.5.

(5) A loss decreases equity.

3.9.2 Revision exercise 2

On 28 February 20.2 Alpha Services showed the following income and expenditure for the financial year

	R
Services rendered	850 000
Salaries	520 000
Wages	50 000
Telephone expenses	4 000
Stationery	2 000
Interest income	1 000
Insurance	12 000

Calculate the net profit/loss of Alpha Services on 28 February 20.2.

Solution: Revision exercise 2

Income = Services rendered + Interest income
= R(850 000 + 1 000)
= R851 000

Expenditure = Salaries + Wages + Telephone expenses + Stationery + Insurance
= R(520 000 + 50 000 + 4 000 + 2 000 + 12 000)
= R588 000

Profit = Income - Expenditure
= R851 000 - R588 000
= R263 000

SELF-ASSESSMENT

Now that you have studied this study unit, can you:

	• describe the concept of income? • describe the concept of expenditure? • calculate the profit (or loss) of an entity? • calculate the effect of profit/loss on equity?