

Chapter 2

THE STATEMENT OF FINANCIAL POSITION AND STATEMENT OF PROFIT OR LOSS

1. Introduction

In this chapter we will look at what information the Statement of Financial Position and Statement of Profit or Loss are giving and also examine the standard layout and terminology that will be required from you in the examination.

2. The dual (or double) effect of transactions

Let us consider the effect of the following transactions on a sole trader:

- (a) The owner puts \$10,000 into a separate bank account for the business:

The business owns

The business owes

- (b) The business buys a shop for \$2,000

The business owns

The business owes



- (c) The business buys goods for resale (in cash) for \$1,000

The business owns

The business owes

- (d) The business buys more goods for resale (on credit) for \$2,000

The business owns

The business owes

- (e) The business buys a car for \$3,000 (cash)

The business owns

The business owes

- (f) The business sells half of the goods for \$2,400 (cash)

The business owns

The business owes

- (g) The business sells the remainder of the goods for \$2,800 on credit

The business owns

The business owes



- (h) The business pays \$600 of the amount owing, on account

The business owns

The business owes

- (i) The business pays electricity of \$200

The business owns

The business owes

- (j) The business receives half of the amount owing to it, on account.

The business owns

The business owes

- (k) The owner takes \$1,200 from the business

The business owns

The business owes

Check on profit:

In each case, the summary we have prepared is effectively a Statement of Financial Position and shows the owner: how much they are owed, why they are owed it, and how the amount is held within the business.

The check made on the profit is effectively a Statement of Profit or Loss. This shows the owner how the profit was actually made.



3. The Statement of Financial Position

Below is an example of the layout of a Statement of Financial Position for a sole trader:

Statement of Financial Position as at 31 March 2009

	\$	\$
ASSETS		
Non-current assets		
Land and Buildings	100,000	
Plant and Equipment	50,000	
Fixtures and Fittings	20,000	
Motor Vehicles	30,000	
		200,000
Current assets		
Inventories	10,000	
Accounts receivable	12,000	
Prepayments	3,000	
Cash	4,000	
		29,000
		<u>\$ 229,000</u>
CAPITAL AND LIABILITIES		
Capital		
Capital at 1 April 2008	130,000	
Profit for year to 31 March 2009	50,000	
Less: withdrawals	(10,000)	
		170,000
Non-current liabilities		
8% Loan		25,000
Current liabilities		
Accruals	2,000	
Accounts payable	20,000	
Bank overdraft	12,000	
		34,000
		<u>\$ 229,000</u>



Terminology:

- **Asset** an economic resource controlled by the business
- **Non-current asset** an asset the business intends to keep (longer than 12 months)
- **Current asset** not a non-current asset (!)
- **Inventory** an asset bought by the business intended for sale
- **Accounts receivable** amount owed to the business by customers
- **Prepayment** a payment made by the business in advance
- **Capital** amount owing by the business to the proprietor (owner)
- **Drawings (or withdrawals)** anything taken from the business by the owner
- **Liability** amount owing by the business
- **Current liability** a liability due within 12 months of Statement of Financial Position date
- **Non-current liability** a liability due more than 12 months from the date of the Statement of Financial Position
- **Accounts payable** liability due to suppliers
- **Bank overdraft** liability due to the bank (a “negative” bank balance)



4. The Statement of Profit or Loss

Below is an example of the layout of a Statement of Profit or Loss for a sole trader:

Statement of Profit or Loss for the year ended 31 March 2009

	\$	\$
Sales revenue		180,000
Cost of sales:		
Opening Inventory	30,000	
Purchases	120,000	
	150,000	
Closing Inventory	(40,000)	
		110,000
Gross Profit		70,000
Other income:		
Rent received	10,000	
Interest received	1,000	
	11,000	
		81,000
Expenses:		
Rent	5,000	
Electricity	3,000	
Telephone	2,000	
Wages and salaries	15,000	
Motor expenses	6,000	
	31,000	
Net profit		\$50,000

Terminology

- **Revenue**
- **Purchases**
- **Trading Account**

5. The difference between Capital and Revenue items

You should note from the previous exercises that when we pay for anything, there are two possible reasons. Either we buy an asset, which appears on the Statement of Financial Position, or we pay an expense, which appears on the Statement of Profit or Loss.

We call the purchase of assets (for the Statement of Financial Position) Capital Expenditure, whereas the payment of expenses (for the Statement of Profit or Loss) is called Revenue Expenditure.



6. The Accounting Equation

You should note from the earlier illustrations that at any point in time:

$$\text{ASSETS} = \text{CAPITAL} + \text{LIABILITIES}$$

It follows from this that:

$$\text{ASSETS} - \text{LIABILITIES} = \text{CAPITAL}$$

The term "net assets" is often used to refer to assets – liabilities, and so:

$$\text{NET ASSETS} = \text{CAPITAL}$$

Over a period of time (for example, over a year), the net assets of a business will change. Since the above equation is true at any point in time, it also holds true that over a period of time:

$$\text{INCREASE IN NET ASSETS} = \text{INCREASE IN CAPITAL}$$

There are only three reasons why the capital of a business should change over time:

- More capital introduced (this will increase the capital)
- Profit for the period (this will increase the capital)
- Drawings during the period (this will reduce the capital)

Therefore, finally, over a period of time,

$$\text{INCREASE IN NET ASSETS} = \text{CAPITAL INTRODUCED} + \text{PROFIT} - \text{DRAWINGS}$$

Example 1

On 1 January, net assets of a business were \$25,000. On 31 December they had increased to \$32,000. During the year the owner had introduced more capital of \$10,000 and had made drawings of \$7,000.

You are required to calculate the profit for the year

Example 2

On 1 January, the net assets of a business were \$118,000. On 31 December, the net assets were \$150,000. During the year the owner had introduced no additional capital, and the profit for the year was \$54,000

How much were the drawings during the year?

WHEN YOU FINISHED THIS CHAPTER YOU SHOULD ATTEMPT THE [ONLINE FA MCQ TEST](#)

