Understanding Statement of Profit and Loss

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Understand what profit and loss statement is
- ✓ Explore how to prepare profit and loss statement

Understanding Statement of Profit and Loss

A complete set of financial statements is comprised of the following:

- a) a statement of financial position as at the end of the period (Balance Sheet);
- b) a statement of profit or loss and other comprehensive income for the period (Profit & Loss Statement);
- c) a statement of changes in equity for the period; and
- d) a statement of cash flows for the period

Introduction

This unit is meant to help you understand the meaning and need for a profit and loss statement. It also contains methods of preparing the statement of profit or loss. The Profit and Loss, which is known as an Income Statement presents the outcome of a business's activities through a specific time period. All revenues and expenses for the period are recorded in this statement and their net difference determines whether the business has earned a profit or incurred a loss.

Meaning of the Statement of Profit or Loss

One of the most important accounting statements, the Profit or Loss Account (P & L Statement) summarises the result of a company's business operations in an accounting period. It lists all the revenues or income that a business earns and all the expenses that have been incurred for that income and calculates the profit or loss. This statement is an important indicator of a business's financial health. First, we look at the reasons for preparing a Profit and Loss Account.

Why is there a Statement of Profit or Loss?

The main objective of any business organization is to earn profit. The Profit and Loss statement determines if the business has been successful in fulfilling that objective.

Some of the reasons for preparing an income statement are as follows:

1. **Knowledge of net profit or net loss (Gain & Deficit):** The Profit and Loss Account determines if the business has earned profit or suffered losses during a specific accounting period.
2. **Comparison with previous year's profit**: The efficiency and growth of a business can be determined by comparing the income statement of a particular accounting period with that from a previous period.
3. **Control over expenses:** Comparing the expenses incurred by the business during a particular accounting period with the expenses from a previous period gives the business control over how much they are spending. This can help in reducing expenses and also, making the business spending more efficient.

Measurement of Income

A business generates income through its assets and expenditure on day-to-day business operations. Revenue and expenditure are important aspects of the profit and loss statement, therefore, there is a need to know how they are recognized and measured.

1) **Realisation Concept:** This concept relates to the recognition of revenue. Revenue is recognised or considered to be 'earned' when goods are delivered or services are rendered. In other words, the recognition of revenue has nothing to do with receipt of cash. The customer can pay in cash or promise to pay later, but revenue is earned once the goods are delivered or services rendered. Take for example a firm, which delivers goods to a customer in August and the customer pays for the goods in November. Revenue will be realized in August when the ownership of the goods was transferred from the firm to the customer. The following are some exceptions to this rule:

    - Revenue is recognised before the completion of job, based on partial or proportionate completion in case of long-term contractual work;
    - When it is doubtful whether the debtor will pay or not, revenue is recognised when cash is paid; and
    - Revenue is recognised based on the proportion of installment over price in hire purchase transactions.

2) **Accrual Concept:** Evaluation of transactions and analyzing their effects on owner's equity are covered under Accrual Concept. The changes in owner's equity are studied in a period and the profits are determined from the difference between the values at the start and at the end of an accounting period. If there has been an increase in equity value then it is registered as revenue and if there has been a decrease it is recorded as an expense. Income is generated when revenues are greater than expenses, and loss is borne when expenses are greater than revenues.

3) **Matching Concept:**
    The Matching Concept helps us better understand about the handling of Profit and Loss Accounts of firms. Under this concept, the revenues calculated in one accounting period are required to be matched with their corresponding expenses made in that accounting period. Expenses are usually made to generate revenues and can be easily matched with their corresponding revenues under this concept. The expenses that cannot be linked with the generated revenue include few items like salaries etc. and they are charged to period expenses.

4) **Accounting Period**: In order to know an organisation's profitability and financial position periodically, time is divided into various segments called "accounting periods." Income and expenses are matched for each period and profits or losses are determined for that specific accounting period.

This accounting period is usually one year for external reporting. This year is also called the financial year and depends mainly on the firm's business operations or its tax considerations. For internal reporting, however, a much shorter time period is used. This can be half yearly, quarterly or monthly; depending on the how frequently the management requires knowing the firm's financial position. For

most of the businesses, the financial year starts from 1st April and ends at 31st March of the next year. The accounting period must be clearly stated so that the management gets an update on the firm's financial position frequently.

Relation between Statement of Profit or Loss and Statement of Financial Position (SOFP)

The Statement of Profit or Loss and the Statement of a Financial Position are financial statements that indicate the financial health and profitability of a business.

The Statement of Financial Position (SOFP) maintains a record of a business's assets, its liabilities, and the owner's equity at a particular date. The Statement of Profit or Loss, on the other hand, matches the firm's revenues against its expenses and determines the profit or loss situation during a particular accounting period. Therefore, the Profit and Loss Account in indicative of a firm's earning capacity in the light of its business operations.

While the Statement of Profit or Loss or income statement calculates the result of a firm's business operations, during a particular accounting period, the SOFP reflects the firm's financial status at a particular point in time. In other words, the Statement of Profit or Loss is a **flow report** whereas, the Statement of Financial Position is a **stock report**. The Profit or Loss Account and Statement of Financial Position are linked to one another. The Profit or Loss Account records the inflow and outflow of a firm's assets and liabilities over a particular accounting period and the statement of financial position gives the final position of the firm regarding its assets and liabilities on a particular date.

According to the simple accounting equation, a firm's assets are equal to the sum of its liabilities. These liabilities include outsiders' claims, as well as owner's equity.
The **Accounting Equation** is deduced as follows:

Assets = **Equities (total claims)**

or

Assets = **Liabilities** + **Owner's equity** **(1)**

or

Assets - Owner's equity = **Liabilities** **(2)**

We may also define owner's equity as:

Owner's equity = **Contributed Capital** + **Retained Earnings**

In case the owners do not withdraw anything from the business, then, the following will occur:

Retained Earnings = **Revenue** - **Expenses** **(3)**

Elaborating the meaning of owner's equity in (1) we get:

Assets = **Liabilities + Contributed Capital**
+ **Retained Earnings** **(4)**

Again, we can derive from (3):

Assets = **Liabilities** + **Contributed Capital**
+ **Revenue** - **Expenses** ***(5)***

Profit = **Revenue** - **Expenses** **(6)**

Therefore, we can conclude that the Profit or Loss Account, which summarises a firm's revenues and expenses, is an important part of the statement of financial position. It can be called an expansion of one of the terms used in the balance sheet.

Some Important Terms

Some of the important terms used in Profit and Loss Accounts are defined below:

Gross Sale: Total selling price of all goods and services sold by the firm during an accounting period. Cash sales are separated from credit sales.

Returns & Allowances: Sometimes, the buyer of the firm's goods returns some of those goods due to various reasons. The returned goods are a reduction in the firm's gross sales. The firm should ensure that it minimizes the occurrence of returned sales.

Net Sales: Net sales of a firm are determined by subtracting returns and allowances from gross sales. Net sales reflect the total volume of a business during an accounting period and are key in figuring out the profit or loss.

Gross Profit: Subtracting the total cost of goods, which are sold from the net sales, gives the gross profit figure of a firm.

Revenues: This word is usually used synonymously with sales (the amount received from the sales of goods and services). A firm may earn revenue from sources other than sales, such as, interest, securities, and dividends, etc. The income generated from a firm's main business operations is called **operating income** whereas revenue earned from activities accompanying the main operations is called **non-operating income.**

Expenses: Expenses are the cost of earning revenue or of carrying out business operations. Expenses come as a result of an increase in liabilities and a decrease in assets in

order to produce revenues. However, the cost is not the same as expense. Cost can be divided into an **expired cost** and **unexpired cost.**
While expired cost is considered as an expense and recorded in the income statement, unexpired cost is considered an asset and recorded in the statement of financial position. Three principles are followed in recognizing expenses, namely: the principle of associating cause and effect, the principle of systematic and rational allocation and the principle of immediate recognition.

According to the **Principle of Cause and Effect,** a firm incurs certain costs, which are directly linked to certain revenue and are recognized during that accounting period. For example, costs incurred in manufacturing goods that are sold.

The **Principle of Systematic and Rational Allocation** relates to expenses that generate revenue in the accounting period but cannot be linked to any specific revenue, for example, the depreciation expense.

According to the **Principle of Immediate Recognition,** all costs, that are incurred for non-productive activities, such as, marketing expenses, salaries, and miscellaneous expenses, etc. must be recognized immediately. These costs do not produce any future revenue, for example, selling and administrative costs, losses, etc.

Cost of Goods Sold: It is the total cost incurred for manufactured goods that are sold by the firm. It includes cost of raw materials and labour overheads, etc.

Interest: It is the money that a firm pays over and above the borrowed amount. It is a non-operating expense. Interest receivable (money that is received by the firm over and above the amount that it has lent) is treated separately from interest payable. Both the interest receivable and interest payable are calculated on the closing date of the accounting period and are shown in the income statement.

Repairs & Renewals: These expenses relate to the repair, maintenance and renewal of the firm's existing assets such as, plant, equipment, machinery, building, etc.

Depreciation: Depreciation is the systematic process of allocating a Tangible Fixed Asset's cost over its useful life. It is charged to different assets such as, plant, equipment, machinery, buildings, office furniture etc. The accurate calculation of profit entails that provision must be made for depreciation during that accounting period.

Selling & Distribution Expenses: These expenses include salaries of employees involved in selling and distributing goods, cost of samples, cost of packaging, advertising, and commissions, etc.

Insurance: This relates to the insurance premium that the firm pays against risks such as fire, theft etc. In case these payments exceed the accounting period for which income statement is being prepared, the amount pertaining to the relevant accounting period is considered.

Operating Income: It is the profit that is calculated after deducting all expenses from gross profit and before deducting the tax.

Income Tax: Income tax is calculated after the operating profit determines the taxable income. Profit after tax is the net profit calculated after subtracting income tax from operating profit.

Preparation of Profit or Loss Account

The Profit and Loss Account is related to the analysis of revenues and expenses in transactions. This account gives us profits earned or losses incurred in an accounting period by working on and comparing revenues and expenses. By looking at the profits, individuals or companies can formulate an opinion on the success of businesses. Let’s look at how the Profit or Loss Account is prepared.

First, all the expenses (including the indirect expenses not related to the revenues but excluding the direct expenses) are recorded on the debit side of the Profit and Loss Account. These expenses may have been in administration, finance, and distribution, etc. In the next step, all the revenues and income generated besides sales are entered on the credit side of the Profit or Loss Account. The revenues may include commission or rent received. Direct expenses, which relate to purchase of goods in manufacturing, are recorded on the debit side of the Trading Account and direct incomes, which are sales revenues, are entered in the credit side of the Trading Account.

Gross Profit or Gross Loss is calculated from the difference between direct incomes and direct expenses. Net Profit or Net Loss is calculated from the difference between indirect revenues and indirect expenses. In other words, preparation of Profit or Loss Account gives us a summary of all transactions whether they are resulting in increase in income or leading to expenditures. Following equations can also provide a better understanding of Profit and Loss Account:

Assets = **Owner's capital or Equity**
or
Assets = **Liabilities** + **Capital**

This equation can be further elaborated as:

Assets = **Liabilities** + **Capital** + **Revenue** - **Expenses**
or
A = **L + C + R – E**

In the equation above, the effect of dividends and withdrawals has been ignored. If withdrawals or dividends are taken into consideration, then the amount of assets will be reduced by the amount of withdrawal or dividend.
This is shown in the equation below:

A = L + C + R - (E + D)

(Where D = drawings or dividend) or we can rewrite the equation in the following form:

A + E + D = L + C + R

This is the fundamental accounting equation. All items on the left hand side are called debit (Dr.) and the items on the right hand side are called credit (Cr.). The preparation f profit and loss account is illustrated in the following example:

Profit and loss account is prepared in report format; operating revenue is mentioned separately from non-operating revenue. It also includes information about gross profit, profit before tax and profit after tax.
Profit and Loss Account is prepared in a report format in the following example:
Income Statement in Report Format

M/S. XYZ Limited Profit or **Loss A/c**
For the year ended on Dec. 31, 2012.

Revenue	100,000
Cost of Sales	(40,000)
Gross Profit	**60,000**
Distribution costs	(18,000)
Admin Costs	(12,000)
Profit Before Tax	**30,000**
Income Tax Expenses	(9,000)
Profit After Tax	**21,000**

Further Reading:

- ✓ ***John Wiley & Sons, (2010), Hotel Front Office Management, 5th Edition***
- ✓ ***Michael J. O'Fallon, Denney G. Rutherford, (2011), Hotel Management and Operations***
- ✓ ***Clayton W. Barrows, Tom Powers, (2009), Introduction to Management in the Hospitality Industry, Study Guide***