UNIT 18 UNDERSTANDING PROFIT AND LOSS STATEMENT

Strucuture

18.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and need of profit and loss account;
- distinguish between profit and loss account and balance sheet;
- classify various income and expenses account; and
- prepare profit and loss account.

18.1 INTRODUCTION

The Profit and Loss Account or Income Statement is prepared to ascertain overall result of business activities for an accounting year. This account presents all the revenues or incomes and all expenses for earning that revenue. The net difference between revenues and expenses shows the profit or loss for that period. In this Unit, we familiarise you with the meaning and need of Profit and Loss Statement. You will learn the methods of preparing of the Profit and Loss Account.

18.2 MEANING OF PROFIT AND LOSS ACCOUNT

The Profit and Loss Account is one of the important financial statements. It shows the net results of the business operations during an accounting period. It summarises all the revenues or incomes and all the expenses for earning that revenue. The net difference reflects the profit or loss for that period. This account is one of the most important indicators of financial health of the business. Let us first learn why do we prepare profit and loss account.

Why Profit and Loss Account?

The major aim of the business entity is to earn profit. Hence, profit and loss account is prepared to calculate the net profit or net loss of the business. In specific term it is prepared for:

i) **Knowledge of net profit or net loss:** Profit and loss account provides information about the net profit or net loss earned by the business during a particular accounting period.

ii) **Comparison with previous year's profit :** The profit figure ascertained by the profit and loss account for a particular accounting period can be compared with that of the previous year's profit. It helps in ascertaining the efficiency or goodwill of the business.

iii) **Control over expenses: An** analysis of the various expenses included in the profit and loss account and their comparison with the expenses of the previous period helps in taking concrete steps for effective control over the expenses.

183 MEASUREMENT OF INCOME

Profit and Loss Account measures the income generated by the entity. You must be knowing that income is generated from or with the use of assets. The revenue and expenses are important elements of profit and loss account. Hence, there arises the question of recognition and measurement of revenue and expenses. Let us now explain the basic concept of measurement of income.

1) **Realisation Concept:** This concept deals with the determination of the point of time of recognising the revenue. Revenue is considered to be earned when goods are delivered or services are rendered to customer. The customer may pay in cash or promise to pay cash in the near future. The revenue realisation, therefore, does not depend upon the receipt of cash. For example, if a firm sell goods to a customer in month of April, but cash is received in May, then, the revenue is considered to be realised in April, when the possession of goods was transferred to customer. However, there are some exceptions to this rule:

   - In long-term contract work in progress, revenue is recognised before completion of job on the basis of a proportionate or partial completion method.
   - On cash basis when debt collection is doubtful.
   - Hire purchase transaction in which revenue is recognised in proportion of instalment over price.

2) **Accrual Concept:** Accrual concept evaluates every transaction in terms of its impact on the owner's equity. Profits are measured by changes in owner's equity between the beginning and end of an accounting period. An increase in owner's equity arising from operations of a business is called revenue and, a decrease an expense. **When revenues exceed expenses the difference is known as income, whereas, when expenses exceed revenues the difference is called loss.**

3) **Matching Concept:** This is an important concept in preparing the profit and loss account of a firm. The **matching concept requires that expenses for an accounting period should be matched against related revenues of appropriate accounting period.** Therefore, firstly the revenues earned should be determined during a particular accounting period and correspondingly, expenses incurred to generate those revenues during that accounting period are matched. This ensures that sales and cost of goods sold in that income statement refer to the same product. There are some expenses which can not be traced to any specific item of revenue, like salary of a head of division etc. These are charged to the accounting period in which they are incurred. They are called **on period expenses.**

4) **Accounting Period :** The income statement or profit and loss account is a flow report. Hence, in order to know the results of business operations and financial position of the firm periodically, time is divided into segments referred to as accounting periods. Income is measured for these periods and the financial position is assesed at the end of an accounting period. The accounting period used for external reporting is usually one year. It is referred to as financial year and is chosen mainly on the basis of the business characteristics of the firm and tax considerations. It may be noted that the accounting peridd for internal use may be half yearly, quarterly, monthly, etc. because managers need financial information more frequently. The majority of business units adopt the' year from 1st April to 31st March as an accounting year. The need for explicitly stating the accounting period arises because the management is interested in the state of affairs at frequent intervals.

Check Your Progress-1

1) What do you mean by income statement?

....

....

....

....

....

2) What is owner's equity?

....

....

....

....

....

3) Why do you prepare profit and loss account?

....

....

....

....

....

18.4 RELATION BETWEEN PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

Profit and Loss Account or Income Statement and Balance Sheet are important financial statements of the business entity. They reflect the financial health of the **firm.**

The Balance Sheet is an important document showing the financial conditions of a **firm giving** details about the **assets, liabilities** and **owner's equity** on a particular day. However the **earning** capacity of a firm through the business operations is shown in income **statement** or **profit and loss** account. The **Income Statement shows the results of operations of a business for an accounting period.** It shows whether a firm is making or losing money. In the income statement **revenues of a** certain **period are compared with the cost of earning those revenues.**

In other words, Profit and Loss account **summarises** the results of operations for the **given** accounting period whereas Balance Sheet represents the financial status of an enterprise at a particular point of time. Therefore, the profit and loss account is a flow report **whereas** Balance Sheet is a stock report. The Profit and Loss Account and **Balance** Sheet are related to each other. The Income Statement for an accounting period works as a link between the Balance Sheet at the beginning of and closing of **accounting** period. This is because Income Statement represents the **inflow/** outflow of assets and liabilities for that period.

The simple accounting equation shows that total claims i.e., the claims of the outsiders and the proprietors are equal to the total assets of the firm.

This means that the total claims include the owner's capital or equity and the liabilities.

Assets = Equities (total cliams)
or
Assets = Liabilities + Owner's equity (1)
or
Owner's equity = Assets − Liabilities (2)

We may also define owner's equity as:

Owner's equity = Contributed Capital + Retained Earnings

If there is no withdrawal from the business by the owners then:

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 wright from (3):

Assets = Liabilities + Contributed Capital
+ Revenue − Expenses (5)

The Profit = Revenue − Expenses (6)

The accounting summarisation of Revenue and Expenses is shown in the Profit and Loss account. Hence, we can say that the Profit and Loss account is an integral part of the Balance Sheet. In fact, it is an expansion of one of the terms of the Balance Sheet. Therefore, they are related to each other.

18.5 SOME IMPORTANT TERMS

In this Section we define some important terms of Profit and Loss Acount.

Gross Sale : This refers to the total selling price of all merchandise and services sold during an accounting period. However, the cash sale and credit sale are separated.

Return and Allowances : Sometime it happens that the merchandise sold are returned back to the firm due to various reasons. The return of merchandise sold represents the amount of reduced gross sale. The firm should ensure that return of goods sold should be mininum.

Net Sale : The deduction of return and allowances from gross sales gives the volune of net sales. The amount of net sales is the effective volume of business during an accounting period on which a profit or loss is worked out.

Gross Profit : The gross profit is obtained by deducting the cost of goods sold from the amount of net sales.

Revenues : Many fums use this term synonymously with sales i.e., amount realised from sale of goods or services. A firm may earn revenues from other sources like interest, dividends, securities etc. Generally the income obtained from the operations of a business are separated from the incomes obtained from activities incidental to main operations.

The income gencratcd from main operations is called operating income, and the income obtained from other sources is known us non-operating income.

Expenses

The cost of earning revenue is called expenses. Expenses occur when assets decrease or liabilitics are increased in order to produce revenue. Cost is not synonymous with expense. Cost is distinguished as expired cost and unexpired cost. Expired costs are those which have helped in geneating revenues. The expired costs are considered as expenses in income statement. Unexpired cost are considered as assets in Balance Sheet. In recognising the expenses. the principlc of associating cause and effect, principle of systematic and rational allocation and principle of immediate recognition are followed.

As per the **principle of cause and effect,** certain costs expire in an accounting period and can be directly associated with specific revenue recognised during the period. Example of such costs are those related to producing goods that are sold.

The **principle of systematic and rational** allocation deals with those costs which expire to generate revenue during a period but cannot be associated with specific revenuc. Depreciation expense is an example of such costs.

The **principle of immediate recognition** states all those costs which will not provide any future benefits should be recognised immediately. The selling and administrative. expenses and losseses are example of such costs.

General and Administrative Expenses

These are the expenses incurred in support of the firm's non-productive activities and include marketing expenses, salaries of corporate staff personnel, and other miscellaneous expenses.

Cost of Goods Sold :

This represents cost of raw material, labour overheads, and other expenses that can be matched against the goods sold by the firm.

Interest

The fmed charges paid by the firm on the money borrowed arc called interest. This is a non-operating expense. Interest receivable should be shown separately. All interest whether receivable or payable by firm should be calculated on date of close of accounting period and should be shown in the income statement.

Repairs and Renewals

The amount incurred in repair and renewal of existing assets such as plant and equipment, machinery, building:; etc. are considered expcnses.

Depreciation

Depreciation is the process of allocating cost to a tangible fixed asset over its life in a rational and systematic manner. Depreciation is charged to fmed assets like plant and machincry, buildings, office furnitures, equipments etc. In order to arrive at true profits made in an accounting period, provision made for depreciation should be charged from profits made during that period.

Selling and Distribution Expenses

These include the salaries of those engaged in selling and distribution of goods, commissions for selling, advertising, cost of samples, packing charges etc.

Insurance

This includes premium paid against fire, or other type of risks involved in carrying out the business. If such payments extend beyond the accounting period for which income statement is prepared, then the amount attributable to the accounting period only is considered.

Operating Income :

The before tax profit after all the operating expenses have been deducted from the gross profit is called operating profit.

Income Tax : Operating profit determines the taxable income and income **tax** is calculated accordingly. The net profit obtained after deducting the income tax is called the profit after tax.

18.6 PREPARATION OF PROFIT AND LOSS ACCOUNT

Profit and Loss Account is a summary of all accounts dealing with transactions relating to revenue and expenses. It is a statement of the profit earned or loss incurred during an accounting year. This statement is very **useful** to the end users because the analysis of this statement enables the evaluation of **profitability** of the business operations.

In the preparation of the Profit and Loss Account all expenses (indirect expenses and losses relating to normal activities of the business are shown on the **debit side** of the Profit and Loss Account. For example, administrative expenses, selling and distribution expenses, financial expenses, etc. All incomes and gains (other than sales) such as rent received, interest and commission received, etc., are shown on the **credit side** of the profit and loss account. You should also know that all direct expenses (expenses relating to purchase and manufacturing of goods) are shown in the debit side of the Trading Account and **direct** incomes are shown in the credit side of the Trading account. The difference between direct revenues and direct expenses are known as gross profit or gross loss.

On other hand, the difference between indirect revenues and indirect expenses are termed as net profit or net loss. In other words, **the net excess of all revenues over all the expenses during the accounting year is known as net profit. The net excess of all expenses over all revenues is termed as net loss.**

Now it must be clear to you that Profit and Loss Account **is a summary of all accounts dealing with transactions relating to revenue and expenses.** You can also understand about the preparation of Profit and Loss Account through the help of the following equation:

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

We can further elaborate this equation as:

Assets = Liabilities + Capital + Revenue − Expenses
or
$$A = L + C + R - E$$

In the above equation the withdrawals or dividend have been ignored. If we consider withdrawal, it means that the assets will be lesser by the amount of the withdrawal. Then we can **wright** the equation as:

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

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

$$A + E + D = L + C + R$$

This is the basic accounting equality. Here, the quantities on the left hand side are referred to as debit or **Dr.** in short and quantities on the right hand side as credit or **Cr.** in **short**. Let us now learn the preparation of Profit and Loss Account through the help of an example.

The Profit and Loss Account may be presented either in the accounting format or report format. In the first case, all the revenues earned are shown on the ***right*** side and all expenses incurred on the left hand side. Thus, profit is a **credit balance,** while **loss is a debit balance.** The **format** for this **type** is shown below:

The Account-Format of Profit and Loss Account

M/s. ABC Company Ltd.

Profit and Loss Account for the year ended on December 31st, 1995

Expenses	(Rs.)	Revenues	(Rs.)
Cost of goods sold	10,00,000	Sales	15,00,000
General & Admn. Exp.	1,00,000	Other Income	2,00,000
Selling Expenses	60,000		
Interest	40,000		
Depreciation	1,00,000		
Non-operating Exp.	40,000		
Provision for tax	60,000		
Net Profit	3,00,000		
	17,00,000		17,00,000
		Net Profit	3,00,000
Provision for Dividend	1,70,000		
Reserve and Surplus	1,30,000		

The Profit and Loss Account can also be presented in the report form. In this type, there is a mention of operating revenue and non-operating revenues. It also gives information about gross profit, profit before tax and after tax.

Income Statement in Report Form

M/s. ABC Limited Profit & Loss A/c
for the year ended on Dec. 31,1995.

	(Rs.)	(Rs.)
Sales	15,00,000	
Less Cost of Goods sold	10,00,000	
Gross Profit		5,00,000
Less Operating expenses:		
General and Admn. expenses	1,00,000	
Selling Expenses	60,000	
Depreciations	1,00,000	2,60,000
Operating Profit		2,40,000
Less Interest		40,000
Other Income	2,00,000	
Less Non-operating Expenses	40,000	1,60,000
Profit before tax		3,60,000
Less provision for tax		60,000
Net Profit (after tax)		3,00,000
Provision for Dividend		1,70,000
Reserve & Surplus		1,30,000
		3,00,000

Check Your Progress-2

1) Distinguish between Gross Sale and Net Sale.

. . . .

. . . .

. . . .

2) What do you mean by Operating Income ?

. . . .

. . . .

. . . .

. . . .

18.7 LET US SUM UP

The Profit and Loss statement is one of the important financial statements. It summaries all the revenues or incomes and all the expenses for earning that revenue during an accounting period. The statement is prepared to know the net profit or net loss, to compare with previous year's profit and to control over expenses. The important processes of recognition and **measuremnt** of revenue and expenses are **Realisation,** Accrual, Matching and Accounting Period. This account is an integral part of the Balance Sheet. The Profit and Loss Account may be presented either in the accounting format or report format.

18.8 KEY WORDS

Operating Profit : It is the difference between gross profit and operating expenses.

Profit before interest and tax : It is sum of operations profit and non-operating profit.

18.9 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress-1

1) Read **Sec.** 18.3.

2) See **Sec.** 18.4,

3) See **Sec.** 18.2.

Check Your Progress - 2

1) Read **Sec.** 18.5.

2) See Section 18.5.