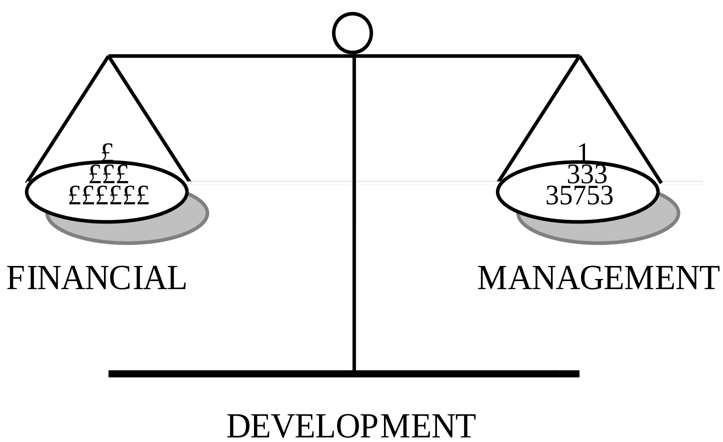
# FINANCIAL MANAGEMENT DEVELOPMENT

## Financial Accounting

## Basic Accounting

## NO 112

# PROFIT AND LOSS ACCOUNT




**ONE OF A SERIES OF GUIDES FOR**

**FINANCIAL MANAGEMENT DEVELOPMENT**

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**www.FinancialManagementDevelopment.com**

This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

# THE PROFIT AND LOSS ACCOUNT

## Objective

The objective of the Profit and Loss Account is to match Income from Sales with the costs of making those sales for a given period of time. It says nothing about the assets involved in generating the profit nor does it necessarily indicate whether cash is being generated. However, it is a key document in assisting measurement and therefore improvement of Business Performance.

## What is in the Profit and Loss Account?

Profit is Sales Income less attributable Cost. Because Value Added Tax is collected from customers on behalf of the Government, taxes on sales and recoverable taxes on expenditure are normally ignored in the Profit and Loss Account. Business owners who ignore VAT in real life end up in jail. That apart, all incomes and all costs should appear in the Profit and Loss Account. By convention it is not the cash received or paid which is shown but the amounts earned or incurred. (The Accruals concept of Accounting).

## Sales

Sales represents amounts earned from business activities during the period. It will normally be the invoice value of goods and services provided to customers. It may therefore bear little relation to cash received. To the extent that income is generated without receiving cash the figure for debtors in the Balance Sheet will change.

## Cost of Goods Sold

In most Retailing and Manufacturing organisations it is normal to calculate the Direct Costs of Goods sold in the period to enable a comparison of the Gross Margin (Sales less Direct Costs). The cost of Goods sold is frequently calculated by adjusting the figure for purchases by the movement in opening and closing stocks.

In the oil industry and other industries with volatile raw material prices it is vital to identify the Replacement Cost of Goods sold as well as the Historic Cost.

## Gross Margin

The Gross Profit percentage is frequently used as a check on the accuracy of the data. In most industries it is expressed as:

**Gross Margin on Sales** (i.e. gross Profit divided by sales value)

However in the Retail Industry it is common to find Gross Profit expressed as:

**Mark up on Cost** (i.e. gross Profit divided by cost of goods sold)

 

**Overheads**

Overhead analysis should always be determined by the business need. Having one account code avoids the possibility of miscoding but does not help informed analysis. Too many codes or headings causes inefficiency and destroys the value of the analyses; which is to help, not hinder informed management decision making.

**Operating Profit**

This is the amount generated from Trading Activities and should therefore exclude non-trading or exceptional items which are worthy of separate identification.

**Interest (Net)**

Interest income or expense is normally identified separately as it arises from the funding approach adopted by the business. Where appropriate it should show the interest element of finance lease rentals payable.

**Profit Before Tax**

Profit after all costs have been charged.

**Taxation**

The charge based on profits for the year. This is payable nine months after the year end for Companies. For Partnerships and Sole Traders the payment dates are half on 31 January and half on 31 July on the profits to the year end within the tax year.

**Profit after Tax**

The true measure of corporate performance and the basis of the Earnings Per Share Calculation. Profit after all business costs.

**Dividends**

The amount declared by the Company as payable to shareholders out of the profits for the period. The figure will be the amount chargeable to the Company. In a partnership or sole trader this figure will be the drawings for the period.

**Retained Profit**

The amount left in the business out of the period's profits. This is also the extent to which the Net Worth of the business has grown through its trading activities (i.e. excluding any impact due to changes in Foreign Exchange or asset valuations).

 

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

 