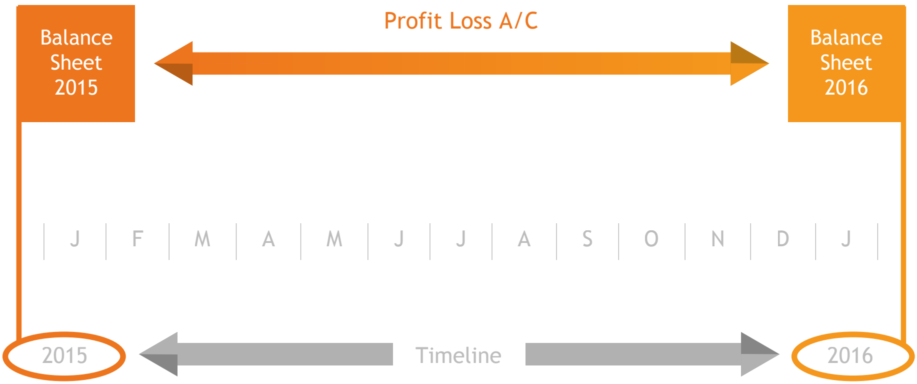
Chapter 3

The Profit and Loss Account

What is a profit & loss account?

A profit and loss account indicates how well an organisation has performed over a period of time, by showing how much profit or loss it has made over the last year.

A profit and loss account reports on the period between two balance sheets.

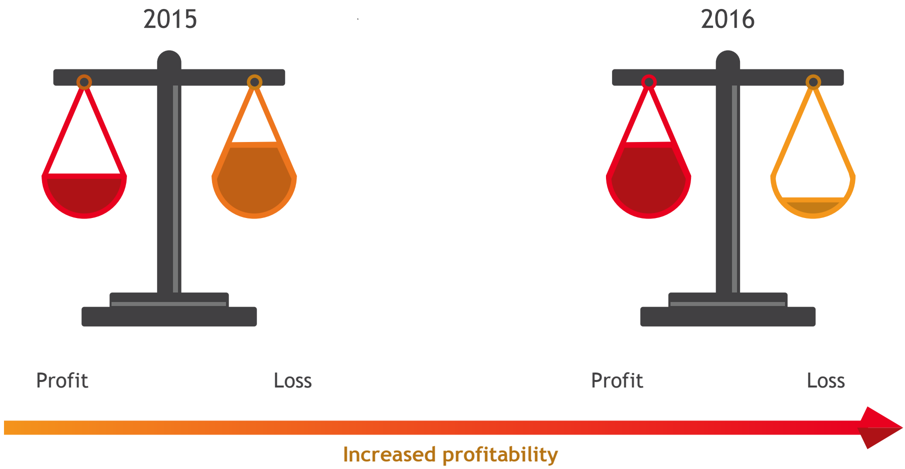


Businesses keep track of their performance by preparing a profit and loss account at different points throughout the year. At the end of each financial year, however, businesses are legally obliged to produce an audited profit and loss account.

This information can be used to compare current performance with previous years' and with other businesses in the same industry.

Profit and Loss Account for X-AMPLE Ltd for the Year Ended 30th September 2016		
	£	£
Sales		**20 000 000**
Cost of sales		(8 00 000)
Gross profit		**12 000 000**
Less expenses		
Marketing costs	(3 000 000)	
Administration	(2 000 000)	
Depreciation	(500 000)	
		(5 500 000)
Operating profit		**6 500 000**
Interest		500 000
Profit before tax		**6 000 000**
Corporation tax		(2 000 000)
Net profit after tax		**4 000 000**
Dividends		(2 500 000)
Retained profit		**1 500 000**

A profit and loss account shows how much profit or loss has been made over the last year.



How do I use profit & loss to judge my business' performance?

The first part of the profit and loss account is a sub-section called the trading account. This shows the business' gross profit by calculating the difference between the sales revenue or turnover it receives from selling its products, and its cost of sales or direct production costs. Gross profit equals sales, minus cost of sales.

		£
Sales		20 000 000
Cost of sales		(8 000 000)
Gross profit		12 000 000

The figure for cost of sales is shown in brackets because it is being subtracted from the sales revenue.

The cost of sales is cost incurred only in making the products. It does not include the costs of marketing, sales or administration.

Gross profit is the profit made after paying direct costs, but before paying any overheads. It represents the value added by the business.

Gross profit = Sales - Cost of sales

If sales are £20m and the cost of goods sold is £8m, the business will make a gross profit of £12m.

Cost of sales = direct production costs

Gross profit = the value added by the business

The business must aim to increase its gross profit by pushing up sales and reducing the cost of sales, whilst still offering customers good value.

Some businesses might increase their cost of sales by buying expensive production materials, without any corresponding increases in the sales price. In such cases, their gross profits are squeezed, and they end up giving away value to customers.

Increase gross profit by:

* pushing up sales
* reducing cost of sales

The next section is the main profit and loss account. This is where the business' net profit is calculated – the amount it keeps after paying its overheads or expenses, its interest, and its tax.

		£
Gross profit		12 000 000
Less expenses		
Marketing costs	(3 000 000)	
Administration	(2 000 000)	
Depreciation	(500 000)	
		(5 500 000)
Operating profit		6 500 000
Interest		(500 000)
Profit before tax		6 000 000
Corporation tax		(2 000 000)
Net profit after tax		4 000 000

Net profit = amount kept after expenses and tax

But first, we must calculate the operating profit, which is the gross profit minus expenses. This is how much the business earns after paying its overheads, but before paying interest or tax.

Operating profit = gross profit – expenses

Operating Profit = Gross Profit – Expenses

		£
Gross profit		12 000 000
Less expenses		
Marketing costs	(3 000 000)	
Administration	(2 000 000)	
Depreciation	(500 000)	
		(5 500 000)
Operating profit		6 500 000

After making a gross profit of £12m, X-AMPLE deducts marketing expenses of £3m, administration costs of £2m, and depreciation of £500,000. This leaves it with an operating profit, or profit before interest and tax (PBIT) of £6.5m.

Next, after deducting the interest the business owes to the bank (£500,000) its profit before tax is £6m.

		£
Operating profit		6 500 000
Interest		(500 000)
Profit before tax		6 000 000

The operating profit allows us to compare profits, irrespective of differences in the levels of borrowing, interest rates or tax.

Operating profits (profit before interest and tax PBIT) can be compared, regardless of differences in borrowing, interest rates or tax.

Finally, X-AMPLE must pay the government £2m in Corporation Tax, leaving it with a net profit of £4m.

		£
Profit before tax		6 000 000
Corporation tax		(2 000 000)
Net profit after tax		4 000 000

Net profit equals operating profit minus interest and tax, and is the amount the business can keep after it has paid all of its expenses and tax.

Net profit after tax = operating profit – tax

A third section, the appropriation account or statement of changes in equity, is usually shown below the main profit and loss account. This shows how the organisation's net profit is distributed.

It might choose to pay part of it to shareholders in the form of dividends.

		£
Dividends		(2 500 000)
Retained profit		1 500 000

This is £2.5m in X-AMPLE's case. The rest, £1.5m, is kept as retained profit or retained earnings, to be reinvested in the business at a later date. This will be added to the business' capital and reserves shown on its balance sheet.

Profit and Loss Account for X-AMPLE Ltd for the Year Ended 30th September 2016		
	£	£
Sales		20 000 000
Cost of sales		(8 000 000)
Gross profit		12 000 000
Less expenses		
Marketing costs	(3 000 000)	
Administration	(2 000 000)	
Depreciation	(500 000)	
		(5 500 000)
Operating profit		6 500 000
Interest		(500 000)
Profit before tax		6 000 000
Corporation tax		(2 000 000)
Net profit after tax		4 000 000
Dividends		(2 500 000)
Retained profit		1 500 000

Retained profit is added to the business' capital and reserves on its balance sheet.