
Introduce Profit & Loss Statement

Questions asked by owners/managers

- Was it a good year or bad year?
- What was the volume of operations?
- What was the margin available on sales realization?
- The answer...

Profit and Loss Account

Profit and Loss Account

- ❑ A Profit & Loss Account shows a company's earnings and expenses over a given period of time
- ❑ It exclusively summarizes revenue and expenses of the period and shows the net difference i.e., profit or loss of the period
- ❑ It is a part of the final accounts drawn up at the end of the accounting period
- ❑ It establish the net earning of the business

Measurement of Income



- Comparing the revenue from sales against the cost of resources parted with for earning that revenue
- The net difference in this comparison, represents the net income or profit

Revenue

- Broadly, it is the total amount realized from the sale of goods (or provision of services) together with earnings from interest, dividend, rents and other items of income
- It is usually referred to as '*operating income*' and the latter, as '*other income*' or '*non-operating income*'
- **Implication of Realization Principle**
 - If the right to receive that income is created or the time for which the income relates have expired it is accrued income

Characteristics of Revenue

- Normally, generated out of business activities
- Results in inflow of assets (cash or receivable) and outflow of goods or services
- Usually related to a specific period i.e., revenue of one year cannot be included in the revenue of the other year
- Leads to increases in owner(s) equity
- Different from 'profit' or 'net income'

Expense

- The expiration of the assets and the resultant decrease in assets leading to the decrease in owner(s) equity
- Costs incurred and expired in connection with the earning of revenue
- Sacrifice made or resource consumed in relation to the revenues earned during an accounting period
- Costs that have expired during an accounting period are treated as expense
- The expired cost, directly or indirectly related to a given fiscal period

Characteristics of Expense

- Expenses are incurred for the purpose of generating revenue or benefit
- Benefit is usually derived during the same accounting period
- It is related to a particular period. However, the payment of expenses can be made before the recognition of expense or afterwards
- Leads to decreases in owner's equity

More on expenses...

Expenses of a given period are

- Costs and expenses of current accounting period (such as cost of material bought & sold during the same accounting period)
- Costs incurred in a previous accounting period that become expenses or expired costs during this year (such as inventory purchased during the previous period, but unsold during that period and sold during this year)
- Expenses of this year, the monetary outlay for which will be made during a subsequent period (such as rent due for the current accounting period, but is to be paid in the next accounting period)

Expense recognition

Under following circumstances:

- In the period in which there is direct identification or association with the revenue of the period
- An indirect association with the revenue of the period (such as rent, salaries, insurance etc. which are not usually inventoried)
- Measurable expiration of assets (unexpired costs) though not associated with the production of revenue for the current period (such as loss from flood, fire & similar events)
- Assets that become expenses: inventories, prepaid expenses, and long-lived assets

Possible Future Expenses

- Sometimes costs are incurred directly in relation to the revenue of a given accounting period, in subsequent periods
- Amount of expense in question is estimated, relating to an accounting period in order to make a reasonably accurate measurement of the profit or loss of the period
- Example: Provision for bonus
- Bad debt expense
 - Arises out of credit sales
 - Credit Sales → Receivables → Bad Debts

Dividends & Retained Earnings

□ Dividends

- An appropriation of profits among owners → not an expense
- Technically the withdrawals by owners of the business
- In Joint Stock Companies, it is subject to Company Law

□ Retained Earnings

- After subtracting dividends declared from the net profit, any surplus remaining is added to (accumulated) retained earnings. Also referred to as *reserves and surplus*
- Sometimes designated to signify retention of earnings for different future purposes such as redemption of debt (redemption reserve), replacement of assets etc.

Thank You

