

Profit and loss account basics

What is a profit and loss account?

The profit and loss account (p&l) is usually presented as a statement and it shows the trading activity and associated expenditure of an organisation over a defined period of time.

A typical p&l will contain the following:

Sales

This is the turnover of the business, the main source of income from sales of products or services. This figure is always net of taxes as these are payable to the government and do not form part of the income of the business.

Purchases (stock/inventory)

Purchases are the items of stock you buy in order to sell on to customers. A basic accounting principle is that income is exactly matched against the cost of generating that income. In this regard the stock or inventory on hand at the end of the accounting period is always deducted from the total purchases cost. These stock items will be used to generate future sales and will be matched against those sales in the next period.

Sales related expenditure

These costs are those that are directly incurred in the process of making a sale to a customer. They include items such as sales commission, promotional costs and courier charges.

Overheads

Lastly there are the overheads of the business. These are the costs incurred on the rest of the business that is not directly involved with the selling process. Examples of overhead costs are: admin staff salaries, lighting and heating, office stationery, computer maintenance and legal and accountancy fees.

Two versions of the profit and loss account

In published accounts the p&l account has a standard format, this is to aid understanding and interpretation of the information. The accounts are typically known as Financial (or Statutory) accounts and are subject to accounting and legal governing principles.

However, to really understand how your business is performing you need to prepare a fully detailed p&l account, this is an expanded version of the published accounts and usually has extra information such as ratio analysis and key performance indicators.

This version is typically referred to as the 'management accounts' simply because they are figures intended for management and not external publication. Therefore, there are no regulatory guidelines on their composition to worry about.

Management accounts are the tool you need to have in order to see if your business is profitable and are normally prepared on a regular basis, usually monthly, for each of your product lines. The p&l is a central part of the management accounts package.

Regular review is necessary because you need to be aware of areas not meeting targets as soon as possible; so that you give yourself time to take corrective action before the end of your financial year. For instance, if a regular client has started placing orders erratically it may be that on investigation, you find they are testing out one of your competitors. This gives you an opportunity to carry out some special promotions or re-negotiate the deal with your client to win their business back from your competitor.

In addition, you will find budgeting is a valuable tool for your business. A budget is a financial plan for the year ahead. Creation of a budget allows you to review all areas of your business both to ensure their existence is justified and that you are making the most of your assets or resources.

During the year you compare your actual results to your budget and investigate where results have not turned out according to plan. Examples of problems could be cost overruns due to inefficient ordering or use of more expensive components unnecessarily. Again, this review process gives you time to make changes before problem areas run out of control.

About the author:

Trevor Sadowski has worked in finance departments for the past 23 years and has been a member of the Chartered Association of Certified Accountants (ACCA) since 1994.

Trevor currently provides contract accountancy support through short-term placements or interim management in the UK. To find out more, visit his web site at www.moveaheadonline.com