A Guide to Understanding Profit and Loss Accounts

Business Information Factsheet
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Introduction

The profit and loss (P&L) account provides a record of how a business has performed over a specific period, which is usually 12 months for formal accounts and one month for management accounts. It provides a 'snapshot summary of the total income and expenses for that period. It will show a profit if income is greater than expenses, and a loss if expenses are greater than income.

All limited companies that are trading must prepare an annual P&L account to comply with company law. Self-employed sole traders, or anyone who is part of a business partnership, do not have a legal obligation to produce an annual P&L account but will need the information it contains to complete their self-assessment tax return.

The P&L account forms a key part of a firm's annual financial statements and should be viewed alongside the balance sheet to assess the financial performance and strength of a business. See BIF007, A Guide to Understanding Balance Sheets, for more information.

This factsheet outlines what information is typically covered in a P&L account and explains the commonly used terms. It looks at how the P&L account can be used to help manage a business and reviews some of the limitations of P&L accounts.

Why is profit important?

Profit is a simple concept - it is the difference between the income of a business and its expenses. Conversely, a loss occurs when expenses are higher than income. If a business is unable to generate a profit consistently, it will fail once it has exhausted its cash and capital reserves. However, if a business can successfully make a profit, it can fund its growth and any surplus profits can be shared between its owners.

Not-for-profit organisations should also aim to operate with a surplus of income over expenses. This allows them to provide their services and build reserves. This creates a financial buffer for the organisation in the event of an issue occurring that may otherwise result in a trading loss.

It is essential for the owner or manager of a business to measure the level of profitability the business is achieving by regularly reviewing the P&L account.

What does a P&L account cover?

A P&L account shows:

- The **income** for a specific period. This comprises the sales revenue (or turnover) from products or services as well as other sources of income, including the sale of business assets and bank interest received.
- The **business expenses** for the period. This includes the costs associated with sales as well as all other business expenses.
- The **profit or loss** achieved in the period.

P&L accounts are typically prepared for the 12-month period that corresponds to the business' financial year. It is good practice to prepare a monthly P&L account as part of the regular management accounts for the business. In a retail or cyclical business, or at critical times of the year, it may be useful to produce a P&L account for a shorter period such as a week.

Example of a simplified statement of a P&L account

The following table shows how a simplified P&L account can be laid out.

ABC Company Ltd	
Profit and loss account	
Year ended 30 November 2016	
Sales turnover	400,000
less cost of sales	(120,000)
Gross profit	280,000
Administrative expenses	(220,000)
Operating profit	60,000
Tax on profit	(15,000)
Net profit	£45,000

The following key terms are used in P&L accounting:

Sales turnover

This is the invoiced income from the sales of products or services during the period shown in the P&L account (excluding VAT if the business is VAT-registered). It does not represent the actual amount of cash received from customers because some payments may still be outstanding or may have been paid in advance.

Cost of sales

Cost of sales, also known as direct or variable costs, are the costs that can be directly attributed to the production of a particular product or the sale of an item. If a business manufactures tables, for example, the cost of sales will be the cost of the raw materials (wood, glue, tools and machine hire) that are used to produce each table. A large business may show the cost of labour used for production as direct costs, but small firms, which in general do not hire and fire people to keep pace with demand, tend not to do this. For a retail business, the cost of sales is the cost of the stock items being sold. A service business would not usually show a figure for cost of sales.

It is important to note that the cost of sales equates to the cost of producing the goods that have actually been sold, and does not necessarily account for all the payments for raw materials that the business has made in the period. The value of unused raw materials, as well as the value of goods that have been made but not yet sold, will be shown on the balance sheet as stock. The balance sheet is a financial snapshot that summarises the value (assets less liabilities) of the business at a specific point in time, usually the end of the business' financial year. See BIF007, A Guide to Understanding Balance Sheets, for more information.

Gross profit

Gross profit is the difference between sales turnover and the cost of sales. It is often known as the 'contribution', because it contributes towards the overhead costs of the business and, when these are all paid, contributes towards net profit.

Administrative expenses

Administrative expenses cover all operating costs that are not linked directly to producing a product. This includes rent, utilities, insurance and staff costs not recorded under cost of sales. These costs are often referred to as 'overheads'. Generally speaking, they are regarded as fixed costs because they do not rise or fall in direct proportion to output.

Operating profit

Operating profit is also referred to as 'profit before interest and tax'. It is the profit generated after all normal administrative expenses have been deducted.

Tax on profit

Corporation tax is chargeable on the profits of a company and the amount is shown in the distribution account below the P&L account. The actual calculation of the tax due will be adjusted to take account of those expenses not allowed for tax purposes (generally depreciation) and to include those items that are allowed for tax purposes (such as capital allowances). A sole trader or partner will pay income tax on the trading profits so a tax charge is not shown in their P&L account. The tax charge is calculated through their self-assessment tax return instead.

Net profit

Net profit is also referred to as 'profit after tax'. It can either be distributed between the owners of the business or retained and used to fund further growth.

Using a P&L account

Business performance can be monitored by reviewing the P&L account regularly (preferably once a month), together with the balance sheet and the cash book, which records all the money coming in and out of the business. It is useful to produce a forecast P&L account for each year and, ideally, each month. This will help to compare the actual figures the business achieves against the forecast.

By analysing the differences between the two sets of figures - forecast and actual - it is possible to identify what has gone well, such as achieving higher sales, or what might need more attention, such as coping with increased costs. This enables the business owner or manager to take corrective action as soon as possible.

Comparing the performance of a business in the current year against the previous year provides a useful benchmark for demonstrating the progress of the business. It is important to factor in any relevant industry or market trends to get the fullest picture.

The following table compares P&L accounts from two different years for the ABC Company.

ABC Company Ltd			
Profit and loss account			
Year ended 30 November 2016			
	2016	**2015**	**Variance**
Sales turnover	400,000	300,000	100,000
less cost of sales	(120,000)	(80,000)	(40,000)
Gross profit	280,000	220,000	60,000
Administrative expenses	(220,000)	(170,000)	(50,000)
Operating profit	60,000	50,000	10,000
Tax on profit	(12,000)	(10,000)	(2,000)
Profit after tax	48,000	40,000	8,000

The 2016 P&L results for the business are good compared to the previous year. Turnover is up, as are all of the profit indicators (gross, operating and after tax). However, although turnover has increased by 33% between the two years, the profit after tax has increased by only 20%. The figures need further investigation to explain what has happened. A good starting point is to compare the profit figures as percentages of turnover and this is shown in the following table.

	2016	2015	Change
Gross profit	70%	73%	(3%)
Operating profit	15%	17%	(2%)
Profit after tax	12%	13%	(1%)

Looking at the percentages more closely shows that the relative profit has declined against all the profit indicators. A 13% profit after tax in 2016 would have generated £52,000 rather than the £48,000 actually achieved. The net effect is that in 2016 the business has made £4,000 less profit than might have been expected if it had achieved the same level of profitability that it did in

2015. Although the change is small, it is important to find out why this is happening and whether it is a one-off occurrence or a trend. Questions to ask include:

- Are selling prices under pressure from competitors?
- Are raw material prices increasing faster than selling prices?
- Why have overhead costs increased so quickly?

Considering these questions will help with gathering critical information and deciding on a strategy to improve profitability.

Developing a more detailed P&L account

The P&L account for ABC Company Ltd shown above is typical of the format of formal annual accounts prepared by accountants. However, it may be that more detailed information is required for regular monthly management accounts, which will help problems to be identified more quickly.

It is good practice to retain the P&L framework described above, but more detail can be added under each of the sections to suit the particular needs of a business. For example, sales turnover could be split by showing income for each of the main product lines. The cost of sales could be split in a similar way. Administrative expenses could be divided into a number of categories, such as staff, premises, marketing and finance costs.

Using accrual accounting in a P&L account

One of the basic principles of accounting is to match income and expenses to the period being reported. This is known as accrual accounting and will give the most accurate assessment of net profit for the period.

Most businesses record income and expenses in their P&L account based on the date of the sales or purchase invoice, rather than the date that cash is received or paid. While in many situations this system is satisfactory, there are occasions, particularly around the year end, when it can lead to an over- or understatement of profit. Using a year-end date of 30 November, the following examples will help to explain the impact of this principle.

- **Income deferral.** An IT business issues an invoice for £10,000 on 30 November for annual licence fees and technical support, which start on 1 December. If the invoice date is used to account for the income, it will increase the recorded turnover in the current year by £10,000. However, the service does not begin until the next accounting period and the costs of providing the service (ie staff time) will be incurred in that period. The income should therefore be deferred until the next accounting period, which will reduce the reported income in the current year by £10,000. In this particular instance, it would probably be better to date the invoice 1 December.
- **Expense accrual.** Accountants' fees are typically charged and invoiced after the year end. However, the cost can be attributed to the current year and an accrued provision for those costs can be included in the administrative expenses for that year. As a result, the profit will be reduced by the fees, even though an invoice has not been received in the current year.
- **Expense prepayment.** Some costs, such as rent, are invoiced and paid for in advance. A rent invoice for £6,000 dated 30 November covers the period 1 December to 28 February.

If the invoice date is used to account for the cost, profits in the current financial year will be reduced by £6,000. However, as the rent period covered by the invoice is for the next accounting period, the cost should be attributed to the next accounting period. The full amount should be classed as a prepayment in the current year.

It is useful for a business owner to discuss with their accountant whether accrual accounting will be a significant issue for their business. It may need to be taken into account when preparing regular management accounts, or it could be that the income and expenses of the business are quite straightforward and that only minor adjustments will be required when its year-end accounts are prepared. If annual accounts are prepared using accrual accounting, monthly P&L accounts should also be prepared on this basis.

Limitations of P&L accounts

While the P&L account is very important in providing an understanding of how a business is performing, it has limitations.

The P&L account shows the profit of a business but it does not show the cash position. While it is important to ensure that a business is making a profit, it is also vital to ensure that the business does not run out of cash. This is quite easy to do if sales are poor or if they are much better than forecast but everything is sold on credit. It is therefore essential that when regular forecasts are prepared for a business, a cash flow forecast is included with a P&L projection. See BIF058, How to Forecast Cash Flow, for more information.

The P&L account does not show the solvency of a business: this can only be determined from the balance sheet. A business with a strong balance sheet may be able to survive a long period of losses, while a weak balance sheet may cause a business to fail very quickly once it starts making trading losses.

The P&L account does not account for all payments made by the business. The full costs of assets that have a useful life of more than a year are not shown in the P&L account. However, the depreciation charge for an asset is shown in the P&L account, which allows for the cost of the asset to be spread over its useful life. See BIF041, Understanding and Calculating Depreciation, for more information.

Hints and tips

- Accounting software is a great help in producing regular P&L information as long as all sales and purchase data are processed promptly and accurately.
- When setting up an accounting system, professional advice should be taken for categorising the different types of income and expenses so that the information for the P&L account is easy to compile.
- When reviewing a company's accounts, the notes that accompany financial statements should be read for an explanation of the policies that have been used to compile the accounts.
- VAT should not be included in P&L account figures once a business is VAT-registered. The output tax (ie VAT on sales) is exactly equal to the input tax (ie tax on purchases) plus the tax paid over to HMRC. In other words, VAT-in plus VAT-out exactly balances, with no benefit or

deficit to the business. It is likely, however, that there will be a balance of VAT owing to or from HMRC, and this will be shown on the balance sheet.

- While producing a P&L account is very useful, it is essential to understand the story the figures are telling. Professional advice should be sought to explain exactly how to interpret P&L accounts.

Further information

BIF007 A Guide to Understanding Balance Sheets
BIF009 An Introduction to Understanding Financial Ratios
BIF024 Keeping Sales and Purchase Ledgers
BIF041 Understanding and Calculating Depreciation
BIF058 How to Forecast Cash Flow
BIF069 A Guide to Preparing and Submitting Company Accounts to Companies House
BIF260 An Introduction to Preparing a Budget

Useful contacts

The Institute of Chartered Accountants in England and Wales (ICAEW) is a membership organisation for accountants. It has a searchable directory of accountants on its website.
Tel: (01908) 248250
Website: www.icaew.com

The Institute of Chartered Accountants of Scotland (ICAS) is a membership organisation for accountants in Scotland. Its website includes a directory of Chartered Accountants in Scotland.
Tel: (0131) 347 0100
Website: www.icas.org.uk

Chartered Accountants Ireland represents accountants in Ireland and offers a 'find a member' facility on its website.
Tel: (028) 9043 5840 (Northern Ireland office)
Website: www.charteredaccountants.ie

The Association of Chartered Certified Accountants (ACCA) is a membership association for accountants. It offers a 'find an accountant' facility on its website.
Tel: (0141) 582 2000
Website: www.acca.org.uk

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