The Profit & Loss Account Accounting for Revenue & Expenses

Chapter 3

Profit & Loss Account

The main reason why people set up in business is to make a profit. The profit and loss account shows whether the business is successful in this regard. The calculation of profit follows the following formula

Revenues - Expenses = Profit or Loss

Profit & Loss Account

Product Provider	€	€
Sales		100,000
Less Cost of sales		(10,000)
Gross Profit		90,000
Add Rent Received		5,000
Less expenses		
Rent payable	20,000	
Rates	5,000	
Wages and Salaries	25,000	
Repairs	3,500	
Advertising	5,000	
Consultancy fees	12,000	
Insurance	10,000	
Phone	1,500	(82,000)
Net Profit		13,000

Profit & Loss Account

Service Provider	€	€
Sales		**100,000**
Less expenses		
Rent	18,000	
Rates	5,000	
Wages and Salaries	40,000	
Repairs	3,500	
Advertising	5,000	
Accountants’ fees	2,000	
Solicitors’ fees	1,000	
Insurance	7,000	
Phone	1,500	83,000
Net Profit		**17,000**

Revenue

Revenues are income earned (not necessarily received) from the sales of the products or services provided by the business.

Revenue Samples

A separate account is opened for each

- Sales
- Rental income
- Commission received

Expenses

Expenses are the costs incurred in running the business on a day to day basis and thus do not include the cost of purchasing fixed assets or repayment of any loans. Expenses are the cost of using the resources available to the business to produce a product or service and sell it.

Expense Samples

A separate account is opened for each expense

- Rent account
- Wages account
- Salaries account
- Telephone account
- Postage account
- Stationery account
- Insurance account
- Motor expenses account
- General expenses account

Double-entry for Revenue and Expenses

Double-entry for Revenue and Expenses

Up to this the double entry system accounted only for assets liabilities and capital (the balance sheet entries) with a debit representing assets and a credit representing liabilities and capital.

This representation is now extended to include both revenues and expenses (the profit and loss entries)

Expenses are debit entries while revenue is a credit entry.

Example

Returning to Fred Smith who has just set up a business retailing in fruit and vegetables from a stall in a market under the banner of ‘Fred’s Veggies’.

Fred has incurred a number of expense and revenue transactions during the first week in July.

Transaction 1 – Payment of Insurance

Fred has had to pay an insurance premium of €375 by cheque on the 1st July

DR		Insurance Account			CR
1Jul	Bank a/c	€375			

DR		Bank Account			CR
			1Jul	Insurance a/c	€375

Transaction 1 – Payment of Rent

Fred has entered a rental agreement to occupy a stall in a market paying €800 by cheque on 1 July

DR			Rent Payable Account		CR
1 Jul	Bank a/c	€800			

DR			Bank Account		CR
			1 Jul	Rent Payable a/c	€800

Transaction 2 - Insurance

Fred has had to pay an insurance premium of €375 by cheque on 1 July

DR		Insurance Account			CR
1 Jul	Bank a/c	€375			

DR		Bank Account			CR
			1 Jul	Rent Payable a/c	€800
			1 Jul	Insurance a/c	€375

Transaction 3 – Advertising

On the On 2 July Fred arranged for promotional leaflets to be produced and distributed to market his new stall and pays €250 by cheque

DR			Bank Account		CR
			1 Jul	Rent Payable a/c	€800
			1 Jul	Insurance a/c	€375
			2 Jul	Advertising a/c	€250

DR			Advertising Account		CR
2 Jul	Bank a/c	€250			

Transaction 4 – Rent Received

On the 3nd July Fred agreed to sub-let a small portion of his stall and received a cheque for €40

Bank Account

DR			CR		
3Jul	Rent received a/c	€40	1 Jul	Rent Payable a/c	€800
			1 Jul	Insurance a/c	€375
			2 Jul	Advertising a/c	€250

Rent Received Account

DR			CR		
			3Jul	Bank a/c	€40

Double-entry for Stock

The Asset of Stock

Usually goods are sold at a price higher than the purchase price.

The Stock Account is shown as four separate accounts:

- A purchases account
- A purchases returns (returns in) account
- A sales account
- A sales returns (returns outwards) account

Summary of Stock

TRANSACTIONS APPEAR ON:

Purchases account – Debit
Sales account – Credit

Purchases returns account – Credit
Sales returns account - Debit

Example

Fred Smith has just set up a business retailing in fruit and vegetables from a stall in a market under the banner of ‘Fred’s Veggies’. The following transactions are a sample from Fred’s first week of trading.

Cash & Credit Purchases

Cash Purchases

- Debit = Purchases a/c
- Credit = Cash or Bank a/c

Credit Purchases

- Debit = Purchases a/c
- Credit = Creditors a/c

Then

- Debit = Creditors a/c
- Credit = Cash or Bank a/c

Transaction 1 - Cash Purchases

Fred bought stock of fresh fruit and vegetables from a supplier paying €500 by cheque on the 1st July.

DR		Purchases Account			CR
1Jul	Bank a/c	€500			

DR		Bank Account			CR
			1Jul	Purchases a/c	€500

Transaction 2 - Credit Purchases

On the 2nd July Fred bought stock of vegetables amounting to €750 from a Market Suppliers, a wholesale business, who agreed to grant Fred credit.

DR		Purchases Account			CR
1Jul	Bank a/c	€500			
2Jul	Market Suppliers a/c	€750			

DR		Creditor (Market Suppliers) Account			CR
			2Jul	Purchases a/c	€750

Transaction 3 – Purchases Returns

On the 3nd July Fred returned €100 of sub-standard vegetables to Market Suppliers, and received an allowance for the full amount.

DR		Creditor (Market Suppliers) Account			CR
3Jul	Purchases Rtns a/c	€100	2Jul	Purchases a/c	€750

DR		Purchases Returns Account			CR
			3Jul	Market Suppliers a/c	€100

Cash & Credit Sales

Cash Sales

- Debit = Cash a/c
- Credit = Sales a/c

Credit Sales

- Debit = Debtors a/c
- Credit = Sales

Then

- Debit = Cash a/c
- Credit = Debtors a/c

Transaction 4 – Cash Sales

Fred sold stock of fresh fruit and vegetables for cash totalling €880 on the 4th July.

DR		Cash Account			CR
4Jul	Sales a/c	€880			

DR		Sales Account			CR
			4Jul	Cash a/c	€880

Transaction 5 – Credit Sales

On the 5th July Fred sold stock of vegetables amounting to €260 to the ‘Dame Café’ on credit.

DR — **Debtor (Dame Café) Account** — **CR**

5Jul	Sales a/c	€260			

DR — **Sales Account** — **CR**

			4Jul	Cash a/c	€880
			5Jul	Dame Cafe a/c	€260

Transaction 6 – Sales Returns

On the 6th July a customer returned vegetables amounting to €15 to Fred and received a cash refund.

DR	Sales Returns Account				CR
6Jul	Cash a/c	€15			

DR	Cash Account				CR
			6Jul	Dame Cafe a/c	€15

Summary of credit transactions

Credit purchases transactions involve:

- A stock purchases account
- A creditors account

Credit sales transactions involve:

- A stock sales account
- A debtors account

Summary

Owner invests new capital in the business	DR Bank a/c CR Capital a/c
Owners withdraws cash own personal use	DR Drawings a/c CR Cash a/c
Purchase stock paying by cheque	DR Purchases a/c CR Bank a/c
Sold goods for cash	DR Cash a/c CR Sales a/c
Paid rent by cheque	DR Rent a/c CR Bank a/c
Purchase stock on credit from A Dunne	DR Purchase a/c CR A. Dunne a/c
Paid rates by cheque	DR Rates a/c CR Bank a/c
Paid advertising bill by cheque	DR Advertising a/c CR Bank a/c
Purchased vehicle paying by cheque	DR Vehicles a/c CR Bank a/c
Paid for petrol for motor vehicle	DR Motor exps a/c CR Bank a/c
Bought equipment on credit from OE Ltd	DR equipment a/c CR OE Ltd
Repairs to equipment paid for by cheque.	DR Repairs a/c CR Bank a/c
Paid light and heat bill by cheque	DR Light and heat a/c CR Bank a/c
Paid wages by cheque	DR Wages a/c CR Bank a/c

The Effect of Profit on Capital

During the first week of March the total stock which cost €5,000 was sold for €8,000 making a profit of €3,000. The monies were received and banked immediately.

Balance Sheet as at	**1 March**	**7 March**
Assets	€	
Premises	100,000	100,000
Equipment	56,000	56,000
Stock	5,000	0
Debtors	10,000	10,000
Bank	3,000	11,000
	174,000	177,000
Liabilities		
Creditors	11,000	11,000
Loans	87,000	87,000
	98,000	98,000
	76,000	**79,000**
Capital	76,000	76,000
Profit	0	3,000
	76,000	**79,000**

The Effect of a Loss on Capital

During the first week of March the total stock which cost €5,000 was sold for €3,000. The monies were received and banked immediately. In this situation a loss of €2,000 is made.

Balance Sheet as at	**1st March**		**7th March**
Assets	€		
Premises	100,000		100,000
Equipment	56,000		56,000
Stock	5,000	→	0
Debtors	10,000	→	10,000
Bank	3,000	→	6,000
	174,000		172,000
Liabilities			
Creditors	11,000		11,000
Loans	87,000		87,000
	98,000		98,000
	76,000		**74,000**
Capital	76,000		76,000
Loss	0	→	-2,000
	76,000		**74,000**

Accounting Concepts

Money Measurement Concept

- The assets of the business must be measured in some uniform way, in some monetary form.
- Some assets of the business cannot appear on the balance sheet of a company because to put a monetary value on them would be too subjective.

Cost/Current Value Concept

- In presenting financial statements a measurement basis must be chosen for each category of asset and liability. The choice is:
  - **Historical cost:** This is where the asset or liability is valued at its initial transaction cost. This may be subsequently re-measured if the recoverable amount of the asset is lower than cost.
  - **Current value:** This is where the asset is valued based on its current value at the time it was acquired. Assets and liabilities measured on the current value basis are carried at up-to-date current values and thus will be re-measured frequently. Re-measurement however will only be recognised if there is sufficient evidence that the monetary values of the asset /liability has changed and the new amount can be measured with sufficient reliability.

Going Concern Concept

- In preparing the accounts it is assumed that the business will continue into the foreseeable future.
- This ensures the basis of measuring and valuing assets and liabilities will remain at either cost or current value.
- If the accounts were to be prepared on the basis that the business was to be sold or about to go into liquidation then an alternative basis for valuing the assets would have to be considered including the break-up values for assets.
- Thus unless the business entity is in liquidation or the directors have no alternative but to cease trading then the going concern basis will apply and all assets and liabilities will be valued at historic cost or current value, whichever is appropriate.

Realisation Concept

- The concept clarifies when a business accounts for a transaction and thus the related profits or losses on the transaction.
- There are three clear stages in the life of a transaction;
  - The order stage
  - The transfer of goods and acceptance of liability by the purchaser
  - The payment or cash stage
- Holds to the view that a transaction should be accounted for at the transfer of goods and acceptance of liability stage *not* at the order stage.
- Tells when to recognise the profits or loss on a transaction.
- States that profits or losses on transactions can only be accounted for when realisation has occurred.
- Essential that all businesses account for transactions on the same basis.

The accruals concept

The calculation of profit is based on the accruals concept and knowledge of this concept is essential in understanding the net profit figure and the differences between cash and profit.

key issues

When calculating net profit expenses should be matched against related revenues. In the trading account of a product based company expenses are matched to sales on a unit basis, and in the profit and loss account expenses are matched on a time basis. For a service company all expenses are matched on a time basis.

Net profit is the difference between revenues earned (not necessarily received) and expenses charged (not necessarily paid). Thus net profit is worked on a transactions basis. Transactions are matched, checking that all costs incurred in earning the periods revenue have been included whether paid or not

This is also consistent with the realisation concept which states that transactions are accounted for when they have issued or have been issued an invoice not necessarily when cash is received. Many business that buy and sell on credit, sales and purchases in the trading, profit and loss account will be a mixture of cash and credit transactions. Also, some expenses will not have been paid by the year-end however they are still included as expenses in the profit and loss account irrespective of whether they are paid or not. Any unpaid expenses will also be shown in the balance sheet under liabilities.

Sales in the trading account is made up of cash sales and credit sales.

Debtors in the balance sheet will be made up of credit sales for which monies have not been received by the end of the period.

Purchases in the trading account is made up of cash and credit purchases.

Trade creditors in the balance sheet will be made up of credit purchases for which no payment has been made by the period end.

Expenses in the profit and loss account are made up of expenses paid and expenses owed

Expenses owed at the year-end will be shown in the balance sheet under current liabilities