# FINANCIAL ACCOUNTING (LECTURE # 8)

## LEARNING OBJECTIVE

- After studying this chapter, you will be able to:
  - Draw up Profit & Loss account from the information given in trial balance.
  - Differentiate the term, Receipt & Payment, Income & Expenditure and Profit & Loss account.

## FINANCIAL STATEMENTS

- Every business is carried out to make profit. If it is not run successfully, it will sustain loss. The calculation of such profit & loss is probably the most important objective of the accounting function. Such information is acquired from "Financial Statements".
- Financial Statements are the end product of the whole accounting process. These show us the profitability of the business concern and the financial position of the entity at a specified date.
- The most commonly used Financial Statements are 'profit & loss account' 'balance sheet' & 'cash flow statement'.

## PROFIT & LOSS ACCOUNT

- Profit & Loss account is an account that summarizes the profitability of the organization for a specific accounting period.
- Profit & Loss account has two parts:
  - In the first part, Gross Profit is calculated.
  - Gross profit is the excess of sales over cost of goods sold in an accounting period.
  - In trading concern, cost of goods sold is the cost of goods consumed plus any other charge paid in bringing the goods in salable condition. For example, if business purchased certain items for resale purpose and any expense is paid in respect of carriage or bringing the goods in store (transportation charges). These will also be grouped under the heading of 'cost of goods sold' and will become part of its price.
  - In manufacturing concern, cost of goods sold comprises of purchase of raw material plus wages paid to staff employed for converting this raw material into finished goods plus any other expense in this connection.
  - In the $2^{nd}$ part, Net Profit is calculated.
  - Net Profit is, what is left of the gross profit after deducting all other expenses of the organization in a specific time period.

### How to prepare Profit & Loss account

- One way is to write down all the Debit and Credit entries of Income and Expense accounts in the Profit and Loss. But it is not sensible to do so.
- The other way is that we calculate the net balance or we can say Closing Balance of each income and expense account. Then we note all the credit balances on the credit side and the entire debit balances on the debit of profit and loss.
- If the net balance of profit and loss is Credit (credit side is greater than debit side) it is Profit and if the net balance is Debit (Debit side is greater than credit side) it is a loss.

# FINANCIAL ACCOUNTING (LECTURE # 8)

**Income, expenditure, profit and loss**

- Income is the value of goods and services earned from the operation of the business. It includes both cash & credit. For example, if a business entity deals in garments. What it earns from the sale of garments is its income. If somebody is rendering services, what he earned from rendering services is his income.
- Expenses are the resources and the efforts made to earn the income, translated in monetary terms. It includes both expenses, i-e, paid or to be paid (payable). Consider the above-mentioned example, if any sum is spent in running the garments business effectively or in provision of services, are termed as expenses.
- Profit is the excess of income over expenses in a specified accounting period.

  Profit= Income-expenses

  In the above mentioned example, if the business or the services provider earn Rs. 100,000 & their expenses are Rs. 75,000. Their profit will be Rs. 25,000 (100,000-75,000).
- Loss is the excess of expenses over income in a specified period of time. In the above example, if their expenses are Rs. 100,000 & their income is Rs. 75,000. Their loss will be Rs. 25,000.

**RULES OF DEBIT & CREDIT**

- Increase in expense is Debit (Dr.)
- Decrease in expense is credit (Cr.)

- Increase in income is credit (Cr.)
- Decrease in income is Debit (Dr.)

**Classification of expenses**

- It has already be mentioned that a separate account is opened for each type of expense. Therefore, in large business concerns, there may exist large number of accounts in organization's books.
- As profit & loss account is summarized record of the profitability of the organization. So, similar accounts should be grouped for reporting purposes.
- The most commonly used groupings of expenses are:
  - COST OF GOODS SOLD
  - ADMINISTRATION EXPENSES
  - SELLING EXPENSES
  - FINANCIAL EXPENSES

- Cost of goods sold is the cost incurred in purchasing or manufacturing the product, which an organization is selling plus any other expense incurred in bringing the product in salable condition. Cost of goods sold contain the following heads of accounts:
  - Purchase of raw material/goods
  - Wages paid to employees for manufacturing of goods
  - Any tax/freight is paid on purchases
  - Any expense incurred on carriage/transportation of purchased items.
- Administrative expenses are the expenses incurred in running a business effectively. Main components of this group are:

  - Payment of utility bills
  - Payment of rent
  - Salaries of employees
  - General office expenses
  - Repair & maintenance of office equipment & vehicles.
- Selling expenses are the expenses incurred directly in connection with the sale of goods. This head contains:
  - Transportation/carriage of goods sold
  - Tax/freight paid on sale
- If the expense head 'salaries' includes salaries of sales staff. It will be excluded from salaries & appear under the heading of 'selling expenses'.
- Financial expenses are the interest paid on bank loan & charges deducted by bank on entity's bank accounts. It includes:
  - Interest on loan
  - Bank charges

**Receipt & Payment Account**

- A receipt & payment account is the summarized record of actual cash receipts and actual cash payment of the organization for a given period of time. This is a report that provides cash movement during the reported period. In other words, it can be defined as the summarized record of the cashbook for a specific period.

**Receipt & Payment Vs. Profit & Loss Account**

- Receipt & payment account is the summarized record of actual cash receipts and actual cash payment during the period while profit & loss account includes incomes & expense both paid and payable.

**Income & expenditure Vs. Profit & Loss Account**

- These are two similar terms. Only difference between these two terms is that income & expenditure account is prepared for non profit organizations, e.g. Trusts, N.G.O's, whereas profit & loss account is prepared in profit oriented organizations, e.g. Limited companies, Partnership firms etc.