Financial Accounting Homework

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Profit and Loss Account

The profit and loss account looks at how well the firm has traded over the time period concerned (usually the last 6 months or year). It basically shows how much the firm has earned from selling its product or service, and how much it has paid out in costs (production costs, salaries and so on). The net of these two is the amount of profit they've earned.

A profit and loss account would usually be made up as follows: -

	£ Million
Turnover (sales revenue)	500
Less Cost of goods sold	(200)
Gross profit	300
Less other costs @	(100)
Trading / operating profit	200
****	
Profit for shareholders (dividends)	75
Retained profit	125

These other costs may include marketing and dis tribution costs, office costs and so on. They are also known as indirect costs or overheads.

****** In here may also be included any other income or expenses. These may include interest - paid or received - tax, extraordinary items (profits from selling assets or parts of the company) and so on.**

The final retained profit figure is the one that goes to the balance sheet as a source of funds for the company to use.

This retained profit may be used to buy fixed assets (machinery, equipment etc.) or it may remain as current assets (cash in the bank perhaps).

The purpose of the profit and loss account is so that business owners can see how much profit they have made at the end of the trading year. The size of the profit may be a guide to the performance of the business.

The limitations of the profit and loss account are that the accounts can't be used to show what is going to happen in the future. Also stakeholders who are very interested in the accounts must be aware that it is possible to disguise or manipulate financial information in the accounts. For example a business may attempt to hide its profits to reduce tax or to deter a potential takeover. Furthermore a business may try to show a greater profit to satisfy shareholders.

The Balance Sheet

The balance sheet is one of the financial statements that limited companies and PLCs produce every year for their shareholders. It is like a financial snapshot of the company's financial situation at that moment in time. It is worked out at the company's year-end, giving the company's assets and liabilities at that moment.

It is given in two halves - the top half shows where the money is currently being used in the business (the net assets), and the bottom half shows

where that money came from (the capital employed). The value of the two halves must be the same - Capital employed = net assets, hence the term balance sheet.

The money invested in the business may have been used to buy long-term assets or short-term assets. The long-term assets are known as fixed assets, and help the firm to produce. Examples would be machinery, equipment, computers and so on, none of which actually get used up in the production process. The short-term assets are known as current assets - assets that are used day to day by the firm. The current assets may include cash, stocks and debtors.

The top half of the balance sheet will therefore be made up of the total of the fixed and current assets, less any current or long-term liabilities the firm may have (creditors, loans and so on). It may look as follows: -

			£ Million
Fixed assets			200
Current assets	- Stock	40	
	- Debtors	50	
	- Cash	<u>20</u>	
	TOTAL	110	
Less Current liabilities		(40)	<u>70</u>
NET ASSETS			£270m

The bottom half of the balance sheet then looks at where this money came from. This depends on how the business was originally funded. The main source of money for a limited company starting up is the issue of shares. This is termed the share capital - the money the original shareholders put into the business. From then on the assets of the company may be built up by ploughing profit back into the business.

This is called retained profit, and is the other source of money usually included in the bottom half of the balance sheet.

This may therefore look as follows:

Share capital	**100**
Retained profit	**170**
CAPITAL EMPLOYED	**£270m**

The balance sheet has a number of uses for a business.

- **In general, it provides a summary and valuation of all business assets, capital and liabilities.**
- **The balance sheet can be used to analyse the asset structure of a business. It can show how the money raised by the business has been spent on different types of asset.**
- **Also looking at the value of working capital can indicate whether a firm is able to pay its everyday expenses or is likely to have problems. The value of working capital is the difference between current assets and liabilities.**
- **A balance sheet may provide a guide to a firm's value. Generally, the value of the business is represented by the value of assets less any money to outside agents such as banks or suppliers.**

The limitations of the balance sheet could be:

- **The value of many assets listed in the balance sheet may not reflect the amount of money the business would receive if it were sold. For example, foxed assets are listed at costs less an allowance for depreciation. However, accountants estimate the depreciation allowance. If estimates are inaccurate, the value of assets will also be inaccurate.**
- **It can also lack detail, many of the figures are totals and are not broken down.**