3.4 b) Final accounts: The profit & loss account (AO2, AO4)

- The profit and loss account shows a firm's profit (or loss) after all production costs have been subtracted from the organisation's revenues, each year.
- It is also known as the statement of profit or loss or income statement. The prescribed IB format for the profit and loss account for profit-making entities is shown below:

Format of the P&L account for a for-profit organization	
Statement of profit or loss for (Business name), for the year ended (date)	
	\$m
Sales revenue	700
Cost of sales	(350)
Gross profit	350
Expenses	(200)
Profit before interest and tax	150
Interest	(10)
Profit before tax	140
Тах	(25)
Profit for period	115
Dividends	(35)
Retained profit	80

- Sales revenue is the money an organization earns from selling goods and services. It can also include other revenue streams.
- Costs of sales (COS) are the direct costs of production, such as the cost of raw
 materials, component parts, and direct labour. COS are sometimes referred to as cost of
 goods sold, i.e., the cost of production paid by the business for the goods and services
 that it sells.

The formula for calculating COS is: Opening stock + Purchases – Closing stock.

- **Gross profit** refers to the profit from a firm's everyday trading activities. It is calculated by the formula: Sales revenue Cost of sales.
- Expenses are a firm's indirect costs of production, e.g. rent, management salaries, marketing campaigns, accountancy fees, bank interest charges, travel expenses, utilities, repairs and maintenance, and general insurance. Note that both interest and tax are not included in this section of the P&L account, despite being expenses. This is because both interest and tax costs that the firm has no control over as interest rates and tax rates are determined by the government. By excluding these expenses in this part of the P&L, it is easier to make historical, inter-firm and international comparisons.
- The profit before interest and tax section of the P&L shows the value of a firm's profit (or loss) before deducting interest payments on loans and taxes on corporate profits.
- The profit for period section of the P&L account shows the actual value of profit earned by the business after all costs have been accounted for, i.e., profit after interest and tax.
 The profit (after interest and tax) belongs to the owners of the business, so can then be distributed between the shareholders/owners and/or bee kept in the business as a source of internal finance.
- **Tax** refers to the compulsory deductions paid to the government as a proportion of a firm's profits. In the above example, corporation tax is 10% of a company's profits.

- **Dividends** are the payments from a company's profit (after interest and tax) paid to the shareholders (owners) of the company. The amount of dividends paid to shareholders as a whole is determined by the company's board of directors. The amount of dividends paid to an individual shareholder depends on the number of shares held by the individual.
- Any funds left over from profits (after interest and tax) that is not paid to shareholders is kept within the business for its own use. This is called retained profit. It is a vital internal source of finance for most businesses. Retained profit is is important for assessing the profitability of a business over a specific period of time, usually one year. It is calculated as by using the formula: Retained Profit = Profit after interest and tax – Dividends.

Note: Where profit and loss account is given in case studies or examination questions, it will be presented in the prescribed format shown above. Students need to be familiar with this layout, which is not provided as a template in the formula sheet. Despite various names for this set of final accounts, the term to be used in IB assessment in the presentation of the profit and loss account (or income statement) is statement of profit or loss.

Top tip 1!

Retained profit appears in both the profit and loss account (income statement) and balance sheet (statement of financial position):

- Balance sheet: retained earnings is recorded as a source of equity. This is the cumulative
 amount of profit (after deductions for interest, tax, and dividend payments) that has been
 retained and accumulated by the business.
- Profit and loss account: retained profit (after taxes have been deducted and dividends have been distributed).

totament of musik and are four (name of NDO) fourther was and of (data)	
tatement of profit or loss for (name of NPO), for the year ended (date)	
	\$m
Sales revenue	700
Cost of sales	(350)
Gross surplus	350
Expenses	(200)
Surplus before interest and tax	150
Interest	(10)
Surplus before tax	140
Тах	(0)
Surplus for period	140
Retained surplus	140

Source: adapted from Business Managen	nent guide, page 60 (May 2022)	
Top tip 2!		
and "surplus" for non-profit entities. This of for-profit organizations, such as entrep entitled to a share of any profit earned by	pt within the business for its operations, rathe	rs
For-profit entities	Non-profit entity	
Gross profit	Gross surplus	

Profit before interest and tax	Surplus before interest and tax
Profit before tax	Surplus before tax
Profit for period	Surplus for period
Retained profit	Retained surplus

One other important difference to note is that dividends are not recorded in the P&L for non-profit entities. This is because dividends are distributed to owners of for-profit businesses as a financial reward for their investment in the limited liability company.

Some non-profit social enterprises may have to pay taxes. This is because they are not registered as charities in their respective jurisdictions. Qualifying as a charity (which is beyond the scope of the IB syllabus) will depend on complying with each country's specific and unique laws and regulations.

Top tip 4!

As stated in the guide, the profit and loss account needs to be taught to AO2 and AO4 (page 29). Hence, this term must be referred to when teaching and learning this component of Unit 3.4.

However, when constructing or presenting the profit and loss account in the external assessments, the term "statement of profit or loss" should be used as the heading (page 59).

So, this means that students can refer to the "profit and loss account" in their written responses to a question in the exams, but not for the title when constructing or presenting this as a set of final accounts.

Key terms

- Costs of sales (COS) are the direct costs of production, such as the cost of raw materials, component parts, and direct labour.
- Dividends are the payments from a company's profit (after interest and tax) paid to the shareholders (owners) of the company.
- Expenses are a firm's indirect costs of production, e.g. rent, salaries, marketing, accountancy fees, bank interest charges, utility bills, repairs and maintenance, and general insurance.
- Gross profit refers to the profit from a firm's everyday trading activities.
- The profit and loss account (also known as the statement of profit or loss or income statement) shows an organization's profit (or loss) after all costs have been subtracted from the organization's revenues, each year.

- The profit before interest and tax section of the P&L shows the value of a firm's profit (or loss) before deducting interest payments on loans and taxes on corporate profits.
- The profit for period section of the P&L account shows the actual value of profit earned by the business after all costs have been accounted for, i.e., profit after interest and tax.
- Sales revenue is the money an organization earns from selling goods and services.
- Retained profit refers to the funds remaining from a firm's profit (after interest and tax)
 that is not paid to shareholders but kept within the business for its internal use.
- Tax refers to the compulsory deductions paid to the government as a proportion of a firm's profits.

Balance sheet (AO2, AO4)



- The balance sheet (also known as the statement of financial position) is an essential set of final accounts that shows the value of an organization's assets, liabilities, and the owners' investment (or equity) in the business at a particular point in time. Hence, the balance sheet is often referred to as a "snapshot" of a firm's financial position, indicating its financial health. The reporting date of the balance sheet for an organization is the same each year.
- Assets are the possessions of a business that have a monetary value. Assets are owned by a business. Typical examples include: buildings, land, machinery, equipment, stock (inventory), and cash.
- **Liabilities** are the debts of a business, i.e., the money owed to others. Typical examples include any money owed to financiers (such as commercial banks), trade creditors, and the government (for corporation tax).

- Essentially, a balance sheet must show two important things:
- the organization's *sources of finance*, including borrowed funds (part of its liabilities) and equity (internal finance invested by shareholders, and any accumulated retained earnings).
- the organization's uses of finance, i.e. how the business has used its sources of finance, such as the purchase of non-current assets (also referred to as non-current assets) and current assets for trading.

So, the balance sheet is so called as a firm's uses of finance must match its sources of finance.

Note that where balance sheets are given in case studies or IB examination questions, they will be presented in the format shown below. Students must be familiar with these layouts - they are <u>not</u> included in the formulae sheet in the final external examinations.

Please note that the term to be used in external assessments for the presentation of the balance sheet should be called the "statement of financial position".



An explanation of the terms appearing in the balance sheet is provided below.

- Non-current assets are the long-term assets or possessions of an organization with a
 monetary value but are not intended for resale within the next twelve months of the
 balance sheet date. Instead, the non-current assets are used over and over again as part
 of the organization's operations. Typical non-current assets include buildings, plant
 (production facilities), equipment, machinery, and vehicles.
- The value of most non-current assets falls in value over time due to depreciation. Hence, the balance sheet includes "accumulated depreciation" (of non-current assets) to calculate the net value of the organization's non-current assets at the point of constructing the balance sheet. Non-current assets are generally highly illiquid assets. These items of value, owned by the business, cannot be sold quickly, are difficult to sell, and/or cannot be sold easily without incurring a significant loss in value.



Buildings and machinery are examples of non-current assets

Current assets are possessions of an organization with a monetary value, but intended to be liquidated (turned into cash) within twelve months of the balance sheet date. These include cash (in hand and at the bank), debtors, and stocks (inventory):

- 1. **Cash** refers to the money an organization has either "in hand" (at its premises) and/or "at bank" (i.e. in its bank account). Cash is the most liquid of current assets and is easily accessible to the business.
- Debtors are a type of current assets, referring to individual or business customers
 that owe money to the organization because they have bought goods or services
 on trade credit. The usual trade credit period is between 30 and 60 days.
- 3. **Stocks (also known as inventories)** are the goods that a business has available for sale, per time period. Stocks are intended to be sold as quickly as possible, thereby generating cash for the business.

In turn, stocks (inventories) can be categorized in three ways:

- Raw materials are the natural resources used in the production process to create goods and provide services to customers.
- Work-in-progress (also referred to as semi-finished goods) are parts and components of a final product in the production process. They are the items that are in the process of being produced in order to sell to customers.
- **Finished goods** are the final products, ready for sale to customers. These products are of most value to customers.

Total assets are simply the sum of non-current assets and current assets.

Current liabilities are the short-term debts of a business, which need to be repaid within twelve months. Typical examples include bank overdrafts, trade creditors, and other short-term loans.

- Bank overdrafts allow customers to temporarily take out more money than is available in their bank account. This banking service enables pre-approved customers are used for very short term purposes and typically repaid within a few months in order to avoid high interest charges.
- 2. **Trade creditors** Suppliers may give trade credit (typically for 30 to 60 days), which needs to be repaid at a future date.
- 3. **Short-term loans** These are advances (loans) from a financial lender, such as a commercial bank, that needs to be repaid within 12 months of the balance sheet date.

Non-current liabilities are the long-term debts of a business, falling due after 12 months of the balance sheet date. In other words, this refers to the long-term borrowings of the business, such as long-term loans and mortgages.

Total liabilities are simply the sum of current liabilities and non-current liabilities, i.e. the sum of all the monies owed by the business.

Net assets refers to the overall value of an organization's assets after all its liabilities are deducted. Hence, net assets is calculated by using the formula:

Net assets = Total assets - Total liabilities

10

Net assets = (Non-current assets + Current assets) – (Current liabilities + Non-current liabilities)

Equity refers to the value of the owners' stake in the business, i.e. what the business is worth at the time of reporting the balance sheet. Equity is comprised of both share capital and retained earnings.

- 1. **Share capital** refers to the value of equity in a business that is funded by shareholders, either through an initial public offering or via a share issue.
- 2. Retained earnings is value of equity in a business that is funded by the accumulated profit after tax that has not been distributed as dividends to shareholders. Instead, it is kept as an internal source of finance for the business to use. It is calculated by the formula:

Retained earnings = Opening retained earnings + Profit after interest and tax for current period – Dividends for current period

For a balance sheet to balance, the value of the firm's net assets must equal the value of its equity. This is to ensure the firm's total value of its *sources* of finance matches its *uses* of finance.

? Top tip 2!

Students often get confused between the components of the **profit and loss account** and the balance sheet. Be aware of a couple of important and clear differences between these two sets of final accounts:

- 1. Whereas the P&L account records a firm's income and expenses, the balance sheet show the firm's assets and liabilities.
- 2. The P&L account covers a specific period of time (such as the period up to the end of the firm's financial year). By contrast, the balance sheet provides a snapshot (at one point in time) of what the firm owns and what it owes.

Top tip 3!

As stated in the guide, the balance sheet needs to be taught to AO2 and AO4 (page 29). Hence, this term must be referred to when teaching and learning this component of Unit 3.4.

However, when constructing or presenting the balance sheet in the external assessments, the term "statement of financial position" should be used as the heading (page 59).

So, this means that students can refer to the "balance sheet" in their written responses to a question in the final exams, but not for the title or heading when constructing or presenting this as a set of final accounts.

Key terms

- Accumulated depreciation refers to the sum of the fall in a non-current asset's value because of wear and tear over time.
- Assets are the possessions of a business that have a monetary value, such as buildings, land, machinery, equipment, stock (inventory), and cash.
- The balance sheet (or statement of financial position) shows the value of an organization's assets, liabilities, and the owners' equity at a particular point in time.
- Bank overdrafts allow customers to temporarily take out more money than is available in their bank account.
- Cash is the money an organization has either "in hand" (at its premises) and/or "at bank" (i.e. in its bank account).
- Current assets are possessions of an organization with a monetary value, but intended to be liquidated within twelve months of the balance sheet date.
- Current liabilities are the short-term debts of a business, which need to be repaid within twelve months of the balance sheet date.
- Debtors are entities (individuals or businesses) that owe money to an organization as they bought goods or services on trade credit.
- Equity refers to the value of the owners' stake in the business, i.e. what the business is worth at the time of reporting the balance sheet.
- Finished goods are the final products that are ready to sell to customers.
- Liabilities are the debts of a business, i.e. the money owed to others such as bank overdrafts and trade creditors.
- Net assets refers to the overall value of an organization's assets after all its liabilities are deducted.
- Non-current assets (also referred to as fixed assets) are the long-term assets or
 possessions of an organization with a monetary value but are not intended for resale
 within the next twelve months of the balance sheet date.
- Non-current liabilities are the long-term debts of a business, falling due after 12 months
 of the balance sheet date.
- Raw materials are the natural resources used in the production process to create goods and provide services to customers.
- Retained earnings refers to the equity in a business funded by the cumulative amount of net income that has been retained and accumulated by the organization.
- Share capital refers to the value of equity in a company that is funded by shareholders.
- Short-term loans are advances from a commercial lender that needs to be repaid within
 12 months of the balance sheet date.
- Stock (or inventory) are the goods that a business has available for sale, per time period.
- Total assets are the sum of non-current assets and current assets.
- Total liabilities are simply the sum of current liabilities and non-current liabilities, i.e. the sum of all the monies owed by the business.

- Trade creditors are the suppliers owed money as the business has purchased items on trade credit, so this form of current liability needs to be repaid at a future date.
- Work-in-progress (or semi-finished goods) are parts and components of a final product in the process of being produced in order to sell to customers.