

How to Prepare a Profit and Loss (Income) Statement

E. Bond
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WHAT TO EXPECT

This Business Builder will guide you through a step-by-step process to create a profit and loss statement for your business.

WHAT YOU SHOULD KNOW BEFORE GETTING STARTED

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A Profit and Loss (P & L) statement measures a company's sales and expenses during a specified period of time. The function of a P & L statement is to total all sources of revenue and subtract all expenses related to the revenue. It shows a company's financial progress during the time period being examined.

The P & L statement contains uniform categories of sales and expenses. The categories include *net sales*, *costs of goods sold*, *gross margin*, *selling and administrative expense (or operating expense)*, and *net profit*. These are categories that you, too, will use when constructing a P & L statement. Since it is a rendering of sales and expenses, the P & L statement will give you a feel for the flows of cash into (and out of) your business. The P & L statement is also known as the income statement and the earnings statement.

This Business Builder will explain, through a step-by-step process and the use of a worksheet, how to create a P & L statement. Accounting terms will be defined as they are introduced, and a glossary is included for your reference.

Watch Out For... Matching sales and costs. If the P & L statement you develop is going to be of value, and acceptable to the Internal Revenue Service (IRS), the revenues and expenses reported during the period must match. That is, the expenses incurred to generate the sales of your product (or services) must be related to actual sales during the accounting

period.

This Business Builder will define and explain the data needed to put together a P & L statement, but before you start, it might be helpful to consider the following questions:

- Does your inventory method allow you to calculate or reasonably estimate the quantity and cost of goods sold during a specific time period?
- Do you have records of general and administrative expenses?
- Can you separate selling-related expenses from other expenses?

Why Prepare a P & L Statement?

There are two reasons to prepare a P & L statement. One reason is the P & L statement answers the question, "**Am I making any money?**" It is a valuable tool to monitor operations. A regularly prepared P & L statement — either quarterly or monthly for new businesses — will give owners timely and important information regarding revenues and expenses and tell them whether adjustments might be necessary to recoup losses or decrease expenses. The P & L statement also allows outsiders to evaluate your ability to manage and use your company's resources.

The second reason to prepare a P & L statement is because it is required by the IRS. It is the record of a business' operation that is used to assess taxes on profits earned. It is the only financial statement required by the IRS.

An Overview

The profit and loss statement uses data from your business and three simple calculations to tell you the net profit (or net loss) of your company. Usually, it helps to know where you are going before you get there, so here's a shell of a P & L statement and a completed P & L statement for the fictional ABC Company.

Shell of a P & L statement:

Net Sales - Cost of Goods Sold = Gross Margin

Gross Margin minus Selling and Administrative Expense = Net Operating Profit

Net Operating Profit + Other Income - Other Expense = Net Profit before Taxes

Net Profit before Taxes - Income Taxes = Net Profit (or Net Loss)

Sample of a P & L statement:

ABC Wholesale Company
Profit and Loss Statement

For the Quarter Ended March 31, 200X

NET SALES		\$200,000
Cost of goods sold:		
Beginning inventory	- \$ 45,000	
Merchandise purchases	- \$120,000	
Freight	- \$ 15,000	
Cost of goods available for sale		\$180,000
Less ending inventory	- \$ 50,000	
COST OF GOODS SOLD		- \$130,000
GROSS MARGIN		\$ 70,000
Selling, Administrative, and General Expenses:		
Salaries and Wages	- \$ 22,000	
Rent	- \$ 6,000	
Light, heat, and power	- \$ 1,000	
Other Expenses	- \$ 4,000	
State and local taxes and licenses	- \$ 1,000	
Depreciation and Amortization on leasehold improvements	- \$ 500	
Repairs	- \$ 1,500	
Total selling, administrative, and general expenses		- \$ 36,000
Profit From Operations		\$ 34,000
Other income	+ \$ 2,500	
Other expense	- \$ 500	
Net Profit Before Taxes		\$ 36,000
Provision for income tax	- \$ 14,400	
NET PROFIT AFTER INCOME TAX		\$ 21,600

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The heading of the P & L statement should always tell the reader what period of time is being examined. Unlike a balance sheet, which is a snapshot of a company during a particular date in time, the P & L statement shows a listing of what has transpired or happened during a time period.

As such, the heading should contain wording that describes the time period being examined, such as: for the month ending-month/day/year;

for the quarter ending — month/day/year; for the year ending — month/day/year.

Step 1: Fill in the heading of your worksheet with your company's name and the period the P & L statement will reflect.

The data items that you must be able to provide to construct a P & L statement are:

- Net Sales
- Cost of Goods Sold
- Selling and Administrative Expenses
- Other Income and Other Expense

Net Sales [[top](#)]

Net sales is the total sales during the time period being analyzed minus any allowances for returns and trade [discounts](#). The amount allowed for returns will necessarily vary considerably between different types of businesses. A small retail store may have a few returns compared to a manufacturing operation. It is commonly figured as a small percentage (1 percent or 2 percent) of total sales. An amount allowed for trade discounts recognizes the discrepancy between a standard or "catalog" price and the actual price paid by customers. An allowance for trade discounts decreases total sales to reflect prices actually paid.

This is an important consideration if sales are recorded when the order is placed rather than when the goods are shipped or payment is received. The choice of when and how to record sales is a function of your bookkeeping/accounting system and the decisions made related to its setup. This Business Builder assumes that system is in place.

Step 2: Fill in total sales, and any allowances on the worksheet. Calculate net sales.

Costs of Goods Sold [[top](#)]

Costs of goods sold is also called the cost of sales. For retailers and wholesalers it is the total price paid for the products sold during the accounting period. It is just the price of the goods. It does NOT include selling or administrative expenses (these expenses are listed elsewhere on the P & L statement).

For service and professional companies, there will be no cost of goods sold. These types of companies receive income from fees, commissions, and royalties and do not have inventories of goods. The costs to generate services will be included in the selling and administrative expense and the general expense sections of the income statement.

For retailers and wholesalers, the cost of goods sold may be computed several different ways using either a direct or indirect method. This means it will be an actual accounting of the prices of goods sold based on inventory (direct) or an estimate by deduction (indirect), such as

deflating sales. Most small retail and wholesale businesses will compute the cost of goods sold directly by taking the value of inventory at the beginning of the accounting period (original inventory), adding the value of goods purchased during the accounting period (new inventory) and then subtracting the value of the inventory on hand at the end of the accounting period (remaining inventory). These calculations will yield the amount of inventory consumed during the accounting period:

- **Beginning Inventory**
 - + **Inventory Purchased During the Period**
 - **Inventory on Hand at the End of the Period**
-

Inventory Used for Product the Time Period

Deflating Sales Figures

A cost of goods sold could also be derived indirectly by deflating sales figures.

For example, if a retail store has a storewide gross margin (or mark-up) of 40 percent and sales of \$100,000 are recorded during the accounting period, the cost of goods sold would be \$60,000. See the following calculation for how this works:

Total Sales x Gross Margin (%) = Gross Margin (\$)

\$100,000 x 40% = \$40,000

Total Sales (\$) - Gross Margin (\$) = Cost of Goods Sold (\$)

\$100,000 - \$40,000 = \$60,000

If the application of a uniform margin is inappropriate, product classes could be developed based on gross margins. That is, product group A would be all products with a gross margin of, say, 30 percent; product group B would be products with a gross margin of 25 percent; and Product C would be products with a gross margin of 10 percent. The calculations shown above would then be done for each product category and totaled.

Manufacturer's cost of goods sold

For manufacturers, the method for compiling the cost of goods sold (or, more accurately, the cost of goods manufactured) is different than the way it is done for retailers and wholesalers. This is because a manufacturer's costs come from both the acquisition of raw materials to create a product and the costs related to its manufacture.

For a manufacturer, the cost of goods sold is divided into two categories: *direct costs* and *indirect costs*.

Direct costs include inventory costs based on beginning and ending inventories — computed in the same manner as retailers, and it also includes the costs of raw material, and work-in-process inventories, PLUS direct labor costs.

Indirect costs include indirect labor, factory overhead and materials and supplies. Because of these additions, the cost of goods manufactured is often compiled as a separate statement. Information from the separate statement is then incorporated into the P & L statement. Here is information on each of the data categories for manufacturers:

- **Labor** — [direct labor](#) is the cost of labor to convert raw materials into finished products. Indirect labor includes other factory personnel such as shipping personnel or maintenance workers.
- **Factory overhead** — includes the following: depreciation of plant and equipment; factory utilities — light, heat and power; insurance; real estate taxes; and the wages of supervisors and others who do not work directly to create the product.
- **Materials and supplies** — consumed in the production of goods are included in the direct cost of goods sold for manufacturers. Supplies that are not consumed during the manufacturing process are included as indirect costs.

For manufacturers, if containers or packaging is an integral part of the product, then these expenses are included in the costs of goods sold. If they are not integral to the product, then these expenses would be recorded as selling expenses.

Step 3: Fill in the cost of sales for your company on the worksheet.

If you are a manufacturer, complete the separate Cost of Goods Manufactured Worksheet to make sure all applicable costs are accounted for. Transfer your costs of goods manufactured to the general worksheet and continue using the general worksheet to calculate the net income for your operation.

Gross Margin

Once net sales and cost of goods sold are entered on the P & L statement, it is possible to compute the gross margin for the accounting period. Gross margin is also referred to as gross profit.

$$\text{Net Sales} - \text{Cost of Goods Sold} = \text{Gross Margin}$$

Step 4: Calculate the gross margin for your company.

Selling and Administrative Expenses [[top](#)]

Two types of expenses are recorded on a P & L statement for all types of companies: *selling expenses* and *general and administrative expenses*.

- **Selling expenses** are expenses incurred directly and indirectly in making sales. They include salespeople's salaries, sales office costs, commissions, advertising, warehousing and shipping. In general, selling expenses are the expenses of order taking and order fulfilling.
- **General and administrative expenses** are operating expenses not directly associated with the sale of goods. They include nonsales personnel salaries, supplies, and other operating costs necessary to the overall administration of the business. General and administrative expenses are commonly considered "overhead" expenses, and include rent, utilities, telephone, travel and supplies.

Repairs and improvement expenses incurred for either equipment or property may also be deducted as an expense. However, this is only for expenses to maintain property or equipment — such as roof repairs, repainting and other maintenance. Major overhauls of equipment or maintenance that extend the life of the asset must be capitalized (that is, depreciated over the asset's useful life and not deducted from income as an expense). For managerial purposes, general and administrative expenses are considered managed costs. They are controlled by the decisions of management and not directly tied to sales or production.

Step 5: Fill in selling, general, and administrative expenses for your business on the worksheet.

Net operating profit

Net operating profit is the difference between the gross margin and selling and administrative expenses.

$$\text{Gross Margin} - \text{Selling and Administrative Expenses} = \text{Net Operating Profit}$$

Step 6: On the worksheet, compute the net operating profit for your business.

The last items on a P & L statement are: other income, other expense and income taxes. Let's look first at other income and expense.

Other Income and Other Expense [[top](#)]

These are line items for any unusual income or expense items not directly related to the operations of the business. Other Income includes income from interest, dividends, miscellaneous sales, rents, royalties and gains from the sale of capital assets. Other Expenses is a line item to record any unexpected losses unrelated to the normal course of business. It could include a loss from the disposal of equipment. Other income is added to net operating profit and other expense is subtracted from net operating profit to compute Net Profit Before Income Taxes.

Net Operating Profit (+ Other Income - Other Expenses) = Net Profit
Before Income Taxes

Step 7: Enter any Other Income or Other Expense for your business on the worksheet and calculate Net Profit Before Income Taxes.

Net Profit

Net Profit is calculated by subtracting what you estimate is owed for state and federal income taxes from Net Profit Before Income Taxes.

Net Profit Before Income Taxes - Income Taxes = Net Profit

Step 8: Calculate the net Profit for your business.

Conclusion

The creation of a profit and loss statement is an important event for a small business. At one glance, it provides a summary of the most important activities of the company.

A P & L statement is the record of the good news of sales and the less propitious news of expenses. It provides valuable information to managers and owners including the costs of goods sold, gross margin, selling and administrative expenses, and net profit. Compiled on a regular basis, the P & L statement is one of the most important tools for a small business owner to use to evaluate and make adjustments to operations.

CHECKLIST [[top](#)]

Net Sales and Cost of Goods Sold

___ Did you subtract an [allowance for returns](#), transportation, and discounts from total sales?

___ Are all appropriate costs included in the costs of goods sold?

___ If you are a manufacturer, have you included labor costs, factory overhead, and inventory costs in the costs of goods sold?

Selling Expenses and Net Profit

___ Have selling expenses been separated from general and administrative expenses?

___ Has any income or expenses from outside of the normal course of business been added to or subtracted from Net Operating Profit to compute Net Profit?

___ Are allowances for both state and federal taxes included in the deduction for income taxes?

RESOURCES [[top](#)]

Books

[*Analysis and Use of Financial Statements*](#), 2nd ed., by Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried. (John Wiley & Sons, 1997).

[*Corporate Controller's Handbook of Financial Management*](#), 2nd ed., by Joel G. Siegel, Jae K. Shim, and Nicky A. Dauber. (Prentice Hall, 1997).

Magazines

[*Journal of Accountancy*](#)

Other Sources

[Small Business Administration](#)

[American Institute of Certified Public Accountants](#)

GLOSSARY [[top](#)]

Allowance for Returns - In the computation of net sales, an amount subtracted from sales to reflect returns of merchandise. Generally figured as a small percentage of sales.

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Cost of Goods Sold - Total price paid for products sold during the accounting period, plus transportation costs to acquire the goods. Service and professional companies will have no costs of goods sold, whereas, manufacturers will have detailed statements.

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Direct Labor - The cost of labor to convert raw materials into finished products. Direct Labor is included in the cost of goods sold for manufacturers.

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Discounts - Allowance subtracted from total sales for trade discounts. Used in the calculation of net sales.

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General and Administrative Expense - Overhead expenses not directly associated with the sale of goods. Includes salaries (of nonsales personnel), rent, utilities, telephone, travel and supplies.

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Gross Margin - Net sales minus any adjustments for returns or discounts.

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Net Sales - Total sales minus any adjustments for returns or discounts.

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Selling Expense - Expenses related to order taking and product sales.

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Other Income - Income produced from other than the normal operations of the business. Includes interest, dividends, and gains from the sale of assets.

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Other Expense - Expenses not incurred from normal operations. Can include losses on the sale of assets.

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Net Operating Profit - Gross margin minus selling and administrative expense.

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Net Profit Before Income Taxes - Net operating profit plus other income and minus other expense.

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Writer: E. Bond

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The Edward Lowe Foundation was created by Ed and Darlene Lowe in 1985 to "champion the entrepreneurial spirit." Headquartered near Cassopolis, Michigan, the foundation works with entrepreneur support organizations nationwide to encourage peer learning among second-stage business owners. Before his death in 1995, Ed Lowe, the creator of Kitty Litter, had become an advocate for entrepreneurship as the key to the success of the free-enterprise system.

Contact: 800-232-LOWE(5693) or edwardlowe.org

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