PIPSO
Pacific Islands Private Sector Organisation

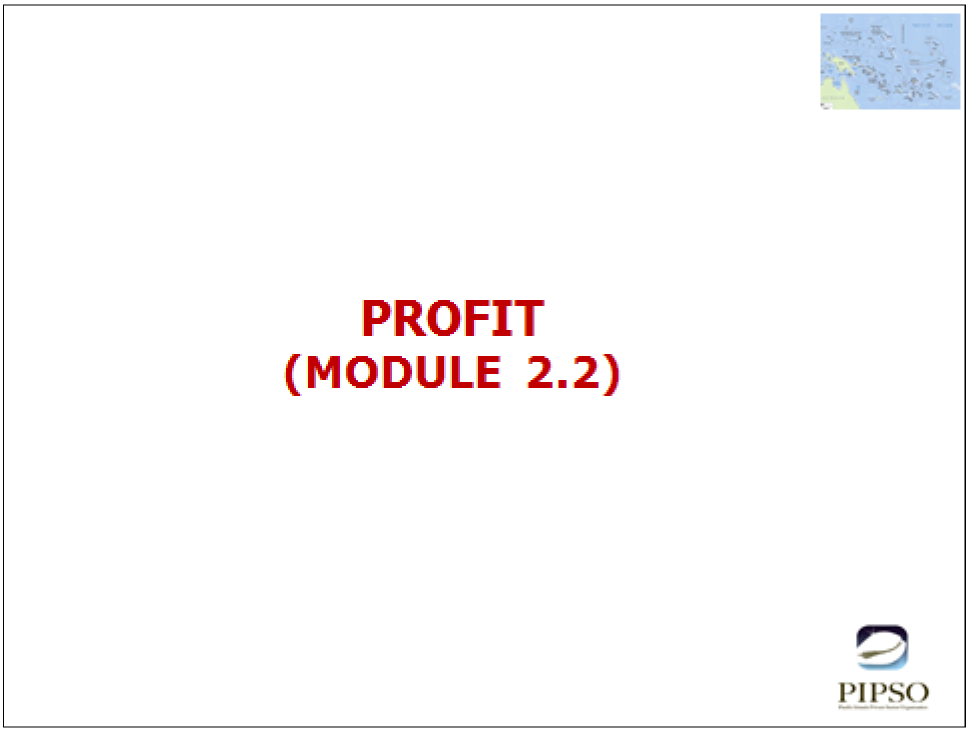
November 1

PROFIT

2016

This Module highlights the importance of a business generating consistent profits. After defining profit, it considers the way profit is reported, the differences between profit & cash flow & why, in the longer term, profit matters.

MODULE 2.2



Contents

PURPOSE

This Module considers the importance of maintaining profitability in a business. In Modules in Level 1 the focus was on the short term & cash flow rather than accounting profitability. This begins to change in this Module.

Participants are herein introduced to sufficient accounting concepts to now recognise the longer term importance of achieving profits, not just a positive cash flow.

This Module is intended to highlight the need to achieve business profitability plus a positive cash flow. The Module describes:

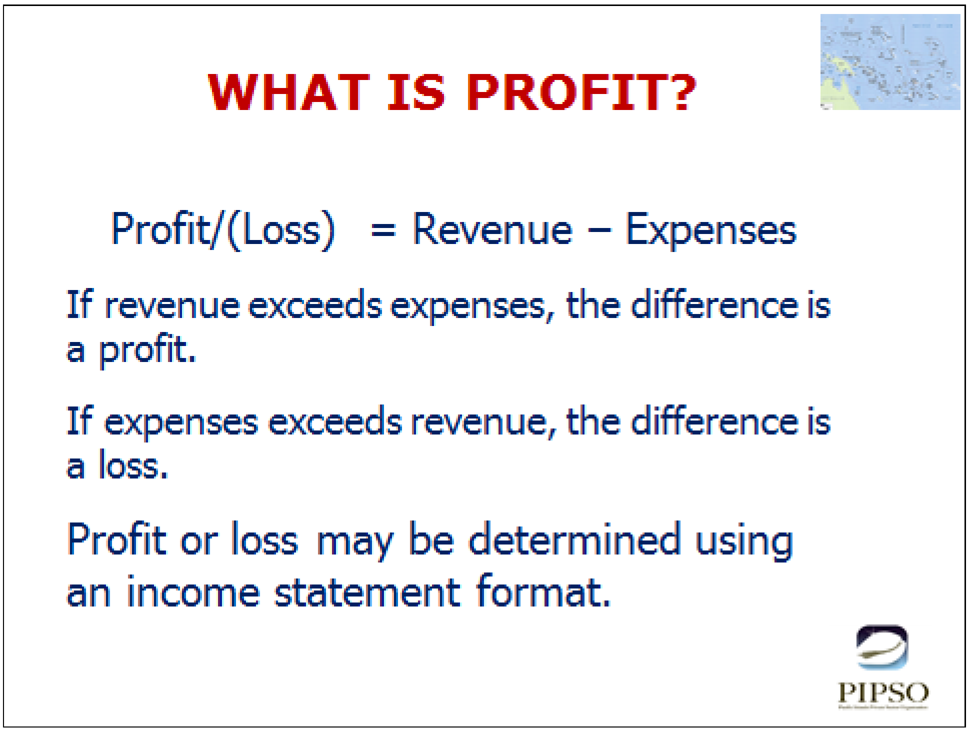
- What profit is
- How profit is determined
- The differences between profits & cash flow
- Why profit is essential to long term survival

In Level 1 Modules the importance of cash flow was stressed for micro & small businesses. As a business grows, holds larger amounts of fixed assets for use in the business & looks at external funding for growth, the need to measuring profit, in addition to cash flow, becomes more important. In the longer term,an enterprise must cover all costs of running the business, which include recouping the past cost of assets. It must also be able to service, pay interest on, loans & repay them when due.

Measuring, reporting & forecasting profit, in addition to cash flow, is critical to a business owner when the business is growing. The role of the owner changes from doing it all themselves to understanding the dynamics of their business, its cash flow & profitability while others complete the day to day activities that they once did personally.

On completion of this Module participants should have an idea of the differences between cash flow & profit & the business need for both.

WHAT IS PROFIT?



This definition of profit flows directly from the accounting equation introduced in the previous Module 2.1, Accounting Concepts. It is the ultimate measure of whether a business is viable in the longer term.

The recording of profit follows a simple format, subject to the particular nature of a business. While profit or loss is the difference between revenues & expenses, it is useful for many businesses, where relevant, to measure profit at two levels in the income statement. These are:

1. Gross profit – the difference between revenue from sales & the costs incurred to receive &/or make the goods &have them ready for sale, but excluding other selling, administration & financial expenses
2. Net profit – the difference between all revenues & all expenses, including the above

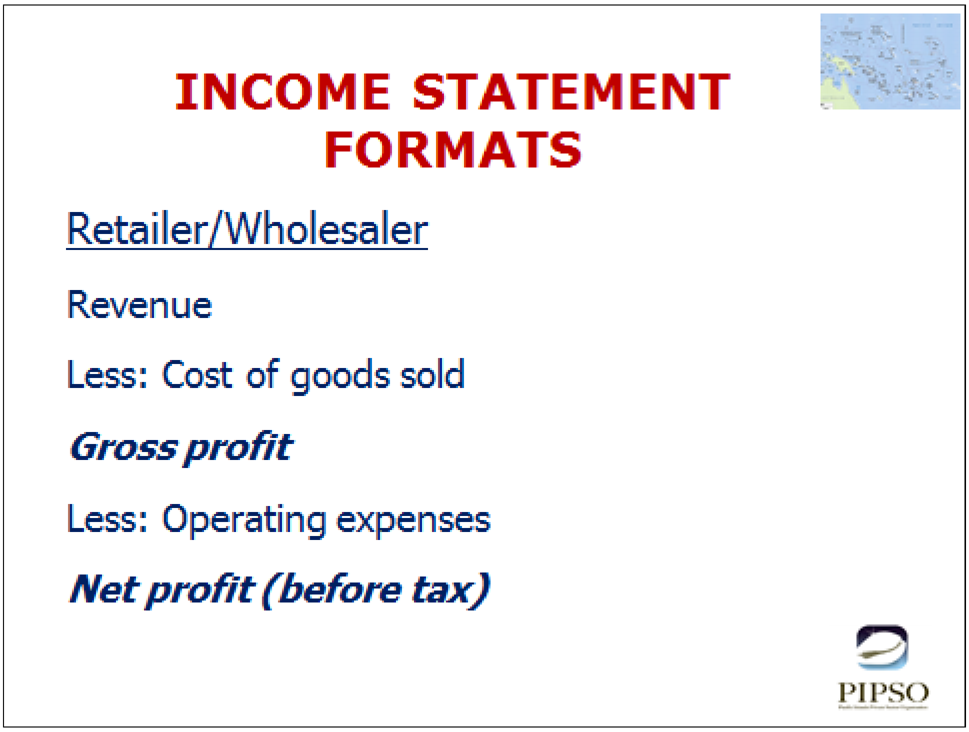
Gross & net profit are measured before the payment of any tax due. There is also a third measure based on net profitafter tax for companies.

There are basically three different income statement formats as follows:

1. Trader
    a. Wholesaler
    b. Retailer
    c. Exporter

2. Producer
    a. Manufacturer
    b. Farmer/primary producer
    c. Processor of products
3. Service provider
    a. Maintenance & repairs
    b. Professional services

The presentation of accounts for each different business type follows:



Retailer/wholesaler

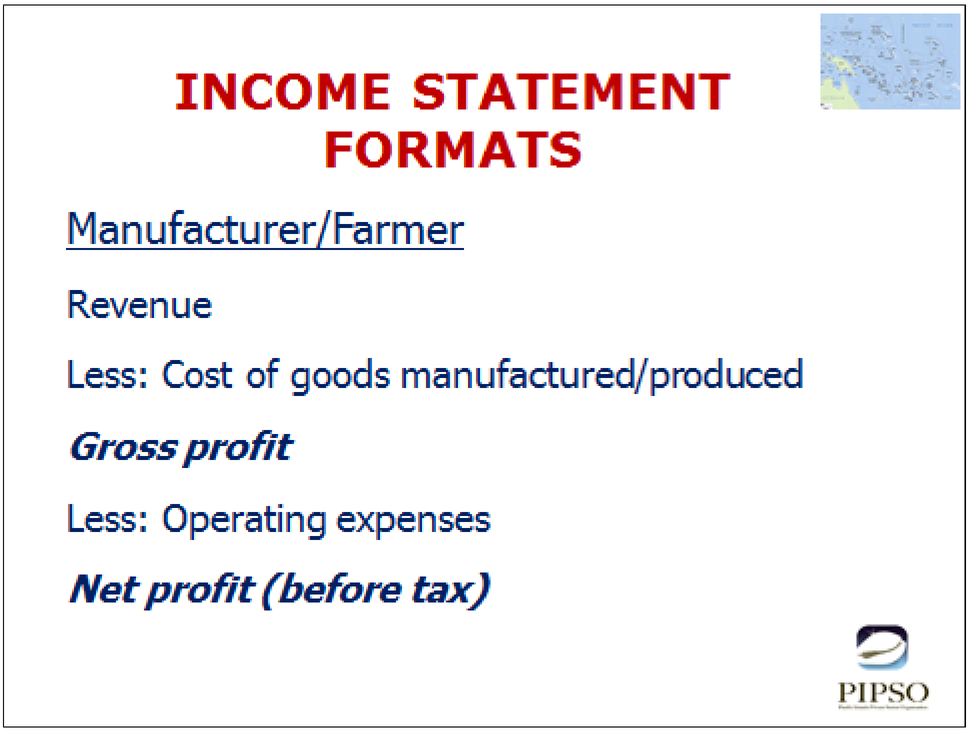
Cost of Goods Sold is the same as Cost of Sales previously introduced. It is presented as:

Opening stock/inventory at cost

+ Purchases during period

+ Costs to receive raw materials (e.g. freight in & customs duties) but **not** outward costs

- Closing stock/inventory at cost



Manufacturer/farmer

Cost of Goods Manufactured/Produced is presented as:

Direct materials used

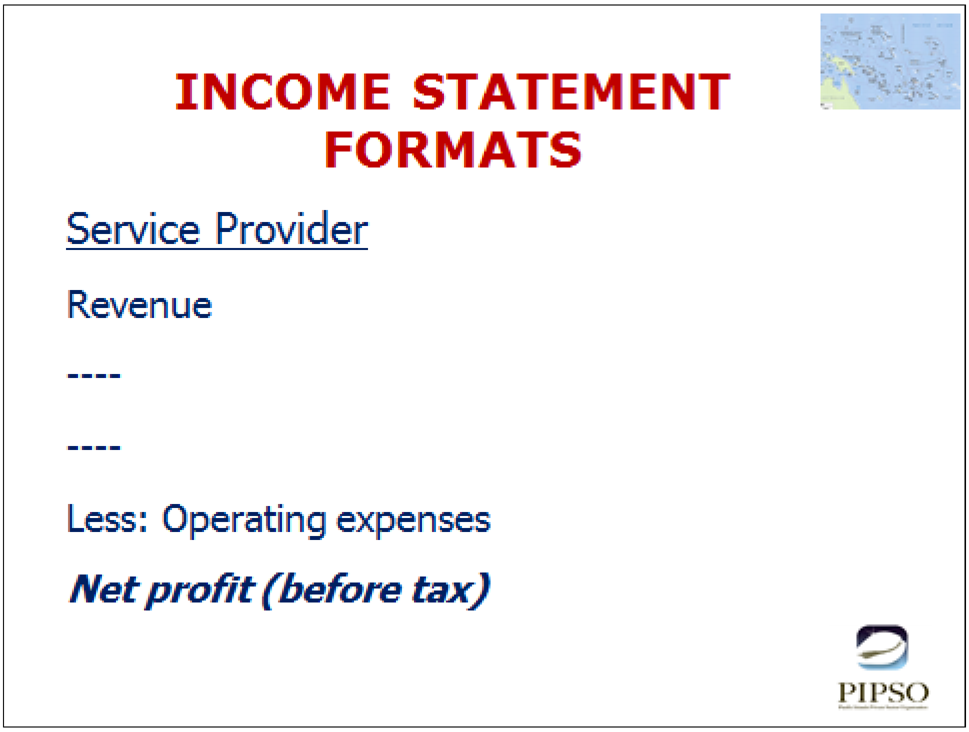
+ Direct labour used

+ Factory/farm/production overheads

NOTE: Does not include costs incurred after production or processing.

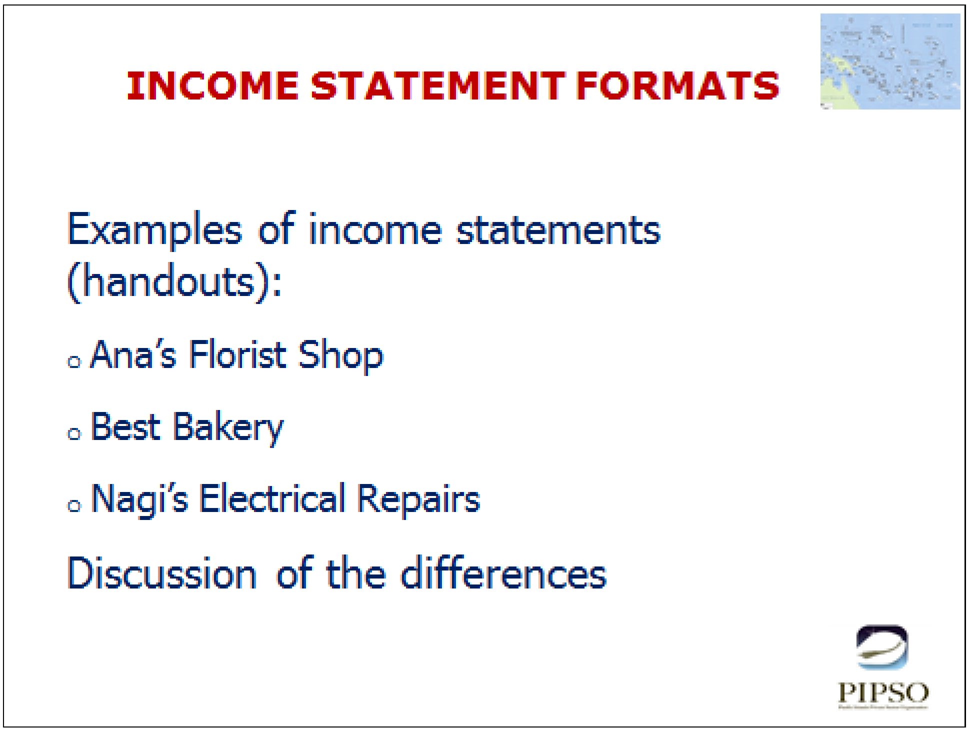
For those businesses that calculate a cost of goods sold or produced, it is possible & desirable to calculate a Gross Profit after deducting the relevant costs & before deducting all other operating expenses.

This gives two measures of profitability & the opportunity to identify & isolate any cost based business problems before & after the calculation of gross profit.



A service provider does not produce or purchase goodsfor sale & cannot, therefore calculate a cost of goods produced or cost of sales (goods sold).

Service providers have to find other ways to identify & isolate relevant costs for analysis.



NOTE FORFACILITATOR

Provide all participants with hard copy of these formats for their perusal & future reference.Ask participants:

- Which expense listed below does not affect cash flow? Depreciation.
- Which expense may differ from cash flow? Severalitems, including purchases & sales, if on credit,will differ from cash due to timing of payments. Other may include Insurance, superannuation, telephones & wages. These are less obvious & will be considered later.

ANNUAL INCOME STATEMENT OF A RETAIL/WHOLESALE BUSINESS

AMY'S FLORIST SHOP
INCOME STATEMENT
FOR YEAR ENDED 30 JUNE 2013

		2013	2012
		$	$
REVENUE			
Sales		491,062	458,580
	Total revenue	491,062	458,580
less COST OF GOODS SOLD			
Opening Stock @ cost		34,788	40,801
Stock purchases		341,525	328,751
less Closing stock @ cost		-32,570	-34,788
	Total cost of goods sold	343,743	334,764
GROSS PROFIT		147,319	123,816
less OPERATING EXPENSES			
Accounting fees		676	560
Advertising		4,039	5,168
Bank charges		254	240
Depreciation		632	632
Electricity		809	762
Insurances		1,477	1,650
Interest paid		1,600	1,600
Legal fees		208	210
Motor vehicle expenses		17,003	16,871
Rent		26,354	24,945
Stationery		433	428
Sundries		389	363
Superannuation		3,271	3,488
Telephone		930	1,936
Wages		36,343	38,750
	Total Operating expenses	94,418	97,603
NET PROFIT BEFORE TAX		$52,901	$26,214

ANNUAL INCOME STATEMENT OF A MANUFACTURER/FARMER

BEST BAKERY
INCOME STATEMENT
FOR YEAR ENDED 30 JUNE 2013

		2013	2012
		$	$
REVENUE			
Sales		505,089	467,380
	Total revenue	505,089	467,380
less COST OF GOODS SOLD			
Direct materials		110,940	101,333
Direct labour		120,977	105,788
Bakery overheads		95,622	87,900
	Total cost of goods sold	327,539	295,021
GROSS PROFIT		177,550	172,359
less OPERATING EXPENSES			
Accounting fees		1,000	750
Advertising		10,353	9,503
Bank charges		303	298
Depreciation		15,989	14,765
Electricity		2,578	2,007
Insurances		1,600	1,800
Interest paid		1,600	1,600
Legal fees		350	798
Motor vehicle expenses			
Rent		2,800	25,500
Stationery		505	522
Sundries		480	467
Superannuation		3,511	3,507
Telephone		1,122	1,345
Wages		39,006	38,962
	Total Operating expenses	81,197	101,824
NET PROFIT BEFORE TAX		$96,353	$70,535

ANNUAL INCOME STATEMENT OF A SERVICE BUSINESS

NAGI'S ELECTRICAL REPAIRS
INCOME STATEMENT
FOR YEAR ENDED 30 JUNE 2013

	2013	2012
	$	$
REVENUE		
Sales	355,009	342,864
Total revenue	355,009	342,864
less OPERATING EXPENSES		
Accounting fees	1,409	1,499
Advertising	7,805	8,941
Bank charges	551	523
Depreciation	12,206	12,195
Electricity	1,001	1,057
Insurances	1,506	1,784
Interest paid	2,700	3,091
Legal fees	646	1,849
Motor vehicle expenses	38,576	39,013
Rent	43,354	41,945
Stationery	1,056	859
Sundries	1,483	1,037
Superannuation	10,861	10,658
Telephone	2,904	2,865
Wages	120,678	118,421
Total Operating expenses	246,736	245,737
NET PROFIT BEFORE TAX	$108,273	$97,127

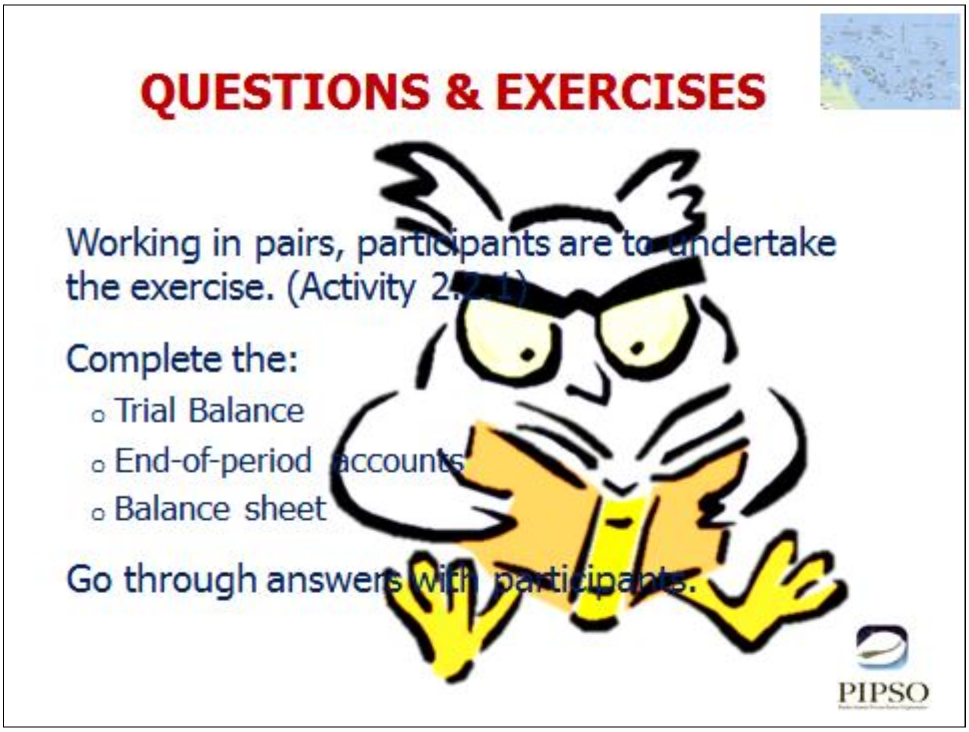
NOTES

- Composition of cost of goods sold/sales includesall costs of inward, **but not outward**, delivery (e.g. customs duty & freight in).
- Cost of goods produced, would depend on the nature of the business – consider some alternatives, e.g. primary producer& manufacturer.
- Could a producer have both of the above? Yes, if business sells goods from the stock of finished goods; sales would not equal production. In this case there is a manufacturing statement & an income statement.
- Gross profit calculation – compare with industry, past years or for budgeting.
- Different business costs structures – different businesses have different structures, e.g. a wholesaler who collects & delivers goods will run vehicles that other businesses do not; a professional practice will have different (possibly expensive) equipment, personal services & replacement costs.
- Differences in profit & cash flow– this topic will be covered later in more detail.

PREPARING FINANCIAL SATEMENTS

The following hand-out describes the double entry bookkeeping process culminating in an activity that requires participants to prepare a list of the balances of the accounts posted in the exercise. This list is called a Trial Balance & the numbers on each side, debits & credits, must be equal.

Participants should calculate the totals of each side of the Trial Balance to be sure.



ACTIVITY 2.2.1

Ledger Accounts & Double Entry Book Keeping

WORKING EXAMPLE

S. Still decides to set up a business and enters into the following transactions:

1. Pays $25,000 into a business bank account on first day of the month;
2. Buys a Delivery vehicle for $15,000 with a business account cheque;
3. Buys kitchen equipment for $10,000 on credit;
4. Negotiates a $20,000 loan from the bank;
5. Buys a supply of foodstuff for re-sale costing $27,000 with a business cheque;

6. Sells goods for $26,000. The customer pays $13,000 by cheque. The customer will pay in one month's time;
7. Sells goods for $900. The customer will pay in one month's time;
8. Pays $5000 to the supplier of the shop equipment with a business cheque;
9. A credit customer pays $13,000 by cheque;
10. Checks stock of goods at the end of the month, value is $5,500.

ACCOUNTS

Consider the first two transactions entered into by S Still in the previous example. Remembering the classification of assets and liabilities and that *debits are recorded on the left of the T* and *credits are recorded on the right of the T*, the accounts for these transactions would be as follows:

General Ledger of: S. Still

Date	Details	DR	CR	Balance	
		Bank			
(1)	Capital	25,000		25,000	Dr
(2)	Delivery vehicle		15,000	10,000	Dr
		Capital			
(1)	Bank		25,000	25,000	Cr
		Delivery vehicle			
(2)	Bank	15,000		15,000	Dr

For transaction 1, $25,000 is going into the bank as S. Still is paying this into the business, and therefore it is recorded as a debit in the bank account. Cash in an asset, and an increase in an asset is a debit. The corresponding credit goes into the Capital account. Capital is owner's equity (it belongs to the owner) and is increased, hence it is a credit.

For Transaction 2, S. Still is paying for the delivery vehicle and therefore, money is paid out of the Bank (hence a credit and a decrease of an asset), and the corresponding entry is a debit in the Delivery vehicle account (an asset because it will provide future benefits).

Note each entry in an account tells which account to use for the other side of the entry.

The completed records of S Still would be as follows:

General Ledger of: S. Still

Date	Details	DR	CR	Balance	
		Bank			
(1)	Capital	25,000		25,000	Dr
(2)	Delivery vehicle		15,000	10,000	Dr
(4)	Bank loan	20,000		30,000	Dr
(5)	Supplies		27,000	3,000	Dr
(6)	Sales	13,000		16,000	Dr
(8)	Creditor		5,000	11,000	Dr
(9)	Debtor	13,000		24,000	Dr
		Capital			
(1)	Bank		25,000	25,000	Cr
		Delivery vehicle			
(2)	Bank	15,000		15,000	Dr
		Kitchen equipment			
(3)	Creditor	10,000		10,000	Dr
		Creditors			
(3)	Kitchen Equipment		10,000	10,000	Cr
(8)	Bank	5,000		5,000	Cr
		Supplies (Purchases)			
(5)	Bank	27,000		27,000	Dr
(10)	Stock of supplies		5,500	21,500	Dr
Date	**Details**	**DR**	**CR**	**Balance**	
		Bank loan			
(4)	Bank		20,000	20,000	Cr

Sales					
(6)	Bank		13,000	13,000	Cr
(6)	Debtor		13,000	26,000	Cr
(7)	Debtor		900	26,900	Cr

Debtors					
(6)	Sales	13,000		13,000	Dr
(7)	Sales	900		13,900	Dr
(9)	Bank		13,000	900	Dr

Stock of supplies					
(10)	Supplies	5,500		5,500	Dr

Now let's consider how the data from these financial transactions can be used to complete the following Trial Balance. A trial balance is simply a listing of the total on every T-account maintained by the business.

This is correct if the Debit side of the Trial Balance equals the Credit side.

Finally, we put each of these balances into the Income Statement & Balance Sheet. The Debit side of the Balance sheet also equals the Credit side.

FINANCIAL STATEMENTS

Trial Balance		
Account	**Debit $**	**Credit $**
Bank		
Capital		
Delivery vehicle		
Kitchen equipment		
Creditor		
Supplies (Purchases)		
Bank loan		
Sales		
Debtor		
Stock of supplies		
Total		

Having completed the trial balance, participants should be able to prepare the income statement & balance sheet from it.

Income Statement	**$**
Sales	
Less Cost of sales	
Supplies (Purchases)	
Gross profit	
Less Expenses	
Net profit	

Balance Sheet				
Assets		**Liabilities**		
Cash		Creditors		
Stock of supplies		Bank loan		
Debtors				
Delivery vehicle				
Kitchen equipment		**Owners' Equity**		
		Capital		
		Net profit		

NOTE FORFACILITATOR

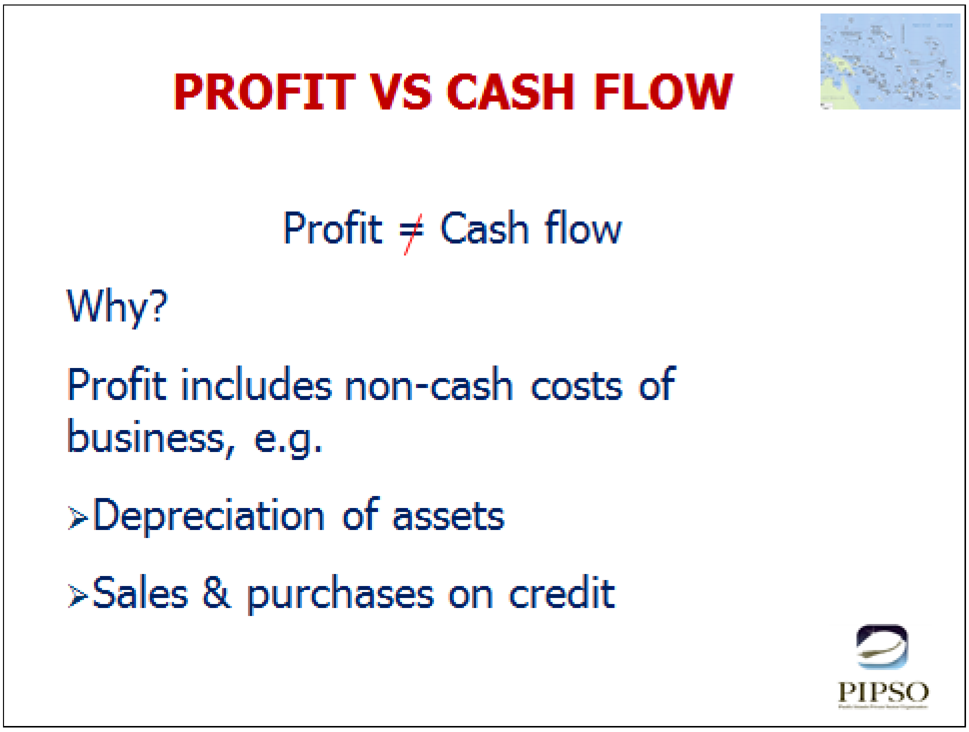
Allow sufficient time before completing the exercise & discussing the results. It may be necessary to show participants that the Trial Balance lists the final figure in each account.

Ask participants if the total of the debits equal the total of the credits in their Trial Balance? They must check this before doing the rest of the activity.

Suggest they tick items in the trial balance as they use them to create the income statement & balance sheet. When all items are ticked, they can complete the activity & the balance sheet should have equal totals on each side (for debits & credits).

PROFIT & CASH FLOW

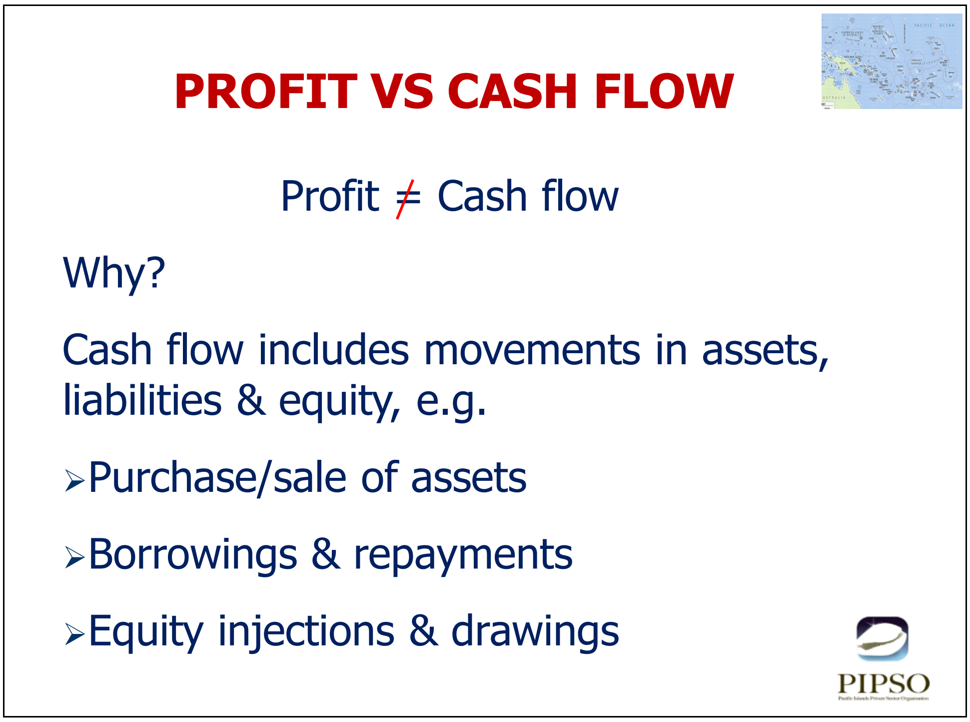
Profit does not equal cash flow. This is normal, not unusual, & should be expected.



Accumulated (or provision for) depreciationis the recoupment of the cost of a past asset, not a fund for the purchase of a new asset. It therefore has an annual profit consequence, but no cash consequence whatsoever – this having preceded it.

All purchases & sales on credit have both a cash & a profit consequence, but at different times. This represents a timing only difference between the date of the sale& the date of the receipt of the cash.

IMPORTANT: When a business is reporting on a cash basis only, this difference will not occur as purchases & sales are only recognised on receipt of cash.

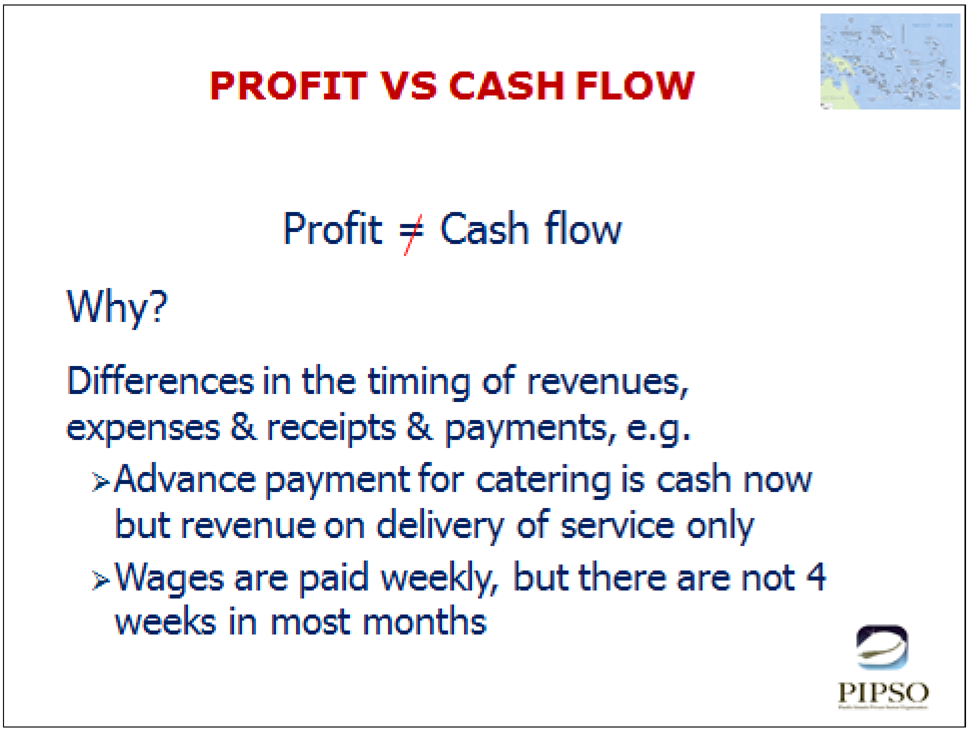


The purchase of an asset has a cash consequence when it occurs, but a profit consequence spread over its estimated useful life, which is a period of years.

A sale of an asset has a cash consequence equal to the proceeds, but a profit consequence equal only to the difference between the current book value (original cost less accumulated depreciation)& the proceeds.

The borrowing & repayment of the principal amount of a loan has a cash consequence, but no profit consequence. The interest on the loan has both a cash & a profit consequence, but the timing of this will vary. The cash consequence occurs when paid, but the profit consequence occurs daily as interest is accrued.

Any additions to or drawings from equity by the business owners have a cash consequence but no profit consequence.



Revenues received prior to being earned have a cash consequence at the time of receipt but a profit consequence only as earned.

Wages are paid weekly, fortnightly or monthly as per agreement, but they are earned as work is done. At most times the wages earned & paid will not be the same.

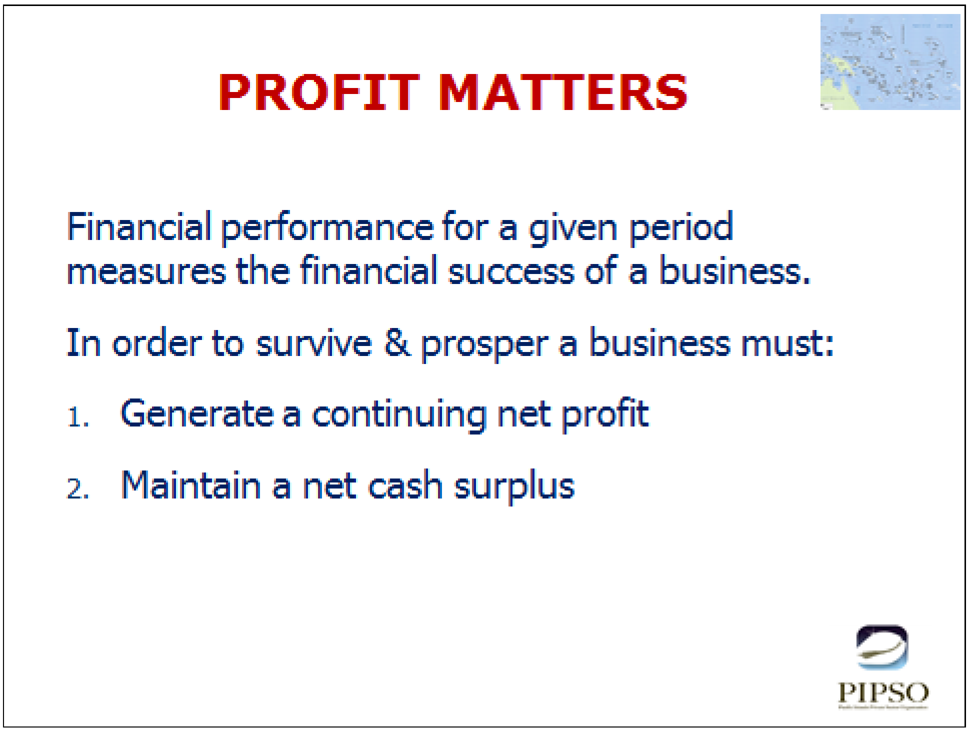
Put another way, cash flow is simply the reflection of the cash book or bank statement while profit must take account of events that cash flow does not as follows:

- The loss in value of assets used in the business
- Receipts that precede the business earning them (receipts in advance – when a customer pays a deposit or in total in advance to have goods made)
- Earnings that precede the receipt of cash (credit sales)
- Payments made for goods not used during the period (inventory or insurance)
- Goods received by not paid for, where payment is in arrears (credit purchases)
- Liabilities incurred but not paid (wages & salaries, annual & long service leave& tax)
- Amounts receivable that are not likely to be collected (customer who has gone bankrupt or who's business has collapsed)
- Profits or losses on the sale of assets

Profit does not account for any cash transactions that only affect the Balance Sheet as follows:

- Purchase of an asset
- Sale of an asset (except for the profit or loss on the sale)
- Borrowing for business purposes
- Repayments of the principle amount of borrowings
- Owner injections of cash into a business
- Owner drawings, or the payment of dividends, in cash from a business

PROFIT MATTERS



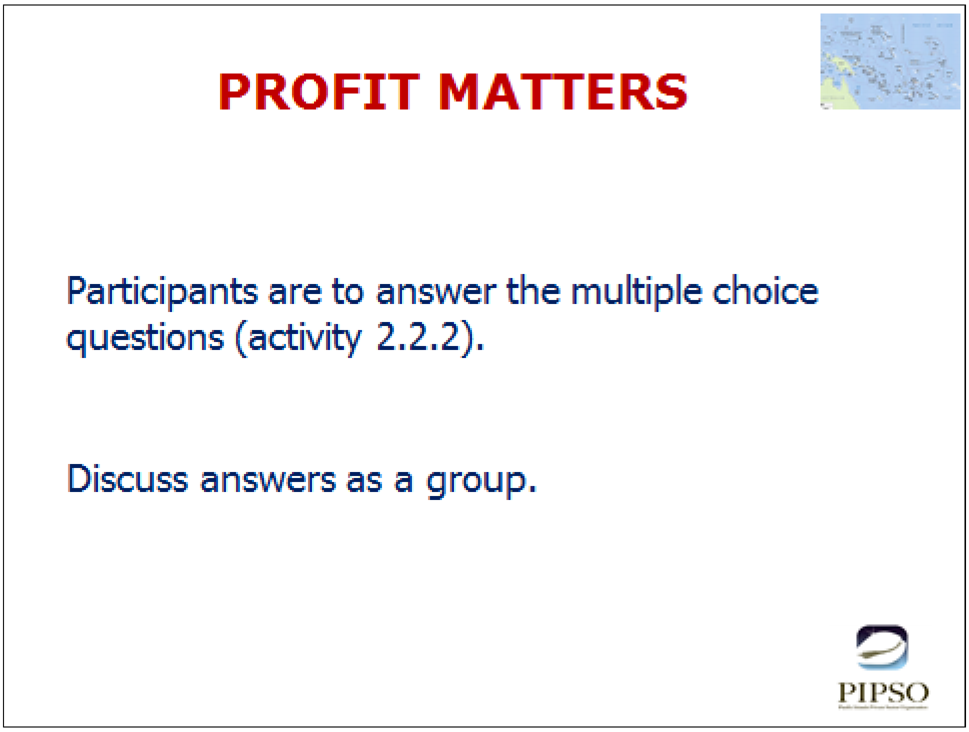
In the longer term all the transactions & the timing of those transaction that profit accounts for are a better measure of performance than merely the business cash flow. Therefore, in the long run profit is the better measure of business performance & used by credit analysts,along with a range of other financial measures, when comparing business performance.

Points 1 to 4 in the slide above should be self-evident to a reader, but the introduction of goodwill is new. Goodwill is simple the extra value added to a business in excess of the financial value of the net assets employed in the business, i.e. the intangible vale that makes the business worth more than its asset value. Successful businesses will be seen as more than the financial value of the components. The reasons for this mayinclude:

- The skills of the proprietor & staff
- Market penetration or list of satisfied customers
- Share of market
- Brand loyalty
- Product standards & quality assurance
- Patents, copyrights & other competitive advantages
- Capacity to innovate

IMPORTANT: In the end, there is no magic. There are only three ways to improve profit:

1. **Increase sales volume**
2. **Increase the price to the customer**
3. **Reduce costs; the cost of goods sold or other expenses**


PROFIT MATTERS
Participants are to answer the multiple choice questions (activity 2.2.2).
Discuss answers as a group.
PIPSO

Activity 2.2.2

PROFIT – A Quick Quiz

1. Profit is defined as:

   a. Assets minus liabilities
   b. Equity minus expense
   c. Equity plus revenue minus expenses
   d. Revenue minus expense

2. Profit is calculated in the:

   a. Income statement
   b. Cash flow statement
   c. Balance sheet
   d. All of the above

3. In the balance sheet, profit forms a part of:

   a. Assets
   b. Owner's equity
   c. Liabilities
   d. Net assets

4. Gross profit is $55,000, Opening inventory is $4,500, Closing inventory is $6,000, Operating expenses are $15,000. Net Profit is:

   a. $41,500
   b. $38,500
   c. $53,500
   d. $40,000

5. A flower nursery selling flowers to retailers would prepare accounts using the following format:

   a. Wholesaler
   b. Producer
   c. Service provider
   d. Any of the above

6. In order to grow in the long run a business would expect to:

   a. Make increasing profit
   b. Increasing its cash flows
   c. Increase its assets
   d. All of the above

7. A business has sold a motor vehicle for $25,000. It purchased the vehicle 4 years before for $50,000 In the books of account the vehicle is currently valued at $30,000. The cash flow impact of this transaction is:

    a. A decrease of $5,000
    b. An increase of $25,000
    c. A decrease of $25,000
    d. An increase of $5,000

8. The profit impact of the transaction in 7 above is:

    a. A loss of $5,000
    b. A profit of $25,000
    c. A loss of $25,000
    d. A profit of $5,000

9. When a business generates continuous profits, it:

    a. Increases creditor wealth
    b. Increases owner wealth
    c. Both of the above
    d. Neither if the above

10. For any given period profit will differ from cash flow because:

    a. There is a loss of value in assets
    b. Cash in the bank statement is different to cash at bank in our records
    c. There is a difference in timing of cash revenues
    d. All of the above

TAXATION

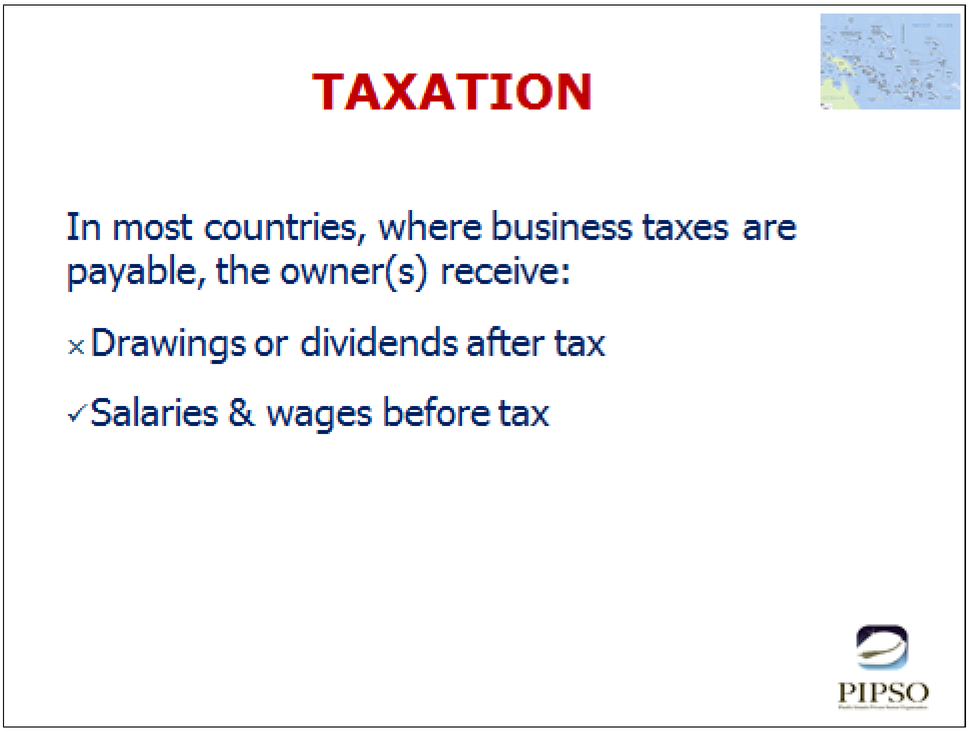
To date we have looked at business profit on a "before tax" basis. Credit analysts use both the before & after tax basis for critical analysis for different purposes.

Business may be taxed in a number of different ways & any profit calculation & reporting must be made in a manner consistent with current taxation regulations. While Governments tax both individuals & businesses in a number of ways, there are a range of taxes typically collected by business & paid directly to Government even though they may not be strictly business taxes.

These include:

- Receipts & payments that must be quarantined from revenues & expenses &, therefore, recorded & reported separately (VAT/GST)
- Payments that include taxes to be recorded & paid when due, but are expenses of the business & not recorded separately in the books of account (deductions for tax payable on behalf of employees)
- Payments that are expenses in the books of account but may not be tax deductions from income (stamp duties on land or other property transfers)

It is worthy of mention that owner's drawings from an unincorporated business or dividends from an incorporated business are taken out after tax, while the payment of the same wage or salary would be a tax deduction & therefore taken out of the business before tax. This may create a legitimate tax saving for a company.



This slide ends this Module.

ANSWERS TO ACTIVITIES

Activity 2.2.1

Trial Balance

Account	Debit $	Credit $
Bank	24,000	
Capital		25,000
Delivery vehicle	15,000	
Kitchen equipment	10,000	
Creditor		5,000
Purchases (supplies)	21,500	
Bank loan		20,000
Sales		26,900
Debtor	900	
Sock of supplies (closing)	5,500	
Total	76,900	76,900

Income Statement

	$
Sales	26,900
Less Cost of sales	
Supplies	21,500
Gross profit	5,400
Less Expenses	-
Net profit	5,400

Balance Sheet

	$			$
Assets		**Liabilities**		
Cash at bank	24,000	Creditors	5,000	
Stock of supplies	5,500	Bank loan	20,000	25,000
Debtors	900			
Delivery vehicle	15,000	**Owners' Equity**		
Kitchen equip	10,000	Capital	25,000	
		Net profit	5,400	30,400
	55,400			**55,400**

Activity 2.2.2

PROFIT – A Quick Quiz

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   d. Revenue minus expense

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   d. All of the above

3. In the balance sheet, profit forms a part of:

   a. Assets
   b. Owner's equity
   c. Liabilities
   d. Net assets

4. Gross profit is $55,000, Opening inventory is $4,500, Closing inventory is $6,000, Operating expenses are $15,000. Net Profit is:

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   b. $38,500
   c. $53,500
   d. $40,000

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   f. Increasing its cash flows
   g. Increase its assets
   h. All of the above

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c. A decrease of $25,000
d. An increase of $5,000

8. The profit impact of the transaction in 7 above is:

a. A loss of $5,000
b. A profit of $25,000
c. A loss of $25,000
d. A profit of $5,000

9. When a business generates continuous profits, it:

a. Increases creditor wealth
b. Increases owner wealth
c. Both of the above
d. Neither if the above

10. For any given period profit will differ from cash flow because:

a. There is a loss of value in assets
b. Cash in the bank statement is different to cash at bank in our records
c. There is a difference in timing of cash revenues
d. All of the above