

# Chapter 3: Profit & Loss Account

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## List of Transactions for Rewanchal Software Ltd. (RSL)

- On March 1, Rewanchal & others invest Rs. 50,000 in cash in RSL.
- On March 2, Rewanchal took a loan of Rs. 20,000 from Venu for RSL.
- On March 3, RSL purchased for cash two computers, each costing Rs. 29,000.
- On March 4, RSL purchased supplies for floppy disks and stationary for Rs. 6,000 on credit.
- On March 19, RSL completes its maiden sale of software to a retail store and receives a price of Rs. 12,000.
- On March 21, RSL pays Rs. 2,000 to its creditors for supplies.
- On March 29, RSL pays salaries to its employees, amounting to Rs. 4,000 and as office rent Rs. 1,200.
- On March 30, RSL completes a software package for a shoe shop. The customer agrees to pay the price of Rs. 8,000 a week later.
- On March 31, Rewanchal withdraws Rs. 3,500 for his personal use.

# Questions asked by owners/managers

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- Was it a good year or bad year?
- What was the volume of operations?
- What was the margin available on sales realization?
- The answer...

## Profit and Loss Account

# Profit and Loss Account

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- While a Balance Sheet
  - Reports value of assets, liabilities and owners equity at a particular point in time
  - And Reflects net change in owner(s) equity brought about by operations
- A Profit & Loss Account shows a company's earnings and expenses over a given period of time
- It exclusively summarizes revenue and expenses of the period and shows the net difference i.e., profit or loss of the period

# *Measurement of Income*

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- Comparing the revenue from sales against the cost of resources parted with for earning that revenue

# Balance Sheet Equation

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- ❑ Owners' equity = Assets – Liabilities ... (1)
- ❑ The amount of sales revenue realized increased owner(s) equity
- ❑ The amount of goods parted with decreased the owner(s) equity
- ❑ Thus, the resultant increase in owner(s) equity was equal to the net increase in assets. That is equal to the profit

# Profit and Loss Account

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- ❑ Owner(s) Equity = Contributed Capital + Retained Earnings
- ❑ Retained earnings = Revenue – Expenses ... (2)
- ❑ From (1) i.e., previous slide
- ❑ Assets = Liabilities + Contributed Capital + Revenue - Expenses ... (3)
- ❑ (2) is referred to as Profit & Loss Account

# Profit and Loss Account

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- It measures the income generated by the entity with the use of assets
- Revenue and expenses relate to a period and not to a point in time
- Recognition and measurement of revenue and expense are based on the ideas of realization, accrual, and matching

# Realization Principle

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- Process of converting non-cash resources and rights into money
- Recognition of revenue from sale of assets for cash (or specifically claims to cash)
- Revenue is recognized when goods are delivered (or services are rendered)
  - Possible Rationale ... Guess!!
  - Enables to have a reference in recognizing the expiration of costs incurred in making available such goods (or services)
- Exceptions:
  - Construction Contracts & Installment Sales contracts

# *Accrual Principle*

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- ❑ It is a generally accepted accounting principle (GAAP)
- ❑ Evaluates every transaction in terms of its impact on owner(s) equity
- ❑ Implies recognized revenue results in increase in owner(s) equity and expired costs or recognized expense results in decrease in owner(s) equity
- ❑ Net income arises from events that change owner(s) equity in a specified period which are not necessarily the same as change in the cash position

# Illustration ...

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- Ali Mehdi Khan starts his business on 1st July. He took a loan of Rs. 1,00,000/- from bank @ 12% per annum for purchasing plant & machinery, on the same day. The machine has a life of 10 years with no scrap value. He also paid Rs. 60,000/-, three months rent in advance
- Bank borrowing does not represent revenue – increase in cash is offset by an increase in liabilities
- Interest (Rs. 1000) depreciation (Rs. 833/-) are accrued expenses for July
- Rent expense for July will be Rs. 20000/-

# Illustration ...

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- Khan had written orders worth Rs. 2,00,000 in the month of June itself (even before starting his business). He started the production accordingly; the total production cost was Rs. 1,20,000; sales of merchandise to its customers till 31-07-2006 are as follows:
  - Total Sales = Rs. 95,000 (Cash Sales 25,000 and Credit Sales to Rajesh Rs. 70,000)
- Sales for June:
  - Nil – Because revenue is recognized only when goods are sold to the customers and not on receiving the order or on incurring the production cost

# Solution

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- Sales for July:
  - Rs 95,000
  - Accounting equation would be:
  - Cash + Debtors = Liabilities + Owner(s) Equity
  - $25,000 + 70,000 = 0 + 95,000$
- When Rajesh pays Rs. 70,000 in August
  - Sales does not occur
  - Cash would increase by Rs. 70,000 and the debtors would decrease. The amount of owner(s) equity remains same

# Accrual Vs Cash Basis

<b>Basis of Accounting</b>	<b>Accrual Basis</b>	<b>Cash Basis</b>
<b>Revenue</b>	When earned	When cash is collected
<b>Expense</b>	When incurred	When cash is paid
<b>GAAP Compliance</b>	Yes	No

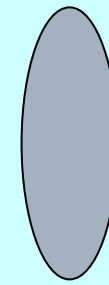
# Illustration

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- *We purchase merchandise worth Rs. 1,000 during the period; sell one half of this during the period for Rs. 750. Rental for the facilities during the period was Rs. 200*

# Discussion...

Item	Remarks
<i>Cost of inventory</i> Rs 1000	The purchase prices of the merchandise.
<i>Increase in owners equity i.e., Revenue</i> Rs 750	The sale proceeds realized in exchange of one half of the merchandise.
<i>Expenses i.e., expiration of inventorable cost</i> Rs 500	The cost of the merchandise parted with in exchange for the revenue. The cost with respect to the revenue earned and hence expired cost.
<i>Expenses i.e. expiration of non-inventorable cost</i> Rs 200	The cost of rent for the facility is a cost incurred during the period and expiring during the period i.e., a period cost.
<i>Ending Inventory</i> Rs 500	The unexpired cost. An asset merchandise inventory, as a convention valued at cost.



# Accounting Period

- A convenient segment of time, to collect, summarize and report all information on the material changes in owner(s) equity during the period
- Realization and Accrual principle will have to be applied in the context of the accounting period

$t_0$	Accounting period -1	$t_1$	Accounting period -2	$t_2$
Balance Sheet 0	Profit & Loss Account for the first accounting period	Balance Sheet 1	Profit & Loss Account for the second accounting period	Balance Sheet 2

□ Links in the information chain which makes up the life of the enterprise

# *Matching Revenues & Expenses*

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- ❑ The entire process of periodic earnings measurement
- ❑ Means deducting from revenues of a period the cost of goods sold or other expenses that can be identified with such revenues, or of that period, on the basis of a cause and effect relationship
- ❑ The expenses to be matched against the revenue of the period will be all those costs expiring during the accounting period

# Revenue

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- Broadly, it is the total amount realized from the sale of goods (or provision of services) together with earnings from interest, dividend, rents and other items of income
- '*Operating income*' Vs '*non-operating income*'
- Implication of Realization Principle
  - If the right to receive that income is created or the time for which the income relates have expired it is accrued income

# *Characteristics of Revenue*

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- ❑ Normally, generated out of business activities
- ❑ Results in inflow of assets (cash or receivable) and outflow of goods or services
- ❑ Usually related to a specific period i.e., revenue of one year cannot be included in revenue of the other year
- ❑ Leads to increases in owner(s) equity
- ❑ Different from 'profit' or 'net income'

# *Expense*

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- ❑ The expiration of the assets and the resultant decrease in assets leading to the decrease in owner(s) equity
- ❑ Costs incurred and expired in connection with the earning of revenue
- ❑ Sacrifice made or resource consumed in relation to the revenues earned during an accounting period
- ❑ Costs that have expired during an accounting period are treated as expense
- ❑ The expired cost, directly or indirectly related to a given fiscal period

# *Characteristics of Expense*

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- ❑ Expenses are incurred for the purpose of generating revenue or benefit
- ❑ Benefit is usually derived during the same accounting period under consideration
- ❑ It is related to a particular period. However, the payment of expenses can be made before the recognition of expense or afterwards
- ❑ Leads to decreases in owner's equity

# More on expenses...

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Expenses of a given period are

- ❑ Costs and expenses of current accounting period
- ❑ Costs incurred in a previous accounting period that become expenses or expired costs during this year (such as prepaid rent and prepaid insurance)
- ❑ Expenses of this year, the monetary outlay for which will be made during a subsequent period (such as salaries payable and taxes payable)

# Expense recognition

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Under following circumstances:

- ❑ In the period in which there is direct identification or association with the revenue of the period
- ❑ An indirect association with the revenue of the period
- ❑ Measurable expiration of assets (unexpired costs) though not associated with the production of revenue for the current period
- ❑ Assets that become expenses: inventories, prepaid expenses, and long-lived assets

## *Profit & Loss Account Preparation*

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- It is a summary of all 'accounts' dealing with transactions relating to revenue and expenses
- Done by summarizing all individual accounts accumulating information on different items relating to the elements of '*expense*' and '*revenue*'

Assets = Liabilities + Contributed Capital + Revenue – Expenses – Dividends

$$A = L + C + R - (E + D)$$

- 'Revenue - (Expenses + Dividends or Drawings)' is equal to the 'Retained Earnings'

# Illustration

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- *During an accounting period Ramsons buys twelve units of inventory for Rs. 1,200. Another ten units are purchased on credit for Rs. 1,000. Fifteen units of inventory were sold during the period on credit for Rs. 2,250. Five units of inventory were sold for cash for Rs. 750 during the same period.*

# Horizontal and Vertical format of P&L Account

<b>Revenue of the period:</b>	Rs.
15 units sold on credit	2,250
5 units sold for cash	750
<b>Total revenue of the period</b>	<b>3,000</b>
Less: Cost of goods sold or expired cost of inventory	2,000
<b>Profit of the period</b>	<b>1,000</b>

<b>RAMSONS</b>			
<b>Profit &amp; Loss Account (for an accounting period)</b>			
<b>Expenses</b>	<b>Rs</b>	<b>Revenues</b>	<b>Rs</b>
Cost of goods sold	2,000	Sales	3,000
Profit for the period	1,000		
	3,000		3,000

## *Possible Future Expenses*

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- Sometimes costs are incurred directly in relation to the revenue of a given accounting period, in subsequent periods
- Amount of expense in question is estimated, relating to an accounting period in order to make a reasonably accurate measurement of the profit or loss of the period
- Example: Provision for bonus
- Bad debt expense
  - Arises out of credit sales
  - Credit Sales → Receivables → Bad Debts

# *Possible Future Expenses*

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- A business is started with owner(s) equity of Rs. 2,500. The business makes four credit sales of Rs. 250 each during a period. Cost of sales for the same is known to be Rs 500.*
- Suppose one of the credit sales account becomes doubtful*

# Financial Statements

<b>Profit &amp; Loss Account</b> for an accounting period			
<b>Expenses</b>	<b>Rs</b>	<b>Revenues</b>	<b>Rs</b>
Cost of goods sold	500	Sales	1,000
Profit for the period	500		
	1,000		1,000

<b>Balance Sheet</b> as at the close of an accounting period			
<b>Assets</b>	<b>Rs</b>	<b>Liabilities &amp; Capital</b>	<b>Rs</b>
Accounts receivable	1,000	Retained earnings	500
Other assets	2,000	Owner(s) equities	2,500
<b>Total</b>	<b>3,000</b>	<b>Total</b>	<b>3,000</b>

# After accounting for Bad Debts

<b>Profit &amp; Loss Account</b> for an accounting period			
<b>Expenses</b>	<b>Rs</b>	<b>Revenues</b>	<b>Rs</b>
Cost of goods sold	500	Sales	1,000
Bad Debt expense	250		
Profit for the period	250		
	1,000		1,000

Bottomline hit by Rs. 250

<b>Balance Sheet</b> as at the close of an accounting period			
<b>Assets</b>	<b>Rs</b>	<b>Liabilities &amp; Capital</b>	<b>Rs</b>
Accounts receivable	1,000	Retained earnings	250
Estimated Collection loss	250		
Other assets	2,000	Other equities	2,500
	2,750		2,750

# *Fixed Assets and Depreciation*

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- The cost of a fixed asset, written off or matched as expense against the revenues of different periods during which the asset is used
- It is the expired cost of an asset during an accounting period
- *Illustration – A crushing machine purchased for Rs 50,000 having a five-year life and no salvage value is used in a business. During the life of the asset, it will be able to earn revenue of Rs 100,000*

# Computations...

## Revenue over the period of use of the assets

Total Revenue						= Rs 100,000
Period →	1	2	3	4	5	
Amount	Rs 20,000	Rs 20,000	Rs 20,000	Rs 20,000	Rs 20,000	= Rs 100,000

\* Assu

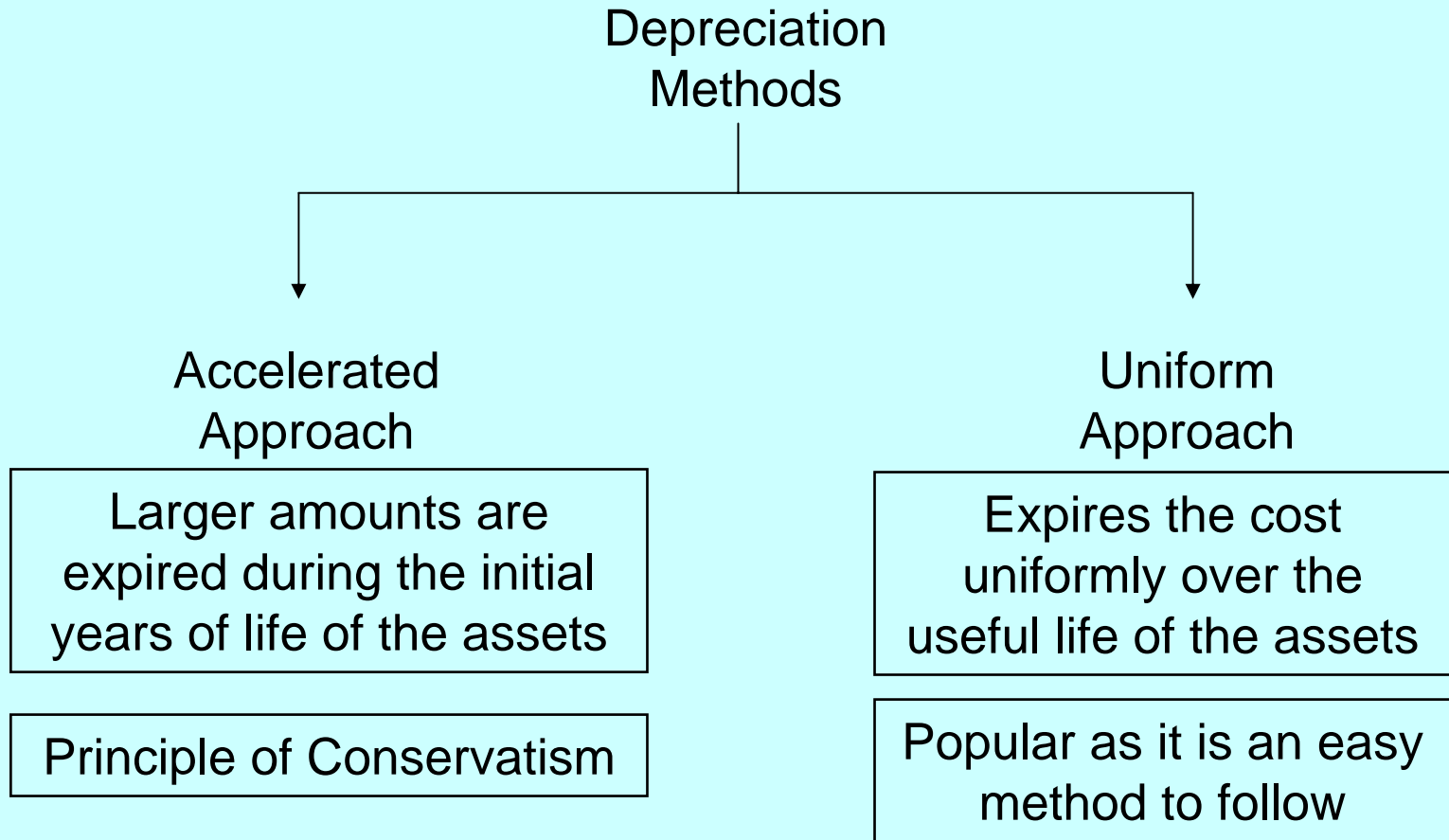
**Hence, profit per annum is Rs 10,000  
or Rs 50,000 over the useful life of the asset**

ets

Total Machine Cost						=Rs 50,000
Period →	1	2	3	4	5	
Amount	Rs 10,000	Rs 10,000	Rs 10,000	Rs 10,000	Rs 10,000	=Rs 50,000
Unexpired at the end of the period	Rs 40,000	Rs 30,000	Rs 20,000	Rs 10,000	Rs 0	

\* Assuming that asset is used evenly over the useful life

# Methods of Depreciation



# Depreciation: Some concepts

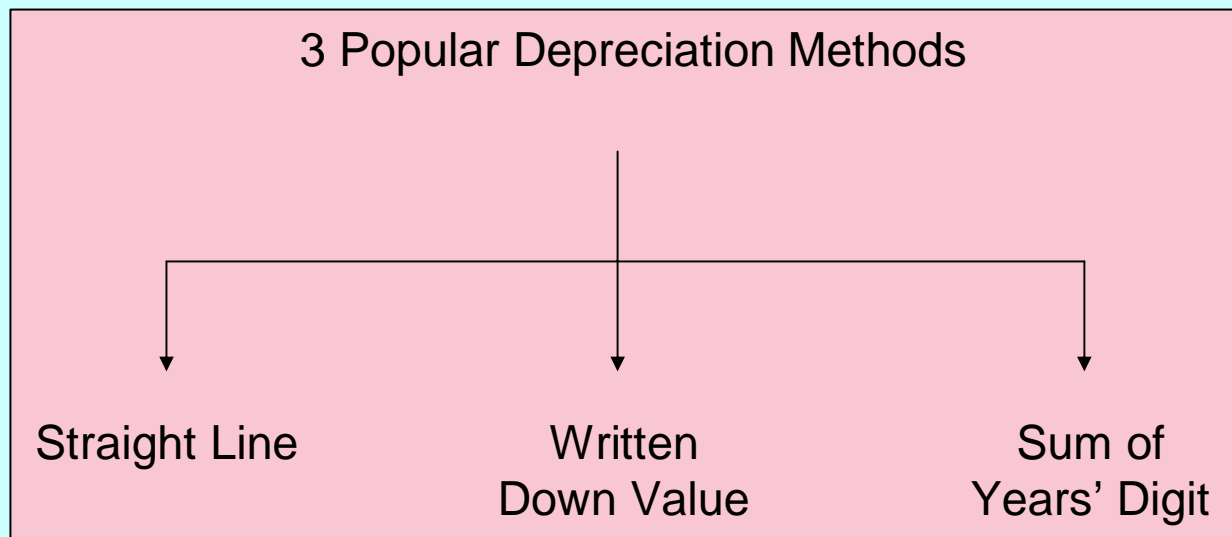
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- *Original cost*
  - Cost incurred in making the asset available for use at the first instance. This amount is specific and known on the acquisition of the asset
- *Salvage value*
  - Recovery (or sales value) of the asset at the end of its useful life. Value needs to be estimated (mostly).
- *Useful life*
  - Expected time period for which the asset is to provide economic service or productive life. Estimated based on experience/technical factors

# Depreciation: Some concepts

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- *Depreciable cost*
  - Original Cost of asset – Salvage Value
- *Book value*
  - Original Cost – Accumulated Depreciation



# Straight Line Method

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- Depreciable cost of the asset is proportionately allocated as expense against the revenues during each year of useful life of the asset

- Illustration
- A company acquires a machine at the beginning of operations at Rs 10,000. It is expected that machine will last 10 years and will have no salvage value at the end of its useful life

# Depreciation @ 10% per annum: Straight-line Method

Year	Cost	Annual Depreciation	Accumulated Depreciation	Remaining Book Value
0	10000	-	-	-
1	10000	1000	1000	9000
2	10000	1000	2000	8000
3	10000	1000	3000	7000
4	10000	1000	4000	6000
5	10000	1000	5000	5000
6	10000	1000	6000	4000
7	10000	1000	7000	3000
8	10000	1000	8000	2000
9	10000	1000	9000	1000
10	10000	1000	10000	0

# Written Down Value Method

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- ❑ Depreciation is taken as a certain rate applied to the written down value of the asset as at the beginning of each year
- ❑ The amount of expiration of the cost of the asset is higher during the initial years

# Written Down Value Method: @20% per annum

Year	Original Cost	Annual Depreciation	Accumulated Depreciation	Remaining Book Value
0	10000	-	-	10000
1	10000	2000	2000	8000
2	10000	1600	3600	6400
3	10000	1280	4880	5120
4	10000	1024	5904	4096
5	10000	819	6723	3277
6	10000	655	7378	2621
7	10000	524	7902	2097
8	10000	419	8322	1678
9	10000	336	8658	1342
10	10000	268	8926	1074

Since there is no salvage value for the asset at the end of its useful life, the terminal year depreciation will be taken as Rs. 1,342 i.e., Rs. 268 (the depreciation for the period) plus Rs 1074 (the terminal value of the asset).

# Sum of the Years' Digit Method

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- This method applies a declining fraction year to the depreciable cost of the asset
- The declining fraction is constructed by taking the number of years of useful service left at the beginning of the year as numerator and sum of the digits of the number of years of useful life as denominator
- Produces results akin to the written down value method with the difference that there will be no residual left
- If the asset has 10 years useful life the denominator of the fraction will be equal to  $(10+9+8+7+6+5+4+3+2+1)$  i.e., 55
- So, the first year's depreciation charge will be  $10/55$ , second years depreciation will be  $9/55$  and so on

# Sum of the Years' Digit Method

Year	Original Cost	Annual Depreciation	Accumulated Depreciation	Remaining Book Value
0	10000	-	-	-
1	10000	1818	1818	8182
2	10000	1636	3455	6545
3	10000	1455	4909	5091
4	10000	1273	6182	3818
5	10000	1091	7273	2727
6	10000	909	8182	1818
7	10000	727	8909	1091
8	10000	545	9455	545
9	10000	364	9818	182
10	10000	182	10000	0

# Intangible Assets & Amortization

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- ❑ Intangible assets such as patent rights or distribution rights represent unexpired cost
- ❑ The expiration of intangibles, though akin to depreciation, is distinguished by referring to it as amortization
- ❑ Usual practice is to amortize on straight line basis over a reasonably short period

# Depreciation & Profit Measurement

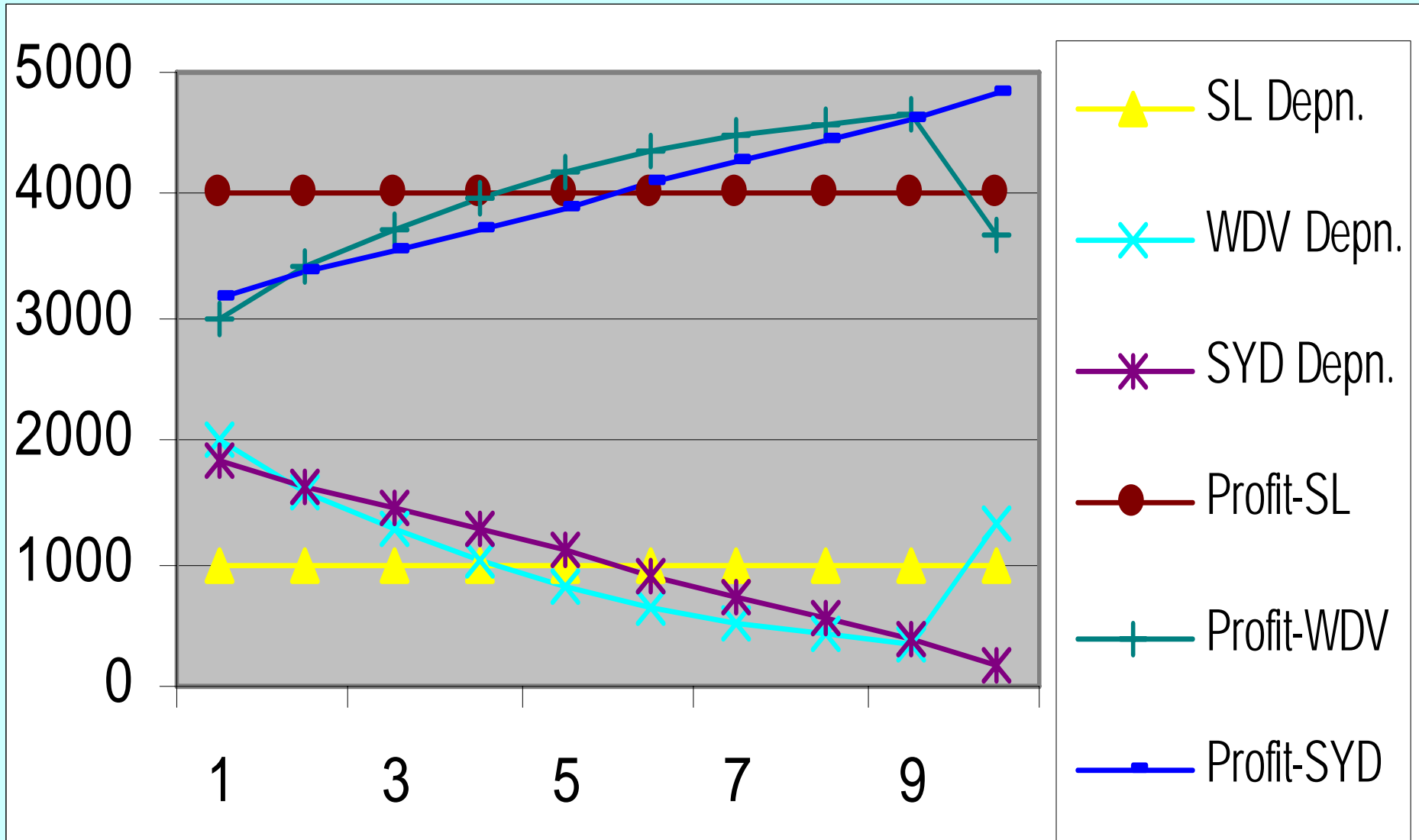
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- ❑ Depending on the method used for charging depreciation, we have a different amount of charge for annual depreciation
- ❑ Difference is only in terms of annual apportionment
- ❑ The net effect of the methods is therefore in terms of showing less or more profit in any particular year

# Profit Measurement under Different Depreciation Methods – Illustration

Year	Earnings Before Depreciation (say Rs.5000/- per annum)	Straight line depreciation	Written down value depreciation	Sum of the years' digit depreciation	Profit under Straight line	Profit under written down value	Profit under sum of the years' digit
1	5,000	1,000	2000	1818	4000	3000	3182
2	5,000	1,000	1600	1636	4000	3400	3364
3	5,000	1,000	1280	1455	4000	3720	3545
4	5,000	1,000	1024	1273	4000	3976	3727
5	5,000	1,000	819	1091	4000	4181	3909
6	5,000	1,000	655	909	4000	4345	4091
7	5,000	1,000	524	727	4000	4476	4273
8	5,000	1,000	419	545	4000	4581	4455
9	5,000	1,000	336	364	4000	4664	4636
10	5,000	1,000	269+1,074*	182	4000	3657	4818
	<b>50,000</b>	<b>10,000</b>	<b>10,000</b>	<b>10,000</b>	<b>40,000</b>	<b>40,000</b>	<b>40,000</b>

# Profit Measurement under Different Depreciation Methods



# Profit & Loss A/c – Horizontal Format

<b>Tools India Ltd.</b>		
<b>Profit &amp; Loss Account For the year ended December 31, 2006</b>		
	Schedule	Amount
<u>Sales net</u>	1	255
Other income	2	5
<b>Total Revenue</b>		<b>260</b>
Cost of goods sold	3	130
<b>Gross profit</b>		<b>130</b>
Operating expenses:		
Personnel	4	49
Depreciation	5	11
Other expenses	6	28
<b>Operating profit</b>		<b>42</b>
Interest	7	12
<b>Profit before taxes</b>		<b>30</b>
Income tax provision		12
<b>Net profit after tax</b>		<b>18</b>

# Profit & Loss A/c – Vertical Format

<b>Tools India Ltd.</b>					
<b>Profit &amp; Loss Account</b> for the year ended December 31, 2006					
<b>Debit</b>			<b>Credit</b>		
	Schedule	Amount		Schedule	Amount
<u>Cost of goods sold</u>	3	130	<u>Sales net</u>	<u>1</u>	255
Gross profit		130	<u>Other income</u>	2	5
		<b>260</b>			<b>260</b>
<u>Personnel expenses</u>	4	49	Gross profit		130
<u>Depreciation</u>	5	11			
<u>Other expenses</u>	6	28			
Operating profit		42			
		<b>130</b>			<b>130</b>
<u>Interest</u>	7	12	Operating income		42
Profit before taxes		30			
		<b>42</b>			<b>42</b>
Income tax provision		12	Profit before taxes		30
Net profit after tax		18			
		30			30

# Schedule 1: Sales

<b>Schedule 1: Sales (Rs Millions)</b>		
Gross sales		260.00
Less: Sales returns and allowances	1.75	
Sales discount	3.25	5.00
<b>Net sales</b>		<b>255.00</b>
Net sales –Domestic		
Machine Tools group	83	
Watch group	87	
Tractor group	60	
Lamp group	13	
Dairy Machinery group	2	
<b>Total domestic sales</b>		<b>245.00</b>
Export:		
Machine Tools Group	6	
Watch Group	2	
Others	2	
<b>Total Export Sales</b>		<b>10.00</b>

# Profit & Loss A/c Items

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## □ Trade discounts

- Given when sales are done in bulk (i.e., *discount* is based on volume of business)
- Never brought into accounts – the sales and hence sales invoice are valued at net of trade discount

## □ Other Income

- Operating income – Derived from the main-line operations of the business
- Other income – Arises from activities incidental to the business

# Profit & Loss A/c Items

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## □ Sales Returns and Allowance

- Not according to specifications, damaged, or defective

## □ Sales/Cash Discount

- Sales discounts are reduction from invoice price granted for prompt payment of the invoice within specified time limit
- 'Net amount' or 'No cash discount' (N)
- 'A 3 percent discount if payment is made in 10 days otherwise net amount to be paid in 60 days' (3/10, n/60)

# Profit & Loss A/c Items

<b>Schedule 2: Other Income</b>	
	Rs Million
Interest – banks	0.50
Interest – staff and offices	1.20
Export incentives	1.80
Sales agency commission	0.50
Profit on sales of assets	0.30
Dividend on trade investments	0.20
Other miscellaneous income	0.50
<b>Total</b>	<b>5.00</b>



# Profit & Loss A/c Items

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## □ Cost of Goods Sold

- Complex in cases of multi-product, multi-division companies, having large volumes of semi-finished goods
- Two challenges:
  - First is with respect to changes in the price per unit of purchase. At what price should we identify the cost of goods sold?
  - Second, how do we evaluate cost of semi-finished goods?

# Cost of Goods Sold Details

<b>Schedule 3: Cost of goods sold</b>	
	Rs Million
Inventory on January 1, 2000	81.00
Add: Purchase	110.00
Freight-in	10.00
Other direct material costs	15.00
<b>Total goods available</b>	<b>216.00</b>
Less: Raw material & semi finished inventory on Dec 31, 2000	71.00
<b>Goods available for sale</b>	<b>145.00</b>
Less: Finished goods inventory on December 31, 2000	15.00
<b>Cost of goods sold</b>	<b>130.00</b>

# Profit & Loss A/c Items

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## □ **Gross Profit**

- Reflects the direct input costs
- To a great extent variable with the volume of operations

## □ **Operating Expenses**

- All those costs of making the inventory available for sale
- Are directly or indirectly traceable to the inventory to be sold
- Usually segregated under two groups – selling expenses & administrative expenses

# Profit & Loss A/c Items

## □ Personnel Expenses

- Includes remuneration and other benefits to staff and workmen

<b>Schedule 4: Personnel expenses</b>	
	<i>Rs Millions</i>
Salaries, wages and bonus	37.81
House rent allowance	2.19
Gratuity	0.75
Contribution to provident fund	2.75
Contribution to Employees State Insurance (ESI)	0.50
Workmen and Staff Welfare expense	5.00
<b>Total</b>	<b>49.00</b>

# Profit & Loss A/c Items

## □ Depreciation expense

- Expiration of costs of fixed assets
- Usual practice to classify the depreciation expense for different groups of assets

<b>Schedule 5: Depreciation</b>	
	<i>Rs Millions</i>
Fixed assets	9.84
Tools and Instruments	0.02
Patterns, Jigs and Fixtures	1.14
<b>Total</b>	<b>11.00</b>

# Profit & Loss A/c Items

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## □ Other Expenses

- Expenses other than those disclosed separately are usually grouped together
- Relatively very small when considered as individual items

## Schedule 6: Other Expenses

*Rs Millions*

Power and Fuel	3.10
Rent	0.50
Rates and Taxes	0.40
Insurance	0.50
Water and Electricity	0.60
Repairs to buildings	0.20
Repairs to machinery	0.80
Printing and Stationery	0.90
Advertisement and Publicity	2.40
Audit fees	0.05
Royalties	0.85
Sole selling and other agents commission	4.70
Directors fees	2.00
Provision for bad debts and advances	0.20
Loss on assets sold or discarded	1.30
Provision for warranty repairs	1.00
Miscellaneous expenses	8.50
Total	28.00

# Profit & Loss A/c Items

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## □ Operating Profit

- Measure of 'operational efficiency'
- Obtained by deducting personnel, depreciation and other expenses from gross profit
- Usually referred to as OPBIT or EBIT

## □ Interest Expense

- Arises out of management's decision to finance part of the assets from borrowings
- The level of interest expense presents the amount of risk the company is carrying in terms of fixed commitments

# Profit & Loss A/c Items

<b>Schedule 7: Interest</b>	
	Rs. Million
Debentures	0.58
Fixed deposits	1.50
Loans from Government	5.00
Term loans from Banks/Financial Institutions	0.42
Cash (packaging) credit from banks	3.50
Others	1.00
<b>Total</b>	<b>12.00</b>

# Profit & Loss A/c Items

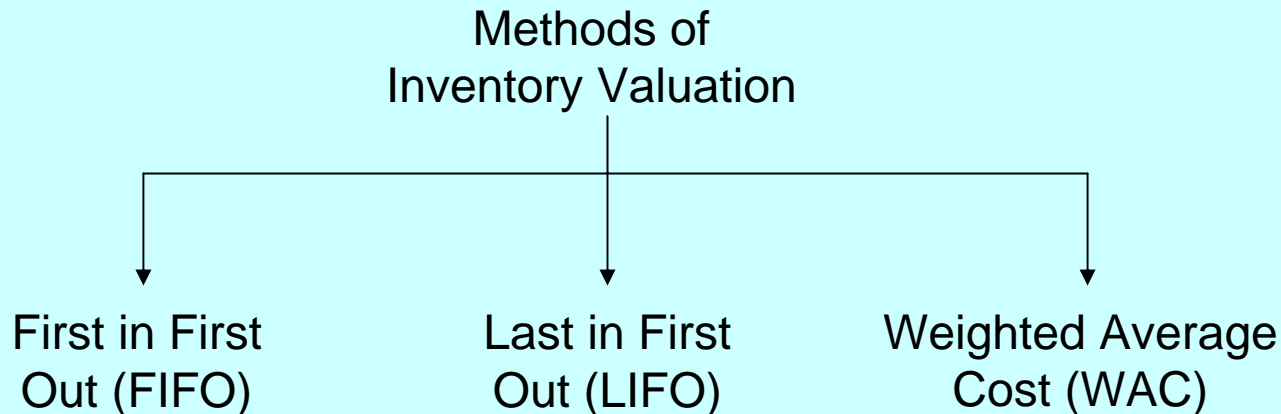
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- Net Profit before Tax
  - The surplus after meeting all expenses including interest
  - The profit available as a result of both operating and financing performance
- Income Taxes
  - Determined by profit before tax
  - Tax payable is determined by tax laws
- Net profit or Profit after Tax
  - It is the net amount of surplus earned by the company
  - The amount ultimately available for appropriation
  - Can be either distributed as dividends or retained

# Methods of Inventory Valuation

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- “Only thing certain with prices normally is that it is not certain”
- The recording of inventory as well as its expiration as cost of goods sold made on the basis of historical cost



# Inventory Valuation: FIFO, LIFO, and WAC

<b>Milk &amp; Milk Limited Example</b>					
<b>Balance Sheet on January 1</b>					
<b>Assets</b>			<b>Equities</b>		
Cash	INR	26.00	Owners Equity	INR	26.00
Total Assets		26.00	Total Equity		26.00
<b>Transactions during January</b>					
<b>Date</b>		<b>Item</b>			
13-Jan	Bought	one kg sugar @ Rs 12			
22-Jan	Bought	one kg sugar @ Rs 14			
31-Jan	Sold	one kg sugar @ Rs 15			
<b>Statement of Income for January</b>					
		FIFO	Average Cost	LIFO	
Sales	INR	15.00	INR 15.00	INR	15.00
Less: Cost of Sales		12.00	13.00		14.00
Trading Income		3.00	2.00		1.00

# Take Home ...

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- ❑ Purchase Cost is the same irrespective of the method of inventory valuation
- ❑ Cost of goods sold and ending inventory at the end of the period are different for the three different methods of inventory valuation
- ❑ Try preparing its balance sheet at the end of the period?
- ❑ What do you observe?
- ❑ In all the cases inventory *plus* cost of goods sold amount to the same, since it is based on actual historical cost only

**ACC****P&L a/c for the year ended 31.12.06**

<b>Income</b>	<b>in Rs Crores</b>
1. Sale of Products & Services (gross)	6504.46
less excise duty recovered	653.22
less Sales Discounts, Sales Return	120.41
Net Sales	5730.83
2. Other Income (Non - operating)	123.1
Gross Revenue	5853.93
<b>Expenditure</b>	
3. Manufacturing Expenses	2642.84
<b>Gross Profit</b>	3211.09
4. Personnel Expenses	322.54
5. Depreciation	260.95
6. Other Expenses	939.77
<b>Operating Income</b>	1687.83
7. Interest	54.37
<b>Profit Before Tax</b>	1633.46
8. Corporate Tax	393.86
<b>Profit After Tax</b>	1239.6

# Explanations to Items

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- ❑ **Gross Sales (or Gross Turnover):** The aggregate amount for which product sales are effected (or services rendered) by an enterprise (inclusive of taxes paid)
- ❑ **Net Sales (or Net Turnover):** The sales after deduction of sales returns & allowances, sales discounts, etc.
- ❑ **Operating Income:** The net income arising from the normal operations and activities of an enterprise without taking into account extraneous transactions and expenses of a purely financial nature

# Explanations to Items

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- **Gross Profit (or Gross Margin or Gross Loss):** The excess of the proceeds of goods sold and services, rendered during a period over their cost, before taking into account administration, selling, distribution and financing expenses
- **Net Income (or Net Profit or Net Loss):** The excess of revenue during a particular accounting period

# Dividends & Retained Earnings

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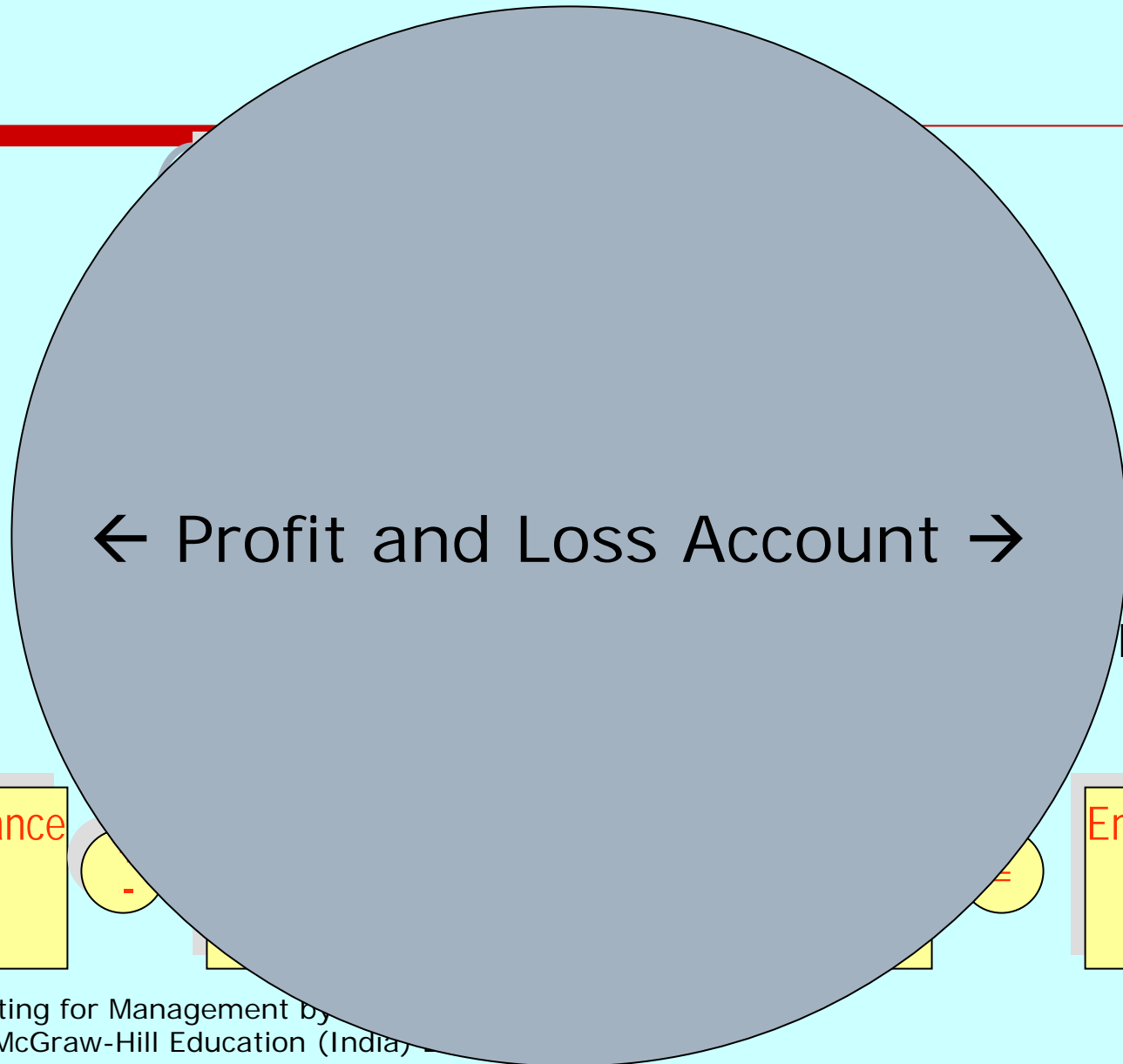
## □ Dividends

- An appropriation of profits among owners → not an expense
- Technically the withdrawals by owners of the business
- In Joint Stock Companies, it is subject to Company Law

## □ Retained Earnings

- After subtracting dividends declared from the net profit, any surplus remaining is added to (accumulated) retained earnings. Also referred to as *reserves and surplus*
- Sometimes designated to signify retention of earnings for different future purposes such as redemption of debt (redemption reserve), replacement of assets etc.

# Components Of Retained Earnings



Start of the Period

End of the Period

Beginning Balance of Retained Earnings

Ending Balance Of Retained Earnings

# Further Discussion (Optional)

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# Profit & Loss Account of a Manufacturing Concern

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- Profit & Loss account during a period can be divided into 4 parts:
  - Trading Account: Indicates the amount of gross profit earned by matching the cost of sales with the revenues generated
  - Manufacturing Account: Gives the cost of goods manufactured by the manufacturer
  - Profit & Loss Account: Used to measure the profit/loss of the firm by way of deducting the administrative expenses, selling & distribution expenses, non-trading losses, and finance charges from gross profit and the non-trading income
  - Profit & Loss Appropriation Account: Reflects how the net profit earned by the firm is utilized → it is an income distribution statement

# Thank You

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