**Financial Accounting**
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**Lecture – 10**
**Profit and Loss Account 3**

Namaste. Welcome to Financial Accounting. We have discussed about balance sheet which is one of the most important statements of financial nature. In the last statement or in the last session, we had started with discussion on Profit and Loss Account.

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We had almost done, we will just have some more discussion today. So, as you all know profit and loss account is a statement which gives you profit or loss and in case of nonprofit entities it is called as a surplus for a particular period. It has to list all incomes and all expenses.

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So, it has two parts; income part and expense part and this is our short form a very simple form of P and L and we are also seen in detailed form as per the schedule III of companies act. So, its starts from revenue; revenue or the income of the entity, then other income; you get total revenue.

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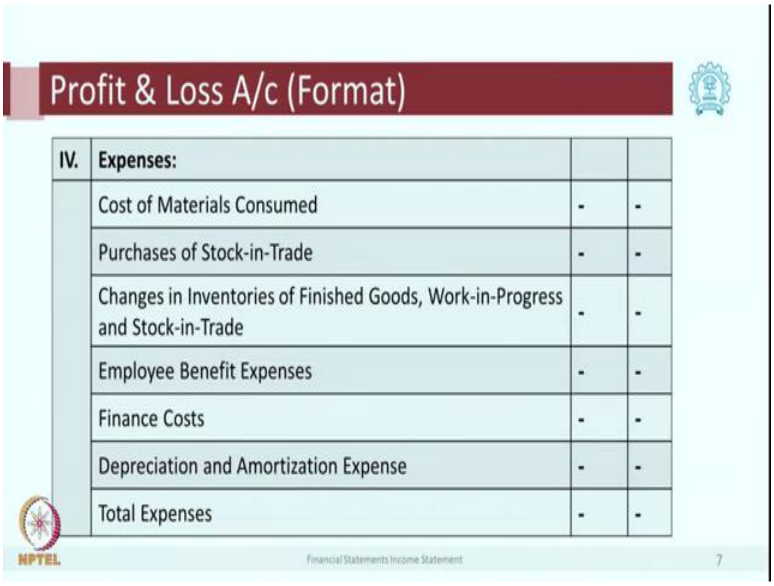


Then in item number IV, you consider the expenses. There are six categories of expenses, starting from cost of material to depreciation. I had told you that change in inventory is slightly confusing item because it is not a direct expense as such. What happens is you have got opening inventory you have got closing inventory, if there is a reduction in the inventory. So, more opening inventory less closing inventory, there will be a decrease in inventory which is an expense.

So, in the it is in the under the head expenses will have a positive sign. But if you have got less inventory in the beginning more inventory in the end so, increase in the inventory is mean actually conveys that there is less expenditure in the period; you are keeping more inventory for future that is since it is an under the expense head. Increase in the inventory would you have a negative sign.

So, I had told you that go to your balance sheet of your company and see the sign of this item, it can be positive, it can also be negative. While for all other items it will be positive; positive means it is added to expense. Then employee benefits, then financial cost; financial cost is slightly unique type of expense because it is related to your business, but it is specifically for raising of funds.

So, if you have taken loan, you will have to pay interest; if you have issued debenture, you will have to pay interest; if you have leased an asset that is you are taking somebody else's asset for use, then you will have to pay financial cost for the lease that is also finance cost. So, all these items are added in finance cost and the last item of expense is also unique in nature that is depreciation and amortization. Do you remember what is depreciation? There is a reduction in the value of fixed asset. If it is for tangible fixed asset, we call it depreciation; if it is for intangible fixed asset, it is called as amortization.

Now, how the depreciation is calculated, we will see in the next session. But as of now whatever is a depreciation as calculated represents an expense of the entity for that period. Suppose you have purchased a machinery for 5 lakhs and the life of the machinery is let us say, 5 years. You cannot charge the whole 5 lakhs in year 1, but you also cannot say that nothing is a cost throughout the 5 years. At the end of 5 years, we will consider 5 lakhs.

So, this 5 lakh rupees, you will credit over its useful life which is 5 years may be you can take 1 lakh each year that 1 lakh represents the depreciation for that year. I hope you are getting it. More methods of depreciation we will see later on, but depreciation is one of the expense it is unique because it is non cash in nature; you do not pay any cash for it, but there is a fall in the value of assets, so you record it ok.

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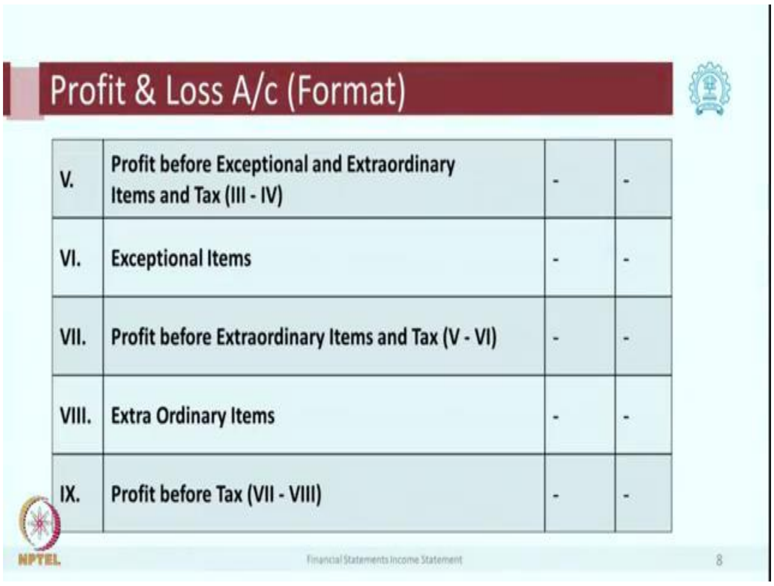

Profit & Loss A/c (Format)

| | | | |
|---|---|---|---|
| V. | Profit before Exceptional and Extraordinary Items and Tax (III - IV) | - | - |
| VI. | Exceptional Items | - | - |
| VII. | Profit before Extraordinary Items and Tax (V - VI) | - | - |
| VIII. | Extra Ordinary Items | - | - |
| IX. | Profit before Tax (VII - VIII) | - | - |



So, after taking these six items, you get total expense. Now 3 minus 4 gives you profit this is your initial profit. Now, a few more items are considered there, they are known as exceptional and extraordinary. Do you remember what these items are? These items are non recurring in nature. Normal course of business, we do not expect them every year like say fire, like some major accident I am not talking of a very small fire or a very small accident, that is in normal course, that will be in item IV.

But some big happening which causes major losses or major incomes, they would be categorized as exceptional incomes or expenses the losses because of them would be under this item. In rare cases, there can be also exceptional incomes. What is an example? Last time we said sale of asset; asset like a land not your normal goods, then it is your revenue. But if you sell land maybe once in 10 years, 15 years, 50 years like that it can happen, it will be categorized as a exceptional and extraordinary item; it is shown either in 6 or 8.

It needs to be separately categorized because readers of P and L account should know that this is not a profit in the normal course of business. So, it is separately shown, so item V is your normal profit to that you adjust for VI and VIII. First you take VI, then you get profit before extraordinary item and tax then you take VIII; you get profit before tax. So, by after you deduct VIII in IX you have considered all items exceptional and extraordinary, you have only not considered the taxes.

Now, from IX we will reduce the taxes, so you have a tax expense. Now, what do you mean by tax expense? There are variety of taxes for example, GST. Will you include GST here? The answer is no because GST is a indirect tax. They indirect taxes which are incurred are part of your cost. So, it will be already included in these expenses.

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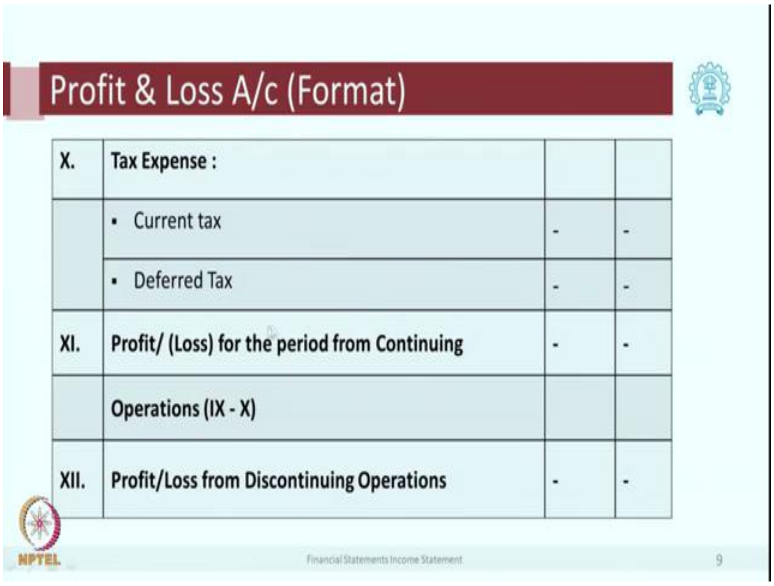


So, what you are considering here in tax expense is only taxes on your profits which is nothing, but income tax. So, profit before tax; here the word tax refers to income tax only. Now from that you are deducting two types of taxes, it is both are income tax only, but under the provision of income tax certain taxes are allowed to be deferred; that means, you can pay them after 2 years, 3 years, 4 years etcetera. Most of the taxes you have to pay now; they are called as current taxes. If you are allowed to defer the amount of tax, it will be called as a defer tax.

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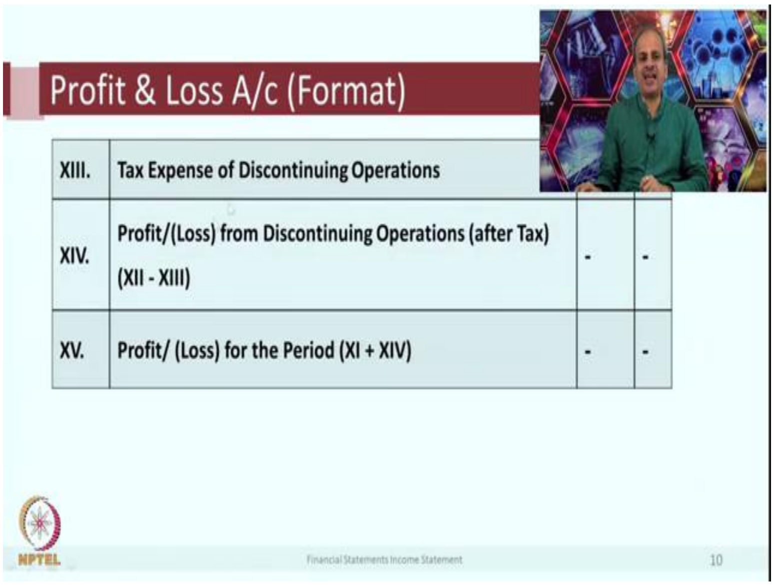


So, from IX, you will this is profit before tax you will deduct the tax expense, then you will get XI. Now this is a profit from your normal business. So, it is a profit for the period from continuing operations. Now, some part of the business, you might have stopped that business. For example, certain factory is closed now or certain line of business is closed then again the readers of P and L should know that this is a profit or loss coming from a closed business. So, it is to be separately categorized in XII as profit from discontinuing operations ok.

So, at XI, you have calculated all the profit from continuing operation, then profit from discontinuing operation, you reduce any tax expense on discontinuing operation. So in XIV, you get profit or loss from discontinuing operation. Now, this XII sorry this XI plus XIV together gives you profit or loss for the period.

Now, they have written loss in bracket because suppose this figure is negative, it will be shown in bracket which indicates that you have incurred the loss for the period. It says for the period, I think you all know that profit and loss account itself is paid for a particular period may be a year or a quarter or for a month. So, unlike a balance sheet, suppose last year sales or last year's expenses cannot be shown in P and L account whatever profit you have incurred is a profit for the particular period.

I hope you understood P and L, if you have any queries please discuss them on our discussion forum. Now, we will just consider one or two important concepts. One important concept is income because there we had said revenue here; we had said revenue from operations.

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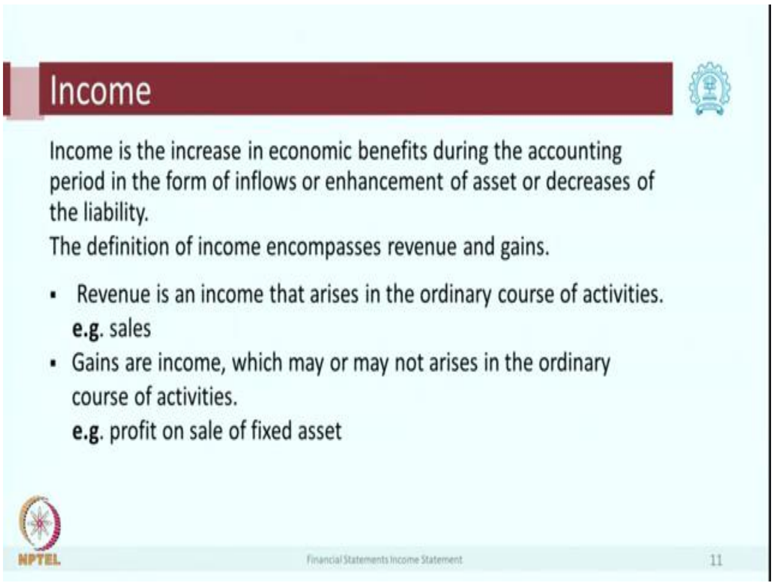


So, first of all we should be clear as to what is a income. Now, income is defined as increased in economic benefit during a particular accounting period. Normally it reflects in inflows or enhancement of asset either you get cash or some of your assets are enhanced or your liabilities are reduced, then it is called as a income.

Every income is not revenue, income is of two types. It can be revenues or it can be gains. Income which you get from a normal business activity or from a day to day business activity is called as revenue and income which occurs because of an occasional activity because of a onetime activity is called as a gain.

So, we had already seen one example that we have a piece of land you sale it after 10, 15 or 20 years. This is not your normal business, you are not into a developer or as a builder. For a builder buying and selling of land will be normal course that will be a revenue, but for any other company sale of land or a sale of fixed asset would be a onetime activity; it is not a nor normal or a ordinary activity. So, any gains from sale of fixed asset would be categorized as a gain.

So, all the incomes are into revenue and gains keep in mind in P and L account the item number I is revenue, so you do not write any gain there. Are you getting me? So, whatever is your normal operations; if there is any sale or any revenue from provision of services that will be one that is your normal business. Other than that is categorized as other incomes, so you would have wondered here it is called revenue, but here it is called income. Because here you can show revenue as well as gains which are not from normal businesses ok.

So, for example, if you have purchase shares, you will get some dividend on it or if you make profit by selling, then dividend as well as the gain from sale both together would be shown as other incomes. Same way, there are other gains which we had categorized as exceptional or extraordinary items like from sale of a big land. Are you getting me?

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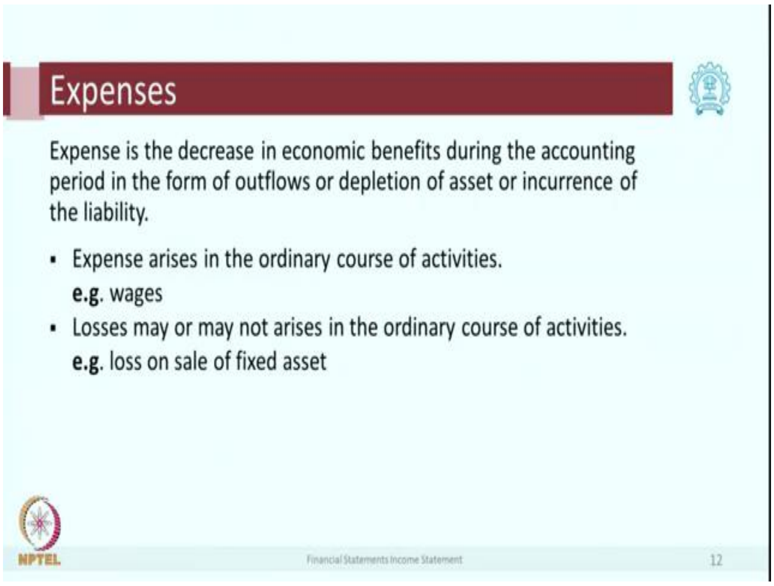


So, here just a conceptual understanding as to what is a income. The other one is expense. Now almost everybody knows expense because every now and then we keep on incurring some expense. So, expense happens means what for a normal persons if his cash reduce then that person calls as a expense because there is a outflow of cash. Sometime there is a reduction in the value of asset like depletion in the asset or sometime suddenly a new liabilities created. All this put together lead to decrease in economic benefit which is called as an expense.

Now, expenses are also of two type. When it is in the normal course, then we just call it as an expense. For example, if you pay salary if you pay rent, if you pay electricity charges, if you pay travelling expenses; all this is a example of are examples of expenses.

There is also a peculiar type of expense which is known as loss, so it is not in a normal course.

So, if you have purchase machinery life is expected to be 5 years, then every year you will depreciate; depreciation is your expense. But suddenly the machinery proves to be a bad machinery, it is not serving your purpose either it is of a outdated technology or there are some problems with running of machinery, so you will have to dispose of the machinery in the second year for zero value. So, the whole amount is lost, then we will not call it as a day to day expense, we will call it as a loss on sale of machinery and it will be categorized as loss. Are you getting?

So, any expense of such type which is not day to day or normal, can you give any other example of any such loss? So, suppose you have purchased a patent; patent has a life of 4 years, you were expecting that that technologies usable for 4 years, but within next year a better technology has come; I think we are all in knowledge era. So, you are aware that last year you purchased a new mobile, but this year now you there is a better mobile available, so you feel the old mobile is outdated.

So, whatever expense which is incurred in buying that particular patent is not of any use you might have to write it off, then that is also an example of a loss. So, as you got expenses, we divide into two types. If you go back to P and L, you can see here in item IV the term used is expenses. So, from the revenue we deduct only those items which are normal in nature. Those which were not normal we are categorizing them mostly as exceptional or sometimes as extraordinary and in some cases as relating to discontinuing operations, but normally the item in IV, items in this IV are day to day types of expenses. Are you getting? So, this was like the P and L is essentially a list of incomes and expense.

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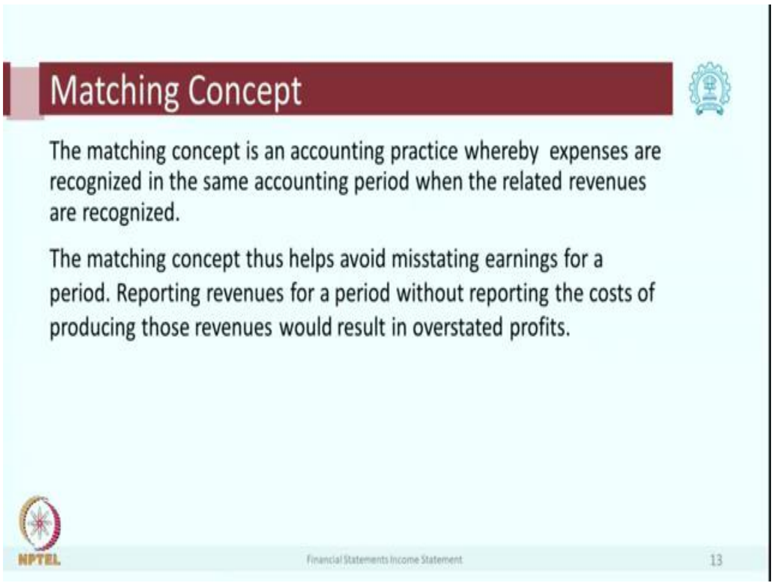


Now, in the last part, we will look at an at a important concept known as matching concept. Now, why there is a need to list incomes and expense? There is a need because of an accounting principle which is known as matching. So, at the end of the year as per the accounting norms or as per the accounting requirement, you have to make a list of all incomes and all expense. Why there is such a requirement? Because unless you do that you will not be able know profit or loss that is why accountants have made it a rule that incomes and expenses should be listed at the end of the period and that net result should be available in P and L account.

Now, matching concept avoids misstatements in earnings. So, what happens is suppose you have generated revenue in the current period, the expense which is related to that should also be recognized in the same period. If you record revenue now, you will show lot of profits in this year; expense will come in the next year, but that year in revenue is not there because you will again show lot of losses in the next year, so that leads to a misstatement.

So, matching concept says that whenever you recognize the revenue also recognize the expense related to that. So, neither there is a excessive profit in earlier year and sudden losses in the next year that is avoided. Similarly, it should not happen that now you record expense, but you suddenly record revenue in the next year which is also a misstatement. Can you give an example of such a happening that revenue is recorded now, but expense suddenly comes later?

Let us say you are selling some item and you give the customer guarantee for 5 years, you record revenue now, show the profit also now, but the guarantee is for next 5 years; that means, in the next 5 years whatever is a repair etcetera on the item sold, we will have to be incurred by the business in year 2, 3, 4 and 5. But in year 1 you are recorded all the revenue. So, how will you avoid that?

If you remember in our earlier class, we had discuss that we create a provision exactly how much will be incurred because of guarantee nobody knows, but we will create a reasonable provision for year 2, 3, 4 and 5 and record it write in year 1. This is due to matching concept. Can you think of any other example? I think you have heard about depreciation in last two classes, little bit discussion on happen on depreciation happen.

For example, if you purchase machinery of 5 lakhs having a life of 5 years. Now, you have paid entire 5 lakhs in year 1, but you will use the machinery write up to year 5. Is it right full that the whole expense shown in year 1 only? The answer is no because you are going to use that machinery in year 1, 2, 3, 4 and 5. So, revenue which is generated by using that machinery is spread over 5 years, so what we do is the expenses there on are also spread over 5 years.

So, what we do is we create different types of provisions. If you remember we had discussed in the balance sheet a concept called provision what is the need of provision is because of the matching concept. Same way why you have to provide for depreciation is also because of the matching concept; I am just discussing matching concept because this is a base for P and L.

Why was P and L account prepared? It was because of the matching concept like that actually there are several principles and concepts in accounting. So, I am going to discuss as and when the relevant statement comes into picture, so that you are not suddenly board and you can relate the concept to the relevant statement I hope you are getting a.

So, with this discussion we have completed the discussion on P and, we already had discuss balance sheet, so you have understood the basics statements now. I know we have not done any cases or problems we will do them in later sessions, but overall understanding of statements have happened you can read this statements and once again remind you that you have to download annual report of your company whichever company you choose start reading their P and L account and balance sheet along with my lectures.

So, that you also see the actual statement instead of just theoretical discussion, in coming sessions we will discuss some relevant concepts. For example, what is depreciation, how do you calculate and value inventory, what are important accounting rules. We will discuss a few concepts like this and then we will go for actual preparation of P and L and balance sheet. Till that time keep refreshing yourself by reading those P and L and balance sheets. So, with this we will stop here. Namaste.