

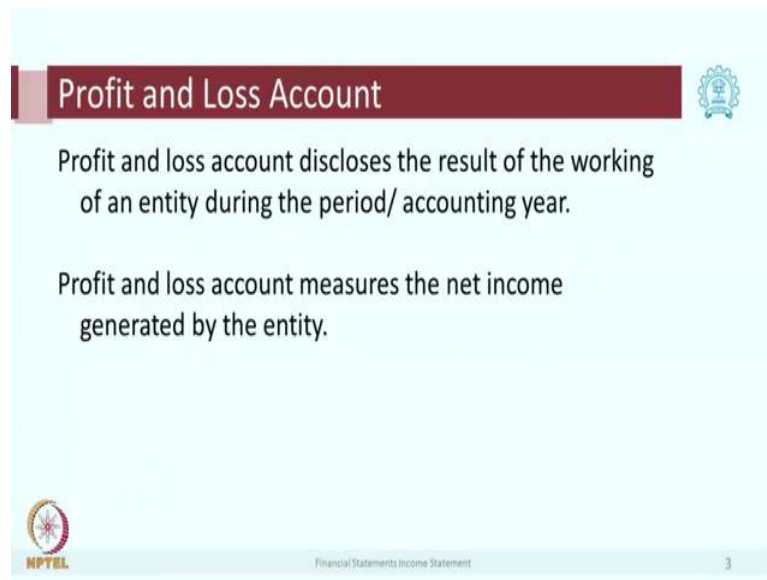
**Financial Accounting**  
**Prof. Varadraj Bapat**  
**School of Management**  
**Indian Institute of Technology, Bombay**  
**Lecture – 08**  
**Profit and Loss Account 1**

Namaste. Welcome everybody to our sessions on Financial Accounting. We have already discussed what is accounting, then we started with financial statements. And in our last sessions we have discussed one of the most important financial statement that is balance sheet. We have also seen the format of balance sheet a short form then in detail as per schedule III of Companies Act.

So, can you tell me what does the balance sheet give you? The balance sheet is a statement which shows the financial position of the entity as on a particular day. Normally it is prepared at the end of the year, you have a list of assets, you have a list of liabilities and you also have a balancing figure as owners fund or equity shareholders money that is there in the balance sheet. Today we are going to start with the next financial statement which is profit and loss account; sometimes it is called as income statement.



So, for business entities in India we call it P and L account, in some countries like us it is called income statement. For non-profit organizations like trusts and societies it is called as income and expenditure account, but the basic concept is that of profit and loss account. So, today in the session we will discuss what is P and L account? And try to understand what are the elements of P and L account. Now P and L account discloses the results of operations of the entity.

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**Profit and Loss Account**

- Profit and loss account discloses the result of the working of an entity during the period/ accounting year.
- Profit and loss account measures the net income generated by the entity.

Financial Statements Income Statement 3

If you are a company; obviously, you would be looking for the profit. So, P and L account will show you the profit during a particular year or during a particular month. If you are a nonprofit organization then you will prepare income and expenditure account and it will give you the surplus.

Now for every entity to calculate the profit, you will need to know the incomes and expenses. Now in our first session we had a look at the money cycle or at the business cycle; from the business cycle you will come to know what are the incomes, you will also come to know what are the expenses and they would be listed out and the difference between them would be the surplus or would be the profit of the entity.

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So, the major components of P and L account are incomes and expenses.

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The table is titled 'Profit & Loss A/c (Short Format)' in a white serif font on a dark red background. It has two columns: 'Particulars' and 'Amount'. The rows are: Sales (XX), Cost of Goods Sold ((XX)), Gross Profit (XX), Other Expenses ((XX)), Tax ((XX)), and Net Profit (XX). The background is light blue. In the top right corner is a small circular logo. In the bottom left corner is the NPTEL logo. In the bottom center, it says 'Financial Statements Income Statement'. In the bottom right corner, the number '5' is displayed.

Particulars	Amount
Sales	XX
Cost of Goods Sold	(XX)
Gross Profit	XX
Other Expenses	(XX)
Tax	(XX)
Net Profit	XX

And this is a simple format or a short form of P and L account; so, it starts with sales most of the entity's income is the sales. Then less cost of goods sold gives you gross profit, then you deduct other expenses or operating expenses taxes that is the net profit; this is a very simple format of P and L.

Now let us look at the Company Act format as per the schedule III of Company Act; now instead of sales the word uses revenue from operations.

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Profit & Loss A/c (Format)			
Particulars (format as per revised schedule III )	Year Ended		Year Ended
	31st Mar 2011	31st Mar 2010	
I. Revenue from Operations	-	-	
II. Other Incomes	-	-	
III. Total Revenue (I + II)	-	-	

Now, what do you mean by revenue from operations? For a simple understanding in the earlier slide I had used the word sales; which is more or less same as revenue, but now the term revenue because entity might not be selling the goods it can also be providing variety of services.

So, the revenue it generates from services plus the revenue it generates from sales both together; it is called as revenue from operations. Operations indicate that this relates to day-to-day functioning of the entity; that is why any money or any income which is generated from the normal course of business would be shown as revenue from operations.

Next to that there is other income; now what is other income? As the name suggests it is other than revenue if any incoming generated; it is shown separately. Now you can add both of them, so in step number III; you get total revenue which is I plus II, but now the users of that P and L account want to know how much is a revenue generated from operations and how much is other income? That is why it has to be classified; in item I, you only show the revenue from operations in item II; you show other incomes and in item III; it is a total of I plus II.

Now, what is an example of other income? Can somebody think of the example. Suppose we have deposited some money in the bank, we have a surplus cash we deposit in a bank at the end of the quarter or at the end of the 6 months; bank gives us some interest, that

interest is an example of other income. It is not a income from our regular business, it is not a sale of goods or it is not a supply of services done by us. But from our surplus money we invested, we got some income from that investment in the form of interest then it is an example of other income.

Same way sometimes, if we sell our fixed asset at profit then the profit which you generate will be an example of other income. The loss which you incur by selling asset is also other income ok. So, search items which are not in the normal course of business, but they are also revenue in nature they would be shown as other income; now both together forms the total revenue for that entity. Now item number IV is expenses; now all expenses of the concern in that particular year or that for that period are listed out.

Company Act has specified certain headings, so you just like in balance sheet there were certain headings; there are certain headings in P and L account all your expenses you are to fit in those headings.

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Profit & Loss A/c (Format)		
IV. Expenses:		
Cost of Materials Consumed	-	-
Purchases of Stock-in-Trade	-	-
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade	-	-
Employee Benefit Expenses	-	-
Finance Costs	-	-
Depreciation and Amortization Expense	-	-
Total Expenses	-	-

So, the first item is cost of material consumed; now what do you understand here by material consumed? Suppose you are a manufacturing entity, you would purchase raw material, you may also purchase some components, some spare parts; now the cost of all these items is considered as material consumed.

If it is in stock; you will not take it here what is actually consumed in the period is shown as cost of material consumed. Next is purchase of stock in trade; now, what do you understand by stock in trade? Now, if you are a trading entity you will buy goods and sell them as it is as finished goods that will be an example of stock in trade.

Sometimes even manufacturing companies buy finished goods sell finished goods. So, whatever you purchased as a ready item; what raw material you consume will be in item number I, but what you purchased and sold as it is to the customer that will be shown as purchases of stock in trade. Now next item is very interesting changes in inventory of finished goods, work in progress and stock in trade; keep in mind all these are different types of inventories or stocks in your hand.

Now, if there is any change in those stocks that will be shown. Do you think of any other type of inventory? Actually there is one more type are you remembering it? There is also a raw material inventory, but that is not shown here because you remember in item number I, we have considered raw material consumed. So, we have not considered opening and closing stock; what is actually consumed is taken to P and L. But in case of stock in trade or in case of finished goods, we have considered purchase of stock in trade not consumed actual purchase.

So, out of that purchase some of the amount of stock in trade is not sold out; remains with the entity as a closing stock, there might be some amount of stock in the beginning which is known as opening stock. Now opening stock minus closing stock is your change in stock; now that change in the stock in trade will have to be included here. Same way whatever finished goods you have or whatever work in progress you have any change there on will be shown as changes in the inventories. Now this is a very important item and you have to be very careful about the sign of these changes.

Because see first item that is cost of material consumed; whatever you consume is an expense; purchase whatever your purchase is an expense. But in case of change if there is decrease in the inventory earlier you have more inventory, now you have less inventory there is a decrease; that shows that you have consumed that in inventory it becomes your expense it has a positive sign.

But suppose there is an increase in the inventory, then there will be a negative sign getting it? So, earlier you have got less inventory; now you have got more inventory; that means,

there is a increase in the inventory that will be shown in the expenses with the negative sign because it is a like your income it reduces your expense ok. So, look at the balance sheet or of your own company; you be careful because this change in my inventory will be small item, but it can have a positive sign it can also have a negative sign ok.

The next item is employee benefit expenses, so in simple terms you can say it is a salary expense. But it may include some other employee benefits like overtime, like bonuses, like work visits, like the cost of any other facilities given to employees, the cost of recruitment of those employees; all that items would be clubbed together in the heading employee benefit expense. The next item is also very interesting it is called as finance cost.

Now, what do you mean by finance cost? You are using money, if you are paying any cost for raising those finances that will be called as a finance cost. What will be an example of finance costs? The best and simple example is payment of interest. Suppose you have obtained loan from the bank; at the end of every quarter normally you will have to pay interest that interest will be considered as finance cost.

If you pay interest on your debentures, interest on lease all this will be considered and included in finance cost. In fact, even the cost of raising the debentures; some charges which you incur as one time charges, they would also be amortized that is a part of that will be included in the finance cost ok.

The next item is also a different type of item; that is depreciation and amortization expense. Now what is meant by this item? After this session we are going to discuss; we are going to have a separate session on depreciation, but as of now you can understand that depreciation is a fall in the value of fixed assets. Now fixed assets are there in the balance sheet, if their value falls. Because as you use the asset suppose you own a car; when you use your own car, you do not have to pay any rent, but the value of your car is falling that fall in the value is called as a depreciation and that depreciation is considered as a expense in the balance sheet.

Any fixed asset which you are using will lose value; at the end of the year its value will be less than the value in the beginning. There are various methods of calculating depreciation that we are going to discuss later. But as per the method which is used by

your company whatever is a fall in the value that will be shown separately as a depreciation in the profit and loss account.

Keep in mind that this is a unique expense because it is a non-cash expense. All the expenses starting from cost of raw material consumed to finance cost; we were paying in cash. Suppose you hire somebody you pay salary, suppose you take loan, you pay interest; suppose you purchase raw material, you pay for the raw material. Like that there will be a cash cost involved in other items, but in depreciation, there is no cash cost.

We have purchased say a car or we have purchased some machinery at that time you have paid in cash. But now that car is being used for 5 years; let us assume, there will be no cash to be paid every year. I think you are getting me, If we hire that asset on rent then we can pay rent but if it is our own asset then no cash cost will involve. But even if you are not paying in cash, the value of your asset is falling and that value fall in the value is to be estimated and calculated and to be shown in P and L account as a depreciation. Now what do you understand by amortization? Because there are two items depreciation and amortization; I think most of you are able to judge it. Because there are two types of fixed assets there are tangible assets when they lose value it is called as being depreciated, there are intangible assets when they lose value it is called as amortized.

So, suppose you have got software, you have purchased software and the license is for 3 years; that means, every year; one third of the cost will be reduced in the beginning if you pay 3 lakhs for 3 years, then you can calculate that for each year 1 lakh rupees is a fall in the value of that software; at the end of three years it will become 0; that 1 lakh which is calculated each year is called as amortization. So, like that for any intangible asset, there is a reduction in the value that will be calculated it is just like depreciation; only thing is it is on intangible assets. So, there is a separate name for it known as amortization.

So, all the expenses for any company are to be put under six heads; keep in mind you can have more expenses also, but you would put them under the most appropriate head and at the end of the six items you calculate the total expenses.



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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)	-	-

Now, we have got next heading; heading V that is profit before exceptional and extraordinary items and tax. So, it is III minus IV; earlier we have seen this III was referring to the total revenue minus total expenses; this gives you profit, very simple. Whatever is the Total revenue you minus total expense from that, what you get is a profit; only thing is you are yet to calculate or take into consideration some other items which are exceptional extraordinary and taxes. That is why it is called as profit before exceptional and extraordinary items and taxes; what these items are? We will just take into account.

But right now we are at item number V which you can say is a profit calculated as a initial profit. Now from that you are going to deduct two items; item number VI is exceptional item, item number VIII is extraordinary item. Now what is an exceptional item? As the name suggests, if certain item is not likely to recur every year it is not in the normal course of business, it is required to be separately shown and it will be categorized as an exceptional item.

Can you think of any example of exceptional item? Let us see there is a major flood in the factory and because of flood your stocks are damaged, your machinery is damaged, you will have to incur lot of repairs after the flood to restore your machinery and make your factory in proper order. So, the loss of stock, damage to the machinery and

repairing cost all these taken together; if the amount is significant keep in mind I am talking of major flood.

Normal flood like every year water logging, then it is not an exceptional item; if it is a significant loss because of a major flood, then that will be separately shown as a extraordinary item. Same way you can also say about fire, any such eventualities which is not in the normal course; it is not likely to recur every year, you will need to classify it.

Now here the judgment is given to the management whether a particular item is to be classified exceptional or to be shown as a normal item. If they would have treated it as a normal item it would have come in the normal expenses. For example, your raw material is destroyed in flood; if it is a minor amount you would anyway including cost of raw material consumed, you do not have to separately show.

But if it is a sizable amount; we will show it as exceptional item because it is not going to happen every year. Same way, there are extraordinary items; if the happening is even more exceptional than exceptional then it will be called as extraordinary. For example, flood is so much devastating that it has completely destroyed our factory then it can be considered as a extraordinary item.

Keep in mind this is a rarest of a rare case; normal if flooding happens then either it is exceptional nor extraordinary. If there is a major flood which might occur somewhere in 10, 20 years once then it is exceptional. If flood is so large that it has totally destroyed our factory something which you expect once in 100 years perhaps and it may have impact in the existence of your entity itself, then you will characterized it as a extraordinary item.

Now, the discretion is given to management to categorize is that either exceptional or extraordinary. Now why these items are shown separately? Because the users of financial statement; that is those who are reading the P and L should know whether a particular item is going to happen every year or no. Normally we assume that the items which are categorized as expenses are in the normal course of business; so they will happen repeatedly regularly we have already defined P and L it is a statement which shows normal incomes and expenses.

So, it is assumed that they are going to be recurring in nature; however, if there is a major loss which is not going to recur; you will go and categorize it as an exceptional or extraordinary. Keep in mind that this cannot be recorded in the balance sheet because that is also a revenue item; it is not creating any new asset that I can write it in the balance sheet. In fact, it is destroying my existing assets; that is why it has to be removed from the balance sheet and those losses have to be booked somewhere in P and L; so, special headings are created to show it as exceptional and extraordinary.

Now when somebody is reading P and L and they look at an exceptional or extraordinary expense, they would understand that this is not a normal expense. So, next year we can expect to have more profits because there will not be exceptional and extraordinary losses in the next year when I am referring to losses it can also be profits sometimes.

Can you think of an exceptional item of profit? Just think over; suppose we own a piece of land. We have purchased land for 5 lakhs in 1950, today in 2019 or in 2020; after 70 years the land which was purchased for 5 lakhs, perhaps today might have a value of 5 crores. So, 5 lakh rupees land if we sell in 5 crore we will make a profit of 4 crore 95 lakhs.

Now all profits are shown in P and L; so that profit is also shown in P and L, can we show it in our revenue? Obviously, no because it is not our business to sell land, neither can we show it as other income; though it is other income it is not going to recur every year because if we sell land this year then, next year no land available for sale. It is not like sale of our normal goods; that is why this 4 crore 95 lakhs is an example of an extraordinary item. Remember here that we said extraordinary item, they have not said extraordinary expense it can be income as well as expense.

So, you will have to be careful about the sign here; this is not always a negative sign, it can be negative sometimes it can be positive also. In addition to that management will have to write a note below explaining what is an extra exceptional extraordinary item and why they have categorized that item as exceptional or extraordinary. So, I will advise you now you go back to your balance sheet for your own company, check if there are any exceptional or extraordinary items and write a note as to why they are classified so; fine.

So, I hope you have got this; so now we were at V, profit before exceptional extraordinary then we will deduct exceptional items, we will deduct extraordinary items; so you get IX which is profit before tax.

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Profit & Loss A/c (Format)			
X.	Tax Expense :		
	▪ Current tax	-	-
	▪ Deferred Tax	-	-
XI.	Profit/ (Loss) for the period from Continuing Operations (IX - X)	-	-
XII.	Profit/Loss from Discontinuing Operations	-	-

Now from that item X is tax expense; so we will deduct current taxes and deferred taxes to get profit or loss for the year from continuing operations. Now what is a current tax and what is a deferred tax? I think we have discussed it earlier I will just repeat again.

So, on the profits which you have earned in IX, you will have to pay some money to government that is a taxes. If those taxes are due in the current year, they would be called as current taxes; if they are allowed to be paid and after 2 years, 3 years, 4 years something like that they would be called as deferred tax; still we this show them in the today's P and L.

Because they are on the profits of this year, but they can be paid afterwards they will go to balance sheet. So, tax expense is categorized as current differed; so you get profit from continuing operations.

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Profit & Loss A/c (Format)			
XIII.	Tax Expense of Discontinuing Operations	-	-
XIV.	Profit/(Loss) from Discontinuing Operations (after Tax) (XII - XIII)	-	-
XV.	Profit/ (Loss) for the Period (XI + XIV)	-	-

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Then separately you have to show profit from discontinuing operations; that means if some business is stopped, then those profits will have to be profits or losses will have to be shown separately the taxes on those discontinuing operations. Like some factory which is closed, but you get some profit or loss from there; so, profit before tax and profit after tax from ex discontinuing operation is shown in item number XIV.

And finally, item number XV is profit or loss for the year which is total of XI; that is profit or loss from continuing operation plus XIV. So, continuing plus discontinuing both the profit after taxes are added and you get the final result, it is like a final scorecard for that business as profit or loss for the year. Now this was the format as per schedule III of Companies Act.

So, we stop here and in next session we will continue the profit and loss account. Namaste.