

HOW TO READ THE P&L STATEMENT

The profit-and-loss statement gives a summary of the income and expenses, and thus profitability of a business.



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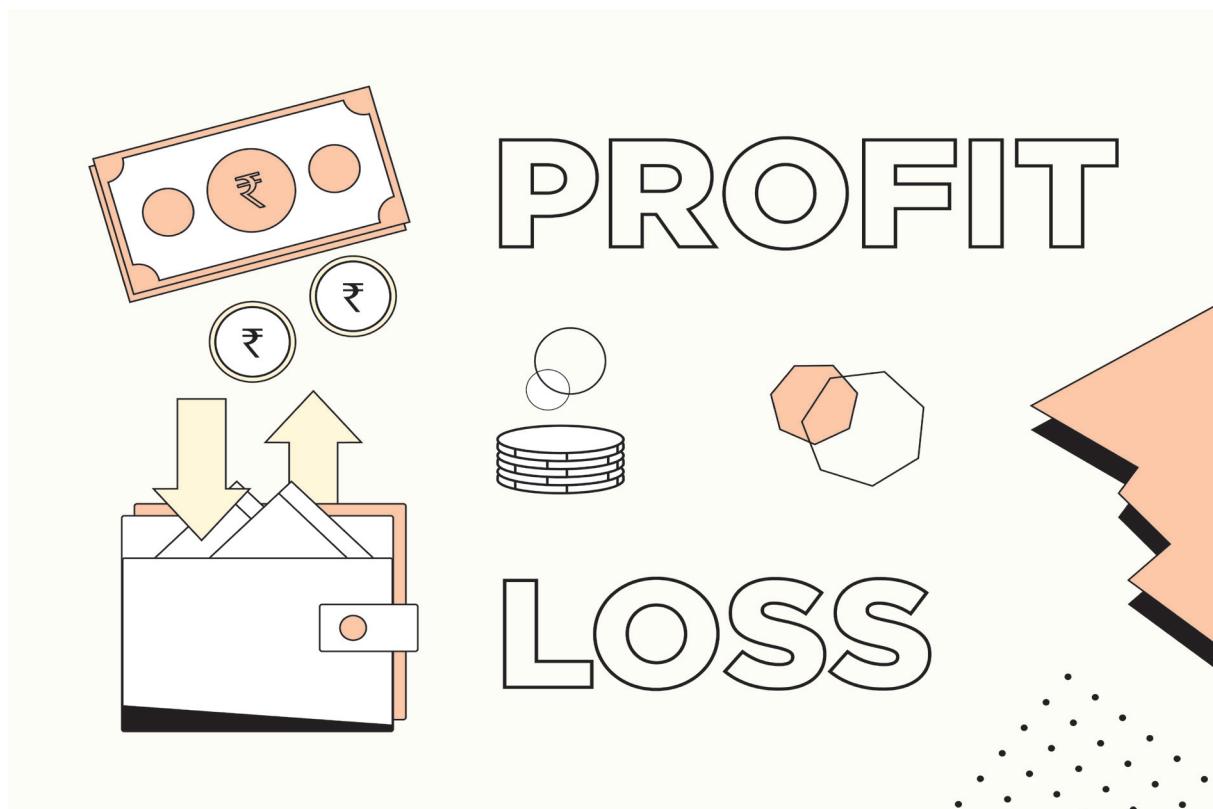
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Introduction

The profit-and-loss statement gives a summary of the income and expenses, and thus profitability, of a business.

The P&L account (which is officially known as the statement of profit & loss) is arguably the most important financial statement. This is because it provides key financial information about a company's operational metrics, such as sales, expenses and most importantly, the net profit. To get a better understanding of this vital statement, we need to know its nature and format.

What is a P&L statement?

The P&L statement is a very intuitively designed financial statement, which gives its readers

information about three important numbers: income, expenses and net profit - which is the difference between the income and expenses.

To illustrate the format, we can look at a simplistic P&L of an imaginary trading company, ABC Limited:

Total income: Rs 100

Total expenditure: Rs 70

Profit: Rs 30

This P&L indicates that the company, ABC Limited, made a profit of Rs 30 by spending Rs 70 for producing goods/services and selling the

same for Rs 100. Although this is a simplified version of a P&L statement, the real world P&L statement is very much based on similar principles.

Today's P&L statement begins with the amount of money earned (also called turnover/revenue/income) and moves on to different types of expenditures incurred by the company so that the amount of profit can be finally calculated. Each of these entries is further subdivided so that the readers can have clear, understandable and insightful information about the company's financial affairs.

Other important characteristics

The most crucial characteristic of the P&L statement is that it is based on the accrual system of accounting, which means that transactions are recorded in the time period of their occurrence, no matter when the underlying cash is actually exchanged. This concept is best understood with an illustration. If our imaginary company, ABC Ltd, makes a sale of Rs 50 on March 31, 2021 and receives a cheque dated April 1, 2021, then the sale transaction will still be recorded for the year 2020-21, even though the money would be received only in the year 2021-22. Similarly, if ABC Ltd receives a bill in April 2021 to pay electricity charges for the month of March 2021, then this expense would still be reflected in March, even though the payment was not made in that month.

The advantage of using an accrual-based accounting system is that it ensures that the transactions in the P&L are more reflective of underlying operational realities. But the disadvantage is that it can potentially result in misleading financial statements, with a wide divergence between the profit and cash available. Take for instance a scenario where

ABC Ltd regularly sells goods to a large retailer who is facing financial difficulties. Even if the retailer does not make payments, ABC Ltd will continue recognising the income and be profitable on paper, however, in reality, it could be undergoing a severe financial crunch. Many electricity-generating companies (gencoms)

suffer a similar fate since distribution companies (discoms) delay payments by months, if not years.

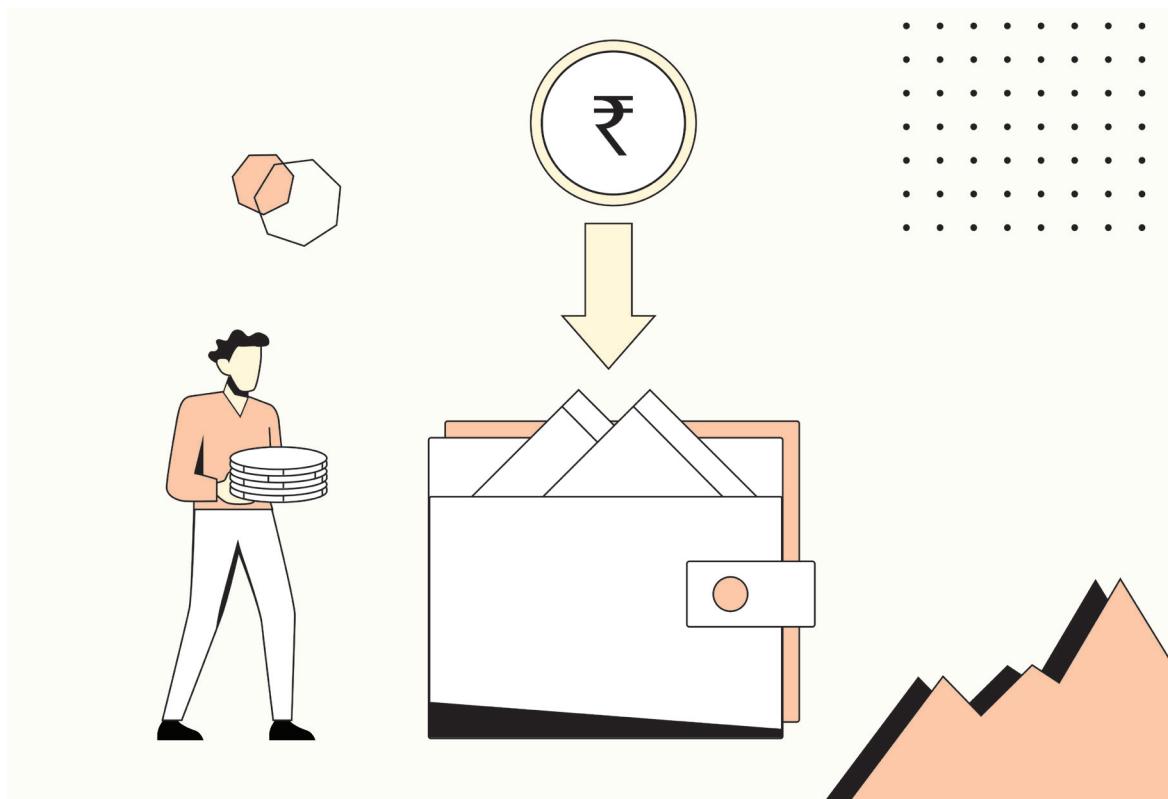
An important aspect of the P&L statement is that it is prepared for a particular time period. And since all listed companies come out with their P&L statements

every three months (as per SEBI's regulations), investors must differentiate the quarterly P&L from the annual P&L.

The P&L statement gives its readers information about three important numbers: income, expenses and net profit.

Key takeaways

Despite its drawbacks, the P&L statement is a very important financial statement. But investors need to be aware of its drawbacks in order to better understand a company's financial position. It goes without saying that investors must conduct an in-depth analysis of a company's financial statements before deciding to invest in it. The P&L of every listed company is freely accessible on Value Research Online. Details are available under the 'Financials' tab. For instance, the P&L of Reliance Industries, one of India's largest companies by market capitalisation, can be found [here](#).



Understanding Income

The income part of the P&L statement tells what a company has earned from its operations and other sources

After gaining a basic understanding of the **P&L statement** let us focus a bit more on the ‘income’ part. Here investors need to conduct a more in-depth review of the accounting principles in order to have a more nuanced view of this important entry and evaluate a company’s financial performance.

Principle 1: Income ≠ cash

As explained in the first part of this series, income is calculated by using accrual-based accounting principles. This means that sale is recorded in the P&L statement on the basis of

the timing of the transaction, regardless of when the cash is received. For many retail businesses, there is no difference in timing, as they receive cash from customers immediately at the time of sale. However, for many B2B businesses, there is a significant gap between the sale of a product/service and the receipt of the payment for the same because their customers don’t always pay on time. Businesses, which supply to the government (such as defence, infrastructure construction, etc.) and those entities that are in a weak financial position (for example: airports providing services to cash-strapped airlines and gencoms supplying electricity to distressed

discoms) are particularly affected by this. Although the P&L would reflect the total amount of sales, it wouldn't show how much of the stated income has actually been received.

Takeaway: Investors should not presume that all the income shown in the income statement has actually been received by the company.

Principle 2: Operating income is more important than other income

When investors look at the P&L of any company on www.valueresearchonline.com, the total income is classified into two types of entries - operating revenue and other income (the terms revenue and income can be used interchangeably). While the former reflects the core income from the company's primary business, the latter reflects the income from all other sources, which are not directly related to the company's business. For example, a car manufacturer may earn interest from FDs or dividends from shares in other companies. There could also be a scenario where other income is purely an accounting entry, which is based on management estimates (ex: revaluation of the fair value). Therefore, investors must focus on the core operating revenue because earning other income is not only unsustainable but also not the fundamental purpose of running the company.

Takeaway: Investors should pay more attention to operating income and should not get carried away by increases in other income.

Principle 3: Revenue recognition varies from industry to industry

When it comes to recognising long-term contracts, the complicated nature of accrual accounting makes it a bit more tricky. Companies usually follow either the percentage completion method or completed contracts method. In the former method, the quantum of income recognised will be dependent on the percentage of the work completed, while in the latter, income is only recognised when the contract is fully completed. For example, when a real-estate company constructs an apartment, investors must check what method of income recognition is being followed by the company. Companies, like Ashiana Housing, recognise income only when homes are delivered. So, it may seem like their revenues are more uneven and lumpy (as it is tied to the completion of their projects) as compared to other companies who recognise revenue as construction progresses. But it doesn't reflect the ground reality and is just a natural consequence of their accounting principles.

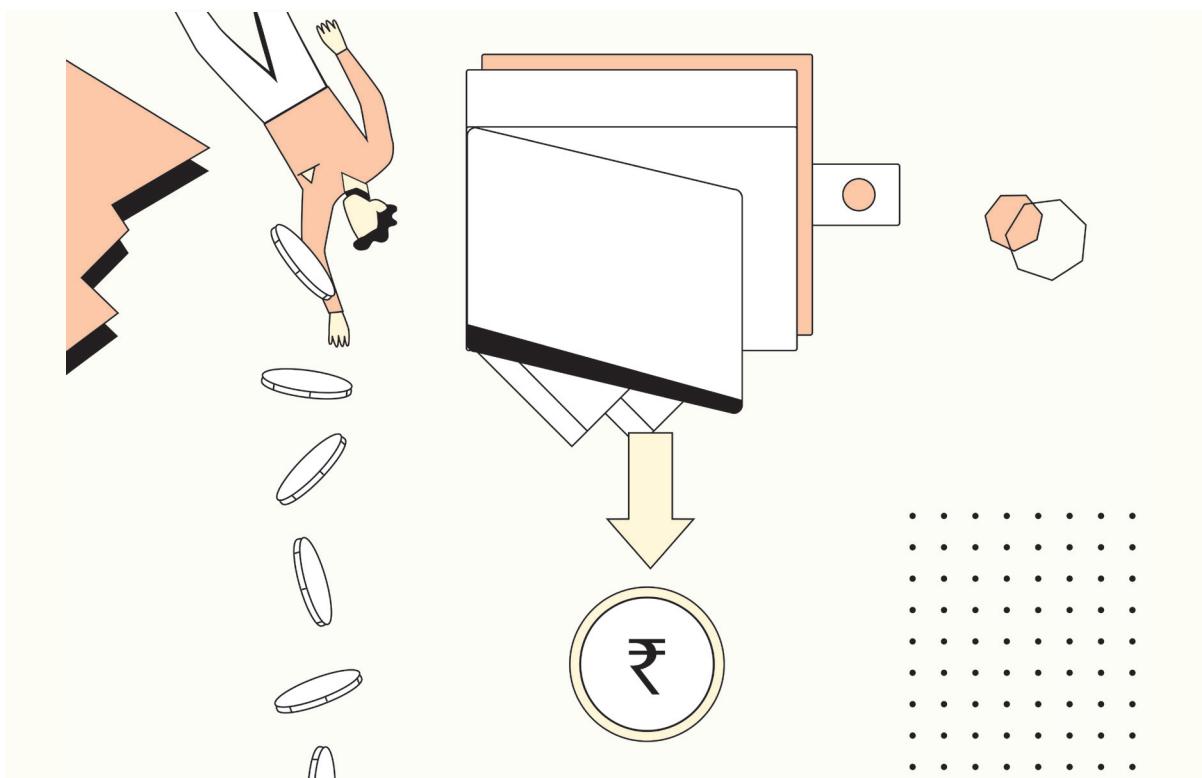
Takeaway: Investors must always be mindful of the differences in accounting while comparing two different companies.

Conclusion

Figuring out the amount of money a company is earning is more complicated than it sounds. Therefore, investors need to rigorously examine every bit of the annual report and not just the financial statements before investing. Investors can access the P&L of every listed company on www.valueresearchonline.com. All they need to do is type the name of the company in the search bar and they can access the company's page, which has the P&L under the 'Financials'

tab. The P&L of Reliance Industries can be found [here](#) and a screenshot of the same is given below.

Reliance Industries Ltd.  PDF							
Premium Coverage		Snapshot	Financials	Peers	Ownership	Annual Report	
Annual Consolidated		Annual Standalone		Quarterly Consolidated		Quarterly Standalone	
		TTM	Mar-21	Mar-20	Mar-19	Mar-18	Mar-17 Mar-16
Income Statement (₹ Cr)							
Operating Revenue		6,64,643.00	4,66,924.00	5,97,535.00	5,69,209.00	3,91,677.00	3,05,382.00 
Other Income		15,727.00	17,142.00	13,279.00	8,386.00	9,949.00	9,443.00 
Total Income		6,80,370.00	4,84,066.00	6,10,814.00	5,77,595.00	4,01,626.00	3,14,825.00 
Total Expenditure		5,62,198.00	3,87,002.00	5,08,641.00	4,85,042.00	3,27,501.00	2,59,188.00 



Understanding Expenses

Expense items of the P&L statement shed light on the costs incurred by a company to generate revenues

We have already gained insights into the basics of the **P&L statement** and the **income part** of it. Next, we will focus on 'expenses,' which is more important than the income part.

Like income items, expense items also follow accrual-based accounting principles. But expenses are more complicated. Here are a few important aspects of expenses:

Greater disclosure

Unlike income items which are divided into two parts, expenses are divided into multiple heads, such as raw-material expenses, employee expenses,

selling and distribution expenses, etc. The following is a screenshot of different types of expenses of Reliance Industries Ltd.

A higher amount of disclosure with regard to expense items is very beneficial for investors because it enables them to keep track of a company's expenses over a period of time and compare different companies based on how efficiently they are running their operations.

Greater management discretion

Unlike income items, recognising expense items under the accrual-based accounting systems depends substantially on the management's

discretion. For example, the decision to either capitalise or expense a particular expenditure rests on a company's management. This distinction arises because under accrual-based accounting, an organisation needs to only

Annual Consolidated	Annual Standalone	C
	TTM	Mar-21
Total Income	6,80,370.00	4,84,066.00
Total Expenditure	5,62,198.00	3,87,002.00
Increase/Decrease in Stock	-	-8,823.00
Raw Material Consumed	-	3,01,765.00
Power & Fuel Cost	-	13,214.00
Employee Cost	-	14,817.00
Other Manufacturing Expenses	-	28,555.00
General and Administration Expenses	-	23,605.00
Selling and Distribution Expenses	-	13,295.00
Miscellaneous Expenses	-	1,565.00
Operating Profit	1,18,172.00	97,064.00
Interest	15,072.00	21,189.00

expense those items from which it will derive benefits in the current year. Think about rent or electricity expenses for a particular year. The benefits of this expenditure can be enjoyed only for a small period. But if the company purchases an asset, which will last for many years (such as a car or a manufacturing plant), then it would not be fair to charge the entire expenditure only in the first year. The correct thing to do would be to consider only the portion of the capital asset that has been used in the current year as expenses, a method known as depreciation.

Besides, accounting standards require the management's inputs for various decisions.

Therefore, the management can exercise significant control over expenses. For example, while calculating depreciation, a company's management decides important factors, such as the expected useful life of the equipment, the choice of the depreciation method and the expected salvage value. Similarly, there are other areas where the management's inputs are integral to the accounting process. Although such inputs are believed to make the books of accounts more pertinent, there is always a possibility of unscrupulous managements misusing this discretion to manipulate earnings.

One-time expenses

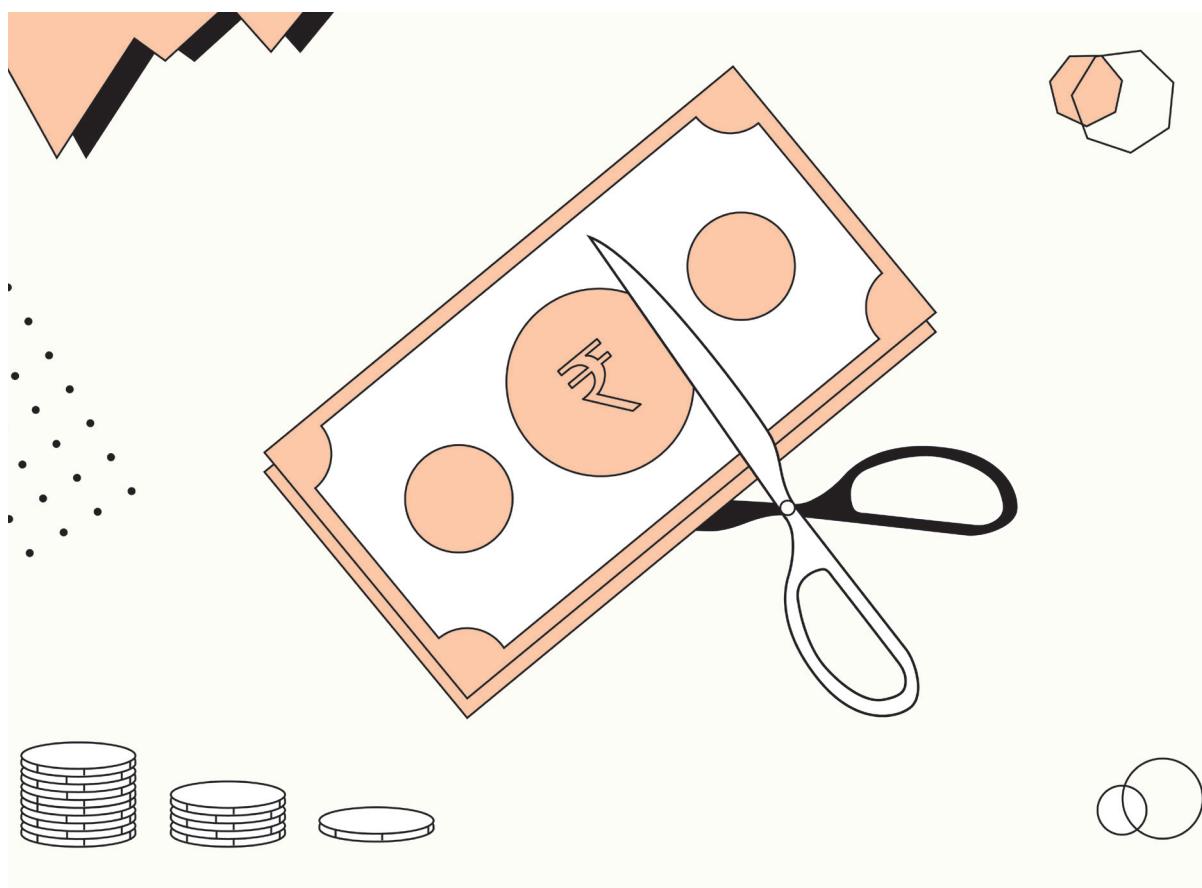
**Investors need to analyse
the expenses segment
with a fine-toothed comb
before making any
investment decision**

Even though accrual accounting requires the management to account for all the expenses associated with a particular accounting period, sometimes certain expenses are not mentioned. These expenses could be in the nature of write-downs of goodwill (an accounting term that refers to the difference between the market value and book value of an asset), the unfavourable outcome of tax litigation, etc. Also, there are other scenarios where sudden unforeseeable events happen, forcing the management to take a hit. For example, a sudden drop in the prices of oil or gold could lead to a write-down in inventory for oil-marketing companies and gold jewellers. Even though both these categories of expenses are recorded as expenses,

investors need to differentiate between them. While the former can be attributable to aggressive management practices, the latter is more likely than not attributable to the business's core nature.

Key takeaways

The expenses segment is a very significant part of the P&L statement. Investors need to analyse this segment with a fine-toothed comb before making any investment decision. The P&Ls of all listed companies are accessible on www.valueresearchonline.com for free.



Understanding Tax and other items

How tax, minority interest and share of associates impact a company's bottom line

After learning about the basics of the **P&L statement** and the **income** and **expenses** part of it, readers may now think that all they need to do now is subtract expenses from the income in order to compute the profit or loss. While this is almost true, some more steps are required to calculate the real profit/loss of a business.

Tax expense

The Government of India levies income tax on the profit earned by every company. Therefore, when you subtract all expenses from the income, the figure you get is the profit before tax or PBT. Tax expenses are calculated based on the PBT and recorded in the P&L statement as the

provision for tax. The real profit is what you get after the tax is deducted from the PBT. This figure is known as the profit after tax or PAT.

Annual Consolidated	Annual Standalone	Q
	TTM	Mar-21
Employee Cost	–	14,817.00
Other Manufacturing Expenses	–	28,555.00
General and Administration Expenses	–	23,605.00
Selling and Distribution Expenses	–	13,295.00
Miscellaneous Expenses	–	1,565.00
Operating Profit	1,18,172.00	97,064.00
Interest	15,072.00	21,189.00
PBDT	1,03,100.00	75,875.00
Depreciation	28,769.00	26,572.00
PBT & Exceptional Items	74,331.00	49,303.00
Exceptional Items	3,633.00	5,642.00
Profit before Tax	77,964.00	54,945.00
Provision for Tax	13,294.00	1,722.00

Investors must bear in mind that the provision for tax may not necessarily be the tax rate multiplied by the PBT. This is because there are many allowances and deductions from an income-tax point of view. Therefore, the amount of PBT is different and the tax payable varies too. Since this is an area where the management's inputs are required, investors should remember that the PAT declared in the P&L statement is also, to some extent, only an estimate and not the final figure.

Minority interest

Minority interest is another important aspect that investors should consider. However, this part comes only in a consolidated P&L (as opposed to a standalone P & L) where a company has

Tax expenses are calculated based on the PBT and recorded in the P&L statement as the provision for tax.

subsidiaries and therefore, needs to prepare a single P & L, comprising the income and expenses of all its subsidiaries. According to accounting principles, the consolidated figure is calculated simply by adding all income and expenses. Let's look at a simplified version of the consolidated P&L of a hypothetical company (ABC Ltd), which has just one subsidiary (XYZ Ltd).

A simplified P&L of a parent company and its subsidiary

	ABC Ltd (parent) Standalone	XYZ Ltd (subsidiary) Standalone	ABC Ltd Consolidated
Income (₹)	200	120	320
Expenses (₹)	140	80	220
Profit (₹)	60	40	100

As stated in the above-mentioned table, the consolidated P&L is calculated by just taking the simple sum of the parent and subsidiary companies. However, when it comes to calculating this type of consolidated P&L, it is always presumed that the parent company owns 100 per cent of the subsidiary company.

Now a problem arises with this method when the parent company owns anything less than that. For example, if the parent company owns only 75 per cent of the subsidiary company in our above-mentioned consolidated table, then the parent company is entitled to only Rs 30, i.e., 75 per cent of Rs 40. Therefore, there would have to be an adjusting entry to decrease the profits by Rs 10 and this is precisely what the term 'minority interest' refers to.

So, investors must always look at PAT after adjusting for the minority interest.

Annual Consolidated	Annual Standalone	Q
	TTM	Mar-21
General and Administration Expenses	–	23,605.00
Selling and Distribution Expenses	–	13,295.00
Miscellaneous Expenses	–	1,565.00
Operating Profit	1,18,172.00	97,064.00
Interest	15,072.00	21,189.00
PBDT	1,03,100.00	75,875.00
Depreciation	28,769.00	26,572.00
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Exceptional Items	3,633.00	5,642.00
Profit before Tax	77,964.00	54,945.00
Provision for Tax	13,294.00	1,722.00
Profit after Tax	64,670.00	53,223.00
Minority Interest	-7,090.00	-4,611.00

Figuring out the amount of money a company is earning is more complicated than it sounds. Therefore, investors need to rigorously examine every bit of the annual report and not just the financial statements before investing.

Share of associates

When a company has subsidiaries in which it has less than 50 per cent shareholding, then

accounting principles do not require the company to create a consolidated P&L. Instead, the company can recognise a proportional share in its investee company's profits. It could be said that this entry is, in a way, the corollary of minority interest. For example, in the previous illustration, if ABC Ltd is the minority shareholder, holding 25 per cent in the subsidiary company (XYZ Ltd), then it would recognise a profit of Rs 10 in the P&L statement as its 'share of associate'.

Annual Consolidated	Annual Standalone	Q
	TTM	Mar-21
Selling and Distribution Expenses	–	13,295.00
Miscellaneous Expenses	–	1,565.00
Operating Profit	1,18,172.00	97,064.00
Interest	15,072.00	21,189.00
PBDT	1,03,100.00	75,875.00
Depreciation	28,769.00	26,572.00
PBT & Exceptional Items	74,331.00	49,303.00
Exceptional Items	3,633.00	5,642.00
Profit before Tax	77,964.00	54,945.00
Provision for Tax	13,294.00	1,722.00
Profit after Tax	64,670.00	53,223.00
Minority Interest	-7,090.00	-4,611.00
Share of Associate	149.00	516.00

Again, investors would do well if they recognise that the net income as adjusted for the share of Associate is a better metric as it would give a more accurate picture of the company's overall profitability.

Earnings per share

After making the above-mentioned adjustments, the final number is the consolidated PAT. This is

Annual Consolidated		Annual Standalone	
		TTM	Mar-21
Cashflow (₹ Cr)			
Cash From Operating Activities	-	26,185.00	
Profit Before Tax	-	55,461.00	
Adjustment	-	24,668.00	
Changes In working Capital	-	-50,731.00	
Tax Paid	-	-3,213.00	
Cash Flow from Investing Activities	-	-1,41,634.00	
Cash from Financing Activities	-	1,01,902.00	
Net Cash Inflow / Outflow	-	-13,547.00	
Ratios			
Financials			
Adjusted EPS (₹)	85.32	76.23	

the total amount of profit that is available to all shareholders. Although it is the primary factor that investors should take into consideration, it is equally important to consider earnings per share or EPS. It is calculated by dividing the total PAT by the total number of shares outstanding and is given on the website of Value Research under the head 'Adjusted EPS'.

While there is generally a perfect correlation between the consolidated PAT and the EPS, there are certain circumstances when these two numbers diverge. These happen when there is a significant change to the capital base of the company. A case in point is YES Bank Ltd. After a spell of poor performance, new shareholders infused a large chunk of capital at very nominal prices, thereby causing massive dilution for existing shareholders. This has led to a situation where even if the consolidated PAT of Yes Bank returns to its pre-stressed levels, the EPS will remain extremely depressed.

Conclusion

With the P&L being an important financial statement, this ebook will not only help investors understand the true picture of a company's financial affairs but also become better investors. For example, the concept of the superiority of earnings per share over net income would assist investors in evaluating the impacts of mergers, acquisitions and other corporate activities such as buybacks, rights

issues, etc. Likewise, when investors are aware of complications related to accrual accounting, they can identify companies with deteriorating financials. And finally, getting a better understanding of different types of one-time expenses will enable investors to assess a company's accounting policies more effectively. We hope you have enjoyed reading this ebook and we wish you the best in your investment journey.

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insightful articles, visit

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