

Format of Balance Sheet

Balance Sheet at 31st March 20XX

Particulars	Schedules	Amount
Equity and Liabilities		
<i>Shareholder's Funds:</i>		
• Share capital		XXX
• Reserves and Surplus		XXX
<i>Non-current Liabilities:</i>		
• Long term borrowings		XXX
• Deferred tax liabilities		XXX
• Long term provisions		XXX
<i>Current Liabilities:</i>		
• Short term Borrowings		XXX
• Trade Payables		XXX
• Other current liabilities		XXX
• Short term provisions		XXX
Total		XXX
Assets		
<i>Non-current Assets:</i>		
• Fixed Assets		
○ Tangible Assets		XXX
○ Intangible Assets		XXX
• Non-Current Investments		XXX
• Long term loans and advances		XXX
<i>Current Assets:</i>		
• Current Investments		XXX
• Inventories		XXX
• Trade Receivables		XXX
• Cash and Cash Equivalents		XXX
• Short-term loans and advance		XXX
Total		XXX

- Meaning of the terms used in Part I of Revised Schedule VI, i.e., Balance Sheet

S. No.	Term	Meaning
I. EQUITY AND LIABILITIES		
1.	Shareholders' Funds	Shareholders' Funds mean funds belonging to the shareholders. They are categorised in three categories, which are:
	(a) Share Capital	It is the amount invested by the shareholders as capital in the company. It includes both equity and preference share capital.
	(b) Reserves and Surplus	Reserves and Surplus is a part of shareholders' funds and may be free reserve or committed reserve. It may be received as securities premium or may have been appropriated out of Surplus of Statement of Profit and Loss or may be the balance of Statement of Profit and Loss.
	(c) Money received against Share Warrants	Share Warrant is the amount received against commitment made by the company to issue shares at a predetermined price on a future date. It is part of the shareholders' funds because the amount received can be utilised only for conversion into shares.
2.	Share Application Money Pending Allotment	It is the amount received as Application Money for allotment of shares against which shares are pending for allotment.
3.	Non-Current Liabilities	Liabilities are broadly classified into Non-current Liability and Current Liability. The term Non-current Liability is defined as a liability that is not a Current Liability. Therefore, it is important to understand the meaning of Current Liability (Discussed under Current Liability). Non-current Liabilities are categorised into four categories, as follows:
	(a) Long-term Borrowings	Long-term Borrowing is the amount of loan, which is not due for payment within 12 months from the date of loan. For example, Loan obtained repayable in a period of 5 years on 1st March, 2013. It is Long-term Borrowing.

	(b) Deferred Tax Liabilities (Net)	Deferred Tax Liability is a book entry arising because of Accounting Standard-22. Deferred Tax Liability arises when accounting income (i.e., income arrived according to the accounting principles) is more than the taxable income (i.e., income arrived according to the provisions of Income Tax Act). Deferred tax is calculated every year and adjusted to the existing balance.
	(c) Other Long-term Liabilities	Other Long-term Liabilities are those liabilities which are not long-term loans but liability incurred otherwise (say for machinery purchased on deferred payment basis) and is payable after 12 months of the Balance Sheet date.
	(d) Long-term Provisions	Provision means providing for a liability by estimating the amount. It means liability is certain but the amount is not. If the liability and also the amount are certain, it will be Outstanding Liability. Provision is also required to be classified into long-term and short-term and long-term provisions are shown under this head.

4. **Current Liabilities** are those liabilities which are:

- expected to be settled in company's normal operating cycle (refer to discussion in the chapter); or
- due to be settled within 12 months after the reporting date; or
- held primarily for the purpose of being traded; or
- there is no unconditional right to defer settlement for at least 12 months after the reporting date.

Operating Cycle is the time between the acquisition of assets for processing and their realisation into cash and cash equivalents. If operating cycle cannot be identified, it is assumed to be 12 months.

Operating Cycle can be different for different businesses.

Current Liabilities are divided into four categories, which are discussed below:

	(a) Short-term Borrowings	Short-term Borrowings are shown under the main head 'Current Liabilities' and are the amounts of loan, which are due for payment within 12 months of the date of loan.
	(b) Trade Payables	Trade Payables are the amounts payable for goods purchased and services received in the ordinary course of business.
	(c) Other Current Liabilities	Liabilities other than short-term borrowings, trade payables and short-term provisions are shown under this head. For example, outstanding expenses, salary payable, workmen compensation payable, income received in advance, unpaid dividend, interest accrued but not due, etc.
	(d) Short-term Provisions	Provision means providing for a liability by estimating the amount. It means liability is certain but the amount is not. Provision is also required to be classified into long-term and short-term and short-term provisions are shown under current liabilities. Examples are provision for expenses, provision for taxation, provision for dividend, etc.

II. ASSETS

Assets which are not Current Assets are Non-Current Assets.

1. Non-Current Assets

(a) Fixed Assets

(i) Tangible Assets Tangible Assets are those Assets which have physical existence, i.e., which can be seen and touched. Examples are: land, building, machinery, computers, etc.

(ii) Intangible Assets Intangible Assets are those assets which do not have physical existence, i.e., which cannot be seen and touched. Examples are: patents, trademark, computer software, etc.

(iii) Capital Work-in-Progress Capital Work-in-Progress means amount incurred on construction or development of tangible assets.

(iv) Intangible Assets under Development Intangible Assets under Development means amount incurred on development of intangible asset such as patent for improvement in production process leading to cost reduction.

(b) Non-current Investments Non-current Investments are those investments that are invested from long-term point of view. It means they are made with the intention to hold them for a period of more than 12 months from the date of Balance Sheet. They may be trade investments or non-trade investments.

	(c) Deferred Tax Assets (Net)	Deferred Tax Asset is a book entry arising because of Accounting Standard-22. Deferred tax arises when accounting income (<i>i.e.</i> , income arrived according to the accounting principles) is less than the taxable income (<i>i.e.</i> , income arrived at according to the provisions of Income Tax Act).
	(d) Long-term Loans and Advances	Long-term Loans and Advances are those loans and advances which are receivable by the company in cash or kind after a period of 12 months from the date of Balance Sheet. For example, advance of ₹ 10 lakhs given to the machine manufacturer for machine to be delivered after a period of 12 months from the date of Balance Sheet.
	(e) Other Non-current Assets	All long-term assets which do not fall in the above categories or classification are shown under this head. For example, advance given to an employee repayment of which is to be after 12 months from the date of the Balance Sheet.

2. **Current Assets** are those assets which are:

- expected to be realised in or intended for sale or consumption in normal operating cycle of the company. If the operating cycle cannot be determined it is taken to be 12 months; or
- held primarily for the purpose of trading; or
- expected to be realised within 12 months from the reporting date or closing date; or
- it is cash and cash equivalent.

Operating Cycle is the time between the acquisition of assets for processing and their realisation into cash and cash equivalents. If operating cycle cannot be identified, it is assumed to be 12 months.

Operating Cycle can be different for different businesses.

All other assets shall be classified as non-current assets.

	(a) Current Investments	Current investments are those investments that are made for a short period, <i>i.e.</i> , for less than 12 months from the date of Balance Sheet. It means they are made with the intention to hold them for a period of less than 12 months from the date of Balance Sheet. They may be trade investments or non-trade investments.
	(b) Inventories	Inventory is the term used for stock. It is the tangible asset held by an enterprise for: <ul style="list-style-type: none"> (i) the purpose of sale in the ordinary course of business; or (ii) for the purpose of using it in the production of goods meant for sale or services to be rendered. Inventory may be <i>opening inventory</i> or <i>closing inventory</i> . In case of a trading concern it comprises of stock of traded goods in hand the value of goods lying unsold at the end of the accounting period. In case of a manufacturing concern, closing stock comprises raw materials, work-in-progress (<i>i.e.</i> , semi-finished goods) and finished goods in hand at the end of the accounting period. Inventory is valued on the principle of "cost or net realisable value (<i>i.e.</i> , market price) whichever is lower".
	(c) Trade Receivable	Trade Receivables are the receivables against sale of goods or services rendered in the ordinary course of business. Normally, they are known as Sundry Debtors.
	(d) Cash and Cash Equivalents	It is the new term used for 'Cash and Bank'. It includes cash in hand and balances with banks.
	(e) Short-term Loans and Advances	Short-term loans and advances are those loans and advances which are receivable by the company in cash or kind within a period of 12 months from the date of Balance Sheet. For example, advance of ₹ 10 lakhs given to the machine manufacturer for machine to be delivered within a period of 12 months from the date of Balance Sheet.
	(f) Other Current Assets	All other current assets which do not fall within the above categories of current assets are shown under other current assets. But, each current asset shown under this head is to be disclosed. For example, prepaid expenses will be shown under this head.

PROFITABILITY RATIOS

The long-term survival of our business enterprise depends on satisfactory income earned by it. An evaluation of a company's past profits may give the investors, creditors and others a better understanding for decision making. The profitability positioned also affects the liquidity position that is vital to creditors as well. These ratios are:

Return on Capital Employed or Return on Investment

This ratio measures the profitability in relation to the total capital employed in a business enterprise. The terms invested capital; capital funds and total capital may be used interchangeably. It is a useful ratio when comparing the overall performances of companies, particularly where they have different proportions of debt in their capital structure. This ratio would also show whether the company's borrowings policy is economically wise and whether the capital had been employed judiciously. For instance, assume that the funds have been borrowed at 7.5% and return on capital employed is 7%, it would be better not to borrow unless it is essential. It would also show that the firm had not been employing the funds efficiently. The business can survive only when the return on capital is more than the cost of capital employed in the business.

According to some analysts, short-term borrowings, such as bank loans, commercial paper, deferred tax liability, should be included under capital. Current accrued payables, which are not interest bearing, should be excluded because their interest component is not observable.

Example: Calculate Return on Capital Employed with the following information:

(ii) RETURN ON INVESTMENTS (ROI)

Meaning : This ratio also known return on capital employed is a basic ratio of profitability. It is calculated by establishing a relationship between the profit earned and the capital employed to earn the profit. This ratio is generally stated in the form of percentage with a view to ascertain how much profit a firm has earned with the use of ₹ 100 of capital. It is therefore an indicator of the earning capacity of the capital invested in the business. It is calculated as :

$$\text{Return on Investment or Capital Employed} = \frac{\text{Profit Before Interest, Tax and Dividend}}{\text{Capital Employed}} \times 100$$

The given net profit figure is adjusted by adding back to the net profit the interest paid on debentures and other long-term loans, and abnormal losses, e.g., loss by fire, loss on sale of fixed assets and so on. Similarly, abnormal or non-recurring gains such as gain on the sale of fixed or long-term assets are deducted from net profit. In case profits are taken after tax, the same must be clearly stated.

Capital employed can be computed by any of the given two methods :

First method : Equity share capital *plus* Preference share capital *plus* Reserves and surplus *plus* Long-term loans *minus* Fictitious assets (e.g., preliminary expenses, discount on the issue of shares and debentures etc..) and Non-operating assets like investments made outside the business.

Second method : Fixed assets *net* of depreciation *plus* working capital, i.e., current assets *minus* current liabilities.

Significance

- (i) The ratio measures the overall profitability of a business enterprise. It shows how efficiently the sources committed to the business are being utilised.
- (ii) This ratio also enables to find out how efficiently the borrowed funds are being employed by the management so as to provide additional income to the equity shareholders by **trading on equity**.
- (iii) Similarly this ratio is useful in making capital budgeting decisions since a project giving higher return will be undertaken.
- (iv) This ratio is also very significant measure for **inter-firm comparison** and for evaluation of the various departments within a firm.
- (v) Moreover, this ratio can also be used in judging the efficiency of two different units of the same business enterprise.
- (vi) This ratio can be used for **determining the price of the product** of the firm. In other words, the price of the product should be fixed in such a way that the price recovers not only the cost of the product but ensures a reasonable rate of return.
- (vii) This ratio can be usefully employed in **planning the capital structure of the firm**. It means that management should not depend on borrowed funds if it is not in a position to earn more than what is payable as a fixed charge on such funds.

Illustration 5 (Return on Investments)

Following is the balance sheet of Yoshita Ltd. as on 31 March, 2011 :

Liabilities	₹	Assets	₹
Equity Share Capital	18,00,000	Fixed Assets	30,00,000
General Reserve	4,00,000	Cash at Bank	1,50,000
12% Debentures	8,00,000	Other Current Assets	15,00,000
Current Liabilities	12,00,000	Preliminary Expenses	50,000
Profit of the year	5,00,000		
	47,00,000		47,00,000

Calculate the Return on Investment

Solution

Profit as given

Add : Interest on Debentures

Capital Employed

Share Capital

General Reserve

12% Debentures

Profits

Less : Preliminary expenses

₹	5,00,000
96,000	
<hr/>	5,96,000

₹	18,00,000
4,00,000	
8,00,000	
5,00,000	
(50,000)	
<hr/>	34,50,000

or

Fixed Assets (Net)

Add : Working Capital ($16,50,000 - 12,00,000$)

₹	30,00,000
4,50,000	
<hr/>	34,50,000

$$\text{Return on Investment} = \frac{\text{Profit Before Tax and Interest}}{\text{Capital Employed}} \times 100$$

$$= \frac{5,96,000}{34,50,000} \times 100 = 17.28\%$$

Example: Calculate Return on Capital Employed with the following information:

Particulars	Amount (₹)
Equity Share Capital	20,00,000
Reserves and surplus (including current year profit of ₹ 5,00,000)	9,00,000
10% Debentures	10,00,000
Current Liabilities	16,00,000
Fixed Assets	30,00,000
Current Assets	25,00,000

ution:

Profit Before Interest

$$\begin{aligned} &= \text{Current year's profit} + \text{Interest on Debentures} \\ &= 5,00,000 + 10\%(10,00,000) \end{aligned}$$

$$= 6,00,000$$

$$\begin{aligned} &= \text{Fixed assets} + \text{Current Assets} - \text{Current Liabilities} \\ &= 30,00,000 + 25,00,000 - 16,00,000 \end{aligned}$$

$$= 39,00,000$$

OR

$$\begin{aligned} &= \text{Equity Share Capital} + \text{Reserves and Surplus} \\ &\quad + \text{Long-term debt} \\ &= 20,00,000 + 9,00,000 + 10,00,000 \\ &= 39,00,000 \end{aligned}$$

Return on Capital

$$= \frac{\text{Profit before Interest and tax}}{\text{Total Capital Employed}} \times 100\%$$

Employed/ ROI

$$\begin{aligned} &= \frac{6,00,000}{39,00,000} \times 100\% \\ &= 15.4\% \end{aligned}$$

Equity Shareholders Funds

available.

(iv) RETURN ON EQUITY SHAREHOLDERS' FUNDS

Meaning and objective : This ratio measures the relationship between net profit (after taxes and preference dividend) and equity shareholders' funds. In fact equity shareholders are the real owners who bear all risk, control the management and entitled to all profits remaining after appropriation for preference shareholders. Thus this ratio provides a real test for the utilisation of equity shareholders' money.

Components : The components of this ratio are : (i) Net profit after tax and preference dividend (including participating dividend, if there are participating preference shareholders.) (ii) Equity shareholder's funds include equity share capital (paid up) *plus* Reserves and Surplus *minus* fictitious assets.

Important point : Since the equity capital may change during the accounting period because of issue of new equity shares or buy-back of existing equity shares, it is appropriate to calculate the average equity shareholders' funds by aggregating equity capital in the beginning *plus* equity capital at the end and then divided by 2.

Formula : The ratio is calculated as under :

Return on Equity Shareholder's Funds =

$$\frac{\text{Net Profit After Tax and All Types of Preference Dividends}}{\text{Average Equity Shareholders' Funds}} \times 100$$

It is expressed as a percentage

Illustration 7 (Return on Ordinary Share Capital)

10% Preference Share Capital (fully paid)	₹ 2,00,000
32,000 Equity Shares of ₹ 10 each (fully paid)	3,20,000
Uncommitted Reserves and Surplus	12,80,000
Net Profit after tax	4,75,000
Calculate Return of Ordinary Share Capital	

Solution

Dividends on Preference Share Capital (10% on ₹ 2,00,000)	₹ 20,000
Ordinary Share Capital (Paid up Equity Share Capital)	3,20,000
Add : Uncommitted Reserves and Surplus	12,80,000
Total	<u>16,00,000</u>

$$\begin{aligned} \checkmark \text{Return on Ordinary Capital} &= \frac{\text{Net Profit After Tax} - \text{Preference Dividend}}{\text{Ordinary Share Capital}} \times 100 \\ &= \frac{4,75,000 - 20,000}{16,00,000} \times 100 = \frac{4,55,000}{16,00,000} \times 100 = 28.44\% \end{aligned}$$

Uses and interpretation : The rate of return on the ordinary capital is an important factor in determining the market value of the ordinary share, that is, the price at which it can be sold. A comparison of the rate with similar companies also indicates the performance of equity capital. Further, it reveals the way the profit has been earned so as to derive benefit from trading on equity. It is also a tangible proof of the efficiency of the management.

Example: Calculate **Return of Equity (ROE)** from the following information:

10% Preference Share Capital (fully paid up)	₹ 10,00,000
1,60,000 Equity Shares of ₹10 each fully paid	16,00,000
Reserves and Surplus	64,00,000
Net profit after tax	23,75,000

Solution

Returns on Equity = Net Profit – Preference dividend

Preference dividend = 10% on ₹ 10,00,000 = ₹ 1,00,000

Equity Shareholders' funds:

Paid-up Equity Share Capital	₹ 16,00,000
+ Reserves as Surplus	64,00,000

80,00,000

$$\text{Return on Equity} = \frac{23,75,000 - 1,000,000}{80,00,000} \times 100$$

$$= 22,75,000/80,00,000 \times 100 = 28.44\%$$

$$= 22,75,000 / 50,00,000 \times 100 = 45.44\%$$

Return on Total Assets (ROTA)

This ratio measures the effectiveness of assets invested in the business. It is based on Earnings before Interest and Tax (EBIT) and Total Assets Invested. It is expressed in percentage or decimal. ROTA follows 'the higher, the better' principle however no universal standardized metric is defined as ideal ROTA. It is based on book value of Total assets.

$$\text{Return on Total Assets} = \text{EBIT} / \text{Total Net Assets} \times 100$$

This ratio might be affected by depreciation expense as the total assets value may change. A simple average of opening and closing total assets may be used instead of closing figure only due to the assumption of uniformity in earning profits. It is a useful ratio for competing firms within the same industry.

It may then be referred to as Return on Average Assets.

Example: Calculate Return on Total Assets (ROTA) from the following information.

Net Income	₹ 1,00,000
Interest Expenses	12,000
Taxes	28,000
Total Assets	40,00,000

Ratio Analysis

Solution:

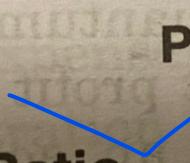
Return on Total Assets = EBIT / Total Assets × 100

= Net Income + Interest + Taxes on Total Assets × 100

= 1,00,000 + 12,000 + 28,000/40,00,000 × 100 = 3.5%

PROFITABILITY RATIOS RELATED TO SALES

Gross Profit Ratio



PROFITABILITY RATIOS RELATED TO SALES

The main purpose of business unit is to make profit. The profitability ratios are computed to throw light on the current operating performance and efficiency of the business firm when they are related to some other figures such as sales, cost of the goods sold, operating expenses, capital invested etc.

(i) GROSS PROFIT RATIO

This ratio shows the relationship between the gross profit to net sales (or turnover) and is generally expressed in percentage. It is calculated as under:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

Components : This ratio is based on net sales and gross profit. Net sales are arrived at after deducting sales returns from the total amount of cash and credit sales. Gross profit is the excess of sales over the cost of the goods sold which includes all expenses directly connected with the purchases such as carriage inwards. In case of manufacturing concerns, the cost of goods sold would also include all manufacturing expenses directly related to the quantity produced, e.g., wages, power, freight etc.. It is the sales margin expressed in percentage

Solution:

$$\begin{aligned}
 \text{Return on Total Assets} &= \text{EBIT} / \text{Total Assets} \times 100 \\
 &= \text{Net Income} + \text{Interest} + \text{Taxes} / \text{Total Assets} \times 100 \\
 &= 1,00,000 + 12,000 - 28,000 / 40,00,000 \times 100 = 3.5\%
 \end{aligned}$$

PROFITABILITY RATIOS RELATED TO SALES

Gross Profit Ratio

It is a profitability ratio that captures the relationship between Gross Profit and Net Sales. It is expressed in percentage terms.

It helps in evaluating operational performance of the company.

$$\text{Gross Profit} = \text{Gross Profit} / \text{Net Sales} \times 100$$

$$\text{Where, Net Sales} = \text{Gross Sales} - \text{Sales Returns}$$

As gross profit reports profits left after deducting direct expenses, a gross profit ratio indicates quantum of profits left to meet indirect expense, financing expenses and remaining return. A steady gross profit may indicate stable profitability position of the company.

Example

	₹
Gross Sales	20,00,000
Sales Returns	1,80,000
Opening Stock	4,00,000
Purchases	11,80,000
Purchase returns	1,40,000
Closing Stock	90,000

Solution:**Gross Profit**

$$\begin{aligned}
 &= \text{Gross Sales} - \text{Sales Returns} + \text{Closing Stock} - \text{Opening Stock} - (\text{Purchases} - \text{Purchase Returns}) \\
 &= 20,00,000 - 1,80,000 + 90,000 - 4,00,000 - \\
 &\quad (11,80,000 - 1,40,000) = 4,70,000
 \end{aligned}$$

$$\begin{aligned}
 &= \text{Gross Sales} - \text{Sales Returns} = 20,00,000 - 1,80,000 = \\
 &\quad 18,20,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Net Sales} &= \text{Gross Profit} / \text{Net Sales} \times 100 = 4,70,000 / 18,20,000 \times \\
 \text{Gross Profit Ratio} &= 100 = 25.82\%
 \end{aligned}$$

✓ Net Profit Ratio

It is the ratio of profits after tax with net sales. Net profits indicate the profits left after deducting selling, administration and financing expenses and taxes. It is a popular measure to capture overall profitability of the firm. 'Net profit' is an absolute term but "Net profit Ratio" aids comparison amongst firms being a relative term. This ratio is expressed as percentage. It signifies the quantum of profits left for dividend distribution and retained earnings. A healthy net profit ratio does not necessarily indicate healthy cashflows because net profit is an accounting term calculated after deducting non-cash expenses too.

$$\text{Net Profit Ratio} = \text{Net Profit After Tax}/\text{Net Sales} \times 100$$

Example: Calculate Net Profit Ratio with the following, information:

Sales	₹ 20,00,000
Sales return	80,000
Cost of goods sold	11,00,000
Selling and administration expenses	7,20,000
Tax rate	35%

Solution:

$$\begin{aligned}
 \text{Profit Before tax} &= \text{Sales} - \text{Sales Return} - \text{Cost of goods sold} \\
 &\quad - \text{Selling and administration expenses} \\
 &= 20,00,000 - 80,000 - 11,00,000 - 7,20,000 \\
 &= 1,00,000 \\
 \text{Net Profit after tax} &= \text{Profit Before Tax} - \text{Tax} \\
 &= 1,00,000 - 35\% (1,00,000) \\
 &= 65,000 \\
 \text{Net Sales} &= \text{Sales} - \text{Sales Return} \\
 &= 20,00,000 - 80,000 \\
 &= 19,20,000 \\
 \text{Net profit ratio} &= \text{Net Profit After Tax}/\text{Net Sales} \times 100 \\
 &= 65,000 / 19,20,000 \times 100 \\
 &= 3.385\%
 \end{aligned}$$

✓ Operating Ratio (Profit)

OPERATING PROFIT AND NET PROFIT

Profit may be divided into:

- (i) Operating Profit; and
- (ii) Net Profit.

Operating Profit is the profit earned by the enterprise from its operating activities. It is calculated by deducting the Operating Expenses from the Gross Profit.

$$\text{Operating Profit} = \text{Gross Profit} - \text{Operating Expenses}$$

Net Profit is the profit earned through operating and non-operating activities of the business.

Operating Expenses are the expenses incurred by an enterprise that are associated (incurred) with its operating activities. For example, a retail store's main or operating activities are buying and selling of goods. Therefore, cost of goods sold, salaries paid to staff, electricity expenses, rent, repairs, depreciation and amortisation are operating expenses because without incurring these expenses, the enterprise cannot carry its operating activities.

Financial Statements of Sole Proprietorship ... 18.31

Non-Operating Expenses are the expenses which do not relate to the main activity of the enterprise such as interest on loan, charity, donation, loss on sale of fixed assets and loss by fire or theft or damage, etc.

Expenses, Operating and Non-Operating, are debited to Profit & Loss Account.

Operating Incomes are the incomes earned by an enterprise that are earned from its operating activities. For example, a retail store's main or operating activity is buying or selling of goods. Incomes earned in carrying the operating activities such as income from renting of space in the showroom, renting of show window, etc., are operating incomes. Besides the above, it includes cash discount received and commission received, etc.

Non-Operating Incomes are incomes earned and which do not relate to the operating activity of the enterprise such as interest received on investments, gain (profit) on sale of fixed assets, etc.

Incomes, Operating and Non-Operating, are credited to Profit & Loss Account.

$$\text{Operating Profit} = \text{Gross Profit} - \text{Operating Expenses}$$

Or

$$\text{Operating Profit} = \text{Net Sales} - \text{Cost of Goods Sold} - \text{Operating Expenses}$$

Or

$$\text{Operating Profit} = \text{Net Profit} + \text{Non-Operating Expenses} - \text{Non-Operating Incomes}$$

$$\text{Operating Profit} = \text{Net Sales} - \text{Operating Cost}^*$$

**Operating Cost = Cost of Goods Sold + Operating Expenses*

Difference between Net Profit and Operating Profit

The concept of Net Profit is different from the concept of Operating Profit. Net Profit is calculated after considering non-operating incomes and non-operating expenses/losses, while ascertaining the operating profit, non-operating items are not considered.

$$\text{Net Profit} = \text{Gross Profit} - \text{Operating Expenses} - \text{Non-Operating Expenses}$$

$$+ \text{Non-Operating Incomes}$$

$$\text{Net Profit} = \text{Operating Profit} - \text{Non-Operating Expenses} + \text{Non-Operating Incomes}$$

//

Illustration 18

...
expenses if there has been unreasonable increase of such expenses.

(iii) OPERATING PROFIT RATIO

This ratio expresses relationship between operating profits and net sales. It is computed as :

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Net Sales}} \times 100$$

Components : Operating profit means the excess of gross profit over operating expenses. Gross profit is the excess of net sales revenue over cost of the goods sold. Operating expenses include office and administrative expenses, selling and distribution expenses, cash discounts allowed, interest on bills payable and other short-term debts, bad debts, and so on. Net sales mean cash sales plus credit sales minus sales returns.

Objectives : The primary objective is to determine the operational efficiency of the management. So operating profit does not include gains from and losses on non-operating items, e.g., profit or loss on sale of investments, rent income, interest income and so on.

Interpretation : This ratio helps in knowing the amount of profit earned from regular business transactions on a sale of ₹ 100. And then what amount of sales is left to cover non-operating expenses, to pay dividends and to create general reserves. Higher operating profit ratio is an indicator of more efficiency of the operating management. **The following factors increase the ratio namely:** (i) higher gross profit, and (ii) less amount of operating expenses.

Example: Calculate Operating Profit Ratio with the following information:

Net Sales	₹
Gross profit	= 8,00,000
Income from investment	= 2,80,000
Selling expenses	= 2,000
Administration expenses	= 70,000
Loss on sale of asset	= 50,000
	= 4,000

Solution:

$$\begin{aligned}
 \text{Operating Profit} &= \text{Gross Profit} - \text{Selling expenses} - \text{Administration expenses} \\
 &= 2,80,000 - 70,000 - 50,000 \\
 &= 1,60,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Operating Profit Ratio} &= \text{Operating Profit}/\text{Net Sales} \times 100 \\
 &= 1,60,000/8,00,000 \times 100 \\
 &= 20\%
 \end{aligned}$$

Operating Ratio

$$= 20\%$$

Operating Ratio

It is an expense ratio calculated to capture the relationship between operating cost and net sales. Non-operating expenses like interest received or paid, taxes, etc. are excluded from the calculations.

$$\text{Operating Ratio} = \text{Operating Expenses}/\text{Net Sales} \times 100$$

Example: Calculate Operating Ratio with the following information:

	₹
Net Sales	4,00,000
Cost of Goods Sold	2,40,000
Selling expenses	40,000
Administration expenses	40,000

Solution:

$$\begin{aligned}\text{Operating Cost} &= \text{Cost of Goods Sold} + \text{Selling expenses} + \\ &\quad \text{administration expenses} \\ &= 2,40,000 + 40,000 + 40,000 \\ &= 3,20,000\end{aligned}$$

$$\begin{aligned}\text{Operating Ratio} &= \text{Operating Expenses}/\text{Net Sales} \times 100 \\ &= 3,20,000/4,00,000 \times 100 \\ &= 80\%\end{aligned}$$