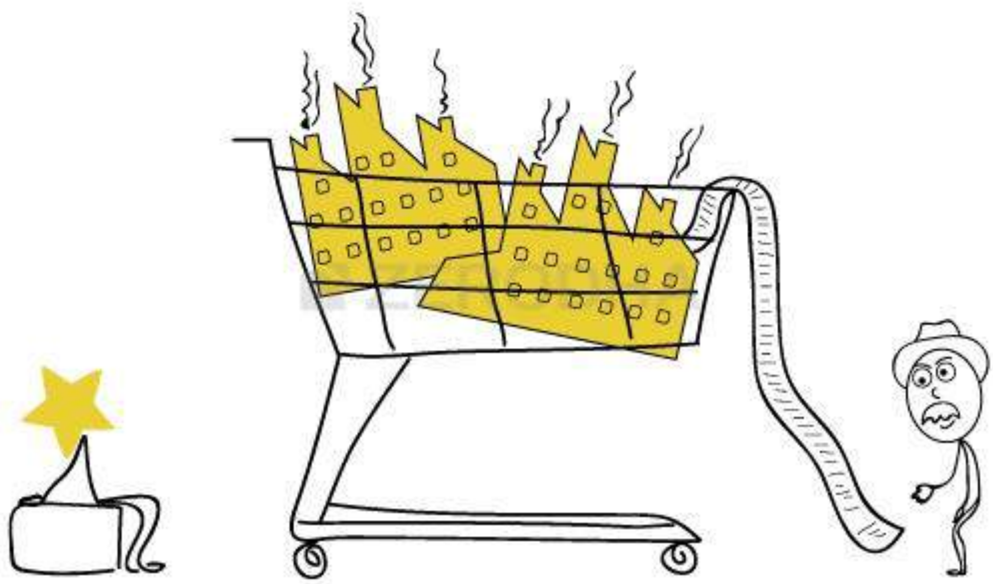
Understanding P&L Statement (Part 2)



5.1 – The Expense details

In the previous chapter we had learnt about the revenues a company generates. Moving further on the P&L statement, in this chapter we will look at the expense side of the Profit and Loss Statement along with the associated notes. Expenses are generally classified according to their function, which is also called the cost of sales method or based on the nature of expense. An analysis of the expenses must be shown in the Profit and Loss statement or in the notes. As you can see in the extract below almost all the line items have a note associated to it.

EXPENSES			
Cost of materials consumed	19	21,011.95	17,603.12
Purchases of stock-in-trade	20	2,113.69	2,632.54
Changes in inventories of finished goods, work-in-process and stock-in-trade	20	(292.10)	(320.89)
Employee benefits expense	21	1,583.16	1,262.30
Finance costs	22	7.18	2.69
Depreciation and amortisation expense [includes impairment loss of ₹Nil (PY ₹75.52 million)]	23	645.71	660.92
Other expenses	24	4,346.60	3,904.24
Total Expenses		29,416.19	25,744.92

The first line item on the expense side is 'Cost of materials consumed'; this is invariably the cost of raw material that the company requires to manufacture finished goods. As you can see the cost of raw material consumed/raw material is the largest expense incurred by the company. This expense stands at Rs.2101 Crs for the FY14 and Rs.1760 Crs for the FY13. Note number 19 gives the associated details for this expense, let us inspect the same.

NOTE 19: COST OF MATERIALS CONSUMED *(Contd.)*

a) Materials consumed comprise

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Lead	9,882.97	8,221.83
Lead alloys	8,183.44	6,646.43
Separator	895.49	799.95
Others	2,050.05	1,934.91
Total	**21,011.95**	**17,603.12**

As you can see note 19 gives us the details of the material consumed. The company uses lead, lead alloys, separators and other items all of which adds up to Rs.2101 Crs.

The next two line items talks about 'Purchases of Stock in Trade' and 'Change in Inventories of finished goods , work–in-process & stock–in-trade'. Both these line items are associated with the same note (Note 20).

Purchases of stock in trade, refers to all the purchases of finished goods that the company buys towards conducting its business. This stands at Rs.211 Crs. I will give you more clarity on this line item shortly.

Change in inventory of finished goods refers to the costs of manufacturing incurred by the company in the past , but the goods manufactured in the past were sold in the present/current financial year. This stands at (Rs.29.2) Crs for the FY14.

A negative number indicates that the company produced more batteries in the FY14 than it managed to sell. To give a sense of proportion (in terms of sales and costs of sales) the company deducts the cost incurred in manufacturing the extra goods from the current year costs. The company will add this cost when they manage to sell these extra products sometime in future. This cost, which the company adds back later, will be included in the "Purchases of Stock in Trade" line item.

Here is an extract of Note 20 which details the above two line items:

NOTE 20: PURCHASES OF STOCK IN TRADE AND CHANGES IN INVENTORIES OF FINISHED GOODS, WORK-IN-PROCESS AND STOCK-IN-TRADE

a) PURCHASE OF STOCK-IN-TRADE

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Storage batteries	1,619.44	1,437.71
Home UPS	494.25	1,194.83
Total	2,113.69	2,632.54

b) CHANGES IN INVENTORIES OF FINISHED GOODS, WORK-IN-PROCESS AND STOCK-IN-TRADE

₹ million

Particulars	Year ended March 31, 2014		Year ended March 31, 2013	
Work-in-process				
Opening stock - Storage batteries	828.95		811.41	
Less: Closing stock - Storage batteries	1,052.11	(223.16)	828.95	(17.54)
Finished goods				
Opening stock - Storage batteries	536.44		563.49	
Less: Closing stock - Storage batteries	941.75		536.44	
	(405.31)		27.05	
Less: Excise Duty on (increase) / decrease of finished goods	(41.95)	(363.36)	6.12	20.93
Stock-in-trade				
Opening stock - Storage batteries	145.01		21.15	
- Home UPS	223.97		23.55	
	368.98		44.70	
Less: Closing stock - Storage batteries	36.73		145.01	
- Home UPS	37.83		223.97	
	74.56	294.42	368.98	(324.28)
Net increase in inventories		(292.10)		(320.89)

The details mentioned on the above extract are quite straightforward and is easy to understand. At this stage it may not be necessary to dig deeper into this note. It is good to know where the grand total lies. However, when we take up 'Financial Modeling' as a separate module we will delve deeper into this aspect.

The next line item on the expense side is "Employee Benefit Expense". This is quite intuitive as it includes expense incurred in terms of the salaries paid, contribution towards provident funds, and other employee welfare expenses. This stands at Rs.158 Crs for the FY14. Have a look at the extract of note 21 which details the 'Employee Benefit Expense'.

NOTE 21: EMPLOYEE BENEFITS EXPENSE

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Salaries and wages	1,361.32	1,086.99
Contribution to provident and other funds	81.54	69.81
Staff welfare expenses	140.30	105.50
Total	1,583.16	1,262.30

Here is something for you to think about – A company generating Rs.3482 Crs is spending only Rs.158 Crs or just 4.5% of its sales on its employees. In fact this is the pattern across most of companies (at least non IT). Perhaps it is time for you to rethink about that entrepreneurial dream you may have nurtured.

The next line item is the "Finance Cost / Finance Charges/ Borrowing Costs". Finance cost is interest costs and other costs that an entity pays when it borrows funds. The interest is paid to the lenders of the company. The lenders could be banks or private lenders. The company's finance cost stands at Rs.0.7 Crs for the FY14. We will discuss more about the debt and related matters when we take up the chapter on the balance sheet later.

Following the finance cost the next line item is "Depreciation and Amortization" costs which stand at Rs.64.5 Crs. To understand depreciation and amortization we need to understand the concept of tangible and intangible assets.

A tangible asset is one which has a physical form and provides an economic value to the company. For example a laptop, a printer, a car, plants, machinery, buildings etc.

An intangible asset is something that does not have a physical form but still provides an economic value to the company such as brand value, trademarks, copyrights, patents, franchises, customer lists etc.

An asset (tangible or intangible) has to be depreciated over its useful life. Useful life is defined as the period during which the asset can provide economic benefit to the company. For example the useful life of a laptop could be 4 years. Let us understand depreciation better with the help of the following example.

Zerodha, a stock broking firm generates Rs.100,000/- from the stock broking business. However Zerodha incurred an expense of Rs.65,000/- towards the purchase of a high performance computer server. The economic life (useful life) of the server is expected to be 5 years. Now if you were to look into the earning capability of Zerodha it appears that on one hand Zerodha earned Rs.100,000/- and on the other hand spent Rs.65,000/- and therefore retained just Rs.35,000/-. This skews the earnings data for the current year and does not really reflect the true earning capability of the company.

Remember the asset even though purchased this year, would continue to provide economic benefits over its useful life. Hence it makes sense to spread the cost of acquiring the asset over its useful life. This is called depreciation. This means instead of showing an upfront lump sum expense (towards purchase of an asset), the company can show a smaller amount spread across the useful life of an asset.

Thus Rs.65,000/- will be spread across the useful life of the server, which is 5. Hence 65,000/ 5 = Rs.13,000/- would be depreciated every year over the next five years. By depreciating the asset, we are spreading the upfront cost. Hence after the depreciation computation, Zerodha would now show its earrings as Rs.100,000 – Rs.13,000 = Rs.87,000/-.

We can do a similar exercise for non tangible assets. The depreciation equivalent for non tangible assets is called amortization.

Now here is an important idea – Zerodha depreciates the cost of acquiring an asset over its useful life. However, in reality there is an actual outflow of Rs.65,000/- paid towards the asset purchase. But now, it seems like the P&L is not capturing this outflow. As an analyst, how do we get a sense of the cash movement? Well, the cash movement is captured in the cash flow statement, which we will understand in the later chapters.

Here is the snapshot of Note 23, detailing the depreciation cost.

NOTE 23: DEPRECIATION AND AMORTISATION EXPENSE

₹ million

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Depreciation	634.41	652.72
Amortisation	11.30	8.20
Total	**645.71**	**660.92**

Note: Depreciation includes impariment provision on freehold land of ₹NIL (PY ₹75.52 million).

The last line item on the expense side is "other expenses" at Rs.434.6 Crs. This is a huge amount classified under 'other expenses', hence it deserves a detailed inspection.

NOTE 24: OTHER EXPENSES

₹ million

Particulars	Year ended March 31, 2014		Year ended March 31, 2013	
A. Manufacturing expenses				
a. Stores and spares consumed (including packing material)		449.41		378.41
b. Power and fuel		922.56		978.14
c. Insurance		8.49		7.29
d. Repairs and maintenance to				
i) Machinery	44.46		55.79	
ii) Buildings	18.72	63.18	14.28	70.07
Total (A)		**1,443.64**		**1,433.91**
B. Selling expenses				
a. Advertisement and promotion		275.85		154.41
b. Freight outward		595.20		553.25
c. Commission on sales		8.40		10.13
d. Service expenses		219.36		94.16
e. Warehousing and secondary freight		250.50		223.43
f. Other sales expenses		242.15		155.81
g. Royalty on sales		-		0.05
h. Product warranties		383.15		494.62
Total (B)		**1,974.61**		**1,685.86**

NOTE 24: OTHER EXPENSES *(Contd.)*

₹ million

Particulars	Year ended March 31, 2014		Year ended March 31, 2013	
C. Administrative expenses				
a. Rent		114.10		98.31
b. Commission to Non-Executive Chairman		175.99		140.88
c. Payment to Auditors (Refer Note No. 28)		3.92		2.73
d. Research and development expenses		4.00		2.83
e. Donations		135.42		112.23
f. Travel and conveyance		147.00		116.70
g. Repairs and maintenance to office equipment		18.50		10.27
h. Communication expenses		18.81		16.58
i. Consultancy charges		34.45		39.18
j. Information technology expenses		26.62		18.71
k. Office maintenance expenses		92.79		83.24
l. Loss on sale of current investments		0.20		-
m. Sundry expenses		96.52		77.71
Total (C)		868.32		719.37
D. Other expenses				
a. Provision for doubtful trade receivables		0.07		-
b. Bad debts and irrecoverable advances written off	32.33		4.84	
Less: Opening provision reversed	30.27	2.06	3.63	1.21
c. Tangible fixed assets written off		24.90		44.27
d. Premium on forward contracts		1.08		-
Total (D)		28.11		45.48
E. Rates and taxes (excluding Income tax)				
a. Rates, taxes and licenses		5.57		3.63
b. Duties and taxes (indirect taxes)		24.35		14.16
c. Wealth tax		2.00		1.83
Total (E)		31.92		19.62
Grand Total (A+B+C+D+E)		4,346.60		3,904.24

From the note it is quite clear that other expenses include manufacturing, selling, administrative and other expenses. The details are mentioned in the note. For example, Amara Raja Batteries Limited (ARBL) spent Rs.27.5 Crs on advertisement and promotional activities.

Adding up all the expenses mentioned in the expense side of P&L, it seems that Amara Raja Batteries has spent Rs.2941.6 Crs.

5.2 – The Profit before tax

It refers to the net operating income after deducting operating expenses but before deducting taxes and interest. Proceeding further on the P&L statement we can see that ARBL has mentioned their profit before tax and exceptional item numbers.

Simply put the profit before tax (PBT) is:

Profit before Tax = Total Revenues – Total Operating Expenses

= Rs.3482 – Rs.2941.6

=Rs.540.5

However there seems to be an exceptional item/ extraordinary item of Rs.3.8 Crs, which needs to be deducted. Exceptional items/ extraordinary items are expenses occurring at one odd time for the company and the company does not foresee this as a recurring expense. Hence they treat it separately on the P&L statement.

Hence profit before tax and extraordinary items will be:

= 540.5 – 3.88

= Rs.536.6 Crs

The snapshot below (extract from P&L) shows the PBT(Profit Before Tax) of ARBL:

Profit before exceptional items and tax		**5,405.54**	**4,309.74**
Less: Exceptional items (net)	33	38.84	91.57
Profit before tax		**5,366.70**	**4,218.17**

5.3 – Net Profit after tax

The net operating profit after tax is defined as the company's operating profit after deducting its tax liability. We are now looking into the last part of the P&L statement, which is the profit after tax. This is also called the bottom line of the P&L statement.

Profit before tax			**5,366.70**	**4,218.17**
Less:	Tax expense			
	Current tax		1,580.00	1,377.97
	Deferred tax (credit) / expense		106.23	(24.51)
	Earlier year's (excess) / short provision		6.11	(2.34)
Profit for the year			**3,674.36**	**2,867.05**
Basic and diluted earnings per equity share of ₹1 each		37	21.51	16.78

As you can see from the snapshot above, to arrive at the profit after tax (PAT) we need to deduct all the applicable tax expenses from the PBT. Current tax is the corporate tax applicable for the given year. This stands at Rs.158 Crs. Besides this, there are other taxes that the company has paid. All taxes together total upto Rs.169.21 Crs. Deducting the tax amount from the PBT of Rs.536.6 gives us the profit after tax (PAT) at Rs.367.4 Crs.

Hence Net **PAT = PBT – Applicable taxes**.

The last line in the P&L statement talks about basic and diluted earnings per share. The EPS is one of the most frequently used statistics in financial analysis. EPS also serves as a means to assess the stewardship and management role performed by the company directors and managers. The earnings per share (EPS) is a very sacred number which indicates how much the company is earning per face value of the ordinary share. It appears that ARBL is earning Rs.21.51 per share. The detailed calculation is as shown below:

NOTE 37: EARNINGS PER SHARE

Particulars	Year ended March 31, 2014	Year ended March 31, 2013
Numerator - Earnings		
Net profits for the period in ₹ million	3,674 .36	2,867.05
Denominator - Equity shares		
Number of shares at the beginning of the year	17,08,12,500	17,08,12,500
Add: Shares issued during the year	-	-
Less: Shares forfeited / bought back during the year	-	-
Number of shares outstanding at the end of the year	17,08,12,500	17,08,12,500
Weighted average number of shares outstanding at the end of the year (Basic and Diluted)	17,08,12,500	17,08,12,500
Basic and diluted earnings per equity share of ₹1 each	₹21.51	₹16.78

The company indicates that there are 17,08,12,500 shares outstanding in the market. Dividing the total profit after tax number by the outstanding number of shares, we can arrive at the earnings per share number. In this case:

Rs.367.4 Crs divided by 17,08,12,500 yields Rs.21.5 per share.

5.4 – Conclusion

Now that we have gone through all the line items in the P&L statement let us relook at it in its entirety.

Statement of Profit and Loss for the year ended March 31,2014 ₹ million

Particulars	Note No.	Year ended March 31, 2014	Year ended March 31, 2013
REVENUE			
Sale of products		38,041.27	32,949.37
Less: Excise duty		4,005.15	3,512.45
Net sale of products		34,036.12	29,436.92
Sale of services		309.32	137.02
Other operating revenue		21.15	15.21
Net revenue from operations	17	34,366.59	29,589.15
Other income	18	455.14	465.51
Total Revenue		34,821.73	30,054.66
EXPENSES			
Cost of materials consumed	19	21,011.95	17,603.12
Purchases of stock-in-trade	20	2,113.69	2,632.54
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Other expenses	24	4,346.60	3,904.24
Total Expenses		29,416.19	25,744.92
Profit before exceptional items and tax		5,405.54	4,309.74
Less: Exceptional items (net)	33	38.84	91.57
Profit before tax		5,366.70	4,218.17
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Current tax		1,580.00	1,377.97
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Earlier year's (excess) / short provision		6.11	(2.34)
Profit for the year		3,674.36	2,867.05
Basic and diluted earnings per equity share of ₹1 each	37	21.51	16.78

Hopefully, the statement above should look more meaningful to you by now. Remember almost all line items in the P&L statement will have an associated note. You can always look into the notes to seek greater clarity. Also at this stage we have just understood how to read the P&L statement, but we still need to analyze what the numbers mean. We will do this when we take up the financial ratios. Also, the P&L statement is very closely connected with the other two financial statements i.e the balance sheet and the cash flow statement. We will explore these connections at a later stage.

Key takeaways from this chapter:

1. The expense part of the P&L statement contains information on all the expenses incurred by the company during the financial year
2. Each expense can be studied with reference to a note which you can explore for further information

3. Depreciation and amortization is way of spreading the cost of an asset over its useful life
4. Finance cost is the cost of interest and other charges paid when the company borrows money for its capital expenditure.
5. PBT = Total Revenue – Total Expense – Exceptional items (if any)
6. Net PAT = PBT – applicable taxes
7. EPS reflects the earning capacity of a company on a per share basis. Earnings are profit after tax and preferred dividends.
8. EPS = PAT / Total number of outstanding ordinary shares