Addendum to the 'The five-minute read # 7 - Financial Statements -2 Profit & Loss statement'

The previous writeup ended with the following paragraph:

*Operating profit is equal to GROSS PROFIT – minus all '**operating expenses'** except **'Interest'** paid for any loans. [When you borrow money from anybody, particularly banks, you have to pay interest on that.]*

The following are some of the operating expenses items:

- Payment of rent
- Advertisement expense
- Salary
- Transportation expense
- Maintenance
- Legal expense
- Truck hiring charge received
- Amortization of Prelem. & preop.
- Telephone bill payment
- Electricity bill payment
- Insurance
- Audit fees
- Traveling expenses
- Stationeries

The following are items in accounting books but are not part of operating expenses:

Cost incurred to:

- purchase of equipment – balance sheet item
- Closing stock – balance sheet item
- Purchase of goods – used in estimation of 'Gross Profit'
- Construction of factory shed – balance sheet item
- Purchase of truck – balance sheet item
- Repayment of bank loan – balance sheet item
- Trade Receivables – balance sheet item
- Purchase of telephone – balance sheet item
- Sale of old machine (say, book value: 2400) – balance sheet item
- Interest on bank loan – used to estimate 'Profit Before Tax' after obtaining 'Operating Profit'
- Sale of goods – used in estimation of 'Gross Profit'
- Fresh long-term loan raised – balance sheet item
- Trade Payables – balance sheet item
- Company pays dividend during the year

- Founders contribute to new equity capital – balance sheet item
- Company pays income tax @ 30% - used in estimating income tax and it is deducted from 'Profit Before Tax' to obtain 'Net Profit', also known as 'Profit After Tax'
- Outstanding in short term loan – balance sheet item

Let us go back to the example we have begun in writeup of Week #7.

Your gross profit is: ₹4,500

Suppose the following expenses are also incurred:

Transportation cost (from Kolkata to IIT Kharagpur) during the year: ₹ 500

Rent paid to IIT Kharagpur for using the room for business for the year: ₹ 600

Electricity charge for the year: ₹ 100

Telephone bills paid for the year: ₹ 300

Salary: Nil (you do not have any staff as of now)

Stationeries (some small expenses incurred): ₹ 20

Insurance: Nil

Depreciation and amortization (to be discussed later): ₹ 100

Total operating expenses: (500+600+100+300+20+100) = ₹ 1,620

Therefore, Operating Profit for the year = ₹4,500 (GP) – ₹1,620 (all operating expenses) = ₹ 2,880

The percentage of operating profit or 'Operating Profit Margin' = (Operating profit/Sales)*100 = (₹ 13,500/2,880)*100 = 21.33%

Suppose that you borrowed some money from a friend to start this business and pay interest of ₹ 15 for the year 2020-21 against the same.

Therefore, Profit Before Tax (or PBT) = Operating profit – Interest = ₹ 1,620 – ₹15 = ₹1,605

If the income tax rate is say @20%, then, Income tax payment = 20% of ₹1,605 = ₹321

Net Profit (or profit after tax or PAT) = ₹1,605 – ₹321 = ₹ 1,284

Assume that you pay dividend of ₹ 500 to the founders (owners of the business) during the year.

Therefore, Retained Profit or Retained Earnings = ₹1,284 – ₹500 = ₹784

This amount of 'Retained Earnings' goes to the balance sheet and is added to 'Reserves & Surplus' or 'Other Equity'. this is where the **PROFIT & LOSS ACCOUNT** is connected to the **BALANCE SHEET**.