Two-Minute Read #7

Understanding financial statements: Profit & Loss Account

On must gain an intuitive understanding of financial statements to be a more effective business leader. A firm grip on the financial statement may help one to manage the various components of business and transform a weak business model into a winning business. You will discover how and why cash is vital in business and how to ensure you never run out of it.

The three key financial statements are

Profit & Loss Account

Balance Sheet

Cash Flow Statement

Let us understand the Profit & Loss Account.

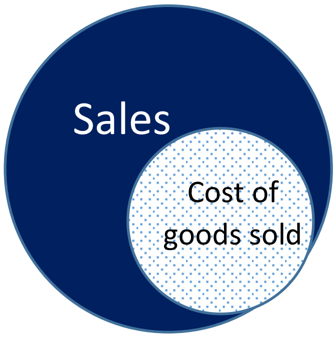
Have a global view of an enterprise. You earn money by selling products and/or services and meet all the expenses out of it. If anything is left after meeting all expenses, that surplus is the profit before tax, whatever remains after payment of tax belongs to the owners of the business.

For understanding the different levels of efficiency with which firms utilize its resources, various types of profits are defined. You progressively estimate the following different profits:

“You have to understand accounting and you have to understand the nuances of accounting. It's the language of business and it's an imperfect language, but unless you are willing to put in the effort to learn accounting - how to read and interpret financial statements - you really shouldn't select stocks yourself.” - Warren Buffett

GROSS PROFIT = Sales minus Cost of goods sold

Gross Profit = Sales – Cost of goods sold



EBIDTA = Gross profit – all the expenses except Depreciation (D), Interest (I), Tax (T), and Amortization (A). [in EBIDTA, B stands for 'before' meaning minus. Full form of EBIDTA is 'Earnings before interest, depreciation, tax and amortization'. In USA, the word 'earnings' is used to mean what we call 'profit'].

OPERATING PROFIT or EBIT = Gross profit – Interest & Tax

PROFIT BEFORE TAX (or PBT) = Operating profit – Interest

NET PROFIT (or Profit After Tax or **PAT**) = Profit Before Tax – Income Tax

RETAINED PROFIT or **RETAINED EARNINGS** = Net profit – dividends

(In this context, please know that people in the USA use the term 'Earnings' to mean what we call 'Profit.')

Know that financial year in India begins on 01st of April of one year and ends on 31st of March of the next year (though a company is free to choose any 12 months period as the financial year). We write the year as year 2020-21 (or simply 20–21), which means the period from 01st of April 2020 to 31st of March 2021. [However, some companies follow different financial year to report to stakeholders other than the government agencies since their operation is largely cyclical or their parents in another country follow different period.]

Let's take a simple example. Suppose you start a business in your hostel room. You buy pens from Kolkata and sell them from your room. Say, each pen cost you ₹10, and you sell them for ₹15 each. Consider that you have just completed the second year of business (say 2020-21) and now want to estimate the profit for the year. The first question you need to find an answer to is, 'how many pens have you sold?' The answer is intuitive but needs some explanation. Suppose you bought 500 pens in the previous year, i.e. year 2019-20 and sold 400 of them. Therefore, as at the close of the business of year 19-20, you are left with 100 unsold pens (this bundle of 100 unsold pens is referred to as '**closing stock'**). Therefore, when you start the year 2020-21, i.e. on the 1st of April 2020, you already have these 100 pens with you (this bundle of 100 pens that remained unsold in the previous year as 'closing stock', is referred to as '**opening stock'** for the year 2020-21). So, you start selling the pens and keep buying pens from Kolkata throughout the year 2020-21. You buy a total of 1000 pens during this year. At the end of the year, i.e. on 31 March 2021, you notice that 200 pens remained unsold. Therefore, your '**closing stock**' for the year 2020-21 is 200 pens. So, how many pens have you sold during 2020-21?

The intuitive formula is: Opening stock + purchase during the year – closing stock = 100 + 1000 – 200 = 900. Therefore, you sold 900 pens during the year 2020-21. In reality, you sell many items and, therefore, we do not refer by numbers but by their cost of purchase. Suppose, your closing stock was worth ₹ 1000, your purchase during the year was ₹ 10,000 and your closing stock as on 31.03.2021 was ₹ 2,000. The cost of the goods that you sold during 2020-21 can be estimated using the same formula:

Cost of Goods Sold (or CoG) = opening stock + purchase – closing stock = 100,000 + 10,00,000 – 200,000 = 9,000 or ₹ 9,000.

You sell pens @15 apiece. Your sales during the year is ₹ 13,500 (900*15).

GROSS PROFIT (GP) = SALES – COST OF GOODS SOLD = 13,500 – 9,000 = 4,500

The percentage of GROSS PROFIT MARGING is also important. MARGINS ARE ALWAYS ESTIMATED WITH RESPECT TO SALES. For the above example:

Gross Profit Margin = (Gross profit/ Sales)*100 = (4,500/13,500)*100 = 33.33%

We have just estimated one form of profit, i.e. Gross Profit.

Let us now understand OPERATING PROFIT:

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