

## COMPONENTS OF INCOME STATEMENT

### Revenue or Sales

Revenue represents sale of products and services produced or traded by an enterprise. These are usually recorded at gross value, including excise duty if any. When an organisation provides services or sells goods it receives cash immediately or receives commitment to be paid on some future date. Such commitments are called debtors or receivables. The excise duty is then separately deducted from the gross sales. Revenue can be generated by a firm in a variety of ways. According to the Schedule VI (see Appendix 7.1 for the details of Schedule VI) of the Companies Act, the aggregate amount for which sales are effected by the company, giving the amount of sales in respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately. In 2006, NALCO generated a revenue of 4851 crores as shown in Exhibit: 7.1 . Other income of NALCO was less than 5% of the total income for the year 2006.

<b>Exhibit: 7.1: NALCO</b>			
<b>Profit and Loss Account for the year ended March 31, 2006</b>			
(Rupees in crores)			
	Schedule	Year ended March 31, 2006	Year ended March 31, 2005
<b>INCOME:</b>			
Gross Sales	H	5,287.36	4,420.14
Less: Excise Duty		435.46	316.03
Net sales		4,851.90	4,104.11
Finished goods internally consumed/capitalised		8.52	15.43
Other income	I	222.18	235.22
		<b>5,082.60</b>	<b>4,354.76</b>

### Other Incomes

The income received by a company from sources other than sales of its main products and services is mentioned separately. In many companies the other income constitutes a significant portion of the profit before tax. Other incomes on average account for around 2% of the sales and less than 20% of the profit after tax as shown by the Table 7.12,

<b>Table: 7.12</b>			
<b>Position of Other Incomes of the companies forming a part of Nifty</b>			
	2004	2005	2006
As % of Sales	2%	2%	2%
AS % of PAT	18%	16%	19%

Source: CMIE data base

Other incomes include dividend and interest from the investments made by the company in other companies.

### Expenditure Side

The expenditure side of income statement shows the details of all the revenue expenses whether accrued or paid for during a year.

### **Revenue Expenses**

Revenue expense are those transactions (reduction of assets or increase in liabilities) the benefit of which expires within an accounting period. The accounting period may be a year, half year, quarter, or a month. According to the matching concept of accounting, expenses of an accounting period should be charged against the income of that period to determine profit for the period. See the Table 7.13 to get a better understanding of revenue expenses and the accounting period:

<b>Table 7.13</b>			
<b>Expense, Cash Outflow, Asset, and Liability</b>			
Accounting Period	3 months	6 months	12 months
Expense Per Month	1000	1000	1000
Expense Paid	6000	6000	6000
Expense for the period	3000	6000	12000
Liability (Outstanding Expense)	0	0	6000
Asset (Advance Expense)	3000	0	0

In the following section we will understand the various components of expenditure.

### **Cost of Goods Sold/Consumed (COGS)**

The cost of goods consumed is arrived at after making suitable adjustments for opening and closing stocks. According to the matching concept, when the goods are sold, the corresponding cost will be treated as an expense and it is called cost of goods sold (COGS).

#### **Example 7.8**

ABC Ltd had an opening stock of 800 units @ 20. During the first quarter it purchased 3000 units @ 40 and sold 3300 units @ 50.

<b>Cost of Goods Sold</b>			
	Qty	Price	Value
Opening Stock	800	20	16,000
Add Purchase	3000	40	120,000
			136,000
Cost of Goods Sold	3300		126,000

Cost of goods sold = Opening stock + Purchases – Closing stock

It is important to note that the cost of goods consumed depends of the value of the closing stock. Value of closing stock depends on the methods of issuing inventory. Following are some of the common methods of issuing inventory.

#### Last-in-first-out (LIFO).

Under this method the goods purchased last will be used first. So the unsold stock is generally from the past purchases or the opening stock.

#### Example 7.9

ABC Ltd had an opening stock of 1000 units @ 10. During the first quarter it purchased 3000 units @ 20 and sold 2500 units @ 40.

Cost of Goods Sold using LIFO			
	Qty	Price	Value
Opening Stock	800	20	16000
Add Purchase	3000	40	120000
			136000
<b>COGS</b>	3000 @40	120000	
	300 @ 20	6000	<b>126,000</b>
Closing Stock	500	20	10,000

#### First-in-first-out (FIFO):

Under this method, the oldest purchase is used first. So the unsold stock is from the latest purchases.

#### Example 7.10

ABC Ltd had an opening stock of 1000 units @ 20. During the first quarter it purchased 3000 units @ 40 and sold 3300 units @ 60.

Cost of Goods Sold using FIFO			
	Qty	Price	Value
Opening Stock	800	20	16000
Add Purchase	3000	40	120000
			136000
<b>COGS</b>	800	20	
	2500	40	<b>116,000</b>
Closing Stock	500	40	20,000

- Profit = Sales – COGS = 198,000 – 116,000 = 82,000

#### Simple Average Method

Under this method, the material issued or used during the period are valued at the simple average price.

**Example 7.11**

ABC Ltd had an opening stock of 2000 units @ 20. During the first quarter it purchased 3000 units @ 40 and sold 3300 units @ 60.

Simple average price =  $(P1 + P2 + P3 + Pn)/n$

Cost of Goods Sold using FIFO			
	Qty	Price	Value
Opening Stock	2000	20	16000
Add Purchase	3000	40	120000
			136000
<b>COGS</b>	3300	30	<b>99,000</b>
Closing Stock	1700	30	51,000

- Profit = Sales – COGS = 198,000 – 99,000 = 99,000

**Weighted Average Method:**

Under this method, the material issued or used during the period is valued at the weighted average price.

Weighted average price =  $(p1*q1 + p2*q2 + p3*q3)/q1+q2+q3$

**Example 7.12**

ABC Ltd had an opening stock of 2000 units @ 20. During the first quarter it purchased 3000 units @ 40 and sold 3300 units @ 60.

Simple average price =  $(P1 + P2 + P3 + Pn)/n$

Cost of Goods Sold using FIFO			
	Qty	Price	Value
Opening Stock	2000	20	16000
Add Purchase	3000	40	120000
	5000		136000
<b>COGS</b>	3300	27.2	
			<b>89,760</b>
Closing Stock	1700	27.2	46,240

- Profit = Sales – COGS = 198,000 – 89,760 = 108,240

**Inventory Valuation in NALCO**

- Finished goods are valued at lower of cost or net realisable value. Cost is determined on the basis of current year's average cost of production and excludes selling and distribution overheads, interest, exchange variation and depreciation on capitalised exchange variation.
- Raw materials, stores, spare parts and tools are valued at weighted average cost net of CENVAT credit wherever applicable.

**Example 7.13**

Following are the details of the purchases made by ABC Ltd on different dates at different rates.

Purchase Date	Stock	Rate (Rs.)
1.5.2006	3000	4.5
2.5.2006	1000	5
4.5.2006	2000	6

Suppose the company sells 2500 units at Rs. 10 per unit. Accounting profit of the company is equal to the sales less the cost of goods sold. However, the COGS depends on the method of valuing inventories.

Gross Profit and Inventory Valuation			
	Sales	COGS	G. Profit
FIFO	25,000	11,250	13,750
LIFO	25,000	14,500	10,500
Simple Average	25,000	12,917	12,083
Weighted Average	25,000	12,708	12,292

It is important to note that the change in profit not because of the change in the operating efficiency, but just because of the change in the valuation method.

FIFO results in higher profits because of lower cost of goods sold and a higher closing stock. LIFO results in lower profits because of higher cost of goods sold.

By changing the method of inventory valuation one is able to shuffle between expenses and assets. See the following table:

	LIFO	FIFO	Simple Average	Weighted Average
COGS (Expense)	14500	11250	12917	12708
Stock (Asset)	16000	19250	17583	17792
Total value of purchase	30500	30500	30500	30500

**Excise Duty**

This is the amount paid to the government as a tax, before the goods are dispatched from the factory. Generally excise duty is deducted from the gross sales.

### Salaries and Wages

Salaries and wages and all other employee benefits and amenities are included in this expenditure. They include provident fund, ESI (Employees State Insurance) contributions, and medical benefits, leave travel benefits, bonus, gratuity, pension, other superannuation benefits etc. Table 7.14 shows salaries and wages as percentage of total sales of some of the well known Indian companies.

Table 7.14			
Salaries and Wages as % of Sales (2006)			
IT		Pharma	
Wipro Ltd.	42%	Sun Pharmaceutical Inds. Ltd.	6%
Tata Consultancy Services Ltd.	46%	Ranbaxy Laboratories Ltd.	9%
Satyam Computer Services Ltd.	59%	Glaxosmithkline Pharmaceuticals Ltd.	10%
Infosys Technologies Ltd.	47%	Cipla Ltd.	5%
H C L Technologies Ltd.	35%	Dr. Reddy'S Laboratories Ltd.	9%

### Administrative Expenses

Administrative expenses include head office expenditure, secretarial costs, postage and telephones, directors' remuneration and other administrative expenses.

### Cost of Production

Income statement will not show the cost of production as a separate item. However, one can calculate the cost of production by collecting the relevant information. Cost of production includes raw material cost, energy, salaries and wages etc. and other operating expenses. Selling expense and the interest cost are not the part of the cost of production. Table: 7.15 shows the cost of production advertisement as a percentage of sales of some Indian companies.

Table 7.15	
Cost of production as % of Sales (2006)	
Hindustan Petroleum Corpn. Ltd.	94%
Steel Authority Of India Ltd.	69%
Tata Motors Ltd.	73%
Reliance Industries Ltd.	73%
National Aluminium Co. Ltd.	44%
Hero Honda Motors Ltd.	68%
I T C Ltd.	35%

Source: CMIE Data base

### Selling Expenses

Selling expenses include freight, advertising and sales promotion, commissions and discounts and other selling and distribution costs. Table: 7.16 shows advertisement as a percentage of sales of some Indian companies.

<b>Table:7.16</b>	
<b>Advertisement as % of Sales (2006)</b>	
Tata Tea Ltd.	9%
Hindustan Lever Ltd.	8%
Dabur India Ltd.	11%
Bharti Airtel Ltd.	4%
Ranbaxy Laboratories Ltd.	6%

Source: CMIE Data base

### Borrowing Cost

According to the Accounting Standard -16, borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds. Borrowing cost may include the following items:

- interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- amortisation of discounts or premiums relating to borrowings;
- amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

According to the AS- 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Statement. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The interest cost consists of interest on long-term loans, debentures, bank loans for working capital, interest on public deposits and other loans. Table 7.17 shows interest as a percentage of sales of some Indian companies.

<b>Table 7.17</b>	
<b>Interest as % of Sales (2006)</b>	
Williamson Magor & Co. Ltd.	138%
G V K Power & Infrastructure Ltd.	74%
J C T Electronics Ltd.	43%
Indiabulls Financial Services Ltd.	30%
R P G Cables Ltd.	23%
Mukand Engineers Ltd.	18%

Source: CMIE Data base

### Depreciation

Depreciation is the charge for using the assets. It can be described as the cost of the assets used during the year. Depreciation is the wear and tear of the asset. It is the decrease in the value of the asset with the passage of time. Depreciation is the allocation of the cost over the life of the asset. Depreciation will be shown as an expense in the income statement and as reduction in the value of the asset in the balance sheet. Table 7.18 shows depreciation as percentage of sales of the well known companies of India.

<b>Table 7.18</b>	
<b>Depreciation % of Sales (2006)</b>	
A B B Ltd.	1%
A C C Ltd.	4%
Bajaj Auto Ltd.	2%
Bharat Heavy Electricals Ltd.	2%
Bharat Petroleum Corpn. Ltd.	1%
Bharti Airtel Ltd.	14%

Source: CMIE Data base

Two popular methods of calculating depreciation are : Straight line method (SLM), Reducing balance method (RBM).

#### Straight Line Method (SLM)

In the SLM depreciation is determined by allocating the cost over the life. The total cost of the asset less salvage value, if any, will be distributed over the life of the asset.

- Depreciation = (Cost of the asset – Salvage Value)/Life
- Depreciation = (Cost of the asset – Salvage Value)\*Rate

This method is called SLM because the amount of depreciation remains constant over the life.



**Example 7.14:**

A limited started business with capital of Rs. 100,000. Purchased plant costing 50,000 on credit from Mr.X and stock worth of 75,000 for cash. Life of the plant is 5 years. No salvage value. Table 7.19 shows the depreciation, accumulated depreciation and the written down value of the asset.

Table 7.19				
Depreciation: SLM				
Year	Cost	Depreciation	Accumulated Depreciation	Written Down Value
1	50,000	10,000	10,000	40,000
2		10,000	20,000	30,000
3		10,000	30,000	20,000
4		10,000	40,000	10,000
5		10,000	50,000	0

**Reducing Balance Method**

In the Reducing balance method (RBM), depreciation is calculated on the opening balance of the asset or in other words, it is calculated on the written down value of the asset. Written down value of the asset is cost of the asset less the accumulate depreciation. In this method, the amount of depreciation goes on reducing over the life. Unlike the SLM, the written down value of the asset will not become zero.

**Example 7.15:**

A limited started business with capital of Rs. 100,000. Purchased plant costing 50,000 on credit from Mr.X and stock worth of 75,000 for cash. Rate of depreciation =40 %. No salvage value. Table 7.20 shows the depreciation, accumulated depreciation and the written down value of the asset.

Table 7.20				
Depreciation: RBM				
Year	Cost	Depreciation	Accumulated Depreciation	Written Down Value
1	50,000	20,000	20,000	30,000
2		12,000	32,000	18,000
3		7,200	39,200	10,800
4		4,320	43,520	6,480
5		2,592	46,112	3,888

For details of depreciation please refer to the chapter on the fixed assets.

**Depreciation and Financial Statements**

Let us see the impact of depreciation on the financial statements.

**Example 7.16**

ABC Ltd started business with Capital of 100,000; Purchased stock of goods for Rs. 50,000; Purchased plant on credit from Mr. X for Rs. 50,000; 60% of the stock of goods sold for Rs. 50,000 for cash. Rate of depreciation = 10% Table 7.21 shows the financial statements at the for the first year

Table:7.21- Financial Statement					
Balance Sheet at the end of the first year		Income Statement		Cash Flow Statement	
Capital	100,000	Sales	50,000	Capital	100,000
Accumulated Profit	15,000			Sales	50,000
X	50,000	Less			150,000
	165,000	COGS	30,000		
Cash	100,000	Depreciation	5,000	Stock	50,000
Stock	20,000				
Plant	50,000		35,000		
Less Accumulated Depreciation	-5,000			CIH	100,000
	165,000	Profit	15,000	Total	150,000

- Depreciation = Costs \* Rate = 50,000 \* 10% = 5000
- Depreciation is shown as an expense in the income statement
- Depreciation is reduced from the value of the plant in the balance sheet
- Accumulated depreciation = Depreciation for the first year

**Example 7.17:**

Let us continue with the information given in the example 7.16.

Second year: Transactions are as follows:

- Sold entire stock for 50,000
- Took a new show room and paid Rs. 15,000 for three years
- Table 7.22 shows the financial statements.

Table:7.22- Financial Statement					
Balance Sheet		Income Statement		Cash Flow Statement	
Capital	100,000	Sales	50,000	Opening CIH	100,000
Accumulated Profit	35,000			Sales	50,000
X	50,000	Less			150,000
	185,000	COGS	20,000		
Cash	135,000	Depreciation	5,000	Rent	15,000
Stock	0	Rent	5,000		
Advance Rent	10,000				
Plant	50,000		30,000		
Less Accumulated Depreciation	-10,000			CIH	135,000
	185,000	Profit	20,000	Total	150,000

- Depreciation = Costs \* Rate = 50,000 \* 10% = 5000
- Depreciation is shown as an expense in the income statement

- Depreciation is reduced from the value of the plant in the balance sheet
- Accumulated depreciation = Depreciation for the first year + Depreciation for the second year
- Advance Rent = Rent Paid – Rent for the current year
- Accumulated Profit = Profit of the first year + Profit for the second year

### Bad Debts:

When a company extends credit to customers, there is always the risk of not getting the amount. Bad debt is the loss due to the non-payment by the customers. Each year the company is required to estimate amount of bad debt and do the following:

- Show it as a loss in the income statement, or charge it against the provisions for bad and doubtful debt;
- Reduce the debtors to that extent

### Example 7.18:

Assets and the corresponding sources of ABC as on 1<sup>st</sup> April 2006 are as follows: Capital of ABC Ltd = 50,000; 12% Loan = 70,000; Cash = 20,000; Stock = 25,000; Debtors (Mr. Y) = 75,000. During the year 2006, the company sold entire stock for Rs. 35,000 to Mr. X on credit. Mr. Y became insolvent and could pay only 75% of the money due. Table 7.23 shows the necessary financial statements.

Table- 7.23: Financial Statement							
Opening Balance Sheet		Income Statement		Cash Flow Statement		Closing Balance Sheet	
Capital	50,000	sales	35,000	CIH	20,000	Capital	50,000
12% Loan	70,000			Y	56,250	12% Loan	70,000
	120,000	COGS	25,000	Total	76,250	Profit	-17,150
							102,850
		Bad Debts	18,750			Cash	67,850
Cash	20,000	Interest	8,400	Interest	8,400	Stock	0
Stock	25,000		52,150			Y	0
Y	75,000			CIH	67,850	X	35,000
	120,000	Profit	-17,150	Total	76,250		102,850

- Money due from Mr. Y = 75,000
- Money received from Mr. Y = 75% = 56,250
- Bad Debt = 75,000 – 56,250 = 18,750

### Provisions for Bad and Doubtful Debts

Sometimes companies keep aside a part of the current profit to meet future bad debt. Such amount kept aside is called provisions for bad and doubtful debts.

**Example 7.19:**

On 1<sup>st</sup> April 2005, ABC started business with capital of Rs. 50,000. Purchased stock of goods for cash = 20,000 and sold 50% of goods for 35,000 on credit. Rent paid for the period = 5,000 and the company created a provision of 5% of the debtors to meet unexpected loss due to the bad debts. Table 7.24 shows the financial statements at the end of the accounting period.

<b>Table-7.24: Financial Statements</b>					
<b>Income Statement for the year ending March 2006</b>		<b>Cash Flow Statement for the year ending March 2006</b>		<b>Balance Sheet as on 31<sup>st</sup> March 2006</b>	
Sales	35,000	Capital	50,000	Capital	50,000
		Total	50,000	Profit	18,250
COGS	10,000			Total	68,250
Rent	5,000				
Provisions for Doubtful Debts	1,750	Stock	20,000	Stock	10,000
	16,750	Rent	5,000	Debtors	35,000
		CIH	25,000	Less Provision for Doubtful debts	-1,750
				Cash	25,000
Profit	18,250	Total	50,000	Total	68,250

**Example 7.19**

Refer to the financial statements shown in the table 7.24. During the year 2006-07 the company had following transactions:

- Sold 60% of the stock for 15,000 for cash.
- One of the debtors who had to pay Rs. 2,000 became insolvent. She could pay 60% of the amount due.
- Rent paid for the two years: 10,000

Table 7.25 shows the financial statements at the end of the year 2007

<b>Table- 7.25: Financial Statements</b>					
<b>Income Statement</b>		<b>Cash Flow Statement</b>		<b>Closing Balance Sheet</b>	
Sales	15,000	Opening CIH	25,000	Capital	50,000
COGS	6,000	Sales	15,000	Profit	22,250
Rent	5,000	Collection	1,200	Total	72,250
Provisions for Doubtful Debts	0		41,200		
	11,000	Rent	10,000	Stock	4,000
		CIH	31,200	Debtors	33,000
				Less Provision for Doubtful debts	-950
				Advance Rent	5,000
				Cash	31,200
Profit	4,000	Total	41,200	Total	72,250

- Rent paid = 10,000
- Rent for the current year (Expense) = 5000
- Advance Rent (Asset) = 5000
- Opening Provision for doubtful debt = 1750
- Bad debt for the current year = 40% of 2000 = 800
- Bad debt for the current year is not charged against the income once again since the company is already having the Provisions. Bad debt is charged against the Provisions. So the balance sheet will show the balance provisions to be carried forward.
- Since the company has no further credit sales, it has not creas

### Other Expenses

The other expenses include auditors' remuneration, petty expenses, small donations, if any etc.

### Appropriation of Profit

Appropriation of profit is the distribution of profit. Profit after tax (PAT) is available for distribution among the shareholders as dividend. However, the management is under no obligation to distribute the profit. Profit appropriation statement, which is generally incorporated in the income statement, shows the profit retained for reinvestment, profit distributed as dividend, tax on dividend distributed, profit transferred to some specific reserves. Exhibit 7.3 shows the profit for the year and the appropriations of Wipro Limited for the year ending March 2006 and the March 2005

	2006	2005
<b>Exhibit 7.3: Wipro Limited (Rs. Million)</b>		
PROFIT BEFORE TAXATION	23,404.30	17,570.23
Provision for taxation including FBT [refer note 19(14)]	3,199.50	2,622.02
<b>PROFIT FOR THE YEAR</b>	<b>20,204.80</b>	<b>14,948.21</b>
Appropriations		
Proposed dividend	7,128.77	3,517.85
Tax on dividend	999.81	493.38
<b>TRANSFER TO GENERAL RESERVE</b>	<b>12,076.22</b>	<b>10,936.98</b>

Source: Annual Report of Wipro Limited

### Earning Per Share

According to AS -20, a company should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period.

For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

According to AS-20, the weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares. Diluted earning per share reflects the existence of stock options or other rights that can be converted into shares in the future. Exhibit 7.4 shows the basic and diluted EPS of Wipro Limited for the year ending March 2006 and March 2005.

	2006	2005
<b>Exhibit 7.3: Wipro Limited</b>		
<u>EARNINGS PER SHARE - EPS</u>		
(PY : Adjusted EPS for bonus issue in ratio of 1:1)		
Equity shares of par value Rs. 2/- each:		
Basic (in Rs.)	14.37	10.74
Diluted (in Rs.)	14.15	10.64
<u>Number of shares for calculating EPS</u>		
(PY : Adjusted for bonus issue in ratio of 1:1)		
Basic	1,406,505,974	1,391,554,372
Diluted	1,427,915,724	1,404,334,256

Source: Annual Report of Wipro Limited