



SIMPLE IS BETTER

SIMPLE IS BETTER – ISSUE -10 – RELATIONSHIP BETWEEN PROFIT & LOSS ACCOUNT AND BALANCE SHEET

We have seen profit and loss account in [Issue-8](#) and Balance sheet in [Issue-9](#). There is a relation between profit & loss account and balance sheet; which I am going to discuss in the current issue. We have to understand that relationship for better analysis of the financial statement and make more wise investment decision.

“The double entry system of accounting or bookkeeping means that every business transaction will involve two accounts (or more).” - Accounting coach

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Share capital		Fixed assets	
Add: net profit/less: net loss		Land & building	
Less: drawings		Plant & machinery	
Long-term liabilities		Furniture & fixtures	
Debentures		Vehicles	
Loans & advances from banks		Goodwill	
Other loans & advances		Investments	
Current liabilities		Current assets, loans & advances	
Sundry creditors		Sundry debtors	
Bills payable		Cash in hand	
Bank overdraft		Cash at bank	
Outstanding expenses		Bills receivable	
Income received in advance		Prepaid expenses	
Provisions		Closing stock	
For taxation			
For dividend			

Particulars	Schedule	Amount (Rs)
Income		
Sales and operating income	1	.....
Other income	2	.....
Total		.....
Expenditure		
Cost of goods sold	3	.....
Operating and other expenses	4	.....
Depreciation/Amortisation		.....
Interest		.....
Total		.....
Add/(Less): Exceptional items		.....
Profit/(Loss) before tax		.....
Less: Tax		.....
Profit/(Loss) after tax		.....

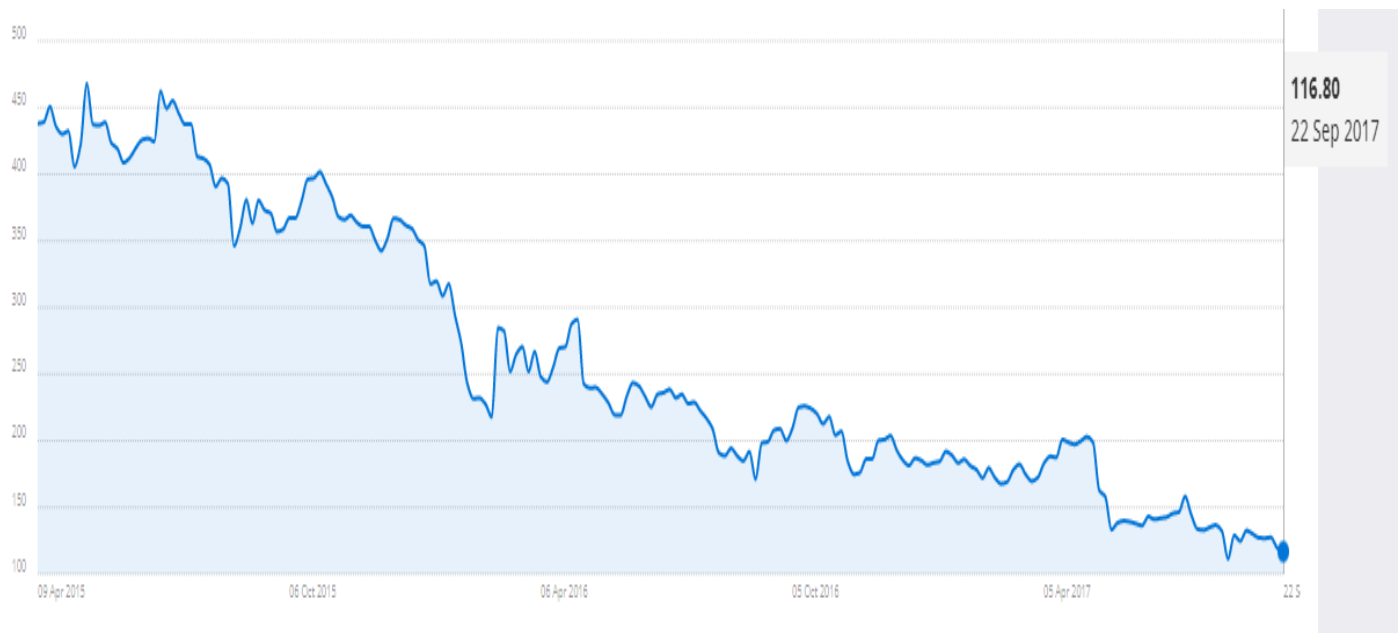
Let's try to understand the relationship between Profit & Loss account with the Balance sheet.

1) Relationship of sales with cash or Trade receivables

When the company sells products/services then there will be two possibilities. One company sell that products/services for the cash or on credit. If company sell their products/services on cash than those amounts will be added to the cash and cash balance of the company will increase. If company sell their products/services on credit then the company has to receive payment from the customer. This will increase their trade receivable on the balance sheet.

So that we can able to say that if the company selling their product/service on credit terms then trade receivable will increase at the balance sheet. Higher the receivable from the sales than higher will be the possibilities of conversion of those receivables into the bad debts; which can be harmful to the company. This shows that company facing problem to collect the cash from the customer and the company need to bring more fund for the managing their day to day operations.

Year	2013	2014	2015	2016	2017	CAGR
Net Sales	1058.91	1566.81	2708.97	4450.67	3415.00	26%
Sundry Debtors	500.22	709.58	1432.18	2408.97	2382.43	37%
Debtors as a % of sales	47%	45%	53%	54%	70%	
Equity - Issued	40.00	200.00	221.92	221.92	221.92	
Short Term Borrowings	205.49	425.40	767.06	1382.47	1341.63	46%



2) Relationship of other income with Investment or cash

Whenever the company gets any income other than their core business than that income will be added to the cash and cash balance on the balance sheet will increase. Also if company invest that other income in the investment instruments then investments on the balance sheet will increase. Also as the investment of the company will increase the income from that investment will increase that means other income will get increases on profit & loss account.

3) Relationship of Cost of goods sold with an Inventory or Trade payable

When the company purchases raw material, tools, etc. The company needs to make payment to their vendors. The company might have purchase material on the cash basis or on the credit basis. If the company has purchases material on the cash basis then it will be added to the inventory and inventory will get increases in the balance sheet. If the company has purchases material on the credit basis then it will be added to the trade payable and trade payable of the company will increase.

Higher amount of the trade payable work as a blessing for the company and also payable excess of debtors will work as a short-term funding to the company. The company does not require to bring additional capital for day to day business. But also extreme payable will shows the inability of the company to make payment to their vendors and which cannot be survived in the long term. If company solely staying dependent on the payable then that will also harmful to the company. Also, create a concern that which vendors give huge credit terms to the customers.

4) Relationship of Operating and other expenses with prepaid expenses or trade payable

When the company purchases any product /service then those product/services can be purchased for the cash or on the credit. If the company has made a purchase on the credit basis then that will be added to the trade payable and trade payable of the company will get increases. Sometimes the company makes a payment for product/service in advance then it will be reflected under the heading of prepaid expenses.

5) Relationship of Depreciation / Amortization with Tangible/Intangible assets

When a company purchases any assets then company count a depreciation as the monetary value of the assets gets reduced due to uses of assets. When any new asset get purchased by the company then company starts charging depreciation on the asset. Depreciation is shown as expenses on the profit & loss account and gets deducted from the assets on the balance sheet to shown reduced in the value of assets. Many times, we can get to know mischief of management by checking depreciation with assets. Management can understate depreciation by overstating useful life of the assets and can able to overstate profitability.

6) Relationship of Finance cost (Interest) with borrowings

When the company takes a borrowing then company record those amount of borrowing on the liabilities side and due to the borrowing, interest expenses of the company will increase. Interest expenses are shown as expenses on the profit & loss account and due to the payment of interest cash balance will get reduced. Finance cost not only includes interest portion but also include installment for the borrowing and due to the payment of installment value of borrowing will get reduced on the balance sheet.

7) Relationship of Net profit with retained earning

After meeting all the expenses, the company remains with the net profit which will get transferred to the surplus as a retained earnings on the balance sheet. This profit kept as a retained earnings for meeting the future needs

of the company. This provides an idea to the investors that how much money company is putting back to business. If the company has generated profit then that profit will be added to the surplus and if the company has incurred losses then it will get deducted from the surplus. If company continuously generating profit and transfer it as retained earnings then surplus on the balance sheet will increases. If company incurred the losses then it will get deducted from the surplus and continuous loss will result in the negative shareholder's fund.

No financial statement useful to us in isolation. We have to understand the impact of changes in one element on the other element of the financial statements which can be much use to us for knowing hidden stories of the companies. We can become better investors when we can able to understand the hidden truth behind the financial statements.

Love to read again and again

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Disclaimer

Above article is just my perception, and perception can be wrong. For me, my perception can be right but for others, it might be wrong.

I am Grateful to

I am really grateful to - Mr. Neeraj Marathe Sir, Prof. Sanjay Bakshi Sir, Mr. Vishal Khandelwal Sir, Dr. Vijay Malik Sir, Mr. Rajeev Thakkar Sir, Mr. Raunak Onkar Sir, Mr. Vijay Kedia Sir, Mr. Howard Marks, Mr. Warren Buffett, Mr. Charlie Munger, Mr. Benjamin Graham, Mr. Walter Schloss, Mr. Porinju Veliyath

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Please forgive me, if I forget to mention any person who has contributing value to my journey.

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*As a founder of Lucky Idiot; My mission through **“Lucky Idiot”** is to educate novice investors and to distribute learning to more and more people in a simple manner.*

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