Financial Accounting
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Lecture – 92
7.4 Profit and Loss Appropriation Account

In this video, I am going to introduce you to Profit and Loss Appropriation Account. The profit and loss appropriation account is essentially a sequel to the profit and loss account. It tells you what happens to the profit that is made during the year, after the profit and loss account is closed.

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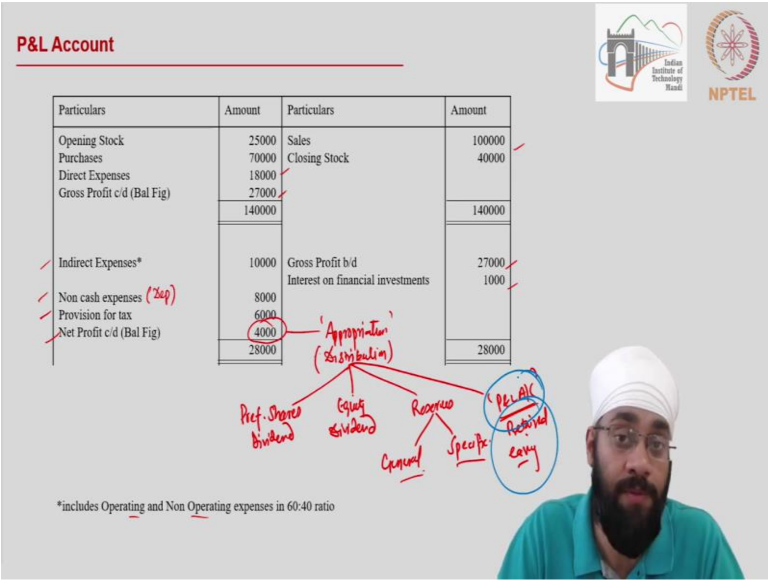

Let us get started. So, this is a typical format of profit and loss account. You have seen all these items before, there is nothing new. You have sales here, you have all the direct expenses here, you have gross profit; gross profit is brought down. You have other incomes and then you have indirect expenses which include operating and non-operating expenses. You pay for some non-cash expenses which can be depreciation, you pay for taxes, and then you have the profit.

So, in the course till now we have been only looking at the income statement, the profit and loss account, till this extent. What happens after this? After this, what happens is that this profit needs to be distributed; this profit needs to be appropriated.

So, the appropriation essentially refers to the distribution. I think misappropriation is more popular term than appropriation. But this is appropriation, it is not a misappropriation: this is the right kind of appropriation that you need to do. Now, where do you distribute this? You have to distribute some of this profit to the preference shares, they need to be paid a dividend, you also need to pay a dividend to equity. And, then you could transfer some of the profit to the reserves that you have. Reserves can be general in nature or reserves can be for specific needs of the company. General reserve could be a multipurpose reserve wherein you put money and then in future when contingency arises and then you take money from the general reserve. Specific reserve would be like if you have to pay back a specific loan in next 5 years, so every year you save some amount of profit and put it in this separate account. Thus, that at the end of the 5 years, you have money when you have to pay the principal amount of this loan. So, there is a specific reserve. Likewise, for any purpose, when you create a reserve, you should not use it for any other purpose- that is the idea. So, there can be a general reserve or a specific reserve. And, then whatever is left gets added to the balance in the profit and loss account. So, there is a balance, this is called retained earnings. Retained earnings can be then carried forward to the next year. Over the years, let's say, we have accumulated this additional money, even after paying everybody and saving for future contingencies. We still have some money left and profit made during the year will be added to that amount. So, that is what the appropriation means and therefore, after these two sections in the profit and loss account we prepare the third section.

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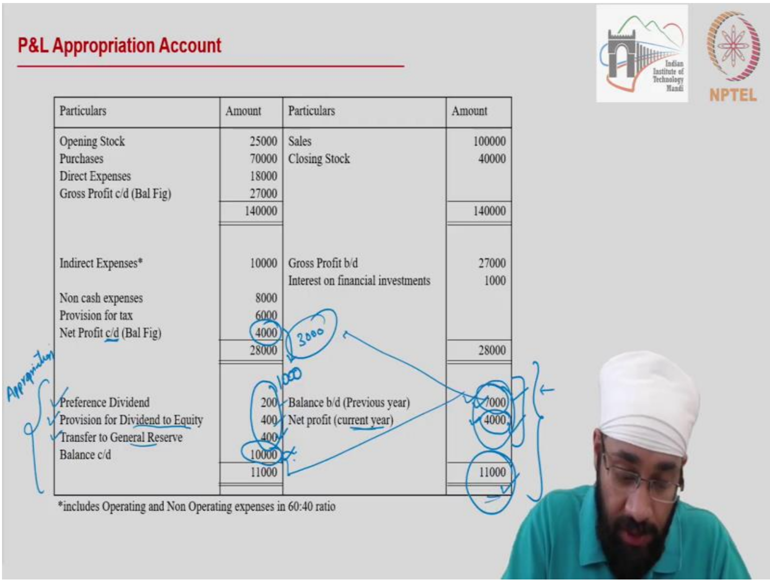

And, then we start calling the profit and loss account as the profit and loss appropriation account here. On the screen you see the same section as before and the new information in this statement is as follows. This third section is called profit and loss appropriation account or when prepared, in this wholesome way you can call the whole thing as the profit and loss appropriation, but the appropriation is happening here in the third section.

So, this 4000 which is the profit made during the year, is carried down and then it is brought forward as well. So, this 4000 is shown here. Which means, during the year during the current year 4000 additional profit has been made and this 7000 here is taken from the balance sheet. In the balance sheet there is an account called reserves and surpluses, major head, and within that you will find an item called balance in profit and loss account.

This is the money that is the balance I was talking about in the previous slide. We have this retained earnings, you keep it in the profit and loss account. Because this is now unutilized this is left to the business for some future purposes. So, in this case this 7000 is left over from the previous years, after doing everything, every appropriation that you wanted to do, and this year you have 4000 more that you have made.

Therefore, you have 11000 rupees in the profit and loss account which can now be appropriated, which can now be distributed. This year we made only 4000, but from the previous year 7000 is with us.

And, you can use those 7000 from the previous year in this year. So, it is not important, it is not essential that you only distribute the 4000. You can club it with the previous balance. Now this total 11000 can be distributed if you like. How is it distributed? Let us go to the debit side. On the debit side you have all the appropriations. Where do you want to distribute this? Well, we want to pay a dividend to the preference shareholders 200 out of this 1100 total that we have. Then, we also want to have some money set aside, if we decide to pay a dividend to the equity shareholders, 400. Alright keep it aside, then you have a general reserve. Let us put some money aside for the rainy day, so 400 has been kept on the capital side. After doing all of this you are left with 10,000 at the end of the appropriation, which can be taken to the next year as well. So, in this case we only used 1,000. Let us say if you say from this 4,000 we use 1,000, then 3,000 is left and from the previous year 7,000 was the balance. So, now you are left with the 10,000-closing balance, because 3,000 is added into this 7,000 and you have a new balance

10,000 here. So, again just to make things further more clear let me reemphasize on this point. What I am saying is this 7000 was from the previous year, so you already had this money.

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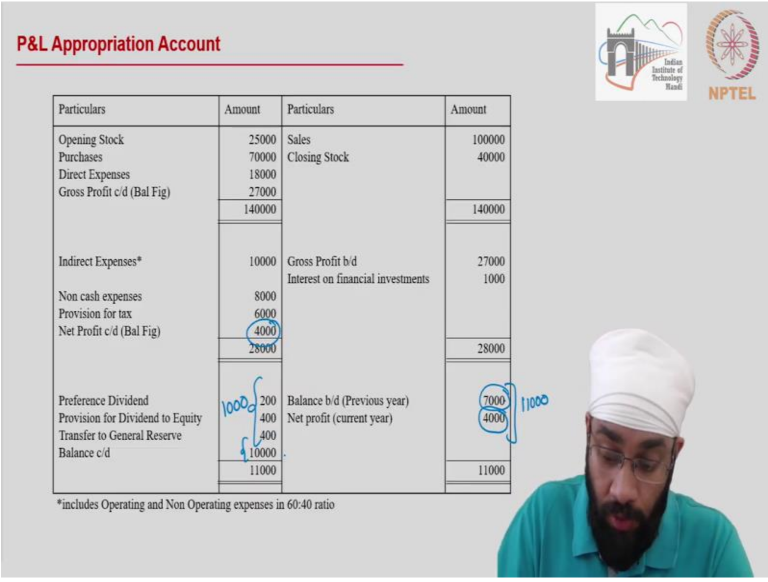

In this year you have 4,000 that you made. So, you add to this. Now you have 1,1000 that you can distribute, but you distribute only 1000. Therefore, you are left with 10,000 which can be taken to next year and then be distributed.

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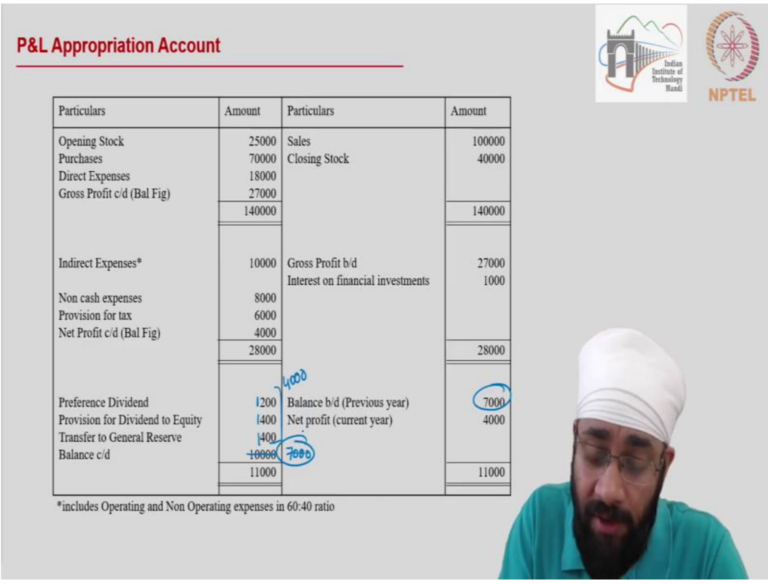

You could also decide that instead of 200 we will pay 12000, 1400 and 1400. So, 3000 more which would mean all the 4000 are going to be exhausted. So, yes this comes out to be 4000.

So, 4000 has been distributed and you are left with only 7000, which you already had. So, current year's earnings have been totally distributed.

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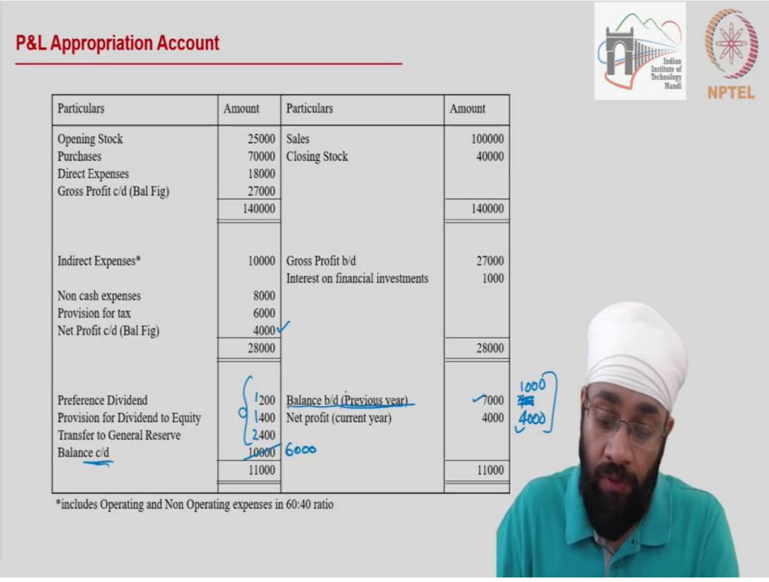

The other case could be that you distribute 1200, 1400 and 2400 which means, you are not using just the 4000, but you are also using 1000 additional from this 7000. So, you will be left with a balance of 6000 only to be taken to the next year. Therefore, you used 4000 from the current year and 1000 from the previous year. So, a total of 5000 has been distributed this year. So, all these scenarios can take place, but what is important for you to understand is this previous year's balance. What is this balance and where is it coming from? And, the balance which is the closing balance in the retained earnings.

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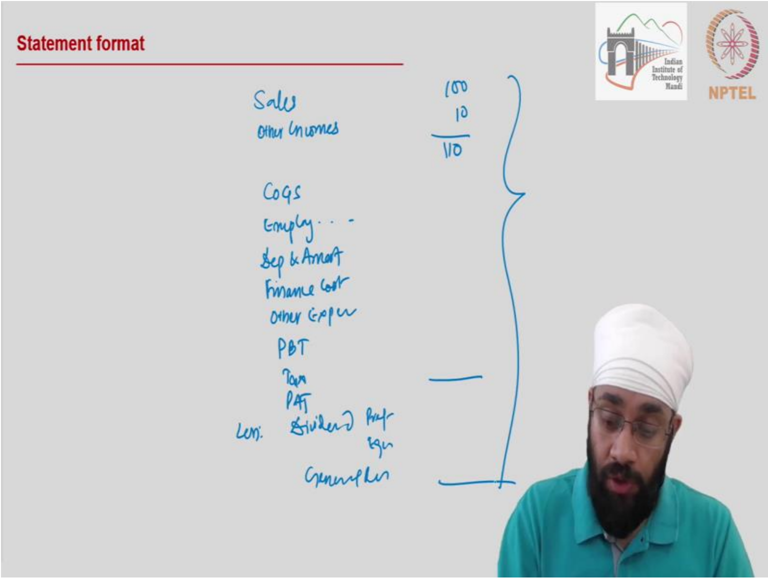

So, all of this is when you look at the statement of a company, it is given to you in a statement format which is as follows. We have sales, we have other incomes, you are familiar with this format. So, let us say 110 is the total income and then you have all the rest of expenses: you have cost of goods sold, you have employee benefit expenses, you have depreciation and amortization, and then you have finance cost and then all the rest of expenses here. And, then you have profit before the taxes, you pay tax on it, and you have profit after taxes. So, after this you take money, you appropriate the money, and then you say we are paying dividend to equity, we are paying dividend to preference, and we are transferring to general reserve, and so on. So, all I am saying is you could also have it one at the top of the other in this format. In the statement format nothing would change, you would again have all the balances here. So, the only difference between the account format and the statement format is that this balance does not appear in the statement format. But you know all these details are provided in different ways in the statement, there are notes provided, there are other details that are provided.

So, this is the profit and loss appropriation account that I wanted to discuss in this video. The reason for discussing this appropriation is that we are going to make extensive use of this appropriation. Most of the appropriation that you do does not result in cash being affected. For example, a provision being created does not mean the dividend has actually been paid or transferring to reserve does not mean the cash is being paid. And, in the cash flow statement we are only interested in the cash transaction. Therefore, this profit loss appropriation account becomes important for us, in order to track, to identify non-cash items and then segregate them to arrive at only the cash flows of the business.

I will see you in the next video.