BASIC ACCOUNTING – 2

THE INCOME STATEMENT

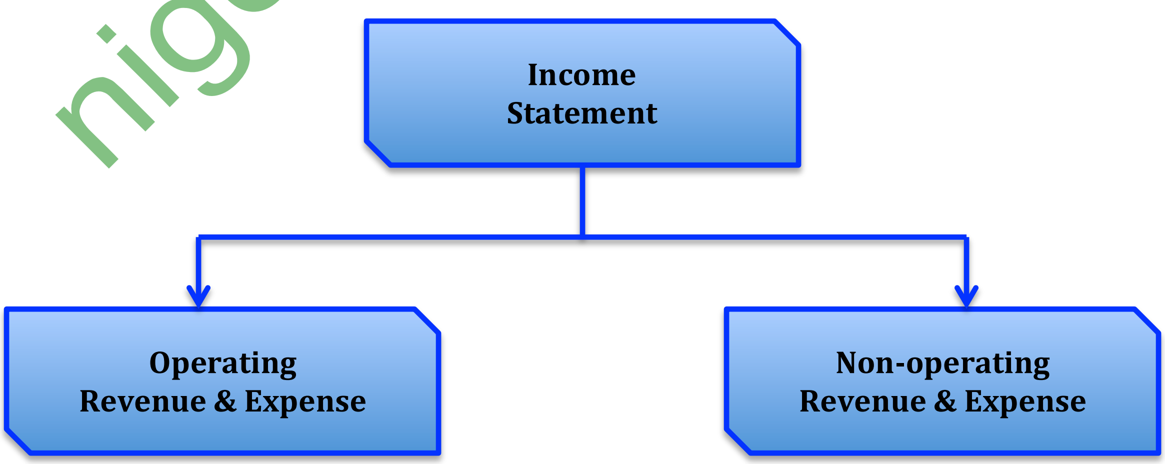
Financial accounting focuses on providing information about an organization and provides decision makers with an overview of the underlying financial transactions of the company being assessed. Accounting provides a good measure of transparency and accountability: the ability to see straight through the words and numbers and gain a clearer vision of the company and its operations.

Financial statements are prepared to ascertain the profit or loss status of a business, and thus gain an insight into its financial position.

- ➔ The income statement (profit & Loss) accounts ascertain the net profit over an accounting period and
- ➔ The balance sheet reflects the financial position of the business at a point in time.

An income statement (also called a statement of operations or a statement of earnings) is an accounting statement that shows business results (or financial performance) in terms of revenues and expenses. This is a list of revenues and expenditure incurred during the course of running a business enterprise over a period of time, expressed in currency. It shows the net profit or loss incurred over the period and is often referred to as 'Profit and Loss' or 'Revenue and Expenses' statement. If revenues are greater than expenses, the report shows net income. If expenses are greater than revenues, the report shows net loss. A gain is an increase in the net assets of an organization created by an occurrence outside its primary or central operations. A loss is a decrease in net assets from a similar type of incidental event. An income statement can cover 1, 3, 6, or 12 months.

An income statement consists of two sections: operating and non-operating activities.



- ➔ The operating section details the revenue and expenses directly associated with business operations, for example the purchase of raw materials or goods.
- ➔ The non-operating section details revenue and expenses that result from activities outside of normal business operations, for example the sale of an office block or land.

This division of revenue and expenses into ‘operating’ and ‘non-operating’ is particular to each organization.

- ➔ **Revenue:** incoming assets in return for sold goods or services.
- ➔ **Expenses:** outgoing assets or liabilities incurred.
- ➔ **Net Income:** the difference between Revenue and Expenses.

The main content of an income statement is rather straightforward: a listing of all revenues earned and expenses incurred by the reporting organization during the period specified. As indicated previously, revenue figures disclose increases in net assets (assets minus liabilities) that were created by the sale of goods or services resulting from the primary operations of the organization.

Conversely, expenses are decreases in net assets incurred by a reporting company in hopes of generating revenues. For example, salaries paid to sales people for the work they have done constitute an expense. The cost of facilities that have been rented is also an expense as is money paid for utilities, such as electricity, telecoms and water. When Nokia sells a phone to a customer, it reports revenue but if the company disposes of a piece of land behind its facilities, it reports a gain (if sold above cost) or a loss (if sold below cost). Selling phones falls within Nokia’s primary operations whereas selling land does not. If Mr. *Biggs* sells a package of fried rice and chicken, the transaction brings in revenue. Revenue has been earned and should be reported. If this same company disposes of one of its old deep fryers, the result is reflected as either a gain or loss. Mr. *Biggs* is not in the business of selling appliances. This classification split between revenues/expenses and gains/losses helps provide decision makers with a clearer picture of what actually happened to the company during the reporting period.

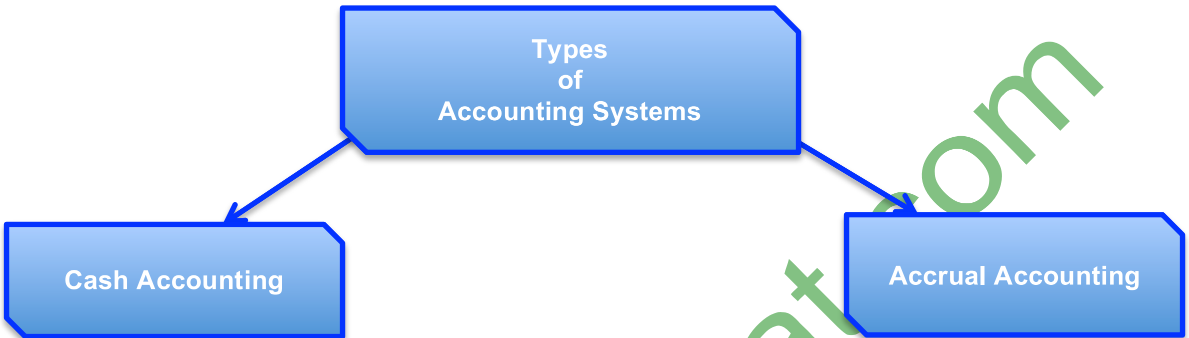
The income statement is prepared from data found in the revenue and expense columns of the expanded accounting equation. Software programs may call this statement a profit and loss statement or an earnings statement.

Operating expenses may be listed in alphabetical order, in order of largest amounts to smallest, or in a set order established by the accountant.

If this statement of owner’s equity is omitted, the information will be included in the owner's equity section of the balance sheet.

The heading of an income statement tells the same three things, as all other accounting statements: the company's name, the name of the statement, and the period of time the statement covers.

There are two types of accounting systems: - 'cash accounting' and 'accrual accounting'.



Cash Accounting

This is an accounting method where receipts are recorded on the date they are received, and the expenses on the date that they are actually paid. This type of accounting is only applicable to small businesses and government.

There are limitations of cash accounting that can create serious problems. For more complex businesses, cash accounting can create a situation that leads to insolvency, while reporting the business as profitable.

Insolvency is the inability of a debtor (in this case, a business) to pay its debts. This can result from either cash flow insolvency or balance sheet insolvency.

- ➔ ***Cash flow insolvency*** is an insufficiency of funds to payoff debts as they fall due.
- ➔ ***Balance sheet insolvency*** is a situation of negative net assets. In other words, the business owes to others more than it has in assets inclusive of money that it is owed.

Accrual Accounting

Accounting rules stipulate that, with few exceptions, businesses avoid the cash accounting method and prepare their accounts on the 'accrual' basis. Accrual accounting is considered to be the standard accounting practice for most organizations, and is mandated for organizations of any real size.

The accrual method recognizes a sale at the point at which the customer takes ownership of the goods or at the point when the service is delivered, even though the cash is not yet in the bank. Similarly, costs are recognized before an invoice is received, if the organization accepts that the cost has been incurred during the accounting period.

This method provides a more accurate picture of the organization's current condition, and can be complex to administer when payments received are less than the amount invoiced. This can happen if the customer disputes the amount or simply refuses to pay. The need for the accrual method arose out of the increasing complexity of an organization's transactions and the desire for more accurate financial information.

Credit sales and projects that provide revenue streams over a long period of time affect the organisation's financial circumstances at the point of the transaction. It makes sense that this is reflected in the financial statements during the same reporting period in which these transactions occurred.

Accrual accounting relies on two principles, which have already been alluded to:

- ➔ The ***revenue recognition principle*** states that revenues are recognized when they are realized or realizable, and are earned (usually when goods are transferred or services rendered), no matter when the payment is received.
- ➔ The ***matching principle*** states that expenses are recognized when goods are transferred or services rendered, and offset against recognized revenues, which were generated from those expenses, no matter when the cash is paid out.

These two principles are absolutely central to understanding how accrual accounting works.

The Revenue Recognition Principle

Organizations all over the world have primary activities and it is the revenues or incomes generated by these activities that are referred to as 'sales' or 'sales revenue'. For example, a retailer buys goods, which they then sell. It is the sale of these products that generates their revenue.

For service organizations the primary activities are the acquisition of and selling of skills and expertise. These revenues are often referred to as fees earned, income, or service revenues.

The Matching Principle

The matching principle aims to minimize any mismatch in timing between the point at which an organization incurs costs and the point at which it realizes any associated revenue.

A company may prefer to use the matching principle when deciding how to record its financial performance, because it enables its financial accounts to show a better evaluation of actual profitability and performance

This principle is used by organizations to achieve this by minimizing, wherever possible, the timing mismatch between the incurrence of costs and the realization of revenues. This should be attained whilst adhering to the accounting standards of recording costs as they occur and revenue when it is earned.

INCOME STATEMENT FORMAT

ABC Holding
Income Statement for year ended Dec 31 20XX

	₦		₦		
₦					
Revenue		xx			
Return inwards		xx			xxx
Cost of goods sold:					
Opening inventory	xx				
Purchases	xx				
Return outwards	(xx)				
Carriage inwards	xx	xx			
Closing inventory			(xx)		
Cost of goods available for sale					(xxx)
GROSS PROFIT					xxx
Admin Expense:					
Salaries & wages			xx		
Warehouse rent			xx		
Carriage outwards			xx		
Insurance			xx		
Motor vehicle expenses			xx		
Stationery			xx		
Lighting and heating				xx	
General expenses			xx		(xx)
NET PROFIT (profit Before Tax)					xxx
Taxation					(xx)
Profit for the year					xxx
Gains/loss on property revaluation					
xx/(xx)					
Gains /loss on property sale or disposal					xx/(xx)
Total comprehensive Income for the year					
xxx					
APPROPIATION:					
Dividend proposed /paid					xx
Retained profit for the year					
xxx					
Transfer to reserve					xx
					xxx
Retained profit brought forward					xx

Retained profit carried forward	xxx
EPS –Earnings per share	x kobo
DPS –Dividend per share	x kobo

An example of an income statement for a small company is shown below:

Shayo Group of Companies Limited (SGCL)

Income Statement for year ending Dec 31 20XX

Revenue:		
Sales of goods		=N= 1,500,000
Expense:		
Cost of goods sold	=N=900,000	
Salaries	120,000	
Rent	20,000	
Advert	30,000	
Insurance	15,000	
Others	25,000	
Total Expense		(1,110,000)
Opening Income		390,000
Others Gains & Losses		
Gains on sales of delivery truck	5,000	
Loss on sale of land behind building	(15,000)	(10,000)
Income before tax		380,000
Income tax		(50,000)
Net Income		330,000

Shayo Group of Companies Limited (SGCL) generated sales of =N=1.5 million in the Year 20XX. Customers came in during that period of time and purchased merchandise at its sales price. That is the first step in the sale and is reflected within the revenue balance. The customers then took these goods with them and left the store; such merchandise no longer belongs to SGCL. In this second step, a decrease occurred in the company's net assets. Thus, an expense has occurred. As the title implies, "cost of goods sold" (sometimes referred to as "cost of sales") is an expense reflecting the cost of the merchandise that a company's customers purchased during the period. It is the amount that SGCL paid for inventory items, such as smartphones, tablets, earpieces, batteries, screen protectors, memory cards and other phone or tablet accessories, that were sold.

Note that the timing of expense recognition is not tied to the payment of cash but rather to the loss of the asset. As a simple illustration, assume SGCL pays =N=20,000 in cash for a Smartphone on Tuesday and then sells it to a customer for =N=25,000 on Thursday. The income statement will show a revenue of =N=25,000 (the increase in the net assets created by the sale) and cost of goods sold of =N=20,000 (the decrease in net assets resulting from the sale). Both the revenue and the related expense are recorded on Thursday when the sale took place and the inventory was removed.

The difference in revenue and cost of goods sold is often referred to as the company's gross profit, gross margin, or markup. It is one of the reported figures studied carefully by decision makers. For this year, SGCL earned a gross profit of =N=600,000 (=N=1.5 million in revenues less =N=900,000 cost of goods sold). Its gross profit was 40 percent of sales (=N=600,000/=N=1.5 million).

Definition of Terms

Sales or Revenue

Revenues arise from the ordinary activities of a company and take many forms such as sales, fees, interest, dividends, and rents. Gains represent other items that meet the definition of income and may or may not arise in the ordinary activities of a company. Gains include, for example, gains on the sale of long-term assets or unrealized gains on trading securities. Revenues should not be confused with receipts. Under the accrual basis of accounting, revenues are shown in the period they are earned, not in the period when the cash is collected. Revenues occur when money is earned; receipts occur when cash is received.

Expenses

Expenses are really the opposite of revenues. They represent the outflow of economic benefits arising from the ordinary activities of a business. This loss of benefits will result in either a decrease in assets or an increase in liabilities. Expenses are incurred in the process of generating revenue, or attempting to generate it. The nature of the business determines the types of expenses incurred. Examples of the more common types of expenses include:

- The cost of buying goods that are subsequently sold – known as *cost of sales* or *cost of goods sold*;
- Salaries and wages;
- Rent and rates;
- Motor vehicle running expenses;
- Insurances;
- Printing and stationery;
- Heat and light;
- Telephone and postage, etc.

Fixed Assets

This refers to all of those assets the business owns that will have value (to the business) over a long period of time. This is usually understood to be a time period of over one year. These include freehold property, plant, equipment, machinery, computers, motor vehicles, etc.

Cost of Sales (Cost of Goods Sold)

There is a cost involved in purchasing or producing item for sale. Production costs for a given item can vary over time, based on varying constraints and the situation of the market vis-à-vis raw materials, transportation, labour & skills, etc. Cost of goods is the purchase cost of the merchandise that is subsequently sold to customers.

Current Assets

This refers to assets of value entirely available in the short term. Current assets must meet one of any of four criteria:

- They are held for sale or consumption in the normal course of a business's operating cycle;
- They are for short term (that is, to be sold within the next year);
- They are held primarily for trading;
- They are cash, or near cash such as easily marketable, short-term investments.

Examples include inventory/stock, money owed by customers (trade receivables or debtors), cash (at hand or in the bank), or short-term investments.

Current Liabilities

Liabilities represent amounts owed to creditors, whereas capital represents what the owner invests. Current Liabilities are basically amounts due for settlement in the short term. To be more precise, they are liabilities that meet anyone of four criteria:

- They expect to be settled within the normal course of the business's operating cycle;
- They are due to be settled within 12 months of the balance sheet date;
- They are held primarily for trading purposes;
- The business does not have the right to defer settlement beyond 12 months

after the balance sheet date.

Current liabilities primarily include sundry creditors, expenses payable, bills payable, short-term loans, advances from customers, etc.

Working Capital

This is the difference between current assets and current liabilities. Capital does not mean cash. Capital is the owner's current investment. The owner could have invested equipment that was purchased before the new business was started.

Liquidity

This is the ability to meet current obligations with cash or other assets that can be quickly converted into cash in order to pay bills as they become due. In other words the organization has enough cash or assets that will become cash so that it is able to write checks without running out of money.

Debtor

A debtor is a person owing money to the business, for example a customer to whom goods are delivered on credit.

Creditor

A creditor is a person to whom the business owes money, for example a supplier, a landlord, or a utility organization that has not yet been paid.

Bad Debt

After all reasonable means to collect a debt have been exhausted without success, the amount owed is written off as a loss and becomes categorized as an expense on the income statement.

Depreciation

Depreciation indicates reduction in value of any fixed asset over time.

- Reduction in value of assets depends on the life of assets.
- Life of assets depends upon the usage of assets.
- The value of asset depreciates as a result of age, wear and tear, or obsolescence over time.

There are a number of factors that are taken into consideration in ascertaining the value of assets vis-à-vis depreciation. For example:

- In the case of a building, the deciding factor is time.
- In case of leased assets, the deciding factor is the lease period.
- For plant and machinery, the deciding factor should be production as well as time.

The choice of factors and formulae for ascertaining depreciation should be made in such a manner to achieve reasonable results and comply with extant laws.