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[FINANCIAL STATEMENT]

Income Statements

An income statement, otherwise known as a profit and loss statement, is a summary of a company's profit or loss during any one given period of time, such as a month, three months, or one year. The income statement records all revenues for a business during this given period, as well as the operating expenses for the business.

What is income statements used for?

- ✓ You use an income statement to track revenues and expenses so that you can determine the operating performance of your business over a period of time.
- ✓ Small business owners use these statements to find out what areas of their business are over budget or under budget. Specific items that are causing unexpected expenditures can be pinpointed, such as phone, fax, mail, or supply expenses.
- ✓ Income statements can also track dramatic increases in product returns or cost of goods sold as a percentage of sales.
- ✓ They also can be used to determine income tax liability. It is very important to format an income statement so that it is appropriate to the business being conducted.
- ✓ Income statements, along with balance sheets, are the most basic elements required by potential lenders, such as banks, investors, and vendors. They will use the financial reporting contained therein to determine credit limits.

Terminologies

1. Sales: The sales figure represents the amount of revenue generated by the business. The amount recorded is the total sales, less any product returns or sales discounts.
2. Cost of goods sold: This represents the costs directly associated with making or acquiring your products. Costs include materials purchased from outside suppliers used in the manufacture of your product, as well as any internal expenses directly expended in the manufacturing process.
3. Gross profit: Gross profit is derived by subtracting the cost of goods sold from net sales. It does not include any operating expenses or income taxes.

4. Operating expenses: These are the daily expenses incurred in the operation of your business. In this sample, they are divided into two categories: selling, and general and administrative expenses.
5. Sales salaries: These are the salaries plus bonuses and commissions paid to sales staff.
6. Collateral and promotions: Collateral fees are expenses incurred in the creation or purchase of printed sales materials used by sales staff in marketing and selling product. Promotion fees include any product samples and giveaways used to promote or sell your product.
7. Advertising: These represent all costs involved in creating and placing print or multi-media advertising.
8. Other sales costs: These include any other costs associated with selling product. They may include travel, client meals, sales meetings, equipment rental for presentations, copying, or miscellaneous printing costs.
9. Office salaries: These are the salaries of full- and part-time office personnel.
10. Rent: These are the fees incurred to rent or lease office or industrial space.
11. Utilities: These include costs for heating, air conditioning, electricity, phone equipment rental, and phone usage used in connection with your business.
12. Depreciation. Depreciation is an annual expense that takes into account the loss in value of equipment used in business. Examples of equipment that may be subject to depreciation includes copiers, computers, printers, and fax machines.
13. Other overhead costs. Expense items that do not fall into other categories or cannot be clearly associated with a particular product or function are considered to be other overhead costs. These types of expenses may include insurance, office supplies, or cleaning services.
14. Total expenses. This is a tabulation of all expenses incurred in running business, exclusive of taxes or interest expense on interest income, if any.
15. Net income before taxes (EBIT). This represents the amount of income earned by a business prior to paying income taxes. This figure is arrived at by subtracting total operating expenses from gross profit.
16. Taxes. This is the amount of income taxes a business owe to the government and, if applicable, state and local government taxes (corporate tax in Kenya).

17. Net income. This is the amount of money the business has earned after paying income taxes.

Format of Profit and Loss Account/Income Statement in Statement Form:

Trading and Profit and Loss Account/Income Statement
For the year ended 31st December, 199-----

Income From Sales:			
Sales		------	
Less: Sales returns	------		
Sales discount	------	------	
Net Sales			------
Cost of Goods Sold:			
Merchandise is stock on 1st January		------	
Purchases	------		
Less: Purchases returns	------		
Net purchases		------	
Cost of goods available for sale		------	
Less merchandise in stock on 31st December		------	
Cost of goods sold			------

GROSS PROFIT			------
Operating Expenses:			
Selling Expenses:			
Sales salaries	------		
Advertising expenses	------		
Insurance expense - selling	------		
Store supplies expenses	------		
Sundry selling expenses	------		
Total selling expenses			

General Expenses:			
Office salaries	------		
Taxes	------		
Insurance expenses general	------		
Office supplies expenses	------		
Sundry general expenses	------		
Total general expenses		------	
Total operating expenses			------
Net profit from operations			------
Other Income:			
Rent income		------	
Other Expenses:			
Interest expenses		------	

NET PROFIT/LOSS	------

Profit and Loss Account in Statement Form/Income Statement:

Trading and profit and loss account/income statement may be prepared either in account form (T form) or in report form (statement form). Trading and profit and loss account in both the forms give the same information. The account or T form is traditional and is used widely but in recent years many business houses prefer to present the profit and loss account/income statement in the report form.

Explanation of Certain Items of Income Statement:

Income from sales: The total of all charges to customers for goods sold, both for cash and on credit, is reported in this section. Sales returns and allowances and sales discounts are deducted from the gross amount to yield net sales.

Cost of Goods Sold: Cost of goods sold refers to the cost price of goods which have been sold during a given period of time. In order to calculate the cost of goods sold we should deduct from the total cost of goods purchased the cost of goods at the end of the year. This can be explained with the help of following formula/equation:

(Opening stock + Cost of goods purchased) - Closing stock = Cost of goods sold

Gross Profit: The excess of the net income from sales over the cost of goods sold is also called gross profit on sales, trading profit or gross margin. It is as gross because all other expenses for the period must be deducted from it to obtain the net profit or net income of the business.

Operating Expenses: The operating expenses also called operating costs of a business may be classified under any desired number of headings and sub-headings. In small retail business it is usually satisfactory to classify operating expenses as selling or general.

1. Expenses that are incurred directly in connection with the sale of goods are known as selling expenses. Selling expenses include salaries or the salesmen, store supplies used, depreciation of the store equipment, and advertising.
2. Expenses incurred in the general administration of the business are known as administrative expenses or general expenses. Examples of general expenses are office salaries, depreciation of equipment, and office supplied used.

Net Profit from Operations: The excess of gross profit on sales over total operating expenses is called net profit or net profit from operations. If operating expenses should exceed gross profit, the excess is designated as net loss or net loss from operations.

Other Income: Minor sources of income are classified as other income or non-operating income. In a merchandising business this category often includes income from interest, rent, dividends and gains from the sale of fixed assets.

Other Expenses: Expenses that cannot be associated definitely with the operations are identified as other expenses or non-operating expenses. Interest expense that results from financing activities and losses incurred in the disposal of fixed assets are examples of items reported in this section.

The two categories of non-operating items, other income and other expenses, are offset against each other on the profit and loss account. If the total of other income exceeds the total other expenses, the excess is added to net profit from operations; if the reverse is true, the difference is subtracted from net profit from operations.

Net Profit: The final figure on the profit and loss account is labeled as net profit (or net loss) or net profit carried to balance sheet. It is the net increase in capital from profit making activities.

Income Statement
For the Year Ended December 31, 20x'X

Sales Revenue		
Gross Sales Revenue		$900,000
Less: Sales Returns and Allowances	$80,000	
Sales Discounts	20,000	(100,000)
Net Sales Revenue		800,000
Cost of Goods Sold		
Inventory, January 1, 20x1	40,000	
Add: Cost of Goods Purchased	525,000	
Cost of Goods Available for Sale	565,000	
Less: Inventory, December 31, 20x1	(65,000)	
Cost of Goods Sold		(500,000)
Gross Profit		300,000
Operating Expenses		
Salaries and wages	130,000	
Depreciation	10,000	
Advertising	20,000	
Telephone and utilities	15,000	
Supplies and postage	7,000	
Insurance	9,000	
Property taxes	5,000	
Total Operating Expenses		(196,000)
Operating Income		104,000
Other Income and Expense		
Interest income	1,000	
Interest expense	(5,000)	
Other Income and Expense, net		(4,000)
Net Income		$100,000

Balance sheet

Definition and Explanation:

A **balance sheet** is a statement drawn up at the end of each trading period stating therein all the assets and liabilities of a business arranged in the customary order to exhibit the true and correct state of affairs of the concern as on a given date.

A *balance sheet* is prepared from a trial balance after the balances of nominal accounts are transferred to the trading account or to the profit and loss account. The remaining balances of personal or real accounts represent either assets or liabilities at the closing date. These assets and liabilities are shown in the balance sheet in a classified form - the assets being shown on the right side and the liabilities on the left hand side.

Objectives of the Balance Sheet:

The function of the correctly prepared balance sheet is to exhibit the true and correct view of the state of affairs of any concern. In a balance sheet as the assets and liabilities are shown in details after being properly valued, a trader can judge the position of his business from it.

Classification of Assets:

The properties and possessions of a business are called assets and they are classified into the following classes:

Fixed assets:

Fixed assets are assets which are acquired not for sale but for permanent use in the business e.g., land and buildings, plant and machinery, furniture etc. These assets help the business to be carried on.

Current Assets or Circulating Assets or Floating Assets:

Current assets denote those assets which are held for sale or to be converted into cash after some time e.g., sundry debtors, Bills receivables, stock of goods etc.

Liquid Assets:

Liquid assets are those assets which are with us in cash or easily converted into cash e.g., cash in hand, cash at bank, investments etc.

Wasting Assets:

The assets that depreciate through "wear and tear", whose values expire with lapse of time or that become exhausted through working are known as **wasting assets**. This is a sub-class of fixed assets e.g., plant machinery, mines etc.

Intangible or Fictitious Assets:

There are assets which have no physical existence, that is, assets which can neither be seen with eyes nor touched with hands. These are called **intangible assets** or **fictitious assets**. They do not represent anything valuable. They include debit balance of profit and loss account, goodwill etc.

Contingent Assets:

A **contingent asset** is one which comes into existence upon the happening of a certain event. If that event happens the asset becomes available, otherwise not. For example uncalled capital of a limited company.

Outstanding Assets:

Expenses paid in advance i.e., prepaid expenses, and income earned but not received are known as **outstanding assets**.

Classification of Liabilities:

The liabilities of a business are classified as follows:

Fixed Liabilities:

These are the liabilities which are payable immediately or in the near future. These liabilities are payable after a long period. Long term loans, capital of the proprietor are the examples of such kind of liabilities.

Current Liabilities:

These are the liabilities which are payable immediately or in the near future, such as creditors, bank loans etc.

Contingent Liabilities:

Contingent liabilities are those liabilities which arise only on the happening of some event. The event may or may not happen. Thus a contingent liability may or may not involve the payment of money. Examples of contingent liabilities are:

1. **Liabilities on bills discounted:** In case the bill is dishonored by the acceptor, the holder may be called upon to pay the amount to the discounter.
2. **Liability under guarantee:** In case the debtor fails to fulfill his obligation, the man who has given a guarantee or surety has to make good the loss to the creditor.
3. **Liability in respect of a pending suit:** A suit pending against a person in a court is a contingent liability because if the decision of the court goes against him, he may thereby become liable to pay compensation.

Contingent liabilities are not recorded in the books not they are included in the balance sheet. They are simply referred to by way of foot notes on the balance sheet.

Outstanding Liabilities:

Outstanding expenses and unearned income are examples of outstanding liabilities.

Classification of Capital:

The surplus or excess of assets over liabilities is called the capital or the proprietor. Capital may be classified as follows on the basis of the capital fund invested:

Trading Capital:

The portion of the funds of a concern which is represented by the fixed and floating assets is called the trading capital

Fixed Capital:

The portion of the funds of a concern which is represented by the fixed assets is called fixed capital.

Circulating Capital:

The portion of the funds of a concern which is represented by the floating or circulating assets is called the circulating or floating capital.

Working capital:

It is the amount which remains for the working of the business after the liabilities for acquiring the fixed assets have been discharged. The excess of the floating assets over the floating liabilities is also called the working capital.

Loan Capital:

The debentures and other fixed loans are sometimes called loan capital.

Watered Capital:

It is represented by fictitious assets.

Valuation of Assets:

In order to exhibit a true financial position of a business, assets are to be valued carefully. The basis upon which the various assets are valued depends to some extent on the nature of the business and the objects for which the assets are held. The following principles, however, will serve as a valuable guide in this respect:

Fixed Assets:

Fixed assets are valued on the method "**going concern**." Valuation of the fixed assets must be ascertained from their capacity to earn revenue and that is shy they should be valued for the purpose of the balance sheet at cost price less depreciation which is an estimated loss arising out of the use of the fixed assets in course of the business.

Floating Assets:

Floating assets are valued on the principle of the "**cost or market price whichever is less**." They are valued at a figure which they are likely to realize when converted into cash and as such they are valued at cost price or market price if the same is below the cost price at the date of valuation. It is never valued at a price exceeding the cost even if the market price is in excess of the cost price at the date of such valuation.

Vertical or Report Form of Balance Sheet

ASSETS	
Current Assets:	
Cash-in-hand	---------
Cash at bank	---------
Debtors (Accounts receivable)	---------
Bills receivable (Notes receivable)	---------
Stock in trade (Inventory)	---------

Total Current Assets		---------
Fixed Assets:		
Furniture and fittings	---------	
Buildings	---------	
Plant and machinery	---------	
Land	---------	
Total Fixed Assets		---------
Total Assets		---------
Liabilities:		
Current Liabilities:		
Creditors (Accounts payable)	---------	
Bills payable (Notes payable)	---------	
Bank overdraft	---------	
Total Current Liabilities		---------
Fixed Liabilities:		
Long terms loans	---------	
Owner's capital	---------	
Add net income for the year	---------	

Total Liabilities and Capital	---------

EXAMPLES

From the following balances extracted from the books of X & Co., **prepare a trading and profit and loss account** and **balance sheet** on 31st December, 1991.

	$		$
Stock on 1st January	11,000	Returns outwards	500
Bills receivables	4,500	Trade expenses	200
Purchases	39,000	Office fixtures	1,000
Wages	2,800	Cash in hand	500
Insurance	700	Cash at bank	4,750
Sundry debtors	30,000	Rent and Rates	1,100
Carriage inwards	800	Carriage outwards	1,450
Commission (Dr.)	800	Sales	60,000
Interest on capital	700	Bills payable	3,000
Stationary	450	Creditors	19,650
Returns inwards	1,300	Capital	17,900

The stock on 31st December, 1991 was valued at $25,000.

Solution:

X & Co.
Trading and Profit and Loss Account
For the year ended 31st December, 1991

To Opening stock		11,000	By Sales	60,000	
To Purchases	39,000		Less returns i/w	1,300	
Less returns o/w	500				58,700
		38,500	By Closing stock		25,000
To Carriage inwards		800			
To Wages		2,800			
To Gross profit c/d		30,600			
		83,700			83,700
To Stationary		450	By Gross profit b/d		30,600
To Rent and rates		1,100			
To Carriage outwards		1,450			
To Insurance		700			
To Trade expenses		200			
To Commission		800			
To Interest on capital		700			
To Net profit transferred to capital a/c		25,200			

	30,600		30,600

X & Co.
Balance Sheet
As at 31st December, 1991

Liabilities		$	Assets	$
Creditors		19,650	Cash in hand	500
Bills payable		3,000	Cash at bank	4,750
Capital	17,900		Sundry debtors	30,000
Add Net profit	25,200		Bill receivable	4,500
		43,100	Stock	25,000
			Office equipment	1,000
		65,750		65,750

Example 2:

The following trial balance was taken from the books of Habib-ur-Rehman on December 31, 19 ....

Cash	13,000
Sundry debtors	10,000
Bill receivable	8,500
Opening stock	45,000

Building	50,000	
Furniture and fittings	10,000	
Investment (Temporary)	5,000	
Plant and Machinery	15,500	
Bills payable		9,000
Sundry creditors		20,000
Habib's capital		78,200
Habib's drawings	1,000	
Sales		100,000
Sales discount	400	
Purchases	30,000	
Freight in	1,000	
Purchase discount		500
Sales salary expenses	5,000	
Advertising expenses	4,000	
Miscellaneous sales expenses	500	
Office salary expenses	8,000	
Misc. general expenses	1,000	
Interest income		1,000
Interest expenses	800	
	2,08,700	2,08,700

Closing stock on December 31, 19 ... was $10,000

Required: Prepare income statement/trading and profit and loss account and balance sheet from the above trial balance in report form.

Solution:

Habib-ur-Rehman
Income Statement/Profit and Loss Account
For the year ended December 31, 19.....

Gross sales		100,000	
Less: Sales discount		400	
Net Sales			99,600
Cost of Goods Sold:			
Opening stock		45,000	
Purchases	30,000		
Add: Freight in	1,000		
	31,000		
Less purchase discount	500		
Net purchases		30,500	
Cost of goods available for sale		75,500	
Less closing stock		10,000	
Cost of goods sold			65,500

Gross profit			34,100
Operating Expenses:			
Selling Expenses:			
Sales salary expenses	5,000		
Advertising expenses	4,000		
Misc. selling expenses	500		
		9,500	
General Expense:			
Office salaries expenses	8,000		
Misc. general expenses	1,000		
		9,000	
Total operating expenses			18,500
Net profit from operations			15,600
Other Expenses and Incomes:			
Interest income	1,000		
Interest expenses	800		
Net increase			200
Net income			15,800

Habib-ur-Rehman
Balance Sheet
As at December 31, 19…..

ASSETS		
Current Assets:		
Cash	13,000	
Sundry debtors	10,000	
Bills receivable	8,500	
Stock on Dec. 31, 19 ..	10,000	
Investment	5,000	
Total Current Assets		46,500
Fixed Assets:		
Buildings	50,000	
Plant and Machinery	15,500	
Furniture and fittings	10,000	
Total Fixed Assets		75,500
Total Assets		122,000
LIABILITIES:		
Current Liabilities:		
Sundry creditors	20,000	
Bills payable	9,000	

Total Current Liabilities		29,000
Fixed Liabilities:		
Habib's capital	78,200	
Net income for the year	15,800	
	94,000	
Less: Drawings	1,000	
		93,000
Total Liabilities and Capital		122,000

Financial Statement Ratios and Calculations

As we progress through this series of Analysis of financial statements, you must remember John Burr William's basic truth that a business is only worth the profit that it will generate for its owners from now until doomsday, discounted back to the present, adjusted for inflation. The income statement is the "report card" of those earnings, which ultimately determine the price you should be willing to pay for a business. Listed below are just some of the many ratios that investors calculate from information on financial statements and then use to evaluate a company. As a general rule, desirable ratios vary by industry.

- *Debt-to-equity ratio* compares a company's total debt to shareholders' equity. Both of these numbers can be found on a company's balance sheet. To calculate debt-to-equity ratio, you divide a company's total liabilities by its shareholder equity, or

Debt-to-Equity Ratio = Total Liabilities / Shareholders' Equity

If a company has a debt-to-equity ratio of 2 to 1, it means that the company has two dollars of debt to every one dollar shareholders invest in the company. In other words, the company is taking on debt at twice the rate that its owners are investing in the company.

- *Inventory turnover ratio* compares a company's cost of sales on its income statement with its average inventory balance for the period. To calculate the average inventory balance for the period, look at the inventory numbers listed on the balance sheet. Take the balance listed for the period of the report and add it to the balance listed for the previous comparable period, and then divide by two. (Remember that balance sheets are snapshots in time. So the inventory balance for the previous period is the beginning balance for the current period, and the inventory balance for the current period is the ending balance.) To calculate the inventory turnover ratio, you divide a company's cost of sales (just below the net revenues on the income statement) by the average inventory for the period, or

  Inventory Turnover Ratio = Cost of Sales / Average Inventory for the Period

  If a company has an inventory turnover ratio of 2 to 1, it means that the company's inventory turned over twice in the reporting period.

- *Operating margin* compares a company's operating income to net revenues. Both of these numbers can be found on a company's income statement. To calculate operating margin, you divide a company's income from operations (before interest and income tax expenses) by its net revenues, or

  Operating Margin = Income from Operations / Net Revenues

  Operating margin is usually expressed as a percentage. It shows, for each dollar of sales, what percentage was profit.

- *P/E ratio* compares a company's common stock price with its earnings per share. To calculate a company's P/E ratio, you divide a company's stock price by its earnings per share, or

P/E Ratio = Price per share / Earnings per share

If a company's stock is selling at Kshs 20 per share and the company is earning Kshs 2 per share, then the company's P/E Ratio is 10 to 1. The company's stock is selling at 10 times its earnings.

- *Working capital* is the money leftover if a company paid its current liabilities (that is, its debts due within one-year of the date of the balance sheet) from its current assets.

Working Capital = Current Assets – Current Liabilities