FINANCIAL ACCOUNTING

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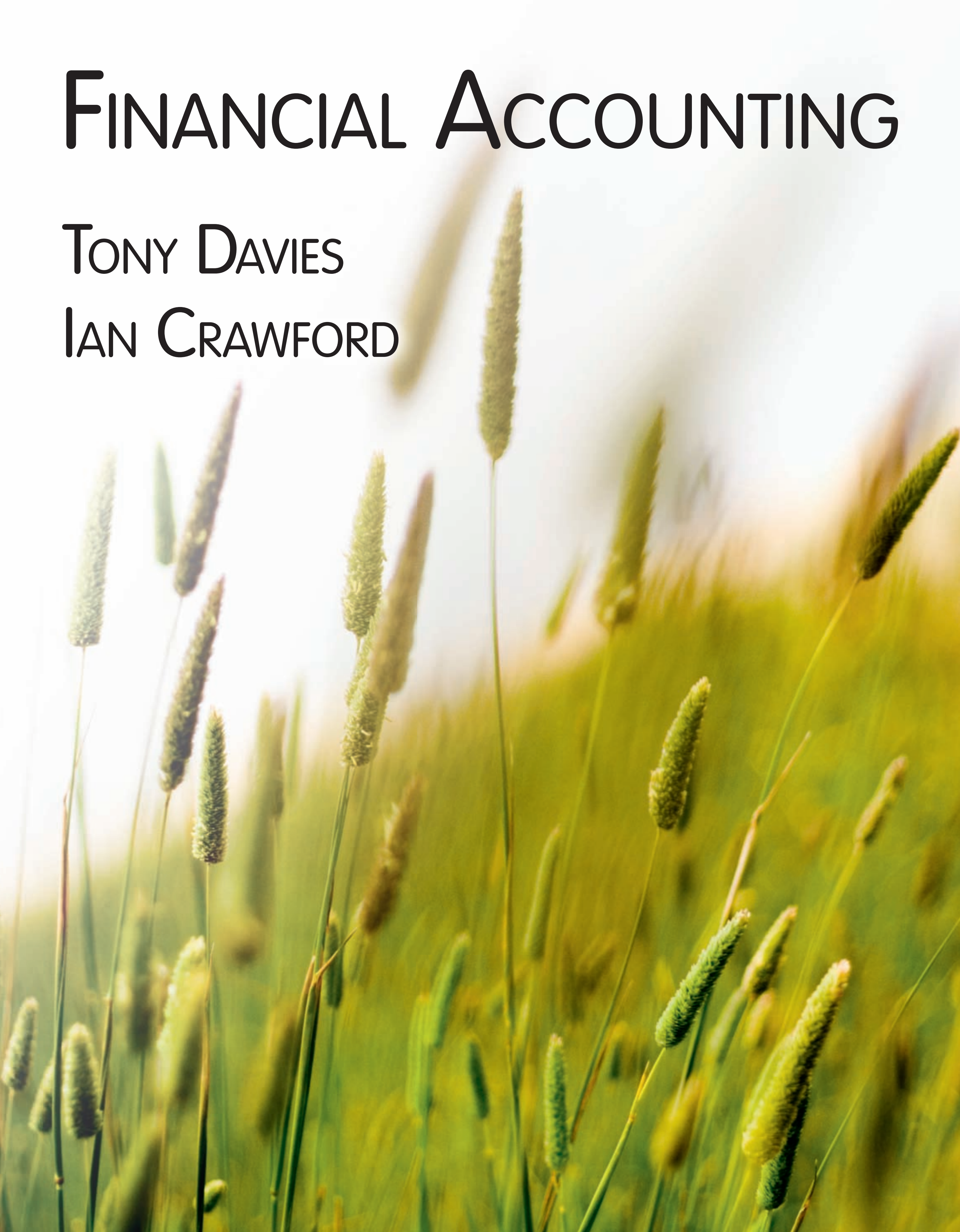

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Profit (or loss) considered in this way can be represented in the equation:

profit (P) = total revenue (TR) − total costs (TC)

and it should be noted that

retained profit (RP) = profit (P) − dividends

Worked example 4.2

A trading company, Squirrel Ltd, has an accounting period that covers the 12 months to 31 December 2010. During that period the company entered into the following transactions:

Sales revenue of £1,300,000 included a sales invoice for January 2011 amounting to £100,000. Expenses of £1,000,000 included a payment of £60,000 for rent relating to the six months to 31 March 2011.

The expenses excluded some heating costs relating to the last two weeks of December 2010, for which the estimated cost was around £5,000. The quarterly invoice covering that period was not expected until late March 2011.

The above information may be used to look at why the annual net profit should be revenues less expenses, and why there should be accounting concepts applied to the treatment of those expenses.

The income statement for a year tries to match revenues and expenses for that year (complying with the matching concept – see Chapter 1). Profit means the difference between revenues and expenses. Gross profit or gross margin is derived from sales revenue less the costs of those sales, and profit is derived from deducting expenses from gross profit. Profit is not the difference between cash receipts and cash payments. Cash inflows and outflows suffer from timing differences.

The reported sales revenue for the year must relate only to the 12 months to 31 December. Sales revenue for Squirrel Ltd for the year 2010 is £1,200,000 (£1,300,000 less £100,000). Using the matching concept, the expenses must also be for 12 months. So the estimated heating costs of £5,000 for the last two weeks of December 2010 must be added, and the rent relating to January to March 2011 of £30,000 (£60,000/2) must be deducted from the total expenses of £1,000,000. Without these adjustments, the expenses would not represent 12 months' expenses.

Profit for the 12 months to 31 December 2010 for Squirrel Ltd is therefore:

Revenue	£1,200,000	[£1,300,000 less £100,000]
less		
Expenses	£975,000	[£1,000,000 plus £5,000 less £60,000 plus £30,000]
Which equals	£225,000	

There must be an application of accounting concepts and standard practices in arriving at profit, otherwise users of financial information would not have reasonable confidence in the amounts being shown in the financial statements reported by companies, large or small.

In this chapter we will look at the income statement from the second perspective. We will look at how an income statement is constructed and prepared by deducting total costs from total revenues, as the second of the three key financial statements that are required to be prepared by a limited company.

Progress check 4.1

Explain the perspectives from which we may consider the profit (or loss) of a business.

Income statement formats

The format of the income statement is explained in IAS 1 Presentation of Financial Statements. IAS 1 outlines the minimum information that should be disclosed on the face of the income statement, which gives a little flexibility to the ways in which individual companies report, rather than setting out a rigid format that must be adopted by every company.

IAS 1 does include the minimum information that should be disclosed on the face of the income statement, which includes:

- revenue
- finance costs
- profits or losses arising from discontinued operations
- income tax expense
- profit or loss for the year.

IAS 1 recommends two alternative ways of presenting costs and expenses on the face of the income statement:

- according to business functions, for example distribution costs and administrative expenses
- according to their nature, for example employee expenses, depreciation etc.

The income statement in the example adopted by Flatco plc (see Figure 4.4) has been based on the format that presents expenses and costs according to business functions, and this format will be adopted generally throughout this book. Directors of companies will adopt this format if they believe that presenting how much of the revenue of the company was 'used' by particular functions of the business may provide more relevant and accurate information and a better impression of the efficiency of the business.

It is not always a straightforward matter to allocate costs within a company to specific functions. The costs of shared resources are often allocated between functions on a fairly arbitrary basis. The alternative presentation of the income statement which presents costs and expenses according to their nature, for example employee expenses, depreciation etc., may be adopted by companies. Certainly for management reporting within the company this analysis is far more useful in support of forecasting and planning.

Unlike FRS 3, Reporting Financial Performance, and UK GAAP, IAS 1 does not use the term 'exceptional items'. Exceptional items relate to material (significant), non-recurring items of income and expense of abnormal size and incidence arising from infrequent circumstances but which are derived from the ordinary activities of the business. FRS 3 required exceptional items to be included under the statutory format headings to which they relate and disclosed separately on the face of the income statement if necessary to give a true and fair view.

Although it does not refer to them as exceptional items, IAS 1 makes it clear that such material items of income and expense must be separately disclosed if they are relevant to an understanding of the financial performance of the business. These need not be shown on the face of the income statement so long as they appear within the notes on the financial statements. The material, non-recurring income and expense items that require separate disclosure include:

- write-downs of inventories to net realisable value, and reversals of such write-downs
- write-downs of property, plant and equipment to net realisable value, and reversals of such write-downs

- restructuring of the activities of the company
- reversals of provisions
- disposals of property, plant and equipment
- disposals of investments
- discontinued operations
- litigation settlements.

Another separate term, 'extraordinary items' as distinct from exceptional items, is defined as material income or costs which are derived or incurred from unusual events or transactions outside the ordinary activities of the company which like exceptional items are infrequent and therefore not expected to occur frequently or regularly. The costs resulting from the complete destruction of a factory may be sufficiently material and infrequent and possess such a high degree of abnormality as to warrant its disclosure as an extraordinary item.

Up until 2004, IAS 1 required extraordinary items to be disclosed in a separate line on the income statement. A company's ordinary activities have now been defined so broadly that the disclosure of extraordinary items is now expressly prohibited by IAS 1. US GAAP still requires extraordinary items to be disclosed in the income statement if they are unusual and infrequent.

Earnings per share (eps) are dealt with in IAS 33, Earnings per Share, which requires basic earnings per share and diluted earnings per share to be presented on the face of the income statement with equal prominence. Both should be presented relating to:

- the profit or loss from continuing operations attributable to ordinary equity shareholders of the parent company

and

- for total profit or loss attributable to such shareholders.

Earnings per share from discontinued operations should be shown either on the face of the income statement or in the notes on the accounts.

Basic earnings per share are calculated by dividing earnings, or profit of the year, by the weighted average number of ordinary shares in issue over the year. Diluted earnings per share are calculated by adjusting for a reduction in the earnings per share for the year caused by an increase or potential increase in the number of shares in issue, for example through the conversion of convertible securities into ordinary shares.

Earnings per share should also be presented for each class of ordinary shares that has a different right to participate in the profit of the company.

Group financial statements must to be prepared for the holding company in addition to the financial statements which are required to be prepared for each of the individual companies within the group. Consolidated financial statements exclude all transactions between companies within the group, for example inter-company sales and purchases. In most other respects the group consolidated financial statements reflect an amalgamation of each of the components of the income statements, balance sheets and statements of cash flows of all the companies within the group.

Progress check 4.2

There are broadly two income statement formats that are outlined in IAS 1. How do these formats differ? Which format appears to be favoured by the majority of large companies?

Structure of the income statement

As we have seen previously, the income statement measures whether or not the company has made a profit or loss on its operations during the period, through producing or buying and selling its goods or services. It measures whether total revenues are higher than the total costs (profit), or whether total costs are higher than total revenues (loss).

The total revenue of a business is generated from the provision of goods or services and may include, for example:

- sales of goods or services
- interest received (on loans)
- rents (from property)
- subscriptions (for example to TV channels)
- fees (for example professional subscriptions)
- royalties (payable on books and CDs)
- dividends received (from investments).

The total costs of a business include the expenditure incurred as a result of the generation of revenue. The total costs of a business include, for example:

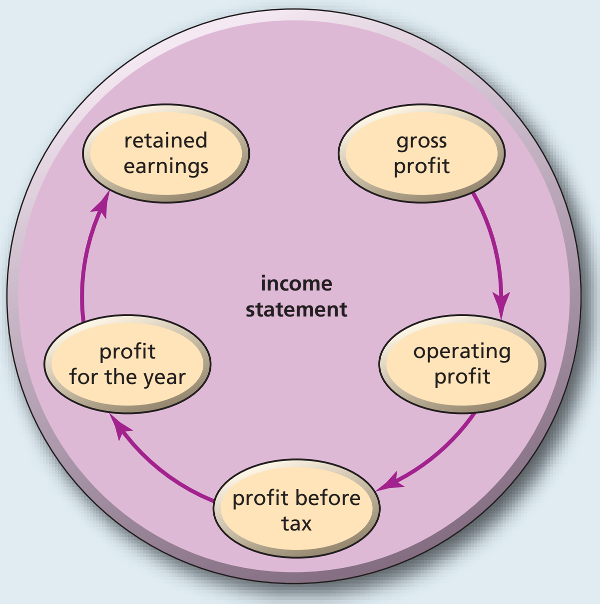
- costs of goods purchased for resale
- costs of manufacturing goods for sale
- transport and distribution costs
- advertising
- promotion
- insurance
- costs of the 'consumption' of non-current assets over their useful lives (depreciation)
- wages and salaries
- interest paid
- stationery costs
- photocopy costs
- communications costs
- electricity
- water and effluent costs
- travel expenses
- entertaining expenses
- postage.

Each of the above examples of costs (which is by no means an exhaustive list) incurred in the generation of revenue by a business appears itself as a separate heading, or is grouped within one or other of the other main headings within the income statement. Figure 4.2 shows each of the levels of profit that are derived after allowing for the various categories of revenues and expenses.

We will look at how a basic income statement is constructed to arrive at the profit for the year after taxation (or net profit) for the company. Profit is also sometimes called earnings, or net income, from which may be deducted dividends payable to ordinary shareholders. The net result is then the retained earnings (or retained profit) for the financial year.

Each of the levels of profit shown in Figure 4.2 can be examined to show the categories of revenue and costs included in the income statement. These are illustrated in Figure 4.3, which is completely consistent with the headings shown in Figure 4.2.

Figure 4.2 Levels of profit within the income statement



We will look at each of the headings included within the income statement as shown in Figures 4.2 and 4.3 in a little more detail.

Revenue

The main source of income for a company is its **revenue**, primarily comprising sales of its products and services to third-party customers. Revenues and costs are not necessarily accounted for when cash receipts and payments are made. Sales revenues are normally accounted for when goods or services are delivered and invoiced, and accepted by the customer, even if payment is not received until some time later, even in a subsequent trading period.

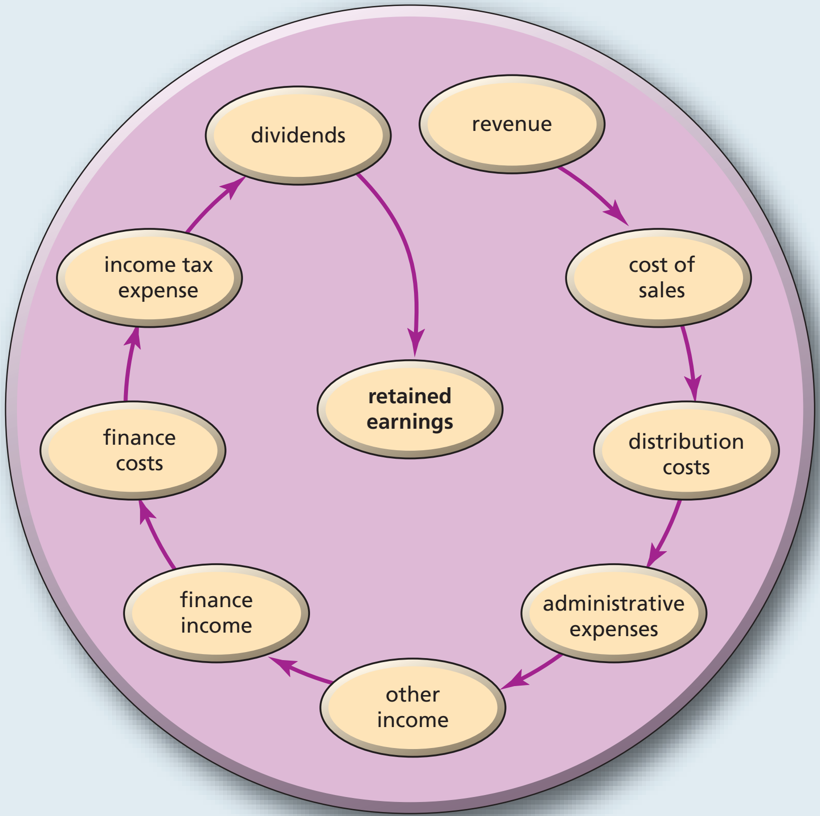
Cost of sales (COS)

It should be noted that a cost or expense is the financial result of the 'consumption' that occurred during the accounting period that relates directly or indirectly to the production or sales of the goods or services, and is accounted for as it is incurred rather than on a cash payment basis. Costs may be cash-related, invoiced costs such as raw materials, or non-cash items like depreciation charges.

The sum of direct costs of goods sold plus any manufacturing expenses relating to the sales revenue is termed cost of sales, or production cost of sales, or cost of goods sold. These costs include:

- costs of raw material inventories used
- costs of inward-bound freight paid by the company
- packaging costs
- direct production salaries and wages
- production expenses, including depreciation of trading-related non-current assets.

Figure 4.3 Elements of the income statement



Gross profit (or gross margin)

The difference between revenue and cost of sales (COS) is **gross profit** or gross margin. It needs to be positive and large enough to at least cover all other expenses.

Distribution costs and administrative expenses

Although not directly related to the production process, but contributing to the activity of the company, there are further costs that are termed 'other operating expenses'. These include distribution costs and selling costs, administrative expenses, and research and development costs (unless they relate to specific projects and the costs may be deferred to future periods).

Distribution costs include the costs of selling and delivering goods and services. Such costs may include:

- advertising
- market research
- promotion
- costs of the sales department
- outbound freight costs
- delivery vehicles fleet costs
- costs of the warehouse and goods outward department.