Accounting (Basics) - Lecture 3

COSTS (EXPENSES) AND REVENUES OF ACCOUNTING UNIT AS PART OF PROFIT AND LOSS STATEMENT AND RELATED ACCOUNTING PROCEDURES.

Content

- Costs (expenses) and revenues
- Income statement (profit and loss statement)
- Related accounting procedures
- Cash-flow statement
- Difference between cost (expenses) – expenditure and revenues - income

Costs (expenses) and revenues

- The income statement tracks both revenue, which is the output from the economic activity of the business, and costs (expenses), which are inputs into the economic activity of the business.

Revenues

- The revenue is defined as the result (output) of the economic activity of the enterprise achieved by spending of costs (expenses).
- Revenues give the sense to economic existence of the enterprise.
- The revenue can influence assets (increasing of assets) or equities (decreasing of equities).
- **<u>But not every increasing of assets or decreasing of equities must be automatically revenue!</u>**

Costs (expenses)

- The cost (expense) is defined as the input into the economic activity of the enterprise with the aim to achieve revenues (outputs).
- The cost (expense) can influence assets (decreasing of assets) or equities (increasing of equities).
- <u>**Not every decreasing of assets or increasing of equities must be automatically a cost (expense)!**</u>

Costs (expenses) and revenues

- Costs (expenses) and revenues are charged on special accounts in the system of double-entry accounting system.
- Systematically they are recorded in the profit and loss statement
  - (income statement) or (P/L Statement)

Profit and loss statement

- The profit and loss statement provides information about the company performance over an accounting period.
- The attention is paid to the structure of the income statement and dynamism of particular components
- The information from the income statement is a very important source material for evaluation of profitability.

Profit and loss statement

- if the balance sheet enables us to evaluate whether the company is economically stable, the profit and loss statement tells us about its ability to create enough profit
- If you think of the balance sheet as a snapshot, then you can think of the income statement as a video recording covering the period between before and after pictures

Profit and loss statement

- Like the balance sheet, the profit and loss statement is an important source material for analysing the financial management of the company, the objective of which is to evaluate the economics and profitability for a particular period

Revenues – Costs (expenses) =
Economic result (Profit/loss) or Net income

Profit and loss statement

- The most important component of the statement is “income on operating activities” (EBIT) because it reflects the efficiency of the company to generate positive net income on company’s main operations

Profit and loss statement

- The structure of P/L statement is a little bit more complicated than the structure of the balance sheet.
- The P/L statement is composed gradually with the aim to calculate several partial indicators which represent single parts of economic activity of the enterprise.
- The concrete structure of the P/L statement is as follows:

Profit and loss statement

- Gross profit
- Operating profit (EBIT)
- Financial profit / loss
- Earnings before tax (EBT)
- Non-operating costs and revenues
- Net income

Gross profit

- The difference between net sales and the cost of goods sold.
- It includes total revenues and costs of sales.
- For example:
  - Services ordered by the company, consumption of material, cost of goods sold
  - Revenues from the goods sold, revenues from own products and services

Operating profit

- It includes salaries, rents, utilities, depreciation, advertising costs, administrative costs + gross profit.

Financial profit / loss

- Revenues from securities, interest revenues
- Interest expenses, bank account fees, sold securities and ownership interests

Earning before taxes

- The sum of earnings before taxes (including financial prifit or loss)

Non-operating costs and revenues

- Costs and revenues from extraordinary activity – not such as the core business activity
- Extraordinary revenues or costs (expenses)

Profit and loss statement - sample

Profit and loss statement	Thousands of … (currency)
Gross profit	
Operating Costs and Revenues	
Total Operating Profit (EBIT)	
Financial Costs and Revenues	
Earnings before Tax (EBT)	
Non-operating Costs and Revenues	
Total Sum of Costs and Revenues	
Tax (19)%	
Net Income	

Differences between BS and P/LS

- The basic difference between the balance sheet and the income statement is that the balance sheet records assets and liabilities **at a given moment**, while the income statement is always **related to a given time interval** – an overview of resulting operations over a time interval
- The income statement includes flow quantities based on a cumulative basis and their changes at the time do not have to be even

Profit and loss statement

- **The P/L statement** is - after the **balance sheet** - the second basic financial statement that must be obligatory compiled to the date of accounting shutter (so called financial statements compilation date).

Cash-flow statement

- The primary purpose of the statement of cash flows is to provide information about the state of financial resources at the beginning and at the end of an accounting period
- The statement also shows how particular business operations participate in inflows and outflows of financial resources

Cash and its equivalent

- Cash, bank account
- Valuables (stamps, telephone cards, meal vouchers)
- Cash in transit
- Cash equivalents, which are defined as liquid financial assets, ie. the assets easily convertible to a known amount of money - the marketable securities (treasury bills, bonds of large banks, certificates)

Cash-flow statement

- Double-entry bookkeeping guarantees that the sum of the cashflows from the three main categories (operating, investing, financing activities) equals to the change in cash balances over the accounting period

Why to know the cash-flow statement

- Net income is an extremely useful metric in financial analysis; it reflects ongoing profitability.
- However, since the income statement measures profitability using accrual accounting, it suffers from the limitation of not being able to objectively tell us what is happening to cash during the year.

Difference between cash flow statement and income statement

- Income statement measures revenues and costs (expenses) and at the bottom you can see the profit/loss of the accounting period (net income)

- Cash flow statement measures inflows (incomes) and outflows (expenditures) of the money

Expenditure and income

- **Expenditure** is a decrease of money.
- **Income** is an increase of money.
- Incomes and expenditures are shown in **cash-flow statement**.
- Cash-flow statement provides information about structure of incomes and expenditures realized during an accounting period by enterprise.

Cash-flow statement

- The cash-flow of enterprise is usually divided into cash-flow in **operating activity** (incomes and expenditures for material, goods, products, from paid wages, etc.), **investment activity** (incomes and expenditures for fixed tangible and intangible assets) and **financial activity** (incomes and expenditures for financial assets (securities, deposits, cash, etc.).

Cash-flow statement

- The most simple form of cash-flow statement is following:

Cash-flow statement (in thousand of currency)	
Opening balance of cash	
Increase of cash (incomes)	
Decrease of cash (expenditures)	
Final balance of cash	

Cash-flow statement

- The statement of cash flows is used for evaluation of company's financial stability, short-term planning of cash receipts and cash payments, long-term compiling of a financial plan and evaluation of cost-effectiveness of investment variants.