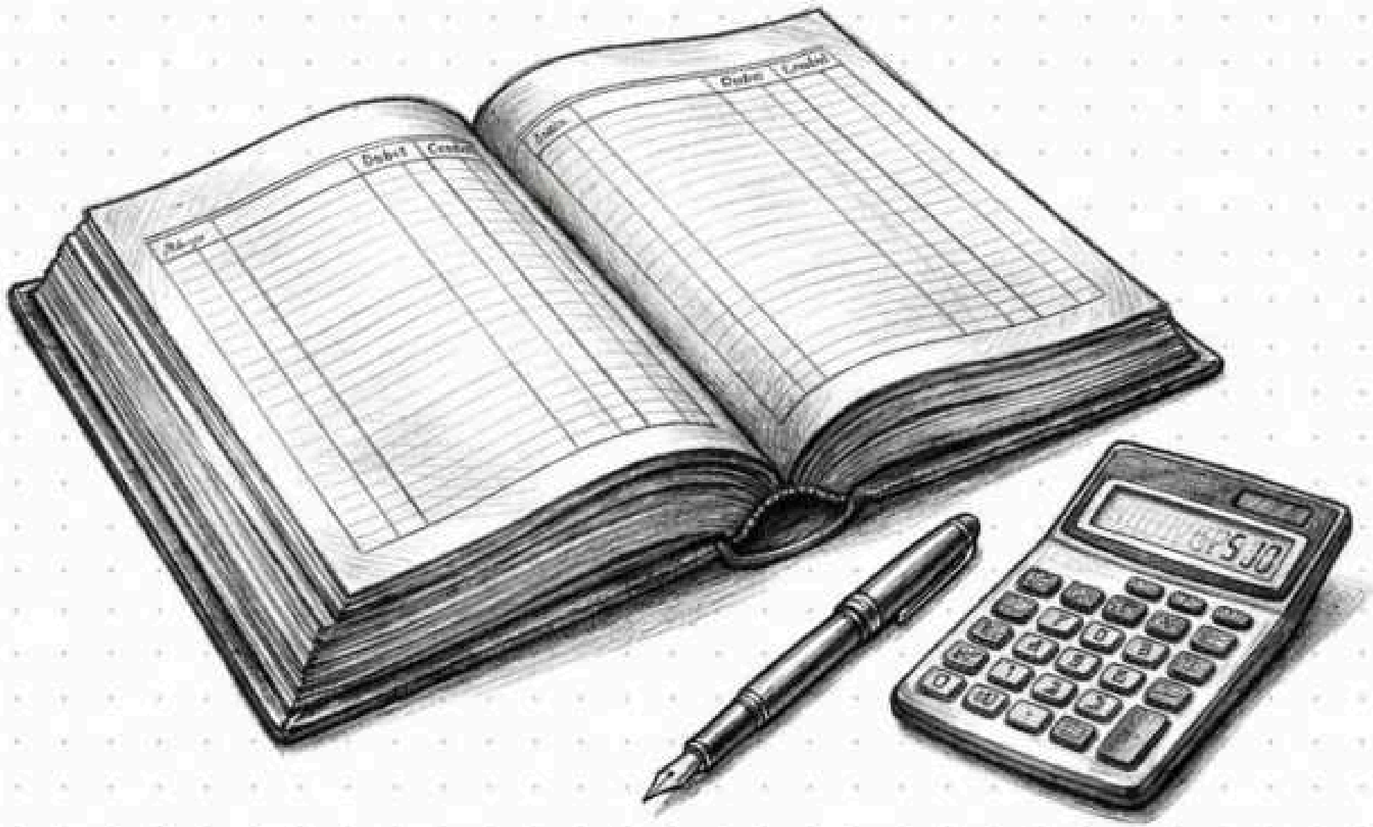


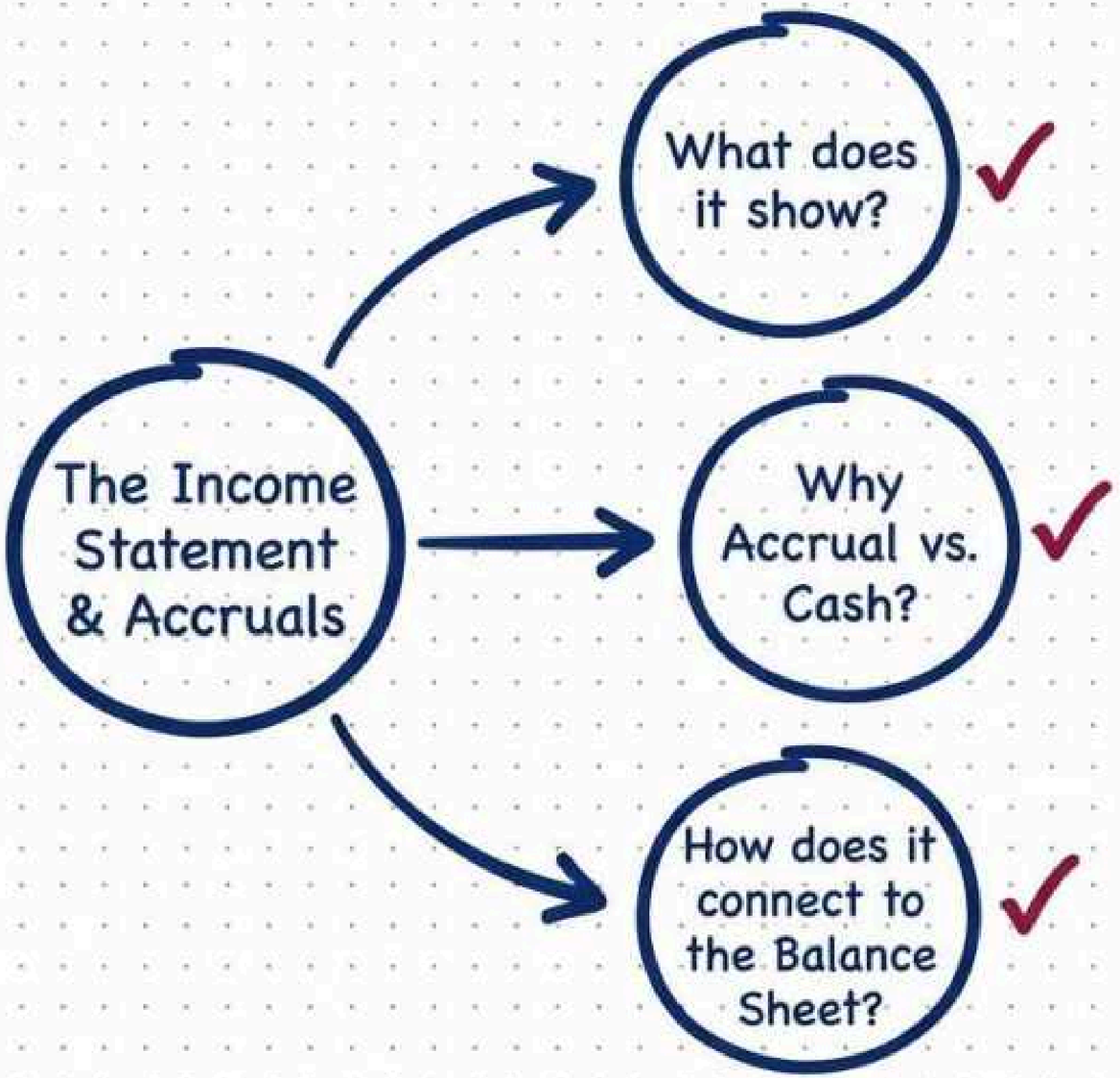
The Income Statement & Accruals

Revenue, Expenses, and the Lens of Financial Truth

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Three Questions for the Financial Engine

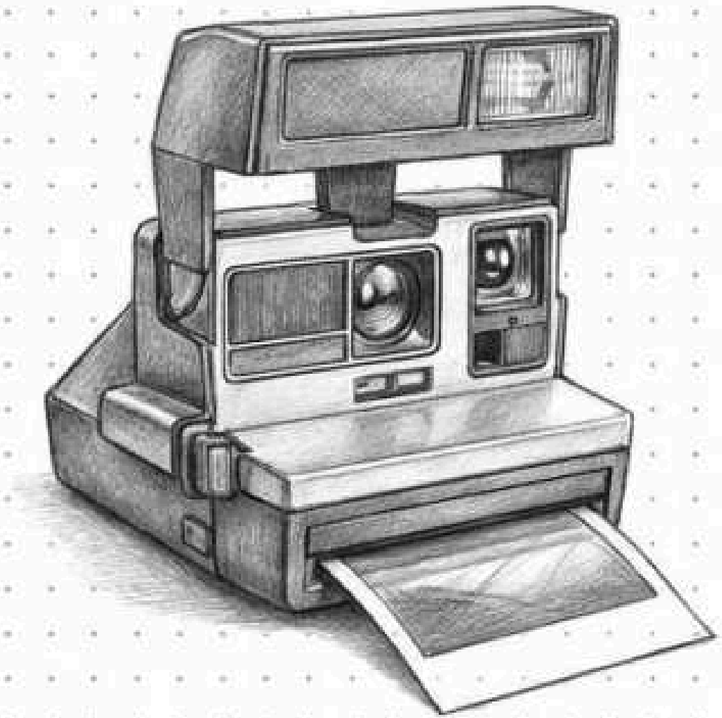
¶ 3.1



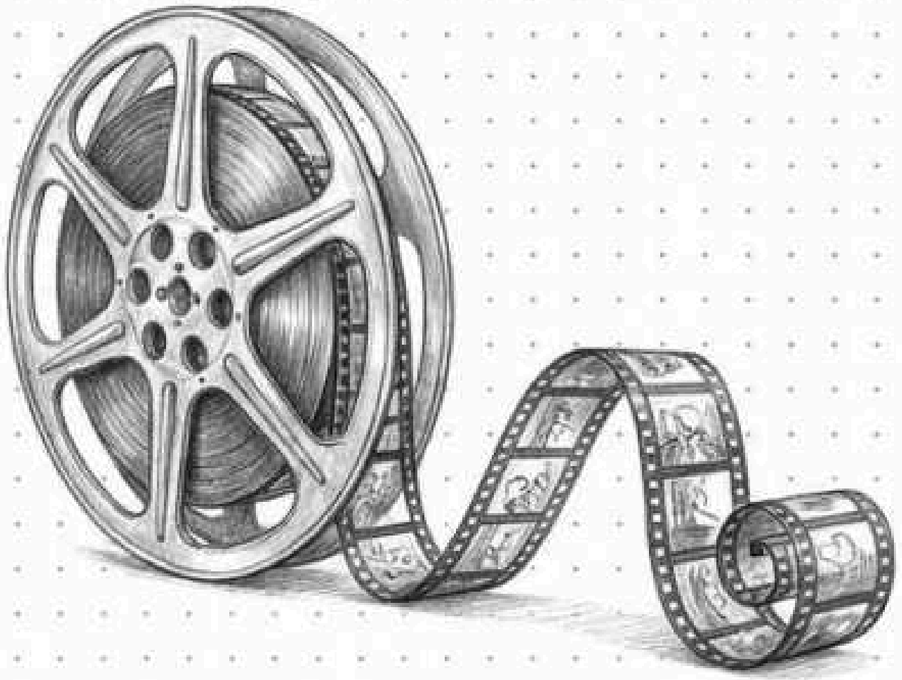
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The Snapshot vs. The Video

¶ 3.2



The Balance Sheet: A snapshot at a specific point in time.



The Income Statement (Profit & Loss): A video over a period of time (e.g., a year).

Revenue – Expenses = Net Income (Profit)

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The Anatomy of Profit

¶ 3.3

REVENUE

(Income from selling goods/services)

− **Cost of Goods Sold (COGS)**

(What the company paid for the items)

= **Gross Profit**

− **Operating Expenses**

(Rent, wages, marketing)

= **Operating Profit**

− **Interest & Taxes**

= **NET INCOME**

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¶ 3.4

Year One at the Bicycle Shop



Revenue: $20,000

− COGS: $12,000

= Gross Profit: $8,000

− Operating Expenses (Rent + Wages): $5,000

= Operating Profit: $3,000

− Interest ($300) & Taxes ($700)

= Net Income: $2,000

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¶ 3.5

Accrual vs. Cash Accounting

	Accrual Accounting (A truer picture of performance in a period)	Cash Accounting
Revenue trigger	Recorded when EARNED.	Recorded when CASH ARRIVES.
Expense trigger	Recorded when INCURRED.	Recorded when CASH LEAVES.

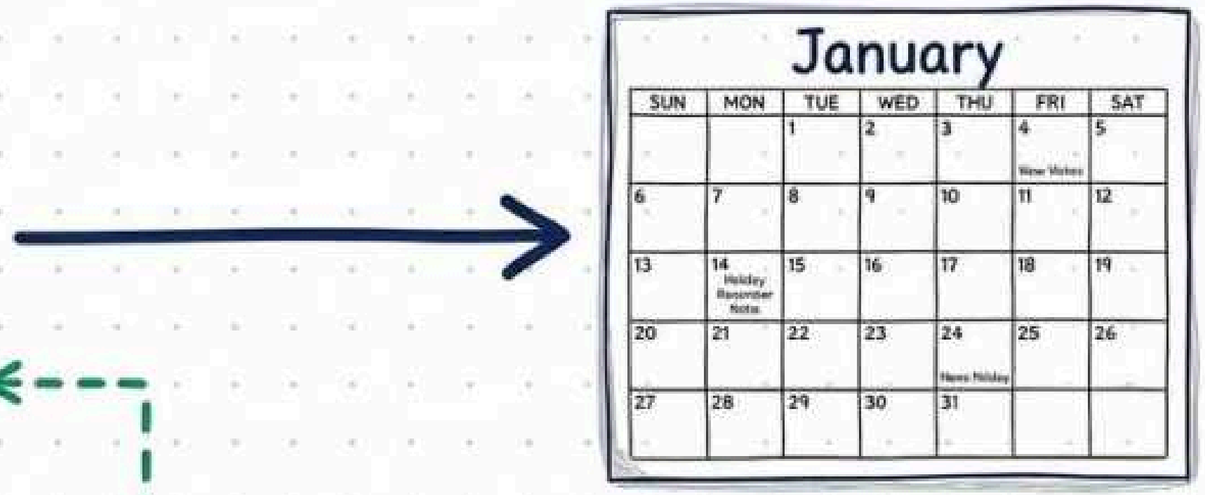
The Key Idea: Disconnect the event from the cash transfer.

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The Timing Disconnect

¶ 3.6







The Sale

Shop EARNS the sale.
Records Revenue +
Accounts Receivable (Asset).

Zero Cash.



The Payment

Cash arrives.
Accounts Receivable falls,
Cash rises.

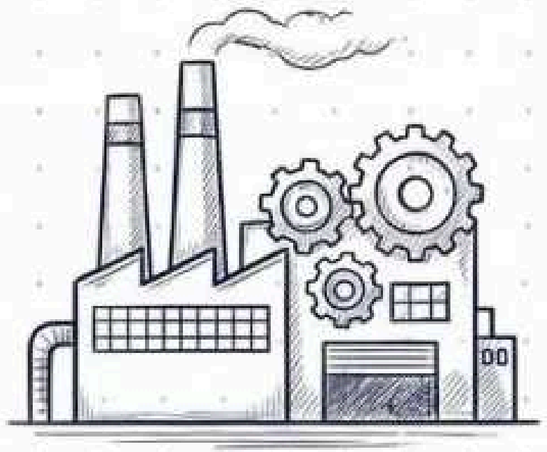
Zero New Revenue Recorded.

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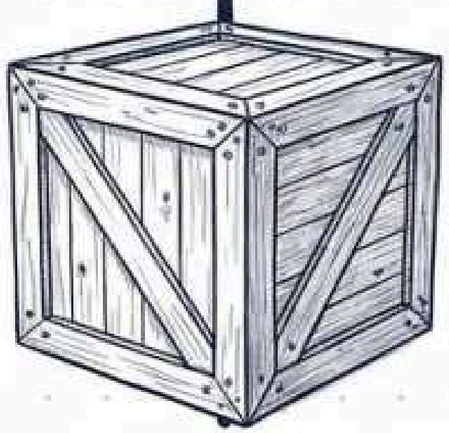
The Rule of Revenue Recognition

¶ 3.7

Transfer of Control



The Company





The Customer

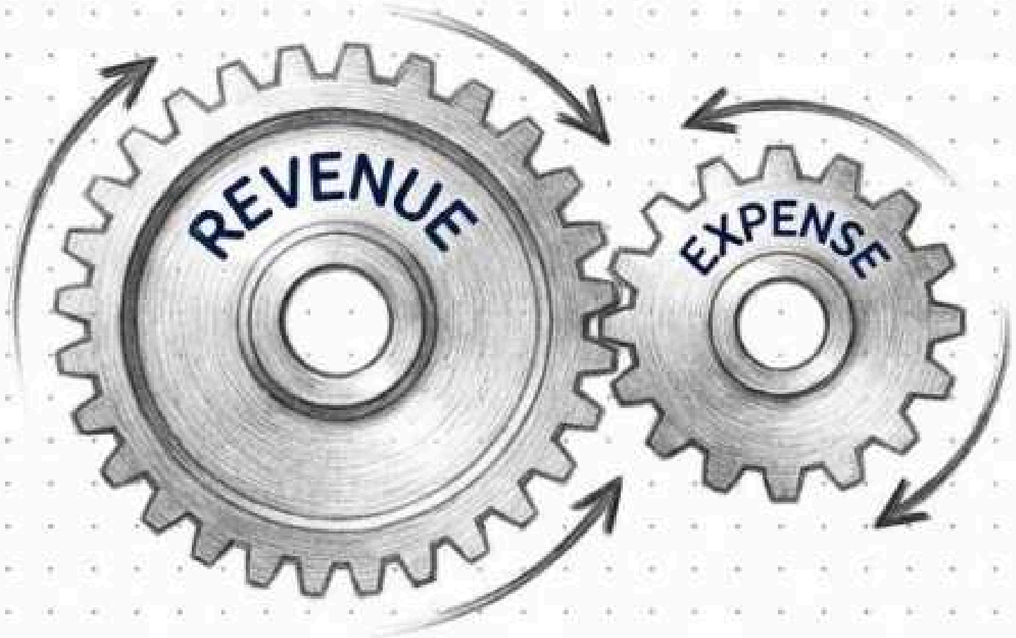
Under current standards (2018), revenue is recognized exactly when control transfers, in the expected amount.

[Exception: For long contracts, revenue may be recognized gradually as work is done.]

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The Matching Principle

¶ 3.8



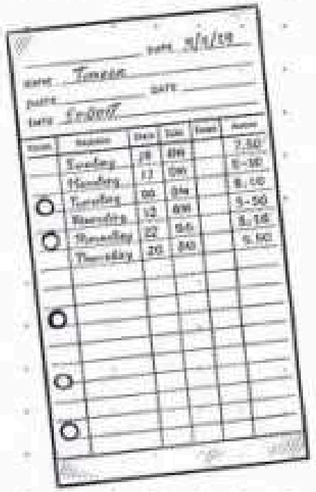
← Expenses must be recorded in the same period as the revenues they help to earn.

- Bicycle Example: Cost of the bicycle is expensed only when the bicycle is sold, not when bought.
- Insurance Example: A year of prepaid insurance is spread smoothly over the 12 months it covers.

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Period-End Adjusting Entries

¶ 3.9



✓ Wages earned but not yet paid.

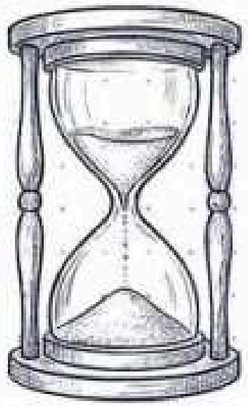


✓ Interest owed.

Making statements reflect reality.



✓ Revenue earned but not yet billed.

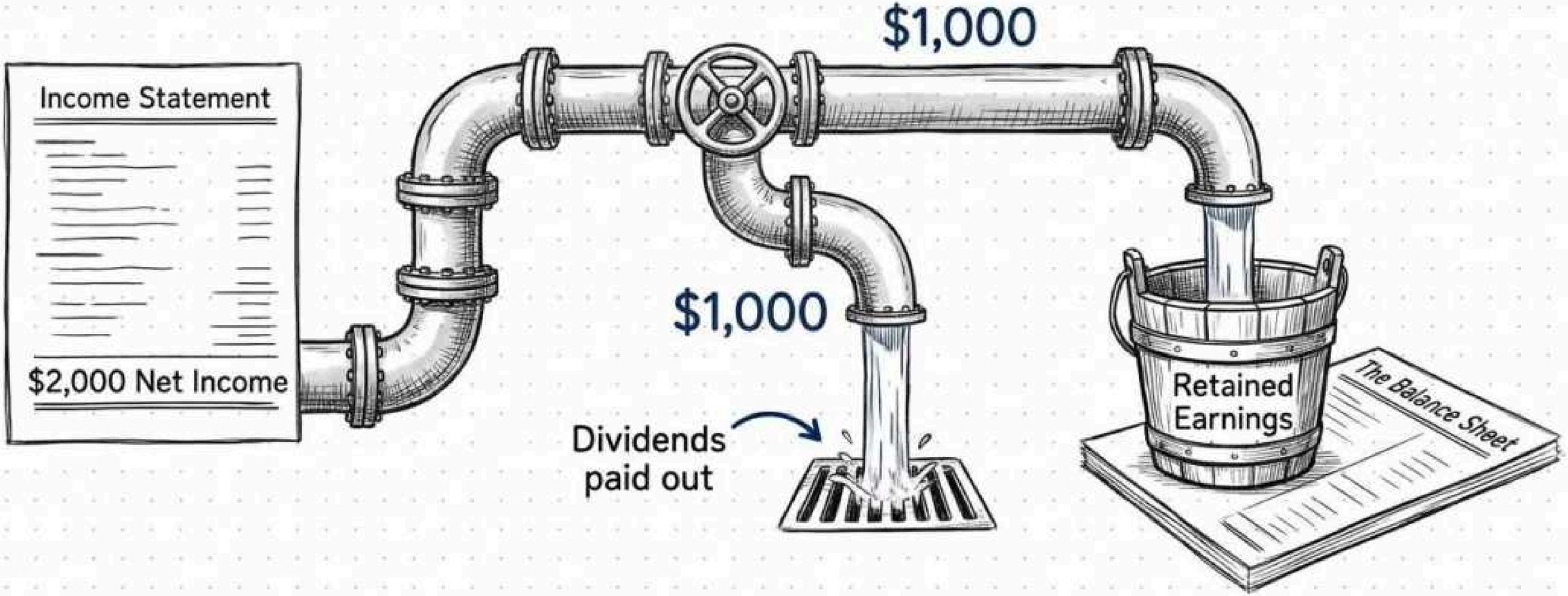


✓ Portion of prepaid costs used up.

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¶ 3.10

Articulation: Connecting the Statements



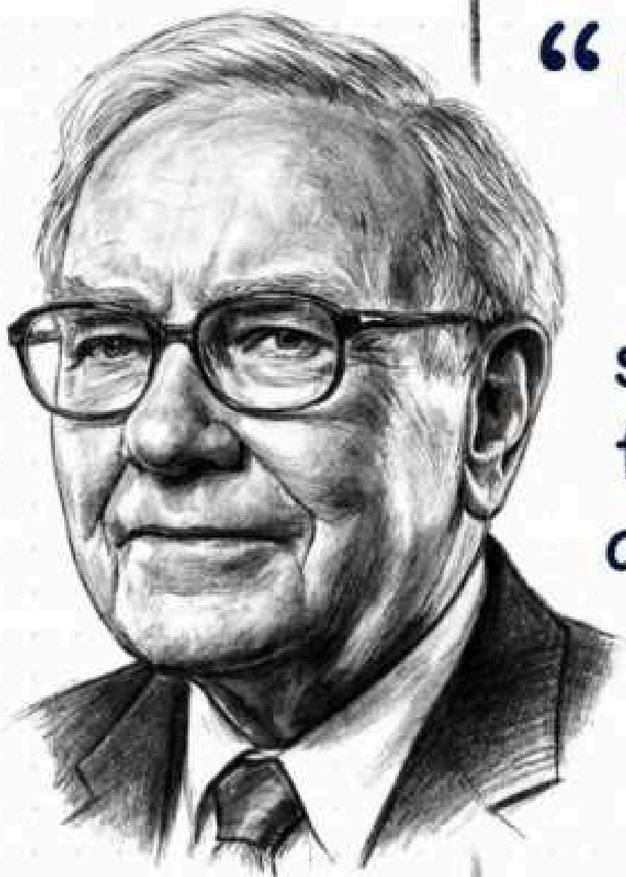
This link is why the statements articulate, or fit together.

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¶ 3.11

The Danger of Alternative Metrics

E Earnings
B Before
I Interest,
T Taxes,
D Depreciation, and
A Amortization

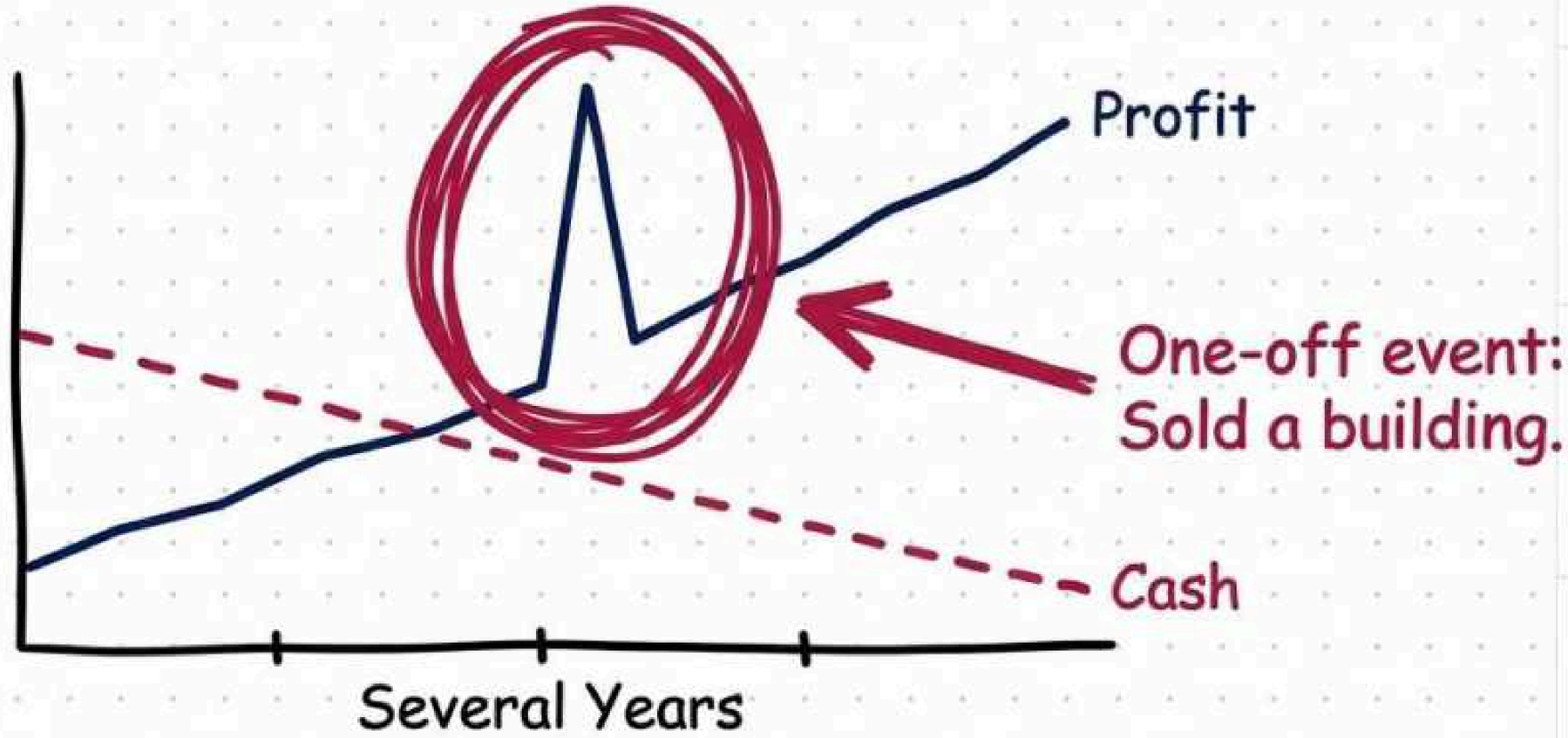


"EBITDA is not defined by accounting standards, can flatter results, and ignores the real cost of replacing equipment.

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¶ 3.12

Profit is Only Part of the Story

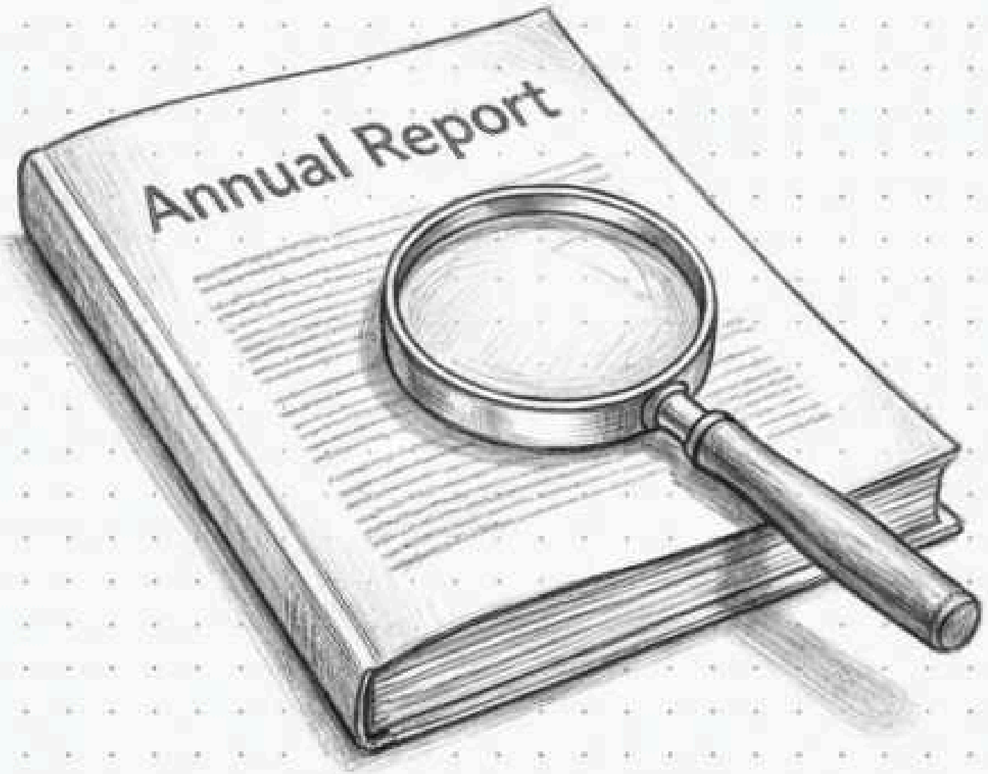


Analysts look at multi-year trends and separate one-off items from ongoing results.

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Next Steps: Field Work

¶ 3.13



- [ ] Locate Revenue
- [ ] Calculate Gross Profit
- [ ] Calculate Operating Profit
- [ ] Identify Net Income

Check investor education pages of national regulators (e.g., American SEC) for guides on reading financial statements.

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¶ 3.14

Closing Exercise: Year Two

Year 2 Inputs: Revenue: $30k, COGS: $18k, Op Exp: $7k, Int/Tax: $1.5k

Revenue

− COGS

= Gross Profit: ?

− Operating Expenses

= Operating Profit: ?

− Interest & Taxes

= Net Income: ?

Next up in Lecture 4:
We follow the cash.

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