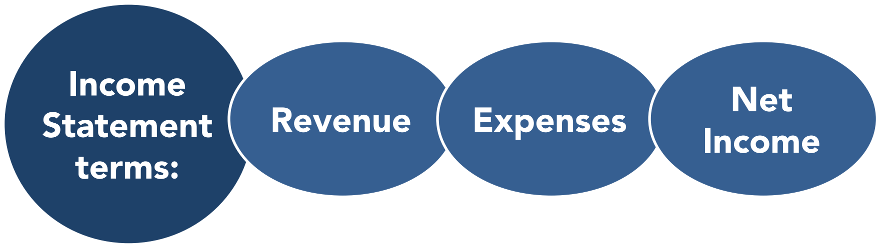
A Sample Simple Income Statement

This sample simple income statement covers a twelve-month period for 'Suzy's Signs,' a one-person business that designs signage. It details the amount of revenue and expense that comes in and goes out of the organization without distinguishing between operating and non-operating items.



The income statement uses three terms that can be defined as:

- **Revenue**—incoming assets in return for sold goods or services.
- **Expenses**—outgoing assets or liabilities incurred.
- **Net Income**—the difference between Revenue and Expenses. This shows whether you are generating a profit or you are operating at a loss.

In our example, Suzy runs her own design agency called Suzy's Signs. She works from her home office and offers a design service for customers who need a sign for their business premises. The design is done according to a brief supplied by the customer.

Once the design has been approved, Suzy obtains quotes for its manufacture from three suppliers. She then sends the design and the quotes to the customer including her invoice for the total number of hours spent on this design, based on an hourly rate of $45.

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The following table gives you an example of what a simple income statement would look like for Suzy Sign's.

Suzy's Signs Income Statement	**Jan 1—Dec 31**	
	$	**$**
Revenue (Design)		8,000
Less Expenses:		
Travel	420	
Stationery	140	
Telephone	80	
Broadband	120	
Miscellaneous	25	
Expenses Total	785	
Net Profit Before Tax		**7,215**

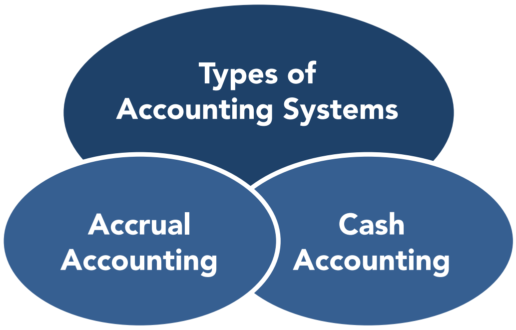
The net profit or loss is the difference between the income received and all of the costs paid out. In this case Suzy has made a profit for the year of $7,215.

She may need this information to give to the tax authorities or she could use it to compare this year's performance to last year's, or even to her expectations at the beginning of the year.

As simple as this document is, there are some practical issues that it raises. For example:

> *Suzy sends out an invoice in December, but it has not been paid by 31 December.*
>
> *What does she do?*
>
> *Should the invoice amount appear on the statement or not, and does it matter?*

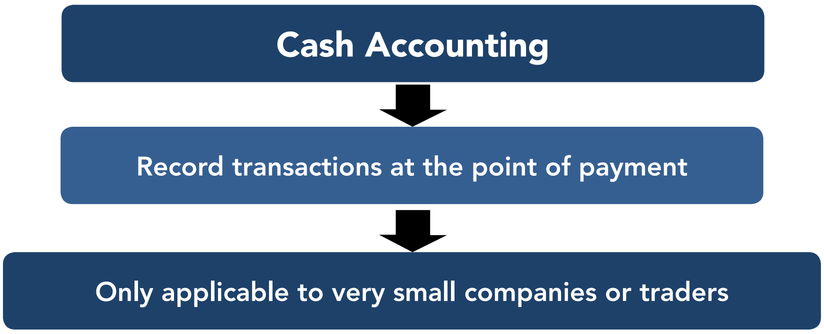
The answer to this question depends on the type of accounting that Suzy is using. There are two types, known as 'cash accounting' and 'accrual accounting.'



The practical implications of each type for your organization are explained in the next sections using our example of Suzy's Signs.

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. As a small business, Suzy has the option of 'cash accounting,' which means that she only needs to record transactions at the point of payment. In other words when the money leaves or is paid into her bank account.



So referring back to Suzy's query:

> ***If her December invoice is not paid until the following January, then she does not need to enter it on the income statement for this period.***

> ***Similarly, if she received a bill in December (for example a phone bill) but she does not pay it until January, then that amount will not appear either.***

ISBN 978-1-62620-953-4

Accounting rules stipulate that, with few exceptions, businesses should not use this method but should prepare their accounts on the 'accrual' basis. However, it is acceptable for very small companies to use the cash accounting method. In Suzy's case, cash accounting confers two advantages.

1. It reflects exactly what she has in her bank account.
2. It helps her cash flow.

Whilst the first point is obvious, the second point needs some explanation.

> ***In November and December Suzy raised invoices for $2,500 worth of work, which she is awaiting payment for.***
>
> ***Under the cash accounting rules, she does not have to declare this income during the period and she will not have to pay any tax due on it until the end of the next accounting period (the period when the money will actually be paid into her account).***
>
> ***This is counterbalanced by the fact that she cannot include any expenses. For example, her December telephone bill cannot be included until she has actually paid it, irrespective of the date on the invoice.***

Suzy's business has relatively low expenses and because her clients can be slow to pay, cash accounting is probably the best option for her to use. By using cash accounting, she will only be paying tax on money she has actually received. It is also straightforward: if she uses a tax adviser, she could simply give him her checkbook and bank statements and he could calculate her tax liability from those two things alone.

KEY POINTS

- ✔ Under cash accounting rules, transactions are recorded at the point of payment.
- ✔ Very small businesses and traders can use cash accounting.
- ✔ It reflects exactly what the business has in its bank account and can help with cash flow.

The Limitations of Cash Accounting

In cash-based accounting, expenses are not recorded until they have been paid, which means that there is nowhere on the books to show unpaid bills.

Limitations of Cash Accounting method:

- Nowhere to show an organization's 'unpaid bills'
- No accurate historical trend is produced
- No allowance is made for major purchases or asset acquisition

These limitations can create serious problems if the business is much more complex than Suzy's Signs. In fact, cash-based accounting can create a situation that leads to insolvency while reporting that the organization is making a profit.

When an organization is termed 'Insolvent' it means:

> ***The inability of a debtor to pay their debt and can result from either cash flow insolvency or balance sheet insolvency.***

The definitions of these two types of insolvency are:

- **Cash flow insolvency** involves a lack of funds to pay debts as they fall due.
- **Balance sheet insolvency** involves having negative net assets. In other words, the business owes to others more than it has in assets including the money that it is owed.

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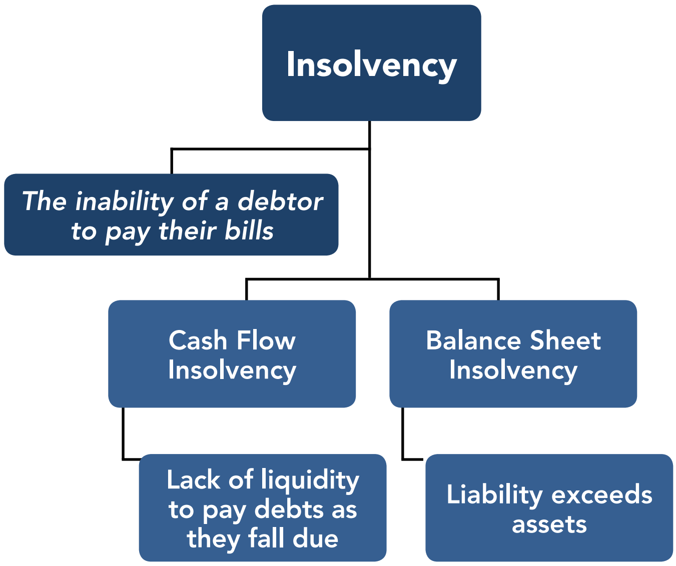
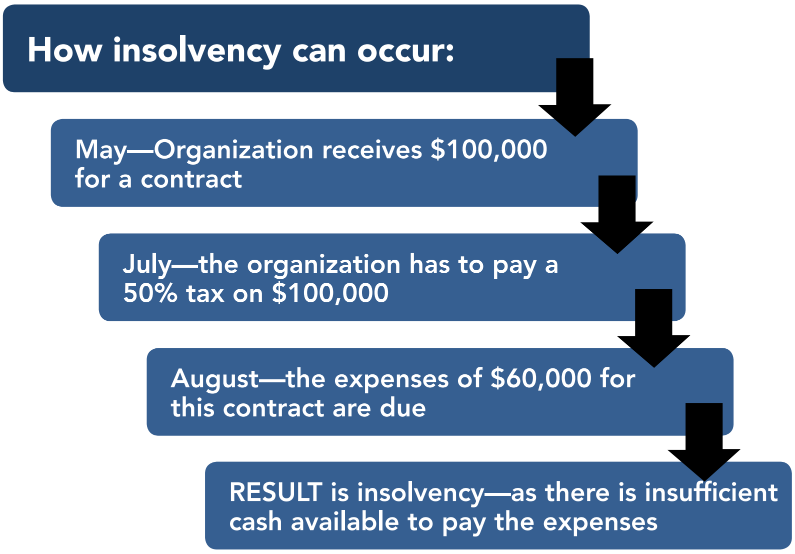


Many people confuse bankruptcy with insolvency and it is important to understand the difference.

> ***An organization may be cash flow insolvent but balance sheet solvent if it holds assets that it cannot turn into cash if it needs to do so.***
>
> ***Conversely, an organization can have negative net assets showing on its balance sheet but still be cash flow solvent if ongoing revenue is able to meet debt obligations, and thus avoid default. (Many large corporations operate permanently in this state.)***
>
> ***Bankruptcy is not the same as insolvency. It is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency.***

To illustrate why cash-based accounting can lead to insolvency, imagine an organization that receives income prior to completion of the job, but where major costs are not paid out until after completion. This could lead to a situation where the organization receives say $100,000 in sales for the period, but most of the associated costs (say $60,000) do not appear on the income statement for that period.

Consequently, the income statement shows a profit for the period, which is overstated by the $60,000 in as yet unpaid costs. The organization is then taxed on this notional profit. Several weeks later, the $60,000 expenses need to be paid, but there is no cash available because it has already been paid out in tax. The organization is now insolvent.



This is a very simple example, but in many organizations there may be large amounts of money flowing through the business and profits may appear to be high. As time goes by, cash deficits accumulate year after year and with the unpaid expenses not recorded, the cash-based income statement will report that the business is profitable even though it may be insolvent.

Another problem with cash-based accounting is that it does not create an accurate historical trend of business operations. This is because transactions are recorded only when cash changes hands. It does not (as a rule) represent the sale date of goods or services. Major purchases or other asset acquisitions can also distort the picture.

This can be illustrated using the Suzy's Signs example and looking at her first three years income statement figures, shown in the table below. These cash-based net profit figures appear to show a steady growth year on year. But to fully understand her growth you need to know more about her costs.

Cash Accounting	
	Net Profit Before Tax
Year 1	6,500
Year 2	7,000
Year 3	7,300

What these figures are unable to show are:

- **Her set-up costs**—including office furniture, computer, printer, and stationery. These were allocated to her first year, even though she is still getting the benefit of these things in years two and three.
- **Her outstanding invoices**—by the end of her third year this amounts to $4,000. This is a substantial amount given the size of her business and yet it does not appear anywhere in the accounts.

In order to overcome the problems associated with cash-based accounting, most organizations use an alternative system called accrual accounting and this is dealt with next.

KEY POINTS

- ✔ The main limitations of cash accounting are that: there is nowhere to show 'unpaid bills'; there is no way of seeing any historical trend in the figures; and no allowance is made for major purchases or asset acquisition.
- ✔ Cash-based accounting can create a situation that leads to insolvency while reporting that the organization is making a profit.