Financial Accounting 101

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Exercises with Solutions

Lesson 2: The Income Statement (“P&L”)

*Note: don’t worry too much if your answers aren’t worded exactly like these. These answers are probably more exact and detailed than what I’d expected from someone who is just seeing this stuff for the first time. I made my answers detailed and “precise” because I want to get you thinking analytically about these concepts, because they will play into what you learn in future lessons.*

1. How would you define revenue?

Revenue is the total amount of money that a business earned selling its goods or services over a given period, before any expenses are taken out.

1. What’s another word for revenue?

*Sales*, *sales revenue*.

1. How would you define an expense?

Expenses are the costs a business incurs as it produces and sells its product to earn revenue.

1. How would you define net income?

The amount of money earned by the firm, “net” of (i.e., after) expenses.

Net income = revenue – expenses

Net income is also known as *net profit*, or *net earnings*

1. What, above all, is the income statement’s purpose? (“To show the company’s net income” is generally not a sufficient answer. What is someone who picks up the income statement trying to understand about the company?)

A business’s job is to earn more money than it costs to run. Another way of thinking about it is that the business must earn more in sales than it costs to generate those sales. The income statement tells us the extent to which it does this.

1. Why would a potential investor want to see the income statement?

An investor “buys into” a company (contributes capital) so she can earn dividends/distributions, which are just her slice of that company’s net income. If the company isn’t producing sufficient net income, there won’t be any money to pay the investor.

(The investor can also make money by selling her share(s) for more than she paid. But even in this case, to sell it at a higher price usually means that the person they sell it *to* must believe that *they* can make money from the company’s income. So it’s very difficult to make money in *either* of these strategies if the company isn’t producing earnings. Therefore, an investor wants to know that they’re buying into a profitable company, otherwise they won’t want to invest.)

1. Why would a potential creditor (e.g., a bank whom the company has asked for a loan) want to see the income statement?

A creditor lends money to the company, expecting to get back:

1. The original (*principal*) amount, and
2. *Interest* on that amount (that’s how creditors make their profit)

A company’s ability to pay back principal and interest depends on its ability to sell its goods for more than it costs to produce them.

1. What is the cost of goods sold expense?

The *cost of goods sold* is what it cost the company to produce the physical goods it sold to customers, including raw materials, parts, and labor. (If the company doesn’t actually produce its own goods, but instead purchases them from *another* company, then the *cost of goods sold expense* would be what they paid the *other* company to acquire them.)

1. What is the selling, general, and administrative expense?

*This is a “catch-all” term that encompasses all expenses that aren’t directly related to producing the firm’s core product or service. SG&A refer to the firm’s \*For example, a*

1. What is the research and development expense?

*This is the cost incurred by the company to come up with new products (or improve existing ones).*

1. What is the interest expense?

This is the cost of borrowing money. The firm must pay back the principal—the amount they originally borrowed—plus an additional amount, called *interest*. Interest is typically determined as a percentage of the outstanding principal amount.

1. Below is information given on Queen Industries, for the year ending 2017 (dollar amounts in thousands):

**Selling, general and administrative expenses 13,000**

**Research and development expense 7,500**

**Sales revenue 80,000**

**Total expenses [Missing]**

**Cost of goods sold expense 42,000**

**Pretax income [Missing]**

**Net income [Missing]**

**Interest expense 400**

**Tax expense 6,000**

* 1. First, reorder the items so they appear as they come in an income statement, and in proper formatting.

**Sales revenue 80,000**

**Cost of goods sold expense 42,000**

**Selling, general and administrative expenses 13,000**

**Research and development expense 7,500**

**Interest expense 400**

**Total expenses [Missing]**

**Pretax income [Missing]**

**Tax expense 6,000**

**Net income [Missing]**

* 1. Second, solve for the missing values.

**Sales revenue 80,000**

**Cost of goods sold expense 42,000**

**Selling, general and administrative expenses 13,000**

**Research and development expense 7,500**

**Interest expense 400**

**Total expenses 62,900**

**Pretax income 17,100**

**Tax expense 6,000**

**Net income 11,100**