A Simple Model

Income Statement

NOTES TO ACCOMPANY VIDEOS

These notes are intended to supplement the videos on ASimpleModel.com. They are not to be used as stand-alone study aids, and are not written as comprehensive overviews of the topic detailed. The purpose of these notes is to provide a tangible collection of the visuals used in the videos with comments highlighting the more important aspects covered.

This video introduces the income statement. The video starts by showing the income statement in its most concise format as pictured below.

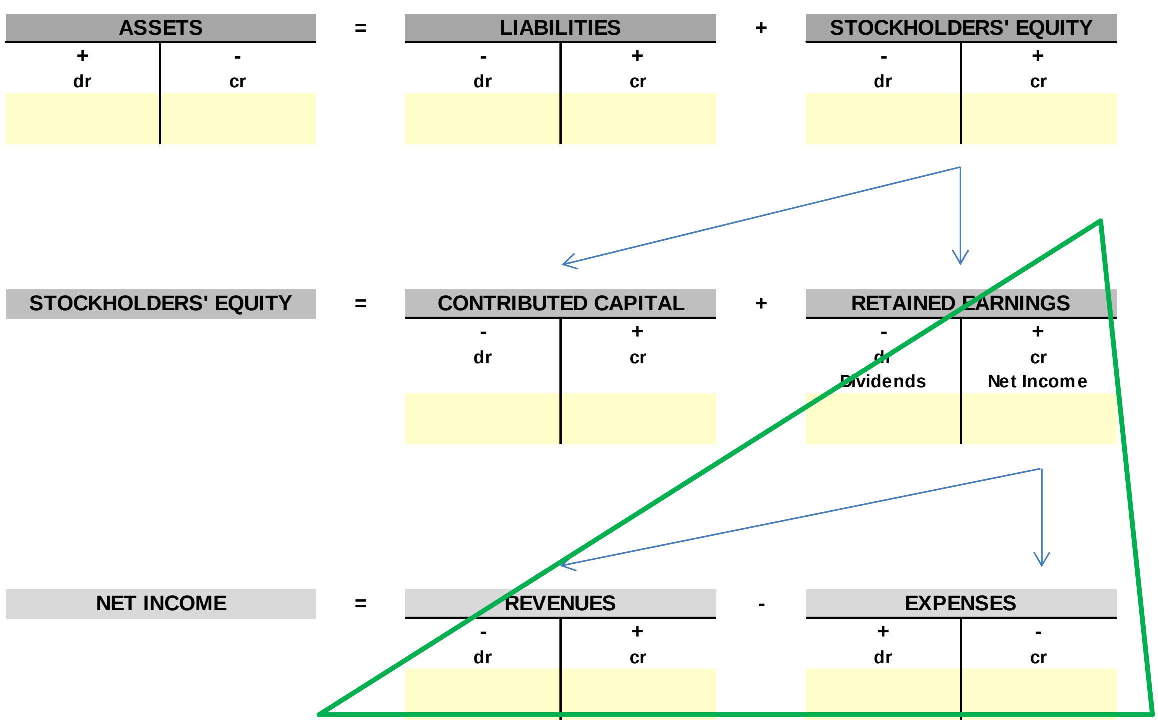
Income Statement

INCOME STATEMENT	20X1	20X2
Revenue	74,452	83,492
Growth (%)	*NA*	*12.1%*
Expenses	72,434	80,925
Margin (%)	*97.3%*	*96.9%*
Net Income	**2,018**	**2,567**

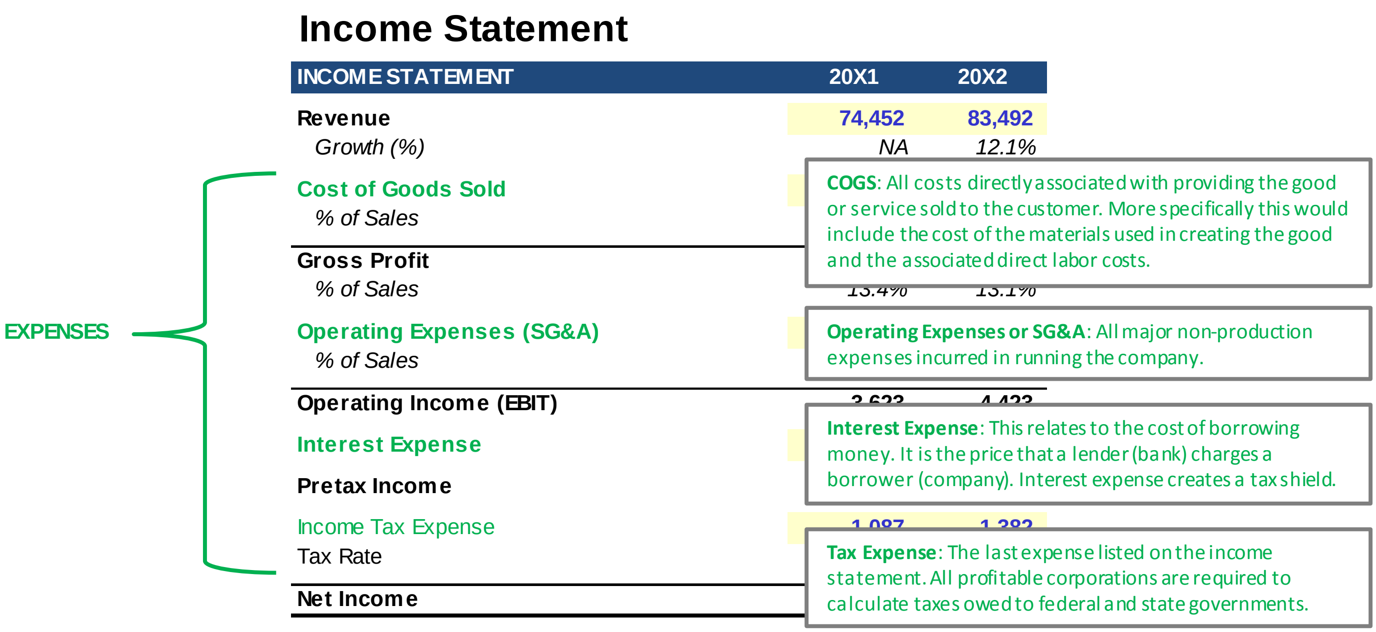
Measure of profitability of the firm over a specified time period.

Measure of success in selling a good or service.

After this introduction the accounting equation is revisited to help illustrate how the balance sheet and income statement relate to one another. The most significant relationship here is that stockholders' equity grows with net income.



The video then elaborates on the various categories of expenses found on the income statement. The text has been included below as a reference.



NOT MENTIONED IN VIDEO: The text under interest expense concludes stating that interest expense creates a tax shield. This is not elaborated upon in the video, but tax shields (interest expense is not the only tax shield) are important and will be referenced in future videos.

For the time being, all that is important is that interest expense is deducted from net income before tax expense is calculated, which results in a lower tax burden (tax shield).

On this tab the video focuses on the difference between operating income (or EBIT) and net income. The reason for making this distinction is that expenses that do not relate to the core operation of the business come after EBIT.

For this reason the gross profit margin and EBIT margin are more commonly referenced in analysis detailing a companies operations and profitability.

Income Statement

INCOME STATEMENT	20X1	20X2
Revenue	74,452	83,492
Growth (%)		
Cost of Goods Sold		
% of Sales		
Gross Profit		
% of Sales		
Operating Expenses (SG&A)		
% of Sales		
Operating Income (EBIT)		
Interest Expense		
Pretax Income	3,105	3,949
Income Tax Expense	1,087	1,382
Tax Rate	*NM*	*NM*
Net Income	2,018	2,567

EXPENSES

Operating Income vs. Net Income

Operating Income is calculated by subtracting expenses related to the core operation of the business.

Net Income is calculated by subtracting additional expenses unrelated to the core operation of the business.

Continuing with measures of profitability, the video then references EBITDA. EBITDA is an acronym that stands for Earnings Before Interest, Taxes, Depreciation and Amortization.

It is generally not found on a company's income statement, but it is commonly referenced in most financial models because it is frequently used in determining the value of a company.

Income Statement

INCOME STATEMENT	20X1	20X2
Revenue	74,452	83,492
Growth (%)	[illegible]	[illegible]
Cost of Goods Sold	[illegible]	[illegible]
% of Sales	[illegible]	[illegible]
Gross Profit	[illegible]	[illegible]
% of Sales	[illegible]	[illegible]
Operating Expenses (SG&A)	[illegible]	[illegible]
% of Sales	[illegible]	[illegible]
Operating Income (EBIT)	[illegible]	[illegible]
Interest Expense	[illegible]	[illegible]
Pretax Income	3,105	3,949
Income Tax Expense	1,087	1,382
Tax Rate	*NM*	*NM*
Net Income	2,018	2,567
Operating Income (EBIT)	3,623	4,423
Depreciation	2,648	2,981
Amortization	0	0
EBITDA	6,271	7,404

EBITDA is frequently used in determining the value of a company.

EBITDA is an acronym that stands for **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization.

EBITDA

The objective of the income statement is then revisited to point out two important accounting concepts:

1. The Matching Principle
2. Depreciation

Objective of the Income Statement

(Defined & Simplified)

The objective of the income statement is to demonstrate how successful a company is at selling a good or service.

Matching Principle
Matching revenue generated by the sale of a good or service with the expense of providing that good or service in the same accounting period.
The matching principle requires that the cost incurred in generating revenues be recognized in the same period. (REGARDLESS OF WHEN CASH IS PAID)

Depreciation
The allocation of the cost of tangible assets (property, plant or equipment) over multiple accounting periods representing the useful life of the tangible asset.

Because the matching principle requires that expenses be recorded when revenue is recognized, the video then details the four conditions required to recognize revenue.

Matching Principle Relies on Revenue Recognition

Revenue Principle	
1	**Delivery has occurred or services have been rendered.**
2	**There is persuasive evidence of an arrangement for customer payment. This can be cash or a promise to pay cash at a future date (accounts receivable).**
3	**The price must be fixed or determinable.**
4	**Collection is reasonably assured. The company must review the customer's ability to pay.**

Another important relationship to keep in mind as you build financial models is that the cash flow statement starts with net income.

The video demonstrates this relationship with the visual pictured below, and then by showing this link in a fully integrated financial model.

The Cash Flow Statement Starts with Net Income

INCOME STATEMENT	20X1	20X2
Revenue		
Expenses		
Net Income	**0**	**0**

CASH FLOW STATEMENT	20X1	20X2
CASH FLOW FROM OPERATING ACTIVITIES		
Net Income	**0**	**0**
Add Back Non-Cash Items		
Depreciation		
Amortization		
Changes in Working Capital		
Accounts Receivable		
Inventory		
Accounts Payable		
Net Cash Provided by Operating Activities		
CASH FLOW FROM INVESTING ACTIVITIES		
Capital Expenditures - Purchase of PP&E		
Net Cash Used in Investing Activities		
CASH FLOW FROM FINANCING ACTIVITIES		
Revolving Credit Facility (Line of Credit)		
Long Term Debt		
Net Cash Provided by (Used in) Fnce Activities		
Net Cash Flow		
Beginning Cash Balance		
Ending Cash Balance		

> Net income is derived from accounting rules and accruals, and does not equate to the actual cash earnings realized in the accounting period.

The video concludes by highlighting the difference between an accrual basis of accounting and a cash basis of accounting.

Accrual vs. Cash Basis of Accounting

(Defined & Simplified)

ACCRUAL BASIS of Accounting

Revenue	**Recognized when earned. (Revenue Principle)**
Expenses	**Recognized when incurred. (Matching Principle)**

CASH BASIS of Accounting

Revenue	**Recorded when cash is received. (Cash Receipts)**
Expenses	**Recorded when cash is paid. (Cash Payments)**