



UNICOURSE

Unit 1: Introduction to the course

Information Pack

Techniques for presenting accounting information: Income Statement

What is in income statement?

An income statement is a financial statement that shows you how profitable your business was over a given reporting period. It shows your revenue, minus your expenses and losses.

Also sometimes called a “net income statement” or a “statement of earnings”, the income statement is one of the three most important financial statements in financial accounting, along with the balance sheet and the cash flow statement (or statement of cash flows).

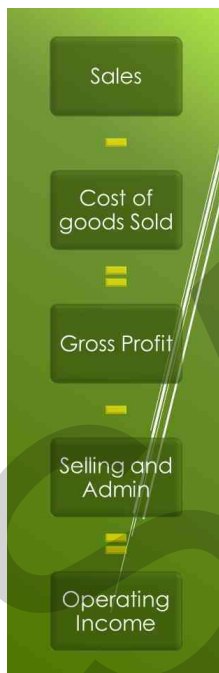
Small businesses typically start producing income statements when a bank or investor wants to see how profitable their business is.

When a business makes an income statement for internal use only, they will sometimes refer to it as a “profit and loss statement” (or P&L).

Absorption Cost Income Statement

The traditional income statement, **also called absorption costing income statement**, uses absorption costing to create the income statement. This income statement looks at costs by dividing costs into product and period costs. In order to complete this statement correctly, make sure you understand product and period costs.

The traditional format for this kind of income statement usually consists of;



A template for this in the assignment has been provided.

A complete income statement may look like this;

Price	\$	100.00
Direct Materials	\$	20.00
Direct Labor	\$	15.00
Variable Overhead	\$	9.00
Variable Selling	\$	5.00
Fixed Overhead	\$	48,000.00
Fixed Selling & Admin	\$	112,000.00
Units Produced		10,000
Units Sold		8,000

Calculating the Cost per unit

When doing an income statement, the first thing I always do is calculate the cost per unit. Under absorption costing, the cost per unit is direct materials, direct labour, variable overhead, and fixed overhead. In this case, the fixed overhead per unit is calculated by dividing total fixed overhead by the number of units produced (see [absorption costing post](#) for details).

	Absorption
Direct Materials	\$ 20.00
Direct Labor	\$ 15.00
Variable Overhead	\$ 9.00
Fixed Overhead	\$ 4.80
	<hr/>
	\$ 48.80

Once you have the cost per unit, the rest of the statement is easy to complete. All variable items are calculated based on the number of units sold. This includes sales, cost of goods sold, and the variable piece of selling and administrative expenses. The matching principle states that we must match revenue with expenses. Therefore, we can only expense the cost of the units that are sold. The units that are not sold end up in inventory.

Example of Calculating the Sales

Start with sales. Take your price per unit and multiply it by the number of units sold.

$$\text{Sales} = \text{Price} \times \text{Number of units sold}$$

$$\text{Sales} = \$100 \times 8,000$$

$$\text{Sales} = \$800,000$$

Sales	\$	800,000
Less: Cost of Goods Sold		<hr/>
Gross Profit		
Less: Selling and Administrative		<hr/>
Operating Income		<hr/>

Marginal Costing Income Statement

The marginal cost of an item is its variable cost. The marginal production cost of an item is the sum of its direct materials cost, direct labour cost, direct expenses cost (if any) and variable production overhead cost. So as the volume of production and sales increases total variable costs rise proportionately.

Fixed costs, in contrast are cost that remain unchanged in a time period, regardless of the volume of production and sale.

Marginal production cost is the part of the cost of one unit of production service which would be avoided if that unit were not produced, or which would increase if one extra unit were produced.

From this we can develop the following definition of **marginal costing** as used in management accounting:

Marginal costing is the accounting system in which variable costs are charged to cost units and fixed costs of the period are written off in full against the aggregate **contribution**.

Note that variable costs are those which change as output changes - these are treated under **marginal costing** as costs of the product. Fixed costs, in this system, are treated as costs of the period.

Marginal costing is also the principal **costing** technique used in decision making. The key reason for this is that the **marginal costing** approach allows management's attention to be focussed on the changes which result from the decision under consideration.

The contribution concept

The **contribution** concept lies at the heart of **marginal costing**. **Contribution** can be calculated as follows

Contribution = Sales price - Variable costs

The idea of profit is not a particularly useful one as it depends on how many units are sold. For this reason, the **contribution** concept is frequently employed by management accountants

- **Contribution** gives an idea of how much 'money' there is available to 'contribute' towards paying for the overheads of the organisation.
- At varying levels of output and sales, **contribution** per unit is constant.
- At varying levels of output and sales, profit per unit varies.
- **Total contribution = Contribution per unit x Sales volume.**
- **Profit = Total contribution - Fixed overheads**

marginal costing income statement

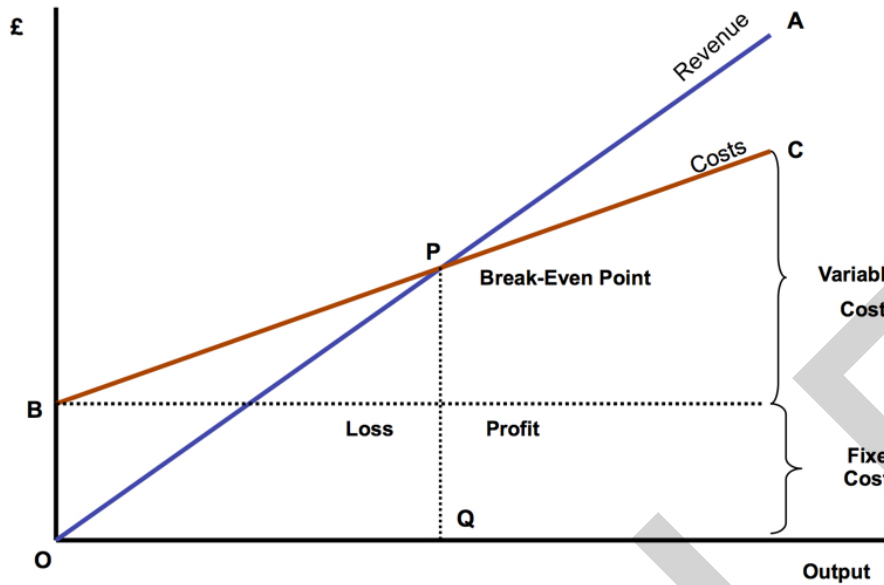
	\$	\$
Sales		X
Less Cost of sales:		
Opening inventory	X	
Variable cost of production	X	
Less Closing inventory	(X)	
	—	
		(X)
		—
Less Other variable costs		X
Contribution		(X)
Less fixed costs		X
		(X)
		—
Profit/loss		X
		—

- **Valuation of inventory** - opening and closing inventory are valued at marginal (variable) cost under **marginal costing**.
- The **fixed costs** actually incurred are deducted from **contribution** earned in order to determine the profit for the period.

The first assignment for this unit entails an activity in which you are given information and you must compile two income statements:

To aid in doing so I thought I would create a key of information for you to refer to for each of the fields contained within both the statements.

- Sales revenue – Total income from sales
- Marginal cost of sales - **Marginal cost** refers to the increase or decrease in the **cost** of producing one more unit or serving one more customer. It is also known as incremental **cost (direct materials, direct labour, variable production overheads variable distribution and admin expenses)**.
- Contribution – money available to contribute towards the overheads
- Fixed costs – costs that remain the same no matter how many units are produced ie, rent, salaries, insurance etc.
- Variable costs – costs that change depending on the number of units produces, ie raw material.
- Net Profit – indicates a company's **profit** after all of its expenses have been deducted from revenues.
- Gross Profit - **Gross profit** refers to a company's **profits** earned after subtracting the costs of producing and distributing its products
- Break Even Point - The **breakeven point** is the level of production at which the costs of production equal the revenues for a product. Often interpreted using a graph to display the number of units sold and the cost of producing that number of units as you can see from the diagram below.



The break-even point is a useful tool as it indicates to an organisation how many units need to be sold before a profit can be made. In the above diagram you can see the fixed costs at a straight line, this is because they remain the same no matter how many units are produced. The variable costs are highlighted with the red line and you can see the more units produced the higher the variable costs. The red line "B" you can see starts at the point where the dotted line (fixed costs) starts. This is because the red line is total costs both fixed and variable. The blue line in this diagram represents the money earned from sales (revenue). As you can see the point in which the two lines cross is where sales revenue and total costs are equal, hence breaking even.

For the second part of the activity you will be creating your own break-even chart like the one above. For the scenario organisation.

To do this you may want to use excel. And begin to plot the data into a table first. The image below shows what your table could look like in terms of headings and I have placed the first unit of data in for you as an example. You will need to carry on this table until you reach the break even point for the organisation, for the month of September set in the scenario.

Variable cost per unit (£)	Sale Price (£)	fixed costs (£000's)	Units sold (000's)	Sales Revenue (£000's)	Variable cost (£000's)	Total Cost (£000's)
15	10	210	0	0	0	210
		210	1	25	15	225

Figure 4 Sample Break even table



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