Exercise walk-through

Income statements ▪ 5.3

eXercise

You must be able to

- explain what an income statement shows
- calculate gross profit and the profit for the year
- explain how stakeholders use the income statement

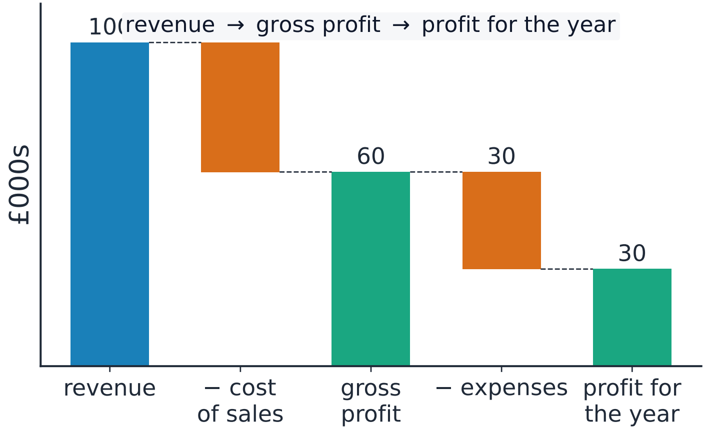
Method — Reading an income statement

$$\text{gross profit} = \text{revenue} - \text{cost of sales} \qquad \text{profit for the year} = \text{gross profit} - \text{expenses}$$

- **Worked:** revenue \$200,000, cost of sales \$120,000 $\rightarrow$ gross profit $= \$80{,}000$; expenses \$50,000 $\rightarrow$ profit for the year $= \$30{,}000$.
- **Stakeholders use it:** owners check the profit, lenders check their loans are safe, managers spot problems.

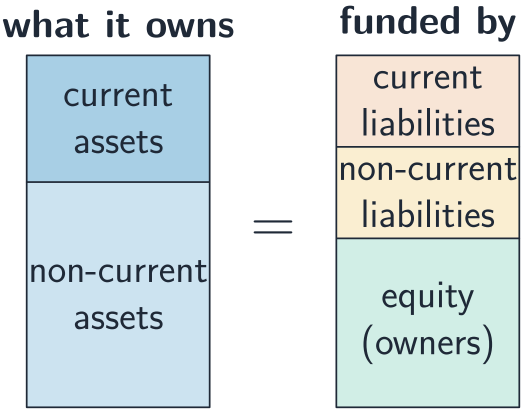
Answer shapes: K + App + An + Ev (a justified judgement, for “do you think” questions).

Method — Reading an income statement



The income statement steps down from revenue to the profit for the year

Method — Reading an income statement



The two sides always balance: assets equal liabilities plus equity

Practice 2.1 ▪ 2 marks

Define the term *gross profit*.

Solution 2.1

Method: Reading an income statement

Worked steps

revenue minus the cost of sales (the cost of making or buying the goods sold) (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

A business has revenue of \$150,000 and cost of sales of \$90,000. Calculate the gross profit.

Solution 2.2

Method: Reading an income statement

Worked steps

$\$150{,}000 - \$90{,}000 = \$60{,}000$ (2; award 1 for a correct method with the wrong figure).

Practice 2.3 ▪ 2 marks

State one stakeholder who would use an income statement, and why.

Solution 2.3

Method: Reading an income statement

Worked steps

any one stakeholder + reason: owners — to check the profit; lenders — to check their loan is safe; managers — to spot problems (2 for stakeholder + reason; 1 for stakeholder only).

Exam-style 3.1 ▪ 2 marks

From the gross profit of $60,000, expenses of $40,000 are taken. Calculate the profit for the year.

Solution 3.1

Method: Reading an income statement

Worked steps

$\$60{,}000 - \$40{,}000 = \$20{,}000$ (2; award 1 for a correct method with the wrong figure).

Exam-style 3.2 ▪ 6 marks

Explain two reasons why a business prepares an income statement.

Solution 3.2

Method: Reading an income statement

Worked steps

[6] For **each** of two reasons: K 1 + An up to 2 — e.g. *show profit*: it tells owners how much profit was made → they judge the firm's success. *Find problems*: comparing with last year shows if costs are rising → managers can act. Maximum 3 each.

Exam-style 3.3 ▪ 6 marks

A business's gross profit is high but its profit for the year is low. Do you think this is a serious problem? Justify your answer.

Solution 3.3

Method: Reading an income statement

Worked steps

[6] Both sides + judgement. **Yes (serious):** a high gross profit but low final profit means **expenses** (rent, wages, advertising) are very high → little is left for the owners, and the firm is vulnerable if sales fall. **Not always:** if the firm is investing in growth (e.g. marketing), high expenses now may raise future profit. **Judgement (Ev):** it is a warning sign worth investigating, but whether it is serious depends on *why* expenses are high — wasteful spending is a real problem, planned investment may not be.