Yale SCHOOL OF MANAGEMENT

MGT 402: Basics of Accounting

Income Statement

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Fall 1 2025

Class 3

Last class: Balance Sheet

- **Assets:**
  - **Owned or controlled** by the firm
  - Expected to generate **future benefits**
  - Result of **past** transaction or exchange
  - Must be **measured reliably**

- **Liabilities:**
  - Future economic **obligation**
  - Result of **past** transaction or exchange
  - Must be **measured reliably**

- **Equity = Assets – Liabilities**

Balance Sheet

XX/XX/20XX

Assets: economic resources	**Liabilities: economic obligations**
Cash	
Inventory	**Shareholders' Equity:**
Property, Plant & Equipment	Paid-in-Capital
Land	
…	Retained Earnings

Assets = Liabilities+ Equity

Today’s agenda

How do we measure Income?

- Cash vs. Accrual Accounting
- Revenue Recognition
- Expense Recognition

Income Statement:

- reports the **profit earned during a period of time**.
- period of time? the time passed between two balance sheet dates

Income Statement	
	Revenues and Gains made in a fiscal period
-	Expenses and Losses for the same fiscal period
	Net Income (Loss)

Net Income connects Income Statement and Balance Sheet

Balance Sheet

Assets = Liabilities + Shareholder's Equity

Current assets
+
Long-term assets

Current liabilities
+
Long-term liabilities

Paid-In Capital
+
Retained Earnings (RE)
+
Accumulated Other Comprehensive Income (AOCI)

Income Statement

Revenues – Expenses + Gains – Losses = Net Income (Loss)

RE at the beginning of fiscal period
+ Net Income (Loss)
- **Dividends Declared**
= RE at the end of fiscal period

Netflix: Income Statement

Expenses related to revenue generation of Netflix

NETFLIX, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

Companies will report last 3 years

		Year ended December 31,		
		2024	**2023**	**2022**
"Top line"	Revenues	$ 39,000,966	$ 33,723,297	$ 31,615,550
	Cost of revenues	21,038,464	19,715,368	19,168,285
	Sales and marketing	2,917,554	2,657,883	2,530,502
	Technology and development	2,925,295	2,675,758	2,711,041
	General and administrative	1,702,039	1,720,285	1,572,891
	Operating income	10,417,614	6,954,003	5,632,831
	Other income (expense):			
	Interest expense	(718,733)	(699,826)	(706,212)
	Interest and other income (expense)	266,776	(48,772)	337,310
	Income before income taxes	9,965,657	6,205,405	5,263,929
	Provision for income taxes	(1,254,026)	(797,415)	(772,005)
"Bottom line"	Net income	$ 8,711,631	$ 5,407,990	$ 4,491,924

Expenses NOT related revenue generation of Netflix

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Handout: Most Common Items in Balance Sheet and Income Statement

Handout from Class 1 (also on Canvas) could be useful reference when reading FS

Cash vs. Accrual Accounting

- **Cash Basis Accounting** records revenue when cash is **received** and records expenses when cash is **paid**

- **Accrual Basis Accounting** [mandated by US GAAP, IFRS, other GAAPs] requires recording revenue when **earned** and expenses when **incurred**, <u>regardless of the timing of cash receipts or payments</u>

Accrual accounting is an attempt to measure **firm performance** in a particular period regardless of when cash is exchanged

Cash vs. Accrual can make a big difference

Evans H. Inc., signed an agreement to construct a garage for $22,000.

- In January: Evans H. Inc. begins construction, incurs cost of $18,000 on credit, and by end of January delivers a finished garage to buyer.
- In February: Evans H. Inc. collects $22,000 cash from customer.
- In March: Evans H. Inc. pays $18,000 that was due to creditors.

Required:

Prepare income statements for January, February, and March under cash and accrual basis.

Cash Basis Accounting records revenue when cash is received and records expenses when cash is paid

Accrual Basis Accounting [mandated by US GAAP, IFRS, other GAAPs] requires recording revenue when earned and expenses when incurred, regardless of the timing of cash receipts or payments

Income Statement

What is revenue?

Income Statement
Revenues and Gains made in a fiscal period
- Expenses and Losses for the same fiscal period
Net Income (Loss)

What is revenue?

- **FASB:** Revenue is an **increase in net assets** (not necessarily cash) in the period between two balance sheet dates from delivering goods or services (i.e., from operating activities)

  Net Assets = Assets – Liabilities
- Revenue is also an increase in Retained Earnings

Two important issues:

- Timing of revenue recognition
- Measurement of revenue

Revenue recognition: Timing

Revenue is recognized when the following conditions are met:

1. **Earned** - the seller has completed its duties under the sales agreement
   Did I do the work?

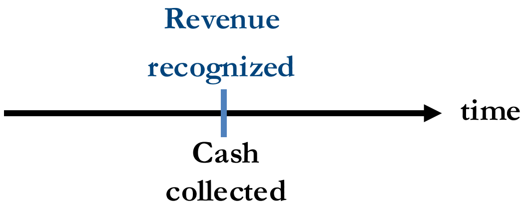
2. **Realized or realizable** – the seller receives an asset or satisfies a liability as a result of the transaction or event
   Can I collect cash? (now or at some future point)

For most businesses, these conditions are met at the point of delivery of goods and services, regardless of when cash is received

Example for Blue State Coffee:

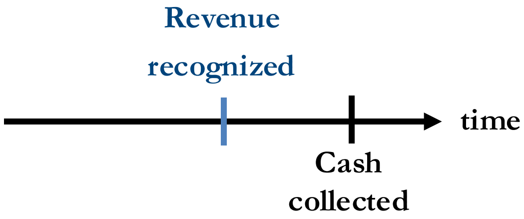
sell coffee vs. sell a gift card

Revenue recognition: Timing



- **Revenue is recognized when cash is collected**

  Cash(+A) ↑ Revenue(+R, +SE) ↑

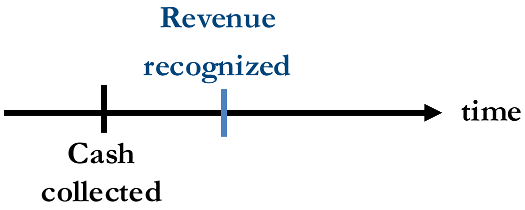


- **Revenue is recognized before cash is received**
  - At the point of revenue recognition:

    Accounts Receivable (+A) ↑ Revenue(+R, +SE) ↑
  - At the point of cash collections:

    Cash(+A) ↑ Accounts Receivable (-A) ↓

McKinsey & Company



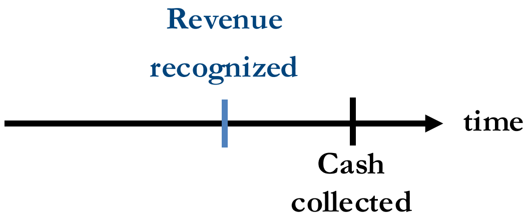
- **Cash is collected before revenue is recognized**
  - At the point of cash collection:

    Cash (+A)↑ Deferred Revenue (+L) ↑
  - At the point of revenue recognition:

    Deferred Revenue (-L) ↓ Revenue(+R, +SE) ↑

Revenue recognition: Measuring amount

- when **Accounts Receivable (+A) ↑ and Revenue(+R, +SE) ↑**



- US GAAP: In the end of the period, the company must **estimate** the amounts of uncollectible amounts, sales discounts & returns and reduce revenue accordingly

- **Uncollectible accounts** have no value by definition and are not included in revenue

- more on this in the next weeks!!!

How much revenue to recognize in December?

1. Best Buy delivers $500,000 worth of washing machines in December to customers who don't have to pay until in January next year. **$500,000**

2. Tyco collects $300,000 cash in December for toy sales made in October. **$0**

3. Audubon leases space to a tenant for the months of December and January for $20,000, all of which is paid for in cash in December. **$10,000**

4. Peoplesoft issues 20,000 shares of stock in December and receives $10 per share, which is $2 per share more than they expected. **$0**

Income Statement

What is an expense?

Income Statement
Revenues and Gains made in a fiscal period
- **Expenses** and Losses for the same fiscal period
Net Income (Loss)

What is an expense?

- **FASB:** Expense is a **decrease in net assets** (can be decrease in assets or increase in liabilities) in the period between two balance sheet dates from providing goods or services (i.e., from operating activities)

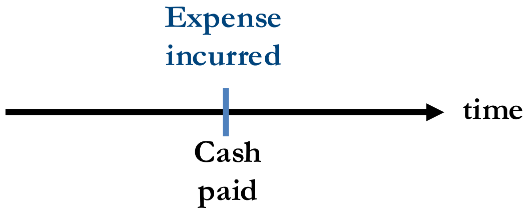
  Net Assets = Assets – Liabilities
- Expense is also a decrease in Retained Earnings

- **Matching Principle for expenses:**
  - Recognize expenses in same period as associated revenue
  - If it is difficult to match to revenue specifically, then expense in the period **incurred**

<u>Two types of expenses:</u>

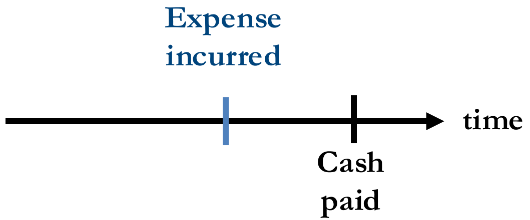
- **Product costs** - in the same period when related revenues are recognized (i.e., cost of goods sold)
- **Period costs** - in the same period when these costs produce benefits (i.e., rent)

Expense recognition



- **Expense is incurred when cash is paid**

  Cash (-A) ↓ Expense(+E, -SE) ↑



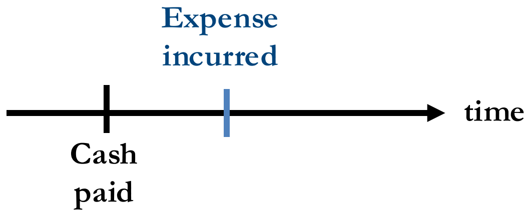
- **Expense is incurred before cash is paid**
  - At the point when expense is incurred:

    Accrued Expense (+L) ↑ Expense(+E, -SE) ↑
  - At the point of cash payment:

    Cash(-A) ↓ Accrued Expense (-L) ↓

accrued wages

interest



- **Cash is paid before expense is incurred**
  - At the point of cash payment:

    Cash (-A) ↓ Non-cash asset (+A) ↑
  - At the point when expense is incurred:

    Non-cash asset (-A) ↓ Expense(+E, -SE) ↑

pre-paid rent

insurance

depreciation

How much expense to recognize in December?

1. GM sells cars costing $8,000,000 in December for $15,000,000. **$8,000,000**

2. GM incurs $180,000 in salaries for its marketing staff in December. **$180,000**

3. GM pays a public relations consultant $50,000 in December for services to be rendered in December and January. **$25,000**

4. GM pays $1,200,000 in cash dividends in December. **$0**

Income Statement

What are gains and losses?

Income Statement

Revenues and **Gains** made in a fiscal period

\- Expenses and **Losses** for the same fiscal period

Net Income (Loss)

Revenues and Expenses vs. Gains and Losses

Revenues – Expenses + Gains – Losses = Net Income (Loss)

– **Revenues & Expenses**: **inflows & outflows of assets** from delivering or producing goods, rendering services, or other activities that constitute **the entity's ongoing major or central operations.**

– **Gains & Losses: increases & decreases** in equity (net assets) from **peripheral or incidental transactions** of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues/expenses or investments/distributions by owners.

- Example gain: Macy's, a department store chain, sold stores with a net book value of $10m and the proceeds were $12m
- Example loss: Merck settled the Vioxx litigation and paid $4.9bn

Whether an item is a gain/loss or revenue/expense depends on the business model

Cash vs. Accrual accounting

	Only Tracking Cash	**Accrual Accounting (mandated under GAAP)**
Easy to learn and use?	Intuitive and easy	Requires effort to learn and master (**you are acquiring this skill now**)
Measure performance accurately?	Can be volatile and detached from underlying; more so over short horizon	Matches revenues and expenses; Better measures performance
Estimates by preparers?	No	Yes. Requires estimates and judgements, such as impairment tests, bad debt expenses
Possible manipulation?	Subject to manipulation through the timing of cash payments/receipts	Subject to manipulation through estimates

Key takeaways

- **Accrual Accounting** [mandated by GAAP] requires recording revenue when **earned** and expenses when **incurred**, regardless of the timing of cash receipts or payments
- **Revenue** is recognized when it is earned, and collectability is reasonably assured
- **Expenses** are matched to revenue or recognized periodically

Next class

- **Assignment: Understanding income statement assignment**
  - **Due:** to be uploaded on Canvas before the class starts

- **Agenda: Transaction Analysis**