Case Study: Income Statement

by Sophia

WHAT'S COVERED

This lesson will cover the preparation of an income statement in the context of a case study, using a hypothetical business.

Our discussion breaks down as follows:

1. Case Study: Legacy Realty

The subject company for our case study is called Legacy Realty. Legacy Realty is a sole proprietorship, which is a type of company that is owned by one single individual, and where that individual and the business are legally treated as the same.

The purpose of Legacy Realty as a business is to own, lease, and manage its own rental properties. It purchases houses and condominiums and leases them out to tenants. They also perform their own management of their units, making repairs, performing maintenance, and collecting rent. Legacy Realty is located in Washington DC, and they have a small staff of five people.

Legacy Realty	
Type of company	Sole proprietorship
Business purpose	Own, lease, and manage rental properties
Business location(s)	Washington, D.C. Staff of 5 people

Legacy Realty needs an income statement to provide information about a business's profitability, informing about the health or strength of the business, over one year or less of activity. This is important so that Legacy Realty can analyze the inflows and outflows within their business, which is critical information for potential investors and banks, as well as for the owners themselves.

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2. Case Study: Income Statement

So, where do we start when we need to prepare an income statement? Well, we start with the trial balance worksheet, specifically the adjusted trial balance, shown below.

As you can see, we've prepared the trial balance, listing all of the general ledger accounts, as well as their corresponding debit and credit balances. We've also prepared the adjustments and adjustment explanations, making corrections to the accounts to match all revenues and expenses with the correct period. We've also corrected any errors or omissions may have been made.

Using this information, we have also prepared the adjusted trial balance, accounting for all of those adjustments that were made. Similar to the trial balance, the adjusted trial balance is a listing of all of the general ledger accounts, as well as the corresponding debit or credit balances within those accounts.

This adjusted trial balance is going to be the source for the financial statements, containing all the information needed to create those statements for Legacy Realty.

	Trial Balance		Adjustments		Adjusted Trial Balance	
Accounts	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	63,000				63,000	
Accounts Receivable	10,000				10,000	
Supplies	5,000			2,500 (a)	2,500	
Prepaid Insurance	12,000			6,000 (b)	6,000	
Buildings	500,000				500,000	
Land	50,000				50,000	
Accumulated Depreciation - Buildings				15,000 (c)		15,000
Accounts Payable		5,000		25,000 (e)		30,000
Unearned Revenue				10,000 (d)		10,000
Notes Payable		300,000				300,000
Retained earnings, 1/1/12		200,000				200,000
Owner's Drawing	10,000				10,000	
Revenue		600,000	10,000 (d)			590,000
Salaries Expense	325,000		25,000 (e)		350,000	
Repairs Expense	50,000				50,000	
Advertising Expense	10,000				10,000	
Rent Expense	50,000				50,000	
Interest Expense	20,000				20,000	
Depreciation Expense - Buildings			15,000 (c)		15,000	
Insurance Expense			6,000 (b)		6,000	
Supplies Expense			2,500 (a)		2,500	
Totals	1,105,000	1,105,000	58,500	58,500	1,145,000	1,145,000

Adjustments Explanation

(a) Adjust Supplies used

(b) Adjust Insurance incurred

(c) Record Depreciation Expense

(d) Correct incorrect Revenue recognition

(e) Accrue Salaries Expense

Now that we've got our adjusted trial balance, we can begin to prepare the income statement. The first part of the income statement is the heading, which includes the business's name, Legacy Realty Partners, "Income Statement," and that important phrase, "For the period ending December 31, 2012."

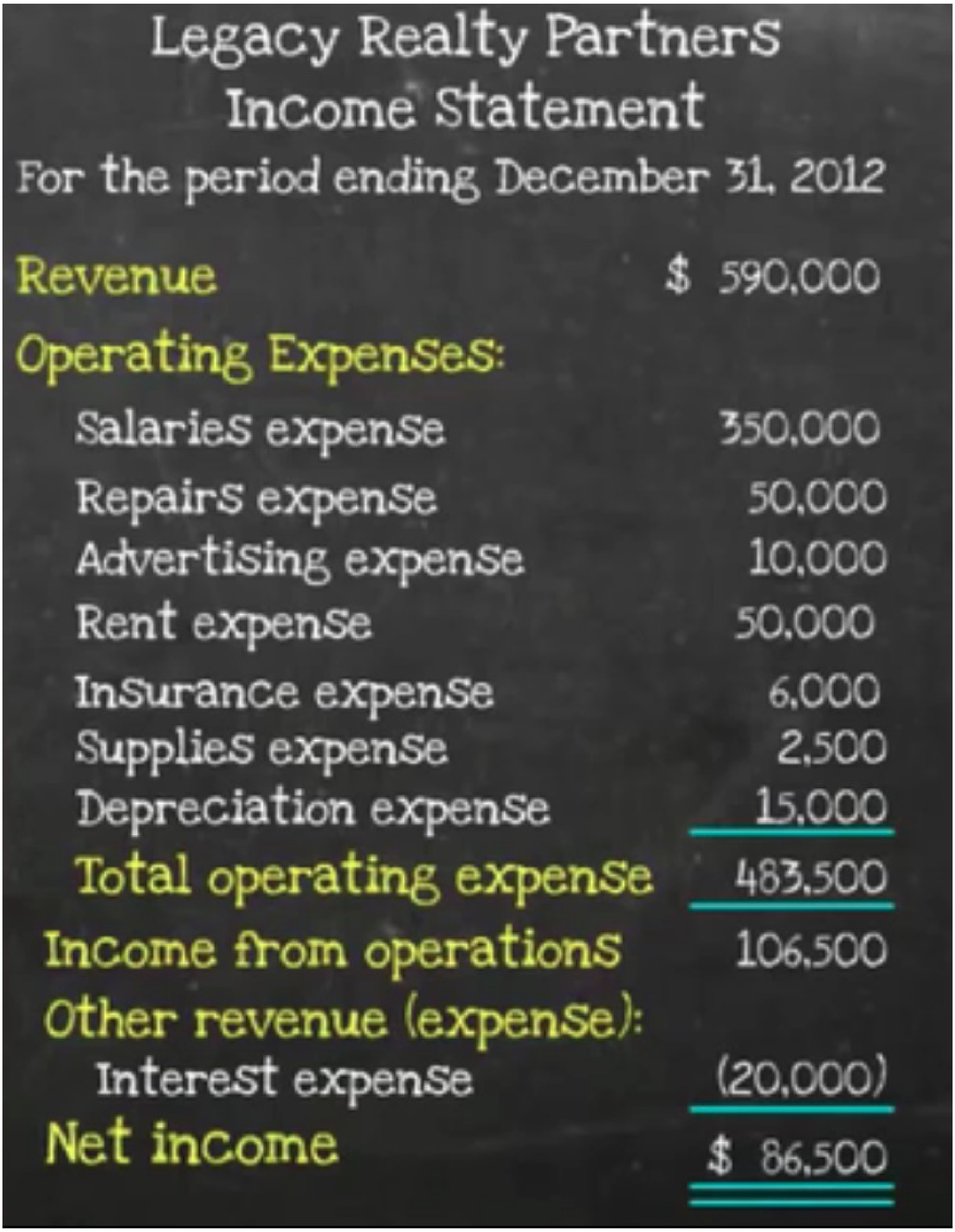
Now, referring back to the adjusted trial balance, do you think we need the information from all of these accounts to prepare the income statement? No, we don't need the permanent accounts--the assets, liabilities, and equity. All we need are the revenue and expense accounts, which are the temporary accounts.

Accounts	Adjusted Trial Balance Dr.	Cr.
~~Cash~~	~~63,000~~	
~~Accounts Receivable~~	~~10,000~~	
~~Supplies~~	~~2,500~~	
~~Prepaid Insurance~~	~~6,000~~	
~~Buildings~~	~~500,000~~	
~~Land~~	~~50,000~~	
~~Accumulated Depreciation - Buildings~~		~~15,000~~
~~Accounts Payable~~		~~30,000~~
~~Unearned Revenue~~		~~10,000~~
~~Notes Payable~~		~~300,000~~
~~Retained earnings, 1/1/12~~		~~200,000~~
~~Owner's Drawing~~	~~10,000~~	
Revenue		590,000
Salaries Expense	350,000	
Repairs Expense	50,000	
Advertising Expense	10,000	
Rent Expense	50,000	
Interest Expense	20,000	
Depreciation Expense - Buildings	15,000	
Insurance Expense	6,000	
Supplies Expense	2,500	
Totals	**1,145,000**	**1,145,000**

We start with revenue, then input all of the operating expenses: salaries, repairs, advertising, rent, insurance, supplies, and depreciation. This provides the total operating expenses.

Next, we calculate a subtotal of what is called income from operations. This represents the operating income.

We add in other revenue or expense items, which in this case is the interest expense. We subtract the interest expense from the income from operations, to arrive at the total net income of $86,500.



Legacy Realty Partners
Income Statement
For the period ending December 31, 2012

Revenue		$ 590,000
Operating Expenses:		
Salaries expense		350,000
Repairs expense		50,000
Advertising expense		10,000
Rent expense		50,000
Insurance expense		6,000
Supplies expense		2,500
Depreciation expense		15,000
Total operating expense		483,500
Income from operations		106,500
Other revenue (expense):		
Interest expense		(20,000)
Net income		$ 86,500

SUMMARY

Today we introduced our **case study** company called **Legacy Realty**, that is in the business of owning and leasing their own rental properties. We walked through an **example of preparing an income statement** for Legacy Realty, starting with the adjusted trial balance and pulling information from the revenue and expense accounts to create the income statement.

Source: Adapted from Sophia instructor Evan McLaughlin.