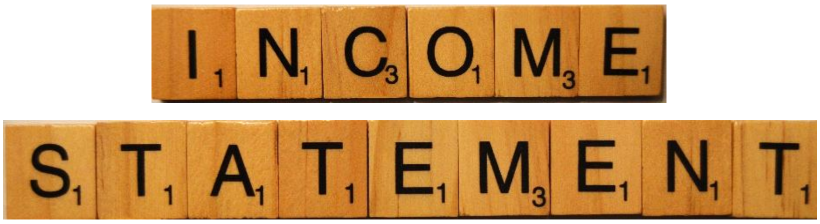
.Dott
Risk
**Reducing Your Risk Guide**




# Income Statement Risk Guide

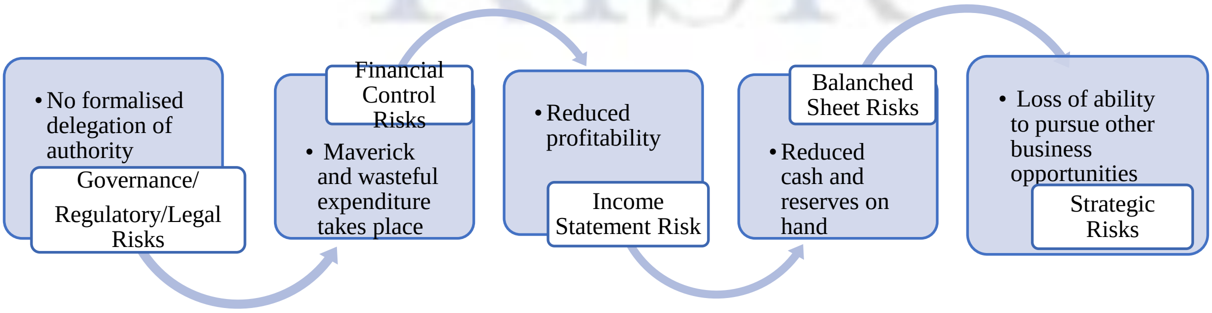
## What is this risk area?

The risks of falling profitability as a result of revenue or income not keeping pace with the rate of the growth in expenses, or as a result of the contraction of profit margins or as a result of being faced with unexpected or unanticipated expenses.

## Where does this risk area emanate from?

This risk arises from operational mismanagement, a lack of financial control, debtor/credit extension, socio-economic factors, regulatory non-compliance or crime event.

## Example of Income Statement Risk interconnectedness to other risk areas:




## Where does this risk area manifest itself?

This risk results in a material financial loss or loss of profitability due to a reduction in revenue and/or an increase in expenditure or write-offs, an impact on the cash resources and a weakening of the balance sheet of the organisation.

## Why is it important to manage these risks?

The income statement is the reflection of the revenue, expenditure and profitability of the organisation. It provides details of the revenue mix, profit margins and total expenditure incurred in the operations. Managing each of these aspects is integral to the survival of the organisation.

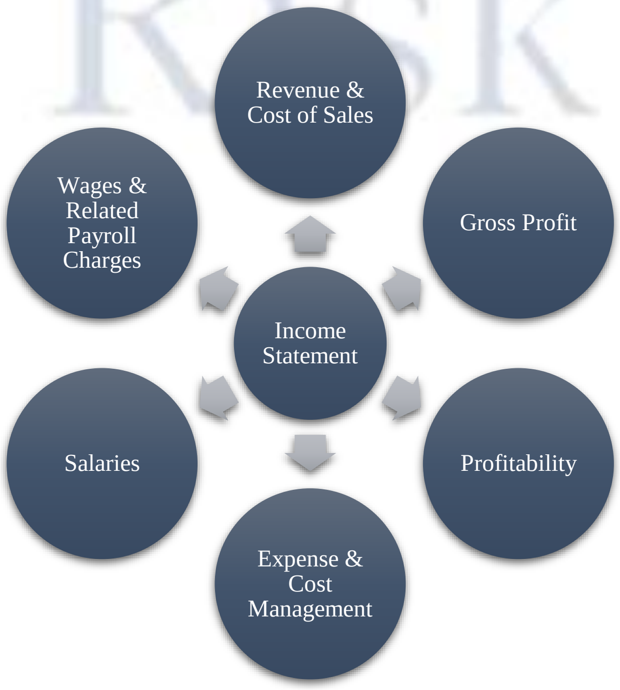
## Where to start managing this risk area?

Income statement risk management typically starts with the owners and managers and their accountants doing a review of all the key elements of the income statement. This will require a critical analysis of trends in both revenue and expense items. The key drivers of both revenue and expenses need to be reviewed. Gross and net profit levels then need to be examined in the context of return on investment and cash flow generation. Budgets, revenue and expenditure then need to be focused on around specific strategic objectives.

## What is the benefit of actively managing this risk area?

Effective risk management of the income statement will ensure that the organisation makes deliberate and conscious decisions about the products and services it sells, the pricing of the services or products and the level and extent of the expenses incurred in the production of the revenue or income.

DottRisk has the following detailed risk guides covering what we believe are the critical areas for the management of the income statement and profitability of the organisation:



## Introduction to Income Statement Risk

An income statement is the reflection of the financial performance of a business over a specific accounting period. It shows how a business accrues its revenue and how it incurs its expenses from both operational and non-operating activities. Also known as the profit and loss statement or the statement of revenue and expense, the income statement primarily focuses on the company's revenues and expenses during a particular period. Income statements come with various monikers. The most commonly used terms are "statement of income," "statement of earnings," "statement of operations" and "statement of operating results." The terms "profits," "earnings" and "income" all mean the same thing and are used interchangeably.

In a high-level simplistic way, the income statement shows how money came in and how it went out.

- The Income statement starts with the revenue which a company makes by selling products or services to its customers. As revenue is reflected at the top of the income statement, it is also known as the top line for a company.
- Other than revenue, the income statement consists of all other items that lead to the net income of a company which is reflected at the bottom. That's why net income is also known as the bottom line of a company. All the expense items are deducted from the revenue of the company to arrive at the net income.
- The line items in between consist of the cost of goods sold in order to manufacture or produce those goods. Revenue less cost of goods sold equates to Gross Profit.
- Costs also include marketing, selling, general & administration expenses.
- The line item that comes next is depreciation which is also part of the balance sheet.
- Other items which are deducted to arrive at net income are interest expenses and taxes paid/payable.

The income statement basic equation can be presented as Revenue less Expenses = Net Profit

It must be remembered that the income statement measures profitability, not cash flow.

Two basic formats for the income statement are used in financial reporting presentations – the multi-step and the single-step. These are illustrated below in two simple examples:

| **Multi-Step Format** | **Single-Step Format** |
|---|---|
| Net Sales | Net Sales |
| Cost of Sales | Materials and Production |
| Gross Income* | Marketing and Administrative |
| Selling, General and Administrative Expenses (SG&A) | Research and Development Expenses (R&D) |

| | |
|---|---|
| Operating Income* | Other Income & Expenses |
| | |
| Other Income & Expenses | Pre-tax Income |
| Pre-tax Income* | Taxes |
| Taxes | Net Income |
| Net Income (after tax)* | -- |

## Revenue, Cost of Sales, Gross Profit

At the heart of the income statement of any organisation is the revenue or gross income. Revenues need to be robust and sustainable for a business to be able to survive. Potential disruptions to revenue need to be anticipated where possible. These can come about as a result of seasonality, supply chain breakdowns, political events, natural disasters, pandemics and other socio-economic events. Revenues should be consistent and largely predictable if cash flow and expenses are to be managed and costs covered.

The revenue of an organisation needs to be continually monitored and managed. Impacts on revenue can be rapid, permanent, slow or of a temporary nature and this needs to be identified as early as possible.

As important as the sales or revenue figure is the actual cost of these sales. This figure is the direct cost associated with the corresponding level of sales or income. The level of the cost of sales relative to the sales or revenue figure is going to dictate the level of gross profit. It is thus possible to reduce the level of sales revenue or gross income, and by decreasing the corresponding direct cost of sales, increase gross profit.

Gross profit is the profit an organisation makes after deducting the costs associated with making and selling its products, or the costs directly associated with providing its services.

True profitability is only realised when the inflow of cash from sale of goods or the provision of services exceeds the outflow of cash associated with the sales made or services rendered and expenses incurred.

## Profitability, Expense and Cost Management

The gross profit from your core trading operations and activities is going to largely dictate whether a net profit is ultimately made or not. The level and extent of your cost of goods sold or the cost of manufacturing relative to selling prices will determine the level of gross profit. Gross profit needs to be sufficient to cover overall operating expenses in order to ensure a net profit is made.

In order to manage expenses and costs, a detailed understanding of your expenses and their behaviour is required. Expenditure or operating expenses can be categorised as direct or indirect, fixed or variable. In some instances, you get expenses that are semi-variable. You need to analyse all your expenses and have a clear understanding of the mix and nature of them i.e. are they fixed, variable or semi-variable.

Each of the key elements of the income statement will have a material impact on the ultimate net income e.g. sales/revenue, cost of raw materials, profit mark up, general operating expenses, interest charges, salaries and wages, extraordinary items, contingent liabilities etc. As such, they each have to be monitored and managed to ensure that an acceptable net profit will be achieved.

Understanding how overheads grow and the relationship of expenses to each other as a result of increases or decreases in turnover or revenue, business activity and volumes, is essential. If a business wants to achieve scale it needs to clearly understand the nature of its expenses, which expenses are largely fixed and where its sales break-even levels are.

## Salaries, Wages and Related Payroll Charges

Salaries and wages comprise a significant component of the expense base of most businesses or organisations and as such require specific focus and management. They along with statutory deductions, also need to be paid on specific dates and form part of contractual and compliance obligations with employees and authorities.

If the organisation is committed to paying increases, commissions, bonuses or thirteenth cheques, both profitability and cash resources must be sufficient to meet these and the related statutory deductions. Getting caught on an ever escalating roller-coaster of salary and wage costs can be a recipe for disaster if revenues and profitability are not growing at the same rate.