

Income Statement

(Cheat Sheet)

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Income Statement

The income statement is also known as the *statement of income*, *statement of operations*, *statement of earnings*, *profit and loss statement*, and *P&L*. It reports a corporation's *revenues*, *expenses*, *gains*, *losses*, and the resulting *net income* that occurred during the period of time shown in the heading of the income statement. The period of time or time interval could be a year, quarter, five months, one month, 52 weeks, 4 weeks, etc.

If the corporation's shares of common stock are publicly traded, the earnings per share of common stock must also appear on the face of the income statement.

As with all of the external financial statements, the notes to the financial statements are to be referenced on the face of the income statement.

Generally Accepted Accounting Principles

In the U.S., an income statement that is distributed to someone outside of the corporation must comply with *generally accepted accounting principles* (referred to as GAAP or US GAAP). US GAAP includes basic underlying concepts such as the cost principle and matching principle to some very complex accounting standards developed by the Financial Accounting Standards Board (FASB).

As a result of US GAAP, a corporation's income statement will be prepared using the accrual method of accounting (as opposed to the cash method). Under the accrual method, revenues will be included on the income statement in the period in which they are earned (which often occurs sooner than the receipt of cash). The accrual method also means that expenses will appear on the income statement when they best match the revenues or when a cost expires or is used up (instead of when the cash is paid out).

Double-entry accounting also means that the income statement is connected to the balance sheet. For example, the net income from the income statement will be an increase to the Retained Earnings reported on the balance sheet.

Components or Elements of the Income Statement

1. Revenues

- *Operating revenues* such as the sale of goods by a retailer or services provided by a law firm
- *Nonoperating revenues (or other income)*, which are amounts earned but which are outside of the corporation's main activities. An example is interest income that is earned by a retailer when it invests its idle cash.

2. Expenses

- *Operating expenses* such as the cost of goods sold, selling and administrative expenses
- *Nonoperating expenses (or other expenses)*, which are amounts incurred but which are outside of the corporation's main activities. An example is the interest expense incurred by a retailer.

3. Gains

- An example is the *Gain on Sale of a Plant Asset* which results from *selling* a plant asset for more than the asset's book value.

4. Losses

- An example is the *Loss on Sale of a Plant Asset* which results from selling a plant asset for less than the asset's book value.

The net result of these components is a corporation's net income or net earnings.

Format of Income Statement

Accounting textbooks often present two types of income statement formats:

- *Multiple-step*. This format has more than one subtraction before displaying the company's net income. The following is a condensed version of a multiple-step income statement:

XYZ Corporation	
Income Statement	
For the Year Ended December 31, 2020	
Sales	\$400,000
Cost of goods sold	<u>310,000</u>
Gross profit	90,000
Selling, general and administrative expenses	<u>50,000</u>
Operating income	40,000
Other income (expense)	
Interest expense	<u>(3,000)</u>
Net income before tax	\$37,000

- *Single-step.* This format has only one subtraction before displaying the company's net income. In other words, *all revenues* (operating and nonoperating) minus *all expenses* (operating and nonoperating) equals net income. The following is a condensed version of the single-step income statement:

XYZ Corporation	
Income Statement	
For the Year Ended December 31, 2020	
Revenues	
Sales	<u>\$400,000</u>
Expenses	
Cost of goods sold	310,000
Selling, general and admin expenses	50,000
Interest expense	<u>3,000</u>
	<u>363,000</u>
Net income before tax	\$ 37,000

Cost of Goods Sold

The cost of goods sold is likely the largest expense on the income statement of a retailer or manufacturer. Since the amount is very significant it is important that the proper costs are matched with the sales revenues.

On the internal financial statements of a retailer, the cost of goods sold might be presented in one of two ways:

1. The cost of goods sold could be calculated as the cost of the beginning inventory *plus* the cost of its net purchases *minus* the cost of the ending inventory:

Beginning inventory	\$ 50,000
Add: Net purchases	<u>320,000</u>
= Cost of goods available	370,000
Less: Ending inventory	<u>60,000</u>
= Cost of goods sold	\$310,000

2. The cost of goods sold could be calculated as the cost of the net purchases *minus the increase* in the cost of the company's inventory:

Net purchases	\$320,000
Less: Inventory increase	<u>10,000</u>
Cost of goods sold	\$310,000

The logic is that not all of the goods that were purchased were sold. Some of the purchases (having a cost of \$10,000) were added to inventory.

Note:

If the ending inventory was \$35,000 the cost of goods sold would be presented as the cost of the net purchases plus the \$15,000 decrease in the cost of the company's inventory (beginning inventory of \$50,000 vs. ending inventory of \$35,000):

Net purchases	\$320,000
Add: Inventory decrease	<u>15,000</u>
Cost of goods sold	\$335,000

The logic is that the company not only sold all of the goods it had purchased in the accounting period, but it also sold part of its inventory having a cost of \$15,000.

Gross Profit

Gross profit is the remainder of a company's *net sales* minus its *cost of goods sold*. Gross profit is often expressed as a dollar and as a percentage of net sales. It is also known as *gross margin*.

Selling, General and Administrative (SG&A) Expenses

Selling, general and administrative (SG&A) expenses are a company's operating expenses (along with the cost of goods sold). SG&A expenses are not considered to be product costs and therefore they are *not* inventoriable costs. Rather, SG&A expenses are considered to be expenses of the accounting period.

Inventory Cost Flow Assumptions

When inventory items are purchased at different unit costs during the year, a company must elect a cost flow assumption. In the U.S. the options are 1) first costs in are the first costs out (first-in, first-out or FIFO), 2) last costs in are first costs out (last-in, first-out or LIFO), 3) average costs, 4) specific identification, and others. The inventory systems could be periodic or perpetual. Hence, the combination of the cost flow assumptions and the system used can result in differing amounts for the cost of goods sold, gross profit, net income, taxable income, and income tax expense.

Notes to the Income Statement

In addition to the amounts appearing on the face of the income statement, there needs to be a reference such as "See notes to the financial statements." or "The accompanying notes are an integral part of the financial statements." The notes to the financial statements are especially important because a corporation's net income is dependent on the accounting policies regarding inventory, depreciation, revenue recognition, and more. There may also be some potential losses that are looming, but have not yet been finalized. Hence, the notes will disclose this and other important information pertinent to the income statement and the other financial statements.