The Income Statement

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WHAT'S COVERED

In this lesson, you will learn about elements of an income statement that aid valuation. Specifically, this lesson will cover:

1. The Income Statement

The **income statement** is the financial statement responsible for informing past performance, forecasting future performance, and evaluating the organization's ability to produce future profits. It has also been referred to as a statement of operations, profit and loss statement, or the statement of earnings.

The income statement consists of revenues and expenses, along with the resulting net income or loss over a period of time due to earning activities. **Net income**, or the "bottom line," is the result after all revenues and expenses have been accounted for. The income statement reflects a company's performance over a period of time. This is in contrast to the balance sheet, which represents a single moment in time.

XYZ Retailers

Income Statement

For the year ended 30 June 2011

REVENUE	$	$
Sales		250,000
Cost of Goods Sold		
Opening inventories (as at 1 July 2010)	40,000	
Add purchases	100,000	
Add freight-in and customs duty	10,000	
Less closing inventory (as at 30 June 2011)	60,000	
Less Cost of Goods Sold		90,000
Gross Profit		160,000
Add other operating revenue		
Rent received	3,000	
Commission received	2,000	
Total Revenue		165,000
LESS OTHER OPERATING EXPENSES		
Selling & Distribution expense		
Advertising	5,000	
Public Relations	2,000	
Website marketing	7,500	
General and Administrative expenses		
Depreciation	10,000	
Electricity	1,500	
Insurance	1,000	
Rent expense	30,000	
Wages & salaries	46,500	
Financial expenses		
Bad debts	1,500	
Total expenses		105,000
NET PROFIT (EBIT)		60,000

The most common means of constructing the income statement is with the single step method. This involves calculating all revenues for the period, and then calculating and subtracting all expenses for the period in order to arrive at the net income.

The more complex multi-step income statement (as the name implies) takes several steps to find the bottom line. First, operating expenses are subtracted from **gross profit**. This yields income from operations. Then, other revenues are added and other expenses are subtracted. This yields income before taxes. The final step is to deduct taxes, which finally produces the net income for the period measured.

TERMS TO KNOW

Income Statement

A calculation which shows the profit or loss of an accounting unit during a specific period of time, providing a summary of how the profit or loss is calculated from gross revenue and expenses.

Net Income

Gross profit minus operating expenses and taxes.

Gross Profit

The difference between net sales and the cost of goods sold.

1a. Operating Revenues and Expenses

The operating section includes revenue and expenses. Revenue consists of cash inflows or other enhancements of the assets of an entity. It is often referred to as gross revenue or sales revenue. Expenses consist of cash outflows or other using-up of assets or incurrence of liabilities.

Elements of expenses include:

- *Cost of Goods Sold (COGS)*: the direct costs attributable to goods produced and sold by a business. It includes items such as material costs and direct labor.
- *Selling, General and Administrative Expenses (SG&A)*: combined payroll costs, except for what has been included as direct labor.
- *Depreciation and amortization*: charges with respect to fixed assets (depreciation) and intangible assets (amortization) that have been capitalized on the balance sheet for a specific accounting period.
- *Research & Development (R&D)*: expenses included in research and development of products.

1b. Non-Operating Revenues and Expenses

The non-operating section includes revenues and gains from:

- Non-primary business activities, such as rent or patent income
- Expenses or losses not related to primary business operations, such as foreign exchange losses
- Gains that are either unusual or infrequent, but not both
- Finance costs (costs of borrowing), such as interest expense
- Income tax expense

In essence, if an activity is not a part of making or selling the products or services, but still affects the income of the business, it is a non-operating revenue or expense.

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2. Reading the Income Statement

Certain items must be disclosed separately in the notes if it is material (significant). This could include items such as restructurings, discontinued operations, and disposals of investments or of property, plant and equipment. Irregular items are reported separately so that users can better predict future cash flows.

In viewing an income statement, the last line, net income, is often referred to as the bottom line. This is what remains after all expenses have been subtracted from revenue. This number is important to investors in order to determine the profit that is available to shareholders at the end of the year.

For companies with shareholders, earnings per share (EPS) are also an important metric and are required to be disclosed on the income statement.

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3. Limitations of the Income Statement

Income statements are a key component to valuation but have several limitations stemming from estimation difficulties, reporting error, and fraud.

Limitations include:

- Items that might be relevant but cannot be reliably measured are not reported, such as brand loyalty

- Some figures depend on accounting methods used
- Some numbers depend on judgments and estimates

One of the limitations of the income statement is that income is reported based on accounting rules and often does not reflect cash changing hands. This could be due to the matching principle, which is the accounting principle that requires expenses to be matched to revenues and reported at the same time. Expenses incurred to produce a product are not reported in the income statement until that product is sold.
Another common difference across income statements is the method used to calculate inventory, either FIFO or LIFO. **FIFO** stands for first-in, first-out, and assumes that the oldest inventory items are recorded as sold first, while **LIFO** stands for last-in, first-out, and assumes that the most recently produced items are recorded as sold first.

In addition to good faith differences in interpretations and reporting of financial data in income statements, these financial statements can be limited by intentional misrepresentation. One example of this is earnings management, which occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports in a way that usually involves the artificial increase (or decrease) of revenues, profits, or earnings per share figures.

The goal with earnings management is to influence views about the finances of the firm. Aggressive earnings management is a form of fraud and differs from reporting error. Managers could seek to manage earnings for a number of reasons.

> ↱ EXAMPLE If a manager earns his or her bonus based on revenue levels at the end of December, there is an incentive to try to represent more revenues in December so as to increase the size of the bonus.

While it is relatively easy for an auditor to detect error, part of the difficulty in determining whether an error was intentional or accidental lies in the accepted recognition that calculations are estimates. It is therefore possible for legitimate business practices to develop into unacceptable financial reporting.

TERMS TO KNOW

FIFO
Stands for first-in, first-out; method for accounting for inventory and assumes that the oldest inventory items are recorded as sold first.

LIFO
Stands for last-in, first-out; method for accounting for inventory and assumes that the most recently produced items are recorded as sold first.

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4. Effects of GAAP on the Income Statement

GAAP's assumptions, principles, and constraints can affect income statements through temporary (timing) and permanent differences.

Although most of the information on a company's income tax return comes from the income statement, there often is a difference between pretax income and taxable income. These differences are due to the recording requirements of GAAP for financial accounting (usually following the matching principle and allowing for accruals of revenue and expenses) and the requirements of the IRS's tax regulations for tax accounting (which are more oriented to cash).

GAAP's assumptions, principles, and constraints can affect income statements through temporary (timing) and permanent differences. Timing differences between financial accounting and tax accounting create temporary differences.

> ↪ EXAMPLE Rent or other revenue collected in advance, estimated expenses, and deferred tax liabilities and assets may create timing differences.

Also, there are events, usually one time, which create "permanent differences," such as GAAP, which recognizes as an expense an item that the IRS will not allow to be deducted.

To achieve basic objectives and implement fundamental qualities, GAAP has four basic principles:

GAAP Principles	Description
Historical Cost Principle	It requires companies to account and report based on acquisition costs rather than fair market value for most assets and liabilities.
Revenue Recognition Principle	It requires companies to record when revenue is (1) realized or realizable and (2) earned, not when cash is received.
Matching Principle	This governs the matching of expenses and revenues, where expenses are recognized, not when the work is performed or when a product is produced, but when the work or the product actually makes its contribution to revenue.
Full Disclosure Principle	This suggests that the amount and kinds of information disclosed should be decided based on a trade-off analysis, since a larger amount of information costs more to prepare and use. GAAP reporting also suggests that income statements should present financial figures that are objective, material, consistent, and conservative.

5. Non-Cash Items

Non-cash items that are reported on an income statement will cause differences between the income statement and cash flow statement. Common non-cash items are related to the investing and financing of assets and liabilities, and depreciation and amortization. When analyzing income statements to determine the true cash flow of a business, these items should be added back in because they do not contribute to inflow or outflow of cash like other gains and expenses.

Fixed assets, also known as a non-current asset or as property, plant, and equipment (PP&E), is an accounting term for assets and property. Unlike current assets such as cash accounts receivable, PP&E are not very liquid. PP&E are often considered fixed assets; they are expected to have relatively long life, and are not easily changed into another asset. These often receive a more favorable tax treatment than short-term assets in the form of depreciation allowances.

Broadly speaking, **depreciation** is a way of accounting for the decreasing value of long-term assets over time.

> ↪ EXAMPLE A machine bought in 2012 will not be worth the same amount in 2022 because of things like wear-and-tear and obsolescence.

On a more detailed level, depreciation refers to two very different but related concepts: the decrease in the value of tangible assets (fair value depreciation) and the allocation of the cost of tangible assets to periods in which they are used (depreciation with the matching principle). The former affects values of businesses and entities. The latter affects net income.

In each period, long-term non-cash assets accrue a depreciation expense that appears on the income statement. Depreciation expense does not require a current outlay of cash, but the cost of acquiring assets does.

> ↪ EXAMPLE An asset worth $100,000 in year 1 may have a depreciation expense of $10,000, so it appears as an asset worth $90,000 in year 2.

Amortization is a similar process to depreciation but is the term used when applied to intangible assets. Examples of intangible assets include copyrights, patents, and trademarks.

TERMS TO KNOW

Depreciation
The measurement of the decline in value of assets; not to be confused with impairment, which is the measurement of the unplanned, extraordinary decline in value of assets.

Amortization
The distribution of the cost of an intangible asset, such as an intellectual property right, over the projected useful life of the asset.

SUMMARY

In this lesson, you learned about the **elements of the income statement**, as organized by the simple step or multi-step method. When **reading the income statement**, the focus is often on the "bottom line," or net income. The income statement has **limitations** similar to other financial statements, including variable accounting methods and human interference. **GAAP also affects the income statement** by creating both temporary and permanent discrepancies between income statements and income tax statements. Discrepancies are also created between the income statement and the cash flow statement by **non-cash items** that must be depreciated or amortized.

Best of luck in your learning!

TERMS TO KNOW

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Gross Profit

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LIFO

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Net Income

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