THE INCOME STATEMENT

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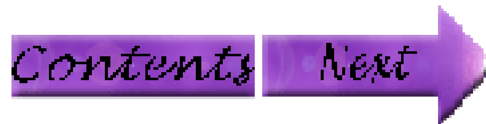

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LEARNING OBJECTIVES

When you have successfully completed this module, you will be able to:

- identify the typical structure and content of the Income Statement
- understand and apply commonly used financial terms in the income statement
- correctly interpret the financial results of a company as stated on the Income Statement
- identify and apply accounting principles/practices as they relate to the Income Statement

The Income Statement

Income Statement
Company ABC
"period of time"

Unlike the balance sheet, which gives us a snapshot of the financial status of a company at any point in time, the income statement is what we would call a periodic statement; it covers a certain period of time.

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The income statement might cover the most recent month, the most recent quarter, or the entire fiscal year of a company. Whereas when we look at the balance sheet we want to look at the date it refers to, in the case of the income statement, we want to look at what period it covers. Is it a month, a quarter or a year and which month, quarter or year does it cover?

The Income Statement Equation

Income Statement
Company ABC
Fiscal 1995-96

Net Income = Revenues of period - Expenses incurred in earning revenues - Corporate income tax

Expenses incurred in earnings revenues: This is where we use the matching concept of accounting, where we always match any expenses we incurred in earning revenues against the revenues of that period. **Corporate income tax:** When we deduct the expenses of that period from the revenues of the period, this determines the income that we made which, if we made a profit, triggers an income tax liability. We have to deduct the corporate income tax that we owe related to that income in order to get the **net income** or the **profit after tax** or the “**bottom line**” of a company.

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In the remainder of this module we will be exploding the income equation ***Net Income = Revenues of period - expenses incurred in earning revenues - corporate income tax*** into a more disaggregated form. For instance, we will see that there are various categories of expenses. Rather than just "expenses", we are going to break expenses down into various sub categories to give more meaning to individuals who are responsible for managing those expenses.

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In simple terms the income statement does nothing more than take the revenues of that period, deduct the expenses that we incurred in earning those revenues, which determines our corporate income tax if there is a tax liability. A corporate income tax liability associated with the income of that period will be deducted and we are left with the "bottom line", or the profit after tax.

Components of the Income Statement

Income Statement
Company ABC
Fiscal 1995-96

Revenues

    Less: Cost of Good Sold

Gross Margin

    Less: Operating Expenses

Operating profit

    Less: Extraordinary Income/(Expenses)
    Less: Non-operating Income/(Expenses)

Profit Before Tax

    Less: Corporate Income Tax

Net Income

Here we see a typical structure of an income statement. The revenues of the company are always recorded at the top of the statement and below the revenues we start deducting the expenses, but notice that we do not just have the word expenses. The expenses are broken down into costs of goods sold, operating expenses, extraordinary gains and losses, and non-operating income and expenses.

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So all we have done is expand the "expenses" category to all of its sub categories as it is typically done in many companies' income statements. Thus, we are providing more information on the structure of the expenses of the firm. The revenues minus the overall expenses will result in the profit before tax, which minus the corporate income tax will determine the net income.

Components of the Income Statement

Revenues

Using the realization concept, accountants normally recognize revenues, sometimes referred to as sales, at the time that the company's goods or services are delivered or perhaps when the customer is invoiced.

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Remember that revenue and sales are not necessarily cash. We may deliver the goods today to a customer but that customer may not pay us for 30 days or 60 days or perhaps even 90 days. A very important observation about the income statement is that although we might have delivered or sold the goods or services, we may not have the cash yet. Such transactions would be recorded in the accounts receivable account of the balance sheet.

Components of the Income Statement

Cost of Goods Sold (COGS)

"Direct costs of production, or - Beginning inventory plus purchases less ending inventory"

Cost of goods sold is a category of expense that we would certainly find in manufacturing businesses or any business that involves some production process. However, we would not see this label in some businesses such as in many service businesses.

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An Accounting Principle:
It is important to recognize that accountants have latitude on how they record costs of goods sold. Some accountants would put certain costs into costs of goods sold and others may put them elsewhere. The key thing we are talking about is the direct costs of production.

The most common way of measuring cost of goods sold is as follows. The accountants would take the inventory at the beginning of the period, add to that any purchases made during that period (i.e. raw materials) and subtract the inventory at the end of the period. Therefore the direct production cost of the goods that were sold during this accounting period can be expressed with the formula:

Beginning Inventory + Purchases – Ending Inventory = Costs of Goods Sold.

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For example if we are in the furniture manufacturing business we buy some raw materials (wood, fabric, fasteners, etc.) and put it through a production process where we use the labor to convert the raw materials into finished goods or furniture. The direct expenses that went into the production process are what we refer to as costs of goods sold.

In most service businesses you will not see the Cost of Goods Sold label. You may see for example, operating revenue less operating expenses and the operating expenses might be broken down into several categories, but you would not see the costs of goods sold.

Components of the Income Statement

Gross Margin

"Revenues less Cost of Goods Sold"

The gross margin is simply the first level of profitability; it is the ***sales*** or ***revenues*** of the period, less the ***cost of goods sold***, in the case where the cost of goods sold appears in the income statement. If it does not appear, then we may see operating margin or operating profit. The gross margin is really what remains of the sales dollars after the direct expenses of the production or service process have been deducted.

Sales/Revenue - Cost of goods sold = Gross margin

Gross Margin is at times referred to as Gross Profit.

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Gross margin is a measure of business success. A sufficiently high gross margin is vital to a business, since all other expenses of the company are deducted from this gross margin.

Components of the Income Statement

Operating Expenses

"Expenses related to normal business operations as identified in the chart of accounts"

Operating expenses are those expenses, other than the Cost of Goods Sold, that are incurred in the normal business operations. These expenses are normally set out and categorized depending upon the nature of the business. For example, in an aquaculture business you may see categories such as fish feed, diving and boat expenses. In another type of business you might see a totally different set of labels.

Some examples of labels under the operating expenses category, that you would commonly see in an income statement are:

- depreciation

  The calculation of the depreciation of fixed assets was presented in the balance sheet. Those expenses would show up under operating expenses. Note that the accountant might actually include some depreciation expenses in costs of goods sold, depending on how he or she decides to set up the accounting system.

- maintenance

  Some maintenance expense might go into the costs of goods sold, maybe on the machinery that is producing the goods sold. But maintenance expenses of vehicles or on the building would be under operating expenses.

- utilities

  Heat, light, and power are also operating expenses. The accountant might choose to allocate some of those expenses to costs of goods sold and she/he might allocate them just to other operating expenses or to overhead.

- administration

  Salaries, wages and administration related expenses (i.e. supplies, computer expenses, etc.) might be categorized under administration.

- rentals

  If the building where the operation of the business takes place is rented, then the renting expense would be included as an operating expense. In such cases there would not be any depreciation expense since the company does not own the building. If equipment or vehicles were rented this would show up under the heading rentals or some other similar heading. The accountant might break rentals down into sub categories (e.g. vehicle leases, office rent).

- sales commissions

  Commissions, whether paid on a straight commission basis or salary plus commissons, would be accounted for under operating expenses because they are expenses related to the day to day operations of the business.

Note: These are not necessarily the only labels or accounts that an accountant could use in describing the various categories of expenses. It varies from business to business.

Components of the Income Statement

Other Expenses

Expenses that are outside the main operation of a business, such as a loss or gain on a sale or the sale of capital assets, would fall under the category of "Other Expenses". The interest on loans, would also be listed in this category as an Interest expense.

Components of the Income Statement

Operating Profit

"Gross margin less operating expenses. Profits from normal business operations."

Operating profit is also referred to as Operating Income or Income from Operations.

Many people view Operating profit as an important indicator of a business's performance because it measures the results of the enitity's major ongoing activities.

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Operating profit is an important indicator of profitability. While it does not show the total profit of the company, it tells us how much of the total profit was generated from operations as opposed to other activities in a certain period.

Components of the Income Statement

Extraordinary Gains/Losses

Gains or losses that result from the disposal of assets, or from extraordinary events such as a catastrophic loss of inventory, or from some other type of unusual event are categorized under "Extraordinary Gains/Losses". These revenues and expenses are outside the main operations of the business. They are ften also referred to as "Other Revenues and Expenses".

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Extraordinary gain

For example, lets say you are in the trucking business and from time to time you decide to dispose of the trucks that you have because you feel that they are at the end of their economic life. You may want to replace them with newer trucks. Well if you are in the trucking business you are not in the business of selling trucks. You are in the business of operating those vehicles to earn revenue and profit. That is your normal day to day operations. So when you decide to dispose of some trucks, your accountant will most likely treat that as an extraordinary event. If you sold the vehicles at a fair market value that exceeded their net book value, in other words their original costs less their accumulated depreciation on those vehicles, this triggers what is known as a gain or capital gain on the sale of those assets. That gain would be recorded here as an extraordinary item.

If you sold them at fair market value to somebody that wanted to buy used trucks, that was less than the net book value after you completed your negotiations, then you would have triggered a capital loss in your company. It would be recorded here as an extraordinary event, extraordinary because as I said before you are not in the business of buying and selling trucks. You are in the business of operating them to earn revenue and earn operating profit from those assets.

Extraordinary Loss

Similarly if you had some catastrophic event, lets say you are a fish farmer and a seal gets into your cage of fish and you lose an entire cage of fish. This would be treated as an extraordinary item and extraordinary loss. You would write off whatever cost you had in that inventory. You would write it off at that point in time because you would not be able to recover it and the accountant being conservative would want to disclose that event immediately. It is extraordinary because in the normal course of business, you hope that this does not occur on a day to day basis. So you do not include it as a normal operating item.

If we bury such an event into the normal expense of a company, we might have a terrible looking income statement that really is not reflective in what is happening in the business. That is why we take those events out and treat them separately and record them as extraordinary events on the same income statement.

Components of the Income Statement

Non-Operating Income/(Expenses)

"Income/expenses not associated with operations"

For example, non-operating income could be earned as interest on a short-term investment of surplus cash. Since investing money in short term investments might not be the core business of the company, this income would be non-operating income that must be recorded nonetheless.

One of the typical expenses that accountants might record under this category is interest expense on debt or borrowings of the company because it arises as a result of how the business is financed as opposed to the nature of operations. Interest expense is a legititmate expense and therefore should be accounted for and matched against the revenues of the period.

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Suppose we have surplus cash in our company. We decide to invest it for three months in T-bills or some kind of government security to earn a higher rate of interest. We are going to earn interest income on those short term investments and the accountant would most likely record it as non-operating income because we are not in the business of investing money unless we are some kind of investment brokerage firm that does that.

We may be in the production business or service business or manufacturing business of some kind and yes we have some surplus cash so we invest it to generate some extra income. But we record this separately so that we do not confuse it with our income from normal business operations. Because we always want to see how the company is doing in our core business.

Components of the Income Statement

Profit Before Tax

Profit before tax, or taxable income, is profit after all the allowable expenses have been deducted from revenues. The tax department of the government, in our case Revenue Canada, provides guidelines/policies that determine what deductions companies are allowed to make against their revenues to lower their taxable income.

Components of the Income Statement

Corporate Income Tax

Income tax payable, taking into account the applicable corporate tax rate and any tax shelters for which the corporation is eligible, is also considered an expense on the income statement. You have to determine what your income tax liability is, and your income tax payable takes into account the applicable corporate tax rates. These vary according to the size of the company, the tax shelters for which the company is eligible, as welll as other conditions that Revenue Canada defines.

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There is always one piece of advice that I give here; there is no simple answer to this question of Corporate Income Tax. The tax rules are quite complex and they change from time to time, with each new budget the government brings in, there are often changes in the corporate tax rules, creating new tax incentives for businesses to invest or what you transact in that might make your company eligible for tax shelters.

So if you are in business, no matter how small, it would really pay to retain professional advice in terms of filing your income tax returns because you cannot if you are managing a small business possibly become an expert in tax law or what tax shelters that your company may be eligible for.

Components of the Income Statement

Net Income

"Profit after tax or earnings of the company - or - "THE BOTTOM LINE."

The bottom line of the income statement is **net income**, if total revenues exceed total expenses. When expenses exceed revenues, the result is a **net loss**.

Once you have determined the profit before tax and with the help of professional advice and determined your taxable liability, whatever is leftover is what is called the ***bottom line*** of your company, or the ***profit after tax*** or the earnings of the ***company*** and this would typically be your net income.

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The income statement is often referred to as the Profit and Loss statement or acronym "P and L" (meaning profit and loss) or Earnings Statement. What we are really talking about is what is the profit of the company after all of the expenses of the company has been accounted for, in this particular period of time matched against the revenues that we earned in that same period. Then after determining our tax liability, we deduct this liability and come up with the profit after tax or bottom line of the company. This is where the term bottom line comes from; it is our profit after tax and is the "bottom line" on the income statement.

Summary

THE INCOME STATEMENT

Income statements reflect the revenues and expenses of a business during a period of time, as opposed to the balance sheet that reflects a given point in time. An Income statement is based on a simple model:

net income = revenues of the period - expenses incurred in earning the revenues - corporate income tax on corporate income

Typical Accounts of an income statement are:

Revenues

Cost of Goods Sold

Gross Margin

Operating Expenses

Operating Profit

Extraordinary Gains/(Losses)

Non-Operating Income/(Expenses)

Profit before tax

Income Tax
Net Income