What is the income statement in accounting?
Peter Baskerville

The definition and place of the income statement in accounting - Foundation level

The Income Statement reports on the financial performance of a business for a given accounting period. Typical accounting periods are monthly, quarterly and annually. The Income Statement summarizes the revenues earned and subtracts the expenses incurred in earning that revenue to calculate the resulting net profit or loss for the business for a given accounting period. The Income Statement may also be referred to as the 'Profit & Loss Statement', 'P&L' , 'Statement of Financial Performance' , 'Revenue Statement' , 'Earnings Statement', 'Operating statement' or 'Statement of Operations'.

'Income Statement' in accounting

Background to the Income Statement.
Prior to reading on through this Knol, it may be best to firstly familiarize yourself with the accounting terminology differences in regard to income, earnings, profit, revenue, gains, sales and turnover.

Now, along with the Balance Sheet, the Income Statement is a key financial report produced by the accounting information system. These financial reports convey to management and other stakeholders, a concise picture of the profitability and financial position of a business. While the Balance Sheet reports on the financial position, strength and net worth (Owners Equity) of a business at a specific point in time, the Income Statement reports on the viability, profitability and 'bottom line' (Net profit/loss) of a business for a given accounting period. These accounting periods are typically monthly, quarterly or annually.

So, while net profit is the result of deducting from the revenue the expenses incurred in earning that revenue, net earnings for a period further deducts the interest and tax expense and adds/subtracts gains/losses from non-core business activities (e.g. foreign exchange, asset sales). The net earnings amount from the bottom line of the Income Statement, is reported in the account Current Year Earnings which is part of the Owners Equity section of the Balance Sheet. Changes in owners Owners Equity then occur directly in proportion to those transactions involving earning revenue and incurring expenses. This is why in double-entry bookkeeping, increases in revenue are treated in the same way as increases in Owners Equity, as a Credit - because the potential profits that revenues produce are due to the owners of the business.

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The Income Statement primarily addresses the question regarding the economic performance of the business which is why it is also called the Statement of Financial Performance. The Income Statement answers the question: Did the business do well (make a profit) or did it do badly (incur a loss)? Earning revenue and incurring expenses is so critical to the viability of a business that it requires this separate and detailed Income Statement report to periodically monitor the operating results of a business.

An Income Statement firstly describes the outcomes derived from a business generating revenue as it exchanges goods or services with its customers in return for money or other assets. It then describes the outcomes in relation to the expenses incurred in exchanging its goods and services with these customers in the pursuit of revenue. Finally, the Income Statement describes the net income or profit realized from offsetting the expenses against the revenues that they generated. If the revenue exceeds the expenses then the business generates a profit. If the expenses exceed the revenue, then the business incurs a loss.

Income Statement details

The Income Statement summarizes the revenues earned and subtracts the expenses incurred in earning that revenue to calculate the resulting net profit or loss for a given accounting period. The Income Statement contains the often referred to "bottom line" of a business in that it calculates the net profit or losses for a given period and reports this as the last line on the Income Statement.

At the top of the Income Statement is the total amount of money received from the sale of products or the provision of services. This top line may also be referred to as sales or gross revenues because expenses have not yet been deducted. If sales returns and allowances have been given in the period, then these will be deducted from Gross Sales to produce the Net Sales.

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Not all Income Statements follow the exact same format due to the fact that not all revenue and expense accounts are used by all businesses to produce net profit. Business selling tangible goods will usually separate the Cost of Goods Sold from other expenses so that a Gross Profit result can be calculated. Other manufacturing and service industries may deduct direct costs from the sales/fees earned to calculate their gross profit or gross margin. Gross Profit directly reflects on the pricing policies of a business which can be easily compared to industry benchmarks and competitor results. Other revenues are then added to the gross profit to calculate the total revenue for the period.

Operating expenses is the next section that is summarized on the Income Statement. These are the costs of doing business or are the expenses incurred in earning the revenue. Under the matching principle that is applied in accrual accounting, all expenses that were incurred in earning the revenue for the given accounting period should be included in the Income Statement regardless of their paid or unpaid status.

These expenses are typically summarized and reported by expense classifications including: Selling & distribution (often referred to as 'selling expenses'), General & Administration expense and Financial Expense. These expenses are totaled and subtracted from the gross profit to produce the Net Profit or EBIT. (Earnings Before Interest and Tax). This result is often called “income from operations. Net Earnings (after interest and taxes have been deducted) is the amount that is reported as Current Earnings in the Owners Equity section of the Balance Sheet.

NOTE: Non-profit organizations do not generally produce an income statement. They produce a statement of activities which compares funding sources with program expenses, administrative costs, and other operating commitments to arrive at a surplus or shortfall in funds.

Income Statement uses and issues

Income statements are designed to help the internal and external stakeholders of a business make sound financial derisions. For example: they help investors assess the

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viability and financial performance of the business that they have invested in, particularly in relation to the profit/loss trends; they help creditors/lenders determine their credit limits and loan exposures with the business; they help the internal managers respond to current opportunities and pinpoint unexpected expense increases and to predict future performance via the budgetary process and they provide a basis for calculating the income tax liability of the business by the government tax office.

While accounting attempts to produce a 'true and fair' picture of the financial performance of a business via the Income Statement, there are some issues that will impact of this goal. For example:

- There are some valuable items that while very relevant to a business but are not measured by the accounting system and so are not reported on the Income Statement. These items could include such things as brand recognition, organisational reputation or customer loyalty.
- Different valuation methods allowable in accounting will produce different profit results. For example the valuation of inventory using the FIFO (Firsts In First Out), LIFO (Last In First Out) or Item Cost method will each produce a different profit result.
- Some values reported on the Income Statement depend on judgments and estimates. For example depreciation expenses is calculated based on the estimated useful life and estimated salvage value of the fixed asset.

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Example of an Income Statement

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

Income Statement Example

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