

What is an Income Statement?

The income statement, also called the profit and loss statement, is a report that shows the income, expenses, and resulting profits or losses of a company during a specific time-period. The income statement is the first financial statement typically prepared during the accounting cycle because the net income or loss must be calculated and carried over to the statement of owner's equity before other financial statements can be prepared.

The income statement calculates the net income of a company by subtracting total expenses from total income. This calculation shows investors and creditors the overall profitability of the company as well as how efficiently the company is at generating profits from total revenues.

The income and expense accounts can also be subdivided to calculate gross profit and the income or loss from operations. These two calculations are best shown on a multi-step income statement. Gross profit is calculated by subtracting cost of goods sold from net sales. Operating income is calculated by subtracting operating expenses from the gross profit.

Unlike the balance sheet, the income statement calculates net income or loss over a range of time. For example, annual statements use revenues and expenses over a 12-month period, while quarterly statements focus on revenues and expenses incurred during a 3-month period.

Income Statement Purpose

How is an Income Statement Used?

It is important to note that there are different types of income statements which are created for different reasons. For example, the year-end statement that is prepared annually for stockholders and potential investors doesn't do much good for management while they are trying to run the company throughout the year. Thus, interim financial statements are prepared for management to check the status of operations during the year. Management also typically prepares departmental statements that break down revenue and expense numbers by business segment.

In the end, the main purpose of all profit and loss statements is to communicate the profitability and business activities of the company with end users. Each one of these end users has their own use for this information. Let's look at who uses the P&L and what they use it for.

Who Uses an Income Statement?

There are two different groups of people who use this financial statement: internal users and external users.

Internal users like company management and the board of directors use this statement to analyze the business as a whole and make decisions on how it is run. For example, they use performance numbers to gauge whether they should open new branch, close a department, or increase production of a product.

External users like investors and creditors, on the other hand, are people outside of the company who have no source of financial information about the company except published reports. Investors want to know how profitable a company is and whether it will grow and become more profitable in the future. They are mainly concerned with whether or not investing their money in the company will yield them a positive return.

Creditors, on the other hand, aren't as concerned about profitability as investors are. Creditors are more concerned with a company's cash flow and if they are generating enough income to pay back their loans.

Competitors are also external users of financial statements. They use competitors' P&L to gauge how well other companies are doing in their space and whether or not they should enter new markets and try to compete with other companies.

Example:

- Paul's Guitar Shop, Inc.
- Income Statement
- For the Year Ended December 31, 2015

Income Statement Example

Here is an example of how to prepare an income statement from Paul's adjusted trial balance in our earlier accounting cycle examples.

Single Step Income Statement

Paul's Guitar Shop, Inc.		
Income Statement		
For the Year Ended December 31, 2015		
Revenues		
Merchandise Sales	\$ 24,800	
Music Lesson Income	<u>3,000</u>	
Total Revenues:		\$ 27,800
Expenses		
Cost of Goods Sold	10,200	
Depreciation expense	2,000	
Wage expense	750	
Rent expense	500	
Interest expense	500	
Supplies expense	500	
Utilities expense	<u>400</u>	
Total Expenses:		<u>14,850</u>
Net Income		<u><u>\$ 12,950</u></u>

As you can see, this example income statement is a single-step statement because it only lists expenses in one main category. Although this statement might not be extremely useful for investors looking for detailed information, it does accurately calculate the net income for the year.

This net income calculation can be transferred to Paul's statement of owner's equity for preparation.

Common Income Statement Questions

What is considered an expense on the income statement?

Expenses are outlays of resources for goods or services. These costs include wages, depreciation, and interest expense among others. They are reported on several sections of the income statement. Cost of goods sold expenses are reported in the gross profit reporting section while the operating expenses are reported in the operations section. Other expenses are reported further down the statement in the other gains and losses section.

How do you calculate the income statement?

The income statement is used to calculate the net income of a business. The P&L formula is $\text{Revenues} - \text{Expenses} = \text{Net Income}$. This is a simple equation to show the profitability of an organization. If revenue is higher than expenses, the company is profitable. If revenue is lower than expenses, the company is unprofitable.

What is a multi step income statement?

A multi-step statement splits the business activities into operating and non-operating categories. The operating section includes sales, cost of goods sold, and all selling and admin expenses. The non-operating section includes other income or expenses like interest or insurance proceeds. This type of income statement is not used much in practice (no example is provided here).

How do you make an income statement?

1. Determine the Time Period
2. Transfer Income Accounts for Trial Balance into our template
3. Transfer Expense Accounts for Trial Balance into our template
4. Transfer Other Gains and Losses
5. Calculate the Net Income

Use a template to list the sales, expenses, and other gains or losses in the correct format. At the bottom of the statement, compute the net income for the organization.