13.6: The Income Statement

5. How does the income statement report a firm's profitability?

The balance sheet shows the firm's financial position at a certain point in time. The **income statement** summarizes the firm's revenues and expenses and shows its total profit or loss over a period of time. Most companies prepare monthly income statements for management and quarterly and annual statements for use by investors, creditors, and other outsiders. The primary elements of the income statement are revenues, expenses, and net income (or net loss). The income statement for Delicious Desserts for the year ended December 31, 2018, is shown in Table 14.2.

Income Statement for Delicious Desserts			
Delicious Desserts, Inc.			
Income Statement for the Year Ending December 31, 2018			
Revenues			
Gross sales		$275,000	
Less: Sales discounts		2,500	
Less: Returns and allowances		2,000	
Net sales			$270,500
Cost of Goods Sold			
Beginning inventory, January 1		$ 18,000	
Cost of goods manufactured		109,500	
Total cost of goods available for sale		$127,500	
Less: Ending inventory December 31		15,000	
Cost of goods sold			112,500
Gross profit			**$158,000**
Operating Expenses			
Selling expenses			
Sales salaries	$31,000		
Advertising	16,000		
Other selling expenses	18,000		
Total selling expenses		$ 65,000	
General and administrative expenses			
Professional and office salaries	$20,500		
Utilities	5,000		
Office supplies	1,500		
Interest	3,600		
Insurance	2,500		

Income Statement for Delicious Desserts			
Delicious Desserts, Inc.			
Income Statement for the Year Ending December 31, 2018			
Rent	17,000		
Total general and administrative expenses		50,100	
Total operating expenses			115,100
Net profit before taxes			**$ 42,900**
Less: Income taxes			10,725
Net profit			**$ 32,175**

Table14.2

Revenues

Revenues are the dollar amount of sales plus any other income received from sources such as interest, dividends, and rents. The revenues of Delicious Desserts arise from sales of its bakery products. Revenues are determined starting with **gross sales**, the total dollar amount of a company's sales. Delicious Desserts had two deductions from gross sales. *Sales discounts* are price reductions given to customers that pay their bills early. For example, Delicious Desserts gives sales discounts to restaurants that buy in bulk and pay at delivery. *Returns and allowances* is the dollar amount of merchandise returned by customers because they didn't like a product or because it was damaged or defective. **Net sales** is the amount left after deducting sales discounts and returns and allowances from gross sales. Delicious Desserts' gross sales were reduced by $4,500, leaving net sales of $270,500.

Expenses

Expenses are the costs of generating revenues. Two types are recorded on the income statement: cost of goods sold and operating expenses.

The **cost of goods sold** is the total expense of buying or producing the firm's goods or services. For manufacturers, cost of goods sold includes all costs directly related to production: purchases of raw materials and parts, labor, and factory overhead (utilities, factory maintenance, machinery repair). For wholesalers and retailers, it is the cost of goods bought for resale. For all sellers, cost of goods sold includes all the expenses of preparing the goods for sale, such as shipping and packaging.

Delicious Desserts' cost of goods sold is based on the value of inventory on hand at the beginning of the accounting period, $18,000. During the year, the company spent $109,500 to produce its baked goods. This figure includes the cost of raw materials, labor costs for bakery workers, and the cost of operating the bakery area. Adding the cost of goods manufactured to the value of beginning inventory, we get the total cost of goods available for sale, $127,500. To determine the cost of goods sold for the year, we subtract the cost of inventory at the end of the period:

$127,500−$15,000=$112,500$127,500−$15,000=$112,500

The amount a company earns after paying to produce or buy its products but before deducting operating expenses is the **gross profit**. It is the difference between net sales and cost of goods sold. Because service firms do not produce goods, their gross profit equals net sales. Gross profit is a critical number for a company because it is the source of funds to cover all the firm's other expenses.

The other major expense category is **operating expenses**. These are the expenses of running the business that are not related directly to producing or buying its products. The two main types of operating expenses are selling expenses and general and administrative expenses. *Selling expenses* are those related to marketing and distributing the company's products. They include salaries and commissions paid to salespeople and the costs of advertising, sales supplies, delivery, and other items that can be linked to sales activity, such as insurance, telephone and other utilities, and postage. *General and administrative expenses* are the business expenses that cannot be linked to either cost of goods sold or sales. Examples of general and administrative expenses are salaries of top managers and office support staff; utilities; office supplies; interest expense; fees for accounting, consulting, and legal services; insurance; and rent. Delicious Desserts' operating expenses totaled $115,100.

Net Profit or Loss

The final figure—or bottom line—on an income statement is the **net profit** (or **net income**) or **net loss**. It is calculated by subtracting all expenses from revenues. If revenues are more than expenses, the result is a net profit. If expenses exceed revenues, a net loss results.

Several steps are involved in finding net profit or loss. (These are shown in the right-hand column of **Table 14.2**.) First, cost of goods sold is deducted from net sales to get the gross profit. Then total operating expenses are subtracted from gross profit to get the net profit before taxes. Finally, income taxes are deducted to get the net profit. As shown in **Table 14.2**, Delicious Desserts earned a net profit of $32,175 in 2018.

It is very important to recognize that profit does not represent cash. The income statement is a summary of the firm's operating results during some time period. It does not present the firm's actual cash flows during the period. Those are summarized in the statement of cash flows, which is discussed briefly in the next section.

CONCEPT CHECK

1. What is an income statement? How does it differ from the balance sheet?
2. Describe the key parts of the income statement. Distinguish between gross sales and net sales.
3. How is net profit or loss calculated?
