

# *The Income Statement*

The income statement is a report of operating results for a company over a specified period of time. Income statements must be prepared annually for Revenue Canada purposes but preparing them more frequently will provide you with current information about how your business is performing.

In practice, there are many variations to the amount of detail recorded in an income statement dependent upon the type of business you are operating. The basic format lists all revenues and subtracts all expenses. The difference between revenue and expenses is known as net income or loss. The following is an example of what a typical income statement would look like:

Company Name Income Statement	
For the Month ....	
NET SALES	\$ _____
Less Cost of Goods Sold	\$ _____
Gross Profit	\$ _____
OPERATING EXPENSES	
-	
-	
-	
TOTAL EXPENSES	\$ _____
INCOME BEFORE TAXES (gross profit-total expenses)	\$ _____
Less Income Tax	\$ _____
OPERATING INCOME (loss)	\$ _____

## **Sales**

Include in this section, the total of all sales for all services/products, both cash and on account. To arrive at net sales subtract returns, allowances and discounts.

### **Cost Of Goods Sold**

This is the amount that it cost to obtain and sell your product or service.

### **Gross Profit**

This is the difference between your net sales and the cost of goods sold. It is the amount of money that is available to pay your operating expenses.

### **Operating Expenses**

These are the costs that will be incurred as a result of being in business. They are not a direct cost of producing your product.

### **Operating Income (loss)**

It is the difference between the Gross Profit and Total Expenses. It puts a dollar figure to your business performance for a specified period.

## **Analyzing the Income Statement**

There are three primary methods you can use to analyze your company's profitability. Keep in mind that these formulas should be used in conjunction because none of them alone can give you a total picture of your business' financial health. They are important ratios for you to learn because they are also used by outsiders, such as bank loan officers and investors because a) profits are the main reason for being in business b) they are a good way to evaluate your company's management skill and potential for success.

### **Gross Profit Margin Ratio**

The gross margin is an important measure of profitability because it looks at the major inflows and outflows of a company: sales and the cost of goods sold. Gross profit is the amount left after the cost of goods sold has been subtracted from net sales. Without a suitably large gross margin, a company will not be able to pay its operating and other expenses. It is a real measure of profitability because it must be sufficiently high to cover costs and provide for profits.

In general, your gross profit margin ratio should be stable. There should be little fluctuation from period to period unless your industry is undergoing changes that influence your pricing policies or cost of goods sold. If your gross profit margin is falling from quarter to quarter, it may mean that your inventory management needs to be improved or that your prices are not keeping pace with the increasing costs of the goods you sell. In either case, adjustments must be made.

$$\text{Gross Profit Margin} = \text{Gross Profit} / \text{Sales} \times 100\%$$

*(Gross profit = Net sales - Cost of Goods Sold)*

### **Operating Profit Margin Ratio**

Operating profit margin is an indicator of the future cash position of your company because it looks at a company's operating income before taxes are subtracted, it is sometimes considered a more objective evaluator than the net profit margin ratio. If operating income is not sufficient to support your company, it means that you must find other sources of cash. By looking at this ratio over time, you can get a fix on whether your overall costs are trending up or down. In general, the operating profit margin is an indicator of management skill and operating proficiency. It is a ratio that you can use to compare your company's competitive position to other companies in your industry.

$$\text{Operating Profit Margin} = \text{Operating Income} / \text{Sales} \times 100\%$$

### **Net Profit Margin Ratio**

Net profit is often referred to as the bottom line because it represents the difference between net sales and all expenses, including income taxes and interest. In other words, it shows you how much of each sales dollar is left over after all other costs have been met. It is probably the profitability ratio with which most business owners are intimately familiar. You should consider industry

standards when determining a range within which you expect your profit margin to fall. If you don't reach your expected range of profitability, it might mean that you set an unrealistic goal or your costs are getting out of control. However, the net profit ratio itself will not diagnose what went wrong. Your gross profit margin ratio or operating profit margin will give you a better picture of what the problem may be.

$$\text{Net Profit Margin} = \text{Net Income} / \text{Sales} \times 100\%$$

**For More Information:**

**Internet:** [http://www.onlinewbc.gov/docs/finance/fs\\_incstmt1.html](http://www.onlinewbc.gov/docs/finance/fs_incstmt1.html)