Income Statement Additional Reading

In the previous lesson we talked about how doctors need to know your current condition and your medical history over time. We discussed how a business' balance sheet shows its current financial condition on that day. Managers and lenders use an Income Statement (also called a Profit & Loss Statement or simply, a P&L) to look at how the business has performed over time - similar to how a doctor looks at your medical history. We refer to this performance as Profitability – did the business make money or lose money last year?

An Income Statement shows all of the Revenues and Expenses of the business over a period of time, usually one year. Revenues are the dollars that come into the business from the sale of goods or services. For Greta, her revenues are the money coming in from the sale of produce and crafts. To calculate Revenues, simply multiply the selling price of the product by the amount that you sell. For example, if Greta sells 100 dozen ears of corn at a price of $5/dozen, her revenues are $500 (100 dozen x $5/dozen). The Income Statement lists all of the revenues that come into the business over that period of time.

Expenses are the costs of doing business. Remember from Lesson 1 – The Language of Business – we classified expenses into Operating (or Variable) Expenses and Overhead (or Fixed) Expenses. Greta's Income Statement will show her operating expenses for the year:

Cost of the Produce she purchased to resell	$150,000
Cost of the Crafts she purchased to resell	$80,000

Greta has direct control over her Operating Expenses. She can decide to purchase more produce this year than she did last year, or she can decide to not purchase certain items at all. Remember that Operating Expenses change with the level of sales – the more produce Greta sells, the more she has to purchase; or if she purchases less, she will have less produce to sell, and her sales will decrease. When you purchase items to resell, like Greta's produce and crafts, the purchase price is often called "Cost of Goods Sold".

Greta has less control over her Overhead Expenses than she does for her Operating Expenses. Overhead Expenses are those expenses that she has just because she is in business. Examples of her Overhead Expenses are:

Business License	$1,000
Utilities (electricity, water, etc.)	$15,000
Liability Insurance	$5,000
Supplies	$10,000
Interest on her loans	$14,000
Labor	$70,000
Office Expenses	$6,000

Property Taxes	$15,000
Advertising	$25,000
Legal Fees	$4,000
Depreciation	$30,000

Notice that the Overhead Expenses do not necessarily change with the level of sales. Greta will have to pay for her business license, property taxes, and liability insurance regardless of how much produce she sells. Her utility bills and labor expenses may change a little as the level of sales changes, but not very much. Her assets, such as the refrigerators, cash registers and building will lose value (depreciate) whether she has a lot of sales or if she has a bad year. Because these overhead expenses do not change (much) with the level of sales, they are often called “Fixed Expenses”.

The expenses that are listed on an Income Statement are directly related to the business. Greta will not include any of her personal expenses on her Income Statement. There are two other items that are not included on an Income Statement: Principal payments on loans, and income taxes. When you borrow money you typically make regular payments back to the lender to repay the loan. These payments consist of interest (the cost of borrowing money) and principal (money you borrowed from the lender). Let’s look at a very simple example. Assume that you borrow $100 from a bank. You will pay the bank $110 at the end of the year. This $110 includes the $100 (principal) that you borrowed from the bank and $10 of interest. The principal is not an expense – you are just repaying money that someone lent to you. In this example, the bank loaned you $100 of principal. The principal is NOT a revenue for the business, so it doesn’t get listed in the revenue section. When you pay the bank $110 at the end of the year, you are simply returning the $100 of principal – this is NOT an expense for the business – plus $10 of interest, which is an expense. The interest is the cost of getting the loan, so it definitely goes on an Income Statement.

We don’t include income taxes for the business on an Income Statement. That’s because we use an Income Statement to help figure out how much taxes the business will owe on its profits. For this reason, the bottom line of the Income Statement is often called “pre-tax net income” or “earnings before taxes”.

There are several formats for an Income Statement. Two examples are attached to this lesson. Each format has three main sections: Total Revenues, Total Expenses, and Net Income (or Profit). Some formats are much more detailed, some are very basic. Look at the differences in the two example Income Statements. The Schedule F tax form from the Internal Revenue Service (the IRS) is very detailed, listing specific revenues and expenses. The “generic” format simply lists the main categories. But the bottom line on both formats is the same – Net Income.
Now, let’s look at the Income Statement for Greta’s business:

Greta's Green Grocery
Income Statement
For the year 2022

Revenues:	
Produce	$325,000
Crafts	$175,000
Total Revenues	**$500,000**
Operating Expenses:	
Produce	$150,000
Crafts	$80,000
Total Operating Expenses	**$230,000**
Overhead Expenses:	
Business License	$1,000
Utilities (electricity, water, etc.)	$15,000
Liability Insurance	$5,000
Supplies	$10,000
Interest on her loans	$14,000
Labor	$70,000
Office Expenses	$6,000
Property Taxes	$15,000
Advertising	$25,000
Professional Fees (lawyer, accountant)	$4,000
Depreciation	$30,000
Total Overhead Expenses	**$195,000**
Total Expenses	**$425,000**
Net Income (Profit)	**$75,000**

Greta's Income Statement shows that she earned a profit of $75,000 for the year. This is before she pays her income taxes. If Greta is operating her business as a sole proprietorship all of these profits are hers – basically, the profits of a sole proprietorship are the owner's "salary" for the year.

Income Statements are an important financial statement for business managers and lenders. This statement shows whether the business has been able to earn profits over time. A business cannot stay open if it doesn't earn profits. Profits, the money that is left after the expenses are paid, allow the business to grow and expand over time. The profits can be put into a savings account so that the owner is prepared for the bad times when sales are very low. And finally, profits allow the manager to repay the loans that have been taken out by the business.

A more detailed Income Statement lets that manager or lender analyze their business much better. Rather than just showing if the business made profits for the year, a detailed statement can show which products were the most profitable, or which products were actually losing money. A detailed statement helps the manager see what the main expenses are – I like to look at the business' 5 largest expenses to see where the manager can save the most money.