# How to know if income statement is correct

The income statement is one of three financial statements that stock investors rely on. (The others are the balance sheet and cash flow statement.) Understanding an income statement is essential for investors who want to analyze the profitability and future growth of a company.  The income statement summarizes a company's revenues and expenses over a period, either quarterly or annually.The income statement comes in two forms, multi-step and single-step.The multi-step income statement includes four measures of profitability: gross, operating, pretax, and after tax.The income statement measures profitability and not cash flow. In the context of corporate financial reporting, the income statement summarizes a company's revenues (sales) and expenses, quarterly and annually, for the fiscal year. The final net figure and other numbers in the statement are of major interest to investors and analysts. Income statements come with various monikers. The most commonly used are "statement of income," "statement of earnings," "statement of operations," and "statement of operating results." Many professionals still use the term P&L, which stands for profit and loss statement, but this term is seldom found in print these days. The words "profits," "earnings," and "income" all mean the same thing and are used interchangeably. Two basic formats for the income statement are used in financial reporting–the multi-step and the single-step. These are illustrated below in two examples: Multi-Step Format Single-Step Format Net Sales Net Sales Cost of Sales Materials and Production Gross Income* Marketing and Administrative Selling, General and Administrative Expenses (SG&A) Research and Development Expenses (R&D) Operating Income* Other Income & Expenses Other Income & Expenses Pretax Income Pretax Income* Taxes Taxes Net Income Net Income (after tax)* -- In the multi-step income statement, four measures of profitability (shown with an asterisk*) are revealed at four critical junctions in a company's operations: gross, operating, pretax, and after-tax. In the single-step presentation, the gross and operating income figures are not stated. They can be calculated from the data provided. In this method, sales minus materials and production equal gross income. By subtracting marketing and administrative and research and development (R&D) expenses from gross income, we get the operating income figure. Investors must keep in mind that the income statement recognizes revenues when they are realized—that is, when goods are shipped, services rendered, and expenses incurred. With accrual accounting, the flow of accounting events through the income statement does not necessarily coincide with the actual receipt and disbursement of cash. The income statement measures profitability, not cash flow. Net sales (sales or revenue): This is the value of a company's sales of goods and services to its customers. Although a company's bottom line (its net income) gets most of the attention from investors, the top line is where the revenue or income process begins. In the long run, profit margins on a company's existing products tend to reach a maximum that is difficult to improve upon. Thus, companies typically can grow no faster than their revenues. Cost of sales (cost of goods/products sold (COGS), and cost of services): For a manufacturer, the cost of sales is the expense incurred for labor, raw materials, and manufacturing overhead used in the production of goods. While it may be stated separately, depreciation expense belongs in the cost of sales. For wholesalers and retailers, the cost of sales is essentially the purchase cost of merchandise used for resale. For service-related businesses, cost of sales represents the cost of services rendered or cost of revenues. Gross profit (gross income or gross margin): A company's gross profit is not just the difference between net sales and the cost of sales. Gross profit also provides the resources to cover all of the company's other expenses. Obviously, the greater and more stable a company's gross margin, the greater potential there is for positive bottom line (net income) results. Selling, general, and administrative expenses: Often referred to as SG&A, this is the company's operational expenses. Financial analysts assume that management exercises a great deal of control over this expense category. The trend of SG&A expenses as a percentage of sales is watched closely to detect signs of managerial efficiency, or lack of it. Operating income: Deducting SG&A from a company's gross profit produces operating income. This figure represents a company's earnings from its normal operations before any non-operating income and costs such as interest expense, taxes, and special items. Income at the operating level, which is viewed as more reliable, is often used by financial analysts rather than net income as a measure of profitability. Interest expense: This item reflects the costs of a company's borrowings. Sometimes, companies record a net figure here for interest expense and interest income from invested funds. Pretax income: Another carefully watched indicator of profitability, earnings garnered before the income tax expense is an important bullet in the income statement. Many techniques are available to companies to avoid or minimize taxes that affect their reported income. Because these actions are not part of a company's business operations, analysts may choose to use pretax income as a more accurate measure of corporate profitability. Income taxes: As stated, the income tax amount has not actually been paid. This is an estimate or an account that has been created to cover the amount a company expects to pay in taxes. Special items or extraordinary expenses: A variety of events can occasion charges against income. They are commonly identified as restructuring charges, unusual or nonrecurring items, and discontinued operations. These write-offs are supposed to be one-time events. Investors need to take these special items into account when making year-to-year profit comparisons because they can distort evaluations. Net income (net profit or net earnings): This is the bottom line, which is the most commonly used indicator of a company's profitability. Of course, if expenses exceed income, this account caption will read as a net loss. After the payment of any preferred dividends, net income becomes part of a company's equity position as retained earnings. Supplemental data is also presented for net income based on shares outstanding (basic) and the potential conversion of stock options, warrants, etc. (diluted). Comprehensive income: The concept of comprehensive income, which is relatively new, takes into consideration the effect of such items as foreign currency translations adjustments, minimum pension liability adjustments, and unrealized gains/losses on certain investments in debt and equity. The investment community continues to focus on the net income figure. The adjustment items all relate to economic events that are out of the control of a company's management. Their impact is real, but they tend to even out over an extended period. Now let's take a look at a sample income statement for company XYZ for the fiscal years ending 2019 and 2020 (expenses are in parentheses): Income Statement For Company XYZ FY 2019 and 2020 (Figures USD) 2019 2020 Net Sales 1,500,000 2,000,000 Cost of Sales (350,000) (375,000) Gross Income 1,150,000 1,625,000 Operating Expenses (SG&A) (235,000) (260,000) Operating Income 915,000 1,365,000 Other Income (Expense) 40,000 60,000 Extraordinary Gain (Loss) - (15,000) Interest Expense (50,000) (50,000) Net Profit Before Taxes (Pretax Income) 905,000 1,360,000 Taxes (300,000) (475,000) Net Income 605,000 885,000 From the above example, we can deduce that between the years 2019 and 2020, Company XYZ managed to increase sales by about 33% while reducing its cost of sales from 23% to 19% of sales. Consequently, gross income in 2020 increased significantly, which is a huge plus for the company's profitability. Also, general operating expenses have been kept under strict control, increasing by a modest $25,000. In 2019, the company's operating expenses represented 15.7% of sales, while in 2020, they amounted to only 13%. This is highly favorable in view of the large sales increase. As a result, the bottom line—net income—for the company increased from $605,000 in 2019 to $885,000 in 2020. The positive year-over-year trends in the statement components, both income and expense, have lifted the company's profit margins (net income/net sales) from 40% to 44%—again, that's highly favorable. If you are a DIY investor, you'll have to do the math. If you use investment research data, the experts crunch the numbers for you. By understanding the income and expense components of the statement, an investor can appreciate what makes a company profitable. In the case of Company XYZ, it experienced a major increase in sales for the period reviewed and was also able to control the expense side of its business. That is an indicator of efficient management. The one worth further investigation with a view to a possible investment.