



THE INCOME STATEMENT: CONCEPT AND PRINCIPLES

Khalilov Bahromjon Bahodirovich
Asia International University, Bukhara
Lecturer of department of Economics


Abstract: *This article provides a practical analysis of the practical application of the income statement and the problems in the transition to international financial reporting standards and ways to overcome them.*

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An important component of manager–owner communication is the firm’s financial statements. Firms organized as proprietorships or partnerships are not required to prepare financial reports or statements except for tax purposes. Of course, proprietors and partners must gather financial data so as to be able to evaluate their financial performance over time. Requests for bank loans need to be accompanied by recent financial statements, too. In contrast, companies organized as corporations are required to prepare financial reports annually for the benefit of their shareholders. Public corporations are required to file annual reports with the SEC. An annual report contains descriptive information on operating and financial performance during the past year, a discussion of current and future business opportunities, and financial statements that provide a numerical record of financial performance. Usually, financial highlights are provided on the first page or two, followed by a letter to the stockholders by the firm’s chairman of the board and chief executive officer (CEO). The CEO summarizes the financial results for the year and identifies the firm’s strengths, such as employee talents and the size of its customer base. After the CEO’s letter, most companies describe their current business areas, future opportunities, and financial goals, such as a target return on equity or earnings growth rate.


The income statement reports the revenues generated and expenses incurred by a firm over an accounting period, such as a quarter or year. The accrual concept is used to construct the income statement. Let’s look at some of the major income statement accounts in greater detail. The starting point of the income statement reflects the revenues or sales generated from the operations of the business. Often, gross revenues are larger than net revenues. This is due to sales returns and allowances that may occur over the time period reflected in the income statement.





Sometimes, when customers make early payment on their bills, cash discounts are given by the firm. If customers buy in large quantities, trade discounts may be given. Thus, discounts will reduce gross revenues. The costs of producing or manufacturing the products sold to earn revenues are grouped under cost of goods sold (COGS). These expenses reflect costs directly involved in production, such as raw materials, labor, and overhead and, thus, vary with the level of production output. Selling, general and administrative expenses tend to be stable or fixed in nature and cover requirements such as record keeping and preparing financial and accounting statements. These expenses reflect the costs associated with selling the firm's products. This includes salaries and/or commissions generated by the sales force as well as promotional and advertising expenditures. Depreciation is an estimate of the reduction in the economic value of the firm's plant and equipment caused by the creation of the firm's products or services. Each financial period's income statement shows the amount of depreciation expense specific to that period. Accumulated depreciation, or the sum of prior period depreciation expense, appears in the balance sheet. No cash outflow is associated with depreciation, so it is considered to be a noncash expense. Operating income is a firm's income before interest and income taxes, and is sometimes referred to as earnings before interest and taxes (EBIT). Interest expense is subtracted from operating income. When a portion of a firm's assets are financed with liabilities, interest charges usually result. This is true for bank loans and long-term corporate bonds. Operating income less interest expense gives the firm's pretax earnings, or earnings before taxes. Businesses are required to pay federal income taxes on any profits. Most states tax business profits. Taxable earnings, or profit, are defined as income remaining after all other expenses have been deducted from revenues, except income taxes. Effective income tax rates can vary substantially depending on whether the firm is organized as a proprietorship, partnership, or corporation. More information on taxes appears in this chapter's Learning Extension. The net income, or profits, remaining after income taxes are paid reflects the earnings available to the owners of the business. This income may be retained in the business to reduce existing liabilities, increase current assets, and/or acquire additional fixed assets. On the other hand, some or all of the income may be distributed to the owners of the business. Because of accrual accounting, a firm's net income over some period may not be the same as its cash flow. The amount of cash flowing into the firm can be higher or lower than the net income figure. For a corporation, a firm commonly shows its net income on a per-share basis. This is referred to as the earnings per share (EPS) and is calculated by dividing the net income by the number of shares of common stock that are outstanding.






In addition to the income statement and balance sheet, corporate annual reports also want to measure changes in cash flows. All three of the previously described financial statements are prepared using an accrual accounting system whereby items are recorded as incurred but not necessarily when cash is received or disbursed. For example, a sale of \$100 is recorded as a sale this year even though the cash is not expected to be collected until next year.

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