

Parts of an Income Statement, Part 2

Of course profit and cost of goods sold expense are the two most critical components of an income statement, or at least they're what people will look at first. But an income statement is truly the sum of its parts, and they all need to be considered carefully, consistently and accurately.

In reporting depreciation expense, a business can use a short-life method and load most of the expense over the first few years, or a longer-life method and spread the expense evenly over the years. Depreciation is a big expense for some businesses and the method of reporting is especially critical for them.

One of the more complex elements of a an income statement is the line reporting employee pensions and post-retirement benefits. The GAAP rule on this expense is complex and several key estimates must be made by the business, such as the expected rate of return on the portfolio of funds set aside for these future obligations. This and other estimates affect the amount of expense recorded.

Many products are sold with expressed or implied warranties and guarantees. The business should estimate the cost of these future obligations and record this amount as an expense in the same period that the goods are sold, along with the cost of goods expense. It can't really wait until customers actually return products for repair or replacement, should be forecast as a percent of the total products sold.

Other operating expenses that are reported in an income statement may also have timing or estimating considerations. Some expenses are also discretionary in nature, which means that how much is spent during the year depends on the discretion of management.

Earnings before interest and tax (EBIT) measures the sales revenue less all the expenses above this line. It depends on all the decisions made for recording sales revenue and expenses and how the accounting methods are implemented.