Reading the Income Statement

Is It Actually Profitable? — Lesson Explainer

The Concept

The income statement walks from revenue down to net income. Gross profit (revenue minus cost of goods sold) shows how much the core product makes. Operating income (gross profit minus running costs) shows overall profitability. Net income (operating income minus interest and tax) is the true bottom line.

Turning each into a margin (dividing by revenue) lets you compare companies of different sizes fairly. Don't stop at the headline net income - check whether profit is growing from the core business or propped up by a one-off item that won't repeat.

Illustrative Example: Two Years, One Real Improvement

Real income statements don't come with round numbers, so here's a clean illustrative example to see the mechanics clearly.

Line Item	Year 1	Year 2	Change
Revenue	$400.0M	$460.0M	+15.0%
Cost of Goods Sold	$240.0M	$262.2M	+9.3%
Gross Profit	**$160.0M**	**$197.8M**	**+23.6%**
Gross Margin	40.0%	43.0%	+3.0 pts
Operating Expenses	$104.0M	$124.2M	+19.4%
Operating Income	**$56.0M**	**$73.6M**	**+31.4%**
Operating Margin	14.0%	16.0%	+2.0 pts
One-Off Gain (asset sale)	$0.0M	$18.0M	new
Interest & Tax	$16.8M	$22.1M	+31.5%
Net Income	**$39.2M**	**$69.5M**	**+77.3%**
Net Margin	9.8%	15.1%	+5.3 pts

Net income jumped 77.3% - but operating income (the core business) grew a more modest 31.4%, while $18M came from a one-off asset sale. Strip that out and net income growth is closer to 33% - still good, far less dramatic than the headline.

5 Things to Know About the Income Statement

1. Revenue growth alone isn't the full picture - margins can shrink even as revenue grows.

2. Margins matter more than the raw profit number - expanding margins mean rising efficiency.

3. One-off items distort the headline - asset sales and settlements inflate net income temporarily.

4. Operating income is often the most honest number - it sits above one-off items and interest/tax.

5. Compare margins to history and peers - a good margin in one industry is mediocre in another.

4 Things to Check When Reading an Income Statement

• Check multi-year trends - one good year means little on its own.

• Scan for one-off items in the filing notes.

• Compare margins to direct competitors in the same industry.

• Watch the expense lines - costs growing faster than revenue is an early warning sign.

Worth knowing:
the income statement is one of three core financial statements - pair it with the balance sheet and cash flow statement for the full picture. A company can look profitable here while quietly running into trouble elsewhere.

Quiz — Answer the questions, then check the key on the next page

1. What does gross profit measure?

A. Total cash in the bank
B. Revenue after all expenses including tax
C. Revenue minus the direct cost of making the product
D. The company's stock price

2. Why can net income jump sharply without the core business improving much?

A. Net income can only change if revenue changes
B. A one-off item like an asset sale can inflate net income for a single period
C. Companies are required to grow net income every year
D. It's always due to a stock split

3. Why is operating income often a more honest measure than net income?

A. It's always a bigger number
B. It includes one-off gains, which net income excludes
C. It's the same thing as revenue
D. It sits above one-off items and interest/tax, unrelated to core performance

4. Why does a margin need context to be meaningful?

A. A given margin can be great in a low-margin industry and mediocre in a high-margin one
B. Margins are always exactly 10% regardless of industry
C. Margins only apply to technology companies
D. Context never matters once you have the margin number

5. Why was the 77.3% net income growth in the example less impressive than it first appears?

A. Because revenue actually fell that year
B. Because the company changed its accountant
C. Because a large chunk came from a one-off asset sale that won't repeat
D. Because net income growth is never a meaningful number

Answer Key

1. What does gross profit measure?

Correct answer: C. Revenue minus the direct cost of making the product

Gross profit is revenue minus cost of goods sold - it shows how much the core product makes.

2. Why can net income jump sharply without the core business improving much?

Correct answer: B. A one-off item like an asset sale can inflate net income for a single period

One-off gains can inflate the net income headline without reflecting the ongoing business.

3. Why is operating income often a more honest measure than net income?

Correct answer: D. It sits above one-off items and interest/tax, unrelated to core performance

Operating income reflects day-to-day performance before items that can swing for unrelated reasons.

4. Why does a margin need context to be meaningful?

Correct answer: A. A given margin can be great in a low-margin industry and mediocre in a high-margin one

A 10% margin is strong in groceries but mediocre in software - always compare against peers.

5. Why was the 77.3% net income growth in the example less impressive than it first appears?

Correct answer: C. Because a large chunk came from a one-off asset sale that won't repeat

Stripping out the $18M one-off gain, underlying growth was closer to 33% - still healthy, less dramatic.