Understanding Income Statements

A company's **income statement** is a record of its earnings or losses for a given period. It shows all of the money a company earned (revenues) and all of the money a company spent (expenses) during this period. It also accounts for the effects of some basic accounting principles such as depreciation. The income statement is important for investors because it is the basic measuring stick of profitability. A company with little or no income has little or no money to pass on to its investors in the form of dividends. If a company continues to record losses for a sustained period, it could go bankrupt. In such a case, both bond and stock investors could lose some or all of their investment. On the other hand, a company that realizes large profits will have more money to pass on to its investors.

Example of an Income Statement

The income statement shows revenues and expenditures for a specific period, usually the fiscal year. Income statements differ by how much information they provide and the style in which they provide the information. Here is an example of a hypothetical income statement, with revenues in black and expenditures in red (and parentheses):

Wilma's Widgets Income Statements for the Years Ending 1998 and 1999

	1998	**1999**
Sales	$900,000	$990,000
Less Cost of Goods Sold	(250,000)	(262,500)
Gross Profit on Sales	**650,000**	**727,500**
Less General Operating Expenses	(120,000)	(127,500)
Less Depreciation Expense	(30,000)	(30,000)
Operating Income	**500,000**	**570,000**
Other Income	50,000	30,000
Earnings Before Interest and Tax	**550,000**	**600,000**
Less Interest Expense	(30,000)	(30,000)
Less Taxes	(50,000)	(54,500)
Net Earnings (Available Earnings for Dividends)	**470,000**	**515,500**
Less Preferred and/or Common Dividends Paid	(70,000)	(80,000)
Retained Earnings	**400,000**	**435,500**

Now, as perplexing as those numbers might seem at first, you will become comfortable with them very quickly once we explain what all this financial jargon really means. Let us start by looking at the first term that was calculated - gross profit on sales.

Gross Profit on Sales

Gross profit on sales (also called **gross margin**) is the difference between all the revenue the company earns and the sales of its products minus the cost of what it took to produce them. Let us move on to clarify how to calculate this important number.

Gross Profit on Sales = Net Sales - Cost of Goods Sold

Simple, yes, but let's be sure we know what the terms sales and costs of goods sold means to the accountants.

Net sales are the total revenue generated from the sale of all the company's products or services minus an allowance for returns, rebates, etc. Sometimes on an income statement, you might see the terms "gross sales" and "returns," "rebates" or "allowances." Gross sales are the total revenue generated from the company's products or services before returns or rebates are deducted. Net sales on the other hand have all these expenses deducted.

Cost of goods sold is what the company spent to make the things it sold. Cost of goods sold includes the money the company spent to buy the raw materials needed to produce its products, the money it spent on manufacturing its products and labor costs.

When you subtract all the money a company spent in the production of its goods and services (cost of goods sold) from the money made from selling them (net sales), you have calculated their **gross profit on sales**.

Gross profit on sales is important because it reveals the profitability of a company's core business. A company with a high gross profit has more money left over to pump into research and development of new products, a big marketing campaign, or better yet - to pass on to its investors. Investors should also monitor changes in gross profit percentages. These changes often indicate the causes of decreases or increases in a company's profitability. For instance, a decrease in gross profit could be caused by an industry price war that has forced the company to sell its products at a lower price. Poor management of costs could also lead to a decreased gross profit.

Operating Income

Operating income is a company's earnings from its core operations after it has deducted its cost of goods sold and its general operating expenses. Operating income does not include interest expenses or other financing costs. Nor does it include income generated outside the normal activities of the company, such as income on investments or foreign currency gains.

Operating income is particularly important because it is a measure of profitability based on a company's operations. In other words, it assesses whether or not the foundation of a company is profitable. It ignores income or losses outside of a company's normal domain. It also excludes extraordinary events, such as lawsuits or natural disasters, which in a typical year would not affect the company's bottom line.

An easy way to calculate operating income is as follows:

Operating Income = Gross profit - General Operating Expenses - Depreciation Expense

General operating expenses are normal expenses incurred in the day-to-day operation of running a business. Typical items in this category include sales or marketing expenses, salaries, rent, and research and development costs.

Depreciation is the gradual loss in value of equipment and other tangible assets over the course of its useful life. Accountants use depreciation to allocate the initial purchase price of a long-term asset to all of the periods for which the asset will be used.

Earnings Before Interest and Taxes

Earnings before interest and taxes (EBIT) is the sum of operating and non-operating income. This is typically referred to as "other income" and "extraordinary income" (or loss). As its name indicates, it is a firm's income excluding interest expenses and income tax expenses. EBIT is calculated as follows:

EBIT = Operating Income +(-) Other Income (Loss) +(-) Extraordinary Income (Loss)

Since we already know what operating income is, let's take a closer look at what other income and extraordinary income mean.

Other income generally refers to income generated outside the normal scope of a company's typical operations. It includes ancillary activities such as renting an idle facility or foreign currency gains. This income may happen on an annual basis, but it is considered unrelated to the company's typical operations.

Extraordinary income (or loss) occurs when money is gained (or lost) resulting from an event that is deemed both unusual and infrequent in nature. Examples of such extraordinary happenings could include damages from a natural disaster or the early repayment of debt.

Many companies may not have either other income or extraordinary income in a given year. If this is the case, then earnings before income and taxes is the same as operating income. Regardless of how it is calculated, EBIT is especially relevant to bondholders and other debtors who use this figure to calculate a firm's ability to "cover" or pay its interest payments with its income for the year.

Net Earnings (or Loss)

Net earnings or **net income** is the proverbial bottom line. It measures the amount of profit a company makes after all of its income and all of its expenses. It also represents the total dollar figure that may be distributed to its shareholders. Net earnings are also the typical benchmark of success. Just a reminder, however, many companies report net losses rather than net earnings.
How do we calculate net earnings?

Net Earnings = Earnings Before Interest and Taxes - Interest Expense - Income Taxes

Interest expense refers to the amount of interest a company has paid to its debtors in the current year. Meanwhile, income taxes are federal and state taxes based upon the amount of income a company generates. Often a company will defer its taxes and pay them in later years.
Net earnings are particularly important to equity investors because it is the money that is left over after all other expenses and obligations have been paid. It is the key determinant of what funds are available to be distributed to shareholders or invested back in the company to promote growth.

Retained Earnings

Retained earnings are the amount of money that a company keeps for future use or investment. Another way to look at it is as the earnings left over after dividends are paid out. Generally, a company has a set policy regarding the amount of dividends it will pay out every year. In this case, 70% of net earnings become retained earnings.
Calculation of retained earnings:

Retained Earnings = Net Earnings - Dividends

To better understand retained earnings, we need to explain the nature of dividends. Dividends are cash payments made to the owners or stockholders of the company. A profitable year allows them to make such payments, although there generally are no obligations to make dividend payments. When a company has both common and preferred stockholders, the company has two different types of dividends to pay.
Every publicly traded company has common stockholders. Dividend payments to common stockholders are optional and up to each company to decide how (or if) it will make such payments. A firm may decide to plow all of its earnings into new investments to promote future growth. Preferred stockholders are in line before common stockholders if a dividend is declared. However, not all companies have preferred stockholders.
As an investor, it is important to know what a company does with its net earnings. An investor needs to know the company's dividend and retained earnings policies to decide whether the company's objectives are in line with the investor's. If the company pays dividends it is income-oriented. If it retains earnings for future expansion, it is growth-oriented.
Knowing the sources of income and expenses is necessary when reading an income statement..

The Importance of the Income Statement to Investors

The income statement provides the investor with much insight to the company's revenues and expenses. You can identify where the company spends much of its income and compare that to similar companies. You can also compare a company's performance with previous years. Most importantly, the income statement tells an investor if the business is profitable. If the company continually makes substantial profits, it indicates to bondholders that it is a stable company. The savvy investor will compare income statements of similar companies.

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