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THE INCOME STATEMENT STRUCTURE AND PRELIMINARY CONSIDERATIONS

The Income Statement Structure

The income statement reveals the results of the company's operation and management. This usually is the first section of the financial statement to be analyzed, because, among other things, it affects most of the components of the balance sheet, either directly or indirectly. For example, businesses selling products on credit have accounts receivable on the balance sheet. If credit sales change, either in volume or in repayment terms offered to purchasers, so should accounts receivable.

The chart below shows the typical income statement structure. The left side shows the account lines and the various additions and subtractions made in order to calculate the net profit or income. The right side shows the same items, but in the order usually found in a tax return.

| Income Statement Structure | |
|--------------------------------------|--|
| Account lines on financial statement | Account lines on tax return |
| Gross sales | Gross sales |
| – discounts, allowances and returns | – discounts, allowances and returns |
| = Net sales | = Net sales |
| – cost of goods sold | – cost of goods sold |
| = Gross profit | = Gross profit |
| – operating expenses | + other income |
| = Operating profit | = Total income |
| + other income | – operating expenses |
| – other expenses | – other expenses |
| – interest expense | – interest expense |
| = Net profit before taxes | = Ordinary income* or taxable income** |
| – taxes | – taxes** |
| = Net profit after taxes | = Net profit after taxes |

* Partnerships, LLCs, and S corporations

** C corporations

In both financial statement and tax returns, the income statement begins with net sales, which is derived by subtracting discounts, returns and allowances from gross sales. Cost of goods sold is the cost of producing or purchasing a product and varies somewhat by type of business. Subtracting cost of goods sold from net sales determines gross profit. Gross margin is gross profit expressed as a percentage of net sales.

Some costs are fixed or semi-variable, and also controlled by the owner, such as lease costs. Other costs are variable, such as cost of goods sold. Operating expenses are more in the control of the business owner. These expenses include advertising, selling, salaries, and other expenses for the ongoing operation of the business. The relationship of fixed costs, total costs and net sales is called operating leverage.

Operating income is calculated by subtracting total operating expenses from gross profit. If a company has an operating loss, it may not be able to repay its loans. Other income and other expenses also must be considered. Some of these expenses may be extraordinary or nonrecurring. Notice that in the tax return format, other income is added to gross profit to determine total income. Other expenses and interest expense are included in the operating expenses category.

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Finally, when applicable, taxes are calculated, and net profit after tax is determined. Reconciling net worth shows whether net profit was retained as a future source of funding for the business, or was distributed among its owners. Earnings retained in a business increase net worth, while money taken out as dividends decreases net worth.

An income statement may be called a profit and loss statement, an earnings statement or an operating statement. Whatever the designation, it provides a summary of a firm's total revenues and total expenses recognized in the generation of profit for a specific period. For comparative purposes, income statements reflect the normal operating cycle of a business. A financial statement covering an operating cycle of 12 months is a fiscal-year statement. Tax returns also usually cover a 12-month period. A financial statement prepared for a period of less than 12 months (that is, semiannual, quarterly or monthly) is called an *interim statement*.

How the type of business affects the structure

Income statement analysis is affected by the type of business. Service and agricultural businesses generally have little or no cost of goods sold. Components of the cost of goods sold are different for manufacturers, wholesalers, retailers, and construction businesses. The accounting method used for reporting revenue (accrual or cash basis) and for reporting inventory (LIFO, FIFO, or weighted average) ultimately affects various profit subtotals. The lender must understand and know the following major accounts of an income statement:

- Net sales
- Cost of goods sold
- Operating expenses
- Other income and other expense
- Interest expense
- Net profit/income

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Preliminary Considerations

A feature of most income statement spreads is to express each account as a percentage of net sales. As part of a comprehensive analysis, each account is further evaluated. The first step is to understand the company's business and some basics about its income statements by asking the following questions:

- How are the statements prepared?
- What operating strategy and objectives are employed?
- Under what conditions does the company operate?
- What methods are used to recognize revenue and expenses?

| Income Statement Spread: Dry Supply | | | | | | |
|-------------------------------------|----------------|-------|----------------|-------|----------------|-------|
| Income Statement (\$ in 000s) | Review 20x4 | | Review 20x5 | | Review 20x6 | |
| | Amount | % | Amount | % | Amount | % |
| Net sales | \$895 | 100.0 | \$937 | 100.0 | \$918 | 100.0 |
| Cost of goods sold | 645 | 72.1 | 667 | 71.2 | 631 | 68.7 |
| Gross profit | 250 | 27.9 | 270 | 28.8 | 287 | 31.3 |
| Selling, gen. and admin. expense | 157 | 17.5 | 173 | 18.5 | 180 | 19.6 |
| Officer's compensation | 36 | 4.0 | 31 | 3.3 | 28 | 3.1 |
| Rent expenses | 15 | 1.7 | 18 | 1.9 | 20 | 2.2 |
| Bad debt expense | 2 | 0.2 | 1 | 0.1 | 0 | 0.0 |
| Profit sharing expense | 7 | 0.8 | 7 | 0.7 | 0 | 0.0 |
| Depreciation expense | 12 | 1.3 | 12 | 1.3 | 13 | 1.4 |
| Total operating expenses | 229 | 25.6 | 242 | 25.8 | 241 | 26.3 |
| Operating income | 21 | 2.3 | 28 | 3.0 | 46 | 5.0 |
| Other income | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Interest income | 2 | 0.2 | 2 | 0.2 | 2 | 0.2 |
| Rental income | 3 | 0.3 | 3 | 0.3 | 3 | 0.3 |
| Interest expense | 6 | 0.7 | 7 | 0.7 | 11 | 1.2 |
| Net profit before tax | 20 | 2.2 | 26 | 2.8 | 40 | 4.4 |
| Taxes | 11 | 1.2 | 12 | 1.3 | 17 | 1.9 |
| Net profit after tax | \$ 9 | 1.0 | \$ 14 | 1.5 | \$ 23 | 2.5 |

Types of businesses

Income statements reflect the different operating characteristics of agricultural, wholesaling, retailing, manufacturing, service, and construction businesses. For example, relative to other types of businesses, manufacturing and retailing companies realize a higher gross profit as a percentage of net sales. Because of substantial operating expenses, a greater gross profit margin typically is more necessary for a manufacturer or a retailer than a wholesaler. Because the product cost is generally not marked up substantially, a wholesaler has a low gross profit. Furthermore, because it sells products faster, a wholesaler is in less danger of absorbing significant losses when a product becomes obsolete or loses consumer acceptance. Service and agricultural businesses often have no cost of goods sold, so gross profit margin and net sales are the same.

Many other differences between businesses show up on the income statement. Selling expenses are a large item on a retailer's income statement, whereas salaries and general and administrative expenses make up a significant part of a professional service company's operating budget. A business banker should be aware of the typical differences among businesses and industries, and consider the financial statements of a borrower within the proper context.

Management objectives

Business operating strategies and objectives also shape income statements. If Dry Supply, wanted to penetrate or capture a large share of a market, it might reduce the selling price of its products without lowering costs. Over one or more years, this action likely would result in a decrease in net profits. Similarly, introducing a new product, such as a new cleaning powder, may increase selling expenses and temporarily depress the company's earnings. By understanding these considerations before analyzing an income statement, a business banker will be able to more accurately interpret trends.