

6. STATUS RESULTS, INCOME, EXPENSES AND PROFIT

6.1 EXPLAINED: The **income statement** is a financial accounting report showing a company's income (earnings) for a given time period, including primarily the period's revenues and expenses that result in that income.

The relationship between income, revenues and expenses is given by the **income statement equation**:

$$\text{Income} = \text{Revenues} - \text{Expenses}$$

Income is viewed as a measure of a company's earning performance for a specific time period. Earning income is a top-level objective for profit-making companies: income increases owner value through retained earnings (which build owner equity) and through dividends paid directly to owners.

This entry defines and explains income statement structure and content with examples, in context with income-related terms including revenue, expense, margin, and profit,

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Other terms for income and income statement

The term income is essentially synonymous with several other terms including **earnings** and **profits** (more accurately, **net profit** or **profit after taxes**). Income is also known less formally as the **bottom line**, referring to its position on the income statement.

Note, however, that several different income statement results are called "profit," including the reported overall net profit (the bottom line), but also **gross profit** and **operating profit** (see the example statement below and the section Profits and margins defined below).

Many people refer to the income statement as a **profit and loss statement** or **P&L**. The income statement may also be called a **statement of financial performance** or **statement of financial operations**.

Also, even though they are not driven by profit-making objectives, government and non-profit organizations still report and account for incoming funds and outgoing expenses. These organizations regularly publish an income-statement-like report under the name statement of operations or statement of activities.

The meaning of income and income statement: Company objectives and performance measures

Publicly traded companies (those that sell shares of stock to the public) are required almost everywhere to report publicly on financial performance and financial position, quarterly and annually. Privately held companies, however, may withhold such information from the public and from competitors (but not from the tax authorities).

The line items and figures that appear on a detailed income statement consist primarily of account names and the sums of account transactions for the entity's revenue and expense category accounts, across a reporting period. Income statements also include the results of adding and subtracting certain account figures so as to show items such as gross profit, operating profit, and net profit after taxes.

Income statements usually cover a reporting period just ended (a fiscal quarter or fiscal year), presenting all of the entity's revenues, expenses, and income, from:

1. Operations in the company's normal line of business
2. Financial investments (even if the company is not in financial services).
3. Extraordinary or special one-time kinds of gains and expenses that are not part of the company's normal business (such the sale of assets, or actions such as re-structuring the company).

When an income statement is published (reported), those with a serious interest in company survival and growth generally look primarily to the first category above, results for the company's normal line of business. These results are summarized as operating income (operating profit). Results in categories 2 or 3 may be large or small, beneficial or detrimental, but it is the normal operating income (operating profit) that signals the company's ability to operate profitably in its own line of business.

Other profit metrics extracted from the income statement, which are slightly more inclusive, and which have a similar meaning, include:

- Earnings before interest and taxes (EBIT)
- Earnings before interest, taxes, depreciation, & amortization (EBITDA).

Income measures such as EBITDA are sometimes called **selective income metrics** because they reflect only some of the company's revenues and expenses for the period. See the encyclopedia entry [earnings before interest and taxes](#) for more on the meaning and reasons for using EBITDA and other selective metrics.

By contrast, the overall "bottom line" net income (net profit) is sometimes called **residual profit**, or **residual income**, because it is all that remains after all expenses have been subtracted from revenues.

The income statement itself normally begins with a statement of the time period covered by the report, with a phrase such as

"...for the year ended 31 December 2014. "
 "...for the quarter ended 30 June 2014."

This contrasts with another financial accounting statement, the balance sheet, which shows the status of assets, liabilities and owner's equities at one point in time (e.g., At 31 December 2014.)

In principle, profit making companies exist and operate primarily to create value for their owners. The company's primary way of doing this is by earning income. Once income is declared there are essentially only two things the company can do with it:

1. Declare all or part of the income as "retained earnings," which increases owner value by increasing owner's equity on the balance sheet.
2. Distribute all or part of the income to the company owners (shareholders) as dividends—a more direct way to provide owner value.

Income statement explained with an example

The income statement is an application of the income statement equation:

Income = Revenues – Expenses

The income statement format simply builds detail into each term of this equation. The income statement sample below might represent a manufacturing company, but the general statement format and major categories are typical for companies across a wide range of industries. A company that sells services rather than manufactured goods might report "Cost of services" rather than "Cost of goods sold," but aside from a few such minor differences in terms, the income statement format (structure and contents) is nearly universal.

Note by the way, that reported income, revenues, and expenses do not necessarily represent real cash inflows or outflows. This is because regulatory groups, standards boards, and tax authorities, allow or require companies to use conventions such as depreciation expense, allocated costs, and accrual accounting on the income statement. Actual cash flow gains and losses for the period are reported more directly on another reporting instrument, the statement of changes in financial position (or cash flow statement).

Those familiar with double entry bookkeeping and accounting systems may also note that most of the income statement line items are really the names of accounts from the organization's Chart of Accounts—specifically, the organization's "Revenue" and "Expense" category accounts.

Expenses fall into five major categories. The first three categories represent expenses that come from the company's normal business:

- Cost of Goods Sold
The costs of producing goods or services (other companies may report this expense category as "Cost of Services" or "Cost of Sales.")
- Operating Expenses – Selling Expenses
The costs of selling the goods or services
- Operating Expenses – General and Administrative Expenses
Overhead, support, and management costs from across the company

Also note that depreciation expenses may appear in each of these categories, depending on what the assets in question are used for.

The remaining two major expense categories refer to both gains and losses from activities that are not in the company's normal line of business. This company is not, for instance, in the financial services, or financial investing, or lending business. This company is also not in the real estate business. Financial

transactions in these areas must be reported separately from the areas that contribute to normal operating income.

- **Financial Revenues and Expenses**
These include revenues from invested funds and costs from financing borrowed funds
- **Extraordinary Items**
These may include large gains or losses from selling land or major assets, or from major actions restructuring the company (e.g., the expenses of laying off part of the workforce).

Profits and margins defined:

**Gross margin,
Operating margin, and
Profit margins**

Bottom line net income is a measure of the company's financial performance for the period, but the income statement contains other performance metrics as well. The difference between net sales revenues and cost of goods sold is called gross profit, for instance, while the net income from operations—before taxes and before gains and losses from financial and extraordinary items—is called operating income (or operating profit).

All three of the profit lines from the income statement (gross profit, operating profit, and bottom line net profit) can also be expressed as a percentage of net sales, that is, as margins.

Margins, in turn, are very important indicators of a company's performance, watched keenly by stock market analysts, potential investors, boards of directors, and the company's own management.

- Analysts will compare the company's margin percentages directly with margins from competitors and with industry "best in class" standards. They will consider not only the current margins, but also period-to-period trends in margins.
- The company's management attention will focus on margins for several reasons:

First, margins are central to the company's business model. Margins in the model, that is, show exactly where the company expects to make money.

Secondly, management will watch closely year-to-year changes in margins. Margins are a highly sensitive indicator of the company's ability to compete effectively and reach strategic objectives in its business plan.

Thirdly, margins for individual product lines and individual products are central to product planning and product portfolio management. The income statement shows the gross margin, for instance, of the whole company, but underneath the company average gross margin (and shielded from competitors and public eyes), each product has its own gross margin as well. Only by knowing and managing the mix of individual product gross margins can management optimize the gross margin for the overall product set.

Income and financial statement metrics

The term Financial Metrics refers to analyses performed on financial statement figures, as well as cash flow estimates in the business case and investment analysis. The word *metrics* refers to measurement, and financial metrics—like descriptive statistics—reveal characteristics of a body of data that might not be appreciated easily simply by reviewing the data figures. Several of the major line items on the income statement provide further indicators of company performance by contributing to commonly used financial statement metrics (financial statement ratios).

The financial statement metric (or ratio) "Inventory Turns," for instance, describes the company's ability to use inventory assets efficiently and effectively. The metric is derived from an income statement term ("net sales") and a balance sheet term ("inventories"), and has meaning based on the idea that a company's assets should be working for the company and not sitting idle and unproductive.

Financial metrics based primarily on income statement and balance sheet figures are designed specifically to address questions like these:

- Is the company prepared to meet its short term financial obligations?
Liquidity metrics such as current ratio address questions of that kind.
- Is the company using its resources efficiently?
Activity metrics such as inventory turns are designed for such questions.
- Are the company's funds supplied primarily by owners or by creditors?
Leverage metrics, such as debt to asset ratio provide answers
- Is the company profitable? Is it making good use of its assets?
Profitability metrics such as operating margin address such questions.

- What are the company's prospects for future earnings?
Valuation metrics, e.g., price to earnings ratio deal with such questions.
- How does the company's growth over the last five years compare to growth of similar companies? To industry averages? Growth metrics such as the cumulative average growth rate for sales revenues address such questions.

6.2 CYCLE OF CASH FLOW: The statement of cash flows includes only the inflows and outflows of cash (and cash equivalents). Income statements and balance sheets are typically prepared on an accrual basis. On an accrual basis when a product is sold on 30 day terms, the sale is recognized at the time the products or services are provided. On a cash basis, the sale is not recognized until the cash is actually received. The statement of cash flows provides a bridge between these two accounting systems.

The statement of cash flows is typically divided into three sections:

Operating Activities

Investing Activities (also called Discretionary)

Financing Activities

Cash Inflows

<u>Operating</u>	<u>Investing</u>	<u>Financing</u>
<ul style="list-style-type: none"> • Receipt from the sale of goods or services • Proceeds from the sale of marketable securities held in a trading portfolio • Interest or fee income • Dividends 	<ul style="list-style-type: none"> • Principal collections from loans and sales of other entities' debt instruments • Sale of equity instruments in other entities • Sale of property, plant and equipment 	<ul style="list-style-type: none"> • Proceeds from issuing stock • Proceeds from debt

Cash Outflows

<u>Operating</u>	<u>Investing</u>	<u>Financing</u>
<ul style="list-style-type: none"> • Payments for inventory 	<ul style="list-style-type: none"> • Purchase of property, plant & equipment 	<ul style="list-style-type: none"> • Payment of Dividends • Repurchase of stock

- Payments to suppliers
- Payments to employees
- Payments of interest
- Purchase of debt or equity in a trading portfolio
- Purchase of equity in other businesses
- Repayment of debt principal
- Capital lease payments

Cash Flow from Operations

The indirect (reconciliation) method derives net cash from operating activities by adjusting net income for revenue and expense items not resulting from cash transactions.

The direct method determines cash flow from operations from operating cash receipts and payments as opposed to adjusting net income for items that do not impact cash.

Cash Flow from Investing Activities (Discretionary Cash Flow)

Cash flow from investing activities is usually negative and reflects the acquisition of fixed assets and investments. These discretionary purchases may be funded through positive cash flow from operations, a reduction in cash or from financing activities (borrowings). Components of Investing activities include the purchase and sale of fixed assets (PP&E) and the acquisition and sale of investments.

Cash Flow from Financing Activities

The cash flow from financing activities section details repayment of principal and borrowings. Cash flow from operations should be sufficient to support the amortization of debt, a major component of financing activities. Components include short-term borrowings, changes in capital leases and borrowings and repayment of long-term debt. The impact of debt restructuring is summarized in this section.

Cash Flow - Trend Analysis

Cash flow from operations is viewed over a period of time to see if it is trending positively or negatively. As a lender, cash flow should be sufficient to support loan payments with a coverage buffer. Banks usually want this buffer or coverage ratio to be at least 1.2x higher than debt service requirements. High growth companies

typically have negative cash flow from operations, as accounts receivable and/or inventory growth requires cash. As a company's growth rate stabilizes, cash flow tends to increase as working asset growth becomes less demanding. Stable and declining companies sometimes provide the highest cash flow as accounts and inventory shrink. It is extremely important to understand the components of cash flow from operations as it can be skewed in a period by an increase or reduction of a single component. A temporary increase or reduction in either working assets or liabilities at year-end can have a positive or negative impact on cash flow.