Today’s Content

• The Income Statement
  – Revenue - expenses = Income (Profit … earnings)
  – Several earnings measures
    • EBIT
    • Net income
  – Earnings per share
  – Comprehensive income
  – Ratios & trends
• The Statement of Stockholders’ Equity
The Income Statement

- The income statement … statement of earnings for an accounting period
  - Revenues - expenses = Net income
  - And “earnings per share”
    - Net income/Shares outstanding
  - Consolidated
  - Three years of data in Annual report & 10K
  - Usually in “multi step” format
    - With several intermediate profit measures

Net Earnings

- Net sales … Net revenue
  - Total sales or revenue net of returns & allowances
  - Trend & margins are always important piece of information (as with most income statement items)
  - When does a company recognize revenue?
    - When both title & risk of loss transfers to the customer
    - Has become a significant issue in the e-world!

Cost of Goods Sold

- Cost of Goods Sold (COGS) … Cost of revenue
  - Based on a “cost flow assumption”
    - FIFO … LIFO … Average cost
  - Microsoft “… includes direct costs to produce and distribute product and to provide online services, consulting, product support, and training and certification of system integrators” (ref: Microsoft notes)
Gross Profit

- Gross profit … Gross margin
  - Gross profit = Net revenue - Cost of revenue
  - The first earnings measurement
  - Gross profit margin = Gross profit/Net sales (revenue)

Operating Expenses

- Operating expenses … usually expensed as incurred:
  - Sales and marketing
    - Directly related sales & marketing expenses including advertising
  - Research and development
  - General and administrative
    - Includes depreciation & amortization
  - Special charges
    - Employee termination packages … closing facilities … etc.

Operating Profit

- Operating profit … Operating income
  - Operating profit = Net revenue - Cost of revenue - Operating expenses
  - EBIT … earnings before interest & taxes
  - Operating profit margin = Operating revenue/Net revenue
  - The second earnings measurement
Investment & Other Income

- Investment & other income, net
  - Income from investments + dividends - interest expenses - losses from sale of fixed assets
  - Essentially non-operating income and expenses

Income Before Taxes & Effect of Accounting Change

- Income (earnings) before taxes
  - EBT = Operating income + Investment income
  - The third earnings measurement
  - Provision for income taxes
    - US federal rate: 35%

Change in Accounting

- Income before cumulative effect of accounting changes
  - Income before acctg change = EBT - Taxes
  - The fourth earnings measurement
- Cumulative effect of change in accounting principle
Net Income

- Net income (earnings)
  - Net income = All revenue - All expenses
  - The overall earnings measurement
  - Net profit margin = Net earnings/Net revenue

Earnings Per Share

- Earning per common share
  - Basic: Net income/Common shares outstanding
    - The return to the common shareholder
  - Diluted: Net income/Common shares outstanding + Outstanding stock options, warrants, & convertible securities
    - The return adjusted for the potential effects of options & other convertibles

Comprehensive Income

- Comprehensive income
  - Includes all income from gains & losses & adjustments, as well as operations
  - Four special items:
    - Gains & losses from foreign currency translations
    - Unrealized gains & losses on investments
    - Additional pension liabilities
    - Cash flow hedges … derivatives (financial instruments that derive their value from an underlying asset or index)
Comprehensive Income
(Example)

• Statement of Stockholder’s Equity (Microsoft 2001):
  – Net income $7,346
  – Other comprehensive income:
    • Cumulative effect of acctg. change (75)
    • Net gains on derivative instruments 634
    • Net unrealized investment losses (1,460)
    • Translation adjustments & others (39)
  – Comprehensive Income $6,406

Income Statement

• The Income statement is relatively straightforward
  – The ratios and trends are very important for determining a company’s health
  – But its what’s behind the numbers that count
    • Presenting a good income statement is very important … so much so that management sometimes plays tricks with the numbers to suit their own purposes
    • Further analysis tells the story

Statement of Stockholders’ Equity

• Statement of Stockholders’ Equity
  – Details the transactions that affect the equity accounts on the balance sheet
  – Shows the “changes to stockholders’ equity” during an accounting period
    • Stock accounts
    • Retained earnings
    • Other comprehensive income
Dell

  - Preferred stock - -
  - Common stock $4,795 $3,583
  - Retained earnings 839 1,260
  - Other comp. Income 62 533
  - Other (74) (68)
  - Total stockholders’ eq.$5,622 $5,308

Summary

- The Income Statement
  - Revenue - expenses = Income (Earnings)
  - Earnings measures:
    - Net revenue - cost of revenue (cogs) = Gross profit
    - Net revenue - cogs - operating expenses = EBIT (operating income)
    - Operating income + investment income = EBT & Effect of Accounting Changes
    - EBT - Taxes = Income before effect of acctg change
    - All revenue - All expenses = Net income
    - Net income/Common shares out = EPS
Summary
(continued)

• Comprehensive income
  – All revenues, gains and losses recognized during an accounting period … not just those from operations
• The Statement of Stockholders’ Equity
• Trends and ratios tell more of the story!
  – And it’s what’s behind the numbers that really tells the story!