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A note on income statementS: A beginner’s guide

Janey Zhang wrote this note under the supervision of Professor Zhichuan (Frank) Li solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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If you can understand football scoring or read a recipe, you can understand an income statement (with the help of this note!). An income statement is a report that shows all the revenues and costs over a specific period of time, typically a year or a quarter. A company (in reality, the company’s accountants) uses its income statement to show managers and investors how much money has been earned (revenue), how much has been spent (such as costs and taxes), and most importantly, how much is left (net earnings or losses).

It is important to be able to understand an income statement (which is why we suggest that everyone read this note), as it tells investors and company stakeholders whether the company is making money. It also provides information to company managers that allows them to make better forecasts and decisions.

Fortunately, all income statements are standardized, which means that they look similar. As a result, this two-page guide is sufficient to help readers understand all the basics of any income statement; Tesla, Inc.’s (Tesla’s) 2020 income statement will be used as an example.

Every income statement starts with the Total Revenue (also termed the Total Sales) at the top. This is the total amount of money earned from sales of products and/or services. Next, the Cost of Goods Sold (COGS) is deducted from the Total Revenue to determine the Gross Profit. For its car-making business, Tesla purchases auto parts from other manufacturers, and the total cost of such purchases is the COGS. In addition to the COGS, there are Operating Expenses, such as selling expenses, administrative costs, depreciation, as well as research and development costs. These expenses are deducted from the Gross Profit to determine the Earnings Before Interest and Taxes (EBIT) (also known as the Operating Income). After a company pays interest on the money it has borrowed, the remaining sum is the Earnings Before Taxes (EBT) or Taxable Income. Next, the company pays tax to the government based on its taxable income and the tax rate. Finally, the money that remains is the Net Income (or Net Earnings), that is, the actual money earned by a company for its owners (i.e., stockholders). If the number is negative, it represents a Net Loss for the owners. The company must then decide to either distribute the Net Income to stockholders in the form of dividends, or reinvest it in the company for expansion purposes. In sum, an income statement shows the steps by which the Net Income is calculated as the revenue minus the cost of goods sold, operating expenses, interest, and taxes (yes, the order matters!) (see Exhibit 1).

EXHIBIT 1: Tesla Income Statement

|  |  |  |
| --- | --- | --- |
| **Tesla Income Statement (in Trillion US$)**  1/1/2020–12/31/2020 | | |
| *Line items* | *Amount* | *Steps* |
| **Total Revenue** | **$32** | 1. The Total Revenue summarizes all the money earned. |
| **Cost of Goods Sold (COGS)** | **-$25** | 2. Subtract the COGS from the Total Revenue to determine the Gross Profit. |
| **Gross Profit** | **=$7** |
| **Operating Expenses** | **-$5** | 3. The Operating Expenses summarize all the costs of running a business. |
| **Operating Income (EBIT)** | **=$2** | 4. Subtract the Operating Expenses from the Gross Profit to determine the EBIT. |
| **Interest Payment** | **-$0.8** | 5. Subtract the Interest Payment to creditors from the EBIT to determine the EBT. |
| **Earnings Before Taxes (EBT)** | **=$1.2** |
| **Taxes** | **-$0.3** | 6. Based on the EBT, pay taxes, and what remains is the Net Income. Investors care about the Earnings Per Share (EPS), which is the Net Income divided by the total number of shares. |
| **Net Income** | **=$0.9** |

Source: “Tesla, Inc. (TLSA),” Yahoo! Finance, accessed April 4, 2021, <https://finance.yahoo.com/quote/TSLA>.