Summary Notes: A3—Income Statement and Statement of Retained Earnings

Income statement records information on:
Revenue--income from goods and services sold
Expenses—spending undertaken by the firm to generate revenue

The income statement tells us if the company made a **profit or loss** *over a particular time frame* (month, quarter, or year).

Net Income Equation:

Revenue − Expenses = Net Income

Income statement (figures are in thousands):

J&M, INC.		
INCOME STATEMENT for Year Ending December 31, 2015)		
Total revenue		**$300,000**
Cost of revenue		**188,000**
Gross profit		**112,000**
Operating expenses		
Selling/admin	**44,720**	
Depreciation	**20,000**	
Lease expense	**14,000**	
Total	**78,720**	**(78,720)**
Operating income		**33,280**
Interest pmt.		**(5,200)**
Income before income taxes		**28,080**
Provision for income taxes		**(8,080)**
Net income		**$20,000**

Notes on income statement:

- **Revenue** from goods and services sold in accounting period
- **Cost of revenue**—wages, cost of raw materials etc.
- **Gross profit (gross margin)** = revenue - cost of revenue as percent of revenue
    - ($112,000,000/$300,000,000) x 100 = 37.33%
- **Operating expenses** (interest, rent, payroll, selling, administration etc.)
    - Unlike cost of revenue, operating expenses are incurred even if no goods are sold
    - **Depreciation** (allowance for aging of an owned asset) is an operating expense because it is part of normal business operations
- **Operating margin** = gross profit – operating expenses as percent of revenue
    - $33,280,000/$300,000,000) x 100 = 11.09%
- **Interest pmt.**—interest paid on bonds, lines of credit etc.

- **Net income** = net profit = accounting income = net margin = “the bottom line”

- **Net margin** = net income as a percent of revenue
  - ($20,000,000/$300,000,000) x 100 = 6.67%

Why do we bother to calculate 3 different definitions of profit for the firm?

- If firm is having trouble with its profitability, doing so can help identify the source(s) of problem(s)
  - Too few sales and too high cost of goods? That will show up in gross margin
  - Too much spent on advertising or other costs? That will show up in operating margin
  - Can't have a healthy bottom line unless the other margins are healthy
  - Stock analysts often compare these margins to other firms in the industry which, presumably, operate under similar conditions--red flag if costs seem excessive.

Companies report retained earnings to show how net profit was deployed

Example: Statement of retained earnings for J&M, Inc. 2015 (figures are in thousands)

Cash Dividends	
Preferred stock	$600
Common stock	9,400
Total dividends	$10,000
Retained earnings	
Beginning of year (01/01/2015)	$32,400
Current year	10,000
End of Year	**$42,400**

Notes:

- Recall from the income statement that J&M, Inc. had net income of $20,000,000 this year
- Paid out dividends totaling $10,000,000 to both preferred and common stock holders
- Retained $10,000,000 to reinvest in the business
- The balance sheet (Summary Notes A2) shows retained earnings for 2015 were $42,400,000, up $10,000,000 from 2014 when they were $32,400,000.
- Companies that are growing rapidly often don't pay dividends and plough any profits back into the company to support future growth:
  - Shareholders in growth companies interested in growth of the stock price, not dividend
- Companies that offer a mature product in a mature market (like electrical utilities) pay dividends

Earnings per share (EPS)

- How many fellow shareholders do you have to split the pie with?
- Example: Balance sheet shows 10 million shares outstanding (Summary Notes A2):

$$EPS = \frac{\$20,000,000}{10,000,000} = \$2$$