Posted to the Gilder forum - March 24, 2001

Income Statement for Dummies!

All Income Statements look more or less like this. They can have more or fewer details depending on how the company is organized but the concepts remain:

Title	Meaning
Sales (Revenue)	This is the net sales of a company, what customers paid for the stuff they bought. This item actually has two components, sales and returns. Returns are seldom made public but they are an important measurement for management.
Less: Cost of Sales	This item is sometimes placed further down in the Income Statement as part of general expenses. If the company uses outside sales reps and has to pay them a commission for sales, then this might be the better place for it
Net Revenue	Sales less the Cost of Sales
Less: Cost of Goods Sold	This item includes all the direct manufacturing costs that can be attributed to specific manufacturing processes Parts, Raw materials, Direct labor, Depreciation, R&D
Gross Income	Net Revenue less Cost of Goods Sold
Less: General Expenses and Overhead	This item includes all the expenses that cannot be assigned directly to "Cost of Good Sold" and that cannot be segregated as "Extraordinary" or "Financial," items, see below
Net Income	Gross Income less General Expenses and Overhead
Plus or minus: Extraordinary Items	Here you put stuff that is not recurring like the purchase of other companies and the income and expense generated by investment or loans.
Gross Profit, or Profit Before Taxes	Net Income plus or minus Extraordinary Items
Less: Taxes	What your Uncle Sam gets
Net Profit after Taxes	Gross Profit less Taxes

Not all items in the above statement are monetized and that is why you draw up a Cash Flow Statement.

For example:

- If you sell on credit not all sales will become cash and old Accounts Receivable can become cash
- If you buy on credit same thing backwards
- You pay for a factory and equipment but its useful life is several years. You don't expense the plant when you buy it. You add it to "Fixed Assets" and depreciate it an appropriate amount each year. Here is a non monetized expense except when you paid for it when it was a huge sum
- Same for other capital investments that are not depreciated but amortized
- Taxes credits are not monetized when they happen but are used over time

So, the Cash Flow adjusts the Income Statement in such a way as to show what happened to your cash.

This is a pretty simplistic view but it is sufficient for the Individual Investor. You might want to read about "look-through" earnings (point 6 in the Owner's Manual) which is what Warren Buffett looks at.

Later:

Rick:

What interests you is what you get from your company after all the other people have taken their share, including customers, providers, creditors and Uncle Sam. So, **Earnings** is what's left after taxes. That's why it's called **"The Bottom Line,"** because it is the last, bottom most line on the Income Statement! BTW, **"The Top Line"** is either gross or net revenues, depending on how the company reports its sales.

If it were only that easy!

There are "Real" earnings and "Pro Forma" earnings. Accounting can tells as many lies as statistics and almost as many as politicians. For example, when you do a merger, in some cases the GAAP forces you to create a "Good Will" account where you put the excess you paid over book value of the company you acquired.

This seems to say that you overpaid for the company you bought. But this is generally not the case. The real story is that the "Book Value" of the company you bought does not reflect the real value that you are buying. This happens for several reasons, one of them being that fact that accounting does not always reflect reality. For example, a company like US Steel builds a furnace and that goes to "Fixed Assets" and gets depreciated over 10 or 20 years. On the other hand, a company like Microsoft spends the same amount of money on R&D for Windoze and it gets expensed the year it is spent. In other words, Windoze does not show up in "Fixed Assets," according to the accounting it's worth ZIP, ZILCH, NADA! Ridiculous!!!!! (Well, it's almost true ;-)))) Things can go the other way. Say you pay your top people with stock options, there is no "direct cost" involved so it does not show up in the accounting but the value of the stock holder's shares become diluted so they do feel the effect of it.

To sum up, accounting, "GAAP," is a BIG LIE!

Based on this big lie, people make forecasts, no wonder they usually get them wrong!

But to get back on track, companies that did buy other companies then try to undo the BIG LIE by reporting "Pro Forma Earnings." In essence, they "undo" the "Good Will" accounting.

But there is more confusion:

ttm = trailing twelve month. This is not the figure that shows up the 10-Q three out of four times, it only matches the 10-Q for the last fiscal quarter.

Earnings estimates, analysts consensus. This is the figure that analysts dream up and seldom has too much to do with reality. For years, Cisco has managed to massage their accounting in such a way as to beat the analysts consensus estimates by ONE CENT! Highly suspicious, I would say.

Then people use 'Forward P/E" which is based on the "Analysts Guesstimates."

What all this means is that it's a mine field out there and you have to use a lot of common sense to make any sense out of it. I like what Buffett does, he ignores most of the playing around. He uses the real "Bottom Line" and makes some adjustments to it. Like I said before, it's good to study what Warren Buffett does. He has learned to get the accounting and reporting bull shit out of the way. Half the time the figures you get out of management were designed to make them look good. What you want is the naked truth, not the management's fairy tales.

As to cash flow, in most companies you can ignore cash flow because, long term, it will be very similar to earnings. There are some exceptions but I don't know much about them. it seems that capital intensive industries like oil are better analyzed on a cash flow basis. The same would be true of GX which is very capital intensive. For most others, just ignore cash flow.

Denny
"Demand creates queues. Supply gets rid of them."
Software Times