Five Tips for Analyzing an Income Statement

By Christopher Mallon

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In today's article, we'll be looking at the income statement, which is the most deceptively simple of the major financial statements. I say simple because it's just a list of all the revenue, minus all the expenses, to calculate what's left over in profit. It's no more difficult than putting your family budget together, right?

That's where the deceptive part of the description comes in. The items on the income statement are easily manipulated by, say, less-than-honest management, and don't necessarily represent the true situation at a company. Even totally honest companies can have income statements that don't represent economic reality. Cash flows define economic reality, revenue and expenses define accounting reality.

You see, the difference between your household budget and a company's income statement is their relationships to actual cash flows. Your household budget will generally match your cash inflows and outflows. Not so with an income statement. Income statements can vary significantly from the company's cash flow, meaning that a company in economic trouble can show a very "good" income statement up until the day it goes bankrupt.

Generally speaking, though, the income statement is a good place to start when evaluating a company. In my forthcoming e-book, Fundamentals of Financial Statement Analysis, I lay out the process for evaluating the health of a company through the financial statements. I'm shooting for publication in the beginning of 2004, but in the meantime, here are some tips and strategies for evaluating an income statement.

1. Create a Common Size Statement

What's a common size statement, you ask? It's the income statement, only with each line item represented as a percentage of sales. This is easy to do with a spreadsheet on your computer, but you can do it on paper just as well. Net Sales is always 100% at the top, and each of the expenses is divided by total sales to arrive at a percentage. For example, if a company has $100 in sales and $50 in cost of goods sold, the common size statement will look like this:

Sales 100%
Cost of Goods Sold 50%
Gross Profit 50%

The importance of the common size statement can't be overstated. It gives you the calculation of all your profit margins, from gross to net, and shows how much each cost item takes away from your profits.

2. Create a Year-to-Year Comparison Statement

The next step is to make a year-to-year comparison statement. You can't evaluate financial statements for just a single year; they have to be compared to previous years. The only formula you need to know for these calculations is:

(current year / previous year) – 1 = % change

Again, a spreadsheet makes this process so much easier, but it can be done by hand. I like to have five years of data, which yields four years of comparison data. This way you aren't just looking at an exceptionally good or bad year for the analysis. Plus, you can get a reasonable estimate of future growth when you do your discounted cash flow analysis. (I'll have more on the Discounted Cash Flow in the future.)

3. Read the Management Discussion and Analysis

If you take the time to read the MD&A, you'll have an advantage on most investors. A majority of individual investors simply skip this part, and go right to calculating ratios or looking at the EPS. Seasoned investors know that the MD&A provides the backup data for the income statement line items, and they will take time to read it.

A good Management Discussion and Analysis will give you the details you need to understand the items on the income statement. You should get segmented sales data, cost drivers, etc. in this section. If you can't make sense of the MD&A, that should set off alarm bells in your head. If you don't find the information you need in the MD&A, you should…

4. Look at the Notes to Consolidated Financial Statements (Footnotes)

The footnotes tend to be more difficult to understand than the MD&A, but you get really detailed information here. The footnotes are where management hides the dirty laundry. And when you've got guys making today's corporate salaries that laundry pile can get pretty big. Here's where you'll likely find what you couldn't in the MD&A, it's just that in the notes you may have to do some putting of two and two together.

Take your time sifting through this section, and try to identify the income statement items that relate to the footnotes you're reading. You can do it the other way around, as well, and look for the footnotes that relate to the income statement item.

If you still can't figure out what the company is doing, after going through the MD&A and the footnotes, you may want to consider looking at another company. This one may be too complicated (or too devious) for your abilities. Don't feel bad about not understanding the business, either. Even the great Warren Buffett admits that he doesn't understand some businesses, and he never lets his ego run away from him. If he can't understand it, he won't invest in it. I recommend you do the same thing.

5. Look at segmented data

I always like to look at segmented sales and profit figures to determine which product lines, or operating businesses, are growing sales faster than the others. This information is usually in the MD&A. If you can, try to find the operating profit for each business segment as well. Then look at the profit margins for each segment of the business.

You may be surprised at the different profitability levels of each business segment. Compare the segment with the fastest growing sales versus the segment with the highest operating profit. If these are the same segment, that's good news. If they aren't, that's okay too.

You do want to watch out for companies that have the lowest operating profit in their fastest growing segment. This could cause a decline in the company's overall profitability as sales grow faster than profits. For example, a segment that's growing 5% a year, but has a 10% margin, will contribute more to total operating profit growth than a segment growing at 20% a year with a 1% margin.

I hope you find these tips helpful. Of course, there are plenty of other analysis tools that you can use to evaluate financial statements. It's important that you keep looking for more and better ways to analyze company data, because constant learning will make you a consistently better investor.

Chris Mallon is the editor and publisher of the Undervalued Weekly, a free personal finance and investment newsletter dedicated to creating smarter investors.

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Are You Financially Fit?

By Abel Cheng

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When it comes to health, you go for a medical checkup to see if you're physically fit. The medical report will tell everything about your health.

But when it comes to wealth, it's as important that you do a regular checkup for your financial health. You need to know where you are financially before you decide what you want to achieve financially.

What do you do to ascertain your level of financial fitness?

You can use financial statements to determine your financial fitness. They are income statements and balance sheets.

It sounded boring and alien to me when I first prepared my income statement and balance sheet. The process is tedious as you need to dig out things and get them organized in a proper format.

But I can tell you once you've done this checkup, you'll have a clear picture where you stand financially and you can take the necessary measures to achieve financial freedom.

Besides that you'll be more in control of your money and know how to spend your money wisely.

Let's get started to determine your financial fitness.

Income Statement

First, you can prepare an income statement. An income statement is also called profit and loss statement. An income statement consists of two sections: monthly income and expenses.

Your income would probably comprise salary, rent from real estate, dividends from stocks and bonds, interests from savings accounts, and royalties.

Your expenses would be food, clothing, utilities, car loan payments, credit card payments, home mortgage payments, medical expenses, entertainment, insurance payments, charity, taxes, and education.

List down your income and expenses into each section accordingly. Then calculate your total income and expenses.

Once you've done that, it's time to calculate your net income. Net income is the difference between your gross income and expenses:

net income = gross income - expenses

If you have a negative net income, it tells you that you spend more money than you make. You'll have to have plans to reduce your spending or increase your income.

Balance Sheet

Next step is to prepare a Balance Sheet. Like income statements, balance sheets also have two sections: assets and liabilities.

Assets are your cash, real estate, car, bank accounts, stocks and bonds, mutual funds, retirement accounts, and businesses.

Liabilities include mortgages, credit card loans, car loans, personal loans, education loans, and taxes.

Prepare your own balance sheet by listing down your assets and liabilities. Calculate your total assets and total liabilities.

The following step is to calculate your net worth. Net worth is the difference between total assets and total liabilities:

net worth = assets - liabilities

Net worth is usually used to determine whether a person is wealthy.

You deserve a pat on your shoulder if you've come so far with me. By doing this simple exercise, you are one step ahead of many people.

You'd have known the level of your financial fitness by now.

So, are you financially fit?

To help you with this exercise, you can use our free money worksheet at http://www.financiallyrich.com/wealth-calculator.asp

Abel Cheng offers small and medium enterprises exclusive global profits insider tips in his free publication, Abel Cheng's Business Diary. To officiate a bi-weekly subscription, please go tohttp://www.abelcheng.com/diary.html

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