Understanding the Income Statement

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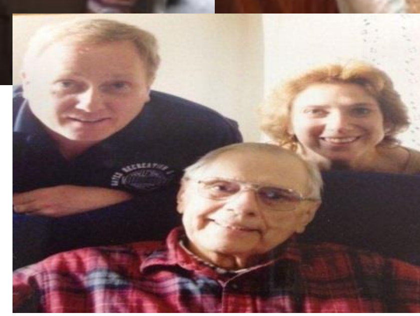
FREDONIA STATE UNIVERSITY BLUE DEVILS

DARTMOUTH BIG GREEN



How to start analysis process

- The user of a firm's annual report can expect to encounter a great quantity of information that encompasses the required information:

- - Financial statements
- - Notes to the financial statements
- - The auditors report
- - Five year summary of key financial data
- - Management's discussion and analysis of operations
- – As well as material that is included in the report at the imagination and discretion of management.

Starting the analysis process

- To understand how to navigate the vast amount of information available to financial statement users, background on the accounting rule-making environment is necessary.

- Financial statements are prepared according to generally accepted accounting principles (GAAP) that have been adopted in order to achieve a presentation of financial information that is understandable by as well as relevant and reliable for decision making.

Continuing the analysis process

- The SEC regulates US companies that issue securities to the public and requires issuance of a prospectus for any new security offering. The SEC also requires regular filings of:
- Annual reports – 10-K
- Quarterly reports 10-Q
- Other reports- if you change auditors that would be a 8-K.

Who regulates the SEC

- The SEC has congressional authority to set the accounting policies and has issued rulings called Accounting Series Releases (ASRs) and Financial Reporting Rulings (FRR's).
- For the most part however, accounting rule making has been delegated to the Financial Accounting Standards Board (FASB).
- The FASB is comprised of seven full time paid members. The Board issues Statements of Financial Accounting Standards and Interpretations, usually after some lengthy process of deliberations.
- The SEC and FASB work together to develop accounting policy, with the SEC playing mainly a supporting role.

Where to find financial information

- Corporate financial statements are available from several sources. All publicly held companies must file a form 10-K annually with the SEC. The information in this document is mandated by the SEC and contains uniform content, presented in the same order for all filing companies.

- Documents filed with the SEC can usually be accessed through the Electronic Data Gathering, Analysis, Retrieval (EDGAR) database at the SEC's website www.sec.gov

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Which Financial statements to use

- **Balance Sheet-**Shows the financial position – assets, liabilities, and stockholders equity of a firm on a particular date, such as the end of quarter or year.

- **Statement of Cash Flows –** The Statement of Cash Flows is, in reality, another way of presenting the balance sheet

The Income Statement

- The income statement, also called the statement of earnings presents revenues, expenses, net income and earnings per share for an accounting period, generally a year or quarter.

- The SEC requires that for reporting purposes you show three years of data.

Understanding the Income Statement

- Show how net income is derived
- Calculate earnings per share
- Reconcile changes in retained earnings
- Discuss the statement of shareholders equity

Just the income statement?

- The income statement is just one of many reports of the financial statement package and like the other reports it is partially the product of a wide range of accounting choices, estimates, and judgements. (LIFO/FIFO), Straight line or accelerated deprecation.)

- Earnings are measured on an accrual basis (not Cash) – you recognize the sale when it happens not when you get paid.

What is in the Income Statement

Gross Sales
-Sales Returns
-Sales Discounts
NET SALES
-Cost of goods sold
GROSS PROFIT
-Selling and Administrative Exp.
-Advertising
-Depreciation/Amortization
OPERATING PROFIT
Other Income
-Other Expense
Earnings before interest and Taxes (EBIT)
-Taxes
Net Income

Common Size Income Statement

	Income Statement			
	As of 12/31/15			
	2015	%	2014	%
Net sales	$300,000		$270,000	
Cost of Goods	($140,000)	46.67%	$129,600	48.00%
Gross Profit	**$160,000**	**53.33%**	**$140,400**	**52.00%**
Selling and Admin	($65,000)	21.67%	($54,000)	20.00%
Advertising	($21,000)	7.00%	($16,200)	6.00%
Deprec./Amortiz	($4,000)	1.33%	($3,000)	1.11%
Operating Profit	**$70,000**	**23.33%**	**$67,200**	**24.89%**
Other Income(Expense)				
Income	$2,000	0.67%	$1,500	0.56%
Expense	($6,000)	2.00%	($5,000)	1.85%
Earnings before Income Taxes	$66,000	22.00%	$63,200	23.41%
Provision for Taxes 33%	$21,780	7.26%	$20,856	7.72%
Net Income	**$44,220**	**14.74%**	**$42,344**	**15.68%**

Items requiring Separate Disclosures

Discontinued operations -

Gains/losses resulting from sale of a major portion of the business

Extraordinary transactions

Gains/losses from items meeting two criteria

1) Unusual in nature
2) Not expected to recur in the foreseeable future

Cumulative effect of accounting changes

Gains/losses from adopting a different accounting principle

**** Each item is shown after operating income. ****

Start with Sales

- Most companies report Net sales on the income statement- however to get there you must start with Gross sales.
- Gross sales **less** sales returns and allowances gets you to NET SALES.
- Should you see Net Sales increase from one year to the next you need to find out what was the reason for the increase- did they have quality growth in their sales?

Cost of goods sold

- The first expense deduction from Sales is the cost to the seller of products or services sold to customers. These are called the cost of goods sold. (CGS)
- All costs involved in manufacturing the product.
- The amount of the CGS will be affected by the inventory method of costing you firm chooses, LIFO/FIFO.
- Once the CGS number is determined you have also determined your Gross Profit number.
- For most firms the CGS number is the largest expense for most firms.

Gross Profit Percentage

- The difference between **Net Sales** and **CGS** is:

Gross Profit

- Gross Profit and CGS have an inverse relationship percentage wise. **Example:**

- Net Sales $1000, CGS $600, Gross Profit $400 CGS is 60% of sales, Gross profit is 40%

Operating Expenses

- These expenses **are not** directly related to the manufacturing of the product and are broken down as follows:
- Selling and administrative (SGA)
- Advertising
- Depreciation/Amortization

These are all area's that management has choices over and they all have considerable impact on the firms current and future profitability.

Operating Profit

- This is also known as EBIT or earnings before interest and taxes.
- This is the second step of profit determination of a firm.
- This figure provides a basis for assessing the success of a company apart from its financing and investing activities, which have nothing to do with how the firms operates in core business.

Other Income

- This lists the revenues made or lost through other operations such as dividend or interest income, interest expense, gains or losses from investments.

- After Other income and/or loss have been listed, income taxes will be assessed at the appropriate rate.

Net Income

- This is the Big number or the "Bottom Line" it represents the firms profits after all Revenues and Expenses have been reported for period.
- Just because a company shows they have Net Income we need to confirm that it was mainly from the operations of the business, not "Other Income."

- **INVENTORY -**

  FIFO versus LIFO

- **DEPRECIATION-**

  Straight Line versus Accelerated

- **BAD DEBT**

  Reserve method versus Direct

Profitability Ratios

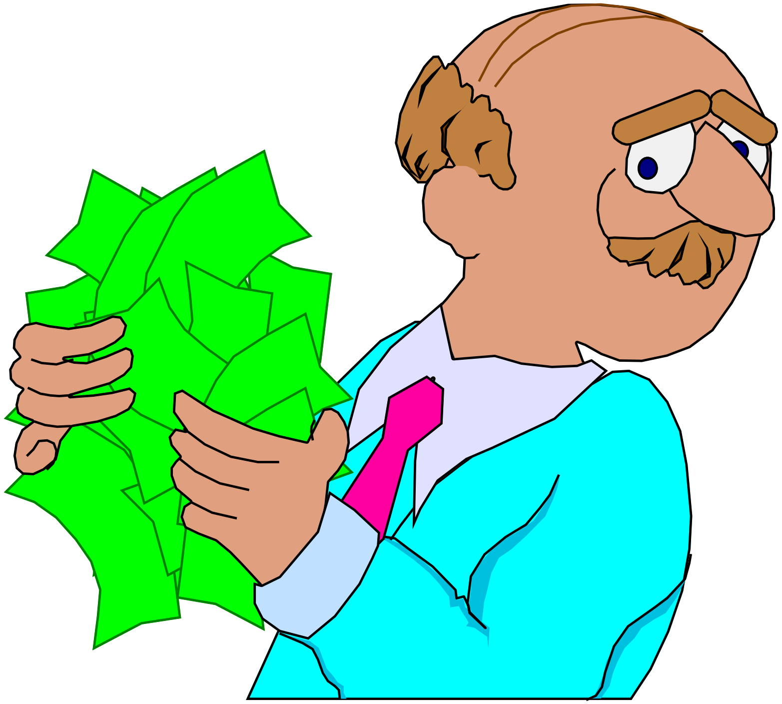
- net profit / sales
- gross margins
- Operating Profit
- net profit / net worth

Activity Ratios

- Accts receivable turnover in days –DSO
- Account Payable turnover in days -DPO
- Inventory turnover in days
- Asset turnover in days

Earning Power

- Income / Sales
- Sales / Assets
- Income / Assets



Profitable Companies

- Good Margins
- Turnover

Rons SpoRTs

CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE EARNINGS

(CAD $000's, except share and per share amounts)

Years ended October 31		2010		2009	
Sales	+13,296,000 +9.5%	$ **153,166**		$ **139,870**	
Cost of sales		109,390	71.4	97,009	69.4
Gross profit		**43,776**	28.6	**42,861**	30.6
Advertising		18,069		18,098	
Selling, general and administration		19,708		16,758	
Amortization		2,272		2,585	
Share-based compensation *[note 12]*		485		694	
Interest expense (income)		96		(67)	
Foreign exchange (gain) loss		97		(110)	
Listing costs		-	40,727 26.6%	906	38,864 27.8
Earnings before income taxes		**3,049**	2.0	**3,997**	2.9
Income tax expense – current *[note 17]*		171		1,286	
Income tax recovery – future *[note 17]*		(224)		(36)	
Net earnings		**3,102**	2.0	**2,747**	2.0
Unrealized foreign exchange losses on translation of financial statements of self-sustaining foreign operations		(301)		(578)	
Comprehensive earnings		$ 2,801		$ 2,169	
Basic net earnings per share		$ 0.05		$ 0.05	
Diluted net earnings per share		$ 0.05		$ 0.05	

Weighted average number of common shares outstanding *[note 14]*

	2010	2009
Basic	56,910,149	57,559,629
Diluted	58,101,504	57,869,238

Rons SporTs

CONSOLIDATED BALANCE SHEETS

(CAD $000's)

As at October 31	**2010**	**2009**
ASSETS		
Current		
Cash and cash equivalents *[note 5]*	$ 18,266	$ 11,532
Accounts receivable	8,866	7,965
Inventory	17,536	15,701
Prepaid expenses	3,109	1,532
Future income tax *[note 17]*	97	109
Related party promissory notes *[note 18]*	204	374
	48,078	37,213
Property, equipment and leasehold improvements *[note 7]*	5,558	2,813
Intangible assets *[note 8]*	8,908	9,517
Goodwill *[note 9]*	7,715	7,757
	$ 70,259	$ 57,300

CONSOLIDATED STATEMENTS OF CASH FLOWS

(CAD $000's)

Years ended October 31		2010		2009
OPERATING ACTIVITIES				
Net earnings	$	3,102	$	2,747
Non-cash items affecting earnings:				
Amortization		2,272		2,585
Amortization of deferred lease inducement		74		(73)
Share-based compensation		485		694
Future income taxes		(179)		(19)
Changes in non-cash working capital:				
Accounts receivable		(979)		(788)
Inventory		(2,125)		(6,149)
Prepaid expenses		(1,240)		311
Accounts payable and accrued liabilities		6,634		(521)
Income tax payable		(514)		621
Deferred gain on disposition of property and equipment		373		-
Cash provided by (used in) operating activities		**7,903**		**(592)**

Altman Z Score

- **Given** Z=1.2XI + 1.4X2 + 3.3X3 + 0.6X4 + 1.0X5
- X1= Working Capital/Total Assets
- X2=Retained Earnings/Total Assets
- X3=EBIT/Total Assets
- X4=Market Value of Equity/Total Liabilities
- X5=Net Sales/Total Assets
- **Inputs**
- Total Assets ________________
- Working Capital ________________
- Retained Earnings ________________
- PRE Tax Earnings (EBIT) ________________
- Market Value of Equity ________________
- Total Liabilities ________________
- Sales ________________

- **Altman Z score** ______________

- **Z Greater than 2.99** **Indicates a non Bankrupt company**
- **Z Between 1.81 – 2.99** **Indicates the Zone of Ignorance**
- **Z less than 1.81** **Indicates a Bankrupt prone company**

Altman Z Score for Ron's 2009

Given Z=1.2XI + 1.4X2 + 3.3X3 + 0.6X4 + 1.0X5

X1=Working Capital/Total Assets
X2=Retained Earnings/Total Assets
X3=EBIT/Total Assets
X4=Market Value of Equity/Total Liabilities
X5=Net Sales/Total Assets

<u>Inputs</u>

Total Assets	$ 57,300,000
Working Capital	$ 18,690,000
Retained Earnings	$ 35,163,000
Pre-Tax Earnings (EBIT)	$ 2,747,000
Market Value of Equity *(If not public use book value)*	$ 35,163,000
Total Liabilities	$ 22,137,000
Sales	$ 139,870,000
<u>Altman Z Score</u>	**4.80**

Z greater than 2.99	Indicates a non-bankrupt company
Z between 1.81-2.99	Indicates the Zone of Ignorance
Z less than 1.81	Indicates a bankruptcy prone company

Altman Z Score for Ron's 2010

Given Z=1.2XI + 1.4X2 + 3.3X3 + 0.6X4 + 1.0X5

X1=Working Capital/Total Assets
X2=Retained Earnings/Total Assets
X3=EBIT/Total Assets
X4=Market Value of Equity/Total Liabilities
X5=Net Sales/Total Assets

<u>Inputs</u>

Total Assets	$ 70,259,000
Working Capital	$ 20,123,000
Retained Earnings	$ 36,012,000
Pre-Tax Earnings (EBIT)	$ 3,102,000
Market Value of Equity *(If not public use book value)*	$ 36,012,000
Total Liabilities	$ 34,247,000
Sales	$ 153,166,000
Altman Z Score	**4.02**

Z greater than 2.99	Indicates a non-bankrupt company
Z between 1.81-2.99	Indicates the Zone of Ignorance
Z less than 1.81	Indicates a bankruptcy prone company

Ron’s Sporting Goods

Company Name	**Ron's Sports**			
BP Number(s)	111111		111111	
Year of statements	10/31/2010		10/31/2009	
Sales				
Current Year	$4,125,258		$3,857,520	
Prior Year	$3,857,520		$3,582,250	
Current Ratio				
CA/CL	1.72		2.01	
Debt/Equity				
Toal Debt/Equity	0.95		0.63	
Free Cash Flow				
Cash from Op - Cap Purch	$3,870,000		-$592,000	
Cash Flow Liqidity				
Cash+Mark Sec+CFO/C/L	$26,169,000	0.94	0.59	
Working Capital				
CA- CL	20,123,000		18,690,000	
DSO				
AR/Average daily sales	419,633	21.13	383,205	20.79
DPO				
AP/Average Daily CGS	299,699	90.13	265,778	67.38
Sales	153,166,000		139,870,000	
Gross Profit	43,776,000	28.58%	42,861,000	30.64%
Operating expenses	40,727,000	26.59%	38,864,000	27.79%
Earnings Before Income Tax	3,049,000	1.99%	3,997,000	2.86%
Net Income	3,102,000	2.03%	2,747,000	1.96%
Altman Z score	4.02		4.80	
Auditor Opinion	Unqualifed		Unqualifed	

History of Ron’s Sporting Goods

- Ron's sporting goods store was founded in Vancouver, British Columbia by Ron Sereika in 2000. They are one of the largest online sporting goods stores in North America, and the largest seller of personalized sports equipment in the world. In 2011, the company sold more than $180 million of merchandise. In 2004 Ron's raised $6M in an initial public offering which they used to expand in the United Kingdom and parts of Europe. In late 2004 they acquired a mail order sporting goods business in Europe called Sven's and in 2006 they also bought one in Holland and one in Japan. In 2010 they moved into the women’s sportswear arena with designer personalized sportswear. In 2011 they changed their name to R&S sporting goods and in January of 2012 they had shipments totaling over $800,000 in just women’s designer personalized clothes which at that time set a service record for online sales of made-to-order personalized women’s clothes by an online provider. As of 2012 R&S owned the following company’s; Especially for her.com, Personalize it for her.com.uk, She is the one.com.jp, Clearlyher.com. au and It's all hers.com.uk. In 2010, R&S introduced overnight shipping on all products in response to customer feedback. As a result, in 2010 they saw a 41% sales increase in the United States. Ron's provides top end athletic wear that they purchase from Nike, Addias, and Eastbay. In March of 2011 R&S expanded their designer sportswear to include the Plus sizes for women and have signed a contract with Liz Claiborne Ltd for the next 5 year. R&S also started a project called cloth the children of Africa and they will donate 1% of their annual sales to the children of Africa fund each year. Internet Retailer magazine ranked R&S as one of the top 3 web retailers in social media in January 2013.

Summary and Conclusion

- With sales in 2009 being $139,870,000 CAD they showed an increase of 9.5% as sales hit $153,166,000 CAD in 2010. Although sales increased they did see their CGS increase from 69.4% to 71.4% which could have been attributed to the new import tax the USA implemented in 2010 . Although they did have in increase in CGS they made the right move by reducing expenses in 2010 by 1.2% from 2009. (Advertising and share based compensation where the biggest expenses that decreased) With this reduction in expenses this allowed them to still record earnings before taxes of 1.99%. The biggest thing I see is that in 2010 they generated cash flow from operations of $3,870,000 where in 2009 they did not generate any cash from operations. This cash generation mainly is contributed to their AP as they must have negotiated longer payment terms as their AP and accrued liabilities went from an outflow of $521,000 in 2009 to an inflow of cash of $6,634,000 in 2010. If you look at their DPO they were at 67 days in 2009 and in 2010 their DPO calculated out to 90 days, a big improvement. They also showed improvement in how they managed their inventory in 2010 as that only increased by $2.1M as compared to 2009 when it jumped up $6.1M from 2008. They appear to have control of their debt as their debt/equity ratio is under 1 coming in at .95% in 2010. Overall we see that R&S had a 9.5% increase in sales in 2010 as compared to 2009, they generated $3.8M in cash from operations in 2010, they lowered operating expenses 1.2% from the previous year and showed a 2% profit. Their debt is under control, their working capital increased from $18.6M in 2009 to $20.1 in 2010. They easily passed the Altman Z score as they scored a 4.8 and 4.2 in 2009 and 2010 so there does not appear any chance of them filing for bankruptcy in the near future. Overall they are a very sound company.

QUESTIONS

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