One Step At a Time: A Practical Approach to Understanding an Income Statement

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Attorneys involved in lost profits litigation have likely seen more than a few income statements, or "profit and loss" statements. A solid understanding of the income statement is helpful in identifying the strengths and weaknesses of a case, assessing an expert report, or preparing a successful cross-examination. This article sets forth a practical approach for reading, understanding and analyzing an income statement.

The Pieces

Generally, there are four pieces to the income statement:

1 **Sales:** Inflows from selling products or rendering services.
2 **Cost of sales:** The direct cost of the goods sold or services provided. The amount left after subtracting cost of sales from sales is gross profit, which is the amount left to pay all other operating expenses.
3 **Operating expenses:** The costs of running the business.
4 **Net income:** What is left after all costs and expenses are paid. If costs and expenses exceed sales, a net loss results.

Think of the income statement as a staircase; navigating and understanding this document is a matter of walking down the steps. The staircase starts with the total amount of sales made during the accounting period. Each step taken after that represents a deduction of some sort. At the bottom of the staircase, one stands on what is left over from sales in terms of profit, or is left with the unsettling realization that expenses were more than sales.

Making Sense of the Pieces

While descending the staircase, one should seek to *learn* from each step. Trying to take in an entire income statement in one fell swoop is a challenge, even for a seasoned accountant. Therefore, remember the old adage and take one step at a time.

The learning process involves making *observations* and *questioning* what is seen. When observing data with respect to sales, some questions arise: What are the annual sales? Is it a small, midsize, or large company? What are the average monthly sales? How does the sales level compare to other companies in the industry? These answers pave the way for expectations. For example, one could have a reasonable expectation of how much the company would lose in sales by being closed for a month.

Observing data related to cost of sales and expenses might lead to the following questions: What is cost of sales expressed as a percent of sales? What is the largest expense? Are these the types of expenses one would expect for this type of business? Are there any non-recurring or personal expenses included? These often relate to the specific circumstances of a given case.

For many non-accounting types, an income statement is literally a page of numbers. Making sense of the income statement is a matter of turning the numbers into words and turning words into stories. For example, navigating each step of a restaurant's income statement, one might come away with this story: "The restaurant generates approximately $200,000 per month in sales. Approximately 40 cents of every dollar of sales goes to pay for food. After food costs, labor is the largest single operating expense, consuming about 20 cents of every dollar earned. Sales are sufficient to cover all expenses. For every dollar of sales, the company earns about 15 cents in profit." When one has a commanding grasp on the income statement, the numbers become stories.

Analyzing the Pieces

After navigating and learning from the income statement, the next step is to analyze the statement to draw higher-level conclusions about the business. This involves making comparisons between the numbers and one's expectations, or the numbers from two different periods (often this year and last year). Consider the following hypothetical data:

	LAST YEAR	THIS YEAR
SALES	$5,000,000	$5,500,000
COST OF SALES	2,000,000	2,125,000
GROSS PROFIT	3,000,000	3,375,000
LABOR EXPENSES	1,250,000	1,325,000
ALL OTHER EXPENSES	1,000,000	1,075,000
NET INCOME	$750,000	$975,000

A simple comparison would lead one to conclude sales, cost of sales, labor, expenses and net income all increased this year versus last year. However, looking at things on a relative basis tells a different story. Sales increased 10% for the current year, but cost of sales increased by only 6.25%. This means cost of sales actually *decreased* on a relative basis. This could signal the presence of pricing power, better purchasing practices, improved operational efficiencies, or some combination of all of them. Other expenses *decreased* on a relative basis as well. Net income increased 30%, which is three times the rate of the sales increase. These observations are only possible with analysis.

The preparation of income statements is bound by consistent accounting standards and should not vary in design and substance from company to company. Accordingly, the basic pillars to understanding the income statement of "step, observe and analyze" are applicable to pretty much any business or circumstance.