

How to Read an Income Statement – by Dan Sautner

Before we can start the reading of an income statement, we need an income statement to look at. For this article we are going to use the following as a basis:

Sample Salon Income Statement For the 5th month Ended 05/31/03				
	Current Period	%	Year-to- Date	%
Sales:				
Services	2,800	93.3	10,000	94.8
Products	200	6.7	550	5.2
	-----	-----	-----	-----
Total Sales	3,000	100.0	10,550	100.0
	-----	-----	-----	-----
Expenses:				
Accounting & Legal	100	3.3	500	4.7
Advertising	150	5.0	400	3.8
Depreciation	200	6.7	1,000	9.5
Maintenance & Repair	25	0.8	85	0.8
Memberships	125	4.2	175	1.7
Rent	250	8.3	1,250	11.8
Supplies	410	13.7	1,450	13.7
Telephone	60	2.0	300	2.8
Utilities	25	0.8	145	1.4
Wages	1,050	35.0	3,950	37.4
	-----	-----	-----	-----
Total Expenses	2,395	79.8	9,255	87.7
	-----	-----	-----	-----
Income from Operations	605	20.2	1,295	12.3
	=====	=====	=====	=====

To begin we will review the basic terminology. This statement can be called an income statement, a statement of operation, a profit and loss (P&L) or the simple revenue and expense. They all mean the same thing. It is the financial results of operating the business for a specified period of time.

The third line uses the phrase "For the 5th month Ended 05/31/03". This phrase gives you the period of time under consideration. In our sample statement we show the current period (May) and the year-to-date totals. In an annual statement you may see this year and last year and the titles will note this.

Generally speaking, the income statement will show the results of operation separate from other related business activities such as interest revenue and gain on sale of fixed assets. Next the statement will show net income before taxes. The estimate of taxes is listed next and deducted to give the true net income. Remember, while the business may be, say, a hair salon, the net income reflects all of the business activity of the company. For this article we will concern ourselves only

with income from operations.

Statements always start with the sales. This is followed with the expenses of the operation. In this sample we have listed them alphabetically; other statements may show the categories from largest to smallest in dollar value.

The above are the basics of how an income statement will look. Let us now move on towards how to read it and what it should tell you. Keep in mind that accounting seeks to turn all decisions into mathematical relationships to show the results of those decisions.

To do this I have reorganized the income statement slightly to highlight certain features.

Sample Salon

Income Statement
For the 5th month Ended 05/31/03

	Current Period	%	Year-to- Date	%
Sales:				
Services	2,800	93.3	10,000	94.8
Products	200	6.7	550	5.2
	-----	-----	-----	-----
Total Sales	3,000	100.0	10,550	100.0
	-----	-----	-----	-----
Expenses:				
Variable:				
Wages	1,050	35.0	3,950	37.4
Supplies	410	13.7	1,450	13.7
Maintenance & Repair	25	0.8	85	0.8
Fixed:				
Rent	250	8.3	1,250	11.8
Depreciation	200	6.7	1,000	9.5
Accounting & Legal	100	3.3	500	4.7
Telephone	60	2.0	300	2.8
Utilities	25	0.8	145	1.4
Discretionary:				
Advertising	150	5.0	400	3.8
Memberships	125	4.2	175	1.7
	-----	-----	-----	-----
Total Expenses	2,395	79.8	9,255	87.7
	-----	-----	-----	-----
Income from Operations	605	20.2	1,295	12.3
	=====	=====	=====	=====

Sales

These lines will tell you the composition of the business in terms of gross dollars. In our sample the sales are essentially based in the provision of services (hair salon). Very few dollars are derived from the re-sale of products. If this line of sales had been larger we probably would have wanted to show the cost of these sales separately and calculate a gross profit. The questions are: "Can the company do better with product sales?;" "Is that an area that can be expanded?;" "Should we simply ignore this and concentrate on providing services where the bulk of our sales are?" The low-product sales should also indicate a low inventory of product. If we do not sell much, we should not have to stock much. In our sample statement we have put together the supplies and the costs of these sales.

Now we move down into the body of the statement and look at the different types of expenses that this company is incurring. They are realigned into three types: variable costs - expenses that vary with the volume of business above a certain level; fixed costs - expenses that will remain the same within a wide range of volume; and discretionary costs - expenses that occur as a result of a specific purpose. Now we can look at each type and learn more about this business.

Variable Costs

These costs will vary with the level or volume of business. The reality is that no expenses are truly variable as all costs have a fixed element. Labor, for instance, is included here, but there is a certain labor cost to simply open the doors. Until the operation hits certain volume levels, the fixed portion is higher than the variable portion. In our sample, the year-to-date labor expenses, as a percentage of sales, is higher than the current period. It would seem that the volume is reaching a level where the labor costs are incremental. This means now that we have passed the base sales and the expense should fluctuate with volume. If the percentage is erratic, or constantly shrinking, it could mean you are under or over staffed. The labor expense is the largest item on this income statement and that alone requires that we examine the return on this expense closely. It is easier to save money on the larger expenses than on the smaller ones.

Fixed Costs

This type of expense is obvious. It tends to remain the same, period in and period out, within certain wide ranges of volumes. The rent expense, for example, is unlikely to change until such time as more space is needed. Rent is not something that you can buy piecemeal, and as a result needs to be considered in determining how close to capacity this business is. Department stores often use a ratio of sales per square foot of retail space as an indicator of how efficiently the space has been used. The same can hold true for your business. Look at the fixed components of cost to determine the base level of sales that this business can be supported on. Look also in terms of the highest level of business that can be done before an expansion of fixed costs is necessary.

Discretionary Costs

These are costs that are incurred in order that a specific result is achieved. In our example, we show advertising as discretionary. You should be reviewing these types of costs in terms of their ability to help the company grow. What the amount will not show you is how effective the expenditure was. Often these types of expenses, while incurred in the current period, will have longer lasting benefits. When reviewing these lines try to understand why the money was spent, and what it was meant to achieve. Think in terms of long and short term effectiveness.

To summarize, look at the following areas - sales, to learn where the core business is and where it could be expanded, and variable costs, to understand the direct costs incurred in order to earn the revenue. This will also give you an indication as to whether the businesses are above the base sales needed to survive. Fixed costs speak more to the capacity of the business. They tend to stay the same for periods of time and often cannot be reduced quickly. This is a good indicator of how much it will cost to operate a business with no sales. The discretionary costs are those expenditures designed to achieve a specific result. Look to see if they are achieving that result and whether a clear definition of these expected results are present.

In this sample statement we have shown clear-cut divisions among the three types of expenses. This has been done for simplicity. The reality is that every expense contains factors relating to all three. In budgeting it is useful to break out the fixed, variable and discretionary portion of each expense.

Finally we look to the bottom line. Here is where the sum of activity shows. Is the company profitable? Without profits, we do not survive in business. Recognize that this is an accounting profit. Adding back depreciation will give you a close look at cash profits, and by better understanding your tax situation, there may be a third type, the taxable profit. (Yes, it may sound confusing.) First, under any basis be profitable; accountants can sort out the rest.