

**From PLI's Course Handbook**

***Basics of Accounting for Lawyers 2008: What Every Practicing Lawyer  
Needs to Know***

**#14137**

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USING THE INCOME STATEMENT  
IN LEGAL PRACTICE

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# Using the Income Statement in Legal Practice

## 1.1 An Introduction to the Income Statement

The income statement is part of a company's total reporting "package"<sup>1</sup> and is an important way to measure the financial health of companies. Compared to the balance sheet - which measures financial condition including total assets, total liabilities, and the resulting net worth as of a point in time - the income statement provides insight as to how the company did over a period of time, typically a year. While the income statement is not a tax return, it does share some aspects of that statement. An income statement, like a tax return, provides information on sales (or revenues), expenses, and the net result for a period of time.

The income statement measures results of operations for a defined time period, typically a full operating cycle, or one year. Companies can also issue quarterly income statements. The income statement summarizes how much a company earned (or lost) based on all sources of revenue and expenses—including things like interest expense and the sale of assets. However, the income statement does more than tell the reader how much was earned for the period. It can also be used to evaluate the firm's historical growth, the return on the owners' investment, and how the company is doing compared to its peers. This document helps decision makers - investors, lenders, regulators, etc. evaluate a company both for historical results and its prospects. Many

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<sup>1</sup> A standard reporting package includes the income statement, the balance sheet, the statement of cash flows, and the notes. SEC registrants are required to include additional information, such as management's discussion and analysis ("MD&A").

investors focus heavily on earnings per share, a measure of the company's income over a period. Companies that "miss their number" or projected earnings per share may see their share price hit hard. A company that doesn't meet a loan covenant that measures income may be in default.

There is a reason why the income statement is traditionally the first financial statement presented after the auditor's opinion letter. It is a place where many people start their analysis of the company. (Unfortunately it is also a place where many stop their analysis.)

Refer now to Figure 1-1, below. It is the income statement for a hypothetical entertainment firm involved in films, theme parks, and licensing. Its income statement is fairly typical of most of the income statements you're likely to see in your practice. As with the balance sheet, it reflects many assumptions and estimates. Going through the sample income statement below will allow us to identify some of the common characteristics you'll see in the income statements which come across your desk.

*Figure 1-1****The Income Statement******Consolidated Statements of Income  
The Worldwide Entertainment Company and Subsidiaries***

(in millions, except per share data)	For the Year Ending 9/30/2007
Revenues	\$ 22,473
Costs and expenses	(18,161)
Gain on sale of TV station	<u>135</u>
Operating income	\$ 4,447
Corporate activities and other	(367)
Net interest expense	<u>(693)</u>
Income before income taxes	\$ 3,387
Income taxes	<u>(1,421)</u>
Net income	\$ <u>1,966</u>
Earnings per share	\$ <u>2.86</u>
Average number of common shares	687

The income statement starts out by showing the *revenues* (sometimes called *sales*) which the company has generated by selling products and services. As noted elsewhere in this book and program, you need to remember that, for the majority of companies, revenues are *not* the same as the cash receipts. Revenues merely reflect what has been accrued (“booked” or “recognized”) according to GAAP accounting principles.

**Revenues Do Not Equal Cash Receipts**

**“Revenues reflect what has been accrued  
or earned,**

***not what has actually been collected.”***

The income statement starts with the products or services sold to a company’s customers. Different products, different customers and different prices, when recognized, result in net sales or revenues. Revenues, or the “top line,” is generally what is referred to when we hear that the company “did” \$250 million last year. The \$250 million is not the cash in bank, net income, equity or total market value; it is the revenue (or “turnover” to the British). Measuring revenue is one way analysts and management evaluate a company’s results and its prospects.

At a grocery store or restaurant, for example, there are a large number of transactions every day, paid for with cash, check, or a credit card, which is the same thing to the merchant. In those cases, revenues are about the same as the cash receipts to those companies. In a construction company or a bank, however, the revenues accrued by the firm are typically based on estimates and reserves. The accounting rules say that the earnings process should be *substantially complete* before the revenues can be booked, that is, before they can be reported on the financial statements. In many ways revenue recognition - or when a company gets to claim it made a sale - is similar to the UCC. A company can claim to have made a sale (or “recognize the revenue”) when title has passed, the goods or services meet the contractual requirements, etc. Even a relatively simple consulting contract, to install an accounting system, for example, can create a number of

revenue recognition issues for the company that made the sale.

Unfortunately, “substantially complete” is open to interpretation. Frequently, management chooses to interpret aggressively. The stories of companies overstating revenues are too numerous to mention here, but they cover virtually all industries. In the late 1990s, energy trading companies and telecoms were particularly notable. A motivated manager of a company reporting to outsiders with some financial “smarts” can sometimes create the appearance of sales where none actually exist. On the other hand, owners of privately held companies may have an incentive to go the other way, to actually defer reported sales since they may have to report only to tax authorities.

In the legal industry, for example, a lawyer with a contingency fee practice who is contemplating a divorce or buying out the partners in her practice may decide to keep certain monies in her escrow account rather than showing them as income—all in an effort to reduce the apparent value of the equity in the firm.

## **1.2 Revenue Recognition**

How then do we determine the *reliability* (also sometimes referred to as the *quality of earnings*) of this top line on the income statement? One way is to go back to the all-important notes. The notes will help you understand the basis for the amount of revenue recorded or booked.

Elsewhere in the book and program, we discuss the *matching principle*, the concept of matching revenue with the costs incurred in generating that revenue. This is an issue about which you need to be familiar if financial statements are part

of your practice. You need to know the fundamental principles of revenue recognition, not to the extent that you are qualified as a public accountant, but enough that you're sufficiently knowledgeable to properly advise your client, or at least, spot issues. For example, if your client is buying another business, the client will want to know if too much revenue has been recognized already and has artificially increased the transaction price.

Revenue recognition deals with the application of specific principles which help you determine when to recognize or record earnings from a particular transaction. For example, suppose your client has a complex transaction that closes right at the beginning of her company's fiscal year. She may want to use that transaction to try to increase or enhance the company's reported income for the prior year.

Certain things will have to occur for the client to book the revenue in the prior period. If the transaction that was closed in the new fiscal year actually became a sure thing in the previous year—*sure* to the extent that a contract was agreed to, but perhaps not actually signed until the current year—it may be legitimate to recognize some or all of that revenue in the previous year. However, if the transaction was simply negotiated, but an obligation to actually buy the product did not occur (or other requirements were not met) until the current year, such previous-year recognition would not be appropriate. You should be alert to these issues in order to understand the reported results of the company.

### **1.3 Cost of Goods Sold**

Before going on to this topic, let's take a detour to Figure 1-2 which shows a generic financial statement. We've gone through the revenue part of the statement and now we come

to the next item, the cost of goods sold. If a company sells a product or a physical good, this next item on the statement is called *cost of sales* or *cost of goods sold*. For example, a supermarket sells food and other goods to its customers which it purchases from its suppliers. The cost of sales is what the company pays for the goods it then sells to its customers.

At the entertainment conglomerate, the cost of goods sold includes the cost of products which are manufactured for the company by other companies as well as the estimated cost of some items like movies, which it makes internally. In the case of the creative content, as the latter is called, the cost of sales is affected by a number of estimates such as the movie's expected economic life. This is so that the cost of making the movie can be spread out over all the periods in which it will generate revenue for the company.

Figure 1-2

### A Generic Financial Statement

Revenues (or Sales)	\$ 1,000
Cost of Goods Sold	<u>600</u>
Gross Profit	\$400
Operating Expense (S, G & A)	<u>(200)</u>
Operating Income	\$200
Interest, Taxes, Extraordinary Expenses	<u>(100)</u>
Net Income	<u>\$ 100</u>

Here's an interesting sidelight. In the case of the Walt Disney Company, a competitor to our hypothetical entertainment conglomerate, when Disney made *Snow White* available on



videocassette (and then again later on DVD), the cost only included the cost of the videotape (or DVD) and the box, since the cost of actually making the movie had been written off on Disney's books many years ago. (This "hidden treasure" was worth millions of dollars, but was carried at zero on the company's books.)

By contrast, the DVD for a movie like *Cars*, a more recent item in Disney's film catalog, will include both the cost for the physical disc and box and some of the costs Disney originally incurred in making the movie.

A major factor in determining the cost of sales is the method used to account for inventory. This is discussed in a separate part of the course and book. In light of our previous discussion, can a company *legally* manipulate its earnings up or down? The answer is, yes, within limits.

**"A major factor in determining  
the cost of sales  
is the method used to value the inventory."**

One way to accomplish this is to change inventory methods, from LIFO to FIFO, for example. Other ways include being aggressive or conservative in cost allocation, in determining the completion of projects, the amount of goods on hand, estimates of bad debts, and the like.

When a company manufactures products itself, like General Motors, the cost of goods sold also includes amounts paid by General Motors for labor, materials, and other costs incurred in manufacturing or assembling its product. Because cost

accounting can be complicated, it is sometimes subject to manipulation. Both treasures and traps can be buried in the cost of goods sold category. If the company you're looking at manufactures its own products, pay very careful attention to which costs it claims are the costs of the goods it sold and which are the costs of its operations. It can make a big difference in its gross profit, if not its operating income. Even a services firm, like a consultancy or a law firm, has a cost of services provided to the clients. These costs are typically the amounts paid to the employees who work on the client engagements.

**Cost Accounting**

**“For a manufacturing company, pay attention to which costs it claims are costs of goods sold and which are costs of operations.”**

**1.4 Gross Profit Margin**

The difference between revenues - the amount of income the firm is booking - and the cost of goods sold is frequently called the *gross margin* or the *gross profit* or simply the *margin on sales*. This is an important number. If it's not directly reported, you can and should calculate it in most cases.

**Gross Margin = Revenues - Cost of Goods Sold**

The gross margin for a supermarket chain or a grocery store is fairly straightforward. If a can of corn sells for \$1 and the cost to the grocer for that can is 70 cents, the margin is 30 cents or 30% in this case. What's the margin at a bank or a

law firm? This is discussed in another part of the course. For now, remember that the gross margin is important enough that the people who prepare financial statements will try to manipulate it up or down if doing so will help their cause. Frequently it will. The gross margin is also one of the *single best measures* of a company's profitability and financial health. Keep in mind, of course, that measuring a company's financial health is like measuring a person's physical health. There are number of ways to measure it and the composite or total health (fiscal or physical) depends on many things.

### **1.5 Other Income Statement Expenses**

Refer now to Figure 1-1. Moving down the income statement, we next find a section labeled *Other Expenses* or something similar. Some companies may give a very short summary of these costs, which are also known as Selling, General and Administrative Expenses and often abbreviated in conversation as "S, G & A." Other companies may be more detailed in their description of these costs and break it out among employment costs, costs for jet fuel, landing fees, etc. (for an airliner).

Included under S, G & A are costs like salaries and compensation of management, depreciation on assets, marketing costs, leases on equipment, office space, phone bills, legal fees, and similar items. Because this area is so broad and because it captures so many different kinds of expenses, it's possible to put in there costs that should be put in other places. Conversely, costs such as research and development expenditures may be included in this category even though they are not really expenses and should be considered assets ("capitalized: or put on the balance sheet).

Figure 1-3

**Other Expenses or Selling,  
General & Administrative (S, G & A)**

- Compensation of management
- Depreciation on assets
- Marketing costs
- Leases on equipment or office space
- Legal and other fees
- Etc.

The company's R&D department may be creating an asset, but the accounting rules governing research and development require companies to write off or expense most such outlays. As discussed elsewhere, this is primarily due to conservative accounting principles under GAAP. Typically no one really knows whether the research will ever pay off (say for a new drug) so it is considered an expense.

This uncertainty about the payoff of R&D, like other problems in accurately capturing what's happening, means that this "other expenses" category may be too high or too low and, therefore, reported income may be too low or too high due to the uncertainty.

The expenses incurred in running the business are typically called operating expenses.

One expense often found under operating expenses is *depreciation*. Depreciation is an estimate of the decline in value of equipment and other tangible assets. The deduction

for the decline in value of *intangible* assets, such as patents or film rights, is called *amortization*.

**Depreciation**

**“An estimate of the decline in value of a tangible asset.”**

**Amortization**

**“An estimate of the decline in value of  
an *intangible* asset.”**

Both categories of this expense (depreciation or amortization) are estimates made by management of the ongoing value of the asset. Accelerated depreciation means that the asset is being written off quickly, such as may be the case with computers or cell phones. Even though a computer may physically work for a long time, economically it typically has a short life, perhaps as short as two or three years, and may lose more than half its value in the first six months of ownership.

A slower depreciation method such as, for example, straight line depreciation, assumes that the asset declines in value evenly over time. This would be the case with property like office furniture which may have a useful life of 20 years. (In this case the “equipment” is probably out of style long before it is worn out physically.).

Some equipment, like vehicles or a drill press, may decline in value only through use and is written off depending on volume and not age.

The choice of depreciation method will give you an idea of management’s “reporting personality.” Does management use the most conservative method for depreciation along with an aggressive method for recognizing revenue? That means it

may be maximizing current income. Alternatively, is management holding back some income for future years by being more aggressive in writing off expenses and more conservative in recognizing revenues? This has been called “cookie jar” accounting as management “puts away” current earnings for a later date. The answers to these questions can give you a vital clue about management’s intentions in this area.

### **1.6 Operating Income**

The income left after all the operating expenses are deducted from the revenue is called the operating income or operating margin. This is the income the firm generates from its primary operation and usually excludes financing costs like interest paid or income realized from investments in securities. Unless, of course, the company you’re looking at is a bank, in which case interest is its primary source of revenue and interest expense represents the cost of goods sold or the cost of funds in that industry. Operating income should tell the reader what ongoing operations are producing and should exclude extraordinary items like the sale of a division.

The operating income also allows the reader to focus on the company’s core activity before considering costs like financing which is not a part of operations.

Operating income represents a very important number. For example, a lender would be interested in knowing what kind of earnings the firm is generating before unusual or infrequent events like the sale of a division. The latter are considered *extraordinary items* and are accounted for separately. Pay very careful attention to the consistency and quality of operating income. Just as an aside, you may have noted in Figure 1-1 that the hypothetical entertainment included the sale of its TV station as an income item *above*

the operating income. It might have come below that figure, but since it's a relatively small item in terms of the firm's overall revenue, it does not make a material difference. The separate line tells the reader it's not likely to happen again this year.

Every company has an operating income. It is a standard measure for all companies, whether they sell software (like Oracle) or groceries (like Safeway). It is a constant over a company's life. Comparing the operating income over years shows how much money a company is keeping compared to itself over the years. It also allows the reader to see how a company is doing compared to its peers.

Referring back to Figure 1-2, from the operating income we next deduct interest and taxes, and then any extraordinary gains and losses. These are intended to reflect truly extraordinary revenues and costs such as a business settlement, significant currency devaluation, losses due to a natural disaster, and the like.

Look carefully at these extraordinary items, since the people who prepare the statements or who cause them to be prepared may try to classify certain types of gains as ordinary, or operating, gains and classify certain kinds of losses as extraordinary to improve the apparent profit of the core operations. As with most other important items in the financial statements, you'll learn more about the extraordinary and operating items in the notes.

It is typical to see the accrual for income taxes here. The accrual, remember, is not the amount actually paid. It is an estimate of how much the company will pay (or has paid) based on that year's taxable income.

### **1.7 Other Items**

Below the operating income line come other items that will affect the “bottom line,” or net income. These include the following:

- Interest expense
- Other income/expense
- Changes in accounting principle
- Extraordinary items
- Tax cost/benefit

These items are separated out so a reader of the statement can evaluate the results of operating the business (operating income) compared to other factors such as a financing decision (the amount of interest expense). For example, if two firms were identical except that one borrowed a lot of money to finance operations, they would both have the same operating income, but the net income would be different because one has higher borrowing costs. The firm financed entirely with equity might also have higher taxes.

### **1.8 Net Income**

After all the income and all the expenses have been accounted for, the company will calculate its *net income* or its *bottom line*. This is an important figure for many users of financial statements, not merely to owners and investors. Net income may also be adjusted by lenders and others in making credit decisions about the company. Remember, however, that only in rare cases is net income the actual net cash



coming into the business. After all the estimates, all the reserves, and all the adjustments required for GAAP accounting, the profitability on a cash basis of the company may be much higher or much lower than what's being reported on the GAAP income statement. Nevertheless, net income and its relative, earnings per share, are widely relied on to measure the profitability of a company.

Earnings per share is the amount of the firm's total income that is theoretically attributed to each individual share of the corporation's stock.

$$\text{Earnings per share} = \frac{\text{Net Income}}{\text{Number of Shares Outstanding}}$$

Whether net income and earnings per share accurately measure profitability depends on the quality of the earnings as we discussed earlier. In simple terms quality of earnings means the reported numbers reflect reality and have not been managed up or down. Some financial statement readers equate high quality earnings with conservative earnings. The creditability and reliability of reported earnings relies on two factors: first, whether management is making realistic estimates and elections in preparing the financial statements. Being too conservative or too aggressive can mislead readers. Second, whether a truly independent auditor is involved. As we all learn from numerous accounting scandals, an audit is not really a guarantee of accuracy. It's merely a guarantee that the statements at least conform to GAAP, and that's a start. The changes to corporate reporting, including Sarbanes-Oxley are discussed elsewhere.

Outside accountants can provide lower levels of service than full audits but these also provide even lower levels of assurance about the statements. Also, keep in mind that the income statement prepared on the basis of GAAP is different from an income statement prepared for federal or state

income tax purposes. There is some resemblance to each other, but for large corporations these statements are prepared using two very different methods of accounting. For smaller and mid-size businesses, however, the tax return may be the only income statement the company ever prepares.

If you've ever prepared your own tax return, keep in mind what most preparers of tax returns want the tax statement to convey, namely *the lowest possible income*. Conversely, anyone who has prepared a loan application knows the incentives for loan statements. They are exactly the opposite. Preparers of GAAP statements often have the same incentives as the loan applicant, to convince the reader of immense prosperity and great future potential.

### **1.9 Summary and Conclusion**

The income statement provides information related to a company's operations over a defined period. On a GAAP basis it is subject to accruals, reserves, allowances, and other estimates. If the accounting is applied consistently—between periods and across companies—the statement can provide a reasonable measuring stick for evaluating a company's profitability. Under GAAP, revenue and expenses are accrued so cash flow can be, and usually is, different.

Consistent with any annual summary of results, there may be a motive by the preparer—to over or understate the true results. As with the other information in a company's reporting package, the reader needs to understand what's behind the numbers and whether they need to be adjusted for the issue at hand. The best place to start is with the notes.