Income Statement Analysis Walkthrough

% oldschoolvalue.com/blog/valuation-methods/analyzing-financial-statements-crox-income-statement/

Previously we had a look at the Statement of Cash Flows with AeroGrow and another discussion on Free Cash Flow and points to consider as investors. In this post, let's take a look at the Income Statement for Crocs (CROX) and try to find warning and other signs.

To help get new investors started, here are some great resources to get you started on the Income Statement

Income Statement Analysis Overview

Cost of Goods Sold

When analyzing the income statement, we should always try to compare each line with Revenues as a percentage. As numbers go from 6 figures (millions in revenue) to 9 figures (billions in revenue), it's easy to lose track of the numbers. Below is a screenshot of how I have my spreadsheet set up.

Straight away we see that Crocs COGS (Cost of Goods Sold) is 98.6% of revenues in its latest quarter. Also keep an eye out for how COGS increases in relation to sales over many quarters. If COGS increases faster than sales, that is a red flag which must be looked into.

CROCS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share and per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues	$ 174,187	$ 256,275	$ 595,497	$ 622,554
Cost of sales	171,788	100,883	417,575	250,729
Gross profit	2,399	155,392	177,922	371,825
Selling, general and administrative expenses	104,391	77,156	271,224	187,958
Restructuring charges	2,450	—	6,769	—
Impairment charges	31,584	—	45,301	—
Income (loss) from operations	(136,026)	78,236	(145,372)	183,867
Interest expense	413	191	1,385	306
Other income	(734)	(1,158)	(782)	(2,074)
Income (loss) before income taxes	(135,705)	79,203	(145,975)	185,635
Income tax expense	12,275	22,655	4,399	55,690
Net income (loss)	$ (147,980)	$ 56,548	$ (150,374)	$ 129,945
Income (loss) per common share:				
Basic	$ (1.79)	$ 0.69	$ (1.82)	$ 1.62
Diluted	$ (1.79)	$ 0.66	$ (1.82)	$ 1.55
Weighted average common shares:				
Basic	82,854,419	81,543,769	82,687,861	80,362,112
Diluted	82,854,419	85,370,351	82,687,861	83,842,675

See notes to condensed consolidated financial statements.

Income Statement Analysis

Margins

If we then move to the gross profit line we have to consider many things regarding margins. Gross margins tell you a lot about a firm's competitive position. If a company can increase its gross margins, the company is doing two things;

1. cutting production costs or
2. raising prices

Both are good signs and margins that can trend up is always a good thing and will lead to an increase in future earnings.

Unfortunately, for Crocs, compared to a year ago, their margins have jumped off a cliff from an impressive 60% to 1.4% in 3 months ended September 30. This deterioration could mean that raw and production costs are rising, as evidenced by the increase in COGS compared to 2007.

If production costs increase, the company has to proportionally increase their prices, but do people really want to spend an extra $5 for an already expensive fad shoe? On the other hand, if a rise in production cost is not the cause, then the company must be cutting prices in order to maintain market share and gain some revenues.

Brad at TMWTFS has stated clearly that a company should never compete on price. Those that do, have no competitive advantage.

Operating margins and net margins also provide vital information about the capabilities of the company. Gross margins could be superb but if operating margins are low, any drop in gross margins could have a material effect on the overall profit of the company. Huge drop in gross margins lead to a loss in operations and subsequently, net margins.

An important note about margins is that we must identify the company strategy before immediately jumping to conclusions. Crocs is an example of a typical company banking on high returns with low inventory turnover to make a profit. Costco, Wal-Mart and other super retailers have small margins yet their inventory turnover is extremely high. The volume of products sold is where the profits come from. So think strategy before dismissing a company completely.

Selling, General and Administrative Expenses

For a company doing so poorly, SG&A for Crocs is far too high. High SG&A for any company is a serious problem. This line is also where companies expense the limos, private jets, boats etc used by executives. For a company doing so poorly, as a shareholder you would expect the CEO to take economy.

Companies should try to keep SG&A to a certain percentage of revenues. This prevents future problems caused by hiring sprees and huge bonuses. Costco has been able to keep their SG&A between 8.5-10% for the past 10 years. A clear indication of the quality of management.

Impairment Charges

A fancy way of saying “we made some bad decisions which will cost us millions of dollars”. This is **not** a line in the Income Statement that we want to see. Crocs is writing off $31.6m from goodwill in the 3rd quarter which is essentially writing off $31.6m from equity. Another reason why a company with high goodwill should be examined further.

Impairment charges is also another way to evaluate management.

> *The impairment charge also provides investors with a way to evaluate corporate management and its decision-making track record. Companies that have to write off billions of dollars due to impairment have not made good investment decisions. Managements that bite the bullet and take an honest all-encompassing charge should be viewed more favorably than those who slowly bleed a company to death by deciding to take a series of recurring impairment charges, thereby manipulating reality. – Investopedia*

Other Income, Income tax, EPS, Shares Outstanding

Footnotes should always be reference to determine exactly what Other Income is. This is evermore true if the number is high.

Income tax and Earnings Per Share (EPS) is straightforward and doesn't require additional comments.

Shares outstanding should be monitored as well. Always use the diluted number as it includes stock options. Crocs has been buying back its shares from the previous year in an attempt to increase shareholder value but that is a minor point compared to what has been discussed above.

Summary

- View numbers as percentages and compare over several quarters and years
- COGS should never be higher than sales
- Margins reflect competitive position and company strategy
- SG&A and Impairment Charges determines the company's management quality

That is how to properly conduct an income statement analysis.

Disclosure

No positions in any stocks mentioned at time of writing.