January, 2002 From the Forty Ninth Issue

Mini-Lesson: Earnings

Earnings, specifically Net Income, can be a very confusing part of investing. If I were to define earnings from an accounting point of view, it would be as follows: *Earnings is the difference between revenues plus other income and all expenses related to those revenues plus all period expenses for a given accounting period.* Accounting periods can be of any length, but the most common measuring periods are years, quarters and months. Presented formulaically, it would look like this for any given accounting period:

Sales
Less Expenses related to Sales (COGS)
Gross Profit (Loss)
Less All other Period Expenses
Plus All Other Income for the Period
Net Income (Earnings)

COGS (Cost of Goods Sold) are expenses specifically "matched" to the when revenue is recognized. For example, all the costs related to a particular inventory item are recognized when the product is sold, not when they are purchased.

Period costs are time dependent, rather than dependent on revenue flow.

Earnings per Share (EPS) is generally defined as Net Income divided by Shares Outstanding. For most disclosure purposes, this means fully diluted EPS, calculated as if all the possible shares outstanding were actually outstanding.

A different earnings measure is called EBITDA *(Earnings Before Interest, Taxes, Depreciation and Amortization).* Interest and taxes are both period expenses requiring the current use of cash. Depreciation and amortization are noncash period expenses, but they are legitimate allocations of cash outlays related to prior capital expenditures. EBITDA can be useful when used in conjunction with actual earnings for comparing companies. However, it's not generally used that way. EBITDA is generally used by person(s) trying to sell stocks whose underlying companies are losing money when all expenses are recognized. Be careful when using it.

Other earnings are sometimes referred to as *pro forma* earnings. *Pro forma* means "as if" in Latin. These "earnings" are generally entirely fictitious and have created quite a stir in the SEC recently. There are limited disclosure requirements for *pro forma* statements and earnings, but, in general they either modify expenses or revenues from those reported in the actual financial statements. Abuses of this type of reporting have created enough concern in regulatory bodies such as the FASB and SEC that they will likely eliminate or severely restrict such presentations in the near future.

Trend Capital Management, LLC
9717 W 121 Terrace ▪ Overland Park, KS 66213 ▪ O (913) 897-7576 ▪ C (913) 568-9916
e tcm@trendcapitalmgmt.com ▪ www.trendcapitalmgmt.com