Checkpoint 3.1

Constructing an Income Statement

Use the following information to construct an income statement for Gap, Inc. (GPS). The Gap is a specialty retailing company that sells clothing, accessories, and personal-care products under the Gap, Old Navy, Banana Republic, Piperlime, and Athleta brand names. Use the scrambled information below to calculate the firm's gross profits, operating income, and net income for the year ended January 31, 2009. Calculate the firm's earnings per share and dividends per share.

Interest expense	$74,000,000	Revenues (sales)	$14,549,000,000
Cost of goods sold	$9,079,000,000	Common stock dividends	$243,000,000
Operating expenses	$3,836,000,000	Income taxes	$536,000,000
Shares outstanding	716,296,296	Other income or expense	$5,000,000

STEP 1: Picture the problem

The income statement can be visualized as a mathematical equation using Equation (3–1) as follows:

$$\text{Revenues} - \text{Expenses} = \text{Profits} \quad (3\text{–}1)$$

(3.1 CONTINUED >> ON NEXT PAGE)

However, this equation belies the level of detail normally included in the income statement. That is, expenses are typically broken down into multiple categories, including cost of goods sold, operating expenses (including such things as selling expenses, administrative expenses, and depreciation expenses), finance charges or expenses (interest), and income taxes. After subtracting each of these general categories of expenses, a new profit number is calculated. The following template provides a useful guide for reviewing the format of the income statement:

Revenues

Less: Cost of Goods Sold

Equals: Gross Profit

Less: Operating Expenses

Equals: Net Operating Income

Less: Interest Expense

Equals: Earnings before Taxes

Less: Income Taxes

Equals: Net Income

STEP 2: Decide on a solution strategy

Given the account balances provided, constructing the income statement simply entails substituting the appropriate balances into the template found above.

STEP 3: Solve

Revenues = **$14,549,000,000**

Less: Cost of Goods Sold = $9,275,000,000

Equals: Gross Profit = $5,274,000,000

Less: Operating Expenses = $3,836,000,000

Equals: Net Operating Income = $1,438,000,000

Less: Interest Expense = $74,000,000

Equals: Earnings before Taxes = $1,364,000,000

Less: Income Taxes = $536,000,000

Equals: Net Income = $828,000,000

Earnings per share ($930,000,000 net income ÷ 716,296,296 shares) = **$1.16**
Dividends per share ($243,000,000 dividends ÷ 716,296,296 shares) = **$0.34**

STEP 4: Analyze

There are some important observations we can make about Gap's income statement. First, the firm is profitable because it earned net income of $828,000,000 over the year ended January 31, 2012. Second, the firm earned more net income than it distributed to its shareholders in dividends.

STEP 5: Check yourself

Reconstruct Gap's income statement assuming the firm is able to cut its cost of goods sold by 10 percent and that the firm pays taxes at a 40 percent rate. What is the firm's net income and earnings per share?

ANSWER: $1,374,900,000 and $1.92.

Your Turn: For more practice, do related **Study Problem** 3–1 at the end of this chapter.

>> END Checkpoint 3.1