FINANCIAL STATEMENTS ANALYSIS
Reclassified financial statements: the Income Statement

TEACHING MATERIAL FOR THE ADVANCED ACCOUNTING COURSE

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Two approaches to the measurement of companies' performance

INPUT		OUTPUT
Cost of Sales & other expenses, classified by function	1."ANGLOSAXON TRADITION"	Production **sold** in the financial period
Costs referring to the whole production obtained in the financial period, classified by nature	2. "CONTINENTAL TRADITION"	Production **obtained** in the financial period

Gross Margins in the Income Statement: the "Value of Production" structure

	20X2	20X1
Revenues & other op. income	X	X
Changes in inventory of finished prod. and W.I.P.	(X)	X
Work performed by the enterprise and capitalized	X	X
-Raw materials and services used	(X)	(X)
ADDED VALUE	**X**	**X**
-Staff costs	(X)	(X)
EBITDA	**(X)**	**X**
-Depreciation and Amortization	(X)	(X)
-Provisions	(X)	(X)
OPERATING INCOME	**(X)**	**X**
Income from associates	(X)	X
EBIT		
- Financial expenses	(X)	(X)
Profit before tax	**(X)**	**X**
-Income taxes	X	(X)
Net profit (loss) from ordinary activities	**(X)**	**X**
+/-Extraordinary items	X	(X)
Net profit for the period	**(X)**	**X**

- This structure of Profit & Loss Statement compares the "Value of Production Obtained" in the financial period with the "Cost of Obtained Production"
- The Gross Margins (Added Value, EBITDA, EBIT, PBT) improve the understanding of the determinants of the net income

Gross Margins in the Income Statement: the "Cost of Sales" Structure

	20_2	20_1
Revenues & other op. income	X	X
- Cost of Sales (C.O.S. or C.O.G.S.)	(X)	X
GROSS PROFIT	**X**	**X**
Other operating income	X	X
- Distribution costs (selling expenses)	(X)	(X)
- Administrative expenses	(X)	(X)
- Other operating expenses	(X)	(X)
Profit from operations	**(X)**	**X**
-Finance costs	(X)	(X)
Income from associates	(X)	X
Profit before tax	**(X)**	**X**
-Income tax expense	X	(X)
Net profit (loss) from ordinary activ.	**(X)**	**X**
+/-Extraordinary items	X	(X)
Net profit for the period	**(X)**	**X**

- Also the "Cost of Sales" structure can provide interesting margins:

1. Gross profit
2. Operating income (EBIT)
3. EBT

Gross Margins

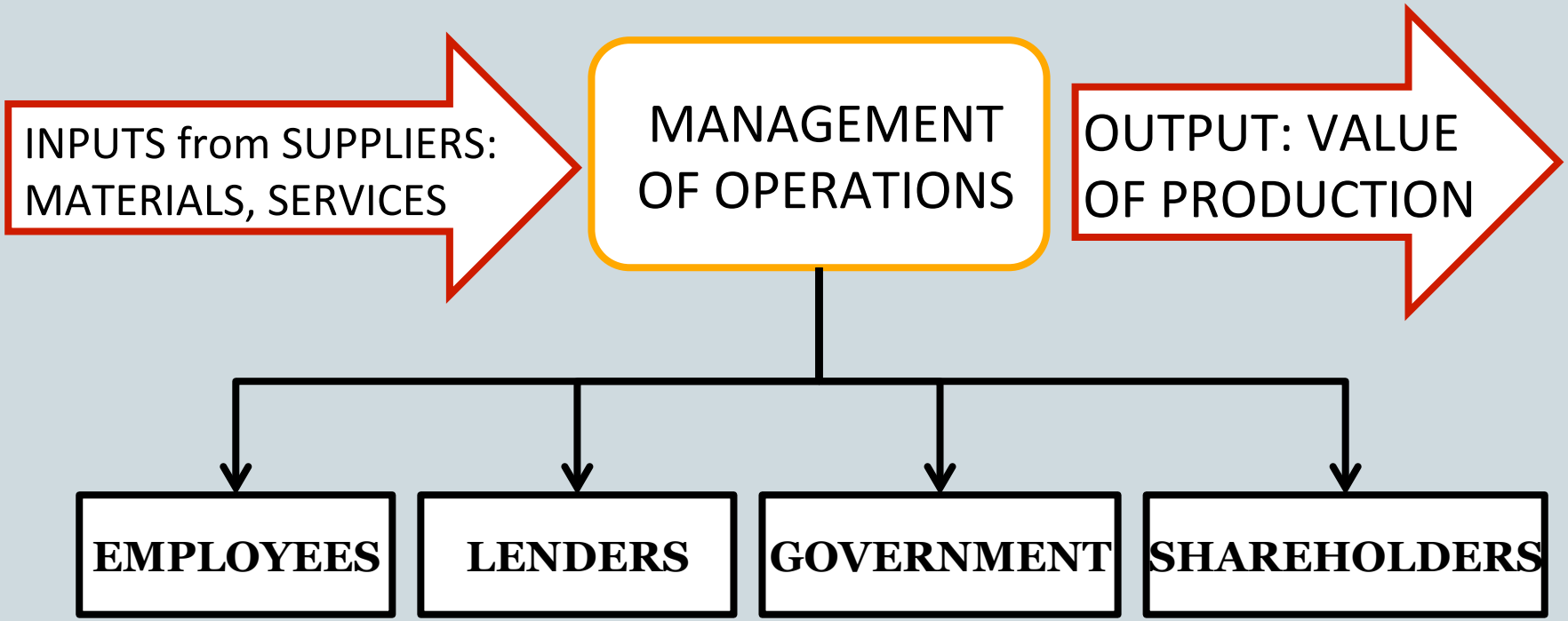
GROSS PROFIT:	margin on sales (sales - cost of sales)
ADDED VALUE:	value of production - cost of materials – cost for services (before labour expense, amortization, depreciation, provisions…)
EBITDA:	earnings before interest, taxes, depreciation and amortization
OPERATING INCOME:	income before financial expenses and financial incomes
EBIT:	earnings before interest and taxes
NOPAT:	net operating profit after taxes

Added Value

Added Value = VPO – (Materials + Services)

- It is the value the firm adds to external resources used (materials and services purchased from third parties).
- The Added Value is distributed to: employees, lenders, shareholders, the Government.

Added Value


INPUTS from SUPPLIERS: MATERIALS, SERVICES
MANAGEMENT OF OPERATIONS
OUTPUT: VALUE OF PRODUCTION
EMPLOYEES
LENDERS
GOVERNMENT
SHAREHOLDERS

EBITDA

(Earnings Before Interest Taxes Depreciation & Amortisation)

EBITDA: it's a margin calculated before expenses that are not cash movements, such as: Depreciation & Amortization.

1. EBITDA is not influenced by costs that can be subjectively estimated: therefore, it is considered more relyable;
2. EBITDA is also important because it gives a first signal about the firms' capability to produce cash through operations.

A negative EBITDA is a very bad signal! A company with a negative EBITDA has two problems: the financial position and the profitability are both weak!

EBIT & Operating Income

- EBIT and the Operating Income are calculated before:
  - Expenses from financing activities;
  - Taxes
- Both margins exclude the effect of the capital structure of the firm on its profitability.
- The difference between EBIT and the Operating Income depends on the activities to which the margin refers:

a. EBIT refers to both operating and non operating activities (i.e., it includes incomes from equity investments or similar incomes from financial assets).

b. The Operating Income refers only to the operating activities.

NOPAT

- NOPAT (Net Operating Profit After Taxes) is the profit from operations after taxes.
- It is a good measure of performance: it measures the profitability of the core business, considering also the effect of taxation.
- It is often compared to the WACC (Weighted Average Cost of Capital) in order to assess the difference between the profitability of invested capital and the cost of the capital collected from owners and lenders.

The Value of Production

INCOME STATEMENT (art. 2425 of c.c.)	
A1	SALES REVENUES
A2	CHANGE IN THE INVENTORY OF F.P. & W.I.P.
A3	CHANGE IN THE INVENTORY OF COMM. WORK IN PROG.
A4	INCREASE IN VALUE OF FIXED ASSETS FOR CAPITALIZED IN-HOUSE WORK
A5	OTHER REVENUES AND INCOME

- **Operating Incomes from non-core businesses**
- **Costs recoveries**
- **Adjustments of revenues and expenses from previous periods**
- **Gains from disposal of fixed assets employed in the core business, that the company wants to substitute**
- **Subsidies**

Reclassifying the Income Statement: A5

Cost recoveries can either be included in the Value of Production or deducted from the operating expense to which they refer.

A5) OTHER INCOMES
Subsidies
Cost recoveries
Operating Incomes from non-core businesses
Adjustments of revenues and expenses from previous periods
Gains from disposal of fixed assets employed in the core business, that the company wants to substitute

Sales Revenues
Changes in inventory of finished prod. and W.I.P.
Work performed by the enterprise and capitalized
Subsidies
Other incomes
VALUE OF PRODUCTION
-Raw materials and services used
- Services used
ADDED VALUE
-Staff costs
EBITDA
-Depreciation, Amortization, Provisions
OPERATING INCOME
+ Financial Incomes (dividends, interest)
TOTAL EBIT
- Financial expenses
Net profit (loss) from ordinary activities
+/-Extraordinary items
Profit before taxes
-Income taxes
Net income

Reclassifying the Income Statement: the Operating Expenses

B) COST OF PRODUCTION
6) Purchase cost of materials
7) Services
8) Leasing and rentals
9) Cost of Labor
10) Depreciation, Amort. & Write Downs
11) Change in materials' inventory
12) Provisions for risks
13) Other provisions
14) Sundry costs

Sales Revenues
Changes in inventory of finished prod. and W.I.P.
Work performed by the enterprise and capitalized
Subsidies
Other incomes
VALUE OF PRODUCTION
-Raw materials and services used
- Services used
ADDED VALUE
-Staff costs
EBITDA
-Depreciation, Amortization, Provisions
OPERATING INCOME
+ Financial incomes (dividends, interests…)
TOTAL EBIT
- Interest expenses
Net profit (loss) from ordinary activities
+/-Extraordinary items
Profit before taxes
-Income taxes
Net income

Reclassifying the Income Statement: B14

Taxes and Sundry costs can be assimilated to services and considered in the calculation of the Added Value

B14) OTHER OPERATING EXPENSES
Taxes (other than income taxes)
Sundry costs
Adjustments of revenues from previous periods
Losses from disposal of fixed assets employed in the core business, that the company wants to substitute

Sales Revenues
Changes in inventory of finished prod. and W.I.P.
Work performed by the enterprise and capitalized
Subsidies
Other incomes
VALUE OF PRODUCTION
-Raw materials and services used
- Services used
ADDED VALUE
-Staff costs
EBITDA
-Depreciation, Amortization, Provisions
OPERATING INCOME
+ Financial incomes (dividends, interests…)
TOTAL EBIT
- Interest expenses
Net profit (loss) from ordinary activities
+/-Extraordinary items
Profit before taxes
-Income taxes
Net income

Reclassifying the Income Statement: Financial Incomes & Expenses (C15-17)

C) FINANCIAL INCOME AND CHARGES
15) Income from equity investments *-Subsidiaries* *- other companies*
16) Other financial Income *-From receivables included in fixed assets* *-From securities (fixed assets)* *-From securities (current assets)* *-Other*
17) Interest expenses
17 bis) Foreign exchange gains & losses

Sales Revenues
Changes in inventory of finished prod. and W.I.P.
Work performed by the enterprise and capitalized
Subsidies
Other incomes
VALUE OF PRODUCTION
-Raw materials and services used
- Services used
ADDED VALUE
-Staff costs
EBITDA
-Depreciation, Amortization, Provisions
OPERATING INCOME
+ Financial incomes (dividends, interests…)
TOTAL EBIT
- Interest expenses
Net profit (loss) from ordinary activities
+/-Extraordinary items
Profit before taxes
-Income taxes
Net income

Reclassifying the Income Statement: Adjustments to the value of financial investments(D18-19)

D) ADJUSTMENTS TO THE VALUE OF FINANCIAL INVESTMENTS
18) Revaluations *- Equity Investments* *- finan. fixed assets other than equity inv.* *-Fin. Curr. Assets other than equity inv.*
19) Write downs *- Equity Investments* *- finan. fixed assets other than equity inv.* *-Fin. Curr. Assets other than equity inv.*

As a general rule:

a) Revaluations of equity investments should be considered:

- ordinary, when they depend on the adoption of the "equity method": according to this method, the value of the investment depends on the performance of the subsidiary
- extraordinary incomes, when they represent recoveries of previous years' write downs

a) Write downs and revaluations of financial current assets are ordinary components, to be reclassified before EBIT

Extraordinary Incomes & Expenses in the Reclassified Income Statement: a summary

General rule: all elements that hinder comparability of performances of different financial periods should be considered extraordinary . The assessment of the performance should not be influenced by these elements

Gains from disposal of fixed assets (A5) + (E19) & from disposal of equity investments in subsidiaries
Adjustments of previous years' revenues and expenses (A5 & B14)
Permanent write downs and subsequent recoveries in the value of equity investments (cost method)
Other extraordinary incomes & charges usually recorded in the class E

Sales Revenues
Changes in inventory of finished prod. and W.I.P.
Work performed by the enterprise and capitalized
Subsidies
VALUE OF PRODUCTION
-Raw materials and services used
- Services used
ADDED VALUE
-Staff costs
EBITDA
-Depreciation, Amortization, Provisions
EBIT from the core business
Other oper.income & expenses (non core business)
Incomes from associates
TOTAL EBIT
- Financial expenses
Net profit (loss) from ordinary activities
+/-Extraordinary items
Profit before taxes
-Income taxes
Net income