Interpreting the Income Statement

By Michael Kemp

Listed companies are required by law to produce an annual report every year. It's effectively a company's report card informing shareholders, potential investors and other interested parties how it performed over the previous 12 months.

While an annual report can contain as many pages as a short novel it's the one headed 'Income Statement' which people usually turn to first. Not surprising since it's supposed to answer the question: Is the company delivering a good return on the capital invested?

However, it is important to appreciate how the earnings figures are constructed, because things are never as simple as one might hope.

Financial analysts add to the earnings confusion by reconstructing the figures into different forms. So earnings can be described as 'Net Profit after Tax', 'Earnings before Interest and Tax' or 'Earnings before Interest, Tax, Depreciation and Amortisation'. New languages are then produced using acronyms like EBIT and EBITDA.

So what do these acronyms actually mean? And which best measures a company's earnings performance?

Net Profit after Tax

Net Profit after Tax (NPAT) is reported on the bottom line of the Income Statement. It's supposed to indicate what the company has earned after ALL expenses have been accounted for. If you are a shareholder you can calculate how much of this profit is yours. Firstly divide NPAT by the total number of shares on issue (to derive the earnings per share). Then multiply the earnings per share by the number of shares you own.

Sounds easy but does it really measure how much the company earned?

The answer is - not really. The reality is NPAT is an accounting construct derived by the company's accountants. Whilst accounting standards guide their decisions, many are still open to interpretation. How the accountants classify income and expense items can change reported NPAT. The accounting period to which income and expense items are allocated also impacts reported NPAT.

Using the Cash Flow Statement to check NPAT

The Cash Flow Statement can be used as a check on the legitimacy of reported NPAT. It records actual cash flows in and out of the business during the year. This means it's a more objective representation of earnings. It's less open to interpretation or misrepresentation.

To do this first look part way down the Cash Flow Statement for the total given as "Net Cash flows from Operating Activities". This is like a cash-based profit figure. But it doesn't include the amount spent on new equipment. That cost is found as a separate item further down the page called "purchase of property, plant and equipment". Deduct this from the net cash flows from operating activities to derive a figure referred to as free cash flow. Compare this to reported net profit after tax. If they are close you can feel more comfortable about the reported net profit figure. If not ask why. There can be legitimate reasons for the difference but a significant difference warrants investigation.

Earnings before Interest and Tax (EBIT)

EBIT is calculated by adding the company's interest expense (cost of borrowings) and tax payable back to the net profit figure.

It's also referred to as operating earnings or operating profit. It allows better comparison between companies with different tax rates and borrowing levels.

Earnings before Interest, Taxes, Depreciation and Amortisation (EBITDA)

Earnings before Interest, Taxes, Depreciation and Amortisation (EBITDA) is calculated by adding back two non-cash expense items, depreciation and amortisation, to the EBIT figure.

Since figures for depreciation and amortization can vary widely from one company to the next some analysts support the use of EBITDA on the basis it allows for better comparisons of inter-company performance (profitability).

A counter argument is that in removing more costs it moves us further from economic reality. After all companies typically do have borrowings to service, tax bills to pay and aging equipment to replace. Take these costs out and companies increasingly appear to be in better financial shape than they really are.

EBITDA became popular in the 1980s when leveraged buyouts were all the go. Corporate raiders searched for acquisition targets capable of servicing the debt soon to be used to acquire them. The popularity of EBITDA as a metric has stuck. But, for the following reasons, it has no shortage of critics.

- A common misconception is that EBITDA represents cash earnings. EBITDA is a good metric to evaluate profitability, but not cash flow.
- EBITDA doesn't factor in the cost of replacing worn and redundant equipment. This is a real cost and it can be significant. Whilst depreciation expense isn't always an accurate reflection of future capital expenditure it's better than ignoring it altogether.
- EBITDA doesn't comply with Generally Accepted Accounting Principles (GAAP).

Owner's Earnings

US investor, Warren Buffett, has described a preference for a measure of earnings he calls "Owner's Earnings". Buffett well recognises that equipment needs to be replaced for a business to remain viable. And he believes that in many cases depreciation is not the appropriate figure. It represents past purchases not future ones. Therefore he defines owner's earnings as:

"reported earnings plus depreciation, depletion, amortization, and certain other non-cash charges...less the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume...."

This means future capital expenditure is necessarily an estimate. It's therefore a less objective measure than depreciation (which is based on past actual expenditure). In that sense the depreciation figure is more precise. But Buffett argues it is less likely to reflect future economic reality.

Normalised Earnings

Typically company earnings vary from one period to the next. There can be many reasons for this. For example reported profit can suffer when the value of a non-performing business division has to be written down (the write down being recognized in the Income Statement). Alternatively reported profit can be unusually high due to a financial windfall from the one-off sale of an asset which has appreciated in value. Revenue differences can also occur due to variations in the economic cycle.

Investors, in determining the underlying value of the business, should look through these one-offs and cyclical variations in profitability. If the profit has changed (for the better or worse) ask: Is this because the long-term dynamics of the business have changed? It's important to focus on what represents a company's core earnings: Those which will be repeated and which are sustainable.

Earnings can be adjusted by splitting out non-core operating items, one-offs and cyclical variations in earnings; in other words 'normalising' the earnings.

The problem is how much trust you put in the normalised earnings figure depends on who is performing the adjustments. The adjustment process does leave the way open for misrepresentation. Prior to 2001, Australian accounting standards required unusually large items of revenue and expense to be classified as 'abnormal items' for financial reporting. However this classification was removed from accounting standards from 2001. There were concerns that the distinction allowed companies to manipulate profit results to present them in the most favourable light. That is to define large 'normal' expense items as abnormal and large 'abnormal' revenue items as normal.

Which Earnings Figure should you use?

By now you will appreciate the take home message is don't treat accounting figures as gospel. But which earnings figure should you use?

For investors analysing financial statements there is no perfect definition of earnings. It boils down to a case of appreciating the strengths and weaknesses of the many ways that earnings can and are reported.

Each has its place. You just need to appreciate what place that is and what information you require from the figures.

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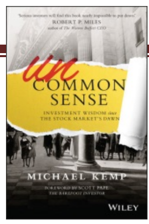

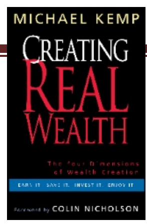

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.