FinanceTalking

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Understanding & Analyzing the Income Statement

US Edition - April 2015

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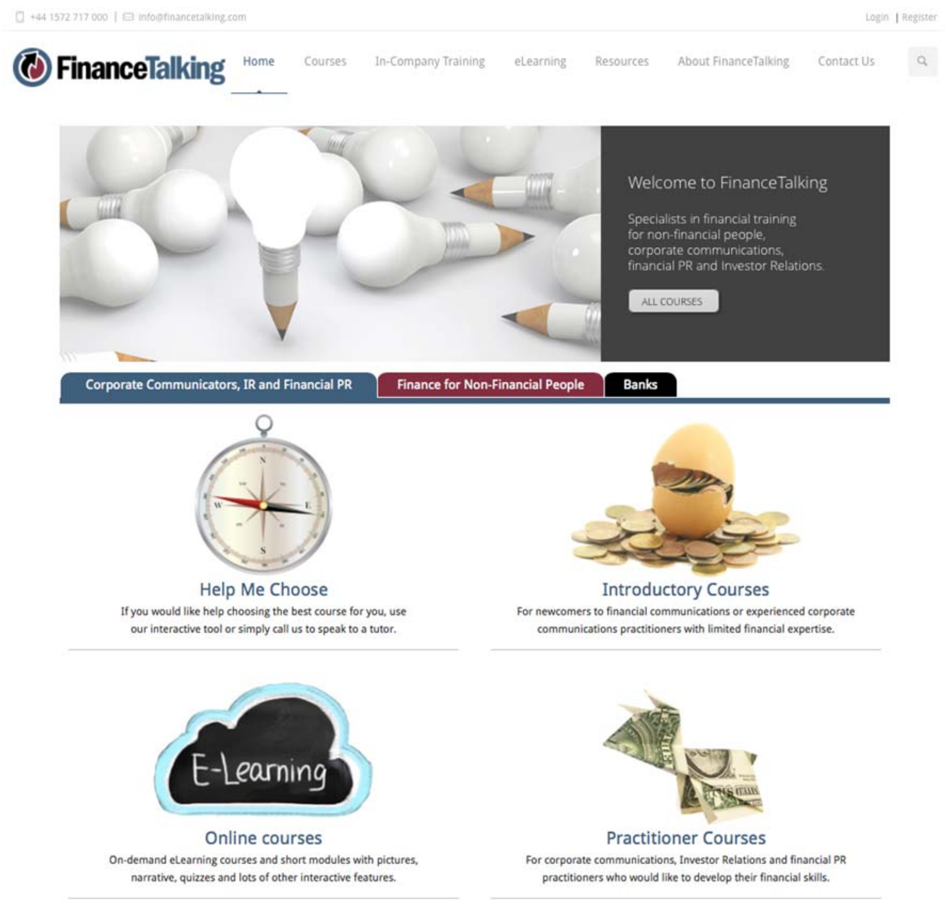


Contents

1 Introduction

The income statement (profit and loss account or statement of operations) is a portrayal of the performance of a business over a period of time - usually a year, a half- year, a quarter or a month. It shows items of revenue and expenditure and how they combine to make a profit or a loss.

Example Income Statement

INCOME STATEMENT	
REVENUE	100,000
- COST OF SALES	-80,000
= GROSS PROFIT	20,000
- OPERATING EXPENSES	-14,000
- RESTRUCTURING COSTS	-1,000
= OPERATING INCOME	5,000
-INTEREST	-1,000
= INCOME BEFORE TAX	4,000
-TAX	-1,000
= NET INCOME	3,000

Sales revenue earned during the period
Volume x price (eg 100,000 units @ 1)

Cost of goods sold (eg 100,000 units @ 0.80)

Profit from what the business does
after all operating expenses (opex)

Cost of financing debt (borrowed money)

What's left for shareholders
Earnings per share (EPS) is calculated here
= net income/number of shares

The income statement tells a story from top to bottom. In the example above, the company sold 100,000 units @ 1 each, giving revenue of 100,000. The direct cost of buying or making each unit was 0.80, giving a cost of goods sold (or cost of sales) of 80,000. The gross profit (profit after direct costs only) was therefore 20,000. Operating expenses were 14,000 and restructuring costs were 1,000 so the operating profit (profit that the company made from what it does) was 5,000. The company paid 1,000 of interest and 1,000 of tax, leaving net profit (attributable to shareholders) of 3,000.

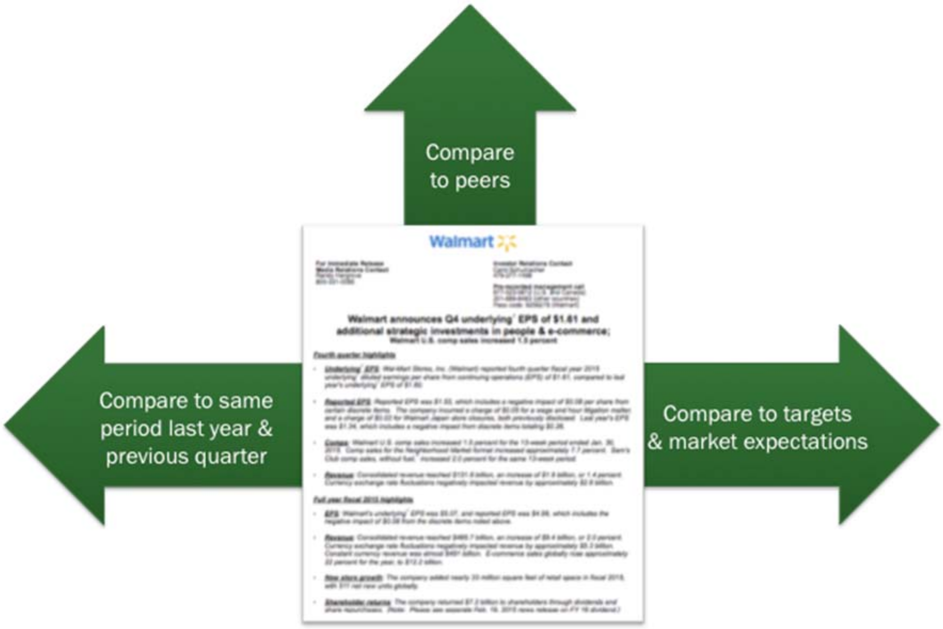
1.1 Reviewing the Income Statement

The income statement above is of course useful as it is, but in order to judge whether a profit of 1,000 is good or bad for this company, it helps to have something to compare to.

- Depending on your perspective, you might compare performance for a period to:
- The same period last year (e.g. Q1 2014 compared to the Q1 2013)
- The previous period (e.g. Q1 2014 compared to the Q4 2013)
- Budget – the original plan for the period
- Forecast – the latest management estimate of the profit for the period
- Peers/competitors
- Stock market expectations or "consensus[1]" (for listed companies).

[1] "Consensus" is the average of sell- side analysts' forecasts

Comparing Performance



1.2 Who Uses Which Line?

You will notice that in addition to revenue and costs, the income statement shows various levels of profit – gross profit, operating profit, profit before tax and net profit. The diagram below shows who tends to use which line.

Who Uses Which Line

INCOME STATEMENT	
REVENUE	100,000
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= NET INCOME	3,000

- Good indicator of size/scale

- Customers
- Competitors

- Operational management
- Competitors
- Employees
- Banks
- Analysts

- Board
- Tax authorities
- Some financial media

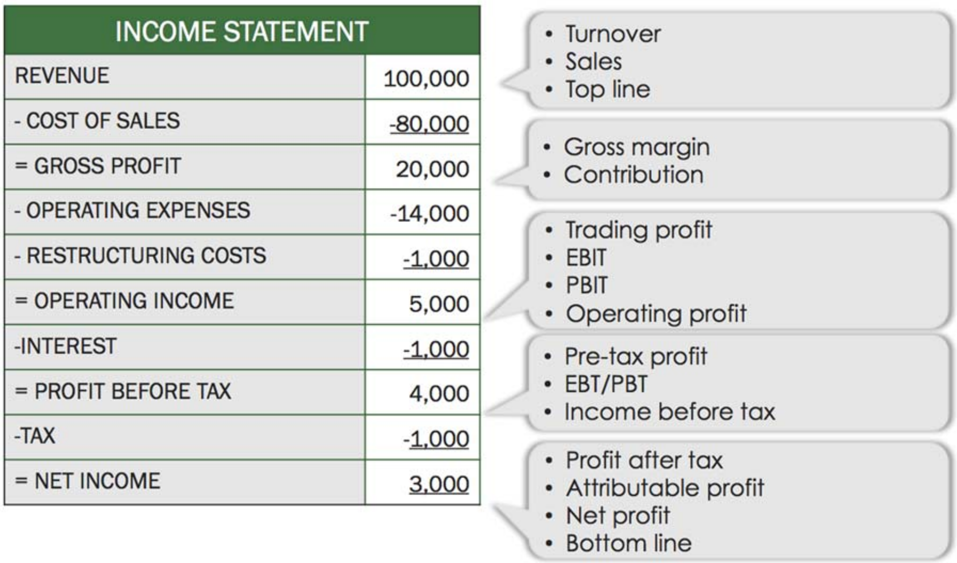
- Shareholders
- Most financial media

1.3 Income Statement Jargon

There is lots of jargon associated with the income statement. For example, some companies refer to “revenue” whilst others refer to “sales” or occasionally in the UK, “turnover”. Similarly, we have talked about “profit” but some people might call it “earnings” or “income”.

The image below shows the alternative jargon for each line.

Jargon



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= PROFIT BEFORE TAX	4,000
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= NET INCOME	3,000

2 Analyzing Income Statement Lines

2.1 Revenue

The trend in sales is an indication of both the company's growth and its competitive performance. Furthermore, sales (or revenue) is a function of **price** and **volume** and will drive everything else further down the income statement – making it the starting point for analysis.

Key points on revenue:

- Sales growth[2] is essential for profits growth – growth through cost cutting is clearly not sustainable in the medium to long term.
- Does sales growth come from the core business or from non- core activities?
- How much of the sales growth is organic (i.e. from the existing business) rather than from acquisitions?
- Is sales growth affected by currencies (i.e. is there growth in local currency or is the growth simply due to changing exchange rates?
- How sustainable is the sales growth?
- What is the mix of products or services and what are the implications of this going forwards?
- How easy is it to predict future sales volumes and prices? (i.e. how visible is the future?)
- Look at the five- year record in the annual report, if there is one. Is the record consistent or are sales and profits volatile? Estimate the compound annual growth rate in sales (and profits) - is it showing real growth (above inflation)?

2.2 Costs and Cost Control

Companies can choose the precise breakdown of costs, so the categories might vary from one company to another. Indeed some companies do not disclose the cost of sales separately from the other operating costs. Whichever breakdown the company chooses, it must still disclose various costs, by law, such as:

- Staff costs
- Depreciation and amortization
- Research and development costs
- Operating lease payments
- Auditors' remuneration

[2] The percentage increase or decrease in each line of the income statement will help us to interpret the results in relation to a prior period or to budget or forecast. Here is the formula (for example looking at revenue growth):

$$\frac{\text{This period's revenue} - \text{Last period's revenue}}{\text{Last period's revenue}} \quad \text{X } 100 \quad = \text{X\%}$$

In addition to the auditors' remuneration for the audit, you will also find disclosure of the auditors' remuneration for other services. Some shareholders consider that significant non- audit fees paid to the statutory auditors could impair their independence.

Key points on costs:

- What are the key costs for the company and how well are they controlled?
- Are costs mainly fixed (i.e. they do not change with the volume of goods or services sold) or variable and what are the implications given likely future sales volumes?
- Are costs largely controllable by the company or not? If costs are not controllable (e.g. commodity prices), can increases be passed on to customers?
- Are costs increasing with sales or is the company benefitting from economies of scale?
- Are there significant one- off costs (e.g. restructuring costs) and if so, are they really one- off or do they tend to recur?
- Are costs affected by changing exchange rates?

2.3 Operating Profit (Earnings Before Interest & Tax)

Operating profit is the profit for which operational management can be held accountable. It shows how the business has performed, before taking into account the cost of finance (interest etc.) and tax. Furthermore, investment analysts often use valuation metrics that focus on operating profits.

Key points on operating profit:

- A positive operating profit indicates that the actual operations are profitable, before taking into account the cost of financing.
- Operating profit may include unusual, non- recurring (exceptional) items. To see the underlying trend, it is useful to strip out these items and review them separately.
- If the company is loss- making at the operating level, you can add back depreciation and amortization to see if it is EBITDA positive – i.e. if the company is making a profit before non- cash expenses, depreciation and amortization. Although depreciation is a normal business expense, because it is not a cash cost, a company could be cash generative without being profitable. Young companies will therefore consider turning EBITDA positive as a major step towards profitability.
- You will usually see a breakdown of operating profit by business and geographic region in the segment information in the notes to the accounts. This will allow you to see which parts of the group are growing the fastest and which are the most profitable.
- Remember that today's companies often invest in things like research and marketing – which are treated as expenses rather than assets in the accounting model. Development costs on the other hand are capitalized when their recoverability is certain (i.e. the company knows it will have a profitable product as a result). Heavy investment in these items will impact on profits in the short term, but may result in growth later on.

2.4 Profit Margins

2.4.1 Definition

A profit margin shows how much of revenue comes through as profit for every 100 of product or service sold. Margins are expressed in percentage terms.

- Margins are usually calculated at operating profit level, so that we are looking at the profitability of the business without taking into account issues like financing and tax.
- It may also be appropriate to consider the gross profit margin – the margin after the direct cost of goods or services sold, before taking into account administration and distribution costs.

2.4.2 Calculation

$$\frac{\text{Operating profit (or gross profit)}^{[3]}}{\text{Revenue}} \times 100 = X\%$$

In our example, gross profit margin is 20% and operating profit margin is 5%.

2.4.3 Factors Affecting Margins

- **Value added:** Generally, businesses that add a great deal of value (e.g. taking raw materials and turning them into something more valuable) tend to make higher margins. For example, compare P&G's operating profit margins of around 20% with Walgreens' retail operating profit margin of around 5%. Walgreens is adding less value (simply putting the product on the shelf) and like all low margin businesses, must rely much more heavily on volume to do well.
- **Strong brands:** Strong brands often carry a perception of value- added, which enables them to command a high price (and therefore higher margins) than non-branded products or a weaker brand. Strong branding is a key factor in Reckitt's high margins.
- **Competition:** Competition will also have a big impact on margins, with very competitive businesses making lower margins than those in a less competitive environment. Of course, if a business is in a unique, monopoly position, it can get away with extremely high prices. This explains why utilities, which are in monopoly or near monopoly situations, are price- regulated.
- **Cost control and economies of scale:** Efficient cost control will raise margins whilst poor cost control will lower them. As companies grow they may be able to achieve economies of scale in their cost base thereby improving margins.
- **Operational leverage:** Operational leverage is the sensitivity of profit to changes in sales volume (as a result of fixed costs within the total cost base).

2.4.4 Impact of Operational Leverage

Stock market analysts will be keen to understand a company's cost structure – and in particular the sensitivity of profit to changes in revenue – as this will be a crucial driver of their forecasts.

[3] You would normally use adjusted profit here – i.e. removing the impact of one- off or non- trading items. You would also exclude profits from associates and joint venture as the revenue line will not include these.

This is called "operational leverage". A company with a high level of fixed costs – i.e. costs that do not vary with changes in volume, is said to have high operational leverage. Such companies find that profits increase rapidly for relatively small increases in revenue. By the same token, profits decrease rapidly for small falls in volume.

Consider the following example of a service business. This company makes sales of 120m. The total costs are 100m and the profit is 20m. Of the costs, 80% are fixed – i.e. they do not vary with sales volume. These could be salaries and premises costs. The remaining 20% of costs are variable – i.e. they change with the number of clients and could include telephone bills, entertaining and temporary staff brought in to help when things get busy.

First, imagine that the number of clients increases by 25%. The staff costs and premises costs remain the same (they are fixed costs) and the variable costs increase by 25%. This means that the costs overall increase by just 5% and profits more than double.

Now imagine that the company loses 25% of its client base. The fixed costs remain, the variable costs reduce by 25% and the company is pushed into a loss.

		Volume +25%	Volume - 25%
Sales	120	150	90
Costs			
Fixed	80	80	80
Variable	20	25	15
	100	105	95
Profit	20	45	- 5

The lesson here is that businesses with high operational leverage (high fixed costs) will have more variable profits and margins than those with low operational gearing. Also, businesses with high fixed costs are particularly vulnerable to downturns and must act rapidly to cut their cost base. We see this in the investment banking sector, where staff are rapidly made redundant in a downturn.

Walmart talks about the importance of operational leverage. This extract from Walmart's annual report shows how Walmart aims to grow sales faster than costs, enabling profit to grow at a faster rate than revenue. The implication is that a proportion of SG&A are fixed costs.

Extract from Walmart's 2015 Annual Report

Company Performance Metrics

Our performance metrics emphasize three priorities for improving shareholder value: growth, leverage and returns. Our priority of growth focuses on sales through growth in net sales, comparable store and club sales, including e-commerce sales, and unit square feet growth; the priority of leverage encompasses our objective to increase our operating income at the same rate as or a faster rate than the growth in net sales by growing our operating, selling, general and administrative expenses ("operating expenses") at a slower rate than the growth of our net sales; and the priority of returns focuses on how efficiently we employ assets through return on investment and how effectively we manage working capital through free cash flow. While all three priorities are important, our top priority is growth, with increased investment in digital retail and our associates. Sales growth will contribute to improving leverage and returns over time.

2.4.5 Impact of Price Reductions

The situation is even worse if we assume that we still have the same number of clients but they are paying 25% lower fees. In this case, we still have all the fixed costs AND all the variable costs and the entire reduction in sales of 30 million comes straight off the bottom line, taking us from a profit of 20m to a loss of 10m.

		Volume +25%	Volume - 25%	Price - 25%
Sales	120	150	90	90
Costs				
Fixed	80	80	80	80
Variable	20	25	15	20
	100	105	95	100
Profit	20	45	- 5	- 10

2.5 Segment Analysis

Large and listed companies must report a summary of their results by segment. In other words, by the category that the directors allocate capital, run and monitor the business.

You are likely see this information by both product category and geographical area, all of which is useful for a better understanding of the company on a more granular level and to enable you to compare more accurately to peers.

2.6 Interest Expense

"Financial income or expense" will include any interest earned on bank deposits, together with interest incurred on loans. It might also include:

- The change in value of financial instruments and
- The finance element of the pension cost.

The ratio of operating profit to net interest expense (interest payable less interest receivable) shows how easily the company can afford to service its debt.

$$\frac{\text{Operating profit or EBITDA}}{\text{Net financial expense}} = x \text{ times}$$

In our example, interest cover is 5 times (5.000/1,000), based on operating profit.

If cover is low (less than 5 times) and profits are volatile, a fall in profits or a rise in interest rates could cause problems.

For example, a water company with very stable profits and a relatively certain regulatory regime might be happy with interest cover of only 3 times, whereas a more volatile company might be comfortable with cover of 8 times.

Clearly it is important to think carefully about the potential variability of profits when determining how strong or weak the interest cover appears to be. Operational leverage will be highly significant – generally businesses with high operational leverage are unsuitable for high levels of debt.

Here are some examples of factors that are likely to affect the variability or sustainability of profits:

- Operational leverage
- Exposure to volatile commodity prices (e.g. oil)
- Competition
- Exposure to political issues
- Exposure to weather conditions
- High susceptibility to economic growth, interest rates or exchange rates
- Dependence on a single customer or supplier
- Dependence on a single technology or group of talented people
- Dependence on large one- off contracts

2.7 Profit Before Tax

From the operating profit, a company will pay interest on any debt funding or receive interest on cash balances. The financial income or expense is therefore a function of funding decisions, usually taken by the CFO or the Treasury department. Profit before tax is therefore the profit on which the entire board can be judged, as it is the result of both the operational decisions and the financial decisions. For this reason, profit before tax is often reported by the financial media.

2.8 Tax

Tax rates vary from country to country. The US corporation tax rate at the time of writing is among the highest in the developed world at 35%. Relief is generally given for double tax (i.e. if the company has already paid tax on overseas income).

Tax is not calculated directly from the accounts, so the rate of tax will rarely work out to be exactly the tax rate multiplied by the pre- tax profits:

Companies should explain significantly low or high effective tax rates (tax as a % of profit before tax). This is particularly important where the effective rate is low, as analysts may assume that the tax authorities are taxing a more realistic profit than the accounting profit.

2.9 Non- Controlling Interests (Minorities)

Holding companies often hold 100% of their subsidiary companies and so 100% of the profits or losses belong to group shareholders. Sometimes, however, the holding company controls the subsidiary (by holding more than 50% of the voting shares) but does not own 100%. The income statement shows 100% of the profits and losses under the control of the group, whether 100% is owned or not.
So if the ownership is less than 100%, the profit attributable to the non- controlling interests (minority shareholders) is shown separately from the profit attributable to the group's shareholders.

2.10 Net Profit Attributable to Shareholders (Net Income)

Shareholders will clearly be interested in net income, as that is the profit which is attributable (or belongs) to them and which is theoretically available to pay dividends. Journalists often report net profit for this reason.

2.11 Earnings Per Share

All quoted companies must state an Earnings Per Share (EPS) figure. The calculation is profit after tax, attributable to group shareholders (earnings), divided by the number of ordinary shares in issue during the year. The calculation is given in a note to the accounts.

Companies will also often show "diluted" earnings per share. Diluted EPS shows the profits spread over a larger number of shares, assuming that all share options are exercised and that any convertible loans have converted into shares. Effectively this shows the shareholders their earnings on the most conservative basis.

Companies sometimes calculate an additional EPS figure, based on another level of earnings excluding one- off unusual items, to show the underlying profitability. Analysts too will do their own calculations of adjusted EPS. Typically, they adjust for non- recurring exceptional items, discontinued activities and the associated tax.

2.12 Dividends

The net profit (after any non- controlling interests) is attributable to shareholders. It is up to the directors to decide how much of this profit to pay out to shareholders in cash by way of dividend and how much to retain for investment back into the business. Dividends do not show in the income statement as a deduction as they will not have been approved by shareholders until the company's annual general meeting. However, the amount proposed will be disclosed in a note.

The level of pay- out will be influenced by how much can be paid in cash terms, how much profit the company has made and how much needs to be reinvested in the business. Dividend levels are also influenced by the tax regime, which generally encourages companies to reinvest.

You should be able to find the earnings per share and the dividend per share amongst the financial highlights. You can then calculate the dividend yield and cover.

- The dividend yield is like an interest rate. Based on last year's dividend as a proportion of the share price, it gives an indication of the cash return that the investor could expect on his investment in the shares if the same dividend is paid in future. The average yield in developed markets is around 3%.
- The dividend cover shows how affordable the company's dividend was. The average cover in developed markets is around 2 times – that is to say the average company pays out half of its profits and reinvests the other half. Weak cover (less than 2 times) could throw doubt on the sustainability of the dividend and/or the company's ability to pay higher dividends in future.
- The other way of looking at this ratio is to calculate the pay- out ratio – the proportion of earnings paid out as dividends. Cover of 2 times equates to a pay-out ratio of 50%.
- Shareholders will expect a company that is growing to reinvest a greater proportion of profits (i.e. have a lower yield and higher cover) than a mature company. If a company is mature, has very few profitable reinvestment opportunities and produces fairly stable profits, then shareholders may expect a higher dividend yield (and so lower cover would be acceptable).
- Dividend policy often signals management confidence (or lack of it).

Dividend Yield

$$\frac{\text{Dividend per share}}{\text{Share price}} \times 100 = X\%$$

Dividend Cover

$$\frac{\text{Earnings per share}^{4}}{\text{Dividend per share}} = X \text{ times}$$

Pay-out Ratio

$$\frac{\text{Dividend per share}}{\text{Earnings per share}^{4}} \times 100 = X\%$$

In practice, the most attention will be paid to market expectations. Investors like companies to pay regular, increasing dividends (to match increasing profits) even if the increase is slight. Generally, investors prefer steady income to erratic payers. A dividend increase will usually be interpreted as a sign of confidence about the future. Conversely, a cut in the dividend will tend to undermine investor confidence and implies that the directors may be unsure of the company's future and wish to conserve the company's cash.

[4] Use adjusted EPS here – stripping out one- off items.

The attention paid to dividends by investors will depend on how they see the investment. Value and income investors are likely to see a cut in the dividend as a reason to sell the shares. Growth investors by contrast might view the decision to increase the dividend significantly as a sign that the company has gone ex- growth and this too might trigger a sell.

For these reasons, it is important for companies to have a clear dividend policy. Dividend policy is often expressed in terms of a pay- out ratio (the percentage of earnings that the company intends to pay out). A common dividend policy is a "progressive" policy. This means that dividends will rise in line with increases in profits, but if profits fall, the dividend will be maintained rather than cut.

In general terms, companies that do not have profitable reinvestment opportunities will find it difficult to justify retaining profits in the business. Cash in the bank simply does not earn a high enough return to satisfy shareholders, who could otherwise reinvest this money into other companies at a higher rate of return.

Equally, investors will not appreciate companies over- distributing – i.e. paying out too much, at the expense of investment for the future. On the other hand, if a company is investing profitably, many investors would prefer to forgo a dividend altogether. It is worth remembering that in uncertain stock market conditions, the dividend is the only reliable part of the investment return and therefore takes on a greater importance.

3 Adjusting the Numbers

Sometimes the income statement includes one- off items of revenue or cost that distort the trend. It is often helpful to strip these items out before considering how the company is doing so that you can look at "underlying" performance, excluding the noise from these items.

3.1 Reported and Adjusted Numbers

Whenever a "reported[5]" profit number is adjusted in any way, for external reporting purposes, it is known as a non- GAAP measure i.e. NOT defined by Generally Accepted Accounting Principles (IFRS or US GAAP). Internally, adjusted numbers are often labelled "business as usual" or "BAU".

Because there are no standard definitions for non- GAAP measures it is important to give clear definitions for external reporting purposes. In most countries, it is a requirement that non- GAAP measures are reconciled to the nearest GAAP measure (e.g. Regulation G in the US).

Non- GAAP measures are generally preferred by management because they are more indicative of a trend. However, many journalists prefer to report the "reported" or GAAP numbers as they are less open to manipulation.

You might see any of the following terms for adjusting the GAAP profit:

- Normalized profit
- Core profit
- Clean profit
- Adjusted profit
- Underlying profit.

3.2 EBITDA, EBITA and EBITDAR

Many companies use EBITDA as a measure of performance, both internally and externally. EBITDA is earnings before interest and tax (operating profit) before depreciation and amortization. Depreciation and amortization[6] are added back to the operating profit because they are non- cash expenses and because depreciation policy varies from company to company.

Internally, operational management is often judged on EBITDA performance, rather than operating profit performance because depreciation policy is usually set by finance and so is considered to be beyond the control of the operational management.

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[5] Reported in accordance with Generally Accepted Accounting Principles

[6] Depreciation is the way accountants spread the cost of fixed (non- current) assets against profit over the period of time that is expected to benefit from the use of the assets. There is no cash involved – the cash goes out when the asset is purchased – the depreciation is simply a notional accounting expense to match the cost with the profits. Assets that you can touch (tangible assets) depreciate, whilst intangible assets (those that you cannot touch) are said by accountants to "amortize" hence a company might have one charge for the depreciation of its tangible assets and another for the amortization of intangible assets such as patents and licenses.

Externally, analysts often compare companies on the basis of EBITDA to remove the impact of different depreciation policies across an industry. However, it is worth remembering that depreciation in particular is a real cost of doing business and can be very significant for capital intensive businesses. EBITA (earnings before interest, tax and amortization) is sometimes used as an alternative to EBITDA and may be more useful for capital- intensive businesses.

EBITDAR (earnings before interest, tax, depreciation, amortization and rent) is another alternative, often used in the retail sector to compare companies irrespective of whether their stores are owned (and depreciated) or rented.

Adjusted Profit and EBITDA

INCOME STATEMENT	
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= PROFIT BEFORE TAX	4,000
-TAX	-1,000
= NET INCOME	3,000

Includes depreciation & amortization 4,000

Includes depreciation & amortization 1,000

Includes one-off items of 1,000 (cost)
Profit before unusual items is 6,000
(= underlying/adjusted operating income)

EBITDA = 5,000 + 4,000 + 1,000 = 10,000
Adjusted EBITDA = 6,000 + 4,000 + 1,000 = 11,000

3.3 Constant Currency Numbers

Large companies often do business in lots of different countries. When the results for all the group's businesses are "consolidated" into a single set of group accounts, they have to be translated into the group's chosen reporting currency.

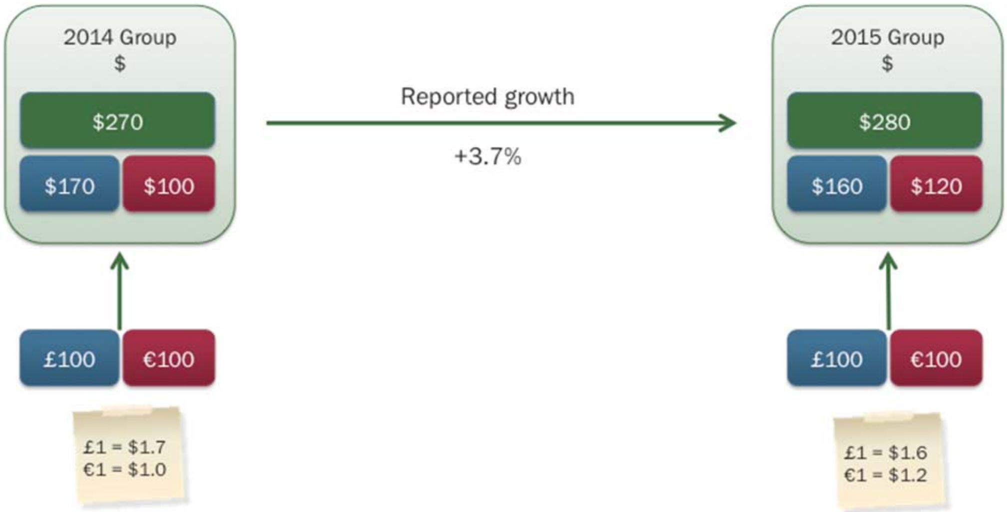
As a result, the group's results will be affected by:

- Overseas business performance in local currency AND
- The rate of exchange between the local currency and the group's reporting currency.

The example below shows a company earning profits in pounds and euros but reporting in dollars. You can see that the group reported growth of 3.7%.

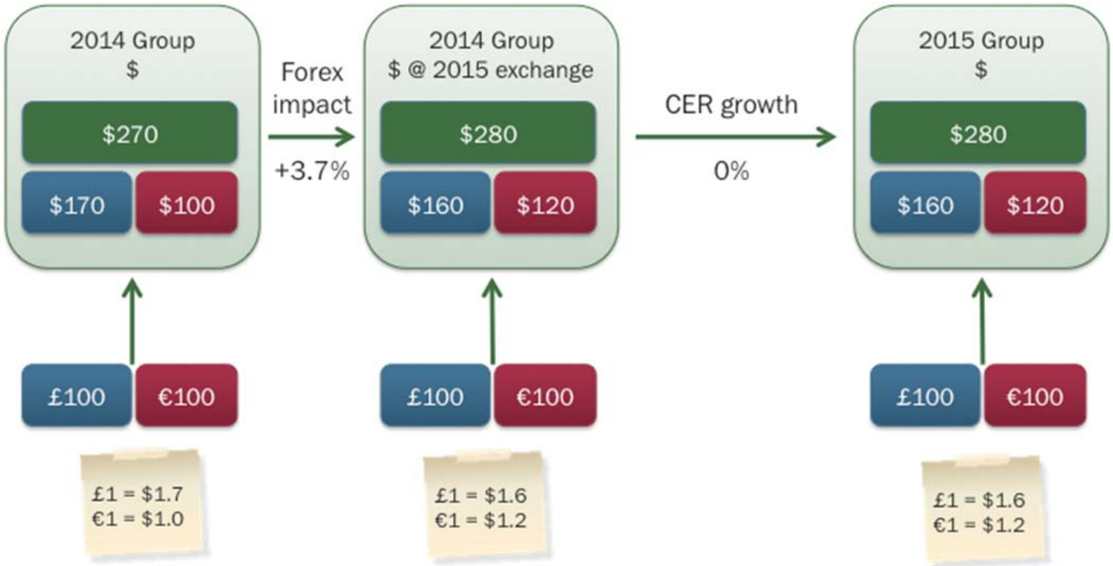
However, if you look at the results in local currency, you can see that there was in fact no growth at all.

Constant Currencies Example 1



By retranslating the 2014 numbers using the 2015 exchange rates we can see from the diagram below that the full 3.7% reported growth was due to currency movements and that the underlying “constant currency” or “constant exchange rate (CER)” growth was in fact zero.

Constant Currencies Example 2



4 Understanding Financial Performance - Walmart

Below are the earnings release headlines and income statement for Walmart for the year to January 31, 2015. We will use these to demonstrate how to analyze the numbers for a real company.

Walmart Headlines from 2015 Earnings Release

Walmart

For Immediate Release
Media Relations Contact
Randy Hargrove
800-331-0085

Investor Relations Contact
Carol Schumacher
479-277-1498

Pre-recorded management call
877-523-5612 (U.S. and Canada)
201-689-8483 (other countries)
Pass code: 9256278 (Walmart)

Walmart announces Q4 underlying[1] EPS of $1.61 and additional strategic investments in people & e-commerce;

Walmart U.S. comp sales increased 1.5 percent

Fourth quarter highlights

- ***Underlying[1] EPS***: *Wal-Mart Stores, Inc. (Walmart) reported fourth quarter fiscal year 2015 underlying[1] diluted earnings per share from continuing operations (EPS) of $1.61, compared to last year's underlying[1] EPS of $1.60.*
- ***Reported EPS***: *Reported EPS was $1.53, which includes a negative impact of $0.08 per share from certain discrete items. The company incurred a charge of $0.05 for a wage and hour litigation matter, and a charge of $0.03 for Walmart Japan store closures, both previously disclosed. Last year's EPS was $1.34, which includes a negative impact from discrete items totaling $0.26.*
- ***Comps:*** *Walmart U.S. comp sales increased 1.5 percent for the 13-week period ended Jan. 30, 2015. Comp sales for the Neighborhood Market format increased approximately 7.7 percent. Sam's Club comp sales, without fuel,[1] increased 2.0 percent for the same 13-week period.*
- ***Revenue***: *Consolidated revenue reached $131.6 billion, an increase of $1.9 billion, or 1.4 percent. Currency exchange rate fluctuations negatively impacted revenue by approximately $2.6 billion.*

Full year fiscal 2015 highlights

- ***EPS***: *Walmart's underlying[1] EPS was $5.07, and reported EPS was $4.99, which includes the negative impact of $0.08 from the discrete items noted above.*
- ***Revenue***: *Consolidated revenue reached $485.7 billion, an increase of $9.4 billion, or 2.0 percent. Currency exchange rate fluctuations negatively impacted revenue by approximately $5.3 billion. Constant currency revenue was almost $491 billion. E-commerce sales globally rose approximately 22 percent for the year, to $12.2 billion.*
- ***New store growth***: *The company added nearly 33 million square feet of retail space in fiscal 2015, with 511 net new units globally.*
- ***Shareholder returns***: *The company returned $7.2 billion to shareholders through dividends and share repurchases. [Note: Please see separate Feb. 19, 2015 news release on FY 16 dividend.]*

Walmart Income Statements from 2015 Annual Report

(Amounts in millions, except per share data)	Fiscal Years Ended January 31, 2015	2014	2013
Revenues:			
Net sales	**$482,229**	$473,076	$465,604
Membership and other income	**3,422**	3,218	3,047
Total revenues	**485,651**	476,294	468,651
Costs and expenses:			
Cost of sales	**365,086**	358,069	352,297
Operating, selling, general and administrative expenses	**93,418**	91,353	88,629
Operating income	**27,147**	26,872	27,725
Interest:			
Debt	**2,161**	2,072	1,977
Capital leases	**300**	263	272
Interest income	**(113)**	(119)	(186)
Interest, net	**2,348**	2,216	2,063
Income from continuing operations before income taxes	**24,799**	24,656	25,662
Provision for income taxes:			
Current	**8,504**	8,619	7,976
Deferred	**(519)**	(514)	(18)
Total provision for income taxes	**7,985**	8,105	7,958
Income from continuing operations	**16,814**	16,551	17,704
Income from discontinued operations, net of income taxes	**285**	144	52
Consolidated net income	**17,099**	16,695	17,756
Less consolidated net income attributable to noncontrolling interest	**(736)**	(673)	(757)
Consolidated net income attributable to Walmart	**$ 16,363**	$ 16,022	$ 16,999

4.1 Underlying Results

You can see from the earnings release above that the company has commented that certain "discrete items" have negatively affected earnings per share. Walmart has separately identified the "underlying" performance, which excludes these discrete items, from the "reported" or statutory EPS. This is to give readers a better understanding of the performance before the impact of various non- operating and one- off items. You can see the company's rationale for the adjustments in the clip below.

Extract from Walmart's 2015 Earnings Release

Underlying EPS

The underlying diluted earnings per share from continuing operations attributable to Walmart (Underlying EPS) for each of the three-month periods and fiscal years ended Jan. 31, 2015 and 2014 is considered a non-GAAP financial measure under the SEC's rules because the Underlying EPS for each such period includes certain amounts not included in the diluted earnings per share from continuing operations attributable to Walmart calculated in accordance with GAAP (EPS) for each of the three-month periods and fiscal years ended Jan. 31, 2015 and 2014. Management believes that the Underlying EPS for each of the three-month periods and fiscal years ended Jan. 31, 2015 and 2014 is a meaningful metric to share with investors because that metric, which adjusts EPS for such period for certain items recorded in such period, is the metric that best allows comparison of the performance for the comparable period. In addition, the metric affords investors a view of what management considers Walmart's core earnings performance for each of the three-month periods and fiscal years ended Jan. 31, 2015 and 2014 and also affords investors the ability to make a more informed assessment of such core earnings performance for the comparable period.

4.2 Growth and Margin Analysis

The table below shows the growth and margin (% of revenue) for each line of the income statement.

Walmart Income Statement Analysis

US$ million	Jan-15	% rev	growth	Jan-14	% rev
Revenues: net sales, membership and other	**485,651**	100.00%	1.96%	**476,294**	100.00%
Cost of sales	-365,086	-75.17%	1.96%	-358,069	-75.18%
Gross profit	**120,565**	24.83%	1.98%	**118,225**	24.82%
Costs: operating and SG&A	-93,418	-19.24%	2.26%	-91,353	-19.18%
Operating income	**27,147**	5.59%	1.02%	**26,872**	5.64%
Interest: debt and capital leases	-2,461	-0.51%	5.40%	-2,335	-0.49%
Interest income	113	0.02%	-5.04%	119	0.02%
Net interest	-2,348	-0.48%	5.96%	-2,216	-0.47%
Income from continuing operations before taxes	**24,799**	5.11%	0.58%	**24,656**	5.18%
Taxes	-7,985	-1.64%	-1.48%	-8,105	-1.70%
Income from continuing operations	**16,814**	3.46%	1.59%	**16,551**	3.47%
Income/loss from discontinued operations	285	0.06%	97.92%	144	0.03%
Consolidated net income	**17,099**	3.52%	2.42%	**16,695**	3.51%
Less net income attrib. to non-controlling interest	-736	-0.15%	9.36%	-673	-0.14%
Consolidated net income attributable to Walmart	**16,363**	3.37%	2.13%	**16,022**	3.36%

4.2.1 Revenue

We can see that revenue grew from $476,294m in 2014 to $485,651m in 2015, an increase of just under 2%. This is sometimes referred to as "top line" growth. Of course revenue growth is a function of both price and volume and what this increase does not tell us is to which of these the increase can be attributed.

However, Walmart does give us a useful breakdown of the growth from the same stores from year to year in the clip below:

Extract from Walmart 2015 Annual Report

(Amounts in millions, except unit counts)	Fiscal Years Ended January 31,		
	2015	2014	2013
Net sales	**$482,229**	$473,076	$465,604
Percentage change from comparable period	**1.9%**	1.6%	5.0%
Total U.S. calendar comparable store and club sales increase (decrease)	**0.5%**	(0.5)%	2.4%

You can see that the growth in same store sales was 0.5% and that there was a further 1.4% increase as a result of new selling space (e.g. more stores).

4.2.2 Costs

Cost of sales (for Walmart, this includes actual product cost, the cost of transportation to the Company's distribution facilities, stores and clubs from suppliers and the cost of transportation from the Company's distribution facilities to the stores) increased from $358,069m to $365,086m, a rise of just under 2%. This is exactly in line with the reported sales growth therefore the gross profit remained about the same at 24.8%.

SG&A (also known as administrative expenses/operating expenses/costs) are the selling, general and admin expenses, i.e. all the other expenses of running the business. SG&A for Walmart would include store costs, advertising, legal, head- office functions, and other general and administrative costs.

SG&A grew by 2.3%, so the improvement in reported operating profit was 1%, lower than the improvement in gross profit. However, don't forget, this reported operating profit includes discrete items that affect the change.

4.2.3 Margins

You can see that gross profit margins remained the same. Changes here can often be caused by changes in the mix of products sold or better/worse buying.

Although administrative expenses increased, they remained broadly the same proportion of revenue (19%), which means that the reported operating profit margins decreased by 5 basis points from 5.64% to 5.59%.

4.3 Further Analysis

4.3.1 Interest Cover

Operating profits of $27,147m covered the net finance cost of $2,348m 11½ times. This is relatively strong interest cover. Even if profits fell and/or interest rates rose, Walmart would have no problem servicing its debt.

4.3.2 Effective Tax Rate

The effective tax rate for Walmart is calculated as follows:

Tax charge $7,985m/profit before tax $24,799m x 100 = 32.2%.

The image below shows why the effective tax rate of 32.2% is lower than the standard US tax rate of 35%.

Extract from Walmart's 2015 Annual Report

	Fiscal Years Ended January 31,		
	2015	2014	2013
U.S. statutory tax rate	**35.0%**	35.0%	35.0%
U.S. state income taxes, net of federal income tax benefit	**1.8%**	2.0%	1.7%
Income taxed outside the U.S.	**(2.7)%**	(2.8)%	(2.6)%
Net impact of repatriated international earnings	**(1.5)%**	(1.4)%	(2.5)%
Other, net	**(0.4)%**	0.1%	(0.6)%
Effective income tax rate	**32.2%**	32.9%	31.0%

4.4 Comparison to Peers

Here is an example of how you might go about comparing Walmart with Target. We have added the segment information for Walmart because while Target's operations are based in the US, Walmart operates globally so it is more helpful to compare Target with Walmart's US operations only.

Target Income Statement Analysis

US$ million	Jan-15	% rev	growth	Jan-14	% rev
Revenues: net sales, membership and other	**72,618**	100.00%	1.88%	**71,279**	100.00%
Cost of sales	-51,278	-70.61%	2.48%	-50,039	-70.20%
Gross profit	**21,340**	29.39%	0.47%	**21,240**	29.80%
Costs: operating and SG&A	-16,805	-23.14%	4.57%	-16,070	-22.55%
Operating income	**4,535**	6.25%	-12.28%	**5,170**	7.25%
Net interest expense	-882	-1.21%	-15.92%	-1,049	-1.47%
Income from continuing operations before taxes	**3,653**	5.03%	-11.36%	**4,121**	5.78%
Taxes	-1,204	-1.66%	-15.63%	-1,427	-2.00%
Income from continuing operations	**2,449**	3.37%	-9.09%	**2,694**	3.78%
Income/loss from discontinued operations	-4085	-5.63%	N/A	-723	-1.01%
Net earnings	**-1,636**	-2.25%	N/A	**1,971**	2.77%

Walmart Income Statement Segment Analysis

	2015 $m	2014 $m	% growth
Revenue			
Walmart U.S.	288,049	279,406	3.1%
International	136,160	136,513	-0.3%
Sam's Club	58,020	57,157	1.5%
Membership	3,442	3,218	
Revenues: Net sales, Membership and other income	**485,671**	**476,294**	2.0%

	2015 $m	Margin	2014 $m	Margin	% growth
Operating income/(loss)					
Walmart U.S.	21,336	7.4%	21,787	7.8%	-2.1%
International	6,171	4.5%	5,153	3.8%	19.8%
Sam's Club	1,976	3.4%	1,843	3.2%	7.2%
Corporate	-2,336		-1,911		-22.2%
Income from continuing operations before income taxes	**27,147**	5.6%	**26,872**	5.6%	1.0%

Target has a 2015 gross profit margin of 29% compared to Walmart's of 25%. Since cost of sales is not defined by GAAP, the two companies may not include the same costs and therefore the gross profits might not be comparable. Additionally, we are comparing Walmart's global operations with Target's US operations at this level.

If we look at the operating profit level, all the costs of running the business are now included and we also have a segment analysis for Walmart so any performance metrics at this level are far more comparable.

Walmart's US operations are growing faster (3.1%) than Target's (1.9%). You can see that Walmart's 2015 US retail margins (segment profit/segment revenue) are higher at 7.4% compared to 6.25% for Target and both have fallen since 2014.

In general, you need to be careful when comparing to peers to ensure you are comparing like with like:

- Are the activities you are comparing exactly the same?
- Are they in similar regions?
- Does each company have the same definition of the line you are comparing? For example, different companies include different things in cost of sales, so gross profit margins are often less comparable than operating profit margins.

5 Conclusion

5.1 Analyzing Performance

Here is a summary of the key measures you can use to help you analyze and assess performance.

Is revenue growing, declining or static?	→	Revenue growth
Is revenue and profit growth impacted by changing exchange rates?	→	CER/constant currency growth
Is the company more or less profitable than it used to be?	→	Profit growth Profit margins
Is the company more or less profitable than its peers?	→	Profit growth Profit margins
Are there unusual items that impact your interpretation/trends?	→	Underlying/adjusted profits
Are profits and margins likely to be volatile?	→	Operating leverage
Can the company easily service its debt?	→	Interest cover
Is the tax rate reasonable?	→	Effective tax rate
Is the company's dividend policy consistent with its growth potential and how does it compare to peers?	→	Dividend policy Dividend yield Dividend pay- out ratio

5.2 The Perspective of Investment Analysts

We mentioned that analysts (who are among the most important users of financial results for listed companies) start analyzing performance at the operating profit level. However analysts also need to forecast future profits in order to value the business.

They will try to assess:

- Likely growth in earnings
- The quality of earnings
- The likely impact of risk factors

5.2.1 Earnings Growth

Earnings growth must be generated by good performance in the underlying business (strong volumes and prices and a close attention to cost control) if it is to command a high valuation. Growth, which is unsustainable, is clearly less valuable.

Examples would be growth due to one- off factors such as property disposals or growth due to a reduction in marketing or R&D, both of which might have delivered growth in the past.

This is why analysts try to establish "one- off" contributions to profits at results meetings to get at the underlying performance of the business and make it easier to forecast future profits without all the "noise" from short- term decisions that may have helped the results but not the business.

5.2.2 Earnings Quality

The "quality of earnings", as well as referring to the impact of one- offs and any accounting issues, also refers to how predictable or "visible" the company's earnings are:

- A company operating in a growing market and where contracts might run over several years would be said to have good quality earnings. While such a company may not be growing as rapidly as some others, investors may be attracted by the security of the earnings stream. This might be particularly true in difficult economic environments when people will pay more for lower risk.
- Conversely, where a company's sales are very volatile – this may be due to rapid changes in demand or very volatile pricing for its products – predicting the company's earnings is quite a hazardous exercise. Remember, earnings are an outcome of the interaction between sales (price x volume) and costs. In this situation the earnings are far from predictable and would be deemed "low quality". This does not necessarily mean the company is low quality – the business may manage these difficult circumstances extremely well. The market it operates in, however, makes forecasting a risky business.
- Associates' profits are often regarded as lower quality as there is no guarantee that the amount included in the income statement for associates' profits will actually be received in cash.
- Profits that are boosted by one- off items such as the release of provisions which are no longer required are clearly not trading profits and will therefore be regarded as lower quality.

5.2.3 Risk

Turning to risk, leveraging up (using more debt to finance the business) increases earnings – but it may be a one- off effect and achieved at the cost of increased risk. Another issue related to risk is the impact of deals. The market is often cautious about the value of earnings growth that is delivered by deals (as returns on the capital invested may in fact be falling). Similarly, any earnings growth achieved by the risk profile being increased will be viewed with caution.

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