

# ACCT7106 – Session #6: Reformulating the Financial Statements

## PART 1 – Background

- overarching objective:* **Assignment Project Exam Help**  
to conduct fundamental value for the purpose of estimating the ‘intrinsic value’ of a firm’s common shares <https://powcoder.com>
- requires an understanding of the firm’s ‘value drivers’ **Add WeChat powcoder**
- ➔ need to accumulate a ‘tool kit’ as the basis for developing the *pro forma Financial Statements*

$\Rightarrow$  **projected**  $\left\{ \begin{array}{l} \text{Balance Sheet (B/S)} \\ \text{Income Statement (I/S)} \\ \text{Statement of Cash Flows (SCF)} \end{array} \right\}$   
 over the forecast horizon

$\Rightarrow$  core inputs into the valuation model  $\rightarrow x \quad g$   
<https://powcoder.com>

Add WeChat powcoder

$$V_0 = \sum_{t=1}^{\infty} \frac{x_t}{(1+k_t)^t} = \sum_{t=1}^n \frac{E(x_t)}{(1+k)^t} + \frac{E(x_n)(1+g)}{k-g} \frac{1}{(1+k)^n}$$

Sessions #3 → #9



### STEP 1 Understanding the past

1. Information collection
2. Understanding the business
3. Accounting analysis
4. Financial ratio analysis
5. Cash flow analysis

### STEP 2 Forecasting the future

Assignment Project Exam Help

1. Structured forecasting
2. Income Statement forecasts
3. Balance sheet forecasts
4. Cash flow forecasts



<https://powcoder.com>  
Add WeChat powcoder

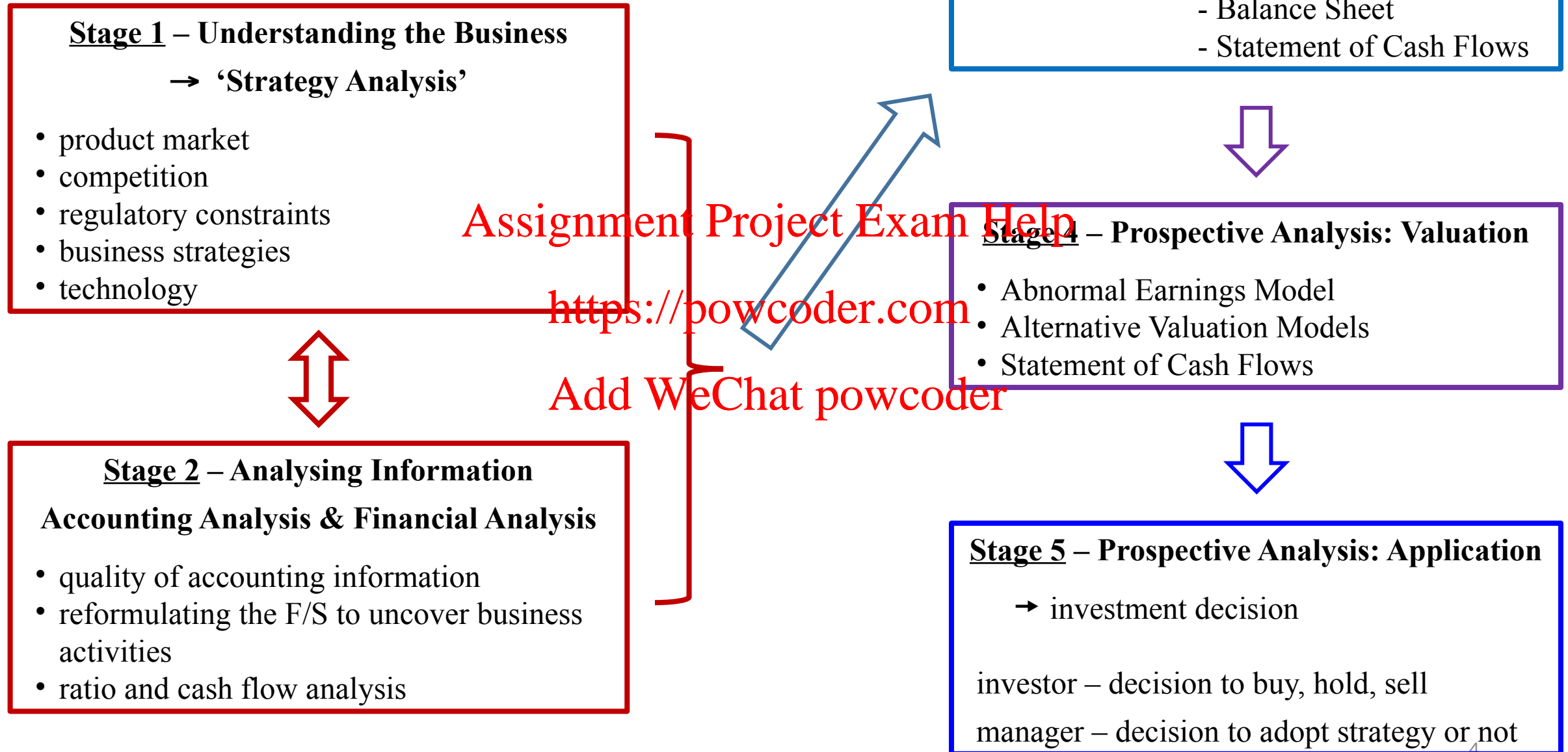


### STEP 3 Valuation

1. Cost of capital
2. Valuation models – AE, FCF, D
3. Valuation ratios
4. Complications
  - a. Negative values
  - b. Value creation and destruction

Figure 1.1 Lundholm & Sloan, *Framework for Equity Valuation*

# Stages of the Analysis



### external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

### Analysis of Financial Statements

- understanding current F/S
- re-formulating the F/S
- accounting quality

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

### Industry dynamics

#### → Porter's five forces

(suppliers, buyers, new entrants, substitutes, rivalry)

- analysts' reports
- management forecasts
- financial press
- ???

➤ Financial Statements – AASB 101:

- Balance Sheet
- Income Statement *and/or* Statement of Comprehensive Income
- Statement of Changes in Equity
- Statement of Cash Flows
- Notes to the financial statements

Assignment Project Exam Help

<https://powcoder.com>

➤ building blocks → definitions specific to accounting

➤ accounting principles → AASB / IFRS rules to guide accounting decisions/choices

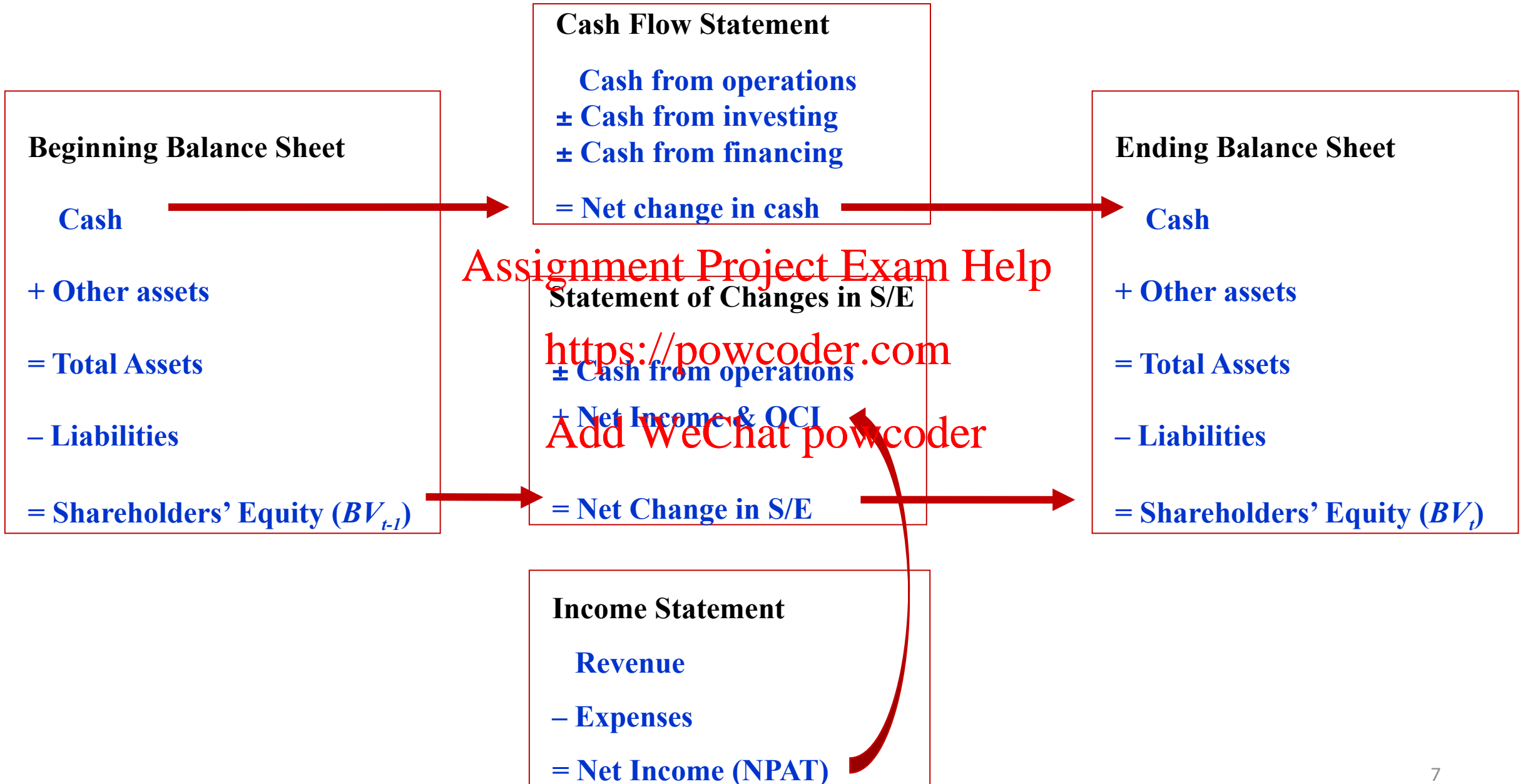
➤ recognition (item to F/S) *versus* disclosure (notes)

**‘*articulation*’** → Financial Statements constitute an **‘*integrated system*’**

beginning stock

flows

ending stock



## *pro forma Income Statement*

	2019	2020	2021E	2022E	2023E
<b>Sales</b>	<b>38,176</b>	<b>37,408</b>	<b>± ?</b>	<b>± ?</b>	<b>± ?</b>
Other operating revenue	288	376			
<b>Cost of sales</b>	<b>(29,253)</b>	<b>(28,043)</b>	<b>± ?</b>	<b>± ?</b>	<b>± ?</b>
Other income	428	408			
<b>Administrative expenses</b>	<b>(8,031)</b>	<b>(8,081)</b>	<b>± ?</b>	<b>± ?</b>	<b>± ?</b>
Other expenses	(146)	---			
Share – equity investments	5	(6)			
<b>Financing costs</b>	<b>(42)</b>	<b>(443)</b>	<b>± ?</b>	<b>± ?</b>	<b>± ?</b>
<b>Income tax expense</b>	<b>(347)</b>	<b>(341)</b>	<b>± ?</b>	<b>± ?</b>	<b>± ?</b>

*caution* – for ‘clean surplus’ and consistent estimates, the accounting system must reconcile

⇒ **‘articulation’**: must concurrently develop the *pro forma* B/S and SCF



## PART 2 – Reformulation Preliminaries

### ▪ Objectives:

- separate **operating** activities from **financing** activities
- fix-up some accounting classifications (relatively few)
- for the Income Statement, separate revenues and expenses based on their *driver* (sales volume or other), and whether they are recurring or non-recurring

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

➤ separation of a company's **operations** from how those operations are **financed**

- ❑ *Operations*: buying and selling goods and services
- ❑ *Financing*: the company's use of debt and equity to finance its operations, as well as the company's investment in financial assets

## Assignment Project Exam Help

➤ Why separate the two?

<https://powcoder.com>

- industrial companies generate value from their operations, not from their financial activities
- financial activities can hide a company's true operating performance

➔ notion of '**levered**' versus '**unlevered**'

**Levered** ➔ measured **after** the effects of financial activities

- ➔ reflect the company's operations and the effects of financial activities
- ➔ levered metrics capture the shareholders' perspective

**Unlevered** ➔ measured **before** the effects of financial activities

- ➔ reflect purely the company's operations
- ➔ unlevered metrics capture the combined debtholder/shareholder perspective

In general: **Unlevered metrics = Levered metrics + Effects of financing**

*note* – this disaggregation can be applied at the overall firm level, as well as individually with the B/S, I/S, and SCF

**levered \***

→ firm after financing charges  
→ to only common shareholders

**unlevered \***

→ firm before financing charges  
→ to debt + equity

\* need to adjust both for tax

	NOTES	CONSOLIDATED	
		YEAR ENDED 28 JUNE 2020 \$M	YEAR ENDED 30 JUNE 2019 \$M
<b>Continuing operations</b>			
Sales revenue	1.3	37,408	38,176
Other operating revenue		376	288
<b>Total operating revenue</b>		<b>37,784</b>	<b>38,464</b>
Cost of sales		(28,043)	(29,253)
<b>Gross profit</b>		<b>9,741</b>	<b>9,211</b>
Other income		108	428
Administration expenses	1.4	(8,081)	(8,031)
Other expenses		-	(146)
Share of net (loss) / profit of equity accounted investments	5.1	(6)	5
<b>Earnings before interest and tax (EBIT)</b>		<b>1,762</b>	<b>1,467</b>
Financing costs	1.5	(443)	(42)
<b>Profit before income tax</b>		<b>1,319</b>	<b>1,425</b>
Income tax expense	1.6	(341)	(347)
<b>Profit for the year from continuing operations</b>		<b>978</b>	<b>1,078</b>
<b>Discontinued operations</b>			
Profit from discontinued operations after tax	5.3	-	357
<b>Profit for the year</b>		<b>978</b>	<b>1,435</b>

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

## *applied to valuation*

$$\text{market value of net operating assets} = \text{market value of equity} + \text{market value of net financial obligations}$$

$$\square \quad \text{market value of equity} = \text{market value of net operating assets} - \text{market value of net financial obligations}$$

Assignment Project Exam Help

‘market value of NOA’ is often called the <https://powcoder.com> market enterprise value (EV)

- the market value of the company’s operations
- ‘*unlevered*’ because it measures the value of the equity and net debt together

Add WeChat powcoder

‘market value of equity’ is also called the market capitalisation (market cap)

- ‘*levered*’ because it measures the value of the company after removing the value of net debt (financing activities)

‘market value of NFO’ represents the company’s financing activities

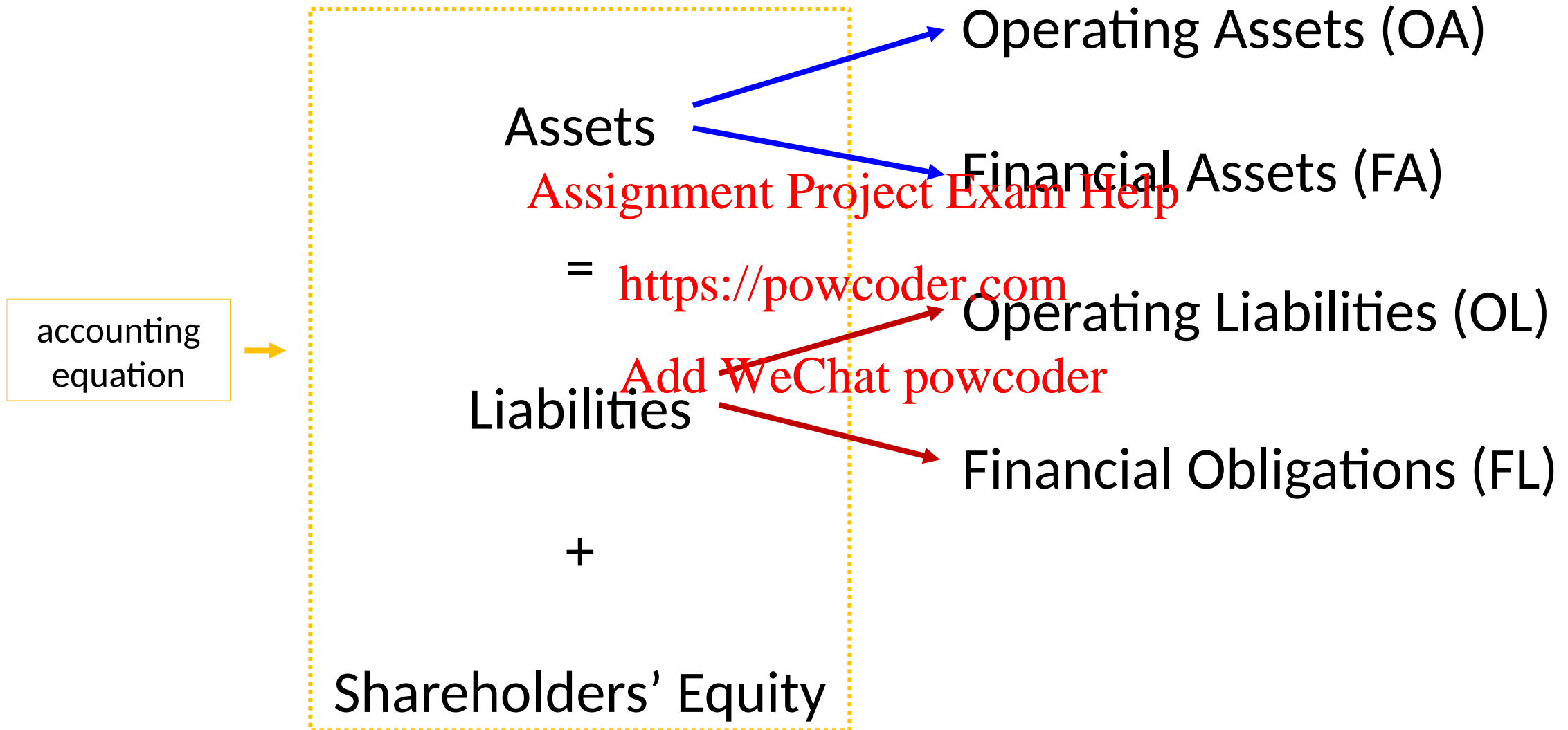
	Balance Sheet (Book Value)	Income Statement	Our Valuation	Market Valuation
Operating activities	NOA	OI (after-tax)	$V_F$	$MV_F$
Debt financing	NFO/NFA	NFE (after-tax)	$V_D$	$MV_D$
Equity financing	CSE	CI	$V_E$	$MV_E$
	$NOA = CSE + NFO$ $CSE = NOA - NFO$	$OI = CI + NFE$ $CI = OI - NFE$	$V_F = V_E + V_D$ $V_E = V_F - V_D$	$MV_F = MV_E + MV_D$ $MV_E = MV_F - MV_D$

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

## PART 3 – Balance Sheet Reformulation



$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Shareholders' Equity (S/E)}$$

$$[\text{OA} + \text{FA}] = [\text{OL} + \text{FO}] + \text{S/E}$$

□

reformulating →  $(\text{OA} - \text{OL}) = (\text{FO} - \text{FA}) + \text{S/E}$

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

net operating assets	net financial obligations	Shareholders' Equity
(OA - OL)	(FO - FA)	S/E
=	+	

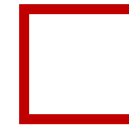
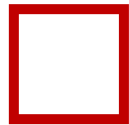
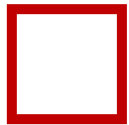




## AASB / IFRS Balance Sheet

Assets		Liabilities & Equity	
Operating Assets	OA	Operating Liabilities	OL
Financial Assets	FA	Financial Obligations	FO
		Shareholders' Equity	S/E
<b>Total Assets</b>	<b>OA + FA</b>	<b>Total Claims</b>	<b>OL + FO + S/E</b>

Assignment Project Exam Help



<https://powcoder.com>

## Reformulated Balance Sheet

Add WeChat powcoder

Net Operating Assets		Financial Obligations & Shareholder's Equity	
Operating Assets	OA	Financial Obligations	FO
Operating Liabilities	OL	Financial Assets	(FA)
		Net Financial Obligations	NFO
		Shareholders' Equity	S/E
<b>Total</b>	<b>OA - OL</b>	<b>Total</b>	<b>NFO + S/E</b>

## Step #1 – Operating Assets (OA) versus Financial Assets (FA)

- *Operating Assets (OA)* – essentially assets used in selling goods and services (the company's business)
- *Financial Assets (FA)* – essentially assets used to invest excess cash (i.e. financial investments not tied to the company's business)

Assignment Project Exam Help

*Aside:* there is an active debate in the accounting literature about how best to achieve this separation (e.g., Barker, 2010, *Accounting and Business Research*) – this is why accountants have not adopted this structure for IFRS reporting!

<https://powcoder.com>  
Add WeChat powcoder

There are two broad things to consider (Barker, 2010):

- **nature** of the item itself e.g., p,p&e is inherently operational (physical assets that are used in production) compared to an investment in government bonds
- **function** of the item in the company's operations e.g., a retail company does not generate profits from trading financial securities, but a hedge fund does → investments in financial securities are likely a FA for a retail company, but an OA for a hedge fund

## Typical Operating Assets (OA):

- *Operating cash* (see later slide)
- *Accounts Receivable*: almost always an OA, but check that it isn't a hidden loan to another company
- *Inventory*: almost always an OA
- *Prepaid expenses*: check what it relates to, but usually an OA
- *Goodwill*: almost always an OA
- *Equity-accounted investments* (e.g., investment in associates/JVs): usually an OA, but check nature of the investment to ensure it is related to the company's operations
- *Property, plant & equivalent (p,p&e)*: almost always OA
- *Intangibles*: almost always OA
- *Deferred tax assets*: treat this as an OA in this course

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

Typical indicators of Financial Assets (FA) (none are decisive on their own):

- the item is financial nature, such as investments in debt/equity securities
- typically measured at fair value e.g., investments in debt or equity
- typically earn interest or dividends for the company
- the asset is not integrated into the company's operations (could be sold without disrupting anything) and/or the company is not expected to generate value above ordinary investment returns on the asset.

Assignment Project Exam Help

<https://powcoder.com>

**Typical Financial Assets (FA):** Add WeChat powcoder

- financial cash (see later slide)
- short-term investments
- investments in debt or equities securities (without control/significant influence e.g., an investment in another company's bonds or a small <20% equity stake in another company)

*note* – there is sometimes room for disagreement about what constitutes a OA and FA for a particular company. Use your judgement where there is doubt, but make sure you can justify your decision

*aside:*

- in the Balance Sheet, assets and liabilities are classified into current and non-current – this distinction does not play a part in the reformulated Balance Sheet; rather, similar current and non-current accounts are combined together (e.g., short-term and long-term bank loans)

Add WeChat powcoder

‘common’ problem areas –

- ❖ cash & cash equivalents
- ❖ investment properties
- ❖ ‘other assets’

## ❑ Cash & Cash Equivalents

- most businesses need some cash to operate i.e., to meet day-to-day cash flows (transaction motive) → 'working cash' → 'operating cash'  $\equiv$  OA
- *however*, many businesses maintain much larger cash balances than they need for daily operations → 'financial cash'  $\equiv$  FA

Assignment Project Exam Help

- separating operating cash (OA) and financial cash (FA) is a matter of **judgement**
- things to consider:
  - competitor cash balances
  - the company's historical cash balances
  - nature of the company's operations
- a classic approach (used by the textbook and often in practice) is to **assume** operating cash is some percentage of sales (e.g., 0.5% of sales)

## ❑ *Investment Properties*

- for most companies, land and buildings will be an OA i.e., the company uses them in its operations (perhaps a factory)
- *however*, some/all of a company's land and buildings can be FA in the following circumstances:
  - the land and buildings are clearly excessive to the company's needs
  - they are rented/leased out to other companies
  - they are accounted for using 'AASB 140 Investment Property' (note - investment properties can be carried at fair value or cost)

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

## ❑ *'Other assets'*

- check the notes for details about what 'Other assets' means (if provided)
  - if the company provides a break-down, classify each component as OA or FA depending upon details
  - if the company provides no information, usually it is safe to assume they are OA

## re: Coles

		CONSOLIDATED		
		28 JUNE 2020	30 JUNE 2019	
		NOTES	\$M	\$M
<b>Current assets</b>				
Cash and cash equivalents	2.1	992	940	→ OA / FA (0.5%)
Trade and other receivables	2.2	434	360	→ OA (after checking note)
Inventories	2.4	2,166	1,965	→ OA (after checking note)
Income tax receivable		42	-	→ FA
Assets held for sale	5.2	75	94	→ OA (after checking note)
Other assets	2.3	70	47	→ OA (after checking note)
<b>Total current assets</b>		<b>3,779</b>	<b>3,406</b>	

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder



	NOTES	28 JUNE 2020 \$M	30 JUNE 2019 \$M	
<b>Non-current assets</b>				
Property, plant and equipment	2.5	4,127	4,119	→ OA (after checking note)
Right-of-use assets	2.7	2,660	-	→ OA (after checking note)
Intangible assets	2.6	1,597	1,541	→ OA (after checking note)
Deferred tax assets	1.6	849	365	→ OA (after checking note)
Equity accounted investments	5.1	217	212	→ OA (after checking note)
Other assets	2.3	120	134	→ OA (after checking note)
<b>Total non-current assets</b>		<b>14,570</b>	<b>6,371</b>	

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

## PART 4 – Reformulating the Balance Sheet (cont)

### Step #2 – Operating Liabilities (OL) versus Financial Obligations (FO)

- *Operating Liabilities (OL)* – liabilities associated with selling goods and services (i.e. the company's business)
- *Financial Obligations (FO)* – sources of financing other than CSE (basically debt)

Assignment Project Exam Help

<https://powcoder.com>

Typical indicators of Financial Obligations (FO):

Add WeChat powcoder

- the company pays interest on them and has an obligation to repay
- most are measured at amortised cost (or rarely fair value)
- the liability is not integrated with the company's operations, e.g. an industrial company could switch a bank loan for a bond without much disruption, but couldn't easily separate its provision for warranty expenses from its operations

## ❑ Typical Operating Liabilities (OL):

- Accounts Payable: almost always an OL (but if the company has to pay interest, you should investigate whether it is a hidden FO)
- Accrued Expenses: almost always an OL
- Provisions: almost always a OL, but check the notes
- Deferred revenue
- Deferred tax liabilities: treat this as an OL in this course
- Income tax payable

Assignment Project Exam Help

<https://powcoder.com>

## ❑ Typical Financial Obligations (FO):

Add WeChat powcoder

- Interest-bearing liabilities/loans
- Lease obligations
- Notes/bonds (in liabilities)
- Preference shares and other hybrid securities

❑ Dividends payable is sometimes classified into Current Liabilities

- this make no sense from a shareholder perspective – can't owe ourselves money!
- why do accountants recognise dividends payables in current liabilities?
- we will instead treat Dividends payable as part of CSE

Assignment Project Exam Help

<https://powcoder.com>

❑ Preference shares (or preferred stock) is sometimes classified as part of Equity

- preference shares are usually a type of hybrid security that does not neatly fit the definition of Liability or Equity
- from the common shareholder perspective, *preference* shares should be classified as a FO and dividends on preference shares should be classified as a financial expense

Add WeChat powcoder

## ❑ Derivative Securities

- 'derivative financial assets' and 'derivative financial liabilities' basically represent unrealised gains/losses on derivative contracts
- *conceptually*, classification should depend on why the company uses the derivative – to illustrate,
  - if it is an interest rate swap used to hedge interest rate risk related to a loan, then the derivative asset/liability should also be a FA/FO
  - if it is forward contract used to hedge currency risk on the purchase of an operating asset, then the derivative asset/liability should be an OA/OL
- given the challenges in specifically confirming each contract, we will treat 'derivative financial assets' as FA and 'derivative financial liabilities' as FO

## ❑ Leases

- leases appear on both the asset and liabilities side of the Balance Sheet
- historically came in two varieties:

*Operating leases:* basically rental agreements

the company does not recognise the leased asset or the associated liability on the Balance Sheet; but recognised an 'operating lease expense' on the Income Statement

*Finance/capital leases:* basically a loan to buy an asset

the company recognises the leased asset and a liability on the Balance Sheet; and associated depreciation and interest components on the Income Statement

- under the new AASB 16, operating leases will basically disappear and all leases will be recognised as finance leases

⇒ treat financial lease assets as OA and lease obligations as FO  
treat lease interest as a financial expense

\* Note 2.9 reveals that 2019 'provisions' include amounts for 'lease provisions' = FO

		CONSOLIDATED	
		28 JUNE 2020	30 JUNE 2019
<b>Liabilities</b>			
<b>Current liabilities</b>	NOTES	\$M	\$M
Trade and other payables	2.8	3,737	3,380
Provisions	2.9	861	743
Lease liabilities	2.7	885	-
Other		198	168
<b>Total current liabilities</b>		<b>5,681</b>	<b>4,291</b>
<b>Non-current liabilities</b>			
Interest-bearing liabilities	3.1	1,354	1,460
Provisions	2.9	472	598
Lease liabilities	2.7	8,198	-
Other		29	71
<b>Total non-current liabilities</b>		<b>10,053</b>	<b>2,129</b>
<b>Total liabilities</b>		<b>15,734</b>	<b>6,420</b>

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

- OL (after checking note)
- OL/FO (after checking note)
- FO (after checking note)
- OL (assumed)
- FO (after checking note)
- OL/FO (after checking note)
- FO (after checking note)
- OL (assumed)

# Reformulation Summary - Coles

	2020	2019			2020	2019
OA	17,502	9,028		FA	847	749
OL	<u>5,297</u>	<u>4,308</u>		FO	<u>10,437</u>	<u>112</u>
				NFO	9,590	(637)
				S/E	<u>2,615</u>	<u>3,357</u>
NOA	12,205	2,720		NFO + S/E	12,205	2,720



## *applied to valuation*

$$\begin{array}{ccccc} \text{market value of net} & & \text{market value} & & \text{market value of net} \\ \text{operating assets} & = & \text{of equity} & + & \text{financial obligations} \end{array}$$

‘market value of equity’ (16 December)

[Assignment Project Exam Help](https://powcoder.com)  
 $= 1,334 \text{ million shares} \times \$18.16 = \$24,225.44 \text{ million}$

‘market value of NFO’ – most practitioners use book (accounting) value of NFO instead of market valuation  
<https://powcoder.com>  
[Add WeChat powcoder](#)

→ \$9,590

➡ ‘market value of net operating assets’ (enterprise value)

$$= \$24,225.44 \text{ million} + \$9,590 = \$33,815.44 \text{ million}$$

## PART 5 – Income Statement Reformulation

*overview* – reformulation of the AASB/IFRS Income Statement and Statement of Comprehensive Income into a Reformulated Income Statement such that it:

1. divides Income Statement items into operating versus financing activity related
2. further divides operating income into three categories, based on whether the items are recurring and driven by sales
3. reallocates income tax expense to remove the tax effects of debt financing/financial assets
4. divides OCI into operating and financing aspects

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

**Process** (as per schema on the next slide) -

**Step #1:** divide every line item in the Income Statement between operating and financing

**Step #2:** divide operating items into:

- core operating income from sales
- core other operating income
- unusual operating income

Assignment Project Exam Help

<https://powcoder.com>

**Step #3:** divide income tax expense between:

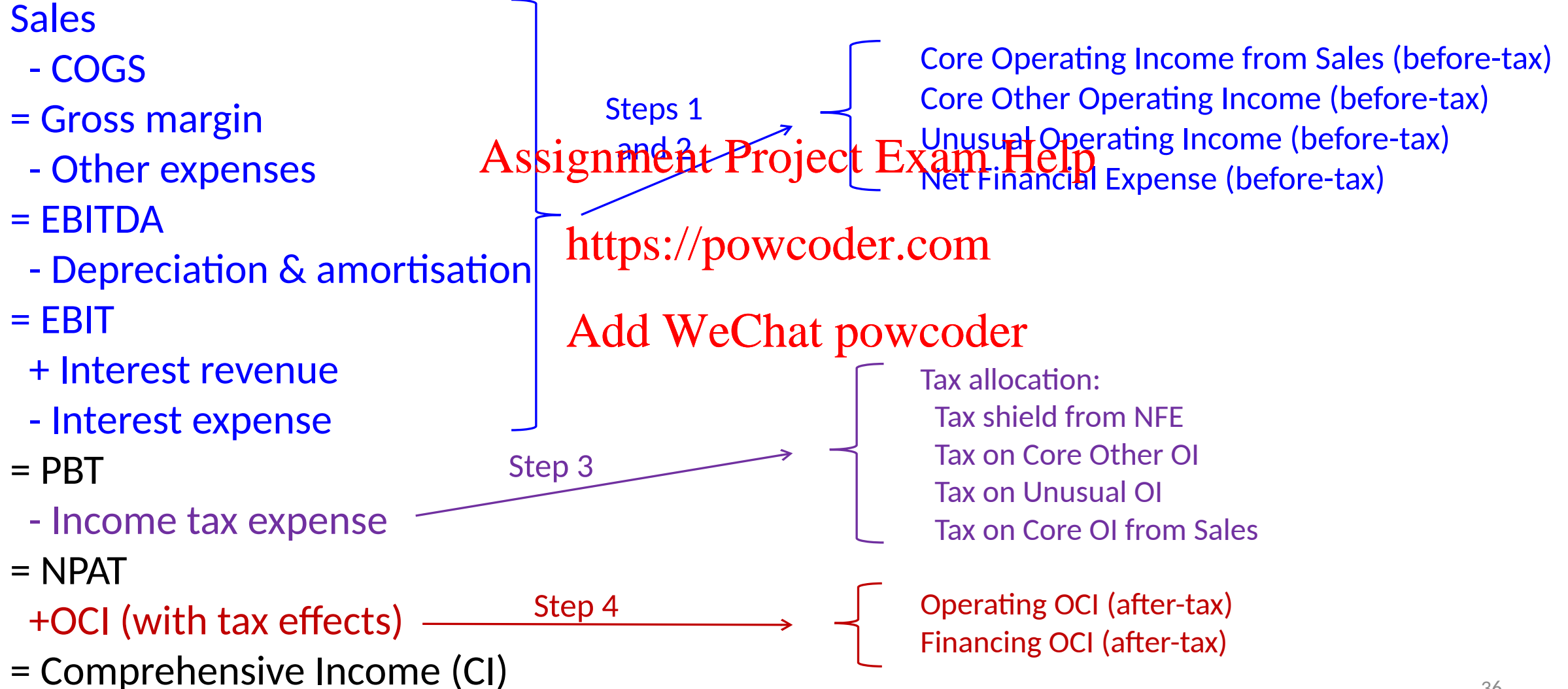
- core operating income from sales
- core other operating income
- unusual operating Income
- net financial expense (or net financial income)

Add WeChat powcoder

**Step #4:** divide OCI items (after-tax) between operating and financing

# AASB/IFRS Income Statement & Statement of Comprehensive Income

## Reformulated Income Statement



**Step #1:** divide every line item in the Income Statement between operating and financing

- ❑ **Operating** items: revenues/expenses (or gains/losses) related to the company's operations e.g., sales, COGS, wages, advertising, depreciation, etc.
- ❑ **Financing** items: revenues/expenses (or gains/losses) related to the company's financing activities e.g., interest revenue, interest expense, etc.

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

- consider information in the notes and the company's operating model (use judgement)
- try to be consistent in how you reformulate the B/S and I/S
  - operating revenues/expenses should relate to operating assets/liabilities
  - financial income/expenses should relate to financial assets/obligations
    - e.g., if a company's 'equity-accounted investments' are classified as a FA, then 'share of profits of equity-accounted investments' should be a financial gain/loss

## □ Typical operating items:

- sales or revenue from sales of goods/provision of services
- cost of goods sold or cost of sales
- wages and salaries or employee benefits
- advertising
- research and development
- selling, general & administrative expenses (SG&A)
- repairs and maintenance
- depreciation and amortisation
- operating lease expense
- share of profits/loss on equity-accounted investments

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

## □ Typical financial items:

- interest revenue or financial revenue
- interest expense or financial expense
- finance lease expense
- dividend revenue from financial assets
- gain/loss on revaluation of financial assets reported in the income statement (e.g. investment property, financial securities)

	NOTES	CONSOLIDATED	
		YEAR ENDED	YEAR ENDED
		28 JUNE 2020	30 JUNE 2019
		\$M	\$M
<b>Continuing operations</b>			
Sales revenue	1.3	37,408	38,176
Other operating revenue		376	288
<b>Total operating revenue</b>		<b>37,784</b>	<b>38,464</b>
Cost of sales		(28,043)	(29,253)
<b>Gross profit</b>		<b>9,741</b>	<b>9,211</b>
Other income		108	428
Administration expenses	1.4	(8,081)	(8,031)
Other expenses		-	(146)
Share of net (loss) / profit of equity accounted investments	5.1	(6)	5
<b>Earnings before interest and tax (EBIT)</b>		<b>1,762</b>	<b>1,467</b>
Financing costs	1.5	(443)	(42)

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

lacking Notes on 'other operating revenue' and 'other income', will treat all items as 'operating items' except 'financing costs' which will be classified as a 'financial item'

## PART 6 – Reformulating the Income Statement (cont)

**Step #2:** divide 'operating items' into:

- core operating income from sales
  - recurring operating income related to the company's main operations (driven by sales volume) e.g., sales, COGS, wage expense
- core other operating income
  - recurring operating income that is not related to the company's main operations (not driven by sales volume) e.g., share of profits of equity-accounted investments, royalty income
- unusual operating income\_
  - non-recurring (one-time) operating income e.g., restructuring charges, extraordinary items, gain/loss on sale of PPE

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder



*Why these classifications?*      **facilitates forecasting**

*Why separate 'core operating income' and 'unusual operating income'?*

- when evaluating historical performance, it is useful to know whether earnings was affected by unusual items e.g., suppose a company makes \$100m in profit, but \$80m came from a one-time gain on selling surplus land
- when forecasting, it is useful to know whether an item is likely to repeat in the future e.g., a loss due to a flood is not likely to occur every year

*Why then further split 'core operating income' into 'core operating income from sales' and 'core other operating income'?*

- for forecasting purposes, it is useful to know the 'driver' of an item
- items in 'core operating income from sales' are likely to be associated with sales volume (e.g., COGS), whereas items in 'core other operating' are likely driven by other factors (e.g., royalty income)

## ❑ Core versus Unusual

- **core** items occur every year, and are fairly stable and predictable
- **unusual** items do not occur every year, or vary greatly from year-to-year and/or are unpredictable
- restructuring charges, extraordinary items, impairments, asset/business sales are generally **unusual items**, but check to make sure they are not recurring
- clues as to what be non-recurring can be found in other sections of the annual report and the company's investor presentation (note - exercise judgement; do not necessarily follow the company's advice if an item looks like it is actually a normal expense or recurring)

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

*note* – 'other comprehensive income (OCI)' is considered separately in Step #4; we will implicitly treat all OCI items as 'unusual'

## ❑ Core Operating Income from Sales *versus* Core Other Operating Income

- typical 'core operating income from sales':
  - sales or revenue from sales of goods/provision of services
  - cost of goods sold or cost of sales
  - wages and salaries or employee benefits
  - advertising
  - research and development
  - selling, general & administrative expenses (SG&A)
  - repairs and maintenance
  - depreciation and amortisation

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

- typical 'core other operating income':
  - royalty income
  - rental income (not related to Investment property, which would be financing)
  - grant income
  - share of profits/loss on equity-accounted investments
  - 'other income'
  - income from 'side businesses' if they are separately broken-out on the income statement

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

		CONSOLIDATED		
		YEAR ENDED	YEAR ENDED	
		28 JUNE 2020	30 JUNE 2019	
	NOTES	\$M	\$M	
<b>Continuing operations</b>				
Sales revenue	1.3	37,408	38,176	→ Core OI from sales
Other operating revenue		376	288	→ Core other OI
<b>Total operating revenue</b>		<b>37,784</b>	<b>38,464</b>	
Cost of sales		(28,043)	(29,253)	→ Core OI from sales
<b>Gross profit</b>		<b>9,741</b>	<b>9,211</b>	
Other income		108	428	→ Core other OI
Administration expenses	1.4	(8,081)	(8,031)	→ Core OI from sales & Unusual OI*
Other expenses			(146)	→ Core financing expense (NFE)
Share of net (loss) / profit of equity accounted investments	5.1	(6)	5	→ Core other OI
<b>Earnings before interest and tax (EBIT)</b>		<b>1,762</b>	<b>1,467</b>	
Financing costs	1.5	(43)	(42)	→ Core financing expense (NFE)
<b>Profit before income tax</b>		<b>1,319</b>	<b>1,425</b>	
Income tax expense	1.6	(341)	(347)	→ Step #3
<b>Profit for the year from continuing operations</b>		<b>978</b>	<b>1,078</b>	
<b>Discontinued operations</b>				
Profit from discontinued operations after tax	5.3	-	357	→ Unusual OI
<b>Profit for the year</b>		<b>978</b>	<b>1,435</b>	

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

\* Note 1.4 indicates that 'Administrative expenses' include an 'impairment reversal' of \$41 million in 2020 and an 'impairment expense' of \$42 million in 2019 → 'Unusual OI'

## Summary – Coles reformulated Income Statement (following Steps #1 & #2)

	2020	2019
Core OI from Sales (before tax)	1,243	934
Core Other OI (before tax)	478	721
<b>Core OI (before tax)</b>	<b>1,721</b>	<b>1,655</b>
Unusual OI (before tax)	41	315
Core NFE (before tax)	(443)	(188)

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

\* 2020 reconciles; 2019 does NOT – tax adjustment on 'discontinued'

versus reported profit before tax from the I/S

	2020	2019
<b>Profit before tax</b>	<b>1,319</b>	<b>1,425</b>

## Process –

✓ **Step #1:** divide every line item in the Income Statement between operating and financing

✓ **Step #2:** divide operating items into:

- core operating income from sales
- core other operating income
- unusual operating income

Assignment Project Exam Help

<https://powcoder.com>

**Step #3:** divide income tax expense between:

Add WeChat powcoder

- core operating income from sales
- core other operating income
- unusual operating Income
- net financial expense (or net financial income)

**Step #4:** divide OCI items (after-tax) between operating and financing

## PART 7 – Summary: Sessions #1 → #6

*overarching objective:*

to conduct fundamental value for the purpose of estimating the ‘intrinsic value’ of a firm’s common shares

→ requires an understanding of the firm’s ‘value drivers’

→ need to accumulate a ‘tool kit’ as the basis for developing the *pro forma Financial Statements*

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

### STEP 1 Understanding the past

1. Information collection
2. Understanding the business
3. Accounting analysis
4. Financial ratio analysis
5. Cash flow analysis



### STEP 2 Forecasting the future

1. Structured forecasting
2. Income Statement forecasts
3. Balance sheet forecasts
4. Cash flow forecasts



### STEP 3 Valuation

1. Cost of capital
2. Valuation models – AE, FCF, D
3. Valuation ratios
4. Complications
  - a. Negative values
  - b. Value creation and destruction



### external environment

- economic prospects
- macroeconomic factors
- socio-cultural forces
- political / regulatory

### Analysis of Financial Statements

- understanding current F/S
- re-formulating the F/S
- accounting quality

Assignment Project Exam Help

<https://powcoder.com>

Add WeChat powcoder

### Industry dynamics

#### → Porter's five forces

(suppliers, buyers, new entrants, substitutes, rivalry)

- analysts' reports
- management forecasts
- financial press
- ???