Scenic Video Transcript

Income Statement Line Items

Topics

- Comprehensive income statement – level 4
- Owners' equity change (OEC) map – complete
- Primary elements:
  - Income (revenue and gains)
  - Expenses (ordinary expenses and losses)
- Common line items:
  - Net revenues
  - Cost of goods sold
  - Selling, general, and administrative expenses (SG&A)
  - Other income and expenses
- Assessing performance:
  - Common size income statements
- Company disclosures:
  - Vodafone
  - América Móvil
  - AT&T
  - Common size income statement comparisons
- Take-aways

Transcript

Introduction

Welcome to the Line Item scenic route where we're going to learn more about operating and non-operating income by studying the line items within these groupings. This is the fourth and final level of the hierarchical analysis of income statements. To gain a deeper understanding of how reported numbers connect to the business and thus to help you better interpret them, well we're going to have to go behind the numbers and we'll do that by studying entries later in the chapter.

So our agenda for this video includes an examination of the comprehensive income statement level 4 and that will be line items. And then we're going to use the Owners' Equity Change Map to introduce some specific line items that we'll be studying but also to get to what's called the primary elements of the income statement, namely income and expenses under IFRS under US GAAP, revenues and expenses, gains and losses. And then we're going to look at some common line items. And by common line items, these are line items that virtually every company uses and that you're going to have to have command over by the end of the chapter in order to understand the exercises. So for example, net revenues, cost of sales and selling, general and administrative expenses. We'll explain these in great detail.

We'll also touch on some of the other line items that will help give us a better understanding of what's going on in the three telecommunications company. But you may not have as profound in understanding as you do of these line items which we're going to be carrying forward every chapter. And then we're going to assess performance and we were looking at ratios throughout the scenic routes and then in this case it's no different, but the ratios are going to be called common size income statements. And we'll explain why those are ratios when we get to that section. And then we'll apply all the concepts as we've done in the other scenic route videos to the three telecommunications companies, and in particular look at their common size income statements and we'll close out with some take-aways. So it's a relatively long video but it's very important. Now let's get started.

CIS- Level 4
When we look at our hierarchical analysis of income statements, we're on levels 1 through 4 on this picture. We started with comprehensive income and then we took that and we broke it down into two parts and dissected it into net profit, OCI. We said well OCI was kind of like winning the lottery. It goes up and it goes down but it's not very persistent. It won't help you predict the future. Net profit can be profit before taxes and then tax expense. And then we could take profit before taxes and break it up into operating profit and other income and expense. And this is where most of our focus is going to be in this video. Looking at the line items behind these two issues and in particular revenues, cost of goods sold, SG&A and other income and expenses. "Other" is just a generic term in Bischoff so we're not going to learn much from that. So most of our focus is on these three line items and then we'll do some analysis.

OEC Map Completed
The first thing we're going to do is finish up the Owners' Equity Change Map. And then you're going to see this section and more importantly as we move into the next module which is on the statement of changes and owners' equity. The change map is powerful for understanding how all the statements connect together. So you might recall how it works. Over here we have the assets, liabilities, and owners' equity at the beginning of the year, over here at the end of the year. We're looking for how the company performed within one-year and we do that by looking at the change on the balance sheet. We then say "Well, how much of that change in owners' equity was due transactions with owners?" And those transactions were contributions from owners like the company issued shares of stock and we exchange for cash or distributions such as paying dividends and how much of the change in owners' equity was due to other things? And it turned out the most important other thing was comprehensive

income, which was our first level of analysis and then we broke that down into two parts, net profit and OCI. So the same stuff we just saw and now we want to go one step further down to what's called the Primary Elements and they're going to be slightly different for IFRS than US GAAP. But the differences are really subtle. In the future you probably won't get fixated on those differences and think of them as essentially the same.

So the primary elements for IFRS are what's called Income and Expenses. Now, this is not net income. This is income as a bigger concept and then expenses. And for US GAAP their revenues, gains, ordinary expenses and losses. So, one way to think about it is that US GAAP defines the primary elements at one level lower. It takes income and says, well, there are two types of income, revenues and gains; two types of expenses, ordinary expenses and losses. And we will come back and talk about these in more detail after we get to the formal definitions of income and expenses and tie them back to what's going on in the Owners' Equity Change Map.

Primary Elements

So income under IFRS and here's what's important, it's an increase in the economic benefits during the accounting period in the form of inflow or enhancement of assets or decreases of liabilities. Well, that's just a fancy way to say "net assets". Either the assets go up or the liabilities go down. On top of all this we had the entire Owners' Equity Change Map. So let's go back to that just for a second. So what is income? Income traces back up. It's a part of profits, part of comprehensive income, all the way back up. And oh yes, it's either an increase in the assets or a decrease in the liabilities. And expenses is just going to be the opposite, either an asset goes down or a liability goes up or some combination of that that causes net assets to change.

So you can have an asset go up and a liability go up and have no effect on owners' equity, that would just be buying inventory on account. Assets go up, liabilities go up, no change in owners' equity. So we're focusing on when an asset goes up for example, income goes up. We'll be showing you lots and lots of examples of this later. But for now the most important thing is to understand that income and expenses, the primary elements on the income statement, well they're defined consistent with the map and in particular in terms of the increases in the net assets or the decreases in the net assets for expenses. And that's all we've got over here for the primary elements. And the formal definitions you'll see that, an expense then will increase when net assets goes down and income increases when net assets goes up.

Well, and what's the difference between revenues and gains in terms of income because there are two different flavors of income, if you will. Revenue arises in the course of the ordinary activities of an entity and gains represent items that meet the definition of income that may or may not come about from the ordinary activities. That's kind of a confusing definition. So the way you want to think about it early on is that revenue is pertained to the ongoing operations of the company and the gains are more one-off things. So for example, if a company sells a building and it's not in the business of selling buildings, it just happens to sell say at the corporate headquarters. Well, they'd look at the gain on that. If they got more money for that, then the asset was on their balance sheet. They'd look at the difference between what they got and what they have in their balance sheet. Putting cash on their balance sheet of more value than the asset they take off. So assets would go up and that would be a gain. And on the other hand, revenues will be selling inventory that would give rise to revenues.

So anyway, those are revenues, gains and expenses of just the opposite. We are going to wear you out with examples on what income is and what expenses are later in the chapter when we go behind the numbers. You will understand these concepts so clearly. So for right now, just try to get the big picture, they're connected to the change and net assets, that will be again explained in great detail later and there's going to be a lots of examples for you to grasp but right now what you want to know is the primary elements on an income statement under IFRS or income and expenses and under US GAAP or revenues and gains, ordinary expenses and losses, and the effects they have on the owners' equity is income makes owners' equity goes up, expenses makes it go down. That's intuitive right? If you think about income you tend to think about good news for the owners and expenses just intuitively, well that's not necessarily good for the owners.

COMMON LINE ITEMS

Net Revenues

Now, what we want to do is tie all this to the income statement. So we're going to take revenues and we're going to look at the income statement and we're going to see net revenues. Now, why don't I just say revenues? Why NET revenues? What's the net in net revenues? And students often get confused with net revenue and net income, net what? Net always means take one number and subtract another and what you're looking at is the difference between those two numbers, the net of two numbers. And so you need to understand in the context what's being netted against what? That's always important. Out of context it makes no sense. So, net revenues means gross revenues net of discounts, product returns, rebates, and other sales incentives. So if you go to a store and you see an item on sale and that item was regularly $10 and now you can buy it for $9, well that's a discount or you get a rebate because the company will mail you a dollar later if you buy it now for $10, if you submit a form.

Well, all of those are netted against revenues. And then gross revenue is the value of the cash or the other economic benefits that would have been received, WOULD HAVE been received, from customers if there were no discounts, product returns, etc. Here's a little example and for right now just try to get the big picture. But do understand the net revenues is different than gross revenues, and that net revenues is what you're always seeing on the income statement even if the company leaves off the word "net" they say "Well, you know you ought to know enough accounting to know that's a net." So what do we mean by that? Here's a simple little example that will give you some intuition.

XYZ Company sold merchandise for $100 M in 2013, and it granted customers a 5% discount for early payment, and expected $7 M of products to be returned. So they sold $100 M worth: that was the price of the goods. They gave a 5% discount, that got them down to $95 M, and then oh by the way, they expect $7 M of this to come back, customers are going to return the product. So that got them down to $88 M of net revenues. The $100 M gross revenues take away the $5 M of discount, take away the $7 M for product returns. Now, if you look at product returns and discounts, there are some businesses for which those are barely material. But there are other companies and especially high-end retailers for example. You know in America, Sachs, they have very generous return policies and that's expected, that's a part of doing business. And so when you look at net revenues for them, well, it's very important to understand the difference between net and gross.

Cost of Goods Sold

Cost of goods sold. This is another big line item, so we want to make sure we understand what it is. First of all it's an expense, cost of goods sold is subtracted from net revenues, from NET revenues. So it's not netted within net revenues. It's subtracted from it to get what's called gross profit. Well, but what is cost of goods sold? Cost of goods sold includes all costs that can be directly, DIRECTLY tied to the sold products, except cost for sales commissions. And the reason they are not included is some companies have sales commissions that is if the sales staff gets paid a bonus for making a sale and others just give them a flat rate. So if you're comparing those two companies, well, you wouldn't want to have a cost of the one that's tied to the sale included for one company as a direct cost and not for another company because there was no commission. You'd be comparing apples to oranges.

So, sales commissions are excluded. They're going to be included in SG&A later on. So this includes the cost to acquire or manufacture products, store them, and ship them to customers. If you're a retailer say and you buy inventory for $30 and then turn around and sell it for $50, well a part of the cost of goods sold will be the $30 that you pay for that inventory. There will be other things included and that will be the shipping cost that you had to pay to get that inventory, that would be in cost of sales and the shipping cost for example to ship that to a customer because that's directly tied to the sale. So cost of goods sold is a really important number. It's generally very, very large.

So, analysts when they're studying a company, they're going to study the gross profits or the gross margins very, very carefully. Again, gross margin is another word for gross profit. We're going to study those very, very carefully because good deal the revenues are used to cover the cost of goods sold.

Well, let's look at some synonyms for cost of goods sold because one of the things we're going to try to train you for is to pick up a variety of different income statements and that means you're going to get bombarded with a variety of different terms and you don't want to be bothered by this. You want to learn to say "Well, what's the second line item or an income statement generally?" Or it's somewhere close to the second line item. And it's usually cost of goods sold. It's this concept of direct costs that are tied to the sale.

But when you see a line item that kind of sounds like that and it's in the same position, well, that's the same thing. As so what are some of those cost of sales? You'll see that frequently. Cost of products sold, cost of services sold for a service company. Again, all synonyms for the same thing. Companies that have material sales of both goods and services must report separate revenues for the products and services and separate costs of goods sold for the services. That allows analyst to get separate margins. But sometimes those are reported on the income statement, sometimes they're reported in the footnotes and sometimes they're not reported at all because the amount of revenues for example that are serviced is immaterial. So while not required, many companies report gross profit. This subtotal is revenue less cost of goods sold and that's what we saw over here. But you're going to see that pretty widely but not always but analysts calculate themselves even when it's not reported. Some synonyms are gross margins or gross profit margins. You'll see both of those.

SG&A

Here we come to selling, general, and administrative expenses, SG&A. This could mean different things for different companies. As the name suggests, it's kind of a general category and that means different companies will report different things and you have to know the company and again try to get a feel for what's in there, and we'll teach you how to do this as we go through the line items, not necessarily today but in subsequent modules. The SG&A typically includes, among other things, commissions, the sales commissions we talked about earlier, other selling expenses, research and development expenses, marketing expenses, rental expense and depreciation expenses. Anyone of those can be included in SG&A. But as we're going to see it later, some of them are excluded under both IFRS and US GAAP companies must disclose material expenses separately either on the income statement or in the footnotes.

And again, we'll see that word "material." So there is some understanding within the community as to what that means. That's beyond the scope of this chapter. But for right now what it means for you is that sometimes you'll see a company that it will include say, depreciation expense in SG&A. It won't be reported separately on the income statement. And other times, you'll see it reported separately on the income statement. A great example is research and development expenses. Intel reports that separately as those, Merck, the pharmaceutical company. Why? Because it's a gigantic expense for those companies. It's not just material. It's huge. They are hi-tech companies and so they report those items separately on the income statement. The analyst community expects that, so they're not included in SG&A. Well, again context is everything and in context you'll learn, you'll get comfortable with interpreting what's in SG&A at least at the big picture level. So as a result, often companies will report separate income statement line items for expenses, other companies include it in SG&A.

Other

Other Income and Expenses. We have other operating and other non-operating but we haven't called it that. Other operating expenses includes operating income or expense items not reported elsewhere in the operating section. In the later chapters, we're going to see that for Bischoff other includes gains and losses associated with equipment sales and other items. So they're going to sell off some of their property plant and equipment, and actually we will do a little bit of that in this chapter, and then there's a just a variety of other things. So for Bischoff you might recall it from the balance sheet chapter. The way we use this company is we keep taking things out of other and putting them onto the income statement as you learn more and more concepts. So this other looks like it just contains a little bit of nothing almost. Well, that's the net effect of lots of things going on. It's just that they net to zero for operations but individually well they're not zero. And they net to a very small number one here but in fact they're individually significant.

Now we're almost finished with Bischoff's income statement and we started out, remember with comprehensive income so you know what that is, Level 1 and then other comprehensive income and net profit, Level 2. And then we looked at profit before taxes and income tax expense, Level 3. And then operating profit as a line item again, Level 3. And then we looked at other income and expenses just now and other operating income and expenses. And here's the take-away: generic line items such as these typically you combine gains, losses and ordinary expenses, hardly ever revenue. Revenue is the top line item. So, that's pretty much everything. We've covered all the line items on this income statement but it's a simple income statement because we buried a great deal on the other. So we're going to want to look at real companies, but first we want to do a little bit of analysis.

ASSESSING PERFORMANCE

Common Size Income Statements

So let's go look at the ratios that we're going to look at for this company. Remember how we've been looking at the ratios and getting a deeper insight as to how the companies are performing. Well, the ratios here are called Common Size Income Statements. And let's look at it. Here we have our income statement for 2013 and 2012. Here are the reported numbers for Bischoff. They are the numbers we just analyzed. So how do you get the common size income statement which is these columns here? How do you get that? It's very simple. You take every number on the income statement and you divide by revenues. For example to get this -50.10% for cost of goods sold, well, we took revenues which is $505 and we divided it into the $253 with the negative sign of course. And you can tell that's around 50%, which is what it was.

Now, that means that we're expressing every item on the income statement as a percent of sales and that allows us to calibrate from year to year how are the items changing as a percent of sales? But it also allows us to make comparisons across different currencies which we'll do when we look at the telecommunication companies because they're all standardized by the company sales, and therefore currencies really don't matter, and it also allows us to make comparisons across different industries. We'll look at those ratios for the three companies we've been following.

COMPANY DISCLOSURES

Vodafone

First, let's just look at their income statements before we common size them. So we start with Vodafone. What have we learned that we didn't know at Level 3? Well, let's look at some of these line items and see how many are common line items and a few others that we're just going to point out now but we don't want you to panic over. You just need to get the big picture for. Well, there's revenues, notice I didn't say "net revenues." Does that mean there are no discounts? Oh come on. This is a gigantic company. They've got discounts. They probably got rebates. They probably got all the items we talked about. How significant are they? Who knows? But they're just not saying it.

So they expect you to know that's net revenues. And then they have cost of sales which are like cost of goods sold and they get gross profit which could have been called gross margin. So these are all concepts that you'll gain a much deeper understanding for. Much, much deeper when we go behind the numbers, and when we look at the entries that are behind these numbers. But for right now, we got a pretty good idea of what they are. Now, what about the expenses? Well, you don't see SG&A. You see selling and distribution expenses so they're going to break it down and give you more detail. They're going to give you administrative expenses. So instead of selling, general and administrative, they're going to give you selling, distribution and administrative broken out separately. That's just the way they chose to do it because probably their analyst community wanted to see these numbers.

What's next? The share of results of associates. Now, let's go and take a little bit of discussing, but I want to do it because there's a really important lesson as we analyze these companies and understanding what is meant by the share of results of associates. So let's look at what it is. It's kind of another perspective on something we looked at earlier, the controlling and non-controlling interest. And in that case, here we have a parent company up here and what we looked at before is the parent company own part of a business and had owned 80% of it and it had a controlling interest and there were these other guys over here that are owned 20% and they were called the non-controlling interest. Remember that from another scenic route video? And we see that at the bottom of every statement, non-controlling interest equity shareholders.

That's different situation but it's kind of related to what we're looking at here. Because what we're looking at here is now the parent is not going to be a controlling interest but they're going to be a non-controlling interest. So there's going to be business over here or say the parent owns say 25%. So it doesn't control, it doesn't even have 50%. It's not going to tell this business how to run the company, but it has a significant influence on the company. So it can't just buy three shares. An associate generally is more than 20%, but the concept is significant influence. And so there would be a parent over here or a bunch of other owners that make up 75% of the ownership and that maybe one company or several other companies in a joint venture.

Now, the key thing you understand is we've been taking care of these situations up here and all these line items, put all those guys together and we get to the bottom line and then we split them up into controlling and non-controlling. Now suppose this associate company has income of $100. Now, I picked that number because it's easier to work with. Well then, what we're going to do in our income statement, and you don't have to worry about the entries or anything, is we're going to say "You know they reported an income of $100 and we're entitled to 25%. We have a claim on 25% of that." So our share of their income is $25 and we're going to report that.

Now, let's go back here and look at this line item, share of results of associates, and that's what it means. Let's trace it across and see what we get. Well, we get 5,059. Now that's a big number, that's a number we can't ignore and the thing I want you to see right now because it's going to differ for the three companies, and this is the bottom line; Vodafone, and it can do this, has chosen to include this line item up in operations. So it's part of the operating profit. The other two companies are going to report it down here, in the non-operating items. They're going to consider it non-operating. And under IFRS, they can put it in either place. So what we need to do if we're analyzing these companies is we need to say "Well look, one company is including almost 5 B up in operating profits but the other ones are putting down below." So if we're comparing operating margin, say, that's an unfair comparison.

So we're going to have to make an adjustment for that and we'll do that when we do the ratios and we wanted you to know why we do that, because it's very common to see these items sometimes up in operating profit, sometimes down below and you got to get it in one or the other for a consistent comparison across companies. And I don't think there's a right way to necessarily think about it, some people would disagree, and you might consider the operations, I could tell you a story about that or non-operations. So it's not a matter of right or wrong. It's a matter of if you want to compare one company to another, you got to be consistent where you put it. Again, what it means by share of results of associates is the associate is a company, we own a significant influence in, but we don't control them. We don't control them. We have a significant position and what we're going to show on our income statement is our proportionate share of their income and a few other things that we're going to ignore right now.

Now, we come down to impairment losses. We see that they were 6 B in 2011, 2 B the year before and around 6 B the year before that. That's a huge number. Remember that's being subtracted. Those are being treated like expenses. Remember losses are like expenses and that's on an income that ends up as an operating profit of around 5 B. So have we not had those impairments look how much larger our operating profit would have been. It would have been around 11-12 B in 2011 and so on down the line. Now, the only reason I point that out is we saw this big difference in the ratios earlier and we'll see it again later and one of the reasons is these impairment losses. And what's an impairment loss? We're going to learn about them when we go behind the numbers just to get a feel for them, just a feel.

But if you have asset equal liability plus owners' equity and the asset impairment is when we write down the value of the asset and that effectively writes down the value of the owners' equity, and how does that happen? By taking an expense on the income statement. More details to follow. For right now what I want you to see is whereas you don't need to fully understand impairment losses or share of associates, if you're going to analyze these companies, you're going to have to at least know those are big line items. And you want to have at least an intuitive feel for what they are and that's all we want you to get right now.

Now, let's look down to the non-operation section. Here we see investment income and we see financing cost. An investment income is what it sounds like. They invest in shares, they get dividends. They invest in other companies' debt, so they get interest. Financing costs are like interest expense for example. We've gone into a fair amount of detail here because we're going to see similar line items later on. And just to summarize, the ones you really need to understand right now to get through the exercises are revenues, SG&A and cost of sales. And the other ones, well it's nice to have at least a general understanding of them so that we can begin to interpret some of these numbers.

América Móvil

What we see for América Móvil is a lot more detailed. For example, look at revenues. Not only have they given you revenues, they've given you about 6 or 7 line items on revenues. They have broken down the revenues by mobile voice services, fix voice services. Companies generally will do something like this in the footnotes or on the face of the financial statement. And it's very important for an analyst to know that. How is the company generating revenues? Well, how are they doing in these new mobile services? Are they doing well? Are they starting to gain market share? All those things are important to an analyst. And then cost of sales and services right here combined and then commercial, administrative, and general expenses. Now, think about that, commercial, administrative and general expenses. Not quite SG&A but it kind of sounds like the same sort of thing.

And here's "Other." If I was an analyst following the company I want to say "Well, what's in "Other" here versus what's in this number?" Especially if I was comparing two companies and they were using slightly different labels. But get used to different labels but sort of the same general idea of what they include. And they're reporting depreciations as a separate line item, and we'll be recording depreciation later in the chapter so you'll have an idea of what this number represents. And right now all you need to know is this an expense.

Under non-operating income they've got interest income, interest expense, foreign exchange and valuation of derivatives. Don't worry about the details here. This is just stuff that doesn't have anything to do with the day-to-day operations.

AT&T
Now we look at AT&T and we're going to move relatively quickly here. We see under operating revenues, they also break out their revenues, slightly different classifications but you get quite a few details about revenues right there on the face of the income statement. Then they have a category called operating expenses, and the first thing they include is cost of service and sales but they say, look, it's exclusive of depreciation and amortization. Because some companies would include some of their depreciation and amortization, and cost of services and sales, this company doesn't, and then selling general and administrative expenses, and depreciation and amortization outside of that.

Now, if we move down here and this is something I mentioned earlier that we see equity and net income of affiliates. Affiliates is just another word for associates. That's our share of their income. So exactly what we talked about earlier for Vodafone, what's their difference? Well, for AT&T it's below the operating income subtotal, so it's not included. That 762 is not included in operating income, whereas it was for Vodafone. So again, we can adjust your analysis for that, for moving it out of operating income for Vodafone, for the purposes of our analysis or by moving it in operating income, either way with this company. But we can't leave them one in and one out and compare the companies.

Ratio Comparisons
So here is our analysis of the comparisons and all these footnotes down here say is, look, we took care of that equity and the share of the associates. I think we excluded it from operations and we included it in non-operating items. So let's look at what we learned. I want you to focus on Vodafone at a line item, pre-tax income from continuing operations of 21%. Well, that's pre-tax profit divided by revenues because a common size statement divides everything by revenues. So that's pre-tax profit over revenues or net revenues more precisely, and that's how we get 21%. Well, that's a ratio we looked at before. Remember that was the key profit margin, it was in the DuPont model. It was one of the 4 factors.

So what did we learn from a common size statement? Here's the profit margin. Let's get a better idea of what's behind the profit margin. How did we get to this profit margin? Well, all these lines items. See they give us more detail about how we get down to that profit margin. So what the common size income statement allows us to do is to drill down on the profit margin in the DuPont model which is one of the four key factors in the DuPont model and therefore to extend our analyses. Before we analyze the common size statements for the three companies, I want to do a little background work.

First of all, notice what we've done here. We've combined a bunch of other operating items into a single line item. And we put all the non-operating items into a single line item. We recall the three companies have different line items, and so we couldn't really make common size statements comparisons unless we combine items. But when combine items we're at risk of combining apples and oranges. And I want to talk a little bit about that before we get started because you want to put some caveats around the analysis. So let's go back and look at fresh copies of the income statements for the three companies and I want to focus on three issues, the share of the equity and the income of the associates. We discussed that earlier. The impairments and the depreciation line items. So let's go back and just focus on those and we're going to see differences in those.

Now, if we look at Vodafone we recall they have significant impairments. And the second observation is they don't show a single line item for depreciation. And the other two companies are going to. So we did a little background work. We're going to do a footnote and we discovered that they had about 8 billion pound Sterling of depreciation and amortization. And so we looked at the numbers here and we saw it. Well, I wonder where they're putting it now. Well, they can't be putting it in selling and distributing cost, they can't be putting it in administrative cost and it's surely not in share of associates. And so we suspect that 8 billion is included in cost of sales. And when we started these concepts in later chapters, you'll see, "We'll that's not such a bad place to put it."

So we think it's in cost of sales and that's a very important observation because when we look at the other companies it's not going to be in cost of sales. And so an analyst is going to have to take that in consideration, that's an apples to oranges comparison. But because we're not quite confident, we won't make an adjustment for that. We're just keeping in the back of our mind that maybe as an alternative we'll consider an adjustment.

And then the third thing we'd have you look at is something we mentioned earlier. The share of the associates' income is up here in operations. To summarize, they have large impairment losses, the share of results of associates is in operations, and their depreciation is up here in cost of sales. And these are going to be areas we want to look for comparisons now as we look at the other companies. Now, if we look at América Móvil on the same dimensions, first of all, notice that depreciation is a separate line item. So it's not included in cost of sales and services. And in fact, we're pretty confident of that because we look at their depreciation footnote and these numbers tend to align with the total that they recorded during the year.

So we're pretty sure that it's not up here in cost of sales and services, so that's the difference. We also don't see any significant impairments here, now they may have had impairments but they weren't sufficiently significant to record as separate line item. And so we're not going to make adjustments for those. And what about the share of the associates' income? Well, it's way down here at the bottom, equity interest in net income of associated companies. It's outside operations. So that income is outside operations, depreciation is a separate line item and we don't really see any impairments, quite different from Vodafone.

Now when we look at AT&T along these same dimensions, first of all, we see that depreciation and amortization is reported separately and they actually tell us that up here, you might recall we saw earlier. And that's a significant number. And by the way, for all these telecommunications companies, depreciation is large. Think of all the infrastructure, all the equipment they need to support their services that they provide. We don't see any explicit impairments. It doesn't mean they didn't have them but they're not showing up explicitly here. And where is the share of the equity income? Well, it's down here, equity and net affiliates, outside operations.

Once again, we see there are some differences between Vodafone and América Móvil and AT&T. But that América Móvil and AT&T are fairly comparable in terms of their line items. Now, let's go back and do our analysis and let's be careful. Again, just to remind you, we took care of the equity and the income of associates by making an adjustment for that. But we haven't made an adjustment for depreciation. We could. We could have extended our analysis, so when we look up here at cost of sales, well, we expect Vodafone to have a larger cost of sales because it's got 8 billion in that cost of sales, that's related to depreciation whereas the other companies don't. If you look at the cost as a percent of revenues, these are around 40% and this is 67%, significant difference and now we know the reason. And we could control for that if we decided we wanted to.

Now, let's look at the other operating income items. They're all around 30% to 40%. But if we look at what's left afterwards, the operating profit margin, well it's 1%, 25%, 16%. What's going on? If we took the depreciation and moved it down here as a separate line item, well we'd have a much, much larger number for other operating items for Vodafone and for the other two companies and that would be an apples to apples comparison. Why is the operating profit so much smaller for Vodafone than the other two? Well, it's those impairments more than anything else. We're pretty confident about that. And like I said, we could refine this analysis significantly by just adjusting the depreciation and things will be a little clearer. But we just didn't want to do that because we weren't certain that all the depreciation was in cost of sales. We're pretty sure some of it is. We weren't sure all of it. By contrast, we were sure of the equity and income of associates so we made that adjustment.

And if we look at the non-operating items, what we see is significant difference there too between the results. And so there is something going on in the non-operating items for Vodafone. An analyst would want to look in to those items in more detail. And in fact, once we've gone through a few more chapters, you'll be prepared to do that. At the big picture level, what we want you to take away is that you can dig deeper into profit margins, one of the key factors of the DuPont model by examining the line items above, but when you're making comparisons across companies, you must be careful and understand what's in the line items. And that's a good reason to understand the accounting we keep making references to. In later chapters you'll learn about the accounting. If you don't understand the accounting that's going to these various line items, then you won't know how to make these comparisons.

And for right now, that's the central point. Don't worry about the details or whether you could have discovered the depreciation differences or not, we wouldn't expect that at this point. But we would expect you to recognize that you really need to have a better understanding of the accounting and the business issues in order to make these comparisons. You just can't create these common size statements and rely totally on the numbers that you're observing without making adjustments.

Take-aways

What would we have you know by now? Well, again we come back to the change map. And as we increasingly move from one level to the other, we're seeing the power of the change map, and there are two things we'd have you understand about that.

One, that we emphasize over and over again, income statements are based on balance sheets. So everything you know about a balance sheet, translates into what we need to know about income statements. And what we've added to the map as we've gone to this next level, is we've gone from just taking comprehensive income and breaking it up into net profit, and other comprehensive income which we did at Level 2. Well, now we've gone down to these primary elements and we said, "Well, they're really important." Income, which breaks into revenues and gains, and revenues had to do with just ongoing ordinary activities and gains were basically income and that is increases in the net assets that had to do with non-ordinary activities such as selling buildings, for example.

And so we walk away with all the concepts we need to begin to understand these line items you see, because the line items are all based on these primary elements. Cost of goods sold for example is an expense. Revenue is obviously a revenue. We can now see we have a much broader understanding of income statements. And here we see it. And the important thing we'd have you take away here is, as we move from one level to the next, not only have we began to move our way up the income statement, but our analysis has progressed. We've gotten a clearer understanding of what's going on in the company through the ratios that we've analyzed. Remember we started out with this broad idea of, "What does it mean to perform?" Well, to perform from the investor's perspective means to make a return on their investment. And from a book value perspective, that is accounting measures perspective, that means how much comprehensive income did you generate from the owner's perspective? And so that was our ROE-comprehensive income over average owners' equity.

And then we took that and we said "yes" but we can get more insights in terms of whether an item is transient or persistent by moving to the second level of our analysis. And that started our focus on net profits. And then we said, "Well okay, we can do even better than that. We can take ROE and we can break it up in the DuPont model, into these 4 factors: profitability, turnover, financial leverage, and taxes. And then we could take profit margins and look at the profitability in even more detail. So that was really insightful and at the next level we said, "Yeah. But when you go to line items, you can actually take the profit margins and factor those down into one line at a time." What is the impact of that line item? And that allowed a rich comparison across the telecommunications companies where we got great insights about the importance of looking at line items and not drawing all your emphasis too quickly based on the DuPont model.

And as we moved in this direction, we were able to tie the numbers on this statement and more tightly to what's going on in the business. And of course we can continue that analysis but to do that we have to go behind the numbers which we'll do later in the chapter.