

Reformulated Financial Statements

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Abstract

This case deals with reformulated income statement and reformulated cash flow statement. First, students will learn the objective of reformulating the financial statements of a company. Then, they will prepare a reformulated cash flow statement for a company. Finally, they will prepare a reformulated income statement for a company. This case is a hands-on experience for students who want to learn about the reformulated financial statements.

Keywords: financial statement, reformulated financial statement, income statement, statement of cash flows

Introduction

Zach and Kristin are almost done with their “Financial Statement Analysis” class. Recently, they have learned about reformulated financial statements. Their professor showed them some examples where reformulated income statement and reformulated cash flow statement are prepared for a firm.

“We are almost done with this class. I hope that we can get a full score from this final homework. I want to get an A. We have studied so hard for this class.” Zach says.

Kristin adds “An A would be nice. I don’t want to drop my GPA below 3.0”

“I have my notes with me. I also brought my laptop. Maybe we can find some examples on the web.” Zach suggests.

“I am not sure if we can find some good examples on the internet. But, I am sure the class notes and the book will help. The book is tough though. It is not easy to read.” Kristin adds.

“I agree. I don’t understand why professors require textbooks that are not easy to understand by the students. You know, our derivatives book is even worse. I don’t understand a thing in it.” Zach says.

“I know, it is frustrating. I am happy that the semester is ending” Kristin sighs.

Reformulated Statements

The reformulated financial statements allow the Treasurer of a firm to look at his/her firm’s numbers from a different perspective. A reformulated cash flow statement separates the operations-related items from the financing-related items. This helps the Treasurer to see how the firm is doing in each area. Similarly, a reformulated income statement also separates the operations-related items from the financing-related items.

“Financial Statement Analysis and Security Valuation” by Penman shows the layout of a Reformulated Statement of Cash Flows as follows:

Cash flows from operations		C
Cash investment		<u>(I)</u>
Free cash flow		C - I
Equity financing flows:		
Dividends and share repurchases	XX	
Share issues	<u>(XX)</u>	d
Debt financing flows:		
Net purchases of financial assets	XX	
Interest on financial assets	<u>(XX)</u>	
Net issue of debt	<u>(XX)</u>	
Interest on debt	<u>XX</u>	<u>F</u>
Total financing flows		<u>d + F</u>

As shown above, the reformulated statement separates the operations-related items (i.e. cash flow from operations, cash investment which is capital investments, and the resulting FCF) from the financing-related items (i.e. equity financing flows items and debt financing flows items).

In the end, FCF (which is C – I) that the firm creates should be equal to the summation of equity financing flows and debt financing flows.

“Financial Statement Analysis and Security Valuation” by Penman shows the layout of a Reformulated Income Statement as follows:

Operating income		
Operating revenue	OR	
Operating expense	<u>(OE)</u>	<u>OI</u>
Net financial expense		
Financial expense	FE	
Financial revenue	<u>(FI)</u>	<u>NFE</u>
Earnings		<u>Earn</u>

The notations used above are:

OR: Operating revenue

OE: Operating expense

OI: Operating income (which is equal to OR – OE)

FE: Financial expense

FI: Financial revenue

NFE: Net financial expense (which is equal to FE – FI)

As shown above, the reformulated statement separates the operations-related items (i.e. operating revenue, operating expense, and the resulting operating income) from the financing-related items (i.e. financial expense, financial revenue, and the resulting net financial expense).

Case Study Series

In the end, OI minus NFE gives us Earnings (or net income). As shown above, the reformulated statement separates the operations-related items (i.e. cash flow from operations, cash investment which is capital investments, and the resulting FCF) from the financing-related items (i.e. equity financing flows items and debt financing flows items).

In the end, FCF (which is C – I) that the firm creates should be equal to the summation of equity financing flows and debt financing flows.

Below are examples for reformulated cash flow statement and reformulated income statement.

An Example for Reformulated Income Statement

We want to prepare a reformulated income statement for a firm with the following information:

Sales = \$100 million, depreciation expense = \$12 million, cost of goods sold = \$40 million, marketing expenses = \$3 million, administrative expenses = \$20 million, interest payment = \$15 million, interest income = \$2 million

Reformulated Income Statement

Operating revenue	\$100 million		
Operating expense	(\$75 million)	(12+40+3+20=75)	
Operating income	\$25 million		
Financial expense	(\$15 million)		
Financial income	\$2 million		
Net financial expense	(\$13 million)		
Earnings	\$12 million	(25-13=12)	

An Example for Reformulated Statement of Cash Flow

We want to prepare a reformulated statement of cash flows for a firm with the following information:

CF from operations = \$33 million, cash investment = \$10 million, dividends = \$5 million, share issues = \$20 million, net purchase of financial assets = \$25 million, and interest payment = \$13 million.

Reformulated Statement of Cash Flows

CF from operations		\$33 million	
Cash investment		(\$10 million)	
FCF		\$23 million	(C-I)
Equity financing flows:			
Dividends	\$5 million		
Share issues	(\$20 million)	(\$15 million)	(d)
Debt financing flows:			
Net purchase of financial assets	\$25 million		
Interest payment	\$13 million	\$38 million	(F)

Total financing flows \$23 million (d+F)

Note: $d + F = (\$15 \text{ million}) + \$38 \text{ million} = \$23 \text{ million}$ (which is equal to FCF)

The Task

Zach's assignment is below:

1. What is the purpose of reformulating an income statement?
2. What is the purpose of reformulating a cash flow statement?
3. A company has the following information. What is the FCF for that firm?
CF from operations = \$42 million, cash investment = \$11 million, dividends = \$7 million, share repurchases = \$40 million, net sale of financial assets = \$19 million, and interest payment = \$9 million.
4. What is the net equity financing (d) number for this firm? What is the net debt financing number for this firm? What is the value of the shares issued by this firm (in million dollars)?
5. How will the reformulated statement of cash flows for that firm look like?
6. What is the operating income for a firm with the following information?
Sales = \$80 million, depreciation expense = \$8 million, cost of goods sold = \$22 million, marketing expenses = \$4 million, administrative expenses = \$13 million, interest payment by the firm = \$42 million, financial income = \$4 million
7. What is the net financial expense for that firm?
8. Prepare a reformulated income statement for that firm. How much is the Net Income for that firm using the reformulated income statement?
9. With a regular income statement, should we find the same NI?

References

Financial Statement Analysis and Security Valuation (5th Edition) by Penman – McGraw Hill Higher Education

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