

- 1 **Business activities versus financing activities.** Analysts typically analyze and value a firm's business activities separately from the firm's sources of financing because both have different value implications. Whereas business activities affect the firm's value creation, financing activities affect the allocation of value among the firm's capital providers more than the value itself. As we will see in a later chapter, for example, a common approach to equity valuation is to estimate equity value as the value of a residual claim on a firm's business assets or, alternatively stated, as the value of a firm's business assets after subtracting the value of its fixed financing obligations. The standardized financial statements must clearly separate business from financial assets or liabilities to follow such an approach.
- 2 **Aggregation versus disaggregation.** A central task in many business analysis and valuation applications is to predict the amount, timing, and uncertainty of a firm's future cash flows or profits. Although aggregation of line items in the standardized financial statements generally helps to remove unnecessary details, the statements must be sufficiently disaggregated to enable users to separately analyze items that have materially different future performance consequences. This need for disaggregation is why we distinguish, for example, operating from investment items, current from non-current items, and continued from discontinued operations.

In sum, following the preceding general rules, we classify balance sheet items along the following dimensions:

- Business (operating and investment) versus financial assets or liabilities.
- Current versus non-current assets or liabilities.
- Assets or liabilities from continued versus discontinued operations.

This classification is useful not only because managers' business and financing decisions have different valuation implications and must be separately analyzed, but also because the three categories of assets and liabilities receive different accounting treatments. For example, in contrast to most operating assets, several financial and discontinued assets are recognized at their fair values rather than their historical cost. Consistent with the approach used for the balance sheet, in the income statement, we distinguish business items, such as revenue, cost of sales, and investment income, from financial items, such as interest expense and income from discontinued operations.

Tables 3.1, 3.2, 3.3, 3.4, and 3.5 present the format used throughout the book to standardize the income statement, balance sheet, and cash flow statement, respectively.

To create standardized financials for a company, the analyst classifies each line item in that firm's financial statements using the appropriate account name from the templates set out in the tables. This may require using information from the notes to the financial statements to ensure that accounts are classified appropriately. For example, applying the templates to standardize the 2020 financial statements for apparel retailer H&M AB is shown in the appendix at the end of this chapter.

**TABLE 3.1** Standardized income statement format (classification of operating expenses by function)

Standard income statement accounts	Description	Sample line items classified in account
<b>Business – operating items</b>		
<i>Revenue</i>	Revenues generated through the use of operating assets.	Sales Turnover Membership fees Commissions Licenses

**TABLE 3.1** Standardized income statement format (classification of operating expenses by function) (continued)

Standard income statement accounts	Description	Sample line items classified in account
<b>Business – operating items</b>		
<i>Cost of sales (by function)</i>	Expenses recognized to account for the use of operating assets in production or procurement activities.	Cost of merchandise sold Cost of products sold Cost of revenues Cost of services Depreciation on manufacturing facilities
<i>SG&amp;A (by function)</i>	Expenses recognized to account for the use of operating assets in selling, distribution, or overhead activities.	General and administrative Marketing and sales Distribution expenses Servicing and maintenance Depreciation on selling and administrative facilities Amortization of intangibles
<i>Other operating income, net of other operating expense (by function)</i>	Recurring income from noncore operating activities <i>minus</i> recurring expenses that are not directly related to current-period revenues but primarily incurred to generate other operating income or future revenues.	Research and development Start-up costs
<b>Business – investment items</b>		
<i>Investment income</i>	Non-interest income generated from (non-operating) investment assets.	Result from associate companies Share of the profit or loss from associates accounted for using the equity method Dividend income Rental income
<i>Interest income</i>	Interest accrued on investment assets during the period (net of the amortization of costs of acquiring the assets).	Interest income Interest earned
<b>Financial items</b>		
<i>Interest expense</i>	Interest accrued on financial liabilities during the period (including the amortization of costs of issuing financial liabilities).	Interest expense Finance cost Interest charge on non-current provisions Post-employment/pension benefits interest cost Amortization of issue costs on loans Dividend on preference shares
<i>Profit/loss to non-controlling interest</i>	Portion of net group income that is attributable to minority interests.	Minority interest

(continued)

**TABLE 3.1** Standardized income statement format (classification of operating expenses by function) (continued)

Standard income statement accounts	Description	Sample line items classified in account
<b>Other items</b>		
<i>Net non-recurring income or expense</i>	Gains <i>minus</i> losses from non-recurring transactions or events.	Foreign exchange gains/losses Special charges Gains/losses on sale of investments/ non-current assets Asset impairments Restructuring charges
<i>Tax expense</i>	Current and deferred tax expense or credit (arising from business or financing activities).	Provision for taxes
<i>Profit/loss of discontinued operations</i>	Net after-tax profit or loss generated by operations that have been discontinued or will be sold.	
<i>Profit/loss to ordinary shareholders</i>	Profit or loss attributable to ordinary shareholders, i.e., excluding profit/loss of discontinued operations and profit/loss attributable to non-controlling interests.	Net income

**TABLE 3.2** Standardized income statement format (classification of operating expenses by nature)

Standard income statement accounts	Description	Sample line items classified in account
<b>Business – operating items</b>		
<i>Revenue</i>	Revenues generated through the use of operating assets.	Sales Turnover Membership fees Commissions Licenses
<i>Cost of materials (by nature)</i>	Expenses recognized to account for the cost of inventories sold or used during the period.	Cost of outsourced work and services received Raw materials and work subcontracted Cost of components Changes in inventories and own work capitalized (correction)
<i>Personnel expense (by nature)</i>	Expenses recognized to account for the cost of personnel during the period.	Salaries and wages Social security Post-employment/Pension benefit service cost Share-based payments
<i>Depreciation and amortization (by nature)</i>	Expenses recognized to account for the cost of non-current operating assets used during the period.	Depreciation on property, plant, and equipment Amortization of intangibles

**TABLE 3.2** Standardized income statement format (classification of operating expenses by nature) (continued)

Standard income statement accounts	Description	Sample line items classified in account
<i>Other operating income, net of other operating expense (by nature)</i>	Recurring income from noncore operating activities <i>minus</i> expenses that are: <ul style="list-style-type: none"> <li>• recognized to account for operating expenditures or the use of operating assets;</li> <li>• recurring in nature;</li> <li>• not classified as cost of materials, personnel expense, or depreciation and amortization.</li> </ul>	Transport and distribution costs Operating lease installments Insurance premiums
<b>Investment, financial and other items</b>	See Table 3.1	

**TABLE 3.3** Standardized balance sheet format – assets

Standard balance sheet accounts	Description	Sample line items classified in account
<b>Business – operating items</b>	Business assets related to the company's core business activities.	
<i>Cash and cash equivalents</i>	Fair value of cash and cash equivalents used in the financing of short-term business activities.	Cash and cash equivalents Short-term investments Time deposits
<i>Trade receivables</i>	Claims against customers (to be settled within one year).	Accounts receivable Trade debtors
<i>Inventories</i>	Net cost of inventories produced or acquired.	Inventory Finished goods Raw materials Work-in-progress Stocks Stock-in-trade
<i>Other current assets</i>	Claims against others than customers (to be settled within one year) or expenditures incurred for next year's operations (other than the cost of inventories).	Prepaid expenses Claims for tax refunds Amounts due from affiliates Amounts due from employees Current contract assets
<i>Derivatives – assets</i>	Fair value of investments in derivative financial instruments.	(Non-) current derivative financial instruments
<i>Non-current tangible assets</i>	Depreciated cost of tangible resources to be used in the long-term operations of the firm.	Property, plant, and equipment Land and buildings Right-of-use assets

*(continued)*

**TABLE 3.3** Standardized balance sheet format – assets (continued)

Standard balance sheet accounts	Description	Sample line items classified in account
<i>Non-current intangible assets</i>	Amortized cost of intangible resources to be used in the long-term operations of the firm.	Goodwill Software/product development costs Deferred financing costs Deferred subscriber acquisition costs Deferred catalogue costs Deferred charges Trademarks and licenses Non-current contract assets
<b>Business – investment items</b>	Business assets unrelated to the company's core business activities.	
<i>Minority equity investments</i>	Cost of minority investments in subsidiaries plus the accumulated share in subsidiaries' retained earnings.	Investments accounted for using the equity method Investments in associates
<i>Other non-operating investments</i>	Cost or fair value of investments in (non-equity) assets that are not used in the company's core business activities.	Finance lease receivables Derivative financial instruments Biological assets Investment property
<b>Other items</b>		
<i>Deferred tax asset</i>	Non-current tax claims arising from the company's business and financing activities.	
<i>Assets held for sale</i>	Assets that were used in operations that have been discontinued or will be sold.	Current assets classified as held for sale Non-current assets classified as held for sale

**TABLE 3.4** Standardized balance sheet format – liabilities and equity

Standard balance sheet accounts	Description	Sample line items classified in account
<b>Business – operating items</b>	(Non-interest-bearing) liabilities arising from the company's business activities.	
<i>Trade payables</i>	Suppliers' claims against the company (to be settled within one year).	Accounts payable Trade creditors
<i>Other current liabilities</i>	Claims against the company held by others than suppliers (to be settled within one year) or revenues to be earned in next year's operations.	Accrued expenses Amounts due to related parties Income tax liabilities Social Security and payroll taxes Dividends payable Current contract liabilities Current provisions

**TABLE 3.4** Standardized balance sheet format – liabilities and equity (continued)

Standard balance sheet accounts	Description	Sample line items classified in account
<i>Derivatives – liability</i>	Fair value of investments in derivative financial instruments.	
<i>Other non-current liabilities (non-interest-bearing)</i>	Non-interest-bearing, non-current liabilities arising from the company's business activities.	Non-current contract liabilities Other non-current liabilities
<b>Financial items</b>	Liabilities incurred to finance the company's business activities.	
<i>Current debt</i>	Current interest-bearing liabilities or current portion of non-current interest-bearing liabilities.	Current borrowings Notes payable Bank overdrafts Current portion of non-current borrowings Current portion of finance lease obligation
<i>Non-current debt</i>	Non-current interest-bearing liabilities.	Long-term borrowings/financial liabilities Subordinated debentures Finance lease obligations Convertible debentures Provision for post-employment benefits Provision for decommissioning costs Other non-current provisions
<i>Preference shares</i>	Preferred shareholders' investment in the company.	Preference shares Convertible preference shares
<i>Non-controlling interest in equity</i>	Consolidated subsidiaries' minority shareholders' share in the company's net assets.	
<i>Ordinary shareholders' equity</i>	Ordinary shareholders' investment in the company.	Share capital Share premium Retained earnings Treasury share/own share purchased but not canceled Other reserves
<b>Other items</b>		
<i>Deferred tax liability</i>	Non-current tax claims against the company arising from the company's business and financing activities.	
<i>Liabilities held for sale</i>	Liabilities related to operations that have been discontinued or will be sold.	

TABLE 3.5 Standardized cash flow statement format

Standard cash flow statement accounts	Description	Sample line items classified in account
<b>Business – operating/investment items</b>		
<i>Profit before interest and tax</i>	Profit/loss plus net interest expense and tax expense.	
<i>Taxes paid</i>	Tax payments made during the current fiscal period.	
<i>Non-operating gains (losses)</i>	Adjustment to profit for non-cash gains (and losses) resulting from non-operating activities.	Gain (loss) on disposal of investments/ non-current assets Cumulative effect of accounting changes Gain (loss) on foreign exchange
<i>Non-current operating accruals</i>	Adjustment to profit for accruals related to changes in the book value of non-current assets or liabilities that result from the company's operating activities.	Depreciation and amortization Deferred revenues/costs Deferred taxes Impairment of non-current assets Other non-cash charges to operations Equity earnings of affiliates/unconsolidated subs, net of cash received Minority interest Stock bonus awards
<i>Interest received</i>	Interest payments received on other non-operating investments.	
<i>Dividends received</i>	Dividend payments received from subsidiaries.	
<i>Net (investments in) or liquidation of operating working capital</i>	Net changes in working capital components arising from the company's operating activities.	Changes in: Trade receivables Other receivables Prepaid expenses Trade payables Accrued expenses (liabilities) Due from affiliates Accounts payable and accrued expenses Refundable/payable income taxes Inventories Provision for doubtful accounts Other current liabilities (excluding current debt)

**TABLE 3.5** Standardized cash flow sheet format (continued)

Standard cash flow statement accounts	Description	Sample line items classified in account
<i>Net (investment in) or liquidation of non-current operating or investment assets</i>	Net changes in the book value of non-current assets arising from the company's business activities.	Purchase/disposal of non-current assets Acquisition of research and development Acquisition/sale of business Capital expenditures Acquisition of subsidiaries and equity investments Capitalization of development costs Cost in excess of the fair value of net assets acquired Investment in financing leases
<b>Financial items</b>		
<i>Interest paid</i>	Interest payments made on financial liabilities.	Interest paid Dividends paid on preference shares
<i>Net debt (repayment) or issuance</i>	Net change in current and non-current debt arising from issuances and/or repayments.	Principal payments on debt (leases) Borrowings (repayments) under credit facility Issuance (repayment) of long-term debt Net increase (decrease) in short-term borrowings Notes payable Issue (redemption) of preferred securities Amortization of leases
<i>Dividend (payments)</i>	Dividend payments made during the current fiscal year.	Cash dividends paid on ordinary shares Distributions
<i>Net share (repurchase) or issuance</i>	Net change in shareholders' equity arising from issuances and/or repurchases.	Proceeds from issuance of ordinary shares Issue of ordinary share for services Issue of subsidiary equity Purchase (issue) of treasury shares Capital contributions

## eXtensible Business Reporting Language

An increasing number of firms worldwide prepare and report their financial statements using the eXtensible Business Reporting Language (XBRL) or Inline XBRL (iXBRL). XBRL is a markup language used to prepare structured financial statement documents that are computer-readable. Inline XBRL helps embed XBRL data into an HTML document, such that the data also become human-readable and more easily accessible to users of financial statements. The U.S. Securities and Exchange Committee (SEC) has mandated all companies listed on a U.S. exchange to prepare and disclose XBRL-based financial data since 2009 and use Inline XBRL since 2019. European regulator ESMA has