

ANALYZING THE INCOME STATEMENT

Using PepsiCo

- Purpose:**
- Understand the relationship between the trend for sales and the trend for other items on the income statement.
 - Use ratios to enhance understanding of amounts reported on the financial statements.
 - Understand nonrecurring items may distort certain computations.

PEPSICO INC

Fiscal year ended (\$ in 000s)	12/27/1998	12/28/1997	12/30/1996	12/31/1995
Net sales	\$22,348,000	\$20,917,000	\$20,337,000	\$19,067,000
Cost of goods sold	<u>9,330,000</u>	<u>8,525,000</u>	<u>8,452,000</u>	<u>8,054,000</u>
Gross margin	13,018,000	12,392,000	11,885,000	11,013,000
Operating expenses:				
Selling, general, and administrative expenses	9,924,000	9,241,000	9,063,000	8,133,000
Depreciation and amortization expense	<u>222,000</u>	<u>199,000</u>	<u>206,000</u>	<u>-0-</u>
	10,146,000	9,440,000	9,269,000	8,133,000
Income from operations	2,872,000	2,952,000	2,616,000	2,880,000
Other revenues and expenses:				
Non-operating income (loss)	(214,000)	(165,000)	(485,000)	(160,000)
Interest expense	<u>395,000</u>	<u>478,000</u>	<u>565,000</u>	<u>629,000</u>
	(609,000)	(643,000)	(1,050,000)	(789,000)
Income before income tax	2,263,000	2,309,000	1,566,000	2,091,000
Income tax expense	<u>270,000</u>	<u>818,000</u>	<u>624,000</u>	<u>669,000</u>
Income before nonrecurring items	1,993,000	1,491,000	942,000	1,422,000
Nonrecurring items	<u>-0-</u>	<u>+ 651,000</u>	<u>+ 207,000</u>	<u>+ 184,000</u>
Net income	<u>\$ 1,993,000</u>	<u>\$ 2,142,000</u>	<u>\$ 1,149,000</u>	<u>\$ 1,606,000</u>
Outstanding shares (in thousands)	# 1,471,000	# 1,502,000	# 1,545,000	# 1,576,000

Source: Disclosure, Inc., *Compact D/SEC*, 2000.

1. Net sales are (**increasing / decreasing**). This indicates the company is (**staying competitive within its industry / purchasing more assets / issuing more common stock**).
2. Cost of goods sold is (**increasing / decreasing**). This is (**expected / not expected**).
3. Compute the Gross Margin Percentage (Gross margin / Net sales) for each year and *comment* on the results.

fye 12/27/98 58.3% *fye 12/28/97* 59.2% *fye 12/30/96* 58.4% *fye 12/31/95* 57.8%

The gross margin percentage has remained fairly stable since 12/31/1995. This indicates cost of goods sold and gross margin are remaining fairly constant as a percentage of sales. In 1998, 58 cents of gross margin was earned from a dollar of sales.

4. Total operating expenses are (**increasing / decreasing**). This is (**expected / not expected**).
5. Interest expense is (**increasing / decreasing**). *Identify* at least one event that would result in this trend. **To decrease interest expense, PepsiCo could have either paid back outstanding debt, or refinanced debt at a lower rate of interest.**
6. Nonrecurring items are items that occur only once within the life of a company.

For PepsiCo, the nonrecurring items reported (**increased / decreased**) net income.

In 1997, did the \$2.1 billion net income result entirely from continuing operations? (**Yes / No**)

The amount on the income statement that is the better predictor of future income is (**Income before nonrecurring items / Net income**). *Explain why.*

Income before nonrecurring items only includes amounts that are expected to continue again next year and, therefore, is a good predictor of future income. Whereas, net income includes nonrecurring items, which are those items that are expected to occur once and never again. Nonrecurring items must be excluded when predicting future income.

7. Compute Return on Sales for each year using the following ratio formula:
(Income before nonrecurring items / Net sales). *Comment* on the results.

fye 12/27/98 0.089 fye 12/28/97 0.071 fye 12/30/96 0.046 fye 12/31/95 0.075

Since 12/31/1995, return on sales has increased, which is a favorable trend indicating increased profits from each dollar of sales. In 1998, 8.9 cents of profit was earned from each dollar of sales.

8. Compute Earnings per Share for each year using the following ratio formula:
(Income before nonrecurring items / Number of shares outstanding). *Comment* on the results.

fye 12/27/98 \$1.35 fye 12/28/97 \$0.99 fye 12/30/96 \$0.61 fye 12/31/95 \$0.90

Since 12/31/1995, earnings per share have increased, which is a favorable trend indicating increased profitability. In 1998, each outstanding share of stock earned \$1.35 in profits from continuing operations.

9. Return on sales and earnings per share are ratios used by investors and creditors to predict future earnings. *Comment* on why "Income before nonrecurring items" is more appropriate than "Net income" for computing Return on Sales and Earnings per Share for PepsiCo.
Nonrecurring items are simply what the name implies -- nonrecurring. Generally they occur once and never occur again. In order for ratios to be comparable, the same items should be included in the computations each year. Therefore, to make the ratios comparable from year to year, the nonrecurring items should be omitted and "income from continuing operations before nonrecurring items" should be used in the ratio computations.

10. Review the series of income statements presented above. PepsiCo appears to report a (**strengthening / weakening**) operating position. *Support* your response with at least two observations.
Since 1995, net sales, income before nonrecurring items, gross margin percentage, return on net sales, and earnings per share have all increased, which indicates increased profitability. Interest expense has decreased, which is also a favorable trend for expenses. Overall, the operating results of PepsiCo appear to be strengthening each year.