2017

ANALYSIS OF EARNINGS: OPERATING VS. NON-OPERATING INCOME

BY NICK COLLETTA, SNOQAP FINANCIAL WRITER

Original Link: https://snoqap.com/2826-2/

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All questions can be directed to alex@snoqap.com.

March 1, 2017

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If you follow the stock market with the slightest bit of intensity, you may notice the frenzy that happens every quarter when companies release their earnings. You may think it is a little ridiculous how certain companies may increase their earnings, but miss analysts' expectations and their stock price goes down. There's also the case where a company beats analysts' expectations but they do not consider it "healthy" growth and the stock price goes down. When I first started analyzing the stock market, I thought this was absolutely ridiculous. However, as I have researched more, it has become obvious that there are really good reasons for the frenzy. There is a difference between having high earnings and having quality earnings.

The best way to find quality earnings is to dissect the three financial statements: the balance sheet, the income statement, and the statement of cash flows. As you may have seen, the title of this article is saying we're going to analyze the difference between operating vs. non-operating income and what this means for the quality of earnings. To understand the differences between high and quality earnings, and how to properly analyze them for investment purposes, we first need to understand what each one is on a fundamental level.

Operating Income:

To understand the operating income of a company, you need to understand the fundamental **purpose** of that company. For example, when you think of Apple, what is the first thing that comes to mind? If you said a fruit, you're not wrong; you're just in the wrong place. When people hear the word Apple, they mostly likely think of an iPhone or one of their "I" products. Well, that is exactly where the operating income from Apple comes from. It is the income that a company gets from the operations of their business. Basically, it's the income from what the business is *in business for*.

The place to locate operating income is on the very top of the income statement which will be the line that says "Revenues." After revenues, there will be a subtraction of the cost incurred to earn those revenues, most of the time called, "Cost of Goods Sold." The line right after that will be the companies "Gross Income." The gross income is the profit the company is making from their operations less (minus) what it costs the company to perform their operations. For Apple, the cost of goods sold would be all the materials that went into their products and the direct labor required to produce them.

After we subtract out the Cost of Goods sold, we then need to subtract out operating expenses, which are all the indirect things the company has to pay in day to day operations. Operating expenses include (but are not limited to) marketing expenses, administrative expenses, fuel, insurance payments, etc. Basically, it's all the operations of the company that does not go *directly* into making or doing whatever that company does. After operating expenses are out, then we subtract out depreciation and amortization to arrive at our operating income! Wasn't that fun? Here are the equations since you're probably having a difficult time visualizing this in an article format!

Gross Income **= Revenues – Cost of Goods sold**

Operating Income = ***Gross Income*** **– Operating Expenses – Depreciation – Amortization**

Now, what is non-operating income and how does it affect earnings?

Non-Operating (nonrecurring) Income:

Now that we understand operating income, we can analyze what non-operating income is and why it is important for investment analysis. Let's go back to our Apple example. Apple is clearly in the business of making technology and selling it to a large base of consumers. This is what goes directly into their revenues. However, what if Apple sells one of its manufacturing buildings? Or what if their financial analysts make a killing in the stock market for a year? If you guessed that this revenue goes into non-operating income, then you're probably too smart to be reading my articles (just kidding, please stay). Non-operating income is income (or expenses) that come from transactions that are not related to the *day-to-day* operations of the company.

This seems easy, right? Well, nobody said it was difficult! However, it is often overlooked by the average investor and it can have a huge effect on year-over-year earnings which will indubitably have a large effect on the stock price. For example, let's say that a paper company run by a hilarious owner has 1 million outstanding shares of common stock and they earned $5 million last fiscal year. Therefore, they have earnings of $5 per share. Somebody comes up to you and says that this company has increased their earnings by 25% over last year (went from $4 to $5) and it needs to be invested in now before the stock price reacts! What should you do? Well, first don't take investing advice from strangers (I see the irony) and second you should do your own research in order to be confident in your decision. After some research, you realize that the company had a non-operating income of $1.2 million dollars from the sale of one of their buildings. What does this mean? This means that this company actually had a year over year loss of $200,000 in operating income. While your friend is investing their hard earned money, a quick check of the income statement saved you from making a poor investment.

You might be saying, "That's it? That's all I have to do?" Well, pretty much! There are times where companies may try to lie and put items that should be nonrecurring/non-operating income into operating income to make their earnings look healthier than they really are. However, unless you're an analyst working for an investment company, there's no reason to pull your hair out trying to find this rarity. That's what we have our lovely accountants for, to make sure that the information is in the right spot and is in accordance with GAAP. The next time you see a company beat their earnings but their stock price goes down, just take a gander right under income from operations and see what nonrecurring/non-operating income says! Who knows, it might save you from a big mistake one day.