

WHAT DO I SEE ON INCOME STATEMENTS?

LEARNING OBJECTIVES

After completing this module you will be able to:

- Identify the purpose and structure of comprehensive income statements and some of the ways managers, investors, and others use them to assess financial performance.
- Connect changes in balance sheets to recognition of income.
- Define comprehensive income, net profits (loss), revenues, expenses, gains, losses, and other common line items, and apply these definitions to real companies' reports.
- Apply a hierarchical approach to assessing companies' financial performance using information on income statements.



Key take-aways:

- Comprehensive income, the broadest measure of performance, captures the extent management increased net assets during a reporting period, other than transactions with owners and accounting changes and restatements.
- Comprehensive income has two components: net profit (loss) and other comprehensive income.
- Net profit (loss) is the accounting measure users of financial statements tend to place the most reliance on when assessing performance.
- Other comprehensive income (OCI) is comprised of items standard setters have decided not to include in net profits, primarily because these items are transient and result from factors largely outside a company's influence.
- Under IFRS, income statements have two primary elements: income and expenses. Under U.S. GAAP, revenues, gains, expenses, and losses are all considered primary elements of income statements.
- Because the definitions of income and expenses are based on changes in assets or liabilities, measurement and recognition decisions associated with income statements depend on measurement and recognition decisions associated with assets and liabilities. Thus, all the uncertainty, judgments, and risks associated with balance-sheet measures affect income measures.
- Figure 2 illustrates how income statements can be analyzed hierarchically: Level 1: Comprehensive income is at the top of the hierarchy. To facilitate comparisons across companies and assess the return a company has earned on the net capital contributed by owners and the comprehensive income retained on their behalf, users can analyze the ROE-CI ratio.

- Level 2 splits comprehensive income into two major categories: net profit (loss) and other comprehensive income (OCI). At level 2, return on equity (ROE) is frequently used to facilitate performance comparisons across companies and time. This allows users to get a better assessment of how management performed in areas where they can influence performance since OCI tends to be transient and thus not as useful for forecasting.
- Level 3 examines significant subcategories of net profits. While companies have a great deal of latitude as to how they group income-statement line items into categories, the groupings illustrated are prevalent. Virtually all companies first divide net profits into profit before tax and tax expense. Many companies go one step further and divide profits before tax into operating profits and other income and (expenses). Profit margin and operating profit ratios are frequently used to facilitate comparisons.
- Level 4 centers on line items. Just as balance-sheet line items can help users assess asset risks and the confidence they should attribute to reported numbers, income-statement line items help them assess the confidence they should put in income measures and gauge the persistence of these measures when forecasting future performance.

Key terms:

- **Comprehensive income** - Net income plus other comprehensive income. Broad performance measure that reflects the effects of all events and transactions that affect owners' equity, except those arising from transactions involving the owners and accounting changes and restatements.
- **Cost of sales** - Expenses directly tied to sold products, except costs for sales commissions. This includes the cost to acquire or manufacture products, store them, and ship them to customers. When a sale is recognized as revenue, cost of sales is recognized as an expense. Also called cost of goods sold, cost of products sold, and cost of services sold.
- **Expenses** - Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to contributions from equity participants.¹ For example, decreases in net assets (assets - liabilities) associated with inventing, developing, producing, and delivering goods and services, or performing other activities central to the company's operations.
- **Gains** - Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.² Under IFRS, gains are items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity.³
- **Income** - Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.⁴
- **Losses** - Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events

1 IASB Framework, ¶ 70

2 FASB Statement of Financial Accounting Concepts Number 6 ¶78-83

3 IASB Framework, ¶ 74-75

4 IASB Framework, ¶ 70

and circumstances affecting the entity except those that result from expenses or distributions to owners.⁵ Under IFRS, losses represent other items that meet the definition of expenses and may, or may not, arise in the course of ordinary activities of the entity.⁶

- **Net profits (loss)** - Revenues less expenses (including tax expense) plus gains less losses plus other income (expense). Also called net income or net earnings.
- **Other comprehensive income (OCI)** - Comprehensive income standard setters decided not to include in net income. Typically arise from changes in market prices.
- **Revenues** - Income that arises in the course of the ordinary activities of an entity.⁷ Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.⁸ The IFRS definition of income encompasses both revenues and gains.⁹ Revenue is referred to by a variety of names including sales, fees, interest, dividends, royalties and rent. Generally revenues pertain to inflows from customer sales.
- **Selling, general, and administrative (SG&A)** - Expenses that typically include, among other things, commissions and other selling expenses, research and development expenses, marketing expenses, rental expenses, and depreciation expenses.

Key formulas:

- $ROE-CI = \text{comprehensive income} / \text{average owners' equity}$
- $ROE (\text{Return On Equity}) = \text{net profit} / \text{average owners' equity}$
- $ROE-OCI = \text{other comprehensive income} / \text{average owners' equity}$
- $\text{DuPont ROE} = \text{profit margin} \times \text{turnover} \times \text{financial leverage} \times \text{tax factor}$
 - $\text{Profit margin} = \text{pretax profit} / \text{revenues}$
 - $\text{Turnover} = \text{revenues} / \text{average assets}$
 - $\text{Financial leverage}^{10} = \text{average assets} / \text{average owners' equity}$
 - $\text{Income tax factor} = 1 - (\text{tax expense} / \text{pretax profit})$
- $\text{Gross margin} = (\text{revenues} - \text{cost of sales}) / \text{revenues}$
- $\text{Operating profit margin} = \text{operating profit} / \text{revenues}$
- $\text{Profit margin} = \text{pretax profit} / \text{revenues}$
- $\text{Net profit margin} = \text{net profit} / \text{revenues}$

⁵ FASB Statement of Financial Accounting Concepts Number 6 ¶78-83

⁶ IASB Framework, ¶ 74-75

⁷ IASB Framework, ¶ 74-75

⁸ FASB Statement of Financial Accounting Concepts Number 6 ¶78-83

⁹ IASB Framework, ¶ 74-75

¹⁰ In general, there's no universally accepted formula for financial leverage. However, the leverage formula in the DuPont model is average assets / average owners' equity. Using this formula is critical to maintaining the integrity of the model so that the product of the factors equals return-on-equity (ROE).

Figure 1 Connecting Owners' Equity Change (OEC) Map to Balance Sheets and Income Statements

This figure uses the OEC map to demonstrate how balance sheets and income statements are connected.

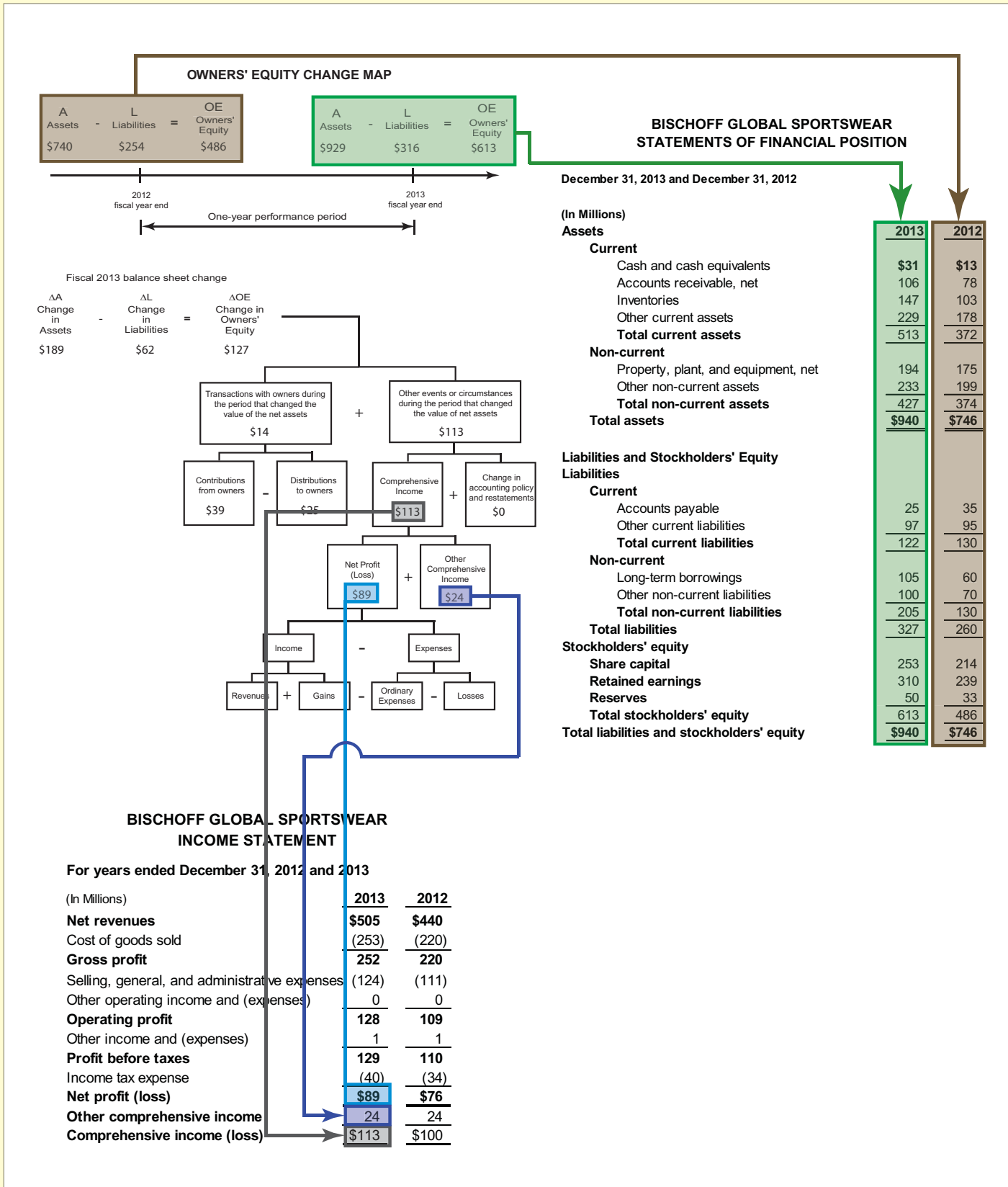


Figure 2 Hierarchical Analysis of Income Statements

This figure illustrates how income statements can be analyzed hierarchically.

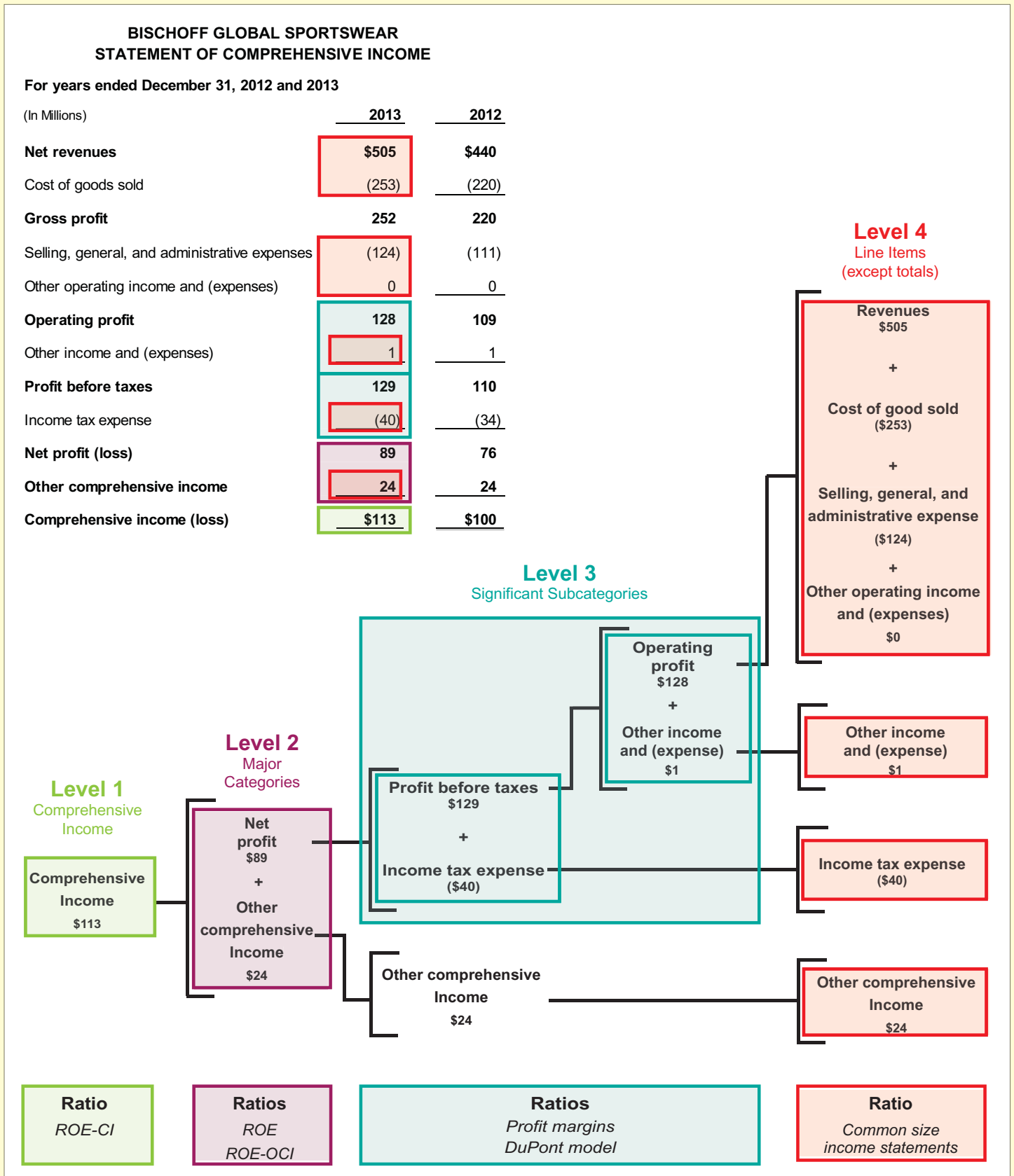


Figure 3 Accounting is not a spectator sport — it's game time

This figure lists Scenic route menus for additional information.

