What's Behind Income Statements?

Learning Objectives

After completing this module you will be able to:

- Connect events to changes in balance sheets and recognition of revenues, expenses, gains and losses.
- Record entries and create income statements.

Key take-aways:

- Revenue recognition determines whether and when revenues are recognized in income statements. Revenue mostly pertains to sales agreements with customers.
- Companies recognize revenue when net assets associated with these agreements increase. Their rights and performance obligations as sellers in the agreements give rise to assets and liabilities and increases in the related net assets give rise to revenue.
- Revenue is associated with cash inflows from customers. However, revenue can be recognized before, when, or after cash is collected from customers.
- When revenue is recognized before cash is collected from customers, the increase in net assets associated with the revenue is due to an increase in an asset: receivables. When revenue is recognized at the same time cash is collected, the increase in net assets is due to the increase in cash. When revenue is recognized after cash is collected, the increase in net assets is due to a decrease in a liability: deferred revenue.
- Revenue recognition can require considerable judgment in some contexts and investors place a great deal of emphasis on revenues when evaluating companies' future prospects. As a result, companies often have significant opportunities and incentives to accelerate revenue recognition. In the past companies have often been penalized by regulators and the courts for having acted on these incentives. These incidents have lead regulators to tighten the criteria for revenue recognition over the years.
- Expense recognition determines when costs are recognized as expenses on income statements. Expense recognition depends on asset and liability recognition because expenses are defined as decreases in net assets associated with activities that are central to companies' operations.
- Expenses are usually associated with cash outflows to resource providers. However, expenses can be recognized before, at the same time, or after the related cash outflows.

- Just as increases in net assets associated with revenue recognition can be due to increases in assets (cash or receivables) or decreases in liabilities (deferred revenues), the decrease in net assets associated with expense recognition can be due to decreases in assets (cash, inventories, or another asset) or increases in liabilities (accounts payable or accrued liabilities).
- When the decrease in net assets associated with recognizing an expense is due to decreasing an asset, the asset can be cash, in which case the expense is recognized at the same time as the related cash outflow. Alternatively, an asset other than cash is recognized at the time it is acquired and subsequently derecognized as its benefits are used up. In this case, we say the cost of the asset is capitalized rather than expensed when it is acquired.
- When the decrease in net assets associated with recognizing an expense is due to incurring a liability, the related cash outflow occurs when the liability is settled later. In this case, a liability and expense are recognized at the same time because using or otherwise benefiting from a resource obligates the company to make a future payment.

Key terms:

- **Accounting cycle** - Process of recording entries during a reporting period and, thereafter, of recording adjusting and closing entries during a closing period to prepare financial statements and set up for the next reporting period.
- **Accrual basis accounting system** - Accounting method where transactions that affect cash as well as those that don't affect cash are recorded, in contrast to the cash basis accounting system. Accrual basis is required by IFRS and U.S. GAAP. When the accrual basis of accounting is used, an entity recognizes items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements.[1]
- **Accrual entries** - Entries where income elements (revenues, expenses, gains, or losses) are recognized before related cash flows occur.
- **Adjusting entries** - Entries to recognize events and circumstances that occurred during the reporting period that were not yet recognized during the period. These entries never involve cash or more generally transactions with outsiders.
- **Capitalized cost** - Cost recognized as an asset rather than an expense.
- **Closing entries** - Entries to transfer income account balances to permanent owners' equity accounts, leaving income account balances at zero at the end of the reporting period. For example, entries to transfer net income account balances to retained earnings.
- **Contra-asset** - Contra-account associated with an asset. For example, accumulated depreciation is a contra-asset account deducted from gross property, plant, and equipment.
- **Deferral entries** - Entries where income elements (revenues, expenses, gains, or losses) are recognized after related cash flows occur — when cash flows occur, income recognition is deferred until a later date.

1 IAS 1 ¶28.

- **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.[2] 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.[3] 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.[4]
- **Losses** - Decreases 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 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]
- **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.

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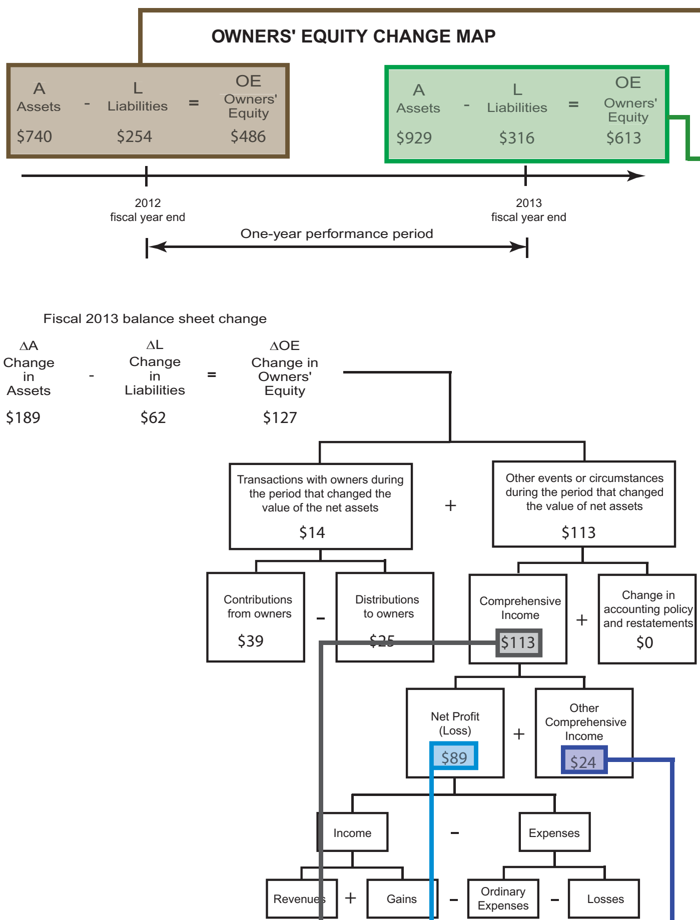
2 IASB Framework, ¶ 70
3 FASB Statement of Financial Accounting Concepts Number 6 ¶78-83
4 IASB Framework, ¶ 74-75
5 FASB Statement of Financial Accounting Concepts Number 6 ¶78-83
6 IASB Framework, ¶ 74-75
7 IASB Framework, ¶ 74-75
8 FASB Statement of Financial Accounting Concepts Number 6 ¶78-83
9 IASB Framework, ¶ 74-75

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.



BISCHOFF GLOBAL SPORTSWEAR
STATEMENTS OF FINANCIAL POSITION

December 31, 2013 and December 31, 2012

(In Millions)	2013	2012
Assets		
Current		
Cash and cash equivalents	**$31**	**$13**
Accounts receivable, net	106	78
Inventories	147	103
Other current assets	229	178
Total current assets	513	372
Non-current		
Property, plant, and equipment, net	194	175
Other non-current assets	233	199
Total non-current assets	427	374
Total assets	**$940**	**$746**
Liabilities and Stockholders' Equity		
Liabilities		
Current		
Accounts payable	25	35
Other current liabilities	97	95
Total current liabilities	122	130
Non-current		
Long-term borrowings	105	60
Other non-current liabilities	100	70
Total non-current liabilities	205	130
Total liabilities	327	260
Stockholders' equity		
Share capital	253	214
Retained earnings	310	239
Reserves	50	33
Total stockholders' equity	613	486
Total liabilities and stockholders' equity	**$940**	**$746**

BISCHOFF GLOBAL SPORTSWEAR
INCOME STATEMENT

For years ended December 31, 2012 and 2013

(In Millions)	2013	2012
Net revenues	**$505**	**$440**
Cost of goods sold	(253)	(220)
Gross profit	**252**	**220**
Selling, general, and administrative expenses	(124)	(111)
Other operating income and (expenses)	0	0
Operating profit	**128**	**109**
Other income and (expenses)	1	1
Profit before taxes	**129**	**110**
Income tax expense	(40)	(34)
Net profit (loss)	**$89**	**$76**
Other comprehensive income	24	24
Comprehensive income (loss)	$113	$100

Figure 2 Basic Revenue Recognition

This figure illustrates how revenue is recognized in simple example.

Relatively Simple Accounting Context

- No significant judgment in Starbucks' examples — experts agree on accounting.
- Revenue was recognized when:
  - An asset increased without any offsetting decrease in another asset or any offsetting increase in a liability:

$$\underset{\text{Change in Assets}}{\Delta A} - \underset{\text{Change in Liabilities}}{\Delta L} = \underset{\text{Change in Owners' Equity}}{\Delta OE}$$

Cash or Acc. Rec. Revenue

  - Or a liability decreased without any offsetting increase in another liability or any offsetting decrease in an asset:

$$\underset{\text{Change in Assets}}{\Delta A} - \underset{\text{Change in Liabilities}}{\Delta L} = \underset{\text{Change in Owners' Equity}}{\Delta OE}$$

Deferred Revenue Revenue

Figure 3 Basic Expense Recognition

This figure illustrates how expense is recognized in simple example.

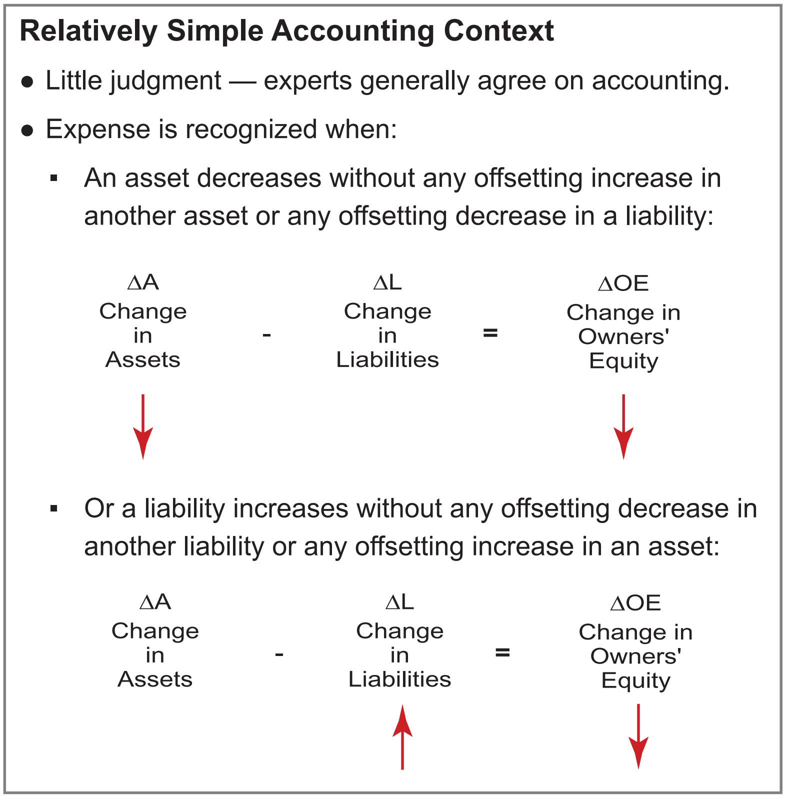


Figure 4 Cash Flow Myths

This figure lists common misconceptions about cash and income recognition.

Cash Flow Myths

- Revenue is only recognized when customers pay for products and expenses are only recognized when costs are paid.

Accrual System Realities

- Revenues and expenses can be recognized before, at the same time, or after related cash flows.
- Accrual entries ensure income elements are recognized before related cash flows occur.
    - A liability is recognized when expense is recognized and derecognized later when the related cash outflow occurs.
    - An asset is recognized when revenue is recognized and derecognized later when the related cash inflow occurs.
- Deferral entries ensure income elements are recognized after related cash flows occur.
    - An asset is recognized when the cash outflow occurs and is decrecognized later when expense is recognized.
    - A liability is recognized when the cash inflow occurs and is derecognized later when revenue is recognized.

Figure 5 Creating Comprehensive Income Statements

This figure illustrates how income statements are created from balance-sheet-equation matrix.

	+	Comprehensive Income																				
		Net Income																			+	OCI
	+	Rev	-	CGS	-	DepEx	-	MSGA	-	OSGA	+	PPEGL	+	OOI	+	ONOI	-	TaxEx	+	IncS		
Pre-close trial balance	+	+ $505	-	+ $253	-	+ $7	-	+ $99	-	+ $18	+	+ $3	+	- $3	+	+ $1	-	+ $40	+	+ $0	+	+ $24

BISCHOFF GLOBAL SPORTSWEAR
STATEMENT OF COMPREHENSIVE INCOME

For years ended December 31, 2012 and 2013

(In Millions)	**2013**	**2012**
Net revenues	$505	$440
Cost of goods sold	(253)	(220)
Gross profit	**252**	**220**
Selling, general, and administrative expenses:		
Depreciation	(7)	(6)
Other selling, general, and administrative	(117)	(105)
Total	(124)	(111)
Other operating income and (expense):		
Gain (loss) on sale of building	3	3
Other	(3)	(3)
Total	0	0
Operating profit	**128**	**109**
Other income and (expenses)	1	1
Profit before taxes	**129**	**110**
Income tax expense	(40)	(34)
Net profit (loss)	**89**	**76**
Other comprehensive income	24	24
Comprehensive income (loss)	**$113**	**$100**

Figure 6 Accounting is not a spectator sport — it's game time

This figure lists Scenic route menus for additional information.

Accounting is not a spectator sport – it's game time

Tackle the exercises → Check the solutions → Identify things you don't know → Take corrective actions

↕ **Seek additional information as needed**

Scenic route menus

Scenic 1: Accounts
- Temporary accounts
- Account signs

Scenic 2: Revenue recognition
- Introduction
- Basic revenue recognition
  - Tied to asset increases
    - Example 1
    - Example 2
  - Tied to liability decreases
    - Example 3
  - Summary
- Challenging revenue recognition
  - Challenges
  - Authoritative guidance
- Take-aways

Scenic 3: Expense recognition
- Introduction
- Expense recognition tied to asset decreases
  - Cash expenses
    - Example 1
    - Example 2
    - Example 3
  - Asset usage
    - Example 4
    - Example 5
    - Example 6
  - Asset impairment
    - Example 7
- Expense recognition tied to liability increases
  - Accounts payable accruals
    - Example 8
  - Accrued liabilities
    - Example 9
    - Example 10
    - Example 11
- Take-aways

Scenic 4: Gain/loss recognition
- Introduction
- Terms and concepts
  - Realized gains/losses
    - Definition
    - Example 1
    - Example 2
  - Unrealized gains and losses
    - Definition
    - Example 3
    - Recognition
- Entries
  - Example 4
  - Example 5
- Take-away

Scenic 5: End-of-period decisions
- Accounting decisions
  - Accrual systems
  - Accrual entries
  - Deferral entries
  - Accounting cycle
  - Adjusting entries
    - Accruals
    - Deferrals
    - Judgments
- Business decisions
  - Aligned with owners
  - Conflicting with owners
- Take-aways

Scenic 6: Creating income statements
- Pre-close trial balances
- Creating statements
- Take-aways

Scenic 7: Matching principle and conservatism
- Historical income recognition
- Standard setters views
- Take-aways