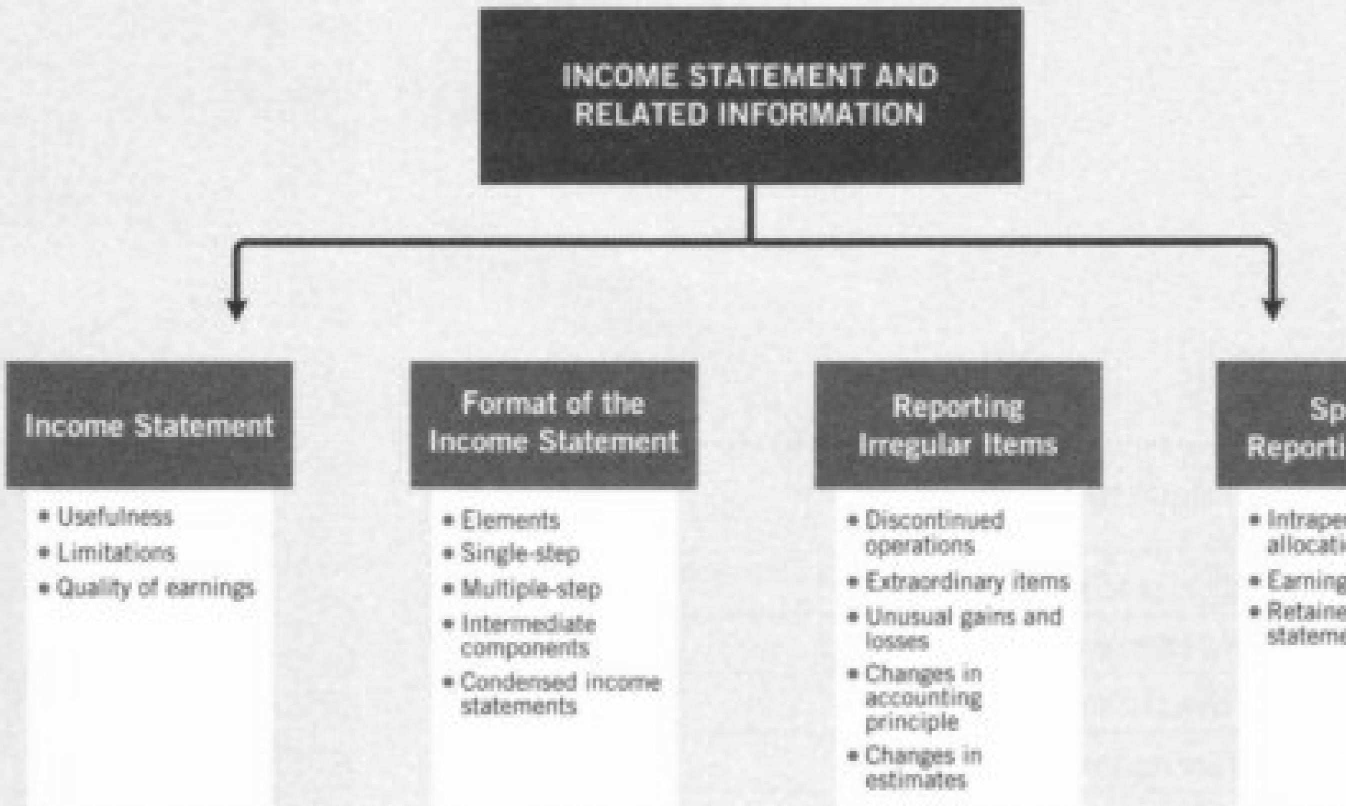
Reporting Financial Performance

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Identify the uses and limitations of an income statement.
2. Prepare a single-step income statement.
3. Prepare a multiple-step income statement.
4. Explain how irregular items are reported.
5. Measure and report gains and losses from discontinued operations.
6. Explain intraperiod tax allocation.
7. Explain where earnings per share information is reported.
8. Prepare a retained earnings statement.

The way items are reported within the income statement can affect its usefulness. The purpose of this chap
many different types of revenues, expenses, gains, and losses that are represented in the income statement
tion. The content and organization of this chapter are as follows:



INCOME STATEMENT

The **income statement**, often called the statement of earnings or statement of income,[1] is the report that **measures the success of enterprise operations** for a given time period. The business and investment community uses this report to determine **profitability**, **investment value**, and **credit worthiness**. It provides investors and creditors with information that helps them allocate resources and assess management stewardship.

Usefulness of the Income Statement

The income statement helps financial statement users allocate resources and assess management stewardship in a number of ways.[2] For example, investors and creditors can use the information in the income statement to:

1. **Evaluate the enterprise's past performance and profitability**. By examining revenues, expenses, gains and losses users can see how the company (and management) performed and compare its performance with its competitors. (Balance sheet information is also useful in assessing profitability, i.e., by calculating return on assets. See Appendix 5A.)

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[1] *Financial Reporting in Canada, 2000* (Toronto, CICA) indicates that for the 200 companies surveyed, 86 used "earnings", 60 used "income" and 43 used "operations". The use of the latter is increasing while "income" and "earnings" are declining in terms of usage, p. 93.

[2] In support of the usefulness of income information, accounting researchers have documented that the market prices of companies change when income is reported to the market. See W.H. Beaver, "The Information Content of Annual Earnings Announcements," *Empirical Research in Accounting: Selected Studies, Journal of Accounting Research* (Supplement 1968), pp. 67-92.

2. **Provide a basis for predicting future performance.** Information about past performance can be used to determine important trends that, if continued, provide information about future performance. However, success in the past does not necessarily mean the company will have success in the future.
3. **Help assess the risk or uncertainty of achieving future cash flows.** Information on the various components of income—revenues, expenses, gains, and losses—highlights the relationships among them and can be used to assess the risk of not achieving a particular level of cash flows in the future. For example, segregating a company's recurring **operating income** (results from continuing operations) from nonrecurring income sources (discontinued operations, extraordinary items) is useful because operations are usually the primary means by which revenues and cash are generated. Thus, **results from continuing operations** usually have greater significance for predicting future performance than do results from nonrecurring activities.

Limitations of the Income Statement

Because net income is an **estimate** and reflects a number of **assumptions**, income statement users must be aware of certain limitations associated with information contained in the income statement. Some of these limitations include:

1. **Items that cannot be measured reliably are not reported in the income statement.** Current practice prohibits recognizing of certain items from the determination of income even though of these items arguably affect an entity's performance from one point in time to another. For example, contingent gains may not be recorded in income, as there is uncertainty regarding whether the gains will ever be realized.
2. **Income numbers are affected by the accounting methods employed.** For example, one company may choose to depreciate its plant assets on an accelerated basis; another chooses straight-line amortization. Assuming all other factors are equal, the first company's income will be lower, even though the companies are essentially the same. In effect, we are comparing apples with oranges.
3. **Income measurement involves the use of estimates.** For example, one company may estimate in good faith that an asset's useful life is 20 years while another company uses a 15-year estimate for the same type of asset. Similarly, some companies may make overly optimistic estimates of future warranty returns and bad debt write-offs, which result in lower expense and higher income.

Quality of Earnings

Users need **high quality information** about a company's earnings to make decisions,[3] however, not all income statements provide this. This issue was addressed in part above (limitations of the income statement) and will be examined further here. When analysing information for usefulness, there are two aspects that must be considered— content **and** presentation (i.e. a clear, concise manner that fosters ease of use). The nature of the **content** and the way it is **presented** are referred to as the **quality of earnings**.

Earnings numbers may be of a **higher quality or conversely, lower quality**. Higher quality earnings are **more reliable**, with a lower margin of potential misstatement. Illustration 4-1 articulates some attributes of high quality earnings.

Looking at Illustration 4-1, there are some factors, which are under management control, such as the **integrity** of the information, i.e., **what information is captured**, how it is **measured** and how it is **presented/disclosed**. Management may also have some control over how quickly cash is generated from operations and how closely this correlates to reported earnings, i.e., through choice of sales and payment terms. (Noted under (2) in the illustration.)

High quality earnings

1. related to the **integrity** of the information itself
   - little, if any **bias** (numbers not subject to manipulation)
   - **objectively determined** (consider need to estimate, accounting choice, application of professional judgement)
   - reflect **economic reality**—all transactions/events captured and appropriately presented
   - **transparency**—no attempt to disguise or mislead
2. related to the **utility** of the information (i.e., its usefulness in specific decision-making such as valuing a company or share price). As a general presumption, **less uncertainty/more stability lends itself to greater usefulness in many decisions.**
   - reflect primarily **earnings generated from ongoing core business** activities (as opposed to one time gains/losses). Earnings that are **sustainable** have greater predictive value.
   - **less volatile** (consider riskiness of business, business strategy, industry, economic and political environments and effects of all these on earnings stability/volatility). Again, less volatile earnings allow creditors and investors to assess future cash flows.
   - more **closely correlated with cash flows from operations** (i.e. when one dollar of earnings is reported, the cash has been received or will be received shortly). Note that this could be a function of accounting choice (i.e. revenue recognition policies) or the nature of the business i.e. a cash based business. Earnings that convert to cash more quickly provide a better measure of real earnings as little or no uncertainty exists as to realizability.

Format of income statement

Single-Step Income Statements

In reporting revenues, gains, expenses, and losses, a format known as the single-step income statement is often used. In the **single-step statement**, just two groupings exist: revenues and expenses. Expenses and losses are deducted from revenues and gains to arrive at net income or loss. The expression "single-step" is derived from the single subtraction necessary to arrive at net income. Frequently, income tax is reported separately as the last item before net income to indicate its relationship to income before income tax.

For example, Illustration 4-2 shows the single-step income statement of Dan Deines Corporation.

DAN DEINES CORPORATION
Income Statement
For the Year Ended December 31, 2002

Revenues	
Net sales	$2,972,413
Dividend revenue	98,500
Rental revenue	72,910
Total revenues	3,143,823
Expenses	
Cost of goods sold	1,982,541
Selling expenses	453,028
Administrative expenses	350,771
Interest expense	126,060
Income tax expense	66,934
Total expenses	2,979,334
Net income	$ 164,489
Earnings per common share	$1.74

The single-step form of income statement is widely used in financial reporting in smaller, private companies. The multiple-step form described below is used almost exclusively among public companies.[7]

The primary advantage of the single-step format lies in the simplicity of presentation and the absence of any implication that one type of revenue or expense item has priority over another. Potential **classification** problems are thus eliminated.

Multi-step income statements

1. A separation of the company's **operating and nonoperating** activities. For example, enterprises often present an "income from operations" figure and then sections entitled "other revenues and gains" and "other expenses and losses." These other categories include interest revenue and expense, gains or losses from sales of miscellaneous items, and dividends received.
2. A **classification of expenses by functions**, such as merchandising or manufacturing (cost of goods sold), selling, and administration. This permits immediate comparison with costs of previous years and with the cost of other departments during the same year.

A **multiple-step income statement** is used to recognize these additional relationships. This statement recognizes a separation between **operating transactions** and **nonoperating transactions** and matches costs and expenses with related revenues. It highlights certain intermediate components of income that are used for the computation of ratios used to assess the enterprise's **performance** (i.e. gross profit/margin).

To illustrate, Dan Deines Corporation's multiple-step income statement is presented in Illustration 4-3. Note, for example, that in arriving at net income, at least three main subtotals are presented: net sales revenue, gross profit, and income from operations. The disclosure of **net sales revenue** is useful because regular revenues are reported as a separate item. **Irregular or incidental revenues** are disclosed elsewhere in the income statement. As a result, trends in **revenue from continuing operations** (typical business activities) should be easier to identify, understand, and analyse. Similarly, the reporting of **gross profit** provides a useful number for **evaluating performance and assessing future earnings**. A study of the trend in gross profits may show how successfully a company uses its resources (prices paid for inventory, costs accumulated, wastage); it may also be a basis for understanding how profit margins have changed as a result of competitive pressure (prices the company is able to charge for its products/services). This is a very important ratio in the retail business.

Finally, disclosing **income from operations** highlights the **difference between regular and irregular or incidental activities**. Disclosure of **operating earnings** may assist in **comparing** different companies and assessing operating efficiencies. Note that if this company had **discontinued operations** and **extraordinary items**, these would be added to the bottom of the statement and shown separately. These items are by definition **atypical and/or nonrecurring** and therefore have little **predictive value**. They do, however, give **feedback value** as to prior decisions made by management. Net income that consists primarily of "net income from continuing operations" would be viewed as **higher quality**.

DAN DEINES CORPORATION
Income Statement
For the Year Ended December 31, 2002

Sales Revenue			
Sales			$3,053,081
Less: Sales discounts		$24,241	
Less: Sales returns and allowances		56,427	80,668
Net sales revenue			2,972,413
Cost of Goods Sold			
Merchandise inventory, Jan. 1, 2002		461,219	
Purchases	$1,989,693		
Less: Purchase discounts	19,270		
Net purchases	1,970,423		
Freight and transportation-in	40,612	2,011,035	
Total merchandise available for sale		2,472,254	
Less: Merchandise inventory, Dec. 31, 2002		489,713	
Cost of goods sold			1,982,541
Gross profit on sales			989,872
Operating Expenses			

Selling expenses			
Sales salaries and commissions	202,644		
Sales office salaries	59,200		
Travel and entertainment	48,940		
Advertising expense	38,315		
Freight and transportation-out	41,209		
Shipping supplies and expense	24,712		
Postage and stationery	16,788		
Amortization of sales equipment	9,005		
Telephone and Internet expense	12,215	453,028	
Administrative expenses			
Officers' salaries	186,000		
Office salaries	61,200		
Legal and professional services	23,721		
Utilities expense	23,275		
Insurance expense	17,029		
Amortization of building	18,059		
Amortization of office equipment	16,000		
Stationery, supplies, and postage	2,875		
Miscellaneous office expenses	2,612	350,771	803,799
Income from operations			186,073
Other Revenues and Gains			
Dividend revenue		98,500	
Rental revenue		72,910	171,410
			357,483
Other Expenses and Losses			
Interest on bonds and notes			126,060
Income before income tax			231,423
Income tax			66,934
Net income for the year			$164,489
Earnings per common share			$1.74

Intermediate Components of the Income Statement

When a multiple-step income statement is used, some or all of the following sections or subsections may be prepared:

INCOME STATEMENT SECTIONS

1. **Continuing Operations**

   (a) **Operating** Section. A report of the **revenues and expenses** of the company's principal operations.[8]

      i. **Sales or Revenue** Section. A subsection presenting sales, discounts, allowances, returns, and other related information. Its purpose is to arrive at the net amount of sales revenue.

      ii. **Cost of Goods Sold** Section. A subsection that shows the cost of goods that were sold to produce the sales.

      iii. **Selling Expenses.** A subsection that lists expenses resulting from the company's efforts to make sales.

      iv. **Administrative or General Expenses.** A subsection reporting expenses of general administration.

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[8] Note that the CICA Exposure Draft Business Combinations–Accounting for Goodwill (2001) proposes that goodwill impairment be presented as a separate line item in income before extraordinary items and discontinued operations (par. .46). Whether goodwill is considered part of operating or non-operating would be a matter of professional judgement and depend upon the business situation.

INCOME STATEMENT SECTIONS (cont'd)

(b) **Non-operating** Section. A report of revenues and expenses resulting from the company's secondary or auxiliary activities. In addition, special gains and losses that are infrequent or unusual, but not both, are normally reported in this section. Generally these items break down into two main subsections:

i. **Other Revenues and Gains.** A list of the revenues earned or gains incurred, generally net of related expenses, from nonoperating transactions.

ii. **Other Expenses and Losses.** A list of the expenses or losses incurred, generally net of any related incomes, from nonoperating transactions.

(c) **Income Tax.** A short section reporting income taxes levied on income from continuing operations.

2. **Discontinued Operations.** Material gains or losses resulting from the disposition of a **segment of the business** (net of taxes).
3. **Extraordinary Items.** Atypical and infrequent material gains and losses beyond the control of management (net of taxes).

Although the operating section's content of the is always the same, the organization of the material need not be as described above.

Usually, financial statements that are provided to external users have less detail than internal management reports. The latter tend to have more expense categories—usually grouped along lines of responsibility. This detail allows top management to judge staff performance.

Whether a single-step or multiple-step income statement is used, irregular transactions such as **discontinued operations** and **extraordinary items** are required to be reported separately following income from **continuing operations**.

Condensed Income Statements

In some cases it is impossible to present all the desired expense detail in a single income statement of convenient size. This problem is solved by including only the **totals** of expense groups in the statement of income and preparing **supplementary schedules** of expenses to support the totals. With this format, the income statement itself may be reduced to a few lines on a single sheet. For this reason, readers who wish to study all the reported data on operations must give their attention to the supporting schedules. The income statement shown in Illustration 4-4 for Dan Deines Corporation is a **condensed version** of the more detailed multiple-step statement presented earlier and is more representative of the type found in practice.

DAN DEINES CORPORATION
Income Statement
For the Year Ended December 31, 2002

Sales		$2,972,413
Cost of goods sold		1,982,541
Gross profit		989,872
Selling expenses (see Note D)	$453,028	
Administrative expenses	350,771	803,799
Income from operations		186,073
Other revenues and gains		171,410
Other expenses and losses		126,060
Income before income tax		231,423
Income tax		66,934
Net income for the year		$164,489
Earnings per share		$1.74

Exercises

E4-2 (Calculate Net Income—Capital Maintenance Approach) Presented below is selected information pertaining to the Videohound Video Company during 2002:

Cash balance, January 1, 2002	$ 13,000
Accounts receivable, January 1, 2002	19,000
Collections from customers in 2002	210,000
Capital account balance, January 1, 2002	38,000
Total assets, January 1, 2002	75,000
Cash investment added, July 1, 2002	5,000
Total assets, December 31, 2002	101,000
Cash balance, December 31, 2002	20,000
Accounts receivable, December 31, 2002	36,000
Merchandise taken for personal use	11,000
Total liabilities, December 31, 2002	41,000

Instructions

Calculate the net income for 2002.

E4-3 (Income Statement Items) Presented below are certain account balances of Paczki Products Corp.

Rental revenue	$ 6,500	Sales discounts	7,800
Interest expense	12,700	Selling expenses	99,400
Beginning retained earnings	114,400	Sales	390,000
Ending retained earnings	134,000	Income tax	31,000
Dividends earned	71,000	Cost of goods sold	184,400
Sales returns	$ 12,400	Administrative expenses	82,500

Instructions

From the foregoing, calculate the following: (a) total net revenue; (b) net income; (c) dividends declared during the current year.

E4-4 (Single-step Income Statement) The financial records of Jones Inc. were destroyed by fire at the end of 2002. Fortunately the controller had kept certain statistical data related to the income statement as presented below.

1. The beginning merchandise inventory was $92,000 and decreased 20% during the current year.
2. Sales discounts amount to $17,000.
3. 20,000 common shares were outstanding for the entire year.
4. Interest expense was $20,000.
5. The income tax rate is 30%.
6. Cost of goods sold amounts to $500,000.
7. Administrative expenses are 20% of cost of goods sold but only 8% of gross sales.
8. Four-fifths of the operating expenses relate to sales activities.

Instructions

From the foregoing information, prepare an income statement for the year 2002 in single-step form.

E4-5 (Multiple-step and Single-step) Two accountants for the firm of Elwes and Wright are arguing about the merits of presenting an income statement in a multiple-step versus a single-step format. The discussion involves the following 2002 information related to Singh Company ($000 omitted).

ADMINISTRATIVE EXPENSE	
Officers' salaries	$4,900
Amortization of office furniture and equipment	3,960
Cost of goods sold	60,570
Rental revenue	17,230
SELLING EXPENSE	
Transportation-out	2,690
Sales commissions	7,980
Amortization of sales equipment	6,480
Sales	96,500
Income tax	9,070
Interest expense on bonds payable	1,860

Instructions

(a) Prepare an income statement for the year 2002 using the multiple-step form. Common shares outstanding for 2002 total 40,550 ($000 omitted).

(b) Prepare an income statement for the year 2002 using the single-step form.

(c) Which one do you prefer? Discuss.