Chapter 3

STATEMENT OF INCOME AND COMPREHENSIVE INCOME

Learning Objectives

After you have studied this chapter, you should:

LO-1	Understand the difference between accounting, economic and comprehensive income.
LO-2	Prepare the 'profit and loss' section of the statement of comprehensive income under alternative presentations.
LO-3	Compare intraperiod tax allocation with interperiod tax allocation.
LO-4	Explain the accounting asset disposals, discontinued operations and restructurings.
LO-5	Contrast the income statement presentation under Canadian ASPE with that in IFRS.
LO-1	Understand the difference between accounting, economic and comprehensive income.

Lecture Notes

The statements of income and comprehensive income are the primary source of information for a company's current profit performance. This chapter focuses on how information is displayed or disclosed on the income statement and which items are displayed in other comprehensive income. One item that requires special classification in the income statement is the reporting of discontinued operations. The main body of this chapter will conclude with a section on "discontinued operations" as well as other types of asset disposals.

1. NATURE OF INCOME

The word "income" can mean any number of different things. In IFRS income is used to describe revenues and gains (all amounts flowing into the entity) while "profit or loss" is used instead of "net income". Largely due to this confusion, most Canadian companies avoid the use of "income" and instead use *revenue*, *gains* and *earnings*.

Accounting versus Economic Income

Economic income measures an increase in wealth and uses the **events approach**.
Accounting income has in the past been based strictly on the historical cost principle and the **transactions approach.** This approach recognized changes in value only when such a change was *realized* through an existing transaction. Currently, however, accounting also recognizes some changes in value that have not yet been realized which is in line with the economic income definition.

Comprehensive Income is defined as all changes to owners' equity that are not the result of transactions with the owners (shareholders).

Two categories of comprehensive income:

1. Periodic profit or loss (also known as net income or earnings); and
2. Other Comprehensive Income (OCI).

Companies can choose two different reporting formats:

1. Two separate statements (consecutively presented) consisting of a) a statement of profit or loss and b) an SCI that begins with profit or loss on first line or
2. A continuous Statement of Comprehensive income (SCI) that starts with revenue, goes down to a subtotal for net profit or loss (or "earnings" after tax) and then continues to other comprehensive income.

The vast majority of items (other than transactions with owners) are included in profit or loss and are those items that represent value changes in both net assets and in profit or loss.

Items of other comprehensive income result from changes in net assets that are not recognized in current earnings (usually due to a volatility in fair value change).

There are some items excluded from profit or loss. These include:

- Cumulative changes to retained earnings that are the result of:
  1. Changes in accounting policies or 2. Corrections of errors in prior periods.
- Certain specified changes are recognized in the SFP which include: the value that will be recognized in income only if and when realized or the value that will be matched by an offsetting gain or loss. These items are reported in OCI.
- Foreign currency exchange rate gains or losses due to the consolidation process, when companies have operations in foreign countries, are reported in OCI.
- Net actuarial gains and losses relating to pension plans be reported in OCI.

2. GENERAL PRESENTATION FORMAT

IFRS prescribes little detail for either the content or format of the statement of comprehensive income except for the clear division between profit or loss and other comprehensive income.

Line Items Required for Profit or Loss Section

In reporting net earnings, the following line items are required according to IFRS:

1. Revenues
2. Finance costs (including interest expense)
3. The enterprise's share of earnings from associated companies and/or joint ventures
4. Income tax expense on continuing operations
5. Profit or loss on discontinued operations, net of tax
6. Net earnings

7. Earnings per share

There is no requirement to show cost of goods sold or inventories recognized as an expense (it can be shown in a note disclosure). Three additional requirements should be disclosed on the face of the SCI or in the notes:

a. The amount of inventory charged to expense;
b. Depreciation and amortization expense; and
c. Employee benefits expense, which includes wages and salaries, payroll taxes, health care costs and post-retirement benefits.

Materiality (the idea that including or excluding certain information may change a user's decision with respect to the financial statements) may lead to items other than those on this specific list being disclosed in the notes or on the face of the SCI.

Alternative Formats

IFRS

IFRS specifies two alternative formats that may be used for the "profit or loss" section of the SCI:

1. Classification by *nature of expense*
2. Classification by *function within the enterprise*

Classification by type of expense will be on the basis of input costs – what the money was spent on. Classification by function is an output-based presentation – what the expenditure was used for.

By Nature of Expense - See Exhibit 3-1 for an example using Air Canada

By Function of Expense in two statements rather than one continuous statement – See Exhibit 3-2 and Exhibit 3-3 for examples using Bombardier.

When a company reports on the basis of function, the other required information such as employee benefit expense and depreciation expense are shown in the notes.

Non-controlling Interest

A consolidated income statement includes the revenues and expenses of both the parent company and of the subsidiaries that it controls. The final net income figure must be allocated proportionately to the controlling interest and the **non-controlling interest (NCI).** Exhibit 3-2 for Bombardier includes this allocation.

Earnings per share

Public companies are required to report earnings per share (EPS) on the face of the income statement. EPS must be reported for continuing operations, discontinued operations and net income, both basic and diluted. A company must also disclose the weighted average number of shares used in the EPS calculations.

Basic earnings per share is computed by dividing reported net income (not total comprehensive income) less preferred share divided by the weighted average number of common shares.

Diluted earnings per share is computed by using the weighted average of all shares that would have been outstanding if all conversion privileges had been exercised by the holders of convertible bonds, preferred shares and other complex instruments.

If the company reports discontinued operations, EPS must be reported in three steps:

- EPS (basic and diluted) for continuing operations
- EPS (basic and diluted) for discontinued operations
- Total EPS (basic and diluted)

Single-step versus Multiple-step Statements

There is no specified format for organizing and presenting the elements of income. Two common formats are:

- **Single-step format**, which uses only two broad classification sections: *revenues and other income,* and *expenses and losses*. This has the advantage of simplicity but is rarely used in practice.
- **Multiple-step, fully classified** is illustrated in Exhibits 3-1 (Air Canada) and 3-2 (Bombardier) in the textbook. This format highlights important relationships and intermediate subtotals.

Both companies present amounts for

1. Earnings before interest and taxes (EBIT) and
2. Earnings before income taxes (EBT)

However, although both companies are using a multiple-step format, the subtotal lines chosen vary between the companies. Unusual items are separated out by many companies, which are usually gains and losses not part of normal earnings.

One item that does require special attention is discontinued operations. The results of operations that have been discontinued (e.g., sold) during the reporting period are relevant for measuring profit or loss for the period but are irrelevant as a basis for predicting future earnings. Thus, if a company reports discontinued operations, additional subtotals must be provided both before and after discontinued operations—(1) earnings from continuing operations after tax and (2) earnings after discontinued operations net of tax.

Other Comprehensive Income

Exhibit 3-3 show's Bombardier's consolidated SCI The SCI format is straightforward:

- Net income (loss)/earnings/profit
- The items of OCI, segregated into two categories: Items that may be reclassified to earnings (net income) and items that are never reclassified to earnings
- The total comprehensive income allocated to the company's shareholders and NCI

Net Income or Comprehensive Income?

What is the "correct" measure of a company's earnings? IFRS seems to give us at least three options: (1) earnings after tax from continuing operations, (2) net income, or (3) comprehensive income.

The only EPS figures that IFRS requires are those based on net income, both before and after discontinued operations.

3. INCOME TAX ALLOCATION

Intraperiod tax allocation refers to the allocation of income tax expense within the financial statements of any reporting period. The total amount of income tax expense (or benefit) must be reported along with the components to which they relate:

- Continuing operations;
- Discontinued operations;
- Items of other comprehensive income; and
- Other components of shareholder's equity.

Intraperiod tax allocation also applies to the cumulative effect of a retrospective change in accounting policy, shown in the statement of changes in equity.

Interperiod tax allocation is the allocation of income tax liability to different periods and will be discussed in Chapter 16. You will see the results of it on most financial statements amount for "deferred taxes" or "future income taxes", which mean the same thing. The income statement usually shows only one line for income tax expense (or benefit) but that amount is almost always composed of two components:

- Current income tax (or benefit); and
- Deferred (or future) income tax (or benefit)

Usually the components are shown in a note rather than on the face of the SCI.

The current tax expense reflects only revenue and expenses actually reported on the company's income tax return. The deferred income taxes reflects the taxes that would have been paid if the company had reported exactly the same items of revenue and expense on the tax return as it reports on the income statement.

4. ASSET DISPOSALS, DISCONTINUED OPERATIONS, AND RESTRUCTURING

A company can decide to make significant changes in the way it operations and can shut down or abandon parts of its operations, reorganize or sell a major business line as an operating unit to the highest bidder (*a discontinued operation*).

Asset Disposals
For accounting purposes, two different scenarios exist for asset disposals:
1. Disposing of individual non-current assets or
2. Disposing of several assets as a group

Under IFRS, assets put up for sale are reclassified from non-current to current on the statement of financial position. This treatment is similar to ASPE.

Abandonment
An abandoned asset is one a company continues to own but has permanently stopped using. An abandoned asset should *not* be reclassified as current because there is no plan to sell it. The depreciation stops, the asset is written down to its ***recoverable amount***, which is the *higher of the value in use and the fair value less costs to sell.* The asset is still subject to impairment tests as long as the company owns it. If the asset's value has increased, the asset should be written up, but not to more that its original carrying value at the time of abandonment.

An *abandoned asset* is not the same as an **idle asset** which is temporarily not in use. Idle assets continue to depreciate and are accounted for as productive assets, even though they currently are not producing.

Selling Individual assets
Current asset
There is no special treatment necessary for a current asset sale as long as the carrying value does not exceed recoverable value. If a writedown is necessary, loss is reported as part of operating expenses.

Non-current asset
If the asset is put up for sale, it is subjected to an impairment test and written down to recoverable value, if lower than carrying value. It is classified as **held-for-sale** and reclassified as a current asset in SFP No further depreciation is taken.

Conditions for held-for-sale classification for a non-current asset:
1. Asset is **available for immediate sale** in its present condition
2. Asset's sale is **highly probable**

For the sale to be **highly probable**, five requirements must be satisfied:
1. Price is reasonable.
2. An active program to find a buyer must have been started
3. Management is committed to selling the asset
4. It is unlikely that the offer to sell will be withdrawn or that the terms of the offer will be changed significantly
5. The sale is expected within one year of the asset's being reclassified as "held-for-sale".

The held-for-sale two-step:

1. A non-current asset that is intended for sale must first be "remeasured" to the lower of its carrying value and its fair value less costs to sell.
2. After remeasurement, the asset can be declared to be "held-for-sale" and classified as a current asset, provided the five conditions listed above are met.

If written down, loss is part of that period's net income. If it increases later, the increase in value may be reported in profit and loss as a gain, but writing up the asset is an *option*, not *a requirement* under IFRS.

Declassification as "held-for-sale" occurs if the asset no longer satisfies the criteria. It is restored to its original classification at the lower of:

1. Its net recoverable value at the date of the decision not to sell or
2. What its carrying value would have been if the asset was not reclassified in the first place – i.e. if depreciation had continued as usual.

A **disposal group** is a group of assets sold together is a single transaction. Normally, a disposal group is an operating part of the business.

Procedures for the accounting for the sale of a group of assets is similar to a single noncurrent asset as follows:

1. The group of assets is remeasured by its individual components.
2. The asset group as a whole are reported separately as a current asset, and the liabilities are reported separately, not netted.
3. Future revaluations are based on the group as a whole.

Decreases and subsequent recoveries in recoverable value are reported in net income, limited to the carrying value of the asset group at date declared held-sale. Depreciation stops at date classified as held-for-sale.

There are two categories of disposal groups:

1. Asset groups that are stand-alone groups and
2. Asset groups that are part of a *discontinued operation*.

Discontinued Operations

The sale or disposal of a segment of a business results in a **discontinued operation.** The revenue and expenses, gains and losses are removed from the SCI and the assets and liabilities are segregated on the SFP as a single held-for-sale asset. This allows users to compare financial statements for continuing operations. It applies to the current and prior year's comparative income statement.

Discontinued operations is a part of the enterprise that is clearly distinguishable from the rest of the enterprise, and the operations must therefore be *separable*. Discontinued operation can be a subsidiary or operational division, and can comprise either an asset group or pure operations without any long-lived assets.

The important element is that the operation can be separated from the rest of the organization. Its revenues, expenses, gains and losses, assets and liabilities must be able to be separately identified. The assets of a discontinued operation are held-for-sale current assets under IFRS (but not ASPE). Depreciation is discontinued and the assets are re-measured at their fair value.

Definition

To qualify as a discontinued operation, a disposal group must be a **cash-generating unit** of the business that constitutes a major line of business or significant geographic segment. A cash-generating unit is a "group of assets that generates cash flows that are largely independent of the cash inflows from other assets or groups of assets."

IFRS 5 defines a discontinued operation as an operating segment of a company that either (1) has been sold or (2) is held-for-sale. Under IFRS, the special reporting requirements for discontinued operations should be applied only upon the discontinuance of major business segments. An operation is reported as discontinued when management has made the decision and has begun the process of selling it or shutting it down and the proceeds of the sale must be recovered mainly through a sales transaction rather than continued use.

Reporting Discontinued Operations

The results are reported in the Statement of comprehensive income as a single line item after earnings from continuing operations. The results of discontinued operations should appear in the profit or loss section of the statement, not in OCI.

The two broad components are:

1. The net profit or loss, net of related income taxes from operating the discontinued operation to the date of disposal or the end of the reporting period, if the disposal is not complete by year-end and
2. Write downs of asset carrying values to fair value less cost to sell, and all realized gains or losses on disposal to the extent not previously recognized, net of related income taxes.

Statement of Financial Position (SFP)

The assets are reclassified as held-for-sale and are reported as a single current asset line item, labeled as *assets of discontinued operations held-for-sale*. Liabilities are reclassified as a single liability item as *liabilities related to discontinued operations*.

Effects on the SFP are summarized:

1. Depreciation and amortization ceases, effective on the date of the discontinuance decision.
2. Current assets are carried at lower of cost or fair value less costs to sell (or at fair value under IFRS)
3. Capital assets (tangible and intangible) are carried at lower of amortized cost or fair value less costs to sell.
4. All assets are grouped together and shown as a single "held-for-sale" current asset.
5. Liabilities continue to accrue, and are shown as a single current liability item.

Disclosure
In the notes, the company should provide a description of the facts and circumstances leading to the disposal along with the expected manner and timing of disposal. As well, the components of the single amount of net gain or loss from discontinued operations that is reported in the income statement should be disclosed. The disclosed components should be:

- The revenue, expense, and pretax profit (or loss) of the discontinued operation;
- The income tax amount that is related to the pretax profit or loss;
- The gain or loss recognized on the remeasurement of assets and liabilities to fair value less costs to sell; and
- The income tax relating to the remeasurement gain or loss

Adjusting Comparative Statements
All prior period amounts relating to discontinued operations should be segregated for that business segment, both on the SFP and on the income statement.

See **Exhibit 3-5** for an example of the comparative year statement adjustment.

Distinction between asset groups and discontinued operations
The major difference is that both the gains and losses from disposals as well as operating profit are loss are segregated and reported below earnings from continuing operations.

See **Exhibit 3-5** for a discontinued operations disclosure example

Restructuring is fairly common in most lines of business. Costs include relocation costs, retooling costs, training costs and employee severance pay. A particularly important aspect of most reorganizations involves the employees.

Definition of a Restructuring Plan
IAS37 defines it as having two characteristics:

1. The program must be planned and controlled by management and
2. The program must significantly alter either or both of:
    a. The manner in which the business is conducted, and/or
    b. The scope of business in which the company is engaged.

Only major alterations in an entity's operations may be reported as restructurings under IFRS. Costs to be recognized must be direct expenditures arising from the restructuring plan and not related to continuing activities of the company. The future costs of a formal restructuring plan can be recognized in the financial statements only if the future expenditures are a *constructive obligation*.

Definition of a Constructive Obligation It is a is a liability of uncertain timing and amount that will arise in the future as a result of an entity's present or past practices and actions. The company must have publicly communicated the plan and taken specific actions to implement the plan. Without the guidance of accounting standards, a company could set up a provision for future costs.

See **Exhibit 3-6**, a flow chart for deciding when restructuring costs can be recognized. Otherwise, a company can only disclose the restructuring in the notes to the financial statements.

A **provision** for restructuring costs is a reliably estimated liability for a probable cost that will arise due to a past action. Both newly-estimated costs and revisions of previously recognized costs will show up in the income statements throughout the years of restructuring, as well as in later years as payments are actually made (e.g. for retraining).

These costs are an expense under *continuing operations* in the profit or loss section of the statement of comprehensive income. The only exception is if the plan includes the discontinuance of a major segment of the business. Then, only the discontinued operation will be reported *below* the line while other restructuring costs will be reported as expenses *above* the line.

Exhibit 3-7 in the text shows a disclosure example

ASPE

5. ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES

Comprehensive Income

There is no statement of comprehensive income in Canadian ASPE, therefore, only the income statement should be provided. However, some specific adjustments under ASPE are worthy to note.

1. Net income after taxes is transferred directly from the income statement to retained earnings (or via the statement of changes in retained earnings, if a separate statement is prepared);
2. Unrealized foreign exchange translation gains or losses related to a foreign subsidiary (a component of OCI under IFRS) are reported as a separate component of shareholders' equity; and
3. Any other non-earnings items that affect shareholders' equity are reported in shareholders' equity, as appropriate. Under ASPE, consolidated financial statements are not required.

Format

ASPE does not specify a *"functional"* versus "*nature of expense"* format.
ASPE requires just one subtotal in the statement, "income or loss before discontinued operations".
Discontinued Operations are reported separately, similar to IFRS.

Line Items

All line items required by IFRs are required under ASPE, except for information relating to employee expenses, *which is not required*.

Held-for-Sale Assets
IFRS classifies as current but ASPE continues to classify the assets as current or non-current, depending on their nature.

Restructuring
ASPE does not specifically deal with it but the general concepts underlying the recognition of constructive obligations still would apply for private enterprises.

Earnings per Share
ASPE does not require this information.

Relevant Standards
CPA Canada Handbook, Part I (IFRS):

IAS 1, Presentation of Financial Statements
IAS 8, Accounting Policies, changes in Accounting Estimates and Errors
IAS 37, Provisions, Contingent Liabilities and Contingent Assets
IFRS 5, Non-current Assets Held-for-sale and Discontinued Operations

CPA Canada Handbook, Part II (ASPE):

Section 1520, Income Statement
Section 3475, Disposal of Long-lived Assets and Discontinued Operations

PowerPoint Slides
The PowerPoint slides can be used in part or in their entirety in computer adapted classrooms.