Income Statement & Comprehensive Income

An income statement, also known as a profit and loss (P&L) statement, statement of profit or loss, revenue statement, or statement of financial performance, is a crucial financial statement that illustrates a company's revenues and expenses over a specific period. It helps managers, investors, and other stakeholders understand whether the company generated a profit or incurred a loss during the reporting period, and it is vital for assessing past financial performance, predicting future outcomes, and evaluating cash flow generation capability. Unlike a balance sheet, which represents a single moment in time, an income statement covers a period of time.

Income Statement Formats

Generally accepted accounting principles (GAAP) provide companies with the option to present their income statements in either a single-step or a multiple-step format.

- **Single-Step Income Statement**
  - **Format and Structure**: This format presents a simplified view of a company's financial activities. It typically comprises two main sections: total revenues and gains, from which total expenses and losses are subtracted to arrive at **net income**. Revenue includes items like sales revenue, interest income, dividend income, rental income, and gains on sales. Expenses encompass cost of goods sold, selling and administrative expenses, interest expense, losses on disposal, and income tax expense. While income tax expense is conceptually part of expenses, it is often presented separately at the bottom for comparability.
  - **Advantages**: The primary advantage of a single-step format is its **simplicity**, making it easier for both accountants to prepare and investors to read. Shareholders can quickly focus on the net income figure to assess a company's overall health.
  - **Disadvantages**: A major drawback is the **lack of detailed information**. This format does not emphasize specific types of revenue or expense and lacks key metrics such as gross margin and operating margin data, which can make it challenging for investors to identify the sources of most expenses or project future profitability.
  - **Typical Users**: Small businesses, including single-product or single-service businesses, sole proprietorships, and partnerships, may opt for single-step income statements.
- **Multiple-Step Income Statement**
  - **Format and Structure**: This format emphasizes various sections and relationships within the income statement by separating operating and non-operating activities. Expenses are categorized as either **direct costs** (non-operational) or **indirect costs** (operational). Direct costs are tied to specific items (e.g., cost of goods sold), while indirect costs are broader expenses for company infrastructure (e.g., salaries, marketing, R&D, administrative expenses). This format takes several steps to derive net income, starting with **gross profit**, then calculating **income from operations**, followed by the inclusion of other

revenues/expenses to reach **income before taxes**, and finally deducting taxes for **net income**.
  - **Advantages**: Multiple-step income statements provide a **more comprehensive and in-depth view** of a company's financial performance. The detailed breakdowns allow for sharper analysis of gross, operating, and net margins, offering stakeholders a clearer understanding of how the business is managed.
  - **Disadvantages**: The granularity required in managing and recording copious data makes multiple-step statements **labor-intensive to produce**. Any inaccuracies in categorization or recording can lead to erroneous assumptions by investors, potentially impacting the business negatively.
  - **Typical Users**: Most publicly traded companies utilize multiple-step income statements.

Discontinued Operations

Discontinued operations are reported separately in financial statements to allow users to understand and evaluate the effects of a disposal transaction on an entity's ongoing operations. This separation helps users predict future cash flows more effectively, as these items are unlikely to recur.

- **Criteria for Reporting Discontinued Operations** For a component of an entity to qualify as a discontinued operation, it must meet specific criteria outlined in ASC 205-20-45-1B. This typically involves a three-step process:
  1. **Component of an Entity**: The disposed or held-for-sale portion must qualify as a "component of an entity". A component is defined as operations and cash flows that can be **clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity**. This can include a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group. It is generally believed that a component cannot be at a lower level than an asset group because cash flows must be distinguishable.
  2. **Disposal Event**: The component must either be **disposed of** (e.g., through sale, abandonment, or spin-off) or **meet the held-for-sale criteria** of ASC 205-20-45-1E. The held-for-sale criteria are the same six criteria set forth in ASC 360-10-45-9:
     - Management commits to a plan to sell the disposal group.
     - The disposal group is available for immediate sale in its present condition.
     - An active program to locate a buyer has been initiated.
     - The sale is probable, and transfer is expected to qualify as a complete sale within one year.
     - The disposal group is being actively marketed at a reasonable price.
     - It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.
  3. **Strategic Shift and Major Effect**: The disposal must represent a **strategic shift** that has (or will have) a **major effect** on the reporting entity's operations and financial results. Examples of a strategic shift include the disposal of a major geographical area, a major line of business, a major equity method investment, or

other major parts of an entity. The assessment considers both quantitative and qualitative factors, with no single factor being determinative. Key financial metrics such as assets, net assets, revenues, operating income, pretax income, net income, and operating cash flows are evaluated.

  - **Exception for Newly Acquired Businesses**: A business or nonprofit activity that, **upon acquisition, meets the held-for-sale criteria** is required to be presented as a discontinued operation **regardless of whether it represents a strategic shift**. The objective here is to include businesses that will never be considered part of the entity's continuing operations.
- **Presentation and Disclosure of Discontinued Operations**
  - **Income Statement**: The results of operations of a discontinued component, including any **gain or loss on disposal (or loss on classification as held for sale)**, are reported as a **single amount, net of applicable income taxes**, in the discontinued operations section of the income statement. This single amount is presented **after income from continuing operations** and before extraordinary items. Prior period results are also reclassified and presented in discontinued operations for comparative purposes. Adjustments to previously reported amounts in discontinued operations from a prior period should be classified separately in the current period with disclosure of their nature and amount.
  - **Balance Sheet**: For discontinued operations classified as held for sale, the **assets and liabilities are presented separately** in their respective sections of the statement of financial position (balance sheet) for the current and all prior periods presented. They should not be offset as a single amount. For prior periods, the classification of assets and liabilities as current or long-term should not change if they did not meet the held-for-sale criteria in those periods.
  - **Cash Flow Statement**: An entity must present (either on the face of the statement or in the notes) **net cash flows** attributable to the operating, investing, and financing activities of discontinued operations.
  - **Earnings Per Share (EPS)**: Entities that report discontinued operations must present basic and diluted per-share amounts for this line item, either on the face of the income statement or in the notes.
  - **Other Disclosures**: Detailed disclosures are required in the notes to the financial statements, including:
    - A description of the facts and circumstances leading to the disposal/expected disposal, including the expected manner and timing.
    - The gain or loss recognized, if not presented separately on the income statement.
    - The reportable segments under which discontinued operations are reported.
    - Summarized financial information, such as pretax profit or loss, major classes of line items constituting pretax profit or loss, and total operating and investing cash flows.
    - Information about significant continuing involvement with a discontinued operation after the disposal date, including the nature of activities and expected duration. While significant continuing involvement generally precludes discontinued operations reporting, there are exceptions where it

may still qualify if the operations and cash flows are eliminated from the ongoing entity and no significant influence is retained.

Comprehensive Income

Comprehensive income represents the change in equity (net assets) of an entity resulting from transactions and other events from **non-owner sources**. It includes all changes in equity during a period, except those resulting from investments by owners and distributions to owners. Comprehensive income consists of two main components: **net income** and **other comprehensive income (OCI)**.

- **Other Comprehensive Income (OCI)**
  - **Definition**: OCI comprises revenues, expenses, gains, and losses that have **yet to be realized** and are therefore **excluded from net income** on the income statement. These are temporary adjustments that are not part of regular earnings but impact the entity's overall financial position.
  - **Accumulated Other Comprehensive Income (AOCI)**: OCI amounts accumulate over time and are reported in a component of equity on the balance sheet, separate from retained earnings and additional paid-in capital. This accumulated balance is referred to as **Accumulated Other Comprehensive Income (AOCI)**.
  - **Components of OCI (PUFE(R))**: The components typically included in OCI under U.S. GAAP can be remembered by the mnemonic **PUFE**:
    - **P**ension funded status changes (specifically, actuarial gains and losses arising from defined benefit pension plans).
    - **U**nrealized gains and losses on available-for-sale (AFS) debt securities. (Note: Unrealized gains and losses on trading securities are recognized in net income).
    - **F**oreign currency translation adjustments (gains and losses on foreign currency transactions designated as hedges of a net investment in a foreign entity).
    - **E**ffective cash flow hedge changes (realized gains and losses on derivative instruments that qualify as cash flow hedges).
    - **(R)eclassifications** or **Revaluation surpluses** (primarily under IFRS, but not generally for US GAAP). While not a direct component in the same way as the others under US GAAP, the concept of "reclassification adjustments" is critical for OCI.
  - **Reclassification Adjustments ("Recycling")**: A **reclassification adjustment** is made to avoid double-counting items that were reported in OCI in a prior period and are now recognized in net income in the current period. This process is sometimes referred to as "recycling" OCI. Entities are required to provide information about the effects of significant reclassifications out of AOCI on the respective line items in net income. This information can be presented:
    - **Parenthetically on the face of the statement** where net income is presented, for amounts required to be reclassified to net income in their entirety in the same reporting period.

        - **As a separate disclosure in the notes** to the financial statements. For amounts not reclassified in their entirety to net income (e.g., certain pension costs that may be capitalized), entities must cross-reference to other GAAP disclosures that provide additional detail. The objective is to compile information about reclassifications in one location, serving as a "roadmap" for users.
- **Presentation of Comprehensive Income** Companies are required to report comprehensive income and its components in a complete set of financial statements. This can be achieved in two ways:
    1. **Single Continuous Financial Statement**: A statement that includes both net income and other comprehensive income sections, culminating in a total comprehensive income amount.
    2. **Two Separate but Consecutive Financial Statements**: An income statement is presented first, followed by a separate statement of other comprehensive income that begins with the net income figure from the first statement and details the OCI components, leading to total comprehensive income. For both presentations, OCI elements can be shown either **net of tax** or **before tax** with a single amount for the aggregate tax effect of all OCI items.

Understanding these core concepts related to the income statement and comprehensive income is crucial for accurately interpreting a company's financial performance and position under US GAAP.