FA Module 3: The income statement (statement of profit and loss) – overview

(The attached PDF file has better formatting.)

Readings: chapter 4 understanding income statements, *excluding*

- Exhibit 4 (Daimler/Chrysler) in §3
- Exhibit 5 (Ford Motor Company) in §3
- sub-section 3.2.2 (installment sales)
- sub-section 3.2.3 (barter)
- sub-section 3.3 (implications for financial analysis)
- Exhibit 9 (extraordinary gain on debt forgiveness)
- Example 11 (Revenue recognition: a change in accounting principle)
- Example 16 (Median Common-Size Income Statement Statistics for the S&P 500)

All modules of this course assume you understand income statement and balance sheet entries. Some entry names may confuse readers: revenue is an income statement item but deferred revenue is a balance sheet liability; expenses are income statement items but prepaid expenses are balance sheet assets.

Every entry has a balancing item. Net revenue on the income statement is a credit, the offsetting debit entry on the balance sheet may be cash or accounts receivable. Some income statement entries may have several offsetting balance sheet items. Tax expense is a debit on the income statement, and may be offset by credits to cash, deferred tax assets, or deferred tax liabilities on the balance sheet.

The textbook discusses three methods of revenue recognition for long-term contracts

- Pro-rata method
- Percentage-of-completion method
- Completed contract method

and two methods of expense recognition:

- Matching with revenue recognition
- Period costs

The discussions of insurance contracts in the final modules focus on insurance revenue and expenses:

- GAAP for long-term vs short term contracts
- IFRS 17 general measurement vs premium allocation approaches

Short duration insurance contracts under GAAP recognize income similarly to the percentage of completion method. For long duration insurance contracts, the percentage of completion is hard to determine. The IFRS 17 premium allocation approach is similar to the procedure for short duration contracts under GAAP.

Expense recognition for insurance contracts is similar to the expense recognition discussed in the textbook: deferrable acquisition costs (under GAAP) and acquisition costs directly attributable to the insurance contracts (under IFRS 17) are matched with revenue (under GAAP) or included in fulfilment cash flows (under IFRS 17). Other acquisition costs are expensed as incurred.

The readings on the discussion forum update the textbook for the topics most relevant to actuaries. Other changes in GAAP or IFRS since the textbook was published are mentioned on the discussion forum but are not tested on the final exam. For example, the textbook often mentions that goodwill is not amortized. GAAP recently changed to allow amortization of goodwill for private firms (not publicly traded firms). For the final exam, use the goodwill rules in the textbook.

Final exam problems also deal with the following topics:

- Nonrecurring items, nonoperating items, discontinued operations, and extraordinary items
- Changes in accounting standards vs changes in estimates
- Earnings per share and price-earnings ratios
- Other comprehensive income vs profit or loss
- Common-size analysis and income statement ratios