

FA Module 3: The income statement (statement of profit and loss) – overview 3<sup>rd</sup> edition

(The attached PDF file has better formatting.)

(Readings from the third 3<sup>rd</sup> edition of the Robinson text.)

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)

Skip §3.6 on earnings per share; this material is covered in a later module on earnings per share and diluted earnings per share.

Focus on

- ! the matching principle (see especially Example 7 The Matching of Inventory Costs with Revenues)
- ! period costs and inventory costing methods (see especially Example 8 Alternative Inventory Costing Methods); explained in a later module
- ! depreciation and amortization (4.2.3. Depreciation and Amortisation; Example 9 Sensitivity of Annual Depreciation Expense to Varying Estimates of Useful Life and Residual Value; EXHIBIT 7 Annual Depreciation Expense; Example 10 An Illustration of Diminishing Balance Depreciation); explained in a later module
- ! income statement ratios
- ! other comprehensive income

The topics to focus on (the list directly above) are discussed more fully in later modules and are tested on the final exam. The discussion forum has practice exam problems explaining all the relations and calculations that you will be tested on.

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 examples and exhibits contain accounting entries described in later chapters, such as impairment of assets, discontinued operations, joint ventures, goodwill, non-controlling (minority) interests. CFA students are familiar with these terms; actuarial students are not. The practice problems for the module show what you will be tested on; do not worry about unfamiliar accounting terms.

The textbook discusses the format of the income statement; the final exam does not test the format.

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 fulfillment cash flows (under IFRS 17). Other acquisition costs are expensed as incurred.

Review end of chapter problems 3, 5, 6, 7.

Take heed: the examples and exhibits in the textbook contain dozens of accounting entries that are used to derive other figures, relations, or ratios, but the end of chapter problems rarely ask mathematics. The final exam problems for this course, like the practice problems on the discussion forum, provide abridged financial statements, with just the relevant accounting entries, but they require computation of the formulas, relations, or derived ratios. As you read the textbook, work through the practice problems. The accounting details in the textbook are not needed for the final exam.