Bruce Pounder, CMA, CFM, Editor

Integrating the Income Statement

Newly proposed changes to U.S. GAAP and IFRS would force many reporting entities to change the way they present their income statements.

Under both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), reporting entities have considerable flexibility in choosing how to report their financial performance in their income statements. Not surprisingly, different entities report their financial performance in different ways. As I noted in last month's column, such diversity in practice often renders financial statements less useful to investors, creditors, and other users as a result of the statements being less comparable among entities.

On May 26, 2010, the Financial Accounting Standards Board (FASB) proposed changes to U.S. GAAP aimed at reducing the options that entities have for reporting financial performance. The following day, the International Accounting Standards Board (IASB) proposed similar changes to IFRS. In this month's column, I'll:

- Provide background information on the Boards' proposals,
- Explain the changes that the Boards have proposed, and
- Describe how the proposed changes would affect the manner in which reporting entities present their income statements.

A Tale of Two Performance Measures

Most users of financial statements are irresistibly drawn to "the bottom line"—the one number that they believe best summarizes an entity's financial performance over a particular period of time. Under U.S. GAAP, that number is called *net income*; under IFRS, it's called *profit or loss*. For simplicity's sake, I'll refer to it as NI from here on.

Traditionally, the income statement was considered the principal medium for reporting an entity's financial performance, and NI was literally the bottom line of the income statement. But over time, accounting standards setters came to believe that NI by itself was an insufficient—and possibly even useless—measure of financial performance. In 1987, the FASB stated that "it is important to avoid focusing attention almost exclusively on 'the bottom line,' earnings per share, or other highly simplified condensations" (Statement of Financial Accounting Concepts (SFAC) No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises"). More recently, the FASB and the IASB have seriously considered banishing NI entirely from income statements (see, for example, the front-page story of *The Wall Street Journal* on May 12, 2007, "Profit as We Know It Could Be Lost With New Accounting Statements").

While NI has lost status in the eyes of standards setters, another measure of financial performance—*comprehensive income*—has gained status. As its name implies, comprehensive income (CI) is a more complete measure of an entity's financial performance than NI is, especially from the perspective of the entity's owners. There's even a whole topic of the FASB's *Accounting Standards Codification*™ (ASC) devoted to CI (Topic 220), whereas there's no topic devoted exclusively to NI.

CI vs. NI: What's the Difference?

The FASB ASC defines CI as "The change in equity (net assets) of a business entity during a period from transactions and other events and circumstances from nonowner sources." The definition continues, noting that CI "includes all changes in equity during a period except those resulting from investments by owners and distributions to owners."

NI is the primary component of CI. But there are also several

other components of CI, and those components are known collectively as Other Comprehensive Income (OCI). The FASB ASC explicitly references OCI items when it defines NI as "A measure of financial performance resulting from the aggregation of revenues, expenses, gains, and losses that are not items of other comprehensive income." In short, the difference between CI and NI is OCI.

OCI reflects certain changes in equity that aren't reflected in NI, such as:

- Unrealized holding gains and losses on "available for sale" equity securities held as investment assets,
- Foreign currency translation adjustments, and
- Adjustments associated with recognizing an employer's minimum liability for defined-benefit plans.

Much in the same way that NI is closed to the retained earnings balance-sheet account at the end of each reporting period, OCI is closed to an accumulated OCI balance-sheet account, with both accounts appearing in the equity section of the balance sheet.

If One Income Statement Is Good, Are Two Better?

As their regard for NI waned, standards setters began to reassess the content and format of the traditional income statement. In 1997, the FASB decided to require entities to report CI and its components in their financial statements (see Statement of Financial Accounting Standards (SFAS) No. 130, "Reporting Comprehensive Income"). But knowing that users of financial statements still had great affection for NI and the traditional income statement, the FASB decided that entities could continue to present the traditional income statement as-is and relegate OCI items and CI to a separate, additional income statement or even bury OCI and CI in the statement of owners' equity. The IASB eventually followed suit with a similar change to IFRS (see the 2007 revision to International Accounting Standard (IAS) 1, "Presentation of Financial Statements").

Given that the FASB and the IASB allow entities to report OCI and CI on a nontraditional and easily ignored separate statement, many entities choose to do so. As a result, CI as a measure of financial performance has remained virtually invisible to many financial-statement users. What's more, the relative obscurity of OCI and CI has made OCI an attractive "dumping ground" for transactions and events that the Boards' constituents would prefer to exclude from NI, even though the transactions and events frequently have a significant impact on the financial position of the entity and the economic welfare of its owners. As a result, the distinction between those components of financial performance that are represented on the traditional income statement and those that aren't has become increasingly arbitrary. Thus, for many reasons, contemporary financial statements often fail to convey financial performance in as complete and informative a manner as the Boards would like to see.

A New Bottom Line?

What the FASB and the IASB have now proposed is that all entities report CI and its components (including NI, OCI, and their subcomponents) in a single, continuous financial statement. In other words, there would be only one income statement, and its bottom line would be CI. This would force many reporting entities to change the way they present their income statements, especially if they report any OCI items.

A minor difference between the Boards' proposals is that the IASB proposal would require entities to separately state items of OCI that won't be "recycled" into NI. Recycling is a phenomenon that can occur, for example, when holding gains on "available for sale" equity securities are realized upon sale.

The single-income-statement presentation would be applied retrospectively to prior periods that are reported on a comparative basis in conjunction with the current period. Early adoption would be permitted because the mandatory presentation that the Boards have proposed is permissible under U.S. GAAP and IFRS today.

As always, exposure drafts of the Boards' proposals are freely available in electronic format at the FASB and IASB websites (www.fasb.org and www.iasb.org, respectively). The comment period on the exposure drafts ends September 30, 2010. **SF**

Bruce Pounder, CMA, CFM, DipIFR (ACCA), is president of Leveraged Logic, a provider of educational products and services for accounting professionals. He is the immediate past chair of IMA's Small Business Financial and Regulatory Affairs Committee. You can reach Bruce at BPounder@LeveragedLogic.com.