

# **CFA LEARNING OUTCOMES DECODED**

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. This article is written by Nicki DeGroot, CFA. Nicki works as a finance consultant and tutors for Tutor.com.

# FINANCIAL STATEMENT ANALYSIS: UNDERSTANDING INCOME STATEMENTS

**LOS: Contrast operating and non-operating components of the income statement**

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This LOS introduces analytical concepts such as operating and non-operating components of the income statement, expanding on previous learning outcome statements that simply cover definitions or policies. Understanding the difference between operating and non-operating components sets the standards for analyzing company performance.

## **Operating versus non-operating components**

Financial statements are considered more useful if the operating items are separated from the non-operating items. Both are helpful for investors in understanding performance. For example, large non-operating items such as dividends paid (a financing cash flow) should cause an investor to question the company's financing strategy and capital structure.

Non-operating items on the income statement are typically classified as investing or financing items on the cash flow statement. However, the separation of operating and non-operating components can vary based on accounting standards. There are also major differences between financial and non-financial companies.

## **IFRS definitions**

International Financial Reporting Standards (IFRS) does not have a strict definition of operating items. Interest paid on debt and dividends paid on equity could be classified as either operating or financing (non-operating) on both the cash flow and income statements. Similarly, the receipt of interest or dividends could be either operating or financing under IFRS.

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## GAAP definitions

The United States accounting standard of Generally Accepted Accounting Principles (GAAP) includes stricter standards on operating and non-operating components in financial statements. The US GAAP definition notes that activities that involve producing or delivering goods or services are generally operating activities. Under these definitions, interest paid on debt is considered an operating item while dividends paid on equity are considered financing (non-operating). Both interest and dividends received are considered operating items.

## Financial companies

The definitions above generally cover non-financial companies. For financial companies, borrowing and lending are core operating activities. Therefore, a financial company should include interest paid, interest received, and dividends received as operating items. Dividends paid are still considered financing since they are associated with the company's capital structure rather than its operations.

## Examples

Common examples of operating expenses on the income statement are staff salaries, advertising, rent, and utility expenses. These are all core to the day-to-day operations of the business. Non-operating items can be non-recurring such as gains or losses from asset sales, costs to reorganize, or expenses related to a lawsuit. Large non-operating items on the income statement are often questioned by financial analysts and should be scrutinized.

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### PRACTICE QUESTION

QRT Inc. reports under US GAAP and is considered a non-financial company. Would QRT's interest paid and dividends paid be classified as operating or non-operating on its income statement?

- A. Both are operating components.
- B. Interest paid is a non-operating component while dividends paid is an operating component.
- C. Interest paid is an operating component while dividends paid is a non-operating component.

**C is correct.** Under US GAAP, interest paid on debt is considered an operating item while dividends paid on equity are considered financing (non-operating).