CHAPTER 4

Income Statement and Related Information

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1. Income measurement concepts.	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 18, 22, 23, 30, 33, 34, 35				2, 3, 4, 6
2. Computation of net income from balance sheets and selected accounts.		1	1, 2, 3, 8		
3. Single-step income statements; earnings per share.	11, 19, 25, 26	1, 2, 8	4, 5, 7, 8, 10, 11, 13, 17	2, 3, 4, 5	1, 5
4. Multiple-step income statements.	12, 17, 19, 20	3, 4	5, 6, 7, 9	1, 4	
5. Extraordinary items; accounting changes; discontinued operations; prior period adjustments; errors.	13, 14, 15, 16, 22, 29, 31, 37	4, 5, 6, 7	6, 8, 10, 11, 13, 14	3, 5, 6, 7	1, 2, 4, 5, 6
6. Retained earnings statement.	32	9, 10, 11	9, 12, 16, 17	1, 2, 4, 5, 6	
7. Intraperiod tax allocation.	21, 24, 27, 28, 29		9, 11, 13, 14, 17	3, 5, 7	
8. Comprehensive income.	36	11	15, 16, 17		7
9. Disposal of a component (discontinued operations).	31, 37			1, 3, 6, 7	

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1. Understand the uses and limitations of an income statement.	1, 2, 6, 7, 9				CA4-1, CA4-2, CA4-3
2. Describe the content and format of the income statement.	5, 8, 10	4, 5	1, 2, 3, 4, 5, 6, 7		CA4-5, CA4-6
3. Prepare an income statement.	8, 11, 12, 19, 20, 17	1, 2, 3, 4, 5	4, 5, 6, 7, 8, 9, 11, 15, 17	1, 2, 3, 4, 5, 7	CA4-6
4. Explain how to report various income items.	3, 4, 13, 21, 22, 23, 24, 27, 28, 29, 30, 31, 33, 17	4, 5	2, 3, 6, 8, 9, 11, 17	1, 3, 4, 5, 6, 7	CA4-4
5. Identify where to report earnings per share information.	25, 26	8	6, 7, 8, 9, 10, 11, 13, 14, 17	1, 2, 3, 4, 5, 7	CA4-4
6. Understand the reporting of accounting changes, and errors.	14, 15, 16, 18	6, 7, 10	14	4, 5, 6, 7	CA4-2
7. Prepare a retained earnings statement.	32	9, 10	9, 12, 16, 17	1, 2, 4, 5, 6	CA4-6
8. Explain how to report other comprehensive income.	34, 35, 36, 37	11	15, 16, 17		CA4-7

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E4-1	Computation of net income.	Simple	18–20
E4-2	Compute income measures.	Simple	10–15
E4-3	Income statement items.	Simple	25–35
E4-4	Single-step income statement.	Moderate	20–25
E4-5	Multiple-step and single-step.	Simple	30–35
E4-6	Multiple-step and extraordinary items.	Moderate	30–35
E4-7	Multiple-step and single-step.	Moderate	30–40
E4-8	Income statement, EPS.	Simple	15–20
E4-9	Multiple-step statement with retained earnings.	Simple	30–35
E4-10	Earnings per share.	Simple	20–25
E4-11	Condensed income statement—periodic inventory method.	Moderate	20–25
E4-12	Retained earnings statement.	Simple	20–25
E4-13	Earnings per share.	Moderate	15–20
E4-14	Change in accounting principle.	Moderate	15–20
E4-15	Comprehensive income.	Simple	15–20
E4-16	Comprehensive income.	Moderate	15–20
E4-17	Various reporting formats.	Moderate	30–35
P4-1	Multiple-step income, retained earnings.	Moderate	30–35
P4-2	Single-step income, retained earnings, periodic inventory.	Simple	25–30
P4-3	Irregular items.	Moderate	30–40
P4-4	Multiple- and single-step income, retained earnings.	Moderate	45–55
P4-5	Irregular items.	Moderate	20–25
P4-6	Retained earnings statement, prior period adjustment.	Moderate	25–35
P4-7	Income statement, irregular items.	Moderate	25–35
CA4-1	Identification of income statement deficiencies.	Simple	20–25
CA4-2	Earnings management.	Moderate	20–25
CA4-3	Earnings management.	Simple	15–20
CA4-4	Income reporting items.	Moderate	30–35
CA4-5	Identification of income statement weaknesses.	Moderate	30–40
CA4-6	Classification of income statement items.	Moderate	20–25
CA4-7	Comprehensive income.	Simple	10–15

SOLUTIONS TO CODIFICATION EXERCISES

CE4-1

According to the Glossary:

(a) A change in accounting estimate is a change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. Changes in accounting estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage value of depreciable assets, and warranty obligations. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities.

(b) A change in accounting principle reflects a change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle. A "Change in Accounting Estimate Effected by a Change in Accounting Principle" is a change in accounting estimate that is inseparable from the effect of a related change in accounting principle. An example of a change in estimate effected by a change in principle is a change in the method of depreciation, amortization, or depletion for long-lived, nonfinancial assets.

(c) Comprehensive Income is defined as the change in equity (net assets) of a business during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

CE4-2

The master glossary provides the term "Unusual Nature", a link from which yields the following:

<u>Glossary Term Usage</u>

The glossary term is used in the following locations.

Unusual Nature

- 225 Income Statement > 20 Extraordinary and Unusual Items > 45 Other Presentation
  – 225 Income Statement > 20 Extraordinary and Unusual Items > 45 Other Presentation > General, paragraph 45-2.

Following this link yields the following paragraph:

45-2 Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Thus, both of the following criteria shall be met to classify an event or transaction as an extraordinary item:

a. **Unusual nature.** The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates (see paragraph 225-20-55-1).

CE4-2 (Continued)

b. **Infrequency of occurrence.** The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates (see paragraph 225-20-55-2).

Thus, "unusual nature" is one of the criterion that determines whether an item meets the definition of an extraordinary item.

CE4-3

Entering "extraordinary item" and "interim" into the search window, yields the following guidance (FASB ASC 225-20-50-4):

Interim Reporting

50-4 As indicated in paragraph FASB ASC 270-10-50-5, extraordinary items shall be disclosed separately and included in the determination of net income for the interim period in which they occur. In determining materiality, extraordinary items shall be related to the estimated income for the full fiscal year. Effects of disposals of a component of an entity and unusual and infrequently occurring transactions and events that are material with respect to the operating results of the interim period but that are not designated as extraordinary items in the interim statements shall be reported separately. In addition, matters such as unusual seasonal results and business combinations shall be disclosed to provide information needed for a proper understanding of interim financial reports. Extraordinary items, gains or losses from disposal of a component of an entity, and unusual or infrequently occurring items shall not be pro-rated over the balance of the fiscal year.

CE4-4

Entering "effect of preferred stock" in the search window yields the following link (FASB ASC 260-10-S55): 260 Earnings per Share > 10 Overall > S55 Implementation Guidance and Illustrations.

General

Effect of Preferred Stock Dividends and Accretion of Carrying Amount of Preferred Stock on Earnings Per Share S55-1 See paragraph 225-10-S99-5, SAB . . . views on this topic.

Following that link yields the following guidance:

Income or Loss Applicable to Common Stock

S99-5 The following is the text of SAB Topic 6.B, Accounting Series Release 280—General Revision Of Regulation S-X: Income Or Loss Applicable To Common Stock.

Facts: A registrant has various classes of preferred stock. Dividends on those preferred stocks and accretions of their carrying amounts cause income applicable to common stock to be less than reported net income.

Question: In ASR 280, the Commission stated that although it had determined not to mandate presentation of income or loss applicable to common stock in all cases, it believes that disclosure of that amount is of value in certain situations. In what situations should the amount be reported, where should it be reported, and how should it be computed?

CE4-4 (Continued)

Interpretive Response: Income or loss applicable to common stock should be reported on the face of the income statement (FN1) when it is materially different in quantitative terms from reported net income or loss (FN2) or when it is indicative of significant trends or other qualitative considerations. The amount to be reported should be computed for each period as net income or loss less: (a) dividends on preferred stock, including undeclared or unpaid dividends if cumulative; and (b) periodic increases in the carrying amounts of instruments reported as redeemable preferred stock (as discussed in Topic 3.C) or increasing rate preferred stock (as discussed in Topic 5.Q).

(FN1) If a registrant elects to follow the encouraged disclosure discussed in paragraph 23 of Statement 130, and displays the components of other comprehensive income and the total for comprehensive income using a one-statement approach, the registrant must continue to follow the guidance set forth in the SAB Topic. One approach may be to provide a separate reconciliation of net income to income available to common stock below comprehensive income reported on a statement of income and comprehensive income.

(FN2) The assessment of materiality is the responsibility of each registrant. However, absent concerns about trends or other qualitative considerations, the staff generally will not insist on the reporting of income or loss applicable to common stock if the amount differs from net income or loss by less than ten percent.

ANSWERS TO QUESTIONS

1. The income statement is important because it provides investors and creditors with information that helps them predict the amount, timing, and uncertainty of future cash flows. It helps investors and creditors predict future cash flows in a number of different ways. First, investors and creditors can use the information on the income statement to evaluate the past performance of the company. Second, the income statement helps users of the financial statements to determine the risk (level of uncertainty) of income—revenues, expenses, gains, and losses—and highlights the relationship among these various components.

It should be emphasized that the income statement is used by parties other than investors and creditors. For example, customers can use the income statement to determine a company's ability to provide needed goods or services, unions examine earnings closely as a basis for salary discussions, and the government uses the income statements of companies as a basis for formulating tax and economic policy.

2. Information on past transactions can be used to identify important trends that, if continued, provide information about future performance. If a reasonable correlation exists between past and future performance, predictions about future earnings and cash flows can be made. For example, a loan analyst can develop a prediction of future performance by estimating the rate of growth of past income over the past several periods and project this into the next period. Additional information about current economic and industry factors can be used to adjust the trend rate based on historical information.

3. Some situations in which changes in value are not recorded in income are:
(a) Unrealized gains or losses on available-for-sale investments,
(b) Changes in the fair values of long-term liabilities, such as bonds payable,
(c) Changes (increases) in value of property, plant and equipment, such as land, natural resources, or equipment,
(d) Changes (increases) in the values of intangible assets such as customer goodwill, brand value, or intellectual capital.

Note that some of these omissions arise because the items (e.g., brand value) are not recognized in financial statements, while others (value of land) are recorded in financial statements but measurement is at historical cost.

4. Some situations in which application of different accounting methods or estimates lead to comparison problems include:
(a) Inventory methods—LIFO vs. FIFO,
(b) Depreciation Methods—straight-line vs. accelerated,
(c) Accounting for long-term contracts—percentage-of-completion vs. completed-contract,
(d) Estimates of useful lives or salvage values for depreciable assets,
(e) Estimates of bad debts,
(f) Estimates of warranty costs.

5. The transaction approach focuses on the activities that have occurred during a given period and instead of presenting only a net change, a description of the components that comprise the change is included. In the capital maintenance approach, only the net change (income) is reflected whereas the transaction approach not only provides the net change (income) but the components of income (revenues and expenses). The final net income figure should be the same under either approach given the same valuation base.

6. Earnings management is often defined as the planned timing of revenues, expenses, gains and losses to smooth out bumps in earnings. In most cases, earnings management is used to increase income in the current year at the expense of income in future years. For example, companies prematurely recognize sales in order to boost earnings. Earnings management can also be used to decrease current earnings in order to increase income in the future. The classic case is the use of "cookie jar" reserves, which are established by using unrealistic assumptions to estimate liabilities for such items as loan losses, restructuring charges and warranty returns.

7. Earnings management has a negative effect on the quality of earnings if it distorts the information in a way that is less useful for predicting future cash flows. Within the Conceptual Framework, useful information is both relevant and representationally faithful. However, earnings management reduces the reliability of income, because the income measure is biased (up or down) and/or the reported income is not representationally faithful to that which it is supposed to report (e.g., volatile earnings are made to look more smooth).

8. Caution should be exercised because many assumptions and estimates are made in accounting and the net income figure is a reflection of these assumptions. If for any reason the assumptions are not well-founded, distortions will appear in the income reported. The objectives of the application of generally accepted accounting principles to the income statement are to measure and report the results of operations as they occur for a specified period without recognizing any artificial exclusions or modifications.

9. The term "quality of earnings" refers to the credibility of the earnings number reported. Companies that use aggressive accounting policies report higher income numbers in the short-run. In such cases, we say that the quality of earnings is low. Similarly, if higher expenses are recorded in the current period, in order to report higher income in the future, then the quality of earnings is also considered low.

10. The major distinction between revenues and gains (or expenses and losses) depends on the typical activities of the company. Revenues can occur from a variety of different sources, but these sources constitute the entity's ongoing major or central operations. Gains also can arise from many different sources, but these sources occur from peripheral or incidental transactions of an entity. The same type of distinction is made between expenses and losses.

11. The advantages of the single-step income statement are: (1) simplicity and conciseness, (2) probably better understood by the layperson, (3) emphasis on total costs and expenses, and net income, and (4) does not imply priority of one revenue or expense over another. The disadvantages are that it does not show the relationship between sales revenue and cost of goods sold and it does not show other important relationships and information, such as income from operations, income before income tax, etc.

12. Operating items are the expenses and revenues which relate directly to the principal activity of the concern; they are revenues realized from, or expenses which contribute to, the sale of goods or services for which the company was organized. The nonoperating items result from secondary activities of the company. They are not directly related to the principal activity of the company but arise from incidental activities.

13. The current operating performance income statement contains only the revenues and usual expenses of the current year, with all unusual gains or losses or material corrections of prior periods' revenues and expenses appearing in the retained earnings statement. The modified all-inclusive income statement includes most items including irregular ones, as part of net income. The retained earnings statement then would include only the beginning balance (adjusted for the effects of errors and changes in accounting principle), the net amount transferred from income summary, dividends, and transfers to and from appropriated retained earnings.

GAAP recommends a modified all-inclusive income statement, excluding from the income statement only those items, few in number, which meet the criteria for prior period adjustments and which would thus appear as adjustments to the beginning balance in the retained earnings statement. Subsequently a number of pronouncements have reinforced this position. Recently, changes in accounting principle are also adjusted through the beginning retained earnings balance.

14. Items considered corrections of errors should be charged or credited to the opening balance of retained earnings.

15. (a) This might be shown in the income statement as an extraordinary item if it is a material, unusual, and infrequent gain realized during the year. However, in general and in accordance with **FASB ASC 225-20** this transaction would normally not be considered extraordinary, but would be shown in the nonoperating section of a multiple-step income statement. If unusual or infrequent but not both, it should be separately disclosed in the income statement.

(b) The bonus should be shown as an operating expense in the income statement. Although the basis of computation is a percentage of net income, it is an ordinary operating expense to the company and represents a cost of the service received from employees.

(c) If the amount is immaterial, it may be combined with the depreciation expense for the year and included as a part of the depreciation expense appearing in the income statement. If the amount is material, it should be shown in the retained earnings statement as an adjustment to the beginning balance of retained earnings.

(d) This should be shown in the income statement. One treatment would be to show it in the statement as a deduction from the rent expense, as it reduces an operating expense and therefore is directly related to operations. Another treatment is to show it in the other revenues and gains section of the income statement.

(e) Assuming that a provision for the loss had not been made at the time the patent infringement suit was instituted, the loss should be recognized in the current period in computing net income. It may be reported as an unusual loss.

(f) This should be reported in the income statement, but not as an extraordinary item because it relates to usual business operations of the firm.

16. (a) The remaining book value of the equipment should be depreciated over the remainder of the five-year period. The additional depreciation ($425,000) is not a correction of an error and is not shown as an adjustment to retained earnings. The change is considered a change in estimate.

(b) The loss should be shown as an extraordinary item, assuming that it is unusual and infrequent.

(c) The write-off should be shown either as other expenses and losses or in a separate section, appropriately labeled as an unusual item, if unusual or infrequent but not both. It should not be shown as an extraordinary item.

(d) Assuming that a receivable had not been recorded in the previous period, the gain should be recognized in the current period in computing net income, but not as an extraordinary item.

(e) A correction of an error should be considered a prior period adjustment and the beginning balance of Retained Earnings should be restated, if material.

(f) The cumulative effect of the change is reported as an adjustment to beginning retained earnings. Prior years' statements are recast on a basis consistent with the new standard.

17. (a) Other expenses and losses section or in a separate section, appropriately labeled as an unusual item, if unusual or infrequent but not both.

(b) Operating expense section or other expenses and losses section or in a separate section, appropriately labeled as an unusual item, if unusual or infrequent but not both. **FASB ASC 225-20** specifically states that the effect of a strike does not constitute an extraordinary item.

(c) Operating expense section, as a selling expense, but sometimes reflected as an administrative expense.

(d) Separate section after income from continuing operations, entitled discontinued operations.

(e) Other revenues and gains section or in a separate section, appropriately labeled as an unusual item, if unusual or infrequent but not both.
(f) Other revenues and gains section.
(g) Operating expense section, normally administrative. If a manufacturing concern, may be included in cost of goods sold.
(h) Other expenses and losses section or in separate section, appropriately labeled as an unusual item, if unusual or infrequent but not both.

18. Perlman and Sheehan should not report the sales in a similar manner. This type of transaction appears to be typical of Perlman's central operations. Therefore, Perlman should report revenues of $160,000 and expenses of $100,000 ($70,000 + $30,000). However, Sheehan's transaction appears to be a peripheral or incidental activity not related to its central operations. Thus, Sheehan should report a gain of $60,000 ($160,000 – $100,000). Note that although the classification is different, the effect on net income is the same ($60,000 increase).

19. You should tell Greg that a company's reported net income is the same whether the single-step or multiple-step format is used. Either way, the company has the same revenues, gains, expenses, and losses; they are simply organized in a different format.

20. Both formats are acceptable. The amount of detail reported in the income statement is left to the judgment of the company, whose goal in making this decision should be to present financial statements which are most useful to decision makers. We want to present a simple, understandable statement so that a reader can easily discover the facts of importance; therefore, a single amount for selling expenses might be preferable. However, we also want to fully disclose the results of all activities; thus, a separate listing of expenses may be preferred. Note that if the condensed version is used, it should be accompanied by a supporting schedule of the eight components in the notes to the financial statements.

21. Intraperiod tax allocation should not affect the reporting of an unusual gain. The FASB specifically prohibits a "net-of-tax" treatment for such items to insure that users of financial statements can easily differentiate extraordinary items from material items that are unusual or infrequent, but not both. "Net-of-tax" treatment is reserved for discontinued operations, extraordinary items, and prior period adjustments.

22. (a) A loss on discontinued operations is reported net of tax in the income statement between income from continuing operations and net income.
(b) Noncontrolling interest allocation is reported in the income statement after the net income,
(c) Earnings per share are shown in the income statement after the noncontrolling interest allocation.
(d) A gain on sale of equipment in shown under other revenues and gains in the income statement.

23. Lebron presents the income information as follows:

Net income	$ 124,700
Less: Net income attributed to the noncontrolling interest	30,000
Net income attributable to Lebron Company	$ 94,700

24. Intraperiod tax allocation has no effect on reported net income, although it does affect the amounts reported for various components of income. The effects on these components offset each other so net income remains the same. Intraperiod tax allocation merely takes the total income tax expense and allocates it to the various items which affect the tax amount.

25. If Neumann has preferred stock outstanding, the numerator in its computation may be incorrect. A better description of "earnings per share" is "earnings per **common** share." The numerator should include only the earnings available to common shareholders. Therefore, the numerator should be: net income less preferred dividends.

The denominator is also incorrect if Neumann had any common stock transactions during the year. Since the numerator represents the results for the entire year, the denominator should reflect the weighted-average number of common shares outstanding during the year, not the shares outstanding at one point in time (year-end).

26. The earnings per share trend is not favorable. Extraordinary items are one-time occurrences which are not expected to be reported in the future. Therefore, earnings per share on income before extraordinary items is more useful because it represents the results of ordinary business activity. Considering this EPS amount, EPS has decreased from $7.21 to $6.40.

27. Tax allocation within a period is the practice of allocating the income tax for a period to such items as income before extraordinary items, extraordinary items, and prior period adjustments.

The justification for tax allocation within a period is to produce financial statements which disclose an appropriate relationship, for example, between income tax expense and (a) income before extraordinary items, (b) extraordinary items, and (c) prior period adjustments (or of the opening balance of retained earnings).

28. Tax allocation within a period (intraperiod) becomes necessary when a firm encounters such items as discontinued operations, extraordinary items, or corrections of errors. Such allocation is necessary to bring about an appropriate relationship between income tax expense and income from continuing operations, discontinued operations, income before extraordinary items, extraordinary items, etc.

Tax allocation within a period is handled by first computing the tax expense attributable to income before extraordinary items, assuming no discontinued operations. This is simply computed by ascertaining the income tax expense related to revenue and expense transactions entering into the determination of such income. Next, the remaining income tax expense attributable to other items is determined by the tax consequences of transactions involving these items. The applicable tax effect of these items (extraordinary, prior period adjustments) should be disclosed separately because of their materiality.

29.

LISELOTTE COMPANY
Partial Income Statement
For the Year Ended December 31, 2014

Income before tax and extraordinary item		$1,500,000
Income tax		510,000
Income before extraordinary item		990,000
Extraordinary item—gain on sale of plant (condemnation)	$450,000	
Less: Applicable income tax	135,000	315,000
Net income		$1,305,000

30. The damages would probably be reported in Frazier Corporation's financial statements in the other expenses and losses section. If the damages are unusual in nature, the damage settlement might be reported as an unusual item. The damages would not be reported as a correction of an error (prior period adjustment).

31. The assets, cash flows, results of operations, and activities of the plants closed would not appear to be clearly distinguishable, operationally or for financial reporting purposes, from the assets, results of operations, or activities of the Linus Paper Company. Therefore, disposal of these assets is not considered to be a disposal of a component of a business that would receive special reporting.

32. The major items reported in the retained earnings statement are: (1) adjustments of the beginning balance for corrections of errors or changes in accounting principle, (2) the net income or loss for the period, (3) dividends for the year, and (4) restrictions (appropriations) of retained earnings. It should be noted that the retained earnings statement is sometimes composed of two parts, unappropriated and appropriated.

33. Generally accepted accounting principles are ordinarily concerned only with a "fair presentation" of business income. In contrast, taxable income is a statutory concept which defines the base for raising tax revenues by the government, and any method of accounting which meets the statutory definition will "clearly reflect" taxable income as defined by the Internal Revenue Code. It should be noted that the Code prohibits use of the cash receipts and disbursements method as a method which will clearly reflect income in accounting for purchases and sales if inventories are involved.

The cash receipts and disbursements method will not usually fairly present income because:

(1) The completed transaction, not receipt or disbursement of cash, increases or diminishes income. Thus, a sale on account produces revenue and increases income, and the incurrence of expense reduces income without regard to the time of payment of cash.

(2) The expense recognition principle generally results in costs being matched against related revenues produced. In most situations the cash receipts and disbursements method will violate this principle.

(3) Consistency requires that accountable events receive the same accounting treatment from accounting period to accounting period. The cash receipts and disbursements method permits manipulation of the timing of revenues and expenses and may result in treatments which are not consistent, detracting from the usefulness of comparative statements.

34. Problems arise both from the revenue side and from the expense side. There sometimes may be doubt as to the amount of revenue under our common rules of revenue recognition. However, the more difficult problem is the determination of costs expired in the production of revenue. During a single fiscal period it often is difficult to determine the expiration of certain costs which may benefit several periods. Business is continuous and estimates have to be made of the future if we are to systematically apportion costs to fiscal periods. Examples of items which present serious obstacles include such items as institutional advertising costs.

Accountants have established certain rules for handling revenues and costs which are applied consistently and in a systematic manner. From period to period, application of these rules generally results in a satisfactory matching of costs and revenues unless there are large changes from one period to another. These rules, influenced by conservatism in the face of the uncertainties involved, tend to charge costs to expense earlier than might be ideally desirable if we had more knowledge of the future.

Costs or expenses of the types mentioned above, by their very nature, defy any attempt to relate them to revenues of a specific period or periods. Although it is known that institutional advertising will yield benefits beyond the present, both the amount of such benefits and when they will be enjoyed are shrouded in uncertainty. The degree of certainty with which their time distribution can be forecast is so small and the results, therefore, so unreliable that the accountant writes them off as applicable to the period or periods in which the expense was incurred.

35. Elements are the basic ingredients which comprise the income statement; that is, revenues, gains, expenses, and losses. Items are descriptions of the elements such as rent revenue, rent expense, etc.

In order to predict the future, the amounts of individual items may have to be reported. For example, if "income from continuing operations" is significantly lower this year and is reported as a single amount, users would not know whether to attribute the decrease to a temporary increase in an expense item (for example, an unusually large bad debt), a structural change (for example, a change in the relationship between variable and fixed expenses), or some other factor. Another example is income data that are distorted because of large discretionary expenses.

36. Other comprehensive income must be displayed (reported) in one of two ways: (1) a single continuous income statement or (2) two separate but consecutive statements of net income and other comprehensive income (two statement approach).

37. The results of continuing operations should be reported separately from discontinued operations, and any gain or loss from disposal of a component of a business should be reported with the related results of discontinued operations and not as an extraordinary item. The following format illustrates the proper disclosure:

Income from continuing operations before income tax.............................	$XXX
Income tax..	XXX
Income from continuing operations...	XXX
Discontinued operations	
Gain (loss) on disposal of Division X	
less applicable income taxes of $–	XXX
Net income..	$XXX

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 4-1

STARR CO.
Income Statement
For the Year 2014

Revenues		
Sales revenue		$540,000
Expenses		
Cost of goods sold	$330,000	
Salaries and wages expense	120,000	
Other operating expenses	10,000	
Income tax expense	25,000	
Total expenses		485,000
Net income		$ 55,000
Earnings per share		$0.55*

*$55,000 ÷ 100,000 shares.

Note: The increase in value of the company reputation and the unrealized gain on the value of patents are not reported.

BRIEF EXERCISE 4-2

BRISKY CORPORATION
Income Statement
For the Year Ended December 31, 2014

Revenues		
Net sales		$2,400,000
Interest revenue		31,000
Total revenues		2,431,000
Expenses		
Cost of goods sold	$1,450,000	
Selling expenses	280,000	
Administrative expenses	212,000	
Interest expense	45,000	
Income tax expense*	133,200	
Total expenses		2,120,200
Net income		$ 310,800
Earnings per share**		$4.44

*($2,431,000 – $1,450,000 – $280,000 – $212,000 – $45,000) X 30% = $133,200.

**$310,800 ÷ 70,000 shares.

BRIEF EXERCISE 4-3

BRISKY CORPORATION
Income Statement
For the Year Ended December 31, 2014

Net sales		$2,400,000
Cost of goods sold		1,450,000
Gross profit		950,000
Selling expenses	$280,000	
Administrative expenses	212,000	492,000
Income from operations		458,000
Other revenue and gains		
Interest revenue	31,000	
Other expenses and losses		
Interest expense	45,000	14,000
Income before income tax		444,000
Income tax expense		133,200
Net income		$ 310,800
Earnings per share		$4.44*

*$310,800 ÷ 70,000 shares.

BRIEF EXERCISE 4-4

Income from continuing operations		$10,600,000
Discontinued operations		
Loss from operation of discontinued restaurant division (net of tax)	$315,000	
Loss from disposal of restaurant division (net of tax)	189,000	504,000
Net income		$10,096,000
Earnings per share		
Income from continuing operations		$1.06
Discontinued operations, net of tax		(0.05)*
Net income		$1.01

*Rounded

BRIEF EXERCISE 4-5

Income before income tax and extraordinary item		$6,300,000
Income tax expense		1,890,000
Income before extraordinary item		4,410,000
Extraordinary item—loss from casualty	$770,000	
Less: Applicable income tax	231,000	539,000
Net income		$3,871,000
Earnings per share		
Income before extraordinary item		$0.88*
Extraordinary loss, net of tax		(0.11)*
Net income		$0.77

*Rounded

BRIEF EXERCISE 4-6

	2014	2013	2012
Income before income tax	$180,000	$145,000	$170,000
Income tax (30%)	54,000	43,500	51,000
Net Income	$126,000	$101,500	$119,000

BRIEF EXERCISE 4-7

Vandross would not report any cumulative effect because a change in estimate is not handled retrospectively. Vandross would report bad debt expense of $120,000 in 2014.

BRIEF EXERCISE 4-8

$$\frac{\$1,000,000 - \$250,000}{190,000} = \underline{\underline{\$3.95}} \text{ per share}$$

BRIEF EXERCISE 4-9

PORTMAN CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, January 1	$ 675,000
Add: Net income	1,400,000
	2,075,000
Less: Cash dividends	75,000
Retained earnings, December 31	$2,000,000

BRIEF EXERCISE 4-10

PORTMAN CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, January 1, as reported	$ 675,000
Correction for overstatement of expenses in prior period (net of tax)	80,000
Retained earnings, January 1, as adjusted	755,000
Add: Net income	1,400,000
	2,155,000
Less: Cash dividends	75,000
Retained earnings, December 31	$2,080,000

BRIEF EXERCISE 4-11

(a)	Net income (Dividend revenue)	$3,000
(b)	Net income	$3,000
	Unrealized holding gain (net of tax)	4,000
	Comprehensive income	$7,000
(c)	Unrealized holding gain (net of tax) (Other comprehensive income)	$4,000
(d)	Accumulated other comprehensive income, January 1, 2014	$ 0
	Unrealized holding gain (net of tax)	4,000
	Accumulated other comprehensive income, December 31, 2014	$4,000

SOLUTIONS TO EXERCISES

EXERCISE 4-1 (18–20 minutes)

Computation of net income

Change in assets:	**\$79,000 + \$45,000 + \$127,000 – \$47,000 = \$204,000 Increase**
Change in liabilities:	**\$ 82,000 – \$51,000 = 31,000 Increase**
Change in stockholders' equity:	**\$173,000 Increase**

Change in stockholders' equity accounted for as follows:

Net increase		**\$ 173,000**
Increase in common stock	**\$125,000**	
Increase in paid-in capital in excess of par	**13,000**	
Decrease in retained earnings due to dividend declaration	**(19,000)**	
Net increase accounted for		**(119,000)**
Increase in retained earnings due to net income		**\$ 54,000**

EXERCISE 4-2 (10–15 minutes)

Sales revenue	$310,000
Cost of goods sold	140,000
Gross profit	170,000
Selling administrative expenses	50,000
	120,000
Other revenues and gains	
Gain on sale of plant assets	30,000
Income from operations	150,000(a)
Interest expense	6,000
Income from continuing operations	144,000
Loss on discontinued operations	(12,000)
Net Income	132,000(b)
Allocation to noncontrolling interest	(40,000)
Net income attributable to controlling shareholders	$ 92,000(c)

Net income	$132,000
Unrealized gain on available-for-sale investments	10,000
Comprehensive income	$142,000(d)

Net income	$132,000
Dividends	(5,000)
12/31/14 Retained earnings	$127,000(e)

EXERCISE 4-3 (25–35 minutes)

(a) Total net revenue:

Sales revenue		$390,000
Less: Sales discounts	$ 7,800	
Sales returns	12,400	20,200
Net sales		369,800
Dividend revenue		71,000
Rent revenue		6,500
Total net revenue		$447,300

(b) Net income:

Total net revenue (from a)	$447,300
Expenses:	
Cost of goods sold	184,400
Selling expenses	99,400
Administrative expenses	82,500
Interest expense	12,700
Total expenses	379,000
Income before income tax	68,300
Income tax	31,000
Net income	$ 37,300

(c) Dividends declared:

Ending retained earnings	$134,000
Beginning retained earnings	114,400
Net increase	19,600
Less: Net income	37,300
Dividends declared	$ 17,700

EXERCISE 4-3 (Continued)

ALTERNATE SOLUTION

Beginning retained earnings	$114,400
Add: Net income	37,300
	151,700
Less: Dividends declared	?
Ending retained earnings	$134,000

Dividends declared must be $17,700
($151,700 – $134,000)

(d) Income attributed to controlling stockholders = (Net income – Allocation to noncontrolling interest)
$37,300 - $ $17,000 = $ 20,300

EXERCISE 4-4 (20–25 minutes)

LEROI JONES INC.
Income Statement
For Year Ended December 31, 2014

Revenues		
Net sales ($1,250,000[b] – $17,000)		$1,233,000
Expenses		
Cost of goods sold..	500,000	
Selling expenses...	400,000[c]	
Administrative expenses...............................	100,000[a]	
Interest expense..	20,000	
Total expenses		1,020,000
Income before income tax		213,000
Income tax		63,900

Net income	**$ 149,100**
Earnings per share..	**$ 7.46***

***Rounded**

EXERCISE 4-4 (Continued)

Determination of amounts

(a)	**Administrative expenses**	**=**	**20% of cost of good sold**
		=	**20% of $500,000**
		=	**$100,000**
(b)	**Gross sales X 8%**	**=**	**administrative expenses**
		=	**$100,000 ÷ 8%**
		=	**$1,250,000**
(c)	**Selling expenses**	**=**	**four times administrative expenses. (operating expenses consist of selling and administrative expenses; since selling expenses are 4/5 of operating expenses, selling expenses are 4 times administrative expenses.)**
		=	**4 X $100,000**
		=	**$400,000**

Earnings per share $7.46 ($149,100 ÷ 20,000)

<u>Note:</u> An alternative income statement format is to show income tax part of expenses, and not as a separate item. In this case, total expenses are $1,083,900.

EXERCISE 4-5 (30–35 minutes)

(a)

Multiple-Step Form

P. BRIDE COMPANY
Income Statement
For the Year Ended December 31, 2014
(In thousands, except earnings per share)

Sales revenue			$96,500
Cost of goods sold			60,570
Gross profit			35,930
Operating Expenses			
Selling expenses			
Sales commissions	$7,980		
Depr. of sales equipment	6,480		
Delivery expense	2,690	$17,150	
Administrative expenses			
Officers' salaries	4,900		
Depr. of office furn. and equip.	3,960	8,860	26,010
Income from operations			9,920
Other Revenues and Gains			
Rent revenue			17,230
			27,150
Other Expenses and Losses			
Interest expense			1,860
Income before income tax			25,290
Income tax			9,070
Net income			$16,220
Earnings per share ($16,220 ÷ 40,550)			$.40

(b)

Single-Step Form
P. BRIDE COMPANY
Income Statement
For the Year Ended December 31, 2014
(In thousands, except earnings per share)

Revenues		
Net sales		$ 96,500
Rental revenue		17,230
Total revenues		113,730
Expenses		
Cost of goods sold		60,570
Selling expenses		17,150
Administrative expenses		8,860
Interest expense		1,860
Total expenses		88,440
Income before income tax		25,290
Income tax		9,070
Net income		$ 16,220
Earnings per share		$.40

Note: An alternative income statement format for the single-step form is to show income tax a part of expenses, and not as a separate item.

(c) Single-step:
1. Simplicity and conciseness.
2. Probably better understood by users.
3. Emphasis on total costs and expenses and net income.
4. Does not imply priority of one revenue or expense over another.

EXERCISE 4-5 (Continued)

Multiple-step:

1. **Provides more information through segregation of operating and nonoperating items.**
2. **Expenses are matched with related revenue.**

Note to instructor: Students' answers will vary due to the nature of the question; i.e., it asks for an opinion. However, the discussion supporting the answer should include the previous points.

EXERCISE 4-6 (30–35 minutes)

MARIA CONCHITA ALONZO CORP.
Income Statement
For the Year Ended December 31, 2014

Sales Revenue		
Sales revenue		$1,380,000
Less: Sales returns and allowances	$150,000	
Sales discounts	45,000	195,000
Net sales		1,185,000
Cost of goods sold		621,000
Gross profit on sales		564,000
Operating Expenses		
Selling expenses	194,000	
Administrative and general expenses	97,000	291,000
Income from operations		273,000

EXERCISE 4-6 (Continued)

Other Revenues and Gains		
Interest revenue		86,000
		359,000
Other Expenses and Losses		
Interest expense		60,000
Income before income tax and extraordinary item		299,000
Income tax ($299,000 X .34)		101,660
Income before extraordinary item		197,340
Extraordinary item—loss from earthquake damage	$150,000	
Less: Applicable income tax reduction		
($150,000 X .34)	51,000	99,000
Net income		$ 98,340
Per share of common stock:		
Income before extraordinary item		
($197,340 ÷ 100,000)		$1.97*
Extraordinary item (net of tax)		(.99)
Net income ($98,340 ÷ 100,000)		$ .98

*Rounded

EXERCISE 4-7 (30–40 minutes)

(a)

Multiple-Step Form
LATIFA SHOE CO.
Income Statement
For the Year Ended December 31, 2014

Net sales			$980,000
Cost of goods sold			496,000
Gross profit on sales			484,000
Operating Expenses			
Selling expenses			
Salaries and Wages	$114,800		
Depr. exp. (70% X $65,000)	45,500		
Supplies	17,600	$177,900	
Administrative expenses			
Wages and salaries	135,900		
Other admin. expenses	51,700		
Depr. exp. (30% X $65,000)	19,500	207,100	385,000
Income from operations			99,000
Other Revenues and Gains			
Rent revenue			29,000
			128,000
Other Expenses and Losses			
Interest expense			18,000
Income before income tax			110,000
Income tax			37,400
Net income			$ 72,600
Earnings per share ($72,600 ÷ 20,000)			$3.63

EXERCISE 4-7 (Continued)

(b) **Single-Step Form**

LATIFA SHOE CO.
Income Statement
For the Year Ended December 31, 2014

Revenues	
Net sales	$ 980,000
Rent revenue	29,000
Total revenues	1,009,000
Expenses	
Cost of goods sold	496,000
Selling expenses	177,900
Administrative expenses	207,100
Interest expense	18,000
Total expenses	899,000
Income before income tax	110,000
Income tax	37,400
Net income	$ 72,600
Earnings per share ($72,600 ÷ 20,000)	$3.63

Note: An alternative income statement format for the single-step form is to show income tax as part of expenses, and not as a separate item.

(c) Single-step:

1. Simplicity and conciseness.
2. Probably better understood by users.
3. Emphasis on total costs and expenses and net income.
4. Does not imply priority of one revenue or expense over another.

EXERCISE 4-7 (Continued)

Multiple-step:

1. **Provides more information through segregation of operating and nonoperating items.**
2. **Expenses are matched with related revenue.**

Note to instructor: Students' answers will vary due to the nature of the question, i.e., it asks for an opinion. However, the discussion supporting the answer should include the above points.

EXERCISE 4-8 (15–20 minutes)

(a)	Net sales	$ 540,000
	Cost of goods sold	(210,000)
	Administrative expenses	(100,000)
	Selling expenses	(80,000)
	Discontinued operations-loss	(40,000)
	Income before income tax	110,000
	Income tax ($110,000 X .30)	33,000
	Net income	$ 77,000

(b)	Income from continuing operations before income tax	$150,000*
	Income tax ($150,000 X .30)	45,000
	Income from continuing operations	105,000
	Discontinued operations, less applicable income tax of $12,000	(28,000)
	Net income	$ 77,000

***$110,000 + $40,000**

Earnings per share:

Income from continuing operations ($105,000 ÷ 10,000)	$10.50
Loss on discontinued operations, net of tax	(2.80)
Net Income ($77,000 ÷ 10,000)	$ 7.70

EXERCISE 4-9 (30–35 minutes)

(a)

IVAN CALDERON CORP.
Income Statement
For the Year Ended December 31, 2014

Sales Revenue		
Net sales		$1,300,000
Cost of goods sold		780,000
Gross profit		520,000
Operating Expenses		
Selling expenses	$65,000	
Administrative expenses	48,000	113,000
Income from operations		407,000
Other Revenues and Gains		
Dividend revenue	20,000	
Interest revenue	7,000	27,000
		434,000
Other Expenses and Losses		
Write-off of inventory due to obsolescence		80,000
Income before income tax and extraordinary item		354,000
Income tax		120,360
Income before extraordinary item		233,640
Extraordinary item		
Casualty loss	50,000	
Less: Applicable income tax ($50,000 × .34)	17,000	(33,000)
Net income		$ 200,640
Per share of common stock:		
Income before extraordinary item ($233,640 ÷ 60,000)		$3.89*
Extraordinary item, net of tax		(.55)
Net income ($200,640 ÷ 60,000)		$3.34

*Rounded

EXERCISE 4-9 (Continued)

(b)

IVAN CALDERON CORP.
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, Jan. 1, as reported	$ 980,000
Correction for overstatement of net income in prior period (depreciation error) (net of $18,700 tax)	(36,300)
Retained earnings, Jan. 1, as adjusted	943,700
Add: Net income	200,640
	1,144,340
Less: Dividends declared	45,000
Retained earnings, Dec. 31	$1,099,340

EXERCISE 4-10 (20–25 minutes)

Computation of net income:

2014 net income after tax		$33,000,000
2014 net income before tax [$33,000,000 ÷ (1 – .34)]		50,000,000
Add back major casualty loss		18,000,000
Income from operations		68,000,000
Income tax (34% X $68,000,000)		23,120,000
Income before extraordinary item		44,880,000
Extraordinary item:		
Casualty loss	$18,000,000	
Less: Applicable income tax reduction	6,120,000	(11,880,000)
Net income		$33,000,000

EXERCISE 4-10 (Continued)

Net income	$33,000,000
Less: Provision for preferred dividends	
(8% of $4,500,000)	360,000
Income available to common stockholders	32,640,000
Common stock shares	÷10,000,000
Earnings per share	$3.26*

Income statement presentation

Per share of common stock:

Income before extraordinary item	$4.45[a]
Extraordinary item, net of tax	(1.19)[b]
Net income	$3.26

[a] $\dfrac{\$44{,}880{,}000 - \$360{,}000}{10{,}000{,}000} = \$4.45^*$ [b] $\dfrac{\$11{,}880{,}000}{10{,}000{,}000} = \$1.19^*$

*Rounded

EXERCISE 4-11 (20–25 minutes)

SPOCK CORPORATION
Income Statement
For the Year Ended December 31, 2014

Net sales[(a)]		$4,162,000
Cost of goods sold[(b)]		2,665,000
Gross profit		1,497,000
Selling expenses[(c)]	$636,000	
Administrative expenses[(d)]	491,000	1,127,000
Income from operations		370,000
Rent revenue	240,000	
Interest expense	(176,000)	64,000
Income before income tax		434,000
Income tax ($434,000 X .34)		147,560
Income before extraordinary item		286,440
Extraordinary loss	70,000	
Less: Applicable income tax	23,800	46,200
Net income		$ 240,240

Earnings per share ($900,000 ÷ $10 par value = 90,000 shares)	
Income before extraordinary item ($286,440 ÷ 90,000)	$3.18*
Extraordinary item, net of tax	(.51)*
Net income	$2.67

*Rounded

Supporting computations

(a) Net sales:
$4,275,000 – $34,000 – $79,000 = $4,162,000

(b) Cost of goods sold:
$535,000 + ($2,786,000 + $72,000 – $27,000 – $15,000) – $686,000 = $2,665,000

(c) Selling expenses:
$284,000 + $83,000 + $69,000 + $54,000 + $93,000 + $36,000 + $17,000 = $636,000

(d) Administrative expenses:
$346,000 + $33,000 + $24,000 + $48,000 + $32,000 + $8,000 = $491,000

EXERCISE 4-12 (20–25 minutes)

(a)

EDDIE ZAMBRANO CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2014

Balance, January 1, as reported	$225,000*
Correction for depreciation error (net of $10,000 tax)	(15,000)
Cumulative decrease in income from change in inventory methods (net of $14,000 tax)	(21,000)
Balance, January 1, as adjusted	189,000
Add: Net income	144,000**
	333,000
Less: Dividends declared	100,000
Balance, December 31	$233,000

*($40,000 + $125,000 + $160,000) – ($50,000 + $50,000)
**[$240,000 – (40% X $240,000)]

(b) Total retained earnings would still be reported as $233,000. A restriction does not affect total retained earnings; it merely labels part of the retained earnings as being unavailable for dividend distribution. Retained earnings would be reported as follows:

Retained earnings:	
Appropriated	$ 70,000
Unappropriated	163,000
Total	$233,000

EXERCISE 4-13 (15–20 minutes)

Net income:		
Income from continuing operations before income tax		$23,650,000
Income tax (35% X $23,650,000)		8,277,500
Income from continuing operations		15,372,500
Discontinued operations		
Loss before income tax	$3,225,000	
Less: Applicable income tax (35%)	1,128,750	(2,096,250)
Net income		$13,276,250
Preferred dividends declared:		$ 1,075,000
Weighted average common shares outstanding		4,000,000
Earnings per share		
Income from continuing operations		$3.57*
Discontinued operations, net of tax		(.52)**
Net income		$3.05***

*($15,372,500 – $1,075,000) ÷ 4,000,000. (Rounded)

**$2,096,250 ÷ 4,000,000. (Rounded)

***($13,276,250 – $1,075,000) ÷ 4,000,000.

EXERCISE 4-14 (15–20 minutes)

(a)

	2014
Income before income tax	$450,000
Income tax (35%)	157,500
Net Income	$292,500

(b) Cumulative effect for years prior to 2014.

Year	Weighted-Average	FIFO	Difference	Tax Rate (35%)	Net Effect
2012	$370,000	$395,000	$25,000		
2013	390,000	430,000	40,000		
		Total	$65,000	$22,750	$42,250

(c)

	2014	2013	2012
Income before income tax	$450,000	$430,000	$395,000
Income tax (35%)	157,500	150,500	138,250
Net income	$292,500	$279,500	$256,750

EXERCISE 4-15 (15–20 minutes)

(a)

ROXANNE CARTER CORPORATION
Statement of Comprehensive Income
For the Year Ended December 31, 2014

Sales revenue	$1,200,000
Cost of goods sold	750,000
Gross profit	450,000
Selling and administrative expenses	320,000
Net income	130,000
Unrealized holding gain, net of tax	18,000
Comprehensive income	$ 148,000

(b)

ROXANNE CARTER CORPORATION
Income Statement and Comprehensive Income Statement
For the Year Ended December 31, 2014

Sales	$1,200,000
Cost of goods sold	750,000
Gross profit	450,000
Selling and administrative expenses	320,000
Net income	$ 130,000
Comprehensive Income	
Net income	$ 130,000
Unrealized holding gain	18,000
Comprehensive income	$ 148,000

EXERCISE 4-16 (15–20 minutes)

C. REITHER CO.
Statement of Stockholders' Equity
For the Year Ended December 31, 2014

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock
Beginning balance	$520,000	$ 90,000	$80,000	$350,000
Comprehensive income				
Net income*	120,000	120,000		
Other comprehensive income				
Unrealized holding loss	(60,000)		(60,000)	
Comprehensive income				
Dividends	(10,000)	(10,000)		
Ending balance	$570,000	$200,000	$20,000	$350,000

*($700,000 – $500,000 – $80,000).

EXERCISE 4-17 (30–35 minutes)

(a) **ROLAND CARLSON INC.**
Income Statement
For the Year Ended December 31, 2014

Revenues		
Sales revenue		$1,900,000
Rent revenue		40,000
Total revenues		1,940,000
Expenses		
Cost of goods sold		850,000
Selling expenses		300,000
Administrative expenses		240,000
Total expenses		1,390,000
Income from continuing operations before income tax		550,000
Income tax		187,000
Income from continuing operations		363,000
Discontinued operations		
Loss on discontinued operations	$75,000	
Less: Applicable income tax reduction	25,500	(49,500)
Income before extraordinary items		313,500
Extraordinary items:		
Extraordinary gain	95,000	
Less: Applicable income tax	32,300	62,700
		376,200
Extraordinary loss	60,000	
Less: Applicable income tax reduction	20,400	(39,600)
Net income		$ 336,600
Per share of common stock:		
Income from continuing operations ($363,000 ÷ 100,000)		$3.63
Loss on discontinued operations, net of tax		(.49)
Income before extraordinary items ($313,500 ÷ 100,000)		3.14
Extraordinary gain, net of tax		.63
Extraordinary loss, net of tax		(.40)
Net income ($336,600 ÷ 100,000)		$3.37

(b)

ROLAND CARLSON INC.
Comprehensive Income Statement
For the Year Ended December 31, 2014

Net income	$336,600
Other comprehensive income	
Unrealized holding gain, net of tax	15,000
Comprehensive income	$351,600

(c)

ROLAND CARLSON INC.
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, January 1	$600,000
Add: Net income	336,600
	936,600
Less: Dividends declared	150,000
Retained earnings, December 31	$786,600

TIME AND PURPOSE OF PROBLEMS

Problem 4-1 (Time 30–35 minutes)
Purpose—to provide the student with an opportunity to prepare a multi-step income statement and a retained earnings statement. A number of special items such as loss from discontinued operations, unusual items, and ordinary gains and losses are presented in the problem for analysis purposes.

Problem 4-2 (Time 25–30 minutes)
Purpose—to provide the student with an opportunity to prepare a single-step income statement and a retained earnings statement. The student must determine through analysis the ending balance in retained earnings.

Problem 4-3 (Time 30–40 minutes)
Purpose—to provide the student with an opportunity to analyze a number of transactions and to prepare a partial income statement. The problem includes discontinued operations, an extraordinary item, and the cumulative effect of a change in accounting principle.

Problem 4-4 (Time 45–55 minutes)
Purpose—to provide the student with the opportunity to prepare multiple-step and single-step income statements and a retained earnings statement from the same underlying information. A substantial number of operating expenses must be reported in this problem unlike Problem 4-1. As a consequence, the problem is time-consuming and emphasizes the differences between the multiple-step and single-step income statement.

Problem 4-5 (Time 20–25 minutes)
Purpose—to provide the student with a problem on the income statement treatment of (1) a change that is usual but infrequently occurring, (2) an extraordinary item and its related tax effect, (3) a correction of an error, and (4) earnings per share. The student is required not only to identify the proper income statement treatment but also to provide the rationale for such treatment.

Problem 4-6 (Time 25–35 minutes)
Purpose—to provide the student with an opportunity to prepare a retained earnings statement. A number of special items must be reclassified and reported in the income statement. This problem illustrates the fact that ending retained earnings is unaffected by the choice of disclosing items in the income statement or the retained earnings statement, although the income reported would be different.

Problem 4-7 (Time 25–35 minutes)
Purpose—to provide the student with a problem to determine the reporting of several items, which may get special treatment as irregular items. This is a good problem for a group assignment.

SOLUTIONS TO PROBLEMS

PROBLEM 4-1

DICKINSON COMPANY
Income Statement
For the Year Ended December 31, 2014

Sales revenue		$25,000,000
Cost of goods sold		16,000,000
Gross profit		9,000,000
Selling and administrative expenses		4,700,000
Income from operations		4,300,000
Other revenues and gains		
Interest revenue	$ 70,000	
Gain on the sale of investments	110,000	180,000
Other expenses and losses		
Write-off of goodwill		820,000
Income from continuing operations before income tax		3,660,000
Income tax		1,244,000
Income from continuing operations		2,416,000
Discontinued operations		
Loss on operations, net of applicable tax	90,000	
Loss on disposal, net of applicable tax	440,000	(530,000)
Income before extraordinary item		1,886,000
Extraordinary item—loss from flood damage, net of applicable tax		390,000
Net income		$ 1,496,000

Earnings per share:		
Income from continuing operations		$ 4.67[a]
Discontinued operations		
Loss on operations, net of tax	$(0.18)	
Loss on disposal, net of tax	(0.88)	(1.06)
Income before extraordinary item		3.61[b]
Extraordinary loss, net of tax		(0.78)
Net income		$ 2.83[c]

PROBLEM 4-1 (Continued)

DICKINSON COMPANY
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, January 1		$ 980,000
Add: Net income		1,496,000
		2,476,000
Less Dividends declared on:		
Preferred stock	$ 80,000	
Common stock	250,000	330,000
Retained earnings, December 31		$ 2,146,000

[a] $\dfrac{\$2,416,000 - \$80,000}{500,000 \text{ shares}} = \$4.67$

[b] $\dfrac{\$1,886,000 - \$80,000}{500,000 \text{ shares}} = \$3.61$

[c] $\dfrac{\$1,496,000 - \$80,000}{500,000 \text{ shares}} = \$2.83$

PROBLEM 4-2

THOMPSON CORPORATION
Income Statement
For the Year Ended December 31, 2014

Revenues		
Net sales ($1,100,000 – $14,500 – $17,500)	$1,068,000	
Gain on disposal of land	30,000	
Rent revenue	18,000	
Total revenues		$1,116,000
Expenses		
Cost of goods sold*	645,000	
Selling expenses	232,000	
Administrative expenses	99,000	
Total expenses		976,000
Income before income tax		140,000
Income tax		53,900
Net income		$ 86,100
Earnings per share ($86,100 ÷ 30,000)		$2.87

*Cost of goods sold: Can be verified as follows:

Inventory, Jan. 1		$ 89,000
Purchases	$610,000	
Less: Purchase discounts	10,000	
Net purchases	600,000	
Add: Freight-in	20,000	620,000
Inventory available for sale		709,000
Less: Inventory, Dec. 31		64,000
Cost of goods sold		$ 645,000

PROBLEM 4-2 (Continued)

THOMPSON CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, January 1	$160,000
Add: Net income	86,100
	246,100
Less: Cash dividends	45,000
Retained earnings, December 31	$201,100

PROBLEM 4-3

MAHER INC.
Income Statement (Partial)
For the Year Ended December 31, 2014

Income from continuing operations			
before income tax			$838,500[a]
Income tax			220,350[b]
Income from continuing operations			618,150
Discontinued operations			
Loss from disposal of recreational division	$115,000	(1)	
Less: Applicable income tax reduction	34,500		(80,500)
Income before extraordinary item			537,650
Extraordinary item:			
Major casualty loss	90,000	(2)	
Less: Applicable income tax reduction	41,400		(48,600)
Net income			$489,050

(1) $115,000 × 30% (2) $90,000 × 46%

Per share of common stock:	
Income from continuing operations	$5.15*
Discontinued operations, net of tax	(0.67)*
Income before extraordinary items	4.48
Extraordinary item, net of tax	(0.40)
Net income ($489,050 ÷ 120,000)	$4.08

*Rounded

[a]Computation of income from cont. operations before taxes:

As previously stated		$790,000
Loss on sale of securities		(57,000)
Gain on proceeds of life insurance policy ($150,000 – $46,000)		104,000
Error in computation of depreciation		
As computed ($54,000 ÷ 6)	$9,000	
Corrected ($54,000 – $9,000) ÷ 6	(7,500)	1,500
As restated		$838,500

PROBLEM 4-3 (Continued)

(b) Computation of income tax:

Income from continuing operations before taxes..........	**$838,500**
Nontaxable income (gain on life insurance)..................	**(104,000)**
Taxable income..	**734,500**
Tax rate	**X .30**
Income tax...	**$220,350**

<u>Note</u>: No adjustment is needed for the inventory method change, since the new method is reported in 2014 income. The cumulative effect on prior years of retroactive application of the new inventory method will be recorded in retained earnings.

PROBLEM 4-4

(a)

TWAIN CORPORATION
Income Statement
For the Year Ended June 30, 2014

Sales		
Sales revenue		$1,578,500
Less: Sales discounts	$31,150	
Sales returns and allowances	62,300	93,450
Net sales		1,485,050
Cost of goods sold		896,770
Gross profit		588,280
Operating Expenses		
Selling expenses		
Sales commissions	97,600	
Salaries and wages expense	56,260	
Travel expense	28,930	
Delivery expense	21,400	
Entertainment expense	14,820	
Telephone and Internet expense	9,030	
Maintenance and repairs expense	6,200	
Depreciation expense	4,980	
Bad debt expense	4,850	
Miscellaneous selling expenses	4,715	248,785
Administrative Expenses		
Maintenance and repairs expense	9,130	
Property tax expense	7,320	
Depreciation expense	7,250	
Supplies expense	3,450	
Telephone and Internet expense	2,820	
Office expenses	6,000	35,970
Income from operations		303,525

PROBLEM 4-4 (Continued)

<u>Other Revenues and Gains</u>		
Dividend revenue		38,000
<u>Other Expenses and Losses</u>		
Interest expense		18,000
Income before income tax		323,525
Income tax		102,000
Net income...		$221,525
Earnings per common share		
[($221,525 – $9,000) ÷ 80,000]........................		$2.66*

*Rounded

TWAIN CORPORATION
Retained Earnings Statement
For the Year Ended June 30, 2014

Retained earnings, July 1, 2013, as reported.......		$337,000
Correction of depreciation understatement, net of tax..		(17,700)
Retained earnings, July 1, 2013, as adjusted		319,300
Add: Net income		221,525
		540,825
Less:		
Dividends declared on preferred stock	$ 9,000	
Dividends declared on common stock........	37,000	46,000
Retained earnings, June 30, 2014.........................		$494,825

PROBLEM 4-4 (Continued)

(b)

TWAIN CORPORATION
Income Statement
For the Year Ended June 30, 2014

<u>Revenues</u>	
Net sales	$1,485,050
Dividend revenue	38,000
Total revenues	1,523,050
<u>Expenses</u>	
Cost of goods sold	896,770
Selling expenses	248,785
Administrative expenses	35,970
Interest expense	18,000
Total expenses	1,199,525
Income before income tax	323,525
Income tax	102,000
Net income	$ 221,525
Earnings per common share	$2.66

TWAIN CORPORATION
Retained Earnings Statement
For the Year Ended June 30, 2014

Retained earnings, July 1, 2013, as reported		$337,000
Correction of depreciation understatement, net of tax		(17,700)
Retained earnings, July 1, 2013 as adjusted		319,300
Add: Net income		221,525
		540,825
Less:		
Dividends declared on preferred stock	$ 9,000	
Dividends declared on common stock	37,000	46,000
Retained earnings, June 30, 2014		$494,825

PROBLEM 4-5

1. The usual but infrequently occurring charge of $8,500,000 should be disclosed separately, assuming it is material. This charge is shown above income before extraordinary items and would not be reported net of tax. This item should be separately disclosed to inform the users of the financial statements that this item is nonrecurring and therefore may not impact next year's results. Furthermore, trend comparisons may be misleading if such an item is not highlighted and adjustments made. The item should not be considered extraordinary because it is usual in nature.

2. The extraordinary item of $6,000,000 should be reported net of tax in a separate section for extraordinary items. An adjustment should be made to income taxes to report this amount at $21,400,000. The $2,000,000 tax effect of this extraordinary item should be reported with the extraordinary item. The reason for the separate disclosure is much the same as that given above for the separate disclosure of the usual, but infrequently occurring item. Readers must be informed that certain revenue and expense items may be unusual and infrequent, and that their likelihood for affecting operations again in the future is unlikely.

3. The adjustment required for correction of an error is inappropriately labeled and also should not be reported in the retained earnings statement. Changes in estimate should be handled in current and future periods through the income statement. Catch-up adjustments are not permitted. To restate financial statements every time a change in estimate occurred would be extremely costly. In addition, adjusting the beginning balance of retained earnings is inappropriate as the increased charge in this case affects current and future income statements.

4. Earnings per share should be reported on the face of the income statement and not in the notes to the financial statements. Because such importance is ascribed to this statistic, the profession believes it necessary to highlight the earnings per share figure. In this case the company should report both income before extraordinary item and net income on a per share basis.

PROBLEM 4-6

(a)

ACADIAN CORP.
Retained Earnings Statement
For the Year Ended December 31, 2014

Retained earnings, January 1, as reported	$257,600
Correction of error from prior period (net of tax)	25,400
Adjustment for change in accounting principle (net of tax)	(23,200)
Retained earnings, January 1, as adjusted	259,800
Add: Net income	52,300*
Less: Cash dividends declared	32,000
Retained earnings, December 31	$280,100

*$52,300 = ($84,500 + $41,200 + $21,600 – $35,000 – $60,000)

(b)

1. Gain on sale of investments—body of income statement. This gain should not be shown net of tax on the income statement.
2. Refund on litigation with government—body of income statement, possibly unusual item. This refund should not be shown net of tax on the income statement.
3. Loss on discontinued operations—body of the income statement, following the caption, "Income from continuing operations."
4. Write-off of goodwill—body of income statement, possibly unusual item. The write-off should not be shown net of tax on the income statement.

PROBLEM 4-7

WADE CORP.
Income Statement (Partial)
For the Year Ended December 31, 2014

Income from continuing operations before income tax			$1,200,000*
Income tax			456,000**
Income from continuing operations			744,000
Discontinued operations			
Loss from operations of discontinued subsidiary	$ 90,000		
Less: Applicable income tax reduction ($90,000 × .38)	34,200	$ 55,800	
Loss from disposal of subsidiary	100,000		
Less: Applicable income tax reduction ($100,000 × .38)	38,000	62,000	(117,800)
Income before extraordinary item			626,200
Extraordinary item:			
Gain on condemnation		125,000	
Less: Applicable income tax		50,000*	75,000
Net income			$ 701,200

* $125,000 × 40%

Per share of common stock:

Income from continuing operations	$4.96
Discontinued operations, net of tax	(0.79)
Income before extraordinary item	4.17
Extraordinary item, net of tax	0.50
Net income ($701,200 ÷ 150,000)	$4.67

PROBLEM 4-7 (Continued)

***Computation of income from continuing operations before income tax:**

As previously stated	**$1,210,000**
Loss on sale of equipment [$40,000 – ($80,000 – $30,000)]	**(10,000)**
Restated	**$1,200,000**

****Computation of income tax:**

$1,200,000 X .38 = $456,000

Note: The error related to the intangible asset was correctly charged to retained earnings.

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 4-1 (Time 20–25 minutes)
Purpose—to provide the student with the opportunity to comment on deficiencies in an income statement format. The student is required to comment on such items as inappropriate heading, incorrect classification of special items, proper net of tax treatment, and presentation of per share data.

CA 4-2 (Time 20–25 minutes)
Purpose—to provide the student an illustration of how earnings can be managed. The case allows students to see the effects of warranty expense timing on the trend of income and illustrates the potential use of accruals to smooth earnings.

CA 4-3 (Time 15–20 minutes)
Purpose—to provide the student an illustration of how earnings can be managed by how losses are reported, including ethical issues.

CA 4-4 (Time 30–35 minutes)
Purpose—to provide the student with an unstructured case to comment on the reporting of discontinued operations and extraordinary items. In addition, the student is asked to comment on materiality considerations and earnings per share implications.

CA 4-5 (Time 30–40 minutes)
Purpose—to provide the student with the opportunity to comment on deficiencies in an income statement. This case includes discussion of extraordinary items, discontinued items, and ordinary gains and losses. The case is complete and therefore provides a broad overview to a number of items discussed in the textbook.

CA 4-6 (Time 20–25 minutes)
Purpose—to provide the student with a variety of situations involving classification of special items. This case is different from CA 4-5 in that an income statement is not presented. Instead, short factual situations are described. A good comprehensive case for discussing the presentation of special items.

CA 4-7 (Time 10–15 minutes)
Purpose—to provide the student with an opportunity to show how comprehensive income should be reported.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 4-1

The deficiencies of O'Malley Corporation's income statement are as follows:

1. The heading is inappropriate. The heading should include the name of the company and the period of time for which the income statement is presented.

2. Gain on recovery of insurance proceeds should be classified as an extraordinary item in a separate section of the income statement.

3. Cost of goods sold is usually listed as the first expense, followed by selling, administrative, and other expenses.

4. Advertising expense is a selling expense and should usually be classified as such, unless this expense is unusually different from previous periods.

5. Loss on obsolescence of inventories might be classified as an unusual item and separately disclosed if it is unusual or infrequent but not both.

6. Loss on discontinued operations requires a separate classification after income from continuing operations and before presentation of income before extraordinary item.

7. Intraperiod income tax allocation is required to relate income tax expense to income from continuing operations, loss on discontinued operations, and the extraordinary item.

8. Per share data is a required presentation for income from continuing operations, discontinued operations, income before extraordinary item, extraordinary item, and net income.

CA 4-2

(a) Earnings management is often defined as the planned timing of revenues, expenses, gains and losses to smooth out bumps in earnings. In most cases, earnings management is used to increase income in the current year at the expense of income in future years. For example, companies prematurely recognize sales in order to boost earnings. Earnings management can also be used to decrease current earnings in order to increase income in the future. The classic case is the use of "cookie jar" reserves, which are established, by using unrealistic assumptions to estimate liabilities for such items as loan losses, restructuring charges and warranty returns.

(b)

Proposed Accounting	2011	2012	2013	2014	2015
Income before warranty expense				$43,000	$43,000
Warranty expense				7,000	3,000
Income	$20,000	$25,000	$30,000	$36,000	$40,000

Assuming the same income before warranty expense for both 2014 and 2015 and total warranty expense over the 2-year period of $10,000, this proposed accounting results in steadily increasing income over the two-year period.

CA 4-2 (Continued)

(c) **Appropriate Accounting**

	2011	2012	2013	2014	2015
Income before warranty expense				$43,000	$43,000
Warranty expense				5,000	5,000
Income	$20,000	$25,000	$30,000	$38,000	$38,000

The appropriate accounting would be to record $5,000 of warranty expense in 2014, resulting in income of $38,000. However, with the same amount of warranty expense in 2015, Bobek no longer shows an increasing trend in income. Thus, by taking more expense in 2014, Bobek can save some income (a classic case of "cookie-jar" reserves) and maintain growth in income.

CA 4-3

(a) The ethical issues involved are integrity and honesty in financial reporting, full disclosure, accountant's professionalism, and job security for Charlie.

(b) If Charlie believes the losses are relevant information important to users of the income statement, he should disclose the losses separately. If they are considered incidental to the company's normal activities—i.e., the major activities of the Kelly Corporation do not include selling equipment—the transactions should be reported among any gains and losses that occurred during the year.

CA 4-4

(a) It appears that the sale of the Casino Knights Division would qualify as a discontinued operation. The operation of gambling facilities appears to meet the criteria for discontinued operations for Simpson Corp. and, therefore, the accounting requirements related to discontinued operations should be followed. Although the financial vice-president might be correct theoretically, professional pronouncements require that such segregation be made. The controller is incorrect in stating that the disposal of the Casino Knights Division should be reported as an extraordinary item. A separate classification is required for disposals meeting the requirements of discontinued operations. If this disposal did not meet the requirements for disposal of a component of a business, extraordinary item treatment might be considered appropriate.

(b) The "walkout" or strike should not be reported as an extraordinary item. Events of this nature are a general risk that any business enterprise takes and should not warrant extraordinary item treatment. FASB ASC 225-20-45 specifically indicates that the effects of a strike should not be reported as an extraordinary item.

(c) The financial vice-president is incorrect in his/her observations concerning the materiality of extraordinary items. The materiality of each extraordinary item must be considered individually. It is not appropriate to consider only the materiality of the net effect. Each extraordinary item must be reported separately on the income statement.

(d) Earnings per share for income from continuing operations, discontinued operations, income before extraordinary items, extraordinary items, and net income must be reported on the face of the income statement.

CA 4-5

The income statement of Walters Corporation contains the following weaknesses in classification and disclosure:

1. **Sales taxes.** Sales taxes have been erroneously included in both gross sales and cost of goods sold on the income statement of Walters Corporation. Failure to deduct these taxes directly from customer billings results in a deceptive inflation of the amount of sales. These taxes should be deducted from gross sales because the corporation acts as an agent in collecting and remitting such taxes to the state government.

2. **Purchase discounts.** Purchase discounts should not be treated as revenue by being lumped with other revenues such as dividends and interest. A purchase discount is more logically a reduction of the cost of purchases because revenue is not created by purchasing goods and paying for them. In a cash transaction, cost is measured by the amount of the cash consideration. In a credit transaction, however, cost is measured by the amount of cash required to settle immediately the obligation incurred. The discount should reduce the cost of goods sold to the amount of cash that would be required to settle the obligation immediately.

3. **Recoveries of accounts written off in prior years.** These collections should be credited to the allowance for doubtful accounts unless the direct write-off method was used in accounting for bad debt expense. Generally, the direct write-off method is not allowed.

4. **Delivery expense.** Although delivery expense (sometimes referred to as freight-out) is an expense of selling and is therefore reported properly in the statement, freight-in is an inventoriable cost and should have been included in the computation of cost of goods sold. The value assigned to inventory should represent the value of the economic resources given up in obtaining goods and readying them for sale.

5. **Loss on discontinued styles.** This type of loss, though often substantial, should not be treated as an extraordinary item because it is apparently typical of the customary business activity of the corporation. It should be reported in “Costs and expenses” as an operating expense.

6. **Loss on sale of marketable securities.** This item should be reported as a separate component of income from continuing operations and not as an extraordinary item. The conditions of unusual in nature and infrequent in occurrence are not met.

7. **Loss on sale of warehouse.** This type of item is specifically excluded by FASB ASC 225-20-45 from treatment as an extraordinary item unless such a loss is the direct result of a major casualty, an expropriation, or a prohibition under a newly enacted law or regulation. This item should be separately disclosed as an unusual item, if either unusual in nature or infrequent in occurrence.

8. **Federal Income taxes.** The provision for federal income taxes and intraperiod tax allocation are not presented in the income statement. This omission implies that the federal income tax is a distribution of net income instead of an operating expense and a determinant of net income. This assumption is not as relevant to the majority of financial statement users as the concept of net income to investors, stockholders, or residual equity holders. Also, by law the corporation must pay federal income taxes whether the benefits it receives from the government are direct or indirect. Finally, those who base their decisions upon financial statements are thought to look to net income as being a more relevant measure of income than income before taxes.

CA 4-6

	Classification	Rationale
1.	No disclosure.	Error has "washed out"; that is, subsequent income statement compensated for the error. However, prior year income statements should be restated.
2.	Extraordinary item section.	Material, unusual in nature, and infrequent in occurrence.
3.	Depreciation expense in body of income statement, based on new useful life.	Material item, but change in estimated useful life is considered part of normal business activity.
4.	No separate disclosure unless material.	Change in estimate, considered part of normal business activity.
5.	Reported in body of the income statement, possibly as an unusual item.	Sale does not meet criteria for either the disposal of a component of the business or an extraordinary item.
6.	Adjustment to the beginning balance of retained earnings.	A change in inventory methods is a change in accounting principle and prior periods are adjusted.
7.	Reported in body of the income statement, possibly as an unusual item.	Loss on preparation of such proposals is not considered extraordinary in nature.
8.	Reported in body of the income statement, possibly as an unusual item.	Strikes are not considered extraordinary in nature.
9.	Prior period adjustment, adjust beginning retained earnings.	Corrections of errors are shown as prior period adjustments.
10.	Extraordinary item section.	Material, unusual in nature, and infrequent in occurrence.
11.	Discontinued operations section.	Division's assets, results of operations, and activities are clearly distinguishable physically, operationally, and for financial reporting purposes.

CA 4-7

(a) **Separate Statement**

	Current Year	Prior Year
. . . income components . . .		
Net income	$400,000	$410,000

Comprehensive Income Statement		
Net income	$400,000	$410,000
Unrealized gains	15,000	
Comprehensive income	$415,000	$410,000

(b) **Combined Format**

. . . income components . . .		
Net income	$400,000	$410,000
Other comprehensive income		
Unrealized gains	15,000	
Comprehensive income	$415,000	$410,000

(c) Nelson can choose either approach, according to FASB ASC 220-10-45. The method chosen should be based on which one provides the most useful information. For example, Nelson should not choose the combined format because the gains result in an increasing trend in comprehensive income, while net income is declining.

FINANCIAL REPORTING PROBLEM

(a) **P&G uses the multiple-step income statement because it separates operating from nonoperating activities. A multiple-step income statement is used to recognize additional relationships related to revenues and expenses. P&G recognizes a separation of operating transactions from nonoperating transactions. As a result, trends in income from continuing operations should be easier to understand and analyze. Disclosure of operating income may assist in comparing different companies and assessing operating efficiencies.**

(b) **P&G operates in the consumer products market. The company separates its operations into six global segments: (sales by segment)**

Fabric and Home Care,	30%
Beauty,	24%
Baby and Family Care,	19%
Health Care,	14%
Snacks and Pet Care,	4%
Grooming,	9%

(c) **P&G's gross profit (Net Sales – Cost of Products Sold) was $41,791 million in 2011, $41,019 million in 2010, and $38,004 million in 2009. P&G's gross profit increased by 2% in 2011 compared to 2010. The gross profit percentage declined slightly from 2010 to 2011 due primarily to higher commodity and energy costs. (see MD&A).**

(d) **P&G probably makes a distinction between operating and nonoperating revenue for the reasons mentioned in the solution to Part (a). By separating out these revenue and expense items, the statement reader can see the separate impacts of operating and financing activities.**

(e) **P&G reports the following ratios in its 11-year "Financial Summary" section: Net earnings margin and Earnings and Dividends per share. The Financial Summary also reports income statement items, such as advertising and research and development expenses and operating income.**

COMPARATIVE ANALYSIS CASE

(a) Both companies are using the multiple-step format in presenting income statement information. Companies use the multiple-step income statement to recognize additional relationships related to revenues and expenses. Both companies distinguish between operating and nonoperating transactions. As a result, trends in income from continuing operations should be easier to understand and analyze. Disclosure of operating income may assist in comparing different companies and assessing operating efficiencies.

The Coca-Cola Company shows an additional intermediate component of income—gross profit. PepsiCo does not report this information on its income statement.

(b) The gross profit, operating profit, and net income for these two companies are as follows:

PepsiCo	2011	2010	2009	% Change
Net revenue	$66,504	$57,838	$43,232	53.83%
Cost of sales	31,593	26,575	20,099	57.19%
Gross profit	34,911	31,263	23,133	50.91%
Operating profit	9,633	8,332	8,004	20.35%
Net income	6,443	6,320	5,946	8.36%

Coca-Cola	2011	2010	2009	% Change
Sales	$46,542	$35,119	$30,990	50.18%
Cost of sales	18,216	12,693	11,088	64.29%
Gross profit	28,326	22,426	19,902	42.33%
Operating income	10,154	8,449	8,231	23.36%
Net income	$8,572	$11,809	$6,824	25.62%

As shown in the table above, however, Coca-Cola had greater growth in net income from 2009 to 2011. PepsiCo reported stronger growth in net sales over the three-year period. Both companies are doing well.

(c) Coca-Cola has reported gains on the equity transactions related to bottling operations. PepsiCo reported gains on its equity investments. PepsiCo provided the following disclosure for Items Affecting Comparability:

ITEMS AFFECTING COMPARABILITY

The year-over-year comparisons of our financial results are affected by the following items:

53rd Week

In 2011, we had an additional week of results (53rd week), Our fiscal year ends on the last Saturday of each December, resulting in an additional week of results every five or six years. The 53rd week increased 2011 net revenue by $623 million and operating profit by $109 million ($64 million after-tax or $0.04 per share).

Inventory Fair Value Adjustments

In 2011, we recorded $46 million ($28 million after-tax or $0.02 per share) of incremental costs in cost of sales related to fair value adjustments to the acquired Inventory included in WBD's balance sheet at the acquisition date and hedging contracts included in PBG's and PAS's balance sheets at the acquisition date. In 2010, we recorded $398 million ($333 million after-tax or $0.21 per share) of incremental costs related to fair value adjustments to the acquired inventory and other related hedging contracts included in PBG's and PAS's balance sheets at the acquisition date. Substantially all of these costs were recorded in cost of sales.

Venezuela Currency Devaluation

As of the beginning of our 2010 fiscal year, we recorded a one- time $120 million net charge related to our change to hyperinflationary accounting for our Venezuelan businesses and the related devaluation of the bolivar. $129 million of this net charge was recorded in corporate unallocated expenses, with the balance (income of $9 million) recorded in our PAB segment. In total, this net charge had an after-tax impact of $120 million or $0.07 per share.

Asset Write- Off

In 2010, we recorded a $145 million charge ($92 million after- tax or $0.06 per share) related to a change in scope of one release in our ongoing migration to SAP software. This change was driven, in part, by a review of our North America systems strategy following our acquisitions of PBG and PAS. This change does not impact our overall commitment to continue our Implementation of SAP across our global operations over the next few years.

Foundation Contribution

In 2010, we made a $100 million ($64 million after- tax or $0.04 per share) contribution to The PepsiCo Foundation, Inc., in order to fund charitable and social programs over the next several years. This contribution was recorded in corporate unallocated expenses.

Debt Repurchase

In 2010, we paid $672 million in a cash tender offer to repurchase $500 million (aggregate principal amount) of our 7.90% senior unsecured notes maturing in 2018. As a result of this debt repurchase, we recorded a $178 million charge to interest expense ($114 million after- tax or $0.07 per share), primarily representing the premium paid in the tender offer.

Non-GAAP Measures

Certain measures contained in this Annual Report are financial measures that are adjusted for items affecting comparability (see "Items Affecting Comparability" for a detailed list and description of each of these items), as well as, in certain instances, adjusted for foreign currency. These measures are not in accordance with Generally Accepted Accounting Principles (GAAP). Items adjusted for currency assume foreign currency exchange rates used for translation based on the rates in effect for the comparable prior-year period. In order to compute our constant currency results, we multiply or divide, as appropriate, our current year U.S. dollar results by the current year average foreign exchange rates and then multiply or divide, as appropriate, those amounts by the prior year average foreign exchange rates. We believe investors should consider these non-GAAP measures in evaluating our results as they are more indicative of

our ongoing performance and with how management evaluates our operational results and trends. These measures are not, and should not be viewed as, a substitute for U.S. GAAP reporting measures.

In the discussions of net revenue and operating profit below, *effective net pricing* reflects the year-over-year impact of discrete pricing actions, sales incentive activities and mix resulting from selling varying products in different package sizes and in different countries. Additionally, acquisitions and divestitures reflect all mergers and acquisitions activity, including the impact of acquisitions, divestitures and changes in ownership or control in consolidated subsidiaries and nonconsolidated equity investees.

Servings

Since our divisions each use different measures of physical unit volume (i.e., kilos, gallons, pounds and case sales), a common servings metric is necessary to reflect our consolidated physical unit volume. Our divisions' physical volume measures are converted into servings based on U.S. Food and Drug Administration guidelines for single- serving sizes of our products.

In 2011, total servings increased 6% compared to 2010. Excluding the impact of the 53rd week, total servings increased 5% compared to 2010. In 2010, total servings increased 7% compared to 2009. 2011 servings growth reflects an adjustment to the base year (2010) for divestitures that occurred in 2011, as applicable.

FINANCIAL STATEMENT ANALYSIS CASE 1

(a) Depending on the company chosen, student answers will vary. Given the ready availability, the analysis for Walgreens is provided below:

Z-Score Analysis

$$Z = \frac{\text{Working Capital}}{\text{Total Assets}} \times 1.2 + \frac{\text{Retained Earnings}}{\text{Total Assets}} \times 1.4 + \frac{\text{EBIT}}{\text{Total Assets}} \times 3.3 + \frac{\text{Sales}}{\text{Total Assets}} \times .99 + \frac{\text{MV Equity}}{\text{Total Liabilities}} \times 0.6$$

Walgreens ($ 000,000)

	2011	2010		Z-Score	Z-Score
			Multiple	2011	2010
Total Assets	$27,454	$26,275			
Current Assets	$12,322	$11,922			
Current Liabilities	$ 8,083	$ 7,433			
Working Capital	$ 4,239	$4,489			
Working Capital/Assets	0.154	0.171	1.2	0.1853	0.2050
Retained Earnings	$18,877	$16,848			
Retained Earnings/Assets	0.688	0.641	1.4	0.9626	0.8977
EBIT	$ 4,365	$ 3,458			
EBIT/Assets	0.159	0.132	3.3	0.525	0.434
Sales	$72,184	$67,420			
Sales/Assets	2.629	2.566	0.99	2.603	2.540
MV Equity	$31,880	$26,159			
Total Liabilities	$12,607	$11,875			
MV Equity/Total Liabilities	2.529	2.203	0.6	1.517	1.323
Market Price (8/31/11)	35.21	26.88	Z-Score	5.793	5.400
(8/31/10) ycharts.com	905.42	973.18			
Total Equity	$14,847	$14,400			

FINANCIAL STATEMENT ANALYSIS CASE 1 (Continued)

Deere & Co. ($ 000,000)

	Oct. 31, 2011	Oct. 31, 2010	Weights	Z-Score 2011	Z-Score 2010
Total Assets	48,207.4	43,266.8			
Current Assets	38,816.7	33,366.8			
Current Liabilities	17,720.5	14,364.0			
Working Capital	21,096.20	19,002.80			
Working Capital/Assets	0.438	0.439	1.2	0.526	0.527
Retained Earnings	14,519.4	12,353.1			
Retained Earnings/ Assets	0.301	0.286	1.4	0.421	0.400
EBIT	$6,904.80	$5,661.90			
EBIT/Assets	0.143	0.131	3.3	0.472	0.432
Sales	29,466.1	23,573.2			
Sales/Assets	0.611	0.545	0.99	0.605	0.540
MV Equity	$30,505.90	$32,552.45			
Total Liabilities	41,392.50	36,963.40			
MV Equity*/Total Liabilities	0.737	0.881	0.6	0.442	0.529
			Total	2.466	2.426

*Market price X Shares Outstanding		
Market Price (10/31/11 and 10)	$73.70	$76.80
Share Outstanding	413.92	423.86
Total Equity	6,814.9	6,303.4

(b) Walgreens' Z-score in 2011 has increased but is still well above the cutoff score for companies that are unlikely to fail. The company has improved on just about all components of the Z-score.

Deere's Z-score analysis indicates its likelihood of bankruptcy is more tenuous. Its value in 2011 is below the likely cutoff but above the very likely cutoff. The Z-score has increased slightly in 2011.

Note to instructors—as an extension, students could be asked to conduct the analysis on companies which are in financial distress (e.g., Xerox) to examine whether their financial distress could have been predicted in advance.

(c) EBIT is an operating income measure. By adding back items less relevant to predicting future operating results (interest, taxes), it is viewed as a better indicator of future profitability.

FINANCIAL STATEMENT ANALYSIS CASE 2

Earnings (loss) per common share	
Earnings from continuing operations	
($97,700,000 ÷ 177,636,000)	**$0.55**
Discontinued operations	**(0.20)**
Earnings before extraordinary item	**0.35**
Extraordinary items	**(0.03)***
Net earnings ($56,100,000 ÷ 177,636,000)	**$0.32**

***$.01 rounding difference.**

FINANCIAL STATEMENT ANALYSIS CASE 3

(a) **Assumptions and estimates related to items such as bad debt expense, warranties, or the useful lives or residual values for fixed assets could result in income being overstated.**

(b) **See the table below.**

December 31, 2011	Price	EPS	Sales per Share	P/E	PSR
Tootsie Roll	$23.67	$0.76	$ 9.13	31.1	2.59
Hershey	61.78	2.85	$36.95	21.7	1.67

(c) **Tootsie Roll has a higher P/E relative to Hershey by 43%. Tootsie Roll's PSR is also higher than Hershey's but by much more than 30%. Thus, Tootsie Roll's stock may be overpriced.**

Accounting

COUNTING CROWS, INC.
Income Statement
For the Year Ending December 31, 2014

Revenues		
Sales revenue		$1,900,000
Rent revenue		40,000
Total revenues		1,940,000
Expenses		
Cost of goods sold		850,000
Selling expenses		300,000
Administrative expenses		240,000
Income tax expense		187,000
Total expenses		1,577,000
Income from continuing operations		363,000
Discontinued operations		
Loss on discontinued operations	$75,000	
Less: Applicable income tax reduction	25,500	(49,500)
Income before extraordinary items		313,500
Extraordinary items:		
Extraordinary gain	95,000	
Less: Applicable income tax	32,300	62,700
Net income		$ 376,200

Per share of common stock:	
Income from continuing operations ($363,000 ÷ 100,000)	$3.63
Loss on discontinued operations, net of tax	(0.50)
Income before extraordinary items ($313,500 ÷ 100,000)	3.13
Extraordinary gain, net of tax	0.63
Net income ($376,200 ÷ 100,000)	$3.76

COUNTING CROWS, INC.
Retained Earnings Statement
For the Year ended December 31, 2014

Retained earnings, January 1	$600,000
Net income	376,200
Dividends declared	(80,000)
Retained earnings, December 31	$896,200

COUNTING CROWS, INC.
Statement of Comprehensive Income
For the Year ended December 31, 2014

Net income	$376,200
Other comprehensive income:	
Unrealized holding gain, net of tax	15,000
Comprehensive income	$391,200

Analysis

The multiple-step income statement recognizes important relationships between income statement elements. For example, by separating operating transactions from nonoperating transactions, the statement user can distinguish between elements with differing implications for future operating results. In addition, the multiple-step format generally groups costs and expenses with related revenues (e.g., cost of goods sold with sales revenue to yield a gross profit measure). Finally, the multiple-step format highlights certain intermediate components of income that analysts use to compute ratios for assessing the performance of the company.

Principles

Pro forma reporting is inconsistent with the conceptual framework's qualitative characteristic of comparability. For example, similar to the discussion in the opening story, if Counting Crows Inc. classifies some items in a pro forma manner but other companies do not, investors and creditors will not be able to compare the reported incomes. This is the reason the SEC issued Regulation G, which requires companies that issue pro forma income reports to provide a reconciliation to net income measured under GAAP, which interested parties can then compare across companies.

PROFESSIONAL RESEARCH

(a) **FASB ASC 220 – Presentation, Comprehensive Income. The predecessor standard for this topic is FAS No. 130 Reporting Comprehensive Income (Issued June, 1997). By following this Codification String: Presentation > 220 Comprehensive Income > 10 Overall > 5 Background and then click on Printer-Friendly with sources, FAS 130 is identified; you can then go to www.fasb.org/st/ to find the issue date.**

(b) **The definition of comprehensive income (Master Glossary of ASC): The change in equity (net assets) of a business entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.**

(c) **Classifications within net income and examples (FASB ASC 220-10-45-7):**

45-7 [Items included in net income are displayed in various classifications. Those classifications can include income from continuing operations, discontinued operations and extraordinary items. This Subtopic does not change those classifications or other requirements for reporting results of operations.]

(d) **The classifications within other comprehensive income (220-10-45-13):**

45-13 [Items included in other comprehensive income shall be classified based on their nature. For example, other comprehensive income shall be classified separately into foreign currency items, gains or losses associated with pension or other postretirement benefits, prior service costs or credits associated with pension or other postretirement benefits, transition assets or obligations associated with pension or other postretirement benefits, and unrealized gains and losses on certain investments in debt and equity securities. Additional classifications or additional items within current classifications may result from future accounting standards.

(e) Reclassification adjustments (FASB ASC 220-10-45-15)

45-15 Reclassification adjustments shall be made to avoid double counting in comprehensive income items that are displayed as part of net income for a period that also had been displayed as part of other comprehensive income in that period or earlier periods. For example, gains on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains in the period in which they arose must be deducted through other comprehensive income of the period in which they are included in net income to avoid including them in comprehensive income twice (see paragraph 320-10-40-2).

PROFESSIONAL SIMULATION

Explanation

As indicated in the income statement below, the loss on abandonment is reported as an "other expense and loss." The gain on disposal of a business component is reported as part of discontinued operations, net of tax. The change in inventory costing from FIFO to average cost is a change in accounting principle. The cumulative effect of a change in accounting principle is adjusted through the beginning balance of retained earnings.

Measurement

Answers are revealed in the income statement below.

JUDE LAW CORPORATION
Income Statement
For the Year Ended December 31, xxxx

Sales		$3,200,000
Cost of goods sold		1,920,000
Gross profit		1,280,000 (a)
Selling expenses	$340,000	
Administrative expenses	280,000	620,000
Income from operations		660,000
Other revenues and gains		
Interest revenue	10,000	
Other expenses and losses		
Loss from plant abandonment	40,000	(30,000)
Income from continuing operations before income tax		630,000 (b)
Income tax (30% X $630,000)		189,000
Income from continuing operations		441,000 (c)
Discontinued operations		
Gain on disposal of component of business	90,000	
Less: Applicable income tax	27,000	63,000

Income before extraordinary item		**504,000**
Extraordinary item		
Loss from earthquake	**40,000**	
Less: Applicable income tax	**12,000**	**28,000**
Net income		**$476,000 (d)**
Per share of common stock		
Income from continuing operations		**$4.41**
Discontinued operations, net of tax		**.63**
Income before extraordinary item		**5.04**
Extraordinary item, loss from earthquake, net of tax		**(0.28)**
Net income		**$4.76 (e)**

Note to instructor: The change for inventory costing is reflected in the current year's cost of goods sold. If comparative statements are presented, prior year's income statements would be recast as under the new method. The cumulative effect of the change in accounting principle is shown as an adjustment to beginning retained earnings.

IFRS CONCEPTS AND APPLICATION

IFRS4-1

Companies are required to present an analysis of expenses classified either by their nature (such as cost of materials used, direct labor incurred, delivery expense, advertising expense, employee benefits, depreciation expense, and amortization expense) or their function (such as cost of goods sold, selling expenses, and administrative expenses).

IFRS4-2

(a) A loss on discontinued operations is reported, net of tax in a separate section between income from continuing operations and net income.

(b) Noncontrolling interest is reported as a separate item below net income or loss as an allocation of the net income or loss (not as an item of income or expense).

IFRS4-3

Bradshaw should report this item similar to other unusual gains and losses. While under U.S. GAAP, companies are required to report an item as extraordinary if it is unusual in nature and infrequent in occurrence, extraordinary item reporting is prohibited under IFRS.

IFRS4-4

Sales revenue		$310,000	
Cost of goods sold		140,000	
Selling and administrative expenses		50,000	
Gain on sale of plant assets		30,000	
Income from operations		150,000	(a)
Interest expense		6,000	
Income from continuing operations		144,000	
Discontinued operations		(12,000)	
Net income		$132,000	(b)
Attributable to:			
Non-controlling interest		(40,000)	
Controlling shareholders		92,000	(c)
Retained earnings, beginning of year		$ 0	
Net income	$132,000		
Unrealized gain on non-trading equity securities	10,000	142,000	
Comprehensive income		142,000	(d)
Dividends declared and paid		(5,000)	
Retained earnings, end of year		$137,000	(e)

IFRS4-5

(a) Some of the differences are:

1. Units of currency—Avon reports in pounds sterling and Earnings per share in pence.
2. Terminology—Interest revenue and expense are referred to as "Finance Income" and "Finance costs", and Avon uses the term "exceptional for unusual items. This should not be confused with the term "extraordinary" in U.S. GAAP. IFRS does not allow extraordinary item reporting.
3. Avon provides a breakout of operating profit into before exceptional items and exceptional items in 2010. The details for these items are explained in the footnotes (see http://www.avon-rubber.com/corporate/reports/Avon_Rubber_Report_Account_11.pdf). They are comprised of such items as profit on disposal of fixed assets and fixed asset impairments.

IFRS4-5 (Continued)

(b) Both the "Exceptional items" and the "Discontinued operations" are example of irregular items. As in the U.S., these items are included in the measurement of income but they are separate from "Operating Profit", likely due to their non-recurring nature. IFRS companies also report interest revenue and expense under a separate heading in the income statement. This distinguishes income from the operating and financing activities of the company.

IFRS4-6

(a) International Accounting Standard 1, Presentation of Financial Statements addresses the statement of comprehensive income reporting. This standard was issued in September 2007 and includes subsequent amendments resulting from IFRSs issued up to 30 November 2008. Its effective date is 1 January 2009.

(b) Total comprehensive income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. Total comprehensive income comprises all components of 'profit or loss' and of 'other comprehensive income' (Paragraph 7).

(c) Paragraphs 85 and 86 provide the rationale for presenting additional information: An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance (Para. 85).

IFRS4-6 (Continued)

Because the effects of an entity's various activities, transactions and other events differ in frequency, potential for gain or loss and predictability, disclosing the components of financial performance assists users in understanding the financial performance achieved and in making projections of future financial performance. An entity includes additional line items in the statement of comprehensive income and in the separate income statement (if presented), and it amends the descriptions used and the ordering of items when this is necessary to explain the elements of financial performance. An entity considers factors including materiality and the nature and function of the items of income and expense. For example, a financial institution may amend the descriptions to provide information that is relevant to the operations of a financial institution. An entity does not offset income and expense items unless the criteria in paragraph 32 are met (Para. 86).

(d) When items of income or expense are material, an entity shall disclose their nature and amount separately (Para. 97). Circumstances that would give rise to the separate disclosure of items of income and expense include:

a. write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;
b. restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
c. disposals of items of property, plant and equipment;
d. disposals of investments;
e. discontinued operations;
f. litigation settlements; and
g. other reversals of provisions.
(Para. 98).

IFRS4-7

(a) **M&S uses a condensed format income statement. This format provides highlights of a company's performance without presenting unnecessary detailed computations.**

(b) **M&S's primary revenue sources are from General merchandise (£4,195.1m) and from Food (£4,673.1m).**

(c) **M&S's gross profit was £3,724.7m in 2011 and increased to £3,755.2m in 2012. Gross profit increased in 2012 because Revenue increased £194m while cost of sales increased only £163.5m.**

(d) **M&S reports operating profit separately from nonoperating profit because nonoperating profit is non-recurring and not expected to arise in the future. In order to make valid comparisons between companies and years, nonoperating must be reported separately from operating profit.**

(e) **M&S did report Non-GAAP measures. The adjusted profit and earnings per share measures provide additional useful information for share-holders on the underlying performance of the business.**

M&S provided the following disclosure:

Non-GAAP performance measures
The directors believe that the underlying profit and earnings per share measures provide additional useful information for shareholders on the underlying performance of the business. These measures are consistent with how underlying business performance is measured internally. The underlying profit before tax measure is not a recognised profit measure under IFRS and may not be directly comparable with adjustment profit measures used by other companies. The adjustments made to reported profit before tax are to exclude the following:

—profits and losses on the disposal of properties;
—significant and one-off impairment charges that distort underlying trading;
—costs relating to strategy changes that are not considered normal operating costs of the underlying business;
—one-off pension credits arising on changes of the defined benefit pension scheme rules; and
—non-cash fair value movements in financial instruments.

