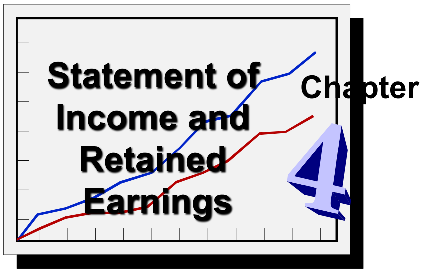

Learning Objectives

1. Identify the uses and limitations of an income statement.
2. Prepare a single-step income statement.
3. Prepare a multiple-step income statement.
4. Explain how irregular items are reported.
5. Explain intraperiod tax allocation.
6. Explain where earnings per share information is reported.
7. Prepare a statement of retained earnings.
8. Explain how other comprehensive income is reported.

Income Statement Basics

- What is an income statement?
  - Tells what happened;
  - For a STATED PERIOD;
  - Another way to think of it is "retained earnings for this period"
- Transaction based.
  - Something has to actually HAPPEN first
  - Can only purchase goodwill. But do you think that Maybe GM, Xerox, Palm, etc…names have value?
- Important Fact: Inherently relies upon estimates. Example:
  - Valuation of receivables and inventories;
  - Goodwill valuation
  - Completeness of reported impairments
- Quality of earnings
  - Is Management being conservative? Aggressive? Fraudulent? Slippery?

Elements of the Income Statement

***NOTE:* See textbook for formal definition, which is within the scope of exam possibilities!**

Revenue:
Inflow from the entities principal operations.

Expenses:
Costs of earning the revenue.

Gains & Losses:
Other income activities which are not from principal operations and which are presented "Net" on the income statement.

Income Statement Formats

Single-Step
- Concise and simple
  - Captions for (1) revenues (2) expenses
- Less detail, consequently less informative

Multiple-Step
- More complex, more subtotals
  - Captions to segregate operating activities from non-operating activities
- More detail, consequently more informative.
  - Separates operating from non-operating
  - Matches costs to revenue generating activities

Examples of Single-Step & Multiple-Step

KWIC Single step.htm

KWIC multiple step.htm

IRREGULAR ITEMS

In an attempt to provide financial statement users with the ability to better determine the long-range earning power of an enterprise, certain professional pronouncements require that the following irregular items be highlighted in the income statement.

- Unusual gains and losses. NOT net of tax
- Extraordinary items. Net of tax
- Discontinued Operations. Net of tax

- CHANGES IN ACCOUNTING PRINCIPLE ARE TREATED WITH RETROACTIVE RESTATEMENT OF PRIOR FINANCIAL STATEMENTS.

ALL BUT UNUSUAL GAINS AND LOSSES ARE PRESENTED NET OF TAX.

Unusual Gains & Losses

Items that are:
- EITHER Unusual or Infrequent, but not both (which is an extraordinary item);
- Material
- Non-Operating

Presentation:
- Separate line-item on income statement
- NOT net of tax
- Not necessarily "special"- can be lumped with other non-operating items such as interest expense.

EXAMPLES:
KWIC multiple step.htm

INTRAPERIOD TAX ALLOCATION

FANCY TERM FOR "NET OF TAX"

Certain items, which we are about to cover, are given specific attention in the income statement. These items, are excluded from the "tax provision" and presented net of tax themselves.

A Company has a 40% tax rate, and an extraordinary loss of $100,000:

- The tax impact is?

  $40,000

- So the "net of tax" amount is?

  $60,000

AND THE PRESENTATION IS:

Extraordinary loss, net of $40,000
Tax benefit $60,000

Intraperiod Tax Allocation Details

Allocation is applied to --

a. Income from continuing operations

b. Discontinued operations

c. Extraordinary items

e. Prior period adjustments (including changes in accounting principle)

Discontinued Operations

A **Discontinued Operation** occurs when

(a) the results of operations and cash flows of a component of a company have been (or will be) eliminated from the ongoing operations, and

(b) there is no significant continuing involvement in that component after the disposal transaction.

SFAS No. 144 substantially increases the occurrence of discontinued operations in financial reporting by requiring that the operations and gain/loss on disposal of all long-lived assets be reported "for all periods presented" as a discontinued operation.

Discontinued Operation Example

A company sells a rental property during the year which generated operating income of $100,000 for the year until it was sold for a $200,000 loss.

- Is this an "operating" item?

  NO

- Is this presented net of tax?

  YES

- How would it appear?

Discontinued Operation Presentation

Income from continuing operations	$500,000
Discontinued operations:	
Income from operation of disc. operation, net of tax provision of $30,000	$70,000
Loss from sale of disc. Operation, net of tax benefit of $60,000	$(140,000)
Net income	$430,000

Extraordinary Items

Requirements consider two criteria:

- **Unusual in nature and**
- **Infrequent in occurrence,.......**

Consider the environment

Are these Extraordinary Items?

A large portion of a tobacco manufacturer's crops are destroyed by a hail storm ...
Severe damage from hail storms in the locality where the manufacturer grows tobacco is rare.

Yes

Are these Extraordinary Items?

A citrus grower's Florida crop is damaged by frost. Frost damage is normally experienced every three or four years.

No

Are these Extraordinary Items?

A company which operates a chain of warehouses sells the excess land surrounding one of its warehouses. When the company buys property to establish a new warehouse, it usually buys more land than it expects to use for the warehouse with the expectation that the land will appreciate in value ....

In the past five years, there have been two instances in which the company sold such excess land.

No

Are these Extraordinary Items?

A large diversified company sells a block of shares from its portfolio of securities which it has acquired for investment purposes. This is the first sale from its portfolio of securities.

No

Are these Extraordinary Items?

An earthquake destroys one of the oil refineries owned by a large multi-national oil company.

Earthquakes are rare in this geographical location.

Yes

Are these Extraordinary Items?

The Newhall Land & Farming Company (Developer of the town of Valencia) incurred $3.7 million in earthquake damage due to the 1994 Northridge eartquake. The Company experienced eartquake damage from the Sylmar earthquake in the 1970's.

No

NLF ex item.txt

Extraordinary Item Reminders

- If an item is not unusual and infrequent and material, it is disclosed in "Other Revenues and Expenses" section of the income statement.
- Extraordinary items are presented net of tax in the income statement, below discontinued operations.

Change in accounting principle – RETROACTIVE RESTATEMENT

1999 2000 2001 2002 2003 2004 2005

- Calculate the cumulative effect of the accounting change as of the beginning of the period in which the change is made. "Fix" the ending balances by adjustment to retained earnings.
- Adjust the Account for under new method for all years presented.
- Continue accounting for under the new method.

Cumulative effect

CHANGE IN ACCOUNTING PRINCIPLE EXAMPLE

In 2009, the company changes their inventory costing principle from FIFO to weighted average. They have a 35% effective tax rate and began business in 2003. Assume they have not recorded COGS for 2009 yet.

	COGS Recorded (FIFO)	COGS If used Wtd Average
2003	10,000	11,000
2004	12,000	13,000
2005	18,000	15,000
2006	15,000	18,000
2007	16,000	12,000
2008	10,000	15,000
CUMULATIVE EFFECT	81,000	84,000
2009	17,000	15,000
TOTAL THRU 09'	98,000	99,000

COGS recorded through end of 2008	81,000
COGS if using wtd average over the same period	84,000
Cumulative effect through 12/31/08	3,000

TO GET BEGINNING BALANCES RIGHT (Catch-up 2003-2008):

Beginning retained earnings	1,950	
Tax effect	1,050	
Inventory		3,000

AMOUNT TO RECORD IN 2009 AND THEREAFTER IS DETERMINED WITH NEW PRINCIPLE

2009 entry		
COGS	15,000	
Inventory		15,000

RECAP. WHAT WE JUST DID:

COGS recorded before we started messing with it:	81,000
Cumulative effect adjustment	3,000
2009 COGS reported	15,000
Hmmm, isnt that the total we would have if we were using the new method all along!!	99,000

Changes in Estimate

Adjustments that result from periodic revisions in estimates. THEY ARE TREATED ON A "CURRENT AND FORWARD BASIS" Meaning that you account for it from the beginning of this period forward based on the new estimate

Examples ?

- Bad debt expense;
- Asset impairments;
- Depreciable lives or residual values;
- Contingent losses
- MANY MANY OTHERS

Change in Estimate Example

Dell Co., purchased equipment for $510,000 which was estimated to have a useful life of 10 years with a salvage value of $10,000 at the end of that time. Depreciation has been entered for 7 years on a straight-line basis. In 1999, it is determined that the total estimated life should be 15 years with a salvage value of $5,000 at the end of that time.

Question:

What is entry to correct the prior years' depreciation?

No Entry

Change in Estimate Example — After 7 years

Equipment			Accumulated Depreciation	
510,000				350,000
510,000				350,000

Balance Sheet

Fixed Assets:

Equipment	510,000
Accumulated depreciation	350,000
Net fixed assets	160,000

Change in Estimate Example — After 7 years

Fixed Assets:

Equipment	510,000
Accumulated depreciation	350,000
Net fixed assets	160,000
Salvage value	5,000
Depreciable base	155,000
Years remaining	8
Current year expense	19,375

Earnings Per Share

Required for each year income statement is presented:

- Capital Structure:
  - Simple
  - Complex (diluted)
- Calculation:

$$\frac{\text{Net Income - Preferred Dividends}}{\text{Weighted Average Common Shares Outstanding}}$$

Earnings per Share (EPS) required for

Calculate and present per share amounts for:
- Income from continuing operations
- Income before extraordinary items
- Net income

Recommended for:
- Discontinued operations
- Extraordinary items

EPS Example

- **If net income is $5,000,000 for the year and the weighted average shares outstanding are 10,000,000 shares, what is the net income per share?**

  $.50
- **If there was a $500,000 loss (net of tax), due to an extraordinary item, would this be presented as a "per share" amount?**

  Yes
- **How much per share?**

  $<.05>

Income Statement Summary

HANDOUT

..\Handouts\CH 4 SUMMARY.xls

Statement of Retained Earnings

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 1999

Balance, January 1	$ 1,050,000
Net income	360,000
Dividends	(300,000)
Balance, December 31	$ 1,110,000

Statement of Retained Earnings

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 1999

Balance, January 1	$	1,050,000
Net income		360,000
Dividends		(300,000)
Balance, December 31	$	1,110,000

Before issuing the report for the year ended December 31, 1999, you discover an error that caused the 1998 inventory to be overstated (overstated inventory caused COGS to be lower and thus net income to be higher in 1998).

Would this discovery have any impact on the reporting of the Statement of Retained Earnings for 1999?

Statement of Retained Earnings

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 1999

Balance, January 1, as previously reported	$	1,050,000
Prior period adjustment - error correction (NET OF TAX)		(50,000)
Balance, January 1, as restated		1,000,000
Net income		360,000
Dividends		(300,000)
Balance, December 31	$	1,060,000

Retained Earnings Example

Turgeon Corporation had retained earnings of $529,000 at January 1, 1999. Net income in 1999 was $1,496,000, and cash dividends of $650,000 were declared and paid. Prepare a 1999 retained earnings statement for Turgeon Corporation.

Also, prepare a retained earnings statement for Turgeon Corporation, assuming that in 1999 Turgeon discovered that it had overstated 1997 depreciation by $125,000 (net of tax).

Retained Earnings Example

Turgeon Corporation
Statement of Retained Earnings
For the Year Ended December 31, 1999

Balance, Jan. 1	**$ 529,000**
Net income	**1,496,000**
Dividends declared	**650,000**
Balance, Dec. 31	**$1,375,000**

Retained Earnings Example

Turgeon Corporation	
Statement of Retained Earnings	
For the Year Ended December 31, 1999	
Balance, Jan. 1, as reported	$ 529,000
Correction of error, net of tax	125,000
Balance, Jan. 1, as restated	654,000
Net income	1,496,000
Dividends declared	650,000
Balance, Dec. 31	$1,500,000

ADDITIONAL BALANCE SHEET INFORMATION

- Investments/ FAS 115
  - Held to maturity
    - Current or long-term, depending on maturity;
    - Reported at cost.
  - Trading
    - Always current;
    - Reported at fair value with gains and losses flowing through the income statement.
  - Available for sale
    - Current or long-term, depending on circumstances/ management intent;
    - Reported at fair value with gains and losses flowing through "other comprehensive income".

FAS 115 Illustrated

Purchase Investment for $100,000

Entry to record purchase is the same for all three methods:

Investments	100,000	
Cash		100,000

UNREALIZED LOSS OF $10K:

Held to Maturity

No entry

Trading

Unrealized loss (P&L)	10,000	
Investment		10,000

Available for Sale- assuming tax-free entity

Other comprehensive loss	10,000	
Investment		10,000

DIVIDENDS

All three methods report dividends received as a source of income:

AFS or TRADING or HELD TO MATURITY

If receive $1,250 divident, entry is:

Cash	$1,250	
Dividend income		1,250

Comprehensive Income

All changes in equity during a period except those resulting from investments by owners and distributions to owners.

Therefore, includes all revenues and gains, expenses and losses reported in net income, and in addition it includes gains and losses that bypass net income but affect stockholders' equity.

Three approaches to reporting Comprehensive Income (SFAS No. 130, June 1997):

1. A second separate income statement ;
2. A combined income statement of comprehensive income; or
3. as part of the statement of stockholders' equity

Option 3 above is most common and not allowed after 2012

Separate Income Statement

V. Gill Inc.
Income Statement
For the Year Ended December 31, 2002

Sales revenue	$	800,000
Cost of goods sold		600,000
Gross profit		200,000
Operating expenses		90,000
Net income	$	110,000

V. Gill Inc.
Comprehensive Income Statement
For the Year Ended December 31, 2002

Net income	$	110,000
Other comprehensive income		
Unrealized holding gain, net of tax		30,000
Comprehensive income	$	140,000

Combined Income Statement

V. Gill Inc.
Combined Statement of Comprehensive Income
For the Year Ended December 31, 2002

Sales revenue	$	800,000
Cost of goods sold		600,000
Gross profit		200,000
Operating expenses		90,000
Net income		110,000
Unrealized holding gain, net of tax		30,000
Comprehensive income	$	140,000

Stockholders' Equity Statement

V. Gill Inc.
Statement of Stockholders' Equity & Comprehensive Income
For the Year Ended December 31, 2002

	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Total
Beginning balance		50,000	60,000	300,000	410,000
Net income	110,000	110,000			110,000
Unrealized holding gain	30,000		30,000		30,000
Comprehensive income	140,000				
Ending balance		160,000	90,000	300,000	550,000

Balance Sheet Presentation

V. Gill Inc.
Balance Sheet
As of December 31, 2002
(Stockholders' Equity Section Only)

Stockholders' Equity		
Common stock	$	300,000
Retained earnings		160,000
Accumulated other comprehensive income		90,000
Total stockholders' equity	$	550,000

Regardless of the display format used, the *acculumated other comprehensive income* of $90,000 is reported in the stockholders' equity section of the balance sheet.

STATEMENT OF STOCKHOLDERS' EQUITY

Rolls-forward the balance of each of the equity accounts from their opening balance to their ending balance based on current period activity.

Account titles on top row, activity below that.

EQUITY STATEMENT EXAMPLE

BEGINNING EQUITY BALANCES		
Retained earnings		100,000
Accumulated Other Comprehensive income		15,000
Common Stock $1 par		1,000
APIC		99,000
	TOTAL EQUITY	215,000
ACTIVITY		
1	Change in accounting principle: COGS in prior periods would be $20,000 less under the new principle than what was recorded (inventory on the balance sheet would be $20,000 higher than it is)	
2	Restatement: In a prior period a sale on credit of $10,000 was erroneously	
3	Net income $50,000	
4	Available for sale securities increased in value by $5,000	
5	Sell 1,000 shares for $10,000	
6	Dividends $25,000	
-	Tax rate is 35%	
INSTRUCTIONS:		
I.	For items 1, 2, 4, 5, and 6 above, resport the appropriate journal entry	
II.	Based upon all of the above, prepare the combined statement of stockholders equity and comprehensive income.	

Journal entries from Prior slide facts

JE'S TO PRIOR SLIDE			
1	Inventory	20,000	
	Retained earnings		13,000
	Tax effect		7,000
2	Retained earnings	6,500	
	Tax effect	3,500	
	Accounts receivable		10,000
4	A.F.S Investments	5,000	
	O.C.I. Unrealized gain		3,250
	Tax effect		1,750
5	Cash	10,000	
	Common stock		1,000
	APIC		9,000
6	Retained earnings, dividends	25,000	
	Cash		25,000

SOLUTION TO PREV SLIDE

XYZ, INC.
STATEMENT OF STOCKHOLDERS EQUITY
FOR THE YEAR ENDED DECEMBER 31, 2003

	Comprehensive Income	Retained Earnings	Accumulated Other compre. Income	Common Stock	APIC	Total
Balance January 1, 2003, as previously reported		100,000	15,000	1,000	99,000	215,000
Correction of error (note __), net of $3,500 tax effect		(6,500)				(6,500)
Cumulative impact of change in accounting principle, net of $7,000 tax effect		13,000				13,000
Balance, January 1, 2003, as restated		106,500	15,000	1,000	99,000	221,500
Comprehensive income:						
Net Income	50,000	50,000				50,000
Other comprehensive income- unrealized holding loss, net of tax benefit of $1,750	3,250		3,250			3,250
Comprehensive income:	53,250					
Stock issuance				1,000	9,000	10,000
Dividends		(25,000)				(25,000)
Ending balance		131,500	18,250	2,000	108,000	259,750

XYZ EXAMPLE

XYZ HAD THE FOLLOWING INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2003

XYZ, Inc.
Statement of Operations
For the year ended December 31, 2003

Revenue	3,000,000
Cost of goods sold	900,000
Gross Profit	2,100,000
Operating expenses	
Selling expense	250,000
General & administrative expense	175,000
Depreciation expense	200,000
For convenience, net operations of sold property	100,000
	725,000
Income before income taxes	1,375,000
Income tax provision	412,500
NET INCOME	962,500

ACTIVITY FOR XYZ:

- Effective tax rate of 30%;
- $200,000 Loss from impairment of fixed assets which was infrequent, but NOT unusual;
- Earthquake damage of $2.5 million, which is infrequent and unusual;
- Sale of a property, deemed a discontinued operation under SFAS No. 144. The property generated income of $100,000 for the year and resulted in a loss on sale of $200,000;
- A change in estimated useful life of a piece of equipment. The new estimate requires the asset to be fully depreciated on December 31, 2008.
  - The net book value at the beginning of the year was $600,000 and depreciation expense recorded for the year was $75,000;
- The FASB issued a new statement which requires it to be applied as a cumulative effect of a change in accounting principle by restatement of prior periods. During 2003, the Company recorded its expense properly under the new method. The cumulative difference between the two methods as of January 1, 2003 was a $90,000 benefit (credit);
- Available for sale securities generated a loss of $100,000 during the year. GAAP requires this gain to be reflected as 'other comprehensive income;
- Retained earnings and Accumulated comprehensive income on January 1, 2003 were $300,000 and $450,000, respectively;
- It was discovered that there was a material error in the prior year (not a change in estimate or accounting principle), which overstated income by $125,000;
- Weighted average shares outstanding for the year were 5,000,000.
- The common stock balance was $5,000,000 as of January 1, 2003. There were no share sales or repurchases during the year.

Prepare a multiple-step income statement and statement of stockholders equity (including comprehensive income) for XYZ based on the facts on this and the previous slide

SOLUTION - IncomeStatement

XYZ, Inc.
Statement of Operations
For the year ended December 31, 2003

Revenue	3,000,000	
Cost of goods sold	900,000	
Gross Profit	2,100,000	
Operating expenses		
Selling expense	250,000	
General & administrative expense	175,000	
Depreciation expense	225,000	*+25K change in estimate*
For convenience, net operations of sold property	-	Moved to disc. Ops
	650,000	
Other expense: Impairment of fixed assets	200,000	*New*
Income before income taxes, discont. Operations and ex- items	1,250,000	
Income tax provision	375,000	
Income from continuing operations	875,000	*Changed due to above*
Discontinued operatins:	*Description updated*	
Income from operations of discontinued operations, net of tax provision of $30,000	70,000	All new
Loss from sale, net of tax benefit of $60,000	(140,000)	Based on
Income before extraordinary items	805,000	New
Extraordinary loss- earthquake damage, net of tax benefit of $750,000	(1,750,000)	Activity
NET LOSS	(945,000)	
Per share of common stock (5,000,000 wtd avg outstanding)		
Income from continuing operations	0.18	
Income from operations of discontinued operations, net of tax provision	0.01	
Loss from sale of disc. Operation- net of tax	(0.03)	
Income before extraordinary items	0.16	
Extraordinary loss- net of tax	(0.35)	
Net Loss	(0.19)	

SOLUTION- STATEMENT OF EQUITY

XYZ, INC.					
STATEMENT OF STOCKHOLDERS EQUITY AND COMPRHENSIVE INCOME					
FOR THE YEAR ENDED DECEMBER 31, 2003					
	Comprehensive Income	**Retained Earnings**	**Accumulated Other compre. Income**	**Common Stock**	**Total**
Balance January 1, 2003, as previously reported		300,000	450,000	5,000,000	5,750,000
Correction of error (note __), net of $37,500 tax benefit		(87,500)			(87,500)
Cumulative impact of change in accounting principle, net of $27,000 tax provision		63,000			63,000
Balance, January 1, 2003, as restated		275,500	450,000	5,000,000	5,725,500
Comprehensive loss:					
Net Loss	(945,000)	(945,000)			(945,000)
Other comprehensiveloss- unrealized holding loss, net of tax benefit of $30,000	(70,000)		(70,000)		(70,000)
Comprehensive loss:	(1,015,000)				
Ending balance		(669,500)	380,000	5,000,000	4,710,500