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PART 5

Income and Cash Flows

Manpower Inc. is a world leader in employment services, providing clients with temporary, contract, and permanent employees. The company is often cited as a bellwether for the health of the job market as well as the overall economy. From 2007 to 2008, annual revenues rose from $20.5 billion to $21.6 billion, a 5.1 percent jump in a difficult economic environment. Yet profits fell 55 percent, from $485 million to $219 million. At the same time, cash flows from operations increased an outstanding 83 percent, from $432 million to $792 million. Three different measures of operating success seemed to be moving in vastly different directions. How can revenues shoot up, while profits lag and operating cash flows jump so dramatically? These kinds of questions are addressed in Chapters 13 and 14, which cover the income statement and statement of cash flows, respectively.

CHAPTER 13
The Complete Income Statement

CHAPTER 14
The Statement of Cash Flows

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CHAPTER 13 The Complete Income Statement

KEY POINTS

The following key points are emphasized in this chapter:

- **Economic consequences associated with reporting net income.**
- **Two different concepts of income: matching and fair market value.**
- **A framework for financing, investing, and operating transactions.**
- **Categories that constitute a complete income statement and how they provide measures of income that address the objectives of financial reporting.**
- **Intraperiod tax allocation.**
- **Earnings per share disclosure on the income statement.**

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The income statement from pharmaceutical giant Merck's 2009 annual report is provided below (dollars in billions).

	2009	2008	2007
Sales	**$27.4**	**$23.8**	**$24.2**
Costs and expenses:			
Materials and production	**(9.0)**	**(5.6)**	**(6.1)**
Marketing and administrative	**(8.5)**	**(7.4)**	**(7.6)**
Research and development	**(5.8)**	**(4.8)**	**(4.9)**
Restructuring costs	**(1.6)**	**(1.0)**	**(0.3)**
Equity income from affiliates	**2.2**	**2.6**	**3.0**
U.S. Vioxx settlement charge	**0**	**0**	**(4.9)**
Other income	**10.7**	**2.3**	**0.1**
Income before taxes	**15.3**	**9.9**	**3.5**
Taxes on income	**2.3**	**2.0**	**0.1**
Net income	**$13.0**	**$ 7.9**	**$ 3.4**

Net income appears to have increased from $3.4 billion (2007) to $7.9 billion (2008) to $13 billion (2009), a very steep upward slope both in terms of raw numbers and as a percentage of sales. Indeed, Merck's future looks rosy! Yet, what about expense and income items like restructuring costs, equity income, the Vioxx settlement, and "other" income? They have all been included in the net income calculation, but are they part of Merck's core operations, and can they be expected to persist in the future? And taxes—why only $0.1 billion in 2007, but $2.3 billion in 2009? The rules governing income statement disclosure, which are covered in this chapter, are designed to help.

This chapter covers (1) the economic consequences associated with income measurement and disclosure, (2) conceptual issues of income measurement, and (3) the disclosure rules that must be followed when preparing an income statement.

THE ECONOMIC CONSEQUENCES ASSOCIATED WITH INCOME MEASUREMENT AND DISCLOSURE

Income is the most common measure of a company's performance. It has been related to stock prices, suggesting that equity investors use income in their decisions to buy and sell equity securities. An article in the *Journal of Accountancy* stated that "[accounting] research . . . has provided some well-established conclusions. Perhaps the most conclusive finding is the importance of accounting income to investors." Almost daily the *Wall Street Journal* reports how stock prices respond to corporate earnings reports.

Income has also been related to bond prices, which indicates that debt investors use income in their decisions to buy and sell corporate bonds. Credit-rating agencies, such as Standard & Poor's and Dun & Bradstreet, use income numbers to establish credit ratings. In response to "improved financial statements," for example, Standard & Poor's raised the credit rating on bonds issued by two of China's top four banks (Bank of China and China Construction Bank) from BBB− to BB+ which, in turn, increased the market value of their outstanding debt. In addition, three of Dun & Bradstreet's fourteen key business ratios (return on sales, return on assets, and return on net worth) explicitly use a measure of income in the formula, and most of the numbers used in the remaining eleven ratios are indirectly affected by the dollar amount of reported income.

Due to the importance attached to income, periodic public earnings announcements, which appear in newspapers such as the *Wall Street Journal* and in corporate

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annual reports, are also considered important news items, having important effects on the economy. For example, an article in *USA Today* titled "Do Profits Matter?" noted:

Profit is the compass of the free enterprise system. When it dries up, the repercussions echo at every level of society. . . . Profits keep a free-market economy humming. They help pay for the development of new plants, products, and jobs. A sizable chunk of profits helps finance government in the form of taxes. Another chunk goes as dividends to shareholders—often the pension funds that pay for your retirement. Says an economist from the University of Chicago: "Economies . . . won't grow without corporate profit."

Various measures of income are also found in contracts written among shareholders, creditors, and managers. Such contracts are normally designed either to protect the interests of creditors or to control managers and encourage them to act in the interests of the shareholders. Loan agreements relating to the outstanding debts of Marriott Corporation, for example, limit the company's annual dividends to a portion of net income. Such covenants serve to protect the investments of corporate creditors by limiting the amount of cash that can be paid to shareholders in the form of dividends. The board of directors of pharmaceutical giant Eli Lilly encourages company employees to act in the shareholders' interests by providing incentive compensation in the form of a profit-sharing plan. As reported in the 2008 annual report, the payment of this compensation is based on changes in the company's annual earnings per share.

The measurement, definition, and disclosure of income are important to investors, creditors, managers, auditors, and the general public in a number of different ways. Students of accounting, therefore, must understand how income is measured and presented.

THE MEASUREMENT OF INCOME: DIFFERENT MEASURES FOR DIFFERENT OBJECTIVES

According to the *Statement of Financial Accounting Concepts No. 1,* the objectives of financial reporting are to provide information that is: (1) useful to those making investment and credit decisions who have a reasonable understanding of business and economic activities; (2) helpful to current and potential investors, creditors, and others in assessing the amounts, timing, and uncertainty of future cash flows; and (3) about economic resources, the claims to those resources, and changes in them.[1] Three important features of this objective relate directly to the income statement and the measure of income. The statement focuses on supplying useful information to those who provide debt and equity capital to the firm; the information should help to predict future cash flows; and the information should reflect changes (increases or decreases) in the company's resources. No single measure of income can achieve this set of broad objectives, and income statements prepared under GAAP are designed to provide a variety of different measures of income. It is important that financial statement users understand how they differ and the situations under which each should be used.

To achieve this understanding, one must be familiar with several important definitions that appear in the *Statement of Financial Accounting Concepts No. 6.*[2] Figure 13–1 contains the definitions of ten key concepts, referred to as the elements of financial statements.

1. "Objectives of Financial Reporting by Business Enterprises," *Statement of Financial Accounting Concepts No. 1* (Stamford, Conn.: FASB, November 1978), pars. 5–8.

2. "Elements of Financial Statements," *Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, December 1985), pp. ix and x.

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The objectives and elements of income under IFRS are very similar to those discussed under U.S. GAAP.

FIGURE 13–1
Elements of the financial statements

Assets. **Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.**

Liabilities. **Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.**

Equity. **Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.**

Investments by Owners. **Increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.**

Distributions to Owners. **Decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.**

Comprehensive Income. **Change in equity (net assets) of an 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.**

Revenues. **Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.**

Expenses. **Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.**

Gains. **Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.**

Losses. **Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.**

You may be familiar with many of these definitions already, but several points are of special interest here. Revenues and expenses, which are ongoing and central to the company's operations, for example, are distinguished from gains and losses, which are peripheral or incidental to operations. Revenues and expenses occur frequently and are part of a company's core activities and, therefore, are related to the company's future cash flows. Gains and losses, however, tend to be infrequent and/or tangential

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to the company's core activities. Such items would not be expected to reflect future cash flows, yet they would be part of a company's comprehensive income and reflect changes in a company's resources.

To illustrate, consider two transactions entered into by a company: (1) sale of inventory with a cost of $50 million for $75 million, and (2) winning a settlement of $25 million in a one-time lawsuit. Both transactions increased the company's net assets by $25 million, making the company wealthier. Should they be included in income and reflected on the income statement? Transaction (1) involved the sale of inventory, a transaction that occurs frequently and is part of the company's core activities. It is likely to occur again, so it both reflects future cash flows and increases the company's resources. It seems that including this transaction on the income statement helps it to meet the objectives of financial reporting under almost any definition of income. Transaction (2) is a different story. The lawsuit was one-time, so it is not expected to occur again, and winning lawsuits is not part of the company's core activities. Consequently, this transaction would not be a good indicator of future cash flows, but it did increase the company's resources. It could be included, therefore, under a broad definition of income.

Refer to the Merck income statement introduced at the beginning of this chapter. What is the Vioxx settlement charge, and should it be included on the income statement? How did including the charge in 2007 instead of 2008 affect the apparent growth of Merck's earnings? As an analyst, would you consider this expense in the same way you consider operating expenses? As reported, Merck's earnings more than doubled from 2007 to 2008. Do you agree?

Comprehensive income represents a broad definition of income, including any change in the company's equity due to nonowner transactions. In June 1997, the FASB issued *SFAS No. 130,* "Reporting Comprehensive Income," which established standards for the reporting and display of comprehensive income and its components. This concept of income encompasses items not included in the computation of net income, such as foreign currency translation adjustments and unrealized gains and losses on available-for-sale securities (see Chapter 8). The standard does not change the display or components of net income, but it requires that the components of comprehensive income be displayed with the same prominence as the other financial statements. The following disclosure, which was taken from the 2009 annual report of Campbell Soup, was placed as a part of the statement of shareholders' equity (dollars in millions).

	2009	2008	2007
Net earnings	**$ 736**	**$1,165**	**$ 854**
Foreign currency translation adjustments	**(148)**	**112**	**43**
Cash flow hedges, net of tax	**(25)**	**11**	**9**
Minimum pension liability, net of tax	**(409)**	**(136)**	**51**
Comprehensive income	**$(582)**	**$1,152**	**$(957)**

This discussion demonstrates that there are different ways to measure income, and different measures of income address different objectives of financial reporting. It also shows that the nature of individual transactions must be considered to determine if and how they should be reflected in income. The following section develops a framework for different kinds of transactions and relates them to the different measures of income used in financial statements.

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Under IFRS, an entity must present a statement of comprehensive income, often called the statement of recognized income and expenses (SORIE). The SORIE below was taken from the 2008 annual report of Unilever Group, a Dutch-based consumer-goods company that publishes IFRS-based financial statements (in million euros).

	2008	2007	2006
Net profit	5,285	4,136	5,015
Fair value gains (losses) on cash flow hedges	(118)	84	6
Fair value gains (losses) on available-for-sale securities	(46)	2	15
Actuarial gains (losses) on pensions	(2,293)	542	853
Currency retranslation gains (losses)	(1,688)	(413)	(335)
Total recognized income and expense	1,140	4,351	5,554

Which of the numbers—net profit or total recognized income and expense—represents a more accurate metric of Unilever's past performance? Which provides a better indication of future performance? Why?

Two Different Concepts of Income: Matching and Fair Market Value

Through most of the text we have described income as the result of the **matching process**—first, revenues are recognized in a particular time period in line with the principles of revenue recognition, and then the costs necessary to generate the revenues (expenses) are subtracted from them in the computation of net income. This basic procedure, illustrated below, has provided the basis for income measurement for many, many years.

Revenues (n) − Expenses (n) = Net Income (n)

Recently, there has been an increased emphasis on measuring income in terms of changes in the fair market values of a firm's assets and liabilities. IFRS relies more heavily on fair market value accounting than does U.S. GAAP, and just a few years ago the United States introduced the fair value option for financial instruments, which allows companies to book gains and losses when the values of their financial assets and liabilities change. This notion of income does not rely on a matching process. Rather, it simply computes income for a given period by comparing the fair market value of a firm's net assets (assets – liabilities) at the end of a particular period to the fair market value of the firm's net assets at the beginning of the period, as illustrated below.

FMV Net Assets (end) − FMV Net Assets (beginning) = Net Income (n)

To illustrate the difference between these two ways of measuring income, assume that you purchased a machine for $1,000. The machine had a five-year useful life, and you rented it to another company, receiving $300 per year for five years. Under the matching principle, you would capitalize the $1,000 cost of the machine, and depreciate it over the five-year life. Net income on the machine each year would be the $300 in revenue less the depreciation taken in each year. If you used straight-line depreciation ($1,000/5 = $200), net income each year would be $100 ($300 − $200). The balance sheet carrying amount (book value) of the machine would be the original cost less the accumulated depreciation.

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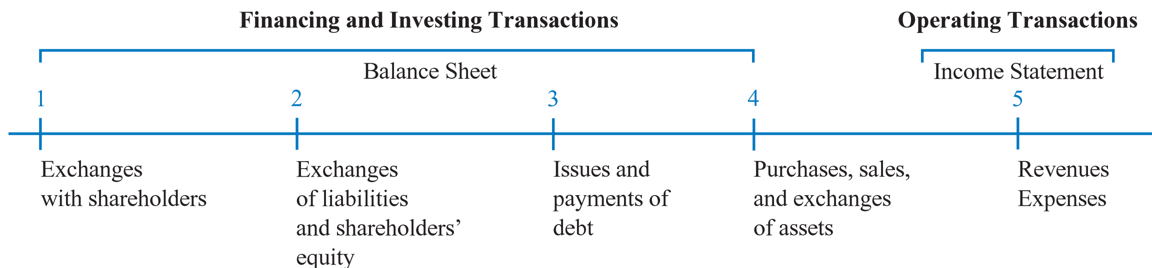
Under the fair market value approach, net income each year would be the $300 rent collected plus or minus the change in the machine's fair market value during the year. If the fair market value of the machine decreased, the amount of the decrease would be subtracted from the $300. If the fair market value increased, the increase would be added to the $300. The balance sheet carrying value of the machine would be its fair market value.

The current system of measuring income—under both U.S. GAAP and IFRS—is a hybrid of these two approaches. We still rely heavily on the recognition of revenue and the matching of expenses, but in certain cases we now book gains and/or losses when the values of certain assets (e.g., marketable securities) and liabilities change. Depending on the rules, some of these changes are reflected directly on the income statement, while others do not appear on the income statement; instead, they appear as other comprehensive income items, affecting only shareholders' equity. It is important that you understand the basics of these two forms of income measurement, and how income is reported both on the income statement and, more generally, on the statement of comprehensive income.

Financing, Investing, and Operating Transactions: A Framework

Financing and investing transactions basically involve setting up a company so that it can conduct operations, while **operating transactions** entail the actual conduct of the operations. Figure 13–2 represents a continuum for classifying financing, investing, and operating transactions. Note that five categories of transactions are described, and each is placed at a point along the continuum. Category 1 at the extreme left contains purely financing transactions, and Category 5 contains operating transactions. Categories 2, 3, and 4 increasingly resemble operating activities. Later, we point out that operating transactions can also be subdivided into categories, based primarily on how germane they are to a company's normal, everyday operating activities. Review the figure closely because we will be discussing it in detail in the following paragraphs.

FIGURE 13–2 Classifying financing, investing, and operating transactions



1. Exchanges with shareholders: stock issuances, stock redemptions, and dividend payments.
2. Exchanges of liabilities and shareholders' equity: debt refinancing and conversion of convertible bonds and stocks.
3. Issues and payments of debt: cash borrowings evidenced by notes payable, issuing bonds, and payments on debts, including the redemption of debt.
4. Purchases, sales, and exchanges of assets: purchases, sales, and exchanges of all assets.
5. Revenues: inflows of assets (or outflows of liabilities) due to operations.
   Expenses: outflows of assets (or inflows of liabilities) due to the generation of revenues.

(1) EXCHANGES WITH SHAREHOLDERS

Exchanges with owners include (1) issuances of preferred or common stock, (2) purchases, retirements, and reissuances of treasury stock, and (3) cash, property, and stock dividends. This group is located on the far left side of the continuum because these are

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purely financing transactions involved exclusively with the formation and dissolution of the company's equity capital and the returns (i.e., dividends) to the company's owners. The most distinctive and important feature of the transactions in this category is that they never affect the income statement. Even when treasury stock is reissued for an amount different from its cost, the dollar amount of the difference is not recognized as a gain or a loss on the income statement.

During 2008, clothing retailer The Gap reissued treasury stock with a cost of $24 million, receiving $23 million. Did the company recognize a $1 million loss on the reissuance? Why or why not?

(2) EXCHANGES OF LIABILITIES AND SHAREHOLDERS' EQUITY

Exchanges of liabilities and shareholders' equity refer to transactions in which liabilities are exchanged for other liabilities (debt refinancing arrangements) or converted into shareholders' equity (conversion of convertible bonds or preferred stocks to common stock). Such exchanges are considered financing transactions because they deal only with a company's capital structure. Accordingly, they generally do not affect the income statement. However, these transactions are located to the right of exchanges with shareholders because in certain limited circumstances they can give rise to gains or losses that appear on the income statement.[3]

(3) ISSUES AND PAYMENTS OF DEBT

Issues and payments of debt include cash borrowings associated with the issuance of notes or bonds payable as well as the cash payments required to service or retire such liabilities. These transactions involve exchanges with a company's creditors and thus are reflected in the liabilities section of the balance sheet. They are considered financing transactions because they involve how a company pays for its operations through debt. However, these transactions are not completely separate from a company's operations. Interest payments on debt are directly reflected on the income statement through interest expense; book gains and losses are recognized when debt is retired; premiums and discounts on notes and bonds are amortized to the income statement (via interest expense) over the life of the debt, and under the fair value option, changes in the fair market value of liabilities can be reflected in income. Consequently, this category of transactions is located to the right of exchanges of liabilities and shareholders' equity.

During 2008, Honeywell International issued long-term debt in the amount of $1.5 billion and paid $884 million to reduce debt and cover interest. How did these transactions influence the basic accounting equation, and how was the income statement affected?

(4) PURCHASES, SALES, AND EXCHANGES OF ASSETS

Category 4 includes the purchase, sale, or exchange of all assets. Such assets include marketable securities, inventories, prepaid expenses, long-term investments, and long-lived

3. The methods used to account for refinancing arrangements and the conversion of convertible bonds and stocks are complex and controversial, and we do not discuss them in this textbook. For our purposes, it is sufficient to note that, according to current generally accepted accounting principles, such transactions rarely give rise to income statement gains and losses.

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assets. These transactions, all of which are capitalized, represent both investing and operating activities. Activity involving long-term assets is considered investing, while activity involving short-term assets is considered operating. This category is located next to the operating section of the continuum because it is only a matter of time before these capitalized costs appear on the income statement. Prepaid expenses and long-lived assets, for example, are amortized, depleted, or depreciated on the income statement over their useful lives. Capitalized inventory costs, investments, and long-lived assets are matched against revenues when they are sold.[4] Also, under fair value accounting, changes in the values of these assets can be reflected in income.

During 2008, Southwest Airlines invested approximately $923 million in property and equipment. How does this transaction affect the income statement in the current year and future years?

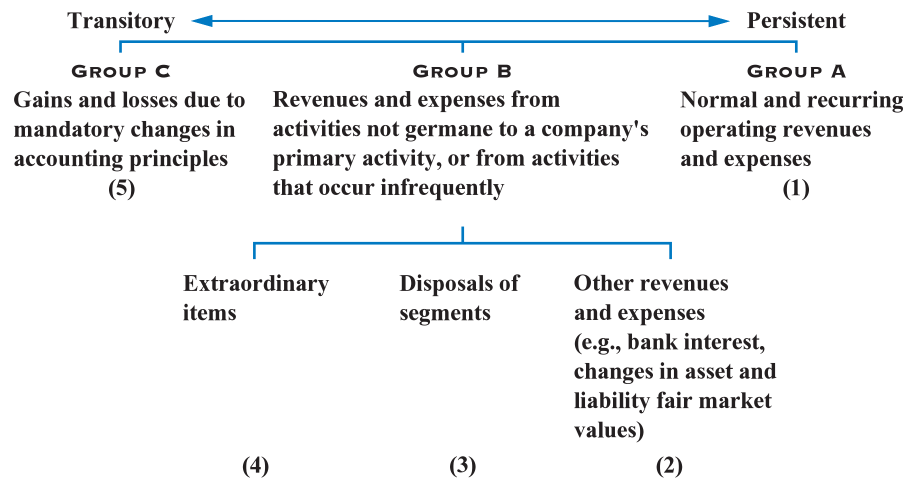
(5) REVENUES AND EXPENSES

The right side of the continuum includes exchanges that are considered operating transactions. Revenues represent inflows of assets (or outflows of liabilities) due to a company's operating activities, and in line with the matching principle, expenses represent outflows of assets (or inflows of liabilities) associated with the generation of the revenues.

Classifying Operating Transactions

Income statements include transactions ranging from those that are fundamental and necessary to a company's operations to those that are only marginally related to operations. Figure 13–3 shows three groups of operating transactions, based primarily on how germane the transactions are to the normal operations of a company and how frequently they occur.

FIGURE 13–3 Classifying operating transactions



4. Many companies also sell outstanding accounts receivable to financial institutions for immediate cash, and an income statement gain or loss is recognized in the amount of the difference between the book value of the receivable and the cash proceeds. These transfers accelerate cash collections from sales on account as well as pass on the risks and costs associated with uncollectible accounts to the financial institution. Such exchanges are called *factoring* arrangements. Sales made on credit using major credit cards, such as VISA, American Express, and MasterCard, represent factoring arrangements.

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Group A contains revenues and expenses that result from transactions that are normal to company operations and occur frequently. Examples include the sale of the company's inventories or services and the payment and recognition of expenses due to such items as wages, utilities, rent, insurance, depreciation, and other administrative and selling activities.

Group B contains items that are much less germane to the normal activities of a company or that may occur infrequently. Examples include interest earned on bank savings accounts held by manufacturing, retail, and service companies; rent earned from temporarily leasing company property planned to be used later for other purposes; gains and losses recognized on sales of long-lived assets and debt retirements; write-downs due to long-lived asset impairments and restructurings; and gains and losses related to such items as litigation, employee strikes, infrequent natural disasters, and changes in the values of certain assets and liabilities.

Group C contains gains and losses recognized from changes in accounting principles mandated by new financial standards, which reflect very little about the operations occurring during the periods in which such changes were made. They are simply bookkeeping entries that do not reflect an economic event.

In the past, there was considerable controversy over the proper classification and disclosure of the transactions contained in Groups B and C. Some accountants argued that transactions from Group C should not enter into the computation of net income. Others took an even more extreme view and suggested that transactions in both Groups B and C were not germane to operations and, accordingly, should not appear on the income statement, which should be limited to operating revenues and expenses in the strictest sense.

The accounting profession has now adopted the position that nonoperating items (Groups B and C) should be included on the income statement, but they must be separately and clearly disclosed in specific categories. Specifically, the income statement should consist of five categories: (1) operating revenues and expenses, (2) other revenues and expenses, (3) disposals of business segments, (4) extraordinary items, and (5) mandated changes in accounting principles. In terms of Figure 13–3, Category 1 corresponds to Group A, Categories 2, 3, and 4 come from Group B, and Category 5 corresponds to Group C.[5]

The different categories on the income statement allow users to assess the significance of the items in each category and to choose to include or exclude them in the computation of net income as the situation dictates. The next section defines and illustrates the five categories of a complete income statement.

From 2006 to 2008, Time Warner, Inc. included the following items on its income statement: cost of revenue, asset impairments, gain (loss) on disposal of assets, and discontinued operations. Classify each of these items in the groups illustrated in Figure 13–3.

A COMPLETE INCOME STATEMENT: DISCLOSURE AND PRESENTATION

Figure 13–4 provides an income statement that contains each of the five categories introduced in the previous section. Review the statement carefully. The following discussion first considers the income statement in general and then covers each category individually.

5. A recent financial standard requires that the financial effects of discretionary accounting changes should no longer affect net income.

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FIGURE 13–4 A complete income statement[a]

XYZ Company
Income Statement
for the Period Ending December 31, 2012

Item			Category
Gross sales		$325	1. Operating revenues
Less: Sales discounts and returns		25	
Net sales		$300	
Less: Cost of goods sold:			1. Operating expenses
Beginning inventory	$ 75		
+ Gross purchases	150		
− Purchase discounts and returns	(5)		
+ Freight-in	20		
− Ending inventory	(80)	160	
Gross profit		$140	
Operating expenses:			
Wages and salaries	$ 30		
Advertising	10		
Insurance	8		
State and local taxes	7		
Depreciation	25		
Utilities	20		
Miscellaneous	15	115	
Net operating income		$ 25	
Other revenues		10	2. Other revenues and expenses
Less: Other expenses		(13)	
Net income from continuing operations before tax		$ 22	
Less: Federal income tax		7	
Net income from continuing operations		$ 15	
Income (loss) on segment up to disposal (net of tax)		(3)	3. Disposal of business segment
Gain (loss) on disposal of segment (net of tax)		5	
Net income before extraordinary items		$ 17	
Extraordinary gain (loss) (net of tax)		(5)	4. Extraordinary item
Net income before change in accounting principle		$ 12	
Income effect due to change in accounting principle (net of tax)		7	5. Mandated changes in accounting principles
Net income		$ 19	
Earnings per share (100 shares outstanding):			
Net income from continuing operations (after tax)		$ .15	
Disposal of business segment		.02	
Extraordinary items		(.05)	
Change in accounting principle		.07	
Total earnings per share		$ .19	

[a]Most real-world income statements are variations of two basic formats: (1) single-step or (2) multistep. This income statement uses the multistep format. Under the single-step format, all revenues and expenses above “net income from continuing operations” are grouped into two separate categories. Below “net income from continuing operations,” the two formats are identical.

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The computation of net income on the income statement involves five major components, each representing one of the five categories. In general, as one moves from the top to the bottom of the income statement, the events become increasingly less important to the operations of the business. Net operating income (operating revenues less operating expenses) reflects financial performance resulting from transactions that are both fundamental to a company's normal activities and occur frequently. Other revenues and expenses and disposals of business segments reflect the financial effects of events that are either not part of a company's normal operations or do not occur frequently. Extraordinary gains and losses result from events that are both highly unusual and infrequent, and gains and losses due to mandated changes in accounting principles result simply from book entries.

The income statement is divided into these categories to enable users to distinguish transactions that are due to operations from those due to unusual, infrequent, and sometimes uncontrollable events (e.g., extraordinary items) or simply to changes in accounting principles. Presumably, measures of profit disclosed near the top of the income statement (e.g., net operating income) better reflect management's performance and are more indicative of the future than are those disclosed near the bottom of the statement (e.g., net income). The boards of directors of many companies, for example, express their management compensation agreements in terms of net operating income instead of net income. The boards apparently believe that if management acts to increase net operating income, it will increase the long-term earnings of the company and thus further the interests of the shareholders. Consider the following excerpt from a recent annual report of The Pillsbury Company:

Certain employees of the Company participate in compensation programs which include a base salary plus incentive payments based on the level of operating earnings.

(1) Operating Revenues and Expenses: Usual and Frequent

Operating revenues and expenses refer to asset and liability inflows and outflows related to the acquisition and delivery of the goods or services provided by a company. They are considered usual and frequent. The term **usual** refers to the normal operations of the business. If a company is in business to sell furniture, for example, *usual* revenues come from furniture sales. Automobile dealerships, on the other hand, are in business to sell and service automobiles; for them, revenues generated from selling office furniture would not be considered usual.

The term **frequent** refers to how often the revenue is generated or the expense incurred. Revenues and expenses are considered frequent if they are expected to recur in the foreseeable future. They are not "one-shot," unpredictable events. For many companies, the sale of a fixed asset or a long-term investment, for example, which can generate either a gain or a loss, is a transaction that tends to occur infrequently.

Which of the following two companies would likely consider a gain on the sale of investments a usual and frequent transaction—Bank of America or JCPenney? Why?

(2) Other Revenues and Expenses: Unusual or Infrequent

The section of the income statement headed "other revenues and expenses" contains revenues and expenses related to a company's secondary or auxiliary activities. The most common examples are interest income and interest expense, which relate to the

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company's investments and debt financing, respectively. While interest is important and recurring, with the exception of financial institutions, it is not directly a part of the acquisition and selling of a company's goods and services. IBM Corporation and Coca-Cola Enterprises, like many other large U.S. companies, include both interest income and interest expense in this category. Another item commonly disclosed in this section is income (or loss) from long-term investments accounted for under the equity method. Both Yahoo and AT&T, for example, disclosed equity earnings from associated companies in this manner on their 2008 income statements.

Other examples include dividend income from investments, gains and losses from price changes in trading securities, gains and losses from sales of investments and long-lived assets, long-term asset and goodwill impairments, receivable and inventory write-downs, gains and losses on foreign currency transactions, losses due to employee strikes, income from the rental of excess warehouse space, and gains and losses due to litigation. Many companies, like Hewlett-Packard, Merck, and Intel, restructured their operations during 2008 and reported the associated costs in this section of the income statement. During 2008, Boston Scientific recorded a $250 million gain on the divestiture of a subsidiary, and Sears reported a gain of $51 million on the sale of assets in the same manner. Over a recent three-year period, Goodyear Tire & Rubber Company recorded gains and losses from asset sales and write-downs, workforce reductions, and lawsuits in this section of the income statement.

The key feature of the items in this section of the income statement is that they are "unusual or infrequent, but not both." Interest and dividend income, for example, are considered unusual because they are not germane to the normal operations of the business. They are secondary to the major activities of most companies. At the same time, interest and dividend revenue may be recognized every year and are therefore considered to occur frequently. Receivables and inventory write-downs and losses from employee layoffs, on the other hand, though part of the normal business risks faced by virtually all companies, occur infrequently. They are, therefore, considered to be infrequent but not unusual.

The nature of a particular business and the environment in which it operates must be considered when deciding what is unusual and/or infrequent. Dividend and interest income, for example, are secondary to the operations of manufacturing, retailing, and service companies, yet they represent the primary revenues for financial institutions. Interest income for Bank of America Corporation, for example, normally represents 80–85 percent of total revenues generated by the company. Consequently, for Bank of America, interest income is an operating item, both usual and frequent.

In April 2008 Limited Brands sold its share of a joint venture, resulting in a gain of $128 million. Net income for Limited Brands in 2008 was $220 million. In what section of the income statement did the gain appear and why?

(3) Disposal of a Business Segment

A **business segment** is defined as a separate line of business, product line, or class of customer involving an operation that is independent from a company's other operations. Highly diversified companies consist of many independent segments. DuPont, for example, consists of nine different segments: agriculture, biomedical products, coal, fibers, industrial and consumer products, petroleum exploration, petroleum refining, marketing and transportation, and polymer products. Each of DuPont's segments generates well over $1 billion in revenue each year. The sale or discontinuance of any

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one of these segments would be referred to as a disposal of a business segment, and the related financial effects would be disclosed separately on the income statement. It is not uncommon for companies to sell major business segments. In recent years, for example, Whirlpool Corporation, Goodyear Tire & Rubber, and DuPont all disposed of major business segments. Indeed, several years ago DuPont recognized a $6 billion gain on its sale of DuPont Pharmaceuticals.

The disposal of a business segment is a significant and complex transaction that is subject to a number of detailed rules under generally accepted accounting principles. We do not cover these detailed rules here. For our purposes, it is sufficient to view the disposal of a segment as similar to the sale or retirement of a long-lived asset: more specifically, the sale or retirement of a large piece of equipment that generates revenues and incurs expenses that are independent of the company's other operations.

Note in the complete income statement in Figure 13–4 that two separate disclosures are associated with a disposed business segment. The first reflects the income or loss associated with the segment's operations for the time period extending from the previous balance sheet date to the point when the segment is actually disposed of. Since the segment is an independent entity, the expenses associated with it can be matched against its revenues to provide a net income or loss for that time period. The second disclosure reflects the gain or loss recognized when the segment is actually disposed of. At that time, the assets and liabilities of the segment are written off the books, the proceeds (if the segment is sold) are recorded, and a gain or loss on the disposal is recognized in the dollar amount of the difference between the book value of the segment and the proceeds. This dual disclosure allows users to separately ascertain both the profitability of the segment and the book gain or loss on the disposal.

To illustrate, during 2008 Campbell Soup Company sold the Godiva chocolate business, as management considered the unit not related to the "core" operations of the company. Since the earnings of this unit would no longer be part of Campbell's normal and recurring operations, GAAP requires that these earnings be disclosed separately on the income statement, along with the gain or loss from the actual sale. The disclosures below were taken from Campbell Soup's 2008 income statement (dollars in millions). They show that during 2008 the company recorded operating profits on the Godiva unit of $494 million, and after taxes the gain on sale of the unit (proceeds less costs) was $462 million. Together, these two profit numbers exceeded the profits booked by Campbell Soup associated with its continuing operations ($671 million).

Earnings from continuing operations	**$671**
Gain on sale of business, net of $236 taxes	**462**
Earnings from discontinued operations	**494**

(4) Extraordinary Items: Unusual and Infrequent

Extraordinary items are defined as material events of a character significantly different from the typical, customary business activities of an entity, which are not expected to recur frequently in the ordinary operating activities of a business. In other words, extraordinary items are both unusual and infrequent. *Accounting Trends and Techniques* (AICPA, 2009) reports that, of 500 major U.S. companies surveyed, only 2 (<1 percent) disclosed an extraordinary item on the income statement.

The concept of extraordinary items does not exist under IFRS.

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Examples of extraordinary items include gains and losses from terminating pension plans; gains and losses from litigation settlements; losses resulting from casualties like floods, earthquakes, tornadoes, hurricanes, droughts, and volcanoes; and gains and losses resulting from expropriations (forced government takeovers or purchases of company property) and prohibitions under new law. Note, however, that losses due to employee layoffs, inventory write-downs due to obsolescence, receivables write-downs, and foreign currency translation gains and losses should never be classified as extraordinary according to generally accepted accounting principles. Such items are considered to arise from normal operating business risks.

Dole, a major food company with fruit groves in many warm-weather locations, once reported two special charges—$100 million to reflect crop damage from a hurricane and $20 million to reflect damage to citrus groves caused by freezing temperatures in California. In neither case did the company consider these charges extraordinary. Explain why.

(5) Mandatory Changes in Accounting Principles

Chapter 4 defines the concept of consistency and mentions that once a company chooses an acceptable principle or method of accounting (e.g., straight-line depreciation, FIFO inventory valuation, etc.), it must continue to use that method consistently from one year to the next. Consistency helps to maintain the credibility of accounting reports, enabling investors, creditors, and other interested parties to make more meaningful comparisons and to identify more easily the trends in a company's performance across time.

Companies change their accounting methods either by choice or by mandate. Discretionary accounting changes are allowed if management can convince the independent auditor that the business environment has changed such that a new accounting method better reflects the company's economic position and performance. A recent accounting standard requires that the effects of discretionary accounting changes should not be disclosed on the income statement and therefore not influence the computation of net income. They should be handled retrospectively, which means that prior years' financial statements should be restated as if the new method was always in place. In cases where this treatment is impractical, the standard requires that the cumulative adjustment affect the beginning balance of retained earnings.

Accounting changes mandated by new financial reporting standards are implemented in the manner set forth by the standard. Some may require retrospective application; others may involve adjustments to retained earnings; and still others may be disclosed on the income statement and affect net income. For example, in recent years the FASB issued new standards covering asset impairments, goodwill, and stock option compensation. In each case, a number of companies changed their accounting methods to conform with these new standards, and these changes were accompanied by prominent disclosure in the footnotes, on the income statement, and in the audit opinion. In 2008 pharmaceutical company Eli Lilly booked a $1.9 billion charge due to adopting the new standard on accounting for asset retirements.

Mandated changes in accounting methods must be disclosed in three prominent places in the financial report: (1) The auditor's report to the shareholders must mention the change, (2) the footnotes to the financial statement must clearly describe the change, and, if applicable, (3) the cumulative effects of the change on net income must be disclosed (net of tax) separately on the income statement, immediately below extraordinary items. Figure 13–5 shows how Starbucks disclosed the accounting change in its 2006 annual report.

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FIGURE 13–5
Starbucks excerpts from the annual report

For the Year Ended October 1, 2006

NOTES TO THE FINANCIAL STATEMENTS

On October 1, 2006 Starbucks adopted FASB Interpretation No. 47 "Accounting for Conditional Asset Retirement Obligations" . . .

AUDITOR'S REPORT TO THE SHAREHOLDERS

As discussed in Note 1 . . . the Company changed its method of accounting for conditional asset retirement obligations" . . .

2006 INCOME STATEMENT (THOUSANDS OF DOLLARS)

Earnings before cumulative effect of change in accounting principle	$581,473
Cumulative effect of accounting change	(17,214)
Net earnings	$564,259

Mandated changes in accounting principles can make it more difficult to compare a company's financial performance across time because in the annual report the financial statements from periods prior to the change are prepared using the previous accounting methods. However, generally accepted accounting principles require that net income on a **pro forma (as if) basis** be disclosed on the face of the income statement for all periods presented, as if the newly adopted principle had been applied to those periods. This disclosure enables users to make more meaningful comparisons, at least across the periods presented on the face of the income statement.

One final point: It is important to realize that an accounting method differs from an accounting estimate, which is used to implement an accounting method. The allowance method of accounting for bad debts is implemented by estimating the amount of bad debts at the end of each year. This section has discussed how to account for a change in an accounting method. How to account for revisions in accounting estimates was described in Chapter 9.

?

The following excerpt was taken from information in the 2006 annual report of Avis Budget Group, Inc. (dollars in millions):

	2006	2005	2004
Income (loss) from continuing operations	($451)	($11)	$71
Income from discontinued operations, net of tax	478	1,088	1,822
Gain (loss) on disposal of discontinued operations, net of tax	(1,957)	549	198
Net income (loss) before cumulative effect of accounting change	(1,930)	1,626	2,091
Cumulative effect of accounting change, net of tax	(64)	(8)	—
	$(1,994)	$1,618	$2,091

Comment on the income trend across time before and after considering the effects of discontinued operations and the change in accounting method. Which of the trends would you consider to be more valid?

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INTRAPERIOD TAX ALLOCATION

Federal income taxes, which do not include state and local taxes, are disclosed in two different ways on the income statement. The first income tax disclosure immediately follows net income from continuing operations (before tax). It represents the tax expense resulting from all taxable revenues and deductible expenses except for those listed below it on the income statement.[6]

The dollar amounts associated with the remaining items (disposal of business segments, extraordinary items, and changes in accounting principles) are all disclosed *net of tax.* Such presentation means that each of these revenue and expense items is disclosed on the income statement after the related income tax effect has been removed. The practice of including the income tax effect of a particular transaction with the transaction itself on the income statement is known as **intraperiod tax allocation.** It enables users to assess the total financial impact of these special transactions as well as the tax benefit or cost associated with them.

For example, when Ralston Purina Company sold its Van Camp Seafood division for $260 million, the book value of Van Camp was $147.3 million, and a gain of $112.7 million was recognized on the transaction with the following journal entry (dollars in millions):

Cash (+A)	**260**	
Net Assets of Van Camp Seafood (−A)		**147.3**
Gain on Disposal of Segment (Ga, +RE)		**112.7**
Sold business segment		

The gain, however, was included in Ralston Purina's taxable income and increased the company's tax liability by $42.5 million. The increase in tax liability was recorded with the following journal entry (dollars in millions), and Ralston Purina disclosed a $70.2 million ($112.7 − $42.5) gain on its income statement. The gain appeared under disposals of business segments.

Gain on Disposal of Segment (−Ga, −RE)	**42.5**	
Income Tax Liability (+L)[7]		**42.5**
Recorded increase in tax liability		

The general formula for computing the net-of-tax dollar amount for a revenue or expense item is:

$$\text{Net-of-Tax Dollar Amount} = (\text{Gross Revenue or Expense}) \times (1 - \text{Tax Rate})$$

If, for example, an accounting change leads to a book and tax gain or loss of $10,000, and the company's federal income tax rate is 35 percent, the net-of-tax dollar amount disclosed on the income statement would be calculated as follows:

$$\begin{aligned}\text{Net-of-Tax Dollar Amount} &= \$10{,}000 \times (1 - 35\%)\\ &= \$6{,}500\end{aligned}$$

When General Electric adopted a new accounting standard concerning goodwill accounting, it booked a one-time $1.2 billion charge, but only $1 billion appeared on the income statement. Explain.

6. Appendix 10B, which covers deferred income taxes, provides a more complete description of tax expense listed in the income statement.

7. If the income tax effect of the transaction is not realized in the current year due to timing differences between tax rules and GAAP, the account "deferred income taxes" is debited or credited.

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EARNINGS-PER-SHARE DISCLOSURE

Generally accepted accounting principles also require that earnings per share be disclosed on the face of the income statement and that the specific dollar amounts associated with (1) net income from continuing operations (after tax), (2) disposals of business segments, (3) extraordinary items, and (4) changes in accounting principles be disclosed separately. Note the form of this disclosure in Figure 13–4. The earnings-per-share amount for each category is calculated by dividing the dollar amount of the gain or loss associated with that category by the number of common shares outstanding. The income statement in Figure 13–6 was taken from the 2008 annual report of Bristol-Myers Squibb. Note, in particular, the earnings-per-share disclosure near the bottom. These breakdowns allow users to focus on the components of earnings per share.

Generally accepted accounting principles require an additional disclosure, called **diluted earnings per share,** for companies that have the potential for significant dilution. Many companies, for example, have issued and presently have outstanding options to purchase their common stocks or bonds that can be converted to common stocks in the future. If and when these options and conversion privileges are exercised, the number of outstanding common shares will increase, which, in turn, will dilute the ownership interests of the existing common shareholders. The calculation of diluted earnings per share, which is described in intermediate and advanced financial accounting textbooks, reflects these possibilities by essentially increasing the denominator of the earnings-per-share ratio and thereby reducing its dollar value. The extent of potential dilution, as measured by the difference between diluted and unadjusted (basic) earnings per share, can be useful information to existing or potential shareholders who are concerned with maintaining the value of their investments.

Review the income statement of Bristol-Myers Squibb in Figure 13–6 and estimate the number of common shares outstanding as of the end of 2008, 2007, and 2006. By how much would the number of shares increase in 2008 if all potentially dilutive securities were converted to common shares?

INCOME STATEMENT CATEGORIES: USEFUL FOR DECISIONS BUT SUBJECTIVE

The income statement classifications discussed in this chapter introduce a very important concept to those who use financial accounting information to predict the future cash flows of an enterprise. The concept is called **earnings persistence,** and it reflects the extent to which a particular earnings dollar amount can be expected to continue in the future and, thus, generate future cash flows. Earnings amounts with high levels of persistence are expected to continue in the future, while those with low levels of persistence are not. The income statement classifications are useful because, for the most part, they are defined in terms of their persistence. Net operating income is the result of usual and frequent activities that can be expected to continue in the future; "other revenues and expenses" are considered to have somewhat less persistence; and disposals of segments, extraordinary items, and accounting changes are all considered to be "one-shot" events that should not be counted on in the future. Financial statement users

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FIGURE 13–6 Financial statements and supplementary data

BRISTOL-MYERS SQUIBB COMPANY
CONSOLIDATED STATEMENT OF EARNINGS
Dollars and Shares in Millions, Except Per Share Data

Item 8. FINANCIAL STATEMENT AND SUPPLEMENTARY DATA.

	Year Ended December 31		
	2008	2007	2006
EARNINGS			
Net Sales	$20,597	$ 18,193	$16,208
Costs of products sold	6,396	5,868	5,420
Marketing, selling and administrative	4,792	4,516	4,469
Advertising and product promotion	1,550	1,415	1,304
Research and development	3,585	3,227	2,951
Acquired in-process research and development	32	230	—
Provision for restructuring, net	218	183	59
Litigation expense, net	33	14	302
Gain on sale of product lines and businesses	(159)	(273)	(200)
Equity in net income of affiliates	(617)	(524)	(474)
Gain on sale of ImClone shares	(895)	—	—
Other expense, net	191	351	292
Total Expenses, net	15,126	15,007	14,123
Earnings from Continuing Operations Before Income Taxes and Minority Interest	5,471	3,186	2,085
Provision for income taxes	1,320	682	431
Minority interest, net of taxes	996	763	440
Net earnings from Continuing Operations	3,155	1,741	1,214
Discontinued Operations:	113	424	371
Earnings, net of taxes	1,979	—	—
Gain on Disposal, net of taxes	2,092	424	371
Net earnings	$ 5,247	$ 2,165	$ 1,585
Earnings per Common Share			
Basic:			
Net earnings from Continuing Operations	$ 1.60	$ 0.88	$ 0.62
Discontinued Operations:			
Earnings, net of taxes	0.05	0.22	0.19
Gain on Disposal, net of taxes	1.00	—	—
Net Earnings per Common Share	$ 2.65	$ 1.10	$ 0.81
Diluted:			
Net earnings from Continuing Operations	$ 1.59	$ 0.88	$ 0.62
Discontinued Operations:			
Earnings, net of taxes	0.05	0.21	0.19
Gain on Disposal, net of taxes	0.09	—	—
Net Earnings per Common Share	$ 2.63	$ 1.09	$ 0.81
Average Common Shares Outstanding:			
Basic	1,977	1,970	1,960
Diluted	2,001	1,980	1.963
Dividends declared per common share	$ 1.24	$ 1.15	$ 1.12

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cannot ignore these classifications since they contain valuable information about a company's future prospects.

In terms of the objectives of financial accounting, earnings numbers with high persistence are considered to reflect future cash flows, while low persistence earnings are not. Both kinds of earnings, however, reflect changes in the company's resources and in that respect are considered useful.

It is also important to realize that income statement classifications can be quite subjective, and management has incentives to use its discretion to disclose the financial results of certain events in categories that serve its interests. For example, management may use its reporting discretion to include certain "gains" in the operating section and certain "losses" in the nonoperating sections of the income statement. By using such a strategy, management might influence users to believe that the "gains" are persistent while the "losses" are not. As noted in *Forbes* magazine: "clever accountants can find all sorts of different meanings in those simple sounding words [usual and frequent]. . . . It all comes down to a judgement."

Review The Bristol-Myers Squibb statement of earnings on the prior page, and note that it does not include a section called "other gains and losses" and an item called "net income from operations." What items would you consider to fall in the "other" category, and what would you consider net income from operations for 2006, 2007, and 2008?

Consider Western Savings of Phoenix, a savings and loan company that reported $49 million in *operating* income, almost half of which ($24 million) was due to the sale of one large investment. Many accountants agreed that this particular sale was nonrecurring and that similar gains could not be expected in the future. Consequently, the gain on this transaction should not have been included in the operating section of the income statement. *Forbes* pointed out that this and other accounting practices followed by the company suggested that "Western is a classic case of how reported profits can misrepresent economic reality."

The *Wall Street Journal* once noted that many companies use subjective restructuring charges to manage earnings. Often, they prematurely recognize expenses within a charge that is disclosed on the income statement outside of the operating section. This activity reduces future operating expenses and increases net income from operations. The article went on to say: "The most obvious way restructuring charges make companies' earnings look better is if the company can convince investors that operating earnings—before the charges—provide a more meaningful indication of trends."

The subjectivity associated with classifying gains and losses in different sections of the income statement can give rise to other significant economic consequences. We noted earlier in the chapter, for example, that The Pillsbury Company, now part of General Mills, has instituted a compensation plan that rewards management on the basis of operating income. An important question is whether interest expense is considered to be an operating or a nonoperating expense in the measurement of operating income as defined by the plan. Including interest as an operating expense could discourage management from borrowing needed funds; including it as a nonoperating expense, on the other hand, could encourage managers to borrow too much. Classifying interest as operating or nonoperating is a subjective decision, yet it can influence the manner in which a company functions.

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Robert A. Olstein, a veteran accounting expert and manager of the Olstein Financial Alert mutual fund, noted in the *New York Times:* "We are always looking around and between the numbers to see what a company's real or repetitive earnings are." What does he mean, and how is the income statement designed to help him?

INTERNATIONAL PERSPECTIVE: INVESTMENTS AND INCOME STATEMENT DISCLOSURE

Many times in this textbook we have commented that U.S. businesses are increasingly investing in foreign markets and operations. Such investments introduce certain risks and opportunities that are different from those characterizing domestic business activities. The following quote from Coca-Cola's annual report provides an illustration:

The Company distributes its products in nearly 170 countries and [transacts in approximately 40 different currencies]. Approximately 80 percent of total operating income is generated outside the United States. International operations are subject to certain risks and opportunities, including currency fluctuation and government actions. The Company closely monitors its methods of operating in each country and adopts strategies responsive to changing economic and political environments.

Such a strong international presence increases the number of transactions that require special disclosure on the income statement. Owens Corning, for example, has significant investments in six different non–U.S.-affiliated companies (two in Saudi Arabia and one each in Canada, Japan, Brazil, and Mexico). A portion of the income reported by these affiliates is disclosed, under the equity method, as a special item on the company's income statement. Merck & Co., Inc., which has investments in foreign assets that total over $2.5 billion, has sold and restructured foreign subsidiaries frequently over the last several years. For example, the company sold subsidiaries in South Africa, Lebanon, and Nigeria and restructured operations in Argentina, Brazil, and Venezuela. These activities led to special disclosures in its income statement.

The unique risks associated with investments in countries with high inflation and volatile economies also often give rise to special income statement disclosures. Johnson & Johnson once disclosed two special charges on the income statement: (1) a $104 million write-off for permanently impaired assets and operations in Latin America, which was disclosed in the operating section of the income statement; and (2) a $36 million loss from the liquidation of Argentine debt. The company's annual report also mentions the risks of foreign currency fluctuations and describes how the company hedges these risks.

In such an international investment environment, financial statement users must be particularly aware of, and carefully interpret, the special gains and losses that are reported on the income statement. They should attempt to completely understand the underlying transaction and appreciate the context in which it occurred. An article in the *Wall Street Journal* cautions investors about gains that arise from foreign currency translations in particular:[8]

Foreign exchange gains resulting from the dollar's [recent] tumble . . . raise questions about the quality of soon-to-be-released earnings reports for those U.S. firms

8. An example of foreign currency gains/losses is provided at the end of Chapter 6.

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with big foreign operations. For example, American Family Corp., Gillette Co., American Brands Inc., and Colgate-Palmolive Co. all derive more than 60 percent of their sales from foreign operations. . . . Investors should [not overemphasize the importance of] currency-related earnings . . . because they're really a one-time gain that could easily reverse itself.

These issues underline the importance of carefully reading the footnotes in an annual report. Most of the information required to make the assessments discussed in this section is not disclosed on the face of the financial statements but is buried somewhere in the footnotes.

ROE EXERCISE: USING THE RIGHT EARNINGS NUMBER

The ROE model, introduced and illustrated in Appendix 5A, provides a framework linking the management of a company's operating, investing, and financing activities to its return on the shareholders' investment (return on equity). A key question addressed by analysts using the ROE model involves choosing the most appropriate earnings number. Since the ROE model is designed to explain ROE, and earnings represent the numerator of that ratio, the quality of ROE analysis can be no better than the quality of the chosen earnings number. "Bottom-line" net income, as discussed in this chapter, includes components that vary in terms of the extent to which they reflect a change in the company's wealth as well as their persistence, and consequently may not be the best choice in all cases.

While no hard-and-fast rules exist covering how to choose an appropriate earnings number, in most cases it is best to use a number that is both a reasonable measure of the wealth change experienced by the company and expected to persist in the future. Some analysts believe that after-tax operating earnings are best in this regard. Conducting several ROE analyses using several earnings numbers (including and excluding special charges like restructurings, assert impairments, gains and losses on asset sales, etc.) is often a useful practice. It can help to ascertain whether the conclusions are sensitive to the choice of the earnings number and to what extent. Finally, the analysis should be conducted across time and across similar companies, and any comparisons should use earnings numbers measured as similarly as possible.

ROE ANALYSIS

Access the Web site http://www.wiley.com/college/pratt and conduct ROE analyses on Ford Motor Company versus Toyota and/or Abbott versus Bristol-Myers Squibb, paying special attention to earnings numbers used in the analysis.

REVIEW PROBLEM

The operating revenues and expenses of Panawin Enterprises for 2012 follow, along with descriptions of and entries for several additional transactions. Assume that income taxes on income from continuing operations are $7,000, the effective income tax rate on other items is 34 percent, the balance in retained earnings as of December 31, 2011, is $106,000, and dividends declared during 2012 total $16,000.

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Operating revenues	**$85,000**
Operating expenses	**62,000**
Net operating income	**$23,000**

1. Machinery with an original cost of $14,000 and a book value of $11,000 was sold for $9,000. The transaction was considered unusual but not infrequent.

Cash (+A)	**9,000**	
Accumulated Depreciation (+A)	**3,000**	
Loss on Sale of Machinery (Lo, −RE)	**2,000**	
Machinery (−A)		**14,000**
Sold machinery		

2. A separate line of business (segment) was sold on March 14, 2012, for $18,000 cash. The book values of the assets and liabilities of the segment as of the date of the sale were $10,000 and $4,000, respectively. The business segment recognized revenues of $18,500 and expenses of $14,000 from January 1, 2012, to March 14, 2012.

Revenues of the Segment	**18,500**	
Expenses of the Segment		**14,000**
Income Summary		**4,500**
Recognized business segment income (closing entry recorded at time of sale)		

Income Summary (E, −RE)	**1,530**	
Income Tax Liability (+L)		**1,530**
Recognized income tax liability related to 2012 operations ($4,500 × 34%)		

Cash (+A)	**18,000**	
Liabilities (−L)	**4,000**	
Assets (−A)		**10,000**
Gain on Sale (Ga, +RE)		**12,000**
Sold business segment		

Gain on Sale (−Ga, −RE)	**4,080**	
Income Tax Liability (+L)		**4,080**
Recognized additional tax liability ($12,000 × 34%).		

3. On September 12, 2012, Panawin retired, before maturity, outstanding bonds with a face value of $120,000, for a cash payment of $130,000. The bonds were originally issued at a premium, and the unamortized premium as of the date of retirement was $3,000. The loss on the retirement is considered extraordinary.

Bonds Payable (−L)	**120,000**	
Unamortized Premium (−L)	**3,000**	
Loss on Retirement (Lo, −RE)	**7,000**	
Cash (−A)		**130,000**
Retired outstanding bonds		

Income Tax Liability (−L)	**2,380**	
Loss on Retirement (−Lo, +RE)		**2,380**
Recognized tax benefit ($7,000 × 34%)		

4. The company changed its method of accounting for inventories in line with a new mandated standard. This change increased the ending inventory balance for 2012 by $8,000.

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Inventory (+A)	**8,000**	
Income from Accounting Change (Ga, +RE)		**8,000**
Recognized change in accounting method		
Income from Accounting Change (−Ga, −RE)	**2,720**	
Income Tax Liability (+L)		**2,720**
Recognized additional tax liability ($8,000 × 34%)		

The income statement is shown in Figure 13–7, and the reconciliation of retained earnings is shown in Figure 13–8.

FIGURE 13–7 Income statement for review problem

Panawin Enterprises
Income Statement
for the Year Ended December 31, 2012

Operating revenues	$85,000	(given)
Operating expenses	62,000	(given)
Net operating income	$23,000	
Loss on sale of machinery	(2,000)	
Net income from continuing operations before tax	$21,000	
Less: Federal income tax	7,000	(given)
Net income from continuing operations	$14,000	
Income from disposed segment (net of tax)	2,970	($4,500 − $1,530)
Gain on sale of segment (net of tax)	7,920	($12,000 − $4,080)
Net income before extraordinary items	$24,890	
Extraordinary loss on retirement of debt (net of tax)	(4,620)	(−$7,000 + $2,380)
Net income before change in accounting principle	$20,270	
Income effect from change in inventory accounting (net of tax)	5,280	($8,000 − $2,720)
Net income	$25,550	
Earnings per share (10,000 shares outstanding):		
Net income from continuing operations	$ 1.40	($14,000 ÷ 10,000)
Disposal of business segment	1.09	[($2,970 + $7,920) ÷ 10,000]
Extraordinary item	(.46)	[$(4,620) ÷ 10,000]
Change in accounting principle	.53	($5,280 ÷ 10,000)
Total earnings per share	$ 2.56	($25,550 ÷ 10,000)

FIGURE 13–8 Reconciliation of retained earnings for Review Problem

Panawin Enterprises
Reconciliation of Retained Earnings
for the Year Ended December 31, 2012

Beginning retained earnings balance	$106,000
Plus: Net income	25,550
Less: Dividends	(16,000)
Ending retained earnings balance	$115,550

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SUMMARY OF KEY POINTS

- *Economic consequences associated with reporting net income.*

Income is the most common measure of a company's performance. It has been related to stock prices, suggesting that equity investors use income in their decisions to buy and sell equity securities. It has been related to bond prices, indicating that debt investors use income in their decisions to buy and sell corporate bonds. Income is also used by credit-rating agencies to establish credit ratings. Various income measures are also found in contracts written among shareholders, creditors, and managers. Such contracts are normally designed either to protect the interests of creditors or to encourage managers to act in the interests of the shareholders.

- *Two different concepts of income: Matching and fair market value*

The matching process measures income by first recognizing the revenues of a particular period and then subtracting from them the expenses necessary to generate the revenues. The fair market value concept measures income by comparing the fair market value of the firm's net assets at the end of a period to the fair market value of the net assets at the beginning of the period. For years the matching principle has provided the basis for income measurement, and it still does for both U.S. GAAP and IFRS. However, both systems now rely on a combination of the two concepts. IFRS allows the use of fair market value accounting for a variety of assets and liabilities, and U.S. GAAP, in addition to requiring fair market value accounting for trading securities, has recently adopted a fair market value option for financial instruments in general. Astute readers of financial statements must understand both concepts of income, and how they affect both the income statement and the statement of comprehensive income.

- *A framework for financing, investing, and operating transactions.*

Financing and investing transactions involve setting up a company so that it can conduct operations. Operating transactions entail the actual conduct of the operations. The text identifies five categories of transactions: (1) exchanges with shareholders, (2) exchanges of liabilities and shareholders' equity, (3) issues and payments of debt, (4) purchases, sales, and exchanges of assets, and (5) operating transactions (revenues and expenses). Generally accepted accounting principles consider categories 1–3 as financing transactions, category 4 as investing transactions, and category 5 as operating transactions.

Exchanges with shareholders are involved exclusively with the formation and dissolution of the company's equity capital and the returns to the company's shareholders. Exchanges of liabilities and shareholders' equity deal only with a company's capital structure. Issues and payments of debt involve exchanges with a company's creditors and are reflected in the liabilities section of the balance sheet. Purchases, sales, or exchanges of assets are considered capital transactions because assets represent the capital base on which operations are conducted.

- *Categories that constitute a complete income statement and how they provide measures of income that address the objectives of financial reporting.*

The financial effects of five types of events warrant special disclosure and presentation on the income statement: (1) operating revenues and expenses, (2) other revenues and expenses, (3) disposals of business segments, (4) extraordinary items, and (5) mandated changes in accounting principles.

These classifications highlight income numbers that vary in persistence. In terms of the objectives of financial accounting, earnings numbers with high persistence (e.g., operating earnings) are considered to reflect future cash flows, while low-persistence earnings are not. Both kinds of earnings, however, reflect changes in a company's resources and, in that respect, are considered useful.

- *Intraperiod tax allocation.*

Federal income taxes are disclosed in two different ways on the income statement. The first income tax disclosure immediately follows net income from continuing operations (before tax). It

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represents the tax expense recognized by the company due to taxable revenues and deductible expenses not related to the items listed below net income from continuing operations on the income statement.

The dollar amounts associated with the remaining items (disposal of business segments, extraordinary items, and changes in accounting principles) are all disclosed *net of tax.* Such presentation means that each of these revenue and expense items is disclosed on the income statement after the related income tax effect has been removed. The practice of including the income tax effect of a particular transaction with the transaction itself on the income statement is known as *intraperiod tax allocation.*

Earnings-per-share disclosure on the income statement.

Generally accepted accounting principles require that earnings per share be disclosed on the face of the income statement and that the specific amounts associated with (1) net income from continuing operations (after tax), (2) disposals of business segments, (3) extraordinary items, and (4) mandated changes in accounting principles be disclosed separately. The calculation involves dividing the dollar amounts of each of the four items listed by the average number of shares outstanding during the accounting period.

KEY TERMS

Note: Definitions for these terms are provided in the glossary at the end of the text.

Business segment (p. 608)
Comprehensive income (p. 600)
Diluted earnings per share (p. 613)
Earnings persistence (p. 613)
Extraordinary items (p. 609)
Financing and investing transactions (p. 602)
Frequent (p. 607)
Intraperiod tax allocation (p. 612)
Matching process (p. 601)
Operating transactions (p. 602)
Pro forma (as if) basis (p. 611)
Usual (p. 607)

ETHICS in the Real World

The boards of directors of most major U.S. companies have established executive compensation plans that base executive pay on some measure of company performance. While these plans differ widely across companies, a large percentage use some form of reported earnings as the measure of performance. Recognizing that there are many different ways to measure earnings, these compensation contracts must be very specific about which earnings measure is used. Pillsbury, for example, bases its formula on operating earnings, the result of subtracting operating expenses from operating revenues, excluding such items as interest expense, interest income, gains and losses on asset sales, extraordinary gains and losses, and the effects of accounting changes. Other companies, such as DuPont and Ashland Oil, base their formulas on net income after such items—the "bottom line."

Consider a company that has a compensation plan like that of DuPont, where compensation is a function of earnings after interest expense, and assume that management is analyzing how to finance a particular capital investment—that is, should it be financed with debt or equity? Management knows that if debt is chosen, net income and its compensation will be reduced by the interest expense recognized on the debt. On the other hand, if management chooses equity, there will be no interest expense to reduce its compensation amount.

ETHICAL ISSUE Is it ethical for management to consider the impact of the financing decision on its compensation amount, or should such impact be completely ignored when choosing between debt and equity?

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INTERNET RESEARCH EXERCISE

Yahoo reports a number of items on its 2007–2009 consolidated statements of earnings that one could consider non-operating. Identify these items and comment on their persistence. Begin your search at the company home page (yahoo.com).

BRIEF EXERCISES

REAL DATA
BE13–1
Nonrecurring items

Revenues for Goodrich Corporation increased from $6.4 billion in 2007 to $7.1 billion in 2008 (a 10.5 percent increase), but earnings increased by over 40% from $483 million to $674 million. In recent years the company has reported losses from debt retirements, accounting changes, and discontinued operations. Explain how these items could influence your conclusions about Goodrich's comparative performance from 2007 to 2008.

REAL DATA
BE13–2
Effects on the basic accounting equation

When Anheuser-Busch Company recognized a $160 million charge on its income statement for the closure of Tampa Breweries, it consisted of a write-down of plant assets of $113.7 million, employee severance costs of $19.4 million, and other disposal costs of $26.9 million. The following year the company disclosed a $54.7 million gain associated with the sale of the St. Louis Cardinals baseball team. The team was sold for $150 million.

For each of the elements of these disclosures, discuss how the basic accounting equation could have been affected.

REAL DATA
BE13–3
Interpreting non-operating items

Refer to the Merck income statement presented at the very beginning of the chapter, and note that the company reported climbing profits of $3.4 billion, $7.9 billion, and $13 billion in 2007, 2008, and 2009, respectively. Restructuring charges rose across the three years; equity income affiliates fell across the three years; and there were two very large non-operating items during the three-year period. In 2007 Merck booked a $4.9 billion charge associated with a litigation settlement, and in 2009 the company booked $10.7 billion in "other income." Discuss how each of these non-operating items influenced the basic accounting equation, and compute Merck's net operating income for the three years. Comment on Merck's earnings trend.

REAL DATA
BE13–4
Understanding comprehensive income and how it is reflected on the financial statements

In the shareholders' equity section of its 2008 and 2009 balance sheets, H&R Block reported accumulated other comprehensive income balances of $2.5 million and negative $11.6 billion, respectively. The 2009 income statement reported net income of $486 million. During 2009 the net holding loss for the available-for-sale securities held by H&R Block was $4 million, and the company incurred an additional $10 million loss on foreign currency translations. Neither item affected earnings, but both reduced shareholders' equity.

a. Compute comprehensive income for 2009.
b. Describe how these activities are reflected on H&R Block's balance sheet, income statement, and statement of shareholders' equity.

EXERCISES

E13–1
Which statement is affected?

Listed below are transactions or items that are frequently reported in financial statements.

1. Income effect due to changing from the double-declining-balance method to the straight-line method of depreciation.
2. Collection of accounts receivable.

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3. Purchase of an insurance policy on December 31 that provides coverage for the following year.
4. Accrued wages earned by the employees.
5. Estimated uncollectible accounts receivable using the aging method.
6. Recognized a gain on the sale of plant equipment.
7. Recognized a loss when the government expropriated land for a highway.
8. Declared a dividend valued at $100,000.
9. Under the requirements of a debt covenant, appropriated a portion of retained earnings.
10. Received dividends on stocks held as a short-term investment. The dividends were declared and paid on the same day.
11. Recognized the cost of inventory sold during the year under the periodic method.
12. Paid rent for the current year.

a. Indicate whether each item would be included on the company's income statement, statement of shareholders' equity, or neither, using the following codes:
   IS Income statement
   SE Statement of shareholders' equity
   N Neither
b. Indicate whether the items you coded IS would be considered (1) usual and frequent, (2) unusual or infrequent, (3) unusual and infrequent, or (4) other.
c. Provide a brief explanation of your choice in (b) of (1), (2), (3), or (4).

E13–2

Classifying transactions

Transactions include the following:

1. Declaration of a stock dividend.
2. Purchase of 50 percent of the outstanding stock of another company.
3. Payment of previously accrued interest payable.
4. Accrual of interest expense.
5. Purchase of machinery.
6. Recognition of depreciation on machinery.
7. Purchase of treasury stock.
8. Sale of treasury stock at a price less than its original cost.
9. Conversion of debt to common stock.
10. Receipt of cash on an outstanding receivable.
11. Sale of inventory on account.
12. Purchase of inventory on account.
13. Declaration of dividends.
14. Receipt of dividends on short-term marketable securities.
15. Early retirement of outstanding long-term debt.

a. Refer to Figure 13–2 in the text, and classify each transaction in one of the following categories:
   (1) Exchanges with shareholders
   (2) Exchanges of liabilities and shareholders' equity
   (3) Issues and payments of debt
   (4) Purchases, sales, and exchanges of assets
   (5) Operating transactions
b. Briefly explain why the transactions are considered increasingly operating (or decreasingly financing) as the categories move from (1) to (5).

E13–3

Comprehensive income

The December 31, 2012, balance sheet of Smedley Company is as follows:

Assets	**$70,000**	**Liabilities**	**$15,000**
		Shareholders' equity	**55,000**
Total assets	**$70,000**	**Total liabilities and shareholders' equity**	**$70,000**

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During 2013 the company entered into the following transactions:

1. Common stock was issued for $35,000 cash.
2. Services were performed for $50,000 cash.
3. Cash expenses of $24,000 were incurred.
4. Long-term liabilities of $15,000 were paid.
5. Dividends of $7,000 were declared and paid.

a. Classify each transaction as operating, investing, or financing and then prepare an income statement.
b. Compute comprehensive income, and compare it to the income amount calculated in (a).
c. Explain why the two dollar amounts are equal.

E13–4

Debt covenants expressed in terms of income

Morton Manufacturing maintains a credit line with First Bank that allows the company to borrow up to $1 million. A covenant associated with the loan contract limits the company's dividends in any one year to 20 percent of net income. The 2012 income statement data of Morton Manufacturing is as follows:

Net sales	**$840,000**
Less: Cost of goods sold	**570,000**
Gross profit	**$270,000**
Selling and administrative expenses	**120,000**
Net operating income	**$150,000**
Gain on sale of securities	**14,000**
Interest expense	**(4,000)**
Net income from continuing operations before tax	**$160,000**
Less: Income tax	**51,200**
Net income from continuing operations	**$108,800**
Extraordinary gain (net of tax)	**22,000**
Net income before change in accounting principle	**$130,800**
Income effect due to change in accounting principle	**52,000**
Net income	**$182,800**

a. Compute the maximum amount of dividends Morton can pay if the debt covenant is expressed as 20 percent of each of the following:
   (1) Net income
   (2) Income before change in accounting principle
   (3) Income before extraordinary items (from continuing operations)
   (4) Net operating income
b. Explain why the bank may wish to state the contractual limitation on dividends in terms of income from operations instead of net income.

REAL DATA

E13–5

Special items

In a three-year period AT&T, the telecommunications provider, reported net income of $1.9 billion (Year Three), a net loss of $13 billion (Year Two), and net income of $7.7 billion (Year One). Included in these numbers were the following special items:

Year One: losses from equity investments ($7.5 billion); net loss from discontinued operations ($4 billion); gain on disposition of discontinued operations ($1.3 billion); and gain from accounting changes ($904 million).
Year Two: losses from equity investments ($400 million); net loss from discontinued operations ($14.5 billion); gain on disposition of discontinued operations ($1.3 billion); and loss from accounting changes ($856 million).
Year Three: losses from equity investments ($12 million); net loss from discontinued operations ($13 million); and gain from accounting changes ($15 million).

a. Describe each special item.
b. Comment on AT&T's performance across the three-year period.

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E13–6

Disposal of a business segment

LTB Enterprises consists of four separate divisions: building products, chemicals, mining, and plastics. On March 15, 2012, LTB sold the chemicals division for $625,000 cash. Financial information related to the chemicals division follows:

(1/1–3/15/12)		(3/15/12)	
Sales	$175,000	Assets	$1,850,000
Operating expenses	160,000	Liabilities	1,400,000
Net operating income (loss)	$ 15,000		

a. Provide the journal entry (or entries) to record the sale of the chemicals division. Assume an income tax rate of 35 percent.

b. Prepare the section of LTB's 2012 income statement that relates to the disposal of the business segment.

E13–7

Management choices and earnings persistence

It is December 2012, and Sharon Sowers, the CEO of Mallory Services, has decided to sell the clerical division. She has received an offer for $105,000 but is undecided about whether she wishes to complete the sale in 2012 or 2013. She is currently evaluating the effects of the sale on 2012 reported net income. Income from continuing operations for 2012 is estimated to be $950,000 (excluding the activities of the clerical division), and information about the clerical division is provided as follows. The company's tax rate is 35 percent.

Year Ended 2012		December 2012	
Revenues	$35,000	Assets	$93,000
Expenses	23,000	Liabilities	26,000

a. Prepare the 2012 income statement, beginning with net income from continuing operations, assuming that Sharon accepts the offer, and explain how a user might interpret the items on the income statement in terms of earnings persistence.

b. Prepare the 2012 income statement, beginning with net income from continuing operations, assuming that Sharon chooses not to sell the division in 2012, and explain how a user might interpret the items on the income statement in terms of earnings persistence.

c. Describe some of the important trade-offs Sharon faces as she decides whether to complete the sale in 2012 or 2013.

E13–8

Management choices and earnings persistence

It is December 2012, and Rob Blandig, the CEO of Carmich Industries, has decided to sell the chemical division. He has received an offer for $350,000, but he is undecided about whether he wishes to complete the sale in 2012 or 2013. He is currently evaluating the effects of the sale on 2012 reported net income. Income from continuing operations for 2012 is estimated to be $1,930,000 (excluding the activities of the chemical division and management's bonus), and the company anticipates a weak year in 2013. Information about the division follows. The company's tax rate is 35 percent, and company management is paid a bonus each year in the amount of 20 percent × net income from continuing operations. For purposes of the bonus calculation, net income from continuing operations is not reduced by the bonus.

Year Ended 2012		December 2012	
Revenues	$145,000	Assets	$437,000
Expenses	120,000	Liabilities	218,000

a. Prepare the 2012 income statement, beginning with net income from continuing operations, assuming that Rob accepts the offer, and explain how a user might interpret the items on the income statement in terms of earnings persistence.

b. Prepare the 2012 income statement, beginning with net income from continuing operations, assuming that Rob chooses not to sell the division in 2012, and explain how a user might interpret the items on the income statement in terms of earnings persistence.

c. Describe some of the important trade-offs Rob faces as he decides whether to complete the sale in 2012 or 2013.

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REAL DATA

E13-9

Interpreting non-operating items on IFRS-based income statements

The 2007 income statement for Group Danone, a French-based food processor that publishes IFRS-based financial statements, is provided below (in million euros).

	2007
Net sales	**12,776**
Operating expenses	**(11,230)**
Operating income	**1,546**
Net cost of debt	**(177)**
Income before taxes	**1,369**
Income tax	**(410)**
Income from consolidated companies	**959**
Net income of equity-accounted affiliates	**87**
Net income from continuing operations	**1,046**
Net income from discontinued operations	**3,292**
Net income	**4,338**

a. Briefly explain each of the line items on the income statement.
b. Explain what must have happened at Danone in 2007 that boosted net income by so much, and comment on possible implications for Danone's future.

E13–10

Accounting for unusual losses

You are currently auditing the financial records of Paxson Corporation, which is located in San Francisco, California. During the current year, inventories with an original cost of $2,325,000 were destroyed by an earthquake. The company was unsure how to record this loss and is seeking your advice. The loss is deductible for tax purposes, and the company's tax rate is 35 percent.

a. Prepare the journal entry (or entries) to record the loss of the inventory if the loss is not considered extraordinary.
b. Prepare the journal entry (or entries) to record the loss of the inventory if the loss is considered extraordinary.
c. Should the loss be classified as an extraordinary loss or as an ordinary loss? Explain.
d. Would your answer to (c) change if the plant had been located in Miami, Florida? Explain.

E13–11

Economic consequences of an extraordinary item

The management of Sting Enterprises shares in a bonus that is determined and paid at the end of each year. The amount of the bonus is defined by multiplying net income from continuing operations (after tax) by 12 percent. The bonus is not used in the calculation of income from continuing operations. During 2012, Sting was a defendant in a lawsuit and was required to pay $480,000 over and above the amount covered by insurance. The loss is tax deductible, and the company's tax rate is 35 percent. The company was last involved in a lawsuit five years ago. Net income from continuing operations (before tax) for 2012, excluding the loss from the lawsuit, was $800,000.

a. Compute management's 2012 bonus, assuming that the lawsuit is considered unusual but not infrequent.
b. Compute management's 2012 bonus, assuming that the lawsuit is considered extraordinary.
c. Repeat (a) and (b) above, assuming that Sting was awarded the $480,000 settlement instead of having to pay it.
d. Explain how the decision to include or exclude an item as extraordinary can have significant economic consequences.

E13–12

Earnings-per-share disclosure

The following income statement was reported by Battery Builders for the year ending December 31, 2012:

Sales	**$85,000**
Rent revenue	**23,000**
Interest income	**7,000**

(*Continued*)

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Total revenues		**$115,000**
Cost of goods sold	**$52,000**	
Operating expenses	**24,000**	
Interest expense	**12,000**	
Loss on sale of fixed asset	**6,000**	
Total expenses		**94,000**
Income from continuing operations (before tax)		**$ 21,000**
Less: Income tax		**10,000**
Income from continuing operations		**$ 11,000**
Income from disposed segment (net of tax)		**3,000**
Gain on sale of disposed segment (net of tax)		**2,000**
Income before extraordinary items		**$ 16,000**
Extraordinary loss (net of tax)		**7,000**
Income before change in accounting principle		**$ 9,000**
Income due to change in accounting principle (net of tax)		**6,000**
Net income		**$ 15,000**

Show how Battery Builders would report earnings per share on the face of the income statement, assuming the following:

a. An average of 15,000 shares of common stock was outstanding during 2012.
b. An average of 25,000 shares of common stock was outstanding during 2012.
c. An average of 30,000 shares of common stock was outstanding during 2012.

E13–13

Intraperiod tax allocation and the financial statements

The following information was taken from the 2012 financial records of Rothrock Consolidated. All items are pretax.

	Debit	Credit
Operating revenues		**87,000**
Operating expenses	**32,500**	
Gain on sale of short-term investments		**5,200**
Loss on sale of business segment	**21,000**	
Income earned on disposed business segment		**3,000**
Extraordinary loss	**5,000**	
Income due to change in accounting principle		**12,500**
Retained earnings (beginning balance)		**72,000**
Dividends declared	**18,000**	

The company's income tax rate is 35 percent, and the items above are treated identically for financial reporting and tax purposes.

Prepare the following:

a. An income statement.
b. A reconciliation of retained earnings.

E13–14

Intraperiod tax allocation

The following pretax amounts were obtained from the financial records of Watson Company for 2012:

	Debit	Credit
Retained earnings (1/1/09)		**847,000**
Sales revenues		**1,385,000**
Rent revenue		**360,000**
Cost of goods sold	**475,000**	
Administrative expenses	**100,000**	
Depreciation expense	**250,000**	
Selling expenses	**189,000**	

(*Continued*)

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Extraordinary loss	**202,000**
Loss on sale of fixed assets	**105,000**
Dividends declared	**460,000**

The company's tax rate is 35 percent.

a. Prepare an income statement for the year ended December 31, 2012, using the multistep format.
b. Prepare a reconciliation of retained earnings for the year ended December 31, 2012.
c. What is the income tax effect associated with each item that is reported net of tax? Assuming that no taxes were owed at the beginning of 2012 and no tax payments were made during 2012, what is the total income tax liability at the end of 2012?

E13–15

Covenant restrictions and income reporting

Kennington Company has outstanding debt that contains restrictive covenants limiting dividends to 15 percent of net income from continuing operations. During 2012, the company reported net income from operations of $235,000 after taxes, excluding the following items—all of which ignore tax effects.

1. A $25,000 gain was recognized on the sale of an investment.
2. A $62,000 loss was recognized on a lawsuit.
3. A $38,000 loss was recognized on the early retirement of debt.

Assume that the gain in (1) is taxable, the losses in (2) and (3) are tax deductible, and the company's tax rate is 35 percent.

a. Provide the income statement, beginning at net income from operations, and compute the maximum amount of dividends that the company can declare, assuming that (1) the investment in (1) is a business segment that broke even during 2012 and (2) lawsuits are common for Kennington.
b. Provide the income statement, beginning at net income from operations, and compute the maximum amount of dividends that the company can declare, assuming that (1) the investment in (1) is a short-term equity security and (2) lawsuits are very rare for Kennington.

E13–16

Stock market reactions to income reporting

Madigan International is planning a major stock issuance in early 2013. During 2012, the company reported net income from operations of $865,000 before taxes. The four items below describe major events that occurred during 2012. The company's accountants chose to include items (1) and (4) in the computation of net income from continuing operations and to disclose items (2) and (3) as extraordinary items.

1. A $42,000 gain was recognized on the sale of a subsidiary.
2. Inventory was written down by $53,000 due to earthquake damage.
3. An outstanding account receivable of $38,000 was written off when a major customer declared bankruptcy.
4. A $25,000 gain was recognized due to the change of an accounting principle.

Assume that items (1) and (4) are taxable, items (2) and (3) are tax deductible, and the company's tax rate is 35 percent.

a. Present the income statement, beginning with net income from operations.
b. Critique the accounting treatment chosen by Madigan's accountants, and provide an income statement that is consistent with generally accepted accounting principles.
c. Discuss how Madigan's accounting treatment could influence the price at which the company's stock is sold in 2013, and provide a rationale for why Madigan may have made such choices.

E13–17

Different ways to measure income

Brinkley Leasing purchases farm machinery and leases it to farms. At the beginning of 2011 the company paid $1,000,000 for a fleet of tractors, and estimated their useful lives at five years. Brinkley immediately leased the vehicles for an annual charge of $250,000. Assume that all lease payments were made, the vehicles were disposed of after five years, and at the end of each year the following fair market values for the fleet were estimated.

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December 31, 2011	**$790,000**
December 31, 2012	**$622,000**
December 31, 2013	**$432,000**
December 31, 2014	**$227,000**
December 31, 2015	**0**

a. Compute the net income and balance sheet value associated with the fleet for each year using the matching concept and assuming that Brinkley uses straight-line depreciation.
b. Compute the net income and balance sheet value associated with the fleet for each year using the matching concept, assuming that Brinkley uses double-declining-balance depreciation.
c. Compute net income and balance sheet value associated with the fleet for each year using the fair market value concept.
d. Discuss the differences.

PROBLEMS

P13–1

Classifying transactions

Lundy Manufacturing produces and sells football equipment. The company was involved in the following transactions or events during 2012:

1. The company purchased $250,000 worth of materials to be used during 2013 to manufacture helmets and shoulder pads.
2. The company sold football equipment for $500,000. The inventory associated with the sale cost the company $375,000.
3. One of the company's plants in San Francisco was damaged by a minor earthquake. The total amount of the damage was $100,000.
4. The company issued ten ($1,000 face value) bonds at a discount (.98).
5. The company incurred $143,000 in wage expenses.
6. The company was sued by a high school football player who was injured while using some of the company's equipment. The football player will probably win the suit, and the amount of the settlement has been estimated at $10,000. This is the sixth lawsuit filed against the company in the past three years.
7. The company switched from the double-declining-balance depreciation method to the straight-line depreciation method.
8. The company declared and paid $50,000 in dividends.
9. The company incurred a loss when it sold some securities that it was holding as an investment.

REQUIRED:

a. Classify each of these transactions as financing, investing, or operating.
b. Refer to Figures 13–2 and 13–3 in the text, and identify the category in which each of the items listed should be placed.
c. Which of these items should be included on the company's income statement? Briefly describe how they should be disclosed.

P13–2

Bonus contracts based on income can affect management's business decisions

The managers of Martin House are paid a salary and share in a bonus that is determined at the end of each year. The total bonus is determined by multiplying the company's income from operations by 25 percent. The bonus is not considered an operating expense. Interest on borrowed funds is considered an operating expense when computing the bonus.

During 2012, the company decided to expand its plant facility. The estimated cost of the expansion was $1 million. To raise the necessary funds, the company could either borrow $1 million at an annual interest rate of 8 percent or issue 50,000 shares of common stock at

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$20 each. The company raised the funds using one of these two methods, and income from operations (excluding any interest charges) for 2012 was reported as follows:

Operating revenues	**$6,800,000**
Operating expenses (excluding interest)	**5,600,000**
Income from operations	**$1,200,000**

REQUIRED:

a. Assume that on January 1, 2012, Martin House borrowed the $1 million. Compute the total bonus shared by the company's managers.
b. Assume that on January 1, 2012, Martin House issued common stock to raise the $1 million. Compute the total bonus shared by the company's managers.
c. Why might management choose to issue equity instead of borrowing the $1 million? Is such a decision necessarily in the best interest of the company's shareholders?
d. Repeat (a) and (b) above, assuming that the interest expense is not considered an operating expense when computing the bonus.

P13–3

Financing, investing, and operating transactions

Raleigh Corporation began operations on February 10, 2012. During 2012, the company entered into the following transactions:

1. Issued $110,000 of common stock and $25,000 of preferred stock.
2. Performed services for $580,000.
3. Issued $475,000 in long-term debt for cash.
4. Incurred expenses: $125,000 for wages, $35,000 for supplies, $80,000 for depreciation, and $75,000 for miscellaneous expenses.
5. Purchased fixed assets for $250,000 cash.
6. Declared, but did not pay, cash dividends of $10,000.
7. Purchased fixed assets in exchange for a long-term note valued at $85,000.

REQUIRED:

a. Classify each transaction as either operating, investing, or financing.
b. Prepare an income statement.
c. Compute comprehensive income and compare it to the income reported on the income statement. Discuss.

P13–4

Preparing an income statement

Excerpts from Crozier Industries' financial records as of December 31, 2012, follow:

	Debit	Credit
Sales		**977,000**
Sales returns	**9,000**	
Costs of goods sold	**496,000**	
Dividends	**50,000**	
Rent expense	**90,000**	
Wages payable		**175,000**
Loss on sale of food services division	**2,000**	
Loss incurred by food services division	**10,000**	
Depreciation expense	**100,000**	
Cumulative effect on income of change in fixed asset accounting	**130,000**	
Gain on land appropriated by the government		**92,000**
Insurance expense	**12,000**	
Inventory	**576,000**	
Administrative expenses	**109,000**	
Prepaid insurance	**48,000**	
Gain on sale of short-term investments		**142,000**

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The amounts shown do not include any tax effects. Crozier's tax rate is 35 percent. Assume that all items are treated the same for accounting and income tax purposes.

REQUIRED:

a. Indicate which items should be included on the company's income statement. Classify each item to be included on the income statement as one of the following:
   (1) Usual and frequent
   (2) Unusual or infrequent
   (3) Disposal of business segment
   (4) Unusual and infrequent
   (5) Mandated change in accounting method
b. Prepare an income statement using the single-step format, and assess the persistence of each item on the income statement.

P13–5

Disclosing extraordinary items

In its 2012 financial report, Meeks Company reported $850,000 under the line item "extraordinary losses" on the income statement. The company's tax rate is 35 percent. The footnote pertaining to extraordinary losses indicates that the $850,000 loss, before tax, is composed of the following items:

1. A loss of $260,000 incurred on a warehouse in Florida damaged in a hurricane.
2. A loss of $150,000 incurred when Meeks sold the assets of a business segment.
3. A loss of $225,000 incurred when a warehouse in Iowa was blown up by a disgruntled employee.
4. Accounts receivable written off in the amount of $125,000.
5. A loss of $90,000 incurred when one of the company's distribution centers in Arizona was damaged by a flood.

REQUIRED:

a. Discuss how each of these items should be disclosed in the financial statements, including whether or not they should be disclosed net of tax.
b. Show how the "extraordinary items" section of the income statement should have been reported.

P13–6

Intraperiod tax allocation, income tax expense, and income tax liability

The following information has been obtained from the internal financial records of MTM Company:

Retained earnings, December 31, 2011	**$1,259,000**
Dividends declared and paid during 2012	**100,000**
Dividends declared during 2012 but not paid	**75,000**
Dividends declared during 2011 and paid in 2012	**90,000**
2012 income from continuing operations (before taxes)	**850,000**
Extraordinary losses in 2012 (before tax effect)	**135,000**

The company's tax rate is 35 percent. Assume that financial accounting income equals income for tax purposes.

REQUIRED:

a. What is the company's net income for the year ended December 31, 2012?
b. Compute income tax expense reported in MTM's 2012 income statement.
c. Prepare a reconciliation of retained earnings for the year ended December 31, 2012.
d. Assume that the income tax liability account had a balance of $70,000 on January 1, 2012, and that tax payments of $200,000 were made during 2012. What should be the balance in this account on December 31, 2012?

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REAL DATA

P13–7

Earnings per share and discontinued operations

The lower portion of the 2006 income statement for McDonald's follows (dollars in millions):

Income from continuing operations	**$2,875.0**
Income from discontinued operations net of taxes	**671.2**
Net income	**$3,544.2**
Basic net earnings per share:	
Continuing operations	**$ 2.33**
Discontinued operations	**0.54**
	$ 2.87
Diluted net earnings per share:	
Continuing operations	**$ 2.30**
Discontinued operations	**0.53**
	$ 2.83

REQUIRED:

a. Why is there a distinction between net earnings from continuing operations and net earnings from discontinued operations?
b. Estimate the number of common shares outstanding.
c. Why is there a distinction between basic net earnings per share and diluted net earnings per share?
d. Estimate the number of common shares that would be outstanding if all potentially dilutive securities were converted to common shares.

REAL DATA

P13–8

EPS disclosures

The lower portion of the 2008 income statement for Duke Energy Corporation follows (dollars in millions, except per-share amounts):

Income from continuing operations	**$1,279**
Income from discontinued operations, net of tax	**16**
Income before extraordinary items	**1,295**
Extraordinary items, net of tax	**67**
Net income	**$1,362**
Earnings per share from continuing operations	
Basic	**$ 1.01**
Diluted	**$ 1.01**
Earnings per share from discontinued operations	
Basic	**$ 0.02**
Diluted	**$ 0.01**
Earnings per share before extraordinary items	
Basic	**$ 1.03**
Diluted	**$ 1.02**
Earnings per share from extraordinary items	
Basic	**$ 0.05**
Diluted	**$ 0.05**
Earnings per share	
Basic	**$ 1.08**
Diluted	**$ 1.07**

REQUIRED:

a. Why is there a distinction among income from continuing operations, income from discontinued operations, and income from extraordinary items?
b. Estimate the number of common shares outstanding.
c. Why is there a distinction between basic earnings per share and diluted earnings per share?
d. Estimate the number of common shares that would be outstanding if all potentially dilutive securities were converted to common shares.

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P13-9

Disclosing net of tax, and the earnings-per-share calculation

Woodland Farm Corporation has the following items to include in its financial statements:

	Debit	Credit
Extraordinary loss from a flood	250,000	
Extraordinary gain from bond retirement	55,000	
Sale of inventory		250,000
Loss on disposal of business segment	100,000	
Income effect due to change in accounting method		80,000
Advertising expense	50,000	
Income earned by disposed business segment		150,000

None of the listed amounts includes any income tax effects. The company's tax rate is 35 percent.

REQUIRED:

a. Describe how each item above would be disclosed on the income statement or statement of retained earnings.
b. Compute the tax effect of each of the items that should be disclosed net of tax. What dollar amount would be shown on the financial statements for each of these items?
c. Assume that income from continuing operations (after tax) was $600,000, and 200,000 shares of common stock were outstanding during the year. Provide the earnings-per-share calculation.

P13-10

Preparing an income statement

Tom Brown, controller of Microbiology Labs, informs you that the company has sold a segment of its business. Mr. Brown also provides you with the following information for 2012:

	Continuing Operations	Discontinued Segment
Sales	$10,000,000	$850,000
Cost of goods sold	2,500,000	600,000
Operating expenses	750,000	100,000
Loss on sale of office equipment	60,000	—
Gain on disposal of discontinued segment		250,000

The following information is not reflected in any of the above amounts:

1. Microbiology Labs is subject to a 35 percent tax rate.
2. During 2012, Microbiology Labs retired outstanding bonds that were to mature in 2014. The company incurred a loss of $80,000, prior to taxes, on the retirement of the bonds.
3. Microbiology Labs owns several apple orchards as part of its operations. During 2012, the company's apple crop was destroyed by an infestation of a rare insect. This unusual and infrequent loss, prior to taxes, totaled $800,000.
4. Two million shares of common stock were outstanding throughout 2012.

REQUIRED:

Prepare an income statement for the year ended December 31, 2012, including the recommended earnings-per-share disclosures. In terms of the objectives of financial accounting, comment on the usefulness of each of the different measures of income.

REAL DATA

P13-11

Special items and earnings trends

Over a two-year period Sears reported an 83 percent earnings drop: Net income of $309 million on sales of $10 billion dropped to net income of $53 million on sales of $8.8 billion. It so happened, however, that the $309 million in profits was boosted by a hefty gain on the sale of its credit card division, while the following year was marred by a big restructuring charge, including asset write-downs and an accrual for employee severance packages.

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REQUIRED:

a. Where on the income statement would you find the charges related to asset sales and restructuring?
b. Describe how analysts might treat these special items, and comment on Sears's performance across the two years.

REAL DATA

P13–12

Recognized income and expense under IFRS

Group Danone, a French-based food processor that publishes IFRS-based financial statements, reported 2008 net income of 1.5 billion euros. Accumulated currency translation adjustments and net holding gains/losses from securities, both of which directly affected shareholders' equity but were not reflected on the income statement, together had balances of 311 million euros and negative 955 million euros at the beginning and end of 2008, respectively.

REQUIRED:

a. Recognized income and expense under IFRS is similar to what concept under U.S. GAAP?
b. Prepare a statement of recognized income and expense (SORIE) for Danone.
c. Which of the financial statements—income statement, balance sheet, statement of cash flows, and/or statement of shareholders' equity—contain information about the currency translation adjustments and the net holding gains/losses referred to above?

P13–13

Comprehensive problem

Laidig Industries has prepared the following unadjusted trial balance as of December 31, 2012:

	Debit	Credit
Cash	$110,000	
Accounts receivable	340,000	
Allowance for doubtful accounts		$ 50,000
Inventory (balance 1/1/12)	467,000	
Prepaid insurance	60,000	
Fixed assets	850,000	
Accumulated depreciation		287,000
Accounts payable		200,000
Dividends payable		45,000
Bonds payable		500,000
Common stock		100,000
Retained earnings		673,000
Sales		1,256,000
Gain on sale of land		76,000
Extraordinary loss	35,000	
Income effect due to change in accounting principle	60,000	
Purchases	750,000	
Administrative expenses	100,000	
Selling expenses	255,000	
Interest expense	25,000	
Dividends	135,000	

ADDITIONAL INFORMATION:

1. A physical count of inventory on December 31, 2012, indicated that the company had $480,000 of inventory on hand.
2. An aging of accounts receivable indicates that $75,000 is uncollectible.
3. The company uses straight-line depreciation. The assets have a ten-year life and zero salvage value.
4. The company used a third of the remaining insurance policy during 2012.
5. The company pays interest for its bond payable on December 31 of every year. The coupon rate and the effective rate are both 10 percent per year.

(*Continued*)

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6. The company's tax rate is 35 percent. All income tax charges are recorded at the end of the year.
7. 200,000 shares of common stock were outstanding during 2012.

REQUIRED:
Prepare the following:

a. The necessary adjusting and closing entries on December 31, 2012.
b. An income statement including recommended earnings-per-share disclosures.
c. A reconciliation of retained earnings.
d. In terms of the objectives of financial accounting, discuss the usefulness of the various measures of income included on the statement.

ISSUES FOR DISCUSSION

REAL DATA
ID13–1
Comprehensive income

The components of 2008 comprehensive income for CVS Caremark and for Caterpillar, Inc. are outlined below (dollars in millions):

	CVS	Caterpillar
Net income	**$3,696**	**$3,557**
Foreign currency translation	———	**(488)**
Pension/post-retirement benefits	**7**	**(3,272)**
Derivative financial instruments	**1**	**69**
Available-for-sale securities	———	**(97)**

REQUIRED:
a. The net incomes for the two firms are very similar. Discuss how the total changes to equity due to nonowner transactions compare for the two firms.
b. CVS is a U.S.-based chain of retail pharmacies, while Caterpillar is a global manufacturer of heavy-duty construction equipment. How are the companies' business models reflected in their respective comprehensive incomes?
c. How would an analyst reading the financial statements of the two companies compare their relative financial changes over the course of a year? What specific areas might concern an analyst looking at Caterpillar that would not affect CVS?

REAL DATA
ID13–2
Ratings agencies and assessing risks

Ratings agencies such as Moody's and Standard & Poor's rate securities to give investors an independent grading of the risks involved in financial transactions. During 2007 both Moody's and S&P reported large increases in profits due to the increased volume of securities being issued and the consequent need for their services. Moody's reported a 20 percent rise in net profits during the first quarter of 2007, while the parent company of S&P (McGraw-Hill) indicated its financial services business (including S&P) recorded a 38 percent increase in operating profits. Both companies cited the growth in issuances as the driver of their profits.

Shortly after these earnings announcements in 2007, financial markets tightened in response to the collapse of the "subprime" mortgage market. Subprime home mortgages were bundled together by issuing lenders and sold to investors in what are called mortgage-backed securities, which are rated by agencies like Moody's and S&P. In fact, both companies have come under fire for not accurately rating the risks associated with the subprime securities.

REQUIRED:
a. What will the tightening of credit markets do to the business volume of the ratings agencies?
b. Where on the financial statements will Moody's and S&P reflect the drop in issuing activity?

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c. Assume that the two companies are held responsible for their inaccurate ratings on the mortgage-backed securities. What possible entries might appear on future income statements if the companies' reputation and business are hurt due to the subprime collapse?

REAL DATA

ID13-3

Extraordinary losses

Weyerhaeuser Company is engaged principally in the growing and harvesting of timber and the manufacture, distribution, and sale of forest products. When Mount St. Helens, a volcano located in Washington State, erupted, 68,000 acres of the company's standing timber, logs, buildings, and equipment were destroyed. As a result, the company recognized a $36 million (net of tax) extraordinary loss on its income statement.

REQUIRED:

a. What must have been true for Weyerhaeuser to classify this event as extraordinary?
b. If Mount St. Helens continues to erupt periodically, would future related losses necessarily be classified by Weyerhaeuser as extraordinary? Why or why not?
c. At the same time of the eruption, Weyerhaeuser's income tax rate was approximately 48 percent. Compute the entire loss (ignoring the tax effect) incurred by the company, and provide the journal entries prepared by the company's accountants to record the loss and the related income tax effect.

REAL DATA

ID13-4

Disclosing nonoperating items on the income statement

Several years ago, PepsiCo's earnings either rose or fell, depending on the source of the information. Standard & Poor's reported that PepsiCo experienced a 25 percent earnings gain, while Value Line, another investor service, reported that PepsiCo experienced a 7 percent loss. The discrepancy involved a "normal but nonrecurring charge" taken by PepsiCo to write down foreign bottling assets. Standard & Poor's ignored the charge in its earnings calculation, while Value Line included the charge.

REQUIRED:

a. Provide reasonable arguments that Standard & Poor's and Value Line could have used to support the decision either to ignore or include the charge in the calculation of PepsiCo's income.
b. Briefly describe the categories comprising a complete income statement and explain how such categories are usually disclosed.
c. *Forbes* once reported that "most financial analysts [are not concerned about] the geographic location of such items on the income statement." It is only important that they be disclosed. Explain why financial analysts might take such a position. At the same time, provide an argument suggesting that the specific location of an item on the income statement is important in an economic sense. State your argument in terms of earnings persistence and how income numbers are used in contracts.

REAL DATA

ID13-5

Income statement classification

Many e-tailers (retailers via the Internet) were not profitable in their early years. Analysts who believed in the futures of these firms, therefore, were forced to focus on other positive metrics of performance, such as revenues and gross profit margins (sales less cost of goods sold). The *Dow Jones News Service* (June 2, 2000) reported that the FASB had recently come out with a new rule requiring companies to include shipping and handling costs, significant in the e-tailing industry, in the cost-of-goods-sold category instead of as part of selling and administrative expense. Even though this reporting requirement had no effect on the bottom line, e-tailers like Amazon.com lobbied aggressively against it.

REQUIRED:

a. Why might analysts be interested in companies that were not recording profits?
b. What specific effect did the new FASB rule have on the income statement of companies like Amazon.com, and why would these companies lobby aggressively against the rule?
c. What impact would this new rule have on the reported cash flows of the company?
d. Do you think that the stock market prices of e-tailers would decrease in response to this ruling by the FASB? Why?

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REAL DATA
ID13–6
Litigation, reported income, and stock prices

In 1990, Eastman Kodak recorded a third-quarter net loss of $206 million, but at the same time, it posted a 22 percent rise in operating earnings to $835 million. Much of the loss was due to a $909.5 million charge taken to cover the costs associated with a patent infringement ruling, at which time Kodak was ordered to pay almost $1 billion to Polaroid for infringing on Polaroid's instant photography patents. The dollar amount awarded Polaroid was far below the company's multibillion-dollar claim. Kodak's shares jumped $1.25 to $29.75 in response to the news.

REQUIRED:

a. Where on Kodak's income statement should the charge be disclosed, and should the amount be reported net of tax? If so, assume a 34 percent tax rate and compute the net amount.
b. The patent infringement case between Kodak and Polaroid was well publicized and extended over several years. How do you think this situation was reported in Kodak's 1989 annual report? In Polaroid's 1989 annual report?
c. Explain why Kodak's stock could have increased in value in response to news that the company reported a $206 million net loss for the quarter.

REAL DATA
ID13–7
Income statement categories

In its 2008 annual report, which included a statement of comprehensive income, Bristol-Myers Squibb reported the following items (dollars in millions):

Net earnings from discontinued operations	**$ 113**
Research and development	**(3,585)**
Foreign currency translation	**(123)**
Net gain on disposal of business	**1,979**
Provision for restructuring	**(218)**
Gain on sale of assets	**159**
Cost of products sold	**(6,396)**
Litigation charges	**(33)**
Equity in net income of affiliates	**617**

REQUIRED:

a. Explain the nature of each item, describe where they would be disclosed on the income statement (including comprehensive income), and state whether or not they would be reported net of taxes.
b. Discuss each item in terms of its persistence.

REAL DATA
ID13–8
Analyzing special income statement items

Indicate how the income effects of the following items would be disclosed on the income statement and whether they represent a wealth change and/or can be expected to persist in the future.

a. Federal Express reported $17 million on operating gains from an insurance settlement for a DC-10 aircraft destroyed by fire.
b. Over a three-year period Motorola reported net gains of $443 million on asset sales.
c. Owens Corning reported a $68 million restructuring charge, equity in net income of affiliates of $11 million, and a $15 million cumulative effect of an accounting change.
d. Owens Corning reported an $875 million charge related to expected litigation claims due to asbestos injuries.

REAL DATA
ID13–9
Recurring vs. nonrecurring items

When luxury car maker BMW recently released earnings, the *Wall Street Journal* reported that it compared poorly to the prior year for a number of reasons, including:

- rising raw material costs
- strength of the euro
- a large gain booked during the year
- rising costs to introduce new models

These factors contributed to a 38 percent drop in quarterly income despite a 2.9 percent increase in sales.

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REQUIRED:

a. Discuss where the above reasons would be represented in the financial statements.
b. Which of the above reasons might be considered permanent and recurring?
c. How is net income different from comprehensive income?
d. On the day of the earnings announcement, BMW's stock price rose 1 percent. What other factors would an analyst review in addition to the earnings?

REAL DATA

ID13-10

Classification differences under both IFRS and U.S. GAAP

The Volkswagen Group, a German auto manufacturer, and Carrefour, a French retailer, both publish financial statements under IFRS, denominated in euros. Sony, the Japanese electronics giant, publishes financial statements under U.S. GAAP, denominated in yen. Excerpts taken directly from their 2008 income statements are provided below. Note that the items are in the order in which they appeared on the income statement.

Volkswagen (million euros):	
Operating profit	**6,333**
Share of profits and losses from equity-accounted investments	**910**
Finance cost	**(1,815)**

Carrefour (million euros):	
Finance costs	**(562)**
Net income from operations	**1,471**
Net income from equity method companies	**52**

Sony (billion yen):	
Equity in net income of affiliates	**101**
Operating income	**475**
Interest expense	**23**

REQUIRED:

a. Identify differences in the definitions of operations used by the three companies.
b. Comment on possible reasons for these differences.
c. How might an analyst handle these differences?

REAL DATA

ID13-11

The SEC Form 10-K of NIKE

Portions of NIKE's SEC form 10-K are reproduced in Appendix C.

REQUIRED:

Review the NIKE SEC Form 10-K, and answer the following questions.

a. Describe how nonoperating items affected NIKE's reported net income over the last three years. Did they increase or decrease net income, and by how much?
b. What was NIKE's net income per share of common stock? Has it been increasing or decreasing over the last three years? How much potential dilution do existing shareholders face?
c. How does NIKE disclose other comprehensive income items, and what was the comprehensive income amount for 2009? Was it above or below net income, and why?