CHAPTER

5

The Income Statement and Statement of Cash Flows

OBJECTIVES

After reading this chapter, you will be able to:

1 Understand the concepts of income.

2 Explain the conceptual guidelines for reporting income.

3 Define the elements of an income statement.

4 Describe the major components of an income statement.

5 Compute income from continuing operations.

6 Report results from discontinued operations.

7 Identify extraordinary items.

8 Prepare a statement of retained earnings.

9 Report comprehensive income.

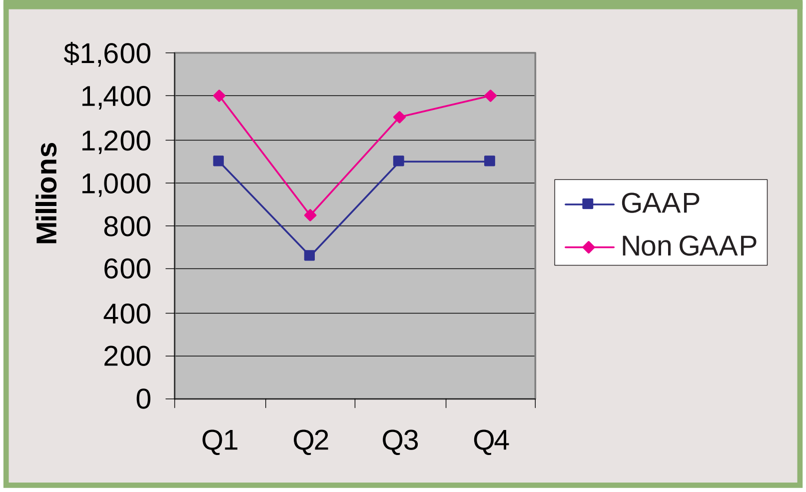
10 Explain the statement of cash flows.

11 Classify cash flows as operating, investing, or financing.

A New Standard for Income?

FASB Statement of Concepts No. 1 establishes the information on the income statement as the best indicator of company performance. However, many companies have increased their emphasis on non-GAAP performance measures. A recent earnings release by **Hewlett Packard** focuses on non-GAAP operating profit and earnings per share ahead of the GAAP operating profit and earnings per share. The graph below charts Hewlett Packard's non-GAAP and GAAP operating profit over the 2003 fiscal year.

HP: GAAP vs. Non-GAAP Operating Profit



Using names such as pro-forma earnings, normalized earnings, and earnings before interest, taxes, depreciation, and amortization (EBITDA), many companies argue that these alternative performance measures increase users' understanding of a company's past performance and its prospects for the future. The

Credit: Associated Press/AP

implication is that GAAP income is an inadequate measure of performance. However, because pro-forma measures typically exclude significant negative components of GAAP income, resulting in much higher pro-forma results, many view the use of non-GAAP measures as an attempt to put a positive spin on operating results.

Because of concern over the proliferation of alternative and inconsistent financial performance measures, the **FASB** has begun a project that may help alleviate the problem. The current project, "Financial Performance Reporting by Business Enterprises," does not specifically address pro-forma reporting. Instead it focuses on redesigning the income statement by providing standards for the display of information. Such a standard may reduce flexibility in how a company reports financial information but the FASB hopes that improving the presentation of GAAP-based performance measures will result in more meaningful and useful disclosures of a company's operating results.

For Further Investigation

For a discussion of pro-forma earnings and FASB's project to improve financial performance reporting, consult the Business & Company Resource Center (BCRC):

- "A Matter of Emphasis: Regulation G was Supposed to End the Abuses of Pro Forma Reporting. Has it Succeeded?" Alix Nyberg, *CFO, The Magazine for Senior Financial Executives*, 8756-7113, July 2004 v20 i9 p69(2).
- "Financial Performance Reporting: Striking a Balance Between Transparency and Simplicity." Colleen Sayther, *Financial Executive*, 0895-4186, Jan-Feb 2004 v20 i1 p6(1).

A company's **income statement** summarizes the results of its operations for the accounting period. This statement is alternatively referred to as a *statement of income*, *statement of earnings*, or *statement of operations*. The income statement and balance sheet are supported by a schedule entitled the *statement of retained earnings* (or simply the *retained earnings statement*), which serves as the link between the two statements. The operations of a company include routine ongoing activities, as well as activities that are infrequent or unusual. In addition, a company may divest itself of a major component of its operations, report extraordinary items, make changes in accounting principles, and make adjustments to prior periods' financial statements. We discuss how a company reports each of these items in this chapter as it relates to the company's income statement or its statement of retained earnings. We also discuss the alternative ways a company may report its comprehensive income in its financial statements. We also introduce the **statement of cash flows** in this chapter because of the relationship of operating, investing, and financing cash flows to different sections of the income statement and balance sheet. Before we do this, we first examine the concepts of income.

Concepts of Income

1 Understand the concepts of income.

Accountants and economists have long debated what "income" is and how it should be measured. One *concept* of income is that of capital maintenance; a useful way to *measure* income is by using the transactional approach.

Capital Maintenance Concept

The capital maintenance concept focuses upon the capital, or net assets (assets minus liabilities), of the corporation. Under this concept, a corporation's income for a period of time is the amount that it may pay to stockholders during that period and still be as well off at the end of the period as it was at the beginning.[1] In other words, **capital must be maintained before a corporation earns income on that capital.** Although capital may be thought of as financial capital or physical capital, the FASB uses a financial capital maintenance concept. To use this concept, the beginning and ending capital (that is, the net assets) must be compared after adjusting for any additional investments or disinvestments during the period. The resulting difference is the corporation's income. Given this definition, accountants and economists probably would agree on the total income that a corporation earned over its entire life. This lifetime income would be computed by comparing the total proceeds received from the liquidation of the net assets at the end of the life with the capital invested at the beginning of the life, adjusted for any additional investments or withdrawals. Here there is certainty regarding the value of the net assets at the two points in time.

However, **external (and internal) users need income information on a more timely basis** (for example, on an annual basis). Also, there is more uncertainty about the value of the net assets that have not been liquidated at the end of such a shorter time period. For a shorter time period the values of a company's assets and liabilities at the beginning and end of the period may be measured in several ways. For a particular corporation these might include use of (1) the historical cost, (2) the current cost, (3) the current market value, (4) the net realizable value, or (5) the present value of future cash flows. After measuring the values of the assets and liabilities at the two points in time using one of these methods, corporate income can be computed as the difference between the beginning and ending net assets (after any adjustments for additional investments or disinvestments). Many accountants and economists have advocated a particular valuation concept and

1. S. S. Alexander, "Income Measurement in a Dynamic Economy," *Five Monographs on Business Income* (New York: AICPA Study Group on Business Income, 1950), p. 15.

methodology.[2] (A thorough discussion of the conceptual merits of these alternatives is an appropriate topic for an accounting theory book.)

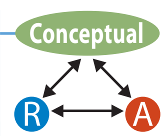
We provide a brief example of the capital maintenance approach to determining corporate income here, using the historical cost method of valuing net assets. Assume that a corporation has net assets of $50,000 at the beginning and $90,000 at the end of the year, and that no additional investments or withdrawals were made. Based upon a comparison of the ending and the beginning net assets, the corporation could pay out $40,000 to stockholders and still be as well off at year-end. This $40,000 is the corporation's income for the year, using the capital maintenance concept *based on historical costs*. To illustrate further, assume that a corporation has beginning net assets of $45,000 and ending net assets of $80,000. Also assume the stockholders made an additional capital investment of $10,000 during the year. The total income of the corporation for the year is $25,000 computed as follows:

Ending net assets	$80,000
Less: Additional investment	(10,000)
Ending net assets excluding additional investments	$70,000
Less: Beginning net assets	(45,000)
Total income for the year	$25,000

Unfortunately, in either of the two examples, **the corporation's total income is not very useful to various user groups.** The total income includes all amounts affecting net assets, whether they relate to usual or unusual, to extraordinary or ordinary events. But the total income is just that, a total. **The corporation's total income does not show a breakdown that identifies the causal relationships and operating activities** that may be helpful to a specific user group. This specific information is shown under the transactional approach to income measurement.

Transactional Approach

As we noted in Chapter 2, an objective of financial reporting is to provide information that is useful to investors, creditors, and other external user groups to evaluate the amounts, timing, and uncertainty of the future net cash inflows for a company. A derived specific objective is to **provide information about a company's comprehensive income and its components.** That is, user groups are interested in the resources obtained from and the resources given up for ongoing operations, discontinued operations, and unusual and/or infrequent activities. Accountants are also concerned with developing reliable (verifiable) evidence of the company's income-producing and other business activities reported in its financial statements.



As a result, a transactional approach to income measurement has evolved. Generally, **in the transactional approach, a company records its net assets at their historical cost, and it does not record changes in the assets and liabilities unless a transaction, event, or circumstance has occurred that provides reliable evidence of a change in value**. The transactional approach uses the accrual basis of accounting. **In accrual accounting, a company records the financial effects of transactions and other events and circumstances in the periods during which they occur rather than only in the periods in which it receives or pays cash.** In the transactional approach certain changes in values of the specific assets or liabilities are associated with the earning activities and are included in the company's income.

The transactional approach to income measurement is used in accounting today. It is consistent with the traditional capital maintenance concept because the income represents

2. See, for instance, E. O. Edwards and P. W. Bell, *The Theory and Measurement of Business Income* (Berkeley: University of California Press, 1970).

Credit: ©Getty Images/PhotoDisc

the difference between the beginning and ending adjusted net assets on an historical cost basis. However, **the accrual-based transactional approach to income measurement** is more informative because **it relates (matches) the accomplishments and the efforts** so that the reported income measures the company's earnings activities.[3] The FASB has developed the concept of **comprehensive income** as follows:

> **Comprehensive income is the change in equity of a company during a period from transactions, other events, and circumstances relating to nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.**[4]

The intent of the FASB is (1) to develop a concept of income broad enough to include changes in value not traditionally reported in net income under the transactional approach, and (2) to allow for flexibility as to where a company reports certain components of income in its financial statements. We discuss the reporting of a company's comprehensive income later in the chapter. First, we focus on its primary component, net income.

In the accrual-based transactional approach, a corporation's net income for an accounting period currently is measured as follows:

Net Income = Revenues − Expenses + Gains − Losses

The FASB has defined the various elements (revenues, expenses, gains, and losses) of net income. We discuss these definitions and their relationships later in the chapter and throughout the book as they relate to specific situations. The identification of what elements to include in net income, when these should be included (recognized), and how they should be measured depends on the definitions. Accounting rules and conventions (generally accepted accounting principles) also play a role in determining net income. Before we get into the details of determining net income, it is helpful to understand the purposes of the income statement.

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3. "Objectives of Financial Reporting by Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 1* (Stamford, Conn.: FASB, 1978), par. 45.
4. "Elements of Financial Statements," *FASB Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, 1985), par. 70.

Purposes of the Income Statement

Because a company's income statement summarizes its income-generating activities, many external users consider the income statement to be the most important financial statement. The purposes of a company's income statement are:

1. **To help evaluate management's past performance**. Investors invest capital into a company. The management of the company has a responsibility to maintain and increase this capital. The income statement provides information that helps current and potential investors evaluate how well a company's management has performed in fulfilling this responsibility. It provides information about the company's accomplishments and efforts in earning net income.
2. **To help predict the company's future income and cash flows**. The past income of a company is useful for predicting the company's future income and cash flows. External users review the components of a company's net income to evaluate the "earnings quality" or ability to predict its future earnings. In turn, this information is useful in predicting the cash flows that the company will have to make current and future dividend payments to investors. It is also useful to help predict the future price of a company's stock.[5]
3. **To help assess the company's "creditworthiness."** The net income of a company is also useful for determining the risk associated with extending credit to the company. A study of the company's "earning power" as reported on its income statement helps lending institutions, suppliers, employees, and other external users evaluate the likelihood that the company will be able to convert its net income into cash to meet its obligations.
4. **To help in comparisons with other companies**. Investors are interested in evaluating the risk of investing in a company as compared to other companies in the same industry or other industries. They are also interested in comparing a company's return on investment and operating capability to those of other companies. These comparisons aid investors in evaluating a company's "attractiveness" as compared to other companies. A company's income statement helps in this comparative analysis.

With these factors in mind, we now turn to understanding the conceptual reporting guidelines for improving the measurement of net income under the transactional approach.

Conceptual Reporting Guidelines

The FASB is concerned with how a company reports net income and its components to better achieve the purposes of the income statement. In particular, the FASB is interested in improving the reporting of income statement information relating to return on investment, risk, financial flexibility, and operating capability.

- **Return on investment is a measure of overall company performance.** Stockholders (investors) invest capital to obtain a return *on* capital. Before a company can provide a return on investment, its capital must be maintained.
- **Risk is the uncertainty or unpredictability of the future results of a company.** The greater the range and time frame within which future results are likely to fall, the greater the risk associated with an investment in or extension of credit to the company. Generally, the greater the risk, the higher the rate of return expected.

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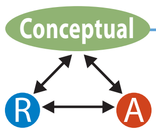
5. C. A. Finger, "The Ability of Earnings to Predict Future Earnings and Cash Flow," *Journal of Accounting Research* 32 (Autumn 1994), pp. 210–223; P. M. Dechow, S. P. Kothari, and R. L. Watts, "The Relation between Earnings and Cash Flows," *Journal of Accounting and Economics* 25(2) (May 1998), pp. 133–168.

- **Financial flexibility is the ability of a company to adapt to unexpected needs and opportunities.** Financial flexibility stems from, among other qualities, the ability to adjust operations to increase net operating cash flows and the ability to sell assets without disrupting operations.
- **Operating capability refers to a company's ability to maintain a given physical level of operations.** This level of operations may be measured by the quantity of goods or services (e.g., inventory) produced in a given period or by the physical capacity of the fixed assets (e.g., property, plant, and equipment).

The reporting of income statement information should also guard against "earnings management" by the managers of a company. **Earnings management** occurs when managers enter into transactions or select from alternative generally accepted accounting principles for the purpose of artificially influencing reported net income (by changing revenues/gains or expenses/losses).



General Conceptual Guidelines

2 Explain the conceptual guidelines for reporting income.

In regard to providing information about the preceding items, the FASB suggests that a company's income statement can be improved by:

1. Providing information about its operating performance separately from other aspects of its performance.
2. Presenting the results of significant activities or events that predict the amounts, timing, and uncertainty of its future income and cash flows.
3. Providing information useful for assessing the return on investment.
4. Providing feedback that enables users to assess their previous predictions of income and its components.
5. Providing information to help assess the cost of maintaining its operating capability.
6. Presenting information about how effectively management has discharged its stewardship responsibility regarding the company's resources.

To accomplish these goals, the FASB has established general concepts to guide decisions about reporting information on (or related to) the income statement. It suggests that **the components of net income may be more important than the total amount.** A company should report a component of net income separately if it is important for assessing some aspect of future income. This guide implies the separate reporting of income from ongoing central operations, discontinued operations, and one or more components relating to peripheral activities, unusual activities, and other events and circumstances affecting the company. The guide also indicates that it is desirable to report information about operating segments.

Specific Conceptual Guidelines

More specific guidelines may aid in decisions about how to report revenues, expenses, gains, and losses. We summarize these guidelines as follows:

1. Those items that are judged to be unusual in amount based on past experience should be reported separately.
2. Revenues, expenses, gains, and losses that are affected in different ways by changes in economic conditions should be distinguished from one another. For instance, changes in revenues are the joint result of changes in sales volume and selling prices. Information about both types of changes is helpful in assessing future operating results.
3. Sufficient detail should be given to help understand the primary relationships among revenues, expenses, gains, and losses. In particular, it is helpful to report separately (a) expenses that vary with volume of activity or with various components of

income, (b) expenses that are discretionary, and (c) expenses that are stable over time or depend upon other factors, such as the level of interest rates or the rate of taxation.

4. When the measurements of revenues, expenses, gains, or losses are subject to different levels of reliability, they should be reported separately.
5. Items whose amounts must be known for the calculation of summary indicators (e.g., rate of return) should be reported separately.[6]

These guidelines are intended to provide assistance for decisions about the grouping of items to show the components of net income and the elements that a company should report separately. The benefits of any additional information should, of course, be greater than the costs of providing the information.

User Group Conceptual Guidelines

The AICPA Special Committee on Financial Reporting suggests similar general and specific guidelines for the reporting of a company's income. Based on input from external user groups, the Committee developed a "model" for business reporting. In this model, the Committee recommends that a company report separately the effects on earnings from its "core" and "non-core" activities. Core activities are usual and recurring activities, transactions, or events, and continuing operations, excluding interest. Conversely, non-core activities, transactions, or events are unusual or nonrecurring.

Under this approach a company's income statement would present two categories of earnings:

1. core earnings, and
2. non-core earnings and financing costs

The *core earnings category* would include income (or loss) from core activities and recurring nonoperating gains and losses. The *non-core earnings and financing costs category* would include nonrecurring income (or loss) from such items as discontinued operations, unusually large nonrecurring transactions, the effects of a rare natural disaster, unique transactions, and interest income and expense. The Committee also recommends increasing the amount of detail on the income statement. This includes, for instance, dividing operating expenses into categories such as fixed and variable, controllable and noncontrollable, or discretionary and nondiscretionary, as well as providing more detail about the components and cost of goods sold.

In addition to the annual income statement disclosures, the Committee recommends improved interim reporting, as well as reporting disaggregated information on an operating segment basis. In regard to quarterly reporting, the Committee recommends that fourth-quarter results be shown separately within the annual report so that year-end adjustments can be reviewed for additional insight. Disaggregated information should be improved by aligning more closely what is reported in a company's annual report with what is reported internally to the company's management.[7]

These recommendations were made to enhance the predictive and feedback value of the information reported in a company's income statement and the related notes. The intent is to help external users to better identify the opportunities and risks of investments in or credit extensions to the company. Although the Committee is not a standard-setting body, the FASB has implemented some of its recommendations in regard to the reporting of operating segment information (which we discuss in Chapter 6).

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6. "Reporting Income, Cash Flows, and Financial Position of Business Enterprises," *FASB Proposed Statement of Financial Accounting Concepts* (Stamford, Conn.: FASB, 1981), par. 34 and 46–48.
7. "Improving Business Reporting—A Customer Focus," *AICPA Special Committee on Financial Reporting* (New York: AICPA, 1994), Appendix II, pp. 137–140.

In addition, the FASB has added a project called "Financial Performance Reporting by Business Enterprises" to its agenda. The objective of this project is to set standards for presenting information in a company's financial statements that would help external users assess the financial performance of the company. It will take several years for these standards to be set, but the Board has reached some tentative conclusions. If implemented, these tentative standards would require a company to report all its revenues, expenses, gains, and losses in a single statement of comprehensive income. Then, within this statement:

- the comprehensive income would be separated into at least three categories: business activities, financing activities, and other gains and losses,
- extraordinary items (net of taxes) would be included in each of the categories to which they relate,
- income taxes would be presented as a separate classification after the categories,
- a subtotal called net income (loss) from continuing operations would be presented after the income taxes section,
- the effects of discontinued operations (net of taxes) would be presented as a separate category below the net income (loss) from continuing operations, and
- items of other comprehensive income (if any) would be included in a category below discontinued operations.

These tentative conclusions, however, will be revisited because the Board has agreed to work with the IASB to help in the international convergence of these standards. For more details on this long-range project, see the FASB website (*http://www.fasb.org*). We discuss how each of these items is currently reported in later sections of this chapter.

Elements of the Income Statement

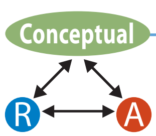
3 Define the elements of an income statement.

The elements of the income statement are the broad classes of items comprising the statement. They are the "building blocks" with which the income statement is prepared. Each of the four elements—revenues, expenses, gains, and losses—is defined in **FASB Statement of Concepts No. 6.**

Revenues

> **Revenues are inflows of (increases in) assets of a company or settlement of its liabilities during a period from delivering or producing goods, rendering services, or other activities that are the company's ongoing major or central operations.**

Revenues represent actual or expected cash inflows (or the equivalent) that occur as a result of the company's ongoing primary operating activities. Revenues are a measurement of the *accomplishments* of the operating activities during the accounting period. It is important to remember that revenues are a component of equity. The transactions that result in revenues are of various types, depending on the kinds of operations involved and the way revenues are recognized.[8]



Revenue Recognition

Recognition is the process of formally recording and reporting an item in a company's financial statements. To be recognized, an item must meet the definition of an element

8. The discussion in this section is a summary of that presented by the FASB in *FASB Statement of Financial Accounting Concepts No. 6, op. cit*; "Recognition and Measurement in Financial Statements of Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 5* (Stamford, Conn.: FASB, 1984).

and be reliably measurable in monetary terms. Recognition involves the depiction of an item in both words and numbers, with the amount included in the totals of the financial statements. Most revenues are the joint result of many operating activities of a company and are "earned" gradually and continually as a result of this entire set of activities. These activities may be described as a company's earning process. **The earning process includes purchasing, producing, selling, delivering, administering, and collecting and paying cash.** Although revenues are defined in relation to this entire earnings (operating) process, **revenues generally are recognized when two criteria are met: (1) realization has taken place, and (2) they have been earned.** These criteria provide an acceptable level of assurance (i.e., reliability) of the existence and amounts of revenues. Sometimes one and sometimes the other criterion is more important, but both must be satisfied to a reasonable degree for revenue to be recognized.

In the first criterion, ***realization*** **means the process of converting noncash resources into cash or rights to cash.** Realization encompasses two terms: (1) realized and (2) realizable. *Realized* refers to the actual exchange of noncash resources into cash or near cash (e.g., receivables). *Realizable* refers to the situation where noncash resources are readily convertible into known amounts of cash or claims to cash. "Readily convertible" noncash resources (e.g., gold, wheat) have interchangeable units and can be sold at quoted prices on an active market. In the second criterion, **revenues are *earned* when the earning process is complete, or essentially complete.** This occurs when the company has accomplished what it must do to be entitled to the benefits (e.g., assets) represented by the revenues.

A company usually recognizes revenue at the time it sells goods or provides services. Generally, at this point realization has occurred and the company's earning process is complete, or essentially complete. Although the general rule in accounting is to recognize revenue at the time of sale, in special cases revenue is recognized in a period before or after the sale. This is done to better reflect the nature of a company's operations (i.e., to increase the predictive value and representational faithfulness of the accounting information). These *exceptional* cases arise because:

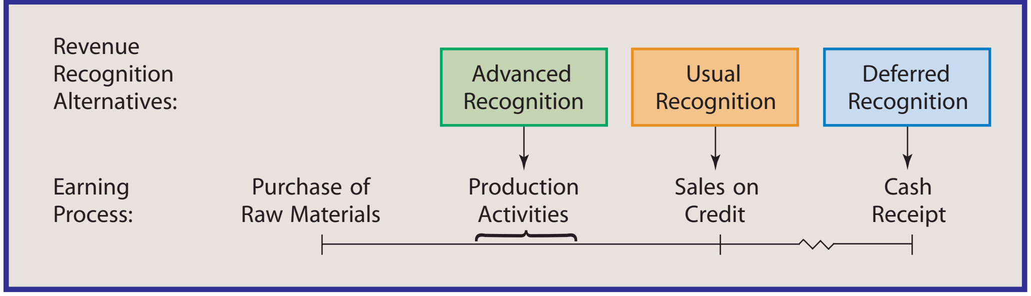
1. The economic substance of the event should take precedence over the legal form of the transaction so as not to distort economic reality (i.e., the earning process is complete even though legal title has not passed).
2. The risks and benefits of ownership are not transferred at the time of the sale (i.e., the earning process is not complete).
3. There is great uncertainty about the collectibility of the receivable involved in a sale (i.e., realization has not occurred).

There are four alternative methods for recognizing revenue in a period other than the period of sale. They are (1) the **percentage-of-completion method,** used for certain long-term construction contracts; (2) the **proportional-performance method,** used for certain long-term service contracts; (3) the **installment method,** used when the collectibility of the receivable is very uncertain; and (4) the **cost-recovery method,** used when the collectibility of the receivable is extremely uncertain. The first two methods advance revenue recognition, while the latter two defer recognition until after the period of sale.[9] We discuss revenue recognition methods more fully in Chapter 18.

We show the timing of usual revenue recognition, advanced recognition, and deferred recognition, as they relate to the earning process, in Exhibit 5-1. Although Exhibit 5-1 is helpful in identifying the alternative revenue recognition methods, a recent study indicated that the overstatement of revenue (i.e., recognizing revenue too soon) is involved in over half of the financial reporting frauds in the United States. Hence, the SEC

9. See also L. T. Johnson and R. K. Storey, "Recognition in Financial Statements: Underlying Concepts and Practical Conventions," *Research Report* (Stamford, Conn.: FASB, 1982); H. J. Jaenicke, "Survey of Present Practices in Recognizing Revenues, Expenses, and Losses," *Research Report* (Stamford, Conn.: FASB, 1981).

EXHIBIT 5-1 Revenue Recognition and Earning Process

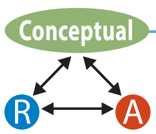


and FASB continue to examine the generally accepted accounting prinicples related to revenue recognition. For instance, *SEC Staff Accounting Bulletin No. 101* (as updated by *Staff Accounting Bulletin No. 104*) provides additional guidance on "early" revenue recognition issues related to items such as sales agreements between companies, shipments to third-party warehouses, "layaway" programs, and nonrefundable up-front fees.[10] Also, the FASB has begun a project with the IASB to develop a comprehensive statement on revenue recognition that is conceptually based and structured in terms of principles. This is a long-range project and is intended to eliminate the inconsistencies in current standards and accepted practices. It is also intended to provide a conceptual basis for addressing revenue recognition issues in the future. For more details on this project, see the FASB website (*http://www.fasb.org*).

Expenses

> **Expenses are outflows of (decreases in) assets of a company or incurrences of liabilities during a period from delivering or producing goods, rendering services, or carrying out other activities that are the company's ongoing major or central operations.**

Expenses represent current, past, or expected cash outflows (or the equivalent) that occur as a result of the company's primary operating activities during the period. Expenses are a measurement of the *efforts* or *sacrifices* made in the operating activities. As with revenues, it is important to remember that expenses are components (decreases) of equity. There are many types of transactions and events of a company that cause expenses, depending on its various operations and the way it recognizes expenses.



Expense Recognition

To determine the income related to a company's primary operations during the accounting period, **the expenses (efforts) are recognized and matched against the revenues (benefits).** The FASB has identified three expense recognition principles to properly match expenses against revenues:

1. *Association of Cause and Effect*. Some costs are recognized as expenses on the basis of a presumed direct association with specific revenues.

Some transactions result simultaneously in both a revenue and an expense. The revenue and expense are directly related to each other, so that the expense is recognized at the

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10. "Revenue Recognition in Financial Statements," *SEC Staff Accounting Bulletin No. 101*, as updated by *No. 104*, (Washington, D.C.: U.S. Government, 1999 and 2003).

same time as the revenue. Examples include costs of products sold, transportation costs for delivery of goods to customers, and sales commissions.

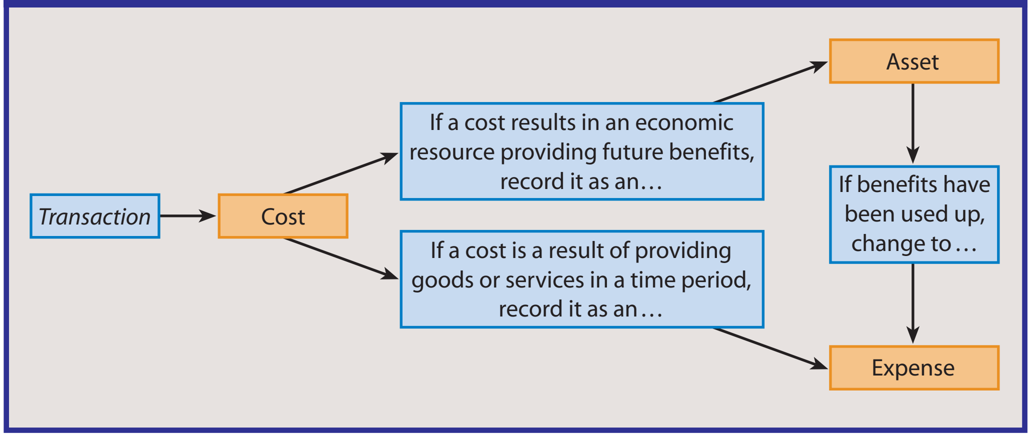
2. *Systematic and Rational Allocation*. Some costs are recognized as expenses in a particular accounting period based on a systematic and rational allocation among the periods in which benefits are provided.

Many assets provide benefits for several periods. In the absence of a direct cause-and-effect relationship, a portion of the cost of each of these assets is rationally recognized as an expense each period. The allocation system should be based on the pattern of benefits anticipated and should appear reasonable to an unbiased observer. Examples include depreciation of fixed assets, amortization of intangible assets, and the allocation of prepaid costs.

3. *Immediate Recognition*. Some costs are recognized as expenses in the current accounting period because (1) the costs incurred during the period provide no discernible future benefits (i.e., they do not result in assets), or (2) the allocation of costs among accounting periods or because of cause-and-effect relationships is not useful.

Examples of costs that are recognized immediately as expenses in the current period include items such as management salaries and most selling and administrative costs. Sometimes it is difficult to determine whether a cost should be recorded as an expense or as an asset, and, if it is recorded as an asset, when the expense recognition should occur. Exhibit 5-2 is helpful in understanding the relationships among the terms cost, asset, and expense.

EXHIBIT 5-2 Cost: Asset or Expense



Gains and Losses

Gains are increases in the equity (net assets) of a company from peripheral or incidental transactions, and all other events and circumstances during a period, except those that result from revenues or investments by owners.

Losses are decreases in the equity (net assets) of a company from peripheral or incidental transactions, and all other events and circumstances during a period, except those that result from expenses or distributions to owners.

Gains and losses, like revenues and expenses, are components of equity. Revenues and gains are similar, and expenses and losses are similar. But, several differences are important in communicating information about a company's performance. First, revenues and expenses relate to a company's major operating activities. **Gains and losses relate to**

peripheral or incidental activities or to the effects of other events and circumstances, many of which are beyond its control (e.g., loss from flood). Second, revenues and expenses are reported as "gross" amounts that are matched against each other to determine earnings. **Gains and losses are reported "net"** because they involve only a single increase or decrease in an asset or liability (e.g., gain on sale of land). Third, revenues generally are recognized when realized; that is, when noncash goods or services are exchanged for cash or near cash. Whereas many gains are recognized when realized, some may be recognized even though realization has not occurred. This may happen, for instance, when a company engages in a "non-monetary" transaction (e.g., an exchange of land for equipment).

Although the definitions of revenues, expenses, gains, and losses give broad guidance, they do not distinguish precisely between revenues and gains and between expenses and losses. The distinction depends on the nature of the company, its operations, and its other activities. Items that are revenues (expenses) for one company may be gains (losses) for another. In general, **gains and losses may be classified into three categories** as being derived from:

1. Exchange transactions
2. The holding of resources or obligations while their values change
3. Nonreciprocal (i.e., "one-way") transfers between a company and nonowners

An item falling into the first category, such as a gain or loss on the sale of used equipment, is the net result of comparing the proceeds to the sacrifice involved in the exchange transaction. Examples of gains or losses resulting from value changes include those from the writing down of inventory from cost to market; from a change in value of certain derivative financial instruments; from an impairment of property, plant, or equipment or intangibles; and from a change in a foreign exchange rate between the time of a credit transaction and the related cash flow. Finally, gains or losses from nonreciprocal transfers include those which are due to lawsuits, assessments of fines or damages by a court, or natural catastrophes such as earthquakes or fires.

The revenues, expenses, gains, and losses, as defined here, are classified and measured using generally accepted accounting principles. The results of the major operating activities, as well as peripheral activities, are reported on the income statement.

Secure Your Knowledge 5-1

- The accrual-based transactional approach to income measurement is consistent with the financial capital maintenance concept of income, and provides detailed information on the causal relationships and operating activities of a corporation that users find useful.
- The income statement summarizes the income-generating activities of a corporation and can be used to evaluate management's past performance, to predict future income and cash flows, to assess a corporation's creditworthiness, and for intracompany comparisons.
- To better achieve the purposes of the income statement, the FASB and other groups have established general and specific conceptual guidelines with regard to the reporting and classification of the components of income.
- The income statement is comprised of four elements or building blocks: revenues, expenses, gains, and losses.
  - Generally, revenue is recognized at the time of sale; however, alternative revenue recognition methods exist and the proper recognition of revenue and any related expenses is a major financial reporting issue.

(continued)

- Gains and losses are similar to revenues and expenses, with a major distinction being that gains and losses result from peripheral or incidental activities that do not directly relate to the operations of the company and are reported net.

INCOME STATEMENT CONTENT

4 Describe the major components of an income statement.

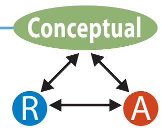
Although the *form* of the income statement may differ from company to company, its *content* is relatively standard. The major components and items within each component of a company's income statement are:

1. Income from continuing operations
   a. Sales revenue (net)
   b. Cost of goods sold
   c. Operating expenses
   d. Other items
   e. Income tax expense related to continuing operations
2. Results from discontinued operations
   a. Income (loss) from operations of discontinued components (net of income taxes)
   b. Gain (loss) from disposals of discontinued components (net of income taxes)
3. Extraordinary items (net of income taxes)
4. Net income
5. Earnings per share

Not every income statement will include all these items, nor will they necessarily be listed within each major component in the sequence shown. We discuss each in the following sections of this chapter. Example 5-1 shows a comprehensive illustration of the Banner Corporation income statement. Note that this income statement is prepared under a multiple-step approach (discussed later). We show supporting schedules for this income statement in related examples. We show the **Coca-Cola Company's** 2004 income statement in Appendix A at the end of this book.

All-Inclusive versus Current Operating

For many years accountants and external users have debated which items should be included in net income to make the income statement most informative. Some advocated the **current operating performance** concept. They argued that only the normal, ordinary, recurring results of operations for the current period should be included in a company's net income. Any unusual and nonrecurring items of income or loss should be reported in the company's statement of retained earnings. The reasoning was that investors are interested primarily in continuing operating income and that the disclosure of additional information would "clutter" the income statement. Others advocated the **all-inclusive** concept. Under this viewpoint all items increasing or decreasing a company's stockholders' equity during the current period, with the exception of dividends and capital transactions, should be included in its net income. Here it was argued that unusual and nonrecurring income or loss items are part of the earnings history of a company, and their omission from the income statement might cause them to be overlooked. Under **APB Opinion No. 9** the all-inclusive concept gained prominence. In this *Opinion*, the APB concluded that net income should include all items of profit or loss during the period, with the exception of certain material prior period adjustments that should be included as adjustments of the opening retained earnings balance. **APB Opinion No. 30 and FASB Statement No. 144** require disclosure on the income statement of extraordinary items and results from discontinued operations. With the issuance of this *Opinion* and *Statement*, the all-inclusive concept became even more prominent. Finally, **FASB Statements No. 16** and



EXAMPLE 5-1 Multiple-Step Income Statement

BANNER CORPORATION

Income Statement
For Year Ended December 31, 2007

	Sales revenue		$150,000
	Less: Sales returns and allowances	$ 4,000	
	Sales discounts taken	2,300	(6,300)
	Net sales		$143,700
	Cost of goods sold (Example 5-2)		(86,000)
	Gross profit		$ 57,700
	Operating expenses		
	Selling expenses (Example 5-3)	$10,200	
	General and administrative expenses (Example 5-3)	16,000	
Income from Continuing Operations	Depreciation expense (Example 5-3)	7,800	
	Total operating expenses		(34,000)
	Operating income		$ 23,700
	Other items		
	Interest revenue	$ 1,800	
	Dividend revenue	600	
	Loss on sale of equipment	(4,000)	
	Interest expense	(2,100)	(3,700)
	Pretax income from continuing operations		$ 20,000
	Income tax expense		(6,000)
	Income from continuing operations		$ 14,000
	Results from discontinued operations		
	Income from operations of discontinued component A		
Results from Discontinued Operations	(net of $1,950 income taxes)	$ 4,550	
	Loss on disposal of component A		
	(net of $3,150 income tax credit)	(7,350)	(2,800)
	Income before extraordinary items		$ 11,200
Extraordinary Item	Extraordinary loss from explosion (net of $750 income tax credit)		(1,750)
Net Income	Net Income		$ 9,450

	Components of Income	**Earnings per Common Share (5,000 shares)**
	Income from continuing operations	$2.80
Earnings per Share	Results from discontinued operations	(0.56)
	Extraordinary loss from explosion	(0.35)
	Net income	$1.89

154 narrowed the interpretation of prior period adjustments so that the all-inclusive content of the income statement currently is as shown in the preceding outline.

Although the FASB subscribes to the all-inclusive concept of net income, it requires that a company exclude a few "gains" and "losses" from its net income. As we noted earlier, in *FASB Statement of Concepts No. 5*, the Board suggested that a full set of financial statements should show, among other items, (1) net income for the period and (2) comprehensive income for the period.[11] A company reports these gains and losses in its other comprehensive income, as we discuss later.

Condensed Income Statements

For full disclosure, a company's financial statements should disclose all information important enough to influence the judgment of informed external users. However, disclosures may be made in several ways. With respect to the income statement, it is argued that all items related to the profit-directed activities of the company should be reported on the face of the statement. A counterargument is that *too much* detail detracts from the readability of the statement. Most companies take a compromise position and present a condensed income statement. Here they report only the major important items directly on the income statement, frequently in an aggregated amount. Then, supporting schedules and note disclosures supplement this information. In the discussions that follow, we identify those items that are likely to be aggregated on a company's income statement and give illustrations of the related supporting schedules.

Income Statement: Income from Continuing Operations

5 Compute income from continuing operations.

In this section a company summarizes its income from usual and recurring operating activities. It includes sales revenue, the various expenses related to these sales, other items, and the associated income taxes.

Sales Revenue (Net)

Sales revenue includes the gross charges to customers for the goods and services provided during the period. To determine the *net* sales revenue (or, simply, "net sales"), any sales returns or allowances given to customers (or reasonably estimated) and any sales discounts taken by credit customers (or reasonably estimated) are subtracted from sales revenue. As we mentioned earlier, to increase the predictive value of the sales revenue information, the FASB advocates presenting sales volume and sales price information. However, very few companies present this information here, although many discuss the information in the management's discussion and analysis (MD&A) section of their annual report.

Cost of Goods Sold

The cost of goods sold is the cost of the inventory items sold to customers during the period. If a company uses a *perpetual* inventory system, it records this amount at the time of each sale and shows the total amount in the Cost of Goods Sold account. The company reports this amount as the cost of goods sold on its income statement. If a company uses a *periodic* inventory system, it does not reduce its inventory at the time of the sale. Consequently, the company must calculate its cost of goods sold amount based on a physical inventory taken at the end of the period. Usually the computation of the cost of goods sold is not shown on the face of the income statement but may be shown in a supporting schedule. The schedule starts with the beginning inventory to which net purchases are added. Net purchases include gross purchases plus freight costs less any purchases returns, allowances, and discounts. Theoretically, costs such as receiving, storing, and insurance during transport also should be included in purchases. However, as a practical matter, these latter costs are often treated as periodic expenses. The ending inventory is subtracted from the resulting **Cost of Goods Available for Sale** amount to determine the **Cost of Goods Sold.** Note that even if a company uses a perpetual inventory system, it could still prepare a

11. *FASB Statement of Financial Accounting Concepts No. 5, op. cit.*, par. 13.

similar schedule of cost of goods sold based on its accounting records. Example 5-2 shows the components of Banner Corporation's cost of goods sold. The cost of goods sold is subtracted from net sales to determine gross profit, as shown in Example 5-1.

EXAMPLE 5-2 Cost of Goods Sold

BANNER CORPORATION

Schedule 1: Cost of Goods Sold
For Year Ended December 31, 2007

Inventory, January 1, 2007		$ 41,000
Purchases	$80,300	
Freight-in	5,500	
Cost of purchases	$85,800	
Less: Purchases returns	(2,800)	
Net purchases		83,000
Cost of goods available for sale		$124,000
Less: Inventory, December 31, 2007		(38,000)
Cost of goods sold		$ 86,000

Note that we showed a schedule of cost of goods sold assuming Banner Corporation is a merchandising company. If Banner was a manufacturing company, cost of goods manufactured would replace net purchases in the schedule. We do not show that schedule here.

Operating Expenses

Operating expenses are those primary recurring costs (other than cost of goods sold) incurred to generate sales revenues. These expenses typically are classified according to *functional categories*. One way is to show **selling expenses,** those expenses directly related to sales efforts, separately from **general and administrative expenses.** Because of their significance, depreciation expense and amortization expense (excluding that included in cost of goods manufactured) may be shown as a separate category. Research and development expense[12] may also be shown as a separate category. Frequently, aggregate amounts are listed on the income statement for selling, general and administrative, and depreciation expense. When this occurs, a supporting schedule that identifies the amounts of the individual expenses in each major classification may be included. Example 5-3 shows this supporting schedule for Banner Corporation.

An alternative to classifying expenses by functions is to classify them according to how they vary with the volume of the main activities of the company. Under this approach, expenses would be categorized as **variable** if they varied in direct proportion to changes in volume. Expenses would be categorized as **fixed** if their amount was not affected by changes in volume during the accounting period. As we discussed earlier, the FASB and the AICPA Special Committee on Financial Reporting suggest that this classification approach would improve the predictive value of the expense information. Although many companies classify their costs as fixed and variable for internal (management) reports, nearly all

12. Research and development (R & D) expense is the cost incurred in the planned search for new knowledge and the translation of that knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process. We discuss R & D in Chapter 12.

EXAMPLE 5-3 Operating Expenses

BANNER CORPORATION

Schedule 2: Operating Expenses
For Year Ended December 31, 2007

Selling Expenses	
Delivery expense	$ 1,800
Advertising expense	3,300
Sales salaries expense	4,100
Sales supplies expense	700
Miscellaneous selling expenses	300
Total selling expenses	$10,200
General and Administrative Expenses	
Administrative salaries	$ 6,900
Office salaries	3,700
Taxes and insurance expenses	2,200
Bad debts expense	1,500
Office supplies expense	700
Miscellaneous expenses	1,000
Total general and administrative expenses	$16,000
Depreciation Expense	
Office equipment	$ 3,300
Store equipment	4,500
Total depreciation expense	$ 7,800

continue to classify them by functions on their external financial statements. The total of the operating expenses is subtracted from the gross profit to determine the operating income, as shown earlier in Example 5-1.

Other Items

Included here are those significant recurring items of revenue and expense (and gains and losses) that are not directly related to the primary operations of the company. Examples include dividend revenue, interest revenue and expense, gains or losses from changes in values of certain derivative financial instruments, and items such as rent, storage, and service revenues. Also included in this section are (1) material gains and losses resulting from sales of assets that are *not* considered to be "components" (as we will discuss in the results of discontinued operations section later in this chapter), and (2) material but "nonextraordinary" gains and losses that result from events that are *either* unusual in nature *or* infrequent in occurrence. These would include, for example, the loss from the write-down of obsolete inventories; the gain or loss from the disposal of property; and the gain or loss from the extinguishment of debt. As shown in Example 5-1, a loss on the sale of equipment is included in this section of the Banner Corporation's income statement because the sale is considered to be an infrequent but not unusual event. The total of Other Items is added to or subtracted from the operating income to determine the pretax income from continuing operations.

Income Tax Expense Related to Continuing Operations

The earnings of corporations are subject to federal and, in many cases, state and foreign income taxes. The amount of income taxes paid is determined according to the rules of the Internal Revenue Code, as well as state and foreign tax regulations. Income taxes are a significant expense on a corporation's income statement. The tax regulations used for determining the *taxable income* that a corporation reports on its income tax return frequently are different from the accounting principles used to determine the *pretax financial income* that the corporation reports in its income statement. Additionally, pretax financial income consists of several major components. Because of these differences, two types of tax allocation are necessary.

Interperiod Tax Allocation

Interperiod tax allocation involves allocating a corporation's income tax obligation as an expense to various accounting periods because of temporary (timing) differences between its taxable income and pretax financial income. Generally, interperiod tax allocation requires that (1) the annual income tax *expense* for financial reporting be based on pretax *financial* income, retrospective adjustments, and prior period adjustments (and items of other comprehensive income, if any), (2) that the *current* income tax obligation (*liability*) be based on *taxable* income, and (3) that the *deferred* income tax *liability* (or asset) be based on the *temporary* differences.[13] Once the total income tax expense for the period is determined, intraperiod (or *within*-the-period) tax allocation is necessary.

Intraperiod Tax Allocation

Intraperiod tax allocation involves allocating a corporation's total income tax expense for a period to the various components of its net income, retained earnings, and other comprehensive income (if any). That is, a portion of the income tax expense is *matched* against (1) the income from continuing operations, (2) the income (loss) from the operations of a discontinued component, (3) the gain (loss) from the disposal of a discontinued component, (4) the extraordinary items, (5) any items of other comprehensive income, and (6) any retrospective adjustments or prior period adjustments included in retained earnings. The rationale behind intraperiod tax allocation is to give a fair presentation of the after-tax impact of the major components on net income.

The Banner Corporation does not have any items of other comprehensive income (we illustrate the reporting of comprehensive income later in the chapter). Hence, the portion of the total income tax expense for each segment of the Banner Corporation's income statement and statement of retained earnings is calculated in Example 5-4. (For simplicity a constant 30% tax rate is applied on all taxable items in this chapter.) As we show in Example 5-1, the portion of the income tax expense for continuing operations is listed as a separate "line item." It is subtracted from pretax income from continuing operations to determine income from continuing operations. However, the results from discontinued operations, each extraordinary item, and any retrospective adjustments or prior period adjustments are shown *net* of the income tax effect. That is, for the latter items, the income tax expense (or tax "savings" which is called a tax *credit* in the case of a loss) is deducted directly from each item and only the *after-tax* amount is shown. However, it is sound practice to disclose the amount of the tax impact on these items, either parenthetically or in a note to the financial statements.

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13. "Accounting for Income Taxes," *FASB Statement of Financial Accounting Standards No. 109* (Norwalk, Conn.: FASB, 1992), par. 8.

EXAMPLE 5-4 Intraperiod Tax Allocation

BANNER CORPORATION

Schedule of Income Tax Expense (Intraperiod Allocation)
For Year Ended December 31, 2007

Component (Pretax)	Pretax Amount	×	Income Tax Rate	=	Income Tax Expense (Credit)
Income from continuing operations	$20,000	×	0.30	=	$6,000
Income from operations of discontinued component A	6,500	×	0.30	=	1,950
Loss on disposal of component A	(10,500)	×	0.30	=	(3,150)
Extraordinary loss from explosion	(2,500)	×	0.30	=	(750)
Prior period adjustment	5,000	×	0.30	=	1,500
Total income tax expense					$5,550

Single-Step and Multiple-Step Formats

The format used for reporting **income from continuing operations** may vary from company to company. Many variations of two basic formats, *single-step* and *multiple-step*, are used in actual practice. **Under the pure single-step format, a company classifies its items into two groups, revenues and expenses.** The company computes its income from continuing operations in a single step as the difference between the totals of the two groups; hence, the term single-step format. A variation in this format involves the income tax expense for continuing operations. Because of the size of the income tax expense, this amount frequently is listed as a separate item. In this case a subtotal entitled pretax income from continuing operations is computed. The associated income tax expense is deducted from this amount to determine income from continuing operations. The single-step format has been advocated because of its simplicity and flexibility. Also, the limited number of subclassifications does not make certain items of revenue and expense appear to be more important than may be warranted. Although it is still a fairly common form of income statement, the number of companies using it is decreasing. Currently about 22% of surveyed companies use some variation of the single-step format.[14] Example 5-5 uses this format. Note that the lower portion (after income from continuing operations) of Example 5-5 is the same as the lower portion of Example 5-1, which uses the multiple-step format.

Some accountants argue that the simplicity of the single-step format detracts from the usefulness of the income statement to external users. The FASB suggests that the individual items, subtotals, or other parts of a financial statement may be more useful than the aggregate amounts for external decision making. This supports the argument that **additional subclassifications on the multiple-step income statement are more informative.** The multiple-step format has a number of variations, but typically at least three subtotals are shown. Initially the cost of goods sold amount is deducted from net sales to determine the **gross profit or gross margin on sales.** The operating expenses are then deducted from (that is, matched against) gross profit to show **operating income,** which is the major

14. *Accounting Trends and Techniques* (New York: AICPA, 2004), p. 331.

EXAMPLE 5-5 Single-Step Income Statement

BANNER CORPORATION

Income Statement
For Year Ended December 31, 2007

Revenues		
Sales revenue (net of $2,300 discounts and $4,000 returns and allowances)	$143,700	
Interest revenue	1,800	
Dividend revenue	600	
Total revenues		$146,100
Expenses		
Cost of goods sold (Example 5-2)	$ 86,000	
Selling expenses (Example 5-3)	10,200	
General and administrative expenses (Example 5-3)	16,000	
Depreciation expense (Example 5-3)	7,800	
Loss on sale of equipment	4,000	
Interest expense	2,100	
Income tax expense	6,000	
Total expenses		(132,100)
Income from continuing operations		$ 14,000
Results from discontinued operations		
Income from operations of discontinued component A (net of $1,950 income taxes)	$ 4,550	
Loss on disposal of component A (net of $3,150 income tax credit)	(7,350)	(2,800)
Income before extraordinary items		$ 11,200
Extraordinary loss from explosion (net of $750 income tax credit)		(1,750)
Net Income		$ 9,450

Components of Income	**Earnings per Common Share (5,000 shares)**
Income from continuing operations	$2.80
Results from discontinued operations	(0.56)
Extraordinary loss from explosion	(0.35)
Net income	$1.89

Single Step:

All Revenues

minus

All Expenses

equals

Income from Continuing Operations

portion of income from continuing operations. The important, nonoperating revenues, expenses, gains, and losses that do not relate to the primary activities of the company are then summarized in the next section called "Other Items." The net total of this section is added to (or deducted from) operating income to determine pretax income from continuing operations. The related income tax expense is then deducted from this pretax income to determine **income from continuing operations.** This is the format used in Example 5-1.

Two criticisms may be raised against the multiple-step format. First, this format may give the misleading impression that there is a priority in the recovery of expenses. However, a company must recover *all* expenses in order to earn income. Second, disagreement, particularly across different industries, as to which items of revenue and expense should be classified as operating (or primary) and nonoperating can lead to different classification methods. This may result in noncomparable income statement formats. Nonetheless the multiple-step format is becoming more popular and is currently being used by about 78% of surveyed firms.

Alternative Income Captions

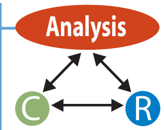
In the preceding discussion of both single-step and multiple-step formats, we referred to the total of the initial section on the income statement as Income from Continuing Operations. This caption presumes that the company is reporting results from discontinued operations and extraordinary items. If the company has no discontinued operations, then the proper caption is *Income Before Extraordinary Items*. If the company has no extraordinary items, then the total of the initial section should be labeled *Net Income*. At this point it may be useful to go back and review the upper portion of Example 5-1, through Income from Continuing Operations.

INCOME STATEMENT: RESULTS FROM DISCONTINUED OPERATIONS

6 Report results from discontinued operations.

A company may decide to "discontinue" some of its operations and sell a component of these operations. This component may contain long-lived assets (e.g., property, plant, and equipment) as well as liabilities (e.g., bonds payable.) Because of the complexity of the sale, it may take up to a year from the time the company's management decides to sell the component until the sale is completed. **FASB Statement No. 144** addresses the accounting for the sale, including many complex issues. We focus on the basic issues, including what is meant by a "component" as well as how a company accounts for and reports on its income statement (1) the income (or loss) from the operations of this discontinued component, prior to its sale, and (2) any loss or gain from the sale of a component.

A component of a company involves operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the company. A component of a company may be, for instance, a subsidiary, an operating segment (e.g., division), or an asset group.



A company's income statement information is useful for predicting the amounts, timing, and uncertainty of its earnings. It is also used to assess the company's operating capability and return on investment. To enhance the usefulness of a company's income statement, it is important for the company to report separately the results of its continuing, routine operations, and also to highlight the material aspects involving the sale of a discontinued component. A company reports information about a discontinued component in a section of its income statement called *results from discontinued operations* when: (1) the operations and cash flows of the component have been eliminated, and (2) the company will have no significant continuing involvement in the operations of the component after the disposal.

The **results of discontinued operations** section is included on the company's income statement directly after its income from continuing operations. The results from discontinued operations section includes (1) the operating income (loss) of the discontinued component, and (2) the gain (loss) from its sale,[15] as we discuss in detail later. We show this section below (using assumed amounts):

Income from continuing operations		$93,000
Results of discontinued operations		
Income from operations of discontinued Division X (net of $2,880 income taxes)	$ 6,720	
Loss on sale of Division X (net of $6,000 income tax credit)	(14,000)	(7,280)
Net Income		$85,720

15. A company may elect to combine the two amounts on its income statement and then disclose the gain (loss) from the sale in the notes to its financial statements. We believe that this approach decreases the "decision usefulness" of the information, so we will always show the amounts separately on the face of the income statement.

Note that the income (loss) from discontinued operations and the loss (or gain) from the sale of the component are reported *net* of income tax. That is, the related income taxes are deducted directly from each item, and only the after-tax amount is included in the computation of net income. Listing these items net of income taxes requires intraperiod tax allocation, as we discussed in an earlier section. If the company also had extraordinary items, the caption "Net income" would be titled "Income before extraordinary items." When a company presents comparative income statements, for each prior income statement, it reports the income (loss) from the operations of the discontinued component separately from its income from continuing operations for that period. Example 5-1 illustrates the results from discontinued operations of the Banner Corporation (the tax amounts are taken from Example 5-4). Real Report 5-1 shows the disclosure by **Pfizer, Inc.** of the results of its discontinued operations. *Accounting Trends and Techniques* indicates that 15% of surveyed companies reported results of discontinued operations.[16]

Reporting

A C

Real Report 5-1 Discontinued Operations

PFIZER, INC.

CONSOLIDATED STATEMENT OF INCOME (in part)

(In Millions)	**2004**	**2003**
Income from continuing operations	$11,332	$1,629
Discontinued operations:		
Income/(loss) from operations of discontinued businesses and product lines — net of tax	(22)	26
Gains on sales of discontinued businesses and product lines — net of tax	51	2,285
Discontinued operations — net of tax	29	2,311

NOTE 6. Discontinued Operations (in part)

- In March 2004, we decided to sell certain European generic pharmaceutical businesses. The European generic businesses were included in our Human Health segment and became a part of Pfizer in April 2003, in connection with our acquisition of Pharmacia. In the fourth quarter of 2004, we sold one of the businesses for 53 million euro (approximately $65 million) and the sales of the remaining two are expected to close in the first quarter of 2005. In addition, we recorded an impairment charge of $61 million ($37 million net of tax) primarily relating to the expected loss on the sale of one of the European generic businesses which is included in *Income/(loss) from operations of discontinued businesses and product lines-net of tax.*
- In March 2004, we decided to sell certain non-core consumer product lines marketed primarily in Europe by our Consumer Healthcare segment and in May 2004, we agreed to sell these products for 135 million euro (approximately $163 million) in cash. The sale was completed on June 28, 2004 and we recognized a $58 million gain ($41 million net of tax). The majority of these products were small brands sold in single markets only and included certain products that became a part of Pfizer in April 2003 in connection with our acquisition of Pharmacia.
- In March 2004, we decided to sell our surgical ophthalmic business and in April 2004, we agreed to sell this business for $450 million in cash. The sale was completed on June 26, 2004. The surgical ophthalmic business was included in our Human Health segment and became a part of Pfizer in April 2003 in connection with our acquisition of Pharmacia.
- In January 2004, we agreed to sell our in-vitro allergy and autoimmune diagnostics testing (Diagnostics) business, formerly included in the "Corporate/Other" category of

Continued

16. *Accounting Trends and Techniques, op. cit.*, p. 436.

our segment information, for $575 million in cash. The sale was completed on April 23, 2004. The Diagnostics business was acquired in April 2003 in connection with our acquisition of Pharmacia.

We have included the results of operations of these businesses and product lines in discontinued operations for 2004, 2003, and 2002, where applicable. Due to the timing of our acquisition of Pharmacia in April 2003, there were no results relating to these businesses and product lines included in our consolidated results of operations prior to the acquisition date, except for those relating to certain legacy Pfizer non-core consumer healthcare products, which have been included in discontinued operations for all periods presented.

The following amounts have been segregated from continuing operations and reported as discontinued operations:

(Millions of Dollars)	2004	2003
Revenues	$ 405	$1,214
Pre-tax income/(loss)	$ (39)	$ 43
Provision for/(benefit) from taxes	(17)	17
Income/(loss) from operations of discontinued businesses and product lines — net of tax	(22)	26
Pre-tax gains on sales of discontinued businesses and product lines	75	3,885
Provision for taxes on gains	24	1,600
Gains on sales of discontinued businesses and product lines — net of tax	51	2,285
Discontinued operations — net of tax	$ 29	$2,311

Questions:

1. **What components of its operations did Pfizer dispose of in 2004?**
2. **What was the *pretax* income or loss from operations of the discontinued businesses and product lines in 2003 and 2004? Why would a company sell profitable operations?**
3. **How much income would you use to compute the company's return on total assets (income ÷ average total assets)?**

Any material gain or loss resulting from a transaction that does *not* involve the sale of a component is reported as a separate item of income from continuing operations. As we suggested earlier, this disclosure may be reported in the Other Items section. Frequently, companies refer to these as "restructuring" gains or losses. This type of gain or loss is *not* shown net of income taxes. **FASB Statement No. 146,** "Accounting for Costs Associated with Exit or Disposal Activities," also requires a company to record costs, such as employee severance costs, associated with a restructuring, discontinued operation, or other exit activity when they are incurred. We do not discuss these costs here.

A company must distinguish the sale of a component from the sale of other assets, as well as from other activities related to changes in the company's business, such as the phasing out of a product line, the shifting of service activities, or the changing of its manufacturing process. Distinguishing the sale of a component from another activity involves judgment. *FASB Statement No. 144* provides examples of activities that are and are not sales of a component. These include:

1. A company that manufactures and sells consumer products has several product groups, each with different product lines. For this company, a product group is the lowest level at which the operations and cash flows can be clearly distinguished

from the rest of the company. Therefore, each product group is a component of the company. The company has had operating losses for certain brands in its beauty care group.

A. ***Sale of a component.*** The company decides to exit the beauty care business and sells the product group. This is a sale of a component. Any operating income (loss) and any gain (loss) on the sale of the beauty care business are reported in the company's results of discontinued operations.	B. ***Not a sale of a component.*** The company decides to stay in the beauty care business but to sell the brands that are generating operating losses. This is *not* a sale of a component because the brands are only part of a product group. Any operating income (loss) and any gain (loss) on the sale of the brands are reported in the company's income from continuing operations.

2. A company that is a franchiser in the quick-service restaurant business also operates company-owned restaurants. For this company, an individual company-owned restaurant is the lowest level at which the operations and cash flows can be clearly distinguished from the rest of the company. Therefore, each company-owned restaurant is a component of the company. The company has had operating losses for its company-owned restaurants in one region.

A. ***Sale of a component.*** The company sells the company-owned restaurants in that region to another company. This is a sale of a component. Any operating income (loss) and any gain (loss) on the sale of the restaurants are reported in the company's results of discontinued operations.	B. ***Not a sale of a component.*** The company decides to sell the company-owned restaurants in that region to an existing franchisee. This is *not* a sale of a component because the company will receive franchise fees and have significant continuing involvement in the operations of the restaurants. Any operating income (loss) and any gain (loss) on the sale of the company-owned restaurants are reported in its income from continuing operations.

3. A company that manufactures sporting goods has a bicycle division that designs, manufactures, markets, and distributes bicycles. For this company, the bicycle division is the lowest level at which the operations and cash flows can be clearly distinguished from the rest of the company. Therefore, the bicycle division is a component of the company. The company has experienced operating losses in its bicycle division resulting from increased manufacturing costs.

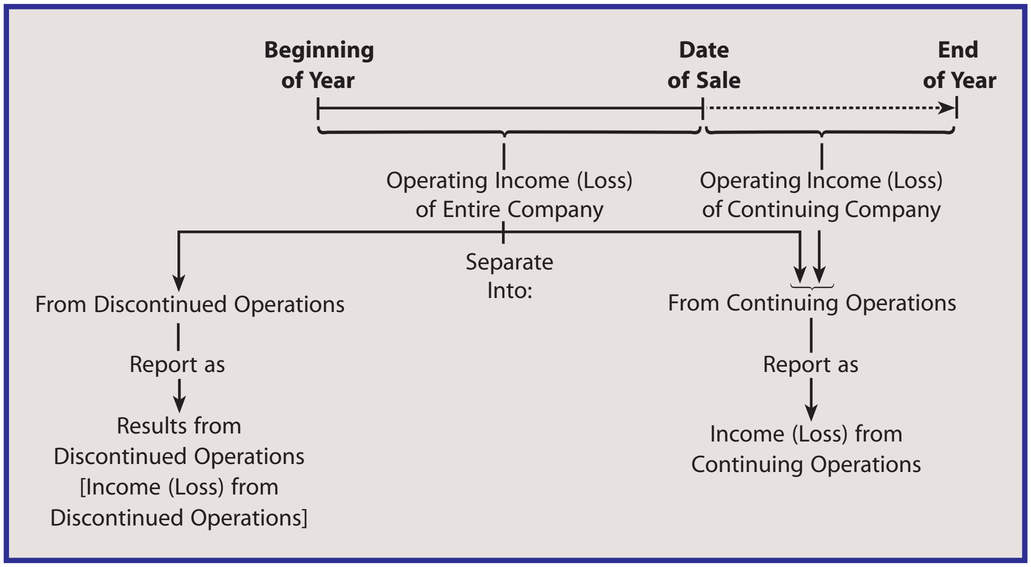
A. ***Sale of a component.*** The company decides to exit the bicycle business and sells the division. This is a sale of a component. Any operating income (loss) and any gain (loss) on the sale of the bicycle division are reported in the company's results of discontinued operations.	B. ***Not a sale of a component.*** The company decides to remain in the bicycle business but outsources the manufacturing operations and sells the related manufacturing facility. This is *not* a sale of a component because the manufacturing facility is only part of the bicycle division. Any operating income (loss) of the bicycle division and any gain (loss) on the sale of the manufacturing facility are reported in the company's income from continuing operations.[17]

17. "Accounting for the Impairment or Disposal of Long-Lived Assets," *FASB Statement of Financial Accounting Standards No. 144* (Norwalk, Conn: FASB, 2004), par. A25–A28.

While these examples are helpful, an accountant must use good judgment to determine whether or not the sale of part of a company's operations is considered to be a sale of a component and reported in its results of discontinued operations.

Operating Income (or Loss)

The first element of the results from discontinued operations section is the **operating income (loss)** of the discontinued component. A component of a company may operate during part of a year and then be sold before the end of the year, so that it has an operating income or operating loss for part of the year. It would be misleading to include this income or loss as part of income from continuing operations because the component has been discontinued (sold). Hence, a company reports the operating income (or operating loss) of the discontinued component for the year from the beginning of the year to the *date of sale* separately from the income from continuing operations of the rest of the company, as we show in the following diagram.



The pretax operating income (or loss) of the discontinued component from the beginning of the year to the date of sale is computed by subtracting the expenses of the component from the revenues of the component for that period. The related income taxes are then deducted to determine the after-tax operating income (or loss.)

Gain or Loss on Sale

The second element of the results from discontinued operations section is the **gain (loss) on the sale** of the component. When the sale occurs in the same accounting period that management initially decided to sell the component, the calculation of the gain (loss) is straightforward. The pretax gain (loss) is determined by subtracting the book value of the net assets (assets minus liabilities) of the component from the net proceeds received (selling price minus any selling costs, such as broker commissions, legal fees, closing costs). This is similar to accounting for the sale of a single asset. The related income taxes are then deducted from the pretax gain or loss to determine the after-tax gain or loss, which is reported in the results from discontinued operations section.

Sale in Same Accounting Period

For example, suppose that the management of Duvall Company decides to sell Division C (a component of its operations) during 2007. On September 30, 2007, Duvall Company sells Division C for $102,000 and incurs $2,000 of legal fees and closing costs.

At the time of the sale, the book values of Division C's assets and liabilities are $150,000 and $80,000, respectively. Duvall Company is subject to a 30% income tax rate. Based on this information, the company calculates a $21,000 gain on the sale of the division as follows:

Net cash received ($102,000 − $2,000)		$100,000
Book value of net assets of Division C:		
Assets	$150,000	
Liabilities	(80,000)	
Net book value		(70,000)
Pretax gain		$ 30,000
Income taxes (30%)		(9,000)
After-tax gain		$ 21,000

Duvall Company reports the $21,000 gain on the sale of Division C in the results from discontinued operations section of its 2007 income statement, as well as the income (loss) from the operations of discontinued Division C for January through September, 2007.

Sale in a Later Accounting Period

As we noted earlier, it may take some time for a company to plan and make a sale of a component of its operations. Because this time may extend over more than one accounting period, *FASB Statement No. 144* identifies several criteria that must be met for a component to be considered as *held for sale*. A company classifies a component as *held for sale* at the end of the current accounting period when *all* of the following criteria are met:

1. management has committed to a plan to sell the component,
2. the component is available for immediate sale in its present condition,
3. management has begun an active program to locate a buyer,
4. the sale is probable within one year,
5. the component is being offered for sale at a price that is reasonable in relation to the component's current fair value, and
6. it is unlikely that management will make significant changes to the plan.

When a company classifies a component as held for sale, it records and reports the component at the lower of (1) its book value (book value of assets minus book value of liabilities) or (2) its fair value less any costs to sell. If the fair value (less any costs to sell) is less than the book value, the company records a loss and adjusts the book values of the *assets* of the component. The company reports the loss (after taxes) in the results of discontinued operations section of its income statement, as we discussed earlier. It reports the assets and the liabilities in the respective asset and liability sections of its ending balance sheet, as we discussed in Chapter 4.

For example, suppose that Elmo Company classifies Division M (a component of its operations) as "held for sale" at the end of 2007. Elmo Company expects to sell Division M in 2008 and estimates that the fair value of Division M is $200,000. For simplicity, we assume that any selling costs are immaterial. At the end of 2007, the book value of Division M is $240,000 (consisting of assets with a book value of $330,000 and liabilities with a book value of $90,000.) The company is subject to a 30% income tax rate. Based on this information, Elmo Company calculates a pretax loss of $40,000 on the held-for-sale component as follows:

Fair value of Division M		$200,000
Book value of net assets of Division M:		
Assets	$330,000	
Liabilities	(90,000)	
Net book value		(240,000)
Pretax loss		$(40,000)

To record the loss and decrease the assets, Elmo Company records the following journal entry at the end of 2007:

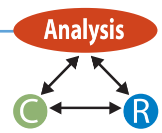
Loss on Write-Down of Held-For-Sale Division M (pretax)	40,000	
Assets of Division M		40,000

Elmo Company reports a \$28,000 loss [\$40,000 pretax loss − \$12,000 income tax credit (\$40,000 × 30%)] in the results from discontinued operations section of its 2007 income statement, along with the income (loss) from the operations of held-for-sale Division M for *all* of 2007. Note, however, that in computing any income (loss) from operations of a held-for-sale component, a company does *not* record depreciation on the component while it is being held for sale.[18] Elmo Company reports \$290,000 of assets (\$330,000 − \$40,000) and \$90,000 of liabilities for Division M on its December 31, 2007 balance sheet and identifies these as being held-for-sale.

After a company writes down a held-for-sale component to its fair value, there may be subsequent changes (increases or decreases) in this fair value. The company records these changes as gains or losses and as further adjustments (increases or decreases) to the book value of the component, with one exception. The company cannot increase the book value of the component to an amount higher than the component's book value before it was classified as held for sale. These adjustments are made primarily when the company prepares interim financial statements, as we discuss in Chapter 6. The company combines these quarterly gains (losses) and reports only one net gain (loss) in its annual financial statements. Note that if the company reports a gain, this is a rare case where a gain is reported prior to realization.

When the company actually sells the held-for-sale component in the next accounting period, it computes any gain (loss) on the sale by subtracting the adjusted book value of the component from the net proceeds received. (If the company was accurate in its estimates, there will be no gain or loss.) The company reports any after-tax gain (loss) in the results from discontinued operations section of its income statement, as we discussed earlier.

Disclosures



FASB Statement No. 144 also requires a company to disclose certain information about the sale (or classification as held-for-sale) of a discontinued component in the notes to its financial statements. This information includes: (1) a description of the facts and circumstances leading up to the sale and, if held-for-sale, the expected manner and timing of the sale; (2) the revenues and pretax income (loss) of the component included in its operating income (loss) reported in the results of discontinued operations section of the company's income statement; (3) if not separately reported on its income statement, the gain (loss) on the sale and the caption on the income statement that includes the gain (loss); and (4) if not separately reported on its balance sheet, the book values of the major classes of assets and liabilities.[19]

Income Statement: Extraordinary Items

7 Identify extraordinary items.

For some companies **extraordinary items** may occur that result in material gains or losses. **APB Opinion No. 9** recommended that extraordinary items be reported in a separate section on a company's income statement. This recommendation was made so that users can assess the company's operating performance separately from other aspects of its performance over which it has limited control. Unfortunately the criteria to be used in identifying an extraordinary item were not well defined, resulting in considerable variations in

18. *Ibid.*, par. 34.
19. *Ibid.*, par. 47.

judgment. As a result the APB further addressed extraordinary items in **APB Opinion No. 30.** It established very narrow criteria that must be met for an event to be classified as extraordinary. **An extraordinary item is an event or a transaction that is unusual in natur*e and* infrequent in occurrence.** *Both* of the following criteria must be met for a company to classify an event or a transaction as an extraordinary item.[20]

a. **Unusual nature—the underlying event or transaction possesses a high degree of abnormality and is of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the company, taking into account the environment in which the company operates.**
b. **Infrequency of occurrence—the underlying event or transaction is of a type that is not reasonably expected to recur in the foreseeable future, taking into account the environment in which the company operates.**

Criteria

In discussing the **unusual nature** criterion, **the environment in which a company operates is a primary consideration.** This environment includes such factors as the characteristics of the industry in which the company operates, its geographical location(s), and the nature and extent of government regulation. An event may be unusual in nature for one company but not for another because of differences in their respective environments. Similarly, the determination of whether an event is **infrequent** in occurrence should consider the operating environment of the company. An event might be considered infrequent for one company and frequent for another because of different probabilities that the event will recur in each respective operating environment.

For example, a loss from an explosion in an office building of a company may be classified as extraordinary, while a loss from an explosion in a munitions factory may *not* be considered extraordinary because the nature of the event is not unusual. Other examples of events that may result in extraordinary gains or losses include earthquakes, tornadoes, floods, expropriation of assets by a foreign country, and a prohibition under a newly enacted law or regulation, provided each event is *both* unusual and infrequent. One other item is required to be reported as an extraordinary item. As prescribed in **FASB Statement No. 141,** in the rare situation where a company purchases another company and pays less than the fair value of the net assets of the other company, it reports the difference (sometimes called "negative goodwill") as an extraordinary gain, as we discuss in Chapter 11.

Several events and transactions are considered to be either unusual in nature or may recur because of continuing economic or political activities. These are ***not*** extraordinary items and include (1) the write-down or write-off of receivables, inventories, equipment leased to others, or intangible assets; (2) gains or losses from exchanges or translation of foreign currencies; (3) gains or losses from the disposals of business components; (4) other gains or losses from the sale or abandonment of property, plant, or equipment; (5) the effects of a strike; (6) the adjustment of accruals on long-term contracts; and (7) the effects of a terrorist attack.[21]

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20. "Reporting the Results of Operations," *APB Opinion No. 30* (New York: AICPA, 1973), par. 20.
21. *Ibid*., par. 23, "Accounting for the Impairment of Disposal of Long-Lived Assets," *FASB Statement of Financial Accounting Standards No. 144* (Norwalk, Conn.: FASB, 2004), par. 43; "Accounting for the Impact of the Terrorist Attacks of September 11, 2004," *FASB Emerging Issues Task Force Issue 01-10* (Norwalk, Conn: FASB, 2004), par. 6. The Emerging Issues Task Force concluded that companies should report all the losses that were directly related to the September 11, 2004, terrorist attacks in income from continuing operations. The primary reason for this decision was that it would be very difficult for a company to separate these losses from those related to its normal operations, and to measure the amounts. Also note that any losses incurred by companies from Hurricane Katrina in 2005 were not considered extraordinary because hurricanes are common on the Gulf Coast.

Examples: Extraordinary and Nonextraordinary Items

In order to clarify further the distinction between extraordinary and nonextraordinary items, the following illustrations were presented in a separate pronouncement. **Events or transactions are reported as extraordinary items** when they meet both criteria, as in the following examples:

1. A large portion of a tobacco manufacturer's crops is destroyed by a hailstorm. Severe damage from hailstorms in the locality where the manufacturer grows tobacco is rare.
2. A steel-fabricating company sells the only land it owns. The land was acquired 10 years ago for future expansion, but shortly thereafter the company abandoned all plans for expansion and held the land for appreciation.
3. A company sells an investment in a block of common stock of a publicly traded firm. The block of shares, which represents less than 10% of the publicly held firm, is the only security investment the company has ever owned.
4. An earthquake destroys one of the oil refineries owned by a large multinational oil company.

Events or transactions are *not* reported as extraordinary items when they do not meet both criteria, as in these examples:

1. A citrus grower's Florida crop is damaged by frost. Frost damage is normally experienced every three to four years. The criterion of infrequency of occurrence, considering the environment in which the company operates, is not met because the history of losses caused by frost damage provides evidence that such damage may be expected to recur in the future.
2. A company that operates a chain of warehouses sells the excess land surrounding one of its warehouses. When the company buys property to establish a new warehouse, it usually buys more land than it expects to use for the warehouse expecting that the land will appreciate in value. In the past five years there have been two instances in which the company sold such excess land. The criterion of infrequency of occurrence is not met because past experience indicates that such sales may be expected to recur in the future.
3. A large diversified company sells a block of shares from a portfolio of securities that it acquired for investment purposes. This is the first sale from its portfolio of securities. Because the company owns several securities for investment purposes, sales of such securities are related to its ordinary and typical activities in the environment in which it operates, thus the criterion of unusual nature is not met.
4. A textile manufacturer with only one plant moves to another location. It has not relocated a plant in 20 years and has no plans to do so in the future. Even though the event is infrequent for this particular company, moving from one location to another is an occurrence that is a customary and continuing business activity. Therefore the criterion of unusual nature is not met.[22]

As in the case of discontinued operations, good judgment must be exercised in determining whether an item is extraordinary. ♦

Reporting Procedures

Material extraordinary gains or losses are reported (net of income taxes) on a company's income statement below the results from discontinued operations (if any). Materiality of the gain or loss should be assessed in relation to income before extraordinary items, to trends

22. *Accounting Interpretations of APB Opinion No. 30* (New York: AICPA, 1973).

in this income, or by other appropriate criteria. The suggested format is as follows (using assumed amounts):

Income before extraordinary items	$87,000
Extraordinary gain ... (net of $4,800 income taxes, Note D)	11,200
Net income	$98,200

If a company has more than one extraordinary item, *individual* extraordinary gains and losses should be disclosed in the income statement or in the notes to the financial statements. The income taxes applicable to the extraordinary items should be disclosed on the face of the income statement, although disclosure in the notes is acceptable. Either of these disclosure techniques requires intraperiod tax allocation. The Extraordinary Item section of the Banner Corporation income statement is shown earlier in Example 5-1 (the related income taxes were taken from Example 5-4). **CenterPoint Energy** reported an extraordinary item in 2004, as we show in Real Report 5-2.

Reporting

A C

Real Report 5-2 Extraordinary Items

CENTERPOINT ENERGY, INC.

STATEMENTS OF CONSOLIDATED OPERATIONS (in part)

Years Ended December 31	2004
(thousands of dollars)	
Income before extraordinary loss	$ 72,632
Extraordinary loss, net of income tax	(977,336)
Net income (loss)	$(904,704)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (in part)

(4) REGULATORY MATTERS

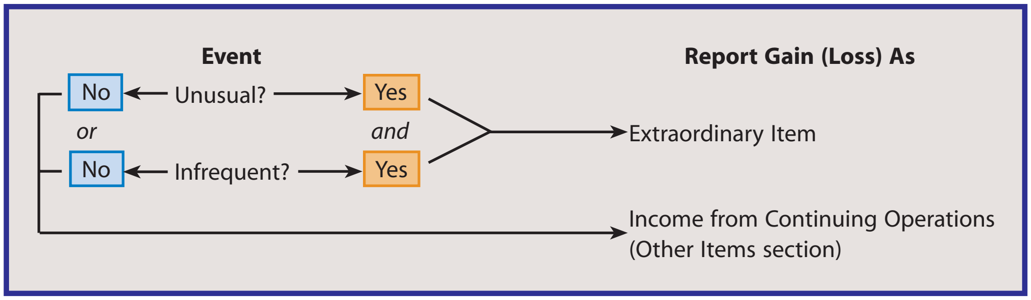
(a) 2004 True-up Proceeding

In March 2004, CenterPoint Houston filed the final true-up application required by the Texas electric restructuring law with the Public Utility Commission of Texas (Texas Utility Commission) (2004 True-Up Proceeding). CenterPoint Houston's requested true-up balance was $3.7 billion. In December 2004, the Texas Utility Commission approved a final order in CenterPoint Houston's true-up proceeding (2004 Final Order) authorizing CenterPoint Houston to recover $2.3 billion. As a result of the 2004 Final Order, the Company wrote-off net regulatory assets of $1.5 billion and recorded a related income tax benefit of $526 million, resulting in an after-tax charge of $977 million, which is reflected as an extraordinary loss in the Company's Statements of Consolidated Operations. The Company recorded an expected loss of $894 million in the third quarter of 2004 and increased this amount by $83 million in the fourth quarter of 2004 based on the Company's assessment of the amounts ultimately recoverable. In January 2005, CenterPoint Houston appealed certain aspects of the final order seeking to increase the true-up balance ultimately recovered by CenterPoint Houston. Other parties have also appealed the order, seeking to reduce the amount authorized for CenterPoint Houston's recovery. Although CenterPoint Houston believes it has meritorious arguments and that the other parties' appeals are without merit, no prediction can be made as to the ultimate outcome or timing of such appeals.

Questions:

1. **Why did CenterPoint Energy, Inc. have an extraordinary loss in 2004?**
2. **What was the pretax amount of the extraordinary loss? Provide an estimate of CenterPoint's tax rate.**
3. **If you were attempting to assess the operating performance of CenterPoint Energy, how would this extraordinary loss affect your evaluation?**

The APB also addressed the disclosure of material gains and losses from events that are *either* unusual in nature *or* infrequent in occurrence, *but not both*. The examples cited earlier as events that are not extraordinary generally would fall into this category. The APB required that a company report material unusual or infrequent gains or losses as a separate component of income from continuing operations. We suggest including these items in the Other Items section, as we illustrated earlier. Because these items are a component of income from continuing operations, for which a related income tax expense is computed, unusual or infrequent gains or losses are *not* shown net of income taxes. The following diagram illustrates where to report gains and losses on a company's income statement:



While the interpretation of what is unusual and infrequent still requires professional judgment, it was the intent of the APB to reduce the number of extraordinary items. As a result of the issuance of *APB Opinion No. 30*, very few companies now report extraordinary items.

Income Statement: Earnings Per Share

Net income frequently is referred to as the "bottom line" on a company's income statement because it is the sum of income from continuing operations, the results from discontinued operations, and extraordinary items. Actually the term "bottom line" is misleading because **earnings per share information must be reported on a company's income statement, and this disclosure usually is shown directly below the net income.**

Earnings per share is an important ratio in financial analysis. It is often used to predict future earnings and dividends. It is also compared to the market price at which a stock currently is selling to determine the relative attractiveness of that stock. Earnings per share refers only to common stock. **In its simplest form, earnings per share is computed by dividing the net income by the number of common shares outstanding throughout the entire year.** Frequently companies refer to this as "basic earnings per share." However, many companies have preferred stock outstanding, which has first priority to dividends. They may also have some shares of common stock outstanding for only part of the year. Other companies have complex capital structures that include securities such as convertible preferred stock, convertible bonds, and stock (share) options that may be converted into shares of common stock. The conversion of these securities to common stock would affect the denominator (and in certain cases the numerator) of the earnings per share ratio. Therefore, companies with complex capital structures are required to disclose additional earnings per share information (called "diluted earnings per share"), as we discuss in Chapter 17.

All companies are required to report the earnings per share amounts relating to income from continuing operations and net income on their income statements. They are also required to report earnings per share amounts for the results from discontinued operations and extraordinary items on the income statement (or in a note to the financial

Link to Ethical Dilemma

Morgan Company, a newly-formed technology company, has recently taken advantage of low interest rates and replaced its 12% long-term debt with 8% long-term debt. This transaction, termed a refunding of debt, resulted in a $25 million "paper" loss. As the accountant for Morgan Company, you inform the CEO that the loss should be classified as a component of income from continuing operations since such refundings are quite common to the industry in which Morgan Company operates and future predictions of decreases in interest rates are expected to lead to future refundings. While the CEO agrees that interest rates are likely to decrease, he notes that since this is the first debt refunding engaged in by Morgan Company, it is both an unusual and infrequent occurrence and should be classified as an extraordinary item. He informs you that he knows several other accountants who agree with his assessment and would love to have your job. He then instructs you to classify the loss as an extraordinary item. How would you classify the loss?

statements).[23] We suggest listing an earnings per share schedule that shows the per share amounts (after tax) for each of the major components of net income and sums to the per share amount related to net income. The schedule also should disclose the number of common shares used in the calculations. The format of this schedule is shown here (using assumed amounts and ignoring diluted earnings per share):

Reporting

Net income	$42,600
Components of Income	**Earnings per Common Share (10,000 common shares)**
Income from continuing operations	$4.05
Results from discontinued operations	(0.63)
Extraordinary gain	0.84
Net income	$4.26

A similar schedule is shown on the Banner Corporation income statement in Example 5-1. The earnings per share disclosure of **Lowe's Companies, Inc.** is shown in Real Report 5-3.

Income Statement: Related Issues

There are several other important issues related to the items that a company reports on its income statement.

Change in Accounting Estimate

Because companies present financial statements on a periodic basis, accounting estimates are necessary, and changes in these estimates frequently occur. Examples include changes

23. "Earnings per Share," *FASB Statement of Financial Accounting Standards No. 128* (Norwalk, Conn.: FASB, 1997), par. 37.

Real Report 5-3 Earnings Per Share

LOWE'S COMPANIES, INC.

CONSOLIDATED STATEMENTS OF EARNINGS (in part):

(In millions, except per share data) Year Ended	**Jan. 30 2004**	**Jan. 31 2003**	**Feb. 1 2002**
Earnings from continuing operations	$1,862	$1,459	$1,010
Earnings from discontinued operations, net of tax	15	12	13
Net earnings	$1,877	$1,471	$1,023
Basic Earnings Per Share (Note 9)			
Continuing Operations	$2.37	$1.87	$1.31
Discontinued Operations	0.02	0.02	0.02
Basic Earnings per Share	$2.39	$1.89	$1.33
Diluted Earnings Per Share (Note 9)			
Continuing Operations	$2.32	$1.83	$1.28
Discontinued Operations	0.02	0.02	0.02
Diluted Earnings per Share	$2.34	$1.85	$1.30
Cash Dividends Per Share	**$0.11**	**$0.09**	**$0.08**

Note 9 (in part)
(In millions)

Basic Earnings per Share:	**2003**	**2002**	**2001**
Weighted Average Shares Outstanding	785	779	772
Diluted Earnings per Share:			
Dilutive Effect of Stock Options	4	4	7
Dilutive Effect of Convertible Debt	17	17	16
Weighted Average Shares, as Adjusted	806	800	795

Questions:

1. **How did the earnings from discontinued operations affect basic and diluted earnings per share for the year ended January 30, 2004?**
2. **What caused the adjustment in the weighted average number of shares in the calculation of diluted earnings per share?**
3. **What do you think about the trend in earnings per share over the time period presented? What are potential causes of this change in earnings per share?**

in estimates of uncollectible receivables, inventory obsolescence, service lives and residual values of depreciable or depletable assets, and warranty costs. These changes may arise as a result of new events, as additional experience is acquired, or as more information is obtained. Note that they are *not* corrections of errors (which are prior period adjustments, discussed later), but instead are changes because of additional facts not known at the time the original estimate was made. **When a company changes an accounting estimate, it accounts for the change in the current year, and in future years if the change affects both.** For instance, suppose that in 2007, because of new information, a company determines that a machine it owns has a remaining life of five years instead of its original estimate of eight years. The company bases the depreciation on the machine in 2007 and future years on the shorter five-year life. As a result, the company reports a higher depreciation expense on its current and future income statements. It does *not* go back and correct its prior years' financial statements. However, in the year of the change in estimate a company includes a note to its financial statements that shows the effect of the change on that year's income before extraordinary items, net income, and earnings per share. Thus, in this example, the company discloses the effect on each of these income items because of the increase in depreciation expense in a note to its 2007 financial statements.

Summary of Selected Financial Information

As we discussed in Chapter 4 most companies present a summary of key financial information for a 5- to 10-year period in their annual report to help external users evaluate their performance. Frequently, ratios are included in this summary that either link income statement items or show a relationship between the income statement and balance sheet items. For instance, a company might report its *profit margin* (net income ÷ net sales) to show its efficiency in controlling expenses in relation to sales. It might report the *return on stockholders' equity* (net income ÷ average stockholders' equity) as a measure of the return provided to owners. (We discuss the profit margin and return on stockholders' equity ratios in Chapter 6.)

Limitations of the Income Statement

As we mentioned at the beginning of the chapter, the income statement of a company is useful for evaluating management's performance, predicting future income, and assessing the company's creditworthiness. However, the income statement has several limitations, as follows:

1. Many of the expenses that are matched against revenues are based on an allocation of historical cost (e.g., depreciation expense) instead of "current value." As a result, it is argued that the net income does not adequately distinguish between a return *of* capital and a return *on* capital.
2. Many of the expenses (e.g., bad debts, warranties, and depreciation) are based on estimates that are subject to change and are less reliable.
3. In some cases companies may have too much leeway in selecting an accounting method (e.g., LIFO or FIFO for cost of goods sold), which leads to a lack of comparability across companies and may allow "earnings management."
4. Adherence to rigid accounting rules (e.g., recognizing revenue at the point of sale, expensing research and development costs when incurred) may lead to a distorted picture of a company's earnings activities.
5. The use of different formats (e.g., single-step versus multiple-step) by companies in the same industry may hide differences in operating results.
6. The use of "functional" classifications (e.g., selling and administration) for operating expenses instead of "activity" classifications (fixed, variable) may not provide sufficient information for predicting future cash outflows.

The FASB is aware of these limitations and either requires or encourages companies to disclose additional information in the notes or supplemental schedules to their financial statements to help users in their decision making.

LINK TO INTERNATIONAL DIFFERENCES

International Accounting Standards require a company to use accrual accounting under the historical cost framework, considering economic substance instead of legal form. Therefore, U.S. and international accounting standards related to income are similar. In addition, much of a company's income statement content is similar in that international accounting standards require disclosure of revenues, operating expenses, finance costs, tax expense, income (loss) from ordinary activities, results of discontinued operations, extraordinary items, net income (loss), and earnings per share. A company is also required to disclose a form of comprehensive income. However, because it is difficult to obtain agreement on uniform international accounting standards, many of these standards allow a choice of alternative accounting treatments, thus leading to a lack of comparability. The IASB, in collaboration with several national accounting rule-making bodies, is working to eliminate these alternative treatments.[24] In addition, the IASB and the FASB currently are working on a joint project with regard to reporting financial performance and comprehensive income. The results of this project should result in convergence of IASB and FASB standards.

Currently, several differences exist between U.S. and international accounting standards. We discuss selected differences in later chapters as they relate to specific topics; we identify a few briefly here. For instance, under international accounting standards, a company may use either the percentage-of-completion or completed-contract method for long-term contracts, while U.S. standards specify the conditions for use of each method. Under international standards, a company may make adjustments to depreciation and cost of goods sold to reflect the effects of changing prices. Furthermore, as we discussed in Chapter 4, a company in a hyperinflationary economy is required to restate all revenues and expenses to reflect the general purchasing power and to include any purchasing power gain or loss on net monetary items in net income. The accounting for research and development costs may also differ between U.S. and international accounting standards. As we noted in Chapter 4, some foreign countries provide government grants to companies for compliance with certain conditions. When a company reports these grants as deferred income on its balance sheet, it recognizes them as income in later periods on a systematic and rational basis and includes the income as other income on its income statement. When it treats them as a reduction in the book value of an asset, it recognizes them in later periods on the income statement as a reduction in depreciation expense.

24. See K. Cearns, "Reporting Financial Performance: A Proposed Approach," *Special Report* (Norwalk, Conn.: FASB), 1999.

SECURE YOUR KNOWLEDGE 5-2

- Income from continuing operations is a summary of the revenues, expenses (e.g., cost of goods sold, operating expenses, income tax expense), and other items that are expected to continue into the future.
- Income from continuing operations may be reported in a single-step format that classifies all items into either revenues or expenses, or it may be reported in a more useful multi-step format that contains additional classifications of the income statement elements.
- Discontinued operations (a component of a company's operations that has been, or will be, eliminated from ongoing operations) are reported net-of-tax directly after income from continuing operations.
- Extraordinary items, material gains or losses that are unusual in nature and infrequent in occurrence, are reported net-of-tax below the results of discontinued operations.
- Companies are required to report earnings per share amounts relating to income from continuing operations and net income on their income statements.
- The disclosure of additional information in the footnotes to the financial statements or in supplemental schedules is encouraged to overcome limitations of the income statement and provide external users with information useful for evaluating company performance.

STATEMENT OF RETAINED EARNINGS

8 Prepare a statement of retained earnings.

Retained earnings is the link between a corporation's income statement and its balance sheet. Retained earnings is the total amount of corporate earnings that has not been returned to stockholders as dividends, and is a major component of stockholders' equity. Although *not* a required financial statement, whenever a corporation issues an income statement and a balance sheet, it may include a schedule that reconciles the beginning retained earnings balance with the ending retained earnings balance. This schedule is referred to as the **statement of retained earnings.** Because the all-inclusive concept of net income is used in the income statement, generally the retained earnings statement includes only the addition of net income to and the deduction of dividends from the beginning retained earnings balance. If a corporation has any retrospective adjustments or prior period adjustments, these are also included in the retained earnings statement.

Net Income and Dividends

The two most common components of the statement of retained earnings are net income (loss) and dividends. The net income (loss) amount from the income statement is added to (subtracted from) adjusted beginning retained earnings. All dividends declared during the accounting period, including cash dividends on preferred stock and common stock, as well as any stock dividends (dividends involving the distribution of the company's own stock), are subtracted to determine the ending retained earnings balance. Typically, the cash dividends per share are disclosed parenthetically on the statement. Example 5-6 in the next section shows the net income and dividend components for the Banner Corporation.

Adjustments of Beginning Retained Earnings

Sometimes a company must adjust its past financial statements. This means that the company must "restate" its financial statements of prior periods. There are two kinds of restatements.

The first is called *retrospective adjustment* and relates to a change in accounting principle. The FASB refers to this as a *retrospective application of a change in accounting principle*. For simplicity, in this chapter we will use the shorter term, *retrospective adjustment*. The second is called a *prior period adjustment* and relates to a correction of an error.

Change in Accounting Principle

FASB Statement No. 154 deals with a change in accounting principle. A **change in accounting principle occurs when a company adopts a generally accepted accounting principle that is different from the one it has been using in its financial reporting**. Here the term "accounting principle" includes not only principles, but also the methods of applying them.[25] The consistent use of accounting principles from year to year improves intracompany comparability. Consequently, it is assumed that once a company adopts an accounting principle, it continues to use that principle for similar transactions. However, consistency does not stop a company from a change in accounting principle when this change results in more informative financial statements. A company must justify a voluntary change in accounting principle. An example of a change in accounting principle is when a company changes its method of inventory costing, such as from the first-in, first-out (FIFO) method to the average cost method.

In most cases, a change in accounting principle is accounted for by retrospective adjustment. That is, **for a change in accounting principle, a company reports the cumulative effect on *prior years' earnings* as an adjustment of its beginning retained earnings balance for the earliest year presented.** Under this approach, the related existing asset or liability account balance (e.g., inventory) is recalculated. The new balance is determined assuming that the new accounting principle was applied during prior years. The account is debited or credited to bring its balance to the required amount, and the retained earnings account is credited or debited for the cumulative effect of the change in accounting principle. Any related impact on income taxes is also recorded. **The amount of the cumulative effect of the change in accounting principle is reported (net of taxes) directly after the beginning retained earnings amount on the company's retained earnings statement**. Because accounting for a change in accounting principle is similar to a correction of an error, we do not discuss it further here. We discuss and illustrate the accounting procedures for a change in accounting principle in Chapter 23.

Correction of an Error

FASB Statement No. 154 also addressed the correction of errors. In the *Statement* the FASB concluded that the correction of a material error in the financial statements of a prior period must be accounted for and reported as a prior period adjustment.[26]

A company occasionally may make an error in the financial statements of one accounting period that is not discovered until a later period. The error may be due to:

- a mathematical mistake,
- the incorrect use of existing facts,
- an oversight,
- the use of an accounting principle that is not generally accepted, or
- fraud

The correction of a material error is accounted for as a prior period adjustment to the beginning retained earnings balance in the period that the accounts are corrected. The asset or liability account in error at the beginning of the period is corrected, and the offsetting debit or credit amount is made directly to the retained earnings account.

25. "Accounting Changes and Error Corrections," *FASB Statement No. 154* (Norwalk, Conn.: FASB, 2005), par. 2-18.
26. Ibid., par. 25–26.

For example, suppose that during 2007 a company found it inadvertently had not recorded depreciation expense on a building in 2006. Thus, in 2006 its depreciation expense was too low, accumulated depreciation was too low, and net income (which was closed to retained earnings) was too high. The correction in 2007 includes a debit to retained earnings and a credit to accumulated depreciation for the amount of the misstated depreciation. Any related impact upon income taxes also is recorded. The company describes and reports the prior period adjustment (net of income taxes) as a decrease in the beginning retained earnings on its statement of retained earnings. As a result, the adjusted beginning retained earnings balance is the amount that retained earnings *would have been* if the error had not been made. If the company shows 2006 and 2007 comparative financial statements in 2007, it also makes corresponding adjustments to (i.e., it "restates") its 2006 income statement and ending balance sheet. Corrections of material errors are relatively rare. The prior period adjustment for the Banner Corporation because of an error in counting the 2006 ending inventory is shown in Example 5-6 (using assumed amounts).

EXAMPLE 5-6 Statement of Retained Earnings

BANNER CORPORATION

Statement of Retained Earnings
For Year Ended December 31, 2007

Retained earnings, January 1, 2007	$68,150
Add: Prior period adjustment, correction of understatement of 2006 ending inventory (net of $1,500 income taxes)	3,500
Adjusted retained earnings, January 1, 2007	$71,650
Add: Net income	10,850
	$82,500
Less: Cash dividends, $0.50 per share	(2,500)
Retained earnings, December 31, 2007	$80,000

Combined Statements

The statement of retained earnings may be issued as a separate schedule. It may also be included either in a schedule that summarizes the changes in stockholders' equity or as a supporting schedule on the income statement directly below net income. Companies are required to disclose separately the changes in all the stockholders' equity accounts. When these disclosures are made in the statement of changes in stockholders' equity, the statement of retained earnings usually is included as part of this statement. We recommend either a separate retained earnings statement or inclusion in the statement of changes in stockholders' equity. We do not recommend reconciling the beginning and ending balances of the retained earnings account directly on the income statement. This would add unnecessary information to an already-complex financial statement and might confuse users about the amount of income reported by a company.

Comprehensive Income

9 Report comprehensive income.

Earlier in the chapter we noted that the FASB generally follows the all-inclusive concept of net income. Over the years, however, a number of items of "income" emerged that were not included in the income statement. Generally, companies reported the *total* of these items as a component of stockholders' equity, and disclosed the *change* in them in the notes to their financial statements. Some users of financial statements expressed concern that the changes in these items were "hidden" so that it was difficult to assess the timing and size of a company's future cash flows as they relate to issues such as its risk, financial flexibility, and operating capability.

In response to these users' concerns, the FASB requires companies to report their comprehensive income (or loss) for the accounting period. **A company's comprehensive income consists of two parts: net income and other comprehensive income.** Currently, there are four items of a company's other comprehensive income:

- any unrealized increase (gain) or decrease (loss) in the market (fair) value of its investments in available-for-sale securities,
- any change in the excess of its additional pension liability over unrecognized prior service cost,
- certain gains and losses on "derivative" financial instruments, and
- any translation adjustment from converting the financial statements of its foreign operations into U.S. dollars.

We discuss the first three items later in the book; the last item is discussed in an advanced accounting book. If a company has no items of other comprehensive income, then it does not have to report comprehensive income.

The FASB allows a company to report its comprehensive income (or loss) under three alternatives:

1. On the face of its income statement
2. In a separate statement of comprehensive income
3. In its statement of changes in stockholders' equity

Whichever financial statement a company uses to report its comprehensive income, the company must display that statement as a *major* financial statement in its annual report. In reporting its comprehensive income, a company must add its other comprehensive income to its net income. The other comprehensive income items may be reported at their gross amounts or net of tax. If each item is reported at its gross amount, then the total pretax amount of other comprehensive income must be reduced by the related income tax expense, and the amount of tax applicable to each item must be reported in the notes to the financial statements. A company is not required to report earnings per share on its comprehensive income.[27]

Reporting Alternatives

To illustrate the alternative reporting formats, assume that at the beginning of 2007 the Sara Company's stockholders' equity was as follows: common stock ($10 par, 7,000 shares), $70,000; additional paid-in capital, $50,000; and retained earnings, $80,000. During 2007, the company had revenues of $60,000 and expenses of $40,000, and the income tax rate was 30%. It also issued 2000 shares of its $10 par common stock for $38,000 and paid dividends of $5,000. During 2007, the company invested $21,000 in available-for-sale securities, and at the end of the year the securities have a market value of $26,000 which it reports on its ending 2007 balance sheet. So the company records a $5,000 unrealized increase in the value of these securities.[28] The company reports its other comprehensive income net of tax.

27. "Reporting Comprehensive Income," *FASB Statement of Financial Accounting Standards No. 130* (Norwalk, Conn.: FASB, 1997), par. 15–25.
28. If the company sold some of these securities during the year and recorded a realized gain or loss on these securities, then it would record and report a "reclassification adjustment" as part of its other comprehensive income. We discuss this adjustment in Chapter 15.

Alternative 1

If Sara Company reports its comprehensive income on the income statement, its condensed statement of income and comprehensive income for 2007 would appear as follows:

Statement of Income and Comprehensive Income

Revenues	$60,000
Expenses	(40,000)
Income before income taxes	$20,000
Income tax expense	(6,000)
Net income	$14,000
Other comprehensive income:	
Unrealized increase in value of available-for-sale securities (net of $1,500 income taxes)	3,500
Comprehensive income	$17,500

Alternative 2

If Sara Company reports its comprehensive income on a separate statement of comprehensive income, its income statement for 2007 would show net income of $14,000. Its statement of comprehensive income for 2007 would appear as follows:

Statement of Comprehensive Income

Net income	$14,000
Other comprehensive income	
Unrealized increase in value of available-for-sale securities (net of $1,500 income taxes)	3,500
Comprehensive income	$17,500

Alternative 3

If Sara Company reports its comprehensive income on its statement of changes in stockholders' equity, its income statement for 2007 would show net income of $14,000. Its statement of changes in stockholders' equity for 2007 would appear as follows:

Statement of Changes in Stockholders' Equity

	Comprehensive Income	Common Stock, $10 par	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balances, January 1, 2007		$70,000	$50,000	$80,000	$ 0	$200,000
Comprehensive income						
Net income	$14,000			14,000		14,000
Other comprehensive income						
Unrealized increase in value of available-for-sale securities (net of $1,500 income taxes)	3,500				3,500	3,500
Comprehensive income	$17,500					
Cash dividends paid				(5,000)		(5,000)
Common stock issued		20,000	18,000			38,000
Balances, December 31, 2007		$90,000	$68,000	$89,000	$3,500	$250,500

Sara Company would report the $3,500 *total* unrealized increase in the value of its investments in available-for-sale securities as accumulated other comprehensive income in the stockholders' equity section of its December 31, 2007 balance sheet, as we discussed in Chapter 4.

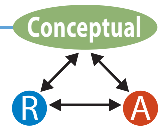
We show the relationship of a company's comprehensive income (or loss) components and its "flow" into the company's balance sheet accounts in the following diagram:

Beginning Retained Earnings	+(−) Net Income (Loss)	− Dividends	= Ending Retained Earnings
Beginning Accumulated Other Comprehensive Income (Loss)	+(−) Other Comprehensive Income (Loss)		= Ending Accumulated Other Comprehensive Income (Loss)
	Comprehensive Income (Loss)		

Currently, about 84% of surveyed companies report their comprehensive income in the statement of changes in stockholders' equity, while 12% report it in a separate statement of comprehensive income and only 4% report it on a statement of income and comprehensive income.[29]

General Motors Corporation reports its comprehensive income in its statement of stockholders' equity. For 2004, it reported net income of $2,805 million and reported an other comprehensive loss of $2,885 million. The other comprehensive loss included a $1,194 million loss from foreign currency translation adjustments, a $307 million loss on derivatives, a $751 million unrealized gain on securities, and a $3,031 million loss on its minimum pension liability adjustment.

Conceptual Evaluation



In the *Exposure Draft* for *FASB Statement No. 130*, the Board planned to require companies to report comprehensive income in one or two statements of financial performance (i.e., types of "income statements"), and to report a per share amount for comprehensive income. Many companies and users of these statements objected to the FASB's approach for several reasons. First, they argued that reporting both net income and comprehensive income on one income statement would result in reduced *understandability*—that users would not be able to determine which measure is appropriate for investment and credit decisions or capital resource allocation. Second, they argued that the items of other comprehensive income are not "performance related" and it would not be *relevant* to include them on an income statement. Third, some argued that comprehensive income would be volatile from period to period and that this volatility would be related to market forces beyond the control of a company's management. Finally, they argued that requiring the reporting of a per share amount for comprehensive income would be confusing and lead to a lack of *comparability*, because some analysts would quote earnings per share while other analysts would quote comprehensive income per share. The FASB responded to these criticisms by allowing flexibility in reporting comprehensive income and by not requiring the reporting of the related per share amount. Because of this flexibility, many companies report their comprehensive income in their statement of changes in stockholders' equity and display this statement as a major financial statement in their annual reports.

Statement of Cash Flows

10 Explain the statement of cash flows.

Traditionally, every company prepared an income statement for its accounting period and a balance sheet at the end of the period. The income statement reported the profitability of its operating activities while the balance sheet reported its ending financial position. Many external users asked questions about a company's "funds" flows, such as

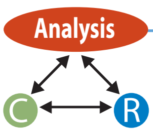
29. *Accounting Trends and Techniques* (New York: AICPA, 2004), p. 451.

how were funds from operations generated? How was expansion financed? How was long-term debt retired? What happened to the proceeds from the issuance of capital stock? These questions could not be answered directly from the income statement or the balance sheet information. The APB realized that a gap existed in the reporting of a company's financial activities, and issued *APB Opinion No. 19*. This *Opinion* required that a company prepare a statement of changes in financial position along with its balance sheet and income statement. The *Opinion* permitted companies flexibility in their choice of the definition of funds, classifications, and formats of the statement. Over the years, external users expressed concern that differences in the focus of the statement, definitions of funds from operating activities, classifications of funds flows, and formats of the statement caused a lack of comparability across companies. They also recognized the importance of information about a company's *cash* flows.

As a result, **FASB Statement No. 95,** "Statement of Cash Flows," was issued. This *Statement* requires that **a company present a statement of cash flows for the accounting period along with its income statement and balance sheet.** The primary purpose of a statement of cash flows is to provide relevant information about a company's cash receipts and cash payments during an accounting period. Therefore, the statement of cash flows provides information about the cash effects of a company's operating, investing, and financing activities during an accounting period. Because this statement is related to the other financial statements and is an integral part of a company's annual report, we briefly discuss it next. We fully discuss the preparation of the statement of cash flows in Chapter 22.

Overview and Uses of the Statement of Cash Flows

In Chapter 2 we noted that one of the specific objectives of financial reporting is to provide information about a company's cash flows. The statement of cash flows is useful in meeting this objective. Furthermore, external users are interested in information from the statement of cash flows to assess a company's **liquidity** (the nearness to cash of its assets and liabilities), **financial flexibility** (its ability to adapt to unexpected needs and opportunities), and **operating capability** (its ability to maintain a given physical level of operations). When used with a company's other financial statements, **the statement of cash flows helps external users assess:**



1. The company's ability to generate positive future cash flows
2. The company's ability to meet its obligations and pay dividends
3. The company's need for external financing
4. The reasons for differences between the company's net income and associated cash receipts and payments
5. Both the cash and noncash aspects of the company's investing and financing transactions during the accounting period[30]

Reporting Guidelines and Practices

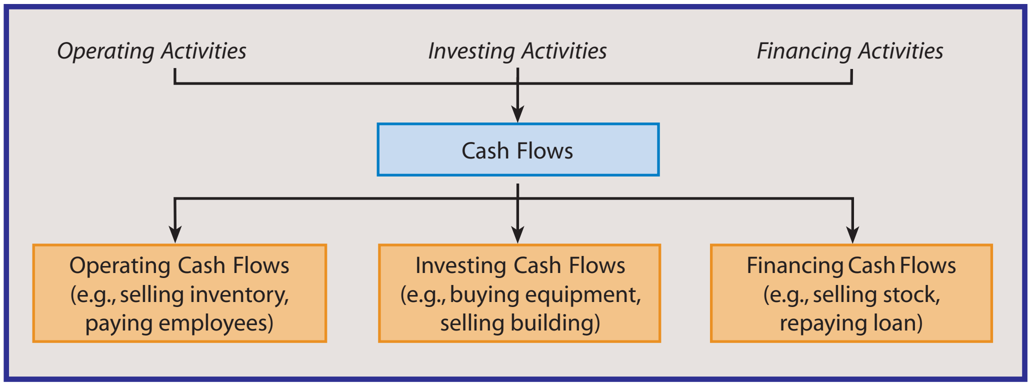
To aid external users in making the preceding assessments, *FASB Statement No. 95* requires that **a statement of cash flows must report on a company's cash inflows, cash outflows, and net change in cash from its operating, investing, and financing activities during the accounting period, in a manner that reconciles the beginning and ending cash balances.** This reconciliation causes the statement of cash flows to **articulate** with the balance sheet.

A company's *operating activities* include all the transactions and other events related to its earning process, such as those involved in purchasing, producing, selling, and delivering

30. "Statement of Cash Flows," *FASB Statement of Financial Accounting Standards No. 95* (Stamford, Conn.: FASB, 1987), par. 3–6.

goods for sale, as well as providing services. *Investing activities* include transactions involving buying and selling property, plant, and equipment; buying and selling long-term investments; and lending money and collecting on the loans. *Financing activities* include transactions involved in obtaining resources from owners and paying dividends, as well as obtaining resources from creditors and repaying the amounts borrowed.

These activities generate cash flows (inflows and outflows) that can be categorized according to each activity as follows:



This categorization is used in the statement of cash flows.

11 Classify cash flows as operating, investing, or financing.

The statement of cash flows of a company includes three major sections: (1) net cash flow from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities.[31] The **Net Cash Flow from Operating Activities** section reports the cash flows from the operating activities of the company. The most common way to prepare this section is called the *indirect method*.[32] Under this method, net income is listed first and then adjustments (additions or subtractions) are made to net income:

1. To eliminate certain amounts, such as depreciation expense and gains (losses), that were included in net income but that did not involve a cash inflow or cash outflow for operating activities
2. To include any changes in the current assets (other than cash) and current liabilities involved in the company's operating cycle that affected cash flows differently than net income

These adjustments are made to convert the net income to the net cash provided by (or used in) operating activities. The indirect method has the advantage of showing the "quality" of income by providing information about differences between income flows and operating cash flows.

The **Cash Flows from Investing Activities** section includes all the cash inflows and outflows involved in the investing activities transactions of the company. The most common cash inflows (receipts) from and cash outflows (payments) for investing activities are:

1. Receipts from selling property, plant, and equipment
2. Receipts from selling investments in stocks and debt securities (e.g., bonds)
3. Payments for purchases of property, plant, and equipment
4. Payments for investments in stocks and debt securities

Similarly, the **Cash Flows from Financing Activities** section includes all the cash inflows and cash outflows involved in the financing activities transactions of the company. The

31. Transactions involving investing and financing activities that *do not* affect cash receipts or cash payments also are included in a separate schedule accompanying the statement of cash flows. We discuss this schedule in Chapter 22.
32. According to *Accounting Trends and Techniques* (New York: AICPA, 2004, p. 549), over 98% of surveyed companies use the indirect method.

most common cash inflows (receipts) from and cash outflows (payments) for financing activities are:

1. Receipts from the issuance of debt securities (e.g., bonds, mortgages, notes)
2. Receipts from the issuance of stocks
3. Payments of dividends
4. Payments to retire debt securities
5. Payments to reacquire stock (i.e., treasury stock)

To complete the statement of cash flows, the cash inflows and outflows within each section are subtotaled, the subtotals are summed to determine the net increase (or decrease) in cash of the company during the accounting period, and the net change in cash is added to or subtracted from the beginning cash balance to reconcile to the ending cash balance reported on the company's year-end balance sheet.[33]

Example: Statement of Cash Flows

Example 5-7 shows the statement of cash flows of the Trevor Corporation for 2007 (using the *indirect* method for operating activities). The statement of cash flows of the **Coca-Cola Company**, as presented in its 2004 annual report, is shown in Appendix A. Note in Example 5-7 that the Trevor Corporation had a net cash inflow of $70,400 from its *operating activities* in 2007. This amount was determined by adjusting the $59,600 net income for several differences between its income flows and cash flows. For instance, depreciation expense of $16,500 was "added back" to net income because it had been deducted as an expense on the income statement but there was no cash outflow. On the other hand, the $1,800 increase in accounts receivable was subtracted because this increase resulted from credit sales, which increased sales revenue (and net income) on the income statement, but provided no cash inflow at the time of the sale. The other adjustments to net income were made for similar reasons, as we discuss more fully in Chapter 22.

The net cash used for *investing activities* was $78,900. The cash outflows were for the purchase of a building and for an investment in bonds. The cash inflow was from the sale of land. The net cash provided by *financing activities* was $16,600. The cash outflows were for the payment of dividends and a mortgage. The cash inflow was from the issuance of common stock.

The $8,100 net increase in cash was determined by adding the $70,400 net cash provided by operating activities and the $16,600 net cash provided by financing activities, and subtracting the $78,900 net cash used for investing activities. The $8,100 net increase in cash was added to the $17,200 cash balance on January 1, 2007 to reconcile to the $25,300 cash balance on December 31, 2007. ♦

Operating Cash Flows: Direct Method

The other way to report cash flows from operating activities is the *direct method*. In *FASB Statement No. 95*, the FASB encourages use of the direct method. This method has the advantage of separating operating cash inflows from operating cash outflows, which may be useful in estimating future cash flows. Under the direct method, a company's operating cash inflows are listed first. The operating cash outflows are then deducted from the operating cash inflows to determine the net cash provided by (or used in) operating activities. The most common cash inflows from and cash outflows for operating activities are as follows:

Operating Cash Inflows

1. Collections from customers
2. Interest and dividends collected

Operating Cash Outflows

1. Payments to suppliers and employees
2. Payments of interest
3. Payments of income taxes

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33. As we noted in Chapter 4, a company may report cash and cash equivalents on its balance sheet. In this case, the reconciliation on the statement of cash flows is to the ending cash and cash equivalents.

EXAMPLE 5-7 Statement of Cash Flows

TREVOR CORPORATION

Statement of Cash Flows
For Year Ended December 31, 2007

Net Cash Flow From Operating Activities			
Net income	$ 59,600		
Adjustments for differences between income flows and cash flows from operating activities:			
Add: Depreciation expense	16,500		
Amortization expense	2,000		
Bond discount amortization	1,100		Cash Flows from Operating Activities
Decrease in prepaid items	400		
Increase in salaries payable	700		
Increase in income taxes payable	2,200		
Increase in deferred income taxes	900		
Less: Increase in accounts receivable (net)	(1,800)		
Increase in inventories	(7,300)		
Decrease in accounts payable	(2,600)		
Decrease in advances from customers	(1,300)		
Net cash provided by operating activities		$70,400	
Cash Flows From Investing Activities			
Payment for purchase of building	$(73,900)		
Payment for investment in bonds	(10,000)		Cash Flows from Investing Activities
Receipt from sale of land	5,000		
Net cash used for investing activities		(78,900)	
Cash Flows From Financing Activities			
Payment of dividends	$(12,400)		Cash Flows from Financing Activities
Payment of mortgage	(14,000)		
Receipt from issuance of common stock	43,000		
Net cash provided by financing activities		16,600	
Net Increase in Cash		$ 8,100	
Cash, January 1, 2007		17,200	Reconciliation
Cash, December 31, 2007		$25,300	

If the Trevor Corporation used the direct method *instead* of the indirect method, the operating cash flows section of Example 5-6 would be as follows:

Cash Flows From Operating Activities		
Cash Inflows:		
Collections from customers	$ 248,100	
Interest and dividends collected	3,800	
Cash inflows from operating activities		$251,900
Cash Outflows:		
Payments to suppliers and employees	$(143,600)	
Payments of interest	(17,200)	
Payments of income taxes	(20,700)	
Cash outflows for operating activities		(181,500)
Net cash provided by operating activities		$ 70,400

Note that the $70,400 reported as the net cash provided by operating activities is the same under the direct and indirect methods, only the approach to determining the amount is different. The remainder of the statement of cash flows is the same under either method. You should use the *indirect* method for all homework, unless indicated otherwise.

SECURE YOUR KNOWLEDGE 5-3

- The statement of retained earnings reports the changes in the balance of retained earnings which are caused by net income or loss, dividends, retrospective adjustments, and prior period adjustments.
- A retrospective adjustment is a restatement of the beginning balance of retained earnings because of a change in accounting principle.
- A prior period adjustment is a restatement of the beginning balance of retained earnings because of a correction of an error.
- Comprehensive income, the change in equity during a period from nonowner sources, includes both net income and other comprehensive income.
- The statement of cash flows provides information about a company's cash inflows and cash outflows during a period by classifying the cash flows into one of three categories: operating, investing, or financing activities.

SUMMARY OF DISCLOSURES

In this chapter we discussed the conceptual issues and disclosure requirements of numerous complex items concerning corporate earnings and cash flows. Exhibit 5-3 presents a brief summary of the most important items, conceptual criteria, disclosure requirements, and related pronouncements for material items. You should review the specific related pronouncements for a complete technical discussion of each topic.

EXHIBIT 5-3 Summary of GAAP for Comprehensive Income and Cash Flows

Item	Criteria	Disclosure	Pronouncement
Income from continuing operations	Revenues and expenses related to usual and recurring operating activities	Upper portion of income statement. Multiple- or single-step format.	*APB Opinion No. 30*
Nonextraordinary gains or losses	Either unusual in nature or infrequent in occurrence but not both	In income from continuing operations (Other Items) on income statement.	*APB Opinion No. 30*
Results from discontinued operations	Sale of a component of a company	On income statement, directly below income from continuing operations. Include (1) gain or loss on sale, and (2) income or loss from operations of discontinued component. Show both net of income taxes.	*FASB Statement No. 144*

EXHIBIT 5-3 (Continued)

Item	Criteria	Disclosure	Pronouncement
Extraordinary gains or losses	Unusual in nature *and* infrequent in occurrence	On income statement, directly below results from discontinued operations. Show net of income taxes.	*APB Opinions No. 9* and *30; FASB Statements No. 4* and *145*
Earnings per share	Net income and components divided by number of common shares outstanding	On income statement, directly below net income. Show earnings per share related to net income and each major component of net income.	*APB Opinions No. 20* and *30; FASB Statement No. 128*
Cumulative effect of change in accounting principle	Adoption of a generally accepted accounting principle different from one previously used	On statement of retained earnings as retrospective adjustment to beginning retained earnings. Show net of income taxes.	*FASB Statement No. 154*
Correction of error	Correction of a material error in financial statements of a prior period	On statement of retained earnings as prior period adjustment to beginning retained earnings. Show net of income taxes.	*FASB Statements No. 16* and *154*
Comprehensive income	Net income plus other comprehensive income	On income statement, statement of comprehensive income, or statement of changes in stockholders' equity.	*FASB Statement No. 130*
Operating cash flows	Cash flows related to earning process	First section on statement of cash flows.	*FASB Statement No. 95*
Investing cash flows	Cash flows from lending activities, and from buying and selling noncurrent assets	Second section on statement of cash flows.	*FASB Statement No. 95*
Financing cash flows	Cash flows from issuing and reacquiring debt and equity securities, and for paying dividends	Third section on statement of cash flows.	*FASB Statement No. 95*

SUMMARY

At the beginning of the chapter, we identified several objectives you would accomplish after reading the chapter. The objectives are listed below, each followed by a brief summary of the key points in the chapter discussion.

1. **Understand the concepts of income.** Under the capital maintenance concept of income, a corporation's capital (net assets) must be maintained before the corporation earns income on that capital. But the corporation's total income is not very useful in evaluating its operating activities. To improve the usefulness of its income information, a corporation uses accrual accounting, under the transactional approach, to match its accomplishments with its efforts in order to provide information about the corporation's comprehensive income and its components.

2. **Explain the conceptual guidelines for reporting income.** Some general guidelines are to provide information about a company's operating performance that is useful in (1) predicting future income and cash flows, (2) assessing the return on the investment, (3) providing feedback to assess previous predictions, (4) assessing the cost of maintaining its operating capability, and (5) evaluating management's stewardship.
3. **Define the elements of an income statement.** The elements of an income statement are the broad classes of items comprising it. The elements include revenues, expenses, gains, and losses. Briefly, revenues result from sales of goods or services, while expenses result from providing the goods or services. Gains (losses) are increases (decreases) in a company's equity from other events and circumstances.
4. **Describe the major components of an income statement.** The major components of an income statement are: (1) income from continuing operations, (2) results from discontinued operations, (3) extraordinary items, (4) net income, and (5) earnings per share.
5. **Compute income from continuing operations.** Income from continuing operations starts with net sales. Cost of goods sold is deducted from net sales to determine gross profit. Total operating expenses (consisting of selling expenses and general and administrative expenses) are deducted from gross profit to determine operating income. The total of any other items is added to (or deducted from) operating income to determine pretax income from continuing operations, from which income tax expense is deducted to determine income from continuing operations.
6. **Compute results from discontinued operations.** The results of discontinued operations consists of the sum of two items: (1) the income from operations of the discontinued component during the accounting period, and (2) the gain (or loss) from the disposal of the component. These items are reported net of taxes.
7. **Identify extraordinary items.** An extraordinary item is an event or a transaction that is both unusual in nature and infrequent in occurrence. Briefly, unusual in nature refers to a high degree of abnormality, while infrequent in occurrence refers to an expectation that the event or transaction will not recur in the foreseeable future.
8. **Prepare a statement of retained earnings.** A statement of retained earnings starts with the beginning balance in retained earnings. Any retrospective adjustment or prior period adjustment (net of taxes) is added or subtracted to determine the adjusted beginning retained earnings. Net income is then added and dividends are subtracted to determine the ending balance in retained earnings.
9. **Report comprehensive income.** A company's comprehensive income is the sum of its net income and other comprehensive income [e.g., unrealized increase (decrease) in market value of its investments in available-for-sale securities]. A company may report its comprehensive income on the face of its income statement, in a separate statement of comprehensive income, or in its statement of changes in stockholders' equity.
10. **Explain the statement of cash flows.** A company's statement of cash flows reports on its cash inflows, cash outflows, and net change in cash from its operating, investing, and financing activities during the accounting period, in a manner that reconciles the beginning and ending cash balances. Its purpose is to help users assess a company's liquidity, financial flexibility, and operating capability.
11. **Classify cash flows as operating, investing, or financing.** A company's operating cash flows result from all the transactions and other events related to its earning process. Its investing cash flows are the cash inflows and outflows resulting from its investing activities (e.g., purchasing equipment). Its financing cash flows are the cash inflows and outflows resulting from its financing activities (e.g., issuing bonds).

Answers to Real Report Questions

Real Report 5-1 Answers

1. In 2004, Pfizer disposed of (1) certain European pharmaceutical businesses that were part of the Human Health segment, (2) certain non-core consumer product lines in the Consumer Healthcare segment, (3) its surgical ophthalmic business, and (4) its in-vitro allergy and autoimmune diagnostics testing business.
2. The pretax loss in 2004 from discontinued operations was $39 million; however, Pfizer was able to earn pretax income in 2003 from discontinued operations of $43 million. A company may dispose of components of its business for several reasons, including inadequate or uncertain future prospects, unsatisfactory contribution to earnings or cash flows, and lack of fit with regard to a company's strategic plan.
3. External users are concerned with predicting the amounts, timing, and uncertainty of a company's future earnings and cash flows. Because discontinued operations will not be present in the future, any income or loss associated with discontinued operations should not be used in the calculation of a company's return on assets. Given the information provided, income from continuing operations of $11,332 million is the most appropriate income measure to use for this calculation.

Real Report 5-2 Answers

1. CenterPoint Energy's extraordinary loss was due to the write off of net regulatory assets because of an adverse judgment by the Texas Utility Commission. CenterPoint had sought to recover costs of approximately $3.7 billion

but the Texas Utility Commission authorized the recovery of $2.3 billion. This decision is being appealed.

2. The pretax amount of the extraordinary loss was $1.5 million. Because the tax benefit related to the loss was $526 million, CenterPoint's estimated tax rate is 35% ($526 million / $1.5 million).
3. While CenterPoint did experience a net loss for the year of $904,704 million, this was due to the extraordinary loss. Excluding this loss, CenterPoint actually reported income of $72,632 million. Because the company has limited control over a loss that is both unusual in nature and infrequent in occurrence, this loss will not generally be considered in evaluating operating performance.

Real Report 5-3 Answers

1. Earnings from discontinued operations, $15 million for the year ended January 30, 2004, increased basic and diluted earnings per share by $0.02 per share.
2. Lowe's possesses a complex capital structure that contained stock options and debt that is convertible into shares of common stock. Diluted earnings per share captures the potential decrease in earnings per share assuming these securities were converted into common stock.
3. Basic and diluted earnings per share increased by $1.06 and $1.04, respectively, over the time period presented. The steady increase in earnings per share, coupled with the large increases in earnings over the period, would most likely be viewed favorably by analysts. While not reported in the text, Lowe's was able to increase gross margin approximately 2% over the period presented. It is this increased margin that was the most significant contributor to Lowe's bottom line.

QUESTIONS

Q5-1 Define income under the "capital maintenance" concept. Identify the alternative ways of measuring capital under this concept.

Q5-2 Briefly discuss the transactional approach to income measurement. Explain its relationship (if any) to the capital maintenance concept of income.

Q5-3 Define comprehensive income. What was the intent of the FASB in developing this conceptual definition?

Q5-4 Discuss (a) return on investment, (b) risk, (c) financial flexibility, and (d) operating capability.

Q5-5 What are the purposes of the income statement?

Q5-6 List the specific conceptual guidelines suggested by the FASB for reporting (presenting) revenues, expenses, gains, and losses.

Q5-7 Define revenues. What operating activities are likely to result in revenues?

Q5-8 What two criteria must ordinarily be met for revenues to be recognized? When does a company usually recognize revenue?

Q5-9 Why might revenue be recognized at a time other than the sale? What are the alternative revenue recognition methods and for what might they be used?

Q5-10 Define expenses. Of what are expenses a measurement?

Q5-11 What are three principles for recognizing the expenses to be matched against revenues? Give examples of expenses that would be recognized under each principle.

Q5-12 Define gains and losses. Give examples of three different types of gains and losses.

Q5-13 What items are included in a company's "income from continuing operations"? How are these categorized if the company uses (a) a single-step format, or (b) a multiple-step format?

Q5-14 Discuss the difference between the "current operating performance" and the "all-inclusive" concepts of net income. Which concept is currently used?

Q5-15 What elements are listed as Other Items on a company's income statement?

Q5-16 What is intraperiod tax allocation and why is it necessary? How is the income tax expense related to each major component of income disclosed on the income statement?

Q5-17 What items are included in a company's results from discontinued operations? For this purpose, how is a "component" defined?

Q5-18 How is an extraordinary item defined? Explain the two criteria that must be met to classify an event as extraordinary. Give two examples of gains or losses from extraordinary items.

Q5-19 How are gains or losses that are either unusual or infrequent reported on a company's income statement?

Q5-20 Why do changes in accounting estimates arise? Give examples of a change in accounting estimate and indicate how such a change should be accounted for.

Q5-21 Where is earnings per share disclosed in a company's financial statements? What components of earnings per share should be disclosed?

Q5-22 Briefly list several differences between international and U.S. accounting standards in regard to a company's income statement.

Q5-23 What items are included in a company's statement of retained earnings?

Q5-24 What is a change in accounting principle and how is it reported on a company's statement of retained earnings?

Q5-25 What are the possible causes of an error in a company's financial statements? How is the correction of a material error accounted for and how is the correction reported on the financial statements?

Q5-26 What is included in a company's comprehensive income? Currently, what are the four items of a company's other comprehensive income?

Q5-27 Where does a company report its comprehensive income?

Q5-28 What is a statement of cash flows? What are the three major sections of the statement?

Q5-29 When used with a company's other financial statements, what does the statement of cash flows help external users assess?

Q5-30 What are the three types of activities that a statement of cash flows reports on for a company? Provide examples of transactions for each type of activity.

Q5-31 Under the indirect method, how is the net cash provided by operating activities determined in a company's statement of cash flows?

Q5-32 Under the direct method, what are the most common cash inflows from and the most common cash outflows for operating activities in a company's statement of cash flows?

MULTIPLE CHOICE (AICPA Adapted)

Select the best answer for each of the following.

M5-1 The following information is available for Cooke Company for the current year:

Net sales	$1,800,000
Freight-in	45,000
Purchases discounts	25,000
Ending inventory	120,000

The gross margin is 40% of net sales. What is the cost of goods available for sale?

a. $840,000 c. $1,200,000
b. $960,000 d. $1,220,000

M5-2 A transaction that is material in amount, unusual in nature, and infrequent in occurrence is presented in the income statement separately as a component of income

a. Net of applicable income taxes
b. As a prior period adjustment
c. From continuing operations
d. From discontinued operations

M5-3 Effective January 1, 2007, Younger Company adopted the accounting principle of expensing as incurred advertising and promotion costs. Previously, advertising and promotion costs applicable to future periods were recorded in prepaid expenses. Younger can justify the change, which was made for both financial statement and income tax reporting purposes. Younger's prepaid advertising and promotion costs totaled $500,000 at December 31, 2006. Assume that the income tax rate is 30% for 2006 and 2007. The adjustment for the effect of this change in accounting principle should result in a net adjustment in the 2007 retained earnings statement of

a. $0 c. $350,000
b. $150,000 d. $500,000

M5-4 A company changes from the first-in, first-out inventory method to the average cost method. The cumulative effect of the change on the amount of retained earnings at the beginning of the period in which the change is made is reported separately as a(n)

a. Extraordinary item
b. Component of income from discontinued operations
c. Component of income from continuing operations
d. Retrospective adjustment

M5-5 Palo Corporation incurred the following losses, net of applicable income taxes, for the year ended December 31, 2007:

Loss on disposal of a component of Palo's business	$400,000
Loss on translation of foreign currency because of devaluation	500,000

How much should Palo report as extraordinary losses on its 2007 income statement?

a. $0 c. $500,000
b. $400,000 d. $900,000

M5-6 Which of the following is expensed under the principle of systematic and rational allocation?

a. Salespeople's monthly salaries
b. Insurance premiums
c. Transportation to customers
d. Electricity to light office building

M5-7 The following information is available for Wagner Corporation for the current year:

Sales	$500,000
Beginning inventory	180,000
Ending inventory	95,000
Freight-out	45,000
Purchases	215,000

How much is the cost of goods sold?

a. $200,000
b. $300,000
c. $345,000
d. $440,000

M5-8 Dobbin Corporation, a manufacturer of household paints, is preparing annual financial statements at December 31, 2007. Because of a recently proven health hazard in one of its paints, the government has clearly indicated its intention of having Dobbin recall all cans of this paint sold in the last six months. The management of Dobbin estimates that this recall would cost $1,000,000. What accounting recognition, if any, should be accorded this situation?

a. No recognition
b. Footnote disclosure
c. Operating expense of $1,000,000
d. Extraordinary loss of $1,000,000

M5-9 A loss from the sale of a component of a business enterprise is reported separately as a component of income

a. After income from continuing operations and before extraordinary items
b. In income from continuing operations
c. After extraordinary items
d. Before income from continuing operations and extraordinary items

M5-10 In a statement of cash flows, receipts from sales of property, plant, and equipment generally are classified as

a. Investing activities
b. Selling activities
c. Operating activities
d. Financing activities

EXERCISES

E5-1 ***Simple Income Statement*** The following are selected accounts taken from the adjusted trial balance of the Dibb Company on December 31, 2007:

Loss on sale of land	$ 5,000	Sales (net)	$198,000
Cost of goods sold	130,000	Operating expenses	45,000
		Extraordinary gain (pretax)	6,000

Twelve thousand shares of common stock were outstanding the entire year.

Required

Assuming a 30% income tax rate on all items of income, prepare a 2007 income statement for Dibb Company using (1) a multiple-step format and (2) a single-step format.

E5-2 ***Simple Income Statement*** The following are selected account balances of the Albertson Company as of December 31, 2007:

Purchases (net)	$63,000	Sales (net)	$100,000
Merchandise inventory, January 1, 2007	20,000	Operating expenses	22,000
Gain on sale of equipment	5,000	Extraordinary loss (pretax)	8,000

The merchandise inventory on December 31, 2007 is $31,000. Ten thousand shares of common stock have been outstanding the entire year. The company uses a periodic inventory system.

Required

Assuming a 30% income tax rate on all items of income, prepare a 2007 income statement for Albertson Company using (1) a multiple-step format, and (2) a single-step format.

E5-3 ***Classifications*** Where would each of the following items most likely be reported in a company's financial statements? Assume the monetary amount of each item is material.

1. Bad debts expense
2. Sales discounts taken
3. Depreciation expense on sales equipment
4. Loss from operations of discontinued Division B
5. Earnings per share
6. Gain on sale of land
7. Administrative salaries
8. Cash dividends declared on common stock
9. Correction of an error made in a prior period
10. Gain from sale of discontinued Division B
11. Cumulative effect on prior years' income of change in accounting principle
12. Advertising expense
13. Merchandise inventory (ending)
14. Loss from write-off of obsolete inventory
15. Net income
16. Unrealized increase in market value of available-for-sale securities

E5-4 ***Classifications*** Where would each of the following items most likely be reported in a company's financial statements? Assume the monetary amount of each item is material and the company uses a periodic inventory system.

1. Loss on sale of equipment
2. Office supplies used
3. Correction of miscount of last year's ending finished goods inventory
4. Freight-in
5. Delivery expense
6. Dividend revenue
7. Gain from retirement of debt
8. Change in the estimated useful life of office equipment
9. Summary of accounting policies
10. Purchases returns and allowances
11. Income tax expense on continuing income
12. Stock dividend
13. Loss resulting from tornado damage
14. Merchandise inventory (ending)
15. Unrealized decrease in market value of available-for-sale securities

E5-5 ***Multiple-Step and Single-Step Income Statements*** Included in the December 31, 2007 adjusted trial balance of the Gold Company are the following accounts:

Cost of goods sold	$101,000	Selling expenses	$28,000
Sales	200,000	Sales returns and allowances	5,000
General and administrative expenses	20,000	Interest revenue	4,000
Loss from strike (pretax)	9,000	Extraordinary loss (pretax)	17,000

Additional data:

1. Seven thousand shares of common stock have been outstanding the entire year.
2. The income tax rate is 30% on all items of income.

Required

1. Prepare a 2007 multiple-step income statement.
2. Prepare a 2007 single-step income statement.

E5-6 ***Multiple-Step and Single-Step Income Statements, and Statement of Comprehensive Income*** On December 31, 2007 the Adandt Company listed the following items in its adjusted trial balance:

Extraordinary loss (pretax)	$ 8,000	Loss on sale of equipment (pretax)	$ 2,000
Interest revenue	2,500	General and administrative expenses	17,000
Sales returns and allowances	3,000	Sales	163,000
Selling expenses	14,000	Unrealized decrease in value of available-for-sale securities	1,800
Cost of goods sold	95,000		

Additional data:

1. Seven thousand shares of common stock have been outstanding the entire year.
2. The income tax rate is 30% on all items of income.

Required

1. Prepare a 2007 multiple-step income statement.
2. Prepare a 2007 single-step income statement.
3. Prepare a 2007 statement of comprehensive income.

E5-7 ***Cost of Goods Sold and Income Statement*** The Fanta Company presents you with the following account balances taken from its December 31, 2007 adjusted trial balance:

Inventory, January 1, 2007	$ 43,000	Purchases returns	$3,500
Selling expenses	35,000	Interest expense	4,000
Extraordinary gain (pretax)	23,000	Sales discounts taken	2,000
Purchases	100,000	Gain on sale of property (pretax)	7,000
Sales	250,000	Freight-in	5,000
General and administrative expenses	22,000		

Additional data:

1. A physical count reveals an ending inventory of $22,500 on December 31, 2007.
2. Twenty-five thousand shares of common stock have been outstanding the entire year.
3. The income tax rate is 30% on all items of income.

Required
1. As a supporting document for Requirements 2 and 3, prepare a separate schedule for Fanta Company's cost of goods sold.
2. Prepare a 2007 multiple-step income statement.
3. Prepare a 2007 single-step income statement.

E5-8 ***Cost of Goods Sold, Income Statement, and Statement of Comprehensive Income*** The Engle Company lists the following accounts on its adjusted trial balance as of December 31, 2007.

Sales	$147,100	Interest revenue	$ 3,300
Purchases returns	5,200	Purchases discounts taken	2,700
Gain on sale of equipment (pretax)	3,800	Inventory, January 1, 2007	12,100
Freight-in	3,400	Sales returns	8,100
Selling expenses	15,600	Purchases	89,700
Unrealized increase in value of available-for-sale securities	2,400	Administrative expenses	24,200
		Extraordinary loss (pretax)	6,500

The following additional information is also available. The December 31, 2007, ending inventory is $14,700. During 2007, 4,200 shares of common stock were outstanding the entire year. The income tax rate is 30% on all items of income.

Required
1. As a supporting document for Requirements 2 and 3, prepare a separate schedule for Engle Company's cost of goods sold.
2. Prepare a 2007 single-step income statement.
3. Prepare a 2007 multiple-step income statement.
4. Prepare a 2007 statement of comprehensive income.

E5-9 ***Income Statement and Retained Earnings*** The Senger Company presents the following partial list of account balances taken from its December 31, 2007 adjusted trial balance:

Sales (net)	$124,000	Operating expenses	$30,400
Interest expense	3,700	Common stock, $5 par	22,000
Cost of goods sold	66,200	Retained earnings, 1/1/2007	45,800

The following information is also available for 2007 and is not reflected in the preceding accounts:
1. The common stock has been outstanding all year. A cash dividend of $1.28 per share was declared and paid.
2. Land was sold at a pretax gain of $6,300.
3. Division X (a component of the company) was sold at a pretax gain of $4,700. It had incurred a $9,500 pretax operating loss during 2007.
4. A tornado, which is an unusual and infrequent event in the area, caused a $5,400 pretax loss.
5. The income tax rate on all items of income is 30%.
6. The average stockholders' equity is $90,000.

Required
1. Prepare a 2007 multiple-step income statement for Senger Company.
2. Prepare a 2007 retained earnings statement.
3. Compute the 2007 return on stockholders' equity (net income ÷ average stockholders' equity).

E5-10 ***Income Statement and Retained Earnings*** The Cobler Company uses a periodic inventory system and presents the following partial list of account balances taken from its December 31, 2007 adjusted trial balance:

Operating expenses	$ 35,800	Common stock, $15 par	$45,000
Dividend revenue	1,000	Merchandise inventory, January 1, 2007	24,000
Retained earnings, January 1, 2007	68,700	Purchases (net)	79,200
Sales (net)	139,600		

The following information is also available for 2007 and is not reflected in the preceding accounts:
1. The common stock has been outstanding for the entire year. A cash dividend of $0.84 per share was declared and paid.
2. The income tax rate on all items of income is 30%.
3. The ending merchandise inventory is $27,300.
4. A pretax $4,000 loss was recognized on the sale of Division X (a component of the company). This division had earned a pretax operating income of $1,900 during 2007.
5. Damaged inventory was written off at a pretax loss of $6,600.
6. An earthquake, which is an unusual and infrequent event in the area, caused a $3,700 pretax loss.

Required

1. Prepare a cost of goods sold schedule for Cobler Company.
2. Prepare a 2007 single-step income statement.
3. Prepare a 2007 retained earnings statement.
4. Compute the 2007 profit margin (net income ÷ net sales).

E5-11 ***Income Statement Calculations*** The income statement information for 2007 and 2008 of the Caleb Company (a sole proprietorship) is as follows:

	2007	2008
Cost of goods sold	$ (a)	$59,300
Interest expense	600	0
Selling expenses	(b)	10,800
Operating income	21,800	(d)
Sales (net)	96,000	(e)
General expenses	7,900	(f)
Net income	(c)	21,600
Interest revenue	0	600
Gross profit	39,000	40,200

Required

Fill in the blanks labeled (a) through (f). All the necessary information is listed. (*Hint*: It is not necessary to calculate your answers in alphabetical order.)

E5-12 ***Income Statement Calculations*** The income statement information for 2007 and 2008 of the Connor Company (a sole proprietorship) is as follows:

	2007	2008
Beginning inventory	$ (a)	$ (d)
Sales	210,000	(e)
Purchases	130,000	140,000
Purchases returns and allowances	7,000	6,000
Ending inventory	62,000	(f)
Sales returns and allowances	4,000	9,000
Gross profit	(b)	100,000
Cost of goods sold	114,000	120,000
Selling expenses	35,000	36,000
Transportation-in	2,000	5,000
General and administrative expenses	20,000	(g)
Net income	(c)	43,000

Required

Fill in the blanks labeled (a) through (g). All the necessary information is listed. (*Hint*: It is not necessary to calculate your answers in alphabetical order.)

E5-13 ***Results of Discontinued Operations*** During December 2007, Smythe Company decides to sell Division F (a component of the company). On December 31, 2007, the company classifies Division F as held for sale. On that date, the book values of Division F's assets and liabilities are $950,000 and $600,000, respectively. Smythe expects to sell Division F in 2008 and estimates that the fair value of Division F is $250,000. During 2007, Division F earned revenues of $1,000,000 and incurred expenses of $1,300,000. Smythe Company is subject to a 30% income tax rate.

Required

Prepare the results from discontinued operations section of Smythe Company's income statement for 2007. Show supporting calculations.

E5-14 ***Results of Discontinued Operations*** On November 30, 2007, Feiner Company announced its plans to discontinue the operations of Division P (a component of the company) by selling the division. On December 31, 2007, Division P had not yet been sold and was classified as held for sale. On this date, Division P had assets with a book value of $920,000 and liabilities with a book value of $610,000. Feiner Company estimates that the fair value of Division P on this date is $190,000. During 2007, Division P earned revenues of $920,000 and incurred expenses of $980,000. Feiner Company is subject to a 30% income tax rate.

Required

Prepare the results from discontinued operations section of Feiner Company's income statement for 2007. Show supporting calculations.

E5-15 **AICPA Adapted** ***Income Statement Deficiencies*** David Company's Statements of Income for the year ended December 31, 2008, and December 31, 2007, are presented here:

	Year Ended December 31, 2008	2007
Net sales	$900,000	$750,000
Costs and expenses:		
Cost of goods sold	$720,000	$600,000
Selling, general and administrative expenses	112,000	90,000
Other, net	11,000	9,000
Total costs and expenses	$843,000	$699,000
Income from continuing operations before income taxes	$ 57,000	$ 51,000
Income taxes	23,000	24,000
Income from continuing operations	$ 34,000	$ 27,000
Loss on sale of Dex Division, less applicable income taxes of $8,000	8,000	—
Cumulative effect on prior years of change in depreciation method, less applicable income taxes of $1,500	—	3,000
Net income	$ 26,000	$ 30,000
Earnings per share of common stock:		
Income before cumulative effect of change in inventory method	$ 2.60	$2.70
Cumulative effect on prior years of change in inventory method, less applicable income taxes	—	.30
Net income	$ 2.60	$ 3.00

Additional facts are as follows:

a. On January 1, 2007, David Company changed its inventory method from the average cost method to the first-in, first-out method, and justified the change.

b. The loss from operations of the discontinued Dex Division (a component of the company) from January 1, 2008 to September 30, 2008 (the portion of the year prior to the date of sale) and from January 1, 2007 to December 31, 2007 is included in David Company's Statements of Income for the year ended December 31, 2008 and December 31, 2007 respectively, in "other, net."

c. David Company has a simple capital structure with only common stock outstanding, and the net income per share of common stock was based on the weighted average number of common shares outstanding during each year.

d. David Company common stock is listed on the New York Stock Exchange and closed at $13 per share on December 31, 2008 and $15 per share on December 31, 2007.

Required

Determine from the additional facts listed whether the presentation of those facts in David Company's Statements of Income is appropriate. If the presentation is appropriate, discuss the rationale for the presentation. If the presentation is not appropriate, specify the appropriate presentation and discuss its rationale. Do *not* discuss disclosure requirements for the Notes to the Financial Statements.

E5-16 ***Net Income and Comprehensive Income*** On December 31, 2007 TNT Company lists the following accounts in its adjusted trial balance:

Sales (net)	$85,000
Unrealized increase in value of available-for-sale securities	4,000
Operating expenses	18,000
Cost of goods sold	47,000

The income tax rate is 30% on all items of income.

Required

1. Prepare a 2007 multiple-step income statement, which includes comprehensive income (disregard earnings per share).
2. Prepare (a) a 2007 multiple-step income statement (disregard earnings per share) and (b) a 2007 statement of comprehensive income.

E5-17 ***Net Cash Flow From Operating Activities*** The following are accounting items taken from the records of the Tyrone Company for 2007:

a. Net income, $22,900
b. Payment for purchase of land, $4,000
c. Payment for retirement of bonds, $6,000
d. Depreciation expense, $7,800
e. Receipt from issuance of common stock, $7,000
f. Patent amortization expense, $2,700
g. Bond discount amortization, $1,000
h. Increase in accounts receivable, $3,400
i. Payment of dividends, $5,000
j. Decrease in accounts payable, $2,600

Required
Prepare the net cash flow from operating activities section of the Tyrone Company's 2007 statement of cash flows.

E5-18 ***Operating Cash Flows: Direct Method*** The following are various cash flows and other information of the Lexie Company for 2007:

a. Payments of interest, $8,200
b. Receipt from sale of land, $7,900
c. Interest collected, $10,000
d. Payment of dividends, $12,100
e. Depreciation expense, $24,700
f. Collections from customers, $101,600
g. Payments of income taxes, $15,400
h. Receipt from issuance of stock, $18,900
i. Payments to suppliers and employees, $67,500
j. Increase in inventories, $4,600

Required
Using the direct method, prepare the cash flows from operating activities section of the Lexie Company's 2007 statement of cash flows.

E5-19 ***Statement of Cash Flows*** The following are several items involving the cash flow activities of the Rocky Company for 2007:

a. Net income, $41,000
b. Payment of dividends, $16,000
c. Ten-year, $28,000 bonds payable were issued at face value
d. Depreciation expense, $11,000
e. Building was acquired at a cost of $40,000
f. Accounts receivable decreased by $2,000
g. Accounts payable decreased by $4,000
h. Equipment was acquired at a cost of $8,000
i. Inventories increased by $7,000
j. Beginning cash balance, $13,000

Required
Prepare the statement of cash flows of the Rocky Company for 2007.

E5-20 ***Statement of Cash Flows*** The following are several items involving the cash flow activities of the Jones Company for 2007:

a. Net income, $60,400
b. Receipt from issuance of common stock, $32,000
c. Payment for purchase of equipment, $41,500
d. Payment for purchase of land, $19,600
e. Depreciation expense, $20,500
f. Patent amortization expense, $1,200
g. Payment of dividends, $21,000
h. Decrease in salaries payable, $2,600
i. Increase in accounts receivable, $10,300
j. Beginning cash balance, $30,700

Required
Prepare the statement of cash flows of the Jones Company for 2007.

PROBLEMS

P5-1 ***Comprehensive Income Framework*** The following is an alphabetical list of accounts for the Mack Company:

Accounts payable
Accounts receivable
Accumulated depreciation, buildings and office equipment
Accumulated depreciation, store and delivery equipment
Administrative salaries
Advertising expense
Allowance for doubtful accounts
Bad debts expense
Bonds payable
Buildings
Cash
Cash dividends declared
Common stock, $10 par
Correction of previous years' error

Delivery expense
Depreciation expense, buildings and office equipment
Depreciation expense, store and delivery equipment
Dividend revenue
Dividends payable
Freight on purchases
Fund to retire long-term bonds
Gain on sale of equipment
Gain on sale of Division T
Income tax expense
Insurance expense
Interest expense
Interest payable
Interest revenue
Investment in securities (long-term)
Loss from expropriation
Loss from operations of discontinued Division T
Loss on sale of office equipment
Merchandise inventory, January 1, 2007
Merchandise inventory, December 31, 2007
Miscellaneous office expenses
Miscellaneous sales expenses
Miscellaneous service revenues
Mortgage payable
Office salaries
Office supplies used
Paid-in capital on common stock
Prepaid office supplies
Property tax expense
Purchases
Purchases discounts taken
Purchases returns and allowances
Rent revenue
Retained earnings, January 1, 2007
Salaries payable
Sales
Sales commissions
Sales discounts taken
Sales returns and allowances
Sales salaries
Stock dividends declared
Unearned rent
Unexpired insurance
Unrealized increase in value of available-for-sale securities
Utilities expense

Required
Ignoring amounts, select the appropriate accounts of Mack Company and prepare for 2007:
1. A multiple-step income statement with proper subheadings
2. A statement of comprehensive income
3. A retained earnings statement

P5-2 *Account Classifications* Given the following code letters and components of financial statements, indicate where each item would most likely be reported in the financial statements by inserting the corresponding code letters. Assume the monetary amount of each item is material.

Code Letter	Component
A	Sales revenues (net)
B	Cost of goods sold
C	Selling expenses
D	General and administrative expenses
E	Other items
F	Results from discontinued operations
G	Extraordinary items
H	Prior period adjustments
I	Additions to retained earnings (other than H)
J	Deductions from retained earnings (other than H)
K	Notes to financial statements
L	Ending balance sheet

_____ 1. Purchases
_____ 2. Loss on sale of equipment
_____ 3. Utilities expense
_____ 4. Cash dividends declared on common stock
_____ 5. Bad debts expense
_____ 6. Sales salaries
_____ 7. Sales discounts taken
_____ 8. Transportation-in
_____ 9. Net income
_____ 10. Gain on retirement of long-term debt
_____ 11. Purchases returns and allowances
_____ 12. Premium on bonds payable
_____ 13. Gain on sale of land
_____ 14. Interest expense
_____ 15. Delivery expense
_____ 16. Expenses incurred as a result of a strike
_____ 17. Summary of accounting policies
_____ 18. Gain on disposal of Division J
_____ 19. Interest revenue
_____ 20. Additional paid-in capital on common stock

_____ 21. Loss from write-down of obsolete inventory
_____ 22. Administrative salaries
_____ 23. Stock dividends declared on common stock
_____ 24. Correction of erroneous understatement of last year's ending inventory
_____ 25. Operating loss related to discontinued Division J
_____ 26. Additional depreciation on office equipment resulting from decrease in estimated useful life
_____ 27. Gain on sale of factory
_____ 28. Loss from frost damage in southern Arizona
_____ 29. Sales returns
_____ 30. Depreciation expense for office equipment
_____ 31. Sales commissions
_____ 32. Promotion expense
_____ 33. Merchandise inventory (beginning)

P5-3 ***Income Statement, Lower Portion*** At the beginning of 2007, the retained earnings of the Cameron Company was $212,000. For 2007, the company has calculated its pretax income from continuing operations to be $120,000. During 2007, the following events also occurred:

1. During July the company sold Division M (a component of the company). It has determined that the pretax income from the operations of Division M during 2007 totals $39,000 and that a pretax loss of $40,500 was incurred on the sale of Division M.
2. The company had 21,000 shares of common stock outstanding during all of 2007. It declared and paid a $1 per share cash dividend on this stock.
3. The company experienced an extraordinary event. It recognized a material pretax gain of $26,000 on the event.
4. The company found and corrected a pretax $18,000 understatement of the 2006 ending inventory because of a mathematical error.

Required

Assuming that all the "pretax" items are subject to a 30% income tax rate:

1. Complete the lower portion of Cameron Company's 2007 income statement, beginning with "Pretax Income from Continuing Operations."
2. Prepare an accompanying retained earnings statement.

P5-4 ***Income Statement, Lower Portion*** Cunningham Company reports a retained earnings balance of $365,200 at the beginning of 2007. For the year ended December 31, 2007, the company reports pretax income from continuing operations of $150,500. The following information is also available pertaining to 2007:

1. The company declared and paid a $0.72 cash dividend per share on the 30,000 shares of common stock that were outstanding the entire year.
2. The company found and corrected a pretax $48,000 understatement of 2006 depreciation expense because of a mathematical error.
3. The company incurred a pretax $21,000 loss as a result of an earthquake, which is unusual and infrequent for the area.
4. The company sold Division P (a component of the company) in May. From January through May, Division P had incurred a pretax loss from operations of $33,000. A pretax gain of $15,000 was recognized on the sale of Division P.
5. Because of additional information, the company determined that the estimated useful life of certain depreciable assets had decreased. As a result, the current depreciation expense included in the 2007 pretax income from continuing operations is $7,000 higher than it would have been had the original estimated useful life been used in the calculations.

Required

Assuming that all the "pretax" items are subject to a 30% income tax rate:

1. Complete the lower portion of Cunningham Company's 2007 income statement beginning with "Pretax Income from Continuing Operations." Include any related note to the financial statements.
2. Prepare an accompanying retained earnings statement.

P5-5 ***Comprehensive: Income Statement and Retained Earnings*** The Houston Manufacturing Company presents the following partial list of account balances, after adjustments, as of December 31, 2007:

Sales salaries expense	$ 27,400	Sales personnel travel expenses	$ 8,300
Miscellaneous administrative expenses	3,000	Property taxes and insurance expense	9,000
Sales returns	5,000	Retained earnings, January 1, 2007	200,800
Sales	468,200	Depreciation expense: sales equipment	9,000
Interest revenue	3,200	Advertising expense	15,700
Office and administrative salaries	30,000	Miscellaneous rent revenue	5,900
Delivery expenses	11,700	Common stock, $10 par	200,000
Loss on sale of factory equipment (pretax)	4,100	Depreciation expense: buildings and office equipment	14,400
Cost of goods sold	232,200		

The following information is also available but is not reflected in the preceding accounts:

1. The company sold Division E (a component of the company) on August 1, 2007. During 2007, Division E had incurred a pretax loss from operations of $16,000. However, because the acquiring company could vertically integrate Division E into its facilities, the Houston Manufacturing Company was able to recognize a $42,000 pretax gain on the sale.
2. On January 2, 2007, without warning, a foreign country expropriated a factory of Houston Manufacturing Company, which had been operating in that country. As a result of that expropriation, the company has incurred a pretax loss of $30,000.
3. In preparing its 2007 adjusting entries at year-end, the company discovered that it had not recorded $10,100 of depreciation on its office building during 2006. This error did not affect the 2007 depreciation expense.
4. The common stock was outstanding for the entire year. A cash dividend of $1.20 per share was declared and paid in 2007.
5. The 2007 income tax expense totals $28,020 and consists of the following:

Tax expense on income from continuing operations	$32,250
Tax credit on Division E operating loss	(4,800)
Tax expense on gain from sale of Division E	12,600
Tax credit on loss from expropriation	(9,000)
Tax credit on 2006 depreciation error	(3,030)
	$28,020

Required

1. As supporting documents for Requirement 2, prepare separate supporting schedules for selling expenses and for general and administrative expenses (include depreciation expense where applicable in these schedules).
2. Prepare a 2007 multiple-step income statement for the Houston Manufacturing Company.
3. Prepare a 2007 retained earnings statement.
4. What was Houston Manufacturing Company's return on stockholders' equity for 2007 if its average stockholders' equity during 2007 was $500,000? What is your evaluation of this return on stockholders' equity if its "target" for 2007 was 15%?

P5-6 ***Comprehensive: Income Statement and Retained Earnings*** The following selected accounts are taken from the Crandle Corporation's December 31, 2007 adjusted trial balance:

Retained earnings, January 1, 2007	$428,900	Office supplies expense	$ 1,800
Interest expense	4,900	Transportation-out (deliveries)	6,000
Depreciation expense: sales fixtures	8,500	Cost of goods sold	191,200
Sales returns and allowances	11,300	Sales discounts taken	5,200
Advertising expense	14,100	Bad debt expense	1,900
Common stock, $10 par	110,000	Sales supplies expense	4,600
Administrative and office salaries expense	29,500	Sales salaries expense	16,500
Dividend revenue	900	Depreciation expense: buildings and office equipment	10,000
Sales	378,000		
Property tax expense	7,700	Income tax expense	15,870
Gain on sale of sales fixtures (pretax)	5,000		

In addition to the preceding account balances, you have available the following information:

1. In the middle of December 2007 the company incurred a material $5,500 pretax loss as a result of a freak flood of a river that had never flooded before.
2. While making its December 31, 2007 adjusting entries, the company discovered the following:
   a. In recording its December 31, 2006 adjusting entries, it had inadvertently recorded depreciation expense twice for the same asset. The amount of the error was $4,000 pretax and is considered material. The error did not have any effect upon the depreciation recorded for 2007.
   b. Based on an analysis of the company's recent favorable experience with uncollectible accounts receivable, the company decided to reduce the percentage used in computing bad debt expense. The use of the new percentage resulted in the $1,900 bad debt expense being $500 less than the amount that would have been calculated using the old percentage.
3. On April 1, 2007 the company sold Division M (a component of the company), which had been unprofitable for several years. For the first 3 months of 2007, Division M had incurred a pretax operating loss of $8,800. Division M was sold at a pretax loss of $7,500.
4. The company paid cash dividends of $0.90 per share on its common stock. All the stock was outstanding for the entire year.
5. The company is subject to a 30% income tax rate. The $15,870 Income Tax Expense account balance consists of $21,210 tax on income from continuing operations and $1,200 tax on the depreciation correction, and tax credits of $2,640 on the operating loss of Division M, $2,250 on the loss from sale of Division M, and $1,650 on the loss because of the flood.

Required

1. As supporting documents for Requirement 2, prepare separate schedules for selling expenses and for general and administrative expenses (include each depreciation expense where applicable in these schedules).
2. Prepare a 2007 single-step income statement for the Crandle Corporation. Include any related note to the financial statements.
3. Prepare a 2007 retained earnings statement.
4. What was Crandle Corporation's profit margin for 2007? What is your evaluation of Crandle's 2007 profit margin if last year it was 8%?

P5-7 ***Comprehensive: Income Statement and Supporting Schedules*** The following is a partial list of the account balances, after adjustments, of the Silvoso Company on December 31, 2007:

Depreciation expense: buildings and office equipment	$ 14,500	Office supplies expense	$ 1,400
Sales commissions and salaries	18,200	Common stock, $10 par	80,000
Inventory, January 1, 2007	37,800	Loss on sale of office equipment (pretax)	5,000
Sales supplies used	5,600	Insurance and property tax expense	8,500
Retained earnings, January 1, 2007	83,700	Sales	340,700
Purchases returns and allowances	6,200	Rent revenue	6,900
Bad debts expense	2,700	Office and administrative salaries expense	32,000
Transportation-in	13,500	Promotion and advertising expense	17,000
Sales discounts taken	4,900	Sales returns and allowances	12,100
Purchases	173,000	Purchases discounts taken	4,100
Delivery expense	7,700	Depreciation expense: sales equipment	9,600
		Interest expense	3,700

The following information is also available:

1. The company declared and paid a $0.60 per share cash dividend on its common stock. The stock was outstanding the entire year.
2. A physical count determined that the December 31, 2007 ending inventory is $34,100.
3. A tornado destroyed a warehouse, resulting in a pretax loss of $12,000. The last tornado in this area had occurred 20 years earlier.
4. While making its December 31, 2007 adjusting entries, the company determined that:
   a. In 2006, it had inadvertently omitted $11,000 depreciation expense on its buildings and office equipment. The error did not have any effect upon the depreciation recorded in 2007.
   b. Because of recently increased obsolescence, its sales equipment should be depreciated over a shorter useful life. The resulting $2,500 of additional depreciation has been included in the 2007 depreciation expense.
5. On May 1, 2007, the company sold an unprofitable division (R). From January through April, Division R (a component of the company) had incurred a pretax operating loss of $8,700. Division R was sold at a pretax gain of $10,000.
6. The company is subject to a 30% income tax rate. Its income tax expense for 2007 totals $930. The breakdown is as follows:

Income Tax Expense (Credit) Related to	Amount
Continuing income	$ 7,440
Operating loss of Division R	(2,610)
Gain on sale of Division R	3,000
Loss from tornado	(3,600)
Error in recording 2006 depreciation expense	(3,300)
	$ 930

7. The company had average stockholders' equity of $150,000 during 2007.

Required

1. As supporting documents for Requirement 2, prepare separate supporting schedules for cost of goods sold, selling expenses, general and administrative expenses, and depreciation expense.
2. Prepare a 2007 multiple-step income statement for the Silvoso Company. Include any related note to the financial statements.
3. Prepare a 2007 retained earnings statement.
4. What was Silvoso Company's return on stockholders' equity for 2007? What is your evaluation of Silvoso Company's return on stockholders' equity if last year it was 10%?

P5-8 ***Misclassifications*** The Rox Corporation's multiple-step income statement and retained earnings statement for the year ended December 31, 2007, as developed by its bookkeeper, are shown here:

ROX CORPORATION
Revenue Statement
December 31, 2007

Sales (net)		$179,000
Plus: Income from operations of discontinued Division P (net of $960 income taxes)		2,240
Less: Dividends declared ($1.50 per common share)		(7,500)
Net revenues		$173,740
Less: Selling expenses		(19,000)
Gross profit		$154,740
Less: Operating expenses		
Interest expense	$ 4,100	
Loss on sale of Division P (net of $1,200 income tax credit)	2,800	
Cost of goods sold	110,700	
Income tax expense on income from continuing operations	5,370	
Total operating expenses		(122,970)
Operating income		$ 31,770
Miscellaneous items		
Dividend revenue	$ 1,800	
General and administrative expenses	(24,300)	(22,500)
Income before extraordinary items		$ 9,270
Extraordinary items		
Loss on sale of land	$ (4,800)	
Correction of error in last year's income (net of $1,500 income taxes)	3,500	(1,300)
Net income		$ 7,970

ROX CORPORATION
Retained Earnings Statement
December 31, 2007

Beginning retained earnings	$ 62,850
Add: Net income	7,970
Adjusted retained earnings	$ 70,820
Less: Loss from expropriation (net of $2,760 income tax credit)	(6,440)
Ending retained earnings	$ 64,380

You determine that the account *balances* listed in the statements are correct but are incorrectly classified in certain cases. No shares of common stock were issued or retired during 2007.

Required

1. Review both statements and indicate where each incorrectly classified item should be classified.
2. Prepare a correct multiple-step 2007 income statement.
3. Prepare a correct 2007 retained earnings statement.

P5-9 ***Misclassifications*** The bookkeeper for the Olson Company prepared the following income statement and retained earnings statement for the year ended December 31, 2007:

OLSON COMPANY
December 31, 2007
Expense and Profits Statement

Sales (net)	$196,000
Less: Selling expenses	(19,600)
Net sales	$176,400
Add: Interest revenue	2,300
Add: Gain on sale of equipment	3,200
Gross sales revenues	$181,900

Less: Costs of operations		
Cost of goods sold	$120,100	
Correction of overstatement in last year's income because of error (net of $1,650 income tax credit)	3,850	
Dividend costs ($0.50 per share for 8,000 common shares)	4,000	
Extraordinary loss because of earthquake (net of $1,800 income tax credit)	4,200	(132,150)
Taxable revenues		$ 49,750
Less: Income tax on income from continuing operations		(12,480)
Net income		$ 37,270
Miscellaneous deductions		
Loss from operations of discontinued Division L (net of $900 income tax credit)	$ 2,100	
Administrative expenses	16,800	(18,900)
Net revenues		$ 18,370

OLSON COMPANY
Retained Revenues Statement
For Year Ended December 31, 2007

Beginning retained earnings	$59,300
Add: Gain on sale of Division L (net of $1,350 income taxes)	3,150
Recalculated retained earnings	$62,450
Add: Net revenues	18,370
	$80,820
Less: Interest expense	(3,400)
Ending retained earnings	$77,420

The preceding account *balances* are correct but have been incorrectly classified in certain instances.

Required
Prepare a corrected 2007 multiple-step income statement and a 2007 retained earnings statement.

P5-10 ***Classification of Unusual and/or Infrequent Items*** The following are a number of unusual and/or infrequent gains or losses that might be disclosed on the income statement or retained earnings statement. All items are considered to be material in amount.

1. A loss from an earthquake that destroyed a chemical plant of a major chemical company. The region where the plant was destroyed had not had an earthquake in 15 years.
2. A gain resulting from the retirement of bonds payable. The bonds payable had been classified as current liabilities on last year's ending balance sheet because of their expected retirement during the current year.
3. A reduction in the current depletion expense as a result of the discovery of additional mineral deposits.
4. A gain from the sale of land. The land had been purchased for the construction of a new factory. The company has built several new factories over the past several years, and in each instance has acquired more land than necessary for the factory site. After completion of the factory, the excess land is sold at its appreciated value.
5. A loss incurred by a corporation on the sale of an investment in bonds of a publicly held company. The bonds constitute 5% of the net assets of the publicly held company. The corporation has been holding these bonds as an investment for several years. This is the only investment in securities the corporation has ever made.
6. A loss incurred as a result of an earthquake that destroyed a 2-year-old storage facility of a large retail chain. The storage facility is located in California. A major earthquake occurred in the same region 2 years ago, just prior to the construction of the facility.
7. A decrease in previous years' earnings as a result of a change from the first-in, first-out inventory method to the average cost inventory method at the beginning of the current year.
8. A loss incurred in the spring by a retail store in a shopping center as a result of a flood of a nearby stream. Although the stream has overflowed several times in the past six years, only 3 stores (out of 38) in the shopping center had previously incurred a significant flood loss.
9. A gain recognized as the result of the sale by a food processing company of a 15% interest in a professional baseball team.
10. A reduction in last year's income as a result of the discovery in the current year of a miscount (overstatement) of last year's ending inventory.
11. A loss incurred by a diversified citrus grower because of frost damage in southern California. No frost damage has occurred in the region for seven years, although last year the citrus grower had incurred a loss because of frost damage to its Florida operations.

Required
For each item, indicate in which section of the income statement or retained earnings statement it should be disclosed. Justify your disclosure.

P5-11 ***Results of Discontinued Operations*** On November 1, 2007, Woods Company announced its plans to sell Division J (a component of the company). By December 31, 2007, Woods Company had not sold Division J and so it classifies the division as held for sale.

During 2007, Woods Company recorded the following revenues and expenses for Division J and the remainder of the company.

	Division J	*Remainder of Company*
Sales revenues	$170,000	$950,000
Cost of goods sold	119,000	560,000
Operating expenses	42,000	190,000

The company is subject to a 30% income tax rate.

On December 31, 2007, the net book value of Division J is $500,000, consisting of assets of $910,000 and liabilities of $410,000. On this date, Woods Company estimates that the fair value of Division J is $420,000. The company had 50,000 shares of common stock outstanding during all of 2007.

Required
1. Prepare the journal entry on December 31, 2007 to record the pretax loss on held-for-sale Division J. Show supporting calculations.
2. Prepare a 2007 multiple-step income statement for Woods Company.
3. Show how Division J would be reported on Woods Company's December 31, 2007 balance sheet.

P5-12 ***Analyzing Coca-Cola's Income Statement and Cash Flow Statement Disclosures*** Review the financial statements and notes of the Coca-Cola Company in Appendix A.

Required (*Note:* You do not need to make any calculations).
1. Does the company use a multiple-step or a single-step format on its income statement? Explain.
2. What was the net income for 2004? What was the basic net income (earnings) per common share for 2004?
3. What was the gross profit for 2004? For 2003?
4. How much interest expense was incurred in 2004? In 2003?
5. What was the amount of the income taxes related to income before income taxes for 2004?
6. What was the amount of selling, general, and administrative expenses in 2004? Of this amount, what was the amount for stock-based compensation expense?
7. What amount of dividends on common stock were paid per share and in total in 2004?
8. What were the net operating revenues and gross profit, respectively, for the fourth quarter of 2004?
9. What method was used to determine the net cash provided by operating activities in 2004? What was the amount?
10. What was the net cash used in investing activities in 2004?
11. What was the cash provided by the issuances of debt in 2004?

P5-13 **AICPA Adapted** ***Complex Income Statement*** The following is the adjusted trial balance for the Woodbine Circle Corporation on December 31, 2007:

	Debit	**Credit**
Cash	$ 500,000	
Accounts receivable, net	1,500,000	
Inventory	2,500,000	
Property, plant, and equipment	15,100,000	
Accumulated depreciation		$ 4,900,000
Accounts payable		2,200,000
Income taxes payable		200,000
Notes payable		1,000,000
Common stock ($1 par value)		1,000,000
Additional paid-in capital		6,200,000
Retained earnings, Jan. 1, 2007		3,000,000
Sales—regular		10,100,000
Sales—AL Division		2,000,000
Cost of sales—regular	6,200,000	
Cost of sales—AL Division	900,000	

	Debit	Credit
Administrative expenses—regular	2,000,000	
Administrative expenses—AL Division	300,000	
Interest expense—regular	210,000	
Interest expense—AL Division	140,000	
Loss on sale of AL Division	250,000	
Gain from extraordinary event		300,000
Income tax expense	900,000	
	$30,500,000	$30,500,000

Other financial data for the year ended December 31, 2007:

Federal Income Taxes

Paid on Federal Tax Deposit Form	$700,000
Accrued	200,000
Total charged to income tax expense (estimated)	$900,000
Tax rate on all types of taxable income	40%

Discontinued Operations

On September 30, 2007 Woodbine sold its Auto Leasing (AL) Division for $4,000,000. The book value of this division was $4,250,000 at that date. For financial statement purposes, this sale was considered as discontinued operation of a component of the company.

Capital Structure

Common stock, par value $1 per share, traded on the New York Stock Exchange:

Number of shares outstanding during all of 2007	1,000,000

Required

Using the multiple-step format, prepare a formal income statement for Woodbine for the year ended December 31, 2007, together with the appropriate supporting schedules. All income taxes should be appropriately shown.

P5-14 **AICPA Adapted** ***Comparative Income Statements*** The Century Company, a diversified manufacturing company, had four separate operating divisions engaged in the manufacture of products in each of the following areas: food products, health aids, textiles, and office equipment. Financial data for the 2 years ended December 31, 2008 and 2007 are presented here:

Net Sales

	2008	2007
Food products	$3,500,000	$3,000,000
Health aids	2,000,000	1,270,000
Textiles	1,580,000	1,400,000
Office equipment	920,000	1,330,000
	$8,000,000	$7,000,000

Cost of Sales

	2008	2007
Food products	$2,400,000	$1,800,000
Health aids	1,100,000	700,000
Textiles	500,000	900,000
Office equipment	800,000	1,000,000
	$4,800,000	$4,400,000

Operating Expenses

	2008	2007
Food products	$ 550,000	$ 275,000
Health aids	300,000	125,000
Textiles	200,000	150,000
Office equipment	650,000	750,000
	$1,700,000	$1,300,000

On January 1, 2008, Century adopted a plan to sell the assets and product line of the office equipment division and considered it a component of the company. On September 1, 2008, the division's assets and product line were sold for $2,100,000 cash, resulting in a gain of $640,000.

The company's textiles division had six manufacturing plants that produced a variety of textile products. In April 2008, the company sold one of these plants and realized a gain of $130,000. After the sale the operations at the plant that was sold were transferred to the remaining five textile plants, which the company continued to operate.

In August 2008, the main warehouse of the food products division, located on the banks of the Bayer River, was flooded when the river overflowed. The resulting damage of $420,000 is not included in the financial data given previously. Historical records indicate that the Bayer River normally overflows every 4 to 5 years, causing flood damage to adjacent property.

For the 2 years ended December 31, 2008 and 2007 the company had interest revenue earned on investments of $70,000 and $40,000, respectively.

The provision for income tax expense for each of the 2 years should be computed at a rate of 40%.

Required

Prepare in proper form a multiple-step comparative statement of income of the Century Company for the 2 years ended December 31, 2008 and December 31, 2007. Earnings per share information and footnotes are not required.

P5-15 **AICPA Adapted** *Financial Statement Deficiencies* The following is the complete set of financial statements prepared by Oberlin Corporation:

OBERLIN CORPORATION
Statement of Earnings and Retained Earnings
For the Fiscal Year Ended August 31, 2007

Sales		$3,500,000
Less returns and allowances		(35,000)
Net sales		$3,465,000
Less cost of goods sold		(1,039,000)
Gross margin		$2,426,000
Less:		
Selling expenses	$1,000,000	
General and administrative expenses (Note 1)	1,079,000	(2,079,000)
Operating earnings		$ 347,000
Add other revenues		
Purchase discounts	$ 10,000	
Gain on increased value of investments in real estate	100,000	
Gain on sale of treasury stock	200,000	
Correction of error in last year's statement	90,000	400,000
Ordinary earnings		$ 747,000
Add extraordinary item—gain on sale of fixed asset		53,000
Earnings before income tax		$ 800,000
Less income tax expense		(320,000)
Net earnings		$ 480,000
Add beginning retained earnings		2,690,000
		$3,170,000
Less:		
Dividends (12% stock dividend declared but not yet issued)		(120,000)
Contingent liability (Note 3)		(300,000)
Ending retained earnings		$2,750,000

Statement of Financial Position
August 31, 2007

Assets		
Current Assets		
Cash	$ 80,000	
Accounts receivable, net	110,000	
Inventory	130,000	
Total current assets		$320,000

Other Assets		
Land and building, net	$4,000,000	
Investments in real estate (current value)	1,668,000	
Goodwill (Note 2)	250,000	
Discount on bonds payable	42,000	
Total other assets		5,960,000
Total assets		$6,280,000
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	$ 160,000	
Income taxes payable	300,000	
Stock dividend payable	120,000	
Total current liabilities		$ 580,000
Other Liabilities		
Due to Grant, Inc. (Note 3)	$ 300,000	
Accrued pension cost	450,000	
Bonds payable (including portion due within one year)	1,000,000	
Deferred taxes	58,000	
Total other liabilities		1,808,000
Total liabilities		$2,388,000
Stockholders' Equity		
Common stock	$1,000,000	
Paid-in capital in excess of par	142,000	
Retained earnings	2,750,000	
Total stockholders' equity		3,892,000
Total liabilities and stockholders' equity		$6,280,000

Notes to Financial Statements

1. Goodwill is not being reviewed for impairment. The goodwill was "acquired" in 2007.
2. The amount, Due to Grant, Inc., is contingent upon the outcome of a lawsuit, which is currently pending. The amount of loss, if any, is not expected to exceed $300,000.

Required

Identify and explain the deficiencies in the presentation of Oberlin's financial statements. There are no arithmetic errors in the statements. Organize your answer as follows:

1. Deficiencies in the statement of earnings and retained earnings
2. Deficiencies in the statement of financial position
3. General comments

If an item appears on both statements, identify the deficiencies for each statement separately.

P5-16 **AICPA Adapted** ***Financial Statement Violations of GAAP*** The following are the financial statements issued by Allen Corporation for its fiscal year ended October 31, 2007:

ALLEN CORPORATION
Statement of Financial Position
October 31, 2007

Assets	
Cash	$ 15,000
Accounts receivable, net	150,000
Inventory	120,000
Total current assets	$285,000
Patent (Note 3)	250,000
Land	125,000
Total assets	$660,000
Liabilities	
Accounts payable	$ 80,000
Accrued expenses	20,000
Total current liabilities	$ 100,000
Deferred income tax payable (Note 4)	80,000
Total liabilities	$180,000

Stockholders' Equity		
Common stock, par $1 (Note 5)	$100,000	
Additional paid-in capital	180,000	
Retained earnings	200,000	480,000
Total liabilities and stockholders' equity		$660,000

Earnings Statement
For the Fiscal Year Ended October 31, 2007

Sales		$1,000,000
Cost of goods sold		(750,000)
Gross margin		$ 250,000
Expenses		
Bad debt expense	$ 7,000	
Insurance	13,000	
Lease expenses (Note 1)	40,000	
Repairs and maintenance	30,000	
Pensions (Note 2)	12,000	
Salaries	60,000	(162,000)
Earnings before provision for income tax		$ 88,000
Provision for income tax		(28,740)
Net earnings		$ 59,260
Earnings per common share outstanding		$ 0.5926

Statement of Retained Earnings
For the Fiscal Year Ended October 31, 2007

Retained earnings, November 1, 2006	$150,000
Extraordinary gain, net of income tax	25,000
Net earnings for the fiscal year ended October 31, 2007	59,260
	$234,260
Dividends ($0.3426 per share)	(34,260)
Retained earnings, October 31, 2007	$200,000

Notes to Financial Statements:

1. *Long-Term Lease*. Under the terms of a 5-year noncancellable lease for buildings and equipment, the Company is obligated to make annual rental payments of $40,000 in each of the next four fiscal years. At the conclusion of the lease period, the Company has the option of purchasing the leased assets for $20,000 (a bargain purchase option) or entering into another 5-year lease of the same property at an annual rental of $5,000.
2. *Pension Plan*. Substantially all employees are covered by the Company's pension plan. Pension expense is equal to the total of pension benefits paid to retired employees during the year.
3. *Patent*. The patent had an estimated remaining life of 10 years at the time of purchase. The Company's patent was purchased from Apex Corporation on January 1, 2007, for $250,000.
4. *Deferred Income Tax Payable*. The entire balance in the deferred income tax payable account arose from tax-exempt municipal bonds that were held during the previous fiscal year, giving rise to a difference between taxable income and reported net earnings for the fiscal year ended October 31, 2007. The deferred liability amount was calculated on the basis of past tax rates.
5. *Warrants*. On January 1, 2006, one common stock warrant was issued to stockholders of record for each common share owned. An additional share of common stock is to be issued upon exercise of ten stock warrants and receipt of an amount equal to par value. For the six months ended October 31, 2007, the average market value for the Company's common stock was $5 per share and no warrants had yet been exercised.
6. *Contingent Liability*. On October 31, 2007, the Company was contingently liable for product warranties in an amount estimated to aggregate $75,000.

Required

Review the preceding financial statements and related notes. Identify any inclusions or exclusions from them that would be in violation of generally accepted accounting principles, and indicate corrective action to be taken. Do *not* comment as to format or style. Respond in the following order:

1. Statement of Financial Position
2. Notes
3. Earnings Statement
4. Statement of Retained Earnings
5. General

P5-17 ***Comprehensive: Comparative Income Statements*** The accountant for the Tiger Company prepared comparative income statements for 2007 and 2008 as follows:

TIGER COMPANY
Comparative Statements of Income
For Years Ended December 31

	2008	2007
Sales	$3,500,000	$4,600,000
Cost of goods sold	(1,600,000)	(2,600,000)
Gross profit	$1,900,000	$2,000,000
Operating expenses	(1,300,000)	(1,500,000)
Operating income	$ 600,000	$ 500,000
Other items	(200,000)	100,000
Income before income taxes	$ 400,000	$ 600,000
Income tax expense (30%)	(120,000)	(180,000)
Net income	$ 280,000	$ 420,000

The auditor of Tiger Company reviewed the accounting records and income statements and discovered the facts described in items 1 and 2 below. All amounts incurred during 2007 and 2008 are included in the preceding statements.

1. Included in the category "Other Items" (along with other smaller miscellaneous items) were the following:
   a. A casualty loss of $60,000 in 2007 that was considered to be both unusual and infrequent
   b. A $150,000 loss in 2008 from an unusually large write-down of inventory because of obsolescence
   c. A $250,000 gain in 2007 that was considered to be both unusual and infrequent
2. On July 1, 2008, Tiger has announced its intention to sell its backscratcher division. This division is considered a component of the company. Operating results for this division are included in the company's overall operating results for 2007 and 2008, as shown previously, and are as follows:

	2008 (7/1–12/31)	2008 (1/1–6/30)	2007
Sales	$200,000	$400,000	$700,000
Cost of goods sold	300,000	320,000	290,000
Operating expenses	100,000	180,000	110,000

The division had not been sold by the end of 2008, so the company classified it as held for sale. The division consisted of the following items with book values and fair values on December 31, 2008:

Item	Book Value	Fair Value
Assets	$720,000	$620,000
Liabilities	450,000	510,000

Required

Prepare corrected comparative statements of income for 2008 and 2007 for the Tiger Company. Ignore earnings per share.

P5-18 ***Net Income and Comprehensive Income*** At the beginning of 2007, JR Company's stockholders' equity was as follows:

Common stock, $5 par	$35,000
Additional paid-in capital	49,000
Retained earnings	63,000

During 2007, the following events and transactions occurred:

1. The company earned sales revenues of $108,000. It incurred cost of goods sold of $62,000 and operating expenses of $12,000.
2. The company issued 1,000 shares of its $5 par common stock for $14 per share.
3. The company invested $30,000 in available-for-sale securities. At the end of the year, the securities had a market value of $35,000.
4. The company paid dividends of $6,000.

The income tax rate on all items of income is 30%.

Required

1. Prepare a 2007 income statement for JR Company which includes comprehensive income (ignore earnings per share).
2. Instead, prepare (a) a 2007 income statement (ignore earnings per share), and (b) a 2007 statement of comprehensive income.

3. Instead, prepare (a) a 2007 income statement (ignore earnings per share), and (b) a 2007 statement of changes in stockholders' equity that includes comprehensive income.

P5-19 ***Statement of Cash Flows*** A list of selected items involving the cash flow activities of the Topps Company for 2007 is presented here:

a. Patent amortization expense, $3,500
b. Machinery was purchased for $39,500
c. At year-end, bonds payable with a face value of $20,000 were issued for $17,000
d. Net income, $47,200
e. Dividends paid, $16,000
f. Depreciation expense, $12,900
g. Preferred stock was issued for $13,600
h. Investments were acquired for $21,000
i. Accounts receivable increased by $4,300
j. Land was sold at cost, $11,000
k. Inventories increased by $15,400
l. Accounts payable increased by $2,700
m. Beginning cash balance, $19,400

Required
Prepare the statement of cash flows of the Topps Company for 2007.

P5-20 ***Statement of Cash Flows*** The following are several items involving the cash flow activities of the Mueller Company for 2007:

a. Net income, $68,000
b. Increase in accounts receivable, $4,400
c. Receipt from sale of common stock, $12,300
d. Depreciation expense, $11,300
e. Dividends paid, $24,500
f. Payment for purchase of building, $65,000
g. Bond discount amortization, $2,700
h. Receipt from sale of long-term investments at cost, $10,600
i. Payment for purchase of equipment, $8,000
j. Receipt from sale of preferred stock, $20,000
k. Increase in income taxes payable, $3,500
l. Payment for purchase of land, $9,700
m. Decrease in accounts payable, $2,900
n. Increase in inventories, $10,300
o. Beginning cash balance, $18,000

Required
Prepare the statement of cash flows of the Mueller Company for 2007.

P5-21 ***Statement of Cash Flows: Direct Method*** The following are various cash flows and other information of the Trainer Company for 2007:

a. Payments of interest, $5,000
b. Depreciation expense, $22,700
c. Receipt from sale of land, $3,100
d. Payments of income taxes, $6,200
e. Beginning cash balance, $16,500
f. Decrease in receivables, $7,400
g. Interest and dividends collected, $6,300
h. Payments of dividends, $5,200
i. Decrease in accounts payable, $8,600
j. Payments to suppliers and employees, $50,300
k. Receipt from issuance of common stock, $11,000
l. Collections from customers, $61,700
m. Payment for purchase of investments, $17,800
n. Net income, $73,400

Required
Using the direct method for operating cash flows, prepare the Trainer Company's 2007 statement of cash flows.

P5-22 ***Comprehensive: Balance Sheet from Statement of Cash Flows*** Gibb Company prepared the following balance sheet at the *beginning* of 2007:

GIBB COMPANY
Balance Sheet
January 1, 2007

Assets		*Liabilities and Stockholders' Equity*	
Cash	$ 1,000	Accounts payable	$ 4,000
Accounts receivable (net)	3,900	Salaries payable	1,100
Inventory	4,700	Total Liabilities	$ 5,100
Land	9,800	Common stock, $10 par	13,500
Buildings and equipment	68,900	Additional paid-in capital	11,200
Less: Accumulated depreciation	(14,100)	Retained earnings	44,400
Total Assets	$74,200	Total Liabilities and Stockholders' Equity	$74,200

At the end of 2007 Gibb prepared the following statement of cash flows:

GIBB COMPANY
Statement of Cash Flows
For Year Ended December 31, 2007

Net Cash Flow From Operating Activities		
Net Income	$ 5,400	
Adjustments for differences between income flows and cash flows from operating activities:		
Add: Depreciation expense	1,900	
Decrease in inventory	500	
Increase in salaries payable	400	
Less: Increase in accounts receivable (net)	(1,100)	
Decrease in accounts payable	(1,000)	
Net cash provided by operating activities		$ 6,100
Cash Flows From Investing Activities		
Payment for purchase of building	$(13,900)	
Receipt from sale of land	3,000	
Net cash used for investing activities		(10,900)
Cash Flows From Financing Activities		
Payment of dividends	$ (3,100)	
Receipt from issuance of bonds	5,700	
Receipt from issuance of common stock	4,500	
Net cash provided by financing activities		7,100
Net Increase in Cash		$ 2,300
Cash, January 1, 2007		1,000
Cash, December 31, 2007		$ 3,300

Additional information related to the statement of cash flows:

1. The long-term bonds have a face value of $6,000 and were issued on December 31, 2007.
2. The building was purchased on December 30, 2007.
3. The land was sold at its original cost.
4. The common stock which was sold totaled 300 shares and had a par value of $10 per share.

Required

Prepare a classified balance sheet for the Gibb Company as of December 31, 2007. (*Hint*: Review the information on the statement of cash flows and the balances in the beginning balance sheet accounts to determine the impact on the ending balance sheet accounts.)

CASES

COMMUNICATION

C5-1 Revenue Recognition

A friend of yours who is not an accounting major states, "I always thought that a company recognizes revenues at the time of sale. Recently, however, I heard that there are specific criteria for revenue recognition and that included in the criteria is something about realization (whatever that means). Furthermore, I also heard that revenue may be recognized before or after the sale. Please explain revenue recognition to me."

Required

Prepare a written response for your friend. Include an explanation of the revenue recognition criteria and realization. Also include a discussion of the reasons for, and alternative methods of, recognizing revenue in a period other than the period of sale.

C5-2 Expense Recognition

The FASB states that expenses are recognized according to three principles to properly match expenses against revenues.

Required

Write a concise report that identifies the three principles, briefly explains each, and provide examples of expenses that would be recognized under each principle.

C5-3 Cost, Expense, and Loss

AICPA Adapted You were requested to personally deliver your auditor's report to the board of directors of Sebal Manufacturing Corporation and answer questions posed about the financial statements. While reading the statements, one director asked, "What are the precise meanings of the terms 'cost,' 'expense,' and 'loss'? These terms seem sometimes to identify similar items and other times dissimilar items."

Required

1. Explain the meanings of the terms (a) "cost," (b) "expense," and (c) "loss" as used for financial reporting in conformity with generally accepted accounting principles. In your explanation discuss the distinguishing characteristics of the terms and their similarities and interrelationships.
2. Classify each of the following items as a cost, expense, loss, or other category, and explain how the classification of each item may change:
   a. Cost of goods sold
   b. Bad debts expense
   c. Depreciation expense for plant machinery
   d. Spoiled goods
3. The terms "period cost" and "product cost" are sometimes used to describe certain items in financial statements. Define these terms and distinguish between them. To what types of items does each apply?

C5-4 Results of Discontinued Operations

FASB Statement No. 144 dealt with, among other issues, reporting the results of discontinued operations. In the *Statement*, a section of the income statement was created and several terms were defined, including "component."

Required

Identify the elements of a company's results of discontinued operations section of its income statement. Define the previously listed term and explain how the elements of the section are computed if the company sells a component in the same accounting period that its management decided to sell the component.

C5-5 Extraordinary Items

APB Opinion No. 30 establishes two narrow criteria that must be met in order for an event or transaction to be classified as an extraordinary item.

Required

1. Identify and explain each criterion.
2. Develop examples of events that might be extraordinary to one company but not extraordinary to another, such as:
   a. An earthquake
   b. A flood
   c. A tornado
   d. A severe frost
   Justify your reasoning.
3. Explain how the following are reported on a company's income statement:
   a. An extraordinary item
   b. An event or transaction that does not meet both criteria

C5-6 Extraordinary Items

AICPA Adapted Morgan Company grows various crops and then processes them for sale to retailers. In the latter part of this year, Morgan had a large portion of its crops destroyed by a hail storm. Morgan has incurred substantial costs in raising the crops destroyed by the hail storm. Severe damage from hail storms in the locality where the crops are grown is rare.

Required

1. Where should Morgan report the effects of the hail storm in its income statement? Why?
2. How does the classification in the income statement of an extraordinary item differ from that of an operating item? Why? Do not discuss earnings per share requirements.

C5-7 Nonrecurring Items

AICPA Adapted Lynn Company sells a component of its business in the middle of the year. On the date of sale, the net proceeds received were less than the aggregate book value of the component's net assets. The component was operating at a loss from the beginning of the year.

In addition, Lynn had one of its manufacturing plants destroyed by an earthquake during the year. The loss is properly reported as an extraordinary item.

Required

1. Explain how Lynn should report discontinued operations of a component of its business on its income statement for this year. Do not discuss earnings per share requirements.
2. What are the criteria for classification as an extraordinary item?
3. Explain how Lynn should report the extraordinary loss from the earthquake on its income statement for this year.

Do not discuss earnings per share requirements.

C5-8 Statement of Cash Flows

The president of a company, which is being audited for the first time, is concerned about all the unnecessary financial information the company is being required to disclose, and says, "We have always prepared only a balance sheet and an income statement. Surely these are enough. The only information anyone is interested in is how much we earned and what we have left. Now I am told we must prepare a statement of cash flows. What is this statement, what information does it provide, what are the major sections of the statement, and what is included in each section (under the indirect method)?"

Required
Prepare a written response that answers the president's questions.

CREATIVE AND CRITICAL THINKING

C5-9 Capital Maintenance

At the beginning of 1995, the Hill family organized the Hill Corporation and issued 8,000 shares of stock to family members for $20 per share. During 1998, it issued an additional 1,600 shares of stock for $25 per share to family members. The 9,600 shares were held by the family until the corporation was liquidated at the end of 2007. At that time the corporate assets were sold for $600,000 and the $50,000 of corporate liabilities were paid off. The remainder was returned to stockholders. During the 13 years of operation the corporation had a volatile operating life. It started out slowly but then increased its activities in later years. It had operated in several industry segments, being quite successful in some, not so successful in others. It had survived a major earthquake, but not without incurring significant losses. The corporation paid out dividends of $100,000 during its lifetime.

You are a member of the Hill family who has just inherited a sizable fortune from one of your relatives. Although you were quite young during the operating life of the Hill Corporation, you are considering establishing and investing in a new corporation that operates in some of the same lines of business, provided that the corporation would be profitable. You have just received your undergraduate accounting degree and upon investigation find that, with the exception of the preceding information, all the corporate accounting records were destroyed in a recent fire. You have been told that these records were sketchy at best, but that a capital maintenance approach to income measurement might yield some useful information.

Required
Compute the lifetime income of the Hill Corporation and comment upon what additional information you would desire before making your investment decision.

C5-10 Accrual Accounting

AICPA Adapted Generally accepted accounting principles require the use of accruals and deferrals in the determination of income.

Required
1. Explain how accrual accounting affects the determination of a company's income. Include in your discussion what constitutes an accrual and a deferral, and give appropriate examples of each.
2. Contrast accrual accounting with cash accounting.

C5-11 Ethics and Sale of Operating Component

It is the end of 2007, and, as an accountant for Newell Company, you are preparing its 2007 financial statements. On December 29, 2007, the management of Newell decided to sell one of its major divisions, subject to some legal work that is expected to be completed during the first week in April 2008 (after the 2007 financial statements have been issued). During 2007, the division earned a small operating income that is just enough for the company to report "record earnings" for the year. However, the estimated fair value of the division at the end of 2007 is less than its net book value, so that management anticipates the component will be sold at a loss.

The president of Newell stops by your office and says to you, "You have been doing a fine job. Keep up the good work, because you are heading for a promotion in early 2009. Once we report the record earnings for 2007, our stockholders and creditors will be happy. Then I think our earnings for 2008 will be high enough so that the loss we expect to report in 2008 on the sale of the division will not look so bad." After the president leaves your office, you continue preparing the 2007 financial statements.

Required
From financial reporting and ethical perspectives, what information, if any, will you include about the upcoming sale of the division in the 2007 financial statements?

RESEARCH SIMULATIONS

R5-1 Researching GAAP

Situation

During 2007, one of the customers of Klote Company declared bankruptcy. This customer had been a major purchaser of Klote's products and had owed $40,000 on account to Klote (a material portion of its receivables) at the time of bankruptcy. As a result of the bankruptcy, Klote had to write off the entire $40,000 account receivable of the customer as a loss. The president of Klote is concerned about how to report this loss on the company's 2007 income statement. The president says, "Since this company that went bankrupt was a major customer, surely that is an unusual and infrequent event, and the $40,000 should be reported as an extraordinary loss. What do you think?"

Directions

Research the related generally accepted accounting principles and prepare a short memo to the president that summarizes how to report the $40,000 loss on Klote's 2007 income statement. Cite your reference and applicable paragraph numbers.

R5-2 Researching GAAP

Situation

The Kelly Company, a small corporation, is preparing its 2007 financial statements. At the end of 2007, the company purchased a building for $100,000, paying $20,000 as a down payment and signing an $80,000 mortgage. The president of Kelly is concerned about how to report this transaction on the company's statement of cash flows and has asked you to "look into this issue for me."

Directions

Research the related generally accepted accounting principles and prepare a short memo to the president that summarizes how to report this transaction on the 2007 statement of cash flows. Cite your reference and applicable paragraph numbers.