Financial Reporting and Concepts

Part 1

Your goals for this "accounting, reporting, and analysis" chapter are to learn about:

- Special reporting situations (errors, discontinued operations, extraordinary items, etc.).
- Earnings per share, price earnings ratios, book value per share, and dividend rates.
- The objectives of financial reporting.
- The qualitative characteristics of useful accounting information.
- The development of generally accepted accounting principles.
- Key assumptions of financial accounting and reporting.
- The growing role and importance of global accounting issues.

1. Special Reporting Situations

In earlier book chapters, it was noted that the accounting profession uses an "all inclusive" approach to measuring income. Virtually all transactions, other than shareholder related transactions like issuing stock and paying dividends, are eventually channeled through the income statement. However, there are certain situations where the accounting rules have evolved in sophistication to provide special disclosures. The reason for the added disclosure is to make it easier for users of financial statements to sort out the effects that are related to ongoing operations versus those that are somehow unique. Specifically, the following discussion will highlight the correct handling of (1) error corrections, (2) discontinued operations, (3) extraordinary items, (4) changes in accounting methods, and (5) other comprehensive income items.

1.1 Corrections of Errors

Errors consist of mathematical mistakes, incorrect reporting, omissions, oversights, and other things that were simply handled wrong in a previous accounting period. Once an error is discovered, it must be corrected.

The temptation is to simply force the books into balance by making a compensating error in the current period. For example, assume that a company failed to depreciate an asset in 20X4, and this fact is discovered in 20X5. Why not just catch up by "double depreciating" the asset in 20X5, and then everything will be fine, right? Wrong! While it is true that accumulated depreciation in the balance sheet would be back on track at the end of 20X5, income for 20X4 and 20X5 would now both be wrong. It is not technically correct to handle errors this way; instead, generally accepted accounting principles dictate that error corrections (if material) must be handled by "prior period adjustment." This means that the financial statements of prior periods must be subjected to a restatement to make them correct -- in essence the financial statement of prior periods are redone to reflect the correct amounts.

Correcting financial statements of prior periods entails reissuing financial statements with the necessary corrections. However, what journal entry is needed, given that revenue and expense accounts from earlier years have already been closed? Suppose that, in 20X5, a journal entry is needed to record the depreciation for 20X4 that was previously omitted in error:

XX-XX-XX	Retained Earnings		50,000	
	Accumulated Depreciation			50,000
	To record correction of error for previously omitted 20X4 depreciation expense			

This entry reveals a debit to Retained Earnings (reducing the beginning of year balance) for the depreciation expense that should have been recorded as an expense and closed to retained earnings in the prior year. The credit to Accumulated Depreciation provides a catch up adjustment to where the account would have been, had the deprecation been correctly recorded in 20X4.

Importantly, if comparative financial statements (i.e., financial statements, side by side, for two or more years as illustrated in the next chapter) are presented for 20X4 and 20X5, depreciation would be reported at the correct amounts in each years' statements (along with a note indicating that the presentation of prior years' data have been revised for an error correction). If an error related to prior periods for which comparative data are not presented, then the statement of retained earnings would be amended as follows:

GOOF UP CORPORATION Statement of Retained Earnings For the Year Ending December 31, 20X5	
Retained earnings - January 1, 20X5 - as previously reported	$500,000
Less: Effect of correction of depreciation error from 20X4	(50,000)
Corrected beginning retained earnings	$450,000
Plus: Net income	125,000
	$575,000
Less: Dividends	(25,000)
Retained earnings - December 31, 20X5	$550,000

Shareholders generally take a dim view of prior period adjustments as they tend to undermine confidence in management and financial information. But, GAAP takes the position that accountants must own up to their mistakes and reissue corrected financial data. As a practical matter, some accountants give way to the temptation to find creative ways to sweep errors under the rug. But, be wary of falling into this trap, as many a business person has found themselves in big trouble for trying to hide erroneous accounting data!

1.2 Discontinued Operations

As you find time to read the business press, you will encounter many interesting articles about high-profile business decisions. Particularly popular with the press is coverage of a major corporate action to exit a complete business unit. Such disposals occur when a corporate conglomerate (i.e., a company with many diverse business units) decides to exit a unit of operation by sale to some other company, or by outright abandonment. For example, a computer maker may decide to sell its personal computer manufacturing unit to a more efficient competitor, and instead focus on its mainframe and service business. Or, a chemical company may simply decide to close a unit that has been producing a specialty product that has become an environmental and liability nightmare.

Whatever the scenario, if an entity is disposing of a complete business component, it will invoke the unique reporting rules related to "discontinued operations." To trigger these rules requires that the disposed business component have operations that are clearly distinguishable operationally and for reporting purposes. This would typically relate to a separate business segment, unit, subsidiary, or group of assets.

Below is an illustrative income statement for Bail Out Corporation. Bail Out distributes farming implements and sporting goods. During 20X7, Bail Out sold its sporting equipment business and began to focus only on farm implements. In examining this illustration, be aware that revenues and expenses only relate to the continuing farming equipment. All amounts relating to operations of the sporting equipment business, along with the loss on the sale of assets used in that business, are removed from the upper portion of the income statement, and placed in a separate category below income from continuing operations.

BAIL OUT CORPORATION
Income Statement
For the Year Ending December 31, 20X7

Sales		$ 5,500,000
Cost of goods sold		3,300,000
Gross profit		$ 2,200,000
Operating expenses		
Salaries	$ 635,000	
Rent	135,000	
Other operating expenses	300,000	1,070,000
Income from continuing operations before income taxes		$ 1,130,000
Income taxes		400,000
Income from continuing operations		$ 730,000
Discontinued operations		
Loss from operation of sports equipment unit, including loss on disposal	$ 600,000	
Income tax benefit from loss on disposal of business unit	130,000	
Loss on discontinued operations		470,000
Net income		$ 260,000

Importantly, if a company is merely disposing of a single manufacturing plant or some other set of assets that does not constitute a business component, then the discontinued operations reporting rules are not invoked. For instance, suppose Sail Out merely sold its facility in Georgia, but continued to distribute the same products at all of its other locations. This would not constitute a discontinued operation. The income statement might include the gain or loss on the sale of the Georgia location as a separate line item in the income statement (as follows), but it would not require the expanded disclosures necessitated for a discontinued operation.

SAIL OUT CORPORATION Income Statement For the Year Ending December 31, 20X7		
Sales		$ 5,500,000
Cost of goods sold		3,300,000
Gross profit		$ 2,200,000
Operating expenses		
Salaries	$ 635,000	
Rent	135,000	
Other operating expenses	300,000	
Loss on sale of Georgia location	600,000	1,670,000
Income from continuing operations before income taxes		$ 530,000
Income taxes		270,000
Net income		$ 260,000

Before moving on, review Bail Out's income statement, noting that total income taxes were "split" between those applicable to continuing operations and discontinued operations. This method of showing the tax effects related to the discontinued operations is mandatory, and is called "intraperiod tax allocation." However, you should also note that only one income tax number is attributed to income from continuing operations; it is improper to further subdivide that amount of tax. For example, in the Sail Out income statement illustration, no attempt was made to match a portion of the total tax to the Georgia transaction.

As you will soon observe, intraperiod tax allocation is also applicable to other items that are reported below the income from continuing operation section of the income statement (additionally, intraperiod tax allocation can impact prior period adjustments and other scenarios beyond the scope of this discussion).

1.3 Extraordinary Items

From time to time, a business may experience a gain or loss that results from an event that is both unusual in nature and infrequent in occurrence. When these two conditions are both met, the item is deemed to be an extraordinary item, and it is to be reported in a separate category below income from continuing (and discontinued, if applicable) operations. Extraordinary items are to be shown net of their related tax effect, as follows:

UFO CORPORATION Income Statement For the Year Ending December 31, 20X2		
Sales		$ 5,500,000
Cost of goods sold		3,300,000
Gross profit		$ 2,200,000
Operating expenses		
Salaries	$ 635,000	
Rent	135,000	
Other operating expenses	300,000	1,070,000
Income from continuing operations before income taxes		$ 1,130,000
Income taxes		400,000
Income from continuing operations		$ 730,000
Extraordinary item		
Uninsured loss from meteorite strike at corporate office	$ 600,000	
Income tax benefit from loss	130,000	
Extraordinary loss net of tax		470,000
Net income		$ 260,000

What does and does not meet the conditions of unusual in nature and infrequent in occurrence? In the example above, I presumed that a meteorite hitting a business and causing a major loss met both conditions. Although meteorites do occur, it is indeed rare for one to hit a specific business and cause a major loss. It would be very unlikely that this same business would ever sustain this type of loss again. On the other hand, flood losses for businesses located along a river, earthquakes for businesses in the Pacific Rim, wind damage in coastal areas, airline crashes, and the like can give rise to losses that are not unusual in nature and may be expected to reoccur from time to time; these types of items would be reported in continuing operations as a separate line item.

HIGH WATER CORPORATION Income Statement For the Year Ending December 31, 20X7		
Sales		$ 5,500,000
Cost of goods sold		3,300,000
Gross profit		$ 2,200,000
Operating expenses		
Salaries	$ 635,000	
Rent	135,000	
Other operating expenses	300,000	
Flood loss at Delta River facility	600,000	1,670,000
Income from continuing operations before income taxes		$ 530,000
Income taxes		270,000
Net income		$ 260,000

Criteria driven rules (e.g., "unusual in nature" and "infrequent in occurrence") can give rise to subjective assessments -- how would you classify the effects of a tornado in Kansas, a major terrorist attack in New York, a drug recall because of newly discovered health risks, an asset seizure by a foreign government, and so forth? You likely have an opinion on each of these, but there is

1.4 Changes in Accounting Methods

Now and again, a company may adopt a change in accounting principle. Such accounting changes relate to changes from one acceptable method to another acceptable method. For instance, a company may conclude that it wishes to adopt an alternative inventory procedure (e.g., FIFO to average cost). These changes should only occur for good cause (not just to improve income in some particular period!), and flip-flopping on a regular basis is not permitted. When such a change is made, the company must make a retrospective adjustment. This means that the financial statements of prior accounting periods should be reworked as if the new principle had always been used. Substantively, this is no different than the treatment afforded error corrections (restatements). However, the FASB chose to attach the different phrase (retrospective adjustment) when the process is implemented for a change in accounting principle; the idea was to use a different term to distinguish between changes resulting from errors (which carry a stigma) and other types of changes.

Disclosures that must accompany a change in accounting principle are extensive. For starters, notes must be included that indicate why the newly adopted method is preferable. In addition, a substantial presentation is required showing amounts that were previously presented versus the newly derived numbers, with a clear delineation of all substantial changes. And, the cumulative effect of the change that relates to all years prior to the earliest financial data presented in the retrospectively adjusted information must also be calculated and disclosed. This is no small task, and a comprehensive illustration is well beyond the scope of any introductory accounting text.

Do not confuse a change in accounting method with a change in accounting estimate. Changes in estimate are handled prospectively. This type of change was illustrated in the property, plant, and equipment chapter. If your recall is a bit fuzzy, you should probably spend a few minutes to review that material. Also, take note that sometimes a change in principle cannot be separated from a change in estimate (e.g., changes in the approach to depreciating an asset); such changes are to be treated like a change in estimate and do not entail retrospective adjustments.

Likewise, do not confuse a correction of an error with an accounting change. If a company changed from FISH (first-in, still-here) to FIFO, this would be an error correction and require a prior period adjustment -- in case there is any doubt, FISH is not an acceptable inventory method. Remember, accounting changes relate to changes from one acceptable method to another acceptable method.

1.5 Other Comprehensive Income

In the long-term investments chapter, you were introduced to other comprehensive income. In that chapter, OCI arose from changes in the fair value of investments classified as “available for sale.” OCI can also result from certain pension plan accounting adjustments and translation of the financial statements of foreign subsidiaries (both of which are beyond the scope of this discussion). Whatever the source of OCI, you have already learned that many companies merely charge or credit OCI directly to equity. However, another option is to position OCI at the very bottom of the income statement.

1.6 Recap

It is highly unlikely that a company would experience all of the previously discussed items within the same year. However, were that the case, its income statement might expand to look something like this (this illustration includes the less common approach of including OCI in the statement of income, rather than direct recording of OCI directly to equity):

RECAP CORPORATION
Statement of Comprehensive Income
For the Year Ending December 31, 20X7

Sales		$ 6,500,000
Cost of goods sold		4,000,000
Gross profit		$ 2,500,000
Operating expenses		
Salaries	$ 750,000	
Rent	250,000	
Other operating expenses	300,000	1,300,000
Income from continuing operations before income taxes		$ 1,200,000
Income taxes		500,000
Income from continuing operations		$ 700,000
Discontinued operations		
Profit on operations of food processing unit, including gain on disposal	$ 800,000	
Less: Income tax on disposal of business unit	200,000	
Gain on discontinued operations		600,000
Extraordinary item		
Gain on discovery of diamonds in company landfill	$ 900,000	
Less: Income tax on diamonds	250,000	
Extraordinary gain		650,000
Net income/earnings		$ 1,950,000
Other comprehensive income adjustments from certain investments		100,000
Comprehensive income		$ 2,050,000

Before departing this rather elaborate look at income reporting, note that certain terms highlighted above are often tossed around rather casually. However, to the well-trained accountant, those terms have specific connotations. In a strictly correct technical sense, Net income or earnings is income from continuing operations plus/minus discontinued operations and extraordinary items. Comprehensive income is net income plus other comprehensive income.

You may feel a sense of dismay as it relates to the potential complexity of income reporting, but remember that this break out is intended to help investors sort out the results of operations that are ongoing from those parts that may not recur or are otherwise unique. Careful study allows financial statement users to fully comprehend the results of operations and gain a deeper understanding of how a company arrived at its “bottom line.” As you can see, Recap Corporation sports a very nice bottom line of $2,050,000, but a huge portion is from special items that cannot be counted on to repeat themselves!

1.7 Ebit and Ebitda

You are apt to hear investors discuss a company’s “earnings before interest and taxes” (EBIT) and “earnings before interest, taxes, depreciation, and amortization” (EBITDA). These are not numbers that you will find specifically reported in financial statements. However, they are numbers that someone has calculated from information available in the statements. Some people argue that EBIT (pronounced with a long “E” sound and “bit”) and EBITDA (pronounced with a long “E” sound and “bit” and “dah”) are important and relevant to decision making, because they reveal the core performance before considering financing costs and taxes (and noncash charges like depreciation and amortization). These numbers are sometimes used in evaluating the intrinsic value of a firm, because they reveal how much the business is producing in earnings without regard to how the business is financed and taxed. Use these numbers with great care, as they provide an overly simplistic view of business performance evaluation.

1.8 Return on Assets

Some financial statement analysts will compare income to assets, in an attempt to assess how effectively assets are being utilized to generate profits. The specific income measure that is used in the return on assets ratio varies with the analyst, but one calculation is:

Return on Assets Ratio = (Net Income + Interest Expense)/Average Assets

These calculations of “ROA” attempt to focus on income (excluding financing costs) in relation to assets. The point is to demonstrate how much operating income is being generated by the deployed assets of the business. By itself, the number can be meaningless, but when you calculate the number for several businesses and start making comparisons, you might be surprised at the variations in return. While this ratio is useful if used correctly, I must caution heavily against misinterpretation of its signals. For example, high-tech companies often have very few tangible assets against which to compare their income (even though they may have previously invested in and expensed massive amounts of research and development monies). In comparison, a manufacturer may have a large tangible asset pool (because GAAP allowed them to capitalize the construction costs of their plant). As a result, the tech company could have a much better ROA even though it would not necessarily be the better company. Always guard against reaching definitive conclusions based on single indicators.