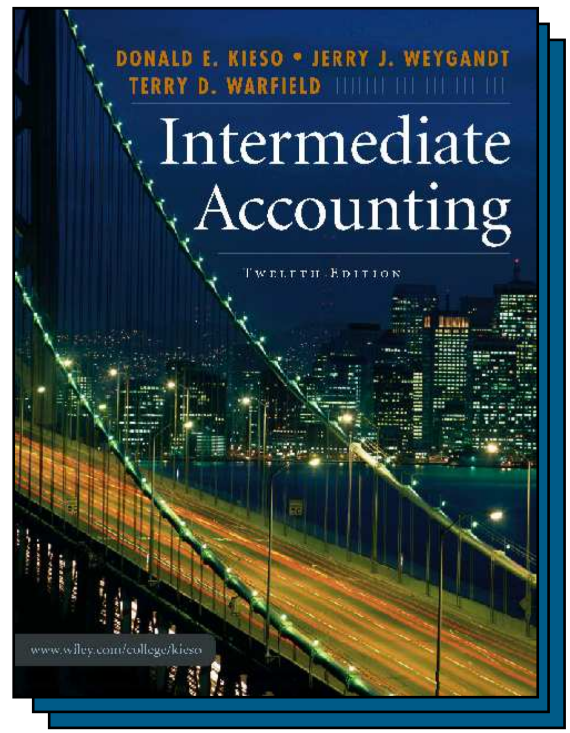
Examining the Income Statement

Chapter 4

Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



Prepared by Coby Harmon, University of California, Santa Barbara

Learning Objectives

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

Income Statement and Related Information

Income Statement

- Usefulness
- Limitations
- Quality of Earnings

Format of the Income Statement

- Elements
- Single-step
- Multiple-step
- Condensed income statements

Reporting Irregular Items

- Discontinued operations
- Extraordinary items
- Unusual gains and losses
- Changes in accounting principles
- Changes in estimates
- Corrections of errors

Special Reporting Issues

- Intraperiod tax allocation
- Earnings per share
- Retained earnings statement
- Comprehensive income

Income Statement

Usefulness of the Income Statement

- Evaluate past performance.
- Predicting future performance.
- Help assess the risk or uncertainty of achieving future cash flows.

LO 1 Understand the uses and limitations of an income statement.

Income Statement

Limitations of the Income Statement

- Companies omit items that cannot be measured reliably.
- Income is affected by the accounting methods employed.
- Income measurement involves judgment.

LO 1 Understand the uses and limitations of an income statement.

Income Statement

Quality of Earnings

Companies have incentives to **manage income** to meet or beat Wall Street expectations, so that

- the market price of stock increases and
- the value of stock options increase.

Quality of earnings is reduced if earnings management results in information that is less useful for predicting future earnings and cash flows.

Elements of the Income Statement

Revenues – Inflows or other enhancements of assets or settlements of its liabilities that constitute the entity's ongoing major or central operations.

Examples of Revenue Accounts

- Sales
- Fee revenue
- Interest revenue
- Dividend revenue
- Rent revenue

Elements of the Income Statement

Expenses – Outflows or other using-up of assets or incurrences of liabilities that constitute the entity's ongoing major or central operations.

Examples of Expense Accounts

- Cost of goods sold
- Depreciation expense
- Interest expense
- Rent expense
- Salary expense

Elements of the Income Statement

Gains – Increases in equity (net assets) from peripheral or incidental transactions.

Losses - Decreases in equity (net assets) from peripheral or incidental transactions.

Gains and losses can result from

- sale of investments or plant assets,
- settlement of liabilities,
- write-offs of assets.

Single-Step Income Statement

The single-step statement consists of just two groupings:

Revenues
− Expenses
Net Income

Single-Step

No distinction between Operating and Non-operating categories.

Income Statement (in thousands)	
Revenues:	
Sales	$ 285,000
Interest revenue	17,000
Total revenue	302,000
Expenses:	
Cost of goods sold	149,000
Advertising expense	10,000
Depreciation expense	43,000
Interest expense	21,000
Income tax expense	24,000
Total expenses	247,000
Net income	$ 55,000
Earnings per share	$ 0.75

LO 2 Prepare a single-step income statement.

Single-Step Income Statement

Review

The single-step income statement emphasizes

a. the gross profit figure.

b. total revenues and total expenses.

c. extraordinary items more than it is emphasized in the multiple-step income statement.

d. the various components of income from continuing operations.

Multiple-Step Income Statement

Background

- Separates operating transactions from nonoperating transactions.
- Matches costs and expenses with related revenues.
- Highlights certain intermediate components of income that analysts use.

Multiple-Step Income Statement

The presentation divides information into major sections.

1. Operating Section

2. Nonoperating Section

3. Income tax

Income Statement (in thousands)	
Sales	$ 285,000
Cost of goods sold	149,000
Gross profit	136,000
Operating expenses:	
Advertising expense	10,000
Depreciation expense	43,000
Total operating expense	53,000
Income from operations	83,000
Other revenue (expense):	
Interest revenue	17,000
Interest expense	(21,000)
Total other	(4,000)
Income before taxes	79,000
Income tax expense	24,000
Net income	$ 55,000
Earnings per share	$ 0.75

LO 3 Prepare a multiple-step income statement.

Multiple-Step Income Statement

Review

A separation of operating and non operating activities of a company exists in

a. both a multiple-step and single-step income statement.

b. a multiple-step but not a single-step income statement.

c. a single-step but not a multiple-step income statement.

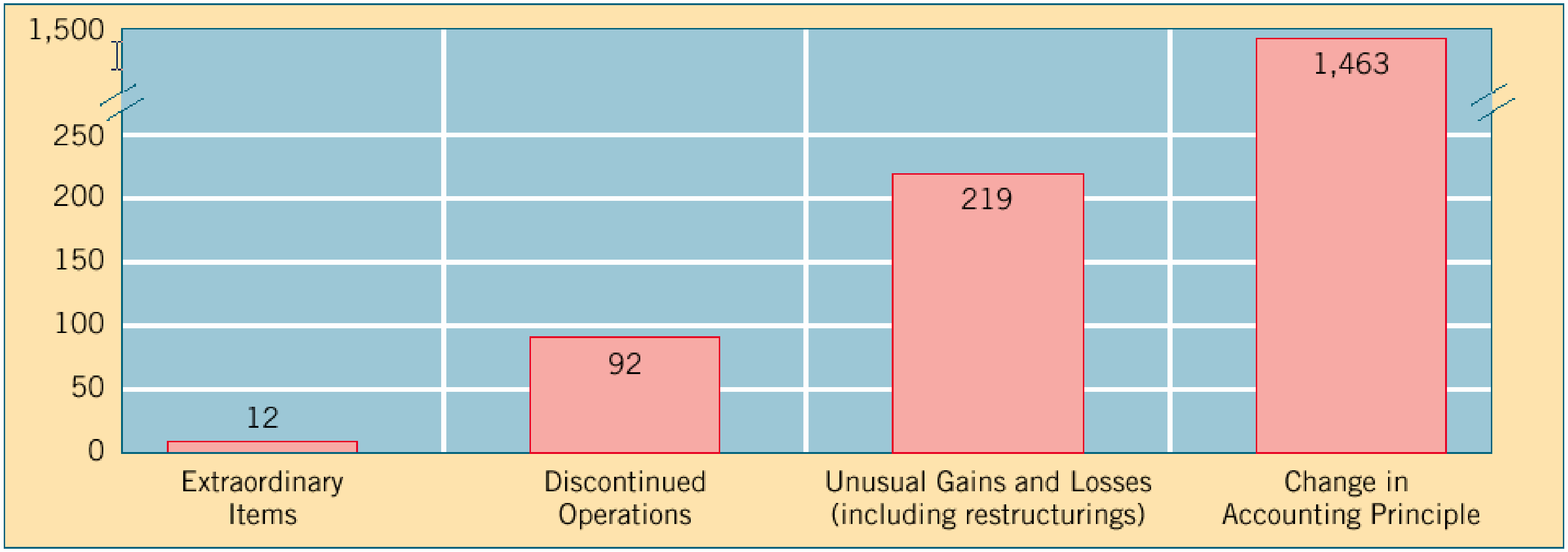
d. neither a single-step nor a multiple-step income statement.

LO 3 Prepare a multiple-step income statement.

Reporting Irregular Items

Companies are required to report irregular items in the financial statements so users can determine the long-run earning power of the company.

Illustration 4-5
Number of Irregular Items Reported in a Recent Year by 600 Large Companies



LO 4 Explain how to report irregular items.

Reporting Irregular Items

Irregular items fall into six categories

- Discontinued operations.
- Extraordinary items.
- Unusual gains and losses.
- Changes in accounting principle.
- Changes in estimates.
- Corrections of errors.

LO 4 Explain how to report irregular items.

Reporting Irregular Items

Discontinued Operations occurs when,

(a) company eliminates the

- results of operations and
- cash flows of a component.

(b) there is no significant continuing involvement in that component.

Amount reported "net of tax."

Reporting Discontinued Operations

Exercise: McCarthy Corporation had after tax income from continuing operations of $55,000,000 in 2007. During 2007, it disposed of its restaurant division at a pretax loss of $270,000. Prior to disposal, the division operated at a pretax loss of $450,000 in 2007. Assume a tax rate of 30%. Prepare a partial income statement for McCarthy.

Income from continuing operations	$55,000,000
Discontinued operations:	
Loss from operations, net of $135,000 tax	315,000
Loss on disposal, net of $81,000 tax	189,000
Total loss on discontinued operations	504,000
Net income	$54,496,000

LO 4 Explain how to report irregular items.

Reporting Discontinued Operations

Discontinued Operations are reported after "Income from continuing operations."

Previously labeled as "Net Income".

Moved to

Income Statement (in thousands)	
Sales	$ 285,000
Cost of goods sold	149,000
Other revenue (expense):	
Interest revenue	17,000
Interest expense	(21,000)
Total other	(4,000)
Income before taxes	79,000
Income tax expense	24,000
Income from continuing operations	55,000
Discontinued operations:	
Loss from operations, net of tax	315
Loss on disposal, net of tax	189
Total loss on discontinued operations	504
Net income	$ 54,496

LO 4 Explain how to report irregular items.

Reporting Irregular Items

Extraordinary items are nonrecurring material items that differ significantly from a company's typical business activities.

Extraordinary Item must be both of an

- Unusual Nature and
- Occur Infrequently

Company must consider the **environment** in which it operates.

Amount reported "net of tax."

LO 4 Explain how to report irregular items.

Reporting Extraordinary Items

Are these items Extraordinary?

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

YES

(b) A citrus grower's Florida crop is damaged by frost.

NO

(c) A company sells a block of common stock of a publicly traded company. The block of shares, which represents less than 10% of the publicly-held company, is the only security investment the company has ever owned.

YES

Reporting Extraordinary Items

Are these items Extraordinary?

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

NO

(e) An earthquake destroys one of the oil refineries owned by a large multi-national oil company. Earthquakes are rare in this geographical location.

YES

(f) A company experiences a material loss in the repurchase of a large bond issue that has been outstanding for 3 years. The company regularly repurchases bonds of this nature.

NO

LO 4 Explain how to report irregular items.

Reporting Extraordinary Items

Exercise: McCarthy Corporation had after tax income from continuing operations of $55,000,000 in 2007. In addition, it suffered an unusual and infrequent pretax loss of $770,000 from a volcano eruption. The corporation's tax rate is 30%. Prepare a partial income statement for McCarthy Corporation beginning with income from continuing operations.

Income from continuing operations	$55,000,000
Extraordinary loss, net of $231,000 tax	539,000
Net income	$54,461,000

($770,000 x 30% = $231,000 tax)

LO 4 Explain how to report irregular items.

Reporting Extraordinary Items

Extraordinary Items are reported after "Income from continuing operations."

Income Statement (in thousands)	
Sales	$ 285,000
Cost of goods sold	149,000
Other revenue (expense):	
Interest revenue	17,000
Interest expense	(21,000)
Total other	(4,000)
Income before taxes	79,000
Income tax expense	24,000
Income from continuing operations	55,000
Extraordinary loss, net of tax	**539**
Net income	$ 54,461

Previously labeled as "Net Income".

Moved to

LO 4 Explain how to report irregular items.

Reporting Irregular Items

Reporting when both Discontinued Operations and Extraordinary Items are present.

Discontinued Operations

Extraordinary Item

Income Statement (in thousands)	
Sales	$ 285,000
Cost of goods sold	149,000
Interest expense	(21,000)
Total other	(4,000)
Income before taxes	79,000
Income tax expense	24,000
Income from continuing operations	55,000
Discontinued operations:	
Loss from operations, net of tax	**315**
Loss on disposal, net of tax	**189**
Total loss on discontinued operations	**504**
Income before extraordinary item	54,496
Extraordinary loss, net of tax	**539**
Net income	$ 53,957

LO 4 Explain how to report irregular items.

Reporting Irregular Items

Review

Irregular transactions such as discontinued operations and extraordinary items should be reported separately in

a. both a single-step and multiple-step income statement.

b. a single-step income statement only.

c. a multiple-step income statement only.

d. neither a single-step nor a multiple-step income statement.

LO 4 Explain how to report irregular items.

Reporting Irregular Items

Unusual Gains and Losses

Material items that are **unusual** or **infrequent**, <u>but not both</u>, should be reported in a separate section just above "Income from continuing operations before income taxes."

Examples can include:

- Write-downs of inventories
- Foreign exchange transaction gains and losses

The Board prohibits net-of-tax treatment for these items.

Reporting Irregular Items

Changes in Accounting Principles

- Retrospective adjustment
- Cumulative effect adjustment to beginning retained earnings
- Approach preserves comparability
- Examples include:
  - change from FIFO to average cost
  - change from the percentage-of-completion to the completed-contract method

Reporting Irregular Items

Changes in Estimate

- Accounted for in the period of change and future periods
- Not handled retrospectively
- Not considered errors or extraordinary items
- Examples include:
  - Useful lives and salvage values of depreciable assets
  - Allowance for uncollectible receivables
  - Inventory obsolescence

Change in Estimate Example

Arcadia HS, purchased equipment for $510,000 which was estimated to have a useful life of 10 years with a salvage value of $10,000 at the end of that time. Depreciation has been recorded for 7 years on a straight-line basis. In 2005 (year 8), it is determined that the total estimated life should be 15 years with a salvage value of $5,000 at the end of that time.

Questions:

- What is the journal entry to correct the prior years' depreciation?
- Calculate the depreciation expense for 2005.

No Entry Required

LO 4 Explain how to report irregular items.

Change in Estimate Example

After 7 years

Equipment cost	$510,000		
Salvage value	- 10,000		
Depreciable base	500,000		
Useful life (original)	10 years		
Annual depreciation	$ 50,000	× 7 years =	$350,000

First, establish NBV at date of change in estimate.

Balance Sheet (Dec. 31, 2004)

Fixed Assets:

Equipment	$510,000
Accumulated depreciation	350,000
Net book value (NBV)	$160,000

LO 4 Explain how to report irregular items.

Change in Estimate Example

After 7 years

Net book value	$160,000
Salvage value (new)	5,000
Depreciable base	155,000
Useful life remaining	8 years
Annual depreciation	$ 19,375

Depreciation Expense calculation for 2005.

Journal entry for 2005

Depreciation expense	19,375	
Accumulated depreciation		19,375

LO 4 Explain how to report irregular items.

Reporting Irregular Items

Corrections of Errors

- Result from:
  - mathematical mistakes
  - mistakes in application of accounting principles
  - oversight or misuse of facts
- Corrections treated as **prior period adjustments**
- Adjustment to the beginning balance of retained earnings

Intraperiod Tax Allocation

Relates the income tax expense to the specific items that give rise to the amount of the tax expense.

Income tax is allocated to the following items:

(1) Income from continuing operations before tax

(2) Discontinued operations

(3) Extraordinary items

(4) Changes in accounting principle

(5) Correction of errors

LO 5 Explain intraperiod tax allocation.

Example of Intraperiod Tax Allocation

Income Statement (in thousands)		Total Tax Allocated
Sales	$ 285,000	
Cost of good	149,000	
Interest ex	(21,000)	
Total other	(4,000)	
Income from cont. oper. before taxes	79,000	
Income tax expense	24,000	$24,000
Income from continuing operations	55,000	
Discontinued operations:		
Loss on operations, net of $135 tax	**315**	(135)
Loss on disposal, net of $61 tax	**189**	(61)
Total loss on discontinued operations	**504**	
Income before extraordinary item	54,496	
Extraordinary loss, net of $231 tax	**539**	(231)
Net income	$ 53,957	$23,573

Note: losses reduce the total tax

LO 5 Explain intraperiod tax allocation.

Earnings Per Share

Calculation

$$\frac{\text{Net income - Preferred dividends}}{\text{Weighted average number of shares outstanding}}$$

- An important business indicator.
- Measures the dollars earned by each share of common stock.
- Must be disclosed on the the income statement.

LO 6 Identify where to report earnings per share information.

Earnings Per Share

Brief Exercise 4-8 In 2007, Kirby Puckett Corporation reported net income of $1,200,000. It declared and paid preferred stock dividends of $250,000. During 2007, Puckett had a weighted average of 190,000 common shares outstanding. Compute Puckett's 2007 earnings per share.

$$\frac{\text{Net income - Preferred dividends}}{\text{Weighted average number of shares outstanding}}$$

$$\frac{\$1{,}200{,}000 \quad - \quad \$250{,}000}{190{,}000} = \mathbf{\$5.00} \text{ per share}$$

LO 6 Identify where to report earnings per share information.

Retained Earnings Statement

Changes in Retained Earnings

Increase	Decrease
• Net income • Change in accounting principle • Error corrections	• Net loss • Dividends • Change in accounting principles • Error corrections

LO 7 Prepare a retained earnings statement.

Retained Earnings Statement

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2007

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

Before issuing the report for the year ended December 31, 2007, you discover a $50,000 error (net of tax) that caused the 2006 inventory to be overstated (overstated inventory caused COGS to be lower and thus net income to be higher in 2006). Would this discovery have any impact on the reporting of the Statement of Retained Earnings for 2007?

LO 7 Prepare a retained earnings statement.

Retained Earnings Statement

Woods, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2007

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

LO 7 Prepare a retained earnings statement.

Retained Earnings Statement

Restricted Retained Earnings

Disclosed

- In notes to the financial statements
- As Appropriated Retained Earnings

LO 7 Prepare a retained earnings statement.

Comprehensive Income

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

Income Statement (in thousands)	
Sales	$ 285,000
Cost of goods sold	149,000
Gross profit	136,000
Operating expenses:	
Advertising expense	10,000
Depreciation expense	43,000
Total operating expense	53,000
Income from operations	83,000
Other revenue (expense):	
Interest revenue	17,000
Interest expense	(21,000)
Total other	(4,000)
Income before taxes	79,000
Income tax expense	24,000
Net income	$ 55,000

+

Other Comprehensive Income

- Unrealized gains and losses on available-for-sale securities.
- Translation gains and losses on foreign currency.
- Plus others

Reported in Stockholders' Equity

LO 8 Explain how to report other comprehensive income.

Comprehensive Income

Review

Gains and losses that bypass net income but affect stockholders' equity are referred to as

a. comprehensive income.

b. other comprehensive income.

c. prior period income.

d. unusual gains and losses.

LO 8 Explain how to report other comprehensive income.

Comprehensive Income

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

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

Comprehensive Income

Illustration 4-19

Two-Statement Format for Comprehensive Income

V. GILL INC.
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2007

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

V. GILL INC.
COMPREHENSIVE INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2007

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

LO 8 Explain how to report other comprehensive income.

Comprehensive Income

Combined Income Statement

V. Gill Inc.
Combined Statement of Comprehensive Income
For the Year Ended December 31, 2007

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

LO 8 Explain how to report other comprehensive income.

Comprehensive Income

Statement of Stockholders' Equity (most common)

Illustration 4-20

V. GILL INC.
STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE YEAR ENDED DECEMBER 31, 2007

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

LO 8 Explain how to report other comprehensive income.

Comprehensive Income

Balance Sheet Presentation

Illustration 4-21

V. GILL INC. BALANCE SHEET AS OF DECEMBER 31, 2007 (STOCKHOLDERS' EQUITY SECTION)	
Stockholders' equity	
Common stock	$300,000
Retained earnings	160,000
Accumulated other comprehensive income	90,000
Total stockholders' equity	$550,000

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

LO 8 Explain how to report other comprehensive income.

Comprehensive Income

Review

The FASB decided that the components of other comprehensive income must be displayed

a. in a second separate income statement.

b. in a combined income statement of comprehensive income.

c. as a part of the statement of stockholders' equity.

d. Any of these options is permissible.

LO 8 Explain how to report other comprehensive income.

Copyright

Copyright © 2006 John Wiley & Sons, Inc. All rights reserved. Reproduction or translation of this work beyond that permitted in Section 117 of the 1976 United States Copyright Act without the express written permission of the copyright owner is unlawful. Request for further information should be addressed to the Permissions Department, John Wiley & Sons, Inc. The purchaser may make back-up copies for his/her own use only and not for distribution or resale. The Publisher assumes no responsibility for errors, omissions, or damages, caused by the use of these programs or from the use of the information contained herein.