

CHAPTER 5

THE INCOME STATEMENT AND THE STATEMENT OF CASH FLOWS

CONTENT ANALYSIS OF EXERCISES AND PROBLEMS

<u>Number</u>	<u>Content</u>	<u>Time Range (minutes)</u>
E5-1	<u>Simple Income Statement</u> . (Easy) Periodic inventory system. Multiple-step and single-step format preparation from selected account balances.	15-20
E5-2	<u>Simple Income Statement</u> . (Easy) Perpetual inventory system. Multiple-step and single-step format preparation from selected account balances.	15-20
E5-3	<u>Classifications</u> . (Moderate) Identification of where various items would be reported in the financial statements.	5-10
E5-4	<u>Classifications</u> . (Moderate) Identification of where various items would be reported in the financial statements.	5-10
E5-5	<u>Basic Income Statement</u> . (Moderate) Multiple-step and single-step income statement. IFRS discussion.	20-25
E5-6	<u>Basic Income Statement and Statement of Comprehensive Income</u> . (Moderate) Multiple-step and single-step income statement. Statement of comprehensive income.	20-25
E5-7	<u>Basic Income Statement</u> . (Moderate) Schedule of cost of goods sold. Multiple-step and single-step income statement preparation.	20-25
E5-8	<u>Basic Income Statement and Statement of Comprehensive Income</u> . (Moderate) Schedule of cost of goods sold. Multiple-step and single-step income statement. Statement of comprehensive income.	20-25
E5-9	<u>Income Statement and Retained Earnings</u> . (Moderate) Multiple-step income statement and retained earnings statement. Extraordinary item, dividends, operating loss. Compute return on stockholders' equity.	20-25
E5-10	<u>Income Statement and Retained Earnings</u> . (Moderate) Cost of goods sold schedule. Single-step income statement, retained earnings statement. Extraordinary item, operating loss, obsolete materials, dividends. Compute profit margin.	20-25

<u>Number</u>	<u>Content</u>	<u>Time Range (minutes)</u>
E5-11	<u>Income Statement Calculations.</u> (Moderate) Determination of various amounts from partial information.	10-15
E5-12	<u>Income Statement Calculations.</u> (Moderate) Determination of various amounts based on partial information.	15-20
E5-13	<u>Results of Discontinued Operations.</u> (Easy) Preparation of results from discontinued operations section when component is held for sale at end of year.	10-15
E5-14	<u>Results of Discontinued Operations.</u> (Moderate) Preparation of results from discontinued operations section when component is held for sale at end of year.	15-20
E5-15	(AICPA adapted). <u>Income Statement Deficiencies.</u> (Moderate) Identify appropriate and inappropriate disclosures. Provide rationale.	20-25
E5-16	<u>Comprehensive Income.</u> (Moderate) Preparation of income statement and statement of comprehensive income under two different methods.	10-15
E5-17	<u>Net Cash Flow From Operating Activities.</u> (Easy) Preparation of operating activities section of statement of cash flows from list of items.	5-15
E5-18	<u>Operating Cash Flows: Direct Method.</u> (Easy) Prepare cash flows from operating activities section of statement of cash flows, using the direct method.	10-15
E5-19	<u>Statement of Cash Flows.</u> (Moderate) Prepare simple statement of cash flows from a list of items.	10-15
E5-20	<u>Statement of Cash Flows.</u> (Moderate) Prepare simple statement of cash flows from a list of items.	10-15
P5-1	<u>Comprehensive Income.</u> (Moderate) Format preparation of multiple-step income statement, statement of comprehensive income, and retained earnings statement.	30-50
P5-2	<u>Classifications.</u> (Moderate) Matching of various items with reporting component in the financial statements.	15-30
P5-3	<u>Income Statement.</u> (Moderate) Lower portion. Dividends, component disposal, extraordinary item, prior period correction. Retained earnings statement.	20-40
P5-4	<u>Income Statement.</u> (Moderate) Lower portion. Dividends, prior period correction, extraordinary item, change in accounting estimate, sale of division. Retained earnings statement.	20-40

<u>Number</u>	<u>Content</u>	<u>Time Range (minutes)</u>
P5-5	<u>Comprehensive.</u> (Moderate) Manufacturing income statement. Supporting schedules, multiple-step income statement, retained earnings statement. Computation of return on stockholders' equity and discussion. IFRS discussion.	40-55
P5-6	<u>Comprehensive.</u> (Moderate) Merchandising income statement. Supporting schedules, single-step income statement, retained earnings statement. Calculation of profit margin and discussion.	40-50
P5-7	<u>Comprehensive.</u> (Moderate) Merchandising income statement. Periodic inventory system. Supporting schedules, multiple-step income statement, retained earnings statement. Computation of return on stockholders' equity and discussion.	40-60
P5-8	<u>Misclassifications.</u> (Moderate) Identification of incorrectly classified items. Preparation of a correct multiple-step income statement and retained earnings statement.	30-50
P5-9	<u>Misclassifications.</u> (Moderate) Preparation of a correctly classified multiple-step income statement and retained earnings statement from one that is misclassified.	20-40
P5-10	<u>Classification.</u> (Moderate) Recognition of unusual and/or infrequent items and indication of where to disclose.	30-45
P5-11	<u>Results of Discontinued Operations.</u> (Moderate) Preparation of journal entry for loss on held-for-sale division. Preparation of income statement including results from discontinued operations section. Preparation of partial balance sheet.	40-60
P5-12	<u>Income Statement and Cash Flow Statement Disclosures.</u> (Moderate) Questions relating to the review of The Coca-Cola Company income statement and cash flow statement disclosures in Appendix A.	20-40
P5-13	(AICPA adapted). <u>Complex Income Statement.</u> (Challenging) Preparation of multiple-step income statement, including results of discontinued operations and extraordinary item.	30-45
P5-14	(AICPA adapted). <u>Income Statements.</u> (Challenging) Comparative. Preparation of a multiple-step comparative statement of income.	30-45
P5-15	(AICPA adapted). <u>Financial Statement Deficiencies.</u> (Moderate) Identification of non-arithmetic errors.	30-45
P5-16	(AICPA adapted). <u>Violations of GAAP.</u> (Moderate) Identification and suggested corrective action.	30-45
P5-17	<u>Comprehensive: Comparative Income Statements.</u> (Challenging) Preparation of comparative income statements.	30-40

<u>Number</u>	<u>Content</u>	<u>Time Range (minutes)</u>
P5-18	<u>Net Income and Comprehensive Income.</u> (Moderate) Preparation of income statement and reporting of comprehensive income using three different methods.	20-30
P5-19	<u>Statement of Cash Flows.</u> (Moderate) Preparation of the statement of cash flows from a list of selected items.	10-20
P5-20	<u>Statement of Cash Flows.</u> (Moderate) Preparation of the statement of cash flows from a list of selected items.	10-20
P5-21	<u>Statement of Cash Flows: Direct Method.</u> (Moderate) Preparation of the statement of cash flows, using the direct method for operating activities, from a list of selected items.	10-20
P5-22	<u>Comprehensive: Balance Sheet and Cash Flows.</u> (Challenging) Preparation from a beginning balance sheet and an ending statement of cash flows.	20-40

ANSWERS TO QUESTIONS

Q5-1 Under the capital maintenance concept, income for an accounting period is the amount that may be paid to stockholders (or owners) during that accounting period and still enable the corporation to be as well off at the end of the period as it was at the beginning. The capital of a corporation (i.e., its assets and liabilities) at the beginning and end of the period may be measured in a variety of different ways. These alternative ways of measuring the net asset value (from which income is subsequently determined) under the capital maintenance concept are: (1) the present value of future cash flows, (2) the net realizable value, (3) the current market value, (4) the current cost, or (5) the historical cost.

Q5-2 In the transactional approach, a company records its net assets at their historical cost and it does not record changes in these assets and liabilities unless a transaction, event, or circumstance has occurred that provides reliable evidence of a change in value. The transactional approach is applied using the accrual basis of accounting. In accrual accounting, a company records the financial effects of transactions and other events and circumstances in the periods in which they occur rather than only in the periods in which it receives or pays cash. This is the approach to income measurement that currently is used in accounting.

The transactional approach is consistent with the capital maintenance concept based on historical cost since the income represents the difference between the beginning and ending adjusted net assets on a 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 performance of a company's earnings activities.

Q5-3 Comprehensive income is the change in equity of a company during a period from transactions, other events, and circumstances related to nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

The intent of the FASB is twofold: (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 the financial statements.

- Q5-4
- (a) Return on investment is a measure of overall company performance. Stockholders (investors) invest capital in order to obtain a return on capital. Before a company can provide a return on investment, its capital must be maintained.
 - (b) 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.
 - (c) Financial flexibility is the ability of a company to adapt to unexpected needs and opportunities. Financial flexibility stems from, among others, the ability to adjust operations to increase net operating cash flows and the ability to sell assets without disrupting operations.
 - (d) Operating capability refers to a company's ability to maintain a given physical level of operations. This level of operations may be indicated 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).

Q5-5 The purposes of the income statement are: (1) to help evaluate management's past performance, (2) to help predict future income, and (3) to help assess the company's creditworthiness.

- Q5-6 The specific guidelines for reporting (presenting) revenues, expenses, gains, and losses are:
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.

Q5-6 (continued)

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.

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

Q5-7

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.

The operating activities that are likely to result in revenues may be described as a company's "earning process" and include purchasing, producing, selling, delivering, administrating, and collecting and paying cash.

Q5-8

The two criteria that ordinarily must be met for revenues to be recognized are:

1. Realization has taken place.
2. The revenues have been earned.

A company usually recognizes revenue at the time of sale.

Q5-9

Revenue might be recognized prior to the sale or after the sale in special cases to better reflect the nature of a company's operations (i.e., to increase the predictive value and representational faithfulness of the accounting information). The alternative revenue recognition methods include: (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.

Q5-10

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 are a measurement of the efforts or sacrifices made in the operating activities.

Q5-11 The three principles for recognizing the expenses to be matched against revenues, as identified by the FASB are:

1. Association of cause and effect. Some costs are recognized as expenses on the basis of a presumed direct association with specific revenues. Examples are sales commissions, cost of products sold, and transportation costs for delivery of goods sold to customers.
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. 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 (a) the costs incurred during the period provide no discernible future benefits (they do not result in assets), or (b) the allocation of costs among accounting periods or due to cause and effect relationships is not useful. Examples are management's salaries and most selling and administrative costs.

Q5-12 Gains are increases in the equity (net assets) of a company from peripheral or incidental transactions, and from 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 from all other events and circumstances during a period except those that result from expenses or distributions to owners. Gains or losses may be classified into three categories:

1. Gains or losses from exchange transactions. Examples are gains or losses on sales or disposals of fixed assets such as equipment or land.
2. Gains or losses from holding resources or obligations while their values change. Examples are a loss from writing inventory down from cost to market, a gain or loss from a change in value of a derivative financial instrument, a loss from an impairment of property, plant, and equipment (or intangibles), and a gain or loss from a change in a foreign exchange rate between the time of a credit transaction and the related cash flow.
3. Gains or losses resulting from nonreciprocal transfers between a company and nonowners. Examples include those due to lawsuits, assessments of fines or damages by a court, or natural catastrophes such as earthquakes or fires.

Q5-13 Items included in a company's "income from continuing operations" are

1. Sales revenues (net)
2. Cost of goods sold
3. Operating expenses
4. Other items
5. Income tax expense related to continuing operations

If the company uses a single-step format to prepare its income statement, those items are classified into two categories: revenues or expenses. All operating and other revenues are itemized and summed to determine the revenues. The cost of goods sold, operating expenses, other expenses, and income tax expense are summed to determine the total expenses. The difference between the total revenues and total expenses is the income from continuing operations.

If the company uses a multiple-step format to prepare its income statement, the format is as follows:

Sales revenues (net)
Less: Cost of goods sold
Gross profit
Less: Operating expenses
Operating income
Other items
Pretax income from continuing operations
Less: Income tax expense
Income from continuing operations

Q5-14 The current operating performance concept of income emphasizes that only the normal, ordinary, recurring results of operations for the current period should be included in a company's net income on the income statement. Any unusual and nonrecurring items of income or loss should be reported in the statement of retained earnings.

In the all-inclusive concept all transactions increasing or decreasing a company's owners' equity during the current period, with the exception of dividends and capital transactions, should be included in its net income. 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. Consequently, they should be included in the income statement (or in comprehensive income).

The all-inclusive concept (except for reporting prior period adjustments and retrospective adjustments on the retained earnings statement) is currently used in accounting practice.

Q5-15 Material recurring revenues and expenses (and gains and losses) that are not directly related to the primary operations of a company are classified as other items on its income statement. Examples are dividend revenue; interest revenue and expense; gains and losses from changes in values of certain derivative financial instruments; items such as rent, storage, and service revenues; gains and losses from the disposals of facilities that are not considered to be significant components; and nonextraordinary items that are either unusual in nature or infrequent in occurrence (but not both), such as losses 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.

Q5-16 Intraperiod tax allocation involves allocating a corporation's total income tax expense for the accounting period to the various major components of its net income, retained earnings, and other comprehensive income (if any). The rationale behind this allocation is that it is necessary to give a fair presentation of the after-tax impact of the major components on net income and retained earnings.

The portion of the income tax expense applicable to continuing operations is listed as a separate item in computing income from continuing operations, but the results from discontinued operations and each extraordinary item are shown net of the income tax effect. However, it is sound practice (and required by GAAP) to disclose the amount of the tax impact on each of these items either parenthetically or in a note to the financial statements.

Q5-17 Items included in a company's results from discontinued operations are (a) the income or loss from the operations of a discontinued component (net of income taxes) and (b) the gain or loss on the sale of the discontinued component (net of income taxes).

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.

Q5-18 An extraordinary item is an event or transaction that is unusual in nature and infrequent in occurrence. These criteria are defined as follows:

1. 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.
2. 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.

Examples of gains or losses from extraordinary items may include gains or losses from earthquakes, tornadoes, floods, expropriation of assets by another country, and a prohibition under a newly enacted law or regulation.

Q5-19 Gains or losses resulting from events or transactions that are either unusual in nature or infrequent in occurrence, but not both, such as the loss from the write-down of obsolete inventories or the gain or loss from the disposal of property, are not extraordinary items and are reported in the Other Items section on a company's income statement.

Q5-20 Changes in accounting estimates arise because a company's financial statements are presented on a periodic basis. These changes are due to the occurrence of new events, as additional experience is acquired, or as more information is obtained. Examples include changes in estimates of uncollectible receivables, inventory obsolescence, service lives and residual values of depreciable or depletable assets, and warranty costs. 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. In the year of the change in estimate, a note is included in the financial statements which shows the effect of the change on that year's income before extraordinary items, net income, and earnings per share.

Q5-21 "Earnings per share" usually is shown directly below the net income on a company's income statement.

The components of earnings per share that should be disclosed are: earnings per share related to income from continuing operations; results from discontinued operations (if any); and extraordinary items (if any). Each of these components is presented on a per-share basis and summed to determine the total earnings per share related to net income.

Q5-22 There are several differences between IFRS and U.S. GAAP in regard to a company's presentation and content of the income statement. Some of these differences are:

- (a) IFRS contain no prescribed format (single-step or multiple-step) for the income statement;
- (b) Companies may use different terminology (for instance, some companies use the term "turnover" to refer to sales).
- (c) IFRS require expenses to be classified by their nature or their function. Under U.S. GAAP, expenses are classified by their function (cost of sales, selling, general, and administrative expenses);
- (d) IFRS allow alternative performance measures to be presented on the face of the income statement while U.S. GAAP prohibits such presentation;
- (e) The definition of a component of an operation is defined much more broadly under IFRS than under U.S. GAAP; and
- (f) IFRS prohibit the reporting of items that are unusual in nature and infrequent in occurrence as extraordinary items.

Q5-23 The items included in a company's statement of retained earnings are: beginning retained earnings; retrospective adjustment (change in accounting principle) or prior period adjustment (correction of an error), if any; and these must be shown net of any income tax expense or tax credit; adjusted beginning retained earnings; net income; dividends; and ending retained earnings.

Q5-24 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.

In most instances, for a change in accounting principle, a company reports the cumulative effect on prior periods' earnings as a retrospective adjustment of its beginning retained earnings balance for the earliest year presented. The related existing asset or liability balance is recalculated and a new balance determined under the assumption that the new accounting principle had been applied during prior years. This cumulative effect (net of the related income tax effect) is reported directly after the beginning retained earnings amount on the company's retained earnings statement.

Q5-25 An error in a company's financial statements may result from 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. Any related impact upon income taxes is also recorded. The prior period adjustment (net of income taxes), then, is appropriately described and reported as an adjustment to the company's beginning retained earnings on its statement of retained earnings.

Q5-26 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: (1) any unrealized increase (gain) or decrease (loss) in the fair value of its investments in available-for-sale securities, (2) certain pension plan gains, losses, and prior service cost adjustments, (3) certain gains and losses on "derivative" financial instruments, and (4) any translation adjustment from converting the financial statements of its foreign operations into U.S. dollars.

Q5-27 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.

Q5-28 A statement of cash flows is a statement that reports 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. The statement of cash flows of a company includes three major sections: (1) cash flows from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities.

Q5-29 When used with a company's other financial statements, the statement of cash flows helps external users to assess: (a) the company's ability to generate positive future cash flows, (b) the company's ability to meet its obligations and pay dividends, (c) the company's need for external financing, (d) the reasons for differences between the company's net income and associated cash receipts and payments, and (e) both the cash and noncash aspects of the company's investing and financing transactions during the accounting period.

Q5-30 The three types of activities that a statement of cash flows reports on for a company are its:

1. Operating activities which include all the transactions and other events relating to its earning process. These include, for instance, transactions involving purchasing, producing, selling, and delivering goods for sale, as well as providing services.
2. Investing activities which include transactions involving buying and selling property, plant, and equipment; buying and selling long-term investments; and lending money and collecting on the loans.
3. Financing activities which include transactions involving obtaining resources from owners and paying dividends, as well as obtaining resources from creditors and repaying the amounts borrowed.

Q5-31 Under the indirect method, the net cash provided by operating activities is determined by adjusting net income (1) to eliminate certain amounts included in net income that did not involve operating cash flows and (2) to include any changes in current assets (other than cash) and current liabilities involved in the operating cycle that affected cash flows differently than net income.

Q5-32 Under the direct method, the most common cash inflows from operating activities are (1) collections from customers and (2) interest and dividends collected. The most common cash outflows are (1) payments to suppliers and employees, (2) payments of interest, and (3) payments of income taxes.

ANSWERS TO MULTIPLE CHOICE

- | | | | | |
|------|------|------|------|-------|
| 1. c | 3. c | 5. a | 7. b | 9. a |
| 2. a | 4. d | 6. b | 8. c | 10. a |

SOLUTIONS TO REVIEW EXERCISES

RE5-1

BRANDT CORPORATION
Income Statement (Partial)
For Year Ended December 31, Current Year

Sales revenue		\$500,000
Cost of goods sold		<u>(240,000)</u>
Gross profit		\$260,000
Operating expenses		<u>(50,000)</u>
Operating income		\$210,000
Other items		
Interest revenue	\$ 2,000	
Interest expense	<u>(12,000)</u>	<u>(10,000)</u>
Pretax income from continuing operations		\$200,000
Income tax expense		<u>(60,000)</u>
Income from continuing operations		<u>\$140,000</u>

RE5-2

BRANDT CORPORATION
Income Statement (Partial)
For Year Ended December 31, Current Year

Revenues		
Sales revenue		\$500,000
Interest revenue		<u>2,000</u>
Total revenues		\$502,000
Expenses		
Cost of goods sold	\$240,000	
Operating expenses	50,000	
Interest expense	12,000	
Income tax expense	<u>60,000</u>	
Total expenses		<u>(362,000)</u>
Income from continuing operations		<u>\$140,000</u>

RE5-3

Beginning inventory		\$ 50,000
Purchases	\$110,000	
Freight-in	<u>8,500</u>	
Net purchases		<u>118,500</u>
Cost of goods available for sale		\$168,500
Less: Ending inventory		<u>(47,800)</u>
Cost of goods sold		<u>\$120,700</u>

RE5-4

<u>Selling expenses</u>		
Delivery expense	\$ 2,300	
Advertising expense	5,500	
Sales salaries expense	13,750	
Sales supplies expense	<u>1,250</u>	
Total selling expenses		\$22,800
 <u>General and administrative expenses</u>		
Office salaries expense	\$12,750	
Insurance expense	3,000	
Office supplies expense	<u>900</u>	
Total general and administrative expenses		\$16,650

RE5-5

NILER CORPORATION
Income Statement (Partial)
For Year Ended December 31, Current Year

Income from continuing operations		\$35,000
Results from discontinued operations		
Income from operations of discontinued		
Line C (net of tax)	\$ 8,400	
Loss on disposal (net of tax)	<u>(12,500)</u>	<u>(4,100)</u>
Net Income		<u>\$30,900</u>

RE5-6

PALLEST CORPORATION
Income Statement (Partial)
For Year Ended December 31, Current Year

Pretax income from continuing operations	\$40,000	
Income tax expense	<u>(12,000)</u>	
Income from continuing operations	\$28,000	
Extraordinary loss (net of \$2,400 income taxes)	<u>(5,600)</u>	
Net Income	<u>\$22,400</u>	

	<u>Earnings per Common Share</u>
	<u>(8,000 common shares)</u>
<u>Components of Income</u>	
Income from continuing operations	\$3.50
Extraordinary loss	<u>(0.70)</u>
Net income	<u>\$2.80</u>

RE5-7

MANGOLD CORPORATION
Income Statement (Partial)
For Year Ended December 31, Current Year

<u>Components of Income</u>	<u>Earnings per Common Share (80,000 common shares)</u>
Income from continuing operations	\$0.98
Extraordinary loss	<u>(0.08)</u>
Net income	<u>\$0.90</u>

RE5-8

OWENS, INC.
Statement of Retained Earnings
For Year Ended December 31, Current Year

Retained earnings, 1/1	\$250,000
Less: Prior period adjustment, correction of understatement of bad debt expense for last year (net of \$7,500 income tax credit)	<u>(17,500)</u>
Adjusted retained earnings, 1/1	<u>\$232,500</u>

RE5-9

JORDAN CORPORATION
Statement of Retained Earnings
For Year Ended December 31, Current Year

Retained earnings, 1/1	\$225,000
Add: Net income for current year	<u>45,000</u>
	\$270,000
Less: Cash dividends	<u>(3,750)</u>
Retained earnings, 12/31	<u>\$266,250</u>

RE5-10

AMELIA'S BOOKSTORE
Statement of Cash Flow (Partial)
For Year Ended December 31, Current Year

Net Cash Flow From Operating Activities	
Net income	\$62,000
Adjustments for differences between income flows and cash flows from operating activities:	
Add: Depreciation expense	5,000
Decrease in accounts receivable	2,000
Less: Increase in inventory	(5,500)
Decrease in accounts payable	<u>(1,250)</u>
Net cash provided by operating activities	<u>\$62,250</u>

RE5-11

ROSS CORPORATION
Statement of Cash Flow (Partial)
For Year Ended December 31, Current Year

Cash Flows From Investing Activities	
Payment for purchase of warehouse	\$(45,000)
Receipt from sale of land	<u>7,900</u>
Net cash used for investing activities	\$(37,100)
Cash Flows From Financing Activities	
Payment of dividends	\$ (1,000)
Issuance of common stock	<u>25,000</u>
Net cash provided by financing activities	\$ 24,000

SOLUTIONS TO EXERCISES

E5-1

1. DIBB COMPANY
Income Statement
For Year Ended December 31, 2010

Sales (net)	\$198,000
Cost of goods sold	<u>(130,000)</u>
Gross profit	\$ 68,000
Operating expenses	<u>(45,000)</u>
Operating income	\$ 23,000
Other items	
Loss on sale of land	<u>(5,000)</u>
Income before income tax and extraordinary items	\$ 18,000
Income tax expense	<u>(5,400)</u>
Income before extraordinary items	\$ 12,600
Extraordinary gain (net of \$1,800 income taxes)	<u>4,200</u>
Net Income	<u>\$ 16,800</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(12,000 common shares)</u>
Income before extraordinary items	\$1.05
Extraordinary gain	<u>0.35</u>
Net income	<u>\$1.40</u>

2. DIBB COMPANY
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net)		\$198,000
Expenses		
Cost of goods sold	\$130,000	
Operating expenses	45,000	
Loss on sale of land	5,000	
Income tax expense	<u>5,400</u>	
Total expenses		<u>(185,400)</u>
Income before extraordinary items		\$ 12,600
Extraordinary gain (net of \$1,800 income taxes)		<u>4,200</u>
Net Income		<u>\$ 16,800</u>

E5-1 (continued)

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(12,000 common shares)</u>
Income before extraordinary items	\$1.05
Extraordinary gain	<u>0.35</u>
Net income	<u>\$1.40</u>

E5-2

1. ALBERTSON COMPANY
Income Statement
For Year Ended December 31, 2010

Sales (net)	\$100,000
Cost of goods sold	
Inventory, 1/1/2010	\$20,000
Add: Purchases (net)	<u>63,000</u>
Cost of goods available for sale	\$83,000
Less: Inventory, 12/31/2010	<u>(31,000)</u>
Cost of goods sold	<u>(52,000)</u>
Gross profit	\$ 48,000
Operating expenses	<u>(22,000)</u>
Operating income	\$ 26,000
Other items	
Gain on sale of equipment	<u>5,000</u>
Income before income tax and extraordinary items	\$ 31,000
Income tax expense	<u>(9,300)</u>
Income before extraordinary items	\$ 21,700
Extraordinary loss (net of \$2,400 income tax credit)	<u>(5,600)</u>
Net Income	<u>\$ 16,100</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(10,000 common shares)</u>
Income before extraordinary items	\$2.17
Extraordinary loss	<u>(0.56)</u>
Net income	<u>\$1.61</u>

E5-2 (continued)

2.

ALBERTSON COMPANY
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net)	\$100,000	
Gain on sale of equipment	<u>5,000</u>	
Total revenues		\$105,000
Expenses		
Cost of goods sold (Schedule 1)	\$ 52,000	
Operating expenses	22,000	
Income tax expense	<u>9,300</u>	
Total expenses		<u>(83,300)</u>
Income before extraordinary items		\$ 21,700
Extraordinary loss (net of \$2,400 income tax credit)		<u>(5,600)</u>
Net Income		<u>\$ 16,100</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(10,000 common shares)</u>
Income before extraordinary items	\$2.17
Extraordinary loss	<u>(0.56)</u>
Net income	<u>\$1.61</u>

ALBERTSON COMPANY
Schedule 1: Cost of Goods Sold
For Year Ended December 31, 2010

Inventory, 1/1/2010	\$20,000
Add: Purchases (net)	<u>63,000</u>
Cost of goods available for sale	\$83,000
Less: Inventory, 12/31/2010	<u>(31,000)</u>
Cost of goods sold	<u>\$52,000</u>

E5-3

1. Income statement; as part of General and Administrative Expenses
2. Income statement; as a deduction from Sales Revenues
3. Income statement; as part of Selling Expenses
4. Income statement; in Results from Discontinued Operations
5. Income statement; below Net Income
6. Income statement; in the Other Items section
7. Income statement; as part of General and Administrative Expenses
8. Statement of retained earnings; as a deduction from retained earnings
9. Statement of retained earnings; as an addition to or as a deduction from beginning retained earnings (as a prior period adjustment) to determine the adjusted beginning retained earnings
10. Income statement; in Results from Discontinued Operations
11. Statement of retained earnings; as an addition to or as a deduction from beginning retained earnings (as a retrospective adjustment) to determine the adjusted beginning retained earnings
12. Income statement; as part of Selling Expenses
13. Both balance sheet and income statement; as a current asset on the balance sheet and as a deduction from cost of goods available for sale to determine cost of goods sold on the income statement
14. Income statement; in the Other Items section
15. Income statement; also as an addition on the statement of retained earnings.
16. In whichever financial statement the company uses to report its comprehensive income; as a positive component of other comprehensive income

E5-4

1. Income statement; in the Other Items section
2. Income statement; as part of General and Administrative Expenses
3. Statement of retained earnings; as an addition to or as a deduction from beginning retained earnings (as a prior period adjustment) to determine the adjusted beginning retained earnings
4. Income statement; as to an addition to Purchases in the Cost of Goods Sold section
5. Income statement; as part of Selling Expenses
6. Income statement; in the Other Items section
7. Income statement; in the Other Items section
8. Income statement; Depreciation Expense (in General and Administrative Expenses) would be computed in the usual manner based on the new estimated life. The effect on current net income, income before extraordinary items, and earnings per share would be disclosed in a note to the financial statements.
9. Note to the financial statements
10. Income statement; as a deduction from Purchases in the Cost of Goods Sold section
11. Income statement; as a deduction to determine income from continuing operations
12. Statement of retained earnings; as a deduction from retained earnings
13. Income statement; as an Extraordinary Item (if unusual and infrequent), otherwise in the Other Items section
14. Both balance sheet and income statement; as a current asset on the balance sheet and as a deduction from cost of goods available for sale to determine cost of goods sold in the Cost of Goods Sold section on the income statement
15. In whichever financial statement the company uses to report its comprehensive income; as a negative component of its other comprehensive income

E5-5

1.

GOLD COMPANY
Income Statement
For Year Ended December 31, 2010

Sales		\$200,000
Less: Sales returns and allowances		<u>(5,000)</u>
Net sales		\$195,000
Cost of goods sold		<u>(101,000)</u>
Gross profit		\$ 94,000
Operating expenses		
Selling expenses	\$28,000	
General and administrative expenses	<u>20,000</u>	
Total operating expenses		<u>(48,000)</u>
Operating income		\$ 46,000
Other items		
Interest revenue	\$ 4,000	
Loss from strike	<u>(9,000)</u>	<u>(5,000)</u>
Income before income tax and extraordinary items		\$ 41,000
Income tax expense		<u>(12,300)</u>
Income before extraordinary items		\$ 28,700
Extraordinary loss (net of \$5,100 income tax credit)		<u>(11,900)</u>
Net Income		<u>\$ 16,800</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(7,000 common shares)</u>
Income before extraordinary items	\$4.10
Extraordinary loss	<u>(1.70)</u>
Net income	<u>\$2.40</u>

E5-5 (continued)

2. GOLD COMPANY
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net of \$5,000 returns and allowances)	\$195,000	
Interest revenue	<u>4,000</u>	
Total revenues		\$199,000
Expenses		
Cost of goods sold	\$101,000	
Selling expenses	28,000	
General and administrative expenses	20,000	
Loss from strike	9,000	
Income tax expense*	<u>12,300</u>	
Total expenses		<u>(170,300)</u>
Income before extraordinary items		\$ 28,700
Extraordinary loss (net of \$5,100 income tax credit)		<u>(11,900)</u>
Net Income		<u>\$ 16,800</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(7,000 common shares)</u>
Income before extraordinary items	\$4.10
Extraordinary loss	<u>(1.70)</u>
Net income	<u>\$2.40</u>

*Note to Instructor: \$12,300 = 30% x \$41,000 (\$199,000 - \$101,000 -
\$28,000 - \$20,000 - \$9,000)

3. If Gold Company used IFRS, its income statement presentation and content might differ as follows:
- (a) It could choose to use either the single-step or multiple-step format;
 - (b) It might use the term "Turnover" instead of Sales;
 - (c) It might classify its expenses by their nature rather than their function;
 - (d) If it has revalued its property, it may adjust any related depreciation expense included in its cost of goods sold, selling expenses, and/or general and administrative expenses;
 - (e) It may present alternative performance measures on the face of the income statement; and
 - (f) It would not report an extraordinary loss. Instead, it would report the loss in other items (and it would not be reported "net of tax").

E5-6

1.

ADANDT COMPANY
Income Statement
For Year Ended December 31, 2010

Sales		\$163,000
Less: Sales returns and allowances		<u>(3,000)</u>
Net sales		\$160,000
Cost of goods sold		<u>(95,000)</u>
Gross profit		\$ 65,000
Operating expenses		
Selling expenses	\$14,000	
General and administrative expenses	<u>17,000</u>	
Total operating expenses		<u>(31,000)</u>
Operating income		\$ 34,000
Other items		
Interest revenue	\$ 2,500	
Loss on sale of equipment	<u>(2,000)</u>	<u>500</u>
Income before income tax and extraordinary items		\$ 34,500
Income tax expense		<u>(10,350)</u>
Income before extraordinary items		\$ 24,150
Extraordinary loss (net of \$2,400 income tax credit)		<u>(5,600)</u>
Net Income		<u>\$ 18,550</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(7,000 common shares)</u>
Income before extraordinary items	\$3.45
Extraordinary loss	<u>(0.80)</u>
Net income	<u>\$2.65</u>

E5-6 (continued)

2. ADANDT COMPANY
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net of \$3,000 returns and allowances)	\$160,000	
Interest revenue	<u>2,500</u>	
Total revenues		\$162,500
Expenses		
Cost of goods sold	\$ 95,000	
Selling expenses	14,000	
General and administrative expenses	17,000	
Loss on sale of equipment	2,000	
Income tax expense	<u>10,350</u>	
Total expenses		<u>(138,350)</u>
Income before extraordinary items		\$ 24,150
Extraordinary loss (net of \$2,400 income tax credit)		<u>(5,600)</u>
Net Income		<u>\$ 18,550</u>

<u>Components of Income</u>	<u>Earnings per Common Share (7,000 common shares)</u>
Income before extraordinary items	\$3.45
Extraordinary loss	<u>(0.80)</u>
Net income	<u>\$2.65</u>

3. ADANDT COMPANY
Statement of Comprehensive Income
For Year Ended December 31, 2010

Net income	\$18,550
Other comprehensive loss	
Unrealized decrease in value of available-for-sale securities (net of \$540 income tax credit)	<u>(1,260)</u>
Comprehensive income	<u>\$17,290</u>

E5-7

1.

FANTA COMPANY
Schedule 1: Cost of Goods Sold
For Year Ended December 31, 2010

Inventory, 1/1/2010		\$ 43,000
Purchases	\$100,000	
Freight-in	<u>5,000</u>	
Cost of purchases	\$105,000	
Less: Purchases returns	<u>(3,500)</u>	
Net purchases		<u>101,500</u>
Cost of goods available for sale		\$144,500
Less: Inventory, 12/31/2010		<u>(22,500)</u>
Cost of goods sold		<u>\$122,000</u>

2.

FANTA COMPANY
Income Statement
For Year Ended December 31, 2010

Sales		\$250,000
Less: Sales discounts taken		<u>(2,000)</u>
Net sales		\$248,000
Cost of goods sold (Schedule 1)		<u>(122,000)</u>
Gross profit		\$126,000
Operating expenses		
Selling expenses	\$35,000	
General and administrative expenses	<u>22,000</u>	
Total operating expenses		<u>(57,000)</u>
Operating income		\$ 69,000
Other items		
Gain on sale of property	\$ 7,000	
Interest expense	<u>(4,000)</u>	<u>3,000</u>
Income before income tax and extraordinary items		\$ 72,000
Income tax expense		<u>(21,600)</u>
Income before extraordinary items		\$ 50,400
Extraordinary gain (net of \$6,900 income taxes)		<u>16,100</u>
Net Income		<u>\$ 66,500</u>

	Earnings per Common Share
	<u>(25,000 common shares)</u>
<u>Components of Income</u>	
Income before extraordinary items	\$2.02
Extraordinary gain	<u>0.64</u>
Net income	<u>\$2.66</u>

E5-7 (continued)

3.

FANTA COMPANY
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net of \$2,000 discounts)	\$248,000	
Gain on sale of property	<u>7,000</u>	
Total revenues		\$255,000
Expenses		
Cost of goods sold (Schedule 1)	\$122,000	
Selling expenses	35,000	
General and administrative expenses	22,000	
Interest expense	4,000	
Income tax expense	<u>21,600</u>	
Total expenses		<u>(204,600)</u>
Income before extraordinary items		\$ 50,400
Extraordinary gain (net of \$6,900 income taxes)		<u>16,100</u>
Net Income		<u>\$ 66,500</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(25,000 common shares)</u>
Income before extraordinary items	\$2.02
Extraordinary gain	<u>0.64</u>
Net income	<u>\$2.66</u>

E5-8

1. ENGLE COMPANY
Schedule 1: Cost of Goods Sold
For Year Ended December 31, 2010

Inventory, 1/1/2010		\$12,100
Purchases	\$89,700	
Freight-in	<u>3,400</u>	
Cost of purchases	\$93,100	
Less: Purchases returns	(5,200)	
Purchases discounts taken	<u>(2,700)</u>	
Net purchases		<u>85,200</u>
Cost of goods available for sale		\$97,300
Less: Inventory, 12/31/2010		<u>(14,700)</u>
Cost of goods sold		<u>\$82,600</u>

2. ENGLE COMPANY
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net of \$8,100 returns)	\$139,000	
Interest revenue	3,300	
Gain on sale of equipment	<u>3,800</u>	
Total revenues		\$146,100
Expenses		
Cost of goods sold (Schedule 1)	\$ 82,600	
Selling expenses	15,600	
Administrative expenses	24,200	
Income tax expense*	<u>7,110</u>	
Total expenses		<u>(129,510)</u>
Income before extraordinary items		\$ 16,590
Extraordinary loss (net of \$1,950 income tax credit)		<u>(4,550)</u>
Net Income		<u>\$ 12,040</u>

	Earnings per Common Share
<u>Components of Income</u>	<u>(4,200 common shares)</u>
Income before extraordinary items	\$3.95
Extraordinary loss	<u>(1.08)</u>
Net income	<u>\$2.87</u>

*Note to Instructor: \$7,110 = 30% x \$23,700 (\$146,100 - \$82,600 -
\$ 15,600 - \$24,200)

E5-8 (continued)

3. ENGLE COMPANY
Income Statement
For Year Ended December 31, 2010

Sales revenue			\$147,100
Less: Sales returns			<u>(8,100)</u>
Net sales			\$139,000
Cost of goods sold (Schedule 1)			<u>(82,600)</u>
Gross profit			\$ 56,400
Operating expenses			
Selling expenses	\$15,600		
Administrative expenses	<u>24,200</u>		
Total operating expenses			<u>(39,800)</u>
Operating income			\$ 16,600
Other items			
Gain on sale of equipment	\$ 3,800		
Interest revenue	<u>3,300</u>		<u>7,100</u>
Income before income tax and extraordinary items			\$ 23,700
Income tax expense			<u>(7,110)</u>
Income before extraordinary items			\$ 16,590
Extraordinary loss (net of \$1,950 income tax credit)			<u>(4,550)</u>
Net Income			<u>\$ 12,040</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(4,200 common shares)</u>
Income before extraordinary items	\$3.95
Extraordinary loss	<u>(1.08)</u>
Net income	<u>\$2.87</u>

4. ENGLE COMPANY
Statement of Comprehensive Income
For Year Ended December 31, 2010

Net income			\$12,040
Other comprehensive income			
Unrealized increase in value of available-for-sale securities (net of \$720 income taxes)			<u>1,680</u>
Comprehensive income			<u>\$13,720</u>

E5-9

1.

SENGER COMPANY
Income Statement
For Year Ended December 31, 2010

Sales (net)		\$124,000
Cost of goods sold		<u>(66,200)</u>
Gross profit		\$ 57,800
Operating expenses		<u>(30,400)</u>
Operating income		\$ 27,400
Other items		
Gain on sale of land	\$ 6,300	
Interest expense	<u>(3,700)</u>	<u>2,600</u>
Pretax income from continuing operations		\$ 30,000
Income tax expense		<u>(9,000)</u>
Income from continuing operations		\$ 21,000
Results from discontinued operations		
Loss from operations of discontinued division X (net of \$2,850 income tax credit)	\$ (6,650)	
Gain on disposal of division X (net of \$1,410 income taxes)	<u>3,290</u>	<u>(3,360)</u>
Income before extraordinary items		\$ 17,640
Extraordinary loss caused by tornado (net of \$1,620 income tax credit)		<u>(3,780)</u>
Net Income		<u>\$ 13,860</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(4,400 common shares*)</u>
Income from continuing operations	\$4.77
Results from discontinued operations	(0.76)
Extraordinary loss	<u>(0.86)</u>
Net income	<u>\$3.15</u>

*\$22,000 ÷ \$5 par

E5-9 (continued)

2. SENGER COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$45,800
Add: Net income for 2010	<u>13,860</u>
	\$59,660
Less: Cash dividends (\$1.28 x 4,400)	<u>(5,632)</u>
Retained earnings, 12/31/2010	<u>\$54,028</u>

3. Return on stockholders' equity = $\frac{\text{Net income}}{\text{Average stockholders' equity}}$ = $\frac{\$13,860}{\$90,000}$
= 15.4%

E5-10

1. COBLER COMPANY
Schedule 1: Cost of Goods Sold
For Year Ended December 31, 2010

Merchandise inventory, 1/1/2010	\$ 24,000
Add: Purchases (net)	<u>79,200</u>
Cost of goods available for sale	\$103,200
Less: Merchandise inventory, 12/31/2010	<u>(27,300)</u>
Cost of goods sold	<u>\$ 75,900</u>

E5-10 (continued)

2.

COBLER COMPANY
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net)	\$139,600	
Dividend revenue	<u>1,000</u>	
Total revenues		\$140,600
Expenses		
Cost of goods sold (Schedule 1)	\$ 75,900	
Operating expenses	35,800	
Loss on write-off of damaged inventory	6,600	
Income tax expense*	<u>6,690</u>	
Total expenses		<u>(124,990)</u>
Income from continuing operations		\$ 15,610
Results from discontinued operations		
Income from operations of discontinued division X (net of \$570 income taxes)	\$ 1,330	
Loss on disposal of division X (net of \$1,200 income tax credit)	<u>(2,800)</u>	<u>(1,470)</u>
Income before extraordinary items		\$ 14,140
Extraordinary loss due to earthquake (net of \$1,110 income tax credit)		<u>(2,590)</u>
Net Income		<u>\$ 11,550</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(3,000 common shares#)</u>
Income from continuing operations	\$5.20
Results from discontinued operations	(0.49)
Extraordinary loss	<u>(0.86)</u>
Net income	<u>\$3.85</u>

*Note to Instructor: \$6,690 = 30% x \$22,300 (\$140,600 - \$75,900 - \$35,800 - \$ 6,600)

$\$45,000 \div \15 par

E5-10 (continued)

3. COBLER COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$68,700
Add: Net income for 2010	<u>11,550</u>
	\$80,250
Less: Cash dividends (\$0.84 x 3,000)	<u>(2,520)</u>
Retained earnings, 12/31/2010	<u>\$77,730</u>

4. Profit margin = $\frac{\text{Net income}}{\text{Net sales}}$

= $\frac{\$ 11,550}{\$139,600}$

= 8.3%

E5-11

Note to Instructor: The solution is shown in an income statement format. The answers are lettered (a) through (f) below.

CALEB COMPANY
Income Statement
For Year Ended December 31

	<u>2010</u>	<u>2011</u>
Sales (net)	\$96,000	\$99,500 (e)
Cost of goods sold	<u>(57,000) (a)</u>	<u>(59,300)</u>
Gross profit	\$39,000	\$40,200
Selling expenses	(9,300) (b)	(10,800)
General expenses	<u>(7,900)</u>	<u>(8,400) (f)</u>
Operating income	\$21,800	\$21,000 (d)
Interest expense	(600)	0
Interest revenue	<u>0</u>	<u>600</u>
Net Income	<u>\$21,200 (c)</u>	<u>\$21,600</u>

E5-12

Note to Instructor: The solution is shown in an income statement format. The answers are labeled (a) through (g) below.

CONNOR COMPANY
Income Statement
For Year Ended December 31

	<u>2010</u>	<u>2011</u>
Revenues:		
Sales	\$210,000	\$229,000 (e)
Less: Sales returns and allowances	<u>(4,000)</u>	<u>(9,000)</u>
Net Sales	\$206,000	\$220,000
 Cost of Goods Sold:		
Beginning inventory	\$ 51,000 (a)	\$ 62,000*(d)
Plus: Purchases	130,000	140,000
Transportation-in	2,000	5,000
Less: Purchases returns and allowances	<u>(7,000)</u>	<u>(6,000)</u>
Ending inventory	<u>(62,000)</u>	<u>(81,000) (f)</u>
Cost of goods sold	\$114,000	\$120,000
 Gross profit	 \$ 92,000 (b)	 \$100,000
Operating expenses:		
Selling expenses	\$ 35,000	\$ 36,000
General and administrative expenses	<u>20,000</u>	<u>21,000 (g)</u>
Total operating expenses	<u>\$ 55,000</u>	<u>\$ 57,000</u>
Net Income	<u>\$ 37,000 (c)</u>	<u>\$ 43,000</u>

*Ending inventory for 2010

E5-13

Results from discontinued operations		
Loss from operations of discontinued		
Division F (net of \$90,000 income tax credit)		\$(210,000) ^a
Loss on write-down of held-for-sale Division F		
(net of \$30,000 income tax credit)		<u>(70,000)^b</u>
		<u><u>\$(280,000)</u></u>

^a\$1,000,000 - \$1,300,000 = \$(300,000) pretax loss from operations
 \$(300,000) x 0.30 = \$90,000 income tax credit
 \$(300,000) - \$90,000 = \$(210,000) loss from operations

^b Fair value of Division F		\$ 250,000
Book value of net assets of Division F:		
Assets	\$950,000	
Less: Liabilities	<u>(600,000)</u>	
Net book value		<u>(350,000)</u>
Pretax loss		\$(100,000)
Income tax credit [(\$100,000) x 0.30]		<u>30,000</u>
After tax loss		<u><u>\$(70,000)</u></u>

E5-14

Results from discontinued operations		
Loss from operations of discontinued		
Division P (net of \$18,000 income tax credit)		\$ (42,000) ^a
Loss from write-down of held-for-sale Division P		
(net of \$36,000 income tax credit)		<u>(84,000)^b</u>
		<u><u>\$(126,000)</u></u>

^a\$920,000 - \$980,000 = \$(60,000) pretax loss from operations
 \$(60,000) x 0.30 = \$18,000 income tax credit
 \$(60,000) - \$18,000 = \$(42,000) loss from operations

^b Fair value of Division P		\$ 190,000
Book value of net assets of Division F:		
Assets	\$920,000	
Less: Liabilities	<u>(610,000)</u>	
Net book value		<u>(310,000)</u>
Pretax loss		\$(120,000)
Income tax credit [(\$120,000) x 0.30]		<u>36,000</u>
After tax loss		<u><u>\$(84,000)</u></u>

E5-15 (AICPA adapted solution)

The change in inventory method from the average cost method to the first-in, first out method is a change in accounting principle and should not be reported in David Company's statements of income for the year ended December 31, 2010. Instead, it should be reported as a retrospective adjustment to David Company's 2010 beginning retained earnings to enhance the interperiod comparability of the accounting information.

The loss from operations of the discontinued Dex Division from January 1, 2011, to September 30, 2011 (the portion of the year prior to the date of sale) and from January 1, 2010, to December 31, 2010, should not be presented in the continuing operations section of the income statement. For comparability purposes, each should be presented in the income statement after income from continuing operations as a component of discontinued operations, less applicable income taxes, because it is not part of the continuing operations of David Company.

David Company's statements of income should be corrected as follows:

- (a) "Other, net" and "total costs and expenses" should be decreased to exclude the loss from operations of the discontinued Dex Division.
- (b) "Income from continuing operations before income taxes" should be increased to exclude the loss from operations of the discontinued Dex Division.
- (c) "Income taxes" should be increased to exclude the tax reduction applicable to the loss from operations of the discontinued Dex Division.
- (d) "Income from continuing operations" should be increased to exclude the loss from operations of the discontinued Dex Division, less applicable income taxes.
- (e) A new caption, "results from discontinued operations," should be added.
- (f) A new subcaption, "loss from operations of the discontinued Dex Division, less the amount of applicable income taxes," should be added under the caption "results from discontinued operations."
- (g) The subcaption, "loss on disposal of Dex Division, less applicable income taxes of \$8,000," should be under the caption "results from discontinued operations"

E5-15 (continued)

- (h) "Earnings per share of common stock" should be presented on the face of the income statement for income from continuing operations and net income. As for results from discontinued operations, earnings per share of common stock may be presented on the face of the income statement or in the notes to the financial statements.
- (i) The cumulative effect on prior years of change in inventory method, less applicable income taxes, should be omitted from the 2010 income statement and added to the beginning retained earnings balance on the 2010 statement of retained earnings.

E5-16

1.

TNT COMPANY
Statement of Income and Comprehensive Income
For Year Ended December 31, 2010

Sales (net)	\$85,000
Cost of goods sold	<u>(47,000)</u>
Gross profit	\$38,000
Operating expenses	<u>(18,000)</u>
Income before income taxes	\$20,000
Income tax expense	<u>(6,000)</u>
Net income	\$14,000
Other comprehensive income	
Unrealized increase in value of available-for-sale securities (net of \$1,200 income taxes)	<u>2,800</u>
Comprehensive Income	<u>\$16,800</u>

2.(a)

TNT COMPANY
Income Statement
For Year Ended December 31, 2010

Sales (net)	\$85,000
Cost of goods sold	<u>(47,000)</u>
Gross profit	\$38,000
Operating expenses	<u>(18,000)</u>
Income before income taxes	\$20,000
Income tax expense	<u>(6,000)</u>
Net income	<u>\$14,000</u>

E5-16 (continued)
2.(b)

TNT COMPANY
Statement of Comprehensive Income
For Year Ended December 31, 2010

Net income	\$14,000
Other comprehensive income	
Unrealized increase in value of available-for-sale securities (net of \$1,200 income taxes)	<u>2,800</u>
Comprehensive Income	<u>\$16,800</u>

E5-17

TYRONE COMPANY
Partial Statement of Cash Flows
For Year Ended December 31, 2010

Net Cash Flow From Operating Activities		
Net income	\$22,900	
Adjustments for differences between income flows and cash flows from operating activities:		
Add: Depreciation expense	7,800	
Patent amortization expense	2,700	
Bond discount amortization	1,000	
Less: Increase in accounts receivable	(3,400)	
Decrease in accounts payable	<u>(2,600)</u>	
Net cash provided by operating activities		\$ 28,400

E5-18

LEXIE COMPANY
Partial Statement of Cash Flows
For Year Ended December 31, 2010

Cash Flows From Operating Activities		
Cash Inflows:		
Collections from customers	\$101,600	
Interest collected	<u>10,000</u>	
Cash inflows from operating activities		\$111,600
Cash Outflows:		
Payments to suppliers and employees	\$ (67,500)	
Payments of interest	(8,200)	
Payments of income taxes	<u>(15,400)</u>	
Cash outflows for operating activities		<u>(91,100)</u>
Net cash provided by operating activities		<u>\$ 20,500</u>

E5-19

ROCKY COMPANY
Statement of Cash Flows
For Year Ended December 31, 2010

Net Cash Flow From Operating Activities		
Net income	\$ 41,000	
Adjustments for differences between income flows and cash flows from operating activities:		
Add: Depreciation expense	11,000	
Decrease in accounts receivable	2,000	
Less: Increase in inventories	(7,000)	
Decrease in accounts payable	<u>(4,000)</u>	
Net cash provided by operating activities		\$ 43,000
Cash Flows From Investing Activities		
Payment for purchase of building	\$ (40,000)	
Payment for purchase of equipment	<u>(8,000)</u>	
Net cash used for investing activities		(48,000)
Cash Flows From Financing Activities		
Payment of dividends	\$ (16,000)	
Receipt from issuance of bonds	<u>28,000</u>	
Net cash provided by financing activities		<u>12,000</u>
Net Increase in Cash		\$ 7,000
Cash, January 1, 2010		<u>13,000</u>
Cash, December 31, 2010		<u>\$ 20,000</u>

JONES COMPANY
Statement of Cash Flows
For Year Ended December 31, 2010

Net Cash Flow From Operating Activities		
Net income	\$ 60,400	
Adjustments for differences between income flows and cash flows from operating activities:		
Add: Depreciation expense	20,500	
Patent amortization expense	1,200	
Less: Increase in accounts receivable	(10,300)	
Decrease in salaries payable	<u>(2,600)</u>	
Net cash provided by operating activities		\$ 69,200
Cash Flows From Investing Activities		
Payment for purchase of equipment	\$ (41,500)	
Payment for purchase of land	<u>(19,600)</u>	
Net cash used for investing activities		(61,100)
Cash Flows From Financing Activities		
Payment of dividends	\$ (21,000)	
Receipt from issuance of common stock	<u>32,000</u>	
Net cash provided by financing activities		<u>11,000</u>
Net Increase in Cash		\$ 19,100
Cash, January 1, 2010		<u>30,700</u>
Cash, December 31, 2010		<u>\$ 49,800</u>

SOLUTIONS TO PROBLEMS

P5-1

1.

MACK COMPANY
Income Statement
For Year Ended December 31, 2010

Sales			\$XXXX
Less: Sales discounts taken		\$ XX	
Sales returns and allowances		<u>XX</u>	<u>(XXX)</u>
Net sales			\$XXXX
Cost of goods sold			
Merchandise inventory, 1/1/2010		\$XXX	
Purchases	\$XXX		
Freight on purchases	<u>XX</u>		
Cost of purchases	\$XXX		
Less: Purchases discounts taken	\$XX		
Purchases returns and allowances	<u>XX</u>	<u>(XX)</u>	
Net purchases			<u>XXX</u>
Cost of goods available for sale		\$XXX	
Less: Merchandise inventory, 12/31/2010			<u>(XX)</u>
Cost of goods sold			<u>(XXX)</u>
Gross profit			\$XXXX
Operating expenses			
Selling expenses			
Sales commissions	\$ XX		
Sales salaries	XX		
Delivery expense	XX		
Advertising expense	XX		
Miscellaneous sales expense	<u>XX</u>		
Total selling expenses			\$XXX
Administrative expenses			
Administrative salaries	\$ XX		
Bad debt expense	XX		
Insurance expense	XX		
Office salaries	XX		
Miscellaneous office expenses	XX		
Office supplies used	XX		
Utilities expense	XX		
Property tax expense	<u>XX</u>		
Total administrative expenses			XXX
Depreciation expenses			
Depreciation expense: building and office equipment	\$ XX		
Depreciation expense: store and delivery equipment	<u>XX</u>		
Total depreciation expenses			<u>XX</u>
Total operating expenses			<u>(XXX)</u>
Operating income			\$XXXX

(continued on next page)

P5-1 (continued)

3.

MACK COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010		\$XXXX
Add: Prior period adjustment, correction of previous year's error (net of income taxes)		<u>XXX*</u>
Adjusted retained earnings, beginning		\$XXXX
Add: Net income for 2010		<u>XXXX</u>
		\$XXXX
Less: Cash dividends declared	\$ XXX	
Stock dividends declared	<u>XXX</u>	<u>(XXX)</u>
Retained earnings, 12/31/2010		<u>\$XXXX</u>

*This amount could also be negative

P5-2

- | | | |
|-------------------|-------|-------------------|
| 1. B | 12. L | 23. J |
| 2. E | 13. E | 24. H |
| 3. D | 14. E | 25. F |
| 4. J | 15. C | 26. D, K |
| 5. D | 16. E | 27. E |
| 6. C | 17. K | 28. G |
| 7. A (deduction) | 18. F | 29. A (deduction) |
| 8. B | 19. E | 30. D |
| 9. I | 20. L | 31. C |
| 10. E | 21. E | 32. C |
| 11. B (deduction) | 22. D | 33. B |

1.

CAMERON COMPANY
Partial Income Statement
For Year Ended December 31, 2010

Pretax income from continuing operations		\$120,000
Income tax expense		<u>(36,000)</u>
Income from continuing operations		\$ 84,000
Results from discontinued operations		
Income from operations of discontinued		
Division M (net of \$11,700 income taxes)	\$ 27,300	
Loss on sale of Division M (net of		
\$12,150 income tax credit)	<u>(28,350)</u>	<u>(1,050)</u>
Income before extraordinary items		\$ 82,950
Extraordinary gain (net of \$7,800 income taxes)		<u>18,200</u>
Net Income		<u>\$101,150</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(21,000 common shares)</u>
Income from continuing operations	\$4.00
Results from discontinued operations	(0.05)
Extraordinary gain	<u>0.87</u>
Net income	<u>\$4.82</u>

2.

CAMERON COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$212,000
Add: Prior period adjustment, correction of understatement of 2009 ending inventory (net of \$5,400 income taxes)	<u>12,600</u>
Adjusted retained earnings, 1/1/2010	\$224,600
Add: Net income for 2010	<u>101,150</u>
	\$325,750
Less: Cash dividends (\$1 per share)	<u>(21,000)</u>
Retained earnings, 12/31/2010	<u>\$304,750</u>

1.

CUNNINGHAM COMPANY
Partial Income Statement
For Year Ended December 31, 2010

Pretax income from continuing operations		\$150,500
Income tax expense		<u>(45,150)</u>
Income from continuing operations		\$105,350
Results from discontinued operations		
Loss from operations of discontinued		
Division P (net of \$9,900 income		
tax credit)	\$(23,100)	
Gain on sale of Division P (net of		
\$4,500 income taxes)	<u>10,500</u>	<u>(12,600)</u>
Income before extraordinary items		\$ 92,750
Extraordinary loss due to earthquake		
(net of \$6,300 income tax credit)		<u>(14,700)</u>
Net Income		<u>\$ 78,050</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(30,000 common shares)</u>
Income from continuing operations	\$3.51
Results from discontinued operations	(0.42)
Extraordinary loss	<u>(0.49)</u>
Net income	<u>\$2.60</u>

Note: Due to additional information, the estimated useful life of certain depreciable assets has decreased causing 2010 depreciation expense to be \$7,000 higher than would have been reported using the original life. This caused a decrease in 2010 income from continuing operations and net income of \$4,900 (after taxes) and a decrease in earnings per share of \$0.16.

2.

CUNNINGHAM COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$365,200
Less: Prior period adjustment, correction of understatement of 2009 depreciation expense (net of \$14,400 income tax credit)	<u>(33,600)</u>
Adjusted retained earnings, 1/1/2010	\$331,600
Add: Net income for 2010	<u>78,050</u>
	\$409,650
Less: Cash dividends (\$0.72 per share)	<u>(21,600)</u>
Retained earnings, 12/31/2010	<u>\$388,050</u>

P5-5

1.

HOUSTON MANUFACTURING COMPANY
For Year Ended December 31, 2010

Schedule 1: Selling Expenses

Sales salaries expense	\$ 27,400
Delivery expenses	11,700
Sales personnel travel expenses	8,300
Depreciation expense: sales equipment	9,000
Advertising expense	<u>15,700</u>
Total selling expenses	<u>\$ 72,100</u>

Schedule 2: General and Administrative Expenses

Depreciation expense: buildings and office equipment	\$ 14,400
Office and administrative salaries	30,000
Property taxes and insurance expense	9,000
Miscellaneous administrative expenses	<u>3,000</u>
Total general and administrative expenses	<u>\$ 56,400</u>

P5-5 (continued)

2. HOUSTON MANUFACTURING COMPANY
Income Statement
For Year Ended December 31, 2010

Sales		\$468,200
Less: Sales returns		<u>(5,000)</u>
Net sales		\$463,200
Cost of goods sold		<u>(232,200)</u>
Gross profit		\$231,000
Operating expenses		
Selling expenses (Schedule 1)	\$ 72,100	
General and administrative expenses (Schedule 2)	<u>56,400</u>	
Total operating expenses		<u>(128,500)</u>
Operating income		\$102,500
Other items		
Interest revenue	\$ 3,200	
Miscellaneous rent revenue	5,900	
Loss on sale of factory equipment	<u>(4,100)</u>	<u>5,000</u>
Pretax income from continuing operations		\$107,500
Income tax expense		<u>(32,250)</u>
Income from continuing operations		\$ 75,250
Results from discontinued operations		
Loss from operations of discontinued Division E (net of \$4,800 income tax credit)	\$ (11,200)	
Gain on sale of Division E (net of \$12,600 income taxes)	<u>29,400</u>	<u>18,200</u>
Income before extraordinary items		\$ 93,450
Extraordinary loss from expropriation (net of \$9,000 income tax credit)		<u>\$ (21,000)</u>
Net Income		<u>\$ 72,450</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(20,000 common shares*)</u>
Income from continuing operations	\$3.76
Results from discontinued operations	0.91
Extraordinary loss	<u>(1.05)</u>
Net income	<u>\$3.62</u>

*\$200,000 ÷ \$10 par

P5-5 (continued)

3. HOUSTON MANUFACTURING COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$200,800
Less: Prior period adjustment, correction of understated depreciation expense of 2009 (net of \$3,030 income tax credit)	<u>(7,070)</u>
Adjusted retained earnings, 1/1/2010	\$193,730
Add: Net income	<u>72,450</u>
	\$266,180
Less: Cash dividends (\$1.20 per share)	<u>(24,000)</u>
Retained earnings, 12/31/2010	<u>\$242,180</u>

4. Return on stockholders' equity = $\frac{\text{Net income}}{\text{Average stockholders' equity}}$

$$= \frac{\$72,450}{\$500,000}$$
$$= \underline{14.5\%}$$

Houston Manufacturing Company's return on stockholders' equity for 2010 of 14.5% was below its target of 15%. However, Houston had both results from discontinued operations and an extraordinary loss in 2010. If income from continuing operations (\$75,250) had been used as the numerator, the 15.1% return exceeds the target return.

5. If Houston Manufacturing Company used IFRS, its income statement presentation and content might differ as follows:

- (a) It could choose to use either the single-step or multiple-step format;
- (b) It might use the term "Turnover" instead of Sales;
- (c) It might classify its expenses by their nature rather than their function;
- (d) If it has revalued its property, it may adjust any related depreciation expense;
- (e) Although Division E appears to be a separate line of business, if it is not, then Houston would include the results of discontinued operations in pretax income from continuing operations;
- (f) It may present alternative performance measures on the face of the income statement; and
- (g) It would not report an extraordinary loss. Instead, it would report the loss in other items (and it would not be reported "net of tax").

P5-6

1.

CRANDLE CORPORATION
For Year Ended December 31, 2010

Schedule 1: Selling Expenses

Selling Expenses	
Depreciation expense: sales fixtures	\$ 8,500
Advertising expense	14,100
Sales supplies expense	4,600
Sales salaries expense	16,500
Transportation-out	<u>6,000</u>
Total selling expenses	<u>\$ 49,700</u>

Schedule 2: General and Administrative Expenses

General and Administrative Expenses	
Administrative and office salaries expense	\$ 29,500
Property tax expense	7,700
Office supplies expense	1,800
Bad debt expense	1,900
Depreciation expense: buildings and office equipment	<u>10,000</u>
Total general and administrative expenses	<u>\$ 50,900</u>

P5-6 (continued)

2.

CRANDLE CORPORATION
Income Statement
For Year Ended December 31, 2010

Revenues		
Sales (net of \$11,300 returns and allowances, and \$5,200 discounts)	\$361,500	
Dividend revenue	900	
Gain on sale of sales fixtures	<u>5,000</u>	
Total revenues		\$367,400
Expenses		
Cost of goods sold	\$191,200	
Selling expenses (Schedule 1)	49,700	
General and administrative expenses (Schedule 2)	50,900	
Interest expense	4,900	
Income tax expense	<u>21,210*</u>	
Total expenses		<u>(317,910)</u>
Income from continuing operations		\$ 49,490
Results from discontinued operations		
Loss from operations of discontinued Division M (net of \$2,640 income tax credit)	\$ (6,160)	
Loss on sale of Division M (net of \$2,250 income tax credit)	<u>(5,250)</u>	<u>(11,410)</u>
Income before extraordinary items		\$ 38,080
Extraordinary loss due to flood (net of \$1,650 income tax credit)		<u>\$ (3,850)</u>
Net Income		<u>\$ 34,230</u>

	Earnings per Common Share
<u>Components of Income</u>	<u>(11,000 common shares#)</u>
Income from continuing operations	\$4.50
Results from discontinued operations	(1.04)
Extraordinary loss due to flood	<u>(0.35)</u>
Net income	<u>\$3.11</u>

Note: As a result of its recent analysis of uncollectible accounts receivable, the company decided to reduce the percentage used in computing bad debt expense. Using the new percentage, the \$1,900 bad debt expense for 2010 was \$500 less than the amount that would have been reported using the old percentage. This caused an increase in 2010 income from continuing operations and net income of \$350 (after taxes) and an increase in earnings per share of \$0.03.

*Note to Instructor: \$21,210 = 30% x \$70,700 (\$367,400 - \$191,200 - \$49,700 - \$50,900 - \$4,900)

#\$110,000 ÷ \$10 par

P5-6 (continued)

3.

CRANDLE CORPORATION
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$428,900
Add: Prior period adjustment, correction of overstated depreciation expense of 2009 (net of \$1,200 income taxes)	<u>2,800</u>
Adjusted retained earnings, 1/1/2010	\$431,700
Add: Net income	<u>34,230</u>
	\$465,930
Less: Cash dividends (\$0.90 per share)	<u>(9,900)</u>
Retained earnings, 12/31/2010	<u>\$456,030</u>

4. Profit margin = $\frac{\text{Net income}}{\text{Net sales}}$

= $\frac{\$ 34,230}{\$361,500}$

= 9.5%

Crandle Corporation's profit margin increased 1.5 percentage points from 2009 to 2010, so it appears to have better control over its expenses in relation to sales. However, a better comparison would be the profit margin based on income from continuing operations, since Crandle had several items on nonrecurring income (loss) in 2010 which it may not have had in 2009.

P5-7

1.

SILVOSO COMPANY
For Year Ended December 31, 2010

Schedule 1: Cost of Goods Sold

Inventory, 1/1/2010			\$ 37,800
Purchases		\$173,000	
Transportation-in		<u>13,500</u>	
Cost of purchases		\$186,500	
Less: Purchases discounts taken	\$4,100		
Purchases returns and allowances	<u>6,200</u>	<u>(10,300)</u>	
Net purchases			<u>176,200</u>
Cost of goods available for sale			\$214,000
Less: Inventory, 12/31/2010			<u>(34,100)</u>
Cost of goods sold			<u>\$179,900</u>

Schedule 2: Selling Expenses

Sales commissions and salaries		\$ 18,200
Sales supplies used		5,600
Delivery expense		7,700
Promotion and advertising expense		<u>17,000</u>
Total selling expenses		<u>\$ 48,500</u>

Schedule 3: General and Administrative Expenses

Bad debt expense		\$ 2,700
Office supplies expense		1,400
Insurance and property tax expense		8,500
Office and administrative salaries expense		<u>32,000</u>
Total general and administrative expenses		<u>\$ 44,600</u>

Schedule 4: Depreciation Expense

Buildings and office equipment		\$ 14,500
Sales equipment		<u>9,600</u>
Total depreciation expense		<u>\$ 24,100</u>

P5-7 (continued)
2.

SILVOSO COMPANY
Income Statement
For Year Ended December 31, 2010

Sales		\$340,700
Less: Sales discounts taken	\$ 4,900	
Sales returns and allowances	<u>12,100</u>	<u>(17,000)</u>
Net sales		\$323,700
Cost of goods sold (Schedule 1)		<u>(179,900)</u>
Gross profit		\$143,800
Operating expenses		
Selling expenses (Schedule 2)	\$48,500	
General and administrative expenses (Schedule 3)	44,600	
Depreciation expense (Schedule 4)	<u>24,100</u>	
Total operating expenses		<u>(117,200)</u>
Operating income		\$ 26,600
Other items		
Rent revenue	\$ 6,900	
Interest expense	(3,700)	
Loss on sale of office equipment	<u>(5,000)</u>	<u>(1,800)</u>
Pretax income from continuing operations		\$ 24,800
Income tax expense		<u>(7,440)</u>
Income from continuing operations		\$ 17,360
Results from discontinued operations		
Loss from operations of discontinued Division R (net of \$2,610 income tax credit)	\$ (6,090)	
Gain on sale of Division R (net of \$3,000 income taxes)	<u>7,000</u>	<u>910</u>
Income before extraordinary items		\$ 18,270
Extraordinary loss due to tornado (net of \$3,600 income tax credit)		<u>\$ (8,400)</u>
Net Income		<u>\$ 9,870</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(8,000 common shares*)</u>
Income from continuing operations	\$2.17
Results from discontinued operations	0.11
Extraordinary loss due to tornado	<u>(1.05)</u>
Net income	<u>\$1.23</u>

*\$80,000 ÷ \$10 par

Note: Due to recently increased obsolescence, the sales equipment is being depreciated over a shorter useful life. The related \$9,600 depreciation expense for 2010 is \$2,500 more than the amount that would have been reported using the original useful life. This caused a decrease in 2010 income from continuing operations and net income of \$1,750 (after taxes) and a decrease in earnings per share of \$0.22.

P5-7 (continued)

3.

SILVOSO COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$83,700
Less: Prior period adjustment, correction of understatement of 2009 depreciation expense (net of \$3,300 income tax credit)	<u>(7,700)</u>
Adjusted retained earnings, 1/1/2010	\$76,000
Add: Net income	<u>9,870</u>
	\$85,870
Less: Cash dividends (\$0.60 per share)	<u>(4,800)</u>
Retained earnings, 12/31/2010	<u>\$81,070</u>

4. Return on stockholders' equity = $\frac{\text{Net income}}{\text{Average stockholders' equity}}$

$$= \frac{\$9,870}{\$150,000}$$
$$= \underline{6.58\%}$$

Silvoso Company's return on stockholders' equity decreased over 3 percentage points from 2009 to 2010, so it appears to have provided a poorer return to its owners. However, a better comparison would be the return on stockholders' equity based on income from continuing operations, since Silvoso discontinued a segment and had a large extraordinary loss that decreased its return in 2010, which it may not have had in 2009.

1. Income statement:

- a. The statement properly should be titled "Income Statement," not "Revenue Statement."
- b. The income statement reflects results for a period of time, not a point in time. The heading should read "For Year Ended December 31, 2010."
- c. Income from operations of discontinued Division P should be separately reported in the Results from Discontinued Operations section.
- d. Dividends declared should be reported as a deduction on the statement of retained earnings.
- e. Selling expenses should be reported as part of Operating Expenses.
- f. Interest expense should be included as part of Other Items.
- g. Loss on sale of Division P should be reported in the Results from Discontinued Operations section.
- h. Cost of goods sold should be deducted from net revenues to determine gross profit.
- i. Income tax expense on income from continuing operations is not part of Operating Expenses. It is deducted from pretax income from continuing operations to determine income from continuing operations.
- j. Dividend revenue should be reported under Other Items.
- k. General and administrative expenses are part of Operating Expenses.
- l. Loss on sale of land is not an Extraordinary Item. It should be reported in Other Revenues and Expenses.
- m. Correction of error in last year's income is a prior period adjustment. It should be reported as an adjustment to beginning retained earnings on the statement of retained earnings.
- n. Earnings per share information should be disclosed below net income.

Statement of retained earnings:

- a. The statement of retained earnings reflects results for a period of time, not a particular point in time. It should be dated "For Year Ended December 31, 2010."
- b. The label "Adjusted retained earnings" is used only after beginning retained earnings is adjusted for a retrospective adjustment or a prior period adjustment.
- c. Loss from expropriation is an Extraordinary Item. It should be reported in the income statement directly below income before extraordinary items.

P5-8 (continued)

2.

ROX CORPORATION
Income Statement
For Year Ended December 31, 2010

Sales (net)		\$179,000
Cost of goods sold		<u>(110,700)</u>
Gross profit		\$ 68,300
Operating expenses		
Selling expenses	\$ 19,000	
General and administrative expenses	<u>24,300</u>	
Total operating expenses		<u>(43,300)</u>
Operating income		\$ 25,000
Other items		
Dividend revenue	\$ 1,800	
Loss on sale of land	(4,800)	
Interest expense	<u>(4,100)</u>	<u>(7,100)</u>
Pretax income from continuing operations		\$ 17,900
Income tax expense		<u>(5,370)</u>
Income from continuing operations		\$ 12,530
Results from discontinued operations		
Income from operations of discontinued		
Division P (net of \$960 income taxes)	\$ 2,240	
Loss on sale of Division P (net		
of \$1,200 income tax credit)	<u>(2,800)</u>	<u>(560)</u>
Income before extraordinary items		\$ 11,970
Extraordinary items		
Extraordinary loss from expropriation		
(net of \$2,760 income tax credit)		<u>(6,440)</u>
Net Income		<u>\$ 5,530</u>

Components of Income

Earnings per Common Share
(5,000* common shares)

Income from continuing operations	\$2.51
Results from discontinued operations	(0.11)
Extraordinary loss from expropriation	<u>(1.29)</u>
Net income	<u>\$1.11</u>

*\$7,500 dividends ÷ \$1.50 per common share dividend = 5,000 common shares

P5-8 (continued)

3. ROX CORPORATION
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010		\$ 62,850
Add: Prior period adjustment; correction of error in last year's income (net of \$1,500 income taxes)		<u>3,500</u>
Adjusted retained earnings, 1/1/2010		\$ 66,350
Add: Net income		<u>5,530</u>
		\$ 71,880
Less: Dividends declared, \$1.50 per common share		<u>(7,500)</u>
Retained earnings, 12/31/2010		<u>\$ 64,380</u>

P5-9

1. OLSON COMPANY
Income Statement
For Year Ended December 31, 2010

Sales (net)		\$196,000
Cost of goods sold		<u>(120,100)</u>
Gross profit		\$ 75,900
Operating expenses		
Selling expenses	\$ 19,600	
Administrative expenses	<u>16,800</u>	
Total operating expenses		<u>(36,400)</u>
Operating income		\$ 39,500
Other items		
Interest revenue	\$ 2,300	
Gain on sale of equipment	3,200	
Interest expense	<u>(3,400)</u>	<u>2,100</u>
Pretax income from continuing operations		\$ 41,600
Income tax expense		<u>(12,480)</u>
Income from continuing operations		\$ 29,120
Results from discontinued operations		
Loss from operations of discontinued Division L (net of \$900 income tax credit)	\$ (2,100)	
Gain on sale of Division L (net of \$1,350 income taxes)	<u>3,150</u>	<u>1,050</u>
Income before extraordinary items		\$ 30,170
Extraordinary loss due to earthquake (net of \$1,800 income tax credit)		<u>(4,200)</u>
Net Income		<u>\$ 25,970</u>

(Income statement continued on next page)

P5-9 (continued)

1. (continued)

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(8,000 common shares)</u>
Income from continuing operations	\$3.64
Results from discontinued operations	0.13
Extraordinary loss due to earthquake	<u>(0.52)*</u>
Net income	<u>\$3.25</u>

*Rounded down to balance

2.

OLSON COMPANY
Statement of Retained Earnings
For Year Ended December 31, 2010

Retained earnings, 1/1/2010	\$ 59,300
Less: Prior period adjustment, correction of overstatement in last year's income (net of \$1,650 income tax credit)	<u>(3,850)</u>
Adjusted retained earnings, 1/1/2010	\$ 55,450
Add: Net income	<u>25,970</u>
	\$ 81,420
Less: Cash dividends (\$0.50 per common share)	<u>(4,000)</u>
Retained earnings, 12/31/2010	<u>\$ 77,420</u>

P5-10

1. Income statement; disclose as an Extraordinary Item. Since the earthquake is unusual in nature in this area and it is of infrequent occurrence, the resulting loss is treated as an extraordinary item.
2. Income statement; disclose as part of Other Items. Since the gain is infrequent in occurrence but not unusual in nature, it is not an extraordinary item.
3. Income statement; include in current depletion expense because it is a change in accounting estimate. Disclose effect of change on net income and earnings per share in a note.
4. Income statement; disclose as part of Other Items. Since it is neither unusual in nature nor infrequent in occurrence, it is not an extraordinary item.
5. Income statement; disclose as an Extraordinary Item. Since, for this company, the transaction is both unusual in nature and infrequent in occurrence, the resulting loss should be considered an extraordinary item.

P5-10 (continued)

6. Income statement; disclose as part of Other Items. The fact that a similar earthquake occurred in the same region 2 years ago indicates that earthquakes are not infrequent in this area and the loss should not be considered an extraordinary item.
7. Retained earnings statement; since it is a cumulative effect on prior years' income of a change in accounting principle, it should be disclosed as a retrospective adjustment.
8. Income statement; disclose as part of Other Items. Since the flood is not infrequent in occurrence, the loss should not be considered an extraordinary item.
9. Income statement; disclose in Results from Discontinued Operations. Since the baseball team is a component of the business and is distinguishable from the remainder of the business, the gain (as well as the operating profit or loss) is shown separately in Results from Discontinued Operations.
10. Retained earnings statement; since it is a correction of last year's income, it should be disclosed as a prior period adjustment.
11. Income statement; disclose as an Extraordinary Item. Since frost damage is unusual in nature in this area and does not frequently occur, the loss should be considered an extraordinary item.

P5-11

1.	Loss on Write-Down of Held-For-Sale		
	Division J (pretax)	80,000 ^a	
	Assets of Division J		80,000
		<u>Total</u>	
	^a Fair value	\$420,000	
	Book value of net assets		
	Assets	\$910,000	
	Less: Liabilities	<u>(410,000)</u>	
	Net book value	<u>(500,000)</u>	
	Pretax loss	<u>\$ (80,000)</u>	

P5-11 (continued)

2. WOODS COMPANY
Income Statement
For Year Ended December 31, 2010

Sales revenue		\$950,000
Cost of goods sold		<u>(560,000)</u>
Gross profit		\$390,000
Operating expenses		<u>(190,000)</u>
Pretax income from continuing operations		\$200,000
Income tax expense (30%)		<u>(60,000)</u>
Income from continuing operations		\$140,000
Results from discontinued operations		
Income from operations of discontinued		
Division J (net of \$2,700 income taxes)	\$ 6,300 ^a	
Loss from write-down of held-for-sale Division J		
(net of \$24,000 income tax credit)	<u>(56,000)^b</u>	<u>(49,700)</u>
Net Income		<u>\$ 90,300</u>

<u>Components of Income</u>	<u>Earnings per Common Share</u> <u>(50,000 common shares)</u>
Income from continuing operations	\$2.80
Results from discontinued operations	<u>(0.99)</u>
Net income	<u>\$1.81</u>

^a\$170,000 - \$119,000 - \$42,000 = \$9,000 x (1 - 0.30)

^b\$80,000 (from Requirement 1) x (1 - 0.30)

3. WOODS COMPANY
Partial Balance Sheet
December 31, 2010

<u>Assets</u>		<u>Liabilities</u>	
Other Assets:		Other Liabilities:	
Assets of held-for-sale		Liabilities of held-for-sale	
Division J	\$830,000 ^a	Division J	\$410,000
^a \$910,000 - \$80,000			

P5-12

- The company uses a multiple-step income statement (p. 66) because it deducts cost of goods sold from net operating revenues to determine gross profit, then deducts selling, general, and administrative expenses and other operating charges from gross profit to determine operating income, after which it adds or deducts other income and expense items to determine income before income taxes, and then deducts income taxes to determine net income.

P5-12 (continued)

2. Net income, 2007: \$5,981 million; Basic net income (earnings) per common share for 2007: \$2.59 (p. 66).
3. Gross profit for 2007: \$18,451 million. Gross profit for 2006: \$15,924 million (p. 66).
4. Interest expense for 2007: \$456 million. Interest expense for 2006: \$220 million (p. 66).
5. Income taxes related to income before income taxes for 2007: \$1,892 million (p. 66).
6. Selling, general, and administrative expenses, 2007: \$10,945 million (p. 66); Of the \$10,945 million, \$313 million was for stock-based compensation expense (p. 97).
7. Cash dividends on common stock paid per share and in total in 2007: \$1.36 per share; \$3,149 million total (p. 69).
8. Net operating revenues and gross profit for the fourth quarter of 2007: Net operating revenues, \$7,331 million, gross profit, \$4,690 million (p. 131).
9. The indirect method was used to determine the net cash provided by operating activities. Net cash provided by operating activities in 2007: \$7,150 million (p. 68).
10. Net cash used in investing activities in 2007: \$(6,719 million) (p. 68).
11. Cash provided by issuances of debt in 2007: \$9,979 million (p. 68).

Note to Instructor: Certain of the above information also may be located on other pages within the financial statements and related notes.

P5-13 (AICPA adapted solution)

WOODBINE CIRCLE CORPORATION
Income Statement
For the Year Ended December 31, 2010

Sales		\$10,100,000
Cost of sales		<u>(6,200,000)</u>
Gross profit		\$ 3,900,000
Administrative expenses		<u>(2,000,000)</u>
Operating income		\$ 1,900,000
Other expense		
Interest expense		<u>(210,000)</u>
Income from continuing operations		
before income taxes		\$ 1,690,000
Income taxes (Schedule 1)		<u>(676,000)</u>
Income from continuing operations		\$ 1,014,000
Discontinued operations (Schedule 2)		
Operating income from discontinued AL		
Division (less applicable income		
taxes of \$264,000)	\$396,000	
Loss on sale of AL Division		
(less applicable income tax		
saving of \$100,000)	<u>(150,000)</u>	<u>246,000</u>
Income before extraordinary item		\$ 1,260,000
Extraordinary gain (less applicable		
income taxes of \$120,000)		<u>180,000</u>
Net income		<u><u>\$ 1,440,000</u></u>

Earnings per Common Share		
From continuing operations	\$1.01	
From discontinued operations	0.25	
From extraordinary item	<u>0.18</u>	
Net income	<u><u>\$1.44</u></u>	

Schedule 1: Income Taxes on Continuing Operations

Income from continuing operations		\$1,690,000
before income taxes		\$1,690,000
Income tax rate		<u>x 40%</u>
Total income taxes on continuing operations		<u><u>\$ 676,000</u></u>

P5-13 (continued)

Schedule 2: Income from Operations of AL Division
for the Nine Months Ended September 30, 2010
(Date of Discontinuance)

Sales	\$2,000,000
Cost of sales	<u>(900,000)</u>
Gross profit	\$1,100,000
Administrative expenses	<u>(300,000)</u>
Operating income	\$ 800,000
Interest expense	<u>(140,000)</u>
Income before income taxes	\$ 660,000
Income taxes (at 40%)	<u>(264,000)</u>
Income from operations of AL Division	<u>\$ 396,000</u>

P5-14 (AICPA adapted solution)

THE CENTURY COMPANY
Comparative Statements of Income
For the Two Years Ended December 31, 2011 and
December 31, 2010

	<u>2011</u>	<u>2010</u>
Net sales	\$7,080,000 ^a	\$5,670,000 ^a
Cost of sales	<u>(4,000,000)</u>	<u>(3,400,000)</u>
Gross profit on sales	3,080,000	2,270,000
Operating expenses	<u>(1,050,000)</u>	<u>(550,000)</u>
Operating income	<u>2,030,000</u>	<u>1,720,000</u>
Other items		
Interest revenue	70,000	40,000
Gain on sale of plant	130,000	---
Loss due to flood damage	<u>(420,000)</u>	<u>---</u>
	<u>(220,000)</u>	<u>40,000</u>
Income from continuing operations before income taxes	1,810,000	1,760,000
Less provision for income taxes	<u>(724,000)</u>	<u>(704,000)</u>
Income from continuing operations	<u>1,086,000</u>	<u>1,056,000</u>
Discontinued Operations		
(Loss) from operations of discontinued office equipment division	---	(420,000) ^c
Less applicable income taxes	---	<u>168,000</u>
	---	<u>(252,000)</u>
Gain on sale of office equipment division	110,000 ^b	---
Less applicable income taxes	<u>(44,000)</u>	---
	<u>66,000</u>	---
Net Income	<u>\$1,152,000</u>	<u>\$ 804,000</u>

P5-14 (continued)

Notes to Instructor:

^aThe results from operations of the discontinued office equipment division are shown separately from the results of continuing operations.

^bIn this unofficial solution, the \$640,000 gain on the sale of the discontinued office equipment division is offset against the \$530,000 (\$920,000 - \$800,000 - \$650,000) loss from operations of the division. A more informative disclosure would be to show these two items separately, especially for comparative purposes.

^cSince the results from discontinued operations are shown separately from continuing operations in 2011, for comparative purposes the \$420,000 (\$1,330,000 - \$1,000,000 - \$750,000) operating loss of the office equipment division is shown separately in 2010.

P5-15 (AICPA adapted solution)

1. Deficiencies in the statement of earnings and retained earnings

Purchase discounts. These preferably should be shown as a reduction of purchases in the cost-of-goods-sold computation. Although some accountants treat purchase discounts as financing revenue, most would argue that a company theoretically cannot generate revenue by purchasing goods.

Gain on increased value of investments in real estate. This is an unrealized gain that does not appropriately belong on a corporation's earnings statement.

Gain on sale of treasury stock. This is not part of an earnings statement, but it should be treated as an increase to a paid-in capital account.

Correction of error in last year's statement. This should be treated as a prior period adjustment; it should be added, net of applicable income tax effect, as an adjustment to the beginning retained earnings.

Gain on sale of fixed assets. Two possible deficiencies are identified. First, this type of gain is not an extraordinary item because it does not meet the conditions of being unusual and infrequent; it should be shown among the ordinary items as another revenue. Second, assuming an item is properly classified as an extraordinary item, it should be shown net of the applicable income tax effect as per requirements of intraperiod tax allocation.

Income tax expense. One can logically assume that there were temporary differences during the fiscal year necessitating the use of interperiod tax allocation procedures. Under this condition, the components of income tax expense relating to amounts currently payable and to tax effects of temporary differences should be separately disclosed.

Earnings per share. These amounts must be shown on the face of the earnings statement. They have been omitted from Oberlin's statement. Because there is a simple capital structure in this situation, only a single series of earnings-per-share figures are required.

P5-15 (continued)

2. Deficiencies in the statement of financial position

Accounts receivable, net. The allowance for doubtful accounts should be shown either parenthetically or as a contra-asset account for disclosure.

Inventory. The basis for valuation of the inventory must be disclosed.

Land and building, net. Two deficiencies are identified. First, land and building accounts should be shown separately because land is not depreciable. Second, the accumulated depreciation on the building must be disclosed.

Investments in real estate (current value). These assets are appropriately valued at historical cost with the current value indicated parenthetically or in a note if management so desires.

Goodwill. This should be reviewed for impairment each period for financial accounting purposes.

Discount on bonds payable. This should be a contra-liability account rather than an asset because the discount is a valuation adjustment of the liability.

Stock dividend payable. This should be classified as part of stockholders' equity rather than as a liability because it does not involve a distribution of corporate assets.

Due to Grant, Inc. This is a possible loss contingency but does not meet the conditions of GAAP that requires accrual by a charge to earnings. Therefore, the contingency should be disclosed in a note, or management may appropriate a portion of retained earnings, as it did. Such appropriation, however, should be included in the Stockholders' Equity section and not shown as a liability.

Accrued pension cost. A note should be added describing the plan, listing the components of annual pension cost, reconciling the funded status, and other matters. Apparently such cost is included in the general and administrative expenses on the earnings statement.

Bonds payable (including portion due within one year). The interest rate and maturity date should be disclosed. The portion due within one year should be reclassified as a current liability so that working capital will not be distorted.

Common stock. The number of shares authorized, issued, and outstanding, and the par (or stated) value should be disclosed.

3. General comments

Statement of cash flows. Oberlin Corporation should also prepare a statement of cash flows. A statement of cash flows is required if the corporation issues an earnings statement and a statement of financial position because it discloses certain information not readily attainable from these other statements.

Supporting schedules. Oberlin could prepare schedules showing the composition of cost of goods sold, selling expenses, and general and administrative expenses. The schedules could be attached to the earnings statement for better disclosure.

Accounting policies. A corporation is required to disclose its accounting policies; for example, inventory method. This is usually done in a note to the financial statements.

P5-16 (AICPA adapted solution)

1. Statement of Financial Position

The deferred income tax liability should not be shown on the statement because it arose from a permanent difference, not a temporary difference. The patent should be amortized over the 10 year remaining life, using the straight-line method of amortization. Accounts receivable should be shown at the gross amount and an amount net of the allowance for doubtful accounts. Also, the number of common shares authorized, issued, and outstanding should be disclosed in the stockholders' equity section.

2. Notes

The lease discussed in note 1 is a capital lease because of the bargain purchase option. Therefore, lease expense shown in the earnings statement is incorrect. The present value of the future minimum lease payments (net of executory costs and any profit thereon) should be determined and recorded on the statement of financial position as an asset and as a liability (divided between the current and noncurrent portions). The cost of the leased assets is then matched with earnings as amortization expense over the life of the assets and interest expense should be recognized on the outstanding lease liability over the life of the lease.

The pay-as-you-go or terminal funding methods are not generally accepted methods of accounting for pension cost. Pension cost must be accrued as employees render services using the benefit/years-of-service method.

Even though there is no income tax deferral to be recorded on the statement of financial position because the difference between taxable income and accounting income is a permanent difference, not a temporary difference that would turn around at a later date, note 4 describes an incorrect method of determining the deferral. Had the deferred income tax recognition been required to be used, the liability method is the generally accepted method, based on enacted future tax rates.

The warranty contingency meets the two tests for the accrual of a contingent loss (probable, and amount reasonably estimable) and should be accrued as a liability and an expense shown in the earnings statement.

Preceding the notes to the financial statements, or as the initial note, there should be a description of all significant accounting policies used by the company. Based on the statements as presented, this note should address itself to the following areas: (1) inventory, (2) amortization of patent, (3) basis for valuation of land, (4) pension plan accounting procedures, and (5) capitalized lease information.

P5-16 (continued)

3. Earnings Statement

An analysis of the earnings statement discloses the following violations of generally accepted accounting principles.

Earnings per share as shown is incorrect for several reasons. First, the title "earnings per common share" is incorrect because these are warrants outstanding calling for a dual presentation using the titles "basic earnings per share" and "diluted earnings per share." The amount shown as earnings per share is incorrect for three reasons:

1. The dilutive effect of the warrants outstanding is not considered (that is, not properly accounted for using the treasury stock method).
2. The extraordinary item should be considered in the computation of basic and diluted earnings per share.
3. Basic earnings per share and diluted earnings per share should be stated for earnings before extraordinary items, for extraordinary items, and for net earnings.

Net earnings are incorrect because the patent amortization expense, warranty expense, and the extraordinary gain are omitted. To correct this, the patent amortization expense and warranty expense should be subtracted and the extraordinary gain should be taken out of the statement of retained earnings and added in the earnings statement. In addition, adjustments to net income must be made for changes in expenses related to the lease (e.g., interest, depreciation) and the pension plan.

4. Statement of Retained Earnings

The extraordinary item does not belong in this statement; properly, it should be reflected in the earnings statement. Also, the correction of the deferred tax amount should be reflected in this statement as a correction of an error made in a prior period.

5. General

The statement of cash flows is missing; one should be prepared and included with the other statements and disclosures in order to make this a complete set of financial statements.

TIGER COMPANY
Comparative Statements of Income
For Year Ended December 31

	<u>2011</u>	<u>2010</u>
Sales	\$2,900,000 ^a	\$3,900,000 ^b
Cost of goods sold	<u>(980,000)^c</u>	<u>(2,310,000)^d</u>
Gross profit	\$1,920,000	\$1,590,000
Operating expenses	<u>(1,020,000)^e</u>	<u>(1,390,000)^f</u>
Operating income	\$ 900,000	\$ 200,000
Other items:		
Loss from obsolete inventory	(150,000)	
Miscellaneous	<u>(50,000)^g</u>	<u>(90,000)^h</u>
Pretax income from continuing operations	\$ 700,000	\$ 110,000
Income tax expense (30%)	<u>(210,000)</u>	<u>(33,000)</u>
Income from continuous operations	\$ 490,000	\$ 77,000
Results from discontinued operations		
Income (loss) from operations of discontinued division (net of \$90,000 income tax credit in 2011 and \$90,000 income taxes in 2010)	(210,000) ⁱ	210,000 ⁱ
Loss on write-down of held-for-sale backscratcher division (net of \$48,000 income tax credit)	<u>(112,000)^k</u>	<u> </u>
Income before extraordinary items	\$ 168,000	\$ 287,000
Extraordinary loss (net of \$18,000 income tax credit)		(42,000)
Extraordinary gain (net of \$75,000 income taxes)		<u>175,000</u>
Net income	<u>\$ 168,000</u>	<u>\$ 420,000</u>

^a\$3,500,000 - \$400,000 - \$200,000

^b\$4,600,000 - \$700,000

^c\$1,600,000 - \$320,000 - \$300,000

^d\$2,600,000 - \$290,000

^e\$1,300,000 - \$180,000 - \$100,000

^f\$1,500,000 - \$110,000

^g\$(200,000) + \$150,000 (disclosed in same section but as a separate line item)

^h\$100,000 + \$60,000 (extraordinary loss) - \$250,000 (extraordinary gain)

ⁱ[\$(400,000 + \$200,000) - (\$320,000 + \$300,000) - (\$180,000 + \$100,000)] x 70%

^j(\$700,000 - \$290,000 - \$110,000) x 70%

^k[\$110,000 (\$620,000 - \$510,000) fair value - \$270,000 (\$720,000 - \$450,000) book value] x 70%

1.

JR COMPANY
Statement of Income and Comprehensive Income
For Year Ended December 31, 2010

Sales revenues	\$108,000
Cost of goods sold	<u>(62,000)</u>
Gross profit	\$ 46,000
Operating expenses	<u>(12,000)</u>
Income before taxes	\$ 34,000
Income tax expense	<u>(10,200)</u>
Net income	\$ 23,800
Other comprehensive income	
Unrealized increase in value of available-for-sale securities (net of \$1,500 income taxes)	<u>3,500</u>
Comprehensive Income	<u>\$ 27,300</u>

2.(a)

JR COMPANY
Income Statement
For Year Ended December 31, 2010

Sales revenues	\$108,000
Cost of goods sold	<u>(62,000)</u>
Gross profit	\$ 46,000
Operating expenses	<u>(12,000)</u>
Income before taxes	\$ 34,000
Income tax expense	<u>(10,200)</u>
Net income	<u>\$ 23,800</u>

(b)

JR COMPANY
Statement of Comprehensive Income
For Year Ended December 31, 2010

Net income	\$ 23,800
Other comprehensive income	
Unrealized increase in value of available-for-sale securities (net of \$1,500 income taxes)	<u>3,500</u>
Comprehensive Income	<u>\$ 27,300</u>

3.(a)

JR COMPANY
Income Statement
For Year Ended December 31, 2010

Sales revenues	\$108,000
Cost of goods sold	<u>(62,000)</u>
Gross profit	\$ 46,000
Operating expenses	<u>(12,000)</u>
Income before taxes	\$ 34,000
Income tax expense	<u>(10,200)</u>
Net income	<u>\$ 23,800</u>

JR COMPANY
Statement of Changes in Stockholders' Equity
For Year Ended December 31, 2010

	Comprehensive Income	Common Stock \$5 par	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balances, January 1, 2010		\$35,000	\$49,000	\$63,000	\$ 0	\$147,000
Comprehensive income				23,800		23,800
Net income	\$23,800					
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	<u>\$27,300</u>					
Cash dividends paid		5,000		(6,000)		(6,000)
Common stock issued		<u>\$40,000</u>	<u>9,000</u>		<u>\$3,500</u>	<u>14,000</u>
Balances, December 31, 2010			<u>\$58,000</u>	<u>\$80,800</u>	<u>\$3,500</u>	<u>\$182,300</u>

TOPPS COMPANY
Statement of Cash Flows
For Year Ended December 31, 2010

Net Cash Flow From Operating Activities		
Net income	\$ 47,200	
Adjustments for differences between income flows and cash flows from operating activities:		
Add: Depreciation expense	12,900	
Patent amortization expense	3,500	
Increase in accounts payable	2,700	
Less: Increase in accounts receivable	(4,300)	
Increase in inventories	<u>(15,400)</u>	
Net cash provided by operating activities		\$ 46,600
Cash Flows From Investing Activities		
Payment for purchase of machinery	\$ (39,500)	
Payment for purchase of investments	(21,000)	
Receipt from sale of land	<u>11,000</u>	
Net cash used for investing activities		(49,500)
Cash Flows From Financing Activities		
Payment of dividends	\$ (16,000)	
Receipt from issuance of bonds	17,000	
Receipt from issuance of preferred stock	<u>13,600</u>	
Net cash provided by financing activities		<u>14,600</u>
Net Increase in Cash		\$ 11,700
Cash, January 1, 2010		<u>19,400</u>
Cash, December 31, 2010		<u>\$ 31,100</u>

MUELLER COMPANY
Statement of Cash Flows
For Year Ended December 31, 2010

Net Cash Flow From Operating Activities		
Net income	\$ 68,000	
Adjustments for differences between income flows and cash flows from operating activities:		
Add: Depreciation expense	11,300	
Bond discount amortization	2,700	
Increase in income taxes payable	3,500	
Less: Increase in accounts receivable	(4,400)	
Increase in inventories	(10,300)	
Decrease in accounts payable	<u>(2,900)</u>	
Net cash provided by operating activities		\$ 67,900
Cash Flows From Investing Activities		
Payment for purchase of building	\$ (65,000)	
Payment for purchase of equipment	(8,000)	
Payment for purchase of land	(9,700)	
Receipt from sale of long-term investments	<u>10,600</u>	
Net cash used for investing activities		(72,100)
Cash Flows From Financing Activities		
Payment of dividends	\$ (24,500)	
Receipt from issuance of common stock	12,300	
Receipt from issuance of preferred stock	<u>20,000</u>	
Net cash provided by financing activities		<u>7,800</u>
Net Increase in Cash		\$ 3,600
Cash, January 1, 2010		<u>18,000</u>
Cash, December 31, 2010		<u>\$ 21,600</u>

TRAINER COMPANY
Statement of Cash Flows
For Year Ended December 31, 2010

Cash Flows From Operating Activities		
Cash Inflows:		
Collections from customers	\$ 61,700	
Interest and dividends collected	<u>6,300</u>	
Cash inflows from operating activities		\$ 68,000
Cash Outflows:		
Payments to suppliers and employees	\$ (50,300)	
Payments of interest	(5,000)	
Payments of income taxes	<u>(6,200)</u>	
Cash outflows for operating activities		<u>(61,500)</u>
Net cash provided by operating activities		\$ 6,500
Cash Flows From Investing Activities		
Receipt from sale of land	\$ 3,100	
Payment for purchase of investments	<u>(17,800)</u>	
Net cash used for investing activities		(14,700)
Cash Flows From Financing Activities		
Receipt from issuance of common stock	\$ 11,000	
Payment of dividends	<u>(5,200)</u>	
Net cash provided by financing activities		<u>5,800</u>
Net Decrease in Cash		\$ (2,400)
Cash, January 1, 2010		<u>16,500</u>
Cash, December 31, 2010		<u>\$ 14,100</u>

GIBB COMPANY
Balance Sheet
December 31, 2010

<u>Assets</u>		
Current Assets		
Cash	\$ 3,300 ^a	
Accounts receivable (net)	5,000 ^b	
Inventory	<u>4,200^c</u>	
Total current assets		\$12,500
Property, Plant, and Equipment		
Land	\$ 6,800 ^d	
Buildings and equipment	\$82,800 ^e	
Less: Accumulated depreciation	<u>(16,000)^f</u>	
Total property, plant, and equipment		<u>73,600</u>
Total Assets		<u>\$86,100</u>
<u>Liabilities</u>		
Current Liabilities		
Accounts payable	\$ 3,000 ^g	
Salaries payable	<u>1,500^h</u>	
Total current liabilities		\$ 4,500
Long-Term Liabilities		
Bonds payable	\$ 6,000	
Less: Discount on bonds payable	<u>(300)ⁱ</u>	
Total long-term liabilities		<u>5,700</u>
Total Liabilities		\$10,200
<u>Stockholders' Equity</u>		
Contributed Capital		
Common stock, \$10 par	\$16,500 ^j	
Additional paid-in capital	<u>12,700^k</u>	
Total contributed capital		\$29,200
Retained Earnings		
Total Stockholders' Equity		<u>46,700^l</u>
Total Liabilities and Stockholders' Equity		<u>\$86,100</u>

^aLast item on statement of cash flows

^b\$5,000 = \$3,900 + \$1,100

^c\$4,200 = \$4,700 - \$500

^d\$6,800 = \$9,800 - \$3,000 sold

^e\$82,800 = \$68,900 + \$13,900 purchased

^f\$16,000 = \$14,100 + \$1,900 annual depreciation

^g\$3,000 = \$4,000 - \$1,000

^h\$1,500 = \$1,100 + \$400

ⁱ\$300 = \$6,000 face value - \$5,700 issue price

^j\$16,500 = \$13,500 + (300 shares x \$10 par)

^k\$12,700 = \$11,200 + (\$4,500 - \$3,000 par value)

^l\$46,700 = \$44,400 + \$5,400 net income - \$3,100 dividends

ANSWERS TO CASES

C5-1

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 and be reliably measured in monetary terms. Revenues are generally 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 the most 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 have interchangeable units and can be sold at quoted prices on an active market. In regard to 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 in order 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. Revenue might be recognized prior to the sale or after the sale in special cases to more accurately 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 when: (1) the economic substance of the event should take precedence over the legal form of the transaction so as not to distort reality, (2) there is great uncertainty about the collectibility of the receivable involved in the sale, and (3) the risks and benefits of ownership are not transferred at the time of sale. The alternative revenue recognition methods include: (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.

C5-2

The three principles for recognizing the expenses to be matched against revenues are:

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

C5-2 (continued)

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 expensed each period. The allocation system should be based upon 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, or (2) the allocation of costs among accounting periods or due to cause and effect relationships is not useful. Examples of costs which are immediately recognized as expenses in the current period include items such as management's salaries and most selling and administrative costs.

C5-3 (AICPA adapted solution)

1. a. Cost is the amount measured by the current monetary value of economic resources given up or to be given up in obtaining goods and services. Economic resources may be given up by transferring cash or other property, issuing capital stock, performing services, or incurring liabilities.

Costs are classified as unexpired or expired. Unexpired costs are assets and apply to the production of future revenues. Examples of unexpired costs are inventories, prepaid expenses, plant and equipment, and investments. Expired costs, which most costs become eventually, are those that are not applicable to the production of future revenues and are deducted from current revenues or charged against retained earnings.
 - b. Expense in its broadest sense includes all expired costs; that is, costs that do not have any potential future economic benefit. A more precise definition limits the use of the term expense to the expired costs arising from using or consuming goods and services in the process of obtaining revenues; for example, cost of goods sold and selling and administrative expenses.
 - c. A loss is an unplanned cost expiration and for this reason is often included in the broad definition of expenses. A more precise definition restricts the use of the term loss to cost expirations that do not benefit the revenue-producing activities of the firm. Examples include the unrecovered book value on the sale of fixed assets and the write-off of goodwill due to unusual events within an accounting period.

The term loss is used also to refer to the amount by which expenses and extraordinary items exceed revenues during an accounting period.
2. a. Cost of goods sold is an expired cost and may be referred to as an expense in the broad sense of the term. On the income statement it is most often identified as a cost. Inventory held for sale that is destroyed by an abnormal casualty should be classified as a loss.

C5-3 (continued)

2. (continued)

- b. Bad debts expense is usually classified as an expense. However, some authorities believe that it is more desirable to classify bad debts as a direct reduction of sales revenue (an offset to revenue). A material bad debt that was not provided for in the annual adjustment, such as bankruptcy of a major debtor, may be classified as a loss.
 - c. Depreciation expense for plant machinery is a component of factory overhead and represents the reclassification of a portion of the machinery cost to product cost (inventory). When the product is sold, the depreciation becomes a part of the cost of goods sold, which is an expense. Depreciation of plant machinery during an unplanned and unproductive period of idleness, such as during a strike, should be classified as a loss. The term expense preferably should be avoided when making reference to production costs.
 - d. Spoiled goods resulting from normal manufacturing processing should be treated as a cost of the product manufactured. When the product is sold the cost becomes an expense. Spoiled goods resulting from an abnormal occurrence should be classified as a loss.
3. Period costs and product costs are usually differentiated under one of two major concepts. One concept identifies a cost as a period or a product cost according to whether the cost expires primarily with the passage of time or directly for the production of revenue. The other concept identifies a cost as a product or a period cost according to whether or not the cost is included in inventory.

Under the first concept, period costs are all costs that expire within the accounting period and are only indirectly related to the production of revenue within the period and product costs are those costs associated with the manufacture of a firm's product and that generate revenue in the period of its sale. Some costs are easily associated with the production of revenue, such as the manufacturing or purchase cost of a product sold, and are designated as product costs. Other costs may be incurred as costs of doing business and are more difficult to relate to the production of revenue, such as general and administrative costs, and are classified as period costs. Costs that cannot be readily identified with the production of revenue in any particular period, such as the company president's salary, which may produce revenue in many distant future accounting periods, are also classified as period costs because they cannot be specifically identified with any future accounting period.

Under the second concept, product costs include only the costs that are carried forward to future accounting periods in inventory and all expired costs are period costs.

C5-4

The elements included in a company's results of discontinued operations section of its income statement are (1) the operating income (or loss) from a discontinued component and (2) the gain (or loss) on the sale of the discontinued component.

A "component" of a company involves operations and cash flows that can be clearly distinguished, physically and operationally and for financial reporting purposes, from the rest of the company.

When the company has operated the component for part of a year before the component is sold, the company reports the operating income (or operating loss) from the discontinued component for the period up to the date of sale separately from the income from continuing operations of the rest of the company. To calculate the operating income (or loss) of the discontinued component for the period of time up to the date of sale, the revenues and expenses from operating the discontinued component are segregated from those related to continuing operations. The expenses (including income taxes) of the discontinued component are then subtracted from the related revenues to determine the operating income or loss.

When the company sells a component in the same accounting period that its management initially decided to sell the component, the calculation of the gain (loss) is as follows. The company determines the pretax gain (loss) by subtracting the aggregate book value of the net assets (assets minus liabilities) of the component from the net proceeds received [selling price minus any selling costs (e.g., broker commissions, legal fees, closing costs)]. This is similar to the accounting treatment for the sale of a single asset. The company then deducts the related income taxes from the pretax gain or loss to determine the after-tax gain or loss, which it reports in the results from discontinued operations section.

C5-5

1. The two criteria identified by GAAP that must be met in order for an event or transaction to be classified as an extraordinary item are:
 - 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. The environment in which a company operates is a primary consideration with regard to the unusual nature criterion. The environment includes such factors as the characteristics of the industry in which the company operates, its geographical location, and the nature and extent of government regulation. An event that is unusual in nature for one company may not be unusual for another because of differences in their respective environments.
 - b. Infrequency of occurrence. The underlying event or transaction is of a type that is not reasonably expected to recur in the foreseeable future. The determination of whether an event is infrequent in occurrence should take into consideration the operating environment of the company.
2.
 - a. An earthquake is likely to be extraordinary for a company in Missouri but may not be for one in southern California.
 - b. A flood is likely to be extraordinary for a company in southern Nevada but may not be for one in southern Louisiana.

C5-5 (continued)

2. (continued)

- c. A tornado is likely to be extraordinary for a company in western Oregon but may not be for one in Arkansas.
- d. A severe frost is likely to be extraordinary for a company in southern Arizona but may not be for one in Florida.

In each of the preceding examples, the environment in which the company operates is the primary determination of whether the two criteria (unusual in nature and infrequent in occurrence) are met. Geographical locations are used as illustrations of how the operating environment can affect whether or not an item is extraordinary. Other examples could be equally appropriate.

- 3.
 - a. An extraordinary item is reported separately (net of tax effect) immediately below the section summarizing the results from discontinued operations. Individual extraordinary items should be described and reported when practical; otherwise, disclosure in the notes to the financial statements is also acceptable.
 - b. If only one of the two criteria of extraordinary items is met, a gain or loss is reported as a separate component of income from continuing operations, preferably in the Other Items section. The gain or loss is not be shown net of tax.

C5-6 (AICPA adapted solution)

- 1. Morgan should report the effects of the hailstorm as an extraordinary item in its income statement because it meets both of the criteria for classification as an extraordinary item. It is unusual in nature and infrequent in occurrence, taking into account the environment in which the company operates.
- 2. The classification in the income statement of an extraordinary item differs from that of an operating item in the following ways. First, an extraordinary item is shown as a separate item in the income statement below the continuing operations section of the income statement. Second, an extraordinary item is shown net of applicable income taxes. An extraordinary item is unrelated to Morgan's normal and ongoing operations.

C5-7 (AICPA adapted solution)

- 1. Lynn should report the results of discontinued operations separately from continuing operations. Discontinued operations should be shown on Lynn's income statement immediately below the continuing operations section.

Discontinued operations reported in the income statement should be composed of two separate elements, with each element shown net of income taxes.

- a. Loss from operations of the discontinued component from the beginning of the year to the date of sale.
 - b. Loss on sale of the discontinued component.
- 2. Both of the following criteria must be met for classification as an extraordinary item. An extraordinary item must be unusual in nature and infrequent in occurrence, taking into account the environment in which the company operates.

C5-7 (continued)

3. First, the extraordinary loss should be shown as a separate item in the income statement below discontinued operations. Second, the extraordinary loss should be shown net of applicable income taxes.

C5-8

A statement of cash flows is a statement that reports 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. The statement of cash flows provides information to external users 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).

The statement of cash flows of a company includes three sections: (1) net cash flow from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities. The Net Cash Flow From Operating Activities section reports on the cash flows from the operating activities of the company. Under the indirect method, generally this involves adjusting net income: (1) to eliminate certain amounts that were included in net income but did not involve an operating cash inflow or outflow, and (2) to include any changes in the current assets and current liabilities involved in the company's operating cycle that affected cash flows differently than net income. The Cash Flows From Investing Activities section includes all the cash inflows and cash outflows involved in the investing activities transactions of the company. 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. 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 determine the ending cash balance.

C5-9

HILL CORPORATION
Income Statement (Lifetime)
January 1, 1998 to December 31, 2010

Net Assets at Liquidation		
Assets' selling price		\$600,000
Less: Liabilities paid off		<u>(50,000)</u>
Total net asset liquidation value		\$550,000
Total Investments		
Year 1998, \$20 x 8,000	\$160,000	
Year 2001, \$25 x 1,600	<u>40,000</u>	
Total investments		<u>(200,000)</u>
Net lifetime increase in stockholders' equity		\$350,000
Add: Lifetime cash dividends paid		<u>100,000</u>
Lifetime net income		<u>\$450,000</u>

C5-9 (continued)

The additional information in which you might be interested includes:

1. The history of the activities in which the corporation was involved.
2. The revenues, expenses, net income, and asset data about each significant operating segment in which this corporation operated.
3. The cash and working capital flows (changes in current assets, current liabilities, working capital, current ratio, etc.) through the lifetime of this corporation.
4. In relation to items 2 and 3, the financing and investing activities (and sources and uses of cash) during the corporation's lifetime.
5. The debt ratio of the corporation throughout its lifetime to determine its overall capital structure.
6. Information about the earthquake: the cause, amount of losses, related insurance policies, and likelihood of recurrence.
7. The book value of the liquidated assets to determine whether the assets were sold at a gain or a loss and what impact liquidation had on total net income.
8. Accounting policies of this corporation as compared with other, similar corporations.

C5-10 (AICPA adapted solution)

1. Accrual accounting recognizes and reports the effects of transactions and other events on the assets and liabilities of a company in the time periods to which they relate rather than only when cash is received or paid. Accrual accounting attempts to match revenues and the expenses associated with those revenues in order to determine the company's net income for an accounting period. Revenues are recognized and recorded when earned. Expenses are recognized and recorded as follows:
 - (a) Associating Cause and Effect. Some expenses are recognized and recorded on a presumed direct association with specific revenue.
 - (b) Systematic and Rational Allocation. In the absence of a direct association with specific revenue, some expenses are recognized and recorded by attempting to allocate expenses in a systematic and rational manner among the periods in which benefits are provided.
 - (c) Immediate Recognition. Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits, or (3) allocating costs either on the basis of association with revenues or among several accounting periods is not useful.

C5-10 (continued)

An accrual represents a transaction that affects the determination of a company's income for the period but has not yet been reflected in its cash accounts of that period. Accrued revenue is revenue earned but not yet collected in cash. An example of accrued revenue is accrued interest revenue earned on bonds from the last interest payment date to the end of the accounting period. An accrued expense is an expense incurred but not yet paid in cash. An example of an accrued expense is salaries incurred for the last week of the accounting period that are not payable until the subsequent accounting period.

A deferral represents a transaction that has been reflected in the cash accounts of the company for the period but has not yet affected the determination of its income for that period. Deferred (prepaid) revenue is revenue collected or collectible in cash but not yet earned. An example of deferred (prepaid) revenue is rent collected in advance by a lessor in the last month of the accounting period, which represents the rent for the first month of the subsequent accounting period. A deferred (prepaid) expense is an expense paid or payable in cash but not yet incurred. An example of a deferred (prepaid) expense is an insurance premium paid in advance in the current accounting period, which represents insurance coverage for the subsequent accounting period.

2. In cash accounting, the effects of transactions and other events on the assets and liabilities of a company are recognized and reported only when cash is received or paid; while in accrual accounting, these effects are recognized and reported in the time periods to which they relate. Because cash accounting does not attempt to match revenues and the expenses associated with those revenues, cash accounting is not in conformity with generally accepted accounting principles.

C5-11

Note to Instructor: This case does not have a definitive answer. From a financial reporting perspective, GAAP is identified and summarized. From an ethical perspective, various issues are raised for discussion purposes.

From a financial reporting perspective, when a company sells a component, it reports the results of discontinued operations of the component in the year of the sale. In this situation, the company includes on its income statement a results from discontinued operations section which includes two elements (both shown net of taxes): (1) the income (loss) from operating the discontinued component during the year up to the date of sale, and (2) the gain (loss) on the sale of the component.

C5-11 (continued)

However, if the company has committed to a plan to sell a component and the sale has not occurred by the end of the year, then the component is to be classified as held for sale if several criteria are met. These criteria include: (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 component is classified as held for sale, the company records and reports the component at the lower of its aggregate net book value or its fair value (less any costs to sell). In this situation, the company also includes on its income statement a results from discontinued operations section which includes two elements (both shown net of taxes): (1) the income (loss) from operating the held-for-sale component for the year, and (2) the gain (loss) from the write-down of the held-for-sale component.

From an ethical perspective, the issue is when to report the results from discontinued operations on Newell Company's income statement. The timing of the reporting will have an impact on the rights of, and fairness to, the stakeholders. The primary stakeholders include the president and the accountant of Newell Company, as well as its creditors and stockholders. If the criteria for identifying a held-for-sale component are met in 2010 and the results from discontinued operations are not reported until 2011, the Newell Company's 2010 income from continuing operations and net income will be overstated. External users may look favorably on the president's management ability and the president may look favorably upon the accountant's ability. However, creditors and stockholders may be misled into being overly optimistic about the company's return on investment, risk, operating capability, and financial flexibility. On the other hand, if the criteria for identifying a held-for-sale component are not met in 2010 but the component is treated as though it was held for sale, then the results from discontinued operations section would be included on Newell Company's 2010 income statement. Then, Newell Company's income from continuing operations would be understated, a loss on the write-down of the held-for-sale component would be included in the results from discontinued operations, and its net income would be understated. This may cause the opposite effects (from those discussed above) on the different stakeholders.

What is critical in this situation is to fairly determine whether each of the criteria for classifying a significant component as held for sale is met. It appears that criteria (1), (4), and (5) are met. However, from the information presented, it is unclear whether (2) the component is available for immediate sale (since some legal work still has to be completed), whether (3) there is an active program to locate a buyer, and whether (6) it is unlikely that management will make significant changes to the plan. If the answer is yes for each of these latter criteria, then the results from discontinued operations section should be included in Newell Company's 2010 income statement; otherwise, it should be included in the company's 2011 income statement.

ANSWERS TO RESEARCH SIMULATIONS

R5-1

Note to Instructor: Students are expected to cite references to GAAP in their research of this issue. They might use the FARS electronic database, pronouncements listed on the FASB web site, the FASB Original Pronouncements, the FASB Current text, or other primary sources of GAAP to obtain these references. They may also use the FASB Accounting Standards Codification which is cited in parentheses.

To: President, Klote Company

From: Student

I have researched the issue of how to report the \$40,000 loss from the write-off of a major customer's accounts receivable due to its bankruptcy on the Klote Company's 2010 income statement. According to APB 30, par 23 (FASB Cod. #225-20-45-4), losses from receivables, regardless of size, do not constitute extraordinary losses. The fact that a loss arises from a receivable from a company in bankruptcy proceedings does not alter this conclusion in any way. APB30, par. 26 (FASB Cod. #225-20-45-16) states that a material event that is unusual or infrequent, but not both, should be reported as a separate component of income from continuing operations.

Based on these findings, I recommend that the \$40,000 loss be separately reported in the "other items" section of the company's income from continuing operations as follows:

Other items

Loss from write-off of major customer's receivable due to bankruptcy	\$40,000
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R5-2

Note to Instructor: Students are expected to cite references to GAAP in their research of this issue. They might use the FARS electronic database, pronouncements listed on the FASB web site, the FASB Original Pronouncements, the FASB Current text, or other primary sources of GAAP to obtain these references. They may also use the FASB Accounting Standards Codification which is cited in parentheses.

To: President, Kelly Company

From: Student

I have researched the issue of how to report the purchase of a \$100,000 building by making a \$20,000 down payment and signing an \$80,000 mortgage on the Kelly Company's 2010 statement of cash flows. According to FAS 95, par. 32, (FASB Cod. #230-10-50-3) information about all investing and financing transactions that affect assets or liabilities but do not result in cash receipts or payments during the period must be reported in related disclosures to the statement of cash flows, either in a narrative or summarized in a schedule. Some transactions are part cash and part non-cash. Only the cash portion is reported in the statement of cash flows, but the disclosures must relate the cash and noncash aspects.

R5-2 (continued)

Based on these findings, I recommend that the \$20,000 be reported on the company's statement of cash flows for 2010 as follows:

Cash Flows From Investing Activities

Payment for purchase of building	\$(20,000)
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The \$80,000 non-cash portion should be reported in a narrative or in a schedule. For instance, the narrative or schedule might indicate that the company invested \$80,000 in the \$100,000 building by financing the transaction through the issuance of an \$80,000 mortgage.